“European monetary integration - challenges for the Romanian banking system”

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European monetary integration – challenges for the Romanian banking system

Abstract

The European monetary integration and the adoption of a single currency will have profound implications on the Romanian banking system, both in the period before and in the period after the adoption. Among the main consequences of adopting the euro as the national currency on the Romanian banking system, analyzed in the paper, we highlight: the alignment of the interest rates, commissions and banking charges with those in the euro area countries as a result both of a greater transparency and an increasing competition on the bank market; better bank products and services; mutations in the National Bank of Romania's monetary policy, in the banking legislative and regulations system; the transformations in the payment systems and in the bank credit policies and the credit boom, both in retail and corporate banking. The main trends in the Romanian banking system are analyzed in connection with the evolution in other Central and Eastern European countries, and in the euro area countries. In the proposed study we use the "Structure-Conduct-Performance Hypothesis" (SCP) and the "Efficient Structure Hypothesis" (ESH) for evaluating the impact of competition on the evolution of the price of Romanian bank's products and services.

Keywords: bank system, competition, challenges, EU integration, EMU.
JEL Classification: E44, F36, G21, N24, O16.

Introduction

In the last few years, the Romanian banking system suffered profound transformations due to the privatization and restructuring process; the increasing competition, due to the higher number of credit institutions, including ones with foreign capital, permitted the development of better and more competitive products and services. The higher returns in the banking system, the more favorable economic environment, including sound macroeconomic indicators, the EU integration perspective and its concretization on the 1st of January, 2007, attracted even more participants to the market.

Now, the Romanian banking system faces new challenges, due to the potentially higher competition (since the beginning of 2007, more than 70 credit institutions announced their intention to develop their activities in the Romanian market to the National Bank of Romania) in the system and to the prospect of euro area integration and its consequences.

1. The evolution of the Romanian banking system – comparisons with the EU countries' banking systems

The perspective of Romania's integration into the EU structures determined a series of transformations in the Romanian banking system, both on regulation and functional levels, for adapting at the community acquis and for the future challenges.

The progress registered in banks during the transition to the market economy period was more than welcomed; the banks adopted strategies in order to improve their performances and to adapt to the increasing competition[1].

However, the Romanian banking system still has to decrease the gap between itself and the EU banks (even comparing with the banks from the countries that entered the EU in 2004), a proof being the indicators of development compared with the similar ones in other European economies.

Taking into account the savings indicator, even if the situation is not favorable, it is improving continuously due to a better economic climate (macroeconomic stability), Romanians working abroad and sending home significant amounts of money, and also the increasing confidence in banks and in the national currency (controlled inflation).

Table 1. Comparative statistics for savings in 2003 and 2005 in selected CEE countries

Country	Deposits in GDP (%) 2003	Deposits in GDP (%) 2005
Bulgaria	34	49
Croatia	61	61
Poland	39	39
Romania	21	28
Slovakia	67	55
Hungary	40	43
CEE	44*	38
Euro area	73*	93

Note: * – unpondered average.
Source: Ziarul Financiar, the supplement Piața Bancară, 9.11.2004, p. VIII; Piața financiară, September 2004, p. 36; Unicredit Group – BA-CA – Banking in CEE and the role of international players, July 2006.

[1] STOICA, O., CĂPRARU, B., FILIPESCU, D. (2005) *Efecte ale integrării europene asupra sistemului bancar românesc*. Iasi: "Al. I. Cuza" University Publishing House, 155.

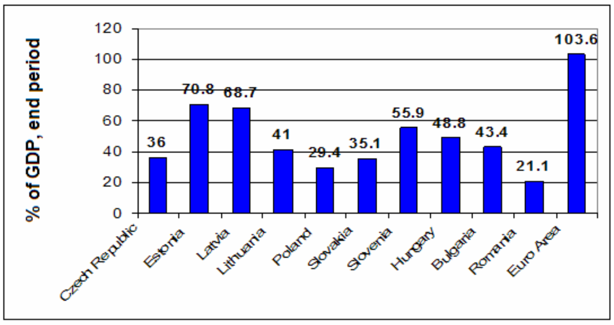
Another suggestive indicator is the weight of the non-governmental credit in GDP. The weight of the non-governmental credit in GDP is still the smallest in the EU beside the very impressive rate of growth in the last five years. The National Bank of Romania was very worried about the negative consequences of a very rapid increase and, through monetary policy decisions, tried to temper the market.

