NATIONAL BANK OF ROMANIA

FINANCIAL STABILITY REPORT

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The Report was examined and approved by the National Bank of Romania Board in its meeting of 28 May 2007.

Analyses are based on information available until 15 April 2007.

C O N T E N T S

Abbreviations

ASLR	Association of the Leasing Companies of Romania
ALB	Leasing and Non-banking Financial Services Association
AUCI	Association of Undertakings for Collective Investments
CEECs	Central and Eastern European countries
EBIT	Earnings before interest and taxes
EC	European Commission
ECB	European Central Bank
EM	Emerging markets
EPS	Electronic Payment System in Romania
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
GVA	Gross value added
HH	Herfindahl Hirschmann index
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISC	Insurance Supervisory Commission
MCIT	Ministry of Communications and Information Technology
MoPF	Ministry of Public Finance
NBR	National Bank of Romania
NBFI	Non-bank financial institutions
NIS	National Institute of Statistics
NSC	National Securities Commission
NUUCITS	National Union of Undertakings for the Collective Investment of Transferable Securities
PIB	Payment Incident Bureau
PPSSC	Private Pension Scheme Supervisory Commission
ReGIS	Romanian electronic Gross Interbank Settlement
ROA	Return on assets
ROE	Return on equity
SaFIR	Settlement and Financial Instrument Registration
SENT	System for Electronic Net Settlement run by TransFonD
SEPA	Single Euro Payments Area
SMEs	Small- and medium-sized enterprises
STFD	Short-term foreign debt
WEO	World Economic Outlook

CHAPTER 1. OVERVIEW

The financial system remained stable in the reviewed period, but some risks are on an uptrend, yet without short-term disruptive outcome. The most important challenges are: (i) Romania's external disequilibrium, (ii) significant households' indebtedness, and (iii) non-financial companies' exposure to a possible exchange risk.

Domestic and international **macroeconomic framework** has remained favourable to Romania's financial stability since the previous *Report*. The main foreign trade partners resumed economic growth, and the ready access to finance for East and Central European countries was maintained. The market sentiment for emerging markets to cope with tighter financial conditions has not deteriorated, except some corrections in May-June.

2006 was the seventh consecutive year of economic growth for Romania, amid the persistence of a downward inflation rate. Romania's main economic and financial indicators registered positive dynamics, evidence of the catching-up process with other new EU Member States. The widening of the gap between nominal and real convergence, and the uncertainties on economic growth patterns were the main risks to financial stability arising from the **real sector**.

The financial system experienced sound development in 2006 until today, entailing financial deepening and narrowing of the gap between Romania and the other EU Member States. The banking sector consolidated its leading position. Non-bank financial institutions that provide loans entered under the supervision scope of the central bank. The measure is aimed at containing the risks arising from this sector, and at improving the efficiency of monitoring credit developments, through a more unitary regulatory framework.

The main characteristics of **the banking sector** in the reviewed period were the same as in 2005: the credit pace to the private sector stood high, and the financial stability indicators remained at comfortable levels, ensuring resilience to strong exogenous shocks. The additional prudential and administrative measures aimed at containing credit expansion were maintained in 2006, but were abolished in the first part of 2007. Increasing the rigorousness of the prudential supervision is a must in these conditions.

Romania's EU accession on January 1, 2007 will stiffen domestic competition on the bank markets, taking into account the higher profitability of the banking sector, the still low level of financial deepening, and the regulatory and supervisory framework in line with EU standards. Rising exposure to households and longer loans maturities are trends that call for closer monitoring.

The risks posed by **the non-bank financial institutions** are low and prone to overlap those faced by the banking sector. The concentration level and currency risk are higher, but might decrease due to the bringing of non-bank financial institutions under the central bank supervision umbrella.

The Romanian **capital market** continued the convergence towards the European markets, from the perspective of both market dynamics and infrastructure. Nevertheless, the same process amplified some vulnerabilities that materialized in increased sensitivity to shocks on the international markets and a relative slowdown of market growth. The correction of the uptrend in the BSE trading during April-June 2006 coincided with similar moves on international stock exchanges. They seem to have the same explanation as all the other emerging markets, being associated mainly with profits marking and portfolio re-adjustments of foreign investors towards safer markets. The capital outflows from emerging markets did not seem to be discriminating, as they were not necessarily triggered or influenced by economic fundamentals in these economies.

We anticipate a strengthening of the primary market for the period ahead. The relatively small size of the local capital market, as well as the very limited dependence on bank financing, suggest that potential shocks to this market, possibly caused by contagion, would not seriously affect the stability of the financial system as a whole.

FX market developed considerably from the previous *Report*, but still lags behind those in the region in terms of depth and structure. The spreads were comparable to those seen in other countries in the region during the first part of the year, but higher in the second, mirroring the international financial markets turbulence. The domestic currency appreciated significantly, and the volatility was comparable with that in the region. Nonresidents were the main contributors to the development of the market. The volume of their daily average transactions rose almost four times in 2006 compared with 2005, exceeding the volume of operations conducted by residents and local banks. Spot transactions prevailed, the poor development of the FX market instruments acting as a shield against ample exchange rate fluctuations.

External balance deteriorated, but there are some prospects that the situation may improve in the medium and long run. Current account deficit increased by around 45 percent in 2006, but, positively, the highest import dynamics was registered by capital goods. Foreign direct investments (even net of privatization receipts) continued to finance the current account deficit substantially.

The twofold increase in short-term foreign debt (STFD) in 2006 requires close monitoring. Firstly, the rate of increase of indebtedness of the non-bank sector equalled that for the banking sector. Secondly, the concentration of STFD is rising. Thirdly, the real estate sector and manufacturing hold approximately 50 percent of STFD, but companies with such debt have a liquidity ratio below par.

The monetary policy decision implementation was bolstered by a stable financial system. Turbulent episodes experienced by international markets did not trigger a significant impact on domestic money market liquidity. The inter-bank rate volatility did not transmit to the real sector.

Companies maintained their moderate risk profile mentioned in the previous *Report*. The profitability and liquidity improved, but operating activity efficiency posted mixed developments. The positive performance of companies without bank loans makes them eligible for bank resources allocation, without inducing adverse effects on financial stability.

Credit risk induced in the banking sector remained at a moderate level. On one hand, debt servicing capacity diminished, and bank loans are more concentrated. On the other hand, probability of default is decreasing and creditors' perception on credit risk induced by companies is positive.

An interest rate shock (domestic or external) would moderately impact companies. A foreign exchange rate shock may have a higher negative impact, as the companies' FX exposures are only to a small extent naturally hedged (22 percent). On the costs side, potential hikes in wages or utilities costs may be critical only to some economic sectors, but they will not usually induce systemic risks.

The financial deepening process improved, while the payment discipline showed a mixed picture: arrears hit a historical low and the number of payment incidents rose slightly.

The risks to financial stability stemming from **the household sector** have increased both on the asset and liabilities side. Amid upbeat expectations, household money incomes stayed on an upward trend, representing the key element that prompted households to take higher risks.

In the household balance sheet, the value of real estate assets rose almost exclusively due to the price effect not to quantity, the liquidity of financial assets improved, but the risk profile of financial liabilities was superior. The household foreign currency position deteriorated, fostering the negative impact of a potential FX shock.

Household indebtedness dynamics generated two main risks: the debt service burden grew at a brisk pace and the household net creditor position declined significantly. However, the concentration of loans and the overdue payment ratio diminished.

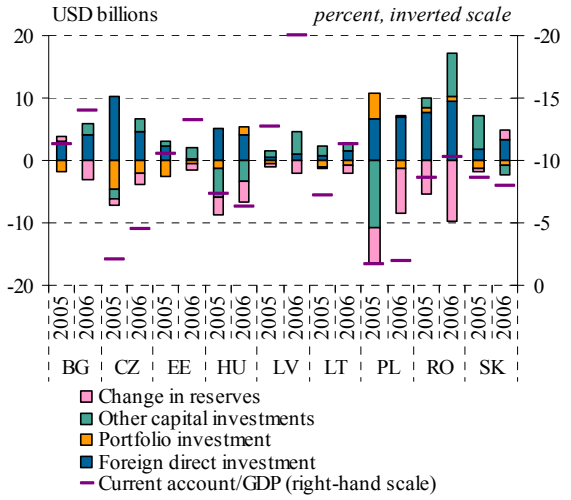
The financial infrastructure improved in 2006, especially the regulatory framework of the financial system. The primary legislation and most of the secondary legislation are in line with the European standards. The main event was the transposition of the Basel II regulatory framework. Credit institutions chose to implement the new regulation starting 2008, because the banking sector has a high liquidity and the implementation costs would be considerable.

CHAPTER 2. INTERNATIONAL ECONOMIC AND FINANCIAL ENVIRONMENT

The international macroeconomic environment remained favourable to financial stability in Romania. In 2007, Romania faces the same risks as in 2006, namely: (A) slower economic growth in some trade partners, (B) less favourable perception of international markets with regard to emerging countries' ability to deal with more restrictive financial conditions, and (C) higher interest rates or the correction of asset prices, which would entail the redirection of capital flows towards less risky placements than those in emerging countries.

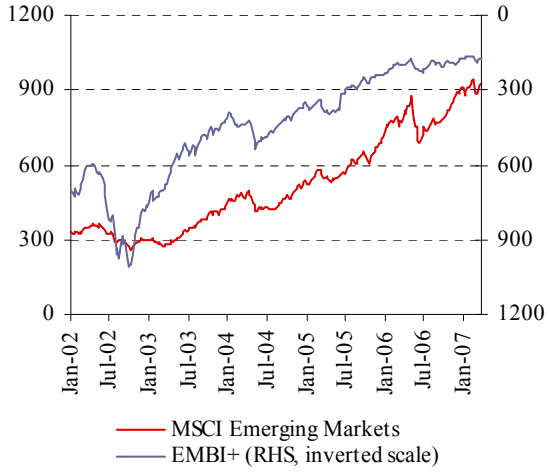
(A) The **international macroeconomic climate** was favourable in 2006. World economic growth is estimated at 5.4 percent, while the outlook for 2007 points to a slight deceleration to 4.9 percent (IMF, WEO, April 2007). The economic growth of Romania's main trade partners regained momentum in 2006, yet the projections for 2007 hint at mixed developments. France and the Netherlands are expected to continue recording a favourable performance, whereas a slowdown in the pace of increase is anticipated for Italy, Germany and Austria (EC forecasts).

Chart 2.1 – Current account deficit and the financing sources in some CEECs



Source: Bloomberg

Chart 2.2 – MSCI Emerging Countries and EMBI+ indexes



Sources: Bloomberg, WEO April 2007

(B) Risks in CEECs will further be: (i) overheating of economies, also on the back of faster credit growth rate and (ii) widening of current account deficit (Chart 2.1) and fiscal deficit, amid higher private external financing. Corrections in May-June 2006 (mostly determined by portfolio investment outflows) occurred against the backdrop of mounting uncertainties surrounding developments on the oil and metals market and scarcer liquidity, with investors becoming increasingly concerned with raising the emerging countries' degree of indebtedness.

(C) Financing conditions for emerging countries remain favourable. Excess liquidity on international markets and the still low interest rates on the major markets safeguarded a high tolerance towards the risk of financing these countries. The MSCI index for emerging countries (which captures portfolio investment inflows) follows an upward path, while the spread related to

bonds issued by emerging countries (reflected by the EMBI+ index) dropped again below 200 basis points, following the rise in May-June 2006 (Chart 2.2).

The rise in financing costs in foreign currency will have an increasingly stronger impact on debtors in Romania. The share of forex loans (both domestic and external) taken by such debtors remained high, i.e. 64 percent in December 2006. The share of Euribor-based medium- and long-term external debt in total debt widened from 21 percent to 38.6 percent during 2004-2006.

Although these risks could have an impact on financial development and growth in Romania, the key economic and financial indicators show that the country is currently heavily engaged in catching-up with the other countries in the region, despite some major delays being still manifest (Box 1).

Box 1: Romania's economic and financial position within CEECs, 2006

Romania lags behind the other EU-8* countries in terms of economic growth (Chart 1), although the investment rate (as a share of GDP) is among the highest in the region (Chart 2). Domestic private saving posts one of the lowest rates, but the public sector's borrowing requirements rank far below those of the other EU-8 countries, while the share of total public debt is among the lowest in Europe (Chart 3).

Chart 1 – GDP per capita

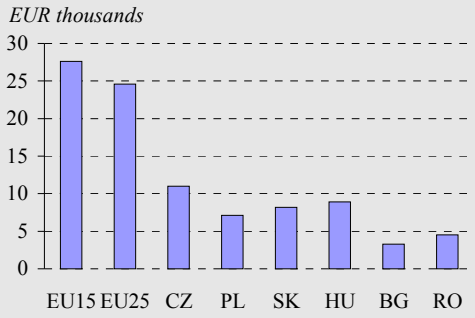


Chart 2 – Savings and investment rate

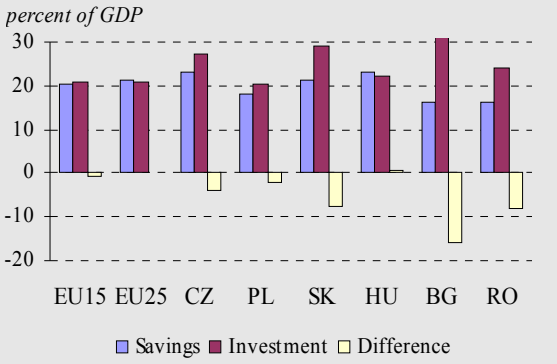


Chart 3 – Public debt and fiscal deficit

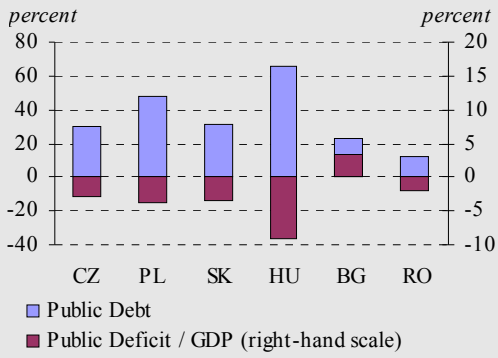
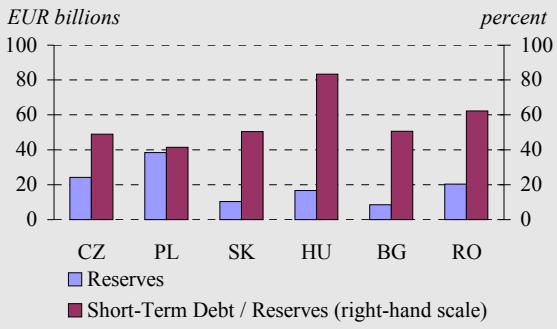


Chart 4 – International reserves and short term debt



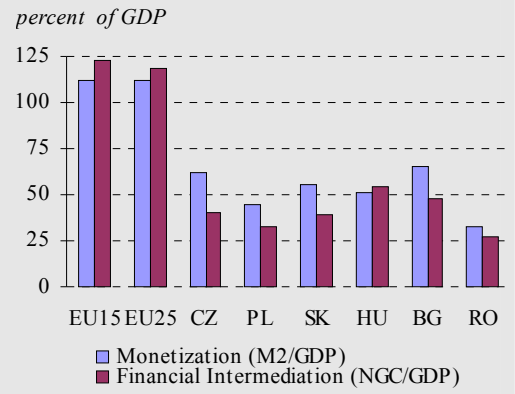
Source: Eurostat

*Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Slovenia, Slovakia

Romania's short-term external debt records similar levels to those of most CEECs countries, although debt coverage through official reserves is below average (Chart 4). In 2006, Romania witnessed the fastest pace of increase of short-term debt.

In terms of financial development, Romania trails behind other EU Member States in the region (Chart 5), despite posting one of the highest growth rates of non-government credit (along with the Baltic States). Foreign currency-denominated loans hold a major share in total credit, with Romania being outdone by Hungary and the Baltic States.

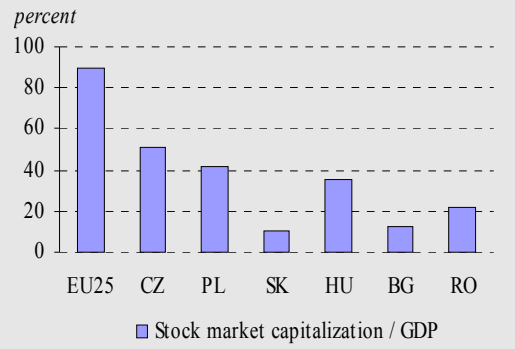
Chart 5 – Financial intermediation and monetization indexes



Source: Eurostat

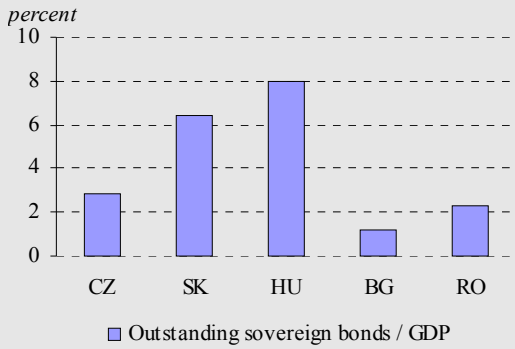
The performance of the Romanian capital market hovers around the CEECs average (Chart 6) in terms of capitalisation and pace of expansion (with capitalisation advancing to 22.5 percent of GDP in 2006 from 6.2 percent of GDP in 2003). The still high growth rate calls for the horizontal expansion of the Romanian market through (i) admission to trading of companies operating in key sectors of the economy, which however are not heavily traded on the stock exchange and (ii) listed foreign companies entering the local market and domestic issuers entering European markets. The activity on the government securities market (through its government bonds component) is inextricably linked to the fiscal policy background and not so much to participants' appetite for this type of instruments. The balanced fiscal policy has also left its imprint on the development of the secondary market for government securities, which has yet to succeed in providing a benchmark to the local market for fixed-income financial instruments. The government securities market is much more active in countries with a higher public debt, such as Hungary, Poland or Slovakia (Chart 7).

Chart 6 – Stock exchange capitalization



Source: Eurostat

Chart 7 – Outstanding sovereign bonds (2005)



Source: IMF

CHAPTER 3. FINANCIAL SYSTEM AND ITS RELATED RISKS

3.1. Structure of the financial system

In 2006, the banking sector, which accounted for 83.8 percent of total financial assets, remained the most significant component of the Romanian financial market. Non-bank financial institutions engaged in lending are undergoing the process of notification and registration with the NBR registers set in accordance with the legislation in force. Even though funds are raised mostly from banks, the activity of such institutions is less likely to generate systemic shocks, owing to their small share in the financial system.

Financial depth of capital and insurance markets is still shallow, yet integration with international markets has been rising. In terms of financial stability, the likelihood of a systemic shock generated by these markets is low, since they still play a small part in real sector financing.

The upward trend in non-government loans, upheld by favourable expectations of households concerning their incomes, remained, in 2006 too, the main driver of the increase in bank assets (Table 3.1.1). Nevertheless, financial intermediation in Romania is still low by EU standards.

Table 3.1.1 – Financial system structure

share in GDP (%)

Financial intermediation institutions	2002	2003	2004	2005	2006
Credit institutions (1)	31.0	30.8	36.6	44.6	50.6
Insurance companies (2)	1.5	1.8	1.9	2.2	2.5
Investment funds (3)	0.1	0.1	0.2	0.2	0.3
Financial investment companies (4)	1.4	1.4	1.3	1.8	2.3
Leasing companies (5)	1.5	1.8	3.0	3.6	3.4
Other institutions engaged in financing (lending activities) (6)	0.4	0.4	0.6	0.9	1.3
Total	**35.9**	**36.3**	**43.6**	**53.3**	**60.4**
Other financial companies					
BSE (7)	6.1	6.2	13.9	19.5	21.5
RASDAQ (7)	4.0	4.0	3.2	2.9	3.1

Source: NBR, NSC, ISC, BLS, NIS (for 2006, provisional data)

1) Net assets of credit institutions, including CREDITCOOP;
2) Total assets;
3) Assets of investment funds;
4) Net assets of financial investment companies (FICs);
5) Financed net assets;
6) Total assets related to consumer credit companies, to entities engaged in issuing guaranties and assuming commitments, to microfinance companies, and to companies engaged in multi-credit activities;
7) Stock market capitalisation.

The favourable effects of financial development are, however, accompanied by risks arising from the wider trade deficit against the background of financing demand for imported durables by also resorting to bank loans or the heightening demand-pull inflationary pressure.

At present, under the new regulatory framework, **non-bank financial institutions** engaged in lending are undergoing the process of registration with the National Bank of Romania. The restrictions imposed on the authorisation of such entities, as well as other factors, affected their market share (Table 3.1.2).

In 2006, financial leasing[1] continued to take the largest share in total leasing contracts, i.e. 98 percent. The external leasing market stayed on a downward drift, accounting for less than 1 percent of total contracts. As at 31 December 2006, the sector including companies affiliated to banks came in first in terms of market structure, accounting for 75 percent of total capital, ahead of independent companies and captive companies, on 17.5 percent and 7.5 percent respectively.

Table 3.1.2 – Market share of financial institutions in 2002-2006

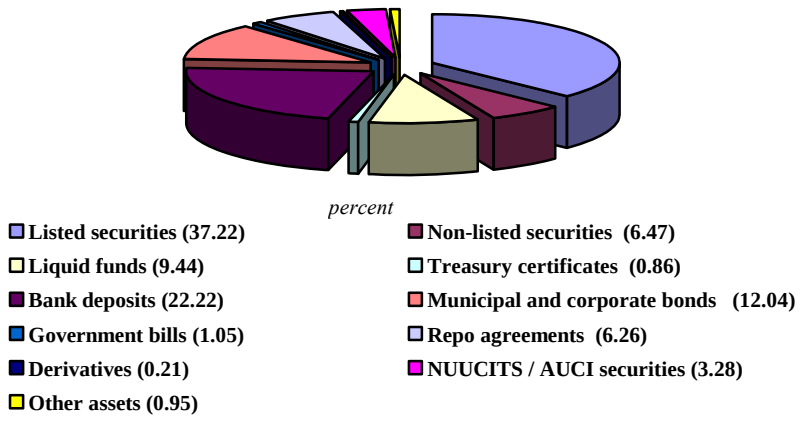
% in total assets

	2002	2003	2004	2005	2006
Credit institutions	86.3	84.8	83.9	83.7	83.8
Insurance companies	4.2	4.9	4.4	4.1	4.1
Investment funds, of which:	0.2	0.2	0.5	0.3	0.5
Open-end investment funds	0.2	0.1	0.2	0.2	0.3
Financial investment companies	4.0	4.0	3.0	3.3	3.8
Leasing companies	4.1	5.0	6.8	6.8	5.6
Other institutions engaged in financing (lending activities)	1.2	1.1	1.4	1.8	2.2

Source: NBR, NSC, ISC, BLS, NIS (for 2006, provisional data)

The development of the **insurance sector** and its closer ties with the banking sector caused the former to play a greater part in maintaining financial stability. Capital increases performed in order to comply with the norms on insurers' solvency, reassessment of tangible corporate assets, authorisation of new insurance companies and, last but not least, the rise in the volume of subscribed insurance premiums[2] led to the expansion of total assets of insurance companies at a rate of more than 34 percent year on year. In 2006, the harmonisation of technical requirements in the field of insurance with the provisions of the Community law was also completed.

Chart 3.1.1 – Structure of assets in open-end investment fund portfolios as of end-2006



Source: NSC

Net assets of **open-end investment funds** (Chart 3.1.1) rose by about 86 percent year on year. The upward trend was attributed to both the launch of new funds, which came to a total of 34, i.e. the rise in the number of shares in circulation, and to the improvement in the value of financial

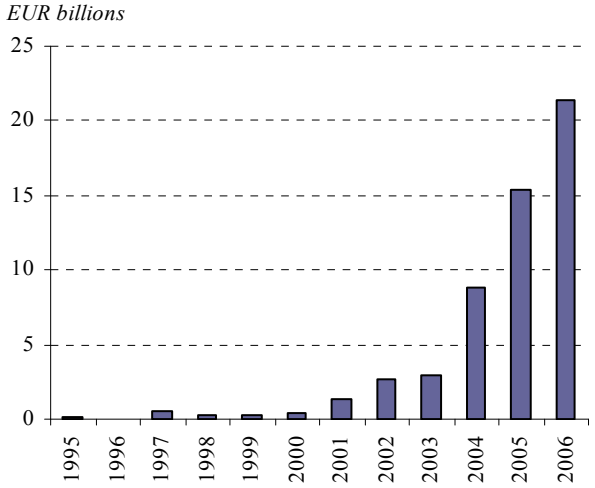
[1] Figures taken from the Press Release of BLA and LCAR dated April 12, 2007.

[2] To about EUR 1.6 billion against EUR 1.2 billion in the previous year.

instruments held in their portfolios. The decisions to invest in high-yield financial instruments (largely shares traded on regulated markets) helped boost the standings of such entities.

Against the backdrop of high volatility, **stock market indices** remained in 2006 on an upward course. In fact, most equity markets in the region were plagued by increased volatility. The high yields on the Romanian stock market were also underpinned by the steady appreciation of the *leu* against the euro, a feature similar to the Polish *złoty*, the Czech *koruna* and the Hungarian *forint*. It may be asserted that the developments seen on financial markets in the region tend to be increasingly interlinked, as reflected by the developments on equity markets.

Chart 3.1.2 – BSE capitalisation



Source: BSE

At end-2006, **regulated market capitalisation** in Romania denominated in euros posted an upturn (Chart 3.1.2) of almost 40 percent year on year, although the number of listed companies on this market dropped to 58, from 64 at end-2005. The eight withdrawals from the regulated market quotation were mostly the result of implementation of the provisions of the new "**Stock Market Code of Ethics**"[3], setting forth a higher degree of rigorousness in complying with liquidity and transparency requirements. Nevertheless, the fact of delisting the eight stocks had a marginal detrimental impact on market capitalisation in 2006, which was offset by the increase in capitalisation following the admission of two new companies[4] to quotation on the regulated market.

Behind the growth of total regulated market capitalisation stood the upturn in prices of most shares traded, along with capital increases performed by some companies via reserve capitalisation or issues of shares offered for subscription to their shareholders.

The most actively traded shares on the Bucharest Stock Exchange (BSE) were those issued by **Financial Investment Companies** (FICs), accounting for more than 50 percent of market turnover in 2006. Higher prices of these shares were chiefly driven by the completion of legislation providing for raising the holding threshold (to 1 percent from 0.1 percent). In fact, the developments in FIC shares prompted the market trend during 2006, with the trades involving such stocks making up 84.82 percent of total trades on the BSE.

Romania's new status of EU Member State could bring in new investors eyeing the country's equity market and even remote members. This could exert further pressure to increase financial market diversification.

[3] The "Stock Market Code of Ethics" provides for a new structure for the regulated market managed by the Bucharest Stock Exchange and introduces stricter criteria for assessing liquidity conditions that must be fulfilled by the shares admitted to quotation. Moreover, a breakthrough for the Romanian capital market was the regulation of more sophisticated techniques such as margin buying and short selling.

[4] Transelectrica and Mecanica Ceahlău, whose cumulated market value at end-2006 accounted for more than 11 percent of the increase in capitalisation recorded in the reported year.

For **2007**, expectations point to a momentous diversification of the range of financial products dealt in on the regulated market under the BSE management. Firstly, government securities are anticipated to be admitted to trading and conditions are in place for commencing transactions in mortgage bonds, as well as for the admission to quotation of the first warrants. Furthermore, some foreign companies' keen interest in the Romanian market could cause the first shares issued by non-resident legal persons to be listed on the BSE. Nevertheless, the launch of trades in financial derivatives is foreseen to have the strongest impact on the functioning of the regulated market under the BSE management.

The newly-established Central Depository, the future clearing house for trades in financial instruments performed on the BSE, will be able to share with the latter institution a common vision on the development of the equity market in Romania. Thus, the development projects of each of the two institutions will enjoy a greater degree of consistency and complementarity benefiting the major market participants, i.e. issuers, investors and stockbrokers.

In the medium- and long-term, **pension funds**[5]**,** a cheap financing source, are expected to help increase liquidity and dynamics of the stock exchange, as well as to boost the volume of bank investments.

3.2. Banking sector

3.2.1. Structural developments

In 2006, the shifts in shareholding[6] resulted in major changes in the Romanian banking sector. A major event in the reported year was the unprecedented amount of foreign capital inflows to the domestic bank market, coming mostly from reputed banks. Domestic banks' market share dwindled considerably in favour of foreign investors. Against the background of Romania's accession to the European Union, heightened competition will require small- and medium-sized banks to subject their strategies to in-depth changes in order to enhance their financing capability. The first sign in this respect could be the fact that 39 world-famous credit institutions asked the National Bank of Romania to be authorised for providing services directly on the territory of Romania.

The equity structure of the Romanian banking system witnessed substantial changes as well. The rise in capitalisation, by a real 21.8 percent year on year, is reflected in the 10 percentage point increase in the share of foreign-owned credit institutions in total bank assets to as much as 78.8 percent. The share of state-owned credit institutions in total bank assets rose 2.9 percentage points up to 14.9 percent, largely as a result of state intervention in the capitalisation of the Savings Bank (CEC) in December 2006. The developments in structural indicators of the Romanian banking sector are shown in Table 3.2.1.

