

Abstract

The concept of cost efficiency has repeatedly been proven to have some signaling effect for the risk of a bank failure. In this paper we examine the informative value of the efficiency scores of institutions that have been experiencing distress within the current 'subprime' crisis. For this purpose we employ the parametric stochastic cost frontier method and estimate the cost frontier of five European banking sectors using the pre-crisis data of the period 2004- 2007. On a sample of 18 bailed-out institutions we then investigate whether abnormal development in terms of relative cost efficiency preceded the distress. We find that in all examined sectors, except of the British one, distressed institutions performed prior to the crisis on average worse than their peers in terms of relative cost efficiency. Besides, we observe that while the high-profile rescue cases of continental Europe (Dexia, Fortis, HRE) were preceded by years of excessively poor performance, the bailed-out British banks were in all concerns best performers within their relevant industries. The paper is concluded by a discussion of the fundamental risks that result from the current reshaping of the European banking industry.