THE ROLE OF THE NATIONAL BANK OF ROMANIA IN REGULATING THE BANKING DIVIDEND POLICY – AN ESSENTIAL COMPONENT OF BANKING SUPERVISION

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Abstract:

In the Romanian banking system, National Bank of Romania (Banca Națională a României) in the institution which, according to Romanian law, is assigned, on one hand, with the "exclusive jurisdiction to authorize credit institutions" and, on the other hand, with the responsibility for "prudential supervision of credit institutions that authorized them to operate in Romania". One of the most important 'tools' at the command of National Bank of Romania in its 'arsenal' it uses to exert its prudential supervision of credit institutions is the dividend policy, as a means to 'streamline' shareholder returns so as to make sure capital will be available for the need of absorbing (potential) losses and also to make lending still possible, especially so during an economic crisis. For this – in principle –, prudential supervision can be exerted through restricting dividend payments to stakeholders in order to increase banks' capital buffers and their lending capacity.

Keywords: *prudential supervision, dividend, returns*

JEL classification: *E50, E58*

Introduction

The management of commercial banks must, from the point of view of the operating mechanism of a commercial bank, take care first of all to have a sufficient level of bank capital, for the normal conduct of banking activity.

Under "normal" conditions, management must take the necessary measures to increase the amplitude of credit offered to individuals and legal entities, for which a sufficient amount of bank capital is needed so that the bank does not resort to exceptional measures, namely - usually - to the reduction of bank assets, the effect of which is contraction in lending (Mishkin, 2022, p.250).

All the more so in an economic and financial crisis, when banks were having a hard(er) time due to both the fall of housing market, on one hand, and had to contend with the *increasing* number of debtors unable to make payments for their loans, on the otherhand,they are faced with capital reduction, which must be stopped quickly and decisively: as in 2008 and 2009,

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the method usually used for this was credit reduction, which *further* weakened the (global) economy (Mishkin, 2022, p.251).

Literature review

The National Bank of Romania (NBR) is, according to Romanian law, the **central** bank of Romania, the independent state institution and the *only* Romanian institution that is entrusted with achieving a fundamental goalfor a market economy, respectively with a fundamental attribution needed by it to achieve this goal:

I.The NBR's fundamental goal is ensuring and maintaining price stability (NBR, 2021, p.4);
II.Among its fundamental attributes, one of the most important is the authorization, regulation and *prudential supervision* of credit institutions, respectively the promotion and monitoring of proper functioning of payment systems to ensure financial stability (NBR, 2021, p.4).

According to Romanian law, **prudential supervision** is achieved through:

1.establishing benchmarks and indexes of prudential regulation
2.monitoring compliance with these and other requirements provided by law and applicable regulations
3.imposing any necessary measures, inclusively applying sanctions when appropriate, in order to prevent and limit banking **risks** (OUG, no. 99, 6 dec.2006, Titlul III, Capitolul I, Art. 164).

Romanian bank law makes NBR the only institution in Romania allowed tomonitor compliance with prudential requirements and other requirements provided – monitoring based onspecific reports and through inspections carried out at:

a) Headquarters of banks, Romanian legal entities, their branches and other secondary headquarters in the country and abroad (OUG, no. 99, 6 dec.2006, Art. 169);

b) The headquarters of branches of foreign credit institutions operating in Romania (OUG, no. 99, 6 dec.2006, Art. 169).

After Romania joined up European Union, BNR,as the institution responsible with authorization, regulation and prudential supervision of all Romanian credit institutions, the NBR recalibrated Romanian bank law– as part of the community *acquis*, respectively the specific policies in this regard, the emphasis falling on (Apetri, 2015, p.79):

1.Central bank independence;
2.Adjusting central bank regulations regarding payment system modernization;
3.Prudential requirements of commercial banks' lending;
4.Standardization of bank account coding (i.e., IBAN codes);
5.Gradual liberalization of foreign exchange transfer operations;
6.Adjusting regulatory requirements to combat money laundering.

In the specific field of banking system prudential *supervision*, the specific NBR*policies* in this field are, mainly, the following ones (with the observation NBR in *not* the only 'source' of(secondary) legislation on prudential supervision in Romania – NBR cooperates on this with Romania's National Securities and Exchange Commission and Romania's Insurance Supervisory Commission)(Apetri, 2015, p. 79):

1.Supervision of banking activity on an individual basis
2.Supervision of consolidated personal funds
3.Supervision of the solvency and large exposures of credit institutions
4.Extending accounting regulations to *all* credit institutions.

