THE NEW BUSINESS MODEL IN THE BANKING SECTOR AND ITS CHALLENGES

Nicolae DĂNILĂ[1]

Abstract. *The financial crisis exposed a number of caveats of the business model in the banking sector among which the most visible one was the relation between leverage and multiplied losses. The new Basel capital and liquidity requirements will force some costly changes on the banking sector daily management. These costs will trigger a reform of banking in all its aspects: maturity transformation, assets portfolio restructuring, client and regional prioritization, operations costs, corporate governance, innovation, mentality and culture. This paper analyses the main elements driving the change of the banks' business model in order to capture its challenges and threats confronting the stakeholders on the medium and long term run. These analyses are meant to point out the impact of international banking sector transformation on the Romanian economy, on its short, medium and long term financing, as well as on its banking community, which consists mainly of subsidiaries of foreign banks (a number of which are systemically important financial institutions for both home and host sides)..*

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JEL Classification: D24, F36, G21, G32

1. Introduction

Several provisions regarding the functioning of the financial sector in general and the banking sector in particular have been crafted both at European and international level after 2012 (the European agreement for unified supervision in the euro area and the BIS minimum liquidity criteria). Such events are just two points in a string of measures that form an integrated process of restructuring the functioning of the financial system at international level. The starting point for the reform was the realization of the staggering social costs triggered by the 2007 – 2009 financial crisis. This financial crisis represented a catalyst for the efforts to rethink the fundamentals of old banking practices. The bottom line is that the financial and banking status-quo has become unacceptable.

There is a long list of measures that are still in the pipeline since there is no agreement at international level regarding their definition, content, measurement, and implementation. However, those measures ready to be implemented regarding

[1]PhD, Member of the Academy of Romanian Scientists, Professor - Academy of Economic Studies Bucharest

Basel III, liquidity criteria etc. give some flavour of the main issues affecting the banking business model for the period to come.

This article contains personal ideas, which do not represent the view of me as a former commercial banker (asked to find solutions for alleviating the crisis effects on a bank, as demanded by the on-going concern principle) or of a central banker (my current position). Some readers might find themselves in these comments, be it as teachers, researchers, an ordinary observer of today's events, or even as a client of the banking sector or a taxpayer who is affected by these events. The post-crisis banking sector regulation is not the main factor pushing for the change in banking business model, but just an element channelling the change. If regulation would be the main factor than we no longer talked about a free market economy, but about a central planned one. The question persists though: what made the change in the banking business model necessary? Another important question that needs to be raised is about the way banks will look after these changes are implemented. In theory, these changes should bring about a banking sector providing services without creating risks and vulnerabilities. Many financial institutions are still on a diet of government aid (especially in Europe) and under such circumstances the economic environment can hardly offer insights into the new banking business model. In short, one of today's priorities is the following: how to bring the banking sector back to its normal state, whereby the banking sector is a financial intermediary protecting the interests of all stakeholders.

It is evident that the Romanian banking sector is exposed to the same pressures for reform. The reason lies in the fact it is dominated by foreign owned capital banks mainly from the euro area, which means that is dependent on the group strategies and credit lines from the mother banks. Therefore, it is important to ponder on the significance of internal and external pressure factors that trigger the change in the business model of the banks in Romania. It is certain the euro area banks will go through a major transformation process. These banks have global systemic importance and thus have to undertake the reforms leading to the strengthening of each banking group and of the European banking system in general. The reasons for this transformation are obvious. In 2010, US banks had US 8.6 trillion assets (80% of US GDP). In the same period, the banks in the EU had euro 43 trillion assets (350% of EU GDP). Such a situation if not skilfully managed could be explosive for the global economy. One can say that if the banks in the US are too big to fail, the banks in the EU are both too big to fail and too big to save.

