THE CONSOLIDATION OF OWN FUNDS OF CREDIT INSTITUTIONS IN THE CURRENT STAGE OF ECONOMIC-FINANCIAL CRISIS

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1. Introduction

The credit institution's own funds consist of own funds of 1st level and own funds of 2nd level. The own funds of the Romanian subsidiaries of credit institutions from third countries are represented by own funds of 1st level.

The constitutive elements of own funds have to be used any moment and with priority in order to absorb the losses and not to involve the fixed costs and to be made available for this and to be fully paid.

The own funds of 1st level consist of:

a) subscribed and paid capital, except for cumulative preferential shares or if appropriate the endowment capital made available for the Romanian subsidiary by the credit institution from the third state;

b) fully cashed share premiums associated with share capital ;

c) legal, statutory reserves and other reserves and the positively reported result of the previous financial exercises after the distribution of the profit according to the general shareholder`s meeting.

In the calculation of own funds one can also include the interim net profit, registered up to the date of determining the own funds, only if it is checked by the persons responsible with auditing the financial situations of the credit institutions and if in the report carried out after the verification contains the opinion that the interim profit was determined according to the accounting and evaluation principles and rules in force and that this value is net with no predictable bond or dividend up to the date of determination.

According to the rule no. 18 from 14.Dec.2006 regarding own funds of credit institutions and investment companies, the banks, Romanian legal entities should have during the authorization process a minimum initial capital of 37 million RON.

Mortgage banks should have during the authorization process a minimum initial capital of 25 million RON.

Savings and credit banks in the locative field should have during the authorization process a minimum initial capital of 25 million RON.

The electronic money institutions should have during the authorization process a minimum initial capital of 12 million RON.

The Romanian subsidiaries of credit institutions will maintain permanently the initial capital or at least the minimum level settled through the current regulation.

The own funds of 2nd level consist of:

- Basic own funds of 2nd level;
- Additional own funds of 2nd level.

The basic funds of 2nd level consist of:

a) reserves from the re-evaluation of intangible assets, adjusted with associated fiscal obligations predictable on the date of calculating the own funds;
b) other elements which fulfil the conditions;
c) titles for undetermined period and other instruments of the same nature which meet all the requirements.
One can add to these the cumulative preferential shares.

The additional own funds of 2nd level consist of cumulative preferential shares on a determined period and the subordinated loan capital. The total of own funds of 2nd level which can be taken in the calculation of the own funds cannot exceed 100% of the 1st level own funds. NBR can approve at the request of the credit institutions exceeding the above mentioned limit but only in extraordinary situations and for a limited period.

The credit institutions report monthly the level and the structure of the own funds on an individual level according to the current regulation and data registered in bookkeeping and the data calculated outside the accounting field. This report is sent to the National Bank of Romania in 25 days from the end of the month.

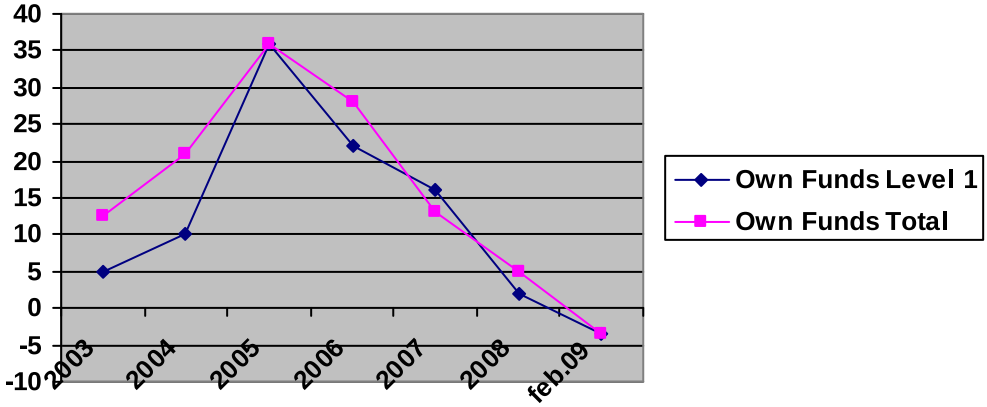
For all the prudential ratios which are determined according to own funds, the credit institutions have to use the level of the own funds calculated for the reporting period of those indicators or for the previous reporting period of those indicators (in the case of different reporting periods).

