Prudential Indicators of Romanian Commercial Banks

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Abstract: *Economic and financial crisis of the last decade has affected the entire global financial system. Emerged from the need for financial reform, Basel III is the proposal of the Supervisory Committee of the Bank for International Settlements on the development of micro and macro prudential supervisory framework for risk management and avoidance of shocks' propagation within banking systems. This paper aims to develop an overview of the main provisions of Basel III and assesses the current state of implementation of Basel III Agreement in Romania. Evaluation is performed using analysis of key prudential indicators of the banking sector in Romania.*

Keywords: balance sheet, profit and loss account, financial regulations, central supervision authority

JEL Classification: G21

1. Introduction

Accounting, as a means of representing economic reality is the one that "allows the production and dissemination of information for decision-making" (Ionaşcu, 2003, p. 36). Financial and accounting information, as a starting point in analyzing business performance and future orientations of activities, is of interest for many users: managers, shareholders, third parties, potential investors, analysts and financial advisors, employees and unions, state, regulators and researchers, and public (J.-F. Casta, 1997, pp. 540-543).
For banks and credit institutions, analysis of information within the annual financial statements is of great interest for the central supervisory authority as a central actor of the banking system. Financial indicators resulting from analysis of balance sheet, profit and loss accounts and other annual financial statements are constantly observed by central supervising authorities, in order be aware and to limit potential risks commercial banks might be faced with, but also to prevent spread of these risks within the entire banking system.

Following adoption of Basel III Agreement, Romania has committed to implement a banking system reform, imposed by the new regulations introduced throughout this agreement. Provisions of Basel III Agreement started implementing gradually since 2011, with expectations to complete this process by the end of 2019. This reform involves adopting a more cautious behavior of credit institutions on national and international financial markets and limiting total exposures. As an enhanced version of Basel II, Basel III aims to reform the entire global financial system in order to prevent future banking crises and to develop a series of defense instruments for addressing potential banking crises.

2. Basel III Agreement

Adoption of Basel III by the G20 in 2010 marked the beginning of a global financial reform aimed to create "A Global Framework for Regulating Banks and banking system more robust" and "International framework for measurement, standardization and monitoring liquidity risk". This new agreement is tightening micro prudential regulations and supervision of financial systems, in terms of capital adequacy and liquidity. Also, Basel III Agreement introduced macro prudential regulations in order to limit systemic risk.

Basel III Agreement is based on three pillars. The first pillar refers to capital requirements, risk coverage and leverage ratio. Regarding capital requirements, it emphasizes the importance of common equity within balance sheets (tier 1). Hence, tier 1 capital required by Basel III needs to stand for at least 4.5% of risk weighted assets. In addition, a 2.5% of total capital must be held in common equity, for medium and long-term capital conservation (named capital conservation buffer). Therefore, regulations introduced by this agreement require common equity to represent at least 7% of total equity. In terms of external financing instruments, Basel III Agreement introduces a clause that allows write-off or conversion of such financial instruments into common shares, by relevant authorities. Basically, consequence of these new regulations are involving the private sector in addressing potential financial crises.

In addition to these regulations, the agreement also proposes that supervisory authority can set up a new capital requirement, in case of detecting excessive credit growth, which can cause difficulties to the entire banking system. This means that, temporarily, supervisory authority may require credit institutions for additional capital, between 0-2.5% of employed capital, to be represented by common shares - Tier 1. This countercyclical buffer, as it is called, is used according to the evolution of economies - economic growth or economic decline.

Regarding risk coverage, Basel III strengthens conditions in treatment of complex securitization instruments. Thus, this new regulation requires a careful analysis of banks' credit activity due to external exposures. For derivatives and trading assets activities, credit institutions are required to maintain higher capital, as in the case of complex securitization instruments. Regulations referring to risk coverage include credit management related to counterparties. To this end, the agreement proposes revision of credit risk framework, in order to tighten requirements for measuring exposures. In cases of central counterparties, associated commercial exposures will be weighted at 2% risk, while default exposures will be analyzed based on consistent risk estimation methods.

