

BANKING CREDIT MARKET IN ROMANIA: BASEL II IMPACT

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1. Introduction

Within the totalized economy of the new start of millennium, the banks are facing many challenges, especially with the increased competition and the danger of the diminishing of the market quota, context where new action ways are imposed. Thus, the international banking community instituted through the Banking Supervision Committee from Basel, a methodological forum destined to assure the consolidation of the national banking supervision systems and the countries mobilization for cooperation within a unitary banking supervision system world wide.

The present paper wants to approach the deep mutations induced by the Basel II Agreement from the perspective of banking risks management. The focus on the risk management had in 2007 also a positive influence on the quality of the supervision practices of the national Bank of Romania. The place of the traditional approach based upon the checking of the accordance with the valid norms and the stipulations, is step by step taken by the supervision oriented on the risk evaluation and the banks' capacity to appropriately administrate their risks. According to this new approach, the inspection teams verify most of all those activities which have the greatest probability to expose the bank to some important risks, the objective being thus the improvement of the management and internal control deficiencies of the banks before their financial performances deteriorate.

2. New approaches of the banking risk management

The existence both of a robust system of risk management, and of a good capitalization is essential for a bank to operate in a healthy manner and to contribute to the maintenance of the financial system's stability. In this context, the identification of some eventual lacunas in the main banking risks management kept on representing the weight centre of the supervision actions.

2.1. The credit risk

Once the products have diversified and the volume of the crediting activity has increased, the banking system progressed as far as its capacity to administrate and control the credits portfolios, their structure, terms and the size of the credits, in order to prevent and even eliminate the problems before they produce consequences.

Still, on the background of a tight competition for winning and making loyal the clients, a series of banks have registered misfits in administrating the credit risk, generally manifested through:

- deficiencies in the legal constitution of warranties for every credit type, the obligatory insurance of the assets taken in warranty and the cession of the insurance policies in favor of the bank;

- non respect for the conditions that must be fulfilled by the clients in order to obtain credits and the absence of some documents necessary to their approval ;

- the non registration or the delayed registration of the warranties legally constituted in the extra-balance evidence;
- the increase of the volume of the credits taken out of the balance and the low rhythm of their recovery;
- the high weight in the structure of the warranties received by the clients of those with high risk non recoverability degree;
- the wrong determination and reporting of the level of loans representing great exposures, namely the exceeding of the maximally admitted limit for these;
- high concentration degree of credits on a relatively reduced number of clients.

2.2. The operational risk

On the second place in the hierarchy of the potential risks identified on the occasion of the *on site* actions was, as importance, the operational risk. The main noticed aspects have aimed, mainly, problems related to:

- the insufficient personnel or significant personnel fluctuations;
- not respecting the stipulations of the *BNR Norms no.3/2002 regarding the standards of knowing the clients*;
- deficiencies as far as the organization manner of the audit and internal control activity is concerned.
- short-comings of the data processing system;
- non segregation of the personnel's attributions;
- the reporting of some wrong information at CRB, with consequences on the evaluation of the global risk;
- non identification of some operations which through their nature can be included in the category of suspect transactions.

2.3. The reputation and legal risk

The preoccupations of 2007 stood mainly under the sign of the

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transposing and implementation of the European demands regarding the New Capital Agreement, the BNR efforts inscribing themselves in the direction of developing the media necessary to the achievement of an adequate prudential supervision for this new frame. An important contribution to the realization of these objectives was held by the intensification of the cooperation and partnership with the banking community, which actively participates to the Basel II implementation.

In this regard, for the evaluation of the influences of implementing the stipulations of *Directive regarding the capital requirements (2006/48/CE)* on the regulated level of the necessary of the own funds of the credit institutions, the National Bank of Romania and the Romanian Association of the Banks made a study of quantitative impact using the data on September 30th, 2007. Thus, the options of the credit institutions for the application of the Basel II requirements on September 30th, 2007 are the following [Georgescu Florin, 2007]:

a) as far as the *credit risk* is concerned: 31 entities – the standard approach; a standard entity - approach (in case of the exposure for the public sector) and an approach based upon the internal rating models (in case of the exposure towards the sovereign and banks entities);

b) as far as the *operational credit*: 22 entities – the basic approach; 9 entities – the standard approach; an entity – the advanced approach.

