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THE IMPACT OF THE FOREIGN CAPITAL BANKS ON ENSURING FINANCIAL STABILITY ON LONG TERM

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Abstract:
The present study is focusing on analysing the role played by the foreign banks within the national and international banking system as well the impact the foreign banks have on the autochthon banking system, on the financial activity, on the real economy and on the financial stability on long terms.

The research conducted highlights the fact that along the positive impact on the banking system and on the economy of the host country, generated by their quality as vectors of mobilizing and directioning the international financial flows towards the host country, there can also be considered a negative impact. The study shows that the impact of the negative effects, that have as main cause the reversibility of the international financial flows, depends, on a great extent, on the specific conditions of the host country, on the characteristics of the foreign banks, but mostly, by the share held by the foreign countries within the framework of the host banking system.

Starting from the role played by the capitalization of the banking system to ensure financial stability, the research made on Romania's case shows both, the positive effects generated by the presence of the foreign banks and also, their vulnerability in front of this excessive dependence on the foreign capital induced by this presence. The solution to reduce this dependence can only come from the autochthon capital direction whose mobilization may countervail the gap made by the foreign banks and, by surceasing the process of financial disintermediation, to ensure the maintenance of the financial stability on long term.

Key words: financial stability, foreign banks, banking capital, globalization, financial crisis.

JEL classification: F21, F23, G21, G28.

1. INTRODUCTION

The globalization phenomenon that has started since the 70s and that materialized mainly through ample profound deregulation and capital market liberalization processes, has become the determinant for a long period of economic growth registered in the last forty years on the global level. There are undisputable economic and social benefits deriving from this process, the financial globalization bringing its contribution to the improvement of the macroeconomic performance, to the institutional development and to the appropriate risk management, not only in the developed countries as in the emerging ones, as well.

However, the global crisis registered between the years 2007-2008 represents, according to Lane (2012), a test for globalization as model, as, apart from the positive contribution brought to the economic and social development, this globalization process has determined the spread of the financial crisis. The foreign banks action as well as the quick swelling of the banking balance sheet represent the two lines identified by the author, that, induced by the financial globalization, have contributed, to the increase of the vulnerability of the loaning market and eventually, to the activation of the crisis spread. Definitely, I have to emphasize the idea that, in the absence of these vectors, I generally consider the foreign banks and investors, whose activity is based on the freedom of capital movement, and, under these circumstances, it is difficult to say which were the exact funding resources needed to support the process of economic growth recorded especially in the emerging countries.

The reformation of the regulation and supervision setting to ensure the financial stability has to consider both, identification and management of systemic risk, induced or aggravated by the phenomenon of globalization, as well as the need to ensure future economic development conditions. Strengthening the resilience of the financial system should not lead to stagnation or even economic underdevelopment.

One of the most important course of action in reforming the framework of ensuring financial stability is focusing on the capitalization of the banking system as an important post in the process, direction that is promoted and supported by the new Basel III agreement on the global level. By the macroprudential approach, the reform suggested by the new Basel III agreement, is aiming at improving the financial system resistance to shocks by actions focusing on two main directions: the improvement of the capital base and of the liquidity. As the first course of action, namely, the improvement of the banking system capitalization, that, in my opinion is the most important, is expected to improve the capital basis from the quantity and quality points of view, it is to raise the question which direction to follow in the case of the emerging countries, as in the case of Romania, considering the modest capacity of mobilizing the necessary amount and the necessary quality of capital. The present article has the main objective of studying the positive or negative effects, as appropriate, of the presence of the foreign banks in the autochthon financial system and the identification of solutions to the issue of improving the banking capital base, a recurrent problem of the countries with less developed financial systems, also considering the fact financial stability is not the last objective of the reform, it is just one of the means of ensuring sustainable development.

Further, the work is structured as follows: Section 1 Introduction; Section 2 Review of scientific literature on the role of recapitalizing the banking system in order to ensure stability; Section 3 Analysis of the impact of the presence of foreign banks in the autochthon banking system; Section 4 Conclusions.

2. RECAPITALISATION OF THE BANKING SYSTEM – THE MAIN STEP TO IMPROVE THE RESILIENCE TO SHOCK

The literature is replete with studies supporting the role of capital as an important pillar in supporting financial stability. Most researchers who considered this issue concluded the fact, supported by Caruana (2012) or by Brei and Gadacnez (2012), that more capital and better quality is the appropriate step that can lead to strengthening the resilience of the financial system to shocks.

