

## THE INTERNAL ISSUES MANAGEMENT OF BANKING PROFITABILITY ON CENTERS OF LIABILITY

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The views regarding the role and importance of banks in the economy led to the emergence, over time, of what is known as banking *regulations* and *deregulations*. Regardless that the banking activity operates under regulations or deregulations, banks, to work, must have a organizational and functional structure.

Banking activity is one of the most regulated areas. It has a certain specific and it needs, so, a special treatment compared to other sectors of the economy, although it is increasingly based on market mechanisms. For these reasons and others, society through the rule of law, and by default, the banking mechanism as a whole, for reasons of solidarity and security professional, must statue precise rules for the conduct of banking profession and its organization in specific units.

Synthesized, we can say, that a bank should be organized into a structure type: central (coordinating authority) with legal personality and subunits (branches, agencies, offices) without legal personality.

The functions of a commercial bank done through these organizational structures, banking activity is looking unitary at the central level of it under the legislation and accounting standards in force. Activity being seen as unique, its profit is, also, followed in whole by external factors (banking supervisory authority, fiscal authority, etc.).

Given the evolution of the Romanian and world banking system in the last time, that *centralism* (in all kinds) has been happening increasingly, in our

opinion, may outline the following **questions**:

1. *Determining the periodic efficiency of profit centers (banking cuts) is necessary or not?;*

2. *To banking cuts can be established powers for the placement of resources or not?;*

3. **Risk-return** *relationship should or should not be tracked at the level of banking cut, too?;*

4. *It is necessary to limit or increase the competence at the level of a profit center?*

Banking practice has shown that, the *risk* is better controlled in a centralized system, as opposed to *profit*, whose size and scale is better controlled in a decentralized system that is an increase of the powers of banking cut.

Under these conditions is born a new question directly related to the **risk-return** relationship. What is the optimum relation of power between banking cut – central bank (as represented the centralism), the banking cut being assimilated to the concept of **profit** (higher efficiency) and the central bank at the **risk** (more efficient check).

To answer these questions, we started for the conclusions drawn from several studies, as follows:

**A. The study of the consultancy company Roland Berger** made for the period 2002 - 2006, to 37 banks, representative at the European level from the point of view: geographical, financial, juridical. Romania was not included in this study ([www.smartbank.ro](http://www.smartbank.ro)).

**The conclusion** of the study was:

*Flexibility branches - the key factor for the European banks performance and cost efficiency.*

Branches flexibility relate to aspects such as: the variable program of employees; variable pays, flexible work schedule.

The study stressed that, strategy and operational models differ regionally, significantly, as follows:

- *in Northern Europe*, it notes a strong delegation at the level of branches, technology and higher management costs;
- *in Western Europe*, it retains higher-incomes on customer;
- *in ex-sovietic states (CIS)* – big flexible work schedule;
- *In Central and Eastern Europe* - low delegation at the level of branches, cost efficiency suffers because of the effect of scale (small volume of activity).

The study shows, that in the last years :

#### **1. revenue per customer :**

- they have increased more rapidly in the CIS and Central and Eastern Europe / CEE / - 17.1% and 4.4%
- in Western Europe have increased an average of 0.5%;
- in Northern Europe have decreased with 1,7%.

#### **2. banking transactions :**

- in Northern Europe 44% are made by telephone, 36% at ATM ; 6% on website and only 14% at branches ;
- in other regions branches have the dominant role - 43% in West, 56% in CEE and 51% in CIS.

#### **3. annual average revenue per customer to banks branches:**

- from Northern Europe are 630 euro (at active clients) ;
- in West - 750 euro ;
- in CEE - 205 euro ;
- in CIS - 110 euro.

#### **4. unit cost per employee of the banks branches is:**

- 63,000 euro (annual) in North ;
- 65,000 euro in West;
- 23,000 euro in CEE;

- 10,000 euro in CIS.

#### **5. production costs related to revenue:**

- in North are 5,4% ;
- in West are 8,1% ;
- in CEE are 8,4% ;
- in CIS are 20,8%.

#### **The final conclusion of the study:**

Banks that require an increase in revenues, such as those in northern Europe, they should increase the flexibility of branches, the consultants from Roland Berger recommend.

