THE QUALITY OF LENDING THE ECONOMY

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ABSTRACT: *Credit has a very important role in the economy, and the evolution of national economies has become largely dependent on the private banking system. Credit policy has become one of the main means of action on the economic conjuncture, being called upon to prevent the uncorrelations and potential imbalances that may arise. Poor credit risk management can cause the banking system to collapse, with unimaginable economic, social and political consequences.*

KEY WORDS: *quality, loans, economy, credit, bank, companies, development.*

JEL CLASSIFICATIONS: *G21, O16.*

1. Economic growth is the goal of any state or company

Specialist papers (Lombardi et al., 2017) point out that economic growth is strongly influenced by debt levels. So the evolution of indebtedness generates a series of nonlinear effects. Measures to stimulate short-term lending have positive effects on the economic sector, but in the long run, the growth of private sector indebtedness leads to negative economic externalities.

Some authors (Schularick and Taylor, 2012, Jordà et al., 2013, 2015 and 2016) have pointed out that increased levels of private sector indebtedness are good predictors of financial crises and determinants of the intensity of implicit recessions. Other studies (Mian et al., 2015) mention that in times of contraction, households with high levels of indebtedness are most affected by the occurrence of adverse shocks.

His approaches (Cecchetti and Kharroubi, 2015 or Borio et al., 2016) based on the effects of debt on the supply sector demonstrate that excessive credit growth periods have long-term adverse effects on productivity through inefficient allocation of funds.

The EU financial system is very dependent on the banking system, with a significant impact on economic growth. The EU banking system has reached a level of

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magnitude that will have a negative impact on economic growth, leading to additional risks at both bank and sector level as a whole. Since the 1990s, banking intermediation has accelerated its pace of growth, with the share of credit in GDP in Europe increasing significantly compared with other regions of the world (US).

The size of the European banking sector is considered to be oversized in relation to GDP, as compared to the income and wealth of the population, as well as to other sources of intermediation. Large-scale universal banks have a higher systemic risk than smaller specialized activity banks, and they have a major share of total banks in recent years at EU level. The main challenges facing the European banking sector are: increasing concentration within it; increasing the size within it; higher degree of indebtedness of European banks.

The ESR Advisory Scientific Committee (ASC) report shows that in countries with a financial system dominated by banks, there are lower increases in the long run, even after being controlled for other specific factors. The bank lending offer is more volatile than other sources of funding such as the capital market, amplifying financial and economic instability.

An economy that is mostly funded through the banking sector has contingent liabilities larger than an economy that is mostly funded through the stock market.

Thus, in bankruptcy of banks, the state is always the ultimate lender to cover possible system losses, even though this risk has diminished with the emergence of the bail procedure and the bank resolution framework. By contrast, a stock crash does not present contingent liabilities for the state, in which case the risk is entirely assumed and borne by the investors on the stock exchange.

In this context, the main policy measures that have been proposed to be adopted at European level are:

1) the elimination of preferential tax treatment of debts;

2) adopting more aggressive competition policies to diminish the importance of large banks;

3) increase in minimum capital requirements (either by setting a minimum leverage ratio or by setting up a capital buffer for systemic risk) in order to increase the resilience of banks and protect taxpayers from the potential risks generated by an over-sized banking system;

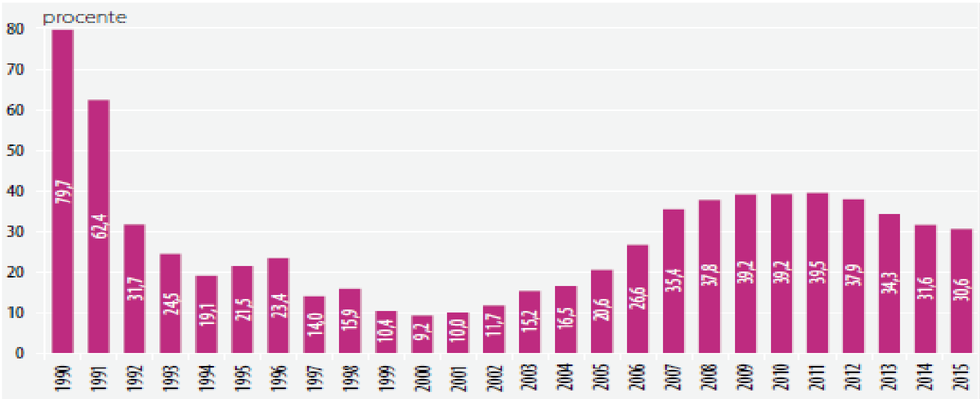
4) policies that encourage access to non-bank credit sources;

5) the formulation of requirements for the separation of certain non-banking activities from the core business of banks

6) increasing the risk weights associated with the existent intra-financial exposures, in order to reduce the excessive activities within this sector (as stipulated in CRD).