Table 2. Comparative statistics for the non-governmental credit in 2003 and 2005 in selected CEE countries

Country	Credits in GDP (%) 2003	Credits in GDP (%) 2005
Bulgaria	26	43
Croatia	61	68
Poland	31	30
Romania	18	21
Slovakia	34	36
Hungary	39	53
CEE	34*	33
Euro area	102*	115

Note: * – unpondered average.
Source: Ziarul Financiar, the supplement Piața Bancară, 9.11.2004, p. VIII; Piața financiară, September 2004, p. 36; Unicredit Group – BA-CA – Banking in CEE and the role of international players, July 2006.

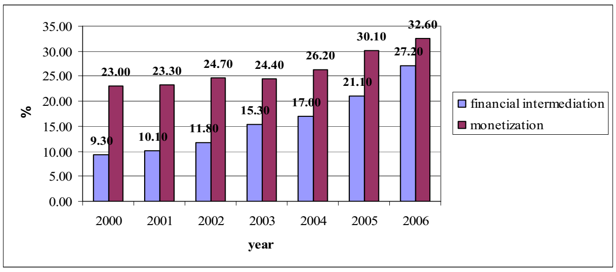
The low level of monetization and financial intermediation, as well as the relatively low level of development of the financial market in Romania, are some weak points of the Romanian economy. In 2005, the financial intermediation (non-governmental credit/GDP) was below the CEE average.



Source: Ziarul Financiar, the supplement Piața Bancară, 9.11.2004, p. VIII; Piața financiară, September 2004, p. 36; Unicredit Group – BA-CA – Banking in CEE and the role of international players, July 2006.

Fig. 1. Comparative figures: financial intermediation in selected CEE countries in 2005

Analyzing the evolution in the Romanian market we note that the financial intermediation is three times higher in seven years. The level of monetization started to increase more rapidly after 2004. The NBR decided that the economy can be re-monetized without the danger of rebounding inflation, after a very long and difficult period, resulting in a sound disinflation trend.



Source: www.bnr.ro

Fig. 2. The evolution of financial intermediation and monetization in Romania (2000-2006)

2. EU integration and competition in the Romanian banking system

Nowadays, the banking market concentration in Romania is very high. The top five banks according to the market share (BCR, BRD-GSG, Raiffeisen Bank, HVB Țiriac Bank Romania, BancPost) are the main players, as all relevant bank indicators suggest.

Table 3. Market share for Romanian banks with more than 1% of the total assets (%)

Name of the bank	December 2005	December 2006
BCR	25,7	26,2
BRD-GSG	15,0	16,3
Raiffeisen Bank	8,7	8,3
Unicredit Țiriac Bank	n,a,*	5,1
Transilvania Bank	3,9	4,7
Bancpost	4,5	4,5
Alpha Bank	3,8	4,3
ING Bank	5,3	4,2
Romanian Savings Bank	4,4	4,1
ABN Amro Bank	3,7	3,1

Note: * – merger not yet finalized (HVB with Țiriac Bank and HVB with Unicredit bank).
Source: commercial banks, National Bank of Romania.

As we see in the previous table, in 2005, the first 10 banks had a market share of about 75% and more than 80% in 2006. The first five banks had, in 2005, more than 60% of the market share. Moreover, it is relevant that the fifth rated bank has a market share less than 5%; it means that the other 29 banks, in Romania, count less than the first bank and count about the same as the second important player does.

Table 4. Top five banks in Romania, weight in the system (%)

Indicator	December 2005	December 2006
Assets	58,7	60,3
Loans	61,1	63,5
Deposits	57,0	58,3
Own capital	55,2	53,3

Source: National Bank of Romania.

