

# **SOME CONSIDERATIONS ON THE GLOBAL FINANCIAL CRISIS AND ITS IMPACT ON THE BANKING SYSTEM IN ROMANIA**

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**Abstract:** : The modern economies under the impact of globalization have created an opportunity for investors to set up the various portfolios of financial assets (stocks, bonds, treasury bills, derivatives and other securities) diverse in terms of the structure, size and scale of the companies where investments have been made and a very diverse geographical area. This diversification has had considerable support from the development of technical instruments of transactions and of information technology, a general trend of market convergence.

**JEL classification: G21, E44**

**Key words: financial crisis, economic crisis, globalization, financial risks, banking system**

## **1. INTRODUCTION**

The internationalization of business and bank loans, the banks seen in terms of business perspective are subject to increased international risks, and when they are involved in processes of acquisition and mergers with other entities, the financial risks have a tendency to aggregation. However, the scope of economic, political, social, financial and wide-ranging phenomena, the problematic of the loan risk is marked by new trends. Thus, if the game rules are followed, banks are a real supplier not only of cash but also of the stability and confidence, while if the rules of the game are not followed, banks are obliged to restrict liquidity in the system, but may also contribute to the widespread insecurity, the low propensity to invest, thus contributing to the deepening of the recession.

## **2. THE GREATER FINANCIAL CRISIS**

The phenomena of regionalization and globalization can be highlighted also when the effects of greater financial crisis in history are analyzed, such as<sup>1</sup>:

- 1907. The crisis called "The Panic of the Banker" consisted in a decrease of 50% in the stock exchange in comparison with the peak of 1906. The main cause was the retraction of loans by some banks, first in New York, then across all North America;

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<sup>1</sup> M. Paduraru, *The World Economy Governors calm the International Financial Crisis*, "Business Standard" Magazine, August 14<sup>th</sup>, 2008;

- 1929. The Great Depression, which resulted in the collapse of Wall Street, or "The Black Thursday" (i.e. "The Black Tuesday" in the history of the economy) was caused by the inaction of the Federal Reserve, which had left the monetary reserves to fall by up to one third without reaction;
- The 1980s. The crisis "Savings & Loans", when more than 1,000 savings and credit institutions recorded losses of up to \$ 150 billion, of which 125 billion were subsidized directly by the state to resolve a crisis;
- 1997. The Asian financial crisis began in July, with the financial collapse of Kia, which affected the stock exchanges and financial markets;
- 1998. The crisis "Long Term Capital Management", a *hedging* fund very important in the United States of America, directly affected by the 1997 Asian crisis. The total losses were of 4.6 billion U.S. dollars, of which 3.625 billion were covered by most of the major world class banks;
- 2007. Triggering the subprime crisis in the United States and its expansion in Europe and worldwide.

If the crisis in 1907 remained only in the United States, since the crisis of 1929-1933 we can speak of a globalization of the crises, all countries being affected to a lesser or greater extent by the effects of the crisis.

The current financial crisis began in August 2007 when American Home Mortgage collapsed, one of the largest U.S. banks for loans for housing building, following the collapse of the housing market in the United States. Also in August 2007, "BNP Paribas", one of the largest in France, suspended three of its investment funds worth two billion euros, citing problems in the U.S. housing sector.

On September 13, 2007, the largest British mortgage bank, "Northern Rock", ceased to conceal the lack of liquidity triggering a rapid migration of customers to other banks, and in autumn 2007 it went bankrupt because of the U.S. mortgage crisis. The losses amounted to 35 billion euros.

The English state was forced to act as guarantor of deposits, and the bank assets were taken over by a company, which converted them into treasury bills and guaranteed by the state, and placed them into the private sector. On January 20, 2008, "Group Société Générale" has uncovered a 4.9 billion euro fraud committed by an employee of the financial and investment division, which knowing the control procedures succeeded to hide the investments, through a complex scheme of fictitious transactions and a loss of EUR 2.5 billion resulting from the downward revision of the book value of assets associated with mortgages market in the United States.

**Fortis**, the largest Belgian financial group, received in September 2008, 11.2 billion euro aid from the Belgian, the Netherlands and Luxembourg authorities, after there were signs that investors were concerned about the economic situation of the bank.

In addition, the UK Treasury announced that the British bank **Bradford & Bingley** (B & B) will be nationalized and its assets will be transferred to the Spanish financial group Santander, while nonperforming assets will be managed by the state.

