The Transformation of the Romanian Financial and Banking Sector

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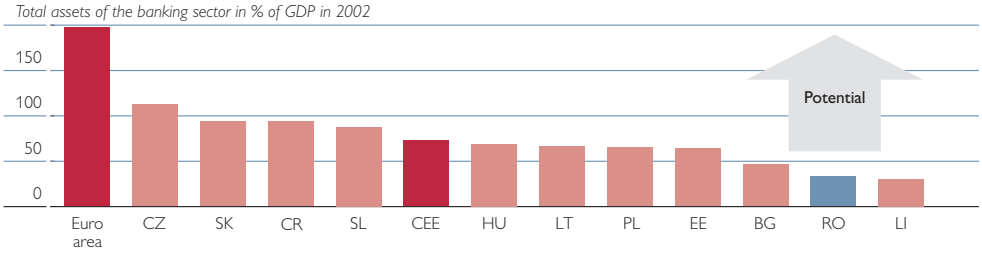
Compared to other transition countries, the Romanian banking sector and stock exchange are small. However, Romanian banking has been on the catching-up route since the economic crisis the country experienced in 1997–99. Banking reform has achieved considerable progress since then. Today a major share of the assets of the sector is in foreign ownership, with Austrian banks in prominent positions. As a consequence of the swift credit expansion in 2002 and 2003 as well as of continuing structural problems and weaknesses, the risk potential has risen recently, though. Overall, given the size of the country, the Romanian financial sector bears an impressive growth potential, which, however, can only be tapped if the authorities persevere with their reform efforts.

Introduction

Compared to other countries, the Romanian banking sector and stock exchange are small. According to recent estimates, only about one-third of the population is reported to possess a bank account and less than one-fifth of Romanian enterprises take out bank loans. In terms of loan volume to GDP, Romania accounts for less than half of the average level of Central European transition countries, which themselves are still substantially behind the EU-15. Currently, banking intermediation (in terms of assets to GDP or credit to GDP) in Romania may be comparable to the level witnessed in Austria in the early and mid-1960s. However, Romanian banking activities have been on the catching-up lane since the crisis the country experienced in 1997–99. Today a major share of the assets of the banking sector is in foreign ownership, with Austrian banks in prominent positions. As a consequence of the swift credit expansion in 2002 and 2003 as well as of continuing structural problems, the risk potential has risen recently, though.[1] Notwithstanding recent dynamic growth, non-bank intermediation has remained on a very modest level of development in Romania. Overall, given the size of the country, the Romanian financial sector bears an impressive growth potential. Chart 1 gives a comparative illustration of this potential with respect to the banking sphere.

Chart 1

Banking Sectors: Degree of Intermediation



Source: Bank Austria Creditanstalt.

[1] *IMF (2002, p. 19); Banca Națională a României (2003c, p. 31); Economic Intelligence Unit (2003); National Bank of Greece S.A. (2003, p. 8).*

Banking and Financial Crises and Reform Measures

Until 1998 the Romanian commercial banking system was overwhelmingly state-owned. Credit institutions granted loans to a largely unrestructured real sector dominated by big, inefficient state-owned factories, subject to quasi-automatic refinancing by the Romanian central bank, which conducted an accommodative monetary policy. Inflation rates were very high. For example, CPI inflation (year-end) amounted to 62% in 1994 and 57% in 1996. The Bucharest Stock Exchange was established in 1995, the over-the-counter market (RASDAQ) in 1996. The latter traded shares created in the wake of Romania's mass privatization program. The National Securities Commission was also set up in the mid-1990s. Following early years of rapid expansion, stock values and turnover in both markets were badly affected by repercussions of the turmoil in Asian and Russian financial markets in 1997 and 1998. Supervision, initially at a rudimentary stage, improved only slowly.

After the election of a more strongly reform-minded government at end-1996, serious macroeconomic stabilization policies and structural reforms were initiated. The Romanian central bank (Banca Naţională a României, BNR) tightened its hitherto lax banking supervision. The quasi-automatic central bank refinancing of loans was discontinued. A number of large state-owned credit institutions thereupon experienced serious financial difficulties and could only be kept afloat with sizeable public financial assistance. This goes particularly for Bancorex, the former state foreign trade bank, and for Banca Agricola, an institution specializing in the financing of agriculture.

