PERFORMANCE OF EUROPEAN BANKS: CRISIS, CORPORATE GOVERNANCE AND CONVERGENCE

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Abstract

Financial performance as a phenomenon in the European banking sector is an issue of a wide debate. The paper is seeking to detect the variables that have an impact on performance. Ratios and stratification variables are used in panel data regressions and the time period of the study is from 2004 to 2013.

The results show that performance (ROAA) is dependent on four categories of ratios (Asset quality, Capital ratios/risk and solvency ratios, Operations ratios, Liquidity ratios). Corporate governance system and the geographic location (political and macroeconomic factors) of the bank seem to effect significantly the factors that have an impact on performance.

Keywords: Performance, Europe, Banks, Corporate Governance

1. INTRODUCTION

The European banking sector has been through a major change through the last twenty years. Merger waves (Lazarides, Drimpetas & Kyriazopoulos, 2015; Lazarides, 2015), sovereign debt crises (Drimpetas & Lazarides, 2015), restructuring and strategy changes, legal-auditing-accounting reforms, are some of the changes that took place. The paper seeks to find what happened during the last decade (2004-2013).

Their external environment is changing rapidly and the necessity for changes in their internal environment is great. The threats that the European banks are facing are real and they have to respond accordingly to survive. The new global economy, after the turbulent decades of '90 and 2000, is heavily based on banks and banks have base their survival on factors like performance, capital adequacy, corporate governance, growth, cost effectiveness, credit ratings, ownership – ability to attract and maintain a steady shareholder basis and macroeconomic factors.

Performance is the indicator of attractiveness and enhanced survival probabilities. The importance of this factor is measured by the large body of literature covering this topic. Performance is linked, among others, with market structure (Lloyd-Williams et al., 1994; Goldberg and Rai, 1996; Mehra, 1996), the size of banks (Boyd and Runkle, 1993), the

dynamics of globalization (Berger et al., 2000), the corporate and social performance (Simpson and Kohers, 2002), regulation and ownership (Barth, Caprio and Levine, 2001; Brissimis, Delis and Papanikolaou, 2008; Saunders, 2014), corporate social responsibility (Wu and Shen, 2013), financial crisis (Molyneux, 2016). The paper addresses the issue of performance using panel data regressions.

2. THE BANKING SYSTEM OF EUROPE

The market structure of the European banking system has changed significantly. The banking system is not homogeneous. There are differences in size (see for example Spain's banking system), type, goals and governance systems. These differences create a complex banking system that it becomes even more complex when other factors – differences are considered (political, economic status and growth, capital market maturity, etc.). Some of the events or changes or reforms that shaped the current system have major impact on performance.

Furthermore, a Mergers and Acquisitions (M&A) wave struck the sector during the last years of the '90s and during the early years of '00s. The causes of the M&A wave may be many and their effect on performance significant. Since then the number of M&As been relatively stable. The crises of 2002 doesn't seem to have any effect on the trend and the

number of inactive banks per year is lowering until 2006 (Lazarides, 2015). Small increase is observed during the crisis of 2008, but the number is stabilized the years that follow 2009. The main reasons for the major wave of 1998 – 2004 can be attributed to the adoption of Euro as a common currency by many the European countries.

The relation between performance and sector concentration is not clear. Focarelli, Panetta and Salleo (2002) show a long-run increase in profitability for acquired banks. On the contrary Goldberg and Rai (1996) do not find a significant relationship between concentration and profitability.

The M&A wave affects, also, the performance of the banks by mitigating the competition at the country level, transferring the field of competition to a European and global level. At this level the access to credit, leveraging and the credit ratings are even more crucial factors for performance.

The European Union has enforced – encouraged and promoted several initiatives that affected the banking sector. The main goal of all the initiatives was to make a market with common legal – regulatory framework and to enforce a convergence trend. Some of the events have helped the convergence trend and others have diverted the markets creating a more fragmented European banking system.

The adoption of Euro, common regulation and accounting standards and the concurrent M&A wave (1998-2004) seem to be the main factors that affected the banking system during this period: facilitated the cross-border provision of financial services and cross-border penetration (Schoenmaker & Peek, 2014), internationalization of banks and concentration.

The sovereign debt crisis that followed has contributed to the instability of banks. European banks' portfolio was based heavily on government bonds. Moro (2016) argues that there is a strong interdependence between sovereign credit and banking systems. The convergence trend was reversed after the 2008 banking crisis and the sovereign debt crisis. Oddly, these reverses were regulatory driven as well. This is a fact for the periphery and the banks that are located at countries under distress (Greece, Portugal, Ireland, Spain, Italy) but not for the core of the European banking system (Schoenmaker and Peek, 2014).