The interest on mortgage loans in the U.S. between 2002-2005 was about 1-2%, boosting the demand for loans in an environment characterized by a negative real interest "when the currency is virtually free, any rational lender will continue to credit until there is

no one left to”<sup>2</sup>. Also, the pledge was 3 times less than the loan amount as the U.S. banks estimated that the economy would grow in the future and the debtors would increase gradually their revenues, which means a reduction of the standards to ensure an increase in the volume of credits and on this basis an increase in revenue from fees. But with increasing interest rates, many borrowers had difficulties in the repayment of loans, because, contrary to expectations, the U.S. economy went into recession and it was shown that housing prices had not increased following the increase in disposable incomes of purchasers of homes but because of the ease with which American banks offered credits. When the enforcements began and the volume of mortgages granted by banks decreased, the real estate prices started to decrease until they collapsed, reaching a level of 4-5 times lower than the one before the onset of the subprime crisis. So, it seems clear that the current crisis in the U.S. economy and its echoes in the international stock exchanges has overlapped with an acute liquidity crisis of major economies (U.S., Japan, EU), "reality stemming from the entropy of the system itself, which has a length of over 500 years and which tends to make the centre “a huge black hole” ready to swallow the "periphery system" within some profound transformations”<sup>3</sup>.

The two largest providers of mortgages in the U.S., Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association (nicknamed "Freddie Mac" and "Fannie Mae") and other banks started offering mortgages to people who, under normal banking criteria, presented a high risk not to carry out their obligations. They were thus called "substandard mortgages" (subprime).

There have been many debates regarding the influence of CRA<sup>4</sup> in the creation of what later became crisis subprime. However, there is the view that many banks were forced to enter the market section of high-risk lending, which they would not have taken into consideration if they had used the usual commercial criteria. Therefore, since the '90s there has been a wave of aggressive selling of subprime mortgages, often to individuals who had no realistic prospect of being able ever to repay debts.

When banks lend through mortgages, credit cards, car loans or other forms of lending, they are invariably going to "reduce" their risk through a process of guarantee. Such loans are a financial asset in the balance sheet, representing cash flow that will be charged by the bank in future years through interest payments and the possible loan repayment. The securitization of loans, the bank removes the risk attached to its future revenue and transforms the loan into cash which can be lent again, and so on, in an extended cycle of credit creation.

The securitization is obtained by transferring the loan to specially created companies, called "special purpose vehicles" (VSS). If conventional mortgage loans, VSS acquires the actual record of a bank teller mortgages that are raised by issuing bonds backed by cash flow which is obtained from the owner of mortgages. In case of the substandard mortgages, the high levels of risk required a different type of securitization,

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<sup>2</sup> G. Soros, *The New Paradigm of the Financial Markets*, “Litera International” Publishing House, Bucharest, 2008;

<sup>3</sup> <http://expert-grup.org/>, *The International Financial Crisis: the Impact on the World Economy and the Republic of Moldova*;

<sup>4</sup> CRA is the sign for Community Reinvestment Act – law appeared in the 1980s, which, through its further amendments, tried to eliminate the discrimination practices of granting the bank loans;

obtained by the creation of derivative type instruments, known as the "bonds of collateralized debt or ODC"<sup>5</sup>.

There is a number of possibilities to get out of this crisis - but all are painful. The American solution is that the federal government should purchase the so-called toxic assets from banks, and there have already been set aside for this purpose up to 850 billion U.S. dollars.

The UK solution is that the UK government should inject new capital into banks through preferred securities and to support the operations of financial markets by providing loan guarantees and loans to the banks that are in difficulty. There is a serious risk that the government intervention, no matter how much it will be, does not restore the confidence, with the result that the banking sector may not be able to offer services on the financial markets. In this case, the government investment will record significant losses. However, the other side of the coin is that the banks should recover - to resume activities as close to normal as possible - and the governments involved should withdraw with high capital gains. Only one problem remains: what to do with these toxic assets<sup>6</sup>?

In order to get out of this financial crisis, the professionals from the academic environment, although they do not directly bear the responsibility for what has happened, will have to work to identify the optimum solution for each national economy, but for every entity and, primarily for banks, because, although the same causes have triggered the banking crisis<sup>7</sup>, the solutions should be adopted in accordance with the characteristics of regional financial markets.

