The Romanian Banking System after EU Accession

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Abstract. Banks play an important role in the financial sector, in the proper functioning of economic entities and in the economy as a whole, therefore over time the establishment of a functioning banking system capable of delivering a wide range of products and services to meet the requirements of all potential customers has been a permanent concern. Considering the economic and financial reality, both internationally and domestically, each country and therefore, Romania is interested in creating a solid banking system, enabling the appropriate organizational framework in order to ensure a development of the financial mechanisms. The banking system as the basic element of the financial system, allows an efficient allocation of resources in the economy and, in order to function properly, we need to know the risks they face: a slow economic growth may cause losses due to difficulties in repaying bank loans, due to lower sales or lower wages, changes in asset prices may cause financial losses to investors, decreasing a sector of the economy which has monopolized the banks' and investors' attention.

Keywords: banking system, post-accession, capital adequacy, risk, financing, reform, banking law, bank assets, bank liabilities, dynamics.

1. Introduction

Financial stability is a new term in the vocabulary of central banks and is even newer to the public. However, it is essential to remember that financial stability is a part of the activity of a central bank, as important as inflation or exchange rate.

Balanced combination of micro and macro-prudential policies[91] must consider the so-called concept of "fallacy of composition", i.e. it is considered that the financial system and within it the banking system is safe and stable in its entireness in the case when each component (in our case each bank) is secure, stable.

This hypothesis can be contradicted by the cases when taking the measures that are considered prudent in a bank, can cause destabilization in the entire banking system. For example, during a financial crisis a bank may decide to reduce exposure/assets because indicators show an inadequacy of capital; if all banks take the same decision simultaneously there will be a credit supply reduction, which would draw a macroeconomic contraction followed by a further deterioration of the banks' loan portfolio, with pressure on costs and capital requirements.

The objectively necessary implementation of macro-prudential policies requires taking into account the actual connections between the financial system and the real economy. Any non-correlation between the two major elements can be reconciled with a policy mix that includes, on one hand, changes in the areas of financial sector regulation and supervision, and on the other hand changes in macroeconomic policies which will address imbalances in the financial sector.

On the larger scale of regulatory policies and supervision of the financial system, the mechanism of feedback the real economy and the financial sector has been treated in terms of:

- the evolution of the aggregate risk and business cycle synchronization – „*Time Dimension*"
- the distribution of risk in the financial system in a given time – „*cross-sectional dimension*"

If a bank or a group of banks should enter a period of problems and losses generating systemic risk, each institution could follow different scenarios:

- it may enter into liquidation;

[91] National Bank of Romania, www.bnr.ro.

- it may recapitalize (by increasing capital or reducing lending and loan portfolio – generating particularly negative effects for the real economy);
- it may sell part of the assets at prices sometimes distorted, affecting the portfolio assets of other banks.

As the current crisis has shown, in all developed countries the state intervened in support of banks with strategic and systemic importance, recapitalizing them and extending guarantees (often 100% guarantees of bank deposits), thereby helping to maintain confidence in the banking system.

Analysis of the financial system takes into account the following three categories of players:

- the banking sector;
- the non-banking financial sector (insurance market, private pension market and non-banking financial institutions);
- the capital market.

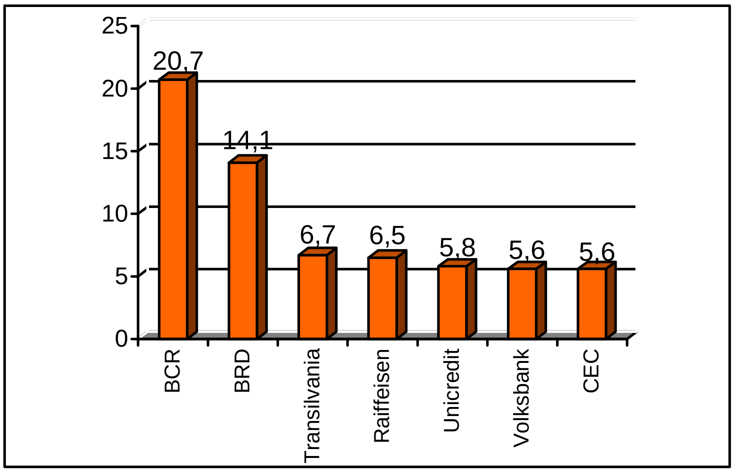
The evolution of financial institutions during 2010 and 2011 doesn't indicate significant changes. Significant slowing of the decline in economic activity has allowed financial intermediation activity without a high volume of mergers and acquisitions, with risks being managed within the banks or financial groups they belong to.

