TRENDS REGARDING THE EVOLUTION OF THE ROMANIAN BANKING SYSTEM IN RELATION TO THE ONES BELONGING TO CENTRAL AND EASTERN EUROPEAN COUNTRIES

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Abstract

This paper aims at highlighting the aspects concerning the impact suffered by the Central and Eastern European banking systems since the onset of the financial global crisis. The focus of the paper is on the position of the Romanian banking system in relation to the Central and Eastern European countries, mainly those countries which were former members of the Communist bloc, in terms of both the prudential and banking profitability indicators.

Hence, a comparative case study has been conducted, at a macroeconomic level, regarding the evolution stage of the Romanian banking system in the context of the financial crisis, based on several representative banking systems in Central and Eastern Europe such as Czech Republic, Hungary, Poland and Russia. The conclusion from these studies is that in Romania, the banking system has made significant progress over the transition to a market economy, as the Romanian banks have been embracing banking strategies intended to improve performance. However, there are still steps necessary to be taken in order to catch up with the most representative banks in Central and Eastern Europe in terms of their level of development and performance.

Key words: *financial crisis, banks within the CEE region, banking prudential indicators, banking profitability indicators*

J.E.L. CODES : *G01, G21, G28*

1. Introduction

The actual condition of the banking system is the result of a profound process of transformation, **[8]** performed during the post-communist period, which included the modernization of the surveillance system, especially with strategic investors from old member-countries of the EU. Massive entries of foreign capital channels, mostly towards the banking system, led to a rapid economic growth of the non-governmental credit in the majority of the countries within the region.

Havrylchyk and Jurzyk (2006) **[7]** warned on the fact that the spread of the level of the foreign capital in the CEE banking systems took place at the same time with the concentration of the banking market, and the high level of market concentration led to a low competitive behavior on the behalf of banks as well as to a decreased profitability.

The typology of the financial system correspondent to the ex-communist countries is one based on universal banks: the assets represent averagely 85% of the total of the assets belonging to the financial system **[1]** , the capital market having a less important role.

In the specialized literature, the expansion of the credit and the associated evolution of the financial mediation are considered capable to stimulate the economic growth and to improve the resource allocation efficiency **[10]**. At the same time the specialized literature warns that the rapid expansion of the credit can have serious economic and prudential consequences, being often associated with financial and macroeconomic crises.

Therefore, the authorities confront themselves with a dilemma imposed on one hand by the necessity to assure sustainability on medium and long term and of the minimization of the risk of a financial crisis, and on the other hand, by the need to allow for the credit expansion to contribute to the economic growth and allocating efficiency. The effects of the financial crisis started to show up in Central and East Europe in 2008 after a period of economic growth, financed mostly by external credits. This fact made the region to become vulnerable at the sudden slowdown of the external credit flow which took place in the autumn of 2008. The fact that Eastern and Central European countries joined EU led to their own economic growth phenomenon explained by the exports towards the Western European market. According to the data provided by the European Commission the share in the GDP of the Eastern European countries' export within the old member states increased with 7% after joining EU.

By the summer of 2008 it is generally believed that emerging markets would avoid economic crisis in the USA and Western Europe (the decoupling hypothesis). Things have not been so as the Eastern European countries have been seriously affected by the crisis which was manifested internationally **[4]**. Lehman Brothers bankruptcy caused as an effect the increase of the aversion towards risk within financial markets. Western banks have been forced to reduce their balance sheets and the result was the drastic decline of the capital transfers towards Eastern Europe and other emerging economies. The decline was major particularly in Russia (-10%), Czech Republic (17%) and Hungary (18%).

Christensen **[2]** noted that uncertainty had as a result the increased pressure on the currencies of those countries and raised concerns about the effective financial collapse because the main private sector liabilities were denominated in foreign currency.

In the fall of 2008, **[3] - [5],** the worsening of the crisis in Eastern Europe, the assessment of the market risk of some Western European countries and of their banks indicated that the degree of risk had also increased. Western European banks had accumulated a high degree of exposure to Eastern European market through acquisitions. Before the crisis, investments had high returns but with the deep recession banks risked major losses as a result of the increasing number of bad loans.

