# BANKING RISKS IN A GLOBAL ECONOMY

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**Abstract**

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The end of the second Millennium brought a new problem to mankind, that of globalization. In its evolution, the world economy determined a higher interdependence of the economies, the local development of an economy being possible only in direct and diverse contact with international material, informational and financial economic flows.

During recent years, the global economic integration has been accelerated on a multitude of fronts, speed being a characteristic of these times. While trade liberalisation, which started long time ago, still continues, the changes were extreme in the sphere of finances, not seen before. The great banks and financial groups, already gigantic, are caught in a frenzy of mergers. We call it today "mergermania", the great ones becoming even more powerful.

The fall of communism created an attraction for the emerging markets, with opportunities for large investments, which attracted the private financial capital in the accelerated financing of external misbalances of the developing countries.

The reform from these countries, characterised mainly by price liberalization, monetary stabilization, control of inflation, reduction of the budget deficit and transfer of part of state property into private property

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(privatization) didn't manage to stimulate the "market creation" effect due to the misunderstanding of the concept of intermediation. The effects were divergent and manifested in a hyperbola of prices and with chronicized (2 figures until recently) inflation in some countries, Romania among them. Inflation eroded the savings of the population and slowed the rate of investments in the economies where the value is volatile, which caused higher dependence of the East on the Western financial flows.

Essentially, worldwide, we may say that there is an increase of the global trend to de-save by the "fall of the national saving" both in the developed states and in the developing states.

Within this context, the chances for Romania to learn from this phenomenon depend largely on the establishment of the proper framework allowing the utilization of the benefits brought by globalization and the decrease of its adverse effects.

The influences of globalization are felt by the Romanian banking system too.

The banking activity in Romania is not up to the exigencies and standards of the European banking industry, the Romanian banking market having a small number of operators (Table 1).

**Table 1. Structure of the Romanian credit institutions**

| | December 2004 | September 2005 |
|---|---|---|
| Banks with full or majority state capital | 2 | 2 |
| Banks with majority private capital (including the branches of foreign banks), of which: | 37 | 37 |
| *- Banks with majority foreign capital, of which:* | *30* | *30* |
| *- branches of foreign banks* | *7* | *6* |
| TOTAL banking system | 39 | 39 |
| CREDITCOOP | 1 | 1 |

Source: www.bnr.ro

In order to analyse the banking structure specific to the Romanian banking system we need to consider the type of property. Essentially, the structure of property of the banking system is an indicator of quality which reflects the intensity of banking reform and reorganisation, being in direct proportionality with the structure of property in economy.

Thus, at the end of September 2005, the Romanian banking system consisted of 39 commercial banks, of which 31 with full or mostly private capital, 2 with state capital and 6 branches of foreign banks. The banks (Romanian legal persons) with mostly private capital that operate in Romania hold 73.2% of the social capital and 64.3% of the assets of the Romanian banking system. If we add the branches of the foreign banks, the above figures become 47.6% and 71.7%, respectively. The highest proportion is held by investors from Austria (26.6% of the aggregate capital), Greece (11.4%) and Italy (8.2%) at the end of the first quarter 2005.

The process of privatizing the banks with majority state capital experienced an important moment in December 2005, when the Romanian Commercial Bank (BCR) was privatized, the largest bank with state capital. The first two attempts of privatization had failed mainly due to the unfavourable international environment. The winner was Erste Bank, which will pay 3.75 billion Eur for 61.88% of BCR shares.

Thus, with the privatization of BCR, the evolution of the Romanian banking system will be determined by foreign capital, by its interests and by the way in which the foreign banks will direct their crediting policy, shifting the weight from crediting the Romanian state (safe debtor) towards the real economy.

The privatization of the Romanian Commercial Bank (BCR) and the House o Savings and Bonds (CEC) set for 2006 will increase the proportion of banking assets held by foreign investors to 90%, one of the highest in Europe, as shown by Fitch analyses. The perspectives of the Romanian banks are positive because of the improved situation of the market boosted by the economic growth and by the experience of the foreign shareholders. For the time being, the foreign investors control 64.3% of the banking sector assets. Thus, the effects of the banking internationalization on the Romanian banking system are visible particularly as participation in the social capital of the commercial banks, Romanian legal persons, or by the initial capital, in the case of the branches of foreign banks.

Comparing the structure of property in economy with that from banking, we may notice that the banking system is private to a larger degree than the Romanian economy in general.

