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Romania: Financial Sector Stability Assessment

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Romania

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets Department and the European Department

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April 28, 2009

This report presents the conclusions of the Financial Sector Assessment Program (FSAP) Update mission that visited Romania from 3-14 November, 2008. The findings and recommendations were discussed with the authorities during the Staff Visit in January 2009.

The FSAP update team comprised Scott Roger (Co-Lead, IMF/MCM), Sophie Sirtaine (Co-Lead, World Bank), Tonny Lybek (IMF/EUR), Jochen Andritzky, and Abdullah Al-Hassan (IMF/MCM), Martin Melecky, Michel Noel, Tony Randle, and Heinz Rudolph (all World Bank), and Michael Ainley, Susan Quill, and Richard Pratt (expert consultants). The mission received excellent cooperation and support from the authorities.

The main findings of the FSAP update are that:

- In recent years, Romania's financial sector regulatory authorities have made significant progress in adopting international best practice, including through transposition of EU directives, as well as through implementation of many of the recommendations of the 2003 FSAP.
- The banking system dominates the financial sector and entered the crisis well capitalized and with high liquidity buffers. However, the rapid deterioration in economic conditions and the depreciation of the leu will put strains on bank capital positions. Stress testing analysis suggests that some banks may be at risk of becoming undercapitalized as the downturn continues. A strengthening of capital positions of some banks is warranted, and it will be important for parents of foreign-owned banks to maintain lines of credit to their subsidiaries and corporate borrowers in Romania.
- In the current circumstances, a number of measures to strengthen the crisis management and safety net framework are recommended. In particular, crisis management coordination should be intensified both with home supervisors of foreign banks and among domestic supervisors, bank restructuring powers strengthened, and deposit insurance funding and payout arrangements improved.
- A number of cross-sectoral themes emerge in considering improvements in Romania's supervisory frameworks. These include the need for better cross-sectoral cooperation in supervision, especially of financial groups; further movement toward a more risk-based approach to supervision; and adoption of IFRS accounting.

The main authors of this report are Scott Roger and Sophie Sirtaine with input from the other members of the FSAP update team.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud

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GLOSSARY

BCP	Basel Core Principles
BVB	Romanian Stock Exchange
CAR	Capital adequacy ratio
CASCO	Casualty and Collision insurance
CEBS	Committee of European Banking Supervisors
CEE	Central and Eastern Europe
CMO	Credit Mutual Organization
CNVM	National Securities Commission
CSA	Insurance Supervisory Commission
CSD	Central Securities Depository
DSG	Domestic Standing Group
ELA	Emergency lending arrangements
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LGD	Loss, given default
MEF	Ministry of Economy and Finance
MTPL	Motor third party liability
NBR	National Bank of Romania
NCFS	National Committee for Financial Stability
NPL	Non-performing loan
ONPCSB	Financial Intelligence Unit
OTC	Over the counter
PD	Primary dealer
PFMC	Pension fund management company
PPSSC	Private Pension System Supervisory Commission
RDGF	Romanian Deposit Guarantee Fund
MRR	Minimum Reserve Requirement
ReGIS	Romanian electronic Gross Interbank Settlement
RON	Romanian leu
ROSC	Report on standards and codes
SME	Small- and medium-sized enterprise
MoU	Memorandum of understanding
MMoU	Multilateral memorandum of understanding
PoD	Probability of default
LOLR	Lender of Last Resort
FX	Foreign exchange
AML/CFT	Anti money laundering/combating financing of terrorism
IASB	International Accounting Standards Board
CRD	Capital Requirements Directive
RAS	Romanian accounting standards
CRC	Romanian Clearing House
CCB	Bucharest Clearing House
CAFR	Chamber of Financial Auditors
CIS	Collective investment scheme
RTGS	Real Time Gross Settlement
SRO	Self-regulatory organization
FATF	Financial Action Task Force

EXECUTIVE SUMMARY[1]

Context of the FSAP update. The FSAP update has taken place in exceptional circumstances, putting a priority on immediate measures to bolster financial stability as opposed to less urgent, but nonetheless important issues in financial system development. The rapid deterioration in the macro-financial situation and outlook has also required a significant adaptation of the FSAP assessment, with the consequence that the overall assessment of the stability and resilience of the financial system is more somber than was reflected in the initial assessment in November. Priority recommendations are outlined below, and summarized in tabular form.

Financial stability assessment. The financial system is particularly vulnerable to the effects of further slowing or reversal of capital inflows and associated downward pressure on the exchange rate. A large part of the growth of the banking system in recent years has been funded from abroad. A sharp contraction or reversal of inflows could threaten macroeconomic and financial stability through a drying up of credit to the private sector, resulting in an even sharper slump in economic activity and larger increases in loan defaults. In addition, a reversal of capital inflows would put additional downward pressure on the exchange rate. With substantial unhedged foreign currency debts, the financial positions of households and companies would be adversely affected, accentuating the risk to macro-financial stability. Stress testing exercises suggest that, although most banks are fairly well placed in terms of capital positions and liquidity ratios to cope with the deterioration in economic and financial conditions to date, a further deterioration in conditions could lead to undercapitalization of some banks. Indeed, the fact that the economic outlook has deteriorated rapidly and, in some respects, even beyond the "hard landing" scenario used in the stress tests underscores the importance of action on the broad range of recommendations in this report.

In view of the vulnerability of the economy and financial system to external financial developments, measures to strengthen the resilience of banks and to maintain access to external finance should be given a high priority. Since nearly 90 percent of the banking system is foreign owned, close cooperation and coordination with the home authorities of foreign banks is essential. Although there is already a high level of cooperation, contacts and information sharing need to be intensified. Special efforts also need to be made to ensure that parent banks strengthen the capital positions of their Romanian subsidiaries, as well as maintain their lines of credit for lending purposes.[2] In addition, banks also need to be proactive in enhancing loan

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[1] The assessments and recommendations in this report are based primarily on the discussions and analysis surrounding the FSAP update mission in November 2008. The report also reports on numerous actions taken by the authorities to address issues raised during the FSAP update, as well as on stress tests undertaken in March-April 2009 in the context of the development of the IMF-supported program. The report does not take into account any developments or policy actions subsequent to the IMF Board discussion of the FSAP at the beginning of May 2009.

[2] The need to strengthen capital positions is reflected in the inclusion of stress test based assessment of additional capital needs of banks in the proposed Fund-supported program. The issue of maintaining lines of credit for

(continued)

quality by developing and implementing effective debt restructuring or workout procedures for household and corporate clients.

Crisis management and safety net. In the current environment, it is essential to ensure that crisis management systems and financial safety nets are strong and flexible enough to deal with potential problems rapidly and effectively, and that there is public confidence that this will be the case. There are important areas in which modifications or clarification of the current framework should be considered on a priority basis. In particular, cross-border bilateral and regional cooperation should be intensified; cross-sectoral cooperation on crisis management planning should be accelerated; the bank resolution framework should be reviewed, to strengthen the NBR's capacity to restructure troubled banks, and weaknesses in the deposit insurance framework should be remedied.

Overall regulatory framework. In recent years, Romania's four financial sector regulatory authorities have made significant progress in adopting international best practice, including through transposition of EU directives, as well as through implementation of many of the recommendations of the 2003 FSAP.[3] Looking forward, the growing importance of international, cross-sectoral financial groups highlights the need to complement strong home-host coordination arrangements with enhanced coordination and cooperation among the domestic financial sector authorities. Additionally, all supervisory authorities are encouraged to move towards a more risk-based approach to supervision. Finally, the appointment process for Board members of non-bank supervisory agencies should be reviewed, and in some cases modified, with a view to strengthening their credibility and autonomy.

Banking supervision. Virtually all of the weaknesses identified in the 2003 FSAP have been addressed, notably the introduction of consolidated supervision, and the supervisory framework has been strengthened by the transposition of the relevant EU directives into Romanian law associated with Romania's accession to the EU. Going forward, three principal challenges stand out. The first is the desirability of adopting a fully IFRS accounting system, consistent with international best practice. Second, the NBR and especially the banks need to continue their progress in implementing Basel II, but this will require augmenting resources and skills. Third, the NBR should continue to move toward an increasingly risk-based approach to regulation and supervision, recognizing that developing the necessary skills for effective implementation will take time and deliberate effort.

Romanian subsidiaries is being addressed on a multilateral basis with the accord reached in Vienna on March 26 with the top 9 foreign-owned banks active in Romania.

[3] Appendix II reports on implementation of the 2003 FSAP recommendations.

Capital market development. Despite its integration in the single market, Romania's securities market remains shallow. Development of the market is hampered *inter alia* by the absence of liquid government bond benchmarks. Also, deficiencies in market infrastructure, at the exchanges, OTC markets, and the CSD, limit market efficiency, international connectivity, and transparency. Finally, consistent valuation rules for market instruments should be adopted.

Insurance sector. As Romania moves to implement Solvency II, the CSA will need to strengthen its skills in order to move to a more risk-based approach to supervision. Also, the CSA should pay attention to potential fiscal risks under the Law on Obligatory House Insurance, where it is not clear that the premiums are adequate. It should also consider requiring additional capital in MTPL and CASCO classes unless premiums are adjusted. Finally, actuarial reviews of the guarantee and protection funds are needed.

Pension Sector. The authorities are to be commended for the major pension reform, but important challenges remain. First, measures should be taken to promote a longer-term focus of pension fund portfolio management. Second, pension funds should use identical asset prices, based on agreed methodologies and data. Third, the governance structure of PFMCs should ensure that their directors act in the best interests of contributors when transacting with other related entities.

The Romanian authorities have already begun to implement recommendations of the FSAP update. The NBR has been proactive in strengthening its stress testing capability and encouraging banks to strengthen their capital positions pre-emptively. In the crisis management area, the NBR has established a special unit to focus on crisis management issues, and has taken the lead in developing contingency plans and enhancing transparency and public communications. The RDGF has also made proposals for reforms in line with FSAP recommendations. More recently, in the context of negotiations of a Fund program, the authorities have also committed to implement other priority recommendations, including reforms to bank resolution and deposit guarantee arrangements, and adoption of IFRS accounting. The BNR has also been participating actively in the Vienna initiative to coordinate support of parent banks for Romanian subsidiaries.

Priority recommendations are summarized in the table below.[4] In the current circumstances, improvements in the crisis management and safety net framework should be regarded as urgent, and have been incorporated into the proposed Fund-supported program. Other recommendations are less time critical, but the crisis should not be seen as a reason for delay in implementing other reforms to the financial system. Indeed, progress in these other areas should improve Romania's ability to participate more fully and soundly in the economic recovery.

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[4] See Appendix I for a complete listing of recommendations

Priority Recommendations

Priority Recommendations	Timeframe
Crisis Management and Safety Net	
Seek strengthening of capital positions of some banks and set medium term targets for increasing minimum CARs	Immediate
Strengthen monitoring of bank loan portfolios and problem loan workout procedures and capacity	Immediate
Accelerate crisis management planning, communications, implementation of simulation exercises, and strengthen cross-border and cross-sectoral coordination of crisis management	Immediate
Consider additional measures to provide liquidity, especially under ELA	Immediate
Review bank resolution framework to facilitate rapid action and options for bank restructuring.	Immediate
Strengthen deposit insurance funding arrangements and speed up payouts	Immediate
Cross-Sectoral Issues	
Align the degree of independence and financial autonomy of the non-bank regulators with those of the NBR	Near term
Issue consistent valuation methodologies for financial assets	Near term
Strengthen information exchange and cooperation among regulators and the MEF	Near term
Expand resources of the FIU (ONPCSB)	Near term
Banking Sector	
Strengthen (i) judicial, accounting and auditing standards; and (ii) communication and consultation between NBR and regulated entities.	Near term
Securities and Capital Markets	
Concentrate primary issuance of government bonds on one or two maturity points until liquidity is enhanced	Near term
Revise contracts of primary dealers and establish PD rotation policy to provide incentive for market making	Near term
Amend the Law of Capital Markets to remove the limit on voting rights in regulated market operators	Near-term
Insurance and Pensions Sectors	
Review law on obligatory house insurance	Near term
Clarify interpretation of minimum contribution guarantee and weighted average return guarantee	Near term
Revise investment management fees	Near term
Establish unique valuation methodology and responsibility	Near term
Access to Financial Services	
Implement the recommendations of the ROSC on Accounting and Auditing	Near term

I. MACROECONOMIC ENVIRONMENT AND RISKS

A. Macroeconomic and Financial Developments[5]

1. **Romania's macroeconomic and financial outlook has deteriorated dramatically as its access to external sources of finance has become much more constrained and demand for its exports has plummeted.** The sharp slowing of capital inflows partly reflects a generalized increase in risk aversion toward emerging markets, together with contagion effects from the financial crises in several other European transition economies. Additionally, more specific concerns regarding the sustainability of Romania's large current account deficit, the outlook for fiscal and wage policies, and the health of foreign banks with subsidiaries or branches in Romania, all contributed to cuts in its international credit rating in late 2008 by an even larger margin than those of several other countries in the region.

2. **The deterioration in market confidence has led to recurrent bouts of downward pressure on the exchange rate, upward pressure on interest rates, and huge declines in equity values.** By end-March 2009, the leu had depreciated roughly 25 percent from its mid-2007 peak against the Euro, despite significant increases in domestic interest rates. Rises in interest rates partly reflected a rise in the NBR policy rate from 7 percent in September 2007 to 10.25 percent in August 2008, to counter inflation pressures.[6] Upward pressures on interest rates in the October-November period also reflected a combination of transient and structural factors. Transient factors included increased segmentation of the interbank market resulting from a loss of confidence among banks,[7] while structural factors included the banking system's shift to a net negative liquidity position vis-à-vis the NBR, together with a generalized increase in demand for liquidity in the face of uncertainties about the economic outlook. The worsened economic outlook, as well as withdrawals by foreign investors, has led to a nearly 80 percent decline in capitalization of the Bucharest stock exchange from its 2008 peak.

3. **The financial crisis is also now clearly reflected in a rapid weakening of economic activity.** Through much of the year, strong agricultural production led to upward revisions of growth estimates for 2008, but the final months of the year have seen rapid contractions in the construction, manufacturing, and service sectors, and record declines in surveys of consumer confidence and business prospects. Credit aggregates, which were growing extremely rapidly earlier in the year are now falling, while NPLs are increasing rapidly.[8] The sharpness of the

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[5] See also Appendix III, reporting selected macroeconomic and financial stability indicators.

[6] The NBR policy rate was cut to 10.0 percent in February 2009.

[7] Downward adjustments in interbank exposure limits may also have played a role.

[8] Since September 2008, credit growth to both the household and corporate sector has been falling. Lending in lei over the September-February period declined at an annualized rate of 4.4 percent (6.9 percent excluding overdue loans), while foreign currency lending has fallen at a rate of 10 percent (36 percent excluding overdue loans), after

(continued)

deterioration in macroeconomic conditions and prospects is also reflected in the substantial cuts in GDP growth forecasts for 2009.[9] In short, a soft-landing scenario for the Romanian economy now appears unlikely; the most likely prospect is closer to the hard-landing scenario envisaged in the stress testing exercise.

4. **The NBR has taken a number of important measures to manage developments**.[10] These have included both monetary policy measures and prudential measures. Romania's monetary policy is based on an inflation targeting framework. Inflation is currently running above the target rate, partly reflecting depreciation of the leu in late 2008. In these circumstances, the NBR has needed to maintain a firm policy stance, dampening downward pressure on the exchange rate, in order to ensure that inflation returns to the target range. Other measures have also been introduced to discourage unhedged foreign currency borrowing, especially by households, as well as to constrain household debt exposures, especially with regard to mortgage debt. In November 2008, as the financial crisis worsened and the liquidity position of the banking system shifted to a deficit, MRR on leu deposits was cut from 20 percent to 18 percent. More recently, MRR on foreign currency deposits with over 2 years residual maturity was reduced to zero. Although the NBR recognizes that high MRR is no longer needed to contain credit expansion, it also recognizes that a significant easing could lead to substantial capital outflows. Consequently, any easing of MRR is likely to be gradual. The NBR also acted to counter adverse spillover effects from the global crisis on domestic money market liquidity conditions and interbank interest rates. Romania also followed the EU lead in raising household deposit insurance coverage .

5. **Key risks to the macroeconomic and financial outlook include:**[11]

- **A further marked slowing of capital inflows**, including FDI and lending by foreign banks, would accentuate the slowing of growth and incomes, as well as further weaken the exchange rate and household and business financial positions, posing substantial risks to financial stability.

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adjusting for depreciation of the lei. NPLs (including loans classified as doubtful and loss, unadjusted for collateral) have increased from 4 percent of total loans at end 2007 to 5.3 percent in September 2008, and to 6.5 percent by end-2008.

[9] Between August 2008 (when the stress-testing scenarios for the FSAP Update were agreed) and October, just ahead of the mission visit to Bucharest, the average Consensus forecast for GDP growth in Romania in 2009 declined only modestly, from 5.2 percent to 4.5 percent. By January, 2009, however, the average growth forecast was cut to just 0.8 percent, and to -2.3 percent in April.

[10] Appendix IV provides a more detailed listing of measures.

[11] Appendix V elaborates on the key risks and implications for financial stability.

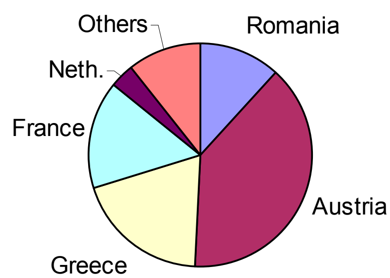
- **A severe and prolonged euro area recession** would intensify pressures on household and business incomes and financial positions, with adverse consequences for banks.

