

# THE NATIONAL BANK OF ROMANIA'S ROLE IN ENSURING THE MACRO-STABILITY AND THE PRUDENTIALITY OF THE BANKING SYSTEM

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## **Abstract:**

*The central bank, a cast plate of the banking system, aims to design and implement the monetary, exchange and credit policy, regulating and prudentially supervising the banking system and the payment system, having as ultimate objective to ensure and maintain price and financial stability. By writing this paper we attempt to approach a topical and scientific interest subject in the financial-monetary area, namely the National Bank of Romania's role in ensuring banking macro-stability and prudentiality. The purpose of the present research is to provide a qualitative analysis of policies and measures implemented by the National Bank of Romania, as the central bank and especially as the supervisory authority in the current economic context.*

**Key words:** The National Bank of Romania, macro-stability, prudentiality, the banking system, policies and measures

**JEL classification:** E58, G21

## **1. INTRODUCTION**

The research of the role of the central bank hold an important place in many economic analyses, especially in emerging economies. The present study synthesizes in a personal vision, having as a starting point the previous research made by academicians and experienced specialists who provide a significant amount of information, sometimes in contradictory tones, pursuing the combination of theoretical analysis with data of the actual evolution from the Romanian banking system.

The economic and financial turmoil of the past decade have caused much debate and criticism regarding the position of the central bank, contesting this status and even proposing the dissolution of the monetary authority. In the current economic context, there are various reasons to support the central bank's independent status, given that it represents an important safety measurement against the inflationist side-slip, especially when the phenomenon overlaps with other financial imbalances that have severe macroeconomic consequences.

Writing this paper, we aimed to highlight the role of the National Bank of Romania (NBR) in maintaining the viability and efficiency of the banking system, and hence the economic system as a whole.

The rest of the paper is organized as follows: section 2 contains a brief description of the specialty literature; Section 3 presents the National Bank of Romania's intervention through monetary policy to ensure financial macro-stability; Section 4 describes the National Bank of Romania's policy on ensuring prudentiality in the banking activity, while Section 5 concludes by pointing out the main aspects that the present study captures.

## **2. LITERATURE REVIEW**

Various studies in the literature highlight the intrinsic role of the National Bank of Romania in ensuring macro-stability and banking prudentiality, given the responsibilities resulting from its double position of monetary and prudential authority.

According to the NBR statute, the central bank's primary objective is to ensure and maintain price stability, and the main task is the development and implementation of monetary policy. Both specialty and practice literature prove that the ultimate goal of monetary policy can be achieved by using certain monetary policy strategy. Since 2005, the NBR has started implementing a new monetary policy strategy, that is, inflation targeting.

Reducing inflation in recent years has been the result of a mix of economic policies favorable to disinflation accompanied by a restrictive monetary and fiscal policy and an almost neutral budgetary policy. The monetary policy was characterized mainly by high interest rates, high rates of minimum reserves and the currency appreciation (Pop, 2011). The economic literature highlights that in modern economies, achieving a low and stable inflation level led to the creation of a new economic climate that requires rigorous reconsideration of the relationship between price stability and financial stability (Borio and Shin, 2007).

In the paper *Compared banking systems*, Cristi Spulbăr and Mihai Nițoi (2012) highlight another essential role incumbent the central bank, together with its primary objective of ensuring price stability, namely to ensure financial macro-stability. Over the last years, ensuring the financial stability has become particularly important, given both the expansion and liberalization of financial systems and the incidence of financial crises or the exogenous shocks followed by particularly high national and international negative consequences. The recent financial crisis has highlighted once again, the insufficiency of the established supervision arrangements (monetary and prudential regulation) and imposed supplementing this framework with a macroprudential approach in order to monitor connections between financial and macroeconomic stability.

In the context of the recent economic and financial crisis, the NBR applied a countercyclical policy using all the tools at its disposal. In order to counteract the procyclical attitudes, strategies and decisions of the commercial banks, and also the risks occurring in the economy, the NBR adopted a countercyclical attitude, both in terms of the boom phase and the recession phase. This attitude was applied on both the monetary and prudential policy. In terms of prudential measures, the NBR resorted to several controversial decisions, aiming to reduce the systemic risk produced by high dynamics of credit for households. On the same countercyclical principle, the NBR operated on the prudential framework in recession to give more resources to the economy (Isărescu, 2011).

