

THE IMPACT OF CAPITAL INTERDEPENDENCE ON THE FINANCING OF NATIONAL ECONOMY CAPITALIZATION

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The capital interdependence has contributed to the amplification of negative effects of the present credit crisis. This thing has been felt both at the economic agent level and at the banking level. The effects of the credit crisis have emphasized the false capitalizations among the economic agents which finally will lead to de-capitalizations among them and the banks. Under these conditions it is required a re-orientation of policies regarding the finding out and forming of groups asking for financing. Also, this paper reveals the importance of banking balance auditing and consolidation in the process of banking capitalization advancing arguments to support the idea of a more severe control on behalf of the state authorities. In the future the effects of such a crisis could be much diminished by an adequate capitalization of economic agents and banking system.

Key words: group, false capitalization, unique debtor, audit, balance

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1. Groups and false capitalization

To quantify the risks generated by the capital structure must be studied the juridical links between the economic agents from the property rights upon capitals point of view.

In practice, an economic agent can own parts of the other economic agent's capital and thus, by his exercised right to vote he can have a decisive influence upon his economic activity. The B.N.R and of other commercial banks norms pay a great attention in the case of capitals interpenetration defining the implied economic agents as belonging to a group which is treated as a unique debtor.

The notion of unique debtor is defined as being any person or group of natural and/or juridical persons to which the crediting institution has a statement and:

-which means only one risk, if it is not proved otherwise, because one of them directly or indirectly, controls the other or the others; or

-among which does not exist a control relation as it has been shown above, but which should be considered as representing only one risk because there are such links between them so if one of them should face up to financial problems there is the great possibility that the other or all the others to face up to return difficulties.

Taking into account greater and greater dimensions of some business under the impact of the trans-nationalization phenomenon the commercial companies begin to have a very expended capital structure. In this respect, the legislation in our country foresees that these companies can have subordinated units that do not have juridical personality, they draw up only certain account documents and they do not have their own property. Not having their own property, they do not have the right to have links with third parties, but only the right to manage it.

If the subordinated unit wants to make a decision in the process of capitalization in point of capital increase by investments, the decision should be approved by the central one. Also, if it wants a des-investment or a capital diminish because of loses, it is required the approval from the mother-company. Thus, the process of capitalization is limited, in practice proving that a territory distance to the concrete realities at place can be an obstacle.

Denatured relations which could appear between the mother-company and sub-units at a certain moment, can generate what we name "false capitalization" in the national economy. The false capitalization can be achieved by repeated transfers of amounts between the companies of the

group, the amounts that contribute to the false capital increase, too. Therefore, very big capital amounts are reached to at the unit level under the conditions in which real capitals can be several times smaller.

The false capitalization can be achieved also by fixed means between the companies of the group in documents being as investments and being incorrectly taken at the national economy level in the calculus of fixed capital gross formation. If we have a capital of x millions lei then the false capitalization is given by the sum of all the transactions between the component units, that is $n \times x$. If it is about the false transfers of fixed means of a declared purpose to participate in the process of production at least for one year, then the false measure of the fixed capital gross formation is also $n \times x$.

The artificial increase of capitals and money turn over as a result of such transactions can allow a more rapid penetration to financing from the banking sector with negative implications on the quality of credit portfolio at the national level.

The false capitalization determines a supra-crediting which can be avoided only by a very exact knowing of the relations that develop between the mother-company and sub-units. In this respect we distinguish:

- relations of contracting nature developed on the basis of statutory term or of an independent contract;
- juridical and financial relations, the control of mother-company being done because of owing capital share;
- personal relations where the main role is owned by one person who controls more companies which have a link between them in point of capital.

The notion of group is defined according to the VII norm regarding the consolidated accounts adopted by the Council of European Community on 18th July 1983: "a dominating company and one or more companies depending on it form a group in the sense of this norm if the dominating company effectively influences it so that the assembly of these companies should be placed under the unique rule of the dominating company. Each of these companies is a group company".