The banking internationalization overlapped in Romania the process of financial reorganisation of the banks and was reflected particularly in quantitative terms by the number of foreign banking operators and by the volume of their assets. The qualitative side of the phenomenon will be emphasized during the coming years, by the emergence and development of new banking products and services both for the retail and for the corporate segments and by the specialisation of particular banks or by the establishment of specialised banks (saving facilities for housing).

In terms of the level of capitalization of the banking system we may notice the consolidation of the position held by banks with foreign capital.

Although the number of the banking institutions increased seven times since 1991 to the present time, the Romanian banking system is still rather concentrated (Table 2).

**Table 2. Level of concentration of the banking system in Romania (top 5 banks)**

| March 2005 | | | |
|---|---|---|---|
| **Assets** | **577160.3** | **15673.1** | **59.1** |
| **Credits** | 254985.6 | 6924.3 | 59.4 |
| **State bonds** | 3991.0 | 108.4 | 43.1 |
| **Deposits** | 396662.4 | 10771.6 | 56.8 |
| **Own capital** | 74189.3 | 2014.6 | 61.4 |

Source: www.bnr.ro

In March 2005, the Romanian banking market was dominated by five banks: Romanian Commercial Bank, Romanian Development Bank, Raiffeisen, HVB and CEC, *which hold together 59.1% of the total assets of the banking sector.*

According to the data presented by the Financial Market, the market share of BCR increased much mainly due to the mortgage credits; BRD and CEC displayed a descending trend of their market share, while Raiffeisen Bank, Eximbank, Unicredit Romania and Finansbank Romania increased their market share. The reduction of banking concentration is another effect of the internalization of the banking capital in Romania.

Business internalization, as specific form of the global economy, and of the banking intermediation, engages considerable financial, human and material resources; the banks will have activity on the foreign markets only if they estimate sufficiently significant profits to cover the risks they take.

Under the conditions of internationalized business and banking credits, the banks seen from the perspective of business are submitted to the international risk, and when they are not involved in purchases or mergers with other entities, the financial risks tend to aggregate, particularly during the first stage of the processes.

In its extreme form, the credit risk, which amplifies in the case of international credits, causes losses to the financing bank due to the debtor bankruptcy and the loss is permanent in this case. The external disturbing factors specific to the credit agreement, which make the people break their promise, is the policy of that organisation which we call State, which tends to intervene into the free relation of the sides, acting in reverse direction of the “invisible hand” principle. A characteristic example of the Romanian transition is the anti-inflationist monetary policy adopted by the central bank, state entity which sets the increase of the minimal compulsory reserve, globally motivated by the necessity to inhibit credits by blocking a part of the financial resources of the banking society at the central bank. Thus, that particular bank can only use (a lower) part of its total resources that it has drawn in deposits, which decreases the number and volume of transactions (credit contracts) concluded by the financer and which determines it to grant just short-term credits. At the same time it pays a passive interest calculated at the total level of the financial resources drawn from its clients which, compared to the interest given by the central bank for the established reserve, can only make the loans more expensive. Thus the cost of the anti-inflationist operation of the state is thrown on the debtor, not by will of the lender, but by will of the state to stabilise inflation and do a social good.

The global credit risk is the risk that expresses the probability of deterioration of the banking assets engaged for credits. The global risk of insolvency is an increasing unction of the mass of credits, of the interest rate and of the national economic medium. Furthermore, as the volume of credits increases, the cases of insolvency multiply fast, expression of the fact that the increased volume o credits brings an increasing number of potentially insolvable persons. The increase of the interest rate due to economy overheating is another factor which amplifies the global insolvency.

During the past decade, under the incidence of large scale economic, political, social and financial phenomena, the problem of credit risk displays new trends, as follows:

1. Unprecedented expansion of the credit, revealing, on the one hand, business internationalization and, on the other hand, the increasing deficit of resources and o the necessities of crediting for the large transnational companies.

2. Enormous development of the varieties of banking intermediation, materialized in the diversity and novelty of the banking products and services offered to the customers, which increased the risk of crediting, thing that may catch the economy of any country in unprecedented situations with long-term adverse consequences.

Within this context, the merger of banking companies came as a modern method to manage the global risk of crediting, both within each individual country, and worldwide. The new banking entity resulting from the merger has a consolidated capital that covers better the losses caused by the risk of credits. The merging process is a general characteristic of the modern economies and it can be observed in all economic branches, but mostly in the financial area.