The European banks seem more fragile now than before. "Pressure from structural regulatory reforms, also Basel 3, and the related EUs Capital Requirements Directive (IV) is forcing banks to restrict their business, & boost their regulatory capital & liquidity" (Molyneux, 2016). The deleveraging of European banks & the regulatory pressures will have a significant impact on performance. Saunders (2014) estimates that bank ROE's is expected to be reduced at the level of 8-10%.

So, the basic drivers for performance might be the pressure to boost their regulatory capital (Oino, 2017; Barth, et al., 2016; Berger and Bouwman, 2013; Demirguc-Kunt, Detragiache & Merrouche, 2013) and liquidity (negative relation), the general political and economic situation and environment (Psillaki & Mamatzakis, 2017) (positive relation), the corporate governance system (Fernandes, et al., 2017; Berger, Imbierowicz & Rauch, 2016) (positive relation), the

concentration of the sector (Weiß, Neumann and Bostandzic, 2014; Altunbaş and Marqués, 2008; Bonin, Hasan, and Wachtel, 2005) (positive relation), the restructuring of their portfolio (Pennathur & Vishwasrao, 2014) (negative relation), their need for liquidity (Berger et al., 2016; Dietrich, Hess & Wanzenried, 2014) (negative relation) and their internal restructuring to improve cost efficiency (Pasiouras, Tanna & Zopounidis, 2009; Ismail, Davidson & Frank, 2009) (positive relations). All these factors-relations must be confirmed empirically.

3. METHODOLOGY AND DATA

The data were collected from Bankscope. A transformation of data was necessary to implement panel data regressions. The data cover a period from 2004 to 2013. The period covers a significant array of events that were described in the previous sections of the paper and is focused on the twenty-seven (27) European Union countries. The initial sample was 8.115 individual banks. The final sample is comprised from 2.721 to 3.081 commercial and cooperative banks (dependent on the availability of data for every ratio) individual cases. The data collected were mainly financial ratios. The use of stratifying variables aims at finding the spatial and cross-sectional differences among the fragmented banking systems of Europe (North-South, Corporate governance system, pre-and post 2008-2009 crisis period). The dependent variable is the ROAA (Return on Average Assets). Alternatively, many indicators – ratios of performance were used (i.e. ROE, Tobins'Q, Interest Income on Loans, Operating profit, Recurring Earning Power) but ROAA had the best fit. The independent variables used were ratios (for comparability reasons) and can be categorized into four groups of indicators: asset quality, capital adequacy or capital structure, operations and liquidity. The main variables used for the construction of the models are listed in Table 2.

Fixed and random effects models were used. For each group of independent variables, only variables that didn't correlate significantly were used in the model to avoid any statistical problems. The generic form of the models is:

$$ROAA = constant + \beta 1n \ x \ asset \ quality \ ratios + \beta 2n \ x \ capital \ adequacy \ or \ capital \ structure \ ratios + \beta 3n \ x \ operations \ ratios + \beta 4n \ x \ liquidity + ui$$

