

EFFECTS OF THE ROMANIAN ECONOMIC CRISIS UPON THE BANKING SYSTEM

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Abstract:

The Romanian economic crisis manifests in all fields of activity. One of the affected sectors is the banking system. The studies performed so far, the official press releases of the government and of the National Bank of Romania show that the Romanian banking system has been only slightly affected. The objective of this study is to identify whether the economic crisis has really affected the Romanian banking system in a slight or deeper manner. Meanwhile, we tried to study which are the medium and long-term implications upon the economic environment of the fact that the banking system as a whole or only some banks suffer from the economic crisis. The research starts from determining the economic crisis size based on the macroeconomic indicators published in different studies. We hereby identify the main social-economic factors that could create difficulties in the banks' activity. Then we determine their effects upon the banking system by analyzing specific bank indicators as they were published by the National Bank of Romania and by other banks. The performed study shows that the Romanian banking system, in spite of the reassuring press releases given by different public authorities, is deeply affected by the economic crisis. It is a matter of time until the banks report serious difficulties in their activities. While the exit from crisis is moving further and further away, the existing problems will amplify because the clients' trust in banks deteriorates in a rapid manner. There are big risks that the economic recovery will be aggravated by the banking system that is only now entering the crisis.

Key words: economic crisis, banking system, austerity measures, saving rate, bad loan, non-governmental loan.

JEL Classification: E31, G01, G217

1. INTRODUCTION

The external vulnerabilities induced by the fiscal policies and the pro-cyclic incomes allowed the effects of the international crisis to affect Romania also.

The Romanian banking system succeeded in avoiding the initial phase of the economic crisis in the second half of 2007. Starting with the last trimester of 2008 the outcomes of the international depression got more and more noticed in the Romanian economy, therefore in the banking system.

The soothing news and the fade and powerless press releases coming from the banks and the National Romanian Bank (NRB/BNR) determined me to study the official data concerning the Romanian banking system. My premisis started from that fact that it is such a miracle that the banking system would run as well as the press releases are presenting it, taking into consideration the deep drop-off in which the Romanian economy encounters itself. Last year's cutting back on government spending and incomes of the public employees is affecting even more the banking system.

As the recession results in a progressive high number of insolvencies and bankruptcies among the local businesses and firms, the credit risk is becoming a major concern for the Romanian banks. The banks anticipate that the quality of the credit portfolio will continue to deteriorate and they raise provisions for bad loans, fact which could conclude into important losses for the creditors. This tendency will make credits harder to obtain because the banks will invest in available assets, delaying the economic recovery. This paper has as a mean to investigate the impact of the economic depression on the economy. Afterwards, there will be a study on how the banking system fostered the spreading of the crisis.

The actions taken in order to put an end to the negative economic effects and their consequences on the banking system represent the core of the study.

Finally, based on the information that was available we will try to forshadow the short-time evolution of the banking system and the impact on the economic activity.

2. THE ECONOMIC DEPRESSION – THE IMPACT ON THE ROMANIAN ECONOMY

In the year 2009, the economy suffered a major drop-off, fact certified by the 7,1% decrease of the Gross Domestic Product (GDP) by comparison to the previous year. The first trimester of the year 2010 underlines the progressive decline of the Romanian economy, with 1,5% less than the first trimester of 2009. The main crisis displays can be analyzed through the evolution of the macroeconomic indicators like:

The budget deficit has significantly increased in 2009, reaching 8.3% of the GDP, as resulting from the following: chart no.1.

