

THE POLITICS OF THE NATIONAL BANK OF ROMANIA TO DEAL WITH CREDITING RISK

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The market economy refers to the implicit presence of a banking system which could ensure the mobilization of all the monetary resources of the respective economy and their temporary orientation towards the development of efficient economic activities.

A significant aspect of the bank performance refers to the measurement of risks with the aim to diminish them. If the bank management is poor and the risks are not taken into consideration, it will be possible that the earning capacity to be reduced and to lead even to the bankruptcy. Due to the fact that the banks are lending, they assume risks which are determined by the doubtful debtor (it appears the insolvency), or by the general economic evolution (which involves interest and exchange rate risks), or by the financial structure of the bank (financing long-term credits from short or sight deposits).

The bank risk can be determined by external or internal factors of the bank due to the competitive environment.

In the professional literature, the methodology used for the risk management involves several steps: the risk identification and analysis; the risk elimination and control; the risk assessment and assuming; the risk financing by debiting the general or specific reserves or by transfer which means the insurance of the bank company.

For those banks operating in Romania, the risks are even more evident due to the hostile environment in which they operate, but also due to the specificity of the Romanian banking system which is still evolving and adapting to the competitive stringencies of the market economy.

This paper is trying to follow the risk involvement towards the bank activity taking into account its importance and role in order to ensure the increase of the bank earning capacity.

Keywords: crisis, credit risk, bad loans, banking supervision

JEL classification: G21

Introduction

The financial risks originate in the impossibility of foreseeing the evolution of the variation of the financial and banking risks. When employing their resources, the banks are confronted with a series of risks determined either by the quality of the organization providing the loan or by the general economic evolution or by the general structure of the bank.

The bank risk can be defined as a phenomenon which appears along with the bank activities and which determines negative effects towards the specific activity by damaging the business quality, diminishing the profit or even registering losses affecting the bank functionality.

By means of their activity of collecting financial resources and at the same time investing them in those institutions which have temporary supplementary needs, the banks fulfil an important role acting as an intermediary. In this respect, the credit becomes an active instrument in the

stimulation of economic development since it encourages the emergence of certain phenomena according to the objectives that are to be followed in perspective.

Detecting the potential banking risks presupposes familiarity with the emergence and evolution of the release factors. The quantification of their manifestation parameters and the tracking down of those indicators which can lead to their identification are very important.

Due to the authentication and prudential monitoring norms of The National Bank of Romania, the **credit risk** is defined as “the risk of recording losses or of not making the estimate profits as a consequence of the inobservance of the promissory notes.”

From an economic agent’s point of view, the *credit risk* is defined by means of the losses registered because the advance cash flow was not collected till due as a result of the degradation of the *debtor’s crediting quality*. From this perspective, the credit risk has two coordinates: rating the risk and its quality.

Rating the risk shows the kind of loss the creditor has suffered as a consequence of the debtor’s inability to refund the credit whereas *the quality of the risk* results from both the possibility that the payment may take place and from the guarantees which can cut down losses in case of non-payment. The impossibility of refunding a debt represents an insecure event. In addition, the future exposures are not known for a fact till due because crediting on the basis of refunding programs established according to solid contract clauses is to be applied only in a limited number of situations. The advance refunding of the outstanding loans displays a credit risk because in this situation the bank has to ensure a refinancing of the unattainable income and to cover the expenses generated by the credit granting.

Starting from these assumptions, the credit risk could be divided into three types of risk: *default risk, exposure risk and recovery risk*.

The Default Risk

This risk resides in the probability of non-payment of an outstanding debt. There are several possible definitions for *non-payment*: failure to keep to a payment bond, violation of a convention or economic non-payment. The default risk is proclaimed when the scheduled payment has not been carried through in a minimum period of time from the due date. *The economic non-payment* takes place when the economic value of the debtor’s assets decreases beyond the value of the outstanding liabilities, a situation which can stop the debt repayment.

The deterioration of some economic and financial indicators as compared to the assumed level at the credit contracting date could be associated with *technical non-payment*. This non-payment usually triggers negotiations even if the failure to reimburse the credits till due does not jeopardize the debtor’s creditworthiness. In certain situations, the bank can even make use its right to ask for a prompt reimbursement of all outstanding debts.

