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ASPECTS OF BANK RECAPITALIZATION, AND IT'S IMPACT ON CAPITAL MARKETS

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Abstract: *To identify the impact of the recapitalization of the capital market, we wanted to assess to what extent stock prices of those banks that received capital infusion was changed after running the process. Thus in the work we aim to highlight: whether bank recapitalization schemes financial crisis, with European matters and the estimated effects of bank recapitalization schemes on stock market.*
Key words: *bank recapitalization, capital market's, stock price*

1. INTRODUCTION

The current financial crisis has spurred a variety of policy responses around the globe. To help struggling banks, governments have announced plans to purchase bad assets, infuse troubled banks with liquidity, help negotiate mergers in the industry and increase or even expand deposit insurance programs. One of the most important, and hotly debated, policy responses has been the announcements of capital injections into the banking sector. The approach chosen for this article is due to reactions that financial markets have encountered, as the recapitalization was announced, from "Troubled Assets Relief Program" (TARP). The increase with 3% of the securities price on the American market after September 2008, the appreciation of the US dollar, compared to other currencies, the increase of oil barrel, as well as the growth of interest rates on mortgages, were just some reactions of the market, immediately after, given the perspective of saving the bank sector. It is for this particular reason that we have focused our analysis on relevant aspects of the bank recapitalization in the USA and Europe, while making a comparative approach of the effects of a similar process which has taken place in Japan, in the 90's.

According to a report published by the International Monetary Fund (IMF), the ongoing subprime crisis has cost the banking sector losses comparable to the total losses incurred in Japan's financial crisis in the late 1990s. But losses incurred by nonbank financial institutions are estimated to be twice as high. In this environment, regulatory authorities face special challenges in accurately assessing the extent of losses and designing appropriate policy responses.

Over the past few years, real estate market and real estate loans in the USA, have witnessed a tremendous growth. It was mainly based on securing real estate loans and structuring them in various types of financial products, which were then sold to investors from all over the world, mainly to investment banks. The important banks from the USA have raised the percentage of real estate loans, from 44% in 2003, to 53% in 2007. In March 2008, Bear Stearns was facing bankruptcy, but was purchased by J.P. Morgan and thus received financial counseling from FED. Given the context, governmental authorities from the USA, more aware now of the current situation, have developed a plan, and entitled it TARP.

It was a program to purchase assets and securities issued by financial institutions, with the purpose of providing support to the financial sector.

The structure of the program brings forth the interest of authorities in ensuring the stability of the financial system, also identifying: mortgage backed securities program (MBS), the program for loan revival, the program for ensuring bad assets and the program for purchasing the shares issued by financial institutions. The most difficult aspect for this program was the price for troubled assets. It is thus necessary that the purchasing price preserves the balance between the efficiency of public funds coming from tax payers, and furnishing the needed assistance and support to institutions. (Andrews 2009)

2. CONSIDERATIONS REGARDING BANK RECAPITALIZATION

Certainly no two crises are identical. However, it is important to draw lessons from past experience to guide policymakers struggling to stabilize the world's financial markets. (Takeo and Kashyap 2008)

2.1 European settlement's in matter of bank recapitalization

Implementing the plan for financial revival in EU members, has yet again brought the attention to the effects of bank recapitalization, a widely controversial subject, given the crises that banks in Japan are being faced with. This particular measure is quite meaningful, given the current state of affairs, since it helps carry out a significant number of objectives:

- First of all, bank recapitalization contributes to the restoration of financial stability as well as the confidence in loans between different banks. The additional capital has the main role of absorbing losses as well as limiting the risk of banks insolvency
- Secondly, by recapitalization it is also intended to ensure loans to the real economy, as this prevents loan restrictions.

The recommendations of the Euro system point towards a certain methodology, based on which the lucrative rate must be calculated, for the capital provided by the government, differentiated based on the type of instruments used: preferential shares and other hybrid instruments. In compliance with the framed methodology, a fluctuating price must be preferred, in the limits of: lucrative rate for the subordinating debt and lucrative rate for ordinary shares.

In addition, it is the Commission's recommendation that the recapitalization be achieved at the current interest rate on the market. If by capital infusion, the government or any other private investors choose to have a significant involvement (of at least 30%), they will then have to accept a payment established together with the banks, so as to limit disloyal competition. In compliance with the principles that point to the necessity of preventing possible abuses or distortions of such competition, generated by recapitalization schemes, the recommendation is that capital infusion be limited to the minimum, and at no cost is it to cause an aggressive commercial expansion at the level of financial institutions.

2.2 Possible effects of recapitalization

From the many effects that the recapitalization generates, in our opinion, the most important one is that of distorting the competition. Access to capital, with a low interest rate, can have a real impact on bank competitively on European market.

