

# THE COMPETITIVENESS OF THE BANKING SECTOR IN ROMANIA IN THE POST CRISIS

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***Abstract.** On the background of structural changes recorded in the past ten years and the micro and macro-prudential policy mix, the Romanian banking sector has seen an improvement of the main financial and prudential indicators. At the same time, it was emphasized the linkage between the risk associated with the banking sector and the related government sector. The regulatory system in the banking field has experienced significant changes, including for the purposes of consumer protection, with a direct effect on the profitability of this sector. Commercial banks' strategies have led to changes in the balance sheet of commercial banks, as well as at the market level, by reducing their number, increasing competitiveness, reducing the vulnerability associated with the currency risk, changes in the structure of credits granted by reducing the credit intake in foreign currency in total credits, increasing the level of lending in the population sector, notably by supporting the mortgage credit, reducing external financial dependence, improvement solvency. This article aims to highlight the evolution of the profitability of the banking sector in the last decade and the main factors that have influenced the level of financial profitability.*

***Keywords:** banking system, competitiveness, profitability, financial profitability rate, credit.*

**JEL Classification System: E58, E52, E59, E60, K10**

## 1. Introduction

The banking system represents an important pillar for running the economy and commercial banks are those who conceive, develop and implement financial policies to the level of an economy. In the context of macro-prudential developments over the last ten years the profitability of the banking sector from Romania exceeded the European Union (EU) average. By the end of 2018, according to data provided by the National Bank of Romania (NBR), the profitability of domestic capital was over

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15% in comparison with the EU average of just 7.2 percent. However if we look at the return on assets (ROA) from the year 2015 (11.89%) there has been a downward trend, which was established in mid-2018 to 7.2%. This trend has been counterbalanced by the cost/income ratio, which rose from 58.46% to approximately 63%. The main causes of this trend were represented by a low level of net expenses adjustments for expected losses and maintaining a low level of lending.

The strategies of commercial banks are particularly oriented to retail lending. The level of crediting of the population was allocated in similar proportions to consumption and real estate purchases, and from the perspective of the credit currency a sensible increase of those granted in the national currency, at the expense of the foreign currency loan, thus diminishing the risk associated with the evolution of the national currency in relation to the credit currency. It is to be mentioned that this evolution has resulted implicitly from the evolution of non-performing credits, whose rate has fallen sharply in recent years but also the degree of coverage with provisions of non-performing credits. This consolidation process has been maintained and has not affected the competition and competitiveness of the banking sector.

The banking sector in Romania, compared to the rest of the EU Member States, has a small size, with a level of banking assets in the year 2017 of about 54% and of lending 27% of GDP. The share of bank assets in GDP is at 50%. By comparison, at EU level the share of the banking sector's assets in GDP is 255% and in the euro area of 288%. According to the data provided by the Romanian Bank Association (in Romanian Asociația Română a Băncilor – ARB)<sup>1</sup>, Romania's banking system contributed with about 4.2% to Romania's GDP in the period 2012-2016, respectively about 30 billion Euros.

Since 2013 the Romanian banking sector has been characterized by a prudential level of reserves and liquidity, which has enabled it to accommodate the market shocks, generated from adverse external and internal macro-economic developments.<sup>2</sup> This was necessary due to dependence on the exposure of subsidiaries in Romania to the evolution and decisions of the mother banks. However, over the last ten years, dependence has diminished considerably from 30.7%, the share of external liabilities in total liabilities in the year 2008, at around 9% at the end of 2018.

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<sup>1</sup> <https://www.arb.ro/wp-content/uploads/REV-ARB.pdf>

<sup>2</sup> NBR-Financial Stability Report December 2014

The distribution of financial sector assets in Romania shows that the first eight credit institutions hold a share of 75.3%.<sup>3</sup> This gap has deepened in recent years, as economic growth has been higher than that of banking activity, and the convergence process is a long-lasting one. On the background of processes of fusion and acquisition, the number of credit institutions decreased from 43 to 35 in 2017. Of these, about 50% are banks with assets of less than 1% of the total, being considered small banks with a cumulative market share of 5%.

## **2. Structure and the degree of concentration of the Romanian Banking Sector**

### *2.1. Market characteristics*

The evolution of the banking sector started from 2008 onwards, against the background of a severe contraction in consumption, capital inflow stops, change in market liquidity conditions, overall increase in risk aversions and pressure achieved as a result to the depreciation of the national currency. Since commercial banks have accumulated stocks of non-performing loans, the real sector's financing capacity has diminished. The majority of credit institutions started to operate on the banking market in Romania are of universal type, with the exception of those holding about 2% of the total assets. The latter are specialized in areas such as housing, SME funding, special purpose credit for car purchase, export support. Credit institutions have shifted to credits for the acquisition of real estate, given the low cost of this type of credit, including the First House credit, to the retail class debtors, to reduce the level of the rate of non-performing loans at a level of approximately 6.4% at the end of 2017 and about 5.56% at the end of 2018.

