An Overview: Romanian Banking System During the Crisis,

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Abstract

One of the most important macroeconomics concepts there is the economic growth, whose anatomy and evolution are indispensable for understanding and influencing of unemployment, inflation, final product (materialized, usually, from more recurrent elements point of view, in GDP), a nation' welfare, in a single word.

As the independent forces acting on supply and demand are "kept on a tight hand" by the occurrences on the prices "market", the same as, the saving and investment decisions are controlled and influenced by what happens at the level of income (fiscal policy domain) and of monetary base → money supply → interest rate (monetary policy attribute).

Little components of the economic policy are so, as important for the welfare of a nation as monetary policy. Its acting field consists of the terms and conditions money and credit are supplied to the economy.

It is worth to be mentioned that monetary policy is neither a scope itself, nor an universal panacea. In the very moment the general expenditures are too large thus allowing prices to have an inflationist trajectory, monetary authority (central bank) will shrink the growing rhythm of money supply (draining reserves). If unemployment has reached alarming levels and investments are languishing, the sense of the central bank action will be reversed, it operating to expand the money supply (liquidity injection).

In Romania the main bank's activity is lending operation. Indeed, between banks' placements in first place stand the credits. The way in which banks allot the funds they manage can influence a decisive economic development locally or nationwide. On the other hand, any bank will assume, to some extent, risks when granting credits and, certainly, all banks currently register losses in the credit portfolio, when some borrowers does not honor their obligations. But whatever the risks, the credit portfolio losses can be minimized if credit operations are organized and managed professionally.

From this point of view, the most important feature of the bank's management is to control the quality of the credit portfolio. This is because the poor quality of loans is the main cause of the banking failure.

The IMF Guide recommends that loans and other assets should be classified as non-performing when rates representing principal and interest payment are overdue 90 days or more. Non-performing loans will also include loans with debt service less than 90 days which are considered by national law as non-performing when there are clear indications of the non-reimbursing situation or bankruptcy.

Keywords: lending, loans portfolio quality, credit policy, non-performing credits, gross exposure
JEL Classification: G21

Introduction

Risks and uncertainty have ever been associated with the activity of companies, banks, financial institutions, individuals and of other legal entities, as well. Economy is governed by incertitude and any projection of a certain future events, is threatened by the risk of accuracy of the forecasted parameters. Risk does exist and is produced or not depending on the created conditions and it is continuously changing.

Banking risk is an event which appears along with the banking transactions and brings negative effects on the banking activity, by deteriorating the quality of business, profit diminishing and even losses, affecting the bank' functionality.

Risks have a considerable impact on a bank's market value or a financial institution, both an intrinsic effect (as direct losses supported, usually) and an induced effect at the level of the customers, personnel, partners and economy, as well. That's why the risks permanently appearing in the daily activity of a bank must be identified in order to diminish or to avoid their negative impact on banking activity, by using the specific and adequate techniques and methods.

To surpass systemic and procedural deficiencies, leading to increased losses from credit portfolio, banks must devise and implement policies of credit performances and to hire/train a staff of an irreproachable professionalism, which understand and respect the discipline of these rules. For this you need to have a permanent feed-back through which the Bank's management to be informed about the effectiveness of the quality control process, so that problem credits to be detected and corrected in due time.

In this phase the behavior of a bank can thus be presented: a credit shall not be granted unless you can predict the likelihood of repayment if it surpasses that of it. Reflects this repayment capacities can be done, but is based on different procedures, depending on the borrower quality: company, individuals, State.

The determinants of individual credit risk management are: the ability to pay, the debtor's character-his desire to make the payment, the debtor-capital, guarantee (real or personal), environmental conditions. Of these five factors, the first is the most important.

1. Literature review

Any credit represents an anticipation of future revenues. From this perspective, (of cashing flow), any credit encounters the risk that these receipts have not done at all or partially. This risk is called risk of insolvency of the debtor; it is essential in banking activity because the main function of a bank is giving loans. Fair appreciation of credit risk is therefore of major importance for the Bank. To minimize exposure to risk, the most important stage of the process is the selection of applications for credit lending.

