WORLD BANK WORKING PAPER NO. 45

# Capital Markets and Non-bank Financial Institutions in Romania

## *Assessment of Key Issues and Recommendations for Development*

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THE WORLD BANK
Washington, D.C.

First Printing: November 2004

printed on recycled paper

1 2 3 4 5 06 05 04



ISBN: 0-8213-6015-9
eISBN: 0-8213-6016-7
ISSN: 1726-5878

Library of Congress Cataloging-in-Publication Data

Shojai, Ramin, 1965–
Capital markets and non-bank financial institutions in Romania : assessment of key issues and recommendations for development / Ramin Shojai, Michel Noel.
p. cm.— (World Bank working paper ; no. 45)
Includes bibliographical references.
ISBN 0-8213-6015-9
1. Capital markets—Romania. 2. Financial institutions—Romania. I. Noel, Michel, 1954–
II. Title. III. Series.

HG5692.S48 2004
332'.041'09498—dc22

2004059857

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# Acknowledgments

This report was prepared by a team comprised of Ramin Shojai (co-task team leader), Michel Noel (co-task team leader), Yibin Mu, Michael Borish, Mohamed Ramzi Roshdi Ismail, Alexandra Drees-Gross, Anna Sukiasyan, Steen Byskov, and Sorin Teodoru.

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The team appreciates the guidance and support of Khaled Sherif (Sector Manager, ECSPF) and Albert Martinez (Operations Adviser, ECCU5) in the preparation of the study.

The team members would like to thank the Ministry of Public Finance, the Ministry of Economy and Trade, the Ministry of Transportation, Housing and Tourism, the National Bank of Romania, the National Commission for Securities, the Insurance Supervision Commission, the Bucharest Stock Exchange, and the RASDAQ for offering tremendous input and support in the preparation of this report.

# Acronyms and Abbreviations

| | |
|---|---|
| ADRs | American Depository Receipts |
| AMC | Asset Management Companies |
| AML | Anti-Money Laundering |
| APAPS | The Authority for Privatization and Management of State Ownership |
| AVAS | Authority for State Assets Recovery |
| ASLR | Romanian Association of Leasing |
| BCR | Banca Comerciala Romana (The Romanian Commercial Bank) |
| BVB | Bucharest Stock Exchange |
| BRD | Banca Romana pentru Dezvoltare (The Romanian Development Bank) |
| BUBID | Bucharest Interbank Bid |
| BUBOR | Bucharest Interbank Offered Rate |
| CE-3 | Czech Republic, Hungary, and Poland |
| CEC | Casa de Economii si Consemnatiuni (The Romanian Savings Bank) |
| CNVM | National Securities and Exchange Commission |
| CSA | Insurance Supervisory Commission |
| DvP | Delivery versus Payment |
| EBRD | European Bank for Reconstruction and Development |
| EEC | European Economic Community |
| EMDB | Emerging Markets Database |
| EU | European Union |
| EU-15 | European Union Member countries Prior to Recent Enlargement |
| FDI | Foreign Direct Investment |
| FMR | Financial Market Reform project |
| FNI | National Investment Fund |
| FSAP | Financial Sector Assessment Program |
| GAAP | Generally Accepted Accounting Principals |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| IAIS | International Association of Insurance Supervisors |
| IAS | International Accounting Standards |
| IFIs | International Financial Institutions |
| IFRS | International Financial Reporting Standards |
| IFS | International Financial Statistics |
| IOSCO | International Organization of Securities Commissions |
| IMF | International Monetary Fund |
| MoPF | Ministry of Public Finance |
| MOUs | Memorandum of Understanding |
| NAV | Net Asset Value |
| NBFI | Non-Bank Financial Institutions |
| NBR | National Bank of Romania |
| OECD | Organisation for Economic Co-operation and Development |
| PAYG | Pay-As-You-Go |
| RASDAQ | Romanian Association of Securities Dealers Automatic Quotation (Romanian Securities Market) |
| ROL | Romanian Lei |

| | |
|---|---|
| ROSC | Report on Observance of Standards and Codes, Accounting and Audit Field |
| RTGS | Real-Time Gross Settlement system |
| SIFs | Financial Investment Companies |
| SME | Small and Medium Enterprise |
| SPF | State Pension Fund |
| SPVs | Special Purpose Vehicles |
| UCITS | Undertakings of Collective Investments in Transferable Securities |
| UNOPS | United Nations Office for Project Services |
| USAID | The United States Agency for International Development |
| VAT | Value-Added Tax |
| WB | The World Bank |

# Executive Summary

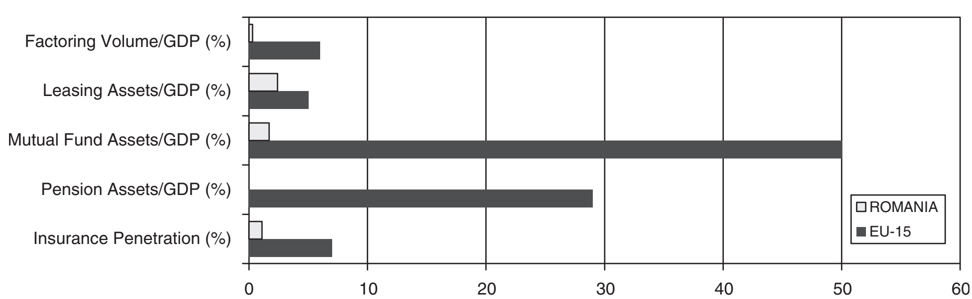
With just three years remaining before joining the European Union (EU), Romania is working hard to improve its capital markets and non-bank financial institutions (NBFIs), which remain less developed than those in other accession countries.[1] Strengthening these sectors has become a top priority for policy makers, whose primary objective is to ensure that the financial system is sufficiently developed to serve the growing demands of the Romanian economy.

Between 2003 and 2004, the Romanian authorities made significant efforts to draft, adopt, and enact new legislation that align Romania with EU financial directives. Despite these efforts, however, challenges relative to the capacity of supervision and to the implementation of laws and regulations still remain. In addition, the planned secondary legislation and regulations still need to be completed.

Financial assets at the end of 2003 were approximately US$22.1 billion, or 39 percent of GDP. Banks are the most important financial institutions in Romania, and they account for 84 percent of the country's financial assets.[2]

Romania's indicators show NBFI development lags well behind European Union countries prior to recent enlargement (EU-15 countries; see Figure 1). Insurance depth is low in Romania, although it is growing. NBFI development in Romania also lags behind Czech Republic, Hungary and Poland (CE-3 countries). Insurance penetration has reached 3–4 percent ratios in the CE-3, as opposed to Romania's 1 percent. Because the CE-3 countries have initiated significant pension reform, their private pension funds (second and third pillars) are now 3 percent to 4.5 percent of GDP. Their mutual funds now have assets under management of about 5 percent in the Czech Republic and Hungary, and about 3 percent in Poland. These are two to three times the levels achieved in Romania, most of which are held by the five Financial Investment Companies (SIFs).

**Figure 1. Financial Sector Development Indicators: Romania vs. EU-15, 2002**




With the macroeconomic environment beginning to show improvement, most of the constraints to NBFIs and the capital markets are structural. Major constraints to securities market development in Romania have included perceptions of political and investment

1. Accession countries are those Central European and Baltic countries that joined the European Union (EU) on May 1, 2004.
2. As for the Romanian banking sector, data are calculated based on the Monetary Survey.

risk; corruption and a weak judiciary, weak corporate governance; the limited presence of institutional investors, a narrow supply of instruments and range of maturities (as well as insufficient development of benchmarks for yield curves); uneven tax incentives (for example, insurance and pension); inadequate utilization of deductibility and incentives; perceptions of complexity and costs of issuance in the marketplace, lack of transparency and information disclosure; restrictions imposed by law or guidelines on the size of securities issues (for example, corporate and municipal bonds) and investment policy (for example, insurance). These restrictions are being removed.

On the legal and regulatory front, a number of measures have been undertaken in the areas of capital markets, insurance, housing finance, and pension, including:

- The new Capital Market Law ("the Law"), which is fully consistent with EU financial sector directives; the aim is to prepare the secondary capital markets legislation so that this legislation can be adopted before the end of 2004.
- In addition, the Government is preparing a comprehensive set of legislation to support the development of the housing mortgage market. Three key laws have been prepared under a Financial Market Reform project supported by USAID: the Mortgage Loan Law, the Mortgage Bond Law, and the Securitization and Receivables Law.[3] The Government plans to finalize this legislative package by the end of 2004. The National Securities and Exchange Commission (CNVM) will need to develop the detailed regulations required to support the issuance of mortgage bonds and mortgage-backed securities, which the authorities are planning to complete by mid-2005.
- In the area of insurance, the Government has adopted new primary legislation that is fully consistent with EU insurance directives and plans are underway to begin work on the secondary legislation.
- In the area of pensions, the Government has assigned the authority for pension fund supervision to the Insurance Supervision Commission (CSA). A key Priority for the CSA will be to prepare the regulatory framework and to establish and develop the capacity for pension supervision ahead of the introduction of the second and third pillars.

On capacity building for supervisory authorities, the authorities plan to undertake a comprehensive functional/capacity assessment review of the Security Exchange commission and Insurance inspectorate, which will cover the organizational structure, size, management and staff skills, internal reporting, enforcement, and infrastructure; changes in organizational structure, staffing and infrastructure in line with international principles. The Functional/Capacity Assessment Reviews (FCARs) will identify staffing, and training requirements based on the above diagnostic.

Despite the reforms initiated by the authorities to achieve full convergence of the legal and regulatory framework for capital markets and NBFIs, more will need to be done in the

3. Before this legislative package is adopted, the statutes of the mortgage companies will need to be modified (regulated by OUG no.200/2002), respectively, to allow them to become credit institutions licensed and supervised by National Bank of Romania, so that they have access to the secondary mortgage market. Otherwise, mortgage companies will not be allowed to issue mortgage bonds and, therefore will not be subject to the provisions of Mortgage Bond Law, as in the present draft.

next three years to strengthen market institutions and infrastructure for domestic capital markets and NBFIs. Specific changes are necessary in the areas of (i) structural reforms, market institutions, and infrastructure; (ii) accounting, transparency, and disclosure; (iii) market infrastructure; and (iv) perhaps in credit enhancements.

## Structural Reforms and Market Institutions

**Structural reforms.** The authorities will need to continue their current efforts to make structural reforms in the following areas: privatization, anti-corruption, public sector reform, auditing and accounting, and judicial reform.

**Corporate governance.** Improving corporate governance remains a prerequisite to financial sector development in Romania, and in particular to capital markets development. As a first step, the company law should be revised to strengthen joint stock companies and require that boards of administrators (supervisory boards) have minimum fiduciary duties set by law—and that the boards have the necessary authority and internal structures to carry out their fiduciary obligations to shareholders and other stakeholders. In addition, publicly traded companies should be required to disclose both their significant shareholders and the indirect control relationships. Financial reporting should be fully compliant with international standards. Similarly companies should be required to buy and sell assets at "market" prices, particularly where the transaction is conducted with a related-party, such as a controlling shareholder. For publicly-traded companies that are part of financial conglomerates, the legislation should define such conglomerates and provide the regulatory agencies with explicit authority to supervise their activities in the financial markets. Also helpful would be development of a corporate governance code and an institute of directors to provide guidance and training for boards of administrators in applying modern corporate governance principles to Romanian companies.[4]

**Coordination among regulatory authorities.** The legal and regulatory reform process will need to be more interactive and encourage greater dialogue between policy makers, regulators, and market players. Strengthening the framework for coordination among regulatory authorities is essential, as is developing a framework for implementing consolidated supervision. The authorities could investigate the pros and cons of introducing a unified supervision mechanism. Furthermore, establishing a more professionalized approach to the appointment process of the boards overseeing regulatory agencies is needed to improve independence and confidence in market structures. Developing the capacity needed to monitor, investigate, and prosecute criminal activity, with a particular focus on fraud and money laundering, is also needed to improve confidence.

**Securities market regulation and supervision.** The government should continue its efforts to improve observance with IOSCO principles and EU directives. Efforts to strengthen the independence and capacity of the CNVM should also be increased.

**Pension reform** needs to accelerate to further strengthen the institutional investor infrastructure of the capital markets. This can be done by developing a long-term financing strategy to ensure that the unfunded pillar's obligations are met while encouraging the

4. Recently, the Bucharest Stock Exchange established its own Institute of Corporate Governance, which is expected to provide a training ground for corporate governance.

migration of retirement savings to the second and third pillars. This strategy involves adopting legislation in 2004 to accelerate movement toward second and third pillars, finalizing tax issues regarding levels of payroll contribution and deductibility, and focusing on establishing licensing procedures and supervisory capacity in 2004–05. At the same time all needed infrastructure must be prepared to ensure fiduciary responsibilities are fully met and the reporting capacity is in place by 2007. In order to build the capacity of the sector in the long term, information systems also need to be developed with an emphasis on strengthening actuarial capacity as a high priority.

**Insurance sector.** Now that the new primary legislation on insurance has been adopted, there remain several weaknesses in the legal and regulatory framework that need to be strengthened so that a more dynamic and responsive insurance sector can be maintained. The needed improvements include the legal separation of life and non-life insurance operations, additional changes in capital requirements to better reflect coverage of risk, more explicit recognition of the importance of corporate governance provisions (including qualifying holdings in insurance undertakings), and the need for legislation regulating insurance companies that are part of larger financial conglomerates.[5]

**Housing finance.** Continued progress in drafting legislation[6] for a modern mortgage finance framework should be reinforced with a commitment to build institutional capacity so that markets can function efficiently. The legislation should focus on mortgage contracts, mortgage insurance and guarantees, mortgage securities, and other areas of infrastructure and support for a vibrant mortgage market. It is important that underwriting procedures be standardized, that clear title and ownership rights and responsibilities according to contract be provided, that database needs with underwriting requirements and broader market development be harmonized, that the necessary regulations related to mortgage securities, and the premiums and regulations related to contractual housing savings and loans systems be adjusted, and that clear foreclosure procedures in cases of default (albeit with provisions to permit restructuring for debt service and repayment) be effectively implemented.

**Government bonds.** The Government needs to take the lead in establishing a yield curve. This can be done by increasing the role of domestic securities issues to meet long-term government financing needs, introducing regular emission schedules one year in advance,[7] and extending maturities. In an effort to unify the platform for government securities market trading (including differences in payment and settlement), the authorities plan to adopt RTGS payment system early next year, which is expected to improve the infrastructure of capital markets.

**Municipal bonds.** Development of the municipal bond market requires legal reform, institutional capacity building, and better accounting and financial information. building local administrative capacity for budgetary planning, financial management, and service

5. The authorities have recently established a working group and developed a timetable for the drafting and implementing of the necessary legal acts. According to the agreed timetable, the above-mentioned act will be drafted by the end of semester I, 2005; the deadline for approval by the Romanian Parliament is the third quarter of 2006.

6. The authorities have recently drafted Mortgage Bond draft law and Law on securitization of receivables. The World Bank has provided number of comments on these laws.

7. According to the new public debt law no.313/2004, which has been published in the Official Gazette and will enter into force on 1st of January 2005, the Ministry of Public Finance will announce the schedule of domestic and external government issues for the new year at the end of December. The schedule could change during the year because of financial market developments.

provision; and designing credit enhancements based on modern accounting and management principles that allow for increased revenue flows resulting from longer maturities.

**Corporate bonds.** Initiatives to develop the corporate bond market should now be easier to achieve with the removal of legal constraints on the size of corporate bond issues. The focus can now be on developing market infrastructure so that potential purchasers of securities (mainly institutional, but also individual) have the information needed to determine risk-return options. A move to establish a domestic credit/securities rating agency may also be feasible.

**Leasing.** Leasing has the potential to become an important area of growth in the financial sector of Romania, and it is important that a strong legal and regulatory framework for the sector should be in place. Recognizing leasing companies as non-deposit-taking credit institutions, and promoting a more defined regulatory framework for them are important first steps. Tax and accounting issues need to be addressed to provide an added catalyst to leasing sector development, and depreciation schedules should be structured to be consistent with IAS principles. Any residual tax discrimination against leasing activity for industrial and agricultural machinery, and business equipment (for example, computers) should be eliminated for increased diversification of leasing applications.

## Accounting, Transparency, and Disclosure

Romania will need to continue it efforts to move swiftly to improve financial accounting and reporting for all financial and corporate institutions to reduce perceptions of risk and to increase investment flows. This can be achieved by working closely with the major international audit firms, the International Accounting Standards Board, and other related professionals to accelerate the understanding and observance of IAS for market development purposes. The focus should continue to be on key transparency and disclosure practices that are consistent with internationally accepted accounting practices as a basis for attracting investment from abroad.

Transparency in the primary government securities market needs to be improved to increase market confidence and predictability. This can be achieved by providing an issuance calendar for T-bills and, to the extent possible, other government securities. Announcing the exact amount to be tendered one week in advance and accepting bids at any price until the targeted volume is reached—rather than the current practice of applying cut-off rates after the T-bill auction—would increase confidence and participation.

## Market Infrastructure

Financial market infrastructure should be consolidated, upgraded, and modernized. Progress can be achieved through the introduction of a centralized registry for all securities including T-bills, T-bonds, and other bonds and equities; the toughening of standards and the consolidation of registrars and clearing agencies; and the implementation of DvP and the planned RTGS.

Romania should focus on regional and global integration to counter the small size of its market. It is recommended that Romania link with one or more exchanges in the EU (for example, Euronext, Deutsche Boerse/London Stock Exchange/NASDAQ), and/or with all of the CEFTA markets, because these will be under the umbrella of EU legislation. Romania should also explore the possibility of cooperative links and co-listings in the event that formal mergers of exchanges are not feasible. With the merger of BVB and RASDAQ, there should also be an over-the-counter option for firms seeking to trade on markets but unable to meet the minimum threshold requirements for listing on more formal and larger exchanges. Recently, the authorities have been advocating an Alternative Trading System (ATS) to address the inactive nature of the Romania capital market. The authorities may want to expand the ATS concept to cover the potential regional cooperation. Given the market size, the authorities may want to consider launching various forms of collaboration and outsourcing of back-office functions with regional markets.

Romania needs to expand the money market beyond T-bills, and to make the existing T-bill market more efficient. This can be done by Delivery versus Payment system, developing a standardized master repurchase agreement covering both banks and NBFIs, and eliminating restrictions on the use of commercial paper and other money market instruments, which are widely used by private companies for cash management purposes.

The Romanian Association of the Banks (RAB) has established a credit bureau that will become operational in the coming months. However, this credit bureau only covers the credit information of its member banks. In this context, Romania should continue its effort to establish a domestic credit rating agency with strong ties to one of the three major international credit rating agencies, and seek ratings for all bonds as well as first-tier listings on the exchange(s). If this is not feasible, an active credit information bureau may be able to make a contribution to the information available to investors about an issuer's creditworthiness.

Upgrading Romania's property and company registries also is a priority and can potentially offer important benefits to the financial sector. These improvements can be accomplished by establishing a centralized registry/central depository (with a combined central property registry for moveable and immoveable assets), providing electronic access to ensure that complete information is available to prospective creditors and investors (and other stakeholders) setting up systems that prevent simultaneous claims on pledged assets, increasing search capacity, providing greater server capacity to handle increased entries, and introducing standardized formats for data entry to avoid potential losses of important data.

## Equity Mobilization and Credit Enhancements

The use of guarantees for or insurance on bonds floated by municipalities and/or infrastructure providers is being considered by the authorities as a tool to modernize local administration and stimulate the capital markets development effort. More specifically, a few broad equity mobilization and credit enhancement products are being studied by the authorities to mobilize local capital markets for infrastructure and housing investment finance.

**Equity mobilization for Private and Public Partnerships (PPP).** Given the considerable investment requirements for the local infrastructure to meet requirements of EU directives, the current allocation from EU cohesion funds will not be enough to fund all of these investments. The local governments in Romania currently face a real challenge to mobilize other sources of funding including domestic debt market, without having adequate creditworthiness. Options such as private public partnerships are being considered, however, this will require the private sector to take a majority ownership in local utility companies, through concessions or divestitures. To overcome this problem, the authorities are considering alternative PPP frameworks to attract private investors in local infrastructure transactions. As part of the PAL program, the Government has established an Inter-Ministerial Working Group on municipal finance (IWG), which will undertake a number of studies to support the strengthening of the municipal finance borrowing framework and the development of equity mobilization and debt enhancement instruments to improve the access of local governments to domestic capital market.

**Municipal debt market.** The IWG is also considering the development of a partial credit guarantee facility for municipal debt. The facility would cover the repayment of the principal of a municipal bond at maturity, or the repayment of principal of outer year maturities of a municipal loan.

**Housing mortgage market.** Following up on the adoption of primary and secondary mortgage market laws, the authorities are considering the feasibility of supporting the mortgage market by: (i) developing a mortgage default insurance (MI) scheme, which would allow primary mortgage issuers to extend higher loan-to-value (LTV) mortgages to middle income or lower-middle income households, and (ii) the development of mortgage-backed securities (MBS) through a partial credit guarantee facility for MBS, that would create an enhanced security for institutional investors, including insurance companies, mutual funds, and pension funds.

CHAPTER 1

# Introduction

## Background

With just three years remaining before joining the European Union (EU), Romania is working hard to improve its capital markets and non-bank financial institutions (NBFIs), which remain less developed than those of other accession countries. Strengthening these sectors has become a top priority for policy makers, whose primary objective is to ensure that the financial system is sufficiently developed to serve the growing demands of the Romanian economy.

The banking sector is relatively concentrated and small compared with GDP. The Romanian banking sector comprises 38 banks, including eight branches of foreign banks. The total assets of the banking sector represent approximately 33.3 percent of the GDP, whereas the ratio is on average 70 percent in accession countries, and 260 percent in the Euro zone. In Romania the ratio between real sector credit loan and GDP was only 16 percent in 2003. Although it increased to 18.8 percent in 1996, it has since fallen dramatically following major banking crises in 1998 and 1999. At the end of 2003, the sector was highly concentrated, with two banks which have significant state ownership[8]—Banca Comerciala Romana (BCR) and the Casa de Economii si Consemnatiuni Savings Bank (CEC)—holding 35 percent of the assets. In addition, foreign-owned banks (including foreign banks branches) are also active participants, with 58.3 percent of the total assets and 66.3 percent of the aggregate share capital.

In Romania corporate finance relies primarily on bank lending. Securities markets are shallow and narrow. Despite rapid growth in the last two years, stock market capitalization was only 10.7 percent of GDP in 2003, half the average of EU accession countries. Trading is highly concentrated on very few securities, and free float is minimal. The government bond

8. With the sale of 25 percent of BCR's shares to the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) in June 2004, BCR can be regarded as a private bank with significant state ownership (37 percent). This leaves Casa de Economii si Consemnatiuni (CEC) as the only major public bank.

market is narrow, and maturities do not extend beyond five years. A municipal bond market is emerging, with about twenty issues that have maturities up to five years. Corporate bond issuances had been very limited in the domestic markets, although in 2004 a number of larger new issues have been authorized.[9] Among institutional investors, insurance is growing rapidly, but market depth remains well below levels achieved in the other accession countries. There are no private pension funds. The investment fund business is small, and slowly recovering from the lack of confidence due to fraudulent investment schemes in the midnineties and banking crises at the end of the decade. Mortgage finance and leasing are growing rapidly, albeit from a very low base. Credit enhancement facilities are nonexistent.

During the preparation of this document a number of legislation was introduced to meet the requirements of EU financial directives. However, a number of deficiencies still remain in the institutional, legal, and regulatory framework for capital markets and NBFIs. More specifically, related secondary legislation and regulations still need to be drafted and the capacity of related supervisory agencies remains well below international standards, especially in the area of enforcement. Furthermore, despite the recent adoption of a corporate governance code, corporate governance lags significantly behind OECD principles.

Although Romania plans to become an EU member in 2007, the EU will have completed the implementation of its Financial Services Action Plan, resulting in the establishment of a single financial market among its members two years prior. Upon accession, Romanian capital markets and NBFIs will face the challenge of integration within the single EU wholesale market and within the open EU retail market. They will be supervised according to international standards, free of unequal tax treatment relative to the other EU members,[10] and subject to an efficient and transparent legal system of corporate governance.

Creating the conditions for the development of deep and diverse capital markets and NBFIs are critical to successful integration within the EU single financial market. Increasing competition and rapid transformation of the sector ahead of accession will undoubtedly create major risks for market participants. At the same time, however, the emergence of competitive capital markets and NBFIs ahead of accession will create major opportunities for businesses, provide new avenues for household savings mobilization, increase financial resources available for investment by government, municipalities, and enterprises, and transfer risks to those economic agents that are better equipped to bear them. Following accession, the presence of competitive capital markets and NBFIs will have farreaching implications for savings mobilization, investment, and growth over the medium to long term.

## Objective of the Study

This study was discussed with the Romanian authorities and their comments have been incorporated into the document. The study's objective is to highlight the key impediments to the development of capital markets and NBFIs in Romania and to formulate policy

9. This includes BRD—Groupe Societe Generale and Raiffeisen Bank who issued corporate bonds in April and May 2004, respectively.
10. EU members before the recent enlargement.

reform priorities for capital markets and NBFIs ahead of integration within the EU single financial market. Furthermore, the authorities welcomed a benchmarking exercise to measure the depth of different NBFIs with respect to EU accession countries. The study is meant to facilitate a dialogue between different stakeholders in Romania on the development of non-bank financial institutions.

The study builds on the extensive work carried out by the Joint World Bank-IMF Financial Sector Assessment Program (FSAP) of March 2004. In addition, the study incorporated the findings of other reports carried out by the World Bank,[11] the EU Commission and the US Agency for International Development (USAID).

The study is organized as follows. Chapter 2 benchmarks the Romanian capital market and NBFI with that of EU and CE-3 countries. In Chapter 3, the report highlights the main impediments to further development of NBFI and capital markets, incorporating the results of other relevant studies. Given the extent and complexity of the capital market and NBFIs, Chapter 4 aims to highlight the major issues that will need to be implemented to bring the Romanian market and NBFI within the single EU financial market.

11. Including the Accounting & Auditing Report on Observance of Standards and Codes (ROSC) 2003, and the Corporate Governance ROSC 2004.

CHAPTER 2

# Recent Evolution of NBFIs in Romania

## Overall Financial Sector Development

### *Macroeconomic Environment*

Since 2000, macroeconomic trends in Romania have been quite favorable. Table 1 shows that real GDP growth has averaged nearly 5 percent since 2001, following four consecutive years of either negative or weak real growth. The inflation rate has declined from 46 percent in 1999–2000 to 15.3 percent in 2003. With an average inflation projected at 12 percent in 2004, this would bring the inflation rate down to approximately one-fifth of the levels experienced as recently as 1998. Fiscal deficits have been brought under control (less than 3 percent of GDP since 2002), with the improving trend likely to continue.

Exporting enterprises have had relative success penetrating foreign markets, as reflected in higher merchandise export earnings since 1999. While performance in attracting FDI has not been strong, it has been consistent since 1999, and appears to have increased in 2003 to its highest level. In recent years, FDI has been supplemented by rising levels of net private transfers from Romanians working abroad, which were estimated to be more than US$1.6 billion in 2003. These inflows have been roughly equivalent to (or higher than) net FDI since 2002, and constitute an important financial source that stimulates both consumption as well as investment. Meanwhile, reserves have also increased since 1999 and at the end of 2003 covered more than four months' imports.

Romania lags behind its EU counterparts in many of its economic indicators. Per capita income is only 9.2 percent of the EU average (2002 figures). At current rates of growth, it would take Romania decades to converge with Portugal, the country with the

**Table 1. Macroeconomic Profile of Romania, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| Real GDP | 4.0 | –6.1 | –4.8 | –1.2 | 2.1 | 5.7 | 5.0 | 4.9 |
| Inflation (Avg. CPI %) | 38.8 | 154.8 | 59.1 | 45.8 | 45.7 | 34.5 | 22.5 | 15.3 |
| Fiscal Balance/ GDP (%) | –3.9 | –3.51 | –3.6 | –1.9 | –4.0 | –3.3 | –2.6 | –2.31 |
| Current Account/ GDP (%) | –7.3 | –6.0 | –6.9 | –4.0 | –3.7 | –5.6 | –3.4 | –5.7 |
| Net Current Private Transfers ($ million) | 546 | 515 | 701 | 569 | 790 | 922 | 1,255 | 1,629 |
| External Debt/ GDP (%) | 26.7 | 27.2 | 27.3 | 29.4 | 33.4 | 32.3 | 33.8 | 33.4 |
| Public Debt/ GDP (%) | 28.8 | 27.8 | 28.0 | 33.2 | 31.3 | 28.6 | 28.3 | 26.6 |
| FDI ($ million) | 263 | 1,224 | 2,040 | 1,025 | 1,048 | 1,174 | 1,128 | 1,800 |
| FDI per capita ($) | 12 | 54 | 91 | 46 | 47 | 52 | 52 | 83 |
| Gross Official Reserves ($ million) | 1,587.3 | 3,060.9 | 2,299.1 | 2,492.9 | 3,389.7 | 4,861.2 | 7,305.9 | 9,486.2 |
| Months' Import Cover | 1.52 | 2.9 | 2.2 | 2.6 | 2.9 | 3.5 | 4.7 | 4.5 |

*Notes:* Net current private transfers are "other sectors" through 2001, and from NBR balance of payments in 2002–03; Real GDP growth, external debt and gross official reserves for 2003 are projected; external debt includes private debt, not just external debt that is public or publicly-guaranteed); Romania public debt-to-GDP ratios differ slightly from MoPF figures due to differing GDP denominators.

