PRUDENTIAL POLITICS PROMOTED BY NBR WHERE TO?

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1. General considerations

Recent turmoil in financial markets has clearly shown that they are increasingly interconnected and globalized. Although the risks were very diffuse, global financial sector has been affected. This latest episode again emphasizes the need for a globally convergent approach in regulation and supervision, prudential rules characterized by a safe and consistent approach to supervision.

Legislative framework had to protect the development of financial intermediation institutions as non-integrated financial system. In many economies, legal and supervisory framework for financial institutions is made separately for each sector of the financial market and does not provide a unified approach to financial market as a whole. Regarding finding the appropriate institutional structures to supervise the financial markets institutions, the decision should be made taking into account the number and size of these institutions and their links with each other and especially with the banks.

2. The role of the prudential supervision for the financial system stability

In the last decade, worldwide, it has intensified debate about the optimal institutional structure for regulation and supervision of the financial system. Literature provides arguments both in favor of a single regulatory authority and financial supervision, for so the authorities empowered to regulate and supervise all services and institutions, national and even global, and also arguments in favor of specialized financial regulatory authorities.

In Romania, on the authority of law regulation and supervision of the financial system so far, the institutional model was applied. Thus, the National Bank of Romania is the body of trusteeship for credit institutions and non-bank financial National Securities Commission is the institution in charge of capital market supervision, the Insurance Supervisory Commission supervises insurance operators and Supervisory Commission Private Pension System for the field of private pensions.

In a structure with several supervisory bodies should be given special legal powers of each entity to define, identify areas of conflict and double rules. Such a system focused on sectors is a source of discontinuities and ambiguities which causes irregularities in the regulation and supervision in many countries. A single supervisory structure facilitates the adoption of a set of common standards for institutions with the same risk profile. If a single supervisory structure, with a significant number of financial institutions, the existence of a department dedicated exclusively to their supervision is a common practice.

In countries with different regulatory bodies and financial

institutions should be evaluated by degree of risk posed, and regulations are accordingly. Given the diversity of these institutions, however, these basic principles should be added to complete additional principles adapted to each type of financial institution, according to its operational characteristics. For example, for most non-bank financial institutions that accept deposits from the public, competition rules and a set of minimum rules as for transparency and monitoring by another institution, should be sufficient.

The advantage of a single supervisory structure is that allows monitoring of developments in different sectors in a consolidated manner. As mentioned in the principles of Basel II on banking supervision, an essential element of it is the ability of those responsible for supervising banking institution as a whole, which includes both banking activities and non-bank ones, undertaken by banks.

Supporters say the expansion of the consolidated supervision of financial groups in multiple areas of activity required an adequate supervision or even a single supervisory authority, by whose single measure can be significantly reduced the excessive transfer of risk between financial sectors.

Moreover in recent years, the EU had taken the first steps in this direction.

Thus, to improve surveillance assets scale transnational conglomerates and supervisory convergence in the Community, there have concluded several bilateral and multilateral memoranda of cooperation between supervisory authorities of European states and there have set up colleges of supervisors (permanent and flexible cooperation and coordination between authorities responsible for overseeing the various components of transnational banking groups) and the Joint Committee on Financial Conglomerates (JCFC-the Joint Committee on Financial conglomerates) composed of representatives of banking supervisory authorities, insurance, pensions and securities. The main task of the Committee is to ensure convergence of national practices in the supervision of financial conglomerates, transfer and application of the Financial Conglomerates Directive (2002/87/EC) in Member EU and to advise the European Commission.

Thanks to these measures, MEPs and Arnold Schilder[1], believes that "the work of supervisors of EU banking and insurance market, is not as fragmented as it sounds."

However, on June 1, 2008 came into force Agreement on cooperation between financial supervisory authorities, central banks and ministries of finance in the European Union on cross-border financial stability. It is in fact a cross-sectoral cooperation protocol in the field of supervision.