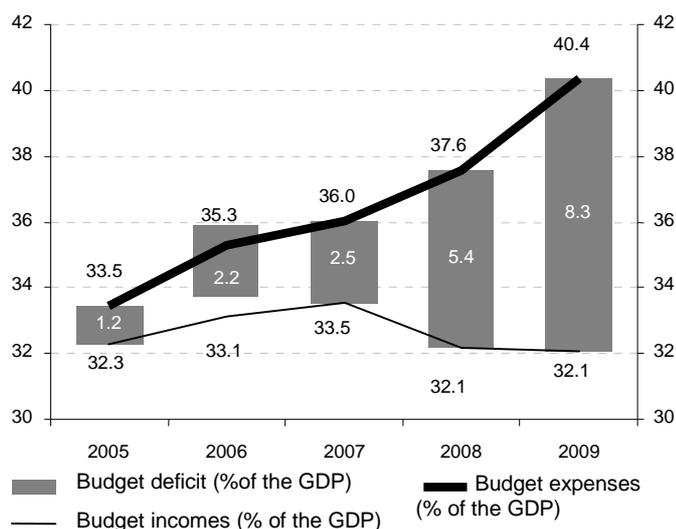


Chart 1. The evolution of the budget deficit between 2005-2009

Household income statistics showed a real decline as it can be observed in chart no. 2 and the expectation of economic growth in 2011-2012 remain inconspicuous. The taxes increase leaves a negative impact on the potential economic upbringing on the medium and long-term as well as the inflation rate.

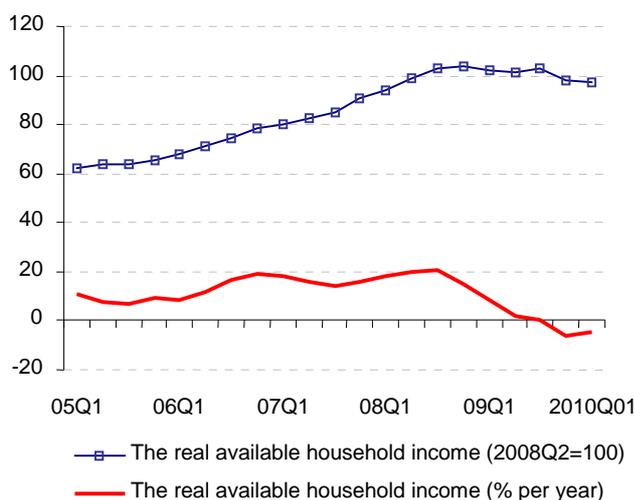


Chart 2. The real household income

The unemployment rate recorded a growth and it will continue to rise as an effect of the economic activity decreasing due to demand (expenses) decrease as well as an effect of the pressure increase on costs in the productivity area (chart no.3).

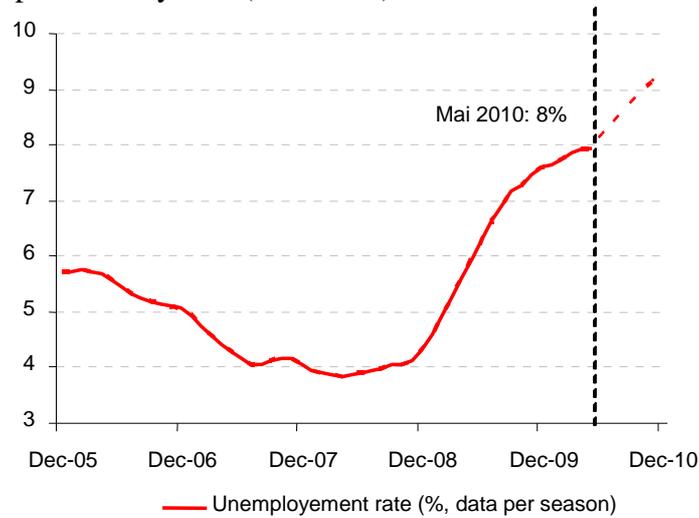


Chart 3. The evolution of the unemployment rate during 2005-2009 and the outlook for 2010

A high sales drop-off of the long-term usable goods is taking place. (Chart no. 4)

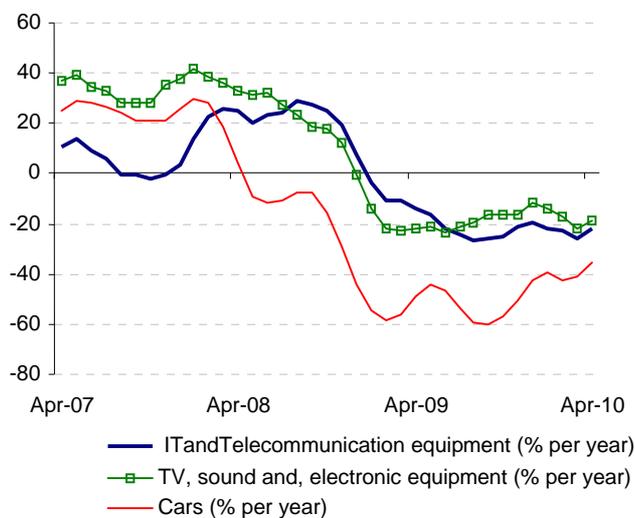


Chart 4. The evolution of long-term usable goods sales

The trust of consumers and business environment concerning the economic perspectives is low and keeps on dropping off. (Figure no.1)