Globalization and internationalization of the banking credit meant on the credit market:

- Diversification of the “credit” products both for the corporate segment, or the households and for the state;
- Development of transactions by means of IT technologies and networks;
- Lower price of the credits (in parallel with lower margins), process visible in the EU member countries, influenced both by the rate of domestic saving, specific for each country, and by inflation, fiscality and monetary policy of the particular countries;
- Development of the consumption credit and of the mortgage credits;
- Higher elasticity of the demand for “credit” products.

Of course, Romania might benefit mainly from the positive effects of globalization, but for a functionally open economy and with frail structures, the emergence of risks is very high.

Given the fact that in Romania the credits for the private sector are rather low (35.4% of the non-governmental credit), much less than in other EU member countries (where these credits may exceed 100% of the GDP) and then in Central Europe countries, we may witness a new episode of fast expansion of the credit, similar to that from 2002-2003. The fast expansion of the credit might trigger the spectacular increase of assets price ("asset bubble") and economic overheating.

The fast increase of credit may be due to multiple causes, such as:

- **Increased financial intermediation** – the faster increase of the credit compared to the GDP, as the economy grows, such as it is the case of Romania;
- **Normal cyclic movements** – that accompany the period of economic revival, when the credit grows faster than the GDP, (because the requirements of the companies or investments and circulating capital fluctuate depending on the economic cycles);
- **Excessive cyclic movements (*credit boom*)** – the excessive expansion of the credit is unsustainable and will end by collapsing. The credit-booms are often associated with banking and currency crises.

These risks might amplify with the adoption of the Euro, which will stimulate the demand, with higher volumes of credits in the Romanian economy. The decrease of the risk premiums will decrease the costs of external financing of the banks, allowing them to finance the fast increase o the credit with external funds. Also, the interest rate evolution, significantly determined by the Euro Zone conditions, might increase the risk for a new credit-boom, while the cyclic and structural influences will keep inflation at a higher rate than the rest of the Euro Zone leading to lower or even negative interest rates.

The reorganization of the banking system in Romania, together with the high risk aversion of the banks after the 1999 crisis, and the stronger surveillance and banking regulation, improved bank performance. Presently, the banks display very good indicators of liquidity and solvency and they seem to be resistant to a large array of shocks and risks (Table 3).

**Table 3. Main indicators of banking prudence**

**September 2005**

| | |
|---|---|
| **A. Capital risk** | 19.3 |
| Solvency rate ( > 12%) | 8.4 |
| Rate o own capital (own capital/total assets) | 0.3 |
| **B. Credit risk** | 0.2 |
| Overdue and doubtful credits (net value/total credit) | 2.1 |
| Rate of credit risk | 3.4 |
| General risk rate | 47.5 |
| **C. Liquidity risk** | |
| Liquidity indicator (actual liquidity/required liquidity) | 2.5 |
| **D. Profitability** | |

| | |
|---|---|
| ROA (net profit/total assets) | 2.0 |
| ROE (net profit/own capital) | 16.9 |

Source: www.bnr.ro

Analysing the evolution of the main indicators of prudence, we may notice that the expansion of crediting didn't affect the quality of the credit portfolio, which remained constant. The rate of the credit risk and the general rate of risk increased slightly to 3.4 and 47.5%, respectively. The rate of capital profitability (ROE) and the rate of economic profitability (ROA) were 15.6% (December 2004) and 16.9% (March 2005) for ROE and 2.0% (December 2004) and 2.0% or ROA.

The aggregate solvency indicator at the end of the first quarter 2005 was 19.2%, higher than the set limit of 12%. Significant progress has been achieved in the evolution of the indicators defining the quality of the assets portfolio, the proportion of overdue and doubtful credits within the total volume o credits being of just 0.4% at the end of the first quarter 2005.

However, the evolution of crediting is still hampered by the structural deficiencies of the credit market in Romania, which is common to the economies in transition and because of this the credit still is risky and expensive for the banks (Table 4).

**Table 4. Factor hampering the increase of the volume of credits for the private sector in the transition economies**

| Factor | Countries where this factor is relevant (%) |
|---|---|
| Poor protection of the creditors | 87.8 |
| Lack of trust in debtors | 50 |
| Finalization of the process of reorganization after periods of crisis or change o the owner | 5 |
| Inadequate accounting standards | 37.5 |
| Direct external financing | 25 |
| Other | 37.5 |

Source: www.bnr.ro

After all these deficiencies are removed, the Romanian banks will probably direct their attention on credits for the private sector. This is very likely, given the high proportion of EU banks capital in Romania, the adoption of the community acquis in terms of banking regulations, the increasingly tight connections with the interbanking market and with the Euro Zone, as well as the increasing cooperation between the surveillance organisms from Romania and the EU.