Through 2009-2014 the banking sector shifted towards low-risk lending activities, to products with guarantees issued by State, implicitly and by increasing the level of provisions. Moreover, the central bank recommended that credit institutions apply pro-active prudential measures aimed at recognizing losses and readjusting the level of provisions, refocusing the lending activity, adjusting the territorial network and number of employees.

From the point of view of the territorial dimension, the banking sector continued to restrict, at the level of the year 2016, 168 branches and

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<sup>3</sup> <https://www.arb.ro/sistemul-bancar-din-romania/sistemul-bancar-din-romania/>

banking agents were closed,<sup>4</sup> with about 60 units more than during 2014-2015. According to the data provided by NBR, a territorial unit of a commercial bank covers on average about 3700 people, compared with the EU average that is 2450. At EU level Romania registers the smallest number of employees in the population ratio, the average level being 345 people/employee compared to the Union average of 345 people/employee. In Romania, an employee in the banking sector manages about 1.5 million Euros compared to the EU average of EUR 10 million. The main goal was to resize banking activity and reduce costs.

## *2.2. Structure of the banking sector in Romania*

The post-crisis period was marked by structural changes, both in the form of diminution of the number of banking entities from 43 to 35, according to Table No. 1, but also to the change of shareholding. For Banca Românească SA the majority shareholder, the National Bank of Greece Group purchased the EBRD package (European Bank for Reconstruction and Development). The year 2013 was marked by the resizing of the group of banks with Romanian majority capital, Libra Internet Bank respectively, went into the category of banks with foreign majority capital, following the consolidation of the position of majority shareholder of the American Fund Broadhurst Investments. From a structural point of view, the year 2014 was not marked by major changes, but it is worth noting that the Transilvania Bank, in the first part of the year, became one of the institutions with domestic majority capital, following the end of the year to return to the category of foreign banks as a result of the purchase of a majority package of shares by the International Financial Corporation. Moreover, a new trend of the market materialized through mergers between banking entities and non-bank entities has been outlined. Garanti Bank has merged with Domenia Credit NFI (non-banking financial institution), and Raiffeisen Bank with Raiffeisen Capital Invest. The year 2015 was characterized by large structural changes, in April Transilvania Bank signed the takeover process of Volksbank Romania SA, which was finalized at the beginning of the year 2016. Also in the same period Nextbank SA became the majority shareholder of the Carpatica Commercial Bank. Alio Bank SA Warsaw – Bucharest Branch has notified the central bank of the start of the activity on the Romanian market, and by its entry on the market the number of branches of credit institutions of foreign legal persons increased to 8, and the number of those with

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<sup>4</sup> NBR- Financial Stability Report December 2017

Romanian legal personality remained at 29. At the same time at the end of 2015, the merger by absorption process between OTP Bank and the Millennium Bank was completed. There have also been changes in the ownership structure at the level of credit institutions, thus the Italian group Unicredit has conjoined its position by purchasing the majority shareholder package within the Unicredit Țiriac Bank.

As a result of these structural changes, it was reached at the end of 2017, as more than 80% in the total credit institutions in Romania to have foreign private majority capital, influencing the competitiveness of the domestic sector, decreasing from the end of the year 2015 when they owned more than 90% of the net aggregate asset.<sup>5</sup> 12 countries were present on the Romanian market, of which 8 belong to the Euro Area, 3 are European countries outside the Euro Area and a third State, thus the Romanian banking sector is formed to an important extent from credit institutions coming from the European Area, placing Romania in the ranking of the first three EU countries after the foreign shareholder, alongside Slovakia and the Czech Republic.<sup>6</sup> Depending on the portfolio structure of the Romanian sector banks, the degree of concentration is lower in the case of credits granted to debtors – legal persons and higher in the credits granted to individuals.

### *2.3. The degree of market concentration*

The market share of institutions with foreign majority capital, including branches of foreign credit institutions, increased in the previous period with a level of over 91% at the level of the year 2016. As regards the market share of the state-owned banks, it remained relatively unchanged, with a level of about 8.2%, i.e. CEC BANK AND EXIMBANK on the banking market at the end of 2017.

