MUTATIONS IN THE INVESTMENTS' STRUCTURE OF THE BANK OF ROMANIA IN THE YEARS 2009-2010: NEW WAYS OF ACTION

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Abstract: The paper outlines the changes in the investments' structure of credit institutions in our country lately, as a consequence of the international financial crisis, and guidelines for investment in debt and equity capital for banking institutions. It found, however, aspects of the effects of bank involvement in securities activities, and potential conflicts of interest resulting from such activity.

JEL classification: G01, G11, G21;

Key words: commercial banks, investment banking, non-government credit, government credit, securities, financial instruments

Introduction

The main operations that commercial banks realize their most mobilized resources are represented by investment operations, resulting in lending and purchase transactions of securities. Analysis of the loans extended by commercial banks in Romania highlights the contribution of the banking system and real economy to cover the consumption needs of the population.

Credit market development is not a simple problem: it requires, above all, attracting the necessary resources, which in turn is conditioned by the growth of population and economic income, saving behavior and their fruition.

In structure, domestic credit to the two components, Non-government Credit (awarded to companies and households) and Government Credit (awarded to public administrations) recorded an increase from year to year in the period before the international financial crisis, due solely to non-government loans.

Uncertainties induced by the global crisis had occurred, mutations in Romanian credit institutions' balance sheet structure, from the last months of 2008, when the volume of credit to the private sector has substantially reduced the growth rate in favor of government securities.

Placement in securities plays an important role in the management of bank assets, using funds available and providing the necessary liquid assets the bank at a time, by conducting sale and purchase transactions in the market. Thus, investment in securities and bank portfolio diversification contributes to its protection against financial risk. At the same time, encouraging the sale and purchase of treasury bills by central bank through the discount offers made by the bank of the open market (open market), is one of the monetary and credit policies commonly used in current conditions.

The advantages of investment in securities are:

- they bear either as dividend income or as interest;
- provide a greater security and profitability;
- through them, the bank uses all funds raised;
- can be pledged to the bank at times difficult to obtain loans;
- provide the necessary liquidity through a bank to maturity securities perfect correlation with the bank's liquidity needs;
- government bonds issued by the Ministry of Finance and securities issued by institutions guaranteed by foreign governments that are devoid of risk;
- securities portfolio diversification reduces risk.

The evolution of investment banking in Romania during 2009-2010

To give a suggestive picture of the credit market in Romania, it seems useful to show the Total Domestic Loan growth, its components: Non-government Credit and Government Credit, and comparison between it and the Gross Domestic Product - both indicators are expressed in comparable prices, for the period 2008-June 2010, according to data provided by B.N.R. (Table no. 1)

Table no. 1. Domestic Credit in the period 2008 - 2010

- mil. lei -

Year	Total	Non-government Credit	Government Credit	Report Domestic Credit / GDP (%)
2008	2.276.892	2.138.710,4	138.181	22,13
2009	2.855.436	2.411.090	444.346	17,20
2010*	1.521.438	1.212.099,6	309.338	-

** until June*

Source: NBR Monthly Bulletins processing in the period 2008 - July 2010

Datas presented in the table. 1. reveal that in our country, during the period 2008 - June 2010, Total Domestic Credit volume was an increasing trend from year to year, though from the last quarter of 2008 the international financial crisis became evident in the Romanian economy. The explanation is more pronounced increase in the volume of Government Credit in the year 2009 compared to the volume of non-government credit, as seen in the Figure no. 1. In the period under review, the accelerated growth of claims on government was presented to increased demand for loans of the central government (the volume of securities issued by the Ministry of Finance in 2009 was around 65 billions lei, and in the first half of 2010 approximately 21 billion, in addition, the Ministry of Public Finance attracting foreign resources with 3.88 billion on the domestic market).

During 2009, the National Bank of Romania's position creditor of the domestic banking system was strengthened gradually accommodating the increased demand for central bank reserves to banks through the active use of open market operations. Central Bank actions have resulted in improved banking system liquidity by increasing the stock of government securities held by banks. Also, the actual Government Credit growth is a counterpart of contraction in credit to the private sector. The preponderance of total investments at the Central Bank in interbank operations (91 percent at end of

March 2009) was maintained as a feature of recent years due, in particular, minimum reserves requirements.