2. The evolution of the own funds of the banks, Romanian legal entities in the period 2004-2009

Continuing the trends from 2006, both the *own funds* of the banks, legal entities from Romania and their main component – *own funds of 1st level* (Chart no.1) have registered in December 2008 the lowest annual rhythm of growth, in real terms, from the last six years. This situation was determined both by some negative financial results registered by a series of banks which have 10% of the aggregate bank assets (with a direct impact on the level of the own funds of 1st level), and of the modifications from August 2008 in the banking prudence regulations which aim at the elimination of the 1st level own funds from the calculation (and of the total own funds) and of the most volatile element, the result of the current exercise representing profit. Until the mentioned modification comes into force only one part of the banks which registered profit included the respective amount in the eligible reserves due to the requirements imposed by the banking prudence regulations in force consisting of auditing the financial exercise representing profit. In consequence, in 2008 the share capital and the eligible reserves represented the main elements of sustaining the 1st level own funds.

A preoccupying evolution is the decrease of the volume of 1st level own funds in March 2009 for 22 credit institutions (having 39% of the aggregate assets) as a consequence of some negative financial results in the context of a significant growth of the risk provisions for the non-banking customers.

Although the level of decrease is relatively low (1% of the 1st level own funds reported for December 2008), the evolution of the capitalization level of the banks is closely supervised by the central bank. Otherwise, the banking prudence regulations stipulate that the amounts of the elements included in the own funds (respectively the 1st level own funds and the 2nd level own funds) have to be made available for the credit institution in order to be used immediately and unrestricted to cover the risks or losses when these may appear.



Real rhythm of growth of the total own funds and 1st level own funds
Chart no.1.

Due to the modification in the banking prudence regulations from December 2008, the 1st level own funds have fallen by more than 2 percentage points, the contribution to sustaining the total own funds belonging to the banks legal Romanian entities (table no.1) with the corresponding increase of the contribution of 2nd level own funds, especially due to the growth of the volume of subordinated loans contracted by the credit institutions.,

The proportion of the 1st level own funds was relatively constant in December 2009, due to the negative financial results registered by a series of banks. One has to mention that although the share of the 2nd level own funds in the 1st level own funds has increased in 2008 (up to 34%), the potential of growth of this element is high, the credit institutions can resort to secondary capitalization sources in order to develop the banking activity.

In 2008, *the share capital* was the most important element of sustaining the 1st level own funds, its contribution growing up to 66,5%. This situation has also been caused by the elimination of the current financial result representing profit from the calculation of the 1st level own funds as well as by the increase of the share capital. In 2008, out of the total of 32 banks Romanian legal entities, the shareholders of 18 banks increase their shares in the share capital.

There were also registered increases of the share capital of the Central Cooperative Bank Credit Coop and of the endowment capital of two of the 9 subsidiaries of the foreign banks carrying out their activity in Romania which led to a real annual growth of the aggregate social capital of the Romanian capital of 12,6 % in 2008, but under the investment of the same nature between 2005 and 2006. In the first three month of the current year, another two banks have resorted to new capital contributions, leading to an increase of 48% and 63% as compared to the level reported in the end of December 2008. Moreover other two subsidiaries of some foreign banks as well as the Central Cooperative Bank Credit Coop have registered capital increases of the share capital, but with a low volume.

