FINANCIAL INTERMEDIATION AFTER THE FINANCIAL CRISIS

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ABSTRACT: *The purpose of this paper is to provide a perspective on financial intermediation in the Romanian banking system and bank profitability during and after the financial crisis. The global financial crisis that occurred in 2007 had a great impact and significant negative effects on the real economy, as well as on the banking system. Mainly because of external adverse macroeconomic developments, economic downturn caused by the crisis, weak or negative economic growth and poor economic environment, bank lending declined dramatically and the banking system registered extremely high levels of non-performing loans due to a continuous deterioration in the quality of loan portfolios. As a result, bank profitability was severely affected and since 2010 the profitability of the Romanian banking system entered in a negative territory.*

KEY WORDS: *international financial crisis, financial intermediation, non-performing loans, bank profitability.*

JEL CLASSIFICATIONS: *G21.*

1. INTRODUCTION

Financial experts agree that financial institutions are the backbone of the economy and play a large role in providing liquidity to the economy. In the same time, the financial system is unique because of its primary objective to channel savings into investments in the process of transferring financial resources from those with surplus funds to economic agents that would like to make use of those funds.

Banks are the main direct providers of liquidity, facilitating financial intermediation through offering demand deposits and lines of credit and they are key agents in promoting economic development. In order to complete their role effectively, banks have to be developed and able to provide a variety of financial services so as to attract customers and to meet their needs.

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The financial crisis of 2007-2008 converted into an enormous global economic crisis with dramatic negative effect on the overall economy, reaching its maximum intensity and extension in 2009. The crisis had serious impact on the Romanian economy as well. However, in terms of direct impact, the banking system was less affected at the beginning since it was not exposed to toxic assets. Nevertheless, the Romanian banking system began to experience the effects of the crisis starting with 2009 due to low credit and higher funding costs with a negative impact on financial intermediation and bank profitability (Drigă, 2013).

The financial crisis has created a series of vulnerabilities in the Romanian financial system recording the lowest level of financial intermediation in Europe and continuously declining after the burst of the financial crisis. Financial intermediation measured by the share of bank credit in GDP reached 29% at the end of 2016, compared to 38% in 2008. This result was caused both by factors related to credit demand and by factors associated to credit supply. An uneven evolution of financial intermediation at sectoral level was also recorded and, according to the financing strategies of the main banks, the target became to expand lending for companies faster than for the population.

2. OBJECTIVES AND METHODOLOGY

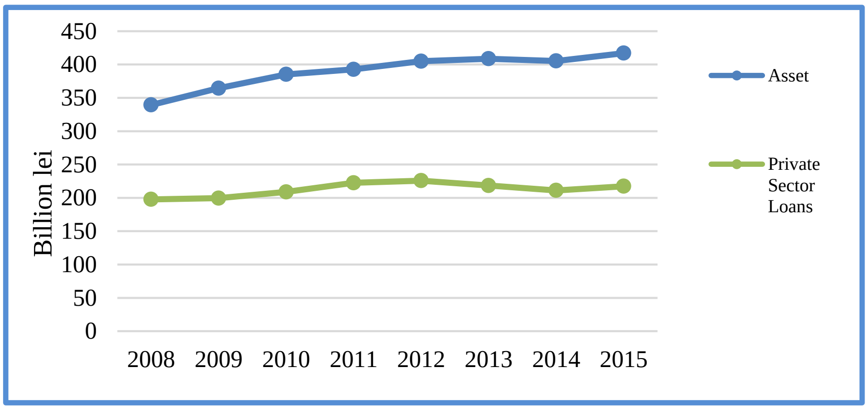
The purpose of the paper is to provide an overall perspective on financial intermediation in the Romanian banking system and addresses issues related to non-performing loans and bank profitability. The methodology used in this study concerns qualitative approaches. The study explores data available from reports and studies of Romanian credit institutions, periodicals and occasional publications of the National Bank of Romania, database and research of international organizations and consulting companies, as well as foreign and Romanian literature or websites and other media sources. Factual observation and extensive statistical data collected led to relevant results findings and general conclusions.

