

**Romania: Financial System Stability Assessment,  
Including Reports on the Observance of Standards and Codes on  
the following topics: Banking Supervision, Securities Regulation,  
Anti-Money Laundering and Combating the Financing of Terrorism,  
Monetary and Financial Policy Transparency**

This Financial System Stability Assessment on **Romania** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **September 22, 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Romania** or the Executive Board of the IMF.

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ROMANIA

**Financial System Stability Assessment**

Prepared by the Monetary and Financial Systems and the European I Departments

Approved by Ulrich Baumgartner and Michael Deppler

September 22, 2003

In the context of the joint World Bank/IMF Financial Sector Assessment Program (FSAP) and requested by the Romanian authorities, a joint World Bank/IMF team conducted an assessment of the Romanian financial sector, during missions from March 10–14 and May 12–23, 2003. The team comprised Mr. Rodrigo Chaves (World Bank, mission leader), Mr. Jan Willem van der Vossen (IMF, mission co-leader), Ms. Rupa Duttagupta, Mr. R. Sean Craig, Mr. Steen Byskov (all MFD) and Mr. Nikolay Gueorguiev (EU1), all IMF, and Mmes. Gabriella Ferencz, Cari Votava, Leora Klapper, Sue Rutledge, and Sophia Cox, Messrs. Peter Kyle, Gregorio Impavido, Edil Dushenaliyev, Luc Laeven, Loic Chiquier, and Richard Symonds (all World Bank).

On the information available to the mission, the banking system currently appears well capitalized, liquid, and generally well supervised. However, the 40 percent average credit growth in real terms in the enterprise, mortgage and consumer sectors since mid-2002, specifically in foreign exchange to non-foreign exchange earners, raises concerns. Banks' credit and risk management skills may not have grown accordingly. To avoid potentially higher nonperforming loans (NPLs), from their current level of 12 percent of loans [March 2003], NPLs should be monitored and managed carefully. Currently, high liquidity mitigates immediate banking risks. However, as banks' intermediation function matures, this liquidity buffer will decrease. Capital markets and insurance are still vulnerable, but small and underdeveloped and hence pose little systemic risk. The pension system is financially unviable over the longer term and poses fiscal risks. Although banking supervision complies with the great majority of Basel Core Principles, strengthening is needed on consolidated reporting and supervision, as well as market and country risk management.

Using the current period of stability, the authorities are strengthening the regulatory framework, also with a view to meeting the requirements for EU accession, targeted for 2007. The authorities now face the challenge of prudently managing the economic recovery and increasing financial intermediation. This also involves building confidence in individual banks, the banking system, capital markets, and insurance and pension schemes. Further improvements in bank and corporate governance, a more effective judicial system, better accounting and auditing, and continued privatization remain key prerequisites.

The authorities are building a robust framework of financial law and regulations in line with EU requirements. Parts of this framework assessed by the team meet most international standards, in particular most of the FATF AML/CFT recommendations.

This report was prepared by Jan Willem van der Vossen, R. Sean Craig, Rupa Duttagupta (all MFD), and Nikolay Gueorguiev (EUI), based on input from the entire FSAP team.

*FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure and enhance their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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## LIST OF ACRONYMS

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCR	Banca Comerciala Romana
BSE	Bucharest Stock Exchange
BRD	Romanian Development Bank
CAR	Capital Adequacy Ratio
CNMV	National Securities Commission
DGF	Deposit Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FIU	Financial Intelligence Unit
FSI	Financial Soundness Indicators
GDP	Gross Domestic Product
GPI	Gross Premium Income
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ISC	Insurance Supervision Commission
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LOLR	Lender of Last Resort
NBR	National Bank of Romania
NPL	Nonperforming loan
NSCSDC	National Securities Clearing Settlement and Depository Corporation
OPCSB	Office for the Prevention and Control of Money Laundering
ROE	Return on Equity
RTGS	Real Time Gross Settlement
SIF	Financial Investment Fund
SNCDD	National Securities Clearing and Settlement Depository Company
SME	Small- and Medium-Size Enterprise
SOE	State-Owned Enterprise

## I. OVERALL STABILITY ASSESSMENT<sup>1</sup>

1. **After a decade of uneven economic performance, the Romanian authorities have successfully stabilized the economy and financial sector and, at present, risks of systemic threats to the banking system appear to be low although growing.** On the available information, banks currently appear to be well capitalized and highly liquid. However, banks are rapidly increasing their exposure to credit and market risks. Although a symptom of the developmental stage of the market, the segmentation of the interbank market and limited interaction with the capital markets thus far limit contagion risks.

2. **The extremely rapid growth of credit to the enterprise, consumer, and mortgage sectors of around 40 percent in real terms since mid-2002, led by more rapid growth in the latter two sectors, could give rise to additional risks in the near term, especially with loans in foreign currency accounting for around two thirds of loans.**<sup>2</sup> Already, levels of nonperforming loans have been revised upward from a little over 1 percent to 5 percent of loans, as a result of the introduction of new loan classification and provisioning rules and to almost 12 percent [March 2003] when substandard loans are included, as is good international practice.<sup>3</sup> Also, while reported capital ratios are high, they are not calculated on a consolidated basis, and measurement and valuation may be difficult, in particular of fixed assets. In any event, capital levels could come under pressure due to the risks inherent in rapid credit growth and potential debt service difficulties in case of devaluation.

3. **Financial Soundness Indicators (FSIs) and stress tests applied to the banking system indicate a currently high level of resilience, owing in part to relatively low credit and market exposures as a proportion of total assets.** An analysis of corporate sector vulnerabilities and the exposure of the banking system to the sector suggest that banks can withstand considerable stress in the corporate sector. This is partially a result of banks' high liquidity and the overall low exposure to the enterprise sector until recently. However, as the corporate sector increases its leverage, its vulnerability to interest rate movements also increases, with implications for credit quality.

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<sup>1</sup> See paragraph 5 for key short-term recommendations and Box 1 for Recommendations to support development of a sound financial system.

<sup>2</sup> Information on the currency composition of credit growth differs somewhat depending on the source. For instance, the Credit Bureau in the NBR report the total amounts of approved credit lines to companies, a large share of which is in foreign currencies, as loans; while the Statistics Division reports only the disbursed amounts.

<sup>3</sup> All reported data pertaining to the "current" period refer to mid-2003, unless indicated as otherwise.

Box 1. Recommendations to Support Development of a Sound Financial System

**General**

- Continue to privatize state-owned/controlled firms and banks;
- Continue preparations to ensure the smooth introduction of the new electronic RTGS payment and settlement systems in 2004 through good public and market information and rigorous testing, and the development of an appropriate legal framework;
- Further improve financial sector laws, their enforcement, and judicial system effectiveness focusing on governance issues, and through sufficient resources and training for investigative and judicial bodies.
- Continue with rapid implementation of international accounting standards, and providing training for bank supervisors and the accounting and auditing professions;

**Banking**

- Expand the availability of credit information to improve credit assessment by banks;
- Develop an effective system for oversight of credit cooperatives and credit unions;

**Capital markets**

- Strengthen disclosure, transparency, and integrity of capital markets by strengthening and using the enforcement powers of the Securities Commission;
- In particular, enforce listing requirements and de-list inactive companies on stock exchanges;
- Improve the transparency and disclosure of the Financial Investment Funds (SIFs)

**Insurance**

- Continue to strengthen the capacity of the Insurance Supervisory Commission.

4. **More robust confidence in the banking system is a prerequisite for further development.** While banking supervision is much improved, weaknesses in accounting, disclosure, and governance practices have contributed to fraud and bank failures and continue to depress confidence in the system. Further improvement in these areas is imperative for the growth of the intermediation system. Confidence building requires (i) continued privatization and restructuring of state-owned enterprises and banks to foster a more competitive business environment; (ii) more transparent accounting and audit practices; (iii) stronger prevention and prosecution of fraud in the financial and enterprise sectors,

(iv) improved investor and creditor rights protection, (v) strengthening of the financial expertise and efficiency of the judiciary; and (vi) enforcing better payments discipline, especially in the large state-owned enterprises.

5. **The following highest priority recommendations aim to strengthen financial stability in the near term and to foster development of the financial sector that ensures stability over the longer term.** The recommendations that should yield immediate financial stability benefits are (i) strengthened monitoring by supervisors of banks' loan exposures, especially of relatively weak banks and foreign exchange lending, and (ii) implementation of consolidated supervision and reporting of banks. Box 1 presents the recommendations contributing to the stability and developments of the financial system over a somewhat longer time horizon.

6. **Further improvements in Romania's core financial sector legislation are necessary to build a stronger and more stable financial system.** While banking supervision is in compliance or largely in compliance with nearly all Basel Core Principles, work remains to be done to strengthen supervision on a consolidated basis, and of market risk and country risk. Moreover, the judiciary suffers from limited experience, specifically on financial sector issues, low funding, poor infrastructure and working conditions, and does not yet enjoy full public confidence.

7. **Nonbank intermediation channels are still insufficiently developed.** The insurance sector is very small, with annual premium income a little over 1 percent of GDP at end-2002; capital markets capitalization at 11 percent of GDP at end-2002 is half that of other EU accession countries in the region. The publicly funded pay-as-you-go pension system does not contribute to intermediation and is a quasi-fiscal liability over time. Additional pillars in the pension system are still in the design phase. Credit cooperatives and credit unions are becoming more important, although only very limited data on the volume of their activities were available to the mission. An appropriate form of supervision needs to be developed for these entities.

8. **Building further confidence is also key to the development of nonbank intermediaries.** Supervision over capital markets and the insurance sector is still at a developmental phase and will need to combine essential institution building work with continued prudential vigilance. Also, the efficiency and transparency of the market need improvement.

9. **Romania intends to be in full compliance with International Accounting Standards by 2005.** The authorities are making good progress in adapting their accounting and auditing standards to modern international standards. The Accounting Law has incorporated EU accounting directives.

10. **Payment systems are being reformed, and a new electronic system, including real time gross settlement, will become operational in 2004.** The NBR will need to ensure smooth introduction of the envisaged electronic payment system and RTGS in consultation



with the EU and system participants, and only at a time when NBR, banks and public are fully informed and prepared. Current systems are relatively slow and inefficient.

11. **Finally, impressive results have been achieved in bringing the anti-money laundering and combating of the financing of terrorism framework up to international standards on all but a few issues, and in improving implementation** (see Table 3 in Annex).

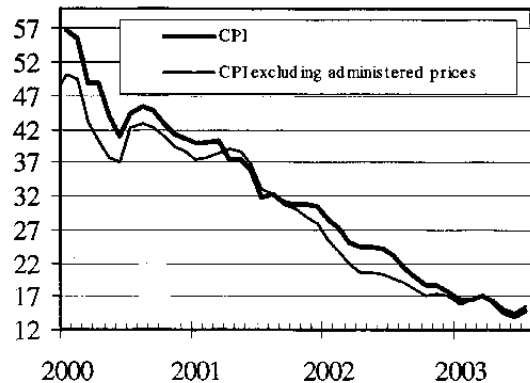
## II. MACROECONOMIC BACKGROUND

### A. General Developments

12. **After a decade of uneven performance, the macroeconomic picture has brightened since mid-2001.** The program of budget restraint and reduction of the quasi-fiscal losses, supported by the IMF's Stand-By Arrangement, was successful in bringing domestic demand down to sustainable levels, lowering inflation (Figure 1) and narrowing the current account deficit. At the same time, real GDP and export growth were among the highest in the region, driven by private investments in export-oriented consumer goods industries and gains in competitiveness (Figure 2). For 2003, projected growth is about 4¾ percent as in 2002, with end-year inflation expected at 14 percent.