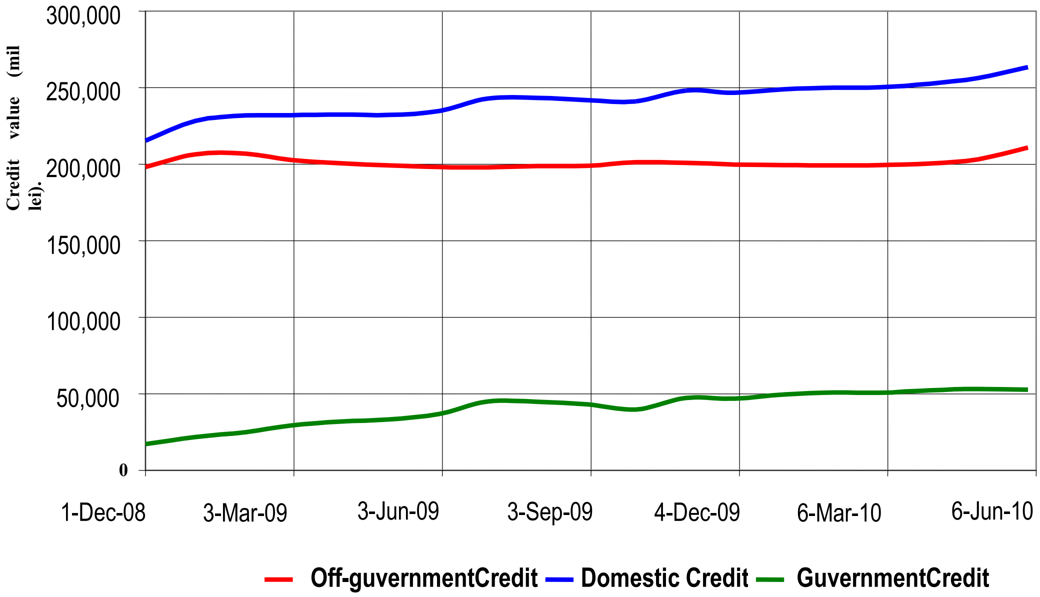

Figure no.1: Variation in Domestic Credit component (Non-government Credit and Governmental Credit) in the period December 2008-June 2010
Data processed from B.N.R Monthly Bulletins in the period 2008-2010

The fact that the domestic market continued to occupy the first position that investment of Romanian credit institutions, the decisive contribution claims was of the domestic bank sector, is revealed by the data in Table no. 2.

Table no. 2. Structure of assets of credit institutions operating in Romania

- percent in total assets -

	Dec 2008	Jun 2009	Dec 2009	Mars 2010	Jun 2010
Domestic assets, of which:	98,5	97,6	96,9	97,1	98,0
Claims on central bank and credit institutions, of which:	23,8	21,5	18,6	15,9	16,2
- Claims on central bank	21,8	19,8	15,7	12,9	13,8
Claims on domestic non-banking sector, of which:	63,4	66,0	67,5	70,4	71,1
- Claims on government sector	5,0	10,3	12,7	14,2	14,1
- Claims on corporations	29,2	27,7	27,3	28,5	28,8
- Claims on households	29,2	28,0	27,5	27,7	28,2
Other assets	11,3	10,1	10,8	10,8	10,7
Foreign assets	1,5	2,4	3,1	2,9	2,0

Source: NBR, cash balance in Financial Stability Report, 2010, page 26

A more detailed analysis based on data from the Central Bank's monthly bulletin, reveals that the annual growth rate of private sector credit in nominal terms, fell from 34.1 percent in December 2008 to 1.4 percent in December 2009, ranking in January 2010 for the first time in the last ten years, landing on a negative (-3.5 percent in January), the evolution being positive but since April 2010 (0.5 percent April and 3.8 percent in June 2010).

