



ORIGINAL PAPER

The Determinants of Bank Profitability in Romania

Klejda Gabeshi¹⁾

Abstract:

The profitability of a banking sector is a mirrored image of how banks use their resources to achieve their objectives. The determinants of bank profitability have attracted the interest of academic research, as well as that of the financial markets and bank supervisors. The main objective of this paper is to identify the bank specific and macroeconomic factors that affect the profitability of all commercial banks operating in Romania, through adequate empirical analysis. The econometric model used is that of multiple linear regression where as the dependent variable used as proxy for bank performance is obtained the Return on Equity ratio and as independent variables are chosen a number of macroeconomic indicators and indicators of assets and liabilities of the Romanian banking system. The results of the econometric model showed that there is a direct statistically significant relationship between ROE as determinant of bank profitability and factors such as bank credit to the private sector as percent of GDP, real interest rate and the inflation rate. On the other hand, the results of the econometric model showed that there is an indirect statistically significant correlation between the level of ROE and the indicators of bank assets as percent of GDP and the unemployment rate. The Romanian banking system has prudent indicators of solvency, profitability and balance sheet structure better than the European average, but the quality of assets is still discordant, due to the rate of non-performing loans and loans with restructuring measures, which, although decreased sharply, remain above EU average levels.

Keywords: *Bank Profitability; Macroeconomic and Bank Specific Determinants; Multiple Linear Regression; Romanian Banking System.*

¹⁾ PhD Student, Faculty of Economics and Business Administration, University of Craiova, Romania
University of Craiova, Romania & Ass/Lecturer, Logos University, Tirana, Albania, Email:
klea.gabeshi@gmail.com.

Introduction

Banks play a crucial role in determining the standard of living of modern economies. They have the ability to collect a very important part of society's savings and distribute it among companies and families requesting loans to finance their economic activities. In the emerging markets, which have less complex financial systems, banks play an even more important role than in developed economies, as they are the main institutions that produce the information needed to carry out financial intermediation.

Profitability is one of the main reasons for the existence of business enterprises, and business enterprises continue their operation by securing profits. Banks are business enterprises, which aim to secure profits just like other enterprises. In this regard, the profitability performance of banks indicates the success of bank management. Therefore, bank profitability is one of the most important indicators for investors.

The profitability of a banking sector is a mirrored image of how banks use their resources to achieve their objectives. More accurately, it reflects the quality of bank's management and stakeholder's behavior, bank's competitive strategies, efficiency and risk management capability. The determinants of bank profitability have attracted the interest of academic research, as well as that of the financial markets and bank supervisors. The researchers mainly used two indicators to determine the bank's profitability: ROA (return on assets) and ROE (return on equity). In order to determine the profitability of a banking sector, both micro and macroeconomic factors need to be examined. The environments in which banks operate can affect their performance and also their strategic positioning. External determinants represent events outside the scope and influence of banks. The external environment defines the legal, political, economic, technological and social picture in which banks operate. These factors are called external because banks have no control over them, although banks can anticipate changes in the external environment and strategically take advantage of them. Macroeconomic determinants reflect general macroeconomic factors and market conditions in a country. Internal determinants of banks' profitability are usually composed of factors that are within the control of commercial banks. They are factors that affect the income and expenses of banks. Some studies classify them into two categories namely financial statement variables and non-financial variables. The variables of the financial statements include factors that are directly related to the bank balance sheet and the income statement. Meanwhile, the variables of non-financial statements include factors such as the number of branches of a particular bank, the location and size of a bank, etc.

As "micro" environmental factors are considered the specific banking factors, that include a series of indicators measured by financial ratios that reflect: liquidity, profitability, efficiency, portfolio quality, capital adequacy and others. Among the factors of the "macro" environment are all those factors that are not related or determined by the bank's management, such as growth, gross domestic product, inflation, unemployment and others related to them. Among the factors of industry, market structure we can mention: concentration, competition, etc. Other determinants of performance indicators are related to the structure of the bank such as ownership, origin, longevity of the activity, etc.

The main objective of this paper is to identify the bank specific and macroeconomic factors that affect the profitability of all commercial banks operating in Romania, through adequate empirical analysis. In recent years, the Romanian economy has become extremely dependent on financing from the banking sector. The banking sector in Romania is showing a growing evolution, both at the operational level and at

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the level of risk management. Profitability is concentrated in the sector, as over 75% of profit was generated by the top 5 institutions (of total assets). ROE registered a value of 12.3% in 2019 following a slight downward trend. The Romanian banking system has prudent indicators of solvency, profitability and balance sheet structure better than the European average, but the quality of assets is still discordant, due to the rate of non-performing loans and loans with restructuring measures, which, although decreased sharply, remain above EU average levels.