Vasquez and Federico (2012), seeing the complementarity of the two courses of action of the Basel III, respectively, capitalization and liquidity, demonstrate that a better capitalization improves the banks capacity to be more resistant to crisis situations. Providing liquidity is essential in fighting against a crisis situation, however, the banks capacity to generate liquidity is closely related to the leverage. In the same time, the leverage, that is a measure of capital relative to total risk-weighted assets held, besides the fact that it is closely correlated with the size and quality of the capital ratio, it is one of the causes of the pro-cyclicality phenomenon which is specific to the financial activity.

Pro-cyclicality of the banking activity amplifies the business cycle and is seen by many researchers (Drehmann, and Tsatsaronis Borio (2011), Caprio (2010), Cardarelli, Elekdag, Lall (2009)) as the main cause of financial instability. The explanation is simple, during the economic boom, the banks, under the impact of leverage, of the increase of the assets value and of the undervaluation of risk, they expand their balance sheets at an accelerated rate. Subsequently, during the phase of economic decline, when the financial shocks result into great loss, simultaneously takes place an erosion of the capital ration, a diminishing in the value of the assets and an increase of the associated risks, so that, in the end, a phenomenon of credit compression and of financial disintermediation takes place which leads to economic collapse.

In the given case, the most appropriate instrument to fight against pro-cyclicality is the capital that can contribute, by an established anti cyclical component, to shock attenuation. Practically, the anti cyclical characteristics of the instrument is determined by the possibility to make up some capital buffers during the *good* times (economic growth) that can be used for shock absorption occurred in *bad* times (economic decline).

For this purpose Cardarelli, Elekdag and Lall (2009) state that restoring the capital base of banks is the most secure way to stop the economic downturn, when the banks were caught with over expanded balance sheets when the economic crisis set off, and that is at the regulators' hand.

Nier et al. (2008) in their turn show that there is a direct link between the aggregated capital of the entire banking system and the probability of bankruptcy of banks in the system, given the fact that a low level of aggregated capital weakens its resistance, seen as a whole, by amplifying the systemic risk and the contagion effect.

Therefore, as you can see, the literature shows unequivocally the importance of capital in an greater amount and of a better quality, for ensuring financial stability, however, designing an operational framework of capital management remains a major challenge. Capital is the most appropriate instrument to counter pro-cyclicality and to restore confidence, which is relatively a simple instrument and which eliminates issues of discretionary policies. Capital management challenges are related to the sizing the optimal level and to the *timing*, in other words, when the capital reserve should be increased, to what extent and when to be used.

Given this objective, to make the banking system more resistant, regulators have proposed, in their turn, through Basel regulatory framework, a series of measures that emphasize the role of capital. Since 2004 the Basel II standards have been established which introduced minimum capital requirements for banks to cover credit risk and operational risk. By this regulatory framework they established principles for the necessary estimates can be made both for banks and for supervisors regarding capital adequacy to the assumed risks. The financial crisis has shown the need to review these standards, so in 2010 the Basel Committee published the new agreement Basel III (BCBS, 2010). The new regulatory framework is a reform of the previous agreement designed to increase resistance to the existing banks and of the financial system in general.

Basel III aims to increase the strength of the system / banks based on the important combined role played by the liquidity and capital, the conclusion being that a stronger capitalization is associated with a lower probability of recording banking crises and with less severe costs to affect the system.

Finally, restoring capital base is seen by the literature as the first step in restoring confidence and ensuring financial stability, however, for countries with less developed financial systems, affected by the shortage of resources and where the banking system is dominated by banks with foreign capital, solving this problem can become particularly difficult, with adverse effects on the level of financial intermediation.

3. IMPACT OF THE FOREIGN BANKS ON THE EVOLUTION OF THE AUTOCHTHON FINANCIAL SYSTEM

3.1 ADVANTAGES AND DISADVANTEGES OF FOREIGN BANKS PRESENCE

On the background of globalization the role of foreign banks has increased permanently on a global level occupying an important position in the domestic financial intermediation. The inability of some countries to raise sufficient capital to support banking activities and hence the real economy was offset by the increased role of foreign banks in the local financial systems that, entering these markets have contributed decisively to increase levels of capitalization and liquidity through intake capital and easier access to international financial resources.

