

# Evaluating Banking Localism: Trends and Critical Issues

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## Abstract

This study, after having mentioned the characteristic elements for the definition and conceptual framework of local banks, questions the evaluation methods that can be used to best appreciate their economic value. There are frequent academic studies that address the examination of the evaluation criticalities related to the specificities of banking companies (Beltrame & Previtali, 2016); conversely, there are few scientific contributions of interest on the appraisal techniques of local banks. The main objective is to hypothesize a new specific synthesis model of business valuation.

## Keywords

Equity Value, Local Banks, Evaluation Methods, Size Premium, Excess Capital

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## 1. Local Banks: Definition and Requirements

The banking system is in continuous metamorphosis, subjected to new strategic and organizational structures, which respond to the changes taking place in the global financial intermediation scenario (Bake, Filbeck, & Ricciardi, 2017).

The international economic and financial crisis has constituted in recent years the main exogenous variable to be contained through the implementation of corporate choices, which in appearance could even prove to be contradictory. In fact, if on the one hand there have been business aggregations, through mergers among several banks or the creation of new business groups, on the other hand the number of bank branches present in the territory appears unchanged, and in some cases even in an increasing trend.

From this observation arises the interest, on the one recipient investigating the phenomenon of banking localism<sup>1</sup>, for the improvement of the information qual-

<sup>1</sup>The local bank is an organization born and raised in the district, very well connected to local entrepreneurs, strongly involved in local life which it knows in all its details (Becattini, 1991).

ity offered to customers, in the risk assessment phase (adverse selection) and in the estimation of the recipients' future behavior (moral hazard), while, on the other hand, financial globalization can be faced through the realization of appropriate corporate acquisitions. Naturally, in the case of territoriality, banking firms will be equipped with perceptive structures adequate to receive the various and distinct requests of customers, offering financial services useful for realizing any appropriate local strategies (Shefrin, 2010; Statman, Fisher, & Anginer, 2008).

The company management wants to combine the advantages deriving from relationship lending strategies, combined with traditional banking localism, with those of transaction lending, which can be compared to the model of large banks. The objective is to privilege the economic-local substance of the financial service offered, without losing the economic privileges of large banks (Kobler, Bucherer, & Schlotmann, 2016).

The large banks, sensing a loss of market share, especially in collection services (deposits) and lending, have opted for strategic choices of market segmentation by geographical territories, inspired by decision-making and operational decentralization through the provision of specific organizational sub-units and the development of networks. All this is possible if the increasing size of banking institutions is compatible with the occurrence of banking localism, through the implementation of the so-called multi-layered strategic planning (Messori, 2010). This implies that the dimensions to working on daily are at least three levels: a corporate strategy; a national/international strategy and a local strategy.

Therefore, when drafting a possible annual business plan, it is necessary to start by designing a single, centralized and generic mission, which must then be "customized" at the country level to identify the critical national factors in line with the general indications. Finally, the same reasoning is repeated downstream of each individual strategic business area (SBA) where, in greater detail, the tactics will be defined, understood as actions or sets of actions capable of implementing the predefined strategy upstream, at the local level (Ayadi & De Groen, 2014).

From a management point of view, what has just been stated, from a strategic perspective, will be achievable by adapting the organizational structure to the new market needs. The latter has undergone substantial changes in recent years regarding both the actor's role and the customers' needs (Mottura, 2006).

As regards the actors, the diffusion of the figure of global players has just been mentioned, even in the banking sector, to safeguard the competitive advantage. Instead, as regards the needs of the customers, there is a demand for globalized financial products and therefore comparable to those of the other major banks, even if developed considering their own local needs. In practice, an organizational system that responds to the matrix scheme is spreading. This implies that the functions and processes at central level can also be represented at local level, with the identification of a local manager (Farnè & Vouldis, 2017).

From here, the term used at the doctrinal level of "glocalization" is explained, it summarizes the sought-after union between globalization and localism (An-

selmi, 2002). The need is to reconcile a common image with peculiar local characteristics<sup>2</sup>.

In this context, the main difficulty is to adapt to localism with dimensional growth, considering that local banks generally arise in small and medium-sized business contexts. This latter aspect favors the development of interpersonal relationships between employees and customers; local banks, in this way, achieve a better knowledge of the territory and become more aware interlocutors (Angelini, Di Salvo, & Ferri, 1998).

However, at present, the recessionary phase, affecting the various economic sectors transversally, is causing a weakening in the customers' perception of the differences emerging in the banking products offered. This has led, and perhaps only for a transitory phase, to the interest of local customers in those products at a lower cost. This means that, in a period of economic crisis, consumers prefer strategic policies of cost leadership, rather than those of differentiation.

