The financial crisis and some lessons that we never learn

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1. It is the administrators of the system, not capitalism that is guilty (I)

- The crisis: not a market failure
- Three technical causes: abundant liquidity, bad loans, frenetic securitization
- Three underlying causes: central banks, politicians, and regulators and supervisors

1. It is the administrators of the system, not capitalism that is guilty (II)

- Politicians in the USA adopted The Community Reinvestment Act, 1977

- CRA requires banks to extend credits using also social criteria

- Continuing banks’ business was made conditional on fulfilling CRA requirements

1. It is the administrators of the system, not capitalism that is guilty (III)

- Central banks:
  - Liquidity injections whenever a new financial crisis emerged
  - Reduced credit cost
- Regulators and supervisors:
  - Lagging behind market innovations

2. There is a special interaction between major events and theories or rules (I)

- It affects **assumptions** of a theory and the **speed** with which a consensus is reached in practice
- Before the Great Depression: classical theory was the only orthodoxy:
  - ✓ Economic agents optimize a utility function to their own benefit
  - ✓ Prices clear all markets
- Failed to explain the high and persistent level of unemployment during the Great Depression

2. There is a special interaction between major events and theories or rules (II)

- Keynesian theory came with two new assumptions:
  - ✓ Prices do not clear markets and do not secure a right balance between demand and supply
  - ✓ People cannot always make the best decision to their own interest, thus leaving room for public policies
- Major failure in the 1970s with the Great Inflation
  - ✓ Replaced by the new classical theory
  - ✓ Today, the classical approach of public policies is replaced by the Keynesian approach again

3. Keynesian interventions: a big step in the wrong direction (I)

- Authorities in the USA, Japan, and in some European countries decided that public money would replace private money

- Thus, some sectors were allowed to receive money from public funds, avoid asking for money from private banks

- Helping declining industries by governments is detrimental to new profitable sectors

3. Keynesian interventions: a big step in the wrong direction (II)

- But resorting to Keynesian measures leads to:
  - ✓ Losing confidence in free markets, as it happened after World War II
  - ✓ Higher inflation, as it happened in the 1970s
- The ever-higher prosperity of the last three decades was provided by free markets

4. Regulations will always be lagging behind

- Today we have rules but they do not dictate what we can or cannot do
- Regulations say what criteria we should fulfill and what standards we should meet, whatever we choose to do
- They favor competition among firms and more freedom to choose for consumers
- Free people with enthusiasm, imagination, new ideas, energy

5. Good times do not last forever...

- It is in the nature of the human being to behave irrationally during boom periods, as if nothing can change the present

- **Private agents**
  - ✓ Excessive risk taking, benefiting of non-transparent institutions, incomplete understanding of new financial instruments

- **Public authorities**
  - ✓ Capital flows-bonanza is not an implicit approval by foreigners of domestic reform delays

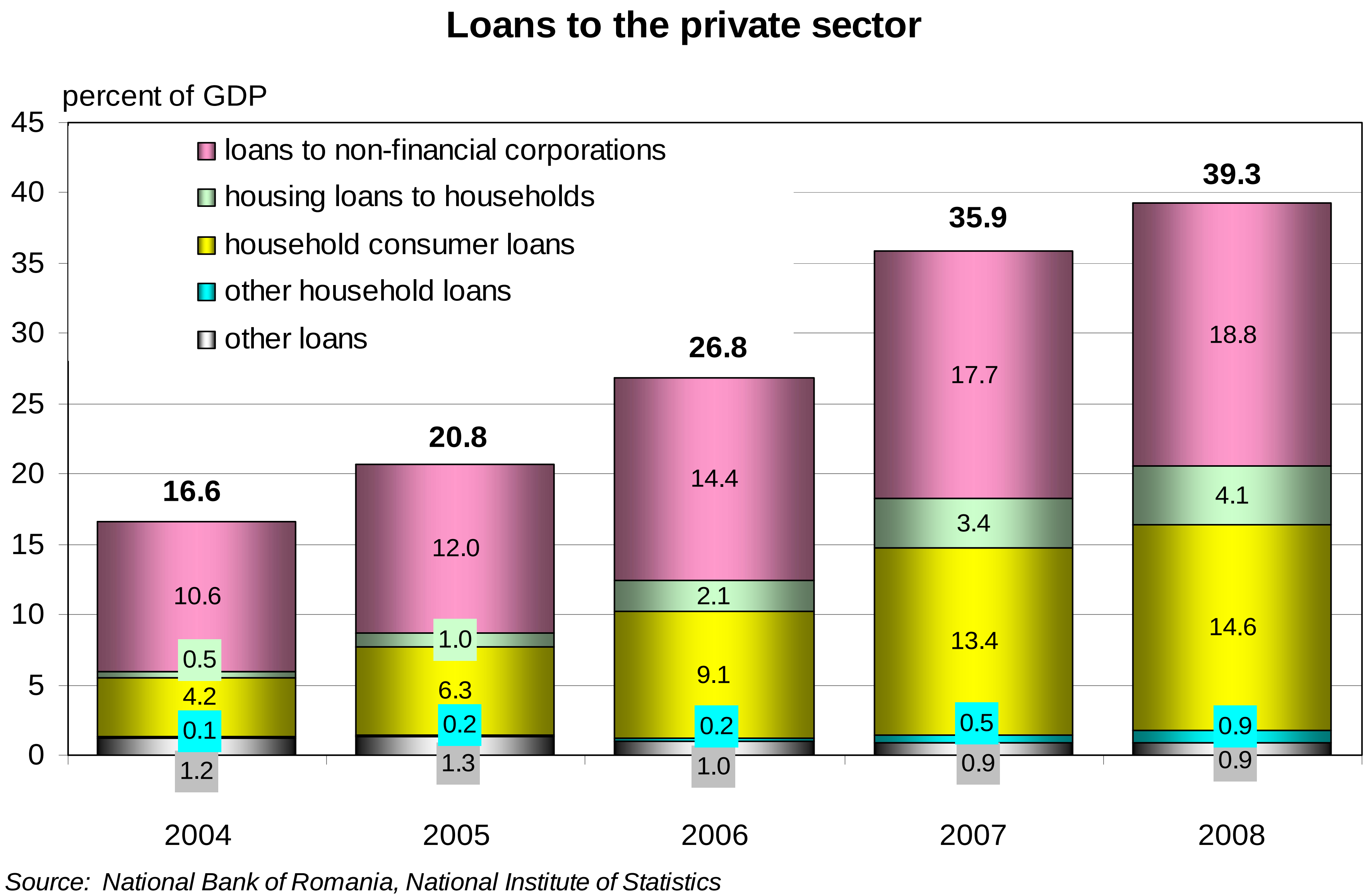
6. ...which means that there will be a new crisis