  Fiscal and wage policy slippages: market sentiment and creditworthiness assessments of Romania could react negatively if government does not act decisively to ensure that public sector spending and wage increases are consistent with fiscal and monetary objectives.

B. Financial Structure and Risks

6. **The Romanian financial system is dominated by foreign-owned commercial banks**.[12] Banks account for 83 percent of total assets of the financial system, and also own the largest share of leasing companies, which account for a further 7 percent of total assets. Of the 43 banks in Romania, 37 (including 10 branches) are foreign-owned, and accounted for 88 percent of total bank assets at end-2008. Austrian, Greek, French, and Italian banks dominate, with over 76 percent of total bank assets.

Shares of banks from different countries in total assets of the Romanian banking system, 2008



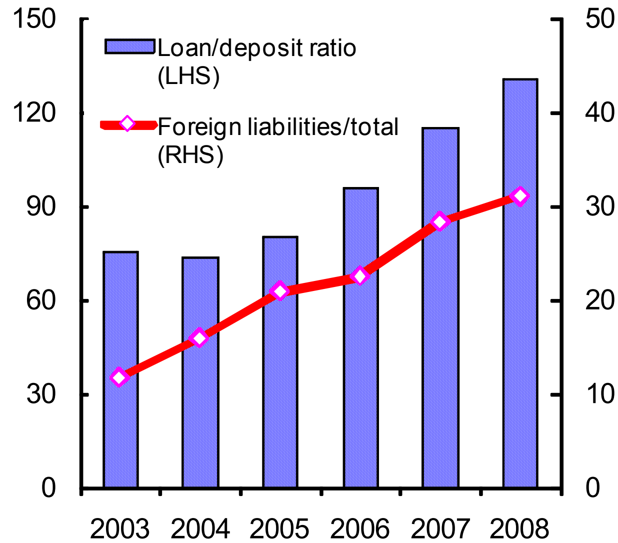
Source: NBR

7. **The banking system has grown rapidly, but is still fairly small relative to GDP.** Since 2003, private sector credit has grown at an average annual rate of 50 percent, rising from 15 percent of GDP to 39 percent by end-2008. Even so, the shares of bank credit and deposits in GDP are amongst the lowest in Europe.

[12] Appendix VI provides additional detail on the structure of the financial system.

8. **The expansion of bank lending has been increasingly dependent on foreign currency financing, largely from parent banks.** Lending growth in recent years has far outstripped local sources of funding so that banks have relied increasingly on external funding, primarily from parent banks. This is reflected in a sharp increase in the loan-to-deposit ratio to 131 percent by end-2008, as well as in an increase in foreign liabilities to 31 percent of total liabilities by end-2008. The substantial dependence of banking system on funding from foreign parents points to a key source of liquidity risk—a drying up of inflows from abroad in response to troubles at the level of the parent banks, or as a consequence of a rise in Romania's country risk profile, as demonstrated by Romania's downgrading by major international ratings agencies in late 2008.

Loan/deposit ratio and foreign liabilities/total liabilities (in percent)



Source: NBR

9. **The major source of risk to the banking system is through its indirect exposure to the foreign exchange risks faced by businesses and households.**[13] The direct exposure of banks to foreign exchange risk through their net open positions is low, as their foreign currency borrowings are almost entirely offset through foreign currency lending to households and non-financial firms. The share of lending to households and non-financial firms in foreign exchange (mainly euro) rose from 50 to 58 percent between 2005 and 2008, and the rise in share was particularly marked for household lending.[14] As a consequence, both household and corporate sector balance sheets face significant exposure to movements in the euro exchange rate and interest rates on euro loans.

10. **The vulnerability of banking system to exchange rate risk is greater than their own lending in foreign exchange suggests.** While the much higher reserve requirements on foreign currency deposits than on leu deposits have provided an incentive for local borrowing in lei, they have also led large firms in particular to borrow directly from abroad, and this is reflected in the

[13] Appendix VII elaborates on the financial vulnerabilities of the household and non-financial corporate sectors

[14] Over 2005-2008, the share of lending to households in foreign exchange rose from 44 to 59 percent, while the share of lending to non-financial firms in foreign exchange declined slightly, from 59 to 57 percent. The share of foreign currency lending declined from a high of 62 percent in mid-2006 as a result of NBR measures (see Appendix IV).

rapid increase in such borrowing, from the equivalent of 4 percent (on a net basis) of Romanian GDP in 2005 to nearly 11 percent in 2007. Consequently, the exposure of the corporate sector to currency risk is greater than their local borrowing suggests.[15]

II. Stability Assessment of the Banking System

11. **The Romanian banking system entered the crisis well capitalized and with high liquidity buffers, but deteriorating macroeconomic and financial market conditions now pose significant risks to financial stability.** The capital adequacy ratio[16] (CAR) for the entire banking system, at 13.8 percent at end-2008, was well above the 8 percent EU minimum requirement, and the Tier-1 capital ratio was just over 8 percent. Romania's high reserve requirements (18 percent on lei deposits and 40 percent on foreign currency deposits) also provide a substantial liquidity buffer.

12. **Nonetheless, stress tests suggest that a further deterioration in conditions could lead to undercapitalization of some banks.**[17] With the rapid deterioration in the economic outlook for Romania and other countries in Eastern Europe since late 2008, the stress tests in the FSAP update now look much less extreme than when they were conducted. Nonetheless, the broad lines of the central macroeconomic scenario remain valid: a sharp decli Modified: 2/18/10 depreciation of the leu, higher interest rates, and a marked fall in prope

13. **In the central macroeconomic scenario, as well as in single factor shock analysis, it is clear that credit deterioration is the key risk to the banking sector.**[18] In the central scenario, the stress test results suggest that the primary risk to banks is through a sharp rise in NPLs as weaker growth and exchange rate depreciation impairs the ability of households and businesses to service their debts, especially their foreign currency debt. In the central scenario NPL ratios increase by between 7 percent initially, and by up to 11 percentage points over the medium term,

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[15] To the extent that local banks guarantees for such loans, they would carry an off-balance sheet risk. Data on such exposures is limited, but Romanian banks do not appear to have significant exposure of this kind.

[16] Until 2007, CAR was defined as own funds (Tier 1 plus Tier 2 capital) relative to total risk-weighted balance sheet assets and off-balance sheet items, net of provisions. From January 2008, the CAR is defined as own funds relative to total capital requirements for credit risk, operational risk, and market risk.

[17] Appendix VIII describes the methodology and key results of the stress tests. The stress tests are applied only to banks, partly reflecting data limitations for other financial institutions, and partly because the financial system is so heavily dominated by banks. The stress tests were based on data up to end-June 2008, and therefore do not reflect subsequent developments in household or corporate financial positions, or in bank balance sheets and capital positions.

[18] It may be noted that the stress tests do not address a range of other possible shocks, such as a decline in equity values, or the separate effects of, say, a fall in property prices. This partly reflects the lesser importance of these kinds of shocks relative to exchange rate, interest rate, and GDP shocks,

of which roughly half is attributable to the impact of the depreciation of the leu, one third attributable to slower growth, and the rest reflects the decline in property prices.

14. **For banks at risk of falling below the minimum capital requirement, an increase in capital would be appropriate.** In the central scenario, the losses for all banks are estimated at € 2.1-2.6 billion, equivalent to 1.8-2.3 percent of GDP, and several banks would have CARs fall below the 8 percent minimum. To restore their CARs to their end-June 2008 levels, the capital of these banks would need to be increased by € 1.6 billion, equivalent to 1.4 percent of GDP.[19] By comparison with capital injections that have taken place in several other European countries, this is a relatively modest amount, largely reflecting the smaller size of the Romanian banking sector relative to GDP than in most European countries. In addition, the estimates do not take into account recapitalization needs of the smaller banks not included in the stress tests.

15. Updated stress tests have recently been conducted in conjunction with the NBR, using assumptions much closer to the current WEO projections.[20] The tests cover almost all banks, rather than the largest 14, and are largely based on end-2008 data. The analysis focuses on estimating bank-by-bank capital increases required under the program scenario. The results suggest a somewhat lower recapitalization estimate of around € 1 billion. The lower figure largely reflects the fact that in the updated scenario, recapitalization needs are based on maintaining CARs above 10 percent, whereas the FSAP analysis involved restoring CARs to pre-shock levels averaging 12.8 percent.[21] The fact that several banks received capital increases before end-2008 also reduces the additional capital needs.

16. **Increased capital buffers are recommended, together with a medium-term objective of raising CAR norms.** Ideally, this should occur through fresh capital injections in the form of Tier 1 capital. It is recognized that raising new capital, even from parent banks, is likely to be difficult in present circumstances. However, for several banks, significant increases in capital could be achieved simply by adding 2008 profits to capital rather than remitting to the parent as dividends.[22] Additionally, it would be helpful if the NBR could clearly signal to banks what level

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[19] These figures do not take into account subsequent capital increases by several banks. [19] Subsequent to the stress tests, several banks have strengthened their capital positions.

[20]In the updated scenario GDP growth in 2009-2010 is assumed to be substantially weaker than in the FSAP scenario. The adverse impact of this on NPLs, however, is significantly offset by the assumptions that the leu depreciates less over the period, and interest rates are also significantly lower (reflecting lower euro interest rates and the need to lower domestic interest rates as inflation pressures ease).

[21] If the FSAP analysis had used a 10 percent CAR, the estimated recapitalization need would have been around € 800 million for the 14 largest banks, Alternatively, if the updated scenario had been based on achieving CARs of at least 12.8 percent, then the recapitalization needs of the banking system would be around € 1 billion more that with a 10 percent minimum CAR.

[22] This is in fact being done; in April, several banks indicated that all profits would be retained in capital, while a few banks indicated that part of their profits would be paid out as dividends. Press reports suggest that the retained

(continued)

of CAR that it regards as a prudent medium-term objective. This should be well above the 8 percent minimum, and might need to vary across banks, depending on the character of their portfolios. To avoid having a procyclical increase in CAR, which could occur if banks raised CARs by cutting back lending, it would be important for the NBR to indicate that this is a medium-term objective. Moreover, the emphasis should be placed on increasing capital. It may be noted in this context that the stress testing exercise employed in the assessment of capital needs in the proposed Fund-supported program is based on maintaining bank CARs over 10 percent throughout the program, to be achieved through additions to capital if necessary.

17. **The stress tests also indicate that although most banks are fairly well placed to cope with the immediate impact of a liquidity shock, a sustained loss of credit lines could be much more damaging.** The high levels of required reserves, both in domestic currency and foreign exchange, provide an important cushion against financial outflows. What is less certain, and potentially much more damaging is the potential for more constrained access by foreign-owned banks to parent bank funds or limited rollovers of maturing external debts. A contraction of external funding of bank subsidiaries, as well as in direct lending to Romanian corporates by foreign banks would have two major effects. First, it would lead to a sharp contraction in lending by banks in Romania, which would accentuate the economic downturn, leading to a subsequent rise in NPLs and losses by the banks. Second, a reversal of capital inflows would accentuate downward pressure on the exchange rate, worsening the balance sheets of households and companies with unhedged foreign currency debts, again leading to a rise in NPLs and losses by the banks. To an important degree, these kinds of effects are already incorporated into the central scenario, but the stress tests are not readily able to isolate the specific effects of a slowing of foreign funding, partly for data reasons, but also because it is difficult to estimate the impact of a slowing of foreign funding on the macroeconomic variables that drive NPL projections. Nonetheless, it is clear that impact could be large, and that substantial efforts should be made to secure banks' external lines of credit. In this regard, the recent agreement in Vienna of the major foreign banks present in Romania to maintain the funding of their subsidiaries is an important development that will help to promote macro-financial stability.

18. **Banks should also step up measures to monitor and strengthen the quality of loan portfolios.** Recent initiatives to strengthen problem loan workout procedures and capacity are welcome, but need to be accelerated in recognition of the likelihood that many borrowers are likely to run into payment difficulties. In this regard, banks should take a proactive role in identifying potentially problematic loans, as well as establishing clear guidelines for restructuring loans and ensuring that they have the capacity to implement workouts expeditiously.

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profits would substantially cover recapitalization needs of most large banks. The NBR can request banks to raise capital, but it cannot compel them to retain profits as capital.

19. **Subsequent to the FSAP mission, some important steps have been taken to strengthen financial stability.** First, the NBR Supervision Department has advised several banks on the need to enhance their capital positions, which was reflected in a rise in the aggregate solvency ratio of the banking system from 11.8 percent in September 2008 to 13.8 percent at year-end. Second, the banks themselves have taken steps to establish debt workout units, develop loan refinancing policies, and identify and contact corporate clients to restructure potentially troubled loans.[23] Third, the NBR has also been an active participant in the initiative to coordinate support of foreign banks for their subsidiaries in Romania. In particular, as noted earlier, NBR has undertaken stress tests to assess the level of capital that each bank in Romania would need to maintain its CAR above 10 percent throughout the program period under alternative macroeconomic scenarios, centering on a Fund-supported program scenario.

III. Crisis Management and Safety Net Arrangements

20. **International financial developments underscore the need to have in place a comprehensive and flexible set of arrangements for responding rapidly to liquidity and solvency problems in the financial sector.** Major elements of a crisis management and safety net framework are in place, but urgent improvements are need in a number of areas in order to ensure the ability of the authorities to act quickly and effectively to contai financial crisis.

Modified: 2/18/10

A. Crisis Management, Cooperation, and Coordination

21. **A framework has been established to strengthen domestic coordination and contingency planning.** A National Committee for Financial Stability (NCFS) was established in 2007. Operationally, the Domestic Standing Group (DSG) coordinates activities of the four supervisory authorities and the MEF, and several working groups have since been set up.[24] A list of contacts has been prepared and is regularly updated and each authority is developing a contingency plan.

22. **In view of the increased risks to financial stability, development of crisis management procedures needs to be accelerated.** Priority recommendations include:

- **The DSG should establish regular monthly or quarterly meetings, and strengthen public communication.** More frequent meetings, with agendas planned well ahead will help to speed up progress in developing crisis management plans, to ensure close coordination, and to share pertinent information. A schedule of meetings could be

[23] Appropriately, the NBR has acted very cautiously in this area, recognizing the potential risk of undermining credit discipline and generating moral hazard.

[24] The NBR and MEF have also been also participants in the longer-standing crisis simulation exercises organized at the EU level by the Economic and Financial Committee of the Council.

published on members' websites, so as to divorce the timing of meetings from whatever may be happening in financial markets. The objectives and activities of the NCFS should be explained in broad terms, with a view to underpinning public confidence.

- **The MEF should take a more active role in crisis management planning**. In part this is because large amounts of public funds could potentially be involved in the resolution of a crisis. In this context, the MEF should rapidly strengthen its capacity to monitor and evaluate financial sector developments, possibly by establishing a Financial Sector Unit within the MEF with a clear responsibility for financial stability issues.

- **Crisis simulation exercises, involving all NCFS members, should begin as soon as possible.** Simulation exercises are extremely valuable as a means of identifying potential weaknesses in contingency plans, and allowing participants to gain familiarity with the procedures.

- **Cross-border coordination on crisis management should be intensified.** Formally, Romania engages in extensive cross-border cooperation through multilateral and bilateral MOUs, as well as through its participation in various EU bodies. Since almost any financial crisis in Romania would have international dimensions, close coordination with selected home country supervisors should be stepped up, including through joint crisis simulations. The NBR might also consult with other host authorities to major foreign banks to explore how they might collectively respond to difficulties at the parent bank or group level.

23. **The authorities have acted on FSAP update recommendations.** The recommendation to establish and publish a regular schedule of DSG meetings has been implemented, and coordinated communication measures have been taken to inform the media on the objectives and activities of the NCFS. The NBR has also established a dedicated crisis management unit to strengthen its commitment in this area.

B. Liquidity Support

24. **The NBR has taken a range of measures to enhance its monitoring and management of liquidity conditions**. These have been taken in response to the increase in volatility and uncertainty in the foreign exchange and domestic money markets, as well as the emergence of a net negative liquidity position in the banking system since October 2008. The NBR has stepped up monitoring of trading activity and banks' foreign currency debt payment schedules, and undertaken repo operations to provide short-term liquidity additional to overnight Lombard lending, and occasional bilateral swaps against euro.

25. **The NBR should consider additional measures strengthen its ability to provide liquidity, either in normal operations or in an emergency lending context.**[25] Measures should focus on broadening the range of its market operations and eligible collateral, while avoiding a dilution of the collateral framework or increasing moral hazard. Potential avenues include:

- **Broadening the range of eligible collateral for central bank lending.** In particular, obstacles should be eliminated to the use of high quality assets, such as RON-denominated bonds issued by International Financial Institutions (IFI), and Romanian government bonds denominated in foreign exchange. Only as a last resort should the NBR accept bank loans as collateral for lender of last resort (LOLR) loans, and even here, priority should be given to government guaranteed loans.

- **Extending the availability of the FX-collateralized swaps** that have been conducted recently by the NBR, even if recourse to such swaps were to be very limited and at costs appropriately spread against the Lombard rate.

- **Extending the tenor of repo operations.** With the illiquidity of the interbank market at all but very short maturities, the NBR should make greater use of its powers to conduct repo operations at a variety of maturity tenors.

26. **Emergency lending arrangements (ELA) should be reviewed and clarified.**[26] Current arrangements are vague. While it is important to allow considerable flexibility in implementation of ELA, the NBR should establish internal guidelines and a checklist covering, at least in broad terms:

- The supervisory regime that would be applied in conjunction with ELA (e.g., whether Special Supervision or Special Administration would be mandatory);

- Terms and conditions of such lending (the maturity of such loans, acceptable collateral and haircuts);

- Procedures for information sharing and coordination of liquidity provision arrangements with home authorities of parent banks as well as with the MEF and other domestic financial regulators;

- The conditions under which ELA would be terminated.