In the first half of 1998 the government carried out important legal reforms: a new central bank law and a new banking law were passed, which strengthened the independence of the BNR and its role in banking supervision. At the same time, the new bank insolvency law encountered difficulties in application. Although in 1998 Romanian bookkeeping standards were largely adjusted to French standards, which resemble IAS, some important differences have remained; for instance, loan-loss provisioning requirements have been weaker and consolidated reporting is not obligatory in Romania. The Bank Deposit Guarantee Fund was established earlier in 1996.

Given the strong initial contractionary effect of the reform efforts, in late 1997 and in 1998 the government partly reverted to stop-and-go macroeconomic policies. The effects of the Russian crisis of 1998 aggravated the instable economic situation, which contributed to runs on both abovementioned banks, triggering the collapse of Bancorex in 1999. By the time, more than two-thirds of Bancorex's loans were reported to be nonperforming. The authorities decided to shut down the bankrupt bank. Parts of Bancorex were liquidated, some dubious assets were transferred to the consolidation agency AVAB, created the year before. The BNR absorbed Bancorex's liabilities to foreign-owned banks. The remaining parts of Bancorex were merged with the state-owned Banca Comercială Română, which thus became the largest Romanian commercial bank. Some smaller credit institutions also collapsed in 1999 and 2000. By contrast, Banca Agricola survived due to re-

peated recapitalization and restructuring measures taken by the authorities. Banca Agricola also ceded large nonperforming claims to the consolidation agency.

The financial cost of the various recapitalization and public support schemes for the institutions in distress amounted to about 10% of GDP.[2] The shock of the collapse of Bancorex made banks generally more prudent in lending; at the same time portfolios were restructured in favor of lower-risk assets (including treasury bills). In late 1999 the BNR established an early warning system for its supervisory authorities: Credit institutions are assessed and ranked on a scale of 1 to 5, institutions that rate 5 being considered the weakest performers. The system incorporates regulations for troubled banks and specifies the point at which a bank's license is to be withdrawn and bankruptcy proceedings triggered. The creation of the Credit Information Bureau at the BNR in December 1999 aims at enhancing transparency for lenders. Thus, the legal and institutional environment for banking in Romania had improved considerably by the end of the 1990s.

With hindsight, 1999 proved to be a kind of structural turning point for the Romanian economy. The same year, the authorities carried out the first privatizations of major Romanian banks to foreign strategic investors: A majority stake in Banca Română pentru Dezvoltare ("Romanian Development Bank") was sold to Société Générale. General Electric Capital and Banco Português de Investimento purchased the majority of Banc Post. Later on, parts of Banc Post were acquired by EFG Eurobank Ergasias (of Greece). In addition, a number of smaller credit institutions were liquidated in recent years. After considerable delay and some further injections of resources, the authorities in April 2001 succeeded in selling Banca Agricola to Raiffeisen Zentralbank (RZB, which received a majority share) and the Romanian-American Investment Fund. In May 2002 Banca Agricola was merged with the Romanian branch of RZB and renamed Raiffeisen Bank. Later, RZB took over the share of the Romanian-American Investment Fund and now holds over 99% of the credit institution. Restructuring Raiffeisen Bank has not been easy, since good clients had been lost and trust had to be regained. Since the merger of 2002, losses have been shrinking, the breakeven point is expected to be reached in 2003–04. Raiffeisen Bank focuses on corporate business, but is also expanding retail activities and trade finance. Based on its ownership of about 210 former Banca Agricola branches, Raiffeisen Bank is aiming to become a leading universal bank in the Romanian market.

