



# ROMANIA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2018

This paper on Romania was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with Romania. It is based on the information available at the time it was completed on May 16, 2018.

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# ROMANIA

## FINANCIAL SYSTEM STABILITY ASSESSMENT

May 16, 2018

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This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Romania in November 2017 and January 2018. The FSAP findings were discussed with the authorities during the Article IV consultation mission in March 2018. More information on the FSAP may be found at <http://imf.org/external/np/fsap/fssa.aspx>

- The FSAP team was led by Erlend Nier and included deputy chief Froukelien Wendt, and Hee Kyong Chon, Ernesto Crivelli, Armand Fouejieu, Mario Mansilla, Tjoervi Olafsson, Nadine Schwarz, Maral Shamloo, Giovanni Ugazio (all IMF); Laurent Gonnet (World Bank mission chief), Raquel Letelier (World Bank deputy chief), and Juan Buchenau, Andrea Dall'Olio, Olena Koltko, Tanya Konidaris, Cedric Mousset, Natalie Nicolaou, Madalina Pruna, Simon Walley and Peter Wrede (all World Bank), as well as Marcel Otten and David Thomas (external experts).
- The FSAP team met with the National Bank of Romania (NBR), the Ministry of Public Finance (MoPF), the Financial Supervisory Authority (ASF), the Bank Deposit Guarantee Fund (FGDB), the Financial Intelligence Unit (FIU), the Competition Authority, the Consumer Protection Agency, the Bucharest Stock Exchange (BVB), and representatives of banks, investment firms, insurance companies, other financial institutions and industry associations, and representatives of the auditing, accounting and legal professions.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Erlend Nier and Froukelien Wendt, with contributions from the FSAP team members. It draws on a number of Technical Notes and a Detailed Assessment Report on compliance with the Basel Core Principles for Effective Banking Supervision (BCP) that accompany this report.

## CONTENTS

Glossary	4
<b>EXECUTIVE SUMMARY</b>	<b>6</b>
<b>MACROFINANCIAL SETTING</b>	<b>9</b>
<b>SYSTEMIC RISK AND RESILIENCE</b>	<b>10</b>
A. Key Vulnerabilities Facing the Romanian Financial System	10
B. Financial Sector Resilience	13
<b>MACROPRUDENTIAL FRAMEWORK AND POLICIES</b>	<b>16</b>
A. Macroprudential Framework	16
B. Macroprudential Policies	18
<b>SECTORAL SUPERVISION</b>	<b>19</b>
A. Bank Supervision and Regulation	20
B. Financial Market Infrastructures	21
C. Anti-Money Laundering and Combating the Financing of Terrorism	22
<b>FINANCIAL SAFETY NETS AND CRISIS MANAGEMENT</b>	<b>22</b>
<b>FINANCIAL SECTOR DEVELOPMENT</b>	<b>24</b>
<b>FIGURES</b>	
1. Economic Developments 2008–17	26
2. Financial Developments 2008–16	27
3. Network of Balance Sheet Exposures	28
4. Mortgage Lending and House Prices	28
5. External Borrowing and Corporate Leverage	29
6. Macroeconomic Scenarios	30
7. Stress Test Results	31
8. Losses in the Adverse Scenario	32
9. Large Exposure Sensitivity Test	33
10. Funding and HQLA Structures of Romanian Banks	34
11. Regulatory Liquidity Ratios	35
12. NBFL Sector	36
13. Bank-NBFL Contagion Analysis	37

**TABLES**

1. FSAP 2018 Key Recommendations _____	8
2. Selected Economic Indicators _____	38
3. Financial Soundness Indicators _____	39

**APPENDICES**

I. Implementation of 2010 FSAP Recommendations _____	40
II. Stress Testing Matrix (STEM) _____	43
III. Risk Assessment Matrix _____	48
IV. The Systemic Risk Buffer: Design and Impact _____	49

**ANNEX**

I. Report on the Observance of Standards and Codes—Basel Core Principles for Effective Banking Supervision _____	56
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## Glossary

AC	Additional Criteria
ASF	Financial Supervisory Authority
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BIS	Bank for International Settlements
Bps	Basis points
BRRD	Bank Recovery and Resolution Directive
BVB	Bucharest Stock Exchange
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CDS	Credit Default Swap
CET1	Common Equity Tier 1
COREP	Common Reporting
CP	Core Principle
CRD	Capital Requirement Directive
CRR	Capital Requirement Regulation
CSD	Central Securities Depository
DSTI	Debt-Service-to-Income
EBA	European Banking Authority
EC	Essential Criteria
ECB	European Central Bank
EDD	Enhanced Due Diligence
ELA	Emergency Liquidity Assistance
ESRB	European Systemic Risk Board
EU	European Union
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FGDB	Bank Deposit Guarantee Fund
FINREP	Financial Reporting
FIU	Financial Intelligence Unit
FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSD	NBR Financial Stability Department
FSSA	Financial System Stability Assessment
FX	Foreign Exchange
GDP	Gross Domestic Product
GFC	Global Financial Crisis
HQLA	High Quality Liquid Assets
ICT	Information and Communication Technology
IFRS	International Financial Reporting Standards

IRRBB	Interest Rate Risk in the Banking Book
LEU (multiple LEI)	Romanian currency
LCR	Liquidity Coverage Ratio
LTV	Loan to Value
MiFID	Markets in Financial Instruments Directive
MoAI	Ministry of Administration and Interior
MOJ	Ministry of Justice
MoPF	Ministry of Public Finance
MSME	Micro- Small- and Medium-Sized Enterprise
NBFL	Nonbank Financial Lenders
NBR	National Bank of Romania
NCMO	National Committee for Macroprudential Oversight
NFC	Nonfinancial Corporate
NPE	Nonperforming Exposure
NPL	Nonperforming Loan
NSFR	Net Stable Funding Ratio
OSII	Other Systemically Important Institutions
PD	Probability of Default
PEP	Politically Exposed Person
PFMI	Principles for Financial Market Infrastructures
RCAP	Regulatory Consistency Assessment Program
ROA	Return on Assets
ROBOR	Romanian Interbank Offer Rate
ROE	Return on Equity
RON	Romanian currency abbreviation
RP	Related Parties
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Asset
SD	NBR Supervisory Department
SME	Small- and Medium-Sized Enterprises
SRB	Systemic Risk Buffer
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism
STeM	Stress Testing Matrix
T1	Tier One

## EXECUTIVE SUMMARY

**Romania's financial sector has strengthened significantly over the last few years.** Effective supervisory measures have helped reduce the high level of nonperforming loans (NPLs) from 21.9 percent at its peak in 2013 to 6.4 percent as of December 2017. Foreign-owned banks' dependence on parent funding has significantly declined, while deposits from the domestic private sector have increased, reducing liquidity risks. Banks' capital buffers strengthened, on the back of a slowdown of credit and low interest rates, with an average capital to risk-weighted assets now above 18 percent. Substantial progress made since the last FSAP is summarized in Appendix I.

**However, some vulnerabilities are emerging.** Banks' holdings of domestic sovereign paper have grown large, exposing them to valuation losses in case of an increase in interest rates or sovereign risk spreads. Banks' indirect exposures to government guarantees through the Prima Casa program further strengthens the sovereign-bank nexus. An increase in interest rates or economic shocks may also negatively impact NPL ratios on banks' mortgage portfolios, which are growing fast and are at variable rates. The share of foreign exchange (FX) denominated loans and deposits significantly decreased, but remains relatively high, and a large share of corporate borrowers is unhedged. Finally, lending practices of nonbank financial lenders (NBFLs) may lead to loan defaults and reputational risks for the banking sector. As the financial system is small, shocks may further discourage financial intermediation, which is already among the lowest in the European Union (EU).

**The mission's risk analysis finds that these vulnerabilities are significant.** In the event of a sharp increase in interest rates, combined with a shock to growth that is comparable to the 2008 crisis, banks' capital is impacted significantly. Stress test results indicate that, over a three-year horizon, banks face losses of close to 900 basis points (bps) in capital, resulting from trading losses on their sovereign securities portfolios, and credit losses on their loan portfolios. A number of the 12 stressed banks fail to meet the minimum threshold for the common equity Tier 1 capital ratio (CET1). The team also found that exchange rate depreciation is an important driver of credit losses in FX loans. The overall impact of the scenario on banks' profitability is significant as banks' net interest income decreases by almost 40 percent through the stress test horizon.

**Policy action is needed to address these risks and strengthen financial stability.** The authorities are already contemplating a debt-service-to-income (DSTI) limit on mortgages and calibration of this limit could draw on the mission's analysis of loan-level information from the Romanian credit register. The gradual scaling back of the Prima Casa program should continue to mitigate risks of housing sector imbalances and to support the effectiveness of the existing loan-to-value (LTV) limits. In addition, the team recommends a currency-differentiated Liquidity Coverage Ratio (LCR), and the monitoring of a currency-differentiated Net Stable Funding Ratio (NSFR), to limit FX liquidity risks. Strengthened monitoring of NBFLs is warranted to avoid reputational risks and regulatory arbitrage. The mission also recommends introducing capital buffers to increase resilience and guard against

risks from large sovereign exposures. Open and transparent discussion in the newly created macroprudential committee should link policy action to identified risks.

**The NBR is transitioning to a risk-based supervisory approach that needs further enhancements.** The new Supervisory Review and Evaluation Process (SREP) Guidelines of the European Banking Authority (EBA) are still in the initial stages of implementation. The NBR should conduct more risk-focused, banking industry-wide thematic analyses and develop its off-site monitoring tools, such as by conducting bottom up stress tests. The NBR should also build up specialized expertise, in particular in IT and cybersecurity. This will also benefit the systemically important payment and securities settlement systems that are currently being brought under the roof of the NBR. Finally, remaining gaps in the AML/CFT framework should be addressed.

**The upgrade of crisis management and resolution procedures that is currently underway should continue.** Important progress has been made, in particular through the adoption and implementation of the Bank Recovery and Resolution Directive (BRRD), which strengthened significantly the crisis preparedness of the NBR, the MoPF, as well as the FGDB. Further coordination, through inter-agency simulation exercises, will help crisis preparedness. The NBR is also encouraged to ensure that Romanian interests are sufficiently addressed in the recovery and resolution plans for foreign banks with subsidiaries in Romania. The NBR should develop an Emergency Liquidity Assistance (ELA) policy that accepts a more diverse asset pool as collateral, including FX securities, and provide liquidity facilities for the FGDB. The FDGB, in turn should diversify its investment policy, reducing holdings of domestic sovereign bonds and bank deposits.

**Finally, the FSAP recommended the adoption of a comprehensive strategy for financial development.** Public initiatives to support access to finance are too fragmented and lack efficiency and coordination. A holistic approach would encompass all state institutions and initiatives and could be catalyzed through the establishment of a Financial Sector Development Committee.



**Table 1. Romania FSAP 2018: Key Recommendations**

<b>Recommendations</b>	<b>Agency</b>	<b>Time<sup>1/</sup></b>
<b>System Risks and Macroprudential Policies</b>		
1. Strengthen the NCMO's accountability framework by i) requiring proposed policy actions and distribution of votes to be publicly disclosed in the summary of meetings; and ii) developing a common assessment of systemic risk at each NCMO meeting.	NBR, MoPF, ASF	NT
2. Apply a stressed DSTI limit to household loans and continue scaling back the Prima Casa program.	NBR, MoPF	NT
3. Enforce a currency-differentiated LCR and monitor a currency-differentiated NSFR for significant currencies.	NBR	NT
4. Introduce a carefully calibrated Systemic Risk Buffer to increase resilience against risks from large exposures to the sovereign.	NBR, MoPF, ASF	NT
5. Ensure provisioning requirements for NBFLs tighten in line with the application of International Financial Reporting Standards (IFRS) 9 to banks.	NBR, MoPF	NT
<b>Sectoral Oversight</b>		
<b>Bank Regulation and Supervision</b>		
6. Ensure consistency and objectivity in Supervisory Review and Evaluation Process (SREP) scores, findings and supervisory measures.	NBR	NT
7. Enhance supervisory tools by incorporating more forward-looking views (e.g., bottom up stress testing tools) and conducting more thematic reviews.		MT
8. Strengthen bank corporate governance (number of independent board members, content and periodicity of exchanges between the NBR and board members).		NT
9. Review and amend the regulations not governed by EU harmonization (e.g., transactions with related parties) in a more prudent manner.		NT
<b>Financial Market Infrastructures</b>		
10. Adopt the PFMI and formalize and strengthen cooperation between the NBR and the ASF for the supervision of the Bucharest Stock Exchange CSD.	NBR, ASF	NT
11. Invest in more and more qualified IT staff, in particular in the area of cyber resilience, and implement a formal project management methodology.	NBR	I
<b>AML/CFT</b>		
12. Address the remaining gaps in the AML/CFT preventive framework, including with respect to PEPs, and entity transparency; assess and mitigate the ML/TF risks.	MoJ / MoAI	I
<b>Crisis Management and Bank Resolution</b>		
13. Prepare an interagency simulation exercise that includes the NBR, ASF, MoPF and FGDB.	All	I
14. Seek an exemption from the Procurement law for bank resolution purposes.	NBR, MoPF	MT
15. Include MoPF officers linked to bank resolution under personal legal protection provisions.	MoPF	MT
16. Ensure that Romania's interests are addressed in recovery and resolution plans for Romanian subsidiaries of foreign banks.	NBR	NT
17. Diversify the investment policy of the FGDB, and establish operational procedures with the NBR that allow the FGDB to have accounts in the central bank and a repo line.	FGDB/NBR	NT
18. Finalize and implement an ELA scheme and provisions for FX liquidity support.	NBR	NT
<sup>1/</sup> Time Frame: C = continuous; I (immediate) = within one year; NT (near term) = 1–3 years; MT (medium term) = 3–5 years.		

## MACROFINANCIAL SETTING

**1. Romania made important progress in addressing economic imbalances and restoring growth after the global financial crisis, but macroeconomic risks are rebuilding.** Partly in the context of successive EU and International Monetary Fund (IMF)-supported programs in the period to 2015, macroeconomic stability was restored. Growth more recently accelerated on the back of fiscal stimulus, and Romania's real GDP growth surged to 6.9 percent in 2017 (Figure 1, Table 2). Low imported inflation and indirect tax cuts kept inflation subdued, but inflationary pressures have increased since mid-2017 on account of sharp wage increases and strong domestic demand, leading monetary policy to tighten after a long period of accommodation. With signs of overheating, there is a risk that the current policy trajectory increases macroeconomic volatility, and wears down buffers, adversely affecting market confidence.

**2. Romania's financial sector remains dominated by banks, a large share of which is foreign-owned, but the importance of NBFLs is growing.** There are 35 banks in Romania, 29 of which are foreign-owned (22 subsidiaries and 7 branches).<sup>1</sup> The banking system as a whole holds around 80 percent of financial sector assets (Figure 2). Concentration is moderate, with the largest five banks accounting for about 60 percent of total deposits (and 57 percent of all loans) in the system. Loans granted by NBFLs, a majority of which are owned by banks, accounted for just over 10 percent of total loans, but the share is increasing.

**3. Bank soundness indicators strengthened over the past few years.** NPLs reached 21.9 percent of total loans in 2013, but have been brought down to 6.4 percent in December 2017, while the provisioning ratio (including general provisions) is high, at about 65 percent. Following the balance sheet clean-up that started in 2014, through write-offs and sales of NPLs to debt collection agencies, banking sector profitability rebounded to positive territory in 2015 and further improved into 2017, with average sector return on assets (ROA) increasing to 1.3 percent (Table 3). Romanian banks' capital ratios appear at comfortable levels and banks show favorable leverage ratios compared to European counterparts (Figure 2).

**4. Foreign-owned banks' dependence on parent funding has significantly declined.** The share of deposits from the domestic private sector (about a third of which are demandable, and the rest at short terms of up to one year) has increased from about 48 percent of banks' total liabilities in 2011 to about 66 percent in 2017, while parent funding has declined markedly to about EUR 7 billion (approximately 7 percent of total liabilities), a third of the level in 2011. As a result, the system-wide loan-to-deposit ratio fell to around 77 percent in 2017, from 131 percent in 2008. Moreover, in the context of the Vienna initiative, debt liabilities were replaced to some extent by capital injections from parent banks, boosting capital ratios and reducing vulnerabilities.

<sup>1</sup> Many significant institutions are owned by large European banking groups. The main foreign parent banks are Société Générale, Raiffeisen, Erste Group, BBVA, Unicredit, Alpha Bank, and Eurobank.

**5. The ratio of private bank credit to GDP in Romania is among the lowest in the region.**

Measures of financial intermediation place the local banking sector last among EU countries, with bank assets at just 52.7 percent of GDP in September 2017. While large corporates do not appear to be credit-constrained, since many of them tend to borrow directly from abroad, access to and demand for financing for micro, small- and medium-sized enterprises (MSMEs) appears limited. This reflects legacy issues, as the share of NPLs was highest among MSMEs, where balance sheet repair is still ongoing, and banks remain reluctant to lend, as well structural impediments.

**6. The traditional nonbank financial sector remains underdeveloped.** The Romanian insurance market has one of the lowest levels of insurance density and insurance penetration in Europe. The sector has recently been stagnant as several major insurance companies have come under financial strain. The Romanian stock market has a market capitalization of just 20 percent of GDP, as well as low market liquidity. The fixed-income market is also relatively small, with about 80 bonds traded at the BVB—including 16 corporate bonds—and a total value traded of US\$403 million in 2017.

## SYSTEMIC RISK AND RESILIENCE

### A. Key Vulnerabilities Facing the Romanian Financial System

**7. Concerns about the stability of Romania's financial system, identified by the FSAP team, can be organized around four main issues:**

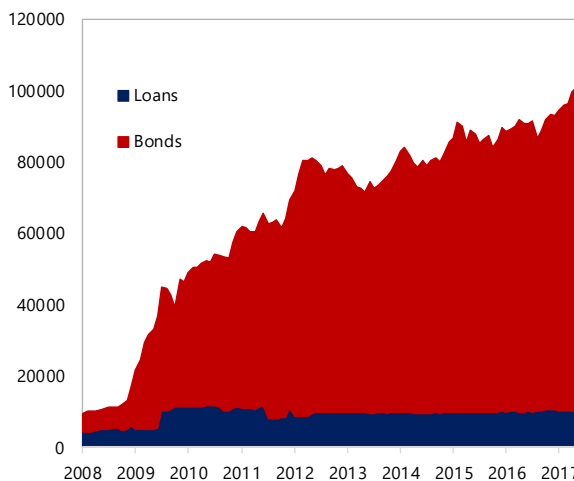
- Banks' exposure to the government through large positions in domestic sovereign debt and guarantees for Prima Casa loans;
- *Growing exposures of banks to the real estate market at variable interest rates;*
- *Exposures of banks and NBFLs to an increase in NPLs, both on domestic and foreign currency loans, with corporates leverage still high; and*
- *Growing lending by NBFLs leading to vulnerabilities and reputational risks for the banking sector.*

**8. The exposure of banks towards sovereign risk is increasing, creating potential adverse bank-sovereign feedback loops.** As of December 2017, the exposure of banks to the Romanian sovereign was about 22 percent of assets, increasing steadily from below 5 percent in 2008 to one of the highest in the EU (see text figure). The team's balance sheet analysis shows that in 2008 the government was still a net lender, it became a net borrower in 2012 (Figure 3), and has placed increasing amounts of securities with the banking system. This appears to have crowded out lending to the real sector to some extent. More importantly, in an environment of very short-term funding, the relatively long duration of domestic sovereign debt means that banks are heavily exposed to

losses from increases in interest rates.<sup>2</sup> The government guarantees issued in the context of the Prima Casa loan program create an additional indirect exposure of the banking sector to the sovereign.

**9. Even though government debt is relatively low as a share of GDP, banks' exposures are still at risk.** At roughly 36.8 percent of GDP at year-end 2017, the stock of Romania's public debt is relatively low compared to other EU countries. However, for an emerging market economy it is approaching levels that may give rise to concern. An analysis of the NBR, based on two different empirical approaches, points towards a debt level between 40 and 45 percent of GDP as threshold for a material increase in the likelihood of economic recession and detrimental impact on the government's debt refinancing capacity (Special Feature in the [2015 Financial Stability Report](#)). Moreover, Romania's sovereign risk premia have historically been volatile despite low levels of debt to GDP (text figure).<sup>3</sup> In the current conjuncture, procyclical fiscal policy may lead to sharp increases in policy rates, worsening debt dynamics and increasing the scope for valuation losses on sovereign securities. A rapid rise in sovereign risk premia and enhanced interest rate volatility may therefore materialize, even at relatively low levels of debt to GDP.

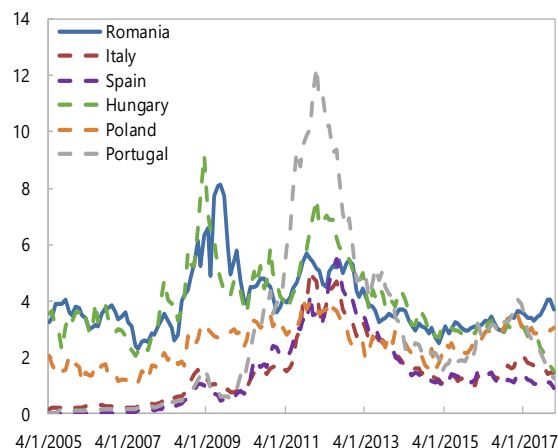
**Sovereign Exposures in the Banking System**  
(In millions of lei)



Source: NBR.

**Sovereign Risk Premia**

(Percentage points above 10 year German government bond yields)



Sources: Bloomberg and IMF staff calculations.

<sup>2</sup> The overall (weighted) average duration of sovereign bonds is around three years, which is close to the average duration of sovereign bonds issued in domestic currency. Domestic banks holdings' residual maturity is lower since most of the long-term duration bonds are held by offshore investors. However, there is significant intra bank variation, with some banks having durations as high as seven years.

<sup>3</sup> Romania faced rollover challenges in 1999 and 2009, despite having a considerable lower level of debt than currently, and has more recently seen yields rise as demand at auctions was insufficient to place issues at the desired yields. All the three main credit rating agencies lowered Romania to speculative grade following the GFC and it was not until May 2014 that they had all upgraded the country back to investment grade. However, Romania remains in the lowest quartile of European Union member countries in terms of credit rating and credit default swap (CDS) spreads.

**10. The banking system is also becoming increasingly exposed to real estate.** Housing loans increased from 21 percent of loans to households to more than 54 percent between 2008 and 2017. As much as 36 percent of total private sector credit reflects real estate lending to households, predominantly at variable rates, and at an average maturity of just over 24 years, with a further 33 percent accounted for by loans to corporates collateralized by real estate. As a result of increased provision of mortgages, house price appreciation has gained momentum with property prices registering an annual growth rate of 6.2 percent as of September 2017 (Figure 4), while the effectiveness of the existing LTV limits on mortgages are undermined by the Prima Casa program,<sup>4</sup> which allows for LTV ratios of up to 95 percent. Moreover, since the large majority of mortgage contracts are at variable rates, loan performance could deteriorate and default rates rise if interest rates increase.

**11. The share of FX loans has been trending downwards, but banks' credit risk from FX loans remains a concern.** Loans in foreign currency continue to have a higher nonperforming ratio than loans in lei (approximately 12 percent compared to 3 percent). Although the share of new loans in foreign currency originated by local credit institutions declined, the share in the stock was still 43 percent for corporate loans and 38 percent for household loans in June 2017, a large share of which is unhedged. And while the share of FX in total new bank lending to the non-financial private sector slowed to just below 20 percent in June 2017, mainly to the corporate sector, FX bank lending may pick up again in the future, if domestic rates were to rise relative to euro area rates, while NBFL lending to the corporate sector is already predominately in FX (84 percent). The currency mismatch on banks' balance sheets is limited, though, as the NBR has in place a strict net open position limit and households' deposits in FX have recently been increasing.

**12. Notwithstanding low domestic bank lending, corporate sector leverage remains elevated.** Corporate leverage, defined as total non-equity liabilities over capital, declined sharply between 2008–12. However, leverage rebounded between 2012–16 with a more prominent role of external borrowing and trade credit between domestic corporates, as domestic bank credit decreased (Figure 5). Although most of the increase in external funding is linked to equity and debt in the context of foreign direct investments (FDI) external portfolio debt in foreign currency loans remains significant. A sizable contribution to the elevated corporate leverage also comes from the common practice of corporate funding through "shareholders" loans."

**13. Finally, growing provision of loans by NBFLs may lead to vulnerabilities and reputational risks for the banking sector.** NBFLs are providing credit to small- and medium-sized enterprises (SMEs), mainly in FX, and alongside a growing leasing business, as well as to households, often to those at lower income and at high interest rates and DSTI ratios. A macroeconomic downturn may negatively impact highly indebted households and increase NPLs in this sector. Debtors can also face loan traps, since borrowing from NBFLs effectively results in financial exclusion.