The internal legislation that is the order of the ministry of finance no.1414/29.07.1997 defines the group as an "assembly of companies including the company which consolidates (consolidating) and the Romanian and foreign companies (consolidated) in which it directly or indirectly, makes an exclusive control, a joint control or a notable influence".

The right to control can be exercised as a result of having a majority percentage of the capital or of the rights to vote or merely, exclusively by virtue of a contract or statutory term.

The joint control implies to make decisions in common by a limited number of shareholders but the notable influence implies the right to participate directly or indirectly in the financial and operational policy upon one company but without having the exclusive and even joint control.

To limit the risks which can appear in the process of capitalization financed by the banking system it is necessary to know as detailed as possible the relations ruling these economic entities concomitantly with the improving of present legislation in point of a more strict regulation of money and fixed means transfers between companies belonging to the same group.

2. The necessity of banking balance auditing and consolidation in the process of capitalization

The importance of capitalization or the impact of banking de-capitalization upon the banking system in Romania necessarily implies a very exact knowing of their levels and tendencies under the conditions in which the banking transaction is strengthened. Nowadays, more than ever, banks have diversified and branched out their activity so that the capitals they own within the bank or within other economic and financial entities have become very complex. More and more banks in Romania lay the foundation of companies in the field of insurance, financial

investments, leasing, etc. The exact knowing of the group business can be achieved by the consolidation of the whole group financial state.

The mother-company is defined by the Banking law no.58/1998 republished, as being the entity which is in one of the following situations:

- directly and/or indirectly owns the majority of the rights to vote in another entity called subsidiary;

- has the right to name or to revoke the majority of the members in administration and control bodies or the majority of managers of the other company called subsidiary and at the same time it is a shareholder or a partner of that entity;

- has the right to exercise a great influence upon one entity for which he is a shareholder or a partner by the virtue of a term included in the contracts concluded with the respective entity or some provisions included in the constitutive document of that entity if the legislation governing the subsidiary state allows the existence of some terms or provisions;

- he is a shareholder or a partner of the entity and in the last 2 years he himself named, as a result of his right to vote, the majority of the members of administration and control bodies or the majority of subsidiary managers;

- he is a shareholder or a partner of the entity and he himself controls on the basis of an agreement concluded with the other shareholders or partners, the majority of the rights to vote.

The same law defines in art.24 as being "strong links" those relations existing between two or more natural and/or juridical persons being in one of the following states: one of the persons owns a direct participation or with the help of a control relation of at least 20% of the social capital or of the rights to vote of the other person; one of the persons controls the other; the persons are permanently linked to one and the same person by a control relation.

Considering the above mentioned, the capital branching and increasing can become risky for the bank because it can be affected by the risks specific to the proper banking activity but also by the risks on the insurance, securities and currency markets, etc.

The collapse registered by Baring Brothers Bank in Great Britain in 1995 is very relevant. The reducing of banks income traditional sources in the United States of America and Great Britain as a result of unprecedented development of capital market has determined the banks to emerge these markets founding specialized companies or participating in the capital of some companies already existing on the market. It has determined very rapid changes in the structure of banking capital, at the same time the banks making compromises by accepting some persons who did not have anything in common with the conservative strategies and the principles of banking prudence. Under these conditions, the manager of Baring Futures in Singapore did not only meet such conditions but he dangerously had two incompatible jobs: one of the chief of the transaction settlement department and the other of the chief of the transactions done on financial markets without being a control between the performed transactions and the assumed risk.

Under the conditions of the earthquake in Kobe Japan in 1995 the insurance market and the capital market were visibly affected by its implication, the positions got by Baring Futures remaining unprotected.

The used strategy did not by far respected the norms of the banking prudence, on the market being thrown big amounts of money trying to protect Futures contracts, techniques specific to capital markets. The registered losses were of about one billion dollars. In order to avoid its implication on the banking system, the Bank of England reunited the representatives of the main banks trying to find the one billion dollars in order to re-capitalize the bank. They answered the central bank appeal in order to avoid the implications the Baring bank collapse could have on their banks. But after long negotiations the representatives of these banks considered that they did not want to risk their payers' money in order to support this bank whose operations were based on term contracts.