## 2. A Decline of the Evaluation Methods for Local Banks

After having previously mentioned the characteristic elements for the definition and conceptual framework of local banks, the research focuses on the evaluation methods that can be used to estimate their economic value. There are frequent academic studies on the evaluation criticalities related to the specificities of banking firms (Beltrame & Previtali, 2016); conversely, there are few scientific contributions on the estimation techniques of local banks.

The main reasons can be attributed to the limited empirical evidence of similar business combination operations in this specific area and to the tendency towards a generic type of regulation, without imagining innovative and singular appraisal solutions. There are few valid theoretical references to take into consideration and this study will be based on an examination of local banks in their distinctive elements, from which to derive hypotheses of adequate appraisal models.

The investigation can be conducted in the following three main directions:

- a) dimensional aspect;
- b) ownership structure;
- c) level of control.

They summarize the main peculiarities of local banks, which influence the estimation techniques of the company value. First, the use of estimation systems already in use is admitted, and, conversely, the definition of a single ad hoc model for local banks is still not practically evident.

Therefore, this work will systematize those solutions that seem adequate to the case in question, leaving the evaluator the discretion of the choice based on the circumstances. The most coherent choices will be reported, also trying to define a single model that synthesizes the differences emerging from the various systems.

In fact, a possible future implication of this research is to design a new com-

<sup>2</sup>Globalization can be implemented by creating or distributing products and services designed for a global or international market but modified to suit local practices or culture.

bined model of business valuation, which synthesizes in a single approach the distinctive elements of each measurement technique presented. For all that, in this paragraph, the most suitable methods to enhance each single direction will be indicated, synthesizing them in a single overall solution. The study will be limited to the three contemplated directions only; other peculiarities of local banks could also be included, such as modifying the conceived model.

### 3. The Small Size Premium Approach

This approach assumes the inclusion of a premium for company size. The ratio is to select measurement techniques that are attentive to a particular company characteristic of the local banks under consideration, precisely because they are often small and medium-sized banks (Agliata, 2019).

The basic idea is to admit the existence of a size premium, since historically the shares of smaller firms have achieved a higher return than larger firms. A corrective factor to integrate the market risk is foreseen.

Duff & Phelps (2016) assert that the size variable would differentiate returns, to the detriment of size. In other words, the return would be inversely proportional to the level of company growth, this last aspect can be examined from different points of observation: sales revenues; EBITDA; stock market capitalization; etc..

From a procedural point of view, the correction method in the estimation techniques does not appear clear; a standard premium linked to the size class would be the easiest solution. However, this solution would be unconvincing from a theoretical perspective (Bini, Brugger, Buttignon, Marcello, Massari, & Petrella, 2019). In this regard, a more accurate estimate of the financial flows, discounting the greater risk associated with a reduced size, seems preferable.

The methods of determining this corrective factor are discussed, even before measuring the actual contribution to the company value of the premium associated with size, and the prevailing orientation would converge towards a specifically revised financial analytical methodology (DCF). Therefore, the dimensional risk would be conceived as a correction for specific company risks and, when discounting the expected cash flows, it should be considered in the calculation of the cost of capital or in the determination of prospective cash flows.

As regards the adoption of the discount rate, even for local banks, the CAPM (Capital Asset Pricing Model) method is preferred, typical for equity side approaches (net of debt). The latter are considered more suitable by academic studies, when estimating banks, due to the peculiar role of debt capital and the nature of the production process in these firms (Beltrame, Caselli, & Previtali, 2018).

The studies that have been conducted in the literature, from which the inverse relationship between company size and risk/return of firms has emerged, consider, in fact, the size premium as an expression of the greater return/risk connected to the small size. From here, the calculation of the cost of equity capital has been derived, where this premium is reflected as an added to the CAPM formula; a specific and non-systematic risk could be associated with the size element (Tor-

chio & Surana, 2014):

$$K_e = R_f + \beta(R_m - R_f) + Sp$$

where:

$Sp$  = *size premium*

Otherwise, the intervention in the expected cash flows is conceivable, this last hypothesis is preferable when there is external evidence able to corroborate such adjustments. In this circumstance there would be no theoretical superiority of the valuation approach, based on the adjustment of the discount rate, compared to the method of discounting the expected cash flows at the cost of capital.