- Greenspan: “All financial crises are different but they have a common cause”

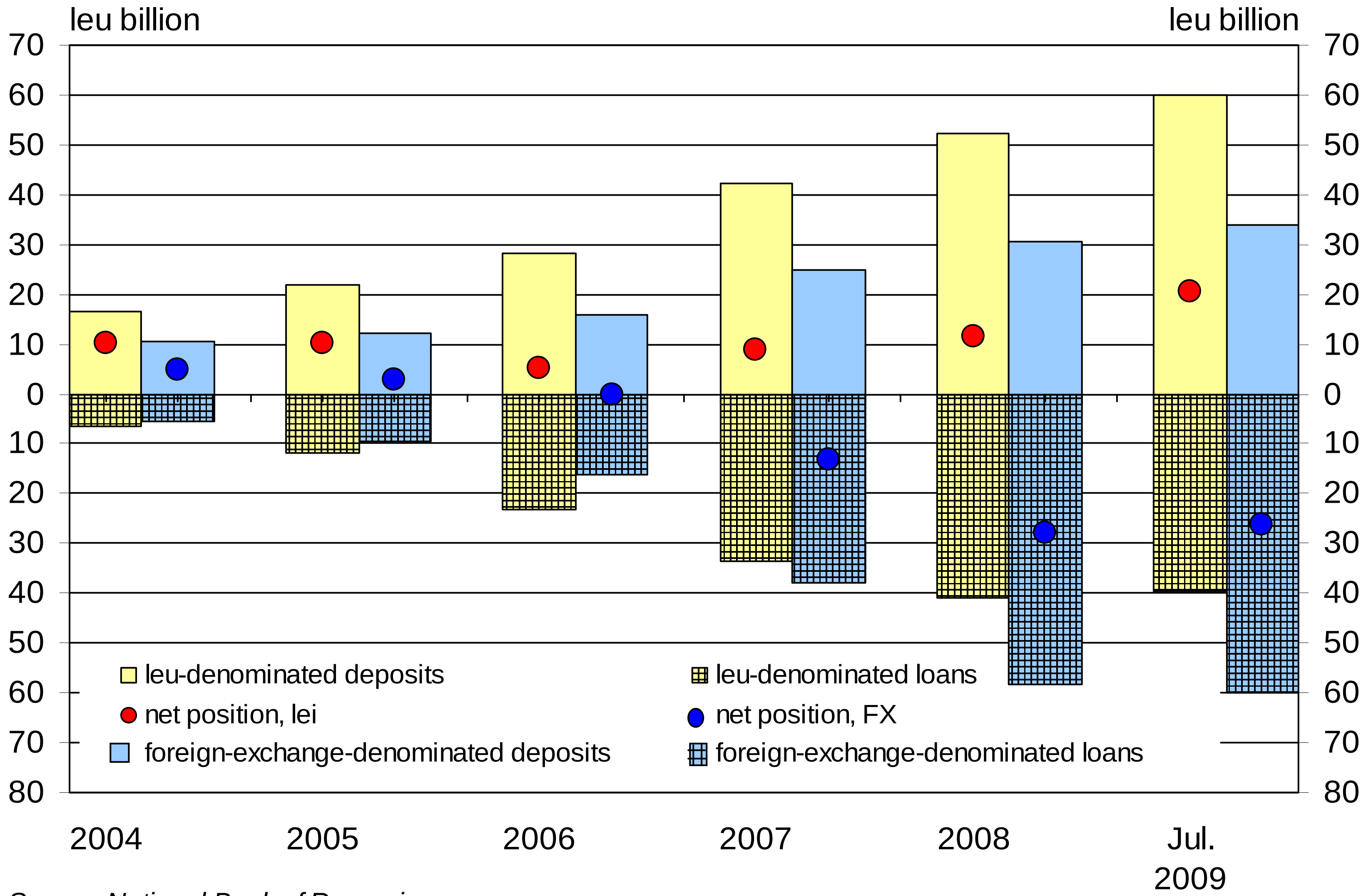
- This is the great capacity of human beings to assume that periods of prosperity do not end

How do all these relate to banks?

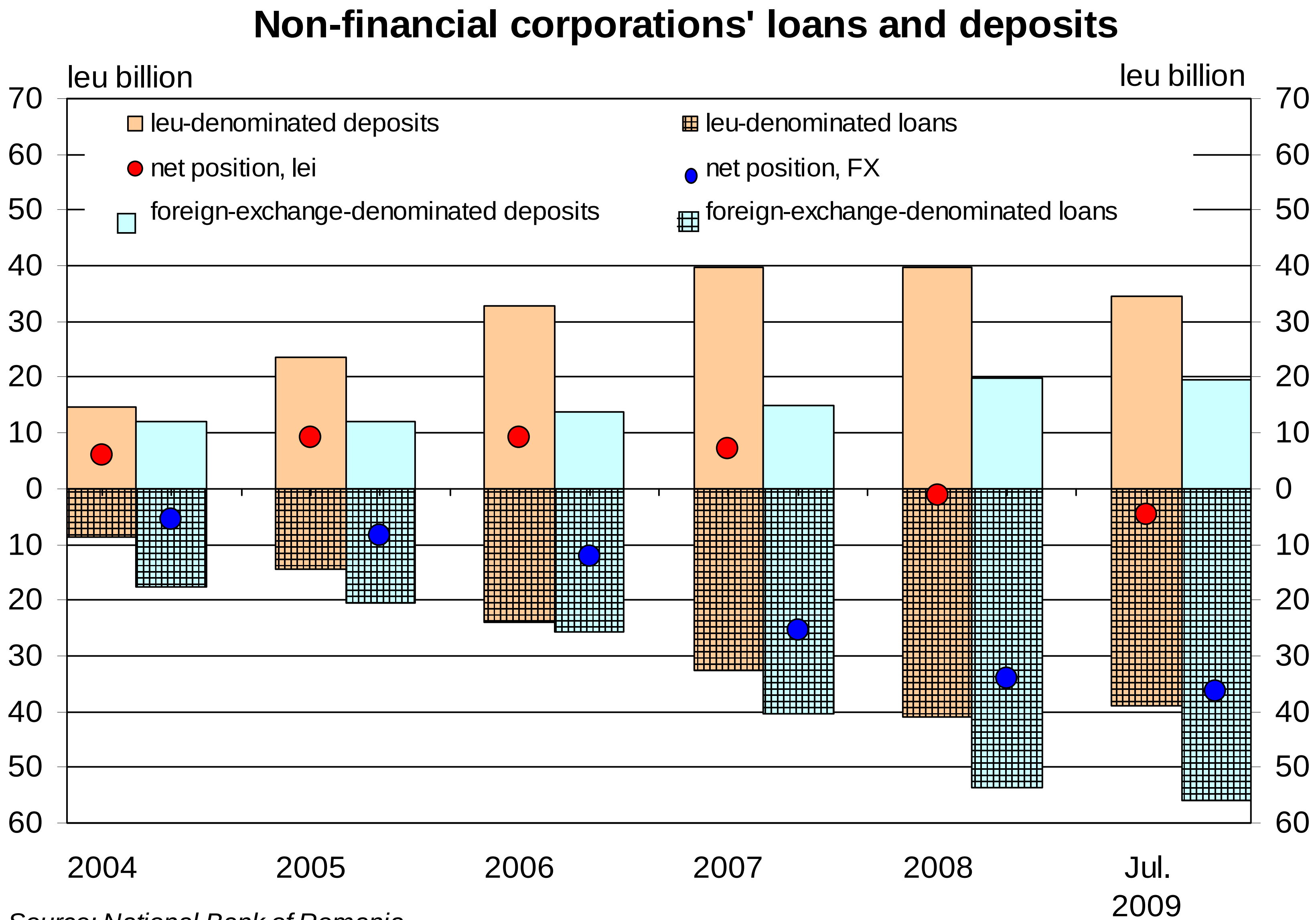
- Bankers knew that their actions were risky
- Many thought that they would feel when it was time to retreat