Such national or international financial groups, active in Romania, they are currently in number of 20. In general, they are organized around a core banks and include several entities, which provides various financial services of a credit institution[2] and the non-bank financial (mainly leasing), capital market, insurance and private pensions market[3]. Their supervision is carried out separately yet by the 4 authority, with but a body which promotes cooperation between them: the National Committee for Financial Stability (CNSF).
The fact that financial institutions need it, that not necessarily means that all surveillance have this need to the same extent. The supervisory authority must

[1] Arnold Schilder, president. IWCFC, „IWCFC speech on the regulation of financial conglomerates", July 18 2007 – http://fs.practicallaw.com/7-372-8985

[2] Non banking institutions and credit institutions are reglemented and supervised by NBR

[3] Examples of these are: BCR Banca pentru Locuințe, BCR Administrare Fond de Pensii, BCR Leasing, BCR Asset Management, BCR Securities; Grupul BRD, care cuprinde mai multe tipuri de instituții financiare: Banca BRD, BRD Asset Management S.A.I.; BRD Pensii SA, BRD Asigurări S.A, BRD Corporate Finance, BRD – ECS, ALD Automotive, BRD Finance IFN S.A., BRD Sogelease.

establish priorities in allocating its supervisory capacity.

Although the main dispute seems to be the followers separate supervisors and the unified agencies, in practical situations there are much more diverse. In some countries, although banking supervision is exercised separately from other financial institutions supervision, it is done in the central bank, but of another entity. Sometimes there are even several authorities responsible for carrying out banking supervision. Discussion on integrated surveillance versus the specialized one was amplified by the signals transmitted by the European Central Bank (ECB). This will not only help keep a role of central banks in carrying out banking supervision, but has indicated its intention to take certain additional powers to turn advice line supervision at EU level.

The main arguments against creating a single regulatory authority and supervision of banking, investment, insurance and private pensions, are related to a considerable increase in power of such authorities and that has not yet accumulated sufficient experience in the area in order to draw conclusions about the superiority of such a model to one based on specialized regulatory authorities and financial supervisors.

3. Recent evolutions of banking prudential indicators in Romania`s case

According to the latest developments, the Romanian banking system may be assessed as stable in its entirety, enjoying capitalisation, solvency and liquidity levels in line with prudential requirements, despite the fast-paced lending reported over the past several years and the deepening of the global financial crisis. Overall, the levels of prudential indicators did not raise major concerns, yet their tendency needs to be closely monitored given the uncertainties surrounding the prospects for global economic growth.

With a view to achieving harmonization with the best international practices and the modernization of prudential supervision, starting with 2008, the financial reporting framework was brought in line with the standardized framework recommended by CEBS for ensuring a single financial reporting recognized at EU level for supervision purposes (FINREP) and prudential purposes (COREP).

In addition, this reporting was outlined and integrated into the electronic reporting system of the NBR.

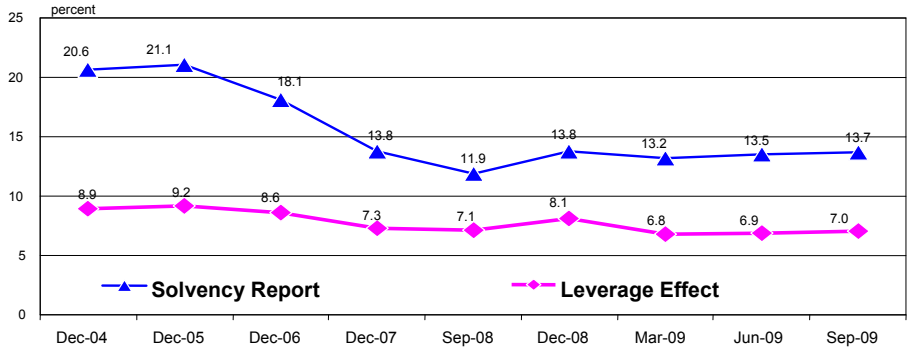
With financial intermediation still running low, according to the share of bank assets in GDP as compared to other EU countries, the Romanian market potential remained high. Thus, over the past several years, banking business and competitiveness moved up, the share of bank assets rising to 50.1 percent of GDP at end-2006, 60.9 percent in 2007 and 62.4 percent in 2008.

✓*Capital adequacy*

The slight downtrend in the solvency ratio in 2008 (12.99 percent at end-March 2008, 12.78 percent at end-June 2008 and 11,85 percent at end-September 2008 until September 2009 – see graphic no. 1) was stimulated by the fast-paced lending growth, the worsening of loan portfolio and by the introduction of an additional requirement for operational risk and market risk.

The higher solvency ratio at end-2008 (13.76 percent) compared to September 2008 was largely attributable to the rise in own funds following the inclusion of the profit achieved during the 2008 financial exercise. In this context, all the banks posted a solvency level higher than the minimum solvency ratio (8 percent), while 20 banks exceeded the average of this indicator for the banking system.

