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The Romanian banking sector restructuring and the economic recovery

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Abstract. *The Romanian economy is highly dependent on the financing coming from the banking sector. The total net assets of the banking system accounted for approx. 60% of the GDP in 2013. The increasingly integrated financial markets have facilitated the foreign capital inflows and the expansion of the Romanian banking system on the one hand, but on the other hand, it determined the transfer of the negative effects of the economic crisis on the domestic banking sector. Currently, the resumption of lending to companies and households along with a more balanced distribution on currencies of the new loans represents one of the main challenges of the banking sector in Romania. This article aims to analyze some of the changes in progress and the ones that already occurred after the economic and financial crisis in the Romanian banking system, and their impact on the recovery process.*

Keywords: banking sector, regulations, economic growth, lending.

JEL Classification: G21, G28.

1. Introduction

The restructuring of a system can be generated both by internal or external factors. The internal restructuring has a proactive nature designed to improve continuously the operating model of the system concerned while, the extern determined restructuring represents in general the systems' adjustment reaction to the action of external factors. The current restructuring of the banking system was caused by the economic crisis and it consists in a process of readjustment to the new market conditions. The post-crisis economy characterized by low growth rates, uncertainty and instability, the pressure for regulation, redefines the conditions under which the banking industry must act in the future (Ernst & Young, 2013).

The imbalances faced by the banking sector during the crisis have determined many banks to rely on state aid. The aid received from national governments came accompanied by a number of conditions and restrictions which eventually forced system restructuring. The contraction of the economic activity has led to a restriction of the loan applications. At the same time, banks were becoming more cautious in granting the loans, setting in this regard severe eligibility criteria for economic agents. Naturally, the number of banking units and personnel employed in this sector was reduced. In Romania, according to the National Bank of Romania (NBR), the number of units was reduced by approximately 1.000 from 2008 to mid-2014 while the number of employees was reduced by more than 10.000 during the same period.

At the same time there is a pressure in the banking sector to improve returns. In this respect it is expected for the banks to shift towards activities that generate economies of scale and to give up activities with a low profit margin or to those activities with a reduced growth rate such as clearing and securities servicing. This type of basic services can be instead outsourced; some banks such as ING already did that in Bulgaria, Romania, Czech Republic, Hungary, Slovakia, Ukraine and Russia (Beitel et al., 2013).

The regulatory process to which the European banking system has been subjected involves also, the strengthening of the capital base which is quite difficult to achieve given the market rigidities and the consumers lack of confidence in the banking system. The interconnections between the banks in the European Union (EU), severely affected by the crisis, and the ones in Romania have turned the domestic banking sector into a less efficient one, forcing the authorities to implement various measures such as the cleansing of balance sheets of non-performing loans.

The structure of the Romanian banking sector reveals the presence of 40 banks. Foreign banks continue to dominate the domestic market. Of the 40 banks present in Romania, 24 have foreign shareholders, 2 are fully or partially owned by the state, 9 are branches of foreign banks and one is a credit cooperative organization (NBR, 2014, pp. 21-22).

According to the information published by the National Bank of Romania in the Financial Stability Report for 2014, the market share of the banks owned by Romanian shareholders doubled, reaching 19.8% in June 2014 from 9.4% in June 2013. This was primarily due to the reclassification of the ownership of the banks function of the country of origin of the main shareholder. Thus, in the first half of 2014, the first positions in the ranking of the banks based on the market share were held by banks with Austrian, Romanian and French ownership.

The difficulties faced by the banking system have also affected the prospects of economic recovery. According to the National Institute of Statistics (NIS), the gross domestic product (GDP) declined in quarter 2 of 2014 by 0.3% compared to the first quarter, and increased by 0,5% in the first quarter of 2014 compared to quarter 4 of 2013. Also, in quarter 3 of 2014 Romania has registered an increase of the GDP by 1.9% compared to the previous quarter.