Loans to the private sector
percent of GDP
45
40
35
30
25
20
15
10
5
0
loans to non-financial corporations
housing loans to households
household consumer loans
other household loans
other loans
16.6
10.6
0.5
4.2
0.1
1.2
20.8
12.0
1.0
6.3
0.2
1.3
26.8
14.4
2.1
9.1
0.2
1.0
35.9
17.7
3.4
13.4
0.5
0.9
39.3
18.8
4.1
14.6
0.9
0.9
2004
2005
2006
2007
2008
Source: National Bank of Romania, National Institute of Statistics

Households' loans and deposits

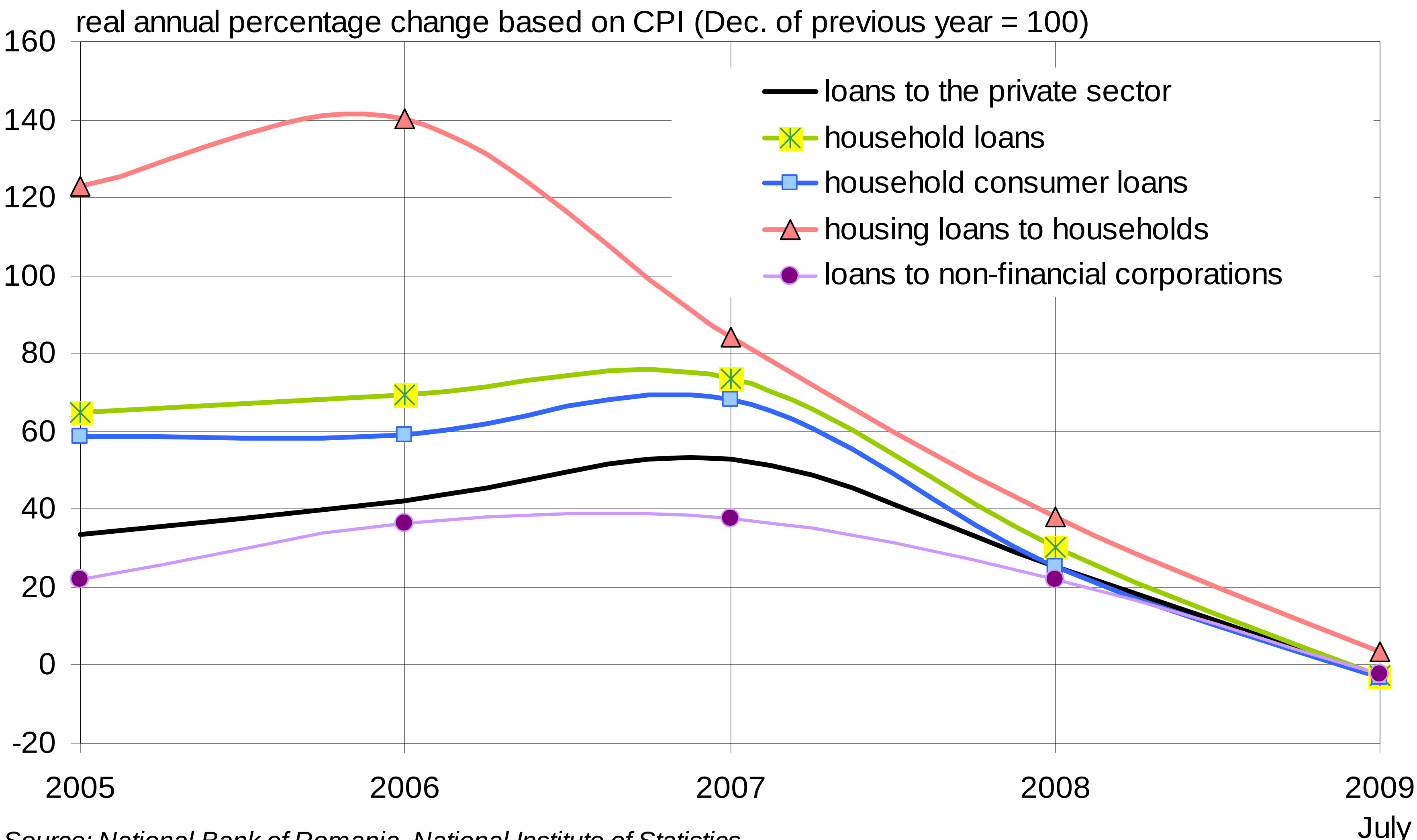


Source: National Bank of Romania



