Financial Stability Report

June 2024

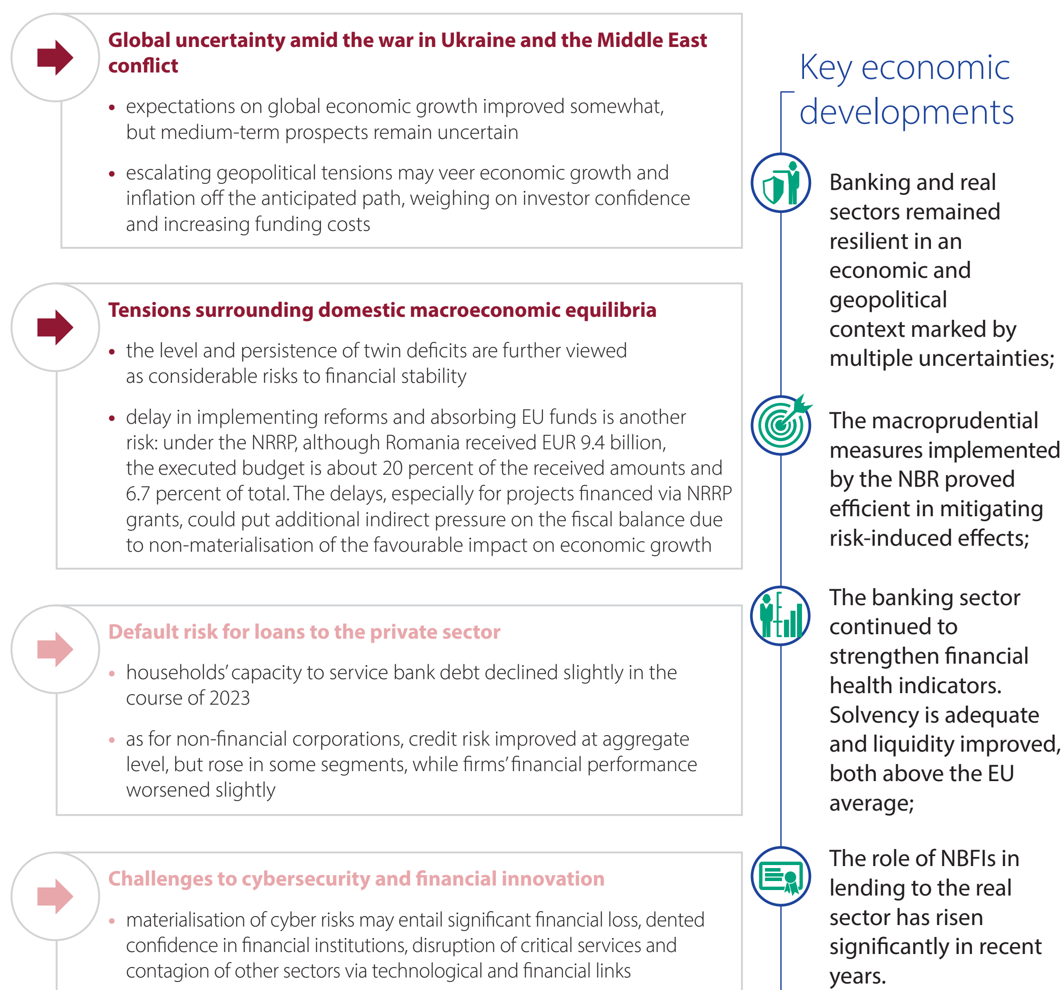
– Overview –

Year IX (XIX), No. 16 (26)
New series

OVERVIEW

Romanian financial institutions remained resilient amid the multiple shocks seen in recent years, from the pandemic crisis and the ensuing supply chain disruptions, followed by Russia's aggression on Ukraine and the energy crisis, to the US and Swiss banking sector turmoil in the spring of 2023 and the intensification of the Middle East conflict. From a cyclical perspective, risks to financial stability in Romania were further broadly similar to those signalled in the previous *Report* (Figure 1), yet, at the same time, new ones emerged.