Graphic no. 1



Source: Florin Georgescu - "The banking system and prudential policy of the National Bank of Romania, Bucharest, December 11, 2009

The leverage effect also illustrates a upward trend, from 7.32 percent at end-2007 to 8.13 percent at end-2008 and then a downward trend in 2009 up to 7 percent, chiefly on account of Tier 1 capital rising at a much faster pace than assets.

✓***Asset quality***

In recent years, lending was the most aggressive segment, with banks focusing mainly on increasing their market share by expanding the range of products and territorial networks. In a new competition-driven environment, in 2008, the Romanian banking system switched from excess liquidity to liquidity shortfall, from aggressive lending in 2008 Q1-Q3 (up 11.1 percent in Q1, 8.2 percent in Q2, 9.0 percent in Q3, compared to 2,0 percent in Q4 2008), to promotions aimed at attracting deposits in 2008 Q4.

At end-2008, banking system-wide indicator illustrating the share of loans to customers in total gross assets stood at 62.50 percent, up 3.4 percentage points from the prior year's figure.

According to monetary balance sheet data of credit institutions, in 2008, the dynamics of non-government credit slowed down versus the previous year (by 33.7 percent in nominal terms or 25.8 percent in real terms, compared to 60.4 percent in nominal terms or 50.5 percent in real terms), as well as the change in the lei/foreign currency structure of loans in favor of foreign currency-denominated loans (their share in total non-government credit stepped up to 57.8 percent in 2008 from 54.3 percent a year earlier.

Loans to households remained the fastest growing segment; at end-2008, the NFC sector posted a 38.7 percent rate[4] of increase versus 29.7 percent year on year. Moreover, it is noteworthy the larger share of foreign currency-denominated loans to households, up 53.6 percent, while RON-denominated loans rose by merely 22 percent in 2008. Against this background, the NBR moved to improve the loan classification framework in order to contain currency risk and the worsening of the loan portfolio quality, imposing credit institutions additional provisioning requirements for loans granted in a currency other than the income currency (NBR Regulation No. 4/2008 on amending and supplementing NBR Regulation No. 5/2002 on the classification of loans and placements, as well as the setting-up, adjustment and use of specific provisions for credit risk and NBR Methodological Norms No. 12/2002 on the enforcement of NBR

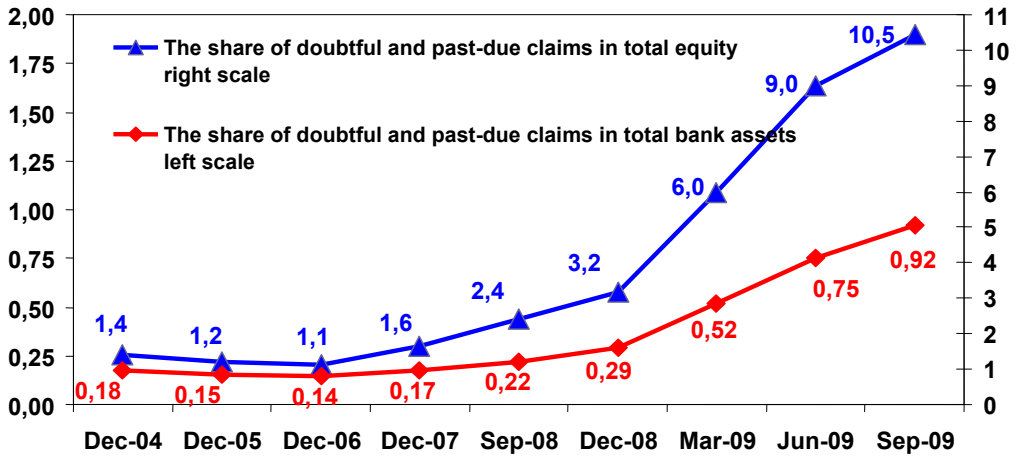
[4] According to the Annual Report of NBR 2008

Regulation No. 5/2002, which came into force in March 2008).

As expected, on the retail credit segment, housing loans destined to the purchase of houses or building materials recorded, in 2008, a growth rate (47.2 percent) faster than that of consumer loans (33.7 percent). Nevertheless, in absolute terms, consumer loans held the largest share in 2008.

