THE ROMANIAN BANKING SYSTEM DURING THE ECONOMIC-FINANCIAL CRISIS

MAGDALENA RĂDULESCU

PHD ASSOCIATE PROFESSOR, UNIVERSITY OF PITEȘTI, FACULTY OF ECONOMIC SCIENCES, DEPARTMENT OF FINANCE,
E-mail: voumagdar@yahoo.com

Abstract

The Romanian banking system was hit by the financial crisis in 2008 and the banking credit activity almost stopped for a few years. National Bank of Romania tightened the credit conditions and imposed strong regulations for banks. After the peak of the crisis, the credit conditions became lax again, trying to re-launch the economic activity by credit, but the effects in the economy didn’t appear until the end of 2013. Our banking system exposure to the foreign capital banks (Greek or Austrian) and the political crisis in some European countries (Greece and Ukraine) didn’t help either and increased the banking risks. Although the fundamentals of the Romanian banking system were sound, it faced the crisis well but it couldn’t support the recovery of our economy.

Key words: financial crisis, banking system, Romania.

JEL Classification: E52, E58, G21.

1. Introduction

The financial lax regulation and the high prices on the real-estate market ended with the collapse of the financial order as we knew it from the past decade. In early autumn of 2007, the whole world was shaken by the news announcing that a famous American investment bank, Lehman Brothers, went bankrupt. Countries in South-East felt with a lag of about a year the combined effects of sub-prime credit crisis. But the effect was stronger than in advanced economies and the recovery from economic recession is expected to be slower.

In Europe, the global crisis effects were stronger in case of stock market and labor market through increased unemployment. In case of capital market, there were direct effects on the financial institutions (resounding bankruptcies, such as that of Lehman Brothers in autumn 2008 and that of the largest savings and loans bank, Washington Mutual Bank, both from the U.S., restructuring of companies and financial institutions, takeovers and mergers, direct financial support with sizable funds); effects on stock prices and volume (the volume of stock transactions decreased, U.S. stock indices fell by about 50% during the crisis, Europe stock index in London FTSE 100 fell by 31.3% in 2008 over the previous year and in 2009 increased by 25%); effects on the behaviour of the investors in the market (we witness the removal and changing the options of investors with direct impact on cost of capital and financial interest - in 2008, the foreign direct investment in Europe stagnated, rising in some countries such as Germany +28% and Italy +39% and decreased in others, Romania -3%, Spain -18%, and in 2009 they decreased compared with the previous year); effects on capital market regulations (increased control over the remaining areas outside the jurisdiction of central banks or supervisory committees of capital markets and rethinking the criteria for granting funding and risk and rating methodologies used in the financing) and effects on GDP. Due to the crisis, the gross domestic product was also affected, negative effects that led to its decline were felt mainly in 2009. Thus, in the European Union, its increasing rate in 2008 was 0.5% and -4.2% decrease in the following year. Other countries also registered GDP decrease: the U.K., from 0.1% in 2008 to -4.9% in 2009, Italy from -1.3% in 2008 to 5% in 2009, France from 0.2% in 2008 to 2.6% in 2009, Germany from 1% in 2008 to 4.7% in 2009 (Eurostat).

2. Romania’s banking system during the crisis

The origins of other crises that have affected the world economy were the real estate bubbles manifested in some specific real estate markets (land, residential, tourist and recreational facilities), a situation similar to the sub-prime credit crisis in 2007-2009. But sub-prime crisis was different from others in some specific elements (Manățe et al., 2010):
- Imprudent expansion of the U.S. residential mortgage market, beyond minimal risk management;
- The sizable decrease in international trade since September 2008 when the crisis intensified, has been a key factor in spreading economic downturn and turning it into a worldwide phenomenon;
- Securitization of mortgages, turning them into trading securities, their gradually packaging and repackaging, and their distribution in all existing channels in the investment community has led to the globalisation crisis;
- The complexity of these financial products, now called “toxic”, made it almost impossible to assess and reassess them correctly and properly, neither as fair value and in terms of associated risk.
Countries in South-Eastern Europe felt with a lag of about a year the combined effects of sub-prime credit crisis. But the effect was stronger than in developed economies, and the recovery from economic recession is expected to be slower. Growth rates of GDP in SEE were consistently higher than in EU-27 since 2001, and in 2008 supported economic inertia and relative partial decoupling of the area, with the notable exception of Romania, of the speculative real estate bubble and unsustainable expansion credit. Year 2009 brought, first of all, contracting demand in EU-27 partners, which was the main cause for the collapse of East GDP, significantly above the EU-27 GDP fall.

