

## **GLOBALIZATION AND PERFORMANCES IN BANKING ACTIVITY**

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**Abstract:** Each area is influenced by globalization and the financial markets are not only an exception but these can be considered a real engine of the globalization. It is obvious that we can't talk only about a national market but of a financial market which works at a global level. The present events guide us to another thinking of the features and effects of globalization. The social-economical consequences transmitted by globalization of the economy and advantages or disadvantages of the banking-financial globalization can't be outlined without having a new vision over the dimension and complexity of this present process.

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### **1. Introduction**

Globalization – a process or a phenomenon very much discussed, appreciated by some people, contested by others – represents a reality of whose consequences are felt by each one of us. Information circulates faster and faster, the access to information is easier because of the technological evolution and this makes that the environment in which we live to change continuously. The speed with which information circulates, the level of development of the communication means determines the elimination of the temporal and space barriers from the humans' development. Each area is influenced by this process and the financial markets not only are an exception but these can be considered a real engine of the globalization. It is obvious that we can't talk only about a national market but of a financial market which works at a global level.

Financial globalization doesn't represent a new phenomenon, but the size and speed which this faces it is without any precedent. The connections between states and the interdependence between financial systems are more emphasized than ever.

In our opinion, the effects of financial globalization act on the banking systems aims at:

- ✓ the globalization and the moves associated to this have changed the financial systems, by strengthening the connection between banks and financial markets;
- ✓ the banks have taken advantage of the changes produced by the financial globalization, and they have evolved and adapted their activity to new realities;
- ✓ the developed banks are the main actors of financial globalization;
- ✓ the tanks redefine their activity constantly;

- ✓ the restructuring of the banking system responds to an industrial and financial logistics;
- ✓ the banking regulations are based on an ever stronger coordination between authorities, markets and institutions;
- ✓ the European banks are facing a triple challenge in trying to achieve their performances: efficiency growth, consolidation, internationalization and promotion of a global expansion strategy;

At the level of Central and Eastern Europe the high level of the presence of the western banks and the ever greater integration make the credit offer in this countries become more sensitive to the external economic evolutions. Therefore, the banking systems of these countries are facing some major challenges: collaboration in the area of prudential regulations between the Eastern and Western Europe, the medium-term and long-term sustainability of the expansion of the regional credit, the perspective of adopting the euro.

## **2. Globalization – challenges and consequences**

In the next paragraphs we will identify the main challenges of the financial globalization and the way in which this affects economies.

First of them refers to the low impact of the monetary policy generated by the financial globalization. In the last years, the relation between monetary policy and financial stability was analyzed careful. The financial and monetary stability represents the medium purpose of the state policy.

The financial stability affects positive the prices stability. First of all, promotes an offer of credit and capital flow which are stable and essential for a harmonious expansion of economy. After that, financial stability sustains the mechanisms of transmission of the monetary policy. A financial stable system assures the transmission of the modification of the monetary policy instruments over the market rates. That is the way, the changes in the monetary policy will affect the consumers and companies behavior and obviously the inflation and the economic activity. In addition, the stability of the prices has at its turn a positive influence over the financial stability.

An efficient monetary policy will promote financial stability by eliminating the contradictory signals transmitted by the prices which are associated with the high and volatile inflation. Low and stable inflation offers to population and companies clear indications regarding the modification of the relative prices. As a consequence the allocation of resources will become more efficient. Some specialists have shown that, because of the capital markets integration, the interest rates will become equal in most of the countries, which will lead to the diminution of the central banks' abilities by the countries with low interest rates, thing which creates a dilemma for central authorities: attracting a high flow of foreign investments or the control of inflation.

A second problem is the faster spread of the risks at the global level. Globalization, synonym with economic and financial integration leads to a larger transmission of the conjunctural exchanges, especially of those produced in USA, taking into consideration the important role of the US economy.

Therefore, the USA contribution at the world GDP reaches 20,50%. In the financial plan, this percentage has a higher level, the percentage of the US exchanges towards the global exchanges is 25% in 2007 knowing a descending evolution and in the '90 this percentage was 32,8%. Also, the intensification of the financial relations had as a consequence to the growth of the percentage of the US assets which are hold by the other states. The

percentage of the US assets hold by the countries from European Union increased from 3,1 % from GDP to 14,1% in 2005. Studying the connection between the consequences of the recession from the USA and industrial countries, we notice a close correlation, the diminution of the US GDP lead also to a limitation of the GDP from these countries as we can see in the following table.

