

Some Problems on the Romanian Bank Segment in the European Union

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Abstract. Present article is the take a short glance at the Romanian bank segment after the accession to the European Union. The analysis deals with three major topics. In the first part the regulation environment is in focus, dealing mostly the actual situation of the preparation works in the banks. The second part is dedicated to market environment, market players, ranges of products and the technical-technological background. The third part is about the macroeconomic environment of the Romanian bank segment. The aim of the article is the take a short glance at the Romanian bank segment one year after the accession to the European Union. The analysis will focus on three major topics: regulation environment, market environment and macroeconomic environment of the bank segment in Hungary.

Regulation environment

It can be told about the legal regulation of the bank segment that the legal regulation system is considerably similar, almost the same, due to the structural reforms and the legal harmonization process of the last fifteen years.

The main task of Romanian banks is related to the regulation environment: the preparation for meeting the capital requirements of Basel is in process at full speed, which will be obligatory also for the already EU member Romanian bank segment from 2006. Let us have a look at this issue in details.

1. 1. Regulation of Basel Capital Accord

The Basel Committee on Banking Supervision published its capital conformity standards in 1988 under the name 'Capital Accord', in which the elements of the regulatory capital of the banks were defined and a unified calculation method was introduced related to the balance sheet total weighted by risks. The agreement stipulated a minimum value of 8% for the capital conformity rate deriving from the ratio of the guaranty capital and the balance sheet total weighted by risks.

Due to the development of the market and the criticism of the banks, modification of the regulation was needed, the first version of which was published in June 1999. After the consultation period in January 2001 the second version was published, which was followed by a consultation period again. At the moment, the third version is the latest, which was published in April 2003 and will be applied from 2006.

The capital standards of Basel contain rules regarding the risk management processes and the internal managing and controlling systems. One of its main aspects is the flexibility: it was defined in a way that it should be suitable for defining the necessary capital requirements in case of institutions of different size, structure and business. The modified new regulation is more complex, and its flexibility resides in the range of the applicable methods. This way it is possible for the institutions to use the most adequate approach regarding their risk management systems.

The three main pillars of the regulation:

1. *Minimum capital requirements*: the first pillar consists of methods elaborated for setting the amount of capital needed to cover the credit, operational and market risks. These methods can measure the risks of the assets in the

portfolio of the institutions much more precise, with greater sensitivity and with several approaches in a more effective way.

2. *Supervisory review*: in the framework of the second pillar the supervisory authority examines the propriety of the capital conformity measuring process of the banks and evaluates the strategy regarding the maintenance of the capital level. In case of inadequate processes and capital level, it takes quick corrective measures.

3. *Transparency requirements ('market discipline')*: with the stipulation of the publishing obligation, the third pillar aims the strengthening of the weight of the market discipline in decreasing the risks. The range of information to be published covers the essential elements of the bank operation, thus making the position of the banks more transparent for the market players.

1. 2. Preparedness of the Romanian banks

'Bank és Tőzsde' has made interviews with representatives of Romanian banks to see how prepared they are for the introduction of the capital conformity regulation of Basel. 11 Romanian banks participated in the survey, some of them giving their names; most of them were however in incognito, to provide data for the aim of statistical data processing.

According to the study, the banks – regarding the general opinion about the new regulation – evaluate the capital conformity regulation of Basel as a positive feature as it encourages applying the advanced risk management and measurement methods, as the rules valid today are simply applicable though, but they reflect the actual credit risks less. At the same time, the three-pillar-solution, the introduction of the selectable methods results also in the increased freedom of the supervisory and the regulating authorities in making decisions, evaluations and consideration. It is still unpredictable, how the authorities will take the opportunity of this freedom, and how it will affect the competition.

As most of the banks are possessed by foreign owners, generally they will not apply self-developed methods, except for the National Bank having the largest portfolio. In case of the other market players, the parent institutions support and coordinate the preparation of their subsidiaries in a centralized way, giving them freedom and at the same time they allow local developments as well. As fifty percent of the bank projects were elaborated to launch the regulation at some banks with smaller work teams of coordinating nature, and where the size gave reason for it, with establishing a whole division.