The degree of market concentration is relatively low. As regards the HERFINDAL HIRSCHMAN Index (HHI)<sup>7</sup> and the market share for the

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<sup>5</sup> NBR-Financial Stability Report December 2015

<sup>6</sup> The Austrian capital holds about 25% of the total aggregate asset, followed by the French and Dutch one with a share of about 13% each, and the last being the Italian one by 10%. At the end of 2017, 9% was held by the Greek, which was diminished as a result of the merger process between Transilvania Bank and BancPost. They hold about 60% of the total number of credit institutions.

<sup>7</sup> HERFINDAL HIRSCHMAN index is calculated by the formula  $HHI = \sum_{i=1}^n S_i^2$ , where  $s_i$  represents the market share of company  $i$ , and  $n$  is the number of companies operating on the market. (Competition Council, 2012)

first five credit institutions, this was lower than the average recorded at EU level. As regards the market share in Romania, has exceeded nine percentage points the threshold of 50% and the HHI index is below the 1000 threshold. At the average level in the EU, HHI is about 1000 and the market share is approximately 63%.<sup>8</sup> It is also noted a counter-proportional relationship between the degree of concentration of the various banking sectors and the ratio between cost and operational income. This issue shows that sectors with higher concentration tend to be more operationally efficient. The evolution in the last ten years of the HHI Index attests a decrease in the level of concentration of the banking system as a result of systemic development and the increase in competition between credit institutions.

The hierarchy of banks by market share was consistently dominated by the group of the first five banks, which hold more than 5% of the total volume of assets of the banking system. It is, however, that this top in the earthlings of the composition has changed over the last ten years.

**Table No. 1.**  
*Structure indicators of the Romanian Banking Sector*

	2008	2009	2010		2011	2012	2013	2014	2015	2016	2017
<b>Number of credit institutions</b>	43	42	42		41	40	40	40	36	37	35
<b>Number of credit institutions with majority private capital</b>	43	40	40		39	38	38	38	34	35	33
<b>Number of credit institutions with majority foreign capital</b>	37	35	35		34	34	34	34	30	32	29
<b>Number of credit institutions branches of foreign banks</b>	10	10	9		8	8	9	9	7	8	7

<sup>8</sup> Eurostat (<http://ec.europa.eu/eurostat/web/digital-economy-and-society/data/data-base>).

<b>Market share of the first five banks in total assets%</b>	56.2	54.3	54.1		54.3	54.8	54.9	54.8	58.1	59.1	58.8
<b>HHI Index Assets</b>	994	928	931		861	849	381	811	876	904	915

Source: Personal processing NBR Data.

### 3. Profitability of the banking sector, causes and effects

The period immediately following the financial crisis was characterized by pressure on the profitability of the banking sector, amid a credit erosion of the real sector, especially at the level of the first eight credit institutions that held about 70% of net assets of the Romanian banking sector. From the point of view of the individual capacity of commercial banks to profit this sector is a heterogeneous one, as long as the positive results were recorded only at the level of large banks, their size being an essential condition. All this have been doubled by an increase in the costs of the provisions constituted as a result of credit risk, increasing the level of non-narcotic loans and decreasing the market value of collateral associated with the credit.<sup>9</sup> Net interest income was the main component of operational revenues, as long as commercial banks practice a high level of interest margin due to high credit risk. Thus, operational efficiency makes this sector fit into the average risk zone, and this positioning is similar to that in Central and Eastern Europe.

Over the last few years, structural changes have been made in the balance sheet of commercial banks. They aimed at: diminishing the vulnerability resulting from currency risk by reducing the share of credits in foreign currency in total credits from 58% in 2008 to around 35% in 2018; increasing lending in the population sector as a result of crediting in the mortgage field; increase of claims against public administration from 5% in 2008 to around 21% in 2018; reducing the importance of external financing by more than 20 percentage points; replacing it with national deposits, in particular from the population.

This development will deepen in the context of creating of new taxes in the banking sector.<sup>10</sup> At the end of 2018 there was the highest profit

<sup>9</sup> NBR- Financial Stability Report December 2018

<sup>10</sup> At the end of 2017, large banks holding more than 73% of the market share registered more than 85% of the net profit, compared with the year 2013 where the market shares were only 66.7% and the profit share of 73%, at the level of 2014-77%. The year 2015 was a reference as long as the share in the market's total profit was 92%.

level of the last period with a level of 5.7 billion lei<sup>11</sup>, amid a high rate of the credit component in the private sector, also reported to the favorable economic conditions. Operationally the efficiency is still in the average risk zone, and the process of consolidation of medium and small banks continues, by keeping some yields under capital cost.

