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Romanian Financial System Reform

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ROMANIAN FINANCIAL SYSTEM REFORM

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by

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I. INTRODUCTION

The Romanian economy is in its first decade of transition from a centrally-planned economy to a free-market economy. Its financial system is currently "mixed," with nascent capital markets, privately-owned brokerage houses, largely state-owned domestic banks and insurance companies, and branches and subsidiaries of foreign banks and insurance companies. At the same time, the actual level of financial intermediation is low, with bank lending only 25% of GDP. Given the current political situation, with a reformist government in place and the ongoing assistance of international financial institutions, this is an appropriate time to reassess the design of the financial system. The question is: what steps should the Romanian government take to reform its financial system and guide its future evolution?

This is an important question because a large body of research has shown that financial sector growth is positively correlated with an increase in economic growth over long periods of time (see De Gregorio and Guidotti (1995), King and Levine (1992, 1993a, 1993b), and Johnston and Pazarbasioglu (1995)). Moreover, Levine and Zervos (1995) show that both the banking sector and equity market variables make significant independent contributions to GDP growth, and Johnston and Pazar's (1995) results demonstrate the crucial importance of having a sound, well-regulated financial system in order to foster growth. Thus, taking steps to reduce financial system fragility is important for sustained economic growth.

Schwartz (1995) defines *financial fragility* as a state in which "the ability of the financial system to withstand economic shocks is weak." This implies that fragility will result in failure. Commercial banks are generally viewed as the most fragile and the most important of all financial institutions. Thus, the majority of the space in this report is devoted to banking.

Over the last few months, we have been researching the Romanian financial system in order to prepare a set of reform recommendations. Our study has focused on two main questions:

- *What are the key problems at present that Romanian financial system reform should address?*

- *What specific action steps are needed to address these problems and achieve the desired financial system reform?*

Our key findings and conclusions on these two questions are as follows:

- *The major problems facing the Romanian financial system at present are inadequate restructuring of and weak corporate governance in both enterprises and banks, a lack of an appropriate credit culture, poor credit skills, legal and regulatory ambiguities, weak banking supervision, and missing markets and institutions.*

- The process of restructuring and privatizing the industrial (real) sector has yet to be completed. Since 1991, state-owned enterprises have been subsidized through negative real interest rates, government-guaranteed bank loans and administratively determined prices. (The interest rate subsidies were stopped in 1994, although they occasionally reappeared in 1997. See Daianu (1996)). There is weak corporate governance in both state-owned and newly-privatized enterprises. This has profound implications for Romanian banks as well as capital markets, as the credit qualities of bank loan portfolios are worsened and capital market growth is retarded.

- Banks have only minimally changed the structure of their loan portfolios and have continued to roll over loans to traditional clients (see Perotti (1996) and Croitoru (1997)). Even though bank balance sheets look healthy in book value terms, this is partly because banks have been reluctant to extend credit in 1997, choosing to focus on fee income rather than interest rate income. In part, banks have behaved this way due to a shrinking economy, worsening repayment behavior on the part of borrowers and corruption. A moral hazard problem resulting from past bailouts is apparent as the banks anticipate further resolutions of loans extended to old clients with government guarantees. The current reluctance to extend new credit is in sharp contrast to 1995-96 when there was extensive lending. The proportion of credit (as well as overdue credits) accounted for by the emerging private sector increased during this time.

- Privatization is a necessary first step to improving bank performance, but conflicting attitudes about the role of banks in the Romanian economy, the cost of restructuring large banks with extensive branch networks, and current management's desire to remain entrenched even after privatization will act as impediments to *effective* privatization. The existing privatization plan has serious flaws and is unlikely to be successful without significant modification. In the meantime, increasing globalization of financial services means that Romania cannot contemplate remaining isolated from international banking.

- The Romanian legal system is both incomplete and inconsistent, with ambiguities that impede the ability of banks to collect their debts and the ability of the Central Bank to close financially-troubled banks. Both the independence and the credibility of the Central Bank are put to question as a result.

- Bank regulation is plagued by lack of clarity and weak supervision. Central Bank supervisors focus too much on accounts rather than risks, and have an inadequate understanding of international banking. At the same time, banks are subject to intervention by several other government bodies, including the fiscal authorities and the Court of Accounts, in a way which seriously distorts their lending behavior.

■ *Our major recommendations for reform are as follows*:

- Implement effective bank privatization and remove impediments to foreign ownership. In light of the Chilean experience, we are particularly concerned about "effective" bank privatization. We suggest numerous steps that can be taken to increase the interest of significant foreign banks and thereby improve post-privatization bank performance.

- Although outside the scope of financial sector reform, both macroeconomic stability and improvements in corporate governance, management skills and capitalization in the industrial sector are necessary for the ultimate success of such reform. Indeed, we strongly believe that unless the industrial sector is reformed *simultaneously* with the financial sector, it is very likely that financial sector reform, no matter how well-thought-out, will fail. Privatization of state-owned enterprises is a good start, but may not be enough. There should be more of an emphasis on selling at least the large state-owned enterprises to foreign multinational corporations who can put in place their own managers. Where this is not possible, there should be an attempt to sell large ownership blocks to foreign institutional investors who would exert the desired corporate control on managers and ensure that the enterprise is managed competently. Moreover, there should also be a focus on improving the net worth positions of firms in the industrial sector. This depends in an important way on a macroeconomic policy that leads to stable and sustainable growth.

- If the EU model of universal banking is fully adopted in Romania, a great deal of care will have to be taken to ensure that problems of internal governance, conflicts of interests and misallocation of risk capital do not become serious impediments to successful development of basic commercial banking functions.

- Improve the legal environment, bank regulation and supervision. Although prudential bank regulation in Romania is well *designed*, problems with implementation remain. We suggest specific initiatives that deal with bank closure policy, capital requirements, deposit insurance, and on-site supervision.

- Focus on creating missing markets and institutions. For example, we suggest the creation of a government or quasi-government agency to facilitate mortgage securitization, providing appropriate incentives for internationally-renowned bond rating agencies and brokerage houses to participate more actively in the Romanian capital markets, and strengthening the role of the Romanian National Securities Commission in enforcing stricter information disclosure requirements on the securities exchanges.

We cannot overemphasize the urgency or the importance of these reform initiatives for Romania. A recent empirical study by Demirgüc-Kunt and Detragiache

(1997) found that systemic banking crises are most likely to erupt in economies with the following attributes:

- a weak macroeconomic environment, especially with low growth and high inflation;
- high real interest rates;
- vulnerability to balance-of-payments crises;
- weak institutions; and
- weak law enforcement.

Many, if not all, of these factors are present in the Romanian economy as well. Expeditious implementation of reform initiatives is an imperative that cannot be ignored.

This report is divided into five remaining sections. In Section II we describe the present state of the Romanian financial system so as to provide a backdrop against which to examine our reform proposals. We provide some fast facts about the economy and the financial system, describe the real (industrial) sector, summarize key facts about banks and bank regulation, explain how privatization works in Romania, and discuss the salient features of Romanian capital markets and its insurance industry. Section III contains an analysis of the major problems in financial sector reform. Section IV contains our reform recommendations. Section V concludes.

II. THE PRESENT STATE OF THE ROMANIAN FINANCIAL SYSTEM

In this section we briefly describe the present state of the Romanian economy with special focus on its financial system. Our objective is to provide an assessment of the current situation so as to have a proper backdrop against which to examine our proposals for financial system reform. The section is divided into six subsections: (A) Fast Facts About the Romanian Economy and its Financial System, (B) The Real Sector, (C) Banking and Bank Regulation, (D) Bank Privatization, (E) Securities Markets, and (F) Insurance.

A. Fast Facts About the Romanian Economy and its Financial System

The Romanian economy has undergone important political and economic changes since 1989 when the country began the transition from a centrally-planned Communist system to a democratic political system with free markets and private ownership. The transition has been somewhat slow and has been fraught with both

economic failures and recurring lapses of determination to forge ahead full steam and rapidly to transform the economy. While the outlook has brightened significantly of late, with the formation of a new pro-market government as a result of the November 1996 general elections, we believe that the Romanian economy is still in a precarious condition.

Romania has numerous advantages. A country of about 23 million people, it is rich in natural resources and situated strategically in the geographic heart of Europe. It has a fairly large potential market, an educated workforce, and a liberal government that seems to be seriously committed to a largely privatized economy in which large foreign multinationals play a significant role.

Table 1 displays basic macroeconomic indicators for 1991 to 1996. On several fronts, progress has been made and creates a favorable environment for ongoing reforms. Real GDP growth has turned around from -12.9% in 1991 to 4.1% in 1996. In 1991, the private sector accounted for only 24% of GDP; this had grown to 50% by 1996.

TABLE 1

Basic Macroeconomic Indicators
(in percentages)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*
Real GDP growth rate	-12.9	-8.7	1.5	3.9	7.1	4.1
Inflation rate (annual ave.)	161.1	210.4	256.1	136.7	32.3	38.8
Unempl. rate (end of period)	2.4	7.4	9.5	9.5	7.4	6.1
Share of private sector in GDP	24	26	35	39	45	50
Share of agric. in GDP	18.9	19	21	20.1	19.9	19.1

Sources: World Bank, EBRD

However, there are also numerous structural and attitudinal impediments to reform. ***On the structural front:***

- Inflation in 1997 has been high and volatile, running at 14 to 31% per month in February and March, and falling to 3.5% in August. The annual inflation forecast for 1997 is about 130%.

- Unemployment is about 7%, and would be a lot higher were it not for the fact that over 70% of all assets in the economy are still state-owned, and many of these state-owned businesses are bloated with excess labor. As more of the economy becomes controlled by the private sector, this number could rise to 14%. Moreover, approximately 80% of funding for the private sector in Romania comes from state-owned banks. None of the previously-state-owned banks had been privatized at the time of writing this report, although five had been identified for privatization. State-owned banks often face political pressures when it comes to calling back loans.

- The agricultural sector is significant, accounting for 20% of the GDP. Farmers receive *interest rate* subsidies, and the reform/elimination of this subsidy structure is politically constrained. Another key problematic sector is energy. Both the agricultural and energy sectors expose *other* sectors to risks as well. For example, Banca Agricola is exposed significantly to agricultural risks and Bancorex to energy risks; both banks have serious financial problems.

- The legal system is creaky and biased very heavily in favor of borrowers. Moreover, issues related to the legal authority of the Central Bank to close problem banks have yet to be resolved.