<sup>4</sup> Under this program of 2009, the state guarantees 50 percent of the mortgage, and loan terms are favorable: the down payment is 5 percent of the property value at a minimum (compared to 15–25 percent for other mortgage loans), and the interest rate is relatively low (at ROBOR +250 bps). This program accounts for most mortgages extended by banks.

The conduct of NBFLs can create reputational risk for the financial sector that already has a negative public reputation.

## B. Financial Sector Resilience

**14. The stability analysis conducted by the FSAP team, in cooperation with the NBR, assessed the resilience of the banking system to the vulnerabilities identified above.** Scenario based solvency tests, as well as single factor sensitivity tests, assessed the resilience of the banking sector against rising interest rates and sovereign risk. These tests also assessed credit losses arising from exposures to the household and corporate sector in the event of a large contraction in GDP, exacerbated by an exchange rate depreciation. The resilience of banks to exchange rate movements is also tested in the context of liquidity stress tests. Finally, vulnerabilities stemming from the nonbank sector are analyzed, using sensitivity analyses as well as an assessment of the contagion risk from these institutions to the banking sector (see Appendix II for the Stress Testing Matrix (STeM)).

### Solvency Stress Tests

**15. The banking sector's resilience was assessed against an extreme but plausible adverse scenario (Figure 6), that draws on domestic and external risks identified in the RAM** (Appendix III). The adverse scenario featured an increase in sovereign spreads and a sharp initial depreciation of the currency, a large hike in domestic policy rates, aiming to reduce pass-through of the weaker exchange rate to inflation, as well as a shock to GDP growth that reaches the targeted level of severity (a two-standard deviation shock to GDP growth) in the second year of a three-year horizon (V-shaped profile). A drop in property prices is implicitly assumed in the scenario through the macroeconomic variables and the stressed loss given default for mortgages, which stresses exposures to households as well as property-backed SME loans.

**16. The solvency stress test suggests that banks are affected significantly by the realization of the shocks captured by the scenario.** Results against the hurdle rates indicate that a number of banks fail to meet the minimum threshold for the CET1 ratio. The CET1 ratio for the 12 banks considered declines from 17.1 percent at end-2017<sup>5</sup> to 8.2 percent at end-2020 in the adverse scenario. The leverage ratio (T1 Capital to Total Assets) also decreases sharply, from 9.3 to 4.8 percent, during the stress test horizon (see Figure 7).

**17. The vulnerabilities highlighted in paragraph 7 contribute to a reduction in capital ratios (Figure 8) in important ways.** More specifically, the stress test results reveal that in the adverse scenario:

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

<sup>5</sup> While the reference date for the exercise was December 2017, data from December 2016 was used. The assumption in the solvency exercise is that the banks' balance sheets remain exactly the same as in end-2016.

rates and depreciation of the currency, credit loss impairments increase from -2.2 percent of RWA in 2017 to -3.5 percent of RWA in 2019, which is the peak in terms of provisioning.<sup>6</sup> In terms of composition, real estate mortgages account for the majority of credit losses (54 percent of total), followed by SME backed by real estate (20 percent of total).

- *Banks face significant trading losses on their sovereign securities portfolios, with a total drop of 300 bps in capital over the three-year horizon.* Banks suffer from declining valuations in their trading book as sovereign yields rise significantly (due to both an increase in the risk-free rate as well as risk premia). As a result of the stress, trading gains on these positions of 0.6 percent of risk-weighted asset (RWA) in 2017 turn to a market loss of 3.6 percent in 2018. In addition, some banks incur provisions for securities in their hold-to-maturity portfolios, in line with the increase in sovereign credit spreads. Importantly, the large securities portfolios incur losses even in the baseline scenario, where interest rates rise to counter inflationary pressures.<sup>7</sup>
- *The exchange rate depreciation plays an important role in driving credit losses on FX loans.* The team estimated the importance of exchange rate depreciation by comparing credit losses under the adverse scenario with those under a hypothetical scenario which is identical in all aspects but assumes a constant exchange rate relative to the reference date. This analysis suggests that roughly 15 percent of total credit losses can be attributed to the exchange rate depreciation.
- *Banks' net interest income decreases by almost 40 percent through the stress test horizon.* The contribution of net interest income to CET1 is, on average, 280 bps per year throughout the horizon, compared to 525 bps in 2017. Three factors contribute to this decline. First, the large NPL formation compresses interest income. Second, the net interest margin is adversely affected due to a rise in funding costs, not matched by a rise in lending rates that are tied to the Lombard rate. Finally, the banks have a non-negligible positive interest rate risk, which exposes them to losses as ROBOR increases throughout the stress test horizon.

## Solvency Tests Based on Sensitivity Analysis

**18. Sensitivity tests assessed vulnerabilities of the banking system to sovereign, interest rate, and concentration risks.** Single factor sensitivity tests find that a 500 bps increase in sovereign yields leads to a systemwide decrease in Tier I capital by 510 bps. The impact can be significantly larger for certain banks (up to 970 bps in capital). In addition, a 50 percent haircut on sovereign exposures would lead to a number of banks falling below the regulatory minima (Figure 9). And a

<sup>6</sup> It is important to note that provisioning and interest income reported by Romanian banks are inflated due to an accounting convention. Romanian banks recognize interest on (uncovered part of) NPLs and provision for this interest income, which leads to higher levels of both items compared to the IMF methodology, where no interest is accrued on (gross amount of) NPLs. This difference in methodology partly masks the true increase in provisions due to formation of new NPLs in the stress test.

<sup>7</sup> Banks hold the majority of their sovereign debt holdings in mark-to-market portfolios (77 percent). Several banks hold their securities entirely in mark-to-market portfolios.

shock to policy rates of 500 bps reduces the system Tier 1 ratio by 120 bps, as a majority of banks hold a positive interest rate risk.

## Liquidity Stress Tests

**19. The lion's share of the banks' stock of High Quality Liquid Assets (HQLA) is composed of claims on the public sector** (Figure 10). These include government bonds as well as central bank reserves. The structure of banks' funding appears relatively homogenous across main currencies. At the aggregate level, the funding structure in the two main currencies (leu and euro) is very similar for the 12 largest Romanian banks in scope. Retail deposits, which are either sight or at very short terms, represent the largest source of funding, while secured funding is almost non-existent. However, the large holdings of government securities also imply that the banks have a relatively low requirement for stable funding under the NSFR framework.<sup>8</sup>

**20. While the aggregate liquidity level is more than comfortable, the results suggest the need for currency differentiated liquidity requirements** (Figure 11). In addition to the Basel III prescribed scenario, the FSAP implemented two tests to assess the short-term resilience of banks to an abrupt withdrawal of funding: (1) a retail stress scenario aimed at replicating a deposit run, and (2) a wholesale funding stress scenario. A 15 percent haircut is applied to government debt securities in both scenarios, to simulate a fire sale or an illiquid market for these securities. The results suggest that a number of banks can meet either their lei LCR or their euro LCR but not both. Almost all banks meet the 100 percent NSFR ratio, though, both in lei and in euro.<sup>9</sup>

## Analysis of the NBFLs

**21. NBFLs show poorer asset quality indicators compared to the banks.** The mission analyzed the 35 NBFLs included in the Special Register of the NBR and subjected them to sensitivity analyses.<sup>10</sup> The firms were split along their business lines: leasing companies, forming the majority of the sector by number (22) and asset share (2/3), versus non-leasing firms, specializing mostly in consumer credit lending. Asset quality is significantly inferior to banks in both sub-sectors, with NPL ratios almost four times larger for non-leasing firms compared to banks' consumer credit portfolio (see Figure 12). While capital levels are comfortably above the minimum requirement (7 percent of assets), at least for the non-leasing subsector, there is significant variation among firms. Leasing companies' capital levels are much closer to the minimum requirements, which may be justified by the secured nature of their lending activity, but this also leaves them more vulnerable to shocks.

**22. Leasing companies prove highly sensitive to a depreciation and further deterioration in asset quality.** Sensitivity stress test results indicate that a large number of NBFLs, accounting for

<sup>8</sup> While banks report their available and required stable funding according to the European template, the ratio was calculated using Basel weights for the various elements of available and required funding.

<sup>9</sup> The FSAP team also undertook a cashflow-based stress test. The results are consistent with the findings of LCR and NSFR analyses and are described in the Risk Analysis Technical Note.

<sup>10</sup> NBFLs with significant activity have to register in the Special Register, and less active NBFLs in the General Register.



almost 80 percent of the sector would fall below minimum capital requirements as a result of a fairly mild depreciation (Figure 12), mainly due to the highly euroized balance sheet of these firms. While in reality some natural hedging on the borrowers' side may exist, the results indicate a strong vulnerability to exchange rate fluctuations. Moreover, increases in funding costs and NPLs lead to significant number of leasing NBFLs falling below minimum capital requirements, highlighting the vulnerabilities of the sector to any additional stress due to low capitalization levels.

### Contagion Analysis

**23. The network and direct exposure analyses reveal potential vulnerabilities of banks to shocks from failures of NBFLs.** The network approach of Espinoza-Vega and Sole (2010)<sup>11</sup> applied to the system of domestic banks and NBFLs finds that, since banks' exposures to NBFLs are more important than interbank exposures, some NBFLs have a greater systemic impact on the network (higher contagion effect) than banks. Banks' losses could amount to around 9 percent of total banking sector capital, in case of an adverse shock leading to the failure of NBFLs.<sup>12</sup> Further analysis shows that parent banks are particularly vulnerable to distress from the NBFLs they own when reputational effects from the failure of the affiliated NBFL are included, which result in a loss of confidence and depositor run on the parent.<sup>13</sup> If these risks were to materialize, the impact on parent banks' capital ratios and liquidity positions would be meaningful (Figure 13).

**24. While domestic interbank contagion appears to be limited, cross-border exposures of Romania's banking sector remain significant.** The network analysis of interbank interconnectedness suggests very limited risk of contagion within the banking system, owing to small interbank exposures. However, exposures to foreign banking sectors are still large, albeit reduced relative to pre-crisis-era levels, mainly due to foreign liabilities.

## MACROPRUDENTIAL FRAMEWORK AND POLICIES

### A. Macroprudential Framework

**25. The NBR has a long experience in implementing macroprudential policy measures and as a result, a relatively sophisticated systemic risk monitoring framework.** The NBR monitors several indicators to assess the build-up of systemic risk, many of which are derived from the nation-wide credit register and related data sources, and constructs summary indicators to facilitate overall

<sup>11</sup> This methodology is based on a matrix of bilateral domestic bank-bank (for interbank contagion) or bank-NBFL (for bank-NBFL contagion) gross credit exposures. The analysis also considers cross-border exposures to foreign banking systems.

<sup>12</sup> For bank-NBFL interconnectedness analysis, the test assumes a 100 percent loss of claims in case of default of a counterpart.

<sup>13</sup> Eight NBFLs are partially owned by six banks. For these parent banks, we assume a 100 percent loss of claims in case the NBFL fails. The reputational risk is reflected through runs on deposits (20 percent run-off rate on retail deposits), and an increase in the cost of funding. The rollover rate is set at 50 and 30 percent for foreign and domestic banks, respectively; with a 50 percent haircut on assets fire sales.

risk assessment. The NBR also has various economic models to assess macro-financial developments and the effects of various shocks, and to assess policy actions. Furthermore, the NBR subjects banks to regular solvency and liquidity stress tests. Nevertheless, data and information gaps remain, for instance, due to extensive NPL exposures being sold to debt collection agencies, which do not have to report to the credit registry.

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

**27. The institutional arrangements seem to guarantee adequate powers to ensure NCMO's ability to act.** The NCMO has direct (hard) powers over a wide-range of macroprudential tools; it is empowered to recommend actions to be taken by other supervisory authorities or the government, coupled with a "comply or explain" mechanism, and to issue warnings and opinions. However, the functioning of the NCMO is still being established. As of April 2018, it has only held five meetings and issued ten recommendations, including the required quarterly recommendations on the countercyclical capital buffer. The Technical Commissions on Systemic Risk and Financial Crisis Management, respectively, who should support the NCMO's work, are still to become operational.

**28. The NCMO's accountability, transparency, and coordination frameworks need to be strengthened to help counteract the underlying inaction bias.** Generally, macroprudential policymaking is challenged by the so-called policy inaction bias, resulting from the cost of policy actions being sooner and more easily observable than their potential benefits. Given the set-up of the NCMO and concerns regarding the independence of the ASF following the removal of its previous president, overcoming the inaction bias may prove particularly challenging.<sup>14</sup> Strong transparency, accountability, and coordination frameworks can facilitate stronger commitment towards policy actions. Currently, the NBR can recommend policy action and be outvoted without the need for the decision to be disclosed or related to a common overall risk assessment. The framework should be strengthened by requiring proposed policy actions and distribution of votes to be publicly disclosed in the summary of meetings. A common assessment of systemic risk should also be developed at each NCMO meeting to foster consensus and common ownership of actions, including on risks stemming from large and concentrated sovereign exposures.

<sup>14</sup> The World Bank's review of the Insurance Sector, conducted as part of the 2018 Romania FSAP, suggests that the independence of the ASF could be strengthened.

## B. Macprudential Policies

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

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

**31. The macroprudential policy toolkit should be strengthened further to address risks identified in the mission's risk analysis.** A stressed DSTI limit should be applied to mortgages to mitigate risks of excessive credit growth and rise in defaults given households' vulnerabilities to a rise in interest rates or risk premia, as featured in the mission's stress test. The calibration could draw on the joint analysis with the NBR using loan-level information from the Romanian credit register.<sup>15</sup> The scaling down of the Prima Casa program should continue, to mitigate risks of housing sector imbalances and support the effectiveness of the LTV limits. The risk analysis also identified that FX liquidity risks can exist within an environment of ample overall liquidity and a revival of FX lending reliant on wholesale funding cannot be excluded. The authorities should therefore enforce a currency-differentiated LCR for significant currencies and monitor a currency-differentiated NSFR.

**32. A carefully calibrated Systemic Risk Buffer (SRB) should be considered to address risks stemming from the strong sovereign-bank nexus.**<sup>16</sup> The Romanian banking system is

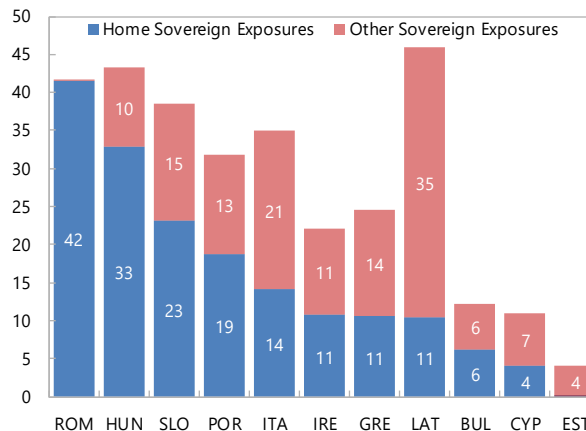
<sup>15</sup> NBR and IMF staff have conducted an economic analysis based on micro data to guide the calibration of a DSTI limit on mortgages and consumer loans. This analysis is available as a Technical Note.

<sup>16</sup> The Basel Committee on Banking Supervision issued a discussion paper (BCBS, 2017) on the regulatory treatment of sovereign exposures. Further, in the European context, there is an ongoing debate about the merit of linking capital charges to sovereign risk concentration (Veron, 2017). While staff favors additional discussions on the regulatory treatment at the international level, the FSAP team does not take a view on the appropriate design of the capital framework. Rather, the FSAP proposes a macroprudential approach to the case of Romania. This is grounded in the team's analysis of systemic risk in Romania and based on an assessment of the available macroprudential tools in the European context, which points to the SRB as the preferred tool to mitigate risks stemming from large sovereign exposures.

characterized by exceptionally concentrated and large exposures towards the domestic sovereign. As the risk analysis finds that these large and concentrated sovereign exposures pose an important risk for individual banks and the system as a whole, prudential policy measures should be considered. Their main objective would be to enhance resilience to shocks, through increased loss absorbing capacity, and to provide disincentives against excessive concentration of risks. At the same time, the calibration of buffers should seek to avoid unintended side-effects, such as an excessive reduction of liquidity, a bond market sell-off, or other unwarranted macro-financial dynamics. Appendix IV provides an example of a SRB calibration that aims to ensure resilience for banks with concentrated exposures, while minimizing adverse impacts.<sup>17</sup>

### Sovereign Exposures

(In percent of total risk exposures, H1/2017)



Sources: EBA Transparency Exercise and NBR.

**33. The SRB should preferably be complemented with other measures.** In particular, an expansion of the NBR's collateral framework to include euro area government bonds (potentially with minimum credit ratings or additional haircuts) could be useful to support a diversification of banks' bond holdings away from the domestic sovereign.<sup>18</sup> Further reforms to the government's debt management strategy that broaden the investor base could reduce reliance on the banking system when placing sovereign debt.

## SECTORAL SUPERVISION

**34. Responsibilities for prudential supervision of the financial sector are split between the NBR and ASF.** The NBR is an administratively independent central bank with a mandate to supervise credit institutions and verify observance of the laws and regulations that apply to the banking sector. In addition, the NBR maintains registers for NBFLs.<sup>19</sup> The ASF, established in 2013, is responsible for

<sup>17</sup> In its December 2017 meeting, the NCMO recommended the use of the SRB to facilitate a continued reduction of NPLs. However, while NPLs have continued to decrease with the share falling below 7 percent as banks are subject to NPL targets in the supervision process, the high concentration of sovereign exposures is by and large left unattended. A potential option is to utilize the SRB to ensure some further progress in lowering NPLs before applying the SRB to mitigate risks from the concentrated sovereign exposures.

<sup>18</sup> Currently, eligible assets include debt instruments issued by the Romanian general government, the NBR, specific international financial institutions, and some mortgage-backed securities. In practice, Romanian government bonds dominate. Central banks' broadening of collateral frameworks towards cross-border collateral is one of the trends identified in a [report by a Study Group established by the Bank for International Settlements Markets Committee](#). Examples include Sweden, a non-euro EU member country, as well as Switzerland and a number of countries outside Europe.

<sup>19</sup> NBFLs in both the Special and General Register must comply with certain prudential requirements, including simple minimum capital requirements. The NBR conducts onsite inspections for NBFLs in the Special Register, whereas General Register entities are monitored based on periodic reports.

the supervision of capital markets, the insurance and private pension fund sector, with the aim to protect the interest of investors and policy holders. Other relevant authorities in Romania are the MoPF, among others responsible for the monitoring of credit unions, the Consumer Protection Agency, and the Competition Authority.

## A. Bank Supervision and Regulation

**35. As an EU Member State, Romania is subject to and aligned with the common EU regulatory framework for banking supervision.** The EU regulatory framework for banking supervision has been subject to significant changes since the 2008 global financial crisis and the subsequent sovereign debt crisis. The adoption of the CRR/CRD IV which forms the Single Rule Book was an important step towards stronger prudential regulation. Given that a large part of Romania's banking system is owned by Eurozone banks, the Single Supervisory mechanism (SSM), as the home supervisor for Eurozone banks, is a key partner of the NBR. As of 2017, the NBR has identified 11 banks as systemically important, of which 8 are supervised at group level by the SSM.

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

**37. Further development of the NBR's supervisory approach will make supervision more effective and in line with the requirements of the 2012 Basel Core Principles (BCPs).** The NBR may need to devote more supervisory attention to banks' risk models and building up further expertise in specialized areas such as IT and market risk. In the area of corrective actions and sanctions, the NBR should review its framework to ensure it is protected from undue legal challenges, and strengthen internal procedures to ascertain that supervisory measures and sanctions are more consistently applied across the banking system. Post examination processes should be enhanced for banks to implement supervisory measures in a prompt manner. Intensified engagement with non-executive/independent board members is warranted for a more proactive supervisory practice.<sup>20</sup>

**38. Some weaknesses were observed concerning regulations not governed by the harmonized EU framework.** Prudential regulations of the NBR are broadly aligned with the requirements of the BCP. However, the regulations on related party transactions and country/transfer

<sup>20</sup> Following FSAP recommendations, the NBR amended its "Procedure on the operational flow of the process of assessment and evaluation of the management framework, strategies, processes, and mechanisms."

risk only include high-level principles, and lack sufficient specificity. The NBR should consider giving clearer guidance to banks and supervisors to avoid undesirable divergence of practices. This could be done through amending regulations, issuing instructions, and/or developing the on-site handbook. The NBR also needs to enhance its oversight of concentration risk and intra-group transactions, even if the exposures comply with the regulatory limits.

**39. The authorities should maintain their current successful and proactive approach to steer the timely reduction in problem assets.** Nonperforming loans (NPLs) peaked at 21.9 percent in 2013 following the 2007 crisis, and since declined to close to 6 percent in 2017. The NBR successfully led efforts to clean up banks' balance sheets through multiple initiatives designed to ensure the timely recognition, realistic provisioning and disposal of NPLs, and maintains annual bank-by-bank supervisory targets for NPL reductions. The framework for credit risk management was significantly strengthened and close monitoring, including through annual examinations, is conducted. Considering still substantial levels of nonperforming and forborne exposures, the NBR should continue to closely monitor these exposures and ensure that proactive measures are implemented to clean-up bank balance sheets and prevent any new increase in credit risk.

**40. The NBR should better ensure banks' boards effectively exercise their responsibilities.** Corporate governance requirements were appropriately strengthened in recent years and now constitute a cornerstone of the NBR's supervisory approach. Attention is paid to effective implementation during on-site full-scope examinations and when approving key persons. However, the NBR only requires some banks (i.e., subsidiaries) to have an "adequate" number of independent board members. Banks usually only have one or two independent board member(s), which is insufficient. Although the NBR places a lot of responsibilities on the board, it does not yet organize regular exchanges with non-executive and independent members.

## B. Financial Market Infrastructures

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

**42. The NBR's project to internalize the payment and settlement infrastructure within the central bank has a strong rationale, but implementation also poses risks.** Currently, the RTGS and CSD systems are technically operated by Transfond S.A., a private company jointly owned by the NBR (33.3 percent) and Romanian banks. A project to internalize these systems within the NBR is scheduled to be finished in the first half of 2018 and will mitigate NBR's dependence on and

exposures towards Transfond S.A. Although the internalization project is generally well managed, additional measures were recommended to reduce migration risks. In response, the NBR drafted and tested fallback scenarios, and is performing a parallel run to compensate for the lack of experience of NBR staff technically operating and controlling the systems. Additional investments in experienced IT people, through hiring new staff and/or external expertise, as well as implementing a formal project management methodology at the NBR will increase the NBR's resilience against operational risks, and in particular information security treats, such as cyber-attacks.

### C. Anti-Money Laundering and Combating the Financing of Terrorism

**43. Romania made good progress in strengthening its AML/CFT framework since it was last assessed.** The MONEYVAL 2008 assessment and 2013 targeted reassessment against the (then) 40+9 Financial Action Task Force (FATF) recommendations noted several deficiencies in Romania's legal framework and its implementation. Shortcomings were notably identified in customer due diligence requirements including for Politically Exposed Persons (PEPs), the CFT framework, the structure and resources of the Finance Intelligence Unit (FIU), and law enforcement efforts. Since then, the AML/CFT law was amended with a view to strengthen the independence of the FIU and the CFT framework, and a draft law aimed at transposing the EU 4th AML/CFT Directive was prepared.<sup>21</sup> Some measures were taken to assess the ML/TF risks in the banking sector, and a national risk assessment is scheduled to start this year. Training on AML/CFT is being provided to a range of reporting entities, and supervision by the NBR and the FIU was strengthened. The reporting of suspicious transactions has increased, in particular by banks, exchanges, transfer services, and notaries, and the FIU was provided with additional resources and updated analytical tools.

**44. Deficiencies nevertheless remain.** The preventive framework, notably with respect to PEPs and the intra-EU correspondent banking system, falls short of the standard. Transparency of beneficial ownership of legal persons and arrangements is insufficient. The understanding of Romania's ML/TF risks appears fragmented, and the number of investigations into, and convictions for ML remains low despite MONEYVAL's conclusion on Romania's ML risk. Romania should address the gaps in the preventive framework, including with respect to PEPs, and increase entity transparency. Transposing the 4th EU Directive will assist in these respects. Romania should also assess its ML/TF risks, take appropriate mitigating action, and ensure that ML is pursued and sanctioned in line with those risks.