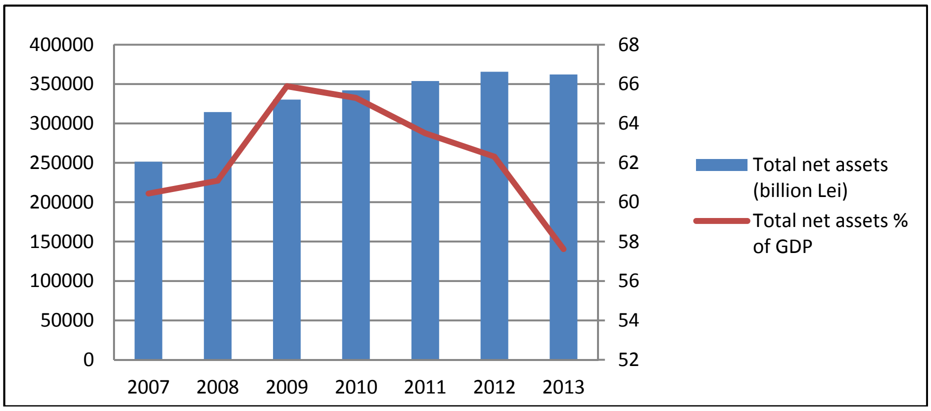
2. Banking sector – influences on the economy

Banks play a central role in the economy; this fact is obvious, especially in Europe where the economy is highly dependent on the funding coming from the banks. However, such model can also have some negative consequences as difficulties in the banking system prevent banks to fulfill their role of main financier, which can condemn an economy to years of anemic economic growth in the absence of other sources of funding. The development and the awarding of a greater role to the stock exchange in financing the economic activity could represent an alternative in this regard. The analysis carried out by Nowbutsing and Odit in 2009 has shown that the development of the stock exchange has a positive effect on economic growth in countries where the stock exchange plays an active role and it is highly liquid.

Regarding the size of the European banking sector, the total assets of the European banks to GDP exceeded three times the value of the GDP in 2013, according to the calculations made based on the OECD and Eurostat data. With such resources, the banking system has established the premises to perform its functions, especially those of financing the real economy.

Although still relatively small in size compared to other European countries, the Romanian banking sector contributes significantly to the financing of the economic activity. Calculated as total net assets the Romanian banking sector has reached 57% of the GDP in 2013, decreasing, as compared to the previous years (see Figure 1).

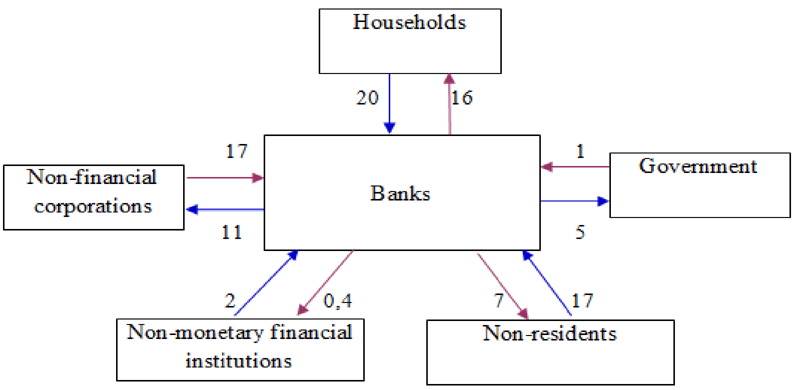
Figure 1. *The evolution of the banking sector size between 2007 and 2013*



Source: NBR, IMF - World Economic Outlook Database October, 2014.

The significant role of the Romanian banking sector in the economy may also be examined by analyzing the flows between institutional sectors – households, government, non-financial corporations, non-monetary financial institutions, non-residents and banks. As Figure 2 indicates, most of the funds available to the banks come from households, namely 20% of GDP, followed by the contribution of the non-residents 17%. With respect to the destination of such funds, the majority is directed towards funding non-financial corporations, namely 17%. Therefore, firms have the highest dependence on the financing coming from the banks, in Romania. In this context, the revival of lending represents a primary need for firms, in particular, and for the economic recovery, in general.