Figure 1. Map of risks to financial stability in Romania



severe systemic risk, high systemic risk, moderate systemic risk, low systemic risk

Note: The colour of arrows shows risk intensity. Their direction indicates the outlook for risk in the period ahead.

The capacity of borrowers and creditors to withstand less favourable financial conditions was also enhanced by the macroprudential measures implemented by the NBR, and the outlook for the period ahead points to the need to maintain a cautious behaviour.

Over the short term, the most important risk factors to financial stability in Romania are as follows: (i) global uncertainty amid the war in Ukraine and the Middle East conflict, (ii) tensions surrounding domestic macroeconomic equilibria, (iii) default risk for loans to the private sector, and (iv) challenges to cybersecurity and financial innovation.

Risks to financial stability at international level have seen mixed developments since the previous *Report*. Most of the economies, as well as the financial system as a whole, remained resilient throughout the disinflationary process, and investor sentiment was positive, helping ease the financial conditions in international capital markets. Nonetheless, the external economic and geopolitical context continues to be marked by multiple uncertainties. While expectations for global economic growth have mildly improved, they are heterogeneous worldwide and are still subdued by historical values. The growth rate of global economic activity is projected to stay unchanged in 2024 and 2025 at the level of 2023, i.e. 3.2 percent, according to the IMF. At the same time, there is a risk of abrupt corrections in financial asset prices in the event of invalidation of these favourable prospects, which may be challenged by both macroeconomic and geopolitical developments, *inter alia* as a result of the escalating Middle East conflict and the ongoing war in Ukraine. Any new supply-side inflationary shocks may instil volatility in international financial markets and may cause a sudden tightening of financial conditions.

Vulnerabilities to the global financial system can be amplified by high indebtedness in both public and private sectors, given the important election year internationally, which is likely to exacerbate fiscal policy risks. Against the backdrop of unprecedented support measures, government debt rose markedly during the pandemic and stays high, with fiscal deficits adding to the public debt burden in many economies. Government debt in the European Union stood in absolute values 27 percent higher in 2023 than in 2019, while growing as a share of GDP from 77.8 percent to 81.7 percent in the same period.

On the domestic front, economic growth slowed further in 2023, with the GDP expanding by a real 2.1 percent in annual terms against 4.1 percent in 2022. The slowdown mirrored a slacker pace of increase of domestic demand, the impact of high inflation on households' real disposable income and that of tighter monetary and financial conditions. Although economic activity decelerated in 2023, within a European context Romania posted one of the highest growth rates, above the EU and euro area averages (0.4 percent each), as well as above the economies in the region. Boosting investment, especially in higher value-added sectors, *inter alia* via a wider use of EU funds and in particular those under the National Recovery and Resilience Plan (NRRP), could help steer economic growth towards a sustainable pattern. As for the implementation of the NRRP, Romania has received EUR 9.4 billion since this programme started, but the amounts were spent only to a small extent.

According to the budget execution data published by the European Commission and the Ministry of Finance, at end-March 2024 the funds actually spent ran at EUR 1.9 billion, accounting for about 20 percent of the amounts received and 6.7 percent of total allocations. The delays, especially for projects financed via NRRP grants, could put additional indirect pressure on the fiscal balance due to belated materialisation and in small proportions of the favourable impact on economic growth. In the case of Romania, a European Commission study shows that the implementation of NRRP investment projects may entail additional economic growth of up to 3.7 percent by 2026. In addition, consistent with the European Commission's estimates, the cohesion policy could lead to a cumulative 3 percent rise in GDP in Romania by 2029. Against this background, an analysis by the NCMO working group on the sustainable increase in financial intermediation highlights the need to boost the role of the financial system in co-financing EU-funded projects, *inter alia* by harmonising the process of operationalisation of financial instruments under the NRRP and the Operational Programmes.

