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FINAL RESEARCH REPORT

Management and Marketing Strategies in the Banking Sector

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Introduction

In the 2009 Intermediary Report I analyzed the economic and financial crisis that began in 2008, and its impact on the banking sector, as well as the steps towards the adoption of the Euro currency by Romania. Since then, the economic and financial situation has registered further developments in 2010. While the United States shows signs of recovery from the crisis, because it has taken measures to better manage, regulate and supervise the financial sector, Europe has still much more work to do. The Euro area countries have felt the burden of the crisis quite strongly, and even if there is consensus that the financial and economic sectors have to be sorted out, they have yet to agree on many of the measures to be adopted.

The goal in this report is to take a look at management and marketing approach in the financial sector, in relation to the changes occurred in the domestic economies of many countries arount the world, with particular emphasis on the United States of America and Europe. To do so, I will look into the way the financial system works, and into the relationships between domestic and foreign banks and the Central Banks, as well as those between banks and their foreign subsidiaries.

Given the fact that the banking system operates in accordance with specific international regulations established by treaties, governing laws and international financial institutions, such as the European Central Bank, the Basel Committee, Federal Reserve, and the domestic Central Banks, I will take a brief look also at the underlying principles of those banking systems. However, I will not stop at the description of these mechanisms, but rather go through the most important issues these institutions face in excercising their front row roles in the journey towards economic and financial recovery.

I will not look into depth at the particular situation in Romania, since that topic will be discussed in detail in the final chapter of my doctoral thesis with the title *"Management and Marketing strategies in the international banking sector and in Romania"*. However, I will go over some of the most recent developments in Romania's economy to pave the way for the next phase mentioned above.

Regulation and Supervision are two of the most important activities that are playing an important role in the reform of the financial and banking sector, therefore I will take a good look at them.

Risk Management has also become an important activity especially in the banking sector mostly because there are many hopes that if proper techniques are put in place, the events that have led to the current worldwide financial crisis will not be repeatable in the future.

Business ethics is also an important issue that I will talk about in the final part of this work. The reason for this choice is that the many case - studies presented in this report will be good topics from which conclusions can be drawn. Until recently, the ethical behaviour in the way business firms conducted their activities was taken for granted in the financial sector. Hoewver, the events that took place in the financial sector have to be distinguished into two categories in my view: 1) fraudulent activities such as the one carried out by Bernard Madoff for more than 20 years, ripping off credulous investors and individuals of more than $ 65

billion[1]; 2) legitimate but wrong activities conducted by financial institutions in their effort to make unlimited profits at any cost.

Next I will be looking at the importance of having a developed insurance sector to better support the development of the financial sector.

During the various subchapters of this work, I will look at the most recent and relevant issues in relation to my analysis, discuss them, and try to find better solutions if possible.
I must also mention that given the fact that marketing strategies are a part of the strategic management mix, having to split specific topics into the first and second chapter was not an easy thing to achieve, however I hope that I have chosen right.

I must mention that the objective of this report is not to present every type of management and marketing strategy in the banking sector, since this would be very difficult to achieve, and would go beyond the scope of this paper. Instead, the report will take you through the most important strategies in the banking sector, in relation to the current financial and economic situation, presenting real-life examples and presenting solutions where possible.

The report is written in English respecting the Doctoral Regulation that allows this. I made this choice because I intend to publish parts of this work abroad, before completing my final thesis. However, I plan to do a translation of this report in Romanian, hopefully before presenting it to the commission at the the oral evaluation.

Having said this, I hope that this paper will be as interesting for you to read as it was for me to research and write.

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[1] Arvedlund, Erin: “Madoff the man who stole $ 65 billion”, Penguin Books 2009, London

1. Chapter I – Management Strategies in the Banking Sector

1.1. The Financial System

Before beginning to analyse the management strategies in the banking sector, we will take a brief look at the mechanisms behind the financial system, of which the banking system is also part.

It is no secret that having a well functioning financial system is of critical importance for any economy. It is crucial for economic development that financial resources be available in those areas of the economy that are in need of them. The role of the financial system is to channel funds from sectors that have a surplus of funds, to those that have a shortage. By doing so, the financial sector performs the functions of reducing information and transaction costs and facilitating trading. Financial systems are made up of all financial intermediaries and financial markets and the relations they establish for the flow of funds between the governments, business firms, and foreign entities and of the financial infrastructure.[2]

1.1.1. The importance of regulation

One of the most important aspects in the financial sector is regulation. Since the banking system is part of it, it too needs to be governed by specific rules. These rules have the goal to protect the financial institutions, and most of all to prevent certain individuals from taking actions that may generate risks for the institutions involved.

One textbook case is the bankruptcy of Barings, the oldest merchant bank in London (1762 – 1995), that went bankrupt due to unauthorized trading by its head derivatives trader in Singapore Nick Leeson that lost £827 million ($1.3 billion) speculating primarily on futures contracts. At a certain moment in time, Leeson held two positions that would have been normally held by two employees: he was floor manager for Barings' trading on the Singapore International Monetary Exchange and head of settlement operations. Because Leeson in effect reported to himself, the internal control and audit safeguards were short-circuited. Leeson even stated “People at the London end of Barings were all so know-all that nobody dared ask a stupid question in case they looked silly in front of everyone else”. Therefore, he put the blame on the bank’s own deficient auditing and risk management practices that allowed him to do what he did.
This was just one of the many events that have prompted reform in the banking sector, and establishing strict rules and procedures, segregation of duties and responsibilities, so that internal auditing, controlling and risk management systems are capable to safeguard the institutions from risks.

The banking sector has established means of establishing how the banking sector should be run and supervised. This is achieved through the renowned Basel Accords. These refer to the

[2] De Haan, Jakob – Oosterloo, Sander – Schoenmaker, Dirk: „European Financial Markets and Institutions”, Cambridge University Press, 2009, UK, pp. 3

banking supervision Accords (recommendations on banking laws and regulations), Basel I and Basel II issued (and Basel III under development) by the Basel Committee on Banking Supervision. The secretariat of the BCSB[3] is in the city of Basel, Switzerland, the city that gave the accords its name.

1.1.2. The importance of supervision

Once an adequate framework of regulations is set in place to establish procedures that make the financial and banking systems tick, it is also necessary to check if they are being followed by those involved in the process. In order for this to be achieved, it is also necessary to have a supervising function that makes sure that the regulations and norms are being followed properly, that risks are being managed adequately, that the indicators and ratios are within the accepted parameters, that there are contingency plans for any foreseeable crisis situations, and that the financial market as a whole is safeguarded properly in difficult conditions.

One structure that has been established for improving supervision in the banking sector is the Basel Committee on Banking Supervision.The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters and relies on national authorities to implement its standards. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches, and techniques, with a view to promoting common understanding. At times, the Committee develops guidelines and supervisory standards in areas where they are considered desirable. Some of these are:

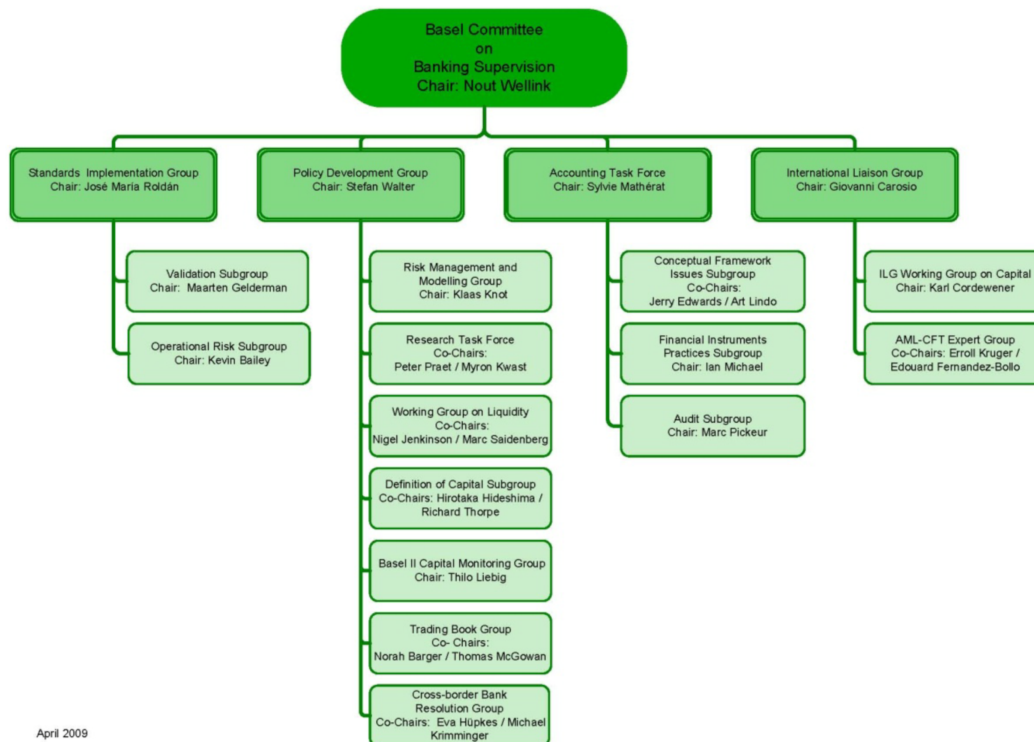
- Standards on Capital Adequacy (Basel I and Basel 11),
- the Core Principles for Effective Banking Supervision,
- the Concordat on cross-border banking supervision.

The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank.

The Chairman of the Committee is Nout Wellink, President of the Netherlands Bank. The Committee's Secretariat is located at the Bank for International Settlements in Basel, Switzerland. The organizational chart of the Committee is presented below.

One of the issues that the committee frequently discusses is minimum capital requirements for banks.

[3] BCSB: Basel Committee on Banking Supervision



Source: The Basel Committee

In 2004, an agreement was reached, generally referred to as the Basel 2 Accord. It uses a three-pillars concept:

- (1) minimum capital requirements,
- (2) supervisory review,
- (3) market discipline.

Basel 2, an improved version of the original rules, has been introduced by most European banks in the past two years, while America's big banks are on track to implement it by 2011. It involves two stages:

- The first is defining capital: crudely, the gap between assets and liabilities.
- The second is comparing this with assets.

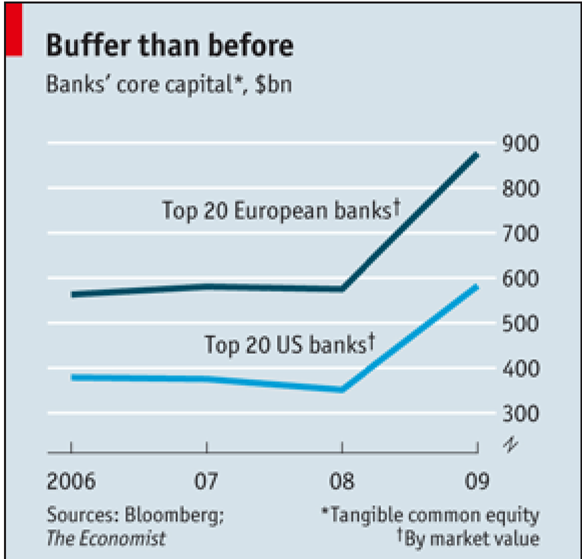
Since not all assets are the same, the rules adjust them for risk, often using complicated modelling: a government bond is regarded as absolutely safe and so needs no capital behind it, but a risky property loan requires lots. The rules say that Tier 1 capital—supposedly, in the main, common equity and equity-like instruments—must be at least 4% of a bank's risk-adjusted assets.

However, the definition of Tier 1 capital was far too lax. Many of the equity-like instruments allowed were really debt. In effect, the fine print allowed banks' common equity, or "core" Tier 1, the purest and most flexible form of capital, to be as little as 2% of risk-adjusted assets. In hindsight, says one regulator, this was "very, very low… unacceptably low". Furthermore, investors lost confidence in the way assets were adjusted for risk to compute a capital ratio. For instance, dodgy mortgage securities could be held with little capital against

them, on the basis that credit-rating agencies had graded them triple-A. Risk-adjusted according to Basel 2, they were judged almost as safe as government bonds.[4]

The new proposals go a long way to remedying these failures. The definition of capital will be much stricter. In essence, only pure equity will be included and that after deducting spurious benefits such as tax assets and including nasties such as short-term losses on securities. According to some estimates, that alone could wipe out much of the equity of several European banks, although the changes are likely to be introduced slowly. José María Roldán, of the Bank of Spain, who chairs the Basel club's implementation committee, says "the more revolutionary we are", the greater the need for a "slower transition".
Its predecessor, the Basel I accord of 1988, dealt with only parts of each of these pillars. Basel II seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face.[5]

The initiatives of the Basel Committee are right in my view, but the implementation of the accords and regulations is an issue in its own. Many important institutions, such as the European Commission, the International Monetary Fund and governments in Europe and America (through the Financial Accounting Standards Board), are all active participants in the process of reforming finance, by implementing new regulations for the financial sector. However, the costs of adopting the new regulations has a substantial impact on the banks' profits: the analysts at Barclays Capital from the United States of America, reckon that domestic legistlation will account to 16% of banks' profits in 2013, while the analysts at Credit Suisse forsee that the European banks' profits will drop by as much as 37% in 2012 due to the proposed new regulation.[6] Banks claim that the cost of "Basel 3" will force them to raise the price of loans, devastating the economy. The French Banking Federation, for example, reckons it could eventually knock more than 6% off the euro zone's GDP.[7] In the chart above you can see the bank's core capital in billion in Europe and in the US from 2006 to 2009.



Sources: Bloomberg, The Economist

The Basel club' study that will be presented by the end of 2010 is expected to be less alarming, but it will have to explain in plain words clearly that the timing of bigger buffers can be staggered and that their cost must be compared with the benefit of fewer meltdowns (the Bank of England reckons global GDP in 2009 would have been 6.5% higher without the

[4] Reforming banking - Base camp Basel: "Regulators are trying to make banks better equipped against catastrophe", Jan 21st 2010
[5] De Haan, Jakob – Oosterloo, Sander – Schoenmaker, Dirk: „European Financial Markets and Institutions", Cambridge University Press, 2009, UK, pp. 49
[6] Basel 3 - The banks battle back: "A behind-the-scenes brawl over new capital and liquidity rules, from the Economist print edition, May 27th 2010
[7] GDP: Gross Domestic Product

crisis). And it must insist that as a bare minimum the system has enough capital and liquidity to absorb a crisis as bad as the last one.[8]

It is understandable that any measure with an impact of this proportion to the profits of the banks isn't easy to swallow, and that the banks are critical of it. However the Basel Committee is true to its objective of reforming the banking sector.

The most important reform inititated by the Basel Committee is the international set of rules known as "Basel 3", which will govern the capital and liquidity buffers banks carry. In December 2009, under instruction from the G20, the Basel club of bank supervisors published new proposals on capital and liquidity "buffers" which aim to boost capital and get banks not to depend on short-term funding. These could be in force by the end of 2012.The response of the banks was to criticize this approach. Although they claim to accept the objective of raising safety buffers, banks argue that any big changes will be an obstacle to economic growth. Many also say that the Basel club's timetable, which is to have the proposals finalised by this year and implemented by late 2012, is unrealistic.[9]

The Economist states that *"During the crisis there was a total loss of confidence in banks' capital standards, with most investors resorting to more basic accounting information to measure solvency. It is for this reason that Basel 3 is likely, however much the banks squeal, to take a firm line on excluding low-quality instruments such as preference shares from core capital. Likewise, few can seriously object to its demand that banks hold enough liquid assets to withstand a severe, month-long liquidity shock."*[10]

It hasn't been decided how big the buffers in the Basel 3 should be. Stefan Walter, the secretary-general of the Basel Committee, says the aim is *"a balanced package where the costs will be phased to avoid economic disruption and the benefits will be substantial."* The response of the banks was to fight back by lobbying the Institute on International Finance in order to estimate the costs of Basel 3, to which the Basel club will publish its own assessment that should be of less concern. In 2099 the Federal Reserve forecasted an erosion of capital according to the conducted stress tests, which in practice have not materialized. Therefore there will probably be less need for banks to raise so much new capital and thus concentrate on fixing other problems in the banking system and find solutions to help the banks that lose the most money.

As mentioned earlier, one of the goals of Basel 3 will be to force banks to cut their structural reliance on short-term funding. This will not be easy at all to achieve because of the way the banking sector functions right now and because it will be difficult to find enough deposits or issue enough bonds to meet the requirements. Credit Suisse has estimated that the regulators' proposed "Net stable funding ratio" would require European banks to raise €1.3 trillion ($1.6 trillion) of long-term funding. As you can see, this is a very large amount for the banking sectors to raise.[11]

It's no secret that the world's banking system is at the same extremely complex and too vital to fail. In the past year, the brightest minds in governments, regulatory bodies and central

[8] Reforming banking - Base camp Basel: "Regulators are trying to make banks better equipped against catastrophe", Jan 21st 2010
[9] Basel 3 - The banks battle back: "A behind-the-scenes brawl over new capital and liquidity rules, from the Economist print edition, May 27th 2010
[10] Ibid
[11] Ibid

banks have decided how to improve the way it is supervised. Their answer was that it should be reinforced and protected in case of rash actions or accident. This answer is of course sensible but doesn't clear out the question if some banks fail if there are other solutions than to use the taxpayers' money to save the weakest banks in case they fail due to a crisis. The way to protect taxpayers is to compel banks to have buffers thick enough to withstand higher losses and longer freezes in financial markets before they call for state help. A 2009 study for Britain's Financial Services Authority concluded that because periodic meltdowns do so much damage, banking systems should ideally be better capitalised and less volatile than they were before the crisis.

Considering that European and American Banks use either version of the Basel accords, 1 or 2, that were at the time carefully planned and backed by minimum capital requirements and detailed formulae, we might ask if that wasn't enough to prevent a crash. The answer is: evidently not. Just think of the fact that five days before its bankruptcy, Lehman Brothers had a "Tier 1" capital ratio of 11%, almost three times the regulatory minimum. In my opinion, the rules and buffers that should be establish to prevent another crisis from having the impact of the current one is to have increased buffers and more thought-out rules that shouldn't be too strict. Instead they should be more flexible to be able to adapt to unforeseeable situations. It is time for banks to become less reliant on governments' help. That should happen as a last resort, but should be avoided at all costs. Anyway, I don't believe that the banking system' problems can be solved just through regulations and buffers. What the banks need are professionals with intergrity that can enforce them. What is missing from the banking regulations is the human factor. If those that are directly involved in the process are not guided by strong principles and act ethically, all regulations in the world won't be able to solve the problems. And as Plato the philosopher said: "the more laws a state has, the more corrupt it is". This can be translated to the situation of the banks into: "the more regulations the banking system has, the higher the probability that those responsible for applying them will try to avoid them to seek their own intrerests". Therefore, in this case, there is one other element that should be taken into consideration: accountability. As long as nobody is held responsible for their actions and measures taken, others will follow their example and history will repeat itself. As Andrew Haldane of the Bank of England has noted, the world has come a long way since 1360, when a banker in Barcelona was executed in front of his failed firm.

Three-quarters of the balance-sheets of America's four biggest banks are now funded by equity, long-term debt or deposits.

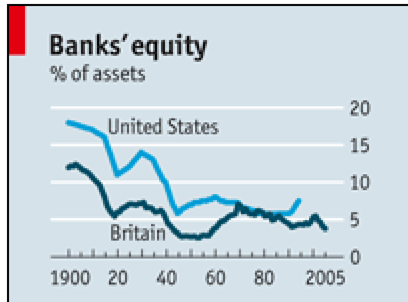
According to the Economist, because most big banks are too interconnected to fail, and could be brought down by a counterparty, the system is only as strong as its weakest member. [12] This approach is similar to that in the computing world: a computer is as powerful as its weakest component. Therefore, it would be useless to use top components to make a computer but use just one low quality component that reduces speed and may fail before the others do. The same applies to banks: being so interconnected is an advantage as well as a disadvantage. I will discuss more about counterparty risk further on in the part where I talk about Risk Management.