Europe needs to re-establish trust into a healthy banking sector besides fiscal consolidation and economic reforms. These are necessary conditions for increased competitiveness and inclusive economic growth. Romania needs to follow the European banking reform process very carefully as it will be affected in a decisive

manner. In the US the banking sector crisis was solved by and large through state intervention (mostly as a signal of support through the participation in the recapitalisation of banks; this measure has strengthened private capital confidence in the banking sector and has encouraged its participation in the recapitalisation of several systemic banks). In Europe the problem is so much more complicated. The structure and the SIFIs status need decisions and political solutions, new regulations and institutional reforms. We perceive a challenging trend for the Romanian banking sector in the sense that foreign owned banking groups will gradually retreat from the Romanian financial market to their home countries. In the same time, while their resources will be oriented towards resuming growth for the home local market, and for the core strategy and core business areas. Most likely this trend is closely linked with the de-globalisation phenomenon of the developed countries financial sectors, which, in my opinion, is set to continue for the following years. Having in mind the Romanian banking sector structure, the Romanian authorities need to pro-actively follow the transformation process in Europe and adopt solutions that can strengthen the position of the Romanian banking sector throughout the on-going European integration process. Romania will face complex issues related to the implantation of the new regulation provisions, which will trigger a cut in the banking finance to the level where banks will balance their capital and liquidity indicators. This is even more important for Romania at this junction where the economy needs reforms and consolidation in order to achieve an inclusive and sustainable economy.

This article is organised as follows: the first section will briefly summarize the literature regarding the banking sector business models; the second section will discuss the current changes in the banking business model; the third will present some alternatives to the banking business models, while the last will comment on the near future challenges for the Romanian banking sector.

2. A brief literature review

The scholar discussion over the business model of the banking sector is at least as old and as divisive as is the subject of the Great Crisis of 1929 – 1939 and is largely related with the saga of the 1933 US Glass-Steagall Act since its adoption, implementation, functioning and abolishment in the late 1990s. The 2007 – 2009 financial crisis and subsequent measures concerning the banking sector at international level elicited great interest from the scholars. The obvious themes of interest related to the triggers of the financial crisis or the involvement of the banking sector in triggering the crisis and the way it unfolded. Many questions though concerned the basics of banking: why financial intermediaries exist after all (Diamond, 1984), but mostly the way the banking sector was functioning, that is the business models this sector was following. Another part of

the debate concerned the differences between the business models of the banking sector of US and EU respectively.

Ayadi et al (2011) analysed the business model of 26 major European banks before and after the financial crisis (from 2006 to 2009) and came up with three major business models. They called these models – retail banks, investment banks and wholesale banks. The conclusions of their study is that over the studied period the retail banks outperformed the other two types, as they were more stable and were less likely to need government bailout, while they managed to expend customer loans despite the financial crisis. The worst performer was the wholesale bank model. An entire string of the literature on banks deals with the economic factors that push banks into diversifying their activities and hence to adopt new business models. One set of factors concerns the asymmetry information between creditors and debtors. Banks are able to obtain more information on their clients if they engage in providing other services (Sharpe, 1990; Diamond & Rajan, 2001).

A second set of factors was rooted in the classic liberalism argument of the functioning of self- regulating market, despite the fact that the banking sector was nowhere near to being a free and/or unregulated market. Thus, the experts in the 1980' and early 1990' thought that by diversifying their activities banks may reduce their risks (Diamond, 1984). After the financial crisis this view was challenged and finally dropped because it was crystal clear that with the diversification of banks' activities into each other areas the system was less diverse and instead of obtaining the diversification of risks, the banking sector became more prone to common shocks (Haldane, 2009). A third set of factors relates to regulation. Regulatory reforms since Basel I managed to actually reduce the competitive advantages of banks and so this became an incentive for banks to offer a wider range of products and to invent new products which would circumvent regulation (Ayadi et all, 2011; Croitoru, 2013). Most of the studies written after the 2007 – 2009 financial crisis find that the diversification of banks' activities is not beneficial for the banks at least for two reasons. On the one hand, the benefits of diversifying in terms of risk-taking, performance and efficiency may be cancelled out by the costs of increased exposure to volatility (De Young & Roland, 2001; Stiroh, 2006; Stiroh & Rumble, 2006). On the other hand, despite the fact that markets value more banks that diversify their activities such banks hold less capital in reality and usually engage in more risky activities (Demsetz & Strahan, 1997; Baele et al, 2007). Most of the debate in the past years was concentrated on the question of the universal bank model. There are those who consider that this model should be dismantled. Blundell-Wignall et al (2013) conducted a study on 94 large global banks from 2004 to 2011 and conclude that as far as systemically important banks are concerned traditional banking should be separated from securities business because of the risks related both to operations

and contagion. On the other hand, Dombert (2012) argues that if regulators and supervisors mange to adequately solve the too big to fail problem there is no reason to forgo the advantages of the universal bank model. In his view, capital adequacy at all times is the fundamental element in order to achieve and maintain financial stability.

