Financial Stability Report

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– Overview –

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OVERVIEW

Risks to financial stability have seen mixed developments since the previous *Report*, in an economic and financial environment rife with uncertainty. A slight improvement was observed in the first part of the period under review, due to better consumer sentiment, lower food and energy prices, and the recovery of economic activity in China after the most recent wave of the COVID-19 pandemic. However, the turmoil in the international banking sector, which started in March 2023, pushed investor risk aversion sharply higher. Moreover, uncertainty about the consequences of the ongoing war in Ukraine has remained high, while the pace of monetary policy tightening has moderated worldwide.

The main systemic risks to financial stability (Table 1) have remained unchanged since the previous *Report*. The risks assessed as severe concerning external developments and the worsening of domestic macroeconomic equilibria, *inter alia* as a result of regional and international geopolitical developments, are expected to stay flat in the period ahead. The other two relevant systemic risks remained constant in terms of both intensity and trend: (i) the delay in implementing reforms and absorbing EU funds, especially via the National Recovery and Resilience Plan (NRRP), and (ii) the default risk for loans to the private sector.

Table 1. Map of risks to financial stability in Romania

→	Global uncertainty amid the energy crisis and the war in Ukraine
→	Worsening of domestic macroeconomic equilibria, *inter alia* as a result of regional and international geopolitical developments
→	Delay in implementing reforms and absorbing EU funds, especially via the National Recovery and Resilience Plan (NRRP)
↑	Default risk for loans to the private sector
	severe systemic risk
	high systemic risk
	moderate systemic risk
	low systemic risk

Note: The colour shows risk intensity. Arrows indicate the outlook for risk in the period ahead.

Expectations regarding global macroeconomic developments point to a slight improvement since the previous Report, yet the risks of a steeper slowdown in economic growth are important, amid (i) the ongoing war in Ukraine, (ii) the still high inflation, albeit on the wane, and, last but not least, (iii) the bank turmoil in several countries. According to the latest assessments, the IMF (WEO, April 2023) foresees a global economic growth rate of 2.8 percent for this year (down from 3.4 percent in 2022 and revised down by 0.1 percentage points from the January 2023 estimates).

For the euro area, growth projections for 2023 stand at 0.8 percent, ahead of a rebound to 1.4 percent in 2024. The energy crisis and the geopolitical tensions may act as an incentive to invest in clean energy, to relocate value chains for reducing dependence on suppliers from other continents, to speed up green transition, or to structurally change the economy towards a higher value-added one. In Europe, the REPower EU package offers substantial opportunities to invest in new production capacities and to enhance energy transport networks. In Romania, available funds amount to EUR 1.4 billion.

Romania reported a pick-up in annual economic growth in the final quarter of 2022 compared to the previous quarter, but the year as a whole saw a loss of momentum (to 4.7 percent, down 1 percentage point from 2021). Economic growth for 2023 Q1 ran at 2.8 percent, down by 2 percentage points from that in 2022 Q1. Forecasts for Romania's economic growth for 2023 point to a deceleration (2.4 percent according to the IMF; 3.2 percent forecasted by the EC), similarly to the global outlook, given the multiple uncertainties, especially as regards the armed conflict between Russia and Ukraine, as well as amid tighter financial conditions and weakening export demand from the euro area.

Romania is still among the first EU countries in terms of the size of twin deficits, i.e. current account deficit and fiscal deficit. The fiscal deficit stood at 5.68 percent at end-2022, 1.05 percentage points lower than in the previous year, Romania being exceeded only by Italy, which recorded a deficit of 8 percent. In the first four months of 2023, the fiscal deficit widened by 0.56 percentage points against the similar year-ago period, to 1.72 percent of GDP. The current account deficit increased further, reaching 8.9 percent of GDP in 2022 Q2-2023 Q1, the highest level among Romania's peers in the region. The growth outlook for export demand is subdued, owing to the economic slowdown in Europe and further high inflation. Romania's public debt rose by 20 percent in March 2023 versus March 2022, its share in GDP adding 0.7 percentage points, up to 49.2 percent. Compared to the pre-pandemic period (December 2019), public debt advanced 89 percent, the second highest increase at EU level after Estonia (+180 percent). A notable vulnerability remains the large share of financing needs to be covered in 2023 by borrowing in foreign markets (approximately 30 percent), as well as the high percentage of foreign currency-denominated public debt (56 percent in March 2023).