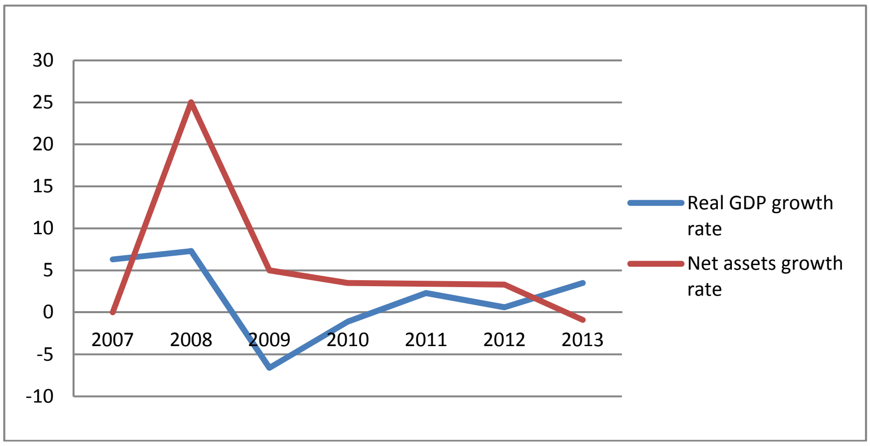
Figure 2. *The structure of loans/deposits by institutional sectors 31 December 2013 (% of GDP)*



Note: The red arrows indicate the amount of loans as a percentage of GDP and blue arrows indicate the value of deposits as a percentage of GDP.
Source: NBR, own calculations.

The banking sector has gone through a comprehensive process of development, growing at an even faster pace than the economy. Figure 3 shows the net assets growth rate of the banking sector as compared to the GDP growth rate. It can be noticed that the volume of assets increased at a faster rate than the GDP between 2008 and 2012. The net assets as well as the GDP recorded the highest growth rate in 2008, namely 25% and 7.3%. The extension of the banking sector in a faster pace than the business it is associated with the risks taken by the banks. For example, in 2009 the total assets of the Irish banking sector grew at a rate nine times higher than the growth rate of nominal GDP, not long after that, the country had to resort to international financial aid to avoid bankruptcy. The same situation was recorded in Iceland as well, the assets growth rate being only two percentage points lower than in Ireland, but still higher than the GDP growth rate. Not merely accidental failures rate was more pronounced in these countries. The risks assumed by the banks leading eventually to their bankruptcy. In countries where the assets growth rate was more moderate, although higher than the GDP growth rate, the consequences were less dramatic. It is the case of Australia, where the banking sector assets increased at a rate twice that of GDP, but significantly lower than those recorded in the European countries. During the crisis, the Australian banking system proved to be more solid (Edey, 2013).

Figure 3. *The evolution of the net assets growth rate and of the real GDP*



Note: The data for the calculation of the 2007 growth rate for the net assets are not available.
Source: NBR, Eurostat, own calculations.

The economic crisis has highlighted the need to review the European banking sector regulatory framework. Subsequent measures such as the increase of the capital base, risk mitigation and the cleansing of the balance sheets may nevertheless have different implications in emerging countries where the banking sector is not as developed. In Romania the deleveraging process represents one of the main problems. The withdrawal of the foreign banks funds in order to meet the new capital requirements in countries where the mother-banks are located, can lead to a decrease of the loans granted in the place where their branches are located, which stifles economic growth.

In Romania the economic crisis had a negative impact on both the net asset and the GDP. The effects were felt immediately in both the banking sector and the economy; the economic downturn coincided with a tightening of lending. Six years after the economic crisis the banking sector still shows signs of weakness. In 2013 the growth rate of the total net assets was negative. However, economic activity showed some signs of recovery; in 2013 GDP growth rate reached 3.5%, being the second in the EU member states. According to the NIS the economic growth was based mainly on the contribution of the industry and agriculture.

