

**PERFORMANCE ANALYSIS OF GLOBAL BANKING OF LENDING
AND DETERMINING OF THE INDICATORS USED TO MEASURE
THE PERFORMANCE**

ION Luminița¹, FRĂȚILĂ Laurențiu²

^{1,2} Academy of Economic Studies, Bucharest

Abstract

The global performances of banking can be obtained under the conditions of the existence by a controlled level of risk and a normal trend of growth of profit from a period to another. The purpose of the article is to present a method of classification of granted loans and the establishment of internal ratings within the bank. The result of classification of assets is the identification of high quality credits and separation their from nonperforming loans. Thus, the bank's earnings it may stabilize in time, because the risks, as the source of unexpected expenses, can be analyzed, quantified and reduced.

Keywords: *global performance, risky assets, classification of loans, outstanding loans*

1. Introduction

The quality of the credit portfolio is reflected in the performance of bank, being closely related to the management of the bank's assets and liabilities. Poor management of the bank's assets and liabilities has as main effects: a high percent of fixed assets in total assets, a low level of capital compared to the obligations, the unbalanced distribution of the banking investment in portfolio or the high level of provisions. All these elements signify a high exposure of the bank at risk as a result of incorrect management policy.

In order to obtain the performance, the bank's management must take into account the following considerations:

¹ *Ph.D. student, Academy of Economic Studies, Bucharest, iluminita71@yahoo.com*

² *Ph.D., Academy of Economic Studies, Bucharest, referateinfo@yahoo.com*

- the existence of a competitive system of information;
- the choice of markets and products that can be used profitably by the bank;
- rewarding of employees of the bank in relation to the performances obtained by these;
- thorough knowledge by the techniques and tools used in the banking business;
- an effective financial administration;
- the development of balanced strategies by determining the rate of return on which the bank seeks to achieve.

A healthy banking system is based on profitable and adequately capitalized banks. Thus, the profitability is an important indicator for determining the competitive position of the bank on the financial markets (Greuning; Bratanovic, 2004).

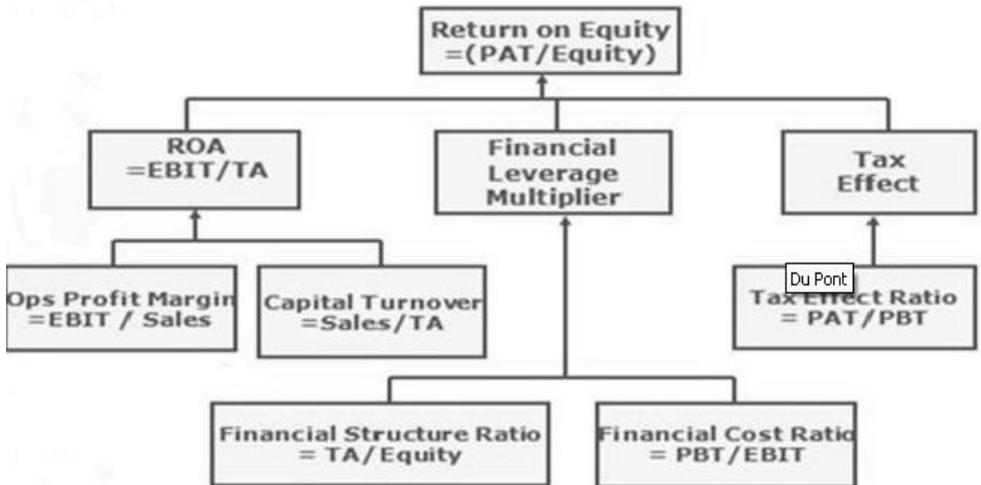
The profit obtained by the financial institution is influenced by factors that can be controlled by the bank's management, and by the uncontrollable factors. Thus, financial risks can be quantified into a system of indicators, so the bank can reduce the exposure to this type of risk. In terms of non-financial risks, by the environment, the bank can develop flexible plans, by the reaction to the influence of exogenous factors, but cannot exert control over their.