Notwithstanding progress in banking reforms, a number of serious unsolved problems remained. Capital markets, more particularly the poorly regulated investment funds sector, were destabilized by the collapse of the country's largest fund, Fondul Naţional de Investiţii (FNI), in May 2000. The collapse was reportedly caused by mismanagement and fraudulent practices. But the erosion of trust in this case extended much fur-

[2] *Compared to other transition countries, this corresponds to a medium level. Public financial cleaning-up costs for the banking sector (as a percentage of GDP) in Poland have been below those in Romania; respective costs in the Czech Republic, Hungary and Bulgaria have been above Romanian costs (Isărescu, 2003).*

ther, since the FNI collapse had repercussions on the state-owned savings bank Casa de Economii şi Consemnatiuni (CEC); the latter was a shareholder in FNI's management company, had invested in FNI certificates and issued a guarantee for investments in the Fund. The chief FNI manager left the country and several officials of the National Securities Commission were arrested. It turned out that for years the FNI had been little more than a pyramid scheme. Weaknesses of the regulatory and institutional framework were one of the root causes of this major scandal.

The FNI collapse put pressure on the largely unregulated so-called "popular banks," which functioned as credit cooperatives without deposit insurance. The swift proliferation of partly dubious deals led to massive undercapitalization in this sphere. The largest institution of this type, the Banca Populara Română, closed its doors in June 2000 after being unable to meet depositor demands. An emergency ordinance issued in July spelled out the central bank's powers of licensing, supervising and monitoring credit cooperatives. The licensing of new popular banks was temporarily suspended.

Economic Recovery and Expansion of Banking Activities

In 2000 the authorities embarked on prudent macroeconomic stabilization efforts. Some political instability was overcome by the election of a new government at end-2000, which sustained the stabilization and reform policies. The same year, the external economic situation, particularly in the EU, brightened and the decade-long conflict in neighboring former Yugoslavia drew to an end. Inflation and budget deficits slowly came down. But price rises were still reaching levels exceeding those of neighboring countries. With the strengthening of the economic upswing in 2001 and the following years (see table 1, real GDP 2001: +5.7%, 2002: +4.9%, 2003 (preliminary): +4.7% year-on-year), market participants gained more confidence and credit institutions expanded their activities speedily (although proceeding from a low point of departure).

Certain successes in real sector structural reforms (for example the sale of the country's biggest steel producer, Sidex, to a British-Indian investor in early 2002) supported the development. Private investment

Table 1

Romania: Macroeconomic and Monetary Indicators

Year	GDP growth (real)	CPI inflation (year-end)	Exchange rate (ROL/USD, year-end)	Exchange rate (ROL/EUR and ECU, year-end)	Broad money (M2, year-end)	Broad money (M2, year-end)	Budget balance (general government)	Current account balance	Gross foreign exchange reserves (excl. gold, year-end), EUR (ECU)	Gross foreign debt (year-end)
	%		ROL		change in %	% of GDP			million	% of GDP
1996	4.0	56.9	4,035	5,182	+66.0	27.9	−3.9	−7.3	426	23.6
1997	−6.1	151.4	8,023	8,859	+104.9	24.6	−4.6	−6.1	1,987	26.9
1998	−4.8	40.6	10,951	12,814	+48.9	24.8	−5.0	−6.9	1,175	23.5
1999	−1.2	54.8	18,255	18,345	+45.0	24.6	−3.5	−3.6	1,519	25.5
2000	2.1	40.7	25,926	24,142	+38.0	23.0	−3.7	−3.7	2,682	28.6
2001	5.7	30.2	31,597	27,881	+46.2	23.2	−3.5	−5.5	4,445	29.4
2002	4.9	17.8	33,490	34,919	+38.1	24.9	−2.7	−3.4	5,877	30.4
2003[1]	4.7	14.1	32,595	41,117	+32.6	25.1	−2.4	−5.8	6,399	31.3

Source: BNR, WIIW, IMF, EBRD, OeNB.

