

## **NEW APPROACHES IN THE ANALYSIS OF THE BANKING PERFORMANCES**

**Prof. Marin OPRÎTESCU, PhD**

**Assist. Prof. Alina Georgiana MANTA, PhD Student**

**University of Craiova**

### **1. The content of the banking performances**

The fundamental objective of a bank, as of any economic entity, is to obtain profit. This represents for the banking society the main source of increase of the capital, and the existence or the lack of this one have a particular impact on the confidence of the public in the respective bank.

The measurement of the earnings and the administration of the risks presents a particular importance in the appreciation of the quality of the activity, of its performances. Considering all the possible risks, the essential purpose of the banking managers is to achieve the maximum of profit in terms of minimum risk. The banking performances and their achievement are very useful to the investors, the companies which solicit a credit, to the simple depositors or business men who have stable relations and a greater scope with a certain banking institution.

The performance can be defined as being the measurable level of stability of the activity of a bank, characterised by low levels of all the risk categories and a general increase tendency of the profits form one period to another.

The profitability concept is not particularly associated to the banking domain. Analyses of the nature of the measurement of the profitability, the determination of the economical-financial indicators of the instrumentation of some modalities of planning the profit represents components of the economical management in general, whose main task is just to make a profit.

At each banking entity level, we must organize a coordinated system of evaluation of the performances and of determination of the efficiency of each type of product, relation or organisational structure of the bank, thanks to the diversity and volatility of the banking products and services and of the organic interdependences between the banks and the rest of the economy.

Thus, it is important for a bank to know the efficiency of the management of a territorial unit or which is the profitability threshold associated to the relation to a client, so that, in the process of the negotiation of the businesses with it, the bank to be able to adjust the options in accordance to this parameter.

The profitability represents one of the key sources of the generation of capital, a relevant indicator of the competitive position of a banking institution and of the quality of its management, which allow a bank to maintain a certain risk profile, offering protection for short term problems, knowing the fact that a healthy banking system is built on profitable and adequately capitalized banks. .

On the background of the increasing competition which is manifested on the banking market, in the context of the globalisation and the one of the European integration, the essential task of the central management of the banks consists in choosing the most efficient profitability models, which aim the possibilities of covering the investments by own resources, at the level of each work unit.

Within the banking sector, characterised by an intensive competition, the modern banks do not allow to offer services lacking profitability, so that they must organise their functions in a way that would allow them to establish the exact contribution to results of the component parts. For the resolution of these needs, over the last decade there have been developed more refined systems for the evaluation of the banking performances, which contribute to the formulation of the decisions of the banks regarding the offered products and services.

An efficient evaluation framework contains a series of elements such as: the adequate organisation which allows the allocation of the incomes and expenses on activity units, in report to different business lines, market products and segments of a bank, an internal system of establishment of the prices in order to quantify the contribution of different activity units at the results of the banks and the means to incorporate the risk elements in a framework of evaluation of the performances. Once we know the contributions on activity lines, products or markets, can be clearly established the clients segments the most promising products that must be analysed regarding their capacity of generating the incomes, an adequate framework of evaluation of the performances allowing and analysing the net contribution that the relations of collaboration with the clients have at the final results of the bank.

The expansion of the territorial network, the increase of the volume of resources and investments and the diversification of the offer of products and services led to permanent preoccupations of the banks for a qualitative development, in the sense of the establishment of the modalities of optimization of the achievements and of the structure of the resources and investments portfolio, in order to obtain some superior performances, elaborating in this regard models of analysis and pursuit of the banking profitability.

## **2. Are the foreign banks more profitable than the autochthonous banks?**

Most of the studies referring to the profitability of the bank focus on the markets with a low presence of the foreign banks. Plus, these studies ignore the fact that the foreign banks can be differently affected by certain factors in comparison to the autochthonous banks, and also other supplemental factors, such as the conditions in the origin country and the strategies of the mother/institutions. The unique study which deals with this problem is that of Williams (1998a, 1998b, 2003), which elaborate an empirical model of the determinant factors of the profit of the foreign banks and test a series of hypotheses linked to the profitability of the foreign banks in Australia. The results show that the internal factors do not bring a plus of descriptive force top the model, even if they offer important information on the decisions of politics and strategy of the foreign banks (Williams, 2003). From the theoretical point of view, the profits of the foreign banks can be influenced by the business environment from the origin countries, and also by the solidity and the strategy of the mother-institutions. These can involve both costs, and also earnings for the banking sectors form the Central and East Europe countries.

