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Romanian banking system evolution and Basel II requirements

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Abstract

Before 1989 Romanian banking system was structured in the specific way of a centralized economy. Restructuring the banking system took its first step at the end of 1990 when the newly established commercial bank Banca Comerciala Romana (BCR) took over retail operations performed previously by the National Bank of Romania (NBR). Simultaneously some privately-owned banking companies were established and foreign banks' branches were integrated into the domestic banking activity. 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 will be 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 information.

Keywords: Romanian banking system, banking systems in transition, bank regulation, Basel II, credit portfolio, bank concentration,

JEL : E58, G21, G28, P43

1. Restructuring Romanian banking system

Restructuring Romanian banking system took its first step at the end of 1990 when the newly established commercial bank Banca Comerciala Romana 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. Thus, the number of banks acting in Romania 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. At end-1998, non-performing loans accounted for more than 58% of total credit portfolio and 253% of Tier1 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 bank in distress was solved by removal from the banking system BANCOREX, the largest state-owned bank (in

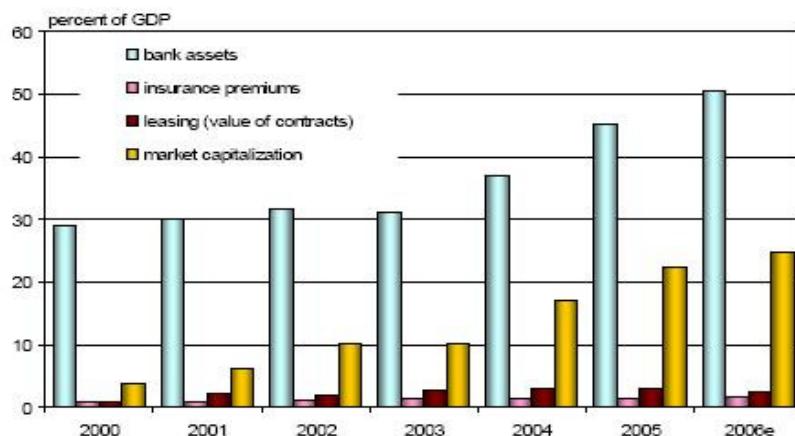
October 1999 BANCOREX was subject to a merger through absorption process with BCR) and by adjudging eight small privately-owned banks bankrupt. BANCOREX bad assets, on and off balance sheet, were transferred to ASAR while viable assets were taken over BCR, which became the largest bank of Romanian banking system, its share in total bank assets rising to about 30%. 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% 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; 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.

2. Characteristics of Romanian banking system at the moment of accession. Structural developments

The development of Romanian banking system is framing into globalization trends of worldwide economy in the last decades, although for 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 Figure no.1 as GDP weight. The clear dominance of the bank assets can be observed.



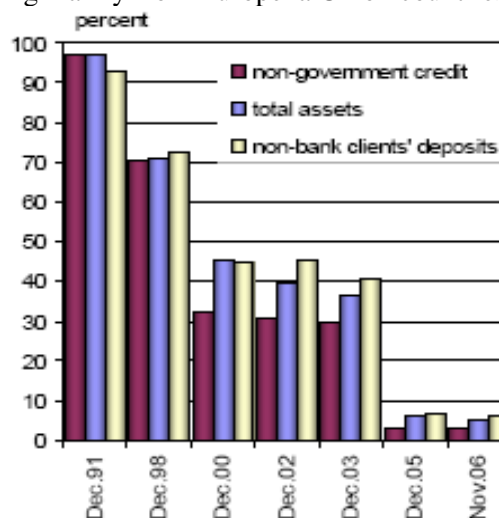
Source: National Bank of Romania

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 with 50% of their activity for 2000-2003 period can be observed. Starting with 2004, their activity was basically non-existent, not because of a clients' trust decreasing in the system but specially due to the privatization of the main state owned banks.

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

coming mainly from European Union countries.



Source: National Bank of Romanian

Fig.2 Evolution of majority state-owned banks in total 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
Netherlands	10,3	7,4
Italy	10	7,4
France	6,5	4,7
Hungary	5,8	4,2
Germany	1,9	1,4

	Foreign share holding	
	% in total foreign capital	% in total capital
Great Britain	1,7	1,2
Other EU countries	2	1,3
Total EU	88,1	63,4
Other countries	3	8,6
Total	100	72

Source: NBR

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

Table 2 Structural indicators of the Romanian banking system

	1999	2000	2001	2002	2003	2004	2005	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	0,18	0,18	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% of total assets of the banking system.

