



December 14, 2005

Mr. Alexandru Matei
General Manager
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Bucharest
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Dear Mr. Matei

I would like to thank you immensely for the readiness and relentless assistance that personally you and your staff have provided us throughout the main stages of this study. The close and fruitful cooperation and the specialized support of RDGF technical staff have been a particular satisfaction and of utmost convenience for all the Convergence team.

I have had the honor of leading the assessment of the size of the Romanian Deposit Guarantee Fund (RDGF). We conducted the study with the Italian Deposit Insurance Fund (FITD). This letter outlines our joint recommendations.

Our views on the adequacy of the RDGF size and related implications for the annual premium policy are placed in the context of the specific structure of the Romanian banking system, which is common to most banks.

In Romania, insured deposits represent about 25% of total liabilities. An RDGF loss emerges when asset losses exceed 75% of total pre-insolvency assets. As liquidity accounts for close to half of total assets, an RDGF loss can occur only in an extreme combination of an insolvency characterized by a major liquidity withdrawal by non-insured creditors and very large loan losses. Except for only few and generally small banks which do not share these features, RDGF is a residual risk-taker. We believe that the RDGF financial policies should be consistent with Romania's specific market structure.

Accordingly, we have identified the following financial policy principles in respect of RDGF risk analysis, funding ratio, funding instrument, size and policy target. Lastly, we derive implications for the annual premium that banks will pay in March 2006 and 2007 respectively.

Risk Analysis

In collaboration with NBR Financial Stability and Supervision Departments, RDGF should analyze at least on an annual basis its risk exposure to the banks, with a view to identify those that pose a plausible risk of default in the next 2-3 years, building on the detailed FITD methodology used in our assessment. For these banks, it should project its at-default pay-out exposure and three related important indicators: a) the risk exposure it will have after collection of risk-free assets; b) a conservative estimate of risk assets collection; and c) the residual item -- that is, the expected final loss.

Funding Ratio

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RDGF should adopt a funding policy in respect of the risks it is exposed to. We do not believe that RDGF needs to set aside any funding reserve for its potential pay-out for banks that today do not pose a plausible risk of default in the next 2-3 years. Conversely, we recommend that RDGF carries a 100% funding reserve for those banks with a plausible risk of default ("risk" banks), even if the probability of this risk is considerably less than 100%. Finally, we recommend that RDGF carries a partial funding reserve for those banks that, although reasonably sound, have characteristics that may deteriorate into a situation of a plausible risk of default ("watch" banks).

Funding Instrument

RDGF should have liquidity quickly available to cover its conservatively estimated expected final loss, as described above. It is critical that RDGF solvency be beyond doubt. Part of the expected final loss may, eventually, be recovered (so called "risk recoveries"). The amount of liquidity should cover 100% of this expected final loss both for "risk" and "watch" banks. We recommend adding an adequate margin for unexpected losses. In deposit insurance terminology, this is "ex ante" funding.

We are otherwise of the opinion that RDGF does not need to tax member banks to have liquidity at hand to cover the difference between initial pay-out and final loss. Collection from risk-less and risk assets, even in distress conditions, is a standard cash-flow based financial transaction. It could be securely funded through a debt instrument. This principle is already applied in the Czech Republic. For this pay-out component, we recommend that RDGF raise from Romanian banks a committed stand-by line of credit that will be drawn down at a time of a pay-out event. RDGF will reimburse the banks on the basis of actual collections. In the unlikely event that actual collections fall short of expectations, RDGF will fund the residual reimbursement through an "ad hoc" supplemental premium levied on member banks. We suggest that the stand-by line of credit covers 100% of expected collections in "risk" banks and 50% in "watch" banks. In deposit insurance terminology, this is equivalent to "ex post" funding – that is, funding that is made available at the occurrence of a pay-out event.

RDGF Size Implications

On the basis of this methodology, and more in particular, by adding up the "ex ante" and "ex post" funding requirements as described above for the "risk" and "watch" banks, we estimate the total RDGF "target" size to be equal to 3.4% of insured deposits. This is equivalent to 2.1% of guaranteed deposits. The RDGF size would become in line with well-capitalized EU deposit insurance schemes – that is, those that have financial resources in excess of 2% of guaranteed deposits. This seems consistent with the fact that the Romanian banking system needs the support of a strong deposit insurance scheme, especially given the ongoing extension of insurance coverage driven by the *EU acquis*, despite significant improvements as noted by the recent IMF/WB FSSA.

The required RDGF "ex post" size – that is the amount necessary to cover the "safe" collections—is of the order of 1.9% of insured deposits. Projected to end-2006, this is equivalent to about €150 million. According to our informal inquiries, the Romanian banking sector is interested in providing this stand-by facility. As noted above, unlike the payment of premiums, a stand-by line of credit does not impact the profit & loss account of banks.

The required RDGF "ex ante" size is of the order of 1.5% of insured deposits (including reserve for unexpected losses), as compared to the present 2.4% level.

Policy Target Implications

Lastly, we recommend shifting the RDGF policy target from annual premium to Exposure Coverage Ratio (ECR). This ratio measures the proportion in which RDGF liquid assets (plus contingent liquidity) cover liabilities, as represented by the insured portion of guaranteed deposits. Every year, in collaboration with NBR, RDGF should calculate the level of annual premiums and the size of the stand-by line of credit necessary to keep the ECR close to its policy target.

Annual Premium

In this overall context, and based on information received from the NBR Supervision Department in June 2005, we believe that the annual premium could be decreased to 0.2% in 2006 and, once again, to 0.1% in 2007 of guaranteed deposits. Even with reduced premium inflow, the RDGF "ex ante" size is projected to stay at a comfortable 20% margin above our recommended operational target. In turn the total RDGF size (including the stand-by line of credit) is expected to stay at around 3.7% of insured deposits. This will keep the RDGF resilient to large system-wide credit deterioration, as our analyses have determined. Furthermore, barring material changes in the risk profile of the banking system, the 2007 premium level appears to be sustainable. It is consistent with keeping the RDGF "ex ante" relative size stable in later years, under reasonable insured deposits growth scenarios.

Investment Policy

The RDGF policy of allowing liquidity investments with member banks significantly raises its risk profile. We recommend RDGF investing its liquidity in risk-free bills and securities, denominated both in RON and foreign currencies, so as to match the currency composition of the insured deposit base.

Concluding Remarks

Finally, let me assure you that we have long had reservations about the possibility of a further decrease in the annual premium, given the ongoing large extension of insurance coverage. However, after a very careful analysis of the banks' financial indicators, in the context of high liquidity, low share of insured deposits in total liabilities and pervasive ownership by large international banks, we are satisfied that the actual risks carried by the RDGF are fairly remote and quite marginal, even under severe stress scenarios.

To assist with the operational implications of these analyses, we will present the details of these findings in a technical seminar with NBR and RDGF staff early in the New Year. We will be happy to assist the RDGF define a capacity-building program, based on the list provided in the attached Technical Annex, if the Board so decides.

We look forward to the Convergence Program continuing to contribute to Romania's financial sector development.

Sincerely,


Shkelqim Cani
Senior Country Advisor

cc: Avv. Roberto Moretti, Director General, Fondo Italiano di Tutela dei Depositi; Mr. Luigi Passamonti, Convergence Program.

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