In the literature there are two approaches concerning the evaluation of the competition: the "Structure-Conduct-Performance Hypothesis" (SCP) and the "Efficient Structure Hypothesis" (ESH). The first approach, SCP, supposes that the concentration in the banking sector generates market power allowing the obtaining of greater profits for banks, through attracting deposits with low interests and offering credits with high interest rates[1]. This is why it is necessary that the governmental authorities issue anti-trust regulations and supervise mergers and acquisitions in the banking sector. The second approach, ESH, suggests that the positive relationship between profitability and market concentration is not a consequence of market power, but of the greater efficiency of firms with larger market share[2]. The superior performance of the market leaders determines the market structure, implying that higher efficiency produces both higher concentration and greater profitability.

In the Romanian case, the privatization of the largest bank, BCR, with Erste Bank, finalized last year, will have a huge impact on the market, especially from the competition point of view. The change in the bank's management imposed an increase in the quality of products and services, more competitive prices and a more coherent policy. For example, at the beginning of January 2006, BCR decided to charge clients (natural persons) the equivalent of 15 euros per month for each inactive current account (without operations in the last three months) no matter the amount of the credit balance. Three weeks later, they publicly announced that they would retract the decision (forced, probably, by the newly-declared major stockholder Erste Bank). Already, after one year of restructuring, one can notice some improvements in BCR; they have the will to fight in order to maintain their market share and also to obtain new clients.

Taking into account this literature review Erste Bank has two alternatives: to make the effort to recoup, very rapidly, their investment (the biggest price paid in Central and Eastern Europe in a privatization, more than 3.5 billion of euros for taking control, at the end of 2005), consequently resulting in higher prices for their products and services, with impact on the entire banking system, or, to make efforts to improve its position on the market and to promote competitive prices. Due to their fight for a major market share and very rapid changes in the banking world's top 5 and top 10 banking institutions, Erste Bank will be forced to make changes in order to preserve its position. This will have a favorable impact on the entire market.

The Romanian banking system will benefit substantially from the EU integration, taking into account the large number of new-entries. The main benefits of foreign entry are higher competition in the banking sector leading to higher quality, more varied services at cheaper prices; this will benefit the consumers of banking services. In addition, increased efficiency of banking services will lead to more efficiency of resource allocation and risk management in the economy as a whole, resulting in a more efficient and competitive economy. Levine[3] specifically mentions that foreign banks may improve the quality and availability of financial services in the domestic financial market by increasing bank competition and enabling the application of more modern banking skills and technology; serve to stimulate the development of the underlying banking supervisory and legal framework, and enhance a country's access to international capital.

Using data from the national banking markets of 80 countries, Claessens, Demirguc-Kunt and Huizinga[4] find that foreign banks operate differently than domestic ones. Larger foreign ownership shares, in banks, indeed, reduce the profitability and the overall expenses of domestically owned banks. These results suggest that foreign bank entry improves the functioning of the domestic bank markets with positive welfare implications for banking customers. The relaxation of restrictions regarding the foreign banks' entry (the case of the Romanian market after the EU integration) may similarly reduce domestic banking profits, but with positive overall welfare implications for the domestic economy. In addition, studies reveal that the number of entrants matters more than their market share. This indicates that foreign banks affect local bank competition upon entry rather than after they have gained substantial market share.

In the last couple of years the Romanian banking landscape was diversified by the development of non-bank financial institutions. The consumer credit institutions and some of those entities registered with "Multiple credit activities", representing the major part of the non-bank financial institutions, appeared, generally, with the objective to avoid the NBR's regulations targeted to moderate the credit's

[1] BAIN, J.S. (1951) Relation of profit rate to industry concentration. *Quarterly Journal of Economics*, No. 65, 293-324.

[2] DEMSETZ, H. (1973) Information and efficiency: Another viewpoint. *Journal of Law and Economics*, No. 10, 1-22.

[3] LEVINE, R. (1996) Foreign banks, financial development, and economic growth. In CLAUDE E. BARFIED (ed.) *International Financial Markets*. Washington, D.C.: AEI Press.