The prospects for EU funds absorption in 2023 point to a slowdown. As for the NRRP, the submission of the third payment request for the next instalment in amount of EUR 3.1 billion is delayed. The absorption rate for the multiannual financial framework 2014-2020 has increased since the previous *Report* (from 69 percent on 8 November 2022 to 78 percent on 15 May 2023), yet it still lags behind the levels recorded in the region (89 percent in Poland, 88 percent in Czechia and 86 percent in Hungary). The EU funds absorption capacity becomes essential in an environment affected by economic growth decelerating below the previous decade's levels, making it difficult for Romania to reduce domestic disequilibria and to support strategic sectors with a view to ensuring transition to a green and inclusive economy, along with a structural shift towards a higher value-added economy.

Non-financial corporations in Romania proved resilient to the challenges posed in the first half of 2022, which was marked by the start of Russia's aggression against Ukraine and by surges in energy and commodity prices. The net profit margin as at June 2022 improved compared to the previous year, witnessing significant developments in certain sectors (agriculture, real estate and mining). However, these companies hold a small share in total income in the economy (up to 5 percent). Conversely, for the sectors with the most important shares in total income (trade, manufacturing and services), the net profit margin was relatively steady compared to 2021 H1. Structural vulnerabilities persisted: chronic undercapitalisation (the capital deficit that must be covered in order to observe the minimum level provided by law is lei 136 billion, December 2021), loose payment discipline, low share of firms in high value-added sectors (for details, see the overview section on structural vulnerabilities of the economy).

The growth rate of households' net wealth slowed down during 2022 compared to the previous year (+6 percent versus +15 percent). Households' net creditor position vis-à-vis the economy strengthened during 2022, financial assets recording a slightly higher increase than liabilities (5 percent versus 4 percent). Nonetheless, households' financial assets still account for a small share in GDP, i.e. 72 percent at end-2022, the lowest level in the European Union.

Compared to the previous *Report*, lending to the private sector lost momentum, with the trend being more visible for households. The growth rate of bank loans to non-financial corporations remains elevated (+18.3 percent in March 2023 versus March 2022), albeit 7 percentage points below the peak seen in June 2022. This was especially attributed to the step-up in foreign currency lending, as outstanding foreign currency loans rose by 40 percent in the period under review, compared with a 4 percent increase in leu-denominated loans. On the other hand, lending to households slowed down significantly, its growth rate standing at 1.5 percent in March 2023 from March 2022, down 7 percentage points from June 2022, amid higher interest rates and tighter credit standards.

The bank loan repayment capacity of companies and households does not indicate a deterioration, but the global and national economic context calls for prudent monitoring. Firms' non-performing loan ratio reached 4.1 percent in March 2023 (down 1.2 percentage points from March 2022), remaining however elevated in a number of sectors, such as construction and mining. The number of newly insolvent companies in April 2022-March 2023 went up at a moderate pace (+4 percent), standing at a level similar to that in 2019. For the households sector, developments were mixed. The NPL ratio for consumer loans remained unchanged in April 2022-March 2023, given the large share of fixed-rate consumer loans. On the other hand, the non-performing loan ratio for housing loans in lei has worsened slightly since June 2022, as these loans were affected to a larger extent by the increase in interest rates. Loans granted in March 2021-June 2022, a period of low interest rates, hold a significant share in the housing loan portfolio (27 percent), but their NPL ratio remains below the aggregate level (0.7 percent versus 1.6 percent). These vulnerabilities are significantly mitigated by prudent credit standards, more precisely by the measures regarding the minimum down-payment and the cap on the level of indebtedness that prevented borrowers' overindebtedness, and helped increase their resilience to negative shocks such as the one which has recently occurred. In view of stabilised interbank rates for the domestic currency, no further increases in the debt service of leu-denominated housing loans are expected for the coming period, whereas for euro-denominated loans interest rates may continue to follow an upward path, given the monetary policy tightening at European level.