- There are missing sectors in the economy. For example, there was a "Pyramid Scheme" type mutual fund crisis about two years ago that led to large investor losses, and consequently, the establishment of the mutual fund industry has been impeded. There is no pension fund industry and no leasing to speak of. There is virtually no mortgage market. Insurance is currently less than 1% of GDP.

- There are also missing institutions within existing industries. For example, the absence of significant venture capital means that small companies, which generally lack access to bank financing, are starved for capital. This impedes the development of vibrant small firms and diminishes the *adaptive* ability of the economy to respond to shocks, increasing its fragility.

- The present French-based accounting system used in Romania lacks transparency.

- The high inflation rate invites firms to speculate in raw materials inventories. In 1996-97, inventories accounted for 12% of GDP, with raw materials inventories representing almost 60% of all inventories. Firms also possess little liquidity and use

very high financial leverage, largely due to the limited supply of equity capital needed to build net worth. This low capitalization (high leverage) makes firms very vulnerable when inflation is high. Moreover, the poor capitalization of privatized and emerging private enterprises affects the quality of bank portfolios as well as the dynamics of the interactions between banks and borrowers.

On the attitudinal front, some of the impediments are:

- There seems to be a widespread belief that privatization of state-owned enterprises by itself will attenuate the many ills of the past. However, the real problems in Romania are poor corporate governance and lack of borrower net worth, and these problems have not been adequately addressed by the mass privatization program.

- There is a lack of general understanding of business ethics and the meaning of contractual obligations. A senior executive in a major foreign bank told us, "Signing a contract in Romania merely seems to be a license to carry on negotiating."

- There are also conflicting opinions among people about the role and objective function of banks. Not everybody believes that the main goal of (private) banks should be to maximize value for the bank's shareholders. There are many who believe that banks should also view the serving of social needs and government industrial priorities as important goals.

- Romania is among Europe's poorest countries. According to a 1994 World Bank estimate, 22% of the population lived below the poverty line in 1994, and there has not been much improvement since then. Average annual after-tax wages are a little over $990, and the average pension is only 60% of that. This means that the government will be constantly pressed to meet the social needs of the poor, and the view that banks and the newly-privatized enterprises have a responsibility to help the government meet this social agenda may continue to frustrate economic reform.

- Differences of opinion between the Central Bank and the Ministry of Finance have led to political compromises that are not necessarily in the best interest of banking reform.

B. The Real Industrial Sector

Early reform of the enterprise sector consisted of a nominal change in the ownership of enterprises, with no real effect on governance. Most Romanian enterprises were transformed into so-called "commercial companies" in 1990. In 1991, their ownership was temporarily transferred to the newly created state ownership fund (SOF) and several private ownership funds (POFs) in anticipation of privatization. While the SOF was required to privatize 10% of its holdings every year, in fact privatization was carried out more slowly. By the end of 1996, only 25% of the commercial companies were privatized, accounting for 15-20% of the shares owned by

the SOF. Of these companies, 68% were privatized through a program of management-employee buyout (MEBO).

This new ownership structure was ineffective in assisting with real enterprise restructuring. Managers felt little accountability, and in the face of an irrational price structure and recession, clung to their pre-existing commercial relationships. This contributed to the spiraling problem of inter-enterprise debt, which the Romanians call "financial blockage." Fears that financial instability would spread to the banking sector, along with disappointing results of privatization, led the government to bail out loss-making enterprises several times and ultimately to get directly involved in corporate restructuring. The largest loss-making state-owned enterprises (SOEs) in the metallurgical, chemical and machine-building sectors were put into a surveillance program in 1993 intended to isolate them from the rest of the economy while assisting with reorganization and restructuring. Recent empirical work on this program shows that its objectives were not met (Djankov and Ilayperuma (1997) and Croitoru (1997)). A majority of the "dirty thirty" companies were neither restructured nor privatized.

The reformist government of Prime Minister Ciorbea has laid ambitious new plans for privatization of the real sector. In response to the failure of direct government intervention with the financial isolation program, the new plan calls for rapid privatization without advance restructuring. By law, the SOF is required to help identify at least 50 companies per week for privatization. Until now, a significant impediment to privatization has been the valuation of companies. There is a feeling that many state-owned enterprises were sold in the past at artificially low prices. A new law enacted in March 1997 governs the prices at which state-owned enterprises can be sold. Clearly, this is going to be more of an issue if privatization involves selling to a foreign company than to Romanian citizens. However, selling to foreign multinationals will not be easy. Most state-owned companies are worth less (in economic value terms) than their book values. With the valuation sensitivity being heightened in potential transactions with foreign buyers, management buyouts and sales to Romanian citizens are more likely than purchases by foreign companies. If this continues, the goal of reforming corporate governance through privatization will remain elusive.

C. Banking and Bank Regulation

Romania's pre-reform banking system consisted of the National Bank of Romania (NBR), which played the role of both central and commercial bank, and specialized banks for investment, foreign trade, agriculture and savings. A two-tier banking system was created in 1991, when the commercial banking activities of the NBR were hived off into the new Romanian Commercial Bank. The remaining specialized banks were not reconfigured, and Romania's banking sector remains dominated by the five state-owned banks which initially had complete monopoly power in their respective sectors. Two significant new pieces of bank legislation, the Law on Banking Activity (Law #33/1991) and the Law regarding the statute of the NBR (Law #34/1991), were enacted in 1991 in order to have consistency with EU banking directives. Currently, three new draft laws on Banks and Banking Activity, Bank Insolvency and NBR Governing Statutes are being discussed in Parliament.

Along with most other state-owned enterprises, the Romanian state-owned banks were turned into joint-stock companies, and in 1991 70% of their shares were transferred to a newly established State Ownership Fund and 6% to each of five Private Ownership Funds which held the shares in the name of Romanian citizens. Simultaneously, new banks entered the market in response to relatively liberal licensing requirements and foreign banks were allowed to establish operations on an equal basis with domestic banks. While Romanian banks are universal in their scope of activities according to the legal framework set up in 1991, securities laws passed in 1994 prohibit banks from conducting brokerage activities.

Table 2 summarizes the current structure of the Romanian banking sector. Almost 75% of total assets remain in the five original state-owned banks, which consist of the Romanian Commercial Bank (RCB), the Romanian Development Bank (former Investment Bank), Bancorex (former foreign trade bank), Agricola Bank (former agricultural bank) and the Romanian Savings Bank. Remaining assets are divided among 23 private domestic banks, two newly established state-owned banks - BancPost and Eximbank, nine branches of foreign banks and five representative offices.

TABLE 2

Major State-Owned Banks in the Romanian Banking Sector
1996

	Banca Agricola	Romanian Commercial Bank	Bancorex	Romanian Development Bank	Savings Bank	Total
Bank credit to non-gov as % of total	20.1	18.8	29.1	7.6	0.3	75.9
Lei Deposits as % of total	18.3	21.3	14.4	8.9	15.4	78.3
Foreign Exchange	2.2	20.6	27.1	8.9	0	58.8
Number of employees	na	10,625	2,500	3,614	12,716	
Number of branches	na	116	23	187	2,438	

Sources: Romanian Financial Almanac1996, World Bank

Table 3 shows the aggregated balance sheet of Romanian commercial banks. In contrast to other Central European economies, there has been little crowding out of enterprise borrowing by the government, though this may change as the government bond market develops. As expected for a transition economy, the majority of lending has consistently been of short duration. Credit to private enterprise, on the other hand, has risen from 8% of total non-government credit in lei in 1992 to 43% in 1996. The liability structure of the banks has improved somewhat, with a growing share of client deposits and own capital.

Aggregate Balance Sheets of Romanian Commercial Banks, 1992-96, December values, in mln. US dollars

	1992	1993	1994	1995	1996
ASSETS	8,700.11	7,714.31	11,553.55	12,583.46	13,910.23
FOREIGN ASSETS	840.50	1,028.07	1,554.03	1,318.37	1,624.33
Convertible currencies	789.73	1,006.80	1,551.10	1,315.61	1,621.81
Non-convertible currencies	50.77	21.27	2.92	2.76	2.52
DOMESTIC ASSETS	7,859.61	6,686.24	9,999.52	11,265.08	12,285.89
National currency holdings	106.12	59.01	111.58	74.04	128.80
Domestic credit	4,589.05	4,153.63	5,698.22	7,103.30	8,007.56
Credit to non-government	4,158.20	3,841.68	5,367.59	6,375.25	6,652.15
as % of total domestic credit	**90.6%**	**92.5%**	**94.2%**	**89.8%**	**83.1%**
In lei	3,693.09	3,182.04	4,207.51	4,490.01	4,199.00
Short-term credit	3,119.77	2,877.64	3,909.57	3,987.27	3,508.36
as % of credit to non-government in lei	**84.5%**	**90.4%**	**92.9%**	**88.8%**	**83.6%**
Current credit	2,900.53	2,762.60	3,601.18	3,374.20	2,956.15
Economic agents					
majority state capital	2,668.81	2,323.35	2,976.12	2,491.32	1,768.10
majority private capital	215.25	390.18	567.60	809.99	1,118.83
Households	9.47	34.76	41.98	57.04	49.55
Other	7.01	14.30	15.48	15.85	19.67
Ovedue credit	219.24	115.05	308.39	613.07	552.21
Economic agents					
majority state capital	204.00	87.28	200.87	327.71	263.78
majority private capital	12.95	24.80	98.32	276.65	281.09
Households	0.70	2.76	5.25	7.53	6.89
Other	1.59	0.21	3.96	1.18	0.45
Medium and long term credit	573.32	304.39	297.93	502.74	690.64
as % of credit to non-government in lei	**15.5%**	**9.6%**	**7.1%**	**11.2%**	**16.4%**
Current credit	563.21	297.28	278.66	449.98	506.04
Economic agents					
majority state capital	372.04	151.79	96.83	102.51	92.08
majority private capital	78.42	86.03	114.03	244.44	264.35
Households	111.62	57.26	63.62	86.83	130.77
Other	1.12	2.20	4.18	16.20	18.84

