RISKS AND VULNERABILITIES OF THE LENDING PROCESS

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Abstract. *After 2008, due to the global economic crisis, we have all witnessed a major decline of industrial production and consumption, a reduction of the level of employment, with direct consequences over the banking system. This paper represents an outline of the global financial crisis consequences in Romania, highlighting the reaction of the banks in the economic crisis circumstance.*

Keywords: *Banking Risks Exposure, Basel agreements, Sarbanes-Oxley*.

1. General considerations about credit risk

The process of globalization, liberalization, diversification of financial instruments by significantly increasing the volume of transactions in financial derivatives (swaps, futures, options) and innovation of technological international financial markets over the last decade have changed the banking environment. It is now highly competitive, but also highly vulnerable to multiple risks to which it is exposed. Traditional banking practices, once based on the formation of deposits and loans is today only a part of banks activities, other sources of profitability being transactions in financial markets and generating revenue through commissions.

Credit risk management process is fundamental to avoid incidents displeasure, such as the bankruptcies of banks as Herstatt, Barings Ambrosiano and, especially to avoid systemic risk due to the fact that a crisis can pass quickly from one financial centre to another. The current world economic crisis is actually a financial imbalance, tied to the credit system. In the summer of 2007, U.S. subprime crisis burst after U.S. housing market collapsed as a result of investment banks and brokerage firms mortgages, involving a high degree of risk. The main effect of this phenomenon was a reduced access to liquidity, due to lack of information on exposure to active players losing; the crisis has affected many companies, especially investment banks such as Lehman Brothers brokerage societies, such as Merrill Lynch.

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The international body governing the banking sector risk management is the Committee on Banking Supervision in Basel, operating through regular meetings at the Bank for International Settlements in Basel. This committee has developed several agreements relating to minimum capital requirements of banks with international business, banking supervision and market discipline, implementation of which aims at achieving a high level of safety and soundness of banking system. Basel Committee standards have already been adopted in more than one hundred countries as part of their national regulatory systems of banking risks.

In 1988, the *Basel Committee* (BCBS) in *Basel, Switzerland*, publicshed a set of minimal capital requirements for banks. The first Basel Accord was enforced by law in the *Group of Ten* (G-10) countries in 1992. Basel I first and foremost focused on *credit risk.* Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero (for example home country *sovereign debt*), ten, twenty, fifty, and up to one hundred percent (this category has, as an example, most corporate debt). Banks with international presence are required to hold capital equal to 8 % of the risk-weighted assets.

Basel II Accord, published in June 2004, created an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face while maintaining sufficient consistency so that this does not become a source of competitive inequality amongst internationally active banks.

Basel II uses a "three pillars" concept[2] – (1) *minimum capital requirements* (addressing risk), (2) *supervisory review* and (3) *market discipline*.

The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: *credit risk, operational risk,* and *market risk.*

The second pillar provides a framework for dealing with all the other risks a bank may face, such as *systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk* and *legal risk*, which the accord combines under the title of residual risk. The third pillar refers to minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to estimate the capital adequacy of an organization.

[2] Bank for international settlements, Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework, http://www.bis.org/publ/-bcbs107.htm

In 2010, a reply to the shortcomings in financial regulation revealed by the *global financial crisis,* a new global regulatory standard[3], Basel III, has been agreed by the members of the *Basel Committee on Banking Supervision.* This accord strengthens bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage.

Of course, regulators and supervisors of the credit system cannot prevent bankruptcies of the banks; they just can monitor the legal framework in which risk is managed and create a healthy and stable financial environment.

All actors of the financial environment need to show responsibility in decision making. Thus, shareholders of financial institutions need to carefully select managers and implement corporate governance principles, internal procedures based on separation of the board of directors and bank management. The board should supervise the management activity and ensure its correct reporting to shareholders. An important event in this regard was the adoption in the U.S. Sarbanes-Oxley Law (2002), which was a reaction to financial scandals that rocked the big famous companies (Enron, Worldcom, Global Crossing, Tyco, Adelphi), which led to loss of public confidence in accounting practices, external audit and the figures reported by companies. Sarbanes-Oxley establishes rigorous standards for accounting, auditing and board responsibilities.