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The prudential indicators exceeded the regulated level, the rate of own funds at the level of the year 2018 reached the threshold of 19%, with about 6 percentage points higher than in 2008. The adoption of European regulations by introducing new liquidity indicators<sup>12</sup> has created the prerequisites for banking sector stability. Thus, the crises recorded at the level of the countries of origin of banks holding branches or subsidiaries in Romania did not have the same effects in the Romanian banking sector. From the point of view of the typology of the business model<sup>13</sup>, according to the information provided by NBR, in the Romanian banking sector, more than 50% of the banks with Romanian legal personality have fallen at the average level of risk, 30% at low level, following that only 10% to fall at high risk level.

The financial profitability rate at the level of the year 2018 approached the level before the crisis, at about 16%, increasing by 4 percentage points compared to the previous year, and the profitability of assets was at 1.66%. This level exceeded the EU average. Most banking sectors in the EU had a modest development, with the exception of southern European states, amid the impact of non-performing loans. The profitability of assets was 0.3% and for the capital was 3.2%.

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<sup>11</sup> Approximately 87% in this profit is concentrated at the level of large banks, which hold more than 5% of the market share, being classified as systemically important banks. The market share of credit institutions that recorded the loss was about 2.4%.

<sup>12</sup> Liquidity coverage requirement indicator LCR and net stable funding indicator NSFR.

<sup>13</sup> At the micro-prudential level the business model is one of the issues assessed in order to determine the level of risk of commercial banks and establishing additional capital requirements in the supervisory process.

## 4. Competitiveness of the banking sector: causes and effects

### 4.1. Evolution of crediting analysis, causes and effects

Crediting the private sector, implicitly the population during the post-crisis period increased its contribution in the balance sheet of commercial banks, amid the stock of non-performing loans, being dictated by the emphasis on adversity at risk. The lending activity was influenced by the gradual transition to credits granted in the national currency, having a majority share in the aggregate balance sheet of commercial banks since the end of 2015, the reorientation of lending activity to individuals from mid-2016 onwards.<sup>14</sup>

The year 2016 was for the credit market given to the private sector a reference as the annual average growth rate of this credit became positive, with at 3.5%, compared with -0.3% in the previous year.<sup>15</sup>

According to NBR's annual report, at the level of 2017 the dynamics and structure of the credit given to population sector registered new adjustments compared to the previous year, an acceleration of the growth rate compared to the last two years, with a dynamic of 4.7% in 2017 towards 1.9% in 2016. Similarly, this level represents the maximum recorded in the last five years, Romania being located in the upper half of the region's ranking of States, exceeding the average level recorded in Hungary and the Euro area. However, it is worth noting that the real dynamics of credit to the private sector has been reduced from 3.3% to 3.5%, amid the evolution of the inflation rate.<sup>16</sup> This trend was mainly due to the increase in demand for consumer credits, and their more alert progress was also determined by their partial use to cover the increased advance of real estate credits.

At the same time, the evolution of the credit balance has also been influenced by factors of a circumstantial nature, by decreasing in relative terms the volume of outsourcing operations of non-performing loans and the credit purchases made by banks.<sup>17</sup> Thus, at the level of this year the share of loans to the population exceeded the level set in the Euro area, Romania occupying the third place in the ranking, after Poland and the Czech Republic. From the perspective of the credit type offered on the market, the market has reoriented itself prudently, which also confirmed

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<sup>14</sup> NBR- Financial Stability Report December 2016

<sup>15</sup> NBR Annual Report 2016

<sup>16</sup> NBR Annual Report 2017

<sup>17</sup> NBR Annual Report 2015

positive developments in terms of profitability, thus confirming that a prudential approach is effective.

The enhanced evolution from the point of view of the dynamics and structure of loans to the private sector has resulted in favorable effects on demand and supply of credits. These included a downward trend in interest rates on credits in Lei to the population, with a level comparable to the rates on credits in Euro, particularly in the case of loans in Lei for housing, mitigating the constraints on commercial bank balances by non-performing loans, increasing the volume of outsourced credits to debt recovery entities, decreasing the level/ratio of loans/deposits. These effects also materialized in adjacent sectors, such as real estate by increasing the price of housing, according to the data provided by the INS at the level of the year 2016-2017 the annual price dynamics was the highest in the last 10 years. However, with all of these legislative changes there are also influences in the opposite direction, concerning the high indebtedness of some borrowers, prolonging the process of adjusting the balance sheets of some commercial banks.