## FINANCIAL SAFETY NETS AND CRISIS MANAGEMENT

**45. The bank resolution and crisis management framework has been significantly revamped since the last FSAP.** The implementation of the BRRD in Romania enhanced the NBR's powers to deal with failing banks, while the FGDB gained greater involvement in these processes, and important new tools for resolution are now established in the law. As the resolution authority,

<sup>21</sup> The draft law broadly meets the technical requirements of the FATF standard. It is expected to be discussed by Parliament in May 2018.

the NBR received the power to: (i) take control of an institution (intervention); (ii) transfer the shares or any other instruments of ownership, rights, assets or liabilities (purchase and assumption); (iii) cancel debt instruments; and (iv) write down/convert into common shares or other instruments of ownership the eligible liabilities of an institution under resolution (bail-in). Furthermore, in exceptional circumstances, if all other resolution tools were insufficient, and financial stability remained at stake, public equity support and temporary public ownership may also be applied.

**46. The efforts to consolidate institutional coordination must continue.** Over the past years, the NBR enhanced the internal organization of resolution and supervision, and the coordination between different crisis management functions. At the same time, the MOPF and FGDB are also adapting to their new responsibilities and are helping to make the new toolkit operational. Coordination has also intensified at the international level through agreements on information sharing, and NBR's participation in supervisory and, more recently, resolution colleges for Romanian subsidiaries of foreign banks. However, some operational elements of the new framework have yet to coalesce. A domestic interagency simulation exercise (involving the NBR, FGDB, ASF, and the MOPF) will help the efficacy of the Romanian framework, by bringing up practical elements, potential coordination issues, and even possible legal constraints to an effective application of the principles in the law, and is now planned for 2018.

**47. Some elements needed for the effectiveness of the crisis management framework are still work-in-progress.** These are primarily legal in nature, and tackling them should be a priority:

- The public procurement law applies to bank resolution action. This could pose serious obstacles, by limiting the ability of the authorities to act swiftly, and constrain the viable resolution options, thereby potentially increasing overall costs. The authorities are implementing actions to improve their readiness, but a comprehensive solution that exempts bank resolution from the scope of the procurement law would be preferred.
- The resolution framework stipulates legal protection for NBR officers in charge of key decisions, but the protection does not include staff from the MoPF. This gap should be addressed.
- The legal instrument that will implement support from the MoPF to the bank resolution and deposit insurance framework (i.e., contingent funding to the FGDB in the event its resources are exhausted), has yet to be formally executed.
- The establishment of the NCMO in 2017 was an important step to enhance crises preparedness, but it is not yet fully operational. In particular, the NCMO's Technical Commission on Financial Crisis Management should be activated.

**48. The important presence of subsidiaries of major international banks in Romania, which are under the authority of the Single Resolution Board, calls for intense cross-border coordination and a domestic capital market strategy.** It is of particular importance to ensure that Romanian interests are properly represented in recovery and resolution planning at the level of parent banks. In addition, the NBR's resolution planning for foreign subsidiaries is based mainly on



single point of entry considerations, and incorporating other resolution alternatives (e.g., multiple point of entry) will require a medium-term strategy for the development of loss-absorbing eligible instruments in the domestic capital market (see also paragraph 52). Under a multiple point of entry approach, resolution planning must also ensure separability and autonomy of Romanian subsidiaries from their parent from a financial and operational point of view.

**49. The responsibilities of the FGDB have grown significantly from a pure paybox function into a vehicle for bank resolution.** The 2015 law empowered the FGDB as the administrator of the newly created bank resolution fund—which is on track to reach its funding target by end-2024. In addition, the FGDB has been mandated to serve as (i) a temporary administrator; (ii) special administrator of a credit institution under resolution; (iii) shareholder of a bridge institution; or (iv) shareholder of an asset management vehicle.

**50. The FGDB should diversify its investment policy, while keeping the principles of liquidity and security, and the NBR should provide the FGDB operational access to its facilities.** Currently, three quarters of the FGDB's funds are invested in domestic T-bills and the rest is deposited in the banking system it insures. A gradual migration towards first-rate paper from domestic and international issuers is warranted to diversify FGDB's portfolio. In addition, the FGDB would benefit from having access to central bank facilities. The FGDB should be provided an account at the central bank, which would help in drawing down its deposits in the banking system to minimum operational levels, while increasing flexibility and liquidity of its funds. The FGDB should also be provided with access to the NBR's repo facility, to enable the fund to obtain liquidity against treasury bills and other assets, in scenarios of reduced market liquidity.

**51. The NBR has a liquidity provision framework for monetary policy purposes, but an ELA scheme is still lacking.** Liquidity support is critical for crisis management, not only prior to resolution, but even once a resolution path has been established (e.g., for a bridge bank, or a for a bailed in institution). ELA arrangements provided for in law have not been fully implemented and there is very limited experience with ELA in the country. An operational framework for ELA policy is under development and should be concluded, including by establishing appropriate conditions, stipulating the necessary operational elements (e.g., haircuts, maximum terms, etc.), and extending eligible collateral to a more diverse asset pool, comprising FX securities. Finally, given the still significant presence of FX transactions in Romania's system (e.g., 41 percent of banks' liabilities are in foreign currency, including a sizable share of retail deposits), the ELA framework will have to incorporate a strategy for a crisis response to cases of illiquidity in FX.

## FINANCIAL SECTOR DEVELOPMENT<sup>22</sup>

**52. Romania has made significant progress in the development of its capital markets; this positive momentum needs to be maintained.** In the past years a broad range of reforms has been

<sup>22</sup> This section is a summary of the World Bank's Financial Sector Assessment (FSA), which was prepared by the World Bank in the context of this FSAP. The FSA also contains a table of further specific recommendations in these areas.

undertaken and progress has been noticed internationally. As a result, more liquidity has been brought to the market, both the domestic and foreign investor base has deepened, and medium to longer term investment has increased. However, country level concerns regarding government support for the development of the market, corporate governance of state-owned enterprises and changes to the private pension system, risk reversing the progress made to date. There are also market level issues that need to be addressed in order to further increase liquidity and successfully introduce new products.

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

**54. The depth of the Romanian banking market is lagging relative to peers.** While poverty, rurality and informality form a set of constraints that may only subside in the long run, credit demand remains overall limited due to low enterprise density, poor health of the enterprise sector, and a high number of foreign owned firms (compared to peers). On the supply side, access to credit continues being restricted for most companies, with gaps notable for MSMEs, start-ups, and in rural areas. While legal frameworks enabling credit, such as insolvency laws, are well designed, their implementation should be further improved.

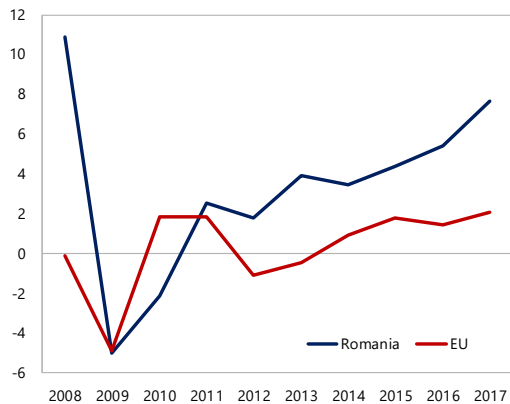
**55. Financial inclusion is also lagging.** In addition to the above mentioned structural factors, low intermediation is the result of a thin (and declining) bank branch network, especially in rural areas. Although the recent law introducing zero fee accounts for about 50 percent of the population may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

**56. Closing these financial sector development gaps would require clear development policies and an efficient coordination mechanism.** Public initiatives to support access to finance are too fragmented and lack efficiency and coordination. It is necessary to adopt a holistic view; in particular, authorities should consider establishing a Financial Sector Development Committee with a clear development mandate, an effective monitoring and evaluation system and accountability mechanism.

**Figure 1. Romania: Economic Developments 2008–17**

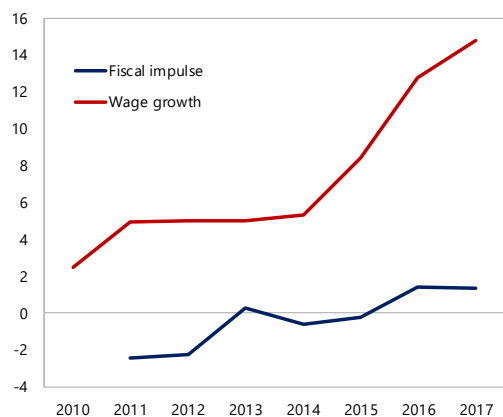
*Economic growth resumed and has accelerated in the last two years...*

**Real GDP Growth Per Capita**



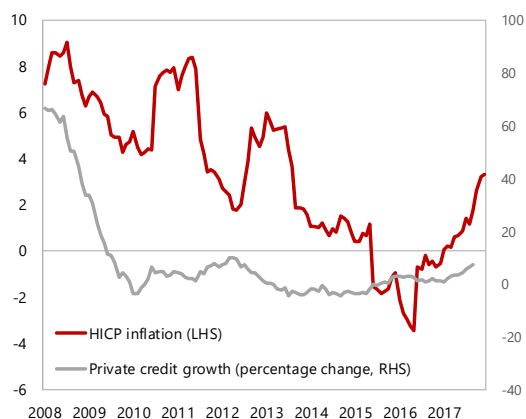
*... fueled by expansionary fiscal policy and wage growth, resulting in the output slack to be absorbed.*

**Fiscal Impulse and Wage Growth**



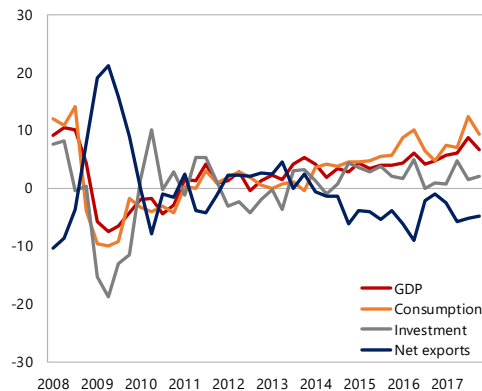
*...in the context of subdued inflation and weak credit growth...*

**Annual Inflation**



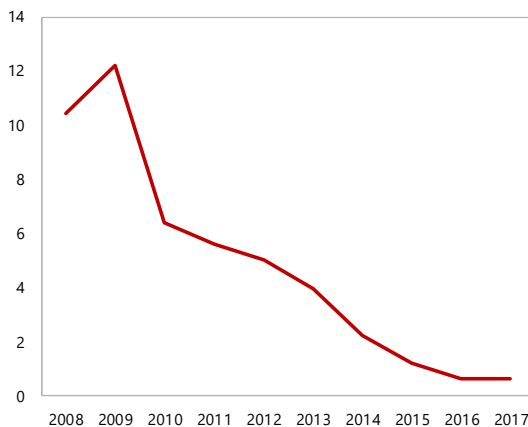
*... driven mostly by an increase in private consumption...*

**Contributions to GDP Growth**



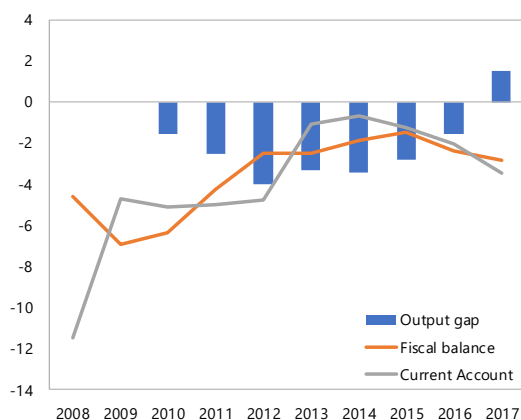
*Monetary conditions have remained supportive of growth...*

**NBR Deposit Rate**



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

**Internal and External Balances**



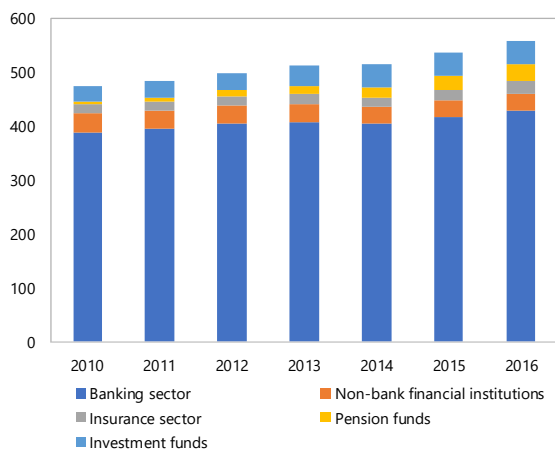
Source: NBR.

**Figure 2. Romania: Financial Developments 2008–16**

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

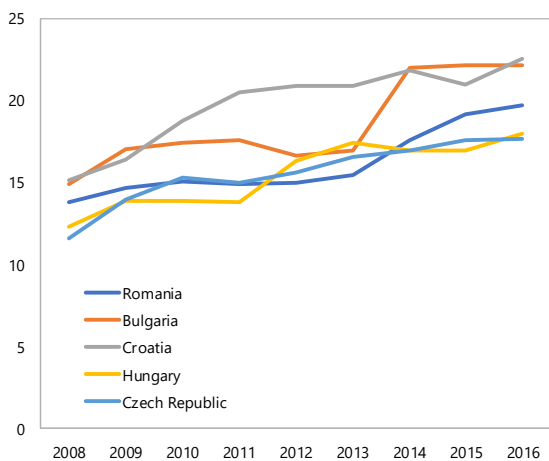
**Structure of Financial Sector**

Total Assets (In billions of lei)



*... a strong decline in NPLs...*

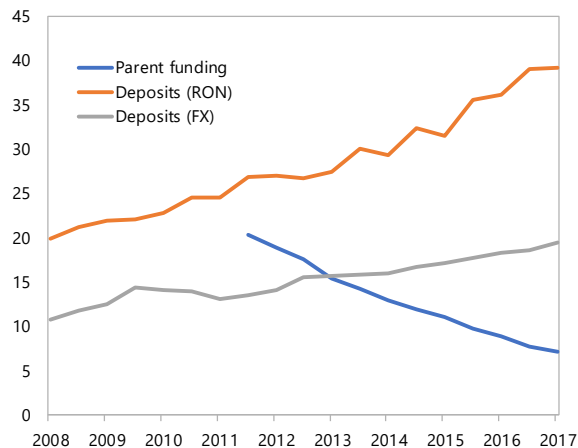
**Regulatory Capital to RWA**



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

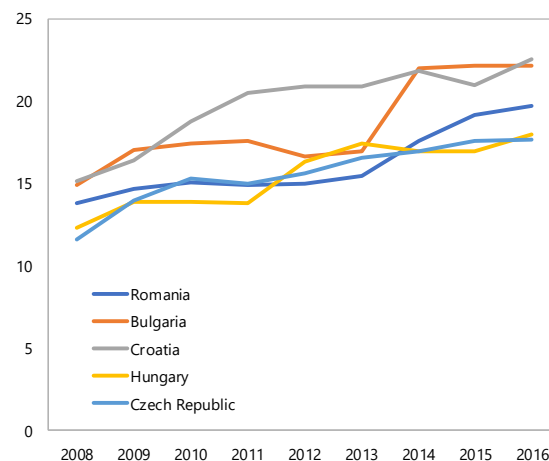
**Bank Funding**

(In billions of EUR)



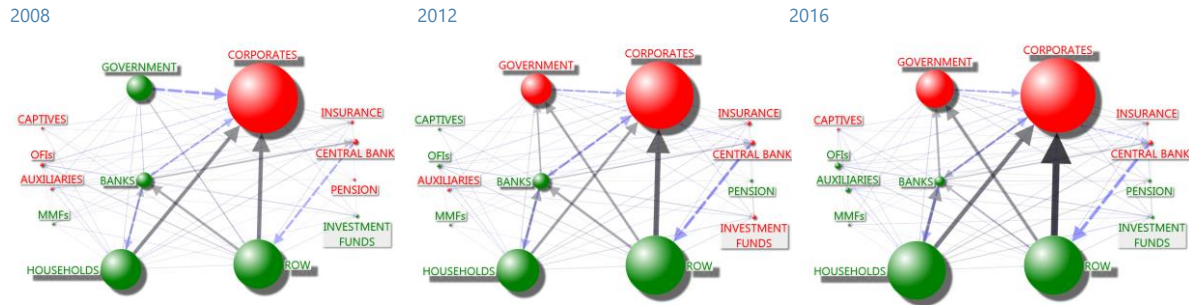
*... and strengthened capital ratios.*

**Regulatory Capital to RWA**



Source: NBR.

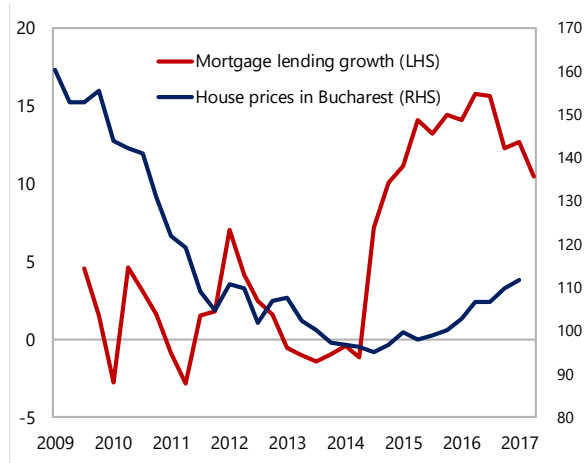
**Figure 3. Romania: Network of Balance Sheet Exposures**



Sources: NBR and IMF staff calculations.

Note: Red nodes represent net borrowers and green nodes net lenders. The diameter of nodes and thickness of arrows show the relative size of imbalances and exposures, respectively.

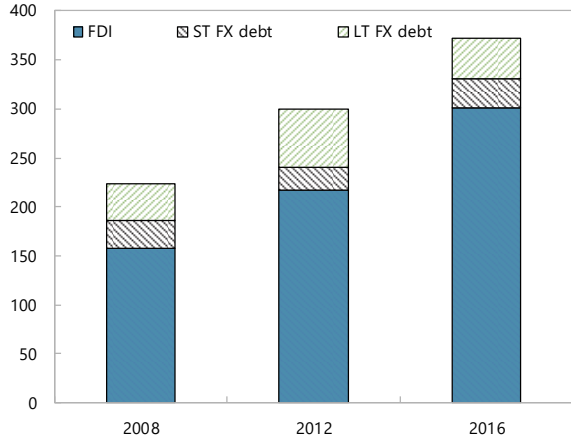
**Figure 4. Romania: Mortgage Lending and House Prices**



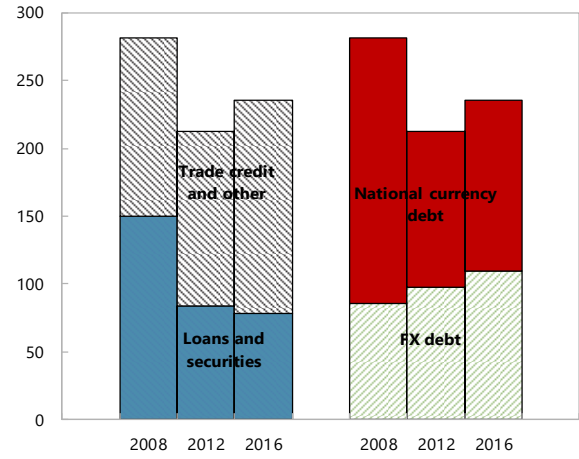
Source: NBR.

Figure 5. Romania: External Borrowing and Corporate Leverage

Romania: Corporate FDI and External Borrowing in FX  
(in billions of lei)



Romania: Structure of Corporate Leverage  
(Percent of corporate equity liabilities)

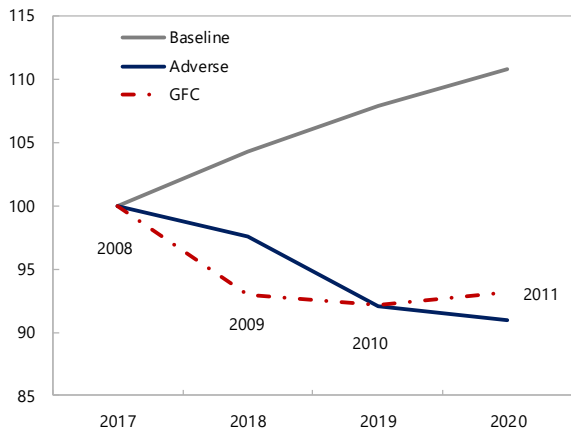


Sources: NBR and IMF staff calculations.

**Figure 6. Romania: Macroeconomic Scenarios**

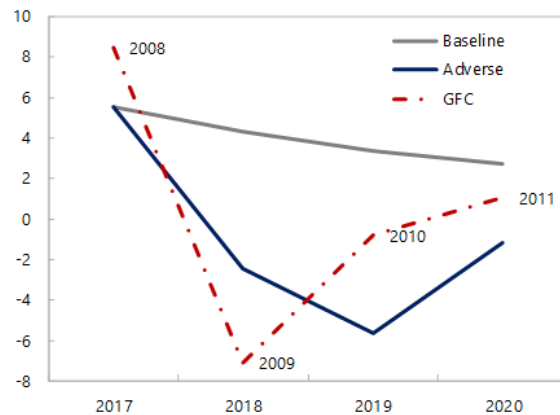
**Real GDP Under the Stress Scenario, 2017-20**

(2017 = 100)



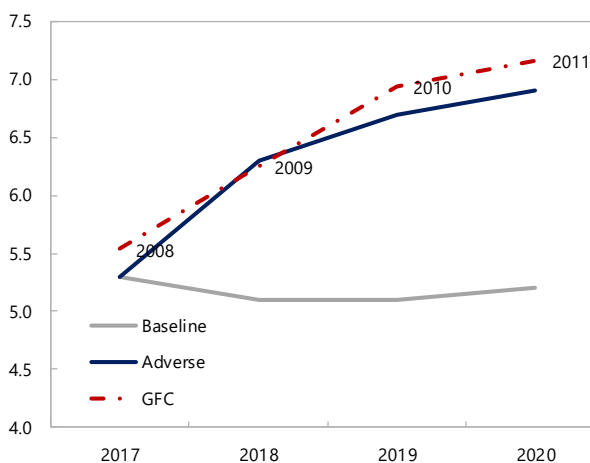
**Real GDP Growth Under the Stress Scenario, 2017-20**

(In percent)



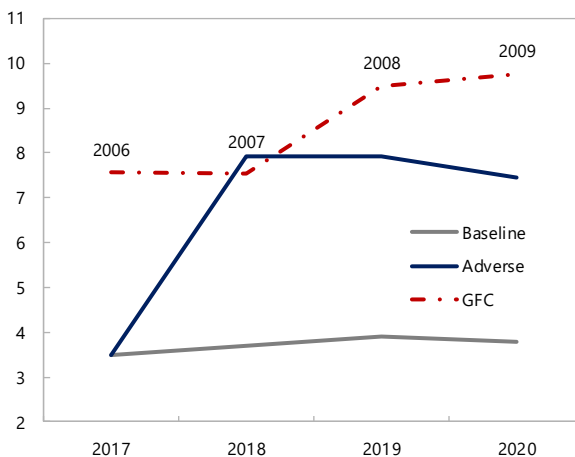
**Unemployment Rate Under the Stress Scenario, 2017-20**

(In percent)



**LT Gov. Bond Yields Under the Stress Scenario, 2017-20**

(In percent)

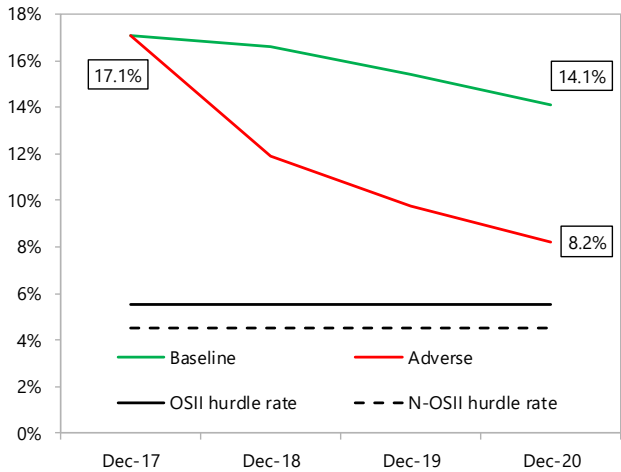


Sources: NBR and IMF staff calculations.