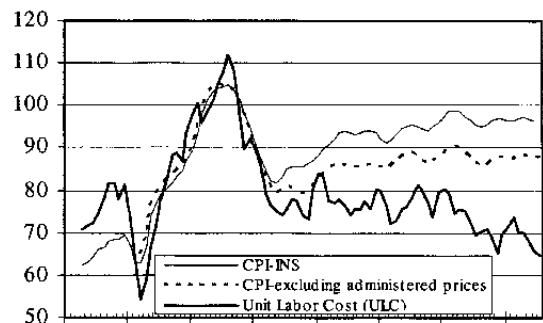
13. **Fiscal policy has supported the stabilization effort.** To aid disinflation and relieve pressure on the external position, the authorities cut the general government deficit from 5.4 percent to GDP in 1998 to 2.6 percent in 2002. Public and external debts are moderate in size and do not pose substantial risks. Total public debt at end-2002 was 27 percent of GDP, of which 22 percent was in foreign currencies. Romania's total stock of external debt amounted to US\$15.3 billion (33 percent of GDP) at end-2002, almost all of which was medium and long term. However, corporate and government guaranteed foreign debt is rapidly increasing.

Figure 1. Consumer Price Index (CPI) 2000-03  
(percent change over 12-months earlier)



Source: Romanian Authorities; and Fund staff estimates.

Figure 2. Real Effective Exchange Rates, 1996-2003  
(3-Month Moving Average)



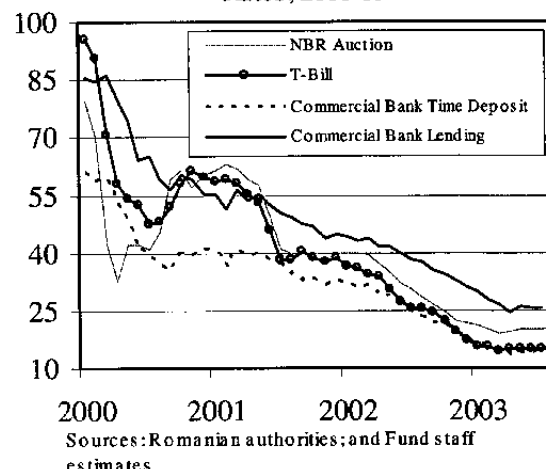
1996 1997 1998 1999 2000 2001 2002 2003  
Sources: Romanian authorities, and Fund staff calculations. CPI-based measures use INS weights, while ULC-based REER includes advanced economy partners only.

14. **The balance of payments strengthened considerably in 2001–02 as a result of trade balance improvement and strong capital inflows.** Rapid growth in exports and private transfers led to improvement of the current account deficit from 5.5 percent of GDP in 2001 to 3.4 percent in 2002, although rapid credit and wage growth led to a widening to a projected 4.8 percent in 2003. Capital inflows, in particular to banks, have been attracted by higher domestic lending rates even after adjusting for exchange rate depreciation. In this context, rising productivity has preserved external competitiveness despite a modest real appreciation of the Leu (Figure 2). In the first half of 2003, however, the balance of payments shifted to a moderately negative position as a result of delays in scheduled public and private borrowing, underreported private debt service and portfolio diversification by residents following the partial liberalization of outward investment in January 2003. As these factors exerted only temporary influence, the inflows resumed again in July-August.

### B. Monetary Policy

15. **Since early 1999, the National Bank of Romania (NBR) has pursued the twin objectives of gradual disinflation and maintaining a sustainable external position by using the exchange rate as an implicit nominal anchor.** The exchange rate regime is officially described as a managed float. In practice, the central bank aims at an annual exchange rate target, consistent with the inflation target and modest real appreciation. Large foreign currency inflows in 2001 and 2002 have created a persistent liquidity surplus in the financial system. Over this period, the NBR attained its exchange rate target by purchasing US\$3 billion worth of foreign currency, sterilizing the associated Lei liquidity, and cutting its main policy interest rate by about 40 percentage points (Figure 3).

Figure 3. Evolution of Nominal Interest Rates, 2000-03



16. **The main sterilization instruments are deposits taken by the NBR from commercial banks at auctions and mandatory reserve requirements on bank liabilities.** Deposit auctions, with currently prevailing maturity of one month, are based on a targeted interest rate ceiling, which is the main monetary policy interest rate. These deposits have grown rapidly as a result of sterilization operations, rising from 7 percent to 62 percent of base money between December 2000 and July 2003, contributing to strong bank liquidity. Reserve requirements are also used for liquidity sterilization, and now stand at 18 percent for Lei deposits and at 25 percent for foreign currency deposits, the latter in order to reduce the Lei deposit-loan interest rate spread and dampen commercial banks' foreign currency lending. This strategy has had only limited success, in view of the strong increase in foreign currency denominated lending. Other liquidity management instruments include standing deposit and Lombard facilities. The NBR is also considering the issuance of tradable 3-month certificates of deposits to help manage liquidity and signal the policy stance.

### C. Central Bank Operations and Financial Performance

17. **The effectiveness of monetary policy depends in large part on the NBR's operational autonomy and a sustainable financial position.** The NBR enjoys operational and financial autonomy as specified in the Law and Statute on the NBR as well as in the Banking Law. Exchange rate intervention and sterilization operations have created bank deposits at the central bank and have increased its foreign exchange reserves as well as the NBRs' net debtor position vis-à-vis the banking sector. Since the interest rate earned on reserves is significantly below that on deposits at the central bank, this contributes to an operating loss. Under Romanian Accounting Standards, the central bank has been able to offset this loss by drawing on reserves of accumulated, unrealized capital gains on foreign exchange. With the move to International Accounting Standards, however, it will only be able to use capital gains for the year that are not used to cover deferred taxes. As a result, it is possible that the central bank may be forced to report a loss, which would adversely affect its reported capital. The authorities should remain prepared to ensure that any such deterioration in the reported financial position of the NBR does not compromise its willingness and ability to independently conduct effective monetary policy.

### III. FINANCIAL SYSTEM DEVELOPMENT AND RISKS

18. **With total assets at US\$15 billion or roughly 30 percent of GDP, the banking sector is small relative to the size of the economy, although it dominates the financial sector, with more than 90 percent of system assets (Table 1).** Loans represent only about 12 percent of GDP, while deposits at the central bank, deposits in nonresident foreign banks, and Treasury bills make up a majority of total banking assets. The financial sector also includes equities and securities markets with a capitalization of roughly 11 percent of GDP. Other types of financial institutions—financial investment companies, insurance companies, credit unions, investment funds, brokerage houses, and credit cooperatives—together account for a very small share of total financial sector assets.

19. **Largely owing to their high, but declining, liquidity, Romanian banks currently do not face risks large enough to pose a major threat to the system.** This preference for liquidity reflects a relatively high perceived liquidity risk in view of the absence of a sufficiently deep and liquid interbank market, and an uncertain operating environment for banks. Residual risks in the system reflect (i) difficulties in assessing credit risk due partly to the lack of reliable financial statements and other credit information; (ii) debt enforcement problems, such as due to inefficiencies of the courts, (iii) low payments discipline, especially in state-owned companies; and (iv) underdeveloped secondary markets for recovered assets. Interbank lending amounts to no more than about 10 percent of bank capital, and some banks are still wary to lend to each other. Liquidity is held largely as deposits at the central bank, as a result of central bank sterilization of foreign exchange inflows. Banks may perceive these assets as more liquid relative to T-bills because T-bill markets could become illiquid during a crisis. The opportunity cost of this high liquidity is compensated to an extent by the high interest rate margins.

Table 1. Romania: Structure of the Financial System

	Number of Institutions	As of end-2002	
		In ROL Billion	In percent of GDP
Commercial banks	39	469,712	31.1
Credit cooperatives	1 network	2,687	0.18
Credit unions	3,895	5,079	0.34
Financial investment companies (SIFs)	5	21,969	1.45
Financial investment service companies	77	723	0.05
Investment funds	26	1,288	0.09
<i>Of which:</i>	23	999	0.07
Open-ended investment funds	3	289	0.02
Venture capital funds			
Insurance companies 1/	49	22,841	1.51

Sources: Romanian authorities and Fund estimates.

1/ The pension scheme is a state-organized “pay as you go” system and there are no private pension funds.

20. **While the limited nature of interbank activity has contained contagion risks so far, the rapidly changing situation indicates that market and credit risks need to be monitored more carefully.** The recent expansion of credit—reflecting both an improvement in the legal and institutional environment as well as an increase in banks’ risk appetite—could lead to accumulation of risks and losses, if asset quality is not effectively monitored and controlled by banks, as well as by the supervisory authority. As intermediation increases with the growth of confidence, the need for a deeper interbank market is also expected to develop. This will inevitably increase the scope for systemic interdependencies, as are naturally associated with a more developed system.

#### A. Bank Performance and Financial Soundness Indicators (FSIs)

21. **The assessment of the soundness of the banking system using FSIs involves an analysis of peer groups distinguished by ownership, specialization, the source and likelihood of outside emergency support and home country supervision.** The peer groups in the Romanian banking sector are:

- state-controlled banks;
- private domestically owned banks, constituting a small share of the system;
- foreign-owned banks that were previously state-owned and which inherited large nationwide branch networks through which they lend to SMEs to a larger extent;
- subsidiaries of the large internationally active banks that generally focus on multinational and large domestic companies;

- other foreign banks, generally with small and less well-known parent institutions that are less likely to provide support in the event of large losses; and
- branches of foreign banks, whose solvency and liquidity cannot be assessed independently of the parent banks.

22. **Overall, the analysis of FSIs indicates that all peer groups are sound with high reported capital ratios and limited market and credit exposures, although there are significant differences among groups (Table 2).**<sup>4</sup> Within these peer groups, some banks are substantially weaker than others. The weaker banks, which mainly include a number of smaller subsidiaries of foreign-owned banks, will need to be more closely monitored by supervisors. If their financial conditions deteriorate significantly, there may be a need for supervisory action to limit the potential for a banking failure. All peer groups—except for a few small foreign banks—appear to be highly liquid—and have a small net foreign exchange position, suggesting that this source of market risk is low.<sup>5</sup> However, the large share of lending to the corporate sector denominated in foreign exchange, gives rise to an indirect credit risk. The interest rate risk arising from the maturity mismatch of assets and liabilities in the banking sector is small but more significant than exchange rate risk, as shown in the stress test (Table 3). FSIs show that interest earnings are high—reflecting a wide interest rate spread between lending and deposit rates associated with relatively high perceived risk in the system—and contributing to high ROA and ROE. However, profitability has been declining—e.g., ROA for the banking system declined from 3.2 at end-2002 to 2.4 in March 2003 in response to a decline in the spread between lending and deposit rates from 16 percent to 14.5 percent during the same period.

23. **NPLs—including substandard loans, and after more stringent provisioning system per January 2003—at 12 percent of loans [March 2003], should preferably be reduced to allow for any increases in NPLs as a result of strongly increased lending.** While the current level of NPLs appears to be manageable given high capital levels, NPLs may increase in light of the recent credit boom. Loan loss provisions to NPL ratio of 30 percent on average could be reasonable for banks, as, under Romanian regulations, exposures are calculated net of specified types of high quality collateral. Moreover, NBR regulations require banks to discount collateral with relatively less liquidity—e.g.,

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<sup>4</sup> These high capital ratios are based on Romanian Accounting Standards (RAS), which do not require consolidated reporting, and could be lower under IAS after consolidation. Also, in some cases, illiquid fixed assets make up a large share of capital. Nonperforming loans increased from a little over 2 percent to almost 12 percent [March 2003] after the implementation on January 1, 2003 of new and stricter loan classification criteria.

<sup>5</sup> Liquid assets are defined as cash, deposits at the central bank, and government securities.

