Anti-system education

"Man is always in need of his fellows' help
and it would be to no avail for him to depend solely on their benevolence."
Adam Smith
"From a political point of view, the modern world in which we live today
was born together with the first atomic blasts."
Hannah Arendt

Mankind cannot overcome its condition because for thousands of years the educational pattern has not changed. Strangely though, the perception is reversed: everybody is taught to believe in the equal chance to success; all the while, through public order (a sort of cord which envelopes everyone's power of understanding) we convey that it is normal, meaning natural, for the distinguished to lead. These people hold an ancient aura either coming from virtue – which would be somewhat natural – but also from elitist conventions, reserved for the 1 or 2 percent of the population, insistently promoted by propagandistic institutions.

It would not be sufficient in observing current reality if we didn't describe the crude dimension of present society, which is totally perverted by the lack of political culture and the precariousness of education with respect to civilized rules. In the modern fury for the equality of chance, which functions as a curtain of the real moral constitution of people, the need for the different is perversely speculated in order to obtain – miraculously for the model, but catastrophic for human kind – the alignment to behavioral standards insistently or presented as being attainable.

In fact, it happens not differently from what used to take place in ancient Rome, where the melodrama of power had imposed seducing images and rhetorical triads which have marked our want for the altitude of the presence. What is truly symptomatic (anyway being a too eloquently a precipitate of the unnatural acceleration of hominization demanded by the Enlightenment project) does not reside in the burning of stages toward and existential formula standing apart from Nature, but lies in the expectance that the superior state will be inevitably reached without resorting to the rational rules of performance. It is essentially the modern expectation of the absolution of success, after the reflex conditioned by kid's cartoons, and not by the ideated ensemble of the context meant to trigger the intimate resorts of the identification with performance.

Somewhat condemnably, education did not break with the ancient precepts, best fixed by Plato as the initiation of the chosen (chosen by either fate, nature, gods, people), while political experience became the laboratory for validating the elitist education.

The failures of democracy (from those expressed by the permissiveness of the totalitarian path to those of the deregulation of morality) are only explained as a direct effect of unequal education under the condition of propagating the equality of chance. The consciousness of the claimed rights in a society constitutes the very quintessence of the democratic model. Educational disparities are expressed as a gradual intensity with respect to the rational appeal to social roles, especially the appeal to the consciousness of the dynamic of rights and responsibilities. The basis for this dynamic contains its cementing ingredient, called discernment. Or, the problem of discernment is at the same time a target of education and a result of social action, while in the situation where both education as well as society guard themselves against the force of the conscious, rational reactions contained by discernment, the experiencing of democracy as a formula for the equality of chances is undermined.

The educational formula of the equality of chances contains both the crisis of equality and the tangible horizon of inequality, because it is a practical impossibility for the consciousness of rights and responsibilities to be awaken in every man without exception. The dual content of the equality of chances is underlined by its implicit suggestion: it has to take place the private individual's option for the accessing of the available chances of equality. But when the miracle happens, the chance is dealt with from different perspectives and with different intellectual force, so different that they actually define inequality. Within these determinants, democracy slips toward the method of representation, a formula of political correctness through which the elitist curtain is drawn over inequality.

Even the inclusion of representative democracy within the quantum universe of the modern theory of the sovereignty of the people cannot completely hide the disfunctionalities of the educational steps, Platonically made and conserved by the Enlightenment (when the need for the creation of the Royal Society was being felt, for instance). The fashion of national schools which consecrate the technology of the access to leadership (in the French case for example, through the École Nationale d'Administration) points to the endurance of the Platonic type of elitist education in the era of maximal belief in the advantages of the democratic political system. It's in the elitist atmosphere (e.g. City College of New York) that the ideas regarding the use of power to moral ends has been forged, including here the use of power for the overthrowing of political regimes in the name of values such as freedom (and this in situations where the emblem of international life is democracy). These are the tangible leads of the tutelary vision of education at odds with the frontispiece of expectations of a world normalized by political action.

Marin Dinu

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Transformation/Innovation or Patchwork? Juxtaposition of Public Policy Process and the Role of Leadership in a Chaotic Environment: Is a New Paradigm in the Make?

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Abstract. *Public Policymaking processes are viewed by some as intertwined relationships of offices, public leaders, and issues, all of which constantly change in a kaleidoscope-like fashion as Gerston (2002) puts it nicely. With historically unprecedented economic debacle now facing US and the world the issue of public policymaking and its implementations come to the fore. At the same time the question of how the leadership of the society at the highest level has played such a decisive dysfunctional role in creating such fiasco and what the potentials are for a turn around occupies everybody's mind. The tenet of this paper is to examine if new efforts and rescue plans, supposedly for bringing some order to the economy, will eventually result in fundamental and long term social and political changes in the very fabric of both public and market systems.*

A corollary to this is whether such long term changes – if materialized – would eradicate the old systems, and move toward a real transformation. Issues like the nature and processes of public policymaking, leadership in terms of power, transparency and accountability will be addressed with direct reference to the approaches adopted by Congress and President elect. An analysis of the new direction of public policy making and institutionalizing a kind of transformative leadership that permeate the whole public administration system is the crux of this paper's argument.

Keywords: public policy direction; leadership factor; recovery plan; transformational leadership; accountability; transparency; emerging paradigm.

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Introduction

The direct economic situation in the United States that was unfolding in the past two years with housing bubble bursting like a big explosion and stretching over like a tsunami over the financial market has caused the nation and the world an unprecedented shock due to its enormity, pervasiveness, and the requirement of huge amount of resources – in some cases even beyond the capability of governments – to cope with it. Some called that the collapse of capitalism the way we know it. Others attributed that to lack of sound and prudent policies and of incompetency of government and it Chief Executive Office, namely the President and his cabinet, overlaid by greed and dysfunctional stock market in general and loose, unregulated derivatives segment of it, in particular. Whatever is or are the cause(s) of such fiasco, attention has once more been attracted, and in very dramatic way, to the role of public bureaucracy in harnessing the unleashed animal called the financial market as the backbone of the free market economy. Ironically in the United States since some 20-30 years ago with the so called champions of free market and privatization polices promoted by former President Reagan and followed through by his successors particularly in an irresponsible fashion by the present US administration and Congress alike created such a phony economic exuberance that apparently everybody, including the financial and economic gurus both inside and outside the US, lost sight of the emerging tsunami. There were, however, few insightful experts who warned since some three years ago that we were heading towards one of most unprecedented economic fiasco of the century due to national debt and continuous budget deficits to no avail since the so-called top decision makers and power brokers, due to personal interest or inherent negligence common to incompetent people at the top, dismissed such warnings. The expansionist nature of the US government in the past eight years in creating expensive and unnecessary commitments for the nation through such adventurisms like Iraq war and fueling other conflicts in the world as well as un-harnessing the stock market and its affiliates to virtually do whatever they wanted to, led to such a dire situation. One cannot forget the former US President advocating free market theory that may have worked many decades ago unqualifiedly as the best way to achieve economic growth and prosperity. He even pushed for the social security contribution by millions of tax payers to invest in stock market rather than in Social Security fund.

While one can argue that there are many causes for creating such a debacle nationally and globally, this paper attempts to focus on two major causes that, in this author's opinion, played a decisive role in this situations both directly relate to the role of government. First, is the issue of Public Policy, how it is formulated, manipulated and implemented resulting in dire consequences when based on wrong premises and without active participation of public. The second has to do with the issue of leadership in that if the Chief Executive Officer, namely the President, and other key players are competent leaders or just power hungry players using their power excessively in pushing their personal agenda.

The paper focuses on these two issues first, and then it will address if, based on this terrible recent experience, a new paradigm that embraces a different approach and orientation to public policy formulation and implementation is in the shape. If so, what different leadership approach at the national level, and by its extension at the state and local levels, might be merging to give the people the power and the say they should have in dealing with societal problems. Evidences of such new development can be observed by what happened in the recent US Presidential election that will be addressed later in this paper.

The economic fiasco

The failure of US housing sector that came to surface in early 2006 and was mostly ignored by both private and pubic sectors until the enormity of the foreclosures in millions hit to the surface. The consequences of failure in derivative segment of the market that nobody could even imagine to have such a scope, eventually, led to an economic debacle unprecedented in a century. Banks started to fail starting with investment giants like Leman Brothers, Merrill Lynch, Fannie and Freddie (even though they were quasi-public organizations) and later AIG – the giant insurance company –, caused massive government intervention and rescue plans costing taxpayers hundreds of billions of dollars and counting. That followed with continuation of unprecedented falling home prices, foreclosures wave and failing of major banks like Washington Mutual, Wachovia, and then lending crunch that forced government with huge intervention in terms of rescuing these institutions and reducing Fed interest rate to a lowest level in recent years, a meager 1%. It did not help much though and the stock market continued to crash. Dow Jones dropped from the high 12,000 to as low as 7,000, and Nasdaq from 2,600 to 1,400s level without getting to the bottom yet. It seems that the failures do not have any end since the whole auto industry is on the brink of being vanished and the large banking system in the world, Citi Corp, needs to be rescued by government to avoid more catastrophes. Many have written on the causes of these problems and what government has to do for correcting the situation. But the reality indicates that nobody knows what the real solution is. As a sample of reactions to the government bail out, here is an excerpt of what Crutsinger wrote about the initial interventions:

President Bush on Tuesday announced a $250 billion plan by the government to directly buy shares in the nation's leading banks, saying the drastic steps were "not intended to take over the free market but to preserve it". Nine major banks will participate initially including all of the country's largest institutions, he announced, in a move that sent stocks soaring on Wall Street... Some of the nation's largest banks had to be pressured to participate by Treasury Secretary Henry Paulson, who wanted healthy institutions that did not necessarily need capital from the government to go first as a way of removing any stigma that might be associated with banks. It was the latest in a long series of moves taken by the administration and the Federal Reserve over the past several weeks to prop up a weakening financial industry (10/14/08).

On the issue of owning the private companies' share in response to government financial help, Paulson, the Treasury Secretary, says "Government owning a stake in any private US companies is objectionable to most Americ,ans — me included", he added "Yet the alternative of leaving businesses and consumers without access to financing is totally unacceptable." Among government intervention was spending $250 billion this year on the stock purchases and another $100 billion would be needed in connection with covering bad assets. That would leave $350 billion of the $700 billion program, presumably to be spent by the next president (Crutsinger, 10/14/08).

With the proposal, the United States follows similar plans announced across Europe, almost all intended to inject money into the banks and unfreeze the credit markets. Markets around the world have rebounded on news of the coordinated efforts although temporarily.

Surrounding with many controversies on such drastic measures, Krugman tried to put government unprecedented intervention into perspective. He stated that "Some skeptics are calling Henry Paulson's $700 billion rescue plan for the US financial system "cash for trash." Others are calling the proposed legislation the Authorization for Use of Financial Force, after the Authorization for use of Military Force, the infamous bill that gave the Bush administration the green light to invade Iraq. There's justice in the gibes. Everyone agrees that something major must be done. But Mr. Paulson is demanding extraordinary power for himself – and for his successor – to deploy taxpayers' money on behalf of a plan that, as far as I can see doesn't make sense. Some are saying that we should simply trust Mr. Paulson, because he's a smart guy who knows what he's doing. But that's only half true: he is a smart guy, but what, exactly, in the experience of the past year and a half – a period during which Mr. Paulson repeatedly declared the financial crisis "contained," and then offered a series of unsuccessful fixes – justifies the belief that he knows what he's doing? He's making it up as he goes along, just like the rest of us, but Mr. Paulson is demanding extraordinary power for himself (New York Times, 22/9/08).

Regardless how we look at this terrible situation, one can easily see that in the present globalized environment with the ease of interactions created by internet and other advanced technologies, people and institutions alike, for personal gains, will internationally or inadvertently create problems that go beyond the boundary of a single nation. The question is that can the market economy with its traditional tools of oversight, self-control and monitoring respond to such a huge change? The answer seems to be negative judging by the recent events. That brings the new role government to the fore in securing the people's interest and those of nation via different initiatives and mechanisms that go beyond what was being preached before particularly in the past couple of decades in terms of privatization and deregulation, that in fact might be the culprit of the present fiasco. Zomorrodian and Matei have explored some specific information on the amount and type of interventions governments on both sides of Atlantic made like infusion of money into the failing companies, helping financial

institutions and getting some share of their equity, and rescue plans as examples of how deep and pervasive such interventions have been. They emphasized the role of government in not only helping the private sector but actually becoming a partner of them at least for a while (Zomorrodian, Matei, 2009).

The role of government

While in recent years many new labels have been created for Public Administration, when discussing the increasing complexity and dimensions of its issues, agenda, and challenges, as Shaftritz and others state, some attempts have been made to link the need for new approach or reformulation of public sector roles and responsibilities as well (2005). It is hard to think that in spite of new proposals in recent years like the New Public Administration Movements as manifested in the works of Polidano and Hulm (1999), Pollitt (2000), and Baaklini (2002) fit the full-fledged fundamental changes for a new "paradigm" using Kuhn's terminology (1974). On the other hand, at the same time some proposals, mostly coming from the West, pushed for moving towards privatization, deregulation and a host of other initiatives that would put the role of the public sector and government less colorful. Such movement, as indicated in a host of literature on development and comparative administration as well as New PA, seemed to have been the modus operandi of the public administration community in the past two decades to say the least (Zomorrodian, 2007). At the same time, Matei and Matei (2008), analyzing the development of public administration in the context of Europeanization and globalization, describe the emergent trends towards a European model of public administration. Now with sudden collapse of the market economy in US, followed by Europe, and stretching into Asian and other countries, one has to pause and look back at the authenticity of such movements and attempts to shift the rather traditional philosophy of public Administration to a less regulated market mentality. It is not the intent of this paper to explore the authenticity of public administration models proposed in the past few decades or suggesting that the market economy, the way we know it, is coming to an end. Rather, it takes the position that regardless of what kind of modified public administration theory and public-private partnership have been in place, a different model of market economy will emerge after this unprecedented crisis. Nonetheless, there seems to be a solid fact that the role of public policy process and authentic leadership in the public sector would be the essential ingredients of any viable emerging government system. As an integral part of such development issues like checks and balances, transparency, citizens' participation and oversight, and most important of all, ethics – not just in prescriptive term but as an indispensible pillar of government and public operations – seem to be the central cluster of any emerging paradigm.

Such changes, nonetheless, must be addressed with the globalized nature of government activities in mind, a topic that has been addressed in the literature and research findings including those of United Nations in the past couple of decades. The

promise of globalizations for economic and social development has not always been positive to say the least, and now with present economic turmoil such negative views might get more rigor and visibility. However, along with such negativism the potentials like expanding markets, huge amount of flexibility, use of advanced information technology and internet, creating economic values in a very efficient an effective way should not be ruled out completely. Point being that globalization had made the business of governments and their responsibilities so complex across the board in coping with the adverse impacts of globalization like environmental concerns, hegemony of powerful countries, and struggle of a majority of developing countries in Africa, Asia, and Latin America in providing a decent life for their citizens. Added to that are fights against poverty, illiteracy, fatal diseases like Aids, as manifested by the U N Millennium report and goals (UN, 2005), are examples of serious global challenges facing all nations. Along the same line are failures of international agencies in helping those countries due to their aggressive, if not dysfunctional, imposition of imported democratization, manifested by the outcomes of misguided one size-fits-all policies. Market liberalization, free trade, defensive budget approaches of international organizations like IMF, WB, and WTO, and impositions by hegemonic powers, among many others, are examples of such dysfunctionality. Ironically new closed knit of globalized financial institutions caused the spread of the recent economic crisis that started in the US and then Europe and other countries through globalized notorious deregulated transactions know as "derivatives" that seems to be the main culprit of such a world-wide problem.

While New Public Administration Theorists have tried to come up with some relevant and partially contextual recommendations in making the public administration functions and processes more relevant to the new realities of the present time, it seems that both the nature and the pace of real world changes are way beyond such propositions. One can easily take issue with some of these recommendations like for example the excessive and misplaced privatization and deregulation that worked adversely and are major part of the present dysfunctional market economy. On the other hand emphasis on transparency, checks and balances, and oversight, that constitute their very useful recommendations, were unfortunately not taken seriously by many public administration systems. In spite of all different academic discourse and some valid recommendations in coping with 1990s Asian and other crises, recent developments in US, Europe, and other countries proved to be of a different sort of problems. Massive financial intervention by US government in a wide range of financial institutions that goes well beyond providing government backed loans and stretched to rescue plans and even ownership of company shares signals a new era for both market economy the way we know it as well as the role of government. This time either due to obvious globalized nature of the problem – financial crises facing US and Europeans alike – or the enormity of the problem that may result in the collapse of the world financial system, it seems that

inevitably both sides of Atlantic as well as other countries have to come together for a kind of harmonious policy approach to cope with such enormous problem. Examples like attempts by both US and EU countries to formulate programs for reducing the administrative expenditures (Zomorrodian, Matei, 2009, Matei, 2008), and putting the economic crisis at the top of the agenda in Davos Conference, are indicative of such trends (Davos Meeting 09). Considering all this, the two salient issues that stand tall in addressing the new direction of government and the role of public bureaucracy in the light of new economic and global situation deem to be the Pubic Policy process and the Leadership factor.

The pubic policy process

Public policy in today's environment is a kind of dynamic process more than before. If we look at the American political scene in the past 25-30 years there has always been a big push for limiting the role of government and giving primacy to the private sector and market to help the economy and put it on the path of progress. Emphasis on "Deregulation", less government, pushing authority to the state and local levels, privatization, as well as other similar measures, all were examples of efforts to give the market a kind of prominence in order to, supposedly, put people in charge of their assets and making decisions about what is right for them.

However, it seems things did not go the right way and problems started to loom since some two years ago resulting the financial system crash in US and Europe as well as other countries. Such unprecedented event caused many to raise doubts about the market economy's functioning as the best way for economic growth and sustainability and people as well as some governments started to lose faith in market mentality as supreme regulator of the economy. All these caused a kind of reactive measures by the government to safeguard the economy in terms of massive infusion of money into the market and intervening into its otherwise independent functions. Such reactive policies were by no means in line with the dynamic nature of the processes that calls for well thought, well designed, and balanced policy agenda through public participation. Rather it was a kind of firefighting approach that nobody knows what would be the consequences for better or worse. Let us first look at some general definitions of the public policy, its processes and dynamics, the role of citizens in shaping it as well as challenges ahead for this process in this volatile environment.

Gerston (2002) define Public Policymaking as intertwined relationships of offices, public leaders, and issues, all of which constantly change in a kaleidoscope-like fashion. He contends that it is the combination of basic decision, commitments, and actions made by those who hold or affect government positions, and the said initiatives direct the flow of resources that impact the public (p. 3). Therefore, it is in their own best interest that citizens are conscious of policy, and be involved to make a social economic impact on the decision making process. To make the public policy effective, it has to ensure the major role of citizens in formulating it as well as providing sufficient

checks and balances in its implementation. The raising of salient public questions by the populace is a key step to policy development, one that not only brings attention to important issues, but helps open the door for ensuing public debate. And while the ideal is not always forthcoming, this system that allows for active citizen engagement can help sway the promotion of sound regulatory outcomes that balances the needs of all stakeholders by keeping policymakers in check. Of course, putting theory aside, reality is much more complex, but at least in democratic societies this ideal can be striven for.

The shaping of public policy in democracies is distinct in its features than in other forms of government. In the United States individual citizens, organizations, and elected officials are all key players in the public policymaking process. It can also be assumed that the process almost always involves efforts by competing interest groups whose intent is to influence policymakers in their favor. Therefore, it is not surprising that debates often occur over proposed legislation and the allocations of funds. While policy development in a democracy can be complex in nature, very simply put, it involves the raising of an issue or problem to governmental entities, the consideration and debate of various strategies by policymakers, the implementation of decisions through laws, regulations, etc., and the evaluation of a policy's effectiveness after it has been implemented (Gerston, p. 17).

In recent years, several policies have been implemented and promoted with the intent of encouraging patriotism through volunteerism (Gerston, 2003). An effective mechanism for avoiding dysfunctional conflict and achieving consensus in setting public policy agenda would be utilizing the triggering mechanism. There are four core principles within this mechanism. Evaluating these processes will help to ensure less conflict and a greater opportunity for consensus. The four components are: Scope, define "How Widespread a Problem"; Intensity, identify "How Troublesome a Problem"; Duration, clarify "How Long a Problem"; and finally Resources, analyze "Costliness of the Problem" (pp. 33-36).

