RULES AND MEASURES FOR AVOIDING RISK IN THE CREDITING ACTIVITY

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The purpose of credit analysis is to avoid profit losses or business losses caused by bad debts, that is, by granting credits to customers who don't pay off the loan or by failing to grant credits to potentially good customers.

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1. The general crediting rules

The crediting operations performed by trading banks are based on bank cautiousness, as well as on the following general rules:

- As per the provisions of Law no. 58/ 1998 on the banking activity, in the process of granting credits, trading banks must verify that the applications display credibility and they will have to log all the crediting operations in contractual documents that must clearly reflect all the terms and all the crediting conditions.
- The crediting activity must be based on an analysis of the viability and realism of the business activity, in order to identify and assess the payment capacity of the customers, respectively their capacity of generating income and liquidity as main source for paying off the loan and the interest.
- The credits, regardless of their amount or length of time, are granted only for the purpose stipulated in the credit agreement, having a precise credit destination being a compulsory requirement for those who get the credit.
- The trading banks apply interest rates to the credits they grant, and the levels of these rates are established by the bank, which also establishes penalties, as per the applicable law, if the credits and/or interest rates are not paid off on their due date.
- The credits are always granted based on certain warranties and the minimum amount of such warranties must cover the maximum debt of the bank loan, made of credits plus applicable interest rates. The bank is allowed to verify its customers to ensure the integrity of all warranties throughout the whole crediting period.
- Throughout the crediting period, credited customers – legal entities, must provide the bank with copies of the balance sheet, regular accounting statements and any other documents requested by the bank.
- The paying off of the credit in due time is the principle that ensures the permanent recommencement of the crediting process, and it is achieved by correctly establishing the debtor's capacity of generating income, by choosing and agreeing on insurance warranties as well as by permanently supervising the way the credit is utilized.
- Credits are granted upon request from economic agents who meet all the following conditions:

1. They are legally established.
2. They own paid-up share capital, as per the Articles of Incorporation.
3. They conduct legal and effective activities.
4. They reach an optimum level of financial solvency ratios.
5. The analysis of their liquidity flow points to the existence of real possibilities for paying off in due time, both the credit installments and the applicable interest rates.

6. The value of the material warranties accepted must be higher or at least the same as the value of the requested credits plus the applicable interest rates, calculated for the entire crediting period.
7. They have opened accounts with the banks at which they are applying for credit.
8. They submit a statement of the commitments involved in the accounts opened with other banking companies, and of the related warranties.
9. They accept the clauses of the credit agreement.
- Physical persons may be granted credits if they meet all the following requirements:
1. They generate certain and permanent income throughout the whole crediting period.
2. They establish and utilize own financing sources.
3. They underwrite the paying-off of the credits they request with the income they generate, as well as real warranties.
4. They don't have debts or other obligations that weren't paid on due time, towards banks or third parties, when applying for the loan.
- In order to manage risk and cover any possible losses from credits and interests, trading banks form a general reserve for credit risks and specific provisions for credits and interests.

2. Checking the credit risk

In a general framework, the credit risk appears as losses caused by the debtor's breach of the contract through his renouncing of the psychological motivation of **mutual trust.** It appears as a worsening of the debt service through a delay in the payment of interest rates or loan installments. This risk may take two forms: **risk that can be insured** (insurable risk), if the probability of the occurrence can be calculated and measured and **risk that can't be insured** (uninsurable risk) if there is no way to calculate the probability of the event's occurrence and no measuring of it.

It would be interesting to discuss in more detail the aspect of renouncing mutual trust - the cause that determines the debtor to breach his initial commitment dating from the signing off of the credit agreement.

In his paper *"Free to Choose. A Personal Statement"* Milton Friedman synthesized: *"the essence of applications in Adam Smith's <The Wealth of Nations> is illusively simple,* **-** *if a transaction between two parties is freely agreed on, it will only take place if the parties believe they will benefit from it. Most economic errors stem from ignoring this simple proof of wisdom, out of their tendency of considering it like a slice of a pie, which one party can only win if the other party loses it"*.

That which drives the parties involved in the contractual credit relation to cooperate in order to achieve distinct interest is the **price system** that is used in this case, which is the **level of interest,** which fulfils primarily three functions:

a) Transmitting information for the debtor, with regards to his financial costs, as he must compare the increase of the financial expenses against the selling price of the products (goods or services) on various markets.

b) Stimulating the debtor to organize his production (activity) **in the most cost-effective way,** by mobilizing available resources, including borrowed ones, for obtaining highest quality products.

c) Allocating income (how much of the product is assigned to various parties). The debtor constantly supervises how much of his work's output is distributed to the creditor (financing bank) by means of paid interest and, obviously, how much is left to him.

In this relational feed-back any perturbation of the freely agreed transaction leads to a distortion in the image of the benefit, which entails the apparition of the principle or thought of wronging the other party in favor of the own entity (the pie becomes too tempting and that party is no longer willing to share it), by allowing subjectivism to take over and abandoning the rational