The tensions surrounding macroeconomic equilibria have lingered since the past *Report*, with the level and persistence of twin deficits posing significant risks to financial stability. The budget deficit is among the highest in the EU (-6.6 percent in 2023 under ESA 2010), after those of Italy and Hungary. Tax revenue collection is still among the lowest in Europe, accounting for 26.6 percent[1] of GDP, compared to an EU average of 40 percent (data for 2023), while current expenditure amounts to approximately 33 percent of GDP. On the one hand, enhancing revenue collection may significantly contribute to deficit correction, given that the VAT gap rate in Romania stands at 36.7 percent versus 5.3 percent, on average, in the EU. On the other hand, the Fiscal Council recommends more efficient spending, which is why it may be useful to make spending reviews similar to those performed by the OECD[2].

The external position places Romania among the countries with the highest deficit in the EU, i.e. the second highest current account deficit-to-GDP ratio (-7 percent of GDP, 2023), after Cyprus (-12 percent of GDP). The developments in the balance of payments are driven by incidental factors, such as those derived from fiscal and income policy, with a stimulative impact on domestic demand, as well as structural factors. In order to tackle some of the latter factors, the NCMO issued Recommendation R/6/2020 on addressing vulnerabilities from the widening of the agri-food trade deficit. Ongoing efforts to implement the measures recommended by the NCMO and investment projects in this area may substantially help reduce dependence on agri-food imports, with positive implications for economic growth.

Although the impact of the macroeconomic and geopolitical context on the default rates of credit to the private sector has been limited so far, there are a number of vulnerabilities that could affect the quality of loan portfolios over the medium term, especially for riskier loans such as those granted to SMEs and consumer loans to households. Higher debt servicing costs and lower profits can pose sizeable challenges to non-financial corporations, especially to more vulnerable firms,

---

[1] Direct, indirect taxes and net social contributions. AMECO database, European Commission.

[2] https://www.oecd.org/governance/budgeting/spending-reviews/

i.e. those with a more pronounced interest rate sensitivity. As for households, debt servicing challenges are stronger for vulnerable borrowers with variable-rate loans.

The default risk for loans to the private sector is also influenced by the balance sheet position and financial soundness of firms and households, which have seen mixed developments since the previous *Report*. Hence, non-financial corporations' financial health worsened somewhat in 2023 H1 compared to the same year-earlier period. However, the financial health indicator remained well above the risk area, both at aggregate level and in the main segments by size, namely SMEs and large companies. Non-financial corporations' interest coverage contracted, owing to the squeeze in profits, concurrently with the rise in funding costs. However, the interest coverage ratio still stands strongly above one (659 percent). At the same time, liquidity and the level of indebtedness held relatively steady. Turning to households, their balance sheet position remains robust, while there has been a diversification trend of their financial investment portfolio. Even though households' wealth continued to strengthen, inequalities are important from this perspective, given that 10 percent of households own more than half of total wealth.

At aggregate level, the debt servicing capacity of the real sector is further adequate, albeit with mixed developments by component. On the one hand, the loan portfolio quality for bank loans to non-financial corporations improved, with the non-performing loan (NPL) ratio hitting an all-time low at the beginning of 2024 (3.7 percent in January), before posting a marginal rise (3.8 percent in March). On the other hand, households' capacity to service bank debt worsened slightly in the course of 2023, a trend that has persisted into early 2024, with the non-performing loan ratio standing at 3.3 percent in March 2024. Credit risk is higher for some specific loan categories, namely loans to SMEs (NPL ratio of 4.5 percent versus 2.5 percent for large companies, March 2024) and consumer loans to households (NPL ratio of 5.9 percent versus 1.7 percent for housing loans, March 2024).

On the whole, the outlook for the private sector's loan repayment capacity is largely conditional on macroeconomic developments, which are saddled with elevated uncertainty, amid the war in Ukraine and the Middle East conflict. The default rate one year ahead is forecasted to pick up further on both corporate loans (from 3.1 percent in March 2024 to 4.4 percent in March 2025) and the two main segments of household loans (from 0.24 percent in March 2024 to 0.26 percent in March 2025 for housing loans and from 3 percent to 3.2 percent for consumer credit in the same period).

Cyber risk has been an increasingly serious risk factor of late, amid mounting digital connectivity, technological developments and financial innovation, *inter alia* amid heightened geopolitical tensions, given the spate of cyberattacks subsequent to Russia's invasion of Ukraine. From a global perspective, the average total cost of firms affected by data breaches rose in 2023 to a record high of USD 4.45 million, up 15.3 percent from 2020. The financial system is the second most cyberattacked sector, after healthcare services, with an average cost triggered by security breaches of about USD 5.9 million.