**Table no. 1 The correlation between US economy and industrial countries**

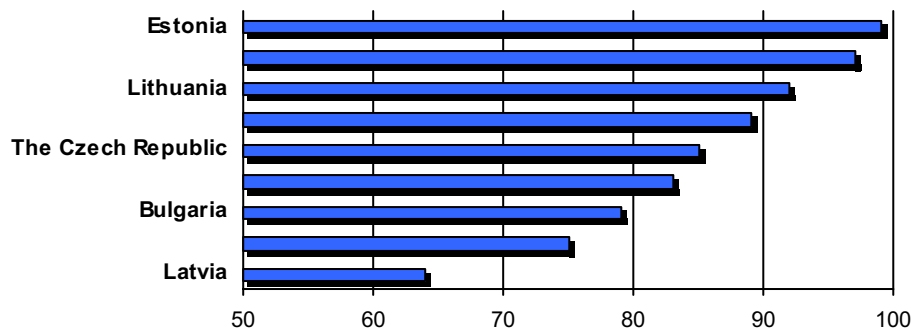
	1974 -1975	1980	1982	1991	2001
United States of America	-6,1	-3,4	- 4,5	-2,1	-2,9
Industrialized countries	-5,4	-1,5	0,4	-1,3	-2,0

*Source: International Monetary Fund*

The present events guide us to another thinking of the features and effects of globalization. The social-economical consequences transmitted by globalization of the economy and advantages or disadvantages of the banking-financial globalization can't be outlined without having a new vision over the dimension and complexity of this present process which is determined, mainly, by three characteristics.

First of these and probably the most powerful is the financial innovation. The process of innovation which marked the financial markets from the last twenty years lead to the creation with the help of the financial engineering of the derivative products form the stock exchange and outside. These, at their turn, became important instruments for the risk of management are used in an investment purpose by the companies, financial institutions, individual investors. For example, the credits' portofolio of the banks can be transformed into a series of titles with a negotiable value. Those are then sold to financial markets, in packets, with a different risk to certain investors, banks can benefit of new resources and investors of important results. Financial institutions can in this way administrate efficiently the exposure and transmit the risk to those investors which are capable to control it.

A second characteristic is the fact that economies become more open from the financial point of view, especially the economies in the development process. Through its instruments: international trade, financial international flows, direct foreign investments, the globalization creates favorable conditions to expand these flows; financial transactions have on the exchange markets a higher percentage than the international trade; the intensity of the relations between countries was possible thanks to the fast liberation of the commercial system and to the investments in the countries in process of expansion and through the progress of the technologies and other means of telecommunication. In the economies from Central and Eastern Europe the banking assets are hold, mainly by the foreign institutions.



Source: *The Economist, A special report on international banking, Mai 2008.*

**Figure no.1 – Banking assets hold by foreign banks (2006)**

This fact was determined mainly by internal factors. From those factors we mention the financial freedom and non-regulation which lead to higher investments. The liberation of the capital account, more flexible policies of the exchange rates, the opening of the capital markets were measures which attracted many foreign investments.

The third characteristic is the fortification of the role and importance of the financial institutions, from those we mention: banks, hedging funds, funds of “private equity”. These have a few common features:

- ✓ play an important role in the assurance of the efficiency of the market and offer liquidity to the capital market;
- ✓ use complex strategies for investments;
- ✓ use advanced methods for the administration of the management risk.