The coronavirus pandemic was a major shock to the European economy, with unprecedented declines in economic activity and significant global uncertainty. The Romanian banking sector was affected as well. The National Bank of Romania has adopted a package of measures to mitigate the negative effects of the crisis caused by the pandemic of the new coronavirus (COVID-19) on the Romanian population and companies. The following were undertaken: monetary policy measures; measures to make the regulatory framework more flexible so that credit institutions and NFI can help individuals and credit companies; bank resolution measures and operational measures. The majority of larger banks reported declining profits in the end of the year 2020 compared to the same period in 2019, in the context of the effects of the coronavirus crisis, which required higher provisions. Transilvania, BCR and BRD were, according to the financial results reported for the first nine months of 2020, on the podium in the top of the most profitable banks, followed by Raiffeisen, ING and UniCredit. Also in the top 10 banks according to the reported profit are CEC Bank, Alpha Bank and OTP Bank.

Literature Review

Researchers have mainly used two indicators to determine bank profitability: ROA (return on assets) and ROE (return on equity). Profitability in the banking system is a topic that has taken a lot of attention in the recent years all over the world. But it is to mention the fact that most of the studies have been conducted for developed countries and just a few of them have been conducted for developing countries.

According to Raphael G. (2013), "for an analysis to be valid it should take into account both micro and macro environments". It is very important to examine the micro and macroeconomic factors that determine the profitability of a banking sector. The "micro" environmental factors in the analysis are considered the indicators of the industry and the individual banks, the bank specific factors. As factors of the "macro" environment are all those factors that are not dependent on or determined by the bank's directors. Firstly, there is a group of bank-specific determinants, resulting directly from managerial decisions, such as asset composition, capitalization, operational efficiency or size. The second group of determinants includes factors relating to the macroeconomic environment or industry specificities, such as industry concentration, economic growth, inflation, and interest rates (Trujillo-Ponce, 2013).

The first to study the determinants of bank profitability in a number of countries were Molyneux and Thornton (1992). They collected data from 18 European countries during 1986-1989, which resulted in a significant positive link between ROE and interest rates in each country and the banks' concentration. Guru et al., (1999) analyzed the determinants of bank profitability in Malaysia, by collecting data from 17 commercial banks over the period 1986-1995. Profitability indicators were divided into two main categories, namely internal determinants (liquidity, capital adequacy and expenditure management) and external ones (ownership, firm size and economic

conditions). The findings showed that cost-effective management was one of the most important determinants in explaining bank profitability. Among the macroeconomic indicators, the high interest rate was associated with a low level of bank profitability and inflation had a positive effect on banking performance.

Staikouras and Wood (2003), analyzed the determinants of bank profitability in 685 European banks. Their analysis was focused on variables such as credit risk, capital adequacy, interest rate, operational efficiency, bank size, GDP growth rate and gross per capita income for each European country. The authors concluded that capital adequacy and bank size positively impacted ROA, while credit risk was negatively related to the bank's profitability. Athanasoglou et al., (2005) investigated the Greek banks' profitability between 1985 and 2001 and concluded that credit risk and operating expenses had a negative impact on profitability, while inflation was positively related to financial performance. In (2008), the same authors studied the profitability behavior of the Southeast European banking industry over the period 1998-2002. The empirical results showed that the effect of market concentration was positive, while the results related to the macroeconomic variables were mixed.

Deger and Adem (2011) analyzed the bank specific and macroeconomic determinants of banks' profitability in Turkey over the years 2002-2010. Banks' profitability was measured by return on assets (ROA) and return on equity (ROE) as a function of bank specific and macroeconomic factors. The results concluded that bank size had a positive and statistically significant impact on banks' profitability. However, the size of the loan portfolio had a statistically significant negative relationship with banks' profitability. Among the macroeconomic variables, only real interest rates affected the banks' performance positively. Wasiuzzaman et al. (2013) have studied the impact of bank specific and macroeconomic indicators on return on equity (ROE) to a few Malaysian banks for 2004-2012. The evaluation result showed that the ratio of operational efficiency, liquidity ratio, consumer price index and financial crisis were negatively correlated with bank profitability.

Hoffmann (2011) examined the profitability determinants of US banks during the period 1995-2007. Empirical analysis combined specific banking and macroeconomic factors. Empirical findings documented a negative correlation between capital ratio and profitability, supporting the idea that banks are operating very carefully.