As we have seen so far, the regulators have to find ways to protect taxpayers from huge bills when all precautionary measures fail and the banks go bust.

[12] Reforming banking - Base camp Basel: "Regulators are trying to make banks better equipped against catastrophe", Jan 21st 2010

This is exactly what the American President, Barack Obama wants to achive in his new plan for the banks who's stated aim is: "Never again will the American taxpayer be held hostage by a bank that is too big to fail."[13] One thing is for sure: the goal is ambitious, but will it succeed without having unforeseen consequences?

The Basel rules, designed to ensure that banks have enough capital to cope with economic crises, present another example of unintended consequences. The rules created an incentive for banks to hold AAA-rated securities, which require less capital to be held against them. But there was a shortage of genuine AAA-rated bonds. So that gave financial whizzkids a motive to create complex securities like collateralised debt obligations (CDOs[14]) based on subprime mortgages. The top tier of CDO[15] debt was usually rated AAA because all the other classes had to default before it got hit. Of course, the worst then happened. In the end, rules designed to make the banking system safer led European banks to become exposed to defaulting homeowners in places like Florida and Nevada.



Source: The Economist

You could also argue that the hedge-fund and private-equity industries are both the unintended result of regulations. Hedge funds owe their appeal to their ability to go short, and thus make money even in falling markets. That marks them out from mutual funds, which are not allowed to short. And private equity would find it much more difficult to function without the rule that allows interest to be tax-deductible.

All these examples illustrate the general rule that capital, like water, tends to flow around obstacles. Try to dam its movement at one point, and slowly but remorselessly it will find its way around.

So what might be the unintended consequences of Mr Obama's plan? The main impact will be on proprietary trading, the desks that attempt to profit from market movements with the bank's own money. If more of these desks are shut down, the markets will become less liquid. That will mean wider spreads and higher dealing costs for other investors, though that may be a price worth paying for safer banks. It is more likely, however, that the prop traders[16] will move to hedge funds. The big hedge funds will get bigger and will have more impact on the markets. The unregulated part of the finance sector will become more important systemically, something the authorities may regret when the next crisis comes along.[17]

Talking about bankers' bonuses we see that governments are now finding ways to tax them, as we see in the most recent Barack Obama's plan to charge banks an annual insurance fee.

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[13] Buttonwood - Not what they meant: "The unintended consequences of past financial reforms", from the Economist print edition, Jan 28th 2010
[14] Soros, George: "The crash of 2008 and what it means – The new paradigm for financial markets", Public Affairs 2009, New York, pp. xviii
[15] CDO: Collateralized Debt Obbligations: Bishop, Matthew: „Economics – An A-Z Guide", The Economist, 2009, UK
[16] Prop trader: Proprietary trader involved in transaction with securities
[17] Buttonwood - Not what they meant: "The unintended consequences of past financial reforms", from the Economist print edition, Jan 28th 2010

The good news is that big banks probably now have enough capital to absorb the aggregate loss rate suffered by the system from 2007 to 2009 (although their build-up of liquidity reserves has been patchier). But buffers can be set at these pragmatic levels only if there is a credible way to deal with the outlier banks that typically lose three to five times more than the average. This is why "resolution schemes" for bad banks, that put losses onto creditors not taxpayers, are so important. They are a linchpin of reform, allowing politicians to argue that bail-outs will not happen again and regulators to resist calls for bigger safety buffers or a radical break-up of banks.[18]

No existing proposal looks strong enough. America's reform package and the industry's plans will create the bureaucratic tools to push losses onto creditors. But will they be used? In a crisis supervisors will still be terrified that the threat of hundreds of billions of dollars of losses will fuel panic. Faced with a near collapse they are far more likely to give banks' creditors a guarantee than to hurt them.

We will move next to see the financial institutions that are at the heart of the financial sector.

1.2. The most important financial institutions and their roles

1.2.1. The European Central Bank

The European Central Bank is the institution of the European Union in charge with administering the monetary policy of the 16 EU[19] member states taking part in the Eurozone. As a result, it is one of the world's most important central banks. The bank was established by the Treaty of Amsterdam in 1998, and is headquartered in Frankfurt, Germany. The current President of the ECB[20] is Jean-Claude Trichet.

For weeks there have been calls for the euro zone's policymakers to get ahead of the sovereign-debt crisis, which started in Greece and was in danger of engulfing other countries with big budget deficits and poor growth prospects. In the early hours of May 10th, 2010, such a plan finally emerged. After a lengthy summit in Brussels, European finance ministers agreed on a "stabilisation fund" worth up to €500 billion ($640 billion) over three years. That sum would be supplemented by a further €220 billion or more from the IMF[21]. In addition, the European Central Bank (ECB) said it would purchase government bonds to restore calm to "dysfunctional" markets.

Jean-Claude Trichet, the central bank's head, denied that the bank had been pressured into buying bonds, even though it is only a few days since he said publicly that the ECB's governing council had not even discussed buying bonds at its regular monthly meeting. He insisted that the ECB was "fiercely and totally independent."

However, for all his protestations, the ECB looks a different to when the fiscal crisis began. Having balked at buying government bonds last year when other central banks were doing so as part of their monetary policy, the bank now finds itself involved in an explicit support operation to European governments' fiscal policies—which is a far bigger threat to its self-

[18] Reforming finance - Bare-knuckle in Basel: "The task of sorting out banking is far from finished", from the Economist print edition, May 27th 2010
[19] EU: European Union
[20] ECB: European Central Bank
[21] IMF: International Monetary Fund

image. This is not the only sharp U-turn Mr Trichet has had to perform in recent weeks. He opposed IMF involvement in the Greek rescue, then welcomed it. And he said the rules would not be changed to suit one country, only to change them to ensure that Greek bonds could be exchanged by banks for ECB cash. The central bank's credibility relies in part on a reputation for living up to its pledges and partly on its disdain for political expediency. On both counts, then, it has lost something.

Even so, it is wrong to conclude that, in trying to get ahead of the crisis, the euro zone's policymakers have gone too far. The threat that Portugal and Spain might be cut off from credit markets, triggering a meltdown in Europe’s financial system, was all too real. The rescue effort will dent the ECB’s reputation as a single-minded inflation-slayer. The insurance provided by the rescue scheme may leave countries that benefit from it a bit less minded to cut deficits and reform their economies. But those faults, real as they are, must be set against the potential costs of doing nothing.[22]

We will see later on in the report what actions the ECB has taken in relation to the crisis and to the actions taken by its peers abroad.

1.2.2. The U.S. Federal Reserve

The Federal Reserve System is the central bank of the United States. It was founded by the U.S. Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, its role in banking and the economy has expanded.

Today, the Federal Reserve’s duties fall into four general areas:

- conducting the nation’s monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates,
- supervising and regulating banking institutions to ensure the safety and soundness of the nation’s banking and financial system and to protect the credit rights of consumers
- maintaining the stability of the financial system and containing systemic risk that may arise in financial markets,
- providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation’s payments system.

Most developed countries have a central bank whose functions are broadly similar to those of the Federal Reserve. The oldest, Sweden’s Riksbank, has existed since 1668 and the Bank of England since 1694. Napoleon I established the Banque de France in 1800, and the Bank of Canada began operations in 1935. The German Bundesbank was reestablished after World War II and is loosely modeled on the Federal Reserve. More recently, some functions of the Banque de France and the Bundesbank have been assumed by the European Central Bank, formed in 1998.[23]

The decision of the European Central Bank to start buying government bonds follows a path trodden by the Federal Reserve in 2008 and 2009. Both entered politically charged territory

[22] The euro-area rescue plan - The price of pragmatism: “The euro zone’s rescue scheme is big and bold but leaves the ECB looking compromised”, from the Economist, May 11th 2010
[23] http://www.federalreserve.gov/pf/pf.htm - The Federal Reserve System: Purposes and Functions

to save the financial system at great risk to their reputations. For the Fed[24], one consequence is that the big financial-reform bill making its way through the Senate—a vote was expected after The Economist went to press—will leave it more powerful but more beholden to Washington, DC.

The Fed has fought for, and kept, its supervision of banks. It acquires important new powers to regulate big non-bank financial companies and even to break up firms deemed a threat to the financial system. Its only significant loss of turf is direct oversight of consumer protection. The Fed keeps its emergency-lending powers, though it needs the Treasury's approval to use them (it has usually sought such approval anyway). It cannot lend to failing firms because that job now sits with the Federal Deposit Insurance Corporation under the bill's new resolution authority.

The price of these powers, though, is to be drawn closer into politicians' embrace. Since its birth the Fed's governance has reflected a mix of political and financial influences. Monetary policy is the joint responsibility of governors in Washington, DC, appointed by the president and confirmed by the Senate, and presidents of the reserve banks, some of whose directors are, or are appointed by, bankers.

Critics have long seen the bankers' role in the running of the Fed as an affront to democracy. Under the reform bill the president will now nominate and the Senate will confirm the New York Fed president (the most important of the regional governors). Fed-supervised banks will lose any say in the governance of the reserve banks. Barney Frank, the chairman of the House Financial Services Committee, wants to go further, either stripping all reserve-bank presidents of their votes on monetary policy or making them more accountable.

Such changes have some worried that the Fed will adopt a looser monetary stance. In the near term, these fears are overdone. The economic environment remains deflationary. Excluding food and energy, inflation fell to a 49-year low of 0.9% in April. Political pressure for more expansionary policy has also been surprisingly slight. Opponents of Ben Bernanke's confirmation to a second term as Fed chairman in January were more likely to criticise lax policy before the crisis and the Fed's interventions during it, not its failure to maintain full employment. Inside the Fed, the pressure is also for tighter policy. Some officials are pressing for a quick sale of its holdings of mortgage-backed securities, although minutes of its April meeting suggest that will not happen before the Fed begins raising short-term rates.

The greater risk to Fed independence is not pressure from outside, but the temptation from inside to broaden its macroeconomic remit as the lines between regulatory and monetary policy blur. Financial stability has been formally added to the Fed's duties, alongside full employment and price stability. More governors will be chosen for regulatory and legal expertise; one will be designated vice-chairman for supervision. If Barack Obama's latest nominees are approved, only three of the seven governors will be economists; two will be lawyers. Decisions on which financial firms to regulate, which to support and which to liquidate will increasingly be made with an eye on the broader economy. Interest-rate decisions will more heavily consider the impact on the financial system. A hard job has got harder.[25]

Next we will look at an international financial organization that has traditionally had authority at international level, and we will see why.

[24] FED: The U.S. Federal Reserve

[25] Central banks under scrutiny - Prometheus bound: "Financial reform will make the Fed more powerful and less independent", from the Economist print edition, May 20th 2010 | WASHINGTON, DC

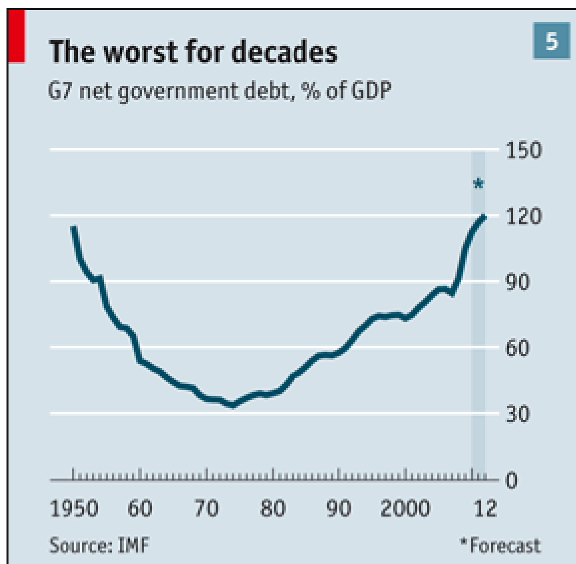
1.2.3. The International Monetary Fund

The International Monetary Fund is an organization of 187 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.[26]

Since I have already discussed more in depth about the International Monetary Fund in the intermediary research project last year, right now I am only going to discuss the most recent developments related to the IMF and the financial sector. But what does the IMF do exactly?

The Economist calls it the "rich-uncle theory": when the private sector struggles, governments often step in to pick up the bill. And when individual countries have trouble meeting their commitments, they turn to their neighbours, or to the International Monetary Fund, for help.[27] I would add to this that the IMF intervenes to help also countries that are not necessarily in a crisis situation, but may be finding it difficult to get cheaper financing from abroad, or just need a backup just in case.

The current recession and the financial crisis that accelerated it have increased the already large government debt in the developed countries, to an extent experienced during the world wars. These governments already had trouble due to their ageing populations. They face unfunded liabilites from these ageing populations because benefits for growing numbers of pensioners will have to be paid for by a shrinking band of workers. These liabilities are difficult to calculate. Pierre Cailleteau of Moody's, a rating agency, says that "the state of public-finance accounting is extremely rudimentary relative to private-sector accounting."



Source: The Economist, IMF

A 2009 report by Jagadeesh Gokhale, of the right-wing Cato Institute in Washington, DC, estimated that the average EU country would need a fund worth 434% of its GDP, earning interest at the government's borrowing rate, to meet such liabilities; alternatively, it would need to save 8.3% of its GDP each year. Neither seems realistic. The only answer is to cut future benefits. But the elderly form a powerful voting block, with a higher turnout than their children, who will pay the bill.
Therefore, one conclusion that comes to my mind is that in today's world, thinking that the governments will take good care of us when we reach pension age (which is being constantly increased), is utopic. Without demographic growth, the world economy will be affected drastically in the long run, because the workforce will decrease, while the old retirees' numbers will increase, as well as their life expectancy. For the moment, politicians do what they can to stay in office, and this means that they will have to accept compromises on this matter, even if just in election years.

[26] www.imf.org
[27] The IMF and the euro-zone rescue - High stakes: "What has the fund got itself into by participating in Europe's bail-out?", from the Economist print edition, May 13th 2010

According to the Economist, during the first and second world wars governments on both sides of the conflict exploited the patriotism of their citizens, persuading them to buy "victory" bonds and the like. Those same governments then penalised the patriots by inflating away their debt after the war. From 1945 onward government debt became a tool of economic management as Keynesian deficit spending was used to cushion economies during recessions. The booms of the 1980s and 1990s led to a surge in tax revenues and kept the debt problem under control. But the recent financial crisis caused some of the biggest deficits recorded in peacetime. The debt-to-GDP[28] ratio of the G7 group of nations is at its highest level for 60 years. As we can see in the chart above, the last peak in government debt was recorded in the 1950s, and has gradually decreased, reaching the lowest point in the mid 1970s, then starting to increase again, with an estimated peak forecasted to be reached in 2010.

Governments compared to private firms, have the possibility to assume debt and offset it to a certain extent by raising taxes, printing money and issuing government bonds. However, this approach is similar to that of a private individual getting a new credit card and making the minimum repayment every month. For a while it seems like free money. The tricky point comes when the credit limit is reached, and he has to look elsewhere for money but nobody is willing to lend anymore.

It's a fact that the euro-zone was hit by the crisis before other regions because of adopting a common currency. Doing so has taken away the possibility for the euro-zone governments to print money and devaluate the currency. It is estimated that the government deficits will disappear gradually when the private sector rebounds. As we can see in the chart above, the government debt has not reached in 2010 the levels of the years after the second world war from which the governments recovered successfully. But we have to keep in mind that at that time the personal, industrial and financial sectors of the economy were much less indebted.

When debt gets too high, a number of problems arise:

First, a spiral is set off in which lower credit ratings for a country lead to higher borrowing costs, in turn increasing the deficit. Markets already seem unwilling to fund some countries at sustainable rates: by the time Greece turned to the IMF and its EU partners for help, its short-term bond yields were nearly 20%. Ramin Toloui of PIMCO, a fund-management group, explains the process this way: *"When government debt reaches extreme levels, concerns about government creditworthiness become so severe that additional government spending produces increases in long-term interest rates that exacerbate, rather than ameliorate, the economic contraction."*

Second, once a country is stuck in this debt trap, it has to bring in austerity programmes to reduce the deficit; but such austerity holds back economic growth because higher taxes and lower spending reduce demand.

Third, larger government deficits imply greater government interference in the economy and thus a less efficient use of resources.

Last, according to the doctrine of Ricardian[29] equivalence, consumers and businesses see larger deficits as the precursor to higher taxes in future, so they save more of their income, meaning that pump-priming by the government ceases to work.

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[28] GDP: Gross Domestic Product

[29] Krugman, Paul – Wells, Robin – Graddy, Kathryn: „Economics – European Edition", Worth Publishers, 2008, New York, NY, pp. 423, 435

Even those governments that are tempted to keep stimulating the economy may find that the markets punish them for it. Once a crisis of confidence has occurred, governments find it difficult to raise the money they need at an acceptable interest rate. A report by an economic adviser to the Bank for International Settlements in March 2010 noted that “our projections of public debt ratios lead us to conclude that the path pursued by fiscal authorities in a number of industrial countries is unsustainable. Drastic measures are necessary to check the rapid growth of current and future liabilities of governments and reduce their adverse consequences for long-term growth and monetary stability.”

Countries that decide to embark on deficit reduction may face another problem. According to Andrew Smithers of Smithers & Co, a consultancy, a debt-cutting policy will make it harder for the government to bail out the private sector in times of need, as well as reducing companies’ cashflow by imposing higher taxes.

Neither Greece nor Iceland has had any choice about tackling its deficits. They may be a long way apart, both geographically and culturally, but both are casualties of the debt crisis. Iceland was the little country that could. A land with just 300,000 people, best known for its volcanoes and its fish, it privatised its banks and suddenly became an international financial powerhouse. “In the Icelandic system, all the banks were aggressive broker-dealers like Bear Stearns and Lehman,” says Asgeir Jonsson, an economist and author of a book, “Why Iceland?”.

Greece is an exemplar of the flaws in the European welfare model. The state gets remorselessly bigger because political parties of the right and left have bought votes by providing supporters with jobs or subsidies. Antonis Kamaris of Levant Partners, an investment group, says the state must “remove benefits that have built up like a ship accumulates barnacles”. Public-sector workers were given pay for 13 or 14 months per year and arcane allowances for things like firewood or carrying files between office floors. Tax evasion is widespread. A report by the London School of Economics estimates that it reduced Greece’s potential tax yield by 26%.

Both economies face fundamental difficulties. For Greece, being a member of the euro zone is now a hindrance rather than a help. Its costs are too high but it cannot devalue its currency, and trying to inflate its way out of its debt would, in effect, be impossible. Iceland, which is not a member of the European Union, has been able to devalue the krona, but that created a problem for individuals and companies which had borrowed in foreign currencies. Its banks had to be nationalised and domestic depositors were favoured over foreign creditors.

Both countries have had to call in outside help. The Icelanders have borrowed from the IMF, with their negotiations made more complex by a dispute with Britain and the Netherlands over compensation for foreign depositors in one of its big banks. Iceland is trying to reduce its fiscal deficit, which in 2008 reached 13.6% of GDP, via increases in value-added tax, income tax, and petrol and alcohol duties. Rising unemployment has prompted many Icelanders to emigrate, causing the population to fall for the first time since the 19th century.

In Greece spiralling debt costs also forced the government to turn to the IMF as well as to its EU partners. But it remains to be seen whether the population will tolerate the austerity needed to bring the debt burden down to a reasonable level. The most recent package of cuts provoked a wave of strikes and riots in which three bank employees died.