The probability of non-payment cannot be directly measured but one can use the historical statistics of internal non-payment, of the rating agencies and of the central authorities. The most representative types of ratings are: the rating of the current debts, the emitter’s rating and the industry rating. In most of the cases, the rating agencies assess the quality risk of a debt which is conditioned both by the probability of non-payment and by the possible recovery in case of non-payment.

The Exposure Risk

The exposure risk quantifies the degree of uncertainty regarding the borrowed sums. If the credit is reimbursed according to a firm contract program the exposure risk could be considered reduced or insignificant. Unfortunately, this thing does not hold valid for all crediting lines. If the crediting lines allow the debtor to access them whenever he wishes according to his needs and a maximum limit established by the bank, then the bank’s risk of exposure is considerable.

The Recovery Risk

In case of non-payment, the recovery is not predictable. It depends on the type of non-payment and other factors such as: the debtor's guarantees and the type of these guarantees which can be correlated with those of a third party. A non-payment does not mean that the debtor will never pay but draws the initiation of certain actions such as renegotiation or the incumbency to reimburse the outstanding loans. If no corrective action is to be taken into consideration then legal procedures step in: the legal instrumentation of the guarantees (which differ according to the type of guarantee accepted) and the foreclosure of the guarantees.

The experience of the banks in Romania has proven that in time, the credit risk has represented the main risk which the Romanian banking system faced against the expansion of the crediting activity since approximately half of the assets are concentrated in credits.

The global financial and economic crisis has strongly influenced the evolutions from the manufacturing and financial sectors in Romania especially during 2009 and 2010.

This interval has reconfirmed the depression tendency of the non-governmental credit starting in the first trimester of the 2008 in spite of some stimulating measures adopted by the central bank. This is an ongoing phenomenon on the credit market and represents a serious challenge for both the banks and the authorities.

A growing vulnerability of the Romanian banking system is represented by the decrease of the credit portfolio quality which has fully manifested itself in 2009 and 2010 and still persists at present against the background of the economic recession. One can add the supplementary burden which the debtors who have contracted currency credits and are not ensured against the currency risk have to support. Even if the outstanding debts are at a manageable level, their growing rate constitutes a reason of worry for the financial stability.

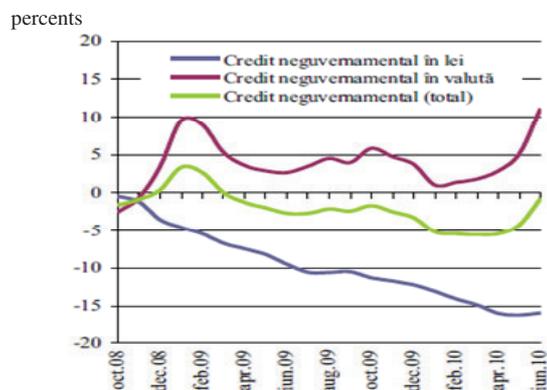
Non-governmental credit contraction in the period 2009-2010 occurred on reducing both the fund supply and demand for loans. In relation to the supply of credit, the determining factor has been represented by the perpetuation of the banks' aversion to risk, despite the measures adopted by the central bank in order to encourage sustainable restart of crediting (reducing the rates of minimum compulsory reserves applicable to the credit institutions' liabilities in lei and in foreign currency, reducing the monetary policy interest rate, amending some stipulations of the bank prudence rules). In the context of these measures, to which one can add the exposure of the main foreign capital Romanian banks, the market has received sufficient liquidity.

The analysis of the monthly developments of the non-governmental credit, in real terms (having as a reference point 30 September 2008 – a moment when the effects of the international economic crisis started to be felt by the banking system in Romania) reveals credit contraction starting with April 2009 (Chart no. 1).

The lending decrease for the private sector was also determined in 2010 by the cumulative action of the following factors: (i) maintaining the economic decline in 2010 and worsening the financial forecast for the population and companies; (ii) the increase of the unsatisfying credits. The credits demand has maintained the cautious character throughout the period and it has registered a relative decrease demand of new credits and an increase demand for refinancing – due to the factors related to the supply-side (interest decrease, reduce or elimination of the commissions). As regards the credit supply it was registered a slight improvement toward the year end reflected by the relative flexibility of the credit standards and terms or by the initiation of the promotion campaign of the credit cards.

