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PUBLIC OR PRIVATE BANKS? A PERFORMANCE ANALYSIS IN THE EUROZONE

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ABSTRACT

The aim of this paper is to develop an empirical research on the nature and consequences of corporate governance on Eurozone banks before and after the crisis of 2007/2008 and the wide changing in the rules and the regulator activity. More particularly, we analyzed the effect of public ownership on banks performance (profitability and efficiency) with respect to privately held banks in the Eurozone. Our results provide quite strong evidence that, coherently with the Agency Theory, publicly traded banks are less profitable end less efficient than the corresponding privately held. No significant changes seem to have occurred on this point from 2005 and 2013.

JEL: M41, G32

KEYWORDS: Banks, Corporate Governance, Performance Measurement, Public Company, Agency Theory

INTRODUCTION

In the last decade, a well-known wide international crisis and the turmoil in financial institutions, that started in 2007 precisely in the banking sector, has affected in some way all the biggest economies in the world and is frequently described as the most serious crisis since the Great Depression (Kirkpatrick, 2008). The crisis in the subprime market (mainly in the US) and the "credit-crunch" phenomenon that followed (liquidity squeeze) is still having nowadays a relevant impact on financial institutions and banks in many Countries. Kirkpatrick clearly stated that "the financial crisis [of the last decade] can be to an important extent attributed to failures and weaknesses in corporate governance arrangements" (Kirkpatrick, 2008). Also the Basel Committee on Banking Supervision (BCBS), in the 2014 revised edition of "Corporate Governance Principles for Banks" clearly stated that "effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole".
As a consequence, strictly related to the financial crisis in the banking sector, new and more severe rules have been introduced, both at national and an international level. Among these, probably the most important is related to the Basel Agreements.

THEORETICAL BACKGROUND

The theoretical background for our study, inside the framework of corporate governance, mainly refers to the Agency Theory and the Stakeholders Theory. Both those theories have broad implications in many field of study and have been a topic of significant interest in recent corporate governance literature. The question of why some entities perform better than others has been largely studied, with some important results and findings, even though no definitive evidence has been clearly defined.Many studies have analyzed whether or not (and how) corporate governance elements affect firms performances. Most of the literature investigating the importance and role of corporate governance is focused mainly on industries rather than on the banking industry or financial services sectors. Only recently an increasing attention has been paid on this topic specifically for the banking sector. The Basel Committee on Banking Supervision (BCBS) defined "corporate governance" for banks in the glossary of its 2014 document "Corporate Governance Principles for Banks" as the "set of relationships between a company's management, its board, its shareholders and other stakeholders which provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance. It helps define the way authority is allocated and how corporate decisions are made".

Regarding how corporate decisions are made, according to the Agency Theory, there is a potential conflict between stakeholders and managers, which is prominent in all modern companies, no matter their sector of activity. The shareholders (or stockholders), as owners of the companies, are obviously the 'principals' that delegate the management of their companies to managers and executives, which are the 'agents' (Jensen and Meckling, 1976). Already in 1932, in the well-know first edition of their book, Berle and Means pointed out clearly that in modern companies those who legally have ownership (the shareholders) have been separated from their control by the managers and that the interests of those two "players" may diverge significantly. The owners of a company expect obviously that the managers make decisions in the principal's interest, but, mainly due to information asymmetry, the agents do not behave in the best interest of the owners, clearly leading to agency problems (Clarke, 2004).

In other words, executives of a company might sometimes take decisions and act to benefit themselves at the expense of the firm's investors (shareholders). According to the theoretical framework, control of the company ultimately rests with shareholders as they elect the board of directors, who, in turn, hire and fire executives. The mechanism by which unhappy shareholders may react to replace existing management is generally called a '*proxy fight*'. But there may be also other ways for managers replacement. For example, companies that are very poorly managed become more attractive for new investors in the market than well-managed firms and consequently acquisitions may take place due to the existence of greater profit potential. More modern managerial theories assessed that firms managers usually have objectives that are not simply financial year profits maximization, but there is a divergence in managers and majority shareholders (or just controlling interest) on one side and minority owners on the other.

