PROVISIONS SYSTEM – METHOD FOR PREVENTING CREDIT RISK IN BANKS

Bâce Grigore

Babeş – Bolyai University, Cluj-Napoca, 0264598583, email: grigore.bace@bnro.ro

Abstract. *In the paper the author shows the modalities of preventing credit risk in financial institutions, based on provisions method.*

Key words: provisions, protection at risk, credits classify

1. Introduction

The risk of non reimbursed credits represents a serious threat as far as the banks' possibility of paying bank deposits is concerned. For this purpose, the regulation of The Central Bank of Romania no. 5/2002 regarding the classification of credits and placements, as well as the formation, regulation and use of provisions specific to credit risk. The methodological norms no. 12/2002, both completed by Regulation no.7/2002, state that banks, for the purpose of protecting the deposits of individual and legal entities, have to limit credit risk and try as much as possible to obtain their receivables from debtors.

As a result, banks classify credits in:[229]

- standard;
- under supervision (only for the credits given to clients belonging to the non banking system;
- below standard (only for credits given to clients belonging to the non banking system;
- doubtful (only for credits given to clients belonging to the non banking system;
- Loss.

The classification of credits and placements is made by the simultaneous use of the following criteria:

- debt service;
- financial performance;
- Initiation of juridical procedures.

The evaluation of the financial performance of a company, outside the sector of credit institutions, will lead to its framing into one of the five categories of financial performance (A-E). This evaluation will be made according to internal norms, based on the score attributed to quantitative and qualitative factors.

The quantitative factors mainly refer to the following indicators:

- liquidity;
- solvability;
- risk;
- Profitability.

The qualitative factors that banks take into account when analyzing the credit, refer to aspects concerning:

- the administration method of the analyzed company;
- the equality of the shareholders; structure;
- received collaterals (others then those accepted with the reduction of the exposal towards the debtor);
- the market context in which the company performs its activity.

The financial indicators are calculated based on the data included in the financial statements of the company, dawn up according to the regulations issued by the Ministry of Public Finances or by foreign

[229] *The regulation of the Central Bank of Romania no. 5 from 22.07.2002 regarding the classification of credits and placements, as well as the formation, regulation and use of provisions specific to credit risk.*

authorities with similar role. The category of financial performance is determined, and helps the category chooses, in the month following the month when the banks had access to the respective reporting.

In the case in which banks are not able to evaluate the financial performance of a client from the non banking sector, it will go directly to category E.

The frequency, with which the financial performance of a company is determined, coincides with frequency with which financial statements are made.

The analysis and classification of the credit portfolio has as purpose the evaluation of the financial performances of the credit requester and their debts service.

The framing of the requesters into categories A, B, C, D, and E is made after the analysis of their financial performance, as shows below:

- **A Category** – their financial performances are very good and they afford to reimburse in due time the interest and the rate and their financial performance are likely to remain very high.
- **B Category** – good and very good financial performance, but they are not maintained at the same level for an extended period of time.
- **C Category** – adequate financial performance, but with an explicit tendency of decrease.
- **D Category** – low financial performance and an explicit cyclic tendency on short period of time.
- **E Category** – the financial performance show losses and there are clear perspectives that neither rates, or would interest be paid.

The debts service of the credit requester is divided into five intervals:

- 0-15 days;
- 16-30 days;
- 31-60 days;
- 61- 90 days;
- Minimum 90 days.

By correlating the data referring to financial performance with the data referring to the debts service, there is obtained credit classification.

Debts service	A	B	C	D	E	No juridical procedures/ with juridical procedures
0-15 days	Standard /Loss	Under supervision/ Loss	Below standard/ Loss	Doubtful/ Loss	Loss/Loss	
16-30 days	Under supervision/ Loss	Below standard /Loss	Doubtful/ Loss	Loss/Loss	Loss/Loss	
31-60 days	Below standard /Loss	Doubtful/ Loss	Loss/Loss	Loss/Loss	Loss/Loss	
61-90days	Doubtful/ Loss	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	
Min. 90 days	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	

Table 1 - The Rating Credits System

Under these circumstances:

- **Standards credits** are those which do not imply deficiencies and risks that might endanger the administration of the debts as stipulated in the credit contract.

- **Credits under supervision** are the credits given to clients with very good economic results, but which, during short periods of time, met difficulties in reimbursing the due rates and the corresponding interest.
- **The below standards credit** presents deficiencies and risks that endanger the liquidation of the debts being insufficiently protected by the net value of the capital and/or the payment capacity of the credit beneficiary. These credits are characterized by the real possibility that the bank should partly overtake some losses as a result of the impossibility in recovering the entire loan, unless the credit's deficiencies are corrected.
- **Doubtful credits** are those loans that the reimbursement or the liquidation of which, based on the existing circumstances, values and collaterals, is uncertain. These assets are those which are unprotected or little protected by the accomplishable value of their collaterals.
- **Loss credits** are those credits that can no longer be repaid to the bank, a fact that causes their recording as assets to be un-guaranteed.

2. Forming risk provisions

The same regulation included the rules regarding the formation of provisions for the expected losses from the crediting activity.

