THE CAPITALIZATION OF BANKS DURING CRISIS

Mihaela RADU, PhD student
Paula GEZA, PhD student
University of Craiova

1. General considerations

The banking sector is one of the most regulated sectors of the entire society, and the rules regarding bank capital represent the most significant weight of this regulation. This banking system self-importance is because banks are actually intermediaries on the financial market and so they have a reduced expenditure of their own resources.

Bank capital plays an important role starting with bank formation and following with the operation period to liquidation. Theoretically, the bank capital is paying several functions:

- It protects the deponents from an eventual insolvency and bank liquidation.
- It absorbs unanticipated lost to maintain trust, so that bank could continue its activity even under stress.
- It serves to the acquisitions of buildings and equipments for the pursuance of the work.
- It serves as an imposed limit for unwarranted expansion of assets.

The main function of a bank is to transmit safety and stability to the people and to the authorities. In order to meet capital needs, the bank management must take into account the next elements:

- Regulations on bank capital.
- Possibilities of increasing bank capital.

Capital adequacy, as a measure of restriction imposed to banks, is the main concern of the regulators; a banking system consisting of highly capitalized banks is more easily able to overcome various internal obstacles. The agreement from Basel I establishes the principles of the adequacy system upon which are implemented significant elements:

- The minimum capital requirements are related to credit risk depending on the structure of bank assets. As the loan is more risky, much higher become the capital requirement;
- Shareholders contribution is considered the most important type of capital, consequently, bank must attend a mandatory minimum rate, depending on the degree of risk;
- Minimum total capital requirements are set at 8% of total risk-weighted assets;
- Extra balance risk operations is included in calculating the credit equivalent conversion of specific commitments;
- Capital requirements were almost standardized between countries which removes the competitive advantages that banks in a country could have on banks in other countries according to regulations or different accounting systems.

Basel agreement determines based on the principle elements a scale of differences in assets depending on the degree of risk that underlies adequacy calculations.

Cooke norm which became operational since 1992 establishes a direct correlation between the level of bank capital and the volume of the weighted assets.

National Bank of Romania (NBR) 8/1999’s norm establishes the supervision by the central bank of both solvency and large exposures and loans

to persons in special relationship with the bank. Banks are required to report monthly the solvency level indicators through some special form.

Minimum limit of the indicator of solvency, calculated as the ratio between the level of its own funds and the net exposure is 12% and minimum limit of the indicator of solvency calculated as the ratio between level its own capital and net exposure will be 8%. According to the same rule, the level of a big exposure may not exceed 20 percent of the bank's own funds and the total amount of large exposures shall not exceed eight times the bank's own funds.

Capital growth is a central concern of the banks, in order to be placed in the provisions of the Basel Agreement. Thus, banks are likely to encounter high cost of the capital or may resort to measures of raising additional capital involving lower costs. A bank may act by one of the following three ways to comply with rule COOKE if it is fewer than 8 percent:

- The capital increase until the appropriate level which can be done by issuing additional shares, distribution of the profit for the benefit of the bank and less to shareholders or through operations more complicated and mergers with banks better funded;
- Diminishing asset in the context of balance sheet shrinkage, but maintaining constant own funds;
- Changing the asset structure in the context of a constant balance.

The harmonization of European legislation in the banking sector came as a necessity in order to create a single European market. In the field of bank solvency within the European Union, two Directives were approved:
-Directiva "Fondurilor proprii "("Own funds" directive) OFN 89/299/EEC from 1989; - Directiva "Ratei de solvabilitate"(Directive "solvency ratio") SRD 89/647/EEC from 1989. First Directive introduces the concept of harmonization of solvency supervision, based on a minimum solvency ratio of 8%, resulting by the calculation of a similar report of NBR Norm applied on 8 /1999, except that the minimum acceptable level of NBR for this indicator is 12%.

The new agreement on the capital, known as Basel II, is structured on three pillars:

- Requirements on minimum capital; the calculation of minimum capital remains like the old agreement, with the difference that has been introduced and the capital requirement on operational risk;
- Prudential supervision is focusing on the need for the supervisor to ensure that any bank dispose of the internal processes to assess the degree to which capital adequacy is properly insured;
- Market discipline.

The third pillar refers to the discipline of market that can be achieved in particular by increasing the transparency activity of each bank by publishing all the information on the activity of the banks.