Constituencies and the political decisions: There are several groups interested and heavily engaged in the public policy process. They include the political parties, interest groups, lobbyists, big businesses, the media and the public. Each of these groups can have a significant impact on the political landscape and can apply a great deal of pressure to policy-makers. Every individual and group is afforded the opportunity to participate in the policy-making process. There are those who choose to remain silent when it comes to political issues while others have become highly effective at leveraging their power to influence the policy-makers. These influential individuals or groups carefully consider which political policy-making group to influence on each issue. Their strategies and tactics will be significantly different when trying to influence a homemaker as opposed to a Senator on a given issue.

In order to understand each group, the Horn et al. (2004) identified six political policy-making groups. They provide some insight into their agendas, points of view and

decision-making processes. The groups are identified as:

- Boardroom Politics: represents the influence that large corporations and companies have on our political process. The private sector has a major influence on political agendas (p. 66).
- Bureaucratic Politics: involves 2.8 million federal employees and another 17 million State and local government employees. Most of these individuals are responsible for administering programs and providing service to citizens (p. 89).
- Cloakroom Politics: policy making that occurs in the committees, sub-committees, council chambers and legislatures of the nation. This type of political decision-making is "perhaps the most visible, open, chaotic and human" (p. 121).
- Chief Executive Politics: is very popular with the American people. The public embraces highly visible and charismatic public figures that demonstrate leadership and a willingness to make decisions. Chief Executives tend to address highly visible issues.
- Courtroom Politics: deals with the occasional situation where the courts find themselves in a position to make policy instead of their usual role of implementing policy made by other branches of government (p. 224).
- Living room Politics: Individual voters head up the Living room policy-makers. Everyone has the opportunity to have their voice heard through their votes and participation in the governmental process.

The interdependence that exists among these groups creates a support system between these policy-making groups that extends down to the state and local government levels. Bureaucrats make up another important group of policy-makers in the system. They are referred to as "the fourth branch of government" (p. 7). Horn et al. state that "Overall, one of the greatest of American public institutions is their indecisiveness." (p. 293). This indecisiveness is caused partially from a fear that their decisions will not be viewed favorably and partially because elected officials are concerned about the opinion of the public and special interest groups. The policy-makers need to stop worrying about themselves and their next election and focus on doing what is right by their constituents. Decisions and policies made with the best interest of the people in mind will speak for themselves.

One of the problems today is that there appears to be a gap between active citizenship and politics. Many individuals in our society tend to think of politics primarily as elective activity. They either have forgotten, or are not aware, that grassroots advocacy has always had a great impact on the political landscape, that participatory politics helps steer the policymaking process. Working for change takes active citizenship that involves time, energy, and effort. As a result, many Americans tend to leave policymaking decisions up to elected representatives. Current apathy toward the political system is another issue in the United States that is also influencing public policymaking engagement today. Participatory government is what our nation is based on; however, its intent was meant to inspire more than just the casting of a vote. Fortunately with an unprecedented level of

participation in the recent Presidential Election, it seems that, through exercising the right political leadership, citizens and young people in particular have recognized that what a heavy cost they have to pay if they remain indifferent and do not participate in the political process in shaping their destiny.

The leadership factor

Much has been said about leadership in the past several decades. Going from Great Man approach to Trait theories, Behavioral theories, Situational/Contingency models, and then stretching them to the Contemporary leadership approaches like Transactional, Transformational, Servant, and Super leadership, all come up with two factors of *leader* him/herself, and the *situational factors* surrounding the leadership environment.

As for the first one, the leader's qualities constitutes the focal point in leadership studies since the ancient time. Popularized by Great man theory, this notion was refined to incorporate new look that those qualities, whatever they might be, that can be learned on the top of leader's inherent traits and predisposition. Examples of such traits have been specifically four of the five general personality dimensions predicted leader emergence and/or leader effectiveness (Emotional Stability, Extraversion, Openness and Conscientiousness). Global leaders because of their high visibility roles are expected to exhibit traits like extraversion, openness, conscientiousness, and emotional stability. Emotional stability is important in leadership effectiveness because it is part of emotional intelligence. Emotional stability is an important factor in having a global mindset. It is important that a global leader be in control of his emotions and knows how to skillfully control the emotions of followers.

Zaccaro and Klimoski express that leadership performance imperatives are derived from the organizational context, which becomes entwined in this obligation as well as in the content of organization or system's direction (2001, p. 7).

More recently traits have been addressed by a new popular term i.e. "emotional Intelligence" that is considered an integral element of most modern leadership styles like transformational, charismatic and servant leadership.

As for the situational factors in leadership environment, they came into fore since late 1970's and dominated the study of leadership until the present time in that the situations leaders are facing are becoming so volatile, changing, and unpredictable due to changes is politics, technology, economy, culture, as well as many other factors, prompted by the forces of globalization. Such situational factors are determinants of what the modern time leadership has to consider and incorporate them into the adopted leadership approach regardless of personal preferences and even what proved to be successful in the past by a given leader. Situational theories in particular pointed out to factors like the nature of organizational functions, size, type of employee, technology, culture, among others at the organizational level. Added to that at the political and societal level, factors like global, economic, political, security,

cultural as well as other relevant factors need to be addressed in choosing a given approach or style of leadership.

Along with this broad classification as a distinctive contemporary approach "transformational leadership" seems specially to be called for when a system – organization or society –needs fundamental changes and turnaround. At the societal level it seems such transformation applies to massive and fundamental cultural changes, inducing new values and strengthening value systems that have been forgotten or have not taken seriously, and replacing the old with the new ones. As Daft states that Transformational Leader (TL) can take the organization (and any system for that matter) through several major changes by successfully achieving the following:

1. Create compelling vision
2. Mobilize Commitment
3. Empower Employees
4. Institutionalize a Culture of change

(Daft, 2005, pp. 507-508).

Thus Transformational leadership is not only forward-looking, but at the same time can be seen as inspirational and ethical process based on the legitimate values and leader's credibility that enable the followers to internalize those values.

While traditional transformational leadership considered the change as its main impetus and accordingly the functional qualifications of the leaders were the key, in recent years due to focus on the followers and pressing needs for cultural and behavioral changes as well as the complexity of issues at hand, such leaders must also enjoy qualities that are normally attributed to the charismatic leadership.

Charismatic Leadership as defined by Robbins accounts for how followers make attributions of heroic and extraordinary leadership abilities when they observe certain behaviors (Robbins, 2005 p. 363). Prominent figures in the political, military, and social arenas like Kennedy, Clinton, Martin Luther King, Mother Teresa, and Gandhi on the positive side and Adolph Hitler, Charles Manson and Jim Jones, on the negative sides are examples of Charismatic leaders. A recent example as will be addressed later may be Barak Obama the President elect of the Untied States.

Several characteristics of Charismatic leaders identified by Conger and Kanugo, as reported by Robbins are ability of these leaders to articulate visions; taking personal risks, sensitivity to the environment, sensitivity to the followers and unconventional behavior meaning engaging in behaviors that are perceived as novel and counter to norms (2005) Thus in a sense Charismatic leaders are more or less change agents like Transformational leaders but with a stronger sense of dedication that may go beyond the limited boundary of a given system like an organization. Although Charismatic leadership seems to have been around since the down of history, a major difference in its new conceptualization has to do with the charismatic qualities and abilities that can be learned and the fact that such traits are not confined to exceptional people who are born with them. In fact a major issue in contemporary leadership theories across the board has to do with Emotional Intelligence (EI) as mentioned before. These qualifications that can be learned, developed and natured denote to the

ability/readiness of leaders who are charismatic, transformational, and are able to appeal to their community or society for major change and redirection. As Robbins reports, key components of EI consist of Self-awareness, Self-management, Self-motivation, Empathy, and Social skills, all giving the leader sufficient proficiency in interacting with the followers, relating to them and inspiring them toward worthy end (pp. 368-369).

The Issue of Power: At the heart of the leadership is the issue of power. Traditional leadership was considered to be the mere exercise of power. The same notion applies today too with a caveat that the sources of power have shifted drastically from formal, position-based, to other more intrinsic and enduring ones. Different types of power have been classified into three major categories. The "Position Power" in which the leader gets his or her power through position whether it is in the organization or a political institution. This is also called the legitimate power in that it is given to the individual based on the virtue of the position or the office held. Such power as Daft (2003) states – Legitimate, position Power – comes from a formal management or leadership position and varies in terms of amount that normally is tied to the hierarchy. Thus CEO's and Executive Directors, usually at the very top of the organizational, have more power than other management positions just because of the spot they hold in the organization. The same thing is true in public sector what Van Wart (2005) refers to, that department heads have more power than the subordinates, and division directors and sectaries or ministers more until you get to the pinnacle of the pyramid that of the President or Prime Minister who has the most authority due to the office she/he holds. The second source of power is "Personal Power" that either has nothing to do with the position power or builds upon it. As we move away from the hierarchical directive styles of leadership, the application of power seems to be moving from position to personal and from the quest for compliance to "identification" i.e. understanding the reason behind following a particularly path prescribed by the leader, and eventually to "internalization" that has to do with adopting the very "values" that the leader espouses and making them their own. The latter is more in line with several major styles like participative, servant, charismatic, super, and transformational leadership approaches, all moving towards empowering the followers. The third source of power comes from "Coalition and Alliances" with others. Leaders do this both for achieving goal and establishing mechanisms for joining forces in terms of capabilities (pooling resources and know-how) and or consensus and agreement (issues dealing with diversity and pluralism) as well as achieving synergy in attaining the power and ability that otherwise would be lacking for such an attainment. This last part is more relevant with the issues of public administration and at the same has great implications for achieving checks and balances, safeguarding ethical principles and timely accountability. Like any other phenomenon when it comes to power all these sources and their relevant mechanisms might unfortunately be misused by unethical and self-serving leaders. There are many

evidences of misuse of position power, and expanded power gained thru collision and alliance for attaining personal goals and agenda in private, public and international arenas, mostly refer to as corruption. While most examples of leaders who are relaying on their personal power and charisma are positive both at the organizational and political/societal levels, there are instances for leaders who misled the followers toward illegitimate and even destructive goals based on either extreme ideology or personal whims. The expression that "power corrupts" stands tall at all time and calls for reliable mechanisms for checks and balances. Corruptions are not limited to the misuse of power and in some cases based on untested ideologies of decision makers. Adopting untested policies, ambitious goals for personal aggrandizement to satisfy person egos, and incompetency and lack of know-how at the pinnacle of executive branch might also be culprits of unfortunate consequences. In retrospect, the move for excessive privatization of government functions that "began most notably in the 1980s during Reagan administration in the US, and the Thatcher administration in the UK" (Shafritz et al., 2005) and then spreading world wide without sufficient monitoring mechanism are examples of such deviation. Such unleashed efforts, while providing some short term gains brought many destructive consequences like the Asian Financial Crisis in 1990s, two recessions in US, in early 1990s as well as in 2001, and eventual the big one, today's Financial and market crises, all due to the assumption that a free rain market has the ability "Smith's invisible hand" to correct its failures.

The issue of trust, ethics and transparency: It is now a common theme that most of recent malice in financial crisis has been to a large extent due to lack of transparency, misuse of trust, and lack of ethics in those who made decisions and had leeway to serve their self interest at the huge expense of the public and the country. Such lack of transparency apparently was due to factors like excessive deregulation, failure of regulating agencies to even enforce the existing laws and regulations, as well as complacency –if not cover up – by their allies in public sector. Part of it can also be attributed to poor leadership of the high executive office due to its incompetency, directive approach to leadership, believing in the executive office as the supreme decision maker. The present crisis has called for an immediate attention to urgency of systems that ensure accountability, legitimacy and ethical behavior at both national and international levels. Lack of transparency and exceeding the boundary of legitimate power by public officials across the globe, including the misuse of power by executive branch whether intentionally or due to incompetency, and problems in lacking oversight resulting in corruption and lose of public confidence in both corporate governance and public institutions, all major challenges callings for different approaches to leadership and governance. One would imagine that after scandals in private companies a few years ago exemplified by notorious cases like World Com, Global Crossing, Tyco, and Enron, both private sector and government had learned their lessons and would take corrective as well as preventive actions. We just realized a few

years later that such situations were just the tip of iceberg and public regulating agencies and oversight mechanisms were not either in place or too obsolete to deal with those problems, all denoting to the very fact of government – executive – incompetency.

Emerging-paradigm

The recent US Presidential election, among many things, revealed that people at the time of crisis will stand and defend their rights, and in this case their survival. In light of looming economic crisis, it seemed that there were some legitimate as well as a few undue promises by each side of the presidential campaign on promises, capability of their selected leader, and what they can do for the future of the country. For example Republicans, while mostly ignoring issues and policies, looked at their presidential candidate as a veteran leader with lots of personal qualifications, but totally ignored their inexperience, untested, and uniformed vice presidential nominee. Democrats took their case mostly by addressing the issues and policies that according to them were handled poorly, if not disastrously, in the past 8 years of the Republicans Administration. They also emphasized the role of leadership justifying that the leader should act as a change agent, have a transformative personality and should not fit the profile of traditional leaders who mostly depend on their repetitive experience.

Regardless of such positions, as a student of public policy and leadership, this author thinks that the two issues of pubic policy process and leadership go hand in hand. Good policies are needed to reflect the realities facing the society and people's needs, with both short and long terms implications at the national and global levels. At the same time the competent and progressive leadership that can materialize those policies with a kind of build-in flexibility and effective mechanisms for ongoing monitoring and corrective actions are called for to be manifested by a visionary, inspirational and transformative leader. The connectivity of these two elements is like the link between Strategy formulation and strategy implementation in the business world and the role of leadership in that process:

Strategic Leadership has also a decisive role in the implementation process. The role of top leadership in that respect is both symbolic and substantive. Two authors argue that leader's action and the perceived seriousness of his or her commitment to the chosen strategy (or policy) significantly influence the intensity of subordinate managers (administrators) commitment to the implementation of that strategy (Zomorrodian, 1998, p. 34).

To support and reinforce such commitment, expanding advocacy, outside government groups, like NGOs, activist groups, unions, etc., like for example "Repower America", an environmental advocacy group, play a decisive role if we want the country wants to maintain and enhance the enthusiasms and participation of majority of people in the political process. Such efforts definitely should target changing the political culture. As Horn et al. indicate "One of the major themes in *Politics* is the powerful influence that political culture has over the policy making process"

They make it clear that political culture often leads powerful government players to make symbolic statements and actions that in reality carry little weight in actually changing a particular situation. They continue to state "….The thrust of such arguments is that administrative policies, either purposefully or unwittingly, are designed not to solve problems, but to appease or legitimate certain interests and to provide an institutional forum in which recognized interests can compete for influence over policy" (p. 106).

Being fully aware and cognizant of such inherent nature of political culture, President elected Obama decided to create the Economic Recovery Board in white House, headed by highly respected Veteran, Paul Volker, to bring outside people together from academia, business, labor and others to critically evaluate the administration's economic policies and provide rigorous feedback to the President (Press Conference 11/26/08). This is on the top of the two existing boards, The National Economic Council headed by Lawrence Summers, and as director and Christina Romer as chair of his Council of Economic Advisers coupled with appointment of Timothy Geithner to be his treasury secretary (Press conference 11/24/08).

With such initiatives even two months before taking the office, Obama proves not only to understand what is at stake, but also that some major transformational changes are badly needed in terms of political culture, opening the doors of government to outsiders for critique and contribution, avoiding "group think", a symptom of malfunctioning government experienced in the recent administration as well as a few in the past. He directly asserted these points in his interview with Barbara Walters when her tried to justify the creation Economic Recovery Advisory Council by say that this council's purpose is to " rigorous analysis of econ recovery plans, using outside members by business, labor, academicians, bring fresh and outside viewpoints, and to avoid group think" (ABC 20/20: 12/26/08)

It so ironic that even in the face of the biggest economic crisis in the past 70 years with such dire social, political, and even global consequences, serious divides still permeates the political environment. Conservatives who are mostly responsible for the past 8 years mistakes and misleading the public repeatedly are lamenting those fundamental changes are moving the country towards socialism and even Marxism. Nothing is far from the truth. One can see such assertions from the Right wing Republicans like Paul Grant of Georgia, Rush Limbaugh, and Ann Gouter who call the President's elect policies and direction as radical and Marxist, some nasty political gimmicks. Regardless of partisanship, one also wonders how the main stream press and not just conservatives and hate media, have lost the real mission of critical analysis of the events and fell into trap of complacency and compliance with what the existing administration is preaching. This is part of the political culture that needs to be changed drastically by removing the iron fist of medial Mongols who can fire independent journalists and reporters due to their alliances with a given political party or systems. Media needs some revolutionary changes too. Bringing fresh, independent and courageous journalists and reporters might bring the lost confidence in such powerful instrument of

democracy along with fundamental changes in government and providing people with real education and information about the realities of serious crisis facing the nation and the world.

In spite of these difficulties and challenges, one can see evidences that the American government in moving towards a new paradigm. A new model that promotes and brings Transparency, Ethics, and Responsibility to the government operations, and taming the unleashed market economy by institutionalizing reasonable checks and balances through appreciate oversight and monitoring mechanisms. One can hope the new President proves to be a true transformational leader who not only imitates and promotes such new direction, but is able to sustain it. There is a place for optimism by looking at his initial appointments to the high offices along with the judgments extended about his qualifications by respected political, military, and social veterans and champions of change like Kennedy and a host of other Democrats and Republicans alike. A good evidence of this is what Collin Powel stated in his interview with NBC when he supported Obama's candidacy. He said, among other things, that Barak Obama has a vision, understand the issues, has judgment and in short is a transformational leader (NBC 10/19). While from the academic viewpoint such political support might not mean much what differentiate Powel's opinion from the others is that he comes from a totally different ideology and values base, and such endorsement affirms Obama's role as transformational leader. It is ironic that the Obama camp in spite of their main slogan, Change, and late "Change we need" rarely address the nature of the change as transformational.

However Obama in his victory speech addressed clearly a few major elements that normally transformational leaders attend to, not to mention that he also blends such qualities with traits and abilities of a charismatic leader by presenting the harsh realities and difficulties facing the nation as well as a vision that embraces hope and responsibility:

... I know you didn't do this just to win an election and I know you didn't do it for me. You did it because you understand the enormity of the task that lies ahead. For even as we celebrate tonight, we know the challenges that tomorrow will bring are the greatest of our lifetime – two wars, a planet in peril, the worst financial crisis in a century… The road ahead will be long. Our climb will be steep. We may not get there in one year or even one term, but America – I have never been more hopeful than I am tonight that we will get there. I promise you – we as a people will get there… For that is the true genius of America, that America can change? Our union can be perfected. And what we have already achieved gives us hope for what we can and must achieve tomorrow (Obama Speech 11/4/08 Grand Park Chicago, Illinois).

Whether Obama can really start a kind of revolution to put the role of government into the right perspective and expedite the move towards the new "paradigm" of government and public administration remains to be seen. Based on his actions some two months before he take the office and with assertion that the question is not

about big or small government, and rather it is about a "smart " government seems to be encouraging. His efforts in changing the political culture and getting away from the irrelevant slogan of overzealous privatization advocates that "no way the government does anything right and no way that market does any wrong" as well as motivating young generation to join public service for the sake of serving people are the main elements of a new way of thinking and a different system of responsible government. The three major pillars of new paradigm must be to institutionalize a vial system for participative public policy, a transformative leadership across government as well as private sector, and built-in mechanisms for transparency, checks and balances, and responsibility.

Post script

Since this research paper was competed a couple of months ago new evidences show that in fact the "new paradigm" with regards to public and global policies by Obama is in the shape as his initiatives and events surrounding them are taking unprecedented changes in a very fast pace. Just in the first ten day being in the office, Obama took many gigantic steps to reshape not only the US public policy agenda and processes, but targeted the global image of US and a total redefinition of its policies and approaches. Looks he walks his talks!

On the domestic side:

- He put together one of the strongest cabinet in recent history in a very bi-partisan fashion.
- He restricted the lobbyists activities and made it much stricter for while House staff to get involved in such activities even after leaving their jobs.
- He approached the opposition party by going to Capitol Hill and have a face-to-face dialog with them over his Recovery Plan.
- He proposed an ambitious $800 plus billion Recovery Plan to ignite the credit market and housing recovery.
- He has made the government activities very transparent and created a web site so that the public can see expenditure items in the recovery plan.