[1] *Preliminary data or estimates.*

Table 2

Romania: Banking Sector-Related Indicators

Year	Number of banks (of which foreign-owned, year-end)	Total assets of banking sector	Share of state-owned banks in total banking sector assets	Deposit rate (average, year-end)	Lending rate (average, year-end)	Deposits of the nonbank sector (year-end)	Credit volume (year-end)	Loans to enterprises	Share of bad loans in total loans	Capital adequacy (capital/risk weighted assets ratio, year-end)	ROA (net)	ROE (net)
		% of GDP	*%*	*% p.a.*		*% of GDP*	*change in %*	*% of GDP*	*%*			
1996	40 (19)	..	..	38.1	55.8	..	..	..	48.0	14.0	..	..
1997	43 (23)	..	..	51.6	63.7	..	+82.1	..	56.6	13.6	..	..
1998	45 (25)	..	71.0	38.3	56.9	..	+95.2	16.6	58.5	10.3	0.2	1.3
1999	41 (26)	..	46.8	45.4	65.9	..	+26.8	10.6	35.4	17.9	−2.0	−15.0
2000	41 (29)	29.2	46.1	32.7	53.5	20.0	+11.5	9.3	6.4	23.8	1.5	12.5
2001	41 (32)	30.5	41.8	23.4	40.6	20.4	+26.8	10.1	3.9	28.8	3.1	21.8
2002	39 (32)	31.6	40.4	12.8	28.9	21.7	+39.8	11.9	2.7	24.6	2.7	19.7
2003	38 (29)[1]	..	38.2[1]	9.9[2]	25.1[2]	..	+50.4	..	11.0[3]	23.2[2]	2.4[4]	16.9[4]

Source: BNR, IMF, EBRD.
[1] *August 2003.*
[2] *May 2003.*
[3] *End-June 2003, after revision (see text).*
[4] *End-March 2003.*

in export-oriented consumer goods industries gathered momentum and triggered some gains in competitiveness. Small and medium-sized enterprises (SMEs) multiplied and became an important and dynamic component of the economy. Still, the restructuring of large state-owned and often inefficient and loss-making industries and particularly of the energy utilities remained sluggish overall and was causally related with the chronic existence of extensive payment and tax arrears.[3] Large-scale privatization projects slowed down in 2003. Although the Stand-by Arrangement reached with the IMF in October 2001 was subject to intermittent slippages, it has nevertheless made progress.[4]

The assets of the banking sector grew from 29.2% of GDP in 2000 to 31.6% in 2002. This corresponds to around EUR 15.1 billion. Loans to enterprises increased from 9.3% of GDP to 11.9% in 2002 (table 2). The year 2002 witnessed a real corporate loan expansion of 29%. In 2003 the speed of expansion accelerated to 49%, which can in fact be considered a credit boom. Lower returns on government debt paper, on deposits with the BNR or on arbitrage transactions on the forex market contributed to the relatively enhanced attractiveness of lending. The increase in loans focused on private and privatized firms, corporate clients as well as SMEs, whereas lending to state-owned firms has been contained.

The maturity structure of loans moved somewhat from predominantly short-term to medium-term, which inter alia reflected increased demand for financing investment projects. Currently about half of all bank loans are short-term (that is with less than one year maturity), the other half is medium- and long-term. Consumer credits, particularly mortgage loans and loans for the purchase of consumer durables, have grown extremely fast and even multiplied, however from a basis of almost zero. Although real deposit interest rates are still in negative territory, deposits of nonbanks have grown from 20.0%

[3] *Daianu (2002).*
[4] *Wagstyl and McAleer (2003).*

of GDP in 2000 to 21.7% in 2002. Bank accounts have remained largely short-term, which reflects some lingering lack of savers' trust in banks. The rapidity of the credit expansion has triggered concern on the part of the BNR management as well as the IMF, given the structural weaknesses of the economy.[5] Risk analysis and management capacities of credit institutions still seem to be insufficient.[6]

Furthermore, the share of large loans denominated in foreign currencies has been on the rise. Whereas foreign currency loans had made up almost 60% of the credit volume at the beginning of 2001, they comprised more than 70% two years later. Among the foreign currencies in which the loans are denominated, the euro has gained weight. Whereas in early 2001, the common European currency had accounted for about one-third of banks' foreign exchange loans, in mid-2003 about half of these loans was denominated in euro, the other half was denominated in U.S. dollar.[7] Since it is not at all clear whether borrowers have substantial hard currency proceeds, the exchange rate risk can turn into a possible credit risk for banks. Thus, a marked slide of the leu could pose a problem for credit institutions. The Romanian exchange rate regime is a managed float; put more precisely the BNR conducts a steady and controlled nominal devaluation of the Romanian leu against a reference currency basket (up to end-2003: 60% euro, 40% U.S. dollar weights; as of 2004: 75% euro, 25% U.S. dollar weights). The goal is a trade-off between reducing inflation and maintaining international competitiveness. The inflation rate, albeit on the decline, came to 17.9% in 2002 and 14.1% in 2003 (end year), which is still higher than in Romania's neighboring countries, not to speak of Central European countries.

