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ROMANIAN BANKING SYSTEM EVOLUTION AND BASEL II REQUIREMENTS

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Before 1989, Romanian Banking System was structured in the specific way of a centralized economy. Restructuring of the banking system took its first step at the end of 1990 when the newly- established bank, Banca Comercială Română, took over retail operations performed previously by the NBR. Simultaneously, some privately-owned banking companies were established and foreign banks' branches were integrated into the domestic banking activity, the number of banks almost trebling. The unfriendly economic environment, the poor quality of bank managers and shareholders and cumbersome legal procedures led to an increase in tensions, the poor quality of credit portfolio representing the major difficulty of the banking sector. In the past years, NBR tried to control more the banking activity by implementing international settlements. More over, since Romania is one of the European Union countries, it is absolutely necessary the harmonization of entire economic and financial system to EU regulations. The paper try to present the position of Romanian banking system in the framework of all these transformations.

Restructuring of the Romanian banking system

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The unfriendly economic environment, the poor quality of bank managers and shareholders and cumbersome legal procedures led to an increase in tensions, the poor quality of credit portfolio representing the major difficulty of the banking sector. At end-1998, non-performing loans accounted for more than 58 percent of total credit portfolio and 253 percent of Tier 1 capital, exceeding by far the usual coverage means – by recapitalization or increase in loan recovery. Against this background, in early 1999, the NBR embarked on a program aimed at restructuring the banking system meant to ward off systemic risk, which focused on:

- removal of problem-banks;
- improvement of the regulatory and prudential supervisory framework governing banks;
- establishment or improvement of some instruments providing indirect support to the banking system, i.e. Credit Risk Bureau, Payment Incident Bureau and Bank Deposit Guarantee Fund. In addition, the Authority for State Assets Recovery (ASAR) was established in order to take over the state-owned banks' non-performing loans;

Ultimately, the problem of banks in distress was solved by removal from the banking system of Bancorex, the largest state-owned bank (in October 1999 Bancorex was subject to a merger through absorption process with BCR) and by adjudging eight small privately-owned banks bankrupt. Bancorex bad assets, on and off balance sheet, were transferred to the ASAR while viable assets were taken over by BCR, which became the largest bank of the banking system, its share in total bank assets rising to about 30 percent. Bank restructuring brought about the resumption of the bank intermediation function and the increase in safety of bank depositors. Financial costs of banking sector restructuring were borne by the government and accounted for 10 percent of GDP during 1990-2003. Notable progress was made also in the field of banking regulation and supervision: implementation of a uniform bank rating system and early warning system; reduction of on-site inspections to one year;

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financial discipline by tougher criteria for sanctioning banks; stricter criteria for the authorization of managers and shareholders of banks; increased co-operation with the Romanian and foreign supervisory authorities.

Characteristics of Romanian Banking System at the moment of accession
Structural developments

The development of Romanian banking system is framing into the globalization trends of world wide economy in the last decades, although for the Romania - case, it is more adequate to talk about a regional concentration of financial market and processes. Banks hold a dominant position in the Romanian financial system. In spite of their rapid growth in the past years, the other financial institutions hold relatively low market shares; therefore, their impact on financial stability is not significant.
The main components of Romanian financial system, in their last six years evolution, are plotted in the next graphic as GDP weight. The clear dominance of the bank assets can be observed.

