

## **CONSTRAINTS OF THE ROMANIAN BANKING SYSTEM DEVELOPMENT – AN INTERVIEW-BASED STUDY**

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### **Abstract**

In the process of transition from planned to market economy, the Romanian banking system has undergone a complex restructuring process from mono-bank system to the two-tier banking system. The large state banks were privatized and European banking groups have invested in Romania, especially after the European Union accession in 2007. However, currently, the Romanian banking system faces some challenges and constraints of development, amid the consequences of the global financial and economic crisis, and the limitations of the business models developed in the pre-crisis period. This article proposes a qualitative research, based on the interview method, on the development constraints and challenges of the Romanian banking system. The results emphasize among these constraints and challenges: low level of financial intermediation, amid a fragile economic environment, pressure of regulatory framework on credit activity, high level of credit cost, low level of domestic saving and high level of household indebtedness, diminishing of trust in the banking system, low level of financial education.

**Keywords:** Romanian banking system, financial system, constraints of development, interview-based study

**JEL Classification:** G21; G28; O11

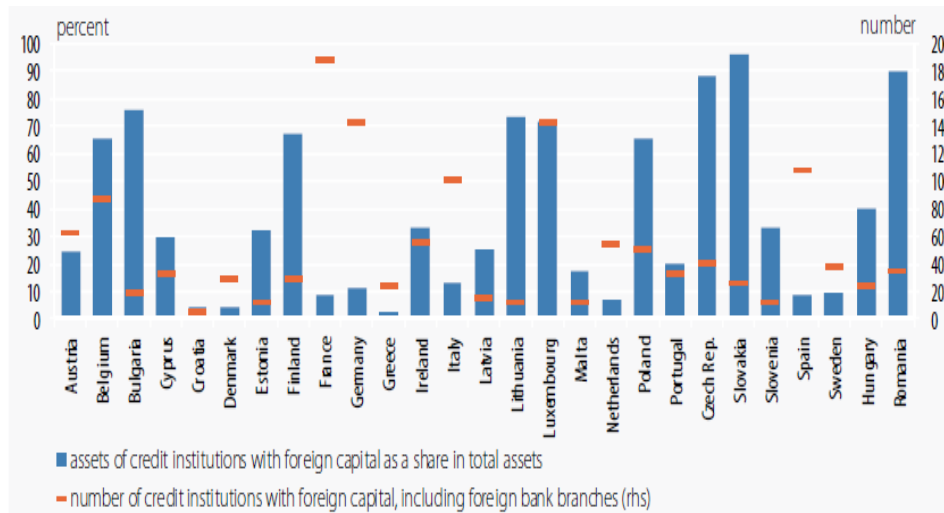
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### **Introduction**

Since 1990, the Romanian banking system has been modernized and restructured. At present day, the banking sector dominates the financial intermediation and has a considerable contribution to financing the economy and population. The banking sector accounts for almost 80 percent of total assets (at end-2014). Investment funds, with 7.9 percent of total assets, and non-banking financial institutions (NBFI), with 5.9 percent, ranks the following positions in the structure of the Romanian financial system (National Bank of Romania [NBR], 2015, pp. 67-68).

In September 2016, there were 37 credit institutions in Romania, and 8 are foreign bank branches (NBR 2016, p. 57). According to the National Bank of Romania - NBR (2016) -,

the market share of foreign capital is high – 91%. Therefore, a feature of the Romanian banking system is the dominant market share held by credit institutions with majority foreign capital. From this point of view, Romania ranks second in the European Union (EU) behind Slovakia. Other countries in Central and Eastern Europe such as Bulgaria, Lithuania, Poland, and the Czech Republic are also positioned on upper places. The countries of the EU integrated into the union in the early stages of development - Austria, Denmark, France, Germany, Italy, Netherlands, Spain, and Sweden - are at the opposite pole (figure no. 1).



Note: 2014 data were available for EU Member States and June 2015 data were available for Romania.

**Figure no. 1: Market share and number of credit institutions with foreign capital (international comparison)**

Source: NBR, ECB (Structural Indicators for the EU Banking Sector) as cited in NBR (2015, p. 72)

The global financial and economic crisis has affected the Romanian economy, real GDP knowing significant changes from year to year. Compared with 2008, when Romania's economy advanced by 8.5 percent compared with previous year, in 2009 decreased by 7.1 percent. The decline continued in 2010. Since 2011 there has been a growing trend (in 2011, the economy advanced by 1.1 percent; in 2012, by 0.6 percent; in 2013, by 3.4 percent; in 2014, by 2.8 percent) (Eurostat, 2015).

According to NBR, growth in 2014 was driven mostly by private consumption. As a result, measures are needed to encourage investments and improve the business environment (Banca Națională a României [BNR] 2015, pp. 16-17). During the period 2004-2014, the average annual growth rate of the EU-28 was 0.9 percent. By reporting to this indicator, Romania is among the top three EU countries with the highest growth (average growth of 2.7 percent per annum), placing it just behind Poland and Slovakia, which recorded the highest rates growth in the EU (Eurostat, 2015a). However, given the indicator GDP per

capita in purchasing power standards (PPS), the value recorded for Romania was slightly more than half the EU-28 average in 2013, followed only by Bulgaria. All other EU countries recorded higher values, first being Luxembourg, where this indicator was over 2.5 times higher than the EU-28 average (Eurostat, 2015b).