Under the circumstances, the banking and NBFI sectors are exposed to cybersecurity threats, the materialisation of such severe incidents having the potential to pose risks to financial stability via several channels: (i) loss of confidence in financial institutions, (ii) disruption of critical functions and of the capability to fulfil customer requests, and (iii) contagion to other sectors. According to a survey conducted by the NBR at end-2023, credit institutions in Romania made strenuous efforts in terms of cybersecurity and protection of the banking sector from cyberattacks, *inter alia* by: (i) preparing a secondary site where the bank can carry out its critical activities should a cyberattack occur, (ii) making frequent data backups, (iii) adopting the principle of security in depth, (iv) carrying out cyber resilience stress tests on an annual basis, and (v) regularly conducting penetration tests.

Although cybersecurity incidents have had no systemic importance thus far, the risk of loss from such incidents has risen. In this context, the cyber resilience of the financial system should be strengthened. The ECB has announced for 2024 an exercise aimed to determine how well individual banks would respond to and recover from a cyberattack. This year, the NBR will also run a cyber risk stress test for credit institutions in Romania.

Banking sector

The Romanian banking sector continued to strengthen its financial health (Table 1).

The solvency ratio remained at an adequate level, standing above the EU average, i.e. 22.9 percent in March 2024 versus 19.9 percent EU-wide in December 2023. At the same time, banks in Romania hold a significant capital buffer relative to the Overall Capital Requirements (OCR, 17.2 percent), thus ensuring a good capacity to absorb potential unexpected losses in the event of macroeconomic shocks.

In the course of 2023, the steps taken by credit institutions to raise MREL eligible resources continued, so that, once the transition period was complete, i.e. the end of 2023, all credit institutions complied with the final MREL requirement plus the combined buffer requirement.

Liquidity improved, with the liquidity coverage ratio (LCR) rising to 286.0 percent, whereas the net stable funding ratio (NSFR) came in at 194.4 percent in March 2024. The latest results of the 2023 liquidity stress test confirm the adequate liquidity position of local banks, which generally have the capacity to manage potential short-term liquidity shocks.

Asset quality indicators, such as the non-performing loan ratio and the NPL coverage ratio (2.4 percent and 65.9 percent respectively in March 2024), place the banking sector in the EBA-defined low-risk bucket, the cumulative market share of credit institutions with a below-3-percent non-performing loan ratio standing at 70 percent in March 2024 versus 91 percent EU-wide in December 2023. Although the asset quality indicators testify to a favourable positioning of local banks in terms of credit risk, the current macroeconomic and geopolitical framework points to the need to maintain a cautious behaviour.

Table 1. Risk indicators for the banking sector

Risk indicators	EBA-defined prudential range	Romania							EU average
		2018	2019	2020	2021	2022	2023	Mar. 2024	Dec. 2023
Solvency									
Tier 1 capital ratio	>15% [12%-15%] <12%	18.64	20.05	23.22	20.86	20.48	20.66	20.05	17.3
CET1 capital ratio	>14% [11%-14%] <11%	18.64	19.95	23.11	20.76	19.98	20.21	19.61	16.0
Total capital ratio		20.71	22.00	25.14	23.32	23.40	23.60	22.91	19.9
Asset quality									
Non-performing loan ratio	<3% [3%-8%] >8%	4.96	4.09	3.83	3.35	2.65	2.37	2.41	1.9
Non-performing loan coverage by provisions	>55% [40%-55%] <40%	58.51	60.75	63.31	66.10	65.55	64.61	65.94	42.3
Ratio of restructured loans and advances	<1.5% [1.5%-4%] >4%	3.26	2,49	2.40	2.60	1.96	1.57	1.48	1.4
Profitability									
ROE	>10% [6%-10%] <6%	14.59	12.21	8.66	13.28	16.40	20.13	19.77	10.3
Cost-to-income ratio	<50% [50%-60%] >60%	53.17	54.32	53.84	53.92	52.11	47.64	49.91	56.0
Balance sheet									
Loan-to-deposit ratio for households and non-financial corporations	<100% [100%-150%] >150%	71.89	69.48	63.61	63.96	65.66	61.00	59.85	107.1
Liquidity Coverage Ratio – LCR	>140% [110%-140%] <110%	237.84	242.59	292.48	238.77	209.16	280.61	286.05	167.1

