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BASEL III IMPACT ON ROMANIAN BANKING SYSTEM PERFORMANCE

Theoretical
article

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Abstract

In the context of economic and financial crisis triggered in EU by autumn 2008, Romania's banking system like that in the other European countries, faced with the consequences of decreasing the standard of living the worsening of purchasing power (in terms of retail) and with gaps and delay occurred in the payment of corporate clients.

The deteriorated quality of bank investments, the increasing of non-performing loans in bank portfolios, ultimately caused the accumulation of excessive risks within the banks.

On the background of the crisis, the impact of Basel III is not only a financial regulation that is applicable to the banking industry; it will also determine the profitability of the banking system. Through this study, we propose a series of measures applicable to the credit institutions to mitigate the impact of alignment with the new capital requirements.

1. Introduction

The extended financial and economic crisis has been a challenge for financial institutions, although those in Romania have been less affected as they were not exposed to toxic assets, but also due to prudential and administrative measures taken by the National Bank of Romania.

In the context of economic and financial crisis emerged in the European Union after the fall of 2008, Romania's banking system as well as the system from other European countries, has been facing with the consequences of declining living standards, the disturbance of purchasing power (in terms of retail), with gaps and payments within corporate clients. All these led to the deteriorating quality of bank investments, increasing non-performing loans in bank portfolios ultimately causing the accumulation of excessive risks to which banks have been exposed.

Amid the gradual collapse of the European financial markets, have been increasingly debated aspects of factors led to these consequences, sometimes disastrous at the level of major European banking institutions.

One thing is certain, namely that there have been factors both microeconomic and macroeconomic that either worked independently or in connection causing the gradual erosion of quality and the confidence in the banking system.

The impact of economic crisis acted as an "echo" of the banking system, as players in the business (both corporate and retail) has been increasingly facing with the issues in conducting business partnerships.

Concurrently, as a boomerang effect, many questions about the warranty / safety provided by credit institutions have been raised: How many banks are more solid in this context? Can I trust a bank with domestic capital more than in one that is part of a multinational holding? Is Romania vulnerable as we have a

significant share of credit institutions with foreign capital as major players in the Romanian banking system?

These are just some of the questions which have begun to take shape immediately after the onset of the financial and banking crisis emerged after the year 2008.

2. General aspects, motivation and introduction to requirements for BASEL III

Basel III has started shaping itself amid the international financial crisis, a consequence of disquietudes determined by the amplitude, depth, and geographic extent of the crisis. This represents an essential revision at the level of regulations as well as surveillance of banking system, having as essential purpose the improving and consolidation of stability degree of financial-banking system.

The following reasons underlie the introduction of Basel II (Walter, 2011, pp 1-2):

- The negative effects of financial crisis: according to expertise, the effect of financial-banking crisis has been materialized in loss at the level of economical production of approximately 60% of GDI, during the pre-crisis period;
- The frequency of banking crisis after the year 1985; it has been registered over 30 crisis in the financial-banking system of state members within the Basel Committee, as there is a probability of 5% that at the level of one member state to interfere a crisis at a certain point;
- The benefits of Basel III are superior to the implementation of costs, as the stability at the banking system level underlies the foundation of a durable development of the economy.

The new standards of BASEL III impose superior capital demands with a better quality, considering a perfection of management risk system as well as an increasing of transparency demands and

publishing of banking societies (credit institutions)

These measures impose superior demands for credit institutions, regarding capital adequacy, demands regarding the liquidity and leverage. The main objective of these measures is to reduce negative effects at the level of economy and financial crisis.

The coverage sphere of measures within Basel III points the microprudential level (individual risks of banks) as well as macroprudential (the banking assembly). At the microprudential level the measures point (BNR, 2011, P124):

- The consolidation of capital base quality through augmentation of minimal demands of own capital (ordinary actions, reported financial result and reserves) and minimum demands of own funds of level 1 (own capital and hybrid instruments) as well as through reconsidering the eligibility criteria for instruments presented when determining the own funds for level one;
- The increasing of the accent on highlighted risks in the crisis period: transaction portfolio (trading book);
- The introduction of international liquidity standards, through which it can be assured on short term (30 days) the resistance of liquidity shocks, and on a long term (one year) a higher level of structural liquidity.

At a macroprudential level, the measures record an anti-cycling character and point the following: (BNR, 2011, p. 124):

- The introduction of an anti-cycling capital bumper having the purpose of protecting the financial system of the emergence of systemic risks which can be associated to untenable augmentation of the credit (2, 5% over the minimum capital demands- own funds of level I formed of ordinary actions) as well as a fixed bumper of conserving the capital having the purpose of covering the loss when the credit institution is dealing with

financial issues. The bumper of anti-cyclic capital is directly proportioned with systemic risk and it is calculated based on the credit/GDI report.

