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SCIENTIFIC REVIEW ARTICLE

doi:10.5937/ekonomika1803055D

Received: March, 15, 2018

Accepted: May, 20, 2018

THE IMPACT OF OWNERSHIP OF BANKS ON THEIR PERFORMANCE: CASE STUDY OF SAMPLE OF BALKAN COUNTRIES

Abstract

The purpose of this paper is to investigate the relationship between bank ownership (foreign vs. domestic) and bank profitability in three South-Eastern European countries, Bulgaria, Macedonia and Serbia using individual bank data. There are a lot empirical evidences that banks with foreign ownership have better performance. This is due on the better corporate governance in those banks that is manifest with better risk management system. In micromanagement, better risk management system is depicted in better granting criteria, more strict and unbiased process, better monitoring system and more proactive strategy. This leads to better quality of the credit portfolio and better performance indicators. This paper will explore this hypothesis on basis of a sample of 24 banks from the three sample countries through a data series of ROE for the period 2008-2016.

Key words: Bank performance, ROA, Balkan countries

JEL classification: G21, G34

УТИЦАЈ ВЛАСНИШТВА БАНАКА (СТРАНИХ ИЛИ ДОМАЋИХ) НА ЊИХОВЕ ПЕРФОРМАНСЕ: СТУДИЈА СЛУЧАЈА КОД БАЛКАНСКИХ ЗЕМАЉА

Апстракт

Циљ овог рада је истраживање односа између власништва банака (страних и домаћих) и профитабилности банака у три државе југоисточне Европе, Бугарске, Македоније и Србије користећи појединачне податке банке. Постоји пуно емпијских доказа да банке са страним власништвом имају боље резултате. Ово је последица бољег корпоративног управљања у овим банкама који се манифестују са бољим системом управљања ризицима. У микро менаџменту, бољи систем управљања ризицима приказан је у бољим критеријумима за одо-

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браване, строжим и непристрасном процесу, бољем систему праћења и проактивној стратегији. Ово доводи до бољег квалитета кредитног портфела и бољих показатеља учинка. Овај рад ће истражити ову хипотезу на основу узорка 24 банке из три државе кроз серије података РОЕ за период 2008-2016.

Кључне речи: *перформансе Банке, РОА, балканске земље*

Introduction

According to OECD (OECD, 2004.p6) Corporate governance is defined as a 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 and responsibility are allocated and how corporate decisions are made. Something in those relationships between the stakeholders of banks was functioning poorly because corporate governance was one of the topics that came under strong criticism after the financial crisis.

BCBS (BIS, 2015.p.3) says that effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole. So, the proper functioning of the system of corporate governance is important because banks perform a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole. Recent literature (Adams and Mehran, 2012.p.28) document the pivotal role of corporate boards as an essential instrument to performance of banks, particularly after the global financial crisis in 2008.

Analysis of the various mechanisms by which corporate governance is exercised becomes relevant given two conditions: an agency problem generating conflicting interests between the various parties involved (owners, managers, creditors, employees); or transaction costs so high as to prevent resolution of conflicts by contract between the parties (incompleteness of contracts) (Generale and Gobbi, 2000.p.35). The most commonly studied conflicting interests are those of providers of finance (owners and creditors) on the one hand and management on the other and those of suppliers of finance enjoying different preference (equity and debt capital). In the former case, the problem is to oblige management to pursue maximization of the value of the firm rather than personal advantages. In the latter, differing positions in case of liquidation create differing preferences on risk-taking. Specific forms of ownership correspond to different degrees of informational asymmetry. Becht (Becht, 2002.p.1) argue that the corporate governance problem arises whenever an outside investor wishes to exercise control differently from the manager in charge of the firm. La Porta and other authors (2001. p.8) identified the risk of outside investors being expropriated by insiders as a corporate governance problem. Berglof and Von Thadden (1999, p.4) pointed out that the “recent literature is based on the premise that the main corporate governance problem is (the conflict between) self-interested management and weak, dispersed shareholders”.

