BANCA NAȚIONALĂ A ROMÂNIEI

New Avenues for Financial Intermediation

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INTRO

Financial intermediation role in economic growth is well documented. However, competition brings in new actors of intermediation and they are no longer confined to banks.

In Romania, non-bank financial institutions, electronic money and payment institutions have generated at least one in every ten credit contracts at the end of last year.

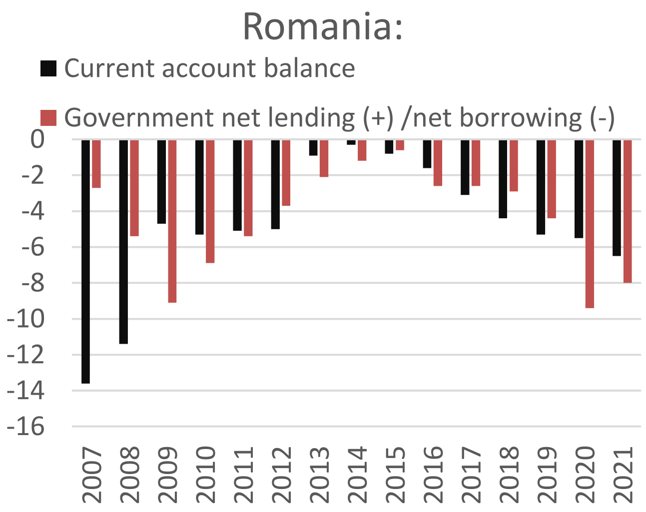
While the banking sector is the primary source for household credits (97 p.c.), one-third of the amount lent to the agriculture sector is supplied by the non-banking sector. Moreover, new lenders are setting their mark both in the services and construction sectors as they provided almost 20 percent of the total credits at the end of last year.

The actual landscape of financial intermediation in Romania may look even more different from what statistics show, since the central bank has no accurate statistics on crowdfunding and DeFi.

Central banks have a good grasp of the activity of the banking sector but are less equipped for dealing with other financial intermediaries, especially on cross-border activities: hence, the effectiveness of monetary policy transmission and financial stability is jeopardized.

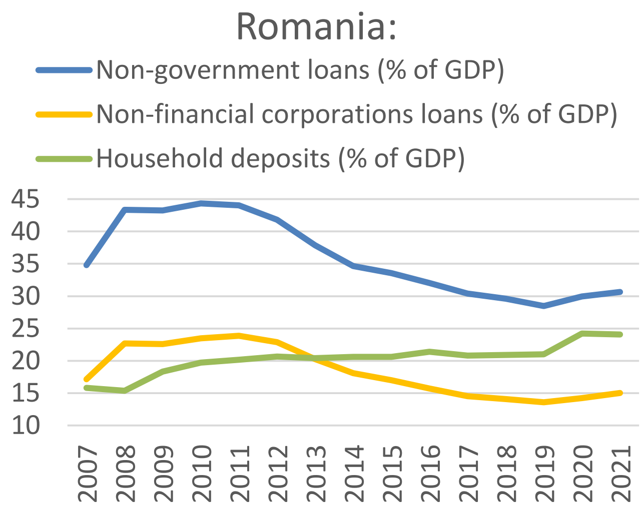
Should the central bank be concerned?

Macroeconomic



Source: Eurostat, European Economic Forecast, Autumn 2021

Financial sector



Source: own calculations based on BNR and Eurostat data

Should the central bank be concerned?

Macroeconomic

From the macroeconomic standpoint, Romania did not enter the pandemic with a balanced situation, and the war next to her borders added to pressure. Both current account and public budget are running in the red.

GDP dynamics in 2021 was high from a historical perspective, mainly due to private consumption, but also due to change in inventories. In contrast, gross fixed capital formation posted a slight drop for the first time in the past 11 quarters. Net exports made a further negative contribution to annual GDP and the current account deficit for 2021 stood 54 p.c. wider than a year ago.

Uncertainties and risks are associated with the fiscal policy, yet challenged by an unsettled economic and social environment, both domestically and globally.

Financial sector

Monetary financial institutions in Romania seem to be more prepared to respond to households and government needs than addressing the needs of non-financial corporations under changing market conditions.

Financial intermediation (total non-government loans to GDP) represented at the end of 2021 just two-thirds of its volume ten years ago. Since 2013 household deposits have been higher than total loans to non-financial corporations. The government credit expanded from 2.2 p.c. of GDP in 2007 to 12.6 in 2013 and rose to 14.6 p.c. of GDP at the end of last year.

Increased uncertainties under Covid-19 and the ongoing war in Ukraine appear increase the risk associated with the business environment, as well as the costs of provisioning for the banks, despite the offered state guarantees (for several programmes as SME Invest Romania).

Monetary financial institutions shall no longer ignore the impact on the financial intermediation arisen from the digital economy. Moreover, under competitiveness strain, non-financial companies' expectations are completely different from financial institution partners.

While commercial banks are called to abide more regulations relatively to risk-taking, non-financial companies are looking for creditors who:

- (i) understand the specific risks to the activity of the potential borrower.
- (ii) are interested in taking risk alongside them, which is a proof to the market that there is value in the activity that is credited.
- and (iii) are flexible enough to understand that financial intermediation is changing.