The analysis of the real terms of the loan portfolio from the perspective of beneficiaries reveals contraction of loans to households (which correlated with a maximum decline rate of around 6 percent during February to April 2010, a phenomenon observed since April 2009). Loans to non-financial companies recorded a decrease of 4 percent over the same period, noted that the development incorporates the effects of outsourcing operations and subsequent recovery of loans sold. In June 2010, credit is a positive development in this segment.

In terms of size, the two components are substantially the same in total loan portfolio, but a slight advance has the loans portfolios held by individuals. These trends are revealed by chart no. 2.

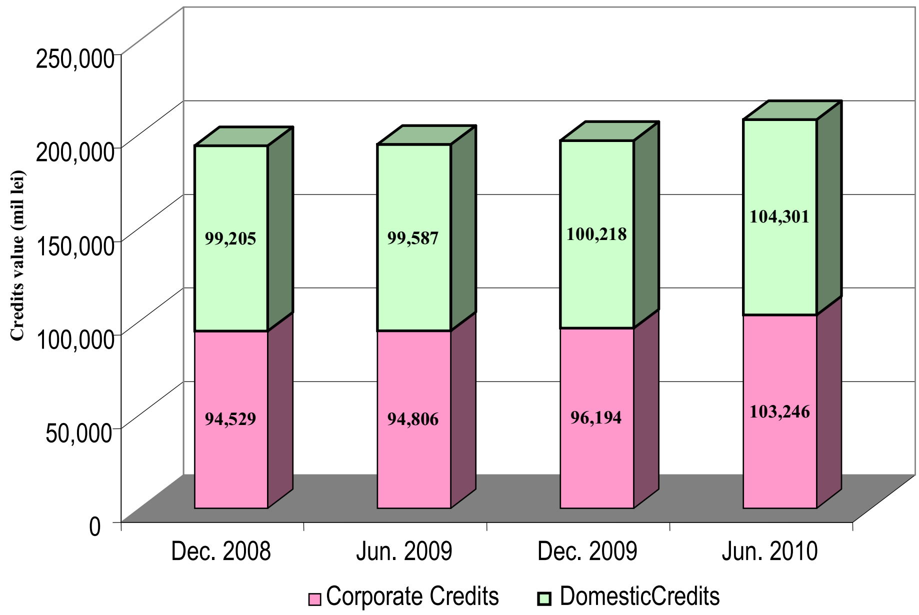

Figure no. 2. Evolution of non-government credit and its components

Data processed from B.N.R Monthly Bulletins in the period 2008-2010

Compression trend rate of growth of loans characterized both components of the private sector - lei and foreign currency, which at the end of March 2010 showed negative annual percentage changes for both components in domestic loans (-5.5 percent population and -4.4 percent for Companies) and foreign currency component of the population (-1.0 percent), a slight improvement in the corporate sector (+2.6 percent), issues highlighted in Figure no. 3.