*Sources:* NBR, MoPF, IMF (various sources), WDI, authors' calculations.

lowest per capita income among the EU-15 members.[12] It is currently unclear how long it will take for Romania to bring its inflation rate down to EU norms, which have been below 3 percent since 1994 and averaged about 2.2 percent since then.[13]

On the positive side, deficits and debt are under control. Romania has been moving toward compliance with Maastricht fiscal criteria since 2002, and its fiscal deficits have been below 3 percent since then. Public debt has been well below 60 percent of GDP (Table 2).

Romania's macroeconomic performance relative to that of the CE-3 countries in recent years has been comparable or superior in terms of real GDP growth and fiscal deficits, but weaker in terms of inflation rates and incomes.

12. All EU states referenced within this report correspond to those maintaining membership prior to the recent enlargement.

13. This assumes per capita incomes (GNI Atlas method) of $10,840 (2002) and average growth in Portugal of only 2 percent per year, which is comparable to the average for most EU countries. Growth rates in Portugal have generally been higher than this level over the last decade, with 1994–95 and 2002 being the exceptions. Romania's GNI per capita was $2,588 in 2003. Thus, with real growth of 5 percent for Romania and only 2 percent for Portugal, these are conservative assumptions, and show the gap between Romania and the lower end of the EU income table.

**Table 2. Macroeconomic Comparison with EU-15 and CE-3 Countries, 1997–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **Romania** | | | | | | | | |
| GDP (billions $) | 35.3 | 35.3 | 42.1 | 35.6 | 37.1 | 40.2 | 45.7 | 56.9 |
| GNI per capita ($) | 1,549 | 1,551 | 1,852 | 1,567 | 1,639 | 1,781 | 2,079 | 2,588 |
| Real GDP (%) | 4.0 | –6.1 | –4.8 | –1.2 | 2.1 | 5.7 | 5.0 | 4.9 |
| Inflation Rate (%) | 38.8 | 154.8 | 59.1 | 45.8 | 45.7 | 34.5 | 22.5 | 15.3 |
| Fiscal Balance/ GDP (%) | –3.9 | –3.5 | –3.6 | –1.9 | –4.0 | –3.3 | –2.6 | –2.3 |
| Public Debt/ GDP (%) | 28.8 | 27.8 | 28.0 | 33.2 | 31.3 | 28.6 | 28.3 | 26.6 |
| **EU-15** | | | | | | | | |
| GDP (billions $) | 8,783 | 8,257 | 8,541 | 8,542 | 7,865 | 7,890 | 8,563 | n/a |
| GNI per capita ($) | 23,113 | 21,729 | 22,476 | 27,479 | 20,697 | 20,763 | 22,534 | n/a |
| Real GDP (%) | 1.6 | 2.5 | 2.9 | 2.9 | 3.5 | 1.6 | 1.0 | 0.7 |
| Inflation Rate (%) | 2.0 | 1.9 | 1.8 | 1.6 | 2.8 | 2.7 | 2.2 | 2.3 |
| Fiscal Balance/ GDP (%) | –4.2 | –2.4 | –1.6 | –0.7 | 1.0 | –1.0 | –2.0 | –2.6 |
| Public Debt/ GDP (%) | 72.3 | 70.9 | 68.7 | 67.8 | 64.0 | 63.2 | 62.5 | 64.0 |
| **Czech Republic** | | | | | | | | |
| GDP (billions $) | 57.7 | 53.0 | 57.0 | 55.0 | 51.4 | 57.2 | 69.5 | 85.4 |
| GNI per capita ($) | 5,180 | 5,280 | 5,160 | 5,120 | 5,250 | 5,320 | 5,560 | n/a |
| Real GDP (%) | 6.4 | 4.8 | –1.3 | –1.0 | 0.5 | 3.3 | 3.1 | 2.9 |
| Inflation Rate (%) | 8.8 | 8.5 | 10.6 | 2.1 | 3.9 | 4.7 | 1.8 | 0.1 |
| Fiscal Balance/ GDP (%) | –1.7 | –2.7 | –2.4 | –2.8 | –4.4 | –5.1 | –6.7 | –8.3 |
| Public Debt/ GDP (%) | n/a | 12.9 | 13.7 | 14.3 | 18.2 | 25.2 | 28.9 | 37.6 |
| **Hungary** | | | | | | | | |
| GDP (billions $) | 45.2 | 45.7 | 47.0 | 48.0 | 46.7 | 51.8 | 65.8 | 83.6 |
| GNI per capita ($) | 4,350 | 4,510 | 4,480 | 4,620 | 4,710 | 4,830 | 5,280 | n/a |
| Real GDP (%) | 1.5 | 1.3 | 4.6 | 4.9 | 4.2 | 5.2 | 3.8 | 2.9 |
| Inflation Rate (%) | 23.6 | 18.3 | 14.2 | 10.0 | 9.8 | 9.2 | 5.5 | 4.6 |
| Fiscal Balance/ GDP (%) | –5.0 | –4.8 | –4.8 | –3.4 | –3.4 | –4.7 | –9.2 | –5.5 |
| Public Debt/ GDP (%) | n/a | 64.2 | 61.9 | 61.2 | 55.4 | 53.5 | 57.1 | 59.0 |

*(continued)*

**Table 2. Macroeconomic Comparison with EU-15 and CE-3 Countries, 1997–2003 (*Continued*)**

| **Poland** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** |
|---|---|---|---|---|---|---|---|---|
| GDP (billions $) | 130.6 | 149.0 | 158.3 | 155.1 | 164.0 | 183.0 | 189.0 | 206.0 |
| GNI per capita ($) | 3,200 | 3,560 | 3,860 | 4,060 | 4,230 | 4,340 | 4,570 | 5,333 |
| Real GDP (%) | 7.0 | 6.0 | 6.8 | 4.8 | 4.1 | 4.0 | 1.0 | 3.7 |
| Inflation Rate (%) | 19.8 | 15.1 | 11.7 | 7.3 | 10.1 | 5.5 | 1.9 | 1.2 |
| Fiscal Balance/ GDP (%) | –3.3 | –3.1 | –3.2 | –3.3 | –3.5 | –5.5 | –6.7 | –6.9 |
| Public Debt/ GDP (%) | n/a | 44.0 | 39.1 | 40.3 | 36.6 | 36.7 | 41.2 | 45.4 |

*Notes:* Eurostat debt figures are higher for Romania than those of the MoPFdue to differing GDP denominators, Authors used MOPF figures.

*Sources:* WDI; IMF; NBR; MoPF; Eurostat; Bakker Gross (2003); authors' calculations.

## *Corporate Sector Developments*

*Privatization and the Business Environment.* The original approach to mass privatization in Romania was to establish five Private Ownership Funds (POFs) in which the funds' managers would (in theory) exercise corporate governance in privatized companies. As elsewhere in many transition countries, mass privatization was relatively ineffective due to insufficient restructuring in many or perhaps most of the companies, weak corporate governance of the fund managers and (following the collapse of the large investment fund, FNI) lack of credibility with investors in attracting new capital.

Romania's cumulative privatization revenues to GDP were only 5.2 percent as of 2003[14] (Table 3). This has generally placed Romania in the same category as Albania (higher than CIS countries but lower than most first wave EU accession countries). For instance, Romania's 5.2 percent figure compares with Hungary's figure of nearly 31 percent, the Czech Republic at 19 percent, and Poland at nearly 13 percent. This has resulted in reduced investor interest in the Romanian market, fewer issuers, and a limited number of institutional investors.

There are persistent problems at the firm level that undermine efforts to achieve competitiveness. Most companies have a substantial number of shareholders who are inactive in company affairs, while blocks of shareholders are in a position to stifle needed restructuring. Unfortunately, this problem is common to privatization programs in many transition economies, whereby the need to support subsequent capital market development is ignored, which in turn constrains privatization activities in long run.

*Financing Issues and Constraints in the Real Sector.* SMEs have traditionally been credit-constrained because of the difficulties banks face in assessing credit risk and obtaining ade-

14. As of the end of June 2004, in AVAS' portfolio (the institution that resulted after the merger of APAPS with AVAB), there were a number of companies to be privatized: 153 companies in which AVAS held a majority stake, and 395 companies in which AVAS held a minority position.

**Table 3. Data on Privatized Firms and Outstanding State Enterprises, 1992–2003**

| | 1992–99 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Privatization Revenues (millions $) | 2,375 | 260 | 241 | 46 | 47 |
| Revenues/GDP (%) | 7.3 | 0.7 | 0.6 | 0.1 | 0.1 |
| Revenues/FDI (%) | 43.4 | 24.8 | 20.5 | 4.1 | 2.7 |
| Cumulative Revenues (millions $) | 2,375 | 2,635 | 2,876 | 2,922 | 2,969 |
| Cumulative Revenues/GDP (%) | 7.3 | 7.1 | 7.2 | 6.4 | 5.2 |
| Cumulative Revenues/Cumulative FDI (%) | 43.4 | 40.4 | 37.4 | 33.1 | 28.0 |

*Notes:* Equity of SOEs are book values; of the 1,151 firms in which APAPS had equity at year-end 2003, 767 were to be privatized and 384 were to be liquidated. APAPS had majority holdings in only 277 of the 767 firms to be privatized.

*Sources:* APAPS; EBRD; authors' calculations.

quate collateral for loans. Even when collateral is obtained, an inconsistent judiciary has often undermined effective creditor rights, reducing banks' willingness to extend credit once prudential norms were toughened by the NBR and state support was diminished.

On an absolute basis, private sector share of credit and GDP have both increased. However, much of this has been to households and NBFIs, not SMEs. The most dramatic change has been lending by banks to NBFIs, which accounted for nearly 35 percent at year-end 2003 as compared with only 10 percent in 2000. Much of the credit has been for housing loans, vehicles and consumer goods, with banks lending to leasing companies and wholesalers who import and distribute machinery, equipment, appliances, and vehicles.

The vast majority of firms in Romania are small and lack access to syndicated lines of credit and the Eurobond market. Instead, they appear to rely on internal sources, retained earnings, loans from family and friends and, in some cases, arrears on obligations to non-banks (for example, utilities, government, employees).

- Sources of financing of new investments were reportedly 72 percent from internal funds and retained earnings, while another 5 percent came from loans from family or friends.
- Borrowings from banks accounted for only 11 percent, and equity less than 1 percent.
- Working capital financing shows similar patterns, with primary reliance on internal funds and retained earnings, and parallel figures for equity, bank borrowings, and loans from family and friends.
- Overdue payments are reported to be primarily on taxes (20 percent) and material input supplies (18 percent), and less on utilities (13 percent) and to employees (8 percent).

By the end of 2001 arrears to the government and other enterprises were reported to be 58 percent of total firm assets. Figures from 2001 for listed firms on the BVB and RASDAQ with more than 50 employees indicated that 34.6 percent of their financing was in the form of overdue payables, of which a sizeable portion (22.4 percent of the 34.6 percent) was owed to the government in the form of delinquent payments on taxes and social security.

Romania's lending trends are beginning to converge with EU indicators, but the average ratio of spreads between Romania and the EU was nearly five-fold from 1997–2003. About 80 percent of current Euro Area credit is provided to enterprises, most of which are privately-owned. By 2007, there should be little differentiation between Romania's proportional exposure to the private sector and government and that of banks in the EU.

Romania's performance has been fairly similar to that of the CE-3 countries in terms of credit exposure to the state and private sectors (see Table 4). However, Romania's intermediation levels are lower, and the cost of credit is higher. There is still a significant gap between Romania's private sector credit as a share of GDP compared with the CE-3, although this narrowed in 2003. Romania's average net lending spreads from 1997–2003 were three to five times the averages of CE-3 countries. This has made credit more expensive for enterprises, while the overall quantity of credit has been lower.

## *Banks in Romania*

Banks[15] are the most important financial institutions in Romania and the main source of financing to the private sector. Intermediation trends are increasingly favorable, with rising depth and declining interest costs. There are 38[16] banks in Romania, and their assets accounted for about 33 percent of GDP in 2003 versus 31 percent in 2002. Banks are also key lenders to NBFIs, and are expected to play a prominent role in capital markets as they develop. Market capitalization of the combined exchanges is less than bank assets (equivalent to 32.3 percent of banking assets). Assets held by SIFs, other funds, insurance companies, and leasing companies are well below those held by banks (accounting for 16 percent of banking assets).

Nominal interest rates are on declining trend.[17] Meanwhile, loan-deposit spread[18] has also declined, from 18.9 percent in 2001 to 17.6 percent in 2002 and 14.7 percent in 2003. These are the lowest nominal spreads for commercial banks since 1997, but they still are very high. This is a reflection of perceived on-lending risks by the banks and is a combination of number of risk factors including: (a) the large share of bank lending in foreign exchange to unhedged borrowers[19]; (b) substantial corporate sector arrears; (c) possible overstatement of capital resulting from overvaluation of fixed assets and lack of consolidated accounting; (d) weaknesses in accounting, auditing, and the judicial system; and (e) the potential for fraud.

Funding of the banking system is increasing, although it is still deposit-oriented[20] with few other debt sources. As Table 5 indicates, deposits have increased from US$6.1 billion (or 16.6 percent of GDP) at year-end 2000, and stood at about US$12.4 billion-equivalent (21.7 percent of GDP) at year-end 2003.

15. Bank assets were about 84 percent of total financial assets in 2003.
16. Includes eight foreign bank branches.
17. Downward interest movement did not continue in second half of 2003 and first half of 2004.
18. Lending rate for non-banks non-government—Deposit rate for non-banks non-government (including sight deposits). If we consider just time deposit rate, the spreads are as follows: 2001: 13.8%, 2002: 14.2%, 2003: 11.2%.
19. Source: Romania FSAP.
20. Commercial bank liabilities can be broken down into following categories: (i) about 70 percent due to customers, almost all in form of deposits from customers, (ii) 14 percent due to other banks and institutions, (iii) 1 percent operation with securities and other operations, and (iv) the rest is own capital.

**Table 4. Structural Comparison of Romania, the EU-15 and the CE-3, 1997–2003**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| **EU-15** | | | | | | | |
| Private Sector Credit/GDP (%) | n/a | 96.3 | 101.2 | 106.45 | 108.4 | 109.2 | 112.7 |
| Private Sector % of Net Domestic Credit | 73.2 | 74.5 | 76.1 | 79.1 | 79.6 | 79.8 | 79.7 |
| State Sector % of Net Domestic Credit | 26.8 | 25.5 | 23.9 | 20.9 | 20.4 | 20.2 | 20.3 |
| Net Lending Spreads (%) | 4.2 | 3.5 | 3.2 | 3.2 | 3.3 | 3.3 | n/a |
| **Romania** | | | | | | | |
| Private Sector Credit/GDP (%) | 8.2 | 10.3 | 7.5 | 6.7 | 8.0 | 10.1 | 14.7 |
| Private Sector % of Credit to non-government | 64.5 | 80.1 | 84.1 | 85.5 | 85.9 | 86.9 | 90.3 |
| State Sector % of Net Domestic Credit | 35.5 | 19.9 | 15.9 | 14.5 | 14.1 | 13.1 | 9.7 |
| Net Lending Spreads (%) | 12.1 | 18.6 | 20.5 | 20.7 | 18.7 | 16.5 | 14.6 |
| **Czech Republic** | | | | | | | |
| Private Sector Credit/GDP (%) | 65.6 | 58.7 | 54.4 | 49.5 | 40.4 | 31.7 | 33.1 |
| Private Sector % of Net Domestic Credit | 83.4 | 84.5 | 83.8 | 82.6 | 74.0 | 61.3 | 59.0 |
| State Sector % of Net Domestic Credit | 16.6 | 15.5 | 16.2 | 17.4 | 26.0 | 38.7 | 41.0 |
| Net Lending Spreads (%) | 5.5 | 4.7 | 4.2 | 3.7 | 4.1 | 4.0 | 3.9 |
| **Hungary** | | | | | | | |
| Private Sector Credit/GDP (%) | 23.9 | 23.8 | 25.5 | 30.4 | 33.9 | 35.3 | 43.8 |
| Private Sector % of Net Domestic Credit | 67.0 | 66.3 | 71.8 | 75.5 | 76.8 | 74.8 | 77.9 |
| State Sector % of Net Domestic Credit | 33.0 | 33.7 | 28.2 | 24.5 | 23.2 | 25.2 | 22.1 |
| Net Lending Spreads (%) | 4.8 | 4.9 | 4.4 | 3.1 | 3.7 | 2.8 | 2.5 |
| **Poland** | | | | | | | |
| Private Sector Credit/GDP (%) | 16.6 | 18.8 | 22.4 | 24.3 | 24.6 | 28.8 | 30.9 |
| Private Sector % of Net Domestic Credit | 49.6 | 53.9 | 59.0 | 66.4 | 66.2 | 74.0 | 71.1 |
| State Sector % of Net Domestic Credit | 50.4 | 46.1 | 41.0 | 33.6 | 33.8 | 26.0 | 28.9 |
| Net Lending Spreads (%) | 5.6 | 6.3 | 5.8 | 5.8 | 6.6 | 5.9 | 4.9 |

*Notes:* Private sector credit in the Euro Area banking institutions = claims on other resident sectors (which may include some state enterprises); State sector credit in the Euro Area banking institutions = claims on general government, and may exclude exposures to state enterprises; 2003 GDP figures for EU-15 annualized from 1Q-3Q totals; net lending spreads in Romania from NBR figures comparing average lending and deposit rates for non-bank customers of banks.

Private sector credit in CE-3 = other claims on residents (which includes state enterprises); State sector credit in CE-3 = claims on general government, including local government, but excludes exposures to state enterprises; 2003 GDP figures for Czech Republic annualized from 1Q-3Q totals; 2003 GDP figures for Hungary and Poland annualized from 1Q-2Q totals; 2003 credit figures and net lending spreads for Hungary from November; 2003 net lending spreads in Poland from June.

*Sources:* IFS; NBR; authors' calculations.

**Table 5. Profile of Romania's Banking System, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **M2/GDP (%)** | 21.3 | 22.0 | 20.1 | 20.6 | 19.3 | 21.3 | 24.4 | 24.8 |
| **Number of Banks** | 40 | 43 | 45 | 41 | 41 | 41 | 39 | 38 |
| Bank Assets/ GDP (%) | 38.6 | 35.4 | 32.1 | 28.0 | 24.2 | 27.7 | 31.2 | 33.3 |
| Total Assets ($ millions) | 13,636 | 12,488 | 13,515 | 9,980 | 8,975 | 11,145 | 14,274 | 18,941 |
| Assets/Bank ($ millions) | 341 | 290 | 300 | 243 | 219 | 272 | 366 | 498 |
| Loans/GDP (%) | 18.8 | 12.7 | 12.8 | 8.9 | 7.8 | 9.3 | 11.7 | 16.3 |
| Total Loans ($ millions) | 6,652 | 4,475 | 5,396 | 3,162 | 2,893 | 3,743 | 5,335 | 9,292 |
| Loans/Bank ($ millions) | 166 | 104 | 120 | 77 | 71 | 91 | 137 | 245 |
| NPLs/Loans (%) | n/a | n/a | 26.6 | 0.6 | 0.7 | 0.7 | 0.4 | 0.3 |
| NPLs/Assets (%) | n/a | n/a | 14.5 | 2.4 | 0.3 | 0.3 | 0.2 | 0.2 |
| NPLs/Capital (%) | n/a | n/a | 253.6 | 31.2 | 3.3 | 2.7 | 2.0 | 2.0 |
| Deposits/GDP (%) | 17.5 | 18.7 | 17.6 | 18.0 | 16.6 | 18.5 | 21.4 | 21.7 |
| Total Deposits (millions) | 6,179 | 6,600 | 7,397 | 6,396 | 6,145 | 7,434 | 9,795 | 12,357 |
| Deposits/Bank (millions) | 154 | 153 | 164 | 156 | 150 | 181 | 251 | 325 |
| Capital/GDP (%) | 2.0 | 0.3 | 2.3 | 1.5 | 1.6 | 1.8 | 1.9 | 2.2 |
| System Solvency Ratio (%) | n/a | n/a | 10.3 | 17.9 | 23.8 | 28.8 | 25.0 | 21.1 |

*Notes:* Figures for loans are to enterprises, households, banks and NBFIs, but do not include purchases of government securities; NPL/Loan figures for 1998–99 are derived; deposits do not include government deposits; bank capital figures are capital accounts plus other items net from IFS.

*Sources:* IFS; NBR; EBRD; authors' calculations.

Bank shareholder equity has also increased to about US$2.5 billion at year-end 2003, or about 13.1 percent of assets; although off-balance sheet items and other items (net) would bring this down to about US$1.3 billion, or about 6.9 percent of assets.

Such trends may slow down in the future as a result of increasing risk in the banking system. Solvency ratios declined in 2003, and risk ratios have also increased. There are questions about asset quality and the quest for earnings by banks as the interest rate environment changes and "inflation profits" are harder to generate. Increasing use of "credit insurance" and other uses of NBFIs (including lending to NBFIs) indicate that the system needs more integrated supervisory efforts.

Banks can be expected to play a prominent role in corporate bond market development in the coming years as issuers, intermediaries and investors. However, improving trends in the banking sector combined with restrictions established in early 1990s on corporate bond issuance to registered capital by corporations, as well as a general lack of familiarity with them, have resulted in very limited movement to the issuance of corporate bonds.

There are some positive signs, however, as banks now see more opportunities in the real economy than in earlier years, and are beginning to seek additional resources to finance these activities. In addition, there is growing demand for longer-term financing, namely for housing, vehicles and white goods. As examples, BRD-Societe Generale, Raiffeisen Bank and BCR's leasing company have recently issued corporate bonds. Thus, it is the comparatively large Romanian banks that are driving the diversification of bank funding in the domestic markets. Given that these banks are seeking additional funding, other banks are likely to consider doing the same as they are more constrained from the funding side than the three largest banks.

*Romania Compared to the EU-15 and CE-3 Countries.* Romania's banking system is underdeveloped compared to that of the EU-15. The EU banking system assets are on average 2.5 times the GDP, as compared with only 33 percent of GDP in Romania. Thus relative depth of EU banking is about eight times the levels found in Romania. Real sector credit as a share of GDP in the EU is about seven times that achieved in Romania, reflecting far higher levels of financing for enterprises and households in EU markets.

Funding is far more stable in the EU-15 than in Romania. Loan-to-deposit spreads have been fairly constant and low in the EU, at about 3.5 percent since the 1990s. This stands in contrast to Romania's spreads of about 15 to 20 percent since 1999. The funding base in EU banks is sound, with deposits about 85 to 90 percent of GDP. In Romania, comparative deposit levels are now only about one quarter the levels found in the EU-15 countries.

The comparison of Romania's banking sector against to that of CE-3 countries is more favorable, although there are still significant gaps. Romania's bank assets tend to be about half of those in Hungary and Poland, and about one-third of levels achieved in the Czech Republic as a proportion of GDP. Credit in the CE-3 countries was about two times the levels, on average, when compared with to Romania.

Pricing of credit in CE-3 countries is far lower than in Romania. While there has been a compression of margins in Romania, these are still far higher than in the CE-3 countries. Deposits-to-GDP are still significantly lower in Romania than in the CE-3 countries. The Czech Republic's ratios are about three times that of Romania. Hungary and Poland have nearly two times Romania's deposit-to-GDP ratios (Table 6).

### *Non-Bank Financial Sector Development*

Financial assets at the end of 2003 were approximately US$22.1 billion, or 39 percent of GDP. Bank assets comprised 84 percent of total financial assets, while insurance companies accounted for only 4.7 percent, mutual and investment funds for 4.1 percent, and about 7 percent for leasing and factoring companies.

As with the banking sector, capital markets have been weakened by the collapse of major open-ended funds, which has damaged investor confidence. The collapse of the National Investment Fund (FNI) in 2000 affected about 80 percent of the 329,000 investors in open-end funds at the time, with losses estimated between US$100 and US$150 million. With equities accounting for 1 to 2 percent of financing, securities markets are insignificant as a source for financing to all but a few Romanian enterprises.

**Table 6. Comparison of Romania's Banking System, the EU-15 and the CE-3, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **EU-15** | | | | | | | | |
| Bank Assets/GDP (%) | n/a | n/a | 224.0 | 232.1 | 236.6 | 243.3 | 245.1 | 253.0 |
| Real Sector Credit/GDP (%) | n/a | n/a | 96.3 | 101.2 | 106.4 | 108.4 | 109.2 | 112.7 |
| Loan-Deposit Spreads (%) | 4.7 | 4.2 | 3.5 | 3.2 | 3.2 | 3.3 | 3.3 | n/a |
| Deposits/GDP (%) | n/a | n/a | 76.8 | 81.5 | 81.9 | 87.8 | 89.3 | 84.0 |
| Corporate Bonds/GDP (%) | n/a | n/a | n/a | n/a | n/a | n/a | 88.6 | n/a |
| **ROMANIA** | | | | | | | | |
| Bank Assets/GDP (%) | 38.6 | 35.4 | 32.1 | 28.0 | 24.2 | 27.7 | 31.2 | 33.3 |
| Real Sector Credit/GDP (%) | 18.8 | 12.7 | 12.8 | 8.9 | 7.8 | 9.3 | 11.7 | 16.3 |
| Loan-Deposit Spreads (%) | 17.7 | 12.1 | 18.6 | 20.5 | 20.7 | 18.7 | 16.5 | 14.6 |
| Deposits/GDP (%) | 17.5 | 18.7 | 17.6 | 18.0 | 16.6 | 18.5 | 21.4 | 21.7 |
| Corporate Bonds/GDP (%) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.01 | 0.01 |
| **CZECH REPUBLIC** | | | | | | | | |
| Bank Assets/GDP (%) | 100.4 | 108.6 | 102.8 | 103.4 | 98.8 | 95.9 | 88.5 | 93.7 |
| Real Sector Credit/GDP (%) | 81.6 | 74.5 | 64.0 | 57.7 | 51.9 | 42.5 | 29.9 | 33.1 |
| Loan-Deposit Spreads (%) | 5.8 | 5.5 | 4.7 | 4.2 | 3.7 | 4.1 | 4.0 | 3.9 |
| Deposits/GDP (%) | 63.7 | 60.1 | 60.0 | 57.5 | 60.8 | 66.2 | 63.0 | 68.6 |
| **HUNGARY** | | | | | | | | |
| Bank Assets/GDP (%) | 41.5 | 44.7 | 46.2 | 47.2 | 51.8 | 55.4 | 55.0 | 67.0 |
| Real Sector Credit/GDP (%) | 22.1 | 24.3 | 24.2 | 26.1 | 32.3 | 33.4 | 42.7 | 43.8 |
| Loan-Deposit Spreads (%) | 8.7 | 4.8 | 4.95 | 4.4 | 3.1 | 3.7 | 2.8 | 2.5 |
| Deposits/GDP (%) | 33.0 | 33.85 | 34.3 | 33.8 | 34.4 | 35.15 | 36.6 | 40.0 |
| **POLAND** | | | | | | | | |
| Bank Assets/GDP (%) | 40.8 | 42.1 | 42.5 | 45.7 | 44.0 | 48.0 | 48.3 | 54.8 |
| Real Sector Credit/GDP (%) | 20.9 | 22.7 | 24.5 | 27.6 | 28.9 | 29.4 | 29.1 | 30.9 |
| Loan-Deposit Spreads (%) | 6.1 | 5.6 | 6.3 | 5.8 | 5.8 | 6.6 | 5.9 | 4.9 |
| Deposits/GDP (%) | 25.6 | 28.1 | 33.0 | 33.6 | 36.8 | 40.7 | 38.1 | 39.0 |

*Notes:* 2003 GDP figures for EU-15 annualized from 1Q-3Q totals; figures for loans are to enterprises, households, banks and NBFIs, but do not include purchases of government securities. Figures for loans are to enterprises, households, banks and NBFIs, but do not include purchases of government securities; 2003 GDP figures for Czech Republic annualized from 1Q-3Q totals; 2003 GDP figures for Hungary and Poland annualized from 1Q-2Q totals; 2003 credit and deposit figures and net lending spreads for Hungary from November; 2003 net lending spreads in Poland from June; data on corporate bonds not available.

*Sources:* IFS; IMF Global Stability Report (2003); NBR; EBRD; authors' calculations.

*Romania Compared to the EU-15 and CE-3 Countries.* Romania's indicators show NBFI development lags behind most OECD countries. As per Table 7, insurance depth is low in Romania, although it is growing. Pension reform when initiated will add to general market development, but it will take several years before reaching the 30 percent of private pension assets-to-GDP threshold figure currently exhibited in the EU. Mutual funds are small in Romania, and they maintain only about 1.7 percent of the relative assets to GDP

**Table 7. Profile of Romania's Financial Sector, 2003**

| | Number | Total Assets ($ millions) | Total Assets/GDP (percent) | Net Assets ($ millions) |
|---|---|---|---|---|
| Banks | 38 | 18,941 | 33.3 | 2,482 |
| Insurance | 40 | 1,056.5 | 1.9 | 284 |
| Pension Funds | 1 | 0 | In deficit | Negative |
| Mutual Funds | 26 | 53 | 0.1 | 46 |
| SIFs | 5 | 878 | 1.5 | 771 |
| Leasing | 100 | 1,484 | 2.6 | 1,272 |
| Factoring | n/a | 153 | 0.3 | n/a |

| | Companies listed | Shares Traded | Market Capitalization (31/12/03) | |
|---|---|---|---|---|
| | | | $ millions | % of GDP |
| BVB | 62 | 4,106,381,895 | 3,710 | 6.5 |
| RASDAQ | 2,460 | 877,960,414 | 2,411 | 4.2 |

*Notes:* Bank net assets is a capital figure for system at year-end 2003; net assets for insurance is capital figure for sector at year-end 2003; Net assets are the same figures as for the net assets taking into consideration for determining of solvency margin; pension fund is state PAYG; leasing assets are depreciated assets in 2003 based on 2002 ratio converted at year-end exchange rates; net leasing assets = contract value; factoring assets from 2002; BVB listed companies do not include 10 bonds listed; RASDAQ companies do not include suspended companies not yet formally de-listed; RASDAQ market capitalization from December 19, 2003.