Fifty percent of the banks interviewed stated that they would use the simpler applicable standard method for measuring credit risks and they would switch to the advanced method based on the internal qualification later. The other banks (mainly the larger banks) would launch the method based on the internal data at once. The case is similar with the processes used for measuring the capital requirements of the operational risks: the domestic banks voted for the standard and the advanced methods in a ratio of 50-50%.

It is a general opinion at Romanian banks that considerable information technology development is necessary in order to meet the requirements, the costs of which – depending on the size and the quality of their information system – amount to around a hundred and five hundred thousands Romanian forints. The representatives of the banks estimate the time needed for the development and the introduction for about two-three years, but some said five years too.

To the question that in what they see the biggest problems during their preparation, banks listed the elements as follows:

- As the new regulations have not been elaborated yet, they 'have to shoot on a moving target'.
- They have to meet both the regulations relating to the parent institution and the domestic rules, while decision making regarding domestic issues is at a rather initial stage.
- The regulation is based on thorough theoretic, statistical and mathematical 'formulas', and all these should be applied in the business life, when granting credits. The biggest challenge for the banks is to convert the theory into a well applicable practice.
- National level aggregated data are missing regarded for example probabilities of arrears, loss rates and information on events relating to the operational risks.
- In some subjects, a unified interpretation applicable in the Romanian legal system is missing: for example the notion of arrears, the acknowledgement of guarantees, etc.

To sum up it can be stated that the preparatory period for launching the regulation of Basel is over, and banks are busy with duties necessary for the introduction. Despite the difficulties and problems emerging, the deadline will probably be kept, and – even if with different strategies – the conversion will be carried out in time.

Taxation of corporations

Taxpayers, rates

All legal entities doing business in Romania are liable to pay corporate income tax ("profit tax") on their taxable profits. From 2000, the standard profit tax rate is 25% applicable to both Romanian incorporated companies and to foreign legal persons operating through a "permanent establishment" in Romania.

Companies that obtain hard currency incomes from export of goods and services pay a reduced profit tax of 5% for the profit related to these export operations. This is conditional on the hard currency being received in a bank account in Romania.

Profit tax computation, deductions, non-deductible items, payments

The taxable income is determined based on the accounting income adjusted for tax purposes. Generally, only expenses related to obtaining revenues are tax deductible.

The main non-deductible expenses are: expenses not based on specific justifying documents, provisions and reserves higher than the legal limits, contractual penalties and fines due to foreign businesses and to both Romanian and foreign authorities, social expenses over the legal limit. Protocol expenses are deductible up to 1% of profit and sponsorship expenses are deductible up to 5% of profit.

Expenses with services provided by non-residents are non-deductible for profit tax purposes (e.g. management and consulting) if their payment entails operational losses at the level of a tax year.

It is compulsory for a company to create legal reserve of 5% of the annual accounting profit before tax until it reaches 20% of the company's share capital. The legal reserves thus created can be deducted from the taxable base when computing the profit tax.

Dividends received by a Romanian legal person from another legal person, whether foreign or Romanian, are not subject to profit tax. On dividends paid by all Romanian companies a 10% dividend tax is applicable for the dividends distributed to legal persons and 5% for those distributed to natural persons. These rates are subject to treaty relief. The dividends may be distributed only after the submission of the annual Balance Sheet (15th April of the following year). No interim dividend distribution is allowed.

Profit tax is computed monthly on a cumulative basis for the calendar year (which is the Romanian fiscal year). It is paid quarterly up to 25th of the month following the quarter it relates to.

Withholding taxes

Non-resident legal and natural persons obtaining income from Romania are subject to the following main withholding taxes if there are no overriding provisions in international treaties:

- 15% on royalties;
- 10% on interest (bank deposit interest paid by Romanian banks are excepted);
- 15% on commissions;
- 15% on revenues obtained from technical assistance and most other services if they are performed in Romania;
- 15% on revenues from international transport activities.