The current account deficit has also been relatively high. After a decline in 2002 (to 3.4% of GDP) it widened again in 2003, on the back of increased lending and rising wages, triggered by a sizeable hike of the minimum wage at the beginning of the year. According to preliminary data, the imbalance rose to 5.8% of GDP in 2003.[8] On average, between one-half and two-thirds of the current account shortfall have been financed by foreign direct investment. Real appreciation and loss of competitiveness do not appear to be a problem so far, given that in recent years the CPI-based real effective exchange rate has appreciated only slightly and that the ULC-based real effective exchange rate has steadily depreciated. In fact, this would imply an improvement in competitiveness. The fact that the leu again depreciated against the euro in the last quarter of 2003 (while remaining more or less stable against the declining U.S. dollar) was certainly not an impediment to Romania's competitiveness. Gross foreign debt, while relatively low, has been on a slight rise in recent years (coming to 29% of GDP in 2000 and 31% in 2003). Expanding gross foreign exchange reserves reached EUR 6.4 billion in December 2003 (three and

5 *Romania: Ministry of Finance, Banca Naţională a României (2003e, p. 56).*

6 *Economic Intelligence Unit (2003); National Bank of Greece S.A. (2003, p. 8).*

7 *One of the reasons for the evolution of the foreign currency structure was households' increasing resort to bank borrowings for purchasing cars and real estate, the prices of which are set in euros (Banca Naţională a României, 2003d, p. 32).*

8 *Banca Naţională a României (2004b, p. 1).*

a half import months). Their expansion was, inter alia, driven by the issuance of a EUR 700 million eurobond in the summer of 2003. The full liberalization of short-term capital movements is not planned to take place before Romania's EU accession (envisaged for 2007).

On the other hand, the increase of foreign currency loans has not only affected trade and current account balances. It has also contributed to putting downward pressure on the leu. This corresponds to a reversal of the previous situation, which had seen capital flow-induced appreciation tendencies of the Romanian currency. Starting in 2002, the BNR has attempted to rein in the growth of foreign currency loans. For instance, in November 2002 reserve requirements were adjusted upwards for foreign currency deposits. The IMF has repeatedly advised the authorities to increase capital requirements for foreign currency loans.[9] In 2003 the dynamics of credit expansion changed and leu loans grew more quickly than foreign exchange loans.[10] The BNR recently tightened its monetary stance by raising the benchmark overnight deposit rate in three steps between August and November 2003, each time by 100 basis points, to 21.25%. In late 2003 the BNR also intervened in the foreign exchange market to support the domestic currency. In December the BNR announced new administrative measures (credit limits per borrower) to curb credit expansion. The measures were introduced in February 2004. It remains to be seen what cushioning effect this will have on bank lending. As of yet, the public does not seem to be losing appetite for further loans.[11]

Financial Consolidation Process and Growing Importance of Foreign-Owned Banks

The slow consolidation process of the Romanian banking sector continued in recent years. The total number of credit institutions (including foreign bank branches) declined from 41 at end-2000 to 38 in August 2003. Three have remained in majority state ownership: Banca Comercială Română (BCR, the largest bank, accounting for around 30% of the country's bank assets), the savings bank CEC (the third-largest bank) and Eximbank (Banca de Export-Import a României).[12] As of August 2003, the state held majority stakes in institutions comprising 38% of bank assets of the country (table 2), 31% of nongovernment credit and 42% of nonbank clients' deposits. The state-owned banks' relative strength in the sphere of deposits is due to the prominence of the savings bank Casa de Economii şi Consemnatiuni in this field.[13]

