

# THE IMPACT OF THE FINANCIAL CRISIS ON THE EUROPEAN BANKS

David Delia<sup>80</sup>

Vasile Goldiș, West University of Arad

Faculty of Economics Science

*The fast innovations existent on financial markets and the internationalization of cash-flows in the last decade led to changes within the banking industry making it unrecognized. The financial innovation within the banking industry, especially the one regarding the off-balance-sheet instruments has effects as the risk focus and the increase of volatility within the entire banking industry. As it is proved by the economic crisis, the financial stability plays an important role within the financial system as well as within the economy as a whole. At the moment, as the number of active financial institutions is getting higher and higher in one or more countries or on one or more continents, the financial stability at a worldwide level became even more important. The objective of this work is to emphasize the way in which the European banks were affected once with the global financial crisis. The economic crisis was triggered by the bankruptcy of the Lehman Brothers ' Investment Bank, in the autumn of 2008 and its effects were felt at the level of the European financial markets, a series of cross-border groups claiming interventions of the state in order for them to be saved. The intensity of the crisis was felt and it affected many states, the impact of these ones being influenced by a series of specific factors which outlined the situation of their financial system, at the moment of the crisis release. At the level of the European Union, a series of measures have been established in order to extinguish the identified dysfunctions at a financial field level, among which we mention: the improvement of the surveillance framework of those financial institutions having cross-border activity, the expansion of the communication and cooperation among the EU surveillance authorities and the ones outside the Union, etc. The conclusions of the study of this paper work in regards to the activity of the main European banks, especially to the ones from Western Europe, is the fact that during the crisis period, they intensified their cross-border activities and increased their incomes. The increase of incomes was generated by both the fast efficient measures taken by the state and the volatility of the emergent markets. All these aspects were detailed in the content of this paper work. As far as this work is concerned, the method used here consist in a deductive-type research, which means that the starting point is represented by general facts in order to get to particular ones, starting from a theory that has as purpose the application of that certain prediction, assuring a wider knowledge area and being more operational. The selection of the pieces of information was done through different methods, as are the quantitative and the qualitative research types. The pieces of information presented here were picked up from different sources, as published articles and specialized books, all being from the financial field.*

**Keywords:** financial crisis, European banks, cross-border activity, the analysis of the indicators, banking activity

**JEL Classifications :** G01,G21, G28

---

<sup>80</sup> This paper is part of post-doctoral research "Trends regarding the evolution of the banking sector in Romania" under the guidance of PhD Professor Silviu Cerna in the post doctoral project: "Post-Doctoral Studies in Economics: training program for elite researchers - SPODE" in the period 2010-2013 developed by the Romanian Academy in partnership with West University of Timisoara, Alexandru Ioan Cuza University of Iasi and Ovidius University of Constanta. Funded by contract no. POSDRU/89/1.5/S/61755

## 1.Introduction

The actual economic crisis took place at two distinct levels: one characterized by tumults and their limited spread, between 2007 and the 15<sup>th</sup> of September, 2008, and the subsequent period characterized by a complete failure regarding the reliability on the financial system, fact which contributed to a global propagation of the crisis. The first phase arose when the average correction of the prices of the USA's Real Estate generated a slight increase of the delinquency regarding the mortgage and at the same time it generated the bankruptcy of the financial institutions which held toxic and complex financial instruments, based on "sub-prime" mortgages. The autumn of 2008 brought itself the increase of crisis' propagation velocity as well as a sequence of the financial institution's bankruptcies, a notable one being the bankruptcy of the Lehman Brothers' investment bank. This marked a turning point where financial tumults started a year earlier transformed into the most severe crisis recorded since the one from 1933. Its effects hit European financial markets, a series of cross-border banking groups claiming interventions of the state in order to be saved. As a result of this, at the UE level, it was necessary to adopt a focused action plan, having as main elements: to facilitate funding for banks by different means; injecting extra capital into the financial institutions; recapitalization of the problematic banks, etc. At the same time, this established common rules which the central banks and their governments were supposed to promote within the context of accessing packages of anti-crisis measures, so that, the demarches adopted at a national level don't induce side effects within the functioning of the Unique Market and of the other member states. In the context of this reality (Georgescu, 2010: 35), it was configured the perception of the banking industry in regards to the risks that this confronts with).The magnitude of the crisis was felt and it affected states differently, the impact on these being influenced by a series of specific factors which outlined the situation of the financial system, at the moment of the crisis release. According to the specialized literature (Schildbach , 2010:67), we can talk about the existence of three categories of states whose financial systems were strongly affected by the global financial crisis:

- States as the USA, the UK, and Ireland, in which banks confronted with a drastic cut within the balance sheet asset value as a result of the diminishment of the collateral and of losses in the granted credits before 2007.
- States as Belgium, Holland, Switzerland and Island, in which the local market was insufficient for the ambition of the financial institutions, which, in consequence built great exposures in products which have been previously structured in other jurisdictions.
- The case of Germany, in which a significant percentage from the banking industry didn't have sustainable business patterns and sufficiently productive, at which is added the employment of banks as "Landesbanks" in transactions with substitutes to credit (example: purchasing secured credits instead of direct crediting).