The Double Taxation Agreements signed by Romania may reduce the withholding tax rates on the payments listed above. The Romanian authorities are frequently aggressive in collecting withholding tax, often disregarding international conventions on how treaties should be applied.

Failure by the payer to properly withhold taxes can lead to a penalty of up to 100% of the tax not withheld plus the delay penalties specified above.

Indirect taxation - Value Added Tax

Rates, payments

The Romanian VAT legislation generally follows the provisions of the EU Sixth VAT Directive.

A 19% VAT rate is applicable in Romania. For export of goods and services a 0% VAT rate applies provided that the foreign currency related to the export operation is paid into an account opened with an authorised bank in Romania.

VAT should be paid monthly by the 25th of the month following the month it relates to. The VAT reverse charge should be paid within 7 days from the date the external invoice is received.

VAT exemption

A VAT exemption applies to a range of activities including banking, finance and insurance, types of research and development work and to specific activities performed inside the free trade zone. Romanian legislation also includes the concept of exemption with input VAT recovery.

Fiscal representative for VAT purposes

Foreign businesses can only register for VAT in Romania through a fiscal representative. In this case VAT on services and goods supplied in Romania is accounted for through a return submitted by the fiscal representative. The foreign business can recover VAT costs incurred through the returns.

VAT refundable

If a company is in a VAT reimbursable position, it is entitled to request a refund according to specific provisions, depending on its operations. Alternatively, the refundable balance can be offset against past or future VAT liabilities. In practice, if a refund is requested it can often take some months for the money to be effectively paid back.

Tax treaties

has signed a significant number of bilateral Double Tax Treaties. Most of these treaties follow the OECD model.

The Double Tax Treaties prevail over domestic legislation, provided that a certificate confirming the fiscal residency of the beneficiary of the payment made abroad is issued for Romanian taxpayers.

Double Taxation Agreements to which Romania is a party:

Albania	Hungary	Poland
Algeria	India	Portugal
Armenia	Indonesia	Russian Federation
Austria	Israel	Slovak Republic
Bangladesh	Italy	South Africa
Belarus	Japan	Spain
Belgium	Jordan	Sri Lanka
Bulgaria	Kazakhstan	Sudan
Canada	Korea	Sweden
China	(Republic)	Switzerland
Costa Rica	Kuwait	Syria
Croatia	Lebanon	Thailand
Cyprus	Luxembourg	Tunisia
Czech Republic	Malaysia	Turkey
	Malta	Ukraine

Denmark	Moldova	United Arab Emirates
Ecuador	Morocco	United Kingdom
Egypt	Namibia	USA
Finland	Netherlands	Uzbekistan
France	Nigeria	Vietnam
Georgia	Norway	Yugoslavia
Germany	Pakistan	Zambia
Greece	Philippines	

Withholding tax rates provided by some DTAS:

Country	Commissions (%)	Dividend (%)*	Interest (%)	Royalty (%)
Non Treaty	15	10	10	15
Austria	X	15	0/10	10
Belgium	5	5/15	10	5
Bulgaria	X	10/15	15	15
Canada	X	15	15	15/10
Cyprus	5	10	10	5
Czech Rep	X	10	7	10
Denmark	4	10/15	10	10
Finland	3	10	10	10
France	X	10	10	10
Germany	X	10/15/25,75	10	10
Greece	5	45/20	10	5/7
Hungary	5	5/15	15	10
Israel	X	15	5/10	10
Italy	5	10	10	10
Japan	X	10	10	10/15
Luxembourg	5	5/15	0/10	10
Malta	10	5/30	5	5
Moldova	X	10	10	10/15
Netherlands	5	10/15	0/10	10
Netherlands	X	0/5/15	0	0
Norway	4	10	10	10
Poland	10	5/15	10	10
Portugal	X	15	10	10
Russia	X	15	15	10
Slovakia	X	10	10	10/15
South Africa	X	15	15	15

