# The Financial Crisis and the Management of Change in the Banking Sector

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*In the last two decades the banking sector had been facing a series of profound changes. After a significant period of growth and wellbeing, the economy has faced a sudden and severe crisis. The main effect of the economic downturn implied a sharp decrease in the economic activity overall, and in the banking sector in particular, which led to millions of people losing their jobs. The article focuses on this heavily affected branch of the economy, and looks into the most efficient change management methods and turnaround strategies that enabled select organizations to remain competitive and overcome the multiple difficulties caused by the financial crisis.*

*Keywords: financial crisis, banking sector, strategies.*
*JEL Classifications: G01*

## INTRODUCTION

The financial crisis became visible in September 2007 starting with the turbulences arising from the US real estate market and turned severe in the second half of 2008, marked by the bankruptcy of the Lehman Brothers investment bank, which led to the worldwide collapse of the stock exchanges capitalization indices. Although the main cause of the financial crisis is attributed to the real estate sector in the USA, some analysts such as Altman (2009) and Buiter (2008)

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mention in their recent papers that, at a fundamental level, the causes of the financial crisis have both macro and microeconomic nature.

Expansionary monetary policies in countries with a developed economy generated global imbalances, characterized by a significantly increase of the US current account deficit. Moreover, the increasing integration in the worldwide economy of some countries such as China and South – East Asia countries in particular that were ensuring high rates of accumulation and global redistribution of wealth and income to exporters of goods (oil, natural gas, etc.) generated a super saturation in savings. Abundant liquidity created super saturation with savings available for investment resources, including sophisticated financial instruments that were not easily understood by some investors.

The consequences of an abundant liquidity were marked by a downfall of interest rates and their volatility that created a tendency to underestimate risk and also increased the appetite of the investors for actives with large gain that ultimately led to insufficient understanding of the risks combined.

On this particular background also operated as aggravating a series of microeconomic causes, such as: frenzy securitization, cracks in rating agencies business models and increased international competition for deregulation.

## CRISIS AFTERMATH AT THE EUROPEAN UNION LEVEL

The impact of the financial crisis on the European countries has been and continues to be alarming, reaching banks in the European Union (E.U.) in a number of ways similar to the impact it had on the U.S. banks. Among these effects, the following may be mentioned:
Assets loss due to the devaluation of properties (the residential ones in particular);

Major suppress American assets loss (considered also the main trigger of the financial crisis)
Reduced liquidity, financing difficulties as a result of the global money market freeze. Thus, banks are forced quarterly to refinance large parts of the balance sheet.

In order to avoid a global economic downturn and also to ensure sufficient liquidity in worldwide financial markets, the negative effects caused by the instabilities in international financial markets require significant actions at both national and international levels. Thus, competent organizations and institutions such as E.U., United Nations, International Monetary Fund, World Bank, etc., discussed and agreed during various high level meetings of the Member States on a series of measures in order to stabilize and neutralize the effects of the financial crisis and also to restore the confidence in the financial markets. In U.S.A. and some European countries, governments and central banks responded by improving liquidity, providing government guarantees for loans, recapitalization of financial institutions, preventing the collapse of large interconnected companies, buying shares in banks and coordinated cuts in interest rates that led to the saving of a number of banks in Germany, Netherlands, England and Belgium.

## 2. CRISIS AFTERMATH AT THE ROMANIAN LEVEL

The turbulences arising from the global financial market turmoil affected the financial stability of Romanian banks indirect, through the real economy and bank liquidity channel, as banks don't have exposures to financial instruments based at the root of the financial crisis. Thus, until 2008, the repercussions regarding the financial crisis had a limited manifestation characterized by an increase in the external finance cost.

Credit risk has increased significantly, especially on the part of foreign currency credit to households. Higher credit risk is associated with high lending rates from recent years (who have contributed to a significant aggregate demand growth that had a negative impact on the current account and disinflation).

In 2007, the non-governmental credit growth enhanced (50.5 percent in real terms), with more than 3 percentage points higher than the previous year. Non-government loans have been the engine of continuing expansion of bank assets. The causes of non-government credit developments listed resides in both the demand and the supply of credit. In 2007, the demand of loans was influenced by different factors, such as: maintaining a high level of economic growth, an increase in population income and a continuous existence of positive expectations regarding their level, a decrease in bank interest levels regarding a number of loan products, given the depth of competition in the Romanian banking market and the appreciation of the national currency in the first six months of 2007, a trend that has encouraged the employment of foreign currency loans.

As for the credit supply, it was influenced mainly by: the continued existence of a liquidity surplus for most of Romanian banks, with easy finance access abroad, increased competition in Romanian banking system due to the rise in the number of players in the market and improving the bank perception on the client's financial situation due to favorable developments in the real economy.