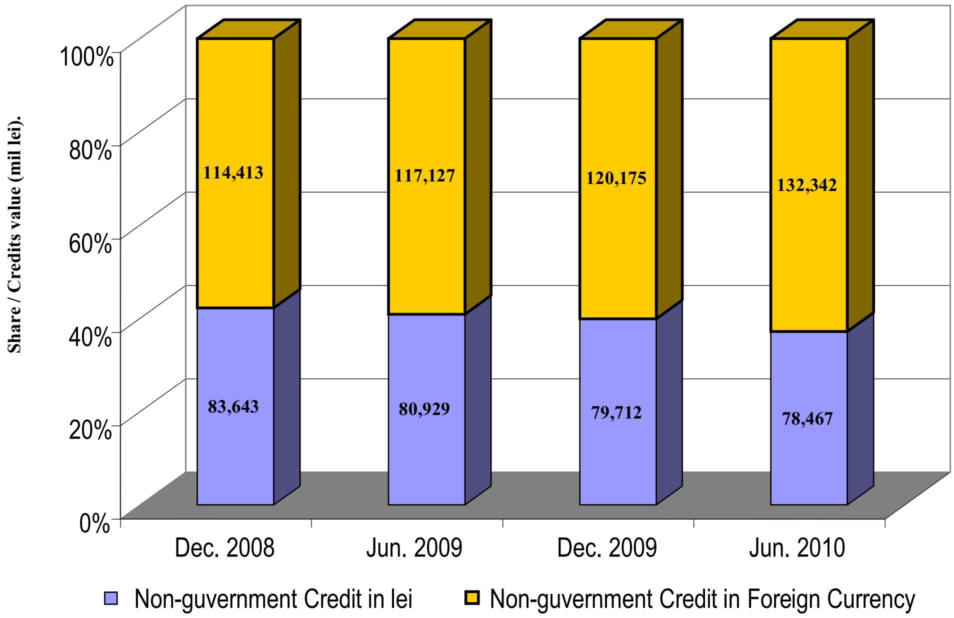

Figure no. 3. Non-government evolution in terms of currency denomination

In terms of maturity (Figure no. 4.), All credit types show negative annual growth rates at end-March 2010, more pronounced for short and medium term loans. In case of long-term credit contraction amplitude was lower.

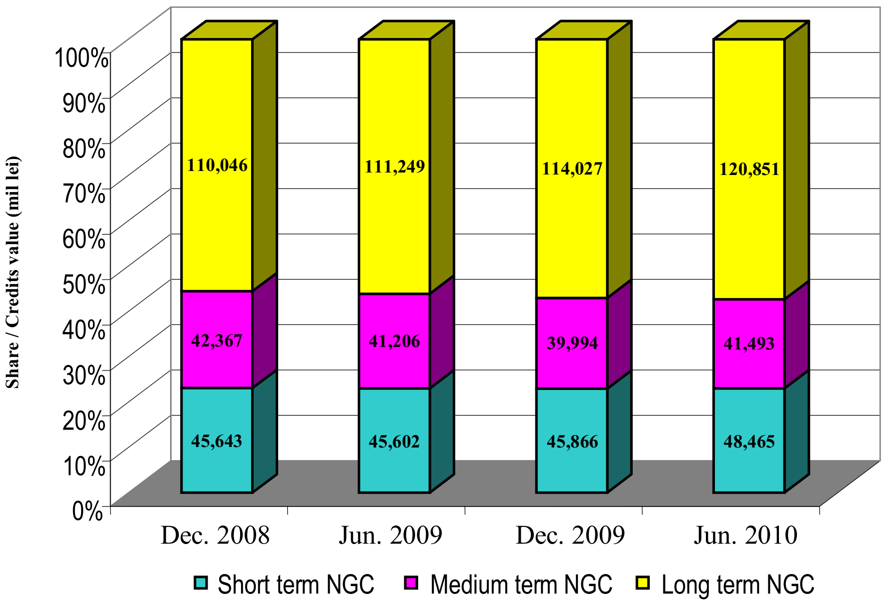

Figure no. 4. Evolution of the non-government maturity

NGC – Non-Governmental Credit

Data processed from B.N.R Monthly Bulletins in the period 2008-2010

In structure, long-term loans held 57.3 percent and short and medium term, 19.7 percent and 23.0 percent of total private sector credit at June 30, 2010. Evolution of long-term foreign currency credit was first supported by higher volume of new loans for real estate in euro (running the "first house" programme) by population and on the other hand, the operations refinance/rescheduling made to improve the ability of companies to meet debt service.

Issues of government bonds were mostly oriented to short-term maturities falling due to the liquidity of the interbank market, but also of high uncertainty on economic growth. Transactions in government securities at the Bucharest Stock Exchange has remained low, however, recorded a time of rising temporary and associated to investor risk aversion.

The deepening downturn in 2009 of economic activity, rising unemployment, tightening standards and credit terms in the context of rising volume of bad loans and the risk associated with guarantees are inhibitory factors that impact on supply and demand of private sector credit.

Interbank deposits, dominated for more than 80 percent of those of the central bank continued downward trend in reducing the level of fund reserve ratio.