[5] During 2006, the **Private Pension Scheme Supervisory Commission** (PPSSC) completed the process of drafting secondary legislation, thus allowing the start of authorization of entities on the optional pension funds market starting with October 30, 2006, with the collection of contributions being scheduled to begin in early 2007. In light of the PPSSC strategy, the process of authorization of entities on the privately-managed pensions market will commence in 2007 Q2; moreover, starting with August 2007, participants may choose the pension fund they are willing to join and the collection of contributions to privately-managed pension funds will start as from January 2008.

[6] During 2006, the changes in the Romanian banking system were as follows: (i) acquisition of a 56.2 percent stake in the capital of Daewoo Bank by C.R. Firenze Romania Bank, part of the Italy-based C.R. Firenze Group; (ii) acquisition of a 96.8 percent stake in the capital of MISR Bank Bucharest by the Egyptian branch of the biggest bank in Lebanon, i.e. Blom Bank; (iii) completion of the takeover of Eurom Bank by Bank Leumi Romania; (iv) acquisition of a 56.96 percent stake in Mindbank by the Agricultural Bank of Greece; (v) acquisition of a 55.4 percent stake in Romexterra Bank by MKB Bank, a member of the German financial group Bayerische Landesbank; (vi) authorisation of Bank of Cyprus to open a branch in Romania; (vii) cessation of activity of Nova Bank, holding an insignificant market share; and (viii) the merger between HVB Bank Romania and Banca Comercială Ion Țiriac.

Table 3.2.1 – Structural indicators of the Romanian banking system

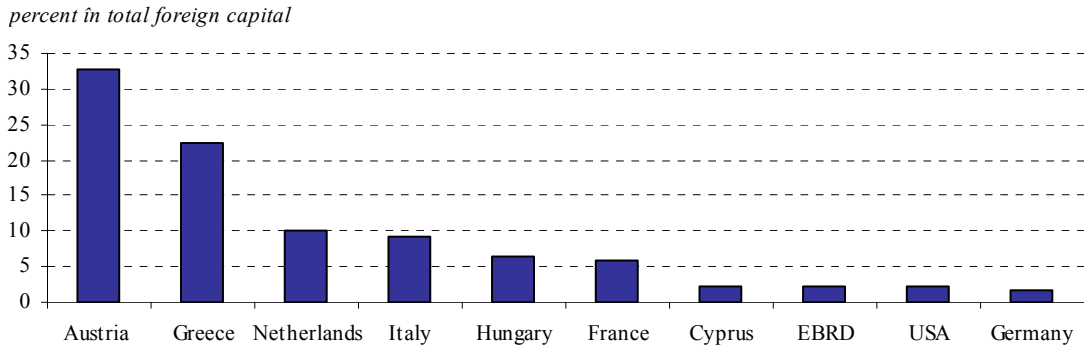
	1999	2000	2001	2002	2003	2004	2005	2006
Number of credit institutions*	41	41	41	39	39	40	40	39
Number of banks with majority private capital	37	37	38	36	36	38	38	37
Number of banks with majority foreign capital, of which:	26	29	32	32	29	30	30	33
– Foreign bank branches	7	8	8	8	8	7	6	7
Number of banks per 100,000 inhabitants	0.18	0.18	0.18	0.18	0.18	0.18	0.19	0.18
Assets of banks with majority private capital/ Total assets (%)	53.2	53.9	58.2	59.6	62.5	93.1	94.0	94.5
Assets of banks with majority foreign capital/Total assets (%)	47.5	50.9	55.2	56.4	58.2	62.1	62.2	88.6
Assets of top five banks / Total assets (%)	66.7	65.5	66.1	62.8	63.9	59.2	58.8	60.3
Herfindahl-Hirschmann index	1,296	1,375	1,427	1,381	1,264	1,120	1,124	1,171

* Including CREDITCOOP

Source: NBR

By country of origin, Greece and Hungary saw the key changes to the capital of credit institutions operating in Romania at end-2006 (Chart 3.2.1). The shares of the two countries in aggregate foreign capital widened by 4.5 percentage points and 2.6 percentage points respectively on the year, with investors representing these Member States further ranking high among foreign investors.

Chart 3.2.1 – Structure of foreign shareholding in the Romanian banking sector



Source: NBR

Special mention deserves the fact that the three banks listed on the BSE accounted for 23.9 percent of total market capitalisation. At end-2006, two of them ranked second and third in top-15 listed companies in terms of market capitalisation and traded volume.

Bank concentration (Table 3.2.2) edged up, whereas the share of banks with majority foreign capital in total bank assets and the Herfindahl-Hirschmann index both posted increases. These developments could be viewed as signs of a consolidating banking system.

Table 3.2.2 – Bank concentration
(top five banks)

percent

	2002	2003	2004	2005	2006
Assets	62.8	63.9	59.2	58.8	60.3
Loans	56.2	57.1	55.7	61.2	63.5
Deposits	63.0	64.9	59.5	57.0	58.3

Source: NBR

3.2.2. Structure of assets and liabilities

In Romania, banks continue to raise funds largely from the deposits taken from residents, both natural and legal persons. However, in 2006, the rising trend in the share of foreign liabilities in total bank liabilities, i.e. borrowings and deposits from non-resident banks and financial institutions, was still manifest. Romanian credit institutions invested widely in the domestic market, especially by granting loans to non-government sector. Specifically, household loans posted a marked increase in 2006.

At the same time, the net creditor position related to operations with non-bank clients, i.e. companies and households, contracted noticeably. Moreover, it should be pointed out that liquidity was running high, as illustrated mainly by the large volume of placements with the central bank. The fact that credit institutions with foreign capital enjoyed easy access to foreign borrowings with long maturities had a significant contribution to the matching of balance sheet items by maturity.

3.2.2.1. Dynamics of bank assets

The favourable economic landscape fostered the maintenance of a swift real annual growth rate of banking system assets, i.e. 28 percent in 2006. Nevertheless, this reading is below the levels seen in the past (35 percent and 31 percent in 2004 and 2005 respectively).

The large share of *domestic assets* in banks' balance sheets remains a feature typical of the Romanian banking system. By making use of the opportunities provided by the Romanian market, banks continued to dispose of part of their foreign assets in order to channel their liquid funds mainly towards granting loans to resident clients, i.e. companies and households.

Table 3.2.3 – Assets structure (% of total assets)

	2001	2002	2003	2004	2005	2006
Domestic assets, *of which:*	**85.5**	**91.7**	**94.3**	**94.3**	**96.5**	**97.4**
Claims on the NBR and credit institutions, *of which*:	27.2	32.0	29.3	36.5	40.0	34.9
– Claims on the NBR[7]	23.4	28.6	26.3	28.5	37.5	31.3
Claims on domestic non-bank sector, *of which*:	44.4	46.6	53.8	48.1	48.5	54.8
– Claims on government	10.8	9.2	4.8	2.4	1.9	1.6
– Claims on corporations	31.3	33.0	36.9	32.7	30.2	30.8
– Claims on households	2.3	4.4	12.2	13.0	16.4	22.4
Other assets	13.9	13.1	11.2	9.6	8.0	7.7
Foreign assets	**14.5**	**8.3**	**5.7**	**5.7**	**3.5**	**2.6**

Source: NBR

[7] The item "Claims on NBR" includes RON-denominated claims (holdings and deposits), foreign currency-denominated claims, certificates of deposit issued by the NBR.

Claims on domestic non-bank sector are still the most significant component of domestic assets, the increase in their share being entirely driven by the expansion of non-government loans (of household loans in particular).

In 2006, the share of *claims on government sector* in total assets kept shrinking, given that the Romanian government refrained from issuing Treasury certificates and the volume of foreign currency-denominated government bonds in the balance sheets of banks dropped from RON 429.1 million at end-2005 to barely RON 15.1 million at end-2006.

The volume of *interbank assets* continued to be high, as reflected by the 2006 balance sheet; the largest share of interbank assets is held by claims on the NBR in the form of minimum reserve requirements and standing facilities granted by the central bank (one-month deposits and certificates of deposit issued by the NBR) in order to sterilize the excess liquidity on the domestic market.

Despite the maintenance of prudential measures and the tightening of monetary policy measures, year 2006 saw the persistent rise in *non-government loans* (household loans in particular) to 53.2 percent of aggregate assets at end-December. Household loans grew at a pace faster than that recorded in December 2005 (175 percent in real terms) and consolidated their third position in bank assets, after claims on the NBR and corporate loans. Among the factors that accounted for this development were: (i) strong demand; (ii) increase in household income; (iii) favourable macroeconomic developments in recent years (economic growth, lower inflation, domestic currency appreciation); and (iv) stiffer competition in the banking sector, which affected the interest rates on foreign currency-denominated loans and on loans in domestic currency in particular. Non-bank financial institutions made a substantial contribution to the heightening of competition on the credit market.

3.2.2.2. Development of own, attracted and borrowed resources

The more favourable access conditions of credit institutions with foreign ownership to external financing sources paved the way for the maintenance of a relatively high growth rate of bank liabilities in 2006 as well, thus supporting the expansion of non-government loans. The structure of the aggregate balance-sheet liabilities of the Romanian banks in the period under review has the following main features:

(i) the prevalence of sources from resident non-bank customers;

(ii) the rapid growth of foreign liabilities, due to the ever increasing financing of banks' activity from loans extended by other banks and financial institutions abroad;

(iii) the narrowing of the net creditor position of banks as regards their operations with non-bank customers, against the background of a fast-paced increase in household loans; and

(iv) the resort to a narrow range of financing instruments as compared to banks in EU Member States.

Resident non-bank customers (companies and households) continue to provide the largest part of credit institutions' financing sources. However, it is worth mentioning the downtrend which began in 2003 by the holdings of non-bank customers. The determinants of this development were the following:

(i) the relative decline in household and corporate savings (particularly deposits), given the continuous increase in the indebtedness of the two sectors (for consumption and investment); and

(ii) the banks' need to provide medium- and long-term financing sources in order to preserve a matching of balance sheet items by maturity. Given that the holdings of non-bank customers consist mainly of one-month and three-month deposits, banks needed more stable financial sources in order to finance the real estate loans to households and investment loans to companies, which were in high demand. Parent undertakings and other financial institutions underpinned the demand for resources, broadly for long-term financing, as the profitability of those institutions remained high.

It is noteworthy that the contribution of non-bank financing sources to the balance sheets of the Romanian banks is still significant, as compared to the structure of such sources of the euro zone banks, whose liabilities are provided by non-bank customers in a proportion of nearly 30 percent.

Table 3.2.4 – Bank liabilities structure (% in total liabilities)

	2001	2002	2003	2004	2005	2006
Domestic liabilities, *of which*:	**94.1**	**93.0**	**88.3**	**84.1**	**79.1**	**77.5**
Inter-bank deposits	3.7	3.3	2.9	3.0	2.5	3.6
Non-bank sector deposits, *of which*:	70.4	71.7	68.3	64.9	61.0	58.1
– Government sector deposits	3.7	3.1	3.0	2.6	3.5	3.1
– Corporate and household deposits	66.7	68.6	65.3	62.3	57.5	55.0
Capital and reserves	14.4	13.5	13.1	11.7	12.2	11.8
Other liabilities	5.6	4.5	4.0	4.5	3.4	4.0
Foreign liabilities	**5.9**	**7.0**	**11.7**	**15.9**	**20.9**	**22.5**

Source: NBR

The ongoing expansion of non-government loans in 2006 led to changes in the structure of banks' aggregate balance sheets. In the past six years, the resident non-bank customers (companies and households) recorded a net creditor position for the Romanian banking system, which followed however a sharp downward trend. The decline was manifest in 2006 as well, when the net creditor position of the non-bank customers' sources dropped 9 percentage points (from -10.9 percent at end-2005 to -1.8 percent at end-2006). During September-November 2006, a notable performance was recorded by non-bank customers as they held a net debtor position, the difference between the share of loans and that of deposits in the aggregate bank assets widening by about 2.4 percentage points in November 2006. It is worth mentioning the slower increase in all categories of companies' deposits, which was generated mainly by: (i) larger payments to the government budget; (ii) higher external payments, including as a result of a wider trade deficit. In December 2006, deposits of non-bank customers rose at a much faster pace (monthly growth rate of 9.7 percent). In the same period, non-government loans posted a much slower monthly growth pace of merely 1.5 percent.

3.2.3. Capital adequacy

In 2006, the Romanian banking system remains adequately capitalised, although solvency indicators continued to decline on the back of non-government loans expansion. Furthermore, the stress test results point out that the Romanian banking system is able to resist to some severe exogenous shocks. A further downward trend in the solvency ratio is expected for the period ahead, against the background of a continuous fast increase in lending. The removal by the central bank of the additional measures to contain credit

growth[8] might be a new potential influencing factor of banks' solvency. On the other hand, the solvency ratio is expected to raise no problems in the short run, considering the maintenance of a safe margin of this indicator in relation to the regulated level.

3.2.3.1. Capitalisation of banks, Romanian legal entities

An adequate level of capitalisation of credit institutions is relevant for their ability to absorb the losses generated by less prudent risk management practices or by various exogenous shocks. Therefore, the level of capital adequacy secures the maintenance of the stability of the banking system and of the financial system as a whole.

Table 3.2.5 – Development of own funds and capital adequacy indicators of banks, Romanian legal persons

Indicator	2003	2004	2005	2006
Own funds (RON mil.)	7,074.2	9,339.7	13,917.3	17,837.5
Tier 1 capital (RON mil.)	6,073.3	7,290.7	10,815.2	13,398.2
Equity capital (RON mil.)	3,674.8	4,615.8	6,848.9	8,702.8
Profit/loss (RON mil.)	1,234.3	1,676.0	1,951.4	2,195.0
Subordinated loans (RON mil.)	239.8	450.1	1,480.3	2,623.8
Revaluation reserve (RON mil.)	1,022.4	1,387.1	1,388.6	1,394.2
Solvency ratio (> 12%)	21.2	20.6	21.1	17.3
Ratio of Tier 1 capital to risk weighted assets (>8%)[9]	18.1	16.0	15.6	13.0

Source: NBR

In 2006, the total solvency ratio[10] calculated for banks, Romanian legal entities[11] (Table 3.2.5), dropped 3.7 percentage points to 17.25 percent, owing mainly to the expansion of non-government

[8] *NBR Regulation No. 3/2007 on limiting credit risk associated with loans to households*, published in *Monitorul Oficial al României* No. 177/14 March 2007 repealed NBR *Norms No. 10/2005, as subsequently amended and supplemented, on limiting credit risk associated with loans to individuals*, which imposed, among others, the following prudential requirements: a) the value of a real-estate investment loan shall not exceed 75 percent of the value of the building for whose purchase the loan is applied for and/or the value of the cost estimate, and value of collateral shall be no lower than 133 percent of the loan value; b) monthly payment commitments shall be no higher than 40 percent of the applicant's and his/her family's net incomes, as appropriate; c) monthly payment commitments, as they arise from consumer loans, shall be no higher than 30 percent of the applicant's and his/her family's net incomes, as appropriate; d) monthly payment commitments, as they arise from real-estate investment loans, shall be no higher than 35 percent of the applicant's and his/her family's net incomes, as appropriate. According to NBR Regulation No. 3/2007, the maximum accepted monthly payment commitments are established by lenders, in terms of categories of customers, in their regulations, which must be approved by the NBR. The Regulation sets forth that, until the approval by the NBR of the internal regulations of credit institutions and non-bank financial institutions, monthly payment commitments shall be no higher than 40 percent.

[9] This indicator shows own capital as a share of total risk-weighted balance sheet assets and off-balance sheet items, net of provisions.

[10] Pursuant to the NBR Norms No. 13/2003 on the oversight of solvency and large exposures of credit institutions, as subsequently amended and supplemented, the solvency ratio shows the own funds calculated as a share of total risk-weighted assets and off-balance sheet items, net of provisions.

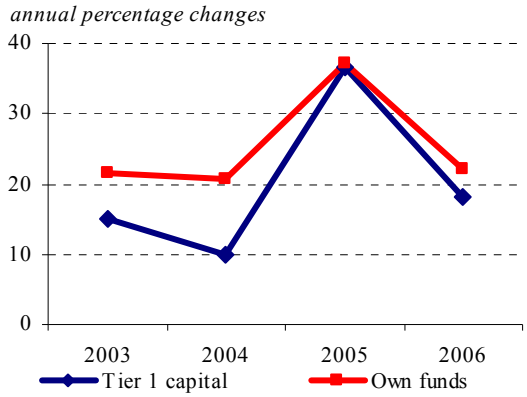
[11] Until 31 December 2006, prudential requirements on own funds were not applicable to branches of foreign banks and, therefore, prudential indicators calculated based on such requirements were not applicable either. According to the provisions of Regulation No. 18/23 December 2006 issued by NBR and NSC, starting with 1 January 2007, the own funds of branches operating in Romania of other foreign credit institutions are represented by Tier 1 capital.

loans. Nevertheless, the solvency ratio is estimated to have been maintained at an adequate level[12], exceeding by far the minimum level laid down in prudential regulations applicable in 2006 in Romania (12 percent) and that required by European and international regulations (8 percent).

The share capital remained the most dynamic item of Tier 1 capital, while current profit is another important element. From among Tier 2 capital components, the banks' subordinated loans continued to increase markedly. Therefore, as compared to the 2003-2004 period, when the level of Tier 2 capital was boosted largely by the volume of reserves resulted from wealth revaluation registered in banks' balance sheets, the shares of the two components were balanced in 2005, while year 2006 saw a 69 percent real annual increase of subordinated debts, which turned them into the key supporting element of Tier 2 capital.

In 2006, the growth pace of banks' *own funds* and of their major component – *Tier 1 capital* – (Chart 3.3.2) slowed down. Therefore, as compared with a real growth rate of roughly 37 percent recorded by both indicators in December 2005 versus the same period a year earlier, own funds advanced by 22.2 percent and Tier 1 capital by 18.1 percent at end-2006.

Chart 3.2.2 – Development of Tier 1 capital and own funds of banks, Romanian legal entities



Source: NBR

Special mention deserve the efforts of commercial banks aimed at ensuring a level of their own financing sources able to support the expansion of their activity, one of the methods used being that of increasing their *share capital or core capital*. As compared to 2005, when out of 40 credit institutions which operated in Romania, 28 increased their share capital (the real growth of the aggregate capital reached about 38 percent versus 2004), in 2006, 21 banks, Romanian legal persons, and two foreign bank branches increased their share capital/core capital (the aggregate share capital rose by 21.8 percent in real terms). The contribution of Erste Bank to the capital of *Banca Comercială Română* was not taken into account.

Capitalisation of credit institutions was further underpinned by their profit, despite the slight setback in its real growth rate recorded in 2006 compared with the previous year (5.5 percent at end-2006 versus 6.3 percent at end-2005).

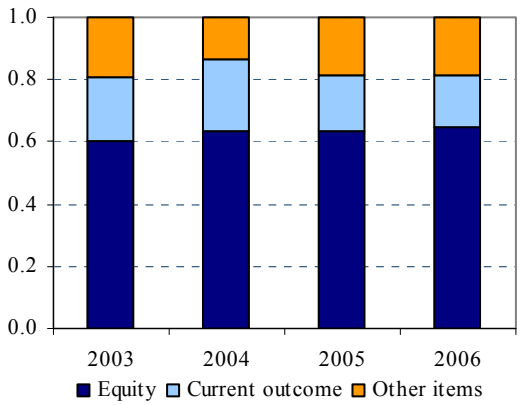
The analysis by component of total own funds of banks, Romanian legal entities, indicates that Tier 1 capital prevailed (75 percent of total own funds at end-2006 versus 78 percent at end-2005 and end-2004), although it followed a downward trend. In 2006, the share of Tier 2 capital moved ahead to 33 percent (from about 29 percent at end-2005). However, the growth potential of Tier 2

[12] In accordance with the Uniform Bank-Rating System – CAMEL, a bank with a solvency ratio higher or equal to 15 percent is defined as an adequately capitalised bank and is granted the 1 rating (the system has five ratings: 1 is the best and 5 is the worst).

capital remains high (the maximum level laid down in prudential regulations is of 100 percent of own funds[13]).

The paid-in share capital and the current profit posted uneven developments in 2006 as well (Chart 3.2.3). Thus, the share capital increased to 65 percent at end-2006 (from nearly 63 percent at end-2004 and end-2005) as a share of Tier 1 capital, whilst the share of profit in Tier 1 capital declined to 16 percent at end-2006 (from 23 percent at end-2004 and 18 percent at end-2005). Other major items of Tier 1 capital include share premiums, legal reserves, statutory reserves, other reserves.

Chart 3.2.3 – Structure of Tier 1 capital of banks, Romanian legal entities

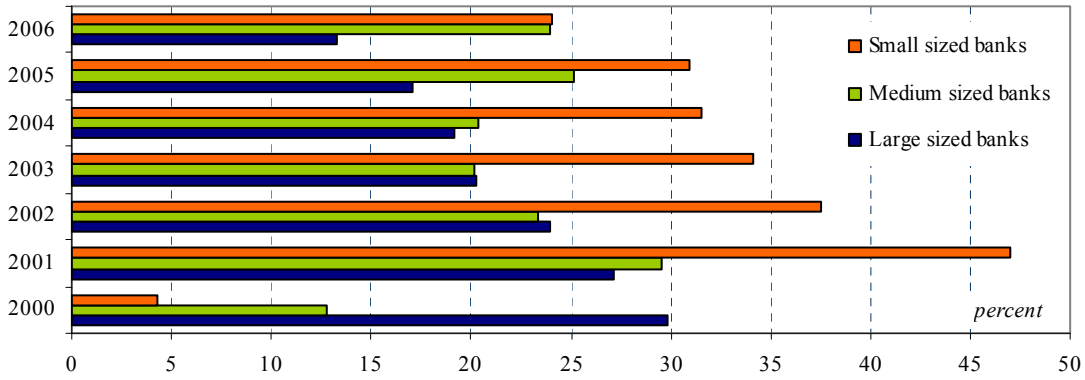


Source: NBR

3.2.3.2. Analysis of solvency

Solvency ratio of total credit institutions stayed on the downward trend it had followed since 2001 and dropped 3.73 percentage points. However, its level of 17.34 percent recorded in December 2006 indicated the adequate capitalisation of credit institutions, as it was higher than the level reported by the euro zone (11.2 percent at mid-2006).

Chart 3.2.4 – Solvency ratio by group of banks (2000-2006)



Source: NBR

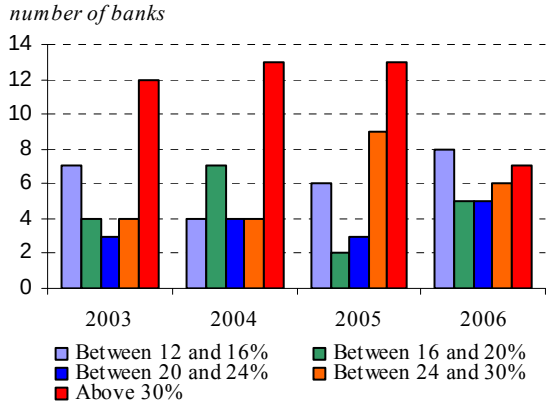
The analysis of solvency ratio by group of banks in terms of bank assets (Chart 3.2.4) shows that the solvency ratio of large banks posted the lowest level.

[13] The Regulation No. 18/23/2006 issued by NBR and NSC concerning own funds of credit institutions and investment companies, which came into force on 1 January 2007, uses, the same as the previous regulation, the maximum level of Tier 2 capital (defined in the new norm as "Tier 2 capital") of up to 100 percent of Tier 1 capital (the equivalent of Tier 1 capital used in the prior regulation). Moreover, financing from subordinated loans is further limited. To this end, Art. 21 of the Regulation stipulates that total permanent cumulative preferential shares and capital in the form of subordinated loans (that are components of Tier 2 capital), which may be considered for the calculation of own funds, can not exceed 50 percent of Tier 1 capital. The Regulation sets forth that the NBR can approve, at the request of credit institutions, the exceeding of the above-mentioned limits, but only provisionally and in exceptional circumstances.

Small banks[14] show the tendency to record solvency ratios close to those calculated for medium-sized banks, as a result of the increasingly active involvement in the lending activity. It is noteworthy that this development occurred amid the higher credit market concentration, with the market share of the top-five banks in total credit going up.

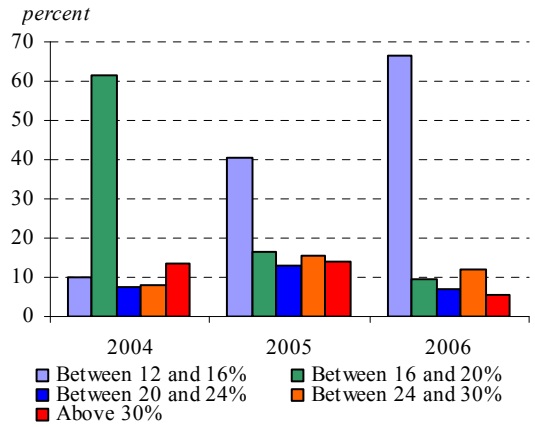
As regards bank distribution in terms of solvency ratio (Chart 3.2.5), 2006 marked the continuation of banks' tendency to migrate towards lower capital adequacy levels, amid the persistently high growth rate of non-government loans.

Chart 3.2.5 – Banks in terms of solvency ratio



Source: NBR

Chart 3.2.6 – Bank assets in terms of solvency ratio



Source: NBR

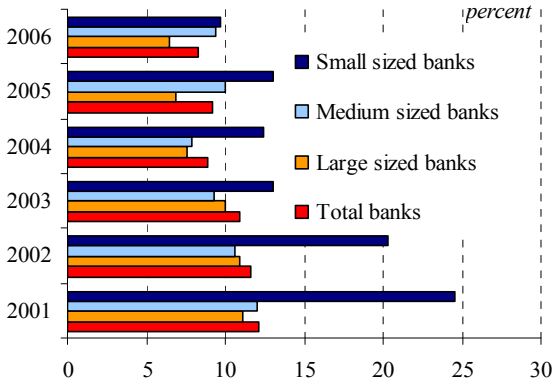
This trend is also substantiated by the bank asset distribution in terms of solvency ratio (Chart 3.2.6).

Although 2006 confirmed the downward trend in solvency ratio, the high capitalisation level of credit institutions in Romania may be deemed as still capable of securing a substantial growth potential for non-government loans. The development of this indicator will be influenced, at least in the short run, by two key factors: shareholders' interest for making the most of their capital (maximisation of ROE), hence solvency ratios as close as possible to the stipulated level, on the one hand, and the relatively cheap excess liquidity in the system which limits the decline in solvency, on the other hand. In the short run, the level of solvency will pose no threats, given the persistence of a comfortable margin of this indicator in relation to the stipulated level. However, the impact of the enforcement, as of 1 January 2007, of the new bank prudential regulations on

[14] In the analyses carried out by the National Bank of Romania, banks are classified in terms of their asset shares in total assets of the banking system, as follows: *large banks* are defined as those banks whose asset share is larger than 5 percent of total; *medium-sized banks* are the banks whose assets hold a share ranging between 1 and 5 percent of total; *small banks* are the banks whose assets account for less than 1 percent of aggregate assets.

capital adequacy[15] cannot yet be fully quantified. The new regulations, which transpose the provisions of Basel II Accord, include – apart from capital requirements for credit risk – specific capital requirements for operational risk, currency risk, commodity risk, dilution risk as well as capital requirements relative to the banking book for the position risk, settlement risk and counterparty credit risk.

Chart 3.2.7 – Tier 1 capital ratio by total banks and group of banks



Source: NBR

The developments in the equity ratio[16] in 2006 illustrates the persistence of the contraction in the self-financing of credit institutions from 9.2 percent at end-2005 to 8.3 percent at end-2006, as a result of the faster increase in assets compared to Tier 1 capital. The level of financing from own sources, calculated by group of banks in terms of the share of their assets in total bank assets, differs significantly (Chart 3.2.7). Large banks still features the lowest equity ratio (6.51 percent at end-2005 versus 6.85 percent at end-2006).

3.2.3.3. Results of stress test in assessing the solvency ratio and own funds

With a view to assessing, by way of the stress test, the capability of the Romanian banking system to absorb the negative effects of exogenous shocks, the Financial Stability Department built, for 30 June 2006, a scenario envisaging a 19.1 percent depreciation of the domestic currency and a 6.1 percent point decline in interest rate, on the backdrop of a null growth over a two-year period, as an extreme, yet plausible assumption. These values were estimated based on the medium-term forecasting macroeconomic model constructed by the Macroeconomic Modelling and Forecasting Department in the NBR under the said extreme assumption.

[15] NBR Regulation – NSC No. 3/18/2006 on determining the minimum capital requirements for credit institutions and investment firms and the related regulations require that credit institutions, Romanian legal entities, branches of foreign credit institutions in Romania, financial investment companies, credit co-operatives within the credit co-operative network and investment companies should maintain a level of own funds at least equal to the sum of the following capital requirements: a) for credit risk and dilution risk, 8 percent of total risk-weighted exposure amounts; b) relative to the banking book, capital requirements for the position risk range between 0 percent and 12 percent, depending on the nature of the positions in the banking book, while the capital requirement for the settlement risk and counterparty credit risk is 8 percent of total risk-weighted exposure amounts; c) own-funds requirement for the currency risk is calculated by multiplying the sum of its net foreign-currency position and its net gold position by 8 percent, whereas capital requirements for the commodities risk is calculated as a sum of: 15 percent of the (long or short) net position multiplied by the spot price of each commodity and 3 percent of the (long or short) gross position multiplied by the spot price of each commodity; d) capital requirements for the operational risk differ depending on the approach of the credit institution such as: in the case of the basic indicator approach, banks must hold capital equal to a fixed percentage (15 percent) of the calculation base; in the case of the standardised approach and the alternative standardised approach, capital requirements are calculated by applying to the relevant indicator the risk quota (12 percent, 15 percent and 18 percent) corresponding to the respective line of business. In compliance with the NBR's approval, credit institutions may also opt for the advanced measurement approach, in which case both expected and unexpected losses are taken into account in determining the capital requirements.

