EGE SCHOLAR JOURNAL

Ege Scholar Journal, Year: 2024, Volume: 1, Issue: 1, Pages : 26-36 **Research Article**

Publication Date: 04.02.2024

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Assessing and Appraising the Performance of Banks

Abstract

A bank is a prime illustration of a financial intermediary. Traditionally, their primary function has been to gather the accumulated funds of the economy through deposits and subsequently provide these funds to segments of the economy in need in the form of loans. This definition is excessively simplistic. The banking process is very intricate, although its fundamental principle can be summarized as follows: gathering deposits and allocating them towards lending activities. Nevertheless, the swift advancement of the financial system, along with heightened competition among financial intermediaries, has prompted banks to considerably broaden their scope of operations. Currently, banks face significant pressure to fulfill the objectives of their shareholders, employees, depositors, and borrowers while also demonstrating to government authorities the stability of their policies, loans, and investments. Due to the growth of banking institutions in recent years, many of them are compelled to transition to the money and capital markets in order to generate funds through the sale of shares, bonds, and other financial instruments. Oftentimes, despite the rise in local deposits, it remains insufficient to adequately fund the substantial requests from clients for loans and other services. Banks participate in the open market to raise funds, meaning that their financial reports are subject to scrutiny by investors and the general public. This development creates a sense of urgency for the banks' management to establish and achieve the banks' operational objectives. Simultaneously, there is a significant surge in competition among banks to attract customers who are interested in utilizing conventional loans and deposits. Bankers are often encouraged to assess their credit and deposit policies, thoroughly examine their strategies for growth and advancement, and analyze their returns and the dangers associated with this emerging competitive landscape. This study will comprehensively analyze the various variables that assess the quality and amount of work in the banking sector. Our primary focus will be on the key elements of each bank's operations, namely profitability and risk. Nevertheless, a commercial bank is essentially a corporate entity. A firm is structured with the aim of optimizing the value of the invested shares' capital while maintaining an acceptable level of risk. The objective is to optimize profitability while maintaining an acceptable level of risk for the bank's shareholders. The recent bank failures worldwide serve as evidence that achieving this goal is difficult. Institutions must consistently make a strong effort to pursue new ways that will raise their income, improve efficiency, and enhance planning and control. This paper will outline the analytical tools that can be employed in the financial reports of banks. These instruments enable bank management and stakeholders to identify and address the most pressing issues inside each bank. Additionally, we'll highlight the various risk categories that banks encounter as well as the widely used techniques for determining the level of risk in banking institutions.

Keywords: Values, ethical leadership, organizational performance, and LPDs.

How to cite: Orhan Rexhat R. (2024). Assessing and Appraising the Performance of Banks. *Ege Scholar Journal, 1*(1), 26-36.

INTRODUCTION

The term "bank" originates from the Italian words "banko," "tezge," and "sportel." The primary purpose of banks initially emerged as a means to facilitate the exchange of currency, particularly in response to the existence of various forms of metallic currency. Consequently, banks were established to fulfill the task of facilitating monetary transactions. A bank is a financial entity that receives deposits, grants loans, and facilitates payment transactions between clients. To precisely delineate the concept of a bank and formulate a definition that aligns with the current operational context of banks, it is necessary to establish criteria that differentiate banks from entities engaged in productive, commercial, and service-oriented activities.

The criteria that are used to provide the most precise definition of banks are:

Does the institution have an impact on money creation through its operations? Is its primary function to provide loans? Does the institution offer strong financial support to achieve the country's economic and development objectives? What are the institution's capabilities in terms of enhancing payment transactions and expediting monetary circulation?

According to the specified requirements, we can provide the following definition of a bank: a bank is a specialized financial institution within the monetary-credit system that professionally handles the receipt and provision of credit, as well as facilitates the flow of payments between clients.