*Sources:* NBR; www.bvb.ro; www.rasd.ro; CNVM; CSA; UNOPS; Romanian Association of Leasing (ASLR); authors' calculations.

of their counterparts in the EU-15. Leasing has increased in Romania, and this represents one area where increasing volume is closing the gap with EU markets. Nonetheless, in absolute figures, Romania is still well behind EU markets on a per capita basis. Factoring has just begun in Romania, whereas factoring volume approximated 6.2 percent of EU GDP in 2002.

NBFI development in Romania also lags behind CE-3 countries. Insurance depth has reached 3–4 percent ratios in the CE-3, as opposed to Romania's 1.28 percent (Table 8). Because the CE-3 countries have each initiated significant pension reform, their private pension funds (second and third pillars) are now 3 percent to 4.5 percent of GDP. Mutual funds now have assets under management of about 5 percent in the Czech Republic and Hungary, and about 3 percent in Poland. This is two to three times the levels achieved in Romania, most of which are held by the five SIFs.[21]

Leasing has been particularly strong in the Czech Republic, with volume at about 5 percent of GDP, roughly comparable to EU levels. Hungary has also shown growth in

21. The SIFs were created from the coupon privatization programs of the 1990s. The five SIFs are the largest institutional investors in Romania and their portfolios include significant holdings in the privatized banks, including BRD. The SIFs were exempted from the 2002 law on collective investment funds and thus operate under the special purpose 1996 legislation approved for the creation and the prior 1993 investment law. The five SIFs are: Banat-Crisana, SIF Moldova, SIF Muntenia, SIF Oltenia, and SIF Transilvania.

**Table 8. Romania's Market Indicators vs. Czech Republic and Hungary, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **ROMANIA** | | | | | | | | |
| Bank Assets/GDP | 38.6% | 35.4% | 32.1% | 28.0% | 24.2% | 27.7% | 31.2% | 33.3% |
| Insurance Depth | 0.4% | 0.5% | 0.71% | 0.82% | 0.85% | 0.87% | 1.1% | 1.28% |
| **CZECH REPUBLIC** | | | | | | | | |
| Bank Assets/GDP | 100.4% | 108.6% | 102.8% | 103.4% | 98.8% | 95.9% | 88.5% | 93.7% |
| Insurance Depth | 3.0% | 2.9% | 3.0% | 3.4% | 3.6% | 3.7% | 4.0% | n/a |
| **HUNGARY** | | | | | | | | |
| Bank Assets/GDP | 41.5% | 44.7% | 46.2% | 47.2% | 51.8% | 55.4% | 55.0% | 67.0% |
| Insurance Depth | 2.2% | 2.3% | 2.4% | 2.6% | 3.0% | 2.8% | 2.9% | n/a |

*Notes:* Insurance depth = gross premium revenues/GDP; pension fund assets in CE-3 countries are private pension funds only; mutual funds in Romania include figures for SIFs; leasing assets are depreciated value.

*Sources:* IFS; Swiss Re; BVB; RASDAQ; World Development Indicators; EMDB; World Leasing Yearbook; various sources (cited from Bakker Gross, 2003); authors' calculations.

this sector at nearly 4 percent of GDP. This is one area where Poland lags Romania, as its leasing volume has been fairly low at about 1.2 percent of GDP in 2002. However, in all these countries, cars and other road transport account for most lease activity, unlike more advanced markets where agricultural and industrial machinery, computer and business equipment, and related activities are more prominent.

Factoring is also an area of greater activity in the Czech Republic, with volume at about 2.6 percent of GDP in 2002. Hungary and Poland have lower factoring volume, although their figures relative to GDP are three to four times those in Romania.

## Capital Markets

### *Equity Markets*

The capitalization of Romania's equity markets has increased rapidly in the past six years while it is still underdeveloped in absolute terms. The equity markets valued US$6.1 billion as of the end 2003 (see Table 9). The steady increase in market capitalization has resulted in an increase from 1.1 percent of GDP in 1996 to 10.7 percent of GDP in 2003; which, in spite of the favorable trend, remain quite low.

There are still many companies listed on the combined exchanges. There were 62 companies listed on the BVB and 2460[22] traded on the RASDAQ as of year-end 2003.[23] A total 1,984 firms have been suspended from the RASDAQ and are awaiting formal de-listing, in addition to the 403 that were already de-listed from the RASDAQ in 2003.

22. According to the Rasdaq Annual Report 2003 on *www.rasd.ro.*

23. As these figures pertain to equities, not recorded in the figures above are the two companies that list abroad on the New York Stock Exchange. Banco Turco-Romana and the Romanian subsidiary of Lafarge have issued ADRs, the former with Bank of New York (two deposits) and the latter with Deutsche Bank.

**Table 9. Market Capitalization in Romania, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **AGGREGATED: BVB + RASDAQ** | | | | | | | | |
| Market cap. ($ millions) | 371.2 | 2,137.6 | 1,151.8 | 1,300.9 | 1,221.8 | 2,301.3 | 4,529.8 | 6,121.3 |
| Market cap./ GDP (%) | 1.1 | 6.1 | 2.7 | 3.7 | 3.3 | 5.7 | 9.9 | 10.7 |
| Per capita value ($) | 17 | 95 | 51 | 58 | 55 | 103 | 203 | 274 |
| **BVB** | | | | | | | | |
| Market cap. ($ millions) | 60.8 | 632.4 | 357.1 | 316.8 | 415.9 | 1,228.5 | 2,717.5 | 3,710.2 |
| Market cap./ GDP (%) | 0.2 | 1.8 | 0.8 | 0.9 | 1.1 | 3.1 | 5.9 | 6.5 |
| Per capita value ($) | 3 | 28 | 16 | 14 | 19 | 55 | 122 | 166 |
| **RASDAQ** | | | | | | | | |
| Market cap. ($ millions) | 310.4 | 1,505.2 | 794.6 | 984.1 | 805.8 | 1,072.8 | 1,812.3 | 2,411.1 |
| Market cap./ GDP (%) | 0.9 | 4.3 | 1.9 | 2.8 | 2.2 | 2.7 | 4.0 | 4.2 |
| Per capita value ($) | 14 | 67 | 35 | 44 | 36 | 48 | 81 | 108 |

*Notes:* "Aggregated" is BVB + RASDAQ; 2000 figures for BVB restated in some cases; market capitalization to GDP figures differ slightly from those reported by exchanges due to differing GDP denominators.
*Sources:* www.bvb.ro; www.rasd.ro; WDI; authors' calculations.

The BVB shows high levels of concentration, while RASDAQ shows less concentration. The five largest listings accounted for 74 percent of BVB market capitalization in 2001, and the 10 largest accounted for 84 percent. These figures were 79.5 percent and 87 percent, respectively, in 2003. On RASDAQ, the 10 largest firms were responsible for only 14 percent of market capitalization in 2003. The RASDAQ traded 878 million shares in 2003, with the average trade equivalent to about US$1,800, while the BVB traded 4.1 billion shares at a significantly lower average trade equivalent of US$698.

Stock market trade volume indicates relatively low levels of liquidity (Table 10), although the trends are rising on the BVB. More than 81 percent of the trading volume consisted of the five closed-end investment funds (SIFs), two banks (BRD and Banca Transilvania), and Petrom. Petrom is the most significant enterprise on the exchange, accounting for 18 percent of trade volume and 45 percent of market capitalization in 2003. As the process of merging the two Romanian exchanges develops, the companies that respond to the criteria for "regulated markets" according to EU directives will be invited to move from the RASDAQ trading technical platform to the one operated by BVB.

The presence of non-resident investors has been decreasing in the past seven years. On the BVB, the value of non-resident purchases was as high as 67 percent in 1997 and 56–59 percent in 2000–01. Since then, it has declined to about 28–35 percent. In dollar

**Table 10. Trade Volume and Turnover on the Romanian Exchanges, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| | | | | AGGREGATED: BVB + RASDAQ | | | | |
| No. of shares traded (millions) | 8 | 1,390 | 2,387 | 3,191 | 3,016 | 3,048 | 6,228 | 4,984 |
| No. of trades (thousands) | 21 | 1,057 | 1,055 | 687 | 637 | 445 | 756 | 509 |
| Annual turnover ($ millions) | 6 | 646 | 612 | 367 | 231 | 226 | 341 | 431 |
| Avg. turnover per company ($ thousands) | 4 | 119 | 110 | 66 | 42 | 44 | 70 | 96 |
| Avg. turnover/ trade ($) | 287 | 611 | 580 | 534 | 363 | 508 | 451 | 847 |
| Turnover ratio (%) | 1.6 | 30.2 | 53.1 | 28.2 | 18.9 | 9.8 | 7.5 | 7.0 |

*Notes:* 2000 figures for BVB restated in some cases; BVB turnover figures in annual reports used; figures on the BVB web site show different market turnover figures from those presented in annual reports.
*Sources:* www.bvb.ro; www.rasd.ro; CNVM; authors' calculations.

terms, this has meant only US$65 million purchases on average per year. RASDAQ's figures are similar, with about the same level of purchases in 2003 as the BVB average (US$66 million), while sales were only US$20 million.

While the level of activity on the stock exchanges has increased, the free-float sensitivity analysis at 15 and 25 percent raises doubts about the sustainability of the individual exchanges (Table 11). It is estimated that a market requires market capitalization of US$15 to US$20 billion to reach a point where it benefits from decreasing costs in the processing of trades (Claessens and others 2000). Nevertheless, evolution of technology, possibility of various forms of collaboration, and outsourcing of back office functions with regional markets will likely make smaller markets sustainable.

*Romania Compared to the EU-15 and CE-3 Countries.* Romania's 2003 market capitalization is only 0.1 percent of the aggregated markets of the EU-15. The combined BVB and RASDAQ market capitalization figure was only about 13 percent that of Portugal in 2001, which has about half the population of Romania and is one of the smallest markets in Europe. Romania's market capitalization to GDP is 10.7 percent, compared to more than 100 percent in the Netherlands. In Portugal, the figure has been above 40 percent since 1998.

Romania's aggregated turnover ratio[24] (for the two exchanges) has declined steadily since 1999, and was only 7 percent in 2003. In contrast, the EU norm is about 80 percent. Portugal, which has one of the least liquid markets in the EU, still had a market turnover ratio nearly eight times that of Romania in 2003. The Netherlands' turnover ratio was 226 percent in 2002, which is high by EU-15 standards.

24. The turnover is mainly from shares traded, since the corporate bond market is at an early stage and needs time to mature.

**Table 11. Adjustments to Market Capitalization and Turnover for Float, 2003**

| | | Companies with Free Float > 25% | | Companies with Free Float > 15% | |
|---|---|---|---|---|---|
| | Total | Actual | % of Actual Total | Actual | % of Actual Total |
| **BVB** | | | | | |
| Traded Companies | 62 | 32 | 51.6% | 47 | 75.8% |
| Market Capitalization ($ millions) | $3,710 | $1,513 | 40.8% | $1,647 | 44.4% |
| Turnover ($ millions) | $ 307 | $149 | 52.2% | $156 | 54.5% |
| Adjusted Market Capitalization/GDP | n/a | n/a | 3.1% | n/a | 3.4% |
| Adjusted Market Capitalization/ Remaining Listed Companies ('000) | n/a | $47,281 | n/a | $35,043 | n/a |
| Adjusted Turnover/ Adjusted Market Capitalization | n/a | n/a | 9.9% | n/a | 9.5% |
| **RASDAQ** | | | | | |
| Traded Companies | 2,460 | 1,170 | 50.5% | 1,647 | 71.1% |
| Market Capitalization ($ millions) | $2,411 | $501 | 20.8% | $817 | 33.9% |
| Turnover ($ millions) | $124 | $34 | 27.4% | $55 | 44.4% |
| Adjusted Market Capitalization/GDP | n/a | n/a | 1.0% | n/a | 1.7% |
| Adjusted Market Capitalization/ Remaining Listed Companies ('000) | n/a | $428 | n/a | $496 | n/a |
| Adjusted Turnover/ Adjusted Market Capitalization | n/a | n/a | 6.8% | n/a | 6.7% |

*Notes:* "Traded" companies on BVB apply to listed firms; adjusted turnover figures for RASDAQ are averages for 1996–2003.
*Sources:* BVB; RASDAQ; authors' calculations.

There are also significant gaps in terms of market capitalization between Romania and the CE-3 countries (Table 12). While Hungary and the Czech Republic each have about half of Romania's population, they have market capitalization of two to three times that of Romania. In Poland, where the population is nearly two times that of Romania, market capitalization is about five times that of Romania. This could be a reflection of lower GDP per capita, which is approximately 40 percent of that of Czech Republic and Hungary.

Romania's market also shows less trade volume and higher levels of concentration than the CE-3 markets. Turnover in the CE-3 ranged from 29 percent in Poland to 46 percent in Hungary, well above Romania's turnover of 7 percent.

## *T-bills*

T-bills approximated US$1.3 billion in value as of year-end 2003, equivalent to the fiscal deficit for the year (Table 13). These were 40 percent of total domestic public debt and about 2.3 percent of 2003 GDP. Compared with total central government bond values (domestic and abroad), money market instruments were 19 percent of total.

**Table 12. Romania's, EU-15 and CE-3 Market Indicators, 1996–2002**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|---|
| **EU-15** | | | | | | | |
| Market Cap. ($ millions) | 4,426,213 | 5,245,230 | 6,870,535 | 8,950,990 | 8,272,149 | 6,709,041 | 5,905,587 |
| Market Cap./ GDP (%) | 50.3 | 63.2 | 79.9 | 104.1 | 104.7 | 84.9 | 68.7 |
| Turnover/ Mkt. Cap. (%) | n/a | n/a | n/a | n/a | n/a | n/a | 80 |
| **ROMANIA** | | | | | | | |
| Market Cap. ($ millions) | 371 | 2,137 | 1,151.8 | 1,301 | 1,221.8 | 2,302 | 4,530 |
| Market Cap./ GDP (%) | 1.1 | 6.1 | 2.7 | 3.7 | 3.3 | 5.7 | 9.9 |
| Turnover/ Mkt. Cap. (%) | 2 | 30 | 53 | 28 | 19 | 10 | 8 |
| **CZECH REPUBLIC** | | | | | | | |
| Market Cap. ($ millions) | 18,077 | 12,786 | 12,045 | 11,796 | 11,002 | 9,331 | 15,893 |
| Market Cap./GDP | 31.3 | 24.1 | 21.1 | 21.5 | 21.4 | 16.3 | 22.9 |
| Turnover/ Mkt. Cap. (%) | 50 | 46 | 38 | 37 | 60 | 34 | 37 |
| **HUNGARY** | | | | | | | |
| Market Cap. ($ millions) | 5,273 | 14,975 | 14,028 | 16,317 | 12,021 | 10,367 | 13,110 |
| Market Cap./GDP | 11.7 | 32.8 | 29.8 | 34.0 | 25.8 | 20.0 | 19.9 |
| Turnover/ Mkt. Cap. (%) | 42 | 73 | 114 | 96 | 91 | 44 | 46 |
| **POLAND** | | | | | | | |
| Market Cap. ($ millions) | 8,390 | 12,135 | 20,461 | 29,577 | 31,279 | 26,017 | 28,750 |
| Market Cap./GDP | 6.4 | 8.2 | 12.9 | 19.1 | 19.1 | 14.2 | 15.2 |
| Turnover/ Mkt. Cap. (%) | 85 | 78 | 54 | 46 | 50 | 26 | 29 |

*Sources:* BVB; RASDAQ; World Development Indicators; EMDB; Bakker Gross (2003 for 2002 figures); authors' calculations.

The domestic money market consists of discount T-bills, used by the government to finance near-term deficits. There is no commercial paper issued and traded, nor are there other money market instruments, due to legal restrictions that prevent companies from issuing commercial paper. The government previously also relied on interest-bearing T-bills, but with two exceptions, these issues were discontinued in late 2000 (Interest-bearing Treasury bonds are still used, however, and these accounted for 25.1 percent of total domestic public debt at year-end 2003).

T-bills are showing longer maturities. They range from 30 to 364 days. In terms of volume, most T-bills are now for 364 days (85 percent of total), followed by six-month matu-

**Table 13. T-bills in Romania, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| T-bills ($ millions) | 944 | 793 | 1,371 | 1,084 | 1,263 | 1,512 | 1,780 | 1,300 |
| T-bills/GDP (%) | 2.7 | 2.2 | 3.3 | 3.0 | 3.4 | 3.8 | 3.9 | 2.3 |
| T-bills/Fiscal Deficit (%) | 69 | 49 | 65 | 85 | 85 | 114 | 150 | 81 |
| T-bills/Domestic Public Debt Securities (%) | 70 | 42 | 56 | 29 | 44 | 52 | 55 | 33 |

*Notes:* T-bill figures are from year end.
*Sources:* MoPF; NBR; authors' calculations.

rities (10.5 percent). This is in stark contrast to year-end 2001, when 52 percent of T-bills had maturities of six months or less.

Pricing on T-bills has provided investors with higher returns than would be obtained from lending to the inter-bank market, yet well below rates on loans to non-bank customers (Table 14). Most issues were at least 150 basis points above the annualized inflation rate, and a substantial number was at least 300 basis points above annual inflation. Three-month T-bill returns were generally about 731 basis points below average bank lending rates to non-bank customers (unweighted basis), while six-month and one-year T-bill returns were about 745 basis points below the same average lending rates.

While the T-bill market is prominent in Romania's domestic markets, Romania is a non-factor in international money market instruments. There have been no money market issues in overseas markets by the government or enterprises.

*Romania Compared to the EU-15 and CE-3 Countries.* Romania's indicators show its money market is limited to T-bill issues that finance government deficits (Table 15). This partly reflects the absence of money market instruments that have been issued by the private sector to meet short-term financing needs. In this regard, Romania's money markets lag behind EU-15 countries.

## *Government Bonds*

Romania's central government bonds accounted for about 3.9 percent of GDP and 67 percent of total domestic public debt outstanding in 2003 (see Table 16). Apart from 1999,

**Table 14. T-bill Yields in Romania, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| Nominal T-bill Yields (%) | 45.3 | 62.4 | 62.0 | 54.8 | 33.5 | 30.9 | 22.2 | 18.0 |
| Yields less CPI (%) | 6.5 | –92.5 | 2.9 | 9.0 | –12.2 | –3.6 | –0.3 | 3.9 |
| Yields less Bank Loan Rates (%) | –10.5 | –1.3 | 5.1 | –11.1 | –20.0 | –14.2 | –13.0 | –7.4 |
| Yields less Inter-bank Rates (%) | 2.9 | 3.5 | 10.6 | 8.6 | 2.5 | 1.8 | 0.4 | 3.0 |

*Notes:* Average yields/interest rates are annualized; 2003 figure is approximate from three-, six- and 12-month rates.
*Sources:* MoPF; NBR Statistical Section (December 2003).

**Table 15. T-bills Rates, 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **ROMANIA** | | | | | | | | |
| Total Money Market Instruments ($ millions) | 944 | 793 | 1,371 | 1,084 | 1,263 | 1,512 | 1,780 | 1,300 |
| Money Market Instruments/ GDP (%) | 2.7 | 2.2 | 3.3 | 3.0 | 3.4 | 3.8 | 3.9 | 2.3 |
| Money Market Rates (%) | 45.3 | 62.4 | 62.0 | 54.8 | 33.5 | 30.9 | 22.2 | 18.0 |
| T-bills/Fiscal Deficit (%) | 69 | 49 | 65 | 85 | 85 | 114 | 150 | 81 |
| **Money Market Rates in Percent** | | | | | | | | |
| **EU-15** | 4.0 | 3.7 | 3.6 | 3.0 | 4.4 | 4.3 | 3.3 | 2.3 |
| **CZECH REPUBLIC** | 12.7 | 17.5 | 10.1 | 5.6 | 5.4 | 4.7 | 2.6 | 2.1 |

*Notes:* Figures are from year end.
*Sources:* IFS; MoPF; NBR; authors' calculations.

when there were large issues, domestic government bonds have been about 3–4 percent of GDP since 1997. As a share of total public debt outstanding, the proportion has fluctuated.

Government bonds outstanding are larger in value in the Eurobond market than they are in the domestic market. Yield curves are now available for ten years, as opposed to two years in 2002 and only one year prior to 2002. The trend has been more favorable recently, as the government has increased its one-year to three-year issues in the domestic market. Yields show that long-term bonds are now issued at rates about 300 basis points lower than T-bills, reflecting confidence that the inflation rate will continue to decline.

Government securities in general are traded, although most are reported to be related to T-bills rather than bonds. There was less secondary market trading in 2003 than in 2002, with many institutions holding their securities for investment and as asset-liability management tools. Monthly turnover relative to the stock of outstanding marketable securities (including T-bills) ranged from 37.2 percent to 65.5 percent in 2003 (Table 17).

There was only US$2.2 billion in government bonds outstanding in domestic markets when netting out Treasury bills at year-end 2003. By contrast, sovereign debt issues outstanding combined with state-guaranteed corporate bonds were valued at US$3.5 billion

**Table 16. Government Bonds and Domestic Debt Securities: 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| Domestic Government Bonds ($ million) | 410 | 1,088 | 1,087 | 2,669 | 1,580 | 1,375 | 1,443 | 2,204 |
| Government Bonds as: % of GDP | 1.2 | 3.1 | 2.6 | 7.5 | 4.3 | 3.4 | 3.2 | 3.9 |
| % of Public Debt Outstanding | 30.3 | 57.8 | 44.1 | 71.1 | 55.6 | 47.6 | 44.8 | 67.3 |

*Notes:* Public Debt Outstanding applies strictly to domestic public debt, and includes Treasury bills; Government Bonds figures exclude Treasury bills.
*Sources:* MoPF; WDI; authors' calculations.

**Table 17. Trading Volume and Turnover of Domestic Government Securities: 2000–2003**

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| Number of Transactions | 19,572 | 27,815 | 32,362 | 23,850 |
| Total Traded Volume ($ billions) | 13.2 | 15.7 | 15.9 | 9.8 |
| Avg. Trade Value ($ thousands) | 675 | 566 | 491 | 409 |
| Turnover Ratios (%) | n/a | 48–73 | 34–79 | 37–66 |

*Notes:* Turnover is traded volume divided by stock of outstanding marketable securities; figures not available prior to 2000; figures for ROL converted to US$ at average exchange rates.
*Sources:* MoPF; authors' calculations.

at end-2003 (Table 18). The reliance on overseas issues to date by government has resulted from capacity constraints in the domestic market plus comparatively low interest rates in the Eurobond market relative to the rates Romania has had in lei-denominated assets.

In general, Romania's sovereign ratings are perceived by the market to be sub-investment grade in terms of quality, but increasingly stable and positive in terms of outlook. The short-term outlook has been fairly steady since 2001, while the long-term outlook has improved. Table 19 highlights trends in sovereign ratings from 2001–03 among four major international rating agencies.

*Romania Compared to the EU-15 and CE-3 Countries.* When compared to the EU-15, Romania's government bond market is underdeveloped. On a per capita basis EU-15 public debt was about US$43,421 in contrast to Romania's per capita of US$693. As a share of GDP, Romania's public debt was about 27.2 percent; the EU-15 levels, on the other hand are high at 184 percent of GDP—nearly six times the level in Romania (Table 20).

Romania's turnover is also comparatively small. While trading has increased in recent years in both the Eurobond markets and Romania's domestic markets, the level of trade volume remains small when compared to EU-15 markets.

Compared with the CE-3 countries, Romania's public debt securities were fairly low and consistent with Poland since 2001. The Czech Republic in particular has shown fairly

**Table 18. Sovereign Debt Securities in the Eurobond Market: 1999–2003**

| | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Outstanding Sovereign Debt ($ millions) | 1,229 | 1,143 | 1,709 | 2,446 | 3,500 |
| Sovereign Debt as: | | | | | |
| % of GDP | 3.5 | 3.1 | 4.3 | 5.3 | 6.1 |
| % of External Debt Outstanding | 19.9 | 16.7 | 22.2 | 25.6 | 28.8 |
| % of Public Debt Outstanding | 12.4 | 11.8 | 16.2 | 19.1 | 22.7 |

*Notes:* Outstanding sovereign debt includes corporate debt with state guarantees; External debt outstanding is medium- and long-term; Public debt outstanding includes T-bills and bonds as well as publicly-guaranteed debt when information made available in both domestic and international markets; exchange rates converted from Euro to US$ from International Financial Statistics at year-end rates.
*Sources:* MoPF; NBR; IFS; authors' calculations.

**Table 19. International Rating Agencies' Perceptions of Romania**

| | | Local Currency | | Foreign Currency | |
|---|---|---|---|---|---|
| Agency | Dates | Short-term | Long-term | Short-term | Long-term |
| *S&P* | March 2001–September 2003 | From C to B | From B to BB+ (4 upgrades) | From C to B | From B-/positive to BB/positive (4 upgrades) |
| *Moody's* | September 2001–December 2003 | n/a | From Caa1/stable to B (3 upgrades) | n/a | From B3/stable to Ba3/stable (3 upgrades) |
| *Fitch* | November 2001–December 2003 | n/a | From B/stable to BB+/stable (4 upgrades) | B | From B/positive to BB/stable (3 upgrades) |
| *Japan CRA* | December 2001–December 2003 | n/a | BB+ | From BB-/positive to BB | From BB-/positive to BB/positive |

*Source:* Cited from Ministry of Public Finance, December 2003.

sizeable growth in domestic government securities issuances since 2002. Hungary has shown similar growth, albeit less as a share of GDP. Poland has kept government debt at less than 30 percent, much like Romania since 2000.

## *Sub-sovereign and Municipal Bonds*

Romania's municipal bond market remains at a preliminary stage of development. There were 21 issues outstanding[25] as of year-end 2003, accounting for US$19 million in notional value. This was equivalent to 1 percent of domestic government bonds, 0.3 percent of total government bonds (including Eurobonds), and 0.03 percent of GDP. The average bond has been about US$0.8 million. Of the 23 municipal bonds issued by year-end 2003, 7 were listed on the BVB in 2003 (Table 21). These accounted for 0.4 percent of BVB market capitalization as of year-end 2003.

While small by global standards, the trend indicates that some of the larger secondary towns in Romania are gearing up for larger issues over time to help finance infrastructure and other development needs. For instance, Oradea is reportedly planning to issue a ROL 150 billion bond (about US$5 million), which is larger than the earlier ROL 100 billion that was the largest as of end-2003.

Fees for issuance are fairly uniform and low, at ROL 1 million (equivalent to US$30) in 16 of 23 cases (Table 22). The range has been as low as ROL 100,000 (five cases) to ROL 2 million (equivalent to US$60) in one case. Thus, fee income is not the motivating factor for issuers to bring municipal bonds to market. Rather, portfolio diversification appears to be the main incentive to buy, and fees associated with such sales are disclosed at the end, not at the point of issuance.

Almost all the issues that have come to market are floating rate notes. These notes are normally issued in emerging markets where there is a perceived environment of rising

25. 24 issues (23 municipal bonds and 1 corporate bond) and 21 is outstanding.

**Table 20. Public Debt Securities in Romania, the EU-15 and CE-3 Markets: 1996–2003**

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| **EU-15** | | | | | | | | |
| Public Debt Securities ($ billions) | 12,767 | 12,331 | 13,321 | 13,914 | 13,381 | 13,488 | 15,756 | 16,500 |
| Public Debt Securities/ GDP (%) | 145.4 | 149.3 | 156.0 | 162.9 | 170.1 | 171.0 | 184.0 | n/a |
| **ROMANIA** | | | | | | | | |
| Public Debt Securities ($ billions) | 7.8 | 8.7 | 9.4 | 9.9 | 9.7 | 10.6 | 12.8 | 15.5 |
| Public Debt Securities/ GDP (%) | 22.1 | 24.7 | 22.3 | 27.8 | 26.2 | 26.4 | 28.0 | 27.2 |
| **CZECH REPUBLIC** | | | | | | | | |
| Public Debt Securities ($ billions) | 8.4 | 8.4 | 17.8 | 20.0 | 17.9 | 20.5 | 36.3 | 62.2 |
| Public Debt Securities/ GDP (%) | 14.6 | 15.9 | 31.2 | 36.4 | 34.8 | 35.8 | 52.2 | n/a |
| **HUNGARY** | | | | | | | | |
| Public Debt Securities ($ billions) | 14.8 | 13.0 | 15.1 | 15.7 | 15.5 | 18.5 | 29.3 | 31.6 |
| Public Debt Securities/ GDP (%) | 32.7 | 28.5 | 32.1 | 32.7 | 33.2 | 35.7 | 44.5 | n/a |
| **POLAND** | | | | | | | | |
| Public Debt Securities ($ billions) | 25.7 | 25.0 | 29.0 | 27.3 | 32.1 | 44.2 | 55.3 | 56.1 |
| Public Debt Securities/ GDP (%) | 19.7 | 16.8 | 18.4 | 17.6 | 19.6 | 24.2 | 29.3 | 27.2 |

*Notes:* T-bills included for comparative purposes; international debt not included apart from Romania as BIS data do not provide figures for government vs. financial institutions/corporate international issuance, nor do these data specify whether governments have guaranteed such issues; in the case of Romania, figures used are public debt in general (including loan borrowings, not just those from bonds or other debt securities); Romania public debt-to-GDP ratios differ slightly from MoPF figures due to differing GDP denominators.