Ovedue credit	10.12	7.12	19.28	52.76	184.60
Economic agents	0.00	0.00	0.00	0.00	0.00
majority state capital	8.39	4.49	3.72	19.67	55.17
majority private capital	1.43	2.07	14.48	31.92	126.41
Households	0.28	0.55	1.03	1.13	1.65
Other	0.01	0.01	0.05	0.03	1.38
Total credit to majority-state-capital econ. agents	3,253.23	2,566.91	3,277.54	2,941.20	2,179.12
as % of credit to non-government in lei	**88.1%**	**80.7%**	**77.9%**	**65.5%**	**51.9%**
Total credit to majority-private-capital econ. agents	308.05	503.07	794.43	1,363.01	1,790.69
as % of credit to non-government in lei	**8.3%**	**15.8%**	**18.9%**	**30.4%**	**42.6%**
Total overdue credit	229.35	122.16	327.67	665.83	736.81
as % of credit to non-government in lei	**6.2%**	**3.8%**	**7.8%**	**14.8%**	**17.5%**
Convertible currencies credit	465.11	659.64	1,160.08	1,885.24	2,453.15
Current	450.95	618.12	1,107.12	1,683.66	2,213.38
Overdue	14.16	41.52	52.96	201.57	239.77
Frozen	0.00	0.00	0.00	0.00	0.00
Credit to government	430.85	311.95	330.63	728.06	1,355.41
as % of total domestic credit	**9.4%**	**7.5%**	**5.8%**	**10.2%**	**16.9%**
In transit account payable to depositors	0.48	1.01	10.86	15.97	11.81
Interbanking assets	2,257.17	1,813.71	2,430.80	2,156.38	1,645.86
Other assets	906.79	658.88	1,748.06	1,915.39	2,491.86
LIABILITIES	8,700.11	7,714.31	11,553.55	12,583.46	13,910.23
FOREIGN LIABILITIES	524.79	560.30	686.55	798.93	1,238.02
Short term	354.80	362.37	281.33	221.11	615.59
Convertible currencies	345.86	354.60	272.81	211.92	604.10
Lei deposits of other non-residents	3.78	3.22	5.71	6.23	9.06
Non-convertible currencies	5.17	4.55	2.81	2.96	2.43
Medium and long term	169.98	197.93	405.22	577.82	622.43
Convertible currencies	169.98	197.92	405.22	577.82	622.43

Non-convertible currencies	0.00	0.02	0.00	0.00	0.00
DOMESTIC LIABILITIES	8,175.32	7,154.01	10,867.00	11,784.52	12,672.21
Non-banking clients deposits	3,140.50	2,683.10	4,780.37	5,630.30	6,179.25
as % of domestic liabilities	**38.4%**	**37.5%**	**44.0%**	**47.8%**	**48.8%**
Demand deposits	1,340.83	926.79	1,320.00	1,287.83	1,430.49
Economic agents	0.00	0.00	0.00	0.00	0.00
majority state capital	527.02	319.42	445.48	429.83	519.34
majority private capital	359.75	301.16	470.48	568.90	635.11
Households	18.28	34.09	103.53	108.69	125.00
Limited cheques	247.94	143.31	165.14	64.68	50.44
Other	187.83	128.81	135.37	115.73	100.60
Households deposits	889.59	506.10	1,543.64	1,992.41	2,182.93
Demand	181.26	91.48	203.35	192.37	195.60
Time	708.33	414.62	1,340.28	1,800.04	1,987.33
Deposits in lei	187.95	234.19	582.20	747.27	809.79
Time	89.00	136.06	276.92	366.25	469.25
Restricted	93.87	87.43	231.18	228.69	163.11
CDs	5.08	10.70	74.10	152.33	177.43
Convertible currencies deposits	722.12	1,016.02	1,334.53	1,602.81	1,756.04
Demand deposits	622.94	826.77	917.87	1,070.76	1,122.38
Economic agents	0.00	0.00	0.00	0.00	0.00
majority state capital	356.40	383.31	273.15	354.39	305.82
majority private capital	149.75	249.64	358.81	359.72	407.67
Households	116.54	167.16	212.65	258.32	290.28
Other	0.25	26.66	73.26	98.33	118.61
Time deposits	99.18	163.28	264.10	336.07	485.56
Economic agents	0.00	0.00	0.00	0.00	0.00
majority state capital	53.87	89.17	99.00	70.03	40.40
majority private capital	20.40	35.93	64.98	75.60	159.83
Households	24.88	37.14	40.54	101.70	176.85
Other	0.03	1.04	59.58	88.74	108.48
Restricted	0.00	25.96	152.56	195.97	148.10
Non-convertible currencies deposits	0.00	0.00	0.00	0.00	0.00
In transit accounts payable to depositors	336.78	123.27	109.25	114.95	140.54
Interbanking liabilities	2,151.30	2,176.65	2,548.10	2,788.13	2,810.92

as % of domestic liabilities	**26.3%**	30.4%	**23.4%**	**23.7%**	**22.2%**
Public deposits	777.41	693.90	737.37	703.63	555.24
as % of domestic liabilities	**9.5%**	9.7%	**6.8%**	**6.0%**	**4.4%**
Capital accounts (own funds)	563.38	444.90	757.17	1,514.13	1,278.66
as % of domestic liabilities	**6.9%**	**6.2%**	**7.0%**	**12.8%**	**10.1%**
Other liabilities	1,205.96	1,032.19	1,934.73	1,033.39	1,707.61

Source: National Bank of Romania

The state-owned banks have gone through several recapitalizations, starting in 1991. These are summarized in several papers, including Tsantis (1996) and Croitoru (1997). While the banking sector appears fairly stable right now, banks have taken advantage of inflation and profitable foreign exchange markets, as well as liberal refinancing by the NBR, to generate profits from fee income rather than interest income. Overdue credit has risen from 6% of non-government credit in lei in 1992 to 18% in 1996, and given the lack of real sector restructuring, this figure is likely to understate the bad loan problem. In addition, banks have not aggressively restructured their portfolios. Bank lending accounts for a mere 25% of GDP.

The continued dominance of the state-owned banks can be explained by several factors, including their large branch networks and established client relationships. However, these banks are neither the most efficient nor the most profitable of the Romanian banks. While their market positions are secure in their traditional areas of business, profit opportunities are concentrated in other areas, including export industries, foreign exchange and, more recently, government bond markets. In these profitable activities, both new private and foreign banks are successfully competing with the state-owned banks.

The National Bank of Romania (NBR) is accountable to the Romanian legislature. The Governor and the Board of Directors of the NBR are appointed by the Prime Minister and Parliament for renewable 8-year terms. The responsibilities of the NBR are to: (i) conduct monetary policy, (ii) supervise banks, and (iii) act as a lender of last resort. The NBR has its licensing standards for banks, and the objective is to ensure quality in banking rather than to limit competition.

Selected *key bank regulations* in Romania are discussed below.

- **Minimum Capital Requirements:**

The minimum capital requirement is Lei 50 billion, roughly $6 million, for a Romanian bank to commence operations; this is below the minimum required in the EU. Beyond that, there are risk-weighted capital requirements in the spirit of the Basle guidelines. Different asset risk categories are established for on-balance sheet items and off-balance sheet items (such as standby letters of credit) are also classified into different risk groups for capital computation purposes. The minimum capital requirement is 8% of risk-weighted assets. Currently, almost all Romanian banks are above this 8% minimum. However, there is some discussion that this requirement could be raised to 12%.

- **Prudential Regulations:**

The design of prudential regulations in Romania is quite good. Its key elements are:

- A loan to a single borrower cannot exceed 20% of the bank's capital and reserves.
- Total loans to insiders cannot exceed 20% of a bank's capital and reserves.
- Investments by banks in non-banking companies cannot exceed 20% of the capital of the non-banking company.
- Open foreign exchange (forex) positions by the bank cannot exceed 10% of the bank's capital and reserves.
- Ownership of a bank by a non-bank exceeding 5% of the bank's capital must be approved by the NBR.
- Specific rules exist for loan classifications (e.g. standard, watch, substandard, doubtful, and loss) and provisioning (loss reserves).

- **Payments System:**

A new net multilateral clearing system was established in April 1995. This has led to lower float and duration of interbank payments.

- **Deposit Insurance:**

A May/June 1996 law has made deposit insurance mandatory for banks. The only two banks currently not in the system are the two ailing banks (Dacia Felix and Credit Bank). Some of the key facts about deposit insurance are as follows:

- Deposit insurance coverage is available only to individuals, not corporations.
- The deposit insurance coverage ceiling was raised to Lei 20 million in August 1997 per depositor per bank. The ceiling is indexed to the CPI and adjusted twice a year.
- The deposit insurance fund is currently financed by banks, but it is a public law fund. The financing of the fund comes from initial contributions by banks (0.1% of the social capital of the bank) plus an annual premium. The annual premium is 0.3% of all deposits, but the fund may ask for an additional "special contribution" if there is a deficiency in the fund. Thus, the minimum effective premium is 0.3% and the maximum effective premium is 0.9%.
- The deposit insurance fund is managed by a 7-member board with three members from the NBR, two from banking associations, and one each from the ministries of Finance and Justice.
- The fund is *not* involved in the reorganization of an insolvent bank in which depositors have to be paid off by the fund; the fund is merely responsible for making the necessary payouts. There is currently no provision in the banking

laws to address the question of institutional responsibility for reorganizing a failed bank, and the expectation is that the courts will do the reorganization.

- **Reserve Requirements:**

For both individual and corporate deposit accounts, minimum reserves equal to 10% of Lei deposits must be held as deposits with the NBR. The requirement is 20% for dollar deposits.

- **Bank Supervision:**
  - The NBR relies on both *off-site* and *on-site* supervision of banks. Off-site supervision consists of reports submitted by banks on solvency ratios, balance sheet accounts, forex deposits, sizes of the largest loans, and loan classifications and provisioning for losses.
  - The use of on-site inspections by the NBR of both state-owned and private banks is growing. There is now a *Manual of Supervision* for on-site supervision that can be used by bank examiners.
  - The NBR is in the process of developing a *central credit risk register* that will provide banks with information about the *total* level of indebtedness of their borrowers, thereby facilitating improved credit risk management by banks.

- **Bank Closure:**

There are two ways a bank can be closed in Romania: (i) by the NBR, subject to approval by the shareholders, in which case it is called an *administrative liquidation*, or (ii) by a judge, in which case it is called a *judicial liquidation*. Recently, the NBR's attempt to close two failed banks, Dacia Felix and Credit Bank, was thwarted by the courts who effectively overruled the NBR's decision.[1] However, a special law is in the works that will soon empower the NBR to close banks without the risk of being overruled by the courts.

- **Main Problems in Bank Supervision:**

(1) On-site supervision needs to be considerably strengthened.