On the global/international front:

1. Appointed the most visible and strong personality, Hillary Clinton, to the State Department with new agenda.
2. Immediate intervention in Palestinian/ Israeli conflict by assigning a veteran politician, George Mitchell, as a special envoy.
3. Re-stated that troops will be pulled out from Iraq in 16 months.
4. Appointment of veteran Richard Holbrooke as special envoy to Afghanistan/ Pakistan.
5. Executive order of closing the controversial Guantanamo Bay Prison in one year.
6. Explicit commitment to honor the international law in dealing with wars and conflicts across the board.
7. Interview with Al-Arabiya TV addressing the Muslim World that U.S. is no longer their enemy and extended a hand for friendship to them, and most important of all declaring that:

his approach is not piece-meal, but an all inclusive, holistic one for coping with both domestic and global problems in order to deal with and remove root causes of such problems lingering for years, exasperating during the previous administration.

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Towards a New Approach of the Economic Intelligence Process: Basic Concepts, Analysis Methods and Informational Tools

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Abstract. *One of the obvious trends in current business environment is the increased competition. In this context, organizations are becoming more and more aware of the importance of knowledge as a key factor in obtaining competitive advantage. A possible solution in knowledge management is Economic Intelligence (EI) that involves the collection, evaluation, processing, analysis, and dissemination of economic data (about products, clients, competitors, etc.) inside organizations. The availability of massive quantities of data correlated with advances in information and communication technology allowing for the filtering and processing of these data provide new tools for the production of economic intelligence.*

The research is focused on innovative aspects of economic intelligence process (models of analysis, activities, methods and informational tools) and is providing practical guidelines for initiating this process. In this paper, we try: (a) to contribute to a coherent view on economic intelligence process (approaches, stages, fields of application); b) to describe the most important models of analysis related to this process; c) to analyze the activities, methods and tools associated with each stage of an EI process.

Keywords: economic intelligence; informational watcher; information search; decision-making process.

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JEL Codes: 32O, 33O
REL Codes: 14A.

Introduction

In the knowledge-based economy, economic intelligence and ICT (Information and Communication Technologies) represent basic components of competitive research and innovation strategies. In this paper, the concept of "economic intelligence" refers to the product resulting from the collection, evaluation, analysis, integration and interpretation of all available information, supportive of the decision-making processes pertaining to the organizational goals of stability, security and development. Focused primarily on information available outside the organization, the scope of Economic Intelligence (EI) covers wide fields, ranging from information technologies to market or legal topics. Economic Intelligence is closely correlated with other information management approaches such as Knowledge Management (that works, in our opinion, on information collected inside the organization), or Business Intelligence, that excels in the use of software tools dealing mainly with quantitative information. Economic Intelligence mainly addresses users in need of up-to-date information in order to make the best decisions in the framework of a defined strategy. The range of ideas associated with this concept is enormous, and the scientific community is far from being homogeneous or aligned to a common approach. The purpose of this research is to answer a few questions: (1) "Which are the basic concepts related to Economic Intelligence?" (2) "Which are the methods of analysis related to Economic Intelligence process?" (3) "Which are the methods and tools for supporting an Economic Intelligence process?"

Regarding the methodological approach we have used:

(a) the systematic consultation of online bibliographic databases; (b) the progressive consultation of books rich in bibliographical references; (c) the systematic consultation of the collections of journals on this subject; (d) elaboration of an analysis framework for the prior research; taking into account the criteria for analysis elaborated previously in other research; (e) data analysis (content analysis and descriptive analysis).

1. A "classical" approach of "Economic Intelligence"

From the beginning of the earliest writings that have made reference to different models describing it, the Economic Intelligence has sometimes been presented as a communication system, sometimes as a monitoring process, as a defensive practice or otherwise offensive to some, as a set of methods and management tools for others and eventually as a management style. The concept has evolved over time, from the initial form of "Business Intelligence System" to the current acceptance of "Economic Intelligence".

H. P. Luhn (1958, p. 314) advanced the concept of "Business Intelligence System" in 1958. The notion of *intelligence* is defined here, in a more general sense, as "the ability to apprehend the interrelationships of presented facts in such a way as to guide action towards a desired goal." Wilensky defines the "organizational intelligence" as "the problem of gathering, processing, interpreting, and communicating of the

information needed in decision-making processes" (1967, p. 3). For Baumard, the "Economic intelligence" is not just an art of observation, but also an "offensive and defensive practice of information. Its purpose is to connect several fields together, in order to better serve the tactical and strategic objectives of the firm. It is a tool of connection between the action and the knowledge of the firm" (1991).

The Martre Report defines Economic Intelligence as the set of coordinated actions of search, processing and distribution for exploitation, of useful information for economic actors (Martre, 1994). These actions have been carried out legally with all the necessary protection for the safeguard of the company's patrimony, and with the best quality, delay and cost.

According to Lesca (1995), the "competitive intelligence" or the "strategic vigil" is the information process with which the organization carries out the "anticipation" listening of those "weak points" of its economic environment with the creative goal of discovering opportunities and reducing risks related to uncertainty.

In Besson and Possin's view, the "economic intelligence" is the art of detecting threats and opportunities by coordinating the collection, sorting, storage, validation, analysis and dissemination of useful or strategic information to those in need. It will involve adequate protection at all stages of its development: acquisition, processing, exploitation and protection of informational patrimony. In essence, economic intelligence is an informational cycle whose purpose is to produce strategic and tactical "high added value".

In 2004, Bertacchini considers that "territorial intelligence" (concept related to "economic intelligence") can be compared with the territoriality which results from the phenomenon of appropriation of resources of a territory; it consists in know-how transmissions between categories of local actors of different cultures" (2004).

According to Juillet (quoted by Kislin, 2007), the economic intelligence represents the control and protection of strategic information that enables the entrepreneur to optimize the decision-making.

According to Salles, these definitions show that there are four major periods (2003) in the evolution of the Economic Intelligence concept:

- The first period, corresponding to the 1980s and early 1990s, where the definitions are primarily focused on processes, tools and techniques that are described in detail (the definitions of Wilensky, Martre and Lesca, for example);
- The second period, which covers the 1990s, where the definitions concerned primarily the use of economic intelligence or strategic vigil and its overall objectives (Besson and Possin);
- The third period, which began in the late 1990s, has emerged the concepts of co-management and collective intelligence, organizational learning and collaborative work;
- The definitions of the fourth period began in the 2000s, and include in addition to previous notions, those of cultural identity, regionalism and the concept of "economic defense" (Bertacchini, Juillet).

In conclusion, Economic Intelligence concerns the set of concepts, methods and

tools which unify all the coordinated actions of research, acquisition, treatment, storage and diffusion of information, relevant to individual or organization in the framework of a strategy. These processes are coherent, permanent and interactive and can induce real changes in decision-making mechanisms. The development of Economic Intelligence in enterprises can affect all the dimensions of the business. Economic Intelligence, based on a set of structured methods and tools, will bring about important changes in individual and collective behaviour.

If we try to find common characteristics for all these definitions, we must emphasize the following key points:

(1) Economic Intelligence is an ethical and legal business practice; it is distinguished by espionage because it uses legal means exclusively;

(2) The focus is on the external business environment;

(3)There is a process involved in gathering information, converting it into intelligence and then utilizing this in business decision making.

The professionals of this domain emphasize that if the intelligence gathered is not usable (or actionable upon) then it is not intelligence.

Alternative approaches, including *Competitive Intelligence* (CI), could be considered more or less similar to Economic Intelligence. CI, developed and widely used by American companies, is a concept that represents a monitoring approach and process, oriented towards the market environment and to enhancing marketplace competitiveness. It uses similar methods and tools as those of EI but aims more specifically at the analysis of information regarding business competitors. The widely adopted *Business Intelligence* focuses on dealing with quantitative information and the software methods and tools to process it, such as Data mining or Data Warehouse. The concept of *Technology Watch* refers to a system focused on the active monitoring of technological topics or issues, such as patents, Intellectual Property Rights, research, standards, trends analysis and foresight programs, in order to provide intelligent support for decision-making. Economic and Technologic Intelligence (ETI) covers the same field as Economic Intelligence, especially stressing the aspects linked to technology. ETI as a concept is widely used within the framework of European Commission for research and development programs.

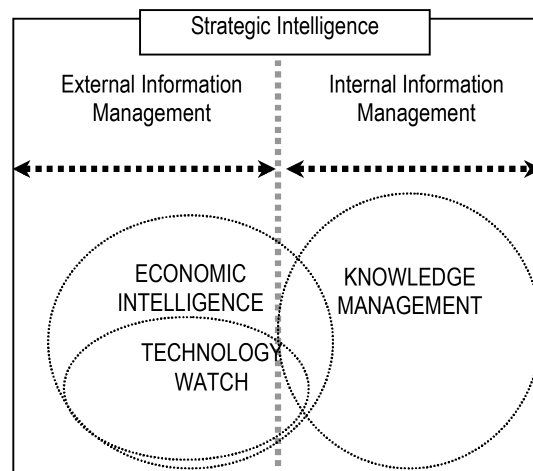

Figure 1. *Fields of application of the different concepts of intelligence*

Source: Cetisme Project, 2002.

On the other hand, Knowledge Management focuses on the existing knowledge inside the organization and comprises a range of practices used in order to identify, create, represent, distribute and enable adoption of insights and experiences. The differences between Knowledge Management and Economic Intelligence concern the fields of application of these concepts (figure 1).

Other intelligence techniques and methods, such as Defense and Lobbying, are sometimes called Strategic Intelligence (intelligence provided in support of strategic decision-making). Sherman Kent defined strategic intelligence as the "kind of knowledge a state must possess regarding other states in order to assure itself that its causes will not suffer nor its undertakings fail because its statesmen and soldiers plan and act in ignorance" (quoted by Choksy, 2005). The concept of Strategic Intelligence is usually employed in France and other European countries as including the areas of Economic Intelligence and Knowledge Management.

2. Economic intelligence: analysis models

We described the economic intelligence as an approach with a dominant informational dimension, which is built around a surveillance process represented by a series of coordinated operations by which the collected information becomes usable, useful and therefore worthy of interest for a decision-maker and a particular decision problem.

The different characteristics of economic intelligence that we have previously presented have highlighted several dimensions of its approach. The inclusion of one or more of these dimensions allows the design of various models used for the analysis (conceptual and practical) of economic intelligence (Bournois, Romani, 2000):

- The dimension called "ecological" characterizes the business environment (partners, competitors, markets, etc.);
- The internal actors of the company represent the "psycho-sociological" dimension;
- The external human networks claimed and mobilized around the project, define the "reticulated" dimension;
- The teleological dimension corresponds to the final purpose of the approach through strategy development;
- Finally, the technological dimension includes all the methods, tools and techniques used for the entire process of decision support through surveillance process, information protection, or benchmarking, for example.

We have selected for analysis four models built on these dimensions: the model presented by F. Jacobiak, the AFDIE model, the model of P. Achard and the analysis model of Salles.

Jakobiak proposes a model of economic intelligence based on five main points (2004):

- A doctrine which consists of the definition of the concept of Economic Intelligence recognized by the whole group;
- An approach consisting of: (a) a

master plan for moving from theory to method (what information flows to whom and for what purposes, what actors will intervene-project manager, monitors, analyzers, policy makers, etc.) in order to develop and implement a coherent strategy; (b) a master plan to develop this method and to introduce the structure, control mode, cost problems and schedule;

- A federated structure of two networks: the network of concerned information poles (the selected monitoring areas) and the network of analyzers (the groups of experts and the selection of critical success factors);
- An experiment which defines the general operational rules of economic intelligence within the organization: the degree of freedom for each group, the recommendations and guidelines, media and technical support (software, materials, etc.), data storage (types of information taken into account);
- A quantitative and qualitative control.

For Jacobiak, the cornerstone of the economic intelligence project is the network of analyzing experts: this is where the raw information transmitted by the observers is transformed into developed information, usable and interpretable by decision makers. The model separates the phase of observation and the phase of analysis and isolates the different actors involved, by interposing a high number of intermediaries. This fact can produce many inconveniences in the communication chain between the main actors of organization.

The AFDIE (Association Française pour le Développement de l'Intelligence Economique) model outlined five basic principles of economic intelligence leading to sustainable performance (Besson and al., 2001):

1. The integration and taking into account of the environments in anticipation logic;
2. The organization design based on collective intelligence;
3. An organization built around systems and networks;
4. A combination of a managerial logic and entrepreneurial logic;
5. Adhesion to a Code of Ethics/ Deontological Code.

The AFDIE model consists of eleven factors (seven action factors: leadership, ethics, forecasting, environment perception, knowledge and skills, influence, networks' organization - and four result factors: value creation, information quality, image, decision-making process) with the same relative importance and without any ranking among them.

This is seen as a system where the performance and the general equilibrium depend on the level of interactions' adjustment between all its parts, not just the excellence of two or three of them. Therefore, the weakest link will determine the fragility of the entire company or organization.

According to Achard model, the implementation of an economic intelligence system can be realized in 5 phases (2005):

(a) A planning phase to define what the expectations of economic intelligence unit are;

(b) A research phase for "people needed vs. skills required";

(c) A phase of positioning economic intelligence in the organization's inner core

as an internal provider system accompanying missions and decision-making objectives, while participating in obtaining information useful at all levels;

(d) A phase of developing EI process in terms of surveillance dimensions, information gathering, processing and dissemination in accordance with decision-making objectives.

(e) An evaluation phase through a measure of model performance, with criteria for qualitative and quantitative assessment.

In the model of Achard, the informational watcher is a basic component of an EI system, providing leadership and system coordination in a sense of complicity with the decision-maker.

The Economic Intelligence approach proposed by Salles (2003) is built on the MEDESIIE method that realizes an analysis of decision-maker needs. The conceptual architecture of this method is based on the definition proposed by Seligmann (1989) for the characterization of the information systems design methods. According to this author, any method necessarily relies on four components (or "way of"): a paradigm (a view or a way of thinking), one or more models (formal representations) to be built, an organizational approach (milestones, success factors) and finally the tools and implemented practices.

The Salles model is a mega-model that consists of five units of analysis:

1. A model of the enterprise established according to its different functions (production, economic, financial and innovation);

2. A model of the environment, congruent with the model of Porter (competitors characterization, markets, conditions of supply, etc.) and which highlights the endogenous and exogenous factors in the relationships the company maintains with its environment;

3. A model of strategy, in order to identify the core competences of the company and to define issues and key tasks (research independence, growth of its business, increase profits, etc.);

4. A model for the collection, analysis and validation of needs;

5. A model of defining the economic intelligence products, that consists in a mockup made according to collected needs in order to identify the cost, power and scope to assess a priori the effects.

In this model, economic intelligence is seen as a cognitive process whose primary purpose is providing assistance in management processes and producing representations of the environment in order to create new knowledge.

3. Economic Intelligence: process, activities, methods and informational tools

The Economic Intelligence process success depends on choices made in each stage, because these choices will eventually determine the type of result. The stages of this process can be defined as follows:

1) Identification of the problems to solve in terms of threat, risk and danger;

2) Transformation of decision-problem into information search problem;

3) Identification of relevant information sources;

4) Validation of the information sources;

5) Collection and validation of information;

6) Processing the collected information for the calculation of indicators;

7) Interpretation of the indicators;

8) Decision-making for the resolution of the problem;

9) Protection of informational patrimony throughout the entire process.

Also in this process, one can identify three main actors:

Decision maker is the individual in the organization that is capable of identifying and posing a problem to solve in terms of danger, risk or threat that weighs on the organization. In EI process, there is a well established flow from raw data, to the highest level of information quality. This process starts with the data sourced in the "real world". The information is analyzed in the context of the personal standards, criteria and expectations of the decision-maker to become knowledge (figure 2). Finally, the decision-maker applies this knowledge to a particular situation to create intelligence.

Information watcher (or *watcher, market watcher, observer, knowledge manager, information specialist, information analyst*, *intelligence manager, record manager, scientific surveyor, industry watcher, gatekeeper, news master in Anglo-Saxon terminology).*The range of concepts from practice referential associated with this profession is enormous. In fact, all the above mentioned concepts refer to the person within the organization that specializes in the methods of collection and analysis of information. His objective is to obtain indicators (based on collected information), or value added information that the decision maker depend on for his/her decision process. After receiving the problem to solve as outlined by the decision maker, the information watcher must translate it into information attributes to be collected and which are used to calculate the indicators. The abilities and skills required to be an informational watcher are set out bellow in Table 1.

End user: this is the final user of the system; it can be either of the previously mentioned users or neither of the two. This user can be identified depending on which layer of the Economic Intelligence system he interacts with.

In order to avoid wasting time and resources making the wrong choice, it is best to initiate the process with an organizational diagnosis (Cetisme, 2002). This should analyze both the hard elements (strategic-structural: law, politics and economic aspects of the working environment or functional: planning, comparing results with efforts, role and task distribution) and soft elements (organizational climate, motivation, various levels of communication, leadership style, problem-solving capability and distribution of power) with the aim of discerning the way they function with respect to the organization mission and objectives.

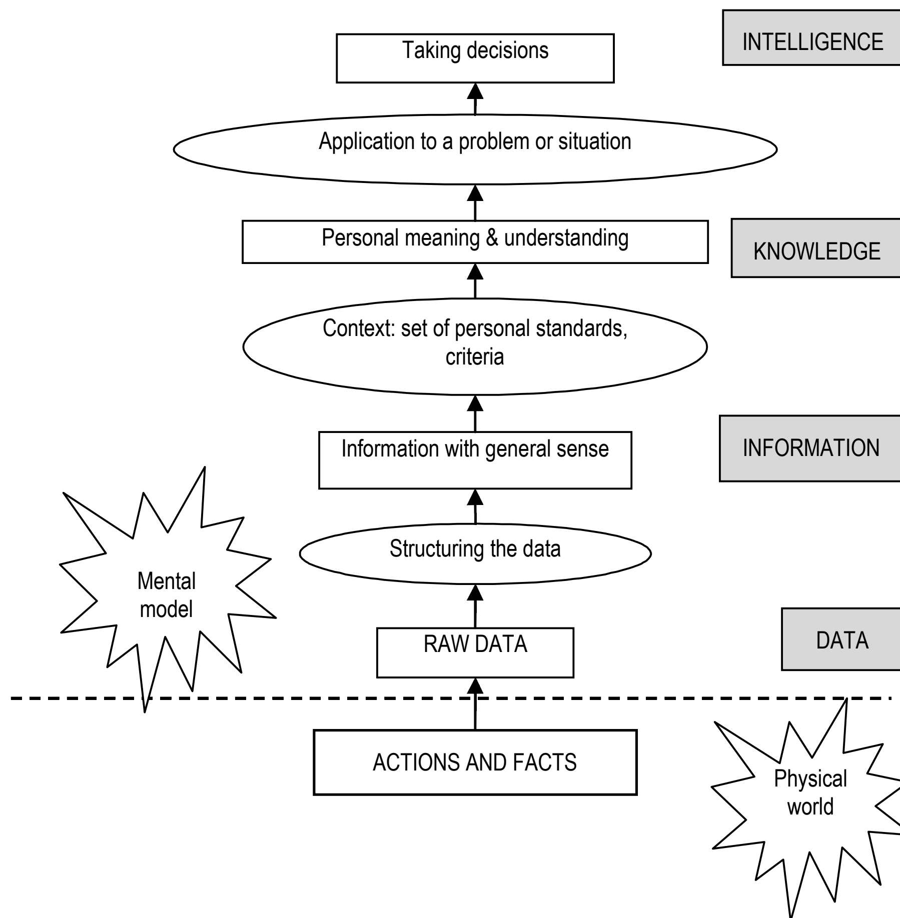

Figure 2. *From data to intelligence*

Source: Cetisme, 2002.

The "organizational diagnosis" should be comprehensive, including the analysis of the firm's ethics, the organization's well being, and other components.

An internal analysis of current information flows is the next key step. This step must offer an answer to the following questions: (a) Is the current approach satisfactory? If not, why not? (b) What is the current flow? (c) What is the organizational culture? (d) Which channels does the organization currently use and which could it use? (e) How is information disseminated into the organization? (f) What kind of information is disseminated to customers or partners? (g) Are employees and managers motivated to disseminate information? How?

Replying to these questions will help identify internal weaknesses (threats, risks and dangers) and therefore provide an indication of how to improve the internal information flow.