4. RESULTS - DISCUSSION

4.1. Hypothesis

One of basic hypothesis of the paper is that performance is not a homogenized phenomenon in the European Banking sector. Graphs 1 and 2 show that if you stratify banks using their corporate governance system (continental Europe (CON), Anglo-Saxon (AS)) or their geographical position (South (France, Italy, Greece, Spain, Portugal, Malta, Cyprus), North) performance is quite different, both at the level and the trend, throughout the study period. Also, there is a difference in performance variance before the crisis of 2008-2009 and after. These differences have prompted the issue of studying the performance using these stratifying variables.
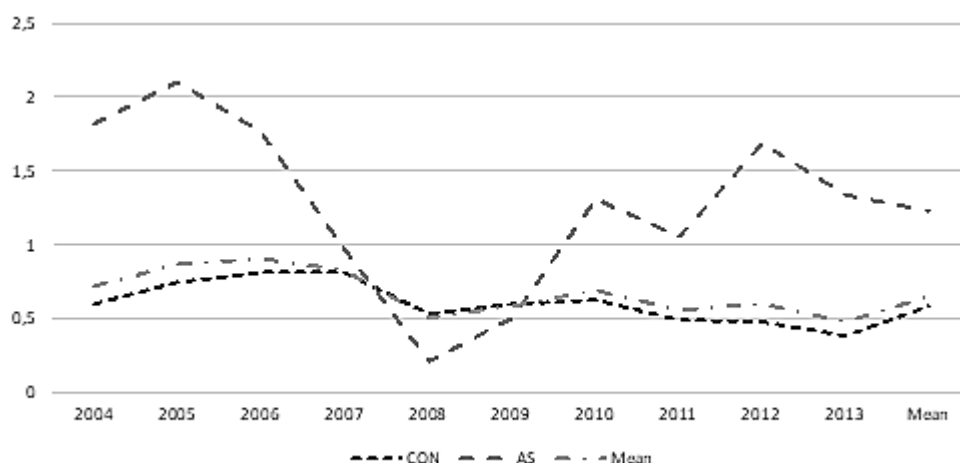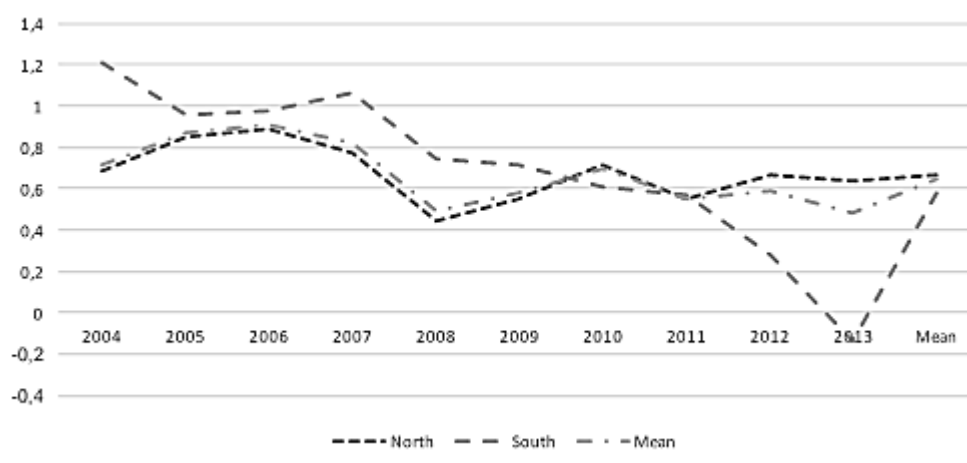
Figure 1. ROAA (Corporate Governance System)

Figure 2. ROAA (North – South division)

4.2. Econometric model results

The results presented in Table 1 show that in all models (using different stratification variables) the fixed effects model is assumed (both Hausman and Breusch and Pagan Lagrangian multiplier indicate that Fixed Effects models are appropriate). This means that the constant is not fixed in each stratum, all other coefficients are fixed and variables vary through time.

The models have good fitness and f tests show that all coefficients in the models are different than zero. Rho statistic show that for the first model (time) that 19,94 % of the variance is due to difference across panels (interclass correlation). That means that there is a small fraction of the variance that is due to time. This hypothesis will be tested using the pre-post crisis stratifying variable.

Using the stratifying variables of corporate governance (CGSys) to establish if the corporate governance system (continental Europe or Anglo-Saxon system) areas of the political, legal, organizational and economic environment of the banks are taken onto account. Factors like the legal-regulatory framework, the type of financial institutions, the interlinkage of financial institutions, and the economic and industrial context are some of the factors that corporate governance systems are comprised off. To control any differences in the European banking industry, geographical and legal origin groups of countries have been created (North-South).

The models show that the Anglo-Saxon system presents greater variance (51,97 %) through time as opposed to continental Europe that the corresponding rho statistic is 23,84 %. The same picture can be seen when using the group variable (North – South). Northern banks show greater variance through time (23,415%), than southern (12,152%). The pre-crisis period's variance through time was 37, 73% that is nearly the same with the one (38, 24%) after the crisis of 2008-2009.

4.3. Discussion

Beyond the interesting findings of the previous section, there are some interesting findings looking at the variables and their calculated signs. One thing that is missing from the statistically significant variables is two capital adequacy variables - ratios (Tier 1 and Total Capital Ratio) that measure the core capital regulators oblige banks to have. This indicates that these capital requirements are

considered sine qua non for European banks. This finding is contrary to the findings of other studies (Oino, 2017; Barth, et al., 2016; Berger and Bouwman, 2013; Demirguc-Kunt, Detragiache and Merrouche, 2013). Especially after the Basel I, II and III initiatives, their adoption by the European authorities and the two major banking crises (2002, 2008), these requirements have been the stepping stone for any operation and strategy for banks across Europe.