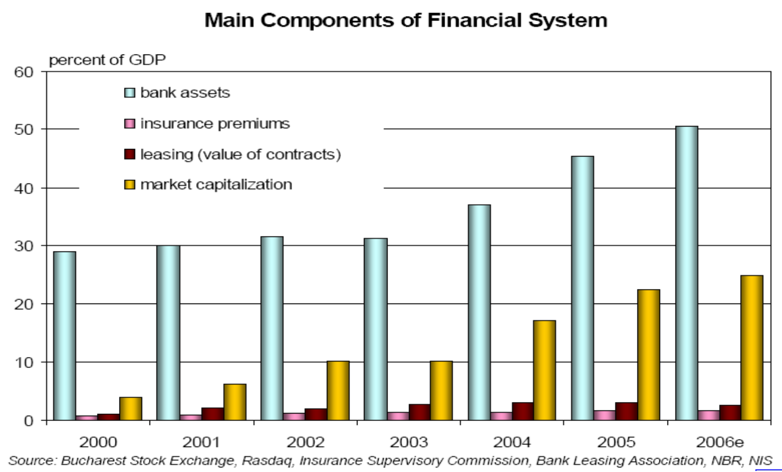


Fig. 1 Main components of Romanian financial system

At present, foreign private capital dominates the Romanian banking industry, facilitating the access to external funding, making credit risk management more efficient and having a positive impact on the banking sector stability. Analysing the participation of the state-owned banks to the activity of banking system in the 1991 – 2006 period, a diminution of 50% of their activity for the 2000 – 2003 period can be observed. Starting from 2004 their activity was basically inexistent, not because of a clients' trust decreasing in the system but mainly due to the privatisation of the main state owned banks.

From the point of view of the weight of the state-owned banks in the whole national banking system, Romania is better integrated than some other states, like Ireland or Sweden where more than 50% of the banking system is still owned by the state. Moreover, analysing the provenience of the foreign capital in the Romanian banking system we can notice that this is coming mainly from European Union countries

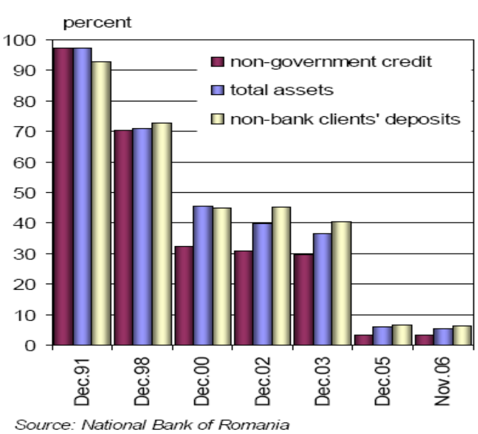


Fig. 2 Evolution of activity for state-owned banks

Table 1 Structure of foreign share holding in the Romanian banking system

	Foreign share holding	
	% in total foreign capital	% in total capital
Austria	26.6	19.2
Greece	23.3	16.8

Holand	10.3	7.4
Italy	10.0	7.2
France	6.5	4.7
Hungary	5.8	4.2
Germany	1.9	1.4
Great Britain	1.7	1.2
Other EU countries	2.0	1.3
Total EU	**88.1**	**63.4**
Other countries	3.0	8.6
Total	100.0	72.0

Source: National Bank of Romania

The structural indicators of Romanian banking system recorded the fallowing evolution from 1999 to 2006:

Table 3 Structural indicators of the Romanian banking system

	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006
Number of credit institutions	40	40	40	38	38	39	39	38
Banks with majority private capital	36	36	37	35	35	37	37	36
Banks with majority foreign capital, of which:	26	29	32	32	29	30	30	33
- Foreign bank branches	7	8	8	8	8	7	6	7
Number of banks per 100,000 inhabitants	0.18	0.18	0.18	0.17	0.17	0.175	0.175	0.17
Assets of banks with majority private capital/Total assets (%)	53.2	53.9	58.2	59.6	62.5	93.1	94	94
Assets of banks with foreign capital/ Total assets (%)	47.5	50.9	55.2	56.4	58.2	62.1	62.2	61.9
Assets of top five banks/Total assets (%)	66.7	65.5	66.1	62.8	63.9	59.2	58.8	61.1

Source: NBR

Foreign capital inflows and privatization led to sweeping changes in the structure of the Romanian banking system. Thus, at the end of 2006, the market share, in terms of assets, of banks with majority state-owned capital declined to 6 percent while that of banks with majority private capital increased to 94 percent. Moreover, during the same period, banks with majority foreign capital held 61.9 percent of total assets of the banking system. Due to the high foreign (especially European) capital weight in the Romanian banking system, the evolution of banking Romanian market is influenced by the trends of European financial system. Thus, according to important European banks actions and policies, nowadays in Romania is developing a concentration process, characterized by acquisitions and fusions such as the one between UniCredit Bank, HVB Bank Romania and "Ion Tiriac". At the same time we can notice a specialization trend.Most of the 38 credit institutions operating at the end of 2006 were universal banks, excepting two banks: one lending to small and medium size companies and the other financing the purchase of motorcars. Three banks operate as specialized banks, out of which two banks are engaged in lending for housing while one bank is involved in financing foreign trade operations. By activity, three banks operate based on special laws. Raiffeisen Bank for Housing and HVB Bank for Housing are engaged in collective saving and lending for housing. The Romanian Export- Import Bank (EXIMBANK) is a specialised bank whose role is to underpin the financing of exports and to provide export-related insurance. Two other banks, although they may provide all financial products and services specific to universal banks (in accordance with their license), specialised mainly in granting loans for purchase of motorcars (Porsche Bank Romania) and for financing small- and medium-sized companies (ProCredit Bank). Special mention deserves the Savings Bank (CEC), specialized in savings in the communist period, which turned into a retail bank, benefiting from the State's guarantee for household deposits. The privatization of the Savings Bank (CEC), which holds 4.5 percent of total bank assets, is in progress. Market concentration (Table 4), which is measured by the share of top-five banks in total bank assets (61.1 percent), points to one of the lowest degree of concentration in the group of acceding and candidate countries, remaining however above that of euro area countries.