Methodology and Data

After economic crisis of 2007-2009, National Bank of Romania adopted measures needed for strengthening the legal framework of prudential regulation, aiming in particular to avoid the *accumulation* of risks in the banking system, by (Apetri, 2015, p. 79.):

i. Modification of computing method for personal funds of credit institutions
ii. Introducing additional requirements for preparation of alternative liquidity risk management plans in crisis
iii. Development of legal regulations to improve risk management of consumer credit.

As far as European Union is concerned, European Central Bank (ECB) absorbed the "lessons" of the recent financial crisisand, as a result, issued a series of recommendations for the effective conduct of prudential supervision of banking sector in all European Union member states, starting from the practical observation that the *essential* thing, in terms of functioning of commercial banks, is their ***lending*** activity, which can only be achieved if they protect their ***capital bases*** - the minimum target being compliance with *minimum capital requirements*.

Thus, in 2015, the ECB issued a RECOMMENDATION on ***dividend distribution policies***, indicating the following minimum requirements (ECB/2015/49):

Credit institutions should implement dividend policies prudently and in a conservative manner, so that, after distribution, they **meet** the applicable capital **requirements**, namely:

-To comply at all times with the applicable minimum capital requirements ('Pillar 1 requirements'). These include a Common Equity Tier 1 (CET1) ratio of 4.5%, a Tier 1 ratio of 6% and a total capital ratio of 8% as set out in Article 92 of Regulation (EU) No 575/2013 (ECB/2015/49, p.2).
- To meet at all times the capital requirements imposed as a result of the applicable decision on the supervisory and evaluation process for the application of Article 16(2)(a) of Regulation (EU) No 1024/2013 and which exceed the Pillar 1 requirements ('Pillar 2 requirements') (ECB/2015/49).
- To comply with the systemic and countercyclical capital buffers set out in Article 128(2), (3), (4) and (5) of Directive 2013/36/EU and all other buffers set by national competent authorities and national designated authorities (ECB/2015/49).
- To comply with the requirements applicable to them regarding the Common Equity Tier 1 ratio, the Tier 1 ratio and the “fully loaded” total capital ratio (1) – until the end of the applicable transitional period (ECB/2015/49).

These recommendations on dividend distribution policies are designed to ensure that commercial banks have *adequate* capital in any situation, or, in other words, of an adequate ***amount*** in order to *prevent* the situation in which banks have insufficient capital to cover exposure to credit, market and operational risk (Mishkin, 2022,336).

In order to make sure this is *done*, ECB has designed its recommendations around the “core” of the “Pillar 1” requirements on the applicable minimum capital requirements, namely the Common Equity Tier 1 (CET1) *ratio*, an indicator whose main characteristics are:

1) Capital adequacy ratio is an index which measures value of bank's capital divided by bank’s assets – these assets, being classifiable, from a prudential angle, according to credit and market risks, are included in the calculation of the capital adequacy ratio as ‘weighted values’, according to the risks they are subjected to (BIS, Definition of capital in Basel III);

2) Thus, *Tier 1* capital ratio is used toassess if a *sufficient* amount of capital is at the disposal of a bank, because this ratio reflects the highest level of capital quality defined by

banking legislation – these own funds usually include shares, retained earnings and other reserves.

The need to observe the relationship between banks' dividend distribution policies to their shareholders and the equity's*quality*, on the one hand, and to actively support the *increase* in the quality of equity, on the other hand, proved indispensable not only during and after the 2007-2009 crisis, but also later – namely, as an indispensable measure to protect banking systems from the effects of COVID pandemic (2020-2021), in which the imposed lockdown (including in Romania) produced a series of negative, cascading effects:

- Sudden economic contraction;
- Significant increase in credit risk;
- Increasing pressure on liquidity.

Technically speaking, it can be admitted these recommendations have the intended effect, insofar as ECB recommendations *inclusively* must be enforced by *each* bank's management. But, still, more is needed, as capital structure of each bank is different, each bank applies rules and recommendations in its own*particular* way, management of dividend distribution policies inclusively, and, above all, asbanks exist in a (banking) *system*, and so also function as its *components*.

