Determining the Drivers of Banking Profitability: A Global Analysis

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The concept of banking as *a service of intermediation* that facilitates economic development and enhances welfare dates to earliest recorded history. While banks have come a long way over the centuries in terms of their offerings, their primary business and operating practices have remained materially unchanged. Banks attract monetary deposits by providing security, interest, and related services. They then use deposited funds to issue credit or loans to borrowers who require financial capital. In this process, banks charge interest as a cost of present consumption, which is higher than the interest paid to depositors who forgo consumption. The spread between lending and borrowing interest rates represents the bank's profits. Hence, one might surmise that interest rate spread alone determines bank profitability. Nevertheless, if interest rates are the only driver of bank profit, one may question why there are differences in bank profitability over time, or more accurately, over different interest rate environments?

To answer this question, I examine a wide range of firm-specific variables alongside industry and macroeconomic variables that impact the profitability of publicly traded banks. Traditionally, banks earn a profit on the interest rate spread, the difference between what they collect from loans and what they pay out to depositors. The measure of profitability is best captured in the bank's Net Interest Margin (NIM).

Although NIM is an effective measure of profitability for traditional banks, the passage of the Gramm–Leach–Bliley Act (GLBA) in 1999 required consideration of non-traditional banking activities. GLBA repealed part of the Glass-Steagall Act of 1933 by removing certain regulatory barriers among banks, brokers, and insurance companies. As a result, more recent academic banking literature employs more comprehensive and holistic profitability measures that are common in non-financial industries, such as Return on Assets (ROA) and Return on Equity (ROE).

In this dissertation, I identify a host of explanatory factors that impact the various measures of bank profitability. Leveraging on prior research, I scrutinize macroeconomics, industry, and firm-specific variables as drivers of bank profitability. Following is a summary of my key findings:

- All three profitability variables, NIM, ROA, and ROE, are serially correlated, suggesting that a strong connection exists between current and lagged profitability. Simply put, current banking profits are substantially associated with prior profits.
- In examining NIM relative to the short-term sovereign rate, rate spread, and general economic health, global publicly traded banks can exploit the spread between the interest paid and interest earned profitably.
- Publicly traded banks in more concentrated industries are able to charge higher interest rates to borrowers and generate higher profits.
- Firm-specific factors moderate each publicly traded bank's capacity to generate higher profitability in each favorable macro and industry environment.
- An analysis of the sample data before and after both a financial and a non-financial exogenous shock suggests that the drivers of profitability remain robust in unusual market environments.

In summary, I find that publicly traded banks generate profitability from both interest rate and non-interest rate sources. The latter appears to be a diversifier for larger global banks, and shocks to our economic and financial systems do not impede the general ability of banks to generate profits from both the interest rate environment and other sources.

Overall, my findings provide evidence that modern banking systems have a broader base of potential profits than when their business was limited to the traditional banking functions. Increasing the scope of their activities enables them to diversify their business in closely related ways that support their overall strength and stability.