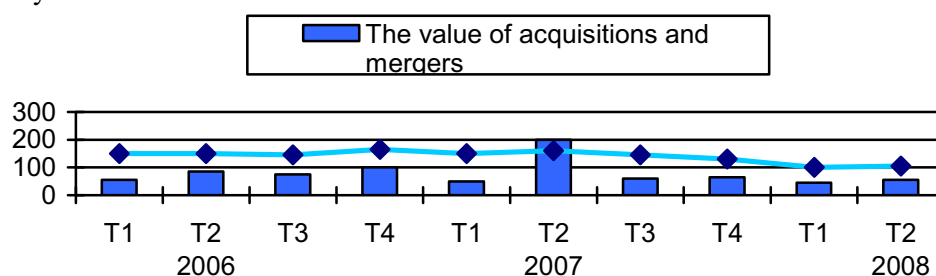
These features lead to an improvement of the economic climate in which the financial institutions act, an obvious trend for the emergent economies, but they also created a strong dependence of the health of these economies to the financial conglomerates. These can generate problems regarding the monetary stability thanks to the important role they have for the equilibrium of the financial markets, they raise certain problems concerning the transparency and their role in sustaining the financial stability. In this context, because of the many aspects regarding prudence included in the some field directions (which are addresses to banks, investments societies) weren't stipulate at the level of financial groups, the European Union adopted rules in harmony with other concerning the prudential control of financial holdings in order to limit the risk that their activity to be one that makes unstable the European financial markets and these are: the Directive no. 2002/87/CE known under the name of Financial Conglomerate Directive.

In what concerns the consequences of the financial globalization we will analyze two of the most important. First of all, the globalization increases the efficiency of the financial markets. Due it and to the technological progress the capital had improved. Every new information is rapidly process and incorporated in the assets' price which will lead to a new dimension closer to the proper understanding of the risk. The efficient allocation of the capital represents the ability to place resources in a way that leads to maximum their value. The operational efficiency gained also due to

the globalization because the cost of the finance diminished as a consequence of the competition.

The process of allocation of the capital can be outlined also through the trend which manifests at the global level to concentrate the resources. This trend manifested by increasing the number of banking acquisitions and mergers, even so, in the present the economic conditions aren't so favorable as we see in the fourth graphic. Still, in the future, it says that it will be a reorganization of the banking system and also an increase of the number of acquisitions and mergers as a consequence of the diminution of the financial power of certain financial groups.

Another consequence of the globalization is made up by the fast maturity of the emergent economies. International Monetary Fund predicts for 2007 and 2008 that half of the economic growth, at the global level it will be registered by the emergent economies. The same trend is registered even for the financial conditions of this country.



**Figure no. 2** The evolution of the banking mergers and acquisitions at global level  
 Source: *The Economist, Under the hammer, 10 July 2008*

**Table no. 2** The evolution of ROE and ROA at the European level

	2003		2004		2005		2006		2007	
	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
<b>Austria</b>	7,0	0,3	14,8	0,6	14,8	0,6	16,9	0,7	18,3	0,8
<b>Bulgary</b>	22,7	2,4	20,6	2,1	22,1	2,1	24,4	2,2	25,4	2,5
<b>Czech Republic</b>	23,8	1,2	23,3	1,3	25,2	1,4	22,5	1,2	23,1	1,3
<b>Greece</b>	8,9	0,6	6,4	0,4	15,9	0,9	12,8	0,8	20,1	1,3
<b>Italy</b>	7,4	0,5	9,3	0,6	9,7	0,7	11,5	0,8	-	-
<b>Poland</b>	5,4	0,5	17,1	1,4	21,9	1,6	21,0	1,7	25,6	1,8
<b>Romania</b>	15,6	2,2	18,5	2,4	15,2	1,9	11,7	1,5	11,4	1,3
<b>Serbia</b>	-1,2	-0,3	-5,3	-1,2	6,7	1,1	10,0	1,7	12,8	2,1
<b>Hungary</b>	19,3	1,5	25,3	2,0	24,7	2,0	24,0	1,8	22,9	1,8
<b>European average</b>	<b>11,3</b>	<b>0,5</b>	<b>13,7</b>	<b>0,5</b>	<b>15,0</b>	<b>0,5</b>	<b>16,7</b>	<b>0,6</b>	-	-

Source: *International Monetary Fund, Global Stability Report, April 2008*

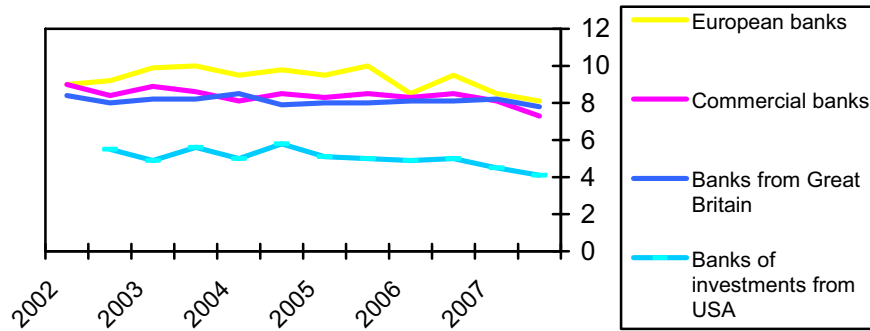
### 3. Globalization and crises

The dynamics of the present crisis of the mortgage credits constitutes a proof of the way in which globalization modifies the reaction of the financial system at shocks.

