THE RELATIONSHIP BETWEEN THE BANKING LEGAL ENVIRONMENT CHARACTERISTICS AND BANKING RISK MANAGEMENT ACTIVITIES

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Abstract: The role of the financial intermediaries such as banks is that to channel savings towards investors. In a modern economy banks do this by maintaining a delicate balance between risk taking and risk management. Our goal here is to examine ***the relationship between bank risk taking and risk management activities and the quality of the legal environment****. Examining this relation is interesting because theoretical studies in this direction are ambiguous and this can be proved by considering the role of the collateral, a very widely spread and widely used risk amelioration mechanism.*

Keywords: banking legal environment, risk management, transition economies

The banking field of the countries in transition remarkably developed in the last 15 years. The bank activity from most countries in transition actually exceeded the specific trauma of transition. Therefore, the banks of these countries are very much alike those of anywhere else at the beginning of the 21st century.

A surprisingly great number of studies that provided information about bank performances were carried out, but not many things about their position about assuming risks and the way in which this is influenced by the bank environment are known. The institutional area of a country differs a lot from that of all the others. Berger and Udell (2002) [1.], Berger et al. (2001) [2.] and Haselmann and Wachtel (2006) [3.] proved that banks differently react according to the existing institutional regime. Berger and Udell (2002), for example, found out that banks are more willing to offer finance to debtors they do not hold insufficient information about into a better legal system. That is to say, if reliable guarantee regulations do exist, the banks will grant credits to risky debtors even though they do not have sufficient information, such as, financial statement or statement of account. From this point of view, the improvement in the bank legislative area is associated to a high level of risk assumed by the banks.

The bank activity of the countries in transition has rapidly got over four different stages (see Bonin and Wachtel 2003) [4.]. The first stage of bank development for the economies in transition meant the setting up of banking institutions at the beginning of the 90's. During the planned economy era – mostly unknown -, the only existing financial institutions were appendix for the state mechanism and bank activity, in the contemporary sense of the word. The commercial banks were separated from the payment central banking system. Anyway, the role of these institutions was mostly unchanged. The state banks financed state enterprises, quickly becoming insolvent. The second stage of the banking transition process consisted of banking crashes and systemic crisis that affected in a negative way all economies in transition after 1990 (see Bonim and Wachtel 2005) [5.]. The third stage consisted of a long process of reorganization by privatization and the intermission of foreign banks. Most banks were private property and the foreign banks dominated the bank activity in the countries in transition at the end of the century. The forth stage brings us to the present moment. In most economies in transition banks are safe, competitive and adequately regulated institutions. The bank activity from the period of transition left aside any kind of track from the period of the planned economy. The research made in the field of the transition economy is exhaustive and the problems about risk assuming and administration still remain with no kind of investigation. The first studies about the bank activity in the transition period were focused on the bank institutions creation and structure (see Corbet and Mayer 1992 [6.], Udell and Wachtel, 1995 [7.]). Accordingly as the transition process developed, the research interest focused on the bank performances and the bank activity efficiency later on. Recent studies approached the bank crises, the processes of reorganization and privatization that marked the transition period. Haas and Lelyveld (2006) [8.] and Haselmann (2006) [9.] finally focused on the consequences the foreign banks intermission brought upon the bank sector stability. The studies concerning the risk management carried out by the banks in the economies in transition are rare because the information about specific bank activities is very limited.

Kager (2002) [10.] focuses especially on banks at individual level and pointed out that the non-performance credit problem persists in many banks having economies in transition, Romania included. In Haselman and Wachtel's work (2007) [11] the three following points resume their discovering: 1. Certain bank groups differ at the risk level; for example, the foreign banks from the European Union and the big ones disclose a less probable loss by comparison with their competitors. Still, they are not but slight differences that are generally statistically insignificant and this issue reveals the fact that the bank markets are relatively homogeneous and no groups of banks that can take excessive risks may be identified. 2. They did not find out a clear connection between the risk taking activity by the banks and their legislative environment. Their discovering still reveals the fact that the banks that carry out their activity in a less secure institutional area retain more capital and assume themselves less credit risk. 3. The banks that take on more risk administrate it by the setting up, for example, different risk administration departments or obtaining information about the borrowers. These banks also have the tendency to retain more capital.