best bucket
intermediate bucket
worst bucket

Source: NBR, EBA

Banks' profitability indicators fared well, with ROE and ROA standing at 19.8 percent and 1.8 percent respectively in March 2024. However, they ran below the average values of non-financial corporations persistently over the last decade. In 2022, ROE and ROA averages for non-financial corporations equalled 28.7 percent and 10.7 percent respectively, while in the Romanian banking sector ROE and ROA came in at 16.4 percent and 1.5 percent respectively. Net interest income contributed most to the improvement in profitability, chiefly on the back of the increase in interest-bearing financial assets (volume effect), another determinant being the low impairment loss on financial assets. Out of their total profits for 2023, credit institutions, Romanian legal entities, retained a large part (57 percent) with a view to supporting their development capacity.

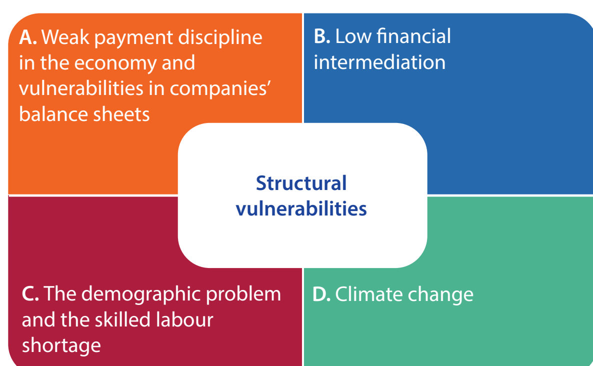
Banks in Romania are characterised by low funding risk, given both the high share of retail deposits and the substantial level of liquid assets. Nevertheless, the banking crises in the USA and Switzerland have shown the ease and speed with which depositors can withdraw their amounts from credit institutions. This can translate into bank runs, especially in the context of fast-paced digitalisation of banking services and the quick spread of information online and in the social media.

Despite the current favourable situation, there are lingering challenges: (i) profit polarisation by bank size, (ii) the lowest financial intermediation in the EU, (iii) credit institutions' shift towards low-risk assets (government securities in particular), enhancing concentration and interest rate risks, and (iv) the prospects for higher credit risk in the real sector amid domestic macroeconomic imbalances. New challenges arise from the need to adapt to climate change, the increase in cyber risks fostered by the geopolitical context and the need to tailor business models to the swift digital progress.

Digitalisation has made notable progress in the banking sector, but the pace of alignment with this trend is heterogeneous, being faster for large banks. The access of customers to digital banking products and services has improved. Specifically, looking at bank clients in 2023, 63 percent of households and 78 percent of legal entities respectively also used digital channels. Due to intensive digitalisation, the role of social media platforms as message amplifiers and the current geopolitical context, the cybersecurity risk has become increasingly relevant. Thus far, credit institutions in Romania have not reported significant losses in the aftermath of cyberattacks, but these events can affect the internal systems of banks and disrupt the functioning of the financial system. Therefore, further measures are needed to enhance operational resilience, especially that the requirements of the Digital Operational Resilience Act (DORA) will apply as of 17 January 2025.

Structural vulnerabilities

Figure 2. Map of structural vulnerabilities to financial stability in Romania



The structural vulnerabilities in the domestic economy (Figure 2) can heighten cyclical risks to financial stability. Implementing adequate and comprehensive measures and policies, including those recommended by the NCMO, should rank among the priorities set at national level.