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[25] In general, the NBR is not legally restricted in the types of operations it may conduct, or the kinds of collateral it can accept. The key shaping policies are the risks associated with different operations, and the moral hazards or adverse selection that could be generated.

[26] ELA typically involves lending for longer periods than under normal lending arrangements and will also typically allow use of lower quality collateral than usual.

C. Banking Sector Intervention and Resolution

27. **In principle, Romania's framework for bank intervention allows for a graduated response to increasing stress in a bank.** In practice, however, there appears to be only very limited scope for action under the regime of "Special Administration." In particular the framework is not well geared to taking rapid and effective steps to restructure a problem bank in order to avert bankruptcy.

28. **A number of elements of the framework should be reviewed urgently**, and measures adopted, in order to: (i) ensure that actions to deal with problem banks can be taken in a timely manner; (ii) clarify and strengthen the NBR's powers, especially vis-à-vis bank shareholders; and (iii) expand the options in dealing with a failing bank. More specifically:

- **It may be appropriate to impose Special Administration at an earlier stage than under past practice.** Currently special administration may be triggered when a bank's own funds fall to under half the minimum level of total capital requirements; i.e. to about 4 percent.[27] To provide greater room for remedial action before reaching the insolvency threshold, imposition of the Special Administration regime should be considered at higher level of capitalization. Moreover, banks should be made clearly aware of such triggers in order to provide them with incentives for early action on their part.

- **In the lead up to possible imposition of special administration, relevant information should be shared within the NFSC.** NFSC should be given the opportunity to consider the potential implications for other regulatory authorities, as well as alternative resolution options prior to imposition of special administration. This may be particularly helpful in anticipating market and creditor actions in response to imposition which is required to be made public.

- **The authorities' powers to restructure or resolve a bank under administration may need to be strengthened.** In particular, consideration should be given to: (i) allowing only the NBR to submit bankruptcy petitions for banks;[28] (ii) strengthening or clarifying the special administrator's powers to write down bank capital without general shareholder approval; and (iii) limiting the scope for the Court of Appeal to return the bank to its owners and former administrators.

29. **In the context of the Fund program, the authorities have committed to strengthening their ability to intervene in troubled banks.** Proposed measures include: (i)

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[27] Own funds consist of capital for regulated and unregulated risks required in accordance with Basel Pillar I and II. It may be noted that the definition is close to, but not precisely the same as the Tier 1 capital ratio.

[28] Currently, creditors of an illiquid bank can submit a bankruptcy petition, which could complicate or pre-empt a resolution.

clarifying the NBR's authority to request shareholders to augment bank capital, and (ii) strengthening the powers of the Special Administrator to restructure or resolve a credit institution rapidly and effectively.

D. Deposit Insurance

30. **The Romanian Deposit Guarantee Fund (RDGF) meets EU minimum requirements, but several features of the Fund should be reviewed and modified**. The two most important areas of concern relate to the adequacy of RDGF resources and the speed with which payouts can be made:

- **RDGF resources should be increased.** At end-2007, RDGF resources, including its own funds based on member premiums, together with lines of credit from member banks would have been inadequate to cover the failure of any medium-sized or large bank. The increase in deposit coverage in October 2008, from € 20,000 to € 50,000 per depositor, will have worsened the situation. Realistically, an increase in funding will need to be through some form of public funding.

- **Measures should be taken to ensure faster pay outs.** Currently, pay outs have to be started within three months after liquidation has been initiated. The EU has suggested that countries begin to reimburse depositors much faster. Consideration needs to be given to the legal and practical challenges of doing so.

31. **Under the proposed Fund program, the authorities have committed to reforming deposit guarantee arrangements.** These commitments include adding a government line of credit to bolster RDGF funding, and shortening the payout period, in line with the main recommendations of the FSAP update in this area, as well as recommendations made by the RDGF to the NBR and MEF.

IV. Financial Sector Development, Regulation, and Supervision

A. Cross-Sectoral Issues

32. **A number of issues cut across the sectoral divisions between Romania's four financial sector authorities**, the NBR, the National Securities Commission (CNVM), the Insurance Supervisory Commission (CSA), and the Private Pension System Supervisory Commission (PPSSC). These issues include:

33. **The degree of independence and financial autonomy of the non-bank regulators should be more closely aligned with those of the NBR.** To this end, it is recommended that these authorities review their appointment procedures for Board members, ensuring appropriate qualification requirements and use of independent recruitment firms to identify suitable candidates. Current processes may not fully guarantee that members are free from political influence as recommended by international standards. Arrangements to ensure the financial autonomy of the non-bank regulators should also be reviewed.

34. **Cross-border cooperation in supervision.** The importance of financial groups, many foreign owned, makes good coordination between domestic supervisors, and between domestic and foreign supervisors critical to effective supervision. With regard to cross-border cooperation, beyond establishing MOUs, the NBR and CNVM participate in joint inspections and share information with their respective foreign counterparts. The CSA and PPSSC should set up similar arrangements.

35. **Cross-sectoral supervision.** Effective supervision of financial groups, including intra-group transactions, risk concentrations and capital allocations, supervisors need to strengthen coordination of their own activities through regular meetings, information sharing and joint inspections. This will become even more important in 2009 with the transposition of the EU Directive on the Acquisition and Increases in Holdings in the Financial Sector. The entry into force of the Directive may require that several large financial groups be defined as Financial Conglomerates, and be regulated and supervised on a collegiate basis under a coordinating regulatory agency.

36. **Risk-based supervision.** The NBR is moving towards risk-based supervision, assessing the risks faced by an institution and the policies in place to mitigate them. The CNVM has commenced to focus on risk but has yet to adopt a formal framework. The other agencies should also move to more risk based approaches.

37. **Simplification of the regulatory frameworks.** The proliferation of financial sector laws in recent years has resulted in some uncertainty for market participants. Wherever possible, regulatory agencies should simplify these laws and support them with guidelines outlining the key principles and regulators' expectations.

38. **Valuation rules.** Supervisors should aim to use consistent valuation rules. In some cases, illiquid markets makes mark to market valuation difficult, while the accrual method is inconsistent with fair value and may distort earnings over time. More liquid OTC prices should be used or where there is no active OTC market, mark to model methodologies, following CESR or IASB principles.

B. Banking Sector[29]

39. **The framework for banking supervision has been strengthened by the transposition of the relevant EU directives into Romanian law.** The NBR has extensive powers to ensure compliance with its regulations and ensure the prudential soundness of credit institutions. Virtually all of the weaknesses identified in the 2003 FSAP have been addressed, notably the introduction of consolidated supervision. The overall assessment of the Basel Core Principles (BCPs) is favorable. In particular, significant progress has been made in the area of home-host

[29] Appendix IX contains the ROSC on the observance of the BCPs.

cooperation through bilateral MOUs and a multilateral cooperation agreement with six other South-East European countries.

40. **Nonetheless, there are several areas where further improvements in the framework are recommended:**

- The banking industry should move towards full adoption of the IFRS framework in place of the existing Romanian accounting standards. The current dual system is inefficient and difficult for investors and outsiders to understand.[30]

- The approach to supervision of credit unions and credit mutual organizations (CMOs) is unusual compared with other EU countries. While the industry is small and not a source of systemic risk, its inclusion in a prudential framework, incorporating elements of government oversight, self-regulation by industry organizations, and higher regulatory requirements, merits consideration.

- The new EU directives need to be made operational. The main concerns include: (i) the effectiveness of the judicial system in enforcing legislation in a timely and impartial manner, as well as auditing and accounting standards; (ii) the effectiveness of cross-institutional cooperation; (iii) the quality and effectiveness of NBR communication, consultation and information sharing with the industry, including at senior levels; and (iv) the adequacy of the financial intelligence unit's (ONPCSB) resources to meet its mandate.

- Implementation of Basel II. The NBR has actively encouraged banks to make the necessary preparations and has assessed the level of readiness in onsite inspections. To move forward with effective implementation, banks will need to strengthen local resources and skills in these areas. The NBR will also need to strengthen further its capacity to assess the full impact of the planned changes on the domestic financial system.

- Moving further towards a more principles or risk-oriented system of supervision. While the NBR has moved somewhat in this direction, the present system is still heavily rules-based. On the other hand, the NBR has adopted a risk rating system, which helps to determine the frequency and scope of onsite inspections, and performs peer group analyses. The results of the peer group analysis are shared with credit institutions. Input from the industry indicates the current approach by the NBR is more useful than in the past. Inevitably, this change in culture will take time to become fully integrated.

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[30] A commitment to adopt IFRS is included in the proposed Fund arrangement, with the timing of implementation to be determined by the NBR.

Additionally, adoption of a more principles-based approach may also raise some legal issues for Romania, but these are unlikely to be insuperable.

C. Securities Markets and Intermediaries[31]

Capital market development

41. **Romania's securities markets remain shallow.** The equity market has a very small number of issuers, IPOs, instruments, low liquidity, and market capitalization has fallen by roughly three-quarters during the financial crisis. The fixed-income market is also small, with 50 bonds traded at the Bucharest Stock Exchange (BVB). Corporate issues are undiversified with only one by a non-financial corporation. Development of the market is hampered by the absence of liquid government bond benchmarks and deficiencies in market infrastructure. In the current circumstances, it is unrealistic to expect that measures to promote capital market development will yield quick results. Nonetheless, steps can be undertaken over the period ahead that should help facilitate economic recovery and help reduce the heavy reliance of the business sector in particular on bank-intermediated finance.

42. **Government efforts to establish liquid benchmark bond yields have had little success to date.** As a result no government bond yield curve can serve as a reference for the pricing of non-government securities. To promote liquidity, MEF should consider concentrating issuance on just one or two maturities and proceed with plans to revise primary dealer contracts to integrate clear market making performance.[32]

43. **A variety of measures should be considered, especially by the CSD, to improve market infrastructure, efficiency, international connectivity, and transparency, including by:** (i) CSD developing additional correspondent relationships with European clearing and settlement systems, subject to proper due diligence of the entities; (ii) extending to all participants and transactions the pilot settlement without pre-validation, lending and borrowing of shares, and omnibus accounts for brokers; (iii) CSD making arrangements for the settlement of OTC trades in non-government securities; (iv) increasing the transparency of trades in Romanian securities consistent with MiFID requirements; (v) developing an electronic trade reporting and information system, including reporting of government bond OTC trades within one minute; and (vi) a thorough review of the high issuance costs in the non-government securities market.

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[31] Appendix X contains the ROSC on observance of IOSCO principles.

[32] Clearly, limiting debt issuance to only a very few maturities would normally go against the principle of smoothing debt repayments. However, in current circumstances, very little debt can be marketed at anything but extremely short maturities. Consequently, concentrating issuance on very few maturities, including, say, a 6-month or 1-year maturity could improve on the existing situation.

44. **The development of a sound municipal bond market is undermined by moral hazard,** originating from perceptions of an implicit State guarantee on municipal debt resulting from the ex ante approval by MEF, and from a low risk weight for loans to unrated local governments in CAR calculation. Passage of the Law on Financial Crisis and Insolvency of Local Government Units could help to reduce the moral hazard problem.

Securities market regulation and supervision

45. **The CNVM is commended for embarking upon a radical revision to its regulatory regime**, designed to meet the EU *acquis* and achieving a high compliance with the IOSCO principles. The key challenges now are to strengthen independence, adopt a more risk-based supervision approach, step up domestic regulatory cooperation, and develop a more constructive dialogue with regulated entities.

46. **To improve investor protection, t**he CNVM should require intermediaries to make daily reconciliations of client accounts, keeping the records for inspection and audit; and redemptions and subscriptions to be based on the price struck on the transaction day.[33]

47. **CNVM inspection and investigations powers may be vulnerable to challenge.** Regulatory information gathering powers are necessarily intrusive, so that their scope, limits and purposes are normally spelt out precisely to ensure they are robust and safe from legal challenge. The current provisions of the Capital Markets Law do not define the nature or scope of an inspection, leave implicit certain requirements, such as their application to former license holders and the duty of an intermediary to co-operate, and could inadvertently lead to breaches of civil rights protections. Inspection and investigation powers should be reviewed to ensure they are comprehensive, specific and unambiguous, while safeguarding civil rights.

D. Insurance and Pensions Issues

48. **The insurance and pensions sectors are small, but growing in importance, and face important development challenges.** In both sectors, risk management, and appropriate pricing of assets and risks, are key issues.

Insurance

49. **The insurance regulator, CSA, is commended for improving technical skills within the CSA and the industry**. Nevertheless, the impending changes from implementing the Solvency II requirements will result in a transition to more risk based supervision. This will require more skills especially as the industry looks to CSA for guidance on implementation. The

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[33] As suggested by the European Fund and Asset Managers Association.

CSA should look to extend twinning arrangements with EU regulator prior to the introduction of the changes.

50. **Premiums should be reviewed in a number of areas.** The Obligatory House Insurance, coming into effect in 2010, is a sensible prefunding mechanism to reduce the burden on the government of catastrophes. However, premiums should be reviewed to ensure they are sufficient for effective reinsurance, and the potential liability of the government under the scheme should be estimated and disclosed. Similarly, for MTPL and CASCO classes of non-life insurance, the CSA should ensure that premiums are set relative to the risks and consider requiring additional capital from insurers who do not do so.

51. **The CSA should also review the adequacy of the guarantee and protection funds via regular independent actuarial reviews.** These funds add confidence to the market by ensuring policyholders are not adversely affected by an insurer's insolvency and add equity by ensuring adequate protection for persons involved with uninsured or unidentified policies.

Pension sectors

52. **The government and the pension regulator, PPSSC, are commended for establishing second pillar pensions, but the sector faces a number of challenges.** Second pillar legislation was passed in 2006, with enrolment finishing in early 2008. Today almost 3.5 million workers participate in the second pillar through 14 Pension Fund Management Companies (PFMCs), mostly belonging to banking or insurance groups.

53. **Steps should be taken to encourage development of pension fund portfolios appropriate to the long term nature of pension funds.** Measures should include: (i) PPSSC clarification that the Minimum Contribution Guarantee applies only at the time of retirement (not whenever a contributor transfers to another fund), and that any shortfall between the payout and the net contributions is to be met from the Guarantee Fund; (ii) reducing uncertainty about the Weighted-Average Return Guarantee, and promote competition, partly by limiting the weight of any one fund to no more than 20 percent in calculation of the Weighted Average Return; and (iii) encouraging asset class diversification by promoting a structure investment fees that ensures that PFMCs are entitled to be reimbursed from the fund for any arms length investment fees incurred.

54. **The investment portfolios of pension funds contain assets difficult to value because there is no active market to determine a fair value.** In addition to bringing valuation rules into line with internationally-recommended fair value methodologies, the PPSSC should issue new valuation rules based on fair value, and require custodians to agree collectively on methodologies and data sources for each instrument so as to provide consistency in the calculation of unit prices.

55. **Fees and contribution rates may also need to be reviewed.** Current fees are well below those in other EU New Members States with DC systems, only PFMCs with large scale will be profitable), and planned increases in contribution rates should go ahead. In addition, inflation

guarantees on pension funds should not be introduced before the domestic capital market provides instruments to hedge against inflation risk.

56. **The majority of PFMCs are part of a large banking or insurance group offering a diverse range of financial services.** This could lead to situations where the directors and management of the PFMC are acting in the best interests of the shareholders of the group rather than those of contributors. The governance structure of PFMCs should ensure that at all times directors of PFMCs act in the best interests of contributors when transacting with other members of the group.

E. Access to Financial Services

57. **Access to financial services has increased in recent years, but substantial parts of the population remains excluded.** Ratios of private sector credit and deposits to GDP, of 39 percent and 30 percent, respectively, at end-2008, are still among the lowest in the EU, and only 27 percent of the population has a bank account and 35 percent a payment card. Government credit guarantee schemes, in particular for rural and SME lending, are playing a key role in enabling financial institutions to penetrate these markets.

58. **Further strengthening of the financial infrastructure would help increase access to borrowing and savings services, as well as enhance the assessment of credit quality by lenders.** The credit bureaus and pledge registry have been improved in recent years; these reforms should be accompanied by an expansion of the coverage of the trade registry to smaller companies and an acceleration of the reform of the real estate registry. In addition, the recommendations of the ROSC on Accounting and Auditing should be implemented to facilitate the assessment of corporate credit risk. In the medium term, the possibility to connect various databases of information used by credit institutions should be explored.

F. Anti-money Laundering and Combating the Financing of Terrorism

59. A detailed assessment of the anti-money laundering (AML) and combating the financing of terrorism (CFT) framework of Romania was conducted in May 2007 and finalized in July 2008 by the Committee of Experts of the evaluation of AML measures and the FT (MONEYVAL).[34] The assessment was undertaken on the basis of the Financial Action Task Force (FATF) 40+9 Recommendations using the 2004 Methodology. A discussion of findings is reported in Appendix XI, and a separate ROSC will be provided to the Board. As noted earlier, however, the BCP assessment concluded that the ONPCSB, the agency primarily responsible for AML/CFT surveillance, is under-resourced.

[34] MONEYVAL is the FATF-style regional body of which Romania is a member.

APPENDIX I. MAIN RECOMMENDATIONS

Recommendations labeled "immediate" envisage action within the next 6 months to 1 year. Near term recommendations envisage action within the next 1-1½ years, and medium term recommendations envisage action within 1½ to 3 years.