The process of strengthening the role and position of foreign banks in the global financial system, shown graphically in Table no. 1, confirms the extent of the phenomenon and the accelerating trend in recent years.

Table no. 1 Evolution of the capital percentage of foreign banks among total banking sector in different countries

Tara	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Romania	21	32	39	45	57	57	63	70	70	74	81	85	81	81
OECD	*22*	*22*	*23*	*24*	*24*	*25*	*26*	*27*	*27*	*27*	*27*	*28*	*28*	*28*
USA	16	16	15	17	19	21	21	21	23	24	24	27	29	32
UK	45	46	47	48	48	48	49	51	53	54	54	56	57	57

Japan	0	0	0	0	0	1	1	1	1	1	1	2	1	1
Italy	3	3	4	5	5	5	5	5	5	5	7	10	10	10
France	7	7	6	7	8	8	7	7	6	6	6	6	6	6
Germany	10	11	10	10	11	12	13	13	12	13	13	13	14	14
Hungary	68	73	75	78	78	81	79	86	85	85	90	93	93	92
Ireland	83	83	84	80	81	85	89	89	89	89	90	90	90	90
Czech R	39	39	44	52	52	54	54	57	57	55	59	64	67	67

Sources: Claessens and van Horen 2012

As it can be seen there has been a lasting phenomenon which affected all countries, certainly on a greater or lesser extent depending on the characteristics and evolution of each economy. On the other hand it is clear, however, that less developed countries were affected earlier, Romania being included in this category. In Table 1 we made a selective presentation of the evolution of some banking systems in the countries of Europe, nevertheless, the analysis and the data presented by the authors (Claessens and van Hören, 2012) are more comprehensive and reinforce the idea that, in particular, less developed economies experienced this kind of development, so that, shares above 80% are to be found in Albania, Bolivia, Nicaragua, Slovakia, Burkina Faso, Burundi, Cameroon, Rwanda, Uganda, etc.

This process has been accompanied by a number of beneficial effects, in addition to increased capitalization and liquidity of the system, which favored its acceleration and which are highlighted by Cull and Peria (2011) such as increased autochthon banking competition, potentiation/ building up of the customers' economic competition, increasing accessibility of financial services and even ensuring financial stability. Romania was no exception to these global trends and introducing technical progress, novelties in the field, the contribution of know-how, but mostly, the easy access to foreign funds, generated by the presence of foreign banks, have brought their contribution to registering a stronger stabilization and development of the banking business in Romania. As shown in Figure 1, recovering the capital base after the banking crisis of 1998-1999, it was achieved solely on their own merits, for later the financial intermediation to grow strongly foreign banks have expanded their networks in many areas of the country, providing banking services to relatively broad categories of the population.

The extent and the evolution of the penetration process of the autochthon financial systems by foreign banks, accompanied by the benefits listed above, are explained by McCauley (2012) who argue that the meaning of international financial flows and capital liquidity are in close correlation with the capital market conditions. When financial and capital markets are characterized by calm and low volatility, the capital *flows* from developed economies to emerging markets, and when volatility increases, the flows are reversed.

Therefore, this phenomenon is reversible and precisely, this reversibility induces the prerequisite of some negative effects that may occur. Claessens and van Hören (2012) show that in addition to beneficial effects, since 2007 there has been a number of adverse effects that can be highlighted, among which, the most important one is reducing lending facilities of the host country economies during the financial crisis.

The problem of adverse effects generated by the position improvement of the foreign banks in the local financial sector has been addressed in other studies which point out that there are difficulties that may occur, caused by contagion effect, namely, transmission of shocks from parent banks to their subsidiaries, with negative consequences for their current work (Cetorelli and Goldberg, 2011).

Risks induced by the foreign banks to financial stability are pointed out by Danila (2011, 2013) who highlights the vulnerability of an economy, such as the autochthon one, which is induced by the dependence of major banks on the capital coming from the outside and the volatility of these financial flows.

Provided to the change of direction of the financial flows the new capital and liquidity requirements imposed by Basel III are added, it is expected a worsening of the adverse effects in the absence of adequate support from their own groups of shareholders of the foreign banks. The consequence of this kind of situation is that foreign banks will be forced to reorganize their activity which will be based mainly on resources resulting from savings and less on loans, fact that will affect lending, especially supporting projects of investment on long terms.