The credit crisis of 2008 has reconfirmed the importance of good governance for sound performance of banks, raising the need to understand the agency problems in banks and the efficiency of various corporate governance mechanisms in mitigating these problems. Therefore, it is easy to see that external shocks to an industry provide researchers intriguing opportunities to investigate the performance and adaptation of corporate governance systems (Kole & Lehn, 1997). Banks have a number of specific characteristics that “alter” the agency problems and require a different view of corporate governance. For example, banks are organized in a variety of ways, from stand-alone corporate entities and single bank holding companies to multiple bank holding companies and diversified holding companies (Macey & O’Hara, 2003.p.93). Banks’ assets are more opaque, which makes it harder for the owners to monitor their bank’s activities.

Banks also have the ability to take on risks very quickly, in a way that is not immediately visible to directors or outside investors (Becht, Bolton & Roell, 2012.p.21). Moreover, banks are subject to stricter regulation by regulators and deposit insurance, which has important implications for the risk-taking incentives of bank managers and moral hazard problem in banks. The existence of regulators and deposit insurance ensures that the core source of funding which comes from the depositors is protected since this group of stakeholders (depositors) pay less attention to the bank’s risk profile. Another reason for banks to be treated differently is the influence/role of their special groups of stakeholders, which are depositors, bondholders and regulators, i.e. banks are multi-constituency organizations (Becht, Bolton & Roell, 2012.p.26).

One important determinant of the structure of corporate governance is the ownership: is the dominant owner domestic or foreign – international bank. If the owner is foreign bank than it can transfer know how but also can be a transmitter of problems in the country of its origin. Domestic shareholders cannot provide capital or liquidity support so easily and also are probable more biased in making credit decisions.

Until the 2008-09 financial crisis, foreign ownership was viewed as a key ingredient of financial development and a driver of economic growth. However, this view changed since foreign banks were the main conduits in transmitting the crisis from western into transition countries (Bakker & Gulde, 2010.p22). Consequently, analyzing corporate governance of banks in relation to their (foreign) ownership and its implications for bank behavior during the recent financial crisis is a current and relevant question. The same applies to the board structures of these banks, as well as risk management frameworks and practices. This is mostly relevant and important for the emerging countries, where the dominance of foreign owned banks is so pronounced. How independent are the supervisory boards and management of such institutions? How relevant are their policies to local conditions, and how responsive are they to local needs? Are the shareholders and board committed to support the local institution in a crisis or will they shut down credit and limit their exposures because of problems originating in their parent bank abroad? Are they collecting local funds for transfer to foreign operations? Are they willing to sacrifice the liquidity and solvency of the small local institution to the needs of the parent?

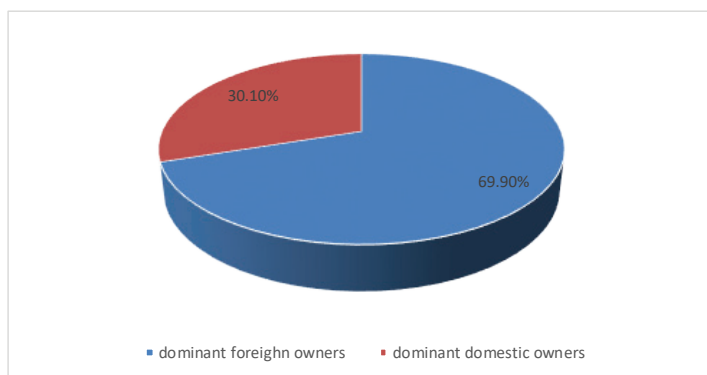
Also, the system of corporate governance influence on the performance of the bank. The studies focusing on the origin of the owner (foreign vs. domestic) find foreign banks to be more profitable in general but specificities of the country of their operation do have an impact on their performance. Demircuc-Kunt & Huizinga (1999.p.405) find that foreign banks have higher margins and profits compared to domestic banks in developing countries, while the

opposite holds in developed countries. In investigating the determinants of bank efficiency and performance Bonin, Hasan & Wachtel (2005.p.26) find that foreign- owned banks are significantly more cost efficient than domestic banks.

