

PROCEDURES AND MECHANISMS FOR PREVENTION OF THE RISK OF FINANCIAL INSOLVENCY IN THE BANKING SYSTEM THROUGH THE USE OF RISK PROVISIONS

Imbrescu Carmen-Mihaela

Universitatea de Vest Timișoara Facultatea de Economie și Administrare a Afacerii. Str.Pestalozzi nr.16 Timișoara carmen.imbrescu@feaa.uvt.ro 0744525972

Hațegan Camelia-Daniela

Facultatea de Economie și Administrare a Afacerii. Str.Pestalozzi nr.16 Timișoara camelia.hategan@feaa.uvt.ro 0745379250

Megan Ovidiu-Octavian

Facultatea de Economie și Administrare a Afacerii. Str.Pestalozzi nr.16 Timișoara ovidiu.megan@feaa.uvt.ro 0723666556

The paper addresses how the central bank put in place procedures and mechanisms for mandatory treatment of the risks the banking activity but also of the classification of loans and investments, the establishment, regulation and use of specific provisions for credit risk.

The rules involves in Bank insolvency are designed to warn of the time the financial crisis and potential or current to serve to avoid reaching the bank unable to achieve its contractual commitments.

Keywords: loans and investments, provisions for credit risk, insolvency

JEL codes: M41

The insufficiency of the own funds, the excessive need for credits and the over indebtedness are at the origin of all bankruptcies. The financial crisis is as the insolvency a situation difficult to perceive and accept. The accounting information, the valuation or the audit reports and the attention from banks can offer criteria to appreciate the risk degree of the activity, and the moment of the alert situation can be appreciated. A list of warning indicators generally accepted and published by the Chambers of Commerce, the audit organisations, the rating agencies and based on them the enterprisers could analyse their financial situation alone. Generally the financial banking system is an important informational source for the company's difficulties, because it is built in such a way that it ensures itself and it ensures the banks for the insolvency risk of their clients. The warnings collected by the banks from the system are further sent to clients in difficulty for an eventual straightening. The scoring and the rating procedures (valuation of the bonity and of the risk degree) are important sources of an early warning. The country rating is essential for the enterprisers confidence into the state's economy, unfortunately there is no rating procedure for small and medium size companies in Romania yet, but they apply to big companies and to public institutes that either issue obligations or are quoted at the stock exchange and the scoring procedures are still in the intentional phase.

During the last four centuries the financial crisis has repeated themselves being generated by the same factors and going through the same stages and in the end there was a frozen of the bank credits. The 20th century has known a powerful crises when the American economy with a spectacular growth causes an increase of some stock exchange titles 5 times. As a result the investments into the economic growth have as bank result the increase of the bank interest. So the economy has slowed down its rhythm and the stock exchanges have slowed down their activity. The climax was the stock exchange collapse that generated an economic depression that spread through the entire economy.

The actual economic crisis originates into the year 2001 when the American banks granted credits with no warranty and with a high risk of non-reimbursement. The Bank increased their interest, the Americans could no longer pay for their houses, so the selling offer has increased

and the prices have gone down. The banks have begun to credit themselves or they have made loans from different funds, no one could retrieve their debts and the insurance companies had no more funds to pay the debts. According to Nouriel Roubini economy professor at Stern School of Business at New York University „The banking system of USA is in insolvency”. He estimates that the total losses registered by the financial institutions as a result of the reduction of the accounting assets is of US dollars 3,600 billions. The experts continue to point out the importance that the American government has to save the banks, Adam Posen ,senior fellow at Peterson Institute for International Economics, says that at the moment, the bank debts have over passed at lot the their assets. Little by little the crisis spreads over to Europe due to inter-connexion of the economy. The expert Cristian Ionescu estimates a powerful decline of the economic growth, an increase of the unemployment, a significant reduction of the consumption, a reduction of the production and the insolvency of the trade companies. It seems that constructions will suffer most due to frozen bank credits, a diminution of purchase demands, and the disappearance of small and medium investors. An increased number of bankruptcies are foreseen. (Cristian Ionescu, Romania – what to expect for the year 2009, Capital magazine 4th December 2008).

The companies with high risk businesses and especially those from the banking - financial field appeal more and more to business risk insurances and managerial liability insurances but also at payment risk provisions for some compensation following some litigation.

In Romania there are around 15,000 new insolvency cases each year. In October 2008 there were 11,525 registered insolvency fields compared to 6,054 from the same period of the year 2007. The most powerful growth of 2.5 has been registered at the constructing companies due to new crediting norms imposed by BNR that have as effect more expensive credits and implicit the reduce access to mortgage credits. The President of the National Union of Practitioners in Insolvency of Romania, Arin Stănescu has declared „Companies reach a state of insolvency from several reasons. The market’s collapse can be to blame, and there can be no blame of the management. We are in a crisis situation and there is no export to the European Union. There are several reasons, but, unfortunately most times companies reach an insolvency situation due to a faulty management”

More and more we debate about the procedures and mechanisms to prevent insolvency in the financial banking system because this sector too can be attacked by the financial crisis, and supplementary and consolidated supervision became a necessity, but also a major preoccupation of the European Community’s right.

