



Project Information Document (PID)

Concept Stage | Date Prepared/Updated: 31-May-2019 | Report No: PIDC27078



BASIC INFORMATION

A. Basic Project Data

Country Romania	Project ID P171039	Parent Project ID (if any)	Project Name Romania: Institutional Strengthening and Financial Safety Net Resilience Project (P171039)
Region EUROPE AND CENTRAL ASIA	Estimated Appraisal Date Dec 02, 2019	Estimated Board Date Mar 02, 2020	Practice Area (Lead) Finance, Competitiveness and Innovation
Financing Instrument Investment Project Financing	Borrower(s) Bank Deposit Guarantee Fund (FGDB)	Implementing Agency Bank Deposit Guarantee Fund (FGDB)	

Proposed Development Objective(s)

The PDO is to strengthen the institutional and financing mechanism of the Deposit Insurance Agency to effectively deal with a financial sector crisis.

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Project Cost	452.00
Total Financing	452.00
of which IBRD/IDA	452.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Bank for Reconstruction and Development (IBRD)	452.00
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Environmental and Social Risk Classification

Concept Review Decision



Low

Track II-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

- 1. Romania has experienced an improved economic performance in recent years, driven by private consumption, although macroeconomic balances have been widening.** Economic growth in the first half of 2018 of 4.1 percent was the sixth highest in the European Union (EU), while unemployment fell to a historical low 4.2 percent at end-March 2019. The acceleration of economic activity in the first half of 2018, as in 2017 and 2016, is attributed to a sharp increase in private consumption (up 4.3 percent year-on-year) fueled by the accommodating fiscal policies, increase in minimum wages and generous wage increases to public sector employees. Investment recorded a marginal growth of 0.5 percent year-on-year. High imports of goods and services continued to affect the current account balance, which stood at -4.6 percent of GDP in 2018 compared to -3.2 percent of GDP in 2017. The budget deficit widened to 1.6 percent of the projected GDP in the first half of 2018, driven by the increases in recurrent expenditure, while continued growth in consumption. Inflation has been on an upward trend reaching 4.1 percent in June 2019.
- 2. Deteriorating external environment and weak efforts to implement structural reforms are expected to moderate economic growth further.** Further slowdown in private consumption and exports of goods and services is expected to affect the economic growth in 2019, estimated at 3.6 percent. The newly introduced tax on banking sector assets and higher interest rates on bank credit are expected to slow credit growth in the country. The accommodating fiscal policies will have a negative effect on the government debt and lead to further deterioration in fiscal deficit. General government gross debt remained at a low level of 36.6 percent of GDP in 2018 but is expected to increase to 38 percent of GDP in 2019. Furthermore, the general government deficit risks widening to above 3.0 percent of percent of GDP in 2019; thus, increasing the risk of Romania's re-entering the EU's Excessive Deficit Procedure in the coming years.