Regarding the administrative measures to limit the lending introduced by the NBR during the last years, Gheorghe Manolescu (2009) states that they could become ineffective on the long term. The author supports his point of view on the experiences of other countries where administrative measures to limit lending have failed to adjust macroeconomic imbalances. Skepticism is justified by the fact that although on a short-term, the administrative measures have an impact on controlling the aggregate demand, on the long term we must implement control solutions of the aggregate demand to focus more on using the traditional macroeconomic policies such as the fiscal policy, the budgetary policy and the monetary policy.

On the other hand, based on the positive argumentation for the NBR intervention, Adrian Vasilescu (2011) argues that in the face of the impetuous trends of lending the National Bank intervened with effective mandatory regulations in the long term, because nothing would be more dangerous for the country's financial stability than the population's overindebtedness. The goal was to protect those who borrow from a possible insolvency. In the opinion of the adviser of the BNR Governor, during the boom years, the Central Bank of Romania – attracting the discontent among the population, the banks, and even of some political circles - has managed to stop to a large extent the ingress in our banking system of financial innovations which would prove to be toxic. The National Bank's option was for a rational regulation based on the good European practices, but without being oppressive.

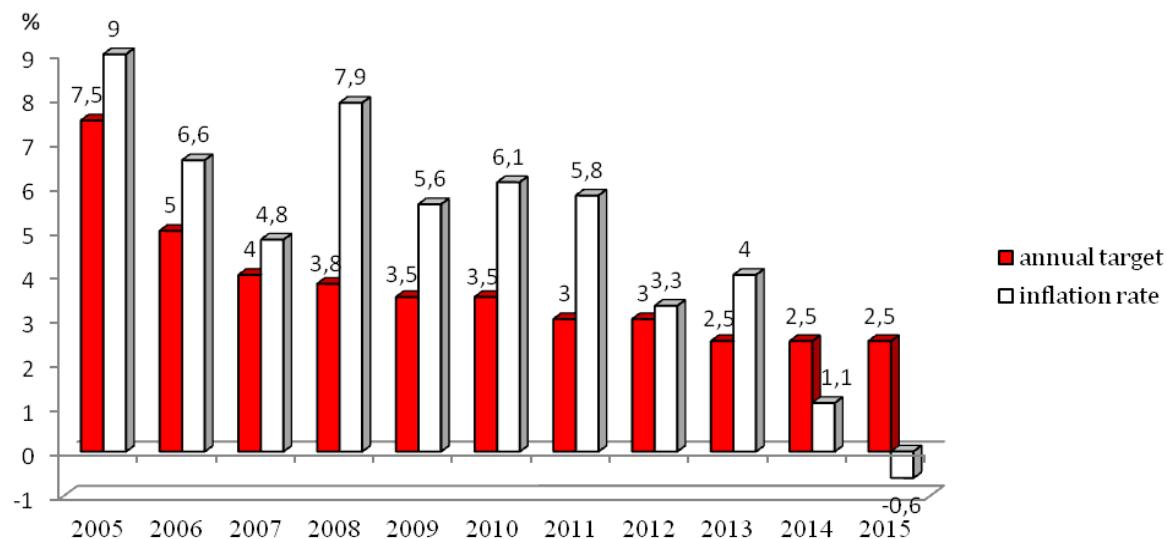
The Central bank governor believes that some criticisms were justified, but often it has become apparent a misunderstanding of the role of the National Bank as an institution of the banking system supervision. Although the causes of the difficulties experienced by the banks in recent years have been many and complex, first of all they were not able to get detached from the drifting general economic climate, the criticisms were directed only to the central bank.

According to the economist Lucian Croitoru (2012), paradoxically, the recent financial crisis has led to the questioning of the activity of central banks, although these institutions were the last bastion of defense against the danger of a collapse in the economy and international flows. He advocates for a more proactive attitude and involvement of the central bank, but without exaggerating the role and capacity of the central bank to solve alone or almost alone, the problems the entire economy is facing. It requires cooperation and involvement of all institutions and national structures in order to implement the mix of policies and programs necessary for consistent and sustainable resumption of the economic growth.

### 3. NBR INTERVENTION BY MONETARY POLICIES AND FINANCIAL MACRO-STABILITY

The overall objective of the NBR is represented by the resumption and consolidation of the disinflation process in the pace assumed by reaching the annual inflation targets and also the inflation target in the medium term. It derives, on the one hand, from the commitments made by the state authorities by signing programmatic documents elaborated in the preparation process of adopting the euro as well as by the agreements with the European Union, the International Monetary Fund and other international financial institutions and, on the other hand, from the particularities of the macroeconomic and financial environment within which the monetary policy has been implemented.

