Deposit Guarantee Fund in the Romanian Banking System
Terms of Reference
Final Phase
(November 2005-January 2006)

Background

The preparation of two technical seminars in Romania (September 24-25 and November 18) to share preliminary analyses and methodological approaches with authorities and market participants has substantially covered the anticipated deliveries provided under the July 2005 revised ToR.

Next Steps

To help the Romanian authorities gain full understanding of the underlying risks carried by the DGF and the attendant financial reserve needs under base and stress scenarios, more analytical work has become necessary. The parallel work conducted by the Italian Deposit Insurance Fund has also opened new horizons for operational application in Romania that require careful integration work with the analytical methodology prepared by the Convergence team.

It is now envisaged to bring the project to completion through two additional rounds of discussions. An informal one in mid-December involving National Bank of Romania officials and a formal one in mid-January through a final presentation to the DGF Board.

For each client interaction, specific analytical work will be required, as determined by Convergence. The consultant will make himself available to travel to Bucharest at Convergence's request.

In addition, an opportunity has arisen to summarize some of the present findings to a regional meeting of the European Forum of Deposit Insurers in Sarajevo.

Professional Fees

The additional work as described above to bring the project to completion will require 20 full-time equivalent working days.

The payment will occur in two tranches: the first at the end of December, based on the actual full-time equivalent days spent on the project but no greater than ten, and the second after the delivery of the Convergence final report to the DGF Board.

ANNEX 1

Convergence

Romanian Deposit Insurance Fund (DIF):
Designing Policy Discussion Documents

Introduction

Initial work on this project has provided analytical background and depicted main lines of thinking about regulatory reform of Romanian deposit insurance scheme. It also helped to define the following *goals and steps to be taken in the remaining part of the project:*

1. *The target is to: (1a) provide comprehensive analytical material to help authorities consider a further decrease in insurance premia despite the recent coverage increase; (1b) success in this activity may lead to a broader mandate to help authorities in reforming deposit insurance system* (including advise on legal changes, working procedures, exchange of data between RNB – Romanian National Bank and DIF, and development of analytical skills of Romanian DIF)
2. In order to achieve the target (1a), three *separate policy discussions / workshops are to be held with banks* (RBA – Romanian Banking Association), *,authorities* (RNB) and client(DIF). Expected dates for workshops: September 15th – Oct 1st
3. In order to achieve the target (2), *three separate policy discussion documents should be sent* to RBA and the RNB and a final one, incorporating feedback from the two previous sessions, for DIF. [A secondary consideration is to which extent to share a summary of the RBA paper with RNB.]
4. Three separate policy discussion documents (3) should be based on the *common analytical platform* that can be used as a supplement for these documents.

The consultants retained for the DIF study will continue to work on (2), (3) and (4) above. *Three documents* should be produced:

1. Main Facts About Romanian Deposit Insurance Scheme (common analytical platform – see 4 above)
2. Romanian Deposit Insurance Scheme: Policy Analysis, Implications and Issues for Consideration (Banks)
3. Romanian Deposit Insurance Scheme: Policy Analysis, Implications and Issues for Consideration (Authorities)
4. Romanian Deposit Insurance Scheme: Policy Analysis, Implications and Issues for Consideration (DIF Board) – with summary of consultations with RBA and RNB.

Structure, format and size of documents should follow standards as set out below.

Preliminary draft documents should be delivered no later than August 24th 2005.

Consultants will participate at the *workshop on August 25th and 26th* organised at consultants' premises with an aim to review preliminary drafts.

Final version of documents will be delivered no later than 10 working days after completion of workshop discussions. Final versions will also be presented in the form of *power point presentations.*

Consultants will participate at *policy discussion workshops* as defined in (2) – see top of the first page.

Consultants will work for [*30] days* each. [Actual number of additional days will be determined after a more detailed assessment in Olivone or Crikvenica].