Following the adverse consequences of the global economic and financial crisis, during the period 2012-2014, loans granted by banks to the private sector contracted. However, in June 2015, loans to the private sector exceeded the amount recorded at end-2014, marking reversing the declining tendency (BNR 2015, p. 84).

### **1. Review of the scientific literature**

The business models performed globally in the pre-crisis period, recent trends, challenges and constraints of the banking system have been widely debated in the specialty literature.

Farhi and Cintra (2009), Vives (2010), Vitols (2009) describe the characteristics of banking models in the pre-crisis period. Ayadi, Arbak and de Groen (2011) have analyzed the business models of European banks during 2006-2009, and they conclude that “investment banks” and “wholesale banks” were more affected by the crises than “retail banks”. After crisis triggering the regulation of shadow banking has become a topic of great interest (see for example Financial Stability Board [FSB], 2011).

European Central Bank [ECB] (2016) highlights the recent trends in the banking models of euro area. Roengpitya, Tarashev and Tsatsaronis (2014) find that in recent years the „retail-funded banks” gained in popularity (p. 64).

As the financial crisis affected trust in banking system, Hutt (2016) considers restoring trust in banks one of the most important challenges of humanity.

The evolution of the Romanian banking system under the impact of the global financial crisis is highlighted by the NBR publications. NBR (2013, p. 48) stresses the factors causing credit contraction in Romania after the global crisis triggering. NBR (2015, p. 83) finds out that monetary policy conducted by the central bank of Romania had an important role in resumption of credit that began in 2015. Regarding the foreign liabilities held by credit institutions in Romania, their share decreased from 30.7 percent in 2008 (BNR 2009, p. 23) to 16.6 percent in June 2015 (BNR 2015, p. 70). The problem of non-performing loans was also debated in the NBR publications. NBR (2014, p. 47) indicates that at end-2013 the non-performing loans ratio reached the level of 21.9 percent. Following the balance sheet clean-up process that has been started in 2014, in June 2015, the non-performing loan ratio dropped to 12.8 percent (BNR 2015, p. 88). Unlike other EU countries, shadow bank in Romania is not well represented – 15.5 percent of total financial assets (BNR 2015, p. 109). The same document (p. 107) states that a vulnerability of non bank financial institutions is the dependence on external funding.

The European Bank Coordination „Vienna” Initiative [EBCI] (2012, p. 1) outlines the importance of the Vienna Initiative in preventing the disorderly deleveraging process in emerging Europe. The study of Dumitru and Mircea (2011, pp. 74-76) indicates that the saving rate in Romania have experienced significant reduction after 1990, compared to the previous period, during communism. Isărescu (2015) states that moderate growth of credit and increase of local sources of funding are the trends that will characterize the Romanian banking system.

## 2. Research methodology

The interview-based survey was conducted between January and March 2017 with 18 professionals from the largest six banks and 4 representatives of academia. Banks were selected on the base of the net assets as at 31 December 2015, according to data provided by the central bank in the latest annual report (NBR 2015, p. 101). According to this document, at end-2015, the following banks held the largest market shares: (1) Banca Comercială Română - 15.8%; (2) BRD Groupe Soci t  G n rale – 13.0%; (3) Banca Transilvania – 12.6%; (4) Raiffeisen Bank – 8.4%; (5) UniCredit Bank - 8.1%; (6) CEC Bank - 7.3%.

We consider that the sample used is representative for the entire Romanian banking system, due to the fact that the total market share of the first six banks is high - approximately 62 percent.

The interview-based survey included seven questions that were related to: the level of financial intermediation in Romania; the constraints facing the Romanian banking system, namely constraints on regulation and constraints on bank loans; challenges for the Romanian banking system; trust in the Romanian banking system; financial education and shadow banking.

**Table no. 1: Interview guide**

	<i>Issue / Theme</i>	<i>Question</i>
1.	Financial intermediation	What are the factors causing the low level of financial intermediation in Romania compared with the European Union?
2.	Constraints on bank regulation	What are the main constraints related to the adoption of the new regulatory framework in terms of developing of your bank / the Romanian banking system?
3.	Constraints on bank loan	What are the main constraints / obstacles on bank credit growth in Romania?
4.	Challenges for the Romanian banking system	What are the main challenges facing your bank / the Romanian banking system currently?
5.	Trust in the Romanian banking system	Do you consider that the Romanian banking system was affected by trust decrease from the population part?
6.	Financial education	Do you appreciate that the low level of financial education among the public constitutes a constraint for the development of the Romanian banking system?
7.	Shadow banking	What are the main constraints regarding the development of shadow banking in Romania?

