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Bank de-risking impacts on finance and development.

The case of Romania

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Abstract. The study aims to investigate the causes, external manifestations and impacts of de-risking phenomenon, increasingly rendered visible in the last years on international financial markets, under the circumstances of the post-crisis global economic developments. The paper reveals that this phenomenon is still little discussed and understood by academics and institutional organizations, consequently, being ignored any theoretical foundation or arguments for the possible guidance, between one or other direction, of policies, norms and regulatory practices in order to monitor and address the slippages with adverse effects. In the paper, the stage of actual knowledge of this phenomenon, as concerns the different forms in which comes out, the main causes and factors of influence, the adverse impact observed and possible counteracting measures is presented. The analysis of the extent to which Romania is affected by de-risking, more visible by reducing the number of clients and financial transactions, halving the non-performing loans of the banking system, having also an important social dimension, in the light of the low level of financial inclusion. The paper presents some reference points for decoding this phenomenon, proposing new directions for more in-depth scientific researches, focusing on the identification of specific solutions based on customized analysis, including for Romania's case, considering the trade-off options, such as stability versus prudentiality in risk taking and risk management, profitability versus social responsibility under uncertainty conditions, banking system interests versus interests of regulatory and supervisory institutions, monetary policies versus government policy and strategies.

Key-words: de-risking; banking system; corresponding banks; AML/CFT; financial stability; non-performing loans; financial inclusion.

JEL Classification: E44, F24, F38, G01, G15, O16, P37

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1. Introduction

The phenomenon called de-risking, which has recently emerged, at least as visible manifestation, entered almost by force, just 2-3 years ago, to the attention of researchers, academics, banking authorities and international and global institutions, has not reached a consensus on its definition. It seems that economics and, particularly, its financial branch, is facing yet again a deadlock, being constrained to react *post-factum* and trying to explain the fundamentals of an event which was not included in its object of study and research, imposed by the new realities of globalization and international practices, situated outside its theoretical and methodological precepts. In our opinion, on the one hand, in terms of a strict conceptual delimitation, the phenomenon could not be defined unambiguously in the absence of clear terms of reference: essence, features, external forms of manifestation, development, effects, benchmarks for evaluation. On the other hand, being expressed by an antinomial grammatical composition, e.g. associating the prefix *de* to the gerund *risking*, in economic terminology it may be included in the broader concept of risk management, meaning, *per se*, an exclusion of risks as sources of uncertainty.

In other words, under the circumstances of compliance with the new financial standards of the post-crisis period, especially by the banking entities that operate globally and intermediate international financial transactions, this new approach implies, in practice, the formal improvement of risk management through avoidance or elimination from the risk assessment system of potential threats, that are considered too likely to occur and bearing excessive adverse effects, and/or whose prevention would be inefficient in terms of cost-benefit.

Thus, according to the new pseudo-paradigm, lacking any theoretical support and macroeconomic or social reliability, we are witnessing a reality of some financial services decommitment, chaotic and totally opaque, contrary to the role and functions assumed by the banking system, as the claimed principles of sustainable development, inclusive growth and the broad access of the population to these financial services. The phenomenon, that became of global magnitude, hides, in fact, the conflict of interests between the finance industry and the society as a whole, both at intra and inter-country levels, indirectly feeding the anti-globalization movement.

Looked at from a different angle, the meaning of the term de-risking can be associated to the one of deleveraging, which has had a wide circulation in the post-crisis, with much clearer connotations, essentially meaning the reducing of risk exposure by withdrawing the credit lines from the geographic areas considered of high risk, as did the parent banks with their subsidiaries in Central and Eastern

Europe, it is true, in a controlled manner, as agreed according to Vienna Initiative in 2009 (Gattini, 2016, p. 92).

Considering that, as concerns only the banking sector, the current range of de-risking meaning covers a very broad area, from avoiding market / business risk and reputational risk, to defining any kind of financial services withdrawal, Erbenova et al. (2016, p. 3) argues, rightly, that the indiscriminational use of the term has led to misunderstandings and created confusion in the dialogue on determinants and trends of the phenomenon.

In this article, having as objective a better understanding of de-risking essence, we intend to point out the main external manifestations of this phenomenon, several causes and influencing factors, a number of adverse effects and possible measures mitigating them, and how they particularly affected Romania.

Our research tries, based on the current state of knowledge and an analytical approach, as much as it was possible, to investigate this phenomenon, looking for an answer, even incomplete, to the dilemma "how risky the de-risking is?".