Thus, for determining the required provisioning for credit risk corresponding to a credit or placement, there are covered the following stages:

1. determining the calculation basis for provisions for credit risk:[230]

a) by deducting from the exposal of the bank the collaterals accepted to be taken into account according to the methodological norms of The Central Bank of Romania no. 12/2002, in the case of a credit classified as "standard", "under supervisions", "below standard" and "loss", in circumstances in which there are no juridical procedures and all the amounts corresponding to that credit record a debt service of no more then 90 days.

b) by taking into account the entire exposal, irrespective of collaterals, in the case of a credit classified as "loss", in the circumstance in which there were started juridical procedures or when at least one of the amounts pf the respective credit record a debt service over 90 days, as well as in the case of a placement, irrespective of the corresponding classification category.

2. Applying the provisioning coefficient to the calculation basis obtained; the correspondence between the classification categories and the provisioning coefficients.

The provisioning coefficients are:

- 0 for "standard" category;
- 0.05 for "under supervision" category;
- 0.2 for "below standard" category
- 0.5 for "doubtful" category;
- 1 for "loss".

The formation of credit risk provisions refers to their creation and will be made by including as expense the amount representing the provisions requires.

The regularization of credit risk provisions refers to the change of their existing level in order to recreate the balance between the existing level and that so the requirement and it will be made by including in expenses of the sum representing the difference between the level existing in balance of credit risk provisions and the level of the requirement.

The use of credit risk provisions refer to the annulment of credit risk provisions in the event of credit risk and it will be made by the reversal on income of the sum representing the level existing in balance of credit risk provisions and the placements taken out of the balance sheet.

---

[230] *The methodological norm of The Central Bank of Romania no. 12 from 22/07/2002 for the application of The Regulation of The Central Bank of Romania no.5/2002 concerning the classification of credits and placements as well as the formation, regulation and use of rpovisions specific to credit risk.*

Banks form and/or regulate on a monthly basis their credit risk provisions corresponding to the credits and placements appearing in the balance at the end of the respective month, by including as expense and/or by reversal on the incomes of the month for which the reporting is made, irrespective of the financial result of the period.

Up to 30.06.2007 considered as extra balance sheet the sums corresponding to a credit or placement in the following circumstances:

1. at least one of the respective sums record a debt service over 360 days;
2. there was given an executor function to:
3. the credit contract, as well as collateral contracts, if the case;
4. the final court decision regarding the credit contract, as well as the collateral contracts, if the case;
5. there was started the procedure of forced execution in the case of individual or legal entities; the court decided to declare bankruptcy;
6. the court decided to declare bankruptcy

3. The solvability indicator

According to the methodological norm of BNR no. 12/2003 concerning the supervision of solvability and large exposal of credit institutions, the banks are forced to calculate the solvability indicator and to maintain it at a minimum level of 12%. This solvability indicator represents the transposable into Romanian legislation of Basel I Agreement concerning capital adequacy, with the mention the minimum value recommended by this agreement for the solvability indicator is 8%.

The solvability indicator expresses own funds (as defined in the norms of The Central Bank of Romania regulating the own funds of the credit institutions) as percentage from the total assets and extra balance sheet elements, net of provisions, adjusted according to the risk.

Credit institutions report to The Central Bank of Romania on a quarterly basis the solvability indicators calculated on individual basis, and, quarterly, the solvability indicators calculated on consolidated basis.

In the calculation of the solvability indicators, assets and extra balance sheet elements are evaluated according to the accounting regulations harmonized with Directive no. 86/635/CEE and with The International Accounting Standards applicable to credit institutions.

The own funds, as defined in the norms of The Central Bank of Romania regulating the own funds of credit institutions; represent the numerator of the solvability indicator. The numerator of the solvability indicator is represented by assets and extra balance sheet elements, adjusted according to the risk.

The risk degree ascribed to assets is expressed by a percentage, while the balance sheet value of each asset is multiplied by the adequate percent in order to obtain a value adjusted according to the risk. In the case of extra balance sheet elements, expressly enumerated by these norms, there is performed a two staged calculation.

In the case of extra balance sheet elements, the potential costs for replacing contracts, in the case in which the counterparty does not pay its obligations, is calculated by applying the method described in annex II to Norms no.12/2003. These costs are multiplied by the amounts corresponding to the counterparty, excepting the amounts of 100%, which are replaced with 50% in order to obtain values adjusted according to the risk. The sum of the amounts according to risk of assets and extra balance sheet elements represents the numerator of the solvability indicator.

In the case in which the asset elements and the extra balance sheet elements enjoy a lower weight due to the existence of direct, express, irrevocable and unconditioned collaterals or to the collateral acceptable in the opinion of The Central Bank of Romania, the smaller weight will be applied only to the parts guaranteed or entirely covered by collateral.

Credit institutions are obliged to permanently maintain the solvability indicator calculated above on a level of at least 12% and, in the case in which the indicator decreases below 12%, the respective credit institutions have to adopt adequate measures in order to re-establish, as soon as possible, the minimum level of this indicator.

Bibliography

1. Beju D. – Monetary Politics,House of Science Pub., Cluj-Napoca, 2006
2. Dedu V. – Administation and Banking Auditing, Editura Economica Publishing, Bucharest, 2003
3. Ionescu L.C – The Banks and the Operations, Economica Publishing, Buharest, 1996
4. Stoica M.– Banking Management, Economica Publishing, Bucharest, 1999