Although FED (Federal Reserve System) reduced the discount rate on 22.01.2008 with 0.75 percentage points (reaching 3.5%) and the U.S. government announced tax breaks of about 1% of GDP (140 billion ), the U.S. economy recession seems inevitable and will contribute to slowing global economic growth (according to the IMF, it was 2001-2,6%, 2002-3,1%, 2003-4,0%, 2004-5,3% , 2005-4,9%, 2006-5,4%, 2007-5,2%). For Romania, if in early 2008 the crisis seemed very far from the borders of the country, in the second half, amid the campaign, the politicians and authorities concerned themselves with the development of programs to limit the effects of crisis.

The experience of the crisis from 1929-1933 showed that an important channel for the penetration of the crisis in our country was the banking system, banks with foreign capital were the first affected by the crisis, the crisis at the mother company head offices outside the country sending it quickly on branches in Romania. So the first institution in difficulty in 1931 was the German-owned Romanian General Bank, then the Bercovitz Bank with Austrian capital collapsed in July, and in October one of the largest banks in the country Bank Marmorosch Blank & Co. sought an arrangement with the creditors. Among the measures being taken to calm the economic crisis there was the conversion of the agricultural and municipal debts.

The parliament reduced by 50% the farm debt, the remaining balance would be repaid in 17 years with interest of 3% per year and reduced the municipal debt by 20%,

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<sup>5</sup> B. Ryan, *The Toxic Assets, the Launching Factor of the World Economic Crisis*, "Audit Financiar" Magazine, no. 5/2009, Bucharest;

<sup>6</sup> Unfortunately, ODCs are not the only toxic assets, to these we have to add CLO (guaranteed loan bonds) and CDS (swap on loan risk);

<sup>7</sup> The toxic assets recorded in the countries where the financial market was developed enough to create so sophisticated vehicles. Fortunately, such products did not appear in Central and Eastern Europe, thus, in Romania either.

and the remaining balance would be repaid in 5 years with an annual interest 6%. The losses resulting from the conversion of agricultural and municipal debts represented approximately 16% of the share capital and reserves of banks, many banks being forced to reduce their capital or to merge so that the total number of banks declined from 1122 in 1928 to 387 banks in 1938. The reduction in number of the banks occurred in parallel with the increase of the strength of large banks, so that the top 17 banks had a market share of 33.5% in 1928, reaching 78.3% in 1938, of which the first 6 banks held 50%. More recently, the effects of the Asian crisis of the '90s that had reflected very strong effects on the banking system in Turkey, had led to the bankruptcy of the Turkish-Romanian Bank licensed to operate in our country, but the small size of this bank did not complicate the situation of the Romanian banking system. Currently the banks with majority of foreign capital and the branches of foreign banks hold 75.7% of the aggregate capital of the banking system as can be seen in Table no. 1 and Picture no.1.

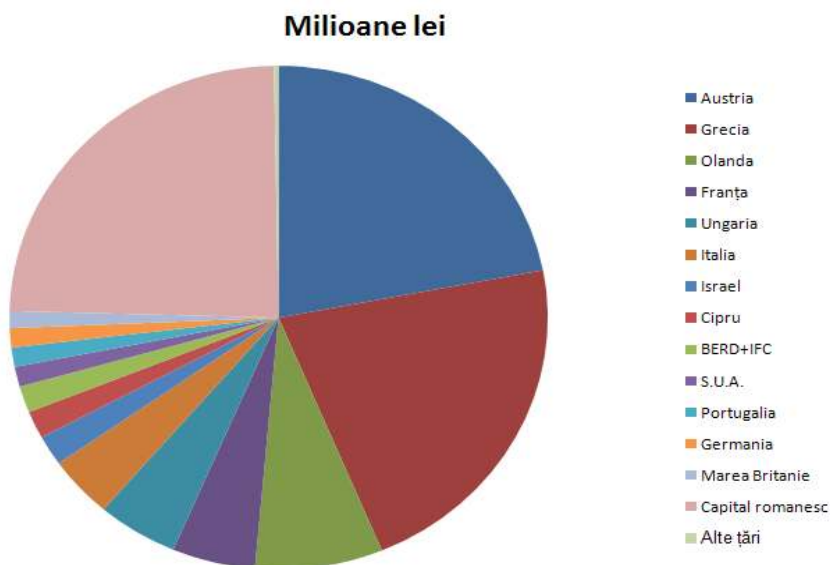
**Table no. 1 The foreign holdings in the capital of the commercial banks and the branches of foreign banks in Romania on 31.12.2008**