On the other hand, America has two huge advantages over other countries that have allowed it to face its debt with relative equanimity: possessing both the world’s reserve currency and

its most liquid asset market, in Treasury bonds. Even in the midst of the credit crunch, when some of the biggest Wall Street banks were collapsing, the dollar rose and Treasury bond yields fell, making it easier and cheaper for America to finance its deficit. There may come a time when America is hit by a funding crisis, but it does not look imminent.
America would be more at risk if the Asian central banks and sovereign-wealth funds had an obvious alternative. But with Europe in the midst of its own debt crisis, the euro does not look like an appealing option. And there is simply not enough gold in the world to absorb a substantial portion of central-bank reserves. For the moment, the dollar is the one-eyed currency in the land of the blind.[30]

The IMF's star has risen steadily through the global economic crisis. Contributions from its members have tripled its firepower. It has rescued economies from Hungary to Pakistan. Yet despite these achievements, its activities did not extend into the heart of the rich world.
That is now changing. Although initially sidelined by the European Union (EU), the IMF eventually cofunded and devised the terms of Greece's massive bail-out. And on May 10th 2010 the EU announced that the IMF is to provide up to €250 billion ($317 billion) to supplement its own €500 billion stabilisation fund[31] to prop up the euro area's weaker members.
But the details of the IMF's promised contribution are far from clear. The fund is keen to emphasise that no money has actually been set aside for the rescue. Its deputy chief, John Lipsky, stresses that the €250 billion figure is "a hypothetical or theoretical number" based on the fund's role in recent joint EU-IMF rescues, where the IMF has provided about a third of the cash on offer.
The amount is hypothetical for a very good reason. Having to set that amount aside immediately would leave the IMF unable to lend to any other country that got into trouble. As of May 6th 2010, its total remaining lending capacity for the year ahead was $272 billion, or €215 billion. It has never lent as much in one go as it would if the euro-area package were to be activated in its entirety.

The fund could, of course, find more money. Its board recently approved an extension of its standing arrangements to borrow from governments and central banks by more than $500 billion. But about half that amount is already included in its current lending capacity. Activating the rest would require many governments to seek legislative approval.
There are other options. The IMF will get some extra cash at the end of the year from a general increase in quotas, the maximum amounts countries are obliged to supply to the fund. In 2009 it also issued $250 billion of Special Drawing Rights (SDRs), its own quasi-currency. These sit in countries' reserves in proportion to their quotas. Dominique Strauss-Kahn, the fund's chief, thinks countries could lend some of this money to others. But there is no precedent for SDRs being transferred on such a massive scale.
The fund could also approach some reserve-rich emerging countries to top up its kitty. Some have already lent to the fund. China bought $50 billion of notes the fund issued last year; Brazil, Russia and India each bought $10 billion. But some of these countries are miffed that the fund did not consult them before rushing to the rescue of the euro area. Emerging Asian economies have bitter memories of the harsh conditions the IMF imposed on them during the Asian crisis; they are concerned about the fund making a huge commitment of resources without clearly setting out what potential borrowers would have to do to get the money.

[30] A special report on debt - The unkindest cuts: "Many countries face the difficult choice of upsetting the markets or upsetting their voters", from the Economist print edition, Jun 24th 2010
[31] Special Drawing Rights: „Held in reserve", From The Economist print edition, Apr 8th 2009

Eswar Prasad, a former chief of the fund's China desk, says that all this is once again leading to questions about "whether the IMF's ultimate fealty is to its main shareholders, the US and the EU". Such concerns repeatedly arise because European countries as a group have the biggest chunk of votes in the IMF, and are over-represented relative to their economic heft.
Some also wonder whether the political ambitions of Mr Strauss-Kahn, who is widely rumoured to be considering a run for the French presidency, were behind the IMF's eagerness to step in. Simon Johnson, once the fund's chief economist, says that "a former French finance minister is the worst possible person to be leading the IMF into negotiations designed to save the euro. The conflicts of interest are overwhelming." The fund's European adventures may help Mr Strauss-Kahn. Their consequences for the institution he heads are less clear.[32]

1.2.4. The Central Banks

1.2.4.1. The role of Central Banks

As I mentioned before, Central Banks play a key role in their domestic economies and financial sectors. They are responsible for maintaing equilibrium in the ecomony, enforcing international regulations and issuing their own regulations in accordance to the international ones and to the domestic laws. Besides the role of regulators, they have the role of supervisors. According to this latter role, they have to verify that the banks in their systems are in good health, that they follow appropriately the regulations and laws in force, and that their actions are correct. We have to admit that their role of protectors of the economy such as that of using the tools they have available to avoid inflation or currency devaluation, has diminished, especially in the member countries of the European Union that have adhered to the Euro.

Moving on, let's see what are the biggest problems that Central Banks face right now. According to the Economist, the rich world's central bankers have responded aggressively to financial panic, recession and the threat of deflation by lowering short-term interest rates close to zero and many then bought government debt and extended vast new loans to banks.[33] However, there are two opinions backed by important institutions: those, including the OECD[34] and the Bank for International Settlements, who give warning that a prolonged period of ultra-low interest rates risks inflation and resurgent risk-taking, while the other opinion is backed by those who side with the IMF, which in the first week of July 2010, prescribed a course of fiscal retrenchment for the world, softened with a commitment by central banks to extended easy monetary policy and perhaps even more expansion of their balance-sheets.

Who's right? The rich world does not seem to be on the precipice of deflation. Among the 18 forecasters surveyed monthly by The Economist, none expects deflation in any big economy next year save Japan. Yet that is a far cry from saying that central banks need to shift their attention to inflation. In fact, inflation in 2011 will be lower than this year, the OECD and IMF agree. In most countries it will be well below 2%, a level thought to provide about the

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[32] The IMF and the euro-zone rescue - High stakes: "What has the fund got itself into by participating in Europe's bail-out?", from the Economist print edition, May 13th 2010
[33] Economics focus - Easy-money riders: "An early warning about the dangers of keeping interest rates low", from the Economist print Edition, Jul 15th 2010
[34] OECD: Organization for Economic Co-operation and Development

right buffer against deflation. And deflation, once entrenched, is fiercely difficult to dislodge, as Japan has found. Deflation remains easily the bigger risk.

Inflation is also low in the euro zone, but it's unlikely to become deflation because prices there are stickier (although some countries may have to endure it in order to become competitive again); the greatest risk is that the area's weak recovery peters out in the face of fiscal retrenchment and the stresses inflicted on banks by the sovereign-debt crisis. Both the Federal Reserve and the European Central Bank need to make it clear that they will act if inflation or growth fall much further.

Central banks are left with a limited scope for conventional action due to the short-term rates at or near zero, thus leaving them with just the explicit promises to keep rates down for a long time, buying more government debt, making larger, longer-term loans to banks and buying foreign exchange.

So although the central banks still have plenty of tools, these are less effective than they were. Central banks have their role to play in restoring the world to health, but they cannot do it alone. Governments need to be acutely aware of this as they calibrate their austerity plans.[35]

Yet some economists believe that very low interest rates have costs that are easily overlooked. Raghuram Rajan, a former IMF chief economist and professor at Chicago's Booth School of Business, says that "We need to challenge the view that the central banks produce low interest rates and nobody gets hurt," he says. The Bank for International Settlements, the Basel-based bank for central banks, has similar anxieties. A chapter in its recent annual report asks whether the hidden costs of low interest rates might be greater than the visible benefits.

The BIS[36] identifies several dangers from too-low interest rates, including a distorted allocation of capital and workers, excessive risk-taking, lopsided balance-sheets and destabilising surges in capital flows. The bank stops short of calling for tighter monetary policy but it gives warning that "keeping interest rates low comes at a cost—a cost that is growing with time."

Low interest rates can have more insidious effects on balance-sheets. The BIS frets that companies and governments might load up on short-term debt to cut borrowing costs; in fact, they seem to be doing the opposite. Banks may be more of a concern, as they borrow at shorter maturities to lend at longer ones. This is a profitable strategy when, as now, short-term interest rates are close to zero and the yields on longer-term bonds are higher. Indeed, low rates are a semi-deliberate subsidy to help nurse banks back to health. But if money is kept cheap for too long banks may be tempted to borrow excessively to fund long-term bonds, risking capital losses should interest rates suddenly rise.

Cheap money may also delay a cleaning-out of bad debts from the banking system. The BIS report points out that a long period of low interest rates in Japan during the 1990s allowed banks to refinance loans that ought to have been written off. As long as firms could pay the low servicing costs on bad loans, banks could pretend that the principal might one day be

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[35] Global monetary policy - The central bankers' burden: "Deflation is not imminent but the rich world's central banks must be ready to do what they can to fend it off , from the Economist print edition, Jul 15th 2010
[36] BIS: Bank for International Settlements

repaid. These actions keep bad firms alive at the expense of more efficient competitors or new start-ups. Bank supervisors should be responsible for stamping out this practice but they may be as loth to admit to past mistakes as the banks are themselves.

Low interest rates in the rich world can impose costs on poorer countries. The Federal Reserve and the European Central Bank determine the world's short-term interest rate, says Mr Rajan, but that rate is often unsuitable for other economies.

The pessimists have a stronger point when they argue that too much emphasis is placed on short-term interest rates as a means of cutting unemployment. "The cautionary tale from Japan is that keeping interest rates low without doing anything to fix structural problems may have little effect," says Mr Rajan. One solution might be to find ways to help the jobless get the skills they need and stop expecting miracles from central banks.[37]

1.2.5. The European Banks and stress tests

The European banking market is made up of 27 national banking systems that have each their own characteristics: number of banks, the level of concentration, and the level and intensity of competition. There are some banking systems that are highly concentraed but there is still good competition between them. One important condition is that markets should be open to new entry so as to allow for adequate competition. The European Commission promotes the elimination of any remaining obstacles to cross-border mergergers and acquisitions. In the past mergers between domestic banks was very common, but in the recent years this trend has moved across borders. Right now the number of European Banks has reached 91, which is quite a large number compared to the 19 banks of Wall Street.

Considering the current financial and economic situation generated by the crisis, there are many eyes turned towards the banking system. These eyes wonder to what extent the banks have been affected by the crisis and what further pressure could they be able to withstand, if a second wave of the crisis was to come.

In 2009, America did public tests on its banks and the results ended panic on Wall Street. The Federal Reserve looked closely at the banks' books, estimated what the losses might be and ordered to the banks with insufficient capital to increase it, the taxpayers acting as a backup investor.

Europe has had more trouble in organizing these stress tests that are due to finish on July 23rd 2010. Whereas America's tests were run in military style according to the established schedule and goals, in Europe there have been large discussions in the form of negotiations about the criteria and quotas, as well as the level of recapitalization. However now that an agreement has been reached, the stress tests will begin and the results will be published on July 23rd 2010.

Stress tests are certainly needed. Banks and transparency are not always a good combination. This is so because the banking sector is different from any other sector. If a manufacturer of computers admits it has a hole in its balance-sheet, its factories are still there a week later; but when a bank does so it usually suffers a devastating run because of panic that determines

[37] Economics focus - Easy-money riders: "An early warning about the dangers of keeping interest rates low", from the Economist print Edition, Jul 15th 2010

people to withdraw their money. This is why regulators sometimes like to deal with bad banks in secret. But when there is already a widespread loss of confidence, the only way is to come out in the sunlight.

Europe has reached a similar point. Some banks have been locked out of international borrowing markets, reflecting worries that they could be brought down by the woes of southern Europe and the suspicion that they are sitting on sour loans from the boom years. The fear of contagion has raised debt costs for other banks. Unless faith is restored, the continent's banking system, heavily reliant on wholesale borrowing, faces a funding crunch. That would force banks to lean even more heavily on central banks and governments to roll over their debts. It could also bring on a double-dip recession.

The task is huge. Europe's banking system is far bigger than America's: 91 banks are being tested, compared with 19 on Wall Street. Politics has made things harder. Lacking a single body with the authority and resources of the Fed, the tests are being run by a tangle of national regulators, the European Commission, the European Central Bank and a quango called the Committee of European Banking Supervisors.

Consistency and credibility seem to have been sacrificed. Germany's banks, which are in poor shape but which can continue to borrow cheaply because they have the backing of a government with strong finances, have given the nod that they expect to pass. The tests may fudge the issue of sovereign defaults by assuming haircuts on assets held in trading books, and not on loans. And unlike America, Europe seems keen to use a wider definition of capital that is no longer viewed by the market as the best benchmark for solvency.

It's too late to remedy all of these faults. Yet it is also too soon to write off the tests, which are still being finalised. For them to work, three things need to happen. First, some banks need to fail—the only thing a 100% pass rate would prove is that the questions asked were not hard enough. Encouragingly, some firms say the tests have been tightened at the last minute.

Second, even if fully factoring in the risk of sovereign defaults is politically impossible, the issue needs to be dealt with convincingly. Each bank's exposures to vulnerable economies should be disclosed in detail. As was the case with subprime debt, it seems likely some banks are underreporting their risks. Tough tests in Spain, the big economy that investors worry about most, are also critical for credibility. It has lowish public debt but some fear it cannot afford to bail out its crippled savings banks. That concern looks overblown and in any case Spain could tap Europe's new bail-out fund. But its regulators and politicians must now back up their hard talk with action—even if other countries treat their banks more leniently.

Finally the stress tests must be stage-managed competently. America's tests were rigorous but also a dazzling display of regulatory skill. The last thing Europe needs is the chaotic release of results for 91 banks, with national regulators privately disowning the conclusions and no plan for recapitalising firms that fail the exam. The worst case is not that the tests are merely irrelevant, but that they actively damage confidence. Europe can surely do a lot better than that.[38]

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[38] European banks - Don't flunk this one: "The stress tests of Europe's banks have been chaotic. But it is too soon to write them off ", from the Economist print edition, Jul 15th 2010

1.3. Corporate Governance in the Romanian banking sector

As a result of the increase of risks in the banking sector, there was the need to create a framework of banking regulation, monitored at international level that must guarantee the organization through regulations of the national banking systems. In this context, prudential norms were put in place to regulate the structure of the banking finances. These functional norms of the banks have as main goal the protection of the depositors and guaranteeing liquidity, without being influenced by monetary and credit policies. The main issues that are targeted by the prudential banking norms are: the liquidity coefficient, the solvability norm, covering the increase in credits with stable resources, the own funds coefficient and the permanent resources coefficient. In order to limit and eliminate the possible disturbances of the banking system or of the banking mechanisms, the banking institutions must adopt and follow certain norms, such as:

- self imposed norms, created by each bank, with the condition to respect the banking legislation;
- the norms imposed by the state monetary authority, which are compulsory for all banks in the system.

The regulations established by the National Bank of Romania are in accordance to the international standards and legislation, as well as to the principles established internationally (The Basel Committee), and to the regulations of the European Union regarding the activities of the financial and credit institutions. The Banking regulations refer to three aspects of the banking activity: a) the authorization of a banking institution; b) the functioning of the banking institution; c) the supervision of its activity.

The authorization: the banks, legal persons or the subsidiaries of other legal persons, are constituted after receiving the authorization from the State, through the National banking authority. The authorization is issued as a result of meeting certain requirements relative to share capital, management, shareholders, feasibility and audit. In Romania, according to the regulations of the National Bank of Romania, the share capital of a bank must be paid in entirely in cash, at the moment of subscription, being decided that the minimum level of share capital is 5 million euro.

1.3.1. The organization of the financial-banking system

The organization of the financial-banking system is based on an institutional structure made of five elements: the Central Bank, banks, other credit institutions, the Treasury and the financial market. As part of the financial system, the organization of the banking system is based on established principles, such as:

a) the dual construction of the banking system, as to establish limits between the institutions that regulate and coordinate (the Central Bank), from the operative banking entities;
b) to safeguard the authonomy of the banking entities in a framework that is guided by regulations at national and international level;
c) to establish a unitary organizational framework;
d) to promote the differentiation and specialisation of the banking institutions;
e) to establish a functional configuration of the banking system, with a center role for the credit organisms.

1.4. The role of governments in the financial system

In the current International financial and economic situation, the governments play a key role reestablishing the equilibrium in their economies. The crisis that started in 2008 has brought many new issues in question.

Governments play an important role in the financial system, because certain actions on its part are needed to make this system function well. The way the government performs these actions is through regulations. It must protect property rights and take actions to enforce contracts. These elements are needed so that financial transactions can take place and that the parties involved in them are protected. Contracts connect those that provide the funds to those that use them, and in case that one of the parties involved does not adhere to the provisions of the contract, then an independent enforcement agency such as a court is needed. The providers of funds must have proper information in order to best decide where to place their capital. In this case, government regulation is needed to reduce possible moral hazard problems in financial systems and to improve their efficiency by deciding and enforcing certain standards, such as accounting standards. Hoewver, idependently of how well regulated a financial system is, there is a good chance that some of the parties involved will try to elude the system in their favour, but this behaviour can be at list limited.
Regulation and supervision of financial institutions is also a task for the governments. By setting rules and monitoring financial institutions, the whole mechanism is protected to a certain extent. Financial intermediaries are normally incentivated to take high risks these types of investments usually bring higher profits. However, if things go wrong and the financial intermediary incurres losses, depositors will also be affected. There are measures to protect depositors, especially in these difficult times, by guaranteeing deposits up to a certain level, or by setting up insurance based systems. Needless to say, the scope of the regulations and supervision is to determine financial intermediaries to be balanced in their decisions and avoid getting into difficult situations and even bankruptcy. Sometimes by means of contagion, more financial institutions may be affected. Even those that are in good health may be affected by panic in the market that determines the public to withdraw their savings. Yet another duty that governments have is to ensure fair competition in the financial market through competition policiy. In the European Union competition policy is based mostly on the Treaty of Rome, articles 81 and 82 referring to Restrictive practices and Abuse of dominant market power respectively.

The governments can have an active role in the financial system by offering protection against disaster. First came liquidity support by central banks; deposit insurance followed; in the latest crisis governments have given all creditors a blanket implicit guarantee. As a result, banks have been prepared to let their insulation wear thin. Going into the crisis, some Western institutions' core capital was 3% of their assets or less, and less than a tenth of those assets were liquid. Government support may also have given banks an incentive to grow much bigger, so that most European countries now underwrite banking systems several times larger than their GDPs.

Such extensive government guarantees render redundant the normal laws of companies' capital structure, which dictate that high leverage and over-reliance on short-term borrowing are a suicidal combination. A bank can operate with almost no equity, safe in the knowledge that it will still be able to borrow and raise deposits cheaply, because creditors know they are guaranteed. Furthermore, if a bank knows the state will always provide liquidity if markets dry up, it has a big incentive to rely on short-term borrowing (which is typically cheaper than

long-term funds). It follows that if banks in a state-backed system are to have safety buffers, the state must determine their thickness and quality. [39]

In the short run inflation is an economic phenomenon. In the long run it is a political one. This week The Economist asked a group of leading economists whether they reckoned inflation or deflation was the greater threat; this was our inaugural question in "Economics by invitation", an online forum of more than 50 eminent economists. The rough consensus was that in the near term, as Western economies struggle to recover, the bigger worry there is deflation. But as the time horizon lengthened, more experts cited inflation, because it seems the most plausible exit strategy for governments trying to deal with crushing debts. "Deflation is not a lasting threat," wrote Arminio Fraga, a former president of Brazil's central bank. "The more interesting question is whether they can manage to keep inflation down over time under the regime of fiscal irresponsibility now prevailing almost everywhere."

The European Central Bank successfully offset its recent purchase of government bonds by enticing banks to deposit an offsetting amount of money with the central bank. The Federal Reserve will start testing a similar system on June 14th, 2010.

If anything, the record of quantitative easing in Japan should heighten worries of deflation. As Adam Posen of the Peterson Institute for International Economics notes in our forum, it *"did not have a predictable or even large short-term result…We need more humility about what we are capable of doing with monetary policy once deflation begins."*

Even if inflation could be created, would it reduce the real government debt, the presumed purpose of such a policy? Not easily. First, for most countries the greatest long-term fiscal threat comes from unfunded retiree benefits, which by their nature are indexed to inflation. Second, the maturity profile of most countries' marketable government debt is relatively short: over half of America's and more than 40% of that of Germany, France and Italy matures within three years. Britain, at 20%, is the exception. This means that unless investors are repeatedly surprised, inflation will lead to higher nominal interest rates as debt is refinanced, and in turn to an unchanged real debt. If governments set out to create inflation, investors are likely to notice and react.

Also, according to the Economist, Central bankers' reputations have been damaged, but few have paid with their jobs. Senators who opposed a second term for Ben Bernanke as Fed chairman were more likely to cite regulatory failures than high unemployment. With the exception of Japan, there have been few instances of governments pressing central banks for more expansionary policies. To be sure, there's not much more they could do. But perhaps politicians, like central bankers, are not yet ready to discard orthodoxy.[40]

As we have seen, governments take an active role in the financial system together with the other players. All of them have to act like an orchestra for their plans to work. Let's look now what are the prospects in Europe.