(2) The NBR need to have increased enforcement powers. In particular, there are no effective intermediate sanctions to address problems in bank behavior in advance of license withdrawal.

(3) The founders of the bank have voting rights that are disproportionately large relative to those of other shareholders. This works against corporate governance and increases the burden put on regulatory supervision to resolve issues arising

[1] In part this was because the NBR initially sought judicial liquidation rather than administrative liquidation, for political reasons. Once court proceedings began, the NBR was powerless to invoke administrative liquidation.

from failures of corporate governance. For example, 80% of the loans at the financially-troubled Dacia Felix and Credit Bank were to insiders (executives and large shareholders) and had huge concentration risk.

(4) Many of the banks we interviewed felt that the NBR supervisors were ill-equipped to supervise a modern banking system with international transactions. The NBR supervision is viewed as focusing on *accounts* rather than *risks*.

(5) State-owned banks are under the authority of the Court of Accounts as well as the Central Bank, distorting the incentive structure of individual bank employees who fear prosecution from government officials who are not familiar with banking practices.

D. Bank Privatization

In 1997, the Romanian parliament approved Law #83 for privatizing the financial services industry. The state-owned banks had been turned into joint stock companies in 1991 along with all other enterprises, but they had not been offered for sale by the SOF. All legislation regarding privatization was prepared by the National Agency for Privatization, which is subordinate to the office of the Prime Minister. As of 1997, the SOF itself also answers to the Prime Minister.

The new law calls for mandatory privatization of state-owned banks, with the likely exception of Eximbank. Ownership is open to foreigners as well as Romanians. While no single company is allowed to acquire more than 20% of an individual bank's shares, "internationally reputed" companies designated as such by the NBR are exempt from this limitation. Individuals seeking to purchase more than 5% of a bank's share must also get NBR approval.

Both government representatives and bank managers seem to welcome the idea of significant participation by strategic foreign investors and the EBRD. There is a clear recognition that access to foreign capital, technology and reputation is critical to the restructuring of Romanian banks. With the exception of Bank Agricola, which is undergoing a recapitalization and restructuring program put together with the help of the World Bank, none of the banks will undergo either financial or organizational restructuring prior to privatization.

For each transaction, a seven member privatization commission is to be appointed by the government, with representatives from the SOF, the NBR and the Privatization Agency. The commission will make almost all decisions about the process of privatization. Early problems with bank privatization have already arisen, since the number of restrictions placed on Commission members in an effort to avoid conflicts of interest has led to a dearth of qualified candidates. In the existing law, members of the Commission are prohibited from working in the banking sector in any managerial or supervisory position for three years. The commission will appoint a financial advisor to write a financial report and feasibility study for each sale.

The SOF itself will propose the new shareholder structure to the government, and the Prime Minister's office will give final approval for the sale of each bank. Privatization can occur either through an increase of share capital or by selling SOF shares. However, another potential obstacle to the privatization process is likely to arise from the government's plan to maintain a golden share, giving it the right to appoint a representative to the Board of Directors, and the right to veto all Board decisions regarding the pledge of real assets, merger or dissolution of the bank. Revenue from the sale of the bank will go to the government budget. Recapitalization of the bank will thus occur primarily through new share issue.

The timetable for bank privatization is very ambitious. The government is under obligation to the World Bank to have most of the banking sector in private hands as soon as possible, with a minimum of two banks privatized by 1999. The SOF itself is scheduled to be disbanded by the end of 1998, with a possible 6 month extension. There is a general consensus in the financial sector that bank privatization is unlikely to proceed as rapidly as currently scheduled.

The goals of bank privatization have not been fully articulated or prioritized by the government, but several objectives were frequently mentioned during interviews with government officials (in no particular order):

(1) Attract international financial institutions.

(2) Minimize the acquisition of control of newly-privatized banks by other state-owned banks, and limit concentration of ownership in Romanian hands.

(3) Privatize fast.

(4) Focus on post-privatization economic effects.

(5) Ensure a fair price in the sale.

(6) Raise revenue for the government.

The goals of state bank managers are somewhat different, and can be summarized as follows:

(1) Maintain managerial independence (from both the state and private owners) through a diffused ownership structure.

(2) Acquire financial, human and reputational capital, and technology, from strategic foreign investors (without giving the investor a controlling share).

The Romanian Development Bank (RDB) is slated as the first bank to be privatized, and Bankpost the second. As the bank which originally dealt with long term investment financing, RDB did not get any enterprise current accounts and thus was able to choose at least some if its clients at the time of its creation. It is thus in a relatively good financial position, with 17% capital adequacy and a conservative loan portfolio. Credit Commercial and Deloitte and Touche lead the consortium which is putting together a valuation and feasibility study for the sale of the bank. The SOF will

then conduct a tender to choose an investment bank to execute the privatization. This process is supposed to be completed in a 6-9 month time period.

In our opinion, bank privatization is faced with the following major problems:

- The government has unrealistic expectations about attracting strategic foreign investors. The state-owned banks have a significant bad loan problem, the full extent of which is uncertain in the absence of real sector restructuring, and no apparent franchise value apart from their branch networks. While the Romanian market is significant and attractive to foreign financial institutions, they may choose to enter this market in ways other than purchase of a state-owned bank, e.g. purchase of a private bank or using a bank acquired elsewhere in Central Europe as a base of operations.

- The government has multiple, and even conflicting, objectives in privatizing the banks. At the same time, communication about the value offered by bank privatization to both foreign investors and the domestic economy has not been very effective.

- Strategic foreign investors are wary of the huge capital cost of reorganizing banks with hundreds of branches, as well as the high political cost of closing branches and laying off both entrenched management and redundant labor. The retention of a golden share by the state exacerbates this problem, leading to a perception that some political issues surrounding the purchase of banks by foreigners remain unresolved.

- There is a mismatch between the goals of the government and of bank managers. In particular, the government has no clear plan for ensuring effective corporate governance in newly-privatized banks.

- Attitudes of managers within state-owned banks are *not* conducive to effective and rapid privatization. Most of them see privatization as a way to gain access to new technology and capital *without* having to give up control. They have a great desire to have multiple "strategic partners", i.e., a lot of *different* foreign investors, including agencies like the European Bank for Reconstruction and Development (EBRD). This would mean diffusion of ownership among these strategic partners, and consequently, a smaller loss of control by existing management. It is unlikely that a major privately-owned international financial institution would be interested in playing the game by these (implicit) rules.

- Legislation is in a state of flux and there is a lack of coherent legislation. This creates a climate of uncertainty and raises the perceived risk on the part of foreign investors.

E. Securities Markets

The securities markets in Romania consist primarily of two markets where corporate equities are traded: The Bucharest Stock Exchange (BVB) and an over-the-counter market called RASDAQ which was set up with USAID help and is patterned after NASDAQ. There is no corporate bond market, and the government (Treasury) bond market is in the process of being established.

The BVB, which was established with the help of Canadian advisors, is the older of the two equities markets, and is an exchange that has an order-driven system. It has about 60 stocks listed at present, of which 8 are 1st-tier (blue chip) companies and the rest are 2nd-tier. The turnover per trading session is Lei 20 billion. The exchange has two strategic priorities at present:

- developing indices, with one index for the 1st-tier companies and one overall index;
- encouraging more companies to list on the exchange.

About 60% of the total money invested in the BVB is foreign capital (mutual funds and other financial institutions).

By law, every state-owned company that privatizes is required to list on RASDAQ. Thus, RASDAQ has over 3000 companies that are listed. The turnover per trading session is Lei 35 billion. RASDAQ has a quote-driven system.

Both the BVB and RASDAQ are supervised and regulated by the *National Securities Commission* (NSC). The NSC is an autonomous public body appointed by the Romanian Parliament which elects the five members of the NSC. The commodities exchange is currently unregulated, but under a new law, the NSC will regulate all spot and derivatives (options and futures) transactions, including commodities.

In our opinion, the following are the challenges facing Romanian capital markets:

- There is competition between the BVB and RASDAQ, and it is distorting the strategies of these two institutions. In particular, the RASDAQ's listing requirements, by the very mandate of its charter, are relatively minimal. Moreover, its information disclosure requirements are also fairly lax. The BVB, in order to compete with the RASDAQ for listings, has fairly lax disclosure requirements as well, even though there is recognition in the BVB that its comparative advantage over the RASDAQ lies in the greater price transparency it offers investors, and this calls for *more stringent* disclosure requirements. Moreover, the BVB has fairly minimal listing requirements because one of its primary objectives is growth.
- Many firms do not understand the benefits of listing on a stock exchange. They do not use the capital market to raise capital since they rely on bank debt for external financing. However, since the availability of bank credit has been limited in 1997, the reluctance of firms to use the stock market as a

viable alternative source of funds is puzzling. Nonetheless, it appears that firms view information disclosure in the capital market as imposing a cost on them without any associated benefits. This makes the BVB's task of obtaining the necessary information disclosure more difficult.

- There is an insufficient number of real blue chip companies available for listing on either the RASDAQ or the BVB. This makes it almost impossible for any exchange to satisfy the dual goals of growth in listings and stringent listing requirements.

F. Insurance

This market was started in 1991. Although there are 53 insurance companies in Romania, the market is dominated by the largest player, a state-owned insurance company named *Asirom* which has 270 branches and over 50% of the insurance premium business in Romania. Asirom offers third-party automobile liability insurance, automobile collision insurance, life insurance, and property and casualty insurance.

The insurance industry in Romania is a relatively small fraction of the country's GDP, although it is growing. Moreover, the market is very incomplete. There is virtually *no health insurance,* although Asirom plans to offer this in the future. There is *no mortgage insurance,* and even though life insurance is offered, the total premium inflow from this business is very small.

Insurance companies are supervised and regulated by a body that resides in the Ministry of Finance. Banks are allowed to offer insurance products and many (e.g. Bancorex) do. However, they are limited in this business to 20% of their capital. An important issue is the manner in which the regulation of banks in non-banking activities like insurance and securities-market brokerage will be conducted. Will the regulation evolve to be *functional* or *institutional*? There is currently a proposal by the NBR that *all* activities of banks be regulated by the NBR. However, the NSC and the insurance regulator feel that bank regulation should be functional, so that bank brokerage activities, for example, should be regulated by the NSC.