The other variables that do appear to be statistically significant represent all other four categories of ratios (see Table 2). The sign of the variables was as expected in the theory and no differences were present. The most significant results come from the specific ratios – variables and their mix that were found to be statistically significant.

Asset quality ratios like Net Charge Offs to Average Loans (NCOAGL), Net charge-off over net income before loan loss provision ratio (NCONIB) and Impaired Loans/Equity (ILE) present different dimensions of the approach of each to bank in handling non-performing loans and bad debt. The results show that for all banks is very important to minimize the percentage of bad debt that a company has outstanding over a specific period and that the effort to clear any bad debt can reinforce bank's effort to enhance profitability and performance.

On the other hand, capital ratios/risk and solvency ratios (Equity/Net Loans (ENL), Equity/Liabilities (EL), Cap Funds / Net Loans (CFNL)) show that leverage (EL and CFNL) and strong equity position matters when it comes to liabilities growth. It is known that specific liabilities accounts are the engine that moves a bank to performance. The peculiarity financial statements of financial firms are that they are heavily dependent on their liabilities to acquire the capital they need to perform. Leverage is a tool on creating performance on one hand and on the other it's a risk. European banks seem to depend more on liabilities than equity and hence the negative sign on leverage ratios like "EL". The Equity to Net Loans (ENL) ratio shows, as expected, that there is a positive relation between net loans and the increase of performance due to the fact that equity providers expect higher performance.

Cost and operations are the third wheel of performance for banks. The cost of producing and promoting services and products to clients, fixed costs handling, as well their ability to produce income from other sources. None of the cost ratios are found to be statistically significant in the models, whereas income from other than interest or income from non - ordinary activity have been found to be significant.

Liquidity has been the corner stone of banks' ability to create income and profits. The models show that the ratio net loans to total assets (NLTA) is significant and hence the bank's ability to invest heavily on assets that are liquid and create immediate income is crucial to the overall effort to create profits. The other factor that seems to be important is the interbank (INTERB) liquidity that is the facilitation of banks borrowing from each other to enhance their liquidity and to exploit opportunities.

5. CONCLUSIONS

Performance of the European bank system through a turbulent decade (2004-2013) is not a balanced through its various sub-systems. The paper has shown that the two distinct corporate governance systems of Europe, the different geographical and historical path that north and south countries have influence the way they operate and perform. On the contrary, the 2008-2009 crisis has affected performance in a more homogenised way.

Regulation capital requirements do not seem to have any significant effect. On the other hand, as expected, bad debt handling, asset quality, operational costs, finding other sources of income, interbank liquidity are the most important factors that affect performance. The crisis of 2008-2009 doesn't seem to influence significantly performance (except the actual year of the crisis). The financial sector's performance is influenced currently by other factors like sovereign debt crisis and factors. Sovereign debt crisis especially for the northern located banks is very important (see Graph 2). In general, financial performance of banks is based on factors that are specific to the sector. Corporate governance system and the geographic location (political and macroeconomic factors) of the bank seem to effect significantly the factors that have an impact on performance. Banks with an Anglo-Saxon corporate governance system and banks that are in north Europe present greater variance of performance and hence they seem to be less entrenched – protected from markets.

