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FINANCIAL SECTOR ASSESSMENT

ROMANIA

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FINANCE, COMPETITIVENESS & INNOVATION GLOBAL PRACTICE
EUROPE AND CENTRAL ASIA REGIONAL VICE PRESIDENCY

A joint World Bank-IMF Financial Sector Assessment Program (FSAP) mission visited Romania from October 31 to November 21, 2017, and from January 11 to January 23, 2018.¹ This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities and development opportunities, and provides policy recommendations.

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CONTENTS

Executive Summary	vi
I. Macrofinancial Background	1
II. Systemic Risk and Resilience	2
A. Key Vulnerabilities	2
B. Resilience	3
III. Macroprudential Framework and Policies	5
A. Macroprudential Framework.....	5
B. Macroprudential Policies.....	6
IV. Sectoral Supervision	7
A. Bank Supervision and Regulation.....	7
B. Financial Market Infrastructures	8
C. AML/CFT.....	8
V. Financial Safety Net and Crisis Management.....	9
VI. Financial Sector Development.....	9
A. Financial Intermediation	9
B. Capital Markets	17
C. Insurance Sector	19
D. Housing Finance	20
Appendix I – Tables and Figures	22
Appendix II - Status of FSAP 2009 Recommendations	26
Boxes	
Box 1. Romania: Financial Infrastructure.....	12
Figures	
Figure 1. Romania: Economic Developments 2008–17	22
Figure 2. Romania: Financial Developments 2008-16	23
Tables	
Table 1. Romania FSAP 2018: Key Recommendations	ix
Table 2. Romania: Selected Economic Indicators	24
Table 3. Romania: Financial Soundness Indicators	25

GLOSSARY

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ASF	Financial Supervisory Authority
ATM	Automated Teller Machine
BCP	Basel Core Principles
bps	Basis points
BRRD	Bank Recovery and Resolution Directive
BVB	Bucharest Stock Exchange
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CB	Credit Bureau
CCP	Central Counterparty
CCR	Central Credit Register
CESEE	Central Eastern and Southeastern Europe
CET1	Common Equity Tier 1
CPSS	Committee on Payment and Settlement Systems
CRD	Capital Requirement Directive
CRR	Capital Requirement Regulation
CSALB	Romanian Alternative Dispute Resolution Center for Banking
CSD	Central Securities Depository
DPA	National Supervisory Authority for Personal Data Processing
DSTI	Debt-Service-to-Income
EBA	European Banking Authority
ECB	European Central Bank
EIF	European Investment Fund
ELA	Emergency Liquidity Assistance
EM	Emerging Market
EU	European Union
EUR	Euro
FATF	Financial Action Task Force
FGDB	Bank Deposit Guarantee Fund
FIU	Financial Intelligence Unit
FMI	Financial Market Infrastructure
FNGCIMM	National Credit Guarantee Fund for SMEs
FSAP	Financial Sector Assessment Program
FTSE	Financial Times Stock Exchange
FX	Foreign Exchange

GDP	Gross Domestic Product
GDR	Global Depository Receipt
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principles
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPO	Initial Public Offering
LCR	Liquidity Coverage Ratio
LTD	Loan to Deposit
LTV	Loan to Value
MiFID	Markets in Financial Instruments Directive
ML/FT	Money Laundering and Financing of Terrorism
MoAI	Ministry of Administration and Interior
MoE	Ministry of Economy
MoJ	Ministry of Justice
MONEYVAL	Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism
MoPF	Ministry of Public Finance
MSCI	Morgan Stanley Capital International
MSME	Micro, Small and Medium-sized Enterprise
MTPL	Motor Third Party Liability
NBFL	Nonbank Financial Lenders
NBR	National Bank of Romania
NCMO	National Committee for Macroprudential Oversight
NPL	Non-Performing Loan
NRA	National Risk Assessment
NSFR	Net Stable Funding Ratio
PAID	Natural Disaster Insurance Pool
PD	Primary Dealers
PEP	Politically Exposed Person
PFMI	Principles for Financial Market Infrastructures
POS	Points of Sale
PSD2	Payment Service Directive 2
RASDAQ	Romanian Electronic Stock Market
ROA	Return on Assets
ROBOR	Romanian Interbank Offer Rate
RON	Romanian Lei

RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SaFIR	Romanian Central Depository and Securities Settlement System
SAL-FIN	Romanian Alternative Dispute Resolution Center for Non-Banking Financial Institutions
SLB	Securities Lending and Borrowing
SME	Small- and Medium-Sized Enterprises
SOE	State-Owned Enterprises
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism

EXECUTIVE SUMMARY

- 1. Romania's financial sector has strengthened significantly over the last few years.** Effective supervisory measures have helped reduce the high level of non-performing loans (NPLs) from 21.5 percent at its peak in 2013 to 6.4 percent as of December 2017. Foreign-owned banks' dependence on parent funding has significantly declined, while deposits from the domestic private sector have increased, reducing liquidity risks. Banks' capital buffers strengthened, on the back of a slowdown of credit and low interest rates, with an average capital to risk-weighted assets now above 18 percent.
- 2. However, some vulnerabilities are emerging.** Banks' holdings of domestic sovereign paper have grown large, exposing them to valuation losses in case of an increase in interest rates or sovereign risk spreads. Banks' indirect exposures to government guarantees through the Prima Casa program further strengthens the sovereign-bank nexus. An increase in interest rates may also negatively impact NPL ratios on banks' mortgage portfolios, which are growing fast and are at variable rates. The share of foreign exchange (FX) denominated loans and deposits significantly decreased, but remains relatively high, and a large share of corporate borrowers is unhedged. Finally, lending practices of non-bank financial lenders (NBFLs) may lead to loan defaults and reputational risks for the banking sector. As the financial system is small, shocks may further discourage financial intermediation, which is already among the lowest in the European Union (EU).
- 3. The NBR is transitioning to a risk-based supervisory approach that needs further enhancements.** The new Supervisory Review and Evaluation Process (SREP) Guidelines of the European Banking Authority (EBA) are still in the initial stages of implementation. The NBR should conduct more risk-focused, banking industry-wide thematic analyses and develop its off-site monitoring tools, such as by conducting bottom up stress tests. The NBR should also build up specialized expertise, in particular in IT and cybersecurity. This will also benefit the systemically important payment and securities settlement systems that are currently being brought under the roof of the NBR. Finally, remaining gaps in the AML/CFT framework should be addressed.
- 4. Financial intermediation relative to the economy is low and declining.** The depth of the Romanian banking sector is lagging both in terms of deposit and loan penetration. While poverty, rurality and informality form a set of constraints that may subside in the long run, other influencing factors currently contribute to a low supply/demand equilibrium. On the demand side, credit needs remain, overall, limited due to low enterprise density, poor health of the enterprise sector, and high number of foreign owned firms (compared to peers). The economic growth had a positive spillover in the enterprise sector, but this did not translate into increased investment activity, despite an unprecedented low interest rate environment. On the supply side, the supply of credit has been constrained by several factors including: i) an acute deterioration of asset quality, particularly among MSMEs, after the crisis, ii) banks' deleveraging pressures, iii) deficiencies in the credit enabling infrastructures (credit reporting, insolvency), iv) preference of banks for sovereign debt, as well as government guaranteed debt in a context of fiscal expansion, v) lack of depth in the NBFIs segment, and vi) declining use of

public partial credit guarantees due to operational problems. As a result, access to credit is particularly problematic for certain firm segments that are underserved by the banking sector, including for micro, small and medium-sized enterprises (MSMEs), start-ups, the agriculture sector, and in rural areas. The emergence of banks with clear MSME lending development strategies or niche market positioning could reverse the banking disintermediation trend.

5. Financial inclusion is also lagging. In addition to the structural factors already mentioned, low intermediation is the result of a thin (and declining) bank branch network, especially in rural areas. Although the recent law introducing zero fee accounts for about 50 percent of the population may enhance inclusion, it may also have adverse effects such as higher interest / fees for other clients, or the acceleration of banks' retrenchment from rural areas. Improving financial inclusion may require broader solutions including i) a better use of the Posta Romana network of branches, ii) measures to enable credit unions to expand and offer more financial services while strengthening supervision, iii) the adoption of incentive mechanisms to accelerate the expansion of digital finance solutions, and iv) the promotion of financial inclusion and literacy as well as effective consumer protection mechanisms.

6. The State is expected to play a more targeted role geared toward the closing of these financial sector development gaps. These gaps persist despite the presence of several public initiatives to support access to finance. Several schemes are poorly designed, too fragmented and insufficiently coordinated. It is necessary to adopt a holistic view by encompassing all state institutions and initiatives, eliminating duplications, identifying and taking into account all market gaps and leveraging commercial finance. The authorities should also consider establishing a Financial Sector Development Committee with a clear development mandate, an effective monitoring and evaluation system and accountability mechanism.

7. The insurance market continues to be underdeveloped. The insurance sector is characterized by low levels of penetration and concentration in the motor-third party liability (MTPL) segment. Recent turmoil in the non-life sector has undermined trust in the industry and affected independence of the regulator, despite initiatives to stabilize the market. Although regulation and supervisory standards have been revised in alignment to EU standards, and new country-specific regulation has been enacted—including a resolution regime for insurers and a new MTPL Law—a thorough external assessment of the regulatory and supervisory framework is warranted to ensure its adequacy and effectiveness. Efforts to develop other segments of the market, such as homeowners' catastrophe property, health, and life insurance are warranted.

8. Romania has made significant progress in the development of its capital markets; this positive momentum needs to be maintained. In the past years a broad range of reforms has been undertaken and progress has been noticed internationally. As a result, more liquidity has been brought to the market, both the domestic and foreign investor base has deepened, and medium to longer term investment has increased. However, more could be done on the institutional investor front (especially given the stagnation of the insurance sector). In addition, country level concerns regarding Government support for the development of the market,

corporate governance of state-owned enterprises and changes to the private pension system, risk reversing the progress made to date. There are also market level issues that need to be addressed in order to further increase liquidity and successfully introduce new products.

9. Housing finance has grown steadily in a benign credit environment which has seen falls in both interest rates and delinquency rates. However, the law on debt-discharge continues to create uncertainty for lenders and provides a further incentive to rely on the Prima Casa program which is exempted from the provisions of that law. In light of the new personal insolvency law, which provides additional rights for borrowers, the law on debt discharge should be repealed to sustain further housing finance expansion.