**B. The analysis of consultancy firm Capgemini**, which included 9 banks, including: BCR, BRD, CEC and Transilvania Bank (The Money Channel on 03.11.2008).

The conclusion of the analysis was:

*Romania is on the last place between European countries in terms of competitive banking environment.*

In Romania, there is a difference of up to 60% of the cost of banking services from one institution to another, while in the euro area, the price differences are on average of 37%.

In the Great Britain (the most competitive market in the world), the difference is only 5 percent. For the same operations in Romania, if a customer does not make a detailed analysis of available offers on the market may pay more than 50% for the same operations.

On the other hand, banks in the euro area, unlike Romania, customers are charged more for the payments made and less on administration accounts. For example, in Austria, Belgium, Ireland and Portugal, these types of revenues covers more than 50% of banks' revenue, while in France and Spain - the share reached 70-80%.

Instead, using the cash - which is charged at us very severely - in the West, is free for most operations.

**How to explain the centralism existing in banking emerging markets (Central and Eastern Europe)? (Low**

### **delegation at the level of branch banking activities).**

In our opinion, a part of the explanations would be found:

- on the one hand, weak qualification of human banking capital, which inevitably leads to the action of risk of staff;
- on the other hand, lack of investment banks in human banking capital, banks, preferring to centralize the activity to control risk, than to invest in human capital to be able to ensure the increase of revenues.

In order to increase the efficiency of the banking activity, it is necessary, as reveals the study of Roland Berger Company - a great flexibility of banking branches (cuttings). This flexibility of banking-cut can, to summarize to what some authors (Lupulescu, G. – Internal Management of Banking Profitability - doctoral thesis, Cluj-Napoca, 2008) recommends that a necessity-the implementation of Internal Management of Banking Profitability (IMBP).

The management of any commercial bank must be determined as precisely (to quantify) who has made contribution to profits realization. In this way, it will take managerial decisions that can positively influence the profit level of future period.

Commercial banks through their organizational and functional specific achieved an accounting profit for the whole entity. To contribute to their components organizational structures, some in direct input, others indirectly. The bank profit is different from one bank to another depending on the types of services and activities developed the attractiveness of these services for customers, ensured transparency of bank and other characteristics depending on the banking management, the size of each bank, and the risk strategy.

One of the major concerns of management of a commercial bank is to quantify exactly the contribution brought by each component of the whole. The difficulty involved in the activity specifics

of a bank, which specifically requires a particular way of organizing work. For a bank to work it must be organized into a structure type: Central (coordinating body), sub-units (branches, agencies, offices) without legal personality.

The only organ which present interest in activity and in the overall profit breakdown on carvings (sub-units), banking management, which must establish rules and its own internal procedures for a more precise quantification of the contribution made by each cutting (subunit) to the general profit bank. As these internal procedures and rules will quantify more accurately the contribution made by each cutting (subunit) to achieve the overall profit, the more, the banking management has the necessary information for the management and the process control to achieve the bank's strategy, the performance evaluation of each cutting (subunit) and their service managers.

In doing so, the banking management contributes to the introduction and expansion, deepening and intensifying the application of *methods of internal management on the centers of responsibilities*- as one of the main ways to improve the banking management, to implement an internal management of banking profitability, as the synthetic component of it (banking management). In the commercial banks, centers of responsibility are treated as banking centers of profit. It requires monitoring the activity both cuttings (subunits) and the central.

Profitability of cuttings (subunits) called the center of responsibility, would have to resolve, to may establish the total effective cost and financial results, the following issues:

- ◆ *the cost of transfer of resources* between the centers of responsibility of the bank;
- ◆ *formation of minimum required reserve and provisions;*
- ◆ *reflecting in management centers of responsibility and other expenses which are centralized*

*contracted, as well as some revenues which is collected centralized;*

◆ *budgeting the centers of responsibility*, the budget that takes into account the local environment in which they carry on the activity that center of responsibility;

◆ *establishment of profitability indicators, related to indicators of risk for each responsibility center.*

Being a method of internal management, the profitability model of a commercial bank remains at the discretion of each bank to establish it and to adjust it (improve) always, depending on the bank's strategy. Establishing the model of internal profitability of a commercial bank is influenced by: the *specific of activity and the organizational structure* of the bank. Thus, in a commercial bank the cover of its investments from attracted resources (mobilized in the economy) and its own resources are followed at a central level of bank and not on cuttings (subunits). Some investments and attracting resources are made only at the central level and they are made to balance the resources with investments taking place in all the organizational structures of the bank.