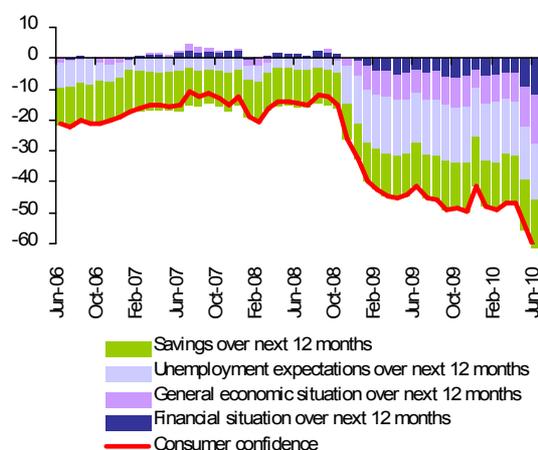


Figure 1. The degree of confidence of the consumers and of the business environment concerning economic perspectives

Romania's perspectives of economic growth for 2010 remain on the negative side[1], as a consequence of a low domestic demand, but also because of the fact that Romanian exports grow at a slow pace. Therefore, there are great risks for the exchange rate to devaluate as a consequence of the inflation and the persistence of uncertainties in economy.

3. THE CRISIS' SPREAD THROUGHOUT THE BANKING SYSTEM

The banking system determined the propagation of the crisis from abroad using the following methods:

The high price raising of loans during 2004-2007, mainly towards the population, from want of boosting domestic production emphasized the economy's extreme vulnerability, by augmenting the external debt. The main reasons of this phenomenon are:

- the positive expectations of the loan institutions regarding the evolution of the economy against the background of Romania's Treaty of Accession to the European Union (EU) and the improvement of the country risk rating at the "investment grade".
- the dismissals of the Romanian workers from abroad increased four times during 2005-2008 (20,8 billion Euros) by comparison to 2001-2004 (5,1 billion Euros)
- the received net funds from the European Union encountered a noticeable increase a year after acceding, evolution which, however, stopped to grow.

The excessive debt, mainly of the population's, contributed among other factors, to the advent of the subprime crisis.

The most holy principle that the classic banking system is following –"deposits make loans"- was not succeeded anymore in Romania. From the money deposits of approximately 35 billion Euros, the Romanian banking system gave loans of 42 billion Euros. The difference stands in loans given from money coming from abroad. This turned out to be a high vulnerability which created alterations in economy. The loans given way over the productive possibilities of the economy represents the main deficit source of the external current account, one of the worst issues of Romania. Due to the fact that domestic production could not keep up with the speed of giving loans, everything focused on imported consumption. All these overlap with the fact that foreign investments, from which it was expected a production growth, were not interested in production, but in service lines (retail, finance, real estate) which amplified the tendency.

The trade and external current account deficit represents the surface of the things. On a deeper level, we can talk about an induced economic growth, which is unhealthy and unsustainable, because is wrongly based on imported consumption.

The once abundant financial resources are getting more and more rare and expensive because Romania has a relatively high risk rate. The banks, after October 2008, because of the lack

of the liquidities on the money market, offered a very high interest rate (by comparison to the interest rate of monetary policy) to domestic economies, therefore the price of loans increased emphasizing the crisis.

4. THE CONSEQUENCES OF THE SUBPRIME CRISIS – AUSTERITY MEASURES

The economic situation presented above shows an economy in recession. The main risk is the increase of the budget deficit to 9-10% from the GDP, an unacceptable and nonfinanceable level.

A high deficit determines investors to have an antipathy towards the countries with a high budget deficit and do not take measures to improve the situation. Controlling the budget deficit is a condition of the agreement made with the International Monetary Fund and the European Commission (deficit shown by the 6.8% of the GDP in 2010 and 4.4% of the GDP in 2011).