Table 1. Romania FSAP 2018: Key Recommendations

Recommendations	Agency	Time
<i>System Risks and Macroprudential Policies</i>		
Strengthen the NCMO's accountability framework by i) requiring proposed policy actions and distribution of votes to be publicly disclosed in the summary of meetings; and ii) developing a common assessment of systemic risk at each NCMO meeting.	NBR, MoPF, ASF	NT
Apply a stressed DSTI limit to household loans and continue scaling back the Prima Casa program.	NBR, MoPF	NT
Enforce a currency-differentiated LCR and monitor a currency-differentiated NSFR for significant currencies.	NBR	NT
Introduce a carefully calibrated Systemic Risk Buffer to increase resilience against risks from large exposures to the sovereign.	NBR, MoPF, ASF	NT
Ensure provisioning requirements for NBFLs tighten in line with the application of International Financial Reporting Standards (IFRS) 9 to banks.	NBR, MoPF	NT
<i>Sectoral Oversight</i>		
<i>Bank Regulation and Supervision</i>		
Ensure consistency and objectivity in Supervisory Review and Evaluation Process (SREP) scores, findings and supervisory measures.	NBR	NT
Enhance supervisory tools by incorporating more forward-looking views (e.g., bottom up stress testing tools) and conducting more thematic reviews.		MT
Strengthen bank corporate governance (number of independent board members, content and periodicity of exchanges between the NBR and board members).		NT
Review and amend the regulation not governed by EU harmonization (e.g., transactions with related parties) in a more prudent manner.		NT
<i>Financial Market Infrastructures</i>		
Adopt the PFMI and formalize and strengthen cooperation between the NBR and the ASF for the supervision of the Bucharest Stock Exchange CSD.	NBR, ASF	NT
Invest in more and more qualified IT staff, in particular in the area of cyber resilience, and implement a formal project management methodology.	NBR	I
<i>AML/CFT</i>		
Address the remaining gaps in the AML/CFT preventive framework, including with respect to PEPs, and entity transparency; assess and mitigate the ML/TF risks.	MoJ, MoAI	I
<i>Crisis Management and Bank Resolution</i>		
Prepare an interagency simulation exercise that includes all members of the macroprudential committee plus the FGDB.	all	I
Seek an exemption from the Procurement law for bank resolution purposes.	NBR, MoPF	MT
Include MoPF officers linked to bank resolution under personal legal protection provisions.	MoPF	MT
Ensure that Romania's interests are addressed in recovery and resolution plans of Romanian subsidiaries of foreign banks.	NBR	NT
Diversify the investment policy of the FGDB, and establish operational procedures with the NBR that allows the FGDB to have accounts in the central bank and a repo line.	FGDB, NBR	NT
Finalize and implement an ELA scheme and provisions for FX liquidity support.	NBR	NT
<i>Financial Market Development</i>		
<i>Financial Intermediation</i>		
Establish steering committee with financial sector development mandate to make proposals on priority actions for financial inclusion, access to finance, and financial literacy.	MoPF	I

Establish a multi-stakeholder committee tasked with improving the quality of credit reporting and enhancing its reach to improve access to finance.	NBR, DPA	I
Undertake cost-benefit analysis related to the further development of the credit union sector including reviewing the regulatory and supervisory framework.	NBR	NT
Prepare a national strategy for financial inclusion, which is well-coordinated, robustly monitored, and evaluated and reflecting all stake-holders to address lagging financial inclusion, especially in rural areas. The strategy should reflect a digital approach and include a financial education component, which is targeted and informed by a baseline household financial capability survey.	NBR, MoPF	NT
Strengthen the monitoring of bank agents (e.g. via a register), which would also highlight areas of regulatory focus for the future.	NBR	I
Provide incentives for the usage of digital payment solutions e.g. by awards to buyers and merchants (through lottery), or merchants' tax cuts based on the volume of card and mobile phone transactions.	NBR, MoPF	I
Amend CSALB's rule so that providers can no longer opt out (and without introducing any new restrictive conditions).	CSALB	I
Capital Markets		
Increase or at least maintain Pillar 2 pension contributions to original targets.	MoPF	NT
Restore best practices on corporate governance for SOEs.	MoPF	NT
Adopt measures improving market liquidity (link to regional CCP, clarify framework for SLB, and take measures to resolve dormant retail accounts).	ASF, MoPF	NT
Address remaining constraints in the non-government bond markets (remove requirement of extraordinary general meeting to issue corporate bonds, level tax playing field between interest payments coming from different instruments, review rating requirements for corporate bonds applicable to pension funds, and definition of a system to manage settlement failures).	ASF, MoPF	NT
Insurance		
Conduct an independent assessment of ASF's compliance with all IAIS Insurance Core Principles (ICPs).	ASF	NT
Strengthen the independence of ASF.	ASF	I
Conduct review of new regulatory framework for motor third party liability insurance with all stakeholders, and adjust as necessary.	ASF	NT
Establish working groups with all relevant stakeholders to develop propositions to stimulate life and health insurance.	ASF	NT
Implement appropriate measures to increase compliance with mandatory homeowners' catastrophe insurance.	ASF	NT
Housing Finance		
Repeal the Law on debt discharge, given the introduction of a personal insolvency framework and the provisions of the Mortgage Credit Directive, both improving borrower rights.	MoE	I

Agencies: ASF = Financial Supervisory Authority; CSALB = Alternative Dispute Resolution Center for Banking; DPA = National Supervisory Authority for Personal Data Processing; FGDB = Bank Guarantee Deposit Fund; MoAI = Ministry of Administration and Interior; MoPF = Ministry of Public Finance; NBR = National Bank of Romania; MoE = Ministry of Economy, MoJ = Ministry of Justice.

Time Frame: C = continuous; I = (immediate) = (within one year); NT = (near term) = (1-3 years); MT = (medium term) = (3-5 years).

I. MACROFINANCIAL BACKGROUND

10. Romania made important progress in addressing economic imbalances and restoring growth after the global financial crisis, but macroeconomic imbalances are rebuilding. Partly in the context of successive EU and International Monetary Fund (IMF)-supported programs in the period to 2015, macroeconomic stability was restored. Growth more recently accelerated on the back of procyclical fiscal policies, and Romania's real GDP surged to 7 percent in 2017 (Figure 1, Table 2). Low imported inflation and indirect tax cuts kept inflation subdued, but inflationary pressures are increasing on account of sharp wage increases and increases in consumption, leading monetary policy to tighten after a long period of accommodation. The perception of weakening fiscal prudence could adversely affect market confidence, leading to a sharp drop in consumption and investment, while increasing the cost of government borrowing, and putting pressure on the exchange rate.

11. Romania's financial sector remains dominated by banks, a large share of which is foreign-owned, but the importance of NBFLs is growing. There are 35 banks in Romania, 29 of which are foreign-owned (22 subsidiaries and 7 branches). The banking system as a whole holds around 80 percent of financial sector assets (Figure 2). Concentration is moderate, with the largest five banks accounting for about 60 percent of total deposits in the system (and 57 percent of all loans). Loans granted by NBFLs, a majority of which are owned by banks, accounted for just over 10 percent of total loans, but the share is increasing. Furthermore, NPL reduction has led to a sizable sector of debt collection companies.

12. Bank soundness indicators strengthened over the past few years. NPLs reached 21.5 percent of total loans in 2013, but have been brought down to 6.4 percent in December 2017, and the provisioning ratio (including general provisions) is high at around 65 percent. Following the balance sheet clean-up that started in 2014, banking sector profitability rebounded to positive territory in 2015 and further improved in 2017, with average sector return on assets increasing to 1.3 percent (Table 3). Banks' liquidity positions also strengthened markedly, as the systemwide loan-to-deposit ratio fell to around 75 percent in 2017, from 131 percent in 2008. Romanian banks' capital ratios appear at comfortable levels and banks enjoy a relatively high-risk weight density resulting in favorable leverage ratios compared to European counterparts (Figure 2).

13. Foreign-owned banks' dependence on parent funding has significantly declined. The share of deposits from the domestic private sector (about a third of which are demandable, and the rest at short terms of up to one year) has increased from about 48 percent of banks' total liabilities in 2011 to about 64 percent in 2017, while parent funding has declined markedly to about EUR 7 billion, a third of the level in 2011. In the context of the Vienna initiative, debt liabilities were replaced to some extent by capital injections from parent banks, boosting capital ratios and reducing vulnerabilities.

14. The ratio of private bank credit to GDP in Romania is among the lowest in the region. Measures of financial intermediation place the local banking sector last among EU countries, with bank assets at just 52.7 percent of GDP in September 2017. While large corporates do not appear to be credit-constrained, since many of them tend to borrow directly from abroad, access to and demand for financing for MSMEs appears limited. This reflects legacy issues on the supply side,

as the share of NPLs were highest among SMEs and their balance sheet repair is still ongoing, making banks reluctant to lend to SMEs, as well as on the demand side.

15. The traditional nonbank financial sector remains underdeveloped and is subject to oversight by the Financial Supervisory Authority (ASF). The Romanian insurance market has one of the lowest levels of insurance density and insurance penetration in Europe. The sector has recently been stagnant as several major insurance companies have come under financial strain. The Romanian stock market has a market capitalization of just 20 percent of GDP, as well as low market liquidity. The fixed-income market is also relatively small, with around 80 bonds traded at the Bucharest Stock Exchange (BVB) -including 16 corporate bonds- and a total value traded of US\$403 million in 2017.

II. SYSTEMIC RISK AND RESILIENCE

A. Key Vulnerabilities

16. Concerns about the stability of Romania's financial system can be organized around four main issues: i) banks' exposure to the government through large positions in domestic sovereign debt and guarantees for Prima Casa loans; ii) growing exposures of banks to the real estate market at variable interest rates; iii) exposures of banks and NBFLs to an increase in NPLs, both on domestic and foreign currency loans; and iv) growing lending by NBFL's leading to vulnerabilities and reputational risks for the banking sector.

17. The exposure of banks towards sovereign risk is increasing, creating potential adverse bank-sovereign feedback loops. As of December 2017, the debt exposure of banks to the Romanian sovereign was around 22 percent of assets, increasing steadily from below 5 percent in 2008 to one of the highest in the EU. In 2008, the government was still a net lender, but by 2012 it became a net borrower, and has placed increasing amounts of securities with the banking system. This appears to have crowded out lending to the real sector to some extent. More importantly, in an environment of very short-term funding, the relatively long duration of domestic sovereign debt means that banks are heavily exposed to losses from increases in interest rates. The government guarantees issued in the context of the Prima Casa loan program create an additional indirect exposure of the banking sector to the sovereign.

18. The banking system is also becoming increasingly exposed to real estate. Housing loans increased from 21 percent of loans to households to more than 54 percent between 2008 and 2017. As much as 36 percent of total private sector credit reflects real estate lending to households, predominantly at variable rates, and at an average maturity of just over 24 years, with a further 33 percent accounted for by loans to corporates collateralized by real estate. As a result of increased provision of mortgages, house price appreciation has gained momentum with property prices registering an annual growth rate of 6.2 percent as of September 2017, while the effectiveness of

the existing loan-to-value (LTV) limits on mortgages are undermined by the Prima Casa program², which allows for LTV ratios of up to 95 percent. Moreover, since the large majority of mortgage contracts are at variable rates, loan performance and default rates could deteriorate if interest rates increase.

19. The share of FX loans has been trending downwards, but banks' credit risk from FX loans remains a concern. Loans in FX continue to have a higher NPL ratio than loans in lei (approximately 12 percent compared to 3 percent). Although the share of new loans in FX originated by local credit institutions declined³, the share of FX in the stock of loans was still 43 percent for corporate loans and 38 percent for household loans in June 2017, a large share of which is unhedged. In addition, NBFL lending to the corporate sector is already predominately in FX (84 percent). The currency mismatch on banks' balance sheets is limited, though, as the NBR has in place a strict net open position limit and households' deposits in FX have recently been increasing.

20. Finally, growing provision of loans by NBFLs may lead to vulnerabilities and reputational risks for the banking sector. NBFLs are providing credit to SMEs, mainly in FX, and alongside a growing leasing business, as well as to households, often to those at lower income and at high interest rates and DSTI ratios. A macroeconomic downturn may negatively impact highly indebted households and increase NPLs in this sector. Debtors can also face loan traps, since borrowing from NBFLs effectively results in financial exclusion. The conduct of NBFLs can create reputational risk for the financial sector that already has a negative public reputation.