In terms of risk to financial stability, the literature confirms the rapid credit growth as one of the predictors of financial turbulence **[8],** without necessarily leading to it. The standard alarm thresholds in the specialized literature as well as the annual growth of financial intermediation by more than 5 percentage points over five years **[6],** beyond which the probability of a crisis becomes significant, were exceeded in Hungary, Bulgaria, Croatia, the Baltic countries and Slovenia.

Since 2008, the deterioration of the macroeconomic conditions and the high volatility of the currency have led to a worsening of the credit risk quantification indicators in Romania as well as in the other Central and Eastern European countries**[9]**.

The main objective of this paper is to assess the overall level of stability of the Romanian banking system in relation to the other Central and Eastern European countries, by analyzing prudential indicators for a period which would allow the emphasis of the expansion and contraction of both the banking activity and the key factors.

This dissertation makes contributions in the following areas:

- it identifies the position of the Romanian banking system in the context of Central and Eastern European countries in terms of their degree of development and performance;
- it assesses the overall stability of the Romanian banking system by analyzing the profitability and prudential indicators for a period long enough to allow reaching conclusions concerning the tendencies manifested in relation to the banks in Central and Eastern Europe.

2. Research methodology

In order to achieve the goal formulated on the subject matter, the study will be based on certain methods of scientific research: the comparison method, observational method, economic analysis method, statistical method, graphical method, case study method, statistical analysis and benchmarking. The methodological process seeks dismissal of existing data, collection and updating of new data and establishing new directions.

The main method used for the collection of data and historical information will be the observation method, both the spontaneous observation and the induced one. The method is useful from the perspective of the prudential and banking profitability indicators belonging to the banking systems of the Central and Eastern Europe countries. During the presentation there will be a descriptive presentation that is based on statistical information as well as macroeconomic indicators and data.

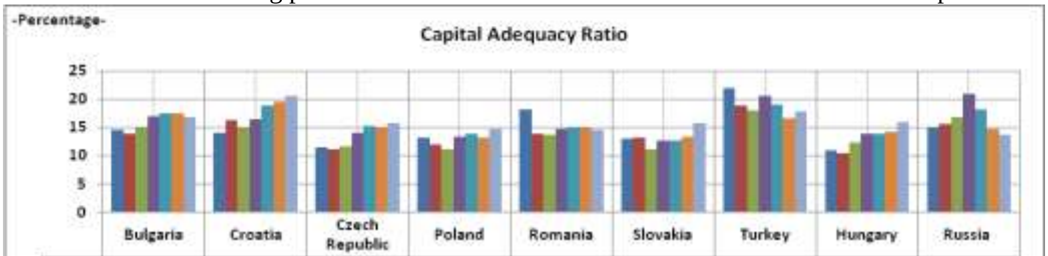
3. Results

As mentioned above we will analyze the evolution of the banking system in Romania compared to the one belonging to several representative Central and Eastern European countries, in particular the countries of the former communist bloc.

At the level of the EU Member States' efforts to increase capital adequacy continued in 2011 in the application of additional capitalization requirements set by Basel III regulatory framework, which established the 2013 to 2018 range as a period of transition deadline that must reached, the target level being the 1st of January 2019.

The capital adequacy ratio respectively the solvency ratio is maintained at a level corresponding to the minimum of 8 % set by European and international regulations for all the analyzed countries. The highest capital adequacy ratio in 2012 is recorded by Croatia with 20.5%, followed by Turkey with 17.9%. Romania recorded a value of 14.6 %, which is characterized by an adequate level of capitalization. Capital injections from parent banks having branches in Romania provided a comfortable solvency ratio, above the 8 percent covered by European standards, which has kept the stability of the system. The commitment of the credit institutions shareholders, materialized by the growth of the banking system capitalization, kept comfortable capital adequacy levels, as a matter of fact, a solvency ratio of 14.67 % was recorded in September 2012 given that the European minimum requirement is 8 %.