Mutations in the dynamics and structure of credit institutions' investments in Romania, in 2009 and the first two quarters of 2010, can be summarized as follows:

- non-government loans tend to stagnate in 2009, despite the stimulating effect of measures taken by the Central Bank (lower minimum reserve requirement ratios applicable in domestic and foreign currency liabilities of domestic and foreign credit institutions, monetary policy interest rate decrease, amend certain provisions of prudential rules). Non-government credit contraction was produced by reducing both of supply and demand for loans. Regarding loan demand, the main factors that contributed to its restrictions were: adverse domestic macroeconomic developments, especially those related to Gross Domestic Product, unemployment and wages; pressures of currency depreciation in early 2009 and the increase in exchange rate volatility, the maintenance cost of borrowing at a high level; increasing population' savings trend.
- after a trend of contraction of credit to the Non-Government sector in most of the period under review, in June of 2010 has been registered a real increase it;
- ability to exercise an effective control over debtors and debt guarantees by centralizing of nonperforming loans;
- extremely low growth of bank assets, mainly due to the restriction of lending (5% in nominal terms in 2009, compared to 26% the previous year). Unlike before, when the increase in bank assets was based on Non-Government Credit growth, in 2009 it brought to the fore a significant increase for government sector exposures. This phenomenon characterize the banking market and is currently a serious challenge for both banks and authorities;
- accelerating the growth rate on government debt amid a sense of risk aversion of banks, but also increase the budget deficit. With sufficient liquidity, banks have preferred to buy government bonds with low risk to improve the quality of asset portfolio;
- the downward trend of banks' deposits at central bank caused by reducing of the reserve fund;
- lower quality loan portfolio, which proved to be more pronounced in 2009 and persists today, mainly due to economic recession. Although bad debts are at a manageable level, their growth is a concern for financial stability. Currently, banks

have sufficient own resources to cover any unexpected losses from credit risk; in addition lack the toxic assets of banks operating in Romania leads to avoid interventions funded with public money.

Based on the results of the analysis of Romanian credit institutions, we consider that the increasing involvement of banks in our country in transactions in securities, both money market and capital market, is not only necessary but also possible, creating synergy effects the following advantages:

- ✓ in terms of efficient allocation of resources, banks have the ability to lower intermediation costs and improve capital allocation. Previously, banks reduce information costs (since there are several debtors, the lower monitoring costs) and resolve the benefit of free information, because loans are not traded, so banks have an incentive to acquire information. Subsequently, direct monitor investments made. On the other hand, banks can use information not available to others in order to extract higher profits from companies;
- ✓ in terms of risk management, banks consider a linearized inter-temporal risk (because investment banks are active in lower risk, while markets investors adjust their portfolios to achieve the higher yields) and perform the management of liquidity risk[2]. On the other hand, the orientation of banks to have projects less risky, makes that financing of innovative ideas (which are more risky) to have suffered[3].

Also, involving of banks in transactions with securities should not be seen at small (only direct funding for the placement of shares and bonds), but large (extended), respectively for an efficient risk management, including as a source of increasing profits.

Thus, given the structural changes occurring in financial markets and different concepts about financial instruments, we believe that banking features (efficient allocation of financial resources in the economy, creating and offering the market for financial instruments for risk management, efficient mechanism payments, including the securities clearing and settlement) warrant inclusion in the scope of titles, alongside the classic among other things, like derivatives.

An argument in support of this idea is a financial innovation process (e.g. conversion of a group which is securitizing assets in illiquid financial instruments traded on the market and credit risk segmentation and transfer risk class), which allowed banks to allocate assets more efficiently structured assets according to risk categories to those who previously had no access to such a wide range of placement availability. Another argument in favor of extending the scope of titles is to consider the development of balance sheet and off-balance sheet of banks evolutions. Items in the second category know most consistent dynamic in the business and bring modern banking revenues increasingly significant.