The real growth rate of non-government loans recorded a decrease in 2008 of 26 percent compared to 50 percent recorded in 2007, due to a deceleration in the economic activity. Moreover, the credit decline was influenced by the accounting effect of currency depreciation.

A slowdown in the governmental credit demand in the late 2008 was influenced by a decrease in credit supply due to liquidity problems on international markets, which have also affected international operating banks that own subsidiaries in Romania. Among other important factors that influenced the credit supply are reducing the cash-flow exceeding that used to characterize the banking sector in the past and a higher banking risk aversion. Some of the most important factors that influenced the credit demand are: higher interest rate, currency depreciation and uncertainties regarding its evolution, negative perspective regarding the economic growth and unemployment.

The turbulences arising from the economic environment in the last months of 2008 and first quarter of 2009 led to lower demand and deterioration of loan portfolios held by commercial banks and granted to non-bank clients. Furthermore, an analysis of credit quality by different group of banks regarding asset holding showed that in just a few months, from December 2008 to March 2009, large banks registered the sharpest deterioration of loans, proceeded by small-sized banks whereas the medium banks improved their credit quality. The growth rate of loans granted to the private sector had witnessed a sharp decrease in the last quarter of 2008, thus its value reaching roughly half of the value registered in the previous year.

Year 2009 reinforced the stagnation trend of the non-government loans, originally having its debut in the last quarter of 2008, despite any tries of stimulating counter measures taken by the central bank. The rate of financial intermediation, computed as a percentage in GDB in non-government loans, granted by commercial banks, had marginally increased to approximately 41 percent in December 2009, being among the lowest rates in Europe.

The downfall of non-government credits during Sept 2009 – May 2010 was influenced on one side by the decrease in credit supply and on the other hand by the decrease in credit demand. Regarding the credit supply, the major determinant represented the stagnation of risk aversion of commercial banks, despite of the measures taken by the central bank in order to encourage a sustainable restart of credit activity. Among this measures, the central bank has diminished the minimum reserve requirement ratio applicable to liabilities on both

national and foreign currency of credit institutions, lowering the monetary policy interest rate, reinforcing some norms on banking prudence. Due to this measures, the market has had sufficient liquidity measures. Regarding the credit demand, the main factors that contributed to its contractions were the following:
The negative macroeconomic evolution, in particular the ones regarding GDP, unemployment and wages;
The tendency to depreciate of the national currency in the first half of 2009 and the increase in the exchange rate volatility;
Maintaining lending costs at a high level;
A more prudent approach at the population level, characterized mainly through the tendency to save money

Credit risk remained the top vulnerability of the banking sector in 2010. The quality of credit portfolio continued to diminish but rather at a slower pace than in 2009. The non – performant credit ratio reached 13.4 percent in June 2011 compared to 7.9 percent in Dec 2009, or 11.9 percent in Dec 2010, however, the encored losses were managed accordingly. The financial intermediation ratio remained stable in 2010 at 41 percent, at the same level as in the previous year.

The most important factors that determined the evolution of non-government credit in 2010 and the in the first half of 2011 were influenced by both credit supply and demand. In terms of supply factors we can mention the persistency of risk aversion among banks, as a result of an increasing number of non-performing credits and the negative influence over the profitability indicators. However, the financial lending standards remained roughly the same for both the private sector and consumers with a marginal tendency of reducing the requirements for real estate credits.

Regarding the credit demand, the non-government loans were negatively influenced by the following factors:
- the decreasing population's revenues on the background of the measure imposed in order to consolidate the national economy

because of the persistency of uncertainty related to these measures in the future;

- a greater care in managing the liquidities, an attitude that projected a decline in consumption and an increase in the tendency to save, either through deposits or state bond acquisition;

The profitability of the Romanian banking system turned negative starting with May 2010. At that point, for the first time after 1999, the banking system closed the year with a loss of 516.4 millions lei, mainly due to a high costs of provisions. However, the loss was not a general fact but rather a very common one witnessed by most of the small and medium sized banks (the totaled market share of the banks which incurred losses being 21.9 percent in Dec 2010). The main factors that affected the profitability of the banks were the increase of provision expenses and the decrease in risk acceptance.

The banks have adopted prudent attitude regarding fresh credit allowances, mostly preferring the refinancing operations and state bond acquisition despite the strive of the central bank to normalize the interest rate level and relaunch the financial lending process respectively.