After analyzing the main determinants of banks' profitability in EU27, Petria N. et.al. (2015), concluded that credit and liquidity risk, management efficiency, the diversification of business, the market concentration/competition and the economic growth have an impact on banks' profitability, both on ROA and ROE variables.

In one of my previous articles (2017) I analyzed the impact of macroeconomic and bank specific factors on Albanian non-performing loans, by employing data approaches to this country over the period 2005-2014. The results of the econometric model showed an indirect, statistically significant link between the level of non-performing loans and factors such as ROE. The data from the Albanian Banking System show that profitability measured by ROE, has suffered a major decline especially after 2008 global financial crisis. This result is in line with the studies conducted in this area, as an increase of the non-performing loans would lead banks to a reduction in the level of ROE. The main objective of the paper I wrote in (2018) was to identify the internal and external factors (bank-specific and macroeconomic factors) that affect the profitability of all commercial banks operating in Albania, through an appropriate empirical analysis. The econometric model used was that of multiple linear regression

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where, as a dependent variable used as a proxy for banking performance, was selected the ROE ratio and as independent variables a number of macroeconomic indicators and indicators of assets and liabilities of the Albanian banking system. The results of the econometric model showed that there is a statistically significant direct relationship between ROE and factors such as bank size and inflation rate. On the other hand, the results of the econometric model showed that there is a statistically significant indirect correlation between the ROE level and the indicators of the non-performing loans ratio and the loan-to-deposit ratio.

The purpose of the study conducted by Neves M. et.al. (2020) was to understand which are the main factors that can influence the performance and efficiency of 94 commercial listed banks from Eurozone countries through a dynamic evaluation, in the period between 2011 and 2016, by generalizing the method of moments estimator technique to analyze the influence of some bank-specific characteristics, controlled by management, on the profitability as a measure of bank performance. The results highlighted the fact that if bank managers want to protect their performance, they will have to improve cost management efficiency.

The regional economic environment does not favor the stability of the financial system, but prevents the increase of the efficiency and productivity of the banking sector. The source of the crisis is the deprivation of the banking sector to play its role in an economy, to raise capital and to invest efficiently. Consequently, the measurement of efficiency and productivity indicators remains the starting point for assessing the soundness of the financial system as a whole (Gabeshi, 2020).

Research Methodology

The analysis of the factors affecting the profitability of a banking system is an important analysis and starts by the identification of bank specific and macroeconomic determinants which exhibit an impact on banks' profitability, followed by the assessment of the impact (negative or positive impact).

The econometric model used is that of multiple linear regression where as the dependent variable used as proxy for bank performance is obtained the Return on Equity ratio and as independent variables are chosen a number of macroeconomic indicators and indicators of assets and liabilities of the Romanian banking system. The method applied is the method of least squares and the model is tested in advance via EViews software for basic assumptions of the method. The data sets are collected mainly from the Global Economy and from the Romanian annual bank reports. All the independent variables, such as the dependent variable are considered for a period of 29 years with annual data, starting from the year 1991 to the year 2019.

As mentioned above, the dependent variable of the econometric model is ROE (Return on Equity), expressed as a percentage and calculated as the ratio of net income to shareholder's equity. ROE is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Instead, the independent variables are classified into two groups: macroeconomic factors and bank specific factors. After an analysis of research in this field as macroeconomic factors, are selected indicators of interest to the context in which the country is. These factors are:

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- *Inflation Rate (INF), consumer prices (%)*. This indicator is calculated as percent change in the Consumer Price Index from the same month last year. Inflation is the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling;
- *Unemployment Rate (UNMP)*. The unemployment rate in Romania, measured in %, is defined as the number of unemployed people as percent of the labor force. Unemployment refers to the share of the labor force that is without work but available for and seeking employment.

Banking group of factors includes many indicators, but by detailed review of the literature and in the current context will be used the following banking indicators:

- *Bank credit to the private sector as percent of GDP (CREDIT)*. Bank credit in Romania is defined as the credit extended by the banking institutions to the private sector only: both firms and households. It does not include lending to the government;
- *Bank assets as percent of GDP (ASSETS)*. This indicator is calculated as total assets held by deposit money banks as a share of GDP. The bank's assets consist of all its investments in loans, government securities, bonds, on the interbank market, on the capital market, on the stock market, etc., to which are added buildings, land, equipment and other assets held by other companies;
- *Real Interest Rate (RIR)*. RIR is calculated as bank lending rate minus inflation. Real interest rate is the lending interest rate adjusted for inflation as measured by the GDP deflator.