We consider that the majority of implementation problems are the result of human conflicts inside an organization. If new procedures are imposed from above and not shared by everyone within the organization, the usual result is de-motivation (Cetisme, 2002).

The information needs analysis can be divided into the steps below:

a. Users' identification;

b. Organization analysis;

c. Identification of key critical factors;

d. Information needs definition;

e. Information available and Information gap;

f. Needs updating.

There are some questions which can help the identification of the users inside an organization: Does a strategic document exist in this organization? How was it developed? Who is aware of it? Why? How is the internal decision system organized?

Is the strategic planning activity based on information about external and internal information? Does a link exist between strategy and information gathering? How is the operational information disseminated within the whole organization?

Once information users have been identified, it is necessary to clearly assess the organization background and strategy. It is vital to clarify the following aspects:

- Organization history;
- Main shareholders and stakeholders;
- Key industry markets in which the organization is involved;
- Organization visibility;
- Management information flow.

In order to identify the organization strategy, it is important to know the answers for the following questions: What are its mission and vision? What are its main long-term objectives? What are its strategies? What is the organization's focus in the past, in the present and in the future? What is the current operating organizational culture? In which new markets is the organization planning to enter? How will the products develop? Are the values and goals shared by all the organization?

The answers to these questions offer a general picture of the organization and its requirements. In order to define an Economic Intelligence process or to improve the current one, this phase plays a key role.

The next step addresses information needs for each strategic area: market, product, competitors, technologies, environment, and customers. The use of an interview questionnaire with open questions is normally the most productive method for the identification of needs.

For each of the identified strategic areas, the current availability of information should be checked, according to the following (Cetisme, 2002):

- Accuracy of management's knowledge on the technical and economic issues of interest for the organization;
- Information priorities;
- Availability of information (who gathers it – and how?);
- Information about schedules, gathering, storing, location (when is it gathered? how is it stored? where? who can use it?);
- Details about the information flow;
- Details about the management involvement in information issues;
- Motivation of staff to report about information issues.

The EI process is a continuous, interactive and iterative process allowing fast and efficient changes. When strategy and organization change, the EI process needs to be assessed and changed accordingly.

The key information sources for an EI process cover the electronic sources (search engines, intelligent agents, alert systems, Semantic Web, News Groups, Newsletters, Weblog, Mail lists), but the traditional sources (books, magazines, technical literature, newspapers, conferences, meetings) can't be ignored.

There are numerous potentially useful analysis tools for getting value out of information in the fields of competition, markets and technology. Different levels of analysis can be conducted depending on the nature of organization´s competitive objectives: a market analysis, an industry analysis or a company analysis. Some of the techniques available include Porter´s five forces model, SWOT analysis, competitor profiling, patent analysis and benchmarking techniques. For those dealing with technical information, scientometric tools (techniques that exploit statistical scientific and technological information contained in databases including patents) can be interesting. Other tools include the technological attractiveness-technological position matrix, the technology-product matrix, core competences and those related to prediction such as foresight, methods based on extrapolation of past trends, S-curves, Delphi methods.

We believe that best practices in the validation of the information are: a) identifying the original source of the information and checking its credibility; b) checking the procedure used to obtain statistical data; c) looking for different sources for the same information, checking if the original sources are different; d) checking the information with external experts.

Once analyzed and validated information has been created, it needs to be disseminated within the organization: first to those who are personally affected by the Economic Intelligence process, and then to all those inside the organization that may find the information useful or relevant to their work.

The Information and Communication Technologies offer the infrastructure and the tools needed to assist all stages throughout the entire EI process. Many authors, like Balmisse (2005) or Goria (2006), the reference portals like INIST and BNF (quoted by Kislin, 2007) have developed directories and repositories that are relatively exhaustive, with software tools useful for an informational watcher.

The activities, methods and tools associated with different stages of economic intelligence process are set out in Table 1.

Activities, methods and tools associated with different stages of economic intelligence process

Table 1

No.	Stages of economic intelligence process	Actors	Activities & Areas of expertise	Examples of tools
1.	Identification of the problems to solve in terms of threat, risk and danger	Decision-maker	- Knowledge of immediate and extended environment (Firm, sector of activity, markets, etc.)	- Analysis methods and tools: Pareto, SWOT, Ishikawa diagram, BCG matrix, MACTOR method, value analysis, Six Sigma, Business process, etc. - MEPD questionnaire - Business Plan, Project Management, Gantt, Pert, etc.
2.	Transformation of decision-problem into information search problem	Decision-maker and watcher	- Skills for decision problem analysis and informational problem projection - Translation and contextual-lization of demands, prior research and stored cases - Defining the basket of informational indicators - Monitoring and evaluating the translation process	Needs analysis and tools (MEPD, MEDESIIE, UML, requirements engineering, etc) - Auditing method and tools, TQM, PDPA - Brainstorming tools and concept mapping - Computer Supported Cooperative Work, (Groupware tools, E-mail, E-conference, workflow) - Case-Based Reasoning Methods
3.	Identification of relevant information sources and validation of sources.	Watcher	- Search for formal and Informal sources; - Selection of appropriate sources for the decision problem, memorization, and information traceability - Valuation of the indicators by information retrieval - Crossing sources, procedures for verification and monitoring of information. - Skills and abilities for information systems and documentary languages (thesaurus, query language, creation of queries)	- Private networks - Databases, documentary software - Browsers, meta-browsers - Enterprise Information Portal (EIP) - Surveillance Software for sources - Alert agents - Intelligent agents - Specialized portals - Specialized browsers - Search engines - Documentation - Archives and other recording tools - Semantic Web
4.	Collection and validation of information	Watcher		
5.	Processing the collected information for the calculation of indicators	Watcher	- Intellectual and physical processing of documents (description, tracking, indexing, memorization, abstract, bibliography, synthesis, …) - Linguistic processing and information mapping (translations, visual represent-tations of information)	- Automatic abstracting and summarizing tools - Classification tools - Content extraction tools, concept mapping - Infometry, statistical methods and tools
6.	The adapted presentation of informational solutions	Watcher	- Elaborating a final format for presenting information (contingency tables, graphs, surveillance reports, synthesis notes, reporting)	- Birotics, PAO, - Collaboration tools, - Sharing tools - Dissemination tools
7.	Interpretation of the information.	Decision-maker	- Ability to analyze and interpret information	- Decision support systems (DSS), SIS, Data Warehouse, Data Mining - Management tools, Scoreboard, decision matrix
8.	Decision making for the resolution of the problem	Decision-maker	- Knowledge of decision-making process - Monitoring the informational indicators - Monitoring the indicators for decision-making	
* throughout the entire process	Protection of informational patrimony	Watcher and decision-maker	- Identifying, disseminating, storing, sharing and protecting knowledge - Selective dissemination of information	- Security software for systems and networks, firewalls, antivirus, cryptography and steganography - Patents, quality norms, brand image, etc. - Securization of LAN and PAN networks, Video Surveillance systems, - Intranet, virtual private networks, secured protocols and secured networks.

Source: adapted from Kislin P., 2007, p. 219.

Conclusion

The purpose of this research was to contribute to a coherent view on economic intelligence process. The prior literature reveals an enormous range of ideas associated with this concept and is far from being aligned to a common approach. This paper tries to review the nature of economic intelligence and to highlight the challenges of systematically managing economic intelligence. The current process of intelligence activity is divided by organizational function, or is related to an individual manager. An optimal management solution should combine the informational tools with the analysis and synthesis abilities of informational watcher. Managing economic intelligence cannot be subject to sole technical solutions. Enabling technology to assist decision-makers in their intelligence scanning and analysis activities is a challenging task. We expect that, in the future, effective managing economic intelligence will rely heavily on an organizational approach including illustration of organizational vision, sharing tacit/explicit or formal/informal knowledge, establishing an intelligence culture, creating an organizational memory and redesigning the process of intelligence gathering, analysis, and dissemination.

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The Internal Capital Adequacy Assessment Process ICAAP – a New Challenge for the Romanian Banking System

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Abstract. *In the near future, Romanian banks will have to implement the second pillar of the Basel II (ICAAP) Agreement. Given this new challenge (in addition to the ongoing economic and financial crisis), my article analyzes and presents both the main requirements of the process, in compliance with the NBR regulation draft, as well as some of the principles and methods used by advanced banks.*

Thus, I've analyzed some of the methods for the assessment of economic capital requirements for credit, market and operational risks (while also explaining the difference between economic capital and regulatory capital), based on the theory of unexpected losses, sustained by case studies.

Keywords: risks; economic capital; unexpected loss; default; Value-at-Risk.

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JEL Codes: G21.
REL Codes: 11C, 11E.

Introduction

In order to sustain healthy and profitable banking activities, protect the interests of their shareholders and clients and avoid inducing negative effects upon the national or, in some cases, even the regional or global economy, banks must grant special importance to the identification, monitoring and limiting of risks.

The results of the assessment of a bank's exposure to the main risk categories (credit risk, liquidity risk, operational risk, market risk, reputation risk and other) leave the bank's management with two possibilities:

- to assume the exposure towards the respective risks, as the potential losses will be covered either from the net profit obtained during the course of the bank's activities, or from the bank's own funds/ capitals drawn up during its existence;
- to take the decision of transferring these risks (for example via an insurance), of eliminating the activities which led to the occurrence of the respective risks or of limiting the exposures to a controllable level.

In this respect, the banking current practice reflects the existence of two approaches on the determining of capital adequacy/own funds covering the risks undertaken:

- one in compliance with the regulations elaborated by the prudential supervision authorities which determine the risk assessment models and the methods for the computation of regulatory capital; the Basel I and Basel II Agreements are relevant in this respect;
- the other one in compliance with the bank's internal methods for the assessment of capital adequacy to risks (ICAAP- Internal Capital Adequacy Assessment Process), mainly based on the economic capital method.

Currently, the most important international standard in the domain of risk management is the Basel II Agreement on the International Convergence of Capital Measurement and Capital Standards for credit institutions and investment companies issued by the Basel Committee for Banking Supervision.

The Basel II Agreement is made up of three pillars (segments), namely the minimum capital requirements, the supervisory review process and market discipline, the purpose of which is to achieve higher levels of security and strength of the financial and banking system.

We mention that the implementation of the Basel II Agreement at the level of the Romanian banking system has begun in 2008, but out of the three pillars only the first one was fully implemented. This pillar is the one stipulating the necessity of computing the bank's solvency indicator (capital adequacy ratio):

$$\frac{\text{Total capital}}{\text{Credit Risk} + \text{Market Risk} + \text{Operational Risk}} = \text{Capital Adequacy Ratio (8\% minimum)}$$

The second pillar of the Basel II Agreement (ICAAP) stipulated requirements concerning both the monitoring authority and the banks monitored, demanding efficient internal processes, able to assess the own capital adequacy ratio based on a proper

assessment of portfolio risks (which, in general, entail different methods than the ones requested by prudential regulations).

1. The implementation of the 2nd pillar of the Basel II Agreement (ICAAP) – a new challenge for the Romanian banking system

The 2nd pillar of the Basel II Agreement will be implemented by the Romanian banking system sometime during 2009. Its specific regulations are currently at draft stages at NBR level.

Thus, banks will be required to elaborate own strategies and procedures on the internal assessment process of capital adequacy to risks, which must cover:

a) risks for which regulated capital requirements were elaborated, in compliance with NBR and CNVM Regulation no. 13/18/2006 on the determining of the minimum capital requirements for loan institutions and investment companies, including significant differences between the regulated treatment of risks for the computation of the minimum capital requirement and the treatment stipulated for the internal capital adequacy assessment process;

b) risks that have no capital requirements regulated, namely:

- risks derived from the utilization of less sophisticated approaches (the underestimating of credit risk in the context of the standard approach; the underestimating of operational risk in the context of or basic or the standard approaches);
- the underestimating of loss given default in crisis situations;
- the residual risk afferent to the techniques used for the mitigation of credit and securitization risk;

c) risks such as: the interest rate risk derived from activities outside the bank's trading book portfolio, concentration risk, liquidity risk, payment risk, reputation risk and strategic risk.

For the risks included in this category, banks may use qualitative assessments and risk diminishment methods (in other words, they must not have capital put aside).

d) risks outside the credit institution, namely the risks entailed by the regulatory environment, economic environment or the by the bank's unfolding of activities which cannot be classified in the situations listed under let. a-c.

Given this new challenge for the Romanian banking system, I would like to present one of the principles and methods used by advanced banks (from this point of view).

The internal capital adequacy assessment process (ICAAP) is used to assess the bank's possibilities to take on risks, reporting the result of the aggregation of all risk categories to its economic capital (thus determining its coverage potential). The bank uses its coverage potential to determine its risk appetite/limits, proactively administrating its risk portfolio.

The main objectives of the ICAAP system are the following:

- the analysis, monitoring and reporting of the bank's risk exposures, as well as its capital sources;
- the analysis, monitoring and reporting of the bank's capital adequacy/coverage potential with respect to its risk profile;

- forecasts on the evolution of risk exposures and the bank's capital/exposure coverage potential;

2. General principles on the assessment of economic capital requirements

The internal capital adequacy assessment process is based on the following principles:

a) the utilization of "economic capital", which differs from "regulatory capital", defined as each bank considers adequate, conditional upon its own risk profile and experience in risk management;

b) the capital necessary for each transaction is defined by the bank in compliance with its own risk exposure assessments associated to the respective transaction, considering credit risk, market risk or operational risk, as well as other risks (such as strategic or liquidity risk, etc.).

The *economic capital* is a bank's means of protecting itself against the various risks derived from banking activities, the objective of which is the covering of all potential unexpected losses.

The *expected loss* is the average estimated loss for a transaction/portfolio in a time interval.

Banks generally compute reserves or provisions for the expected losses, which are covered by the profit achieved during the respective financial exercise and included in the price of the transaction.

An *unexpected loss* represents the possibility that the actual loss might exceed the expected loss, and bank must have sufficient capital to cover this loss as well.

Furthermore, the economic capital is the capital necessary for a bank to remain solvent in case of extreme loss (unexpected losses computed at a specific confidence level and a specific time span) occurrences due to the improper evolution of the macroeconomic environment, market conditions, the economic and financial performances of clients towards whom the bank registers exposures, as well as the manifestation of other banking risks.

The level of a bank's economic capital is determined based on the strategy used to determine the coverage degree of extreme potential losses (worst case losses –WCL) conditional upon a specific confidence level, usually below 100%.

The main reason is that the 100% percentage corresponds to the hypothesis that the bank will never undergo bankruptcy, but because the level of economic capital required in this case is very high, banks prefer using lower percentages.

In such cases, if a bank's management determines a confidence level of say 99.97%, this means there is still a possibility of 3 to 10,000 (or that the respective bank might undergo bankruptcy 3 times in 10,000 years) that the potential losses exceed the value of the estimated economic capital necessary for the covering of unexpected losses, which makes the bank insolvent.

For instance, conditional upon the methodology of Standard & Poor's, one can determine the following relation between the bank's rating and the confidence level which must be used to compute its economic capital (Ong, 2003):

The correspondence between the rating and the confidence level for the economic capital

Table 1

Loan rating put forth by the bank	Confidence level (%)
AAA	99.99
AA	99.97
A	99.90
BBB	99.70
....	

3. The analysis of the differences between economic capital and regulatory capital

In this context, we feel an analysis of the differences between economic capital and regulatory capital in compliance with the Basel II Agreement is necessary, given that some analyses/studies present the two terms as comparable in the perspective of the implementation of the new capital agreement (Burns, 2004).

For instance, the computation of the minimum capital requirements for credit risk in compliance with the Basel II Agreement (Pillar I) is based on the risk profile of the respective bank, the internal indicators for the probability of default and loss given default being used in this respect. However, when turned into a capital requirement, the same approach is used by all banks, meaning that the curves afferent to the regulated risks weights are the same (used as reference elements – proxies – for the correlation of default cases). At the same time, each bank has its own model turning risk indicators into economic capital requirements.

Furthermore, several differences may occur in terms of the risks parameters used. Thus, a bank may use in its internal economic capital assessment model an estimation of the loss given default (LGD) for the long-term which covers the entire economic cycle; at the same time, the LGD estimation used for the determining of the regulated capital reflects negative macroeconomic conditions.

Another fundamental difference between economic capital and regulated capital, computed in compliance with the stipulations of the Basel II Agreement, derives from the scope of the two types of capital. Thus, while the regulated capital requirements cover only credit, market and operational risks, economic capital requirements cover all the risks afferent to banking activities (including liquidity risk, interest rate risks afferent to the banking book, as well as concentration risk, partially explained by the Basel II Agreement, etc.).

Another essential difference is the fact that the measurement of the economic capital requirements also includes a diversification benefit which is not considered in the computation of regulated capital. The diversification benefit is represented by the assessment of the changes in the risk exposures afferent to each business line in relation with the changes in the risk exposures towards all businesses unfolded by the respective bank.

As a rule, the economic capital requirement is superior to the regulated capital requirement; more seldom, the situation can be the other way around, conditional upon the risk profile specific to the respective bank (prudent) and upon the diversification benefit.

We mention the fact that the internal capital (economic capital) assessment process relies on sophisticated models/IT

applications for the determining of the bank's exposure to risks.

Advanced banks supplement this information with information on their profitability, using a model called RAROC (risk adjusted return on capital) to fundament their business decisions.

4. Methods used for the determining of the economic capital of the bank

At least three risk categories are considered in the determining of the bank's economic capital: credit risk, market risk and operational risk (additionally, could be considered liquidity risk, interest rate risk for the banking book, etc.).

Credit risk is the main risk afferent to banking activities. It represents the possibility of registering losses or of failing to achieve the estimated profit due to counterparty's infringement of its contractual obligations, expressed in credit reimbursement failures derived from loans granted to retail and corporate clients, investments at other banks, obligations purchased, etc. (NBR Norm 17/2003). The general definition of market risk is the risk of registering losses or of failing to achieve the estimated profit due to fluctuations in the value of market prices, interest rates and exchange rates afferent to the bank's assets and liabilities.

The assessment of market risk and the determining of regulatory capital require the assessment of the following items only, not of the entire assets and liabilities portfolio:

- the bank's trading book, which requires the assessment of the risks afferent to interest –bearing instruments and shares – namely of interest rate risk and price risk;
- currency risk and the risk associated to merchandise (trading book plus banking book).

The bank's trading book includes its positions on financial instruments or on the merchandise held either to be traded or for the hedging of other trading book items (outside the banking book), namely the portfolio of shares, bonds, other similar items, merchandise and financial derivatives.

The *interest rate risk of the banking book* – occurs due to market fluctuations of the interest rate and may unfavorably affect the bank's financial results conditional upon the structure of its banking book assets and liabilities on fixed and variable interests (the bank's balance sheet minus the trading book).We mention the fact that the assessment of the capital requirement for this risk supplements the assessment of the market risk capital requirement mentioned above.

Operational risk represents the risk of registering losses or of failing to achieve the estimated profit due to internal factors (the improper unfolding of internal activities, improper personnel or improper systems, etc.) or external factors (economic environment, changes in the banking environment, technological progress, etc.).

Liquidity risk is the risk of registering losses or of failing to achieve the estimated profit due to the bank's impossibility of repaying its short-term payment obligations at all times without additional costs or losses which cannot be covered by the bank.

5. Economic capital for credit risk

In order to determine the economic capital necessary to protect a bank against insolvency, banks use internal credit risk models.

The implementation of an internal credit risk model first of all requires systems, IT applications and complex databases (such as warehouses), of which one can extract/in which one can collect information on exposures, default probabilities, recovery rates, etc.

Another important characteristic of the internal credit risk model is linked to the fact that it ensures the computation of risk indicators differentiated on client categories and credit quality levels (rating categories), such as the unexpected and the expected loss indicators.

At the same time, the model must ensure the aggregation of individual risk exposures at the level of the bank's total portfolio by considering other elements in the computation as well, such as the default correlation indicators (based on the premise that not all clients from all activity sectors undergo insolvency/default at the same time), macroeconomic indicators, etc.; in these terms, the expected/ unexpected loss indicators may differ from the value of individual losses.