Main Facts About Romanian Deposit Insurance Scheme (common analytical platform)

Preliminary analysis, which was presented as a background to discussion in Olivone, will serve well as a basis for this document. It needs to be edited in order to erase all parts where opinions or recommendations are made. Any opinions expressed or recommendations made should be transferred to policy discussion papers as defined below. Also, the following indicators should be added to the document:

1. Loans to deposits (peer groups and individual banks)
2. Profitability analysis (peer groups and individual banks)
3. „Self-insurance" = Capital plus non-insured liabilities (for individual banks available in the data base)[1] minus bad assets, in order to indicate the risk that the DIF is exposed to ie. in order to indicate how much credit risk is «self-insured» by non-insured liabilities; plus the other indicators discussed in Olivone: low L/D, high RR, CAR much higher than statutory, higher NIM,.... .
4. Discussion of risk implications of recent coverage extension.

Structure, format and size of this analysis is free. [Indicative number of pages: 10-15]

Romanian Deposit Insurance Scheme: Policy Analysis, Implications and Issues for Consideration (Banks)

The first section should describe EU regulatory requirement, and emphasise the economic and political (financial history and social compact of EU) rationale for deposit insurance regulation. This section should make it clear to banks *why this regulation is imposed on Romania.*

[1] Notice that capital plus non insured liabilities equals total balance sheet sum minus insured amount of deposits.

The second section should present overall financial stability architecture and define the role of deposit insurance within it. The purpose of this section is to *explain complex relationships between different components of financial stability architecture*. This section should prepare the reader for understanding why lower premium in conjuction with higher coverage (incompatible when viewed separatelly from the overall stability framework) may actually lead to improvement in functioning of overal financial safety net.

The third section should be written in parallel with the first section in the policy discussion paper for Authorities (see below). It should start with presenting international comparison of net interest margin (NIM), showing that Romanian NIM will converge towards EU NIM in the long run, making banks more sensitive to any cost of regulation and cost of deposit insurance in particular. The rest of the section should make the reader aware *what 20 000 EUR coverage means if the old logic of calculating premium is applied.*

The fourth section should clearly express the industry position towards regulators (ie. it should support the argument that the premium should actually go down, instead of up). In particular, it should emphasise the following arguments (and provide, to the extent possible, for each of them an approximation of its insurance premium equivalency vs EU standards):

a) high capital adequacy, which is not so high only due to expected credit growth, but partly also for risk management reasons (consultants should explore the option to decompose two kinds of reasons for holding large capital stock),
b) low loans to deposits ratios (peer groups), which partly reflect banks' risk awareness cause they extend less loans than they could due to proper risk assesment in an immature market,
c) relatively high NIM should be interpreted as a source of retained earnings i.e. capital (this argument may be used only after checking for banks' dividends policy in Romania),
d) low cost/income ratios, indicating efficiency and quality of Romanian banks,
e) improved soundness and risk management standards,
f) overall systemic stability, indicating that only in a peer group of smaller domestic private banks there may be several «bad banks» that can be dealt with easily in the case of default.

In conclusion, this section should emphasise „bargaining good“ argument, pointing out that lower premium may lead to either lower lending rates (and more credit) or higher deposit rates and it should sketch a quantity impact analysis given presumed price elasticity of demand for deposits/credit.

Paper should be written clearly, in short sentences, with executive summary included and a lot of graphs and figures illustrating main points that should be highlighted. Not more than 20 pages, 1.5 spacing.

Romanian Deposit Insurance Scheme: Policy Analysis, Implications and Issues for Consideration (Authorities)

The purpose of the first section is to make authorities fully aware of what the 20 000 coverage implies if the old principles of deposit insurance pricing will be followed. Here, too, peer group analysis of «self-insurance» will be used in order to show DIF's risk exposure. The purpose of the policy discussion in this section is to show how this component of financial stability architecture may put some other components (market discipline, supervisory incentive) under jeopardy. Moral hazard argument will be introduced here.