Remarkable development of the banking sector in recent decades, globalization phenomenon, increased volatility of macroeconomic indicators, and the emergence of new financial instruments on the money market trading have made that the risks faced currently by the banks to impose new regulations on capital adequacy. Especially in the context of current crisis, when banks were faced with an acute shortage of liquidity and with an accelerated growth of outstanding loans, we believe that capital adequacy is a priority for international regulators.

2. The agreement Basel II and the capitalization of the banks

Basel II contains recommendations for minimum capital adequacy of the banks, the idea of creating a more stable international

banking system by maintaining a uniform regulatory system.

We believe that this agreement strengthens the significance of internal capital planning and gives to the banks the opportunity to establish a strategy to maintain capital in the level of the risk.

Although implementation of Basel II has meant strengthening international banking system, an obvious question arises after the implementation of this agreement: once with the onset of financial crisis, why was the banking system badly shaken?

Why weren't the banks ready? Why it was necessary to be recapitalized the banks after the onset of the crisis? These are questions to which we will try to answer below.

Basel II implementation has become mandatory in the European Union since January 1, 2007, and in Romania banks were required to apply this regulation from January 1, 2008.

Basel II supporters believe that the agreement has improved awareness of risks from financial institutions and, in general, practices used in banking industry.

If no deadline had approached for the mandatory implementation of Basel II requirements, the current crisis in the financial sector would have surprised the big banks on a weaker position.

3. Why it was necessary to be recapitalized the banks, after the onset of the crisis? Why were not prepared?

Both American and European banks were forced to increase their capital in the past year, and in 2010 it is likely to be continued the capitalization of the banks, regulators of the banking system putting a major emphasis on this aspect.

What we notice is that the European banks proved more resistance to recession than U.S. banks. According to the stress tests conducted last year on the largest banks in the European Union, it seems that European banks could withstand a recession even more severe than this one, although it recorded losses of 400 billion euros. Taking into account the economic assumptions of European officials for 2010, the largest banks in the region will maintain their percentage of the rank I capital…..(basic capital) to over 9% of the total assets, given that the Basel II standard allows un minimum percentage of 4%. In terms of economic damage, the rapport would drop to 8%. The stress test lasted five months and was made to the proposal of the finance ministers from the European Union countries, after U.S. banks went through a similar test. Its results revealed that European banks are properly capitalized.

If in some cases most capital were made with help from parent banks, in other cases, state intervention was necessary.

In Romanian banking system, the Romanian National Bank through the Supervision Department, required in many cases of banks in the Romanian banking system to increase the capital, recommending to some of them a minimum solvency over 10% and not 8%, the normally recommended value. Since the end of 2008, the central bank required the increase of capital in case of some banks with a market share under 1%, because their solvency was fallen too fast or has reached a worrying level.

In 2009, seven Romanian banks increased their capital. The most money from home was of Bancpost, Transilvania Bank and CEC shareholders. Beside these, Libra Bank, MKB Romexterra, Marfin Bank and Piraeus increased their capital too in 2009[1].

CEC Bank increased its capital last year with 230 million lei by an order of the Public Finance. CEC Bank Capitalization was part of the anti-crisis measures program initiated by the Government.

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[1] www.ziare.com

Carpatica Bank also ended 2009 with an increase of the capital after which it managed to raise 26, 82 million lei, after shareholders subscribed for 96% of newly issued titles in connection with an operation needed to ensure a better resistance to macroeconomic and systemic shocks.[2]

In 2010 too, the Romanian banks started their activity with new capital increases, two of the credit institutions, Alpha Bank and Volksbank, announcing that they will receive 300 million euro from shareholders. Money will be used mainly for loans[3].

At European level, major banking groups had a similar behavior concerning the capital increases.

Thus, the Eastern European subsidiaries of the Italian bank, Unicredit, have received in 2009 approximately 432, 4 million euro from European Bank for Reconstruction and Development[4]. This is definitely the biggest injection of capital of EBRD during the economic crisis. According to ERBD representatives, money was intended to alleviate the impact of global crisis on Eastern Europe by providing long and medium term loans.

