RETHINKING THE STRATEGIES IN BANKING SECTOR BETWEEN NECESSITY AND OPPORTUNITY

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Abstract. *Romanian banking sector, as the European one, has been affected by the economic instability manifested worldwide. The global imbalances have imposed changes both in the institutional architecture and in the behavior of the banks in assessing and analyzing the risks assumed. The article presents the main lines of action proposed for the stabilization and strengthening of the Romanian banking system, and also the assessment of the obtained results that, in certain circumstances, require corrective actions. The preponderance of foreign owned banks exposes the entire domestic financial system to the contagion phenomenon that sometimes generates catastrophic effects that are hard to predict and especially to manage. This justifies the increased attention from both national and European oriented institutions.*

Keywords: *contagion effect, crisis, strategy.*

JEL Classification: E44, G01, G32.

1. Introduction

The economic and financial instabilities manifested internationally have had significant consequences for our country in terms of an increasingly open economy to external markets. The dependence of European Union, both commercial and financial had a double negative impact: on one hand it facilitated the transmission of external shocks from the foreign financial system to the local one and on the other hand it made more difficult the economic recovery, due to the decrease in demand in the European Union, Romania's main trading partner.

The magnitude of the crisis and the bank failures that occurred meanwhile demonstrated the weakness of the existing regulatory and supervisory framework, characterized by deregulation, lax capital requirements and unsustainable growth of credit. All these, required the

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need to support banks in order to maintain system stability (NBR, 2013, p. 158).

The main challenge for the authorities in the context of economic recovery is to create a legal framework and to establish new regulating rules in order to prevent and ensure a higher absorption of the economic shocks. It is also required a close cooperation between European institutions so as to ensure a uniform competition environment and a single regulatory framework based on the following principles:

- a stricter and more efficient surveillance of the persons and of the capital origin;
- the dissolution of para-banking industry and of the shadow banking activities;
- submission of new financial products to national and European authorization and supervision etc. (EESC, 2012, p. 7).

The structure of the paper seeks to carry out, in the first part, an analysis regarding the main macroeconomic indicators, to capture the magnitude of the economic crisis, while in the second part it is reviewed the Romanian banking sector with the changes that took place at its level.

2. Macroeconomic position

Romanian banking sector remains subject to the external economic pressures, which have had negative impact on financial stability. Although the local banks have not held in their portfolios toxic assets, the contagion effect has allowed for the negative consequences to spread in the Romanian banking sector as well, even if not as fast as in the rest of the European countries. At the same time the decreasing confidence in the financial system, which accompanied the economic crisis was felt in the domestic banking sector as well.

The efforts made at the European level in order to maintain stability, like the foundation of the European Banking Union and the improvement in the support programs, have contributed significantly to the restoration of confidence in the banking sector.

Regarding the internal factors that led to the restoration of investors' confidence, they had in mind, on one hand Romania's exit from the excessive deficit procedure in 2013, driven by framing the level of deficit in the Maastricht criteria (Fig. 2.1), and on the other hand the inclusion, starting with March 2013, of the bonds issued by the state in the composition of the bond market indexes issued by emerging countries (Barclays capital and JP Morgan) who have supported the loans at much lower interest.