*From the point of view of the credit currency*, the share of credits granted in Lei to the population recorded an upward trend in the post-crisis period, with a minimum level in the year 2012, respectively 35.6% and with a maximum level at the end of 2017 which exceeded the threshold of 62%, compared to the previous year where the level was only 57%.<sup>18</sup> The year 2014 resulted in a decrease in the stock of credits, which constrained the volume of bank assets by default.<sup>19</sup> Starting with year 2015 The National Bank of Romania tightened the prudential measures adopted on the lending line in foreign currency, in conjunction with the adoption of recommendations regarding the cleaning of commercial banks' balances and the reduction of the non-performing credits' rate. All these measures have ensured sustainable bases for the resumption of lending.

At the level of the year 2018 the credit in national currency exceeded 60% of the total credits existing in the balance sheet of the Romanian commercial banks. The evolution was also encouraged by the diminished advance in Lei credits, in parallel with a slow increase in the total flow, as well as by the increase in the share of foreign currency loans in total external loans from the balance sheets of commercial banks, the reduction of the interest differential between the new credits denominated in Lei and

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<sup>18</sup> NBR- Financial Stability Report December 2015

<sup>19</sup> By the end of 2014 stock assets was 405 billion dollars, dropping by 3 billion against the previous year. The trend of decline continued during the next period.

inEuro as a result of the overall adjustment of the monetary policy interest rate, the granting of mortgage credits exclusively in Lei through the First Home program, starting with Mid-2013.

The decrease in the stock level of foreign currency credits was also due to the following factors: the conversion of credits granted in foreign currency, in particular for credits granted in Swiss Francs, the cessation of the granting of guarantees for foreign currency credits in the First House program, Prudential measures implemented by NBR, for the purpose of limiting the risk associated with foreign currencies to debtors not covered by foreign currency risk, following the recommendations of the European Systemic Risk Board on Credits in foreign currency (ESRB/2011/1). All these factors had an effect on both the demand and the supply of credits in foreign currency for the purpose of their constraint. We also appreciate that at the level of the year 2019 this trend will continue, in the context of the prudential strategies of commercial banks.

*From the point of view of the credit destination*, the housing component has increased its share in the total credits granted, with a maximum level in December 2017, 54.3%, compared with about 20% at the level of the year 2008. At national level, the early 2018, the credit institutions consistently maintained credit standards for this type of credit and tightened those intended for consumption. This evolution has otherwise complied with the legislation adopted in the banking sector. In contrast to credit institutions in the Euro area, where there has been a relaxation of standards, in the case of loans relating to the purchase of dwellings and have kept them constant among consumer credits. In this context, the value of *loan to value* decreased by two percentage points, both in the matter of new and total mortgages. As regards the degree of indebtedness of such a portfolio, at the level of the whole sector was relatively constant, with a level of about 44%, with a slight decrease of a percentage point in the matter of new credits. The factors that underwent the tightening of credit conditions for consumer credits were expectations about the financial situation of the population, the risk associated with the creditworthiness of customers. As a result, the demand for such credits declined significantly. The main factor of this development was the First House program, although the guarantee ceiling for this program was diminished in the year 2017. It was doubled by the increase in the flow of credits with this destination, granted by banks in the absence of the state guarantee. However, the dynamics or speed of growth has slowed, compared with the period 2015-2017, with a level of 12% compared to an

average of the preceding period of 15.8%. The share of credits for housing in total credits to the population in Romania is comparative with that of Hungary, but it is lower than that recorded in the Euro zone, with a level around the threshold of 75%.<sup>20</sup>

The increase in credit for housing was trained at Romania's level exclusively by the component in Lei, while foreign currency credits recorded a downward trend. According to the data provided by NBR, the highest share of credits in Lei, more than 40%, but much less than that of 2016, 76.9%.

According to a NBR questionnaire, the main factors that determined the dynamics and structure of credits in Romania were represented by: the level of interest rates on new credits in Lei granted to the population, increasing the level of disposable income of population, notably amid increasing earnings, maintaining a high level of confidence in the private sector from the post-crisis period, increasing the tendency to mitigate the balance sheet constraints of credit institutions generated by non-performing loans, at a level of 6.4% in 2017, compared with 9.6% in 2016, decreasing the credit/deposit ratio to a minimum of 76.9%, reducing the legislative risk as a result of the Constitutional Court's decisions in the field of the Law of giving in payment and of the Law on the conversion of Swiss Francs credits at the historical course.

On the background of normative changes, the credit institutions in Romania at the end of 2018 did not alter the lending conditions in the field of real estate loans and mortgages to the population, but imposed more restrictive conditions in the matter consumer credits. But in the matter of real estate credits there is a risk that in the coming years the trend will change, as a result of the tightening of credit conditions and the elimination of collateral products, such as the First House. According to the latest Survey on crediting of non-financial companies and the population, held in February 2019 by the National Bank of Romania, commercial banks anticipate a readjustment of credit standards in the first quarter of the year 2019, both in terms of mortgage credit and consumer credit to the population sector, which will also result in a significant reduction in the demand for loans.

