THE FINANCIAL PERFORMANCE OF COMMERCIAL BANKS LISTED AND TRADED ON BUCHAREST STOCK EXCHANGE

RODEAN (Cozma) Maria-Daciana[1]

"Lucian Blaga" University, Sibiu

Abstract

Even though banks are playing the role of financial intermediaries, their main objective is to obtain profit. The most commonly used indicator of the profitability assessment, according to the shareholder vision is represented by the return on equity. This study has focused on achieving a factor analysis on financial profitability obtained by the top three commercial banks by using the Du Pont. The purpose of this analysis was to identify the causes rate developments. The analysis was done over a period of eight years, respectively from 2007 since 2014. Data were taken from the financial statements published by the three credit institutions. The results have demonstrated that banks in order to improve the indicator need to maintain the leverage ratio fixed either to reduce capital costs. The decrease in profitability rate determined the downward trend registered by the return on equity.

Keywords:*return on equity, leverage ratio, profitability rate, Du Pont analysis, asset utilisation ratio.*

***JEL Classification**: G32*

***REL Classification:** 11C, 14K*

1. Introduction

The lack or insufficient performance of a certain commercial bank may even lead to cessation of its activity, while its current shareholders do not

[1]*Ph.D. student, Faculty of Economics, Financial Department, "Lucian Blaga" University, Sibiu, Romania, maria.daciana89@yahoo.com*

have enough sources to recapitalize and reinstate the bank. The decrease in performance is likely to generate the commencement of the bankruptcy of the bank. This decision involves high costs, peaking at an increasing of the cost of 13-14 times towards the commencement of merger, or capital increases or decreases it in order to cover the existed losses. In this case the trigger bankruptcy according to European norms, the first step is to remove the existing shareholders through bail-in procedure, then try to save the bank.

Knowing the causes that are likely to generate weak performance of a credit institution is one of the necessary conditions for the bank's management to take the most effective decisions. Taking into acount these considerations, and also the fact that in the shareholders' opinion, the most important indicator able to express the management efficiency is represented by the return on equity, it can be judged as beeing particularly important to study the causes likely to lead to a decrease in this index . This study will provide an overview on the progress achieved by it

2. Literature review

The holistic point of view of a bank performance can be highlighted from the perspective of the classical model of Du Pont analysis. This indicator is likely to compare the profit made by the bank coroborated with the assumed risk, by balancing the gains and the losses resulted from the occurence of the risk. (Badea, L, 2010, pp 438)

Upon the analysis of this indicator fell down several researchers. As the literature highlights, it must be taken into account the fact that banks significantly differ from other companies in terms of the adopted corporate governance, but also because of a much covered field. In this regard, it should be noted that the mission of the managers becomes more difficult due to the fact that their decisions are influenced by supervisors. This most often get in conflict with the shareholders' requirements. (Harm, 2002)

Hawawini and Jack, in 1999 offered another version of Du Pont analysis system, through the decomposition of the return on equity in five different ratios. The two researchers acknowledged that the financial statements elaborated for the preparation of annual reports (that are mostly used by the firms' creditors and investors) are not always the most used tool by managers in adopting the best financial decisions.

In 2001, the researchers Brigham and Houston have shown that this system of analysis is a powerful tool to illustrate the interconnection between the balance sheet and profit and loss account of the company, contributing in this way develops strategy to improve ROE.

The research Soliman into a study done in 2004, have found that the industry specific influenced the components of the Du Pont analysis system providing a more relevant valuation than the one done over the entire economy. In the main time this conducted to the fact that the industry specific indicators rose in appreciation.

Thus, in 2011, the researchers Nisim and Pienmanau suggested to use a modified version towards the traditional system in order to eliminate the effects of financial leverage, and other factors that are not under the control of managers. This proposed system has been widely debated in the literature review.

According to a study made by Mihaela Herciu in 2010, over a sample consisting of the top 20 global companies in terms of profitability, it was shown by Du Pont analysis system, that they do not occupy the same positions in terms of profitability for the investors. In argueing that assertion, the researchers have claimed that they no longer occupy the same position as far as the analysis is performed taking into account indicators such as ROA (economic profitability), ROE (ROE) and ROS (return on sales).

In 2011, the researcher Carl suggested a model that can be used in analyzing the financial position of a commercial bank through the financial Du Pont analysis model used by Saunders (2011) and applied by Collier. The financial profitability of a commercial bank can be divided into three components: net profit margin, total asset turnover and equity multiplier (leverage ratio).