The worse problem created by the under premium crisis is on the credits' market. The financial crisis spread also into the real economy through the credits for consumers and for enterprises, because the financial institutions are confronted with an acute crisis of liquidities. To avoid an obstruction of the credit market, central

authorities, especially those from the USA have interfered. In fact, it is very well known that the theory of Ben Bernake, according to this loss of banks<sup>11</sup> followed by the slow down of the credit rhythm will lead to a moderation of the economical activity and to a diminution of the goods' value which constitutes a mortgage for the credits, creating in this way a negative spiral.

In fact, the solvency ratio of the banking institutions diminished as a consequence of the mortgage credits' crisis.

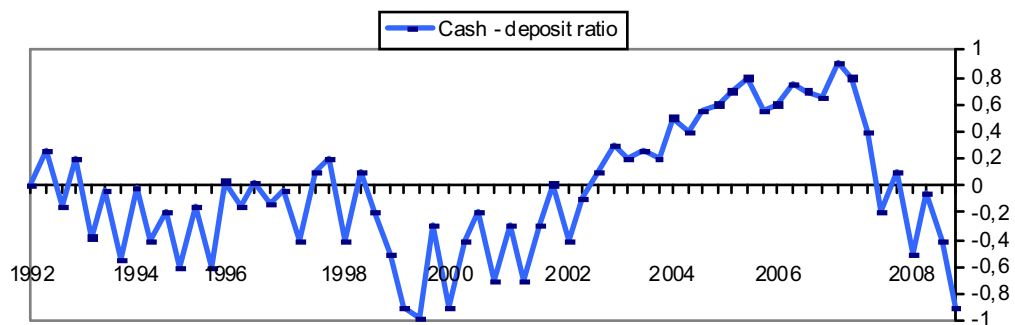


**Figure no.3 The evolution of the solvency ratio at the banking institutions**

Source: Bloomberg

To stop these negative effects the Federal Reserve dropped the interest from 5,25% to 2% and financed the banking system with liquidities of 400 billion dollars.

Still, what appeared to be an sub evaluation of the risk on the mortgage credits market from the USA proved to be one of the biggest crisis from the last ten years. The hedging funds watched as a source of the systemic risk have reacted better than the regulation institutions. The market between banks considered to be one of the most efficient and liquidity suffered a series of malfunctions, especially in the aspect concerning liquidity, as it is shown in the next graphic.



**Figure no. 4 The evolution of the liquidity on the financial market**

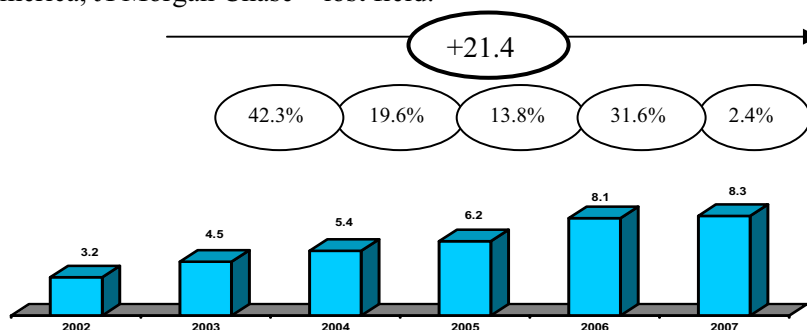
Source: Bank of England, Financial Stability Report, April 2008.

These deficiencies raised a series of problems to the regulation authorities. First and the most important is the liquidity risk which in the Agreement Basel II is not mentioned.