Both the managers and the owners have a shared interest in increasing the firms value over time, but divergence may appear in the choice of which variable maximize (sales, revenues, profit, market share, stock market value?), how much profit should be distributed as dividend (or reinvested as retained earnings) and also the definition of the time horizon. In different ways, Baumol (1962), Marris (1964) and Williamson (1983) developed theoretical models that explain how managers seek their own personal prestige and higher company salaries by trying to expand company sales (revenue maximization) and market shares. Moreover, there is a minimum profits that serve as a constraint on the maximization of the company's revenues. This is the reason why recent literature on corporate governance has shown great attention to the problem of the "separation of ownership and control", mainly in public companies, in order to promote improvements in corporate efficiency. In order to mitigate the agency problem of the conflict between managers and shareholders, the existing literature proposes several solutions, such as compensation contracts, strong monitoring by the board of directors and managerial equity investment.

Some studies showed that public ownership may provide some help to the agency problem and may facilitate the market for corporate control. The idea is that listed companies benefit from the examination of the public markets and market corporate control and this situation may reduce the agency problems more in public than in private firms (Manne, 1965; Jensen, 1993; Holmstrom and Tirole, 1993; Dow and Gorton, 1997; Gupta, 2005; Edmans, 2009). Anyway, it should be pointed out that, opposed to the US system, in the European Union, private firms face the same reporting requirements as public companies. Thanks to the extensive disclosure requirement for European Companies (and, moreover, for banks) it is possible to benchmark public firms with private ones.

Stakeholders Theory clearly showed the importance of companies accountability to a wide range of stakeholders, that are far more than simply the majority shareholders (Freeman et al., 2004; Brunk, 2010).

Previous empirical studies that have found evidence of the effect of corporate governance on firms performance may be divided in two group. The first set includes studies that consider samples of firms from a cross section of industries, while the other set include all those researches that are linked with certain corporate events (such as leverage buyouts LBOs or Initial Public Offerings IPOs), see for example Edgerton (2011).

As the banking sector is very complex and strictly regulated, both at national and international levels, corporate governance of banks is quite different from that of unregulated and/or nonfinancial firms. Ciancanelli and Reyes-Gonzalez (2000) stated that the agency problem and the owners-manager conflict in banks is far come complex in its intrinsic nature than in other companies. One important reason of the difference with other industries is that, according to the stakeholders theory, the number of parties with a significant "stake" in a bank is higher and complicates the governance (for example, in addition to "traditional" investors, also depositors and regulators have a direct and strong interest in bank performance). For instance, Commercial Banks present a much more complex structure of information asymmetry coming from the presence of strict regulation frameworks. Moreover, regulators may also set rules in order to reduce blockholders' incentives to monitor the boards of banks. Finally, another point can be find in the fact that banking firms usually present higher leverage than nonfinancial firms and this may also affect governance problems. For a good and more complete review of existing recent literature on banking see Wilson et al. (2010).

Table 1: Ownersip and Property Concentration

Ownership	
Private Households, Firms, Institutional Investors, Banks, workers, employees, depositants (Credit unions or Co-operative Banks)	***Public*** Government

Property Concentration	
High Company controlled by (majority) owners (controlling interest)	***Low*** Company controlled by managers and executives

This table synthesize the different possible ownership structures and the degree of property concentration.

Relevance of this Study

The banking system is widely considered as one of the most important elements of all the modern economic systems. Economic growth, industrial expansion, efficient capital allocation largely depend on the efficiency of the financial sector (and banking more specifically). *Theory* and *evidence* show that when banks and financial institutions effectively and efficiently mobilize and allocate financial resources, through the interest rates, savings and investments are stimulated, more resources are attracted and a positive effect on economic growth and on the entire economic system is quite evident (Levine, 2004). In other words, "*Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health"* (BCBS, 2014). *Conversely, governance weaknesses in banks may convey problems across the banking sector and the economy as a whole.* The increased attention on risk, its management and the responsibilities of different parts of the organization for addressing and managing it, may have weakened the attention on other aspect of corporate governance in the banking sector that may still be relevant and not completely studied and examined. Our study differ from previous studies because:

