Financial Stability Report
April 2016

Overview

Year I, No. 1 ▪ New Series

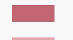
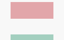
OVERVIEW

In order to adequately and timely reflect both the domestic challenges to financial stability and the swift developments in prudential regulations in Europe, the National Bank of Romania decided to publish the Financial Stability Report on a half-yearly basis starting 2016, thus coming into line with the good practices of the European Central Bank.

Since the release of the previous Report (October 2015), financial stability has remained solid, but risks to financial stability have increased in terms of number and particularly in terms of intensity.

The Financial Stability Report identifies one severe systemic risk, three high and rising systemic risks, three moderate systemic risks and one low systemic risk. It is for the first time since the publication of the Financial Stability Report (2006) and of the map of risks (2015) that a severe systemic risk is identified.

The main risks to financial stability are as follows:

Map of risks to financial stability	
	Uncertain and unpredictable legislative framework in the financial and banking field
	Domestically, the return to pro-cyclical fiscal policies and the reversal of the fiscal consolidation trend, with an impact on fiscal deficit sustainability in 2017
	Risk of abrupt reversal of investor sentiment in emerging economies generated by the uncertainty surrounding global economic growth, the state of the international financial system, and the diverging monetary policy stances of major central banks
	Risk posed by a possible exit of the United Kingdom from the European Union
	Risk posed by the geopolitical situation in the Middle East, through the refugee crisis, with possible consequences on the European single market
	Contagion risk from the banking sector in Greece
	Further modest dynamics of lending, amid a sustainable growth potential of loans to non-financial corporations
	Credit risk associated with the foreign-currency loan stock
	severe systemic risk
	high systemic risk
	moderate systemic risk
	low systemic risk

Note: The colour shows risk intensity. Arrows indicate whether the risk has increased/decreased since the previous Financial Stability Report.

Developments in main systemic risks since the previous Report		
Risk direction	Number	Risk description
New systemic risks	2	Uncertain and unpredictable legislative framework in the financial and banking field
		Risk posed by a possible exit of the United Kingdom from the European Union
Rising systemic risks	2	Domestically, the return to pro-cyclical fiscal policies and the reversal of the fiscal consolidation trend, with an impact on fiscal deficit sustainability in 2017
		Risk posed by the geopolitical situation in the Middle East, through the refugee crisis, with possible consequences on the European single market
Stagnant systemic risks	3	Risk of abrupt reversal of investor sentiment in emerging economies generated by the uncertainty surrounding global economic growth, the state of the international financial system, and the diverging monetary policy stances of major central banks
		Contagion risk from the banking sector in Greece
		Further modest dynamics of lending, amid a sustainable growth potential of loans to non-financial corporations
Decreasing systemic risks	1	Credit risk associated with the foreign-currency loan stock

Two new systemic risks have emerged: one is of a domestic nature and features maximum intensity, i.e. the risk of an uncertain and unpredictable legislative framework in the financial and banking field, and the other is of an external nature and features high intensity, namely a possible exit of the United Kingdom from the European Union (Brexit).

The past six months saw an increasing number of legislative initiatives focused on financial and banking regulation that entail retroactive changes to bank-customer contracts. The law on debt discharge (*datio in solutum*) is the most widely-known initiative of this sort; after being passed by Parliament in December 2015, the Presidency sent it back for re-examination and is currently debated by the members of the Chamber of Deputies. In its initially-passed form, this law generates systemic risk, puts a drag on payment discipline, creates moral hazard for its failing to distinguish between the debtors no longer willing to repay their loans and those no longer able to do so, contains the access to credit for the low-income and/or young people, affects banks' profitability and solvency, and calls into question the state guarantee. In March all credit rating agencies warned against the impact of passing this law on Romania's sovereign rating; should these warnings materialise, the public debt financing cost will go up, triggering direct effects on the general government budget. The National Bank of Romania voiced its strong opposition to this law and, following the President's request for re-examination, made a number of amendments that, if taken into account, will cushion the systemic implications of the law, will render it applicable solely to socially vulnerable individuals, identified as such through clearly-defined criteria, and will remove the "First Home" programme from its scope. The implications of this law on financial stability and on the real estate market, as well as the NBR's proposals, are thoroughly examined in the Report (Chapter 5 and the Special feature). Other legislative initiatives that may affect financial stability, such as the draft law on converting CHF-denominated loans based on historical exchange rates, are currently under parliamentary debate at various stages. Since 2016 is an election year, similar initiatives are likely to crop up in the coming months.