Organizational structure of a commercial bank affects the model of internal profitability of the bank, by the fact that, at this level can sign big disproportions between the level of investments and of resources attracted on local plan, levels determined by the potential of area in which the cutting (subunit) carries on its activity respectively, cutting management (subunit) etc..

The mechanism of operation rather complicated of a bank, defined in summary as mobilizing temporary available sources in the economy and places them in conditions of economic efficiency for the bank, makes the need for liquidity of any bank to be a vital issue for her, being closely followed by banking supervisor. This permanent liquidity need for the good functioning of a bank require

a permanently existence of a marginal resource, defined as the resource to which the bank will have access to meet the demand for liquidity (the last resource to be bought).

In this context appears the marginal cost, which is defined as the additional cost, trained in procurement of an additional source. It is given by the total expenditures increase resulted from the growth of a volume of resources and it is expressed by the relation:

$$CM = \frac{\Delta CT}{\Delta R},$$

In which:  $CM$  – marginal cost;  
 $\Delta CT$  - growth of cost;  
 $\Delta R$  - growth of resources.

Marginal cost can be an instrument for regulating the demand for resources, causing a certain behavior of banking management. The model developed takes into account the marginal revenue, too, expressed by additional revenue from the placement of additional resources.

Thus, in a commercial bank the coverage of its investment, from attracted resources (mobilized in the economy) and the own resources, they are aimed at the central level of the bank and not on organizational structure components (subunits). Certain investments and attracting sources are made only at the central level and they are made to balance the resources with investments, which take place in all the organizational structures of the bank, figure number 1. Solving the problems of these aspects by a commercial bank, it would inevitably lead to the implementation in the banking practice the concept of **internal management of banking profitability** (I.M.B.P.)

The existence of internal management based on responsibilities supposes to give a relative autonomy of these through:

◆ *delegation of the authority (power) of these to negotiate their*

resource needs and objectives to be achieved;

- ◆ organize a system of relations between the responsibility and organization centers of records in a position commensurate the earned or proper revenues from its own activity and consumption of resources related to achieve the objectives set.

The center of responsibility has some *objectives to achieve*, usually expressed in financial terms that depend of the nature center (General Department), which must:

- ◆ to allocate sufficient *resources* to achieve the fixed objectives;

- ◆ to *delegate* some of the authority for him to have some autonomy in decision making.

Each responsibility center must have a system to *measure the performance* to enable to inform the General Department on:

- ◆ achievements in relation to the assumed or negotiated objectives;

- ◆ the consumption of resources;

- ◆ other indicators agreed at the beginning (negotiated).

The choice of relevant performance indicators and agreed by the responsible of centers is a necessary condition for the proper functioning of a bank, approached as a network of centers of responsibility.

The method involves at the level of a commercial bank a monitoring of both the units from the banking network, and the activity realised at the Central Bank level, for a efficient management of

material and financial resources hold by them.

In order to review the efficiency of the developed activities, units of a commercial bank may be grouped in:

- ◆ *profit centers* - representing areas of responsibility for *revenues, costs, outcomes*, planning and tracking of achievements in line with financial plan and the revenues and expenditures budget;