Banks are responsible for issuing the national currency card, accepting deposits, providing loans, facilitating payment transactions for their customers, and performing other related activities. Naturally, these functions are not executed by a single kind of financial institution. Various categories of banks exist, including national banks, commercial banks, savings banks, agricultural banks, and others, which typically carry out one or more of the following duties: The central bank, for instance, is the entity that plays a crucial role in monetary policy and serves as the primary bank for other banks.

Every country, regardless of whether it has a mature market economy or is in a transitional phase, depends on the two-tier banking system. The Central Bank, which is the monetary governing body in charge of creating and carrying out monetary policies, serves as a symbol for the first tier. The subsequent tier consists of commercial banks, which primarily undertake the task of funding the economy.

The banking system in RK comprises two tiers: the People's Bank of Kosovo and second-tier banks, which are further categorized into two primary segments: commercial banks and savings banks. Based on its institutional and systemic makeup, as confirmed by banking law, this system can be accurately described as a universal banking system.

In accordance with the legislation governing the Central Bank of the Republic of Kosovo and the banking sector, the Central Bank of RK is the sole regulatory body responsible for granting licenses to banks and savings banks in the Republic of Kosovo. Additionally, it is also entrusted with the authority to oversee and monitor their operations.

BANKING PRINCIPLES

Banks engage in an economic endeavor that operates on the same principles as a tax-exempt business, with the aim of generating profits for their owners.

Financial institutions, such as banks, adhere to their own set of principles in order to safeguard the stability of their operations and the overall national economy. The three primary tenets of banking are:

1) The notion of liquidity pertains to the capacity of banks to meet all their financial commitments promptly. Some of the key responsibilities that determine a bank's liquidity include: a) fulfilling customer orders to withdraw funds from their deposits within a specified timeframe. b) Granting loans to customers within specific deadlines. c) Repaying loans received from other banks, both domestic and international, within specified deadlines. Banks can ensure their liquidity by effectively coordinating the processes of loan disbursement and deposit collection and by utilizing short-term loans based on deposit collateral. The bank's liquidity is categorized into three levels: primary liquidity, which encompasses cash, assets held with B.Q., and other cash assets; secondary liquidity, which includes primary liquidity assets along with bills of exchange and securities with a maturity of up to 1 year; and tertiary liquidity, which comprises illiquid assets that cannot be converted into cash before their respective deadlines, such as bills of exchange that cannot be extended and promissory notes with a maturity exceeding 1 year.

2) The notion of insurance ensures that the bank may rely on its clients to meet their responsibilities to the bank within specific timeframes and repay the loan. The notion of insurance mandates that the bank must provide loans in secure locations by requiring reliable assurances that the loan will be repaid in a proper manner. Failure to adhere to the principle of insurance while lending can lead to an unstable and illiquid state inside the bank and the overall national economy.

3) The difference between the bank's income and expenses, specifically the distinction between passive and active interest, is what the term "principle of profitability" refers to. Presently, commercial banks uniformly adhere to all three criteria, with banks that have sound business practices striving to achieve profitability while simultaneously considering the attainment of liquidity and insurance principles.

ASSESSMENT OF BANKS' PERFORMANCE

How can we utilize a bank's financial report, specifically its balance sheet and income statement, to evaluate its performance? What indicators should we examine to ascertain if the bank is experiencing significant management issues? Should it be released at the conclusion?

The exercise balance serves as the primary method of periodic communication for the bank regarding its property, financial, and economic situation. It is imperative that it fulfill two fundamental criteria:

- Information regarding RK is available to other entities, such as the central bank, depositors, trusted clients, accounting specialists, and others.
- To provide the owners of capital and those taking risks (including the control group and various minority groups) with a projection of future income based on their current income.

Calculating and examining specific ratios, frequently referred to as quotas or rates, is the process of conducting balance analyses. In order to streamline the analysis, the balance indicators are categorized into three distinct groups:

1. Liquidity indicators provide insight into the bank's capacity to generate adequate funds for timely fulfillment of its financial commitments within short-term intervals.
2. The bank's solvency ratios indicate the bank's capacity to retain an adequate amount of its own capital to cover all accumulating deposits.