In 2014 growth will be most likely a relatively modest one followed by a slight increase in the upcoming years. European Commission forecasts, revised downwards in the autumn report, estimate an increase by 2% for the Romanian economy in 2014, 2.4% in 2015 and 2.8% in 2016. The increase forecasted by the Commission is based on fiscal and monetary policy measures taken to stimulate growth. Thus, the fiscal policy pursued has allowed to decrease the social security contributions and to eliminate the tax on reinvested profit aiming to supplement the resources held by firms and to stimulate investments. These along with the measures aiming to stimulate lending, such as the reduction of the interest rates and of the minimum reserves is expected to support economic growth in Romania. The quantification of the effects of the two fiscal measures must be done cautiously because accompanied by other taxes, such as the taxes on special constructions the effects on growth could prove extremely modest.

The analysis of the interferences between the banking sector and the economy underlines the significant role of the banks in financing the economy in Romania. The risks assumed by this sector in the context of "rational exuberance" have led the banking sector towards a poorer performance. The suggestion favored by most of the economists is that the banks should revert immediately to their primary mission, of extending credit facilities to support the economic development, through the efficient use of financial resources that are attracted from the Romanian market (Dănilă, 2010).

Banks in their role of intermediaries mobilize funds from depositors to borrowers in order to finance the economic activity. The importance of the banking system differs from case to case. In countries where the funding comes from other sources as well, the contribution of the banking sector to economic growth may be more reduced, for example, in the United States where the economy is partially financed through stock exchange. Even so, financing the economic activities through stock exchange has certain limitations especially for smaller enterprises. Consequently, although in certain circumstances the funds from the banks have alternatives, the banking system as a whole has no genuine substituents.

In a study regarding the relationship between economic growth and lending for the Central and Eastern European (CEE) countries it is shown that an increase of one percent of the flow of credit (relative to GDP), causes an increase of about 0.32 percent in the economic activity (Moinescu and Codirlaşu, 2011). In the same study it is also shown that the banking sector interacts with the real economy through the credit accelerator mechanism, the analysis shows that the credit flow change explains between 30 and 70 percent of business development in CEE.

3. Banking regulations

The counter-cyclical policy practiced by the NBR has protected the Romanian banking system. At the onset of the financial crisis most of the banks were well capitalized and were not exposed to the toxic assets to the extent that the banking institutions within the other European countries were.

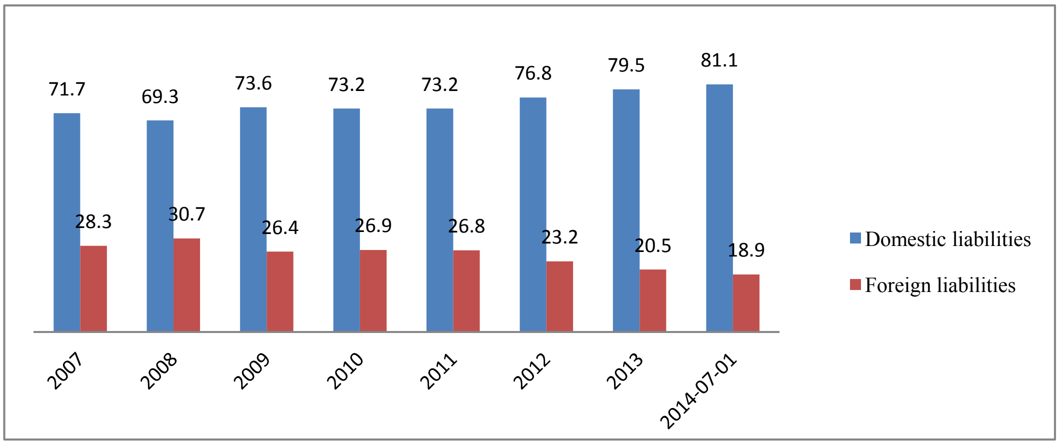
The economic crisis has restarted the process of consolidation of the European institutional framework by focusing on a profound reform of regulation and supervision of the European financial system. The establishment of a Banking Union is one of the most ambitious European projects in this sector. The establishment of this institution completes the Economic and Monetary Union preparing a uniform regulatory framework for the Member States, which allows the reduction of the uncertainties within the economy. The new regulatory framework will also ensure that all EU savers are guaranteed that their deposits up to 100.000 euro are protected at all times and everywhere in the EU. Since November 2014 the European Central Bank (ECB), as part of the Single Supervisory Mechanism, will supervise the 6.000 banks in the euro area. If the collapse some banks will be inevitable despite the careful supervision of the ECB, the Single Resolution Mechanism adopted, will allow a faster and an efficient action of the authorities in order to support the banks in question (European Commission, 2014, p. 2).