2. A worldwide phenomenon: external manifestations and determinants

In the banking system, in practice, the phenomenon of de-risking manifests as financial transactions contraction, including the restricting the access to finance, reducing or eliminating exposures to a range of clients, individuals or legal entities and/or geographical areas, jurisdictions, sectors, services considered with high potential risks. In fact, the emergence of this phenomenon signifies a market failure, the banking sector trying to eliminate its own weaknesses without taking into account the outside effects, mainly on economic and social development, which, for restoring the market mechanisms functionality and safeguarding the financial stability, requires an intervention by the national public authorities and international institutions.

Among the external manifestations of de-risking revealed by the literature and international institutions reports (Alier, 2016; Canuto & Ramcharan, 2016; Corazza, 2016; Erbenova et al. 2016; IMF, 2016; World Bank, 2015) are the reduction of corresponding banking relationships (CBRs), the restricting access to certain services related to financial transfers (Money Service Businesses-MSBs), the nonbanking market operators (Money Transfer Operators-MTOs), which mainly affect the remittances. Also, according to a report by Goldman Sachs (2016), due to the introduction of a stricter risk management, the de-risking phenomenon can occur in the form of reducing credit exposures by lowering, through externalization, the non-performing loans (NPL).

Recent studies issued by the World Bank (World Bank, 2015) revealed that, out of the 170 regional banks and small local banks included in the survey, about half reported a moderate or significant decline in CBRs¹, and in the case of the 20 large international banks, the share was about 75%. The main categories of causes raised by banks consisted, on the one hand, in business reasons (costs versus profitability) and, on the other hand, in the regulations and risks (systemic, operational, legal, reputational).

As concerns the correspondent banks, de-risking has reached also those headquartered in Europe, some of which having subsidiaries in Eastern Europe, including Romania. As found by a study of the European Central Bank (2015, p. 5), under the circumstances of post-crisis decreasing of transactions with correspondent banks, several EU large banks discarded some of these transactions, namely those recording low volume/significant value, due to the introduction in 2014 of the Single Euro Payments Area (SEPA).

The Panama Papers scandal, which severely hit the global finance, showed how difficult it is for large banks to know exactly the origin of funds handled through correspondent banks and how they are used (Mendoza, 2016). It should be noted that the incidence of de-risking and the name of the banks involved are difficult to detect, due to concerns over reputational risk. The global banks does not officially notify such operations, but neither the affected correspondent banks are rushing to make them public, fearing to create a negative perception from customers.

Also, as another influencing factor, the adoption of new rules during the post-crisis period (under Basel III Accords), focusing, *inter alia*, on the minimum capital requirements and increasing the provisions for assets held by international banks in correspondent banks, has reduced their lending capacity, impacting also on profitability indicators.

In this context, it should be noted that financial services run by major banks through correspondent banks, are characterized, in general, by minor profit margins and low volumes of transactions. All in all, it has become that the costs of compliance with the AML/CFT rules on combating money laundering and financing terrorism introduced by the intergovernmental body FATF (Financial

¹Correspondent banking relationships are established on the basis of bilateral agreements according to which, typically, a large international bank and a small regional/local bank are authorizing each other to provide financial services, generally payments to third parties, consisting particularly in crossborder trade related transactions, money transfers, short-term loans and investments and others; the local correspondent banks act as intermediaries, substituting therefore the setting up of subsidiaries/branches by the international banks in the countries (jurisdictions) concerned (Bank for International Settlements, 2016 p . 9).

Action Task Force), including those related to conducting due diligences, increased by over 50% (International Finance Corporation, 2016, p. 2).

These costs, in many cases, exceeded the related benefits, which have led international banks to reduce or eliminate relations with those correspondent banks considered to be too high risks thereby to reward their managing (Artingstall et al., 2016, p. 14).

As concerns other reasons for international banks decisions towards de-risking, the fear of penalties and international/regional sanctions for potential infringement of those rules, which counted more than explicitly appear, are added.

3. Adverse effects and possible countermeasures

As long as the de-risking phenomenon is manifested essentially by reducing the access to financial services, it becomes clear that the very foundations of development are undermined, the investment loans, private and/or public, the international trade in goods and services and related transactions, including the value-added global chains, the flows of foreign direct investments, the private and institutional international transfers being affected (Erbenova et al., 2016).

Direct and indirect effects on the international trade can be significant. A study of BIS (Bank for International Settlements, 2014, p. 45) revealed that about one third of the world trade, which reached 19 trillion dollars in 2014, is supported by trade finance instruments, intermediated, for the most part, by the international banks through a network of correspondent banks. They are asked, for example, to confirm payments to exporters (by documentary credit or letter of credit), based on documentation for the shipment of goods, supplying the lack of direct banking link between buyers and sellers. The de-risking phenomenon in CBR area deepens the deficit in trade financing, mainly affecting the underdeveloped or developing countries (Auboin & DiCaprio, 2017, p. 7), which may explain the weak recent developments in the world trade, entered decline in 2015 (down about 10% compared to 2014). The de-risking implications on the world trade has been also pointed out by the IMF Managing Director (2016, p. 8).