A. The non-financial corporations sector is faced with a series of persistent vulnerabilities, the most important of them being the large share of undercapitalised companies (about one third, i.e. more than 260 thousand firms). The latter have limited access to financing sources, low investment activity, and also affect productivity and reduce the resource allocation efficiency in the economy. Moreover, capital shortfalls weigh on payment discipline and diminish

firms' resilience during periods of stress. In this context, the payment discipline of non-financial corporations deteriorated in 2023 H1, overdue payments in the economy going up by 4.8 percent compared to the same year-earlier period.

Insolvency remained relatively unchanged, the number of companies undergoing insolvency proceedings increasing marginally in 2023 from the year before (+0.7 percent). Insolvent firms account for a significant share of both overdue payments to non-banks, generating nearly half of them in 2022, and non-performing bank exposures, taking 26 percent of total non-performing exposures as at December 2023. One third of the firms undergoing insolvency proceedings were firms with capital shortfalls (33 percent, 2022).

B. Low financial intermediation is another persistent structural vulnerability in the domestic economy. Romania still ranks last among EU Member States in terms of financial intermediation (49.9 percent, calculated as bank assets-to-GDP ratio, 2023 Q3), which is approximately 4.4 times below the EU average and much lower than in peer countries in the region (Poland 89.2 percent, Bulgaria 91.8 percent, Hungary 112.4 percent). Similarly, bank credit to the private sector in Romania remains at the lowest level in the EU (24 percent of GDP). The persistently low financial intermediation in Romania is largely ascribable to structural factors.

The analysis of the NCMO working group on the sustainable increase in financial intermediation identified a number of measures that can help increase financial intermediation, as follows: (i) enhance the absorption capacity of EU funds, (ii) speed up the digitalisation process for financial services, (iii) support firms' access to finance, (iv) improve entrepreneurs' financial education and the professional training of staff in the financial system and (v) underpin the structural shift of the economy to a higher value-added economy. To this end, specific recommendations were made to the relevant authorities, pursuant to NCMO Recommendation No. R/3/2022 on the sustainable increase in financial intermediation.

C. Demographic changes are another structural challenge in Romania and worldwide. Over the past 50 years, life expectancy increased considerably in Europe, concurrently with the population decline and ageing. On the domestic front, the demographic ageing stepped up further during 2023, along with a decrease in population. Specifically, as at 1 January 2024, Romania's population went down by 0.5 percent from the same year-earlier period. At the same time, the demographic ageing index rose markedly over a year, showing a number of 127.5 elderly per 100 young people, up from 122 elderly persons in the year before. As a result, the mean age of the population grew by 0.3 years to 42.5 years.

The skilled labour shortage remains a serious challenge for domestic companies and this problem has worsened in time. Additionally, Romania ranks among the last EU countries in terms of skills utilisation in the European Skills Index (ESI), with only 33 percent of the ideal performance having been reached in Romania, as compared to 70 percent in Czechia, 64 percent in Poland and 45 percent in Bulgaria. Moreover, the skilled labour shortage is sharper in Romania than at EU level, 45 percent of the local companies participating in the Eurobarometer survey stating it was very

hard to find and hire skilled workforce over the past 24 months, as compared to the EU average of 38 percent. Skill mismatches are even more important when looking at the level of education of firms' managers, given that executive management members of one third of non-financial corporations are not graduates of tertiary education (economics or other relevant subjects of study for the business sector of the company).

The skilled labour shortage, together with the unfavourable demographic developments and the modest level of financial education, is closely connected with two other structural vulnerabilities to financial stability in Romania, namely the low financial intermediation and the inadequate financial soundness of companies. In order to address these issues, the NBR in collaboration with important players in the financial sector and academia launched the "Antreprenoriat de TOP" (TOP Entrepreneurship) project. The objectives of this project are to increase the level of financial and economic education of Romanian entrepreneurs and improve financial inclusion, by encouraging a broader use of financial products and services and stepping up the efforts to enhance the digitalisation of financial and business activities.

D. Climate risks act as multipliers that can amplify existing risks or vulnerabilities. The European Environment Agency identified 36 major climate risks in Europe, more than half of them requiring urgent action. In the absence of adequate measures, almost all of the flagged climate risks could reach critical or even catastrophic levels by the end of this century. In particular, multiple climate risks generated by extreme heat and water shortage are concentrated in Southern Europe. According to the Climate Change Performance Index, Romania shows medium performance in what concerns the efforts to combat climate change (with a score of 61.5 percent versus 64.7 percent at EU level, 2024), due to the lower ratings in the Renewable Energy and Climate Policy categories.