All 32 banks which took part to this exercise used the method of the standard approach in determining the capital demand for the *credit risk*. According to the data from the models transmitted by the banks it results a reduction by only 1,52 percentage points of the level of solvability determined through the use of the standard approach - 19,47 per cent – in report to the level determined upon the present regulation frame, 20,99 per cent.

As far as the *operational risk* is concerned, the capital demand for this risk category has been determined by 22 banks by using the basic approach, while 9 banks have used the standard approach. The necessary of capital determined for covering the operational risk contributes to the supplemental diminishing by 1,6 percentage points of the solvability of the banks – from 19,47 per cent to 17,87 per cent. From the analysis of the centralizing data resulted the maintenance of a high volume of the available capital at the level of the banking system, of almost 2,1 times greater than the necessary one, by taking into consideration a minimum level of the solvability from 8 per cent, level which became valid within the Basel II stipulations, starting with January 1st 2007. Also, through its evaluation of the implementation conditions of Basel II at the headquarters of the credit institutions, the supervision authority pursued to keep a permanent contact with these ones, in order to estimate the preparation degree to answer the new prudential demands.

From the boring made by BNR for the identification of the banks' options, it came out that in 2007 banks continued to apply the Basel I stipulations. From 2008, on the compulsoriness of respecting the Basel II stipulations, 32 banks, Romanian legal entities, to which is added the branch of a foreign bank from outside the EU will apply the standard method in determining the credit risk. As far as the operational risk is concerned, most of them (22) will use the basic indicators, followed by those which will count on the standard method (9), while only one bank chose the advanced method.

In the case of advanced approaches, in order to be prepared in the action of validation of the internal models for the credit risk, market risk and operational risk evaluation, that the credit institutions will use in determining the capital demands, the central bank acted in the sense of elaborating some guides based on which this validation is

achieved. According to the decision of BNR's Administration board from November 2006 an interdepartmental work group was constituted which rallied the Supervision Direction, the Financial Stability Direction and the Direction of Regulation and Authorization. At the same time, once our country has adhered to the European Union the National bank of Romania has become a member of the European system of Central Banks, quality it is represented in all its work structures. This presentation supposes the participation to the regulation process at the European Union level which is developed along four work levels.

Among the *main benefits* of this process we find the increase of the adopting speed of decisions through the delegation of technical regulation skills by the specialty committees and the possibility of reaching in time the convergence in the plan of the supervision practices at the level of the competent authorities in the EU. Among the actions taken by BNR [6] to reach the convergence in the plan of the supervision practices of the banking activity are found:

- the adaptation of the reporting systems of the credit institutions at the COREP demands - *Common Reporting* – standardized frame of prudential reporting in the EU – and FINREP - *Financial Reporting* – standardized frame of financial reporting used by the prudential authorities from the EU – through the configuration of the reporting forms and their integration in the electronic system of reporting of BNR;

- the use of the recommendations elaborated by the Committee of the European Banking Supervisors (CEBS);

- the signing of ten bilateral memorandums with supervision institutions from the origin country of the financial groups present on the Romanian market or the flexibility of the exchange of information necessary in achieving an efficient supervision;

– the participation to the information exchange with supervisors from South-East Europe by constructing a regional platform, as a consequence of the dominant role that the subsidiaries of a foreign bank play in the financial intermediary of this region;

– the promotion of a mutual supervision culture through the participation on *twinning* programs, professional training seminars, bilateral meetings between BNR as supervision authority from the host country and those from the country of origin, such as Banca d'Italia, Austrian Financial Market Authority and Austrian National Bank, Hungarian Financial Supervisory Authority and Bank of Greece.

3. The impact of Basel II implementation: new ways of action

The gradual maturing of the banking system led to the increase of the complexity of the bank activity. Passing to the surveillance based on risk was a natural outcome of the consolidation of the process of monitoring the banking sector, focusing on the identification and measurement of the credit risk, the market risk, the operational and reputation risk, risks that at the same time with the reorganization of the banking sector and with the powerful growing evolution of the bank activity and of economy in general did not have a major impact any more on the patrimonial situation and on the image of the credit institutions.