Residential real estate market activity has decelerated since the release of the previous *Report*, residential property prices increasing by 6.8 percent at end-2022 (a growth rate slower by 0.2 percentage points as compared with that in the prior year) and the average period needed to purchase a standard flat in Romania decreasing to 7.4 years (March 2023). Conversely, the slacker dynamics of housing loans were also reflected in the substantial deterioration of the affordability index (down from 102 percent in 2021 to 76 percent in 2022), amid the hike in interest rates on new real estate loans.

At EU level, the European Systemic Risk Board issued Recommendation ESRB/2022/9 on vulnerabilities in the commercial real estate sector in the European Economic Area, amid rising concerns about the vulnerabilities associated with the commercial real estate market, particularly following the tightening of financial conditions. Looking at Romania, the construction activity and commercial real estate transactions posted positive dynamics in the course of 2022. The value of these transactions (EUR 1.23 billion) is significantly below that recorded in Poland (EUR 5.7 billion) and in line with market developments in Czechia (EUR 1.5 billion) or Hungary (EUR 1 billion).

Banking sector

The prudential and financial position of the Romanian banking sector remained adequate (Table 2), despite some disruptive events: the broad-based worsening of the financial market sentiment towards banks, the lingering geopolitical tensions in the region and the persistence of high inflation and interest rates. The solvency ratio is above the EU average, i.e. 21.6 percent (March 2023) as compared with 19.4 percent EU-wide. Liquidity indicators (LCR – 219.5 percent and NSFR – 177.6 percent, March 2023) witnessed favourable developments after the decline seen in the first part of 2022, while banks regained their net creditor position in relation to the central bank. The NPL ratio stayed in the EBA-defined low-risk bucket, albeit recording a marginal increase in 2023 Q1 (up to 2.7 percent, March 2023). NPL coverage ratio was further high, significantly above the European average (66.2 percent in March 2023 versus 43.4 percent in the EU, December 2022). Profitability remained robust, the net profit amounting to lei 10.1 billion at end-2022 (with ROE and ROA running at 16.4 percent and 1.5 percent respectively), due to lending dynamics and the increase in net interest income. On the other hand, banks' return on assets and return on equity are lower than those recorded in the real sector.

The banking sector is challenged by a number of persistent vulnerabilities: (i) the prospects of higher default risk for loans to the real sector, (ii) the close link between the banking sector and the government sector, which may cause the deepening of structural vulnerabilities already present, (iii) the further lower operational efficiency of small credit institutions, despite the permanent improvement in the gap with large banks. The large share of government securities in total assets (20 percent, March 2023) enhances the prudential position, but generates a concentration risk and amplifies interest rate risk. Over the past two years, the economic uncertainty, the geopolitical context and the faster upward trend of interest rates led to the rise in yields on the Romanian government securities, with an impact on the market value of securities measured at fair value and, implicitly, on own funds. The effects on prudential indicators were partly offset by the CRR "quick-fix" measures that expired at the end of 2022. However, once with the mild reduction in government security yields in 2023 and due to the practice of holding to maturity most of the securities classified as measured at fair value through other comprehensive income, banks could see a lower negative impact of marking to market in 2022. Despite the mark-to-market losses, the substantial capital surplus of credit institutions in excess of the overall capital requirement helps ensure adequate prudential indicators.