The accession of Romania to the new framework of economic governance is expected to be achieved before the adoption of the euro. The substantiation of this approach takes into account mainly the high presence of the Euro zone capital in the structure of the credit institutions registered under the Romanian law (Georgescu, 2014).

The accession to the Banking Union could contribute significantly to restoring consumers and foreign investors' confidence in the banking system, given the fact that the banking system would be supervised by the ECB. The access to information for the entire European banking sector could enable a faster identification of the system deficiencies and the correction of those deficiencies in due time. Although a possible accession of Romania to the Banking Union offers some solutions regarding the costs generated by the financial imbalances, it does not solve all the problems faced by the bank on the market such as, those related to bad loans. To this end, and in order to meet the new legislative requirements enforced, the Romanian banking sector has embarked on a comprehensive process of recalibration, aiming to strengthen the system. Given the existing imbalances in the EU and the problems faced by the banks within the Member States, the banking institutions in Romania turned to attracting funding from domestic sources, initiative also supported by the NBR.

As the information presented in Figure 4 indicate, from the beginning of the crisis the share of foreign liabilities in the balance sheet decreased by approximately 10 percentages. That mainly reflects the restrictions on the credit lines extended by parent banks to their branches in Romania.

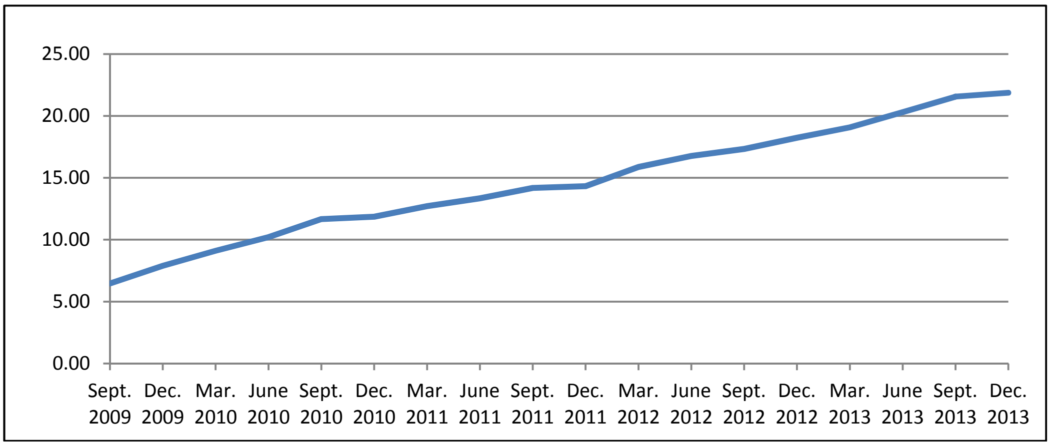
Figure 4. *Banking liabilities structure*



Source: NBR.

Another action taken in the banking system restructuring process envisaged the non-performing loans problem, based on the recommendations of the European Banking Authority (EBA) as part of the European System of Financial Supervision. The EBA objectives consider maintaining financial stability in the EU and ensuring the integrity, efficiency and orderly functioning of the banking sector. To this end, the NBR is empowered to conduct an assessment of banks loan portfolios, risk classification and provisioning, in order to ensure the availability of adequate levels of capital and reserves (EBA, 2013, p. 3). The application of the EU previsions regarding the quality assets evaluation and the cleansing of balance sheets puts pressure on the banks form Romania, which have recorded a steadily increasing level of non-performing loans (see Figure 5). Beginning with September 2013 the growth rate of non-performing loans slowed and it is anticipated that it would stagnate further. The process of cleansing the balance sheets of loans with delays in payments exceeding 90 days will be achieved mainly by selling these portfolios of bad loans. According to the NBR the banks in Romania still have certain reluctance in selling non-performing loans portfolios due to the low market prices, the uncertainties concerning the fiscal treatment and the right to the debtor at the time of the credit sale.