## 3. NATIONAL BANK OF ROMANIA (NBR) COUNTER-MEASURES

In Romania, the counter measures taken against the negative effects of the financial crisis were not similar to the ones taken in European states or even in the USA, due to some economic differences. The main difference was that Romania has a large current account deficit which implies a need for external financing. On this specific macroeconomic context, Romania's National Bank measures focused on mitigating the unsustainable credit growth by adopting a monetary policy in order to slow down the dynamic of foreign currency segment. Therefore, different instruments were used in order to decrease the credit dynamic, such as: operations to reduce the RMO rate, operations to reduce the interest rate in national currency credit or different operations on the monetary market.

The NBR's reaction in this macroeconomic context aimed at attenuating the unsustainable growth rate of credits while also imposing monetary policy measures in order to slow down the foreign currency segment, by using specific interments that reduce its attractiveness compared to the national currency segment - modifying the RMO rate, lowering down the interest rates for credits in the national currency, or other operations in the monetary and exchange rates markets. All these pro-active measures that were aimed at slowing down the alert dynamic of credits were basically canceled once with the entry in economic recession. At that moment, the NBR adopted anti-cyclic measures, by letting loose various components of the monetary policy. Thus, the negative effects projected by the economic crisis were diminished to a certain extent. The NBR's measures strived to correct the macroeconomic unbalance, trying to level the price stability, targeting inflation through monetary policies and improving the banking sector supervision.

Furthermore, the NBR continued to act towards ensuring the proper monetary conditions that, alongside with a sustainable and durable anti-inflation programme, would create the premises for encouraging both the supply and the demand for credits, a necessary factor in order to relaunch a sustainable economic growth. In terms of boosting the supply, the banking norms referring to the minimum reserve requirements were changed towards less strictness, while also improving the liquidity conditions on the market. In terms of improving the demand, the central bank continued to gradually reduce the monetary policy interest rate, that slowly translated into the adjustment of the interest rates for credits. Thus, starting with September 2008, the monetary policy interest rate was decreased with 5 percent (from 10,25% to 5.25%).

This intervention of the central bank in the monetary policy was felt on the market by the increased volume of credits in the private sector. After a two year contraction period, the rate of growth for private sector credits changed to a positive value starting with September 2011 (3,3% in December 2011, 4,2% in June 2012, etc). However, in real terms, the volume of credits has not reached the ante-crisis levels. In real terms, the growth rate of credits in the private sector, having as reference point September 2008, still indicated negative values, but having a decreasing rate (-5.4% in July 2011, -3% in June 2012). On the other side, the foreign currency credits have witnessed positive growth rates in the entire period (11.5% in May 2012, 10.3% in June 2012, etc.), and most of its variation being influenced by the depreciation of the national currency.

Following a prudent credit policy, the commercial banks have oriented towards short-terms financing products, which led to a progressive growth of private sector credits with maturity under one year.

## 4. CONCLUSIONS

The measures adopted by the National Bank of Romania in 2009 (less strict bank prudence norms referring to credit risk provision creation, reduction to zero of the minimum reserve requirements ratio for the liabilities in foreign currency with maturity date greater than two years, etc.) have contributed to the general improvement of the financial situation of the Romanian banks, having positive effects on the relaunch of non-governmental credits and, implicitly, on the economy.

One of the main characteristic of Romanian banking sector was adequate capitalization for preventing prevailing risks. This has been the outcome of both NBR's counter measures and the commitment of parent-banks to maintain an adequate capital level for subsidiaries throughout the country. The capitalization was ensured mainly by the shareholders, the public authorities not being included in the process. In 2011, the shareholder additional capital contributions totaled 280 mil euro and in the first quarter of 2012 reaching approximately 550 mil euros for credit institutions with legal personality.

In 2012, the banking sector incurred losses (2.3 billion lei) due to a substantial growth of nonperforming credits guaranty reevaluation that generated an increase in risk provisions volume, although the profitability of large-sized banks remained in positive levels. Banks portfolios that continue to comprise a significant number of borrowers with overdue loans, including the ones that tend to have a lower probability of repayment, generates high level of non-performing credit ratio that has a negative influence on banking profitability. Moreover, vulnerabilities arising due to a large amount of foreign currency credits maintained, and the risk associated with this kind of financing increased at a faster rate that the one associated with national currency financing.

Further more, the Central European Bank had a continuous contribution at diminishing the risk of a chaotic evolution regarding the financing conditions in European countries. Among the main measures implemented in this matter it's worth mentioning the following: introducing the possibility to acquire bonds on the secondary market (Outright Monetary Transactions, in Sept 2012), continuing the long-term refinance program characterized by the full acceptance of the specific amount (3 months repo), extending the list of assets eligibly accepted by the refinance program and credit operations and the decrease of the monetary policy rate.

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