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[39] Reforming banking - Base camp Basel: "Regulators are trying to make banks better equipped against catastrophe", Jan 21st 2010

[40] Economics focus - A winding path to inflation: "Even if governments could create inflation, they may not want to", from the Economist print edition, Jun 3rd 2010

1.5. The economic outlook in Europe

The European Union consists of 27 Member States as of 2009 (EU-27). Before the accession of the New Member States in 2004 and 2007, the EU consisted of 15 Member States, which are usually indicated by EU-15. The 10 New Member States in 2004 are indicated by NMS-10 and the total of 12 New Member States in 2004 and 2007 are indicated by NMS-12. EU-25 refers to the EU-15 and NMS-10.[41]

At a certain point in 2009 and 2010, the economic and financial forecast for Europe seemed grim. There were even discussions if Europe's single curreny, the Euro would even survive. That sticky point seems the have been overcome and there are already plans for the future. However, the dominant powers in Europe, France and Germany agreee that euro zone should be harmonized, but they don't yet agree on the way to achieve this harmonization.

According to The Economist, Germany believes that the euro must be saved by establishing more stringent rules for spending, borrowing and competitiveness, with sanctions to punish almost automatically the governments that take the wrong step.[42]

As well as those chronic problems, the EU faces an acute crisis in its economic core, the 16 countries that use the single currency. Markets have lost faith that the euro zone's economies, weaker or stronger, will one day converge thanks to the discipline of sharing a single currency, which denies uncompetitive stragglers the quick fix of devaluation.[43]

Germany thinks the euro must be saved by stricter rules on borrowing, spending and competitiveness, backed by quasi-automatic sanctions for governments that stray. These might include threats to freeze EU funds for poorer regions and EU mega-projects, and even the suspension of a country's voting rights in EU ministerial councils. It insists that economic co-ordination should involve all 27 members of the EU club, among whom there is a small majority for free-market liberalism and economic rigour; in the inner core alone, Germany fears, a small majority favour French control.

On the other hand, France has a different approach. They call it "European economic government", to be established within an inner core of euro-zone members. Translated, that means politicians meddling in monetary policy and a system of redistribution from richer to poorer members, via cheaper borrowing for governments through common Eurobonds or outright fiscal transfers. Finally, figures close to the French government have whispered, euro-zone members should agree to some fiscal and social harmonisation: eg, curbing competition in corporate-tax rates or labour costs.

The EU remains however the world's largest trading block. At its best, the European project is remarkably liberal: built around a single market of 27 rich and poor countries, its internal borders are far more porous to goods, capital and labour than any comparable trading area. It is an ambitious attempt to blunt the sharpest edges of globalisation, and make capitalism benign.

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[41] De Haan, Jakob – Oosterloo, Sander – Schoenmaker, Dirk: „European Financial Markets and Institutions", Cambridge University Press, 2009, UK, pp. xvii

[42] The future of Europe - Staring into the abyss: "As the euro-zone crisis spooks governments, opinions are diverging dramatically about what the union is for", from the Economist print edition, Jul 8th 2010 | Brussels

[43] Ibid

The problem is that the "European social model" has become, too often, a synonym for a very expensive way of doing things. It has also become an end in itself, with some EU leaders calling for Europe to grow purely in order to maintain its social-welfare systems. That is a pretty depressing call to arms: become more dynamic so Europe can still afford old-age pensions and unemployment benefits. There is also a theory that The European Union is not what it should be. It's believed to be a bunch of bureaucrats gathered in Brussels that are only interested in their own welfare rather than that of Europe's citizens.[44] Europe is in desperate need of good ideas and leadership. Too many EU leaders have tried to secure voter consent for bailing out weak links like Greece by murmuring darkly about "Anglo-Saxon" conspiracies to destroy the euro, and presenting bail-out mechanisms as a way to impose the will of the state over "speculators".

In France spooked aides to Mr Sarkozy said a "European May 1968" was under way. Their boss suggested that billions of euros in aid for the French car industry should be linked to keeping production in France. It was, Mr Sarkozy explained, "not justified" for French firms to make cars for French drivers in Slovak factories. Alarmed at signs of growing east-west division, the Polish prime minister, Donald Tusk, declared that the European ship was "rocking", and "they're going to start throwing the weaker passengers overboard."

Mr Sarkozy's protectionism was mostly virtual, it turned out. French car firms continue to design economical little cars at home, while building them in lower-cost Slovenia, Romania or the Czech Republic. And the feared waves of civil unrest never came. From Greece to Spain or Ireland, protests and strikes have—to date—been smaller than expected, and dominated by public-sector workers with unusually safe jobs to protect.

In October 2009 the European Commission intervened after Germany was caught offering aid to sweeten the sale of Opel, a struggling carmaker, to a consortium pledging to keep open all four Opel factories in Germany (at the expense of more efficient plants elsewhere). The sale later fell through. On the one hand, it was worrying that Germany tried. On the other, it was a striking display of the power of the EU single market: the German government was told it could not spend taxpayers' money to keep jobs in Germany, without offering equal support to Opel factories in Spain, Belgium, Hungary or Britain.

The single currency was always supposed to drive structural reforms, as once-profligate countries were forced by the rules, and their peers, to live within their means. Instead, France and Germany led a rebellion against the disciplines of the "stability and growth pact" on the first occasion it looked about to catch them.

It was German and French banks that led the way in lending to Greece or Spain. Lenders assumed that euro-zone sovereign debt was all rock-solid. For those pocketing the extra yields on southern bonds, that too felt like free money. In the words of one senior German, the root cause of the sovereign credit crisis in the euro zone was that markets at last "realised that giving credit to Greece is riskier than giving credit to Austria." Northern governments also blocked early attempts at peer pressure. EU leaders, it is said, knew Greece was lying about its deficit figures back in 2008. Yet attempts to confront the then Greek prime minister, Costas Karamanlis, a conservative, came to nothing. Mr Karamanlis was shielded by fellow centre-right leaders, including some of those who now shout loudest for budgetary discipline.

[44] Craig, David-Elliott, Matthew: „The Great European Rip-off", Random House books 2009, London

Lessons do seem to have been learned. German officials say there is now bitter regret in Berlin that their country helped wreck the original stability and growth pact. But wrecked it was.[45]

It seems that many do know what to do to get out of the crisis, but don't do it. Mr Jean-Claude Juncker, prime minister of Luxembourg, said memorably in 2007: "We all know what to do, but we don't know how to get re-elected once we have done it." This is a frank approach to things given the fact that politicians face a difficult choice: doing the right thing for the economy and risk not to be reelected, or do the best to please the citizens in the short term but penalize economic development.

Now, with markets shunning some Euro-laggards, doing the right thing is a matter of survival. Long-stuck dossiers are finally moving. On July 1st the European Commission announced plans to ram through an EU-wide patent valid in all 27 countries (a key demand of European business), after years of delays by Spain and Italy over the status given to their languages.

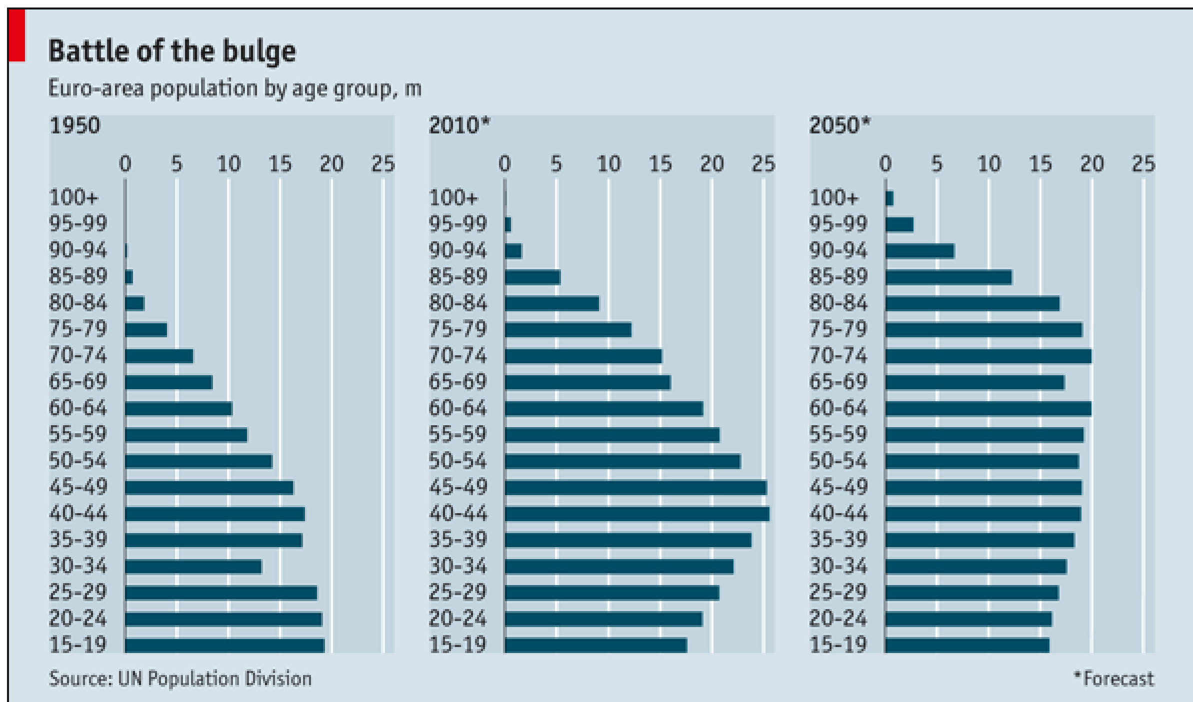
Earlier in 2010, EU leaders like José Luis Rodríguez Zapatero of Spain said flatly that market pressure on Spanish debt was a conspiracy. "There is an attack under way by speculators against the euro, against tougher financial regulation of the financial system and of the markets," he claimed. But with market pressures reaching crisis point in May, Mr Zapatero reversed course, announcing civil-service pay cuts and other austerity measures. He unveiled a (modest) plan to ease Spain's rigid labour laws, which make older workers almost unsackable, leaving young and immigrant workers on temporary contracts to take the pain when Spain's property-led boom turned to bust. At 40%, youth unemployment in Spain is not just high; it is a moral indictment of an entire system.

At an EU summit in June, Mr Zapatero led calls for the publication of stress tests on European banks, a long-overdue measure being resisted by some in Germany. While still grumbling about unfounded rumours in financial markets (and he has a point), a more realistic Mr Zapatero argued: "There is nothing better than transparency to demonstrate solvency."

Between 2005 and 2030 the working-age population of the European Union will shrink by 20m, and the number of those over 65 will increase by 40m. Thanks to the focus on crumbling public finances, that demographic time-bomb is now a common part of European public debate. Governments in places like Britain or the Netherlands have been able to propose paying pensions at 67 or even 70, without angry protests.

We can see in the chart below that in average, the 30 to 54 age groups are decreasing as they will be moving towards older age. This is true in many developed world countries as well as in Asia, which is not presented here. In my view, the economies need to adapt fast to the increasing ageing population in order to find sustainable financial models for their economies. This would necessarily have to be accompanied by a stimulus for demographic growth.

[45] The future of Europe - Staring into the abyss: "As the euro-zone crisis spooks governments, opinions are diverging dramatically about what the union is for", from the Economist print edition, Jul 8th 2010 | Brussels



Sources: The Economist, UN Population Division

Even in France, where most voters told an opinion poll in June they considered a proposal to increase the retirement age to 62 "unjust", few dispute the idea that the current state-pension system faces insolvency. The left and right merely disagree about who should pay to fix this. In Greece, the most disruptive strikes have been staged by hardline Communist trade unions, with larger unions showing some restraint. The press, meanwhile, is filled with commentaries about how the country must live within its means, and how much things must change.

Some of Europe's most stubborn structural problems involve the misallocation of public spending. Governments have spent years padding civil-service payrolls, unveiling benefits like baby bonuses or early-retirement payments just before elections, and shovelling subsidies to politically powerful interest-groups.

The quest for growth is focusing minds on the most stubborn structural problems. In Belgium members of the government admit it is disastrous that just 35% of citizens between 55 and 64 still work (in Sweden, the proportion is twice as high). In Germany senior figures point to the barriers, such as patchy child care, that keep too many women out of the workforce. Fixing this, they suggest, could do more for domestic demand than deficit spending ever would. Even the old debate about whether Europe needs an industrial policy has been rendered less relevant, as governments lack the cash for picking winners.

Yet all these elements do not have to lead to a happy ending for Europe. Today's austerity policies are risky, and may well swell jobless lines in the short and medium term. Politicians fear high unemployment, which can be hard even on the toughest governments.

At the human level, complex interests may undermine reform. Take Spain's lost generation of unemployed youths. Many of them live with their parents, notes a Spanish economist. In broad economic terms their father's job for life makes papa an insider, damaging the

interests of his “outsider” children. But papa also keeps the household afloat: his children have a keen interest in labour laws that keep their parent unsackable.

Public-sector workers, in particular, may look like privileged insiders. But cuts will make many feel like victims. European state workers are often badly paid, having consciously accepted low salaries and tedium in exchange for job security. However, in today’s increasing government deficits, even job security is not so secure.

Leading officials in Brussels say they have to convince voters that Europe’s model of open borders is in the interests of the ordinary citizen. The EU must craft regulation that is seen as stopping abuses, especially in the financial sector, or “we will see the rise of protectionism and populism,” says a senior Brussels official. In Brussels competition regulators face intense lobbying from businessmen, industrialists and many governments demanding that aid and merger rules be eased, to help European champions withstand global competition. Such lobbying exposes a deep dispute about what the modern-day EU is for.

The EU was once a cosy club of western European countries. Now 27-strong, stretching from the Baltic to Cyprus and taking in ten ex-communist countries, the union’s best justification may be as a means of managing globalisation.

For free-market liberals, the enlarged union’s size and diversity is itself an advantage. By taking in eastern countries with lower labour costs and workers who are far more mobile than their western cousins, the EU in effect brought globalisation within its own borders. For economic liberals, that flexibility and dynamism offers Europe’s best chance of survival.

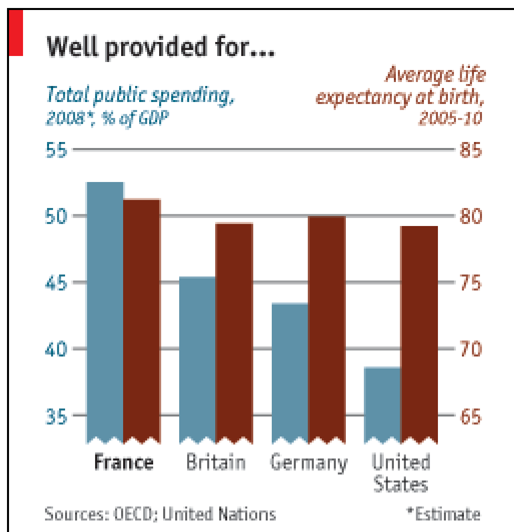
But, for another other camp, involving Europe’s left (and more or less the entire French political class), the point of Europe is to keep globalisation at bay, or at least curb its power. According to this thinking, single nations are too small to maintain high-cost social-welfare models in the face of global competition. But the EU, with its 500m people, is big enough to assert the supremacy of political will over market forces. For such politicians, European diversity is a problem because it undermines the most advanced (meaning expensive) social models. Such competition must be curbed with restrictions on labour migration from Eastern Europe, subsidies for rich-country production and lots of harmonisation—including that old dream of the left, a European minimum wage. Although France and Germany do not agree on the vital issue of euro-zone governance, it would be wrong to assume they will continue to disagree for ever. Eventually they will have to find a compromise; though, alas, few of their clashing solutions currently make sense.

Germany’s push for strict discipline is essentially for public consumption. In private, senior EU officials admit that talk of sanctions is nonsense. France and Germany will never accept being fined or denied a vote, says one flatly. Fragile democracies in the east would react horribly to losing their voting rights, undermining all the EU’s hard work to make them more democratic. Freezing funding for EU mega-projects is equally unworkable; such projects often cross borders, so punishing one country leaves others to suffer too.

How, then, will Europe try to save its single currency? Through bail-outs that are not called bail-outs, but “temporary” rescue funds for weak euro-zone members that prove very hard to cancel, and semi-formal discussions among member governments about their budgetary plans.

Even in a crisis, the French do things differently. Despite calls from the Americans to do more to lift consumer demand, their stimulus plan relies heavily on front-loading investment in infrastructure, cathedrals included, in line with their dirigiste tradition.

In recent years, before the financial crash, what is loosely known as the French model came in for fierce criticism, chiefly for failing to generate enough growth or jobs. Its detractors have not only been the Anglo-Saxons but have also included Nicolas Sarkozy himself. He may be better known now for proclaiming the end of laissez-faire capitalism. But he was elected France's president partly by arguing that the French model was moribund, and picking out the British and American models for praise.



Source: The Economist, OECD, United Nations

The French economy has been battered by the global recession like any other. Firms are cutting output and shedding jobs. Unemployment reached 8.6% in February 2010. There have been regular mass rallies across France in protest at job cuts. More sinisterly, there has been a wave of "boss-napping", a form of kidnapping in which managers are kept by workers overnight in their own offices. Yet France's economy has been less hard hit than many. Its GDP is expected to shrink by 3% this year, according to the IMF, against 4.1% in Britain, 4.4% in Italy and 5.6% in Germany (see chart). It is less dependent on exports than Germany, and consumer spending in the first quarter of 2009 was up on the same period last year. The government, usually reprimanded for profligacy, is set to have a deficit in 2009 (6.2% of GDP) well below those in America (13.6%) and Britain (9.8%).

The French are great savers and most have not taken out unaffordable mortgages or spent heavily on credit. Household debt as a share of GDP is less than half that in Britain or America. The prospect of nationalising banks may give Americans nightmares about turning French. In fact the French government has not yet had to rescue any big French bank from collapse, let alone nationalise one. Though there is outrage at bonus payments in firms laying off workers, bosses' pay in France is not that extravagant, and the income gap between the top 10% and the bottom 10% is far smaller than in Britain or America.

While in Britain, Gordon Brown has declared—like Mr Sarkozy—that "laissez-faire has had its day", Mr Sarkozy hailed the G20 London summit as the end of the Anglo-Saxon model of capitalism. Le Monde, a leading daily, wrote: "In the crisis, the French model, formerly knocked, finds favour once more." Both wanted to have their say and they did.

Across France, 5.2m workers, or 21% of those with jobs, are employed by the public sector. If you count others whose incomes or jobs are not exposed to the economic cycle, 49% of those either in work or retired are only moderately vulnerable to the recession, according to Xerfi, an economics consultancy. Add to that layers of social protection, including unemployment benefits that can reach up to 75% of previous salary, and a raft of direct payments for families, such as €889.72 for newborn babies, and the French are relatively sheltered from market downturns.

A central feature of the French model is the state's role as provider, cushioning citizens, redistributing wealth and propping up demand in hard times. But it has two other functions: planner and regulator.[46]

If investors could ask for two wishes at the end of 2009, they probably would have asked for booming profits and a continuation of ultra-low interest rates. Their wishes have been granted. According to Morgan Stanley, the first-quarter profits of companies in the S&P 500 have been more than 12% better than expected. Meanwhile, few expect the Federal Reserve, the European Central Bank or the Bank of England to raise rates this year. Some think rates will stay where they are in 2011, too.

However, investors' biggest financial concern is sovereign debt, notably that of some southern European countries. In recent weeks the European Union has been forced both to rescue Greece and to unveil a general bail-out package, worth up to €750 billion ($920 billion) including a contribution from the IMF, for struggling countries. Investors seem to be in two minds on sovereign debt. They worry that individual countries may default if they do not cut their deficits and that banks holding their debt will be clobbered. They think that Greece's debt crisis has been postponed rather than solved. But investors are also concerned that, if several governments try to tighten fiscal policy at once, the global economy will take a hit.[47]

Indeed, much bigger rate moves are priced into the forward market. And Pavan Wadhwa, a strategist at JPMorgan, points out that Libor[48] measures the funding cost for only 16 big banks; smaller banks have to pay a premium. The Eurodollar future that shows the cost of borrowing dollars for the average bank in the three months between September and December 2009 is already 1.1%. European banks, which seem desperate to get their hands on the American currency, have to pay a further half a percentage point, making their total cost 1.6%.