*Sources:* BIS (Table 16-A); MoPF; WDI; authors' calculations.

interest rates associated with high inflation (Deloit Touche 2003). However, more recently, Romania's interest and inflation rates have declined, and future trends suggest that fixed pricing may become more the norm once the macroeconomic environment has stabilized. Only two bonds have been either fixed or linked to a reference rate.[26] Meanwhile, interest payments have recently been at about 100 to 200 basis points over the 3-month Bucharest Inter-bank Offered Rate (BUBOR) or above the blended BUBID and BUBOR rates (equally weighted), and then usually with regular payments by trimester.

The municipal issues have come to market without guarantees. Investors are reported to believe that municipals are worth the risk on an unsecured basis. This is because

26. Arad's bond issued in 2003 is fixed at 14 percent. The Cluj issue in 2002 is linked to a reference rate.

**Table 21. Municipal Bonds in Romania: 2000–2003**

| | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|
| **Total Annual Municipal Issues** | **0** | **2** | **7** | **14** |
| Market/Issue Value | 0 | $474,729 | $3,179,105 | $14,880,994 |
| Average Value/Issue | 0 | $237,364 | $454,158 | $1,062,928 |
| **BVB Listed/Traded Issues** | **0** | **2** | **4** | **10** |
| BVB Muni Market/Issue Value | 0 | $474,729 | $1,671,642 | $13,637,061 |
| Average Value/BVB Muni Issue | 0 | $237,364 | $417,910 | $1,363,706 |
| BVB Munis/BVB Market Cap. | 0 | 0.04% | 0.06% | 0.37% |
| **Municipal Bonds as % of GDP:** | 0 | 0.001% | 0.01% | 0.03% |

*Notes:* Issues are new issues each year; market value = face value, not traded value; listed and traded are considered the same year, even though several listed municipal bonds in 2002–03 commenced trading the following year; government securities include T-bills, bonds, and state-guaranteed Eurobonds.

*Sources:* BVB; WDI; authors' calculations.

**Table 22. Profile of Romanian Municipal Bond Features, 2003**

| | |
|---|---|
| **Number** | 23 issues as of year end 2003 |
| **Value** | Average: ROL 26.4 billion, or about $0.8 million<br>Range: ROL 5 billion-ROL 100 billion, or $0.15–$3.03 million |
| **Maturities** | Generally two to three years, although Deva has 4+ years, and Predeal has 3+ years |
| **Fees** | Range: ROL 100,000-ROL 2 million, or $3–$60 |
| **Coupons** | Range: four to 12 |
| **Rates** | Generally [(BUBID+BUBOR)/2]+1–2%, although there is one fixed price municipal bond (Arad, at 14 percent), Cluj is linked to a reference rate, and Predeal is 3 percent above the average of BUBID+BUBOR<br>Most rates are set on a trimester basis, although five (Slobozia, Predeal twice, Tirgu Mures and Cluj) have been each semester, Arad is completely fixed |

*Sources:* CNVM.

municipalities are required to repay creditors prior to compensating staff salary. In accordance with the perceived integrity of the Court of Accounts financial audit of the jurisdiction's books, and the Law on Local Public Finance,[27] total yearly outstanding debt service (including principal, interest, and commissions) is limited to no more than 20 percent of the municipalities' revenues, including bank loans.[28] Risk is also partly mitigated by the relatively short maturities of two to three years. However, the perception that municipals are safe may be misplaced given the absence of protection of a trustee, and the non-use of credit enhancements.

The major buyers of municipal bonds have been the five SIFs, with only a small amount of retail participation. SIFs are natural buyers of fixed income securities, since they

27. Law No. 189/1998 as amended by Government's Emergency Ordinance No. 219/2000 subsequently amended and approved by Law No. 337/2001.

28. See Article 51 (cited from Deloitte Touche 2003).

are required to pay out dividends to their shareholders. However, the municipals provide some diversification, particularly with regard to the variable pricing of most of the issues.

### *Corporate Bonds*

Romania's domestic corporate bond market is underdeveloped. As of year-end 2003, there were only four domestic issues outstanding.[29] The issues were small in value, at a total of less than US$3 million-equivalent. The average domestic corporate bond averaged less than US$1 million equivalent in size. This may start to change dramatically in 2004. Recently, BCR Leasing has issued corporate bonds worth of ROL 75 billion (US$2.3 million-equivalent). In addition, the BRD and Raiffeisen Bank issuances amount to ROL 1,380 billion and ROL 500 billion in corporate bonds, respectively.

Throughout 2003, the maximum maturity for corporate bond issues was three years. Pricing varied, and generally was about 6.5 percent above a reference rate (e.g., LIBOR) or paid out as a percentage of principal on an annual basis. Three of four issues had multiple coupons, while the smallest issue did not. Fees were very low, not exceeding ROL 1 million (US$30), and as low as the equivalent of .0001 percent of the face value of the bond (for more detail, see Table 23). According to the prospectus, the BCR Leasing bond has a maturity of three years and will pay 6 percent semi-annually. It is a lei-denominated bond with calculations linked to the Euro, to mitigate investor perceptions of exchange rate risk. Likewise, the interest rate is fixed at 6 percent.

The major investors of corporate bonds tend to be retail investors, while the major investors of municipal bonds are institutional investors. The underdevelopment of the institutional investor market may be one of the reasons for this anomaly. As the number of issues is small, and because the outstanding size was limited until 2004, it is possible that institutional investors have not bothered with the market, particularly in light of perceived risks. Apart from BCR Leasing, the corporate issuers themselves have not been large companies, raising further questions about transparency and underlying creditworthiness. Alternatively, the issues are often structured to appeal to retail investors, and are sold at

**Table 23. Profile of Romanian Domestic Corporate Bond Features, 2003**

| | |
|---|---|
| **Number** | 4 issues as of year end 2003<br>Larger issue by BCR Leasing in 2004 |
| **Value** | Average: ROL 22.8 billion, or about $0.7 million through 2003<br>Range: ROL 2.2 billion-ROL 49.8 billion, or $0.07–$1.5 million<br>BCR Leasing bond is for ROL 75 billion, or $2.3 million |
| **Maturities** | Generally two to three years |
| **Fees** | Range: ROL 25,000-ROL 1 million, or $1–$30 |
| **Coupons** | Range: one to six |
| **Rates** | Varied: LIBOR plus 4 percent; 6.5 percent to the Euro; in two separate cases, 5–42 percent annually |

*Sources:* CNVM.

29. The corporate bond offerings of BRD and Raiffeisen Bank had also been authorized in 2003.

high coupon rates and in small denominations. This provides opportunities for individual investors to purchase securities through their brokers.[30] The high retail interest is different from normal practice in corporate bond markets. Bonds are traditionally purchased by institutional investors, and there is usually little retail participation.

Romania's corporate bond exposure in the international capital markets is limited. This has been due in part to the legal restrictions designating the total value of corporate bonds that can be issued. As of year-end 2003, corporate Eurobonds outstanding were about US$825 million. While substantially larger than the small domestic corporate bond market, these outstanding bonds are only equivalent to 1.4 percent of 2003 GDP.

Seven corporate bonds have been issued in the Eurobond markets, most for state-owned infrastructure and power companies. Five of the seven corporate bonds have been supported with state guarantees. Corporate Eurobonds have longer maturities than the smaller domestic corporate issues in Romania.

*Romania Compared to the EU-15 and CE-3 Countries.* In the EU, corporate bonds were valued at US$7,662 billion in 2002, equivalent to 88.9 percent of GDP. By contrast, Romania's total corporate bonds were US$825 million in approximate value at the end of 2003, or 1.4 percent of GDP by comparison.

In the European emerging markets, the market is at an early stage of development. CE-3 corporate bonds, including those issued by financial institutions, are fairly limited. The Czech Republic had US$7.6 billion in 2003, followed by Poland (US$6.9 billion) and Hungary (US$2.4 billion). While small in total, they were far larger than Romania's issuances, and in relation to GDP. In the Czech Republic, 2003 corporate bond values were 11 percent of GDP (2002), followed by 3.7 percent in Hungary, and 3.4 percent in Poland.

## Non-bank Financial Institutions

### *Insurance*

At the end of 2003, Romania had 40 insurance companies with total premium revenues of US$738 million. The 2003 figures amounted to 1.3 percent of GDP, reflecting a growing, yet still low, level of insurance market depth. In terms of market coverage, insurance "density" (premiums per capita) was US$34 in 2003, placing Romania among the lowest of European countries in terms of insurance sector penetration. A typical insurance company in Romania is small. In 2003, insurance companies had on average US$18.5 million in gross premium revenues, paid out an average of US$6.99 million in benefits and claims, and had after-tax profits of about US$29. 6 million.

The concentration of insurance companies is high. The 10 largest companies in 2002 represented 82 percent of the total market in terms of gross premium income, 83 percent in terms of assets, and 74 percent in terms of capital. In 2003, the 10 largest companies also

30. The SIFs were interested in the International Leasing issue (2002), valued at ROL 15 billion. However, the issue sold out so quickly that the SIFs were too late in purchasing the bonds. Individual investor demand was a function of the high coupon rate (42 percent annualized), and the small principal amount of each bond (principal was ROL 25,000, less than one US dollar). (See Deloitte Touche 2003.)

represented 82 percent of the total market in terms of gross premium income, 89 percent in terms of assets, and 70.6 percent in terms of capital.

In 2003, all insurance indicators witnessed high growth. For example, gross written premiums increased in real terms by 22.4 percent; technical reserves for the activities (life and non-life) increased in real terms by 36.8 percent; and the total premiums ceded for reinsurance increased by 18.4 percent.

Underwriting performance shows that the insurance sector is profitable and growing, and loss ratios are low. However, low loss ratios have more to do with limited claims and enforcement, than with sophisticated risk management.

Part of the reason for the small market is low incomes, which particularly affect the investment in life insurance. Citizens have limited savings, a preoccupation with current financing needs and challenges, worries about unreported income that could be detected by the tax authorities, and concern over the high costs of other priorities (such as housing purchases) that are considered more necessary. The low life insurance penetration ratio reduces the funds available to insurance companies to invest as institutional investors in the market, which in turn delays the introduction of long-term assets and financing instruments. In the end, this resource constraint reduces long-term investment in the economy.

Likewise, non-life insurance companies have a tendency to build up substantial technical reserves that are available for investment in long-term and marketable financial instruments. While non-life insurance companies cover relatively short-term risks, they serve as major investors in non-current assets, due to the accumulation of reserves from growth in their lines of business. Non-life insurance firms have mixed maturity needs for their portfolios, which are more liquid than life insurance firms but not required to be entirely liquid. Also, because the loss claims non-life insurance companies face are subject to various processing delays until they are settled, non-life insurance companies in advanced OECD markets tend to place a high proportion of their technical reserves in long-term assets.

In terms of asset allocation, the limited reserves of the insurance companies in Romania were mostly invested in liquid assets (for example, cash, bank deposits) and state securities. By law, insurance companies were not permitted to invest more than 20 percent of their assets in non-government securities until changes were made in the legal framework in late 2003. As a result, their investments show little diversification apart from cash, bank deposits, government securities holdings and immovable properties.[31]

The underdevelopment of Romania's insurance sector in both life and non-life has thus deprived such resource flows from entering the capital markets. Even if the resources existed, there would be a question of available instruments, which are currently very limited. Thus, Romania has experienced supply and demand constraints in terms of institutional growth, investment and development of instruments. Table 24 reflects the high year-on-year percentage growth of the sector, as well as the low overall penetration of the insurance sector.

*Romania Compared to the EU-15 and CE-3 Countries.* Romania's insurance sector is small compared to EU countries (see Table 25 above). Even when compared to the weakest markets in the EU, Romania's per capita penetration is little more than 10 percent that

31. Equity shares were only 3.1 percent of total allocation.

**Table 24. Insurance Sector Indicators for Romania, 1997–2003**

| ($ millions unless otherwise noted) | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|
| Total No. of Companies | 43 | 51 | 57 | 61 | 46 | 45 | 40 |
| o/w life insurance | 3 | 3 | 3 | 4 | 4 | 3 | 2 |
| o/w non-life insurance | 33 | 37 | 39 | 38 | 25 | 24 | 18 |
| o/w composite | 7 | 11 | 15 | 19 | 17 | 18 | 20 |
| Gross Premium Revenues | 181.9 | 272.1 | 278.7 | 311.0 | 349.0 | 505.2 | 738.7 |
| o/w life insurance | 11.3 | 22.5 | 33.0 | 49.2 | 72.8 | 125.4 | 174.4 |
| o/w non-life insurance | 170.7 | 249.6 | 245.7 | 260.8 | 271.8 | 372.5 | 555.3 |
| o/w non-life reinsurance | n/a | n/a | n/a | n/a | 4.5 | 7.3 | 9.1 |
| Benefit Payments | n/a | n/a | n/a | n/a | 139.8 | 196.6 | 279.6 |
| o/w life insurance | n/a | n/a | n/a | n/a | 19.8 | 43.2 | 46 |
| o/w non-life insurance | n/a | n/a | n/a | n/a | 120.0 | 153.3 | 233.4 |
| Gross Premiums per Company | 4.2 | 5.3 | 4.9 | 5.1 | 7.6 | 11.2 | 18.5 |
| Life Insurance Premiums per Life Insurance Company | 3.8 | 7.5 | 11.0 | 12.3 | 18.19 | 41.8 | 87.2 |
| Non-life Premiums per Non-life Company | 5.2 | 6.7 | 6.3 | 6.9 | 10.87 | 15.52 | 30.8 |
| Gross Premiums/GDP (%) | 0.50 | 0.71 | 0.82 | 0.85 | 0.87 | 1.09 | 1.30 |
| Premiums per capita ($ only) | 8 | 12 | 12 | 14 | 15 | 23 | 34 |

*Notes:* CSA revenue figures converted to US$ based on average exchange rates published by NBR; revenue figures for reinsurance not known prior to 2002; averages per firm include composites for both life and non-life.

*Sources:* Insurance Supervisory Commission; Swiss Re; NBR; authors' calculations.

**Table 25. Insurance Market Indicators for Selected EU Countries, 2002**

| | Premium Revenue Per Capita ($) | Premium Revenue ($ in millions) | Insurance Premium Revenue/GDP (%) |
|---|---|---|---|
| Austria | 1,452 | 11,910 | 5.84 |
| Belgium | 2,003 | 23,877 | 8.42 |
| Finland | 2,272 | 11,803 | 8.98 |
| France | 2,064 | 125,059 | 8.58 |
| Greece | 253 | 2,694 | 2.05 |
| Ireland | 2,703 | 18,912 | 8.55 |
| Italy | 1,435 | 84,059 | 6.97 |
| Netherlands | 2,472 | 39,757 | 9.51 |
| Portugal | 799 | 8,034 | 6.60 |
| **Romania (2003)** | **34** | **739** | **1.30** |
| UK | 3,879 | 236,682 | 14.75 |

*Notes:* Romania data are from 2003, but all other cited countries are from 2002.

*Source:* Swiss Re; authors' calculations.

of Greece and 3 percent that of Portugal. As a share of GDP, Romania's 1.3 percent ratio is 62 percent that of Greece. Overall, however, it stands at less than 20 percent of all EU-15 countries.

Romania's insurance sector indicators also exhibit a lag in performance in comparison to other transition countries. Romania's premium revenues were only 21 percent of those in the Czech Republic and 31 percent those of Hungary, despite Romania's larger population (Table 26). The gap with Poland is also substantial in terms of per capita measures.

### *Pension Funds*

The Romanian pension system is still based on an unfunded public pillar; for this reason and the fact that the pension system is structurally unsustainable, pension reform is being contemplated. Total expenditure of the State Pension Scheme (SPS) amounted to 6.7 percent of GDP in 2003, as compared with 7.1 percent in 2002 and 7.2 percent in 2001. Both expenditures and revenues fell between 1995 and 1998, but recovered sharply after 1999. The system suffered from a financial deficit that fluctuated between 0.8 and 1.6 percent from 1996 to 2002. The deficit was brought down to 0.4 percent of GDP in 2003, the lowest level in about a decade. While year-on-year deficits have declined, they have continued to accumulate in terms of the impact on fiscal and debt management. For the most part, this deficit was caused by expenditure on the farmers' pensions (which have been shifted directly to the budget since 2002), generous noncontributory benefits (which continue), and a recalculation exercise aimed at increasing pension rights accrued under the old regime. As shown in Table 27, the expenditure for 1.5 million retired farmers and short-term noncontributory benefits amounted to about 1 percent of GDP from 1995–2001 against SPS deficits of nearly 1 percent on average. If farmers' payments were included in 2002 and 2003 figures, then these two expenditures would have accounted for the deficit in 2002 and exceeded the deficit in 2003. As tallied now, short-term benefits are now the main reason for the deficit.

There are several reasons why the unfunded public pension system continues to suffer from major structural weaknesses. These include:

- Previously low entry requirements.
- High levels of tax evasion due to the onerous burden of high payroll taxes.
- Institutional inefficiencies that have made it more costly and complicated to administer.

**Table 26. Insurance Market Indicators for CE-3 Countries for 2002**

| | Premium Revenue Per Capita ($) | Premium Revenue ($ millions) | Insurance Premium Revenue/GDP (%) |
|---|---|---|---|
| Czech Republic | 273 | 2,782 | 3.99 |
| Hungary | 187 | 1,897 | 2.88 |
| Poland | 145 | 5,581 | 2.96 |

*Notes:* Only countries with $150+ million in premiums; premium revenue figures and GDP calculated.
*Source:* Swiss Re; authors' calculations.

**Table 27. Financial Performance of the Pension System, 1995–2003 (% of GDP)**

| | Revenues | State Pensions | Farmers' Pensions | Short-term Benefits | Other | Balance |
|---|---|---|---|---|---|---|
| **1995** | 6.5 | 5.9 | 0.4 | 0.4 | 0.2 | 0.5 |
| **1996** | 5.9 | 5.8 | 0.5 | 0.4 | 0.2 | 0.9 |
| **1997** | 5.4 | 5.2 | 0.6 | 0.3 | 0.4 | 1.1 |
| **1998** | 5.6 | 5.9 | 0.6 | 0.4 | 0.2 | 1.6 |
| **1999** | 6.2 | 6.1 | 0.5 | 0.4 | 0.1 | 1.0 |
| **2000** | 6.2 | 5.9 | 0.5 | 0.4 | 0.1 | 0.7 |
| **2001** | 6.3 | 6.1 | 0.5 | 0.4 | 0.2 | 0.9 |
| **2002** | 6.3 | 6.5 | 0.0 | 0.4 | 0.2 | 0.8 |
| **2003** | 6.4 | 6.1 | 0.0 | 0.4 | 0.2 | 0.4 |

*Notes:* 2002–03 figures for farmers' pension payments understate actual deficit. Other sources show deficits are deeper when accounting for these payments.
*Sources:* National Pension House.

There are plans to introduce a voluntary occupational pension plan, and to possibly supplement this with additional third pillar options. Current estimates of potential participants in a voluntary occupational plan do not exceed 100,000.

The voluntary occupational pension plan is currently limited in focus, and runs the risk of conflict of interest in some cases. The plan as designed in early 2004 is to be based on collective bargaining agreements negotiated by unions with employers. Unions are reported to be interested in this plan as a means to retain members. However, this raises the question of conflict of interest if they require "voluntary" contributions to be channeled to specified pension management companies, which are linked to trade unions. There is also the issue of not having a more universal option for third pillar contributions, and restricting occupational plans to those represented by trade unions and collective bargaining agreements.

There has been discussion and the drafting of legislation for a second pillar, although this would likely not occur until 2007 at the earliest. Based on 4.3 million[32] (current levels) and prevailing demographics, it is estimated that full participation in the second pillar (among those eligible) would leave the government with a Euro 6 billion deficit over the subsequent 10-year period. Twenty-five percent participation from those in the 35–45 age bracket would leave the unfunded pillar with a Euro 2.2 billion deficit.

The level of participation is expected to be low in the voluntary scheme, while growing over time in the mandatory scheme. Draft legislation for the third pillar occupational pension scheme would set contributions between 2 and 8 percent of participants' gross wages (exempt from income taxes). With an average annual wage of about US$1,760 and participation not expected to exceed 100,000, this would be equivalent to US$8.8 million annually in contributions at an average contribution rate of 5 percent.

32. According to the monthly bulletin issued by the National Statistics Office, the number of employees was 4.4 million in May 2004 and 4.3 million in December 2003.

There is expected to be little third pillar push in the capital markets in the next decade. While wages are expected to rise in the coming years, the low figure will limit resource flows into voluntary schemes, and in the process limit the number of pension companies interested in privately managing these accounts. At a minimum, limited resources are expected to flow to third pillar options in the forthcoming decade.

*Romania Compared to the EU-15 and CE-3 Countries.* In general, the EU-15 has significant private pension fund resources in their economies. Assets under management by private pension funds approximate US$2.5 trillion, or about 29 percent of GDP. The average EU-15 citizen has about US$6,583 under management in a private pension fund.

All three CE-3 countries have introduced pension reform, and results to show for the effort. Indicators from 2002 show pension assets to GDP were 3.12 percent in the Czech Republic, 2.79 percent in Hungary, and 4.39 percent in Poland.

## Investment and Mutual Funds

As of December 31, 2003, Romania had three categories of investment funds that are active in the market:

- Twenty-three open-end, or collective, investment funds.
- Three closed-end funds.
- Five financial investment companies, or SIFs.

The most prominent of Romania's institutional funds are the financial investment companies (SIFs). As Table 28 indicates, SIFs had net asset values of about US$771 million as of year-end 2003. With more than 9 million investors, this approximates the net asset value per shareholder at about US$86. SIFs are listed on the BVB and account for a significant share of the trading that occurs on that market. Thus their shares are liquid, and are regularly featured among the top ten traded securities measured by volume.

Foreign mutual funds have played a very minor role in the Romanian capital markets. This is reflected in low portfolio investment figures. To the extent that there has been investment from abroad, this is often direct investment in joint ventures, new start-ups, and/or acquisitions. However, on the mutual fund side, there has been limited investment from abroad.

*Romania Compared to the EU-15 and CE-3 Countries.* In the EU, mutual funds play a key role in the capital markets. There were more than 40,000 mutual funds in the EU-15 countries as of 2002, with assets accounting for about 50 percent of GDP since 2000. This is substantially higher than in Romania on a per capita basis.

There has been major growth of mutual funds in the EU-15 market in the last decade. In 1996, mutual fund assets were only 26 percent of GDP. Thus, relative to GDP, they doubled in four years, and in absolute terms, value has more than doubled since 1996.

Mutual funds play significantly less of a role in the capital markets of the CE-3 countries. Nonetheless, there has been growth exhibited recently. In the Czech Republic, there were 83 mutual funds with assets of US$3.5 billion, equivalent to 5 percent of GDP as of 2002, while Hungary had 104 mutual fund companies with assets of US$3.1 billion, or

**Table 28. Investment Fund Indicators for Romania, 1998–2003**

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|
| Total No. of Open Funds | 10 | 15 | 17 | 23 | 20 | 23 |
| No. of Investors | 116,266 | 239,382 | 47,736 | 43,635 | 55,569 | 58,024 |
| Net Assets ($ millions) | 91 | 158 | 8 | 11 | 27 | 29 |
| Net Assets/ Open-end Fund ($) | 9.1 | 10.5 | 0.5 | 0.5 | 1.4 | 1.3 |
| Total No. of Closed Funds | 0 | 1 | 1 | 1 | 3 | 3 |
| No. of Investors | 0 | 97,949 | 99,266 | 97,934 | 97,593 | 97,335 |
| Net Assets ($ millions) | 0 | 11 | 9 | 8 | 9 | 17 |
| Net Assets/ Closed-end Fund ($) | 0 | 10.6 | 8.6 | 7.9 | 2.9 | 5.6 |
| Total No. of Reporting SIFs | 2 | 4 | 5 | 5 | 5 | 5 |
| No. of Investors (millions) | 9 | 9 | 9 | 9 | 9 | 9 |
| Net Assets ($ millions) | 240 | 325 | 387 | 460 | 656 | 771 |
| Net Assets/SIF ($) | 119.9 | 81.2 | 77.4 | 92.0 | 131.2 | 154.1 |
| Net Assets/GDP (%) | 0.8 | 1.4 | 1.1 | 1.2 | 1.5 | 1.4 |
| Net Assets/ Mkt. Capitalization[a] (%) | 28.7 | 38.0 | 33.1 | 20.8 | 15.3 | 13.3 |

*Notes:* Number of SIF investors are estimates; figures for SIF net assets are based on number of SIFs actually reporting.
a. BVB + Rasdaq
*Sources:* UNOPS; authors' calculations.

4.8 percent of GDP. In Poland, there are currently 105 mutual funds with US$5.5 billion in assets, or 2.9 percent of GDP. Considering assets were less than 1 percent just a few years ago in all three countries, this is a clear sign of progress.

## *Leasing*

The leasing industry in Romania is small, but growing. Annual volume was about US$1.3 billion in 2003, most of it in automobiles and commercial vehicles. As a percentage of 2003 GDP, this is approximately 2 percent.

Leasing in Romania has a legal framework, but is currently operating as a loosely regulated sector. While there is a leasing law, there is no supervisory authority. NBR, which is responsible for banking supervision, is responsible for the oversight of bank-owned leasing companies as part of its larger mandate to supervise credit institutions. However, as NBR has not yet fully moved to consolidated supervision, and as banks have not fully converted their accounting systems to consolidated accounting consistent with IAS, there may be some credit information and transaction gaps with regard to regulatory reporting and information disclosure. By extension, there is a risk that problem loans of the banks are being shifted to their leasing subsidiaries, thus obscuring financial information reflecting the underlying solvency of the consolidated operation. Apart from bank-owned leasing companies, some independent leasing companies are reported to be borrowing from smaller domestic banks and issuing lease contracts that allow those banks to indirectly increase exposures above prudential norms. While not formally owned by the banks, such arrangements may imperil the underlying condition of the bank (and/or insurance companies offering credit insurance or guarantees on lease contracts) should there be defaults on lease contracts.

Leasing market capital requirements are set at ROL 500 million (about US$15,000), which is small. Thus, barriers to entry are low (for more details refer to Table 29). To the extent that such operations are borrowing from banks, in some cases there could be inadequate provisions, capital and reserves to protect against losses should major defaults occur on contracts. However, this risk is mitigated by the ability to repossess and easily sell vehicles in the secondary market. Considering that vehicles account for about 88 percent of lease contract value, no major problems have been reported. In addition, with the presence of banks in the leasing sector, there has been a tightening of underwriting standards (for example, strict covenants, collateral coverage in addition to the asset leased). Nonetheless, there is a risk that lease contracts in some cases are being written on non-commercial grounds or without adequate protection, and this could harm creditor portfolios in the future if stricter standards are not applied and enforced.

**Table 29. Summary of Leasing Data for Romania, 2001–2003**

| | 2001 | 2002 | 2003 |
|---|---|---|---|
| Total market volume ($ millions) | 862 | 851 | 1,272 |
| Market volume as a share of GDP (%) | 2.1 | 1.9 | 2.2 |
| Market volume/non-government bank credit (%) | 23.0 | 16.0 | 13.7 |
| Average value per contract ($) | 57,501 | 23,578 | 42,216 |
| **Market Structure** | | | |
| Automobiles/Commercial Vehicles (%) | 86.9 | 75.3 | 87.8 |
| Other (%) | 13.1 | 24.7 | 12.2 |
| **Type of Customer** | | | |
| Companies (%) | n/a | 86.6 | 75.6 |
| Individuals (%) | n/a | 13.4 | 24.4 |
| **Type of Leasing** | | | |
| Financial (%) | 87.3 | 90.7 | 91.3 |
| Operational (%) | 12.7 | 9.3 | 8.7 |
| **Leasing Companies by ownership:** | | | |
| Independent (%) | n/a | n/a | 68 |
| Bank-owned (%) | n/a | n/a | 20 |
| Captives of suppliers (%) | N/a | n/a | 12 |

*Notes:* Market volume figures converted from 7 to $ at average exchange rates for the year; ASLR affiliates account for about 70 percent of market share; data for contracts and most market structure indicators are for members, not all leasing companies in Romania are reflected; percentages are based on data provided.

*Sources:* Data from Leasing Association of Romania (ASLR); authors' calculations from NBR and IMF data.

The absence of a developed corporate bond market hurts leasing companies. Because most lease contracts are outstanding for five to seven years, leasing companies face some maturity and interest rate risk. Most of the non-bank leasing institutions, which account for about 80 percent of the market, are dependent on bank loans for their financing.

*Romania Compared to the EU-15 and CE-3 Countries.* In contrast to Romania's relatively small lease volume, the EU-15 had about $189.9 billion in leasing volume in 2002, generated by 804 companies. On the other hand, lease volume in the EU-15 was only 2.2 percent of EU-15 GDP in 2002, which does not differ significantly from Romania's 2.6 percent.