B. Resilience

21. The stability analysis conducted by the FSAP team, in cooperation with the NBR, assessed the resilience of the banking system to the vulnerabilities identified above. Scenario based solvency tests, as well as single factor sensitivity tests, assessed the resilience of the banking sector against rising interest rates and sovereign risk. These tests also assessed credit losses arising from exposures to the household and corporate sector in the event of a large contraction in GDP growth, exacerbated by an exchange rate depreciation. The resilience of banks to exchange rate movements was also tested in the context of liquidity stress tests. Finally, vulnerabilities stemming from the non-bank sector were analyzed, using sensitivity analyses as well as an assessment of the contagion risk from these institutions to the banking sector.

22. The analysis finds that these vulnerabilities are significant. More specifically, the stress test results reveal that in the adverse scenario:

- *Credit risk is a significant driver of overall losses, with a total drop of 750 bps in capital during the three-year horizon.* As a result of the severe shock to GDP, as well as increases

² Under this program of 2009, the State guarantees 50 percent of the mortgage, and loan terms are favorable: the down payment is 5 percent of the property value at a minimum (compared to 15–25 percent for other mortgage loans), and the interest rate is relatively low (at ROBOR +250bs). This program accounts for most mortgages extended by banks.

³ The share of FX in total new bank lending to the non-financial private sector was just below 20 percent in June 2017, mainly to the corporate sector.

in interest rates and depreciation of the currency, credit loss impairments increase from -2.2 percent of risk-weighted assets (RWA) in 2017 to -3.5 percent of RWA in 2019, which is the peak in terms of provisioning.⁴ In terms of composition, real estate mortgages account for the majority of credit losses (54 percent of total), followed by SME backed by real estate (20 percent of total).

- *Banks face significant trading losses on their sovereign securities portfolios, with a total drop of 300 bps in capital over the three-year horizon.* Banks suffer from declining valuations in their trading book as sovereign yields rise significantly (due to both an increase in the risk-free rate as well as risk premia). As a result of the stress, trading gains on these positions of 0.6 percent of RWA in 2017 turn to a market loss of 3.6 percent in 2018. In addition, some banks incur provisions for securities in their hold-to-maturity portfolios, in line with the increase in sovereign credit spreads. Importantly, the large securities portfolios incur losses even in the baseline scenario, where interest rates rise to counter inflationary pressures.⁵
- *The exchange rate depreciation plays an important role in driving credit losses on FX loans.* The team estimated the importance of exchange rate depreciation by comparing credit losses under the adverse scenario with those under a hypothetical scenario which is identical in all aspects but assumes a constant exchange rate relative to the reference date. This analysis suggests that roughly 15 percent of total credit losses can be attributed to the exchange rate depreciation.
- *Banks' net interest income decreases by almost 40 percent through the stress test horizon.* The contribution of net interest income to CET1 is, on average, 280 bps per year throughout the horizon, compared to 525 bps in 2017. Three factors contribute to this decline. First, the large NPL formation compresses interest income. Second, the net interest margin is adversely affected due to a rise in funding costs, not matched by a rise in lending rates that are tied to the Lombard rate. Finally, the banks have a non-negligible positive interest rate risk, which exposes them to losses as ROBOR increases throughout the stress test horizon.

23. While the aggregate liquidity level is more than comfortable, the stress test results suggest the need for currency differentiated liquidity requirements. In addition to the Basel III prescribed scenario, the FSAP team implemented two tests to assess the short-term resilience of banks to an abrupt withdrawal of funding: (1) a retail stress scenario aimed at replicating a deposit run, and (2) a wholesale funding stress scenario. A 15 percent haircut is applied to

⁴ It is important to note that provisioning and interest income reported by Romanian banks are inflated due to an accounting convention. Romanian banks recognize interest on (uncovered part of) NPLs and provision for this interest income, which leads to higher levels of both items compared to the IMF methodology, where no interest is accrued on (gross amount of) NPLs. This difference in methodology partly masks the true increase in provisions due to formation of new NPLs in the stress test.

⁵ Banks hold the majority of their sovereign debt holdings in mark-to-market portfolios (77 percent). Several banks hold their securities entirely in mark-to-market portfolios.

government debt securities in both scenarios, to simulate a fire sale or an illiquid market for these securities. The results suggest that a number of banks can meet either their lei LCR or their euro LCR but not both. Almost all banks meet the 100 percent NSFR ratio, though, both in lei and in euro.

III. MACROPRUDENTIAL FRAMEWORK AND POLICIES

A. Macroprudential Framework

24. The NBR has a long experience in implementing macroprudential policy measures and as a result, a relatively sophisticated systemic risk monitoring framework. The NBR monitors several indicators to assess the build-up of systemic risk and constructs summary indicators to facilitate overall risk assessment. The NBR also has various economic models to assess macro-financial developments and the effects of various shocks, and to assess policy actions. The NBR also subjects banks to regular solvency and liquidity stress tests. Nevertheless, data and information gaps remain, for instance, due to extensive NPL exposures being sold to asset management companies, which do not have to report to the credit registry.

25. The institutional framework for macroprudential policymaking has recently been revised and contains a clear mandate and well-defined objectives. A new National Committee for Macroprudential Oversight (NCMO) was established in April 2017. By law, the NCMO is the national macroprudential authority with a clear mandate to set macroprudential policies. It is chaired by the Governor of the NBR and its Secretariat also resides within the NBR. However, after a long parliamentary process, the number of NBR representatives in the nine-member NCMO was reduced from the proposed five members to three, giving the NBR the same number of representatives as the ASF and the Ministry of Public Finance (MoPF).

26. The institutional arrangements seem to guarantee adequate powers to ensure NCMO's ability to act. The NCMO has direct (hard) powers over a wide-range of macroprudential tools, it is empowered to recommend actions to be taken by other supervisory authorities or the Government, coupled with a “comply or explain” mechanism, and to issue warnings and opinions. However, the functioning of the NCMO is still being established. It has, as of April 2017, only held five meetings and issued ten recommendations, including the required quarterly recommendations on the countercyclical capital buffer. The Technical Commissions on Systemic Risk and Financial Crisis Management, respectively, who should support the NCMO's work are still to become operational.

27. The NCMO's accountability, transparency, and coordination frameworks need to be strengthened to help counteract the underlying inaction bias. Generally, macroprudential policymaking is challenged by the so-called policy inaction bias, resulting from the cost of policy actions being sooner and more easily observable than their potential benefits. Given the set-up of the NCMO and concerns regarding the independence of the ASF, overcoming the inaction bias may prove particularly challenging. Currently, the NBR can recommend policy action and be outvoted without the need for the decision to be disclosed or related to a common overall risk assessment. The framework should be strengthened by requiring proposed policy actions and

distribution of votes to be publicly disclosed in the summary of meetings. A common assessment of systemic risk should also be developed at each NCMO meeting to foster consensus and common ownership of actions, notwithstanding on risks stemming from large and concentrated sovereign exposures.

B. Macroprudential Policies

28. The macroprudential policy toolkit was recently expanded with the EU Capital Requirements Directive and Regulation (CRD/CRR) framework becoming operational in Romania. In particular, the authorities have implemented, or are phasing-in, a number of capital buffers and the Liquidity Coverage Ratio (LCR) based on this framework. Longer-standing borrower tools also remain in place, but their scope is narrow. Banks currently only apply stressed DSTI limits to consumer loans and the maximum LTV ratios on mortgages are not applied to mortgages under the Prima Casa program.

29. The scope for regulatory arbitrage of macroprudential measures due to direct external borrowing and lending from NBFLs remain a concern. The authorities need to continue their vigilance regarding regulatory arbitrage. The NBR recently introduced measures to strengthen oversight over the NBFL sector, where lending to SMEs and low-income households was increasing rather rapidly. The NBR should align the sector's provisioning regime with that of the banks to limit possibilities to benefit from different requirements for banks and NBFLs. In addition, overall corporate sector leverage has been increasing despite contracting bank credit extension, as corporates increasingly borrow from abroad. Further analysis is needed to detect possible vulnerabilities and develop policy measures if needed. Debt collecting agencies, specializing in NPL exposure purchases, should be required to report to the credit registry to close data gaps.

30. The macroprudential policy toolkit should be strengthened further to address identified risks. The authorities are already contemplating a debt-service-to-income (DSTI) limit on mortgages and calibration of this limit could draw on the mission's analysis of loan-level information from the Romanian credit register. The Prima Casa program should be gradually scaled back to mitigate risks of housing sector imbalances and to support the effectiveness of the existing LTV limits. In addition, the team recommends a currency-differentiated LCR, and the monitoring of a currency-differentiated Net Stable Funding Ratio (NSFR), to limit FX liquidity risks. Strengthened monitoring of NBFLs is warranted to avoid reputational risks and regulatory arbitrage. The mission also recommends introducing capital buffers to increase resilience and guard against risks from large sovereign exposures. Open and transparent discussion in the newly created macroprudential committee should link policy action to identified risks.

IV. SECTORAL SUPERVISION

A. Bank Supervision and Regulation

31. As an EU Member State, Romania is subject to and aligned with the common EU regulatory framework for banking supervision. Given that a large part of Romania's banking system is owned by Eurozone banks, the Single Supervisory mechanism (SSM), as the home supervisor for Eurozone banks, is a key partner of the NBR. As of 2017, the NBR has identified 11 banks as systemically important, of which 8 are supervised at group level by the SSM.

32. The supervisory approach of the NBR has been changed toward a more risk based approach since the previous BCP assessment, but more needs to be done. The NBR Board approved the adoption of the EBA SREP Guidelines into national supervisory practices in January 2016, making the SREP the core supervisory tool for banking supervision. Nevertheless, the new SREP methodology is still in the early stages of implementation. The processes for ensuring consistency and accuracy of scoring, findings, and supervisory measures across different banks have yet to be formalized and documented, and need to be improved. The NBR needs to further enhance off-site monitoring tools by incorporating a more forward-looking perspective (e.g., through bottom up stress testing tools). More risk-focused and thematic banking industry-wide analyses and examinations triggered by recent trends or events are also warranted.

33. Further development of the NBR's supervisory approach will make supervision more effective and in line with the requirements of the 2012 Basel Core Principles (BCPs). The NBR may need to devote more supervisory attention to banks' risk models and building up further expertise in specialized areas such as IT and market risk. In the area of corrective actions and sanctions, the NBR should review its framework to ensure it is protected from undue legal challenges, and strengthen internal procedures to ascertain that enforcement measures are more consistently applied across the banking system. Post examination processes should be enhanced for banks to implement supervisory measures in a prompt manner. Intensified engagement with non-executive/independent board members is warranted for a more proactive supervisory practice.

34. Some weaknesses were observed concerning regulations not governed by the harmonized EU framework. Prudential regulations of NBR are broadly aligned with the requirements of the BCP. However, the regulations on related party transactions and country/transfer risk only include high-level principles, and lack sufficient specificity. The NBR should consider giving more clear guidance to banks and supervisors to avoid divergence of practices. This should be done through amending regulation, issuing instruction, and/or developing the on-site handbook. The NBR also needs to enhance its oversight of concentration risk and intra-group transactions, even if the exposures comply with the regulatory limits.