3. THE POST-CRISIS BANKING LANDSCAPE

3.1. Recent trends in the Romanian banking sector

The financial crisis strongly influenced developments both in the real and in the financial sector. As a result, the dynamics of bank assets and credit to the private sector declined. Starting with 2012, the volume of loans granted by the Romanian banking system to the private sector registered a downward trend. The negative evolution of lending activity significantly affected the volume of bank assets that went down on a downward slope in 2014, with a modest recovery starting with 2015 (figure 1).

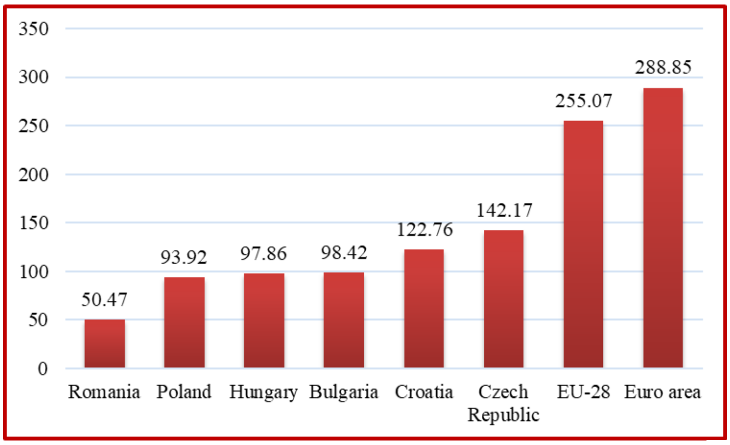
According to data released by the NBR, Romania has the lowest share of bank assets in gross domestic product compared to EU-average and in the first nine months of 2017, the level of financial intermediation in Romania remained on a downward trend (50% in 2017 - figure 2).



Source: based on data from the Financial stability reports of the NBR, 2009-2016

Figure 1. Bank assets and loans granted to the private sector, during 2008-2015

However, in terms of assets held, the banking sector remains the main player in Romania's financial system. According to data released by the NBR, the consolidation trend of the Romanian banking sector continued in 2017. Regarding the asset structure of the banking sector, credit granted to the real economy slightly increased (from 51.3% in December 2016 to 52.8% in September 2017) due to the increase in the volume of new loans granted in national currency and a relative slowdown in non-performing loan resolution operations.



Source: based on data from the Financial stability reports of the NBR, 2017

Figure 2. Total assets of the banking sector as a share of GDP (2017 - Q2)

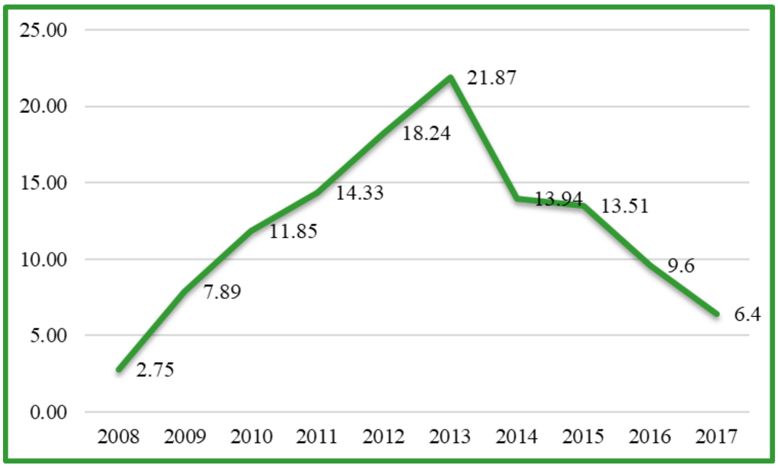
Although financial intermediation in Romania records one of the lowest values in the European Union, the role of the banking sector remains dominant in the Romanian financial system. In the medium term, the main banks from the system have an optimistic perception regarding the evolution of bank assets and lending.

3.2. Non-performing loans - the cause of profitability drop in the Romanian banking system

After the financial crisis, many countries with a booming banking sector were faced with a sudden and significant decrease in lending and non-performing loans (NPLs) have been strongly affected with negative impacts on bank profitability. European financial sectors were disproportionately hit, developed countries was less affected, unlike most EU member states where banks have recorded a dramatic increase in the volume of NPLs. The trend of deterioration in the quality of loan portfolios was mostly a common characteristic of the Central and Eastern European banking market, NPLs grew rapidly reaching levels comparable to those generated by previous financial crises. In 2009, Romania already had a rate of non-performing loans hire than the average in CEE and non-performing loans continued to rise in terms of both volume and ratio.