[16] Equity ratio is the ratio of Tier 1 capital to total assets. The indicator was calculated for banks, Romanian legal entities, and the credit co-operative network CREDITCOOP and it reflects the extent banks are able to ensure their financing from own sources.

As banks still enjoy adequate capitalisation and a high level of liquidity, the stress test has revealed that the Romanian banking system is capable of absorbing the negative effects of shocks considered in the scenario. The solvency ratio after the shock, calculated at aggregate level (Table 3.2.6), shows a 14.91 percent level, higher than the 12 percent minimum level laid down in the Romanian prudential regulations in force as at 30 June 2006. The impact of the above-mentioned exogenous shocks is differently felt by the groups of banks under scrutiny[17]. Therefore, in the case of privatised banks and domestic banks, which post lower levels of solvency ratio (14.4 percent) as compared to the average calculated at aggregate level, impact of the shocks considered in the scenario is reflected in the decline of this indicator to 11.19 percent and 10.94 percent respectively.

Table 3.2.6 – Impact of exogenous shocks on banks' solvency ratio

	Total	Banks with state owned capital	Privatised banks	Banks with domestic private capital	Subsidiaries of leading foreign banks	Other banks with foreign capital
Solvency ratio before the shock (%)	17.76	45.41	14.14	14.14	24.69	22.9
Solvency ratio after the shock (%)	14.91	42.12	11.19	10.94	22.51	19.92
Size of total impact (pp)	-2.85	-3.28	-2.95	-3.20	-2.19	-2.99

Source: NBR

As regards the estimated effect of the said shocks on the aggregate level of banks' own funds, it entailed the contraction of these funds by 19 percent. The analysis of own funds by group of banks shows that privatised banks and domestic banks might be most affected. In the case of these banks, the stress test has revealed a decrease in own funds by 23 percent and 25 percent respectively.

As a conclusion, it is worth noting that the capitalisation of the Romanian banking system, albeit on a downward path, allows the further deepening of financial intermediation. In the short run, banks are estimated to be capable of absorbing the negative impact of the potential exogenous shocks that will pose no threat to the banking system.

3.2.4. Credit risk

Credit risk is still the main risk Romanian banks have to cope with. In the short run, credit risk is expected to increase, amid fast-paced lending and advancement into the economic cycle.

The quality of the loan portfolio of the banking system was preserved against the background of the restrictive policy pursued by the central bank in recent years and banks' efforts to manage risks.

Non-government loans rose by a real 47 percent in 2006 as compared to 33.8 percent a year earlier. Almost 90 percent of credit was granted to non-financial companies and households, which justify the concentration of analyses on these categories of debtors. The structural analysis shows that RON-denominated credit held for the first time the largest share, accounting for 53 percent of total loans granted. In terms of maturity, long-term credit posted the fastest growth rate, its share exceeding for the first time the share of the other maturities (39 percent, compared to 28 percent –

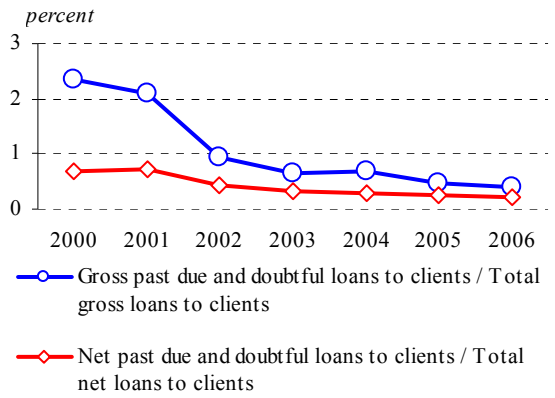
[17] Banks' classification used by the Financial Stability Department in the stress test analysis takes account of the type of share capital.

medium-term credit and 34 percent – short-term credit). Long-term foreign exchange credit saw higher dynamics, which might pose additional risks to the banking system. By type of debtor, non-financial companies are still in the leading position, whereas the share of loans to households is showing higher dynamics (42 percent in 2007 compared to about 7 percent in 2001).

Expansion of lending in 2006 did not cause banks' loan portfolio to worsen. On the contrary, it experienced an improvement from the previous year. Given that, over the past five years, non-performing claims recognised in banks' balance sheets posted very low levels (below 1 percent of outstanding loans), the contraction trend of doubtful and overdue loans granted to non-banks clients in total loan portfolio relative to this segment of customers (calculated as both net and gross values), continued to be manifest in 2006 too, the level of these indicators going down to 0.2 percent and 0.4 percent respectively (Chart 3.2.8).

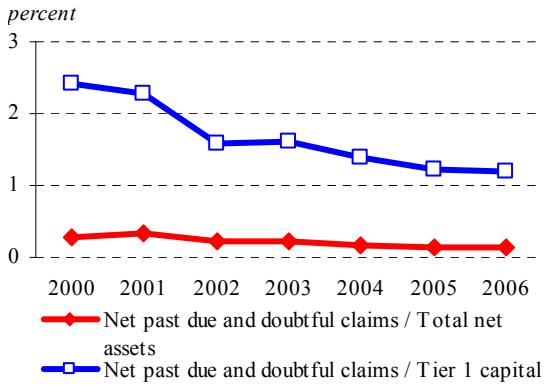
Past-due and doubtful claims (net value) recognised in credit institutions' balance sheets, as a share of total bank assets and of Tier 1 capital (Chart 3.2.9) are posting extremely low levels in 2006 as well (0.15 percent and 1.19 percent respectively), compared to prior year levels. From this perspective, the level of Tier 1 capital of credit institutions is high enough to absorb losses from non-performing claims recorded in the balance sheet.

Chart 3.2.8 – Credit quality in the banking system



Source: NBR

Chart 3.2.9 – Credit quality in the banking system

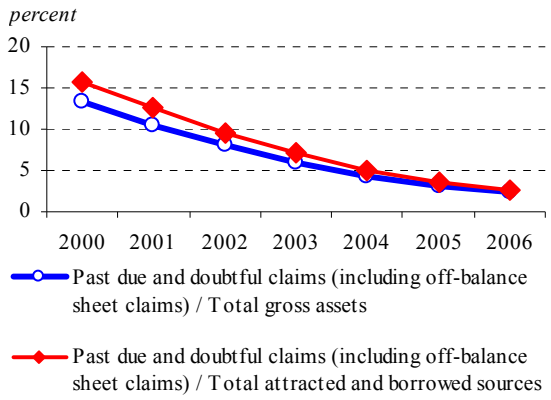


Source: NBR

The share of past-due and doubtful claims (including off-balance sheet claims, still under scrutiny) in total assets (gross value) and in total bank liabilities improved in 2006 (Chart 3.2.10), both indicators moving down around one percentage point (to 2.27 percent and 2.65 percent, respectively, at end-December), which might indicate the improvement in the credit risk management by commercial banks.

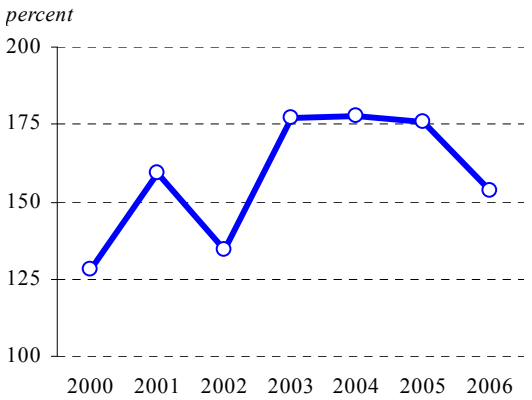
The coverage with reserves and provisions of risk-weighted exposure of bank and non-bank credits, inter-bank deposits and interest associated with these classified under "substandard", "doubtful" and "loss" (Chart 3.2.11), albeit on the downward path, is still satisfactory at end-2006 (153 percent).

Chart 3.2.10 – Credit quality in the banking system



Source: NBR

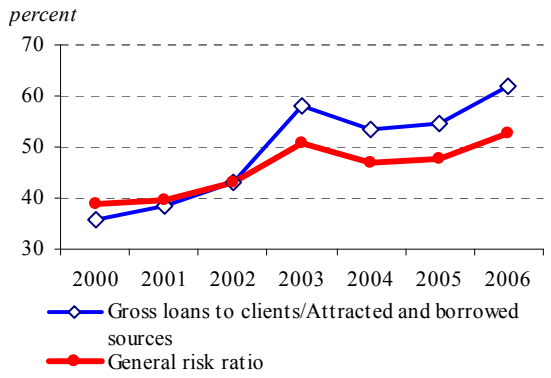
Chart 3.2.11– Coverage of claims classified in *"substandard"*, *"doubtful"* and *"loss"*



Source: NBR

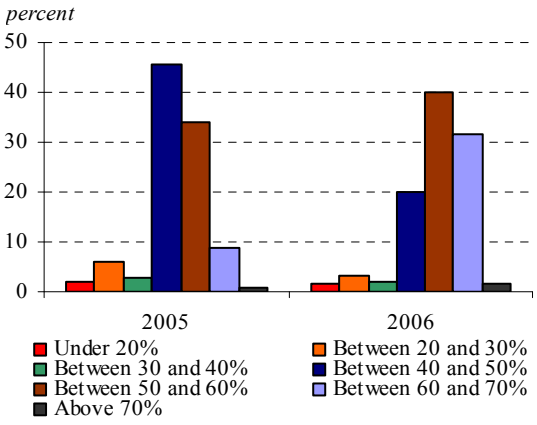
The further deepening of financial intermediation is also mirrored by the increase, in 2006, of the ratio of loans to customers (gross value) to bank liabilities (Chart 3.2.12) to 62 percent, the highest level in the past six years. As a result of the same process, overall risk ratio[18] (Chart 3.2.12) followed the upward path to 52.8 percent at end-2006, the trend of this indicator mirroring the higher degree of credit risk assumed by banks.

Chart 3.2.12 – Risk assessment indicators calculated on the basis of credit institutions' balance sheets



Source: NBR

Chart 3.2.13 – Net assets distribution in terms of general risk ratio



Source: NBR

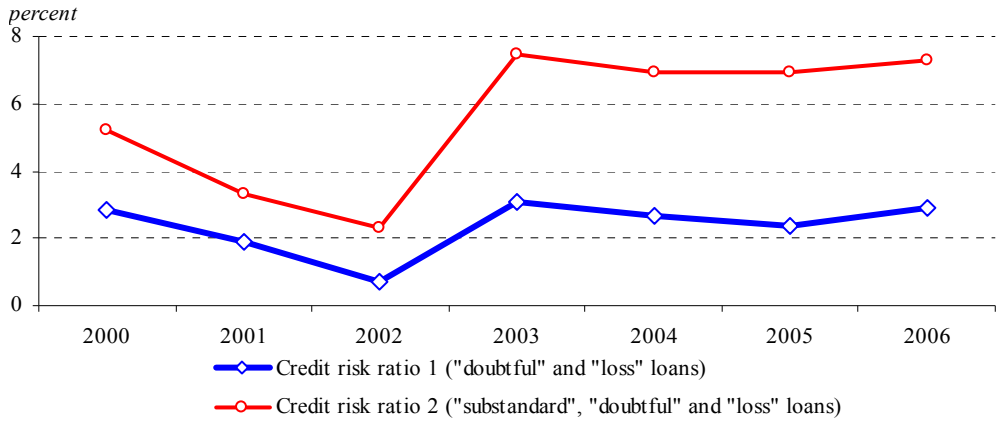
The comparative analysis of bank assets distribution based on the overall risk ratio at end-2005 and end-2006 (Chart 3.2.13) still shows that this indicator moved to levels reflecting higher credit risk. Thus, in December 2005, the largest share of bank assets was accounted for by credit institutions with overall risk ratio ranging from 40 percent to 50 percent (46 percent of assets) and from 50 percent to 60 percent (34 percent of assets) respectively. At the above-mentioned date, only 10 percent of assets were accounted for by banks with an overall risk ratio exceeding 60 percent. In

[18] The overall risk ratio is calculated as a ratio of the sum of balance sheet items and off-balance sheet items at risk-weighted value, on the one hand, to the sum of balance sheet items and off-balance sheet items at book value, on the other hand. The indicator is determined based on the data provided by banks in the solvency report and it measures banks' exposure to credit risk.

2006, only 20 percent of bank assets were held by banks with an overall risk ratio ranging between 40 percent and 50 percent, the share of assets corresponding to the 50-60 percent band reaching 40 percent, whereas 34 percent of bank assets belonged to banks with an overall risk ratio higher than 60 percent.

Credit risk ratios 1 and 2[19] (Chart 3.2.14) stayed on an upward course in 2006, but the levels recorded did not exceed those seen in 2003 (the highest values in the data series under review), when expansion of non-government loans was significant.

Chart 3.2.14 – Credit quality in the banking system



Source: NBR

3.2.5. Liquidity risk

In 2006, the Romanian banking system witnessed further high liquidity, although banks earmarked ever increasing funds for lending[20]. The liquidity indicator continues to be higher than the minimum level set forth in norms, albeit on a slightly downward trend amid the increase in the share of medium- and long-term placements in total assets.

Over the forthcoming period, the banking system liquidity is not expected to pose major problems from the risk standpoint, given that short-term credit and the number of deposits with the central bank account further for a large weight of the asset portfolio.

The banking system saw an expansion in immediate liquidity from 33 percent at end-2005 to 40 percent at end-2006, against the background of the minimum reserve requirement policy[21] and of further sterilization operations, with the National Bank of Romania remaining the most significant

[19] Credit risk ratio 1 is the ratio of unadjusted exposure relative to bank loans, non-bank loans, inter-bank placements to interest classified under "doubtful" and "loss" in total loans, inter-bank placements and related interest. Credit risk ratio 2 is the ratio of unadjusted exposure relative to bank loans, non-bank loans, inter-bank placements to interest classified under "substandard", "doubtful" and "loss" in total loans, inter-bank placements and related interest.

[20] Mainly long-term loans.

[21] Starting with 24 March – 23 April 2006 maintenance period, the minimum reserve ratio for foreign exchange funds, except for non-redeemable borrowings was set at 40 percent (versus the previous level of 35 percent). Furthermore, starting with 24 July – 23 August 2006 maintenance period, the minimum reserve ratio for domestic currency funds, with maturity shorter than 2 years, the float in domestic currency and domestic currency funds with residual maturity longer than 2 years since the end of the observance period, which include provisions concerning early repayments, withdrawals, transfers, was set at 20 percent (versus the previous level of 16 percent).

counterparty to credit institutions (80 percent of total interbank asset operations) amid a still low volume of interbank transactions.

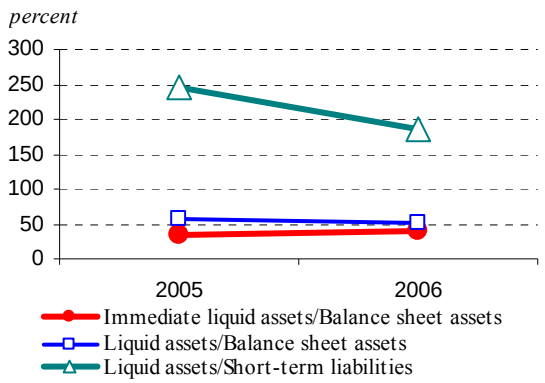
Table 3.2.7 – Liquidity indicator of the banking system

Year	*D ≤ 1 month*	*1 month < D ≤ 3 months*	*3 months <D ≤ 6 months*	*6 months < D ≤ 12 months*	*12 months< D*	*Total*
2005	2.63[22]	10.79	27.31	28.97	7.10	2.59
2006	2.01	6.42	9.12	15.10	8.14	2.30

Source: NBR

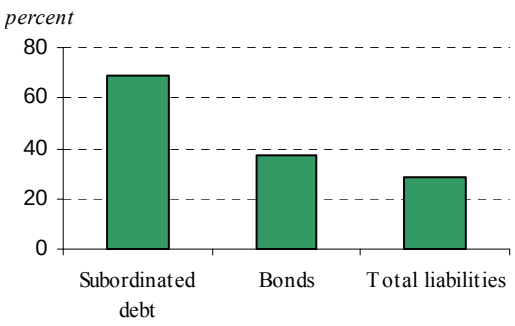
The global liquidity of a credit institution depends on the combined structure of both its assets and liabilities, the maturities of assets as compared to liabilities, playing a decisive role in enhancing the assets' vulnerability to liquidity risk. The liquidity indicator for the banking system, computed according to regulations in force, continued to exceed the lower bound, i.e. 1, as shown in Table 3.2.7.

Chart 3.2.15 – Liquidity indicators of the banking system



Source: NBR

Chart 3.2.16 – The growth rate of subordinated debts and of bonds issued by credit institutions versus the growth rate of total liabilities in 2006



Source: NBR

In 2006, the share of liquid assets[23] in total balance-sheet assets remained at a safety level, although it continued to decrease from 58 percent at end-2005 to 52 percent at end-2006.

The indicator short-term liquid assets/short-term liabilities[24] went down by 61.3 percentage points (nearing the level seen at end-2004), while the indicator loans[25]/deposits of customers continued to go up from 74.9 percent in 2005 to 91.1 percent at end-2006 (Chart 3.2.15), remaining, however, below the average level recorded by EU-12 countries (around 113 percent)[26]. The divergent developments of these two indicators, as well as the decline posted by liquid assets/total assets reveal the behaviour shown by an increasing number of credit institutions that abandon the high level of liquidity in favour of potentially substantial revenues from lending activities.

[22] As compared to 0.61 recorded by the Polish banking system, according to *Summary Evaluation of the Financial Situation of Polish Banks*, page 20, *Warsaw, September 2006.*

[23] Balance sheet assets and commitments assumed with maturity of up to 3 months.

[24] The indicator takes into account the assets, liabilities and off-balance-sheet items with maturity of up to 3 months.

[25] Interbank credits were left out of account.

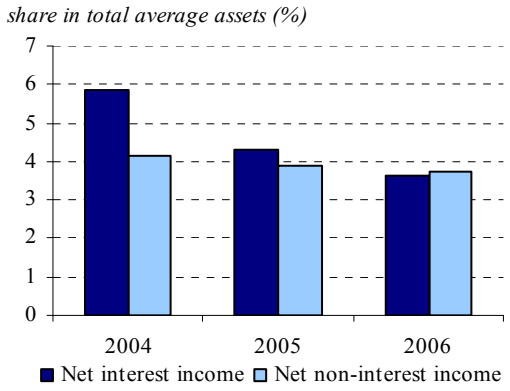
[26] *Eurobank Research, November 2006.*

Credit institutions' focus on more stable financing resources, with longer maturities than bank deposits taken from non-bank customers is emphasised by higher increases in subordinated debts and bonds issued by credit institutions (Chart 3.2.16) than in balance sheet liabilities.

3.2.6. Market risk

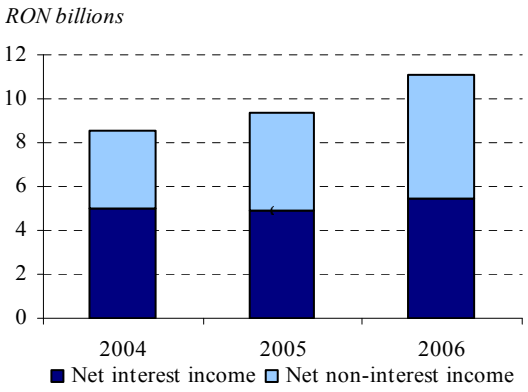
Market risk across the Romanian banking system continues to be generally low, the main trends identified in the previous years being confirmed during 2006. There are no signs indicating severe systemic implications arising from the market risk. The direct exposure of credit institutions to the change in the interest rate, although on a slight increase, remains moderate, whereas direct exposures to the change in the exchange rate and the change in the share price are further less significant. Nevertheless, indirectly, the risk passes through to the loan portfolio quality. The conclusions reached following the analysis of the relevant specific indicators match the outcomes of the stress test assessment for the first six months of 2006.

Chart 3.2.17 – Developments in net revenues from interest rates[27] versus net non-interest income



Source: NBR

Chart 3.2.18 – Structural developments[28] in operational revenues



Source: NBR

As concerns the market risk category, the interest rate risk remains the main source of vulnerability facing the Romanian banking system. Both the share of the net revenues from interest rates in average assets and that of the net revenues from other activities than those generating interest are on a downward trend (Chart 3.2.17).

On the other hand, as far as the profit and loss account is concerned, an increase is detected in operational revenues, namely in the share of net non-interest revenues (Chart 3.2.18). This illustrates that the decrease in the period under review in the return on assets is the result of the development of bank intermediation. Mention should be made that some banks pass on part of the interest cost of loans to the commissions charged for the loans granted to customers, which alleviates the actual impact of the interest rate risk.

The direct exposure of credit institutions in Romania to the exchange rate risk is further low. In addition, the share of the overall foreign exchange position in own funds is further on the downside (Chart 3.2.19). Mention should be also made that foreign exchange transactions resulted

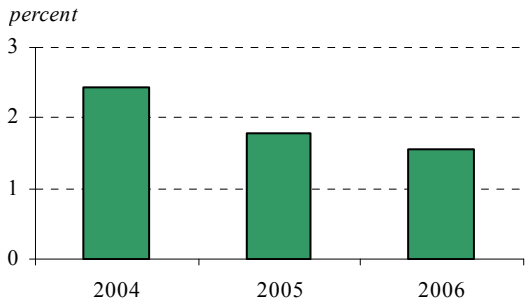
[27] Net revenues from interest rates include net revenues from operations with customers and net revenues from operations with securities.

[28] Comparable prices in 2006.

in considerable net incomes for banks. Over the past two years, these incomes accounted for approximately 20 percent of net revenues from interest rates.

The direct risk of a change in the share price is also low in the case of the Romanian banking system. Credit institutions neither hold significant investments or participations, nor obtain marked incomes from share trading.

Chart 3.2.19 – Developments in share of foreign currency



Source : NBR

The assertions concerning the moderate exposure of the Romanian banking sector to the market risk match the outcomes obtained following the dry runs relative to 2006 Q1, based on the stress test assessment. The analysis of the cumulative effect of interest rate shocks and exchange rate shocks applied directly to the banks' balance sheet and profit and loss account shows a relatively low impact on the banking system, which results in the decline in own funds by almost 16 percentage points (Table 3.2.8). If the interest rate fell by 6.1 percentage points (according to the stress test scenario), net revenues from interest rates would post a decrease, causing a 15.64 percent drop in the banking system's own funds. The direct effect of the exchange rate is insignificant, leading to a 0.32 percent decline in own funds against the background of a 19.1 percent depreciation of the domestic currency.

Table 3.2.8 – Assessment[29] of the considered shock effects on the own funds (percent)

	2006
Interest rate	*-15.64*
Exchange rate	*-0.32*
TOTAL IMPACT	**-15.96**

In the case of the **shock applied to the interest rate**, eight banks in the system might be negatively affected; the decrease in the volume of their own funds would exceed the average for the system in a range from 0.08 to 20 percentage points. The interest rate risk is more significant than other categories of the market risk, because RON-denominated operations with customers are not correlated in terms of assets and liabilities, either as a total, or by maturity band, meaning that, generally, resources are taken for a short term, while assets are medium- and long-term investments. The negative effect is generated primarily by the mismatch at the level of the 1-5 year maturity band, which causes more than 55 percent of the potential loss associated with the interest rate risk.

All these lead to the conclusion that the interest rate risk is moderate, at least for the considered period. In addition, the impact of the shock applied to the interest rate is alleviated by the stance shown by some banks to offset the drop in interest rates by raising the credit amount or by charging new commissions for the same facility.

[29] The analysis of the outcomes of the stress test scenario refers only to banks, Romanian legal entities. Except for the dry runs relative to the interbank market, the branches of foreign banks are not included in the test because they are not subject to capital adequacy requirements and thus the lack of data makes it impossible for the solvency ratio to be determined. As a matter of fact, it is very little likely that, in shock-induced circumstances, these branches default on their liabilities, given the consistent support they benefit from parent undertakings.

The shock applied to the exchange rate, referred to in the scenario (namely the depreciation by 19.1 percent of the domestic currency), might cause a drop in own funds in a range from -2.86 percent to -0.15 percent (Table 3.2.9).

The size of the impact is very low, owing mainly to adequate capitalisation and also to a relatively balanced correlation of foreign exchange assets and liabilities.

However, the foreign exchange risk is indirectly passed on to debtors, with impact on banks by means of the credit risk.

Table 3.2.9 – Distribution of credit institutions in terms of the size of the direct effect of the exchange rate as a percentage of own funds

From 1 percent to 3 percent	**1 bank**
From 0 percent to 1 percent	**17 banks**
From -1 percent to 0 percent	**10 banks**
From -3 percent to -1 percent	**4 banks**

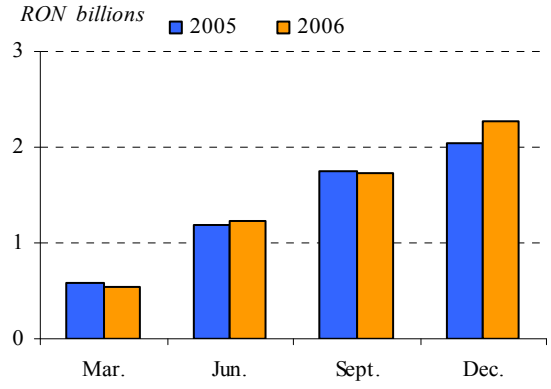
3.2.7. Profitability and efficiency

The year 2006 saw a consolidation of net profit in the banking system. The profit of credit institutions came mainly from the expansion of business activity, given the cut in interest margins. Key financial performance indicators posted slight declines against the previous period, albeit sticking to levels comparable with the values recorded in other countries in the region.

In the short run, the pace of increase of banking sector profit rate is expected to slacken, under pressure from certain developments, such as: fiercer competition, narrower interest margin, the pick-up in the amount of provisions, as a result of the sustained growth rate of lending, further investment in expanding territorial networks, as well as costs related to the implementation of Basel II Accord.

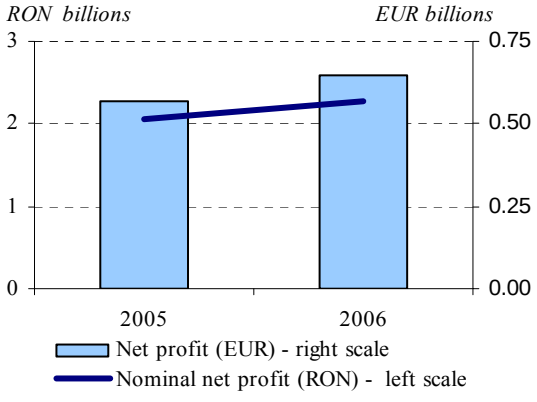
Net profit in 2006 followed a similar pattern as in the previous year (Charts 3.2.20 and 3.2.21), with the aggregate **net figure** on the upside both in nominal terms and in EUR equivalent.

Chart 3.2.20 – Comparative trend of quarterly net profit of the banking system in 2005 and 2006



Source: NBR

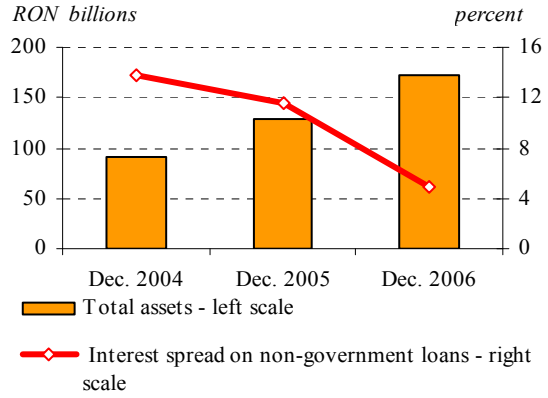
Chart 3.2.21– Trend in net profit of the banking system



Source: NBR

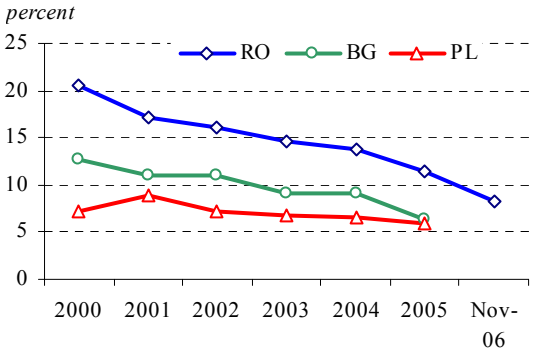
The good performance was achieved in a favourable economic environment, by developing the lending activity and other transactions, which offset the narrower margins[30] between lending and deposit rates (Chart 3.2.22).

Chart 3.2.22 – The spread between average lending and deposit rates during 2004-2006



Source: NBR

Chart 3.2.23 – The spread between average lending and deposit rates in Romania, Bulgaria and Poland



Source: The impact of external regulations on the Romanian banking system, 2006 - Roland Berger

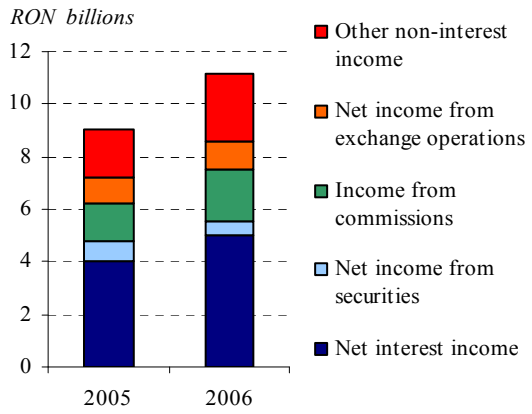
Although on a downtrend, average interest margins in the Romanian banking system are still above the average posted by banking systems of other countries in the region (Chart 3.2.23).