consciousness. This is the quick effect of the conservation response that is fundamental in any system, whether biological, social, or economic.
The perturbation factors for the debtor may come in a large variety, of internal nature, related to the creditor's organization, such as: the management of the financing entity and the wrong strategy applied by the financing entity, which results in the financing bank trying to cover the losses of the previous trading year by an increase in the selling price of the financial resources invested in the newly contracted debtor's business**.** Such a procedure will create even from the start of the relation a premise of non-payment, through the obvious incapacity of the management decision-makers to improve the quality of the credit portfolio.
In this case most debtors penalize the contractual report, in order to preserve their own economic status, by refusing to pay the interest rates and credit installments, and then it is required to re-establish the relation of mutual trust through a new negotiation. In its extreme form, credit risk causes losses to the financing bank by entailing the debtor's bankruptcy, in which case the losses are permanent.
Another internal perturbation factor is the corruption of credit officers at the level of the banking network, within the directly operative units (branch offices, banking agencies), or the corruption of the top management at the level of the parent bank.
Having a top position in the management of any entity, including a banking company, may be the means for fast enrichment (primitive accumulation of capital), which works in direct relation to the existing bureaucracy. The higher is the number of clerks, the more important is the boss, and thus the faster his enrichment. This principle functions within a pyramid system in which corruption operates from the base of the pyramid towards its top.
Although long-term banking practice has proved the existence of various risks, there are only two fundamental banking risks, which are: the insolvency risk and the locking-up risk.
The insolvency risk occurs as a non-payment risk or non-redemption risk and may be written-off on the beneficiary, on the reserves, or on the capital. The non-payment risk may refer to full non-payment, payment delays, or may refer to the capital and/or interest rates. Non-redemption may refer to failure of paying-off in due time the credit and/or the interest.
The locking-up risk may occur as the interest rate risk and results from granting credits with a fixed interest rate from funds collected in deposits with variable interest rates. This type of credit is attached to deposits collected by the bank and for which the bank must obtain profit by granting credits from these funds.
Banking risks may also be classified as:
1. The enterprise risk that includes:
- The organizational risk, related to human actions, also known as professional quality risk.
- The non-operating risk or breakdown risk.
- The environment risk.
*2. The countertrade risk (*partnership risk), which include:
- The credit risk.
- The liquidation risk.
- The interest rate risk.
3. The market risk.
4. The exchange risk.
5. The bank solvency risk.
6. Operational risks – they refer to:
- The fund transfer system.
- The operation of payment tools.
In that which regards assuming the banking risk, this is done based on the economic support of the credit operation and of the warranties.

The means for avoiding credit risk are very complex in nature and may be classified into three categories**:**
- Preemptive measures.
- Operative measures.
- Remedy measures.

a) Preemptive measures

In order to reduce and avoid risk in the crediting activity, the bank must fully comply with the limitations imposed by the NBR norms no. 8/1999. The capital related risk stands in the risk of the customer's insolvency, which may result in losing the loaned amount, and the risk of locking-up the resources, when the customer fails to fulfill the commitment of paying the agreed amount at its due date.

The risks that stem mostly from the debtor's insolvency can be overcome by forming warranties in favor of the bank. The warranties may be *personal,* formed according to the debtor as a person (which don't ensure any legal advantage over the debtor) and *real* warranties, formed in accordance with the consistency of the goods (which ensures real rights over the debtor's patrimony).

The general principle to be taken into account when assessing the timeliness of each credit operation is that the bank must not grant a credit without prior assessment of the possibility for recovering it at its due date, or at the moment when the bank decides to withdraw its credit, which are exceptional, and obviously well justified, cases. The Law no. 58/1998, article 44, provides that "...when granting credits, banks must ensure that the applicants display credibility with regards to their paying them off at the due date. To this aim, banks must request applicants to underwrite their credits as per the conditions set forth through their crediting norms". It is for the first time that the legislative gives an imperative character to the concept of credibility, doubled by underwriting (credible-warranties), but the legislative doesn't refer expressly to the type of warranties requested, as the very viability of a business might be considered as a warranty.

b) Operative measures

Through their very nature, such measures aim to avoid risk, to identify any imminent possibility of its occurrence, and to intervene. In fact, it's actually a system of concrete measures meant to prevent the bank from finding itself facing a completed fact. Their character is obviously preemptive, but using other means than the ones in the above described category.

A first measure of this kind is the singing of the credit bank under such conditions that are favorable for the bank. Other measures taken by the bank include:
- Verifying the operations in the special credit cash account and charge the non-usage fee if the debtor doesn't use the money as agreed in the credit agreement.
- Charging an administration fee.
- Charging a **risk commission** calculated for the value of the commuted amount; this is charged upon signing of the commitment, from the customer's cash account or from his running account.
- The daily verification of the customer's bank statement, both for the cash account and for the credit cash account, for monitoring credit destination.
- Verifying the regularity of the receipts and payments from the account.
- Strict compliance of the credit's object, as set forth in the credit agreement.
- Regular verification of the accounting documents of the economic agent.
- Supervising the way the customer fulfils his contractual obligations.
- Collecting income from interest rates in the "*interest income*" account and from due fees in the "*fee income*" account.
- Supervising the warranties throughout the whole period of the credit.

- Permanently supervising the debtor's status on the market, by calculating the indicators: turnover, net profit, number of contracts, stocks, suppliers, customers, and debts.
To ensure a normal performance of the operative activity, it is required to have an informational system and to correctly use the computer. In case of failure to pay-off, after the bank's notification to the client, the next step consists of coercive measures.

c) Remedy measures
If, in the course of the operative measures, the bank realizes that the contractual obligations have not been fulfilled, it has the right to end the credit agreement which is, in fact, one of the remedy measures.
The ending of the credit agreement can be made either when granting it or, in the case of credit granted in installments, whenever the client fails to comply with the clause in the credit agreement.
In the case when, and after notification from the bank, the debtor doesn't redeem his debts (on their due date), the bank resorts to **extreme measures** such as**:** the execution of the real warranties; filing complaint against the customer at a trading court within whose radius the debtor is seated; recovering the amounts from warrantors.
Another remedy measure is to **avoid risks by forming a reserve fund.** Banking companies allot 20% of the annual gross profit for forming reserves, until the fund that was thus established equals the capital, and another 10% until the fund becomes richer than the capital. The **general reserve for the credit risk** is of 2% from the balance of existing credits.

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