Romania, in the first years of the post-communist period, has witnessed a strong financial disintermediation process, the share of credit to the private sector in GDP falling from 79.7% in 1990 (a characteristic of the planned centralized economy) to only 19.1% one hundred in 1994.

High inflation recorded since 1990 has led to the limitation of credit. The very high inflation rates (in 1992 and 1993 close to hyperinflation) and their high volatility drastically limited the possibility of financing medium- and long-term projects (Isărescu, 2007). Also, the negative interest rates led to the rapid erosion of the population's economies and banks' reluctance to lend to the population. Banks have faced the problem of not having a profitable client for lending because there was no portfolio of creditworthy firms, state-owned companies were in cumbersome privatization processes, and private ones were poorly developed. Against the backdrop of financial indiscipline, they replaced bank credit with arrears - which reached about 85% of GDP in 1991.



Source: EBA, NBR

Figure 1. Credit to the private sector / GDP in Romania

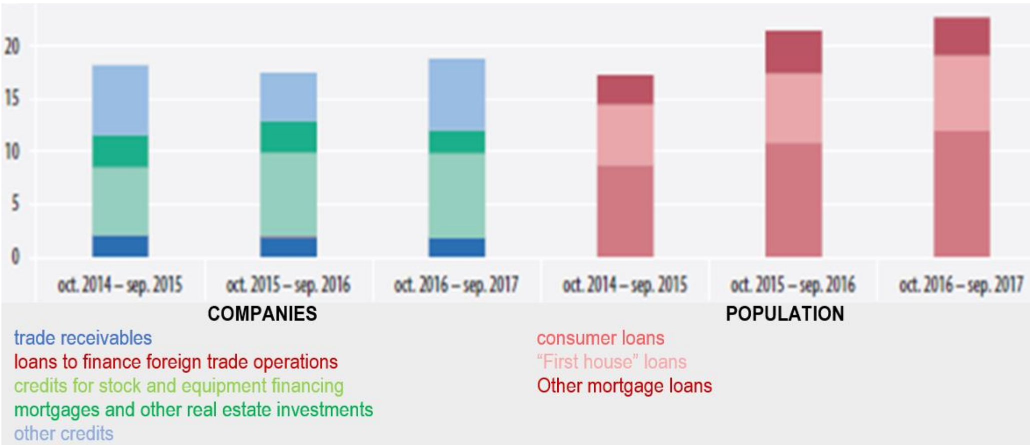
The location of financial intermediation on a low level after 1990 was also determined by the very modest level of credit for the population, its share in credit to the private sector being up to 6 percent, almost exclusively focusing on companies.

The period 1995-1996 was characterized by an increase in targeted credit, but with negative effects in the economy. Thus, the banking system soon faced a very high level of bad loans, but also a severe deterioration in corporate governance, and rescue from bank failures had a budget cost between 4.6% and 6.6%. After 2000, private sector lending was on an upward trend, supported by economic growth, inflation and interest rate cuts, as well as the presence of foreign banks in the domestic banking system, which strengthened. The real annual growth rate of credit to the private sector recorded negative values in the period 2012-2014, returning positively from 2015. This year, the RON component became dominant in the credit structure after a period of 8 years in which the foreign currency credit held the majority position.

The credit for the population became a more dynamic component in 2016, being predominant in the structure of the loan stock. Sustainable lending to non-financial corporations is a priority of the Romanian banking system, as many SMEs are not eligible for credit, and many corporations resort to intragroup loans.

2. CREDIT TO COMPANIES AND THE POPULATION

Sustainable growth of financial intermediation, particularly by widening the lending sphere to the corporate sector, remains a desideratum for the banking sector. Between September 2016 and September 2017, the volume of new loans granted by credit institutions amounted to about 42 billion lei, representing a credit growth rate of 18.5 percent. The new flows of loans to non-financial corporations recorded a more rapid dynamics than those of the population (8% increase in the first case, compared to 6% in the second, in nominal terms), while in the case of loans granted to the sector of the population, an important part (about 31 percent) was achieved through the "First House" program.



Source: EBA, NBR

Figure 2. Structure of the new loan granted

Individual borrowers who accessed loans in the years 2015 and 2016 have a moderate but pro-risky risk profile. The indebtedness of borrowers who have accessed new loans has been in recent years on an upward trend beginning in 2013-2014, as revenue has seen a positive trend in recent years.

Thus, debtors who currently have bad debts have a very high degree of indebtedness (47 percent, compared with 33% for people with high-performing exposures) and a significant share of them is remunerated with a salary below the average at national level (about 80% of them).