Sectoral and Institutional Context

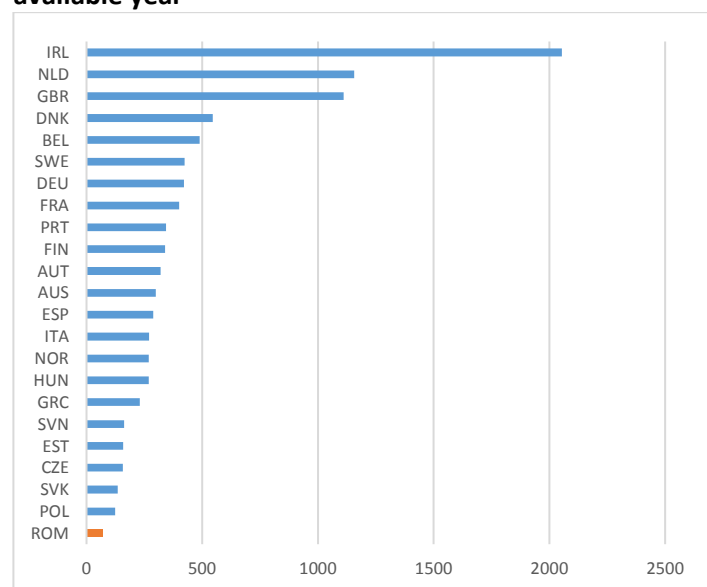
I. Financial sector Context

- 3. Financial intermediation in Romania is among the lowest in the EU.** Financial sector assets as a percent of GDP accounted for about 69.2 percent in Q3 2018, significantly lower than in other OECD countries (Figure 1). Financial sector assets as a percent of GDP continue to decline due to the fast growth of GDP, which outpaces the growth of the financial sector assets. The financial sector is dominated by banking sector, which accounts for 75.5 percent of financial sector assets. Other financial sector players include non-bank financial institutions with a market share of 6 percent, investment funds (6.8 percent), private pension fund (7.7 percent), and insurance (3.9%) (Figure 2).



4. The banking sector is majority foreign-owned and competitive. The sector is dominated by foreign-owned banks, with 75 percent market share of credit institutions with majority foreign capital. As of December 2018, there are 34¹ credit institutions operating in the country, 7 of which are foreign bank branches. There are 2 state-owned banks (CEC Bank, Banca de Export-Import a României – Eximbank) with combined share of assets of 8.4 percent. The number of credit institutions has been gradually declining from 43 in 2008. Banking sector consolidation is expected to continue as there are a number of banks with market share below 1 percent. Large banks (more than 5 percent share in assets) hold 73.5 percent of banking sector assets. The concentration of the banking sector is low, with the Herfindahl-Hirschman at 895 vs around 1,000 in the EU and asset concentration for the top five banks at 58.1 percent vs 63 percent across the EU.² Despite a healthy competition in the banking sector, the population in the rural areas and MSMEs remain underserved by the financial service providers.

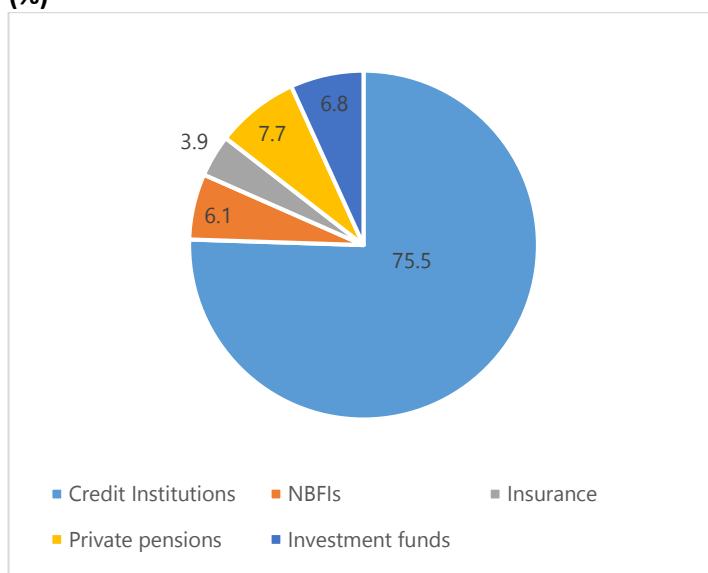
Figure 1. Financial sector assets, % of GDP, latest available year



Note: Data for Romania are for 2017, all other countries are for 2014.

Source: DFSA, OECD National Accounts Statistics.