Table 2. Romania: Financial Soundness Indicators, March 2003

	Total 1/	Romanian State Owned Banks	Romanian Private Banks	Previously State Owned Banks	Subsidiaries of Large International Banks	Other Foreign Banks	Foreign Bank Branches
	<i>(In percent unless otherwise noted)</i>						
Number of banks ( <i>absolute numbers</i> )	39.0	3	4	3	2	19	8
Share of assets	100.0	41.2	3.2	22.9	9.5	15.7	7.4
Share of deposits	100.0	43.5	2.8	23.5	11.3	12.5	6.4
Share of loans	100.0	30.8	3.6	26.0	6.7	22.2	10.6
Capital Adequacy 2/							
CAR	25.0	29.3	38.5	18.1	28.0	23.8	...
Tier 1/RWA	22.9	25.8	38.0	16.4	28.0	23.0	...
Capital/Total Assets	11.3	11.4	20.8	10.0	7.7	13.1	...
Asset Quality 2/ 3/							
NPLs/Gross Loans	11.8	14.8	18.0	8.3	13.9	10.0	...
NPLs/Capital	42.0	39.0	43.4	39.7	60.5	45.8	...
Loan provisions and loan risk reserve/NPLs	29.6	28.5	14.7	44.0	25.1	23.8	...
Loan provisions and loan risk reserve/Capital	12.5	11.1	6.4	17.5	15.2	10.9	...
Earnings and Profitability							
Return on Average Assets	2.4	2.5	4.4	1.2	2.4	2.9	4.2
Return on Average Equity	16.9	15.6	18.0	9.1	27.2	19.1	39.1
Net interest income less provisions/assets	0.9	0.9	1.5	1.0	0.5	1.2	0.6
Net interest income less provisions/gross income	7.2	17.2	21.7	5.1	20.9	9.1	1.3
Non-interest expenses/gross income	76.6	35.8	46.4	83.9	29.7	80.0	94.3
Liquidity							
Liquid assets/Total assets	73.4	77.9	60.1	65.2	85.6	67.9	...
Liquid assets/Short-term liabilities	117.7	127.0	127.8	98.0	119.4	121.6	...
Maturity of Assets and Liabilities							
Liquid Assets<1 Month/Liquid Assets	65.9	70.1	52.8	56.7	81.5	60.7	...
1 Month<Liquid Assets<3 Months/Liquid Assets	7.4	7.8	7.3	8.5	4.1	7.2	...
3 Months<Liquid Assets<6 Months/Liquid Assets	7.0	6.1	9.2	8.3	6.0	7.5	...
6 Months<Liquid Assets<12 Months/Liquid Assets	8.8	5.2	15.6	14.0	5.8	11.4	...
12 Months<Liquid Assets/Liquid Assets	10.9	10.8	15.1	12.6	2.6	13.3	...
Liquid Liabilities<1 Month/Liquid Liabilities	71.7	63.2	56.5	73.9	98.1	76.5	...
1 Month<Liquid Liabilities<3 Months/Liquid Liabilities	16.5	20.1	16.0	19.9	1.5	11.8	...
3 Months<Liquid Liabilities<6 Months/Liquid Liabilities	5.8	7.3	11.4	5.3	-0.5	5.8	...
6 Months<Liquid Liabilities<12 Months/Liquid Liabilities	5.0	8.7	11.5	2.3	-1.3	1.8	...
12 Months<Liquid Liabilities/Liquid Liabilities	1.0	0.7	4.7	-1.3	2.2	4.1	...
Other Indicators							
Gross financial derivatives asset/capital	19.6	5.6	0.9	12.6	173.6	21.7	...
Gross financial derivatives liabilities/capital	19.6	5.6	0.9	12.8	173.6	21.6	...
Personnel expenses/non-interest expenses	7.4	44.3	35.5	5.2	27.6	6.5	0.9
Non-interbank loans/customer deposits	56.2	41.5	76.5	65.0	35.3	105.3	...
Foreign currency denominated loans/total loans	72.6	59.7	48.6	81.3	80.4	73.0	78.0
Foreign currency denominated liabilities/total liabilities	43.8	28.6	29.5	41.1	75.0	60.5	68.3
Total net foreign exchange position/capital	2.5	7.2	7.6	-0.6	-2.5	-6.6	...
Off-balance sheet credit equivalents/Total loans /3	41.2	44.3	23.4	39.3	40.3	42.2	...
Net liquid assets/deposits	39.3	53.6	31.4	27.4	64.6	4.5	11.9
Gross securities assets/deposits	17.5	19.1	23.3	17.5	12.4	16.6	14.5
Loans/deposits	56.6	40.1	77.2	62.7	33.8	99.9	93.9

Sources: National Bank of Romania; and Fund staff estimates.

1/ Includes foreign bank branches only when there are indicators in that column.

2/ Data reflect May 2003.

3/ NPL are non-performing loans including the categories: loss, doubtful, and substandard.

Table 3. Romania: Stress Tests and Sensitivity to Individual Shocks and Crisis Scenario

	Total	Romanian State-Owned Banks	Romanian Private Banks	Previously State-Owned Banks	Subsidiaries of Large International Banks	Other Foreign Banks
	(In percent)					
<b>Crisis scenario</b>						
(Impact of 20 percent depreciation, 10 percent-point interest rate increase, indirect effects, and interbank effect) 1/						
Impact (in percent of capital)	(15.9)	(9.9)	(9.9)	(27.3)	(15.8)	(20.8)
Of which:						
Direct Foreign Exchange Effect (in percent of capital)	0.6	1.6	1.6	(0.1)	(0.5)	(1.4)
Direct Interest Rate Effect (in percent of capital) 2/	(3.3)	(1.8)	(2.6)	(8.5)	0.4	(2.5)
Indirect Foreign Exchange Effect (in percent of capital)	(4.2)	(3.0)	(2.8)	(5.9)	(4.9)	(5.3)
Indirect Interest Rate Effect (in percent of capital)	(9.1)	(6.6)	(6.1)	(12.7)	(10.7)	(11.6)
Total change in CAR	(3.1)	(1.8)	(3.2)	(5.3)	(2.1)	(3.1)
CAR after provisioning	21.9	27.5	35.3	12.8	25.9	20.7
<b>Credit risk scenario</b>						
(Impact of 10 percent of Loans becoming NPLs and 50 percent provisioning for new NPLs)						
Impact (in percent of capital)	(15.5)	(11.3)	(10.5)	(21.8)	(18.4)	(19.9)
Total change in CAR	(3.0)	(2.1)	(3.4)	(4.5)	(2.7)	(3.0)
CAR after provisioning	22.0	27.2	35.1	13.6	25.3	20.8
<b>Narrowing of Loan to Deposit Interest Rate Margins</b>						
(Impact of 2.5 percent-points narrowing of FX spread and 5 percent-points narrowing of ROL spread) 3/						
ROE before shock	3.7	3.5	3.8	3.4	6.1	4.0
ROE after shock	(10.7)	(10.5)	(5.2)	(13.7)	(14.2)	(8.1)
Impact (in percent of capital)	(16.2)	(15.7)	(9.8)	(20.8)	(21.0)	(12.6)
Total change in CAR	(3.1)	(3.1)	(3.2)	(4.4)	(3.3)	(1.5)
CAR after provisioning	21.9	26.2	35.3	13.7	24.7	22.3

Sources: Romanian authorities; and Fund staff estimates.

1/ The interbank effect is based on end-2002 data. Indirect effect are partially based on corporate sector data from end-2001.

2/ The stress uses information on maturity structure derived from maturity bucket data provided by the NBR.

3/ Assesses effect during 1st year. This test analyses the impact of narrowing interest rate margins on net returns, which in turn depletes the capital base

commercial mortgages—by 50 percent of the estimated recovery value in computing net exposures to credit risk. However, provisions may still be insufficient to the extent banks accept collateral with relatively poor recovery rates, under Romanian conditions, and do not value such collateral conservatively.

24. **Reported capital adequacy ratios in the Romanian banking system are high, with ratios ranging from 18 percent to 29 percent over various peer groups, well above the required regulatory minimum of 12 percent.** Furthermore, bank capital is almost exclusively made up of core capital, which provides considerable flexibility for expansion of the capital base. On the other hand, caveats need to be made to account for the lack of consolidated reporting by banks, valuation difficulties specifically with regard to fixed assets,

and potential increases in nonperforming loans (NPLs) resulting from the rapid credit expansion.

## **B. Stress Tests of the Romanian Banking System**

25. **Overall, the stress tests indicate that the banking system is resilient to a range of market and credit risk shocks, reflecting in part its still relatively small – although rapidly growing – credit portfolio.** Stress tests show that the main source of risk to banks is credit risk materializing from exchange rate and interest rate exposures of the corporate sector. Banks have a balanced net position in foreign exchange, and loans carry mostly floating interest rates. Thus, banks have reduced their market risk by shifting it to the corporate sector. About two thirds of bank lending is in foreign currency, much of it to the nontradable sector. Most corporate debt is floating or short term, so that increases in interest rates quickly translate into increased interest expenses for the corporate sector. While the impact of credit losses is limited by banks' low corporate sector exposure, this is likely to change with the rapid growth in lending.

26. **The stress tests were based on a hypothetical sharp outflow of capital that results in a 20 percentage point depreciation of the Leu and a 10 percentage point rise in Lei interest rates.**<sup>6</sup> The stress testing model captures both the direct effect on banks' balance sheet and income statements and the indirect effect through the effect of the exchange rate and interest rate shocks on the quality of banks' corporate exposure. The model is based on a link between companies' financial performance and banks' capital, implied by provisioning rules applied by banks, data from the NBR's credit register, and a corporate sector database.

27. **Sensitivity analysis used to assess banking sector vulnerabilities confirms banks' relative resilience, although increases in NPLs will have considerable impact.** This sensitivity analysis involved applying several standard stress tests directly to banks' balance sheet and income statements to assess which vulnerabilities are relatively important. First, sensitivity analysis of market risk was based on the direct effect of exchange rate and domestic interest rate shocks. As noted above, the 20 percent exchange rate shock and 10 percent interest rate shock have a minimal direct impact. Second, a 10 percentage point rise in NPLs was applied. This has a large impact, especially on the foreign bank peer groups. Third, a hypothetical sharp narrowing of lending margins (the loan minus the deposit rate) was applied. Such a narrowing of spreads could be due to an increased willingness to expand the loan portfolio, resulting from a greater risk appetite, or forced by competition. This test had a large effect on ROE—a drop of 9–20 percentage points for the different groups. This impact is large enough to cause losses across the banking sector.

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<sup>6</sup> The 10 percent increase in interest rates is considered sufficiently high to conduct meaningful stress tests, in light of already high interest levels in the markets, and the low likelihood of a rapid reversal of inflows.



28. **Stress tests to assess the risk of contagion through interbank exposures show that this source of systemic risk is not significant yet, as banks engage in only very limited interbank lending.** However, with the persistent increase in lending and gradual increase in interbank activity, contagion risks could be expected to increase in the near or medium term.

### C. Banking System Liquidity: Development and Risks

29. **The Romanian banking system is highly liquid, as reflected in the high ratio of net liquid assets to deposits.**<sup>7</sup> Over the last three years, the ratio of government securities to deposits has been falling, while the loan to deposit ratio has risen with the rapid real loan growth, reflecting the increase in the risk-adjusted return on loans relative to securities. High bank liquidity, despite higher annualized average interest rates on loans—around 30 percent in nominal terms at end-2002—relative to that on deposits at the central bank—22 percent at end-2002—indicates that banks assign high value to holding liquid assets as insurance against perceived liquidity risk that could be arising from the following:

- The inability of investors and depositors to accurately assess banks' condition, which leads banks to maintain a high liquidity ratio to signal their soundness;
- The difficulty of assessing the credit quality of potential borrowers and weak judicial system;
- The risk of a sharp exchange rate depreciation and a rise in domestic interest rates associated with large foreign exchange outflows; and
- The possibility of bank failures due to fraud—the primary cause of five out of the nine bank failures since 2000.