The Czech Republic and Hungary have more developed leasing markets than Romania; Poland however, still lags behind Romania. In the Czech Republic, there were 83 leasing companies that generated US$3.7 billion in lease volume in 2002, about 5.2 percent of GDP. In Hungary, there were 30 leasing companies that generated more than US$2.3 billion in lease volume in 2002, or 3.6 percent of GDP. Thus Romania's figures are not significantly behind those of Hungary as a proportion of GDP. In Poland, leasing has not progressed as in the other CE-3 countries. Leasing volume was estimated to be US$1.2 billion in 2003, or 2.2 percent of GDP.

## Factoring

Factoring is relatively small as a share of the Romanian financial system. Factoring volume was about US$162 million at the end of 2002. This constitutes an increase from US$117 million in 2001, and only US$35 million in 1999. Yet it is still about 1 percent of bank assets and 0.4 percent of GDP. The two largest banks, BCR and BRD, are reported to be the dominant players in the market with about 73 percent market share in 2002.

*Romania Compared to the EU-15 and CE-3 Countries.* As Table 30 reflects, annual factoring volume in the EU-15 was reported to be US$538 billion in 2002, or 6.2 percent of GDP. This is much higher than in Romania by all measures.

Factoring does not play a prominent role in the CE-3 markets, but it still plays a larger role than in Romania. In the Czech Republic, factoring volume was US$1.8 billion in 2002, or 2.6 percent of GDP. In Hungary, factoring volume was US$616 million, or less than 1 percent of 2002 GDP. Poland's figures were US$2.7 billion in volume in 2002, equivalent to 1.4 percent of GDP.

## Mortgage and Housing Finance

The Romanian mortgage market remains at a relatively early, but promising, stage of development—a period in which rapid legislative and regulatory improvements have become indispensable. The primary mortgage market has recently exhibited substantial growth and progress, although it continues to operate significantly below potential. Since mid-2002, the market was comprised of six mortgage lenders, which accounted for US$100 to US$200 million in financing volume for the year. Since then, the number of market participants has increased to seventeen—comprised of fourteen commercial banks and three non-bank financial institutions—and the lending volume has been raised to US$400 million. USAID estimates that while the 2003 volume is likely to increase by more than three-

**Table 30. Factoring Volume Indicators, 1997–2002**

| | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|---|
| **EU-15** | | | | | | |
| Factoring Volume ($ millions) | 225,070 | 251,774 | 317,295 | 429,670 | 507,794 | 538,269 |
| Factoring Volume/GDP (%) | 2.7 | 3.0 | 3.7 | 5.4 | 6.4 | 6.2 |
| **ROMANIA** | | | | | | |
| Factoring Volume ($ millions) | 19 | 18 | 35 | 65 | 117 | 162 |
| Factoring Volume/GDP (%) | <0.1 | <0.1 | 0.1 | 0.2 | 0.3 | 0.4 |
| **CZECH REPUBLIC** | | | | | | |
| Factoring Volume ($ millions) | 243 | 417 | 732 | 1,091 | 1,375 | 1,806 |
| Factoring Volume/GDP (%) | 0.5 | 0.7 | 1.3 | 2.1 | 2.4 | 2.6 |
| **HUNGARY** | | | | | | |
| Factoring Volume ($ millions) | 247 | 103 | 135 | 373 | 610 | 616 |
| Factoring Volume/GDP (%) | 0.5 | 0.2 | 0.3 | 0.8 | 1.2 | 0.9 |
| **POLAND** | | | | | | |
| Factoring Volume ($ millions) | 289 | 543 | 568 | 2,263 | 3,721 | 2,657 |
| Factoring Volume/GDP (%) | 0.2 | 0.3 | 0.4 | 1.4 | 2.0 | 1.4 |

fold by 2006 to US$1.2 billion (equivalent to 2.2 percent of projected GDP), the market would remain significantly below its estimated current lending potential of US$5 billion.

The lack of a secondary mortgage market to support long-term financing is currently a major impediment to the growth of housing finance in Romania. This impediment is the product of an incomplete legal and regulatory framework for both primary and secondary mortgage markets. Moreover, long-term financial resources for mortgage lending are constrained, thereby subjecting lending institutions to revert to the use of short-term resources, which carries interest rate risk. Currently, the primary sources of long-term financing are international financial institutions, whose participation are non-recurring, and are limited to a single intervention designed to stimulate market growth. In addition, this type of intervention is potentially dangerous and/or limited because households are exposed to foreign exchange risk. The rapidly increasing competition through more affordable products does not correspond to advanced risk management capacities through all the lending institutions.

The Financial Market Reform project (FMR), a USAID initiative administered by Deloitte Touche Emerging Markets, has brought together key market participants in the Romanian mortgage finance sector in an effort to improve long-term growth prospects (USAID 2003). The focus of the initiative is on enhancing the development of mortgage securities (both on balance-sheet mortgage bonds and off balance-sheet securitization), which comprises the primary source of long-term housing lending through effectively raising capital for the lenders, and it transfers risks to capital market participants. In addition to this, the initiative targets the adjusting and streamlining of various laws and regulations affecting primary mortgage lending, and designated them a priority block of reforms. The effort has brought together over seventy representatives from the major banks, mortgage companies, regulatory agencies, legislature, law firms, investors, service providers, and donor agencies, to identifying the key steps for the development of a secondary mortgage market in Romania.

Following a detailed roundtable discussion that included the key market participants, an industry-wide task force was developed, whose objectives are: (1) to drive the development of the Romanian mortgage market; (2) to develop the vision, road map and timeline to support the project; (3) to oversee the drafting of new and the harmonization of existing relevant legislation and regulations; (4) to support the development of crucial existing and new market institutions; and (5) to raise the awareness of the Romanian public and market participants.

To date, the FMR has facilitated the drafting of a Mortgage Bond Law and a law related to securitization, and it brought some changes to the present legislation in the mortgage market area. The mortgage legislative draft package has been submitted to the government agencies for comments and is expected to be finalized at the end of 2004. In addition, the secondary regulation is scheduled to be finalized by mid-2005.

USAID's projected estimates for growth of the housing finance market in Romania are likely to continue to spur the entrance of new market participants. There are currently a number of domestic and foreign banks within the Romanian banking system that do not offer mortgage financing, including four large international banks and a number of smaller ones. This is reflected in the lack of accessibility to housing finance products for lower-income groups. The shortage of adequate long-term financing and refinancing alternatives, however, continues to be a major challenge that must be addressed in order to enable the development of a highly competitive housing finance environment within Romania. The development of an efficient social housing finance policy represents another challenge, notably that mortgage credit insurance schemes would be worth investigating and then compared to the new contractual savings and housing loans schemes.

### *Credit Insurance*

Credit insurance, guarantees, and other credit enhancements are limited in Romania, despite recent growth of some products. Increasingly, risk transfer from banks to insurance companies is taking place. Credit insurance premiums approximated 3 percent of total premiums in 2001 and 2002. These exposures increased in 2003, which led to new regulations that limit such enhancements for mortgage and consumer loans.

Credit insurance is provided mainly by property and casualty firms that issue insurance on properties used as security for loans. While helpful as a factor for increasing access to finance for households and SMEs, credit insurance also represents a transfer of risk that may not be fully understood by those firms that are ultimately liable. For instance, in the small corporate bond market, there have been doubts about how safe the guarantees are in the event of default. The following factors must be taken into account:

- Financial resources of the insurers.
- Insufficiency of reinsurance arrangements.
- Limited tradition of paying claims.
- Willingness to provide financial payment in a timely manner, as required for financial guarantees in structured finance.

- Judicial inexperience with regard to investigation and litigation should financial guarantee payments be made in a timely manner, and then later found to be unjustified or in violation of underwriting terms.

There are some guarantees provided for corporate bonds, but there were only four of these in the domestic market in 2003, of which only one was traded on the BVB. The BCR Leasing bond brings this to two traded on the BVB.

Municipal bonds are not issued with guarantees. There are preliminary plans to eventually issue partial guarantees for sub-sovereign bond issues, and to introduce a mortgage insurance scheme to facilitate development of the housing and mortgage finance market. However, at present the small municipal bond market operates without guarantees.

Housing is insured as part of property and casualty, but there is no comprehensive mortgage insurance system based on common underwriting standards, procedures, and controls found in markets where partial or full insurance coverage is available. A comprehensive mortgage insurance system has not been conceived, and will not likely be introduced until 2005 at the earliest.

## Corporate Governance

The financial crises of East Asia in 1997, Russia in 1998, and Turkey and Argentina in 2001 and 2002 have highlighted the importance of good corporate governance for capital markets. While governance is important for all economies, it is the emerging markets that are most vulnerable to weak governance of the business sector. In developing and transition economies, weak governance of the business sector increases both the likelihood of a financial crisis and the severity of the crisis.

All the transition economies in the Europe and Central Asia Region (ECA) have suffered from weak corporate governance. The impact has been most profound in the regional capital markets. After an initial period of privatization of state enterprises through mass distribution methods and the establishment of stock exchanges and regulatory commissions, the capital markets have largely fallen into decline. Some of this was to be expected: Strategic investors accumulated large blocks of shares, offered to buy the rest, and then took the companies off the stock market. However much of the decline of the ECA capital markets was due to loss of investor confidence.

Among the Balkan countries, for which accession to the European Union is planned for 2007, Romania trails behind. The EBRD rates Romania's corporate governance as a "2" (in a range from 1 to 4), which is weaker than the ratings of Croatia and Bulgaria and substantially behind the ratings of a "3+" for the central European countries that joined the European Union in May 2004.[33]

The corporate governance framework in Romania was reviewed by staff of two World Bank missions. The first review was a part of the Financial Sector Assessment Program (FSAP) in May 2003, and the second was a mission in February-March 2004 to conduct a corporate governance report on the observance of standards and codes (ROSC).

33. Taken from *Transition report 2002* by the European Bank for Reconstruction and Development.

In the Romania corporate governance ROSC review of March 2004, several key issues became clear. They include:

- the weak role of boards of administrators,
- the incomplete disclosure of ownership and control of traded companies,
- unreliable financial reporting, and
- the weak minority shareholder rights for small shareholders of privatized companies.

The new Capital Market Law is expected to address a number of legislative weaknesses identified by ROSC; however, the authorities will still need to draft the remaining legislation (to be discussed in Chapter 3) and to strengthen the capacity of the supervision and capacity of implementation as well.

CHAPTER 3

# Capital Markets and NBFIs

## *Key Challenges and Recommended Policy Reforms*

### Impact of Macroeconomic and Sectoral Policies

Macroeconomic and sectoral policies play a major role in shaping the development of capital markets and NBFIs. Romania's macroeconomic policies have become increasingly favorable to capital market growth and development. However, it will take considerable time for incomes and savings levels to rise to levels that would significantly catalyze capital market growth. Key weaknesses which continue to persist include: double-digit inflation rates, a weak tax base, relatively low direct investment, a high current account deficit in 2003, and continued high arrears.

With the macroeconomic environment beginning to show improvement, most of the constraints to NBFIs and the capital markets are structural. Major constraints to securities market development in Romania have included the following:

- Perceptions of political and investment risk,
- Corruption and a weak judiciary,
- The limited presence of institutional investors,
- A narrow supply of instruments and range of maturities, as well as insufficient development of benchmarks for yield curves,
- Uneven tax incentives (e.g., insurance and pension), and inadequate utilization of deductibility and incentives,
- Perceptions of complexity and costs of issuance in the marketplace,
- Lack of transparency and information disclosure, and
- Lack of efficient market infrastructure.

Weaknesses in the overall business environment have added to costs, slowed investment, encouraged informality and tax evasion, and discouraged open disclosure of meaningful financial information. In terms of financial flows, these weaknesses have ultimately led to risk aversion on the part of the financial markets. In the case of banks, lending is relatively limited, with loans to the enterprise sector about 11 percent of GDP at year-end 2003.[34] Meanwhile, the equity markets are about the only other source of formal financing, but few companies are actively traded, thus reflecting the limited relevance of the markets to most of the economy.

The portfolio of the newly established AVAS (the institution that resulted after the merger of APAPS with AVAB) at end-June 2004 included 548 companies to be privatized, 153 companies of which AVAS owns the majority stake, and 395 companies of which AVAS owns the minority stake. AVAS also has "golden shares," which provide for preferred rights for AVAS on the board of administrators. Along with obvious potential governance problems at the firm level, this raises investment and political risk issues with regard to exit strategies and effects on market pricing. While AVAS is expected to divest its golden shares,[35] the continued presence (2004) of the state in hundreds of companies reflects how long it has taken the state to exit most of the enterprise sector. Slow privatization, particularly in firms that could attract strategic investment, has delayed market development.

The main constraint has been the credit environment, the characteristics of which stifle market development in general. Banks face difficulties in assessing credit risk due to the incompleteness and unreliability of financial statements and other needed information. There have also been problems with the judicial framework, namely inefficiencies in the court system, reports of corruption, the amount of time and money required to enforce debt contracts (itself often a reflection of inefficiency), and the underdeveloped secondary market for recovered assets. All of this makes banks and other creditors more risk-averse, either restricting credit or driving up the cost of borrowing.

Such fundamental weaknesses also add to the risk premium of investing in such companies' equities or buying their corporate bonds. Most companies are unwilling or unable to meet disclosure requirements for listing. Beyond that, a significant number of companies simply do not have strong market positions or sound cash flow. Thus, corporate bond and equity investors are unwilling to assume risk, particularly as they would be minority investors in many cases, and subordinated in others.

With approximately one third of listed companies on the two exchanges facing problems of profitability and cash flow, they are unable to obtain financing on commercial terms. (Particular problems are reported for agricultural enterprises and non-exporting manufacturers.) Unlisted companies likely follow a similar pattern, with some being very

34. Figures are from NBR for state and private enterprises in ROL and foreign currency. Figures are gross, and do not net out overdue loans. Figures from IFS show higher overall credit to the real sector. However, this includes credit to households and other non-enterprises.

35. The legal framework for the transformation of the nominative control shares into ordinary shares was set up by the issuance of the G.O. 31/January 30, 2003, concerning the mandate granted to APAPS (prior to becoming AVAS) for concluding addenda to the share sale-purchase contracts aiming the divestiture of the golden share pursuant to its conversion into an ordinary share, out of the 110 companies where the state initially held nominative control shares. For 99 companies, the nominative control shares were transformed into ordinary shares and sold to the majority shareholders of the companies. For the remaining companies, for which as of June 30, 2004, the addendum for transforming the nominative control share owned by the state into ordinary share was not concluded, the new owners have been re-notified by AVAS in order to conclude this addendum.

competitive, others being in dismal shape, and many others staying afloat from internal resources, informal networks and slow payables turnover.

To counter these financing constraints, real sector enterprises have relied heavily on arrears, a pattern found in many CIS countries. This was initially true on bank loans that later failed to perform, triggering the eventual demise of Bancorex and other banks and weakening financial stability at that time. Once these problems were recognized and conditions tightened in the banking sector (late 1990s), enterprises generally ran up arrears to non-bank creditors, including utilities and power companies, the government (including the unfunded pension scheme), health fund, and employees. At the end of 2001, the stock of arrears was reported to be 58 percent of GDP. More recently, these have reportedly declined to about 38 percent of GDP, which is an improvement of about US$4.8 billion,[36] yet remains very high.

Meanwhile, inter-enterprise arrears clearly impact company cash flow, and this requires companies to maintain higher working capital levels than might otherwise be necessary. Such receivables risk also drives up costs, as companies need to build in reserves to protect against losses the way banks do (as creditors). Such focus on liquidity and working capital weakens resource availability for investment, be it in fixed assets or the securities markets. Such tendencies also often result in tax arrears, as is the case in Romania. With the informal sector thought to approximate 61 percent of GDP (World Bank 2004), such patterns encourage cash and barter to understate tax obligations. As such, the enterprise sector has less in the way of resources and incentives for direct investment in the capital markets.

While serving as a potential opportunity for factoring companies, such characteristics more broadly undermine prospects for NBFIs. The financial profile of such companies raises their risk, making loans, bond financing, and equity investment more difficult to obtain, insurance either impossible to access or more costly, lease contracts more costly, and prospective factoring options excessively risky. In terms of insurance, the financial profile of most firms alone makes it less likely they would purchase voluntary insurance. As there are no tax incentives for companies to obtain life insurance policies for employees, these factors combine to stifle development of the life insurance sector. Meanwhile, financial constraints and pressures may also lead to insufficient coverage of risks when insuring properties and other assets. Such a risk profile makes it more costly to obtain term financing, which is what lease contracts represent for vehicles, machinery, and equipment usage. In terms of company receivables, the weak quality of enterprise debtors combined with poor credit information systems in Romania makes pricing and risk taking less attractive.

Companies' resource constraints also show in their arrears on pension payments. That pension expenditure is about 7 percent of GDP, cumulative deficits since 1995 have approximated 10 percent of GDP (including farmers' payments in 2002–03), and arrears to the state pension system have increased over time reflects the direct impact of these arrears. Under such circumstances, there is a need for pension fund rationalization, which could be done with introduction of a second and third pillar. However, this has not yet been agreed to by government, partly because of the overall deficit faced by the unfunded government pillar as contributions shift to a second pillar. Deficit reduction in 2002–03 can be attributed to an accounting shift of farmers' payments from the pension scheme to the budget.

36. (58 percent of 2001 GDP of $40.2 billion) less (38 percent of 2003 GDP of $48.8 billion) = $23.3 billion less $18.5 billion = $4.8 billion.

Financial constraints may be less severe in leasing markets. In fact, this is one of the reasons why leasing is popular with SMEs. First, ownership of the asset stays with the leasing company until the contract is fully paid up. Thus, in the event of lessee default, the lessor (leasing company) retains ownership and can easily repossess the asset. Bank-owned and captive finance leasing companies in Romania have tightened up on standards in the last few years, and this has helped to improve safeguards against risk. Second, lease contracts are often for smaller amounts than loans requested of banks. In most cases, leasing in Romania involves vehicles, and is more a captive finance operation of auto dealers than anything else. However, there has been little activity in industry and services. Thus, constraints to leasing market development appear to have more to do with an enterprise's familiarity with leasing as an option for machinery and equipment, and less to do with the financial profile of households and companies. However, as leasing companies tighten up on standards, the unwillingness of prospective lessees to present information that meets lessors' underwriting standards can also serve as a constraint even if the financial resources are available.

## *Structural Impediments to Growth*

The capital markets of Romania are constrained in terms of both instruments and the presence of institutional investors. Removing these two sets of obstacles will be needed for Romania to develop its markets, and to eventually comply with EU standards. As Romania continues to pursue measures to bring it closer to the EU, it is expected that the free movement of capital and financial services in an increasingly credible judicial and investment environment will help to accelerate progress toward compliance.

The evolution of technology, accompanied by the possibility of various forms of collaboration and outsourcing of back office functions with regional markets, likely have made smaller markets more sustainable. In spite of this, Romania's market capitalization of US$6 billion suggests that the capital market will still have to grow substantially to enhance its long-term market position. Romania's markets also suffer from insufficient critical mass. For example, there were only 60 listed companies on BVB in early 2004.

An inconsistent legal framework has stifled market development in favor of central government financing. For example, until the recent introduction of the Capital Market Law, the legal restrictions imposed on the value of corporate bonds[37] that can be issued and also on insurance sector exposures, have hindered market development.

There has been other institutional constraints to market development in Romania. There is a shortage of investment banks to encourage corporate bond and equity market development. Offering documentation often lacks sufficient detail or credibility. There is an issue of compatibility of the payment and settlement systems between NBR and the stock exchange which limits bond trading. Market analysis is weak, partly due to the incomplete and sometimes untimely presentation of financial information, and limited information exists in regard to payment histories. Broker/dealers do not advise potential

37. The restrictions being imposed on the value of municipal bonds that can be issued, to 20 percent of previous year fiscal revenues. While this helps to protect against excess leverage, it also keeps the instruments small and of short maturity. (The Oradea bond planned for 2004 will be ROL 150 billion, or about $5 million, the largest to date.)

issuers on a regular basis. The absence of issuers with the expertise to evaluate alternative sources to bank financing also constrains the development of corporate bond and equity markets.

There are alternative sources of finance available to corporations in Romania that could be viable candidates for corporate bond issuance. These include access to direct or syndicated lines of credit (parent to subsidiary) and/or trade finance instruments (contractor to vendor) by companies that are subsidiaries of multinationals, major suppliers to their parent companies, or major trading partners.

## Legal, Regulatory, Supervisory, Tax, and Infrastructure Impediments

One of the key weaknesses in the development of a suitable legal and institutional framework for capital markets has been the lack of coordination and dialogue among regulatory authorities and market players. As a result, much of the exercise in complying with EU standards has been legalistic and mechanical. The focus has been on seeking to replicate EU directives without necessarily working through the implementation issues and arrangements that are critical for functioning market economies. Of particular importance will be the ability to effectively implement fit and proper tests for capital market intermediaries and professionals at registration, and to establish regular monitoring.

Furthermore, as the financial sector becomes more complex, interaction and coordination between parts of the financial sector (domestic and cross-border) becomes important so that accounting and supervision can be consolidated.

In Romania there are weaknesses in the appointment process of the boards that oversee the regulatory agencies. There is a critical lack of expertise in many of these specialized fields, and the financial sector would be better served if technical experts played more of a role while the agencies were steadily de-politicized. Some of these reforms are under way, yet the EU and others have identified these as continuing weaknesses.

There are also issues outstanding in the field of secured transactions, which will affect NBFIs and the capital markets (as well as lending). These include the property registry for both moveable and immoveable assets. While there has been great improvement since 2001, there are reports of systems overload with the property registry system at Ministry of Justice, as well as a need for an updated cadastre (Land Book). The current system needs to be improved, centralized, and accessible electronically to ensure that complete information is available, and to avoid simultaneous claims on pledged assets. Specific capacity enhancements that are needed include increased search capacity, and greater server capacity to handle increased entries. This will be important for successful implementation of mortgage market reform and the movement toward mortgage bonds and mortgage-backed securities, as well as any other asset securitization developments that would materialize in the coming years.

### *Securities Markets*

*Legal Constraints.* Frequent legal and regulatory changes have added uncertainty for investors. Nonetheless, there is now a chance to harmonize Romania's capital markets legislation with EU standards. This synchronization is consistent with the directive for investment services in the securities markets (93/22/EEC) and will bring provisions of Romania's legal framework more closely into compliance with EU[38] Treaty provisions on freedom of capital movements. These changes are essential for Romania's accession prospects, and for the more tangible need to attract needed investment and eventually meet EU standards.

As of 2003, key legal shortcomings or omissions in Romania's draft capital markets legislation still persisted, according to the EU. These included issues concerning:

- The role of state (for example, NBR, national bodies) and credit institutions active in the securities markets.
- Voting rights of significant shareholders.
- Capital adequacy of investment firms.
- Potential for discriminatory treatment in favor of non-EU investment firms.
- Treatment of persons whose actions could prejudice the sound and prudent management of investment firms.
- General responsibilities of compliance and enforcement (as a member state).
- General enforcement powers of supervisory authorities to perform their regulatory functions.
- Coordination with other regulatory authorities for effective supervision of investment firms.

The recent consolidated Capital Market Law, adopted by the Romanian Parliament and published in the Official Gazette in June 2004, is in conformity with EU financial sector directives and recommends removing a number of the shortcomings listed above, including the requirement for SIFs to be regulated as private equity funds.

In the past, there had been criticism that legislation has been not specific enough, and that the CNVM has not had the capacity or the experience to draft and implement regulations in a timely manner. This is supported by the recent Romania FSAP, which cites that the CNVM is still in a developmental stage. New legislation should address this issue, through the reduction of the burden on the CNVM, while providing it with the mandate needed for orderly, stable market expansion. The EU has encouraged this approach as well.

With regard to the SIFs, it is recommended that Romania's capital markets legislation specify the requirements, rules, and instruments for undertaking collective investments in transferable securities (UCITS) to be consistent with EU directives, specifically the EU UCITS Directive. The recent Romania FSAP highlights the fact that SIFs are not transparent and are not subject to adequate supervision, despite comprising a significant part of the trading volume of the BVB. Thus, as Romania moves forward with its capital markets legislation, it should include specific provisions addressing the authorization and licensing of SIFs, information disclosure of SIFs through prospectus and offering documents, regulation of investment policy of SIFs, reporting obligations of SIFs to their investors through annual reports and semi-annual reports, calculation of Net Asset Value (NAV) of SIFs and

38. Current restrictions on the purchase of T-bills and placement of foreign currency deposits in branches of foreign banks are not considered a problem by the EU relative to bringing down inflation rates—on the condition that Romania progresses toward the removal of barriers to capital movements and the provision of financial services by the date of accession.

publication of NAVs to investors, regulation of agency risk and reduction of potential conflict of interest between managers and investors, and registration information concerning fit and proper tests for SIF board members and SIF managers, and ultimate beneficial owners of SIF management companies.

Legal reforms are expected to address capital adequacy issues. This will present new structural and institutional challenges. Compliance with EU Directives (93/6/EEC and 93/22/EEC) on minimum capital requirements for listed companies would reduce the total number of listed companies that meet the minimum share capital of Euro1 million to less than 100 companies. With the planned merger of the two exchanges, legislation will need to account for the over-the-counter trade of de-listed securities. EU legislation also requires that minimum capital be conceptualized on a regulatory basis, meaning that investment firms are subject to a capital adequacy test, and not just minimum capital requirements. The Romanian authorities should include minimum capital requirements in the law to be consistent with EU legislation (93/6/EEC). This would apply as well to investment advisors.

Modalities for the enforcement of 25 percent free float also presents challenges in terms of capitalization and liquidity in the market. EU Directives require that listed companies have a public "float" of at least 25 percent of outstanding shares. Romania's legislation would benefit from setting and enforcing minimum free float targets that are consistent with EU Directives.

Romania's new capital markets legislation will need to be properly enforced to ensure adequate transparency for market confidence—a challenge to date. Management, significant shareholders, and beneficial ownership interests in capital market intermediaries need enhanced disclosure. The threshold of significant ownership subject to disclosure is generally 10 percent (88/627/EEC). Given issues of concern about controlling interests and past problems with the management of funds, Romania might consider a lower threshold as a demonstration of transparency. This could include full public disclosure of any changes of ownership interest that equal or exceed this threshold.

Legal limits on issues and holdings have constrained market development in the past. Under Company Law in Romania, a corporation could only issue bonds to a maximum of 75 percent of its social capital. The recently promulgated Capital Markets Law removed this constraint. However, it is important that the Company Law be updated to reflect the change proposed in the Capital Markets Law. Also, the provision that stipulates that at least 30 percent of issued corporate bonds has to be held by at least 1000 bondholders will be modified[39] because there is no clear reason for these rules in a modern capital market.

*Regulatory and Supervisory Constraints.* Major areas of focus for regulatory and supervisory institutions and market development should include increased coordination with other regulators. Developing and implementing a comprehensive supervisory approach across borders, as well as with other domestic regulatory authorities such as the NBR and CSA are essential for market confidence.

39. This should be modified according to the provisions of Chapter IV, Title VI from the Capital Market Law no. 297/2004 (regarding the admission to trading of corporate bonds).

CNVM needs to develop a comprehensive supervisory strategy that applies to issuers as well as to financial intermediaries active in the capital markets.[40] This would require a more comprehensive framework for off-site surveillance, on-site inspections, enforcement measures[41] (including audits[42]), policy coordination among these groups/functions, and allocation of financial and human resources[43] for enhanced supervisory effectiveness. This should be done by increasing consultation with market players in the drafting and adoption of laws and regulations to assist with more orderly implementation of market functioning thereafter. This will also require increased staffing, training and compensation to perform adequate oversight of the capital market. While the number and pay of staff have both increased, these are still widely thought to be inadequate relative to the complexity of supervision in the coming years.

CNVM will need to exercise greater independence. Based on the EU's recommendations, the statutory provisions regarding the subordination of CNVM to the Romanian parliament have been repelled.[44] This needs to be followed up with the movement of technical decisionmaking to staff members, and away from political influence, to make the institution more technocratic, more autonomous, and less politically influenced. The CNVM's enforcement mandate also needs to cover all financial intermediaries, particularly as a basis for detecting fraud and suspicious transactions as well as general manipulation and unfair business practices.

The CNVM should have the ultimate responsibility for enforcement of compliance of the financial information provided by the issuers: (a) whose securities are admitted to trading on a regulated market and (b) that applied for admission to trading of their securities on a regulated market with the International Financial Reporting Standards.[45] In this context, CNVM should adopt, implement, and enforce the principles of the Committee of European Securities Regulators. In addition, CNVM should be involved in the public over-

40. For example, supervising issuance and trading in treasury bills/bonds is outside the scope of CNVM's authority, but CNVM does have authority over its supervised institutions' (the securities intermediaries, investment funds and stock exchanges) involvement with treasury bills/bonds. Moreover, regulation of bank activity in the securities markets, such as acting as depositaries, custodians and distributors of Collective Investment Scheme units must be agreed on, particularly in light of the possibility that banks will be able to act directly as intermediaries on the stock exchange.

41. The enforcement authority of the CNVM to investigate violations of the laws governing the capital markets is limited by the inability to obtain documents from firms not under its regulatory umbrella.[39] CNVM also does not have the right to subpoena. It can block bank accounts and securities transfers under specified conditions. It can also impose civil sanctions, as well as issue required corrective measures prior to withdrawing a license.