Ownership of banking systems of the sample countries

The banking systems in the Balkan countries are heavily owned by foreign owners mostly from West European countries. The start of the transition process in 1989 heralded the large-scale entry of foreign banks into Emerging Europe. Western-European banks with saturated home markets were attracted to the transition region due to its scope for financial deepening and its ample growth potential. Policy makers and development institutions stimulated financial integration because of its presumed positive impact on the efficiency and stability of local banking systems. The empirical evidence that emerged over the next two decades suggests that foreign bank entry indeed stimulated competition and transferred know-how (Fries and Taci, 2005.p24) and that foreign banks were relatively stable credit sources during local financial turmoil. The ownership structure in the three sample countries confirm the dominance of foreign investors in their banking systems. In the banking system of Macedonia the banking system is dominantly owned by foreign owners. At the end of 2016 the banks that are owned by them contribute with 70% in the total assets of the banking system and comprise of 11 banks (Figure 1). Domestically owned are four banks, from which one is state owned.

Figure 1 - Ownership of Macedonian banking system



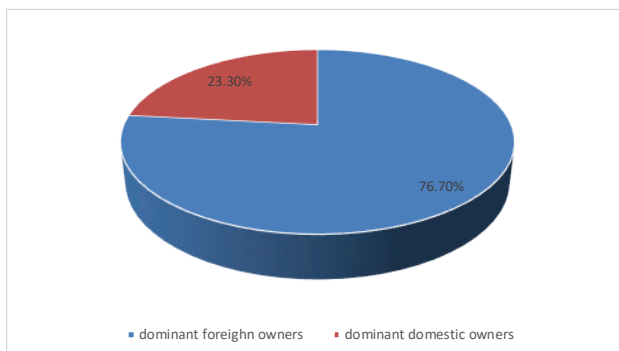
Source: National Bank of the Republic of Macedonia

Not just in total assets, the banks that are owned by foreign shareholders dominate all the positions in the banking system which makes it vulnerable on external macroeconomic developments. The other important characteristic is the concentration. The biggest three banks have share of around 58% in the total assets.

The situation regarding the ownership structure of the Serbian banking system is not so different too. The banks that are owned by foreign shareholders at the end of 2016 hold more than 2/3 of the banking assets (Figure 2). The same share is more or less present in all the rest

of relevant categories like capital, network, employment etc. The number of banks that are owned by domestic shareholders it's 8 and foreign owned are 22 banks.

Figure 2 – Ownership of Serbian banking system

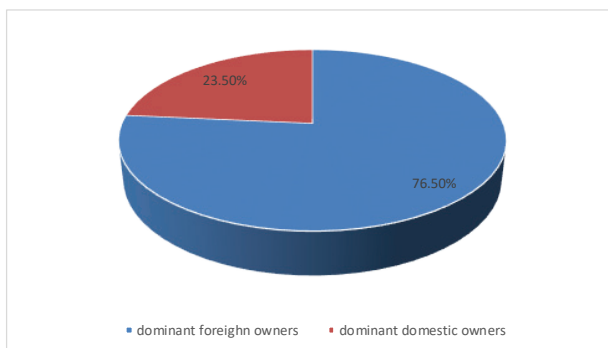


Source: Serbian central bank

Regarding the concentration in the Serbian banking system, the top five banks hold 55% from the total assets, so it is less concentrated system than the Macedonian one.

The Bulgarian banking system, regarding the ownership, is not exception. The share of the banks that are owned by foreign owners at the end of 2016 is more than 2/3 of the total assets of the system (Figure 3).

Figure 3 – Ownership of Bulgarian banking system



Source: Bulgarian central bank

Measure of the performance of the sample banks

In general, the performance is defined as the achievement of the objectives set forth by the firm (the bank) within the agreed time and with minimal costs while using the available resources. For example, for a manager, the performance may be profitability or competitiveness for the company or for the employee, the work environment, or the quality

of services rendered for the customer. The multiplicity of possible approaches brought out a concept determined due to the diversity of groups that make up the organization.