Placing and bank financing through debt securities and equity securities

The structure of financial intermediation by banks has changed, the role of securities in the balance of these institutions is increasing. On the asset side, until

[2] Diamond, D., Dybvig, P. - "Bank Runs, Deposit Insurance, and Liquidity", Journal of Political Economy 91 (3), 1983, pag. 401-419

[3] Weinstein, D., Yafeh, Y. - "On the Costs of a Bank-Centered Financial System: Evidence from the Changing Main Bank Relations in Japan", Journal of Financial Economics, 1998, pag. 532-635

recently, banks have channeled resources mainly to loans and deposits and cash holdings.

Today there is a tendency to modify the structure of bank liquidity, with earnings for the better. Thus, liquidity in the form of cash and deposits is offset by the increase of the share placement in securities or loans (which may be liquidized through the process of securitization). For example, in countries that have experienced the most dramatic reduction in the share holdings of cash and deposits (France and Britain), was identified also the largest increase in investment in debt securities (bonds), equities (shares) or loans.

The share of having cumulate securities (shares, bonds, the OPC) rose in all developed countries (in structure, debt securities are preferred instead of shares). This shows that banks have acquired quality of first players first in segment of claim titles (they are titles net buyers), the offer was less developed.

The increase in bank financing through money market securities or capital generates two challenges for bank management.

First, it can be an increase of interest rate and liquidity risks since: demand from investors for such securities is much more cyclical than for demand deposits; increased dependence on financing by interest rate developments. In the event that capital market yields are rising, the cost of bank resources by attracting increased more than deposits for financing. Similarly, low interest rates allow a reduction in deposits faster than pay for securities.

Second, financing through market instruments implies that the share of bank lenders with expertise in monitoring bank that funds be increased. As a consequence, in the event of problems with that bank, the negative reaction from these lenders will be much faster and broader than in the case of depositors. However, the cost of financing could increase especially for small banks and those with higher risk profile.

An analysis of the reality of the plan's holdings of securities by banks reveals the following aspects:

- involvement in possession of evidence is the prerogative of large banks in particular;
- for large banks has been some uniformity in the distribution of investment in securities;
- there are large banks that placed nearly 65% of the total debt balance sheet asset (the maximum level has been rising in recent years, until international financial crisis, which meant that there were large banks believe it is more efficient to increase exposure in this direction);
- volatility in the securities placement has come to be superior for large banks, which could reflect the fact that large banks are not only the most important players on the securities market, but also the most dynamic and flexible portfolio restructuring;
- large banks, in particular, invest in the securities trading book (i.e. short term), while medium and small banks are using their resources for the purchase of securities issued by central and local authorities.

The most spectacular developments on bank investment securities are recorded on the off-balance-sheet, namely the derivative section. Banks' holdings of such securities have been in seven years (2000-2006) more dynamic than the aggregate banking assets in the last 35 years.

For the case of euro area, banks are active in the area of protection buyers, while regional banks are acting to protect sellers. Many of these banks have been especially motivated more attractive yield credit derivatives and portfolio diversification opportunities offered.

Specifically, the credit derivatives market has an important and increasing role that allows banks to be exposed to large and very large companies; otherwise that exposure would not have done it, either because of difficulties meeting the additional requirements capital, either because of limitations in the existing prudential banking regulations relating to a single debtor.

It becomes increasingly obvious that the analysis of use bank holdings of securities and therefore of management must focus more also to off-balance sheet side. Unlike the balance sheet features of securities, the main purposes for which banks have used derivatives is hedging and less satisfying liquidity requirements.

Also, by offering customers the instruments for hedging risk, banks can get a double benefit, as follows: market value of those companies will increase, and the probability of default is reduced, with positive effects on bank capital requirements and the quality of its portfolio customers; the bank will receive income in return for offering such products. These incomes (excluding interest) are particularly important because they are less correlated with the evolution of interest rate volatility and with favorable effects on profitability and revenue stability.

Effects of bank involvement in securities activities

Bank involvement in securities operations changes:

- risk profile of financial institutions and the way in which management must be done;
- relationships with customers;
- balance sheet and off-balance sheet structure;
- income structure.