Figure 2. Composition of financial sector assets, Q3 2018 (%)



Source: National Bank of Romania

5. The banking sector is shallow in Romania, reflected in both low loan and deposit penetration. Total assets of the banking sector as a share of GDP stood at about 49 percent in Q2 2018, which is significantly lower than in other EU countries, such as Poland (88.5 percent), Hungary (93 percent), Bulgaria (98.6 percent), Croatia (124 percent), and an average for EU28 (243 percent).³ Furthermore, total loans of credit institutions as a share of GDP were at 28 percent in 2018. Loans to private sector accounted for 26 percent of GDP in the same time period, with loans to household at 14 percent of GDP and loans to enterprises at about 12 percent of GDP, which is also low compared to

¹ Credit institutions include banks, branches of foreign banks, and CreditCoop.

² FSAP Financial Intermediation Technical Note, May 2018.

³ Data from the National Bank of Romania.



the levels observed in the peer countries.⁴ The deposit base as a share of GDP stood at 40 percent, with household deposits, which form the majority of deposits, at 21 percent of GDP at the end of 2018.

6. **The banking sector is well capitalized, highly liquid, and profitable and asset quality is good.** The Capital Adequacy Ratio (CAR) of the banking sector was 19.7 percent as of December 2018, which is significantly higher than the minimum requirement of 8 percent set by the National Bank of Romania (NBR). The banking sector profitability was hit by the 2008 financial sector crisis and measures that were introduced by the NBR to reduce the level of nonperforming loans. However, profitability has been improving since 2015, with ROA at 1.6 percent and ROE at 14.9 percent, as of December 2018. The banking sector in Romania is highly liquid with the loan-to-deposit ratio (LTD) at 73.4 percent in December 2018. LTD ratio has been declining since 2008, driven by the stronger growth of deposits than loans. The level of nonperforming assets in the banking sector has been declining from about 21 percent of total loans in 2014 to 4.95 percent in 2018.

