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Impact of regulatory capital on European banks financial performance: A review of post global financial crisis

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ABSTRACT

The importance of having sufficient regulatory capital has undeniably attracted immense attention since the 2008 financial crisis. The notion is that increased capital requirement negatively impact the financial performance of the banks. Using structural equation modelling, the article employs 4503 European banks data from 2001 to 2005 examining the interaction of tier 1 capital and financial performance. The results indicate that the banks have grown post the 2008 financial crisis. Likewise, the tier 1 has increased but the increase is not in line with the expansion. As expected there is a negative association between tier 1 capital and financial performance. The results also indicate that the banks have diversified their revenue streams compared with pre-2008. In terms of efficiency, the results indicate that the cost income ratio post 2008 is higher than pre-financial crisis. The results implies that the regulators must take account of the expansion of banks and the increase in their capital levels.

Firms are managed by directors who act as agents of the shareholders. However, empirical evidence shows that, this agency relationship can be costly, especially on acquisition or takeover situations. This ultimately affects the share price because of conflicts of interest in which directors pursue their own interest. In effect, the agency cost can be said to be the value lost because of directors maximising their own interest at the expense of shareholders. The agency theory suggests that the choice of capital structure may help in mitigating this cost. That is high leverage reduces agency costs outside equity and increases the value of the firm by constraining and encouraging the directors to act in the best interest of the shareholders. The principle agency principle relationship is supported by the ownership and control separation. In this instance, shareholders have the sources to support the firm's activities because of information asymmetry and the skills to run the firm.

Because setting up a perfect contract between shareholders and directors, because of information asymmetry, a pool of agency problem and costs crops up. These can have enhanced by perquisites and insufficient work effort and hence the advent of Corporate Governance. More so the agency theory states that the firm which undertakes high leverage position will have a conflict of interest between the directors and the shareholder about to making investment decisions (1977), the amount of risk to accept in undertaking a project, Barnea et al. (1980) and dividend policy, Stulz (1990). These three arguments exhibit one step forward since 1958 on Miller and Modigliani prepositions on capital structure irrelevance of the value of the firm. However, Modigliani and Miller (1958) preposition were based on the frictionless financial market. Furthermore, when leverage increases, this may generate significant agency costs of outside debt because of financial distress and bankruptcy or winding down.

Financial institutions are opaque in terms of their information. More so regulators set a minimum equity capital. Though there are voluminous studies on capital structure, there is no consensus on how it influences the performance of the firms. Although it is documented that companies that operate in higher inflation environment usually exhibit lower financial leverage, rely more on equity financing and have shorter debt maturity compared to peers in lower inflation countries, Julia et al. (2011). This is because

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high inflation has a negative impact on the level of debt financing and desired debt maturity. Nevertheless, management need to demonstrate that the firm can generate sufficient cash flows to self-finance and that the balance sheet is strong enough to overcome the downturn. This is closely related to corporate sustainability which has been widely researched by Balkyte and Tvaronaviciene (2010).

1. Structural changes in banking

There have been many changes in the banking industry in developed countries over the last twenty years. In fact, the great depression of 1928 saw the first major reform in banking across many industrialised countries by then. Since then, there has been systematic reforms emanating from major failures, especially from big multinational banks. Over and over every reform has centred not only on corporate governance, but also how they are financed. In some countries, banks earn less than half of their income from interest. Banks in all developed countries earn an increasingly large amount of their income from non-interest sources. There are several reasons for this change. The development of securitization to finance various types of loans led to a decrease in interest income and an increase in fee income for banks. Also, decreases in business restrictions and technological innovations have led to an increase in competition for banks.

The development of securitization means that banks no longer hold in their loan portfolio many of the assets that they used to hold. Virtually any type of debt is a candidate for securitization (particularly in the United States). Securitization has grown rapidly since it was introduced because there are many advantages to securitizing loans instead of having banks hold the loans.

Securitization is not necessarily bad for bank profits. Banks play a role in the securitization process. Securitization has both intermediation and capital market characteristics. Banks generally earn fees for originating and servicing the loans. They are also able to avoid the default and interest rate risk that would result from carrying the loans in their portfolios. However, the development of securitization is a sign of structural change within the banking industry.

As discussed earlier, deregulation has blurred the lines between various types of financial intermediaries and has led to increased levels of competition. We have already seen the effect of increased competition on bank performance. Also, increased competition often drives marginal firms either to fail or merge with a stronger firm. Banks also hope to take advantage of economies of scope that may exist in the provision of some of the activities which are allowed under the second directive.

Increases in competition have created pressure on commercial banks to evolve and find new ways to maintain adequate levels of performance. Banks have done this by increasing their non-interest income. Despite the recent increase in the relative importance of capital markets at the expense of banks, banks still have comparative advantages in many areas of the financial service industry. Banks are earning an increasingly large amount of income for providing the services in which they have expertise. These services include loan origination, cash management, trade financing operations and collateral (Chadwick and Weitman, 1993)

2. Literature review

A significant number of work have examined what drives firm profitability. In industrial economics literature, there are two approaches, Structure-Conduct-Performance paradigm (SCP) and Persistence of Profit (POP). Traditional SCP paradigm approach posit that profitability is determined by structural characteristics of the market such as concentration, economies of scale, barriers to entry and exit (Slater and Olson, 2002). The main predictions of the SCP paradigm are: (1) that concentration will facilitate collusion, whether tacit or explicit and (2) that as barriers to entry rise, the optimal price-cost margin of the leading firm or firms likewise will increase. Following this train, it is important to note that, compared with other firms, there are huge barriers to entry to banking because of the minimum capital and regulatory requirements and hence the concentration is very high in most countries. Proponents of banking sector concentration argue that economies of scale drive bank mergers and acquisitions (increasing concentration), so that increased concentration goes together with efficiency improvements (Demirgüç-Kunt and Levine, 2008).

Some theoretical arguments and country comparisons suggest that a less concentrated banking sector with many small banks is more prone to financial crises than a concentrated banking sector with a few large banks. This is partly because reduced concentration in a banking market results in increased competition among banks and vice-versa. Proponents of this "concentration-stability" view argue that larger banks can diversify better so that banking systems characterized by a few large banks will be tend to be less fragile than banking systems with many small banks (Allen and Gale, 2003). Concentrated banking systems may also enhance profits and therefore lower bank fragility. It has also been argued that the higher the concentration in the local bank market; the higher prices are for financial services, and consequently the higher the banks' profits. This is because banks in less competitive environments charge higher interest rates to firms. If concentration is positively associated with banks having market power, then concentration will increase both the expected rate of return on bank assets and the standard deviation of those returns (Beck, Demirgüç-Kunt and Levine, 2004: 2). The policy implication is that higher market concentration is associated with lower socio-economic welfare and, therefore, higher concentration is undesirable. Another cons concentration position is that a more concentrated banking structure enhances bank fragility. Advocates of this "concentration-fragility" view note that larger banks frequently receive subsidies through implicit "too big to fail" policies that small banks do not enjoy (Boyd and Runkle, 1993).

Persistence of Profit (POP) approach focuses on the time-series behaviour of profitability, suggesting that any temporary deviation of firm profitability from market average is quickly adjusted through entry and exit effects (Goddard et al., 2006). This implies that there are two conditions of POP. That is, the entry and exist are sufficiently free to eliminate abnormal profit and all firm's profits tend to converge towards identical long run average value. Levonian (1993) using the data from America finds that despite restraints on competition imposed by bank regulation, abnormal profits tend to be temporary, rather than permanent. Goddard et al. (2004)