Maintaining an adequate degree of prudence, even if it can reduce the access to credit for low-income and very low-income people (below the minimum wage), provides additional protection to eligible borrowers in the event of shocks, especially for those who will contract mortgages, which are particularly vulnerable to interest rate shocks. Slight developments in bank financing are due to structural features such as demand and supply. The main elements limiting the solvable credit claim are represented by: the high degree of indebtedness of certain categories of companies, especially micro-enterprises; the high number of companies with negative or non-performing equity; deficiencies in the insolvency framework of legal persons.

The credit offer raises issues related to the training of bank staff, the provision of financing products that do not address the specific problems of non-financial companies and the preponderance of real estate collateral.

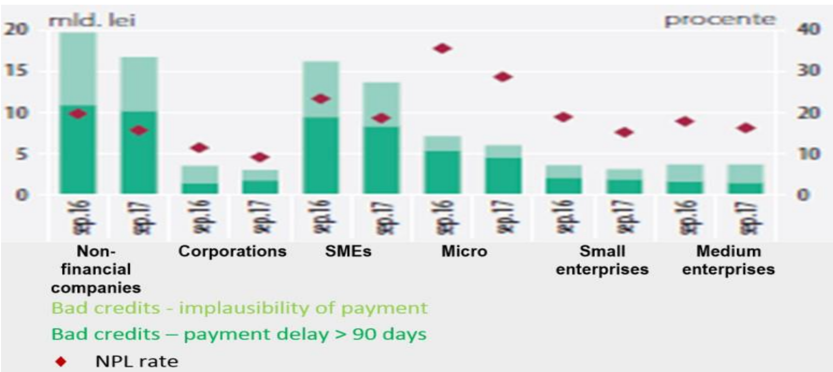
The demand for bank lending by the non-financial corporations sector is low, with other sources of financing being used, such as commercial credit, loans from shareholders or affiliated entities, respectively from non-resident financial institutions. In the period 2004-2017 no more than 15% of the economically active companies have used such loans.

3. BAD CREDIT AGAINST BANKING INSTITUTIONS

The quality of the portfolio of loans to non-financial corporations continued to grow, dynamics being mainly influenced by the aggregate improvement of the financial situation of firms. However, the constraints generated by the existence of structural vulnerabilities, such as the undercapitalization of a significant number of companies, the high degree of indebtedness in certain sectors, the reduced capacity to recover commercial claims, especially at micro-enterprises, combined with the large number of firms of the portfolio of credit institutions that have not gone through a complete business cycle are risk factors for the banking sector.

The rate of non-performing loans decreased by 4 percentage points between September 2016 and September 2017, reaching a value of 15.8 percent. The annual change in the rate of non-performing contributed both to the decrease in the volume of loans with a higher payment delay 90 days (by 0.7 percentage points), as well as the reduction of loans in the implausibility of payment (by 2.3 percentage points).

The average default rate for Romanian companies fell to 3.1 in September 2017, from the 3.9% recorded in September 2016, as the number of companies that entered the default for the first in the last 12 months continued to remain on a declining trend.

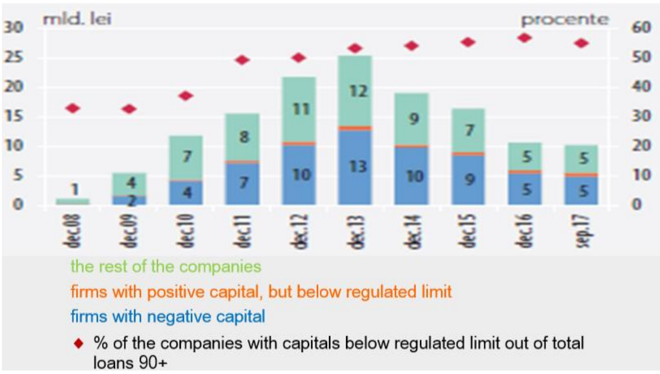


Source: NBR

Figure 3. Rate of non-performing loans according to the size of the companies.

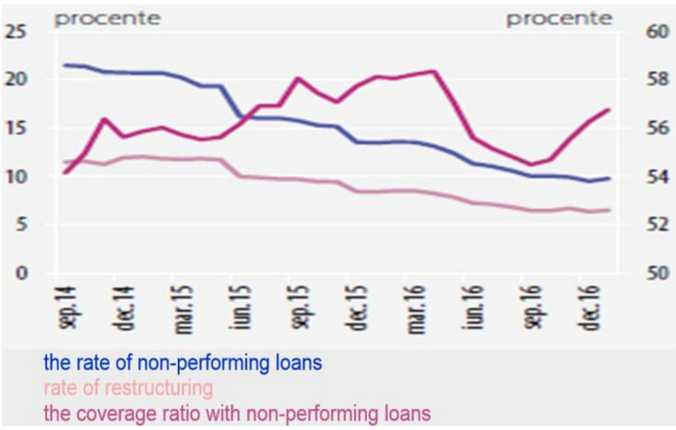
An important role in determining the evolution of the non-performance of the portfolio of loans granted to companies by banks is provided by firms with a capitalization below the regulated threshold. They accumulate late payment loans for more than 90 days, of about ROL 5.6 billion in September 2017, accounting for 55% of total exposures of this type. If are taken into account the credits that are unlikely to payment, the loans classified as non-performing by the undercapitalised firms amount to lei 7.7 billion, or 46% of the total non-performing loans generated by the companies sector in banks' balances.