Table 2. Risk indicators for the banking sector

Risk indicators	EBA-defined prudential range	Romania						EU average
		2018	2019	2020	2021	2022	Mar. 2023	Dec. 2022
Solvency								
Tier 1 capital ratio	>15% [12%-15%] <12%	18.64	20.05	23.22	20.86	20.48	18.81	16.8
CET1 capital ratio	>14% [11%-14%] <11%	18.64	19.95	23.11	20.76	19.98	18.33	15.5
Total capital ratio		20.71	22.00	25.14	23.32	23.40	21.65	19.4
Asset quality								
Non-performing loan ratio	<3% [3%-8%] >8%	4.96	4.09	3.83	3.35	2.65	2.73	1.8
Non-performing loan coverage by provisions	>55% [40%-55%] <40%	58.51	60.75	63.31	66.10	65.55	66.19	43.4
Ratio of restructured loans and advances	<1.5% [1.5%-4%] >4%	3.26	2.49	2.40	2.60	1.96	1.89	1.6
Profitability								
ROE	>10% [6%-10%] <6%	14.59	12.21	8.66	13.28	16.40	21.34	8.0
Cost-to-income ratio	<50% [50%-60%] >60%	53.17	54.32	53.84	53.92	52.11	50.24	60.6
Balance sheet								
Loan-to-deposit ratio for households and non-financial corporations	<100% [100%-150%] >150%	71.89	69.48	63.61	63.96	65.66	65.24	108.1
Liquidity Coverage Ratio – LCR	>140% [110%-140%] <110%	237.84	242.59	292.48	238.77	209.16	219.50	164.7

best bucket
intermediate bucket
worst bucket
Source: NBR, EBA

The direct and indirect contagion resulting from the worsening of the financial market sentiment towards the EU and US banks is relatively low, given (i) the specifics of banking activity in Romania, based on the relation with resident customers (the share of foreign assets was 7.8 percent of the on-balance sheet assets in March 2023), (ii) the business model, based mainly on funding from retail deposits, which is less volatile than wholesale funding, (iii) the low financial complexity and sophistication (with small funding from capital markets, low resort to financial derivatives).

Structural vulnerabilities

The Romanian economy-specific structural vulnerabilities (Table 3) have not improved since the previous *Report*.

Table 3. Map of structural vulnerabilities to financial stability in Romania

A.	Weak payment discipline in the economy and vulnerabilities in companies' balance sheets
B.	Low financial intermediation
C.	The demographic problem
D.	Climate change

A. Payment discipline vis-à-vis non-banks continued to deteriorate, albeit at a more moderate pace. Specifically, the value of overdue payments in the economy went up in annual terms by 3.5 percent (as at June 2022, compared with the 9 percent increase seen in June 2021). Looking at the firms that submitted financial statements in mid-2022, 18 percent recorded losses and 3 percent reported a three-year period of losses. Companies with negative equity remain a significant vulnerability of the economy, contributing 26 percent to the volume of aggregate losses. Moreover, although the banking sector's exposure to these companies stays low (5 percent of exposure to firms as at June 2022), this category accounted for 15 percent of non-performing loans. Firms with capital shortfalls hold a large share of insolvent companies as well. On average, in the period from 2009 to 2022, 24 percent of the firms undergoing insolvency proceedings were firms with capital shortfalls.

Insolvency stabilised in the first part of 2023, the number of firms remaining in March relatively unchanged year on year at 31,823. These entities have a low relevance for the economy, generating 2 percent of the gross value added and hiring 2 percent of total employees in 2021. They are, however, relevant in terms of payment discipline, accounting for 51 percent of overdue payments to non-banks (2021) and 29 percent of banks' non-performing exposures (March 2023).