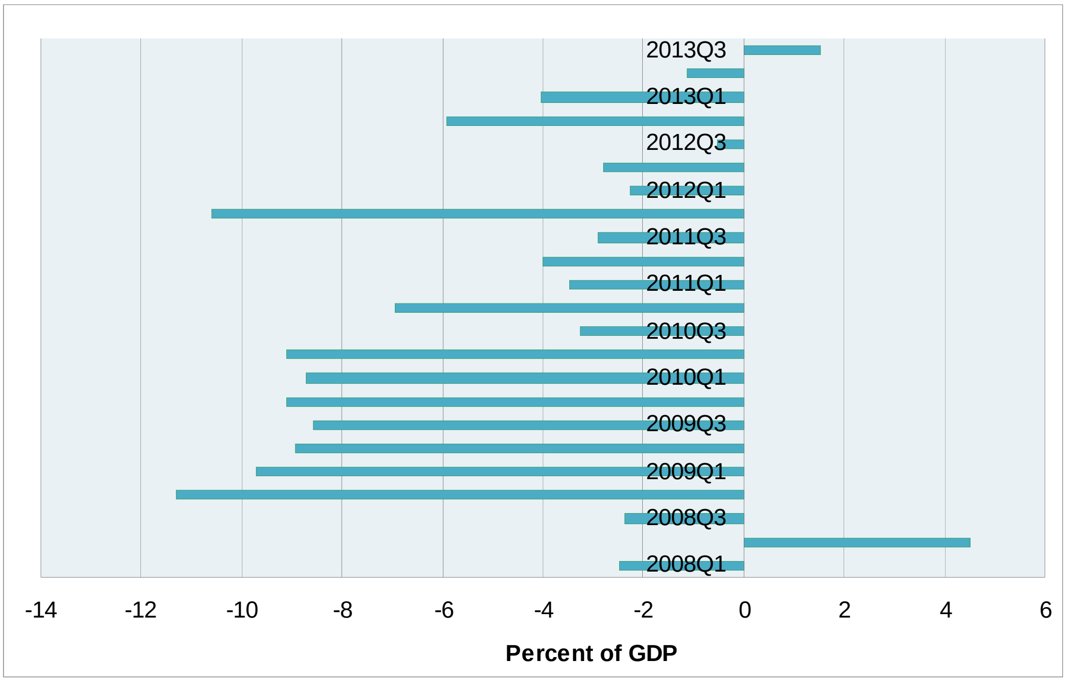

Figure 2.1. Budget deficit.

Source: Eurostat.

If prior to the year 2008 the economic growth was supported by the capital inflows, once the crisis emerged, the capital inflows have decreased drastically, leading from a rate of 17.6% of GDP net capital inflows in 2007 to a rate of –2,5% of GDP in 2009. This phenomenon accompanied by a tightening of credit conditions resulted in a 12 percent reduction in real terms of demand in 2009. The collapse of the aggregate demand has triggered a severe recession in the national economy, reflected in a significant contraction of GDP (Fig. 2.2).

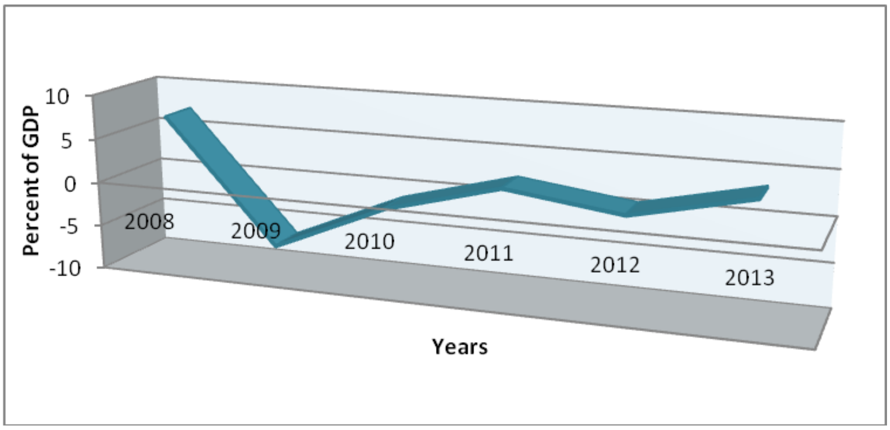

Figure 2.2. Real GDP rate.

Source: Eurostat.

The deterioration of economic condition both nationally and at the European level, have made necessary the subscription of loan agreements with International Monetary Fund, World Bank and European Commission, to support the economy to counter the negative effects of the economic crisis. The measures taken in this regard have increased Romania's public debt (Fig. 2.3), but it is still below 60%, the level set by the Maastricht criteria.

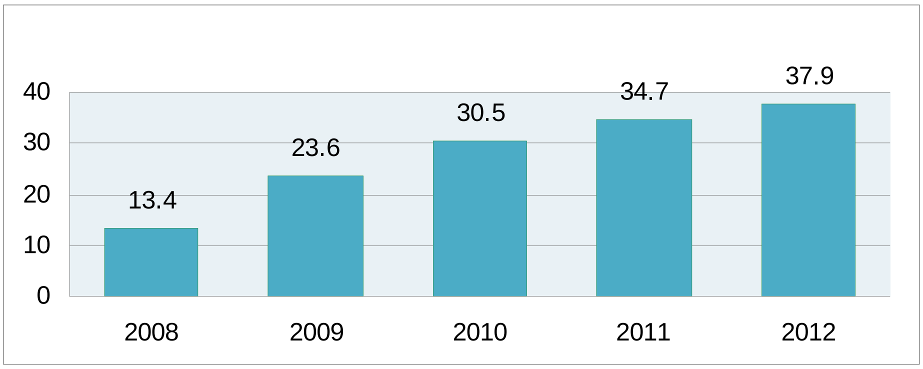

Figure 2.3. Public Debt.

Source: Eurostat.

Reviving economic growth requires both, a stable and predictable fiscal, monetary and financially framework, which can provide certainty to investors and meets the needs of the real economy and of the consumers. To achieve this goal, fiscal policy should be oriented so as to support investments that generate future income, income that will help cover the debt created during the economic recession. The priorities established at the level of monetary policy need to consider: (i) financial sector stability; (ii) restore access to credit; (iii) improving access to long-term financing (World Bank, 2013, p. 24).

3. Banking sector challenges

The economic crisis has required a thorough reconsideration of the current situation of the banking sector, considered stable and well regulated, in order to determine the origins of this major economic downturn.