2. Dynamic interactions of bank assets

The top banks ranked by total assets in June 2011 (total assets in the banking system 339 billion lei, equivalent to 80 billion euros) are:

Figure 1. Classification of banks by total assets

billion euros



Source: BNR – Credit Institution – Aggregate Monetary Sheet

The main weaknesses of this sector have subsided; the risks of banks in Romania are covered by their own effort, by increasing levels of solvency and liquidity provisions. Nonetheless, the following risks still persist:

- the contagion risk due to developments on international markets especially sovereign debt crisis;
- credit risk;
- large foreign debt.

The size of the banking sector (assets in relation to different variables – GDP, deposits, loans) is an important factor for the financial stability because it can influence both systemic risk and contagion.

The level of financial intermediation, calculated as a percentage of bank assets to GDP, continues to rank Romania (about two thirds of GDP) well below the EU average (three times GDP) and even below the values recorded by the other new Member States. The level of concentration in Romanian banking is still moderate, while having a higher rate on the deposits.

The upward trend of the level of intermediation reported in 2009 was mainly due to a lower GDP growth, but for 2010 the nominal growth rate of net assets in the banking system has been slower than the GDP growth rate, leading to a slightly lower level of intermediation than in 2009.

An analysis of aggregate balance sheet assets of banks operating in Romania confirms the following trends:

- a slowdown in banking activity, mainly due to contraction of lending;
- increased exposure to the government sector (the share of such loans in total domestic credit going over 23%);
- reducing the balance of investment in central bank credit institutions, mainly as a result of reducing reserve requirements.

After 2008 banks in Romania saw a significant increase in risk aversion, and have kept that attitude. The proof is that banks turned mainly to investments in government securities while the proportion of claims on the private sector has oscillated around 55% of the total.

Table 1. Evolution of assets of credit institutions operating in Romania during 2005-2011

% of total assets

	2005	2006	2007	2008	2009	2010 Mar.	2010 Dec.	2011 Mar.
Domestic assets, of which:	96,5	97,4	98,3	98,5	96,9	97,1	97,3	97,3
Claims on BNR and credit institutions, of which:	40,0	34,9	28,8	23,8	18,6	15,9	16,5	15,2
- Claims on BNR	37,5	31,3	24,9	21,8	15,7	12,9	14,2	13,1
Claims on domestic non-banking sector, of which:	48,5	54,8	61,2	63,4	67,5	70,4	70,4	71,2
- Claims on public sector	1,9	1,6	3,7	5,0	12,7	14,2	15,8	16,3
- Claims on corporations	30,2	30,8	29,9	29,2	27,3	28,5	28,0	28,5
- Claims on population	16,4	22,4	27,6	29,2	27,5	27,7	26,6	26,4
Other assets	8,0	7,7	8,3	11,3	10,8	10,8	10,4	11,0
Foreign assets	3,5	2,6	1,7	1,5	3,1	2,9	2,7	2,7

Source: BNR – Credit Institution – Aggregate Monetary Sheet

In terms of assets' structure in the banking sector, there were registered two significant changes from 2009:

- the share of claims on the central bank has decreased (from 15.7% on December 31, 2009 to 14.2% on December 31, 2010 and to 13.1% by the end of March 2011);
- the share of claims on public sector increased (from 12.7% to 15.8% and to 16.3%);
- Long-term loans remain dominant (57%).

3. Evolution of Funding Sources

Financial intermediation (service provided by the banking sector) refers to attracting deposits and placing these resources in loans.

Before the financial crisis supervision of the banking sector's health was focused on the quality of balance sheet assets – Basel II Agreement – (loans), but the great danger came from the quality of liabilities (the securitization process involved creating an asset based on a collateral – namely a liability – with a variable value).