Leverage ratio, as new rules proposed by the Basel III recommend, represents ratio of tier 1 capital and total unadjusted exposures (including off-balance sheet exposures). In this latter sense, tier 1 capital must represent at least 3% of the total exposure. This new means of calculation eliminates shortcomings related to former calculation of leverage ratio, respectively one based on risk-weighted exposures.

With regard to liquidity requirements, Basel III imposes that, on the short term, highly liquid assets must represent at least 100% of net outflows, and, on the long term, needs for stable funding must be covered by stable funding sources, to a minimum 100% extent.

Pillar II of the Basel III Agreement includes additional requirements regarding risk management and supervision (corporate governance). For risk management, rigorous analysis of risks related to off-balance sheet exposures must be conducted, as well as those related to securitization activity and risk concentration. To ensure effective corporate governance it is necessary for incentives to be provided to banks (in order to better manage long-term risks and returns), for accurate compensation and valuation policies to be developed, for risk committees to exist, for stress tests to be conducted and for implementation of accounting standards on financial instruments to be reviewed.

The third pillar aims at establishing additional transparency requirements of accounting reporting. Requirements refer to increasing transparency of reporting detailed regulatory capital elements and reconciliation of these reported accounts, including detailed explanations of how credit institutions calculate regulatory capital ratios.

3. Prudential aggregate indicators of the banking system in Romania

Trends registered within balance sheet and profit and loss accounts have a direct influence on financial performance of credit institutions since its analysis is based on financial indicators extracted from annual financial statements. Based on these considerations, we will detail in the following section of this paper key financial indicators reported by credit institutions in Romania.

In order to o analyze degree of capitalization of Romanian banking system we observed, firstly, developments registered by solvency ratio. This indicator remained at a high level during 2008 - 2014, of over 12%, well exceeding limits imposed by present prudential regulations, respectively 8%. The end of 2013 marked, from this point of view, a positive evolution regarding solvency of banking sector, as this indicator approached the 18% threshold in December 2014.

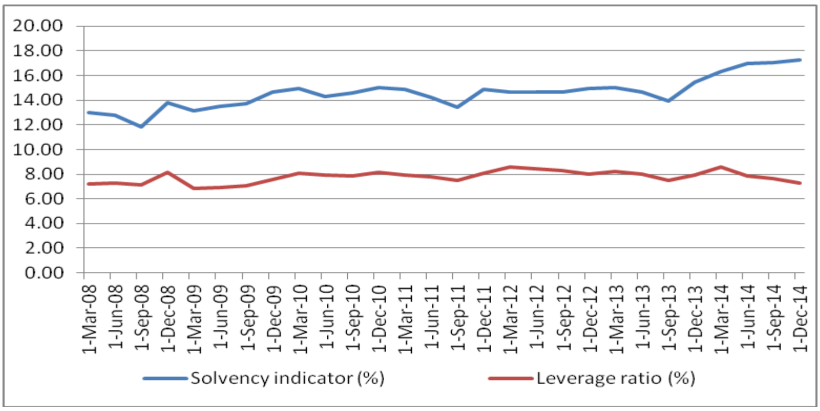

Figure 1 Evolutions of solvency indicator and leverage ratio within Romanian banking system (centralized data).

Source: Authors' own processing based on data collected from NBR.

In order to prevent spread of systemic risk within entire banking system, Basel III requires maintaining leverage ratio at a minimum of 3%. Evolution of this indicator within Romanian banking system indicates compliance with limits imposed by Basel III regulations, as leverage ratio constantly exceeded the 6% threshold in the period under review, and, in some cases (December 2011 to December 2012 , and December 2013 to June 2014), even passed the 8% threshold. Unfavorable evolution of leverage ratio during March-December 2014 was the result of higher growth in average net asset value compared to that of tier 1 capital (ratio refer to these two elements).

Profitability indicators related banking system (ROE, ROA) had an unfavorable evolution since March 2014. Thus, in March both indicators showed positive values, the end of 2014 was marked by negative values of aggregate profitability indicators. Mainly, unfavorable development of profitability indicators was consequence of recording losses within financial system, due to development of spending component -

gap between operating revenues and expenditures of the system has widened. Increase of internal and external financing costs and adjustments in assets values had a significant influence in aggregate operating expenses of the banking system.