Productivity reports attempt to showcase the bank's capacity to create sufficient income in relation to the capital invested.

OPTIMIZING THE VALUE OF THE FIRK: The primary objective of any bank

While there may be justifications for the stated objectives, an increasing number of banks are demonstrating the necessity of prioritizing the valuation of their shares. Essentially, the fundamental tenets of financial management, now employed in the field of science, assert that the primary objective to be given precedence is the endeavor to elevate the worth of the bank's shares to a higher magnitude. Banks are corporate entities that have shareholders who are primarily concerned with the fluctuations in share value and the generation of share income or dividends. If the share value fails to meet the shareholder's expectations, investors may promptly divest their shares, as the bank would encounter challenges in raising fresh capital, which is crucial for future growth. It is evident that bank management must strive to increase the value of shares to a higher level.

What is the reason behind the rise in the value of the shares? The following factors affect the desired shares' price:

Value of bank shares(Yes)	=	The expected stream of future stock dividends	=	$\sum_{t=0}^{\infty} \frac{E(D\ )}{(1+r)^t}$
		Root factor (based on the minimum required market rate of return on capital based on each bank's anticipated risk level)		

The variable E (Dt) reflects the projected dividends that shareholders are expected to receive in future periods, taking into account a minimum acceptable rate of return (r) that is associated with the expected degree of risk in the banking industry. The minimum acceptable rate of return, denoted as r, encompasses two primary factors: (1) the risk-free interest rate (typically approximated by the current yield of government bonds) and (2) the compensation for capital risk (which serves as a reward to investors for assuming the risk associated with investing in bank shares rather than risk-free securities).

The value of the bank's shares appreciates in any of the following scenarios:

1. The future dividends for shareholders are anticipated to rise due to the growth of the markets in which the bank operates or as a result of a lucrative merger conducted by the banking organization.

2. The banking organization's expected level of risk has decreased due to the increase in its capital reserves, the reduction of bad loans, and the perception among investors that the bank is less exposed to risk. This is likely because the bank has expanded its services and entered new markets. As a result, the bank now faces a lower premium for capital risk.

3. Bank shareholders have noticed that there is a decrease in risk along with the anticipated dividend growth.

Research conducted in recent years has shown that the value of bank shares is highly responsive to fluctuations in interest rates, currency rates, and the overall economic conditions in which each bank operates. Nevertheless, management can incorporate the plan into the formulation of policies that enhance the bank's future revenue, mitigate risk, or even synergistically combine both aspects to elevate the value of the bank's shares.

The formula for the price of a bank's shares indicates that the dividend paid on the bank's stock fluctuates. However, if the dividends that banks distribute to their shareholders are anticipated to

increase consistently over a specific timeframe, reflecting a stable growth in income, the equation for the price of bank shares can be simplified and expressed as:

$$Yes = D_1/(r-g)$$

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The variable D represents the anticipated dividend from the bank's shares in period 1, while r denotes the Escont rate, which signifies the expected level of risk associated with investing in the bank's shares. Additionally, g represents the constant expected growth rate at which the dividends for the bank's shares will increase annually. It is important to note that r must exceed g. For instance, let's assume that the bank is projected to distribute dividends of $5 per share in period 1. It is estimated that the dividends will increase by 6% in the next period. Meanwhile, the interest rate, which reflects the level of risk associated with the shares, stands at 10%. The price of the shares would be calculated as follows: Ro = 5 dollars / (0.10 - 0.06) = 125 dollars per share.