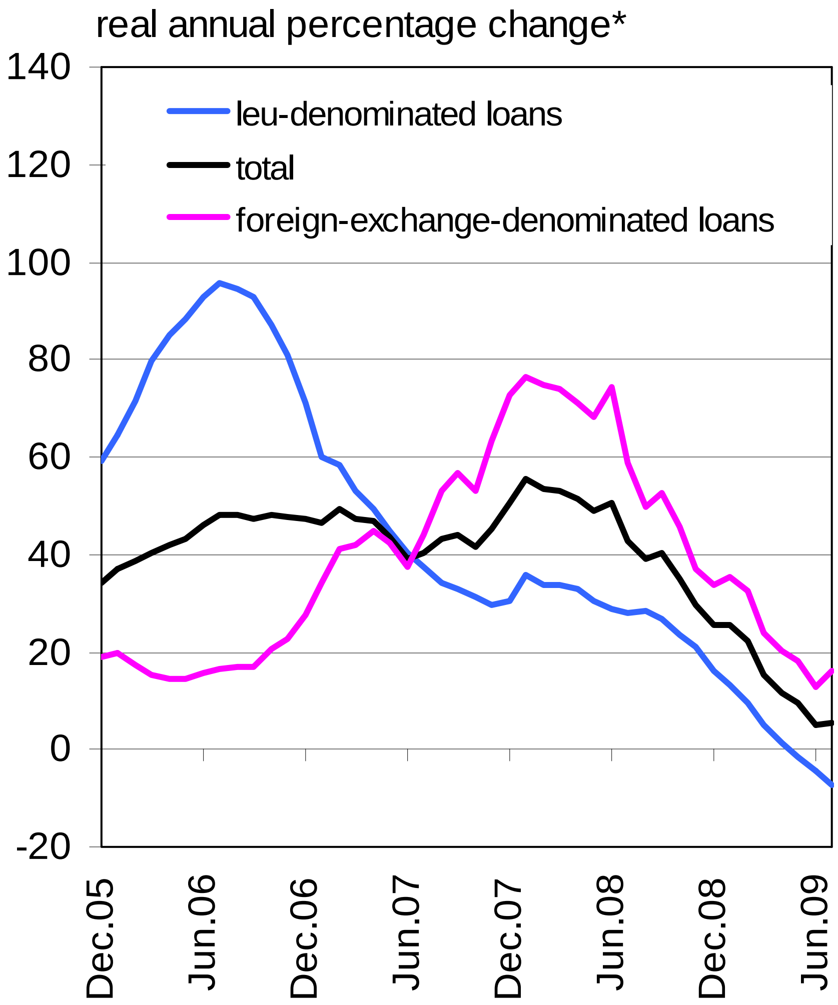
Source: National Bank of Romania

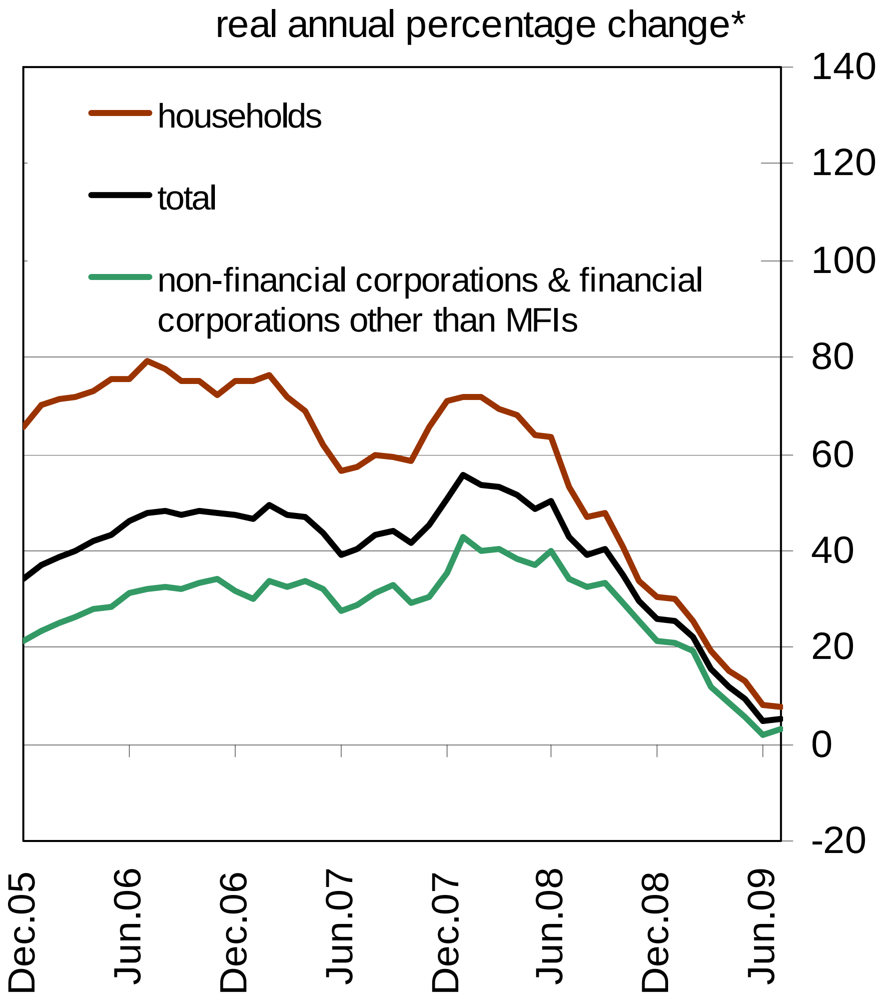
Loans to the private sector



Source: National Bank of Romania, National Institute of Statistics

Loans to the private sector





Source: National Bank of Romania, National Institute of Statistics

*) based on CPI

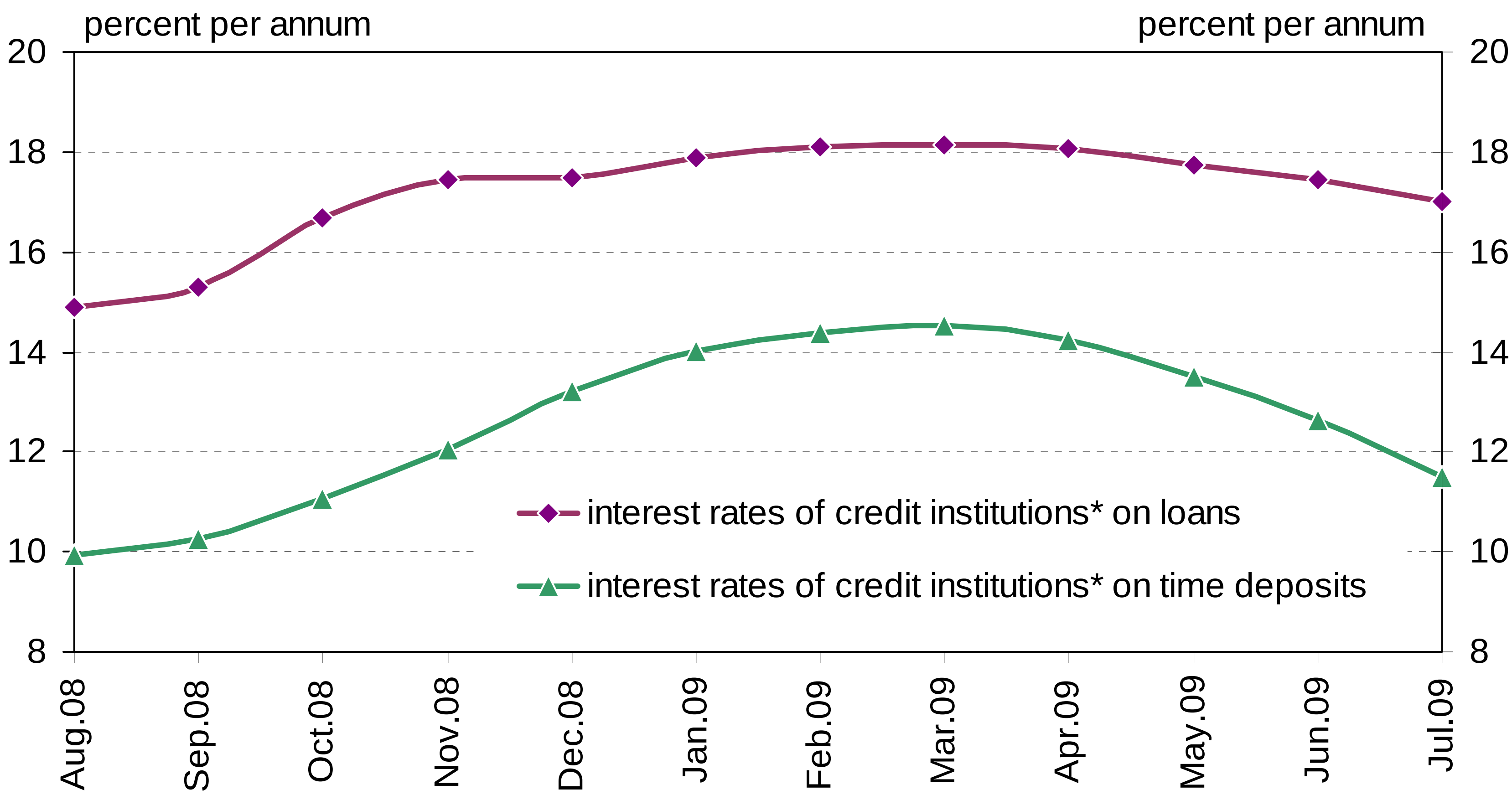
The Romanian banking sector: main challenges

- Improving competition
  - ✓ From competing fiercely for larger market share to...
  - ✓ Product innovation
  - ✓ More proper risk estimation
