JOURNAL OF THE ASIA PACIFIC ECONOMY, 2019
VOL. 23, NO. 3, 428–446
https://doi.org/10.1080/13547860.2018.1469585

Bank- and country-based determinants of banks' performance in Asia

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ABSTRACT

This paper examines the joint impact of bank- and country-based drivers of performance of banks in 11 Asian countries. The panel data technique is used to deal with possible endogeneity issues and the heterogeneity of individual banks. We find evidence that the ownership structure and the capital ratio are critical determinants of the banks' profitability. The revenue diversification impacts negatively on the net interest margin. Examining the institutional factors of banks' performance, we find that enhanced financial and regulatory structures reduce the capacity to generate non-competitive, abnormal profits. Those most affected are the consumers, who bear the burden of higher prices resulting from weak competition.

KEYWORKS

Banks' profitability; agency problems; corporate governance; Asian banking system; capital ratio; regulatory system

1. Introduction

The role of banks as financial intermediaries is to cycle funds from deficit to surplus agents in the most efficient manner possible. Since banks are the most influential agent in countries' economic growth and development (Levine 1997), good corporate governance practices are necessary in the banking industry to ensure stable long-run performance. Nations with well-developed banking systems and sound financial institutions are more likely to experience persistent growth and better face the onslaughts during economic recessions (Hung 2003).

From a global perspective, Asian economies have been gaining significant attention over the last few decades (Peng, Bhagat, and Chang 2010; Pilbeam 2005). Specifically, the performance of Asian banking has been affected in different ways by bank-level financial decisions (Moshirian 2008) as well as of new country-level regulatory conditions and exogenous forces such as economic crises (Soedarmono, Machrouh, and Tarazi 2013). Therefore, the goal of this research is to study how bank-level and country-level variables determine banks' profitability in the Asian region. By doing so, this study provides a broader understanding of the factors affecting the profitability of banks.

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We chose the Asian banking sector for several reasons. First, previous literature is mainly focused on the analysis of US and European banking industry, with much less discussions and insights on the Asian banking industry. Second, Asian countries have faced dramatic financial reforms and deregulations over the last few decades (Cook 2008; Seenaiah, Badri Narayan, and Amaresh 2015). Therefore, the analysis of banks' profitability might provide further insight into the efficiency of such interventions. Third, the private sector of the Asian economies is considered vulnerable due to the presence of poor accounting standards, weak transparency in management, and political turmoil all of which cause restrictions to bank credits (credit rationing) with the subsequent financial instability in the region (Stiglitz and Weiss 1981; Pontines 2008). Hence, the analysis of the determinants of banks' profitability might guide policy-makers and regulators to apply measures to ensure financial stability. Thus, the profitability of the Asian banking industry seems to be an appealing and unexplored research field.

The major contributions of this paper are: (i) unlike the previous literature for the Asian context, we follow an eclectic one-step estimation process based on a behavioral model of banking firms which combines bank-based as well as country-based determinants of banks' profitability under a governance approach. For instance, Lee and Hsieh (2014) examined the impact of foreign ownership on financial stability, but with no consideration of corporate governance features. Similarly, Perera, Skully, and Chaudhry (2013) analyze the determinants of commercial banks' profitability, but they fall short in building hypotheses on the impact of country-level variables on banks' profitability; (ii) the major limitations of the current literature on the Asian banking industry is rooted in either the scope or scale of its analysis for further inference. For instance, there are studies focused only on an individual Asian country (Berger, Hasan, and Zhou 2010; Ariyadasa et al. 2017; Seenaiah, Badri Narayan, and Amaresh 2015). Our study, however, reveals a holistic view of major drivers of Asian bank performance by using a representative sample of banks from 11 Asian countries; (iii) we use a suitable estimation technique that allows us to control the unobservable heterogeneity problem of individual banks and the endogeneity problem, which is a consequence of unclear identification of causality in the model estimations; and (iv) we factor into the analysis certain corporate governance characteristics of individual banks measured through variables which describe the banks' ownership structure features. To the best of our knowledge, there are no studies which link the ownership structure of Asian banks with their profitability.

This paper is organized as follows: Section 2 articulates the related literature and develops the research hypotheses, Section 3 describes the methodology and variables applied in the empirical analysis, the main results are shown in Section 4 and after this, in the final section, the paper draws the conclusions and policy implications.

2. Related literature and research hypotheses

2.1. Determinants of banks' performance and research hypotheses

2.1.1. Bank-based determinants

Bank-based variables are those controllable by management and account for intra-firm differences in commercial banks' profitability. In this section, we derive hypotheses on capital ratio, ownership structure, and revenue diversification as determinants of banks' profitability.