The most important advantage of the foreign property is the lower sensitivity of the foreign banks to the conditions from the host-country and the much better access on the international markets. The experience internationally indicates the fact that the mother-banks become last resort creditor of the branches at difficulty. For instance, the Belgian bank KBC recapitalized its Polish branch Kredyt Bank and the Hungarian one K&H, when the latter had problems. As for the Kredyt Bank the problems were generated by the rapid increase of the volume of credits, which had as consequence the increase of the non-performing credits, while the problems for

the K&H were caused by the fraud administration.

At the same time, the activity of the foreign banks can be influenced negatively by the weak results of by the modification of the strategy of the mother-banks. There are two main channels that must be taken into consideration. The first, a foreign bank can be liquidated if the mother-bank has difficulties and decides to close some of its branches. An example of the impact of the problems of the mother-bank on the foreign banks which operate in the ECE countries is the withdrawal of Dresdner Bank from Romania and Czech Republic. The second channel, the management of the international banks approves the allocation of capital with the highest expected profit. (de Haas & Naaborg, 2005). Thus, even the profitable foreign branches can be closed in order to reallocate capital to a project even more profitable in another country.

The impact of the conditions from the origin country on the foreign countries is more ambiguous and cannot be easily predicted. For instance, if the economical evolution presents an ascendant tendency in the origin country, the mother-banks can have many profitable opportunities in the country and can thus decide to allocate less capital to the branches. At the same time, a powerful economical increase in the origin country makes the mother-banks more profitable and more capable to develop the network of branches abroad.

Beside the economical environment in the origin country and the one from the host-country, other factors would have a differentiated impact on the foreign or autochthonous banks. The increase of the foreign property in the ECE countries took place at the same time with the increase of the concentration on the banking market. The foreign countries contributed to the highest concentration level of the banking market through two channels:

a) the acquisition by the foreign banks of some local institutions and their fusion in a single institution;

b) the consolidation of the local (autochthonous) institutions as a consequence of the competition pressures from the foreign homologue institutions. It is, thus, interesting to analyze whether the local and foreign banks react differently to the changing structure of the market. Plus, the capital markets have developed considerably in the ECE countries, offering the firms alternative financing sources.

Taking into consideration the fact that the foreign banks are often accused of offering services only to the great firms, we should assume that the profits of the foreign banks decrease at the same time with the development of the capital markets.

A study made by the National Bank of Finland, analyses especially the entrance manner on the market of the foreign banks, establishing the difference between the foreign banks which undertook existing institutions and the ones which created new institutions.

The distinction is very important, because there are significant differences as far as the strategies applied by these banks are concerned. The newly created branches of the foreign banks, generally, offer services to great international corporations and, thus, can be influenced in a greater measure by the conditions in the origin country and by the financial institution of the mother-bank than those created by the undertaking, oriented more towards services offered to natural persons.

Also, there are analysed determinant factors of the profitability of the banks, using a set of data containing 265 banks from 10 ECE countries (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia). There are analyzed determinant factors of the profitability of the banks with different property regime, estimating the regressions for the entire sample and separately for autochthonous banks, foreign property, branches of banks created by undertaking and newly created branches of the foreign banks.

For a more detailed evaluation of the factors which influence the profitability of the banks in the ECE countries, we analyze the relation between the output of the assets and the characteristic indicators of the bank, the macroeconomic conditions from the host-country, the capitalization of the capital market, the concentration of the banking market, the results of the mother-banks, and also the macroeconomic conditions from the origin country.

The study contributes in more ways to the improvement of specialty literature. First of all, in the analysis of the profitability we make the distinction between the branches created by undertaking and the newly created ones. Secondly, the study starts from the hypothesis that the foreign and autochthonous banks react differently to the same determinant factors of the profitability, such as the macroeconomic conditions locally, the structure of the market and the development degree of the banking sector. Consequently, there are elaborated separate econometric models for the autochthonous banks, the branches of the foreign banks created by undertaking and the newly created ones. Then, the paper focuses on the countries in transition and test a number of previously verified hypotheses for the developed countries and which would lead to different results for the ECE countries.