These changes determine positive effects, but also possible conflicts of interest and challenges that banks must pass. We believe that in terms of a quality management, bank involvement in securities activity leads to positive effects outweigh the costs and risks. The main identified positive effects on bank involvement in securities activities are:

- development of enduring and long-term relationships with business. A universal bank can be seen as a horizontal merger between a commercial bank and investment bank. In this situation, the cost of a company that supports it to change the bank will increase[4].
- possibility of diversifying risk. A universal bank effecting transactions in securities and may be more stable than a specialized bank, due to the effect of income diversification;
- obtaining a synergistic effect with conventional banking activities through the following channels[5]:
  - ✓ use existing distribution network to offer securities operations for clients;

[4] Rajan, R., „The Entry of Commercial Banks into the SecuritieBusiness: A Selective Survey of Theories and Evidence", Conference on Universal Banking, February 1995, pag. 91

[5] Santos, J., „Commercial Banks in the Securities Business: A Review", Bank for International Settlements Working Paper No. 56, 1998

✓ changes in demand for our products is more manageable because the banks may respond by shifting resources available;

✓ You can use already gained a reputation for traditional banking transactions, for transferring to securities transactions;

✓ consumers may be more willing to purchase a product package from a single vendor than separate products from different banks that can reduce the costs of search and monitoring of the most attractive offer.

- by extending the scope of services, the bank has many instruments available to meet the funding act, while exerting a stronger monitoring of the management company debt;
- deleveraging process will affect more than one bank is involved in securities operations;
- innovative activity is stimulated. This tendency is very strong, but the risk is that the best innovations are immediately copied by the market. However, banks still have an incentive to offer new products that innovators do not win by charging higher prices than those of the imitators of services and products, but by holding a higher market share allows the development of a turnover higher.

On the other hand, bank involvement in securities activities may generate conflicts of interest for several reasons. The bank may:

- promote its titles to customers who subscribed to them for resale, although the market can offer better potions;
- includes in its portfolio securities funds which it manages, but failed to sell;
- to pressure customers to acquire services on which the bank provides securities;
- to pressure a customer, in a delicate financial situation of the bank, to issue securities to subscribe to and resell them to the public. In this way, the company obtain the funds necessary to pay obligations to the bank;
- use confidential information it acquires in the process of underwriting securities companies.

Conclusions

Bank involvement in securities operations, in my view, produces a number of challenges, among which the most important are the following:

- increase in debt placement determines an increase of the elements that are valued at market, in most cases even daily. The effect is increased volatility in asset values and asset off-balance-sheet items considered equivalent, with immediate implications on the volatility of capital. They can gain a stronger pro-cyclical (and this is one of the factors that have boosted the international financial crisis of 2007-2008) because the value of securities in most cases even anticipated economic and financial developments. Under these conditions, monitoring developments in the market prices or values derived from models will increase in importance because the capital will change much broader and often. It may be necessary also a greater safety net of capital to do not fall below the threshold is covered. However, increased funding through securities induces a higher risk of liquidity and interest rate, a more aggressive negative reaction if the bank is in trouble and a higher cost of funding for certain banks;
- identification as a fair value of securities or a service cost of this class will prove an increasingly difficult task due to the increasing complexity of transactions and instruments. Internal models used both for risk management based on current

transactions in securities and capital adequacy could not get validation of supervisory authority, or, at worst, of the market. Furthermore, after a certain threshold of complexity, it is likely that bank's management or specialized departments would no longer understand to use, monitor and evaluate them in an appropriate manner (as has happened in the years leading international financial crisis August 2007);

- the risk profile of banks changes in transactions involving securities. Specifically, credit risk, market risk, systemic risk and the risk of revenue volatility increases (otherwise, the current international financial crisis has demonstrated once again that fact). The risk of contagion no longer be limited especially in the interbank market, but extends to the capital. In this sense, the risk of capital flight and sharp fall in quotes prices is material that should be monitored more widely in the management of modern banking..

In our opinion, these changes in structure of risks need to adapt proper banking management and it's very important to avoid crises like the one that currently exist, so that history does not repeat itself.

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