The banking system of the market economy represents all the banks which perform in a period of time being an interconnected assembly of autonomous banks, authorized and specialized in the circulation of the capital available for lending and they have as target of their activity to achieve profit. ( Bercean et all, 2004:73). Unfortunately, as a reason of a tough competition, some of the bankers and some banks tend not to take into consideration the risks which they expose to and the main question regarding risks ("Which is the payment capacity of this client?") isn't asked any longer and it shows up the probability of losing enormously much.(The banks which succeeded in controlling the risks which they are exposed to, reached the conclusion that this process is in tight correlation with their profitability. In order to get higher incomes, a bank needs to assume higher risks, to increase its exposure towards risk and to diminish the operational costs (which leads to increase risks) (Breban , 2006 :23). The losses existent in the banking industry were borne initially by the profit of the banks without being converted to costs borne by the public sector. The profitability of the banks deteriorates fast in case of a systemic crisis governments' need of fiscal support, in order to restructure the financial sector which was strongly affected.

Even though there are still debates on the contribution of the crisis to the first recession of the global economy after World War II and on the increase of the budget deficits respectively of the public debts, it is still unquestionable the fact that this had a determinant role. In a surprising manner, the economic crisis released in 2007 ended up being ‘the cheapest’, at least in relative terms. The fiscal costs attributed to the financial crisis until 2009 represented, on average, 5% of the PIB, in comparison with 15% in the case of the previous crisis. The adopted politics with the purpose of supporting the good assets and maintaining losses at a low level, as well as high value and the high speed of the private recapitalization, did so that the public recapitalization to take place at a moment when the banking solvability was much stronger than in the case of the previous crisis. The total value of the capitalization from public sources (Claessens et al, 2011:53) got to be of 441 milliards of USD, from which 245 milliards of USD in the USA, within TARP (the Trouble Asset Relief Program) and 196 milliards of USD in the UE, which, at an average of only 5% from PIB of these, represent approximately one third from the amount involved in the previous crisis (the Nordic crisis: Finland, Norway and Sweden( all in 1991); the crisis from Latin America: Brazil (1994), Mexico(1994) and Jamaica(1996); The Asian crisis: Indonesia, Japan, Korea, Malaysia and Thailand (all in 1997); the crisis of the emergent markets: Columbia(1998), Ecuador(1998), Russia(1998), Turkey(2000), Argentina(2001) and Uruguay (2002). Even though the crisis was released in the USA, it propagated rapidly hitting most of the worldwide economy, respectively the UE. The typology of the most important causes which contributed to the release of the economic crisis can be grouped as it follows:

1) Basic deficiencies of the regulatory framework. As the framework for prudential regulation existent at the moment when the crisis was released didn’t succeed to assure solidity and the health of the credit institutions at a level which doesn’t put in danger the financial stability of the system, it was necessary to go for the Program of Reform, in which qualified authorities were involved, its main purpose being to create a regulatory framework which allows the financial system and the banking one to act as a stabilizing force of the real economy. Important elements were put in, among which we mention the following (Georgescu, 2009: 25) :

- Inappropriate macro-prudential surveillance;
- Inefficient early warning mechanisms;
- Minuses related to surveillance practices at a cross-border level;
- Insufficient cooperation and the lack of trust among supervisors;

2) Dysfunctions within the cooperation mechanisms. The existence of significant deficiencies in the cooperation field was revealed, of coherent application of the Union Law and of trust among the surveillance authorities. The system of cooperation between the surveillance authorities, existent at the moment of the crisis release whose competences were limited at an individual level, nationally it was proved that they were inefficient.

