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# An examination of cost structure and production performance of commercial banks in Singapore

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## Abstract

This paper uses a parametric approach in the framework of a translog cost function and a non-parametric approach in the framework of linear programming to examine production performance and cost structure of a sample of Singaporean commercial banks. The results of the parametric methodology suggest that the average cost curve of these banks is U shaped and there are economies of scale for small and medium-size banks. Further analysis provides evidence of economies of scope for all banks regardless of their size. The non-parametric results indicate that the Singaporean banks could have reduced cost by 43% had they all been overall efficient. The sources of this cost inefficiency seem to be caused equally by allocative and technical inefficiencies. © 2002 Elsevier Science B.V. All rights reserved.

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## **1. Introduction**

Due to the global trend toward deregulating financial services, the increasing use of advanced technology, and a revolution in the dissemination of financial information, banking firms are under competitive pressure domestically and internationally. In response to this competitive pressure, banking firms are actively looking for alternative ways to reduce their production costs by enhancing production efficiency, and to exploit scale and scope economies. Consequently, in the last few years, a large number of research papers have examined the cost structure, efficiency and production economies of the banking industry. While most of these studies have examined the cost structure and performance of the banking industry in the US and other developed countries, little attention has been focused on banks located in the Pacific-Basin and other emerging markets.

The implications of the results from studies of the US and other developed economies, however, cannot directly be extended to the banking firms of the Pacific-Basin economies. This is because the banking industry is highly regulated and the regulatory environment that affects the cost structure and performance of banks is not uniform across nations. The examination of the cost structure and performance of banks operating in emerging economies is as important as that of developed countries for the following reasons. First, bond and other debt markets in a number of emerging economies are not well developed and efficient; hence, the role of the banking system in the process of intermediation of funds is essential. Second, commercial banks have been exposed to global competition by the recent waves of deregulatory and anti-protectionism policies imposed on the banking industry as well as the internationalization of financial markets. In order to make appropriate adjustments in managerial policies such that the banking firms become well equipped to face challenges brought about by this new competitive environment, the examination of production and cost efficiency of these banks is worthwhile. The results of the cost study may, then, provide managers and policy makers with valuable information that can be utilized to establish optimal managerial strategies and public policies. Third, few countries in the Pacific-Basin region have been able to become regional financial centers. The findings of the study of the cost structure and performance of banking firms may assist policy makers, regulatory agencies and management of these centers to effectively evaluate their competitive viability.

The present paper attempts to provide empirical evidence on the cost structure and production performance of a sample of commercial banks operating in Singapore. First, we use a translog cost function to estimate overall and product-specific economies of scale and scope to examine banks' cost

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