it focuses only on the banking sector (i.e. only a single industry) and not on a cross section of industries;

it considers the banks of the Eurozone (and not only those of a single Country, as done by other studies). In the Eurozone during the last two decades a great convergence in rules was developed and common capital market settings has been largely adopted, under the supervision of the European Central Bank (ECB);
it does not refer only to certain specific corporate events (such as LBOs or IPOs);

it compares the situation before and after the financial crisis of 2007/2009 and the improvement of the new Basel Agreements.

We tested whether, before and after the years 2007/2009, there had been or not a significant change firstly in the relationship between ownership structure and banks performance and secondly between ownership structure and efficiency. We consider the years from 2007 to 2009 as breaking point for two reasons:

The well-known global financial crises that deeply affected financial markets and particularly financial institutions and banks.

No later than January the 1st 2008, all EU banks had to adopt and follow the new set of rules defined as "Basel II", issued by the Basel Committee and organized on three "pillars".

RESEARCH QUESTIONS

The aim of this study is to compare private and public Eurozone banks, before and after the financial crisis of 2007/2008, under two specific performance dimensions: profitability and efficiency.
According to the existing and analyzed literature, a privately held company would tend to be more profitable and more efficient than a publicly traded company. This is mainly due, according to the agency theory, to the higher level of separation of ownership and control in publicly traded firms. Some studies suggested that publicly held banks have a "composite" and more articulated objective function and this may affect significantly their performance, because, even if there is a strong majority shareholder, it may be difficult (or very expensive) to control executives with multiple institutional objectives.
Our research questions are:

RQ1: are publicly traded Banks of the Eurozone significantly less profitable and less efficient than similar privately held banks?

RQ2: have significant changes taken place before and after the crisis of 2007, regarding the RQ1?

METHODOLOGY

In order to validate the research questions, we used traditional accounting variables to measure banks performances (according to Oyewo Babajide and Babatolu Ayorinde, 67% of UK Banking industry use Financial variables as measure of performance). More specifically, we used Return on Assets (ROA) to measure profitability. ROA is defined as the ration between net income (after tax) and end-of-the-year total assets. Existing literature frequently analyzed efficiency under two different perspectives: "technical" efficiency and "allocative" efficiency. In our study operating efficiency is measured, according mainly to the first perspective, using the 'non interest cost to income ratio' (CtoI). This ratio consider the bank's overhead as a percentage of its revenue. Banks' costs include salaries, rent and other general and administrative expenses. We excluded interest expenses, considered mainly investing decisions that do not depend strictly on operational efficiency. This ratio is a quick and easy way to express the bank's ability to turn resources into revenue. Obviously, the lower the ratio, the better it is. An increase in this efficiency ratio may show either an increase in costs or a decrease in revenues.

The research method is a statistical multi-regression analysis to test whether public or private ownership has a significant effect on the bank performance. This analysis was conducted with performance variables (testing for profitability and efficiency) as dependent variables and bank characteristics (among which we also considered publicly vs. privately held ownership) as independent variables. For this purpose, we used the following equation:

$$Y_{i,t} = \beta_0 + \beta_1 \cdot X_{i,t} + \beta_2 \cdot C_t + \beta_3 \cdot Z_{i,t} + \beta_4 \cdot PUB_i + \varepsilon_t$$

where:

$Y_{i,t}$ is the vector of the dependent variable (ROA, CtoI respectively)
$X_{i,t}$ is a vector of banks characteristics (dimension, type of bank,…)
C_t is a vector of variables that controls for location effects
$Z_{i,t}$ is a vector of time-effect variables that control for macroeconomic effects
PUB_i is a dummy variable (1 for publicly traded banks, 0 for privately held)
ε_t is the vector in terms of error.