35. The NBR should better ensure banks' boards effectively exercise their responsibilities. Corporate governance requirements were appropriately strengthened in recent years and now constitute a cornerstone of the NBR's supervisory approach. Attention is paid to effective implementation during on-site full-scope examinations and when approving key persons. However, the NBR only requires some banks (i.e., subsidiaries) to have an "adequate" number of

independent board members. Banks usually only have one or two independent board member(s), which is insufficient. Although the NBR places a lot of responsibilities on the board, it does not yet organize regular exchanges with non-executive and independent members.

B. Financial Market Infrastructures

36. Both the NBR and the ASF have taken important steps to strengthen the oversight of systemically important financial market infrastructures (FMIs). The NBR oversees the real time gross settlement (RTGS) payment system and SaFIR, the central securities depository (CSD) for government securities and NBR securities. The ASF supervises the clearing and settlement systems of the BVB. The legal framework for FMIs has been strengthened through the adoption of EU legislation. The NBR has formally adopted the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI) and has assessed the FMIs under its purview against these principles. It is recommended that the NBR and ASF increase cooperation in the oversight and supervision of the CSD of the BVB to avoid overlap and inconsistent requirements. Also, the ASF should adopt the PFMI.

37. The NBR's project to internalize the payment and settlement infrastructure within the central bank has a strong rationale, but implementation also poses risks. Currently, the RTGS and CSD systems are technically operated by Transfond S.A., a private company jointly owned by the NBR (33.3 percent) and Romanian banks. A project to internalize these systems within the NBR is scheduled to be finished in the first half of 2018 and will mitigate NBR's dependencies of and exposures towards Transfond S.A. Although the internalization project is generally well managed, additional measures were recommended by the FSAP team to reduce migration risks.

C. AML/CFT

38. Romania made good progress in strengthening its AML/CFT framework since it was last assessed, but deficiencies remain. Since the MONEYVAL 2008 assessment and 2013 targeted reassessment against the Financial Action Task Force (FATF) Recommendations, the AML/CFT law has been amended with a view to strengthen the independence of the FIU and the CFT framework, and a draft law aimed at transposing the EU 4th AML/CFT Directive has been prepared. Some measures were taken to assess the ML/TF risks in the banking sector, and a National Risk Assessment (NRA) is scheduled to start this year. Training on AML/CFT is being provided to a range of reporting entities, and supervision by the NBR and the FIU was strengthened. The reporting of suspicious transactions has increased, in particular by banks, exchanges, transfer services, and notaries, and the FIU was provided with additional resources and updated analytical tools. However, the preventive framework, notably with respect to Politically Exposed Persons (PEPs) and to the intra-EU correspondent banking system, is still not fully in line with the standard. Insufficient measures are in place to ensure adequate transparency of beneficial ownership of legal persons and arrangements. Romania should also assess its ML/TF risks, take appropriate mitigating action, and ensure that ML is pursued and sanctioned in line with those risks.

V. FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

39. The bank resolution and crisis management framework has been significantly revamped since the last FSAP, but the efforts to consolidate institutional coordination must continue. Important progress has been made, in particular through the adoption and the implementation of the Bank Recovery and Resolution Directive (BRRD), which strengthened significantly the crisis preparedness of the NBR, the Ministry of Public Finance (MoPF), as well as the Bank Deposit Guarantee Fund (FGDB). Further coordination, through inter-agency simulation exercises will help crisis preparedness. The NBR is also encouraged to ensure that Romanian interests are sufficiently addressed in the recovery and resolution plans for foreign banks with subsidiaries in Romania. The NBR should develop an Emergency Liquidity Assistance (ELA) policy that accepts a more diverse asset pool as collateral, including FX securities, and provide liquidity facilities for the FGDB. The FDGB, in turn should diversify its investment policy away from domestic sovereign bonds and bank deposits. Finally, authorities should seek a comprehensive solution that exempts bank resolution from the scope of the procurement law, to allow the authorities to act swiftly and not be constrained on viable resolution options.

VI. FINANCIAL SECTOR DEVELOPMENT

A. Financial Intermediation

Background

40. The analysis has focused on the key factors negatively affecting financial intermediation and areas for policy recommendations for sustainable enhancement. The depth of financial intermediation is an equilibrium of two functions – the acquisition of funds by intermediaries, primarily deposits, and the placement of these funds as loans to the real sector. The focus of this analysis is the banking sector as the major intermediary. The analysis is based on historical information of the level of intermediation compared to peer countries, interviews, data received from NBR and other sources, as well as two bank questionnaires. Bank views on financial intermediation were explored with a survey with a high response rate, representing 96.0 percent of banking sector assets.

41. The banking sector in Romania is shallow and has been declining relative to the economy; low intermediation is reflected on both sides of the banking balance sheet. Banking sector assets amounted to 52.7 percent of GDP in September 2017, down from a high of 72.5 percent in 2010 as evolution of bank assets post 2008 (CAGR of 2.5 percent between 2009 and 2016) fell behind GDP (CAGR of 6.2 percent). The relative size of the sector is one of the lowest in the region (peer⁶ average: 104.9 percent of GDP) and Romania is lagging both in terms of deposit and loan penetration. The deposit base stood at 36.3 percent of GDP in September 2017 vs. peer average of 71.4 percent and bank loans reached 33.4 percent of GDP vs. peer average of 68.0 percent. This gap is observed in both major segments of the market: households and enterprises.

⁶ Average for Bulgaria, Croatia, Hungary, and Poland

42. Historical factors explain the low credit intermediation and while it has picked up after 2000, it decelerated in the context of the financial crisis. Similar to other countries in the region, the low credit intermediation in Romania is rooted in the origins of the country's transition to a market economy, which was marked by an embryonic private sector, high inflation, and several state-owned bank failures. In 1996, domestic credit to private sector was 10.9 percent of GDP, 20.7 percentage points lower than the average of the four peer countries. While the gap began to close in the period leading to the crisis, credit growth decelerated in 2010 as a result of both shrinking credit supply and lower demand for credit, and the gap with peers began to widen.

43. Cross-cutting constraints affect both deposits and credit and explain structural low levels of intermediation: poverty, rurality, and informality. Poverty remains distinctively high for Romania's income level with 38.8 percent of the population at risk of poverty or social exclusion in 2016. Poverty is related to the high share of rural population (45.3 percent) one the highest in Europe, whose main occupation is agriculture and for which insufficient access to finance is a significant constraint. Finally, informal employment represents about 20-50 percent of employment in Romania depending on the definition used, while the shadow economy was estimated at 27.6 percent of GDP in 2016, the second highest in the EU after Bulgaria.⁷

Access to finance for the enterprise sector

44. Low access to finance for enterprises is a result of multiple factors affecting supply and demand. The demand for credit is affected by: the size and composition of the Romanian enterprise sector, the level of investment activity and the constraints businesses face, and corporate finance options, among others. The supply of credit to the enterprises is affected by the degree of competition in the banking sector, the performance, the business model of the banks, and the quality of loan portfolio, among others.

Credit Demand

45. Low enterprise density and poor financial condition of enterprises negatively affect the demand for credit, while foreign-owned firms have access to credit from abroad. With about 460,000 enterprises operating in the secondary and tertiary sectors,⁸ 88.5 percent of which microenterprises, 11.1 percent SMEs and 0.4 percent large firms, Romania has only 23 enterprises per 1,000 people, which is 56 percent lower than the rest of the EU and 21 percent lower than the four peer countries. This divergence exists across all size segments (although it is largest for microenterprises). At the same time, banks only consider 128,000 of these companies on average to be within their minimum financial criteria. Romania has also attracted many foreign-owned firms, which now account for 5.9 percent of total enterprises, more than peers, and 44 percent of total value added in 2015. These companies benefit from parent companies' centralized treasuries, which often borrow from bank or bond markets outside of Romania at a lower cost than the local subsidiaries can. Such financing is not included in the domestic aggregate banking balance sheet.

46. Lower credit demand was also driven by lagging business investment, despite a period of intense economic growth. The economic growth had a positive spillover in the

⁷ Schneider, Friedrich (2016)

⁸ As of December 31, 2015, data from EUROSTAT

enterprise sector, with more than 30 percent of businesses reporting an increase in turnover of more than 20 percent over the last 3 years, a share significantly higher than peer countries. However, this improved performance was not accompanied by an increase in investment activity. Top three obstacles cited for lagging investment are availability of transport infrastructure, availability of staff, and uncertainty about the future. While a static analysis of the business environment does not portray a negative picture (Romania is ranked 45 in Doing Business out of 190 economies), over the past couple of years, businesses have been faced with a number of legal measures which severely impacted their ability to plan investment. Banks surveyed, as well as other market participants, cited legal uncertainty e.g. in the fiscal code as the most significant factor affecting financial intermediation.

47. There is high reliance on internal financing and trade credit. The sudden loss of access to credit experienced by some firms during and after the crisis resulted in a loss of confidence in the banking system as a reliable form of financing. Many SMEs, despite needs, tend to rely on internal sources of financing. Furthermore, trade credit accounts for 25.0 percent of financial liabilities for non-financial corporations, much more than peers (average 10.0 percent) and the EU (6.4 percent). Trade credit has -to some extent- replaced bank loans since the crisis, with CAGR 2009-2016 of 4.8 percent while loans balances on corporate balance sheets have registered a very small growth of 0.4 percent.

Credit Supply

48. The banking sector, as the biggest financial intermediary, seems competitive and enjoys profitability and liquidity. The sector consists of 28 banks and 7 branches. The Herfindahl-Hirschman (895) and asset concentration for the top five banks (58.1 percent) point to sufficient room for competition given the size of the real economy. In the latest CESEE Lending survey, 73 percent of foreign parent banks consider Romania a high-potential market and a large majority report higher RoA from Romania compared to the overall group. Banks currently have a low LTD ratio of 71 percent as of mid-2017, indicating excessive liquidity.

49. After the crisis, credit supply was restricted, especially to MSMEs and in rural areas. The banking sector, being mostly foreign-owned, experienced persistent deleveraging after the crisis with external exposures to Romanian banks declining to 7.7 percent of GDP in the second quarter of 2017, down from 21.4 percent at the end of 2008. While the deleveraging process did not generate liquidity pressures, it led to a re-definition of banks' business models. Specifically, following the rapid deterioration of asset quality (corporate NPL ratios peaked in 2013⁹), lending to MSMEs decelerated sharply and several banks retrenched from entire segments. Loans to micro-enterprises experienced a CAGR of -8.4 percent in the period 2008-2016 while loans to SMEs grew more slowly than GDP, despite unprecedented low interest rates. Lending activity increasingly shifted to the household segment, both consumer and housing loans, aided by the Prima Casa program. In the meantime, supply conditions for enterprises have tightened or remained the same in the last several years. Access to finance remains even more difficult in rural areas, where operating branches is less profitable. While public credit guarantees through the

⁹ More than half of loans to microenterprises and almost one fifth of loans to small enterprises were non-performing by 2013

National Credit Guarantee Fund for SMEs (FNGCIMM), had a counter-cyclical effect in 2008-2012 with guaranteed loans to MSMEs reaching 7.4 percent of total loans to MSMEs in 2012, operational problems contributed to a declining use of the instrument among banks. At the same time, banks' sovereign exposures increased, reaching 22.6 percent of banks' assets in 2016, one of the highest in Europe, potentially contributing to a crowding out effect. The gap left in banking intermediation could not be picked up by alternative intermediaries as the NBFIs sector, especially leasing, is underdeveloped and was severely affected by the crisis.