Despite the higher share of income other than from interest rates, **net income from interest rates** remains a major component (50 percent[31]) of operating income (Chart 3.2.24).

Unlike in 2005, net income from interest – net income from securities excluded – witnessed a rebound mainly on account of the real growth of income from interest rates on loans to customers.

Credit institutions' dual behaviour played a major role in the dynamics of interest income. Banks have generally reacted to monetary policy impulses by increasing costs related to loans in progress and cutting lending rates on new business with a view to attracting more customer.

Chart 3.2.24 – Structural trend of operating income



Source: NBR

Income from commissions (accounting for 18 percent of operating income) posted a real growth rate of 30 percent, higher than that of operating income. Given the increase in the volume of transactions, the sources of income other than from interest could be estimated as stable.

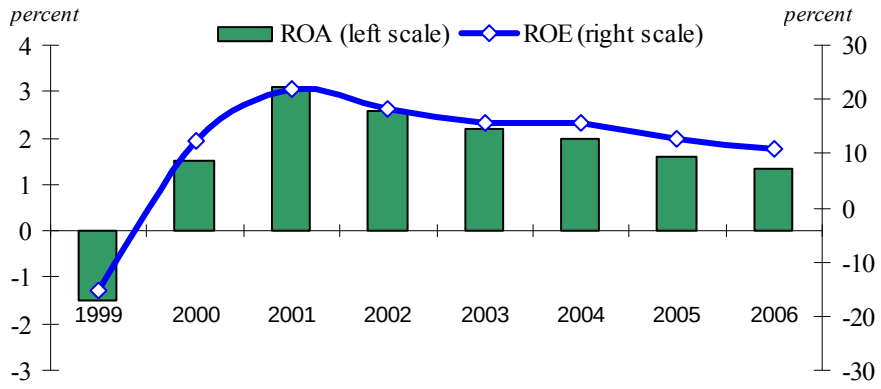
[30] The differential between average lending and deposit rates on credit institutions' RON-denominated operations narrowed from 5.59 percentage points in December 2005 to 4.85 percentage points in December 2006.

[31] Net income from interest also includes net income from securities, which accounted for 5 percent of operating income at end-2006.

The other components of operating income, namely **net income from foreign exchange operations** and **net income from securities**, posted negative growth rates, with lower shares in total income (from 11 percent to 9 percent and from 9 percent to 5 percent respectively). Mention should also be made of the fact that, in 2006, Romania refrained from issuing any Treasury certificates, while the volume of foreign currency-denominated bonds held by credit institutions contracted approximately 30 times.

Key financial performance indicators followed a downward path (Chart 3.2.25) on account of the slower dynamics of net profit compared to the growth of aggregate assets and equity.

Chart 3.2.25 – Comparative trend of ROE and ROA



Source: NBR

Return on assets (ROA) stuck to its downtrend during 2006, shrinking from 1.6 percent to 1.3 percent. This figure is still comparable to the values recorded in other countries in the region[32].

Return on equity (ROE) followed a slightly steeper downward slope than ROA, on the back of the faster rise in total assets (28 percent) compared to that of equity, assimilated capital and provisions (25 percent). Against this backdrop, return on equity ranged between 12.7 percent and 10.7 percent.

A breakdown of credit institutions by ROE hints at a contraction of the share of credit institutions, with ROE ranging between 10 and 15 percent in total bank assets (from 16.35 percent at end-2005 to 7.15 percent at end-2006) in favour of credit institutions with ROE ranging between 5 and 10 percent, whose share in total assets expanded from 5.32 percent to 24.2 percent during the period under review.

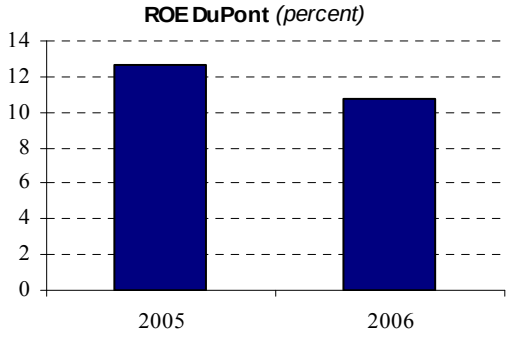
ROE analysis based on determinants, using the **DuPont** breakdown (Chart 3.2.26), shows that lower return on bank equity is mainly ascribable to the contraction in the net profit/income ratio, in the income-generating capacity of assets, amid a slow rise in the leverage effect.

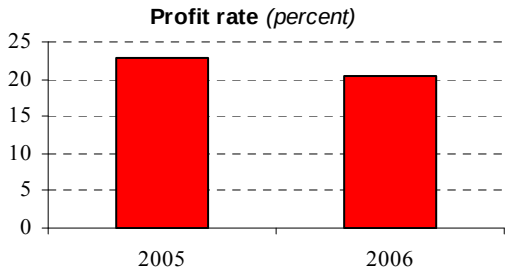
[32] In Bulgaria, return on assets stood at 1.9 percent at end-2006 (*Monthly Bulletin December 2006, National Bank of Bulgaria*), 1.8 percent in Croatia (at the end of 2006 Q2 – *Republic of Croatia: 2006 Article IV Consultation: IMF Staff Report*) and 1.4 percent in the euro area (average reading at the end of 2006 Q2, *ECB Financial Stability Review, December 2006*).

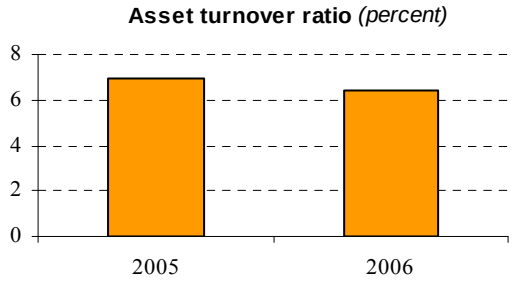
Chart 3.2.26 – ROE analysis based on determinants (ROE-DuPont)

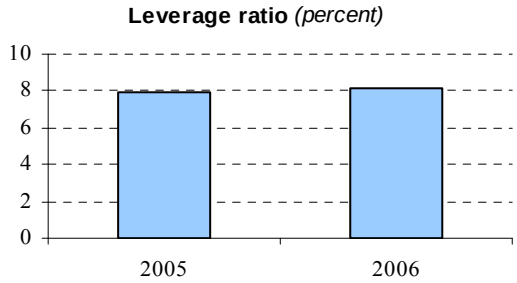
$$ROE = R_{PR} \times RUA \times EP$$

$$\frac{PN}{CP} = \frac{PN}{Vo} \times \frac{Vo}{AT} \times \frac{AT}{CP}$$







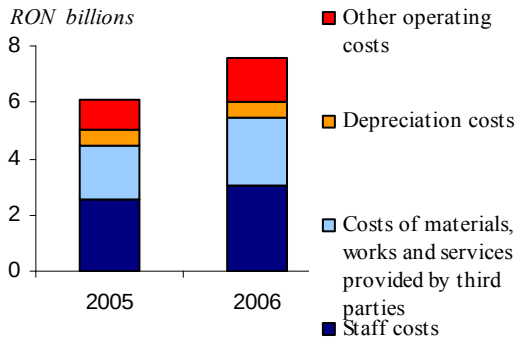


R_{PR} – *Profit rate*
RUA – Asset turnover ratio
EP – Financial leverage
PN – Net profit
Vo – Operating income
AT – Total assets
CP – Own capital

Source: NBR

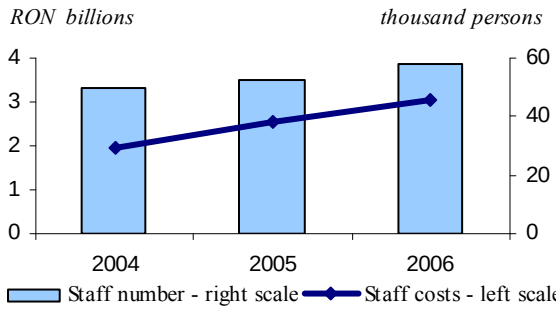
Profitability is high particularly in the case of large banks, which have a good capacity of absorbing potential shocks in a volatile economic environment.

Chart 3.2.27 – Structural trend of operating costs



Source: NBR

Chart 3.2.28 – Trend of staff costs



Source: NBR

Staff costs continued to hold the largest share, i.e. 40 percent, in operating costs (Chart 3.2.27), against the background of further hirings reported by credit institutions (Chart 3.2.28).

Provision-related expenses advanced 41 percent in real terms in 2006, mainly on account of non-government loans expansion by 47 percent and the restrictions imposed on credit institutions by the National Bank of Romania through Regulation No. 8/2005 amending NBR Regulation No. 5/2002 (according to the new provisions, individuals earning permanent income in other currency than the loan currency have to be classified in a lower financial performance category).

The **cost income ratio** has remained virtually unchanged (67.7 percent at end-2006 versus 67.2 percent at end-2005).

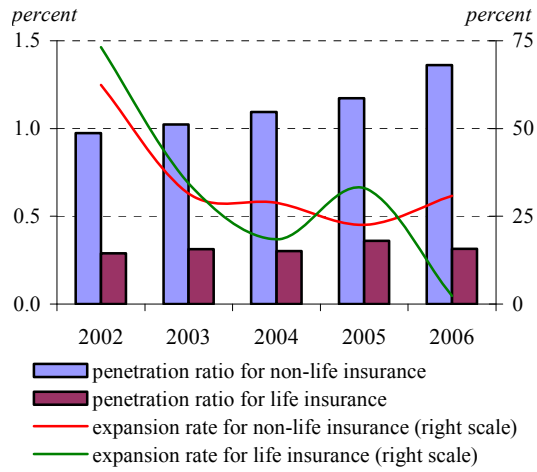
3.3. Non-bank financial sector

3.3.1. Insurance market

Insurance market continued to increase, being spurred by high demand for insurance products and the advance in the national financial intermediation. The capital breakdown by insurance activity and the heightened market competition led to a more stable insurance sector. In order to sustain the convergence with the European market, it is necessary to accelerate the expansion rate of the domestic insurance market. The main risks to the domestic insurance sector are the declining interest rates, few investment alternatives and the rise of the claims rate.

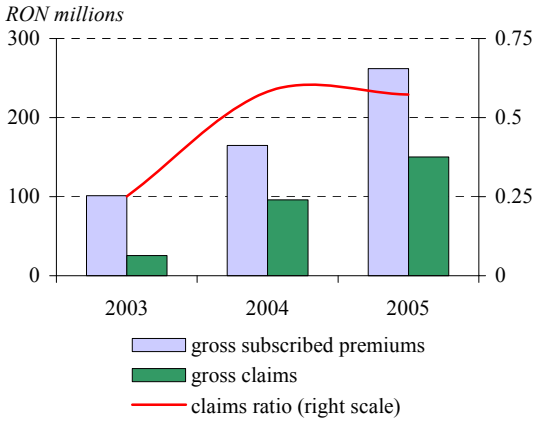
The insurance market is currently experiencing a period of consolidation and capital increases. The most important subscribed policies are life insurance, annuities and unit-linked products for life sector and vehicle insurance for non-life sector. The gross subscribed premiums posted mixed developments in life and non-life sectors. The rate of expansion of life insurance slowed down in 2006, while that of non-life insurance advanced for the first time since 2002, due to the motor vehicle sector development and the more expensive insurance premiums. The penetration rate of insurance went up to 1.68 percent of GDP, but remained among the lowest rates on the European markets.

Chart 3.3.1 – Insurance market development



Source: ISC

Chart 3.3.2 – Credit insurance development



Source: ISC

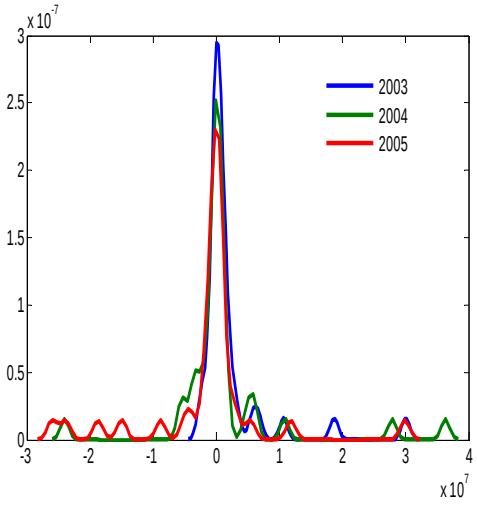
Credit insurance market growth was accompanied by a deterioration of policies portfolio quality managed by insurance companies. The claims ratio (Chart 3.3.2), computed as a share of total

claims in gross subscribed premiums, exceeded the market average in 2005 (which was 0.49). This level poses no threat to the financial stability of the insurance sector, but the issue needs to be closely monitored. Insurance companies have adopted protection measures like stop-loss and franchise in order to decrease the claims ratio. The companies affiliated to financial groups that perform banking activities on the Romanian market held the overwhelming share of credit insurance market in 2005. Credit risk may lead to a contagion from banking to insurance sector if the default ratio increases consistently for banks portfolio.

The insurance sector profitability

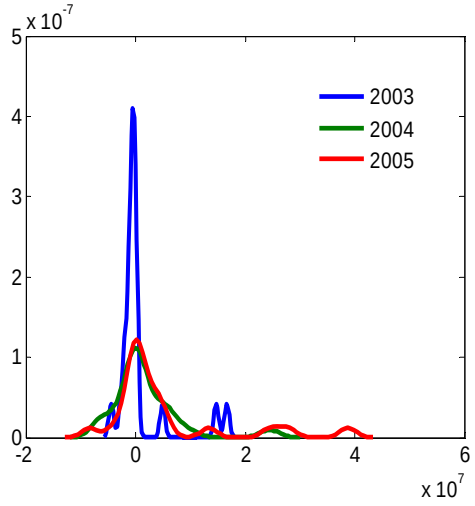
The insurance business generates earnings from underwriting activities and portfolio investments. An efficient insurance sector means a fair risk diversification, a real price for the insurance policies and a sound management of portfolio investments and operational risks. Overall, the profitability of insurance companies continues to decrease, but the solvency ratios remain in the safe area according to the Insurance Supervisory Commission. The technical losses imposed capital increases for some non-life insurance companies. In addition to strengthening their financial position, they need to adjust the insurance premiums taking into account the risks and to improve their risk management systems. Technical results for life insurance companies were favourable, as compared to those of non-life insurance companies, due mainly to the decreasing ratio of net claims to net premiums.

Chart 3.3.3 – Normal kernel distribution for non-life technical result



Source: ISC, NBR calculations

Chart 3.3.4 – Normal kernel distribution for life technical result



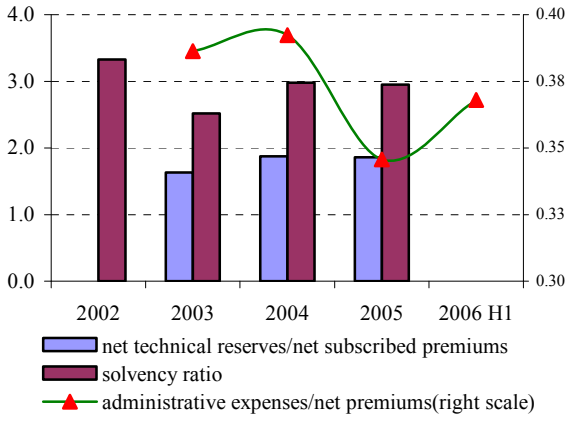
Source: ISC, NBR calculations

The normal kernel function has been used to estimate the probability density functions of technical results for life and non-life sectors, by taking into account the single values of technical gains/losses. The vertical axis of kernel distributions displays probabilities and the horizontal axis displays technical results. The dynamic analyses of kernel distributions show that non-life distribution (Chart 3.3.3) tends to have left asymmetry (higher probability for negative technical results than for positive technical results) and life distribution (Chart 3.3.4) tends to have right asymmetry (higher probability for positive technical results than for negative technical results). The persistency of a negative non-life technical result for a longer period of time may jeopardize insurance companies' capacity to pay claims, as well as their financial stability. The financial results for the insurance sector have sustained the financial stability of the market. In some cases, financial performance offset technical losses, but their negative trend in 2004 and 2005 decreased this buffer function.

Life insurance

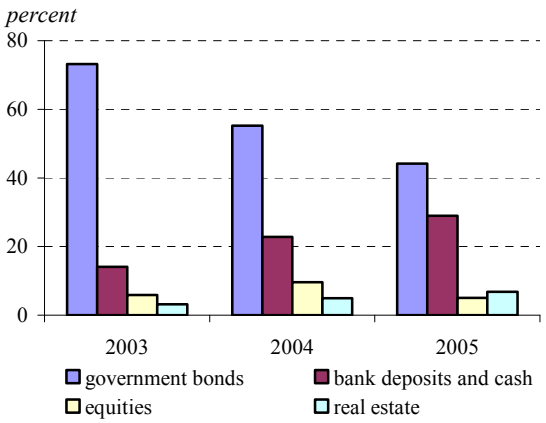
Unit-linked products with market risk transferred to policyholders remain a major component of insurance companies' portfolio, being at the same time a financial stability factor. The disclosure of insurance companies about market risk prevents reputation risk and underpins the life insurance sector growth.

Chart 3.3.5 – Financial stability indicators for life insurance



Sources: ISC, MPF, NBR calculations

Chart 3.3.6 – Structure of technical reserves for life insurance (main assets)



Source: ISC, NBR calculations

Financial stability indicators show that net technical reserves have increased and the ratio of reinsurance premiums to gross premiums remains at the same level (3 percent). The solvency ratio was stable, whereas the administrative expenses divided by net premiums were little changed. Indicators tend to have a cyclic evolution in the medium term owing to the long duration of life insurance portfolios.

The longer life expectations and the lack of long-term investment products deepen the duration gap between assets and liabilities and erode the insurance companies' capital, the same trend being perceived in the European market. Moreover, insurance companies are exposed to interest rate risk in a decreasing interest rate environment. The declining interest rates foster investment in fixed-income and long-term securities, yet the access to such investments is limited due to the low supply. Contraction of government bond issue and the high risk of capital markets and real estate investments generated an increase of insurance companies' liquidity. They need to assure equilibrium between the safety of investments and their returns in order to maintain the financial stability of the insurance sector.

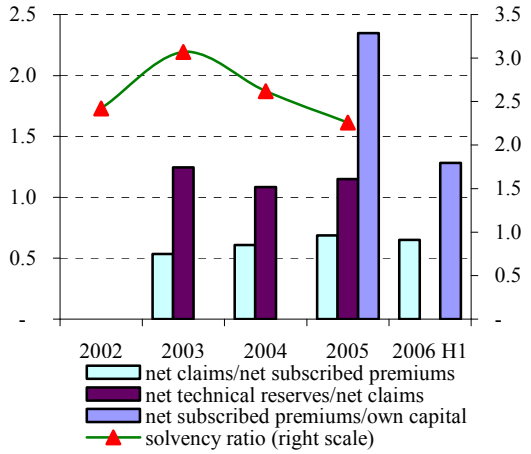
Non-life insurance

The main risks to non-life insurance are the increases of claims and reinsurance premiums. Other risk factors are market competition, which pushes the policy premiums below the risk retained, and credit risk transferred from the banking sector.

The increase of claims did not affect financial stability indicators because of the capital infusion and the advance in the gross subscribed premiums. The growth of technical reserves and the decrease of the risk retention ratio (from 73.4 percent in 2004 to 67.8 percent in 2006 H1) are factors ensuring sound financial stability. The worldwide increase of reinsurance premiums has had

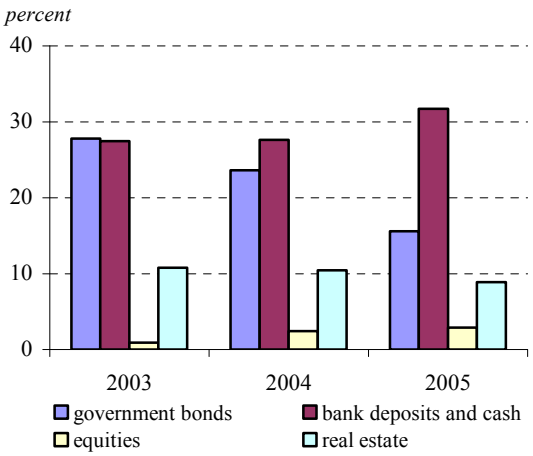
an important impact on the Romanian insurance market as well. These expenses can affect the risk retention ratio. The explanations for the decrease of solvency ratio lie with the ongoing market development process and the decreasing technical results.

Chart 3.3.7 – Financial stability indicators for non-life insurance



Sources: ISC, MPF, NBR calculations

Chart 3.3.6 – Structure of technical reserves for non-life insurance (main assets)



Source: ISC, NBR calculations

The Romanian insurance sector manages large losses risks using reinsurance, their main partners being foreign reinsurance companies (over 95 percent of total reinsurance premiums). The solid financial position of these reinsurance companies add stability to the domestic insurance market, but massive amounts of funds have been transferred outside because the market development stage is not favourable to a strong reinsurance market in Romania.

Non-life insurance companies, the same as life insurance companies, increased their investments in equities, proceeded to a smooth decrease of real estate ratio in the overall portfolio and were affected by the contraction of government bond issue. Overall, the investment policies of life and non-life insurance companies sustain financial stability of the insurance market and are compliant with the regulations issued by the Insurance Supervisory Commission.

3.3.2. Non-Bank Financial Institutions

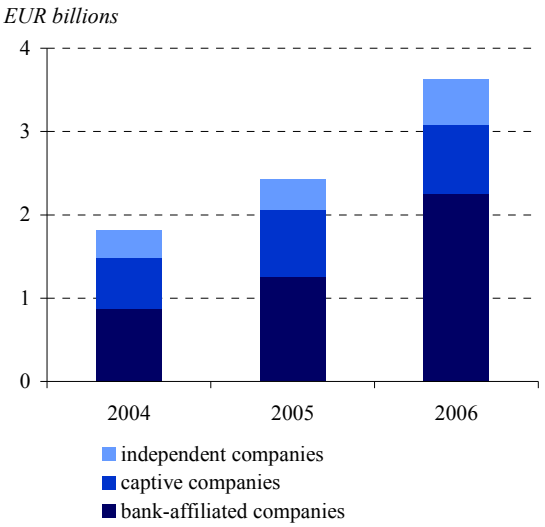
The risks generated by non-bank financial institutions (NBFI) overlap increasingly with the risks at the level of the banking sector. The rapid expansion of financing through leasing is partly due to the measures adopted by the NBR during the last two years in order to contain lending growth. Taking into account the banks' increasing ownership in this sector and the usually high leverage on these companies' balance sheets, their potential buffer function is significantly reduced in case of a reversal in the credit cycle.

Table 3.3.1 – Structure of NBFI by activity, measured as a share in total NBFI credit (2005)

Financial leasing companies	83.67
Consumer credit companies	11.91
Guarantee issuing companies	2.02
Mortgage companies	1.13
Microcrediting companies	0.54
Factoring and discount companies	0.38
Other types of financing companies	0.27
Commercial financing companies	0.05

Source: NBR

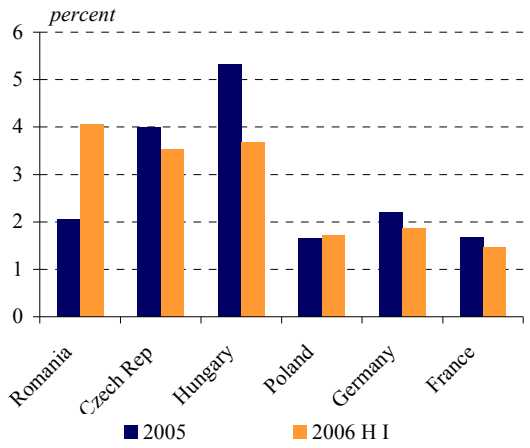
Chart 3.3.9 – Total volume of outstanding leasing contracts



Source: BLA, LCAR, NBR

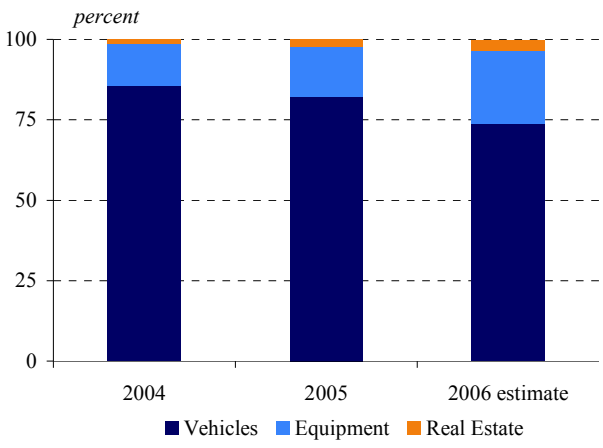
Leasing companies stand out among the other NBFI as a significant contributor to the growth of non-government credit in 2006, being followed at a distance by consumer credit companies. The concentration level is relatively high (10 percent of the total number of NBFI accounted in 2005 for approximately 80 percent of total assets) and rising, mostly due to the increasing market share of a small number of bank-affiliated NBFIs.

Chart 3.3.10 – Share of new leasing contracts in GDP



Source : Leaseurope, BLA, LCAR

Chart 3.3.11 – Structure of leasing contracts by the goods financed



Source : Leaseurope, BLA, LCAR

During the first semester of 2006, the share of new leasing contracts in GDP doubled compared to the previous year, surpassing by far the dynamics of all countries in the region. As to the destination of the goods financed through leasing, the dominant category of vehicles lost some ground in favour of equipment and real estate together with which it accounted for 26 percent of total leasing contracts, a development which points to a certain saturation on the motorcar segment

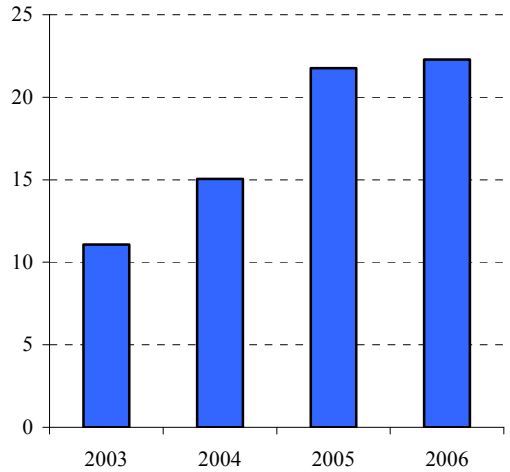
and to the maturation of the market. Considering only the bank-affiliated leasing companies, mention should be made that the two categories account for 36 percent.

A specific feature of the leasing activity undertaken by bank-affiliated companies is that they use mainly sources of financing in the local currency, while almost all the leasing contracts are expressed in euro. The parent bank, owning generally resources in foreign currency, provides financing in *lei* to the subordinated company, while previously buying *lei* from the local market, possibly from the aforementioned subordinated company. The latter uses the foreign currency to purchase the leased goods. Mention should be made that at least 65-70 percent of these goods are imported. The lessee pays the EUR-denominated instalments in local currency carrying the currency risk (plus other specific costs related to the leasing contract). The leasing company services the credit in local currency to the parent bank, barring the interest rate differential (receives a EUR-denominated interest rate, pays a RON-denominated interest rate).

Thus, the restrictions on EUR-denominated credit are eluded, the parent bank being the *de facto* creditor in euro. The costs generated by the RON-EUR interest rate differential at the level of leasing company are tolerated as they cancel out at consolidated level.

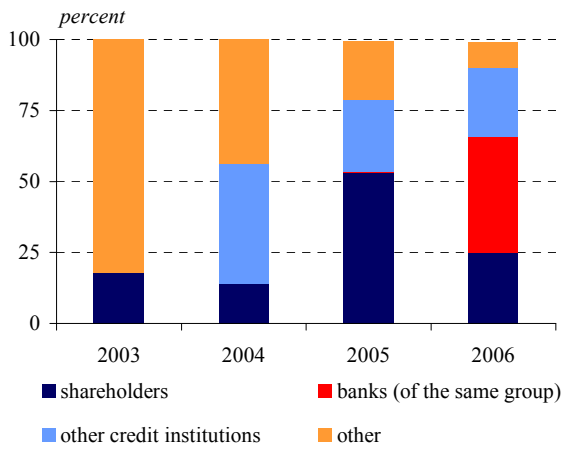
There is evidence supporting the presence of such scenario in 2005-2006: (1) the share of financing sources in local currency from the banking system and from the parent bank increased to 73 percent in 2006 from 46 percent in 2005; (2) the profitability of affiliated leasing companies was in 2005 below the average for the leasing sector, contrary to expectations that they would benefit form much easier access to financing; (3) the growth rate of leasing contracts surpassed the credit growth in the banking sector in 2006; (4) the presence of a strong leverage on leasing companies' balance sheets, especially during the last two years, hinting at the step-up in RON-denominated loans to subordinated units.