<sup>11</sup> Loss of the banks are according to Bloomberg approximately 400 billion dollars

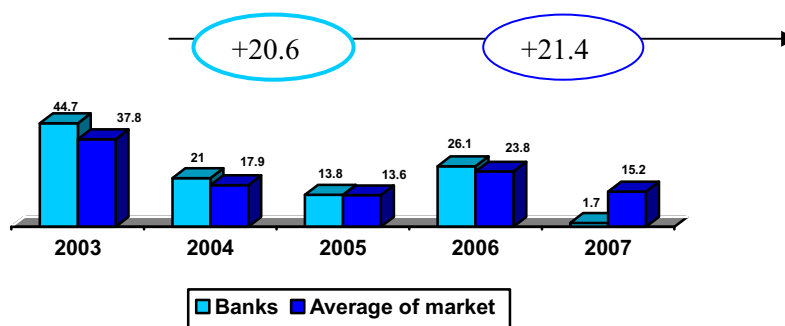
As a consequence of this fact, The International Bank of Regulations took the decision to publish at the end of the year a set of standards to regulate this risk. Mainly, the liquidity risk with which has confronted the banking institutions was administrated through facilities offered by the central banks.

The financial crisis started in august 2007 affected great banks. So, the banking capitalization increased, in 2007, with only 2,4 %, in comparison to 31,6% in 2006. Total profitability of shareholders decreased from 26,1% to 1,7%, in comparison with an average of the market of 15,2%, as can be seen in chart no. 1. The financial crisis affected one of the greatest banking groups, depending on capitalization. So, meanwhile, banks from North America and Europe lost 695 milliards \$, and banks from emergent countries, especially the ones from Brazil Russia, India and China, gained 888 milliards \$<sup>12</sup>. The greatest bank of China – ICBC, China Construction Bank, Bank of China – hold 3 of the first 5 places, meanwhile banks from United States– Citigroup, Bank of America, JPMorgan Chase – lost field.



**Figure no. 5 Banking capitalization (trillions \$)**

Source: The Boston Consulting Group – Creating Value in Banking 2008



**Figure no. 6 Profitability of shareholders(%)**

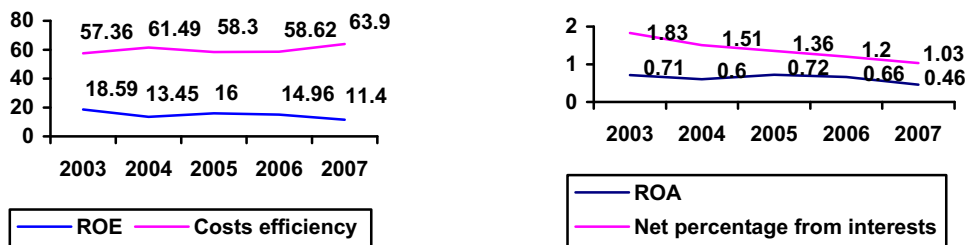
Source: The Boston Consulting Group – Creating Value in Banking 2008

These favorable evolutions, in the period 2002-2006, accompanied by a continuous improvement of profitability, including in the first two trimesters of the year 2007, created the premises for banks to act in a responding manner to financial

<sup>12</sup> Bloomberg - ICBC Deposits Citigroup as Chinese Banks Rule in New World Order

turbulences. As was expected, the financial crisis led to increasing of the lend costs, solvency deficits and implicit, to the diminishing of profit. As a consequence it was reduced the ability of the banks to generate supplementary capital through the agency of incomes. On the contrary, losses from mortgage credits, which raise to 503,8 milliards \$ led to capital increase of 352,5 milliards \$<sup>13</sup>, until 20 august 2008.

The main impact of the crisis of mortgage credits was reflected in the diminishing of the profitability of the banks that reached the most reduced level since 2003<sup>14</sup>. So, ROE decreased from 18,59%, in 2003, to 11,41%, in 2007. Also, the profitableness of the assets was reduced from 0,71%, in 2003, to 0,46%, in 2007. This caused, mainly, the decrease of the incomes and the increase of the balance of risky assets. The capacity of the credit institutions to control operational costs, in the context of the rapid expansion of the crediting activity, become worse in 2007, the value of the indicator of costs efficiency (cost-income ratio), of 63,89%, increasing with about 6,5 percentage points than the level registered in 2003. This evolution was obtained based on a superior dynamics of operational costs, in comparison with the ones of operational incomes.



