Factors influencing the profitability of domestic and foreign commercial banks in the European Union

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Abstract

Using bank level data this paper examines how bank’s specific characteristics and the overall banking environment affect the profitability of commercial domestic and foreign banks operating in the 15 EU countries over the period 1995–2001. The results indicate that profitability of both domestic and foreign banks is affected not only by bank’s specific characteristics but also by financial market structure and macroeconomic conditions. All the variables, with the exception of concentration in the case of domestic banks profits, are significant although their impact and relation with profits is not always the same for domestic and foreign banks.

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1. Introduction

Over the last years a number of factors have contributed to the growing competition in the European Union (EU) banking sector. One of the most important factors is deregulation, promoted by the Second European Directive on Banking and Financial services, concerning establishment, operation and supervision of credit institutions. This Directive sets out the principles of banking in

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the Single European financial market and provides equal competitive conditions for all European banking institutions. As a result banks now compete in previously inaccessible domestic and foreign markets. Furthermore, a number of recent technological advances offered more opportunities for economies of scale and scope while the adoption of euro accelerated the changes in the industry. For instance, income generation from foreign exchange transactions has been lost while the pricing of banking products and services has become more transparent, enhancing competition. Furthermore, the macroeconomic policies that were followed in most countries gradually reduced inflation and interest rates. Finally, in more and more European countries non-financial firms were allowed to offer traditional banking services, leading to further increase in competition. Therefore, banks were forced to generate new products and seek new customers. This is reflected in the continued diversification across geographical areas and business lines. Many banks have been forced to increase in size in order to compete in the enlarged European market and the banking industry experienced an unprecedented level of consolidation through mergers and acquisitions.

It is reasonable to assume that all these changes posed great challenges to banks in the EU as the environment in which they operated changed rapidly, a fact that consequently had an impact on their performance. As Golin (2001) points out adequate earnings are required in order for banks to maintain solvency, to survive, grow and prosper in a suitable environment. Given the relation between the well-being of the banking sector and the growth of the economy (Rajan and Zingales, 1998; Levine, 1997, 1998), knowledge of the underlying factors that influence banks’ profitability is essential not only for the managers of the banks but for numerous stakeholders such as the Central Banks, Bankers Associations, Governments, and other Financial Authorities. Knowledge of these factors would also be of particular interest to the new EU countries whose economies and banking systems are experiencing fundamental changes during this period.

The aim of this paper is to extend earlier work on the determinants of profitability of banks in the EU and examine to what extent the performance of commercial banks operating in EU markets is influenced by internal factors (i.e. banks’ specific characteristics) and to what extent by external factors (i.e. macroeconomic and financial market structure) in view of the ongoing process of integration and concentration. Although a growing literature uses efficient frontier approaches to examine the profit and cost efficiency of EU banks (e.g., Altunbas et al., 2001; Schure et al., 2004), to our best knowledge, there are only few studies that focus on the determinants of profitability while focusing on the EU as a total1 (e.g., Molyneux and Thorton, 1992; Staikouras and Wood, 2003).

Molyneux and Thorton (1992) were the first that examined the determinants of banks profitability operating in 18 European countries over the period 1986–1989. Most recently the European banking sector was examined by Staikouras and Wood (2003) that considered banks from 13 EU countries over the period 1994–1998. The present study attempts to provide additional and more recent evidence on the determinants of banks profitability in the EU. In order to accomplish this task, our paper differs from the earlier mentioned studies in several aspects. First of all, we include more recent years in the analysis by examining the period 1995–2001. Furthermore, we examine

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1 Short (1979) and Bourke (1989) considered European countries, however, only as part of larger studies that included and other countries such as Japan and Canada and America and Australia, respectively. Therefore, the authors have not focused on European countries. Furthermore at the time that these studies were conducted the structure of Europe and its banking sector were significantly different than nowadays. In a more recent study, Abreu and Mendes (2001) considered EU countries but examined only Portugal, Spain, France and Germany over the period 1986–1999. Goddard et al. (2004) also focus only on six major European banking sectors (i.e. Denmark, France, Germany, Italy, Spain, UK) for the period 1992–1998.
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<table>
<thead>
<tr>
<th>امکان دانلود نسخه تمام متن مقالات انگلیسی</th>
</tr>
</thead>
<tbody>
<tr>
<td>امکان دانلود نسخه ترجمه شده مقالات</td>
</tr>
<tr>
<td>پذیرش سفارش ترجمه تخصصی</td>
</tr>
<tr>
<td>امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله</td>
</tr>
<tr>
<td>امکان دانلود رایگان ۲ صفحه اول هر مقاله</td>
</tr>
<tr>
<td>امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب</td>
</tr>
<tr>
<td>دانلود فوری مقاله پس از پرداخت آنلاین</td>
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<tr>
<td>پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات</td>
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