In 1974, at Basel there was the first reunion of the Committee on Banking Supervision (BCBS – Basel Committee on Banking Supervision) composed out of the USA central banks’ representatives, and the representatives from, Canada, Japan, UK, Germany, France, Italy, Switzerland, Sweden, Holland, Belgium, Luxemburg. The regulations of this committee have been taken by the member states and the non-member ones and have been materialized into the Basel I Agreement which was brought up to date in 2003 and became Basel II Agreement which aims to establishing the component elements to determine necessary funds for banks, to regulate the capital demand for the risk of credit and market, to ensure the conditions for the internal control procedures and introducing the basic consolidated supervision of the credit institutes. At the same time it obliges banks to transparency being created to allow the banking system to have a better representation of the bank from the point of view of the total risk it is exposed of. Romanian banks must choose for the standard approach of the Basel II Agreement during the year 2007, but up to April 2007 the agreement has been applied just for banks and they have postponed it for the rest until 2008. The credit risk, the market risk and the operational one can be managed based on some internal organisational and functioning mechanisms of each credit institution. The National Bank of Romania separately issued regulations that impose these mechanisms with a purpose of efficient risk management, risk management procedures identified

as internal structure elements and own procedures of the credit institutes due to valuate risk, to notice on time about its existence or to cover it. These mechanisms and procedures are prevention ways of the insolvency of the financial institutions.

Banks can ensure themselves against own insolvency risk by adequating its capital to risk and by consolidated supervision of the regulated entities of the financial markets. The two principles are from the BNR Regulation and the CNVM regulation no 22 / 27 / 2006 published in the Official Monitor no.1035 from 28th December 2006 regarding the adequation of the capital of the credit institutions and the investment companies. This regulation defines the transactional portfolio and the own funds in compliance to which it sets the capital needs and imposes the consolidated supervision and the cooperation between the competent authorities. The financial institutions must have a level of the own funds that is equal or higher to the amount from the capital demand belonging to the transactional portfolio (it consists out of the entire positions of financial instruments and goods owned with a transactional intention of the institution or to cover other elements of the transactional portfolio or those who are free of any restrictive clauses regarding the possibility of their transaction) and the capital demands for the entire activity.

The credit institutes must take efficient administrative measures of the following significant risks:

Credit risk;

The risk resulting from the crediting relation between the credit institution and its debtor called credit risk of the match;

Operational risk;

Liquidation risk;

Risk existing after taking some measures to diminish the risks of an activity called residual risk;

Concentration risk;

Market risk;

Interest rate risk.

Ever since 2002 BNR applied compulsory treatment procedures and mechanisms of the banking activities and the Regulation no.5 / 2002 stipulates the classification method of the credits and placements (last variant being published in the Official Monitor no 189 from 2007) but also the set-up way, regulation and use of the specific credit risk provisions. This regulation applies to the resident credit institutions and the Romanian branches of the credit institutes of third party states and also the non-banking financial institutions. According to this regulation there is the following classification of the credits and placements: standard, sub-standard, under observation, doubtful and in loss. Their classification is done according to the number of days of payment delay, the economic potential and the financial solidarity, the measures taken for retrieving debts, the court decision to open a bankruptcy procedure.

From a financial performance point of view there are 5 categories as following:

-A category if the credited person is a credit institution;

-In different categories from A to E if the credited person is an individual;

-In different categories from A to E if the credited person is an economic entity outside the credit institutions.

The frequencies of determining the performance category coincides with the frequency financial situations are elaborated. The regulation establishes 2 stages in the procedure to determine the necessary provisions specific for the risk of credit. First of all the calculation base is determined for the specific risk provisions by deduction from exposing the credit institution or the non-banking institution towards a debtor of the warranties accepted to be taken into consideration, if there are no judicial procedures or if the credit amounts register a debt service of more than 90 days. The second stage represents the application of the provisioning percentage on the calculation base.

Constituting specific credit risk provisions is done by including into the expenses the amount representing the level needed for specific credit risk provisions. The regulations of these provisions refers to the modification of the existing level of the provisions for establishing the equality between the existing level and the needed one and it is realised by including into the expenses the amount representing the difference between the existing level in stock of the specific risk provisions and the level needed. Using specific risk provisions refers to annulling provisions and it is done by taking as income the amount representing the existing level as off of the specific risk provisions corresponding to the credits that are taken outside the balance sheet.