3.2 MORE OR LESS RECENT EVOLUTIONS AND THE CURRENT SITUATION

To emphasize the positive or negative impact, as appropriate, of the presence of foreign banks in Romania, I have made, in this present study, an analysis of the evolution of the Romanian banking system over a long period of time, in order to point out the significant events that have happened. The present analysis focused on studying the evolution of the banking capitalization in the period 1996-2013, which is, in my opinion, a relevant indicator on the commitment of foreign banks present on the autochthonous market and, consequently, to determine the positive or negative effects recorded. The analysis took into account both quantitative aspects, expressed by the variation of total own funds at aggregate level, and qualitative aspects, expressed by the variation analysis of Tier 1 capital, noting that, the study focused on the real changes to eliminate the effect induced by inflation, the situation is shown in Figure no. 1.

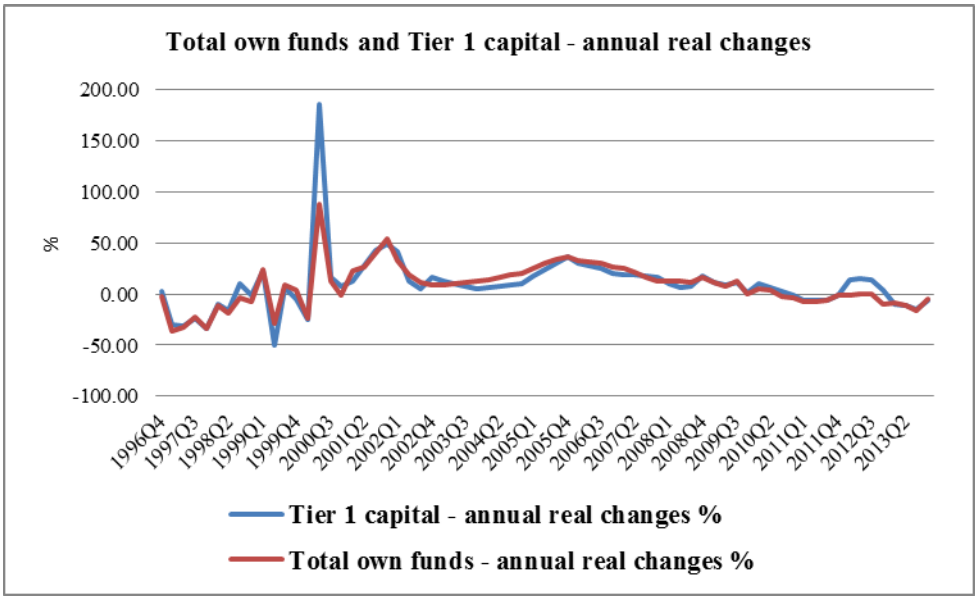

Figure no. 1 Evolution of banking capitalization in Romania
Sources: NBR;author's calculations;

Following the analysis of the evolution of the capital base of the autochthonous banking system there can be identified three distinct phases:

- first stage 1996 - 2000 is characterized by a phenomenon of strong erosion of the capital base determined by the economic crisis that hit Romania and brought the banking system to the brink of collapse (there were some resounding bank failures), requiring extensive rehabilitation and reorganizing processes;
- the second phase 2000 - 1998 is characterized by accelerated development of the banking system and a permanent consolidation of the capital base. Following the banking system reorganization and its repositioning on sound bases, under the impact of foreign capital injection, there is an unprecedented development recorded. However, it will be stopped in 2008, once with the start of global financial crisis;
- the third stage 2008 - 2013 is characterized by the inability of the system to recover its capital base to the required level, so that, even if there were not significant problems

recorded, it suffered a process of financial disintermediation, counterproductive to the development needs of domestic economy and to ensure financial stability;

The phenomenon of erosion of the capital base can be seen much better in a comparative analysis Romania versus EU of the capitalization variation in real terms, in which the year 2008 is taken as reference point (Figure no. 2):