Table 4 Bank concentration (top five banks)

% of total banking assets

	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Sept. 2006
Assets	62.8	63.9	59.2	58.8	61.1
Loans	56.2	57.1	55.7	61.2	64.5
Deposits	63	64.9	59.5	57	58.8
Tier 1 capital	64.5	61.2	60.5	55.1	54.4

Source: NBR

The downward trend of market concentration and the increase in the share of banks with majority foreign capital may point to higher competition. Fiercer competition will entail changes in the strategy of small- and medium-banks (possible merger and acquisition), their long-term selffinancing capability being significantly low when compared with that of major market players. However, they are likely to concentrate on specialized products or on certain client segments. The connection with modern banking practices, assured by the foreign banks, and the increase of costumer exigencies led to a fast assimilation and development of services based on advanced technology. Thanks to technical progress, Romania succeeded to get ahead, almost fast, of checks and instruments based on paper stage and to use the instruments based on electronic processing, process that in other countries was developed during decades. Thus, besides the fast increase of the quantity of operations and the number of users of electronic payments operations, in Romania are more often asked and used services as internet banking, e-banking and e-finances.

At the same time, the wide use of information technology allowed in Romania the introduction of a new concept named "SELF BANKING" that on the one hand satisfies the costumers demands regarding the flexibility of banks working schedule, and, on the other hand allows the decrease of operational costs for banks, a very important element in the framework of a strong competition in the banking field.

At the domestic banks the trend to innovation could be noticed. It is represented by a continue diversification of products offered to the bank clients, either opening specialized subsidiaries or offering new products. Regarding the new products, after years and years of activity oriented only to corporate clients, Romanian banks registered starting with 2002 -2003 a boom of consumer credit, fallowed in a short time by mortgage credit. This way, the retail segment started to approach the level specific to countries with developed banking systems.

The next stage, and the most difficult, is the access of commercial banks to rural places, where lives almost half of the Romanian population and where are two abundant resource, less used:

- the transfers of Romanian seasonal workers
- EU unredeemable (disreimbursable) funds

Structure of assets and liabilities

Restructuring and strengthening of the banking system provided an underpinning to the rapid increase in bank assets in the past five years. Structural analysis of the dynamics of aggregate balance sheet shows that management policy of investments and resources underwent significant changes.

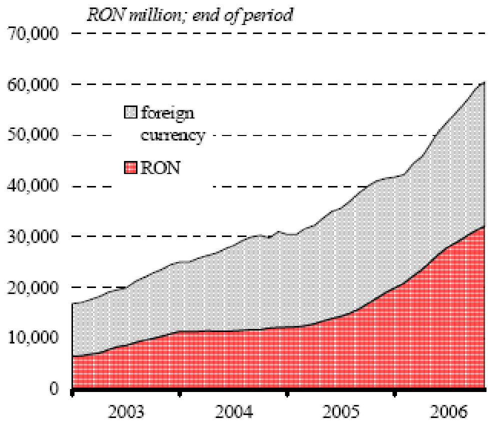
Net aggregate assets of credit institutions expanded 28.2 percent in real terms from year-end 2005, to RON 172.2 billion at year-end 2006. The rise in net aggregate assets was mainly driven by the real growth of interbank operations and the expansion in lending to non-banks. At year-end 2006, operations with non-bank clients continued to hold the largest share in total operations (53.9 percent, up 6.7 percentage points year on year), followed by interbank operations (38.7 percent, 6.8 percentage points higher than at end-2005). Investments in government securities held merely 1.8 percent of total operations, compared with 1.6 percent in 2005 (Table 5).