50. While financial infrastructure supporting credit intermediation is generally effective, there are much needed improvements (see Box 1). The legal framework for insolvency and secured collateral registry is considered best practice although enforcement of secured claims could be streamlined and the regulatory framework for commodity collateralized lending should be strengthened. The credit information system, based on the NBR's Central Credit Registry (CCR) and a private Credit Bureau (CB) is effective but there are significant gaps in the coverage. Additional reporting entities should be included, especially in the CB, such as collection agencies and non-traditional data providers, which would support both access to finance for enterprises and financial inclusion for underserved segments (see below).

Box 1. Romania: Financial Infrastructure

Insolvency & Secured Transactions

The corporate insolvency law includes modern provisions based on best practices, but implementation remains a challenge. Romanian corporate insolvency law was updated in 2015 and contains many provisions considered best international practices. However, the law has not been uniformly applied by judges, who lack sufficient resources to deal with the cases in a timely manner. Stakeholders report repeated delays, especially during the observation period in the process of compiling and confirming a table of creditors. Reorganization culture is not well established, with most reorganization plans focusing on debt restructuring rather than updating business operations, and banks prefer to negotiate with borrowers informally on a bilateral basis. The fiscal authorities have also blocked a number of reorganizations due to unwillingness to accept haircuts on nominal claims. While the profession of insolvency practitioners is regulated, in practice, administrators are rarely held accountable for ethical violations. The personal bankruptcy law entered into effect on January 1, 2018, however, the institutional framework for it is not yet fully established, as the list of receivers and liquidators has not been finalized and, outside of Bucharest, insolvency commissions intended to administer debt rescheduling cases have not been set up.

The secured transactions framework can be strengthened, especially in relation to enforcement of secured claims. Romania has an adequate secured transactions framework, which provides for a variety of lending tools using different movable assets (tangible and intangible) as collateral. However, stakeholders report that banks still prefer real estate as the main collateral base. Enforcement proceedings are lengthy with the borrower being able to appeal every decision during the process and few effective mechanisms to guarantee that movable assets are preserved, especially with regards to inventory and accounts receivable. The legal framework for collateral registry can benefit from alignment with best practices and technical capabilities of the registry should be improved. Furthermore, although commodity collateralized lending exists, the regulatory and

oversight framework should be strengthened to support use of this financing, which would support access to credit for agriculture.

Credit Information system

The Romanian credit information system, consisting of the Central Credit Registry and the private Credit Bureau, is generally effective and bank satisfaction is high. The credit information sharing system consists of the CCR, established in 2000 and operated by the NBR, and the CB, a joint stock company established in 2004 with 25 banks as shareholders. According to NBR Regulation no.2/2012, institutions reporting to the CCR are credit institutions and non-bank financing institutions registered with the Special Register. Registered entities include individuals and non-bank legal entities, with a reporting threshold of 20,000 RON. The CCR coverage for the household sector is 89 percent of the total loan amount and 30 percent of the total number of debtors. According to Decision no.105/2007 of the Data Protection Authority, participants in the CB may be banks, consumer credit companies, leasing companies and insurance companies. The CB coverage for the household sector is 90 percent of the total loan amount and 99 percent of the total number of debtors. In the survey conducted in the context of the FSAP, banks¹ are broadly satisfied with the two entities in terms of: data accuracy (average rating of 4.2 for the CCR and 4.3 for the CB out of maximum 5), data coverage (average 3.9 and 4.3 respectively), and range of services provided (average 4.0 and 3.9 respectively).

The reach of the credit information system could be significantly enhanced by including additional reporting entities, especially to the CB. Enabling collection agencies with NPL portfolios to consult and share data with the CCR and the CB, would facilitate the collection process on one hand and on the other hand facilitate the resumption of credit for borrowers who have repaid their debts to the collection agency. The inclusion of non-traditional data providers in the CB system, such as mobile network operators, would also enhance access to credit and can also have a significant effect on financial inclusion, given the high mobile penetration in Romania.¹⁰ It is also recommended that the CB initiate information sharing on legal entities and to evaluate the integration of additional external data from other sources. In the survey, about 80 percent of respondent banks stated they would be interested in receiving and providing information on legal entities to the CB. Finally, it is also recommended that the CB receive and share data with the credit unions given the significant role they play on financial inclusion.

¹⁰ Including collection agencies in the CCR would necessitate an amendment of legislation. Reporting entities are stated in the Law No. 312/2004 on the Statute of the National Bank of Romania and the Law No. 93/2009 on non-bank financial institutions so other reporting entities to the CCR cannot be regulated by legal acts issued by the NBR. Including collection agencies and non-traditional data providers in the CB necessitate an amendment of the decision of the Data Protection Authority.

Financial Inclusion, Financial Literacy and Consumer Protection

51. Account ownership is lacking, particularly for the poorest 40 percent; while recent legislation may enhance inclusion, it may lead to unintended consequences. Only 60.8 percent of adults have an account in financial institutions, below the average for peers (74.8 percent) and upper middle-income countries (70.4). The Law on Comparability of Payment Account Fees, Change of Payments Accounts and Access to Basic Payments Accounts of 2017 (transposing EU Directive 92/2014) introduces zero fee accounts for vulnerable consumers, which in Romanian legislation was defined as those with under 60 percent of average salary (about 50 percent of consumers), may enhance inclusion although it may also have adverse effects such as higher interest / fees for other clients, or the acceleration of banks' retrenchment from rural areas (see below).

52. While the usage of digital payments is progressing, it is still lagging by regional and peer comparisons. While total number of payment cards, POS terminals, and ATMs have all grown since 2010, penetration of all three is lagging relative to the EU. There are 0.65 payment cards per inhabitant versus 1.57 in the EU, 8.2 POS terminals per 1,000 inhabitants, well below the EU average of 24.2, and 0.56 ATMs per 1,000 inhabitants vs. 0.84 ATMs in the EU. More diversified digital finance services have been introduced in 2014 and 2016, with the launch of two e-wallet initiatives (only one successful as of today). The authorities have recently supported digital payments through several measures, including obliging public utility companies and public institutions to accept card payments, as well as providing incentives for the use of fiscal receipts. The government could further incentivize the usage of digital payment solutions e.g. by awards to buyers and merchants, or merchants' tax cuts based on the volume of card and mobile phone transactions. Also, the transposition of PSD2 would facilitate the development of Fintechs as payment initiators and payment aggregators, which would benefit the expansion of digital payments instruments.

53. Banks branch network has been declining, especially in rural areas, but new initiatives could mitigate the impact on financial inclusion. In 2016 there were 4,804 bank branches (27.9 branches per 100,000 adults), lower than that of peer countries. The commercial bank branch network has been declining since the crisis, in line with the region, with CAGR 2008-2016 of -3.9 percent, especially in rural areas (-5.9 percent). New banking services delivery mechanisms are taking place, thanks to the expansion of agent networks (40 percent of banks are already using bank agents). The majority of banks plan to invest substantially in branchless services in the medium-term, including agents, mobile banking vehicles, and virtual branches. In light of this trend, NBR could strengthen the monitoring of agents (e.g. via a register), which would also highlight areas of regulatory focus for the future. To improve financial inclusion, authorities should also facilitate the use of existing public infrastructures, e.g. through the 5,100 post office outlets, which currently offer limited financial services payments (pension payments, money transfers).

54. Credit unions play an important financial inclusion role, which could be further enhanced albeit with stronger supervision. Access to financial services is supported by 3,000 credit unions serving employees (about 1.2 million members out of a total estimated of 4-5

million) and pensioners (about 1.4 million members out of a total estimated 5 million). They are non-deposit taking institutions funded through the members' social funds (member's monthly contributions, which cannot be withdrawn in the case of the employees' credit unions) and mainly provide short-term small loans to individuals. In contrast to other East-European countries (e.g. Poland), in which credit unions are allowed to mobilize deposits from their members, credit unions in Romania are not supervised by the NBR (in fact, they are not supervised by any external authority). Legal limitations on funding sources, scope of financial services and type of members reduce significantly their operations. Removing these constraints could develop significantly expand their outreach¹¹ but for this to happen on a sustainable manner, a stronger supervision, ideally exerted by NBR, would be needed. This change would however entail the mobilization of a significant amount of additional resources as well as fundamental reforms in the oversight architecture including apex organizations¹², safety nets, and access to national payment networks.

55. Targeted financial literacy programs could help address illiteracy. Only 22 percent of adults are financially literate, significantly lower than peers. Banks consider financial illiteracy the second most important factor affecting financial intermediation. Furthermore, 48 percent of adults mistrust the financial system, higher than in the region.¹³ Trust dropped dramatically during the financial crisis and has not fully recovered yet. While the financial education agenda has been promoted by the NBR, Romanian Banking Association, commercial banks, ASF and others, NBR has recently established a Financial Education department and plans to prepare a National Economic Education Strategy. Such a strategy is a welcome initiative and should be complementary to other priorities (e.g. enhancing inclusion through digital means) and hence should be targeted to appropriate segments, which also requires a baseline survey.

56. Strengthening the consumers protection framework would help reduce the mistrust in financial institutions. Romania transposed the EU Directive 2013/11 on alternative dispute resolution for consumer disputes by Government Ordinance 38/2015. The Directive lays down minimum standards but member states can go beyond these.¹⁴ There are two alternative dispute resolution mechanisms: one for the banking sector (CSALB) and one for the non-banking institutions (SAL-FIN). In the case of the CSALB, the financial services providers can decide unilaterally to opt out. CSALB should amend this rule to make the participation of providers mandatory.

¹¹ E.g. by expanding their services to also serve MSMEs, offer more services such as granting larger and longer-term loans, channeling remittances, handling payments, and acting as bank agents.

¹² An apex organization is a second-tier or wholesale organization that channels funding (grants, loans, guarantees) to multiple financial institutions in single country or region.

¹³ The following countries participated in the Life in Transition survey: Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Cyprus, the Czech Republic, Estonia, FYR Macedonia, Georgia, Greece, Hungary, Kazakhstan, Kosovo, the Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, the Slovak Republic, Slovenia, Tajikistan, Turkey, Ukraine and Uzbekistan.

¹⁴ Article 2 includes "... 3. ... Member States may maintain or introduce rules that go beyond those laid down by this Directive, in order to ensure a higher level of consumer protection."