The purpose of the second section is to present comparative analysis of deposit insurance parameters in Romania with other transition and EU countries. Comparison of premiums, PPP adjusted coverage and coverage ratio (DIF over insured deposits) will be presented here. Main message to convey here is that the Romanian situation is specific, setting grounds for specific remedies.

The purpose of the third section is to define the analytical framework for consideration of policy options. The framework should contain three elements. First, it should provoke discussion on what do authorities want to achieve with DIF (equally, it should point out what should not be achieved with DIF – undermining other components of financial stability architecture). Second, referring to the «self-insurance» analysis in section one, this part should provoke the discussion about supervisory incentive (it should be clear to authorities that close to full deposit insurance may undermine quality of supervision). Third, quantitative simulations for four times three (12) scenarios (i.e. premiums of 1%, 0.2%, 0.12% and 0.08% [0.03 is just not credible], and LGDs 20%, 50%, 80%) should be made. Simulations should show for each of 12 scenarios the following:

a) impact on coverage ratio (DIF over insured deposits)
b) implied number of smallest banks from the «residual» group that may be covered by the scheme in case of hypothetical default.
c) implied number and type of banks that are not covered (e.g. state owned, too international too fail etc.)

In addition, this analysis should:

a) show a plausible scenario according to which the DIF may actually be „overfunded“,
b) project feasibility of a „de facto“ ex-post funding, based on large reserve requirement balances with NBR (to counteract argument that banks should not be taxed in difficult times) – the aim of this analysis is to outline % of RR balances

that may be temporarily used to finance payout of deposits in a (remote) distress scenarios. Distress scenarios will be defined according to min CAR criteria (ie. what if N banks with lowest CARs fail). Also, for each distress scenario, the analysis should show % of capital of surviving banks that will be consumed if the cost of distress will be paid by surviving banks only. Policy options should not be discussed here, but this scenario analysis serves the purpose of introduction to the policy discussion in the last section:

The fourth section should point out policy recommendations i.e. a need for regulatory reform. Recommendation will follow the principle of flexibility: deposit insurance pricing should be reviewed occasionally (at least annualy) and authorities should have well-prepared analysis at hand (along the methodological lines as set out by Convergence in this paper). We will recommend to authorities to have a free space for changing premiums and switching between different types of premiums annually or on an ad hoc basis (in case of unforeseen distress situation). Reduction of base premium will be recommended, but a large manouvering space should be left for the authorities. We will recommend to authorities to continue to employ: (a) additional premium (same for all banks), (b) risk based differential premium, (c) supplementary (flat or differential) premium, which may be used as an element of an ex post system. We should also introduce the concept of contingency planning for Purchase & Assumption transactions (possibly supported by a syndicated line of credit) that are likely to reduce the call on DIF resources in the event of bank insolvency.

Distress situations that should be managed on ex post basis will also be discussed here (following analysis at the end of section three). We will present options for ex post financing, such as: (a) issuing debt at the market, (b) borrowing from the central bank and / or temporary use of reserve requirement, (c) borrowing and/or DIF recapitalization from the government. Here we will discuss principles that should govern the choice of ex post instruments, as well as principles of intervention (emphasising that the two are closely interconected). The framework for this discussion will be defined in terms of trade-off that regulators are facing with in distressed situations: how to find a balance between a need to minimize fiscal implications of banks' distress, and a need not to endanger soundness and solvency of surviving banks. In this context, we will present two basic concepts of DIF (DIF as a „pay-box“ vs. DIF as an active player in banks' failure resolution) with a purpose to motivate authorities to consider broader regulatory reform of deposit insurance system with a help of Convergence in the future.

Investment policy, organisational issues (relationships with NBR) and conflict of interest considerations are to be added in the annex to this paper.

Paper should be written clearly, in short sentences, with executive summary included and a lot of graphs and figures illustrating main points that should be highlighted. Not more than 35 pages, 1.5 spacing.