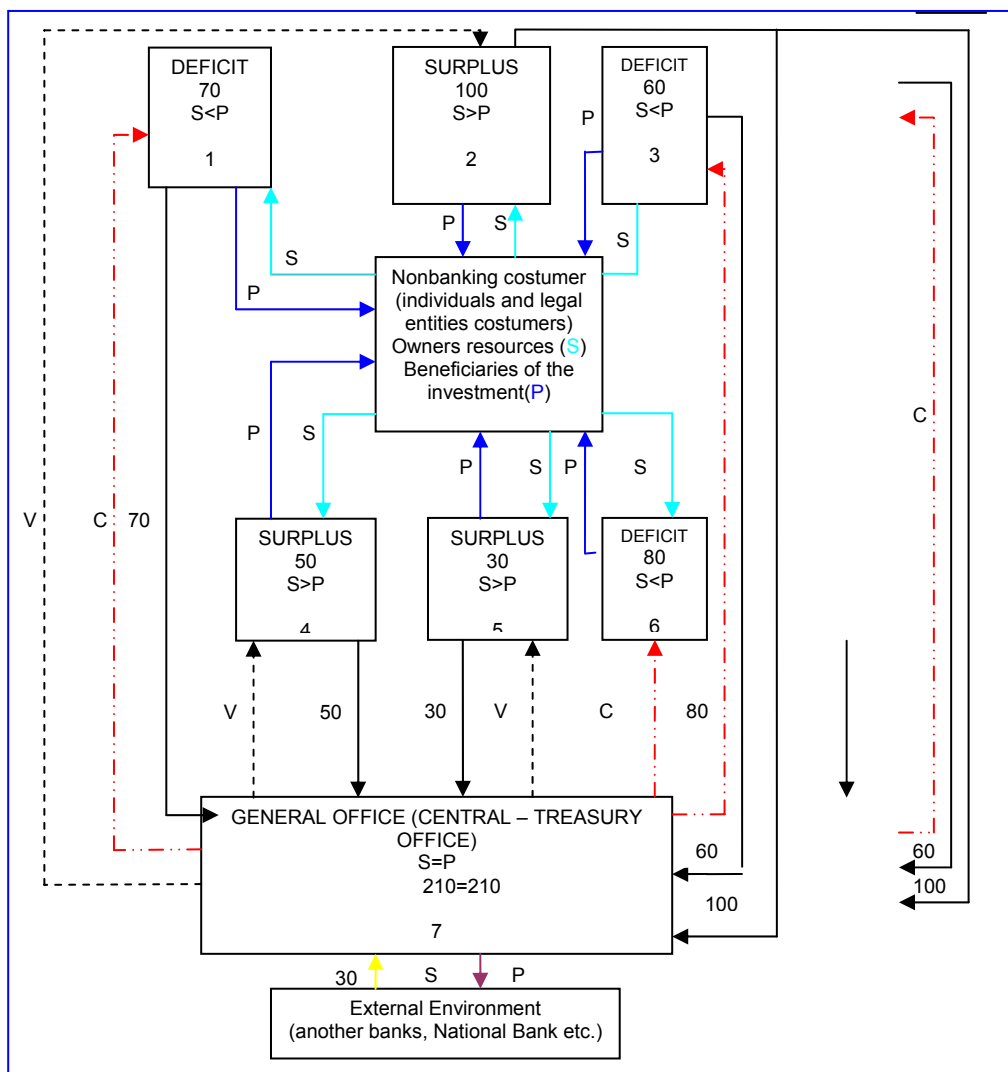
- ◆ *cost centers* – representing responsibility domains for expenses, planning and following them in order to reach the established levels.

- ◆ *cost centers* - representing areas of responsibility for *expenditures*, planning and tracking their classification in the established levels.

Part of the whole, centers of banking responsibility, must be budgeted according to the economic potential of the area, the density of competition, scheduled products and services, so that the plan to be mobilized, but motivated. Periodical review of the achievements compared with their programming (planning) is essential for assessing the respective centers.

Given that the overall performance of a bank is given by the *risk-return* relation and when one of these elements of the relationship – *profitability*, is detailed and followed by all component segments of the whole, it is necessary in our opinion, as the second element of the relationship - *the risk*, to follow the same way.

Figure 1. Scheme of operation of a commercial bank, regarding on the coverage and placing deficit, respectively, the surplus of resources and the redistribution method of revenues and expenditures arising from these transactions between the profit centers reported [1]



