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Banks liquidity risk analysis in the new European Union member countries: evidence from Bulgaria and Romania

Angela Roman[a], Alina Camelia Șargu[a,*]

[a] "Alexandru Ioan Cuza" University of Iasi. B-dul Carol I, Nr.11, 700506 Iasi, Romania

Abstract

In a modern economy the banking institutions fulfil a double role, on the one hand they provide financial resources for investors while on the other hand they represent a trusted body for depositors. Liquidity risk may arise from the inability of a bank to provide liquidity as stipulated in the contracts, either to investors or depositors, this being extremely well underlined in the context of the recent global financial crisis. The ascension to full time members of the European Union of Bulgaria and Romania has had a tremendous effect on these countries banking systems, determining a series of changes both in the operating strategies and also in the market dynamics. Thus, the aim of our research is to evaluate the liquidity risk of the banks operating in Bulgaria and Romania in the context of the EU ascension process. In order to achieve this we have investigated the role and impact that a series of financial indicators for the capital adequacy, assets quality, management quality and profitability have on the liquidity risk of the banking institutions from our sample, the analysed period being 2003-2011. The obtained results underline that the capital adequacy ratio and the ratio of impaired loans to gross loans have a statistically significant impact on the liquidity risk of the banks operating in Bulgaria and Romania.

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* Corresponding author. Tel.: +4-0232-201-440.
E-mail address: s_alina_camelia@yahoo.com.

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1. Introduction

In any modern economy the banking sector has a key role in the financing of both the public and private sector. Banks have the know-how and the ability to intermediate between the persons and entities that have a surplus of liquidity and the ones that register a deficit.

In the case of the new European Union member states, the banking sector has registered a tremendous development starting with the year 2000. Thus, on the background of a strong economic growth, at least until 2008, the banks operating in Romania and Bulgaria have registered a development of their business, an increase of their customer base and a sophistication of their operations.

As these markets matured, banks were able to access new sources of financing, that allowed them to extend their operations. Although this had a positive impact on the banking activity it also lead to an increase of the liquidity risk that the banking institutions operating in these countries were facing. The academic literature (Diamond et Dybvig, 1983; Freixas et al., 2011) underlines that the possibility of a bank run acts as a disciplining mechanism for banks, tempering their expansions plans and making them reevaluate their liquidity position.

Regarding the liquidity risks of the financial system, the academic literature distinguishes between three types, namely funding liquidity risk, market liquidity risk and central bank liquidity risk (Nikolaou, 2009). Funding liquidity risk refers to the possibility that a bank will be unable to face its financial obligations current and future because it cannot get access to funding, thus its daily operation being negatively impacted. Market liquidity risk represents the danger that a bank will be unable to perform large operation on the market without influencing the price of the assets sold. If manifested, the prices of the assets sold by the bank drops rapidly, making the bank in the end insolvent. Central bank liquidity risk represents the inability of this institution to supply the liquidity needed to the financial system. In the context of the financial crisis, it has been observed a significant increase of the three liquidity risks, the interconnections between them being enhanced, this amplifying the possibility of illiquidity spirals to occur in the financial system.

In the case of the analyzed countries, namely Bulgaria and Romania, the ascension process and the joining of the European Union has allowed the banks to tap the EU banking wholesale market and thus have access to cheaper resources (Fisher, 2008). This has lead however to an increased exposure of these banks to market and funding risks, this type of development being underlined and debated extensively in the academic literature over time (Strahan, 2008; Cai et Thakor, 2009; Tirole, 2011). Also, these studies underline that in the event of a negative liquidity shock, like the recent international financial crisis, the banks that have a significant exposure to wholesale financing can enter into a illiquidity spiral determined by the simultaneous manifestation of the funding and liquidity risks, that in the end will determine the bank to collapse.

This subject has been an extremely important one for academics, professionals and policy makers alike, taking into account the serious implication that this topic has for the overall macroeconomic and financial stability, being thus a relevant topic considering the mainstream research in the field. Taking these into account, the aim of our research is to investigate the role and impact that a series of financial indicators for the capital adequacy, assets quality, management quality and profitability have on the liquidity risk of the banking institutions from our sample. The analysed period is 2003-2011, the research filling thus a gap regarding the determinants of bank liquidity in the context of the EU ascension process.

In order to achieve this, the paper is structured as follows: the next part is dedicated to a review of the academic literature on this topic, the third part presents the methodology and data employed, the fourth part underlines the results of the regression analysis while the last part captures the concluding remarks.

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