A KPMG report (KPMG 2012) argues that this is not the end of the universal bank model provided some changes to the way it functioned until now are made. The key message is that the universal bank model has to transform from achieving increased efficiency (from economies of scale and internal synergies) to cost efficiency. In order to obtain cost efficiency banks need to be flexible enough to function successfully in this new environment where they are challenged by new regulations, the downturn economic environment, rapidly changing customers and rapid progress of technology. “Banks need to consider componentized operating models supported by flexible and configurable architectures. Each component should be able to operate independently or at least only loosely connected to other components and industry hubs.”(KPMG 2012, p.5)

3. Changes in the banking business model

3.1. The efficiency of the banking business model

Profitability is the main reason making the change of the banking business model necessary. The financial system has as main function the allocation of financial resources and the limits of its activity are set by the capacity to manage the risk and debt. The 2010 BIS Annual Report analyses the financial data for all economic sectors during the 1995 – 2005 decade at global level and shows that the financial sector was as profitable as the rest of the economic sectors.

Table 1: Return on equity for different economic sectors (1995 – 2009)

	1995 - 2009	1995 - 2000	2001 - 2007	2008 - 2009
Banks	12.2	13.3	12.8	3.2
Nonbank financials	11.2	12.3	11.4	5.4
Nonfinancials	11.7	10.9	12.8	9.8
Energy	14.2	10.8	18.6	10.1
Industrials	10.4	8.3	11.5	11.0
IT	12.8	15.1	12.8	10.3
Utilities	10.8	9.3	11.6	11.9
Source: BIS, Annual Report 2010, p.75				

However, there are two issues concerning the level of profit rate in the financial sector. On the one hand, the financial sector managed to obtain comparable results with the rest of the economy only during the economic boom and within an economic environment dominated by low interest and inflation rates. On the other hand, the financial sector was able to obtain these results only through a high leverage level, 5-6 times higher than the rest of the economic sectors. Thus, the present business model of the banking sector devours too many resources (capital), which could be otherwise used by different economic sectors in a more efficient manner. Moreover, the data presented by the BIS report suggests that other economic sectors could use these financial resources without producing the same high level of risk in the economy.

Most of the risks associated with the banking sector business model come from the dominance of short term financing (overuse of the money market instruments), a method that has prevailed at least after the 1990s. This move was partly encouraged by the changes in central banks' operations. They changed their focus to using the liquidity management as their main monetary policy instrument. But instead of accommodating the needs of the domestic money market (reflecting the demand for funds coming through commercial banks from the real economy) central banks have become prisoners of the liquidity needs of the rent seeking behaviour of commercial banks on the money markets at global level.

It is highly probable that one of the things which encouraged the over-expansion of the banking sector via high debt levels (and consequently the high level of risk) was the lack of financial education. One of the most experienced bankers in the US – Henry Kaufman -, a veteran of many difficult moments of the banking sector in the 20th century, remarked that after the 1980s many top universities in the US have discontinued teaching classes of financial history to their students.

A solid financial education could make a contribution to decreasing the risk of another financial crisis for three reasons. First, understanding the causes of past financial crisis may contain the financial imagination of today's bankers as well as of those who are still students (of course not killing the innovation which is one of the main sources of progress) . Second, financial education should teach banking and financial products which exist on the market at a certain moment too. Only by learning how the latest financial products actually work the students of today will become more than just simple automatons that archive credit files tomorrow, while the risk of those credits are calculated through a complex econometric model at headquarters. It is the duty of the teachers to revisit the syllabus especially in the current situation when there are major changes underway in the banking sector. Third, the main advantage of understanding financial history is that it gives a flavour of the mechanisms determining financial crisis as well as of the way these spread. This can make bankers better equipped

for the next financial crisis. All past financial crisis have only one thing in common: there were no two alike, but they all started by taking in too much risk.

3.2. What was wrong within the banking business model?

There is one question related to the 2007 -2009 financial crisis which does not have a simple, clear and easy to explain answer and that is: What was the cause of the financial crisis? From the point of view of the particular enterprise called bank, one possible answer to this question is that the growth type from this business cycle based on excessive debt eroded almost to extinction the essence of the object of its activity. The essence of the activity of a bank enterprise consists in the allocation of capital between those who have savings and those who have a need for investment. Like any other enterprise, banking carries a risk stemming from the fact that the time horizon of the deposits does not coincide with that of credits (the problem of the maturity transformation).