That is why the following measures have been adopted in order to correct the deficit:

- the drop-off of budget salaries with 25%;
- the increase of VAT from 19% to 24%
- the decrease of social transfers with 15% (the cut-off of pensions was considerate unconstitutional)
- the taxation of incomes from interests with 16% (0% before)
- the taxation of meal vouchers with 16% (0% before)
- the taxation of capital gain for the bonds owned for more than a year with 16% (1% before)
- the cutting down of expenses of goods and services in the public administration and companies belonging to the state with 20% (except for the basic expenses, like the ones in the health department)
- the cutting down the government's employees as well as government agencies with 25%
- the cutting down of the total number of the all public administration employees.

The direct consequences of these measures over the economic life are:

The cutting down of the population's net income as a consequence of the public administration's salaries drop off with 25%, more taxes (incomes based on interest, meal vouchers) and the cutting down of tax deduction of some expenses for certain income categories (copyright)

- the increase of inflation and of population's consumption expenses as a consequence of VAT.
- the cutting down of firm's profits that trade goods with a elastic demand at price and which will not be able to transfer the total growth of VAT to the consumers
- the deterioration of the trust of firms and population considering the raise of uncertainties regarding the financial and economic situation on a short-term
- the decreasing of economic activity as a consequence of the consumption demand decrease
- the increase of unemployment in the private field too because of the increase of pressure on charges in the real sector.

5. THE EFFECTS OF THE AUSTERITY MEASURES OVER THE BANKING SYSTEM

All these measures have a powerful direct and indirect effect on the Romanian banks.

A great part of the characteristics of the banking system until 2008, are no longer applicable nowadays. Mainly, there have been affected the profit and the growth rhythm of the nongovernmental loan bulk.

For the banking system the effects of economic crisis are the following:

- The increase of interests on the monetary market and pressures of devaluation of the exchange rate as a consequence of the inflation increase and the persistence of economic uncertainties
- The loans have reduced dramatically, the growth pace and the amount of individual loans has diminished the most.

Table no. 1. The evolution of nongovernmental loan between 2006-2009

Explanations	2006	2007	2008	2009
Annual percentage variation	47,3	50,5	25,7	-3,6

The year 2009 was denoted by the calming of the banking activity, evolution which reflected itself in the increase with only 5,0 % of the net assets at a system level, from 314 441,5 million lei to 31.12.2008 to 330 183,5 million lei to 31.12.2009. In Euros, the net asset has been easily reduced (with 1,0%), from 78.902,3 million Euros to 78 090,8 million Euros.[2]

- The increase of the loan expense is a consequence of more factors:
 - The growth of Romania's country risk, determined by the drop off of the economic activities and by the lack of precise plan to overcome the crisis, substituted with a long number of proposals and political/fiscal measures that have a doubtful efficiency, is generating the foreign investors disbelief in the yield of their initiatives in Romania.
 - A certain lack of productivity of the Romanian banking system;
 - The rush for "no matter what it takes" profit of the shareholders;
- The amount of governmental loan started to grow again [3], its assets share increasing with another 4.2% by comparison to the year 2009 reaching 12.2 % of the total assets [4]. As a consequence of the more and more visible budget deficit, the banks preferred to loan the state, therefore the risk of loan was reduced but the resources for loaning the real economy diminished.
- The amount of bad loans has increased from 0.14% in 2006 to 1.39% in the first trimester of 2010. Although they produced noticeable effects on a short-term, the cautious measures have lost their efficiency over the time. The quality of bank assets suffered deteriorations, the credit risk remaining the major vulnerability of the banking system. The increase of the amount of bad loans has as a cause the cutting down of net incomes of the population and of the firms that cannot refund the payable debts.

Table no. 2. The evolution of bad loans during 2006-2010

Explanations	2006	2007	2008	2009	2010*
Provisions (billion lei)	1,3	3,6	7,6	15,0	16,9
The weight of bad and doubtful measured in terms of total assets (%)	0,14	0,17	0,29	1,01	1,39

* 31 of March 2010

- There has been an increase in the provisions need with an effect on profit and banking gains, the net spending with provisions increased in real terms with 65% in 2008, taking into consideration the deterioration of credit portfolio, as a consequence of successive increases of loan interests and the devaluation of the national currency. The year 2009 was also denoted by the increase of provisions in the entire banking system. The reports published by the National Bank of Romania show the fact that money set aside for the bad loans for a period longer than 61 days have increased with 130% during the last year, reaching almost 30 billion lei. From an individual point of view, some credit institutions had their share of increases, sometimes even four times the bad loans.
- The increase of interest rates for the term deposits as an effect of the lack of liquidities from the first part of the year 2008 determined the saving growth. By comparison to September, at the end of December 2008 the medium rates of the interests at the population's remaining deposits have increased with 2.3%, and the new deposits grew with 4.1% (with 3.9% and 4% when it comes to nonfinancial companies)