Figure 7. Romania: Stress Test Results

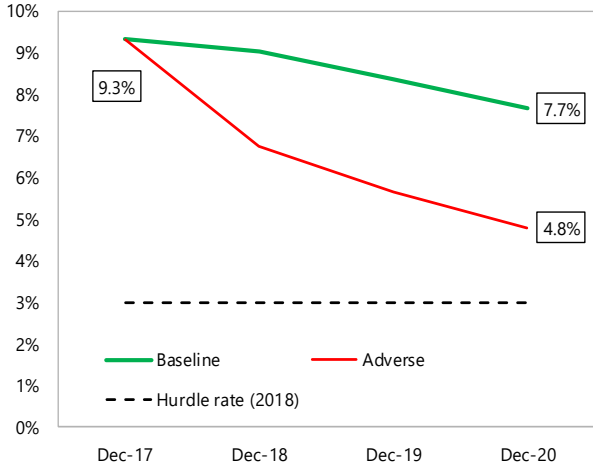
**Common Equity Tier 1 Capital Ratio**

(Fully-loaded, in percent)



**Leverage Ratio**

(Fully-loaded Tier 1/Total assets, in percent)



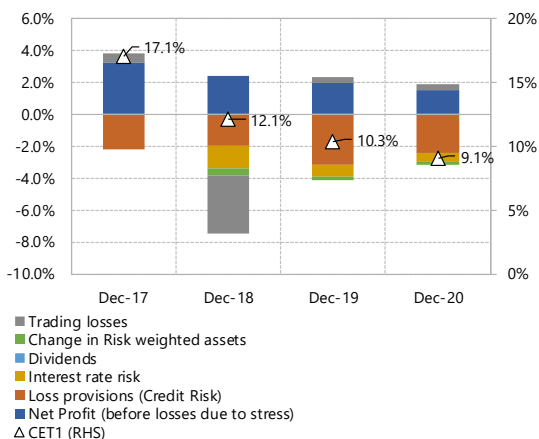
Sources: NBR and IMF staff calculations.



**Figure 8. Romania: Losses in the Adverse Scenario**

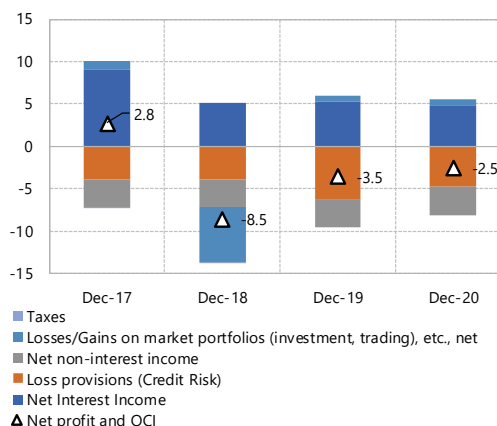
*Factors Contributing to a Drop in Capital Ratios*

**Contribution to Change of Capitalization Ratio**



**Components of Comprehensive Income**

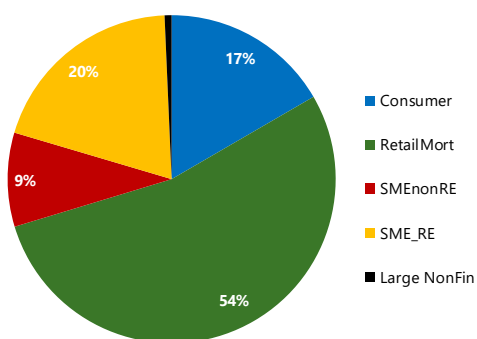
(In billions of RON)



**Components of Credit Losses**

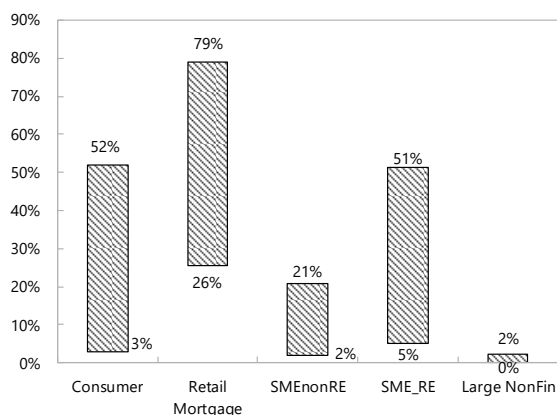
**Composition of Credit Losses**

Adverse scenario



**Contribution of Various Portfolios to Credit Losses\***

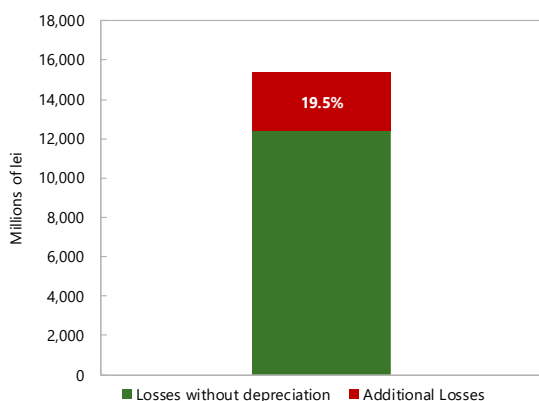
(Share of total credit losses, range across institutions)



**Impact of Depreciation on Credit Losses**

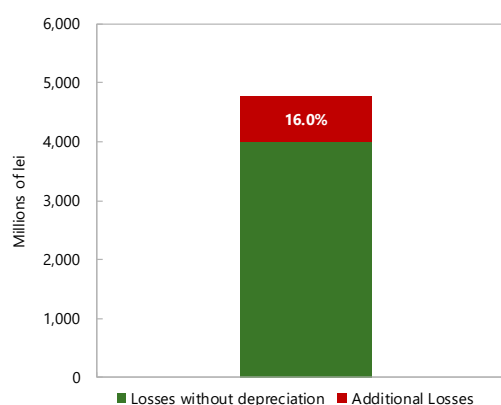
**Mortgage Losses in Adverse Scenario**

Impact of depreciation



**Consumer Losses in Adverse Scenario**

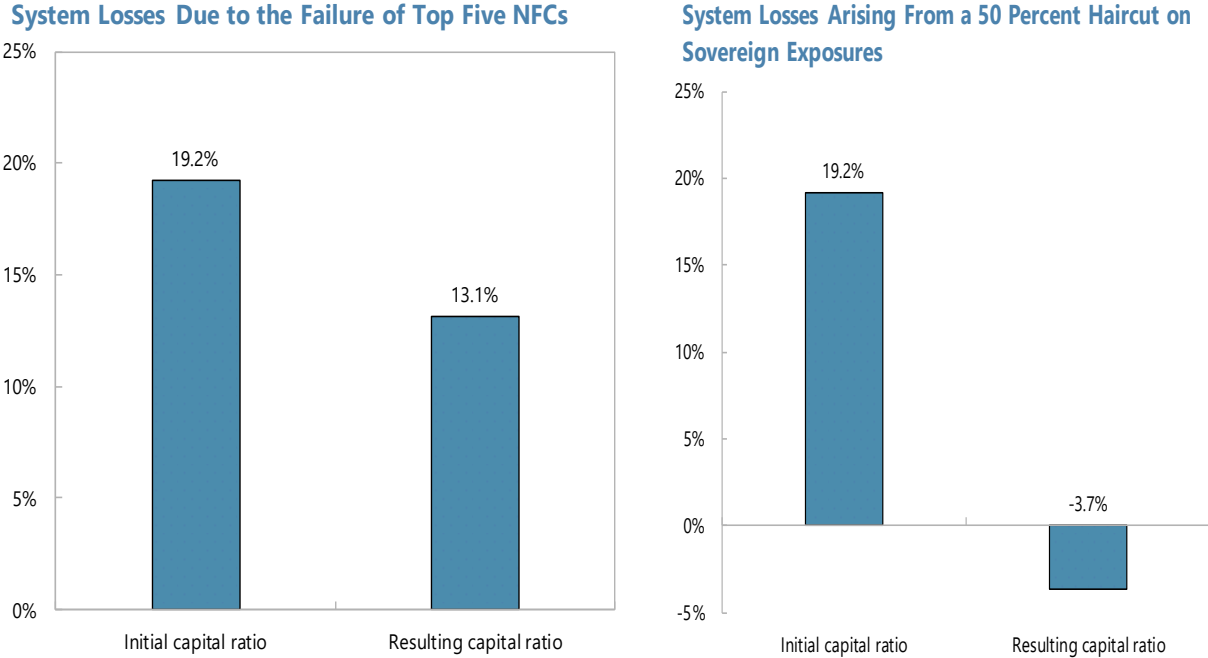
Impact of depreciation



Sources: NBR and IMF staff calculations.

\* The columns show the range of the values for each category across banks.

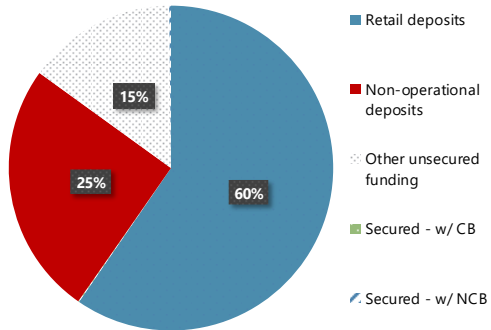
Figure 9. Romania: Large Exposure Sensitivity Test



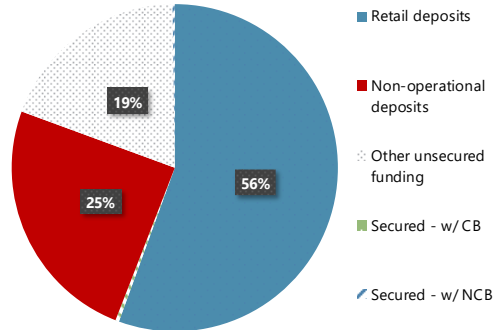
Sources: NBR and IMF staff calculations.

**Figure 10. Romania: Funding and HQLA Structures of Romanian Banks**

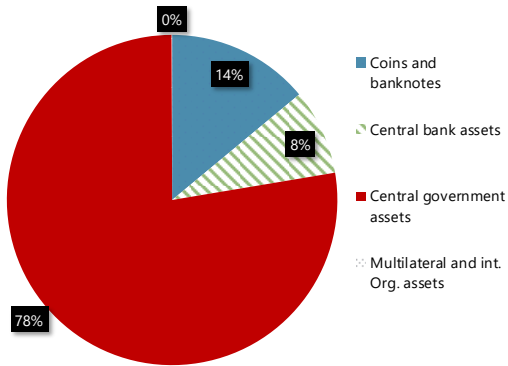
**Structure of Funding (RON)**



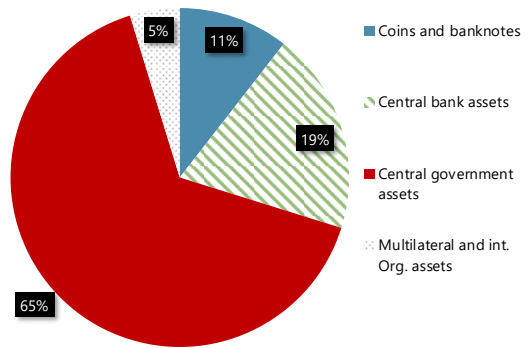
**Structure of Funding (EUR)**



**RON HQLA**



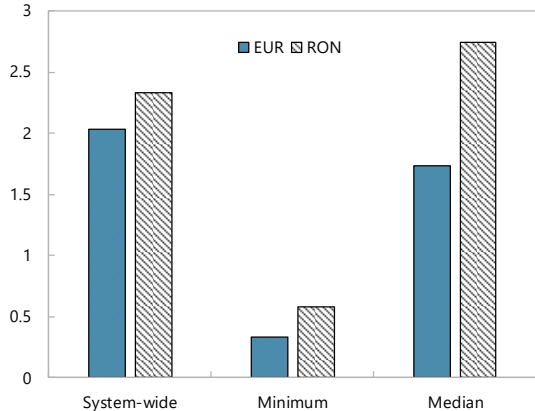
**Euro HQLA**



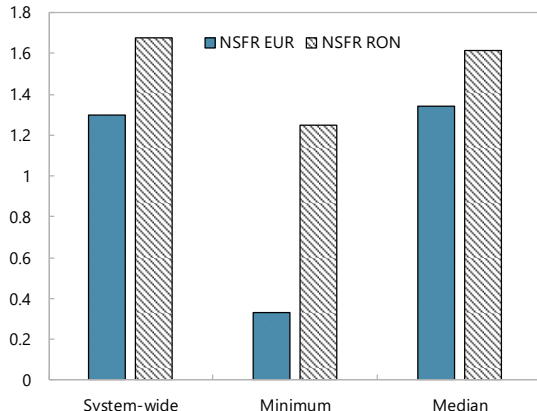
Sources: NBR and IMF staff calculations.

Figure 11. Romania: Regulatory Liquidity Ratios

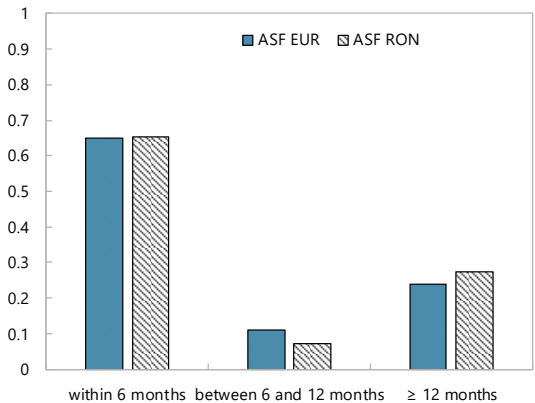
LCR by Currency



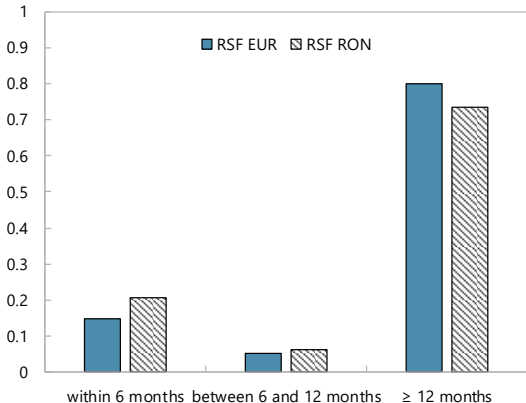
NSFR by Currency



Available Stable Funding (ASF) by Maturity



Required Stable Funding (RSF) by Maturity



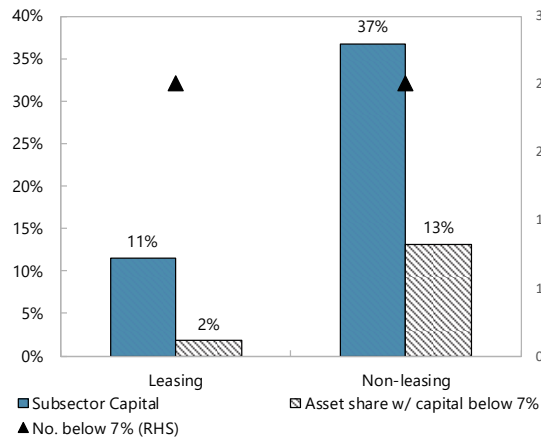
Sources: NBR and IMF staff calculations.

**Figure 12. Romania: NBFL Sector**

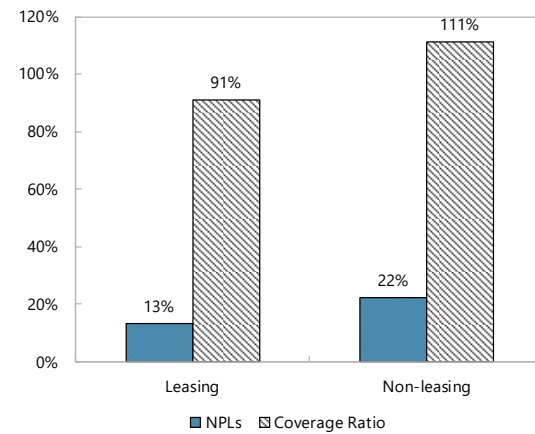
Capital ratios for leasing companies close to the minima...

... NBFLs' assets quality poorer compared to the banks.

**Capitalization Ratios**



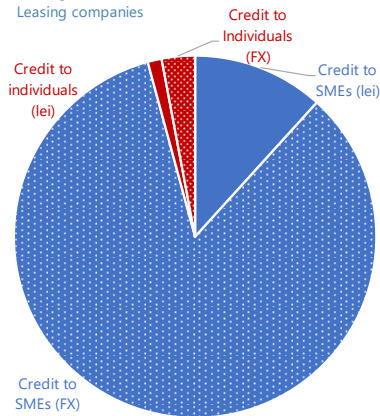
**NPLs and Coverage Ratio**



**Composition of credit portfolio of NBFLs**

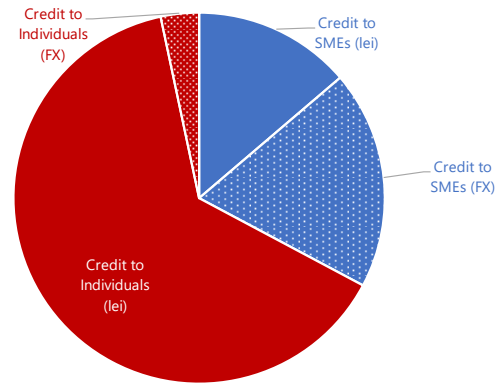
**Composition of Credit to Customers**

Leasing companies



**Composition of Credit to Customers**

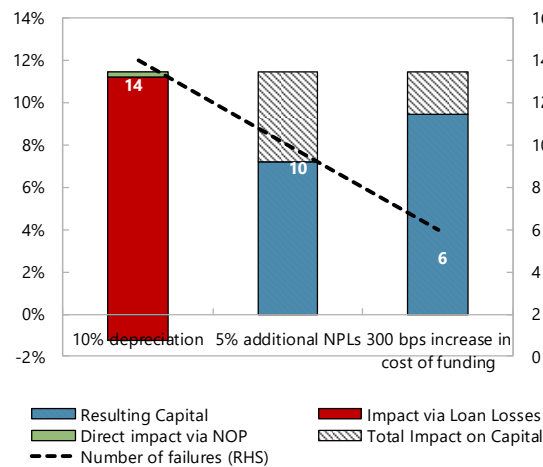
Non-leasing companies



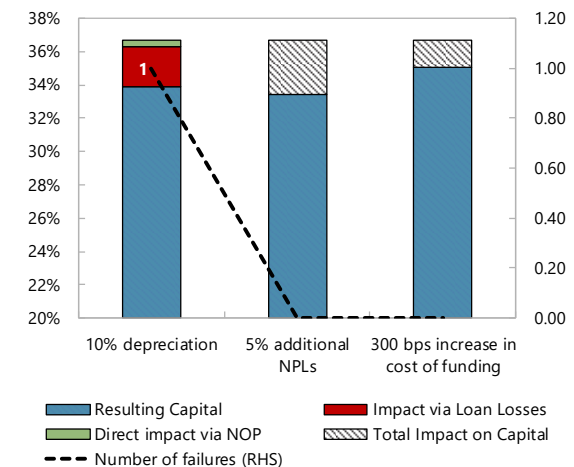
Leasing companies particularly vulnerable to depreciation...

...while non-leasing companies are less so.

**Leasing Companies**



**Non-Leasing Companies**



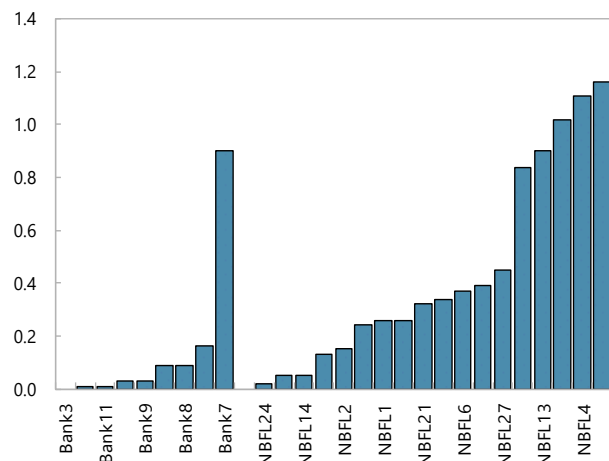
Sources: NBR and IMF staff calculations.

**Figure 13. Romania: Bank-NBFL Contagion Analysis**

*Network approach*

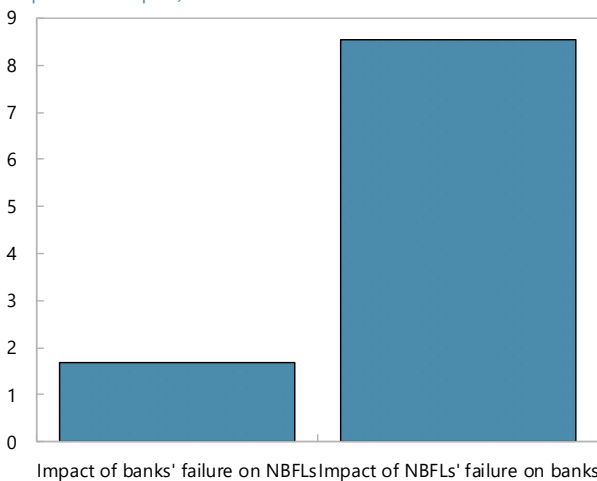
**Network Analysis: Index of Contagion**

(Impact of a bank or NBFL failure on the rest of the network, in percent of capital)



**Network Analysis: Index of Contagion**

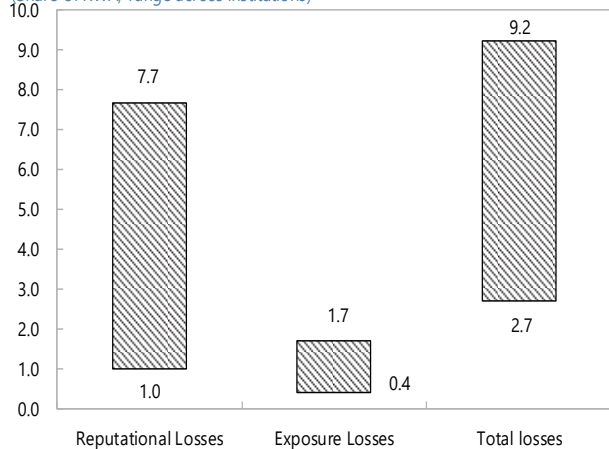
(Impact of failure of group of institutions on the rest of the network, in percent of capital)



*Banks' direct exposures to NBFLs*

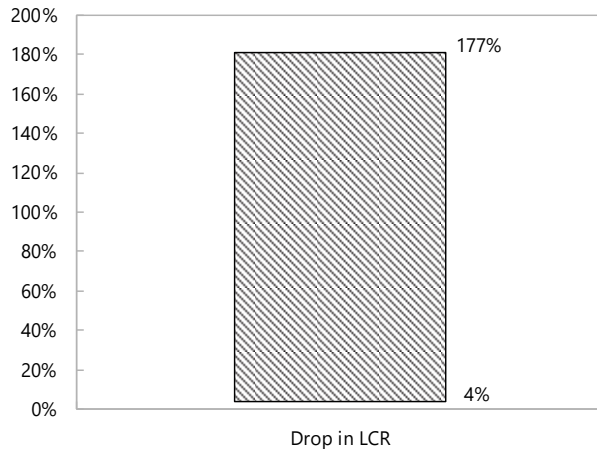
**Range of (Direct and Indirect) Losses Due to Failure of NBFL\***

(Share of RWA, range across institutions)



**Range of Drop in LCR Due to NBFL Failure\***

(In percentage points, range across institutions)



Sources: NBR and IMF staff calculations.

\* The columns show the range of the values for each category across banks.