Central banks have tried to ease the pain. A swap deal between the Federal Reserve and the ECB, intended to last until January 2011, allows banks to borrow dollars for seven days at 1.25%. But the rise in Libor creates a number of potential difficulties. Mr Wadhwa points out that, as banks become more concerned about their own borrowing costs, they become more reluctant to lend. That was precisely what caused the interbank markets to freeze in 2008. Meanwhile, an increase in Libor squeezes the profits of even healthy banks, since they had been borrowing cheaply from the money markets and investing in higher-yield assets such as government bonds.

There is a strange symbiosis between governments and banks. It may have been governments that rescued banks in the autumn of 2008. But governments rely on banks to market and indeed to buy their debt. The one cannot survive without the other. A big reason why EU politicians raced to push through the €750 billion bail-out package was that a default by a southern European government would create a severe funding crisis for banks. Royal Bank of Scotland reckons that foreign banks own about €1 trillion of the sovereign

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[46] The French model - Vive la différence!: "The French way of doing things looks pretty good—at least in these troubled economic times", from the Economist print Edition, May 7th 2009 | BEAUVAIS AND PARIS

[47] Financial markets - Rescuing the rescuers: "Having saved the banks, governments now find themselves under the wary eye of the markets", May 27th 2010

[48] LIBOR: London Inter-Bank Offer Rate. The interest rate that the banks charge each other for loans (usually in Eurodollars).

debt of Greece, Portugal and Spain. There would be a risk of another crisis in the style of 2008, in which the markets would be uncertain which banks were most exposed to the defaulting assets, and would therefore apply a general boycott.

Lacking strong demand at home, governments are tempted to let their currencies depreciate so that their exporters can grab a bigger share of the global market. The problem is that not all currencies can fall at once. Britain stole a march when the pound fell sharply in 2008. Now the euro is taking a battering, hitting a four-year low against the dollar. With China seemingly unwilling to let the yuan appreciate, the danger is that a series of beggar-thy-neighbour competitive depreciations create protectionist pressures. This is a particular danger in America, where congressional elections take place in November 2010.

Governments ought also to consider the creditors' point of view. Deficit countries are all competing for the good opinion of global savers. Depreciation may help the domestic economy, but it inflicts a loss on foreign holders of local-currency government bonds. Rationally, investors should eventually respond by demanding higher yields to compensate for the currency risk. It seems rather surprising, for example, that Britain can still borrow for ten years at 3.5% when its central bank has been so relaxed about letting its currency depreciate and its budget deficit is among the highest in Europe.

In addition, government borrowing could crowd out the private sector. That may not be a problem at the moment, when companies and consumers are so reluctant to borrow. But it could become one if deficits do not fall substantially in the medium term, beyond a mere reflection of a cyclical improvement in the economy. *"We've long held the view that risk assets could see crowding-out over the next few years as there is more and more Western government debt to finance,"* says Jim Reid, a strategist at Deutsche Bank. *"It makes perfect sense that risk assets would trade at lower levels than they would do if governments had less [debt] to issue."*[49]

When investors get a few days without bad political news, bulls argue, the markets will rebound.

Investors who may once have doubted that euro-zone countries could right their public finances seem now to fear that crisis has spurred too much austerity. A handful of countries, notably Greece but also Spain, Portugal and Ireland, have been forced to take drastic action by nervy bond markets. To avoid a similar fate, Italy pledged in May 2010 to cut its budget deficit by €24 billion ($30 billion) by 2012.

Now even the most creditworthy are joining in. On June 8th 2010, Germany's government announced a package of measures that will save it around €80 billion by 2014. Its chancellor, Angela Merkel, said Germany should set an example of budgetary discipline to other euro-zone countries. France has also said it will act to trim its deficit by abolishing tax exemptions and freezing most spending programmes from next year. This rush to don the hair-shirt raises a fresh concern: if budget cuts are too severe, might they push the economy back into recession, defeating their purpose?[50]

[49] Financial markets - Rescuing the rescuers: "Having saved the banks, governments now find themselves under the wary eye of the markets", May 27th 2010
[50] Budget cuts in the euro area: Nip and tuck: "Europe's plans for fiscal austerity are not quite the threat to recovery they seem", From the Economist print edition, Jun 10th 2010

Judged by the claims of those who welcome the new fiscal austerity, as well as those who fear it, a gigantic fiscal blow is about to land. The true picture is not quite so dramatic. Take Germany's measures, for instance. The €80 billion of cuts claimed by the government will be made over four years. Most of the savings are coming in 2013 and 2014. The effect on next year's budget will be just €11.2 billion, less than 0.5% of GDP. With all the talk of cuts, it is easy to forget that Germany's budget deficit will widen this year by 1.5-2% of GDP as the delayed effect of earlier stimulus measures comes through.

The smaller countries at the edges of the euro block are pulling back harder. Greece's budget cuts amount to 7% of GDP this year and 4% next year, according to Laurence Boone at Barclays Capital. Spain, Portugal and Ireland are set to cut their budgets by 2-3% of GDP in 2010 and 2011. Yet they are a fairly small part of the region's economy. Greece is just 2.6% of euro-zone output. Portugal and Ireland are smaller still. With Spain these countries account for less than a fifth of euro-area GDP. Their planned austerity will have a correspondingly small effect on the euro-zone economy. Ms Boone reckons that measures aimed at cutting budget deficits in the euro area will come to around 1% of GDP next year, when weighted by the size of each country's economy. That is big but not excessive for a block that is forecast by the European Commission to have an average budget deficit of 6.6% of GDP in 2010.

There is much uncertainty about the economic impact of fiscal tightening, not least because some temporary measures will also have run their course by next year. Budget cuts weaken GDP growth by shrinking aggregate demand. The simplest gauges of such "Keynesian" effects suggest that each euro of lost public spending reduces GDP by around the same amount.

But in some circumstances budget cuts can help growth—or cause less harm to it than Keynesian models suggest. Firm action to tackle budget deficits may induce anxious consumers to save less (and firms to invest more) by lowering uncertainty about future tax changes. Such anxiety is likely to be bigger when public debts are worryingly high because taxpayers judge that the need to reduce the deficit will soon hurt their finances. Research by Christiane Nickel and Isabel Vansteenkiste of the European Central Bank found that rising budget deficits in high-debt countries are associated with higher private savings.

A lot also depends on how budgets are cut. A much-cited study by Alberto Alesina of Harvard University and Roberto Perotti, now of Milan's Bocconi University, found that budget adjustments that rely on cuts in welfare payments or the government's wage bill are more likely to produce lasting benefits—lower public debt and faster GDP growth—than those based on tax increases or cuts in public investment. The least harmful taxes were on firms' profits or on consumer spending.

It is clear, nonetheless, that certain kinds of austerity are less harmful to growth. The packages announced by euro-area countries seem fairly well designed. Most countries plan to slim the government wage bill and reduce entitlements—the sorts of cuts that are least damaging to economic recovery. Big cuts in public-sector pay and allowances have been pushed through in Ireland, Spain and Greece. Italy plans a three-year wage freeze and, like Germany and Greece, will replace only a fraction of retiring workers with new hires. Welfare payments have been slashed in Ireland and will be reduced in Germany from 2011. Pension costs will be cut in Greece and shaved in Spain and Italy.

No country has relied too much on cuts in public investment, which often cannot be sustained. Spain and Ireland have made large cuts in their capital budgets but have lowered current spending by more. Portugal's austerity relies too heavily on higher taxes, though it has reduced unemployment benefits. Greece has had to raise revenue as well as cut spending

but is at least looking to the "right" sorts of levies, such as value-added tax and "sin" taxes on cigarettes, alcohol and petrol.
Given the seriousness of its fiscal troubles Greece had little choice but to attack its deficit on all fronts. Germany is not under the same sort of bond-market pressure. It might have delayed its cuts a little longer. Officials are now more willing, in private at least, to admit that weak domestic demand in Germany is a problem. But running deficits for longer is perhaps not the best way to tackle it. In a small way, the measures to cut German welfare benefits may help if they encourage more non-workers into the labour force and boost consumers' spending power. At least the government kept tax rises to a minimum.
Budget cuts are rarely good news for the economy. But Europe's austerity drive could have been a lot worse.[51]

Therefore, European countries are doing their best to manage their large budget deficits, reduce costs and stimulate investments in infrastructure and pumping the economy. Next we will see how the insurance business relates to the financial sector and how it is adaptating to the global economic situation.

1.6. The role of insurances in the financial sector

The function of the insurance is to protect individuals and firms from adverse events through the pooling of risks. Life insurance protects against premature death, disability, and retirement. Non-life insurance protects against risks such as accidents, illness, theft and fire. Insurance is a risky business, as insurance companies collect premiums and provide cover for adverse events that may or may not arise somewhere in the future. The pattern of small claims, sucha as fire or car accidents, is fairly predictable. However, larger accidents or catastrophes (like hurricanes) involve high claims with low probability.
The insurance business is plagued by asymmetric information problems. There is a moral hazard problem when the behaviour of the insured, which can be only partially observed by the insurer, may increase the likelihood that the insurer has to pay.

It's no secret that the financial market goes hand in hand with the insurance market. Wherever there are financial or banking products, there are risks to be covered. However, given the size of banks, and the risks to be insured, there is the need for a strong insurance sector.

The Committee of European Insurance and Occupational Pensions Supervisors doesn't think much of the promises of insuurers. Its latest proposals in a grinding rewrite of insurance rules may force insurers to hold lots more capital than they do now.

The proposals, issued in November 2009, underscore a marked shift in the perceived riskiness of insurance firms. Until recently insurers were seen as the plodders of the financial system. Now fears over systemic risk, heightened by the dismal failure of AIG[52], have alerted regulators to the dangers that they may present. Six big insurers feature on a list of 30 global firms that are likely to be subject to cross-border supervision under the watchful eye of the Financial Stability Board, according to the Financial Times. Jean-Claude Trichet, the

[51] Budget cuts in the euro area: Nip and tuck: "Europe's plans for fiscal austerity are not quite the threat to recovery they seem", From the Economist print edition, Jun 10th 2010
[52] AIG: American International Group is a large American insurance company with operations in more than 130 countries

president of the European Central Bank, has argued that pension funds and insurers can no longer be seen as shock absorbers but are themselves sources of systemic risk.[53]

This view dovetails neatly with a five-year-old plan to drag their management of capital and risk into the modern age. Solvency 2, which is loosely modelled on the Basel 2 rules for bank capital, aims to set common standards for European insurers that will come into force in 2012. The new standards will introduce market valuations and risk-based measures of assets and liabilities when determining how much of a cushion insurers need to hold.

As such they promise to shine a light on an industry that for many years determined the value of assets and liabilities on actuarial estimates and expected rates of return, a method more accurately described as guesswork and wishful thinking than accounting. Tweaking an expected return here or a mortality rate there could magically bring both into balance, often without shareholders, policyholders or regulators being any the wiser.

In forcing firms to account better for the risks they face, the new rules should also prompt them to manage risks more intelligently, says Joachim Oechslin, the chief risk officer of Munich Re, the world's biggest reinsurer. Yet the latest proposals also signal a change of heart by CEIOPS[54] over how much capital should be held in total. Previous tests of the rules showed that although firms would have to hold more capital against some risks, this would be balanced by reductions in other cases. The total amount of capital held by European insurers would not change much (an uncomfortable echo of the intended neutral impact of the Basel 2 regime). But now the regulators have turned the "calibration" knobs sharply. The latest rules could force insurers to hold 20-30% more capital.[55]

British life insurers may be especially hard hit, because they sell many more annuities than continental European insurers. Valuing these liabilities is tricky because they stretch many years into the future and their current worth swings wildly in response to small changes in the "discount rate" used to value it. Earlier proposals by regulators to use a "risk-free rate" (such as that on government bonds) would have had the effect of increasing these liabilities, forcing British insurers to raise as much as £50 billion ($83 billion) in extra capital. Furious lobbying seems to have watered down that proposal. Insurers may be allowed to apply an "illiquidity premium" to the risk-free rate, because many of their investments, like the policies they have sold, cannot be cashed in immediately. The risk is that this could open the door to yet more accounting trickery.[56]

As we can see, Insurers have to undergo reform too so that they don't become themselves part of systemic risk. Much will be said about this sector in the future as markets recover from the crisis. When the world economies will stabilize, the insurance sector will too and its revenues will go back up again. In the future, banking and insurance services will become more and more interconnected and this will lead to the development of both sectors. If the plans will be successful, future crises will not have such an impact. Next we will look at how foreign ownership of banks impacts their performace.

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[53] Making insurers safer - Learning lessons: "Concerns over the riskiness of insurers are behind tougher proposals on capital", from the Economist print Edition, Dec 3rd 2009 | *Berlin*
[54] CEIOPS: The Committee of European Insurance and Occupational Pensions Supervisors
[55] Making insurers safer - Learning lessons: "Concerns over the riskiness of insurers are behind tougher proposals on capital", from the Economist print Edition, Dec 3rd 2009 | *Berlin*
[56] Ibid

1.7. The impact of foreign ownership on bank performance

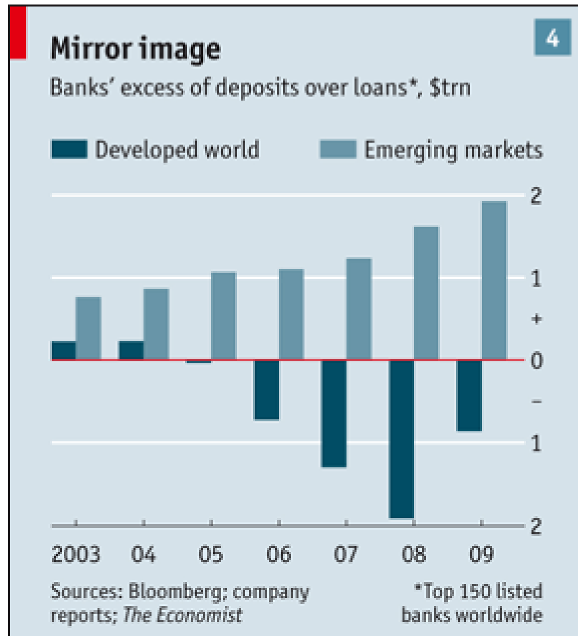
There is a very interesting phenomenon related to the strategies of banks. This has to do with the trend in recent years of foreign banks expanding abroad. The reason behind this approach is that their domestic markets have become saturated and the domestic economies have left no room for further substantial growth of the banking sector. Therefore, the large banks have taken advantage of the possibility to enter new markets abroad. In the following paragraphs I will discuss the advantages and disadvantages of domestic banks vs. foreign banks.

The above mentioned trend leaves us with one question: are foreign banks better than domestic banks? Whether this is true or not, we have to find out. There have been quite a few studies using micro data that have examined whether foreign banks are more efficient than domestic banks. One argument is that foreign banks use better risk management and more advanced technologies, having access to an educated labour force adaptable to new technologies. On the other hand, domestic banks supposedly have better information about their local economy, language, legislation and political situation.

The existing literature does not give an unambiguous answer as to which effect dominates. However, in their review of previous studies, Lensink et al. (2008) conclude that foreign banks in transition and developing markets show higher efficiency than their domestically owned counterparts. However, foreign banks in developed countries exhibit lower efficiency in comparison with domestic banks.
A good example of this literature is the study by Bonin et al. (2005), who have used data from 1996 to 2000 for 11 transition countries to investigate the effect of foreign ownership on the banking sectors in general and bank efficiency in particular. Using stochastic frontier estimation procedures, they compute profit and cost-efficiency scores. Their results indicate that majority foreign ownership generates higher efficiency. Similar results are reported by Fries and Taci (2005), who examine banks in 15 European transition nations between 1994-2001. They conclude that privatised banks with majority foreign ownership are the most efficient and those with domestic ownership are the least.
However, Zajc (2006), who examines banks in CEEC[57] for the period 1995-2000, concludes that foreign banks are less cost efficient than domestic banks. Also Lensink et al. (2008), using stochastic frontier analysis for a broad sample of 2,095 commercial banks in 105 countries (including some NMS[58]), conclude that, on average, foreign ownership has a negative effect on bank efficiency. They also argue that in countries with a good regulatory environment and good governance, the efficiency-reducing effects of a rise in foreign ownership are considerably lower. Their estimation results also suggest that if the institutional distance between the host and the home-country governance becomes smaller, foreign bank inefficiency will decrease as well.[59]

[57] CEEC: The Central and Eastern European Countries
[58] NMS: New Member States
[59] De Haan, Jakob – Oosterloo, Sander – Schoenmaker, Dirk: „European Financial Markets and Institutions", Cambridge University Press, 2009, UK, pp. 241-242

The results of these reasearches are inconclusive in my opinion and fail to set a clear result. The advantage of foreign banks over domestic banks depends very much on the financial strength of those institutions as well as on their governance. Many emerging-market banks are not just getting bigger but also have piles of excess deposits because they are based in countries with high levels of savings. This would appear to give them a decisive advantage over Western banks that rely on fickle borrowing markets to do business. To add to rich-world banks' discomfort, developing-world banks tend to have high capital ratios too. In banking, especially after the crisis, whoever has the deposits and the capital usually wins.



Source: The Economist, company reports, Bloomberg

Emerging-market banks tend to have vast branch networks that suck in deposits from thrifty families and companies. Only some of these get lent out again. Banks park the surplus with the state, by buying government bonds or keeping it in central banks. The state in turn acts as the international recycling agent for those excess savings: it lends them to Western countries through its foreign reserves or through a sovereign-wealth fund, for example by buying US Treasuries, mortgage bonds or money-market instruments.[60]

On the other hand, overextended Western banks do the exact opposite: they borrow from capital markets to plug the hole created by having more loans than deposits. This shows up in the ratio of loans to deposits, which for rich-country banks rose to alarming heights in the run-up to the crisis (though they have since come down somewhat), whereas those for emerging-market banks remained healthier.

In 2008 the surplus of customer deposits over loans (ie, excess savings) at listed emerging-markets banks was about $1.6 trillion, compared with a deficit of about $1.9 trillion at rich-world banks (see the chart above). The imbalances of the world's economies are reflected by their banks.

Domestic banks in the developing world countries that do gather excess deposits may find the government wants to get its hands on them. This could be for prudential reasons. For example, China's regulator requires banks to keep 17% of their deposits with the central bank and tinkers with this ratio to control the economy. Or it could be because the government needs the cash. In India banks are obliged to use about a quarter of their deposits to buy government debt, which helps the government fund its budget deficit. Mr Bhatt of State Bank of India says there is little chance that this will change soon: "It is the model in this country," and allows the government to spend on development. For the moment China's banks show little appetite for taking positions in risky Western assets. Far from being ready

[60] A special report on banking in emerging markets - Rambo in cuffs: "Balance-sheets are less powerful than they look", from the Economist print edition, May 13th 2010

to take on the globe, most emerging-market bankers are consumed by their colossal and growing businesses at home.[61]

As we were able to see, foreign banks and domestic banks have their advantages and disadvantages, depending on their abilities, core competencies, know how, financial strength, human resources and so on. We will see in the next subchapter a discipline that is becoming vital for the financial sector.

1.8. Risk Management

As I mentioned earlier, Risk Management has become a very important component in the financial and banking sector. While risk management has existed for quite some time in the corporate world, it has evolved quite a lot to the point where it is today. In the banking world, risk management has become the tool used by the bankers to assert the health of their banks and thus to gear their strategies accordingly.