Because Romania has a very low level of banking intermediation, it will be important to identify the moment beyond which the increasing banking intermediation may turn into a “credit boom”, with adverse economic effects.

The literature shows that the mere increase of credit proportion within the GDP should not be interpreted as warning for economic overheating. However, two channels of increasing the volume of credits may signal potential expansionist effects in the economy: higher propensity of the banks to give loans because of improved microeconomic factors (privatization, profitability and credit risk) and higher inflow of capital through the banks, which is similar to monetary expansion, which requires the intervention of the central banks on the hard currency market.

In Romania, the emergence of these effects can be favoured by several evolutions: first, the privatization of the state-owned banks which redirected the credits from the state sector towards the private sector; second, the banks will be increasingly tempted to enhance their profitability by giving loans, while they are now investing in safe placement funds whose profitability is limited (state bonds, deposits in the central bank); third, the decrease of the credit risk will prompt the banks to grant new credits while the liberalization of the capital movement will favour the inflow of capitals through banks.

In the hypothesis of a “credit-boom” the authorities must step in using monetary, fiscal and prudential instruments. “Credit ceilings” might be set, compelling the banks that report high increases of the volume of credits to invest part of their resources in instruments remunerated below the market interest rates (case of Greece and Croatia). There also is the possibility of introducing prudential requirements such as the “pro-cyclic” capital requirements, of restrictive rules regarding the collaterals or the imposition of higher provisions or the banks reporting high increases of the volume of credits. Unlike the “credit ceilings”, the prudential instruments do not affect the financial health of the banks.

Within the commitments assumed towards the European Union, Romania pledged to enforce a program for the liberalization of the capital movement, which was largely introduced in 2001-2005. So far, the implementation of the measures to liberalize the capitals was not confronted by major incidents because Romania didn't attract "destabilizing" foreign capitals in terms of volume o structure.

Although the inflow of foreign capitals is generally a desired factor for Romania, if they display potential to become volatile they may affect the proper functioning of the economy. Romania seems to be particularly vulnerable due to some characteristics. The low level of monetization of the economy and o banking intermediation compared to other countries from Central and Eastern Europe tend to amplify the marginal impact of any additional inflows of capital.

There are serious fears as to the behaviour of the local banks after the liberalization of capitals. Much of the bank assets are invested in state bonds. Capitals liberalization provides the non-residents the possibility of access to the local market of the state bonds. This phenomenon may decrease bank profitability because it will decrease the volume of the available state bonds and will decrease the interest rate for these investments. In this situation it is possible that the banks are tempted to take short-term foreign loans using state bonds as collaterals. The risk of such operation is a mismatch o the maturities.

In the Romanian banking system there is a high probability that other risks appear due to the (increasingly pregnant) presence of the foreign financial institutions on the market. Although the banking sector would benefit from the competition generated by the foreign financial institutions, which will ultimately increase the efficiency and reduce the costs of the financial intermediation, this may entail some risks. The local financial institutions might get entangled in increasingly risky operations willing to preserve their market status. This would deteriorate the financial and prudential situation of these financial intermediaries.

The Romanian survey authorities should have proper access to information from the mother financial institution, supplied under conditions of reciprocity by the survey authorities from the country of origin. Although the presence of information flows between the surveying authorities tend to disadvantage the survey authorities from the host country, this balance will have to equilibrate in the future.

The banks remain the most important financial intermediaries in Romania. The banking system is the most important segment of the Romanian financial system, holding 37.7% of the GDP net assets. The dominance of the banking sector is also proved by the secondary role of the Romanian market of capitals. The summed capitalization of the two stock exchange units from Romania (the Bucharest Stock Exchange and Rasdaq) amount to just 11% of the GDP, half the rate in the countries recently admitted in the EU. The market concentrates in the sphere of action of 77 intermediaries whose proportion within the total assets of the financial system is of 0.1%. Except for the banking system, the other financial intermediaries have a low proportion of the total financial assets, which shows the underdevelopment of the markets for capital, of the investment or insurance funds.

The Romanian banking system reached financial stability by a large value of the banking concentration. This is mostly a private-owned system dominated by the foreign capitals. Banking concentration is high and the profitability is good, determined by the maintenance of a large general margin, which is characteristic to the type of unstructured economy.

The influences of globalization on the Romanian banking system opened a new stage in the organization and management of the credit and money in the national economy. It transformed the conditions in which the immediate and long-term prosperity of all states is decided.

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