Chart no. 1.1 The banking prudential indicators at the level of Central and Eastern European Countries



	Bulgaria	Croatia	Czech Republic	Poland	Romania	Slovakia	Turkey	Hungary	Russia
2006	14,5	14	11,4	13,2	18,1	13	21,9	11	14,9
2007	13,8	16,3	11,1	12	13,8	13,2	18,9	10,4	15,5
2008	14,9	15,1	11,6	11,2	13,76	11,1	18	12,3	16,8
2009	17	16,4	14	13,3	14,7	12,6	20,6	13,9	20,9
2010	17,5	18,8	15,3	13,9	15,02	12,7	19	13,9	18,1
2011	17,5	19,6	15	13,1	14,87	13,4	16,6	14,2	14,7
2012	16,7	20,5	15,7	14,8	14,6	15,7	17,9	15,9	13,7

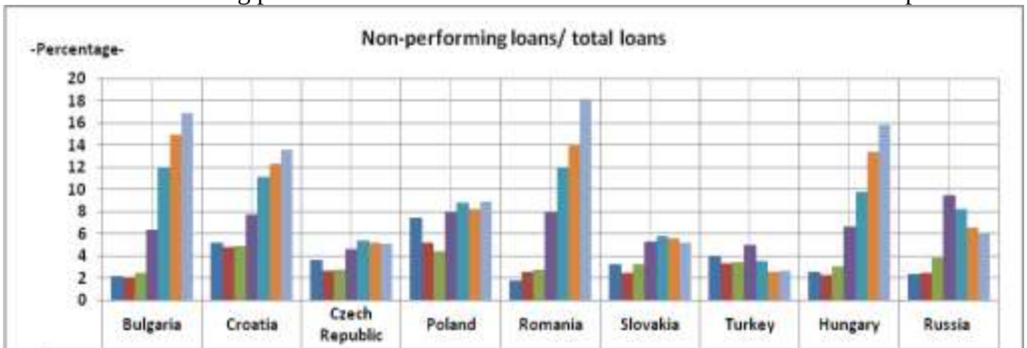
Source: authors based on data taken from *FMI Global Financial Stability Report, December 2013,* **[11]**

The deterioration of macroeconomic conditions since 2008 and the increased volatility of national currency led to the decline of the credit risk measurement indicators in Romania and other Central and Eastern European countries.

Thus in the charts below (chart no.1.2) we can see that at the end of 2012 in terms of non-performing loans in total loans Bulgaria and Romania are the countries with the highest values of 18.2 % and 16.91 % .

The worsening process of the loan portfolio quality has affected other countries like Hungary and Croatia. This situation is the result of unsustainable increases in loan portfolio during 2003-2008 (period characterized by relaxing lending standards) and international difficulties which entered into renewed economic growth after the financial crisis and the legal, judicial , fiscal and regulatory obstacles which prevent rapid resolution of bad debts.

Chart no. 1.2 The banking prudential indicators at the level of Central and Eastern European Countries



	Bulgaria	Croatia	Czech Republic	Poland	Romania	Slovakia	Turkey	Hungary	Russia
2006	2,2	5,2	3,6	7,4	1,8	3,2	3,9	2,6	2,4
2007	2,1	4,8	2,7	5,2	2,6	2,5	3,3	2,3	2,5
2008	2,5	4,9	2,8	4,4	2,8	3,2	3,4	3	3,8
2009	6,4	7,7	4,6	7,9	7,9	5,3	5	6,7	9,5
2010	11,9	11,1	5,4	8,8	11,9	5,8	3,5	9,8	8,2
2011	14,9	12,3	5,2	8,2	14,1	5,6	2,6	13,4	6,6
2012	16,9	13,6	5,1	8,9	18,2	5,2	2,7	15,8	6

Source: authors based on data taken from *FMI Global Financial Stability Report, December 2013,* **[11]** Internal and external economic climate have adversely influenced the financial results of the credit institutions, the Romanian banking system recorded at December 31, 2012 for the third consecutive year, a negative aggregate result. The key indicators of profitability within the banking sector (the financial return - ROE and ROA, the economic rate of return) were negative for Romania since 2010.