Lack of local financial instruments of "toxic" derivatives such loans "subprime" - mortgages with high risk - caused many to hope that Romania will not be affected by the crisis that began in the U.S. even since summer of 2007. But as the credit crisis has spread all over the world's strongest financial centers, trust between financial institutions has been lost, banks knowing the financial situation of competitors and fearing that if they loan money, they could not be able to recover them.

This created a financial jam propagated gradually in the Romanian financial institutions. Many of them were forced to stop credit lines they had granted to companies and thus production costs and investment were immediately affected.

Since the beginning of 2008, national currency lost 4.5% against the Euro, despite the interventions of the National Bank of Romania and the Ministry of Finance. Trend of depreciation of currencies in the region and deepening current account deficit were stronger than the National Bank's and the Finance Ministry's efforts to stabilize. Since the beginning of the year, the National Bank has attracted about 30 billion RON in market, hoping to mitigate the fluctuations of the national currency. NBR interventions took an increasingly lower effect.

In a single or combined action, credit institutions may go bankrupt. This chapter presented the financial reorganization and bankruptcy proceedings of credit institutions, reviewing the first banks that faced bankruptcy, and their reasons for reaching the brink of bankruptcy.

Certainly the problems of the Romanian banking system after 1989 are not about excessive periods of restructuring banks, nor the failure of others. There were objective problems, beyond the control of banks, which they were forced to face. At first, it is about the hyperinflation during 1993–1994, respectively 1997-1998, which forced banks to outbid real estate investments (mainly offices), to preserve equity. In worsening the financial situation, a very poor tax accounting system was involved, heavily taxed inflated profits, even with real losses, contributing to the decapitalization of Romanian banks with domestic capital. In addition, there was a lack of firmness from the central bank, that allowed the accumulation of a large volume of bad loans, without taking an appropriate action in due time.

Apparent, the transition period only meant for the banking system the accelerated growth of bad loans, low financial intermediation, poor asset quality and low volume, low liquidity and even insolvency.

The banking sector has proved one of the most dynamic sectors of Romanian economy in increasing the number of persons employed, thereby contributing to increasing amount of taxes and contributions on banking salaries in banking revenues. More directly put, the banking sector was among the few without tax evasion - payroll taxes in the sector were certain state budget.

Once Romania joined the European Union, a new evolution stage of the Romanian banking system has begun. European integration process is equivalent to Romania's development process of reform, taking into account the existing model of the European states.

In the race for better market shares, the credit institutions in Romania have continued the trend of expansion in the territory, though with a much lesser extent at the end of 2008, due to the global economic crisis. The economic crisis has been felt in Europe, and the Romanian banking system has been exposed to direct or indirect reactions manifested in international economic crisis.

Although during 2008 the dynamics of employment reduction or staff reductions did not affect significantly the number of employees in the system, in 2009 the situation changed, the economic crisis was felt more in the Romanian banking system. Loan market has undergone great changes so that some banks have tried to limit as much as any losses from the failure of creditors to repay debts by applying prudential policies. Other banks have turned to reduce costs by restricting, by reference to the closure of some agencies that were not profitable. An example is the MKB Romexterra Bank SA which in early November 2009 announced the closure of 40 branches from a total of 70 in Romania.

Regarding the financial crisis and its impact in the banking world, we described the socio-economic and political situation in which the crisis began, as well as the triggers.

The credit crisis that erupted in the U.S. in August 2007 led to the bankruptcy of some of the largest banks in the world, and its effects are being felt now in the European financial market. The effects of this crisis have been felt globally, the whole world is on the verge of the worst financial crisis since the Second World War.

Stock exchange from all continents fell one after another, and central banks pumped hundreds of billions of dollars to avoid bankruptcy of the banking system. Moscow Stock Exchange was closed on September 18, after falling for two consecutive days. Federal authorities have stopped trading and convened a crisis meeting.

The main threat for the banks remains the debts growth, especially those of personal loans, to individuals in domestic currency. Moreover, the recent political developments in the region (Greece crisis and Ukraine crisis) challenged the Romanian banking system because of its great exposure to Greek banks and Austrian banks (exposed in Ukraine).
Banks in Romania, overwhelmingly owned by large European banking groups have managed to absorb the shock of the international crisis, but the negative prospects are not entirely removed. The exposure to the Greek banks dropped, but the exposure to the Austrian banks remains.

