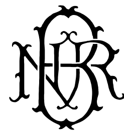


National Bank of Romania

NPL resolution in the case of Romania

Financial Stability Department
National Bank of Romania

June 2015

Summary

- Main features of the Romanian banking sector
- Definition of NPL: significant differences across countries
- Explanation of NPL levels reached
- Reasons for dealing with the NPLs
- Factors leading to a reduction of the stock and ratio of NPLs
- Measures aimed at reducing the stock of NPLs

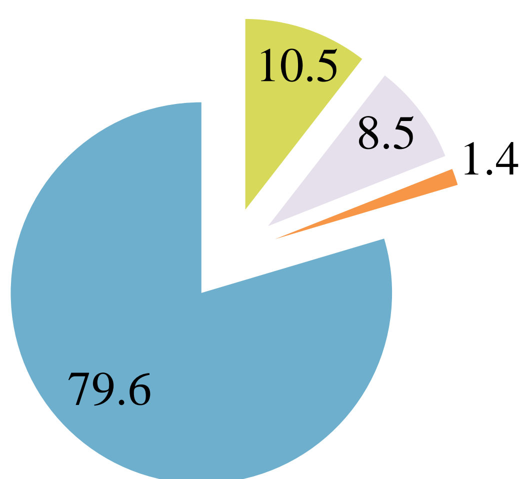
Main features of the Romanian banking sector
- March 2015 -

Number of credit institutions: 40 (9 branches of foreign banks)

- **Assets, gross value**: EUR 91.1 billion
- **Loans to the private sector (gross value)**: EUR 47.7 billion
- **Total capital**: EUR 7.7 billion
- **Deposits of non-government resident clients**: EUR 51.4 million

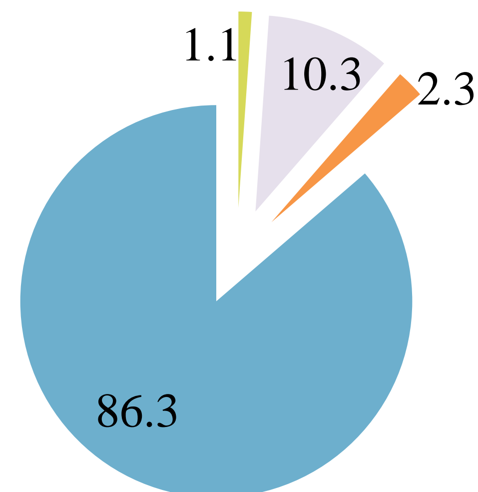
Banking sector ownership

% in total net assets



■ foreign bank branches
■ fully or majority state-owned capital
■ majority private domestic capital
■ majority private foreign capital

% in total capital



Main features of the Romanian banking sector (2)

INDICATORS		12/31/2014	03/31/2015
		%	%
CAPITAL ADEQUACY			
1	**Total Capital Ratio**	17.59	18.64
2	**CET 1 Capital Ratio**	14.56	16.15
3	**T1 Capital Ratio**	14.56	16.15
4	**Leverage Ratio**	7.38	8.26
ASSET QUALITY			
5	**General Risk Ratio**	36.41	37.05
6	**Loans to the private sector (Gross Value) / Total Assets (Gross Value)**	52.09	52.40
7	**Claims on the NBR / Total Assets (Gross Value)**	11.56	8.16
8	**Claims on the government sector / Total Assets (Gross Value)**	21.10	22.47
9	**Non-performing Loans Ratio** (Loans overdue more then 90 days and/or for which legal proceedings were initiated / Total loans)	13.94	13.85
10	**NPL coverage Ratio** (IFRS value adjustments for NPL / NPL)	69.88	70.20
PROFITABILITY			
11	**Return on Assets – ROA** (Annualized Net Profit / Total Assets)	-1.32	0.91
12	**Return on Equity – ROE** (Annualized Net Profit / Own Capital)	-12.45	8.88
13	**Cost-to-Income Ratio**	55.50	58.68
LIQUIDITY			
14	**Quick Ratio** (Cash and Deposits with Banks at Net Value, Government Securities and Bonds Free of Pledge)/ Total Assets (Net Value)	37.18	34.41
15	**LTD Ratio** (Loans / Deposits)	90.50	92.85

Main features of the Romanian banking sector (3)

- An adequate level and quality of capital (Total Capital Ratio: 18.64%, CET1 Ratio is 16.15% as at March 2015)
  - The NBR closely monitors the prudential indicators, with a focus on capital adequacy dynamics and banks' efforts to raise additional capital
  - No bank failure recorded since onset of the financial crisis and no public funds have been used so far to support the banking sector
  - Regular stress tests confirm the comfortable solvency and liquidity position of banks
- Considerable IFRS provisioning of NPLs (70.20% in March 2015)
- FX loan portfolios on a downtrend, as the share of FX credit in total private sector credit decreased to 55% in March 2015 (from 64,4% in May 2012).

Definition of NPL: significant differences across countries

- ***NPL ratio definition used by Romania***

  - **Numerator** - the sum of the gross value of loans for which the repayment of principal and/or interest is overdue by more than 90 days or for which legal procedures were taken against the debtors (whereby gross value means accounting value before the deduction of any loan provisions).