Bad loans can be defined as those bank loans to customers whose economic and financial situation, deteriorated for various reasons, in different phases of the loan circuit, no longer provides full or partial repayment of the loan or related interest and commissions. The level of these loans must, however, be as low as possible due to its impact on bank profitability. This goal can be achieved only through a prudent lending policy practiced in line with the economic situation and financial environment and through an appropriate risk classification.

A credit can become non-performing in any of the phases of the loan process, including analysis phase, due to reasons related or not related to banking practice, but in this early stage it doesn't act like a bad loan; it has to be considered a NPL when it becomes a certainty, so when its recovery becomes a problem for the bank or when loans beneficiaries can no longer provide conditions of loan repayment or payment of interest, or both. The existence of bad loans as a special category of loans and their negative effects made it necessary to separate the management of these types of loans, their inclusion in a portfolio of bad loans. The appearance of these receivables generates a series of negative effects felt by the bank, customer and also at macroeconomic level.

2. Romanian banking system and the situation of bad loans in 2008

According to recent developments, the Romanian banking system can be assessed as stable as a whole, with a level of capitalization, solvency and liquidity in accordance with the prudential requirements, despite the rapid credit growth over recent years and the deepening international crisis implications. In general, levels of prudential indicators do not cause major concern, but this trend should be closely monitored taking into account the uncertain prospects for the world economy.

In 2008 changes happened in the structure of Romanian banking system, as follows:

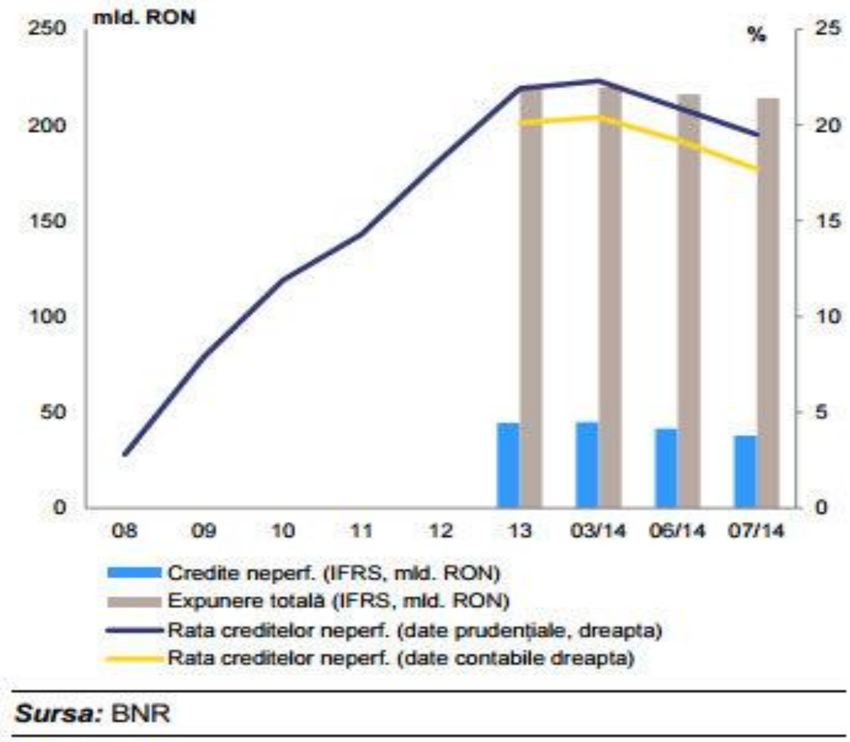
- establishment of BCR Bank for housing;
- opening of a branch of Depfa Bank from Ireland;
- UniCredit Ţiriac Bank took over the activity of Banca di Roma – Sucursala Bucureşti, following the merger at European level of the shareholders of both institutions (UniCredit Group and Capitalia);
- the name change of Sanpaolo IMI Bank Romania Bank to Banca Comercială Intesa Sanpaolo Romania, following the merger of Intesa SpA and SanPaolo IMI SpA;
- the name change of C.E.C. to CEC Bank and of Egnatia Bank to MARFIN Bank;
- the take-over of ABN Amro Bank by Royal Bank of Scotland.