The boards of directors need to implement coherent, operational policies and ensure the proper functioning of banks. Audit committees and auditors (both external and internal ones) need to evaluate the request bank control systems, especially in accounting and information technology. For specific risk management international banks, is necessary to set up risk management committees, to opt for a particular risk profile and to establish objective and strategy for each significant risk, including the outsourced activities.

The management of international banks must maintain appropriate limits on risk exposure, including the crisis, according to the size, complexity and financial condition of the bank to implement procedures and oversee a system of internal control function to recruit and train highly qualified personnel. Bank's risk management strategy must determine the optimal acceptable balance between risk and profit.

Obviously, the public, composed of large consumer credit products, has to anticipate the effects of investment decisions they make and properly assess their degree of solvency they have.

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[3] *Bank for international settlements, Group of Governors and Heads of Supervision announces higher global minimum capital standards, http://www.bis.org/press/p100912.pdf*

Even rating agencies can support credit process through systematic researches on banks, firms and markets. Standard & Poor's, Moody's, Fitch, Institutional Investor, Euromoney, Australian Ratings, JBRI (Japan Bond Research Institute), Nippon Investors Service, are famous agencies that guide investors. It is true that sometimes, objectivity or rating agencies is doubtful. For example, in Japan, U.S. agencies are suspected that they accord lower ratings than Japanese issuers, which influence their credibility in the international markets. Therefore, even ratings are only indicative milestones for potential investors who need to filter such pieces of information through their own assessment process.

Since 2007, credit rating agencies have come to the attention of the European Union After a wave of criticism about the slow reaction of Standard & Poor's and Moody's for the warning on the risks of securities based on speculation on credit U.S. housing. Some EU Member States have proposed a reform of the financial sector to increase transparency in how the rating agencies proceed and separate the activities of consulting to the assessment of risks ones, for the reason of conflict of interest. For example, Michel Prada, chairman Autorité des Marchés Financiers, said that rating agencies should rethink how they assign grades to different classes of financial instruments and to prove „reater transparency and consistency in the basic parameters”[4].

The credit system, which includes both commercial and investment banks as non-bank financial institutions, is subject to multiple risks, which can be classified into four categories, as shown in figure 1:

– nancial risks, such as credit risk, interest rate risk, currency risk and price risk, capital adequacy, liquidity risk

– erational risks and internal systems of banks, including computer systems

– iness risks associated to the environment in which credit instiutions are active, i.e. risks related to macroeconomic factors, regulatory, infra-structure and payments system-risk of occurrence of events, especially political ones.

Deregulatory measures concerning occidental banks at the beginning of the millennium, especially American ones, lead to an excessively rapid credit expansion, and increases of assets prices. After a period of time, the bubble burst, with a sharp drop in prices, disturbance of the asset markets, bankruptcies, increase in non-performing loans, credit losses, and severe liquidity problems within the banking system. Eventually, governments

[4] Tett Gillian, *Regulator urges rating agencies to reform*, article in Financial Times, January 18th, 2008.

have had to bail out the feeble banking system by significant recapitalization and nationalization operations.

Hence, the aftermaths of the crisis were: the loss of confidence in the financial system, sharp drop of liquidity, augmented interest rates, the rising cost of internal and external funding, bankruptcies, restructuring of companies and financial institutions, mergers, takeovers, financial support with funding from governments.