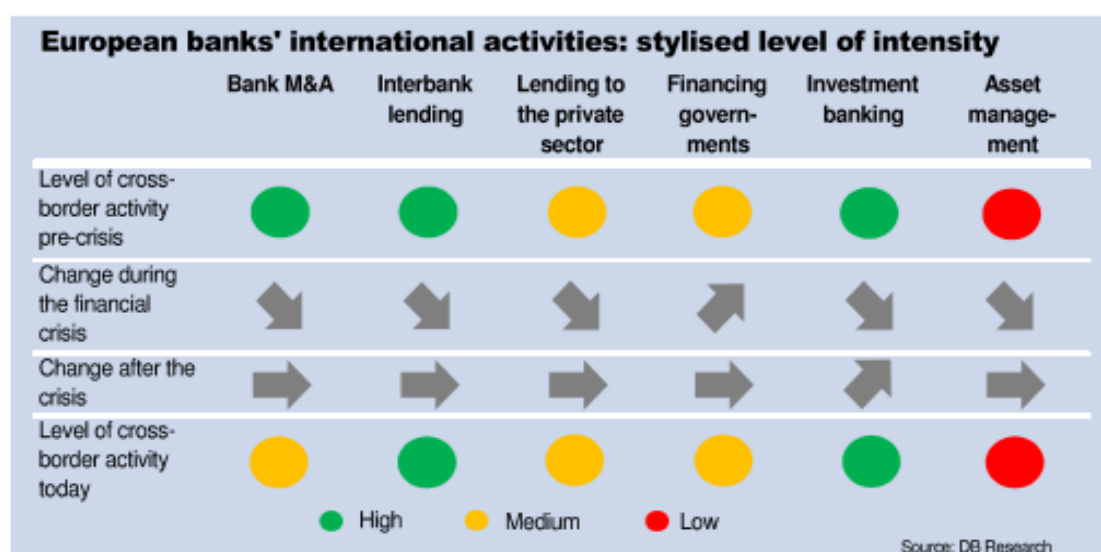
Taking into consideration the deficiencies indentified above, measures waiting to be taken were outlined in order to eliminate dysfunctions regarding the improvement of the achievement framework of the cooperation between these, in both normal conditions for performing the activity as well as for a crisis situation. Among such measures, we remind the following:

- The improvement of the surveillance framework of the financial institutions which work at a cross-border level;
- The assurance of convergence in the prevention field, managing and sorting out crisis situations; the improvement of the well functioning of the surveillance authorities’ network by the delegation of tasks and responsibilities;
- The expansion of dialog and of cooperation between the EU surveillance authorities with the ones out of the EU; the increase of the responsibilities belonging to the EU surveillance authorities in managing coordinates of the crises, as well as in the maintenance process for the financial stability in crisis situations.

The globalization of the financial markets and of nations within a global economy will lead to even a bigger economic interdependence; in this situation it would be inappropriate for the institutional and political agreements not to be exposed to changes in order to accommodate to power and of the different preference of the entities existent on financial markets. (Dumiter, 2011:12). We aim at emphasizing the impact suffered by European banks as a consequence of the global crisis' release in 2007.

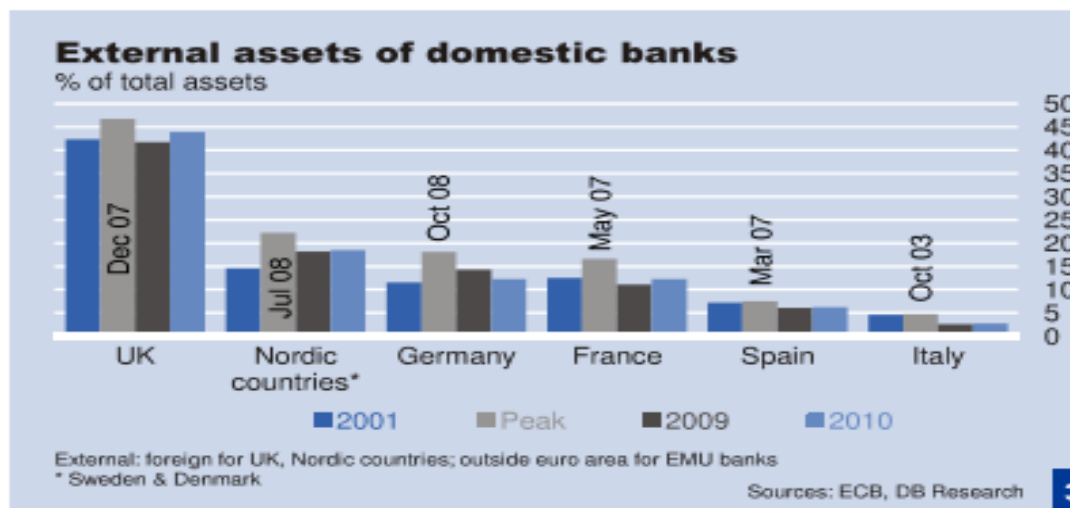
## 2. The effect of the global financial crisis on European Banks