From a financial stability perspective, 2008 was characterized by uneven developments. Until September, the characteristics were similar to those of 2007: a solid system, but facing growing vulnerabilities, in the context of deepening current account deficit and growing debt ratio of individuals and companies. In the last three months of the year , the risks to financial stability have increased in the background of the global financial crisis . Overall , the vulnerability of the financial system has increased in 2008, the contribution of exogenous factors being more significant than those endogenous[5].

The influence of the international crisis on the Romanian financial system also resulted in the temporary manifestation of malfunctioning interbank market; on top of this, unsubstantiated information emerged, implying that an important bank will have major difficulties in the near future.

In these circumstances, in October 2008, a feeling of discontent has spread amongst the depositors of that bank. The National Bank of Romania acted as a last resort lender, according to its status, granting the credit institution, whose solvency ratio stood at an adequate level, special funding to overcome temporary liquidity problems. The loan was reimbursed according to contractual terms. Subsequently, the bank managed to regain access to funding markets, under competitive conditions. Through its intervention, the NBR prevented the evolution of nervousness manifested amongst depositors into a phenomenon with systemic effects.

Chart 1. Evolution of non-performing loans at global level



Despite some rapid advances made recently, asset quality remains a challenge for the Romanian banking sector. It has gradually deteriorated since the start of the global financial crisis. In December 2008, the rate of bad loans stood at 2.8% and had a maximum in March 2014, when it reached 22.6% (chart 1).

3. Romanian banking system and the situation of bad loans in 2009

The year 2009 started with unfavorable expectations regarding the banking system's financial situation, marked by the global crisis and uncertainties on domestic macroeconomic development. In the first months of the year, the increase of credit risk related provisions exerted an overwhelming influence on the profitability of credit institutions, bur most of them managed to recover in the second semester. Over the year, the financial results were positive, but modest.

A growing vulnerability of the Romanian banking system is the deteriorating quality of loan portfolio, phenomenon which worsened in 2009, mostly due to economic recession and rising unemployment. A mention must be made on borrowers who took loans in foreign currency which did not provide protection against currency risk. Although bad debts stay at a manageable level, their growth rate is a concern from a financial stability perspective.

Currently, banks have sufficient own resources to cover potential unexpected losses from credit risk, uncovered by provisions made and capitalization of borrowers' collateral. In addition, the absence of toxic assets from the balance sheet of banks operating in Romania has made it possible to avoid interventions with public money to rescue them. On short term, the maintenance of current trend regarding the credit portfolio quality is to be expected.

4. Romanian banking system and the situation of bad loans in 2010

Despite the international financial crisis and global lending decrease, the Romanian banking system can be considered as solid, having capitalization, solvency and liquidity consistent with prudential requirements.

As the economic and financial crisis raged on, he share of gross exposure related to loans and interest under "doubtful" and "loss" in total loans and interest increased from 13.5 percent in December 2009 to 18.4 percent in December 2010. In the same period, the NPL ratio increased from 7.9 percent to 11.9 percent. As the quality of loan portfolio kept deteriorating, credit institutions have had, on one hand, to make a significant increase in provisions (with negative impact on profitability), and on the other hand, to be extra cautious in granting new credits.

Romania registered in the last years a decrease of loan portfolio quality, thus the share of nonperforming loans in total loans was on a continuous upward trend, exceeding 10 % since summer 2010, after being 7.9% in 2009 and 2.8% in 2008. Explanations point to the steep recession of 2009 and to the 25% salary cut suffered by employees in the public sector in 2010. On the other hand, loan repayment capacity was affected by the increase in VAT to 24 %, which reduced the disposable income of both individuals and firms.

5. Romanian banking system and the situation of bad loans in 2011

Financial stability in Romania remained robust in 2011 and the first quarter of 2012, despite growing challenges. Risks to the banking sector were offset by credit institutions through their own efforts undertaken in the context of NBR’s work on prudential regulation, supervision and proper management of system risks, efforts materialized in enhancing levels of solvency, provisioning and liquidity. The credit institutions have seen an adequate level of capitalization to cover credit risk, the solvency ratio being around 15 percent throughout the period. Compared to the end of 2010, coverage by provisions of gross exposure related to loans classified as "loss", with a debt service longer than 90 days and/or for which judicial proceedings were initiated, has improved, reaching 97,8 percent on December 31, 2011 and 99,2 percent at the end of first quarter 2012.