Therefore, Romanian bankers started to be more and more preoccupied with credit risk and placed non-performing loans at the top of their concerns. Thus, a major concern for banks has been how to manage anticipated and increasingly recorded credit losses on the market. Credit quality indicators got worse in 2011. According to official data, in December 2011 the ratio of NPLs was 14.33%, while till the end of 2012 it reached 18.24%, a fairly high value compared to a value of 11.85% recorded in December 2010.

In 2013 the situation worsened even more as the Romanian banking system recorded the highest rate of NPLs from the CEE countries (21.87%), almost twice the area average. Although the large volume of non-performing loans still remained a major concern, in 2014 and 2015 Romania ranked among the states with a moderate rate of decline in loan quality.

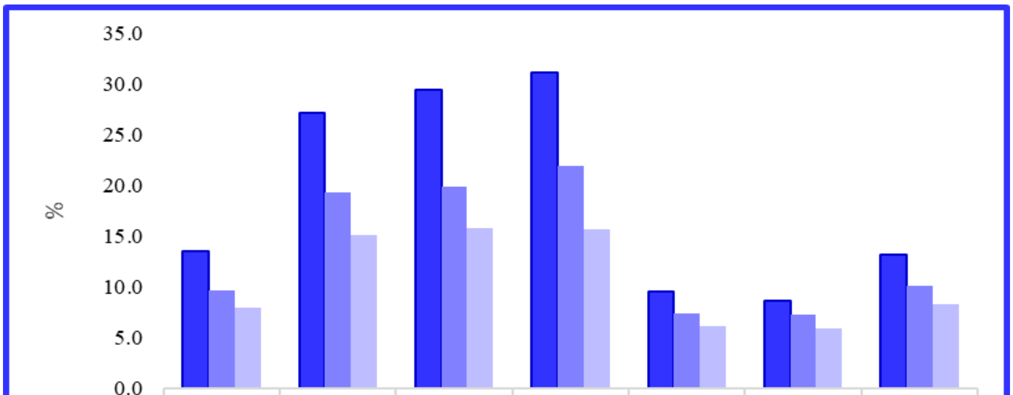


Source: based on data from the World Bank's database, http://databank.worldbank.org/

Figure 3. NPLs ratio in Romania, 2008-2017

In 2016 and 2017 the ratio of NPLs dropped significantly, highlighting the efficiency of the actions taken in the direction of reducing the stock of non-performing loans. The level is below EBA's red threshold of 8%, but is higher than the EU-average under 4.5%.

According to data released by the NBR (Financial stability report, 2017), at the individual level, the rate of non-performing loans stands above the EBA red threshold for less than half of the Romanian credit institutions and their proportion decreased in the first part of 2017. In terms of loan destinations, high values of non-performing loans ratio are still recorded at the level of loans granted to non-financial corporations (figure 4).



	Total	Non-financial corporations	SMEs	Commer-cial real estate loans	House-holds	Residential real estate loans	Consumer credit
Dec. 2015	13.5	27.1	29.4	31.2	9.6	8.6	13.2
Dec. 2016	9.6	19.3	19.9	21.9	7.3	7.3	10.1
Sep. 2017	8.0	15.1	15.8	15.7	6.1	5.9	8.3