Role of the State

57. Current public initiatives are too fragmented and inefficient. Despite a big overall state footprint in the financial sector (state ownership of two commercial banks and financial support programs amounting to 1.7 percent of the state budget), the role of the Romanian state is fragmented with suboptimal coordination and monitoring. There is no clear strategy encompassing all state institutions and initiatives, and existing programs are fraught with duplications, and overlapping and unclear mandates. These initiatives include inter alia the following:

- Posta Romana currently offers limited financial services to individuals (payment of pensions, which provides approximately 55 percent of its revenues, money transfers - through postal mandates and Western Union for international transfers- and location rent for several banks' ATMs. Increasing the diversity of these services (through the status of agent of an existing bank for example) would require the implementation of a comprehensive restructuring plan.
- The Start Up Nation program, launched in 2016 with initial budget of RON 1.7 billion and administered by the Ministry of Business Environment, SMEs and Entrepreneurship, aims at providing grants (200,000 RON) to start-ups. So far, about 8,000 start-ups have been selected. The program's design and implementation has several weaknesses, hindering its sustainability and impact and without achieving complementarity with the entrepreneurial ecosystem.
- There are two guarantee funds that support SMEs: FNGCIMM, whose guarantees cover about 2.2 percent of outstanding SME bank loans, and the Counter-Guarantee Fund, which provides low-fee counter-guarantees almost exclusively to FNGCIMM. Both schemes deviate from best practices in several areas including the legal and regulatory framework, corporate governance and risk management, operational framework and monitoring and evaluation. Both institutions' operations have been hurt by operating problems, as identified in audits by the Court of Accounts, as well as by the growing use of more favorable guarantees by banks through the European Investment Fund (EIF). In light of the strategic priority to increase the absorption of EU funds, the Romanian authorities have assigned the implementation of several EU financial instruments, including guarantees to EIF.
- There are two commercially operating state-owned banks: i) CEC bank (7.2 percent market share) with a focus on MSMEs, the largest branch network in the country and significant presence in rural areas and ii) EximBank (1.1 percent market shares), which does not have retail operations, and also acts as a state agent, intermediating state funds through financing, guarantee and insurance products.

58. Given the financial intermediation gaps, public intervention remains needed but clear development policies and efficient coordination mechanism should first be designed. The MoPF is contemplating the establishment of a development bank, either by transforming EximBank or creating a new institution. An assessment is underway to identify market gaps and design the optimal legal and operational framework. While this initiative and approach is suitable,

it is necessary to adopt a holistic view by encompassing all state institutions and initiatives (see paragraph above), eliminating duplications, identifying and taking into account all market gaps and leveraging commercial finance. To be successful, the authorities should consider establishing a steering committee with a clear financial sector development mandate (e.g. enhancing financial inclusion and intermediation), an effective monitoring and evaluation system and accountability mechanism.

B. Capital Markets

59. Romania has made significant progress in the development of its capital markets in the past few years, but -despite recent issuances- securities markets have yet to play a meaningful role in private sector financing. The equity market is smaller than regional peers with a market capitalization to GDP ratio of 20 percent and 87 listed companies on the BVB, as of end-2017. In 2017, there were four private issuances on the BVB equity market -breaking an almost ten-year drought- and nine corporate debt issuances, including the largest corporate bond issuance on the market to date. New issuance is set to continue with several IPOs planned for 2018. Net assets of mutual funds have grown steadily, reaching EUR 5.3 billion (3.1 percent of GDP) as of end-September 2017, along with pension fund assets, which reached EUR 8.8 billion (5.2 percent of GDP) as of end November 2017.

60. A broad range of reforms were pursued to develop the non-government securities market, advancing in the aim of moving Romania from Frontier to Emerging Market (EM) Status. One of the aims was to diversify the investor base. The ASF undertook comprehensive institutional and regulatory reforms, streamlining and modernizing the regulatory framework and harmonizing with EU capital market standards¹⁵, and improving engagement and communication with the market. Progress was also supported by the Government, who used the BVB to privatize state-owned enterprises (SOEs) through the partial listing of shares. These changes also contributed to attract foreign investors. Pension reform, resulting in the development of mandatory Pillar 2 pension funds, deepened the domestic institutional investor base, and supported capital market development. As a result, Romania has been placed on the FTSE Emerging Market watch list and meets most MSCI EM requirements, with liquidity criteria still to be met.

61. Significant progress has also been made in the government bond market, particularly on the development of a yield curve. The MoPF undertook reforms to extend, deepen and consolidate the yield curve, which now extends to 15 years and is reasonably liquid for all benchmark maturities. Future initiatives for yield curve development include extending

¹⁵ These include -among others- i) amendment to the Capital Market Law 297/2004, ii) resolution of the status of the RASDAQ market, iii) allowing the issuance of Global Depository Receipts - GDR (putting Romania on the radar of foreign investors), iv) pooled accounts for brokers, v) proxy voting, and vi) removal of barriers to issuance, including allowing accelerated book building, removal of barriers for foreign investors, and standardization of corporate action payments through the Central Securities Depository (CSD). Ongoing reforms include the introduction of MiFID II (currently being debated in Parliament), Issuers Law, introduction of risk-based supervision, and Law on Alternative Investment Funds, among others.

maturities, introducing buy backs and exchanges, and the introduction of floating rate notes.¹⁶ Two retail government bonds were issued on the BVB in 2015 and 2016, attracting approximately 22,000 retail investors, and further retail issuance is planned through the MoPF. The performance assessment criteria for primary dealer system was revised in 2016, with minimum obligations for primary dealers that include size, time and spread requirements on the secondary trading platform.¹⁷ The inclusion of Romanian government bonds in the Barclays and JP Morgan indices in 2013 provided a significant boost for the market, increasing medium and long term foreign institutional investment. Although foreign investors currently hold approximately 16 percent of domestic government bond issuance, there is still room to further increase the share of foreign investment in the government bond market.

62. Pension funds should be further developed, and constraints on their investment regime relaxed. After 10 years of existence, Pillar 2 pension funds are beginning to mature; it is appropriate that ASF considers developing a strategic approach for further development of the sector. Currently, Pension Funds face restrictions on real estate investment and securities lending, and a five percent limit for mutual funds. They invest approximately 20 percent of their assets in equities¹⁸, driven by the multiple layers of explicit and implicit investment requirements¹⁹, and ASF's risk weightings for fund categories which encourage conservative investment behavior. Therefore, their investment regime should be reviewed to eliminate potential constraints for investment.²⁰ Capacity building of the ASF staff regulating and monitoring Pension Funds should be pursued.

63. There are concerns that some proposed country level initiatives may go against previous efforts to diversify the investor base, undermine confidence in the markets and weaken further growth. Government support for the capital markets is perceived to have waned, including proposals to freeze SOE listings for five years.²¹ Government proposals to exempt SOEs (including listed ones) from corporate governance requirements risk undermining investor confidence. Concerns exist regarding recent governance of SOEs²², and a reduced focus and interest in investor relations. The reduction in the Pillar 2 pension contribution from 5.1 to 3.75 percent of gross salary, and their potential suspension going forward, has the potential to reduce

¹⁶ MoPF has the flexibility to reject bids and modify amounts (MoPF has rejected bids for the last three auctions held in 2017, thus no issuance took place). It should only reject bids in extreme cases where accepting all bids may create market turbulence and hurt investors, thus providing greater predictability and consistency in issuance to reduce uncertainty and increase confidence in the market.

¹⁷ PDs currently have exclusive access to this platform (E Bond platform), however, read-only access will be given to all investors in 2018.

¹⁸ Despite being allowed to invest up to 50 percent in corporate shares.

¹⁹ Such as the absolute guarantee and relative returns.

²⁰ Restrictions at ASF level could be considered first. Many restrictions are at the level of the primary Law, and will require legislative initiative.

²¹ A planned SOE listing of Hidroelectrica has been repeatedly delayed, but would contribute significantly to the upgrade to EM status.

²² Including replacing of previous management and board turnaround, extended terms for interim boards, and lack of qualifications of board members.

the institutional investor base, affect long term savings and undermine further development of the capital market.

64. Initiatives to address liquidity -a remaining challenge for capital markets- and the introduction of new products are in progress and will require market wide solutions. The derivatives market will require a Central Counterparty Clearing House (CCP). Given current and projected volumes, the complexity, time and costs involved in setting up a CCP, it is recommended to use an existing neighboring CCP until volumes are sufficient to ensure the sustainability of a local CCP. The development of securities lending and borrowing (SLB) requires clarification of the fiscal code with respect to capital gains tax on legal entities, and established mechanisms for collateral management. The resolution of the almost nine million dormant retail accounts (resulting from shares issued during the mass privatization) could increase the free float available in the market.²³

65. Additional constraints in the non-government bond markets should be addressed. These include the requirement to hold an extraordinary general meeting to issue corporate bonds under the Commercial Companies Law, an uneven tax playing field between corporate bond issuance and bank loan interest payments²⁴, and the requirement for corporate bonds to have a rating of investment grade or one notch below for pension fund investors. Some further outstanding technical issues include that there is a perception that settlement failure is not allowed for listed equities. Settlement failure should be allowed, and ASF and CSD should define a system of buy backs and sell outs to resolve settlement failure and manage risks, which should be communicated to the market.

C. Insurance Sector

66. The role of insurance in Romania continues to be limited, and key indicators have shown a negative trend for several years. With an insurance premium amounting to 1.23 percent of GDP in 2016, Romania fares considerably below most regional peers. While this indicator of insurance penetration grew between 2001 (0.87 percent) and 2007 (1.72 percent), it decreased continuously since then. Assets held by insurance companies were in the order of 2.5 percent of GDP in 2016, down from 3.15 percent in 2010.

67. Past market turbulences, compounded by lack of regulatory independence, have adversely affected trust in the insurance industry. Several insurers were found insolvent since 2015, some of them with dominant market shares in motor insurance, which is the main business line in Romania (as of mid-2017, 60 percent of total premium came from property and motor third party liability insurance – MTPL). These failures affected consumers, who were forced to find new insurers at short notice, and other insurers, who had to assume the costs of these failures via the Policyholder Guarantee Fund and the Resolution Fund and were subjected to price controls temporarily enforced by the regulator. The crisis has been compounded by the political influence

²³ The Mass Privatization Program gave eligible citizens shares in entities previously owned by the state. These shares are held in accounts with the CSD, and the majority are listed. Almost 9 million of these accounts are inactive, and are not available for trading on the exchange, with an approximate value of EUR 2.2 billion.

²⁴ While interest on loans is deductible, interest on corporate bonds is not.

that the Parliament exerts on the insurance regulator through the nomination and revocation of all ASF's board members.

68. Since then, the regulatory and supervisory framework for insurance has been subject to a major overhaul, following new EU requirements. Transition to the European regime of Solvency II is bringing numerous changes to almost every dimension of insurance. Preparatory balance sheet reviews in 2015 uncovered financial shortcomings of some insurers that led to market exits, and multiple remedial actions. In response, the authorities have now established a new resolution framework for the insurance sector inspired by the BRRD, representing an important advance.

69. In addition, a new regulation has been passed in 2017 aiming to stabilize the MTPL market. The design of the new MTPL Law appears an appropriate response to the past difficulties, even if its actual impact cannot yet be assessed. However, a track record of monitoring developments and managing new turbulences still needs to be established, and the FSAP recommends an external independent review of the effectiveness of its supervisory and regulatory framework.

70. In view of the low penetration of insurance -other than MTPL-, more effort should be devoted to the development of other business lines, such as homeowners' insurance and life insurance. With the current rate of penetration estimated at 20 percent, the mandatory homeowners' catastrophe property insurance fails to establish the originally intended safety net, continuing to expose the Government to considerable contingent liability should another major earthquake occur. Higher penetration would also further increase the operational efficiency and diversification of the Natural Disaster Insurance Pool (PAID). Recent dynamics of life and health insurance indicate unmet needs, and demand that could be addressed with more suitable products and processes. Working groups to address this opportunity have already been initiated. More dedicated efforts – with suitably chosen representatives of all relevant stakeholders and disciplined output objectives – will allow more Romanians to use insurance better suited to their needs.