**Figure no. 7 Evolution of the appreciation indicators of banking activity (%)**

Source: BankScope

The competition in banking industry became more intense, this being determined by the continuous unsettlements and opening of the international markets, of the acceleration of regionalism and globalization but also the fastest development of online- banking services. So, a great number of banks entered in countries that presented an increased development potential. The stringent concurrency led to the diminishing of the net ratio of the interest, these reaching the most reduced level, decreasing from 1,83% in 2003, to 1,03% in 2007, and created the premises of development of purchasing and mergers from banking industry. In 2007 the market was taken-over by Royal Bank of Scotland, Santander Bank and Fortis of ABN Amro, this taking- over being the greatest transaction from banking industry.

Record incomes that have been registered by banks in years 2002-2006<sup>15</sup> contributed positively to the increase of the capital and strengthen of the solvency ratio. Despite these favorable evolutions, the financial crisis led to significant diminishing of the bank's profitability, in 2007, the profit of the first 20 from global level, diminished

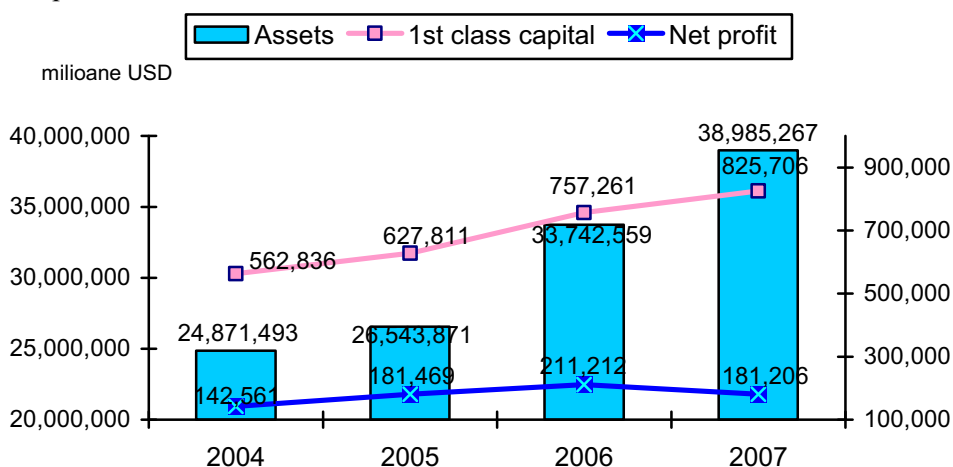
<sup>13</sup> Financial Times – Subprime fall-out

<sup>14</sup> Calculus are realized based on financial results published by the best 20 banks in the world

<sup>15</sup> Calculs are realized based on financial results published b the best 20 banks in the world .



with 14,20% in comparison with 2006, and 1<sup>st</sup> class capital increased with only 9,03%, in comparison with an increase of about 21 % in 2006.



**Figure no. 8 Evolution of assets, 1<sup>st</sup> class capital and profit for the first 20 banks**

Source: *BankScope*

The financial crisis affected visibly the main banks from the United States, but also from Europe. Even banks recognized for risk's management based on highest standards had to suffer. Analyzing financial results of the first 20 banks in the world we can highlight the aspects and tendencies that manifested. So, one of the greatest financial groups at global level, Citigroup had the lowest level of ROE and ROA from the 20 banks. This was caused, mainly, by substantial loss from mortgage credits<sup>16</sup>. Also, rates of law profitability have been registered by Société Générale, being due to losses, of 5 milliards euros, caused by own trader. Concerning the European banks, there should be underlined the evolution of the Spanish bank Santander Bank, the indication of appreciation of profitableness of assets, capital, as well as the efficiency of costs having the best level. This evolution has been determined by internal factors as well as by external factors. Concerning internal factors, must be underlined the fact that, as a result of purchasing ABN Amro, Santander took over its operations in Latin America, so Banco Real from Brazil was being administered by the Spanish bank, contributing to increase of the profit. The second feature, as a result of the politics of the surveillance authority in Spain, Santander Bank was not exposed on the market of mortgage credits. From the measures of the authorities, must be underlined the dynamic system of making up provisions. So, in conditions of accelerated increase of credits portfolios, banks need to made up some increased provisions to be used in conditions of damaging credits, the procedure being seen as a correction of credits portfolios, which will not allow the apparition of some excessive profits in conditions of economic boom. Another measure, contrary to provisions Basel I, would be balancing, depending on risk degree of the extra – balance elements.