The National Bank of Romania is supportive of finding and implementing solutions for the social cases where debt servicing has become overly burdensome for certain economically-hit households, encouraging commercial banks and borrowers to come up with bilateral solutions following direct negotiation. In the course of 2015, more than 27,000 CHF-denominated loans, accounting for about one-third of total CHF-denominated loans, were successfully renegotiated (over 17,000 were converted into leu-denominated loans and more than 10,000 were restructured). Unlike the 'one-size-fits-all' solutions imposed by law, bilateral solutions agreed by the parties do not impinge on the right of ownership and do not hamper market economy functioning.

Another new risk relates to a possible exit of the United Kingdom from the EU. The previous months witnessed the decision on holding a referendum, setting its date (for 23 June), and an escalating debate between supporters of and opponents to the UK's EU membership. What was seen as a dormant risk for a long time has quickly become a tangible systemic risk that, despite its exogenous and indirect nature, may affect Romania in that it questions the functioning of the European Union in its current form, which has been an anchor for the country's progress. There will be knock-on effects on the EU and Romania irrespective of the outcome in the referendum. Were the UK to vote to remain in the EU, the balance of power within the Union would change, which is likely to entail higher costs and lower EU funds for Romania. Were the UK to vote to leave the EU, the remaining Member States would face a tough decision: whether to continue the integration process, yet at a faster pace than before (resulting in enhanced solidarity and political decision among these countries), or to proceed towards an EU break-up initiated by the Brexit. A country's financial stability is not self-sufficient, but part and outcome of a macroeconomic policy mix. The knock-on effects on the peripheral countries of the EU, non-euro-area members in particular, may bring about capital outflows and exchange rate swings in the short run.

The risk stemming from a possible Brexit is expected to fuel financial and forex market volatility ahead of the referendum and, if the UK opts out, especially after the referendum, adds to the two high systemic risks that have already been mentioned in the previous Report.

Domestically, the risk of returning to pro-cyclical fiscal policies is growing, being already partly materialised in the passing of the 2016 general government budget with a 3 percent deficit-to-GDP, more than twice the 2015 actual level, hinting at a reversal of the fiscal consolidation trend seen in 2010-2015. Moreover, assuming that no other policy measures are implemented, the fiscal deficit will near 4 percent of GDP in 2017, causing Romania to be placed again under the excessive deficit procedure. According to the warning issued in the previous Report, a fiscal deficit upwards of 1.5 percent of GDP will result in the public debt threshold being surpassed over the next three years, while the probability of an economic slowdown or even recession exceeds 50 percent. Consolidation of fiscal policy responsibility by securing enhanced predictability in the regulatory field and the preclusion of a pro-cyclical behaviour of the macroeconomic policy mix are of the essence in preserving economic equilibria and supporting financial stability in the period ahead.

The risk of pro-cyclical fiscal policies being implemented domestically heightens the external risk associated with the uncertainty surrounding global economic growth and the diverging monetary policy stances of world's major central banks, to which Romania is exposed as well. This risk also materialised in part in the Federal Reserve's decision to embark on a course of rate hikes (in December 2015). Thus, the risk of abrupt shifts in investor sentiment remains significant. The developments in global economic activity are still marked by uncertainty, with subdued recovery being expected for the European Union as well. Significant contributions to the downward revision in the outlook for global economic activity come from the substantial adjustments in the Chinese economy, corroborated with the corrections seen on emerging markets, lingering uncertainty about economic developments in the European countries constrained by public sector financing and the increasingly difficult migrant crisis.

Compared with the previous Report, the Middle East refugee crisis intensified in Europe, with the conspicuous social and economic tensions impacting the EU's real sector and the fiscal space of transit and destination countries alike.

By contrast, the banking sector in Romania has continued to strengthen. In 2015, banks' profitability reverted to positive territory, high solvency and liquidity ratios were reported, and the non-performing loan ratio was stuck to a downward path. Contagion risk also kept declining, as the reliance of banks in Romania on parent bank funding was on the wane.

Vulnerability associated with the large share of foreign-currency loans continued to decline since the release of the previous Report, as leu-denominated loans became prevalent in the loan stock, thus helping improve monetary policy transmission. On the other hand, currency risk is being replaced by interest rate risk. For the interest rate risk not to materialise over the period ahead, an adequate macroeconomic policy mix is of the essence; fiscal policy must not constrain the monetary policy options. In this vein, one step in the right direction was taken when the Parliament passed the law on the establishment of the National Committee for Macroprudential Oversight, an authority encompassing representatives of the National Bank of Romania, the Government and the Financial Supervisory Authority. The Committee will issue recommendations to ensure macroeconomic policy consistency with a view to preserving macrostability.