3. Datasand methodology

In studying the factorial analysis of the financial performance of the first 3 credit institutions that are operating in the Romanian banking system, it created a database on an horizon of 8 years, respectively during the years 2007-2014. Thus by analyzing the financial statements of Transilvania Commercial Bank SA; Romanian Development Bank - Groupe Societe Generale, Romanian Commercial Bank SA and taking over financial indicators it were determined net profit ratio, asset utilization and leverage. To achieve this goal it was used Du Pont system. According to this system the return on equity is given by:

Equation (1) – The determination formula of ROE

ROE = profitability rate*asset utilisation rate*leverage ratio, where:

Profitability rate = net profit/operating income,

Asset utilisation rate = operating income/total assets

Leverage ratio = total assets/equity

Source: Financial Stability Report,NBR, 2007

4. Study regarding the factorial analysis of the financial performance of credit institutions according to Du Pont system

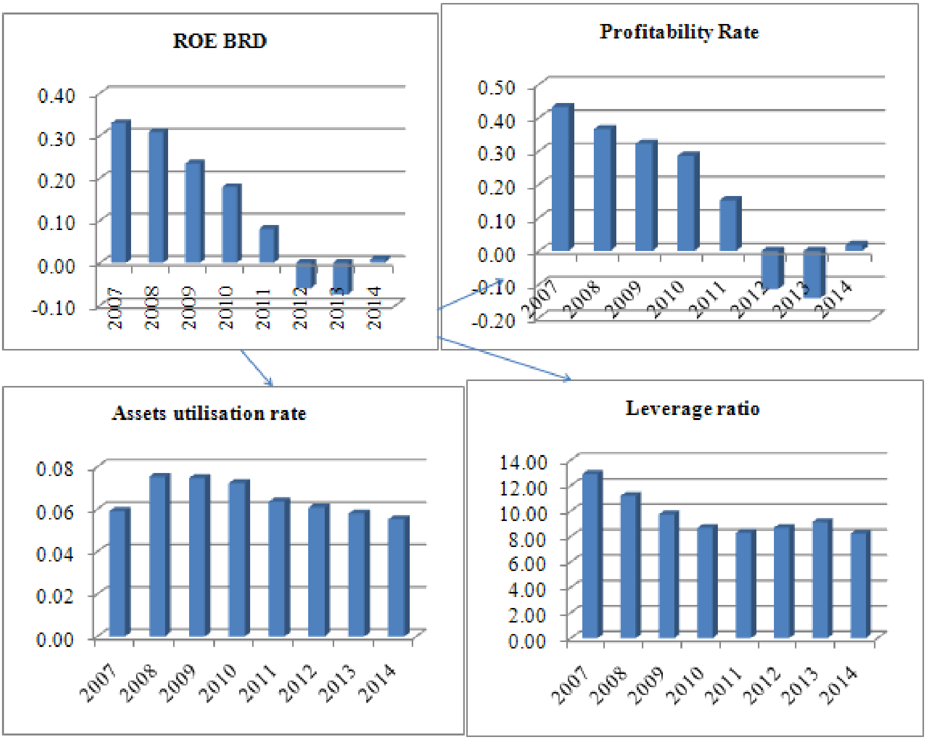
At the end of 2014, the first three commercial banks that operates in Romanian banking system, depending on total asstes, are the Romanian Commercial Bank, Transilvania Bank and the Romanian Development Bank - Groupe Societe Generale. During the crisis, allcommercial banks performance' it was affected, but in a different proportion. Since 2009, the deterioration of the economic environment caused the decrease in profitability of commercial banks, forcing them to rethink their business model and to adjust its prudential indicators in order to respect the imposed requirements. An adverse effect of the decrease in profitability was the desire and also the tendency of foreign banks to leave the Romanian banking system. To avoid this desire, the National Bank concluded a commitment with the parent banks of those that are operating in Romania in order to preserve capital in the country. The other consequence of the decline in profitability was represented by the occurrence of mergers and acquisitions transactions between various commercial banks.

By the end of 2014, Transilvania's Bank board announced the merger with the Austrian bank Volksbank Bank SA, an operation that placed the bank on the second rank in the Romanian banking system.

Analyzing the return on equity of the Romanian Development Bank - Groupe Societe Generale (BRD) on the horizon of the last 8 years, it can be observed a downward trend of this indicator.

As it was shown by the calculations made, the decrease of the registered of the return on equity was mainly due to worsening of BRD' rate of profit, an indicator with a downward trend since 2008. The main reason for this evolution was due to the decline in net profit indicator that the bank recorded. Although the bank is a market leader in syndicated loans market, the decreased demand for loans, especially from legal entities in conjunction with an unstable state of the economy decreased the total amount of funding awarded (12.50% decrease in 2014 compared to 2013).