Among the effects that these changes can produce are: tightening lending conditions and ultimately reducing credit, with a direct impact on consumption, reducing lending in real estate that will cause negative effects on the real estate market, on both developers and potential buyers,

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<sup>20</sup> NBR Annual Report 2017

changing consumer behavior that can lead to a higher rate of non-performing loans, blocking the secondary market for non-performing loans cumulated with the emergence of new disputes in order to obtain an enforceable title, which will also lead to the loading of the judicial system.

In the period 2016-2018 the National Bank of Romania identified 11 factors influencing lending standards: the current or expected situation of the Bank's capital, the monetary or prudential policy decisions of NBR, expectations regarding general economic situation, the risk associated with the industry in which the company operates, changing the share of non-performing loans in the bank's portfolio, the risk associated with collateral or the required guarantee, the risk associated with rapid growth or decreases, and of real estate prices, only for loans secured by real estate mortgages, the pressure of competition in the banking sector, the pressure of competition in the non-banking sector, competition with other sources of financing such as the capital market and shareholders, other factors. Factors such as competitive pressures from commercial banks have had the effect of easing those standards. As a result of this evolution the contractual clauses recorded a relaxation. The spread of the average interest rate on credits compared to ROBOR LA 1M had a moderate evolution, the premiums for risky credits, the maximum ceiling for credit value, the lending period, the maximum maturity but also the contractual clauses would be relaxed marginally. Against the background of these factors, according to the data provided by NBR, the evolution of assets and crediting is an optimistic one. This is expected to maintain a high level, respecting the growth trend in the previous period, of lending to the population, which would reach a share of around 30%. However, recently adopted legislative changes make the strategies of commercial banks acting on the Romanian market, especially the first eight banks, to move towards crediting non-financial companies to the detriment of the population, with an average of about 7%, compared to the average of the last three years not exceeding 6%, the orientation towards the SME sector. As regards the mortgage credits of the population, it is intended to maintain the trend of the last period, i.e. a level of less than 5%.<sup>21</sup>

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<sup>21</sup> The conclusions were drawn up as a result of the annual reports made by the first eight credit institutions within the banking sector in Romania, which they are currently making with the NBR. The eight banks cover over 70% of the net assets in the banking sector.

#### *4.2. The evolution of non-performing credits causes and effects*

Another factor of interest that ensures the high level of profitability of the banking sector is the low level of non-performing credits, as a result of the process of outsourcing them from the portfolio of commercial banks. Moreover, a high level of non-performing loans determines constraints on the balance sheet of commercial banks.<sup>22</sup>

Rates of non-performing credits by the end of 2014 are determined on the basis of the data reported by banks according to the Prudential Regulatory Framework on credit classification and provisioning (NBR Regulation 16/2012) as a ratio of gross exposure on unsecured credits and related interest, overdue for over 90 days and/or those for which judicial proceedings have been initiated against the operation or against the debtor and the total of classified loans and interests related to non-bank clients, excluding non-balance sheet items. Subsequently, it was determined according to the definition of EBA (European Banks Association) (implemented at national level by the NBR Order No. 6/2014) non-performing credits are (i) credits with arrears of more than 90 days and/or (ii) the credits in which the debtor is unable to fulfill his payment obligations in full without the collateral being executed, regardless of the existence of outstanding amounts or number of days of delay. Since 2015, the rate of NPLs (non-performing loans) is calculated according to the EBA definition as a ratio of the gross carrying amount of non-performing loans and advances and the total gross accounting value of credits and advances.

The positive evolution of this sector could be recorded, according to the data provided by the RBA (Romanian Banks Association) not only from a quantitative point of view but also by reporting to the confidence index in the economy at the level of the population, which led to an acceleration of crediting, implicitly by reducing the level of non-performing loans.<sup>23</sup> Thus, in mid-2018, a non-performing credits rate was recorded around the 5% threshold, with less than one percentage point compared to the previous year, and a decrease of four times compared to the year 2014. This level also falls within the range of values set by the EBA as an average risk.