Performance management, based on the determination of a system of indicators, has a limited informational component. For this reason, in the banking activities are used standards of comparison, with the help which it can make comparisons with other similar banks and may be analyzed the trends relating to performance, on certain intervals of time (Badea; Socol; Dragoi; Driga, 2010).

2. Global performance of banking lending

The bank's performance is highlighted using the classic model of the Du Pont analysis, which involves comparing the profit obtained by the bank with the risk assumed by the financial institution in question, by balancing the gains with the losses caused by the occurrence of the risk.

Figure 1. DuPont analysis



Source: system of analysis of the financial situation created by the American company Du Pont Corporation in 1920

Economic rate of return, ROA, it is the most widely used indicator to assess the overall performance of the bank, by the fact that measure the way in which all of the bank's assets are framed into profitability.

$$ROA = \frac{\text{Profit net}}{\text{Active}} \cdot 100 \quad (1)$$

Financial rate of return, ROE, is determined as the ratio between the net profits taken into account, after deduction of the tax expenditure, and capital, determined as the sum of the share capital, non distributed profits and reserve funds. ROE analysis shall be carried out taking into account the peculiarities of the banking system (Treapat, 2011). In general the banks Anglo-Saxon record a level of ROE higher than 20%, and banks from France and Germany have a level of ROE of less than 20%. Romanian banks have adopted the approach Anglo-Saxon, relating to financial profitability, with a level of ROE higher than 20%. In general, it pursues that the rate of financial return to be higher than average rate of interest on the market, in order to increase of the value of bank's shares, by increasing their course at Stock

Exchange (Dedu, 2008). This indicator includes a multitude of aspects, respectively: the degree of generation of profit, degree of financial indebtedness, forecast about tax liabilities, operational efficiency and the extent to which the use of additional resources, contribute to increased of profitability of equity.

$$ROE = ROA \cdot GI \cdot 100 \quad (2)$$

where:

GI representing degree of indebtedness or leverage effect.

From this relation it is noted that under the conditions of low values of the indicator ROA, to achieve higher financial profitability rates, it is necessary to use the most efficient resources attracted and the existence of an equity capital as small as. Thus, the rates of profitability must be analyzed only in parallel with the rates which measure the risks to which financial institutions are exposed. Two types of risks are particularly important for understanding the financial instability (Mishkin, 2009):

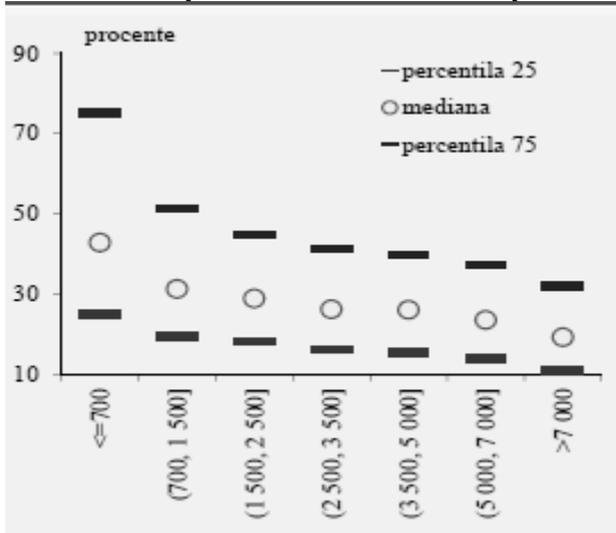
- the risk of assessment due to the the difficulties encountered in the evaluation of property,
- the risk from the macroeconomic level, in the situation in which the financial difficult context affects significantly the entire economy.

The process of division of financial profitability rate (ROE) is named system of decomposition of rates Du Pont (Taymans, 2010).

The unfavorable macro-economic medium, national and international, has a negative influence over the profitability of financial institutions so at the end of 2011 was registered an negative result in all the Romanian banking system. Although at the end of the first semester of the year 2012, lending was resumed, the banking system recorded a loss of 192 million due, mainly, of the increasing of the rhythm of devaluation of financial assets and a reduction in net interest income.