Source: based on data from the Financial stability report of the NBR, 2017

Figure 4. Dynamics of non-performing loan ratio generated by debtor

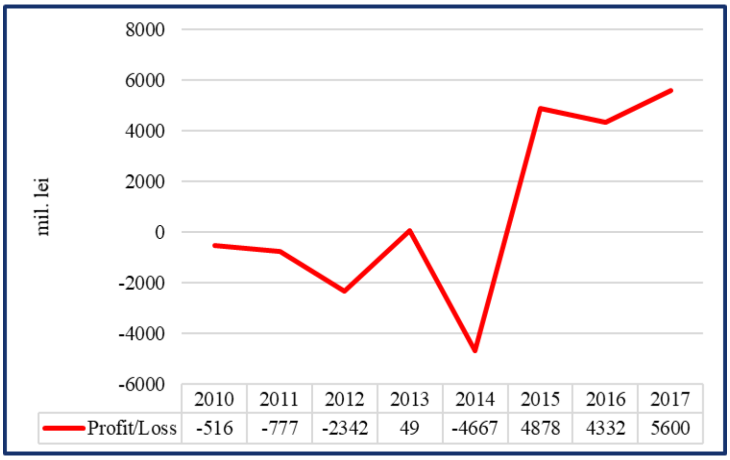
However, a decreasing trend is registered concerning all important portfolios. The largest volume of NPLs consists of exposures to non-financial corporations (67% of total), but the riskiest portfolios continue to be represented by exposures to SMEs, respectively commercial real estate loans. Furthermore, evidence shows that the risk attached to loans is mitigated by the comfortable provisioning, which covers expected losses (non-performing loan coverage by provisions - 59.37%, September 2017).

Besides, the provisioning level calculated for the Romanian banking system is one of the highest among EU member states, the Romanian banking system being considered a good example to follow regarding the way the issue of non-performing loan was handled. The Texas ratio, calculated as a ratio of non-performing loans to the sum of Tier 1 capital and loan-loss provisions, has improved at both individual level and consolidated level. However, this indicator still places Romania in a less favourable position relative to the EU-average (Texas ratio: Romania - 49.65%, EU-average - 37.34%).

3.3. The profitability of the Romanian banking system

Bank profitability is a major issue and indicates whether a bank is able to provide basic financial services and properly function. Besides, banks need to offer a viable business model and the efficiency of the banking system is a key determinant of sustainable growth.

For several years after the burst of the international financial crisis, the high NPLs ratios put pressure on bank efficiency and increased non-performing loans had negatively affected profitability through various channels (unpaid loans and interest, raising provisions, losses on sold or restructured assets). Low profitability among European banks, due to weak economic environment, high cost-to-income ratios, undermined bank lending, high levels of non-performing loans and regulatory reform, became a reality in several countries. Low profitability, both a consequence and a cause of the poor economic environment, weakened the ability and willingness of banks to finance the wider economy (KPMG International, 2016).



Source: based on data from the NBR's database

Figure 5. The profitability of the Romanian banking system, 2010-2016

The crisis strongly hit the Romanian banking sector as well and banks started to experience reduction in retained income and profitability as the entire Romanian economy entered into recession starting with 2009. In just a few years the percentage of banks reporting losses increased significantly (from 28.3% in 2007 to 43.1% in 2008, 52.5% in 2009 and 52.2% in 2010). In 2011 the situation has worsened and the profitability of the Romanian banking system entered in negative territory. As figure 5 shows, in the next 5 years (2010-2014) the banking system recorded a total loss of 3.37 billion lei. Only in 2015 the Romanian banking system returned to profit and in 2016 the system remained profitable but profits slightly decrease (decrease of 11%).

In 2017 profitability prospects for the European banking sector remain mixed mainly due to the still high volume of non-performing loans in some European countries. However, Romania is among the countries with the highest level of profitability (5.6 billion lei), alongside other countries in the region such as Bulgaria, the Czech Republic and Hungary.

4. CONCLUSIONS

In a modern economy, the financial sector plays an important role due to financial intermediation and a sound banking system is crucial in achieving economic growth. While well-functioning banks accelerate economic development, poorly functioning banks are an obstacle to economic growth. Many researchers argue that the international financial crisis led to a prevailing inability of borrowers to pay back their loans, as more companies and people faced payment difficulties and even bankruptcy. Thus, the deterioration of loan portfolios quality became a common characteristic all over the world, including Central and Eastern European banking systems.

In the context of a challenging macroeconomic environment, the Romanian banking system was confronted with poor lending activity and NPLs outburst. In 2013 the situation worsened even more as the Romanian banking system recorded the highest rate of NPLs from the CEE countries. Although the large volume of non-performing loans still remained a major concern, in 2014 lending to the private sector resumed and Romania registered a moderate rate of decline in loan quality.

As a result, after the burst of the financial crisis, a major concern for bank management has been managing the losses caused by non-performing loans. Although, the financial result registered by the end of 2009 still remained positive, the step-down in efficiency continued and the Romanian banking system experienced 5 years (2010-2014) of loss until it returned to profit.

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