Beside macroeconomic effects at the national and global level, there are adverse social costs, among other things, by restricting the consumer loans and remittances of expatriates, disadvantaged groups of the population being financially excluded. Most affected by this phenomenon, paradoxically, are those most in need, whether countries or companies, especially SMEs, or individuals from both, developing and advanced countries, and, as it has been revealed, even humanitarian organizations are hindered in carrying out their missions.

Another paradox is that the de-risking phenomenon in the banking system, having as main motivation the improvement of risk management, due, in fact, to

the elimination of risk sources, which, at macroeconomic level, may lead to the increase in financial and monetary instability, returning, ultimately, by feedback loop, on the banking system itself, and to degenerate, through spillover effects on different transmission channels, in a global financial crisis.

The risk of de-risking is also highlighted by diverting the financing means of those excluded to alternative credit providers as shadow banking, whose oversized expansion, out of any control, has been at the origin of the financial crisis in 2008, with dramatic global effects and on long term.

The adverse effects of de-risking are asymmetric, by decoupling whole regions from the global growth. The literature refers, as an example of regional imbalances, to the Caribbean as the most affected region by de-risking. Particularly to this area, located in the Caribbean Sea, is the small size of the states (islands) and the almost total dependence of foreign exchange receipts from tourism, exports and remittances, with the related financial operations conducted through correspondent accounts. At the annual meeting of central bank governors in the region under the CDB (Caribbean Development Bank) discussed the severity of the problems facing these countries, over which hangs the threat of a balance of payments crisis, the increase in external debt, weakening the financing of development projects, many of them requiring external payments for equipments imported, worsening the business environment (Canuto & Ramcharan, 2016). In fact, the CDB itself, whose activities are constrained by closing the correspondent accounts, most of transactions running into dollars, noting also that banks in the region are dependent on the US financial system, is affected by de-risking.

As mentioned above, the adverse effects of de-risking that have emerged recently, have showed only its main source, e.g. the banking system, more precisely the international banks, but not having succeeded so far to draw a full picture of these effects at global level. Many studies or investigations of international organizations (in particular the IMF and World Bank) focusing on this research objective have provided only partial results or have not been finalized yet.

Other analyzes, including pilot studies, aimed at the assessment of de-risking side effects, on macroeconomic and/or social areas, are only at the stage of data collection, at least at the World Bank, the proposed measures to counter adverse effects, having rather attributes of recommendations (Corazza, 2016).

Thus, these general recommendations refer to the prevention and mitigation of adverse effects by „freezing” de-risking actions pending the clarification of the essential aspects of the phenomenon and the completion of various studies in progress at the global level, taking into account the possibility of introducing global financial regulation standards, that allow, based on case by case risk-based

approach, the improvement of risk management, a faster intervention of central banks and regulatory authorities, as well as a better regional coordination of their actions (Canuto & Ramcharan, 2016).

Other specific recommendations focus on providing assistance to facilitate compliance with AML/CFT regulations and reducing its costs, including through the SWIFT network, improving transparency regarding information on the origin/real beneficiary of cross-border financial transfers, setting a minimum limit for remittances under the AML/CFT regulations and setting daily ceilings for the volume of transactions.

Countries severely affected by de-risking through limiting their access to the global financial system, especially in CBR area, are advised that banking sector initiatives to be accompanied by the introduction of temporary mechanisms and alternative payment channels for international transactions, supported by state authorities, with the possible technical assistance from the IMF, if available thereof (Erbenova et al. 2016, p. 5; IMF, 2016, p. 5).

Further on, it shall be attempting to identify several defining aspects of the de-risking presence in the banking system in Romania, as well as some adverse effects that can be assigned to it, at least to some extent.

4. How is Romania affected by de-risking

Under the circumstances of structural weaknesses inherent in the transition to a market economy and the accumulation of significant twin deficits (budgetary and BoP current account) during the pre-accession period, Romania has experienced the severe global crisis triggered in 2008, managing to maintain its financial stability only by receiving a financial support package from the IMF and EU, through a sovereign loan amounting to 20 billion euros.

Although de-risking phenomenon has not been perceived, as such, at the global scale, it was present in Romania multifaceted forms during the post-crisis period.