Some of the major challenges facing the Romanian insurance industry are as follows:

- The existing insurance law is outdated[2] and lacks clarity. This has discouraged strategic foreign investors from participating more actively in the Romanian insurance industry. Although some foreign companies such as AIG and Canadian Capital have their representatives in Romania, their overall participation in the market is small. The Romanian Parliament is currently discussing a new law dealing with insurance regulation and supervision.
- The current market has tapped into only 10% of the potential market. All the existing players are competing for this 10%. Missing or underdeveloped markets

[2] The thresholds established by this law are antiquated due to currency depreciation, inflation, and other developments in the economy.

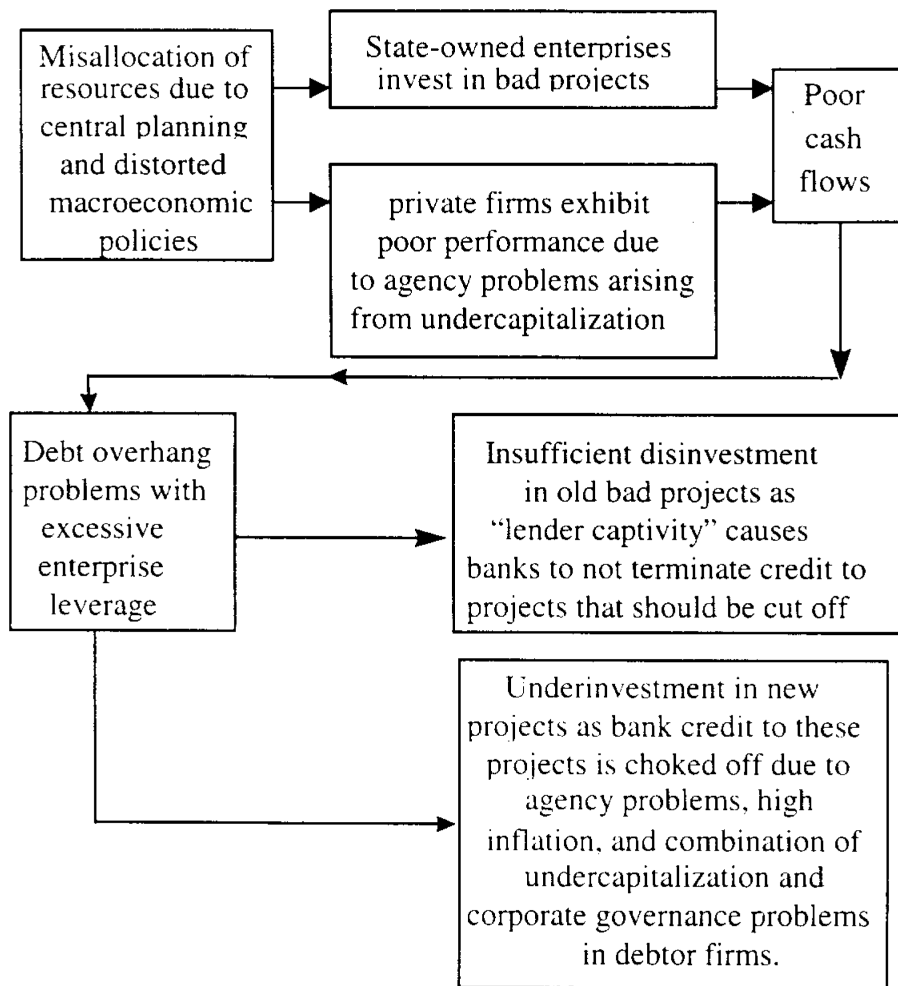
such as those for life, health and mortgage insurance as well as corporate insurance may fail to emerge quickly due to gaps elsewhere in the economy. For example, it is unlikely that there will be a significant demand for life insurance until per capita incomes rise significantly. Similarly, the growth of mortgage insurance is likely to be frustrated by the absence of liquidity in the residential mortgage market and the lack of an effective reinsurance market for mortgage insurance.

- The duties and responsibilities of the supervisory body regulating insurance companies need to be more clearly defined. Perhaps this body needs to be accountable directly to the Romanian Parliament rather than to the government. This may help to provide a clearer legal framework for foreign investors.
- Romanian insurance companies are undercapitalized and have information systems problems as well as facility constraints. This will impede the development of new products and the opening of new markets.
- There have to be greater investments in ports, highways, buildings and other infrastructure to stimulate the growth of the insurance industry. Such investments expose the firms involved in building the infrastructure to risks that must then be insured. Moreover, the employment generated by the building of infrastructure elevates individual incomes for workers and creates a demand for various sorts of insurance at the individual level.

III. ANAYLSIS OF MAJOR PROBLEMS IN FINANCIAL SECTOR REFORM

The most pressing problems arising from the current state of the Romanian economy are summarized in the figure below.

Figure 1: **Major Problems in Banking**



This figure suggests a perverse feedback loop. Poor performance by state-owned enterprises and private firms in the real sector has spillover effects into banking, leading to deterioration in the credit qualities of bank portfolios. Lack of experience and talent in the loan workout departments of banks, in combination with political pressures brought to bear on banks by state-owned borrowers, causes a continuation of credit availability to projects that should be terminated. To make matters worse, there is a

rising share of overdue credits from the new private sector. This insufficient disinvestment in bad projects by banks has two perverse effects. First, it *reinforces* the fundamental lack of project investment discipline in both state-owned and private enterprises, and perpetuates inefficient capital management in the real sector. Second, it siphons off the credit that should have gone to good new projects that now remain unfunded. The result is a lack of sustainable economic growth, and hence impeded growth in the financial services industry (capital markets and insurance, for example) as well. For example, there was a spurt of economic growth in 1995-96, but it could not be sustained.

We can summarize *the main problems in the financial services industry* in Romania as follows:

- There is weak corporate governance in *both* the state-owned and the newly-privatized enterprises in the real sector of the Romanian economy. Privatization has resulted in mostly diffused ownership of these enterprises by individual citizens who represent a highly fragmented ownership block with neither the will nor the monitoring skills to ensure effective corporate governance. The *managers* of these former state-owned enterprises are still, by and large, the same people who were running these enterprises *before* privatization. Little has happened to change either their skills or their incentives. Without improved corporate governance, many of the agency problems that existed in state-owned companies exist in the privatized companies as well.

  Another problem is that most enterprises (including private) are under-capitalized. It is well known that this leads to higher agency costs of debt (see Jensen and Meckling (1976)) and invites borrowers to behave in ways that increase the lender's credit risk. For example, borrowers may increase their business risk by investing in riskier projects, speculating in raw materials inventories, etc. or they may expend insufficient effort to improve cash flows or their managers may consume excessive perquisites. A good example of this is what happened to the thrift industry in the U.S. in the 1980s. Most savings and loan associations had very low net worths, and many blatantly exploited the federal deposit insurance system by significantly increasing their risks.

  Hence, the combination of macroeconomic instability, debt-related agency problems, and weak corporate governance in the real sector has profound implications for banks as well as capital markets. For banks it means greater credit analysis and post-lending monitoring responsibilities as well as elevated credit risk. For the capital markets, it means less activity since managers who are used to weak corporate governance and lax shareholder monitoring are unlikely to expose themselves to heightened shareholder scrutiny by directly accessing the capital market. Thus, weak corporate governance and the associated managerial inefficiencies in the real sector lead to potential problems in banking and also retard the growth of capital markets.

- Corporate governance in the current state-owned Romanian banks is also weak, with a few exceptions. In most cases, current bank management is interested in very

diffused ownership after privatization. Much of the current focus of privatization is on *internal* teams suggesting restructuring measures to *current* management. Consequently, *real* restructuring initiatives in the state-owned banks have been few and far between. Many current bank managers think of restructuring as the acquisition of new technology, new investments, duty exemptions, new holidays, and government-sponsored subsidies, rather than cost cutting, layoffs, wage reductions and asset divestitures. State-owned banks believe that privatization is desirable mainly because it will bring in foreign capital and the "brand equity" of foreign institutions to help attract human capital and expertise.

- Most banks need to improve their risk management skills. Loan workout departments should be organized as separate entities within banks, with employees adequately trained. Fortunately, this is already beginning to happen. The *Romanian Commercial Bank* has a special workout division that was established with assistance from foreign advisers. Similarly, *Romanian Development Bank* has also set up a distinct workout group with the help of EC PHARE and European consultants.

- There are significant impediments to foreign bank participation in Romanian bank privatization. First, there is the "golden share" rule which empowers the SOF to veto decisions by the bank's board of directors that refer to a pledge of real assets or merger/dissolution that may not be in "national interests". For example, if Citicorp were to acquire the Romanian Development Bank, rename it Citibank and propose to close some branches, the SOF could veto this as being against Romania's national interests. The implied lack of control for the foreign acquirer has had a dampening effect on the enthusiasm of foreign banks for bidding for Romanian state-owned banks. Second, revenues from the sale of banks will accrue to the SOF and will *not* recapitalize the bank. Third, the lack of real restructuring in the state-owned banks means that any foreign bank that acquires a state-owned bank would have to lay off a considerable number of employees, close branches and set up new systems. This requires a huge capital investment on the part of the new owners and is likely to be politically sensitive, running the risk of invoking a SOF veto.

The overarching problem is that foreign banks view state-owned Romanian banks as having very little franchise value. The only tangible value is in the branch network because it is difficult to acquire real estate. To see an example of the unattractiveness of Romanian banks to foreign buyers, consider one of the foreign banks we interviewed. It has 13,000 employees worldwide devoted to emerging markets. It generates $2.4 billion in revenue every year. By contrast, if this bank were to acquire the Romanian Development Bank, it would inherit a workforce of 4,000 (a little less than 30% of its total workforce in emerging markets) for an added $70 million in revenue (a little over 2.5% of its current annual revenue in emerging markets). It is unclear why this bank's board of directors would accept such a ratio of revenue added to employees added.

- Credit skills and culture in state-owned banks are still weak. The lack of reliable product market prices (energy, grain, etc.) makes it difficult for banks to determine

credit risks and price them. Exacerbating this is the old relationships banks have with their state-owned borrowers and the political pressures often brought to bear on banks. For example, the agricultural bank, Agricola, has over 50% of its loan portfolio taken up by non-performing loans because the state failed to reimburse it for soft loans given to farmers.

It is difficult to ascertain the credit quality of even the so-called good loans. Many of them could be quite bad, given the overall poor quality of management in the borrowing enterprises and largely illiquid collateral. Moreover, as industrial restructuring continues under Romania's austerity package, there will be an increase in the number of borrowers who will be forced to liquidate and be unable to repay their loans in full. For example, Sorin Dimitru, Chairman of the SOF, recently announced that 222 enterprises had been identified as making sufficient losses that they were slated for liquidation. He added that at least five of these companies are large.

