

# BANKS AND SYSTEMIC RISKS IN THE CONTEXT OF THE COVID-19 PANDEMIC

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## **Abstract:**

*In Romania, banks identified seven high systemic risks and three moderate systemic risks. According to National Bank of Romania analysis, two of the systemic risks assessed at a high level by banks, namely the deterioration of internal macroeconomic balances and the rapid reduction of investor confidence in emerging economies are considered the most important systemic risks for financial stability. The main negative effects generated by the COVID-19 pandemic and the possible long-term implications of the COVID-19 have been identified. This research presents the systemic risks on the financial system for the period September 2020 - September 2021, identified by the banks within the Romanian banking system.*

**Key words:** commercial banks, systemic risks, COVID-19 pandemic, financial sector, National Bank of Romania

**JEL classification:** G 21, G 23

## INTRODUCTION

The severe economic shock caused by the COVID-19 pandemic and the exceptional measures to limit its spread have a profound impact on the economy. Unlike the global financial crisis, the economic shock caused by the COVID-19 pandemic does not start in the banking sector or financial system.

In European Union, banks have an important role in reducing the economic impact of COVID-19. Today, banks are much stronger than they were in 2008, at the start of the global financial crisis. The stress tests coordinated by the European Banking Authority (EBA) showed that the EU banking sector is sufficiently resilient to cope with a severe recession, in a wide range of scenarios. The strength of banks will allow them to play a key role in managing the economic shock generated by COVID-19 and in preparing for a fast recovery. Banks can play this role by maintaining the level of credit to the most affected customers. The following measures have been taken at the international level:<sup>1</sup>

- Central banks have provided liquidity to commercial banks to promote bank loans to customers most affected by the COVID-19 crisis;

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<sup>1</sup> The European Commission - Commission interpretative communication on the application of accounting and prudential frameworks to facilitate bank lending in the EU, Bruxelles, 2020, pp.1-7.

- EU banking supervisors have provided banks with temporary operational support measures in the form of capital and liquidity to ensure that they can continue to play their role in financing the real economy;
- The Basel Committee on Banking Supervision (BCBS) has announced a one-year postponement of the internationally agreed deadline for the implementation of the final Basel III standards.<sup>2</sup> The purpose was to free up the operational capacity of banks and supervisors and to give banks more flexibility;
- Providing facilities for banks to continue to grant loans in the context of the current uncertainty.

These monetary, regulatory and budgetary measures provide resources and flexibility to banks to support the EU economy during the COVID-19 crisis.

The National Bank of Romania is involved with the entire banking system in limiting the negative effects of the COVID-19 pandemic. In this context, in Romania, banks identified seven high systemic risks and three moderate systemic risks.

This research presents the systemic risks on the financial system for the period September 2020 - September 2021, identified by the banks within the Romanian banking system.

## DEFINITION AND CLASSIFICATION OF SYSTEMIC RISKS

According to European Regulation No. 1092/2010 of the European Parliament and of the Council of November 24, 2010, systemic risk means “a risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy”.

The classification of systemic banking risks can be done according to:

- *The importance of risks.* The importance of risk combines the probability of occurrence and impact, taking into account the bank's ability to manage that risk;
- *The probability of occurrence of systemic risks;*
- *The potential impact on the financial system;*
- *The credit institution's ability to manage the risk.*

Detailed analysis of systemic risks allows the bank to establish effective measures to manage these risks and to reduce them.

In the systemic risk survey (September 2020), the National Bank of Romania identified the following ten systemic risks:<sup>3</sup>

1. Liquidity risk in the banking sector;
2. A stronger link between the banking and public sectors, due to both direct exposures (e.g., government securities, loans to central and local government) and indirect exposures (e.g., “First Home” loans);
3. Default risk for loans to the private sector;
4. Worsening of internal macroeconomic balances (domestic macroeconomic equilibria);
5. Fast deterioration of investor sentiment towards emerging economies in the

<sup>2</sup> <https://www.bis.org/press/p200327.htm>.

<sup>3</sup> National Bank of Romania - Systemic risk survey, September 2020, Year IV, No. 11, Annex 4, pp. 21-22.

- context of external and/or domestic developments;
6. Uncertain and unpredictable legislative framework in the financial and banking sector, with implications for banking sector solvency;
  7. Financial innovation and challenges to cyber security;
  8. Developments in the commercial real estate market;
  9. Higher financing costs following an interest rate hike and/or a weaker exchange rate, with a negative impact on the debt servicing capacity of borrowers, especially households and SMEs;
  10. Climate risk.

The National Bank of Romania has identified these systemic risks, with a major impact on banking sector. Also, the three elements of risk are:

- probability of occurrence,
- impact severity and
- capacity to manage the risk.