Nevertheless, banks adapt themselves to the area in which they operate by adapting their own capital. Haselmann and Wachtel (2007) [11.] pointed out that the differences at the legal environment level alter the credit portfolio composition. The banks do not have comprehensive information at their disposal when they engage themselves in a crediting process because the debtors are aware of the risk of their investment project. There are still some stipulations that may be included by the banks in their credit contracts for combating with the lack of information. Bester (1985) [12.] pointed out that the pledge may serve as warning instruments, taking into account the fact that the true risk degree is revealed by the guarantee size that the debtors are willing to produce. A good legislation to regulate the system of pledge and appropriate institutions to apply it are necessary for efficient warning instruments such the guarantee to exist. A growing reliability of the law and the agreements concerning the guarantee system may lead to the development of the guarantee employment for combating with the insufficiency of information and the generalized risk reduction. A debtor may use the same goods as pledge for different credit contracts or decline its handing in case of debt redemption impossibility in a poor regulated environment. A more developed institutional environment is associated with a greater availability to use the guaranteed credits and an intense credit activity in this respect. This is accordingly with the data from the juridical and financial literature that indicates a positive connection between the rights of the creditors and the credit market development. (La Porta, et al., 1997, 1998). [13], [14.].

The guarantees are the juridical means that give to the titular creditors either priority to other creditors concerning the unwilling pursuit of specific assets from the debtor's fortune or the possibility to unwillingly pursue another person that obliged himself together with the debtor. The essential function of the guarantees is to diminish or eliminate the loss risk the creditor takes from debtor's insolvency. The concept of guarantee is defined neither by the Romanian civil or commercial legislation, nor by those of the other countries, and general dispositions applicable to any forms of warrant do not exist either. Only different types of guarantees are regulated and there are special stipulations specific to certain types of warrant. This legislative gap was completed by the juridical literature and different opinions about the concept of guarantee that have been stated [15.] **We mention that no studies about guaranty legislation and the quality of the legislation assessment means have been done in Romania in the field of bank perception**.

The Basel Agreement II or, as it is also called, The International Convergence of Capital Measurement and Capital Standards – a Revised Framework, has been finalized and signed by the Basel Committee in 2005 and progressively implemented by the countries from the European Union from the 1st of January 2007 (with certain impairment of the advanced methods of risk evaluation that had to be applied up to the 1st of January 2008) [16]. The Agreement itself is not compulsory either for the countries that are members of The Basel Committee or other states. The stipulations of the Agreement in Europe are taken over by European Directives obligatory to transpose in the national legislation of the states that are members by virtue of understandings of the gentlemen agreement type. It is the situation of the Directive known as the capital Adequacy Directive. Capital Requirements Directive CRD published in the Official Journal of the European Union on the 30th of June 2006 actually represents a combination of two Directives: The Directive 2006/48/EC concerning the setting up and development of the credit institutions activity (revised [17]) and the Directive 2006/49/EC about the investment societies and credit institutions capital adequacy (revised [18]). Romania, as member of the European Union, has to apply the European Directives stipulations according to the Basel Agreement II. A new package of normative documents in the domain of bank capital adequacy (The Government's Urgency Decree no. 99/2006 regarding credit institutions and