Chart 3.3.12 – Leverage effect (total borrowed funds/own capital)



Source : BLA

Chart 3.3.13 – Structure of borrowed funds of affiliated leasing companies



Source : BLA

Given the removal in 2006 of restrictions on foreign currency lending, the application of prudential regulations imposed by the NBR to non-bank financial institutions as well, and the perspectives of consolidated supervision, it is expected that the tendencies described above will diminish in the future. The risky structure of the affiliated leasing companies' balance sheets makes the assessment

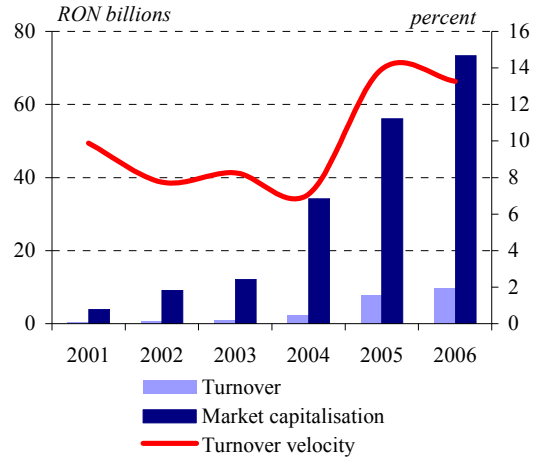
of the default risk impossible, if they are treated individually. Assuming a plausible default rate of more than 5 percent (with an implicit 0 recovery rate – obviously less plausible especially for the leasing activity), at an average industry leverage of 20, the industry would become insolvent. However, taking into account that more than 80 percent of the shareholders are represented by banks and that leasing assets have a small share in the overall banking assets, the default risk of the leasing companies is substituted by that of the parent bank

3.4. Capital markets

The year 2006 witnessed a continuation of the positive process of convergence of the Romanian capital market to the other European capital markets in terms of both market indicators and market infrastructure. The capital market benefited from harmonized regulations to best standards and practices, that stimulated its growth. Nevertheless, it was the same convergence process that amplified a number of vulnerabilities related to higher sensitivity to external shocks and a slowdown in growth in comparable terms. Corporate bonds primary market (measured as total value of issues) increased significantly: the sustainability of such dynamics in the future remains to be tested. Government securities market was flat in 2006, but perspectives for 2007 are encouraging.

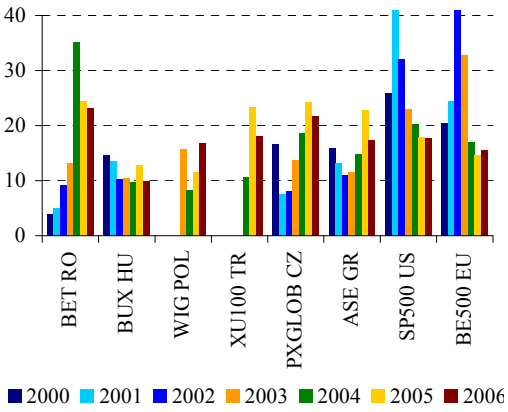
The Bucharest Stock Exchange index (BET) increased by 22.23 percent in 2006, while market liquidity – measured as turnover velocity (yearly turnover/market capitalization) – slightly decreased compared to the previous year to 13 percent. According to the Federation of European Stock Exchanges (FESE) Romania ranked tenth out of the 22 countries represented in terms of index growth, after Spain, Norway, Sweden, Austria, but ahead of Hungary or the Czech Republic.

Chart 3.4.1 – Yearly turnover and market capitalisation



Source: BSE

Chart 3.4.2 – Evolution of average yearly P/E ratios 2000-2006



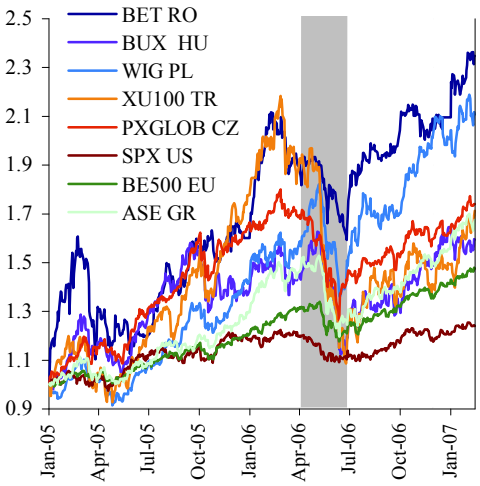
Source: Bloomberg, BSE

The weaker performance of the stock exchanges in the CEECs was due to the global correction that took place between April-June 2006 (Chart 3.4.3), generated by the increasing uncertainties linked to interest rate in the US, the rise in inflationary pressures, depreciation of the US dollar, the price hikes on commodity markets and fears that the positive results at corporate level would not be sustainable.

If these factors of investor sentiment had a direct impact on developed markets, what happened on emerging markets, and especially in CEECs, was largely determined by marking profits and portfolio readjustments by international investors. There are several reasons supporting the idea of a non-discriminative capital flight from the emerging markets: (1) there were no economic fundamentals to trigger such corrections, (2) the stock prices of listed companies had the tendency of falling altogether irrespective of the companies' profile or performance, (3) in the second semester of 2006, quotations on all analyzed exchanges reversed their trend.

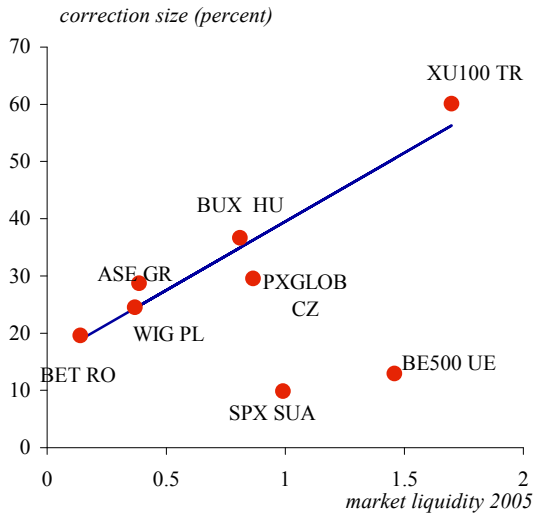
Chart 3.4.4[33] suggests a similar behaviour of investors towards this region by showing a linear relationship between the liquidity level on those markets and the magnitude of corrections. The explanation could be: (1) initial shocks generated by capital outflows, which were proportional to the size of the markets or the presence of foreign investors, followed by local reactions amplified by the liquidity levels probably stemming from the presence of leverage on each of these markets, which was boosted by leverage; and (2) the pure contagion effect among regional markets. It could be asserted that economic factors may have fuelled the reactions in the case of Hungary and Turkey, but these markets are at the same time among the most liquid ones, and the role of fundamentals is inconclusive. The same Chart shows the advantage of the developed markets where in spite of the relatively high level of liquidity the corrections were significantly smaller.

Chart 3.4.3 – Developments in market indices (reference date: January 2005)



Source: Bloomberg

Chart 3.4.4 – Correction levels in relation to market liquidity



Source: Bloomberg, BSE, *World Federation of Exchanges,* FESE

The advantage suggested by the lack of liquidity on the market can turn into a risk, as the local stocks remained relatively expensive in 2006 from the point of view of P/E ratio (Chart 3.4.2[34])

Given the lack of a rebound in listed companies' financial results and/or the fact that other more attractive companies were not admitted to quotation, there is an increased risk of corrections on the local market.

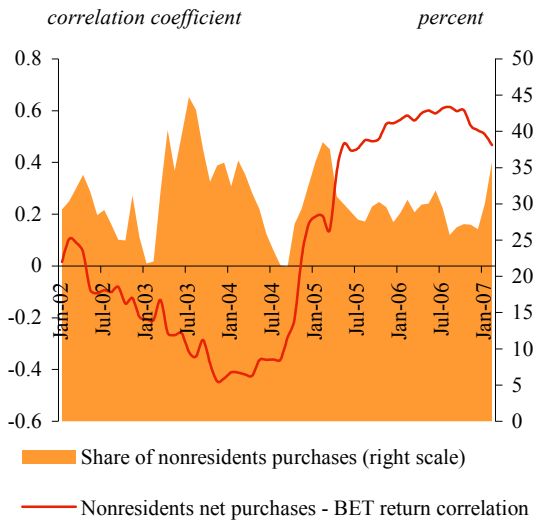
[33] 0x represents market liquidity measured before the events of May 2006 and 0y shows the percentage points decline in the indices over the period highlighted in Chart 3.4.3.

[34] The Chart depicts P/E ratios of the indices and not of the overall markets.

Total market capitalization reached RON 86.4 billion, up 39.8 percent from 2005, while the turnover of RON 9.7 billion increased by over 30 percent. Some 70 percent of the liquidity on Bucharest Stock Exchange is generated by residents (Chart 3.4.5), who tend to reduce their positions on the market, taking into account the rising trend of positive net purchases of nonresidents. Despite the fact that nonresidents have a lower presence on the market, the impact of their decisions grew significantly during the last two years. The level of correlation between the monthly returns of the market index and the share of monthly net purchases by nonresidents in total transactions is positive and high, suggesting that net purchases of nonresidents generate market growth, while the residents have the position of market followers, marking their profits, at the expense of losing market share. Specifically, if in 2005 resident institutional investors (legal persons) had been net buyers, with retail residents being net sellers (natural persons) to a larger extent and counterbalancing the overall effect, in 2006 both categories disinvested in front of nonresidents (natural persons). The tendency of retail investors' disinvestment is a common feature for all European capital markets, with the exception of Poland and Italy.

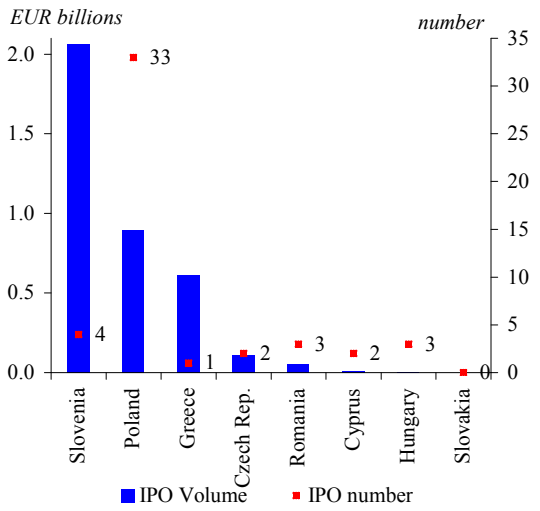
The Romanian primary stock market had a median positioning in the region in 2006, from the point of view of IPO value of EUR 54 million, well ahead of the Hungarian and Slovakian stock exchanges (Chart 3.4.6). A particular case is that of Poland, where the 33 successful IPOs raised over EUR 800 million. There is an increasing imbalance at the level of the Romanian market between the supply of and demand for traded securities, as reflected by the increasingly oversubscribed IPOs.

Chart 3.4.5 – Impact of nonresidents' trading on the market index (BET)



Source: BSE, NBR

Chart 3.4.6 – Total number and volume of IPOs (2006)

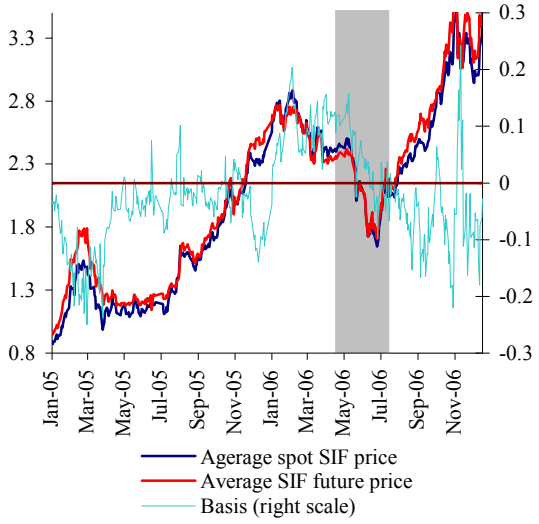


Source: FESE, NSC

Developments on the **Sibiu Monetary, Financial and Commodities Exchange** show an upsurge in financial futures trading (9 times higher than in 2005), mainly on the back of the most liquid closed-end funds (SIF), accounting for 86 percent of the total contracts and hold the most liquid shares quoted on the Bucharest Stock Exchange. Futures contracts have witnessed a growth in terms of trading volumes and the number of open positions. Some 4,232,059 futures contracts were concluded in 2006, as the Sibiu Exchange is nearing the performance of its Polish peer. Chart 3.4.7

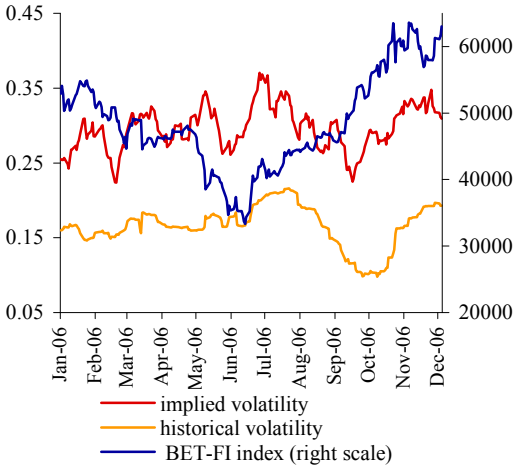
shows a close to zero spot-futures basis[35] during the last semester of 2005 and positive values in the first half of 2006. This basis occurred against the backdrop of a 9-10 times rise in the number of open futures positions (year on year) and reflected fears of local corrections on the spot market. It was for the first time in the last two years that the need to hedge long positions on the spot market proved costly to investors. There was also a significantly higher volatility of the basis during 2006[36]. However, during the international market events that triggered the corrections on CEE markets, futures prices that were already in contango in April started reversing their position relative to spot prices, somehow suggesting that market players considered the international correction to be a short-lived one.

Chart 3.4.7 – Developments in spot and futures prices of SIFs



Source: NSC, NBR calculations

Chart 3.4.8 – Historical and implied volatility of SIF prices in 2006



Source: NSC, NBR calculations

Implied volatility, i.e. the indicator quantifying the risks expected by investors, was on a slight uptrend in 2006, reaching maximum values during the periods of international corrections in spot markets. It should be noted (Chart 3.4.8) the high and steady difference between implied and historical volatility, which is indicative of high hedging costs for option buyers. The main explanation would be that players shorting options have a privileged position in the market, being able to extract rents from the majority of risk-averse participants that cover their long positions in the spot market. The bulk of the contracts were written on futures of banking institutions and mostly on the SIFs, the latter being also the most liquid on both the spot and futures market. There was a spike in the volume of traded options in the last quarter of 2006 (almost 9,000 contracts in December), bringing the total number of options traded to 36,651, i.e. a 200 percent average increase against 2005. Nevertheless, option trading on the Sibiu Exchange still lags behind other derivatives markets in the region.

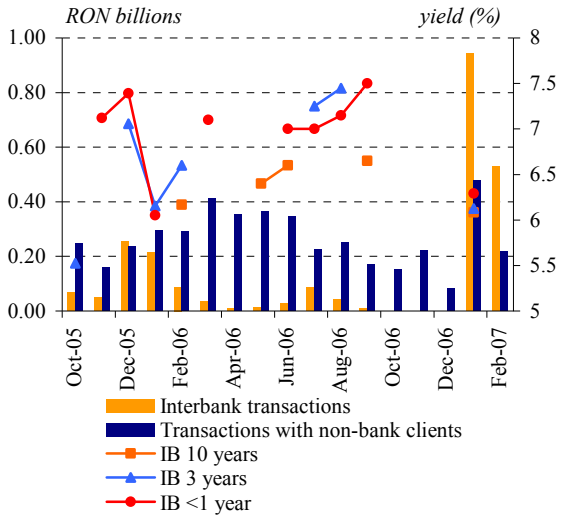
[35] The basis is computed as the difference between spot and 3-month futures prices, computed as weighted averages of trades on the three underlying stocks SIF2, SIF3 and SIF5. The futures price was discounted with the 3-month money market (BUBOR) rate. The series are representative for the futures market, as they accounted for 86 percent of the total futures position in 2006.

[36] The distribution of the basis remains significantly flatter than on other markets in the region. Compared to basis distributions on the market index futures on Polish, Czech or Austrian markets, the standard deviation is 1.8, 2 and 2.5 larger, respectively, hinting at higher arbitrage opportunities.

The government securities market was characterized by the lack of issues during 2006 and the tight monetary policy. Under these circumstances, the benchmark function of these instruments is difficult to achieve. However, the outlook for 2007 is encouraging, as the new issues at the beginning of the year look set to boost trading on the secondary market. During the period under review, yields were responsive to monetary policy measures at the shorter end of the maturity spectrum, while developments at the longer end were mainly determined by unaccommodated demand and disinflationary expectations, thus causing the flattening and even the reversal of the yield curve. Potential risks that could arise with the increase in the size of the market are increasing speculative capital inflows (carry trades).

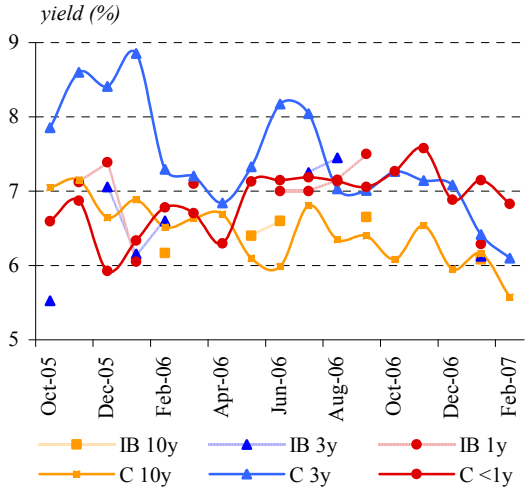
Activity on the government securities market in 2006 was the lowest in recent years, due mainly to the lack of any issue on the primary market. Chart 3.4.9 details the volume of spot transactions (for RON-denominated securities) on the secondary market in interbank trades and the ones between commercial banks and their non-bank clients. The former category was significantly smaller, with less than 200 transactions during October 2005 - February 2007, amounting to a total of RON 1.6 0billion. A second factor contributing to the decline of liquidity on the market was the tightening of monetary policy, which caused higher yields on security trades across the maturity spectrum on the interbank market. Amid a looser monetary policy, the new treasury issues in January 2007 were easily absorbed by the market, bringing down yields, which converged to 6 percent.

Chart 3.4.9 – Turnover on the government securities market and the evolution of yields by maturity



Source: NBR

Chart 3.4.10 – Average yield dynamics by maturity (interbank – IB, with non-banking clients – C)



Source: NBR

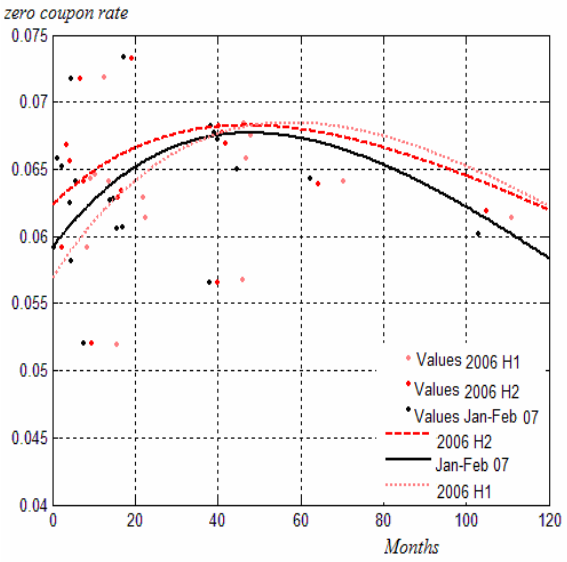
Yield dynamics suggest mainly the high level of volatility generated by low liquidity. Despite expectations that yields on the interbank market would be systematically higher than those on client transactions, they were actually lower, especially in the first half of 2006 for treasuries and medium term bonds. Apparently, banks were involved in these trades only as a last resort, at higher costs.

There are several conclusions that can be drawn from the dynamics of these transactions: Chart 3.4.10 shows a clear tendency of decreasing average yields on government bonds (with maturities above 3 years). This is caused by expectations that interest rates will decrease due to stronger disinflation, particularly in 2006 Q4 and in early 2007, but also due to higher demand for

government bonds with longer maturities. The convergence of yields on 3-year bonds towards the long-term ones denotes increasing optimism related to the disinflation process. The temporary departure from this trend during the summer of 2006 could have also been generated by international events on the capital markets. On the short term (less than one year) yields stayed high in the second semester and decreased significantly with the new issues in 2007, especially on the interbank market.

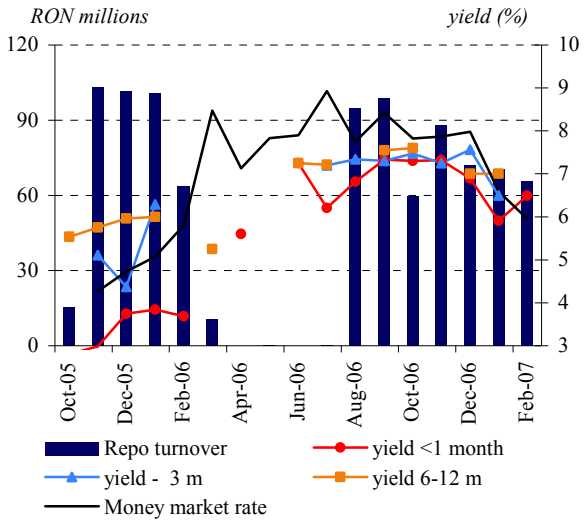
Chart 3.4.11 describes an implied zero coupon curve for the two semesters of 2006 and the first two months of 2007. The large deviations of actual values from the estimated curves are caused by major price differences especially for securities with shorter maturity and the wide time span considered (due to low liquidity). The curves are hump shaped, with maximum zero coupon rates at the 3-5 year maturity. Possible explanations lie with: (1) investor preference for long term securities, given the scant supply and uncertainty of future liquidity levels over the short and medium term; (2) stronger expectations of decreasing interest rates in the long run than over the medium term; (3) the curve may even be uninformative (horizontal), with the current effect generated exclusively by the illiquid nature of the market.

Chart 3.4.11 – Implied zero-coupon[37] rates for government securities



Source : NBR

Chart 3.4.12 – Repo contract turnover and yields (turnover – left scale, yields – right scale)



Source : NBR

In terms of dynamics, implied zero coupon rates increased towards end-2006, influenced by monetary policy measures, but decreased significantly amid the new issues in 2007, indicating a demand outpacing by far even this level of supply. Long term rates decreased over the entire period.

Repo transactions (Chart 3.4.12) are nonexistent on the interbank market, but are present in transactions with non-bank clients. Of these, 90 percent have maturities below 6 months and more that half are under 30 days. This market followed closely money market rates throughout the year, with a clear tendency of narrowing the spread across the maturity spectrum.

[37] Estimated curves are exponential functions of the type: a*exp(b*x)+c*exp(d*x). Only interbank trades are included and the observations are weighted by trade volumes.

A revival of the government bond and treasuries market is expected for the period ahead, given that, out of the RON 8 billion in government issues scheduled for 2007, RON 6 billion have already been raised in the first quarter and the Ministry of Finance has already announced that the issues would be supplemented by another RON 4 billion. Government bonds accounted for more than a third of the new issues.

Corporate bonds witnessed a spectacular growth in 2006, mainly on account of the two issues at fixed rate by Banca Comercială Română (BCR) and the IBRD. While the cumulative value of corporate and municipal bonds for the five years before 2006 was EUR 145 million, the 2006 issues alone totalled EUR 246 million. However, the nature of corporate issues remains undiversified and non-representative of the economy, as only one out of the 6 issues belonged to a non-financial corporation, accounting for less than 1 percent of the total value of issues.

CHAPTER 4. DOMESTIC MACROECONOMIC RISKS

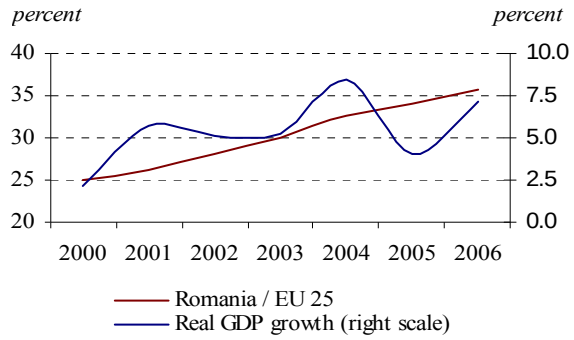
Economic growth and the process of disinflation continued, providing an underpinning to financial stability. The external balance requires, however, close monitoring. Current account deficit increased, while foreign direct investment accounted for a large share of its financing. Short term external debt doubled in 2006. Concentration in the non-bank sector is high and rising.

4.1. The real sector

Romania registered in 2006 the seventh year in a row of economic growth, coupled with a declining inflation rate. Moody's and Fitch raised Romania's rating to Baa3 and BBB, respectively. The main risks to financial stability arising from the real sector may stem from two sources – a structural and an incidental one: (A) the widening of nominal and real convergence gap, doubled by uncertainties regarding economic growth pattern and (B) the contingency of avian flu episodes becoming a pandemic.

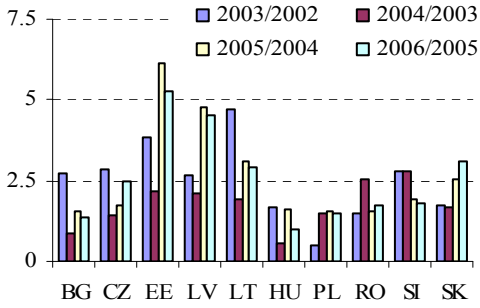
(A) GDP per capita increased compared with EU-25 levels (Chart 4.1.1), but the catching-up pace remained low relative to the EU-8 (Chart 4.1.2). Romania registered one of the highest economic growth rates in recent years. Only Bulgaria, Poland and Hungary had lower catching-up rates in 2006.

Chart 4.1.1 – GDP/capita (PPS) compared with EU-25 and real economic growth



Source: Eurostat, NBR

Chart 4.1.2 – Catching up rate GDP/capita (PPS) compared with EU-15 (percentage differences)



Source: Eurostat

The labour market – essential in correlating the real and nominal convergence – still has rigidities. Workforce migration and the increase in employment rate (reaching 60.9 percent, the highest level since 1997) generate wage pressures. Companies in the real sector are capable of absorbing a labour cost shock (Section 5.1), but effects on convergence are mixed.

The main driver of economic growth remained capital accumulation. R&D expenditure as a percentage of GDP stood below EU rates, while the share of intangible assets in total assets of non-financial companies declined from 5.1 percent in 2005 to 4.7 percent in June 2006. Investments made by technology intensive sectors in intangible assets accounted for only 0.3 percent of gross added value (June 2006). Technology intensive services sector made up 5.5 percent of gross value added, while technology intensive manufacturing sectors held 4.8 percent of gross value added and 25.2 percent of exports (June 2006).

(B) Romania experienced **two avian flu episodes**, one at the end of 2005, and the other in May-June 2006. The second episode was characterized by H5N1 virus being identified in poultry farms. The impact on companies was stronger, through both demand and supply channels (consumer perceptions and increased costs, respectively). Avian flu episodes did not affect the financial stability (Box 2).

Box 2: Implications of avian flu episodes on financial stability in Romania

The poultry sector does not have systemic importance in Romania. It comprises 309 active companies and employs 13,608 staff (0.32 percent of total economy). The sector has a turnover of RON 0.7 billion (0.26 percent of total economy) and attracts 0.66 percent of total domestic bank loans (June 2006).

Chart 1. Turnover and profit dynamics

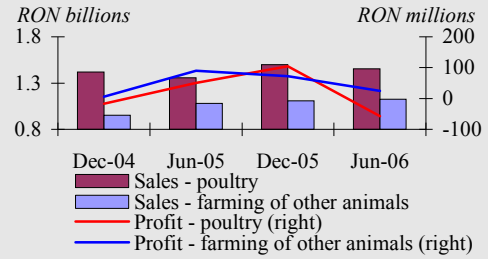


Chart 2. Bank loans and bank loan overdue payments

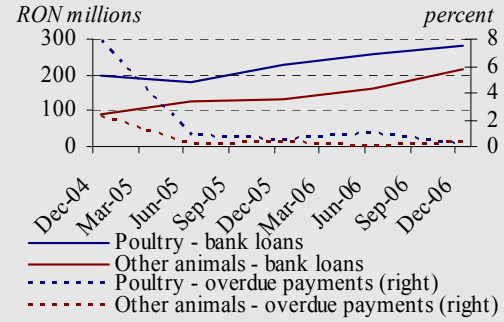
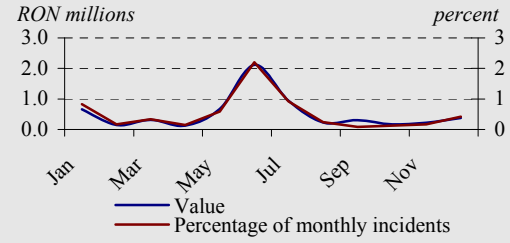


Chart 3. Payment incidents in 2006



Source: MPF, NBR

Sales of the poultry sector were relatively constant (Chart 1), even during the avian flu episodes. The sector's profit had a positive trend in 2004-2005, but deteriorated in the first half of 2006, when the sector registered net loss. Companies operating in farming of animals sectors, other than poultry, reported a slight increase in turnover, while profits remained positive.

The poultry sector is more indebted than sectors farming other animals (Chart 2). Although the sector's profitability is declining, the share of overdue bank payments in total loans is below average (0.92 percent compared with 1.12 percent at December 2006). During avian flu episodes, overdue bank payments registered a hike, which casts doubts about the poultry sector's ability to repay debt in the event of further episodes.