In the period under review, an increase in credit risk for all types of borrowers was noted down. The most affected subjects were the small and medium enterprises, its NPL ratio recording both the fastest growth and highest level (18,8 percent on December 31, 2011 and 20,9 percent on March 31, 2012). Credit risk also increased at household level, albeit at a slower pace (up to 8,2 percent on December 31, 2011 and, respectively, 9.0 percent on March 31, 2012). Corporate sector recorded an NPL rate of 3.7 percent both at the end of 2011 and on March 31, 2012.

6. Romanian banking system and the situation of bad loans in 2012

In 2012, NPL ratio continued to increase for all main categories of borrowers. Non-financial companies have experienced the quickest performance deterioration in loan repayments (19.5 percent at December 31, 2012, compared to 14,4 percent at December 31, 2011), the most vulnerable subjects being the small and medium enterprises. At households, NPL ratio grew slower than for companies (with 1.3 percentage points, to 9.5 percent at December 31, 2012). Foreign currency lending was riskier than lei lending on all categories of borrowers, the volume of bad loans related to foreign currency financing increasing faster than the domestic currency lending.

In 2012, the Romanian banking system recorded a negative financial result due to a further increase of the provisions volume (on the background of financial assets' quality depreciation), a net interest income reduction (due to a decrease of interest spread and contraction in lending to real sector), and a reduction in yield of government bonds held by credit institutions.

7. Romanian banking system and the situation of bad loans in 2013

Financial stability in Romania remained robust throughout 2013. The prudential indicators of the banking sector stood within the appropriate limits, ensuring a good capacity to manage adverse developments coming from the external or internal sector.

The NPL ratio continued to advance in 2013 (reaching 21.9 percent in December), but in a slightly more moderate pace than the previous year. Foreign currency lending remained the high risk component of bank lending, which emphasizes the need to continue the current trend of rising domestic currency lending. The deterioration of loan portfolio affected all classes of exposures, except for large companies (corporations) which recorded a stall. Exposures to the whole sector of non-financial companies registered a non-performing rate of 23.6 percent in December 2013. The NPL ratio for households grew slower compared to non-financial corporations sector, reaching 10.2 percent in December 2013.

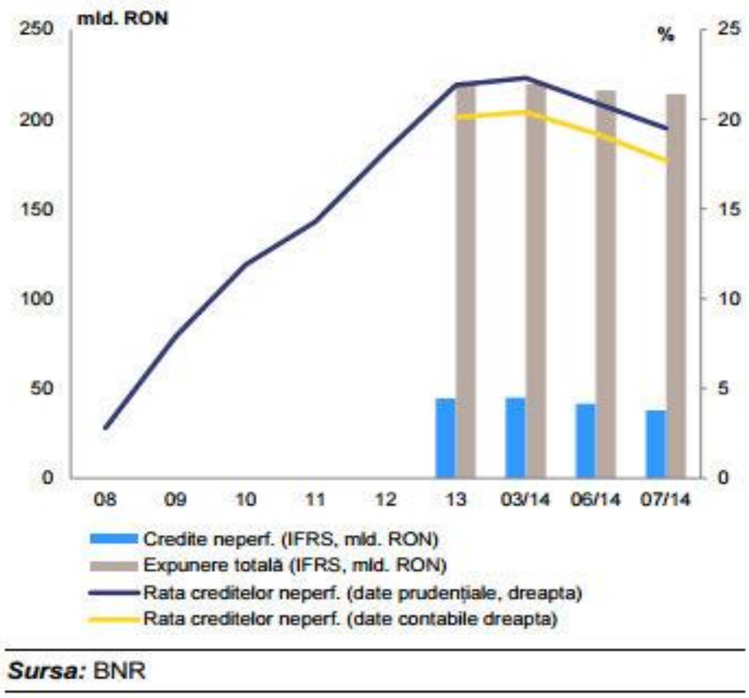
The accumulation of bad loans slowed during 2013 (the bad loans stock went up by 11.2 percent, compared with a rate of 22 percent in December 2012 and, respectively, 29 percent in December 2011). The NPL ratio reached 21.9 percent in December 2013 (3.6 percentage points higher than previous year).