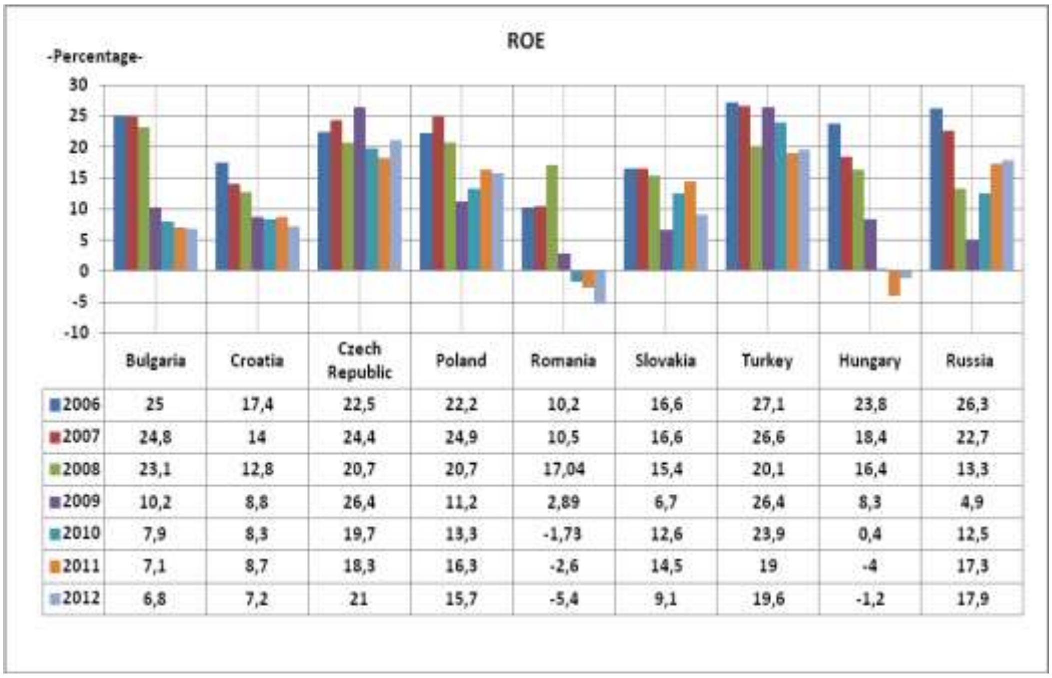
The Romanian banking system recorded at December 31, 2012 negative financial results, because of the substantial increase in the volume of credit risk provisions, the depreciation of the quality of financial assets (particularly for exposures to non-financial companies) respectively the reevaluation of guarantees. The operating income had a negative growth due to the decrease in the net interest income in the context of low volume of new loans given to the real sector.

The concerns of the credit institutions with an eye to resize balance and reduce fixed costs led to reduced operating expenses and set a pace slightly positive operating profitability in the latter part of 2012. The decreasing dynamics of the spending on credit risk provisions created the improvement in the financial results of 2013. Hence the profitability indicators - ROA and ROE - came back to positive values (0.6 percent, respectively 5.9 percent to end of august, according to the financial Stability report for 2013 published by the National Bank of Romania) **[12]**.

Recent estimates reveal a trend of improvement in the profitability of the banking system, subject to the resumption of the lending within the NGO sector. Elements that explain the expected results consist in low cost financing in the context of improving sovereign risk perception, i.e. the recurrent nature of expenditure adjustments for depreciation and the revaluation of collateral generated under conditions of low liquidity markets.

Thus the chart below shows that along with Hungary which recorded a loss of -1.2%, Romania is the very last in terms of profitability indicators. On top spots Turkey is with 19.6%, Czech Republic with 21%, Russia with 17.9% and Poland with 15.7%. The table below shows the values of the indicators of profitability in the banking sector for several countries in Central and Eastern Europe. The analysis reveals that since 2008 the international financial crisis has raised serious challenges regionally, worsening risk perception and contraction of markets deteriorated the external financing capacity and it led to the replacement of the global liquidity risk with the solvency one.