Figure 1. - Factorial analysis of BRD's return on equity



Source: personal processing of the author by BRD's financial statements in the period 2007-2014

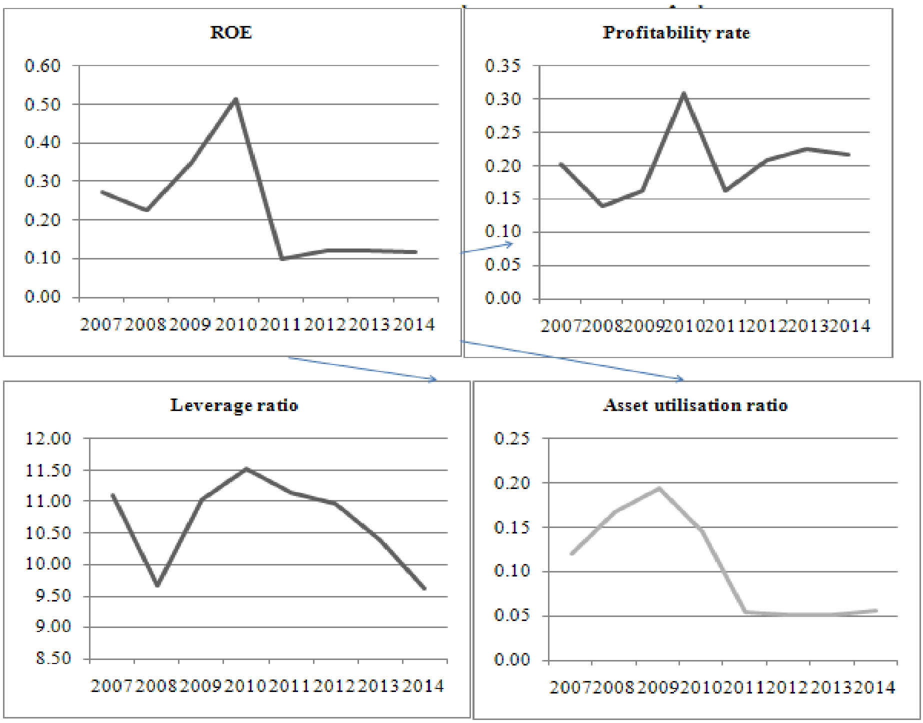
Given that the cost / income ratio obtained by the credit institution has positioned below the average for the Romanian banking system, the growth of net operating income of BRD is lower pace of decrease of operational costs. As a result the profitability was affected.

The generation of the profits for the bank's shareholders is resulted from the profitability of asstes and leverage ratio. In case of BRD, both indicators declined in the analyzed period underlying that the decrease in the awarded funding may be one of the main causes of the weak profitability. According to the results of BRD managed to multiply propyl funds by attracting deposits in a low proportion, up to 13% in the period. The evolution of the asset utilization ratio positioned on a downward trend as a result of the decreasing of the operating income and also obecause of the reduction of total assets of the bank. The new legislative framework has tigthtened the capital requirements, causing a raising in the capitalization of the credit institution. This increase, however, was not based on profit growth, but capital growth through equity, which undelines the importance of keeping funds in the country. Respecting the economical theory, in order to improve their return on equity a bank must handle the capital multiplier either by maintaining its capital at a rate fixed by either own funds limited costs. Another conclusion illustrated by the results aimed the small proportion in which the loans are used as sources.

As regards the evolution of the return on equity of Transilvania Bank, its performance was affected most deeply in 2011, although in 2008 the continuity of its business was conditioned by accessing a loan from the National Bank of Romania of 100 million euro. The evolution of financial profitability is summarized in the graphs from chart 2.

During 2010-2011, the returrn on equity of Transilvania Bank fell most deeply, being justified by the profitability rate, by the leveraging and also the low assets utilization rate. Specifically 55% decrease in operating income in conjunction with the decrease in net profit by 77%, resulted the depreciation of return on equity. As BRD the only financial indicator that took an increasing trend it was recorded by equity. This is due to the tightening of capital requirements imposed by supervisors. The strategy adopted by BT's board, was a successful one, reflected in the growth of granted loans. The orientation towards the needs of SME and creating dedicated departments with qualified staff in understanding the customers needs were important and winning decisions. Although the assets utilization rate remains low due to the decrease recorded by the operating income, while the total assets during this period had an upward trend. The leverage ratio during the analyzed period is maintained at a low levels too. These results illustrate the use of a lesser extent loans. As a consequence of the merger approved at the end of 2014, it is relevant to study the level recorded by this indicator since 2015 when starts the fusion process.