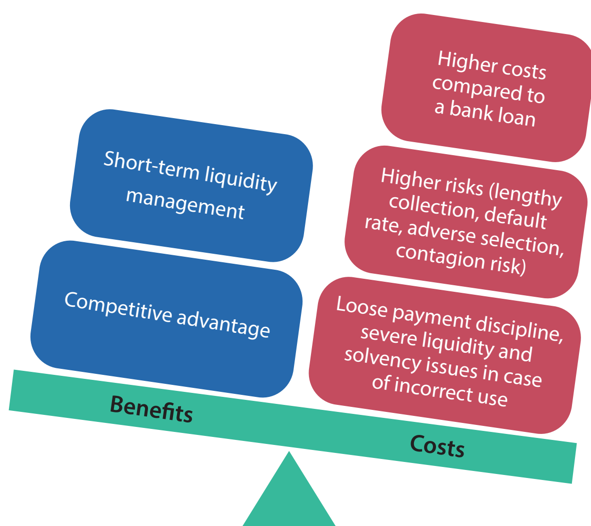
Climate-related financial risks can affect the resilience of banks through the materialisation of physical and transition risks and can hinder the access to financial services and the quality of loan portfolios. In Romania, climate risk remains significant to the domestic banking sector, with lending to climate-relevant (brown) sectors further accounting for about half of total corporate loans, roughly the same as in the European banking sector. Raising firms' awareness on climate change risks should be ranked as a priority, especially that only 3 percent of the total value of corporate loans in 2023 were green loans. To this end, the NCMO issued Recommendation No. R/6/2021 on supporting green finance with a view to sustainably increasing access to finance for projects on the climate change agenda and enhancing transparency, improving reporting and the availability of climate change-related information and raising awareness on the impact of climate change in society and the financial system.

Special feature

The financing pattern of non-financial corporations generates a series of major vulnerabilities for the domestic economy. Firms in Romania largely resort to internal

sources of finance and to trade credit for financing their activity and only to a very small extent to loans from local financial institutions. Even though trade credit can help firms manage cash flows over the short term, especially during periods of tight financial conditions, it is generally much costlier and riskier compared to bank financing, Figure 3.

Figure 3. Trade credit cost-benefit balance



Romania ranks first in the European Union in terms of trade credit, and recent developments point to a widening of the gap vis-à-vis the European average. Trade credit accounts for about a fourth of the owners' funds and liabilities of non-financial corporations in Romania. The high reliance on this type of finance, in the absence of correct practices of use, constitutes a significant vulnerability of the sector to a contagion shock and limits its development (only a fourth of the companies made investments in 2022, while half of the financing used was over the short term). The default or late payment on debt to suppliers can trigger chain reactions, as firms facing repeated extensions of payment deadlines on client invoices have difficulties paying invoices issued by their own suppliers. Firms' response capacity to such a shock is limited by the prevalence of short-term finance (43 percent of total liabilities) and by the low recourse to financing from specialised institutions. Moreover, trade credit has a very lengthy collection period (85 days), which is significantly higher than the average estimated at European level (55 days) and well above the maximum period established by law (60 days). In addition, the default rate on trade credit is four times higher than that on short-term bank loans (12 percent at aggregate level, while in the case of small companies and microenterprises it exceeds 14 percent). Raising awareness among firms about the risks and costs involved in granting trade credit to high-risk clients can help restore payment discipline in the economy, with major benefits on the resilience of the non-financial corporations' sector.

The role of trade credit in the economic activity and the implications of late payments on such credit for payment discipline are a major concern both at European level and domestically. Specifically, in Romania, the National Committee for Macroprudential Oversight (NCMO) has issued several recommendations for identifying the measures that can help improve the financial soundness of the non-financial corporations' sector (NCMO Recommendation No. R/2/2018), as well as for the sustainable increase in financial intermediation (NCMO Recommendation No. R/3/2022).