The vector $X_{i,t}$ controls banks characteristics (total assets, total equity, total cost to total assets, cost to income, funding mix, etc…) that may affect the performance, in order to define more clearly if the ownership structure (public vs. private) has an effect on the banks performance. With (log of) total assets (banks size) we control for scale effects, as public banks tend to be larger than privately held ones. With the ratio of equity to total assets we control for leverage effects. Furthermore, we control location effects with the vector C_t, that defines where the bank is located (i.e. in which Country). The vector $Z_{i,t}$ comprises quite a large number of the most common macroeconomic variables. For the ownership, we distinguish between privately held and publicly traded banks by whether the bank is listed or not (i.e. it issues publicly traded stocks). According to these criteria, we labeled as "listed banks" those whose shares are traded on a main stock exchange in a Country. Finally, we assume that the variable $\mathrm{Y_{i,t}}$ is influenced by a stochastic error ε_t with the following notes of assumption:

1) $E(\varepsilon_t) = 0$ $\quad \forall\, t$
2) $E(\varepsilon_t\, \varepsilon_s) = 0,$ $\quad \forall\, t \neq s$ (absence of correlation)
3) $E(\varepsilon_t^2) = \sigma^2,$ $\quad \forall\, t$ (constancy of the variance)

Data and Sample

Our sample consists of 3,760 banks from all the 18 Country of the Eurozone. Country origin of the sample is reported in table 2. The primary data source is the latest version of Bankscope (Bureau Van Dijk), that provides a wide set of information and detailed financial statements of over 30,000 banks in the globe. For the EU the comparison of financial statements of both private and public banks is made possible largely because European laws require both public and private banks to report the same financial statements. The data are collected from each national official public supervisor in charge of collecting the annual accounts coming from the officially filed and audited accounts. We collected additional data from official websites of banks, financial institution, ECB, Eurostat, EBA, European Banking Federation and local Central Banks. Some data has also been collected from banks official websites.

Table 2: the Sample: Banks and Countries

		N°	%
1	Austria	294	7.82%
2	Belgium	79	2.10%
3	Cyprus	26	0.69%
4	Estonia	12	0.32%
5	Finland	35	0.93%
6	France	385	10.24%
7	Germany	1,783	47.42%
8	Greece	14	0.37%
9	Ireland	43	1.14%
10	Italy	625	16.62%
11	Latvia	23	0.61%
12	Luxembourg	98	2.61%
13	Malta	16	0.43%
14	Netherlands	78	2.07%
15	Portugal	45	1.20%
16	Slovakia	19	0.51%
17	Slovenia	22	0.59%
18	Spain	163	4.34%
	TOTAL	**3,760**	100%

This table shows the distribution by Country of the banks considered in our sample

Table 3: the Sample: Banks Conditions

	N°	%
Delisted	75	1.99%
Listed	159	4.23%
Unlisted	3,526	93.78%
TOTAL	**3,760**	**100%**

This table shows the number of banks in our sample listed, delisted and unlisted

Table 4 reports significant descriptive statistics for the sample of 3.760 banks, both for 2013 and 2005, for the most relevant variables considered in the regressions.

Table 4: Descriptive Statistics

variables	maximum	minimum	mean	median	st. deviation
Total Assets 2013 (th. Eur)	2,252,689,000	1,424	16,430,137	850,900	101,007,054
Total Assets 2005 (th. Eur)	1,258,079,000	72	9,509,020	517,300	64,455,467
Equity 2013 (th. Eur)	700,137,700	-132,739,000	1,121,871	74,372	13,892,263
Equity 2005 (th. Eur)	52,184,000	-72,713,200	428,206	38,400	2,961,769
ROA 2013 (%)	113.51%	-42.23%	0.38%	0.25%	3.50
ROA 2005 (%)	30.49%	-27.32%	0.81%	0.40%	2.34
ROE 2013 (%)	152.27%	-766.27%	2.37%	3.03%	22.98
ROE 2005 (%)	181.25%	-292.50%	8.03%	5.67%	14.30
Cost to income 2013	958.82	0.02	68.82	66.96	36.98
Cost to income 2005	437.04	-	67.59	69.23	21.39
N. of employees 2013	338,000	31	1,981	200	13,889
N. of employees 2005	138,815	22	1,347	224	7,674
Operating profit 2013 (th. Eur)	12,443,000	-9,883,000	58,559	4,900	587,001
Operating profit 2005 (th. Eur)	8,504,000	-2,548,200	64,042	3,100	432,599
Leverage 2013 (%)	24.20%	2.30%	8.45%	6.08%	6.12
Loans/Customer Deposits 2013 (%)	973.82%	0.00%	108.87%	90.10%	89.50
Loans/Customer Deposits 2005 (%)	988.88%	0.00%	108.85%	89.04%	0.92
Customer Deposits / Total Funding (excl Derivatives) 2013 (%)	100.00%	0.00%	69.71%	79.02%	25.96
Customer Deposits / Total Funding (excl Derivatives) 2005 (%)	100.00%	0.00%	68.12%	75.41%	25.54