<u>Summary of analytical processes and outputs implied in the description of documents above with an indication of the degree of complexity, where complexity depends on</u>

method applied and ease of access to data (A- complex analysis, B – routine analysis). This list does not include analysis that has already been done for the status paper for Olivone meeting I

1. Loans to deposits (peer groups and individual banks) - B
2. Profitability analysis (peer groups and individual banks) – B
3. „Self-insurance“ = Capital plus non-insured liabilities (for individual banks available in the data base)[2] minus bad assets, in order to indicate the risk that the DIF is exposed to ie. in order to indicate how much credit risk is «self-insured» by non-insured liabilities – B
4. NIM analysis (EU countries, other selected countries, Romania) – A (due to time consuming access to proper data)
5. Capital holdings can be explained, among other reasons, by risk factors as well as by expected credit growth; two factors should be isolated – A (due to unknown standard methodology)
6. Calculating cost/income ratios for peer groups and individual banks – B
7. Estimating price elasticities of demand for deposits/credit - A
8. Calculating quantitative impact of premium on interest rates (margins) and supply of loans (given results under 7) - A
9. Comparative analysis of deposit insurance parameters for Romania, EU and selected transition countries, including PPP adjusted calculations as well as making cross-country comparisons of DIF parameters vs quality of banking system indicators - B
10. 12 scenarios analysis (four premium scenarios times three LGD scenarios), calculating coverage ratio, number of smallest banks covered, and indicating the number and characteristics of banks not covered. No. of scenarios can be blown up to 36 if we want to see the results for 12 scenarios under different coverage assumptions (10,15 and 20k) – A
11. Distress scenario analysis (what if N banks with smallest CARs fail) – we suggest to make calculations up to 5 banks. For each of five scenarios and three LGDs (15 in total) we need to calculate a ratio of insured deposits to RR holdings and capital of surviving banks - B

[2] Notice that capital plus non insured liabilities equals total balance sheet sum minus insured amount of deposits.

ANNEX 2

Convergence

A World Bank Public-Private Financial Sector Programme

"Assessment of the level of the annual contribution paid by participant banks to the Romanian Deposit Insurance Fund"

1. Project summary

   1.1 Location of project: Romania
   1.2 Duration of Project: 90 days
   1.3 Aim of Project: Optimization of financial efforts of authorities and banks to maintain a viable, credible deposit insurance scheme
   1.4 Target Group/beneficiaries of project: The Romanian Deposit Insurance Fund, local banks, depositors, borrowers
   1.5 Source of Funding: World Bank
   1.6 Project Team/Responsibilities: Convergence Staff + External Consultants
   1.7 Project Leader: Prof. Dr. Shkelqim Cani (World Bank Consultant for Convergence).

2. Project Narrative

   2.1 Project background

The Romanian Deposit Insurance Fund (DIF) was established in 1996, as a mandatory, ex-ante funded insurance scheme to protect individual depositors against the risk of bank insolvency. At that time the Romanian banking sector was not restructured, and the bank failures that occurred in 1999-2000 had completely wiped out the meager resources of DIF. To cope with the resource shortage, the authorities extended two loans to DIF and increased the level of regular annual contributions to be paid by banks to 0.8% of the stock of their deposits. Although this level was subsequently decreased to 0.5% this year and will further drop to 0.3% as from January 1, 2007, it still remains among the highest in the world.
Now the banking sector in Romania appears to be relatively stable and safe by region's standards, as ascertained by the IMF-World Bank FSAP conducted in 2003. Also, resources of the DIF have increased to about 1% of the aggregate deposits in the banking sector, with the loans taken in 2000 repaid almost in full. Against this background, the DIF is currently examining if the level of annual contributions is still appropriate and are in the process of formally requesting Convergence's assistance in this evaluation. The DIF's governing structure consists of a Supervisory Board, chaired by a senor official of the National Bank of Romania, and composed of representatives from the Ministry of Public Finance, the Ministry of Justice, the Bankers' Association and the National Bank of Romania.