[4] CLAESSENS, S., DEMIRGÜÇ-KUNT, A., HUIZINGA, H. (1998) How Does Foreign Entry Affect the Domestic Banking Market? *World Bank Policy Research Working Papers*, no. 1918. Access from: <www.worldbank.org/html/dec/Publications/Workpapers/WPS1900series/wps1918/wps1918.pdf> [Accessed 20.07.2007]

expansion. Their success, signifying an important number of individual clients, could be explained through a higher flexibility and quickness in the credit process, despite the interest rates which are higher when compared to the banks' interest rates.

Table 5. Number of non-bank financial institutions in 2007 in Romania

Type of company	Number
Consumer credit	4
Mortgage credit	2
Micro credit	8
Financial leasing	84
Multiple credit activities	82

Source: National Bank of Romania.

In fact, during recent years, the bank's competition took particular forms. After high interest rates both in deposits and credits in the nineties, due to a high inflation rate, the lower inflation led immediately to low interest rates for deposits. After months of "resistance", correlated with frequent critics from the NBR and the media, the banks finally reduced, gradually, the interest rates for credits, but at the same time started to increase their charges, or to apply new ones.

Accepting the competition through interest rates, the banks started to offer lower and lower interest rates, but also tried not to diminish their revenues resulted from the lending process. Thus, the mortgage credits with fixed interest rates, for a few months, are followed by variable interest rates, nowadays signifying interest rates 2-4% higher. Alternatively, the banks offer credits in so-called "exotic" currencies, like JPY or CHF (choosen for their low interest rates), and apply newly "invented" charges for evaluating the papers, for granting the credit, annual or even monthly management charges; charges for advanced refunds and most of all, sometimes, variable charges. These are some examples suggesting that the battle between the Romanian banks is only on the interest rate field, but they are not ready yet (and are not forced to be ready) for the real battle, the battle to reduce charges and the real cost of credit and, as a consequence, their own revenues.

3. Competition and interest rate convergence in the context of Euro area integration

A study made by Roland Berger, Romania, highlights that, compared with the GDP per capita, the cost of basic financial services in Romania is one of the highest in the world.

Table 6. Cost of basic bank services compared with the GDP per capita in selected countries (%), 2005

Country	Cost/GDP/capita
Czech Republic	1,00
France	0,37
Poland	2,10
Romania	3,00
Slovakia	0,99
UK	0,25
USA	0,30

Source: Roland Berger, Romania, quoted in *** (2005): Piața financiară, (November 2005), p. 44.

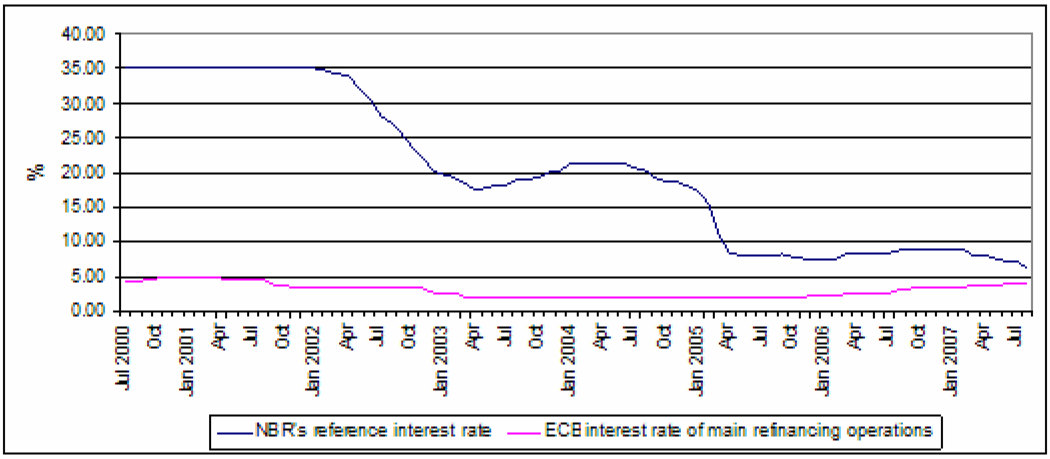
This important gap could be explained as follows:

- the reduced comparison base (smaller GDP per capita);
- the reduced number of bank service users compared with investments made at a similar level in other countries; the banks did not succeeded in obtaining a critical mass of clients for working efficiently; an important part of the population uses only occasionally, or never, most of the banks' services;
- higher costs determined by the bureaucracy and/or by the NBR's regulations.