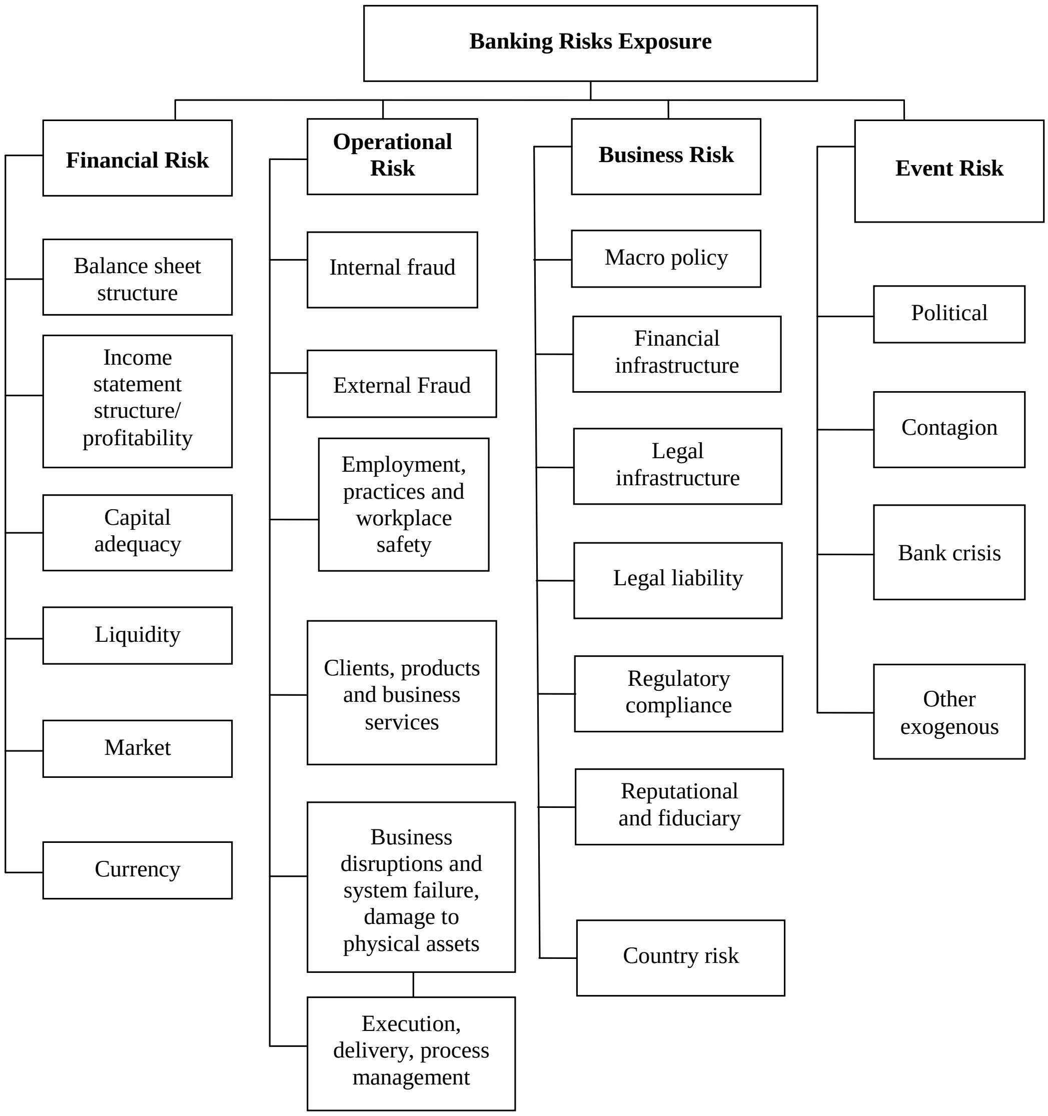

Figure 1. The banking risk spectrum.

Source: Hennie van Greuning, Sonja Brajovic Bratanovic-World Bank, Analyzing and managing banking risk, a framework for assessing corporate governance and financial risk, IBRD- The World Bank, 2003, page 13.

2. Banking risk management during the global crisis

The crisis erupted in Romania with a delay of one year, in 2009, but the consequences were very tough. The decline of external resources caused the decrease of banks' reliance on external financing. Simultaneously, parent banks supported subsidiaries in their attempt to attract local market deposits.

Previous the crisis, there was a soaring household consumption, which was supported by:

– the progressive reduction of the monetary policy interest rate in the period November 2003-September 2005;

– the mounting confidence in the progress of economic framework and in the disinflationary process, and much too optimistic expectations relative to the increase of population's incomes in the context of the EU integration process;

– the fact that higher asset prices augmented the value of the collateral, leading to a higher amount of borrowed funds;

– the high availability of credit, as a result of relaxed monetary policy and to the rising competition between foreign-owned banks and domestic ones.

The main vulnerabilities of the banking sector during the crisis were external funding volatility and increased credit risk.

Since 2009, the external financing and credit institutions of the Romanian companies have recorded costs increase and a reduction in maturities. Subsequently, funding uncertainties have increased, reflecting on the one hand, the liquidity crisis in countries with investments in the banking sector in Romania and, on the other hand, significant exposures to foreign investors and banks balance Romanian companies.