Table 2. Romania: Selected Economic Indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
										Prel.
	(Percent change, unless otherwise indicated)									
<b>Real economy</b>										
Real GDP	8.3	-5.9	-2.8	2.0	1.2	3.5	3.1	4.0	4.8	6.9
Real domestic demand	8.1	-11.2	-2.6	1.9	0.1	-0.1	3.4	5.4	5.3	7.6
Consumption	7.1	-5.8	-3.8	0.9	1.7	-0.3	4.0	4.9	6.8	8.4
Investment	17.6	-35.8	0.1	6.2	3.6	-5.4	3.2	7.4	-2.0	4.7
Exports	-1.8	-4.8	15.1	11.9	1.0	19.7	8.0	4.6	8.7	9.7
Imports	1.1	-20.8	12.5	10.1	-1.8	8.8	8.7	8.0	9.8	11.3
<b>Prices</b>										
Consumer price index (CPI, average) 1/	7.8	5.6	6.1	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3
Consumer price index (CPI, end of period) 1/	6.3	4.8	8.0	3.1	5.0	1.6	0.8	-0.9	-0.5	3.3
	(Percent of GDP; unless otherwise indicated)									
<b>Saving and investment</b>										
Gross national saving	21.7	22.0	22.0	23.0	22.1	24.5	24.0	23.9	21.9	21.0
Gross domestic investment	33.2	26.6	27.1	28.0	26.8	25.6	24.7	25.2	24.0	24.4
Government	6.0	5.0	7.2	7.6	6.4	5.6	5.3	6.2	3.8	3.1
Private	27.1	21.7	19.9	20.4	20.5	20.0	19.4	18.9	20.2	21.3
<b>General government</b>										
Revenue	30.8	29.7	31.8	32.3	32.4	31.4	32.1	32.8	29.0	27.9
Expenditure	35.4	36.6	38.2	36.5	34.9	33.9	33.8	34.2	31.4	30.8
Fiscal balance	-4.6	-6.9	-6.3	-4.2	-2.5	-2.5	-1.7	-1.5	-2.4	-2.8
Gross general government debt (direct debt only)	11.3	20.6	27.8	32.0	35.4	36.6	38.1	37.1	36.8	34.7
Gross general government debt (including guarantees)	13.0	22.6	30.8	34.1	37.7	38.9	40.5	39.3	39.0	36.8
<b>Balance of Payment</b>										
Current account	-11.5	-4.7	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.4
Trade balance	-15.1	-7.3	-7.6	-7.1	-6.9	-4.0	-4.3	-4.9	-5.5	-6.4
Services balance	2.0	0.8	1.2	1.2	1.9	3.3	3.9	4.2	4.5	4.2
Income balance	-2.2	-1.3	-1.2	-1.3	-1.7	-2.2	-1.3	-2.4	-2.6	-2.7
Transfers balance	3.8	3.1	2.5	2.1	2.0	1.9	1.1	1.7	1.5	1.4
Capital account balance	0.4	0.5	0.2	0.5	1.4	2.1	2.6	2.4	2.5	1.2
Financial account balance	-11.8	1.8	-2.0	-2.1	-2.6	-3.0	0.1	0.4	-0.7	-2.0
Current account balance	-11.5	-4.7	-5.1	-5.0	-4.8	-1.1	-0.7	-1.2	-2.1	-3.4
Foreign direct investment, balance	-6.2	-2.8	-1.8	-1.3	-1.9	-2.0	-1.8	-1.8	-2.7	-2.4
<b>Memorandum items</b>										
Gross international reserves (in billions of euros)	28.3	30.9	36.0	37.3	35.4	35.4	35.5	35.5	37.9	37.1
Gross international reserves (in months of next year's imports)	7.8	7.6	7.6	7.9	7.3	6.8	6.4	5.9	5.6	5.0
International investment position (in percent of GDP)	-47.3	-60.2	-62.8	-64.2	-67.8	-61.7	-56.9	-53.6	-49.3	-45.7
External debt (in percent of GDP)	49.6	66.3	74.4	75.3	75.5	68.0	63.0	57.4	54.7	49.7
Short-term external debt (in percent of GDP)	14.1	12.6	15.5	17.2	15.7	13.3	12.6	12.9	13.7	13.2
Terms of trade (merchandise, percent change)	2.4	0.5	1.4	1.7	-3.4	0.8	0.9	2.6	0.6	-1.3
Nominal GDP (in billions of lei)	538.0	526.3	529.6	562.1	595.4	637.5	668.1	712.7	762.3	858.3
Output gap (percent of potential GDP)	13.4	3.7	-1.6	-2.5	-4.0	-3.3	-3.4	-2.8	-1.5	1.5
Potential GDP (percent change)	3.3	2.9	2.4	3.0	2.8	2.8	3.2	3.3	3.5	3.7

Sources: Romanian authorities and IMF staff estimates and projections.

1/ Staff's inflation projections assume monetary tightening.

Table 3. Romania: Financial Soundness Indicators

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Earnings and profitability</b>										
Return on assets*	1.6	0.2	-0.2	-0.2	-0.6	0.0	-1.3	1.2	1.1	1.3
Return on equity*	17.0	2.9	-1.7	-2.6	-5.9	0.1	-12.5	11.8	10.4	12.0
Interest margin to gross income*	44.8	44.1	60.6	62.0	62.3	58.8	58.6	58.5	56.3	58.5
Non-interest expense to gross income*	55.7	63.9	64.9	67.8	58.7	56.5	55.5	58.4	53.0	55.2
<b>Structure of assets</b>										
Total assets (in percent of GDP)	64.8	71.7	72.8	70.2	68.0	64.1	60.7	58.7	56.3	55.6
<i>Of which (in percent of total assets):</i>										
Cash and other payment means	1.7	1.3	1.2	1.3	1.5	1.8	2.2	2.3	3.0	3.1
Marketable securities (other than shares)	3.5	10.0	13.6	15.6	17.4	18.0	19.5	19.4	19.5	19.5
Shares and other equity held by the credit institutions	0.4	0.5	0.6	0.5	0.6	0.6	0.8	1.0	0.8	0.7
Loans	85.1	79.2	75.6	76.1	73.6	72.5	70.8	70.8	70.1	69.6
Credit to households of which:										
RON (in percent of loans)	41.3	38.7	35.2	33.6	32.9	33.5	39.3	48.7	58.5	65.8
EUR (in percent of loans)	46.2	48.8	50.9	53.1	54.6	55.2	50.9	43.9	36.6	30.8
Other currencies (in percent of loans)	12.6	12.4	13.9	13.3	12.4	11.3	9.8	7.3	5.0	3.4
Housing loans (in billions of lei)	20.9	24.2	28.9	33.4	37.1	40.8	44.6	52.0	58.4	66.2
Consumer loans (in billions of lei)	73.7	72.8	64.2	62.0	58.0	53.5	54.3	52.9	52.2	53.8
<b>Funding and liquidity (in percent of total liabilities)</b>										
Marketable securities (other than shares) issued by credit inst.	0.3	0.2	0.3	0.3	0.3	0.5	0.6	0.5	0.4	0.5
Total deposits	80.1	79.4	77.2	78.4	77.8	76.7	78.1	78.6	79.6	80.2
<b>Sectoral distribution of total loans (in percent of total assets)</b>										
Non-financial corporations	27.8	26.3	26.9	29.1	29.3	27.5	26.0	25.1	23.7	22.7
Financial corporations other than MFIs	1.3	0.9	0.7	0.9	0.6	0.7	0.9	1.1	1.3	1.4
General government	1.8	3.1	2.9	2.7	2.4	2.4	2.4	2.4	2.4	2.0
<b>Capital adequacy</b>										
Regulatory capital to RWA*	13.8	14.7	15.0	14.9	14.9	15.5	17.6	19.2	19.7	19.0
Regulatory tier 1 capital to RWA*	11.8	13.4	14.2	12.0	13.8	14.1	14.6	16.7	17.5	17.1
Capital to assets*	9.0	8.6	8.9	8.1	8.0	8.0	7.4	8.2	8.9	8.9
Net open position in FX to capital*	1.6	2.3	-1.4	-4.7	-1.8	2.5	2.0	0.7	0.5	-0.5
NPLs as percent of gross loans*	2.7	7.9	11.9	14.3	18.2	21.9	13.9	13.5	9.6	8.0
NPLs net of provisions to capital*	10.7	11.3	15.7	16.5	14.4	12.1	26.2	41.2	28.9	21.1
Customer deposits to total loans*	81.9	88.7	84.8	84.0	87.3	98.7	110.5	115.6	124.6	123.1
Sources: IMF FSI, NBR.										
* Q3 values used for 2017 (latest available in FSI)										



## Appendix I. Implementation of 2010 FSAP Recommendations

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

Recommendation	Status
<b>Banking Sector</b>	
Strengthen (i) judicial, accounting and auditing standards; and (ii) communication and consultation between the NBR and regulated entities.	i) Implemented. (i) Banks have been required to prepare their financial statements in accordance with IFRS since 2012. Law 162/2017 on the statutory audit transposes the 2014 EU directive (2014/56) that sets out the framework for all statutory audits, strengthens public oversight of the audit profession and improves cooperation between competent authorities in the EU. Law 162/2017 creates a public oversight body for the audit profession in Romania. (ii) Implemented. NBR meets on a regular basis with regulated entities, including banks and their external auditors both at individual and industry levels for more communication and consultation (e.g., NBR meets quarterly with all external auditors).
<b>Securities and Capital Markets</b>	
Concentrate primary issuance of government bonds on one or two maturity points until liquidity is enhanced.	Issuance concentrated in benchmark securities (3, 5, 7, 10, 15 years), liquidity has increased post crisis and due to government bond market development efforts.
Revise contracts of primary dealers and establish a primary dealer rotation policy to provide incentives for market making.	Implemented. The new legal framework governing primary dealer activity on domestic market, in force starting January 2017, including incentives.
Amend the Law of Capital Markets to remove the limit on voting rights in regulated market operators.	Expected to be implemented. The draft law amending Law on Capital Markets and ensuring transposition of MIFID II is not including provisions on limitations of holdings in regulated market operators.
<b>Insurance and Pension Sectors</b>	
Review law on obligatory house insurance.	Partly implemented. As the program continues to mature, a stable well diversified reinsurance program tailored to cover a 1-in-150-year event confirms that premium is considered appropriate by international markets. Premium has vastly exceeded claims in recent years and the retained profits strengthen the company's resilience. Penetration, however, is stagnant, driven more by lax enforcement and low access to housing finance than by adverse selection. A change to the law is being discussed to better enforce compliance. It is unclear by when there will be a decision and what the impact will be.

Recommendation	Status
Clarify interpretation of minimum contribution guarantee and weighted average return guarantee.	Implemented (Norm No. 13/2012 regarding the actuarial calculation of the technical provision for privately managed pension funds, Norm No. 10/2009 regarding rates of return of voluntary pension funds and Norm No. 7/2010 regarding rates of return of privately managed pension funds).
Revise investment management fees.	Not implemented (Law No. 411/2004 regarding privately managed pension funds and Law No. 204/2006 regarding voluntary pension funds clearly provide the levels and the conditions).
Establish unique valuation methodology and responsibility.	Implemented (Norm No. 11/2011 regarding investment and valuation of private pension funds' assets).
Source: staff assessment.	

BANKING SECTOR: SOLVENCY RISK		
Domain	Assumption	
1. Institutional Perimeter	Exercise	<ul style="list-style-type: none"> <li>• Top-Down by FSAP Team</li> </ul>
	Institutions included	<ul style="list-style-type: none"> <li>• The top 12 banks by share of assets.</li> </ul>
	Market share	<ul style="list-style-type: none"> <li>• 80 percent of total assets in the banking system.</li> </ul>
	Data and baseline date	<ul style="list-style-type: none"> <li>• Latest data: December 2016.<sup>1</sup></li> <li>• Supervisory data: balance sheet information, Corep and Finrep, LCR and LE templates provided by the authorities. Also provided were further supervisory information on default rates, by portfolio and bank.</li> <li>• Scope of consolidation: banking activities of the consolidated banking group.</li> <li>• Coverage of sovereign and non-sovereign securities exposures: held to maturity, available for sale, and fair value accounts, valued at MTM or fair-value respectively at starting point.</li> </ul>
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> <li>• Macroeconomic scenarios were quantified using the NBR's Quarterly Projections Model (QPM).</li> <li>• FSAP team satellite models and methodologies.</li> <li>• Balance-sheet regulatory approach.</li> </ul>
	Satellite Models for Macrofinancial linkages	<ul style="list-style-type: none"> <li>• FSAP team estimated models for credit losses on four portfolios: Consumer, Mortgages, SME backed by RE and SME not backed by RE. The PDs for the large corporates were calibrated to the 80<sup>th</sup> percentile. The estimates relied on time-series default rates for</li> </ul>
	Stress test horizon	<ul style="list-style-type: none"> <li>• 2018–20</li> </ul>
<p><sup>1</sup>. While the data is as of December 2016, the stress test horizon covered 2018–20. The assumption was that the balance sheet of the banks remained exactly in their December 2016 position. This is supported by data available as of Q3 2017 (unaudited) which shows that CAR for the banking sector stood at 19 percent, and T1 capital ratio at 17.1 percent (see FSR, NBR, December 2017).</p>		

3. Tail Shocks	Scenario analysis	<ul style="list-style-type: none"> <li>• Macroeconomic scenario analysis: agreed with the authorities.</li> <li>• Baseline scenario based on latest IMF staff projections, with inputs from the authorities' QPM model on variables for which projections were not available.</li> <li>• The (V-shaped) adverse scenario is based on a cumulative decline of GDP of two standard deviations over two years. The shocks to simulate the model were an external demand shock affecting Romania's main trading partners, a risk premium shock to generate the nominal depreciation of the exchange rate, and additional internal confidence shock due to increased risk aversion.</li> </ul>
	Sensitivity analysis	<ul style="list-style-type: none"> <li>• Sensitivity tests to various shocks:</li> <li>• Failure of the largest 1, 2, 5, and 10 corporate exposures; failure of largest non-corporate exposure.</li> <li>• Sensitivity tests to various risks (credit, interest, and market risks).</li> </ul>
4. Risks and Buffers	Risks/factors assessed (How each element is derived, assumptions)	<ul style="list-style-type: none"> <li>• Credit losses by exposure type and country.</li> <li>• Losses from debt instruments (sovereign and other issuers) in the banking and trading books.</li> <li>• Impact of funding cost shocks on net interest income.</li> <li>• Market risk, including foreign exchange risk.</li> </ul>
	Behavioral adjustments	<ul style="list-style-type: none"> <li>• Static balance sheet.</li> <li>• Dividends can only be paid out by banks that remain adequately capitalized and have positive profits. Payout rates consistent with past experience.</li> </ul>
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	<ul style="list-style-type: none"> <li>• PDs and LGDs: point in time for credit losses and through the cycle for stressed RWA calculations.</li> <li>• Regulatory risk parameters for standardized banks.</li> </ul>
	Regulatory/Accounting and Market-Based Standards	<ul style="list-style-type: none"> <li>• Hurdle rate: Pillar I requirements plus relevant systemic buffers.</li> <li>• Capital metrics: Fully loaded Basel III regulatory requirements.</li> <li>• CET1, T1, CAR, leverage ratio.</li> </ul>
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> <li>• Capital shortfall system wide, and share in whole system.</li> <li>• Dispersion of capital ratios: min., avg., max.; percentage of assets that fail.</li> </ul>

<b>BANKING SECTOR: LIQUIDITY RISK</b>		
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> <li>• The top 12 banks by share of assets.</li> </ul>
	Market share	<ul style="list-style-type: none"> <li>• 80 percent of total assets in the banking system.</li> </ul>
	Debt and baseline date	<ul style="list-style-type: none"> <li>• Latest data: December 2016</li> <li>• Source: supervisory data</li> <li>• Scope of consolidation: consolidated banking group.</li> </ul>
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> <li>• Cashflow-based using data on the time structure of undiscounted cashflows for up to one year</li> <li>• Variants of LCR ratios by currency</li> <li>• NSFR.</li> </ul>
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> <li>• Funding liquidity</li> <li>• Market liquidity.</li> </ul>
4. Scenarios		<ul style="list-style-type: none"> <li>• Retail shock</li> <li>• Wholesale shock.</li> </ul>
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	<ul style="list-style-type: none"> <li>• Liquidity gap, survival period</li> <li>• Consistent with Basel III draft standards (LCR).</li> </ul>
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> <li>• Liquidity gap by bank</li> <li>• Survival period in days by bank, number of banks that still can meet their obligations.</li> </ul>

CONTAGION RISK			
		Domestic	Cross-border
1. Perimeter	Institutions included	<ul style="list-style-type: none"> <li>• For domestic network analysis of contagion, interbank exposure is conducted on the top 12 banks by share of banking sector assets, and the rest of the banks treated as a single institution</li> <li>• The analysis of bank-NBFL contagion is based on the top 12 banks, and the 34 NBFLs in the special register.</li> </ul>	<ul style="list-style-type: none"> <li>• Romania and 14 BIS reporting countries.</li> </ul>
	Market share	<ul style="list-style-type: none"> <li>• The top 12 banks account for 80 percent of total assets in the banking system</li> <li>• The top 34 NBFLs account for 90 percent of total NBFLs assets.</li> </ul>	<ul style="list-style-type: none"> <li>• N/A</li> </ul>
	Data and relevant date	<ul style="list-style-type: none"> <li>• Interbank exposures data</li> <li>• Banks-NBFLs exposure data, including participations</li> <li>• December 2016.</li> </ul>	<ul style="list-style-type: none"> <li>• BIS Locational Statistics</li> <li>• July 2016.</li> </ul>
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> <li>• Network analysis using interbank and bank-NBFLs exposures. (Espinosa-Sole approach).</li> </ul>	<ul style="list-style-type: none"> <li>• Network analysis using BIS data (Espinosa-Sole approach).</li> </ul>
3. Tail Shock	Size of the shock	<ul style="list-style-type: none"> <li>• 100 percent loss given default (LGD)</li> <li>• 65 percent roll-over of funding</li> <li>• 50 percent haircut on asset fire sales.</li> </ul>	<ul style="list-style-type: none"> <li>• 100 percent loss given default (LGD)</li> <li>• 30 percent roll-over of funding</li> <li>• 50 percent haircut on asset fire sales.</li> </ul>
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> <li>• Capital shortfall, by institution</li> <li>• Capital shortfall, system wide</li> <li>• Failure of individual institutions</li> <li>• Interconnectedness measures.</li> </ul>	<ul style="list-style-type: none"> <li>• Failure of banking systems</li> <li>• Interconnectedness measures.</li> </ul>

**NBFLs: SOLVENCY SENSITIVITY TESTS**

<b>NBFLs: SOLVENCY SENSITIVITY TESTS</b>		
1. Institutional Perimeter	Institutions included	The 34 NBFLs in the special register.
	Market share	90 percent of total assets in the NBFLs.
	Debt and baseline date	Latest data: December 2016 Source: supervisory data.
2. Tests	Sensitivity analysis	Sensitivity tests to credit risk and funding risk.
3. Regulatory standard	Regulatory standards	NBR regulation governing capital requirements.
4. Reporting Format for Results	Output presentation	Losses system-wide and as a share of sectoral assets.



## Appendix III. Risk Assessment Matrix

Nature/Source of Main Threats and Possible Triggers	Likelihood of Severe Realization of Threat Sometime in the Next Three Years	Expected impact on Financial Stability if Threat is Realized
1. A re-emergence of financial stress in European banks followed by risk aversion in global markets.	<b>Staff assessment: Medium</b> Financial stress may have knock-on effects on sovereign yields in Romania and negative spillovers from financial, trade and investment channels. Risk aversion in global markets may lead to a steepening of the yield curve.	<b>Staff assessment: High</b> A sudden rise in risk premia on Romanian government bonds exposes banks to losses on their domestic government bond positions. Adverse effect on economic activity and social tensions.
2. Policy uncertainty and divergence and a weakening of confidence in the Romanian economy.	<b>Staff assessment: High</b> Procyclical fiscal stance and growing macroeconomic imbalances may lead to a sharp recession, economic disruption, and adverse market sentiment, reflected in consumption and investment decisions.	<b>Staff assessment: High</b> Uncertainty increases borrowing costs, may impact Romania's credit rating, and may lead to sudden capital outflows and slower growth.
3. Surges in global financial market volatility, associated with the exit from unconventional monetary policies.	<b>Staff assessment: High</b> Financial market volatility could lead to a rapid and significant rise in interest rates, a steepening of the yield curve, and currency depreciation.	<b>Staff assessment: High</b> NPLs would likely rise further both in the case of increases in interest rates and in the case of leu depreciation, since both would weaken the repayment capacity of borrowers of lei and FX loans. Also, banks would face losses on their domestic government bond positions.
4. A protracted period of slower growth in advanced and emerging economies.	<b>Staff assessment: Medium</b> Weak growth in European trading partners could slow the Romanian economy through declines in trade and remittances.	<b>Staff assessment: Medium</b> Slower growth could increase NPLs and impact bank profitability.
<p>Note: The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). It reflects current staff views on the sources of risk surrounding the baseline, their relative likelihood, and the overall level of concern.</p>		

## Appendix IV. The Systemic Risk Buffer: Design and Impact

1. **The FSAP is recommending the introduction of prudential policy measures to mitigate risks from the sovereign-bank nexus.** The policy response should aim at ensuring resilience through increased loss absorbing capacity and provide disincentives against excessive concentration of risks, while at the same time avoiding unintended side-effects, such as an excessive reduction of liquidity, a bond market sell-off, or other unwarranted macro-financial dynamics.
2. **The SRB is a particularly well-suited tool to address the sovereign-bank nexus in the European context.** The SRB is a macroprudential tool available in EU legislation that is flexible in implementation and recognized as being suitable to address common exposures and risks which are otherwise unaccounted for in the CRR framework. Use of this buffer can effectively weaken the nexus by increasing banks' resilience to losses from sovereign exposures and encourage them to limit excessive concentration of sovereign exposures. The costs associated with this approach can also be limited by a careful calibration that is appropriately gradual.
3. **The SRB is the preferred option compared to other conceivable prudential measures.** Unlike the use of positive risk weights on sovereign exposures, the SRB is legally possible under the current European CRR framework, and it avoids procyclicality. Use of the SRB builds capital buffers preemptively and allows for the possibility to relax them during periods of stress. Unlike applying large exposure limits on sovereign exposures, the SRB is a price-based measure, and does not entail the risk of potentially strong and detrimental "cliff-effects" in the manner that such quantitative restrictions do. Unlike using Pillar 2 measures to mitigate risks from the sovereign-bank nexus, the SRB involves addressing the issue in a transparent and holistic manner at the appropriate level (i.e., the NCMO) where in addition to systemic risks, debt management and monetary policy implications can be adequately addressed.<sup>1</sup>

### Calibration of the Systemic Risk Buffer

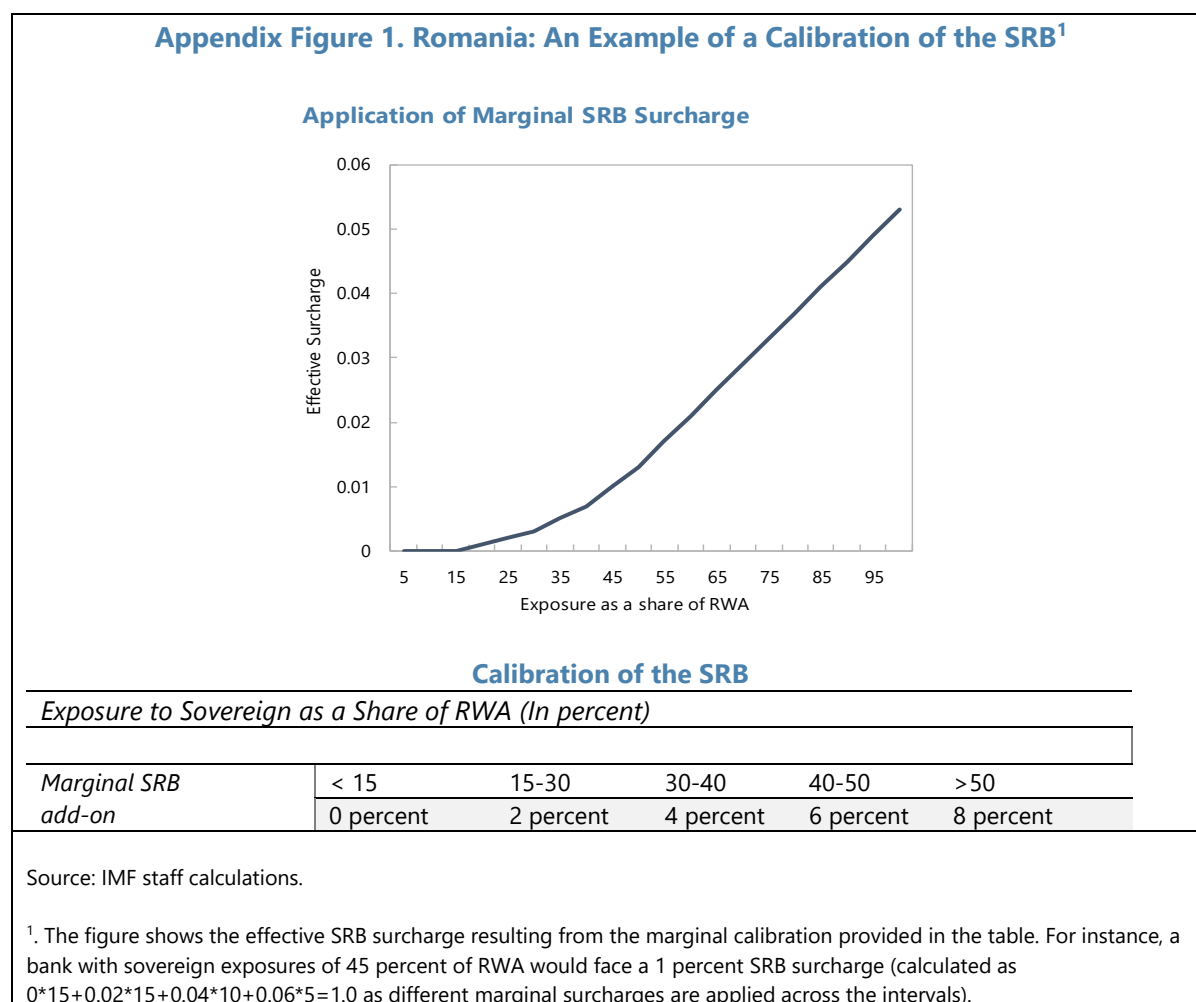
4. **The SRB scheme should be calibrated to levels commensurate to the risks associated with sovereign exposures in Romania.** A gradual calibration is recommended to avoid unintended side-effects. Figure 1 provides an example of such a calibration. It applies a marginal scheme, with increasing SRB surcharges as sovereign exposures rise as a share of RWAs. The calibration applies a positive SRB only for exposure shares beyond a threshold, recognizing that banks hold some domestic government bonds to fulfill liquidity requirements. It then foresees a gradual and marginal rise in capital surcharges as sovereign exposures increase relative to RWA. However, as marginal rates rise through the buckets, it arrives at a sufficient surcharge (of around 3 percent) to ensure valuable resilience for banks with the highest exposures. This example of a calibration wants to err on the side of caution, by limiting unintended side-effects, while at the same time ensuring enhanced resilience towards losses stemming from sovereign exposures.