Figure 1. The maturity transformation and the liquidity mismatch

Assets	**Liabilities**
Market liquidity	Funding liquidity
- Can only sell assets at **fire-sale prices**	- Can't **roll over** short term debt - **Margin**-funding is recalled
Ease with which one can raise money by selling the asset	Ease with which one can raise money by borrowing using the asset as collateral
A **maturity** mismatch is actually a **liquidity** mismatch	

Source: Brunnermeier at all (2011a)

Overstretching the bank's capacity to attract sources for financing credits leads to the erosion of their credibility as it is no longer able to satisfy the minimum condition of its object – maturity transformation. However, the financial crisis in its first phases (from August 2007 to August 2008) is considered mainly a liquidity mismatch.

3.3. The main factors triggering the change of the banking business model

Any economic crisis forces entrepreneurs to restructure and the same must be true for banks. There is another source of elements forcing banks to restructure besides the economic ones mentioned above. Obviously these elements concur to the

increase of costs for banks, but these elements are interventionist and therefore not from the market.

This group of factors could be called the regulation framework, although it refers mainly to the intervention of regulators and supervisors from governmental, inter-governmental and supranational levels. There are three factors in this group:

- the increase of capital cost due to the changes in capital requirements according to Basel III;
- the increase of liquidity cost due to the changes in the liquidity coverage ratio which has to be accomplished in the proportion of 60% by 2015 and 100% by 2019 (high quality liquid assets/Total net cash outflows in a crisis, which actually means how much cash and easy-to-sell assets a bank should hold against short term commitments);
- the increase of functioning costs due to multiplying levels of compliance to supervision.

Thus, national and international supervisory bodies make more difficult and burdensome banks' efforts to put in place a new business model, which is sustainable by imposing new regulation at international level. On the other hand, there are two factors which allow for a decrease of the above mentioned costs. First, there are numerous unknowns regarding the organisation of supervision within the euro area and EU in general. Procrastinated debates in Brussels allow the banks to postpone taking on board the costs related to internal reorganization along the new lines of supervision (i.e. data reporting, training personnel in new regulation provisions). Second, due to more or less objective factors, some deadlines and conditions that were previously announced as part of the new standards are now diluted (i.e. Basel III and liquidity conditions)

The banking sector in Central and Eastern Europe (CEE) moves towards a new paradigm. In the past few years the performance of the CEE banking system decreased under the pressure of volatility and uncertainty from the EU area. The banks had to tackle with the challenges of offsetting this volatility. The average capitalisation of the CEE banking sector has shrunk by 67% in the aftermath of the crisis after it surged by 52% between 2000 -2007.

Under these circumstance we see the successful bank of the near future as one which is able to effectively manage a plethora of challenges: new norms and regulations, increased risks, higher resources costs, major changes in customer behaviour (higher and more complex expectations regarding financial innovation, while customer loyalty will be more and more difficult to maintain and consolidate), fierce competition from non-traditional players. Therefore banks are

in need of deep changes regarding strategy and internal structure in order to internalise the lessons of the past crisis and to prepare for the future expectations. However, this cannot be achieved without finishing the transformation process, including the mentality change and the implementation of a new banking culture.

We acknowledge the fact that from now on the banking activity will be more complex and more difficult as it will face new customer demands while prioritising capital, liquidity and risk management. The 2011 McKinsey paper published in 2011 presented four possible strategies for the banks in this region (which we can assert today that are under way to be implemented):

- asset portfolio restructuring, which in fact speaks of prioritizing markets and clients;
- building a new regional governance model, which refers to the way banking groups can coordinate and centralize regionally;
- differentiating the products and services by segments of clients and businesses, which refers to identifying the growth engines in the region;
- Innovation, which refers to new products and services that can help to reduce costs.

We dare raise a flag for all of stakeholders of the Romanian banking sector . Ii concerns the possible new model, which banking groups from the euro zone could implement for their subsidiaries in Romania, in addition to transforming them into branches. It is possible to have a sort of autonomy for these subsidiaries in the sense of their braking off from the mother group and their transformation into independent banks from the legal point of view as well as from the capital and resources. In this way the legal responsibilities of the mother group are grossly reduced, while in the same time cutting the systemic risk of contagion from the subsidiary towards the group and reducing the consolidated costs for the group with capital and liquidity requirements. The remaining links between the group and the subsidiary will be reduced to strategy and support (IT, risk management, procurement, training, brand management) where synergy potential is achieved. But this new relationship model will see the transfer of many tasks to the host country, to its central bank and supervision body, as well as costs related to restructuring, banking resolution and deposit guarantee. From this point of view we regard it as essential for the Romanian authorities to take part into the negotiations on the new rules covering home-host relations. Same approach on behalf of other CEE countries enjoying similar status. In spite of all these changes we believe that a bank as an enterprise can navigate through crisis periods by combining good risk management with finding solutions that satisfy the principle of “on-going concerns”.