## 3. Results and discussion

*Financial intermediation.* Lack of viable projects for funding was underlined by several respondents as a major constraint on financial intermediation. To this respect, as example, a respondent from academia mentioned that the EU fund absorption rate in Romania is one of

the lowest in the EU, respectively 51.3 percent in July 2015 (according to NBR 2015, pp. 16 -17). Another factor limiting financial intermediation is the low level of domestic savings, explained by: low wages, level of households' indebtedness, lack of the education for saving. Besides, the external funding of Romanian subsidiaries received from parent banks has been diminished.

*Constraints on bank regulation.* The respondents stated that the implementation of the new post-crisis regulatory framework involves the balance sheet adjustment to meet the requirements of national legislation transposing the Basel III Accord. Ultimately, this process leads to the growth of the price of banking products and services. The adjustment of bank balance sheets caused by the new regulatory framework requirements may have the effect of giving up some less profitable activities related to regulatory costs that banks have to bear. An effect of the new regulatory framework with repercussions on the financing capacity of the banking subsidiaries in Romania is also the adjustment of the balance sheets of the parent banks. Another aspect underlined by respondents from banks refers to regulations adopted by the central bank to reduce credit risk, which led to the contraction of foreign currency-denominated credit.

*Constraints on bank loan.* The lack of a sustained, durable economic growth is considered by the most respondents as a major constraint on credit growth in Romania. Other reasons stated by respondents are: the problems of non-performing loans, lack of trust in the banking system accumulated in recent years, low income of a part of the population, the economic problems facing firms and eligibility conditions for finance accessing. The high level of loan cost was also mentioned by some respondents as an obstacle to the growth of bank lending. The respondents believe that implementation of tougher credit standards could lead to credit contraction.

*Challenges for the Romanian banking system.* The respondents from the banking system underlined as a major challenge the growth of profitability under the current fragile and unstable macroeconomic context and the new more restrictive regulatory framework. Some legal initiatives, such as the Law on the discharge of debt obligations, have been included among the challenges and constraints on increasing of profitability. The need to adopt new business models based more on domestic resources and less on external funding was also revealed as a major challenge. Other challenges raised by respondents are: solving the problem of non-performing loans and their efficiently solving, and increasing the efficiency and number of bank employees.

*Trust in the Romanian banking system.* The respondents believe that trust in the Romanian banking system has been affected due to problems with non-performing loans and foreign currency-denominated loans provided to unhedged borrowers. To increase trust in the banking system, the respondents consider that it is necessary to better communicate with customers, so that they understand the basic principles of banking, and cooperate to find efficient solutions for solving problems.

*Financial education.* In the opinion of many respondents, representatives of commercial banks, the lack of financial education in Romania is a constraint to the development of the banking system. Only an informed public can make informed investment choices,

understand the role of saving or portfolio diversification, the various risks posed by lending etc. Raising the financial education level is also in the benefit of the banking system and, ultimately, of the economy. As a result, unanimously, the respondents consider that the level of financial education in Romania should increase. Therefore, some financial education modules should be introduced into the school curriculum. Moreover, a respondent considers that financial education should begin since kindergarten. Some respondents appreciate that the design and implementation of a national strategy on financial literacy is necessary. To this regard it must be mentioned the efforts of the NRB and the Romanian Banking Association to increase the level of financial education. These results confirm a survey made by STANDARD & POOR'S (The S&P Global FinLit Survey) in 2014: Romania ranks last in the EU in terms of understanding financial concepts: only 22% of adults are financially "literate" (Klapper, L., Lusardi, A. and van Oudheusden, P. 2015, pp. 23-25).

*Shadow banking.* Similar to the traditional banking system, following constraints were also highlighted for the shadow banking: the high rate of non-performing loans, the limitations posed by the lack of viable business plans, reduced incomes of the population, highly leveraged etc. In addition, it was mentioned the competition from the part of the traditional banking sector. It was also stressed that in Romania, the legal framework for the development of some activities of shadow banking system, such as securitization, were adopted relatively late (only in 2006). Regarding non-bank financial institutions, some respondents mentioned as constraint the dependence on external funding.

### **Conclusions**

The Romanian banking system has undergone an ample restructuring process in the recent decades, which ranged from the mono-bank system abolition and the two-tier system creation until the EU integration, with the Romania's accession in 2007. Similar to the trends in many countries, in the pre-crisis period, the non-government credit increased in accelerated way, amid easing some regulations and banks' desire to benefit from the growth potential of the credit market in Romania.

In this context, currently, the Romanian banking system faces many challenges, among which very important are: improving profitability, solving the problem of non-performing loans, adapting business models to the new post-crisis conditions, marked by a more restrictive regulatory framework and the need to increase the domestic financing sources.

The fragile economic environment, the low financial intermediation, the diminishing of trust in the Romanian banking system, uncertainties relating to certain legislative initiatives, the high indebtedness of the population and the low level of financial education are among the main constraints for the development of the Romanian banking system in the European Union.

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