  - ✓ Reducing costs to borrowers
- Acquiring an appropriate volume of good quality collateral

What have banks done over the last 11 months?

- Started competing on deposit rates…
- What do people say about interest rate as a factor of savings in Romania?
- They say that this is very important but other factors also matter:
  - ✓ Fees magnitude
  - ✓ Confidence

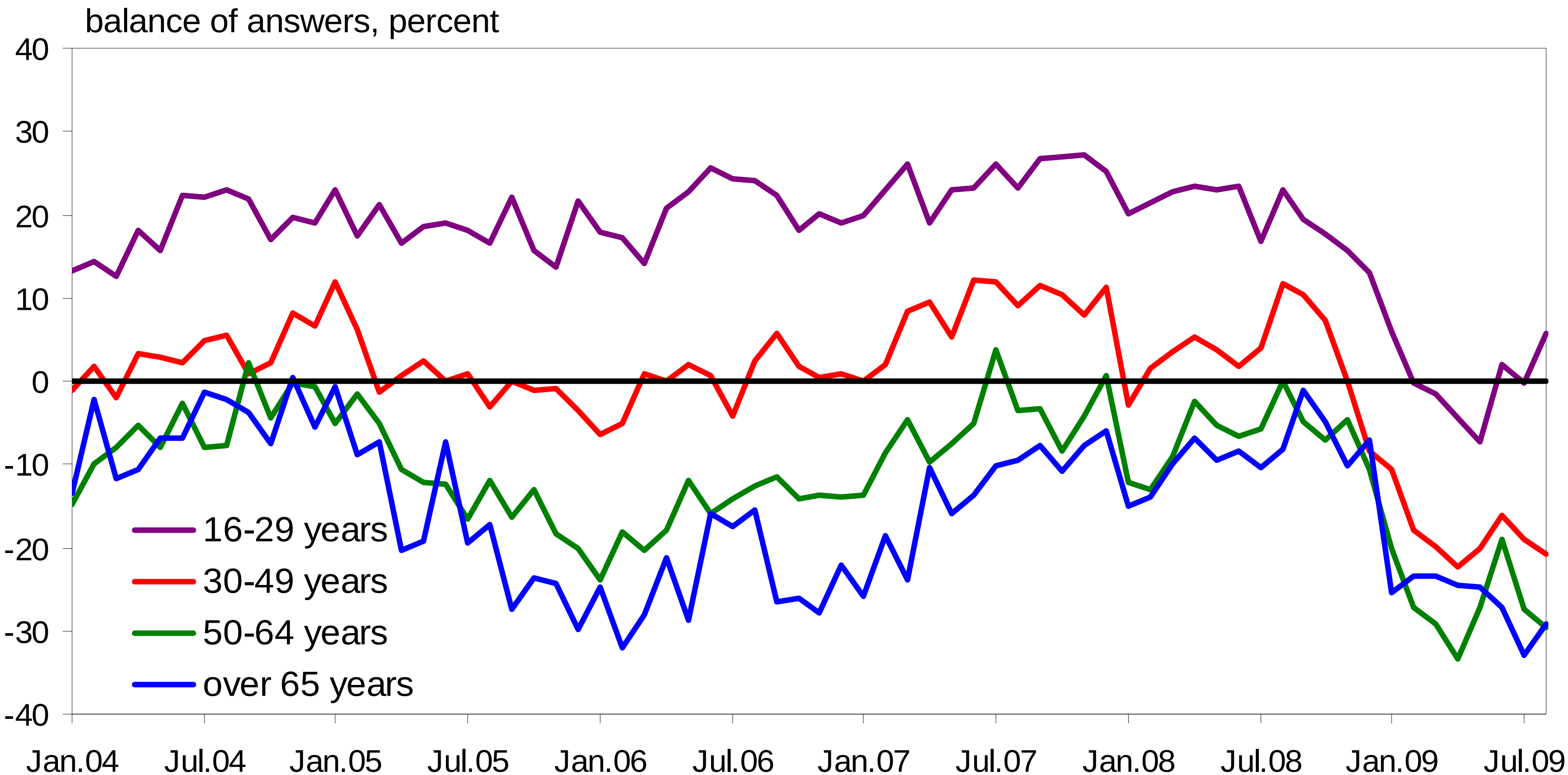
Interest rates in the banking system



* average values; non-financial corporations and households, lei-denominated outstanding transactions