Due to the high foreign (mainly European) capital weight in the Romanian banking system, the evolution of Romanian banking 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 is the one between UniCredit Bank, HBV Bank Romania and "Ion Tiriac" Bank.

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 of them: a lending bank for SMEs and a bank specialized in financing the purchase of motorcars. Other three banks operate as specialized banks, out of which two are engaged in lending for housing while one is involved in financing foreign trade operations. By activity, these three banks operate on the base of 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 specialized bank whose role is to underpin the financing of exports and to provide export-related insurance. Two other banks, although they may provide all types of financial products and services specific to universal banks (in accordance with their license), are specialized mainly in granting loans for

purchase of motorcars (Porches Bank Romania) and for financing small and medium-size companies (ProCredit Bank).

Special mentions deserves Casa de Economii si Consemnatiuni (CEC) specialised in savings during the communist period, which turned into a retail bank, benefiting from State's guarantee for household deposits. The privatization of CEC, which holds 4,5

percent of total bank assets, is in progress.

Market concentration (Table no.3), 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 accession and candidate countries, remaining however above that of Euro area countries.

Table 3 Bank concentration (top five banks)

% of total banking sector assets

Indicators	December 2002	December 2003	December 2004	December 2005	September 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 self financing 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 customer 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 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 customer's 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.

As regarding domestic banks, the trend to innovation could also 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, starting with 2002 – 2003 period Romanian banks registered a boom of consumer credit, followed 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 for Romanian banking system is the access of commercial banks to rural places, where lives almost half of the Romanian population and where there are two abundant resources less used:

- the transfers of Romanian seasonal workers abroad
- EU not reimbursable funds.

3. Structure of Romanian banking system 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 2006. The rise in net aggregate assets was mainly driven by the real growth of interbank operations and the expansion in landing to non-banks. At year-end 2006 operations with non-bank clients continue to hold the largest share in total operations (53,9 percent, up 6,7 percentage points

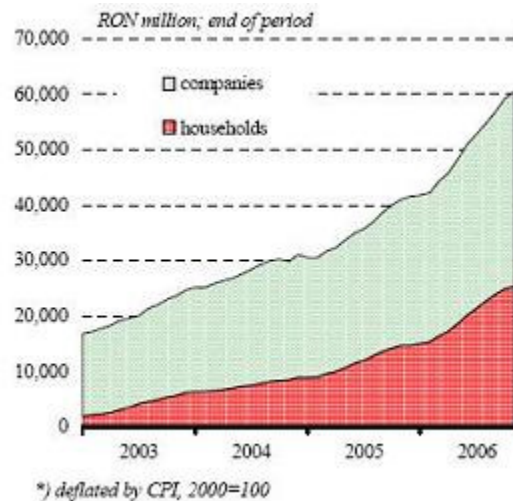
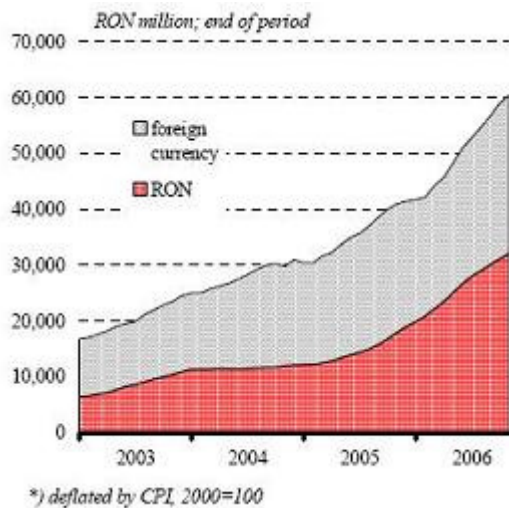
year per year), follow by interbank operations ((38,7 percent, 6,8 percentage points higher that at year-end 2005). Investments in government securities held merely 1,8 percent of total operations, compared with 1,6 percent in 2005 (see Table no. 4)