Table 5 Share of main banking operations in total assets

% in total assets

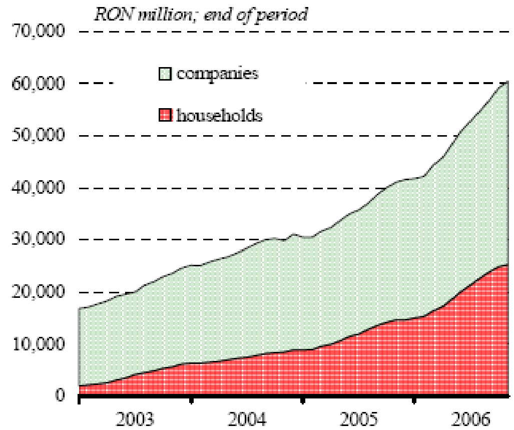
Assets	2005	2006
Operations with non-bank clients	47.2	53.9
Interbank operations	31.9	38.7
Investments in government securities	1.6	1.8
Other assets	5.8	5.6
TOTAL	**100**	**100**

According to monetary balance sheet data, during 2006, nongovernment credit posted a continuing increase as the result of RON loans expansion and as well the rise in foreign currency loans. The structure of non-government credit by currency shifted significantly in favor of the RON component (to 53/47 at end-2006 compared with 46/54 at end- 2005).



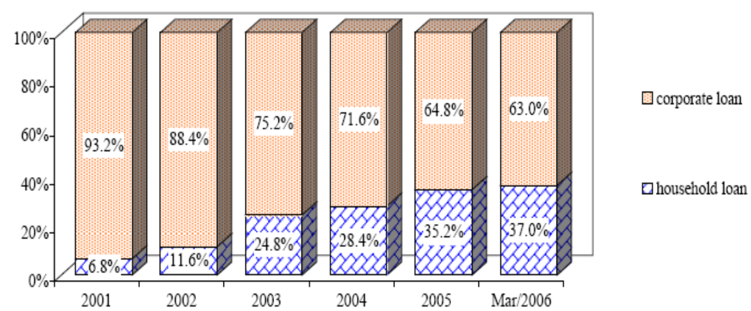
*) deflated by CPI, 2000=100
Source: NIS, NBR

Fig. 3. Non-government Credit in Real Terms*



*) deflated by CPI, 2000=100
Source: NIS, NBR

Fig.4 Non-government Credit in Real Terms



Source: NBR

Fig.5 Development of non-government credit components

Taking into account the initially low level of household loan, its growth is expected to continue, the level recorded at the end of 2005 being well below that of euro area. Moreover, real-estate loan is still in its infant stage of development, accounting for 25 percent of household loan. The moderate growth of corporate loans is also due to:

- increase in corporate self-financing capacity as a result of favorable macroeconomic conditions;
- expansion of financing via commercial debt;
- constraints associated with participation in public auctions;
- increase in external financing.

The increase on loans level in the banking system does not necessary represent an advantage as long as their quality is not adequate. But credit quality in the Romanian banking system is adequate, even recording an improvement compared with 2000. Thus, the share of past-due and doubtful loans to non-bank clients in total credit to the non-bank credit portfolio continues the downward trend regarding both net value and gross value.

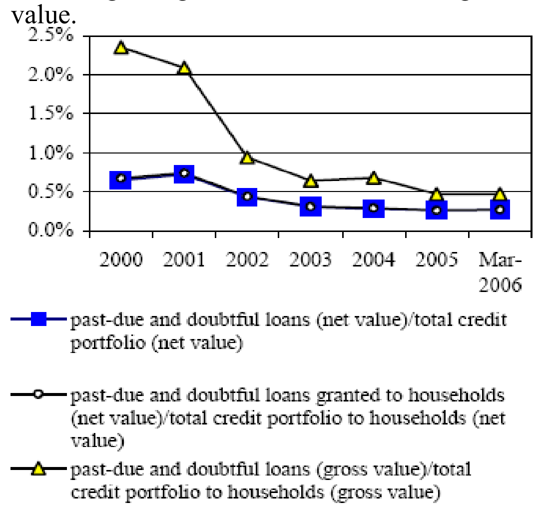


Fig. 6 Credit quality in the banking system

On the liabilities side, deposits taken from non-bank sector, especially corporate and household deposits represented the main financing source of commercial banks (Table 6).