29 banks (including eight branches) or 58% of bank assets are owned by foreigners. Foreign-owned credit institutions account for 65% of nongovernment credit and 55% of nonbank clients' deposits. Their strong credit

9 *IMF (April 2003b, p. 15).*

10 *However, growth of euro-denominated loans outstripped growth of leu-denominated loans. For example, in the 12 months to December 2003, euro bank loans expanded by 94% in nominal terms, while leu bank loans increased by 63% and U.S. dollar loans by 14%. Total foreign currency-denominated loans grew by 48% (in nominal terms), Banca Națională a României (2004a, p. 62).*

11 *Hunya (2004, p. 73).*

12 *For the first two mentioned banks, see table 3.*

13 *CEC commands a countrywide network of more than 1,600 branches (The Banker, 2004, p. 60).*

position largely goes to previously state-owned banks equipped with large nationwide branch networks taken over by foreigners through which these banks lend to domestic firms and consumers. The increased presence of foreigners has stimulated competition in the sector. Among the most important foreign-owned credit institutions are the Romanian Development Bank (the second-largest bank as measured by assets, owned by Société Générale), Raiffeisen Bank (the fourth-largest credit institution), ABN Amro Bank (ranked fifth), ING Bank Bucharest, Banc Post (see above), Alpha Bank Romania, Citibank Romania, Bank Austria Creditanstalt/HVB Bank, and UniCredit Romania (see also table 3).

Bank Austria Creditanstalt/HVB Bank was founded in 1997. It has focused on corporate and international business and has increasingly served SMEs and retail clients. In 2002 it successfully arranged an issue of bonds of the large power company Thermoelectrica. Bank Austria Creditanstalt/HVB Bank has been able to attract a considerable amount of new deposits, its assets and capital have expanded and profits have developed favorably. The institution intends to open around five branches every year until 2005 and to attain a 5% market share by the same year.[14] The third Austrian bank active in Romania is Österreichische Volksbanken-AG, which established Volksbank Romania in 2000. The latter deals primarily with smaller firms and retail clients. Measures have been taken to improve its cost structure. Volksbank Romania is reported to post a profit for the first time in 2003. The outlook for the bank seems quite favorable. *Austrian* investors account for the largest share – namely 40% – of total registered statutory foreign capital (which must not be confused with total foreign equity capital) in the Romanian banking sector, followed by Greek (14%), French (11%), Dutch, American and Italian investors.[15] Austrian credit institutions have inter alia benefited from their know-how acquired in many other Central and Eastern European transition economies.

Six banks together accounting for a mere 4% of banking assets are in private Romanian hands. These private Romanian banks thus appear to be sandwiched between the large state-owned banks on the one hand and foreign-owned credit institutions on the other. Despite intensive efforts, the authorities have so far not found a strategic investor for BCR. Recently it was agreed to sell a quarter of BCR's share capital to the EBRD and the IFC (12.5% each); 8% of BCR is reserved for the bank's employees. While EBRD and IFC are expected to stimulate restructuring of the bank, the authorities hope to find a big investor to take over at least 51% of Banca Comercială Română by 2006.[16] Both CEC and Eximbank are still deemed to be in need of substantial restructuring measures; currently a restructuring program is going on in CEC. The authorities intend to privatize CEC and Eximbank in 2005–06.[17]

The collapse of two smaller credit institutions in 2002 – Banca Română de Scont ("Romanian Discount Bank")

[14] *The Banker (2003b, p. 108).*

[15] *Banca Națională a României (2003a).*

[16] *The HVB banking group has expressed interest in acquiring BCR. – Adevarul Online (2004a).*

[17] *National Bank of Greece S.A. (2003, p. 10).*

Table 3

Romania's Top Ten Commercial Banks (as of September 30, 2003)[1]