5.1. The expected loss afferent to the bank's credit-type product portfolio

Basically, the expected loss indicator is a sum which the bank expects to lose in a specific time horizon (usually one year), due to the impossibility of recovering exposures derived from credit-type products granted to the individual and corporate clients of the bank. Thus, the expected loss per client/ a category of clients represents the difference between the value of the exposure at a certain moment and the sum which can be recovered by the bank if the clients enter default; it depends on three variables:

- The sum exposed to default risk, namely the exposure at default-EAD ;
- The probability of default-PD;
- The loss given default – LGD, defined as the loss registered by a bank due to the occurrence of a credit default event.

Default risk refers to the occurrence of at least one of the following events:

- the analysis reveals the fact that if the debtor might not be able to fully pay its debts (principal, interest, commissions), the bank may undertake measures such as the selling of collaterals;
- the debtor has overdue debts exceeding 90 days.

The estimation of the probability of default may be based on one of the following three techniques: using internal data, using external data or using statistic default models. Furthermore, a bank may also use one main information source and several secondary ones in order to compare the afferent results and to adjust the estimations derived from the utilization of the initial source.

Banks may also use an average determined based on the information collected from several different banks, in order to increase the relevancy of the respective analyses.

In this respect, we believe it is imperative that banks collect and keep

substantial historic data on overdue debts, the ratings granted, the elements which led to the undertaking of crediting decisions, the rating history/changes, a history of PD estimations, the debtors' basic data and information on the facilities granted.

The probability of default is generally determined conditional upon the client's credit rating; at the same time, the weaker its quality, the bigger the expected loss derived from the exposure undertaken towards the respective client, as attested by the example in figure 1:

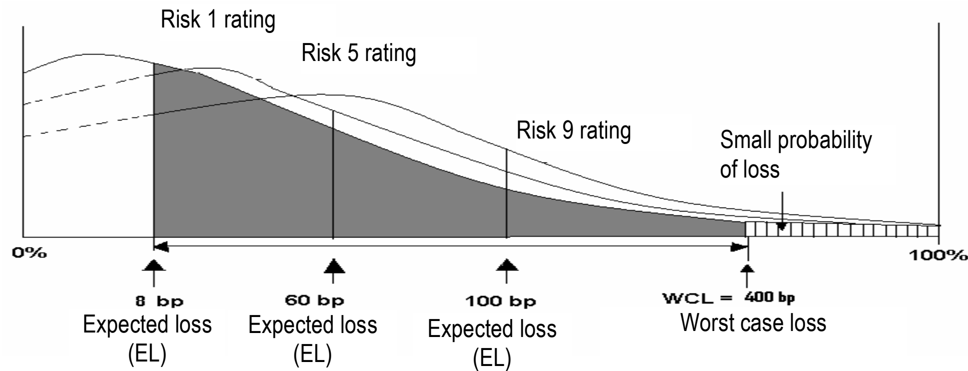

Figure 1. *The correspondence between the expected loss and the client's loan rating*
Note: the example is based on a work scenario.

The above-mentioned data reveals the fact that for a client whose credit rating is 9, the expected loss estimated for a specific time horizon (for instance one year) is close to the expected loss in extreme cases (worst case loss), which in our opinion restricts the access of the respective client to loans.

The probability of default is not the only component of credit risk, and banks measure not only the probability that a debtor registers default, but also how much that debtor would lose if such an event occurred. The actual loss will depend first of all on how much of the respective exposure the bank expects to recover from the debtor. If the sums recovered are insufficient to cover the exposure, this generates a Loss given default-LGD of the debtor (expressed as a percentage of the exposure).

At the same time, the loss depends on the bank's exposure towards the debtor when the latter enters default, expressed as Exposure at default-EAD. Loss given default-LGD and Exposure at default-EAD are determined for each facility/loan-product type.

Furthermore, expected loss is computed with the following formula (International Convergence of Capital Measurement and Capital Standards, 2006):

Expected loss = Exposure at default (EAD) × Probability default (PD%) × Loss given default (LGD%)

The probability of default (PD) and the loss given default (LGD) indicators are computed by the respective bank based on the historic data obtained or by drawing a

correspondence between the bank's internal credit ratings and the PD and LGD indicators determined by external entities (such as international rating agencies).

For instance, by drawing up a correspondence between a bank's internal rating system with 10 rating categories and associated default probabilities for a time span of one year with the external ratings granted by Standard & Poor's, the result is as follows (Burns, 2004):

The correspondence between the rating system of a bank and Standard & Poor's ratings

Table 2

Internal credit rating	1	2	3	4	5	6	7	8	9	10
Probability of default (PD) (%)	0.03	0.06	0.10	0.25	0.50	1	2.50	8	22	100
Correspondence with the external rating	AA	A	BBB+	BBB	BB+	BB	B+	B	CCC	D

The estimation of the actual loss in case of a default situation can similarly be achieved; thus, LGD percentages for loans are usually determined conditional upon the loan-type product/category, the value and the type of the afferent collateral, the existence of a credit hedging instrument such as a credit default swap etc.

At the same time, we believe that, in order to avoid insolvency, banks must register credit risk provisions from the profit achieved based on the value of the expected loss indicators computed. These provisions will be used to cover the respective losses whenever they might occur.

5.2. Unexpected loss and the economic capital for the loan-type products portfolio

Within the time horizon for which expected losses towards a client/client category/portfolio were computed, the bank may not register actual losses at the estimated levels. In these terms, the investments made in the respective loan-type products contribute to the increase in the bank's profit, as the specific credit risk provisions are annulled and registered as incomes or used for the covering of the expected losses computed for the next year.

At the same time, regardless how prudent the standards/risk management methods used by a bank are, the expected loss estimations can be exceeded if unforeseen macroeconomic events or market changes occur, etc.

Chart 2 displays the evolution of the actual losses as compared to the expected (displayed horizontally) and the unexpected losses (Ong, 2003):

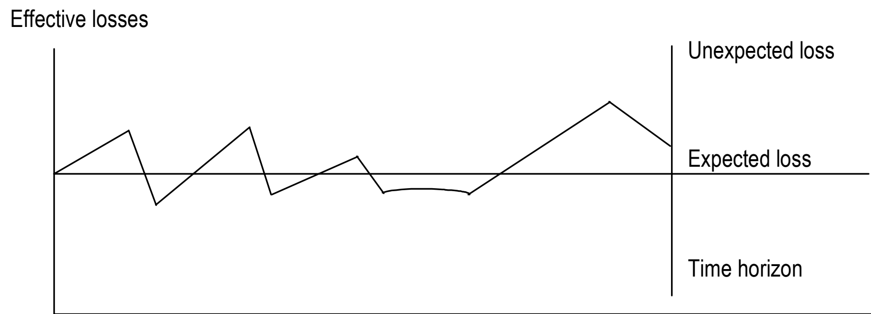

Figure 2. *The evolution of the actual losses as compared to the expected and the unexpected losses*

The unexpected loss is represented by the estimated volatility, namely the standard deviation of the potential (actual) loss as compared to the expected loss and is computed with the following formula (Ong, 2003):

Unexpected Loss – UL =

$$= EAD \times \sqrt{PD \times \sigma^2 LGD + LGD^2 \times \sigma^2 PD}$$

where:

EAD = Exposure at default

PD = Probability of default

σPD = The standard deviation of the PD

σLGD = The standard deviation of the LGD

Here's an example of computation of the unexpected loss afferent to a loan granted for one year to a client with a credit rating of 3 (the equivalent of a BBB rating granted by Standard & Poor 's) (Ong, 2003):

The computation of an unexpected loss for a loan granted for one year, with a loan rating of 3

Table 3

Loan granted (COM) -*EUR*-		10,000,000
Loan used (OS) -*EUR*-		5,000,000
Unused part given default (UGD)		65%
Exposure to default (EAD)	EAD = OS + (COM – OS) × UGD	8,250,000
Probability of default (PD for 1 year, with a rating of 3)		0.15%
Standard deviation of PD (σ PD)		3.87%
Loss given default (LGD)		50%
Standard deviation of LGD (σLGD)		25%
Unexpected loss (UL) -*EUR*-	$UL = EAD \times \sqrt{PD \times \sigma^2 LGD + LGD^2 \times \sigma^2 PD}$	**178,508**

In this context, given the fact that banks must compute the expected and unexpected loss at the level of the entire portfolio, we believe it is necessary that a comparison is made between the result of the aggregated expected and unexpected individual losses at the level of the portfolios they are included in. Thus, the expected loss at portfolio level is equal to the sum of individual asset (credit) losses from the respective portfolio and is computed as follows (Ong, 2003):

$$ELP = \sum_i EL_i = \sum_i EAD_i \times PD_i \times LGD_i$$

where:

ELP = expected loss at portfolio level and Eli = Expected individual loss.

At the same time, the unexpected loss at portfolio level is computed as follows: (Ong, 2003):

$$ULP = \left[\sum_i \sum_j \rho_{ij} \times UL_i \times UL_j\right]^{1/2}$$

where:

ρij is the correlation of defaults between asset (loan) i and asset (loan) j.

The above-mentioned formula makes it obvious that the unexpected loss at portfolio level is not equal to the sum of individual unexpected losses.

Thus, due to the diversification effect, the unexpected loss at portfolio level is much smaller than the sum of individual losses $\left(ULP < \sum_i UL_i\right)$.

We believe this conclusion reflects the fact that only a part of the unexpected loss for each asset contributes to the total sum of unexpected losses afferent to a portfolio. This sum is called risk contribution- RC and is computed in compliance with the following formula (Ong, 2003):

$$RC_i = \frac{UL_i \times \sum_j \rho_{ij} \times UL_j}{ULP}$$

One can determine the unexpected loss afferent to a portfolio as the sum of individual risk contributions, based on the formula:

$$ULP = \sum_i RC_i$$

Here's an example of a computation of the unexpected loss afferent to a portfolio made up of two assets/loans (Ong, 2003):

The computation of the unexpected loss afferent to a portfolio made up of two assets (loans)

Table 4

Loan 1 (example from table 3)		
Unexpected loss (UL) *-EUR-*		**178,508**
Loan 2		
Loan granted (COM) *-EUR-*		2,000,000
Loan used (OS) *-EUR-*		1,500,000
Loan rating		5
Maturity - *years*		3
Unused part given default (UGD)		48%
Exposure to default (EAD) *–EUR -*	$EAD = OS + (COM - OS) \times UGD$	1,740,000
Probability of default (PD for 1 year, with a rating of 3)		4.85%
Standard deviation of PD (σ PD)		21.48%
Loss given default (LGD)		35%
Standard deviation of LGD (σLGD)		24%
Expected loss (EL)-*EUR-*	$UL = EAD \times \sqrt{PD \times \sigma^2 LGD + LGD^2 \times \sigma^2 PD}$	29,537
Unexpected loss (UL) *-EUR-*		**159,906**
Computation of the risk indicators per portfolio		
The correlation indicator of the defaults of the two loans (ρ)		3%
Expected loss of the portfolio *–EUR -*	$EL = EL_1 + EL_2$	35,724
Unexpected loss of the portfolio (ULP) - *EUR-*	$ULP = \left[\sum_i \sum_j \rho_{ij} \times UL_i \times UL_j\right]^{1/2}$	243,212
Risk contribution of loan 1	$RC_1 = UL_1 \times (UL_1 + UL_2 \times \rho)/ULP$	134,538
Risk contribution of loan 2	$RC_2 = UL_2 \times (UL_2 + UL_1 \times \rho)/ULP$	108,656
	$RC_1 + RC_2 = ULP$	243,212
	$UL_1 + UL_2 > ULP$	338,414

The determining of the volume of economic capital is based on the necessity of covering the volume of unexpected losses, so that the respective bank is solvent and able to continue its activities.

In addition to the above-mentioned information, the necessary volume of economic capital is determined as a capital multiplier of the unexpected loss afferent to the portfolio and is based on the statistic confidence level required for the assessment of the volatility of loss, as well as on the necessity of computing "Worst case losses" WCL and the loss distribution "tail".

The capital multiplier represents in this case the number of standard deviations of an unexpected loss and is computed in compliance with the formula (Ong, 2003):

Economic Capital (EC) = Unexpected loss (ULP) × Capital multiplier (CM)

The capital multiplier is determined conditional upon the relation between the bank's rating (according to the Standard & Poor's methodology, for instance) and the afferent statistic confidence level.

Various methods are used for the determining of the capital multiplier, the most popular being the Extreme value theory – EVT, which considers the losses which may occur in extreme cases and the estimation of the loss distribution "tail".

Here are the capital multipliers drawn up in compliance with the Pareto method for loss distribution, which comes across as follows in relation to the Standard & Poor's ratings (Ong, 2003):

Capital multipliers determined in compliance with the Pareto method

Table 5

Credit rating of the Bank	Confidence level (%)	Capital multiplier (tail fit) = 99.95%-99.92%
AAA	99.99	19.64
AA	99.97	14.77
A	99.90	10.32
BBB	99.70	6.95

The complex models used for the determining of the economic capital turn the loss volatility afferent to the portfolio into an economic capital margin. Below is an example of an economic capital computation based on the de probability of default (PD) and loss given default (LGD) indicators, turning/translating them into an economic capital margin via an internal model, also considering the own parameters of the model, such as the default correlation parameter. The capital margin is expressed as the economic capital sum necessary to cover a 100 EUR exposure with a 1 year time horizon:

The determining of the economic capital margin, conditional upon a bank's risk parameters

Table 6

Loan-type facility categories	LGD (%)	Credit rating categories/ PD						
		1	2	3	4	5	6	7
		0.03%	0.06%	0.1%	0.25%	0.5%	1%	2.5%
A	10	0.18 EUR	0.25 EUR	0.37 EUR	0.63 EUR	0.98 EUR	1.45 EUR	1.94 EUR
B	20	0.29 EUR	0.49 EUR	0.73 EUR	1.44 EUR	1.99 EUR	2.75 EUR	4.01 EUR
C	30	0.45 EUR	0.75 EUR	1.08 EUR	1.85 EUR	2.87 EUR	3.91 EUR	5.62 EUR
D	40	0.58 EUR	0.91 EUR	1.33 EUR	2.55 EUR	3.88 EUR	5.33 EUR	7.54 EUR
E	50	0.77 EUR	1.14 EUR	1.88 EUR	3.81 EUR	4.64 EUR	6.55 EUR	10.11 EUR
F	60	0.99 EUR	1.77 EUR	2.18 EUR	3.48 EUR	5.76 EUR	7.98 EUR	12.03 EUR

Note: The data above is based on a work scenario.

Similarly, the results of the assessment of economic capital for each business line category may be centralized in a centralized panel of capital factors expressed in percentages, whereas the determining of the economic capital margin necessary for the covering of credit risk is the result of the weighting of the bank's exposure with the capital factor.

The main difference between this example and the example above is the fact that each capital factor expresses the credit risk of the respective client in percentages, conditional upon the credit rating and the maturity of the respective asset, and the computation considers the credit maturity as follows:

The determining of the economic capital factor (%) conditional upon the maturity of the exposure

Table 7

The confidence level of the capital factors is 99.70%, at a recovery rate of 70% (or LGD of 30%)										
Credit rating (RR)	Maturity (years)									
	1	2	3	4	5	6	7	8	9	10
1	-------	-------	-------	-------	-------	-------	-------	-------	-------	-------
2	-------	-------	-------	-------	-------	-------	-------	-------	-------	-------
3	-------	-------	-------	1,63%	2,09%	2,61%	2,86%	-------	-------	-------
4	-------	-------	-------	2,42%	2,82%	3,30%	3,63%	-------	-------	-------
5	-------	-------	-------	-------	-------	-------	-------	-------	-------	-------
6	-------	-------	-------	7,23%	9,11%	9,70%	10,50 %	-------	-------	-------
-------	-------	-------	-------	-------	-------	-------	-------	-------	-------	-------

Note: The table is based on a work scenario.

As one can see, the capital factor increases conditional upon the maturity of the rating and the deterioration in the quality of the respective loan, given the same maturity.

6. Economic capital for market risk

The determining of the economic capital necessary for the covering of market risk exposure is based on the bank's exposure to

this risk, computed with the Value at Risk method.

Value at Risk is a method for the assessment of market risk which measures the greatest loss that may be registered by an instrument/portfolio of financial instruments in a specific time horizon, given normal market conditions and a preset confidence level. For example, 10-days, 99%, RON, VaR=1,000,000 for portfolio P means that in a time horizon of 10 days, the respective portfolio has a 99% probability of losing a maximum of one million lei.

The fundamental hypothesis of any VaR model is the fact that all changes in the value of a portfolio may be explained by the variation of a limited number of factors, namely the market risk factors. In compliance with international practices, one of the following methods is generally used for the assessment of the capital necessary to cover market risk exposure using the VaR method: delta-normal (variant - covariant), the historic simulation and the Monte Carlo simulation.

- The Delta Normal method (or the variant – covariant method) is based on the idea that risk is measured by the assessment of a portfolio in its initial status and the results are subsequently extrapolated (deducting the potential variations in the value of the portfolio using partial derivatives at local level).
- The historic simulation method – is a method based on the idea that risk exposure can be measured by fully reassessing the portfolio in compliance with scenarios based on historic data.
- The Monte-Carlo simulation method – is, like the historic simulation method, a global method based on the fact that risk exposure can be measured by fully reassessing the portfolio in compliance with randomly generated scenarios based on the estimated distribution of risk factors.

Next, we will display the main quantitative standards which must be observed by the bank for the assessment of market risk using the VaR method in compliance with the stipulations of the Basel II Agreement (Bank of International Settlements, 2006):

- Value-at-Risk must be computed on a daily basis; the Value-at-Risk computation must use a confidence level of 99% and an instant shock price equivalent to a 10 days-change in prices; in other words, the minimum holding period will be of at least 10 trading days; the data history for the computation of VaR will be of one year minimum;
- The updating of information sets at least once every three months and their reassessment whenever market prices change; the acknowledgement of empirical correlations between large risk categories (such as interest rates, exchange rates, merchandise and capital instrument prices, including option-related volatilities from each risk category); the possibility of performing back-testing and stress-testing operations;
- The determining of a separate capital margin covering the specific interest rate risk and capital instruments risk; the utilization of a proper set of market risk factors, namely installments and market prices which affect the value of the positions in the bank's trading book, which must be sufficient so as to stress the risks afferent to the respective positions.

The computation of the capital requirement covering the bank's market risk exposure is achieved in two stages, the first stage being the determining of an initial capital requirement (MRPt), in compliance

with the formula (Bank of International Settlements, 2006):

$$MRP_t = \max(VaR_t, k \times \frac{1}{60} \times \sum_{i=1}^{60} VaR_{t-i}) + MRS$$

where:

k is the multiplication factor and MRS is the risk margin specific to each type of asset in the trading book.

In other words, the capital requirement is expressed as the largest value between the VaR assessment for the previous day and the average of the daily VaR assessments for each of the 60 previous work days (trading days), multiplied with a k factor = 3 or 4.

The results of the assessment of the market risk exposure obtained by estimating the Value at Risk are checked and historically validated via "Back Testing" and "Stress Testing" techniques.

Thus, in the second stage, in order to obtain a precise measure of the risk exposure, VaR measures require adjustments, based on the accuracy of the model determined during the backtesting operations performed, using a correction coefficient (Bank of International Settlements, 2006):

Adjusted Capital Requirement = Correction Coefficient × Initial Capital Requirement

In addition to the above-mentioned requirements, determined in compliance with the stipulations of the Basel II Agreement, banks may use other quantitative standards for the determining of their economic capital, drawn up by the bank's managements in compliance with their risk profiles (for inst., they may draw up another confidence level than the 99% standard Basel II requirement, a level which corresponds to the loan rating target).

Furthermore, aside from the capital requirement derived in compliance with the VaR method, banks may also consider unused market risk limits (as the respective part is not included in the economic capital estimation in compliance with the VaR method and if used, it may lead to additional capital requirements), as well as some penalties if these limits are accidentally exceeded.

Next, we will perform a Value-at-Risk (VaR) analysis of a bank's trading book, where we used the historic simulation method and the Monte Carlo simulation method.

The computation of potential loss from market risk exposure, according to the Value at Risk method

Table 8
-RON-

			April – June 2006	April – June 2005
The Present Value of trading book positions		maximum	201,781,167	300,140,661
		medium	48,968,945	60,890,063
Historic simulation	average VaR		3,675,685	9,372,788
	% in own funds		0.11%	0.31%
	% in medium PV		7.51%	15.39%
	maximum VaR		13,638,258	26,034,709
	% in own funds		0.41%	0.87%
	% in PV maxim		6.76%	8.67%
Monte-Carlo	average VaR		2,927,426	10,010,748
	% in own funds		0.09%	0.33%
	% in medium PV		5.98%	16.44%
	maximum VaR		10,414,765	26,009,936
	% in own funds		0.32%	0.87%
	% in maximum PV		5.16%	8.67%

Note: The table is based on a work scenario.