30. **However, liquidity of the banking system has been declining.** In response to rapidly increasing credit activity, the ratio of net liquid assets to deposits declined to 39 percent in March 2003 from 45 percent in March 2002, reflecting in part that banks are responding to improved economic conditions, increased lending opportunities, and progress in the development of the overall infrastructure. However, this increase in the pace of financial intermediation and decline in bank liquidity emphasizes the need to step up assessment and management of market liquidity, and credit risks in individual banks as well as in banking supervision.

31. **This decline in liquidity notwithstanding, the system would be able to absorb large deposit withdrawals arising from a lack of confidence in the domestic currency or the banking system triggered by bank failures.** Most institutions could absorb a deposit

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<sup>7</sup> Net liquid assets are defined to include cash, deposits at the central bank, and net position in commercial interbank market. This narrow definition of liquid assets excluding government securities is used because markets for these securities can become illiquid in a crisis, which limits their role as a source of liquidity.

withdrawal equal to 30 percent of their deposit base as of March 2003. Moreover, the coverage of deposits by foreign currency reserves is quite high at around 50 percent, indicating that the system could absorb a high level of withdrawals, even if the deposits were to be exchanged for foreign currency.

#### **D. Systemic Liquidity and Safety Net Arrangements**

32. **The NBR functions as the lender of last resort (LoLR), providing short-term liquidity through a fully collateralized Lombard facility, priced at punitive rates.**<sup>8</sup> Since 2000, the NBR has only granted 11 loans under this facility. The NBR can also provide special credits to banks at its discretion to prevent a systemic or payments risk, the terms of which are set on a case-by-case basis.

33. **The Deposit Guarantee Fund (DGF) is operating satisfactorily but will need to strengthen its resources considerably to provide a sufficient level of support.** The guarantee is currently limited to individuals only, with a ceiling of about US\$3,500 per depositor. In anticipation of Romania's EU accession, the law governing the fund will be amended to also cover claims of legal entities, and the guaranteed ceiling will be gradually raised to EUR 20,000 per depositor by 2007. Reflecting the losses incurred during the bank failures in 1999–2000, DGF resources were less than 1.5 percent of the total noninterbank deposits at end-2002. The DGF has been appointed by law as the bank liquidation agency. Over the past two years, the DGF has paid out an equivalent of \$265 million (gross of liquidation proceeds) in guarantee payouts.

#### **E. Payment Systems**

34. **The current payment system in Romania is largely cash based and relatively slow, with average processing times of three days for credit transfers, and five days for checks.** Only one-third of households have bank accounts. At end-2002, cash in circulation amounted to 3 percent of GDP.

35. **The introduction of a new RTGS system by November 2004 will pose challenges in the short term in terms of the need to effect a smooth and orderly transition.** The new electronic payment and settlement system will also include an automated clearing house, a government securities registry and settlement system and will be supported by a new legal framework. The new system intends to comply with the requirements for participation in the EU "Target" RTGS payment system. A CPSIPS Assessment was not performed, in light of the ongoing revision of the system. In this context, the NBR has created a strong transition

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<sup>8</sup> The interest rate on this standing facility declined from 45 percent at end-2002 to 30 percent at mid-2003 in line with declines in other market interest rates—the rate on central bank deposits declined from 21 percent to 18 percent, while commercial lending rates declined from 30 percent to broadly 25 percent during the same period.

team. To set the baseline for building the new system, the European Central Bank has conducted its own assessment. The EU is providing extensive technical assistance to design and introduce the new system, including a new legal framework.

#### F. Banking Supervision and Legislation

36. **The NBR has a strong banking supervision framework that is compliant or largely compliant with the great majority of the Basel Core Principles.** Laws, regulations, inspection authority, and remedial measures provide the tools for effective supervisory oversight. Nevertheless, the supervisory system could be strengthened by ensuring that banks implement interest rate risk management, including stress testing, and take better account of country risk, transfer risk, and operational risk. The NBR is currently working to address weaknesses in some supervisory functions, such as consolidated supervision, and its oversight of banks' investment policies and procedures.

37. **The NBR has put in place an effective framework for closing insolvent banks.** Over the past two years, five banks have been closed,<sup>9</sup> although procedures have been excessively protracted as a result of deficiencies in the legislation and poor understanding of the technical issues on the part of the judiciary.

38. **Bank governance has been strengthened, for instance, by authorizing the NBR to refuse a banking license when the source of shareholders' capital contributions cannot be identified or is unsuitable.** However, there are areas where improvements can be made. The ownership and control structures in some small foreign-owned banks are still difficult to determine. In this context, the ownership structures of banks need to be clarified and the role of banks' boards of non-executive directors strengthened.

39. **Key governance weaknesses of banks remain in the areas of unreliable financial reporting and ineffective supervisory boards.** Implementation of IAS by all banks for 2004 will improve reporting, but weaknesses in the auditing profession will take years to overcome. Also, draft amendments to the banking law would require that banks establish supervising boards, consisting solely of nonexecutive directors.

#### IV. ENTERPRISE SECTOR

40. **Since 1999, the enterprise sector has shown improved profitability, investments, and debt service capacity.** For instance, especially foreign owned, exporting, and industrial companies have experienced a doubling of revenues between 1999 and 2001.<sup>10</sup> Still, about

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<sup>9</sup> Banca Internationala a Religiior, Banca Albina, Bankcoop, Banca Turco Romana, Banca Romana De Scont.

<sup>10</sup> More recent data not available.

one-third of firms report losses and do not generate sufficient cash flow to service their debt. However, the amount of overdue bank debt is small relative to total debt, and both the percentage of firms with overdue credit and the share of overdue credit in total debt have fallen since 1999.

41. **An important constraint on firms' access to credit are inter-enterprise and tax arrears, which at end 2001, stood at about 58 percent of total firm assets (Table 4).** Tax arrears tend to be higher for unprofitable firms, for (majority) state-owned enterprises, and for firms without export revenue. Firms with high arrears have less access to bank credit. For example, manufacturing firms with high tax arrears have less than half the bank credit (as a percentage of liabilities) of manufacturing firms with low tax arrears. Banks may be unwilling to lend to firms with high arrears, either because they are perceived to be riskier, or because these firms are unprofitable and lack growth opportunities.

42. **Corporate sector performance and access to financing may improve due to a substantial strengthening in the governance framework, which has been achieved since 2002.** In particular, the securities legislation introduced in 2002 has strengthened corporate governance, although weaknesses remain in the company law. The banking and capital markets regulators have been vested with substantial authority to improve governance of their sectors. Nevertheless, Romania lags behind other transition countries in its corporate governance framework. Corporate governance problems have contributed to fraud in the banking and capital markets.

## V. CAPITAL MARKETS, INSURANCE, PENSIONS

### A. Capital Markets

43. **The capital market in Romania is one of the smallest in Eastern Europe, with an estimated market capitalization in 2002 of around 11 percent of GDP, half the average in EU accession countries.** There is a lack of investor confidence in the markets, due to two major scandals during 1996 and 2000—involving the collapse of two large open-ended money market mutual funds—and weaknesses in the institutional framework.

44. **Equity market capitalization is insufficient to justify the coexistence of two independent exchanges and ensure the sustainability of functioning capital markets over the long run.** Despite rapid growth during 2002 of trading volume on the Bucharest Stock Exchange (about 120 percent) and on the RASDAQ (about 70 percent), liquidity remains poor on both exchanges, with transaction volume concentrated in a limited number of stocks. On the RASDAQ, many of the roughly 4,800 listed companies are in violation of listing rules, as they either have never been traded, rarely have bid or ask quotes, do not have contracts with a registrar, do not file periodic reports, or have too few shareholders. Compliance with EU Directives in the future could substantially reduce the number of listed shares on these exchanges.

Table 4. Romania: Arrears as Percentage of Enterprise Financing<sup>1</sup>

	Arrears by Source of Funding					
	Number of Firms	Bank Credit	Inter-Enterprise	Social Security	Taxes	Other
1999	1,118	6.46	12.69	9.01	22.29	9.48
2000	901	4.45	12.47	10.26	18.96	14.36
2001	683	2.68	12.49	11.92	18.65	14.64
Profitable	152	2.75	13.91	9.42	14.32	9.58
Unprofitable	531	2.66	12.07	12.65	19.93	16.13
Exporters	240	3.43	11.50	13.33	14.79	14.72
Non-exporters	443	2.27	13.02	11.15	20.76	14.60
State-owned	159	4.03	12.12	14.49	23.25	16.83
Private, domestic	503	2.14	12.73	11.61	17.87	14.37
Foreign-owned	21	5.38	10.30	1.94	5.74	6.30

Sources: Ministry of Finance; and Fund staff estimates.

1/ Based on Ministry of Finance data on BSE traded firms and RASDAQ traded firms with more than 50 employees.

45. **A number of technical and regulatory issues hinder the development of corporate and government securities markets, including: (i) lack of credible bond rating agencies; and (ii) unclear collateral and guarantee mechanisms for secured corporate bonds.** Thus, the fixed income market is still underdeveloped and consists mainly of government securities and a limited number of municipal bonds. This reflects the lack of active trading among banks on the interbank market and of active secondary market trading.

46. **The regulatory structure created by the new securities laws enacted in 2002 complies with best practices in many areas, but still contains deficiencies.** For instance, the authority of the CNVM to investigate violations of the laws governing the capital markets or affecting the orderly winding up of entities is limited by the inability to obtain documents from nonregistrants. The securities law provisions regarding the winding-up of market intermediaries, investment management companies, and open-ended funds are fragmented and inadequate in the event of fraud. Moreover, intermediaries are not required to maintain risk-adjusted net capital standards. Finally, the CNVM lacks sufficient staffing and training to perform adequate oversight.

47. **More disclosure of the financial condition and policies and more transparent governance are required of the five Financial Investment Funds (SIFs), created as vehicles for the shares of privatized formerly state-owned enterprises.** These entities, with more than 9 million shareholders and comprising much of the trade on the BSEs, are still very opaque, and they control funds close to 1½ percent of GDP.

## **B. Insurance and Pensions**

48. **The insurance sector is small and underdeveloped, with assets slightly over 1 percent of GDP.** A limited core of prudent and highly qualified companies operate in a fairly competitive and concentrated market within a group of around 50 licensed companies. Further consolidation of the market is required and the Insurance Supervisory Commission (ISC) plans to encourage it through increased minimum capital requirements, implementation of the newly introduced solvency rules, and further strengthening of prudential rules on asset and liabilities.

49. **Important progress has been made in building a regulatory framework but the Insurance Supervisory Commission was only recently established and still needs to develop effective supervisory processes and supervisory capacity.** Furthermore, critical supervisory areas need further strengthening, including corporate governance, internal controls, reinsurance, and prudential rules on assets and liabilities.

50. **The pension system currently consists of a single, publicly financed pay-as-you-go pillar which is considered to be financially nonviable over time** and so is expected to create an additional fiscal liability in the not too distant future. The high contribution rate and the weak administration of collections, audit and enforcement have contributed to widespread evasion and thus a narrow contribution base.

## **VI. LEGAL AND REGULATORY ISSUES**

### **A. Legal Issues**

51. **While the authorities have made significant progress in developing Romania's core financial sector legislation, the judicial system still needs much improvement.** The judiciary suffers from a lack of trained staff, low levels of funding, poor infrastructure and conditions of service, and a lack of public confidence. Judges are not perceived as independent and the power of the General Prosecutor to file extraordinary appeals against final judgments in civil and criminal cases further compromises the independence of the judiciary. Amendments currently proposed to the Banking Law will bring Romania into closer harmony with EU Directives and modern banking law practices. Romania has modern corporate bankruptcy statutes, but actual court procedures are lengthy and outcomes uncertain.