The implementation of Basel III requirements should deliver a better and more capitalized financial system. It seems that each set of Basel regulation (I, II and III) was designed also to correct the errors and unintended consequences of the previous version. The reality is that each new version of Basel regulation was more complex and less efficient. None of these led to the accomplishment of sufficiently capitalized banks in order for them to cover and absorb the shocks coming from the real economy. We deem that a thorough analysis as well as a structured decision is needed before making Basel III compulsory. This is essential in order for a Basel IV not to become a necessity. It seems that we find it difficult to shake off old habits or otherwise: “we never have enough time to properly do something in the first place, but we always have enough time to do it again”. Banking regulations must always have a purpose: to protect healthy banks, to safeguard public money and the taxpayers, to shield depositors and clients, to build the necessary framework which allows the real economy to access credits, to encourage and not to shy away from innovation – the source of progress. Past experience shows that simple rules are the best.

The report of the experts group led by Erkki Liikanen, the Governor of the Finish central bank, pointed to another controversial chapter in banking regulation – the tendency to separate investment and retail banking. In short, this report underlines the following ideas:

- Separation of investment and retail banking activities. This targets mainly propriety trading. Such investment banking activities refer to taking on risks and initiating transactions with derivatives on behalf of the bank, but using for these operations retail clients deposits. These deposits have a special regime and are guaranteed through the deposit guarantee schemes (and for which, in some cases, in order to eliminate systemic risks and protect the clients, public money were or are still used).
- A new classification of debt instruments (borrowing and debt) and identifying the instruments which should not be on commercial banks’ balance sheets.
- Extra capital requirements for investment banking for trading book with assets.
- Improved governance.

Many experts foresee a diminution of the number and force of universal banks. Some even say that investment banks and retail banks can no longer exist alongside in the same institution. In the words of one analyst: “It is almost as one would put Tesco and Harrods together under the same roof”. It is probable that the strength of universal banks will be eroded by the market forces powered as they are by Basel III (the new capital requirements, but most important the necessity of

a new banking culture). Other experts reached the conclusion that we face a form of financial capitalism, which is mainly based on “transaction banking” instead of the more solid model of “relationship banking”. Some analysts go that far and paraphrase Winston Churchill in saying that “it will not be the end of the universal bank, but it will most certainly mark the beginning of the end”.

I see some truth in these opinions but I favour the following view of the future banking system: the separation of investment and retail banking (which in technical terms would come to the distinction between propriety trading and client driven trading) under the roof of the same universal bank. Such a structure would conserve and strengthen the group synergy, with favourable effects for the clients and market.

4. Alternatives to the banking business model

4.1. The alternative to long term finance

Other types of nonbanking companies were offering funding on certain segment of the financial services market even before the start of the financial crisis. The reason for which such companies have survived and prospered after the debut of the crisis is that they satisfy the basic principle of the maturity match. The new business model of banks and the new capital and liquidity requirements push the banks towards shrinking their long term assets, while funding themselves more from deposits and less from borrowing. Under such circumstances, long term projects (infrastructure, leasing, and real estate) are most affected. The EU banks are by far the biggest player on this market at global level occupying almost two thirds. According to the IMF data (The Economist 2012a), in 2013 the EU banks could shed almost USD 2.8 trillion of their assets. This is quite a significant and difficult balance sheet restructure with potential negative effects for the real economy, including for the Romanian one.