Credit risk has increased, due to the fact that portfolios of debts held by commercial banks worsened during 2009. Borrowers with low incomes have been strongly affected by the crisis and exposure to currency risk. Also, companies have faced increasing difficulties to honour debt service. Currency depreciation has had negative implications on debtors who have engaged in foreign currency loans. The pace of growth of loans to households and companies has declined sharply in 2008 and 2009, as shown in Figure 2.

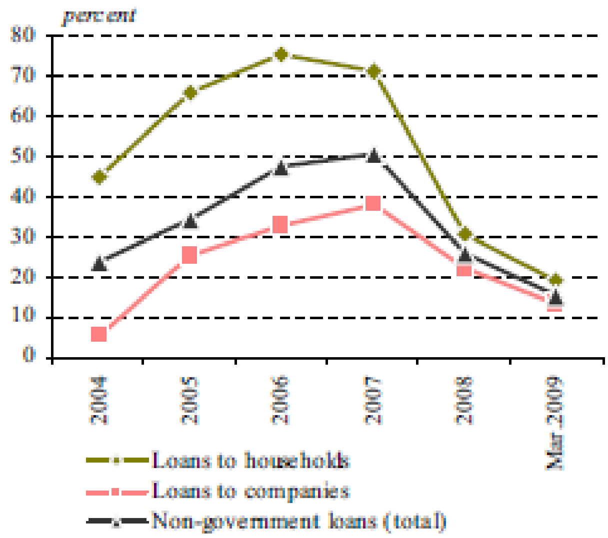

Figure 2. Non-government loans by component.

Source: NBR, *Financial Stability Report*, 2009, ISSN 1843-3235, p. 37.

The central bank responded to these challenges by implementing flexible prudential norms relating to provisioning for credit risk, providing the possibility of inclusion in the calculation of own funds related to the interim profit, reducing to zero of the reserve ratio for foreign currency liabilities with residual maturity within two years. It is a positive fact that, in comparison with banks in some EU countries, the quality of credit portfolios of banks in our country was good, especially because they have had no toxic assets held in their portfolios.

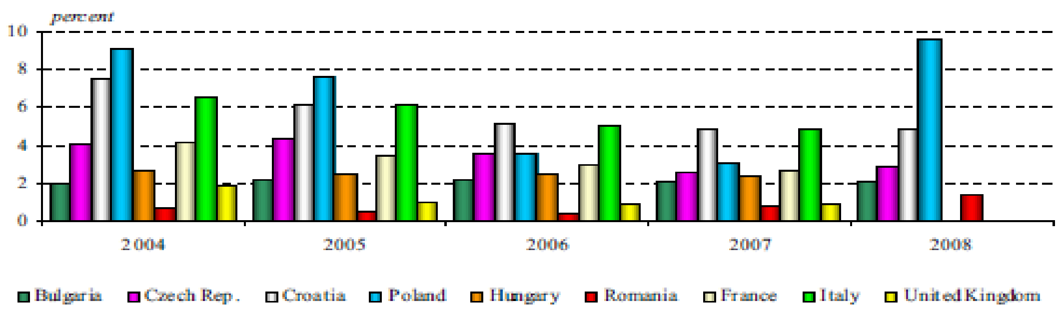

Figure 3. Credit quality in the European Union.

Source: IMF, *Global Financial Stability Report* (October 2008); NBR calculations.

Similarly, the level of provisions for existing non-performing loans of the financial institutions in Romania is higher than that reported by other European Union Member States and is on a slightly upward trend.

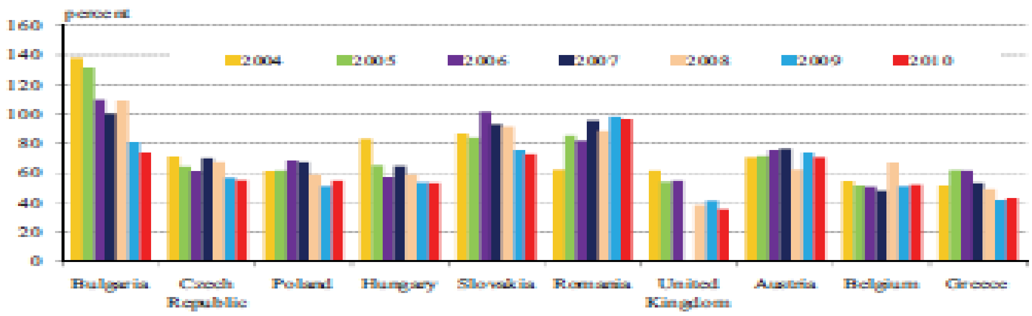

Figure 4. Coverage with provisions of non-performing loans in selected EU countries.

