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Cost and profit efficiency of listed South African banks pre and post the financial crisis

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ABSTRACT

The 2008 financial crisis and the regulations that followed after the crisis have seen an increase in the safeguards to the financial system, adding additional costs to the banking sector. This has significantly impacted on the banking industry. This study investigates the change in cost and profit efficiency in the period before, during and after the financial crisis (2004–2013) in South Africa for banks listed on the Johannesburg Stock Exchange (JSE). It further seeks to explain the relationship between the cost to income ratio (CIR) and the return on average assets (ROAA), as well as in relation to business cycles. The study further seeks to understand how ownership relates to market share, CIR and ROA.

The results indicate that there has been no significant statistical significant change in CIR in the period before, during and after the financial crisis. A different result is observed for profit efficiency as measured by ROAA as a significant statistical change is observed over the three periods. Furthermore, it was found that CIR is a better determiner of company performance as measured by total assets. It was also established that a strong relationship existed between ROAA and business cycles rather than CIR and business cycles. The ownership structure was found not to have a significant relationship with the bank's performance.

1. Introduction

The 2008 financial crisis caused mayhem in the financial sector when governments had to intervene to rescue banks. This suggests that banks may not be able to self-regulate in times of distress. At what can be considered a critical stage in the economy, many banks did not have enough capital for their own liquidity and solvency, leading to a number of failures (Berger and Bouwman, 2013). The uncertainty that was created by the failure of banks, resulted in one of the biggest financial meltdowns of the 20th and 21st centuries. This occurred despite the capital-building initiatives that were already in place in the form of Basel I and II.[1] The failures resulted in even stricter regulation and increased regulatory capital and capital buffer[2] requirements, which are all costly to maintain. This poses the question: what is the impact of regulations, and specifically increased capital and the concomitant increased cost, on the performance and efficiency of banks? The answer to this question may help regulators to determine early signs of fragility and could lead to better and informed regulatory interventions, instead of blanket general regulatory solutions to financial crises.

Even though extensive research has been conducted in the banking sector, outcomes have been diverse. According to Beyleveld

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[1] Basel I and II are published set of minimum capital requirements agreed by central bankers around the world to cater for unplanned material loss risk (as a result of not having liquidity and solvency) to protect banks.

[2] Capital buffers are the amount of capital that banks are required to hold above their minimum capital and are designed to reduce the pro – cyclical nature of lending by promoting countercyclical holding of extra capital.

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(2011), as well as Kumbirai and Webb (2010), the 2008 financial crisis saw the revenue of banks grow only marginally, while expenses increased significantly in comparison to the period prior. This view is contrary to the findings of Cronje (2007), Ncube (2009), and Oberholzer and Van der Westhuizen (2010), who found that South African banks significantly improved their cost efficiencies between 2000 and 2005. The same improvement in cost efficiency was found in Turkey in the 1990s (Isik and Hassan, 2002).

The overall consensus seems to be that South African banks are better at cost containment, and therefore cost efficiency, than they are at profit generation or profit efficiency. This may be due to a number of structural factors, such as limited wholesale funding, which causes increases to costs. Or it can be the result of misguided management strategies that focus on costs disproportionally, such as a disproportionate emphasis on the cost-to-income ratio (CIR). A focus on CIR may lead management to the conclusion that any decrease in profitability must be contained by reduced costs (Tripe, 1998).

The purpose of this study is to investigate whether there has been any change in the cost and profit efficiency of South African banks before, during and after the financial crisis. Since CIR and return on assets (ROA) are also linked to performance and ownership, the study follows two main themes highlighted in literature, namely cost and profit efficiency, as well as ownership.

The study aims to provide evidence that there has been a change in the efficiency of banks due to the increased costs banks have to bear for regulatory compliance (including regulatory capital) and that ownership affects bank efficiency and performance. The investigation is conducted through an analysis of changes in cost and profit efficiency before, during and after the 2008 financial crisis, and whether the nature of ownership impacts efficiency and performance.