However, one must acknowledge that there are significant amounts of funding which by definition have long term maturity – insurance as well as pension funds. This is the case because the insurance and pension sector have by definition long term liabilities. Moreover, the insurance sector was less affected by the financial crisis than was the banking sector since it did not take part in the spiral of short term financing (but it did have some credibility issues as it did take part in the securitization process – see the AIG case). Investing in financing long term investments could be the key to survival in the case of the pension funds due to the double challenge they face. On one hand, in an environment dominated by close to 0% interest rates, pension funds need profitable investment; while on the other hand, pension funds face increasing liabilities due to the unfavourable

demographic changes. Nevertheless, the added sums from insurance and pension funds do not match the resources raised through banks on long term for three reasons. First, the assets of these funds, although significant, are relatively low compared to the levels offered before the crisis by the commercial banks. Thus, a Morgan Stanley paper (The Economist 2012a) gives evidence to the fact that on the medium term the EU banks will cut their exposure to the real estate sector by USD 300 – 600 billion, while the insurance and pension funds can only offer USD 100 – 200 billion. Second, there are regulation issues. Regulators and supervisors do not agree with long maturity assets on the balance sheets of insurance and pensions funds because they are quite illiquid. Third, there are some behaviour barriers, because traditionally pension funds invest their money in assets like stocks and bonds of companies with very good rating, but never in some private infrastructure projects.

4.2. The alternative to medium term financing

The reduction of banking finance will create another serious problem in Europe. European corporations finance their activity up to 90% from the banking sector. In the US the banking sector is the source for only 25 -30% of the corporations finance needs. The current challenge for the European companies is to find an alternative source for around EUR 8.1 billion (Barclays report quoted in The Economist 2012a) funding needs, as the banking sector increases the cost of credit and targets activities with lower risk. The US experience suggests that the only possible answer for the European companies is the capital market. However, the European capital markets raise funds amounting to only EUR 1.3 billion presently (The Economist 2012a).

However, this does not suggest that banks will completely abandon this business. There is a cultural reason behind it. In time, banks have forged strong relations with their clients, be they corporates or households, leaving the banks with significant knowledge of their customers. Besides, the capital market simply does not have all the necessary tools for financing a company. Therefore, banks may become consultants and arrangers both for the companies and for the capital market for the medium term financing. The banks will help with advisory services the process of raising medium term capital, by forming partnerships with institutional investors.

Such an activity will be profitable for banks as it allows keeping the client portfolios and the special relation with these clients, without taking on new risks, while all the same making profit from the advisory and from arranger position. In order to strengthen the credibility of this new concept for the clients, the banks could keep on their balance sheet a part of the finance effort -underwriting (and

also of the risk). This new trend raises some concerns related to the attitude of Europeans towards capital market in general and capital market risks in particular. A new addition to this subject comes from the current international negotiations for the regulation and supervision of the shadow banking sector, aiming at preserving financial stability by eliminating the systemic risk induced by this sector into the banking sector. The main items in these negotiations are the money market funds, collaterals to repo and securities lending operations. More to the point, European authorities in general, and Eastern European ones in particular (Romanian especially) have to undertake major changes regarding their policies and the regulation for the development of the capital markets.

4.3. The alternative to short term financing

Short term assets are by far the most interesting for banks from the risk point of view under the present circumstances. However, from the point of view of the cost of finance, such assets are no longer advantageous, as the cost of cash or very liquid assets operations is higher than zero, despite the next to 0 interest rate environment. There are at least two reasons for the proliferation of alternative short term finance sources (peer to peer finance). First, small and medium enterprises do not have medium and long term financing needs in order to become a point of interest for the banking sector. Moreover, such enterprises do not have the appropriate profile to qualify for financing through the capital market. Second, the risks of small and medium enterprises are too high, since they do not have a predictable cash flow and business cycles triggers major restructuring among such companies. The main two reasons which made possible the alternative short term financing companies are the following:

- banks almost abandoned the short term financing activities before the financial crisis;
- the technological progress allows such alternatives to function with very low costs.

Other pros of such alternative sources of financing are a consequence of the fact that with fierce competition in this sector companies providing financing are interested in offering customer tailored products. There are at least four types of financial relations describing alternative peer to peer short term finance:

- credit to small and medium companies (trade receivables)
- credit to individuals;
- participation with equity in innovative start-ups;
- payment platforms for receivables.

Nevertheless, short term financing through peer to peer transactions cannot replace the short term amounts borrowed through the banking sector despite its diversity because the former are incomparably smaller than the latter. Therefore, banks will remain the main players on the short term financing market for the time being due to a number of inbuilt advantages:

- their size (providing for territorial expansion),
- the nature of their activity (supplying to their client services related to current accounts, payment systems and savings),
- their ability to provide for deposit guarantee.