The results of the study show that there are differences in the reaction of the foreign and the autochthonous banks. The autochthonous banks register greater profits on markets with higher concentration degree. As for the influence of the evolution of the capital market on the profits of the foreign and the autochthonous banks, we can say that the capital markets have a complementary function or of substitution for the banking sector. On the one hand, Miller-Modigliani studies established that the financing of the debt and of the capital are only substitutions in the absence of the fees and of the costs of the bankruptcies. Consequently, we can

recognize a negative impact of the capital markets on the profits of the banks (the effect of the substitution). On the other hand, as the capital markets develop themselves, the banks can obtain more information about the clients, which facilitates the selection and monitoring of the latter. Hence, the capital markets can reduce the problems generated by the wrongful selection and the moral hazard, increasing the profits of the banks (the complementary effect). The present study verifies these hypotheses, introducing the parameter of the dimension of the national capital markets and taking into account the possible modifications of the access to the banking credit through indicators of the dimension of the private credit market and the BERD index for the reform of the banking sector.

As a conclusion, the profits of the foreign banks are not affected by the concentration level on the banking market while the autochthonous banks make greater profits by operating on such markets. This is due to the low rates practiced in order to attract new clients and to obtain the desired market quota.

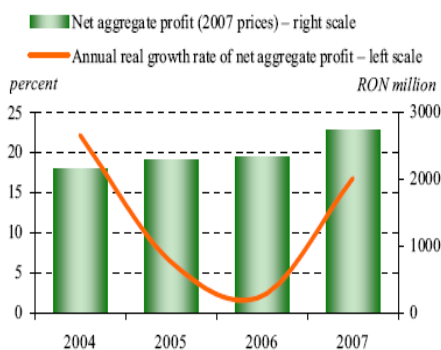
### **3. Romanian banks profitability. New approaches**

Assessments for end-2007 showed a rebound in the growth rate of aggregate profit compared with that recorded in recent years, amid better performance of large credit institutions. Credit institutions' strategy focus on the volume of activity as the main source to achieve favorable financial results strengthened during 2007. In this context, some credit institutions had to restructure their activity while others had to continue the fast expansion of their territorial networks. Profitability ratios (ROA and ROE) continued to decline slightly, although operational efficiency improved in 2007, a mid credit institutions' increased cautiousness regarding operating costs. In the short run, amid global financial market turbulence, the assumption of a stronger negative impact

on the profitability of credit institutions due, most likely, to the increase in costs related to interbank financing, cannot be precluded.

In 2007, the Romanian banking system recorded a net aggregate profit of RON 2,746.6 million (EUR 0.82 billion), up 17 percent from 2006 (Chart 1). The larger territorial network and the new own lending guidelines issued by banks<sup>38</sup> boosted bank intermediation, with credit institutions further pursuing their strategy aimed at offsetting the narrowing of interest margins by diversifying income sources and by higher receipts from a larger loan volume (especially its foreign currency component).

**Chart no. 1. Net profit of the banking system**



Source: National Bank of Romania, Financial Stability Report 2008

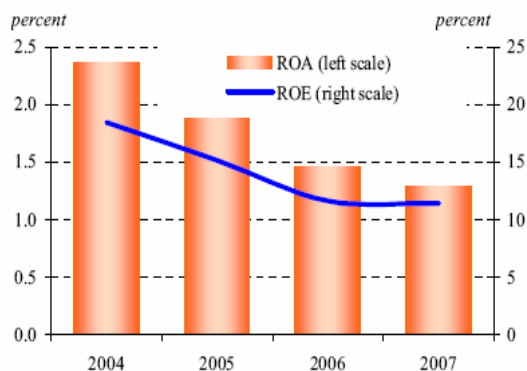
Distribution of profit was heterogeneous, the highest values in both absolute and relative terms being recorded by large banks in particular. Given that the top three credit institutions, in terms of asset holdings, took a market share of 45 percent, they accounted for more than 60 percent of net aggregate result. Some middle- and small-sized banks, cumulating about 5 percent of bank assets, incurred losses at the end of 2007.

Returns on equity (ROE) decreased slightly in year-on-year comparison (11.44 percent in 2007 from

11.67 percent in 2006), the net profit growth rate being comparable to that of equity. ROE analysis using the **Du Pont** breakdown, shows that lower return on bank equity is mainly ascribable to the contraction in the profit generating capacity of assets (from 1.46 percent in 2006 to 1.3 percent in 2007), as an enhanced leverage effect (from 7.97 percent in 2006 to 8.82 percent in 2007) offset only in part the fall in return on assets (ROA). Large investment aimed mainly at expanding bank networks and heightened competition caused the share of profit in operating income to drop about 2.6 percentage points (from 20.18 percent in 2006 to 17.6 percent in 2007).