Table no. 3. The evolution of the saving rate and the investment rate (% in GDP)[5]

Explanations	2006	2007	2008	2009
Saving rate	14,4	17,1	18,8	19,1
Investment rate	25,6	30,2	33,3	25,6
RE-RI	-11,2	-13,1	-14,5	-6,5
Current account balance	-10,4	-13,4	-11,8	-4,4
Fiscal deficit	-2,2	-2,5	-5,5	-7,9

• In the year 2009, the profit of the entire banking system was of only 200 million Euros, being affected by the formed provisions. Many of the credit institutions have ended the year with losses due to these expenses made for provisions.

The financial results of the banking system were positives, however modest along the year 2009. In the first months of the year, the increase of spending with the specific risk provisions had an important impact over the profit of the credit institutions, however many of them managing to recover in the second semester.

The first half of the year 2010 marked the negative course of the profit, due to necessary increase with the spending for provisions. [6].

• The development pace determined by the increase of the number of banking institutions not only slowed down but we witness the bankruptcy of some which turned out to be unprofitable. 265 of shut down unities represents the outcome of the banking system's adaptation to the decline of the credit market in the year 2009.[7]

• As a consequence of this fact the number of bank employees diminished with 2.068 persons in the year 2009.[8]

• And in the first three months of this year 84 unities have been closed and over 500 employees left the banking system.[9]

6. MEASURES INITIATED BY NBR IN ORDER TO DIMINISH THE IMPACT OF THE FINANCIAL CRISIS

The main measures initiated by the National Bank of Romania in order to limit and diminish the effects of the crisis over the banking system were:

- It was settled that it was needed the appeal to external financing from international financial institutions
- The resulting „Vienna Initiative” - In a meeting in Vienna of the European Bank Coordination Initiative the parent banks of the nine largest foreign banks active in Romania(70% of the active banking) settled to maintain during the IFM programme (May 2009-May 2010) their commitments to Romania, which was respected
- The drop off of monetary policy interest from 10.25% (July 2009) to 6.25 % (May 2010)
- Cutting down of the minimum reserve requirements rates:
 - from 40% to 25% for the resources in foreign currency, in three stages, each of 0,5 % (July, August and November 2009)
 - from 18% to 15% for the resources in national currency (July 2009)
- Flexibility measures for loaning households (January, July 2009)
- The convergence of the conditions for provisions towards the International Standards of Financial Report (the cut of the amount of provisions with 25% to the loans with overdue of over 91 days, April 2009)
- In 2008, demands to improve the quality of risk management have been introduced:
 - the imposition of using tax file in the process of income validations (August 2008)
 - determining the maximum grade of debt on client categories based on the analysis of stress testing (August 2008)

- establishing the initial reimbursement graph considering the grade of maximum debt on the entire maturity of the loan in which it is situated (August 2008)
- the introduction of some stricter requirements of provisions for the foreign currency loans given to clients exposed to the currency risk (February 2008)
- the potential systemic risk associated to the foreign currency loans that are being under bank authority surveillance and also under central banks from states that are EU members and also under European Central Bank (ECB) surveillance was discussed and analyzed with the commercial banks. The level of debt in foreign currency represents a permanent care for the authorities, from a prudent management point of view and also from the perspective of preventing, using the right settlement coordinated by the EU in order to revive the increase of foreign currency loans, and not the national currency one, especially the unprotected debtors facing the currency risk. In this matter, ECB brought into discussion a series of pieces of advice regarding the prudent policy in order to maintain the foreign currency loans in limits that do not induce a high risk to the financial markets, including by sustaining the concept of responsible loan, as it follows:
 - implementing some eligibility criteria for debtors
 - implementing restrictions regarding the level of debt
 - the limitation of the maximum sum of the loan given at the value of the property which is to be purchased (LTV),
 - the settlement of a adequate level of awareness for the debtor to take to knowledge of the risk they take by purchasing a foreign currency loan
- better treatment for the rescheduled loans (September 2009),
- the improvement of the structure and of the own funds level, by taking into account the interim profit (September 2009)
- the reinforcement of the corporate governance rules by adopting in September 2009 the new laws in the corporate management field of the credit institutions:
 - principles regarding the best practices in the pay field
 - the regulation of the conformity function inside the internal control mechanisms
 - principles for evaluating the unsettled risks (concentration risk, the interest risk outside the trade portfolio, liquidity risk)
 - requests regarding the introduction of crisis simulations in the process of risk
 - the adequate accountability of the shareholding of the credit institutions by giving more power to NBR, starting with March 2009, in the process of resolving the situation of the credit institutions that are having difficulties
 - the possibility of soliciting from the important shareholder from a credit institutions that is being in difficulty, to supply for it the necessary financial support
 - the possibility of forbidding or limiting the distribution of profit of the credit institutions with difficulties until its financial situations has been resolved.