Generally bank performance studies rely on two types of indicators: accounting based indicators and profit or cost efficiency indicators based on the efficiency and productivity analysis. In this paper we use accounting-based profitability indicators in banking. According to Čok and Košak (2008,p101) profitability ratio return on asset (ROA) is considered to be a core performance indicator used in majority of studies. ROA directly or indirectly incorporates most of the aspects of the banking business. An alternative profitability indicator frequently used in bank performance studies is return on equity (ROE) ratio. If ROA reflects the ability of bank management to generate profits from the available bank's assets, then ROE indicates the return to shareholders' equity. Both indicators are directly related through the asset-to equity ratio, which measures the financial leverage of the banking firm. Čok and Košak emphasize that both indicators have some shortcomings. The ROA indicator may be biased because it ignores the off-balance sheet activities of banking firms, while the ROE indicator disregards the impact of risk associated with different levels of leverage that in connection with ROA directly determines the size of ROE.

This paper will use the ROE as a measure for bank performance. The ROE is chosen because the main focus of the paper is the impact of the ownership (foreign/domestic) on the performance. Having in mind that the shareholders invested their capital for return and their main objective is return on their capital on mid or long term then ROE should be better indicator.

Impact on the type of ownership of the performance of the banks

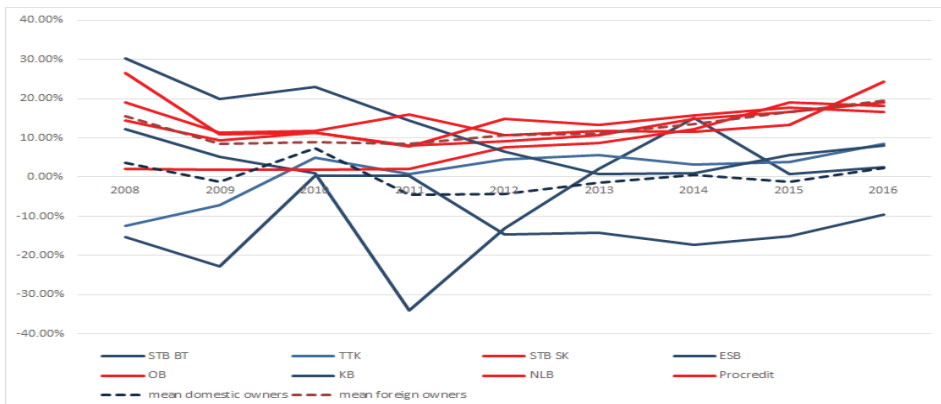
The main focus on this paper is to evaluate the performance of banks with dominant foreign and domestic owners. The literature and empirical evidence, especially when the banking systems of the Balkans are in question, says that the banks with foreign owners have better performance (Fries and Taci, 2005.p24). This is mainly because of the transfer of know-how and better system of corporate governance. This paper will evaluate the performance of sample of banks in three Balkan countries: Macedonia, Bulgaria and Serbia. Of course the performance of a bank, that will be measured by ROE, is not dependent only on the ownership structure but also on market position and other idiosyncratic factors. In order the conclusions of this paper to be relevant, special attention must be put when the sample is determined. So, from each sample country 6-7 individual banks are analyzed and half of them are owned by foreign owners and the other by domestic ones. Also, the banks that are chosen are similar in size in order the results to be relevant. The banks that are in the sample comprise more than 50% of the banking system in all sample countries.

Macedonia

From the banking system of Macedonia eight banks are analyzed, and half of them are owned dominantly by foreign shareholders. The period that is analyzed is from 2008-

