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Drivers of bank profitability: Case of Latvia and Lithuania

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Abstract

The issues regarding measuring and managing bank performance are always on the agenda due to the critically important role of banks in the national economies of new member states of the European Union. The goal of the given study is to explore drivers of bank profitability in Latvia and Lithuania. Research period covers 2008–2014. Performance of the banking sector is proxied by profitability ratios. The set of explanatory factors involves financial and non-financial measures. The core research method is a multiple regression analysis. Data processing is performed in SPSS environment. The paper contributes to the scope of knowledge regarding bank performance drivers and the research results provide the basis for the future studies in the related field.

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1. Introduction

The issues regarding bank performance and its drivers have been a frequently chosen topic for discussion among academicians and business professionals. Besides, the importance of these issues is always emphasized by governmental authorities due to the large contribution of banks into the national economic growth.

Recent global financial crisis revealed the fact that Baltic banking sector is exposed to earnings risk more than the banking sector of other European countries. In 2009, ROE in the banking sector of Latvia and Lithuania was –44% and –56%, respectively (ECB, 2009a). In turn, average ROE in EU27 was only –2.83. Thus, issues regarding reasonable management of bank performance are still prioritized.

Exploring the drivers of bank performance, some authors put the emphasis on the macroeconomic variables (Gerlach, Peng, & Shu, 2005; Jurevičienė & Doftartaitė, 2013; Titko, Kozlovskis, & Kaliyeva, 2015), but the

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most of papers explore both external (macroeconomic and industry-specific) and internal (bank-specific) factors affecting bank performance (Gul, Irshad, & Zaman, 2011; Titko & Dauylbaev, 2015).

Despite the huge amount of scientific literature dedicated to investigation of bank performance determinants, the number of papers analyzing Baltic banking sector is limited. Besides, the results in most of the papers are obsolete (Aarma, Vainu, & Vensel, 2004; Bonin, Hasan, & Wachtel, 2005; Grigorian & Manole, 2002; Košak, Zajc, & Zorić, 2009).

The goal of the current paper is to explore the factors affecting bank performance in the Latvian and Lithuanian banking sector. The authors analyze the driving force of industry-specific (sector-level) factors.

Based on the literature analysis on main drivers of bank performance, the following hypotheses are stated by the authors:

H1: There is a significant positive relationship between bank size and bank profitability
H2: Bank profitability is negatively affected by operational efficiency
H3: Developed infrastructure and e-banking services positively influence bank profitability

Performance of the banking sector is proxied by profitability ratios: return on assets (ROA), return on equity (ROE), net fees and commission income as a percentage of total assets (NFCITA) and net interest margin (NIM). Profitability affecting sector-level are represented by a set of financial and nonfinancial ratios.

Research period covers 2008–2014. The statistics used for research purposes is provided by the European Central Bank (ECB), the Association of Commercial Banks of Latvia (ACBL), The Financial and Capital Market Commission (FCMC), Bank of Lithuania, and the Association of Lithuanian Banks (ALB).

Data processing is performed, using the correlation analysis and the multifactor regression analysis in the SPSS 20.0 environment.

The current research contributes to the scientific literature in the field of bank performance management in the Baltic countries. The results of the study revealed a problem of inconsistency between statistical data provided by different information sources. It is also obvious that availability and quality of bank statistics in Lithuania should be improved.

2. Bank performance and its drivers

Bank performance can be expressed "in terms of competition, concentration, efficiency, productivity and profitability" (Bikker & Bos 2008). The multidimensional nature of the concept of bank performance explains the existence of a wide range of its measures.

The most frequently used measures of bank profitability are return on assets (ROA), return on equity (ROE) ratio and net interest margin (NIM) (Bikker, 2010; Kosmidou & Zopounidis, 2008; Tomuleasa & Cocrish, 2014; Ameur & Sonia Moussa Mhiri, 2013; Ongore & Kusa, 2013; Hasan, Schmiedel, & Song, 2012; Kumbirai & Webb, 2010).

Despite ROE is still the primary performance measure for the most investors and analysts, sometimes ROA provides a better understanding of a company performance (Hagel, Brown, & Davison, 2010). Based on the viewpoint of experts from the European Central Bank, a good level of ROE may either reflect a good level of profitability or more limited equity capital" (ECB, 2009).

Besides, some experts consider that a single-ratio cannot be a good proxy for bank performance due to the "complex operational environment of banks" (Yang, 2009).

In the given research the authors investigate bank profitability that, in turn, determines the scope of the study and the measures used.

Contribution of various factors to bank profitability is a frequently debated topic among academicians and practitioners. Scientific papers dedicated to the investigation of the factors affecting bank profitability can be combined into several main groups according to the analyzed issue.

Analysts study the impact of GDP growth and inflation on bank profitability (Athanasoglou, Brissimis, & Delis, 2008; Pasiouras & Kosmidou, 2007; Rachdi, 2013).

A wide range of papers explore the relationship between market structure, competition level, bank efficiency and profitability in the banking industry (Bikker & Bos, 2008; Guillén, Rengifo, & Ozsoz, 2014; Tabak, Fazio, & Cajueiro, 2011). The theoretical basis for these studies is the Structure-Conduct-Performance (SCP) hypothesis that

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