Both formulas offered for determining the price of the bank's shares presume that it will continue to distribute dividends until a predetermined future date. The majority of investors in the capital market possess a restricted time frame and want to divest their holdings in bank shares upon reaching the conclusion of their investment horizon. In this scenario, it is possible to determine the current value of bank shares by:

$$Yes = \frac{D_1}{(1+r)^1} + \frac{D_2}{(1+r)^2} + .. + \frac{D_n}{(1+r)^n} + \frac{P_n}{(1+r)^n}$$

Assuming that the investor will possess the bank's shares throughout a specific time period, denoted as "n," and will receive dividends D1, D2,..., Dn, the shares will be sold at price Pn at the conclusion of the intended investment duration. For instance, let's consider a scenario where investors anticipate that the bank will provide dividends of $5 at the conclusion of period 1, $10 at the conclusion of period 2, and then want to sell the shares at a price of $150 per share. The current value of the bank's shares should be determined based on a risk reduction rate of 10%.

$$Yes = \frac{5 \text{ dollars}}{(1+0,10)^1} + \frac{10 \text{ dollars}}{(1+0,10)^2} + \frac{150 \text{ dollars}}{(1+0,10)^3} = 136,78 \text{ dollars per share}$$

Ratios are used to measure the profitability of a company.

Profitability coefficients serve as a viable option for assessing the value of stocks.

While stock price determination is generally considered a trustworthy predictor of a firm's performance in the market, it is not consistently accurate or dependable in the banking industry. This is because

the majority of banks, particularly smaller ones, do not have their shares traded in both national and foreign markets. Financial analysts are motivated to utilize other measures, such as profitability coefficients, to assess market value.

Key indicators of profitability in the banking sector

The key coefficients utilized in assessing the bank's profitability are as follows:

Return of capital (ROE) =	Net income after tax / Total share capital	(2)

Asset recovery (ROA) =	Net income after tax / Total assets	(3)

Net interest margin =	(Interest income from investments in loans and securities - interest expenses on deposits and other loans) / Total assets	(4)

Net margin without interest =	(I entered without interest - interest-free loans) / Total assets	(5)

Net operating margin of the bank =	(Total operating income-Total operating expense) / Total assets	(6)

Profit from shares =	Net profit after tax / Common shares	(7)

Return on assets measures the efficiency with which management utilizes the company's resources. A low rate signifies the presence of either exorbitant corporate overhead or cautious lending procedures. On the other hand, a high rate indicates either effective corporate operations or a bold approach to financing. Granting loans. In the second scenario, the commercial bank encounters a heightened risk in order to get superior rates of return on its assets. The return on assets can be utilized for interbank comparisons or for comparisons with the banking system.

The capital return, or capital return rate, indicates the amount of profit that shareholders receive from their investments in an institution. Additionally, capital return can serve as a metric for comparing different banks or for evaluating the performance of the commercial banking sector, with a specific emphasis on profitability for shareholders.

Similar to other financial measurements, these profitability ratios fluctuate over time and across different markets.

DISCUSSION

Elucidation of profitability coefficients

Each of these coefficients pertains to distinct facets of the bank's profitability. Return on assets (ROA) is primarily a gauge of management effectiveness, reflecting the level of success the bank's management has had in utilizing the institution's assets. ROE, or return on equity capital, is a metric that quantifies the profitability of a bank's shares. It quantifies the net profit that shareholders generate by investing their capital in the bank, assuming the associated risk in the hope of achieving a comparable profit.

Net operating margin, net interest margin, and non-interest margin are indicators of both efficiency and profitability. They demonstrate the effectiveness of management and personnel in sustaining revenue growth (primarily from bank loans, investments, and services) relative to the rise in expenses (such as interest on deposits and loans from the money market, salaries, and employee income).

The net interest margin quantifies the extent of the difference between interest income and interest expense that management achieves by effectively managing the bank's interest-bearing funds and seeking out cost-free sources of funds.

The non-interest margin quantifies the non-interest income generated by the bank from provisions for deposit services and other services (referred to as income from provisions) relative to the non-interest expenses incurred, such as salaries, wages, expenses for improvements, and maintenance costs associated with bad loans. For the majority of banks, the non-interest margin is in negative territory. Although the income from the bank's provisions has been growing quickly in recent years and now accounts for all of the bank's income, this is due to non-interest expenses and provisions.

Effective formulas for maximizing profitability

When evaluating the performance of a bank, it is beneficial to break down some profitability indicators into their fundamental elements.