Table 4 Share of main banking operations in total assets

Assets	% in total 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

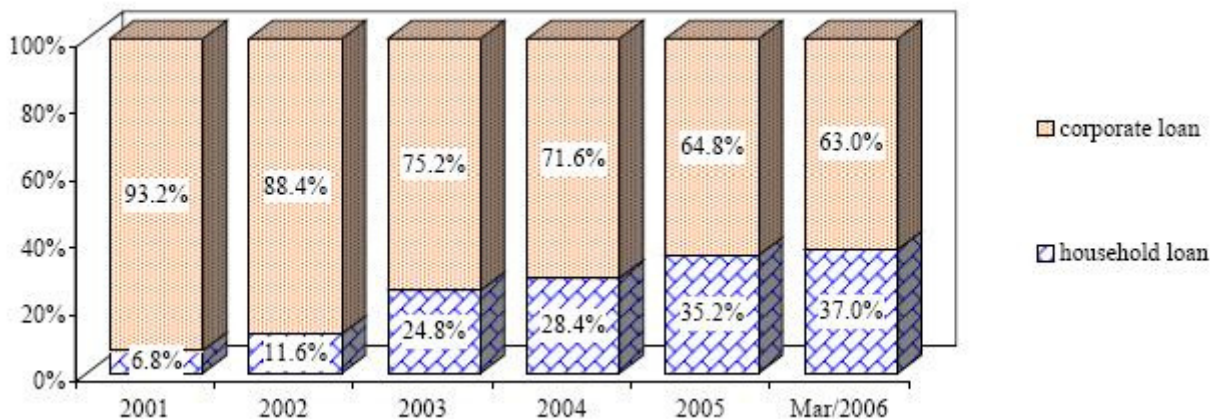
According to monetary balance sheet data, during 2006 non-government credit posted a continuing increase as the result of RON loans expansion and as well the rise in foreign currency loans. The structure

of non-government credit by currency shifted significantly in favour of the RON component (to 53/47 at end-2006 compared with 46/54 at end-2005).



Source: NBR

Fig.3 Non -government credit in real terms*



Source: NBR

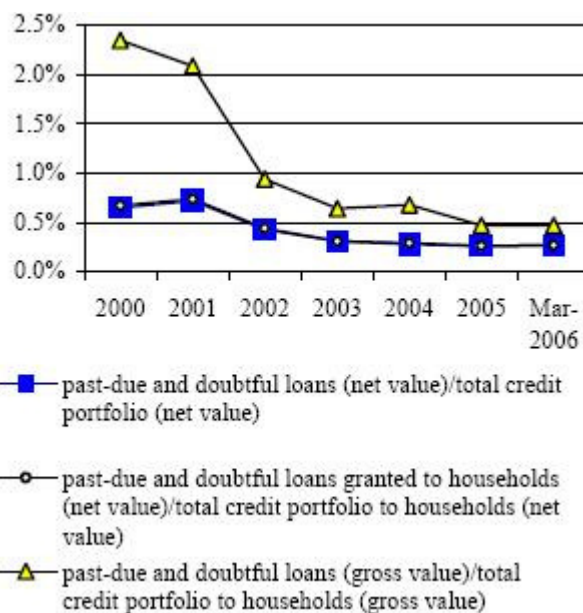
Fig. 4 Development of non-government credit components

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 loans.

The moderate growth of corporate loans is also due to:

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

The increase of loans level in a banking system does not necessary represent an advantage as long as loans' quality is not adequate. Credit quality in Romanian banking system is adequate and have even recorded an improvement compared with 2000. Thus, the share of past-due and doubtful loans to non-bank clients in total non-bank credit portfolio continues the downward trend regarding both net value and gross value (see Figure no.6).



Source: NBR

Fig.6 Credit quality evolution in Romanian banking system

On the liabilities side, deposits taken from non-bank sector, especially corporate and household deposits represent the main financing sources for commercial banks (Table no. 5).

Table 5 Evolution of liabilities structure (%)

Indicators	2001	2002	2003	2004	2005	2006
Total residents deposits, of which:	74,1	75	71,2	67,9	63,5	61,3
Interbank deposits	3,7	3,3	2,9	3	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	11,7	15,9	20,9	21,9
Other	5,6	4,5	4	4,5	3,4	4,4

Source: NBR

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

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 for banks. These sources are channelled mainly to non-government credit, and to a

lesser extent invested in securities and interbank placements.