According to the figure no. 1, starting from 2005 the annual inflation targets dropped from  $7.5\% \pm 1$  percentage point to  $2.5\% \pm 1$  percentage point; the targets listed above were determined by the monetary authorities and the government, including in terms of the requirement to achieve, according to the schedule set for the adoption of the euro coin of an inflation rate level compatible with the criteria of the Maastricht Treaty, but also the quantitative definition of price stability adopted by the European Central Bank (ECB). Regarding the inflation rate, it has been characterized by an oscillating trajectory, the year 2015 being marked as a negative territory.

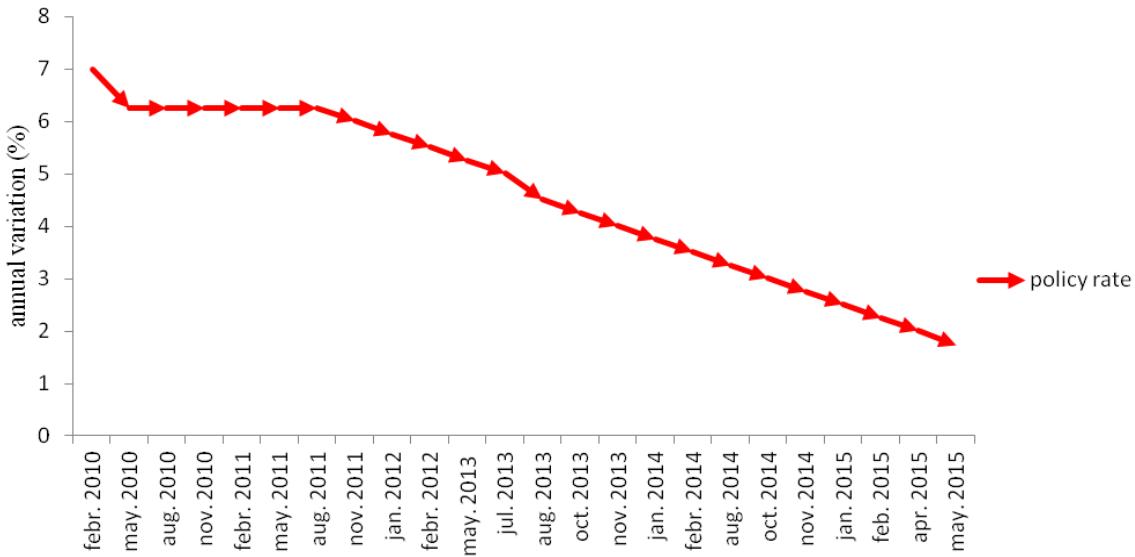


**Figure 1. The evolution of the inflation rate between 2005-2015**

Source: processed after the data from the National Bank of Romania

In the current economic context, printing the prudence that is appropriate for the monetary policy priority was achieved mainly by preserving the status quo of the monetary policy rate and by limiting to 0.25 percentage points of the cuts sequentially operated on it since May 2010, except the decision in August 2013, when the pace of reduction in this rate was increased to 0.5 points liquidities and communication actions and detailed explanation of the reasons for the decisions taken by the Board of NBR. Within this, the NBR has repeatedly stressed that the consistent implementation of an appropriate mix of macroeconomic policies in line with the provisions of the

new preventive external financing agreement concluded with international institutions is likely to strengthen the stability and prospects for the Romanian economy growth and thus strengthen its resilience towards the external shocks. The actions taken by the central bank as well as the permanent adequacy of the monetary policy prudence, in the context of continuing fiscal consolidation, were determined to achieve in December 2013 the lowest annual rate of inflation over the last 24 years, while recording the whole year a growth of 3.5 percent.



**Figure 2. The NBR policy rate between 2010-2015**

Source: processed after the data from the National Bank of Romania

The decisions to maintain the monetary policy interest rate at 5.25 percent for 16 months (March 2012 to June 2013), adopted by the Board of the NBR, were motivated by the increase at the beginning of 2013 of the annual inflation rate gap as opposed to the upper limit of the stationary target interval and of the perspective of prolonging on a very short-term of its significant value, under the impact of new administered prices adjustments and excise increases made in January 2012.

During 2015, the central bank continued to use actively and in a flexible way the monetary policy operational framework components. According to the legislation, the main instruments used by the NBR are: the money market operations, the permanent facilities extended to credit institutions and the minimum reserves.