**LEGEND:**

1, 2, 3, 4, 5, 6, 7 – Profit centers (CP) of a commercial bank (responsibility centers);  
**S** – resources (cash raised by the bank on the market);  
**P** – investments (usually bank loans granted to its clients);  
**D** – deficit, it is recorded when  $S < P$  and it generates costs for the profit center;  
**E** – excedent when  $S > P$ , and it generates revenues for the profit center;  
**V** – revenues from surplus;  
**C** – costs from deficit;  
 Level overview of the bank, the influence of V and C in the general profit of the bank is zero ;  
 — - daily paying of surplus or deficit by CP, to profit center represented by General Office Treasury of bank (also called pool of Treasury);  
 ----- - revenues from surplus;  
 ----- - costs from deficit;  
 — - credits granted to nonbanking costumers (placing sources) by CP;  
 — - sources (cash) attracted from nonbanking costumers by CP;  
 — - sources attracted by General Office from the monetary market  
 — - investments made by General Office on monetary market.  
 Additional information:  
 Profit center (CP) to made resources and place them, does not enter in direct relationship only with individuals or legal entities customers. They do not have direct relations with the external environment (other banks, National Bank etc.).  
 CP daily turns the surplus or covers its deficit only through GENERAL OFFICE (central bank- represented by the Treasury Department organized as a profit center also called pool of Treasury).  
 Daily Treasury Department balances resources (S) with investment (P) by "buying" or "sales" of S or P in the external environment, so that  $S = P$  daily at the level bank as a whole.  
 Periodically (usually monthly or quarterly) in order to assess the efficiency and quality of management profit center (CP), there is the location of all expenditures and revenues on CP. Some expenditures and revenues is done only at central level, but some of them are related to each CP.

Source: Lupulescu G. – *Internal Management of Banking Profitability -doctoral thesis, Cluj Napoca, 2008*

In this way at the level of cuttings (subunits) must require the use of terms such as, *efficiency and risk indicators of cuttings (responsibility centers)*.

In our opinion, *efficiency indicators related to the centers of responsibility*, could materialize in:

- investment in lei and foreign currency on short, medium and long term;
- resources of coverage them as sight cash and term deposits in lei and foreign currency;
- the surplus/deficit of resources;
- implementation of the budget revenues and expenditures, also revenues from interests, commissions, fees and charges and expenses related to the operation unit;
- different customer segments, depending on the revenue class;
- expand operations settlements;
- profit ratio;
- the share of calculated and received profit;

- productivity;
- profit at 1,000 lei / employee;
- the share of wages in total expenditures on bank operation;
- coverage of expenses for bank operation from fees collected;
- number of credits / employees;
- number of settled operations / employee;
- number of counted packets / employee;
- operating expenses / employee;
- average wage;
- spaces / employee;
- the cost of a leu profit (profit / total costs).

*Indicators of risk related to centers of responsibility* could be the following:

- the share of outstanding loans or total unearned interests in total loans or interests;
- the provisions ratios (adjustments);
- degree of repayment of loans;

- degree of hedging credit risk;
- the share of loans from off-balance sheet to those in the balance sheet;
- the share of interest income in total calculated interest;
- coverage degree of loans and interests from off-balance sheet with guarantees;
- degree of recovery of loans and interests from off-balance sheet.

Such a model of internal profitability well fundamented and implemented can:

- be an effective lever to reach the bank management in order to positively affect future profit, through the right decisions based on accurate information provided by the concerned model;
- contribute to establish the results of each activity center (responsibility) and may influence the behavior of managers and employees in various work centers (responsibility);
- contribute to the preparation of the profit or loss account for each activity center (responsibility), including only those numbers which have a clear relationship with the work (responsibility) of that center;
- provide accurate information to employees in connection with the work system, objectives and performance of respectively center.

Models of internal profitability can not be imuable (established once and for all), they have always improved, adjusted by new factors that appear in the unfolding process of bank intermediation (legislative changes, changes in banking

strategy of shareholders, etc.). They may also be different from a commercial bank to another, depending on the market segments addressed by each, by strategy risks, bank size, etc.

### Conclusions

Synthesized the results of undertaken investigations we can say that:

- effectiveness of banking centers of responsibility, as part of the whole, it must be forecasted, monitored and periodically reviewed, as these organizational structures absolutely necessary for the proper functioning of a bank, mobilizes resources and placed them the banking market. Of how this process takes place, depends on the efficiency of banking cut;
- the central of banking responsibility being a mobilizing of resources and a making investments in the banking market, banking cut should have powers in placing resources whereas it knows the best the local environment in which it operates;
- **risk-return** relationship, must be implemented and followed up at the banking cut, being required by the increased power and efficiency of the center of banking responsibility;
- banking cut requires an increase of competence in mobilization and placement of resource, accompanied by an increase in responsibilities.

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