At the moment of the economic crisis' release, the European Banks had already manifested the tendency for internationalization of their activity, the level of this one showing an insignificant variation between countries. It is worthy of remark the fact that the influences on foreign investments had also an important impact on the development of the Romanian economy. According to a study made in June, 2011 by Deutsche Bank, the degrees of evolution regarding the activity of the banks existent in Top 20 European Banks before the moment of the crisis release and until present time are outlined in the following table:



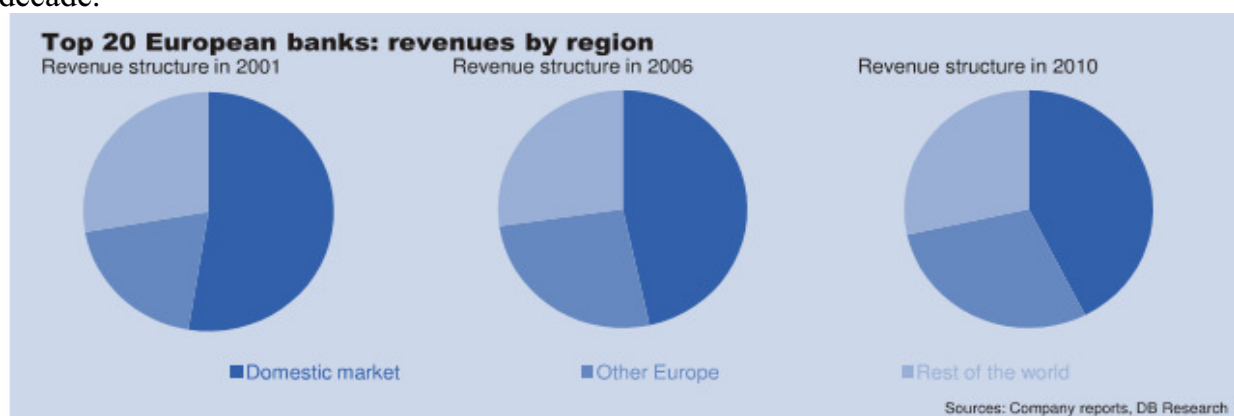
Source : Schildbach, Jan "Home, sweet home? International banking after the crisis," Deutsche Bank Research, June 2011

Even though during the economic crisis the activity of the banks suffered, at the moment it recovered as the level of the cross-border investments having high rates. The same study reveals that the majority of the European banking institutions reached the maximum degree of exposure on the external market between 2007, respectively 2008. This low level went down substantially having a stable value in 2010. Despite this, the evolution of the cross-border activity belonging to European banks proved not to be everywhere the same. According to the graphic presented below, certain countries reached the maximum level of exposure in a previous level, reactive in 2003. The share of the external assets in the total assets for the banks found in Top 20 European Banks is presented in the table below:



Source : Schildbach, Jan "Home, sweet home? International banking after the crisis," Deutsche Bank Research, June 2011

This situation is the result of the following: the expansion of the cross-border activity, the purchase of foreign banks and also non-profitable investments in securities guaranteed by the USA's subprime mortgage credits. In 2008, the external claims of the European banks suffered a decrease while the banking sectors left behind fighting with the crisis (the case of the Irish and German banks) continued their stabilization process. At the moment, the banks found in top 20 European Banks reported a significant increase of the incomes obtained by performing cross-border activities, especially of the ones done in European countries. These incomes recorded values never recorded before not only for the activities performed in European countries, but also internally. These incomes recorded internally surpassed with almost 30% the course of the last decade.



Source : Schildbach, Jan "Home, sweet home? International banking after the crisis," Deutsche Bank Research, June 2011

The question in such a situation is: which are the factors that determined the increase of incomes? Mainly, it was about the stabilization of the financial markets which took place earlier than it was estimated due to the massive and rapid intervention of the state, short periods of recession by adopting appropriate fiscal measures by the developed countries, the volatility of the emergent markets whose phenomenal increase rate attracted again the banks from Western Europe.