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

52. **The Romanian authorities have put a robust AML/CFT framework in place, and cooperate effectively with other jurisdictions.** The AML framework was considerably strengthened by the Law on the Prevention and Sanctioning of Money Laundering introduced in December 2002. The AML law meets most international standards, and authorities are working to enact remaining laws and regulations and implement procedures for prevention,

detection, and deterrence in all relevant sectors. The Office for Money Laundering, Prevention and Detection has been effective in obtaining convictions for money laundering. After September 11, 2001, the authorities acted swiftly to criminalize terrorist financing and terrorist activities.

## VII. EU ACCESSION

53. **Romania's accession to the EU is targeted for January 1, 2007.** Negotiations on 19 of the 31 chapters of the "Acquis Communautaire" have been provisionally closed. To eventually join the European Monetary Union (EMU), a minimum of two-year track record under the Exchange Rate Mechanism is a prerequisite. Thus, EMU membership cannot be achieved before 2009. The chapter on freedom of the provision of services, which includes financial services, is still open. Remaining financial sector issues include the uneven development of supervision in the three main financial sectors, banking, securities, and insurance, with banking supervision being much further advanced than the other two. The NBR still needs to strengthen consolidated supervision. Much secondary legislation still needs to be completed.

**SUMMARY ASSESSMENTS OF THE OBSERVANCE OF FINANCIAL STANDARDS AND CODES**

This part of the Financial System Stability Assessment contains summary assessments of Romania's adherence to the standards and codes mentioned below. These assessments were carried out as part of the May 2003 Romania FSAP. The assessments have provided a basis for recommendations for further strengthening the regulatory and transparency frameworks. The summaries are based on detailed assessments prepared during the FSAP mission, and preceded by self assessments by the Romanian authorities. The final assessments were prepared on the basis of study of the applicable laws and regulations, as well as interviews with the authorities, market participants and trade associations. The assessments reflect the views of the assessors, not of the authorities or the Fund.

Table 1. Codes and Standards Assessors

Basle Core Principles for Effective Banking Supervision	Gabriella Ferencz, World Bank Stefan Niessner, Consultant (Deutsche Bundesbank), IMF
IOSCO: Objectives and Principles	Richard Symonds, World Bank
Anti-Money Laundering and Combating the Financing of Terrorism	Cari Votava, World Bank, Edil Dushenaliyev, World Bank Alan Schott, World Bank Emile van der Does de Willebois, Consultant (Netherland, Ministry of Finance), World Bank
Transparency Assessments	
Banking Supervision	Gabriella Ferencz, World Bank Stefan Niessner, Consultant, (Deutsche Bundesbank), IMF
Deposit Insurance	Jan Willem van der Vossen, IMF
Monetary Policy	Sean Craig, IMF
Securities Markets	Richard Symonds, World Bank

**I. ASSESSMENT OF IMPLEMENTATION OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

**A. General**

1. As part of the joint IMF-World Bank FSAP standards assessment, the National Bank of Romania (NBR), as the functional banking supervisor in Romania, was assessed for its



compliance with the Basel Core Principles for Effective Banking Supervision. The assessment team held extensive discussions with NBR staff charged with the various responsibilities in the implementation in the overall surveillance of banks. The overall assessment is based on these discussions and a review of legislative and regulatory documents made available to the team by the authorities, primarily the Statute of the National Bank of Romania, the Romanian Banking Act, and regulations dealing with various aspects of banking activity, mainly, risk management and reporting and disclosure. The assessment was conducted at the time of the May 2003 Romania FSAP.

## **B. Main Findings**

2. The responsibility for the supervision of banks and credit cooperatives licensed to do banking business lies with the NBR. There are two departments in the NBR, vested with supervisory functions and under the responsibility of a Vice Governor: the Regulation and Authorization Department and the Supervision Department, which conducts off-site as well as on-site supervision.

3. The objectives and the institutional framework for the regulation and supervision of credit institutions are broadly defined in the Statute of the NBR and the Banking Act. Laws, regulations, inspection authority, and remedial measures provide effective tools for supervisory oversight. A CAMEL-based early warning system is in place. On-site supervision and off site surveillance have sufficiently broad scope to enable the supervisor to develop a thorough understanding of the performance of banks in Romania. Banks are inspected with good periodicity with a focus on their risk management procedures and compliance with prudential regulations. Supervisors are knowledgeable and the banking supervision function is adequately staffed.

4. Although the activities of the banks in Romania are not complex, gaps remain in the regulatory framework (e.g., consolidated supervision, interest rate risk, country and transfer risks, investments, and market risk). These gaps do not materially hinder the effectiveness of banking supervision but need to be closed in the medium term. Some of these issues will be addressed in the draft of the Government Emergency Ordinance amending and supplementing the Banking Act.

5. **Preconditions for effective banking supervision and CP 1.** The NBR has the exclusive authority to grant bank licenses and is responsible for supervision of banks licensed to operate in Romania. There is no evidence of political or industry interference. The NBR and its staff have credibility based on their professionalism and integrity. The NBR is empowered to take measures for the observance of the relevant laws and regulations and to apply legal sanctions in cases of infringement. The NBR cooperates with the two other national supervisory agencies and with foreign bank supervisors in order to promote the soundness of the Romanian financial sector. Although members of the Board of Directors or employees of the NBR may not be subject to any civil or penal sanctions for actions or failure to take action while discharging their duties in good faith, they are not protected against the costs of defending these actions.

6. **Licensing and structure, CPs 2 to 5.** With the exception of one, these core principles have been largely implemented. Licensing criteria are sufficiently broad. The NBR does not consult with home supervisors before granting authorization for establishing a subsidiary of a foreign credit institution or when a foreign credit institution seeks to acquire a Romanian bank. The NBR lacks the authority to establish criteria for reviewing major acquisitions or investments by banks in a proactive manner, except for investments in nonfinancial entities.

7. **Prudential regulations and requirements, CPs 6 to 15.** Prudential requirements for capital, large exposure limits, connected lending and market risk, are in place. However, there is a need to more systematically address country and transfer risk, although country risk is not currently significant. NBR should require banks to assess and manage their interest rate risk and should include assessments of interest rate risk in the banking sector as a whole, especially in light of the trend toward more long-term lending. The NBR needs to be more proactive in helping banks establish policies, procedures, and guidelines for effective operational risk management. Credit policies—including with regard to loan evaluation and loan-loss provisioning are largely implemented. The policies for internal audit and control were also found to be in place, although the NBR should require banks to have distinct functions for internal control and internal audit and to test for adherence to controls. No significant deficiencies were found with regard to anti money laundering policies (see separate Anti Money Laundering and Counter Terrorist Finance Template.)

8. **Methods of ongoing supervision, CPs 16 to 20.** With the exception of one, these core principles have been largely implemented. The legal framework provides an adequate framework for bank supervisors to have the necessary means to collect, review, and analyze prudential reports and statistical returns from credit institutions on a solo basis. On-site and off-site supervision have sufficiently broad scope with regard to oversight of credit risk, liquidity risk, and compliance with prudential regulations. The NBR is in the process of establishing a system of consolidated supervision by the end of this year, which will enable them to better assess the risk inherent in nonbank activities of a banking group.

9. **Information requirements, CP 21.** There are accounting laws, regulations, chart of accounts, and reporting requirements for banks, and they represent a harmonization of EU directives and IAS. Consolidated accounting will be applied to the top 9 banks for fiscal 2003 and for all banks for 2004.

10. **Remedial measures, CP 22.** The NBR has adequate formal powers and the authority to take corrective measures, including the ability to issue written warnings, impose fines, dismiss managers, restrict a bank's operations, and withdraw banks' license.

11. **Cross-border banking, CP 23 to 25.** With the exception of one, these core principles have been largely implemented. The NBR has arrangements with domestic and a number of foreign supervisors to allow sharing of information. Although foreign branch results are included in the reports of Romanian banks, there is a need to consolidate the results of foreign subsidiaries and joint ventures. Although the NBR has the authority to close overseas

offices of banks, it does not have the authority to prohibit banks from engaging in specific overseas activities. The prudential reporting requirements by branches of foreign banks are limited to the balance sheet, profit and loss statements, and currency exposure reports and needs to include all prudential reporting requirements.

### C. Recommended Action Plan

Table 2. Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
Legal Protection for Supervisor (CP 1 (5))	Legislation supporting the legal protection of NBR officials regarding the costs of defending their actions in court proceedings needs to be adopted.
Permissible Activities (CP 2)	Credit unions should be subjected to appropriate prudential supervision by the NBR
Licensing and Ownership (CPs 3 & 4)	NBR should be required to consult with the home supervisor before granting authorization for establishing a subsidiary of a foreign credit institution or a subsidiary of the parent undertaking of a foreign credit institution or granting authorization for the acquisition of a significant participation in bank by a foreign credit institution or by the parent undertaking of a foreign credit institution. The pending amendment to the Banking Act is limited to the consultation with EU Member State supervisors.
Investment Criteria (CP 5)	The Banking Act should clearly define what types and amounts of acquisitions and investments need supervisory approval and should provide criteria by which to judge individual proposals. The pending amendment to the Banking Act will address this issue.
Capital Adequacy (CPs 6 & 12)	The Banking Act should require banks to hold capital against market risk. This issue will be addressed with the implementation of the EU Capital Adequacy Directive in 2004.

### D. Authorities Response

The authorities are broadly in agreement with the assessments.

## II. IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION AND TRANSPARENCY OF SECURITIES REGULATION

### A. General

12. During the May 10–23, 2003 FSAP mission, and in a July 2003 staff visit, an assessment was conducted of observance by the Romanian capital markets authorities of the IOSCO Objectives and Principles.

13. The mission met with the National Commission for Securities Markets (CNVM), the Bucharest Stock Exchange, the RASDAQ Exchange, the National Depository Settlement and

Clearing Company (SNCDD), the National Bank of Romania (BNR), the Romanian Shareholders Registry (RRA), the brokers association ANSVM, the mutual fund association, UNOPC, and the Body of Expert and Licensed Accountants of Romania (CECCAR), as well as selected market participants. Interviews were also held with the EU Office and USAID.

### **Information and methodology used for assessment**

14. This assessment was based on the April 2003 methodology. Additional sources of information were CNVM self-assessments, websites, annual reports for 2001 and 2002, and the relevant statutes and regulations, including the Law Regarding the Structure of the CNVM, the Law Regarding Securities, Financial Investment Services and Regulated Markets, the Law Regarding Collective Investment in Transferable Securities, the Law Regarding Commodities Markets and Derivative Financial Instruments, and other laws including the Joint Stock Companies Law and Law 133/2003, regarding auditors. No significant factors impeded the assessment and assessors received full cooperation.

### **Market structure and volume**

15. In 2002, market capitalization on the Bucharest Stock Exchange grew about 120 percent, while the RASDAQ grew about 70 percent (both in U.S. dollar terms), which far outpaced economic growth. Nevertheless, market capitalization at 11 percent of GDP in 2002 is about half the average in EU accession countries. Factors contributing to this growth include (i) lower general interest rates, and (ii) new public offerings triggered by new legislation on mandatory takeover bids. In 2002, the market capitalization on both exchanges was US\$4.5 billion, out of which US\$2.7 billion for BSE. Daily trading volume of both exchanges was US\$3.3 million for the same period, out of which US\$2.13 million was transacted on the BSE. The fixed income market consists mainly of government securities and a limited number of municipal bonds. Corporate bonds are virtually nonexistent. In April 2003, outstanding government securities amounted to about 56,000 billion ROL, and US\$424 million, with daily traded volume of 1,300 billion ROL and US\$4 million, respectively.