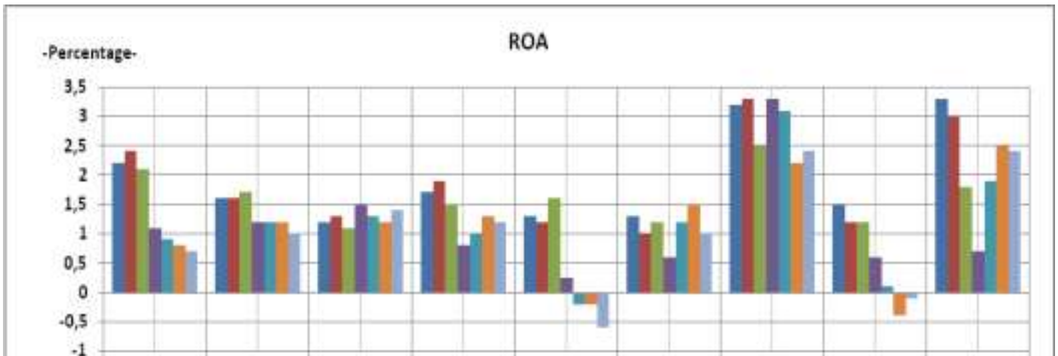
Chart no. 1.3 The banking profitability indicators at the level of Central and Eastern European Countries



	Bulgaria	Croatia	Czech Republic	Poland	Romania	Slovakia	Turkey	Hungary	Russia
2006	25	17,4	22,5	22,2	10,2	16,6	27,1	23,8	26,3
2007	24,8	14	24,4	24,9	10,5	16,6	26,6	18,4	22,7
2008	23,1	12,8	20,7	20,7	17,04	15,4	20,1	16,4	13,3
2009	10,2	8,8	26,4	11,2	2,89	6,7	26,4	8,3	4,9
2010	7,9	8,3	19,7	13,3	-1,73	12,6	23,9	0,4	12,5
2011	7,1	8,7	18,3	16,3	-2,6	14,5	19	-4	17,3
2012	6,8	7,2	21	15,7	-5,4	9,1	19,6	-1,2	17,9

Source: authors based on data taken from *FMI Global Financial Stability Report, December 2013*, **[11]**

Chart no. 1.4 The banking profitability indicators at the level of Central and Eastern European Countries



	Bulgaria	Croatia	Czech Republic	Poland	Romania	Slovakia	Turkey	Hungary	Russia
2006	2,2	1,6	1,2	1,7	1,3	1,3	3,2	1,5	3,3
2007	2,4	1,6	1,3	1,9	1,2	1	3,3	1,2	3
2008	2,1	1,7	1,1	1,5	1,6	1,2	2,5	1,2	1,8
2009	1,1	1,2	1,5	0,8	0,25	0,6	3,3	0,6	0,7
2010	0,9	1,2	1,3	1	-0,2	1,2	3,1	0,1	1,9
2011	0,8	1,2	1,2	1,3	-0,2	1,5	2,2	-0,4	2,5
2012	0,7	1	1,4	1,2	-0,6	1	2,4	-0,1	2,4

Source: authors based on data taken from *FMI Global Financial Stability Report, December 2013*,**[11]**

4. Conclusions:

The financial and prudential indicators represent important signals about the health of the banking sector as a whole, and their study has been and remains a constant concern to various national and international financial institutions such as the National Bank, IMF, ECB, World Bank and other researchers in the field.

The analysis of financial health indicators in the Romanian banking sector indicates their deterioration over the analyzed period in relation to the Central and Eastern European countries. However, the Romanian banking system remained robust and shock resistant even during the financial crisis. This can be explained by the low level of debt (leverage) and the dominant character of the traditional banking, which was a lending based one, at the expense of the securitization transactions, of the off-balance sheet ones as well as of those activities specific to the investment banks.

As far as Romania is concerned, the banking prudential indicators, analyzed in the period 2006-2012, are at levels comparable to those existent in the Central European countries.

The lower Romanian banking profitability compared to other European emerging countries is explained by the simultaneous action of several factors with a negative impact on the Romanian banking sector, such as:

- Stricter provisioning rules set out by the Romanian legislation. In 2009, the Central Bank issued a new regulation on the classification of loans and investments, and the establishment, regulation and use of specific credit risk provisions (NBR Regulation No. 3/2009) which resulted in an improvement of the system of provisions.
- High level of minimum reserve requirements, in particular foreign currency resources.

In conclusion, we wish to point out the fact that in this unstable economic context, it is difficult to quantify certain trends regarding the evolution of both the worldwide banking systems as well as the national one. It is also difficult to assess different degrees of development in regards to the interdependence between countries, especially from a perspective related to Romania, which is currently under development but still dependent on foreign investment.

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