| Country        | Million lei | %    |
|----------------|-------------|------|
| Greece         | 2980.0      | 22.4 |
| Austria        | 2448.3      | 18.4 |
| Netherlands    | 1229.0      | 9.2  |
| Italy          | 637.5       | 4.8  |
| Hungary        | 573.8       | 4.3  |
| France         | 562.1       | 4.2  |
| BERD + IFC     | 295.9       | 2.2  |
| Cyprus         | 274.1       | 2.1  |
| Israel         | 247.8       | 1.9  |
| Portugal       | 241.1       | 1.8  |
| U.S.A.         | 189.6       | 1.4  |
| Germany        | 172.6       | 1.3  |
| United Kingdom | 130.9       | 1.0  |

|  |         |      |
|--|---------|------|
| Other countries                                    | 60.3    | 0.5  |
| Aggregate foreign investment in the banking system | 10043.0 | 75.5 |
| The total capital of the banking system            | 13309.8 | 100  |

*Source: NBR – The Annual Report 2008, p.67*

The first three places in terms of the country of origin of the capital invested in the banks and the branches of foreign banks operating on the Romanian banking market were filled in late 2007 by Austria (22.0% in aggregate capital system), Greece ( with 21.7%) and Netherlands (7.7%), overall European Union member states have 7.763 billion lei 70.5% of the total capital of the Romanian banking system. In 2008 Greece was able to exceed the participation of Austria with a 22.4% to 18.4% given that the share of foreign capital has declined from 75.7% to 75.5%.



**Figure no. 1 The foreign holdings in the capital of the commercial banks and the branches of foreign banks in Romania on 31.12.2007**

A part of the problem consists of the fact that there is no market for such securities other than the financial institutions. This means that the market value of the ODC's and similar instruments is well below the intrinsic value of the trust in the mortgage (the present value of the national income flows and the associated reimbursements). Finally, if held long enough, at least some basic mortgage will be recovered. However, it is beyond the time horizon of any government, so a new market has to be created where investors looking for a speculative investment can freely trade that debt outside the restricted circle of financial institutions and governments which own it. Indeed, the creation of such

markets could be the missing piece of the puzzle necessary to restore the confidence and to make the financial world to work again.

Given the experience of the developed countries to address the financial crisis through concerted efforts of the authorities with supervisory functions of financial market, on July 31, 2007, the Agreement between the Public Finance Ministry, the National Bank of Romania, the National Securities Commission, the Insurance Supervisory Commission and the Commission for Monitoring Private Pension System was signed for the cooperation in the field of financial stability and financial crisis management – based on which the National Committee for Financial Stability was established, with crucial tasks to prevent and combat the effects of international financial crisis.

An important step on the line to harmonize the Romanian legislation with the European law is the *Ordinance no. 90/2008 on the statutory audit of the annual financial statements and the consolidated financial statements* that incorporates provisions of Directive 2006/43/EC of 17 May 2006 of the European Parliament and the Council on the statutory audit of annual accounts and consolidated accounts. According to the Ordinance as approved and amended by Law 278/2008 and European legislation, banks are considered entities of public interest and the annual financial statements must necessarily be audited in accordance with International Standards on Auditing. Through the ordinance, the Public Supervision Board for Statutory Auditing was established and consisted of the following institutions:

- The Ministry of Public Finance;
- The Ministry of Justice;
- The National Bank of Romania;
- The National Securities Commission;
- The Insurance Supervisory Commission;
- The Supervisory Commission of Private Pension System;
- The Chamber of Financial Auditors of Romania;
- The body of Chartered Accountants and Certified Accountants;
- The Association of the Faculties of Economics in Romania.

Thus, involving the National Bank of Romania, banks, seen as public interest entities, will be audited according to International Auditing Standards, ensuring the transparency so necessary to base decisions made by investors and the public, in general.

## **CONCLUSIONS**

The harsh reality of the international financial and economic crisis and its impact on the Romanian economy and policy requires the monetary authorities and the central administration to keep up with the anti-crisis measures to be taken at a European level and the measures should be converging with the decisions taken at the continental level.

The main problem of monetary and fiscal policy crisis is related to its consistency. When the International Monetary Fund has negotiated with both the Government and National Bank of Romania granting loans to the Ministry of Finance to support the budget deficit and to the National Bank of Romania to increase the currency reserves, the true signal aims at the need for consistency of monetary and fiscal policies.

A first step has already been achieved when NBR has aligned to the guaranteed minimum ceiling for bank deposits of 50,000 euros for individuals, or the equivalent in lei at the National Bank for deposits opened at a bank, action meant to annihilate panic that could install with the growing turmoil in the banking market.

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