Figure 2. - Factorial analysis of BT's return on equity

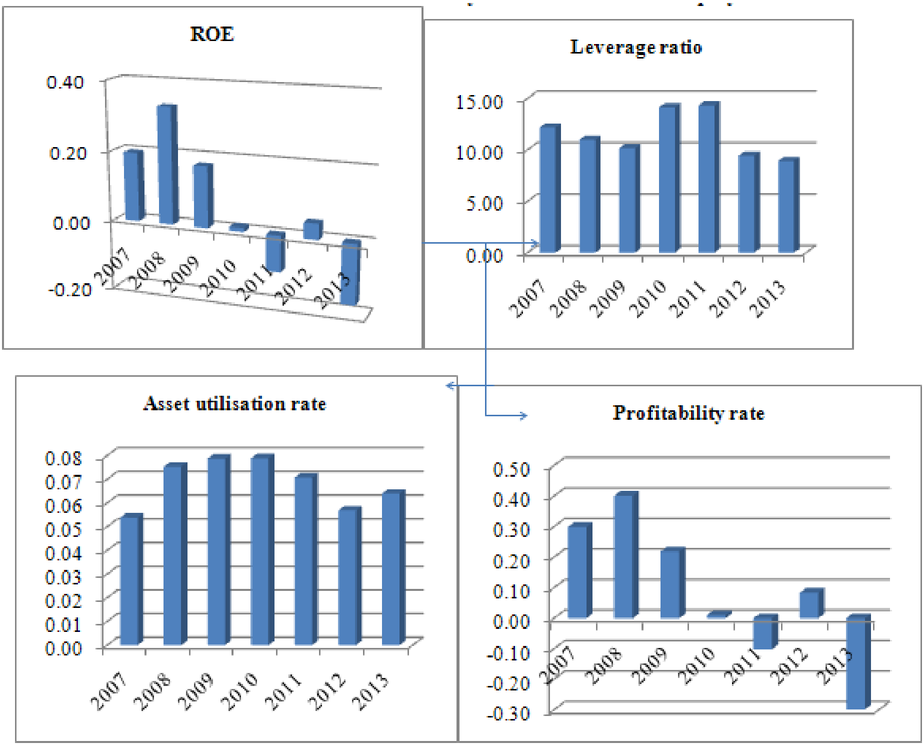


Source: personal processing of the author by BT's financial statements in the period 2007-2014

As regards the return on equity registered by the Romanian Commercial Bank SA, the first bank as size in the Romanian banking system, its level has been seriously affected by the deterioration of the loan portfolio. Pending the completion of the study, the financial results for the year 2014 have not yet been published. A summary of return on equity is done in the chart 3.

The economic crisis has seriously affected the return on equity of the credit institution, due to the problems caused by the deterioration of the loan portfolio and also because of the increasing in bad loans. As in the case of Transilvania Bank, after 2008, the bank's financial situation began to deteriorate. The main cause of the decrease in the profitability rate was due to the high volume of the created provisions. Although the operating income decreased, the pace of decline is significantly below the rate of decline recorded by the profit. Total assets until 2011 showed an upward trend.

Figure 3. - Factorial analysis of RCB's return on equity



Source: personal processing of the author by RCB's financial statements in the period 2007-2013

After this financial year, they went on a downward trend which in conjunction with the evolutions registered by the operating income determined the reduction of the asset utilization rate. As with the other two credit institutions analyzed, the equity has recorded an upward trend. This increase was due to capital by equity contributions from the shareholders of the bank, in order to increase its robustness, but also in order to align to the imposed requirements by supervisors and national banks.

A common feature of the three examined credit institutions, is represented by the low leverage ratio. This suggests that banks have less and less capacity to multiply their funds by attracting resources. Furthermore this level expresses the use by the credit institutions in an increasingly small proportion of borrowed sources. By "handling" this indicator, banks are able to raise the return on equity. This can be achieved either by maintaining a fixed coefficient of the capital multiplier or by limited cost of own funds.

5. Conclusions

The economic crisis has seriously affected the Romanian banking system, making it more fragile to economic environment vulnerabilities. One of the main problems that faced commercial banks and seriously affected their profitability is the level of provisions. Excluding capital contributions from shareholders going concern may be questionable.

One consequence of these reduction of the proftability is the represented by the appereance of new mergers and acquisitions in the Romanian banking system. The inability of banks to provide the necessary capital and thus to align to the imposed requirements by the supervisory authority, as pointed out by the theory, the credit institution’ board has three options: to increase the capital either through the issue of shares, subordinated loan , merger with other banks or capital reduction to cover losses. The changing paradigms in conjunction with excessive risk assumed by credit institutions have now become the main enemies of the continuity of comercial banks business.

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