Table 1. Main Recommendations

	Timeframe
Crisis Management and Safety Net	
Seek strengthening of capital positions of some banks and set medium term targets for increasing minimum CARs	Immediate
Strengthen NBR monitoring of bank loan portfolios and problem loan workout procedures and capacity	Immediate
Accelerate crisis management planning, communications, implementation of simulation exercises, and strengthen cross-border and cross-sectoral coordination of crisis management	Immediate
Consider additional measures to provide liquidity, especially under ELA	Immediate
Review bank resolution framework to facilitate rapid action and options for bank restructuring	Immediate
Strengthen deposit insurance funding arrangements and speed up payouts	Immediate
Cross-Sectoral Issues	
Align the degree of independence and financial autonomy of the non bank regulators with those of the NBR	Near term
Strengthen information exchange and cooperation among regulators and the MEF	Near term
Issue consistent valuation methodologies for financial assets	Near term
Expand resources of the FIU (ONPCSB)	Near term
Pursue efforts towards risk based supervision and increase communication with market participants	Medium term
Banking Sector	
Strengthen (i) judicial, accounting and auditing standards; and (ii) communication and consultation between NBR and regulated entities.	Near term
Continue efforts towards implementation of principles-based supervision	Medium term
Fully implement IFRS	Medium term
Develop an effective system for the supervision and regulation of credit unions and CMOs	Medium term
Supplement staff resources in order to complete the implementation of Basel II	Medium term
Securities and Capital Markets	
Concentrate primary issuance of government bonds on one or two maturity points until liquidity is enhanced	Near term
Amend the Law of Capital Markets to remove the limit on voting rights in regulated market operators	Near term
Revise contracts of primary dealers and establish PD rotation policy to provide incentive for market making	Near/medium term
Encourage the Central Depository to open a correspondent relationship with Euroclear	Near/medium term
Remove all regulatory barriers preventing OTC trading of non-government securities	Near/medium term

Establish trade reporting system for government bonds, and issue regulation requiring reporting of OTC trades in system at T+1 minute	Near/Medium term
Reduce securities registration fees to a flat nominal fee comparable to other EU Member States and streamline registration procedures as on the EU single market	Near/Medium term
MEF should be ready to step in as ultimate market maker through buy-backs and re-issuance of issues	Medium term
Work with CESR to enforce reporting of OTC trading by investment firms in other EU Member States to CNVM	Medium term
Gradually replace ex-ante approval of local government borrowings by ex post control under budget monitoring process	Medium term
Raise base risk weight ratio for unrated local government loans from 50% to 100%	Medium term
Make removal of mayor of county council mandatory in case of local government bankruptcy	Medium term
Allow settlement without prevalidation, lending and borrowing of shares, and omnibus accounts for brokers in connection with establishment of central counterparty	Medium term
Insurance Sector	
Review law on Obligatory House insurance	Near/Medium term
Conduct actuarial review of guarantee and protection funds	Near/Medium term
Review MTPL and CASCO premiums and reserves	Near/Medium term
Continue twinning programs with other EU insurance regulators	Medium term
Pensions Sector	
Clarify interpretation of minimum contribution guarantee and weighted average return guarantee	Near term
Revise investment management fees	Near term
Establish unique valuation methodology and responsibility	Near term
Review current fee levels	Near/Medium term
Harmonize deferral rules for marketing expenses	Near/Medium term
Require PFMCs to maintain their minimum capital throughout their operations	Near/Medium term
Review corporate governance on PFMCs belonging to groups	Medium term
Keep up with promised contribution rate increases of 0.5 percent per annum	Medium term
Do not introduce inflation guarantees before the domestic capital market provides instruments to hedge against inflation risk.	Medium term
Develop annuities products to pay at retirement	Medium term
Consider allowing multi-funds and the outsourcing of asset management	Medium term
Review exit mechanisms for PFMCs	Medium term
Access to Financial Services	
Implement the recommendations of the ROSC on Accounting and Auditing	Near term
Expand the coverage of the trade registry	Medium term
Accelerate implementation of the real estate registry reform	Medium term
Consider inter-connecting the various data bases with debtor information	Medium term

APPENDIX II. IMPLEMENTATION OF THE 2003 FSAP RECOMMENDATIONS

The 2003 FSAP found the Romanian banking system to be well-capitalized, liquid, and generally well-supervised, but that rapid credit growth could overstretch banks' credit and risk management skills. The FSSA also recommended strengthening consolidated supervision as well as market and country risk management. Capital markets and insurance were found to be vulnerable but their small size posed little systemic risk. In 2003 the pension sector was judged to be unsustainable and, consequently, a fiscal risk. The FSAP also noted that financial legislation and regulation were being strengthened in line with EU accession requirements, but also emphasized the need to enhance transparency, accounting standards, and enforcement of regulations and laws.

Table 2. Implementation of 2003 FSAP Recommendations

FSSA Recommendations	Implementation
General	
Continue to privatize state-owned/controlled firms and banks	Privatization largely complete, with no large institutions still publicly owned.
Continue preparations to ensure the smooth introduction of the new electronic ReGIS payment and settlement system in 2004 through good public and market information and rigorous testing, and the development of an appropriate legal framework	Implemented
Further improve financial sector laws, their enforcement, and judicial system effectiveness focusing on governance issues, and through sufficient resources and training for investigative and judicial bodies.	Substantial progress on legal, regulatory, and supervisory reforms, especially in transposing EU directives. Laws and regulations remain complex and poorly consolidated and difficult for the industry to interpret. Little progress on judicial system effectiveness.
Continue with rapid implementation of international accounting standards, and providing training for bank supervisors and the accounting and auditing professions	Some progress, but remains a challenge. Corporate law still to require that all public-interest entities, including non-group listed companies and pension funds, use IFRS. Strengthening of supervision by CSA and CNVM still needed for insurance companies and listed companies respectively. The CNVM's initiative to strengthen legislation by extending the IFRS obligation to all companies preparing accounts should be pursued.
Banking	
Expand the availability of credit information to improve credit assessment by banks	Credit bureau established and coverage expanded. Phases I and II completed; phase III (scoring individuals) is underway for 2009. Pledge registry moved to electronic platform. Strengthening of real estate registry to be accelerated.
Develop an effective system for oversight of credit cooperatives and credit unions and CMOs	Credit cooperatives have been brought under the supervision of the NBR since 2002. Credit unions and CMOs remain

Table 2. Implementation of 2003 FSAP Recommendations

FSSA Recommendations	Implementation
	unregulated and unsupervised.
Capital markets	
Strengthen disclosure, transparency, and integrity of capital markets by strengthening and using the enforcement powers of the Securities Commission	Substantial progress on legal, regulatory, supervisory reforms; substantial enforcement effort in terms of sanctions applied.
In particular, enforce listing requirements and de-list inactive companies on stock exchanges	Listing requirements enforced with greater vigor but compliance with accounting rules remains patchy. Ongoing legal dispute between BVB and CNVM about listings.
Improve the transparency and disclosure of the Financial Investment Funds	Regulation 15/2004 imposes transparency and disclosure obligations in line with EU requirements.
Insurance	
Continue to strengthen the capacity of the Insurance Supervisory Commission	Significant progress achieved through staff training. Further progress still needed especially with regard to analysis of risks.

APPENDIX III. SELECTED MACROECONOMIC AND FINANCIAL SOUNDNESS INDICATORS

Table 3. Romania—Selected Macroeconomic Indicators

	2005	2006	2007	2008	2009 Proj.
Output and prices			(Annual percentage change)		
Real GDP	4.1	7.9	6.2	7.1	-4.1
Consumer price index (CPI, end of period)	8.6	4.9	6.6	6.3	4.5
Unemployment rate	5.8	5.4	4.3	4.0	8.9
Nominal wages	17.0	18.9	22.6	23.6	5.9
Saving and Investment			(In percent of GDP)		
Gross domestic investment	23.3	26.5	31.1	31.4	30.8
Gross national savings	14.7	16.1	17.6	19.1	23.2
General government finances					
Revenue	31.4	32.3	32.5	32.6	33.0
Expenditure	32.1	33.7	35.6	37.5	37.5
Fiscal balance	-0.7	-1.4	-3.1	-4.9	-4.6
Gross public debt (direct debt only)	15.6	15.4	17.5	20.1	23.6
Money and credit			(Annual percentage change)		
Broad money (M3)	36.5	28.1	33.7	17.6	6.6
Credit to private sector	45.8	54.5	60.4	33.7	15.9
Interest rates, eop			(In percent)		
Euribor, six-months	2.79	3.23	4.79	3.52	-
NBR policy rate	7.50	8.75	7.50	10.25	-
NBR lending rate (Lombard)	14.00	14.00	12.00	14.25	-
Interbank offer rate (1 week)	7.00	7.42	7.81	13.90	-
Balance of payments			(In percent of GDP)		
Current account balance	-8.6	-10.4	-13.5	-12.3	-7.5
Merchandise trade balance	-9.8	-12.0	-14.4	-13.4	-7.5
Capital and financial account balance	8.1	9.7	14.0	13.4	-2.4
Foreign direct investment balance	6.6	8.9	5.7	6.8	3.1
International investment position	-29.0	-37.7	-43.7	-51.7	-56.8
Gross official reserves	22.9	23.5	22.0	20.7	23.4
Gross external debt	38.8	42.1	47.3	53.4	64.2
Exchange rates					
Lei per euro (end of period)	3.7	3.4	3.6	4.0	-
Lei per euro (average)	3.6	3.5	3.3	3.7	-
Real effective exchange rate					
CPI based (depreciation -)	17.9	7.6	9.0	-4.2	-10.3
Memorandum Items:					
Nominal GDP (in bn RON)	289.0	344.7	412.8	504.0	531.3
Nominal GDP (in bn euros)	79.7	97.8	123.6	136.8	119.7

Sources: Romanian authorities; Fund staff estimates and projections; and World Development Indicators database.

Table 4. Romania—Selected Financial Soundness Indicators

	2004	2005	2006	2007	2008			2008
					March	June	September	
	(in percent, unless otherwise indicated)							
Capital buffers:								
Capital adequacy ratio 1/	20.6	21.1	18.1	13.8	13.0	12.8	11.9	12.3
Own capital ratio 1/	8.9	9.2	8.6	7.3	7.2	7.3	7.1	7.0
Credit risk:								
Assets, in percent of GDP	37.1	45.2	50.9	63.1	63.7	64.5	65.2	66.2
Domestic credit, in percent of GDP	17.8	21.9	27.8	38.2	40.3	41.5	42.9	42.7
Private sector credit, in percent of GDP	16.6	20.8	26.8	35.9	37.9	39.1	40.5	39.3
Credit to households, in percent of GDP	4.8	7.4	11.4	17.3	18.4	19.1	20.0	19.7
Lending for real estate purchase, in percent of GDP 2/ 3/	1.9	2.7	3.9	3.2	3.8	4.1	4.5	4.1
Medium and long term credits, in percent of non-gov. credit	58.4	63.9	68.4	76.0	76.1	76.1	76.2	76.9
Non-performing loans, in percent of loans 4/	8.1	8.3	8.0	9.7	*9.8*	*10.3*	*11.1*	13.8
Specific provisions, in percent of non-performing loans 4/	16.1	14.4	18.2	25.7	27.9	27.8	29.0	28.7
Off-balance activities, in percent of assets	14.8	15.0	17.1	16.6	16.5	15.6	16.1	16.5
Foreign exchange risk:								
Net open position in foreign exchange, in percent of capital	-2.0	-0.6	0.6	0.3	-0.6	1.6	0.0	0.0
Lending in foreign exchange, in percent of non-gov. credit	61.8	54.7	47.3	54.3	55.0	55.1	56.1	57.8
Foreign currency liabilities, in percent of total liabilities 5/	46.8	44.3	44.1	42.5	39.9	38.3	38.8	38.8
Deposits in foreign exchange, in percent of non-gov. dom. deposits	41.2	34.6	32.3	32.1	33.3	34.1	34.4	34.8
Liquidity risk:								
Liquidity ratio 6/	2.3	2.6	2.3	2.1	2.3	2.3	2.5	2.6
Liquid assets, in percent of total assets 5/	63.6	61.8	54.4	48.3	47.2	0.0	44.3	44.3
Liquid assets, in percent of short term liabilities 5/	193.9	245.7	207.2	171.7	188.5	181.5	190.4	190.4
Loan to deposit ratio, in percent 7/	72.1	80.0	95.8	114.8	123.3	126.6	133.5	130.8
Net foreign assets of credit institutions, in percent of GDP 5/	-2.1	-6.8	-9.8	-16.3	-17.0	-17.6	-18.5	-19.3
Profitability and concentration:								
Return on average assets	2.5	1.9	1.7	1.3	1.5	1.4	1.8	1.7
Return on average equity	19.3	15.4	13.6	11.5	16.5	15.8	19.4	18.1
Market share (assets) of five largest banks	59.2	58.8	60.3	56.3	57.1	59.2	...	54.4
Memorandum items:								
Stock market capitalization, in percent of GDP 8/	17.1	22.3	24.4	26.7	31.4	28.0	21.2	11.3

Sources: National Bank of Romania, Romanian National Institute of Statistics, and Fund staff estimates.

Note: On January 1, 2007, the NBR introduced the ESCB's statistical methodology. Only some time series have been recalculated back to December 2004.

1/ The NBR amended the capital adequacy requirements effective January 1, 2007 to be consistent with EU minimum requirements and Basel II. The former 12 percent capital adequacy ratio and 8 percent Tier I ratio were substituted by a new 8 percent solvency ratio.
2/ Refers to loans and commitments to a single debtor above RON 20,000 according to the Central Credit Register, which covers about 82 percent of total loans and commitments granted.
3/ During 2007, the share of credit to households for house purchase has remained relatively constant around 19–20 percent.
4/ Non-performing loans reflect unadjusted exposure to non-performing loans classified as "loss", "doubtful", and "substandard", according to the NBR's loan classification regulations, as percent of total loans using the balance sheet approach, which may differ from the data published in the NBR's Monthly Bulletin.
5/ 2008 data as of September.
6/ Effective liquidity over required liquidity, the mandatory ratio is thus one.
7/ Loan-to-deposit ratio of domestic credit to resident deposits, including government.
8/ Covers the regulated market at Bucharest Stock Exchange, including SIFs, and RASDAQ. Derivatives, traded at SIBEX, are excluded.

APPENDIX IV. NBR MEASURES TO CONTAIN CREDIT EXPANSION AND CREDIT RISKS

Table 5. Measures to Contain Credit Expansion and Credit Risks

Reserve requirements

- March 2009: Minimum reserve requirement on FX-denominated liabilities, with remaining maturity over 2 years, is reduced to zero, effective May 2009.
- November 2008: Minimum reserve requirement on RON-denominated liabilities, with maturities less than 2 years, is lowered from 20 to 18 percent.
- July 2006: Minimum reserve requirement on RON-denominated liabilities, with maturities less than 2 years, is raised from 16 to 20 percent.
- March 2006: Minimum reserve requirement on FX liabilities of banks increased from 35 to 40 percent.
- January 2006: Minimum reserve requirement on FX liabilities of banks increased from 30 to 35 percent.
- August 2005: Reserve requirement on FX liabilities of 30 percent is extended to all foreign currency denominated liabilities, regardless of their maturity or contract date.
- August 2005: Minimum reserve requirement on RON-denominated liabilities, with maturities less than 2 years, is lowered from 18 to 16 percent.
- August 2004: Minimum reserve requirement on FX liabilities of banks increased from 25 to 30 percent.

Other administrative and prudential measures

- September 2008: Debt-service restrictions on lending to households amended to: (i) require creditors using their own debt service ratio limits to take into consideration the interest rate risk and exchange rate risk when establishing the maximum level of indebtedness for each client category; and (ii) lower to 35 percent (from 40) the ceiling used by the banks not submitting internal rules for NBR validation.
- February 2008: Provisioning requirements for FX credits extended to unhedged borrowers and broadened to include non-bank financial institutions.
- March 2007: Debt-service restrictions on lending to households (introduced in August 2005) modified to allow creditors to draw up specific internal rules on lending to individuals, with limits subject to NBR approval.
- September 2005: A limit of 300 percent of own funds placed on FX lending by credit institutions to unhedged borrowers. Limit lifted in January 2007.
- August 2005: Regulations on limits to household-lending are tightened. The new regulations set a monthly debt-service ceiling of 40 percent of the net monthly income of the borrower, and cover the sum of all commitments (e.g., mortgage, real-estate and consumer loans). Moreover, the monthly debt service ceilings for consumer and real-estate credits are limited to 30 and 35 percent of monthly net income, respectively. Loan to value ratio for real estate investments limited to 75 percent, and collateral requirement set at 133 percent of loan value..
- February 2004: prudential regulations aimed at slowing down consumer credit growth (debt service ceiling of 30 percent of the borrower's net income, down payment, guarantees, etc.) and of mortgage credit (credit amount: 75 percent of the value of the building; guarantees: 133 percent of the credit amount; debt service ceiling of 35 percent of the net income of the borrower and his/her family).