Source: National Bank of Romania

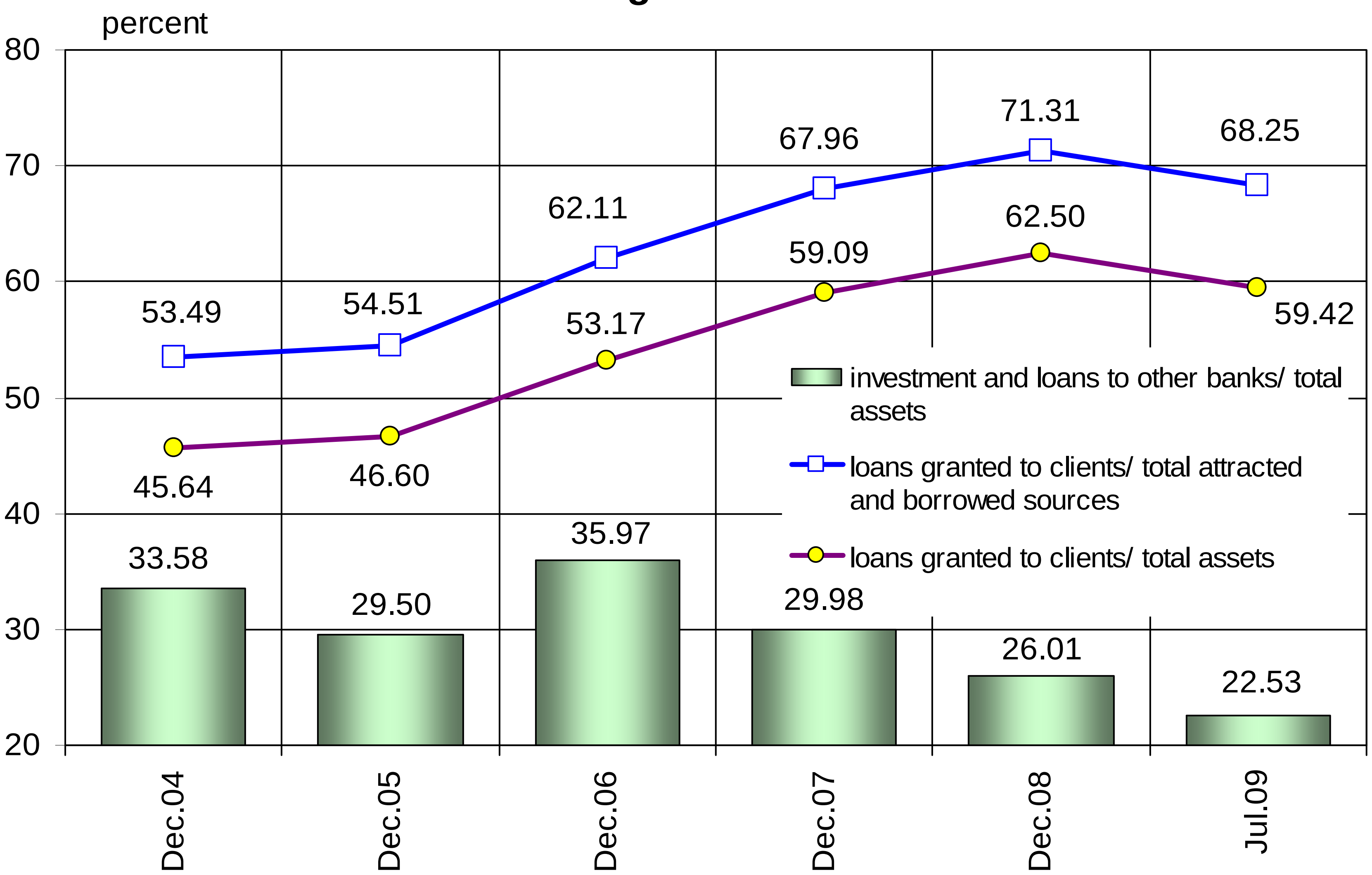
Financial expectations 12 months ahead



(+) improvement, (-) worsening

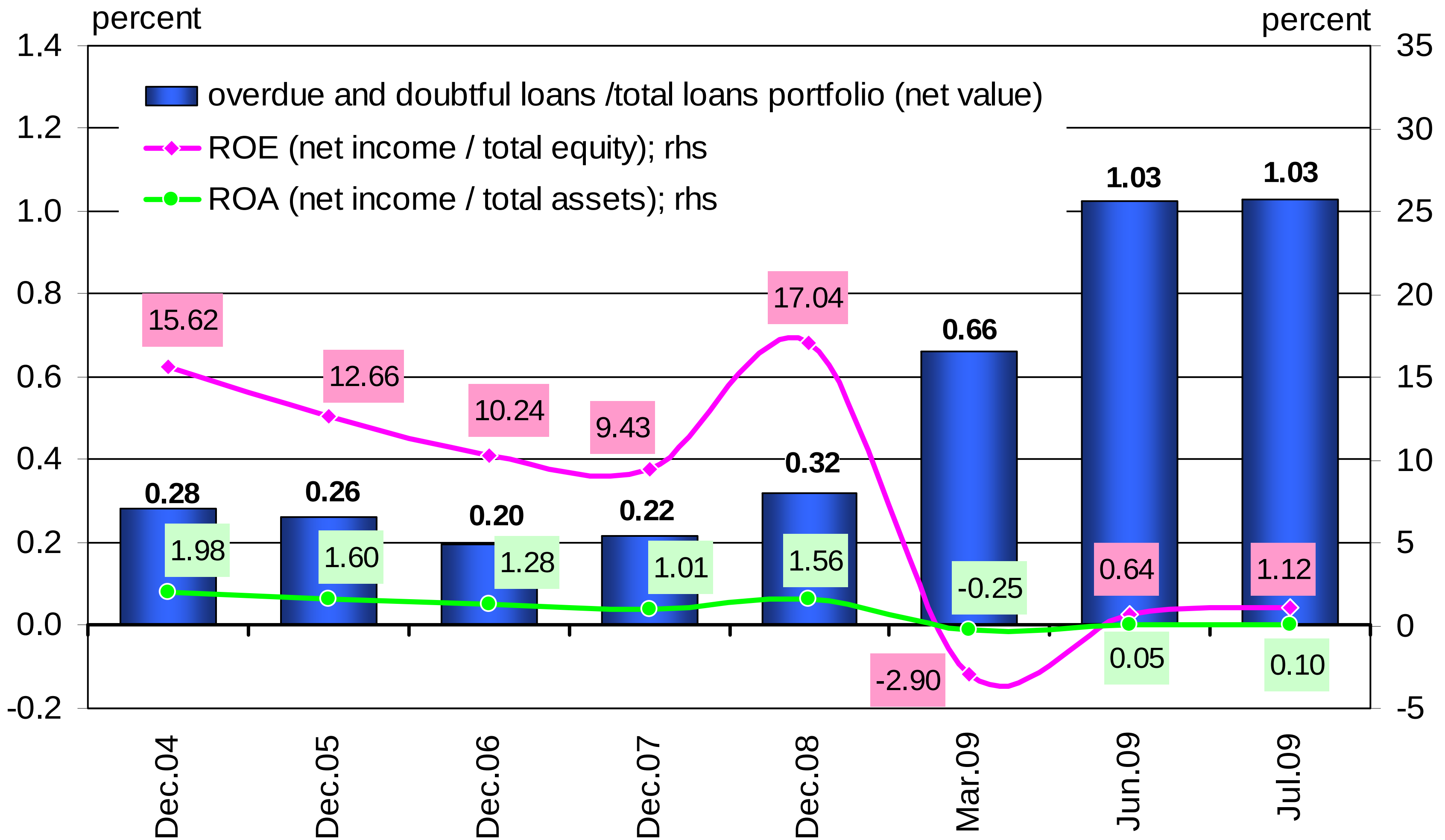