The National Bank of Romania has an important role in both the regulation and the prudential supervision of banking activity.

## SYSTEMIC RISKS IN ROMANIAN BANKS

At international level, in the context of COVID-19 pandemic, the vulnerabilities identified in banking – financial sector are increasing. In economic sectors more affected by COVID-19, the number of insolvent firms rose.

In Romania, in September 2020, the National Bank of Romania conducted the Questionnaire on systemic risks faced by commercial banks in the Romanian banking system. This analysis comprises all banks considered to be systemically important.

The main risks to financial stability in Romania are presented in the table below:

The main risks to financial stability in Romania

Table 1.

No.	Risks to financial stability in Romania	Risk intensity
1.	Worsening of domestic macroeconomic equilibria, also in terms of the structure and financing cost of the budget deficit	severe systemic risk
2.	Rise in global uncertainty and fast deterioration of investor sentiment towards emerging economies	severe systemic risk
3.	Default risk for loans to the private sector	high systemic risk
4.	Risk of an uncertain and unpredictable legislative framework in the financial and banking sector	high systemic risk
5.	Risk of the access to finance of the real economy	moderate systemic risk

*Source:* National Bank of Romania - Systemic risk survey, September 2020, Year IV, No. 11, Annex 1, p. 8.

In Romania, banks identified seven high systemic risks and three moderate systemic risks. According to National Bank of Romania analysis, two of the systemic risks assessed at a high level by banks, namely the deterioration of internal macroeconomic

balances and the rapid reduction of investor confidence in emerging economies are considered the most important systemic risks (severe) for financial stability.

Banks' views on systemic risks to the financial system for September 2020 – September 2021 are presented in the table below:

Banks' views on systemic risks to the financial system  
for September 2020 – September 2021

Table 2.

No.	Systemic risks to the financial sector	Current risk level
Risk 1	Worsening of domestic macroeconomic equilibria	Severe systemic risk
Risk 2	Default risk for loans to the private sector	Severe systemic risk
Risk 3	Uncertain and unpredictable legislative framework in the financial and banking sector, with implications for banking sector solvency	Severe systemic risk
Risk 4	Fast deterioration of investor sentiment towards emerging economies in the context of external and/or domestic developments	Severe systemic risk
Risk 5	Financial innovation and challenges to cyber security	Severe systemic risk
Risk 6	Liquidity risk in the banking sector	Severe systemic risk
Risk 7	Developments in the commercial real estate market	New systemic risk
Risk 8	A stronger link between the banking and public sectors, due to both direct exposures (e.g. government securities, loans to central and local government) and indirect exposures (e.g. "First Home" loans)	Severe systemic risk
Risk 9	Higher financing costs following an interest rate hike and/or a weaker exchange rate, with a negative impact on the debt servicing capacity of borrowers, especially households and SMEs	Moderate systemic risk
Risk 10	Climate risk	New systemic risk

Source: National Bank of Romania - Systemic risk survey, September 2020, Year IV, No. 11, Annex 2, p. 9.

The new systemic risk 7 (Developments in the commercial real estate market) and 10 (Climate risk) were introduced in the September 2020 exercise. In terms of climate risk, according to one commercial bank, losses caused by climate change and the environment are also considered important and one of the main long-term risk factors.

The main negative effects generated by the COVID-19 pandemic and the possible long-term implications of the COVID-19 pandemic have been identified, at least in terms of the evolution of non-performance rates, liquidity level and solvency.

The main problems encountered in the context of the COVID-19 pandemic relate to: payment discipline, access to finance, recourse to the public moratorium or other restructuring measures.

## CONCLUSIONS

The COVID-19 pandemic has intensified systemic risks in banking sector.

One of the objectives of creating the banking union is to improve the existing European Union rules for protection against risks, in cases of banking difficulties.

To identify and analyze systemic risks, the National Bank of Romania conducted a survey based on Systemic Risk Questionnaire.

In Romania, banks identified seven high systemic risks and three moderate systemic risks. According to National Bank of Romania analysis, two of the systemic risks assessed at a high level by banks, namely the deterioration of internal macroeconomic balances and the rapid reduction of investor confidence in emerging economies are considered the most important systemic risks (severe) for financial stability.

The three elements of risk are analyzed, respectively:

- probability of occurrence;
- impact severity;
- capacity to manage the risk.

The analysis includes the top 10 banks in the system by asset value. These held approximately 86 % of total bank assets in August 2020.

National Bank of Romania identifies systemic risks and requires banks to prioritize these risks according to the importance of the possible consequences for the financial system.

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