Source: NBR

APPENDIX V. FINANCIAL STABILITY DIAGNOSTIC AND ASSESSMENT MATRIX

Table 6. Romania—Risk Assessment Matrix

Nature/Source of main threats	**Overall level of concern**	
	Likelihood of severe realization of threat in the next 1-3 years	**Expected impact on financial stability if threat is realized**
1. Sharp contraction of capital inflows	***High*** • Large current account deficit was seen as a potential trigger for a "sudden stop" in capital inflows even prior to eruption of financial turmoil in major financial markets. • SEE region is already experiencing a significant increase in risk premia, and downward pressure on exchange rates. • Liquidity problems of lenders in advanced economies could lead to efforts to liquidate assets in Romania, including loans to bank subsidiaries and direct loans to corporations in Romania. • Corporations in major European economies could also cut funding and FDI inflows to subsidiaries in Romania (e.g. in the construction sector).	***Severe*** • Banks are heavily dependent on external sources of liquidity; a significant contraction in sources of funds would lead to an immediate credit crunch in Romania • If parent banks are unable or unwilling to provide capital to Romanian subsidiaries, this would also accentuate a credit crunch and the risk of failure of some banks, • Weaknesses in the legal environment, and competition for market share resulting in lower standards of scrutiny in lending probably mean that much bank lending has high probabilities of default, so that a deterioration in economic circumstances would lead to a sharp rise in NPLs • Weaknesses in the bank resolution framework could make it difficult to restructure a failing bank, increasing the cost of failure, and undermining confidence in the financial system more broadly. • A sharp weakening of the Leu would almost certainly occur, with significant adverse consequences for household and business balance sheets, leading to a substantial increase in NPLs • Anecdotal information suggests that the property market (mainly Bucharest) has already weakened, with prices down around 30 percent. A sharp contraction in capital inflows could lead to a major slump, and a substantial rise in bankruptcies and unemployment in the construction sector, with adverse consequences for NPLs.
2. Severe recession in major European economies	***High*** • Projections for EU growth have already been revised downward, but there is a possibility that the downturn could be deeper and more protracted than currently expected • Expectations of lower external demand could raise further doubts as to the sustainability of Romania's current account deficit.	***Moderate*** • Exporters dependent on European markets would be adversely affected • FDI inflows to Romania would also probably be adversely affected as investment projects were delayed or cancelled • Remittance income from Romanian guest workers would decrease as Euro area unemployment rose • These effects would contribute to higher unemployment and weaker business profitability, raising both household and corporate NPLs • Adverse macroeconomic effects could be mitigated to some extent by countercyclical monetary & fiscal policy, as well as by terms of trade improvements owing to lower commodity import prices (notably oil prices).
3. Damaging domestic fiscal and wage policies	***Moderate*** • Fiscal authorities are under constant political pressure to run expansionary spending policies • Successive governments have also agreed	***Severe*** • Profligate fiscal and wage policies could undermine investor confidence in Romania, driving up the country risk premium and putting downward pressure on the currency. The economic and financial effects would be similar to a sharp contraction in capital inflows

Table 6. Romania—Risk Assessment Matrix

Nature/Source of main threats	**Overall level of concern**	
	Likelihood of severe realization of threat in the next 1-3 years	**Expected impact on financial stability if threat is realized**
	to wage increases far in excess of the inflation target or productivity gains • Post EU-accession reform fatigue and election politics offer a fertile ground for damaging domestic policies.	

APPENDIX VI. STRUCTURE OF THE FINANCIAL SYSTEM

Table 7. Romania-Structure of the Financial System

(in percent of GDP)

Financial intermediaries	**2003**	**2004**	**2005**	**2006**	**2007**
Credit institutions[1]	30.8	36.6	44.6	50.6	61.5
Insurance companies[2]	1.8	1.9	2.2	2.5	3
Investment funds[3]	0.1	0.2	0.2	0.3	0.3
Financial investment companies[4]	1.4	1.3	1.8	2.3	2.8
Leasing companies[5]	1.8	3	3.6	3.4	5
Other non-bank financial institutions[6]	0.4	0.6	0.9	1.3	1.5
Total	**36.3**	**43.6**	**53.3**	**60.4**	**74.1**
Memo items					
BIS reporting area net lending to non-banks	1.8	2.7	4.1	6.7	10.7

Source: NBR, NSC, ISC, BLS, NIS.
1) Net assets of credit institutions, including CREDITCOOP; 2) Estimated total assets; 3) Assets of investment funds; 4) Net assets of financial investment companies (SIFs); 5) Financed net assets; 6) Total assets related to consumer credit companies, to entities engaged in issuing guarantees and assuming commitments, to microfinance companies, and to companies carrying out multi-credit activities.

Table 8. Structural indicators of the Romanian banking system

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Number of credit institutions*	41	41	41	39	39	40	40	39	42
Number of banks with majority private capital	37	37	38	36	36	38	38	37	40
Number of banks with majority foreign capital, of which:	26	29	32	32	29	30	30	33	36
*branches of foreign banks	7	8	8	8	8	7	6	7	10
Assets of banks with majority private capital/Total assets (%)	53.2	53.9	58.2	59.6	62.5	93.1	94.0	94.5	94.5
Assets of banks with majority foreign capital/Total assets (%)	47.5	50.9	55.2	56.4	58.2	62.1	62.2	88.6	87.8
Assets of top five banks/Total assets (%)	66.7	65.5	66.1	62.8	63.9	59.2	58.8	60.3	56.3

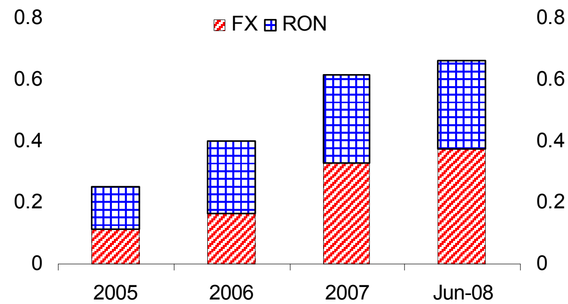
Source: NBR
* Including CREDITCOOP

APPENDIX VII. HOUSEHOLD AND NON-FINANCIAL CORPORATE FINANCIAL EXPOSURES

Financial Exposure of the Household Sector

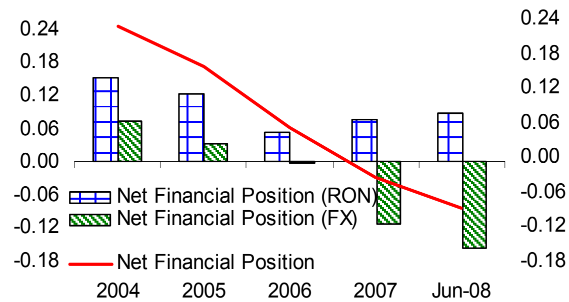
Borrowing by Romanian households has grown rapidly in recent years, and much of it is unhedged foreign currency debt (Figure 1). Over the period 2005 to June-2008, while household disposable income grew at an average annual rate of 20 percent, household debt increased at a rate of 77 percent. As a result, the debt/disposable income ratio rose from 25 percent at end-2005 to 66 percent by mid-2008. Borrowing denominated in FX grew even more rapidly than borrowing in RON, so that the share of FX in total borrowing rose from 45 percent to 56 percent of total household debt by mid-2008.

Figure 1: Household debt/Disposable income



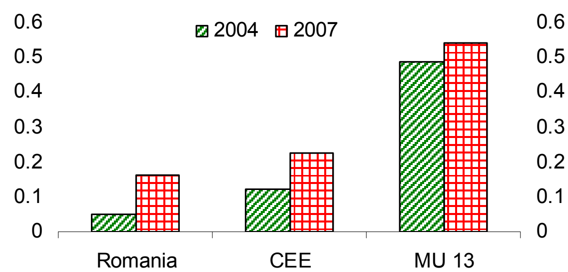
Households have moved from a net creditor to a net debtor position, mainly reflecting increased FX exposure (Figure 2). Households remain net creditors to the banking system in RON, with increases in RON borrowing substantially offset by increased RON deposits. Increased FX borrowings, however, have translated much more directly into a growing net debtor position and corresponding increase in exposure of the household sector to currency risk.

Figure 2: Net Financial Position / Disposable income



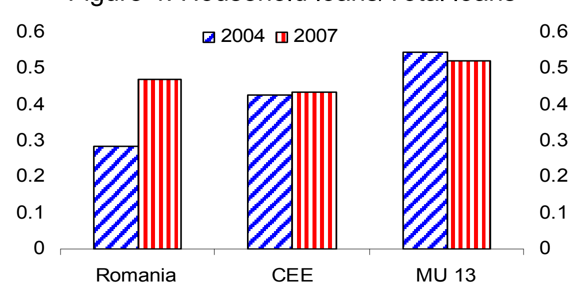
Nonetheless household debt is still low compared with other countries (Figure 3). Although household indebtedness rose from 5 percent of GDP in 2004 to 17 percent as of end of 2007, it is still low by comparison with other European countries. In 2007, household debt/GDP was still only 72 percent of the average for CEE countries, and only 30 percent of the MU-13 average.[1/]

Figure 3: Household debt/GDP



Lending to the household sector has become increasingly important to Romanian banks (Figure 4). The share of lending to households has risen from 28 percent of total lending in 2004 to 48 percent at end-2007. In this respect, Romanian bank exposure to the household sector is now similar to the position of banks in CEE and MU-13 countries.

Figure 4: Household loans/Total loans



1/ Central and Eastern European (CEE) includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia. Monetary Union (MU 13) includes Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Slovenia, and Spain.

Financial Exposure of the Non-Financial Corporate Sector

Non-financial corporate sector borrowing has grown rapidly, and most is denominated in FX (Figure 1). Total borrowing by the sector grew at an annualized rate of 44 percent between 2004 and mid-2008, so that indebtedness has nearly doubled to 28 percent of GDP. Borrowing in FX (both domestic and external) declined from 78 percent to 71 percent of total corporate borrowing over the period. At the same time, there has also been a shift towards direct borrowing abroad, with the share of external borrowing rising to 37 percent of total borrowing by mid-2008.

FX borrowing by the corporate sector has outpaced FX earnings (Figure 2). Corporate FX debt doubled relative to export earnings between 2004 and mid-2008. Nonetheless, the FX debt/ exports ratio is still fairly low at 62 percent.

Compared with other European transition economies, corporate indebtedness in Romania is low (Figure 3). Despite the rapid growth of corporate debt relative to GDP in Romania in recent years, the ratio remains well below the average for CEE countries.[1/] Indeed, in 2007, only Poland had a lower corporate debt/GDP ratio.

Since 2004, the maturity structure of corporate debt has shifted toward medium and long-run financing (Figure 4). Between 2004 and mid-2008, the share of medium and long-term debt in total corporate debt increased from 43 percent to 58 percent. The lengthening of the maturity structure occurred in both RON and FX borrowing, with the share of medium and long-term borrowing rising between 2004 and mid-2008 from 28 percent to 48 percent for RON debt and from 50 to 66 percent for FX debt.

Figure 1: Corporate debt / GDP

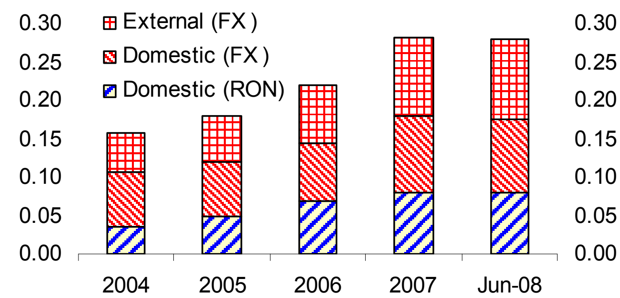


Figure 2: FX debt / Exports

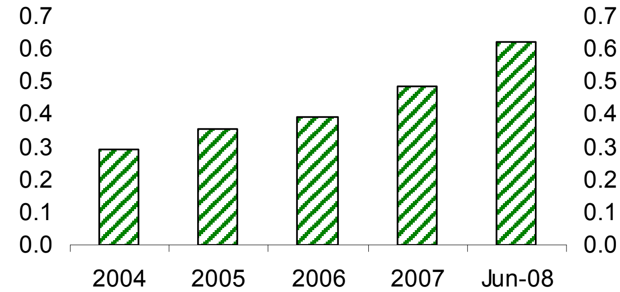


Figure 3: Debt / GDP comparisons

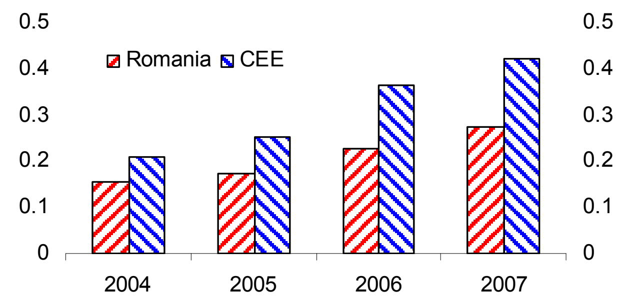
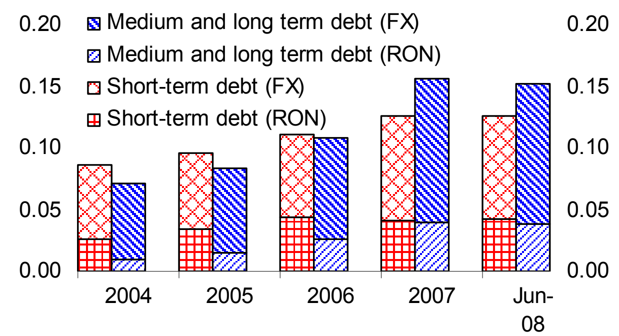


Figure 4: Debt maturity structure / GDP



Sources: NBR, BIS, IFS

1/ Central and Eastern European (CEE) includes Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, and Slovakia.

APPENDIX VIII. STRESS TESTING METHODOLOGY AND RESULTS

60. **Stress tests were conducted to evaluate:** (i) the main vulnerabilities of the Romanian banking system; (ii) the impact of different shocks on individual institutions; and (iii) potential additional capital needs of the banking system. The focus of the stress testing on banks alone partly reflects the smallness of the non-bank financial sectors, as well as the limited availability of data for non-banks. The stress tests covered the 14 largest banks, accounting for 81 percent of banking system assets in Romania, and were completed in November 2008, based on data to end-June.

61. **A variety of approaches to stress testing were used, in collaboration with the NBR and commercial banks:**

- **Single factor sensitivity analyses** to assess the vulnerability of banks to single factor shocks, including interest rate, exchange rate, and liquidity shocks;

- Analysis of two **macroeconomic scenarios** to assess vulnerability to combinations of shocks. These involved "bottom up" analyses, involving banks, as well as "top down" analyses by the NBR and the mission team.

62. **Vulnerability to specific risks was tested with single factor shocks as follows:**

- ***Credit risk***, largely reflecting indirect exposure to exchange rate risk, was tested by assessing the impact on provisioning against increases in NPLs by 5, 10, and 15 percentage points.[35]

- ***Liquidity risk*** was tested by assessing the impact of a drain of up to 25 percent of deposits and assuming limited access to credit lines and repo facilities, and taking into account contagion through the interbank market.

- ***Interest rate risk*** was tested using parallel shifts and tilts or twists of the yield curve of up to 300 basis points.

- ***Direct foreign exchange risk*** to banks' net open positions was tested using up to 30 percent changes in the nominal exchange rate.

[35] Existing provision levels for different loan portfolios are benchmarked against expected losses based on cross-country data inputs reported in the Fifth Quantitative Impact Study (BIS, 2006) for small banks in CEBS member countries and non-G10 countries, and those published by Fitch (2008) for U.S. subprime credits.

63. **The two macroeconomic scenarios comprised:**

- A ***soft landing*** scenario, in which real GDP growth slows from 7.1 percent in 2008 to 4.1 percent in 2009, the leu depreciates by 16 percent from its 2007 average, house prices stabilize and inflation declines gradually. This scenario, however, has been largely overtaken by events—the rapid weakening of the economy and depreciation of the leu since late 2008 mean that this scenario is no longer very relevant.;

- A ***hard landing*** scenario in which the global financial turmoil leads to a sharp, world-wide recession in 2008–09. Capital flows to Romania are assumed to contract sharply and Romanian sovereign spreads increase. The leu depreciates by 39 percent from the 2007 level, while funding costs in lei and foreign currencies increase. Investment and consumption fall, real estate prices fall sharply, and real GDP declines by 1.3 percent in 2009. Household and corporate balance sheets weaken, contributing to a rapid slowing of domestic credit growth to the private sector (while foreign credit growth stops entirely), system-wide bank liquidity conditions deteriorate sharply, as do banks' loan portfolios. This hard landing scenario has become the central downside scenario in light of the latest developments in the region.

64. **"Bottom-up" tests were carried by banks, using their internal models, complementing "top-down" analyses by the NBR and the mission team:**

- In the bottom-up exercises, 14 banks (with about 80 percent of total bank assets) used their internal models to estimate the effects of the single factor shock shocks, with results then pooled, while for the macroeconomic scenarios, 3 banks (with 45 percent total bank assets) provided estimated effects;

- The analysis by the NBR used internal models developed by the Financial Stability Department. The assessment of the macro scenarios are based on a combination of single factor shocks and regression estimates of expected credit migrations derived from financial data on the Romanian corporate sector.

- The mission team estimates of single-factor shocks are calculated from anonymous individual-bank data provided by NBR. Results for the macro scenarios are derived from the direct effects of single-factor shocks in combination with regression results of macro variables, covering ten years of data from 85 countries.[36] The impact of indirect credit

[36] See also Cihák and Schaeck (2007), "How Well Do Aggregate Bank Ratios Identify Banking Problems?", IMF Working Paper No. 07/275.

risk from exchange rate depreciations is based on approaches used by OeNB and other FSAP stress tests.[37]

65. **The single factor stress tests confirmed that credit risk is the major risk factor for the Romanian banking system.** Given the size of banks' loan books and the predominance of traditional lending business in Romania, credit risk, materializing through the need for higher provisions, has a material impact on bank solvency. Based on historical data from periods of financial distress, the stress test examined increases in the NPL ratio of 5, 10, and 15 percentage points. The results are summarized in the table below. Although estimates varied on a bank-by-bank basis, the aggregated estimates by the mission and the banks were fairly similar.