Table 6 Liabilities structure (%)

	2001	2002	2003	2004	2005	2006
Total residents deposits, of which:	74,1	75.0	71.2	67.9	63.5	61.3
Interbank deposits	3,7	3.3	2.9	3.0	2.45	1.7
Non-bank sector deposits, of which:	70,4	71,7	68,3	64,9	61,0	59,6
- Government sector deposits	3,7	3,1	3,0	2,6	3,5	3,4
- Corporate and household deposits	66,7	68,6	65,3	62,3	57,5	56,2
Capital and reserves	14,4	13.5	13.1	11.7	12.2	12.4
Foreign liabilities	5,9	7.0	11.7	15.9	20.9	21.9
Other	5,6	4.5	4.0	4.5	3.4	4.4

Source: NBR

The share of this component in total balance sheet liabilities, albeit on a downward trend, was well above that recorded in the euro area (accounting for 30 percent). In the euro area the deposits of monetary and financial institutions are significant (22 percent).

Securities issues, which are widely resorted to as a financing source in the euro area, hold a small part in total liabilities of Romanian banks, reflecting a still underdeveloped domestic market for private securities.

Foreign liabilities rose significantly during the past few years; their maturity increased, thereby contributing to the matching of balance sheet items. Therefore, corporate and household holdings and deposits as well as external funds represent the main financing sources of banks. These sources are channeled mainly to non-government credit, and to a lesser extent invested in securities and interbank placements.

Certain and less certain evolutions of Romanian banking system

Looking in the future, the development of Romanian banking system has some predictable directions, but there are also some directions that can not be predictable. The fallowing could be included in the predictable evolutions of Romanian banking system:

- **reduction costs for banking intermediation** – it is possible for the payment transfer, thanks to introduction of Electronic Payment System, and for household deposits because the implementing and functioning of Fund for Deposits Guarantee.
- **the measure regarding reserve requirements in national currency -** NBR used a lot the reserve requirements as instrument against inflation, but with big costs for financial intermediation in general, and especially for crediting in national currency. The reduction of reserve requirements is a process already started and it will going on in the next period in order to decrease commercial banks cost, but also to avoid the dangerous mismatches between the savings, mostly in national currency, and loans mainly in foreign currency, yet. Regarding the reserve requirements in foreign currency, the National Bank decided to increase the rate.
- **the increase of non-government credit share in GDP –** it is an obvious trend and it will continue for a while, according with the Romanian economy development, the increase of competition in the banking field and appearance of new banking products.
- **narrowing the interest margins determinate by the development of competition in the banking system.** It is natural to be like this because on functional efficient markets the benefit is gained because of the volume and from margins. It is obviously that also Romania should accept this process.

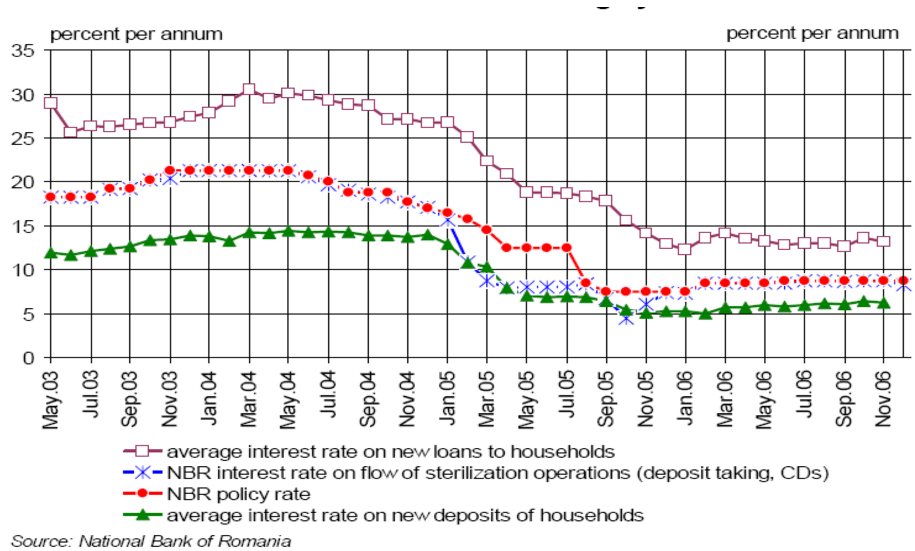


Fig. 7 Interest Rates in the Banking System

In the category of less predictable evolutions is writing down the number of banks in Romania in the future.