	Bank	Total assets	Total share capital of bank	Major owners (share in total registered capital >5%)	Aggregate share of registered capital owned by foreigners
		ROL billion			%
1	Banca Comercială Română S.A.	164,907	7,925	State (75), EBRD (12.5), IFC (12.5)[2)]	25.0[2]
2	Banca Română pentru Dezvoltare – Groupe Société Générale S.A.	73,584	4,181	Société Générale (51.0), State (33.2)	58.4
3	Casa de Economii şi Consemnatiuni S.A.	37,843	1,497	State	0.0
4	Raiffeisen Bank Romania S.A. (former Banca Agricola)	35,003	6,961	Raiffeisen International Beteiligungs A.G. (99.2)	99.2
5	ABN AMRO Bank Romania S.A.	32,538	740	ABN AMRO Bank N.V. Netherlands (99.7)	99.7
6	ING Bank N.V. – Bucharest Branch	25,564	320	ING Bank N.V. Netherlands (100)	100.0
7	Banc Post S.A.	22,323	665	EFG Eurobank Ergasias S.A. (36.3), State (30), Banco Português de Investimento S.A. (17.0), General Electric Capital Corp. (8.8)	62.1
8	Alpha Bank Romania S.A. (former Bucharest Bank)	18,441	1,452	Alpha Romanian Holdings A.E. Greece (53.9), Alpha Bank A.E. Greece (41.5)	100.0
9	Citibank Romania S.A.	17,086	641	Citibank Overseas Investment Corporation (99.6),	100.0
10	Banca Comercială „Ion Tiriac" S.A.	16,347	1,047	Ion Tiriac Group (72.3), of which: Ion Tiriac (28.3), REDRUM T.V. International B.V. (43.4); EBRD (5.7)	83.0

Source: Banca Naţională a României.

[1] According to prudential reports.

[2] As of January 1, 2004.

and Banca de Investiţii şi Dezvoltare ("Investment and Development Bank") – revealed the weakness of their ownership structures and their susceptibility to fraud.[18] Recurrent bank failures and feeble governance practices have contributed to subduing confidence in the system. However, the initiation of bankruptcy proceedings against Banca Columna in March 2003 may have marked the completion of a cleaning-up phase of the sector undertaken by the authorities.[19] Still, increasing competitive pressure may come to threaten the viability of some other small banks, including those left in Romanian private ownership, but possibly also some foreign-owned ones.

The BNR has been striving lately to further improve banking supervision rules and practices. Loan classification and loss provisioning rules were tightened in early 2003. Substandard loans were included in the category of non-performing loans, as is good international practice. This moved Romanian accounting rules nearer to IAS. Today the BNR can be said to possess a solid banking supervision framework that is (largely) compliant with the majority of the Core Principles for Effective Banking Supervision.[20] Due to increasing competition, interest rate spreads have been slightly declining, but they are still high. (In 2002 spreads between deposit and lending rates amounted to approximately 16%, in July and December 2003 they came to 14.5%.) Banks' liquidity is generally satisfactory. Given the economic upswing and the wave of credit expansion, the profitability of Romanian banks has

18 *The Banker (2003c, p. 113).*

19 *"Thus, as of that moment, all banks that were insolvent or had negative net worth have been removed from the system." - Banca Naţională a României (2003b, p. 81).*

20 *IMF (2003a, p. 18).*

steadily risen in recent years, although it slightly declined again in 2002 and early 2003 in the wake of the narrowing of spreads and increased provisions (see table 2). Rising competition is also pushing banks to extend their activities to insurance, leasing and asset management markets.

The capitalization of banks in Romania is quite high. In May 2003, capital adequacy stood at a very good 23%. This is partly the result of the ongoing gradual adjustment of minimum capital requirements to around EUR 10 million. It is also attributable to rising competition, which pushes local banks to attract additional funding by boosting their capital.[21] The share of nonperforming loans in total loans was reported to have fallen to only about 2% at the beginning of 2003. However, this share has recently been revised upward to 11% (June 2003), as a result of the tightening of provisioning rules.[22] Such a level still seems to be manageable for a transition economy. Romania intends to come into full compliance with International Accounting Standards by 2005. As of early 2003, nine banks (including BCR, Romanian Development Bank, BACA-HVB Bank, Citibank Romania) reported their financial statements according to IAS. Of course there is a likelihood that in an economic upswing like the one Romania currently witnesses, doubtful loans pose a lesser problem, only to loom larger once business prospects start to deteriorate.