This table reports descriptive statistics for the sample

RESULTS AND DISCUSSION

In order to analyze profitability, we used ROA in the regression equation, while for the analysis of efficiency, the dependent variable was the previously described ‘non interest cost to income ratio’ (CtoI). The results of the regression analysis are reported in the following table 5-6-7-8.We repeated each regression analysis twice: one with 2013 data and another with 2005 values, in order to check if there has been a break-even among these two periods.

Table 5 and 6 report the results of the multiple regression of ROA for 2013 (table 5) and 2005 (table 6), testing for the effect of the ownership on profitability. Both regressions present an R^2 around 16%, which represent the fraction of the variation in the dependent variable that can be explained by the regression. The F-test of the analysis of variance (ANOVA) shows that at least one of the parameter is linearly related to the response variable.

We find that the coefficient of the PUB variable is significant and is NEGATIVE for both the years. This means that we can state, according to the RQs, that publicly traded Banks of the Eurozone are significantly less profitable than similar privately held banks, both before and after the financial crisis of 2007/2008. All the other independent and control variable are also significant (at 95% confidence), with the exception of the variable Z (macroeconomic effects), but only for 2013. These may suggest that the basic traditional macroeconomic variables considered in the regression (i.e. GDP per person, inflation, unemployment, interest rates), after the crisis may be no longer able to explain significantly the dependent variable (banks profitability) changes.

Table 5: Regression Analysis of ROA 2013 (Significance At 95% Level)

Regression Satistics					
Multiple R	0.395272422				
R Square	0.156240287				
Adjusted R Square	0.155341475				
Standard Error	2.117415285				
Observations	3760				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F (95%)*
Regression	4	3117.426858	779.3567145	173.8297853	0.00000000000000000
Residual	3755	16835.34533	4.483447491		
Total	3759	19952.77218			
	Coefficients	*Standard Error*	*t-Stat*	*p-value (95%)*	
Intercept	7.773879323	0.986388392	7.881154506	0.000000000000004	
X	0.648768593	0.146818763	4.418839793	0.000010203089276	
C	-0.194570304	0.031868217	-6.105465569	0.000000001129070	
Z	0.067839614	0.050397378	1.346094101	0.178353341647218	
PUB	-0.081862546	0.020450419	-4.002976426	0.000063757447769	

This table reports the results of the regression analysis of ROA for the year 2013

Table 6: Regression Analysis of ROA 2005 (Significance At 95% Level)

Regression Satistics					
Multiple R	0.398972163				
R Square	0.159178787				
Adjusted R Square	0.158283105				
Standard Error	1.850079493				
Observations	3760				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F (95%)*
Regression	4	2433.168865	608.2922162	177.718026	0.000000000000000
Residual	3755	12852.59196	3.422794129		
Total	3759	15285.76082			
	Coefficients	*Standard Error*	*t-Stat*	*p-value (95%)*	
Intercept	10.28079729	2.311165225	4.448317751	0.000008904992837	
X	1.012698751	0.505505551	2.003338537	0.045212611156018	
C	-0.446195868	0.090617686	-4.923937993	0.000000884661781	
Z	0.054238964	0.021765622	2.491955564	0.012746958460645	
PUB	-0.109675698	0.032509163	-3.373685627	0.000749198098450	