Source: European Commission - DG ECFIN

Banking indicators



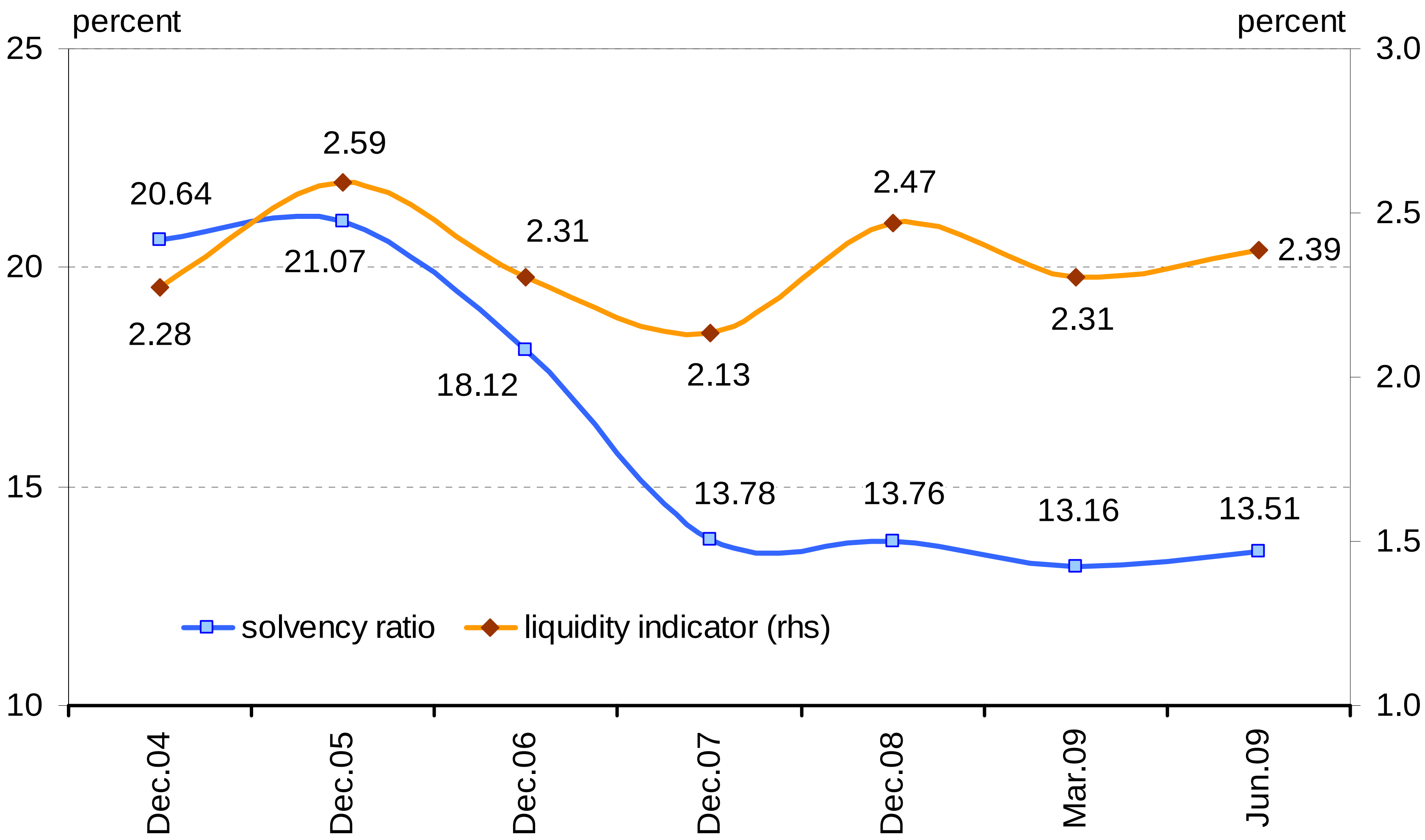
Source: National Bank of Romania

Analysis ratios for the banking system (1)