42. In addition to not having mechanisms in place for oversight of the Chamber of Financial Auditors, CNVM does not have a dedicated department focused on audit enforcement. There is an institutional gap in the event that the financial statements of listed companies are inaccurate and need to be restated.

43. While the number and pay of staff have both increased, these are still widely thought to be inadequate relative to the complexity of supervision in the coming years. The infrastructure of CNVM has improved over the last several years with the help of the EU. Nonetheless, the EU has cited the need for a higher number of skilled employees at CNVM, as well as a redistribution of tasks and resources for greater effectiveness and enforcement.

44. CNVM now reports to the Commissions for budget, finance and banks of the Senate and Chamber of Deputies, to the Economic Commission of the Senate and to the Commission for economic policy, reform and privatization of the Chamber of Deputies.

45. Refer to Regulation No. 1606/2002 of the European Parliament and of the Council of July 19, 2002 on the application of International Accounting Standards.

sight system of the auditing profession. The public oversight system should be consistent with the requirements of the proposal for a new Eighth EU Company Law Directive.

Better offering documentation is needed for market development. Increasing disclosure of asset management companies' fee structures and the clarity of information conveyed in issuance prospectuses is needed to increase investor confidence. The CNVM can address this by drafting appropriate implementing regulations on the required information content of issuance prospectuses. Efforts to standardize the documentation will help issuers and investors, as well as the intermediaries helping to place the issues. Likewise, the CNVM is not required by law to approve a Fund's rules. This should be changed to require asset management companies to draft such rules for publication in the prospectus, and to be approved by CNVM. Directive 85/611/EEC can serve as a basis for this effort.

The CNVM also needs to play an active role in ensuring strong corporate governance. This should include tightening professional requirements for members of the board of directors. All members of the board of directors of financial intermediaries should be competent in finance, and have directly relevant experience. It will be critical for the CNVM to develop its capacity to carry out fit and proper tests for capital market intermediaries and professionals, including discovery and background checks of ultimate beneficial owners. This will require developing collaboration with law enforcement agencies in Romania and a comprehensive set of MOUs with counterpart securities exchange commissions abroad.

*Tax Constraints.* Romania has very little tax discrimination, and what preferences that are made available do not constitute constraints or impediments to securities market development. There are some tax provisions that moderately distort the playing field, although these are considered fairly minor points of discrimination and basically provide a small advantage to individuals for the purchase of government securities. Individuals are granted full tax exemptions on earnings from government securities (including municipal bonds), as opposed to tax payments that need to be made on dividend payments on equities and from Funds (5 percent on dividends) or on interest income from corporate bonds (1 percent). Capital gains for individuals are only taxed at 1 percent, less than the 5 percent dividend tax rate. These apply to gains from sales of municipal bonds as well as corporate bonds, investment funds and equities. Tax treatment for companies is tougher, although less discriminatory across securities. Interest earnings from government securities are still taxed at the normal corporate tax rate of 25 percent (along with other income), whether from central government or municipal bond earnings. This is true also for corporate bonds, as well as for capital gains on equities and Fund shares. However, these rates are higher in general than rates paid on dividends from equities and Fund shares. Meanwhile, companies are permitted to expense interest paid on corporate bonds in a manner similar to interest expense paid on bank loans.

*Infrastructure Constraints.* There are nine independent registrars—a considerable number, given the size of the market. The importance of centralizing the registration function is now feasible with the new provisions in the Capital Market Law regarding the central depository.[46]

46. This shall undertake deposit, settlement, and registry activities for all types of the financial instruments.

## *Bond Market*

The domestic bond market needs to be broadened. The Ministry of Public Finance (MoPF) tends to prefer borrowing abroad over domestic borrowing, which is understandable given the interest rate difference between Euro and Lei. However, given that Lei has been depreciating against the Euro, and that the revenue of MoPF is in Lei, it may not necessarily save the financing cost by borrowing abroad. Actually, in most cases, this will increase the total financing costs for MoPF.

From the demand side, our initial assessment suggests that there is enough ongoing demand to absorb greater domestic issuance. Aside from mitigating foreign exchange risk, the domestic approach has the additional advantage of supporting domestic market players—market-makers, institutional investors, stock exchanges, and information vendors, to name a few—that are key forces for promoting domestic NBFI sector development and financial markets.

In this context the recent plan by MoPF to gradually increase the proportion of domestic borrowing is welcome. According to the new budget deficit financing strategy, the need for external sources to cover the budget deficit should decrease from around 60 to 80 percent in previous years to around 50 percent in the coming years. As a result, an increase in the weight of the domestic financing will benefit the extension of the yield curve, which is one of the objectives envisaged by the Ministry of Finance.

Currently, T-bills cannot be counted as reserves by NBR, which decreases the attractiveness of T-bills. This contributes to the relatively high bidding of yields on T-bills, which discourages the MoPF from issuing government securities domestically. It is understandable that the NBR would not count T-bills as reserves, given the credit expanding tendency of the banking system. However, T-bills are low risk and highly liquid assets that should be qualified as reserves. Liquidity management practices of central banks should be achieved by open market operations and adjustments to reserve requirements, based on monetary policy to encourage or discourage credit expansion (among other considerations, generally related to price stability). With the strengthening of the T-bill credibility, NBR may want to gradually consider the T-bill counted as part of the reserve requirement. To address this issue, there needs to be close cooperation between the MoPF's financing policy and NBR's monetary policy.

Current government financing policy (MoPF) and monetary policy (NBR) are not well coordinated, and could be made more efficient for both fiscal and monetary management. At the moment, NBR requires high reserve requirements, pays low interest on reserves, and compensates banks by offering high nominal interest rates paid in the sterilization process. Rates paid through sterilization are more than 300 basis points higher than rates willing to be paid by MoPF on T-bills or about 800 basis points higher than the inflation rate. This has triggered conflicting positions: the MoPF seeks to keep its interest expense down, and the banks continue to contend with high costs imposed through reserve requirements. A more efficient approach would be to smooth out interest rate differentials, with an interim adjustment for reserve requirements, followed by a convergence of yields and maturities for comparable instruments and financing needs relative to risk. As initial distortions are reduced, the government can then focus on establishing a yield curve. As the inflation rate declines, there will be a positive externality to establishing a yield curve so that other issues (for example, corporate, municipal, asset-based, equities) will then have a benchmark.

## Insurance

*Legal Constraints.* The legislative and regulatory framework for insurance in Romania has been undergoing significant changes in the recent past. Between 1952 and 1991 insurance was a State monopoly, In the following years, several local and international insurance companies entered the market which, as of December 31, 2002, comprises 46 insurance companies. On December 29, 1995, the Romanian Parliament passed Law n.136/1995 on insurance and reinsurance. This piece of legislation introduced basic concepts and principles concerning certain types of insurance: property insurance, life insurance, general liability insurance, and third party motor vehicles liability insurance, which is compulsory in Romania.

This law did not provide an adequate legal framework for proper development of the insurance market in Romania, and in April 2000, a new insurance law was promulgated. This law set a new and more modern framework for operations in the Romanian insurance market, introducing regulatory standards for liquidity ratios, higher capital requirements, criteria for shareholders and members with qualifying holdings, professional qualification requirements for managers of insurance companies, rules concerning the investment and valuation of assets, the format of financial reports, as well as many other aspects. Pursuant to this law, the Supervisory Office of Insurance and Reinsurance Activity—OSAAR was replaced by a new insurance market regulatory body: the Insurance Supervisory Commission (CSA).

Insurance operations[47] in Romania are divided into two categories: life assurance and general insurance. The specific classes of insurance falling into these two broad categories have been subsequently established by the IAS-CSA with Norms n.3/2001 of 24 August 2001, following the accepted classification of risks and classes of insurance at EU level, with the exception of suretyship insurance (direct and indirect) that is not listed by such Norms. Even if the distinction between life and non-life classes of insurance is fully recognized in Romania, under then existing legislation, the separation between life and non-life insurance operations is *not* a legal requirement, so that insurance undertakings can be authorized to pursue both. As of December 31, 2003, there were 25 composite insurance undertakings offering life and non-life insurance products in Romania.

To this purpose, a new draft law has been very recently adopted by the government. Under the new law, the classes of insurance would be fully harmonized with EU classes and they would be listed in an Annex to the main legislative act (and *not* anymore in secondary norms). Moreover, the separation between life and non-life insurance operations would be established as a legal requirement, in keeping with EU standards.

According to the latest EU Accession Progress Report (November 2003), while significant progress has been made in the recent past, legislation in relation to the insurance sector still lacks precision, and both implementing provisions and the decisions of the Romanian Insurance Supervisory Commission are not always consistent over time. Substantial further amendments and new implementing measures will be required to fully align Romanian legislation with the insurance *acquis.* These are planned in several steps until 2006.[48]

47. Pursuant to article 3 of Law n.32/2000.

48. The draft law is being prepared by the Romanian Insurance Supervisory Commission (draft Law no. 32/2000 regarding the insurance undertakings and insurance supervision with subsequent amendments), and the draft secondary legislation (regulations) is expected to be fully harmonized with EU directives.

To this end, the authorities have made substantial efforts in the first half of 2004 to adopt the primary legislation that would align them with EU Directives and international best practices.[49] The drafting and adoption of the secondary regulations is expected to be implemented in 2005.

Minimum capital has been raised to ROL 30 billion (about US$920,000, or Euro 745,000) for non-life insurance (including compulsory); ROL 21 billion (about US$645,000, or Euro 522,000) for life insurance; and ROL 15 billion (about US$460,000, or Euro 373,000) for general non-life insurance excluding compulsory lines. These minimum figures will likely need to be increased further[50] to ensure that companies have the required systems, controls, and financing capacity to handle claims when filed.

Standards were imposed in November 2003 that are more in line with international standards, regarding categories of assets admitted to cover technical provisions, investment diversification and spreads, the evaluation of assets, liquidity ratios, as well as methods to calculate mathematical reserves in life insurance. International standards mandate that assets covering technical provisions must be diversified and spread in such a way as to ensure that there is no excessive reliance on any particular category of asset, investment market, or investment. Further amendments are expected prior to EU accession.

Pursuant to these new standards, listed shares and other listed securities are now permitted to cover up to 50 percent of technical provisions, net of reinsurance. However, there appears to be no specific prudential rules concerning the use of financial derivatives. These changes constitute a significant increase with respect to the previous limit, set at only 20 percent. New rules will need to cover commodities and derivatives.

A corporate governance framework specific to the insurance sector has not been developed. In particular, CSA will need to develop capacity to verify that insurance companies are observing required practices. These include development of comprehensive risk management and portfolio management systems, observance of prudent asset management practices, appropriate accounting for reserves and of revenue recognition, compliance with consumer protection standards to honor legitimate claims in a timely manner according to contract terms, development of internal systems for accurate reporting and disclosure, and autonomous internal audit functions to permit appropriate board oversight of management performance.[51]

Romania does not yet have legal rules concerning supplementary supervision for insurance companies that belong to an insurance group or to a financial conglomerate. This issue shall be taken into account with a view to ensuring future compliance with Directives 98/78/EC[52] (supplementary supervision of insurance undertakings in an insurance group) and 2002/87/EC (supplementary supervision of financial conglomerates).

Romanian legislation does not yet contain provisions aimed at promoting the quality of reinsurance arrangements of domestic companies. It is recommended that legislation to proceed with the proposed amended to promote reinsurance with reputable, internationally recognized re-insurers.

49. The legislative reform process is still underway, following the path of the EU accession program: *see* the discussion in the previous sections.

50. A special Regulation has been drafted by the Romanian Insurance Supervisory Commission; however it will not be in force until January 2006.

51. Very recently, the insurance regulator issued regulations on corporate governance and internal control.

52. Special Regulations were drafted by the Romanian Insurance Supervisory Commission to be in force by January 2006; these regulations would fully transpose the provisions of the said directives.

The legal framework does not yet adequately deal with insurance intermediaries. Insurance agents are not regulated or supervised, and they act under the mantle of the insurance companies. Law 76/2003 introduced a new definition of "insurance broker." However, the provisions currently in place do not appear to be fully in line with Directive 2002/92/EC on insurance mediation, especially with regard to the treatment of insurance agents and to their disclosure duties and responsibilities.[53]

*Regulatory and Supervisory Constraints.* Regulation and supervision of the sector continues to require considerable strengthening, especially as Romania moves towards EU accession. While the law empowers CSA to supervise the insurance sector in support of a stable market and policyholder protection, there is little else related to supervisory objectives, policies, or strategies that address the challenges of complexity and risk that will come from convergence with the EU. The following are some of the main challenges to be addressed.

- *Consolidated Supervision.* Growth and development of the insurance sector will become increasingly complex when Romania joins the EU, and there is a need for consolidated, risk-based supervision. Important links have already been established in the form of strategic alliances between banks and insurance companies. These types of bank-insurance partnerships involve cross-selling that can also involve substantial transfer of risk. The recent Romania FSAP suggests, however, that this process of risk transfer has been growing from a very low initial base, indicating that it will likely require substantial further growth to be successful. In doing so, this will be an area which CSA will need to monitor closely. In this context, the authorities have recently issued an order/regulation for bank-insurance partnerships and cross-selling products that will limit the underwriting risk of consumer credit and mortgage loans. The regulation is expected to come into effect in first half of 2005.
- *Building Supervisory Capacity.* The ISC is organized and financed in a manner somewhat similar to the securities commission (CNVM). Market participants interpret the appointment procedure as one by which political parties select their preferred candidates. Concerns about lack of operational independence from political power are compounded by the fact that no provisions exist on the disclosure of candidate names prior to appointment, and that parliament can dismiss directors without due cause.

  The authorities should evaluate the need for strengthening the governance framework of the CSA to increase transparency of the CSA board nomination process. Measures should include a parliamentary commission mandated to prepare a shortlist of candidates, which would be publicly disclosed. Parliament would then be required to appoint directors from the shortlist and removal of directors could only be done with cause, and only by the parliamentary commission.

  Measures should be taken to ensure CSA has sufficient budgetary resources for it to carry out its mandate independently. The CSA is answerable to parliament (Budget, Finance and Banking of the Senate and Chamber of Deputies), and fund-

53. Besides the provisions provided in draft Law no. 32/2000 regarding the insurance intermediaries, special Regulations were drafted by the Romanian Insurance Supervisory Commission, which is expected to come into force in the first half of 2005, and it would fully transpose the provisions of the said directives.

ing comes from a fee schedule charged to insurers and insurance brokers. It is uncertain if such an approach undermines CSA independence.

Fit and proper tests for Members of the Council are currently considered quite weak. All Members of the Council are required to have insurance sector experience acquired over a minimum of five years.[54] Higher standards should be required of commissioners to comply with fit and proper standards. The use of independent advisors might help close the gap during an interim period in which capacity is built up at CSA.

One of the main concerns relating to the insurance market in Romania is in regards to the experience, skills, and capabilities of the supervisory authority. The EU has also been explicit about Romania's need to train staff in the sector and to develop the institutional capacity required for effective supervision and functioning of the market. While progress is being made, and gaps will continue to narrow over time, capacity remains limited and insufficient relative to EU norms in insurance. In this context, the authority's initiative to implement a training program[55] (in-house and abroad) is timely.

Furthermore, the authorities are expected to receive the following technical assistance funded by EU PHARE; the technical assistance would focus on:

- Improving the professional knowledge of the Insurance Supervision Commission staff;
- Developing a modern, reliable, integrated database (building a central database for gathering, registering, and processing data collected from the supervised entities);
- Providing support for EU accession (alignment of the legal and institutional framework with the "*acquis communautaire*");
- Providing support for improving cooperation with market players and for networking with relevant international organizations; and
- Establishing an information system for data transfer between the insurance supervisory commission, insurance companies, other institutions involved in the management of insurance against civil liability, relative to the use of motor vehicles (MTPL).

- *Licensing.* While licensing policies and procedures are consistent with EU Directives relative to the separation of management of life and non-life insurance businesses, there are questions about the de facto separation of these activities by insurance undertakings. Twenty-Seven of Romania's 40 insurance companies are composite companies; it is recommended that CSA verify that these companies have implemented separate management of their life and non-life insurance components in a manner consistent with the legislation.

  There have been questions raised about the rigor of licensing standards, the absence of feasibility studies/market assessments in making determinations, and weaknesses in evaluating the fitness, professional qualifications, and sources of

54. According to Article 4 (16) of the Law no. 32/2000.
55. This is cofinanced by the Romanian Insurance Supervisory Commission and by the Phare 2002 program.

funds of shareholders seeking a license. Such weaknesses leave the financial sector as a whole open to criminal abuse as well as risk. In the interim, a cautious policy to licensing should be pursued.[56]

- *Guidelines for Risk Management and Internal Controls.* Development of risk management capacity among insurers is essential for all aspects of operations, as well as for broader insurance market stability. Adopting stricter guidelines with regard to risks, particularly in the property and casualty field—which currently accounts for about 70 percent of gross premiums—will be essential in reversing past patterns of under-reserving.

  Verifying compliance will become increasingly important as the insurance sector develops and has greater assets at risk. CSA guidelines for portfolio management and risk management will need to be issued with a view to investment-grade securities abroad being an option. This will be a requirement for accession as part of the Treaty on the free movement of capital. Likewise, assigning market risk requirements (for example, interest rate, exchange rate, pricing, maturity) on asset management and investment policy will be needed. As an extension of this, free assets and technical reserves should be regulated in the same way. In this regard, at least for a transition period, the EU standard of allowing unregulated investment of free assets may not be appropriate. At a minimum, conservative guidelines might be introduced for domestic firms, with an easing of requirements based on demonstrated risk management capacity.[57]

  There are currently questions about the adequacy of reserves and regulatory capital in some of the smaller insurance companies. While there is currently no systemic risk due to the low level of density and depth, smaller companies are expected to eventually merge or disappear due to low capital, inadequate reserves, and/or basic inability to compete.
- *On-site Supervision.* While law provides CSA with a mandate for sanctions and remedial actions in the event of problems, the procedures and application of sanctions are not clear. CSA should develop a more comprehensive framework than exists whereby a sliding scale of administrative and enforcement actions are taken to contain and mitigate solvency and liquidity problems when they surface. The framework should follow recommended practice in EU markets, and should be made transparent to the insurance community. Successful implementation of such procedures will actively involve insurance companies, placing on them the responsibility of notifying the regulatory authorities when problems/risks emerge.
- *Consumer Protection and Supervision of Market Conduct.* The low level of claims payments reflects the possibility of inadequate protection of policyholders, which has stifled growth of the sector. As greater protection is put in place for policyholders, firms will need to improve their pricing of risk, as well as make their reserve practices more precise and justified.

56. CSA recently pledged to implement and enforce the fit and proper test stipulated on Regulation no. 2/2001 regarding the authorization of the significant persons and the provisions of the 2002/83 Directive regarding the requirements for professional qualifications and other conditions which have to be provided for shareholders seeking a license, including ultimate beneficiary.

57. Based on the CSA's very recent comment, they just formulated a special regulation on this issue. The regulation is expected to be implemented in early 2005.

Romania's observance of market conduct lags behind practices in the EU. Consumer (policyholder) protection is a relatively new concept in Romania's insurance sector, but one that is emerging due to rising volume and claims. Regulations are needed on policyholder rights and protection concerning pricing, regulations, claims filings, and consumer recourse. It is not clear whether rules on unfair terms in consumer contracts are enforced in the Romanian insurance sector. Particular attention should be devoted to the development of consumer protection rules and standards for market conduct. The introduction of an alternative dispute resolution mechanism, such as an Insurance Ombudsman, should be carefully considered to handle claims and disputes in a more efficient and expeditious manner.

Rights of cancellation on life insurance policies in Romania are not consistent with EU norms. Directive 2002/83/EC concerning life insurance (recast version) notes that a policyholder who applies for an individual life insurance contract shall have a period of between 14 and 30 days from the time when he/she was informed that the contract had been finalized within which to cancel the contract. The notice of cancellation by the policyholder shall have the effect of releasing him/her from any future obligation arising from the contract. A right of cancellation is also granted to policyholders by Directive 2002/65/EC on distant marketing of financial services. These rights of cancellation do not appear to be currently granted to policyholders in Romania.[58]

The relationship between the supervisory authority and the industry, in particular, needs to be improved. For example, companies are dissatisfied by the way in which CSA manages the funds levied on gross premiums received as supervisory fees and contributions to the two guarantee funds established in Romania (the general Guarantee Fund and the Road Victims Fund); in particular, they claim that there is a lack of transparency in the management and allocation of such funds. Insurance companies are required to pay 0.3 percent of gross premium income as a supervisory fee to CSA, and to contribute an additional 1.5 percent to an insolvency fund administered by the supervisory authority. The authority are aware of the problem and are expected to improve the disclosure of information concerning the utilization of payments by the industry to these funds.

- *Auditing and Disclosure Requirements.* Recently, the insurance industry regulatory framework has made significant progress, but drawbacks remain prevalent, due to pressure from certain market leaders and a lack of technical expertise. Since 2002, all insurance companies have been required to present legal entity and consolidated financial statements in conformity with accounting standards set out in Joint Order of minister of public finance and president of ISC no. 2328/2390/2001, which represents significant progress compared to the previously applied cash basis of accounting. Joint Order 2328 on specific accounting regulations for insurance companies was published in January 2002 in an effort to comply with European Directive 91/674/EEC and IAS.

  However, financial statements prepared in conformity with Order 2328, supplemented by so-called closing rules, differ significantly from International Financial Reporting Standards. For example, the use of IAS 29 (despite high inflation

58. Based on the CSA's very recent comment, they just formulated a special regulation on this issue. The regulation is expected to be implemented from early 2005.

rates) and consolidation[59] is not allowed when preparing financial statements for official use. If a company wants to apply these standards, an additional set of financial statements is prepared. Other major differences generally refer to the existence of statutory technical reserves such as an "equalization reserve," the valuation of assets admitted to cover technical reserves (including fixed assets), the valuation of policyholder liabilities, and revenue recognition.[60]

- *Cooperation with International Supervisory Authorities.* Romania will need to further work closely with foreign supervisory authorities[61] to ensure mutual recognition and cooperation. To date, CSA has not signed the Memoranda of Understanding with the EU or other foreign supervisory counterparts. Within Romania, CSA will need to further improve coordination with NBR, CNVM, and the Financial Investigative Unit responsible for the prevention of money laundering and other suspicious transactions.[62] In this regard, building capacity at CSA, and in insurance companies, with regard to suspicious transactions, high-risk customers, AML audits, monitoring of accounts (internally and externally), and reinsurance will be necessary.

*Infrastructure and Capacity Constraints.* Actuarial systems and databases are reported to be incomplete and sometimes out of date. Systems are also not consistently electronic, which slows information flows. The shortage of relevant actuarial information distorts pricing, adds to risk, makes insurance companies more risk-averse, and slows development of a more robust insurance sector.

Actuarial expertise is often lacking on auditing teams. As a result, questions often arise about attention paid by auditors to actuarial assumptions and calculations of technical reserves. All of this raises doubts about the veracity of financial information transmitted for regulatory purposes and to the market. This problem is compounded at CSA, where there are only two actuaries on staff. Ultimately, weaknesses in the actuarial profession undermine the ability of companies to develop adequate risk management and regulatory reporting systems. In turn, such weaknesses make it more difficult for CSA to develop the kind of off-site surveillance capacity needed to monitor for system stability.

The actuarial profession is currently not unregulated in Romania, which makes it more difficult to evaluate the professional qualifications of actuaries hired by insurance companies. The authorities are working to address this problem, and on a positive note, ING Nederlanden administers an examination center in Bucharest, in cooperation with the U.K. Actuarial Center, and in parallel a link is established with the U.S. Society of Actuaries.

59. The CSA is committed to applying consolidated EU standards, starting with the financial statements of the 2005 financial year.

60. The December 31, 2001, audited financial statements of one of the largest insurance companies in the country show shareholders' equity amounting to US$6.8 million under IAS compared to US$4.5 million under Order 2328.

61. Recently, there is some progress in this regard. In April 2004 a Memorandum of understanding has been signed with the Financial Supervisory Authority from Bulgaria, and the negations for the signing a MoU with the Financial Supervisory Federal Authority from Germany, The Insurance Supervisory and Pension Funds Authority from Poland, The Ministry of Finance and Treasury from Bosnia-Herzegovina are in a final stage.

62. There is some progress in this regard recently, The authorities claims they recently developed protocols concluded with NBR, CNVM, and the Financial Investigative Unit. Periodically, the information and the appropriate measures are taken by the involved authorities regarding the suspicious transactions, high-risk customers, AML audits, monitoring of accounts.

### *Pensions*

The Romanian pension system is still based on an unfunded public pillar; for this reason and the fact that the pension system is structurally unsustainable, pension reform is still needed. Total expenditure of the State Pension Scheme (SPS) amounted to 6.7 percent of GDP in 2003, as compared with 7.1 percent in 2002 and 7.2 percent in 2001. Both expenditures and revenues fell between 1995 and 1998, but recovered sharply after 1999. The system suffered from a financial deficit that fluctuated between 0.8 and 1.6 percent from 1996 to 2002. The deficit was brought down to 0.4 percent of GDP in 2003, the lowest level in about a decade.

There has been discussion and the drafting of legislation for a second pillar, although this would likely not occur until 2007 at the earliest. Based on 4.3 million employees (current levels) and prevailing demographics, it is estimated that full participation in the second pillar (among those eligible) would leave the government with a Euro 6 billion deficit over the subsequent 10-year period. Twenty-five percent participation from those in the 35–45 age bracket would leave the unfunded pillar with a Euro 2.2 billion deficit.

There are two arguments for accelerating the introduction of the second pillar:

- The fiscal cost of transition to the second pillar is a legitimate investment because it reduces future projected deficits of the unreformed first pillar, which are currently unrecognized future liabilities. It makes sense to use privatization revenues and to borrow from IFIs to finance this investment.
- The powerful role that pension funds can play in capital market deepening and diversification, and in terms of providing new demand for domestic securities to finance the development of a broad range of sectors, including infrastructure, mortgages, and SMEs.

The current contribution rate of 31.5 percent of nominal earnings (for social insurance) and total payroll tax of 49.5 percent (for social insurance, health, unemployment and disability) encourages evasion. Arrears on pension obligations were reported to be on the order of 12 percent of large-scale (listed) enterprise financing and 19 percent of total arrears in 2001.

These arrears are directly related to the high tax rates, as well as doubts about future resources being available under the current PAYG system. Evasion narrows the contribution base, making higher rates that much more necessary to plug the deficit. Despite the high contribution rate, effective contributions are only about 36 percent of the average gross replacement rate (2001).[63] In the end, this is an unsustainable spiral that has been shown in year-to-year deficits. On a cumulative basis since 1995, the net deficit has been about 9 percent of. While the net replacement rate of 47 percent (2001) is considered acceptable for a mandatory pension scheme, it is not considered adequate relative to the high contribution rates imposed on businesses and employees.

Meanwhile, the number of registered employees has shrunk from 8 million in 1996 to only 4.3 million in 2003. Employers avoid contributions by running up arrears or outsourc-

63. Between 1990 and 2002, the number of beneficiaries in the State and Farmers' Pension system surged from 3.4 to 6.2 million. The largest increase in beneficiaries took place in the early years of transition, but the growth in their number still remained high (close to 4 percent) during the second half of the decade, outpacing the growth rate of the elderly population.

ing. The use of informal outsourcing vehicles adds convenience, but underfunds the pension system. (The informal sector of the economy is estimated at 61 percent of GDP [World Bank 2004].) For those companies unable to use these vehicles, it either leads to arrears on payments, or has a negative impact on their earnings when they do comply with contributions.

The legal retirement age was 62 for men and 57 for women, yet, the average retirement ages for men and women were 56 and 51, respectively. This led to a rapid rise in the number of beneficiaries. Adding to this was the increase in the number of disabled, which rose significantly during the 1990s because of lax rules allowing workers to claim disability to cope with unemployment.[64] The new 2001 Pension Law raised retirement ages and tightened conditions on qualifications for disability payments.[65] Nonetheless, the cumulative effect resulted in a very high system dependency ratio (beneficiaries over contributors).[66] The progressive aging and consequent projected decline of the Romanian population in the coming years could cause a further deterioration of this ratio,[67] although the gross number of new pensioners is expected to slow.

There have been institutional problems associated with collections and enforcement capacity at the Ministry of Labor and Social Protection. There were multiple collection units (for unemployment insurance, health insurance, pensions, and other professional risks) until adoption of Emergency Decree 147/2002, which provided for the establishment of a single collection agency for all social insurance contributions.

Preparation for a second pillar is not without precedent in Romania. An Emergency Decree was issued in 2000 to create a mandatory funded private pillar, but this was revoked before it was implemented. Instead, Romania's plans to date have focused on trying to stabilize the unfunded pillar as a function of convergence with the broader Maastricht criteria (for example, fiscal deficits, public debt). The concern about introducing a second pillar is that, while the unfunded, PAYG system is imperfect, any movement to create a "rival" mandatory second pillar scheme would divert needed resources and exacerbate fiscal deficits.