The degree of indebtedness of population to the banks has remained at a high level, in the month of June in the year 2012, the number of people who have contracted loans from banks and IFN (non-banking financial institutions) being of 4, 35 million, respectively a percentage of 43% from the active population. The most important aspect is that the people with lower-income recorded the highest degree of indebtedness, being more affected by the adverse evolution of rates of interest and rate of exchange.

Figure 2. The structure of degree indebtedness on income categories -monthly income in national currency-



Source: BNR report of financial stability 2012, available at <http://www.bnro.ro/Publicații-periodice-204.aspx>

The situation of higher indebtedness of population in foreign currency, deposits being established mostly in national currency, lead to the other significant vulnerabilities of the balance sheet situation, respectively the existence of a foreign currency short positions in relation to the financial system. Thus, the outstanding for the foreign currency loans are much more numerous than those recorded to the credits in national currency.

The literature specifies that, in general, risk management strategies depend by the tendency of acceptance of risk by the organizations (Goldman, 2004). But, in practice banks are willing to risk more to achieve higher earnings in the short term. Because of situation created in 2007-2008, is necessary for the banks to avoid model of lending adopted before the start of the economic crisis and to develop strategies of risk management from a short-term at the strategies on the medium and long term, with a view to obtain sustainable and responsible development of the activity of banking of mediation.

The loans portfolio of the financial institution reflects the position occupied on the market demand from customers as well as business strategy and risk strategy which was adopted. Loan portfolio review is conducted periodically in order to provide a better picture of profit and business opportunities of the bank as well as the type of risk assumed by the bank. The classification of assets can determine the appropriate level of provisions to cover potential losses.

The provisions together with general reserves of the bank constitute the basis for determining its capacity to absorb losses. Thus, when there are delays in repaying loans, these outstanding are influenced and by the bank through the rigidity of policies of banking and through credit procedures which are adopted inside the bank, through the increased volume of granted loans or quality of banking staff and through information technology used, not only for the payment behavior of customers (McNeil ; Frey, 2005).

3. Measuring the global performance of lending

Global performance of the bank measure the level of stability of its activity and it involves reducing the different types of risk with which the financial institution is confronted. Also, through measuring the global performance can be established if the profits of bank tend to rise from one period to another.

Quality of performance management, which is reflected in the quality of banking performance, it is closely related to the management of the bank's assets and liabilities.

In banking practice, some components of the balance sheet shall be defined in direct relation to the profits and risk. Thus, banking assets are of two kinds: performing and non-performing. Assets that do not produce income, so are not related to investment banking are not associated with risk.

In the plan of business of a bank has an important role determining the structure of the bank's assets and liabilities for establish the exposure against the risks inherent in its activities and to estimate the level of global profitability.

An inadequate way of management of credit risk lead to apparition of outstanding loans at maturity and determine a decrease in the loan expansion affecting at the same time both the activity of the bank and its clients.

In table no. 1 is presented the situation of loan quality depending on the class of financial assets.

Table 1. The quality of loans depending on the class of assets
-Million Ron-

C r t. n o.	Specification	31.12.N				31.12.N+1				31.12.N+2			
		The sum total of which	%	Loans and advances to customers	%	The sum total of which	%	Loans and advances to customers	%	The sum total of which	%	Loans and advances to customers	%
1.	Low risk	30 256	54,8	23 125	48,8	24 358	45,2	18 271	38,5	30 281	47,3	21 029	44,0
2.	In observation	13 183	23,9	12 525	26,4	15 481	28,8	15 241	32,1	22 347	35,0	15 486	32,4
3.	Substandard	7 579	13,7	7 576	16,0	8 078	15,0	8 078	17,0	3 182	5,0	3 182	6,6
4.	Nonperforming	4 141	7,6	4 141	8,8	5 904	11,0	5 904	12,4	8 109	12,7	8 107	17,0
5.	Total	55 159	100	47 367	100	53 821	100	47 394	100	63 919	100	47 804	100

Source: Consolidated balance sheet of the bank "B" to 31.12.N, 31.12. N+1, 31.12.N+2

Depending on the class of financial assets, bank "B" manages the quality of loans by setting the internal credit ratings. Thus, risky assets of the balance sheet are as follows: claims over credit institutions, assets held for trading, bonds quoted and bonds which are not quoted, loans and advances granted for clients, financial investments for sale, respectively, certificates of treasury and shares quoted and shares which are not quoted and investments financial held till maturity.