The sectoral analysis demonstrates different intensity of the credit tightening during 2010. The decrease of the credit for the population was exclusively caused by the severe tightening of the consumer credit (-18,3% real annual fluctuation), its weight was diminished with approx. 10% of the total retail credit (until 62,9%). The descending trend of those credits has been emphasized in the second part of the year induced by the enhanced decrease rhythm of the population available income caused also by the 25% decrease of the salaries in public sector beginning with July. Concerning the mortgage credit, the annual

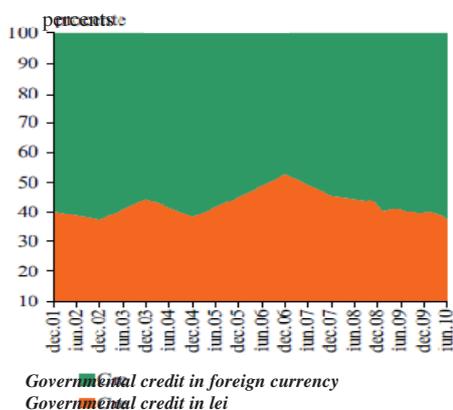
dynamic had a positive trend being maintained at 10,6% due to the flexibility of the credit standards and terms, an important contribution having the increase competition between banks. From the perspective of denomination, trends were similar, but the amplitude of movements was different. Thus, the credit in lei has witnessed a relative decrease since May 2009, the phenomenon being gradually widespread. As regards the component in currency (expressed in lei), the values have maintained positive values during 2009 (a situation mainly occurring due to differences in the exchange rate), but have followed a strong descendent trend. The first months of 2010 have marked the start of the contraction of credit granted in foreign currency, which became positive again only in May 2010.



Source: NBR
*) fixed base 30.09.2008

Chart no. 1. The Real Growing Rythm of the Non-governmental Credit

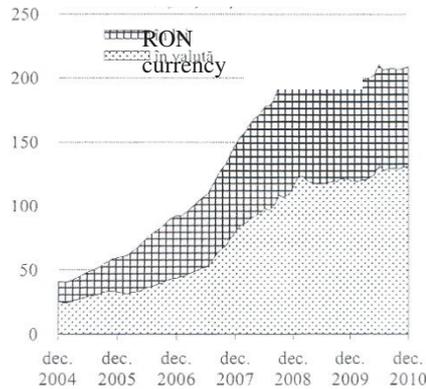
Currency loans were about 60% of the total amount of non-governmental credit between January 2009 and March 2010, but their proportion witnessed a slight increase in the following months (Chart no. 2).



Source: NBR

Chart no. 2. The Evolution of Non-governmental Credit according to the Denomination Currency

Otherwise, in 2010, the currency credit continued to strengthen its weight of the total non-governmental credit (until 63%), taking into consideration that its annual dynamic had a positive trend all over the period (8,3% at 31st of December 2010²²) while the credit in the national currency continued to decrease (-10,1% real annual dynamic).



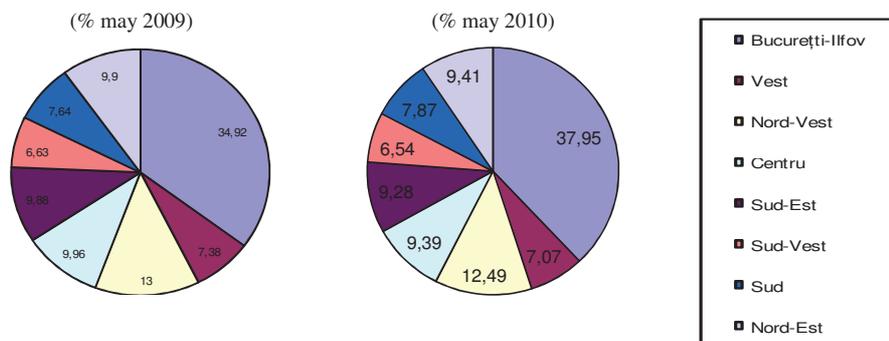
Source: NBR

**Chart no. 3 Non-governmental credit - types of currency-
mld. RON; end of the periode**

In the context of the present economic crisis, according to the data of the National Bank of Romania the analysis of the credit sector of the counties in Romania indicates the fact that in just one year the Romanians' ability to pay their bank credits has considerably decreased. The increment of the arrears is caused by the clients' excessive crediting in relationship with the present income decrease.