Spain	5	10/15	10	10
Sweden	10	10	10	10
Switzerland	X	10	10	0
Turkey	X	15	10	10
Ukraine	X	10/15	10	10/15
United Kingdom	12	10/15	10	15/10
USA	X	10	10	10/15

Note: X not stipulated

* The lower rate provided either by DTA or domestic legislation would apply

- The **Legislation** group re-examines the legal frame applicable to any type of credit institution, in order to unify all the regulations in one single law, containing general principles for all types of credit institutions and also specific sections for different categories.
- The **Capital & Groups** group establishes the requirements regarding the capital adequacy at the group level, also the requirements regarding the capital adequacy at individual level for the entities supervised at consolidated level and the requirements for monitoring the concentration risk, specific for intra-group activities.
- The **Credit Risk** group has three subgroups:
 - The **Quantitative Impact Study** subgroup prepares and performs the quantitative impact study and makes the analysis of the impact study data for the credit risk.
 - The **Standardized Approach** subgroup reconfigures the existent regulation frame for adapting it to the New Capital Accord requirements for solvability indicators, techniques for reducing the credit risk, limits applicable to big exposures, limits applicable for persons having a special relationship with the bank. This subgroup also transposes the provisions regarding the external ratings offered by institutions specialized in external credit evaluation (ECAI) and export credit agencies (ECA).
 - The **Advanced Approaches** subgroup elaborates the regulation frame to implement the sizing methods for the capital requirements based on internal models of rating – base method and advanced method.
- The **Operational Risk** group elaborates the regulations required for the transposing of the New Capital Accord provisions regarding the operational risk. This group prepares and performs the quantitative impact study and makes the analysis of the impact study data for the operational risk.
- The **Market Risk** group establishes the credit institutions CAD type and non-CAD type, performs the impact study for the CAD banks, and modifies the legal frame according with the reconfigured directive. Its target is to realize the convergence of the banking legal frame with the capital market legal frame regarding the market risk.

2. Market environment

2. 1. Market players

Regarding ownerships, the role of private capital dominated in the domestic financial segment. During the privatization, the ownership, institutional and corporate management structures based on private capital were practically consolidated. State property in the bank segment is still considerable, which is not unusual when comparing it with the developed economies: in the bank system of some OECD countries (e.g. Germany), the proprietary share of the state is around 50%.

A further similarity is that the market players are nearly the same. It is due to the fact that during the domestic privatization and the organic growth of the market structure mainly foreign professional investors acquired significant positions. 70% of the Romanian bank segment is owned by such foreign investors, the majority of which operates in the financial market of the EU. It also means that the style and practice of the corporate management and the business policy of the domestic financial service providers are considerably similar to the ones common in the financial markets of the EU.

In the meantime it is worth mentioning that a considerable banking concentration has been started in the EU. The demand and supply will determine as well in Hungary whether the approximately 40 existing banks are needed. The competition will become more fierce, which will result in the improvement of the quality of the services and the introduction of new products. On the middle run the acquisitions and merging of the banks are expected in Hungary as well, while we can count on the increase in the number of bank branches: less banks will provide services with more branches to the customers.

2. 2. Range of products

We do not fall behind the EU regarding the product range: more or less all the products, services and types of services can be found in the Romanian financial segment, which currently exist in the practice of the developed economies and financial systems. Naturally it should not be understood as the given products, services or market are present in Hungary with great business volume and at an advanced stage. On the contrary, in many cases (e.g. some derivatives, corporate bond market, or some electronic bank services, etc.) it is not characteristic at all. It is more important though that relating to the current product range, the necessary professional knowledge and practice and the business and infrastructural background exists at a certain level. Thus, the accidentally not introduced products can be easily established, in case the market provides opportunities for this, or there is demand for it.

It shall be noted in the same time that there are considerable differences between the relative development and the business weight of some financial services: the development of some business fields is at a pretty early stage, while the development of other services branches (e.g. the majority of the commercial banking services), mainly regarding the services volume and the maturity of the market, can be compared with the practice of the developed economies.