capital adequacy, subsequently approved, in 2007, by the Law no. 227; The Order no.12/2007 of the National Bank of Romania regarding the reference of the minimal capital requirements to credit institutions; The Regulation of the National Bank of Romania and Romanian National Securities Commission RNSC no. 22/27/2006 regarding the credit institution and investment firms capital adequacy; the Regulation of the National Bank of Romania and RNSC no. 18/23/2006 regarding private funds of credit institutions and investment firms; the Regulation of the National Bank of Romania and RNSC no. 13/18/2006 regarding the fixation of capital requirements for credit institutions and investment firms) was adopted in the context of the preliminary training of the Romanian banking system for the process of implementation of the Basel II Agreement stipulations in Romania. The concept of capital adequacy is therefore present in our country, too, but in the first years of development of the Romanian banking system, the specific legislation made references to the capital requirements only (art. 40-43 of the Banking Law no. 58/1998 which in the present is abrogated) and the same concept was taken over by the national regulations (for example: the Government's Emergency Ordinance no. 99/2006 regarding credit institutions and capital adequacy) only when the Basel II Agreement has been implemented. The reference formula elaborated by the Bank Supervisors Committee from CEBS Europe that represent instruments necessary for bank supervising according to Basel II have been taken over and adapted for the Romanian banking system. It is about the Common solvency ratio REPorting framework that we are talking about. They were transposed at the individual level and consolidated through the Order of The National Bank of Romania no. 12/2007 regarding the reference of the capital minimal requirements for credit institutions and the FINancial REPorting stipulations that were transposed at individual level and consolidated by the Orders of the National Bank of Romania no.6/2007 and 13/2007 regarding the financial situation of credit institutions according to The International Standards of Financial Report. The references of the COREP type that commercial banks carry out at the National Bank of Romania stipulate the transmission of information that certifies if the credit institutions do respect the prudential requirements regarding the proper funds and capital requirements, credit risk, market risk and the operational one at individual level as well as the consolidated one. The references of the FINREP type represent an important intermediary between the bookkeeping information and the prudential one as well as an instrument used by the supervisors for checking the prudential information.

The national legislation according to the Basel Agreement II suggests two alternatives concerning the **credit risk** evaluation: - *the standard method*, according to which the capital requirements are calculated having in view the debtor's type and rating and allows the possibility of determining the credit quality also by using the evaluations made by institutions of credit external evaluation, - *the internal models*, having two possibilities: basic and advanced internal models that give to the bank the possibility for risk evaluation according to the specific features of each disposal. The risk weight and the capital that is due to it are determined by quantitative entrance combinations provided by credit institutions and formula specified in the Agreement based on modern risk management techniques that involve statistic evaluations. Regarding to the **market risk**, the national legislation according to the Basel II Agreement suggests two measurement alternatives of the interest rate risk, the share price risk , the currency circulation risk, the wares price risk and the transaction of options risk for market risk evaluation: - *the standard method* mesures these components of the market risk by applying weights upon the positions in the transactional portfolio that is held for determining the losses in and extra balance positions owing to the inauspicious fluctuations of the market prices. – *the internal methods* permit us to fix the market risk by using the VAR Calue at Risk models on the basis of a set of quantitative and qualitative criteria and stress testing rigorous programs. The national legislation according to the Basel II Agreement suggests three measurement alternatives for **operational risk** evaluation: - the basis indicator approach, in which a single risk indicator of 15% is used at the level of a bank in order to calculate the capital requirements on the basis of a fix percentage of 15% from the annual average income registered in the last three years. – the standard approach that implies the grouping of the bank activities into eight groups and the proper funds requirement is determined separately for each category by applying a specific coefficient between 12-18% upon the gross proceeds from the last three years. – the advanced evaluation approach, where the capital requirements are calculated on the basis of the internal data of the banks regarding the operational loss through methodologies, as well as those of income volatility, those based on assets evaluation, parametrical models etc.