The loaners will constitute and regulate monthly the specific risk provisions and will take outside the balance sheet the amounts corresponding to a credit if the loaned person register a debt service higher than 360 days. The corresponding amounts will be registered after being taken out from the balance sheet in the category of losses.

A credit is classified according to the number of delay days compared to the due date, the economic potential and the financial solidarity of the economic credited entity and the measures taken to retrieve debts. The financial performance is appreciated after appreciating the liquidity, the solvability, the risk, and the profitability, the administration method of the entity, the warranties received, and the market's conditions.

According to the BNR norm no 12 from 15th December 2003 regarding the solvability supervision and the high exposure of the credit institutions, the rules regarding the bank's solvability are designated to warn about the potential financial crisis or about the actual one and it intended to prevent the bank to reach the impossibility fulfil contractual engagements. The solvability indicator is calculated depending on the own funds of the credit institution, as a proportion from the total assets and elements outside the balance sheet, net provisions, adjusted depending on risk factors. Own funds must not be under the minimum level of the initial capital for authorisation. In compliance to this elementary norm outside the balance sheet there are the engagements in favour of another bank, the titles sold with the re-buying option firmly expressed, doubtful engagements, warranties for clients and the titles given as warranty. In art 7 of the norm it is stipulated that the level of the solvability indicator can not be smaller than 12%, and if it goes below this value the credit institutes must take adequate measures.

As a solvability indicator, the monitoring and the control of high exposures (the engagement of a bank towards a sole debtor, no matter if it is effective or potential, registered outside the balance sheet or inside it including: credits, discounting a bill of exchange, investments in shares and other movable values, , analysed a bill of exchange, issued warranties, acidities opened or confirmed) they are methods of early warning on the potential financial difficulties of the credit institutes, showing their depending degree towards a small number of business partners. BNR has a general supervision through the Supervision Direction to which the credit institution must report the solvability indicator and high exposures in the terms expressly stipulated.

The bank legislation allows BNR to apply special supervision measures when the solvability indicator goes below some limits. The special supervision means drastic limitation of the credit institution manager's attributions and independence, because there is a special committee that will control and supervise the institution's management in stead of the board of administration. The board of administration of BNR appoint a special administrator and the board of administration and the general assembly are being suspended. If the measures prove to be efficient that particular institution comes back to normal, otherwise BNR must ask for that bank's bankruptcy.

The credit institutions, based on Norm no 17 / 2003 must create control compartments and internal audit compartments to prevent the financial crisis risks. In order to have an efficient internal control system the credit institutes must identify and value the significant risks. The credit institutes must ensure the financial, operational and conformance date, adequate and complete. The information must be credible, complete, opportune, and accessible and provided

on a consequent basis. The credit institutions establish the type of risk they are ready to assume and the threshold when such a risk is considered significant. The performance of the internal audit activity follows several planned audit activities stages, examination and valuation of information, communication of the results, recommendation implementation.

In compliance with the “secrete” stipulations of the FMI agreement, BNR will have a higher involvement into initiating liquidation and insolvency procedures of the banks and the special administrator will get increased power in the case of the institutions entering an insolvency situation. The authority of the special administrator will be extended to be able to promptly implement a serial of restructuring measures, including purchasing and mergers, selling of assets, transfer of deposits, capital reduction for covering losses. BNR has the right to establish without waiting for the judges decision regarding the insolvency, when a credit institution can no longer reimburse a deposit and its payment is the competence of the Warranty Fund after modification of the legislation. The payment deadline will be reduced from 3 months with the possibility of prolongation to 9 months as it is for the moment, to 21 days from the BNR decision regarding the impossibility of reimbursing the deposit. The law will establish some provisions stipulated by the general legislation of the insolvency if they do not correspond to prompt implementation of the restructuring measures such as the immediate transfer of a substantial part of assets and capital reduction in order to cover losses. At the same time the law will offer protection to the special administrator of good faith in the activity, for which he has been mandated, and the measures from the special administration period will have a higher legal power and they cannot be suspended or modified based on other legal stipulations. (www.mediafax.ro)

Bibliografy:

1. FINCH V, 2002, Corporate Insolvency Law. Perspectives and Principles, Cambridge University Press
2. NICULEASA I.M. Falimentul instituțiilor de credit, Revista Română de Drept al Afacerilor nr. 5 din 2003
3. PIPEREA GH, 2008, Insolvența: legea, regulile, realitatea, Editura Wolters Kluwer Romania,
4. TURCU I, 2003, Falimentul, noua procedură, Editura Lumina Lex, București
5. www.banknews.ro
6. www.bnr.ro
7. www.capital.ro
8. www.ghiseulbancar.ro
9. www.mediafax.ro
10. www.liquidation.ro
11. www.unpir.ro