Romania: Credit Risk Stress Test

	Largest banks		Local banks		Foreign-owned banks		Banks with LTD > 130%	
Number of banks	14		2		12		7	
Capital Adequacy Ratio (CAR)	*Banks*	*Mission*	*Banks*	*Mission*	*Banks*	*Mission*	*Banks*	*Mission*
Before shock	12.4%		17.2%		11.9%		13.1%	
After shock								
5 percent increase in NPL	11.4%	11.9%	15.8%	16.9%	10.9%	11.3%	12.4%	12.1%
10 percent increase in NPL	9.7%	9.9%	12.8%	15.6%	9.3%	9.2%	10.5%	10.4%
15 percent increase in NPL	7.2%	7.9%	8.8%	14.3%	7.0%	7.1%	8.3%	8.7%
Capital shortfall	*Mission estimates*							
Minimum 8 percent CAR	No. of banks	Capital need (RON bln)	No. of banks	Capital need (RON mln)	No. of banks	Capital need (RON bln)	No. of banks	Capital need (RON bln)
5 percent increase in NPL	1	0.06	0	0.00	1	0.06	1	0.06
10 percent increase in NPL	4	0.69	0	0.00	4	0.69	2	0.34
15 percent increase in NPL	7	2.67	0	0.00	7	2.67	3	0.88

Sources: National Bank of Romania and mission team

66. **Starting from a comfortable capital basis and healthy semi-annual profits, the results suggest that banks could withstand a 2.5 percentage point increase in the NPL ratio without decreasing current CAR levels.** Further increases, however, would significantly erode capital adequacy. Most significantly, local banks assume that increases in the NPL ratios affect their CAR by about double the factor of foreign banks. When there is a 10 percentage point increase in the NPL ratio, the mission estimates identify four banks, with a combined market share of around 30 percent, that would fall below NBR's minimum 8 percent CAR threshold. These banks would require additional capital of at least RON 690 million (0.1 percent of GDP, 3 percent of capital) to maintain the 8 percent CAR, and RON 4.2 billion (0.9 percent of GDP, 20 percent of capital) to restore initial CAR levels. Capital increases since end-June would ameliorate, but not eliminate the shortfall of capital—three banks would still fall below the 8 percent minimum CAR.

[37] Boss, Krenn, Schwaiger, and Wegschaider (2004), "Stress Testing the Austrian Banking System", OeBA 11/04, pp. 841-852.

67. **Direct vulnerability interest rate risk appears to be limited.** Although local banks, primarily dependent on local currency funding, have a large degree of maturity transformation, a large part of their demand deposit base is remunerated at low and stable interest rates. As a result, they are relatively insulated from interest rate risk, especially foreign interest rates. Among the foreign banks, many have received funding in foreign exchange at relatively long maturities. As a result, they are relatively exposed to foreign interest rate risk, though the magnitude of the impact on bank capital is still small compared with credit risk effects.

Romania: Interest Rate Risk Stress Test

	Scenario description 1/			Impact analysis			
	<1 month	1 month to 1 year	>1 year	Largest banks	Local banks	Foreign-owned banks	Banks with LTD > 130%
Time to repricing				(Net assets over total assets)			
Shorter than 1 month				9%	9%	9%	12%
Between 1 and 12 months				17%	1%	19%	25%
Longer than 12 months				5%	34%	2%	-15%
Interest rate shocks	(interest rate change in bps)			(Impact in percent of tier 1 and tier 2 capital)			
Domestic Yield Curve							
Scenario 1	+300	+300	+300	0.0%	0.6%	-0.1%	0.6%
Scenario 2	-300	-300	-300	0.0%	-0.6%	0.1%	-0.6%
Scenario 3	+50	+150	+275	0.5%	0.4%	0.5%	0.4%
Scenario 4	-50	-150	-275	-0.5%	-0.4%	-0.5%	-0.4%
Scenario 5	+300	+200	+75	-0.5%	0.3%	-0.6%	0.3%
Scenario 6	-300	-200	-75	0.5%	-0.3%	0.6%	-0.3%
External Yield Curve							
Scenario 7	+200	+200	+200	2.5%	0.0%	3.0%	3.3%
Scenario 8	-200	-200	-200	-2.5%	0.0%	-3.0%	-3.3%
Scenario 9	+25	+75	+175	0.4%	-0.2%	0.5%	0.8%
Scenario 10	-25	-75	-175	-0.4%	0.2%	-0.5%	-0.8%
Scenario 11	+200	+108	+38	2.4%	0.4%	2.8%	2.6%
Scenario 12	-200	-108	-38	-2.4%	-0.4%	-2.8%	-2.6%

Sources: NBR and mission team.
1/ For illustrational purposes average shock of six different maturity buckets is shown.

68. **Banks also have very little direct exposure to exchange rate risk.** Foreign currency borrowing by Romanian banks is closely matched by foreign currency lending. As a consequence, although banks are exposed indirectly to exchange rate risk, their direct exposure is very limited.

Romania: Direct Foreign Exchange Risk Stress Test

	Largest banks		Local banks		Foreign-owned banks		Banks with LTD > 130%	
	Banks	*Mission*	*Banks*	*Mission*	*Banks*	*Mission*	*Banks*	*Mission*
Net open FX position (in RON bln)	0.9	0.4	0.1	0.1	0.9	0.3	0.1	0.1
Revaluation impact (in percent of capital)								
30% nominal appreciation of RON	-1.4%	-0.5%	-0.9%	-1.1%	-1.5%	-0.4%	-0.5%	-0.4%
30% nominal depreciation of RON	1.4%	0.5%	0.9%	1.1%	1.5%	0.4%	0.6%	0.4%

Sources: NBR and mission team.
Note: Correction made for sign of banks' estimates of revaluation impact based on reported net open FX position.

Macroeconomic scenarios

69. **The NBR and mission analyses of the macroeconomic scenarios used somewhat different approaches.** The NBR analysis used single factor analysis together with estimated credit migration equations applied to corporate financial data to estimate the evolution of NPLs on a bank-by-bank basis. This approach has the advantage of allowing differences in portfolio quality and individual corporate vulnerabilities to be taken into account. However, it also has the drawback of relying on estimated credit migration equations estimated over a short and perhaps unrepresentative sample period. The mission analysis used a combination of single factor analysis plus a regression estimate linking changes in NPLs to the evolution of macroeconomic variables, using panel data covering 45 countries over 10 years.

70. **In the mission analysis, the regression results suggest an increase of the NPL ratio of 11.2 percentage points for the hard landing scenario.**[38] Based on the long-run impact of the macroeconomic variables, the fall in growth is estimated to raise the NPL ratio by 3.6 percentage points; the increase in inflation raises the NPL ratio 1.3 percentage points; and the depreciation of the leu in real terms raises the NPL ratio by 6.3 percentage points.

71. **Additional provisioning needs are calculated from the increase in NPLs and take into account declines in collateral values.** Collateral values are proxied by real estate prices in the macro scenario and are weighted by the portion of real estate loans in bank portfolios. Given that most of secured lending is in foreign currency, a leu depreciation creates a double effect through increased credit risk from a higher debt service burden, while the negative impact on the loan-to-value ratios increases the banks' exposure. Results also assume a 5 and 10 percent mark-to-market loss of assets on the trading book, respectively. The total impact on banks' capital adequacy is calculated based on the effect of increased provisions, direct interest rate and foreign exchange exposure, mark-to-market losses on trading assets, and reduced profitability; slower credit growth is assumed to additionally moderate the growth of risk-weighted assets. Based on

[38] The definition of NPLs includes substandard, doubtful and loss loans.

half-year profits in 2008, RON 2.7 billion is included in expected 2008 profits. The mission's estimates of the impact of the two macro scenarios on bank CARs are compared with the NBR's estimates in the table below.

Romania: Macro Stress Test Results

	Largest banks		Local banks		Foreign-owned banks		Banks with LTD > 130%	
Before shock								
CAR	12.4%		17.2%		11.9%		13.1%	
Assets over system assets	81.2%		9.5%		71.7%		27.4%	
Scenario I	*NBR*	*Mission*	*NBR*	*Mission*	*NBR*	*Mission*	*NBR*	*Mission*
CAR	11.4%	11.2%	16.0%	14.8%	10.8%	10.8%	12.0%	10.8%
Banks with CAR < 8%	1	1	0	0	1	1	1	1
(as % of system assets)	4.8%	4.8%	0.0%	0.0%	4.8%	4.8%	4.8%	4.8%
Recapitalization cost (RON bln)	0.2	0.2	0.0	0.0	0.2	0.2	0.2	0.2
Additional provisions (RON bln)	5.8	2.2	0.2	0.1	5.6	2.1	1.1	0.7
Total loss (RON bln)	5.9	2.4	0.2	0.2	5.7	2.2	1.1	0.7
Cost to restore initial CAR (RON bln)		2.9		0.5		2.3		1.6
Scenario II								
CAR	9.5%	8.5%	15.7%	12.5%	8.7%	8.0%	10.8%	8.6%
Banks with CAR < 8%	3	6	0	0	3	6	1	4
(as % of system assets)	27.6%	45.4%	0.0%	0.0%	27.6%	45.4%	4.8%	17.4%
Recapitalization cost (RON bln)	2.1	2.0	0.0	0.0	2.1	2.0	0.7	0.8
Additional provisions (RON bln)	10.2	7.9	0.4	0.6	9.8	7.3	2.0	2.5
Total loss (RON bln)	11.2	8.9	0.5	0.8	10.7	8.1	2.0	2.7
Cost to restore initial CAR (RON bln)		7.1		0.9		6.3		2.8

Sources: NBR and mission team.

72. **In Scenario 2—the scenario judged to be most consistent with the current outlook—losses of between RON 9 to RON 11 billion (1.8-2.3 percent of GDP) are estimated for all banks, with 6 banks with CARs falling below 8 percent.** The capital shortfall under the 8 percent minimum CAR is around RON 2 billion (0.4 percent of GDP, 10 percent of capital). To restore individual bank CARs to initial (June 2008) levels, aggregate capital would need to be increased by RON 7 billion (1.4 percent of GDP). As noted earlier, capital increases since end-June 2008 would somewhat ameliorate the shortfall in capital adequacy, but would not eliminate the need for some banks to further strengthen their capital positions.

73. **While NBR estimates point to higher provisioning needs, their estimated impact on the capital adequacy is cushioned by assuming continued profit generation going forward.** When taking into account the half-year profits of a total of RON2 billion for the 14 banks (partly boosted from prepayments and the shelving of expansion plans), the impact looks manageable in the short run. However, given that bank profitability is expected to suffer dramatically in 2009, profit generation cannot be expected to suffice. Lack of financing will also put a brake on future credit expansion which is necessary to sustain economic growth. Therefore, recapitalization amounts need to be higher than the regulatory minimum.

74. **There are a number of important limitations to the analysis that should be noted:**

- The stress tests reported above take no account of developments in macro-financial variables and balance sheets since end-June. To the extent that developments were anticipated by the assumptions and analysis, the scenarios remain valid.

- The stress tests do not explicitly assess the impact of the sharp slowing of lending, either as a result of tightening credit standards or in response to reduced funding from foreign parent banks. Clearly, a slowdown of external funding is implicit in the macro scenarios, but there is no distinct "credit crunch" effect.

- The analysis does not include off balance sheet liabilities of the banks.

APPENDIX IX: ASSESSMENT OF OBSERVANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Summary, Key Findings, and Recommendations

General

75. **The assessment of the Basel Core Principles for Effective Banking Supervision[39] in Romania was undertaken as part of the FSAP.** It was conducted during a mission to Romania from November 3 to November 14, 2008 and is based on the laws, regulations, policies and practices in place at that time. The assessment was based on several sources, including: (i) a self-assessment and questionnaire completed by the NBR; (ii) detailed interviews with staff from the NBR; (iii) a review of legislation, regulations and other documentation on the supervisory framework and on the structure and development of the Romanian financial sector; (iv) meetings with other authorities and independent bodies, such as the Ministry of Finance, the Ministry of Justice; and the auditing profession; and (v) external meetings with the banking industry and trade association.

Institutional and Macro Prudential Setting, Market Structure—Overview

76. **Since late 2008, the Romanian economy has been strongly affected by the global financial crisis.** The virtual cessation of capital inflows, including FDI, together with a collapse in external demand are resulting in a dramatic slump in domestic activity. In 2009, the economy is expected to enter a recession.

77. **The Romanian financial system has expanded rapidly, with total assets increasing from 31 percent of GDP in 2003 to 67 percent in 2008, and is dominated by commercial banks, at 82 percent of all financial sector assets.** The banking system has been substantially privatized, and is now largely (88 percent) foreign owned. Concentration in the banking sector is moderate, with the five largest banks accounting for 54.3 percent of total assets.

78. **Despite the strong growth of the banking system in recent years, financial soundness indicators have deteriorated.** Although the capital adequacy ratio (CAR) of 13.8 percent in December 2008 was above the 8 percent minimum required by the European and international regulation, it has fallen from 21 percent in 2003. Non-performing loans have remained elevated despite sizable expansion of loan portfolios and have jumped visibly in recent months. Profitability has kept declining in recent years and appears to be somewhat lower in the Romanian banking sector than in banking sectors of its immediate comparators, in part due to relatively high required reserves. At end-2007, return on assets (ROA) and return on equity

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[39] Issued by the Basel Committee, 2006.

(ROE) averaged 1.0 percent and 9.4 percent, respectively, in Romania, compared with 2.5 percent and 25.4 percent, respectively, in Bulgaria.

79. **Romania's central bank, the National Bank of Romania (NBR), is an independent public institution that, among other things, implements monetary and exchange rate policy and authorizes, regulates and supervises credit institutions.** Without prejudice to its primary objective of ensuring and maintaining price stability, the NBR supports the general economic policy of the government. As regards the monetary policy, the NBR actively manages overall liquidity in the banking system through open market operations, including collateralized FX swaps. These are complemented by standing facilities, including the Overnight Lombard facility. The NBR has the power to act as lender of last resort and can provide emergency loans on an ad hoc basis to credit institutions without collateral to ensure Financial Stability (article 26 of NBR Law). It is accountable solely to parliament and is not subordinated to government. The NBR is a well-respected institution with a professional staff of 103 supervisors.

General preconditions for effective banking supervision

80. **The legal framework underpinning the banking sector in Romania is comprehensive, but there are weaknesses in the judicial system in enforcing legislation in a timely and impartial manner.** Romania's equity markets provide market discipline for the 76 listed companies on the Bucharest Stock Exchange (BVB). However, Romania has not yet moved to fully adopt International Accounting Standards (IAS), which limits the transparency of the markets.

81. **Most major elements of a crisis management and safety net framework are in place, however, there are a number of areas in which improvements should be made.** These include, among other things, increasing the flexibility for an early bank resolution by the NBR and making adjustments to the deposit insurance scheme consistent with EU Directive 94/19/EC and subsequent amendments, preferably in advance of the EU deadline. The coverage of deposits (both in lei and foreign currency) of households is currently € 50,000, the EU standard, and will be increased to this level for small and medium-sized enterprises by end-June 2009.

Main findings

82. **Objectives, independence, powers, transparency and cooperation.** The basic legal framework is set out in the 2004 Banking Act and subsequent ordinances and regulations. The Act, and its supporting regulations, have been amended regularly to bring them in line with EU standards such as the EU capital directive, and changes in the local market. The Act gives the NBR powers to exercise supervision of credit institutions and establishes prudential requirements, such as minimum liquidity and solvency levels, maximum aggregate exposure, and specific risk provisions.

83. **The NBR is an independent entity with full authority and wide-ranging powers to fulfill its mandate.** Additional powers may be needed in cases of stress. Staffing and resources for bank supervision are considered sufficient, and fully budgeted for in the NBR annual budget.

84. **A framework for cooperation between domestic supervisory authorities has been established, however, there are some indications that authorities continue to operate in silos.** Under the auspices of the National Council for Financial Stability, established in July 2007, progress is beginning to be made in developing crisis management measures and contingency planning. However, there is significant scope for closer coordination, which could also include a more active role by the Ministry of Finance which may now be starting to happen. Discussions on a common view of risks in financial conglomerates and supervisory approaches may be needed.

85. **Licensing and structure.** Under the Banking Act, entities must be authorized by the NBR to take deposits or other repayable funds from the public. These entities are supervised by the NBR, and the authorization and transfer of ownership processes are comprehensive and rigorous. Permissible banking activities are defined by statute and generally include taking deposits and granting credit, including financial leasing. As noted in the 2004 FSAP, credit unions and CMOs are not regulated entities. While the industry is small and not systemic, inclusion of the industry in a prudential framework merits consideration.

86. **Prudential regulations and requirements**. Romanian banking laws and regulations require banks and groups to have in place sound risk management processes. This includes, for example, the requirement for banks to have in place dedicated risk specialists and independent risk control units for each of the major banking risks. Board and senior management must be actively involved in the risk control process. In most regards, the NBR's prudential regulations are consistent with the requirements of EU directives. Romania has adopted the EU capital requirements directive (CRD), and banks are using the standardized approach. However, CRD implementation, particularly Pillar 2, poses challenges for the industry and NBR, requiring the strengthening of local resources.

87. **There are, however, significant departures from EU standards and Basel Core Principles that involve the methodology for identifying problem loans and allocating provisions.** In Romania, credit grading guidelines are largely formulaic with a heavy reliance on financial ratios and limited qualitative or subjective inputs. Also Romania uses a benchmark scheme to assign provisions (e.g., allocations are stipulated based on credit ratings), and it does not provide provisioning guidance for country and transfer risks. A more judgmental rating process, particularly for large credits, and a provisioning scheme better aligned with inherent risk is warranted.

88. **Rules and regulations regarding anti-money laundering are harmonized with the third EU money laundering directive.** Banks and other financial institutions are in the initial

stages of implementing the rules. Due to the nature and scope if the FIU's supervisory tasks, it appears that its staff of 15 is insufficient.