4. Certain and less certain evolutions of Romanian banking system

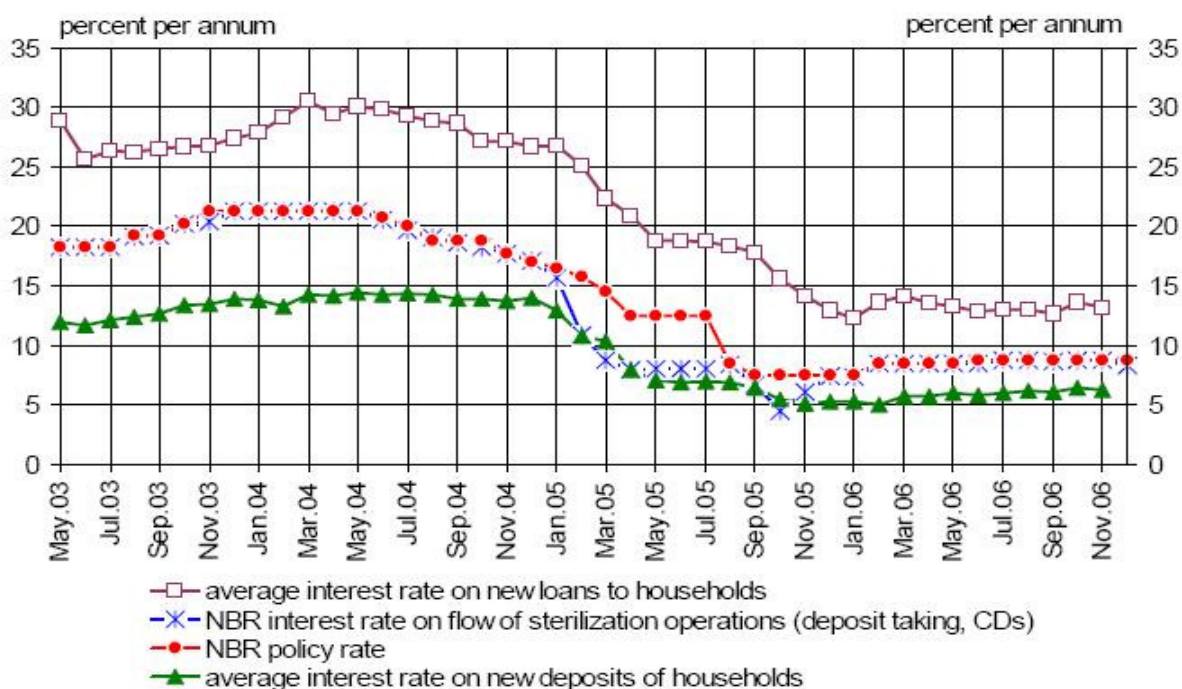
Looking to the future, the development of Romanian banking system has some predictable directions but there are also some directions that can not be predictable.

The following could be considered as predictable evolutions of Romanian banking system:

- **reduction cost of banking intermediation** – it is possible for the payment transfer, due to the introduction of Electronic Payment System, and for the household deposits because of implementing and functioning of Fund for Deposits Guarantee.
- **the measure regarding reserve requirements in national currency** – NRB used a lot the reserve requirements as instrument against inflation, but with big costs of 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 costs but also to avoid the dangerous mismatches between the savings made mostly in national currency and loans still required mainly in foreign currency. 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 the 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 (see Figure no. 7).



Source: NBR

Fig.7 Interest rate trends in Romanian banking system

In the category less predictable evolutions, it is writing down the number of banks from Romanian system 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 percent of existing banks detain less than 10 percent in total assets, therefore they should action in the way of increasing their market share or should proceed to fusions or get acquired. On the other hand, this fact does not mean

necessarily a decrease of banks number; it is possible also to appear specialised banks on the market.

There are also opinions according to the number of banks will not decrease, and the argument in this case is that the number of inhabitants as clients for one bank is still low. Either this argument is strong enough, the number of 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 a result of some complex processes, where interbank competition and the policy of the big players will have an important role. Big players of Romanian banking system will look for increasing their territorial network and incomes. It is obviously that in the future the quality of services will be more important than the number of banks.

5. The main aims of Romanian banking system after accession

Taking into account the importance of Romanian banking system, its future has to meet the conditions of efficiency and competitiveness in order to fulfil the basic functions which are:

- to mobilize and to reallocate the domestic savings to remunerative activities;
- to insure the transmission mechanism of monetary policy;
- to insure an optimum function of payment system.

In order to achieve these aims, it is necessary to start and finish in a short time the next processes:

- restructuring the bank portfolios – it is absolutely necessary a cleaning of credit portfolios;
- 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;
- banks privatization – it is the faster way to introduce changes regarding the banks behaviour and strategy. Thus, it is also assured the banks independence from government and public sector;
- consolidation of banking system – by creating strength and competitive banks at the national level (using actions such as fusions and acquisitions)

All the processes will have as result the reinforcement of competition, which will determinate: the increase of foreign banks number – they will assume more risks regarding the domestic clients; the expansion of loans portfolio; the expansion of bank service for households; 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:

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

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

The opinion imparted by almost all players on Romanian banking market is that our banking system is ready to implement Basel II. There is a relative delay in implementing Basel II in Romania, and the process engenders major challenges both for credit institutions (adjusting risk management and the IT systems, 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) Directives and adjustments 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 focussing 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 the subject to review. Furthermore, secondary legislation will be amended and supplemented to meet the requirements of Basel II.

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