The European Commission adopted the **THE WHITE BOOK regarding the European Union mortgage credit market** integration on the 18th of December 2007. The following situation is presented in the

document: the financial services providers may offer Trans- frontier mortgage credits in different ways: by their local presence (e.g. branches, subsidiaries, fusions and acquisitions); direct distribution channels (e.g.: by phone or internet); or local intermediaries (e.g. brokers). The financial service providers may also engage into trans-frontier activities through mortgage portfolios acquisition from a mortgage creditor in a different state member. The differences of juridical order, the existence of fragmentized structures (for example, credit registers), as well as the lack of an appropriate juridical framework in certain aspects (for example, for mortgage financing) creates juridical and economic obstacles that restrict the trans-frontier loans and hinder the development of the pan-European strategies capable of financing. That is why the European Commission tries to eliminate the disproportioned obstacles in order to reduce the sale cost of mortgage products in the European Union. The impact study that encloses the present White Book suggests that a new legislation would signify the most adequate option of policy for accomplishing the established objectives in certain domains, but the European Commission believes that new analyses and consultations with the interested parts before a final political evaluation regarding the most appropriate way to be followed represent a necessity. The Commission is going to analyze a rigorous impact study that is going to include a quantitative analyze for costs and profits of the different options of policy for all aspects in view especially according to the principles stated regarding the best way to legislate and assure that the expected profit is not going to be overcome by the costs. The Commission believes that it is premature to take a decision before the end of this study and carry on new consulting with the interested parts if a directive would represent the necessary added value. In 2008 the European Commission: 1. is going to finish a revised version of the European Standardized Information Sheet – ESIS) upon the credits for lodging using the positive results obtained by the Group of Experts convened by the Commission in 2006 and formed of creditors and debtors, taking into account the initial results of the tests made by the Commission within the customers in 2007, as much as possible (especially regarding the warning about risks and foreign currency loans); 2. is going to test the revised version of the ESIS sheet in all member states on a large scale; 3. will examine to what extent the stipulations regarding APRC and included in the directive regarding the consumption credit may be extended to the mortgage credit either in the present form or in a way that has to take into account the specific features of the mortgage credit. The European Commission will publish up-to-date board tables containing objective information about the costs and duration of the landed registering and, respectively, prescribing procedure in all member states. In 2008, the European Commission will present a recommendation based on an adequate impact study. That recommendation: 1. is going to invite the member states to secure that the prescribing procedures are completed in a reasonable time and at reasonable cost and their landed book registers are available on line; 2. will encourage the member states to adhere to the EULIS project [European Land Information Service with 10 participants up to present that want to facilitate the trans-frontier access to landed property on line (www.eulis.org.)] financed through the eContent program of the European Commission; 3. invites the member states to secure more transparency and reliability for the landed book registers;

The institutional (legal banking) environment differs a great deal from one country to another. The European countries adhering to the EU in 2004 were forced to establish the creditor's rights and to ensure proper legal regulations while most of the other countries were not subjected to this kind of external reforming pressure. Thus, institutions in this countries offer, on average, less protection to creditors (see EBRD 2004 and Pistor 2000). There are no signs that one particular group of banks in transition has taken excessive risks. The bank markets in transition economies are relatively homogenous varying only slightly regarding banks in different regions, belonging to different ownership groups or having a different size. What's interesting is that we didn't find one single study to present the relationship between the level of risk banks take and the Romanian legal environment they operate in. However, banks operating in an unsafe environment generally maintain a higher level of capital/assets. And banks with a higher risk rate, comparing to their competitors, develop more risk management activities. This suggests that banks in transition economies have learned by now how to manage the risks. Banks that have access to files within the Payment Incident Bureau, Credit Bureau, and Banking Risk Bureau tend to have a considerably lower probability of default than the ones that don't have access to the information. In conclusion, credit Institutions must undertake all necessary precautions to obey local requirements regarding the execution of the collateral security. Credit institutions must ensure that there is a legal frame allowing them, as creditors, to have a first rank preference right regarding the secured debt, except those cases when the national law confers this first rank preference right to preferential, according to legal or procedural stipulations.

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