Figure 5. *The evolution of the non-performing loan rate (%)*



Source: NBR.

In terms of the distribution of credits on coins, in 2013 the largest number of non-performing loans was recorded to the loans in foreign currency. The monetary policy applied by the authorities encouraged the granting of loans in national currency to avoid shocks from exchange rate fluctuations. Thus, from the beginning of the crisis to present day the NBR has reduced the interest rate form 10,25% to 2,75%, and the reserve ratio to 10% for liabilities in national currency and 14% to liabilities in foreign currency.

Also, in order to control to some extent the increase in the burden of the loans in foreign currency, it was initiated a draft law for the Government Emergency Ordinance no. 50/2010 on credit agreements for consumers. The main provisions of this legislative initiative provide consumers the right to convert the loan contracted in an alternative currency within certain limits and subject to specific conditions. To this end we can find in section 2, art. 49^1, par. (2) of the Government Emergency Ordinance no. 50/2010 on credit agreements for consumers the following prevision:

"(2) The alternative currency provided in para (1) is the currency in which the consumer receives its income or the assets that finance loan payment, or the currency of the EU Member State in which the consumer has either resided at the time the credit agreement was concluded, either currently residing, or any other currency requested by the consumer".

And in section 2, art. 49^2, par. (2) of the same law it is stipulated:

"(2) The credit institution or non-bank financial institution shall ensure that, if a consumer has a loan in foreign currency, it is warned, on paper or on another durable medium, in cases where the amount total payable by the consumer, which remains to be reimbursed or regular rates vary by more than 20% to the value that would raise if it would be applied the exchange rate registered in the moment that the contract was signed, between the currency in which the contract is made and the national currency."

Granting the right to convert the contracted loan in the currency of the state in which the respective consumer has or has had resided without any proof of gaining incomes within that state is not sufficient and still involves risks assumption.

Allowing the consumer to contract loans in any currency he requests and then convert it into another currency in case of fluctuations higher than 20% could represent an alternative in order to avoid crisis such as the Swiss francs crisis. The absence of a link between the currency in which the loan was made and the currency in which the revenues were obtained has subjected the respective loan to a currency risk which made the loans more expensive during the repayment. Although the NBR has repeatedly issued warnings about these risks, these were mainly ignored or misunderstood by the population.

The draft law in its current form, even if it does not provide a complete protection to the consumer it is, however, reducing significantly the risks assumed.

Analyzing from the perspective of the effects that this draft legislation could have on the banking sector, it should be emphasized that, in the moment that the contract is signed banks transfer the currency risk to the customer and in return they charge a lower interest rate than the one charged for national currency loans, offering simultaneously the possibility of borrowing a higher amount. The draft law in its current form would convert this mutually beneficial exchange in a one-sided beneficial exchange.

4. Conclusions

The economic crisis has focused authorities' attention to the creation of a stable banking sector resilient to shocks. Although banks in Romania were not so badly affected during the crisis, its consequences were felt nationwide. Amid on these imbalances banks have restricted lending which caused a slowdown in economic activity. In this context and considering the relationship between the two variables, bank restructuring a priority for regulators should be made with caution, taking into account local particularities.

In Romania, the restructuring process takes into account the orientation of the banking sector to domestic sources of funding, this approach is found in most European countries. Another course of action in order to restructure the banking sector was the cleansing of the balance sheet and the review of the legal framework so as to avoid the occurrence of shocks due to currency fluctuations.

The NBR efforts directed towards encouraging lending in national currency, such as reducing the interest rate, the reserve ratio and the standing facilities corridor, have influenced lending, however, later than expected.

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