2016. The empirical results confirm that the banks with foreign owners have greater ROE than the one that are owned by domestic shareholders. The mean ROE is greater on the sample banks of foreign owners through the whole period. Also, in the last three years all the banks that are owned by foreign shareholders have greater ROE than the bank with higher ROE that is owned by domestic shareholder. This is due on the weaker profitability position of the banks with dominant domestic owner. The further analysis shows that the weaker profitability doesn't come from worse operational effectiveness but from the quality of the credit portfolio. In other words, the difference in ROE comes from differences in corporate governance that are expressed through granting criteria, strategic decisions, tolerance for risk etc. The bank with dominant domestic owners with higher ROE in 2015 and 2016 has $\frac{1}{2}$ of the ROE of the bank that is owned by foreign owners with smallest ROE from the sample (Figure 4). And in the case of Macedonian banking system this sample is relevant because it represents more than 75% of the total assets of the banking system. The data from our sample show that from 2012 till 2016 all the banks that are owned by foreign owners have bigger ROE than the bank with higher ROE that is domestically owned. The ROE in one Macedonian bank that is higher in 2014 is due on extraordinary profit and it is not a result of every day operations.

Figure 4 – ROE of sample of Macedonian banks in the period 2008-2016



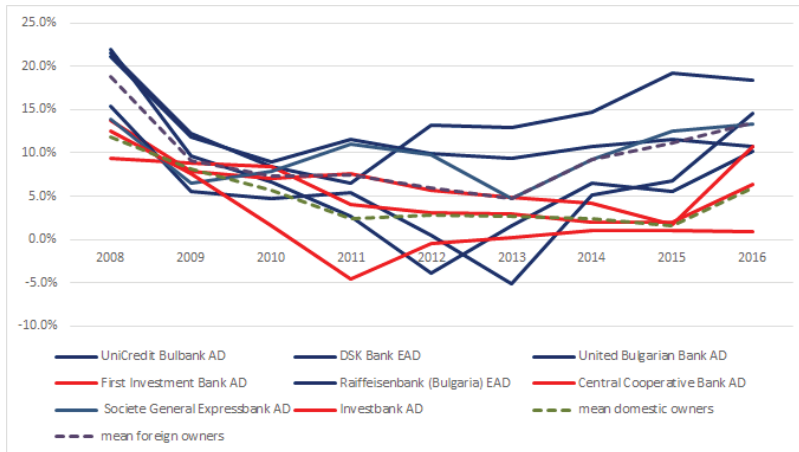
Source: Individual audit reports on the sample banks

Bulgaria

The sample of banks consist of eight banks and five of them are dominantly owned by foreign shareholders. The analysis of ROE in 2016 shows that all the banks with foreign owners have higher ROE than the most profitable locally owned bank. The main difference, if we compare Bulgaria and Macedonia is that in 2010 all the banks from the sample as a consequence of the EU debt crisis, had similar ROE (Figure 5). After 2013, the trend is more than evident. The banks that are dominantly owned by foreign investors have higher ROE. The difference in ROE in the bank with higher return between the banks that are owned by foreign owners and domestic owners is more than double. The average ROE from the two

types of sample banks shows clear gap that is narrowed in 2010 and again expands from 2014 till 2016.

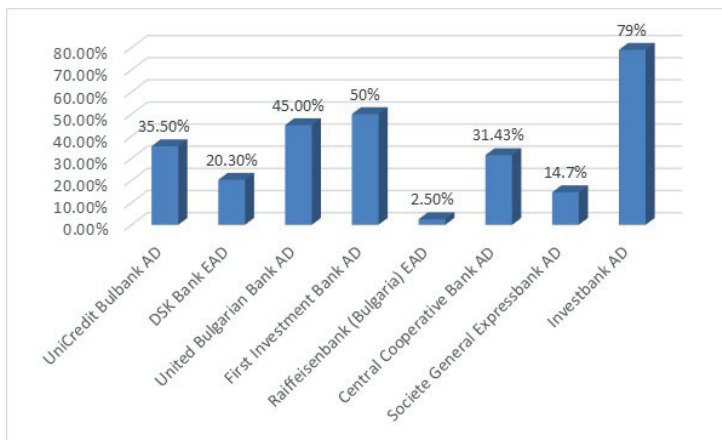
Figure 5 – ROE of sample of Bulgarian banks in the period 2008-2016



Source: Bulgarian central bank

Like in the case of the sample banks from Macedonia, the main difference in ROE comes from the quality of the credit portfolio. The ratio of impairment for 2016 and net interest income gives very clear picture (Figure 6). The banks that are owned by foreign shareholders have smaller ratio and are more profitable. We can argue that that is due on the market position, better access to clients or cheaper source of funding. Still, at banks with similar market share the difference in this ratio is obvious.