There is a growing of loans from category with low risk and those in observation from 74%, at 31.12.N+1, at 82, 9% in the period 31.12.N+2.

Loans and advances to customers rose from 47 367 million RON, at 31.12.N at 47 804 million RON in the period 31.12.N+2, with 437 million RON more. This represents an insignificant increase of just 1%.

In the structure of portfolio of loans the share of loans with low-risk and in observation at the end of the year N, it was 75, 2% while in the period 31.12.N+1 their share has declined with 4, 6 % and for the period 31.12.N+2 share is in a percentage of 76, 4%. In year N + 2 shall be recorded an increase of loans in the observation, by 6 percentage points compared to year N, due to the increase in the number of loans granted to population.

The loans with the major degree of risk (substandard loans, which have debt service lower by 90 days), represents in the structure of loans 16% during the period 31.12.N compared with 15% at 31.12.N+1 and compared

with 6, 6% in the period 31.12.N+2, so are declining compared to periods previous.

From the analysis of the quality of the portfolio of loans in the period 31.12.N+2, result an increase in the share of loans by good quality, with 5.8 percentage points compared to the previous year, respectively 31.12.N+1 and a reduction with 1, 2% and 5, 8% of the share of substandard loans and loss compared to periods N and N + 1.

The nonperforming loans, considered losses for the bank, recorded an increase with 2, 2% in year N + 1 and with 8, 2% in year N + 2, compared with the period 31.12.N.

Depending on the quality of existing loans in the balance at 31.12.N, 31.12.N+1 and 31.12.N+2, have been established specific provisions with different coefficients of provisioning, as follows:

-loans in observation: 0, 05;

-substandard loans: 0, 5;

- nonperforming loans: 1.

Thus, according to the category of classification of loans and in concordance with the coefficient of provisions applied, they result the following amounts:

-in period 31.12.N: 8 590 million RON (13, 7%);

-in period 31.12.N+1: 10 705 million RON (22, 3%);

-in period 31.12.N+2: 10 472 million RON (13, 4%).

The amount corresponding to specific provisions for risk is included in expenses, and the balance of credits granted to borrowers diminishes with the value of guarantees established (mortgages, deposits).

Thus for the bank, are necessary total payments of the borrowers at maturity of the loan in order to protect deposits of customers and in order to limit the credit risk.

The bank will use the specific provisions of risk; respectively they will cancel, through transfer on revenue to the amount that represents the level of existing bank balance for specific provisions corresponding of loans and investments.

As a result of the improvement of the quality of the portfolio of loans of bank "B" level of provisioning fell at 31.12.N+2 with 9, 1% compared with the period 31.12.N+1.

This reduction was mainly due to the application of the prudential policies of lending targeted towards investments with low risk and prevention of granting of loans to the clients who have had losses.

After application the new modality for classifying loans the result was an improvement of the value of loans with low risk and a reduction of loans classified as outstanding.

In table no. 2 are shown the main indicators used to measure global risk of credit to the bank "B" in the periods: N; N + 1; N + 2.

Table 2. Indicators use to measure global risk of credit to the bank "B"

Crt. no.	Indicators	Year N	Year N+1	Year N+2
1.	The share of risky assets in total assets	79, 5	73, 1	83, 3
2.	The share of loans in total assets	68, 3	64, 4	62, 3
3.	The loss value in total loans	8, 8	12, 4	17, 0
4.	The amount of outstanding loans in total loans	16, 0	17, 0	6, 6
5.	The value of performing loans in total loans	75, 2	70, 6	76, 4
6.	The share of the reserve fund in equity capital	17, 4	16, 7	14, 5
7.	Net profit reported at losses of the portfolio of loans	20, 9	7, 8	0, 9
8.	The reserve fund reported at losses of the portfolio of loans	27, 8	20, 1	13, 5