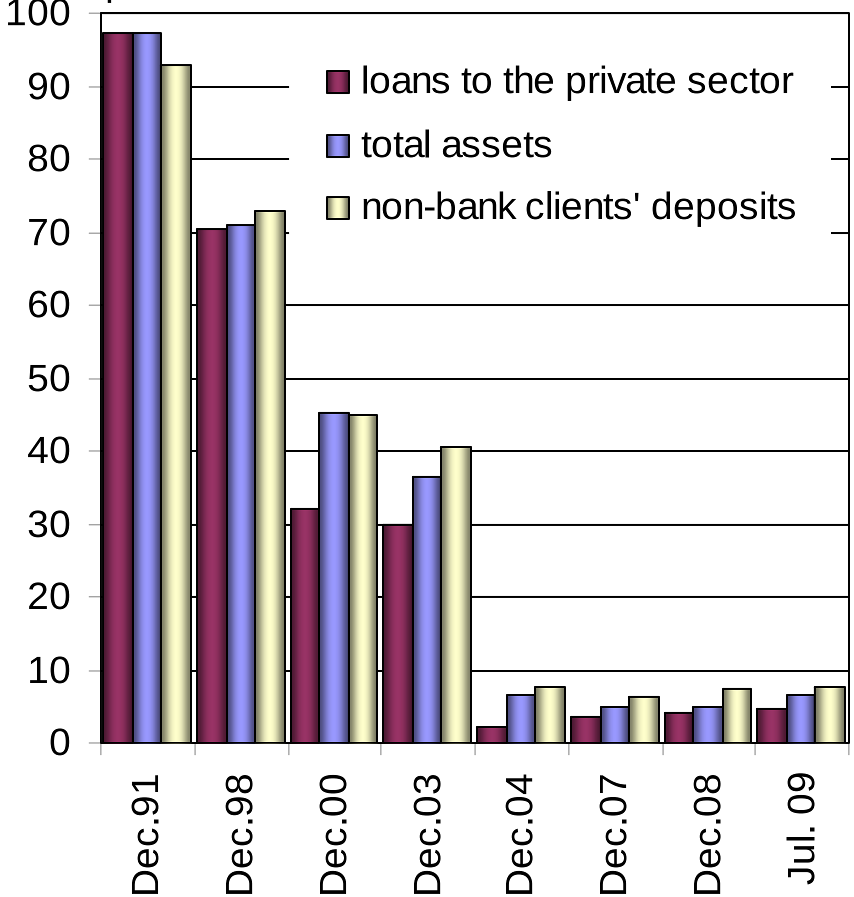
Source: National Bank of Romania

Analysis ratios for the banking system (2)



Source: National Bank of Romania

Share of majority state-owned banks in total credit institutions



share in total banks (%); July 2009

	Total assets	**Loans to the Private Sector**	**Non-bank clients' deposits**
Banks with majority foreign capital	85.1	87.2	81.6
Banks with majority domestic private capital	8.2	8.2	10.6
Banks with majority domestic state-owned capital	6.7	4.6	7.8

Source: National Bank of Romania

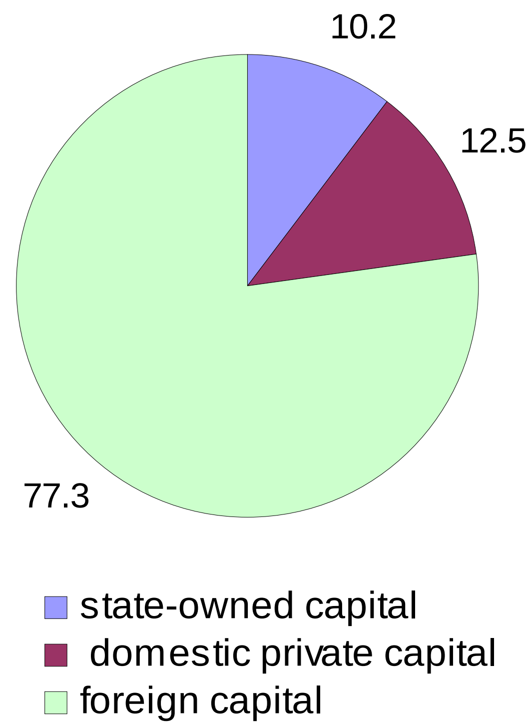
Features of banking sector and shareholding structure*

Features of the banking sector

- **43 credit institutions** (of which **11 branches** of foreign banks and **1 credit cooperative)**
- **Banking assets – total bank net assets**: **EUR 78.2 billion**
- **Top-five banks** account for **54.2% of bank assets**
- **Solvency ratio** = **13.5%**
- **Foreign entities make up most of the shareholding**
- **Market share:**
  - ✓ **86.0% —** credit institutions with **majority foreign capital**
  - ✓ **7.1% —** credit institutions with **majority domestic private capital**
  - ✓ **6.9% —** credit institutions with **majority state-owned capital**

Shareholding structure of credit institutions in Romania

(% in total capital)



***** June 2009

BANKING INDICATORS
(Banks, Foreign Bank Branches and CREDITCOOP)

percent

	Indicators	Dec.07	Mar.08	Jun.08	Sep.08	Dec.08	Jun.09
Capital adequacy							
1.	Solvency ratio (>8%)	13.78	12.99	12.78	11.85	13.76	13.51
2.	Leverage ratio (Tier 1 capital /Total assets, average)	7.32	7.20	7.30	7.10	8.13	6.92
Asset quality							
3.	Loans (gross value) / Total assets (gross value) (1)	59.09	62.06	63.47	65.04	62.50	59.11
4.	Interbank placements and loans (gross value) / Total assets (gross value) (1)	29.98	27.54	26.09	24.79	26.01	23.91
5.	Past-due and doubtful loans / Total loan portfolio (net value) (1)	0.22	0.21	0.30	0.24	0.32	1.03
6.	Past-due and doubtful claims / Total assets (net value) (1)	0.17	0.19	0.25	0.22	0.29	0.75
7.	Past-due and doubtful claims (net value) / Total own capital (1)	1.63	2.03	2.78	2.43	3.19	8.98
8.	Unadjusted exposure to loans and interests classified under “doubtful” and “loss” / Total classified loans and interests, including off-balance-sheet items (2)	3.76	4.23	4.55	5.05	5.95	10.33
9.	Unadjusted exposure to loans and interests classified under “substandard”, “doubtful” and “loss” / Total classified loans and interests, including off-balance-sheet items (2)	9.12	9.20	9.77	10.51	12.54	17.86
10.	Provisioning of risk-weighted exposure to bank and non-bank loans, and interbank placements classified under “substandard”, “doubtful” and “loss” (Provisions for loans and placements / Adjusted exposure to loans and placements classified under “substandard”, “doubtful” and “loss”)	117.0	90.5	91.0	89.7	86.2	89.6
Profitability							
11.	ROA (Net profit /Total assets, average)	1.01	1.51	1.44	1.77	1.56	0.05
12.	ROE (Net profit / Own capital, average)	9.43	16.45	15.82	19.41	17.04	0.64
Liquidity							
13.	Cash ratio	38.70	34.98	33.23	31.74	34.43	33.62
14.	Liquidity ratio (effective liquidity / required liquidity)	2.13	2.29	2.30	2.45	2.47	2.39
15.	Loans to clients / Deposits from clients	108.7	116.1	119.6	124.7	122.0	119.2

Note:

(1) Indicators calculated based on accounting prudential reports.

(2) Indicators calculated based on loan classification reports (pursuant to Regulation 5/2002, as subsequently amended and supplemented). Loan exposures are classified by credit institutions in line with debt servicing, debtor’s financial standing and the principle of downgrade by contamination.