As follows, we will determine the initial capital requirement according to the following formula:

Initial Capital Requirement = Max (VaR of the last day of the previous month) 3 × average VaR for the past 60 day

The VaR value was determined via the historic simulation method using a confidence level of 99% and a holding period of 10 days (in compliance with Basel II). The following results were obtained: average VaR for the 2nd quarter of 2006: 3.675 thousand RON, VaR on 30.06.2006: 4.853 thousand RON. Consequently, the initial capital requirement is:

Initial Capital Requirement = Max (4,853; 3 × 3,675) = 11,025 thousand RON.

In order to obtain a proper means for the measurement of risk exposures, the bank adjusts the initial capital requirement in compliance with the results of the backtesting operations using a correction coefficient:

Adjusted Capital Requirement = Correction Coefficient × Initial Capital Requirement.

Considering a correction coefficient of 1.35, the adjusted capital requirement is:

Adjusted Capital Requirement = 1.35 × 11.025 = 14.883 thousand RON.

The internal model for the determining of the economic capital for market risk can also consider the VaR drawn up by the management. Thus, if in the following example:

- The initial capital requirement derived based on the VaR method using a confidence level of 99.99% is of 4,000,000 EUR; the correction coefficient is 2,
- The VaR limit is 6,000,000 EUR; the margin afferent to the unused part of the limit is 15%,

Then the economic capital for market risk is:

2 × 4,000,000 EUR + 0.15 × (6,000,000 EUR – 4,000,000 EUR) = 8,300,000 EUR

Note: The table is based on a work scenario.

Because the exceeding of the VaR limit is considered an infringement of the bank's risk policy and may lead to losses not assumed/expected by the bank's management to the infringement of prudential indicators (for instance the minimum solvency indicator), it will be adequately penalized.

Thus, if the penalization margin of the bank for the exceeding of the VaR limit is 3, and the exceeding sum is 2,000,000 EUR (for an exposure of over 8,000,000 EUR), the new capital requirement will be:

2 × 4,000,000 EUR + 0.15 × 0 + 0.15 × (8,000,000 EUR – 6,000,000 EUR) = 14,000,000 EUR

Note: The table is based on a work scenario.

In these terms, the economic capital requirement is much higher, and in order to determine its risk adjusted profitability, the treasury department of the bank will obtain much lower results, which will diminish the financial results of this business line, as well as the financial remuneration of the respective employees.

7. Economic capital for operational risk

If renowned banks have been using economic capital assessment methods and systems for the determining of credit risk and market risk for a long time now, when it comes to operational risk most banks consider it a "work in progress" activity.

A simple approach for the assignment of economic capital to operational risk is to attribute a risk rating to each transaction/ business line (one a scale of 1 to 5, for example) based on operational risk factors/ operational risk types. This rating should reflect the probability of risk and of operational loss occurrences, based on which the economic capital requirement is determined.

Another approach is the utilization of the AMA – Advanced Measurement Approach, regulated via the Basel II Agreement; for the determining of the economic capital, risk parameters are adjusted conditional upon each bank's own policies (similarly to the computation of the economic capital for market risk). This method is more sensitive to a bank's actual exposure to operational risk, as compared to the other approach, because, in compliance with the latter, the capital requirement for operational risk is computed by the internal system measuring the bank's operational risk.

Based on this internal system (which includes assessment methods, specialized IT applications, etc.) the bank assesses the losses afferent to operational risks by using a set of information (both internal and external) on the historic data registered due to these risks (the elaboration of this database is another difficult task for the bank). In order to use the AMA, a bank must meet the following requirements (Bank of International Settlements, 2006):

- the internal system must reasonably assess the bank's unexpected losses based on the following elements:
- a relevant combination of internal and external data on the losses registered due to the occurrence of operational risk events;
- an analysis of operational risk scenarios and their financial effects;
- an analysis of the business environment in which the bank unfolds its activity;
- the complexity degree of the bank's internal control system;
- the bank's internal system must be able to assign economic capital for operational risk on business lines, so as to stimulate the improvement of the operational risk management system;
- the bank must have a detailed historic database with all the operational risk events registered (covering at least the past five years).

In order to use this method, banks must collect three types of information for each business line: the exposure to the operational risk indicator (EI), information on loss occurrence probabilities (PE), as well as the loss generated by this event (LGE). Next, the expected loss is computed in compliance with the following formula (Basel Committee, 2001):

Expected Loss (EL) = Exposure Indicator to Operational Risk (EI) × Loss occurrence probability (PE) × Loss generated by the respective event (LGE)

In order to compute the economic capital requirement, the bank applies a fixed percentage (the gamma factor) to the thus-computed indicators and the necessary capital will be the sum of these weights for all operational risk categories assessed by the bank.

The computation of the economic capital requirements for operational risk for a trade bank

Table 9

-thousand RON-

Business lines	Business units	Exposure to operational risk	Gamma factor (%)	Capital requirement
Retail	Front-office activities	205,347.00	18	36,962.00
	Personal loans	65183.00	12	7,822.00
	Mortgage loans	33,532.00	12	4,024.00
	Cards	28,255.00	15	4,238.00
	Consumer loans	20,599.00	12	2,472.00
	Private Banking	1,710.00	12	205.00
Corporate	Local public administrations	8,598.00	18	1,548.00
	SME clients	317,206.00	15	47,581.00
	Large clients	120,232.00	15	18,035.00
	Strategic clients	66,812.00	15	10,022.00
Treasury	Title operations	85,360.00	18	15,365.00
	Money market operations	163,531.00	18	29,436.00
	(FX market operations)	4,049.00	18	729.00
Capital Markets	Syndicated loans	11,659.00	18	2,099.00
	Financial investments	4,075.00	18	734.00
	External participations	198.00	18	36.00
	Internal participations	11,000.00	18	1,980.00
Total economic capital				183,288.00

Note: The table is based on a work scenario.

We mention the fact that similar methods to the ones presented above are used for the other types of risk categories considered in the internal economic capital models of banks (liquidity risk, the interest rate risk afferent to the banking book, etc.) so as to ensure the stability of the economic capital necessary for their coverage.

8. Own capital which may be used by banks to cover their risk exposures

After the assessment of the capital requirements necessary for the covering of the various risk categories mentioned above, the next step undertaken by banks will be to compare the aggregated sums with their own capitals.

As a rule, in the context of losses generated by banking activities, the primary source used to cover these losses represents the profit achieved during the respective year and the risk provisions drawn up. If these are insufficient, the bank will resort to its other funds drawn up during the years (starting from the general risk reserves).

In phase three, a bank resorts to the utilization of its free capital (the one up to the minimum limit of the solvency indicator regulated by the monitoring authorities); if these funds prove insufficient as well and the bank cannot increase its own capital (with the help of its shareholders), then it may undergo insolvency.

Here's an example of an assessment of the economic capital requirement for credit risk, market risk and operational risk, as compared to the bank's own capital:

Distribution of the bank's capital on risk categories

Table 10

31-Dec-07

	Sum (thousand RON)	(%)
Total capital (own funds)	**3,112,055**	**100.00**
Credit risk capital	2,490,791	80.04
Operational risk capital	353,915	11.37
Market risk capital	37,960	1.22
Free capital	229,389	7.37

The data displayed above reveals the following aspects:

▪ based on the assessment of its exposure to credit risk, market risk and operational risk, on December 31st 2007, the bank required a minimum capital level of 2,882.67 million RON.

The bank's own funds level of 3,112.06 million RON was enough to cover the minimum level mentioned and has a reserve of approximative 7,4% for the sustained development of the bank's businesses (including the covering of the other risk categories which were not computed).

▪ The main risk for which the bank assigns own capital is credit risk, which requires approximative 80% from the total capital of a bank, followed by operational risk (approximative 11% from total); market risk has a lower weight (approximative 1%).

The structure of the bank's capital/own funds can be displayed as follows:

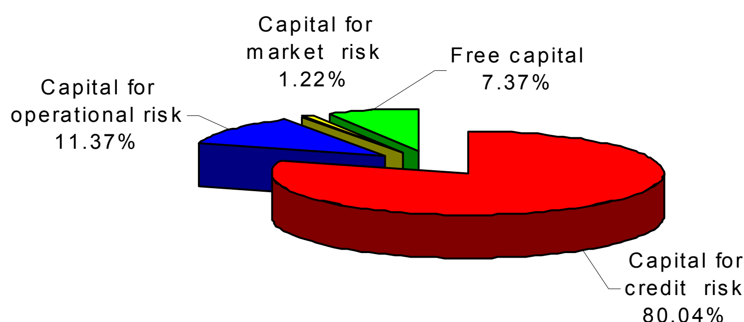

Figure 3. *The structure of the bank's capital/own funds on risk categories*

Considering the fact that it is very important that the bank's management knows the value of the capital assigned for each line of activity, below is a distribution example/structure of the bank's capital assigned on lines and business units:

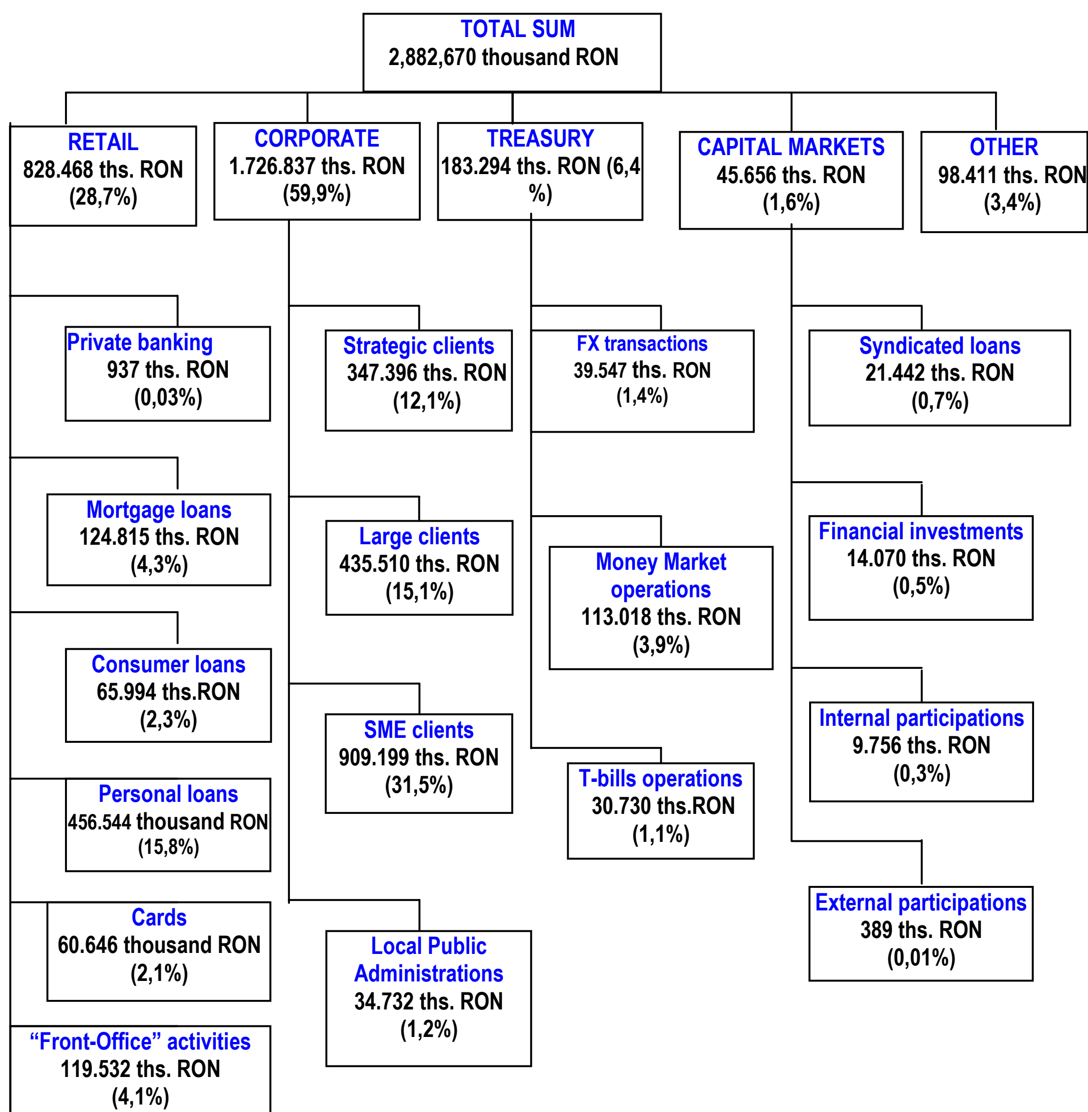

Figure 4. *The structure of the bank's capital assigned on lines and business units*

Conclusions and recommendations

The implementation of the second pillar of the Basel II Agreement (ICAAP) in the subsequent interval (most likely up to the end of 2009) represents a new challenge for the Romanian banking system (in addition to the ongoing economic and financial crisis), as banks will have to elaborate and implement strategies, procedures and systems on the internal capital adequacy assessment process.

This process must consider both the risks for which capital requirements were expressly stipulated in the Basel Agreement (pillar 1), and the remaining risks (liquidity risk, interest rate risk derived from activities outside the trading book, reputation risk, strategic risk, etc.).

In the context of the ongoing crisis, we believe these new requirements will support

banks (mainly those which do not have such processes), as they will lead to the improving of the risk exposure assessment process and the capital management process. Let's not forget the diminishment of the solvency indicator at banking system level either, which dropped from 13.77% on December 31st 2007 to 12.34% la 31 on December 31st 2008.

Furthermore, this descendent trend must be combined with the fact that in 2009 banks will no longer register such good financial results as those registered in 2008. Because of this, the own funs/capitals which have to support the banks' risk exposures in 2010 may not be substantially increased with the profits realized in 2009.

The analysis of the main economic capital assessment methods and the presentation of study cases on the computation of economic capital and on the covering of risk exposures from own capitals reveals that they are increasingly based on assessment methods and instruments which rely heavily on the theory of probabilities/statistics, the existence of complex statistic databases, IT applications and specialized personnel.

In this context, we feel that the implementation of a risk exposure assessment process and of capital management is an important step in the maintenance of the stability of the Romanian banking system. We also believe that Romanian banks should accelerate this process with the help of their mother-banks (over 90% of the Romanian banking system is controlled by foreign capital), most of which have the necessary logistics and the know-how to do so.

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*** Normele BNR nr. 17/2003 privind organizarea și controlul intern al activității instituțiilor de credit și administrarea riscurilor semnificative, precum și organizarea și desfășurarea activității de audit intern a instituțiilor de credit, publicate in Monitorul Oficial nr. 47 din 20.01.2004, cu modificările și completările ulterioare

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Controversies Regarding the Economic Part Played by the State in Economy

▪

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Abstract. *One of the important matters of the economic theory and practice is the relation between the state and the economy. For more than 200 years, the economic thought has been dominated by controversies regarding the economic part played by the State. There have been created many theories. Taking as a starting point the economic and social realities, the supporters of various trends have tried to find arguments in favor of or against the involvement of the State in economy, to justify the cases in which it is necessary for the Sate to intervene in economy or to suggest that the State should not intervene in economy.*

Keywords: liberalism; Keynesianism; market economy; state economy; centralized economy; governing.

▪

JEL Codes: B12, B13, B14, B20.
REL Codes: 1C, 1D, 1E, 1F.

It is a well known thing that the central pillars of the economic thinking are Smith, Max and Keynes. The first described the positive aspects of the liberal economy; the second identified the contradictions which caused its downfall, suggesting its replacement with the planned economy whereas the third presented the solutions for avoiding this downfall by means of the state, setting up the controlled economy.

The economic liberalism is characterized by the fact that the State must not interfere in the economic life. Adam Smith, one of the founders of the liberalism theory, supported the individual's sovereignty and the self-regulatory character of the market. He showed that there is "an invisible hand" which makes the individual producers to promote the society's interests. He agreed with the State's intervention only if there was no private interest for producing certain goods, as it is, for example, the case of some infrastructures or education. This liberal doctrine lays stress on: private property, free actions, free relocation of the production factors from one sector to another depending on the price level, the noninvolvement of the State in the economic life, its part being limited to that of a night guard, the fulfilling of the general interest by means of the free game of individual activities (Todosia, 1992, p. 68).

According to Smith, the economic part of the State can be limited to three very important duties (Smith, 1962, pp. 43):

- "the duty to guard the society against any attack or invasion coming from other independent societies";
- "the duty to make justice";
- "the duty to put into practice and keep in good shape certain public works which cannot be kept in good shape by an individual or by a small group of individuals".

Another classic economist who continued Smith's ideas was John Stuart Mill. In his essay "About Freedom", Mill proves to be against any tyranny against an individual, even if that tyranny is the tyranny of majority. That is why, even if his predecessors, being tolerant, accepted the State's intervention, minimizing the part it played, he did not agree with the State's intervention apart from the case of social need. But, the State's intervention accepted by Mill was meant to support the individual initiative and bearing in mind the principle of individual freedom: "a good government will grant its support in a way that will support and encourage the individual effort which is about to have positive effects" (Onofrei, 2000, p. 88).

As regards the State's intervention in economy, John Stuart Mill brought into discussion two new concepts: "externalities" and "public goods", concepts which will be accepted by the neoclassical school. Mill also pointed out the danger of expanding the bureaucracy when the administrative procedures are granted too much importance. This danger took the shape of governmental machinery which the more perfect it was, the more far away from the citizens' needs and interests were.

The neoclassic theory took over some elements of the classic liberalism paradigm. Its representatives were supporters of individualism, defenders of market economy and private property. They were against the

State's intervention in the individuals' economic activity and supported the free competition policy that is the policy of free exchange. The neoclassic economists consider society "an aggregate made up of autonomous, free, and equal individuals who have all in common the market as a means of coordinating their activity" (Dodescu, 2000, p. 70).

Thus, in accordance with the neoclassic economists, the State's involvement in economy is justified only in those situations when the market proves to be unable to solve its problems by itself: creating some public goods (national defense, justice, police, public lighting, etc.) and externalities (effects caused by the activity of a company on the utility or profit of some other companies, except some market transactions). The State must ensure the collective goods for the individuals, financing them by means of a system of taxes, but the taxes should not have been a hindrance for the economic exchanges and should exclusively have been used to cover the public expenses. At the same time, the State should take an active part for even up the externalities to a competitive activity.

A strong attack against the liberal theory and capitalism came from Karl Marx, who conceived a new manner of approaching and analyzing the economic matters. His economic opinions, mainly reflected in his masterpiece called "The Capital", lay the foundations of a theory about the dynamics of capitalism, of the capitalist means of production. The research made on capitalism, makes Marx draw the conclusion that this "social order" is doomed to come to an end because the contradiction existing between the collective way of production and the individual manner of approaching the results of production. The natural conclusion from the point of view of the Marxist determinism was the replacement of capitalism by a new order: that of socialism.

In the case of the Marxist theories there are two different approaches regarding the State and the part it plays in economy and society. On the one hand, the very existence of the State is disputed, as communism is a society without social classes and state and, on the other hand, its existence is connected to the division of society into social classes, the State being an instrument which serves the dominant class. In practice, in most of the communist countries, the Marxist theory meant the State's intervention in all the fields of the social-economic life, by excessively centralizing the decisions and reducing the companies' initiative and freedom of action. The tools used were administrative and bureaucratic.

Contemporary economic thinking has a new view over the economic part of the State. The Keynesian revolution is the turning point. After this moment, the ways in which the Sate involves in economy has evolved under the impact of changing the environment, of the public authorities' priorities but also of the theories which support the economic policy (Dodescu, 2000, p.71).

Admitting that the market is incapable to self-adjust anytime and automatically by its own mechanism and by free competition, John Maynard Keynes suggested that the State's mechanism should be doubled by the State's intervention, in view of correcting the periodic unbalances and of avoiding their

amplification. He had in view to prevent some negative aspects of economy and markets by means of an active intervention of the State.