Source: Consolidated balance sheet and consolidated profit and loss account of the commercial bank "B" at 31.12.N, 31.12. N+1, 31.12.N+2

From the analysis of indicators that measure the global risk of credit they result the following aspects:

- level of indicators in the period 31.12.N+2 indicates the apparition of some difficulties in the banking activity, due to increased volume of risky assets and the decrease of net profit reported at losses at portfolio of loans;

- in total assets increased the share of risky assets from 79, 5% in year N, at 83, 3% in year N + 2, due to the increase in volume of loans granted from 47, 4 million RON at 48, 7 million RON, loans being considered as assets with the highest degree of risk;

- the share of granted loans recorded a reduction which is not significant from 68, 3% in year N, at 62, 3% in year N + 2, this fact is due, on the one hand, the needs of funding ever increasing of the activities of the corporate and retail, and, on the other hand, the adoption of prudential measures of macroeconomic policy.

In parallel with the increase of the volume of loans granted to the level of bank "B" in the period under review appear a tendency for their depreciation, aspect revealed by the increase of the value of losses in total loans.

Increasing the share of nonperforming loans was due to the low profitability of national companies as well as due to the decrease in the population's income, factors that led to unable to repay the loan at maturity.

About the share of outstanding loans in total loans it observe at the end of the year N + 2 a significant reduction, by about 10% as compared to previous periods.

This means that the bank "B" has granted special attention to compliance of the rules of lending, respectively applying the principle of banking prudence in analyzing credit documentation.

The situation has improved, and by applying new regulations in activity of lending, result being a proper management of risk of credit and a more efficient use of the volume of loans granted.

4. Conclusions

From the analysis performed, we see an increase in the share of bad loans in total of granted loans, thus identifying the potential risk for the portfolio of loans of bank.

In banking practice there are various factors that determine the occurrence of outstanding at loans and lead in the end to apparition of losses. Thus, a bank it may be faced with the following situations:

- breaking the rules of lending by granting the loan prior to the preparation of credit documentation or without to constitute guarantees for the loan in question;

- the lack of analysis of capacity of payment of the borrower;

- failure to comply with destination for which the loan was granted, the money being used by the borrower for other purpose than those provided in the credit agreement and the financial institution is unable to carry out revenue foreseen;

- the granting of new loans towards borrowers for covering the outstanding at rates of interest and credit, the solution of refinance being suitable only on short-term, because in the future the situation of debtors becomes even more difficult by increasing debts towards the bank;

- over-valuing of the guarantees underlying the granting of credits or absence of guarantees in the case of loans of treasury which are granted without the constituting of collateral (mortgage or pledge).

We consider that in order to eliminate these factors which significantly affecting global performance of banking, it is necessary that financial institutions to change their concept of achievement profit based on quantitative accumulations, respectively the large number of transactions and granted loans. Thus, a bank primarily should be oriented towards increasing the efficiency of operations carried out, toward the accumulation of assets which are profitable and toward the constituting of bank deposits and it can realize, in this way, the expected financial results.

5. References

- Badea, L.; Socol, A.; Dragoi, V.; Driga, I. (2010) *Management of banking risk*. Bucharest: Publishing House Economic.
- BNR (2012) *Report of financial stability*. Available at <http://www.bnro.ro/Publicații-periodice-204.aspx>.
- Dedu, V. (2008) *Management and banking audit*. Bucharest: Publishing Economic.
- Goldman, S.(2004) *The Practice of Risk Management, Euromoney publications PLC*.
- Greuning, H.; Bratanovic, S. (2004) *Analyzing and Managing Banking Risk*. Bucharest: Irecson Publishing House.
- Mishkin, F.(2009) *Is Monetary Policy Effective During Financial Crises?*, *National Bureau of Economic Research Working Paper*.
- Mc Neil, A.; Frey, R. (2005) *Quantitative Risk Management*. Oxford: Princeton University Press.
- Taymans, A. (2010) *Assets and Liabilities Management, Romanian Banking Institute*.
- Treapat, L.(2011) *Management and insurance of risks of banking in Romania*. Bucharest: Publishing House Economic.