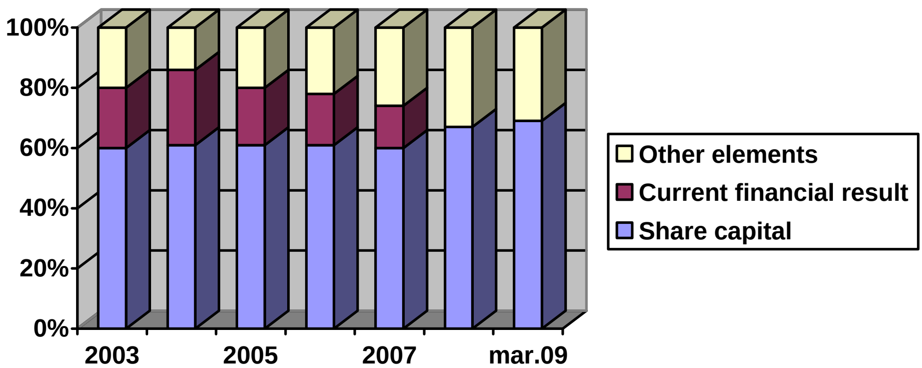
The evolution of the own funds and of the capital adequacy indices

Table.no.1

Indicators	*31.12.2004*	*31.12.2005*	*31.12.2006*	*31.12.2007*	*31.12.2007*	*31.03.2009*
Weight in the total own funds:	100	100	100	100	100	100
1st level own funds	78,1	77,7	74,3	76,7	74,6	74,5
Share capital	49,4	49,2	46,5	46,0	49,7	51,2
Profit/loss Of the current year	17,9	14,0	11,4	10,8	-	-1,7
Subordinated loans	4,8	10,6	14,0	15,8	20,4	21,6
Reserves from revaluation	14,9	10,0	8,8	11,3	10,1	10,1
Solvency report (>8%)	20,6	21,1	18,1	13,8	12,3	12,0

Source: NBR

One must also mention that up to August 2008 the profit of the current exercise was constituted in an important element of sustaining the 1st level own funds (chart no.2). In exchange, the materialization of a negative financial result of many banks in the first three months of the current year had a negative impact on the level of the aggregate own funds.



The structure of the own funds of 1st level 1, Chart no. 2

Subordinated borrowings contracted by banks legal Romanian entities have become the main supporting elements of the 2nd level own funds, representing 20,4% of the total own funds of the banks, legal Romanian entities up to December 2008 and 21,6% in March 2009. Although both in December 2008 and in March 2009 the reserves from the revaluation of the patrimony registered decreases these are still an important element in financing

2nd level own funds (with a 10% contribution).

3. Conclusions on the consolidation of credit institutions own funds under the impact of the economic-financial crisis

The problems regarding the banking system in the multitude of articles and papers on the economic-financial crisis are focused on the lack of trust in banks, in the capacity to be a creditor of the economy on a healthy basis and with sufficient funds.

The current crisis has determined the modification of the public policies towards the financial institutions. These policies were oriented to providing liquidities up to the burst of the financial crisis but afterwards the public interventions were focused more and more on the financial support and providing the own funds for the banks. According to some authors, this change of orientation is a real theoretic and ideological revolution.[1]

The inter-banking markets have a natural capacity of self-regulation which has reduced spontaneously the evolution to normality. The single market is not capable yet to re-balance. In order to facilitate this process the main world banks have taken a series of exceptional measures which in the not too far past would be considered real fallacies:

- extending the maturity of the re-funding facilities;
- extending the range of eligible assets as a counterparty to these operations;
- multiplying the access procedures to the liquidities of the central banks under special circumstances;
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- increasing the international cooperation, etc.

The states intervened massively in order to sustain the solvency and the stability of the banks.

The main forms of intervention in the economy of the large democratic states:

- refunding banks from public funds so that these count finance economy in their turn;
- carrying out some significant reform in the accounting rules; new rules force the banks to transfer the assets registered in the past at the market value to places where it is not possible anymore; at the same time those rules allow for a larger flexibility in the calculation of the ”fair value” of the assets which do not have a market anymore;
- confirming the support of the state in re-capitalizing the banks.

Analysing the events pragmatically, the governments of the highly developed countries have taken financial measures to support the banks which do not necessarily imply nationalization. There were identified two main methods in which the state can support the banks. The first is to guarantee the credits which should not stop banks in granting credits, the guarantee is transformed in a financial expense of the state only when a credit cannot be reimbursed, but this rarely happens as a consequence of the severe mistakes from the near past. The fund assigned for each country for this purpose plays a psychological role.