Figure 6 – Impairment of financial assets/ net interest income for sample of Bulgarian banks for 2016



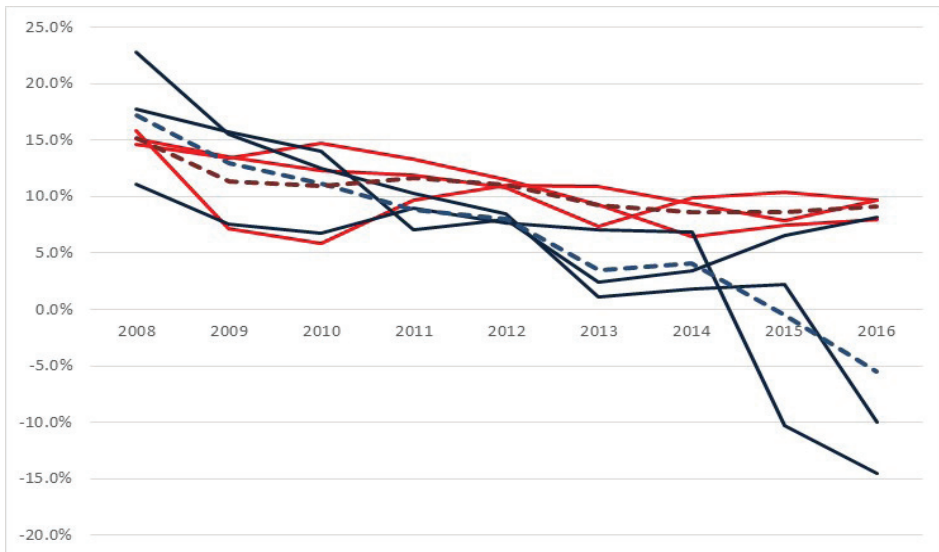
Source: Bulgarian central bank

Serbia

The same conclusion that was brought for Macedonia and Bulgaria can be confirmed on a sample of six banks from which three are owned by dominant domestic owner. The difference in ROE between the two types of banks is evident through the whole period starting from 2010 till 2016. Before that the effects from the financial crisis were felt in all banks. The difference in ROE starting from 2012 is even more emphasized (Figure 7). The biggest bank that is owned by domestic shareholders has negative ROE in the last two years which is due on the bad quality of the credit portfolio. The impairment of financial assets and credit risk-weighted off-balance sheet items is higher than the net interest income for 2016.

The banks that are owned by foreign shareholders have similar ROE around 10% in 2016 and two of three sample banks that are owned by domestic owners have negative ROE in 2016. Starting from 2012, the difference in the average ROE on the two types of sample banks expands.

Figure 7 – ROE of sample of Serbian banks in the period 2008-2016



Source: Serbian central bank

Conclusion

The corporate governance structure is important for the performance of a bank. There are a lot of empirical evidence that the ownership (foreign/domestic) structure in SEE countries have great impact on their performance. Banks in SEE countries that are dominantly owned by foreign shareholders have better performance. One factor that contributes for better performance is the transfer of know-how and better risk management system. The sample of banks from the banking system of three Balkan countries confirm the previous researches. In all countries, especially after the financial

crisis the performance of the banks with dominant foreign owner measured through ROE is much better. And that trend is continuous from 2010 till 2016. In 2016 in all three countries all the banks that are owned by foreign owners have higher ROE than the bank that is owned by domestic shareholders with the highest ROE. The reasons for lower ROE at the banks with domestic shareholders lie at the worse quality of the credit portfolio. And the quality of the portfolio is mainly due on the quality of the granting process and granting criteria and system of monitoring or in one word the quality of management of credit risk. This is pure corporate governance issue and we can argue that the banks with foreign owners in the sample countries have better systems for management of credit risk.

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