<sup>1</sup> See Box 1 in the Technical Note on the Macroprudential Policy Framework and Tools.

## Benefits of the Proposed Buffer

### 5. While the main objective is to increase the resilience of the system, the proposed buffer can have a number of additional benefits:

- First, it provides an incentive for intra-financial system trade of sovereign bond holdings, where banks that have a high exposure and therefore face a higher buffer rate have incentives to trade with banks whose exposure is smaller and therefore face a lower buffer rate. The resulting more evenly distributed sovereign holdings would lower the system-wide capital surcharges from the SRB due to the non-linearity in the proposed schedule. The availability of such opportunities for trade would also limit the potential for a broad-based bond market sell-off, as intra-financial system trade can effectively reduce the SRB.



- Second, to the extent that banks will sell parts of the sovereign holdings, or reduce the share of new issues purchased, a useful side effect from a debt management perspective is that the investor base could become more diversified and include a higher share of other domestic

institutional investors as well as foreign investors.<sup>2</sup> This could be useful since these types of investors have a bigger appetite for long-durations, allowing the government to lengthen the maturity of its debt and reduce rollover risks.

- Finally, the SRB reduces the distortion resulting from the zero risk-weight on sovereign bonds, which provides incentives to expand sovereign portfolios at the expense of lending to the real economy. An SRB would go some way to level this distortion and could at the margin serve to support credit growth to the non-financial private sector and enhance fiscal discipline.

## Quantitative Impact on Government Borrowing Costs

**6. An important question is how the calibrated scheme for the SRB would impact sovereign borrowing costs.** The answer would depend on a) the impact of the additional capital requirements on the banks' funding costs, and b) the extent to which banks pass on these costs to the ultimate borrower (i.e., the sovereign).

**7. We assume that banks' funding costs would be affected by the increase in capital requirements.** Modigliani-Miller's equivalence states that variations in a firm's liability structure (composition in terms of debt or equity) do not affect its funding costs. In reality, there are several reasons why Modigliani-Miller may not hold. Almost all jurisdictions apply preferential tax treatment to debt. Deposits also benefit from deposit insurance, which lowers their cost for the bank. Agency considerations have also been highlighted in the literature: debt has a disciplinary impact from a shareholder's point of view and thus raising equity instead of issuing debt can be costly.

**8. The increase in banks' funding costs is assumed to be passed fully into bond prices.** In this exercise it is assumed that (i) a bank's funding costs increase as it raises equity (i.e., Modigliani-Miller does not hold); (ii) the increase in funding costs is fully reflected in the price of bonds, which will have to yield higher returns; (iii) there is no adjustment in the quantity of bonds issued (or purchased by the banks) and the entire adjustment occurs through prices.

**9. The increase in required bank capital due to the SRB is close to 1 percent of RWA or RON 1.7 billion.** Assets of the largest 12 Romanian banks stood at RON 317 billion as of end-2016. Their exposure to government securities was close to 22 percent of total assets, or roughly RON 69 billion. The proposed SRB calibration implies an effective increase in common equity Tier 1 (CET1) capital of close to 1 percent of RWA for the 12 banks, or RON 1.7 billion.

<sup>2</sup> [The Romanian Government Debt Management Strategy for 2017-2019](#) identifies domestic institutional investors, local asset managers, and private pension funds as having "a significant potential to support the development of the local government securities market in the upcoming period" (page 14). The authorities have also introduced or are introducing initiatives to increase individuals' access to purchasing government securities (page 22). Finally, foreign investors hold approximately 17 percent of domestic sovereign bonds, which is fairly moderate in international comparison, so there is still room to increase the share of foreign investment in the domestic government bond market.

**10. As a result, the increase in the banks' cost of funding is RON 174 million.** The increase in the cost of funding for the banks consists of the difference between the cost of equity and debt (assumed to be deposits) for the increase in capital of RON 1.7 billion. This can be computed as

$$\Delta \text{Cost of funding} = \Delta \text{Capital} * [\text{Cost of Equity} - \text{Cost of debt} * (1 - t)]$$

where  $t$  is the tax rate. To measure the cost of equity vs. debt the latest figures for return on equity (ROE) for Romanian banks (12 percent as of end 2017) and deposit rates (close to 2 percent on average) is used. Considering a tax rate of 16 percent, the annual increase in the cost of funding from switching to equity from deposits amounts to RON 174 million.

**11. The higher funding costs imply an increase in government yields of just over 30 bps.** It is assumed that the increase in the cost of funding will be fully reflected in increased government bond yields. It is also assumed that the impact on yields is the same for all maturities (i.e., there is a parallel shift in the yield curve). The increase in yields that would be required for banks to want to continue to hold government bonds can be computed from

$$\Delta \text{Cost of funding} = \Delta \text{yield} * \text{stock of outstanding debt} * (1 - t)$$

Given the assumptions above, bond yields would have to increase by just over 30 bps to cover the increase in funding costs.

**12. The 30 bps increase in government bond yields is likely to be an upper bound:**

- **First, an increase in capital levels reduces the riskiness of a bank, likely decreasing the cost of equity relative to the current levels.** Analysts typically use a positive pass-through, with the most common assumption being a halfway adjustment between Modigliani-Miller (no change in the cost of funding) and the baseline assumption used here (no change in the demanded return on equity). Assuming a 50 percent adjustment would cut the increase in yields in the baseline scenario into half, or roughly 15 bps.
- **Second, bank debt may be more expensive than deposits, reducing the marginal increase in funding costs from more equity.** In the absence of a good estimate for the cost of bank debt other than deposits, deposit rates have been used here as a conservative estimate for the cost of non-equity funding. In reality, banks also have other types of funding, for instance borrowing from parents, which are more expensive than deposits, thus leading to a smaller increase in the cost of funding.
- **Third, not all the additional capital may need to be raised.** Many banks have significant capital buffers above their regulatory requirements and would be able to absorb the increase due to the SRB surcharge. Thus, the actual capital increase may be smaller than the estimate under the baseline.

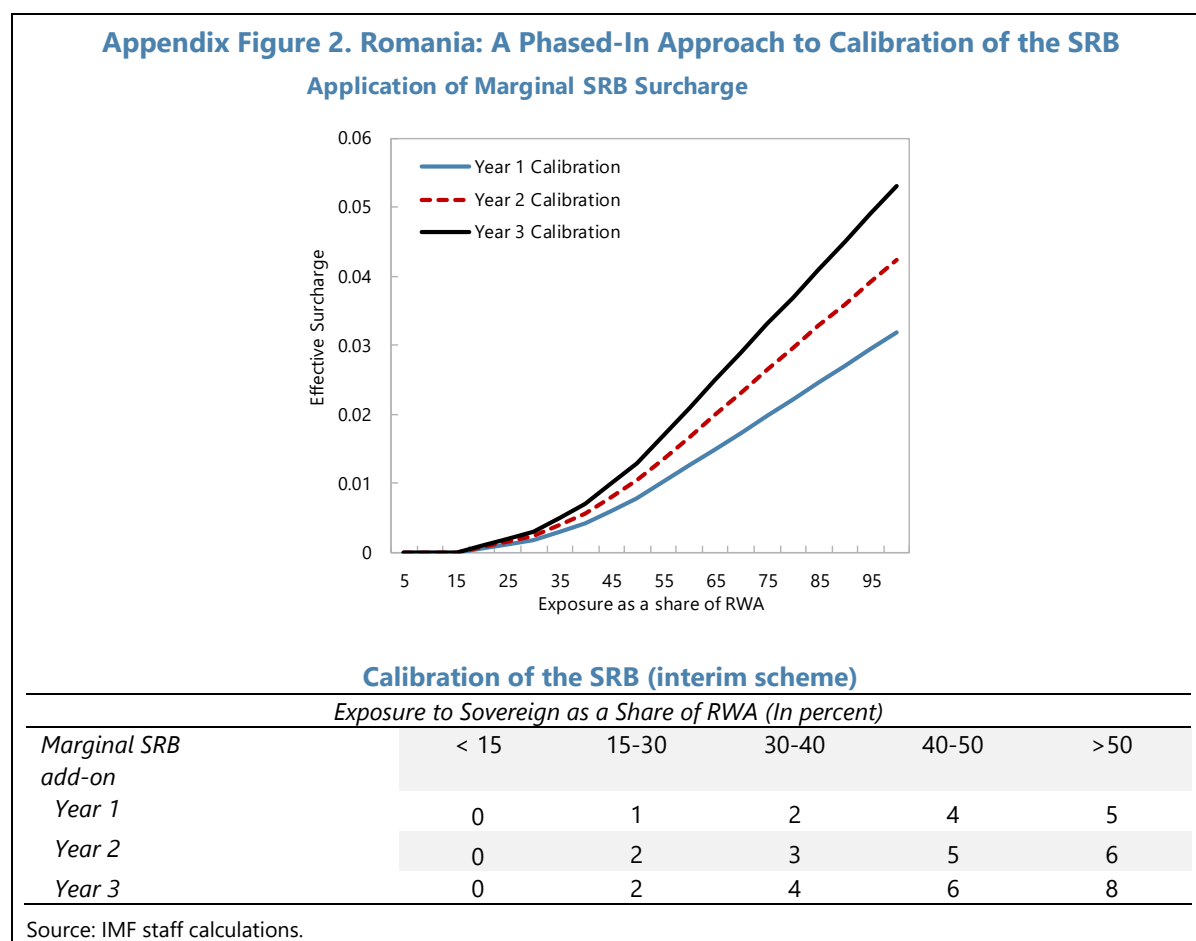
- **Fourth, inter-bank trade could lower the aggregate capital requirements given the non-linearity of the SRB scheme.** Since the marginal SRB add-on increases as exposures to sovereign increase as a share of RWA, the system-wide capital requirements depend on the distribution of sovereign holdings among the banks. For instance, if the current stock of sovereign debt was distributed among banks such that all held the same exposure as a share of RWA, the overall capital requirements due to the SRB add-on would decrease to RON 1.2 billion (compared to the RON 1.7 billion in the baseline case) and the SRB rate add-on would decrease to 0.7 percent of RWA (compared to 1.0 percent of RWA in the baseline case).
- **Finally, to the extent that there is room for adjustment in quantities of bank debt holdings the price impact could be further muted.** For instance, other investors in government bonds such as parent banks, pension funds, and investors abroad who are not subject to the SRB requirement may decide to increase their holdings given the increase in the yields, reducing the ultimate impact to below 30 bps.

**13. The estimates above are consistent with similar studies in the literature.** In the aftermath of the GFC a number of studies estimated the impact of higher capital requirements on lending costs. A [Basel Committee on Banking Supervision \(2010\)](#) study assesses the impact on lending rates of a 1 percent increase in capital requirements to be between 9–20 bps. [Schanz et al. \(2011\)](#) find that for the United Kingdom an increase in the capital ratio by 1 percentage point would imply an increase in lending spreads by about 7.4 basis points. Finally, using data for the United States, [Elliott \(2009\)](#) and [Kashyap, Stein, and Hanson \(2010\)](#) also find the impact on lending rates to be limited.

**14. Such an increase in government bond yields should not pose risks to public sector debt sustainability.** First, it represents a relatively limited increase in yields. During the first four months of 2018, Romania 10-year government bond yields have fluctuated around 4.5 percent. As such, a 30 bps increase amounts to only around 1/16 or less than 7 percent of this level. Second, as government debt-to-GDP is relatively low, the impact of such an increase on debt sustainability is likely to be limited. In fact, one of the scenarios considered in the Public Debt Sustainability Analysis in the 2018 Article IV Staff Report for Romania entails a far greater increase in borrowing costs, without any substantial impact being identified on debt sustainability. Moreover, our analysis suggests that a price increase of roughly 30bps. would make the banking sector indifferent between no SRB surcharge on bonds or holding them at the higher yield. This means that banks' demand for government securities can be secured through an increase of this magnitude, if a change in investor base is not desired, or foreseen only to occur with time.

## A Phased-in Approach

**15. In order to further limit the initial impact on government bonds a more gradual approach to introducing SRB could be adopted.** Such an approach may also be useful since the ex-ante impacts are subject to uncertainty. To account for this, the scheme could be phased in gradually over a period of three years. Figure 2 suggests one example of such a phase-in over three years, that would lead to an estimated additional capital of 0.6 percent of RWA (system-wide) in the first year, rising to 0.8 percent in the second year and ultimately to the 1 percent presented in Figure 1. Using the same logic as above, the initial impact on government bond yields would thus be even more muted, on the order of 20bps for the upper bound in the first year, rising to 25 bps and 30 bps in the second and third year.



## The Impact on Banks' Profitability

**16. The impact on banks' profitability from introducing the proposed SRB scheme can also be assessed.** Note that the extreme assumption underlying the previous exercise was that banks would pass on the entire increase in the cost of funding to the sovereign, such bank profitability, as measured by ROE remains constant. In this exercise, the opposite extreme assumption is made, i.e., that banks absorb the entire increase in funding costs, which would be reflected in a lower ROE.

**17. The bank's ROA is assumed to remain the same.** To calculate the impact of the increase in equity on profitability first note that

$$RoA * \left(1 + \frac{debt}{equity}\right) = RoE$$

Now assume that the banks do not change their asset structure as a result of the SRB capital surcharge. Therefore, ROA for banks remains the same.

**18. The impact of the additional capital requirement on the banking sector's profitability is small.** Assuming an ROE of 12 percent, combined with the current leverage ratio of the banking sector, the ROA for the top 12 banks is approximately 1.3 percent. As a result of the additional RON 1.7 billion raised due to the SRB requirement, the debt to equity ratio would fall from 8.5 percent to 8.1 percent, implying a reduced ROE of 11.4 percent, only 0.6 percentage points lower compared to the current level. Hence, the impact of introducing the proposed SRB on bank profitability is very limited.

### The Impact on Banks' Liquidity Positions

**19. A final exercise examines interactions with banks' liquidity requirements, and finds that the effects are small.** Currently, sovereign securities form 78 percent of all leu denominated HQLA. Therefore, there could be a worry that imposing an SRB surcharge on banks would increase the cost to banks of meeting the LCR and thereby undermine the liquidity requirements. To assess what capital charges flow from banks wanting to meet their LCR, we calculate for each bank the amount of HQLA needed to reach a 100 percent LCR on a leu basis. We then assume, counterfactually that the only available HQLA is government securities,<sup>3</sup> and compute the capital surcharge for each bank associated with holding that amount. We find that under these assumptions, most banks would not face a positive capital buffer, while the SRB buffer for the aggregate banking sector would amount to just 0.1 percent. Therefore, we deem that the cost associated with meeting the LCR imposed by the SRB is very small.

**20. The SRB surcharge could reduce FX liquidity risks by encouraging banks to hold FX denominated HQLA.** The banks in Romania have significant FX denominated deposits (32 percent of total deposits). To hedge the currency risk associated with these liabilities, a significant part of the loans are also issued in FX, exposing the banks to credit risk associated with unhedged borrowers. Therefore, to the extent that the SRB surcharge may, at the margin, encourage banks to hold more FX denominated securities, it would also help them manage currency risk in two ways. First, given a certain level of FX denominated savings in the economy, the need to extend loans in FX would be reduced as the banks can use foreign bonds to close their net open position. Furthermore, highly rated foreign bonds help the banks meet HQLA requirements in FX, in line with the team's liquidity recommendation.

<sup>3</sup> This is more conservative than the actual situation, where government bonds are 78 percent of HQLA holdings.



## Annex I. Report on the Observance of Standards and Codes— Basel Core Principles for Effective Banking Supervision

### A. Introduction

**1. This assessment of the implementation of the BCP in Romania has been completed as part of the Financial Sector Assessment Program (FSAP), jointly undertaken by the IMF and the World Bank in 2017.** The assessment reflects the regulatory and supervisory framework in place as of the completion of the assessment. It requires a review not only of the legal framework, but also a detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision. It is not intended to analyze the state of the banking sector or crisis management framework, which are addressed by other assessments conducted in this FSAP.

### B. Information and Methodology Used for Assessment

**2. This assessment was against the standard issued by the Basel Committee on Banking Supervision (BCBS) in 2012.** Since the past BCP assessment, which was conducted in 2011, the BCP standard has been revised. The revised Core Principles (CPs) strengthen the requirements for supervisors, the approaches to supervision, and the supervisors' expectations of banks through a greater focus on effective risk-based supervision and the need for early intervention and timely supervisory actions. Furthermore, the 2012 revision placed increased emphasis on corporate governance, and supervisors conducting sufficient reviews to determine compliance with regulatory requirements, and having a thorough understanding of the risk profile of banks and the banking system. This assessment for Romania was thus performed according to a significantly revised content and methodology, compared to the previous BCP assessment carried out in 2011.

**3. The Romanian authorities opted to be assessed against both the essential criteria (EC) and the additional criteria (AC), but graded on the basis of EC only.** To assess compliance, the BCP Methodology uses a set of EC and AC for each principle. The EC set out minimum baseline requirements for sound supervisory practices. The AC are recommended as the best practices against which the authorities of some more complex financial systems may agree to be assessed and graded. Romanian authorities chose to be graded against the EC only.

**4. Grading is not an exact science and the CPs can be met in different ways.** The assessment of compliance with each principle is made on a qualitative basis. Compliance with some criteria may be more critical for effectiveness of supervision, depending on the situation and circumstances in a given jurisdiction. Emphasis should be placed on the comments that accompany each CP's grading, rather than on the grading itself.

**5. The assessment team appreciated the excellent cooperation, including extensive provision of internal guidelines, procedures, supervisory files, and reports.** The team held extensive meetings with NBR staff, the MoPF, the industry, and other relevant counterparts who shared their views with the assessors. In particular, the team would like to thank the NBR staff who responded to the extensive and detailed requests promptly and accurately during the assessment.

## C. Preconditions for Effective Bank Supervision

**6. An effective system of banking supervision needs be able to develop, implement, monitor, and enforce supervisory policies under normal and stressed conditions.** There are a number of elements or preconditions that are necessary for effective supervision:

- **Sound and sustainable macroeconomic policies:** See the section “Macrofinancial Setting” in this report.
- **A well-established framework for financial stability policy formulation:** See the section “Macroprudential Framework and Policies.”
- **A well-developed public infrastructure:** Significant improvements have been made on the credit reporting system in the past decade. Credit information sharing is universally considered a key credit infrastructure component for its positive impact on the quality of lending and overall financial sector stability. The project for establishing a Private Credit Bureau was initiated in 2004. The process of collecting and disseminating data was initially limited to negative information, but later expanded to include positive data following international best practices. After five years of operations, the Bureau started to provide additional services to banks, such as credit scoring. In addition, the new Personal Insolvency Law<sup>1</sup> aims at providing over-indebted consumers with a second chance by allowing them to access a debt discharge. On June 9, 2017, the government approved the methodological norms required to administer the procedure, although additional rules, regulations, and guidelines would need to be prepared for an efficient implementation.
- **A clear framework for crisis management and financial safety nets:** See the section “Financial Safety Nets and Crisis Management.”
- **Effective market discipline:** Financial reporting, auditing and disclosure requirements in Romania are largely harmonized with those applicable across the EU and in line with international standards. The Romanian banking system has been required to report financial information based on IFRS at consolidated level since 2006 and at individual level since January 2012. Banks representing close to three quarters of banking assets are subsidiaries of EU banking groups, which are generally listed and subject to effective market discipline at group level. A 2017 law created a new public oversight body for external auditors in Romania.

## D. Main Findings<sup>2</sup>

### Responsibilities, Objectives, Powers, Independence, and Accountabilities (CPs 1–2)

**7. The NBR has clear responsibilities as a supervisor, adequate resources and independence, even if the framework protecting the latter should be strengthened.** Banking

<sup>1</sup> Law No. 151/2015 on insolvency of natural persons was adopted by the Romanian Parliament in June 2015.

<sup>2</sup> The Detailed Assessment Report has been prepared by Hee Kyong Chon (IMF), and Cedric Mousset (World Bank).

supervision in Romania falls exclusively within the responsibility of the central bank. As Romania is a member of the EU, banking supervision is also significantly harmonized and integrated across member states. Laws and regulations are regularly updated. The NBR, as a supervisory authority, possesses stable governance arrangements and effective operational independence. However, the MoPF could participate in NBR Board meetings and the reasons for the dismissal of a board member do not have to be disclosed. The decision to approve sanctions/orders is the sole responsibility of the first deputy governor; there is no internal guidance or formal independent function available to assist the first deputy governor in taking adequate decisions. The NBR dedicates a large amount of resources to supervision, in terms of staff, equipment and other variable costs. The NBR adopted detailed arrangements to prevent and manage conflicts of interests at all levels. However, there is no post-employment or cooling-off framework covering situations where a staff or board member intends to take (or takes) a position in a bank supervised by the NBR (or that it has directly supervised). Although the NBR Board members and staff are adequately protected against lawsuits for actions taken and/or omissions made while discharging their duties in good faith, this protection does not apply to the institution.

### **Ownership, Licensing, and Structure (CPs 4–7)**

**8. The NBR implements a well-designed regime for licensing, transfer of significant ownership and major acquisitions.** Only licensed credit institutions can provide banking services. NBR has exclusive competence for granting and withdrawing the license of banks incorporated in Romania and branches of banks located outside the EU. The last time the NBR licensed a bank was in 2009. The licensing framework includes clear and detailed criteria. The ownership structure of locally incorporated banks and branches of EU banks is transparent. The NBR implements a rigorous definition of transfer of significant ownership, in line with the provisions of CRD IV, as well as requirements on the transparency of bank ownership. This largely, but may not fully, covers the transfer of beneficial ownership. The NBR has a detailed framework to review major acquisitions. As part of the consolidation of the Romanian banking system, the NBR reviewed and approved four requests for acquisitions in the past five years (all related to mergers between banks licensed in Romania). Romanian banks only have small activities outside Romania.

### **Ongoing Supervision (CPs 8–10, 12)**

**9. The supervisory approach of the NBR has undertaken changes towards a more risk based approach since the previous BCP assessment.** As of January 1, 2016, the NBR Board approved the implementation of the EBA SREP Guidelines (EBA/GL/2014/13) into national supervisory practices. The Romanian regulatory framework has implemented the provisions of CRR, CRDIV and BRRD (resolvability assessment). The SREP is a core supervisory tool for banking supervision in Romania and deploys a good mix of onsite and offsite supervisory tools and techniques. The NBR has broad information collecting powers by legislation; in particular, the Central Credit Register allows supervisors to access high-granularity data.

**10. Nevertheless, the new EBA SREP methodology is still in the early stages of implementation.** There is no structured, independent review to ensure consistency and accuracy on SREP scoring, findings, and supervisory measures, which needs to be addressed. Considering the recent implementation of the EBA SREP methodology in Romania, the quality assurance procedure is critical. For instance, the authorities could establish an independent review unit, develop on-site and off-site supervisory assessment handbooks, and improve the electronic platform to more effectively manage findings, measures, and follow-ups.

**11. With regard to the off-site supervision, a significant part of this off-site function includes the approval of requests concerning amendments in a bank's situation.**<sup>3</sup> This responsibility of offsite function could limit to a certain extent, the ability of the NBR to maintain a thorough and deeper analysis of the risks that banks and banking group are facing. Regulatory cost and benefit exercises may be warranted in respect of optimum allocation of supervisory resources. Authorities could review certain off-site activities, i.e., the various approvals, and focus more on qualitative risk analysis.