According to the Report of Financial Stability made by BNR, the implementation of Basel II supposes a series of important challenges both for the credit institutions – the adjustment of the risk management and of the information system, the training of the personnel, the obtainment of the data bases, etc – and for the National Bank of Romania – the adaptation of the surveillance process, the elaboration of a new regulation frame, the training of the personnel, etc.

In this context, expected changes will undoubtedly generate profound mutations in the architecture of the Romanian bank market and naturally the compatibility of the national banking system with systems specific to the other countries members of EU (table no. 1):

◆ This way, through the promoted politic, BNR created a sector formed of banks stronger and stronger, able to assure a financial intermediation based on criteria of efficiency, in which the private bank segment becomes preponderant. The raise of the weight of banks with foreign major capital is profitable, consisting of the raise of competition in the banking system, with a possible favorable impact on the installments of the interests to credits, but negative effects can also appear, since, by accessing the external financing or by giving credits in foreign currency, the monetary politic promoted by BNR could be less effective in these segments.

Table no. 1. Structural indicators of the Romanian banking system

	2004	2005	2006	Sep 2007
Banks with state major capital, of which:	2	2	2	2
Banks with private major capital, of which:	30	31	29	39
- with local major capital	7	7	3	6
- with foreign major capital	23	24	26	35
Branches of the foreign banks	7	6	7	9
The banking system as a whole	39	39	38	41
CREDITCOOP	1	1	1	1

Source: National Bank of Romania, presentation of Florin Georgescu (2007).

◆ At the same time, the exposure to risk of the banking system may be distinguished also by the evolution of the main financial indicators

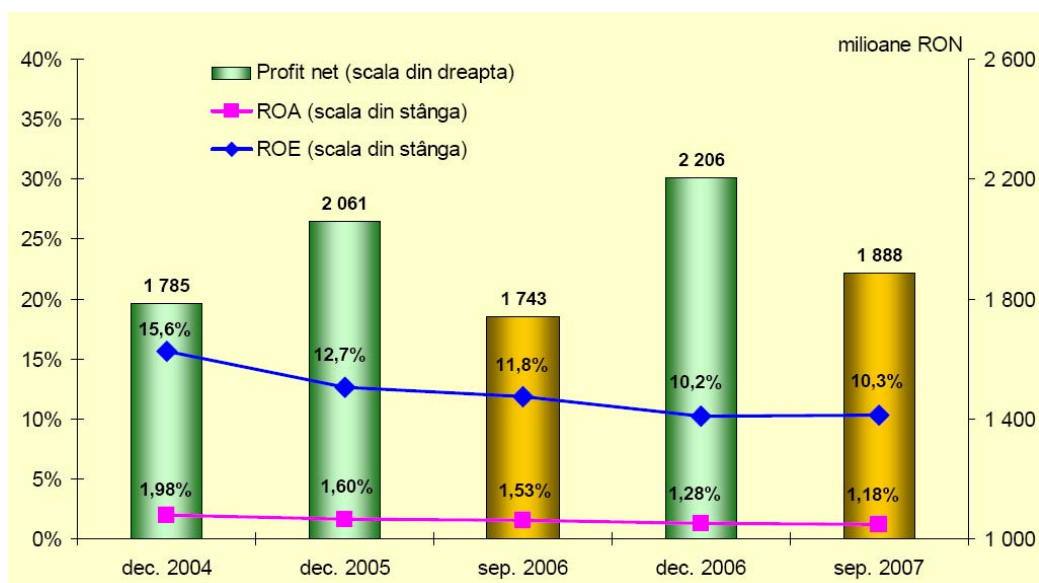
and by the bank prudence, presented in table no. 2 and figure no. 1, which show the following aspects:

