THE WORLDWIDE ECONOMIC CRISIS VS. THE QUALITY OF THE LOANS PORTFOLIO IN THE ROMANIAN BANKING SYSTEM

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Traditionally, banks conduct standard credit evaluation such as credit scoring following the receipt of loan request and make the accept/reject decision accordingly. The major cause of the serious banking problems continues to be closely related to: the standards of the granted loan, the weak management of the loans' portfolio, a lack of attention to the changes in the economic circumstances, which can lead to a deterioration of the credits granted by banks. The non-performing loans generate the biggest risk management expenses for the bank. The maximum level of the costs is reached for loans passed as losses, which can't be retrieved and are covered from the provisions' fund or the risk fund. Covering these losses leads to an adequate diminution of the bank's assets and liabilities, therefore to a reduction of the activities' volume.

Keywords: non-performing loans, quality of the portfolio's credits, risk, causes.

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The stages of the banking activity in countries going through a transition process

Vulnerability of a national economy to volatility in the global markets for credit, currencies, commodities, and other assets has become a central concern of policymakers. Lindgreen et al. (1996) report that, between 1980 and 1996, 133 of the 181 of IMF's member countries have experienced significant banking sector problems, including numerous banking crises. Along the same lines, Caprio and Klingebiel (2003) report that between the late 1970s and 2002, there were 117 systemic banking crises - defined as much or all of the banking capital being exhausted - in 93 countries. The currently unraveling banking crisis only adds to this rather long list.
The banking activity in countries going through a transition process has rapidly covered four stages (see Bonin and Wachtel 2003). The first stage of the banking development in the transition economies required setting up the banking institutions at the start of the 1990s. During the planned economic era, the only financial institutions were appendices of the state mechanism and the banking activity, in today's sense of the word, was largely unknown. The commercial banks were detached from the central payments banking system. Still, the role of these institutions was mostly unchanged. The banks owned by the state were financing state enterprises, thus becoming bankrupt in a short time. The second stage of the banking transition process marked banking collapses and systemic crises which impacted all the transition economies after the 1990s (see Bonin and Wachtel 2005). The third stage implied an abiding restructuring process done through privatizations and intromissions from foreign banks. At the end of the century, most banks were privately owned and in countries going through a transition process the banks were mostly foreign. The fourth stage brings us to present. In most transition economies the banks are safe, competitive and adequately regulated institutions.

The quality of the portfolio's credits

The contract for a bank loan is in its essence a trade deed; the particularity of the commercial obligations consists in the additional exigency needed to honour these obligations.

A first notion that was imposed by the banking realities present in Romania was "non-performing loan".
The non-performing loan is a credit that consists of a sum of money granted by the bank as a loan, which was not reimbursed and whose future reimbursement is doubtful.
A performing loan is the one insured as being refundable from the moment is was granted, which means there are insuring guarantees, a financially stable and prosperous state of the debtor, a good future solvency and liquidity index and an adequate and real reliability.
All the parameters are fluctuant in time and variable, including the element regarding the existence of securities which can't be hedged from the negative social-economic interferences or from the worldwide economic crises.
This can be appreciated depending on the structure of the loans. From this point of view, the loans are divided in the following categories:
1. Standard loans: reimbursing the granted loan is done according to the maturity schedule, and the bank has no reasons to question the repayment ability of the debtor. There are no provisions for this type of loan.
2. The loans under observation: a payment term was not kept or the bank has additional information that question the reimbursement capacity of the debtor.
3. The substandard loans: the provision must be at least 20% of the credit's value.
Doubtful loans are the ones for which the bank has already reduced the credit's value after renegotiations, because it believes it won't be able to get back the full value of the receivable.
4. Losses occur when the bank assesses that nothing from the receivable's value can be retrieved and doesn't consider the loan an investment. These losses must be covered in full percentage from the provisions. The bank can continue to try to partially retrieve the receivable from guarantees or from the assets' amortization.