It is evident that ROE and ROA, which are widely used measures of profitability, are tightly correlated. Both utilize the identical numerator: net income following taxation. Therefore, these two measures of profitability can be directly correlated with:

		Total assets	(9)
ROE=ROA	h	Total amount of share capital	

Or, in other words:

Net income after tax		Net income after tax	(10)
Total amount of share capital	=	Total assets	

	Total assets
h	Total amount of share capital

Nevertheless, it is important to highlight that the bank's net profit is calculated by subtracting its operational expenses and taxes from its total income. Therefore:

ROE =	Total revenue – total operating expenses		it is an asset	(11)
	total assets	h	Total share capital	

The equations (10) and (11) indicate that the shareholders' income is responsive to the method of financing the bank's assets, whether it involves increased debt (leverix) or increased equity capital. While a bank with a low return on assets (ROA) can nonetheless achieve a relatively high return on equity (ROE) by utilizing debt (leveraging) and minimizing the usage of equity,.

Return on equity (ROE) is equal to return on assets (ROA) when considering total assets. Aggregate value of the company's issued shares

The ratio between return on equity (ROE) and return on assets (ROA) effectively demonstrates the inherent correlation between risk and revenue that bank management encounters. As an illustration, the bank, which is expected to have a return on assets (ROA) of approximately 1% this year, will require $10 in assets for every $1 in equity in order to achieve a return on equity (ROE) of 10%. The representation of this can be expressed using equation (9):

=	0,01 h 10 dollars h 100	= 10%
	1 dollars	

If the bank's return on assets (ROA) is projected to decline to 0.5%, in order to achieve a return on equity (ROE) of 10%, each dollar of equity must support $20 in assets. To put it differently:

ROE	=	0,005 h 20 dollars h 100	= 10%
		1 dollars	

It is evident that the bank must assume larger leverage, which has inherent risks, in order to achieve the targeted rate of revenue for its shareholders. The use of ROA as a gauge of profit efficiency indicates this.

Dissecting the capital returns for a more comprehensive examination

Another beneficial formula, which centers on return on equity (ROE), is:

ROE =	net profit after tax		Operating income	(12)
	Total operating income	h	Total assets	

h	total assets
	Total amount of share capital

or

The return on equity (ROE) is calculated by multiplying the net profit margin, asset utilization ratio, and capital multiplier.

Net profit margin (NMP) of the bank	=	net profit after tax / Total operating income	(13)

The bank's asset utilization rate	=	Total operating income / Total assets	(14)

Capital multiplier (RK) of the bank	=	in total Activa / Total amount of share capital	(15)

Every element of this uncomplicated equation serves as an intricate signal for distinct facets of the bank's operations.

Nevertheless, as the multiplier increases, the bank's capacity to generate substantial profits for its stockholders also increases.

CONCLUSION

This article primarily focuses on quantifying and assessing the performance of banks in terms of their provision of services to consumers and their ability to generate satisfactory returns for shareholders. Bankers are required, both due to competition and regulatory requirements, to regularly assess the performance of banks and examine the underlying reasons for any business issues by comparing them with other banks. This analysis helps identify areas for improvement and enhance the bank's future operations. We outlined the fundamental elements of the banks' operations, including their profitability and risk factors. Undoubtedly, prioritizing profitability is crucial, as it safeguards money and guarantees sustainability and growth in the long run.

The market value of shares for large banks serves as a reliable indicator of their ability to generate profits in proportion to the risks they undertake. Nevertheless, the stocks of small and medium-sized banks have low trading activity, rendering the stock market value an insignificant indicator for management. Instead, these banks should prioritize important profitability criteria, including return on assets, return on capital, net interest margin, and net non-interest margin.

In this article, our primary emphasis was on the imperative for management to give careful consideration

to risk. We delineated various forms of risk, with the most crucial ones being credit risk, liquidity risk, interest risk, market risk, risk of income, and solvency risk. Bank managers must anticipate and effectively handle all the many forms of risk.

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