   2.2 Project description

The project will consist of an analysis of the current level of bank contributions to the DIF, as benchmarked against the current structure of the banking sector and of the deposit base in Romania and using international comparisons. The DIF and banks are expected to contribute to the project by supplying data to facilitate the analysis.

It will include considerations of the existing bank supervision and bank resolution framework. Its outcome will be a methodology, to be applied at periodic intervals, to assess a fair and prudent level of annual contributions by banks. It will include a recommendation concerning a current fair and prudent level of annual contributions by banks that may be embedded in an amendment to the Law on the Statute of DIF.

2.3 Beneficiaries

The Romanian financial services clients will benefit from more attractive pricing conditions made possible by reduced deposit insurance contributions by banks, in line with the current lower risks associated with the Romanian banking sector.

2.4 Project sustainability

If successful, the project could be replicated easily and with lower costs for other Convergence countries of operations which have gone through similar experiences as Romania and are now facing the same issue of re-calibrating the banks' contributions to the domestic deposit insurance funds.

2.5 Risks and alternative strategies

The main risk for the project is not to have the recommendation formulated transposed in practice, due to legislative delays and/or weak political commitment. This risk is mitigated by the dialogue conducted by Convergence staff with the Romanian authorities, which will continue throughout the life of the project to ensure local ownership.

2.6 Choice of Consultants

It is envisaged to hire a deposit insurance consultant with regional policy experience. The consultant will need to identify a suitable technical counterpart within DIF. Convergence will seek to mobilize additional technical support from the Secretariat of the European Forum of Deposit Insurers.

2.7 Selection Criteria for the Consultant

The Consultant needs to have the following characteristics:

- To have considerable experience on deposit insurance institutional and policy issues in South East Europe;
- To have been retained by international institutions as a policy advisor for deposit insurance matters;

•To have a significant history of writing on financial, banking or economic matters.

The Consultant will collaborate closely with the Convergence team. Mr. Shkelqim Cani, a World Bank consultant contracted to undertake pre-implementation work for Convergence, will be his primary contact. Mr. Luigi Passamonti, World Bank Convergence Task Manager, will provide overall oversight.

The World Bank and Convergence will assist the consultant to gain access to Romanian authorities and market counterparts.

3. Estimated Budget

The detailed breakdown of the estimated budget for this assignment is provided below:

1) Fees:	US$XY (US$Z*30 working days)
2) Travel costs:	US$ 3,200 (4 air tickets and local travel)
3) Subsistence costs:	US$ x,xxx (Bucharest:10 person-days; $xx per day in per diems plus $1xx per night hotel fee; Rome: 1 person-day)
Total budget:	US$yy,xxx.

It is expected that the consultant will start work in May, 2005.

Project: **Romania Deposit Insurance Fund** **(April 19, 2005 Draft)**

Project Start date: May 16, 2005

	Activity		Output	Duration	Deadline
1	Discussion with DIF Board on detailed project scope		Formal Convergence Proposal		May 18
2	Interviews with DIF Board members and other stakeholders		Mapping note on stakeholders' constraints and objectives		May 20
3	Press Release		Informational Note		May 20
4	Review of EU institutional arrangements for deposit insurance schemes		Internal note		May 31
5	Review of literature on deposit insurance pricing models		Internal Note		May 31
6	Data gathering on banking and deposit base structure in Romania		Internal Note		May 31
7	Review of Romania's bank supervision and bank resolution frameworks		Internal Note		

8	Regional and EU comparative analysis of deposit insurance and banking and deposit structure		Internal Note		May 31
9	Draft Report Writing		Draft Report		June 15
10	Convergence Management Team review		Minutes of Meeting		June 15
11	Discussion with DIF stakeholders		Discussion notes		June 30
12	DIF workshop				July 10
13	Convergence Management Team final review		Minutes of Meeting		July 15
14	Bilateral engagement with NBR and DIF Board members		Discussion Notes		July 25
15	Final Report Submission				July 31
16	Press Conference				July 31

Project End Date: July 31, 2005