The most important monetary policy instrument is represented by the money market operations, also known as open market operations. At the initiative of the central bank, they are meant to guide interest rates, manage open market liquidity conditions and signal monetary policy stance. Between 1997-2008, the use of open market operations was mainly aimed to drain liquidity excess from the banking system. From the last quarter of 2008 to the second quarter of 2010, NBR was located in the position of net creditor of the banking system and open market operations destined for the liquidity injections have become predominant given the net position of liquidity deficit of the banks.

In relation to the monetary policy guidelines practiced by the NBR, its implementation will be carried further in the context of inflation targeting strategy and will remain oriented towards achieving the set targets and to ensure price stability in the medium term, in order to achieve sustainable economic growth. In the long term, the monetary policy implemented by the NBR aims to reduce annual inflation towards levels consistent with the ECB's criteria.

From this perspective, NBR considered an essential change on the inflation targeting strategy. This significant orientation was the overcoming of the annual target steps, gradually decreasing and adopting a multi-annual stationary targets inflation of  $2.5\% \pm 1$  percentage points from 2013.

Also, NBR has sought to continue adapting the minimum reserve requirements to the current and future internal macroeconomic conditions, measure that attenuates its restrictiveness by removing the constraints imposed by the specific legal framework regarding the extension of the initial maturity of liabilities to credit institutions. This step represents a new one in the process of harmonization of the minimum reserve requirements with the European standards.

Given the main risks and uncertainties arising from internal and external current macroeconomic context, the monetary policy implemented by the National Bank of Romania keeps its prudence. However, an effective and sustainable configuration of the monetary policy remains strongly conditioned by the rigorous implementation of fiscal consolidation measures and structural reforms and to respect the commitments entered into with international financial institutions, in order to avoid an increase in the sovereign risk premium, inflation strengthening and sustainable recovery of the Romanian economy.

#### 4. NBR POLICY CONCERNING THE PRUDENTIALITY IN THE BANKING ACTIVITY

Romania joining the European Union determined Romanian banks to enter into direct competition with the foreign ones, the market players facing a genuine competition. The increasingly close competition from the Romanian banking system, privatization of the banking sector and the foreign capital inflows have turned our country into one of the main arenas facing renowned world-class players.

Table no. 1 illustrates the evolution of the Romanian banking system composition on the form of ownership during 2006-2014. Although credit institutions of the Romanian banking market have worked in an environment of austerity and uncertainty, the banking system structure has not suffered significant changes, the total number oscillating between 39 and 40 during the analyzed period.

**Table 1. The structure of the Romanian banking system between 2006-2014**

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Banks, Romanian legal entities, of which:	31	31	32	31	32	32	31	30	30
Fully or majority state-owned capital	2	2	2	2	2	2	2	2	2
Majority private capital, of which:	29	29	30	29	30	30	29	28	28
– with majority domestic capital	3	3	3	4	4	4	3	3	3
– with majority foreign capita	26	26	27	25	26	26	26	25	25
Foreign bank branches	7	10	10	10	9	8	8	9	9
Total banks and foreign bank branches	38	41	42	21	41	40	39	39	39
CREDITCOOP	1	1	1	1	1	1	1	1	1
Total credit institutions	39	42	43	42	42	41	40	40	40

Source: processed after the NBR Annual Reports 2007-2014

The appropriate level of the main indicators of the banking prudence allowed the banking sector to meet without major difficulties, the volatility of external capital flows, the increase of non-performing volume of loans and the need to optimize loan portfolios in preparation for the Basel III implementation. The asset quality problems persisted during 2013 and the external contagion was one of the risks to which the Romanian banks were exposed. The process of deleveraging manifested in the euro area countries led to a decrease in an orderly manner, of the exposure of parent banks to their subsidiaries in Romania, producing changes of the characteristics in the domestic banking system, especially in terms of volume and trend of external funding. Thus, Romanian banks have focused on non-performing exposures management solutions and less on resumption of lending in sustainable conditions.

During 2007-2014, the Romanian banking system continued to have substantial capital reserves, the proper degree for capitalization being also supported by prudential regulation and supervision measures adopted by the central bank.