The impact of the traditional PAYG approach has been to limit the flow of resources to the capital markets, which would have already begun if movement to a second pillar had occurred. First, the absence of a second pillar has limited investments by privately managed pension funds. Second, as there is now movement to a third pillar that is consistent with EU guidelines, investment outside of Romania and into other EU markets will be permitted. While sound from a fiduciary and portfolio management standpoint, it will mean less available funding for investment grade Romanian corporate enterprises. The presence of a second pillar could ensure that a portion of the mandatory pillar is put into investment-grade firms on the local exchange. That this opportunity has been missed represents an opportunity cost in terms of capital market development. Second pillar pension funds seek additional non-government instruments, rather than the current practice of the

64. Their number as a proportion of all beneficiaries grew from 9 percent in 1989 to 15 percent in 2001.

65. Key reforms since 2002 have been to increase coverage of the public system to include farmers and self-employed (albeit only on a voluntary basis), to gradually increase the statutory retirement age from 55 to 60 years for women and 60 to 65 years for men by 2014, to increase the minimum contribution period from 10 to 15 years for both sexes, to introduce a benefit formula based on a point system similar to the German model, and to reduce benefits and increase eligibility criteria for workers in particularly hazardous jobs.

66. The system dependency ratio (SDR) of the old system increased from about 25 percent in 1990 to 98 percent in 2001. Adding farmer pensioners raised the SDR to 134 percent.

67. It has been estimated that the old age dependency ratio (beneficiaries over population younger than 60 years old) will increase from 35.4 percent in 2002 to 50.9 percent in 2050.

SPF to invest almost exclusively in government securities. Third, the presence of professionally managed pension funds would eventually exercise governance in companies in which they serve as investors. No such role is played by SPF. Fourth, the presence of a second pillar would very likely increase the role of existing life insurance companies and composites active in life insurance, as these firms commonly operate pension funds. The absence of the second pillar restricts these firms to purely voluntary contractual savings contracts which, as mentioned, are limited to a small number of people.

To reverse mounting deficits in the unfunded scheme, the government will need to introduce alternative schemes. To finance structural reform, it should pursue reforms originally initiated in 2000 to introduce a second pillar, while issuing sovereign bonds to finance the deficits that will continue (albeit decline) in the current unfunded scheme. This would permit the government to honor its obligations, while providing younger participants with the option of selecting a professional manager under strict investment guidelines. If bond issuance would not fit the government's debt management objective, it could target privatization proceeds for use in funding the second pillar. At a minimum, Petrom and BCR would be expected to generate significant proceeds to help defray some of the projected deficits.

*Legal Constraints and Impediments.* In terms of mandatory contributions, pension funds should be required to meet capital adequacy standards. To be consistent with EU approaches, solvency tests based on adequacy of reserves and capital are considered to be more appropriate as risk-based measures that also provide incentives to funds to observe prudent investment policy norms.

*Regulatory and Supervisory Constraints.* Institutional capacity needs to be developed for pension fund oversight. Now that the authorities have selected CSA as the supervisory body for pension sector, an appropriate regulatory and supervisory structure will need to be in place to ensure that private pension funds have adequate capital, clear and prudent investment policy parameters, sound fiduciary management and approved custodial relations, risk management capacity and systems, accurate accounting and reporting capacity, appropriate internal audit and controls, external audit according to international standards of auditing, and sound investor relations to handle normal administrative queries. The key issue that the new regulator will need to enforce is registration requirements. This will include ensuring fit and proper tests of directors, requiring disclosure of ultimate beneficial owners of fund management companies, and the carrying out of background checks both domestically and internationally, as well as requiring MOUs with counterpart pension fund supervisory bodies abroad.

In the private sector, corporate governance will need to be professional and consistent with best practice, backed by autonomous internal audit, independent and qualified external audit, and well-staffed committees that are active in their oversight functions to ensure management is operating within approved strategic plans as well as consistent with the laws and regulations of Romania.

Professional regulators, managers, administrators and board members should be hired from abroad if needed for an interim period until domestic capacity fully exists. Such expertise, either represented as direct appointments or in the form of advisors to boards and regulatory bodies, is essential for accelerated modernization of pension management and supervision in Romania where second and third pillars are currently untested.

*Tax Constraints.* The main tax constraint to pension fund development is the high payroll taxes required of enterprises that has materialized in high levels of avoidance. Enterprise arrears on pension fund contributions were estimated to be about 20 percent as of year-end 2001. The onerous tax burden on individuals as well has provided an incentive for informal arrangements that further reduce contributions. These tax liabilities (largely unpaid) have resulted in nearly 1 percent of GDP deficits per year.

*Infrastructure Constraints.* Actuarial capacity is considered weak and in need of development. This will require better data and systems, as well as training for more actuaries. This will be important not only for all contractual savings institutions, but also for regulators in terms of their surveillance of market risk and market practices.

*Other Issues.* Pension reform will require a major public education effort to ensure that those directly affected by it understand their rights and responsibilities. This will require a major campaign through the media, public fora, and at company levels so that those making contributions on a mandatory or voluntary basis, and/or selecting between the unfunded and second pillar, have a clear understanding of what the contributions, benefits, rights, responsibilities and potential penalties and fees are.

### *Leasing*

*Legal Constraints.* Although the leasing sector is governed by the Leasing Law (1998), the sector is not currently regulated. As such, there is considerable uncertainty about its status within the financial sector. Legislation should clarify the status of lease companies as credit institutions with obligations and responsibilities relative to financial reporting, provisioning, and risk management, and obligations in the event of default. Consumer protection provisions should likewise be in place, as well as strong creditor protection provisions when lessees fail to comply with contractual obligations.

Secondary legislation should be considered for standardization of contracts to promote securitization once adequate primary legislation is place. Current efforts to draft a mortgage-backed securities law are reported to be extending the scope to other assets and for broader securitization opportunities. This would be helpful to leasing companies, particularly the smaller independent leasing companies, which are not bank-owned or captives of larger specialized international companies (for example, auto leasing).

*Regulatory and Supervisory Constraints.* Because the leasing sector is not yet regulated, the industry is currently seeking a framework that at least monitors levels of borrowing and lending by leasing companies. Although they do not require the same level of supervision as banks, leasing companies should be required to present regulatory reports that help the supervisory body address potential systemic risk. Likewise, as many banks are engaged in non-bank activities, this will help the supervisory body with faster implementation of consolidated supervision. To the extent that leasing companies are bank-owned, their activities should be captured in consolidated financial statements, which currently are not generated in Romania.

Leasing companies should be able to hold reserves, and provisions for losses should be tax-deductible. This is not the current practice, which remains discriminatory when compared with banks. Moreover, many of the smaller leasing companies do not have the cash or capital for larger equipment purchases—a position that is further undermined by the inability to deduct provisions and losses.

Depreciation schedules are considered problematic in Romania due to confusion associated with the movement toward IAS. The current practice is to allow accelerated depreciation of up to 50 percent of asset value, and then to follow a straight-line approach thereafter. This may work financially under current circumstances for automobiles and other landed transport. However, such an approach is slow for agricultural and industrial machinery, as well as large-scale business equipment. As such, there has been little development of the non-transport leasing sector. TA from the EU or other sources would be helpful in assisting Romania with implementation of a modern framework for leasing that is consistent with larger objectives and approaches to NBFI and financial sector development. This would include implementation of VAT depreciation through the lifetime of the lease contract, as is practiced in the EU.

*Tax Constraints and Impediments.* There is some discrimination in the tax code, which constrains leasing, particularly outside of land transport and automobiles. Leasing companies are not able to deduct provisions for losses or for actual losses on lease contracts. This is discriminatory when compared with banks that are able to deduct such losses. Because leasing is a variant of lending and is often conducted by non-deposit-taking firms, the expensing of provisions and losses should be made consistent with banking practices to reduce discrimination between the sectors.

*Infrastructure Constraints.* There is little organized information on lease contracts and payment performance. As with the banks and other NBFI sectors, there is a need for positive and negative credit information to increase contract volume and syndication, stratify performance, and price risk with greater precision. Establishing a database of this sort will also be helpful as the industry moves toward securitization.

## *Factoring*

*Legal Constraints.* There are no known legal constraints to factoring, apart from not having a clear framework for securitization.

*Regulatory and Supervisory Constraints.* There are no known regulatory constraints to factoring. In effect, factoring is short-term in duration (usually 90–120 days), and is a method of syndicating receivables to free up lending resources. If there are constraints, they have more to do with the absence of information sharing to stimulate market development.

*Tax Constraints.* There are no known tax constraints to factoring. Provisions for losses are generally limited due to the short-term nature of the business. Actual losses incurred are deductible.

*Infrastructure Constraints.* Because factoring is new to Romania, there is little organized information on it. With the increase in consumer lending and related factoring, there is a need for positive and negative credit information to stratify performance and price risk.

Such information will also be useful to banks for credit card programs and other forms of consumer finance, which will grow as incomes rise.

### *Impediments to Developing Credit Enhancements and Instruments*

There is currently a problem of over-collateralization with regard to the banks. Movement to a system in which insurance and guarantees are more accurately priced on a risk-basis would help reduce some of the inefficiencies of current approaches, and free up collateral among more efficient and, ultimately, creditworthy borrowers. For this to happen, much better information disclosure is needed for enterprises and households. Likewise, financial institutions will need enhanced risk management capacity to undertake such commitments.

Impediments to insurance and guarantees for corporate bonds to date have less to do with the requirement to have them, and more to do with their actual value in the event of default. In the future, as new bonds come to market, those providing guarantees or insurance will either need to raise fees to cover default risk, or turn down opportunities to provide coverage. Alternatively, as companies offering enhancements develop the capacity to assess risk, they are more likely to be able to price the risk accordingly and determine if it is feasible to provide the coverage. As more of a market develops, a broader array of enhancements should be available. When this occurs, the combined financial regulatory community will need to monitor contracts and coverage—just like any other insurance contract when a claim is filed.

The use of guarantees or insurance on bonds floated by municipalities and/or infrastructure providers are worthy of the capital markets development effort. Likewise, a variety of property-related issues needs to be addressed that would also have an impact on investment and capital markets development. These include resolution of land disputes, infrastructure improvements (for example, gas pipelines for improved heating), municipal capacity and administration (for example, incentives through district heating and other utilities for retro-fitting of housing stock), more demanding building codes (for example, earthquake resistance, insulation), and incentives for other improvements (for example, water filtration, recycling).

### *Mortgage and Housing Finance*

*Legal Constraints and Impediments.* Although a Mortgage Loan Law had been developed and implemented to support housing finance, a number of banks initially provided mortgages under the Banking Law instead of the Mortgage Law. While there are many similarities between the two laws, using two different laws has triggered a number of inconsistencies in the marketplace. Moreover, it remains unclear as to whether mortgage loans can be bundled in a securitization and if the legal provisions would govern the process. In addition, there remains an absence of legislation relating to special purpose vehicles, which are essential to the development of securitizations of mortgage portfolios.

Market participants are also quite restricted in their legal refinancing capacity thresholds. Provisions for refinancing limit mortgage-backed securities issuers to a total indebtedness equivalent to 75 percent of their portfolio. Mortgage bond issuers are not subject to an overall indebtedness threshold, although they are restricted to a bond issuance equivalent to 60 percent of their portfolio. These restrictions have limited the refinancing options available to lenders.

The Mortgage Loan Law and the Land Book Law are also currently not in line with one another. This could pose a problem with regards to securities offerings, which are further hindered by inefficiencies relating to registration and procedures. Similarly, foreclosure procedures (governed by the Romanian Civil Code) are quite costly and very complicated in nature.

*Regulatory and Supervisory Constraints.* Currently, the Mortgage Loan Law stipulates that licensed financial institutions that carry out mortgage lending activities are subject to prudential supervision of the NBR, while bond issuance is subject to supervision by the CNVM. Clear boundaries between the supervision responsibilities of the two institutions must be established, and any potential areas of overlap must be appropriately addressed. The Mortgage Loan Law does not provide sufficient information on the operating authorities of each of the two entities. Moreover, the regulatory framework for mortgage bonds and mortgage-backed securities remains insufficient for the development of a secondary mortgage market and does not provide adequate regulations for the issuance and transfer of mortgage instruments. The main afore-mentioned legal, regulatory, and supervisory constraints will be removed if the legislative package regulating the secondary mortgage market is passed by the Parliament.

*Tax Constraints and Impediments.* There is a need to establish tax incentives or credits to stimulate the growth of the housing finance market in Romania, and to make the process of owning a home more affordable for its citizens.

*Infrastructure Constraints and Impediments.* Market standards for lending criteria and business processes must be established to facilitate growth of the mortgage market in Romania. This includes the development of standards for appraisal, data collection, and agreement terms.[68] In addition, access to information must be made easy for the Romanian public so that they have the benefit of a dynamic competitive environment.

*Impediments to the Development of Mortgage Insurance.* As for mortgage insurance, impediments include the general absence of an overall framework. While the housing sector has grown in recent years, and with it, bank lending to households for mortgage financing, there is still no comprehensive housing or mortgage finance strategy in place in Romania. With adoption of revised mortgage legislation (in 2004) and new legislation related to mortgage bonds and mortgage-backed securities, now is the time for Romania to consider developing a comprehensive mortgage finance framework for the housing sector. This would include development of a viable mortgage insurance system, along with identification of preconditions for success—including standardized underwriting procedures; clear creditor rights; a transparent and consistent foreclosure framework; development of an actuarial database for lenders and insurance provider(s) to price risk; modern appraisal standards for asset valuation (to determine borrowing needs and loan-to-value ratios); and borrower financial information to structure loans, define covenants, and ensure that borrowers are able to comply with exposure limits and debt service requirements.

68. The members of "Standardization Committee" (within the FMR project) have drawn up the drafts of the standardized mortgage and mortgage loan contracts.

## Corporate Governance

As mentioned above, the following four issues were identified during ROSC assessment as being in need of strengthening:

- The weak role of boards of administrators,
- The incomplete disclosure of ownership and control of traded companies,
- Unreliable financial reporting, and
- Weak minority shareholder rights for small shareholders of privatized companies.

Of all the issues related to corporate governance in Romania, the most dominant has been the weak role played by corporate boards of administrators in joint-stock companies. In Romania, boards of administrators fill an unusually weak function—even by the standards of transition economies. Romanian boards of administrators should play their full role as "supervisory boards" but they currently lack a minimum fiduciary obligation to shareholders and stakeholders. Romanian boards also have insufficient statutory responsibility, particularly with regard to internal controls and financial reporting. The new Capital Market Law is expected to provide provisions to strengthen the role of the Board. Once the Romanian legislation provides for the minimum legal framework for boards—to ensure that they have sufficient authority and accountability—additional measures can be taken to provide training for Board members. The process of improving corporate governance practices is in part an effort to teach members of the business and financial community proper governance practices. Establishing an institute of directors that can provide such training and assistance would be very helpful in encouraging the improvement of governance practices, especially with regard to the protection of minority shareholders.

The BVB has set up a Corporate Governance Institute, which could be modified to play the role of an Institute of Directors. (Further resources would be necessary to establish a true Institute of Directors.) Key issues will be the organizational structure of the Institute and its medium-term sources of funding for its programs. It is important that the Institute be established as the central institution for improving corporate governance practices in Romania. The Institute should also be linked with other similar directors' institutes in Central and Eastern Europe.[69] Consideration might also be given to finding ways—over a period of time—of spinning off the Romanian institute from the BVB in order to provide it with additional independence.

In addition to the issues mentioned above, the recent ROSC review identified the following issues, which have resulted in the weak role of the Board:

- The commercial legislation does not require that boards of administrators conduct their duties with due care, diligence and in the interests of the company (fiduciary duties).
- The minimum function of the boards is not adequately specified and does not include approval of the company's annual financial statements.
- There is no minimum size set for the boards.

69. To access the website linking the institutes of directors of the Europe and Central Asia Region, go to http://www1.worldbank.org/gdln/cg.htm.

The disclosure of direct ownership of publicly traded companies in Romania is relatively complete, but it fails to fully incorporate international standards for indirect ownership or control through intermediaries. The new Capital Market Law has provided provisions on the disclosure of ownership, but the ultimate ownership of firms in non-publicly traded firms is still difficult to identify, which raises issues and risks of adequately disclosing related-party transactions—and in some cases, transactions involving criminal activity. Insufficient transparency of ultimate beneficial ownership of financial companies, combined with the absence of a statutory definition of financial conglomerates, undermines the ability of the financial regulators to provide adequate supervision of the sector. Consequently, strengthening the implementation of the related laws and regulations regarding governance becomes very important.

The lack of reliable and transparent financial reporting undermines corporate governance. In law, Romania seeks to attain compliance with the *acquis communautaire,* International Financial Reporting Standards, and International Standards on Auditing. However, on a relatively large scale, the accounting, financial reporting, and auditing standards that are currently in effect do not conform entirely with the *acquis* and these international standards.[70] The remaining "standard gap" may mislead users of financial statements and hence hamper the enforcement of sound corporate governance. In addition, practice lags behind the statutory requirements, which results in compounding the negative effects of the "standard gap" by those of the "compliance gap."[71] Weak financial reporting also undermines the ability of minority shareholders to maintain their proportionate shareholdings, since controlling shareholders may use contributed property and other non-cash assets at current market prices to fund capital increases in companies that have balances diminished by past inflation.

The issue of the rights of minority investors to participate in a company's capital issues (or have their proportionate shares diluted) is one that has received considerable attention in Romania. The continuing risk of share dilution appears to reduce investor demand for equity shares of traded companies—and thus reduce market prices for companies whose shares are traded.

One of the weaknesses of Romanian capital markets is its lack of capacity to implement regulations. The regulations are generally adequate, but the implementation is often not effective.

Difficulties with privatized companies that were formally state-owned remain problematic. In many cases, the privatization contracts for the sale of state companies included provisions that allowed strategic investors to contribute corporate assets as "in-kind" contributions to the acquired company's capital. Conflicts arose among shareholders when the in-kind contributions were improperly valued, or more commonly, were added to a company's asset register without a revaluation of the balance sheet. After years of hyperinflation, a non-revalued balance sheet would be substantially depreciated from current market values, with the non-monetary contribution providing a larger than appropriate increase

70. The application of IFRS starting with financial statements of year 2005 by selected categories of firms is expected to increase the reliability of financial statements, pursuant to information disclosed in those financial statements.

71. Refer to Report on the Observance of Standards and Codes, Accounting and Auditing, Romania, May 9, 2003.

in the new balance sheet. Minority shareholders had the right to participate in the capital increase, but were generally required to contribute cash rather than non-monetary assets.

## Accounting, Transparency, and Disclosure

Romania has been engaged[72] to move faster toward better financial accounting and reporting to reduce perceptions of risk (and the consequent risk premium required), and to increase investment flows. This can be achieved by working closely with the major international audit firms, the International Accounting Standards Board, and other related professionals to accelerate understanding and observance of IAS for market development purposes. The focus should be on key transparency and disclosure practices that are consistent with International accepted accounting practice as a basis for attracting investment from abroad. In fact, the recent Romania FSAP suggests that Romania intends to be in full compliance with IFRS by 2005.

Market analysis needs to be strengthened. This can be achieved by adopting, implementing, and enforcing International Financial Reporting Standards as required by Regulation 1606/2002, improving the quality of statutory audits, and building databases and sharing information on industries, sectors, and companies to allow market analysts to conduct peer reviews that differentiate among competitors based on selected characteristics.[73]

72. The accounting ROSC of 2003 (World Bank) proposed objectives for the accounting and audit field. Those objectives are transposed in the Country Action Plan for the Accounting and Audit Field. The plan is coordinated by Consultative College on stake holders.

73. The Report on the Observance of Standards and Codes, Accounting and Auditing, Romania, May 9, 2003, includes policy recommendations to enhance the quality and availability of financial reporting.

# CHAPTER 4

# Proposed Action Plan

As the Romanians set their sights on EU accession by 2007, the authorities need to prepare the domestic capital market and NBFIs to face the competitive pressures and reap the rewards of integration in the single EU financial market.

In this final chapter of the report, the following two topics will be explored:

- The recent measures taken by the authorities to converge the legal and regulatory framework for capital markets and NBFIs with EU Financial Sector Directives.
- A three-year, broad-based, time-bound action plan to strengthen capital and NBFI infrastructure in an effort to ensure market competitiveness and integration within the single EU financial market. In addition, a number of credit enhancement instruments that the authorities have recently initiated to actively support capital market broadening and deepening will be discussed.

## Recent Government Reforms Supported By PAL

As integral part of the Programmatic Adjustment Loans (PAL I, II, III) extending the period of 2004–2007, the Romanian authorities have embarked on a comprehensive overhaul of the legal and regulatory framework for capital markets and NBFIs with the aim of full convergence with EU financial sector directives as part of EU accession strategy.

### *Legal and Regulatory Reforms*

The Government has prepared a new Consolidated Law on Capital Markets ("the Law"), which is consistent with EU financial sector directives. In particular, the Law repealed the

75 percent tap on the size of bonds issuance. In the area of investment funds, the Law goes beyond the requirements of the UCITS directives and covers closed-end (non-UCITS) investment funds. The Law further stipulates that SIFs will henceforth be considered as closed-end investment funds. As a result, SIFs will no longer be regulated and supervised as regular corporations, but will be subject to the transparency and governance regulations that apply to closed-end funds.

Upon approval of the Law, the CNVM plans to embark on the preparation of the secondary capital markets legislation, so that this legislation can be adopted before the end of 2004. This adoption is critical to ensure that the governance and transparency principles enshrined under the Law are translated into practice, which is important for registration, supervision, dispute resolution and enforcement for listed companies and for market intermediaries. In particular, the authorities is expected to ensure that secondary legislation effectively empowers CNVM to conduct thorough fit and proper tests for listed companies and capital market intermediaries, including background searches for their ultimate beneficial owners.

In addition, the Government is preparing a comprehensive set of legislation to support the development of the housing mortgage market. Three key laws have been prepared: the Mortgage Loan Law, the Mortgage Bond Law, and the Securitization and Receivables Law. The Government plans to finalize this legislative package by the end of 2004. A key priority will be for CNVM to develop the detailed regulations required to support the issuance of mortgage bonds and mortgage-backed securities.

In parallel, the Government has adopted new primary legislation for the insurance sector that is fully consistent with EU insurance directives. The Government has embarked on the preparation of the secondary legislation for the insurance sector, so that this legislation can be adopted before the end of 2004. As in the case of the Capital Market Law, the secondary legislation for the insurance sector will need to give force to the corporate governance and transparency principles enshrined in the primary legislation. Of particular importance will be registration, supervision, dispute resolution, and enforcement for insurance companies. In particular, the authorities will need to ensure that secondary legislation effectively empowers the CSA to conduct thorough fit and proper tests for insurance companies, including background searches for their ultimate beneficial owners.

The Government has recently decided to locate the supervisory authority for private pension funds at the CSA, and aims to prepare the relevant legislative and regulator framework for pension fund supervision. This constitutes a priority action ahead of the launch of the third pillar of the reformed pension scheme at the 2006 horizon.

### *Capacity Building for Supervisory Authorities*

*Securities Exchange Commission (CNVM).* Following the completion of the secondary market regulation by the end of 2004, CNVM plans to undertake a comprehensive Functional/Capacity Assessment Review (FCAR). This FCAR will cover the organizational structure, responsibilities and powers of the Commission, procedures for capital markets (securities registration, filings, market regulation), procedures for capital market intermediaries (principles of business, authorization procedures, supervision procedures), enforcement procedures (information gathering and investigative powers, disciplinary procedures, sanctions, and so on) in line with IOSCO principles. The FCAR will also identify staffing and training requirements based on the above diagnostic.

The FCAR will formulate a comprehensive, multi-year, capacity building program to ensure that CNVM has the capacity to fulfill its responsibilities and powers under the consolidated market law as home country regulator in the EU single financial market.

As part of this capacity building program, a key priority for CNVM is to develop the capacity to carry out background checks of the directors and managers of capital market intermediaries and of the ultimate beneficial owners of capital market intermediaries and listed companies. This will require developing collaborative arrangements with domestic law enforcement agencies as well as with counterpart securities exchange commissions abroad, starting with major financial centers in the EU and in other OECD markets. Recently, CNVM has made noticeable progress in this regard. For example, CNVM has developed collaborative arrangements with some counterparts in other countries such as Bosnia, Czech Republic, and so on; they have established a new division that covers customer protection; and they have drafted a number of secondary regulations.

*Insurance Supervision Commission (CSA).* The CSA is also undertaking a comprehensive Functional/Capacity Assessment Review (FCAR). This FCAR will cover the organizational structure, size, management and staff skills, internal reporting, enforcement, and infrastructure, as well as changes in organizational structure, staffing, and infrastructure in line with IAIS principles. The FCAR will identify staffing and training requirements based on the above diagnostic.

The FCAR will formulate a comprehensive, multi-year capacity building program to ensure that CSA has the capacity to fulfill its responsibilities and powers under insurance market laws and regulations as home country regulator in the EU single financial market.

As part of this capacity building program, CSA will need to develop the capacity to carry out background checks of management and of the ultimate beneficial owners of insurance companies. This will require developing collaborative arrangements with domestic law enforcement agencies as well as with counterpart insurance supervision agencies abroad, starting with major financial centers in the EU and in other OECD markets.

*Pension Supervision.* Once the legal and regulatory framework for pension supervision is completed, the designated supervisory authority will need to develop, fund implement a comprehensive capacity building program so that it meets the standards of other supervisors in the EU single financial market. It is crucial that the pension fund supervisory authority have the power and the capacity to enforce the legal and regulatory framework. Up front, the supervisory authority will need to carry out fit and proper tests of pension fund managers and directors, enforce disclosure of the ultimate beneficial owners of pension fund management companies, and carry out background checks on pension fund managers and directors and ultimate beneficial owners of pension fund management companies.

## Strengthening Capital Market Infrastructure

Although the reforms initiated by the authorities to date are positive steps, more will need to be done in the next three years to strengthen market institutions and infrastructure for domestic capital markets and NBFI. Given the extent and complexity of the capital market and NBFIs, the action plan does not discuss in detail all the necessary amendments and changes that will need to be made; instead it highlights the major issues and provides the reader with a expansive picture of reforms that will need to be implemented to bring the Romanian market and NBFI within the single EU financial market.

## *Structural Reforms*

In tandem with the efforts to develop the various sub sectors, the Romanian authorities will need to continue their current efforts on a number of structural reforms (see Table 31), including privatization, anti-corruption, public sector reform, auditing and accounting, and judicial reform.

## *Corporate Governance Reforms*

Improving corporate governance remains a prerequisite to financial sector development in Romania. As a first step, company law provisions should be revised for boards of administrators of joint stock companies—including setting the minimum number of board members (to allow for specialized committees of non-executive board members); expanding the

**Table 31. Structural Targets**

| | Priority | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Privatization* | High | Sell off or liquidate all minority stakes. | Finalize privatization of large-scale transactions (e.g., Petrom) and all majority holdings; divesting golden shares in all but defense companies. | Finalize liquidation of all remaining assets and companies. |
| *Anti-corruption* | High | Increase staffing at the National Anti-Corruption Prosecutor's Office (NAPO); strengthen legislation to prevent conflict of interest among politicians. | Strengthen the operational independence of NAPO. | |
| *Judicial Capacity* | High | Specialized courts and alternative dispute resolution capacity should be considered to resolve conflicts in a timely manner and to encourage financial markets to function efficiently (e.g., timely payment of financial guarantee claims prior to investigation and litigation, with full reimbursement and penalties should violations of terms be uncovered). The judiciary also needs specialized training in economic crime and money laundering to be effective in enforcing its mandate. | | |
| *Public Administration Reform and Systems Modernization* | High | Ongoing training of financial regulators and supervisors. e-based methods of tax payment with incentives for timely payment (e.g., direct scheduled payments via payroll and bank accounts, and transmission of favorable payment records to credit information systems). More information on the internet, including status of investment applications. | | |

board's authority to include review of company's financials; explicitly requiring board members to conduct their duties with due care and due diligence; and clarifying the mechanism for electing board members. All sales and transfers of assets should be conducted at "market" or "arm's length" prices. Shareholders' meetings should appoint the company's external auditors.

Investment funds should implement higher standards requirements so as to increase confidence. This would establish fiduciary duties for board members of asset-management companies (AMCs) and require that they conduct their duties with due care, due diligence, and in the interests of investors. Use of "forward pricing" rather than "backward pricing" on the calculation of unit prices in investment funds would assist in boosting confidence and the perception of fairness. AMC officers should be prohibited from engaging in conflicts of interest, such as front-running, insider trading, and market timing. Related party transactions should include transactions between legal entities and natural persons. AMCs should be required to designate a compliance officer, as should other financial institutions and listed firms.

As a function of accounting and audit reform, as well as for improved corporate governance and potential dispute resolution, modernized forms of information dissemination and corporate responsibility should be required. As reflected in Table 32, the reforms should include requirements that companies have independent board members and separate audit committees; internal audit functions that are autonomous and effective; investor relations departments to handle inquiries about the financial condition and position of companies; and certified compliance officers to ensure companies are abiding by their respective regulatory requirements.

Romania's new capital markets legislation should disclose management, significant shareholders, and beneficial ownership interests in investment firms. The new Capital Market Law is expected to reduce the minimum threshold reported to 5 percent (as opposed to the EU minimum of 10 percent), which is a step in the right direction, but it will still require significant effort to strengthen implementation. In this context, the authorities will need to develop a plan to carry out this new disclosure ruling.

Other key initiatives to support sound corporate governance should include:

- Modifying the role of the Corporate Governance Institute set up by the Bucharest Stock Exchange to play the role of an Institute of Directors.
- Strengthening institutional structures to improve corporate financial reporting.
- Requiring publicly traded companies to summarize share purchase information, and to disclose the summary annual capital improvement budgets agreed as part of the privatization of the company.

