



Autumn Report

# Trending Financial Sector Risks



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The latest joint report of the European supervisory authorities points out to Brexit, valuation risk given the uncertain yield outlook, low profitability of financial institutions and FinTech rapid developments as the main risks to the stability of the European financial sector.

## How relevant are these risks for the Romanian financial sector?

*The comments below are summarized and adapted from the Autumn 2017 Report on risks and vulnerabilities in the European Union's financial system published by the Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs), which may be consulted [here](#).*

### UK's withdrawal from EU



Upon UK's withdrawal from the Single Market, UK entities would lose their right to conduct business in Romania by way of freedom of establishment and freedom to provide services. For Romanian households and businesses, this would

imply potentially reduced access to certain banking or investment products, or higher costs when accessing certain financial products. Some UK financial entities

may decide to set up local subsidiaries and apply for authorizations with the local competent authorities, posing additional supervision challenges.

Romania's exposure towards UK is among the lowest in EU and therefore the direct impact of Brexit on the financial sector is expected to be limited. However, the ongoing negotiation process is an important factor of economic policy uncertainty, with the potential to expose EU member states to financial instability. Subsequently, additional work is needed to assess the impact of the UK's withdrawal on the risk profile of Romanian financial institutions, e.g. as a result of a potential deterioration in macroeconomic conditions at EU level.

## Valuation risk in the context of uncertain outlook for yields

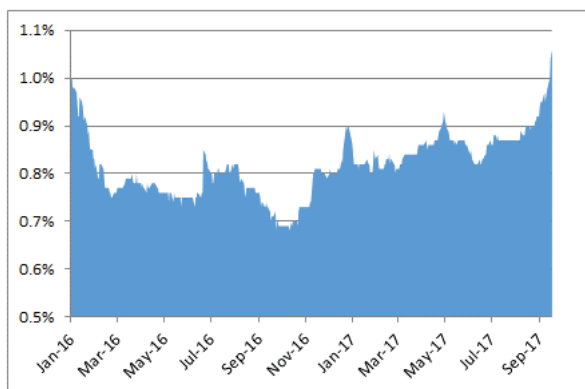


In line with EU-level trends, both interbank interest rates and real estate prices are on the rise, driven by the positive macroeconomic context. Increasing rates might not be sustainable especially for real estate debtors, which might generate

subsequent valuation effects in the real estate loan portfolios held by the local banks.

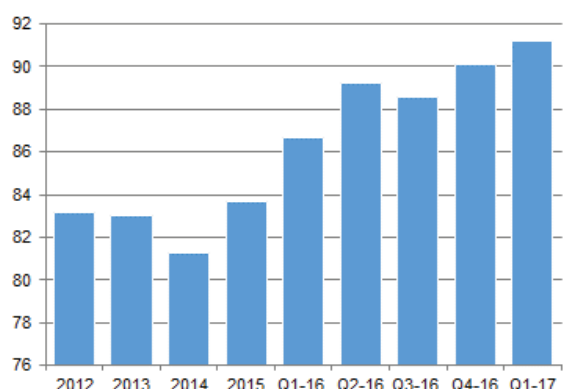
An abrupt increase in yields may also result in significant mark-to-market losses for local banks, insurers and pension funds, which hold significant portfolios of fixed-income treasury bills and bonds.

*3m ROBOR breaks 1% threshold in September 2017, first time since January 2016.*



Source: National Bank of Romania

*Residential property prices are on the rise (nominal values, 2010 = 100)*



Source: Bank for International Settlements

## Low profitability of financial institutions



Romanian banking sector shows better profitability compared to their European counterparts, with an average 10.42% ROE and 1.08% ROA vs. EU averages of 3.3% ROE and 0.21% ROA as of 2016.

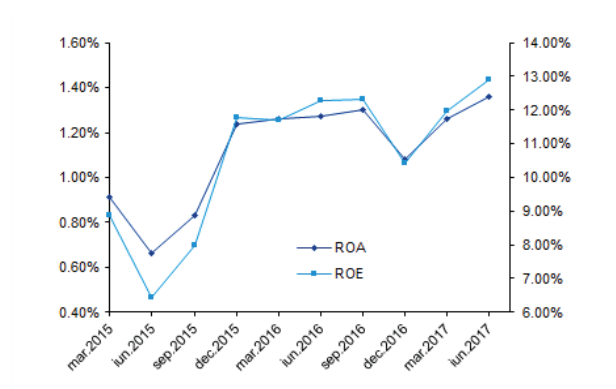
For the Romanian banks, profitability is driven by interest margins which

remained high due to an accelerated decrease of financing costs, as well as by further improvements in operational and risk costs. However, 2015 and 2016 results were also influenced by non-recurring events, raising questions as to their sustainability, and tended to be polarized, with most profits concentrated in several large banks.

In 2016, the Romanian insurance sector posted profits after seven years of aggregated losses, the effects of the low-yield, low economic growth environment being exacerbated by a high exposure towards the loss-making compulsory car insurance segment. Recent structural reforms have addressed some of the challenges of the insurance market, however the sustainability of profits is highly dependent on the increased penetration and diversification of non-auto insurance products.

Solvency ratios remained strong in the banking sector, with an average of 19.68% for 2016, and continued to strengthen in the insurance sector as a result of Solvency II implementation and related stress tests run by the supervisory authority in 2015 – 2016.

*Romanian banks - RoA vs RoE*



Source: National Bank of Romania

## Rapid developments in FinTech



The joint report highlights that FinTech has the potential to transform the provision of financial products and services in the coming years. The local banking sector, for example, is experiencing the entry of new competitors in payments services and

new categories of players are expected once the new Payment Services Directive (PSD II) is in effect. Increased competition may drive changes in the business models of financial institutions, as they adapt product offerings and their interactions with customers.

As per the joint report, the main risks to consumers and financial institutions emerging with the proliferation of technological advances are related to the use of analytical tools (e.g. robo-advice), outsourcing to cloud and other service providers, distributed ledger technologies and the development of tailored products and new risk management tools used in the insurance sector – all of which are still in incipient stages on the local market. EU supervisors are closely monitoring developments in FinTech area and further extensions of the regulatory framework to address the emerging technology risks are not excluded.

Despite a limited exposure to some of the main risks to stability identified at EU level, ongoing and economic and political uncertainties continue to pose threats to the Romanian financial sector. Similar to their European counterparts, Romanian financial institutions are under pressure to adapt their business models to the rapidly evolving environment, with due regard to long term resilience and sustainability.

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