The second way is for the state to grant loans to those banks which do not have any own funds, for which the banks will pay interest to the state treasury. In France for example, the state treasury registered 30 million Euro interest from banks for the loans granted. According to the positive or negative evolution of the forecasted governmental measures, the partial involvement of the state in the capital of some banks or strategic enterprises is not excluded,

[1] Attali J. (2008), *La crise, et après?,* Paris: Fayard, pag. 145.

having the ability to block the board of directors, but only temporarily.

The central world banks started to collaborate intensively in order to solve the crisis and the difficulties they were confronting with, the commercial banks

Because the Central European banks do not have the necessary resources in foreign currency in order to meet the refunding requirements of the European commercial banks, a series of special agreements were concluded (SWAP) with Fed (CEB, The Bank of England, National Bank of Switzerland, The Bank of Japan, etc.). Such agreements were concluded by CEB in order to allow the Euro (with the national Bank of Hungary, The National Bank of Poland, The National Bank of Switzerland, etc.) as well as by the National Bank of Switzerland in order to supply with Swiss Francs. Similar measures were taken by other central banks while some of them resorted to nonconventional measures.

Fed proved to be extremely innovative in creating some facilities which could allow different financial intermediaries to obtain primary currency, to convert non-liquid titles in government bonds or even to assign directly to the bank bonds for which there are no buyers on the market.

Starting with October 2008 Fed has been buying directly from the financial market short or long term titles issued by enterprises or which include credits grated for the population in order to facilitate the financing of the economy and to reduce the cost of this financing. In the beginning the liquidity injections were meant for the monetary market, facilitating its correct development and adequate distribution of the fund resources during the crisis. Lately these measures have been focused more and more on saving certain financial institutions. So, this is all about a different conduct due to the duration and injection of liquidities.

which were trying to re-finance in American dollars. So on 12 December 2007, Fed, ECB and National Bank of Switzerland created a facility which allowed the short-term refunding (one month) in American dollars.

The effects of the international financial crisis led to kickbacks on the Romanian banking system. This system consists mostly of banks with foreign capital or of subsidiaries of some foreign banks which have direct or indirect accounts in structured products. The mother-banks have sometimes registered important devaluations of the assets; have experienced the impact of liquidity evaporation and the paralysis of certain markets and generally the effect of the growth of re-funding costs. All these aspects have influenced negatively the activity of the subsidiaries from

In spite of these, the Romanian banks are solid and profitable. The main factors which explain this favourable situation are the following:

- the own funds of the Romanian banks, being situated over the minimum levels imposed by the prudential regulations and the European practice;
- the Romanian banking system is still profitable; the profit rate calculated for the entire banking system has been slightly reduced, but it is still high as compared to other countries;
- The Romanian subsidiaries of the foreign banks have important funding lines from the mother-banks; this is a vital advantage under the circumstances when trying to draw deposits from the local population and the ability to increase the capital by issuing and placing shares on the internal market are reduced;
- the Romanian banks do not have ”toxic” assets ;
- NBR had taken along time a series of preventive and administrative measures which imposed a safe conduct to the banks.

The characteristics of the Romanian banking system are a source of trust. Beyond the tensions and the recent allegations to the banks, the banking sector benefits from the effects of the reform he had to undertake in the past years, which enables it to face the turbulences which may be produced.

In Romanian, the answer of the authorities to the side effects of the crisis was different than the one of the authorities from the USA or from the European countries. The explanation is that the Romanian economy is different from the other Western economies which makes impossible to copy the measures taken in those countries.

The main difference is that the Romanian economy is registering a high current account deficit which makes it dependent on the external funding. The Romanian authorities were forced to choose between reducing this deficit or the market`s reduction of this deficit which could have had dramatic consequences on the exchange rate and economic growth.