- The calculation of the leverage effect, the objective being to limit the volume of debt in the banking system in boom periods;
- Credit institutions which have a systemic importance, the concerns are aimed at reducing the probability as well as an impact of their eventual bankruptcy, reducing the cost of public sector intervention and the imposition of certain conditions of equal concurrence. The Committee is also considering a possible introduction of additional capital costs (capital surcharges) for the banking companies.

The reforms are significant and bring new lessons of micro and macroeconomics in the crisis. In order to strengthen the financial system stability, is indeed a priority to implement globally the demands of Basel III, in compliance with the terms (Fig. 2).

The responsibility for implementing these deadlines / demands is not taken only by regulators but also by the risk managers of the banks and those of the audit, who have a pivotal role in the action of independent review and disciplined management efforts in the credit institutions.

3. Banking trends in Romania

For some credit institutions in the banking scene in Romania, meeting the requirements of Basel III is likely to be found as being quite difficult.

The implementation of Basel III requirements will unfold over several years and during this period we will probably see a number of restructuring in the domestic banking system. Also, we will witness some withdrawals of certain companies with foreign capital which have a lower share in the total assets of the Romanian banking system.

Thus, if the year 2013 started the appetite of acquisitions in the local banking market

and no more than five banks - Citi Bank, RBS Romania, Romanian International Bank, ATE Bank and Bank of Cyprus - have been the subject of such transactions, in 2014 began the acquisitions with the sale of Romanian subsidiary Nextebank to a fund managed by Axxess Capital.

Romanian banking market, according to information published, the most plausible transactions during 2014 are the selling of a minority stake acquisition of Commercial Bank Carpatica and taking over the subsidiaries Millennium Bank and Marfin Bank.

Millennium BCP, the largest banking company listed in Portugal by the volume of assets, plans to retire by selling the subsidiary Millennium Bank Romania (this one holding less than 1% of market share). This decision is part of the measures/ demands sale agreed with the European Commission representatives. The deadline for the sale is agreed with the European Commission and it is going to be held in June 2015.

In a fairly advanced stage of development for sale process is also Marfin Bank.

Regarding this bank, the selling is the consequence of an objective situation in which the former parent- bank Cyprus Popular Bank entered into dissolution, and the local branch was transferred to a "bad bank" portfolio, although the bank has no sustainability issues.

Another bank that has announced its intention to withdraw from the Romanian banking market is the Volksbanken AG (VBPS) parent bank Volksbank Romania, which is considering selling the local subsidiary after the Russian bank Sberbank bought most of the Volksbank's European subsidiaries.

Also, during the year and in the following periods we are likely to see the trend of mergers and takeovers in the Romanian banking system. The banking companies that have a low share in the total assets of the banking system will be the actors of such processes.

All these transactions that will occur on the financial banking market in Romania will be the effect of alignment to the requirements imposed by Basel III and will aim the maintaining of profitability in the Romanian banking system, with a strong profitability that is currently marked by the consequences of the financial crisis.

4. The impact of Basel III on the banking system in Romania and the alignment measures

Although the impact of Basel III on the Romanian banks is considered to be limited, we propose some measures that banking companies could adopt to conform to the new requirements:

- 1) *Restructuring the banks' balance sheet items.* BASEL III focuses on integrated management of assets, capital and financing, for the banking companies there is no opportunity for optimizing the level of assets and liabilities independently. Regarding credit institutions, a significant level of impact BASEL III derives from capital deductions. The new capital requirements differ from the BASEL II as the banking companies needed to infer (Harle et al., 2010, p 16):
 - The capital of insurance subsidiaries that exceed a threshold of 10 percent, lowering the ability to use much of this capital in the banking activity of the consolidated entity
 - The value of any defined benefit of the pension fund assets;
 - Investments in unconsolidated financial institutions over 10 percent
- 2) *Review the profitability indicators.* Thus, a number of credit institutions will be forced to redesign their products and customer service, taking steps to optimize the capital and bank liquidity. In redesigning the products and customer service, credit

institutions may take action in the following areas:

- Analysis upon the satisfaction level of customer by their products and services;
 - Improvement of parameters products and services that offer a degree of satisfaction to the customers so as to perform in the relationship with the clients;
 - Increasing the share of products and services that have a high degree of profitability in customer service contributing to a more efficient banking activity;
 - Launching and promotion of products that combine the credit with saving factor, thus generating a fundraising both from physical persons and companies
- 3) *Better corporate governance in the banking companies.* The crisis manifested in the banking sector pulled up the weaknesses in corporate governance. The financial crisis has demonstrated a lack of effectiveness of corporate governance principles (not achieving its objectives) in the banking sector, driven primarily by (Bunea, 2013):
- a scope too broad, leaving a great deal of interpretation to the credit institutions, implementing its principles only declarative (policies, codes etc.).
 - a lack regarding clear segregation of roles and responsibilities within the credit institution;
 - not imposing a legal obligation of compliance / implementation, and the absence of sanctions to discourage their violation (e.g. the use of "may" rather than the imperative "must").
- 4) *The increasing of confidence in the banking system.* The confidence that the market players have (partners in the

business) of the banking system is very important; it represents an intangible value that each credit institution owns and which ultimately has an impact on the profitability of the banking entity.