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APPENDICES

Table 1. Econometric results

		Time		CGSys		CON		AS		North-South		North		South	
R-sq:	within =											0,9659		0,9949	
	between =											0,9811		0,999	
	overall =											0,9728		0,9961	
	rho	0,9747		0,9829		0,9721		0,9982		0,9876		0,23415		0,12152	
	Prob > F	0,9893		1,00000		0,9853		0,996		1		0		0	
	Breusch and Pagan Lagrangian multiplier	0,9805		0,9829		0,9775		0,9979		0,9876					
	Hausman (chi2)	0,19943		0,00294		0,23840		0,51972		0,00123					
	Ratio Category	0,00000		0,00000		0		0		0		Coef0,	P>|t|	Coef0,	P>|t|
NCOAGL	Asset quality	1,0000										-0,05549	0,00000	-0,00123	0,77900
NCONIB	Asset quality	Prob>chi 2 = 0,0000										0,00053	0,00000	-0,00002	0,60400
ILE	Asset quality	P>|t|	Coef0,	P>|t|	Coef0,	P>|t|	Coef0,	P>|t|	Coef0,	P>|t|		-0,00035	0,04000	-0,00009	0,10100
ENL	Capital ratios/risk and solvency ratios	0,00000	-0,02447	0,00000	-0,04012	0,00000	-0,00721	0,28500	-0,02098	0,00000		0,01420	0,00100	0,00085	0,79600
EL	Capital ratios/risk and solvency ratios	0,00000	0,00021	0,00000	0,00035	0,00000	0,00007	0,37300	0,00019	0,00000		-0,02900	0,00000	-0,00108	0,71300
CFNL	Capital ratios/risk and solvency ratios	0,00400	-0,00004	0,38200	-0,00032	0,00200	-0,00004	0,76600				-0,01069	0,00100	-0,00049	0,85900
OOIAA	Operations/Cost	0,00000	0,00326	0,00900	0,01683	0,00000	0,00118	0,52700	0,00196	0,06700		0,05030	0,00700	0,00599	0,45200
PTOIAA	Operations/Cost	0,00000	-0,00356	0,00000	-0,01940	0,00000	-0,00035	0,87100	-0,00244	0,00300		0,96611	0,00000	1,00192	0,00000
NOITAA	Operations/Cost	0,00000	-0,00255	0,00800	-0,01698	0,00000	-0,00100	0,46700	-0,00155	0,05900		0,99466	0,00000	0,99490	0,00000
INTERB	Liquidity	0,04700	0,00955	0,01500	0,01972	0,17200	-0,00092	0,91500	0,00700	0,03800		0,00015	0,13500	0,00004	0,08400
NLTA	Liquidity	0,00000	1,00093	0,00000	0,97671	0,00000	1,00440	0,00000	1,00089	0,00000		0,00392	0,00800	-0,00020	0,75700
CONS		0,00000	0,99977	0,00000	0,99449	0,00000	1,00766	0,00000	0,99931	0,00000		-0,02030	0,82500	0,02328	0,65000
		0,04700	0,00005	0,02000	0,00009	0,08000	-0,00001	0,85700	0,00005	0,02400					
		0,00600	0,00044	0,06700	0,00182	0,12200	-0,00011	0,88700	0,00029	0,16100					
		0,99000	-0,00709	0,65000	0,10644	0,21800	0,02426	0,57700	-0,00623	0,66300					

Table 2. Ratios

Assets quality ratios		Capital ratios/risk and solvency ratios	
LRGL =	Loan Loss Reserve/Gross Loans = Loan Loss Res/Gross Loans	T1R =	Tier 1 Ratio
LLPNL =	Loan Loss Provision To Net Interest Revenue = Loan Loss Prov/Net Int Rev	TCR =	Total Capital Ratio
LRIL =	Loan Loss Reserve Impaired Loans = Loan Loss Res/Impaired Loans	ETA =	Equity/Total Assets
ILGL =	Impaired Loans Gross Loans = Impaired Loans/Gross Loans	ENL =	Equity/Net Loans
ILE =	Impaired Loans Equity = Impaired Loans/Equity	EDSF =	Equity/Depositors and Short-Term Funding = Equity/Dep and St Funding
UILE =	Unreserved Impaired Loans / Equity	EL =	Equity/Liabilities
NCOAGL =	NCO / Average Gross Loans	ECSTF =	Equity / Cust & Short Term Funding
NCONIB=	NCO / Net Inc Bef Ln Lss Prov	CFTA =	Cap Funds / Tot Assets
		CFNL =	Cap Funds / Net Loans
Operations and Cost ratios		**Profitability**	
NIM =	Net Interest Margin	NIRAA =	Net Interest Revenue/Average Assets = Net Int Rev/Avg Assets
OOIAA =	Other Operation Income/Average Assets = Oth Op Inc/Avg Assets	ROAA =	Return on Average Assets = Return on Avg Assets
NIEAA =	Non-Interest Expense/Average Assets = Non Int Exp/Avg Assets	ROAE =	Return on Average Equity
NOITAA =	Non Operation Items and Taxes/Average Assets	REP =	Recurring Earning Power = ((Provisions + Profit Before Taxes) /Total Assets) *100
CTI =	Cost to Income Ratio		
PTPOIAA =	Pre-Tax Op Inc / Avg Assets		
Liquidity ratios			
NLTA =	Net Loans/Total Assets		
NLDSF =	Net Loans/Deposits and Short Term Funding		
LADSF =	Liquid Assets/Deposits and Short Term Funding		
INTERB =	Interbank Ratio		