Bankers have more and more problems with the non-performing loans, although they have reported reduced levels of delayed credit payment for each county between 2009 and 2010. There are multiple causes, both the surface ones such as salary decrease, job losses, interest increase and the case when clients have defrauded the banks, especially by using false papers. At the same time, if we take into consideration the fact that most of those who have arrears come from the private environment, the only sector that has known an adjustment at the beginning of the crisis, but we should not forget the state employees will have a diminished income and, thus, the non-performing loans will continue to increase.

The different rhythms of credit contraction have caused changes in the market share of the counties after the balance of granted loans. Bucharest-Ilfov preserves its leading position, with an amount of 38% of the total financing (77.54 billion) followed by the North-West region, with a financing balance at a less than third of the capital's balance (25.5 billion). The third place is occupied by two regions, Centre and North-East, which each had 9.4% of the total loans (19.2 billion). However, one can say that the North-East region has a slight advance, as the credit contraction has been lower.



Source: NBR

Chart no. 4. The Credit Intensity on Regions

According to the destination of credits (for small operators, consumer and mortgage credits) one can observe that in some counties discrepancies among these segments emphasize differences in development among the administrative territorial units of the country. Nationally, the balance of the credits for legal persons registered a total of over 100 billion at the end of May 2010, increasing by 4.4% compared with the same period of 2009.

In the total portfolio of loans the share of the outstanding and uncertain loans granted to the customers has increased from 0.32% to 1.5%, while in the total banking assets the intensity of delays in payment registered a growth from 0.29% to 1.01%. At the same time, the unadjusted exposure regarding loans and interest classified in the categories "uncertain" and "loss", including items out of the balance sheet, has increased from 5.95% to 13.52% by the end of 2010, in the context of aggravation of the financial situation of people and companies, but also in the context of increased volatility of the exchange rate of domestic currency.

The reports elaborated by the Romanian National Bank indicates that the banking system has maintained in 2010 an adequate level of capitalization, the solvency rate being of 14,4% as a result of the banks capital injections made in order to counter the effects of the credits portfolio quality deterioration. This phenomenon is reflected by the evolution of the risk credit indicators, by the risk credit rate which reached 20,8% at the end of 2010 in comparison with 15,3% in 2009.

The banks choice for the less risky investments (public securities) is reflected by the improvement of the general risk rate (until 44,6%).

As it is written in the table below, year 2010 marked the entrance in the negative field of the profit indicators for the Romanian banking system, as a result of the provisions expenses increase, of the unsatisfying assets increase and of the efficiency decrease obtained from the investments in public securities.

Table no. 1. The main indicators of banking caution

	Dec. 2009	Dec. 2010
Capital risk		
Solvability rate ($\geq 8\%$)	14,67	14,66
Leverage ¹	7,55	7,87
Credit risk		
Overdue and doubtful credits (net) / Total credits (net)	1,45	2,22
Overdue and doubtful debts (net) / Total assets (net)	1,01	1,49
Credit risk rate ²	15,29	20,81
General risk rate	47,29	44,56
Liquidity risk		
Liquidity indicator ³	1,38	1,36
Profitabilitate⁴		
ROA (Net profit/Total assets)	0,25	-0,09
ROE (Net profit/Own capitals)	2,89	-1,02
1) Own funds of 1st level/Total average assets; 2) Unadjusted exposure for the credits and interests classified in doubtful and loss /Total credits and interests classified without the elements outside the balance-sheet; 3) Actual liquidity/Necessary liquidity; 4) Starting with 2008, ROA and ROE are calculated taking into account the average levels of the assets and own capital		

After the National Bank of Romania has checked the commercial banks, it has also submitted a report which stipulates a series of measures that refer to: managing risks and establishing the thresholds at which risks are considered significant; reviewing policies regarding management of liquidity risk by improving the control strategies for liquidity crisis; reviewing credit policy by setting the limits of concentration on types of credit facilities; banning the grant of unsecured consumer loans; improving the process of monitoring and implementation of safeguards reevaluation; assessing the credit risk according to alternative scenarios for conditions of crisis; complying with the maximum admissible limits for large exposure.

In conclusion, the evolution of the banking system has proven that bank monitoring remains an activity required to ensure financial stability, and the future will bring even more challenges for the competent authorities. The risks associated with the banking system are in a dynamic process, and the monitoring activity should be improved so as to counteract the functioning problems of the crediting institutions.

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