Combined analysis of assets and liabilities of the banking system in Romania shows at least two imbalances:

- share of external assets and liabilities;
- share of deposits and loans attracted from individuals and companies.

Analysis of the dynamics and structure of the aggregate liabilities revealed the following trends:

- negative dynamics (in real terms) of the balance of deposits attracted from businesses and population in July 2010 for the first time in the last ten years. This happened in particularly with short-term resources attracted;
- increase of resources through capital injections by credit institutions' shareholders;
- maintaining the proportion of foreign liabilities in aggregate bank liabilities.

Table 2. The structure of liabilities of credit institutions operating in Romania

% in total liabilities

	2005	2006	2007	2008	2009	2010 Mar.	2010 Dec.	2011 Mar.
Domestic liabilities, of which:	79,1	77,5	71,7	69,3	73,7	73,5	73,1	73,2
- Interbank Deposits	2,5	3,6	3,8	2,1	5,4	2,9	3,4	2,5
- Deposits from the public sector	3,5	3,1	2,9	3,1	2,1	2,1	1,7	1,7
- Deposits from companies and from individuals	57,5	55,0	49,7	44,6	46,0	47,1	46,2	46,1
- Capital and reserves	12,2	11,8	9,9	10,7	12,1	13,3	14,3	15,1
- Other liabilities	3,4	4,0	5,4	8,8	8,1	8,1	7,5	7,8
Foreign liabilities	20,9	22,5	28,3	30,7	26,3	26,5	26,9	26,8

Source: BNR – Credit Institution – Aggregate Monetary Sheet

Real annual growth rate of deposits from companies and households continued to be negative (-2.2 percent in 2010 and -5.4 percent at the end of March 2011), in the context of:

- decreased revenues;
- maintaining a high level of population's indebtedness;
- increasing interest in government securities.

The tendency to restrict deposits was visible in both categories of customers. The share of deposits of these types of customers in total bank liabilities remained around 46 percent. Resources attracted to mature in one year continued to be dominant thus preserving the non-correlation between maturity of assets and liabilities. According to the Deposit Guarantee Fund, on June 30, 2011 the total amount of deposits was 293 billion lei (about 69 billion euros), which accounted for 53.5% in domestic deposits). Total deposits that were guaranteed by the Fund amounted to 134 billion lei (about 32 billion euros).

4. Capital adequacy

The Basel III Agreement requires that by 2015 banks have to achieve a capital adequacy level of 7% and Tier 1 capital ratio should increase from the currently 4% up to 6%.

Capital ratio = Equity / Risk-weighted Assets

Leverage = Tier 1 Equity / Total Assets

Table 3. Capital adequacy

%

	2008 Dec.	2009 Dec.	2010 Mar.	2010 Dec.	2011 Mar.
Percentage of total equity:	100	100	100	100	100
Tier 1 equity, of which:	77,2	78,4	79,8	80,3	81,0
Capital	43,7	46,0	47,3	50,8	51,7
Share premium	3,8	4,0	6,1	5,7	5,8
Legal reserves	34,6	33,4	33,0	32,3	30,2
Net profit for the period (audited)	-	3,75	0,0	2,5	0,0
Net loss for the period	-0,7	-2,2	-1,2	-5,0	-0,5
Tier 2 equity, of which:	22,8	21,6	20,2	19,7	19,0
Revaluation reserves	8,1	0,06	5,9	5,6	5,7
Subordinated debt (net)	15,8	17,2	15,7	15,7	15,0
Subordinated debt (gross)	17,9	20,1	19,0	20,3	20,0
Solvency ratio (>8%)	13,8	14,7	15,0	15,0	14,9
Tier 1 Equity	11,8	13,4	14,2	14,2	14,5

Source: BNR

The National Bank of Romania placed a special emphasis on Tier 1 because of their role in absorbing losses at any time. The Basel III Agreement brings a better clarification of the definition of Common Equity Tier I, which includes the capital of the highest quality available to the financial institution at any time and which has to fully absorb losses during the sintering problems (principle of going concern); it includes:

- common shares;
- retained income, including interim profit or loss;
- other income and accumulated reserves;
- common shares issued by subsidiaries owned by the bank and its consolidated balance sheet;
- certain adjustments required by the regulations.