D. Housing Finance²⁵

71. Despite having one of the highest home-ownership rates in the World, Romania has high levels of inadequate housing and a significant housing investment gap. Romania lags all other EU countries in most measures relating to quality of housing and living conditions, with one in 5 Romanian citizens facing severe housing deprivation. This is a measure covering both quality of housing and overcrowding. This compares to an EU average of just 1 in 20 facing severe housing deprivation. Despite the high owner occupier²⁶ rate, the overwhelming majority of homeowners do not have a mortgage loan. Investment into the private rental market is also extremely

²⁵ Stability issues related to the housing finance sector are analyzed in the Macprudential Policies section.

²⁶ Romania has an owner occupation rate of 97 per cent which is highest in the World. This is largely the result of the transfer of housing stock following the fall of communism and common across former communist countries, but especially prevalent in Romania.

limited with just 4 percent of the population renting, the majority of whom benefit from subsidized/reduced or free rental arrangements.²⁷

72. In light of the new personal insolvency law, which provides additional rights for borrowers, the ‘law on debt discharge’ should be repealed. The new Law on Personal Insolvency that came into effect in early 2018 introduces a 5-year resolution period once a default event has occurred. This is more reasonable than the previous system where debts could be pursued indefinitely, but also more balanced than the ‘law on debt discharge’ which allows borrowers to walk away from any debts remaining once collateral is realized. This will result in some costs for the financial sector, but helps bring some balance between debtor and creditor in cases of delinquency. Overall, the impact of the ‘walkaway’ law has been to add costs and uncertainty to the mortgage lending process, with some lenders offering different rates on loans where the law may apply. This is negative for both the mortgage market as a whole and in particular lower income households which the law was aiming to assist.

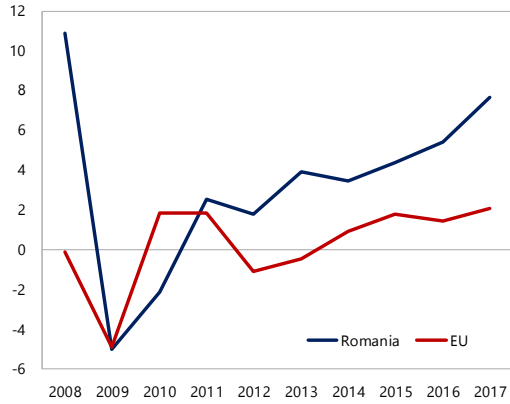
²⁷ Source: Hypostat 2017, European Mortgage Federation

APPENDIX I – TABLES AND FIGURES

Figure 1. Romania: Economic Developments 2008–17

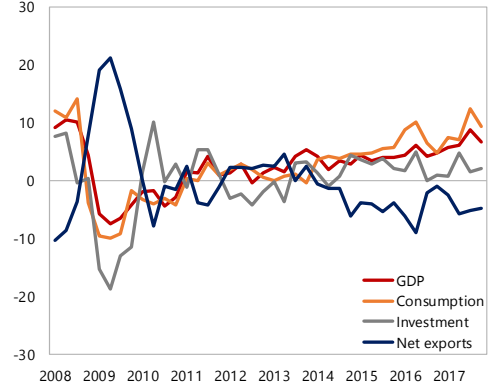
Economic growth resumed and has accelerated in the last two years...

Real GDP Growth Per Capita



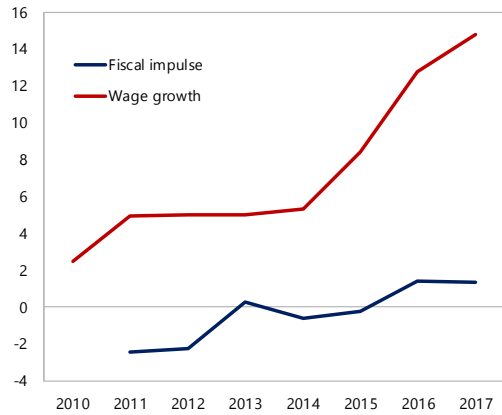
... driven mostly by an increase in private consumption ...

Contributions to GDP Growth



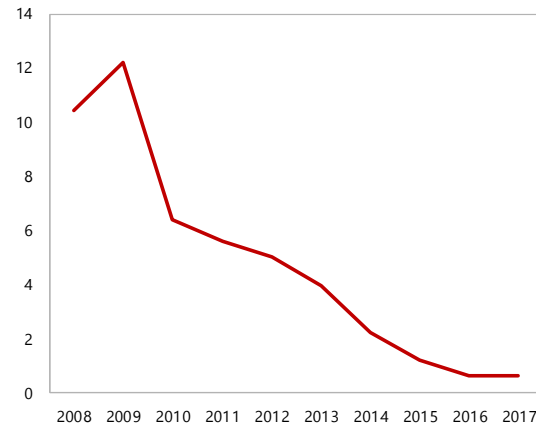
... fueled by expansionary fiscal policy and wage growth, resulting in the output slack to be absorbed.

Fiscal Impulse and Wage Growth



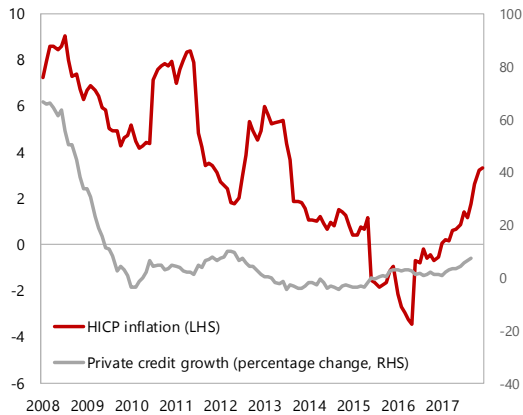
Monetary conditions have remained supportive of growth....

NBR Deposit Rate



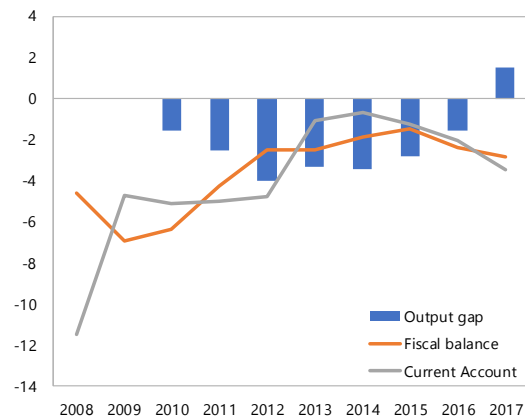
...in the context of subdued inflation and weak credit growth...

Annual Inflation



...but fiscal and external balances have started to deteriorate.

Internal and External Balances



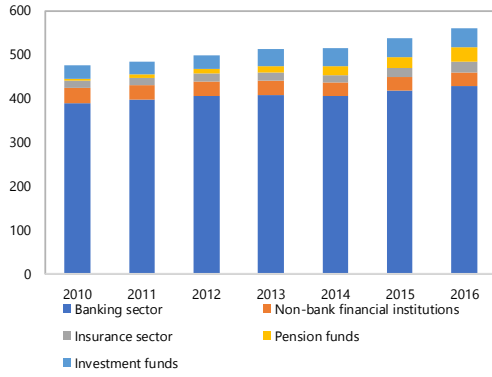
Source: NBR.

Figure 2. Romania: Financial Developments 2008-16

Banks still dominate the financial sector, although the share of other financial institutions increased.

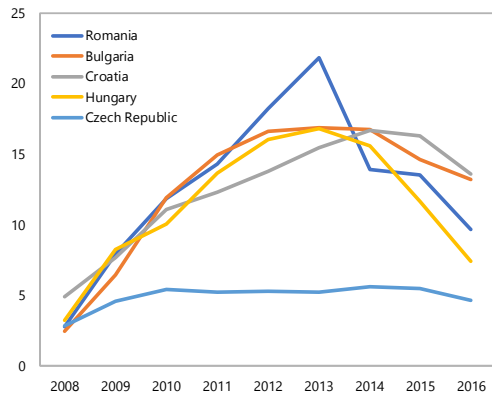
Structure of Financial Sector

Total Assets (In billions of lei)



... a strong decline in NPLs...

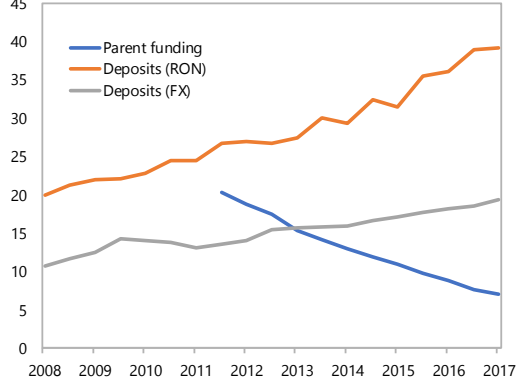
NPL to Total Gross Loans



Banks' resilience improved through reduced dependence on parent funding from abroad....

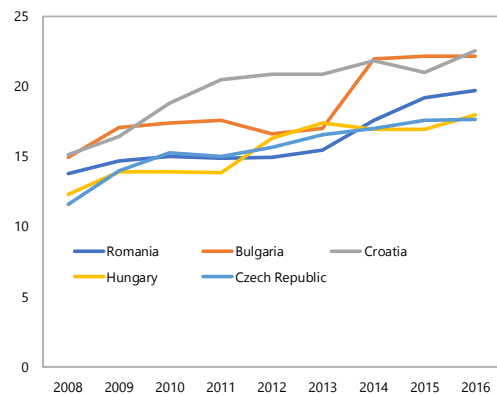
Bank Funding

(In billions of EUR)



... and strengthened capital ratios.