Taking as a starting point the economic, social and political reality in the capitalist world of the ‘30s and ‘40s, Keynes drew up a more complex theory which moves the economic analysis from the microeconomic level to the macroeconomic one. The objective of this theory is “the analysis of the functioning mechanism of the market economy in view of making it sustainable, diminishing or eliminating its unbalances in the circumstances in which one cannot put into practice the idea of its balancing by means of the price mechanism” (Sută-Selejan, 1994, p. 183). Being a defender of capitalism, Keynes sets as his goal to save it by means of the State’s intervention in the economic life. In accordance with Keynes’ opinion, the State is considered a specific company whose intervention is legitimate in enforcing three major functions: the production or allocation of goods and services, the income’s redistribution, the economic stability.

According to Keynes, the only means by which the imbalances can be eliminated is the expansion of the democratic State’s functions. The central goal of its measures will be the full employment. The State’s intervention in economy for solving these imbalances has mainly a social goal, as Keynes said: “the main drawbacks of the economy in the society we live in are its incapacity to assure the full employment and the arbitrary and unfair distribution of wealth and income” (Keynes, 1970, p. 375). The State’s action is achieved by discouraging the savings and encouraging the expenses, especially the public expenses in view of increasing the real demand by using two economic-financial leverages, like the monetary policy and the budgetary policy.

The economic role of the State is, according to Keynes that of eliminating the market’s defects in point of investments, as the market is incapable to show the entrepreneurs what is the level of investments which corresponds to full employment. “As the State is entitled to calculate the marginal efficiency of capital on long term and by means of the community’s social interests, we think it should take an increasing responsibility in direct organization of investments” (Keynes, 1970, p. 63).

Between the two world wars, the expansion of the economic part played by the State meant, a volume increase of the public finance as well as a change in the nature of the public finance. The State’s interventions, which are very numerous in the present, are no longer entirely based on the public finances, but they also have in view measures for setting the rules of the economic game (drawing up regulations having in view the competition, the length and the conditions of work, the minimum wages, the social protection, etc.) as well as the use of monetary policy tools. At the same time, the State also manages the public sector which develops a lot, containing, apart from the traditional public services (post, telecommunications, railroads, etc.) a series of state enterprises which manufacture goods in various fields (coal and ore drawing, metallurgic companies, car, plane, shipyards, nuclear power stations, banks, insurance companies, etc.).

By means of the public finances and monetary policy, the market economy countries, the State made interventions at the level of the economic activity, making public investments and private investments (by getting credits, subsidies, fiscal facilities), giving guarantees for the public sector which dealt with manufacturing goods, redistributed the incomes and fought against some illegalities. By its interventions, in this period, the State supported the achievement of an economic growth as powerful and balanced as possible, when the inflation, the unemployment and the commercial deficit were as low as possible.

Preoccupied by improving Keynes' theory, the economist Roy F. Harrod, in his paper "Towards a Dynamic Economic Theory", presents the pattern of balanced economic growth based on three rates of growth: real, natural and guaranteed. By means of Harrods's economic policy, the State's involvement in economy has in view to diminish the rate fluctuations. In order to eliminate these fluctuations, Harrod suggests that the State should intervene in the economy by means of the "stop and go" policy. This implies the use of the fiscal and monetary policy to stop the expansion ("stop"), when the economy moves too fast, by increasing taxes and the interest rate, and, when the economic activity stagnates, the State should stimulate ("go") it by diminishing taxes, increasing the money quantity that circulates on the market and diminishing the interest. The concrete means of involvement are public works, transactions on the monetary market, budgets over ten years (by means of which the surpluses obtained during the expansion periods cover the deficits in the recession periods, "muffin fund" of goods playing a regulatory part (set up during the recession periods and put on the market during the expansion periods).

In his theory, Harrod suggests that the public sector should evolve but, at the same time, he warns about the negative effects of an excessive involvement of the State: "so far, there has been the tendency to concentrate into the State's hands that huge work of making the most important decisions about the economic life of the country. In the future, such a system will have to be changed, because its incompatibility with the democratic control becomes clear" (Harrod, 1956, p. 165).

In the United States of America, the most important supporter of the Keynesian doctrine was Alvin H. Hansen. The American economist pleads for the reconstruction of a new market economy on the basis of some new institutions (Hansen, 1947, p. 132). He says that "what is being developing is the welfare State, not the State as owner or non-intermediated company. First of all, the welfare State is an income redistributors and an important buyer of the products manufactured by the private company. But all the work is done by the private company" (Hansen, 1957, pp. 147-149). Hansen considers very important the State's investments and the budgetary expenses, in general, as a means of fighting against crises. In the fight against crises and unemployment, he suggests that, among other things, the State's budgetary expenses, including the military ones, the taxes, the borrowings and other financial leverages should be used.

Another important step in the development of Keynesianism has been made by the American professor Paul Samuelson. He considered that the economic system in the western countries is a mixed one, belonging to the free entrepreneur, to the economic control of the society (by means of its specialized, democratic organisms) and to the private and public institutions, having monopolist tendencies. In the case of this mixed system, the control is secured by the simultaneous action of the private and public institutions by means of "the invisible orientation towards the market mechanism", and also by means of "the organizational provisions and fiscal incentives" (Samuelson, Nordhaus, 1989, p. 38). The concrete objective of the State's macroeconomic policy are: ensuring a high and increasing level of the real product, a high level of employment, of some high salaries for the persons that work, a level of the prices influenced by the free markets, of a stable foreign exchange rate. Samuelson's opinion is that the State is not an useless relic, left from a previous epoch, because "it plays an essential part as it provides a climate that helps the markets thrive and eliminates the surpluses that appear when the markets have absolute freedom. The prosperity of a modern economy deepens on finding the balance and sharing the responsibilities between the markets and the State" (Samuelson, Nordhaus, 2000, p. 43).

The neoliberal economists have criticized the most the economic part played by the State that intervenes in the economy. The criticism of the classic and neoclassic liberalism made by the supporters of the State's intervention in the economy has made the liberal economists to reexamine the liberal message in order to adapt it to the realities of the contemporary world. For liberals, the State is an agent preoccupied to make everyone respect the private property and the competition rules, to assure the broadcasting of the information which is useful for the companies as well as peaceful social relations, to be the representative of the country's interests abroad, to assure that everyone respects the territorial integrity and to protect the goods and the persons in accordance with the laws. The State's involvement is accepted only as an exceptional approach, caused by the inefficient or abuse of the private property.

Friedrich Hayek was the declared enemy of the State's intervention in the economy and the supporter of liberalism revival. In the '30s, he argued Keynes. In his paper "The Way towards Servitude", Hayek showed that one cannot accept the existence of a mixed system in which the market economy coexists with the State's intervention and planning because "both competition and the centralized management become weak tools if they are incomplete; they are principles that provide alternative solutions for the same problem, but their mixture means that, in fact, none of the two will be really used and the result will be worse if we rely only on any of the two systems" (Hayek, 1994, p. 55). In his opinion, the individual freedom must be conceived and achieved only in the circumstances of a market economy. The State's involvement is admitted only as a means of guiding the individual efforts. Hayek is categorically against the State's intervention in the economy by means that

prevent or alter the free functioning of the market mechanism, especially in the case of the price mechanisms, considering that these are causes of some economic crises. In his opinion, the State's role is that of creating conditions, by ensuring a legal juridical framework for an efficient competition among companies, as well as that of providing services necessary for the society but for which the respective companies do not obtain a proper profit, services which contain public policy, national security, etc.

Another important economist who has criticized the keynesist trend was Milton Friedman. He is a defender of the modern market economy based on the private property and on the individual freedom. In his opinion, the key for a good market economy functioning is the people's free choice. According to Friedman, the economic role of the State is "to make what the market itself is incapable of making all by itself" (Friedman, 1995, p. 40). In his opinion, the State must "keep the law and the order, to define the property rights, to be an instrument which changes the property rights and the other rules of the economic game, to solve the disputes referring to rules interpretation, to make sure the contracts are carried out, to promote competition, to supply a monetary framework, to eliminate the technical monopolies and to overcome the neighboring effects, to complete the individual charity and the family in protecting the persons that are not responsible" (Friedman, 1995, p. 50). In other words, in a free society, the State's functions are the following: solving the conflicts among different individuals, defining the property rights and ensuring some monetary order.

But, in the last decades, even the most fervent liberals consider that, however, in some respects, the State's intervention in the economy is justified to correct certain negative effects in the field of production and distribution, to facilitate the carrying out of the economic activity, by creating a stable monetary framework and assuring the collective services.

Other theoreticians, too, have had different opinions than Keynes. One of the most important economists of the XX century, Joseph Schumpeter, had original ideas which can not be included in one of the traditional trends. In his paper "Capitalism, Socialism and Democracy", Schumpeter investigates, making use of different tools than Keynes, the capitalism and the socialism. From the economic point of view, he shows that capitalism is performing, its performances being due to the large company: the promoter of the innovative progress. But, as the economic performances of capitalism increase, the large company disintegrates the social structures, attacking the basis of the institutional system of capitalism- the private property, destroying the system from within. Thus, the socialism will gain ground not because of its superiority but because of the failure of capitalism which is undermined from within by its own triumph.

In this context, Schumpeter's position towards the State is that of defending liberalism, fighting against the State's intervention in the economy. He foresaw that the price of success in the case of capitalism can be a weak public power and that is why he suggests a policy oriented towards the

support of the "innovative spirit" and towards solving the social inequities by means of the capital gains tax.

One of the contemporary economists which enjoy a huge reputation is John Kenneth Galbraith, who has an original vision on the contemporary capitalism using the concept of institutional organization. According to him, the economic system functions as an answer to the market demand. But in the cases in which this answer is inadequate or imperfect, the State must intervene to correct the demand and to harmonize it with the public interest. In his paper "The Perfect Society", Galbraith says that "without the government's intervention, a modern economy can not reach performance and can not continuously progress" (Galbraith, 1995, p. 25). In this respect, he shows that there is a wide range of economic activities in which the market is not competitive, as well as a wide range of activities in which the State's services and functions are either necessary or superior on the social level.

According to Galbraith, there are four factors that require a State's intervention and control. These factors are:

- the need to protect the planet in the present and in the future, certain regulations that prevent the environment destroying;
- the necessity to protect the most vulnerable employees working in the productive sector against the negative effects of the economic mechanism;
- the frequent tendency of the economy to produce and sell goods with technical deficiencies or which can lead to physical prejudices;
- the system's inclusion of some self-destroying tendencies which destroy its own functions having a certain efficiency.

Each of these factors generates a conflict between those that consider the system an independent force and those that consider some corrective and protective measures as positive measure.

The analysis of various countries' development strategies confirm some knowledge provided by the evolution of the economic theories, that is the fact that there is necessary a certain convergence towards a balanced view of the State-market relations, eliminating the extreme attitudes which have occurred in this field. Therefore, the State and the market can not be opposed. None of these institutions can replace another. They must be complementary.

From the moment of its coming into being up to the present, the State has been forced to make a difficult choice: freedom or control? The specialized literature calls this choice "the dilemma of the modern era" (Chirot, 1996, p. 218) and it consists in the difficulty encountered by the modern society to choose freedom, sacrificing the society's chances of survival, or to choose control, sacrificing the individual freedom.

Thus, on the economic level, there appears the problem of choosing between the supremacy of the market and the State's noninvolvement or the supremacy of the State over the market. Reality has proved that choosing the individual freedom and the free market is better than choosing the coordination of the economy by the State. At the same time, it is well-known fact that the individual freedom is not the guaranty

of the social adhesion, that the individuals need social support and the free market needs a stabilizing support from behalf of the State. As a result, it is accepted the fact that the free market and the State are complementary factors of the economic system and the prosperity of a modern economy depends on finding the balance and sharing the responsibilities between the markets and the State (Samuelson, Nordhaus, 2000, p. 43).

Therefore, it is obvious that in a market economy, the government has economic and social responsibilities. All modern market economies are mixed economies, in the sense that whereas most economic decisions are taken without the government's intervention, certain decisions are taken by the government out of different reasons, such as those of assuring stable rules which protect the private property, the effective competition and the free exchange of goods and services, a legal framework in which the companies carry out their activities. The civil service's support is, even in the market economy, vital for the development of the economy. Governments play another important part in regulating the market economies and in human development. This does not prevent but accelerates the economic growth and makes it more sustainable.

In the democratic system based on the market economy, the State is the one that takes care of the public needs by means of the juridical and financial tools and the companies are really independent and directly responsible.

Practice has shown that in the cases in which the State's intervention was substantial and aimed at developing the private sector, in the cases in which the legal and administrative framework has developed and the entrepreneurial ideas were supported, the government has become a real "engine" for the economic growth. Therefore, governments can intervene in economy in order to create a favorable framework which makes all social groups take part in the economic development and have benefits from this participation.

Despite the fact that the State has been accused of being a bad manager, insensitive to the social problems, an inefficient factor, a bad regulator of economy, playing the pat of the absolute and all-knowing master, it is a main actor on the economic scene, the main means by which "the rules of the game" are defined and, then, put into practice.

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Loan Products Included in the Offer of Commercial Banks

■

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Abstract. *A bank loan is the main form of economical credit. It is for corporate activities – for medium and big companies and for retail activities – for small companies and individuals.*

The conditions for credit mainly depend on the quality of customers, it means their ability to perform a profitable activity and to be able to pay back the credits.

For reasons which are mainly connected to marketing, bank practice has developed a large range of credit names, trying to emphasize some of the parts of the products or to take profit of some competition advantages in relation with customers' products. We are trying to include the offer of bank loans in a typology which takes into account the law, the bank field rules and the main technical features of the offered products.

Keywords: loan products; short term credit; long and medium term credit; commercial banks; risk.

■

JEL Codes: G21.
REL Codes: 11C, 11E.

A bank loan, as the main form of economical credit, it is based on bank deposit, loans taken from the money market, especially from other banks, loans taken from the financial market and bank's own funds. A bank loan is mainly a short term credit because the resources are also on short term and they come from the money market. The medium and long term credit has as main source the loans taken from the financial market.

A credit is addressed to corporate activities – medium and big companies and retail activities – small companies and individuals. It depends mainly on the quality of the customers, it means their ability to perform a profitable activity and to be able to pay the given loans. Banks give loans only on the base of real guarantees or future income assignment of the beneficiaries, as well as the amounts of money in their bank accounts or personal guarantees. Loans are given for the goal established through the contract and the use of the loan for other goals entitles the bank to stop the credit and to start recovering the given amounts in advance. The contract of credit and the contracts of guarantee have a law value and that means the bank can make use of them against the debtor without any other law trial.

As in practice, for reasons which are mainly connected to marketing, we encounter a very large range of credit names, we are trying to include the offers of bank credits in a typology which takes into account the law, the bank field rules and the main technical features of the offered products. Thus, we can find:

1. Short term credits

Global operation loan

The global operation loan is the main type of credit used by companies for their economical activities. This type of credit has been named in different ways, at least since 1990 to present, according to the orientation of money authorities. In 1990 the name of *production credit* was used and it showed very well the goal of the credit, it means the financing of service supplying and production activities. As the term was considered to be old, in 1995 it was renamed as *global operation loan* and had the same economical meaning, but it was considered more adequately for the new market. Starting 2000 the name of *revolving credit* was preferred, a type of loan used in western countries, which allowed the customer to renew its credit to the level initially approved, thus the company had permanently available the same amount of credit till the due date. The substance of the credit has not changed, but the form of giving and paying back; the classic system has been abandoned in favor of a modern form of credit which allowed that the amount develop according to the cash flow fluctuation of the company, giving and repaying multiple amounts of money during the period of credit, but within the limit of the approved level. The term of revolving credit was largely accepted by the bank community, because it showed quite well the feature of the credit which gave the possibility of using a higher volume of credits than the approved one, but it had to be paid back when the reserves were in the approved limit. This form of credit was a step forward in the field of loan offering advantages mainly for companies,

but also for banks as, by operating a higher volume of credits, within the limits of a contract, they could benefit from a higher volume of interests and bank charges for their payment operations. In 2000 this term was also changed into *credit line,* which was considered to be more adequate to the activity of loan and which represented a revolving credit. The crediting mechanism was the current account, which, through its crediting-debiting operation, reflected whether the existing credit (debit sold) or the money reserves (credit sold). Starting 2007, the central bank has introduced the term of *limit of credit*, with the same meaning and mechanism of operation but with a less representative name. Further on we will be using the term of global operation credit, which shows better the substance of this type of credit.

Global operation credit can be given either for the current supplying, production, sale activities or for other sub activities, projects, contracts which, through their nature, are performed and emphasized distinctively. The loan is given for a period up to 12 months and can be renewed, upon the customer's request, on the base of an analysis similar to the one performed when opening the credit line. The credit can be increased or decreased during this period of 12 months if the customer's business activity is better or weaker than the parameters taken into consideration when the credit was approved.

Global operation credits can be given to companies which have adequate financial performances (categories A or B) and which have a good sense of duty. These credits can also be given to companies included in the performance categories C or D, but only for export activities and when these activities have considerable percentage and permanent status in their turnover.

Object credit

An object credit refers to a loan given for orders, final product stocks which are for sale, including unfinished products within the period of credit. This type of credit is typical to building and manufacturing companies, which operate on base of a contract concluded before the production process starts or to companies which acquires stocks of goods in order to sell them later. For a bank this type of credit is more attractive than the global operation one, as the sale of the products is assured and thus the credit repayment is assured.

Credits for financing temporary stocks

This category includes: (a) credits for *temporary expenses and stocks* of raw materials, materials which exceed the needs following to some factors (supplying in advance from suppliers, supplying with best lots of goods, production shut down, difficulties with shipping the goods to house or abroad customers; and (b) credits for *temporary expenses and stocks* of raw materials and products (animal and vegetable agricultural products, agricultural food, other stocks for a longer period than a quarter of a year but no longer than 12 months). These stocks are typical to companies which perform temporary business activities in the food and agricultural industry.

Treasury credits

This category also known as loans for temporary needs, are given to cover the deficit of cash due to a failure in receiving goods or services, to supply some temporary requests of financing, including for the use of some opportunities offered by the market. Treasury credits are given for a period of maximum

30 days. Credits for *account facilities* are of the same nature as well as credits for overdraft, which are given up to 30 days in order to cover the difference of cash flow following to an unpredictable situation.

Discount loan

A discount loan is given on the base of some payment instruments, also called commercial securities, which can become guarantees given to the bank up to the receipts of those securities or one can guarantee in favor of a bank that it will recover their nominal value as beneficiary. In the same way one can do with the cheque, which is either remitted for the bank or guaranteed in favor of the bank. A trade paper, a promissory note and a cheque are loan securities which entitle one to have access to open currency or to tenor. These kinds of loans cannot be given to the companies which have been included in the Data Bank of the Payment Central with incidents in the last six months or the companies whose right to use them has been suspended for a period of 12 months.

The account loan is more risky than other types of loans, as the payment instruments received as guarantee do not assure their settlement and there are risks of failure of payment by the debtor, who is also helped by the period between the issuing and the remittance (which is sometimes quite long) as well as the postdated cheques. There are very important the situations encountered in our bank system, where the loans given on the base of postdated cheques were refused to be paid because of lack of money, and made the banks which offered them to lose money and to try to recover it in the court.

The factoring

Factoring is the operation performed on the base of a contract through which the factor (the bank) takes debts from the customer or it is appointed adherent through the payment of some invoices resulted following to some trade operation, in exchange to a commission. In fact, there is a financing commission, which should remunerate the bank for offering the amount to the customer in advance and a commission of administration which should remunerate the bank for its effort of recovering the money. Unlike discount, in the case of factoring we do not encounter trade papers.

According to the moment of financing the customer, there are two types of factoring:

- *Old line factoring*, when the factor pays the invoices when overtaking them.
- *Maturity factoring*, when the factor pays the debts of the adherent the moment they become exigible. In this second case, the factor does not receive the financing commission, but it is remunerated for the operation of discount.

Services of insolvency and currency risk evaluation are of a great importance in financing the exports. The insurance against the insolvency risk is made by subrogating the factor for the adherent, so that the importer will be considered valid and the payment will be made to the factor. For the currency risk, there must be added a margin to the cost of operation.

The cost of these services is between 0.5 and 3% of the invoice for the administration of the bookkeeping and for the help with the management, and the payment in advance of invoices means a 1.5-3% higher interest than the bank interest.

To make use of the factor offers a series of advantages: it gives you the possibility to use the trade paper or the letter of credit when making the payment, to avoid the misunderstanding which can come out when using a foreign language or not knowing the laws in force or the custom in the importer's country.