Table no. 2. The evolution of the adequacy indicators of the capital

	INDICATORS	12/31/ 2004	12/31/ 2005	12/31/ 2006	12/31/ 2007
1	Solvency report 1 (>12%)	20.55	20.97	17.25	12.70
2	Solvency report 2 (>8%)	-	-	-	-
3	The ratio of the own capital	8.88	9.13	8.26	6.78
4	The general risk ratio	46.83	47.48	52.73	56.97
5	Overdue and doubtful credits / Total credits (Net value)	0.29	0.20	0.18	0.23
6	Overdue and doubtful credits / Total assets (Net value)	0.18	0.12	0.14	0.19
7	Overdue and doubtful credits / Own capitals	2.05	1.35	1.64	2.63
8	The ratio of the credit risk	2.87	2.62	2.82	3.99
9	ROA (Net Profit / Total actives)	1.98	1.6	1.28	1,18 (sep 2007)
10	ROE (Net Profit / Own capitals)	15.6	12.7	10.2	10,3 (sep 2007)

Source: National Bank of Romania, Monthly Bulletin, January 2008.

Figure no. 1. Banking profitability indicators



Source: Georgescu Florin – The Evolution of the Banking System after One Year since the Accession in EU, Bucharest, November 28 2007.

◆ *The substantial improvement of the two profitability indicators ROA and ROE, during the period 2004-2007, the maximum being reached in 2001. In 2004 and 2005 the profitability of the actives was much more reduced than in the previous year, the profit being generated by the existence of an exogenous factor, the ratio of the interest of intervention of BNR. At the same time, the raise of the banks profitability was also stimulated by an aggressive capitalization process which allowed the extension of the business segments (including of those extra balance) and of the treasury products and the supply of modern solutions for the management of the risk for clients;*

◆ *Solvency enjoyed a slight decrease starting with the year 2004, which however does not suppose the damping of crediting, but: the reduced oscillation around the value of 20% may be due to the influence of the BNR norms which determine banks to be more careful in the crediting process of the population;*

◆ *During the period 2004-2007, the indicator „non performant credits reported to the total actives”, is maintained at normal levels, sub-unitary, specific for any banking system;*

◆ *The bank liquidity in Romania is high, (in 2007 it was 2.15) much above the compulsory minimum levels. The sector of the non banking financial institutions (IFN) is under developed, but possesses a considerable raise potential. The systemic risks are low, taking into account the reduced dimensions of the sector.*

◆ *The dynamic of the crediting activity and the quality of credits, the prudence indicators– the high solvency ratio, the manageable level of non performant credits (under 1% of the credits portfolio of banks) – indicate a reduced credit risk at the level of the banking system and its considerable resistance to shocks;*

◆ *The operational risk was permanently in the attention of the banks, being generated especially by the lacks from the informational system, the adverse monitoring of clients, big fluctuations of personnel or the non reporting in entirety of the information regarding the suspect transactions, with possible repercussions on the image of that respective bank;*

◆ *The risk of the interest rate is relatively minor in the conditions in which the short term credits are preponderant, and those for medium and long term are given with a variable interest. At the same time, the rates of the interests practiced by banks constitute financing sources of the rate risk of the interest, in the eventuality of its happening. We consider that the modification of the credits given in favor of those on medium and long term, as well as the reduction of the spread of interest will determine another dimension of this type of risk. According to the forecast of specialists, the most powerful restrain of the spread between interests will happen in 2007 when this indicator will be reduced with 4,5 percentage points due to the mitigation of the crediting activity;*

◆ *The contamination risk on the inter-banking market is insignificant since the placements on the inter-banking market have been oriented to the central bank, and the adjacent risks (currency risk, rate risk of the interest and credit risk) register a reduced level. At the same time, it can be affirmed that the vulnerability of the Romanian banking system at the financial risks was tested with models of the type stress tests, tests that distinguished the stability of the banking system, a corresponding liquidity and an adequate capitalization;*

The gradual improvement of the indicators of bank prudence is the result of the focus of the central bank on the qualitative side of the surveillance and of the sustained economic raise starting with 2000. Their positive trends were also supported by the raise of the

capitalization level of the banking system and of consolidation of the position of the banks with foreign capital in the structure of the bank sector, although the profitability of the actives in 2004, 2005, 2006 and 2007 was much more reduced than in the previous year (see table no. 2), the profit being generated by the existence of an exogenous factor – the rate of the intervention interest of BNR.