Regulatory Capital to RWA



Source: NBR

Table 2. Romania: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
										Prel.
	(Percent change, unless otherwise indicated)									
Real economy										
Real GDP	8.3	-5.9	-2.8	2.0	1.2	3.5	3.1	4.0	4.8	6.9
Real domestic demand	8.1	-11.2	-2.6	1.9	0.1	-0.1	3.4	5.4	5.3	7.6
Consumption	7.1	-5.8	-3.8	0.9	1.7	-0.3	4.0	4.9	6.8	8.4
Investment	17.6	-35.8	0.1	6.2	3.6	-5.4	3.2	7.4	-2.0	4.7
Exports	-1.8	-4.8	15.1	11.9	1.0	19.7	8.0	4.6	8.7	9.7
Imports	1.1	-20.8	12.5	10.1	-1.8	8.8	8.7	8.0	9.8	11.3
Prices										
Consumer price index (CPI, average) 1/	7.8	5.6	6.1	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3
Consumer price index (CPI, end of period) 1/	6.3	4.8	8.0	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3
	(Percent of GDP; unless otherwise indicated)									
Saving and investment										
Gross national saving	21.7	22.0	22.0	23.0	22.1	24.5	24.0	23.9	21.9	21.0
Gross domestic investment	33.2	26.6	27.1	28.0	26.8	25.6	24.7	25.2	24.0	24.4
Government	6.0	5.0	7.2	7.6	6.4	5.6	5.3	6.2	3.8	3.1
Private	27.1	21.7	19.9	20.4	20.5	20.0	19.4	18.9	20.2	21.3
General government										
Revenue	30.8	29.7	31.8	32.3	32.4	31.4	32.0	32.8	29.0	27.9
Expenditure	35.4	36.6	38.2	36.5	34.9	33.9	33.9	34.2	31.4	30.8
Fiscal balance	-4.6	-6.9	-6.3	-4.2	-2.5	-2.5	-1.9	-1.5	-2.4	-2.8
Gross general government debt (direct debt only)	11.3	20.6	27.8	32.0	35.4	36.6	38.1	37.1	36.8	34.8
Gross general government debt (including guarantees)	13.0	22.6	30.8	34.1	37.7	38.9	40.5	39.3	39.1	36.8
Balance of Payment										
Current account	-11.5	-4.7	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.4
Trade balance	-15.1	-7.3	-7.6	-7.1	-6.9	-4.0	-4.3	-4.9	-5.5	-6.4
Services balance	2.0	0.8	1.2	1.2	1.9	3.3	3.9	4.2	4.5	4.2
Income balance	-2.2	-1.3	-1.2	-1.3	-1.7	-2.2	-1.3	-2.4	-2.6	-2.7
Transfers balance	3.8	3.1	2.5	2.1	2.0	1.9	1.1	1.7	1.5	1.4
Capital account balance		0.5	0.2	0.5	1.4	2.1	2.6	2.4	2.5	1.2
Financial account balance	-11.8	1.8	-2.0	-2.1	-2.6	-3.0	0.1	0.4	-0.7	-1.8
Current account balance	-3.2	-1.1	-1.2	-1.2	-1.1	-0.2	-0.2	-0.3	-0.5	-0.8
Foreign direct investment, balance	-6.2	-2.8	-1.8	-1.3	-1.9	-2.0	-1.8	-1.8	-2.7	-2.4
Memorandum items										
Gross international reserves (in billions of euros)	0.0	30.9	36.0	37.3	35.4	35.4	35.5	35.5	37.9	37.1
Gross international reserves (in months of next year's imports)	7.8	7.6	7.6	7.9	7.3	6.8	6.4	5.9	5.6	5.0
International investment position (in percent of GDP)	-47.3	-60.2	-62.8	-64.2	-67.8	-61.7	-56.9	-53.6	-49.3	-45.8
External debt (in percent of GDP)	49.5	65.4	73.5	74.4	74.6	68.0	63.0	56.4	54.7	50.0
Short-term external debt (in percent of GDP)	14.1	12.6	15.5	17.2	15.7	13.3	12.6	12.4	13.7	13.4
Terms of trade (merchandise, percent change)	2.4	0.5	1.4	1.7	-3.4	0.8	0.8	1.0	0.6	-1.2
Nominal GDP (in billions of lei)	538.0	526.3	529.6	562.1	595.4	637.5	668.1	712.7	762.3	858.3
Output gap (percent of potential GDP)	13.4	3.7	-1.6	-2.5	-4.0	-3.3	-3.4	-2.8	-1.5	1.5
Potential GDP (percent change)	3.3	2.9	2.4	3.0	2.8	2.8	3.2	3.3	3.5	3.7

Sources: Romanian authorities; and IMF staff estimates and projections.
1/ Staff's inflation projections assume monetary tightening.

Table 3. Romania: Financial Soundness Indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings and profitability										
Return on assets*	1.6	0.2	-0.2	-0.2	-0.6	0.0	-1.3	1.2	1.1	1.3
Return on equity*	17.0	2.9	-1.7	-2.6	-5.9	0.1	-12.5	11.8	10.4	12.0
Interest margin to gross income*	44.8	44.1	60.6	62.0	62.3	58.8	58.6	58.5	56.3	58.5
Non-interest expense to gross income*	55.7	63.9	64.9	67.8	58.7	56.5	55.5	58.4	53.0	55.2
Structure of assets										
Total assets (in percent of GDP)	64.8	71.7	72.8	70.2	68.0	64.1	60.7	58.7	56.3	55.6
<i>Of which</i> (in percent of total assets):										
Cash and other payment means	1.7	1.3	1.2	1.3	1.5	1.8	2.2	2.3	3.0	3.1
Marketable securities (other than shares)	3.5	10.0	13.6	15.6	17.4	18.0	19.5	19.4	19.5	19.5
Shares and other equity held by the credit institutions	0.4	0.5	0.6	0.5	0.6	0.6	0.8	1.0	0.8	0.7
Loans	85.1	79.2	75.6	76.1	73.6	72.5	70.8	70.8	70.1	69.6
Credit to households of which:										
RON (in percent of loans)	41.3	38.7	35.2	33.6	32.9	33.5	39.3	48.7	58.5	65.8
EUR (in percent of loans)	46.2	48.8	50.9	53.1	54.6	55.2	50.9	43.9	36.6	30.8
Other currencies (in percent of loans)	12.6	12.4	13.9	13.3	12.4	11.3	9.8	7.3	5.0	3.4
Housing loans (in billions of lei)	20.9	24.2	28.9	33.4	37.1	40.8	44.6	52.0	58.4	66.2
Consumer loans (in billions of lei)	73.7	72.8	64.2	62.0	58.0	53.5	54.3	52.9	52.2	53.8
Funding and liquidity (in percent of total liabilities)										
Marketable securities (other than shares) issued by credit inst.	0.3	0.2	0.3	0.3	0.3	0.5	0.6	0.5	0.4	0.5
Total deposits	80.1	79.4	77.2	78.4	77.8	76.7	78.1	78.6	79.6	80.2
Sectoral distribution of total loans (in percent of total assets)										
Non-financial corporations	27.8	26.3	26.9	29.1	29.3	27.5	26.0	25.1	23.7	22.7
Financial corporations other than MFIs	1.3	0.9	0.7	0.9	0.6	0.7	0.9	1.1	1.3	1.4
General government	1.8	3.1	2.9	2.7	2.4	2.4	2.4	2.4	2.4	2.0
Capital adequacy										
Regulatory capital to RWA*	13.8	14.7	15.0	14.9	14.9	15.5	17.6	19.2	19.7	19.0
Regulatory tier 1 capital to RWA*	11.8	13.4	14.2	12.0	13.8	14.1	14.6	16.7	17.5	17.1
Capital to assets*	9.0	8.6	8.9	8.1	8.0	8.0	7.4	8.2	8.9	8.9
Net open position in FX to capital*	1.6	2.3	-1.4	-4.7	-1.8	2.5	2.0	0.7	0.5	-0.5
NPLs as percent of gross loans*	2.7	7.9	11.9	14.3	18.2	21.9	13.9	13.5	9.6	8.0
NPLs net of provisions to capital*	10.7	11.3	15.7	16.5	14.4	12.1	26.2	41.2	28.9	21.1
Customer deposits to total loans*	81.9	88.7	84.8	84.0	87.3	98.7	110.5	115.6	124.6	123.1

Sources: IMF, NBR.

* Q3 values used for 2017 (latest available)

APPENDIX II - STATUS OF FSAP 2009 RECOMMENDATIONS

Recommendation	Status
Crisis Management and Safety Net	
Seek strengthening of capital positions of some banks and set medium term targets for increasing minimum CARs	Implemented in all material cases. Alignment to EU standards completed.
Strengthen monitoring of bank loan portfolios and problem loan workout procedures and capacity	Implemented. Loan classification, collateral valuation, and provisioning have been strengthened. NPLs dropped significantly.
Accelerate crisis management planning, communications, implementation of simulation exercises, and strengthen cross-border and cross-sectoral coordination of crisis management	Implemented to a great extent by the transposition of the BRRD. In 2013 a simulation exercise was conducted with support from the WB.
Consider additional measures to provide liquidity, especially under ELA	Not implemented yet. Arrangements remain vague and limited by the types of collateral accepted. However, the NBR is working on the implementation of the ECB's standards for ELA.
Review bank resolution framework to facilitate rapid action and options for bank restructuring.	Implemented through the transposition of the BRRD.
Strengthen deposit insurance funding arrangements and speed up payouts	FGDB has reached its target for the deposit insurance fund. The institution's workplan includes increasingly complex tests to enhance its ability to provide fast payouts.
Cross-Sectoral Issues	
Align the degree of independence and financial autonomy of the nonbank regulators with those of the NBR	Partly implemented. The ASF Law has been implemented, however, the FSAP found that the ASF's independence still needs improvement.
Issue consistent valuation methodologies for financial assets	Following the IFRS implementation, credit institutions use professional judgment for drawing up their own provisioning methodologies for financial assets consistent with IFRS.
Strengthen information exchange and cooperation among regulators and the Ministry of Economy and Finance	Partly implemented. Arrangements have been in place to facilitate and ensure cooperation with relevant domestic authorities. However, meetings with ASF are too infrequent to allow effective exchanges and coordination.
Expand resources of the Financial Intelligence Unit (ONPCSB)	Implemented. The number of staff at the FIU has increased from 15 (2009) to 107.

Banking Sector	
Strengthen (i) judicial, accounting and auditing standards; and (ii) communication and consultation between NBR and regulated entities.	<p>(i) Implemented. Banks have been required to prepare their financial statements in accordance with IFRS since 2012. Law 162/2017 on the statutory audit transposes the 2014 EU directive (2014/56) that sets out the framework for all statutory audits, strengthens public oversight of the audit profession and improves cooperation between competent authorities in the EU. Law 162/2017 creates a public oversight body for the audit profession in Romania.</p> <p>(ii) Implemented. NBR meets on a regular basis with regulated entities, including banks and their external auditors both at individual and industry levels for more communication and consultation (e.g., NBR meets quarterly with all external auditors).</p>
Securities and Capital Markets	
Concentrate primary issuance of government bonds on one or two maturity points until liquidity is enhanced.	Issuance concentrated in benchmark securities (3 ,5, 7, 10, 15 years), liquidity has increased post crisis and due to government bond market development efforts.
Revise contracts of primary dealers and establish a primary dealer rotation policy to provide incentives for market making.	Implemented. The new legal framework governing primary dealer activity on domestic market, in force starting January 2017, including incentives.
Amend the Law of Capital Markets to remove the limit on voting rights in regulated market operators.	Expected to be implemented. The draft law amending Law on Capital Markets and ensuring transposition of MIFID II is not including provisions on limitations of holdings in regulated market operators.
Insurance and Pension Sectors	
Review law on obligatory house insurance.	Partly implemented. As the program continues to mature, a stable well diversified reinsurance program tailored to cover a 1-in-150-year event confirms that premium is considered appropriate by international markets. Premium has vastly exceeded claims in recent years and the retained profits strengthen the company's resilience. Penetration, however, is stagnant, driven more by lax enforcement and low access to housing finance than by adverse selection. A change to the law is being discussed to better enforce compliance. It is unclear by when there will be a decision and what the impact will be.
Clarify interpretation of minimum contribution guarantee and weighted average return guarantee.	<p>Implemented</p> <p>(Norm No. 13/2012 regarding the actuarial calculation of the technical provision for privately managed pension funds, Norm No. 10/2009 regarding rates of return of voluntary pension funds and Norm No. 7/2010 regarding rates of return of privately managed pension funds).</p>

Revise investment management fees.	Not implemented (Law No. 411/2004 regarding privately managed pension funds and Law No. 204/2006 regarding voluntary pension funds clearly provide the levels and the conditions).
Establish unique valuation methodology and responsibility.	Implemented (Norm No. 11/2011 regarding investment and valuation of private pension funds' assets).