B. Romania still ranks last among EU Member States in terms of financial intermediation of the banking sector. At the end of 2022, bank credit to the private sector as a share in GDP stood at 25.6 percent in Romania, markedly below the EU average of 88.8 percent and lower than in peer countries in the region (Czechia 55.6 percent, Bulgaria 48.8 percent, Poland 42.8 percent, and Hungary 35.2 percent). Not only the level, but also the composition of lending to non-financial corporations can be improved. Banks' loan portfolio shows a low share of medium-high and high-tech firms in industry and services (10.7 percent at end-2022), similarly to the structure of the economy.

The increase in financial intermediation needs to be underpinned by an effective mix of measures. On the one hand, even though they have proven effective, the government support programmes for lending to the non-government sector, especially the IMM Invest Plus, should gradually shift towards high value-added and high-tech segments, in order to facilitate digital transition. On the other hand, with a view to enabling the implementation of NCMO Recommendations No. R/3/2022, No. R/6/2021 and No. 6/2020, government programmes should be defined in correlation with national and European economic and industrial policies, so as to support the structural shift of the economy to a higher value-added one.

C. Human capital continues to deteriorate, so that Romania's national wealth is at risk. The downtrend in population is accompanied by the high share of minimum wage earners, as well as by changes in the composition of employed persons by age. From 2007 to 2022, the number of employees aged between 40 and 64 rose by 50 percent, significantly outpacing the dynamics at aggregate level (+10 percent), whereas the number of employees aged between 25 and 30 dropped by around 40 percent. This development, amid the high emigration rate among youth[1] and the negative natural population change, has consequences for both the level of financial intermediation and the financing capacity of budget expenditures over the medium and long term. In the recent period, companies have increasingly resorted to workers from outside Europe, with work permits being issued for the entire quota of 100,000 workers approved for 2022.

Moreover, the low level of educational attainment of employees is another important vulnerability, Romania recording at end-2022 the smallest percentage of employees with tertiary education among EU Member States (24 percent, 14 percentage points below the EU average).

D. Climate risk remains important for the banking sector, with lending to climate-relevant (brown) sectors further accounting for about half of total corporate loans, whereas the volume of green financing to non-financial corporations stays low, cumulating around 4 percent of new loans May 2022 through March 2023[2]. In order to support the transition to a low-carbon economy, to ensure an environmentally-friendly growth pattern, the role of private financing is essential. To this end, credit institutions are faced with the opportunity to support non-financial corporations in the decarbonisation of their activity, given the strongly energy-intensive structure of the Romanian economy. Even though greenhouse gas emissions in Romania have declined further, reaching 41.2 percent of the 1990 level in 2020, sectoral developments are still highly heterogeneous.

1 According to NIS data, approximately 40 percent of permanent migrants and 53 percent of temporary ones during 2021 were aged between 20 and 40.

2 As of May 2022, the NBR started collecting information on green loans from banks, pursuant to NCMO Recommendation No. R/6/2021, which stipulates, *inter alia*, the introduction in the NBR's Central Credit Register of information on green loans, starting from the European taxonomy.

According to the assessments conducted by the European Insurance and Occupational Pensions Authority[3], the insurance sector in Romania is exposed to high risks of floods and earthquakes and exhibits a low degree of insurance penetration to cover these risks (26 percent and 29 percent respectively).

Special feature

The high degree of digitalisation in the past decades has also entailed changes in the global financial system and in payment system infrastructures, leading to the emergence of new payment and trading means. One of the components of financial digitalisation is the central bank digital currency (CBDC). The implementation of the CBDC is subject to thorough international debates as regards its effects on the financial system and the real economy. The challenges related to the introduction of the CBDC include: (i) amending the legal framework in place for the recognition of the CBDC statute; (ii) developing an infrastructure to ensure easy and safe CBDC access and use, *inter alia* by minimising cyber-risks and, last but not least, (iii) solving issues regarding the safety and confidentiality of personal data, by complying with democratic principles and values.

[3] *Dashboard on insurance protection gap for natural catastrophes*, January 2023.