Another effect is the advantage given to banks with troubled assets, which weakens global competitiveness of European institutions. Studies have been carried out in the case of possible effects of the plans of financial recovery, shortly after they have been announced, and they all revealed some similarities as well as differences between them and the ones adopted in Japan, (1997-2003). Authors, (Bebchuk 2008), (Baldwin and Eichengreen 2008), (Giannetti and Simonov 2009) speak about the “Japanese lesson” and the teachings which the American authorities should draw and apply to the current situation. What lessons does Japan's experience offer in the current global financial crisis? The first lesson concerns the timing and scale of capital injections. The second lesson to be learned from Japan's experience is the importance of setting clear policy goals for the recapitalization program. The third lesson is the importance of coordinating recapitalization and other government policies. In general, Japan's policy responses to the banking crisis were poorly coordinated and policy measures were implemented piecemeal. U.S. and European policymakers, in contrast, have made policy coordination central to their response (Diamond and Roshuram 2009)

TARP launch by the U.S. Treasury started a lot of researches and analysis on the potential effects, on which he could lead the banking system, strongly affected by the crisis. TARP represented the actual action plan resulting from the legislative package called "Economic Emergency Stabilization Act” and allowed the government to buy assets very difficult to assess or less liquid, as well as shares owned by banks or other financial institutions. Among the assets taken into consideration, we retain CDO's (collateralized debt obligations), which are certificates issued on a portfolio of loans, structured in different degrees of risk, and which have been considered a major investment of financial institutions by 2007. Therefore, a major objective of TARP has been estimating the increase of liquidity and of CDOs values. Also, the program was followed by resumption of lending, both the banks and the customers. For financial institutions entering TARP there were imposed a series of secret criteria, but largely based rating system Camels, in favor of those banks with higher chances of survival, those with solid financial situation, or those too large to be bankrupt.

In this study, we intend to show the reaction of capital markets and investors, following the announcement of bank recapitalization and paying the first installment. To this end, we followed the change in value representative of U.S. market indexes: DJIA and Standard & Poor S. Therefore, we believe that it is necessary that the market reaction is to measure change share price on the day of receipt trance, based on the previous day used. The data base consists of historical information on indices take note, during the period Oct 2008 - Dec 2009. Information on banks we selected the monthly bulletin of the FDIC. We proceeded to use a linear regression in which independent variable is represented by value slices announced recapitalization and injected into the banking system and used as a dependent variable was the percentage change in the value indices representative, providing day trances of capital from previous day. The conclusion of this testing is that in most cases, bank recapitalization cuts have not got any impact on the capital market, its evolution being influenced by other factors. Payment of first installment was perceived as a measure to rescue the banking system, having the biggest impact, having no significant influence on the next installments of the capital market as a whole. Another significant correlation is between the recapitalization and share price changes of those banks listed in the program.

In TARP were included 734 banks, 60 large size and the rest, medium and small size. In the constructed regression, independent variable was represented by trances recapitalization and the dependent variable is the percentage change in market value of shares. The conclusion of this testing is that the recapitalization had a negative effect on stock prices of large banks, and a positive effect in case of small size banks, the situation justified the different perception of investors. They considered that the provision of capital was rather a method in favor of banks affected by the crisis, more than a way of supporting the bank’s capital base.

3. ASPECT’S OF BANK RECAPITALIZATION IN ROMANIA

In Romania’s case, Romania’s National Bank has asked that the capital be increased for 12 loan institutions, with as much as 4.15 billion RON. In compliance with the recommendations of the CE, loan institutions must have a prudent rate of solvency of over 10%. So as to respect this particular condition, the supplementary capital needed must be brought in 2 trenches. The recapitalization of banks in Romania will not have public funds, in the event that they will have insufficient funds, authorities will proceed to selling share packages or petition capital infusion from the mother bank, in the case of those banks that have majoritary foreign capital. The assessment of bank capitalization risk exposure has been conducted in under stress conditions. The basic scenario (an economic decrease of 4% in 2009 and an average exchange rate of 4.4 Ron/Euro) has revealed a certain degree of adequacy of capital on the whole banking system of 9.7%. In the event of a negative scenario (economic decrease of 7% and an average exchange rate of 4.8 Ron/Euro), the average solvency of banks will be reduced with as much as 8%, and thus a capital infusion worth 6.7 billion Ron, will be required. If we are to compare the estimations made and the evolution of the economy, we are not far from partly confirming the negative scenario.

4. CONCLUSION

Even though at a conceptual level the government interventions to save the banks on the basis of the well known-principle “too big to fail” or “too many to fail”, is nothing more than another form of representing moral chance, in reality there are some situations in which the intervention of the government is mandatory. A higher focus on bank institutions, the connections that can be found between autochthon financial institutions and foreign ones, costs with the bankruptcy of an important bank, having activity out of the borders, are just some examples that point out to the necessity of such rescue operations for banks, through public funds.

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