Conditions remain difficult in the Romanian economy from contracting activities and the significant rise in unemployment in 2009 due to the global financial crisis. As a result, local currency was under pressure, the number of bad loans rose significantly, and lending activity slowed down considerably because of banks aversion to risk-taking and limited financial resources.

Another problem could be that banks in Romania in late 2010 had a loan portfolio with 10% higher in value than the deposits, which means that bankers do not have much money available to use for credit.

The main risk remains outstanding loan growth, both because of rising unemployment and a generalized wage freeze. In late January 2010, outstanding loans rose to 4.37% of total, just over two billion Euros (Fig.1). In December 2010, the figure was only 3.88%. Next largest arrears are recorded in domestic credit, especially for personal needs, which reached 4.62 billion RON in the first month of 2010, over 1.1 billion Euros respectively. In foreign currency loans, the arrears rose to 3.45% from 2.85%, but growth was mainly due to decreased balance of credits in foreign currency by over 1%.

3. The effects of the international financial crisis in Romania and the adopted measures

The most notable effect is, by now, the bankruptcy of some banking and credit institutions from the U.S.A. and EU members, as the result of insolvency and impossibility of debt recouping, especially in the real estate sector. Bank insolvency and withdrawals and the distrust in bank solvency have upset severely the stock exchange market, so that the share values of important companies at different stock exchanges decreased so much that stock transactions were suspended for certain periods. The loss caused by the crisis made the financial analysts to forecast a slackening in global economic increase due to production decline in the advanced economies and slow economic development in the emergent ones.

The fall of the US real estate market resulted in the decline of the credit sector, while delinquency increase in case of mortgages and real estate transactions (retail credits or credits for corporations) influence also the European economy, house cheapening, harder credit requirements and economic stagnation.

Some EU states recorded GDP stagnation/decrease, especially Germany, Estonia, France, Italy and Lithuania.

Other effects of the financial crisis refer to the increase of the inflation pressure, interest rate and unemployment, national currency devaluation and the increase of current account deficit and public debt.

Considering the global impact of the present financial crisis with evident potential of starting a sizable economic crisis, the competent decisional national and international institutions (among which IMF, World Bank, EU, etc.), at various meetings of representatives of States, have agreed on a preliminary analysis and a series of measures to counter the worsening crisis and restore confidence in financial markets.

Regarding Romania, noted that, according to officials of the National Bank statements and other financial institutions that, no bank is not in serious situation, no liquidity problems due to international financial crisis.

Subordinated loans, deposits and loans attracted by banks in Romania have received from foreign shareholders in proportion of 50% over 2 years and 3 billion Euros will be paid between 1-2 years and about 2.5 billion Euros 6 months to a year. Bank solvency is at a good level (13%) and weak assets have a relatively small proportion of total assets (less than 1%).

With the increase in credit prudence, Romanian banks have closed one other exposure limits in the inter-bank market, which means there are consistent contingency plans, in terms of providing liquidity.

Another argument supporting the view that local financial market of Romania is affected only indirectly by the effects of the international crisis, refers to Romania’s foreign exchange reserve, an important buffer to counter such effects even in case of harder credit requirements (credit crunch).

Both global and national bankruptcy or financial embarrassment of some banks and not only decrease the stock value of their actions led to a number of merger and acquisitions as a growth stock transactions boosted by price reduced purchases of shares.

A number of European banks in difficulty have been saved, at least temporarily, by state intervention in England, Germany, Belgium and the Netherlands. Therefore, it is appropriate to make the widest possible cooperation of the parties involved in stabilizing and strengthening financial markets, especially for reforms on regulation and supervision of major financial markets and reduce the size of their failures and shortcomings, based on financial education and the effective application of principles based on best practices in lending. Any postponement of reforms in this area may prove counterproductive in the medium and long terms.

Deepen and widen the financial crisis triggered in October 2008, the U.S. and other countries, is the event of the greatest concern to policy makers in the economy and society at macro, micro and global levels. The evolution of this crisis as a problem of insolvency initially fueled by lack of trust in credit, now risks becoming gradually turbulence factor for the global economy.

Although it is doubtful that there is a panacea solution (one-size-fits all), some common views of specialists refer to consistent, clear and coordinated approach of the following issues: guaranteeing liabilities; separation of toxic assets (bad assets); recapitalization of affected institutions.
There are plans of bailouts for financial markets by prudence increasing, institutional monitoring and regulating, that transpire clearly the role public-private partnerships in finance, reducing the rate regulation only exclusivity based on market mechanisms.