In this context, regarding the study made by BNR regarding the **stage of the implementation of the Basel II Agreement in Romania**, in September 2007 it is shown that as for the *adaptation of the data-processing systems* to the new requirements imposed by Basel II, half of the total number of the credit institutions dispose of: a set of policies, procedures and processes of control and diminishing of the risk; IT system of modernisation and reporting of the risk exposure; data recovery plan in case of disaster, adapted to the new requirements. At the same, a quarter of the total number of the credit institutions tested the data-processing applications and analyzed the results of the tests made.

Thus, Basel II has a significant impact on the *administration of the information* at the level of each credit institution: registration, processing, reporting, archiving. In order to respond the new requirements, each credit institution must assure, but not limit itself to these conditions:

- The existence of a centralized data base to respond efficiently to the requirements of the management of adequately administrating the risks;
- The structuring of the data base in accordance to the Basel II requirements: classes of exposures, risk degrees and eligible guarantees;
- The existence of a data-processing application for the determination of the capital requirements afferent to each risk;

- The elaboration of policies/procedures for the assurances of the accuracy of the data

- The existence of a data-processing application for the automatic transposition of the information from the data bases in the new reporting forms.

At the same time, the verifications made by BNR pointed out that *for the adaptation of the data-processing systems to the new requirements*, the institutions opted, generally, for one of the following approaches: the acquisition of *new software solutions*; the expansion of the functionality of the available systems (with the support of the firms which furnished the basic soft); the development of new *“in house”* solutions. However, each of these approaches involves *the allocation of important resources* thanks to:

- The expenses for the consultancy, the preparation of the personnel, the project management;

- The important volume of time and work afferent to the actualization of the data bases (in some cases the inventory exposure by exposure) and the reconfiguration of the algorithm of calculation of the capital requirements;

- The reorganization of the entire process (policies, procedures, applications).

In such a vision, the National Bank of Romania, in its quality of architect of the management of the bank activity fixed the following **objectives and action ways** regarding the implementation of the New Agreement:

- the transposition in the primary and secondary legislation of the new prudential requirements;

- the development of the prudential supervising means adequate to the new context;

- the development of the systems of management of the risks at the level of the credit institutions.

The elaborated strategy and the actions taken for its accomplishment, aiming especially at the qualitative

aspects of the surveillance process, should materialize, in our opinion, in at least the following:

- the adaptation to the new realities of the norms concerning the bank authority in order to increase the certainty that the new operators on the market will be stable, that the shareholders and their managerial teams are qualified for their roles, that they have a good reputation and that the structure of the groups in which they will be integrated, will not affect the quality of the surveillance activity, exercised by the central bank;
- the improvement of the corporatist governance of banks, by the improvement of the control on shareholders, of the methods used by the surveillance authority, and not last, of the regulations regarding the fight against the phenomenon of money laundering;
- the harmonization of the regulations regarding the insolvency risk with the provisions of Basel II. Subsequently, the banks will have to be encouraged to develop models of internal rating. At the same time, the central bank will have to prepare the personnel to be able to test the agreed models;
- the evaluation and harmonization with the community exigencies of the regulations regarding the big expositions and the expositions towards the persons found in special relationships with the banks;
- the improvement of the norms regarding the participations of capital, for the purpose of assimilating the experience of the community banks, of the more rigorous statement of the limits applicable to the participations of capital of the banks and of the creation of the juridical frame necessary to their application on a consolidated base;
- the generalization of the surveillance on a consolidated base, so that the premises for the banking evaluation of a group to be created. In this sense, we consider necessary the inclusion in the consolidation sphere not only of the banking groups, but also of the groups formed by other entities, like

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the financial and mixed companies;