- Mortgage lending is virtually non-existent. One problem is that if the borrower defaults, the collateral may be worth little. The reason is that the buyers are mostly local homeowners and default by one homeowner is likely to have been triggered by a local calamity that affects everybody. This kind of systematic (nondiversifiable) risk limits banks' diversification opportunities, and the lack of mortgage securitization means the absence of a secondary market for banks to manage these risks.

- Bank regulation is ambiguous and too "paper-based". That is, there is too much focus on accounting documentation and on getting banks to micromanage the economy. Moreover, banks are subject to intervention by the Court of Accounts in ways that seriously distort their lending behavior. For example, rescheduling a loan may be considered a criminal offense because by rescheduling, the bank prevents the state from receiving penalties from the borrower.

- NBR Supervisors are inexperienced and inadequately trained, leading to lax supervision. This is evident in the poor quality of on-site inspections, as well as in a poor understanding of international banking. For example, supervisors questioned one of the international banks in Romania about the need for them to seek the approval of their London/New York office before making a loan in excess of $5 million. The supervisors' view was that if you had to do that, you were not really a Romanian bank.

IV. REFORM RECOMMENDATIONS

This section is organized in two parts. First, we provide overarching recommendations for Romanian financial system reform. Then we provide more detailed recommendations.

A. Overarching Recommendations

■ *Privatize banks effectively and remove impediments to foreign ownership.*

Effective bank privatization will improve corporate governance in banking and will also help to generate the creditor pressure necessary to upgrade the quality of management in formerly state-owned enterprises. However, for this to happen, it is essential for the banks to be sold to outstanding international banks. These international banks are unlikely to volunteer as buyers under the present conditions, so these conditions must change.

■ *Take steps to improve the net worth positions of firms in the industrial sector as well as corporate governance in these firms.*

Even if there is effective privatization in banking, problems in the industrial sector could leave banks with few firms that they would be interested in extending credit to. If banks are not lending to industrial firms, then there will be a continuation of the current state of affairs with banks lending to each other and investing in marketable securities.

■ *Carefully consider the range of issues and safeguards needed to effectively adapt the EU universal banking model to Romania.*

There are three issues in universal banking that are particularly relevant for Romania. First, what are the possible ramifications of expanding banking scope for the focus of reform efforts? Second, what kinds of internal corporate governance problems are likely to arise as a result of expanding banking scope? Third, what is the effect of bank ownership stakes in debtor firms on economic efficiency?

■ *Improve the legal environment, bank regulation and supervision.*

The ambiguities in the legal environment and in bank regulation result in confusion among the players in the economy, and also impede creative solutions to problems. Eliminating these ambiguities will also help to clarify the role of the NBR. This should facilitate improvement in the NBR's supervisory function.

■ *Focus on creating missing markets and institutions.*

There are numerous missing markets and institutions that retard the growth of banking and the capital markets. Some of these gaps will be eliminated over time if the earlier recommendations are implemented, but in other cases, regulatory/governmental intervention may be needed.

B. Detailed Recommendations

Here we discuss in detail each of the overarching recommendations from the previous subsection with supporting arguments from available research. Each of the major recommendations consists of smaller recommendations in some cases.

■ *Privatize Banks Effectively and Remove Impediments to Foreign Ownership*

Privatizing state-owned banks is a critical step in reform because it is necessary for improving corporate governance in banking. However, privatization must be done effectively, and for this to happen, large global banks must be induced to buy Romanian banks. While the Romanian government appears to welcome the participation of strategic foreign investors, major obstacles still exist: (1) the SOF golden share and the unwillingness to give foreign banks complete control, (2) the relatively inefficient state of the state-owned banks, and (3) the current mindset in Romania about the appropriate objective function for a bank. Our recommendations are as follows:

- Strategic foreign investors must be allowed to purchase a real controlling share (and up to 100%) in the state-owned banks. This implies either eliminating the SOF's golden share or structuring the sale of the bank so that the investor can be compensated if the government chooses to exercise its veto power. For example, the investor could be given the option of putting shares back to the government under certain conditions, forcing the government to internalize the cost of exercising unilateral control.

- The portfolios of the state-owned banks should be restructured prior to the sale of the banks, with re-capitalization being part of the privatization process in order to avoid the moral hazard problem associated with the expectation of future recaps. Insufficient re-capitalization has led to delays in several bank privatizations elsewhere in Central Europe, as in the case of both Magyar Kulkereskedelmi Bank and Budapest Bank in Hungary. It also led to the eventual re-nationalization of Agroprombank in Russia. Given severe budgetary constraints, some portion of the purchase price of the bank could be used for re-capitalization.

  To allow for organizational restructuring, the SOF could negotiate a memorandum of understanding with all significant new shareholders, and in particular with any strategic foreign investor, about the restructuring changes that will be made after the purchase. The investor will then be less nervous about political impediments to its ability to effectively engage in post-purchase restructuring of the bank, including completely replacing current management if necessary.

- Privatization of state-owned banks should be rapid, all else being equal, allowing for a more rapid realization of the potential franchise value of the

banks. The longer the privatization process drags out, the more likely that state-owned banks will lose their market share to private and foreign banks, making privatization more difficult and delaying the benefits of an efficient banking sector.

- The Privatization Commission for each privatization should produce and publicize a detailed protocol for the privatization transaction. This protocol should include a clear prioritization of government objectives, and a statement about the anticipated impact of the privatization on the bank. If there is one dominant new shareholder, this protocol can be written cooperatively. The intent here is to force the government to deal with conflicting objectives ex ante, to avoid ex post political problems for the new owners and to educate both politicians and public about the real expected outcome of bank privatization.

- In their capacity as lenders, foreign banks that buy Romanian banks should be able to have their representatives on the boards of directors of newly-privatized enterprises. This will improve corporate governance in those enterprises. As DeLong (1990) notes, the value of having a bank representative on the board of directors of the borrower can be quite substantial for the *borrower's shareholders.*

- While the price at which the state-owned bank is sold is obviously important for political as well as economic reasons, the potential economic benefits of privatization are even more important. The SOF should focus attention on the *strategic intent* of the foreign buyer as reflected in the commitment of financial and human capital the foreign bank is willing to make to Romanian banking, rather than exclusively on the revenue raised from bank sales (or the *immediate* impact on the state budget). There are many ways to judge this commitment. For example, the bank's strategic plans for the future could be examined.

The valuation-based question of how to price candidates for privatization does not have any easy answer. When a government sets a price for a state-owned company, it is trying to satisfy various constituencies: retail and institutional investors, taxpayers, the company's employees, and its managers. These interests usually conflict.

In Western Europe, there have recently been examples of two extremes. At one extreme is France, where prices have apparently been set too high. Since 1985, France has privatized a variety of state-owned companies from insurers to large manufacturers. However, shares sold in these companies have underperformed the Paris bourse,[3] and according to a Morgan Stanley estimate in 1996, an investor who had routinely invested in French privatizations since 1990 would have lost money (see *The*

[3] In the case of Renault, which was privatized in 1994, the underperformance the following two years has been to the tune of 41%.

Economist (1996)). This record has tarnished French privatizations in particular and European privatizations in general. Investors are especially wary now, making it difficult for countries like Romania to privatize at prices that may be politically attractive.

At the other extreme is the German privatization of Deutsche Telekom, Europe's largest privatization through 1996, whose shares experienced a 19% price increase in their first day of trading, implying that the price was low relative to the market's valuation. Is pricing low then necessarily the best solution? That depends on who the shares are sold to. If the shares are purchased almost exclusively by a large number of retail and institutional investors who will not be involved in running the company, the answer is not clear. As the British experience shows, in this case early buyers make a quick killing and exit, managers award themselves huge pay increases on the back of rising stock prices, and there is consequently a swelling tide of political opposition to future privatizations.

In Central Europe, the desire to obtain more attractive pricing has led to delays in several bank privatizations. In Poland, for example, privatization of both Wielkopolski Bank Kredytowy and Bank Slaski was delayed by a search for the "right price" (see Abarbanell and Bonin, (1997)). In Hungary, pricing issues have recently been addressed through innovations in the privatizations of both Magyar Kulkereskedelmi Bank and Budapest Bank. These include a performance-based price adjustment, and giving the investor the option to buy shares from or sell shares to the government depending on the performance of the bank in exchange for a relatively high share price (see Meyendorff and Snyder, (1997)).

There will clearly be a great deal of political sensitivity in Romania about the selling price. One way to deal with the political realities surrounding the populist sentiment on this issue and deal with the above-mentioned problems is to permit at least part of the purchase price paid by the foreign buyer to be used to *recapitalize* the purchased bank.[4] This serves two purposes. First, it reduces the effective purchase price, making the bank more attractive to a strategic foreign investor. Second, it ensures an infusion of fresh capital into Romanian banking and makes it easier for the bank to expand.

We understand that many in Romania will be opposed to this recommendation because it implies potentially selling the bank for less than it is worth. Isn't this like giving money away to foreigners? There are two ways to think about this. First, privatizing a state-owned enterprise is a lot like taking a privately-held firm public through an initial public offering (IPO). The buyer does not know as much about the firm as he would if the firm were publicly traded. Consequently, there is an "adverse selection premium" that the firm must pay by deliberately *underpricing* the IPO to ensure investor interest. There is considerable empirical evidence that IPOs are underpriced in just about every country in the world. Similarly, given the many

[4] Under current practice, all of the purchase price accrues to the SOF and none goes to recapitalize the bank.

uncertainties surrounding a state-owned bank that is being privatized, the government should be willing to pay the strategic foreign investor an adverse selection premium by deliberately underpricing the bank. Second, even though part of the proceeds of the sale are returned to the buyer to recapitalize the bank, this is *not* money just given away. The buyer would *not* be allowed to take this capital out of Romania. It would represent banking net worth *that stays within the Romanian financial system.*

Following the Hungarian example, political sensitivity about pricing can be dealt with through financial engineering. For example, a strategic foreign investor may be willing to pay a relatively high price in exchange for a performance-based price adjustment, or for the option to buy shares from or sell shares to the government depending on the post-privatization performance of the bank. In either of these examples, the government can benefit from good bank performance by retaining a non-voting share in the bank.

This is a critically important issue because a focus on the price rather than the quality of the buyer could result in *ineffective* privatization. For example, a bank like BCCI would probably be willing to pay a lot more for a Romanian bank than ABN-Amro would. We do not believe chasing the highest price would serve the Romanian economy well in this case.