This table reports the results of the regression analysis of ROA for the year 2005

Table 7 and 8 report the results of the multiple regression of non interest cost to income ratio for 2013 (table 7) and 2005 (table 8), testing for the effect of the ownership on operating **efficiency**. The regression for 2013 reports an R^2 around 14%, while for 2005 it increases to 16%. The F-test of the analysis of variance (ANOVA) shows in both the regressions that at least one of the parameter is linearly related to the dependent variable. We find that the coefficient of the PUB variable is significant and is POSITIVE for both the periods taken into account. This findings suggest, according to the RQs, that publicly traded Banks of the Eurozone are significantly less efficient than similar privately held banks, both before and after the financial crisis of 2007/2008, as publicly traded banks presents higher operative costs than privately held ones. All the other independent and control variable are also significant (at 95% confidence), with the exception of the variable Z (macroeconomic effects) for both 2013 and 2005.

Table 7: Regression Analysis of Cost-to-Income 2013 (Significance At 95% Level)

Regression Satistics					
Multiple R	0.372575205				
R Square	0.138812283				
Adjusted R Square	0.137894906				
Standard Error	5.885893432				
Observations	3760				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F (95%)*
Regression	4	20968.37632	5242.09408	151.3143169	0.000000000000000
Residual	3755	130087.2493	34.64374149		
Total	3759	151055.6256			
	Coefficients	*Standard Error*	*t-Stat*	*p-value (95%)*	
Intercept	8.787430978	1.92737526	4.559273516	0.000005296515500	
X	-5.986263111	1.348018301	-4.440787715	0.000009220699402	
C	3.131009315	0.613052811	5.107242412	0.000000343121582	
Z	-0.001092418	0.004845613	-0.225444829	0.821645495640673	
PUB	3.310760654	1.004848764	3.294785018	0.000994100458001	

This table reports the results of the regression analysis of Cost-to-Income for the year 2013

Table 8: Regression Analysis of Cost-to-Income 2005 (Significance At 95% Level)

Regression Satistics					
Multiple R	0.395014969				
R Square	0.156036826				
Adjusted R Square	0.155137797				
Standard Error	7.106246126				
Observations	3760				
ANOVA					
	df	*SS*	*MS*	*F*	*Significance F (95%)*
Regression	4	35058.55751	8764.639377	173.5615664	0.000000000000000
Residual	3755	189622.7462	50.498734		
Total	3759	224681.3037			
	Coefficients	*Standard Error*	*t-Stat*	*p-value (95%)*	
Intercept	9.983890689	2.938770398	3.397302047	0.000687608435318	
X	-7.838011661	1.571863964	-4.986444017	0.000000642789803	
C	3.161644325	1.328050377	2.380665959	0.017330916281491	
Z	-0.000363563	0.000205563	-1.768619022	0.077038539479487	
PUB	2.139650067	0.814160613	2.628044188	0.008622653576073	

This table reports the results of the regression analysis of Cost-to-Income for the year 2005

SUMMARY AND CONCLUDING COMMENTS

In this paper we analyzed whether publicly owned banks in the Eurozone are less profitable and less efficient than privately held ones. According to the Agency Theory and some literature and previous studies on industrial firms we expected lower performance results in publicly held banks. According to our analysis we find quite strong evidence supporting our hypothesis and the existing literature. This relationship seems not to have changed before and after the financial and economic crisis that started in 2007 in the US. Also the new stricter rules (for example Basel Agreements) and the far more pressuring and alert activity of the regulator authorities (for example the “stress test simulations”) seem not to have changed the relationship significantly. Anyway, the significance of the control variable for location effects may suggest that, even inside the Eurozone after more than 15 years of common monetary policy under the activity of the same Central Bank, there are still significant differences in the banking activity from Country to Country. Further development of this model may be applied at the risk-taking attitude of banks. Another possible development may led to considering non only the Eurozone, but the entire 27-EU Countries.

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