It's a fact that most failures are caused almost exclusively by human failure and by the absence of satisfactory risk management controls. In the 1970s ignorance was the best form of defence. Organizations simply believed that a disaster was far more likely to happen to someone else. Money invested in loyalty programmes had created customers for life, and it was firmly believed that customers would support rather than reject the business in a disaster. In the 1980s, the rise of the auditor meant that businesses were more aware of the risks they faced, but in reality this simply meant higher levels of insurance. By the 1990s, attitudes shifted again. Increasing evidence showed that disaster could happen to any business and a spate of terrorist activity compounded with emerging corporate governance caused an overnight change. Now, in the twenty-first century, organizations declare that it won't happen to them, because failure is no longer an option.[62]

As we can see, it's a matter of the way we view things if we consider risk a critical element or just another unknown to include in a formula. Risk is everywhere and it has to be managed properly. Successfully managing risk means access to higher earnings and growth. Badly managing risk means losses. The choice is simple.

Nonetheless, risk comes in many forms in today's technologically developed world where information travels fast. The financial sector is very sensitive to information and financial markets can be damaged in a very real way just by rumors. Investors are constantly following what is going on on the financial markets. However, the information they receive might not always be accurate. Nonetheless, their actions can be determined by the way they process that information and their appetite for risk taking.

The Economist compares stampeding crowds that can generate pressures of up to 4,500 Newtons per square metre, enough to bend steel barriers to rushes for the exit in financial markets that can be just as damaging.[63] Investors crowd into trades to get the highest risk-adjusted return in the same way that everyone wants tickets for the best concert. When someone shouts "fire", their flight creates an "endogenous" risk of being trampled by falling

[61] A special report on banking in emerging markets - Rambo in cuffs: "Balance-sheets are less powerful than they look", from the Economist print edition, May 13th 2010
[62] Merna,Tony – Al-Thani, Faisal F.: „Corporate Risk Management – Second Edition", John Wiley & Sons, 2008, West Sussex, England, pp. 208-209
[63] A special report on financial risk - When the river runs dry: "The perils of a sudden evaporation of liquidity", from the Economist print edition, Feb 11th 2010

prices, margin calls and vanishing capital—a "negative externality" that adds to overall risk, says Lasse Heje Pedersen of New York University.

In 2008 liquidity instantly drained from securities firms as clients abandoned anything with a whiff of risk. In three days in March 2008, Bear Stearns saw its pool of cash and liquid assets shrink by nearly 90%. After the collapse of Lehman Brothers, Morgan Stanley had $43 billion of withdrawals in a single day, mostly from hedge funds.

Bob McDowall of Tower Group, a consultancy, explains that liquidity poses "the most emotional of risks". Its loss can prove just as fatal as insolvency. Many of those clobbered in the crisis—including Bear Stearns, Northern Rock and AIG—were struck down by a sudden lack of cash or funding sources, not because they ran out of capital.

In the last 10 years international regulators have paid more attention to capital, thus neglecting liquidity risk and the liquidity stress tests run by the banks resulted in contingency funding plans, but with reluctance. This happened because markets were abundant in cash and hedge funds, private-equity firms and sovereign-wealth funds, all keen to invest in assets, and there seemed little prospect of a liquidity crisis. However, what makes liquidity so important is its binary quality: one moment it is there in abundance, the next it is gone. It comes in two closely connected forms:

- asset liquidity - the ability to sell holdings easily at a decent price;
- funding liquidity - the capacity to raise finance and roll over old debts when needed, without facing punitive "haircuts" on collateral posted to back this borrowing.[64]

Banks are founded on this "maturity mismatch" of long- and short-term debt, but they have deposit insurance which reduces the likelihood of runs. However, this time much of the mismatched borrowing took place in the uninsured "shadow" banking network of investment banks, structured off-balance-sheet vehicles and the like. It was supported by seemingly ingenious structures.

Besides the liquidity risk, there are many other types of risks which are studied closely by regulators. The Risk Management sector is growing steadily. Banks are doing their best to convince markets, regulators and politicians that lessons have been learned from their mistakes. Risk is now the hottest recruitment area in finance, with some large firms, such as Morgan Stanley, doubling the size of their teams. Industry groups are pumping out self-critical reports and are working to bring centralised clearing to over-the-counter derivatives and improve underwriting and disclosure in securitisations. Pay is being aligned more closely with long-term performance, even if it still looks obscenely high to outsiders.[65]

There are a few lessons that have been learned from the crisis in relation to risk management. This activity is not just based on skill or luck or plain mathematical models. There are other areas that need improvement.

One important area of risk is in my view risk governance, which represents the relationships between traders, risk managers, executives and directors. The balance of power is now shifting back from risk-takers to those who police them internally. But a chief risk officer is

[64] A special report on financial risk - When the river runs dry: "The perils of a sudden evaporation of liquidity", from the Economist print edition, Feb 11th 2010
[65] A special report on financial risk - Cinderella's moment: "Risk managers to the fore", from the Economist print edition, Feb 11th 2010

limited in his powers if he is nothing more than a glorified compliance chief, as is still the case at many banks.

The Boards of directors, too, need to monitor risk better[66]. Many were not even asking the right questions—such as whether the boom in mortgage-backed markets was sustainable. A lack of relevant experience among independent directors did not help. As well as having a strong financial-services background, boards should be gradually reduced in size, so they are less vulnerable to groupthink. Directors should also put in more time to mastering the balance sheet.

What we can see is that managers of banks that suffered devastating losses, such as UBS and Royal Bank of Scotland, were generally more interested in striking deals and leaping up league tables than in rooting out danger. By contrast, the top managers at banks that fared better, such as JPMorgan Chase, encouraged managers to inform of potential problems and eyed highly profitable units suspiciously.[67] However some banks' risk issues are handled perfectly well by the audit committee or the full board.

In some areas the need may be for more computing power, not less. Financial firms already spend more than any other industry on information technology (IT): some $500 billion in 2009, according to Gartner, a consultancy. Yet the quality of information filtering through to senior managers is often inadequate.

A report by bank supervisors in October 2009 pointed to poor risk "aggregation": many large banks simply do not have the systems to present an up-to-date picture of their firm-wide links to borrowers and trading partners. Two-thirds of the banks surveyed said they were only "partially" able (in other words, unable) to aggregate their credit risks. The Federal Reserve, leading stress tests on American banks last spring, was shocked to find that some of them needed days to calculate their exposure to derivatives counterparties.[68]

One lesson to be learned is that quantitative finance is important but it has its limits. Models have their place, but they must be coupled with more subjective approaches to risk, such as stress tests and scenario-planning. According to the Economist, three years ago it might have seemed unapropriate to talk about systemic liquidity shocks or the failure of a big investment bank. However, we have seen that the few firms that thought through the consequences of such events were better able to react when they occurred. Fixing finance will take more than sharper boards, greater scepticism towards numbers and more powerful risk managers.[69]

Things will change also in the pay structures: some of the most important risk-related decisions of the next few years will come from another corner: the compensation committee. It is not just investment bankers and top executives whose pay structures need to be rethought. In the past, risk managers' pay was commonly determined or heavily influenced by the managers of the trading desks they oversaw, or their bonus linked to the desks'

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[66] Tricker, Bob: „Corporate Governance – Principles, Policies and Practices", Oxford University Press, 2009, New York

[67] Banks - A better black-swan repellent:"How banks can improve their approach to risk management", from the Economist print edition, Feb 11th 2010

[68] A special report on financial risk - Number-crunchers crunched: "The uses and abuses of mathematical models", from the Economist print edition, Feb 11th 2010

[69] Banks - A better black-swan repellent:"How banks can improve their approach to risk management", from the Economist print edition, Feb 11th 2010

performance, says Richard Apostolik, who heads the Global Association of Risk Professionals. Boards need to eliminate such conflicts of interest.

Meanwhile risk teams are being beefed up. Morgan Stanley, for instance, is increasing its complement to 450, nearly double the number it had in 2008. The GARP[70] saw a 70% increase in risk-manager certifications last year. Risk is the busiest area for financial recruiters, says Tim Holt of Heidrick & Struggles, a firm of headhunters. When boards are looking for a new chief executive, they increasingly want someone who has been head of risk as well as chief financial officer, which used to be the standard requirement, reckons Mike Woodrow of Risk Talent Associates, another headhunting firm.

In the years that led to in 2008 to the beginning of the crisis the financial markets seemed calm and no danger was in sight. Laissez-faire was ruling the financial markets. However, the idea that markets can be left to police themselves turned out to be the world's most expensive mistake, requiring $15 trillion in capital injections and other forms of support. "It has cost a lot to learn how little we really knew," says a senior central banker. Another lesson was that managing risk is as much about judgment as about numbers. Trying ever harder to capture risk in mathematical formulae can be counterproductive if such a degree of accuracy is intrinsically unattainable.[71]

Source: The Economist, „Banking on the State" by Andrew Haldand and Piergiorgio Alessandri; Bank for International Settlements

The Financial Stability Board, an international group of regulators, is trying to co-ordinate global reforms in areas such as capital, liquidity and mechanisms for rescuing or dismantling troubled banks. Its biggest challenge will be to make the system more resilient to the failure of giants. There are deep divisions over how to set about this, with some favouring tougher capital requirements, others break-ups, still others—including America—a combination of remedies.[72] The FASB's[73] actions are welcome at times like this when everything is being reanalyzed. However, it will be difficult to find universally applicable solutions to avoid the failures of giants. There are also other interesting intitiatives taken at the beginning of this year in the US.

In January 2010 President Barack Obama shocked big banks by proposing a tax on their liabilities and a plan to cap their size, ban "proprietary" trading and limit their involvement in hedge funds and private equity. The proposals still need congressional approval. They were seen as energising the debate about how to tackle dangerously large firms, though the reaction in Europe was mixed. In my view, Mr Obama's proposals are a good start towards

[70] GARP: Global Association of Risk Professionals
[71] A special report on financial risk - The gods strike back: "Financial risk got ahead of the world's ability to manage it. Matthew Valencia (interviewed here) asks if it can be tamed again", from the Economist print edition, Feb 11th 2010
[72] Ibid
[73] FASB: Financial Accounting Standars Board

making the banking system more aware of the risks that are out there and of the fact that they should keep their liabilities under control. If all banks fend for themselves appropriately, the whole banking system will find itself in better health.

In an interview in November 2009, Jean-Claude Trichet president of the European Central Bank, said that the task facing global regulators is to construct the financial equivalent of the Delta Works, a protective network consisting of a series of dams, sluices and dikes built in the second half of the 20th century to protect the lowest-lying parts of the Netherlands from the sea. This will require success in three connected areas:

- reducing the threat to stability posed by firms deemed too big to fail because their demise could destabilise markets;
- ensuring that banks have bigger cushions against losses;
- improving system-wide, or macroprudential, regulation.[74]

Systemic risk as I said earlier is a hot topic right now but so is the "too big to fail" concept. Systemic risk can be managed according to the measures I mentioned before. The regulators can deal with the latter concept in the following way: either by addressing the "too big" part (shrinking or erecting firewalls within giants) or the "to fail" bit (forcing them to hold more capital and making it easier to wind down bust firms). Until recently, the focus was on the second of the initiatives. But since President Obama's unveiling of two initiatives in January 2010 last month: a tax on the liabilities of big banks and the "Volcker rule", which proposed limits on their size and activities, the choice has been shifting towards some combination of the two. The Volcker plan - named after Paul Volcker, the former Federal Reserve chairman who proposed it, calls for deposit-takers to be banned from proprietary trading in capital markets and from investing in hedge funds and private equity. This plan would merely limit further growth of non-deposit liabilities (there is already a 10% cap on national market share in deposits). The Financial Stability Board, a Basel-based body that is overseeing the international reform drive, welcomed this proposal cautiously and stressed out that such a move would need to be combined with tougher capital standards and other measures to be effective.

The Basel 3 standards will rely less on the banks' own risk models than Basel 1 and Basel 2 when the goals was capital efficiency, whereas now it's robustness. The markets already demand that banks should hold more equity and this seems to have reversed the trend of constant decreases in capital ratios of the banks that has taken place until 2010. We can see this from the chart on the left.

Before the crisis banks could get away with common equity—the purest form of capital—of as little as 2% of risk-weighted assets. The new regulatory minimum will not be clear until later this year, but markets now dictate that banks hold four to five times that level. Hybrid instruments—part debt, part equity—will be discouraged since these proved bad at absorbing losses. Regulators are encouraging banks to issue a different type of convertible capital: "contingent" bonds that automatically turn into common shares at times of stress.[75]

Accordind to the Economist, Barack Obama's plan cannot fully fulfil its promise to to prevent banks from reaching the taxpayers' pockets. Proprietary trading and investments are

[74] A special report on financial risk - Fingers in the dike: "What regulators should do now", from the Economist print edition, Feb 11th 2010
[75] Ibid

a small part of most big banks' activities and played only a minor role in the crisis. I must mention that the plan cover brokers, insurers or industrial firms' finance arms, all of which had to be bailed out with the taxpayers' money. To persuade markets that the giants no longer enjoy implicit state guarantees, whether they are banks or not, policymakers will need to present a mix of solutions that also include tougher capital and liquidity standards, central clearing of derivatives and credible mechanisms to dismantle firms whose losses in a crisis would overheat even a strengthened safety buffer.

Together, intelligent regulatory reforms and a better understanding of the limitations of quantitative risk management can help to reduce the damage inflicted on the financial system when bubbles burst. But they will never eliminate bad lending or excessive exuberance. After every crisis bankers and investors tend to forget that it is their duty to be sceptical, not optimistic.[76]

As I mentioned in the beginning of the discussion of this topic, the human factor is in itself a risk. Humans are led by principles, by interest and by their conscience. Their behaviour is sometimes rational but not ethical which can lead to a series of problems that I will discuss as the next topic.

1.9. Ethics and banking

Even if I left the discussion about ethics at the end of the first chapter of this report, this does not mean that it's less important, on the contrary. In my view, ethics plays a key role in all areas of the economy and especially in the financial sector. The current financial crisis has brought to the attention even more to this topic.

Managers have had to face in their activity moments when they had to take difficult decisions. Those decisions involved analising many aspects of the problems to be solved, and whether the decision was right or wrong. Sometimes the decisions are right, but the ways to enforce them are unethical. We might ask what this has to do with the financial sector. The answer is that it has everything to do with the financial sector, and it's not hard to find proof of it.

The financial sector is closely related to the accounting business. Accountants are at the heart of the banking system as well and they are put more and more under pressure from top management. Ken McPhail and Diane Walters reckon that accountants appear to exibit lower levels of moral reasoning than other professional groups. Accounting students become less ethical as they progress through their accounting education. They assert that accounting students are less ethically aware than other students and don't recognize the broader social responsibility issues associated with professionalism. The interesting part is that most accounting students think that accounting is an amoral and technical activity. The two co-authors of the book "Accounting and Business Ethics" state that most part of the accounting literature presents the disturbing possibility that conventional accounting education has more negative than positive impact on students' ethical predispositions.[77]

Clearly there are many things to be said about ethics and banking, but there are some conclusions that I can draw from the literature I read. In the area of accounting there should

[76] A special report on financial risk - Blocking out the sirens' song: "Moneymen need saving from themselves", from the Economist print edition", Feb 11th 2010

[77] McPhail, Ken – Walters, Diane: „Accounting and Business Ethics", Routledge, 2009, New York, NY, pp.4

be more interest paid to an ethical approach to this discipline. It's true that math is not an opinion but in accounting numbers can be interpreted in many ways, not always the correct way, but the bosses' way. Even more dangerous is the influence that top managers have on the CFOs[78]. It today's corporate world, window dressing and the extensive use of financial shenanigans can be very dangerous and should be prevented.

2. Chapter II – Marketing Strategies in the Banking Sector

Moving on from the management strategies in the banking sector that we saw in the first chapter, we will move to the marketing strategies adopted by the banks, which are part of the general management strategies. The marketing strategies refer to the way banks present themselves on the market, what products and services they sell and their strategies of increasing market share, revenues, and obviously profits.

The banking sector is a very special sector from a marketing point of view. One might wonder why this is so and ask why the banking sector is so different from a marketing point of view from other sectors. It's true that we are dealing with a services sector, however the product is money. Together with money, banks usually bundle services. We will see what these are.

2.1. Banking products and services

The banking products are meant for the client, being designed with this in mind and provided by the bank in order to satisfy the consumering needs of their clients. Nonetheless, providing the banking product to the client implies the execution of a whole set of banking and non banking operations. The characteristics of the baking activity are, as products, the credits and deposits, these two being themselves the cause of the operations that are generated from them. The bank executes these operations in its quality of financial intermediary, its patrimonial situation being influenced by the mere offering of these products.

The services represent components of the products generated by the operations that the bank realizes on behalf of the clients, meeting certain needs, and are complementary to the banking products. Independently of the fact if they are or not bundled with banking products, the services offered by the bank take many forms, such as: attracting all kinds of deposits, current accont operations, discounting transfers, currency services, issuing obligations, buying and selling currency, leasing and factoring. According to the level of participation of the factors work and capital in providing the banking services, the banking services can be categorized as follows:

a) Personnel services, realized exclusively through the work of the personnel, concretized through consultations, financial engineering;
b) Capital centered services, materialized through deposits and capital, that generate banking services;
c) Mixed services, reflected in payments, received amonts, and management of the portofolios.

The banking products are immaterial, and as thus, are not subject to physical usage, but are affected by moral usage, determined by the financial innovation and the financial environment. The banking products are influenced by banking and fiscal regulations, the

[78] CFO: Chief Financial Officer

introduction of certain new products being an effect of the law. These are presented directly to the customers, the redistribution, attribution or resale not being possible. Moreover, the banking products cannot be protected through patents, because they are generally uniform from a content point of view. For the pure services, not products, the remuneration is achieved through fees. In the case of the services that provide banking products, the prices are based on margins, in relation to the characteristics of the banking products. The main characteristics that differentiate the banking products from the other products offered on the market are the following:

- standardization - the expression of the banking regulation;
- intangibility – the expression of their immateriality;
- volatility – through the unconstant demand of banking products;
- Inseparability – by being attached to a certain bank.

The economic subjects that are the targets of these products are: private individuals, companies, banks, non-banking financial institutions (insurance firms, leasing firms, brokerage firms and stockbrokers) and the State.

Next we will look at how the banks have adapted to the market conditions.

2.2. Measures adopted by banks in the marketing sector

The banks are taking measures in accordance to the market situation, which is currently gloomy. In Europe, many of the economies have slowed down due to the crisis. After the growth in the years prior to 2008, the banking sector has undergone substantial changes also from a marketing point of view.
Talking about the activity of lending money to private individuals, these chances refer to the fact that households have seen their revenues drop dramatically due to the changes in the economy. Besides this, social welfare programs have been reduced by governments where possible, new taxes have been established and jobs restructurations have taken place, first in the private sector, then in the public sector, thus increasing unemployment levels. In the countries that are in the European Union but have not yet adopted the Euro currency, such as Romania and Bulgaria, the fluctuations in the currency rates has had an additional impact on those individuals that have contracted financing in foreign currencies (Euro, USD and CHF).
In Romania the increase in VAT[79] by 5% from 19% to 24% is expected to fuel inflation and generate a decrease in sconsumption. Similar measures have been adopted by many countries struggling with large budget deficits.