After a period during which lending was banks' main option for increasing their market share, signs appeared of a gradual deterioration of the indicators measuring the loan portfolio quality, manifest especially in 2008 H2. Accordingly, although below par, it is noteworthy the steady rise in the share of doubtful and overdue loans in the portfolio of loans to customers (net) from 0.22 percent at end-2007 to 0.32 percent at end-2008. Moreover, the same indicator (gross) saw a faster rise during the said interval, from 0.77 percent to 1.37 percent. The share of doubtful and past-due claims in total bank assets moved up 0.12 of a percentage point in 2008 (from 0.17 percent to 0.29 percent) and 0,92% in September 2009 (see graphic no. 2).

Graphic no. 2.



Source: Florin Georgescu - "The banking system and prudential policy of the National Bank of Romania, Bucharest, December 11, 2009

✓ **Liquidity**

The liquidity indicator was slightly higher than both the minimum requirement (1) and the level at end-2007, to reach 2.47 percent at end-2008 from 2.13 a year earlier (see table no. 1.).

Table no. 1.

Year	Liquidity indicator
2005	2,59
2006	2,30
2007	2,13
2008	2,47

Source: National Bank of Romania – "Financial Stability Report 2009"

Expansion of lending was also affected by the rise in the ratio of loans to customers to deposits taken, from 108.72 percent at end-2007 to 122.03 percent at end-2008, which illustrates a much faster growth of loans (33.6 percent) compared

to that of deposits (19 percent). Against this background, the main types of funds raised with a view to financing the growth of assets and loans were: (i) larger deposits from customers, (ii) increasing interbank sources and subordinated loans (especially from parent banks) and (iii) higher equity stakes.

Therefore, banks needed to take measures to improve resource management with a view to reducing the vulnerability of volatile funds, diversifying financing sources, bolstering the trend and the stability of deposits taken. In addition, the diversification of the financing base in terms of both resources and the classification by maturity may contribute to maintaining an adequate liquidity level.

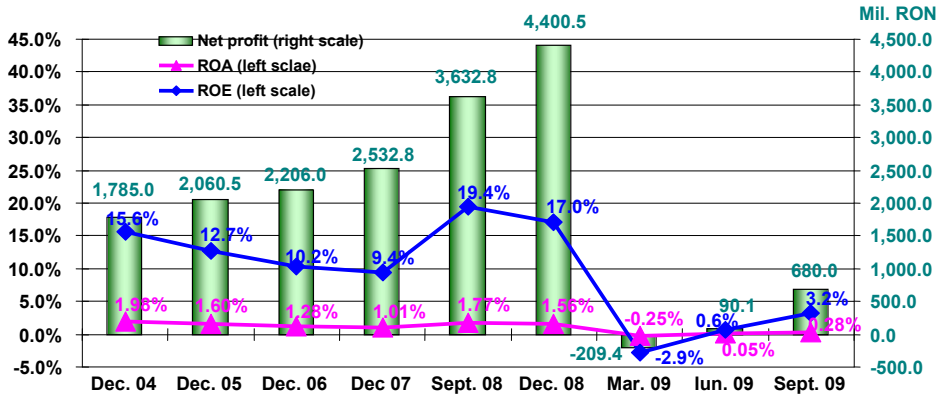
✓ ***Profitability***

At end-2008, the key profitability indicators (ROA – return on assets and ROE – return on equity) showed a significantly higher level (1.56 percent and 17.04 percent) compared to that reported at end-2007 (1.01 percent and 9.43 percent) and in September 2009 the levels were of 0.28 percent and 3.2 percent (see graphic no. 3). This development was due mainly to the sale of participating interests held by four banks in the equity capital of an insurance company, on the one hand, and to the higher net interest income, on the other.

In the year 2009, increase risk provisions on loans granted to non-bank customers was the main cause of negative financial result recorded by the banking system in Romania.

Graphic no. 3.

Profitability of the banking sector



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Given the international context, the cautious policy pursued by the NBR in the regulatory field represented a net advantage, which increased the soundness of the Romanian banking system compared to other countries. Nevertheless, looking ahead, banks performance is expected to diminish amid the contraction of lending and the pick-up in provisioning requirements.