Results

When experiencing a financial crisis, or even a financial-*monetary* crisis (i.e. the Greek crisis, *triggered* by the economic crisis of 2007-2009), the banking *system* is unbalanced, including from the imprudent distribution of dividends, in two main ways (Mishkin, 2022, p.337):

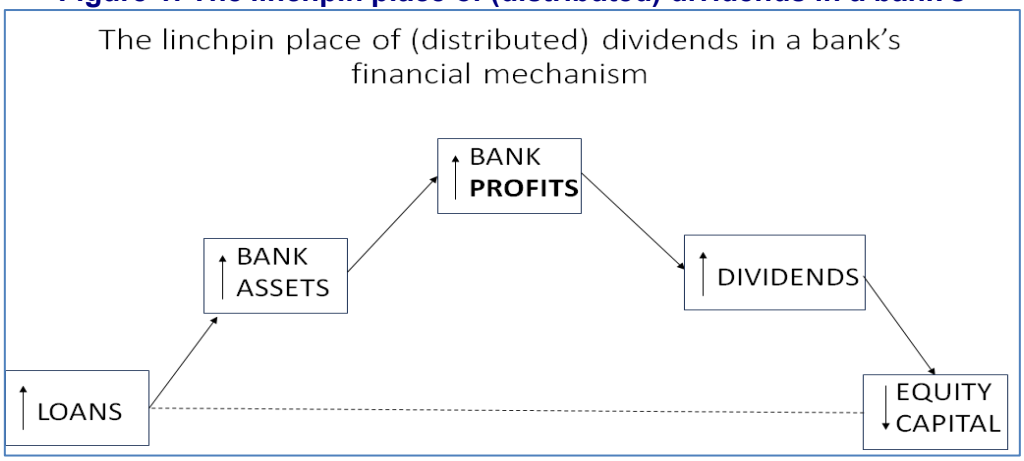
1.On one hand, the impact on the lending capacity of some banks had the effect of risks (credit, market and operational) and losses being "exported" from "ill" banks to (still) "healthy" banks - causing the latter to be negatively affected in turn;

2. On the other hand, when banks affected by the crisis, including through the distribution of dividends, tried to maintain their position by (forced) selling part of their assets, the resulting effect – e.g. the obtained effect, not the *desired* one – was a significant decrease in the value of those assets.

This bank interdependence also produced the (apparently) paradoxical effect of the technical existence of high capital ratios – i.e. 'benchmarks' box-ticking' –, in other words of standards satisfied that could not protect banks from losses. To which it is added the real, if at best marginal, inability of prudential supervision to detect (all) imprudent/risky and/or illegal banking operations.

A second interdependence is that between the effects of dividend distribution policy on bank's financial-accounting "health" and banking mechanisms from which the very distributed dividends are *issued*– namely the bank's **profit**: the increase in banking **assets** (i.e., the volume of performing loans granted by the bank) determines the increase in the bank's profit, a part of which is – or can be – allocated for distribution of dividends. Graphically, this economic mechanism is shown in the graph below:

Figure 1: The linchpin place of (distributed) dividends in a bank's



Source: authors' conception

Conclusions

The graph above is very apt to convey several conclusions, *inclusively* on the role of National Bank of Romania in regulating the banking dividend policy, with the *administrative* insights on the working and mechanisms of national banking *systems* – in our case, in European Union, in general, and in Romania, especially –, but, in the first place, on the ***economic mechanism*** with yield the very money any bank *can* use for distributing dividends to bank's stakeholders.

On one hand, there is a *link* between the size of a bank's equity capital and its loans volume – whence its asset size; and, it is a fact this link is gauged, in a sense, by the volume of distributed dividends: if this is rising, equity capital tends to fall and so the bank's power to grant loans.

On the other hand, *the circuit* described in Graph 1 *is not closed: not quite so, and definitely* ***not*** *by the (volume of) distributed dividends*, in a given quantitative frame, of course; that is, bar the possibility – or the need to counter to the best of one's ability – of an economic and/or financial crisis, distributing a 'reasonable' volume of dividends will not impair a bank's power to grant (more) 'healthy' loans, and therefore to grow its profits. But whatever dividends *are* distributed will inevitably diminish its equity capital, and so its gross *capacity* to grow its assets.

This is why a prudent bank dividend distribution policy must take into account, now and in the future, volume of said dividends notwithstanding, both the structure of its loans portfolioand the structure of its equity capital.

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