In this period the main credits removed from the balance sheet of commercial banks were those in foreign currencies, in particular the

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<sup>22</sup> <https://www.ibr-rbi.ro/12645/managementul-si-monitorizarea-creditelor-neperformante/>

<sup>23</sup> <https://www.arb.ro/sistemul-bancar-din-romania/sistemul-bancar-din-romania/>

mortgage-backed consumer credits, in proportion of 60%, and the mortgage in the proportion of about 30%.<sup>24</sup> Thus the effort of commercial banks to settle the issue of debtors who can no longer pay has materialized. Moreover, this trend was in the mirror compared to the one in the sphere of crediting. The evolution was a comparative one with the EU level, according to the latest data, the rate of non-performing loans for all banks at EU level decreased in the second quarter of the year 2018 reaching a level of 3.4%. Thus, 12 member States recorded low rates of non-performing loans, below the 3% threshold, while three more states exceeded the 10% threshold.<sup>25</sup>

The trend was slowed down due to legislative changes that introduced new barriers to market entry for debt recovery entities.<sup>26</sup> In this context, the deterioration in the quality of the credit portfolio will represent the main vulnerability in the Romanian banking sector in the next period. Thus, the long term can be predicted to be near the level recorded before the crisis.

However, the effect of reducing the level of non-performing loans was not expected by reference to the profitability of this sector due to the increase of the coverage with provisions<sup>27</sup> of non-performing loans, which at the end of the year 2017 exceeded the level of 57%, exceeding the European average of 44% and about one percentage point compared to the previous year. In mid-2018, a level of about 46% was recorded. This level is lower than that recorded at EU level, at the level of the second quarter of the year 2018 a threshold of 58%. These measures also confirm that the prudential policies proposed by NBR in respect of crediting have had direct reflection in the sphere of non-performing credits.

Keeping the downtrend of the level of non-performing credits is strengthened on the premises of the payment behavior of debtors individuals who have been improved in mortgage loans compared to unsecured consumer credits. Analysis of indebtedness at the individual level is evaluated on the basis of debt service to income DSTI. The first regulation on this indicator was introduced at the level of the year 2003,

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<sup>24</sup> NBR Annual Report 2017

<sup>25</sup> [https://eur-lex.europa.eu/legal-content/RO/TXT/PDF/?uri=CELEX:52018DC0766 & from=EN](https://eur-lex.europa.eu/legal-content/RO/TXT/PDF/?uri=CELEX:52018DC0766&from=EN)

<sup>26</sup> Ordinance 52/2016

<sup>27</sup> This indicator expresses the extent to which is covered the risk of registration certain losses in the context of the deterioration of credit quality. A high level of it confers Romania a position in most prudent value range established by the European Banking Authority. Also it shows otherwise the effect and the importance of prudential measures adopted by the NBR, starting in 2013.

setting a maximum duty level of 30%, for consumer loans and 35% for real estate credits, in Lei and in foreign currency. At the level of the year 2005 a ceiling for total debtors' indebtedness to 40% was established. Between 2007-2011 and 2020, the self-regulatory system whereby commercial banks could establish by their internal rules the maximum level of debt by reference to the credit portfolio was adopted. The average indebtedness of people with mortgages and income below the medium level on economy, at the end of 2017, recorded according to NBR data a level of 51%, and in the case of people with incomes above the average level of about 20%.

In the matter of secured credits there was a decrease of about 20% and for unsecured credits an increase of around 17%. However, the macro prudential premises materialized by increasing inflationary pressure can influence this trend. In these circumstances both at the level of commercial banks and at NBR level, increasing the indebtedness of population<sup>28</sup> must continue to be a concern, in particular as regards low-income debtors. This is because a large degree of indebtedness of low-income persons is harder to prevent and supported if they hold mortgages, compared with consumer credit. Increasing the indebtedness of the population has a negative impact on the banking sector as well as on economic growth and social balance.<sup>29</sup>

The intention of credit institutions to remove non-performing credits from their portfolios in order to increase profitability has also materialized through outsourcing operations. The National Committee for Macroprudential Supervision<sup>30</sup> finds that a level of these credits can lead to systemic risk at macroeconomic level, thus a real-time monitoring of progress on the rate of non-performing credits is required. Thus, in the recommendations offered for the purpose of reducing and preventing excessive growth of non-performing lending and the indebtedness have established the need to adapt the requirements of the loans/guarantees ratio and the loans/income expressed by the relationship between debt service and income, at the beginning of 2018 was about 28% for credits in stock, while debtors contracted 30% new credits.<sup>31</sup>

Moreover, the EU has encouraged through the measures adopted the emergence of new secondary markets of non-performing credits, which

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<sup>29</sup> NBR – Financial Stability Report December 2018

<sup>30</sup> Established by Law 12/2017 concerning the macro-prudential supervision of the financial system, is an entity of inter institutional cooperation without legal personality. Its members include the NATIONAL BANK of ROMANIA, as the authority responsible for the supervision and regulation of the financial system, along with the FSA (Financial Supervision Authority) and Government.