Figure 3: Capital Adequacy ratio, %

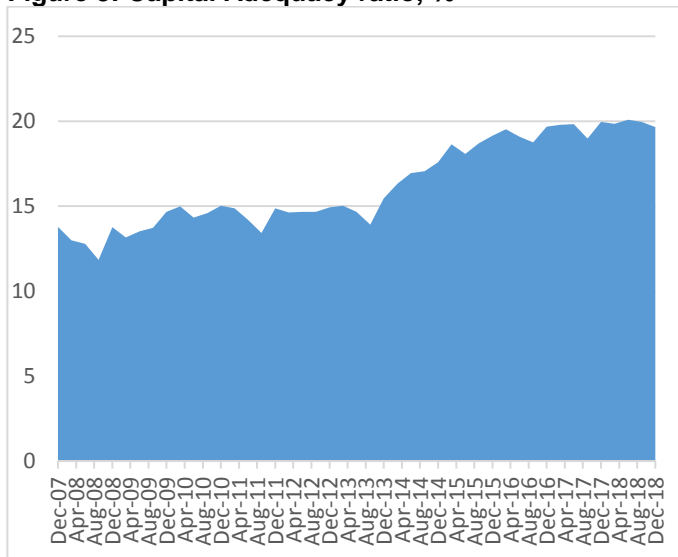


Figure 4: Return of Assets, %

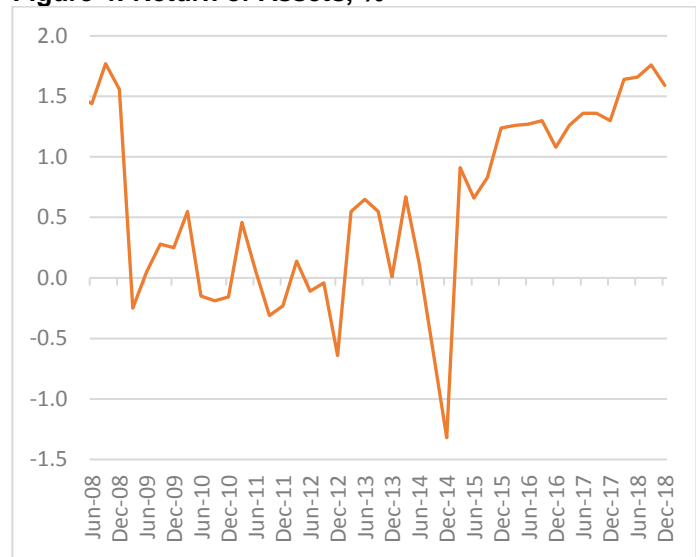


Figure 5: Loan to Deposit ratio, %

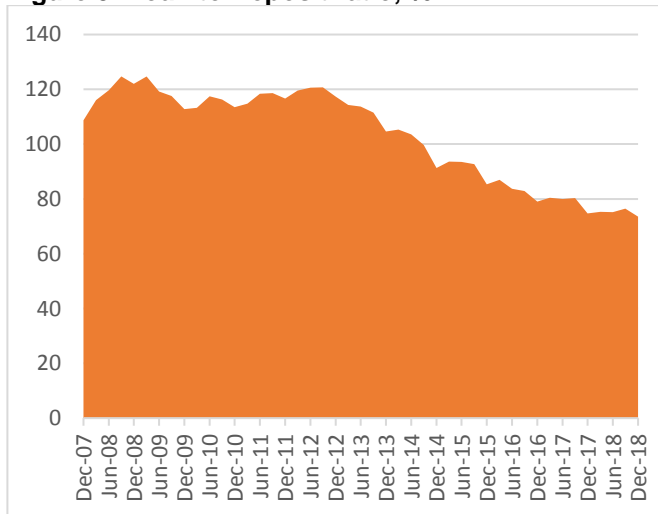
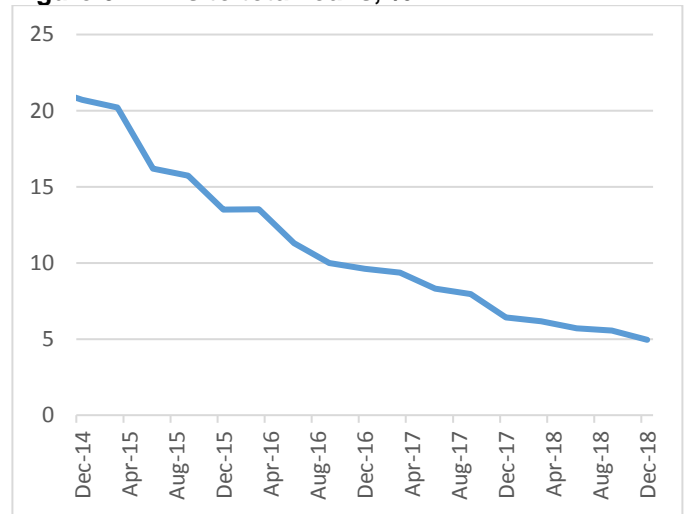


Figure 6: NPLs to total loans, %



Source: National Bank of Romania

⁴ Bulgaria, Croatia, Hungary, and Poland.



7. **Credit to private enterprises is low, driven by structural factors as well as particularly low demand for credit by enterprises.** Credit to private corporate sector amounted to 12 percent of GDP in 2018. According to the Financial Sector Assessment Program (FSAP) Technical Note on Financial Intermediation (2018), the low level of financial intermediation in the enterprise sector is driven by a set of structural factors affecting both supply of and demand for credit including lagging physical infrastructure, high poverty rate, high share of rural population, and high degree of informality. At the same time, weak demand for credit is adversely affected by: a) a relatively low business density in terms of number of enterprises per inhabitant, b) the dominant role of agriculture, a sector facing significant constraints, c) the non-financial constraints businesses face for growth and investment such as fiscal unpredictability, d) the poor health of enterprises (44 percent of firms are undercapitalized and hence non-bankable), and e) access to alternative financing (including access to foreign financing, which accounts for 15 percent of corporate debt).