2.2.1. Deposits and savings instruments

Let’s look for a moment how the measures mentioned above have influenced the banking sector. First of all, if less money is available to people, they have less available to live on, and thus even less is available for saving, if any. Therefore this produces a decrease in deposits, whichin turn has a negative impact on the short to medium term banks’ liquidity. Clearly, not all banks’ funds come from the population, a part of them coming from companies. These companies sometimes save their liquidity in banks until they need it for financial transactions. They save those funds in deposits, current accounts and overnight deposits. One other thing to keep in mind is that while in 2009 interest rates were quite high,

[79] VAT: Value Added Tax

in 2010 they have dropped considerably. The EURIBOR[80] has dropped constantly from 2009 to 2010, thus banks are able to get get financing cheaply. However, the drop in interest rates did not influence so much the interest rates that borrowers pay monthly, as it influenced the interest rates on deposits. Therefore, the margin of the banks has increased due to the increase in the spread. This is not to say that banks are making more money out of this, because we have to keep in mind that the number of late payments and non performing loans has increased as well. As a result, the banks try to compensate for the losses through creative ways. In Romania, in 2009 the tax on the interest received on deposits (which accounted for 16%) was eliminated, this action being considered an anti-crisis measure, meant to bring liquidity to banks. The banks in their turns would have had to restart giving loans. However, starting July 1st 2010 the Romanian Government decided to tax with 16% the revenue from deposits once again. In my view this is not a good measure because it determines people to do other things with their money, or to keep it under the blanket, thus reducing the short-term liquidity of banks. Nonetheless, this action does not consider the fact that the increase in VAT from 19% to 24% will generate inflation, therefore, any interest earned on deposits will be eroded by it. As a result of the fact that less private individuals and firms will keep their liquidity in saving instruments, there will be less to tax. The Romanian government is in desperate need for money but it would have made more of it from taxing economic activity alone through VAT. My suggestion is that if the government wants to tax interest on deposits, it should do so at maturity, if those deposits are not renewed. This would be similar to not taxing the reinvested profit. This way, both parties would benefit: the depositors would be able to see their investments grow more while the government would earn more from taxing compound interest because there would be interest on interest earned. One good measure that was adopted in Romania in 2009 by the government was to guarantee the deposits in case of default of the banks, up to 50.000 Euro. Even so, we might ask ourselves how many people have such amounts of money to be protected by this measure. On the other hand, private firms might have more than 50.000 Euro in deposits and might not be covered by the government's decision for the whole amount. Anyhow, given the current financial situation, it's difficult to say to what extent the Romanian government would be able to cover the losses on deposits, should a critical event take place. Next we will look at what banks do with their liquidity: give loans.

2.2.2. Loans

If we look at lending activity, which is one of the roles of the banking activity (to allocate money from areas that have a surplus to areas that have a deficit), we see that this activity has also been affected. From a marketing point of view, there has been a decrease in loans given to the private individuals sector. Besides the reasons mentioned above, there are other specific ones that I will present to you. As a result of the fact that the households' revenues have dropped, their eligibility for contracting a home financing loan for instance has worsened. The reason for this is that banks evaluate possible eligible customers based on their earnings, age, credit record, their employers' solidity (the riskiness of the sector), the current debt level they have and their level of their expenses. We hear politicians say that banks should start again the lending activity, but on the other hand the measures they adopt go against the functioning of the economy. And if the engine of the economy does not start, it will be difficult for banks to start lending again up to the levels of 2008, or even close to those. The very customers that should benefit from these loans see their revenues diminish, lose their jobs and default on their mortgages or cars' leasing payments. We have to keep in

[80] Euribor (Euro Interbank Offered Rate) is the rate at which euro interbank term deposits are being offered by one prime bank to another within the European Monetary Union zone.

mind that the real estate business was doing great before the crisis began in 2008: banks were lending, people were getting mortgages and the construction business was doing great. However, because getting a mortgage was quite easy, the demand for real estate went up. In Romania until 2008 many were tempted to buy houses on credit because prices were increasing constantly. This increase in prices was caused by more factors: the availability of financing led to an increase in demand, the supply of houses was lower than the demand because the construction businesses could not keep up with the demand. This is what happened in Romania.

The economic and financial crisis started in 2008 has had a major impact on the structure and proportion of banking products all over the world. Retail products have been blamed mostly for making borrowing too easy for customers. This has led many customers to pile up substantial debt that they weren't able to repay. This is why the number of private individuals as well as private firms that are registering an increase in late payments or even non performing loans.

Given the current market situation, banks have increased the activity of restructuring loans for those clients that demonstrated ability to still conduct their businesses. This has given some of those clients a breath of fresh air until better times come once again. As I mentioned in the first chapter, the trend has shifted from supporting the lender or creditor to supporting the borrower. Such is the case in many European countries, including Romania. Bankruptcy procedures or just insolvency procedures or the reorganization of the firms, protects them by law from payments to their creditors.

2.2.3. The competition between banks

Banks compete with eachother by offering better financing conditions, better services, more varied services, lower fees, better customer support, flexibility and better conditions on saving instruments. They also use their brands, mission statements and advertisments to lure clients to their offices and agencies. However, each bank has a unique structure and is able to obtain financing at better or worse conditions than their competitors. The amount of liquidity and sources determines their capacity to lend money at more competitive conditions. Banks make profit from interest rates (the spread between the cost of raising funds and the costs of loans determined by their interest rates), fees on transactions, financial services, consultancy, credit cards, savings plans, investing in financial instruments on the capital market, brokerage services and so on. Even if banks would like their profit margins let's say by increasing the interest rates on loans, they are subject to market competition, which ultimately sets the price. John Maynard Keynes regarded the rate of interest set by the market as the foremost 'unjust price' in the economic system and did not hesitate to use the medieval term 'usury' to condemn it.[81]

Given the current market situation, governments are seeking soft targets for tax revenues and regulators are looking to curb their activities, while investment banks have plenty to deal with. On top of this, the Office of Fair Trading, a British competition agency, said on June 10th, 2010 that it would conduct an inquiry into equity underwriting, following complaints from issuing firms.[82] The banks in Great Britain are wondering what might the OFT[83] be

[81] Skidelsky, Robert: "Keynes – The Return of the Master", Penguin Group 2009, London, UK, pp. 148
[82] Economics focus - Rights and wrongs: "Why price competition between investment banks is so feeble", from the Economist print edition, Jun 17th 2010

looking for. One possible hypoesis is that the industry may have too few firms to ensure vigorous price competition. If one bank has so big a share of the market, it can charge high fees without worrying how its rivals will respond. But it is rare for trustbusters to find a single firm that dominates in this way with a market share below 40%. However, this is unlikely. Another possibility is that a small group of firms might act together to keep fees high. That could be achieved by a formal pact to fix prices (a cartel,) or a tacit agreement not to compete too hard. Cartels are illegal and there is no suggestion that the OFT's inquiry is of a criminal nature. The Economist states that an implicit agreement can work in the right conditions—if demand is stable from year to year and if the bulk of the market is served by four or fewer firms, each with a similar share of business. In such circumstances, firms would have few incentives to undercut their peers. If one firm cut its prices, destroying the unspoken deal to carve up the market, it would succeed only in starting a price war.

One other interesting issue is that investor groups feel that the fees charged by banks do not reflect this competitive structure. One complaint is that fees have got fatter in a way that is not explained by any increase in banks' risks or costs. They think banks were overpaid for the risks they took. This is also true for banking markets of other countries. Banks try to make up for their losses due to provisions on bad loans. According to a corporate adviser, "Our clients want the best, not the cheapest". Like other professionals, investment bankers tend not to compete on price lest customers interpret low fees as a sign of poor quality.

One innovation that might make the market work better is for the terms of a corporate brokerage service to be establieshed explicitly at the start. That way banks can say what they would charge for services should the need arise. As things stand, fees are almost an afterthought. Otherwise, customers may not even know what the charges are until the bill arrives. Nontheless, the market in Britain seems to work better than in America, where investment banks routinely charge a 7% fee on initial public offerings, roughly twice the European norm. That gap has never been satisfactorily explained. Once America's new regulatory set-up is established, its trustbusters may well follow the lead of their British counterparts and take their own look at investment banking.[84]

I would add to the case study presented above that banks can also be victims of non-competitive behaviours of some suppliers of services. For instance, if there are too few suppliers of a given software type, they may achieve a monopoly and overprice their products. This has to be regulated too.

Considering that it's desirable for the market as a whole to have a competitive banking market, banks should compete also on innovation than just on prices. Innovation is the result of research and understanding of the market and it does not come automatically.[85] Extensive efforts have to be made by banks if they want to stay competitive.

2.2.3.1.SWOT analysis

Although SWOT[86] analysis is one of the best-known and most frequently used tools within the marketing planning process, the quality of the outputs often suffer because of the

[83] OFT: Office of Fair Trading

[84] Economics focus - Rights and wrongs: "Why price competition between investment banks is so feeble", from the Economist print edition, Jun 17th 2010

[85] Estrin, Judy: „Closing the Innovation gap – Reigniting the spark of creativity in a global economy", McGraw-Hill, 2009, USA

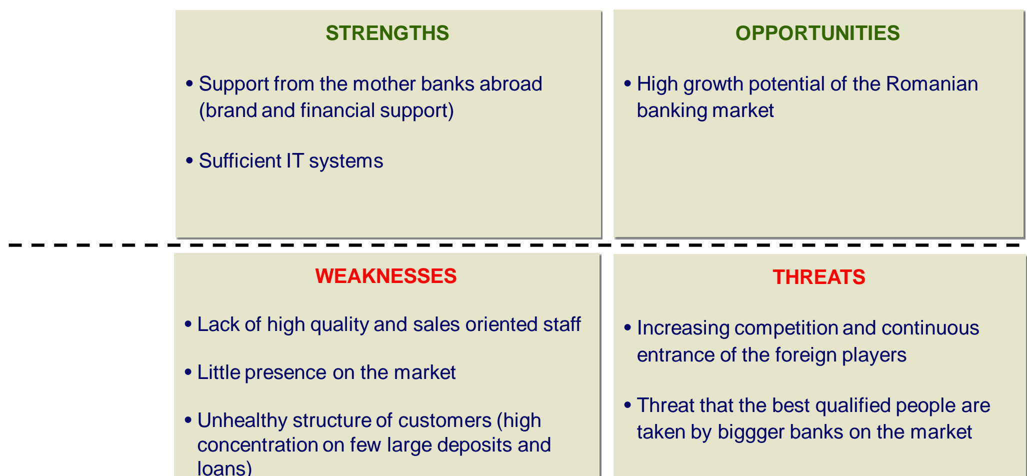
[86] SWOT stands for Strenghts, Weaknesses, Opportunities and Threaths

relatively superficial manner in which it is conducted.[87] To make the SWOT analyses more effective, and use it efficiently in the strategic marketing process, we have to keep in mind some of its weaknesses:

- The planner fails to relate strengths and weaknesses to success factors
- Strenghts and weaknesses are seen in absolute terms rather than in relation to competition
- The elements of the analysis are insufficiently specific
- Competitors' capabilities are underestimated and/or misunderstood
- The focus is upon marketing specific issues rather than reflecting a broader company perspective
- Emphasis is placed largely upon the "hard" or quantifiable elements, and fails to take account of managerial attitudes, cultures, capabilities and competencies.

Since it's difficult to do a SWOT analysis for the whole European Banking Market, given the fact that each country has its own characteristics, I have chosen to look briefly at the Romanian banking sector from the point of view of one foreing banks' subsidiary and discuss the individual issues that I have encountered.

I have put down in the following graph some of the issues that I have thought of, and which I will describe briefly.



Identifying opportunities and threats[88]

[87] Gilligan, Collinand M.S. Wilson, Richard: "Strategic Marketing planning – Second Edition", Botterworth-Heinemann 2009, UK, pp. 85-109
[88] Kotler, Philip: "Marketing Management – 13th Edition", Pearson – Prentice Hall 2009, New Jersey, pp. 705-706.

There are still many opportunities in the Romanian Banking sector, but there have been more in 2008 when the economy was booming. The most important opportunity is the potential of the Romanian banking market to expand in the following years due to the fact that banking services in Romania are far from reaching saturation.

The threats include increasing competition from other banks and possible new entrants on the market, as well as the fact that the competition might steal the best staff the bank currenly has by offering them better conditions.

Identifying and evaluating strengths and weaknesses

The strengths considering we are talking about the subsidiary of a foreign bank as an example, are given by the fact that the bank has the financial support and backing of its much larger and much stronger mother bank, as well as the know-how and support. The IT systems play an important role in the business of the bank since they are useful for making the bank run better and offer better services to its customers.

The weaknesses include the lack of highly qualified staff on the market and the high price of that which is available. The bank is not present in many Romanian cities and for now, given the current market economy, the number is not likely to grow in the short term. Another weakness is that this bank has large exposures on very few customers, thus being vulnerable when these customers decide to leave the bank and take their business elsewhere.

The next part deals with an analysis that complements the SWOT analysis. It is called PEST analyisis.

2.2.3.2.PEST analysis

PEST[89] analysis describes a framework of macro-environmental factors used in the environmental scanning component of strategic management. Some analysts added Legal and rearranged the mnemonic to SLEPT; inserting Environmental factors expanded it to PESTEL or PESTLE, which is popular in the UK. The model has recently been further extended to STEEPLE and STEEPLED, adding education and demographic factors. It is a part of the external analysis when conducting a strategic analysis or doing market research, and gives an overview of the different macroenvironmental factors that the company has to take into consideration. It is a useful strategic tool for understanding market growth or decline, business position, potential and direction for operations.

The Model's Factors:

Political factors, are how and to what degree a government intervenes in the economy. Specifically, political factors include areas such as tax policy, labour law, environmental law, trade restrictions, tariffs, and political stability. Political factors may also include goods and services which the government wants to provide or be provided (merit goods) and those that the government does not want to be provided (demerit goods or merit bads). Furthermore, governments have great influence on the health, education, and infrastructure of a nation.

[89] PEST: Political, Economic, Social, and Technological analysis

Economic factors include economic growth, interest rates, exchange rates and the inflation rate. These factors have major impacts on how businesses operate and make decisions. For example, interest rates affect a firm's cost of capital and therefore to what extent a business grows and expands. Exchange rates affect the costs of exporting goods and the supply and price of imported goods in an economy

Social factors include the cultural aspects and include health consciousness, population growth rate, age distribution, career attitudes and emphasis on safety. Trends in social factors affect the demand for a company's products and how that company operates. For example, an aging population may imply a smaller and less-willing workforce (thus increasing the cost of labor). Furthermore, companies may change various management strategies to adapt to these social trends (such as recruiting older workers).

Technological factors include ecological and environmental aspects, such as R&D activity, automation, technology incentives and the rate of technological change. They can determine barriers to entry, minimum efficient production level and influence outsourcing decisions. Furthermore, technological shifts can affect costs, quality, and lead to innovation.

Environmental factors include weather, climate, and climate change, which may especially affect industries such as tourism, farming, and insurance.Furthermore, growing awareness to climate change is affecting how companies operate and the products they offer--it is both creating new markets and diminishing or destroying existing ones.

Legal factors include discrimination law, consumer law, antitrust law, employment law, and health and safety law. These factors can affect how a company operates, its costs, and the demand for its products.

I decided to mention this type of analysis in my report because I consider it a useful extention of the SWOT analysis when discussing the adoption or not of certain management and marketing strategies. Even banks have to decide if they should or should not enter a specific market or target a certain market segment.

Let’s look briefly at each of the components of the PEST analysis, using the same example I used for the SWOT analysis above.

Political factors in Romania include the policies that the government has adopted: increasing VAT from 19% to 25%, decreasing state employees’ salaries by 25%, increasing taxation on luxury items such as cars with more than 2000cc and on the second, third properties (or more). As far as political stability, the government managed to stay in office even if the opposition parties tried to take it down.

Economic factors in Romania include the fact that the local currency, the Leu has managed to remain stable, within the 4.20 – 4.36 lei/euro. The fact that the government has implemented the austerity measures mentioned above, the country received another tranche from the IMF. This has boosted investor confidence over the future prospects in the economy.

Social factors include the state workers that lost 25% of their salaries, social welfare programes being cut where possible, the population is ageing and many have left the country in the previous years to work abroad.

Technological factors are a plus for now in Romania. There are successful software companies, youngsters are very bright but unfortunately find jobs elsewhere, many multinationals such as Nokia, Renault, Ford and others have opened factories in Romania.

Environmental factors are a problem this year in Romania. Even if the climate is good for agriculture, the floods and harsh winter have had a negative impact. Nature is very well preserved but not promoted and exploited enough in the tourism business. Cities are crowded and due to intense traffic, sometimes pollution levels go above the thresholds.

Legal factors in Romania are a problem. Trials take very long to be solved and this affects the banking market as well. There is still corruption in the society which is not adequately punished. The legislation is adapting to that of the EU but it still has a long way to go.

Having completed the PESTEL analysis, let's move on to Porter's five forces analysis.

2.2.3.3.Porter five forces analysis

Porter's five forces is a framework for the industry analysis and business strategy development developed by Michael E. Porter of Harvard Business School in 1979. It draws upon Industrial Organization (IO) economics to derive five forces that determine the competitive intensity and therefore attractiveness of a market. Attractiveness in this context refers to the overall industry profitability. An "unattractive" industry is one in which the combination of these five forces acts to drive down overall profitability. A very unattractive industry would be one approaching "pure competition", in which available profits for all firms are driven down to zero.[90]

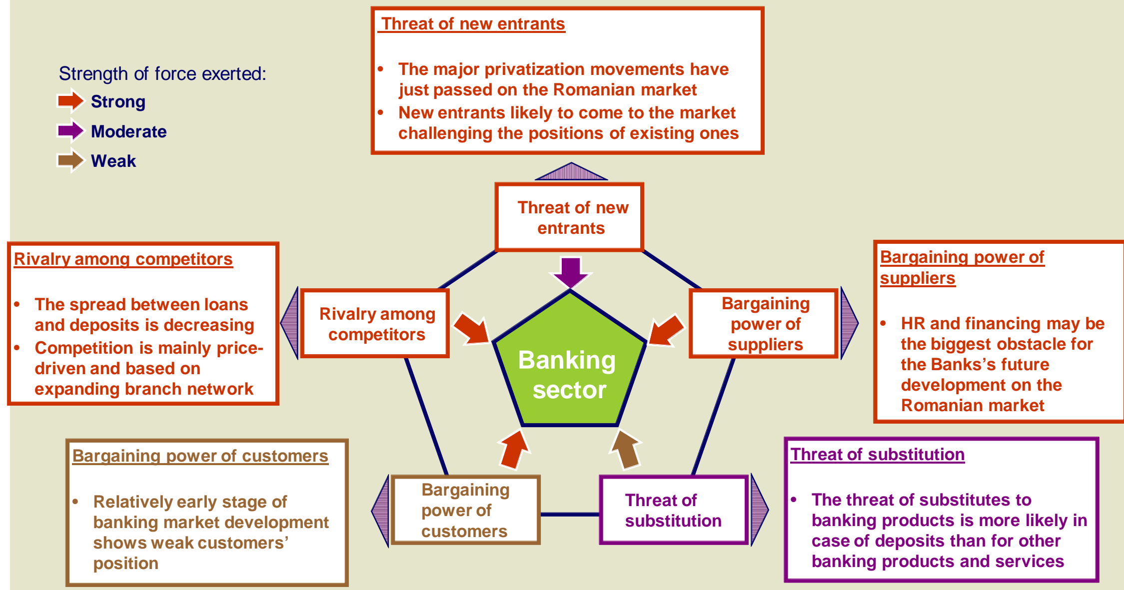
Three of Porter's five forces refer to competition from external sources. The remainder are internal threats. It is useful to use Porter's five forces in conjunction with SWOT analysis (Strengths, Weaknesses, Opportunities, and Threats).

Porter referred to these forces as the micro environment, to contrast it with the more general term macro environment. They consist of those forces close to a company that affect its ability to serve its customers and make a profit. A change in any of the forces normally, requires a business unit to re-assess the marketplace given the overall change in industry information. The overall industry attractiveness does not imply that every firm in the industry will return the same profitability. Firms are able to apply their core competencies, business model or network to achieve a profit above the industry average. A clear example of this is the airline industry. As an industry, profitability is low and yet individual companies, by applying unique business models, have been able to make a return in excess of the industry average.

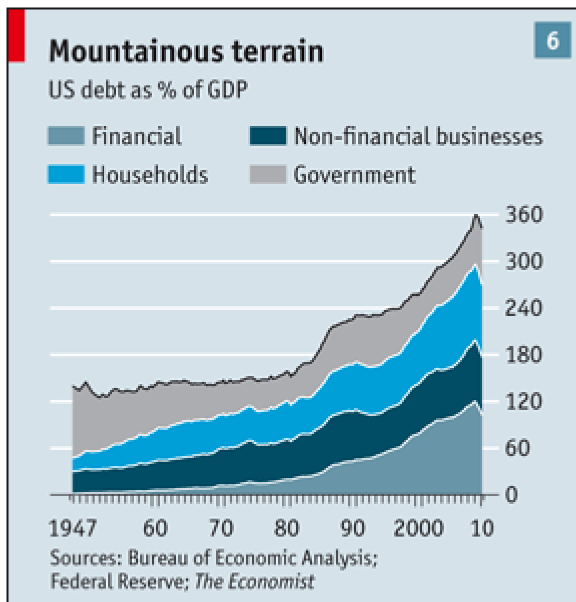
Porter's five forces include - three forces from 'horizontal' competition: threat of substitute products, the threat of established rivals, and the threat of new entrants; and two forces from 'vertical' competition: the bargaining power of suppliers and the bargaining power of customers.