The adopted measures supported governments to recapitalize financial institutions, to stimulate lending and consumer behavior. By reducing interest rates, stimulating aggregate demand by applying a mix of appropriate macroeconomic policies (monetary and fiscal).

In Romania, an example of urgent measure is the increased coverage for bank deposits to 100,000 Euros compared to 20,000 Euros, according to the joint decision of the Ministers of Finance of the EU member states. This measure is intended to increase public confidence in the savings and avoid mass withdrawals from commercial banks, which could lead to their bankruptcy. The measure obviously involves additional costs for banks. A number of other EU member states guarantee bank deposits up to 100,000 or complete (see Spain, Slovakia, etc.), in order to increase depositor confidence.

Another measure taken by the Romanian banks is to improve the interest rate a few percentage points over interest rates. Recourse to sell T-bills with maturity of 6 months and higher average yield, is another measure to prevent financial market turbulences in Romania.

The effects of the international financial crisis affected the Romanian economy. However, in terms of direct impact, the banking system was less affected because it was exposed to toxic assets and prudential and administrative measures taken because over time by the National Bank of Romania. On the financial channel, it limits the access to external financing, and thus restricts lending volume and generates difficulties in case of the private external debt. On the exchange rate channel, the decrease of external financing has reflected in domestic currency depreciation. On the confidence channel, the investors from Eastern European countries have withdrawn (Zaman, 2009).

The effect was the manifestation of moments of panic and speculative attacks on the monetary and foreign exchange market, such as in October in Romania, requiring the central bank intervention. Finally, the effects on wealth and balance sheet channel, the net asset damage occurs people and companies due to the large share of loans in foreign currency (depreciation related) and falling asset prices and capital values of the hedge, unsustainable (of "bubble" type).

In Romania, the answer to the adverse effects of the crisis may be similar to that made by some European countries or the U.S. Essentially, it is the fact that the Romanian economy has a large current account deficit, which indicates its dependence on external financing. One should choose between reducing the deficit or the orderly reduction of the market in the current tension and mistrust, with dramatic consequences for exchange rate and economic growth.

In essence, it is necessary to strengthen significantly fiscal and wage policy (broadly, including bonuses and prizes such quasi-wage ones). Therefore, an existing suboptimal combination in recent years (lax fiscal policies and labor, respectively a very "tight" monetary policy) may be replaced by an optimal combination in all policies (budgetary, wage and monetary policy) and have the same degree of restrictiveness, directing the economic activity toward work and productivity.

In addition, the government may improve foreign investors' perception through measures such as improving the absorption of European funds, thus replacing, to some extent, external financing public or private external financing by creating new jobs work in areas insufficiently (infrastructure, tourism, agro-alimentary sector), which take over gradually as a driver of economic growth (Zaman, 2009).

Though it is clear that a number of areas that until 2008 were the engines of economic growth (banking sector, public-private partnerships in finance, reducing the rate regulation only exclusivity based on market mechanisms).

Business banks in Romania are becoming very profitable again, though there are not attractive offers of funding for Romanians from banking institutions (Fig. 1 and 2). After the launch of the financial crisis in 2008, the levels of the loans granted to non-financial sector (total or medium and long-term) remained almost unchanged, despite the resurrection of inflation. In the first quarter of 2010, the entire banking system made a profit of 100 million Euros, compared to a loss of 50 million Euros in the same period of 2009.

Figure 1. Credit developments at the Romanian commercial banks for clients (bil.ROL)

Source: National Bank of Romania, Annual Reports and Monthly Bulletins 2007-2013
Since the beginning of 2010, banks have cut interest rates for new loans in RON, despite repeated signals transmitted by the National Bank of Romania, a fact that reduced the monetary policy rate many times to 4% at the end of 2013. This decrease did not include former credits that have remained almost the same as the crisis began (Fig. 3). This monetary policy rate is still above the levels achieved in Poland, Hungary (close to the Romanian rate), Czech Republic or euro-zone.

Figure 3. Evolution of the reference interest rate during January 2004-December 2013

There is a turnaround of bank profits, after being repeatedly called for concrete measures to revive the economy, including substantial reduction in lending rates. The business representatives state now that bankers do not show that they would like to credit companies again. There is no credit turnaround, at least a profit turnaround, as a consequence of banks’ actions. Even since the crisis started, the banks lent constantly and supported the state. The state is their best placement, with zero risk.