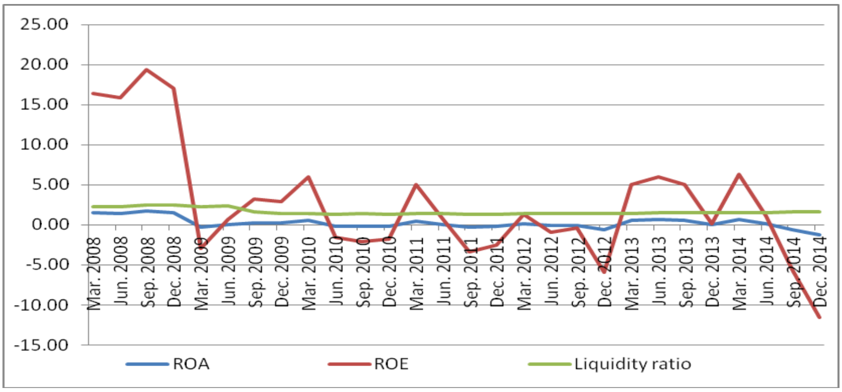

Figure 2 Evolution of profitability indicators and liquidity ratio within Romanian banking system (centralized data).
Source: Authors' own processing based on data collected from NBR.

In terms of liquidity, after adverse developments during the period 2009 -2011, since 2012 liquidity ratio has recorded significant quarterly increases, exceeding 1.6 threshold by end of 2014 (data provided by NBR indicates a value of 1.62 liquidity ratio in December 2014, as an aggregate value). This is due mainly to decreasing credits/deposits aggregate ratio, which dropped below 100% at the end of 2014 (representing 91% in December 2014), given that in previous years, liquidity ratio exceeded 105%.

Following requests of National Bank of Romania, credit institutions have started writing-off non-performing loans from balance sheets. This process was accomplished, in part, by selling non-performing loans to third parties (public, private or public-private syndicates), or, by reflecting these exposures throughout accounts outside balance sheet. Hence, implementation of IFRS accounting standards led to writing-off balance sheets non-performing loans for which there was no reasonable prospect of reclaiming (fully provisioned).

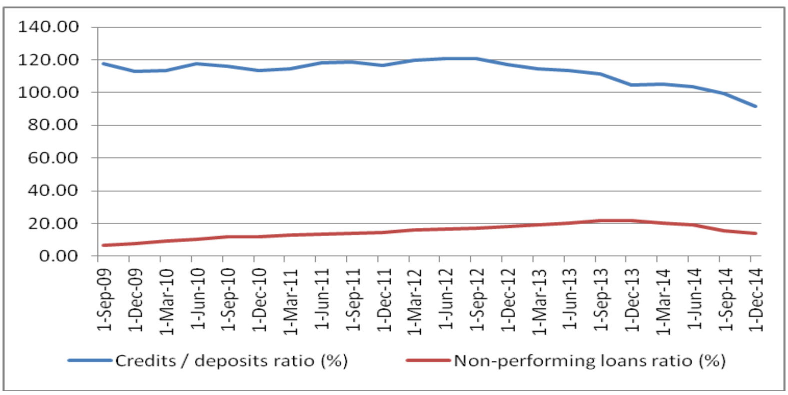

Figure 3 Credit/deposits and non-performing loans ratios within Romanian banking system (centralized data).
Source: Authors' own processing based on data collected from NBR.

Therefore, quality of loan portfolio held by the Romanian banking sector Romania has enhanced in the last two years, as non-performing loans ratio significantly declined during 2014, reaching 13.9% of total loans in December 2014, compared to that of 21.87%, registered in same month of previous year.

4. Conclusions

Romanian banking system is currently a solid one. National Bank of Romania, as competent central authority for prudential supervision, began implementation of Basel III Agreement in order to strengthen stability of the system, but the process is complex and lengthy.

From a prudential perspective, Romanian banking system has recorded favorable developments during the period 2012 - 2104. Aggregate capitalization level of the Romanian banking system was high within reviewed period, as reflected by the increasing solvency ratio of the system, reaching over 17% at the end of 2014. Also, aggregate system liquidity has registered significant improvements, as well as quality of credit portfolio.

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