The number of payment incidents doubled during the avian flu episodes that affected poultry farms (Chart 3). The volume of payment incidents increased over 500 percent, but only accounted for 2.2 percent of total payment incidents in June 2006 (the period with the most severe avian flu episode). The majority of the amount was generated by three companies. The two companies where the H5N1 virus was found either generated payment incidents or registered overdue payments to banks.

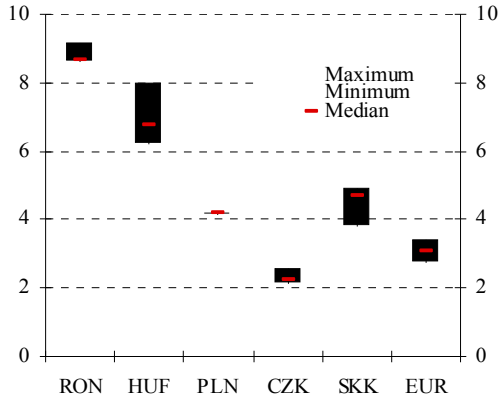
In the case of an **avian flu pandemic**, a loss of EUR 27 million (0.028 percent of GDP) and an increase from 0.59 percent to 1.26 percent in overdue bank payments is estimated at national level. Such developments would not affect the financial stability.

4.2. Economic policies

4.2.1. Price stability and financial stability

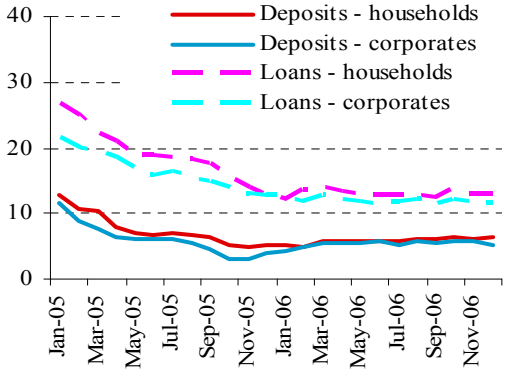
The disinflation process continued in 2006. The implementation of monetary policy decisions has been facilitated by a robust, well performing financial system. Volatility of consumer price and producer price indices fell to the levels of end-2004. Factors such as lower uncertainty regarding the future price movements and a smaller gap between actual and target inflation rates pave the way for a more stable economic environment benefiting financial development.

Chart 4.2.1 – 3-month interest rates in the interbank market in 2006 (percent)



Source: Bloomberg, NBR

Chart 4.2.2 – Nominal interest rates on new deposits and loans denominated in RON (percent)



Source: NBR

In 2006, the developments on the money market did not impair the financial stability. The periods of global financial market downturn did not have a significant impact on the liquidity of the domestic money market[38]. The volatility of interbank interest rates was higher than those seen in Poland or the Czech Republic (Chart 4.2.1), but did not affect the lending process to the real sector (Chart 4.2.2). The most volatile interest rates were those on loans with 3- and 6-month tenures, but these were also less frequently used maturities (less than 1 percent of the total amount of new loans).

4.2.2. Implications of exchange rate developments on financial stability

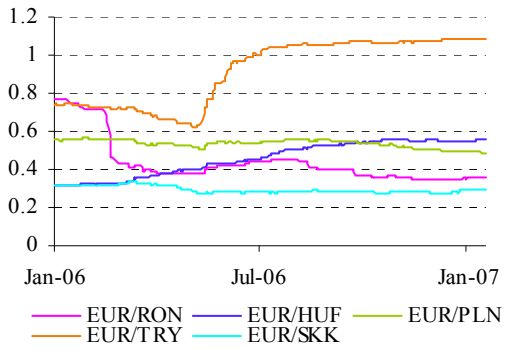
The developments of the exchange rate of the domestic currency and the characteristics of the FX market did not pose major risks to financial stability in 2006. The necessity of monitoring these two factors is important because: (A) the exchange rate movements (in terms of magnitude and volatility) can impair the macroeconomic equilibrium and the ability of domestic agents to service the foreign exchange denominated debt, and (B) the FX market characteristics (such as depth, liquidity, integration) determine the way the shock is channelled to the financial and real sectors.

(A) The domestic currency **appreciated** in 2006 by over 8 percent, more than the majority of the currencies of CEECs. The exchange rate **volatility** was smaller than in 2005 and at similar levels of CEECs currencies (Chart 4.2.3). The probability of a currency crisis[39] is below the signalling

[38] Banks resorted to the credit facility twice, but the volumes were not significant: 3 percent in February and 0.3 percent in June (of interbank transactions volume). Only the last one can be linked to the events from the international markets.

[39] Estimates based on a model developed by the Financial Stability Department.

Chart 4.2.3 – Exchange rate volatility
(12-month moving average, percent)

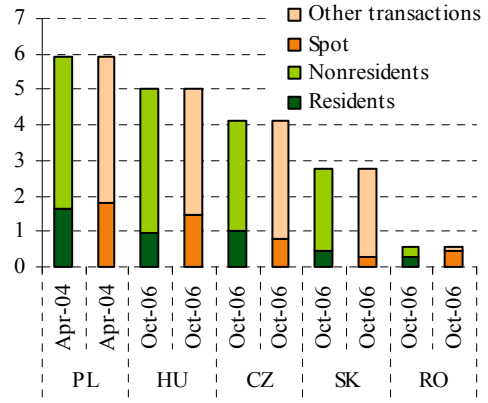


Source: Reuters, NBR

threshold, but slightly higher than it was at the date of the previous *Report*. The main factors that contributed to the worsening of this indicator were (i) the developments of short-term debt and (ii) the current account deficit as percentage of GDP.

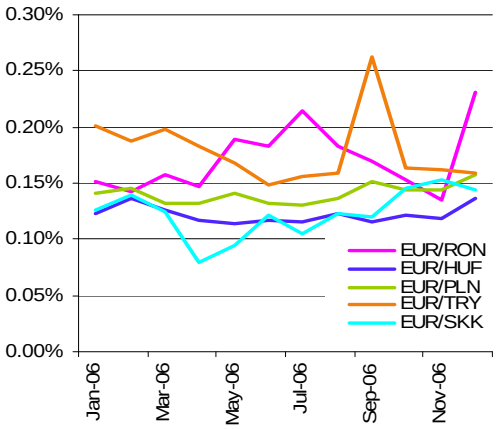
(B) The domestic FX market activity in Romania grew from the previous *Report*, but still lags behind the other CEECs in terms of both depth and structure (Chart 4.2.4). The bid-ask spread was at a level comparable to that of CEECs in the first half of 2006 (Chart 4.2.5), but higher in the first months of 2007.

Chart 4.2.4 – FX market structure
(average daily volume, RON bln.)[40]



Source: central bank sites

Chart 4.2.5 – Relative spread on some CEECs
markets (monthly average)



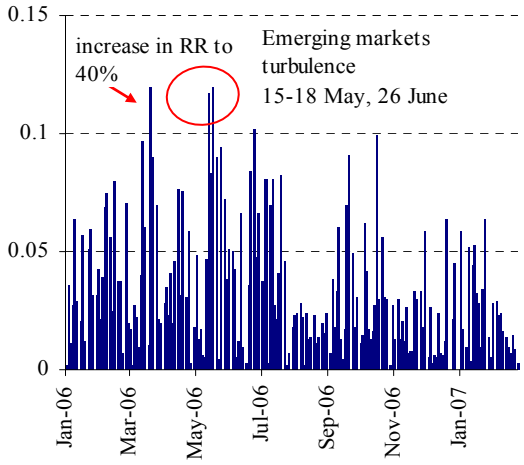
Source: Reuters, NBR

Nonresidents contributed significantly to market development, especially on the speculative transactions segment. The volume of average daily transactions performed by nonresidents grew almost 4 times in 2006 compared to 2005, exceeding that of residents (clients or domestic banks). This evolution was due to the high returns on RON-denominated assets in the context of capital account liberalization, of joining the EU, and of the favourable conditions on the international financial markets.

The net short positions of nonresidents were below EUR 0.3 billion, significantly lower than the 2005 level. Nonresidents were almost constantly on net long positions on RON in 2006. The only months with short positions were May and June 2006, similar to the other EM. The Romanian FX market integration and therefore the risk of contagion grew throughout 2006.

[40] For the Czech Republic, "residents" item includes all the clients (accounting for only 10 percent of the total).

Chart 4.2.6 – Illiquidity index



Source: Reuters, NBR

The average daily volume exceeded the level of EUR 0.9 billion, but the bulk of the transactions were spot. The slow development of derivative products allowed only small currency fluctuations on the domestic FX market. The number of forward and swap contracts is on the rise.

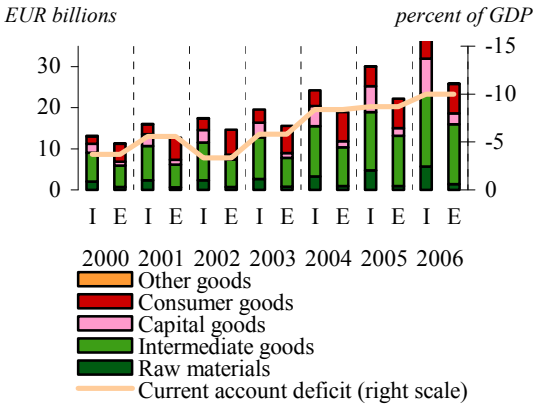
The impact of transaction volume on the currency movements shows a low level of liquidity in May-June (Chart 4.2.6), in the context of the market sentiment change regarding the EM.

4.3. External balance

4.3.1. Current account balancing perspectives

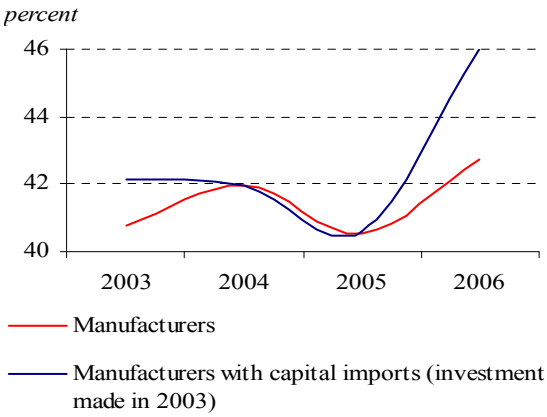
Current account deficit increased by 44.8 percent in 2006 and the trend continued in the first months of 2007. There are some perspectives the situation could improve in the medium and long run. Capital goods accounted for 23 percent of imports and registered the highest dynamics. Over the past years, consumer goods held a constant share of imports of about 15 percent. On the export side, the share of intermediate goods increased from 47 to 57 percent over the period 2000-2006 (Chart 4.3.1).

Chart 4.3.1. Trade balance trends and structure



Source: NIS, NBR

Chart 4.3.2. Export share in total sales across manufacturing



Source: MPF, NBR

Approximately 60 percent of capital goods direct imports were made by companies in the tradable goods sector. Manufacturers that import capital goods for investment purposes sell an increasing share of their output on external markets. The share of exports in total sales increased from 42 percent

to 46 percent over the last 3 years (Chart 4.3.2). Their overall performance is superior to the sector they are part of.

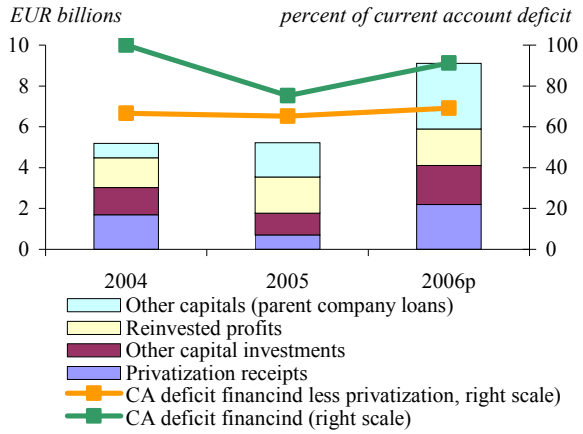
On the other side, active processing companies, although systemically important to the external sector (24 percent of exports) have a diminishing contribution to the current account deficit reduction. The explanation resides in the negative dynamics of net exports over the past two years (23.1 percent in 2005 and 9.6 percent in the first half of 2006), compared with the rest of the economy, which registered increases.

4.3.2. Current account deficit financing

4.3.2.1. Foreign direct investment

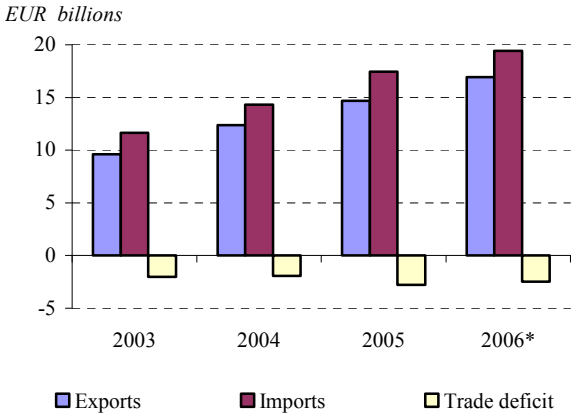
Foreign direct investment (FDI) exceeded EUR 9 billion in 2006, financing 86 percent of current account deficit. Excluding privatization receipts, FDI amount to 69 percent of current account deficit, slightly higher than in previous years (Chart 4.3.3).

Chart 4.3.3. FDI structure and current account deficit financing through FDI



Source: NBR

Chart 4.3.4. Export dynamics for FDI companies



*data for June 2006 were annualized
Source: MPF,NCA, NBR

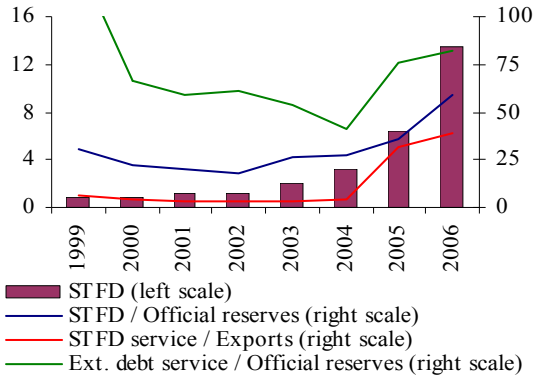
Capital inflows are likely to continue since the excess liquidity on international markets is expected to persist. Moreover, the performance of Romanian companies receiving FDI is satisfactory. These companies' performances are superior in terms of both profitability and productivity to the rest of the economy. Return on equity (ROE) registered a sustained growth from approximately 1 percent in 2003 (below the average economy-wide) to over 19 percent in 2006. Wage-related productivity of FDI recipient companies is constantly increasing, on average, at a pace faster than the rest of the economy. However, coherent macroeconomic policies need to continue in order for the above favourable results to carry on.

Companies receiving FDI generated a decreasing share of the trade deficit. Their turnover increased (in real terms) especially on external markets (from 20.8 percent in 2003 to 25 percent of total turnover in June 2006). FDI recipient companies further held a constant share in exports (around 67 percent). The trade deficit generated by companies receiving FDI remained flat in nominal terms (approximately RON 11 billion), while the national deficit increased (Chart 4.3.4).

4.3.2.2. Short-term foreign debt

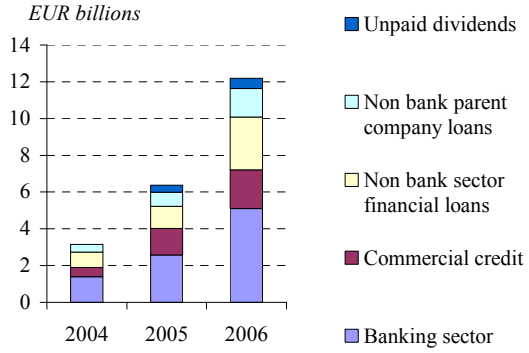
Short-term foreign debt (STFD) doubled in 2006, reaching EUR 13.4 billion (Chart 4.3.5). From a financial stability perspective, STFD needs close monitoring, since (A) its dynamics is much faster than that of other flows that may be used in emergency cases (exports or official reserves) and (B) STFD registered high concentration in the non-bank sector.

Chart 4.3.5. STFD dynamics



Source: NBR

Chart 4.3.6. STFD structure



Source: NBR

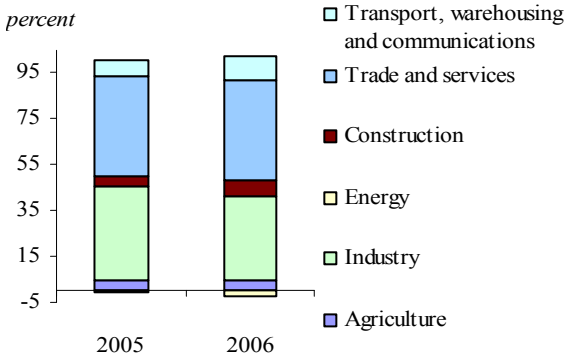
(A) STFD to official reserves ratio reached 60 percent. STFD service increased faster than exports. At the end of 2006, STFD reached 40 percent of export flows. Considering that a high percentage of exports is import dependent and that a significant share of official reserves is made up of banks' required reserves, special attention should be paid to STFD dynamics.

(B) In 2006, the rate of non-bank STFD growth equalled that of the banking sector. Out of the non-bank sector, financial loans and inter-company loans registered the highest dynamics (growing by 146 percent and 130 percent respectively in 2006, Chart 4.3.6).

STFD*[41] **concentration** increased among non-financial companies. The number of companies that generated net STFD* flows fell to 6,000 in 2006). The top-10 companies generated 49 percent of total net inflows, while top-20 companies accounted for 64 percent.

STFD* registers high concentration at sectoral level as well. The largest part of net inflows (44 percent) is generated by the services and trade sector, while industry is attracting 37 percent (Chart 4.3.7). The bulk of net flows was accounted for by five NACE divisions (Table 4.3.1). The Herfindhal index registered extreme values in the road transport and

Chart 4.3.7. STFD* structure at sectoral level (net flows)



Source: NBR

[41] Furthermore, the analysis will cover STFD in the form of financial loans and parent company loans (due to the lack of data availability at company level for commercial credit). This segment will be labelled STFD*. Share of commercial credit in STFD was 34 percent in December 2006.Concentration was calculated using Herfindahl index. It is the sum of squares of market shares for all companies in the market. Empirically, it is considered high concentration when the value of the index exceeds 1,800 – 2,000 (the index can take values between 0 and 10,000).

telecommunications sectors. High concentration levels can be noticed in wholesale trade sector as well, where the top-3 companies account for 93 percent of total net flows. Companies in the (i) real estate sector and (ii) road transport sector generated approximately 50 percent of total STFD*.

Table 4.3.1. STFD* structure and concentration (Herfindahl index), December 2006

Sector	NACE division	STFD percentage*	STFD concentration*
Real estate	70	28	207
Road transport means	34	20	6,014
Wholesale trade	51	12	3,493
Post and telecommunications	64	10	8,763
Construction	45	7	969
Other	-	23	734

Source: NBR

(i) *Real estate sector* further held a substantial share of total net short-term external flows (28 percent in 2005 and 2006). In the real estate sector, companies receiving STFD* financing account for an increasing share of total fixed assets (from 28 percent in June 2005 to 37 percent in June 2006). These companies have a significant foreign debt: short-term foreign debt is accompanied by significant medium- and long-term external exposure (27.5 percent of total financing sources). Liquidity improved, but remains below par, at 0.75 (June 2006). The high and rising percentage of real estate assets of companies with large foreign debt may generate adverse effects on the real estate market in the case of massive capital outflows or exchange rate shocks.

(ii) *Manufacturing industry* accounted for 37 percent of total net flows in 2006. Companies with STFD* have systemic importance, since they generate 37 percent of the sector's added value and attract 11.6 percent of domestic bank loans. Liquidity for these companies is below par; over 50 percent of STFD* is held by companies with higher short-term liabilities than current assets. This fact raises some questions regarding these companies' ability to manage a liquidity shock. The greatest risk in the manufacturing industry may come from the road transport means sector, since it generates 54 percent of the industry's STFD* and has a high degree of concentration (Table 4.3.1). However, the companies in the road transport means sector fared better in terms of (a) profitability (ROE: 17 percent compared with 9.7 percent), (b) cost efficiency (97.8 vs. 99.7 percent) and (c) interest coverage ratio (11 vs. 5).

CHAPTER 5. COMPANIES AND HOUSEHOLDS

5.1. Risks arising from non-financial companies (NFC)

Risks from NFC remained at a moderate level. Since the previous Report, the overall performance of NFC improved, consolidating the real sector's resilience to a systemic shock. Most likely, an exchange rate shock will have the strongest negative impact, as the NFC's foreign currency exposures are hedged naturally only to a small extent. Credit risk induced in the banking sector by NFC remains moderate. The financial deepening process improved, yet the payment discipline showed a mixed picture: (i) the arrears decreased, (ii) while payment incidents increased slightly.

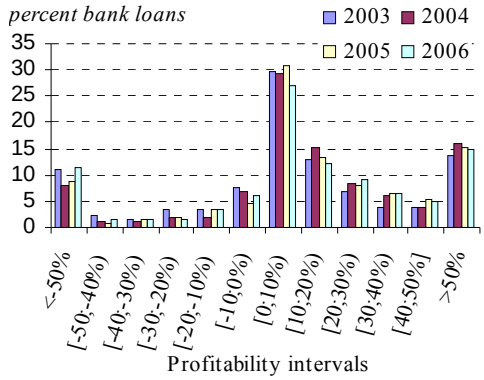
5.1.1. NFC[42] resilience to a systemic shock

5.1.1.1. Economic and financial performance

The profitability and liquidity of the NFC continued the positive trend from the previous Report, thus making the real sector more resilient to a systemic shock. Nevertheless, the efficiency of operating activity posted mixed developments.

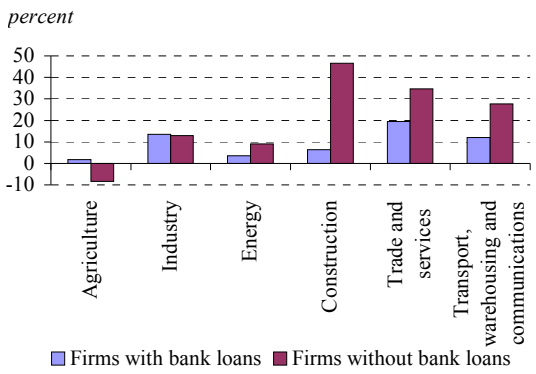
(A) Return on equity (ROE[43]) increased in overall terms from 13.4 percent in 2005 to 14.9 percent in 2006. The breakdown of ROE shows that it is concentrated in two profitability intervals (0 percent, 10 percent) and over 50 percent. The NFC's clustering in the latter interval can be attributed mainly to the low level of capitalization of small companies, which hold a large share of economic activity. Nonetheless, the share of NFC with positive profitability, which are financed by banks, declined from 79.2 percent in 2005 to 74.3 percent in 2006 (Chart 5.1.1).

Chart 5.1.1 – ROE for NFC with bank loans



Source: NBR, MPF

Chart 5.1.2 – ROE for NFC with bank loans vs NFC without bank loans



Source: NBR, MPF

At sectoral level, the companies producing non-tradables obtained the highest profitability, though this trend is slightly decreasing (Chart 5.1.2). The main determinant of ROE's growth in 2006 was the dynamics recorded in the tradable goods sector on the back of (i) increased asset turnover and (ii) efficient employment of resources.

[42] In Section 3.1, the term "companies" is used to refer to "non-financial companies". Financial ratios for 2006 that were computed based on the financial statements from the Ministry of Public Finance are available only for the first half of the year.

[43] ROE figures for 2006 H1 were annualized in order to be comparable with the previous years.

(B) Liquidity constraints decreased in 2006 as well. Current assets exceeded current liabilities by 7 percent at aggregate level. Quick ratio remains constant at 0.18, while cash balance holds 5 percent of total assets (Table 5.1.1), above the levels recorded by companies in the euro zone.

Table 5.1.1 – NFC asset structure (percent)

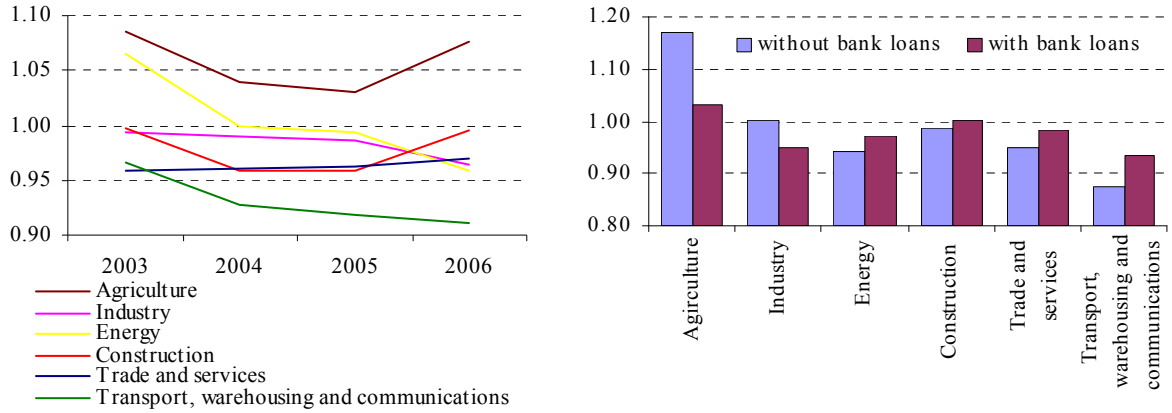
	2005		6/2006	
	a)	b)	a)	b)
Total assets (RON bln.)	**181.4**	**305.9**	**188.6**	**325.3**
Non-financial assets	*59.0*	*67.1*	*59.0*	*66.4*
Tangible assets	55.4	61.0	55.6	60.9
- Fixed assets	42.1	48.3	42.1	47.2
- Inventories	13.3	12.7	13.6	13.7
Intangible assets	3.5	6.1	3.3	5.5
Financial assets, of which	*41.0*	*32.9*	*41.0*	*33.6*
Cash and cash equivalents	10.0	5.1	10.0	4.9
Fixed financial assets	4.1	5.9	3.9	5.5
Account receivables	25.1	20.2	25.3	21.5

a) companies without domestic bank loans
b) companies with domestic bank loans
Source: NBR, MPF

(C) Efficiency of operating activity recorded mixed developments. It decreased in non-tradables sector while it improved in the manufacturing and energy sectors (Chart 5.1.3). The low operating margin associated with an increase in ROE can be explained by (i) higher asset utilization and (ii) the leverage effect[44].

(D) Companies with bank loans are less profitable and less efficient in resource allocation than companies without bank loans. The most prominent differences are in the non-tradables sector (Charts 5.1.2 and 5.1.3). These circumstances could favour the financial stability, because the potential customers for bank resources – companies without bank loans – seem to be less risky.

Chart 5.1.3 – Efficiency of operating activity (operating costs / net sales)



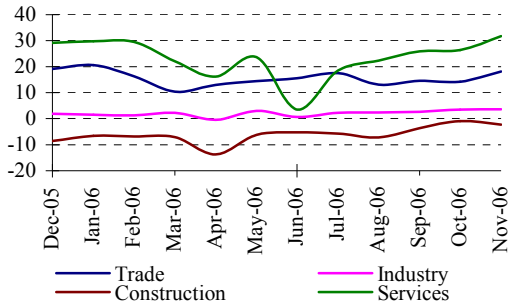
Source: NBR, MPF

(E) Economic sentiment indicator strengthened in the second half of 2006, especially in construction and services sectors (Chart 5.1.4). The financial statements of NFC at end-2006 are expected to confirm such developments.

(F) The number of newly established companies exceeds the number of bankruptcies, thus contributing to an increase in the total number of companies in the economy (as recorded by the Trade Register) (Chart 5.1.5). The actual number of companies is lower, because only 540,000 companies reported their financial situations to the MPF by the end of June 2006.

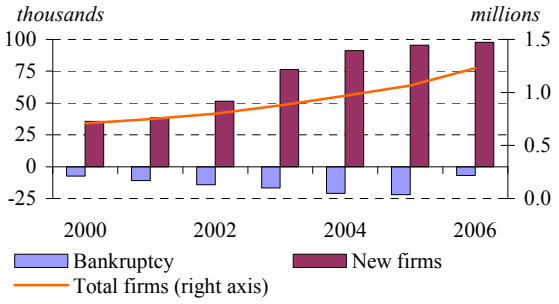
[44] DuPont method of computing ROE.

Chart 5.1.4 – Economic sentiment indicator development



Source: NIS, European Commission

Chart 5.1.5 – Dynamics of NFC



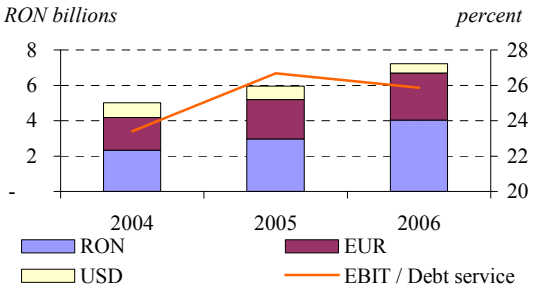
Source: National Trade Register Office, NBR

5.1.1.2. Bank debt servicing capacity

Credit risk induced in the banking sector by the NFC remains moderate. On the one hand, **(A)** debt servicing capacity diminished and (B) bank loans are more concentrated. On the other hand, (C) probability of default is decreasing and (D) creditors' perception of credit risk induced by NFC is positive.