5. Near future challenges for the Romanian banking sector

5.1. Imbalances in the Romanian banking sector

There are some issues related to the business model of the banks in Romania despite the fact that they did not need governmental intervention for bailouts. First, the Romanian banking sector have imbalances even if from the point of view of solvency and provisions for NPLs they can measure up with the banks in developed European countries. The main imbalances are the result of mismatches in the maturity of assets and liabilities and the structure on currencies of assets and liabilities respectively. Both these imbalances can generate liquidity risks. This element is even more important if coupled with the fact that Romanian banks use clients' deposits as the main source for financing their assets.

Another risk factor to the business model of the Romanian banks is the fact that their mother banks have not yet significantly curtailed the funds sent to their Romanian branches. Thus, in the aftermath of the financial crisis the foreign parent banks of the Romanian banks have only reduced by 6% the amounts transferred to their Romanian branches. This situation will dramatically change as international provisions related to capital; liquidity and unified supervision come into force. The funds transferred to the Romanian banks will diminish as foreign parent banks will have to recapitalise and decrease risk (through shortening the maturities of their assets). Romanian banks will reduce their participation to the money market instruments which require large liquidity as their foreign parent banks will be forced to keep larger amounts of cash in order to satisfy the new liquidity requirements. Many banking entities in Romania might be restructured or closed altogether as their foreign parent banks will be reshaped by the unified supervision. Not to forget the good prospect for M&A transactions. All the above changes will impact the Romanian banking system. Consequently the following factors need to be thoroughly thought over:

- the necessity to increase the weight of liquid assets, leading to the reduction of resources available for financing real economy (especially on medium and long term);
- the focus on attracting resources from the domestic market (Romanian and foreign currencies) due to retrenchment of foreign parent banks funds, leading to higher competition on the domestic market for resources and a possible increase in deposit interest rates;
- the restructure of balance sheets through the reduction of assets (be it by selling assets, or by not renewing credit lines) due to the new capital requirements for foreign parent banks, leading to increase distress for the non-financial sector, including bankruptcies and possible increases in unemployment rate.

5.2. The refocusing of Romanian banks

The Romanian banking sector might go through some of the following changes in the near future due to the changes mentioned above:

- decrease of borrowing, mainly for liabilities with maturities exceeding the two year maturity (real estate projects, infrastructure projects);
- increased cost of borrowing, mainly for clients with high risk profile (small and medium enterprises – SME's, individuals with low and medium income). It is necessary for the public authorities (Government of Romania, guarantee funds and the Bucharest Stock Exchange) to provide for alternative financing instruments and sources for SME's.
- increased costs for those operations which are liquidity and human resources consuming;
- upward pressures on money market interest rates as medium and small size banks will need additional resources to restructure their portfolios;
- decrease of banks' network of offices and increased layoffs; this will happen despite the fact that in Romania the network is among the least wide ones (31.7 bank offices to 100000 inhabitants) in EU, with the exception of the Czech Republic and the Baltic states, which places Romania below the EU average of 46;
- some foreign parent banks will chose to close down the business in Romania;
- increase of deposit's interest rates, especially for long term deposits (mostly for foreign currency denominated deposits);
- gradual dissolution of the advantages attached to domestic currency denominated current accounts (and savings accounts);
- expansion of self-banking services destined to clients of large local banks.

However, there is also a different reality, a success story, which was told by the FT in January 2013 and related the experience of Handelsbanken in Sweden. Such an experience is all the more relevant for the Romanian banking sector since it comes from a country that is a member of the EU but outside de euro area and also it comes from a banking sector which is deeply related to the banking sector from other countries in the region that not always share the same currency.

Mr. Par Boman, president of this bank, was revealing that he organises his weekly schedule such as to be able to discuss with the bank's clients in the field offices. By understanding client needs, Mr Boman is able to come up with tailored to client needs solutions. This strategy is able to counteract the mercenary offensive of the non-banking sector which tries to enter the market for banking services. Mr. Boman's bank tries to implement the policy of putting customers first and in this way promoting a sort of "back to the future" business model for banks, representing a mix between modern and tradition - a good risk management with positive long term effects for the bank and its stakeholders. Handelsbanken manages to open up new branches despite current difficult conditions by applying the principle of proximity which brings in new clients and businesses, thus strengthening customers' loyalty towards the bank.