**Table 2. The evolution of the main prudential indicators (%)**

Indicators	Dec. 2007	Dec. 2008	Dec. 2009	Dec. 2010	Dec. 2011	Dec. 2012	Dec. 2013	Dec. 2014
<i>Capital adequacy</i>								
Solvency ratio	13,78	13,76	14,67	15,02	14,87	14,94	15,46	17,59
Leverage ratio	7,32	8,13	7,55	8,11	8,07	8,02	7,96	7,38
<i>Asset quality</i>								
Loans to customers (gross) / Total assets (gross)	59,09	62,05	59,13	58,64	59,24	60,78	58,63	56,18
Interbank loans and investments (gross) / Total assets (gross)	29,98	26,01	23,03	19,58	16,90	14,74	16,24	15,95
Credit risk ratio	4,0	6,52	15,29	20,82	23,28	29,91	32,14	:
Non-performing loan ratio	-	-	7,89	11,85	14,33	18,24	21,87	:
<i>Liquidity</i>								
Liquidity ratio	2,13	2,47	1,38	1,35	1,36	1,57	1,68	1,69
Immediate liquidity	38,70	34,43	35,28	37,82	37,17	35,88	41,49	41,08
<i>Profitability</i>								
ROA (Net income / Total assets, average)	1,01	1,56	0,25	-0,16	-0,23	-0,64	0,01	-1,32
ROE (Net income / Total equity, average)	9,43	17,04	2,89	-1,73	-2,56	-5,92	0,13	-12,45

Note: ":" – not available

Source: processed after the NBR Annual Reports 2008-2014

Thus, according to table no. 2, the solvency ratio was, on average, well above the regulated step at a national and European level (8%) and above the prudential one (10%) recommended by the National Bank of Romania together with the internal emergence of the international economic and financial crisis effects (17.59% at the end of 2014, increasing 2.13 percentage points from the previous year). The leverage effect, calculated as a ratio between level 1 personal funds and the average value of assets was 7.38% (December 2014), observing a slight decrease (0.58 percentage points) compared to December 2013.

In the context of the credit stock contraction and of the constraints imposed by the customers' financial condition, the key indicators in assessing the quality of the portfolio registered a degradation. Thus, the rate of the non-performing loans - the main indicator in assessing the quality of the portfolio from a prudential perspective - continued to rise to a level of 21.87 percent at the end of 2013.

According to the evolution of the indicators in assessing the liquidity risk, the banking sector continued to benefit from an adequate liquidity, their level indicating the existence of reserves to cover any imbalances that may arise as a result of early withdrawal of resources. Maintaining adequate levels of liquidity is, moreover, a prerequisite so that the current banking sector to have a good ability to cope with adverse developments, including external ones.

After three years of recording financial losses, the Romanian banking system managed to improve its profitability during 2013, achieving positive financial results. Reviewing the financial result among the positive values has generated the placement slightly above zero of the main indicators of profitability at an aggregate level (financial rate of return - ROE and economic rate of return - ROA).

An important step in restructuring the Romanian banking system that was based on strengthening prudential supervision exercised by the National Bank of Romania, represents the legislative modifications and amendments regulating banking activity. Therefore, we have hardened the demand on the authorization of managers, directors and shareholders of commercial banks, there were established the legal bases for the cooperation relations between the NBR and the national and international supervisory authorities, they were aligned to international standards, the provisions governing consumer protection and improving procedures change occurred in bankruptcy and in the protection of depositors.

The on-site supervision has experienced significant changes since 1999, every credit institution being included in the supervision process at least once a year. The work of the off-site

supervisory activity experienced quality changes, NBR introducing in 1999 a bank rating uniform and early warning system (CAAMPL), instrument that was continuously augmented and improved in order to determine the risk profile of credit institutions.

Also, because lately, the non banking financial institutions have imposed increasingly on the Romanian financial market, the supervision and regulation area of the central bank was extended to them as well.

## 5. CONCLUSIONS

By writing this paper it was aimed to highlight the role of the National Bank of Romania in maintaining the viability and efficiency of the banking system, and hence the economic system as a whole.

Over the last decade, the central bank imposed a countercyclical policy, using all the tools at its disposal. In order to counteract the procyclical attitudes, strategies and decisions of the commercial banks, and also the risks occurring in the economy, the NBR adopted a countercyclical attitude, both in terms of the boom phase and the recession phase. This attitude was applied on both the monetary and prudential policy.

We consider particularly important to continue the implementation in the Romanian banking system of some appropriate measures to strengthen the capital bases, which would mainly focus on the recapitalization process to maintain its solidity and thus prepare the ground for the adoption of the new Basel III macro-prudential regulatory framework.

Also, based on the performed analysis, a particular significance has the need for more effective regulation in all areas, starting with rethinking the market structures and the risk management. The central bank requires, in one form or another, increased regulation and supervision prerogatives that would aim prudentiality both at a micro level and, especially, at the macro level.

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