8. **Gaps in access to finance for enterprises persist for micro, small and medium-sized enterprises (MSMEs) as well as start-ups, with significant regional disparities.** In the latest access to finance survey produced by NBR in June 2018, 34 percent of firms view access to finance a pressing or moderate problem, with the greatest obstacles being: the fiscal unpredictability, taxation, and competition. Firms primarily rely on non-bank financing, including retained earnings, shareholder loans and trade credit, while only 11 percent of firms have overdrafts. There are also big discrepancies in access to bank finance depending on firm size with large firms relying on banks to a much higher degree than SMEs: 33 percent of large firms have overdrafts and 22 percent have investment loans vs. 12 and 7 percent for SMEs, respectively. In addition, there are significant variations in access to finance within the country. Banks are focusing on urban areas, in particular Bucharest, which accounts for more than a third of SME loans. Young firms rely less on bank financing and more on informal financing as they lack track record and strong balance sheets, which can be used for collateral. Hence risk capital in the form of angel investment and venture capital is better suited for start-ups. In Romania, private equity including venture capital is nascent; total investments amounted to 0.01 percent of GDP in 2017 vs. 0.5 percent in Europe.

9. **Regarding households, Romania lags its regional and income level peers in terms of financial inclusion.** According to the Global Findex database 2017, 58 percent of adults are banked in Romania, unchanged from 2014 data. However, the poor are 33 percentage points less likely to have an account than the rich, significantly higher than the income gap for developing countries. Among the unbanked, some commonly cited barriers included high cost and lack of trust in financial institutions (about a quarter of unbanked adults). Majority of the unbanked cite poverty as a barrier (17 percent report it as the only reason) implying that a product suitable to their needs may not be available. About 5-7 percent of unbanked adults cite “no need” and “family member has an account” as the only reason for not having one.

Table 1: Financial Inclusion

Indicator Name (data for 2017)	Bulgaria	Croatia	Hungary	Poland	Romania	Euro area	Upper middle income
Account at a financial institution (% age 15+)	72%	86%	75%	87%	58%	95%	73.1%
Account at a financial institution, male (% age 15+)	71%	90%	78%	85%	62%	97%	77.0%
Account at a financial institution, female (% ages 15+)	74%	83%	72%	88%	54%	94%	69.3%
Account at a financial institution, rural (% age 15+)	66%	88%	69%	87%	54%	96%	73%
Account at a financial institution, income, poorest 40% (% ages 15+)	55%	81%	68%	84%	38%	94%	62%
Account at a financial institution, income, richest 60% (% ages 15+)	84%	90%	80%	88%	71%	96%	80%
Account at a financial institution, older adults (% ages 25+)	75%	93%	77%	91%	59%	98%	75%
Account at a financial institution, young adults (% ages 15-24)	43%	47%	60%	63%	51%	79%	66%

Source: Global Findex 2017



- 10. Commercial banks have low branch coverage in rural Romania and while the alternative financial service delivery mechanisms that exist do not seem to target unbanked populations.** As of September 2018, there were 4,515 bank branches in Romania, equivalent to 27 branches per 100,000 adults. While this network penetration is at par with the EU, the commercial branch network has been declining. In addition, the network is very thin in the rural areas, which account for only 621 branches, equivalent to 8 branches per 100,000 adults. Alternative banking delivery mechanisms are being offered however initial consultations with banks indicate that these mechanisms do not target the unbanked population. The majority of banks have started to invest substantially in branchless services, including agents, mobile banking vehicles, and virtual branches. As of October 2018, there were 1,429 bank agents.
- 11. Cooperative banks play an important role in providing financial services in rural areas.** There are 40 cooperative banks in Romania that serve around 600,000 members and over 650,000 deposit clients⁵ through 790 points of service, 500 of which are located in rural areas. In contrast to the other commercial banks, which operate as individual entities, cooperative banks are affiliated to CreditCoop⁶. Cooperative banks date back to the 19th century and have a well-developed network throughout the country. Regulated by the NBR, they are able to provide a wide range of financial services. The cooperative bank sector has engaged in a process of consolidation that will likely alleviate the second constraint while allowing for a more efficient operation. In terms of financial safety net, the entities affiliated to CreditCoop rely on CreditCoop's guarantee and mandate to provide liquidity and solvency support to its affiliates.
- 12. Low financial literacy hampers access to and use of financial services.** Only 22 percent of adults in Romania are financially literate, 8 percentage points lower than the regional ECA average and lowest among the EU countries (average at 53 percent). Unbanked adults were 15 percentage points less likely to be financially literate than banked adults. Low financial literacy is correlated with the low trust in financial institutions as well as high preference for holding cash.