## *Legal and Regulatory Issues*

*Strengthening the Framework for Coordination among Regulatory Authorities.* The legal and regulatory reform process will need to be more interactive encouraging greater dialogue between policy makers, regulators, and market players and consultation with the investment community, both foreign and domestic. Strengthening the framework for coordination among regulatory authorities is essential, as is developing a framework for implementing consolidated supervision (Table 33). Establishing a more professional approach to the

**Table 32. Corporate Governance Reform Targets**

| | Priority | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Legislation* | High | (i) Revise Company Law to strengthen practices of boards of administrators. Refine concepts of accountability, management responsibility, independence of board oversight, and internal audit and control.<br>(ii) Revise Securities Legislation to require disclosure of full indirect control relationships. | Implement. | |
| *Corporate Governance Code & Institute of Directors* | Medium | Capacity building and development of corporate governance code and code of ethics. | Ongoing management and board training. Linking the Institute with other similar directors' institutes in Central and Eastern Europe. | |
| | | **For Investment Funds** | | |
| *Asset-Management Companies* | Medium | Adoption of new practices and standards for asset-management companies re fiduciary responsibilities, pricing, etc. | Implement. | |
| *Internal audit* | Medium | The development of guidelines for autonomous internal audits for all listed companies and licensed financial institutions. | All licensed financial institutions have autonomous internal audit functions. | |
| *Investor relations departments* | Low | Revised policies and procedures for information requirements of shareholders. | Regular functioning of investor relations departments. | |
| *Certified compliance officers* | Low | The establishment of standards and commencement of training. | All listed companies and licensed financial institutions have certified compliance officers. | |

appointment process of the boards that oversee the regulatory agencies is needed to improve independence and confidence in market structures. Developing the capacity to monitor, investigate, and prosecute criminal activity, especially fraud and money laundering, is also needed to improve confidence.

## *Securities Market Regulation and Supervision Among Regulatory Agencies*

Reform of securities market regulation and supervision remains a priority for development. The government should continue its efforts to improve observance of IOSCO principles and EU directives. It should also increase efforts to strengthen the independence and capacity of the CNVM. Table 34 provides targets for securities market regulation reform over the short- and medium-term.

**Table 33. Strengthening Coordination Between Regulatory Authorities Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Consultation with market players* | High | Development of areas of focus and establishment of working groups. | Regular reporting to the public, including web-based issuance of white papers and government responses. | |
| *Strategy for consolidated supervision* | High | Formalizing methods of coordination.<br>Establishing contingency planning across financial services.<br>Developing protocols to identify risks to systemic stability, contain criminal activity, and enhance cross-border coordination. | Implementation. | |
| *Regulatory appointment process* | Medium | Establishing independent appointment commissions.<br>Developing criteria for positions for CNVM, CSA and other regulators (e.g., pension), as well as developing and disclosing the selection process and the use of independent advisors.<br>Revision of compensation packages for staff to align competitiveness with private sector rates. | Short lists introduced. Selection process disclosed (e.g., point system with explanations) to the public. | |
| *Financial crime* | Medium | Strengthening the mandate for investigation and prosecution involving legal enforcement authorities, regulatory agencies and auditors.<br>Designing of fast-track prosecutorial system for major crimes uncovered.<br>Enhancing domestic and cross-border coordination.<br>Building capacity-building in banks, insurance companies and other financial institutions to identify and monitor suspicious transactions and high-risk customers. | Ongoing coordination domestically and cross-border. Capacity-building in banks, insurance companies and other financial institutions to identify and monitor suspicious transactions and high-risk customers. | |
| *Coordination and suspicious transactions* | Medium | Increase the number of Memoranda of Understanding (MOU) signed with corresponding foreign authorities. Strengthen surveillance capacity consistent with FATF principles. | Sign multilateral MOU via IOSCO. | Implement capacity building. |

*(continued)*

**Table 33. Strengthening Coordination Between Regulatory Authorities Targets (*Continued*)**

| | Priorities | Year 1 (2005) | Year 2 (2006) Year 3 (2007) |
|---|---|---|---|
| *Specialized courts, arbitration and out-of-court adjudication* | High | Developing types of cases, amounts of disputes, system support needs, and authority of adjudicators/arbitrators. Establishing documentary standards (e.g., insurance policies, mortgages, financial guarantees) based on underwriting requirements and clear specification of the rights and responsibilities of all parties.<br>Implementation of these activities based on standards and requirements among financial market players, relevant regulatory authorities and legal professionals.<br>Archiving cases, opinions (majority and minority) and issues to build a framework for consistent decision-making based on an increasing volume of precedent. | Implementation based on standards and requirements among financial market players, relevant regulatory authorities and legal professionals.<br>Archiving cases, opinions (majority and minority) and issues to build a framework for consistent decision-making based on an increasing volume of precedent. |
| *SIFs* | High | Implementation of capital markets legislation. | |

## *Pension Reform*

Pension reform needs to accelerate further to strengthen the institutional investor infrastructure of the capital markets (see more on pension reform targets in Table 35). This should be done by developing a long-term financing strategy to ensure that the unfunded pillar's obligations are met while encouraging migration of retirement savings to the second and third pillars. The Government has decided to assign the authority for pension funds to Supervision to the Insurance Supervision Commission (CSA). A key Priority for the remains to be the adoption of legislation in 2004 to accelerate movement towards second and third pillars, finalizing tax issues regarding levels of payroll contribution and deductibility, and focusing on establishing licensing procedures and supervisory capacity in 2004–05. In addition, the necessary infrastructure needs to be in place to ensure that fiduciary responsibilities are fully met and reporting capacity is in place by 2007. In order to build the capacity of the sector in the long term, information systems also need to be developed, and strengthening actuarial capacity is a high priority.

According to the latest EU Accession Progress Report (November, 2003), while significant progress has been made in the recent past, legislation in relation to the insurance sector still lacks precision, and both implementing provisions and the decisions of the Romanian Insurance Supervisory Commission are not always consistent over time. Substantial further amendments and new implementing measures will be required to fully align Romanian legislation with the insurance *acquis*—these are planned in several steps until 2006.

**Table 34. Targets for CNVM and Securities Market Regulation/Supervision**

| | Priority | Year 1 (2005) | Year 2 (2006) Year 3 (2007) |
|---|---|---|---|
| *Legislation* | High | Following the recent finalization of consolidated law on capital market, develop the secondary capital markets legislation. This will cover registration, supervision, dispute resolution and enforcement for listed companies and for market intermediaries. | Continue to monitor and enforce risk-adjusted measures for regulatory capital. |
| *Operational efficiency* | High | Following the completion of the secondary market regulation by the end of 2004, undertake a comprehensive Functional/Capacity Assessment Review (FCAR) to cover organizational structure, responsibilities and powers of the Commission, procedures for capital markets, procedures for capital market intermediaries, enforcement procedures in line with IOSCO principles. The FCAR will also identify staffing and training requirements based on the above diagnostic. | Implement. |
| *Free float* | Medium | Develop daily market indicators based on minimum 25% free float observance. Structure transaction fees and other incentives to favor firms that observe the 25% free float rule. | Implement. |
| *Offering documentation* | Medium | Implement the recently formulated regulations on the required information content of issuance prospectuses. Standardize documentation to help issuers and investors, as well as the intermediaries helping to place the issues. Require that asset management companies draft rules for publication in the prospectus, and that these be approved by CNVM. | Implement. |

## *Insurance*

While the legislative reform process is ongoing, the role of the CSA in the implementation of the recently enacted provisions is certainly crucial. The development and strengthening of the insurance market in Romania, in fact, is conditional upon the effective enforcement of prudential norms, solvency regimes, accounting and reporting standards, internal control procedures, and corporate governance rules (Table 36).

**Table 35. Pension: Legal and Regulatory Reform Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) Year 3 (2007) |
|---|---|---|---|
| *Pension: Regulation and supervision* | High | Prepare the relevant legislative and regulator framework for pension fund supervision and supervisory capacity. | Begin to license and supervise third pillar pension funds. |
| *Pension Prudent management* | High | Develop requirements for asset segregation, safe external custody of assets, asset diversification, valuation rules, capital adequacy, and disclosure. | Implement. |

## *Mortgage and Housing Finance*

On housing finance, continued progress in drafting legislation[74] for a modern mortgage finance framework should be reinforced with a commitment to build institutional capacity so that markets can function efficiently. The focus must be on mortgage contracts, mortgage insurance and guarantees, mortgage securities, and other areas of infrastructure and support for a vibrant mortgage market. The following systems must also be in place: standardized underwriting procedures, clear title and ownership rights and responsibilities according to contract, data base needs in harmony with underwriting requirements and broader market development, the adjustment of the necessary regulations related to mortgage securities and the premiums and regulations related to contractual housing savings and loans systems, and the effective implementation of clear foreclosure procedures in cases of default (albeit with provisions to permit restructuring for debt service and repayment), as indicated in Table 37.

## *Municipal and Corporate Bonds*

Development of the municipal bond market requires legal reform, institutional capacity building, and better accounting and financial information (Table 38). Priorities include building local administrative capacity for budgetary planning, financial management, and service provision. An additional priority would be to design credit enhancements based on modern accounting and management principles that would allow for increased revenue flows resulting from longer maturities.

Now that legal constraints on the size of corporate bond issues have been removed, efforts to develop the corporate bond market will be more straightforward. The focus should be on developing market infrastructure so that potential purchasers of securities (mainly institutional, but also individual) have the information needed to determine risk-return options. A domestic credit/securities rating agency will be established if deemed feasible.

Given that leasing has the potential to become an important area of growth in the in Romania's financial sector, the legal and regulatory framework for the sector should be strengthened, as reflected in Table 39. Leasing companies need to be recognized as non-

74. The authorities have recently drafted Mortgage Bond draft law and Law on securitization of receivables. The World Bank has provided a number of comments on these laws.

**Table 36. Insurance: Legal and Regulatory Reform Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Insurance Supervisory capacity* | High | Finalize the comprehensive Functional/Capacity Assessment Review (FCAR), which covers the organizational structure, size, management and staff skills, internal reporting, enforcement, and infrastructure; changes in organizational structure, staffing and infrastructure in line with IAIS principles. The FCAR will identify staffing and training requirements based on the above diagnostics. | Implement. | |
| *Insurance Implementing regulations* | Medium -high | Following the recent adoption of primary legislation on insurance develop the secondary legislation for the insurance sector and bylaws for underwriting standards, asset management, reserve management, policyholder protection and rights, internal systems, procedures and controls, and regulatory and financial reporting. | Enforce implementing regulations with particular focus on risk management capacity, corporate governance, and identification of suspicious transactions. | |
| *Insurance Market conduct* | Medium | Strengthen consumer (policy holder) protection. Issuing regulations on policyholder rights and protection concerning pricing (tariffs), claims filings, and consumer recourse. Introduce code of ethics. Assess feasibility of an ombudsman. | Enforce policyholder rights through the courts when appropriate. Raise professional standards and observe adopted code of ethics. Introduce ombudsman if determined to be feasible. | |
| *Insurance Life vs. non-life* | Medium | Verify *de facto* operational separation. Impose sanctions on composite firms violating legal requirements. | Suspend licenses of firms failing to comply. | |
| *Reinsurance* | Medium | Issue relevant regulations on compulsory cession requirements, and retention rules on a portfolio and individual risk basis. Consult with major market players to help develop standards applicable to qualified re-insurers. | Strengthen capacity to monitor compliance, consult with major market players to help develop standards applicable to qualified re-insurers. | |
| *Investment policy* | | | Amendments to current insurance legislation to comply with freedom of capital provisions of EU Treaty. | Implementation of revised insurance legislation consistent with freedom of capital provisions of EU Treaty. |
| *Tax issues* | High | Determination of appropriate deductibility for life insurance, if any. | Implementation of deductibility provisions, if determined to be appropriate. | |
| *Actuarial capacity* | Medium | Regulate the actuarial profession and introduce the requirement to appoint a qualified and independent actuary in life insurance companies. Ongoing institutional and database development. | Ongoing institutional and database development. | |

**Table 37. Mortgage and Housing Finance: Legal and Regulatory Reform Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Legislation* | High | (i) Prepare a comprehensive set of legislation to support the development of the housing mortgage market—draft Mortgage Loan Law, the Mortgage Bond Law and the Securitization and Receivables Law. (ii) Develop the detailed regulations required to support the issuance of mortgage bonds and mortgage-backed securities. | | |
| *Housing and Mortgage Finance Strategy* | Medium | Develop working committees focused on access to finance for home ownership, land privatization and sales procedures (when sold by local government), energy efficiency, building codes and zoning requirements, environmental safety, and local municipal infrastructure and utilities (e.g., water, district heating). | Finalize reports and recommendations on coordinated strategy involving access to finance for home ownership, land privatization and sales procedures (when sold by local government), energy efficiency, building codes and zoning requirements, environmental safety, and local municipal infrastructure and utilities (e.g., water, district heating). | Implementation. |
| *Mortgage Insurance* | Low | Assess feasibility of mortgage insurance system. Begin to implement needed legal and institutional reforms for a commercially viable system to be implemented. System introduced for integration. | Underwriting procedures standardized. Contracts standardized to provide clear title and ownership rights, as well as responsibilities. Database needs harmonized with underwriting requirements. Clear foreclosure procedures implemented for cases of default (albeit with provisions to permit restructuring for debt service and repayment). | Implementation. |
| *Secondary Mortgage Market Development* | Medium | Harmonization of laws pertaining to mortgage security, and revision of the legal framework to address issues relating to refinancing capacity and SPVs. | Reinforcement of NBR regulation and supervision of mortgage institutions. | Development of sustainable long-term refinancing options and optimizing current procedures. |

**Table 38. Municipal and Corporate Bond: Legal and Regulatory Reform Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Municipal bond market development* | High | Develop market legal framework so that potential purchasers of securities (mainly institutional, but also individual) have the information needed to determine risk-return options. | | |

deposit-taking credit institutions, and a more defined regulatory framework needs to be promoted for them. Tax and accounting issues need to be addressed to provide an added catalyst to leasing sector development. Depreciation schedules should be structured to be consistent with IAS principles. Any residual tax discrimination against leasing activity for industrial and agricultural machinery, and business equipment (for example, computers) should be eliminated so that increased diversification of leasing applications is established.

**Table 39. Leasing: Legal and Regulatory Reform Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Leasing Law* | High | Clarify regulatory status, and establish clear contractual obligations in the event of default, strong creditor protection provisions when lessees fail to comply with contractual, and consumer protection provisions. | Implement and enforce. TA from the EU or other sources to help Romania with implementation of a modern framework for leasing. | |
| *Regulatory or self-regulatory* | Medium | Establish industry principles and guidelines for effective self-regulation and standardization of contracts, and risk management capacity requirements. | Build capacity for self-regulation, or regulation, depending on the appropriate supervisory approach. De-license based on major violations, or challenges to financial sector stability. Bring leasing sector activity increasingly into the broader inter-regulatory review of potential systemic risk. | |
| *Tax issues* | High | Equalize tax incentives for borrowings regarding deductibility as are available to companies borrowing from banks. Adopt provisions to permit leasing companies to provision for losses. Allow amortization of VAT. Permit leasing companies to hold reserves. | Implement provisioning for leasing companies, and VAT depreciation through the lifetime of lease contracts. Permit leasing companies to hold reserves. | |

## *Accounting, Transparency, and Disclosure*

Romania needs to quickly improve financial accounting and reporting for all financial and corporate institutions to reduce perceptions of risk and to increase investment flows. They must work closely with the major international audit firms, the International Accounting Standards Board, and other related professionals to accelerate the understanding and observance of IAS for market development purposes. The focus should be on implementing key transparency and disclosure practices that are consistent with International accepted accounting practice and form a basis for attracting investment from abroad (see Table 40).

Reforms of securities market regulation and supervision are another priority for development. The government should continue its efforts to improve its observance of IOSCO principles and EU directives. It should also continue strengthening the independence of the CNVM.

Transparency in the primary government securities market needs to be improved to increase market confidence and predictability. Providing an issuance calendar for T-bills and, to the extent possible, other government securities, would be a step in the right direction. Announcing the exact amount to be tendered one week in advance and accepting bids at any price until the targeted volume is reached—rather than the current practice of applying cut-off rates after the T-bill auction—would increase confidence and participation.

## *Market Infrastructure*

Financial market infrastructure should be consolidated, upgraded, and modernized (Table 41). Introduction of a centralized registry/depository for all securities including T-bills, T-bonds, and other bonds and equities, toughening standards, consolidating registrars and clearing agencies, and implementing DvP and RTGS are all recommended. Recently, the authorities adopted the concept of an alternative trading system (ATS) to address the inactive issue of the Romanian capital market. Given the market size, the possibility of launching various forms of collaboration and the outsourcing of back-office functions with regional markets should be studied and encouraged. The authorities may want to expand the ATS concept to cover potential regional cooperation.

The Government needs to take the lead in establishing a yield curve. This can be done by increasing the role of domestic securities issues to meet long-term government financing needs, introducing regular emission schedules one year in advance, and extending maturities. Unifying the platform for government securities market trading (including differences in payment and settlement), rather than MoPF continuing to operate in the market separately from NBR, will also be necessary.

Coordination between current government financing policy (MoPF) and monetary policy (NBR) should be carried out more effectively for both debt management and monetary policy operations. Amongst the priorities are (i) establishing a regular information exchange mechanism between MOF and CNB to coordinate fiscal and monetary policies. MOF and CNB can develop an agency agreement to formalize such a mechanism, and (ii) establishing a cash management capacity by the Treasury, in itself.

Romania needs to expand the money market beyond T-bills, and make the existing T-bill market more efficient. This can be done by achieving RTGS and Delivery versus Payment, developing a standardized master repurchase agreement covering both banks and

**Table 40. Accounting and Disclosure Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) Year 3 (2007) |
|---|---|---|---|
| *Regulatory reporting* | High | Reconcile and implement regulatory reporting requirements for financial institutions and listed companies with international accounting standards. | |
| *Fit and proper standards* | High | Develop and implement fit and proper standards for owners and board members. | Scrutinize observance of fit and proper standards for owners and board members. |
| *Professional management* | Medium | Encourage the role of institutional investors and specialized advisers for professional management of large and listed companies. | |
| *Information disclosure* | High | Expand credit information bureau to include other financial services. | Promote information-based market mechanisms for ongoing evaluation and ratings of companies' securities based on accurate and timely financial results and market developments. |
| *CNVM Enforcement mandate* | High | Expanding the scope of operations of the Enforcement and Inquiry Department of the CNVM. Strengthen on-site and off-site supervision capacity. | Implement. |
| *CNVM Disclosure* | Medium | Requiring new shareholders to obtain approval from CNVM when there is a change of more than 5 percent in share capital, rather than simply notifying CNVM; making these openly disclosed via CNVM web site communications and regular reports. | |
| *CNVM Audit standards* | Medium | Establish a dedicated department focused on audit enforcement. Provide CNVM with non-exclusive oversight of the Chamber of Financial Auditors to ensure that auditors meet minimum professional requirements and standards of auditing for securities markets participants. | |
| *Government Securities: Market confidence and participation* | Medium | Strengthen the transparency. Announce an issuance calendar for T-bills. Announce the exact amount to be tendered one week in advance. Accepting bids at any price until the targeted volume is reached. | Announce an issuance calendar for T-bills and other government securities. Announce the exact amount to be tendered one week in advance. Accepting bids at any price until the targeted volume is reached. |
| *Municipal bond market development* | Medium | Introduce advanced financial management systems. Conduct ongoing variance analysis for refinements and adjustments. Evaluate the costs-benefits of outsourcing. Adopt modern contracting and procurement practices. Conduct accurate and fair property tax assessments. | |
| *Corporate bond market development* | Low | Strengthen offering documentation. Promote diversification away from bank loans, particularly for long-term financing needs. | |
| *Pension Public awareness and Information system* | Medium | Launch public awareness campaign on rights and responsibilities and Introduce needed systems. Train actuaries. | Continued development of the actuarial profession. |

**Table 41. Market Infrastructure Targets**

| | Priorities | Year 1 (2005) | Year 2 (2006) Year 3 (2007) |
|---|---|---|---|
| *Centralized registry for securities* | High | Introduce a centralized registry for all securities including T-bills, T-bonds, and other bonds and equities. | |
| *Registrars and clearing agencies* | Medium | Introduce new standards that trigger consolidation. | Implement. |
| *Regional corporation* | Low | Collaboration with regional markets should be studies. | Negotiate and implement the result of the study. |
| *OTC* | Medium | Establish systems, procedures and controls for the OTC market. | Implement. |
| *Insurance* | Medium | Develop a modern, reliable, integrated database (building a central database for gathering, registering, and processing data collected from the supervised entities). | |
| *Credit information* | Medium | Expanding the credit information bureau to include other financial services. | Promote information-based market mechanisms for ongoing evaluation and ratings of companies' securities based on accurate and timely financial results and market developments. |
| *Centralized registry for properties* | Medium | Modernize the land book. Expand registry for movables. Provide electronic access to prospective creditors and investors. Set up systems that prevent simultaneous claims on pledged assets. Increase search capacity. Provide greater server capacity to handle increased entries. Introduce standardized formats for data entry to avoid potential losses of important data. | Continue to modernize the land book. Implement the moveable registry. |
| *Market transactions and infrastructure* | Medium | Strengthen systems, procedures, controls, and compliance between market players and the regulatory authority, consistent with the recent EU Directive on Market Abuse that deals with price manipulation, inside information, unfair trading practices, and enforcement of penalties. Prohibit persons affiliated with a collective investment scheme from trading in securities held by these schemes. | Enforce. |

(*continued*)

**Table 41. Market Infrastructure Targets (*Continued*)**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Strengthening the primary market of government securities* | High | Establishment of close cooperation between the MoPF's financing policy and NBR's monetary policy. An agency agreement should be developed to address this issue. | | |
| *T-bill and money market* | Medium | Achieve RTGS and Delivery versus Payment. Developing a standardized master repurchase agreement covering both banks and NBFIs. | | Eliminate restrictions on the use of commercial paper and other money market instruments widely used by private companies for cash management purposes. |
| *Municipal bond market development* | Medium | Introduce advanced financial management systems. Conduct ongoing variance analysis for refinements and adjustments. Evaluate the costs-benefits of outsourcing. Adopt modern contracting and procurement practices. Conduct accurate and fair property tax assessments. | | |
| *Pension Information systems* | Medium | Introduce needed systems. Train actuaries. | Continued development of the actuarial profession. | |

NBFIs, and eliminating restrictions on the use of commercial paper and other money market instruments widely used by private companies for cash management purposes.

If possible, Romania should establish a domestic credit rating agency with strong ties to one of the three major international credit rating agencies, and seek ratings for all bonds as well as first-tier listings on the exchange(s). If this is not feasible, an active credit information bureau should contribute to the information available to investors about an issuer's creditworthiness. The current credit bureau should be expanded to cover the credit information.

Upgrading Romania's property registry is another priority and can potentially offer important benefits to the financial sector. To this end, the following improvements are recommended: a centralized registry for movable and immovable assets should be established that would provide electronic access and ensure that complete information is available to prospective creditors and investors; systems should be created that prevent simultaneous claims on pledged assets; search capacity should be increased to handle increased entries; and standardized formats should be introduced for data entry to avoid potential losses of important data.

## *Equity Mobilization and Credit Enhancement*

As credit insurance grows, the approach to guarantees and insurance should be more risk-based, with the regulatory focus more on the capacity of providers of enhancements to price risk and reserve for default on commitments. More transparency and higher volumes of information will be needed for sound oversight to contain transfer risks as the use of enhancements increases. Supervisory surveillance should focus on systemic risk, market players' systems, capacity for risk management, and the capability to monitor for increasingly complex products and operations (including those that are cross-sectoral and cross-border). Specialized courts to resolve disputes in a timely manner, particularly payment of financial guarantees in structured finance transactions, are needed. The judicial, regulatory, and insurance community must be encouraged to develop standards for underwriting and policy documentation (including claims forms and time limits for filings) so that all parties have a clear understanding of rights and responsibilities, and that timely payment can be made when financial guarantees are called.

The use of guarantees for insurance on bonds floated by municipalities and/or infrastructure providers is being considered by the authorities as a tool to mobilize domestic capital markets for infrastructure and housing investment finance; more specifically: (i) Equity mobilization for Private and Public Partnerships (PPP), (ii) Municipal debt market, and (iii) Housing mortgage market.

- ***Equity Mobilization for Private and Public Partnerships (PPP).*** Given the considerable investments requirements for the local infrastructure to meet requirements of EU directives, the current allocation from EU cohesion funds will not be enough to fund all of these investments. The local governments in Romania currently face a real challenge to mobilize other sources of funding including domestic debt market, with out having adequate credit worthiness. Options such as private public partnerships are being considered, however, this will require the private sector to take a majority ownership in local utility companies, through concessions or divestitures. In this context, mobilizing equity from private investors at a time where traditional operators/investors have drawn from such transactions in emerging markers is on the critical path to local infrastructure PPP transactions.

  To overcome this problem, the authorities are considering alternative PPP frameworks to attract private investors in local infrastructure transactions. As part of the PAL program, the Government has established an Inter-Ministerial Working Group on municipal finance (IWG), that is responsible for undertaking a number studies to support the strengthening of the municipal finance borrowing framework and the development of equity mobilization and debt enhancement instruments to improve the access of local governments to domestic capital market. This alternative PPP framework is built around four mutually reinforcing instruments: Local Infrastructure Investment Trust (LIIT),[75] A Partial Risk Guarantee Facility (PRGF),[76] Output-based Subsidy Scheme (OBSS),[77] and Contract Transparency and Monitoring (COTAM).[78]

75. The LIIT would be a second-round investment trust that would buy-out equity stakes in local infrastructure companies from first-round private equity funds and hold these equity positions for the long-term, thereby improving exit opportunities for first-round private equity funds investing in local infrastructure companies.

76. The PRGF will cover first and second-round private investors in local infrastructure companies against sub-sovereign breach of contract risk. The cover would be for debt contracted by private investors

**Table 42. Targets for Credit Enhancements**

| | Priorities | Year 1 (2005) | Year 2 (2006) | Year 3 (2007) |
|---|---|---|---|---|
| *Legal* | Medium | Develop standards for underwriting and policy documentation (including claims forms and time limits for filings) to ensure all parties have a clear understanding of rights and responsibilities and that timely payment can be made when financial guarantees are called. | | |
| *Feasibility for Credit enhancement instruments* | High | Finalize the feasibility study for credit enhancement instruments to support (i) Equity mobilization for Private and Public Partnerships, (ii) Municipality bond, (iii) SMEs bonds and (iv) mortgage market finance. Develop an action plan in discussion with stakeholders (IWG). | Implement. | |

- ***Municipal debt market.*** The IWG is also considering the development of a partial credit guarantee facility for municipal debt. The facility would cover the repayment of the principal of a municipal bond at maturity, or the repayment of principal of outer year maturities of a municipal loan. The facility would enhance access of local governments to the domestic debt market, through reduced spreads and extended maturities on municipal bonds and through reduced interest rates and extended maturities on municipal loans. The facility would be structured around a comprehensive set of ex ante[79] and ex post risk[80] management instruments.
- ***Housing Mortgage Market.*** Following up on the adoption of primary and secondary mortgage market laws, the Government is assessing the feasibility of supporting the mortgage market by: (i) developing a mortgage default insurance (MI) scheme, which would allow primary mortgage issuers to extend higher loan to value (LTV) mortgages to middle income or lower-middle income households, (ii) the develop-

in local infrastructure companies, both in the form of loans from domestic private banks and of bonds placed on the domestic bond market.

77. OBSS to ease problems of service access and affordability for low-income households through the transition to cost-recovery tariffs in local utilities. As a priority, the scheme would be developed and applied in the district heating sector where it would replace the currently untargeted, fiscally unconstrained subsidy scheme.

78. COTAM Facility to provide a third, neutral party at contract negotiations between municipalities and private investors in local infrastructure companies. This Facility would be a mixed public-private entity that would be linked to the contract regulator and to the Chamber of Commerce or similar business organization.

79. Ex ante risk management instruments would include specific municipal finance management criteria (budget and budgeting, inter-governmental transfers, local taxes, municipal property management), investment programming and selection criteria, and a local credit rating by two credit rating agencies (international, local).

80. Ex post risk management instruments would include moral suasion by the Government in case of threat of default, and a fiscal revenue intercept in case of default.

ment of mortgage-backed securities (MBS) through a partial credit guarantee facility for MBS, that would create a enhanced security for institutional investors, including insurance companies, mutual funds and pension funds.

To undertake any government supported credit enhancement facilities, the authorities should implement reforms to address a variety of property-related issues would likewise have an impact on investment and capital markets development (Table 42). These include resolution of land disputes, infrastructure improvements (for example, gas pipelines for improved heating), municipal capacity and administration (for example, incentives through district heating and other utilities for retro-fitting of housing stock), and more demanding building codes (for example, earthquake resistance, insulation), and incentives for other improvements (for example, water filtration, recycling).

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With only three years remaining before joining the European Union, Romania is working hard to improve its capital markets and non-bank financial institutions, which remain less developed than those in other accession countries. Strengthening these sectors has become a top priority for policymakers, whose primary objective is to ensure that the financial system is sufficiently developed to serve the growing demands of the Romanian economy.

During 2003 and 2004, the Romanian authorities made significant efforts to draft, adopt, and enact new legislation to align Romania with EU financial directives. Despite these efforts, however, challenges remain in the area of supervisory capacity and the implementation of laws and regulations.

This study assesses key issues and recommendations for development, and reviews the specific changes which are necessary in four areas: structural reforms, market institutions, and infrastructure; accounting, transparency, and disclosure; market infrastructure; and credit enhancements.

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ISBN 0-8213-6015-9