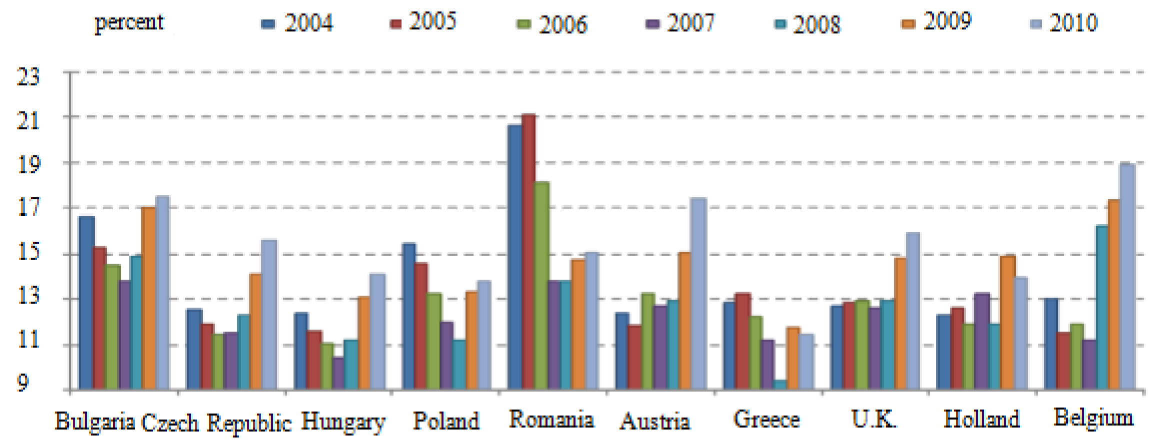
The funds owned by the Romanian banks have remained adequate despite the difficulties that banking activity went through in 2010. Thus, profits from banking recorded a significant tightening of credit institutions and shareholders were called upon to contribute with new injections of capital (their cumulative level in 2010 reached about 650 million euros).

The central bank has strengthened the role of buffer that the Tier 1 equity has in the total equity and in the balance sheet of credit institutions, while regulations specify that Tier 1 equity should be used at any time and the priority being to absorb losses, should not involve fixed costs for the bank and should be actually available to it, that is to be fully paid.

5. Solvency ratio

In order to assess the level of capitalization of credit institutions BNR uses solvency ratio as the only indicator currently regulated for this purpose. Minimum regulated level for solvency ratio is 8 percent, taking into account a ratio of at least 1 between own funds and capital requirements. Solvency ratio calculated at the aggregate level of banks in Romania recorded a growth reaching 15 percent in March 2011 from 14.3 percent in June 2010.

Figure 2. Comparative evolution of solvency ratio in several EU countries



Source: BNR

This comfortable level of solvency is based on three factors:

- BNR's decision to maintain the solvency ratio, as part of the supervision process since October 2010 (when the financial crisis began to show its effects in Romania), at a minimum prudential level of 10 percent;
- a slowdown in lending and deposits in banks' balance sheets placing priority in government securities, which led to the diminished value of risk-weighted assets and off balance sheet items;
- fulfillment by the parent banks of the nine foreign credit institutions operating in Romania of the commitment to provide additional capital ex-ante, so that the capital adequacy ratio is maintained above 10 percent throughout the period the validity of the grant agreement signed by Romania with the EU, IMF and other IFIs (its validity ended in spring 2011). During the European Bank Co-ordination Initiative - Full Forum Meeting in March 2011, nine foreign subsidiaries of parent banks reaffirmed their long-term commitment to Romania, but no longer formally committed to maintain a certain level of exposure.

BNR performs regularly exercises for stress testing solvency, according to a methodology developed in collaboration with the IMF. The purpose of these exercises is to assess the potential impact of adverse changes in the macroeconomic framework on the solvency of the banking system (in eight quarters) on both whole and in each credit institution, using as risk factors variables such as growth, exchange rate, interest rate, inflation rate respectively. As a general rule it is intended that an adequate level of capital and high liquidity limits should allow each bank to have sufficient resources in times of crisis / stress without creating spiral adverse effects on the rest of the banking or financial system.

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