Journal of Economics and Business 83 (2016) 70–90

Contents lists available at ScienceDirect

Journal of Economics and Business

Bank efficiency and local market conditions. Evidence from Italy☆

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ARTICLE INFO

Article history:
Received 27 March 2015
Received in revised form
23 September 2015
Accepted 30 September 2015
Available online 20 October 2015

Keywords:
Local markets
Mutual-cooperative banks
Stochastic frontiers
Efficiency determinantsG21
C13
D22
O16
P13

ABSTRACT

This paper evaluates the impact of local market conditions on small mutual-cooperative banks' (BCCs) efficiency over the period 2006–2011. Efficiency is first estimated applying stochastic frontiers and then regressed against individual and environmental factors. The latter are meant to gauge the structure of the provincial banking market, which is the BCC reference market. Results show that BCCs have performed better than other banks in the present crisis, although efficiency has decreased over time. Furthermore, BCC efficiency increases with market concentration and demand density and decreases as the number of bank branches in local markets increases. This holds whatever the frontier (cost or profit). Finally, local development negatively affects (only) cost efficiency, while BCCs generate more profit when systemic credit risk increases.

☆ The authors would like to thank Sergio Destefanis, Elyas Elyasiani, Damiano Silipo and two anonymous referees for very useful comments on an earlier version of this paper. Editorial assistance by Martin Brimble and John Richard Broughton is also acknowledged. The usual disclaimer applies. At the time of writing this paper, Graziella Bonanno was post-doc visiting student at the Royal Docks Business School, University of East London. She received a Research Fellowship from the Calabria Region and EU Commission.

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http://dx.doi.org/10.1016/j.jeconbus.2015.09.002
0148-6195/

1. Introduction

As in many other countries, the Italian banking industry has experienced great deregulation and consolidation processes over the last two decades. One important reform regards the relaxing of geographic constraints, so allowing banks to open branches throughout the country. This has induced a territorial diversity in bank organization and an increase in competition in even very narrow local markets (Giannola, 2009; Messori, Tamburini, & Zazzaro, 2003; Silipo, 2009)[1].

Due to the restructuring, the market configuration involves (a) several commercial big-banks operating throughout the country—the largest of which also act as big players in international markets, (b) a growing number of medium-sized cooperative banks which are organized as "Popolari" banks and (c) a network of small mutual-cooperative banks (Banche di Credito Cooperativo, henceforth BCCs). While the reform has principally affected the big-players, it has not excluded the BCCs, which have embarked on a process of M&A to increase their size. At the end of 2013, there were 385 BCCs (411 in 2011), while there were more than 700 in the early'90s. Interestingly, the consolidation in the network of cooperative-mutual organizations has mostly involved BCCs, and one result has been that the number of BCC branches doubled in 10 years, from 2226 in 1993 to 4454 in 2013. In relative terms, BCC branches made up 14% of total branches in Italy in 2013, against only 10% in 1993. This process reinforces BCCs territorial specialization, since they tend to expand their relative role and participation within smaller, more local markets. In other words, BCCs have reacted to the reforms by re-organizing their networks through within-group M&A and, thus, maintained their presence in local markets.

Undoubtedly, the permanence of a plethora of BCCs, alongside big-banks, remains one of most interesting peculiarities of the Italian banking sector. Three main characteristics guide their operations and organization. The first is that their governance is based on a democratic member control rule ("one member, one vote") with widespread ownership across the member-customers. Second, they are embedded in the territory where they operate and, finally, they act to achieve goals which are inspired by mutualism. In brief, their mission is to be effective in promoting members' value, social cohesion and sustainable growth in the territory where their members live (Alessandrini, Presbitero, & Zazzaro, 2009; Battaglia, Farina, Fiordelisi, & Ricci, 2010; Boscia & Di Salvo, 2009; Gutiérrez, 2008). However, BCC survival is threatened by two forces. First, a crucial role in the new market is played by complex financial conglomerates which cause the disappearance of small entities. In a world of big-banks, small credit institutions are expected to disappear. Second, BCCs historically operated in small isolated local markets, which are now no longer protected because regulatory barriers to geographic expansion have been removed. Should local markets become contestable, BCCs will lose that quasi-monopoly power which assured their past profitability.

On the basis of these arguments, it becomes meaningful to investigate the determinants of BCC performance, given that they operate within an industry which is now much more concentrated and consolidated than it was. Given their number and the niche BCCs fill, it is important to understand how changes in environmental factors affect their viability. Due to its main research focus, i.e. the influence of local market conditions on BCC performance, this article combines two strands of the literature, one focusing on the evaluation of bank efficiency and another which investigates the determinants of efficiency.

Despite the huge amount of literature on banking efficiency – see, among many others, the exhaustive surveys by Aiello and Bonanno (2015), Berger and Humphrey (1997) and Fethi and Pasourias (2010) – few papers have focused on Italy. In this context, the evidence is mixed, but two main

[1] The major reforms date back to the 1990 Amato-Carli Act, the EU Directive II and the 1993 Consolidated Act and later continued with the 2002 budget law, the 262/2005 law and the 353/2006 Legislative Decree. The deregulation has had many different consequences. For instance, the number of banks has dropped drastically: from 1037 in 1993 to 693 in 2013. At the same time, the increase in bank-branches has been remarkable (22,133 in 1993; 32,106 in 2013). A rapid "bankarizationöf the territory took place: the proportion of municipalities with at least one bank branch increased from 46.43% to 74.23% over the 1993–2014 period. Italy also experienced a transformation from public-owned banks to private banks and nowadays the system is exclusively comprised of private cooperatives and joint stock companies (Ltd). A clear cut-off signal of the reform comes from increased market concentration due to the rise in Mergers and Acquisitions (M&A): the market share of the top 5 banking-groups grew from 36% in 1996, to 50% in 2000 and 64% in 2013 (Bank of Italy, 2013).