Also, the private environment has requested that interest be differentiated according to the purpose of the loan, to stimulate investment, production and trade. Banks credited mostly the state in 2010. But analysts state that companies really will benefit banks’ credit supply only a few quarters of the upturn. Since this forecast is not too optimistic, companies have to wait.

Although the overall banking system also came out in 2010, the first two banks on the market, BCR and BRD, have announced a slight reduction in profit over the same period in 2009.

4. Conclusions

Banking Union became a necessity because the development of the financial crisis underlined some elements of the banking system functioning that were ignored before (e.g. relationship between the banks debts and the sovereign debts). Given the preparations of the banks and the states from the euro-zone on medium-term 2014-2016 to increase the costs to achieve the needed reserves for applying the provisions of the Banking Union it becomes obvious that we will notice a drop of the interest for the emergent EU region (Danila, 2014). Moreover, the banks belonging to the group of institutions supervised by the European Central Bank (there are also some big Romanian banks in this group) will largely reshape their portfolios to cut down the costs. This could generate, at margin, even a drop of businesses in our region.

The current financial crisis has highlighted weaknesses in regulatory and supervisory framework and led to its reform process.

The actions of European authorities and those in Romania, aimed at reforming the regulatory and supervisory framework, show their concern for strengthening the micro-prudential supervision and the increased importance they attach to macro-prudential supervision in financial stability.

While prudential supervision is not easy to implement, requiring analytical tools to assess and monitor systemic risk and tools to limit these risks, we believe that first steps have been taken in this regard by creating the European Systemic Risk Council and proposals introducing dynamic provisioning (Dardac, 2010).
The crisis will be closely connected to the financial markets return to stability, meaning a radical cleansing of balance sheets of large financial institutions, through the market valuation of assets.

Therefore, in conditions of crisis, banks should adopt a policy of prudence, to provide maintenance on the market and find ways to survive so that the crisis’ effects are minimal.

Taking emergency measures such as limiting credit is rather specific means of overcoming short-term financial crisis. Long-term structural reforms of the global financial system aimed at preventing future repetition of such phenomena of crisis and need special measures.

Regulatory and supervisory framework will be better designed so as to help accelerate financial innovation that benefits all and not for speculative purposes, promoting a social minority.

The agreement Basel II must be amended through the new Basel III, in order to increase the minimum capital and ensure a rigorous liquidity management, rating agencies should be regulated to ensure an objective character, have promoted cooperation between regulatory and supervisory authorities must have more power, extending the rules to all entities that provide financial, simplification and standardization of derivatives trading and reduced counterparty risk, greater transparency in the credit market. All these must be a proactive process that does not inhibit further development of financial markets or the European economic and financial integration (Boitan, 2011).

The financial reform should not be located only in the banking sector, but extended to non-bank financial institutions.

On the agenda of governments, the challenges of debate and exchange of experience, while far-reaching, are to varying degrees, financial issues related to competition, incentives for prudent behaviour, consumer protection, improving financial literacy and corporate governance.

At the same time, one should remember that effort is needed to restore consumer confidence in economic development, since the trust has been substantially reduced (as shown in economic confidence index published by the EC), due to treatment of emotional crisis.

Although conceptually, government intervention to rescue banks, on the “too big to fail” or “too many to fail” is a manifestation of moral hazard, in practice there are some situations that require state intervention. A high concentration of the banking sector, the connections between domestic and foreign financial institutions, the costs of failure of large banks with cross-border activity are just some examples that predispose them to rescue the credit institutions with public funds (Barbu et al, 2010). Therefore, many governors strongly suggest extending the powers of national supervisory authorities to address banks “too big to fail”.

No doubt that the implementation of mitigation measures must take into account the impact of the vulnerabilities of each system of financial and macroeconomic imbalances in each country, which limits the room for maneuver of monetary and fiscal policy.

Today, when the Banking Union is built in front of us, it is already known that this frame is based on three pilons: the unified supervision mechanism, the unified resolution mechanism and the resolution unified fund and the deposits guarantee schemes ex-ante financed. The discussions and approval of these started in September 2013 (Danila, 2014).

Two main facts keep on affecting negatively the good development of the Romanian economy: the credit activity remains in negative terms, because of the high and increasing volume of the non-performing loans and the consistent vulnerability of the Romanian economy and the Romanian banking system. The banks have a large credit portfolio denominated in foreign currency and this keeps on requiring an external financing and, in the meantime, it requires a deeper focus on attracting funds from the domestic market.

5. References


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