[90] Daft, Richard L.: "New Era of Management", South-Western Cengage Learning 2008, USA

The trends that will shape the future of the banking market in Romania can be analyzed within the five forces framework



Britain government debt per head has almost trebled, from £5,000 in 2001 to nearly £18,000 today, and household debt has jumped from just under £14,000 to £24,000.[91] In the chart below we can see the growing debt divided into 4 categories.



Source: The Economist, Bureau of Economic Analysis, Federal Reserve

Cutting the debt back to more acceptable levels is both hard and unappealing, since it may involve years of austerity and slow economic growth. It also requires some tough political decisions. If being able to borrow makes people feel richer (however illusory the sensation), having to repay the debt makes them feel poorer. They resent the sacrifices involved, especially if they are imposed by outsiders. This is particularly true in democracies. In a referendum Icelanders voted overwhelmingly against a debt repayment deal with Britain and the Netherlands. I might add that a great part of the population in Romania does not agree with the deficit-cutting measures adopted by the Romanian government in order to meet the criteria for obtaining the tranche payment in July 2010 from the IMF, European Commission and World Bank. The government adopted measures to decrease the salaries of state employees by 25%, increasing the VAT by 5% to 24% and other taxes.[92] In my view, the most disturbing part is not that these measures have been adopted, but rather the fact that we don't know how long will they have to be maintained, and if there are sufficient measures to ignite the economic engine.

Dani Rodrik, an economist at Harvard, has talked of a "trilemma" in which countries aiming for the three goals of **deep economic integration with the rest of the world**, **national sovereignty** and **democratic politics** can achieve two of them but not all three. Left to themselves, voters will resist the sacrifices needed to remain competitive in a system of deep economic integration, and nation states are constantly erecting barriers to international trade.

This pattern of debt is the opposite of what you might expect. At the level of individual consumers, people tend to borrow when they are young because they are hoping for higher incomes in the future. As they reach middle age they start to pay off their debts and save for retirement. By extension, rich countries with their greying populations should be saving whereas younger, fast-growing developing countries should be borrowing heavily. But in fact it is the other way round.

This is not unalloyed joy for the creditor nations. Once the exposure of a creditor to a borrower gets sufficiently large, the two sink or swim together. The relationship between China and America has been described as vendor financing, in which the Chinese lend the Americans the money to buy their cheap manufactured goods; a collapse in American demand would cause substantial unemployment (and social unrest) in China.

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[91] A special report on debt - In a hole: "Stagnation, default or inflation await. The only way out is growth", from the Economist print edition, Jun 24th 2010
[92] Unicredit Group: "CEE Quarterly – Q3 2010", June 2010

The debt burden may also have had a distorting effect on economic policy. In the 1960s and 1970s governments grappled with a wage-price spiral in which demands for higher wages forced companies to increase their prices, which in turn triggered demands for higher wages.

But what is the best solution in the current world economic situation. The best solution for rich countries is to work off their debts through economic growth. That may be harder for some than for others, given that many countries' workforces are set to level out or shrink as their populations' age. It will be all the more important for such countries to pursue structural reforms that will increase productivity. America, which has a younger workforce than Europe or Japan, might still manage it. But for many other countries the hole they have dug for themselves may already be too deep.[93]

2.4. **Bankruptcy**

The term bankruptcy comes from Latin banca rupta = broken bench. In medieval times Italians had the tradition of conducting their business in markets on wooden benches, and if their businesses failed, they had to publicly break those benches. In modern days, bankruptcy was the worst thing that could happen to a company, and still is in some countries.

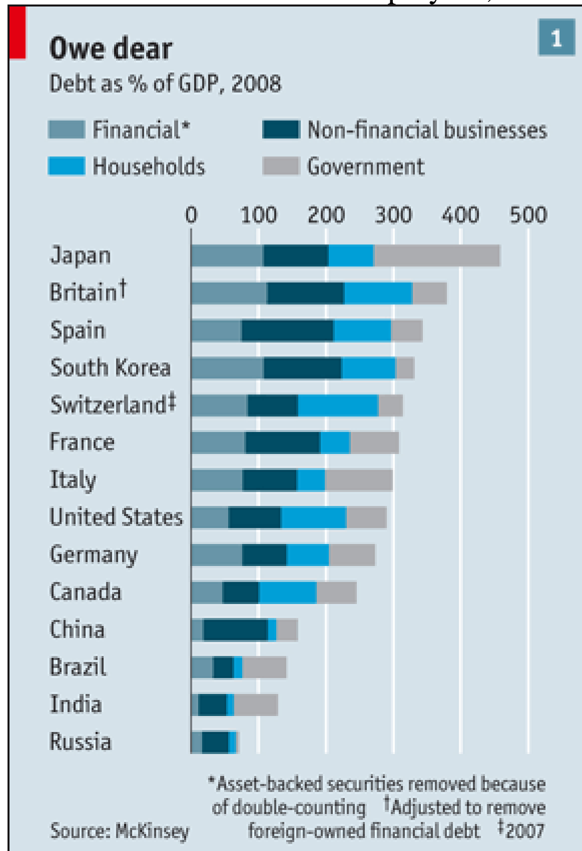
In the US however, the bankruptcy law has changed in favour of the corporate debtor. The main driver has been American law, which has always tended to favour debtors (farmers in the mid-West and South) against creditors (eastern money men). In the 19th century the financial problems of some of the railroad companies made lenders more determined to keep the businesses going; the value of an operational railroad was clearly higher than that of the steel rails and wooden ties that made up its physical capital.[94]

In modern America that approach has morphed into Chapter 11, a structure that allows companies to continue operating and prevents creditors from foreclosing on the business. Chapter 11 has allowed some companies to come back from the dead, although in some industries (notably airlines) at the expense of more profitable rivals. The system has the great benefit of clarity, with the court ensuring that the creditors are paid in order of seniority, with secured lenders getting first cut. Even so, the system struggled to cope with the sheer complexity of Lehman Brothers' failure. The investment bank became the largest ever Chapter 11 deal, involving loans of $640 billion and thousans of creditors which are hard to trace too.

In Europe, there are efforts towards reforming the bankruptcy law but it varies across countries. "It used to be completely impossible to deal with cross-border failures," says Alan Bloom, head of restructuring at Ernst & Young, an accountancy group. That was before Europe-wide insolvency arrangements for dealing with multinationals were introduced in 2005. But it still leaves the issue of which country's courts control the process. That depends on which nation is the "centre of main interest" for the company.

[93] A special report on debt - In a hole: "Stagnation, default or inflation await. The only way out is growth", from the Economist print edition, Jun 24th 2010
[94] A special report on debt - A better bust?: "Bankruptcy is becoming less calamitous", from the Economist print edition, Jun 24th 2010

At the opposite end of the scale is France with its sauvegarde scheme, where the priority is to save the business and the employees, with the creditors taking third place. Only the debtor can apply for sauvegarde. The company has to present a repayment plan to the court, but the court can reject it and impose a plan of its own. The plan also requires a majority vote, with large creditors able to vote down small ones and unsecured creditors able to outvote the secured. Debt repayment can be slow; even under a court order, it can take up to ten years. "It looks brutal to creditors but this is often the subject of pre-negotiation," says Alan Mason of the Paris office of Freshfields Bruckhaus Derringer, a corporate-law firm. There are signs that firms, under pressure from creditors, are reorganising themselves to avoid sauvegarde.[95]



Source: The Economist, McKinsey

In the lending booming days in 2006 and 2007, investors let their guards down at the expectation of obtaining higher yields, and thus dispensed of protections. Investors were so keen to be in the game that lended first and asked questions later.

Now let's look at the debt of private individuals. In the rich world, getting hold of your first credit card is a rite of passage far more important for your daily life than casting your first vote. Buying your first home normally requires taking on a debt several times the size of your annual income. And even if you avoid the temptation of borrowing to indulge yourself, you are still burdened with your portion of the national debt. When in too much debt, the answer to all problems seemed to be more debt. Depressed? Use your credit card for a shopping spree "because you're worth it". Want to get rich quick? Work for a private-equity or hedge-fund firm, using borrowed money to enhance returns. Looking for faster growth for your company? Borrow money and make an acquisition. And if the economy is in recession, let the government go into deficit to bolster spending. When the European Union countries met in May 2010 to deal with the Greek crisis, they proposed a €750 billion ($900 billion) rescue programme largely consisting of even more borrowed money.

Debt increased at every level, from consumers to companies to banks to whole countries. The effect varied from country to country, but a survey by the McKinsey Global Institute found that average total debt (private and public sector combined) in ten mature economies rose from 200% of GDP in 1995 to 300% in 2008 (see the chart above for a breakdown by country).

There were even more shocking rises in Iceland[96] and Ireland, where debt-to-GDP ratios reached 1,200% and 700% respectively. The burdens proved too much for those two countries, plunging them into financial crisis. Such turmoil is a sign that debt is not the

[95] A special report on debt - A better bust?: "Bankruptcy is becoming less calamitous", from the Economist print edition, Jun 24th 2010
[96] Boyes, Roger: "Meltdown Iceland", Bloomsbury Publishing Plc 2009, Great Britain

instant solution it was made out to be. The market cheer that greeted the EU package for Greece lasted just one day before the doubts resurfaced.

Going back to the roots of the problem we ask ourselves why do people, companies and countries borrow? One obvious answer is that it is the only way they can maintain their desired level of spending. Another reason is optimism; they believe the return on the borrowed money will be greater than the cost of servicing the debt. Crucially, creditors must believe that debtors' incomes will rise; otherwise how would they be able to pay the interest and repay the capital? But in parts of the rich world such optimism may not be the right approach. With ageing populations and shrinking workforces, their economies may grow more slowly than they have done in the past. They may have borrowed from the future, using debt to enjoy a standard of living that is unsustainable. Greece provides a stark example. Standard & Poor's, a rating agency, estimates that its GDP will not regain its 2008 level until 2017.

Government default is far from inconceivable. Actually it's quite likely in some cases. Many people are forecasting that Greece, despite its bail-out package from the EU and the IMF, will be unable to repay its debts in full and on time. Faced with the choice between punishing their populations with austerity programmes and letting down foreign creditors, countries may find it easier to disappoint the foreigners.

Adam Smith, a founding father of economics, noted in "The Wealth of Nations" that "when national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having being fairly and completely paid."[97]

The Live 8 campaign in 2005 tried to shame developed nations into forgiving the debts of poor countries, particularly in sub-Saharan Africa. Economists have developed the concept of "odious debt" in which citizens should not be forced to repay money borrowed by tyrannical or kleptocratic rulers. Interest payments on debt are often regarded as an onerous burden placed on the poor; interest is seen as an unjustified reward for capital, a concept that goes back to Aristotle and is implicit in the Christian idea of usury. Islam forbids it altogether. The book of Deuteronomy suggested a debt amnesty every seven years, which survived into later Jewish custom.

But conventional morality has not always been on the side of the borrowers. Some regard debt as the road to ruin and the failure to repay as a breach of trust. In the 18th and 19th century debtors in Britain were often thrown into jail (as in Charles Dickens's "Little Dorrit"), though Samuel Johnson spotted the flaws of the practice: "We have now imprisoned one generation of debtors after another, but we do not find that their numbers lessen. We have now learned that rashness and imprudence will not be deterred from taking credit; let us try whether fraud and avarice may be more easily restrained from giving it." In the past 100 years the moral battle has moved in favour of the debtors. Bankruptcy is no longer stigmatised but simply regarded as bad luck. When consumers borrow beyond their means, the blame is laid on lax lending practices rather than irresponsible borrowing.

Another reason why debt matters is to do with the role of banks in the economy. By their nature, banks borrow short (from depositors or the wholesale markets) and lend long. The business depends on confidence; no bank can survive if its depositors (or its wholesale lenders) all want their money back at once. If banks struggle to meet their own debts, they

[97] Smith, Adam: "Wealth of Nations", Oxford University Press 2008, UK

have no choice but to reduce their lending. If this happens on a large scale, as it did in the 1930s, the ripple effect for the economy as a whole can be devastating.[98]

Both of these effects were seen in the debt crisis of 2007-08. Falling property prices caused defaults and a liquidity crisis in the banking system so severe that the authorities feared the cash machines would stop working. Hence the unprecedented largesse of the bank bail-out.

One might ask if the Western world faces an era of austerity as debts are paid down, how will that affect day-to-day life? I believe that more attention should be paid to saving. Living a way of life that we cannot afford by borrowing more is not a sustainable solution.

In America, the non-financial corporate sector increased its debt-to-GDP ratio from 58% in 1985 to 76% in 2009, whereas the financial sector went from 26% to 108% over the same period. It was that leverage that made the banks so vulnerable when the subprime market collapsed in 2008; the assets they ended up owning were illiquid, difficult to value and even harder to sell. Banks such as Bear Stearns and Lehman made the fatal mistake of assuming that the markets (often their fellow banks) would always be willing to roll over their debts, but they suffered a bank run. The only difference was that the charge was led by institutions instead of small depositors.[99] In turn, the collapse of the finance sector had a huge impact on the rest of the economy and created a dilemma for governments. They want to increase banks' capital ratios to avoid future financial crises. But that will cause bank lending to grow more slowly or even contract, an outcome they are equally wary of.

After the crisis struck the banks needed the governments to rescue them, but now the governments need the banks to buy their bonds. One reason why EU governments eventually rescued Greece was that a default would have threatened the member countries' banking systems. As debtors and creditors, banks and governments are locked in a tight embrace.[100]

In this case, the solution is to find together the best solutions to get out of trouble.

3. Conclusion

As I mentioned in the introduction of this report, my purpose here was to present the banking sector in the current financial and economic situation and the management and marketing strategies adopted by the banks in reaction to the recent changes, as well as the measures adopted by governments, central banks and other institutions to saveguard their economies. This approach was meant to show what was done right, what was done wrong, and what else can be done to set things straight.
In my view this economic and financial crisis has its good parts. It is responsible for giving the world a wake-up call to reality. What I mean to say is that the growth based on debt up until 2008, was unrealistic and unsustainable, and that a crisis was going to take place anyway due to the leaks in financial regulation, that left room for opportunists. These opportunists or speculators knew very well the shortcomings of the financial regulations and laws and have taken actions to enrich themselves beyond limits.

[98] A special report on debt - Repent at leisure: "Borrowing has been the answer to all economic troubles in the past 25 years. Now debt itself has become the problem, says Philip Coggan", from the Economist print edition, Jun 24th 2010
[99] A special report on debt - Betting the balance-sheet: "Why managers loaded their companies with debt", from the Economist print edition, Jun 24th 2010
[100] Ibid

However, they are not the only culprits. The whole financial and banking sector has played its part too. Since private business firm have the goal to produce wealth to their shareholders, the top managers of the major financial institutions have done more than their part to make sure that they reached this objective. The trouble is that the manner through which they tried to achieve this goal was wrong. The financial and banking institutions conducted major campaigns to lend money to private individuals and firms that did not have a sound financial position to be abe to sustain paying back so much debt. Then the financial instruments that allowed for suprime lending and selling of these so called "assets" between them, paved the way for the beginning of the financial crash and subsequent crisis. The idea that taking high risks leads to high revenues can be dangerous by itself. Taking high risks for large profit is not necessarily bad if it's accompanied by solid risk management procedures that aid financial firms to manage risk and avert any threats.

Another conclusion that I have reached is that financial institutions should do what they are meant to do: allocate funds to those business sectors that are critical for the development of the economy. By all means I don't mean to say that banks should not lend to private individuals, but they should do so in those cases in which the financial situation of those individuals is adequate. As a matter of fact, this is what banks currently do: they lend more to the corporate sector than to the retail one.

Next in my findings is that money should be primarily allocated for investments and development. In my view this is a key approach towards financial equilibrium. Goverments have tried their best to save the banks from bankruptcy not because they necessarily had any stake in them, but because the stability of their domestic economies was closely linked to them. The so called "bailouts" have been done using taxpayers' money and it's only fair that banks give back their contribution by investing their liquid funds in the local economies and industries. Besides this, those banks that have benefited from the bailouts should pay fees back to the government until they are able to reach certain goals of risk management or demonstrate that they have offered their support in the economy by financing investments that are of importance to the whole community. In my opinion, taxing the banks indiscriminately will not lead to positive outcomes. As we have seen earlier, Mr Obama's plan to tax banks has yet to be approved, but if it will pass, will in my opinion determine banks to be more careful.

There have been many debates on the banker' bonuses, that in certain cases are exaggerated. In many occasions the top managers have received millions of dollars or euro in bonuses even if they did not reach all objectives set by their Boards of Directors, just because they signed contracts with clauses that permitted this. Such attitudes are not fair for a couple of reasons: the value of the bonuses is not always linked to correct performance indicators and there are ways to do "windowdressing" of the financial results of the banks through financial "shenanigans". The astonishing fact is that many bankers still get huge bonuses even if their financial institutions have received money through bailout programs put in place by governments. There are plans to link bankers' bonuses also to risk management and financial ratios. I believe this will be useful first of all because the financial markets will be in better health and less vulnerable to market crashes and second because more realistic goals can be set for managers keeping in mind the increase in revenues, gaining market share and increasing profits but also better financial ratios. I'd like to add just one more thing to this topic. The banks that failed in the US have created a lot of business for law and consultancy firms. There is proof that employees of such firms, lawyers and consultants alike, are spending way too much taxpayers' money in their task to complete bankruptcy procedures and recover what can be recovered. Here comes the ethics issue.

In my view, ethical management should play an important part in the financial as well as the rest of the business world. If profits are to be made from activities that damage others, then those are to be avoided. Managers should first have integrity, not just wits. The people outside the financial world see these bankers and financial traders, brokers and so on as very intelligent persons. It's true that many are intelligent, otherwise they wouldn't be doing those jobs. However, intelligence has to be put to good use. Otherwise we can say also about thieves or hackers that they are intelligent, but they have put their wits to evil use which can't be good.

Qualified professionals are rare resources in the banking sector and measures should be taken to train and educate such individuals. Banks should spend their money wisely and offer these people proper training.[101] What the world needs right now is leaders with integrity, free from prejudice and fear, and capable of harmonising apparent, age-old antagonisms between economics and ethics, action and contemplation, and financial power and love.

There are some ideas that I would like to share with you, coming from lessons learned from the CEOs[102] of some of the most successful companies, that I believe to give as recommendations for improving the banking business. From Muriel Siebert, President & CEO, Siebert Financial Corp. we learn that "Diversity expands talent: aim to recruit people from all age groups, background, and ethnicities"[103]; Bill Gates, the founder and former CEO of Microsoft Corp. believes that "Success is a lousy teacher." This doesn't mean that failure is an excellent teacher, but rather that in order to reach success, you have to learn from your mistakes. It's just part of the learning process. From Warren Buffet we learn that we should do only what we love because otherwise we will not be either productive nor happy.[104]

The ideas mentioned above are just a few of those that have come to my mind in the process of researching for this report. I hope I managed in my endeavour to present some of the marketing and management strategies in the banking sector and and that I can move on to the final research thesis to take the research to the next step. This report is not at all exausthive in its presentation of the facts, but it is a starting point for future more extensive research.

The final thesis will consist of five chapters. Two will be inspired from the intermediary research report, and two from the present final research report, obviously updated and improved, keeping in mind the suggestions of the evaluation commission as well.
The fifth chapter, which I will have to write from scratch, will take the research further and discuss the international marketing and management strategies that can be applied to the banking sector in Romania, and in what form, and also other possible new strategies.

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[102] CEO: Chief Executive Officer
[103] Davidson, Andrew: "1000 CEOs", Dorling Kindersley Limited 2009, UK
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