In truth, between the two procedural hypotheses contemplated, in general, a different assumption of responsibility within the company can be associated. The accountant expresses his opinion on the amount of the alpha factor (expression of the size premium), in the case of intervention on the cost of capital; vice versa, the management expresses its opinion, in the event of intervention on the prospective financial information. In practice, synthetic intervention on the cost of capital is preferred only when the management is not able to develop a satisfactory and reliable analytical plan.

In support of analytical methodologies, the adoption of synthetic empirical approaches is contemplated (market multiples). Also in this case, the dimensional aspect cannot be overlooked, both in the approach of comparable companies and comparable transactions<sup>3</sup>.

Indeed, the sample of listed companies or comparable transactions must be built considering the characteristics of local banks, so the empirical method can be used as an estimative verification by analytical techniques. Nonetheless, comparability should also be estimated in terms of the business model present in the local banks' activities (Maglio, Cuccurullo, & Tuccillo, 2020). The lack of empirical evaluation evidence for local banks supports market multiples not as the main estimative reference, but rather they could be used as a reference for analytical methods (Massari & Gianfrate, 2009).

#### 4. The Dividend Discount Model

Regarding the second point, the ownership structure becomes a crucial element of corporate differentiation, such that attention is focused on the levels of profitability satisfactory for shareholders, as well as on the estimation techniques of the corporate value based on the dividends payable to investors, considering the regulation on capital ratios and constraints imposed by the supervisory authorities.

This last regulatory aspect legitimizes the inclusion of Excess Capital; it represents that quantity of capital resources like equity that the bank could theoretically distribute immediately to shareholders. It can be considered as a reserve of value relevant for the bank evaluation not to be discounted, being already available at the time of the estimate (Rutigliano, 2018).

<sup>3</sup>Empirical methods are excessively synthetic and empirical, for this reason they are considered auxiliary and not primary measurement methods.

In this circumstance, the private nature of ownership is a prevalent requirement of the banks under examination and, therefore, by privileging this aspect over others, measurement approaches that are attentive to the remuneration of invested capital are preferred. The main criticality that can be found is that the policy of distributing profits over time is not always easily measurable, especially by an external analyst. Even local banks, like any other credit institution, will not necessarily practice a payout ratio equal to 100%, which implies that usually the attribution of the operating result to their shareholders will be subject to strategic managerial choices.

In addition to the traditional directional choices of durable self-financing, which a local bank could practice, frequently divided smoothing procedures are desirable. This latter mechanism presupposes the constant maintenance of outgoing cash flows in measurement of the distribution of profits.

Maintaining a constant trend in the policy of dividends paid is the result of managerial policies, aimed at offering an image of stability and low volatility to the outside world. That said, the clear distinction with traditional income and/or financial models is easily noticeable, precisely because dividends will only represent a portion of the achieved performance; consequently, the calculated corporate value will differ from that obtainable, for example, by a Discounted Cash Flow Model, where the discounted values will be integral and not partial.

In particular, the Dividend Discount Model in the Excess Capital variant is recalled, where the equity value will derive from the net present value of future dividends calculated in compliance with the above-mentioned constraints. The adoption of an equity side approach is again preferred, compatible with what has already been expressed in point a) and which would confirm the theoretical assumptions indicated above on the role of debt within banking activity.

More precisely, the DDM.EC establishes that the value of a bank is equal to the sum:

- *Excess capital*;
- *Expected future dividends*, discounted over the predefined time frame, taking into account the level of capitalization that is deemed satisfactory and adequate for future development and growth;
- *Discounted Terminal value*.

$$W_E = Excess\ Capital_0 + \sum_{t=1}^n \frac{Div_t}{(1+r_E)^t} + \frac{Excess\ Capital_t}{(1+r_E)^t} \cdot \frac{TV}{(1+r_E)^n}$$

where:

$W_E$  = Equity value;

$Excess\ Capital_0$  = capital surplus (or deficit) at the time of valuation;

$Div_t$  = dividends potentially distributable to shareholders in the chosen time horizon, maintaining a satisfactory level of capitalization;

$Excess\ Capital_t$  = capital surplus (or deficit) estimable along the explicit forecast period in relation to the expected dynamics;

$R_E$  = discount rate represented by the cost of equity, equal to the rate of return

on equity required by shareholders for investments with similar risk characteristics (*CAPM model*);

$n$  = number of years of forecast;

Terminal Value (TV) = present value of dividends, theoretically distributable to shareholders in the long term, beyond the explicit forecast period, calculated as the value of a perpetual annuity:

$$TV = \text{Div. norm.} / (r_E - g)$$

where:

Div. norm. = normalized, economically sustainable distributable dividend;

$g$  = long-term growth rate.