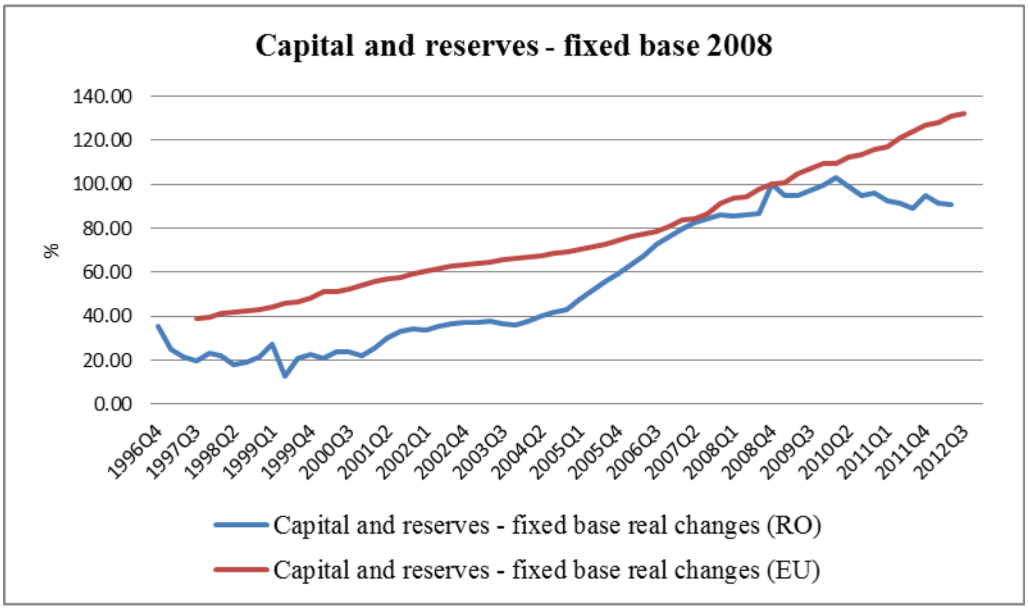

Figure no. 2 Evolution of bank capitalization –Romania vs EU - real variations fixed base 2008

Sources: NBR; ECB; author's calculations;

As it can be seen until 2008 the capital base has permanently been improved in the EU and in Romania, for later, if in the EU the recapitalization efforts continued, in our country this has not happened any longer. The explanation must be studied in the big share the foreign banks are holding in the domestic banking system under the pressure of the problems in their own financial centers that have not provided sufficient support so that it came to an erosion of capital, significant decreases being recorded in real terms in 2011, the trend being the same for the following period of time. It is worth pointing out that while in the EU the financial and banking system is still improving through new capital contributions, registering an increase of 30.76% in mid-2012 comparing to December 2008, in Romania it is registered a decrease of 9.23% in real terms, of the volume of aggregated capital.

4. CONCLUSIONS

In the present study I investigated the effects of the presence of the foreign banks on both levels - the domestic banking system and the economy of the host country, looking at things from the perspective of the need to ensure financial stability. The analysis conducted on the development of the banking sector shows that the beneficial effects of their presence are undeniable. Without their presence it is difficult to explain how it could have sustained the economic development of Romania in the period 2000 - 2008 in the absence of capital injections and funds attracted from foreign banks. It is also hard to believe that restoring the capital base and the banking system after the crisis of 1998-1999 would have been achieved within such a short period of time without the contribution of these banks.

At the same time the reversibility of financial flows and reform of the global regulatory framework, shows that in addition to benefits, especially in the given case of big shares held by foreign banks in the domestic banking system. The effects of this presence on the domestic financial system therefore depend primarily on the share but also on specific local conditions and the type and characteristics of the respective banks. However, looking at things from the perspective of financial stability and the necessity of increasing financial intermediation, excessive dependence on external capital induced by foreign banks is an extreme vulnerability.

Solving this problem must be sought in improving the capacity of local capital to take over the activities of foreign banks, in this way, Claessens and van Hören (2012) show that domestic banks in emerging countries can take the opportunities of market redistribution, thus gaining a stronger position on the market, this way, reducing the effects generated by reversal of financial flows at the global level and the acceleration of disintermediation process. In the same sense, there comes the proposal made by Danila (2011) to allot, in the case of Romania, local public and private resources for the establishment of a systemically important bank through which the public policies can be implemented so that they can achieve financial stability in the context of macro-prudential approach.

Promoting some policies to support the development of local banks with domestic capital, either it is the establishment of a new financial institution or recapitalization of some existing ones, such as banks that are part of the Creditcoop network, it may help to increase financial intermediation, especially in those areas of the country and those activities for which any other credit institutions show no interest.

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