8. Romanian banking system and the situation of bad loans in 2014

Year 2014 marked a significant decline in the stock of bad loans registered in banks' balance sheets, as a result of operations aimed at direct reduction of irrecoverable loans' value, covered in a high proportion by adjustments for impairment, operations performed on the recommendation of the central bank. Thus, the NPL ratio decreased to 13.9 percent in December 2014. The activity of non-banking financial institutions (NBFI) has reduced in 2014, a balance restriction could be noticed both for households loans and non-financial corporations. The loan portfolio continued the trend of adjusting the currency structure, trend noticed during the previous year, which meant an increased share of loans denominated in national currency. At the end of the year, the NPL rate was 22.3 percent, in the context of keeping a relatively constant balance of non-performing loans in the balance sheet.

According to the latest data of the National Bank of Romania, bad loans at system level stood at 15.4% at the end of September 2014 and fell further to around 14 % at the end of December 2014, based on preliminary estimates submitted by NBR. This is the result of the acceleration in cleaning the banks balance, caused by the removal of bad loans, fully provisioned, from the balance sheet and by the sale of depreciated loans. The cleaning process had a negative impact on profitability; at the end of December 2014, the banking system recorded a loss of RON 4.3 billion (EUR 1 billion).

Chart 2. NPL coverage ratio (%; compared to similar countries in the selected region)



The risks associated with asset quality deterioration were diminished by NBR's policy to make provisions for covering credit losses. Romania has the highest NPL coverage rate of the states in the region and one of the highest rates in the EU (chart 2). NPL coverage ratio was 69.8 %, compared to 46% in the EU (in terms of IFRS accounting without the application of prudential filters) at the end of December 2014, compared to 67.6% at the end of December 2013. From a prudential standpoint (with application of prudential filters), NPL coverage is almost 90 % (89,9% at the end of March 2014).

Conclusions

Although the area of banking activities has expanded lately, lending remains a core business of commercial banks. The main elements that differentiate credit from the rest of banking products are that credit is the main source of income but at the same time it presents a high risk. Lending function is important to society, which is why it's necessary to proper allocate resources and to reduce, as much as possible, the occurrence of bad loans.

The granting of the loan must be based on a well established set of rules, which clearly define the principles of lending. These principles and objectives of the loan must be dynamic and adaptable to the changing economic environment and to the market particularities.

The normal operation and repayment of credit are essential to a healthy economy. A smooth functioning of the credit market is good for the economy because credits support investments for both population and companies; this ultimately supports a country's economic growth.

There is the proper place to make some remarks, in the case of Romania, related to the opinion (becoming more and more beloved by inexperienced people) in accordance with (taking into account the peculiarities of Romanian economy which suffers, yet, from an inadequate sectors' structure and from an obsolete technology) a preferential crediting policy (and I'm not referring here to the normal facilities – one or two percent for interest rate and smaller fees, as well – given to the prime rated customers) should be applied.

Differentiating the interest rates in accordance with the sector the credit applicant belongs to is a wrong practice from more reasons: besides it distorts the normal process of resources' allocation, this practice stimulates resources' distribution just toward less profitable sectors and at the same time lowers the companies' interest for capitalizing. It is unfounded the opinion to which a great part of resources will migrate to commerce, domain having a high profitability and an accelerated velocity of inventories. This sector will attract funds only within social need limits revealed by solvent demand.

But there is a viable solution in accordance with the rules of market economy: Government. Subject to it economic priorities and to available funds, Romanian government has the competence to subsidize the interest rates for certain domains, considered as priority. In this way the mechanism transparency is in force and the real costs of this option are precisely known.

But to finish on an optimistic tone, the best news is the largest GDP growth (provisional data) of Romania within EU countries. On the banking market, in the context of discussions on the need for a strong Romanian bank which to give the signal to revigorate lending for GDP growth and increasing consumption, the main factor which must be taken into account is the capital.

The durable growth of Romania and of European Union, as well, deeply depends on the coherence of the economic policies. As a matter of fact, the international economic and financial crises proved once again there is no valid substitute of the coherent economic policies. And when we are talking about adequate policies, programs and regulations, we are talking, in fact, about proper governance.

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