- the increase of the independence of the surveillance authority, respectively of the central bank, in order to get close to the levels registered among the community banks;
- the improvement of the bank rating system and early warning - CAAMPL – through the introduction of new criteria, able to assure a greater accuracy of evaluations;
- the remodeling of the surveillance system „on site" through the adaptation of the CAMELS methodology and the movement of the weight center on the administration of risks;
- a better monitoring of the banking market by strengthening discipline. It should not be neglected one of the essential truths of the competition economy, and that is the fact that the market includes mechanisms that could repay performances and sanction the imprudent behavior of banks. Especially because of this, the authorities must strengthen the market discipline through measures that should increase the number of persons who monitor the banks, as well as the stimulants necessary to encourage an adequate behavior. At the same time, they should promote discipline on the market, not as an alternative to surveillance, but as a complement to it.

4. Conclusions

The dynamic domain of the bank risks determines the rapid modification of the procedures, techniques and models used in their efficient administration, underlining at the same time that they cannot eliminate the risk, they can only prevision and attenuate it. From this perspective, regardless of the models used in the supervising process, the monetary authority cannot prevent the bank bankruptcies and an aggressive bank crisis. Its role is to assure the legal frame where the risk is monitored and administrated.

In this context, we consider that

the implementation of the Basel II Agreement supposes a series of important challenges for the Romanian bank system, priority being those from the domain of the management of the information namely:

a) the realization of a convergence in the organization of the information within FINREP-COREP;

b) measures which are to be taken for the finalization of the reporting frame COREP and FINREP in order to assure its full functionality :

- *for the supervising authors:*
the integration of the new forms in the electronic system of BNR; the accounting of the electronic platform of reporting of BNR with the CEBS platform and the completion of the data referring to Romania;

- *for the credit institutions:*
the adapting of the data-processing applications which generate the reportings destined to the supervising authorities, in order to be able to cope with the new requirements.

At the same time, there are necessary more actions regarding the implementation of the methods advanced of the capital requirements for the operational and credit risk: the improvement of the *rating* systems; the assurance of the existence of the data series (internal and external); the development of the internal models; the assurance of the accuracy of the data; *back-testing*; the integration of the systems of control of the risk; the assurance of the conformity to the Pillar II requirements: the perfecting of the methods of internal governance and implementation of the internal process of evaluation of adequacy of the capital.

Thus, the New Capital Agreement grants the credit institutions a much greater flexibility in the administration of the risks. The afferent costs frightened however for a moment the autochthonous banks, being afraid that this thing will affect the profitableness. According to the specialists of the National Bank of Romania, many banks, didn't wish to

apply for 2007 the stipulations of the Basel II Agreement. There are however clear signals from 2008 will pass preponderantly to the standard approach. Some of the autochthonous banks, especially those which belong to the European bank groups, expressed their intention to pass as rapidly as possible to internal models regarding the determination of the capital requirements, fact motivated by the need of the unitary approach of the risks at the level of the entire group they are part of. These evolutions show the fact both the processes of administration of the risks, and also the supervising practices will develop the Basel I stipulations during this year.

We consider that the postponement of the passage to the Basel II is caused by the weak interest manifested at the level of the banks. These hesitated in making the leap to the new regulations because the associated costs will affect the profitableness. Another reason is characterized by an excess of liquidity. The application of the Basel II Agreement would have led in certain situations to the diminishing of the capital requirements. Thus, the banks would have been forced to look for new investments for these resources, in the conditions where they are dealing with such problems with the resources available nowadays.

However, unlike the banks in Romania, Basel II started to be practiced in many countries of the world, including the European Union, at the end of last year. "The migration from Basel I and Basel II represents the most important event in the history of the banking supervision", specified the BNR governor Mugur Isărescu, on the occasion of the 60th edition of the International Banking Summer School.

As a conclusion, the implementation of the Basel II implementation supposes increasing efforts both from the part of the central bank, and also of the credit institutions, which must allocate increased in this

regard. In a certain measure, the demarche is however made easy in Romania by the fact that the entire banking sector is held by powerful banks on the international market, which have already passed this test and, thus, will be

able to facilitate the transition of the subsidiaries to the new capital requirements and in certain cases the mother-banks will be able to furnish even their own internal models of evaluation of the risks.

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