<sup>31</sup> [http://www.cnsmro.ro/res/ups/Raport-anual-CNSM\\_2017.pdf](http://www.cnsmro.ro/res/ups/Raport-anual-CNSM_2017.pdf)

would allow banks to manage or sell such credits more easily.<sup>32</sup> At the end of March 2019 the proposal to develop a directive aimed at harmonizing the rules whereby non-banking financial institutions or any other specialized legal persons may acquire credit agreements from commercial banks.<sup>33</sup> It proposes to remove the barriers that arise in the process of transferring such a portfolio and implicitly harmonizing the requirements and criteria for authorization for credit management activities at EU level. The proposed solutions include the setting up of trading platforms for these credits, setting up national asset management companies, comparing the effectiveness of national enforcement legal regimes. The prudential guideline has materialized at Member State level since 2017, by reducing the risks of civil nature, with the main aim of preventing a potential excessive increase in lending.<sup>34</sup> At the same time, at EU level, it was chosen to develop instruments that have the main objective of reducing and prevention of non-correlation of maturities and lack of liquidity on the market.<sup>35</sup>

## 5. Conclusions

In the last decade the banking sector in Romania has been predominantly oriented towards the development of a competitive environment, amid efforts made at EU level to reduce risks in the banking sector. The measures taken from the emergence of the financial crisis have so far strengthened the solvency of commercial banks and improved the governance and supervision of the banking sector. The Romanian banking system has demonstrated in recent years the financial and external economic factors, maintaining the level of profitability but also attractiveness at the investment level. Thus, this sector has passed the financial crisis without having to contribute directly to the rescue of a commercial bank. The non-performing credits rate continued to decline, confirming the overall tendency to improve the quality of portfolios and the level of profitability of credit institutions, both at Romania and at EU

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<sup>32</sup> [https://www.consilium.europa.eu/media/37029/joint-risk-reduction-monitoring-report-to-eg\\_november2018.pdf](https://www.consilium.europa.eu/media/37029/joint-risk-reduction-monitoring-report-to-eg_november2018.pdf).

<sup>33</sup> <https://www.consiliu.m.europa.eu/ro/press/press-releases/2019/03/27/non-performing-loans-council-adopts-position-on-secondary-markets-for-bad-loans/>

<sup>34</sup> European Systemic Risk Board – „A Review of Macro prudential Policy in the EU in 2017”, April 2018

<sup>35</sup> Slovakia has introduced explicit limits on indebtedness, the DSTI indicator, and the maturity of consumer credit. The Czech Republic has developed the Mortgage Lending Regulation, especially for high-risk credits.

level, by registering a level Comparable around 3%. However, the effect of this reduction has not been felt in the light of prudential optics in the matter of the provision of provisions. Thus keeping this trend in the coming years will be a challenge at the level of banks.

It is worth noting that in the banking sector, in the post-crisis period, there has been a tendency to improve risk management practices, especially in the case of vulnerable banks, to strengthen the level of provisions for credits, but also to amend the credit structure both in terms of their object and the currency. As a consequence, credit institutions could rely on the stability of financial system, with the help of a regulatory framework that has changed in the context of Supreme Courts' decisions. This climate allows banks to manage their internal lending capacity.

Moreover, in recent years the market has evolved from a quantitative point of view actively, without a significant impact on the degree of concentration of the market. At the end of the year 2017 the Romanian banking sector consisted of 35 credit institutions, of which 22 banks with foreign majority capital, 7 branches of foreign banks and only four credit institutions with domestic majority capital. However, dependence on the parent bank in recent years has considerably diminished, which has resulted in a reduction in the effect that their decisions have at the level of the Romanian system.

Competition in the banking system has intensified over the past ten years, amid structural changes, which have led to a decrease in the number of banking units and the launch of lending products contributing to market development and for which there is demand. Thus, the market focused on credits granted to the population, in national currency, in the mortgage sphere, real estate. This evolution materialized the purpose of the prudential measures proposed by NBR in respect of crediting, i.e. cost and credit risk mitigation, implicitly of non-performing credit.

The positive level of profitability indicators materialized amid a favorable macro prudential context. Thus in the last decade it has registered an average level of 0.3% and the profitability of assets of about 3% as a return on capital. The evolution of the banking sector since 2008 was materialize amid a severe contraction in consumption, capital entry ceasing, the change in market liquidity conditions, and the overall increase of risk adversity and the pressure from the depreciation of the national currency.

The challenges of the next few years in the banking sector will result from its adaptability to new legislative changes and to the management of the effects that the main influence factors have on the market as a whole.

As a result of this, we consider that both commercial banks and the National Bank will put more emphasis on qualitative elements, quantifying the effects of factors influencing the competitiveness of this sector.

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