■ *Improve Corporate Governance and Capitalization in the Industrial (Real) Sector*

While the issue of real sector reform is outside the scope of this paper, it must be recognized that reform of the financial and real sectors should be closely linked in order for either to be successful. For example, a new World Bank study shows that in many Central European countries, increased bank lending in the absence of enterprise privatization is associated with declines in productivity and profitability (see Pohl, Anderson et al., (1997)). For this reason, we include a brief discussion of the real sector reforms we feel are necessary for the success of the financial sector reforms proposed above.

It is now well recognized that a major problem in the emerging free-market economies of the former Communist countries is the widespread failure of enterprise debtors to make scheduled payments of principal and interest to creditors, as well as creditor passivity or lack of aggressiveness in pursuing their claims (see Mitchell (1993) and Begg and Portes (1993)). In Romania, this problem has manifested itself somewhat differently. Enterprise debtors have, in many instances, been repaying banks *but only by increasing their debts to the state budget.* Thus, examining bank balance sheets and income statements fails to reveal the full magnitude of the problems in the real sector of the Romanian economy. The effect on capital discipline and investment efficiency is the same, however. This effect is that managers in the borrowing firms do *not* behave as if enterprise budget constraints are binding. When this happens, the price mechanism loses much of its meaning. Just as importantly, as Begg and Portes (1993) suggest,

simply privatizing the real sector and the banking sector may *not* suffice to resolve this problem.

It is apparent that corporatization and privatization of Romanian state-owned enterprises has not resulted in desired improvements in corporate governance. In many instances, these enterprises are still being run by trade unions and managers who were in control prior to privatization. Private ownership is so diffuse as to be ineffective in monitoring and controlling management. As Jensen (1986) points out, failure of corporate governance leads to an abundance of agency problems and economic inefficiency.

These difficulties in the real sector engender numerous effects that spill over into the financial sector. Some of these are summarized below:

- Bank loan portfolios deteriorate in credit quality.

- Promising new investments get choked off as banks struggle to cleanse their loan portfolios and improve/maintain credit quality by limiting new credit availability. This sacrifices both growth in the real sector and growth in banking.

- Capital market growth is retarded. Because the managers in many privatized enterprises are relatively incompetent and very much used to weak corporate governance, they have no desire to raise capital in the most cost-effective manner, particularly if doing so means they must expose themselves to the harsh glare of capital market scrutiny. Consequently, Romanian capital markets are not being tapped for finance even by credit-starved firms that are unable to expand their credit availability from banks. This limits the growth of the capital markets. Moreover, without the threat of losing business to the capital market, banks face less pressure to lower funding costs for their. borrowers than they do in economies with greater market pressures. This means lower investments by banks in initiatives that focus on cost efficiencies and financial innovation.

The other difficulty in the industrial sector is that borrowers have inadequate net worths. Combined with informational problems, this can lead banks to ration credit to these borrowers (Stiglitz and Weiss (1981)). Dittus (1994) points out that this may well have been what happened in Czechoslovakia, Hungary and Poland in 1991 and 1992. Solving this problem in Romania will require numerous simultaneous steps. First, corporate governance and management skills in the industrial sector must be improved. Second, *macroeconomic policy should be stabilized in a way that improves the profit prospects of enterprises.* Greater government investments in infrastructure and eliminating distortive subsidies may be two ways to do this for some of these enterprises. Third, Romania could try creating support programs for small businesses such as those in Germany (Kerditanstalt für Wiederaufbau or KfW), the Czech Republic (Czech-Moravian Guarantee and Development Bank), or Hungary (the Credit Guarantee Corporation).

This is particularly important because the emergence of viable and vibrant small businesses could go a long way in creating an in-built adaptive ability in the economy to external shocks; small firms typically adapt better than large firms.

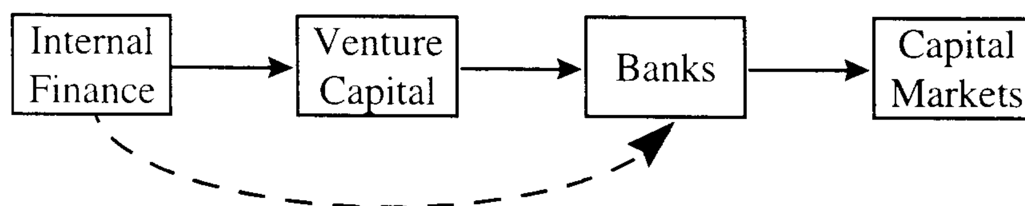
■ ***Carefully consider the range of issues and safeguards needed to effectively adapt the EU universal banking model to Romania.***

The Romanian Parliament is currently discussing an increase in the scope of permissible banking activities, including securities brokerage, that would move Romania closer to the EU universal banking model. As this transition occurs, particular care will have to be taken regarding three main issues.

First, what are the possible ramifications of expanding banking scope for the focus of reform efforts? Second, what kinds of internal governance problems are likely to arise as a result of expanding banking scope? Third, what is the effect of bank ownership stakes in debtor firms on economic efficiency?

- *Where do you focus reform attention?*: In most of the developed countries, borrowers typically follow the *credit life cycle* suggested by the following figure:

Figure 2: Typical Borrower Credit Life Cycle



In countries without a well-developed venture capital industry, borrowers begin with internal finance, then go to banks, and then finally begin to directly access the capital market. Unfortunately, it appears that at present in Romania, there is little internal finance, only an embryonic venture capital industry, and insufficient access to the capital market. This leaves borrowers with mainly bank credit. But their low net worth positions lead to agency problems that cause banks to ration credit to them. Economic growth is thus unsustainable.

The question is: should borrowers in developing countries like Romania follow the steps in *Figure 2* as the financial system develops? On both theoretical and institutional grounds, the answer is YES (see Boot and Thakor (1997a), Blommestein and Spencer (1996), Mayer (1989), Singh and Hamid (1992), and Repullo and Suarez (1995)). Contemporary research points strongly to the desirability of first developing an efficient banking sector and then concentrating on capital markets. The danger for an emerging financial system is that universal banking could create an unfocused agenda where

concerns about banks' securities activities could divert attention from basic commercial banking activities. Moreover, expanding banking scope also raises questions about being able to maintain an effective deposit-insurance safety net that can be confined to banking activities without having to cope with potentially porous Chinese Walls separating commercial banking from non-banking activities; see Kaufman (1996) for a discussion of the importance of an effective safety net for banks in emerging economies. Thus, expanding banking scope will place even greater demands on NBR supervisors who are already quite challenged by the existing banking issues in Romania.

There are many reasons why we should focus first on banking and only later on capital markets:

- Capital markets generally depend on well-functioning banks to provide key services (see Blommestein and Spencer (1996)).

- Banks are key providers of payment services and help to create the necessary liquidity for the capital markets (see Diamond (1996)). A well-functioning payments system greatly expands the opportunities for capital market trading.

- As experts in resolving a variety of borrower-related moral hazards through credit analysis and post-lending monitoring, efficient banks help to improve the overall credit quality of the borrower pool. This has two effects. First, those borrowers who still remain relatively high in credit risk tend to borrow *exclusively* from banks. And second, there are some borrowers who borrow both from banks and the capital market, but whose creditworthiness and *credit transparency* are improved by banks. Both effects serve to enhance the transparency and credit quality of the pool of borrowers who seek financing from the capital market. This improves the functioning of the capital market, encourages its growth, and lowers the cost of capital for a variety of borrowers (see Boot and Thakor (1997a)).

- Participation in the wholesale payments system gives banks privileged access to "good funds" from the central bank and allows banks to provide other financial and non-financial institutions with liquidity at short notice.

• *What internal governance issues does expanding banking scope raise?*: Greater scope in banking activities means that the actions of bank managers become more difficult to ascertain, possibly worsening corporate governance and making these institutions more opaque. In turn, investors may raise the cost of capital for banks to compensate for the greater opaqueness. In this environment, regulation has to become more sophisticated and regulatory supervision more intense.

In addition to potentially worsening corporate governance, expanded scope also increases the likelihood of conflicts of interest (e.g. if a borrower's

loan is overdue, the bank may underwrite the borrower's public debt issue to help repay the loan), and errors in allocating risk capital. The Barings fiasco as well as other recent failures illustrate the point that even western banks are often not very efficient in determining the *relative* risks of capital market trading activities *vis a vis* bank lending. This leads to errors in pricing and determination of prudent capital reserves, and could potentially distort the allocation of resources by banks.

Finally, in a recent paper, Boot and Thakor (1997b) have shown that financial innovation and the rate of growth of capital markets are both slower in universal banking economies than in economies with functionally-separated banking. Their reasoning is that financial innovation and capital market development typically come at the expense of traditional banking. Thus, a universal bank in an oligopolistic financial services industry will wish to invest lesser resources in financial innovation and in facilitating capital market growth because it will internalize the potentially pernicious effect of this on its traditional commercial banking business. The implication is universal banking may retard capital markets; consider the example of functionally-separated U.S. banking compared to universal-banking continental Europe.

- *What is the effect of bank ownership stakes in debtor firms on economic efficiency?*: In the Czech Republic, bank lending practices have been significantly distorted by bank ownership in debtor firms, with the problem being that banks reallocate credit away from financially-strong borrowers to weaker borrowers to ensure that their ownership stakes in the weaker borrowers are not jeopardized. This is a variant of the earlier-mentioned classic conflict-of-interests problem in universal banking that has been rather extensively researched.[5]

This kind of problem should be expected in Romania as well. Its most serious consequence is that it could distort resource allocation to such an extent that the government could not feasibly delegate credit allocation to market-based-mechanisms and expect this allocation to be efficient. Unfortunately, neither bankruptcy laws nor privatization can be relied upon to ameliorate the situation. The only viable alternative may be to separate banks from industrial ownership, as in Poland. This initiative is also currently being considered in the Czech Republic. In the Romanian context, there should be a serious discussion about the upper bound on bank ownership in debtor firms.