16. Trading has been highly concentrated, with the top 10 listed companies accounting for over 85 percent of the market capitalization, compared to an average of 60 percent in other EU accession countries. Over 90 percent of the trading volume has consisted of the 5 closed-end investment funds (SIFs), and a few large banks (BRD and Banca Transilvania), and companies (PETROM). While foreign investors accounted for 53 percent of the purchase of the securities on the BSE in 2000, they only accounted for 17 percent in 2003. This shift can be partly attributed to the lack of large tradable securities and external factors, such as repatriation of profits by large multinationals. In addition, crises in the 1990s, SAFI (1996) and FNI (2000), seriously damaged investor confidence.

## **B. Main Findings**

17. **Market oversight and regulation.** The regulatory body is the National Securities Commission (CNVM). Two self-regulatory organizations, i.e., the ANSVM brokers association and the UNOPC association of collective investment schemes, have had their status withdrawn as they were not seen to be effective.

18. **General preconditions for effective securities regulation.** Deficiencies in the accounting and auditing frameworks, the judicial system and the ongoing general overhaul of the payment and settlement systems, still pose infrastructural constraints to market development. The legal structure is being adapted to EU requirements. Efforts are underway to consolidate the capital markets laws into one law. High capital gains tax as well as a dividend tax has been a disincentive to enter the market. Open-ended funds have more investors than close-ended investment companies, since, unlike the latter, the former are not taxed. There has been some discussion of instituting a tax on open-ended investment funds. This would create disincentives for individuals to invest in equities through the investment funds. The law on the creation, structure, and authority of the CNVM permits the CNVM to create an Arbitration Chamber for resolving disputes between participants in the capital markets; however, it has not been made operational due to a lack of funding. The Chamber would handle contractual disputes between investors and brokers, as well as between the market institutions themselves, but would not handle appeals from administrative actions of the CNVM.

### **Principle by principle assessment**

19. **Regulator (Principles 1–5).** The CNVM is the regulator of the capital markets in Romania. CNVM has not been able to offer competitive salaries, as the government audit agency has been reluctant to approve expenditures for salaries above the governmental rates. However, with few exceptions related to its investigative powers, the CNVM has sufficient powers and authority to regulate the Romanian securities market. The CNVM has the independent authority to issue regulations and the general oversight authority to regulate and supervise the institutions and activity on the securities markets. The decision-making process is transparent. Decisions of the CNVM may be appealed before the Supreme Court. No instances of a violation of the Code of Conduct have come to light since 2000. CNVM members and staff are only given limited legal protection in the event of a suit.

20. **Self-regulatory Organizations (Principles 6-7).** There are currently no entities recognized as Self-Regulatory Organizations by the CNVM. The CNVM withdrew the SRO status of the brokers association, ANSVM, which operated the RASDAQ market, and the mutual funds association, UNOPC, during the market crisis in 2000. Nonetheless, the RASDAQ and SNCDD continue to function in a manner similar to an SRO by submitting all rules for approval by the CNVM and disciplining members who breach the rules of the institutions. The Bucharest Stock Exchange (BSE) was never granted SRO status by the

CNVM since it was given authority by the old and new securities law, which resembles the authority of an SRO and, in fact, has acted as a de facto SRO in the running of its exchange and clearing operations. The formal use of SRO status should be encouraged as the confidence in the market institutions increases.

21. **Enforcement (Principles 8–10).** The CNVM can impose administrative orders, freeze assets of regulated entities for a period of two weeks, and refer matters, where appropriate, to criminal authorities. As set forth in detail in its Annual Reports, these powers are regularly used. The CNVM may suspend trading of securities on the market. The CNVM may not obtain information from unregistered entities. Unauthorized activity as an intermediary constitutes a contravention against which the CNVM can impose a fine. The CNVM has the authority to conduct surprise inspections. The CNVM has a regular program for examination of registrants, based on periodicity and a risk-based approach. It can also conduct examinations as the result of a particular concern, for any reason, such as customer complaints or information contained in periodic reports.

22. **Cooperation (Principles 11–13).** The CNVM, the banking and insurance regulators, have concluded an MOU on cooperation. When the CNVM needs to obtain information from a nonregistered entity, it can request assistance from the financial police and prosecutors. In practice, the CNVM has had some difficulties obtaining information from the other domestic agencies. The CNVM is authorized by law, on basis of reciprocity, to assist investigations by foreign regulators. So far, the CNVM has entered into MOUs with Portugal, China, and Greece and is in negotiation with Cyprus. The IOSCO multilateral MOU has not been implemented, and the CNVM should implement it as soon as possible.

23. **Issuers (Principles 14-16).** The regulatory framework for publicly held companies and shareholder protection are Law 31/1990, as amended, Ordinance 28/2002, and Law No. 525/2002. Significant decisions, such as major asset sales, require a vote of an extraordinary general meeting. Shareholders are informed of meetings on a timely basis and can vote by proxy. Registry of ownership and transfer of shares is performed by companies authorized by the CNVM. Audited annual and semi-annual reports must be filed with the CNVM. Prospectus regulations are currently being prepared, as well as rules on the content of annual and semi-annual reports. Material events regarding the issuer need to be filed within 24 hours of the event. The CNVM reviews complaints with regard to periodic financial filings, only when such complaints arise. Acquisitions over 5 percent must be disclosed to the CNVM progressively as shareholdings increase to 10 percent, 33 percent, 50 percent, 75 percent, or 90 percent. Takeover bids must provide notification and information to the shareholders. The shareholders do not appear to be unfairly disadvantaged in this situation. The administrators and members of the Board of Directors Board are liable for damages to the corporation. If the issuer is fined for violations due to the actions of the administrators, these may be held liable by the shareholders. However, this does not appear to have been tested in court.

24. **Collective Investment Schemes (Principles 17–20).** There is an absolute prohibition against any relationship between the AMC and the Depository. However, some conflict of

interest areas are not covered, such as prohibitions or limitations regarding the holdings of natural persons who are employed by an AMC. Moreover, affiliated transaction restrictions apply only to institutional relationships and do not cover personal relationships. Under the new law, there is a possible conflict between a bank acting as a Depository for a fund and as the fund’s distributor. This arrangement will require heightened supervision of a bank distributor by the BNR and the CNVM. The CNVM currently has no access to a bankruptcy procedure for CIS and other regulated entities, comparable to those available for banks under BNR supervision. However, a temporary administrator can be appointed for an open-ended investment fund until a new asset manager is found. A bankrupt investment company would follow corporate bankruptcy proceedings. The current system would not be efficient in the event of fraud.

25. **Market intermediaries (Principles 21–24).** Minimum capital requirements of market intermediaries are set at 25 percent of initial paid-up share capital. No adjustment for risk takes place, nor are the full range of risks taken into account when calculating the net capital. It is difficult to determine if this level is sufficient. This entire capital structure regime is undergoing review in order to organize it in accordance with EU standards. Ordinance 28/2002; Law No. 525/2002 provides for the establishment of a compensation fund for investors, which has, however, not been implemented yet. As discussed above, the CNVM does not have its own procedure for winding up an intermediary similar to the one given to the BNR for closing down banks, including the appointment of a receiver. The law should be amended to give it such a procedure.

26. **Secondary market (Principles 25–30).** The Romanian regulatory structure provides for monitoring of the exchanges on a day-by-day basis by the CNVM. The system could be more effective if sufficient staff were available. Sanctions are not particularly strong: withdrawal or suspension of authorization (which are never used) and fines. The fines are not large and deterrence is insufficiently effective. In the event of default of delivery, the clearing and settlement system at the SNCDD (which provides securities clearance and settlement for RASDAQ) gives the selling broker an additional day to borrow securities or reach an agreement with the counterparty to cancel the trade. Buy-in by the broker has not been effective due to the illiquid nature of most stocks on the market. This practice has not resulted in any great problems to date, although it will need to be changed in the future as market volume develops and EU accession criteria are adopted.

### C. Recommended Action Plan

Table 3. Recommended Action Plan to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
	<b>Principles Relating to the Regulator (P1-5)</b>
P2	The CNVM needs to have more independence from parliament so that it can objectively regulate the market;

P2	More legal protection for commission members and staff is needed to protect them from doing their lawful business.
P3	More sources of funds are needed for the CNVM until transaction taxation revenue are sufficient.
P3	The CNVM should be able to pay more competitive salaries;
	<b>Principles of Self-Regulation (P 6-7)</b>
P6	BSE should be formally designated as an SRO.
	<b>Principles for the Enforcement of Securities Regulation (P 8-10)</b>
P8	The CNVM should consolidate and simplify record keeping requirements for CIS;
P10	The CNVM should obtain more resources; there is currently no review of periodic financial filings
P9	The CNVM should be authorized to question and obtain documents from nonregistrants. Alternatively, it should be given authority to designate specific prosecutors and magistrates to work with the CNVM. A closer working relationship with the financial police is needed.
P8	The application for a brokerage account should be require identification of the beneficial owner;
P9	The Arbitration Chamber needs to funded and become operational.
	<b>Principles for Cooperation in Regulation (P 11-13)</b>
	None
	<b>Principles for Issuers (P 14-16)</b>
P15	Disclosure of share holdings of directors and senior officers should be made mandatory; and needs to take place within two days.
P16	The RAR standards should be brought up to IAS standards;
P16	An independent corporate governance body is needed to hire and manage the external auditor;
P16	A review cycle is needed for financial information filings.
	<b>Principles for Collective Investment Schemes (P 17-20)</b>
P17	To prevent "front running" and other conflicts of interest, CIS employees should be prohibited from holding CIS stock;
P20	Better practices are needed, i.e., forward pricing in which the purchase price or sale price is based on the NAV on the day the order is received, as backward pricing can leave the fund open to manipulation, since the purchaser will already have a price locked from the previous day, while the market is in play during the day that the order is made.
P17	Book and record keeping rules for CIS need to be consolidated into one comprehensive rule.
	<b>Principles for Market Intermediaries (P 21-24)</b>
P22	The regulation of financial groups should be taken to hand urgently, including a clear definition as to the meaning of the term "financial group."
P24	CNVM needs to have at its disposal of uniform winding-up proceeding for regulated entities, including the ability to appoint a receiver over the entities, similar to the procedure used for banks. The current system would not be efficient in the event of wide-scale fraud by the intermediary due to the largely voluntary nature of the winding up proceedings.
P24	The compensation fund needs to be established in order to have fully implemented status.
	<b>Principles for the Secondary Market (P 25-30)</b>
P28	Finality of settlement at the SNCDD should be improved



#### **D. Authorities' Response**

The authorities are broadly in agreement with the assessments.

### **III. THE 40 + 8 FATF RECOMMENDATIONS FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM**

#### **A. General**

27. This Report on the Observance of Standards and Codes for the *FATF 40 Recommendations for Anti-Money Laundering and 8 Special Recommendations Combating the Financing of Terrorism* was prepared in the context of the Romania FSAP in May/June 2003. The views are those of the assessment team and do not necessarily reflect the views of the government of Romania or the Boards of the IMF or World Bank.

#### **Information and methodology used for the assessment.**

28. In preparing the detailed assessment, staff reviewed the relevant AML/CFT laws and regulations and supervisory and regulatory systems applicable to regulated financial institutions. The criminal law expert not under the supervision of Bank staff reviewed the regulatory systems in place for other nonprudentially regulated sectors, as well as the capacity and implementation of criminal law enforcement systems. The team met with officials from the NBR Supervision Department, General Customs Directorate, Insurance Supervision Commission, National Securities Commission, Ministry of Justice, General Prosecutor's Office, Financial Guard, Ministry of Interior, General Police Inspectorate, Department of Economic Police, Office for the Prevention and Control of Money Laundering (FIU), and the Ministry of Finance. In addition, the team met with officers of Banca Romaneasca, a Romanian bank, and the securities firm, BCR Securities. The assessment is based on the information available at the time it was completed in June 2003.