There were other factors tested for this study, such as economic growth, non-performing loans, interest rate spread, liquid liabilities, etc., the empirical results, however, reveals that they were not statistically important determinants of ROE in the Romanian Banking System.

Table 1. Descriptive analysis of variables

Variables	ROE	INF	UNMP	CREDIT	ASSETS	RIR
Minimum	-19.14	-1.50	3.98	7.13	10.90	-43.05
Maximum	42.06	255.20	8.27	39.33	50.23	12.67
Average	12.12	46.77	6.74	21.34	29.24	1.33
Standard Dev.	12.60	74.36	1.14	11.40	13.86	11.92
Nr. Obs.	29	29	29	29	29	29

These statistics show the minimum, maximum, average, standard deviation and the number of observations for all variables considered in the regression models. The number of observations for each variable is 29. All values are expressed as a percentage.

The aim of this study is to determine and analyze the relationship between the dependent variable (ROE) and independent macroeconomic and bank variables in the Romanian banking system. This study is based on establishing some hypotheses that are expected to be certified through the regression model to be used.

- Null Hypothesis (H_0): None of the independent variables has any impact on the level of non-performing loans.
- Alternative Hypothesis (H_a): At least one of the independent variables has an impact on the level of non-performing loans.

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In the literature, there is an ambiguity with respect to the relationship between real interest rate and bank profitability. As well, the literature has found both positive and negative link between credits and the determinants of profitability. It is expected a positive relationship between bank assets as percent of GDP and ROE pointing out that large commercial banks perform better than small commercial ones, because larger banks can benefit from the economies of scale and also with their increased size some costs can be reduced. Otherwise, it is said that big banks have the “size” advantage to generate more returns. The economies of scale are often cited as the reason why bank size may have a positive effect on bank profits. A positive correlation is also expected between inflation rate and ROE and a negative one is expected between unemployment rate and ROE as determinant of profitability.

Results and Discussion

To test the level of statistical importance of the independent variables, is analysed the critical probability (P-value or Prob). If the probability is below the level of importance, which I choose to work with (5%), the null hypothesis is rejected and the coefficient is considered statistically significant. While F test measures how well the independent variables explain the dependent variable performance. Another indicator used to analyse whether the model is good or not is determined R². This indicator takes values from 0 to 1 and shows the percentage of variation of the dependent variable explained by the considered independent variables. Durbin Watson statistics also, must have a value between 1.8 and 2.2 in order not to have autocorrelation of errors.

After running the regression analysis with the EViews program is obtained this equation:

$$\text{ROE} = 68.41457426 + 0.2035286456 \cdot \text{INF} + 0.419601434 \cdot \text{CREDIT} - 0.475728882 \cdot \text{ASSETS} - 0.618814681 \cdot \text{UNMP} + 0.817354902 \cdot \text{RIR}$$

As seen from the above equation, an increase in INF, CREDIT and RIR, will increase ROE and an increase in ASSETS and UNMP will decrease ROE. While the output of the regression model is given in the following figure:

Dependent Variable: ROE
 Method: Least Squares
 Date: 03/15/21 Time: 13:23
 Sample: 1991 2019
 Included observations: 29

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	68.41457	11.52746	5.934923	0.0000
INF	0.203529	0.064684	3.146517	0.0045
CREDIT	0.419601	0.439953	3.226711	0.0037
ASSETS	-0.475729	0.306074	-4.821476	0.0001
UNMP	-0.618815	1.824199	-4.395799	0.0002
RIR	0.817355	0.265850	3.074493	0.0054
R-squared	0.642629	Mean dependent var	12.11862	
Adjusted R-squared	0.564940	S.D. dependent var	12.60307	
S.E. of regression	8.312872	Akaike info criterion	7.255479	
Sum squared resid	1589.388	Schwarz criterion	7.538368	
Log likelihood	-99.20444	F-statistic	8.271777	
Durbin-Watson stat	2.196577	Prob(F-statistic)	0.000137	

Figure.1. Output Evaluation in EViews, Source: own data processing in the EViews program

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The determination coefficient ($R^2 = 0.6426$) shows that independent variables in regression explain 64.26% of the variation of the dependent variable ROE. Adjusted R^2 is 0.5649. About the statistical significance of the econometric model we reviewed indicated F-statistic, which has a value $F = 8.27$ with a level of probability $p = 0.0001$, which confirms that the model is statistically significant because of the value of F-test and the probability is below the level of importance $\alpha = 0.05$. Durbin Watson statistics is equal to 2.196, which means that residuals are not correlated, pointing their independence as a completion of one of the conditions of the least squares method.