The Romanian banking system is still well capitalized, but the effects of the international financial crisis have been felt from the last quarter of 2008, and especially on the channel of external liquidity and in the credit portfolio as a consequence of the depreciation of the national currency and of the hold-up of economic growth.

All the credit institutions have registered levels of solvency which are above the minimum established limit. A positive aspect is the hold-up of the tendency of decrease of the solvency indicator, as opposed to the previous years due to the increase of capital from the shareholders of the credit institutions and to the decrease of the rhythm of growth of the non-governmental credit.

From the end of 2008 the Central Bank has strengthened the supervision of the financial and prudential situation of the credit institutions by requesting monthly reports of the solvency indicator for the banks having a solvency level below the average and with negative financial results. Some banking prudence norms have also been modified; these modifications included the own funds and 25% of the warranties of the debtors in the calculation methodology of the provisions for the credits from the category”losses”. The effect of both measures will be the growth of the own funds of credit institutions.

In the end of the first quarter, the solvency of the banking system exceeded 12% but this will not influence the decision of increasing the minimum limit to 10% from September 2009. This demand will require from the banks an augmentation of own funds with almost a billion Euro, of which a third has already been brought in the country.

In the context of the financial international financial crisis a positive factor is represented by the commitment of the mother banks which hold the most important credit institutions in Romania maintaining their accounts in their subsidiaries and trying to re-capitalize them in order to provide a solvency report of at least 10%. The average solvency in the Romanian banking system was at the end of the first quarter of 2009 12,03%, high above the minimum limit of 8% imposed by the National Bank. The Supervision manager of the Central Bank, Nicolae Cinteză is constantly requesting banks to comply with the minimum solvency of 10%. The reason is to provide a safety pad in order to strengthen the capacity of the banks to grant credits.

According to the treaty concluded with the International Monetary Fund, the minimum limit of solvency for the Romanian banks has been raised from 8% to 10% starting with September.

The National Bank was committed to determine the necessary of additional capital for commercial banks on the basis of some stress tests so that they could be sure that the solvency rate of each institution could be maintained above the new level. The risk scenarios were focused on the answer of the credit institutions in the case of four shocks: economic growth, interest in lei, interest in foreign currency and exchange rate.

The stress analysis had been applied to all banks with a market share for assets of more than 1%,a s well as to the smaller credit institutions, selected according to quality, evolution of the not performing loans from the last year and the current rate of solvency.

In these circumstances, NBR calculated an additional necessary of own funds of almost a billion Euro. From this amount, the banks which announced to increase the level of their own funds have brought 200-300 million Euro in the country. This requirement does not burden at all the costs of the Romanian institutions, the necessary funds can be brought here under the form of some loans, and they can also affect the resources of the shareholders.

In the Eastern European landscape the Romanian banking system is not the single one where the banks have to increase their own funds as a consequence of some stress analysis. For example in Hungary the same thing happened and the governor of the central bank showed that the necessary for the beginning of that month was between 700-900 million Euro. On the other hand, in Poland the results announced by the banking institutions for the first quarter showed a solvency above 8% which determined the central bank to give up the announced increase of the minimum limit of solvency of 8%.

The crisis outlined the necessity of re-thinking the fundamental ways of ranging the financial systems. The most discussed aspect is the one of supervision where the deficiencies are considered an important cause of the world financial crisis. In this context some authors even talk about the necessity of a new Bretton Woods, that is of a new, international financial order.

The crisis has demonstrated the advantages of bank supervision by the Central Bank or by a body where the Central bank is strongly represented. This conclusion is adopted by all central banks, irrespective of their regulations. The argument is that the central bank knows very well the banking sector and the other financial institutions and can act very fast when there are turbulences on the monetary and credit market.

The way in which NBR has reacted to alleviate the consequences of the crisis on the Romanian economy demonstrates the need of growth of the powers in order to face a destabilization of the Romanian banking system. Although the Romanian banking system is solid, the recent agreement concluded by the Romanian government with IMF includes the modification of the bank legislation in order to strengthen the power of NBR to request the shareholders of the banks to increase the capital and to limit the distribution of the profits.

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