The analysis of the non-performing loans in the Romanian banking system
The non-performing loans are the ones with occurring events in the maturity schedule and are always the loans from the questionable, substandard and losses categories.
The non-performing loans generate the biggest risk management expenses for the bank. The maximum level of the costs is reached for loans passed as losses, which can't be retrieved and are covered from the provisions' fund or the risk fund. Covering these losses leads to an adequate diminution of the bank's assets and liabilities, therefore to a reduction of the activities' volume.
A part of non-performing loans are kept in the portfolio because they are not yet losses and have real chances not to become losses if managed properly.
The set of expenses related to their management is very large for the bank and includes:
1. Increasing the mandatory sampling for the provision fund: 50% of the loan's value for doubtful loans and 20% for substandard loans;
2. The rise of the administrative expenses imposed by the separate and preferential management of these loans which already create problems; these can occur as an opportunity cost or as an additional expense. The opportunity cost occurs because the bank's employees gives special attention to these loans, without insuring a growing profit for the bank, but only to protect the previous investments. Additional time is spent on direct contact with the client, with analyses and additional check-outs. The alleged additional expenses occur if the bank turns to third parties to solve certain specialized problems: evaluation and consultancy services, lawyers;
3. The rise of the legal expenses if the bank is brought to court;
4. The bank's image could be hurt in the eyes of the share-holders, the banking authority and the clients if the non-performing loans ratio is increasing or has already reached a high quantum in comparison to other banks in the system.
The most economic way to minimize these expenses is to increase the quality of the loans' portfolio. This depends not only on the bank's actions because, in some cases, a set of internal

and external factors compete to hurt the client's quality and to reduce his capacity to reimburse the loan.

Table no. 1. THE STATEMENT OF THE LOANS' DISTRIBUTION (An exposure from loans granted to clients outside the credit institutions)

millions ron

Period Month/year	Total	Standard	Under obser vation	Sub standard	Doubtful	Loss	Non-performing loans Weight in total loans
12/2007	145105,3	67371	63607,4	8315,4	2074,6	3736,9	9,73 %
12/2008	192478,9	118628,5	47370	13906,2	3993,3	8580,9	13,75 %
01/2009	198337,2	119376	48580	15278,8	4774,6	10327,8	15,31 %
02/2009	198585,5	117892	48494,6	15440,5	5641,4	11117	16,21 %

A growth of 4.02% of the non-performing loans' weight from the total loan portfolio was recorded in December 2008 in comparison to December 2007 (from 9.73% in 2007 to 13.75% in 2008). On the background of the worldwide economic crises' intensification, which gradually started to impact Romania since the middle of 2008, the weight of the non-performing loans from the total loan portfolio has increased with 1.56% in only one month (since December 2008 till January 2009). The growing tendency of the non-performing loans continued also in February 2009, because the percentage changed from 15.31% to 16.21% (almost one percent).

Credit markets are further beleaguered by another problem created by (ex post) asymmetric information—moral hazard. After the loan is approved and disbursed, the borrowers might seek riskier projects for higher rates of return, which enhance the credit risk faced by banks. The compound effects of adverse selection and moral hazard prevent the traditional price mechanism to work. Even with an excess demand in the credit market, banks may hesitate to raise lending interest rate for two reasons. First, high interest rates force high quality borrowers to leave the market. Second, higher interest rates induce borrowers to take more risk. Both lead to an increase in the chance of default by the debtors.

Credit assessments are meant to help a bank measure whether potential borrowers will be able to meet their loan obligations in accordance with contractual agreements. However, a credit institution cannot perform credit assessments in the same way for all of its borrowers. This point is supported by three main arguments, which will be explained in greater detail below:

1. The factors relevant to creditworthiness vary for different borrower types.
2. The available data sources vary for different borrower types.
3. Credit risk levels vary for different borrower types.

The banks form risk provisions (as a reserve for the bank to cover the possible non-refundable loans) for the loans granted to clients, loans which reimbursed at maturity don't require the use of the provisions, this way they become a profit for the bank.

The constitutive elements of the risk are:

1. The risk occurrence probability and
2. The risk's amplitude

1. The risk occurrence probability's assessment can be quantified based on the perception of the partners affected by the risk. In the case of a loan relation between the bank and the client, each of the two partners has its own perception over the non-payment risk. Taking into consideration a fair value of the risk occurrence probability is possible if during the analysis process regarding the granting of the loan the partners communicate by offering each other all the elements of potential risk.

2. The amplitude and the size of the consequences generated by the risk occurrence, as its constitutive element, are estimated when the transaction is closed.