From Baring bank lesson derives some conclusions as follows:

-the necessity of a more severe control on behalf of banks and central banking authorities upon the branches developing transactions on capital and insurance markets being inexplicable how the Baring Futures managerial team could hide to its auditors all the disorders between February 1994 – February 1995;

-stock-exchange authorities should communicate more between them, the markets could not protect their member capitals without a strong centralization of information.

To prevent such situations, the Banking law no.58/1998 republished foresees in its article 85 that the financial auditor yearly will draw up a report with his opinion from which should derive whether the financial states presents a true image of the financial image, treasury fluxes and to the Romanian National Bank it will offer any information and explanation. The auditor will inform the National Bank about any deed which could affect the property state or which means a grave infringement of the law.

The shares a bank can own in companies other then credit institutions, the financial and insurance institutions cannot exceed 15% from its proper funds and 20% from the social capital of the respective company. All shares portfolio owned by a bank under the above mentioned conditions cannot exceed 60% from the own funds of the bank. These conditions that again limit the banking activity according to the capitals amounts mean another argument in supporting the importance of capitals on the banking market.

That is why, in order to diminish the risks which can appear but also to insure the amounts necessary to gain participants, the law stipulates that it is submitted to a previous approval by the Romanian National Bank:

-any share the bank intends to own in credit, financial and insurance institutions or other entities which as a result of getting the respective share would enter the perimeter of account consolidation;

-any participation whose value is at least 10% of the own funds of the bank which it intends to have in shares or other securities of participating nature unquoted on a regulated market;

-any participation whose value is at least 10% and 15% of the own funds of the bank which it intends to have in shares or other securities of participating nature quoted on a regulated market, issued by entities other than credit, financial, insurance institutions or auxiliary or connecting services institutions companies.

3. Conclusions

The real evaluation of banking capitalization at a certain moment as well as its tendencies is mediated by the banking balance strengthening which allows the achievement of unique accounts for the banking company and the companies independent in juridical point of view but which are linked between them by a center for common decision. By consolidation, the account of profit and losses and the balance of these companies are presented as if they form a single entity.

For a correct evaluation of the process of banking capitalization this way of presentation gives extremely important information regarding the social capital and own funds capital dimensions. Thus, the profile of the other companies with which the bank forms a group, in fact, can be a loss which cumulated with the banking company profile leads to its diminishing or even to registration of losses for the banking unit. Keeping of the bank participations at the companies belonging to the group implies the participation both to the profiles and to the losses. Under the above mentioned conditions the bank will be forced to “finance” the loss registered by companies where it has participations by diminishing the capitals kept by them or by the capital infusion from its own resources.

This actual fact will reflect itself after the account consolidation in diminishing the banking profit or even the banking capitals.

Regarding the consolidated account of profit and losses it is very important to separate the profit in three levels: exploitation, financial and exceptional. Even if the group registers profit it can

overwhelming derive not from exploitation which characterizes the banking object of activity but from certain speculative operations of the capital market of a very high risk. It is good that after the account consolidation to be calculated an indicator we will name “the capitalization risk” calculated as a report between the profit from exploitation and the amount between the financial and the exceptional profit. It would show the possibility, at a certain moment, not to achieve the increase of capitals by non-achieving the financial profit as well as the exceptional one because of new market conditions.

If in the first stage the consolidation of the account of profit and losses could give the measurement of the tendency to increase and decrease the capitals as a result of the ended financial exercise, the banking balance consolidation gives precise information about the capital levels.

It is opportune that after the financial state consolidation to re-calculate certain indicators of banking prudence and banking profitability. Thus, the calculation of some indicators as solvency rates and the proper capital rate is to be done according to the own capitals at the group level showing a more complex state about its solvency. The indicators of banking profitability are to consider the total consolidated net profit and the total consolidated assets as well as the own consolidated capitals. These re-calculated indicators are to be an informative support in the process of the Romanian National Bank monitoring and supervising

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