There are pro and against opinions about this subject. Some of the specialists claim that the number of banks will decrease. Their argument is that 50 percents of existing banks detain less than 10 percents in total assets, there for they should action in the way of increasing their market share, fusion or to be acquired. On the other hand, this fact doesn't mean necessarily a decrease of banks' number; it is possible also to appear specialized banks on the market.

There are also opinions according of the number of banks will not decrease, and the argument in this case is that the number of inhabitants for one bank is still low. Either this argument is strong enough because the number of the banks could decrease, but banks territorial network could be developed.

Concluding, the number of banks in Romania between 2012 – 2014 (when euro currency will be adopted) could be the result of some complex processes, where interbank competition and the policy of the big players regarding their territorial network and incomes from credits will have an important role. It is obviously that in the future the quality of the services will be more important than the number of banks.

The main Romanian banking system objectives after accession

Taking into account the importance of Romanian banking system, its future has to meet the conditions of efficiency and competitively in order to realize the basic functions: a) mobilized the domestic savings and their reallocation to rentable utilizations; b) insuring the mechanisms for transmission of monetary policy; c) optimum function of payment system.

In order to achieve these objectives, it is necessary to start and end in short time the next processes:

1. restructuring the bank portfolios – it is absolutely necessary a cleaning of credit portfolios
2. banks recapitalization – it is necessary to impose, in order to cover the risks generated by assets' operations, an adequate capital to guarantee the continuity of banks activity.
3. banks privatization – represent the faster way to introduce changes regarding the banks behavior and strategy. Thus, it s also assured the banks' independence from government and public sector.
4. consolidation of banking system – by creating strength and competitive banks at the national level (using actions such are fusions and acquisitions

All these processes will have as result the reinforcement of competition, which will determinate: the increase of foreign banks – they will assume more risks regarding the domestic clients; the expansion of loans portfolio; the expansion of householders bank services; the reducing of interest and benefit margins together with the decrease of nominal interest rate and risks; a careful control of costs

According to Vice - Governor of NBR, the Romanian banking system has the following aims on medium and long term:

1. the intensification of financial intermediation based on a modern and solid banking system, well settled regarding the prudence, efficiently overseen.
2. monitoring the financial stability in order to: increase the capacity of a efficiently resources allocation; absorbing the eventually shocks; prevent unfavorable effects of shocks on real economy
3. the increasing of administrative capacity of NBR in order to assure the financial system stability;
4. promoting new attractive investment instruments for institutional investors (specially for pension funds, fund funds and insurance institutions)
5. creating the environment for a more efficiently banking management regarding the long term investments.

Particulars of implementing Basel II in Romania. Is the Romanian banking system ready to access?

The opinion imparts by almost all players from Romanian banking market is that our banking system is ready to implement the provisions of Basel II . There is a relative delay in implementing Basel II in Romania, and the process engenders major challenges both to the central bank and credit institutions. In the case of Romania, implementation of Basel II implies substantial challenges both for credit institutions (adjusting risk management and the IT system, staff training, database availability, etc.) and the National Bank of Romania (supervision adjustment, drafting of the new regulatory framework, staff training, etc.).

The central bank drew up a four-stage strategy to implement Basel II:

- **stage one**: to initiate and carry on exchange of information with national entities (Romanian Banking Association, the Ministry of Public Finance, the National Securities Commission) and international institutions (other supervisory authorities) involved in using Basel II;
- **stage two**: to develop the means for achieving banking sector supervision at Basel II standards, especially through : a) transposition into national legislation of Directives and adjustment of the prudential reporting system; b) drafting of guidelines for the validation of internal models; c) unfolding of assessment missions regarding Basel II implementation conditions at the credit institutions' head offices;
- **stage three**: to validate the internal rating models of credit institutions;
- **stage four:** to perform on-site inspections focusing on the application of Basel II provisions.

The regulatory framework will undergo sweeping changes. The laws governing banking activity, credit co-operatives, savings banks for housing and mortgage banks will be subject to review. Furthermore, secondary legislation will be amended and supplemented to meet the requirements of Basel II.

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