The risk can be illustrated schematically through the following equation:

Risk = a x p
where:
a = amplitude
p = probability
The level of the losses generated by risks is in direct ratio with the size of the risk occurrence probability, on one hand, and the risk's amplitude, on the other hand.
The credit institutions must take into account at least the following when evaluating the loan risk:
a. the current and foreseen financial performance of the countertrade;
b. the concentration of the exposures towards the countertrade, the markets where they operate, the
economic sectors and the countries where they are established;
c. the ability to put into practice the contractual commitments, from a legal point of view;
d. the capacity and possibility to execute the guarantees, by taking into account the market conditions;
e. the contractual commitments with the persons involved in special relations with the credit institutions, own employees, as well as their families.
The loan institutions must take into consideration at least the following regarding the contractual framework:
a. the loans' specific nature;
b. the contractual clauses afferent to the loan;
c. the exposure's profile till the due date through the potential evolutions of the market;
d. the existence of real or personal guarantees;
e. the probability not to comply with the legal obligations, established by an internal rating system.
The credit institutions must run the loaning activity on the basis of healthy and well defined criteria.
The loan institutions must take into account al least the following regarding the loaning activity:
a. the loan's destination and the reimbursement source;
b. the current risk profile of the countertrade and the presented guarantees, as well as the guarantees' c. sensitivity to the economic and the market evolutions;
c. the history of the debt's service afferent to the countertrade and the current and future reimbursement capacity, based on historic financial evolutions and the future projections of the cash flows;
d. the countertrades' experience and the economic sector where it runs its activity, as well as its position within the sector for commercial loans;
e. the terms and conditions written in the loan contract, including the clauses destined to limit the changes in the future risk profile of the countertrade;
f. the loan institution's capacity to execute and capitalize the guarantees, in a period as short as possible if the situation imposes this.
In order to maintain a good quality of the loan's portfolio, is necessary to eliminate the errors committed by the bank's personnel by determining beforehand the deterioration potential of the debtor's quality.
The main cause of the non-performing loan's occurrence is the incompetence or carelessness of the bank's employees, as well as the insolvency due to the general economic conditions. The most frequent errors committed in practice by the bank's inspectors are:
- the inadequate interview;
- the unsuitable financial analysis;
- the faulty granting of the credit;
- the incorrect and incomplete documentation;
- the control and tracing of the clients' quality.

The main causes that favoured and lead to imbalances in the financial statement of different banks and then to their insolvency state, can be grouped in three categories:
1. political and strategic mistakes;
2. the passing over of the banking prudence requirements;
3. the non-compliance of the analysis requirements and even of the own directions regarding:
- the documentation needed for the loan granting and knowing the clients;
- loan approval;
- tracing the compliance with the imposed conditions of the persons who received loans;
- tracing the loan reimbursement and the cashing-in of the incomes from interests.

Conclusions:
In my opinion, the risk management for a loan is governed by four main principles:
- Establishing an adequate risk environment for the loan;
- Operating a healthy process for the loan granting;
- Maintaining an adequate management of the credit and of the measuring and monitoring processes;
- Ensuring adequate controls of the loan risk.
Certain risk management practices for loans vary from one bank to the next, depending on the nature and complexity of their loan activity.
The banks dispose of uncomprehending information when getting involved in a loaning process, because only the debtors know the real risk of their investment projects. Still, there are a few clauses which the banks can include in their loaning contracts in order to fight the lack of information. Bester (1985) showed that the guarantees can serve as warning instruments, because the real risk degree is revealed by the size of the guarantees the debtors are willing to offer. It is essential to have a legislation which regulates the guarantees and, at the same time, proper institutions to apply it in order to have efficient warning instruments, such as the one for guarantees. A high reliability of the laws and agreements regarding the guarantees could lead to an amplification of the guarantees' use in order to fight the insufficient information and a general lowering of the risk. In a weakly regulated environment, a debtor could use the same good as a guarantee for several loan credits or could refuse to give the goods back when he is unable to reimburse the loan. A more solid institutional environment is associated with a higher inclination to use the guaranteed loans and with an intense loaning activity. This is in accordance with information from the legal and financial literature, which shows a positive relation between the creditors' rights and the development of the loan market.

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