In his turn, the Italian group, Unicredit, has increased with two billion euro the capital of Bank Austria, consolidating the division controlling the most of assets owned by the Italian group on emerging markets from Europe. Bank Austria has announced that the capital infusion of two billion euro was approved at shareholders' meeting in March last year. UniCredit had announced last year the capital increase when it made public the decision to fund from the market without resorting to state aid from the governments of Italy or Austria. Unicredit controls through Bank Austria, most of the operations from emerging Europe, including from Romania. The amount comes from the funds of four billion obtained by UniCredit from an equity issue.

Erste Bank, the majority shareholder of BCR and Raiffeisen has received capital injection from Austrian government and also, support to attract liquidities.

In their turn, great Greek groups – Alpha Bank, NBG, Eurobank or Piraeus turned to the support plan offered by state, which came in as their shareholders. The international giants, such as ING, RBS or Citi, which are present on the local market, have also received significant capital injection from governments, after they have experienced huge losses.

Including Societe Generale has turned to state aid, receiving 3, 4 billion euro in December 2008 and May 2009, the State purchasing a part of the shares. But, at the end of last year, it has announced his intention to pay the Loan from State, by increasing the capital with 4,8 billion euro.[5]

No doubt that U.S. banks were the worst shaken by the crisis. The collapse of one of the biggest U.S. investment banks, Lehman Brothers, followed by hundreds of other failures of U.S. banks have strongly shaken the American financial system, and also on the world. Since the beginning of the crisis, the American state has funded the banking system with hundred billion dollars. Stress tests conducted last year by Federal Reserve and American Treasury have prompted authorities to ask several banks to increase its capital either through a securities issue, or by converting some types of securities into simple shares.

Bank of America was forced to increase its capital with 10 billion dollars even it tried to convince the American government that it doesn't need supplementary money[6].

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[2] www.ziare.com
[3] www.ziare.com
[4] www.unicredit-tiriac.ro
[5] www.brd.ro
[6] www.ziare.com

Citigroup has also negotiated a capital increase with Federal Reserve. Like the other big U.S. banks which were evaluated by the American central bank, Citigroup has tried to convince the regulatory authority that it would need a smaller capital increase.

We can notice that American banks have harder realized the importance of capitalization, although they were most affected by the crisis.

Stress tests will continue in 2010 for resistance to economic conditions deterioration of the banking system to be somewhat supervised by the banking supervisory authorities. This measure is especially necessary in the current conjuncture, when we can notice the increase tendency of the outstanding loans, which will force banks to increase its capitals again to continue its activity.

4. Perspectives: Basel III?

Considering that the financial crisis experience has proved the importance of the bank capitalization, regulatory authorities plan to force banks to implement more strict capital rules.

Committee on Banking Supervision in Basel, which is composed of central banks and regulatory authorities from almost 30 countries, has established a set of strict financial regulations, in response to the credit crunch. The new set of measures strengthens the system of rules and supervision from banking industry and is designed to significantly reduce the probability and severity of economic and financial instabilities. Banks will be asked to raise both the level and quality of capital to new heights, but in a manner which will promote stability of national banking systems. The imposition of some bigger obligatory minimum reserves for banks can help to avoid collapses such those occurred a year and a half ago which led to precipitate crisis and massive support from the part of the state in several great economies.

Committee will maintain a plan of gradual implementation of these rules starting with 2012, but it will give banks a transition period to support them to perform it. The measures will be detailed until the end of 2010 and implemented in a testing period.

By implementing the new capital rules, which certainly will be more stringent because of the difficulties that have faced banks during crisis, regulatory authorities intend to strengthen solidarity of banks, and the banking system to be ready for a possible worsening of economic conditions. But, we consider as crucial for banks to comply with the new reforms regarding the increases of capital reserves, especially the experiences of autumn 2008 showed that not in all cases it has complied with the Basel II provisions regarding the capitalization.

5. Conclusions

The experience of current crisis has proved that banks which were properly capitalized in relation to risk level managed to end 2009 in terms of profitability. Worsening conditions and the substantial increase of recorded outstanding loans were certainly factors that put banks in the position to have significant losses. But the banks that have respected the Basel II provisions concerning the capital adequacy, could better manage these loses having necessary resources.

The capital increases which we have seen since the crisis started were requested, in many cases, by regulatory authorities. The control of banks capitalization has become one of the priorities of the regulatory authorities, and so capital rules will become increasingly stringent, and their compliance will be closely monitored, which may lead us to think of a banking system consolidation, banks being prepared to a possible worsening of economic conditions in the future.

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