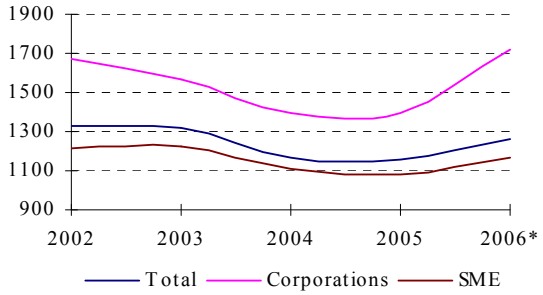
(A) Domestic debt servicing capacity decreased slightly in 2006, due to a higher growth rate of debt service than that of profitability[45] (EBIT) (Chart 5.1.6).

Chart 5.1.6 – Monthly debt service (left-hand scale) and the ability to service it (right-hand scale)



Source: NBR, MPF

Chart 5.1.7 – Concentration of bank loans to NFC as measured by Herfindahl index



* Data for October

Source: NBR

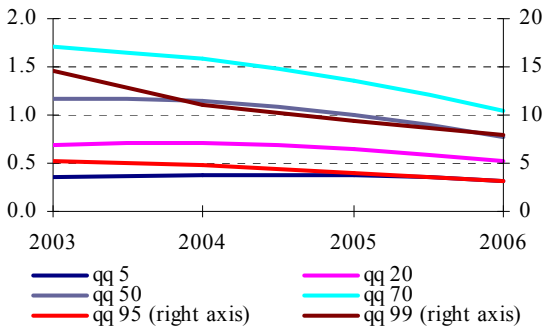
However, NFC have sufficient resources to pay their debts. Besides the significant cash resources that NFC hold, they also have access to RON 7.5 billion overdrafts representing 35 percent of total cash holdings (December 2006).

(B) Institutional concentration of NFC bank loans increased in 2006, but remained below the critical level. Bank loans are more concentrated in case of corporations relative to small- and medium-sized enterprises (SMEs) (Chart 5.1.7).

[45] Debt servicing capacity was evaluated using financial statements of NFC for the first half of 2006. As the financial position of NFC seems to have strengthened in the second half of 2006 (the economic sentiment indicator, Chart 5.1.4), debt service capacity might have also improved.

(C) The banking sector's perception of NFC debt servicing capacity improved. This is reflected by **the decrease of the risk premium**, especially for RON-denominated bank loans (from 560 to 260 basis points). This dynamics may also be the result of (i) heightened competition and (ii) increased importance of non-interest related income for banks.

Chart 5.1.8 – Probability of default quantile (qq) dynamics (percent)



Source: NBR, MPF

(D) Payment default risk decreased in the last years at all quantiles (Chart 5.1.8), as a result of the improvement in most determinants of default: (i) interest costs and bank arrears as a share of total bank loans decreased; (ii) return on assets, assets utilization and liquidity strengthened; (iii) domestic currency appreciated.

5.1.1.3. Shock transmission channels

An interest rate shock (domestic or external) may have a moderate impact on NFC. A foreign exchange shock may have a higher impact, because naturally hedged foreign exposures of NFC are low. On the costs side, shocks on staff and utility costs may have an adverse impact only on some sectors, but without generating systemic risks.

(A) Interest rate shock: NFC reverted to a slight net debtor position in 2006 (RON 3 billion). At sectoral level, companies operating in the energy, transport, communication and warehousing sectors remained net creditors. Most NFC do not have bank loans and have important cash holdings (10 percent of total assets), thus being in a position of net creditor to the economy[46]. An interest rate shock does not trigger adverse implications on these companies, but the large share of cash holdings questions their ability to efficiently manage such amounts of liquidity.

The exposure of NFC with bank loans to interest rate risk increased, but remained at a moderate level. Their net debtor position expanded (from 5.3 percent to 6.7 percent of total assets, December 2005 – June 2006). SMEs are the most exposed to interest rate risk, with a net debtor position of over 15 percent (as compared with SMEs in the eurozone having a net debtor position of 2-3 percent[47]).

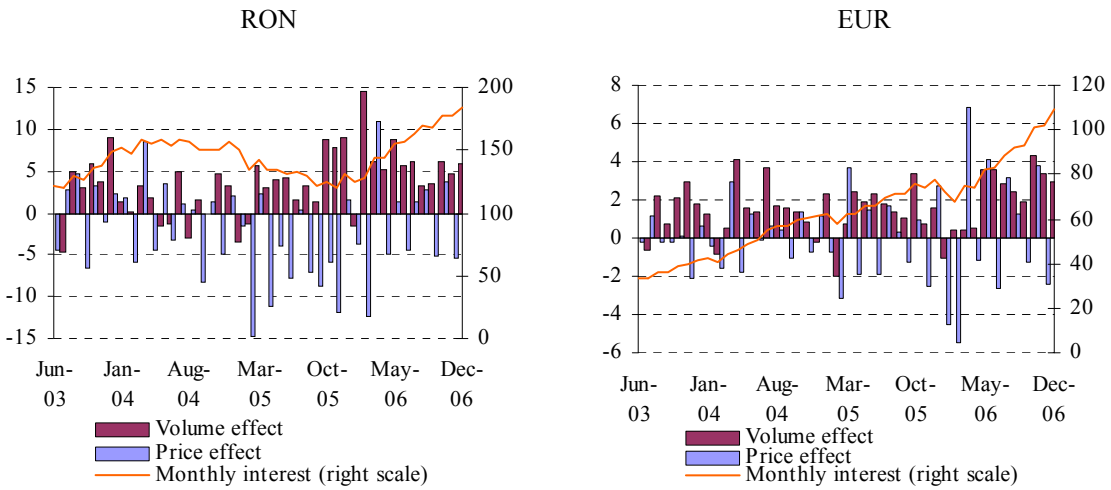
On the other hand, the share of interest costs decreased[48], which alleviates the negative impact of a potential interest rate shock. Interest costs increased significantly as a result of volume effect, while price effect had an opposite outcome (especially for RON-denominated bank loans) (Chart 5.1.9).

[46] These companies generate 43 percent of total gross value added and employ more than 50 percent of total workforce (June 2006).

[47] According to the European Committee of Central Balance Sheet Data Offices, 2007.

[48] Interest rate as a percentage of operating result is 21.5 percent, while as a percentage of operating costs is 1.27 percent - June 2006.

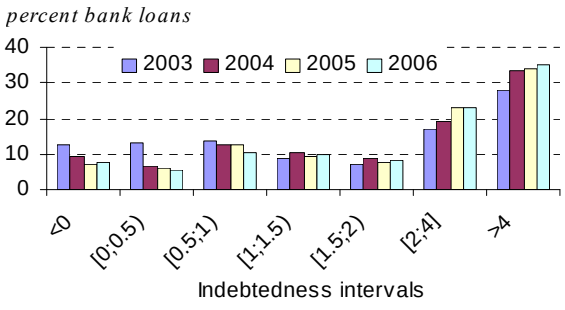
Chart 5.1.9 – NFC real interest costs (mill.)



Source: NBR

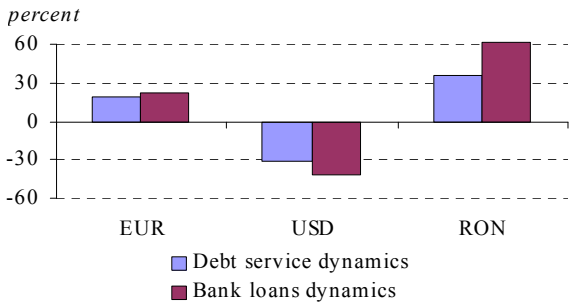
As companies get more indebted especially on the short term, the impact of an interest rate shock affects debtors more severely and rapidly. In Romania, both indicators evolved in this direction in 2006. Thus, the leverage effect increased from 1.67 (2005) to 1.71 (2006), the short-term debt representing over 66 percent of total debt. Companies with bank loans are less indebted than the rest of the economy, but their indebtedness is on the rise (1.44 in June 2006). At structural level, 35 percent of total bank loans to NFC are concentrated in companies whose total debt is 4 times higher than equity (Chart 5.1.10) and furthermore 50 percent of total bank loans are contracted by companies with less equity than debt. The impact on financial stability of potential interest rate shocks through the direct channel is relatively low, since most bank loans are well collateralized[49]. The effect could be more far-reaching[50] through the indirect channel.

Chart 5.1.10 – Indebtedness of NFC with bank loans



Source: NBR, MPF

Chart 5.1.11 – Domestic credit and debt service dynamics in 2006 versus 2005



Source: NBR

(B) Foreign exchange rate shock: The exposure of NFC to currency risk is significant, but decreasing. Credit dynamics indicates a 61 percent increase in RON-denominated loans as compared to the 22 percent increase in EUR-denominated loans and a 9 percent contraction in

[49] 43 percent real estate mortgages, 29 percent other collateral, 13 percent pledge without dispossession. Only 4 percent of total bank loans are uncollateralized.

[50] These companies employ 13 percent of total workforce and produce 11 percent of total gross value added.

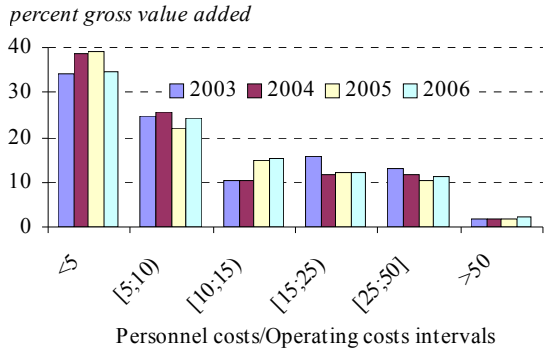
USD-denominated loans (Chart 5.1.11). Debt service dynamics by currency follows a similar pattern.

Even though most NFC are naturally hedged to currency risk, the total value of hedged exposure is low. The share of NFC with foreign currency-denominated bank loans whose receipts from exports are sufficient to cover their foreign currency-denominated debt service is of 75 percent. However, this amounts to only 22 percent of total NFC foreign currency-denominated debt service. When assessing the NFC's ability to service their foreign currency-denominated debt using the net flows generated by foreign trade activities (exports-imports) the result is similar, but the total hedged exposure declines to approximately 10 percent. Corporations hold almost 60 percent of total unhedged foreign currency-denominated debt service. In theory, these companies should more easily find solutions to hedge their currency risk than the SMEs (by means of derivatives or based on the relationship with parent companies).

The sectoral distribution of external private debt shows a concentration in the energy sector (17.2 percent), real estate (15 percent) and telecommunications (10.8 percent). The income of these sectors is highly correlated with exchange rate developments. In case of foreign exchange shock that will adversely impact the ability of customers to repay their bank loans, only the energy sector is more comfortably positioned (as it produces tradable goods). Foreign currency-denominated domestic credit is concentrated in the non-tradables sector (real estate sector holds 8.1 percent), while industry holds 41 percent of total foreign currency debt (December 2006).

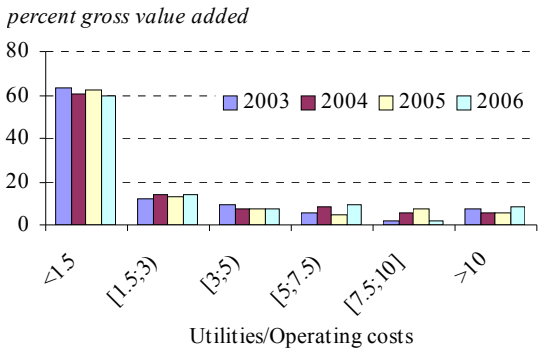
(C) Operating cost shock: The European integration puts pressure on corporate costs, especially personnel and utilities costs. These developments have not generated systemic problems, as these costs hold a relatively low share in total operating costs. Over 60 percent of total gross added value is generated by companies whose personnel costs are lower than 10 percent of total operating costs. Companies with utilities costs of less than 3 percent of total operating costs produce approximately 70 percent of total gross added value (Charts 5.1.12 and 5.1.13).

Chart 5.1.12 – Personnel costs



Source: NBR, MPF

Chart 5.1.13 – Utilities costs



Source: NBR, MPF

The most vulnerable[51] companies to pressures on personnel costs are those from mining, textiles and utilities sectors. Their systemic importance is relatively high[52] (from the point of view of gross value added and accessed banking resources).

[51] The share of staff costs in total operating costs is of 28 percent in mining, 23 percent in textiles industry and 32 percent in water collection, treatment and distribution sector.

Companies from collection, distribution and purification of water sector have significant utilities costs[53] (22 percent of total operating costs as of June 2006). Because of their specific activity, they are in a position to transfer potential cost shocks into the final price, so that systemic risk remains at a moderate level.

5.1.2. Financial resources allocation efficiency

(A) The financial deepening process continued throughout 2006, thus improving the allocation efficiency of bank resources. (B) Payment discipline showed mixed developments: lower arrears and slightly higher payment incidents.

(A) The share of bank loans in total NFC financing resources increased. Domestic credit represents 11.6 percent of total balance sheet in 2006 (almost 20 percent in case of SMEs), versus 10.4 percent at end-2005 (Table 5.1.2). Despite these developments, most NFC do not finance their activity through bank loans – 86 percent of total SMEs do not have bank loans.

Table 5.1.2 – Main financing sources of NFCs (percent)

	2005		6/2006	
	a)	b)	a)	b)
Equity	30.8	41.4	29.6	40.3
Debt	66.4	54.5	67.1	55.7
Debt classification by maturity				
- *Long term debt* (>1year)	16.4	18.8	18.6	18.9
- *Short term debt* (< 1year)	50.0	35.7	48.5	36.8
Debt classification by type				
- *Medium and long term foreign private debt*	5.9	6.3	6.9	5.2
- of which foreign bank loans	1.3	4.5	2.6	3.4
- *Domestic bank loans*	-	10.4	-	11.6
- *Arrears*	16.6	6.5	14.6	6.3
- of which trade arrears	7.3	3.8	6.8	3.7
- *Other debt*	44.0	31.4	45.5	32.6

a) companies without domestic bank loans, b) companies with domestic bank loans
Source: NBR, MPF

The most important differences regarding financing through bank loans between Romanian and euro area NFC are in the services, transport, warehousing, communications and construction sectors (Table 5.1.3). These gaps are caught up by means of higher[54] domestic credit growth rates.

NFC which do not borrow from domestic banks because they have access to external financing sources (credits from parent company or financial credits) are an exception. Companies with domestic bank loans account for 57 percent of total medium and long term foreign private debt and approximately 70 percent of total foreign bank loans. The profile of NFCs with foreign private debt is less risky from the point of view of balance-sheet structure: below average leverage (1.28) and higher liquidity (1.18).

[52] These companies produce 5.6 percent out of total gross value added and hold 3.3 percent of total bank loans to NFC. Companies from textiles industry with foreign trade activity (especially those with active processing activities) generate 20 percent of total exports, 11 percent of total imports and a trade surplus of RON 2 billion (June 2006). Staff costs of these companies had an average annual growth rate of 22 percent expressed in EUR between 2004 and 2006.

[53] The February 2007 Inflation Report considers an 8.2 percent hike in utility costs in 2007.

[54] Bank loans to NFCs grew by 32 percent in real terms compared to the euro area, where the growth was more modest at 10 percent

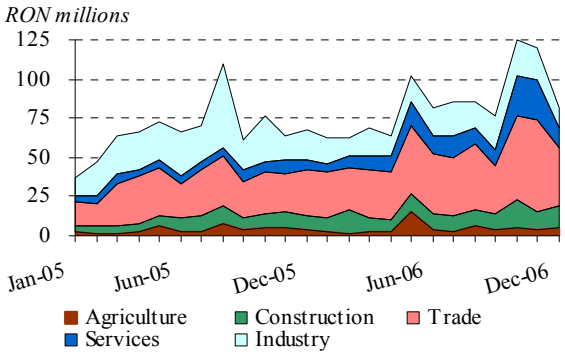
Table 5.1.3 – Bank loans as a share in total balance-sheet (percent), 2005

	Romania	France	Spain	Italy	Austria	Germany
Agriculture	8.4	20.4	23.0	23.0	15.5	…
Industry	7.9	6.6	10.8	18.2	10.9	10.1
Energy	0.9	1.4	9.6	14.0	1.5	…
Construction	6.3	6.0	8.7	20.6	13.3	5.5
Trade and services	9.3	15.8	21.3	16.5	9.1	17.5
Transport, warehousing and communications	3.2	18.0	18.7	17.5	2.5	17.4

Source: NBR, MPF, *European Committee of Central Balance Sheet Data Offices* (ECCBSDO)

(B) Trade credit payment discipline improved.

Chart 5.1.14 – Payment incidents evolution



Source: NBR, MPF

Arrears of NFCs with bank loans improved, reaching a minimum of 6.3 percent of total balance-sheet. Arrears of NFCs without bank loans are higher (arrears represent 14.6 percent of total assets, but decreasing). The discipline in servicing bank debt is better than in the relationships with trade partners. Thus, trade arrears are predominant.

The share of major payment incidents generated by NFC increased from 0.27 percent to 0.29 percent of GDP in 2006 versus 2005. The major contribution comes from the retail and wholesale trade sectors, with 44 percent of total payment incidents (Chart 5.1.14). Out of these companies, only one can be labelled as a corporation, the remaining incidents being generated by SMEs.

NFC with payment incidents usually have an *ex-ante* weak financial position (adverse selection) (Table 5.1.4): operating costs above sales, excessive indebtedness, low liquidity and a receivables cash conversion cycle which triggers liquidity problems. Thus, a better transparency and dissemination of financial information of these companies could determine a decrease of payment incidents.

Table 5.1.4 – Financial position of companies with payment incidents

	ROE (percent)	Costs/ Sales	Debt/ Equity	Liquidity	Receivables cash conversion cycle (days)
Agriculture	-2.8	1.35	1.7	0.92	99
Industry	-18.0	1.16	4.4	0.72	110
Energy	-79.0	1.13	7.2	0.85	220
Construction	-35.7	1.19	10.3	0.73	167
Trade and services	-3.1	1.03	9.0	0.94	116
Transport, warehousing and communications	-5.8	1.02	8.4	0.77	106

Source: NBR, MPF

5.2. Household sector risks

The risks on financial stability stemming from the household sector have increased from the previous Report. The risk profile is higher for the financial liabilities, the debt service burden soared, the value of real estate assets rose almost exclusively due to the price effect and the foreign currency position and net creditor position of the households deteriorated. On the other hand, income was on the rise, financial asset liquidity was higher, while the loan concentration rate and the overdue payment rate decreased.

5.2.1. Household income

Household money income maintained an upward trend, fuelled by income optimistic expectations, which made households undertake higher risks in 2006.

Table 5.2.1 – Remittances of Romanians working abroad* (EUR mill.)

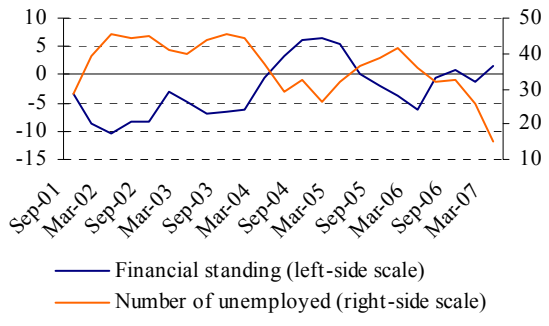
	2004	2005	2006
Remittances of Romanians working abroad, of which:	1 412	3 804	5 317
Compensation of employees – contracts less than one year	91	771	961
Current private transfers of Romanians working abroad to residents	1 321	3 033	4 356

Source: NBR; *credit flows in balance of payments

The dominant elements of household money income with an increasing weight are wages and other income (including remittances of Romanians working abroad)[55]. In 2006, the net average wage raised by 11 percent in real terms. The flow of remittances augmented, albeit at a slower pace (40 percent in 2006 against 169 percent in 2005), which could signal the proximity of a turning point. Most of the flows (82 percent) come from residents that have been working abroad for more than one year (Table 5.2.1). Generally, these flows diminish the longer people reside away from their home country (ECB, Monthly Bulletin, February 2007).

Current private transfers through the banking system are mainly coming from Italy, Great Britain and Spain. On the other hand, Italy, USA, and Germany are the main sources of banking transfers classified as compensation of employees working for less than one year.

Chart 5.2.1 – Households` financial standing and unemployment expectations over the next 12 months



Source: European Commission (3-month moving average of the balance of answers)

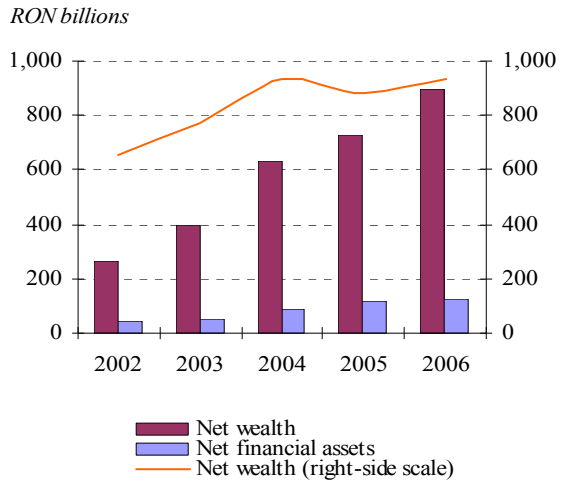
The households' optimistic expectations with regard to their financial standing are also stimulated by a diminishing threat of unemployment prospects (Chart 5.2.1). Improvement of macroeconomic stance, EU integration, as well as the validation of previous expectations concerning income could explain the households` strong propensity to consume and to get indebted. Expectations remain optimistic for 2007, while unemployment prospects reached a historical low.

[55] "Veniturile şi consumul populaţiei", NIS, average for the first three quarters of 2006.

5.2.2. Household balance sheet[56]

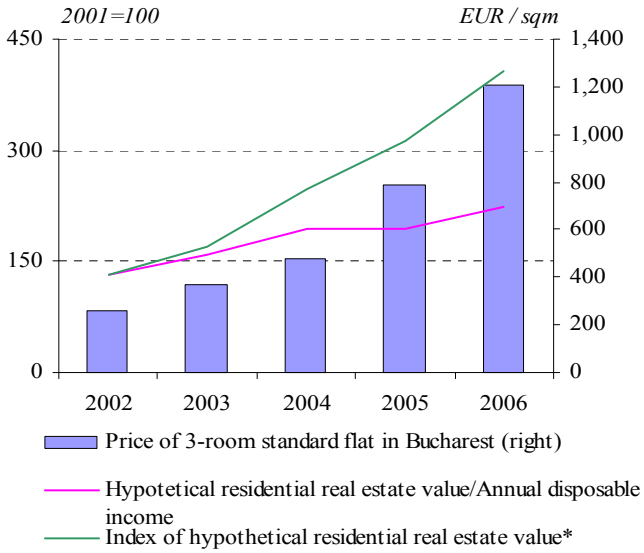
Household financial risks increased: (A) the value of real estate assets boosted almost exclusively due to the price effect, and not to the quantity effect, (B) financial asset liquidity improved, but risks are mixed, (C) the risk profile of financial liabilities is superior, and (D) the foreign currency position deteriorated.

Chart 5.2.2 – Net wealth and net financial assets of the household sector



Source: NBR, NIS, NSC, ISC, NUOCI, LCAR, BLA

Chart 5.2.3 – Residential real estate prices



*hypothetical value of all residential real estate, expressed in euro (estimated following the same methodology described in 2006 FSR)
Source: Chamber of Public Notaries, NIS, NBR

(A) The households` net wealth continued the upward trend in 2006, rising at a faster pace than incomes (Chart 5.2.2). The main component of the net wealth remains the real estate asset. Possible risks connected to a drop in residential real estate market could impact the debtors that undertook a mortgage loan, as well as the banks[57].

Residential real estate prices rose significantly in 2006 (Chart 5.2.3) following the trend of the last four years. The most important urban centres experienced the highest price increase (in Bucharest, a standard flat with no special improvements was almost 53 percent more expensive than in 2005). That feature is not only a Romanian particularity. Price hikes in the residential real estate market were also experienced in 2006 by the capitals of other CEE countries: Latvia (69 percent), Estonia (58 percent) or Poland (54 percent)[58]. However, the annual growth of real estate prices in the eurozone was around 7 percent for the last four years, but the characteristics of the real estate market are different.

[56] Data on household balance sheet have been revised from the previous Report by including new information from the national financial accounts. The main changes concern financial assets, since unquoted shares are taken into account.

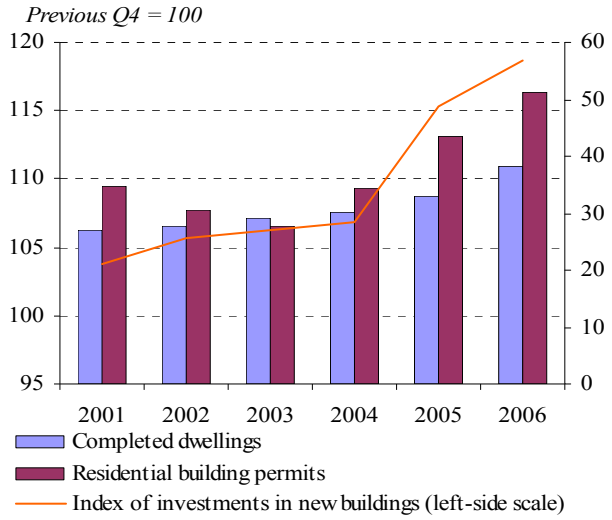
[57] The loans collateralized by mortgages represent 62 percent of household loans worth more than RON 20,000 (December 2006).

[58] Data are collected from central banks through a questionnaire initiated by National Bank of Poland. The price per square meter specific to the European capitals of the respondent countries (2006) varies considerably: EUR 1,145 in Hungary (with a decreasing trend), EUR 1,476 in Estonia, EUR 1,526 in Latvia, EUR 1,898 in Poland, EUR 2,408 in Slovenia.

The demand for real estate was fuelled to a smaller extent by the mortgage loan. The average value of a mortgage loan was of RON 72,000 (December 2006), a value that is far below the price of a house. Almost 67 percent of the mortgage loans have a value that lies below the average. However, household indebtedness was confined by regulated liquidity restrictions that were in force up to February 2007.

The dynamics of the real estate market was boosted by the strong supply deficit. The supply is mostly made up by old buildings and it still has a low level: (i) the number of dwellings rose by only 1.6 percent between 2001 and 2006 and (ii) the weight of annually completed dwellings in the stock of dwellings is 0.46 percent (2006) against 1.13 percent in the euro area (2003).

Chart 5.2.4 – Quantitative indicators of residential real estate (thou)



Source: NIS

Nevertheless, medium- and long-term supply could increase since a large number of building projects were initiated in 2006. The number of building permits reached a peak in 2006 exceeding by 17 percent the level of 2005, which could generate an increasing trend of completed dwellings in the following years (Chart 5.2.4). The soar in the index of investments in new buildings (Chart 5.2.4) and the optimistic expectation pattern of the construction sector point to a greater potential for the real estate sector.

The affordability of a dwelling deteriorated, which could lead to a decline in demand: at an aggregated level, the real estate value is almost seven times higher than the annual disposable income (Chart 5.2.3).

(B) The liquidity of **household financial assets** improved in 2006. Unquoted shares dominate, but their weight diminished in favour of assets with a higher liquidity (Chart 5.2.5). Liquid financial assets[59] are mostly made up by cash, bank deposits and T-bills (63 percent).

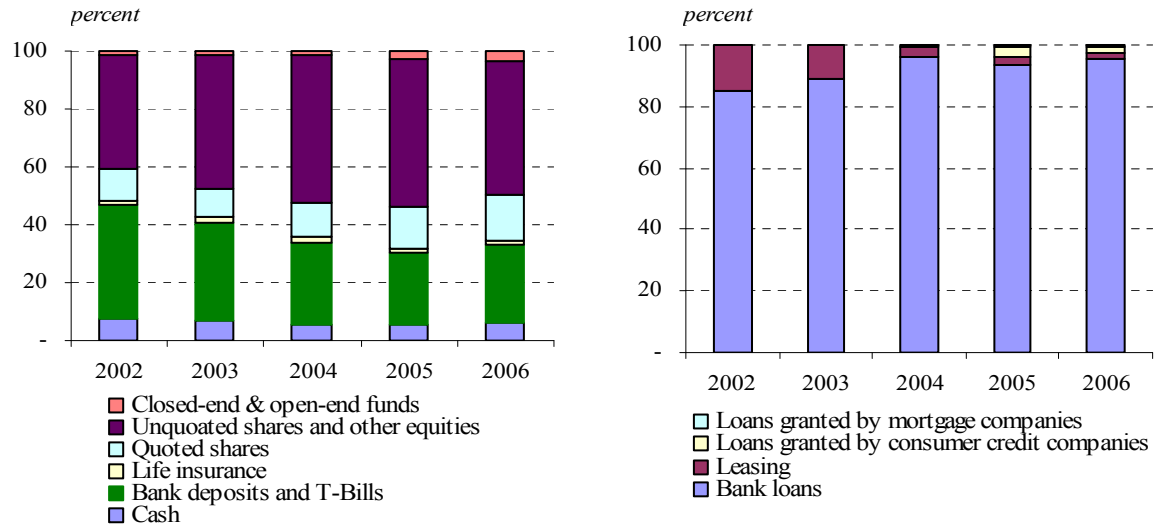
The risks related to financial assets posted mixed developments. The risks were mitigated by the increase in the weight of quoted shares (BSE, RASDAQ and shares realised under the mass privatization program) and of shares in investment companies (open- and closed-end funds, including SIF – financial investment companies). On the other hand, the volatility of stock-market quotations is transferred to households` portfolios and the risks linked to unquoted shares integrate the vulnerabilities of the corporate sector. However, the market risk impinges on households` portfolios to a small extent since only a few households invest in the capital market: only 2.9 percent of total households held shares and bonds (NIS, 2005). Looking at the micro level, capital market investors usually belong to higher income bracket which mitigates some of the risks.