**12. More risk-focused, banking industry-wide thematic analyses and examinations across systems, triggered by detected trends or recent events, appear to be limited.** The Financial Stability Department (FSD) publishes financial stability reports on a half yearly basis, performs top-down stress testing, and shares the results with banking supervisors. However, the results of the FSD have limited applicability and are not directly communicated to individual banks for supervisory purposes. During 2016 and 2017, there were no thematic inspections carried out at the banking system level. The NBR is not differentiating the frequency of full-scope examinations based on the outcome of a risk profile analysis of banks; instead, the asset size and the overall SREP score of the previous year are the main factors in determining the scope and intensity of examinations. Authorities should consider a more risk-focused approach such as conducting thematic analysis and/or examination across banking system with a mix of off- and on-site activities for a specific type of risk.

**13. Other improvements should be sought in intensifying cooperation with other domestic supervisors, bottom-up stress tests, monitoring of intra-group exposures, and more frequent off-site monitoring on a consolidated basis.** While the NBR and ASF share relevant data and supervisory findings, there are no regular meetings between the NBR and ASF, and there is no systematic process to prepare on-site examinations of banking groups, develop a joint view on risks in relation to a particular banking group, align supervisory approaches, and discuss potential concerns on the banking group or subsidiaries. In addition, the main quarterly monitoring tools of the NBR do not seem to have embedded a forward-looking view of a bank's risk profile (e.g., no

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<sup>3</sup> The off-site activities of line supervisors include in-depth interviews and approval of persons nominated to exercise administration and/or management responsibilities, key function holders, and financial auditors, etc. For example, the NBR have interviewed around 1,700 board members, executives, and middle managers (key function holders) from 2009 to 2017. More than half of the interviewees were middle managers.

bottom up stress testing tools) and quarterly KRIs are monitored on a solo basis.<sup>4</sup> The NBR should consider developing a bottom-up stress testing methodology as a complementary supervisory tool, and enhance the intra-group exposures monitoring and consolidated supervision, in coordination with the ASF where relevant.

### **Corrective and Sanctioning Powers (CP 11)**

**14. The NBR has sanctioning powers and tools in almost all respects, however, the sanctioning and order issuance process needs to be enhanced.** Regarding the internal process for determining measures and sanctions, the NBR currently conducts insufficient analysis to ensure consistency, accuracy and justification of inspection outcomes and sanctions across the banking system. More specifically, there is no consistent internal independent review process to ascertain that the applied measures or corrective actions are adequate and consistent. Therefore, the NBR should consider establishing an independent review process and/or introducing relevant guidance in this regard. In addition, the NBR, as a competent authority of credit institutions, cannot impose any measures regarding the merger process or acquisition by a third party per Banking Law.<sup>5</sup>

**15. Post examination processes should be improved to guarantee more effective implementation of corrective actions.** Regarding the supervisory follow-up, the time frame described in the internal rules of the NBR is not always adhered to. Assessors note that the issuance of supervisory reports and written orders is often delayed.<sup>6</sup> Assessors were informed that formal wrap-up meetings after on-site inspections do not always take place. This practice would hinder banks from implementing supervisory measures in a prompt manner.

### **Cooperation and Cross-Border Banking Supervision (CPs 3, 13)**

**16. Cooperation among EU supervisors is intense, reflecting the increasing integration of the EU banking market and the dominance of EU banking groups in Romania.** Arrangements are in place to facilitate and ensure cooperation with relevant domestic and foreign authorities. Cooperation among domestic authorities is organized, but meetings with the ASF are too infrequent to allow for effective coordination. International cooperation is in place for EU banking groups, that control three quarters of banking assets in Romania, and where the NBR is the host supervisor. The NBR is a member of 15 EU colleges of supervisors, which allow for effective information sharing and unified supervisory actions. Close coordination is also in place for crisis management and resolution,

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<sup>4</sup> The NBR mentioned that it would revise the following internal rule to address the deficiencies: "Procedure on the operational flow of the process of assessment and evaluation of the management framework, strategies, processes and mechanisms implemented by credit institutions, Romanian legal persons, as well as credit institutions from other Member States, respectively from third countries."

<sup>5</sup> This could be EU-wide common issue by implementing BRRD, but the CP 11 mentions this tool ("facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank") as a preventive measure for supervisory authorities.

<sup>6</sup> The draft should be sent to banks within 60 working days according to NBR internal procedures, but many examination reports were issued to banks more than six months later with the issuance of written orders taking even longer.

at the domestic level with the resolution arm of the NBR and, for large banks active in Romania, within EU supervisory and resolution colleges. All Romanian banks have prepared recovery plans; resolution plans were also prepared for almost all of these institutions (and their groups where applicable).

### **Corporate Governance, Risk Management, Internal Control and Audit (CPs 14, 15, 26)**

**17. An increased emphasis on the role of independent directors and direct and regular communication between the NBR and non-executive Board members are essential to ensure effective corporate governance.** Corporate governance requirements were strengthened at the EU level and transposed in Romania starting in 2013, clearly laying out the responsibilities of the management body in ensuring that banks operate in a safe and sound manner. The NBR conducts thorough review process, which includes comprehensive interviews before approving members of the management body, and during on-site full-scope examinations. However, the NBR only requires subsidiaries to have an “adequate” number of independent members in the management body. Banks usually only have one or two independent member(s), which is insufficient to challenge other executive and non-executive members and, where appropriate, lead specialized committees. Moreover, although the NBR places a lot of responsibilities on banks’ management bodies, it does not yet meet on a regular basis with non-executive and independent members.

**18. Regulations set detailed and demanding requirements for control functions.**

Discussions with the NBR confirmed the importance placed on risk management, internal controls and audits during on-site inspections. However, the NBR has not yet developed detailed internal methodologies to facilitate a comprehensive and consistent review of these issues. Reviews of practices at industry level in these areas could usefully inform the supervisory process.

### **Capital Adequacy and Liquidity Risk (CPs 16, 24)**

**19. It is noteworthy that the Regulatory Consistency Assessment Program (RCAP) of the BCBS reviewed the EU-wide capital and liquidity framework and concluded that certain features deviated from Basel standards.**<sup>7</sup> The RCAP concluded that the EU requirements follow the Basel standards set by the BCBS broadly, but with a number of divergences, where the EU is less conservative than the BCBS, which positively impacts ratios. In terms of the capital framework, the most significant divergences between the Basel III framework and the EU capital regulation do not seem to be material for Romanian banks. A deviation concerns SME exposures under the Standardized Approach in credit risk, where less stringent capital requirements do seem to be applied.

**20. There is no dedicated team or unit within the NBR’s supervisory department (SD) responsible for evaluating, approving, reviewing and overseeing banks’ internal models.** Two

<sup>7</sup> <https://www.bis.org/bcbs/publ/d300.pdf>, <https://www.bis.org/bcbs/publ/d410.pdf>

banks have been approved to use the advanced approach to calculate regulatory capital for credit risks and three banks for operational risks. Although the number of banks applying the advanced approach is small, the banks that apply it are large in Romania. The FSD has a quantitative assessment division that assists the SD whenever supervisors need to approve the advanced approach in a certain bank or validate internal models, but they are not involved in supervision and examination on an ongoing basis. There would be an increasing need to devote more supervisory attention to banks' risk models used for their own risk management purposes and in regulatory capital calculations. NBR examiners should focus more on periodic validations and independent testing of different models, even when the banks are not generating inputs for the regulatory capital calculations.

### **Credit Risk, and Problem Assets (CPs 17–18)**

**21. Following the 2007–08 sharp increase in nonperforming exposures (NPE), the NBR led efforts to clean up banks' balance sheet and ensure their soundness.** The framework for credit risk management was significantly strengthened and close monitoring, including through annual examinations, is still conducted. NPEs increased rapidly and dramatically after 2007 and peaked at 22 percent in 2013 before declining to 6.4 percent in December 2017. The NBR was instrumental in promoting this rapid reduction through multiple initiatives designed to ensure the timely recognition and realistic provisioning of NPEs (e.g., interim June audits, independent collateral revaluations, full provisioning of high risk exposures, write-offs, etc.). The NBR continues to closely monitor NPEs, thanks to detailed and regular reporting requirements, and ensures a proactive implementation of requirements on problem loans.

### **Related Parties Transactions, Concentration, and Country risks (CPs 19–21)**

**22. The current regulation on transactions with related parties (RP) has deficiencies against the CP.** The definition of affiliated parties is not as broad as the requirements in this CP. For example, the current definition fails to capture any person in a key position, or a major individual shareholder of other group entities within a banking group, including the parent bank/company itself. In terms of RP identification, there is no explicit presumption power of the NBR in the regulation although the NBR, in practice, may exercise discretion in applying the definition on a case by case basis. Moreover, there are no explicit provisions that require that the "write-off" of RP exposures exceeding specified amounts is subject to prior approval by the Board. Information on RP transactions collected during off-site supervision is not sufficiently granular to capture the exact characteristics. Overall, RP regulation describes high level principles, but does not give clear guidance to banks. The NBR should review and amend the regulation on affiliated party transactions in a more prudent manner.

**23. The NBR applies the EU large exposure regime, and the banks' concentration risk management is assessed in the context of SREP.** However, there is no explicit requirement in the regulation that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's board, even though the practices are examined during on-site

inspections. The explicit inclusion in regulation may be important in Romania considering the high level of sovereign debt concentration in the banking industry. Even if the exposures comply with the large exposure or RP limits, assessors noted several examples where certain exposures should be examined further in the context of concentration risk or RP transaction management. The NBR should consider conducting a thematic review on concentration risks across banks (particularly focusing on banks where the large exposure limit is set at EUR 150 million or 100 percent of capital, and banks that have high concentration risks).<sup>8</sup>

**24. The NBR regulation for country and transfer risk management is not sufficiently comprehensive.** The NBR will check the country and transfer risk policies and processes implemented by banks if the country and transfer risks are significant for a bank or banking group. However, the regulation includes only high-level principles similar to the Basel Core Principles text, and lacks sufficient substance. The NBR does not give any further specific guidance to banks and supervisors through regulations, instructions, or the on-site handbook. It is difficult to ascertain what and how supervisors should examine this issue during on-site inspections.<sup>9</sup> There are no specific regulatory provisioning standards for country risk and transfer risk in Romania. Also, there are no specific regulatory requirements for banks to include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis. It is therefore not clear how supervisors perform a banking group-wide country risk analysis across each entity to form a comprehensive view of country risk.

### **Market Risk, Interest Rate Risk in the Banking Book, and Operational Risk (CPs 22, 23, 25)**

**25. In the Romanian banking system, the level of market risk is low for most of the Romanian credit institutions as they do not have complex instruments.** As of June 2017, RWAs for market risk were around three percent of total RWAs. None of the banks use the advanced approach for computing market risk capital charges. The CRR and EBA SREP guidelines are comprehensively stipulated and the NBR conducts on-site inspection on all credit institutions annually. However, there is no market risk specialist in the supervision department; one should be assigned to build up expertise in this area. In terms of interest rate risk in the banking book (IRRBB), the Basel Committee published a new guideline on standards for IRRBB in April 2016, but the NBR has not updated its IRRBB rules accordingly. Authorities mention that they are in the process of amending regulations for IRRBB.

**26. With respect to operational risks, a guideline on cyber security and information communication technology (ICT) for banks has not been implemented yet.** Regarding IT resources, the SD has one IT systems specialist but does not have a dedicated unit; this could be considered insufficient in times of increasing demand, since the SD does not use outside IT experts.

<sup>8</sup> The authorities informed the assessors that a thematic review on large exposure limits and concentration across banks will be performed during 2018.

<sup>9</sup> For example, the regulation is silent in the essential areas to be developed by banks and examined by supervisors to manage country and transfer risks (e.g., procedures for dealing with country risk in times of crisis, oversight mechanism, a periodic review requirement by the board, etc.)



Authorities mentioned that they are planning to hire more IT risk experts and new EBA Guidelines on ICT Risk Assessment (2017) will be implemented starting January 2018.

### **Financial Reporting, Auditing and Disclosure (CPs 26–28)**

**27. Financial reporting, auditing and disclosure requirements are largely harmonized at the EU level.** Banks are required to prepare financial statements in compliance with the IFRS and have them certified by an external auditor which complies with international audit standards. Banks' external auditors belong to the networks of the four biggest global auditing firm and a large French auditing firm (with the exception of the credit cooperative network). Rotation requirements are implemented since 2014, either for the firm or the signing partner. All banks adopted specific policies and most are rotating firms. Five small banks appointed their external auditor in 2001–08 and only rotated the signing partner. The NBR confirmed that the tenure of these signing partners did not exceed seven years. There is, however, no internal methodology defining criteria used by the NBR to assess the adequacy of banks' policies on rotation. Financial and prudential disclosure requirements are detailed and largely unified at the EU level. The NBR confirmed that these fully apply to banks incorporated in Romania. The NBR verifies individual disclosure requirements and published detailed and updated information on banking activities and risks. A review of disclosure practices across the entire industry could usefully be conducted.

### **Abuse of Financial Services (CP 29)**

**28. In recent years, the AML/CFT supervision of the NBR was strengthened to get aligned with changes imposed by the new European Directive.** The new European regulatory framework Directive (EU) 2015/849 provides a number of requirements on risk-based supervision, and a newly enhanced AML/CFT law is to be submitted for the Parliament legislative procedure. The NBR is in the early stages of implementing a risk-based approach to AML/CFT supervision. The NBR has assessed the ML/TF risks, ranked banks, and established a detailed methodology for a risk-based approach to its AML/CFT supervisory activities.

**29. Nevertheless, several shortcomings remain.** Under Romanian law, only correspondent banking relationships with banks outside the EU are subject to enhanced due diligence measures. Under the FATF standard, however, enhanced due diligence should be implemented with respect to all correspondent banking relationships, and no exception is currently made for intra-EU correspondent banking relationships. Simplified due diligence is imposed in specific circumstances without a sound assessment that would have established that these circumstances indeed present low ML/TF risks.

<b>Annex Table 1. Summary of Compliance with Basel Core Principles</b>	
<b>Core Principle</b>	<b>Comments</b>
1. Responsibilities, objectives and powers	Banking supervision in Romania falls exclusively within the responsibility of the central bank. Laws and regulations are regularly updated
2. Independence, accountability, resourcing and legal protection for supervisors	The NBR, as a supervisory authority, possesses stable governance arrangements and effective operational independence. The NBR dedicates a large amount of resources to supervision, in terms of staff, equipment and other variable costs. The NBR adopted detailed arrangements to prevent and manage conflicts of interests at all levels. However, the fit and proper criteria of the standing committees of Parliament, responsible for the appointment of Board members, are unknown. The Minister of Public Finance (and its State Secretary) is allowed by law to attend NBR Board meetings which could compromise its independence. The NBR as an institution is not protected against lawsuits for actions taken and/or omissions made while discharging its duties in good faith. The reason(s) for removal of a Board member do not have to be disclosed and there is no post-employment or cooling-off period framework covering situations where a staff or Board member intends to take (or takes) a position in a bank supervised by the NBR.
3. Cooperation and collaboration	<p>Arrangements are in place to facilitate and ensure cooperation with relevant domestic and foreign authorities. Cooperation among domestic authorities is organized, including with the ASF which regulates insurance, pension and capital market activities, and cooperation with EU authorities is intense.</p> <p>There are no regular meetings between the NBR and ASF to discuss the situation and risk profiles of individual institutions and groups active in banking and other sector(s) supervised by the ASF, and the issues of common interest or coordinate or agree on (joint) supervisory actions.</p>
4. Permissible activities	Only licensed credit institutions can provide banking services.
5. Licensing criteria	The NBR has exclusive competence for granting and withdrawing the license of banks incorporated in Romania and branches of banks located outside the EU. The last time the NBR licensed a bank was in 2009. The licensing framework defines clear criteria for licensing. The ownership structure of locally incorporated banks and branches of EU banks is transparent.
6. Transfer of significant ownership	The NBR implements a rigorous definition of transfer of significant ownership, in line with the provisions of CRD IV, as well as requirements on the transparency of bank ownership. This may largely, but not fully, cover the transfer of beneficial ownership. While banks keep close contacts with the NBR, there is no specific requirement that banks notify the NBR as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principles</b>	<b>Comments</b>
7. Major acquisitions	The NBR has a detailed framework to review major acquisitions. As part of the consolidation of the Romanian banking system, the NBR reviewed and approved four requests for acquisitions in the past five years (all related to mergers between banks licensed in Romania).
8. Supervisory approach	<p>The Romanian regulatory framework has implemented the provisions of CRR, CRD IV and BRRD (resolvability assessment). As of January 2016, the NBR Board approved the implementation of the EBA SREP Guidelines into national supervisory practices. Nevertheless, the new EBA SREP methodology is still in the early stage of implementation.</p> <ul style="list-style-type: none"> <li>• There is no systematic process with the ASF before on-site examinations of banking groups to discuss a common view of risks in the particular banking group supervised, supervisory approaches, and potential concerns on the banking group or subsidiaries.</li> <li>• The off-site monitoring tools do not seem to have embedded a forward-looking view of a bank's risk profile.</li> <li>• More risk-focused, banking industry-wide thematic analyses triggered by detected trends or recent events, and thematic examinations across systems seem to be limited.</li> </ul>
9. Supervisory techniques and tools	<p>The SREP is a core supervisory tool for banking supervision in Romania. It deploys a good mix of onsite and offsite supervisory tools and techniques. The NBR has broad information collecting powers by legislation; in particular, the Central Credit Register allows supervisors to access high-granularity data. Nevertheless, the process for ensuring consistency and accuracy of scoring, findings and supervisory measures across different banks is weak.</p> <ul style="list-style-type: none"> <li>• There is no structured, independent review to ensure consistency and accuracy on SREP scoring, findings, and supervisory measures. Considering the recent adoption of the EBA SREP methodology in Romania, the quality assurance procedure is critical.</li> <li>• With regard to the off-site supervision, a significant part of this off-site function includes the approval/rejection of requests concerning amendments in a bank's situation (including approvals of middle managers of each bank). This responsibility, despite having benefits, could limit to a certain extent, the ability of the NBR to maintain a thorough and deeper analysis of the risks that banks, banking groups, and the banking industry are facing.</li> <li>• There is no systematic process of regular meetings with non-executive/ independent members after on-site examinations to discuss findings and the remedial actions (See CP14).</li> </ul>
10. Supervisory reporting	The Romanian banking system has been required to report financial information based on IFRS at consolidated level since 2006 and at individual level since January 2012. The supervisory reporting/ validation rules and templates are mainly governed by a harmonized EU reporting framework. In case of solo FINREP, as required by national legislation, the reporting templates are consistent with EU reporting requirements. The following shortcomings still remain:

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principle</b>	<b>Comments</b>
10. Supervisory reporting	<ul style="list-style-type: none"> <li>• There are no explicit guidelines/criteria for hiring third parties who conduct supervisory tasks, for assessing the quality of the work performed by those experts, or for requiring them to report to the NBR promptly any material shortcomings identified.</li> <li>• There is no explicit/regular evaluation process in place to periodically review the information collected to determine that it satisfies supervisory needs, particularly in the case of additional prudential returns (except the ones collected according to the common European reporting framework).</li> </ul>
11. Corrective actions and sanctioning powers of supervisors	<p>The NBR has a range of supervisory and sanctioning measures and administrative penalties available to use when, in the supervisor's judgment, a bank is not complying with laws, regulations, or supervisory actions. In practice, corrective actions and sanctioning powers are exercised in a forceful manner and a broad range of measures have been applied to banks, their management, the board, and/or individuals.</p> <p>Regarding the internal process for determining measures and sanctions, the NBR currently conducts insufficient review and analysis to ensure consistency, accuracy and justification of inspection outcomes and measures and sanctions across the banking system.</p> <ul style="list-style-type: none"> <li>• There is no consistent internal independent review process to ascertain that the applied measures or corrective actions are adequate according to the law and regulations, and consistent across the banking system.<sup>1</sup></li> <li>• With respect to supervisory follow-ups, the time frame described in the internal rules of the NBR is not always adhered to. Assessors note that the issuance of supervisory reports and written orders was in many cases delayed. Assessors were informed that official wrap-up meetings after on-site inspections do not always take place. This practice would hinder banks from implementing supervisory measures in a prompt manner. Moreover, the overall follow-up procedures are set by the internal rules in the NBR, not by laws or regulations.</li> <li>• Among the measures required by the EC4, the NBR, as a competent authority, does not have the explicit power to facilitate a takeover by or merger with a healthier institution per Banking Law.</li> <li>• There is no systematic or regular process informing the supervisor of nonbank related financial entities (including ASF), of the NBR's actions, and there is no process to coordinate supervisory actions.</li> </ul>
12. Consolidated supervision	<p>In Romania, the majority of the credit institutions are subsidiaries of European banking groups. Consolidated supervision of the whole group is performed by the ECB or respective authorities while the NBR is responsible for the supervision of the Romanian subsidiary at individual and sub-consolidated levels. The NBR conducts SREP assessments on a consolidated basis.</p>

<sup>1</sup> Approximately 45 cases were submitted to the board within a five-year period with 18 cases being contested in court. Some of the issues were about clarification of findings.

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principle</b>	<b>Comments</b>
	<ul style="list-style-type: none"> <li>• However, there seem to be limited systematic procedures in place for overall monitoring and assessments of contagion and reputation risks that may jeopardize the safety and soundness of the bank and the banking system.</li> <li>• Quarterly key risk indicators are mainly monitored on a solo basis rather than on a solo and consolidated basis.</li> <li>• Formal fit and proper reviews of owners and senior management of parent corporates are conducted in the stage of acquisition or granting licenses, but not on a regular basis.</li> </ul>
13. Home-host relationships	<p>The NBR is a host supervisor, and as such a member of 15 EU colleges of supervisors, which allow for effective information sharing and unified supervisory actions (including joint decisions).</p> <p>Close coordination is also in place for crisis management and resolution, at the domestic level with the resolution arm of the NBR and, for large banks active in Romania, within EU supervisory and resolution colleges. All Romanian banks prepared recovery plans starting in 2016; resolution plans were also prepared for almost all of these institutions (and their groups where applicable).</p>
14. Corporate governance	<p>Corporate governance requirements were strengthened at the EU level and transposed in Romania starting in 2013. Both regulations and the supervisory process appropriately make the management body responsible for ensuring banks operate in a safe and sound manner. The NBR conducts a thorough review process in this area, including comprehensive interviews before approving members of the management body, and as part of on-site full-scope examinations.</p> <p>The NBR only requires subsidiaries to have an “adequate” number of independent members in the management body. Banks usually only have 1 or 2 independent member(s), which is insufficient to challenge other executive and non-executive members and, where appropriate, lead the work of specialized committees (only the audit committees currently has to be chaired by an independent member).</p> <p>Although the NBR places a lot of responsibilities on the management body, it does not yet meet on a regular basis with its non-executive and independent members (neither as part of the off-site process nor during on-site examinations) (See CP9). Moreover, the NBR only sends letters detailing serious shortcomings or transmitting on-site inspection reports to senior management, rather than to the management in its supervisory capacity.</p> <p>Regulations do not include (i) an explicit provision for banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety test of a bank’s board member or a member of the senior management and (ii) requirements regarding the nomination and appointment of board members <i>across the banking group</i>.</p>

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principle</b>	<b>Comments</b>
	The NBR has not yet performed qualitative analyses on corporate governance arrangements and practices at the industry level (to complement individual work and SREP analyses).
15. Risk management process	Regulations set detailed and demanding risk management requirements for banks. Discussions with the NBR confirmed the importance placed on risk management during on-site inspections. The NBR has not yet developed an internal methodology to guide the review of risk management aspects, in addition to the SREP guideline. Explicit requirements would usefully complement existing supervisory practices on the following aspects: (i) the banks' boards and senior management understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use; (ii) the banks' boards and senior management understand the risks inherent in major management initiatives (such as changes in systems, processes, business model and major acquisitions); and (iii) uncertainties attached to risk measurement need to be recognized.
16. Capital adequacy	Romania is subject to the EU common regulatory framework, and applies the CRR and CRD IV. Two banks have been approved to use the advanced approach to calculate credit risk regulatory capital and three banks for operational risk. Although the number of banks applying the advanced approach is small, those banks using the approach are large banks with a considerable percentage based total own funds requirement (credit risk: 17 percent, operational risk: 38 percent). <ul style="list-style-type: none"> <li>• In this CP, it is noteworthy that in December 2014, the RCAP reviewed the EU-wide capital framework and concluded that certain features deviated from Basel standards.</li> <li>• There is no dedicated team or unit within the SD responsible for evaluating, approving, reviewing and overseeing banks' internal models.</li> </ul>
17. Credit risk	Key regulatory requirements regarding credit risk management exist, which were significantly strengthened following new EU requirements, while taking into account Romania's experience with problem assets. The NBR implemented a thorough supervisory process, with an emphasis on credit risk. It regularly requires corrective actions or takes sanctions where appropriate. <p>For subsidiaries of EU banking groups, as well as for the main branch of an EU banking group, credit risk management is addressed by supervisory colleges.</p>
18. Problem assets, provisions, and reserves	NPEs increased rapidly and dramatically after 2007 with a peak at 2013, but declined to 6.4 percent in December 2017. The NBR was instrumental in promoting this rapid reduction through many initiatives designed to ensure the timely recognition and realistic provisioning of NPEs (e.g., interim June audits, independent collateral revaluations, full provisioning of high risk exposures, write-offs, etc.). <p>The NBR continues to closely monitor NPEs, thanks to detailed and regular reporting. Requirements regarding the frameworks to address problem loans exist and their implementation is closely monitored. The NBR intends to amend existing</p>