In the context of a banking sector dominated in a proportion of about 90% by the foreign capital, the deleveraging, albeit controlled, resulted in the withdrawal of credit lines by the parent banks from their subsidiaries in Romania amounting to 13 billion euros over the period 2009-2015, which contributed, among other factors, to the contraction, in real terms, of bank lending in the post-crisis years.

The reduction of the total number of retail clients represents, although partially, another expression of the same de-risking phenomenon. In the case of Commercial Romanian Bank-Erste Group, the largest bank in the system, it lost

more than 1 million clients in the post-crisis period, but, with its remaining 2.8 million clients in 2016, is still ranked as the first among banks from this regard.

The number of banking transactions with payment instructions has decreased (to below 210 million annually during the period 2009-2016, less by 20% compared to 2007) and the remittances have tended also to decrease (less than 4 billion euros annually in the period 2009-2016, compared to amounts between 5 and 7 billion euros in 2007 and 2008).

All this can be considered defining aspects of the evolution of the banking system in Romania, partly attributable to the more or less significant impact of de-risking.

Further, the impact of de-risking on reducing bad loans and the low level of financial inclusion in Romania will be examined in a more analytical manner.

4.1 De-risking and bad loans

The non-performing loans (NPL) in the banking system in Romania followed an evolution in two phases: first, under the post-crisis impact, the NPL ratio recorded an increase to over 20% of the total assets in the latter part of 2013 and early in 2014, after which, being also subject to de-risking, the ratio declined, falling below 10% at the end of 2016 (NBR, 2016, p. 58), taking into account the methodological changes introduced in 2014 (Table 1).

Table 1 The NPL ratio of Romania's banking system during 2010-2016

-%-

Year	NPL ratio according to NBR definition	NPL ratio according to EBA definition **
2016	-	9.46
2015	-	13.51
2014*	13.94	20.71
2013	21.87	-
2012	18.24	-
2011	14.33	-
2010	11.85	-

* Calculations based on reporting by all banks: both those using the standardised approach to assessing credit risk and those that use the internal ratings-based approach.

** According to EBA definition, the non-performing exposures are those that meet any of the following criteria: i) significant exposure overdue more than 90 days; ii) it considers that, in the absence of the collateral execution, the borrower is unlikely to pay its credit obligations in full, regardless of the existence of any outstanding amounts or number of late payment days. Starting from June 2015, the non-performing exposures of cash balances in the central bank and other deposits held at credit institutions were included.

Source: Monthly Bulletin, NBR, November, 2016, p. 58.

It should be noted that these ratios, especially at peak levels, were significantly above the alert thresholds recommended by the international financial institutions throughout the reference period, remaining currently slightly above them. It is worth mentioning that these NPL ratio thresholds ranges from 2-4% considered by the IMF to 8% envisaged by the European Banking Association (EBA), compared with an EU average of about 5.5% recorded in 2016.

The halving of NPL ratio in just three years in the case of Romania is considered a good performance, appreciated among others, under Vienna Initiative, by EBRD experts (Montes-Negret & Cloutier, 2016), who showed that from this experience can be learned six lessons: data and information system accessible and reliable; positive role of the regulatory authority; insolvency framework consistent with the practices of restructuring; incentivizing tax structure for NPL trading; development of a debt market allowing banks partially deleveraging the NPL portfolio.

A report of the European Investment Bank concerning the supervision of banking systems in Central and Eastern Europe also noted that, following the implementation of an action plan of the central bank in this regard², the asset quality improved significantly in Romania, both in the corporate and the retail sectors (Gattini, 2016, pp. 91-98).

According to a recent study by Deloitte (2017, pp. 7, 16, 31), Romania has proved the most active among the countries of Central and Eastern Europe as concerns the liquidation of bad loans portfolio, with a total value of transactions of about 5 billion euro (representing almost 50% of the total NPL) during 2014 - 2016, compared with Hungary (3.2 billion euros) and Poland (1.4 billion euros). However, the average sale prices of bad loans portfolios in Romania stood at a very low level (about 11%), half of those achieved by Czech Republic or Slovakia.

If it is true that reducing the share of NPL help the improvement of assets quality and, thereby, the recovery of the banking system, in Romania's case the fundamental question is how it has been possible that alert thresholds being exceeded so much and for so long, without banking supervisory authority and the European institutions empowered to act only late, although in a radical manner. In our opinion, the reduction in NPL ratio by writing off the portfolio of bad loans at derisory prices do not reflect a real recovery of the banking system in Romania,

² The NBR bad loans restructuring plan, implemented since 2014, has provided measures aimed to banks balance sheets cleaning up through writing off provisioned NPL that were deemed unrecoverable, selling the uncovered NPL portfolio overdue more than one year (except in bankruptcy or insolvency), removing NPL off balance and revaluation of collaterals at market value by external auditors.

being, materialized in financial losses suffered by banks in the years 2009-2014, in fact, as a result of hazardous credit policies during 2004-2008.