89. **Methods of ongoing supervision.** Banking supervision in Romania includes both onsite and offsite examinations. During onsite examinations, inspectors assess the risk profile of the bank to ensure appropriate focus on high-risk activity. However, a major focus of NBR supervisory activities is compliance with rules and regulations and this has resulted in placing undue time and attention to minor issues. A more risk-based approach should be developed. Information provided for offsite supervision, is comprehensive and thorough. A robust independent validation process also appears to be in place. There is regular and frequent contact between the NBR and bank management. However, there is a perceived need by the industry for timely contact with high-level NBR officials when warranted by special circumstances.

90. **Accounting and disclosure.** In Romania, financial statements must be published annually in accordance with IFRS in the case of consolidated statements and with Romanian accounting standards (RAS) in the case of solo statements.[40]Romania should fully adopt IFRS. Financial statements are audited according to International Standards on Auditing. Auditors periodically meet with the NBR and must inform the NBR of significant issues.

91. **Corrective and remedial powers of supervisors.** The legal powers given to the NBR are wide ranging and allow for a flexible and graduated response to varying degrees of stress in a bank. However, additional powers may be needed in cases of stress and should be considered, such as raising the solvency trigger and changing the access to bankruptcy petitions and the rights of shareholders.

92. **Consolidated and cross-border banking supervision.** The NBR's approach to consolidated supervision appears to be comprehensive and effective. Consolidated prudential returns are received semi-annually. Resources are available to visit foreign operations, and NBR places a degree of reliance on overseas regulators. Foreign banks are supervised by the NBR in the same manner as Romanian banks. NBR's approach to sharing information with overseas supervisors seems open and cooperative and where possible is supported by an MOU.

[40] Valuation principles used under RAS generally follow IFRS except in two substantive areas: provisioning and the amortization of loans. For provisioning, RAS uses a benchmark scheme. Such schemes generally result in higher provisions than IFRS, which is based on recognizing existing losses inherent in the portfolio. As a result, it is likely that the provisioning levels in Romania will decrease upon adoption of IFRS.

Table 1A. Summary Compliance with the Basel Core Principles—ROSCs

Core Principle	Comments
1. Objectives, independence, powers, transparency, and cooperation	
1.1 Responsibilities and objectives	The Banking Act provides for an appropriate framework for banking supervision in Romania.
1.2 Independence, accountability and transparency	The NBR is independent and accountable to Parliament. The NBR publishes annual reports and other information to promote transparency.
1.3 Legal framework	The NBR is responsible for authorizing and supervising banks.
1.4 Legal powers	NBR has extensive powers to carry out supervision and remedial action.
1.5 Legal protection	Supervisors are protected from sanctions and costs of judicial proceedings are covered.
1.6 Cooperation	Agreements are in place among supervisors; however, they may not be fully utilized in the case of domestic authorities.
2. Permissible activities	Permissible activities for banks are clearly defined by law. Inclusion of credit unions and CMOs in a prudential framework merits consideration.
3. Licensing criteria	The NBR's licensing process is comprehensive and rigorous.
4. Transfer of significant ownership	NBR has the power to review and reject transfers of significant ownership.
5. Major acquisitions	NBR performs appropriate reviews of major acquisitions.
6. Capital adequacy	Romania has adopted the EU capital directive, however, implementation will require NBR and local management to further strengthen capacity.
7. Risk management process	Banks are required by law and regulation to have in place adequate risk management processes. Continued focus on implementing risk-based supervision is needed.
8. Credit risk	Banks must implement an adequate credit risk management process, however, the credit classification process should be adjusted to increase emphasis on qualitative factors.
9. Problem assets, provisions, and reserves	Credit grading guidelines are largely formulaic with a heavy reliance on financial ratios, and Romania uses a benchmark scheme to assign provisions (e.g. allocations are stipulated based on credit ratings). A more judgmental rating process, particularly for large credits, and a provisioning scheme better aligned with inherent risk is warranted.
10. Large exposure limits	Banks must use specific procedures to manage large exposures, and they must be reported to the NBR.
11. Exposure to related parties	Romania's prudential standards focus on transactions with employees and directors, but do not provide sufficient guidance relative to affiliates and other insiders.
12. Country and transfer risks	Banks must have in place adequate country and transfer risk policies and procedures. Romania does not provide provisioning guidance for these risks.
13. Market risks	Banks must have in place adequate market risk management processes, including an independent risk control unit.
14. Liquidity risk	Banks must have strategies for managing liquidity risk, and NBR sets a minimum liquidity ratio. Currently, banks provide daily liquidity reports to the NBR.
15. Operational risk	Bank policies and systems must address exposure to operational risk, including to low frequency, high severity events, and legal risks. The NBR has inspectors with specialized expertise in this area.
16. Interest rate risk in the banking book	Bank policies and procedures must address exposure to interest rate risk arising from non-trading activities, including limits. Banks use scenario analysis to measure vulnerability.
17. Internal control and audit	Banks must establish appropriate risk management systems addressing, for example, delegation of authorities, segregation of duties, independent audit, and appropriate committee structures.

Core Principle	Comments
18. Abuse of financial services	Rules and regulations regarding anti-money laundering are harmonized with the third EU money laundering directive. Banks and other financial institutions are in the initial stages of implementing the rules. Due to the nature and scope if the ONPCSB's supervisory tasks, it appears that its staff of 15 is insufficient.
19. Supervisory approach	While the NBR is now implementing risk-based supervision, its approach continues to be heavily rules based. Further moves towards a more comprehensive system of risk-based supervision are needed in the short-term, especially as the Romanian financial sector is exposed to very serious risks in the current global environment. .
20. Supervisory techniques	The NBR uses a balanced and appropriate mix of on- and off-site supervision. There is regular and frequent contact between the NBR and bank management. However, there is a perceived need by the industry for timely contact with high-level NBR officials when warranted by special circumstances.
21. Supervisory reporting	The NBR receives and analyzes a wide range of information from the industry monthly, and a robust validation process appears to be in place.
22. Accounting and disclosure	In Romania, financial statements must be published annually in accordance with IFRS in the case of consolidated statements and with Romanian accounting standards (RAS) in the case of solo statements. Valuation principles used under RAS generally follow IFRS except in two substantive areas: provisioning and the amortization of loans. Romania should fully adopt IFRS.
23. Corrective and remedial powers of supervisors	The legal powers given to the NBR are wide ranging and allow for a flexible and graduated response to varying degrees of stress in a bank. However, these powers could be reviewed to ensure that the Special Administration procedure can be used swiftly in practice. There is scope also to consider raising the solvency trigger and changing the access to bankruptcy petitions and the rights of shareholders, and to strengthen the Deposit Insurance Fund.
24. Consolidated supervision	The NBR's approach to consolidated supervision appears to be comprehensive and effective. Consolidated prudential returns are received semi-annually. Resources are available to visit foreign operations, and NBR places a degree of reliance on overseas regulators. Foreign banks are supervised by the NBR in the same manner as Romanian banks.
25. Home-host relationships	NBR's approach to sharing information with overseas supervisors seems open and cooperative and where possible is supported by an MOU.

Recommended action plan and authorities' response

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP 1.6 Cooperation	Coordinate supervisory activities between NBR and other domestic regulators through regular meetings, information sharing, and joint inspections. There is also scope to strengthen crisis management arrangements which should be coordinated by the NBR, involving the Ministry of Finance as well as the other regulatory bodies.
CP 2 Permissible activities	Romanian authorities should evaluate whether non regulated activities and non regulated institutions, such as credit unions and CMOs, should be included in the prudential framework.
CP 6 Capital adequacy	Further strengthen capacity of NBR and local bank management to implement Basel II.
CP 7 Risk management process	Continue the cultural shift of NBR towards risk-based supervision and lessen undue attention to minor issues.
CP 8 Credit risk	Adjust the NBR credit classification system to increase emphasis on qualitative factors, particularly for large credits.
CP9 Problem assets, provisions, and reserves	The Ministry of Finance and the NBR should impose IFRS provisioning guidelines on banks.
CP 11 Exposure to related parties	Develop and provide NBR guidance for banks to avoid conflicts of interest with affiliates and other insiders.
CP 12 Country and transfer risk	Provide NBR guidance for provisioning for country and transfer risk.
CP 18 Abuse of financial services	Increase the ONPCSB's supervisory resources.
CP 20 Supervisory techniques	Increase contact between bank management and high level NBR officials.
CP 22 Accounting and disclosure	Fully adopt IFRS for banks.
CP 23 Corrective and remedial powers	Provide NBR with additional powers, such as raising the solvency trigger and changing the access to bankruptcy petitions and the rights of shareholders. Increase the effectiveness of the Deposit Insurance Fund, consistent with EU Directive 94/19/EC and amendments.

Authorities' response to the assessment

93. ***CP 2:*** The NBR does not agree with the FSAP team view on the treatment of credit unions and CMOs. Credit unions and CMOs in Romania are restricted in their credit activities. They are not permitted to accept deposits or perform other banking activities.[41] In these circumstances, the NBR is of the view that the credit union industry does not pose a systemic risk to the financial system nor would failure of a large credit union or several small ones shake

[41] They are therefore unlike credit unions in the U.K. or France, which can provide banking activities (including deposit taking) for their members.

confidence in the financial sector. The NBR also believes that incorporating the industry into a prudential framework would create costs that would render it unviable. As a consequence, the NBR opinion is that the IMF recommendation disregards the application of proportionality and efficient allocation of resources principles in the process of designing the regulatory and supervisory regime of entities outside the *acquis communitaire.*

94. ***CP7:*** NBR indicates that a shift toward more risk-based supervision began in 2003, and is ongoing.

95. ***CP 9:*** The NBR notes that in the previous FSAP, the BCP8 - "Loan Evaluation and Loan-Loss Provisioning" was rated with "compliant," and is of the view that the current framework provides important variations in risk evaluation according the types of parties and risks involved and high standards of provisioning.

96. ***CP12:*** The NBR notes that although its framework includes policies and procedures for identifying, measuring, monitoring and controlling country and transfer risks, but that such risks are small because foreign assets represent only a small fraction of total bank assets of the credit institutions.

97. ***CP18:*** The NBR notes that in the previous FSAP, the rating was "compliant," and do not believe that effectiveness of the ONPCSB has deteriorated, notwithstanding limitations on resources. They also indicate that deficiencies identified in the 2008 Moneyval Report are being addressed.

98. ***CP 22:*** The NBR indicates that it intends to fully adopt IFRS, but that this requires the approval of the Ministry of Finance, which has not yet been forthcoming.

APPENDIX X: ASSESSMENT OF IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

Summary, Key Findings, and Recommendations

99. **The Romanian CNVM has achieved a high level of compliance with the IOSCO Principles but there is scope for reinforcing its independence and for clarifying its powers and responsibilities to make them more robust while also moving forward with a more risk based approach.** The CNVM acts in an independent fashion but the practice of allocating nominating rights for Board appointments to political parties risks compromising that independence and undermines the advantages of appointment by the Parliament. Although the CNVM is able to exercise the powers of a regulatory authority, the distribution of different regulatory provisions between laws and Regulations is inconsistent and confusing and there is a lack of definition of some of the key information gathering powers. This gives rise to a risk that there may be gaps in coverage and vulnerability to legal challenge. In exercising its powers, the CNVM needs to move away from focusing on finding regulatory breaches and imposing sanctions to a more partnership based approach that seeks to work with market participants to identify key areas of risk and address them. While there are other matters that require attention, the CNVM should be commended on its high level of compliance and its acceptance as a signatory to the IOSCO MMoU.

Introduction

100. **This assessment was conducted as part of a joint World Bank, IMF FSAP mission to Romania from November 3 to 14, 2008**. The assessment was conducted by Richard Pratt, external consultant to the World Bank.

Information and methodology used for assessment

101. **The assessor used the 2008 version of the IOSCO methodology, supplemented by information the authorities and discussions with the authorities and the market.** The assessment benefited from an extensive CNVM self assessment and was informed by other information from the authorities, including in particular the CNVM annual reports for 2006 and 2007 and the CNVM and other web sites. The assessor examined the relevant laws and regulations, including in particular, Law no 514 of 2002 on the establishment of the CNVM and Law no 297 of 2004 on the capital markets. The underlying regulations examined were Regulation 15 of 2004 on collective investment schemes, Regulation 13 of 2005 on the central depository, Regulation 1 of 2006 on issuers and operations with securities, Regulation 2 of 2006 on regulated markets, Regulation 3 of 2006 on the investor compensation fund, Regulation 15 of 2006 on the presentation of investment recommendations and Regulation 32 of 2006 on Investment Services. The assessor had interviews with the CNVM staff, with the exchanges and other market participants. The assessor is grateful for the extensive help and assistance that were given.

Institutional and market structure—overview

102. **The Romanian securities market is regulated by the Romanian National Securities Commission (CNVM).** This has responsibility for authorizing, supervising and imposing sanctions on exchanges, clearing houses, central depositories, market intermediaries and collective investment schemes. It is also responsible for approving prospectuses for public offers and supervision of issuers' reporting obligations.

103. **There are three regulated markets in Romania, operated by two market operators**. The Bucharest Stock Exchange manages one spot market and one derivatives market. The Sibiu Monetary and Commodities Exchange manages one derivatives market. The BVB is also responsible for a second tier market—RASDAQ. The BVB is a mutual organization. The Sibiu Commodity Exchange has a somewhat broader shareholder base. According to information provided by the CNVM to the IMF in October 2008, total equity market capitalization on the BVB has risen from €3.0 billion in 2003 to €24.6 billion in 2008 (latest available data in October 2008). Although there were 68 listed securities, the capitalization is heavily concentrated, with the top ten stocks accounting for around 90 per cent of market capitalization (€22.4 billion out of €24.6 billion). Annual turnover rose from €22.4 million in 2003 to €346.0 million in 2007 before falling back to €181.0 million during 2008. There have been a relatively small number of new issues on the market, with no more than 2 annually between 2003 and 2007 and a total value that peaked in 2007 at €64 million. Equities are cleared and settled through a central depository.

104. **The Corporate Bond market is also relatively small**, with six issuers in 2008, five of which were credit institutions and one was a leading company. Government bonds have been listed on the BVB since July 2008 but, in practice, there is little trading, the main market being an OTC market supervised by the National Bank of Romania. There are 11 issuers of municipal bonds and again, trading on the BVB in these instruments is thin.

105. **The derivatives markets are also small but growing.** The total market value of the Sibiu derivatives market rose from €51 million in 2003 to €3.5 billion in 2007 before falling back to €1.8 billion in 2008. The BVB derivatives market began in September 2007 and, again according to information supplied by CNVM in October 2008, market value of turnover rose to €3.8 million. The clearing houses of both derivative markets also act as central counterparties. The Romanian Clearing House (CRC) clears for the Sibiu Exchange using settlement banks and the Bucharest Clearing House (CCB) clears through the National Bank of Romania.

106. **The banks and their subsidiaries are dominant in the top ten market intermediaries by trading value and volume.** There are 81 market intermediaries of which 10 are credit institutions. In addition, a further 13 market intermediaries are subsidiaries of banks. In 2008, there were 25 authorized investment management companies, (of which seven were foreign owned) and seven custodians. These companies managed some 61 investment funds. All figures relate to October 2008.

Preconditions for effective securities regulation

107. **Romania has been a member of the European Union since January 2007**. In order to satisfy the European Commission that the EU acquis had been successfully implemented in Romania, the authorities undertook an extensive review of their laws. In the context of the securities market, this included the preparation of two key new legislative acts – the Law 514 of 2002, approving Emergency Ordinance GEO 25/2002 which established the National Securities Commission and Law 297 of 2004, the Capital Markets Law. These laws were accompanied by extensive regulatory acts issued by the CNVM. In addition, the Romanian authorities have introduced or updated their banking companies' laws and insolvency laws (amongst others) and have introduced International Financial Reporting Standards. As an EU member, Romania has satisfied the EU authorities with respect to its judicial system. It is subject to EU Competition laws. The essential preconditions for securities regulation are in place.

Main findings

108. **A high level of compliance with IOSCO standards has been achieved, as can be seen from the summary at Table 1.** Much effort in recent years has been focused on adopting the EU acquis. There is a single capital markets law (with separate legislation establishing the regulatory authority). New regulations have been introduced since 2005 for virtually every area of capital markets business and this has been clearly designed to be compatible with EU requirements so as to ensure accession runs smoothly. This has been a successful exercise in that Romania has been judged to have applied EU standards and it also leads to a high degree of compliance with IOSCO standards. The comments and suggestions set out below are intended to strengthen the high level of compliance with international standards that has already been achieved in the drafting of law and Regulations.

The Regulator (IOSCO Principles 1-5)

109. **The independence of the CNVM should be defended and strengthened and the structure of the Law and regulations needs attention.** The CNVM needs to resist attempts to curb its budgetary independence. Independence should be strengthened by amending the process of appointment of Commission Board Members. There should be more detailed appointment criteria, advertising of Board appointments and short lists prepared by professional firms before Parliament makes the appointments. The immunity from civil action in respect of decisions take in good faith needs to be extended to staff and made more secure. The CNVM should rationalize the division of provisions between primary and secondary law, seeking to make it more coherent and easier to follow.

Enforcement (Principles 8-10)

110. **CNVM should improve its relationship with market participants, accelerate the move to risk based supervision and review its inspection and investigation powers.** The

CNVM may well be justified in feeling frustrated from time to time as a result of intermediaries' behavior but it has the primary responsibility for improving the present, poor relationship with the regulated community. The CNVM should adopt a formal and documented assessment of risks to its regulatory objectives and adjust its supervisory approach so as to move beyond finding rule breaches and focus instead on identifying and addressing risks in partnership with regulated entities. The current provisions in Article 2 of the Capital Markets Law are broadly drafted, do not sufficiently define the nature or scope of an inspection and leave implicit certain requirements, such as their application to former license holders and the duty of an intermediary to co-operate. In addition, inspection and investigation powers in the primary law should be reviewed to ensure they are comprehensive, specific and unambiguous.