In contrast to this sunny reality, in the Romanian banking sector there have been significant layoffs and offices were closed down, due to the policy of disintermediation implemented by foreign parent banks. This happens despite the fact that Romania has many regions without proper access to banking services and the financial intermediation is among the lowest in the EU. In the first semester of 2012, commercial banks closed down 352 offices, while 3700 employees were fired. This represented an acceleration compared to the entire previous year, when 130 offices were closed down and 1000 employees were fired. To date more than 8.000 bank specialists having good expertise in banking and local market have been fired. What about complaints concerning the quality of services? This evolution is worrisome for a country interested in continuing development, financing investment or reducing social and regional imbalances.

I'm totally positive in connection with Romanian banking potential and the way it will be covered. I am talking about banking for the future. The banks' business must become strong and sustainable to the benefit of all stakeholders. It is necessary that we may identify in the case of each bank its new philosophy in connection to corporate behaviour, product development and marketing, customer relationship, reputation, collective and social responsibility, and for sure I am not forgetting the credibility. In fact gaining and/or regaining the credibility is probably the core challenge facing banking industry. Revisiting risk we may say that it cannot be eliminated, " and without risk there can be no reward, no

progress and no economic growth" (KPMG Sept 2013). Risk management is one of the core capabilities of the financial services institutions, including, of course, the ones in Romania. Risk taking and risk mitigation are sides of the risk culture. It is my opinion that exaggerated "protection" and "prevention" and too much risk aversion are detrimental in a long run to the economy and living standard, and to the banks' future as well. I expect that in the business model of the near future we all see implementation of a transition from "transaction banking" to a more solid and sustainable model of "relationship banking" , placing the customer first, focussing consistently and continuously on satisfying customer's needs. Probably this is the fundamental theme on banks management response to the current and emerging challenges. The crisis has eroded customer's confidence in financial services institutions. Therefore, restoring trust and credibility in banking sector is a key priority. Rebuilding trust is not just with customers, the process includes the trust in fron of all stakeholders, including regulators, rating agencies, own employees. In this respect the bankers have to concentrate on effective and efficient competence and integrity. It will be impossible to continue business as usual. When building the bank of the future it is necessary to revisit the traditional ways of doing banking, not to forget that simple is probably the best and to bring all models to updated, modern and innovative forms per customers expectations. My own initial years in banking came to my mind. In particular those days with Manufacturers Hannover Trust Co New York accompanies by our commitment in front of our customers which includes three key words: Quality, Loyalty, Consistency. We were able to prove this many years ago and today I invite the bankers to do the same in their partnership with the customers.

5.3. The monetary policy of the NBR

The transformation which commercial banks face will affect the money market. Also, credit retrenchment will affect the real economy, as financing alternatives are slow to fill in the gap. Regulation and supervision will go through significant changes. In short, most of the commercial banks in the EU go through a process of disintermediation with a strong risk aversion. In the same time households prefer savings over borrowing, while companies use their hoarder piles of cash to finance their current expenses, avoiding any investment or modernization programmes. To complete the grim picture, on top of the austerity at the level of households, corporate and banks, the austere fiscal policies have a strong negative impact on GDP growth. It is very difficult to define an effective and efficient monetary policy in such a macroeconomic environment.

The monetary policy of NBR will face new challenges. First, it is possible that the NBR will have to implement a very active management of liquidity if the liquidity demand increases, which will consolidate its position as net creditor to the system,

or debtor in the opposite case. The pressures on the liquidity will also require some rethinking of the Treasury concerning the management of the public debt.

Second, the monetary policy will continue to be focused on achieving price stability and financial stability through strong and proactive mix of policies. The coordination of all macroeconomic policies is the only combination conducive to optimal allocation of resources in order to achieve a sustainable and inclusive economic growth.

Third, the inflation targeting regime is valid strategy for the monetary policy. For Romania this policy proved to be effective and efficient, bringing the inflation to the record low level, NBR being able to set the tone and meeting the expectations. However, the inflation targeting regime is successful each and every time the inflation rate is on a descendent path for a long time and does not have fluctuations. The end of year inflation rate might be higher than the inflation target on medium term, in a scenario whereby the Romanian economy will have a very low growth rate (lower than the potential). This happens because structural adjustment is quite sluggish in Romania.

Despite all these hurdles, I have two main messages. First, the financial crisis has brought many opportunities which are not taken advantage of. Second and more important, it is fair to say that local customers engaged in savings have natural , normal expectations that their bankers contribute to growth and development, improving customers living standards, proving responsibility towards local markets, local stakeholders. This clearly represents an important contribution to the sustainability of a bank business model and to the bank's existence on a market.

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