II. Institutional context

- 13. Four institutions are providing the financial safety in Romania: NBR, the Bank Deposit Guarantee Fund (FGDB), the Ministry of Public Finance (MoPF), and the Financial Supervision Authority (ASF).** The NBR is the monetary authority and lender of last resort, the resolution authority, as well as the supervisor and regulator of the banking system. It is part of the European system of central banks and implements the corresponding European standards and policies in addition to the statutory domestic goal of maintaining price stability. In 2015, Romania transposed EU BRR Directive (2014/59/EU) into the national law (312/2015) that designates NBR as the resolution authority for the banking sector. The FGDB is the deposit insurer that is mandated to manage two funds: the deposit insurance fund and the resolution fund, newly created in 2015. The FGDB also acquired additional functions related to resolution procedures. The MoPF is the main liaison of financial oversight agencies with the government; it is in charge of fiscal policy and, in a scenario of need, is also currently the source of contingent funding to the FGDB. The ASF also takes part in the crisis management framework on issues related to its scope of supervisory work, mainly the insurance and private pension industry, asset managers, and capital markets participants. The ASF is also the resolution authority within its scope of supervision.
- 14. FGDB is mandated with managing the deposit insurance fund in Romania and more recently the resolution fund.** The FGDB was created in 1996, with the mission of insuring deposits held exclusively by individuals up to the amount

⁵ Members of cooperative banks must reside in the defined area of influence of a cooperative bank; clients can reside outside that area.

⁶ CreditCoop services as a federation of cooperative banks that represents its affiliates and provides them a variety of services, such as training, and reports their aggregated information to the NBR. In addition, CreditCoop operates 17 own branches that provide financial services to individuals and firms who are not members or clients of the network's cooperative entities.



of RON 1,000 (then equivalent to roughly USD 239). Over time, and especially after Romania joined the European Union (EU), coverage was extended in line with the EU Directive 2014/49/EU, on deposit guarantee schemes (DGS), and since December 2010 it is equivalent to EUR 100,000 and benefits not only individuals but also legal entities. There have been substantial improvements in terms of payout time, which came down from 90 to 7 days. Romania has transposed the EU Directive 2014/49/EU by enacting Law nr. 311/2015 on Deposit Guarantee Schemes and the Bank Deposit Guarantee Fund, which is the current legal framework for FGDB. The law extended FGDB's mission to include not only paying out depositors, but also (i) managing Romania's resolution fund, (ii) functioning as temporary administrator for failing institutions, (iii) functioning as special administrator for institutions undergoing resolution, (iv) owning bridge-banks and asset management vehicles incorporated within resolution procedures, (v) functioning as administrative liquidator for failed financial institutions. The law also determines, in line with the EU Directive, that FGDB can be required, by NBR, to contribute from deposit insurance fund to the resolution of financial institutions with an amount equivalent up to 0.4 percent of the covered deposits.

15. FGDB is broadly compliant with international best practices. In mid-2018, FGDB went through an assessment to ascertain its compliance with the IADI Core Principles for Effective Deposit Insurance Systems. FGDB was found to be compliant with many of the core principles, including the ones regarding membership (CP 8), coverage (CP 9) and public awareness (CP 12). Cross border issues (CP 7) had also been addressed adequately, and FGDB was largely compliant. The legal framework gives adequate powers to FGDB in recovering funds from failed banks and dealing with parties at fault (CP 18 and 14, respectively).