Given the relatively high exposure of banks to companies with capital values below the regulated limit but not yet in default (about 13% in September 2017), the fragile financial situation of this category of companies may put pressure on the balance sheets of credit institutions over the next period. Another important factor that may lead to an increase in the default rate on loans is the high proportion of newly-granted variable-rate loans under the resumption of the cycle of interest rate hike due to rising inflation. Most companies would quickly feel a potential shock on the interest rate. New loans are granted mainly with variable interest rate, 88% of the new loans granted in MDL, respectively 85% of those granted in euro have the variable interest rate.



Source: EBA, NBR

Figure 4. Loans with overdue payments of more than 90 days, according to the capitalization of companies



Source: NBR

Figure 5. Evolution of asset quality indicators in Romania

Companies with the highest risk profile are micro-enterprises, with a non-performing loan rate of 28.8% in September 2017. However, both small and medium enterprises and corporations recorded credit risk mitigation between September 2016 and September 2017.

In the case of SMEs, the rate of non-performing loans fell from 23.4% to 18.7 percent, while for corporations it was 9.2% in September 2017, from 11.5% in 2016.

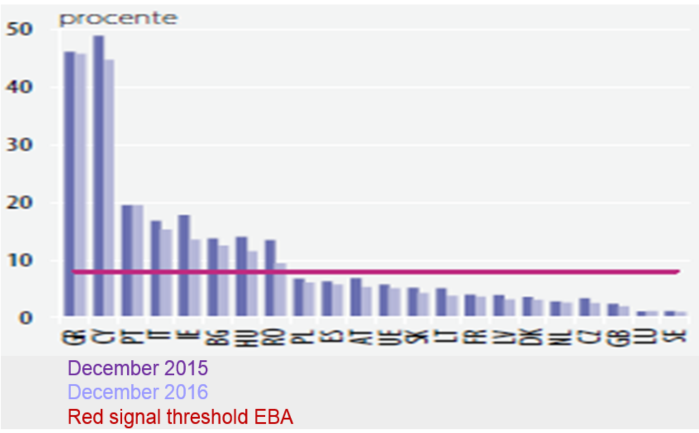
The rate of non-performing loans still places the Romanian banking sector, together with many other EU countries, in the red signal band of the Risk Chart developed by the European Banking Authority, but, as a counterweight, the coverage ratio with non-performing loans is at an adequate level and growing.

4. REDUCING BAD LOANS IS A PRIORITY BOTH IN ROMANIA AND AT EUROPEAN LEVEL

Romania has witnessed a significant increase in the non-performing loans rate since the financial crisis of 2008. The main result of the NBR's supervisory and regulatory measures as well as banks' balance-of-payments efforts was to reduce the non-performing loans ratio to a level 9.8% in January 2017 (in September 2014, the rate of non-performance was 21.5 percent, as defined by EBA). At the same time, these measures proved their effectiveness and generated one of the fastest reductions in the rate of non-performing loans among EU countries.

According to the EBA, a level of non-performing loans of over 8% of total credits (the case of Romania) is in the red band; a level of non-performing loans of 3-8% falls into the yellow band; a level of underperforming loans of less than 3% of total credits falls into the green band.

The Central and Eastern European countries, which are under the low red-tape credit rating, have a negative growth rate of credit (Croatia, Russia), or a weak pace similar to that of Romania and Bulgaria.



Source: EBA, NBR

Fig. 6. The rate of non-performing loans in EU countries.

5. CONCLUSIONS

The rate of non-performing loans continues to remain high, despite the banks' efforts to reduce them, especially in certain business segments, which advocates continuing the process of solving exposures in state of non-reimbursement by credit institutions. Macro-prudential regulations target the segment of lending to the population (especially foreign currency lending), but also the non-financial sector. The measures consist in establishing limits on the degree of indebtedness in relation to the amount of disposable income and the value of the collateral. Thus, the role of credit needs to be repositioned, the new economic conjuncture requires changing the engine of economic growth with a more autonomous one, based more on productivity and domestic saving and less on capital influxes and indebtedness.

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