In this context, most of the banks act as universal banks, trying to acquire more clients and obtain higher shares of the market.

In the Euro area, from the first weeks of the year 1999, in the context of Euro introduction, the differences between the overnight interest rates from the Euro zone countries decreased at the 2% level (after which the arbitration is no longer profitable, under the normal difference between the selling and buying price); the higher interest rates from countries like Spain, Italy, Portugal and Ireland quickly reached lower levels, previously met only in Germany, a fact that emphasizes the medium overnight interest rate convergence.

Of course, this illustrates the emergence of a monetary market at a European level, but from Romania's perspective, we hope we shall assist in an interest rate convergence, too, at least after the national currency (leu) is given up and the adoption of the euro as the national currency. Thus, some financial analysts consider that the interest rates will be 1.5-2% higher than those from the EU until the end of 2012-2014 – the time when Romania will adopt the euro as a national currency – when the interest rates will reach the Euro zone levels.



Source: NBR and ECB.

Fig. 3. The evolution of the NBR's reference interest rate and the ECB's refinancing interest rate in 2000-2007

According to NBR's estimations, the entrance in the ERM II is estimated to be 2012, and the adopting the Euro in 2014. Before entering the Euro area, Romania must sustainably fulfil the nominal and real convergence criteria. The NBR must consolidate the disinflation trend, develop a long-term capital internal market, insure the interest rate convergence, and maintain a stable exchange rate. Most importantly, the real economy must sustain this process, and the structural reforms must continue[1].

Table 7. Real and nominal convergence indicators for Romania in 2006-2007

Nominal convergence indicators	Maastricht criteria	Romania	
		2006	2007***
Inflation rate (percent, annual average)	<1.5 pp above the three best performing Member States 2.8 percent**	6.56	4.0
Long-term interest rates (per cent, per annum)	<2 pp above the three best performing Member States 6.2 percent**	7.49[1]	-
Exchange rate (vs. euro) (maximum percentage change vs. 2- year average*)	+ / -15 percent	+10.0 / -6,1	-
General government deficit (percent of GDP)	below 3 percent	-1.9[2]	-3.2[3]
Government debt (percent of GDP)	below 60 percent	12.4[2]	12.6
Real convergence indicators (GDP/capita) 2006	EU- 15	Romania	-
EUR	27600	4498	-
% in EU-15	16.3		-
PPS***	26500	8800	-
% in EU-15	33.2		-

Note: 1) In August 2005. 2) According to the ESA95 methodology. 3) -2.8 according to IMF's methodology. * – for the period of 2005-2006, because the criterion is evaluated on a two-year basis. ** – according to ECB's Report of convergence – December 2006. *** – purchasing power standards.
Source: ISARESCU, M. Romania – Trecerea la euro. The South-East European Financial Forum, Bucharest, 17th May 2007. Access from: <www.bnr.ro>.

As the previous table shows, the nominal convergence criteria are partially fulfilled; the most difficult part being the monetary one. However, a more sensitive question is the timing, for insuring not only the nominal, but also the real convergence. For example, for Portugal and Greece, the indicator GDP/capita (PPS) in 1996, when the first evaluation for starting phase three of the EMU, was 68,3%, respectively 65,9% from the EU-15 average, in 1999 – 70,19%, respectively 65,27%, and in 2005 – 65,95%, respectively 73,15%. Thus, it results that on the eve of EU integration, the same indicator for Romania was about half of the Portuguese or Greek indicators.

4. Toward a European integrated banking system

Key indicators used to evaluate the market integration are: interest rate convergence, cross-border activity and efficiency.