There are some examples to support the above mentioned facts: several banking services are under-developed, like the corporate procurement and financing branches, and the trading of the financial derivatives. The corporate bond market is missing almost as a whole, and the stockmarket too has little importance in the financing of the economy. Despite of the fast domestic growth, the economic weight of the electronic banking services and the Internetbank falls considerably behind the practice of the developed economies, and numerous retail trade banking and insurance services of high value are missing or are at a very early stage (e.g. home administration on behalf of the customers).

Among the above mentioned fields, in many cases the reason for the backlog is the economy, and the small size of the mentionable businesses and the market – this is the case for example regarding the investment banking services and the stockmarket. A further well-known reason is the monetary stability with a level falling behind the developed economies, and the relating lack of confidence of the investors, which results in high national resources expenses, thus hindering the development of the bond and stockmarket. In other cases, such as the electronic banking services or generally the banking retail trade services, the backlog derives partially from wages or financial reasons, mainly, however, from the limited velocity of the expansion of the necessary financial culture.

2. 3. Technical- technological background

As the financial services considerably depend on the quickly developing technological conditions, it is wise to mention the existence and the continuous development of the information technological (hardware, software) and the telecommunicational infrastructure. In this respect Hungary has caught up during the last years: the service providers have access to the information technology common in the developed economies, regarding the telephone supply we have a backlog of less than five years, and regarding the Internet supply we have a backlog of 5-10 years compared to the most developed economies.

Even despite this relative backlog, the technological background will not considerably hinder the development of the financial segment after joining the EU. Especially the expansion of the Internet-technology together with the emerge of the netbanking-services shall be considered as the primary trends of the development.

3. Macroeconomic environment

In the Romanian economy both inflation and real interests are higher than the ones in the EU. It is also a reason of the increase in the interest margin that the national bank, which is responsible for stopping the inflation acts to decrease the growing demand for capital. The main mean to reach this is to keep the liability costs on a high level in order to limit the capital demand of the domestic private segment.

In the last months this strategy trend seems to be given up, and in parallel with publishment of the better macroeconomical figures the national bank has started to decrease the interest rate in the frame of a slow but continuous action. But the market does not react immediately to these changes: the commercial banks move their interest level gradually to the new one, mainly at first on the business market then later on the private market. As a consequence, the interest rate structure becomes different from the usual European examples, and leads to a high interest margin level for the bank segment. According to the data of 2003, on the Romanian credit market the interest margin on consumer loans was 15.6% versus 7% of the EU, while in case of mortgage loans 7.2% versus 2.5%.

This leads to a very high level of profitability of the bank segment: the average ROE in the Romanian bank segment is about twice as much as it is in the European Union. This is also visible in the 'success story' of the National Savings Bank, OTP: on the qualification list of Euromoney in the first half of 2005 OTP won the first position, mainly because of its extraordinary profitability level.

The potential of growth for the segment is visible even within the Union as well, but on the middle run we can expect a decrease in the margin level, so the difference between the Romanian and the European Union banks will be smaller or fully disappear. But if the developments will go on, and the efficiency could be increased, the profitability can be kept presuming some growth in the volumes and the provision of services. But the profitability on capital should be dropped, and the average ROE of the Romanian bank segment will get closer to the European level, maybe by the end of the decade.

Conclusion

As it could be seen, the Romanian financial segment at all points and in the highest degree got close to the level of EU, and in any kinds of comparison mainly the similarities dominate rather than the differences.

After the accession on 1st May 2004 there were no significant changes in the segment. The legal harmonization had already been realized, and further changes cannot be foreseen, only on mid-term, after joining the EMU, which is scheduled around 2008-2010. Accordingly we should not expect any radical changes in the bank segment in the next few years.

In the meantime it is worth mentioning that in the frame of the integration to EMU and the European single financial market the bank segment will face a strong constraint of an intensive adaptation, which will determinate essentially the development of the segment. And this should lead to a continuous development of our banks and financial segment.

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