4. Measures to improve prudential supervision of credit institutions

In 2008, although the direct impact of the international crisis on the domestic market could not yet be foreseen, the Romanian supervisory authority paid particular attention to countering the potential effects of the crisis and made further efforts to improve the regulatory and supervisory framework for credit institutions, in line with the EU

requirements in the field. The implementation of EU standards and regulations for credit institutions set forth in the documents issued by CEBS was still one of the key objectives of the NBR. The features of 2008 required enhanced international cooperation via regular consultations and meetings of the NBR representatives with foreign supervisory authorities, in order to coordinate the measures taken with a view to maintaining the soundness of institutions performing cross-border operations and the European structures. Moreover, the dialog with the domestic banking community via the Romanian Banking Association and the participation in different events aimed at raising public awareness focused on ensuring the transparency of NBR's activities regarding the issue of new regulations, amendment or implementation of existing regulations, as well as of the challenges and risks the Romanian banking system had to deal with.

The assessment of the manner in which the 25 principles of the Basel Accord on efficient supervision were implemented by the NBR was one of the major events of 2008. During 3-14 November 2008, a joint team of IMF and World Bank experts assessed the Romanian banking system, the supervisory authority's ability and the efficiency of its activity. The mission was part of the Financial Sector Assessment Programme in Romania – FSAP 2008 and was similar to that carried out by the two international institutions in 2003. The objectives of the mission consisted in assessing the laws, regulations, policies and practices at NBR level based on: (i) the self-assessment and a questionnaire to be filled in by the NBR; (ii) in-depth interviews with the NBR staff; (iii) analysis of pieces of legislation, regulations and other documents on which supervision is based, as well as of information on the structure and development of Romania's financial sector; (iv) meetings with other authorities and independent bodies, such as the Ministry of Economy and Finance and the Ministry of Justice; (v) various meetings with banks and the Romanian Banking Association.

With a view to avoiding, as much as possible, the fallout from the financial turmoil, the NBR acted steadily against the higher banking risks generated mainly by the non-government credit surge, by taking measures aimed at dampening lending and especially foreign currency-denominated loans. Thus, amendments to the norms on loan classification provided the basis for both containing currency risk exposure in the case of loans to households in a currency other than the income currency and, at the same time, pushed up the cost of this type of loans, and implicitly caused their dynamics to slow down. Moreover, the NBR in its capacity as supervisory authority took several measures to closer monitor liquidity and solvency issues at bank level, both under normal circumstances and during crisis situations. These measures comprised: (i) enhanced monitoring of interbank market developments; (ii) optimisation of liquidity shortfall management at bank level so as to allow access to specific facilities provided by the central bank (marginal lending facility, foreign exchange swap); (iii) setting up a standardised reporting format for banks to be used for reporting external sources and placements; (iv) organising meetings with the management of credit institutions in order to assess the risks identified by the latter, the strategies adopted with a view to countering the effects of the crisis, the alternate programmes concerning liquidity and capital requirements, as well the results of stress tests on their prudential stance; (v) contacting supervisory authorities, in certain situations, with a view to increasing majority shareholders' contribution to improve liquidity and implicitly solvency.

In the package of measures aimed at ensuring stability and restore households' confidence in the domestic financial system, and apart from the measures adopted at NBR level, the

government decided to increase the deposit guarantee ceiling from the RON equivalent of EUR 20,000 to the RON equivalent of EUR 50,000 starting with 15 October 2008.

With regard to the changes in the supervisory process, they were made in line with the latest developments in the regulatory framework and in the requirements for identifying and containing the risks to which credit institutions are exposed, especially amid the deepening global crisis.

In 2009, the measures that have been taken on the line of NBR prudential supervision were first of all, in **solvency**: the possibility of inclusion by banks to calculate their own funds to the following: interim profits made during the year by the end of current financial year and profit from closing the year before the approval sheet (January to May next year), deduct from the loan outstanding over 90 days or legal proceedings have been initiated to a rate of 25% of the security relating thereto, to 0% before.

Moreover, measures related to the regulatory framework in the field of **liquidity** refer to the relaxation of liquidity coefficients of adjustment of government securities by increasing the respective indexes, the relaxation factor adjustment to the customer deposits, reducing it from 100% to 40%.

5.Conclusions

Experience of the recent financial crisis has revealed major failures in financial supervision, both in cases and in relation to the global financial system. The current supervisory structures have proven unable to prevent and manage crisis, regardless step with the reality of interconnected financial markets, where many financial institutions are internationally active.

Globalization requires an integrated framework to create a more secure and more robust, regulatory and supervision of national financial systems and international cooperation based on multilateral efforts of the factors involved, knowing that an increasingly interdependent global economy, to work effective, it needs rules and international instruments regulating and controlling, based on a series of ethical requirements of sustainable development locally and globally.

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