Old line factoring assures the adherent a financial reserve earlier than the payment date of the loans given to importers, offering the possibility to place another order without the risk of insolvency of its debtors. Besides it offers the possibility of getting some payment facilities, so for an exporter it is a way of promoting the exports.

Consume credit

Consume credit is a credit given to individuals in order to buy goods or services in the commercial network. In general this is a short and medium term credit. Initially it arose from the possibility offered by a trader to buy goods, especially food, and to pay for them when salaries are paid. Consume credit offers advantages for both parties: the buyers have the possibility to get the goods he needs without having the amount of money needed for this purpose, and the traders promote the products. At the beginning the consume credit was in the way of a trade credit where the risk of non-payment was under seller's responsibility, but in time it has turned into a bank credit. There is a large variety of consume credits which can be changed according to more and more varied offers of goods and according to consumers' preferences closely depending on their income, it means their life standard. The most wanted types of consume credits are the following: non-nominal credits, deck credits, card credits, credits through debit cards for overdraft, car credits, credits for long use products, house credits and credits on mortgage.

Consume credit (except the house credit and credit on mortgage) has a minimum and a maximum limit (about 500 – 20.000 RON), which varies from a bank to another, a period of up to four – five years and a variable interest plus commissions. This credit can be taken in RON or in another foreign currency. The size of the credit is given depending on the value of the goods which are to be bought and on the income made by the person (and its family) who takes the loan. The guarantee is the transfer of the income made out of salaries and, if the case, the endorsers' revenues.

Consume credit also has a social component, as it finances the people's going up desires of consume through a later repayment thus becoming the engine of retail activities. The more advanced a society is the higher the amount of consume credits among non government credits is. But there is a limit where one can extend the consume credit determined by the level of people's debts according to the income made by them, which varies from a country to another and it is between 50% and 70%, depending on the country's monetary policy.

Non-nominal credits

A non-nominal credit (also known as credit for personal needs) is the most used form of the consume credit, being used to cover the present requests of the person (and its family) who takes the loan. As a rule, this is a credit which must be guaranteed by personal income and possibly by other endorsers.

On the market there are also non-nominal credits for long use goods, but they operate as long and medium term credits.

Credit through credit cards

A credit through credit cards is a classic short term credit which is given according to the banks' standards. This is a type of revolving credit, it means a credit line of a certain value (also called limit of credit) from which one can make payments within its limits and which has to be monthly renewed. The owner of the card is obliged to pay a third of the credit balance at the end of the month and also to cover the interest and the commissions, then he renews the limit of credit. The risk of a failure of payment is higher for a credit card than for the other short term credits, as the interest is also higher. Yet the credit through a credit card has become a common one and it is now the most favorite way of paying goods.

Credits through debit cards for overdraft

An overdraft credit for individuals is specific for a debit card and it is a line of credit which depends on the operation of this card. Mainly the payment can be made through the debit card only within the limit of the amount of the card account. For a salary card, the bank offers a credit facility, it means that, without money in the account, one can make payments from the credit line within the limit of an amount of the salary and this amount should be paid back from the first salary received together with its interest and commissions. The guarantee is offered by an employer who undertakes to retain the amount from the salary in case the overdraft credit is not paid back.

2. Long/medium-term loans

Development loans

Development loans are the ones which are given for new investments in production facilities and equipment, infrastructure work, water plant management, city construction management and others which can be the base for economical development. Investments are of great values which are to be made in several years and have a long term economical effect. Investments are made on the base of some technical economical documents which should contain the description of its efficiency apart from the technical one.

Loans are approved on the base of these documents, approved by the beneficiary's management board and they must have the expertise of the technical and economical department of banks, and if they do not have this kind of specialists, they have to get the advice of a specialist. A bank analysis is focused on the economical efficiency of the investment which should show the possibility of credit reimbursement and should make the beneficiary increase its profitability. Credits are given to make up the investor's funds, but it is the main financing source (about 60% - 70%). The period of credit is of about 15 – 25 years, depending on the nature and the efficiency of the investment.

For investments of great values, the credit is given by a bank pool, it means a group of banks which is formed to take part with a certain percentage to the financing in order to share the risk of credit. Financing is assured through one of the banks which represents the whole group – the agent bank – and which monitors the credit till the reimbursement is complete. The guarantee is the investment, and if it is considered necessary, because of the long term of the credit, one can ask for other bank or state guarantees.

Credit on mortgage

Credits on mortgage are also long term credits given to buy dwellings (houses, flats, or land) which are based on the mortgage over the investment according to the Law of the loan

on mortgage no. 190/1999. In Romania, the credit on mortgage has increased since 2003 and has developed rapidly because of the deficit between the dwellings and the possibilities of financing which had arisen. 70% of the investment is given as a credit, and the dwelling is on mortgage in favor of the credit bank till the reimbursement of the loan is completely paid back. The size of the credit depends on the income and the age of those who take the credit so that the credit could be reimbursed completely during the active period of their life. The credit period is up to 20-30 years, but these limits can be extended depending on the monetary policy. To finance these investments, there are mortgage banks which take long term credits from the capital market or ask other financing companies or investments funds to co-finance these investments, but the role of agent is played by the mortgage bank. The risk is that the debtor could fail to make the reimbursement during such a long period of time and the bank should be in charge with selling the real estate according to market conditions. The highest risk is the difficulty in anticipating the economical evolution on long terms, a very good example is the crisis of the subprime loans in the USA which made financing companies to lose a lot of money and some of these companies went bankrupt. After the events of September 11, 2001, the government encouraged the drop in interests which decreased from 7% to 1% in order to encourage constructions and to stimulate the economic growth, which led to an avalanche of mortgage credits. The problem was when interests went up again and made a lot of debtors fail to perform the payment of their installments which led to a deterioration of the portfolio of credits on mortgage (one of four credits became unprofitable). The failure of payments led to the collapse of dwelling demands and consequently the drop in price, thus the banks could not sell the dwellings taken from the debtors and lost about US$ 400 billion, some of them almost went bankrupt. This crisis has already started to arise in other countries too, for example in England.

Real estate credits

Credits for real estate investments are given to buy real estates or land for construction and they are guaranteed with those real estates or with the bought land or with other real estates or other land. These credits are medium or long term credits which are based on the deed of sale and on the investor's capacity to reimburse the loan. Real estate credits are also used to erect buildings having as a guarantee the erected building after it has been finished. Before the building is finished there are used other kinds of guarantees, as an unfinished and non operational building can not be considered as a guarantee.

Leasing credits

Leasing credits are medium term credits and are given to leasing companies for buying movables or real estates, which then can be leased or rented with the option to buy the product at a price previously established or to return it to the company at the end of the leasing period. The credit is given up to 85% of the goods value on the base of real guarantees (real estate guarantees) and on the base of the goods that are to be bought and other additional securities under the form of a transfer of debts of the amounts in the account, on the base of compensation from insurance companies. Although the leasing is a new activity, it has expanded quite fast on the base of financing from bank credits.

Nominal credits

This type of credit is given to buy new vehicles from authorized dealers or to buy second hand vehicles from second hand traders or individuals. Its particularity is that the buyer should have at least 25% of the funds as the credit is 75% of the goods value. The goods should be insured by the buyer and the insurance policy is transferred to the bank. Credits for other types of goods (domestic electronic and electric devices, computers, IT components, furniture) are given under the same conditions as for vehicles.

Forfaiting

Forfaiting is an operation of transferring the debts of a foreign business trade made on credit to a bank or to a special financing company. The bank pays for these debts on the spot and it will recover their value from the importing debtor. The operation looks like discounting, but there are several technical elements which are different. Firstly, forfaiting unlike discounting, does not give the bank the right to appeal the seller of the debts in case there are any incidents regarding the payment caused by the debtor. Secondly, the term of the operation makes the difference. Forfating applies not only to the short term debts, shorter than a year, but also to those of medium term, from 1 year to 7 years. But we have to notice that in Romania the operation rather works within the lower limit of the above mentioned period. The bonds used in the forfaiting can be bills of exchange, bills payable to order, letters of credit.

Forfaiting's advantages are: creating cash, respectively improving the cash flow by receiving immediately the value resulted from selling the bills of exchange, avoiding the risk of non-payment of the bills of exchange at the stated term – this risk being overtaken by the bank – and promoting the goods at selling on the base of a sure financing. The cost of financing has a fixed rate of interest, plus a commission established depending on the debtor's reliability, on the fact that the bills of exchange are or not guaranteed, on the estimated risk of operation, on the way of paying the forfaiting. Thus the determined discount reduces the nominal value paid to the exporter. Taking into account the risk overtaken by the bank, we can find here higher costs compared to discount operation.

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Site-uri oficiale ale băncilor comerciale din România

Research Methodologies for Management Information in Romania

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Abstract. *The rocketing trend manifested in the last years in the information system domain has led to a considerable increase of research activity in this field. The purpose of this article is to identify the main research methodologies in management information systems in our country and in European space. Based on our research's results, we present specific categories for research classification and describe various new trends in scientific publications related to management information. In our research we used empiric methods based on knowledge extraction from databases and archives related to various representative publications in management information field.*

Keywords: management information system; research methodologies; modelling; analysis.

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JEL Codes: 23I.
REL Codes: 4A, 2B.

Introduction

Interactions between informatics and other scientific domains has determinated a great interest in academic research area for interdisciplinary studies, most of them referring to management sciences. Meanwhile, there could be observed a growing interest in making decision area and also in designing and modelling of information systems for economic system's analysis and evaluation. The high level of complexity of economic systems involves the use of various methods for modelling and analysis of information system designed for the system management.

We have focused our studies on the research methods related to management information systems and we have tried to make a comparative analysis of methodologies in Europe and in Romania.

A short history of management information systems science

Probably the turning moment, when the management science was born, was when the book Principles of Management by Frederik Winslow Taylor was printed, in the early 90s. In the same period of time, the management sciences gain their autonomy and became popular in universities. The first reporting about management science in United States could be mentioned in 1954, and in 1970 in France there were founded the bases of the discipline known as "science de gestion". The IT technology has been played an important role over the years in the development of management sciences and the dynamic growth of computer power allows problems of great complexity to be solved.

Ionașcu (2007) pleaded for the recognition of management sciences in Romania, delimiting the role of management science in the global context of economic sciences. The main objective of management science is defined as the study of ways to manage, conduct, structure and develop specific organizations.

Simon (1982) has identified the differences between economy and management sciences as following. "The economy has discovered the market institution, the pricing mechanisms as process of adjustment. The management has discovered the institution of formalized organization, mechanisms of authority and interpersonal influence to ensure coordination. The management has discovered the planning as a mean of making decisions. Enterprise has become the border between economics and management".

In international area studies, a reference point for documentation is the prestigious magazine classified ISI JMIS – Journal of Management Information Systems, ISSN: 0742-1222 (http://www.jmis-web.org/toppage/index.html. This documentation source enables viewing of works indexed according to specific keywords.

Research methodology

To achieve this study were used several databases. The first was the archive of the Journal Science in accounting and management information systems available on www.cig.ase.ro/revistacig, magazine ranked by CNCSIS in the B+ category. All the articles related to thematic area of IT management were included.

The second source was the library that contains the details of the paper from the ECIS (EndNote ECIS, 2007) conference, as a source of relevant information reflecting the trend of scientific research in information management in Europe. Information

gathered from these two sources was managed with a Microsoft Access database.

Research methods used in the management information systems domain

The purpose of research in the information systems focuses on the contributions made by information systems in achieving social ideals (Orlikowski, Baroudi, 1991; Hirschheim, Klein, 1994; Ngwenyama, Lee, 1997; Klein, Myers, 1999; Brooke, 2002b; Myers, 2004; Bryman, 2004).

The methodology is understood by Dubravka Cecez-Kecmanovic (2007) as a global strategy for conceptualisation and development of research, focusing particularly on methods of specific empirical research approached from a positivistic, interpretive or critical point of view.

Dubravka Cecez-Kecmanovic (2007) identifies three main lines of a methodology: the first being able to choose from a variety of critical theories and to formulate specific questions; the second is the methods opportunity and the methods application which must be evaluated on the basis of epistemological assumptions and depending on the type of critical questions investigated, while the third methodology harmonizes the principles and processes of building scientific knowledge.

Chua (1986) identifies three categories of research epistemology classification: positivistic, interpretive and critical perspectives.

The purpose of positivistic research in information systems domain is to test theories and causal realities that explain and predict phenomena in the development and use of information systems and analyse the impact on organizations.

In this methodology it is used the hypotheses testing and the estimation (forecast) based on population samples (Orlikowski, Baroudi, 1991). A special category in the positivistic research is the category based on the descriptive articles that typically include case studies, with or without descriptive statistics (frequencies and percentages). Survey and controlled experiments are techniques for collecting primary data, meanwhile statistics are methods of data analysis used to "discover" causal link (Orlikowski, Baroudi, 1991). In the interpretative research of information systems, unlike the positive research, researchers combined the results of their own subjective opinion, considering the reality as a social product that can not be understood independently of social actors (including researchers), who are also "builders" and who influenced the design of the subject of studies (Orlikowski, 1993; Walsh, 1993; 2001; Klein, Myers, 1999). Instead of formulating conclusions as established facts, interpretative research provides form of interpretation (Dubravka Cecez-Kecmanovic, 2007).

Critical research aims to critique and explain the use of information systems (IS) in organizations and society, systems that, for efficiency reasons, require rationality, progress and development, sometime with negative social consequences (Dubravka Cecez-Kecmanovic, 2007). Researches developed within this theory are related to time and context and are common for researching and case studies in historical and ethnography studies (Chua, 1986).

The framework proposed by Dubravka Cecez-Kecmanovic (2007) for a critical research methodology includes four distinct but interrelated components: a) detailed and intensive examination of local situations and

problems that affect real people, working conditions and organizations, b) critical explanation and comparative structural generalization c) open discourse and transformative redefinition or action, and d) reflexive dialectic orientation.

Data analysis

Issues addressed in the scientific research regarding management information systems is quite extensive, including systems design, measuring of effectiveness, the influences of the management information systems and, not at least, the security.

As a research topic at the border of several interdisciplinary sciences, the research in management information systems domain is influenced by:

- The dynamics of technological changes. The emergence of new technological solutions involves analyzing and evaluating how they respond to new challenges.
- Evolution of research in related fields (accounting, management).
- Linguistic turn. The linguistic turn has already impacted IS and this impact may well increase. The language game of re-naming is practiced to a certain extent within the discussion of knowledge management and the transition of Enterprise Resource Planning Systems to Enterprise Systems. Importantly, the linguistic turn not only impacts at the "application level", but also on the methodological level. If the nature of language is considered, then positivist methodological dominance in IS must be questioned (Dreiling, 2007).

Classification of research in management information systems has been enounced by several authors. Banker & Kauffman (2004) have proposed a classification of scientific research in management information systems domain, based on papers published until 2004. This classification was later adapted in the study by Galliers & Whitley (2007).

Categories used to classify research in management information systems

Table 1

Category	Methods	Key words
Decision support systems	Mathematical programming, forecasting, simulation, expert systems	Systems to assist decision, Models, Decisions
System development	Experiments, argumentation, simulation, system test-beds	Systems development, Systems design, Planning systems, Architecture, Modelling
Human	Experiments, argumentation, simulation, system test-beds	Interfaces, Users
Research issues	Case studies, Experiments, empirical analysis	Case studies, Research on information systems, Knowledge
IS organization and strategy	Models, case studies, experiments, argumentation, blend of qualitative and quantitative methods	Organizational management, Enterprise resource planning, Internal market, Strategy, Outsourcing, Business
Economic	Analytical modelling, empirical analysis, cross-sectional and longitudinal design, experiments, simulation	IT productivity, Economy

Category	Methods	Keywords
Technology	Analytical modelling, empirical analysis, cross-sectional and longitudinal design, experiments, simulation	Networking
Society	Analytical models, statistical analysis, simulation, empirical analysis	Governance, Public sector, Public services Society
Electronic Markets	Analytical models, statistical analysis, simulation, empirical analysis	Electronic commerce, Electronic markets

Source: Adjustment after Banker & Kauffman, 2004 and Galliers & Whitley, 2007.

Results

The results based on data analysis are presented in the following graph:

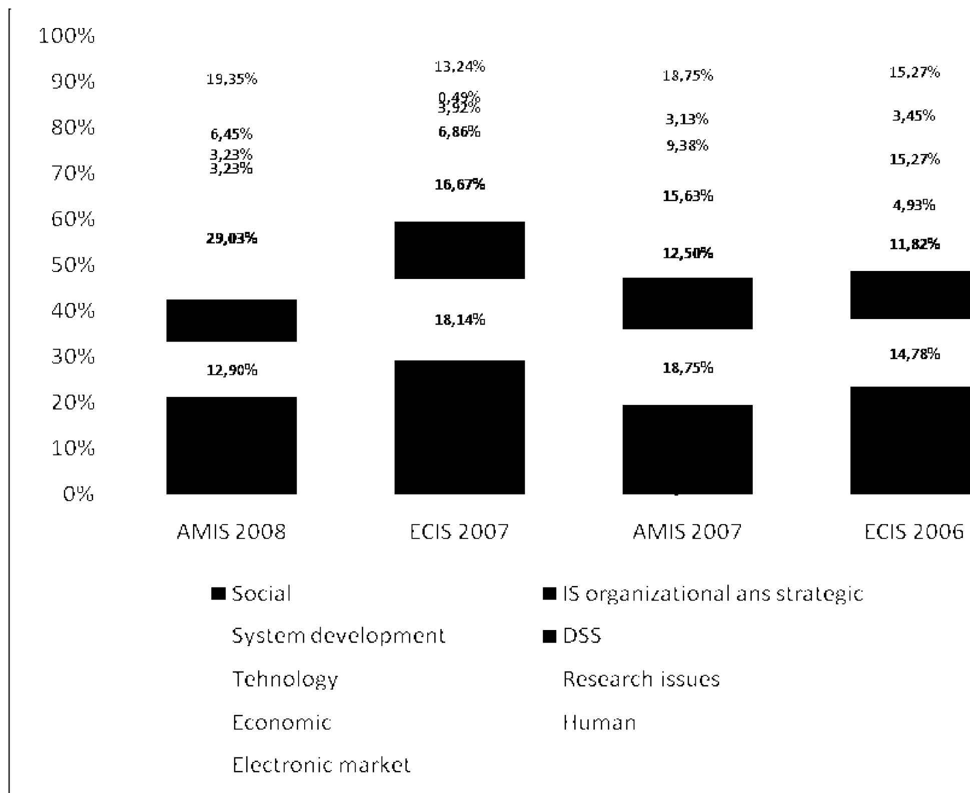

Figure 1. *Percentages of articles in various conferences held by each category of research in information sciences*

Most papers from 2008 at the AMIS conference falls in the Technology category (29.03%), compared to 12.5% in 2007 at the same conference. System development category has about the same percentage each year for AMIS and ECIS Conference.

Unlike in 2007, when the articles in AMIS conference in category "Research issues" had 15.63%, in 2007 at the same conference, articles in this category had a substantially lower percentage, only 3.23%. In terms of research type, positivistic research is the most common style in the articles held within the international conference AMIS.

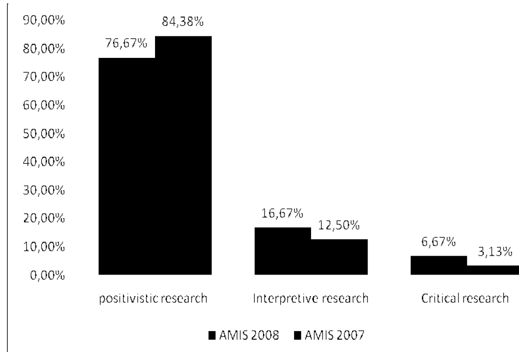

Figure 2. *The number of works by each category of research*

Conclusions

The aim of our studies is to provide an analysis of areas of interest in the research of management information systems. We have tried to achieve a classification of the papers presented in various sessions of scientific communications in nine categories, depending on the keywords associated with each article. For each of these categories it has been described a set of methodologies and techniques whose application is best suited for the specific encountered problems.

Interdisciplinary research in the field of information technology has known in the last years a sustained increase, being further characterized by analysis of problems related to management information systems, including managing business processes, IT Governance, data analysis and support systems to support decision making.

Research in the science of management information systems continues to play a key role in the economic field, especially through various ways of providing support for management decisions.

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