What can be done?

- Competition brings new business models
- European funds
- Education

What can be done?

Competition generates new business models and banks should keep with the trend

The traditional business model in banking is linear and vertically integrated. A bank typically owns each layer of the value chain and creates, packages, and distributes its products, no matter the age of such an institution.

This model is under pressure since new players (especially from the digital realm) do not abide by this vertical integration and select the layer they want to play in, as well as unbundle traditional products into micro-products or services and re-bundle them together with components from other providers to offer better customer propositions.

The European funds

The low absorption rate of EU funds (just 55 percent for the programs of the 2014-2020 Multiannual Financial Framework) speaks volumes about the structural issues in the economy, for all actors and across programmes and instruments.

In order to avoid further dismal performance with the funds made available through the National Recovery and Resilience Plan and other Operational Programs of the ongoing Financial Framework, it becomes necessary to make use of IFI's financial instruments compatible with significant risk transfer (for the intermediaries) targeted to facilitate the access to finance for non-financial companies in areas of green economy, digital transformation and R&D.

Education

Financial intermediaries and non-financial companies need more education on two matters:

i) cyber threats and cybersecurity incidents;

ii) entrepreneurship attitude, tailored to each business (be it start-up and/or scale-up).

Who must be involved?

Legacy system actors

- Regulators
- Financial sector
- Non-financial corporations

Digital economy actors

- Regulators
- Fintech
- Entrepreneurs, Innovators

Who must be involved?

At least three issues must be considered when discussing about who should be involved in reconsidering the financial intermediation process.

First, regulators from the legacy system and the digital economy must find common ground in understanding:

i) the issues the others confront (a balanced and stable macroeconomic environment might not seem the main problem for regulators in the digital world as opposed to central banks);

ii) what types of actors are involved (the digital economy is much more fragmented and new players must be added all the time, something that did not often occur in the legacy system);

iii) when is the best time to regulate (while regulators are usually behind the curve, some innovations do not require any regulation, as it is the case with blockchain).

Second, the borderline between the financial sector actors of legacy system and the fintech players is blurred. Hence, regulators from the legacy system must adapt to the environment created by the new players and learn new processes, technologies and vocabulary.

Third, non-financial corporations, entrepreneurs and developpers must understand the benefits and risks associated with financial intermediation initiated by the legacy system and the fintech sector.

What can a central bank do?

- Play its role in maintaining the macroeconomic stability
- Update its systems and regulations to the digital economy

What can a central bank do?

Central banks are well experienced in managing macroeconomic stability. However, the current environment opens at least three challenges for these institutions in their endeavour.

First, **the level of uncertainty is heightened**. Also, this uncertainty is created by factors outside the market or daily activities of central banks – the aftermath of the pandemic, which triggered several structural changes in economies, and the war in Ukraine.

Second, **the financial sector landscape became populated with actors and processes new to central banks** (fintech, digital identity, regtech, etc.). Hence, they face a steep learning curve and need for a different regulatory work.

Third, **there are new developments in society calling the central banks to update the role of monetary policy**. This is the case of the climate change issues that made necessary to consider how it affects price stability and include climate change considerations in the areas of disclosure, risk assessment, collateral framework and corporate sector asset purchases.

The NBR is learning to work in the new digital economy. A ***Fintech Innovation Hub*** was launched in 2019 to encourage and support innovation in payments and financial services for the benefit of consumers while seeking to identify the potential risks involved and propose measures to manage them.

Last year a ***Crypto and Digital Currency Office*** was, also, set It's role is to study and educate the public about cryptocurrencies and analyse and test the feasibility of a CBDC.

What the future has in store?

- From Bank de-risking
- To Embedded finance and BaaS
- And Open finance

What the future has in store?

From Bank de-risking

Bank de-risking is not a new phenomenon. It is a trend that affected smaller banks and Non-Bank Financial Institutions (NBFIs) before the pandemic but has exacerbated in its aftermath.

In many instances SME's poor capital and disclosure became subject of bank de-risking practice, which led to financial inclusion lessening. The emerged difficulties to secure an alternative provider led to increase of commercial credit and borrowing from shareholders. A survey done by *the Ec fin-ec real Office* found that 16 p.c of local SMEs have turned to NBFIs over the last two years.

To Embedded finance and BaaS

Embedded finance *(banking-like services offered by non-banks)* and BaaS *(Banking as a Service - bundled offerings, cobranded services used by non-banks to serve customers)* have attracted billions in funding and grew three times in 2021 compared to the previous year.

The current environment is suitable for embedded finance because the pandemic accelerated the online transition of many services and embedding online has become much easier. Moreover, embedded finance is a vehicle to bring finance when and where the customer needs it.

And Open finance

In order to regulate and mitigate risks to payment systems and ensure financial stability, central banks are already working to understand how technological innovations, changes in demand, and the arrival of new players impact the financial sector. The lesson to draw is that first and foremost, central banks should not ignore or reject such changes.