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principle</b>	<b>Comments</b>
	requirements to incorporate key elements of the EBA 2017 guidelines on credit risk management practices and accounting for expected credit losses.
19. Concentration risk and large exposure limits	<p>The NBR applies the EU large exposure regime and the banks' concentration risk management is assessed in the context of SREP assessments. The CRR allows that competent authorities may set a lower limit than EUR 150 million as an absolute limit, but the NBR has not exercised this option. As a result, as of June 2017, around 29 percent of Romanian banks apply the LE limit of EUR 150 million (i.e., 100 percent of capital limit) instead of 25 percent of capital. Assessors note that some credit institutions have exposures to a group entity of around 80–90 percent of capital at some point in time. Although banks' internal limits are reviewed during on-site inspections, it is not entirely clear how and through what procedure the NBR determines that the internal limit set by each institution and the relevant transactions are appropriate.</p> <p>Also, there is no explicit requirement in the regulations that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's board.</p>
20. Transactions with related parties	<p>The current regulation on RP transactions does not meet important ECs under this CP.</p> <ul style="list-style-type: none"> <li>• The definition of affiliated parties is not comprehensive enough to meet the requirements in this CP. The current definition fails to capture any person in a key position or a major individual shareholder of other group entities within a banking group including the parent bank/company itself; the definition of affiliated parties also does not explicitly include "special purpose entities."</li> <li>• In terms of identification of related parties, the authorities mention that the NBR, in practice, may exercise discretion in applying the definition on a case by case basis. Nevertheless, there is no explicit presumption power of the NBR in the regulation.</li> <li>• There is no explicit provision that requires that a "write-off" of RP exposures exceeding specified amounts is subject to prior approval by the board.</li> <li>• The information on RP transactions collected is not sufficiently granular to capture the exact characteristic during off-site supervision.</li> <li>• Overall, RP regulations only describe high level principles, do not give clear guidance to banks, and lack sufficient substance.</li> </ul>
21. Country and transfer risks	<p>The NBR will check the country/transfer risk policies and processes implemented by banks if the country and transfer risks are significant for a bank or banking group. However, the NBR regulation for country risk and transfer risk management are not sufficiently comprehensive to meet the ECs in this CP.</p> <ul style="list-style-type: none"> <li>• Regulation includes only high-level principles similar to the BCP text. The NBR does not give any further/specific guidance to banks through regulation or documented instructions. There is no on-site inspection manual in this regard, so it is difficult to ensure what and how supervisors should examine these risks during on-site inspections. For example, the regulation is silent on essential areas</li> </ul>

**Annex Table 1. Summary of Compliance with Basel Core Principles (continued)**

Core Principle	Comments
	to be developed by banks and examined by supervisors to manage country and transfer risks (e.g., procedures for dealing with country risk such as contingency plans or exit strategies in times of crisis, oversight mechanism, a periodic review requirement by the board).
	<ul style="list-style-type: none"> <li>• There are no specific regulatory provisioning standards for country risk and transfer risk in Romania.</li> <li>• There are no specific stipulations in the regulation that banks include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis for risk management purposes.</li> <li>• Although FINREP/COREP reporting contains geographical breakdown information, the necessary information for country risk management, such as risk classification or (internal/external) country rating, is not included in the reporting. It is not clear how supervisors perform a banking group-wide country risk analysis across each entity to form a comprehensive view of country risk.</li> </ul>
22. Market risk	In the Romanian banking system, the level of the market risk is low for most of the Romanian credit institutions that do not have complex instruments that may expose the bank to significant risk. As of June 2017, RWAs for market risk were around three percent of total RWAs. No banks are using the advanced approach for computing market risk capital charge. CRR and EBA SREP guidelines are stipulated in a comprehensive way and the NBR conducts on-site inspection on all credit institutions annually. However, there is no market risk specialist in the supervision department; one should be assigned to build up expertise in this area.
23. Interest rate risk in the banking book	<p>The NBR assesses the IRRBB risk management, risk profile, appetite, tolerance and the stress tests made by the credit institutions during yearly on-site examination. The following points are worthy to mention:</p> <ul style="list-style-type: none"> <li>• The Basel Committee published a new guideline on standards for IRRBB in April 2016, but the NBR has not yet updated the IRRBB rules, since the updating process is based on the EU-wide regulatory amendment process.</li> <li>• There is no explicit provision that requires “independent” validation of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions).</li> </ul>
24. Liquidity risk	<p>Banks are required to have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements, including regular stress testing and contingency funding plans. The NBR conducts on-site inspections annually and off-site quarterly for all banks.</p> <p>The EU-wide requirement follows the LCR set by the BCBS broadly, but with some divergences that could positively impact ratios. However, generally the impact is not significant for Romanian banks.</p>
25. Operational risk	In Romania, three banks have been allowed to use the Advanced Measurement Approach, two use the Standard Approach, and the rest uses the Basic Indicator Approach to calculate operational risk regulatory capital. As of June 2017, RWAs for operational risk have been around 15 percent of total RWAs.



<b>Annex Table 1. Summary of Compliance with Basel Core Principles (continued)</b>	
<b>Core Principle</b>	<b>Comments</b>
	<ul style="list-style-type: none"> <li>• A comprehensive guideline on cyber security and information technology for banks has not been implemented yet.</li> <li>• Regarding ICT resources, the Supervisory Department has one ICT systems specialist but does not have a dedicated unit.</li> <li>• With respect to operational risk reporting, the scope of reporting is not sufficiently broad as this EC requires. There is no framework specifying the minimum elements the bank should report to the NBR, and timing is also unclear.</li> </ul>
26. Internal control and audit	<p>The NBR regularly assesses for each bank incorporated in Romania compliance with its detailed requirements on internal control and audit.</p> <p>Beyond regulatory and SREP requirements (which cover essential topics but with limited details), there is no internal methodology to guide on-site inspections on banks' internal control and audit (detailed scope, criteria to assess specific areas, group approaches etc.) and ensure these aspects are reviewed in a comprehensive and consistent manner.</p> <p>Banks are not specifically required to ensure that the internal audit is kept informed in a timely manner of any material changes made to the bank's risk management strategy, policies or processes. Industry level analyses are not conducted on internal control and audit.</p>
27. Financial reporting and external audit	<p>Banks are required to prepare financial statements in compliance with IFRS, should be certified by an external auditor which complies with international standards on audit and is approved by the NBR. Banks' external auditors belong to the networks of the four big global audit firms and a large French audit firm (with the exception of the credit cooperative network);</p> <p>Rotation requirements are implemented since 2014, either for the firm or the signing partner. All banks adopted specific policies and most rotated the firm. Five small banks appointed their external auditor in 2001-2008 and only rotated the signing partner. The NBR confirmed that the tenure of these signing partners did not exceed seven years. There is no internal methodology defining criteria used by the NBR to assess the adequacy of banks' policies on rotation and the NBR has not set an explicit maximum time limit to guide supervisory assessments.</p>
28. Disclosure and transparency	<p>Financial and prudential disclosure requirements applied to banks are detailed and largely unified at the EU level.</p> <p>The NBR verifies individual disclosure requirements and published detailed and updated information on banking activity and risks.</p>
29. Abuse of financial services	<p>In recent years, the AML/CFT Supervision was strengthened particularly to be in line with the changes imposed by the new European regulatory framework Directive 2015/849 that provided a number of requirements on risk-based supervision. In 2016, 39 inspections were conducted, and one narrowly-targeted thematic inspection was also conducted. However, assessors noted the following shortcomings:</p>

<b>Annex Table 1. Summary of Compliance with Basel Core Principles (concluded)</b>	
<b>Core Principle</b>	<b>Comments</b>
	<ul style="list-style-type: none"> <li>• Under Romanian law, only correspondent banking relationships with banks outside the EU are subject to enhanced due diligence measures. Under the FATF standard, however, enhanced due diligence measures should be implemented with respect to all correspondent banking relationships, and no exception is currently made for intra-EU correspondent banking relationships.</li> <li>• Simplified due diligence is imposed in specific circumstances without a sound assessment that would have established that these circumstances present low ML/TF risks.</li> </ul>

<b>Annex Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks</b>	
<b>Core Principle</b>	<b>Recommendation</b>
2. Independence, accountability, resourcing and legal protection for supervisors	<ul style="list-style-type: none"> <li>• Revise the central bank statute to remove the possibility that the Minister of Public Finance (or its Secretary of State) participate in NBR Board meetings.</li> <li>• Introduce a legal provision protecting the NBR as an institution against lawsuits for actions taken and/or omissions made while discharging its duties in good faith.</li> <li>• Introduce a legal provision that the reason(s) for removal of a Board member have to be publicly disclosed.</li> <li>• Publish rigorous fit and proper criteria that the standing committees of Parliament, responsible for the appointment of Board members, expect applicants to meet.</li> <li>• Adopt and implement a post-employment or cooling-off period framework covering situations where a staff or Board member intends to take (or takes) a position in a bank supervised by the NBR (or that it has directly supervised).</li> </ul>
3. Cooperation and collaboration	<ul style="list-style-type: none"> <li>• Organize regular meetings between the NBR and ASF to discuss the situation and risk profiles of individual institutions and groups active in banking and other sector(s) supervised by the ASF, and issues of common interest, and coordinate or agree on (joint) supervisory actions, including on-site examinations, and implement agreed joint actions.</li> <li>• Introduce an explicit provision in the banking law regarding the treatment of information received from authorities located outside the EU (i.e., no disclosure without the permission of the originating supervisor and, when disclosure is legally required, prompt information of the originating supervisor).</li> </ul>
6. Transfer of significant ownership	<ul style="list-style-type: none"> <li>• Introduce a definition of ultimate beneficial ownership focusing on natural persons in the context of transfer of significant ownership (and defined related requirements for review and reporting).</li> <li>• Introduce a requirement that banks notify the NBR as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.</li> </ul>
8. Supervisory approach	<ul style="list-style-type: none"> <li>• Establish a systematic framework that collects relevant information from nonbank financial institutions (including securities or insurance supervisors) to facilitate on-site examination on banks and banking group.</li> <li>• Enhance off-site monitoring tools by incorporating more forward-looking views (e.g., bottom up stress testing tools).</li> <li>• Enhance a yearly examination planning/approval process to clearly set out the proposed priorities of each banks or banking group for the following year.</li> <li>• Conduct thematic analysis and/or examination across banking system with a mix of off and on-site activities on a particular risk (e.g., concentration risk, cyber risk).</li> </ul>
9. Supervisory techniques and tools	<ul style="list-style-type: none"> <li>• Ensure consistency and objectivity in SREP score, findings and supervisory measures (e.g., establish an independent review function, develop an on-site and off-site supervisory assessment handbook, and improve the electronic platform to more effectively manage findings, measures, and follow-ups).</li> </ul>

<b>Annex Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)</b>	
<b>Core Principle</b>	<b>Recommendation</b>
	<ul style="list-style-type: none"> <li>Review off-site activities regarding various approval process within SD for supervisors to better focus on its qualitative risk analysis.</li> <li>Intensify engagement with non-executive/independent board members as part of the on-site examination process (See CP14).</li> </ul>
10. Supervisory reporting	<ul style="list-style-type: none"> <li>Perform a periodic review of whether the prudential returns (required outside of European reporting framework) satisfy a supervisory need.</li> <li>Develop rules and processes for hiring external experts, including processes for quality controls and avoiding conflicts of interests.</li> </ul>
11. Corrective and sanctioning powers of supervisors	<ul style="list-style-type: none"> <li>Establish an independent review process in determining written orders and sanctions to guarantee consistent approach across banks and clearer justification; introduce internal guidance to ensure more objectivity, accuracy and consistency in exercising corrective actions and sanctioning powers.</li> <li>Improve the post-examination process by formalizing a wrap-up meeting to clearly convey findings that require immediate improvement or corrective actions.</li> <li>Intensify engagement and cooperation with the ASF in the process of imposing corrective actions and sanctions.</li> </ul>
12. Consolidated supervision	<ul style="list-style-type: none"> <li>Further enhance the monitoring of contagion and reputational risks for banking groups or establish guidelines on risk management of intra-group exposures and transactions, if needed.</li> <li>Conduct off-site monitoring on a consolidated basis more frequently.</li> <li>Conduct fit and proper reviews on an ongoing basis in case of corporate owner of banks.</li> </ul>
14. Corporate governance	<ul style="list-style-type: none"> <li>Require all banks to have independent members of the management body.</li> <li>For all banks (i) formalize criteria a bank should follow to determine its minimum number of independent directors (as a share of board members) or (ii) set a minimum level above the generally observed practice.</li> <li>Organize regular exchanges between the NBR and non-executive and independent members of the management body (and send direct communication to the management body in its supervisory capacity on material supervisory issues).</li> <li>Include (i) an explicit provision for banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety test of a bank's board member or a member of the senior management and (ii) requirements regarding the nomination and appointment of board members across the banking group.</li> <li>Consider conducting qualitative analyses on corporate governance arrangements and practices at the industry level.</li> </ul>
15. Risk management process	<ul style="list-style-type: none"> <li>Prepare a detailed internal methodology covering relevant risk management aspects for on-site inspections (including criteria to be applied where judgment is needed, approaches to test specific aspects, e.g., incorporation of risk in internal pricing, group risk management framework in the cases of subsidiaries, etc.).</li> </ul>

<b>Annex Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)</b>	
<b>Core Principle</b>	<b>Recommendation</b>
16. Capital adequacy	<ul style="list-style-type: none"> <li>Devote further supervisory attention to risk models, including the advanced approach for regulatory capital calculation (e.g., establish a dedicated unit for more periodic and rigorous model reviews and validation).</li> </ul>
19. Concentration risk and large exposure limits	<ul style="list-style-type: none"> <li>Conduct a thematic review on the large exposure limit across banks (particularly focusing on banks that apply a large exposure limit of EUR 150 million or 100% of capital, and banks with high concentration risks), and review the suitability of EUR 150 million as an absolute limit.</li> <li>Include explicit provisions in the regulation that require that all material concentrations be regularly reviewed and reported to the bank's board; in practice require banks to manage de facto all concentration risk including sovereign risks.</li> </ul>
20. Transactions with related parties	<ul style="list-style-type: none"> <li>Review and amend the regulation on affiliated party transactions in a more prudent manner (e.g., expand the definition of affiliated parties to comprehensively capture the relevant transaction, include an explicit presumption power in terms of identification of affiliated parties, require prior approval on write-off of RP exposures exceeding specified amounts, etc.).</li> <li>Improve the prudential reporting template on RP transactions for more effective monitoring (e.g., include type of exposures, number of shares, asset classification).</li> <li>Issue a guidance note or instruction that lays down more concrete requirements for monitoring and managing RP transactions and exposures.</li> </ul>
21. Country and transfer risks	<ul style="list-style-type: none"> <li>Review and strengthen the regulation on country and transfer risks or develop a guidance note for supervisors and banks.</li> <li>Include explicit requirements in the regulation that banks include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis.</li> <li>Ensure greater focus on oversight of risks stemming from country (including sovereign) risks and transfer risks on a regular basis during on- and off-site supervision.</li> </ul>
22. Market risk	<ul style="list-style-type: none"> <li>Build up supervisory capacity by having a dedicated market risk specialist</li> </ul>
23. IRRBB	<ul style="list-style-type: none"> <li>Include explicit requirement that banks conduct independent (internal or external) validation of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions).</li> <li>Update current regulation based on EU-wide regulatory amendment process reflecting the new standards for IRRBB, which were published in April 2016.</li> </ul>
25. Operational risk	<ul style="list-style-type: none"> <li>Introduce guidelines on a comprehensive assessment of ICT risks as intended;</li> <li>Enhance IT risk supervisory capacity (e.g., establish a specialized unit/ increase IT specialists).</li> <li>Expand the scope and required items of reporting on operational risk events to keep the NBR apprised of developments affecting operational risk in a timely and comprehensive manner.</li> </ul>

<b>Annex Table 2. Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (concluded)</b>	
<b>Core Principle</b>	<b>Recommendation</b>
	<ul style="list-style-type: none"> <li>Specifically require banks to ensure that the internal audit is kept informed in a timely manner of any material changes made to the bank's risk management strategy, policies or processes.</li> <li>Consider conducting industry level analyses on internal control and audit.</li> </ul>
27. Financial reporting and external audit	<ul style="list-style-type: none"> <li>Prepare an internal methodology defining criteria used by the NBR to assess the adequacy of banks' policies on rotation of external auditors (and set a maximum time limit to guide supervisory assessments).</li> </ul>
28. Disclosure and transparency	<ul style="list-style-type: none"> <li>Consider the opportunity to require banks, at least significant banks, to provide more frequent disclosures.</li> <li>Consider conducting a review of disclosure practices on governance aspects across the industry.</li> </ul>
29. Abuse of financial services	<ul style="list-style-type: none"> <li>Continue implementing a risk-based approach to AML/CFT supervision.</li> <li>Ensure that simplified due diligence is authorized only in instances of proven low ML/TF risks.</li> <li>Ensure that banks are required to implement customer due diligence measures with respect to foreign politically exposed persons in line with FATF Recommendation 12.</li> <li>Ensure that the requirements related to correspondent banking relationships also apply to intra-EU correspondent banking relationships.</li> </ul>

## E. Authorities' Response to the Assessment

**30. The NBR would like to thank the IMF, the World Bank and the entire FSAP mission team for the BCP assessment work.** We recognize the importance of the FSAP not just as an independent peer review assessment but also as a collaborative process that provides learning opportunity to staff on both sides, and is of value for its policy advice. The Basel Core Principles for effective banking supervision introduced requirements that represent a challenge to supervisors worldwide and require adopting a long-term approach toward gradual compliance. In this regard, it is important that the IMF and World Bank continue to analyze different supervisory approaches and disclose the assessments results, in order to build a larger sample of practices, representative enough to outline the main tendencies or tools for reaching convergence with the Basel Core Principles.

**31. Since the last FSAP mission to Romania in 2008–09, substantial improvements have been made and are positively reflected in the report.** The measures adopted by the Central Bank include strengthening of banks' capital positions and setting medium-term targets for increasing minimum CARs; strengthened NBR monitoring of banks' loan portfolios and problem loans workout procedures and capacity; reviewed the bank resolution framework in order to facilitate rapid action and options for bank restructuring; strengthened deposit insurance funding arrangements and significantly lowered the payout period; introduced risk-based supervision; and fully implemented

IFRS. One of the results of these measures is the plummeting NPL ratio from a peak of 21.9 percent in 2013, to 6.4 percent as of December 2017.

**32. Regarding the outcome of the current assessment, we highly value the recommendations provided by the FSAP team with the aim to better align our practices to the highest standards in this field.** The NBR Board, in its meeting from February 28, 2018, has thoroughly analyzed the FSAP recommendations. Three recommendations have already been implemented and six more will be implemented by end of May 2018. Furthermore, a detailed action plan and timeline for implementing the remaining recommendations have been approved. Accordingly, the responsible NBR line departments have been tasked with specific steps to carry on the action plan within the approved timeline, and are providing weekly updates on the implementation status.

**33. We wish to submit a number of general and specific comments on the report's recommendations and evaluations below:**

**34. The NBR is a competent authority from an EU Member state and is bound to comply with all relevant and applicable EU legislation in the field of banking activity.** In this regard, NBR strongly respects the principle of cross EU supervisory practices harmonization, through the implementation of the regulatory packages according to CRD4/CRR and all related European Commission binding technical standards, as well as the EBA Guidelines and Recommendations. These acts represent the best practices and approaches to follow for full supervisory convergence at the EU level. Therefore, there are parts of the Basel Core Principles and consequently, related FSAP recommendations, that are difficult to implement in the national regulatory framework, as they have a different EU level regulatory regime. Considering the above, the NBR will enter into a process of regulatory framework review to the fullest extent possible, given certain limitations imposed by the applicable EU legal and regulatory framework, in the context of the FSAP recommendations.

#### **Independence, Accountability, Resourcing, and Legal Protection for Supervisors (CP 2)**

**35. The independence of the NBR continued to be strong as part of a broader process in the context of euro adoption.** This involves ensuring compliance with the European Commission and the ECB recommendations included in the Convergence Reports.

**36. Under the current Statute, NBR Board members and personnel tasked with prudential supervision have legal protection against lawsuits while exercising their duties, in good faith, and their legal costs are covered by the NBR.** The NBR fully welcomes the recommendation and will pursue this aim by seeking to build consensus among all policy makers to amend the NBR Statute in order to "Introduce a legal provision protecting the NBR as an institution against lawsuits for actions taken and/or omissions made while discharging its duties in good faith."

**37. The NBR is a powerful advocate of increased transparency and welcomes the recommendation to "Introduce a legal provision that the reason(s) for removal of a Board member have to be publicly disclosed."** Nevertheless, given the NBR Statute and the two

Chambers of the Romanian Parliament's Internal Regulation on joint activities which stipulates that the meetings of the joint parliamentary standing committees are generally open to the public, the causes for dismissal are supposed to be publicly-available, although this is not explicitly stated in the law.

**38. The NBR has recently implemented a Code of Ethics, applicable to its staff and Board members. Its enactment expressly regulates conflicts of interests and other cases of misconduct.** The detection of conflict of interests is also promoted by an updated whistleblowing framework, in line with international best practices, aimed at encouraging staff to file reports. In order to "Adopt and implement a post-employment or cooling-off period framework covering situations where a staff or Board member intends to take (or takes) a position in a bank supervised by NBR (or that it has directly supervised)," the NBR will implement policies in line with this recommendation.

### **Supervisory Approach, Techniques, Tools (CP 8 and 9)**

**39. We appreciate the specific recommendations on supervisory practices as an opportunity for improvement as the FSAP mission brought forward essential value added to the effectiveness of the supervisory process.** The NBR will adjust its supervisory practices in order to become as fully compliant as possible with the Basel Core Principles for effective banking supervision.

**40. We agree that further development of the NBR's supervisory approach will make supervision more effective and broadly in line with the requirements of the 2012 BCP.** However, the NBR would like to note that, regardless of some internal processes not exhaustively formalized, all banks are adequately supervised within the current supervision framework, and that the NBR has a good understanding of both individual banks and banking industry as a whole. Accordingly, some of the key indicators have been maintained well above the EU banking system average. Furthermore, the NBR took important decisions, with good results, in order to decrease NPLs stock and strengthen the supervision of NPL.

**41. The supervisory manuals and processes have been revised with a view to aligning them to international best practices as part of an established ongoing improvement framework.** As a result of these actions, the following will be enhanced:

- the consistency and objectivity in SREP score, findings and supervisory measures/sanctions, e.g., through an independent unit in charge with the quality review of SREP assessment outcomes and management of findings, measures, and follow-ups data base);
- the forward-looking components of supervisory framework and more risk focused based approach (e.g., bottom up stress-testing tools, performing thematic reviews etc.);
- the dialogue between supervisors and non-executive/independent banks board members through regular meetings after on-site examinations.



### Home-Host Relationships (CP 13)

**42. The FSAP evaluation also contributes to our efforts to strengthen the bank resolution function and further develop our internal preparedness for dealing with failing banks.** The NBR acknowledges the importance of continuous tests and has planned a simulation exercise for 2018, in order to test the resolution operational readiness/preparedness.

### Country and Transfer Risks (CP 21)

**43. In regards to the statement according to which “There are no specific regulatory provisioning standards for country risk and transfer risk in Romania,” the NBR reiterates that starting in 2018, EU Member States will no longer be allowed to impose additional deductions from banks’ capital (according to Article 481 paragraph 1 of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012).** The prudential provisioning would have the effect of affecting the capital so that EC4 could not be implemented without harming the observance of the above-mentioned EU Regulation.

### Operational Risk (CP 25)

**44. In regards to building up supervisory capacity and improving current employees’ supervisory skills, the NBR acknowledges the necessity to enhance IT risk supervisory capacities as well as expertise in the area of internal risk models assessment and review, in a very fast-changing, high-demanding and competitive environment, either by recruitment process or by identifying proper training for the staff in charge with these tasks.**

### Abuse of Financial Services (CP 29)

**45. The legal shortcomings mentioned in the report for this CP are mainly due to the regime accepted and applicable at the EU level and are derived from the former EU Directives.** The NBR would like to mention that the new Directive (EU) 2015/849 addresses these problems, and consequently its mandatory transposition in the national law, will solve the deficiencies revealed.