Source: IMF, *Global Financial Stability Report* (April 2011); NBR calculations.

Due to the fact that non-government credit has a much reduced growth rate and the banks have turned to less risky investments, the general risk rate level has improved in the last two years.

Concerning the **liquidity risk**, one can notice that starting with the last quarter of 2008, the impact of global financial and economic crisis on the Romanian banking sector was a low liquidity, which has increased funding costs and amplified risks of default related to debts with short maturity. A vulnerability of Romanian banks was the short-term external debt, but it was mitigated by the fact that the main nine credit institutions with foreign capital have pledged to maintain exposure to Romania.

The indicator of liquidity calculated in accordance with in force regulations during the crisis remained at levels that exceed the minimum regulated of 1, which is a positive and hopeful issue.

Regarding the **market risk,** one has to underline a low level of vulnerability of the banking system related to foreign exchange risk. It should be noted however that the currency exposure of the corporate sector is higher than that suggested by internal loans reflected in banks' balance sheets, as many companies borrow directly from abroad, leading to a growth of potential indirect exposure to currency risk.

The implementation of the provisions in the financing arrangement signed with the European Union and International Monetary Fund in 2010 was beneficial for the stability of the banking system. NBR monitors closely the prudential standing of banks with foreign capital originating in the countries hit by the sovereign debt crisis, like Greece. In 2010, banks with Austrian capital accounted for the largest market share, but in terms of the country of origin of the capital invested in Romanian credit institutions, Greece was in the lead.

In Romania, the crisis has had a contrarian but positive effect; clients have constantly saved their money in deposits; in 2008, their total value was 38,003 mil. lei, in 2009, 39,749 mil. lei and in 2010, 41,457 mil. lei; people have really understood the value of money and how important is to have "white money for black days" as a local proverb says.

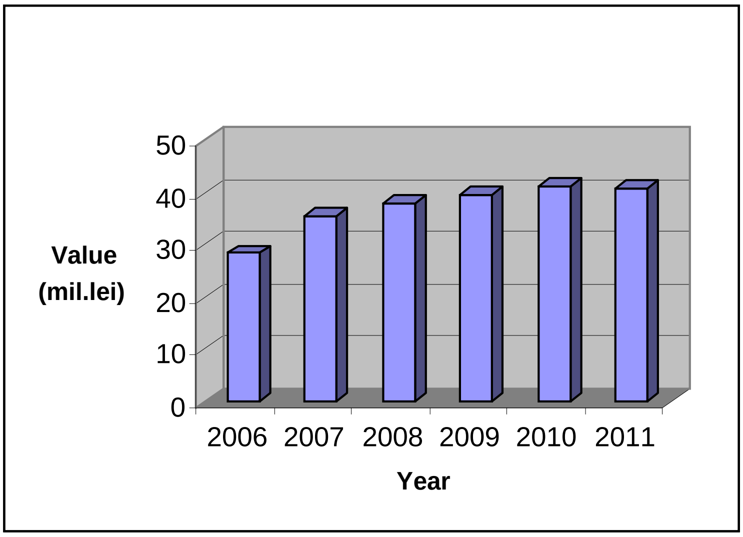

Figure 5. Evolution of deposits in the Romanian banking system.

Source: Own calculations after National Bank of Romania's Monthly Bulletins 2007-2011.

3. Conclusions

The measures for supporting the recovery of lending through the recapitalization of banks could facilitate the recovery of the consumption credit support. In order to revive the banking activities National Bank of Romania should have a prudent credit policy, to stimulate the business environment through low interest rates. To exit the crisis, banks should improve efficiency and productivity, rebuilt the trust of clients and redefine the systems of risk management.

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