The most important indicator for the financial integration is the interest rate convergence, or generally named in the economic theory, the "law of one price". As it can be observed also in the Euro area, the interest rate's differential still exists; however, the gap diminishes in time.

As main influence factors explaining the interest rate's differentials among EU countries we could consider: labor force costs, taxes, and monetary policy influences (for example now the minimum compulsory reserves are 40%, comparing with 2%

[1] ISARESCU, M. Romania – Trecerea la euro. *The South-East European Financial Forum*, Bucharest, 17th May 2007. Access from: <www.bnr.ro>.

in the Euro area). Applying the single monetary policy automatically will reduce some costs for the Romanian banks and could contribute in reducing the interest rate's differential.

We must not neglect a very important factor: the supply and demand for money, especially in the retail market. The weight of credits in GDP in Romania is very low compared with the EU average; however, the growth rhythm is impressive. The interest rates are still higher than normal, but the increasing period in granting credits (a couple of years ago, the mortgage credits were granted for 10 years and now the period could be 30 and even 35 years), the increasing purchase power of the population, the continuous revaluation of the national currency (RON) against the EUR and USD, made more interesting to indebt and especially to indebt in foreign currencies. This, along with lower competition and market risk premium, leads to higher interest rates.

Cross border credits are still negligible in the whole EU market, even between more mature markets, thus there is less likely to be a real alternative for the Romanian citizens in the following years.

As one can see from this short review, the Romanian banking system is still underdeveloped compared with other CEE banking systems or with those in the Euro area. However, it is generally seen to have strong and sound development.

In the following years it is expected to continue to develop on a very alert rhythm. The higher demand for credits will allow the credit institutions to have very high profits, compared with those in the developed countries.

These high returns have already attracted seventy seven credit institutions from the EU only this year. There are still some important players to come: two significant banks, Transilvania Bank and Carpatica Bank, are potentially for sale and probably will attract serious investors.

Table 8. Comparative situation – number of banks in the system and the market share of foreign banks (%) in 2004 and 2005 in CEE countries

Country	Number of banks, 2004	Market share of foreign banks, 2004	Number of banks, 2005	Market share of foreign banks, 2005
Bulgaria	35	81	34	76
Czech Republic	36	93	36	85
Croatia	44	91	34	91
Poland	61	67	61	70
Romania	39	58	39	88
Slovakia	22	89	23	98
Slovenia	21	35	22	19
Hungary	39	77	34	84
Total CEE	297	75*	-	-
Euro area	2287	24*	-	-

Note: * – unpondered average.

Source: Piața financiară, September 2004, p. 36; Unicredit Group – BA-CA – Banking in CEE and the role of international players, July 2006.

In the following years we estimate an increasing weight for the foreign capital from the EU, including credit institutions from the new Europe. Already, a couple of years ago, OTP Bank, Hungary, bought Robank, and had intended to participate in the privatization of the largest Romanian bank, BCR.

The Romania's joining the EU signifies from the banker's point of view, the liberalization of the Romanian banking market and the implementation of the single license; as a consequence, foreign banks can more easily expand their activities in our country and possibly offer bank services without direct implantation will contribute to increasing competition.

As general alternatives, the modalities for penetrating the Romanian banking market could be: opening branches, mergers with, or acquisitions of, Romanian existing banks and even offering financial services without a physical presence on the market; however, it is difficult to realistically consider that without a direct presence and a profound implication (i.e., also substantial investments) a foreign bank could reach a significant market share.

Conclusion

The Romanian banking system is continuously developing on sound basis, enhanced by the very favorable context of a dynamic economy, with impressive indicators and the stimulating framework of European integration. However, the high rate of development is partially determined by the very low starting point.

The perspective of joining the Euro area represents a new challenge not only for the credit institutions, but also for the National Bank of Romania. Taking into account the continuously growing number of participants – credit institutions and non-bank financial institutions as well – it could be appreciated that the competition will continue to increase and Romania could take advantage from the benefits of the financial integrations, especially in terms of price (interest rate) convergence, without facing the potential dangers of serious bankruptcies or a financial crisis.

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