Cooperation (Principles 11-13)

111. **The CNVM is joining the IOSCO MMOU and should supplement this achievement with greater domestic co-operation.** The CNVM should be congratulated for successfully joining the IOSCO MMOU. The CNVM should not require an MOU in order to exchange information with foreign authorities outside the EU and the IOSCO MMOU, but should allow such exchanges subject to appropriate ad-hoc agreements. Domestic co-operation between regulatory authorities is governed by law and protocols and appears to be limited in scope, with requirements for written requests for assistance.

Issuers (Principles 14–16)

112. **Enforcement of Accounting Standards needs to be stepped up.** The regulations governing issuers have been substantially improved and provide a sound basis for investor protection. Enforcement of accounting standards remains somewhat patchy according to the CNVM and needs to be made more consistent. The CNVM is working with the Chamber of Financial Auditors (CAFR) and has developed criteria for establishing who can be an auditor of a listed company. This is to be welcomed, although a formal power for the CNVM to approve (or deny approval to) auditors of regulated entities, would strengthen its position.

Collective investment schemes (Principles 17–20)

113. **The pricing of CISs does not meet European standards and there are insufficient provisions on investor protection.** Redemption are based on the previous day's market valuations, which results is a loss to investors' funds from redemptions made in a falling market and vice versa. The CNVM is addressing this and other valuation issues. CNVM also needs to address the absence of any restrictions on churning of investors' portfolios. With a marked lack of liquidity in most financial instruments, the oversight of valuation and investment policy by the CIS custodians is especially important. To make this more effective, the CNVM should revert to its previous regulation that a depository should not be a member of the same corporate.

Market intermediaries (Principles 21–24)

114. **The client segregation rules need strengthening and the CNVM needs to prepare contingency plans for market failures**. The CNVM reports that, within some intermediaries' omnibus client accounts, funds belonging to one client are sometimes used to settle then obligations of other clients. This is against the regulations but enforcement could be enhanced by requiring daily reconciliation of client accounts, with the daily reconciliation records maintained for inspection. The CNVM has the powers in the law to appoint a trustee in bankruptcy but needs to create a fully functioning contingency plan for operating the law's procedures.

Exchanges and settlements (Principles 25–30)

115. **The CNVM should address settlement reliability.** The Sibex settlement system operates by using settlement banks and is therefore subject to the risk of a bank default. The CNVM should seek to enable CRC and CCB to have access to an account with NBR. As central counterparties, the clearing houses are having their own clearing and settlement systems and they cannot perform gross settlements using Real Time Gross Settlement (RTGS). The risk management of the BVB central depository should also be enhanced.

Table 1. Summary Implementation of the IOSCO Principles

Principle	Grading	Findings
Principle 1. The responsibilities of the regulator should be clearly and objectively stated	Broadly Implemented	Cooperation with other regulatory authorities, particularly the NBR needs to be improved. Laws and Regulations are confusing and difficult to follow because of the inconsistent distribution of provisions between different laws and regulations that lead to duplications and ambiguities.
Principle 2. The regulator should be operationally independent and accountable in the exercise of its functions and powers	Broadly Implemented	The CNVM acts with a reasonable degree of independence but needs to continue to resist diminution of budgetary independence and should strengthen the independence of the appointment of Board members.
Principle 3. The regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers	Fully Implemented	The CNVM is well resourced and sufficient budget but should seek greater flexibility in the management of its budget.
Principle 4. The regulator should adopt clear and consistent regulatory processes	Fully implemented	The CNVM gives reasons for decisions consults the markets about regulations and its decisions are subject to appeal. It should provide more feedback to the market on its response to comments made during consultation and should seek to achieve greater consistency in the use of sanctions.
Principle 5. The staff of the regulator should observe the highest professional standards	Fully Implemented	There is a staff code and good ethical standards. There may be scope for enhancing the staff register of interests.

Principle	Grading	Findings
Principle 6 The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets	Not Applicable	
Principle 7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities	Not Applicable	
Principle 8. The regulator should have comprehensive inspection, investigation and surveillance powers	Partly Implemented	Inspections, investigation and investigation powers are insufficiently defined, given that they are very intrusive. There are ambiguities in the drafting which may means there are gaps. There is no protection for the civil rights of those who are subject to investigation into offences that are designated as crimes (rather than administrative offences) by the capital markets law.
Principle 9. The regulator should have comprehensive enforcement powers	Fully Implemented	Notwithstanding the ambiguities in the powers, the CNVM appears to be able to exercise an investigation and sanctioning power. There is ambiguity about whether or not unauthorized business could be effectively sanctioned.
Principle 10.The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.	Fully Implemented	There is a well organized inspection program. However, its focus is on finding offences and punishing intermediaries. There should be more focus on identifying and addressing the risks in the intermediaries.
Principle 11. The regulator should have the authority to share both public and non-public information with domestic and foreign counterparts	Fully Implemented	The CNVM is accepted as a signatory of the IOSCO MMoU. It should not insist on a MoU with other authorities before providing assistance. It should not insist on written undertakings from receiving authorities about onward transmission of information from the CNVM without prior CNVM permission.
Principle 12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts	Fully Implemented	Membership of the group of signatories of the IOSCO MMoU indicates commitment to this principle.
Principle 13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers	Fully Implemented	The CNVM can and does give assistance to other authorities and can do so even where there is no domestic interest in an investigation. There is ambiguity about whether its investigation powers are sufficient to obtain information from intermediaries where there is no domestic investigation
Principle 14. There should be full, timely and accurate disclosure of financial results and other information that is material to investors' decisions	Fully Implemented	Regulations cover requirements of prospectus and continuing obligations of listed companies.

Principle	Grading	Findings
Principle 15. Holders of securities in a company should be treated in a fair and equitable manner	Fully Implemented	The Companies Law and regulations provide for voting rights, meetings where appropriate for shareholders and for proper notice of meetings with appropriate disclosures for shareholders.
Principle 16. Accounting and auditing standards should be of a high and internationally acceptable quality	Partly Implemented	CNVM have implemented IFRS but have said that compliance is not good enough. The implementation of IFRS, which is a principle based approach to accounting standards, does not sit easily with the previous highly detailed rules based approach.
Principle 17. The regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme	Broadly Implemented	The CNVM is the body that authorizes CISs. It appears to exercise the powers to enforce initial and ongoing requirements. There are, however, some gaps in the provisions that need to be rectified.
Principle 18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets	Not Implemented	There are provisions relating to the structure and corporate governance of CISs. However, there is no requirement to ensure that a custodian is in a separate and independent group from the investment manager and no special provisions to provide safeguards against a loss of independence.
Principle 19. Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme	Fully Implemented	The CNVM has implemented extensive disclosure provisions for prospectuses which cover all material matters. The provisions for advertisements are perhaps too detailed and impose an excessive burden.
Principle 20. Regulation should ensure that there is a proper and disclosed basis for assets valuation and the pricing and the redemption of units in a collective investment scheme	Partly Implemented	There are detailed provisions for the valuation of CIS assets. There is room for doubt about the provisions for valuation of illiquid assets and the basis of pricing of redemptions. The CNVM have accepted these points and are implementing a new Regulation.
Principle 21. Regulation should provide for minimum entry standards for market intermediaries	Fully Implemented	The CNVM Regulations provide for minimum entry standards, including requirements that an intermediary be fit and proper. There are some minor omissions in the requirements particularly the need to provide customers with access to the intermediaries' disciplinary history.
Principle 22. There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake	Fully Implemented	Capital requirements meet the terms of the Principle. CNVM is able to monitor compliance through its off-site review program. There could be enhanced early warning signals of a deterioration of capital between monthly reports.
Principle 23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters	Fully Implemented	The Regulations cover the intermediaries' duties to the client, including segregation of client assets, complaints procedures and the need to avoid conflicts of interest. There are further requirements relating to the adequacy of organizational structures. There is scope for strengthening the client money rules.

Principle	Grading	Findings
Principle 24. There should be a procedure for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk	Fully Implemented	The CNVM has the power to appoint a trustee in bankruptcy to take over the affairs of a regulated entity. There is a compensation scheme for investors in failed intermediaries. The CNVM should ensure that their contingency planning is tested from time to time to ensure it is fully functioning.
Principle 25. The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight	Fully Implemented	The CNVM has adequate powers to authorize, supervise and sanction exchanges and market operators.
Principle 26. There should be ongoing regulatory supervision of exchanges and trading systems, which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants	Fully Implemented	CNVM requires the exchanges have proper trading rules, which it must approve. It monitors trading for compliance with those rules and has Regulations that require market operators to do the same. There is a need to enhance relationships with the exchanges.
Principle 27. Regulation should promote transparency of trading	Fully Implemented	Trading rules require the publication of bids and offers and the volumes bid and offered at those prices. There is also full post trade transparency.
Principle 28. Regulation should be designed to detect and deter manipulation and other unfair trading practices	Broadly Implemented	The CHMV and the exchanges both have responsibility for monitoring trading for signs of market abuse but the primary responsibility for investigation lies with CNVM. There is not sufficient cooperation between exchanges for this purpose.
Principle 29. Regulation should aim to ensure the proper management of large exposures, default risk and market disruption	Partly Implemented	The CNVM and NBR have published rules on the reporting of large positions and other prudential issues. Market operators can share information with the CNVM but not with each other, even where there is scope for contagion across markets, which is inappropriate.
Principle 30. Systems for clearing and settlement of securities transactions should be subject to regulatory oversight, and designed to ensure that they are fair, effective and efficient and that they reduce systemic risk	Not rated	The assessor did not conduct a separate assessment of compliance with CPSS/IOSCO standards for this Principle (although the CNVM self assessment did so). The clearing system is subject to oversight by CNVM and NBR. The rules on clearing and settlement cover trade finality, matching and settlement on a DVP basis. The system could be strengthened by auditing the adequacy of the Guarantee fund and by allowing settlement for the Sibiu Exchange through the NBR. Cooperation between the different parties and the regulatory authorities should be enhanced.

Recommended action plan and authorities' response

Table 2. Recommended Action Plan to Improve Implementation of the IOSCO Principles

Principle	Recommendation
Principle 1	Enhance cooperation with other regulatory authorities, establish joint task forces for specific banks or groups of banks that are important in the market and settlement system; institute joint inspections; establish common rules for the selling of similar investment products.
Principle 2	Strengthen immunity provisions to include staff and further protect Commissioners; develop more transparent process for drawing up short list of Commissioners; ensure accounts are subject to external audit annually; include accounts in published annual report; continue to oppose any diminution in budgetary independence.
Principle 3	Seek more flexibility in the Budget
Principle 4	Seek statutory (or adopt alternative requirement to consider costs of regulation; enhance feedback after consultations; introduce peer review of inspections; give more publicity to reasons for sanction decisions; step up discussions with market participants
Principle 5	CNVM should consider a more extensive register of staff interests in securities
Principle 8	Undertake a full review of inspection and investigation powers with a view to defining their scope and content
Principle 9	Seek amendment to the law to clarify that unauthorized investment business a criminal offence.
Principle 10	Adopt and document a risk assessment and risk mitigation measures; identify key regulatory requirements and focus inspection process on compliance with those measures; move away from a "police and punish" approach to compliance and towards joint discussion with regulated entities of risks and their mitigation.
Principle 11	Remove requirement to have an MoU before cooperating with a foreign regulatory authority who is not a Member State (if such a requirement appears to be in place) ; remove requirement for prior approval by CNVM before a recipient authority passes information to a another authority.
Principle 13	Seek legal advice on whether the legal provisions actually provide the power to conduct investigations on behalf of foreign regulatory authorities; seek amendment to the CNVM Statute that makes international co-operation an objective of the CNVM.
Principle 16	There should be further discussions with accountancy firms to step up the quality of accounting and auditing.
Principle 17	Seek an amendment to Regulations to cover churning, appropriate trading and underwriting.
Principle 18	Amend Regulations to require custodians to be in a separate legal entity from fund managers (or introduce special safeguards to protect independence); consider amending Regulations to ensure that material changes to CISs should be subject to the approval of investors.
Principle 19	Discuss with market participants, ways of reducing cost and burden of rules on advertising.
Principle 20	Discuss with other regulators an appropriate method of valuing illiquid instruments.

Principle	Recommendation
Principle 21	Introduce a requirement that intermediaries should disclose their disciplinary history to investors, at least on request; review the authorization provisions in the Law 297 with a view to making them clearer to follow.
Principle 22	Introduce a requirement for mandatory reporting of sharp falls in capital or reduction below 120 per cent of minimum.
Principle 23	Introduce requirement to make intermediaries obtain a bank letter acknowledging that a client account cannot be used to offset the intermediaries' liabilities; require intermediaries to undertake daily reconciliations of client accounts; require intermediaries' complaints procedures to include assessment of the complaint by a person other than the one complained about and an appeal to the CEO or other senior officer.
Principle 24	The contingency plan for implementing the power to appoint a trustee should be up to date and tested regularly.
Principle 28	Establish a working party to develop better co-operation between exchanges
Principle 30	Assist the Sibiu Commodities Exchange in securing settlement in central bank money through the NBR payments system.

Authorities' response to the assessment

116. **The authorities do not accept that there is any compromise to the independence of the Commission,** pointing out, quite rightly that the practice of Parliamentary appointment can give a high level of independence. The CNVM do not comment on the practice of allocating nomination rights according to political party strength, which is the basis of the concern o the assessor. The authorities have welcomed the recommendation on enhanced budgetary independence.

117. **The authorities are not convinced that the legal structure creates ambiguities** and suggest that, taken together, the law and Regulations sufficiently define the CNVM powers. The authorities point out that, in some cases, some of the powers are defined in more detail (in some cases in the law and in some in Regulations). They suggest that the position in respect of those powers that are not defined can be inferred from those that are. The authorities have also said that none of the offences created in Law 297 (even those that are specified as criminal offences and may result in imprisonment) are subject to the civil rights protection and that there is no fear of any breach of such rights by preliminary investigations by the CNVM.

118. **The authorities are not convinced that there is a need for enhanced cooperation between domestic authorities**, pointing to their statutory duty to cooperate and the existence of task forces on various aspects of regulation. They do not consider that banks, capital markets positions are sufficient to justify closer cooperation and that the information they can obtain either directly or via the NBR is sufficient and that poor cooperation between exchanges is compensated by bilateral cooperation by the exchanges with the CNVM.

119. **The authorities do not accept that the inadequate implementation of IFRS should affect the rating for Principle 16,** suggesting that the criteria for this principle require only that accounting standards should require a cash flow statement and statement of changes in ownership and that provided the standards are of a high acceptable international quality, it does not matter if implementation is inadequate.**.**

120. **The authorities do not accept that the provisions for custodian independence are inadequate but have accepted the recommendation on CIS valuation and have taken action to address the matter.** A new Regulation was implemented in February 2009.

APPENDIX XI: ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM ISSUES

121. **A detailed assessment of the anti-money laundering (AML) and combating the financing of terrorism (CFT) framework of Romania was conducted in May 2007 and finalized in July 2008 by the Committee of Experts of the evaluation of AML measures and the FT (MONEYVAL).**[42] The assessment was undertaken on the basis of the Financial Action Task Force (FATF) 40+9 Recommendations using the 2004 Methodology.

122. **The assessment report notes significant developments since the last assessment, conducted in 2002. The AML/CFT criminal legal framework and the preventive regime is quite comprehensive; Romania has moved to a full "all crimes" approach and extended criminal liability to legal persons.** The money laundering offense is in line with the FAFT standard and the UN Conventions, although the number of convictions is low; the offence of terrorist financing has been introduced in 2004, but some issues of consistency with the FATF standard remain. Proceeds of crime are subject to compulsory seizure and confiscation and equivalent value confiscation is possible. The Romanian financial intelligence unit, the National Office for the Prevention and Control of Money Laundering, a member of the Egmont Group since 2000, is quite effective and undertakes a leading role in the coordination and implementation of the AML/CFT system, although staffing problems are noted to cope effectively with its supervisory responsibility. Law enforcement and prosecutorial authorities are adequately empowered and competent to investigate and prosecute money laundering and terrorist financing offenses.

123. **The major sources of illegal funds in Romania are related to tax evasion and fraud, offences related to the patrimony of legal companies and to the illegal use of electronic means of payments.**

124. **AML/CFT preventive measures apply to the full range of financial institutions envisaged under the FATF standard.** Although the provisions in place address most of the customer due diligence requirements a number of gaps are notable in certain key areas (beneficial ownerships, Politically Exposed Persons-PEPs and correspondent banking relationships). Among other shortcomings that were identified were the lack of explicit provisions to require financial institutions to pay special attention to business relationships and transactions with persons from countries that do not or insufficiently apply the FATF Recommendations. The NBR is responsible for supervision of the banking industry; the CSA supervises the insurance sector and the CNVM supervises the capital market. The supervisory regime should be strengthened in the area of insurance and money and value transfer service

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[42] MONEYVAL is the FATF-style regional body of which Romania is a member. The assessment was completed within the Board's prescribed 18-month window within which an AML/CFT assessment can be associated with an FSAP or OFC assessment.

providers (MVT) services, the lack of licensing procedures is noted for money remittance services.

125. **At the time of the assessment, all FATF-designated financial businesses and professions (DNFBPs) were included in the AML/CFT framework.** The report however notes that also several other businesses are subject to the AML/CFT regime, and that the activities and scope of these businesses are too broad and should be clarified. DNFBPs are subject to the same AML/CFT requirements as the financial institutions; the deficiencies noted in the above preventive measures therefore also apply to DNFBPs. A specific recommendation is made for the authorities to consider implementing adequate legal or regulatory measures to prevent criminals from holding or being beneficial owners of casinos.