<sup>16</sup> Losses will raise, in cofnornity with Bloomberg, at a level of 55,1 milliards dollars at 20 August 2008

It must be pointed out the evolution of banks from China, ICBC and China Construction Bank, which have the lowest level of efficiency of expenses, 36,36% and 39,63%, but also indicators of appreciation of profitableness which are superior to the other banks, this tendency reflecting the capacity of banks from emergent countries to generate increasing incomes. Even if it is difficult to quantify the entire impact that the crisis subprime had on banks it is very clear the fact that we will assist at structural modifications in the modality in which these will evaluate risks. Banks starting this process earlier will have a competitive advantage in front of competitors. We believe that the main measures that must be taken by banks are the following:

- ✓ reevaluation of risks. On short term, banks must evaluate with a higher accuracy the exposition of credits' portfolios. For this, they will have to develop sceneries of stress-test. Also, banks should adopt risk's management patterns that will allow them, not only to measure, but also to detect the potential impact of the operational risk;
- ✓ improvement of transparency. For instance, banks and investors should not be based on ratings of the agencies. They should integrate qualitative aspects in management of risks, meanwhile, quantitative patterns proved to be insufficient;
- ✓ a more efficient assignation of capital. The increased cost of capital will force banks to manage, more efficiently these resources, in conformity with Basel II agreement and autochthon regulations;
- ✓ the development of some patterns for more precise appreciation of the credit's price. The price of credits should include, besides the cost of the capital, the risk bonus for liquidity risk.;
- ✓ renewal of the strategies regarding management of residual credits. The experience showed that recovery of residual credits might increase with up to 15% in conditions of improvement of techniques and processes;
- ✓ banks should be prepared for a more strict regulation. The consequences of the financial crisis have created the premises for authorities to supervise and introduce new regulations.

Unlike banks in developed economies which faced numerous financial problems, the bank sector of emergent economies, was performing over expectations. In conformity with The Banker, Asiatic banks posses 19% from the profit of the first 1000 banks, registering an increase of 7 percentage points, meanwhile banks from Latin America reached a balance of 4% in 2007, from 2% in 2006. In this ascendant evolution have been registered banks from Romania which continues to register record profits from one year to another.

#### **4. Conclusion**

The financial liberation which manifested for 20 years (faster or less faster in different countries) materialized mainly in: the acceleration of the financial innovations, high non-regulation, financial globalization, expansion of the capital markets reflecting a trend of non-intermediation. The financial system becomes, then more efficient as a direct result of globalization and innovation, but not necessarily more capable to absorb the shocks. Concerning the regulation authorities these must stay vigilant and flexible, to elaborate, in this purpose models which have to surprise and correct the unfavorable dynamic of the economic cycles.

The international financial connexions, the new financial products and the more ample distribution of the risk also increased the interconnection degree on an international level of the financial markets. Thus, the financial systems are more

exposed to risks, because of the possible contagion. Due to this, the skeptics expressed their concern related to the stability of financial integration on world level, considered as potential destabilizing of the world economy. There is also the contrary opinion according to which the globalization would reduce the risks with which it confronts the global economy.

*The Report of Financial Stability of the Bank of England*, published on the 23<sup>rd</sup> of October 2007, sustains that the actual financial crisis could not be solved rapidly and without costs. The loans to the sub prime debtors of the USA generated big losses, and the lack of information concerning the bank exposure to global risks determined the effective closing of the market for guaranteed titles with actives and loans with guarantees. In report, it is recognized that both banks and the regulation and supervision institutions need plans to cope with the problems that such banking systems present. The supervisors must assure themselves that banks have adequate liquidity for the type of developed activity. More, the Basel II regulations concerning the banking capital, which demand a bigger exposure of the banks, could contribute to the increase of transparency, thus reducing the tendency to keep the very extreme risk actives outside the bookkeeping balances of the banks.

In our opinion, the conditions of financial fragility should persist for a while, and the system will be vulnerable in front of new shocks.

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