Apart from the above, the study also investigates the correlation between cost and profit efficiency and market share, the relationship between cost and profit efficiency and business cycles, and the correlation between the composite index (higher management, BEE and/or controlling corporate shareholding) and market share for the largest banks in South Africa.

The study is conducted for all listed South African banks for the ten-year period 2004–2013. From a theoretical perspective, this study assist with an explanation of whether regulatory intervention in the banking sector during and just after the financial crisis was appropriate and informed. From a practical perspective, it informs bank management of appropriate strategies to follow between cost containment and marginal revenue maximisation in different economic environments, and hopefully point managers and investors to a metric to assess a company's performance that is appropriate for the economic environment.

The next section provides an overview of previous findings from the literature, followed by a description of the research method, the results of the study and a discussion of the conclusions.

2. Literature review

2.1. Overview

In South Africa, the resilience with which the banking sector withstood the financial crisis is remarkable, especially for a banking system that is intricately linked to the global financial system (Kumbirai and Webb, 2010). Throughout the 2008 financial crisis, the country maintained strong fiscal stabilisation policies, but it was subsequently hampered by continued low growth in gross domestic product (GDP) after the financial crisis. While having averted most of the tumult in the financial crisis and not needing financial bailouts in South Africa, one cannot forget that the practice of banking is a constant trade-off between risk and reward. Risk-taking promises better rewards, hence the aggressive and sometimes reckless behaviour banks undertook before the financial crisis.

Management in many financial institutions are preoccupied with two issues relating to performance: market share and survival (Berger and Bouwman, 2013). This means management is constantly seeking cost and profit optimisation, as observed by Farrell (1957). It is important to bear in mind that survival is not only based on regulators, but also on the strategic direction and conviction of management (Berger and Bouwman, 2013). Therefore, the management team of a bank and its alignment with long-term shareholder value- creation becomes an important consideration in banks' performance.

Many studies have been conducted across the world on the efficiency of banks, with the United Kingdom and the United States at the forefront, as noted by Albertazzi and Gambacorta (2009), as well as Berger and Humphrey (1997). In South Africa, there have been a number of studies that used both econometric and non-econometric techniques to measure the efficiency of banks (Cronje, 2007; Kumbirai and Webb, 2010; Ncube, 2009; Van der Westhuizen, 2008). The results of the studies broadly indicate that cost and profit efficiency in South African banks improved over time, prior to the financial crisis (Maredza and Ikhide, 2013, Mlambo and Ncube, 2011). The studies further note that there are still significant opportunities to improve both cost and profit efficiency of South African banks (Kumbirai and Webb, 2010; Mlambo and Ncube, 2011; Ncube, 2009; Oberholzer and Van der Westhuizen, 2004). Erasmus and Makina (2014) found that the financial crisis did not affect the efficiency of most banks in South Africa.

The South African banking sector is dominated by the so-called "Big Four" banks, namely First National Bank, Standard Bank, Absa Group and Nedbank. The market capitalisation and revenue of South African banks continued to grow from R1.4tn in 2003 to approximately R5tn in 2014, with 85% of the market capitalisation of listed banks being shared among the Big Four banks as per Fig. 1. Banking asset growth increased from 69% of GDP in 2005 to more than 118% of GDP in 2009 (Kumburari and Webb, 2010), and to over 168% of GPD in 2014 (iNet BFA, Statistics SA and World Bank). Erasmus and Makina (2014) found that the banking sector contributes about 10.5% to the GDP in South Africa. This is significant, as there is a direct relationship between GDP and market capitalisation, as well as GDP and the profitability of banks (Kiyota, 2011; Kosmidou, 2008). The good performance of banks is not isolated to South Africa, it is a general phenomenon across geographies, including in emerging Europe where there was a substantial increase in total assets as a percentage of GDP (Anayiotos et al., 2010). As the proportion of assets to GDP grows, growth in non-interest revenue is encouraged, leading to better earnings stability (Albertazzi and Gambacorta, 2009, Capraru and Ihnatov, 2015).

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