If the first measures adopted have aimed the interest rates, and were adopted as emergency measures to counteract the crisis effects, on long term however, it is found that the stability of the financial system requires legislative, fiscal and prudential changes. Since 2008 the European Union has adopted more than 50 legislative measures, with different time schedules, all aiming to strengthen the financial system and to allow supervisors to intervene if any risks are detected. The new imposed regulations which require strengthening capital structure, countercyclical optional reserves, mandatory liquidity rates etc., will generate additional audit and reporting costs, actions that are expected to have an impact on banks organization and will require structural changes (EESC, 2012, pp. 4-9).

The uniform application of the regulations poses risks especially in developing countries, where the banking sector has not reached its potential level. In order to comply with the new regulations adopted and in the context of a free movement of capital, the parent institutions may request a repatriation of the capital, which will no longer be used to fund the local economy, and which may determine a reduction of the investments at the national level.

In Romania from the 41 credit institutions, 27 have foreign private capital, 2 have local private capital, 9 are branches of foreign banks, 2 are totally or partially owned by the state, and one is a cooperative organization (NBR, 2013, p. 29). The repatriation of capital, by complying with the regulations and to cope with the economic crisis have materialized in the Romanian banking sector by withdrawing 19 percent of the parent funding, between the end of 2012 and December 2013 (IMF, 2014, p. 8). In these circumstances banks have had to rely largely on local funds, ensuring a stronger dependence between household’s deposits and borrowed funds was created. The dependence between lending and domestic savings, coupled with a slow recovery of the economy has created a vicious circle, whose negative effects propagate over time.

The unfavorable external context and the implications it has had on the national economy led to an increase in the non-performing loans in the economy, limiting the contribution of the financial system to economic recovery (Fig. 3.1).

Figure 3.1. The evolution of nonperforming loans and of the credit/deposits ratio (percent).

Source: National Bank of Romania.

This evolution shows that many of the strategies implemented by the banks were not viable. The lending decisions without a thorough verification of the persons who contracted the loans and the relaxation of the conditions that needed to be met in order to get the loan, turned against the banks once the crisis emerged. Many of the banking system leaders have admitted that one of the lessons learned from the economic crisis, was that during the economic booms anyone can be successful, but in recession the strategies applied make the difference. Rethinking these strategies may be the solution to overcome the problems that currently exist in this sector. Also, another lesson arising from the current economic context it is that the banks should return to their core activities, less risky and that allow them a greater control over information. The private interest of the banks has prevailed throughout the whole period of growth, the banks activities were extended more and more, in order to gain profit without taking into account the risk they run. These activities with complex products that involve high risk should be left to the investment banks who afford to take these risks.

The correction of the banks errors and the tighter correlation with the economic recovery, have required the intervention of the regulation authorities. Through its monetary policy instruments, with pronounced cyclical character, the National Bank of Romania sought to revive the lending and to support the economy. In the period 2008-2013 the interest rate was reduced by 6 percentage points, and it is estimated that it will further decrease, if the inflation keeps the downward trend. However, the results of the monetary policy measures implemented, aiming lending resumption, fail to appear. The differences between the interbank interest rates and the reference rate, the high volatility of the interbank rates make it difficult to transfer the results of the measures taken by the national authorities to the banking sector and afterwards in the real economy.

The implementation in practice of the results of the monetary policy applied by the National Bank is highly difficult also due to the way this sector is regulated. The economic crisis has shown that in some cases regulation doesn't keep up with markets innovation. Moreover, the lax regulation is considered beneficial to the economy precisely due to and in the support of the innovation potential. This obvious option for deregulation has not allowed the construction of an institutional structure of regulatory and supervisory authorities in the European Union. The competition in the banking sector has led to the development of new products and services that meet the current market demand, but the regulatory framework has not been adapted to the new market realities. At the same time, the economic development and the relative long periods of prosperity have put the development of the crisis management mechanisms on a secondary base. Thus, once the crisis emerged, many of the existing measures in this respect proved to be inadequate. The lesson that can be drawn from this is that the crisis management mechanisms must be continuously updated, so they could respond effectively to unexpected situations (Isărescu, 2009).

The way that the crisis manifested not only in the banking sector but also in the national economy shows that structural reforms are still needed in order to support a sustainable development and economic and financial recovery.

4. Conclusions

The economic crisis has demonstrated on one hand the fragility of the financial system to shocks and on the other hand the need to strengthen financial supervision architecture in order to meet the general needs of the economy.

Banking sector reform must be based on reducing the excessive risks taken by the banks, the limitation of the activities interdependence, meaning a separate conduct of less risky activities and of those involving significant risks, a greater level of competition, transparency and responsibility etc. Also, the development of the banking sector should be closely supervised and regulated.

Economic consolidation measures taken at the national level are more difficult to elaborate because it must be within the regulatory framework that exists at the European Union level in order to preserve and prevent fragmentation of the single market, on one hand, and on the other hand it must be appropriate to the specificities of the existing banking model in the national economy.

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