This reduction, by the manner in which it occurred, is merely a form of de-risking, with adverse effects outside the banking system, mainly by the decrease in lending, affecting the resources to finance the economy and reducing the number of customers, thus limiting companies and population access to financing.

3.2 De-risking and financial inclusion

By restricting access to certain categories of customers to financial services, including those to individuals, it is estimated that one of the biggest threats of de-risking is to the financial inclusion (Artingstall et al., 2016, p. 15; Durner & Shetret, 2015, p. 21; Erbenova et al., 2016, p. 5).

Under the circumstances of increasing concerns for reducing inequality and poverty in the world, the financial inclusion has become a global objective, being subjects of the UN *2030 Agenda for Sustainable Development*, the World Bank initiative on universal access to financial services (WB -*Universal Financial Access 2020*), the G20 *Global Partnership for Financial Inclusion* (GPMI). Also, more than 50 countries have launched national strategies for financial inclusion, with a roadmap stipulating concrete measures, supported by the allocation of necessary resources to implement them.

The World Bank monitors the degree of financial inclusion globally by creating a database (*Global Findex*) that includes over 140 countries and more than 100 indicators (Asli et al., 2015). As can be seen from the data presented in Table 2, in 2014, the financial inclusion in Romania was at a low level, the majority of the selected indicators standing below the average of the country group to which it belongs (upper-middle income) according to the World Bank classification, and well below the average of OECD advanced countries.

Table 2 Indicators of financial inclusion

-% of population aged 15+-

Indicators	Romania	Average of countries <i>upper-middle income</i>	Average of countries <i>OECD high-income</i>
Account held in a financial institution	60.8	70.4	94.0
Debit card	45.8	45.9	61.9
Savings in the past year	13.3	32.2	51.6
Credit in the past year	11.8	10.4	18.4
Bills paid by internet	11.5	15.3	54.1

Source: Data book on Financial Inclusion, Global Findex, World Bank, 2015, p. 122-125.

At EU level, the measurement of financial inclusion is done using a composite indicator, on a scale from 0 to 1, respectively FIS (Financial Inclusion Score) estimated based on the weighted average of a series of indicators on infrastructure financial services, including its quality, as well as to their use, the share of the adult population holding current and savings accounts, that takes consumer credits, or has life insurance.

In the ranking of the degree of financial inclusion according to FIS, compared to countries rated 1.00 (Sweden, Denmark, Finland, Ireland) and to an average score of 0.91 at EU level, Romania is ranked last with a score 0.554 (European Commission, 2015, p. 5).

In Romania, the low level of financial inclusion is explained, in addition to the large share of people at risk of poverty or social exclusion (37.3% according to Eurostat) that do not qualify for bank loans, in that, during the period 2009-2015, a total of about 700 000 people (by 60% more than in 2008) were recorded as having late payments more than 30 days to Central Credit Risk, appearing on the black list of banks and being excluded from applying for another credit.

4. Concluding remarks

The de-risking phenomenon has recently entered the attention of international financial institutions and researchers, particularly due to events emerged in the area of banking, having adverse macroeconomic and social effects and being perceived increasingly more as a global threat, constituting, by itself, a major risk factor.

The main difficulty encountered by the attempts to prevent and counteract these adverse effects is caused by the lack of a proper assessment of the de-risking impact, given insufficient data and inability of separating the cause-effect relation on the alignment of various forms and complex event phenomenon, the multitude of involved actors and the conflict, most often hidden, between the interests of the banking system, dominated by global banks, and those of national and international institutions and society as a whole.

The banking system, which gather most causes of de-risking is facing with extremely difficult trade-off options, each of which having associated a particular set of costs and benefits, variable in time and space, under the pressure of fitting the stability/prudential standards versus risk taking, under a complex of interdependent conditions and high uncertainty, and the achievement of the bank top management performance indicators.

Given the early stage of research on de-risking phenomenon, while following the global studies, especially of the IMF and World Bank, aimed at clarifying the key issues and assessing the implications of this phenomenon to their real dimension, for Romania, which, as revealed in this paper, is also affected, more severe in terms of financial inclusion, is important that regulatory and supervision authorities of financial markets (mainly NBR and FSA), which have basic information and specific data, to start a customized analysis, in order to identify particular solutions to mitigate the adverse effects of de-risking for our country.

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