A most recent incident demonstrates the authorities' proneness to intermittent slippages. In March 2004 the government approached a number of Romanian banks, including foreign-owned ones, to find out whether they would be prepared to grant long-term loans to the country's National Housing Agency and National Investment Company to finance the construction of thousands of new apartments and sports halls. After the credit institutions had shown their reluctance to fund the program, pointing to the likely high risk involved in such an undertaking, the cabinet issued an emergency ordinance ordering CEC to finance the project (coming to ROL 6,500 billion or approximately EUR 185 million). The decree also vested CEC with a special dispensation to ignore single client exposure regulations which would be violated in this case. The government's decision, which appears to be linked to the campaign for the November 2004 general elections, was sharply criticized by independent observers and the EU's representative in Bucharest as being incompatible with Romania's banking laws and EU legislation. Shortly afterwards the government seemed to have backed off and an official stated that the authorities intended to revise the controversial decree.[23]

Despite the rapid growth of the trading volume on the Bucharest Stock Exchange in recent years (about 150% from early 2002 to mid-2003) as well as on the RASDAQ (about 75% over the same period), liquidity remains poor on both exchanges, with a limited number of stocks accounting for the lion's share of the transaction volume. The combined capitalization of both markets came to 11% of GDP in mid-2003, which is about half

[21] *Adevarul Online (2004b).*

[22] *IMF (2003a, p. 5).*

[23] *Associated Press Newswires (2004), Reuters News (2004).*

that of Central European countries. The fixed-income market is still at an early stage of development and consists mostly of government securities and a small number of municipal bonds. This reflects a lack of secondary market trading.[24]

Key Challenges and Prospects

All in all, financial intermediation in Romania – notwithstanding expansionary tendencies – is still at a comparatively modest level. Provided that framework conditions do further adjust, there remains ample growth potential in the medium and long term, just as the growth and catching-up potential of the entire Romanian economy remains large and promising. As a sign of hope and optimism, in mid-October 2003 Romania successfully concluded its IMF Stand-by Arrangement – the first such program that the country fully carried through. The authorities are reportedly aiming to conclude a new agreement with the Fund soon. On the other hand, in its latest progress report on Romania (of November 2003) the European Commission did not yet certify the country as a "functioning market economy" – indicating that there were still substantial reform needs. Moreover, the European Parliament recently (February 2004) pointed to shortcomings in Romania's judicial system and other structural problems. To give just one illustration of the scope for catching up in the financial sphere: With 22.4 million inhabitants and a territory of approximately the size of former West Germany, Romania is the second-largest EU accession country after Poland.[25] If banking sector assets *per capita* in Romania reached the same level as they presently have in Poland, this would imply a medium-term expansion potential of close to 400%.

Apart from the above-mentioned exposure to a possible marked depreciation of the domestic currency and the inherent credit risk, some of the most pertinent risks/problems for the Romanian financial and banking sector appear to be:

- the danger of a mismatch between increasingly medium-term loans and predominantly short-term deposits;
- insufficient risk analysis and management capacities at banks;
- the weakness, limited efficiency and transparency of capital market development and the modest level of supervision;
- the persisting lag in restructuring the real sector, particularly state-owned enterprises, sluggish privatization, weak corporate governance, loss-prone firms, lack of financial discipline;
- continuing limited contract enforcement capacities and de-facto recoverability of claims, inefficient and partly intransparent insolvency procedures, inadequate creditor protection;
- legal complexity and the generally weak rule of law, which may easily fall victim to government emergency decrees;
- despite some progress still unfavorable overall investment climate, still sprawling bureaucracy, pervasive corruption.[26]

[24] *IMF (2003a, p. 19–20).*

[25] *As of 1 May 2004 Poland became member of the European Union.*

[26] *For the last three points see OECD (2002); EBRD (2002, p. 186–187); EBRD (2003, p. 180–181); IMF (April 2003b, p. 17).*

The overarching Romanian national goal of joining the EU as soon as possible (now scheduled for 2007) may be seen as a catalyst giving a clear overall direction and reinforcing reform efforts of the authorities.

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