#### **B. Main Findings**

29. Romania has achieved a high level of observance of the FATF 40 + 8 Recommendations, recognizing its vulnerability to money laundering. Romania has been working continuously over the past several years to develop and implement a thorough AML/CFT regime, and it is evident that the government has made anti-corruption and anti-money laundering efforts relatively high political priorities..

30. Romania has become an active member of the Council of Europe's anti-money laundering (MONEYVAL/PC-R-EV) Committee, which conducted Mutual Evaluations on implementation of AML policies on April 1999 and April 2002. Romania has been quick to address deficiencies identified in these evaluations, with technical assistance from the EU and other donors. Continued attention is needed, however, to the volume of illegal activities and transactions taking place in cash and outside the lawful financial channels.

31. Romania has signed and ratified most major international AML/CFT conventions,<sup>1</sup> including the U.N. Convention Against Transnational Crime (“Palermo Convention”). Romania has adopted several Emergency Government Ordinances to provide the legal basis to combat the financing of terrorism, which include: No. 141/2001 on Sanctioning Terrorist Acts; No. 159/2001 on Preventing and Combating the Use of the Financial System in Financing Terrorist Acts; No. 918/2001 on implementing U.N. Security Council Resolution 1333/2000; and, No. 152/2001 on implementing U.N. Security Council Resolution 1373. Government Decision No. 369/2001 further establishes an Inter-Ministerial Committee for implementation of U.N. Security Council Resolution No. 1333 on Afghanistan.

32. Romania adopted its first AML law in 1999 (No. 21/1999 on the Prevention and Sanctioning of Money Laundering). The country recognized the shortcomings of this law, and enacted a new law (No 656/2002 on the Prevention and Sanctioning of Money Laundering), which took effect in December 2002, and is adopting other rules to be consistent with this law. The Romanian AML Law meets EU standards with respect to coverage of legal entities and professionals, which are obligated to report suspicious transactions or bank transfers and cash transactions above the appropriate threshold to the FIU. Although covered by the Law of 2002, ongoing attention should be given to developing an appropriate supervisory and regulatory framework for money transfer agencies/remitters to prevent the use of these entities by criminals. The competent authorities should ensure that banks have sufficient resources to enable them to comply with AML/CFT standards, even when the daily volume of transactions increases.

33. Formulation of guidelines, implementation and monitoring of compliance obligations in non-bank financial sectors are in need of further development, particularly in the insurance and securities sectors.

34. Romania’s FIU was created pursuant to the AML law and has been a member of the Egmont Group<sup>2</sup> since 2000. It has taken the lead in coordination of AML/CFT efforts. The FIU receives and analyzes reports of suspicious transactions and large cash transactions from various financial sector and private sector entities, which are required pursuant to the AML Law, to report all suspicious transactions and cash transactions which exceed EUR 10,000. The FIU is managed by a governing board made up of senior representatives seconded from

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<sup>1</sup> The 1988 United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (“Vienna Convention”), the 1999 U.N. Convention for the Suppression of the Financing of Terrorism, and the Council of Europe Convention (“Strasbourg Convention”) on Laundering, Search, Seizure, and Confiscation of the Proceeds from Crime.

<sup>2</sup> Egmont Group is the independent international association of financial intelligence units that supports each other’s work in international cooperation, mutual legal assistance, and information sharing for the purpose of combating money laundering.

all government ministries<sup>3</sup> which play a major role in anti-money laundering and counter-terrorism activities. In addition, each Board member is responsible for conducting necessary AML/CFT training of staff within the ministry from which s/he was seconded. This organizational structure is very effective in ensuring inter-agency cooperation always remains at a high level, and that all agencies with a direct role have a voice in how AML/CFT policies are implemented.

35. The FIU serves as a filter to protect confidential financial information and yet submits relevant information to law enforcement officials in appropriate circumstances where illegal activities are suspected. The FIU has published valuable guidelines for detection and identification of potential suspicious transactions. The FIU analyzes all reported transactions to determine whether further investigation by law enforcement authorities is warranted. As a number of convictions for money laundering have occurred, the system appears to be functioning relatively well.

36. Representation of relevant law enforcement agencies on the FIU Board facilitates a high degree of coordination and cooperation in detection and investigation of offenses, which enables appropriate investigation and prosecution of offenses. In this area, sharing of information is important in order to ensure adequate safeguards for the protection of confidential information. It appears that the appropriate legal basis for processing and utilization of information is in place and functions well.

37. The FIU has appropriate information sharing arrangements in place to enable it to cooperate with other FIUs internationally in the prevention and detection of cross-border criminal activities. The FIU has signed several MOUs with counterpart agencies abroad and is working to continue to increase the number of these bilateral agreements.

38. Some amendments to the Criminal Code and Criminal Procedure Code are still needed, particularly, to hold legal entities criminally liable<sup>4</sup> and to enhance the provisional measures available to law enforcement authorities to prevent money laundering. For example, the confiscation laws should extend confiscation to property not directly involved in the criminal acts and the duration of time for which assets can be seized/forfeited pending investigation, as well as the nature of the goods that can be seized/forfeited (assets/property of corresponding value indirectly involved in or proceeds of suspected illegal activities) should be expanded. Additionally, the criminal laws should be amended to permit specifically for the use of modern investigative techniques, including controlled delivery, undercover activities, and wiretapping in appropriate circumstances. Access to IT systems and monitoring of bank accounts are permitted under certain conditions.

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<sup>3</sup> Ministry of Justice, Ministry of Public Finance, Ministry of Interior, Prosecutor's Office, National Bank of Romania, Court of Accounts, and Association of Romanian Banks.

<sup>4</sup> Amendments to the Criminal Code, including criminal liability for legal entities, was being debated in the parliament at the time of the visit of this assessment team, May 2003.

39. Attention should also be given to the definition of “money laundering” to ensure that direct knowledge, as an element of the offense, can be inferred from objective circumstances. In this way, increasing the duty for financial sector, public sector, and private sector professionals would ensure that institutions or companies are not inadvertently used to promote criminal enterprises and activities.

40. Romania acted swiftly to adopt the Emergency Government Ordinance to criminalize terrorist acts and terrorist financing, particularly following the events of September 11, 2001. Although these decrees have the force and effect of law, the obligation of institutions and entities to detect, identify, and report transactions suspected of terrorist financing would be clearer if this obligation was made more specific in the law. Such law should articulate the obligation to detect and report transactions suspected of terrorist financing activities. Romania has made the fight against terrorism and terrorist financing a high priority, and due to its geographic location, obligations to detect and report such transactions should exist in, or along side, the AML law, as well as in relevant supervisory legislation and regulation.

41. Overall Romania has made impressive efforts to build a comprehensive and effective AML/CFT regime and broadly meets the FATF 40+8 recommendations. It appears quite effective and efficient in coverage of transactions that are executed through recognized financial and private sector entities. However, a large volume of transactions in the economy are executed in face-to-face cash payments, which are not captured by the current AML/CFT detection and prevention procedures. Romania should continue its efforts to bring these transactions into the recognized financial sector and increase efforts for detection, particularly at border crossings and airports, to deter and decrease smuggling and trafficking in various commodities.

### C. Recommended Action Plan

Table 4. Recommended Action Plan to Improve Compliance with the FATF Recommendations

Reference FATF Recommendation	Recommended Action
<b>40 Recommendations for AML</b>	
Scope of the criminal offense of money laundering (FATF 4-6)	Amend AML law so that “knowledge” element of money laundering can be inferred from objective circumstances. Amend Criminal Code to permit criminal liability of legal entities.
Other forms of cooperation—Focus of improved mutual assistance on money laundering issues (FATF 36-40)	Amend relevant criminal laws to ensure authorities can take expeditious action in request to requests by foreign countries to identify, seize, freeze, and confiscate proceeds or other property, as well as allowing for sharing of confiscated assets. Consider allowing extradition of Romanian nationals.
Provisional measures and confiscation (FATF 7)	Amend relevant laws to provide specific authority to freeze and/or seize property that is subject to potential confiscation, from the time that there is a suspicion of criminal activity.

Reference FATF Recommendation	Recommended Action
Other measures (FATF 22-25)	Improve monitoring and detection of physical cross-border transportation of cash, including clearer notice at border crossings informing travelers of the specific amounts above which written declarations should be made to customs authorities.
<b>8 Special Recommendations on Terrorist Financing</b>	
<b>III. Freezing and confiscating terrorist assets</b>	Amend relevant criminal laws to ensure authorities can take expeditious action in request to requests by foreign countries to identify, seize, freeze, and confiscate proceeds or other property, as well as allowing for sharing of confiscated assets.

#### D. Authorities' Response

The authorities are broadly in agreement with the assessments.

### IV. OBSERVANCE OF THE IMF CODE OF GOOD PRACTICES ON TRANSPARENCY OF MONETARY AND FINANCIAL POLICIES

#### A. Monetary Policy

##### General

42. This assessment draws on the relevant laws, regulations, administrative policies, and NBR publications, many of which are available on the NBR's website, as well as discussions with NBR officials and Romanian banks. Cooperation by the authorities was very good. The assessment was conducted during the May 2003 Romania FSAP.

##### Main findings

43. The NBR implements **very good transparency practices with regard to its preparation and conduct of monetary policy in all of the main areas**. The areas where transparency could be strengthened are indicated in the action plan at the end of this section. The NBR is also in the process of revising the framework for monetary policy and operating procedures to bring them into compliance with those in the Euro area in preparation for EU accession. These changes, once fully implemented, will go a long way toward strengthening observance in areas where there is room for improvement.

44. The authorities practice a high degree of transparency with regard to the **clarity of roles, responsibilities, and objectives of monetary policy**. Nevertheless, clarifying in legislation that price stability is the NBR's ultimate objective of monetary policy would improve transparency. The proposed shift in the framework to inflation targeting should

provide this specificity and further strengthen transparency practices. Legislation is relatively specific regarding the instruments of monetary policy. While the NBR has the tools to implement exchange rate policy, however, there is some ambiguity with respect to the responsibility for establishing objectives (see below). The role of the NBR vis-à-vis the government is, in general, clearly specified in legislation.

45. The authorities could strengthen transparency with regard to the **process for formulating and reporting monetary policy decisions**. The publicly disclosed intermediate targets for monetary policy correspond only to a limited extent to what is used in practice. The monetary aggregate target has not proved to be a useful intermediate target, and the NBR has adopted as a de facto intermediate target, the nominal exchange rate in the context of a managed float/crawling band exchange rate regime. This target is not announced formally but can be inferred from the inflation and real exchange rate targets announced by the government and the NBR. The role of this target in monetary policy is communicated to the public in NBR publications, but the divergence between the formal and actual target reduces transparency. There may also be scope to strengthen communication on internal decision-making processes. The proposed shift to an inflation-targeting framework should significantly improve transparency in these areas. In addition, the planned implementation of the NBR's revised operational framework should enhance transparency with respect to the role of short-term interest rates as an operational target.

46. The NBR has a **clear structure for decision making** involving the Board, the Monetary Policy Committee, and a committee for monitoring day-to-day liquidity. While this structure is described to the public, the full set of specific regulations and guidelines governing the respective roles of the different decision-making and advisory groups is not (as it is regarded as an internal organization issue). The transparency of the NBR decision-making process could potentially be enhanced if the specific roles and accountabilities of these groups were defined for the public. The NBR's communication of monetary policy, regulatory changes, and of progress towards achieving its objectives is generally effective and transparent.