Also, the banking companies must pay a particular attention to the risks to which they are exposed in the business. It is necessary to analyze the level of exposure to risks deriving from the credit activity, counterparty risks, environmental risks, liquidity risks, etc.

Here, a special role is performed by specialists in the area of risk management, who are responsible to identify, manage and take appropriate measures to reduce the risks within the banking companies.

5. Conclusions

In a period in which both banking companies and the economy in general are facing with the shocks of the financial crisis, the main goal of Basel III is to maintain and enhance the profitability of the banking system.

Therefore, the requirements are improving the ability of credit institutions to resist to shocks through an effective risk management and transparent conditions substantially higher.

Within any banking company is required to take action in order to:

- align internal processes of the bank with the regulations imposed by Basel III;
- implement Basel III in order to optimize the risk management processes and ensure compliance with these standards bank / regulations;
- verify process of optimization within credit institutions.

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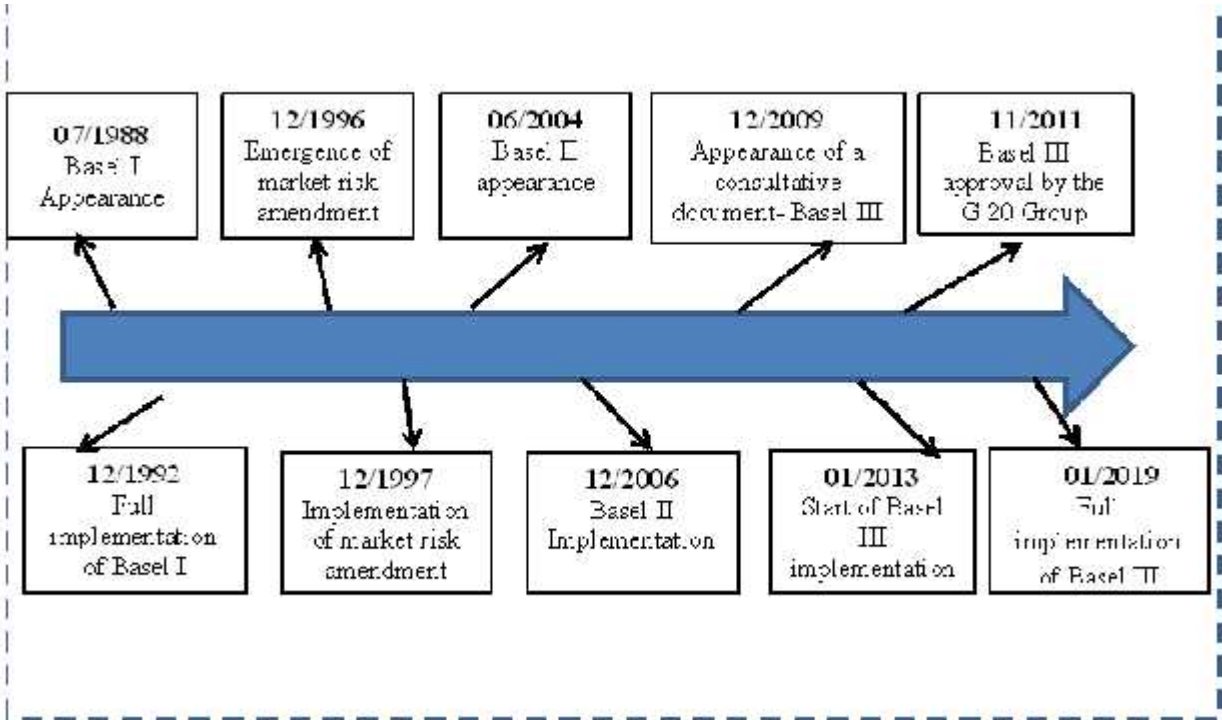
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Figure No. 1. Evolution of the Banking capital reglementation



Source: Basel Committee on Banking Supervision (November 2010), HerveHannoun: *The Basel III Capital Framework: a decisive breakthrough*, p. 2.