However, this development did not affect the income-generating capacity of assets. The asset utilization rate rose slightly to 7.37 percent at end-2007 from 7.26 percent at end-2006. In this context, ROA continued to decline during 2007, albeit at a slower pace than in recent years (Chart 2), remaining at levels similar to those recorded in other European countries (Table 1).

**Chart no. 2. Comparative analysis of ROE and ROA**



Source: National Bank of Romania, Financial Stability Report 2008

Table no. 1. Comparative analysis of ROE and ROA at European level (percent)

|                         | 2003        |            | 2004        |            | 2005        |            | 2006        |            | 2007 |     |
|-------------------------|-------------|------------|-------------|------------|-------------|------------|-------------|------------|------|-----|
|                         | ROE         | ROA        | ROE         | ROA        | ROE         | ROA        | ROE         | ROA        | ROE  | ROA |
| Austria                 | 7,0         | 0,3        | 14,8        | 0,6        | 14,8        | 0,6        | 16,9        | 0,7        | 18,3 | 0,8 |
| Bulgaria                | 22,7        | 2,4        | 20,6        | 2,1        | 22,1        | 2,1        | 24,4        | 2,2        | 25,4 | 2,5 |
| Czech Republic          | 23,8        | 1,2        | 23,3        | 1,3        | 25,2        | 1,4        | 22,5        | 1,2        | 23,1 | 1,3 |
| Greece                  | 8,9         | 0,6        | 6,4         | 0,4        | 15,9        | 0,9        | 12,8        | 0,8        | 20,1 | 1,3 |
| Italy                   | 7,4         | 0,5        | 9,3         | 0,6        | 9,7         | 0,7        | 11,5        | 0,8        | ...  | ... |
| Poland                  | 5,4         | 0,5        | 17,1        | 1,4        | 21,9        | 1,6        | 21,0        | 1,7        | 25,6 | 1,8 |
| Romania                 | 15,6        | 2,2        | 18,5        | 2,4        | 15,2        | 1,9        | 11,7        | 1,5        | 11,4 | 1,3 |
| Serbia                  | -1,2        | -0,3       | -5,3        | -1,2       | 6,7         | 1,1        | 10,0        | 1,7        | 12,8 | 2,1 |
| Hungary                 | 19,3        | 1,5        | 25,3        | 2,0        | 24,7        | 2,0        | 24,0        | 1,8        | 22,9 | 1,8 |
| <b>European Average</b> | <b>11,3</b> | <b>0,5</b> | <b>13,7</b> | <b>0,5</b> | <b>15,0</b> | <b>0,5</b> | <b>16,7</b> | <b>0,6</b> | ...  | ... |

Source: National Bank of Romania, Financial Stability Report 2008

#### 4. Conclusions

In 2007, according to a study elaborated by the National Bank of Romania [Georgescu Florin, 2007] we observe that more banks were retrograded by the rating group 2 in group 3 at the end of September 2007, mainly because of the deterioration of the profitability indicators.

According to the presented estimations, six banks received weaker evaluation grades as compared to December 2006, exiting rating group 2. Thus, the number of the banks included in this group decreased from 17 to 11. In exchange the number of the banks from group 3 increased from 19 to 26, and the one of the banks from rating group 4, from 1 to 3, given the conditions where the total number of the credit institutions on the market climbed from 37 to 40. Presently, rating group 2 represents the best efficiency points the banks in the system can obtain. From the end of 2003, no bank has ever been included in rating group 1.

On the other hand, the rating agency Standard & Poor's improved the risk perspective for the banking sector in Romania, from the eighth group, to the seventh group and diminished the risks of apparition of an economical recession, from 35-50%, to 25-40%. The agency

warns however that the risks for the banks which activate in our country are greater than in other countries in the area, such as Bulgaria, Croatia, Hungary and Poland.

The revision of the risk from the Romanian banking system reflects the considerable increase of the profitability of the active banks in Romania, the increasing penetration degree of the banking sector and the technological improvements in the field.

At the same time, the Standard & Poor's analysts show that this evolution was largely determined by the import of Occidental technology, of the convergence with the EU requirements and the implementation of the Basel II principles.

The accumulation of the economic disequilibria, the deterioration of the flexibility of the banks as a consequence of the limited volume of drawn deposits and the high dependence degree in report to the capital of the mother-banks are the factors that the analysts of the rating agency see as dangerous for the autochthonous banking system.

Still, the rating agency appreciates that the regulations of the National Bank of Romania offered a better mechanism of administration of some eventual major risks for the banking system.

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