47. The authorities exercise good practices with regard to **public availability of information on monetary policy**, through publications and presentations by management and in response to requests. NBR's publication of data effectively meets IMF SDDS standards. The NBR also regularly discloses information on its financial statements, foreign currency reserves and operations through its Annual Report.

48. The authorities exercise good practices with regard to transparency of **accountability and assurances of integrity** by the central bank. The governor is obligated to appear before the legislature at regular intervals and on request. Other senior officials also testify regularly. Officials are obligated to make disclosures intended to identify conflicts of interest. The NBR must consult with the government on monetary policy objectives, although the latter may become discretionary with the strengthening of the independence of the NBR, as central bank legislation is brought into line with that of Euro area central banks.

## **B. Banking Supervision**

### **General**

49. The assessment was based on study of the relevant laws and regulations, including the Law on the National Bank of Romania (NBR) and discussions with the banking supervision authorities and market participants. The assessment was conducted during the May 2003 Romania FSAP.

### **Main findings**

50. The NBR practices a very high level of transparency with regard to the clarity of roles, responsibilities and objectives relative to banking supervision. The publicly disclosed Banking Law and the Statute of the NBR are the two main legislative instruments on banking supervision. Information on these aspects is available on the internet, via the website of the NBR. However, the NBR could consider disclosing the Protocol signed between the NBR, the National Securities Markets Commission, and the Insurance Supervision Commission.

51. The NBR practices a very high level of transparency with regard to the open processes for formulating and reporting of financial policies. All regulations and norms are disclosed in the Official Gazette. In addition to a good annual report, the NBR publishes a monthly bulletin and a quarterly report on the Romanian banking sector. The MOU the NBR has signed so far with various foreign banking supervisory authorities has not been published yet.

52. The NBR practices a very high level of transparency with regard to the public availability of information on financial policies. The annual report of the NBR is submitted to parliament and explained by the governor. It is publicly available on the website of the NBR and contains information on the main activities of the NBR (monetary policy, payment systems, and regulation and supervision of credit institutions) and developments in the banking sector, also at the macroeconomic level. The website of the NBR provides most relevant information on banking supervision. Senior officials of NBR explain the institution objectives via public appearances, such as speeches made at public meetings and media interviews.

53. The NBR practices a good level of transparency of the arrangements for **accountability and assurances of high integrity** of the supervisory authority. Financial accountability is well organized, through a detailed and informative annual report, which includes the externally audited financial statements. The Statute of the NBR provides for robust sections on the governance of the NBR, including internal financial auditing. Although the Statute of the NBR establishes rules for incompatibilities and conflicts of interest, the NBR has not disclosed that employees must present a statement of their financial circumstances to the Personnel Department, nor has it established and published standards for the conduct of personal financial affairs and behavior in relation to the supervised banks. Also, there are no specific legal provisions regarding the coverage of the costs for the defense of staff in legal procedures against actions or omissions committed in the bonafide and

reasonable discharge of their duties. Also, the NBR could consider disclosing the internal regulations, stating the task and the duties of the Internal Auditing and Control Department.

### C. Deposit Insurance

#### General

54. The assessment is based on the review of relevant legislation, information from the NBR website, the Annual Reports of the Deposit Guarantee Fund, and open and informative interviews with the Director of the Deposit Guarantee Fund and his deputy, as well as NBR officials. The assessment was conducted during the May 2003 Romania FSAP.

#### Main findings

55. The authorities exercise very good practices on the **transparency of the roles, responsibilities, and objectives** of the Deposit Guarantee Fund (DGF). The Government Ordinance on the Deposit Guarantee Fund is published in the Official Gazette and contains all necessary details. Information is available on the NBR website and the Annual Report of the DGF. The DGF intends to open its own website in the near future.

56. Although minor improvements are possible, the DGF applies very good transparency practices with regard to the **processes for formulating and reporting of financial policies**. After discussion with the banks and the NBR, technical rules and ordinances are established. The DGF had attempted to have the technical rules and regulations disclosed, but the Official Gazette refused to do this, as it was not mandated by law. Under the draft amended Government Ordinance this will be changed.

57. The DGF exercises very good transparency practices with regard to **public availability of information on deposit insurance policies**. The BNG has a good public information function, although with a total staff of 17, a separate unit for this function is not possible. The Annual Report is proactively disseminated to all banks, parliament, a number of government ministries, and foreign deposit insurance agencies. Additional information is available in the NBR Annual Report and the NBR website. The public is widely informed through the media of the functioning of the DGF in case of bank failure and unavailability of deposits.

58. The DGF practices with regard to transparency of arrangements for **accountability and integrity** could be strengthened in a number of areas. Audited financial statements are disclosed through the Annual Report, but the notes to the annual accounts are not disclosed. The Government Ordinance provides for robust sections on the governance of the DGF, including audit. The DGF is audited by KPMG, who found the 2002 financial statements to provide a true and fair view on all significant aspects. There are no specific legal provisions on legal protection of officials and staff of the DGF. Also, no specific rules exist on the avoidance of conflict of interest. There is no separate legal obligation specifically for officials and staff to disclose their private financial holdings.



## D. Securities Supervision

### General

59. The assessment was prepared based on self-assessments by the authorities, open and informative interviews with the National Securities Commission (CNVM), the Bucharest Stock Exchange (BSE) and the RASDAQ Stock Exchange, and market participants, as well as study of the rules and regulations. The assessment was performed during the May 2003 Romania FSAP.

### Main findings

60. The CNVM practices a very high level of observance of the applicable good practices with regard to the **clarity of roles, responsibilities and objectives** on securities supervision. The institutional framework and the objectives of the Romanian National Securities Commission (CNVM) are publicly disclosed in the Law Regarding the Structure of the CNVM, through the Official Gazette and the CNVM website. The website also contains all other relevant legislation and regulations of the CNVM, also published in the Official Gazette. A Weekly Bulletin, also on the website, contains all administrative actions taken during the relevant period. The CNVM sets forth its objectives in its Annual Reports, submitted to parliament. The Law also sets forth the procedures for the appointment, terms of office, and removal of members of the CNVM. The Law also sets out the incompatibilities which would require the resignation or revocation of appointment of a CNVM member. The Protocol on the sharing of information between the CNVM, BNR, and the Insurance Supervisory Commission is a public document. MOUs concluded with Portugal, China, and Greece are also public documents. The regulations regarding the CNVMs oversight over the settlement and payment systems of the Bucharest Stock Exchange and the National Depository Settlement and Clearing Company (SNCDD) are public documents.

61. The CNVM practices a very high level of transparency with regard to **formulating and reporting of financial policies**. The conduct of the CNVM's policies is disclosed to the public through the Weekly Bulletin, its website, and Annual Report. CNVM regulations set forth the reporting requirements for Collective Investment Schemes (CIS) and Intermediaries on a weekly and monthly basis, respectively. These are public regulations published in the Official Gazette and on the CNVM's website.

62. The timely disclosure of general policy principles is achieved through a public approval process, covering any changes in the rules of the BSE and SNCDD. After adoption, the rules are disclosed in the Weekly Bulletin or Official Gazette. The division of rule making responsibilities of the CNVM and BSE is fully open and publicly disclosed.

63. CNVM rules are clarified through Instructions, announced for industry comment, and when adopted, published in the Official Monitor, the CNVM's Weekly Bulletin, and on the CNVM website. There is a presumption in favor of public consultations for proposed substantive changes to the structure of financial regulations. The fee structure for market

participants is set forth in the Law Regarding the Structure of the CNVM and CNVM regulations, disclosed in the Official Gazette and on the CNVM website.

64. The CNVM practices a very high level of transparency with regard to the **public availability of information on securities supervision**. The Annual Report contains a section on the development of the capital market sector during the previous year. It also includes information on enforcement actions taken and new issues that have come on the market. The CNVM has an active customer information department and the CNVM website contains comprehensive information, also on how to access capital markets information and request information from the CNVM. The CNVM obliged to publish a weekly Bulletin—also available on the website—on its activities, setting forth all CNVM actions during the relevant time period. Furthermore, senior officials explain the CNVM's objectives and performance to the public on a regular basis. The text of the public statements is released in the Bulletin and other publications, the media, the website, and through seminars, discussions, and conferences. Rules, instructions, forms and general guidelines are disclosed through the Weekly Bulletin, the Official Monitor, and the web site.

65. The CNVM practices a very high level of transparency with regard to the arrangements for **accountability and assurances of integrity**. The law sets out the accountability of the CNVM to parliament, which reviews the CNVM's Annual Report and approves the CNVM budget. Moreover, the law sets forth the right to appeal the decisions of the CNVM to the Supreme Court. Parliament can check on the CNVM's activity at any time in addition to reviewing the official reports. CNVM officials regularly go to parliament to report on CNVM activities, the effectiveness of its performance, and to give the CNVMs opinion and exchange views on the state of the Romanian capital market. In addition, the parliament debates the past and proposed budget in a joint session of the Chamber of Deputies and Senate. The CNVM discloses its audited annual financial statements, as well as the report of the State Audit Agency to parliament, along with its annual report. The audit is not performed by a commercial auditing firm. The CNVM has an internal control department. Its audit arrangements are not publicly disclosed as part of its regulations.

66. Staff and officials are subject to rules against conflicts of interest, as laid down in the Law Regarding the Structure of the CNVM. In addition, staff is subject to a Code of Ethics. The regulation establishing the Code is published on the Website. The Law Regarding the Structure of the CNVM sets forth the protection for CNVM members and staff for conduct in the lawful exercise of their duties. The law is publicly available on the CNVM website.

Table 5. Recommended Action Plan to Improve Observance of the IMF's MFP Transparency Code on Monetary and Financial Policies

Reference Practice	Recommended Action
<b>Monetary Policy</b>	
I. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	Increase the specificity of the ultimate objectives of monetary policy. Provide guidance on how to assess the extent to which objectives are met to enhance accountability. Ensure that the new central banking legislation addresses these issues.
II. Open Process for Formulating and Reporting Monetary Policy Decisions	Bring intermediate targets into line with current practices by clarifying the role of, or abandoning, the monetary aggregate target. Strengthen communication of internal decision-making processes and how they contribute to observed outcomes.
<b>Banking Supervision</b>	
V. Clarity of Roles, Responsibilities and Objectives	Publication of the Protocol between the Supervisory Agencies
VI. Open Process for Formulating and Reporting Monetary Policy Decisions	Publication of the signed Memoranda of Understanding with Foreign Supervisors
VIII. Accountability and Assurances of Integrity	Publication of the internal regulations of the Internal Audit and Control Department
	Establishment of standards for the conduct of personal financial affairs and behavior in relation to the supervised banks and their publication. Publication of the information that the employees of the NBR have to disclose their financial circumstances.
	Providing of funds for the cost of defending staff actions preformed in the discharge of their duties.
<b>Deposit Insurance</b>	
V. Clarity of Roles, Responsibilities and Objectives of Central Banks for Monetary Policy	Routinely also disclose technical rules and regulations. The necessary changes can be introduced with the adoption of the amended Government Ordinance
VI. Open Process for Formulating and Reporting Monetary Policy Decisions	Open own DGF website as soon as possible; place web address in a clearly visible place on all DGF publications. Implement end-2003 with issuance of new publications
VIII. Accountability and Assurances of Integrity by the Central Bank	Also disclose notes to the annual financial statements; implement with 2003 financial statements
<b>Securities Supervision</b>	
V. Availability of information on Financial Policies	The CNVM needs to finalize regulations under its new statutes in order to clarify legal obligations of entities acting under the new statutes.
VIII. Accountability and Assurances of Integrity by Financial Agencies	The CNVM should make its internal control procedures more public through published regulations.

### E. Authorities' Response

The authorities are broadly in agreement with the assessments.