The tendencies of the European banks for intensifying their cross-border activity depend on the following aspects:

- The longer the huge differences between the industrialized states and the emergent ones will idle, the more irresistible will become the need to get a consolidation of the position in regions

with high increase. The Western European banks will continue to expand their operations in Asia and Latin America;

-The regulatory measures imposed by the Central Banks of the countries;

-Fiscal regulations showed up after the financial crisis show up in Europe and in the entire world. In case the measures imposed by the regulatory authorities prove to be too tough for banks and that it forces them to take back their loan policy (increase) this could lead to a discrimination of the foreign creditors. Confronted with the situation of choosing between activating abroad and submitting to a long term partnership risking to devolve its image, a bank would go for the first alternative. It will depend on politicians and other factors of decision in which new regulations will impede a future cross-border integration of the financial markets;

-In the countries with emergent economy, the entire concept for opening the internal market for foreign financial institutions could be questionable in case the authorities of these foreign countries will use the financial crisis as an argument to block the access of the Western European Banks.

The Western banks had a stabilizing effect on Central Europe and the Eastern Europe and most probably will continue to invest and to expand abroad, especially on emergent markets. Anyway, there will be a higher risk degree because of the dependence of the banking system way of working, of the adopted measures and policies. Despite these aspects, there's no way to go back for the banks and that's because these, resembling other industries which preceded them, underline their certain tendency to become a truly international sector, respectively a global one.

Another problem could be the measure in which the European banks are affected by a potential bankruptcy of Greece. The new president of Bundesbank, Jens Weidmann thinks that "the euro could surpass without problem a possible bankruptcy of Greece" and it refers to the fact that Greek banks have high market rates only in Romania and Bulgaria. We can deduce from this assertion that due to the weak presence of the Greek banks on the banking market of the other European states, the impact could be a minor one. Even though there are Western banks which have exposure on Greece, the biggest part of the Greek crisis stopped to the doors of the Euro area where the Greek banks have the highest rates.

### **3. Conclusions:**

As we can notice from the analysis done above, the European banks, especially the ones from Western Europe recorded increases in incomes from the activity performed during economic crisis, which were obtained as a result of the intensification of the cross-border activity. The reasons of this increase are on one side fast measures and on the other side efficient on the behalf of the state and the volatility of the emergent markets. This volatility allowed banks to have earnings as a consequence of the speculative operations which were performed. Also, the surveillance authorities, at the level of the European Union, regarding the activities from the financial market, adopted a series of measures regarding the improvement of the legislative framework for the banks which perform cross-border activities, as well as the expansion of the communication and cooperation between the EU surveillance authorities with the ones outside the union. The improvement of the legislative framework but also the expansion of the communication between the EU surveillance authorities and the ones outside the union represents important elements when assuring financial stability at the level of the European banking industry.

### **4. Acknowledgments**

„This work was supported by the project "Post-Doctoral Studies in Economics: training program for Elite Researchers -SPODE" co-funded from the European Social Fund through the Development of Human Resources Operational Programme 2007-2013, contract no.POSDRU/89/1.5/S/61755 ".

## **Bibliography:**

1. Breban, Ludovica , *Managementul riscului în societățile bancare*, *Revista Finanțe Publice și Contabilitate* nr.3-martie/2006,
2. Bercean, R., Pădurean, V., Breban, L.. *Management financiar-bancar*. Editura Silvania, Zalău-2004,p.73,
3. Claessens, S, Pazarbasioglu,C, Laeven,L,Dobler, M, Valencia, F, Nedelescu, O and Seal, K, *Crisis Management and Resolution: Early Lessons from the Financial Crisis*, IMF Staff
4. Dumiter, Florin. *Independența băncii centrale*. Editura Mirton , Timișoara , 2011
5. Georgescu, Florin. *Sistemul bancar în România – prezent si perspective*. Conferinta Finmedia, 10 noiembrie 2009;
6. Georgescu, Elena ,*“Perspective ale supravegherii bancare în contextul corelării cadrului legislativ intern cu cel comunitar”*, Conferinta Internationala “Actualitatea în activitatea juridică bancară”, Piatra Neamt, 1-5 iunie 2010;
7. Schildbach, Jan ”*Home, sweet home? International banking after the crisis*,” Deutsche Bank Research, June 2011;
8. Claessens, S, Pazarbasioglu,C, Laeven,L,Dobler, M, Valencia, F, Nedelescu, O and Seal, K, *Crisis Management and Resolution: Early Lessons from the Financial Crisis*, IMF Staff Discussion Note, March, 09,2011 SDN/11/5
9. *Regulamentul (UE) nr.1093/2010 al Parlamentului European si al Consiliului de instituire a Autoritatii europene desupraveghere (Autoritatea bancara europeana), de modificare a Deciziei nr.716/2009/CE si de abrogare a Deciziei2009/78/CE a Comisiei Europene, alin .1 si alin 133*