(C) Bank loans account for the bulk of **households` financial liabilities**[60] - more than 95 percent (Chart 5.2.5). In 2006, household loans witnessed the highest growth among the components of

[59] Liquid financial assets are computed by pulling out the unquoted shares and life insurance premiums from financial assets.

private credit (75.2 percent in real terms). Furthermore, the weight of household loans in total private loans reached a historical peak of 42.1 percent. The determinants remained the same as mentioned in the previous Report: income dynamics and optimistic expectations of future income, the need of endowment with durables and the banks` household-oriented policy.

Chart 5.2.5 – Structure of financial assets and liabilities of households



Source: NBR, NSC, ISC, NUOCI, LCAR, BLA

Household indebtedness risks stem from the dynamics and also from the structure. The bulk of indebtedness is for consumption (79 percent of household loans in 2006 against 75 percent in 2005) and it also spans along progressively longer maturities (the weight of long-term debt rose to 61.1 percent in 2006 from 42.4 percent in 2005). On the other side, the value of the assets financed by consumer loans depreciates (physically and morally) much faster than the debt is paid, which negatively influences the household wealth. The identified developments could continue if (i) the need of endowment with durables persists[61] (especially for low income categories), (ii) the refinancing policies of small loans trough a larger loan on a longer maturity proliferate and (iii) the real estate prices continue to be prohibitive for most of the households.

The weight of RON-denominated loans grew in 2006 diminishing, therefore, the foreign exchange risk. The main drivers of the mentioned trend are: (i) the decrease in interest rates on RON-denominated loans and (ii) the banks` policy to promote RON- denominated loans, particularly consumer loans. Households became indebted also in CHF or JPY starting with 2006. However, the weight of those loans in total loans is very low (1.4 percent in December 2006). Indebtedness to foreign financial institutions has no systemic importance, accounting for only 0.5 percent of household loans granted by the Romanian banking sector.

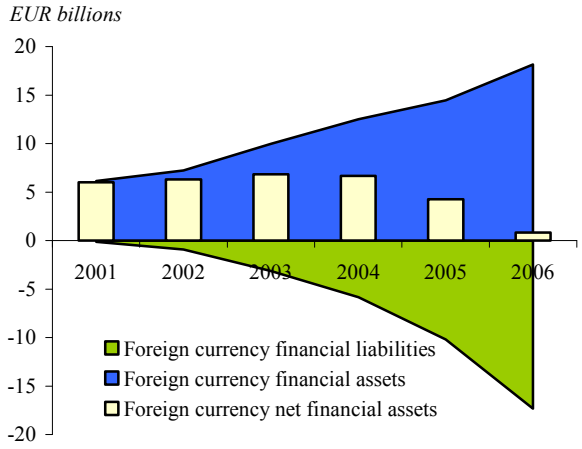
(D) Household **foreign currency risks** increased in 2006. For the first time, households became net debtors for the foreign currency bank exposures (October 2006). Net foreign currency assets diminished by 80 percent in 2006 (Chart 5.2.6). Considering the probable uneven distribution of foreign currency assets (concentrated with households that do not need to borrow money in order to

[60] According to NIS survey, 15.6 percent of households were indebted in 2005 (against 10.4 percent in 2003), of which 84.7 percent to financial and banking institutions and the rest to relatives, friends etc. Urban households are more prone to indebtedness.

[61] The intentions of households to acquire durables are on an upward trend, especially in the urban area (NIS, 2006, *Life standard of Romanian households*).

satisfy their consumer or housing needs), the foreign currency position of low income households could be even shorter (assets lower than liabilities). In that case, a depreciation of the national currency could additionally impair the stance of that category of debtors.

Chart 5.2.6 – Households' foreign currency position



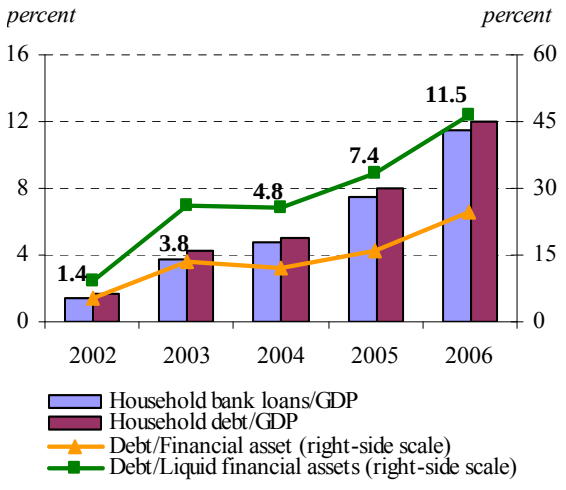
Source: NBR

The debt service burden for the foreign currency loans represents 48 percent of the entire foreign currency volume bought by households in 2006 from banks and exchange offices. Households continued to be net buyers of foreign currency (EUR 3.6 bn.), but the position follows a decreasing trend compared to 2005. Purchases of foreign currency go along a seasonal pattern with August peaks. A foreign exchange shock in that period is surmounted by the seasonal pick-up in foreign exchange sales in August and December (fuelled by remittances and holiday periods).

5.2.3. Household indebtedness

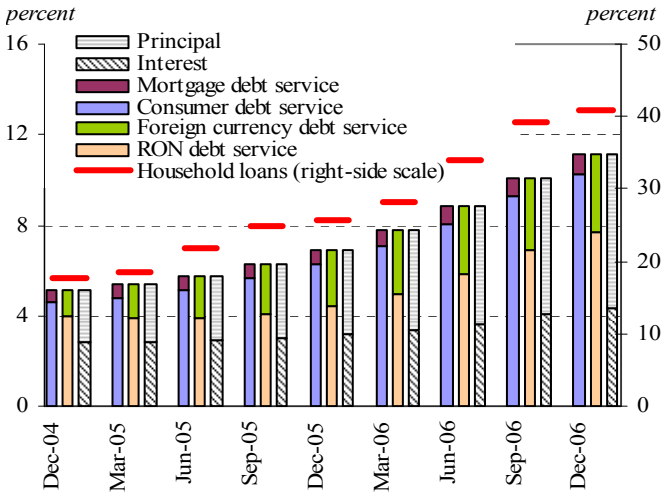
Household indebtedness dynamics generates two main risks: (A) the debt service burden rose at a very fast pace and (B) the household net creditor position deteriorated significantly. Nevertheless, (C) the concentration of loans diminished and (D) the overdue payment ratio followed a decreasing trend.

Chart 5.2.7 – Household indebtedness and liquidity



Source: NBR, NIS

Chart 5.2.8 – Household debt service and household loans as a share of the annual disposable income



Source: NBR

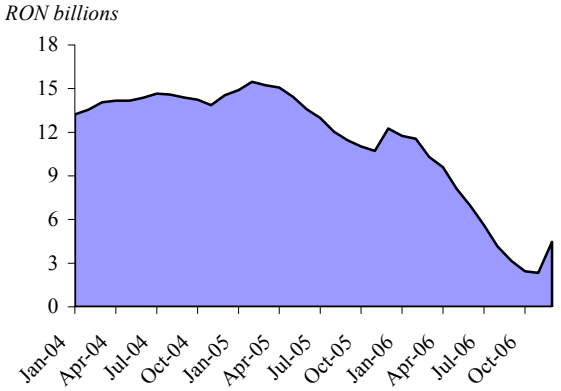
(A) Household financial deepening improved in 2006 as indicated by the ratio of household loans to GDP[62]. The debt rose faster than financial assets (especially compared to liquid assets) calling for a closer monitoring (Chart 5.2.7).

Household debt service burden to disposable income speeded up in 2006 (Chart 5.2.8) reaching the euro area level[63]. However, the breakdown of consumption expenses differs. Consumer loan generates 92 percent of debt service, being the main contributor to household loan growth, through the quantity effect. The contribution of RON-denominated loans to the debt service burden increased amid higher interest rates and rising volume of national currency-denominated loans (Chart 5.2.8).

The interest rates on newly granted loans followed a slightly decreasing trend both for national currency and for euro. Furthermore, there is a certain downside rigidity of the interest rates on outstanding loans in comparison with the interest rates on newly granted loans. That feature could suggest that banks use some contractual clauses in order to fix the interest rates[64] (when interest rates decrease) and conversely maintain a high debt service burden. The contribution of interest rates to the debt service burden stays on a decreasing path. However, the amount of interest augmented significantly last year, also fuelled by the quantity effect.

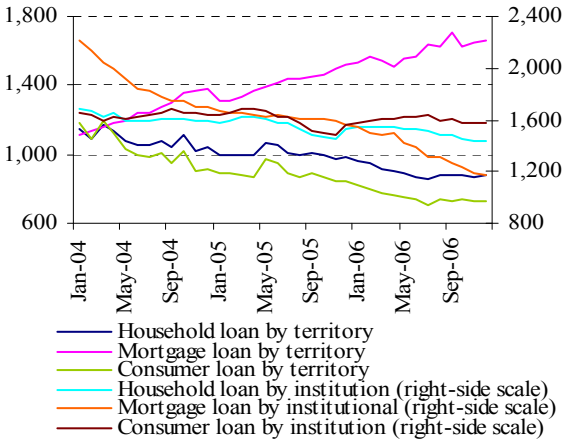
(B) Household indebtedness to banks rose at a much faster pace than bank savings. The number of debtors undertaking large value loans (over 20,000 RON) doubled compared with 2005. Households **maintain their position of net creditors** for the banking sector (Chart 5.2.9). Still, the net creditor position witnessed a steep deterioration in 2006 (diminishing by 56 percent in real terms in comparison with 2005). From a financial stability point of view, this situation could trigger additional risks if households reduced their investments in other types of financial assets and conversely used their incomes for consumption only.

Chart 5.2.9 – Households' net creditor position for the banking sector



Source: NBR

Chart 5.2.10 – Developments in the geographical and institutional concentration ratio for the components of household loans (Herfindahl index)



Source: NBR

[62] In the euro area, household debt to GDP reached a maximum of 58.5 percent in the last quarter of 2006.

[63] In the euro area, the debt service burden to disposable income ranged around 10 percent to 11 percent in 2005. The indicator is relatively constant for the last 10 years as the hike of household loans is offset by the decrease in interest rates (the comparability of the ECB indicator to the NBR indicator is not perfect as the estimation methodologies comprise certain differences).

[64] For example, there are credit products that stipulate interest rate variability, without, however, specifying the reference rate. Furthermore, if the interest rates on the new loans diminish, the interest rates on the previous loans remain unchanged.

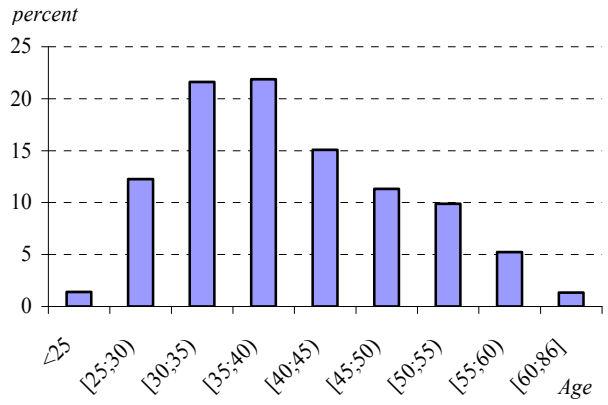
The net creditor position is strongly concentrated in Bucharest. Except for the Bucharest area and the central area of the country, households became net debtors for the banking sector starting with 2006. The risks are even stronger since the geographical areas witnessing this phenomenon have higher unemployment rates than in Bucharest.

(C) The concentration risk[65] diminished in 2006, especially geographically, indicating a higher competition for the household sector (Chart 5.2.10). *Geographical* concentration reveals that: (i) consumer loans have the highest dispersion and their concentration index follows a decreasing trend, (ii) the bulk of consumer loans is granted in Bucharest, followed by Constanța, Argeş, Cluj, (iii) mortgage loans continue to have the highest geographical concentration, without exceeding 1,800 units, (iv) an overwhelming percentage of mortgage loans is granted in Bucharest, followed by Cluj, Timiş and Constanța. Mortgage loan concentration in the mentioned areas poses no important threats to financial stability, since those counties are more developed, the incomes of debtors are higher and the local real estate market hiked.

Institutional concentration of mortgage loans diminished considerably, given that most of the banks strongly promoted that type of loan in 2006. In the long run, we expect a better institutional dispersion as mortgage financing develops.

(D) The overdue payments ratio decreased in 2006, reaching 0.37 percent in December. The weight of unsecured RON-denominated loans worth more than RON 20,000 is low (4.3 percent). Insurance companies cover 26 percent of the loans. On the other hand, factors like: (i) the increase in overdue payments to the banking sector by 49 percent in real terms (versus 2005) and (ii) the 32 percent soar in the number of defaulters (exceeding 300,000 in December 2006) call for cautiousness in analysing the future ability of households to service debt.

Chart 5.2.11 – Large value loans - breakdown by debtors` age (December 2006)



Source: NBR

Alternatively, the breakdown of debtors by age indicates that the credit risk could be moderate since large value loans are concentrated among people aged 30 to 40 years (Chart 5.2.11). Additionally, households, whose family head is aged 30 to 40 years, earned higher incomes in 2005 (NIS, 2006) than other age categories.

[65] The concentration indicators are computed as Herfindahl indexes and do not exceed the threshold of 1,800 units.

ANNEX

Financial regulation

During 2006, the regulatory framework governing the financial system was enhanced and hence many pieces of primary and secondary legislation were published. The newly-introduced regulations are aimed at maintaining the trend of modernising institutional mechanisms and putting in place the best practices in all financial market segments. Such in-depth changes are the driver of convergence to European standards in terms of supervision practices, a prerequisite for Romania's integration into the single market of financial services. Financial regulation is a key component of financial stability, since it governs the banking sector, the capital market, insurance, pension funds, financial conglomerates, payment systems, etc.

Implementation of the New Capital Accord

As far as the banking sector and the capital market were concerned, the transposition of EU legal acts ensuring implementation of Basel II standards into national legislation was high on the agenda for 2006. The transposition of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (following the recast of Directive 2000/12/EC) and of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (following the recast of Directive 93/6/EEC) of the European Parliament and of the Council of 14 June 2006 was rather extensive. In order to fulfil this task, the authorities having sectoral competences in the financial field, i.e. the National Bank of Romania and the National Securities Commission, joined their forces with those of the Ministry of Public Finance and of the banking community. In December 2006, Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy was published. The legal act, ensuring transposition at principle level of EU Directives both for credit institutions and financial investment companies, gathers together the legal provisions for all types of credit institutions (banks, saving banks for housing, credit co-operatives, mortgage loan banks), which had previously been governed by separate pieces of legislation.

In order to supplement primary legislation, numerous secondary legal acts drafted with a view to solving the technical issues arising from EU Directives were published in the same period. They were adopted jointly by the two competent authorities. This approach ensures equal treatment for the legal provisions applicable both to credit institutions and financial investment companies.

The new regulatory framework relating to Basel II Accord took effect as from 1 January 2007.

The current legislative context, along with Romania being an EU Member State, helps highlight some features of implementing in the EU the capital standards applicable to credit institutions and investment companies.

Following the publication of the New Capital Accord by the Basel Committee on Banking Supervision (New Framework, July 2004), the European Commission mapped out its own proposals on capital requirements for credit institutions and investment companies. The proposals reflect to a considerable extent the Basel II standards but, at the same time, they are tailored to EU specifics. The Commission's initiative is part of the Financial Services Action Plan (FSAP), a major project launched in 1999, which encompasses the overarching objectives and the measures to revamp the single market of financial services. One of the objectives is to ensure financial stability by streamlining prudential supervision and regulation, especially in regard to bank solvency

requirements. Three-party negotiations between the European Parliament, the Council of Europe and the European Commission, as well as the talks with market officials highlighted a considerable number of amendments to the initial rules. The amendments take a piecemeal approach which clarifies the issues regarding the specifics of some domestic markets in EU Member States.

A major difference compared to the initial rules is the legal nature of the framework on capital adequacy. Basel II Accord is agreed by the national supervisory authorities represented in the Basel Committee on Banking Supervision, so its implementation remains, as a rule, a matter of choice, but the EU Member States are bound by Community legislation to implement it. A typical feature of the implementation process is the existence of some arrangements and regulation and supervision structures operating in the EU, as described in the Lamfalussy Report. In the beginning, this model was applicable to the capital market, but thereafter it was also used for the financial sector as a whole, including the banking sector. The Lamfalussy model, introduced to increase celerity and flexibility of the process of drafting regulations, sets forth three competence levels in the legislative process and provides for comitology for two of them. These institutional structures are meant to raise the degree of convergence and consistency in implementing regulations in Member States and play a major part in ensuring a minimum level of non-discriminatory conditions in the single market.

As for the scope, it should be pointed out that Basel II Accord is to be applicable only to internationally-active banks, whereas the capital standards are applicable, as a rule, to every bank and investment company in the EU, regardless of its size or the geographic area covered. Moreover, Basel II Accord applies to bank groups on a consolidated basis and on a sub-consolidated basis, whilst EU legislation applies, in principle, to both an individual level and a consolidated level, with the possibility of making an exception to the rule for expressly stipulated cases. The one-size-fits-all approach to the application of capital standards across the EU, from sophisticated, very internationally active banks to non-sophisticated investment companies, needs a certain "customisation" of prudential regulations.

In a single market, particular importance is attached to the issues relating to "home/host Member State" and "competent authority responsible for supervision on a consolidated basis". Application of the New Capital Accord will foster the co-operation between supervisory authorities responsible for the entities included in the group structure, as the new standards apply to all its levels. Implementation of capital standards requires that the group get the approval for using certain methods from the supervisory authorities in the host Member State, for individual or sub-consolidated levels, as well as from the supervisory authorities in the home Member State, for the consolidated level.

In this respect, it is noteworthy the fact that the responsibility of national supervisory authorities is left unharmed, even though the competent authority in the home Member State plays a key role in overseeing the implementation process. The well-established mechanism for optimising the relations between supervisors is the increasingly active co-operation between supervisory authorities in the home Member State and those in the host Member State

In order to clarify the responsibilities arising from the interaction between the entities of a group with different supervisory authorities, EU legislation limits this area to the prudential reports and the approval of internal models as regards computing the capital requirements. While Basel II Accord keeps in place the responsibilities of national supervisory authorities, the EU attaches greater importance to the authority responsible for supervision on a consolidated basis of the group as a whole.

The prominent role that EU legislation has assigned to the authority responsible for supervision on a consolidated basis, along with a faster exchange of information between competent authorities, is a benefit for financial integration and stability. Nevertheless, the principle of the "competent authority responsible for supervision on a consolidated basis" poses some problems as far as its application is concerned. The first aspect regards the fact that resources, competences and expertise of national supervisory authorities are very little homogeneous due to a number of factors such as: the size of the national financial system, the strategy and the financing sources of the national supervisory authority, the implemented supervision models.

Furthermore, the possible domestic-market distortions caused by the different approaches taken by competent authorities should not be overlooked. A looser prudential approach taken by the competent authority responsible for supervision on a consolidated basis is in favour of subsidiaries in a host jurisdiction belonging to a bank group in relation to other entities that are not part of a group and must comply with stricter prudential regulations issued by the competent authority in that jurisdiction.

Vesting the competent authority responsible for supervision on a consolidated basis with increased powers and responsibilities should not create a gap between prudential supervision responsibilities and the responsibilities regarding other fields governed by public policies. The latter include financial stability oversight, management of deposit protection schemes, emergency assistance in case of a liquidity crunch and financial back-up from public funds. Since most of the above-mentioned fields will further be organised on national foundations, the involvement of the competent authority responsible for supervision on a consolidated basis in the process of supervision of locally-licensed institutions may pose some difficulties that will be dealt with by developing adequate manners in which competent authorities co-operate.

For 2007, most banks decided not to apply the new regulations. For next year, there are signs that banks will largely take the standard approach. Some of the domestic banks, particularly those belonging to European bank groups, voiced their intention of adopting as fast as possible the domestic models on determining capital requirements as a result of the need to take a unitary approach to risk management, at group level. Such developments are indicative of the fact that in 2007 both risk management processes and supervision practices will virtually stick to the provisions of Basel I. The explanation for the sluggish pace of switching to the new model lies with banks' weak interest, owing to the related costs that would reduce their profits and the overall banking context rife with excess liquidity which, even though requiring additional costs, prevents market players from seeking alternative resources.

Financial conglomerates

Government Emergency Ordinance No. 98/2006 on the supplementary supervision of credit institutions, insurance and/or reinsurance undertakings, financial investment companies and asset management firms in a financial conglomerate was published at end-2006. Furthermore, the authorities completed and published the secondary legislation ensuring the transposition of technical provisions laid down in community regulations applicable to financial conglomerates. The drafting and the publishing of pieces of legislation regulating financial conglomerates follow the ever-swifter trend of inter-sectoral integration and provide both the competent authorities and the entities involved with the adequate risk monitoring, management and quantification tools. Designed to ensure the proper protection of depositors, investors and insured parties alike, as well as to meet the financial stability objectives, the legislation governing financial conglomerates –

seen as financial groups with inter-sectoral activities – is the result of sustained efforts of three sectoral authorities, namely the NBR, the NSC and the ISC. Domestic legislation provides for the option of carrying out supplementary supervision at the level of each subgroup that meets the criteria for a financial conglomerate, with the possibility of being excepted from the supplementary supervision regime, without prejudice to the attainment of financial stability objectives. Directive 2002/87/EC also sets forth the possibility of including the largest financial conglomerate under the scope of supplementary supervision.

Legal framework governing the capital market

The year 2006 also abounded in regulations applicable to the capital market, following two major directions: transposition of Community legislation into domestic legislation governing the capital market, ahead of Romania's joining the European Union on 1 January 2007, as well as the steady improvement of secondary legislation. Aside from participating in inter-sectoral projects, such as Basel II and financial conglomerates, the NSC also pursued many other objectives related to its regulatory tasks on the capital market. In this sense, mention should be made of the coming into force of the new rules on financial investment services ensuring the transposition of Directive 2006/73/EC implementing Directive 2004/39/EC (MiFID). The new regulation stipulates more detailed organisational requirements for financial investment companies, risk management requirements, general rules for identifying conflicts of interest, provisions on safeguarding client assets, eligibility criteria for the best possible result for the execution of client orders, client order management rules, as well as any other provisions meant to mitigate risks and strengthen financial performance to the benefit of financial stability.

Another objective targeted the setting-up of the central depository, an institution whose proper functioning is an essential prerequisite for the secure and low-cost conduct of post-transaction and cross-border operations.

The regulation ensuring the transposition of Directive 2003/125/EC into domestic legislation has been drafted more recently. It sets forth the rules on the fair presentation of investment recommendations as regards financial instruments on the capital market as well as the transparency requirements when disclosing any conflicts of interest of persons recommending or suggesting investment strategies. The aim of the new regulation is to contribute to capital market stability.

As far as rating agencies are concerned, the NSC is currently looking into the possibility of issuing regulations on certifying such institutions. According to the envisaged regulations, rating agencies will be certified only if they make proof of compliance with the Code of Conduct Fundamentals for Credit Rating Agencies, as published by IOSCO in 2004.

Legal framework of the private pension system

The regulatory framework applicable to the private pension system witnessed a consolidation during 2006. Thus, publication of Law No. 204/2006 on optional pension schemes was followed by the publication of the secondary legislation drafted by the Private Pension System Supervisory Commission. The regulations governing optional pension funds show an assimilation of standards common to all financial sectors, such as: requirements on shareholding quality and the origin of capital, managers' reputation and professional background, corporate governance and transparency, etc. The institutional architecture of the optional pension funds market reveals yet another type of

inter-sectoral integration. Thus, the fact that optional pension funds may be managed by dedicated pension companies or by other financial institutions (investment management companies, insurance undertakings), the fact that depositories of pension funds may only be banks or branches of banks authorised in EU Member States, as well as the fact that pension funds are institutional investors call for an efficient co-operation among the authorities with sectoral tasks. Hence, in December 2006, the Private Pension System Supervisory Commission became a signing party of the Memorandum of Understanding between the NBR, the NSC and the ISC.

Experts are currently drafting the secondary legislation in application of Law No. 411/2004 on privately-administered pension funds, as the procedure to amend and supplement this piece of legislation was completed by publishing Law No. 23/2007.

Developments in the regulation of the financial system during 2006 validate the competent authorities' unflinching interest in adopting the most relevant standards with a view to ensuring viability and stability of related institutions and infrastructures. Furthermore, these objectives that marked the pre-accession period stand out as permanent responsibilities stemming from Romania's EU member status, in an environment of Community regulations steadily tailored to the developments and requirements of the single market. The strengthening and the updating of the financial sector regulatory framework play a major part in safeguarding financial stability

GLOSSARY

Interest coverage ratio	The ratio of the profit before interest and taxes to the debt service.
Carry Trades	Transactions where the investor sells the currency with the lower interest rate and buys the currency with the higher one. The investor gains from the appreciation of the target currency (e.g. RON), but also from the interest rate differential (e.g. between RON and YEN money market interest rates). By entering such transactions, investors are betting against the interest rate parity.
EMBI+	It is calculated by J.P. Morgan as a weighted average of 15 emerging countries sovereign bonds over U.S. Treasury bonds. The countries included are: Argentina, Brazil, Bulgaria, Columbia, Ecuador, Mexico, Morocco, Nigeria, Panama, Peru, Philippines, Poland, Russia, South Korea, Venezuela.
Forward contract	A contract settled now to buy an underlying asset at some point in the future at a price agreed. A special forward contract is NDF *(Non-Deliverable Forward)*. In this contract, the parts will exchange only the amounts exceeding the spot price at maturity.
Spot contract	A contract by which an investor buys or sells a currency. The delivery date differs from market to market. The most common delivery period is that of two days.
Kernel normal distribution function	The probability density function is estimated using a normal kernel function. Each value has associated a normal distribution centered on that value with the variance equal to a smoothing parameter. The normal kernel distribution function is composed of the aggregation of the individual distributions. The advantage of this method compared to a histogram resides in the continuity of the estimated probability density.
Avian flu	A bird flu that is hardly transmitted to other species (except for pigs, to whom it is easily transmitted). Human avian flu is generated by the avian flu virus that infects a human being under particular conditions. The virus is not transmitted from human to human. The ordinary flu is generated by a virus that can easily be transmitted from human to human and is specific to the human species. The pandemic human flu (namely bird flu) is an epidemic flu transmitted on a large area that affects many individuals (humans and birds respectively).
Operating expenses efficiency	The ratio of differences between operating expenses and stocks to turnover. An increase in the operating efficiency is equivalent to a lower value of this indicator.
Illiquidity Index	Calculated as $\gamma_t = \|r_t\| / V_t$, where r is daily return of the asset, and V is daily average transactions volume (in the *Report* as 100 millions EUR). The interpretation of the results has to consider the index limitations. The method considers that the price changes are symmetrically (in the same size on sell and buy orders), investors have equal positions and the number of buying/selling orders is constant. (Amihud, Y., 2002, *Illiquidity and stock returns: Cross-section and time-series effects*, Journal of Financial Markets, No. 5).

MSCI Emerging Markets	Calculated by Morgan Stanley as weighted average of 26 emerging stock markets capitalization. The countries included are: Argentina, Brazil, Chile, China, Columbia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, South Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.
Exchange rate option	A contract by which the buyer has the right to buy (in a call option contract) or to sell (in a put option contract) a specified currency at a strike price at maturity (in European-type contracts) or any time until the contract expiration (in American-type contract).
High technology industries	OECD classification (Frascati Manual, *Proposed standard practice for surveys on research and experimental development*, 2002). Includes the following (the ISIC Rev. 3 code in brackets): Manufacture of pharmaceuticals, medicinal chemicals and botanical products (244), Manufacture of aircraft and spacecraft (353), Manufacture of medical, precision and optical instruments, watches and clocks (33), Manufacture of radio, television and communication equipment and apparatus (32), Manufacture of office, accounting and computing machinery (300).
High-medium technology industries	OECD classification (Frascati Manual, *Proposed standard practice for surveys on research and experimental development*, 2002). Includes the following (the ISIC Rev. 3 code in brackets): Manufacture of electrical machinery and apparatus n.e.c. (31), Manufacture of motor vehicles, trailers and semi-trailers (34), Manufacture of railway and tramway locomotives and rolling stock (353), Manufacture of transport equipment n.e.c. (355), Manufacture of chemicals and chemical products (24 excluding 244), Manufacture of machinery and equipment (29).
High tech knowledge intensive services (KIS)	Eurostat classification that includes (NACE Rev. 1.1 codes in brackets): Post and telecommunications (64), Computer and related activities (72), Research and development (73).
Debt service	The amount due by a debtor for a predetermined period of time. It is calculated as the sum of principal and interest.
Cross currency swap	A contract in which the investor buys a currency at settlement and agrees to sell it at maturity at a predetermined exchange rate. Sometimes the statistics includes also the interest rate swap contracts with foreign currency risk. This type of contract is the same as interest rate swap. The only difference is that the notional on the two legs are denominated in different currencies.
Households disposable income	Approximated as the sum of total wage income (weighted average of the net wage by the number of employees), of other incomes from budgetary and extra-budgetary sources (social security, unemployment aid, health insurances), of remittances from abroad and of current transfers from nonresidents.