## 5. Control Premiums and Minority Discounts

Regarding the third guideline contemplated, the degree of concentration, an extremely relevant aspect in the banking sector, indicates the level of corporate control, empirically signaling its own positive relationship with the creation of value. All this legitimizes the interest of local banks in those methods of measuring corporate value, which respectively include control premiums and minority discounts (Romano & Riccardo, 2021; Mercer & Harms, 2020).

More precisely, valuation procedures involving the valuation of shareholdings are frequent, where they are representative of non-total portions. This circumstance confirms the opportunity to make corrections on the average normal value of each individual share, derived from the total value of the company, precisely because the contemplated shareholding package contains a series of peculiar characteristics, dictated by the possible advantages deriving from control.

The latter entail for the participating entity the obtaining of those so-called “private” benefits deriving from control, namely: appointment of management; ability to influence the definition of strategic directions; implementation of capital operations; etc. On the other hand, however, the effects of share leverage arising from control are also extremely relevant, based on which, through the acquisition of share packages or majority shareholdings, the investor acquires the availability to manage capital, which largely exceeds the amount of the overall investment.

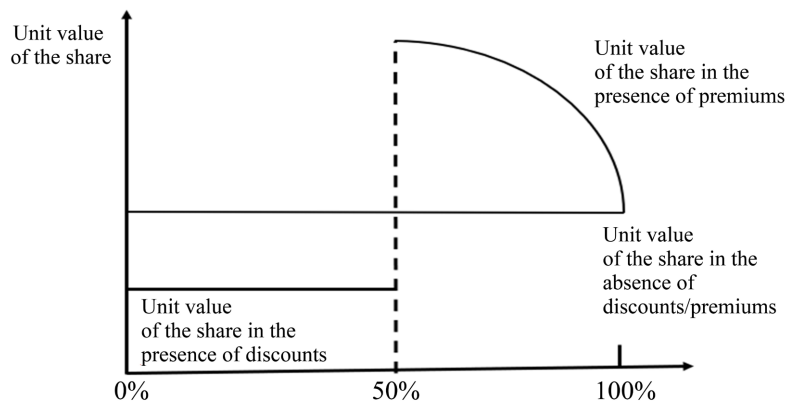
In particular:

- Majority premiums, when the unit value attributed to the shares is higher than the average value;
- Minority discounts, when the unit value attributed to the shares is lower than the average value.

However, the majority premium impacts the unit value of the shareholding not symmetrically with respect to the corresponding minority discount. On the one hand, there is a constant decremental adjustment on the average value of the minority shareholding, such that its unit value will not change as the percentage of the shareholding held varies, on the other hand, assuming that the premium is a single and predefined value, it will be attributed pro-rata to the majority shareholdings; this last assertion highlights how there is an inverse proportionality be-

tween the unit value of the shareholding and the percentage of the shareholding held (Buongiorno, 2013; Rutigliano, 2018).

In this regard, the following **Figure 1** is shown:



**Figure 1.** The premium impact.

The assigned unit majority premium reaches its maximum level in proximity to a 51% holding, decreasing instead, until reaching the average value, in the case of a total holding. Therefore, the level of the overall majority premium is unique, constant and predefined, calculated with a reduction of the amount from the overall company value; rather, the amount of its unit share is variable, being inversely proportional to the variation of the percentage of ownership. Rather, the constant impact of the discount on minority holdings is reiterated, with no type of variability recorded in relation to the holding rate.

## 6. Conclusion

At this point in the discussion, the question arises as to how these three distinct examples of measurement can be used in practice and whether one approach has supremacy over another. Such a decision should be made by converging to the most reliable and empirically tested method, or a selection can be assumed based on the established priority of one of the three above-mentioned methods over the others.

The main criticality lies in the partiality of each single approach to a singular aspect of the local banks under examination, which would not cover all the various existing peculiarities. Therefore, a combination of the three methodologies indicated above in a single summary formula is conceivable; this study hypothesizes a Dividend Discount Model, where the dividend discounting procedure used is affected by the impact of the size premium, calculated in various ways, which considers adequate correction techniques aimed at recognizing the impact of majority premiums or minority discounts on share packages.

Now there are no application examples of the model examined. The starting point for a correct implementation will certainly be the balance sheet data. In addition, the different regulatory frameworks of the countries or regions should not

influence the use of the combined measurement model.

In conclusion, a future implication of the research would consist in deepening the distinctive elements of local banks, broadening the study of their peculiar and characterizing characteristics, and subsequently in identifying the corresponding evaluation techniques, to be merged into an integrated synthesis model.

## Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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