7. WHAT TO EXPECT

Short-term prospects of the banking system in Romania depend largely on rebuilding the trust in the economy, on sustainable recovery of economic growth, and also on the international developments.

It is noted as a pro-cyclical tightening of lending standards, in conjunction with increased international reserves and the trend of reduction in this period of bank intermediation, and some signs of recovery in lending, particularly non-financial firms of important dimensions, and less in the real estate loans for individuals. The new economic environment less favorable is increasing the pressure for restructuring as for each bank, but also for the entire banking system. There is already the problem of restructuring the banking branch network by closing unprofitable ones.

The banking industry being a business that relies heavily on trust, it appears that banks refrain from violent gestures to reduce the number of establishments and employees for not giving signals to the risky market.

The pressures for a better cost control are increasing staff costs are important, banks have initiated measures to control costs by scaling both the branch network and through non-partisanship, or dismissal of employees. Considering the crisis, there will be an increased number of cases of theft, fraud and money laundering. [10]

Nowadays (and also in the future) investments will be selected very carefully, but also ***delaying and reducing investment programs will happen.***

Perhaps the market consolidation process will be at one point through mergers and acquisitions, because it is clear that for a market that no longer increases the number of banks is too high.

It is therefore a favorable period of mergers and consolidation of the banking system, most experts expecting such a step.

The main short-term measures to improve the financial situation have been the increasing of interest margins on national and foreign currency, sale of fixed assets and purchase of government bonds. These measures are unusual but necessary because the situations in the first quarter of 2010 have recorded falls in income from fees, leaving banks to rely on earnings from interest margins. In the current global crisis, sophisticated methods of bank risk management, promoted by Basel II, have shown their limits. Basel III is preparing to rebuild the entire regulatory and supervisory framework for banking activity, with emphasis on early warning component of the risk of escalation.

In this way regulatory risk will increase, an example being Ordinance 50/2010 which created tensions between banks and customers, with repercussions that cannot be calculated at this time.

Loans and mortgages were granted, in general, with real-estate collateral guarantees and the price of this guarantees decreased ***At this time banks record losses from enforcement of these guarantees.***

Therefore the banks' large exposure to mortgage loans on real estate prices fall conditions strongly affected the profitability of current and future lending volume.

8. CONCLUSION

Despite claims, the banking industry in Romania is not the only one (and not the most) responsible for the economic crisis we are going through.

No doubt there are mistakes that banks should not repeat in the future, but responsibility of the precarious economic situation is shared between different industries (which knew how to manage the consumption and grew because of it), politicians (who encouraged savings and less credit), supervisory/regulatory institutions (which didn't have effective tools to correct trends), and the mass of consumers / customers which are ***synchronized to be all optimistic before crisis and pessimistic now.***

You can hardly see in the Romanian bank system, the effects of the subprime crisis, because banks refrain from taking drastic measures not to give signals of risk in the market.

Not even available data from the banking system can't show us the true extent of the crisis faced by the banks because they are not transparent.

Nonperforming is a taboo subject for many bankers. ***Of the 42 credit institutions present in our country outstanding credit data can be found at only a quarter of institutions.*** We are unable to compare data from different banks. For example, some institutions show debts greater than 90 days ***others on those late payments over 60 days.***

Released data by National Bank of Romania represents most of the time average results which can hide serious situations of underperforming in some big banks for the banking system.

All this leads us to the conclusion that the Romanian banking system is in crisis.

Because of this even the economic recovery is threatened, as loaning can provide an important impulse for boosting economic life.

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