As seen from the EViews output of the econometric model, there is a direct statistically significant relationship between ROE as determinant of bank profitability and factors such as bank credit to the private sector as percent of GDP, real interest rate and the inflation rate. On the other hand, the results of the econometric model showed that there is an indirect statistically significant correlation between the level of ROE and the indicators of bank assets as percent of GDP and the unemployment rate.

C coefficient is the intercept that represents ROE when all the independent variables are equal to zero. The other coefficients are the expected slopes of how much ROE will change, for one percent of change of each independent variable. The results show a significant relationship ($p\text{-value} = 0.0001$) but reversed, so negative, between ROE and the bank assets as percent of GDP. Thus, an increase by 1% of the level of ASSETS ratio will decrease ROE by 47.57%. A significant negative correlation ($p\text{-value}=0.0002$) has resulted even between ROE and the unemployment rate. An increase by 1% of the level of UNMP ratio will decrease ROE by 61.88%. On the other hand Inflation Rate ($p\text{-value}=0.0045$), bank credit to the private sector as percent of GDP ($p\text{-value}=0.0037$) and real interest rate ($p\text{-value}=0.0054$) have a significant positive relationship with ROE. An increase in the Inflation Rate by 1% will increase ROE by 20.35%, an increase of CREDIT ratio by 1% will increase ROE by 41.96% and an increase of RIR ratio by 1% will increase ROE by 81.74%.

The impact of macroeconomic and banking factors on bank profitability can be summarized in the table below:

Table 2. Correlation Between: ROE and Other Variables

Positive Correlation with ROE	Negative Correlation with ROE
Credit to the private sector as % of GDP Inflation Rate Real Interest Rate	Bank Assets as % of GDP Unemployment Rate

Conclusions

In recent years, the Romanian economy has become extremely dependent on financing from the banking sector. The Romanian banking sector has entered the health crisis well prepared, its solvency and liquidity rates remaining at levels higher than European averages. The profitability of the Romanian banking sector has improved in recent years, after a period with negative values of ROA, mainly due to additional reductions in net impairment losses and the high growth rate of loans in national currency (Romanian lei) granted to the private sector. Profitability is concentrated in the sector, as over 75% of profit was generated by the top 5 institutions (of total assets). ROE registered a value of 12.3% in 2019 following a slight downward trend.

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The results of the econometric model showed that there is a direct statistically significant relationship between ROE as determinant of bank profitability and factors such as bank credit to the private sector as percent of GDP, real interest rate and the inflation rate, indicating that an increase in one of this factors leads to an increase in bank profitability. In the literature, there is an ambiguity with respect to the relationship between real interest rate and bank profitability. In general, banks borrow on a short-term basis, and grant loans on a long-term basis; therefore, it seems that an increase in the real interest rate allows Romanian banks to improve lending margins, which leads to an increase in banks' profitability. Low interest rates increase competition, put pressure on banks' capital and reduce profits. Also, the direct relationship between credit to the private sector and ROE, can be explained by the fact that banks that tend to lend more are the most profitable ones. While the positive impact of the inflation rate on ROE suggests that commercial banks can predict inflation rates and take advantage of the opportunity to benefit from the inflationary environment to increase profits and control their operating costs.

On the other hand, the results of the econometric model showed that there is an indirect statistically significant correlation between the level of ROE and the indicators of bank assets as percent of GDP and the unemployment rate. In line with the studies conducted in this area, an increase of the unemployment rate would lead banks to a reduction in the level of ROE. Borrowers will have difficulties in paying their debts, so banks will be faced with a rise in the non-performing loans, being unable to recover these loans and as a result it would lead to a deterioration of their performance, which ultimately will be translated into a lower ROE indicator. Generally, the effect of a growing size, determined by bank assets, on profitability has been proved by the majority of empirical studies to be positive to a certain extent. However, in this study resulted an indirect correlation between ROE and bank assets, pointing out that for banks that become extremely large, the effect of size could be negative due to bureaucratic, aggressive competitive strategies, increase in costs and other reasons.

The crisis generated by COVID-19 will accelerate the consolidation of the banking sector in Central and Eastern Europe, given that small banks risk not to overcome the challenges of profitability and capital, and Romania is among the countries in the region with the most transactions in the field. The decrease in the market value of commercial banks, in the profitability, in the volume of assets and the decrease in the value of government securities portfolios held by commercial banks are some of the effects of the coronavirus pandemic found by the National Bank of Romania.

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Article Info

Received: March 25 2021

Accepted: April 06 2021