It is true that the global trend is toward universal banking, including the case of the U.S. However, many of the problems we have discussed here may be resolved by market forces in *well-developed* financial systems. In Romania, market forces may be far less efficient for some period of time. This places a greater burden on regulators. Thus,

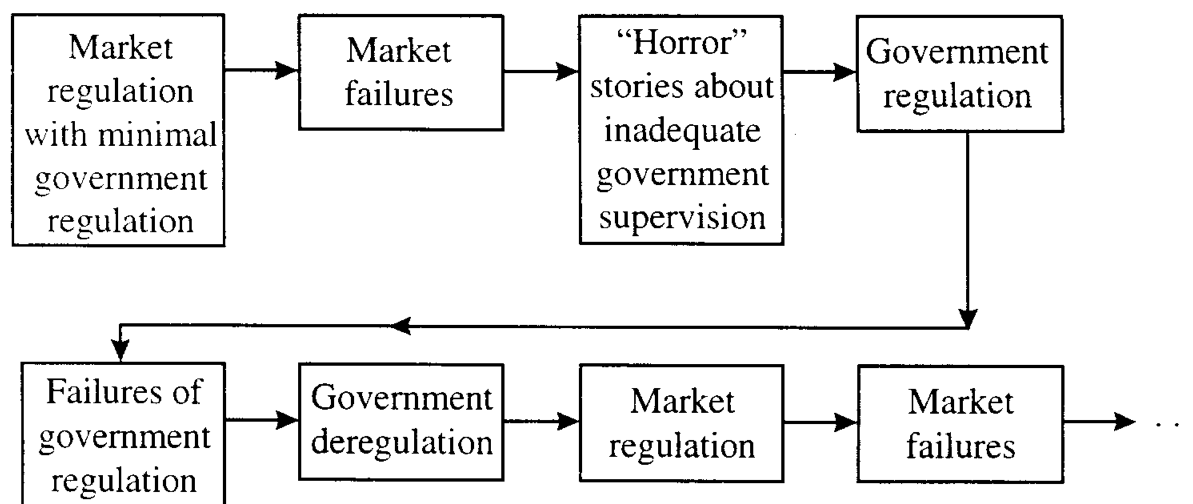
[5] See, for example, the review paper by Rajan (1996).

in light of the fact that Romania is likely to adopt the EU universal banking model, we urge that sufficient attention be devoted to discussing these issues from the standpoint of designing regulatory safeguards.

■ ***Improve the Legal Environment, Bank Regulation and Supervision***

Kaufman (1996) suggests that in economies in which *both* government and market regulations exist, there is a *tension* between these two forms of regulation that simultaneously protects the system against both *excessive* government regulation and *insufficient* market regulation. The tension plays out as shown in the figure below.

Figure 3: The interplay between government and market regulation



This interplay assures a fairly efficient regulatory dynamic. However, this beneficial interplay is missing in transitional economies like Romania's because banks are state-owned and do not face market pressures. Thus, the onus shifts even more to government regulation to foster a healthy operating environment for banks.

Another lesson for Romania in the context of Figure 3 is that it is possible for a *vicious regulatory cycle* to start. If privatization and deregulation are done ineffectively, then failures will result. This will invite a new wave of government regulation that may lead to significant backsliding in financial system reform. It is interesting to note that this is similar to what happened in Chile. Their state-owned banks were privatized. But because this privatization was not effective, there were failures in banking. This then led the government to nationalize these banks. For Romania then, the key question is: how do you effectively privatize? The answer, we believe, lies in focusing on the most reputable and capable strategic foreign investors and their commitment to Romanian banking, rather than the price at which the bank is sold. Our specific recommendations for regulatory reform are as follows:

- Minimize ambiguities in the legal framework of banking. This is particularly important since Demirgüc-Kunt and Maksimovic (1996) find that the efficiency of the legal system is an important determinant of its economic growth rate. Moreover, Demirgüc-Kunt and Detragiache (1997) have shown that systemic banking crises are more likely in countries with weak law enforcement. Specific initiatives to improve the legal system should include tightening bankruptcy laws so that they are: more creditor-friendly, permit collateral to be collected at lower cost from delinquent borrowers, and provide positive incentives to creditors to enforce debt contracts. Reform should also clearly provide the NBR with the authority to expeditiously close insolvent banks without fear of being overruled by the courts. The ability and willingness of bank supervisors to close financially-troubled banks in a *timely* fashion is central to having a healthy banking system. As is well recognized now, regulatory tardiness in closing insolvent institutions was a major factor is driving up the social cost of resolving thrift insolvencies in the U.S. in the later 1980s (see Kane (1989, 1990)). The FDICIA of 1991 provided the regulatory reform necessary to permit U.S. regulators to close financially-troubled institutions *even before their book net worth becomes zero or negative.*

- Eliminate as much ambiguity as possible in bank regulations, and make all sanctions explicit. Most of the banks we interviewed felt that there was considerable vagueness in the NBR's regulatory guidelines. This vagueness related to loan risk classifications, among other things. We strongly believe that at this stage of development, the Romanian banking system would benefit greatly from greater precision in regulatory guidelines (see also Kaufman (1996)).

- The NBR needs to focus on well-designed *prudential* regulation that is concerned with providing an *incentive-compatible safety net*. Elements of such a safety net would include:

  - deposit insurance protection for small depositors, but not large ones, so as to preserve the incentives of large uninsured depositors to monitor the bank (this means the current coverage may be adequate and there should *not* be any great haste to raise it to EU levels);

  - an appropriately risk-sensitive deposit insurance premium structure (see Chan, Greenbaum and Thakor (1991) for issues related to the design of such a structure);

  - on-site inspections of banks, with the *frequency* of inspections *inversely* related to the bank's capital, so that scarce auditing resources can be focused where they are most needed;

- Minimize *non-prudential* regulation that focuses on political, social or other objectives. Banks should be viewed as profit-maximizing institutions that

lubricate the market-mechanism-based engine for efficient credit allocation, rather than as vehicles for implementing sociopolitical agendas. In particular, the role of the Court of Accounts should be reduced or eliminated. While this Court only has jurisdication over state-owned banks, the credit behavior of these banks prior to privatization will improve if individual loan officers do not feel criminally liable for their lending decisions.

- Improve NBR bank supervision. The specific steps that should be considered are:

  - replace accountants with bankers and economists as supervisors;

  - provide adequate training for bank supervisors so that they learn to focus on risks rather than accounts;

  - encourage regular dialogue between bank supervisors and banks;

  - provide special training for supervisors in dealing with international banking issues, so that they are better prepared to deal with branches/subsidiaries of large foreign banks;

  - make sure that supervisors are adequately compensated and on an attractive career track, so as to minimize the risk of their integrity being compromised by the lure of higher-paying jobs in the banks they supervise (a major problem during the U.S. thrift crisis).

  The AID program of assistance to the supervision department of the NBR should make significant progress on several of these issues.

- Make sure that all banks have adequate *economic* capital. As Kaufman (1996) points out, inadequate economic capital in banks will mean that privatization and prudential regulation will be less effective, and inappropriate prudential regulation and/or lack of privatization will make it more difficult to effectively recapitalize banks.

  While the Basle capital standards are correct in spirit for Romania, we do not believe that the 8% minimum is adequate for transitional economies like Romania. The 8% minimum was developed for banks in major industrialized countries, where many of the risks present in transitional economies are absent. Unfortunately, many countries that have adopted these standards have far greater macroeconomic instability, narrower financial markets, and less effective supervision than the countries for which these standards were developed. Neither the 8% minimum nor the specific Basle risk weights are necessarily appropriate for Romania. We recommend an in-depth study to investigate how the Basle capital standards should be adapted for the Romanian banking system.

- Adopt *functional* rather than institutional regulation. This means that the securities activities of banks--if universal banking is continued--should be regulated by the NSC, for example.

■ ***Focus on Creating Missing Markets and Institutions***

The key missing and underdeveloped financial markets in Romania are: capital markets, mortgages, and insurance. To provide the necessary impetus for the development of these markets, we suggest the following:

- focus strongly on macroeconomic stabilization, the industrial restructuring process, and improving corporate governance in the newly-privatized enterprises so as to create more blue-chip companies that want to list on BVB, the Bucharest Stock exchange;

- continue efforts to develop the government bond market which in turn will potentially provide banks with additional collaterizable assets;

- have the NSC play a more active role in enforcing stricter disclosure requirements by firms listing on the BVB and possibly also RASDAQ;

- invite international bond rating agencies and brokerage houses with experience in evaluating and rating companies to help set up rating agencies in Romania; this should improve the dissemination of information about firms and help these firms raise capital in the market;

- establish a government or quasi-government agency to help develop a secondary market for securitized mortgages, along the lines of Fannie Mae, Ginnie Mae and Freddie Mac in the U.S.;

- speed up the industrial restructuring process and infrastructure investments to create new opportunities for insurance companies;

- privatize state-owned insurance companies, so as to attract new capital, information technology, and infrastructure investments;

- continue the process of revising insurance regulations to provide greater clarity.

V. CONCLUSION: AN INTEGRATED PLAN FOR REFORM

We have made numerous recommendations for financial system reform. If implemented, we believe that these action steps will help reduce the fragility of the Romanian financial system. We conclude with a brief discussion of an integrated plan for reform which addresses the question of the appropriate sequence of changes. This

sequence is related to our earlier discussion that the most urgent problems in Romania are improving corporate governance and borrower net worth in the industrial sector and also reforming the banking sector. Attention can be focused on the capital market at a later stage. We believe these changes should be implemented in three phases, with each new set of reforms building on the success of the previous phase:

Phase 1:

- Take steps to improve corporate governance and capitalization in the industrial sector, and continue emphasis on macroeconomic stabilization.
- Privatize banks effectively and structure privatization transactions so as to increase the franchise value of the banks to strategic foreign investors.
- Carefully examine the regulatory safeguards associated with universal banking.
- Improve the on-site supervisory skills of the NBR and link frequency of on-site inspections to bank capital.
- Remove the legal ambiguities that obstruct the supervisory ability of the NBR.
- Continue development of the government bond market.

Phase 2:

- NBR should focus on well-designed prudential regulations that provide an incentive-compatible safety net, including a revised set of capital guidelines, and a re-examined deposit insurance pricing scheme.
- Gradually dismantle as many non-prudential regulations as possible that are motivated by sociopolitical agendas.
- Focus on developing functional (rather than institutional) regulation of different financial institutions.
- Set up an agency to provide support programs designed to encourage small business growth.

Phase 3:

- Focus on the development of the capital market by inviting internationally-renowned bond rating agencies and brokerage houses to participate more actively in the market and by enforcing stricter disclosure requirements.
- Establish a government or quasi-government agency to facilitate the development of a secondary market for securitized mortgages.
- Privatize insurance companies and continue the process to develop clearer insurance regulations.

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