16. The institutional relationships in the event of a crisis need to be formalized. In the extreme event of the deposit insurance fund being insufficient, such an agreement should establish the levels of authority (with alternate signatories) to execute the financing, perhaps by tranches, the type of security to be issued, and mechanisms to operationally transfer the funds to the FGDB. Also, good practices specify that this kind of support to the deposit insurer should take the form of a credit to be repaid on the basis of future contributions from banks.

Relationship to CPF

17. The project is fully aligned with the Country Partnership Framework (CPF) for Romania for the period 2019-2023 by focusing on strengthening the domestic institutional capacity for managing a financial crisis. The overarching goal of the CPF is to "build institutions fit for a prosperous and inclusive Romania". The proposed Project will contribute to the overarching CPF goal by strengthening Romania's institutional framework to effectively managing a banking sector crisis and ensure access to deposits for its small savers. By ensuring a working financial sector the project is also linked to objective 6 which is enhancing access to finance.

18. The Project will also focus on expanding the reach of the financial safety net to include currently vulnerable individuals. The Project meets also the "inclusion" filter, one of three filters in the CPF, by ensuring the FGDB can adequately fulfill its mandate of protecting the deposits of vulnerable depositors, most of which are households.

C. Proposed Development Objective(s)

The PDO is to strengthen the institutional and financing mechanism for the Deposit Insurance Agency to effectively deal with a financial sector crisis.

Key Results (From PCN)

The proposed Project is expected to contribute to financial stability in the banking sector of Romania, by having a contingent facility with the FGDB during the course of the Project. Key results include improvement of the institutional



arrangements in the event of a crisis. Possible expansion of coverage can be an additional result. However it needs to be decided if the results are only measured in the event of a drawdown or not.

D. Concept Description

19. The FGDB expressed interest in a WB contingent financing instrument for the deposit insurance fund. In a letter to the WB dated December 18th, 2018, the FGDB requested further technical discussions regarding instrument and related operational/procedural workflows. In Romania, the proposed product can be covered under the alternative funding arrangement approved by the FGDB. The NBR has already approved the alternative funding mechanisms in accordance with the provisions of the Law no 311/2015 concerning. The WB team held an identification mission in response to the request to define the main parameters of the intervention. During the visit the team held discussions with the FGDB, MoPF and the NBR, as key stakeholders on the broad terms of a contingent investment loan, and on the possible timeline for such an operation

20. The product could either take the form of a Contingent IPF or an IPF DDO. The Borrower has the option of a contingent Investment project Financing (IPF). Alternatively, the Borrower may have the option of an IPF Deferred Draw Down (DDO). The IPF DDO product is still in pilot stage at the Bank and being approved by the Board on a case by case base. This product would allow the Borrower to customize terms (pricing and repayment) of each tranche/disbursement at the time of disbursement. This means that each tranche can have different repayment and pricing terms which can be decided by the Borrower when the funds are needed. This is currently not possible under the contingent IPF. Also, the contingent period can be longer than for contingent IPFs (maximum 5 years).

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

Romania lags its regional and income level peers in terms of financial inclusion. According to Global Findex database 2017, 58% of adults are banked in Romania which has remained unchanged since 2014. However, the poor are 33% points less likely to have an account in comparison to the rich, which is significantly higher than the income gap for developing countries. Among the unbanked, about one quarter of adults state: some commonly cited barriers include high cost and lack of trust in financial institutions. Majority of the unbanked cite poverty as a barrier implying that a product suitable to their needs may not be available. About 5 to 7% of unbanked adults cite 'no need' and 'family member has an account' as the only reason for not utilizing financial institution.

Note To view the Environmental and Social Risks and Impacts, please refer to the Concept Stage ESRS Document.



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APPROVAL

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