  - **Denominator** – the sum of the gross value of loans.

- There was no harmonized definition of NPLs across countries, as different countries applied differing national definitions (in respect to number of days overdue, use of a net of provisions definition, rules applied in respect to contamination principle etc.)

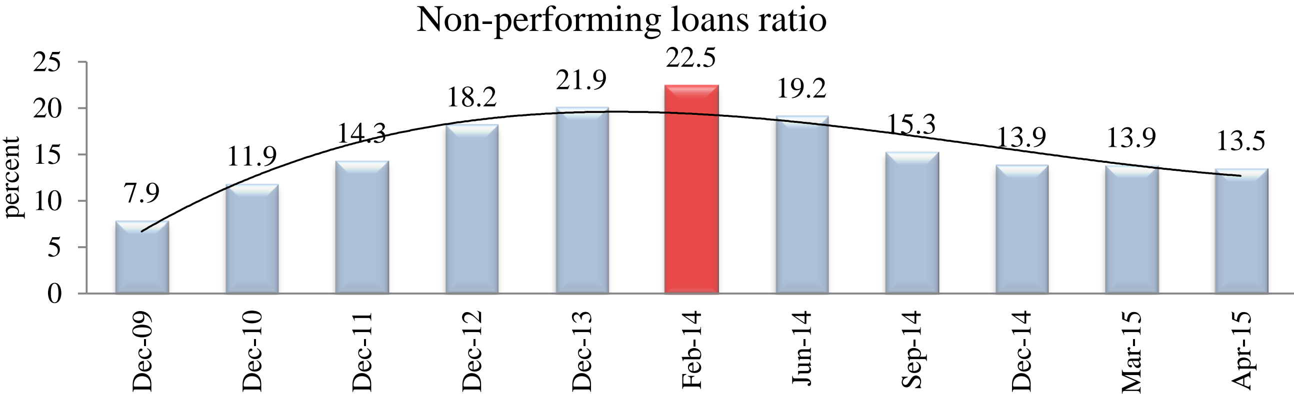
- ***The new EBA ITS definition***

  - Broadens the type of instruments covered (debt securities, loans and advances, off balance sheet items)

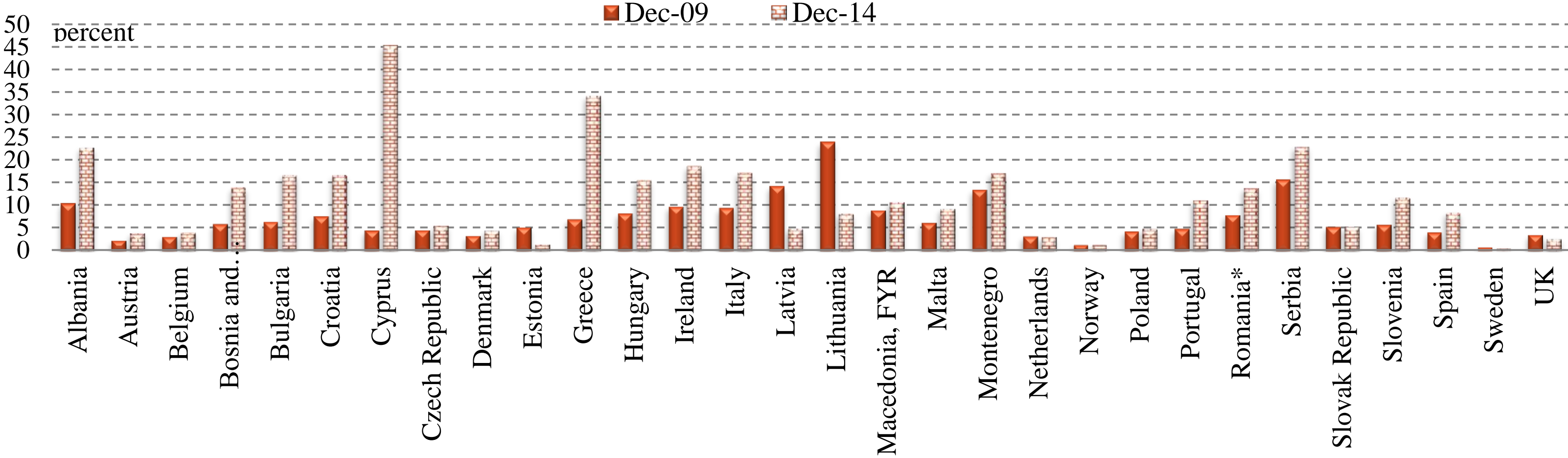
  - Introduces uniform criteria: “material exposures which are more than 90 days past-due or for which the debtor is unlikely to pay in full without realization of collateral’, increasing the scope in the case of loans. Criteria also taken into account are the default status (Article 178 of Regulation (EU) No 575/2013) and the impairment according to the accounting framework.

- The EBA ITS is mandatory only at consolidated level data. On an individual basis, the countries are allowed to use their national definition.

NPL Ratio – Romania and other European Countries

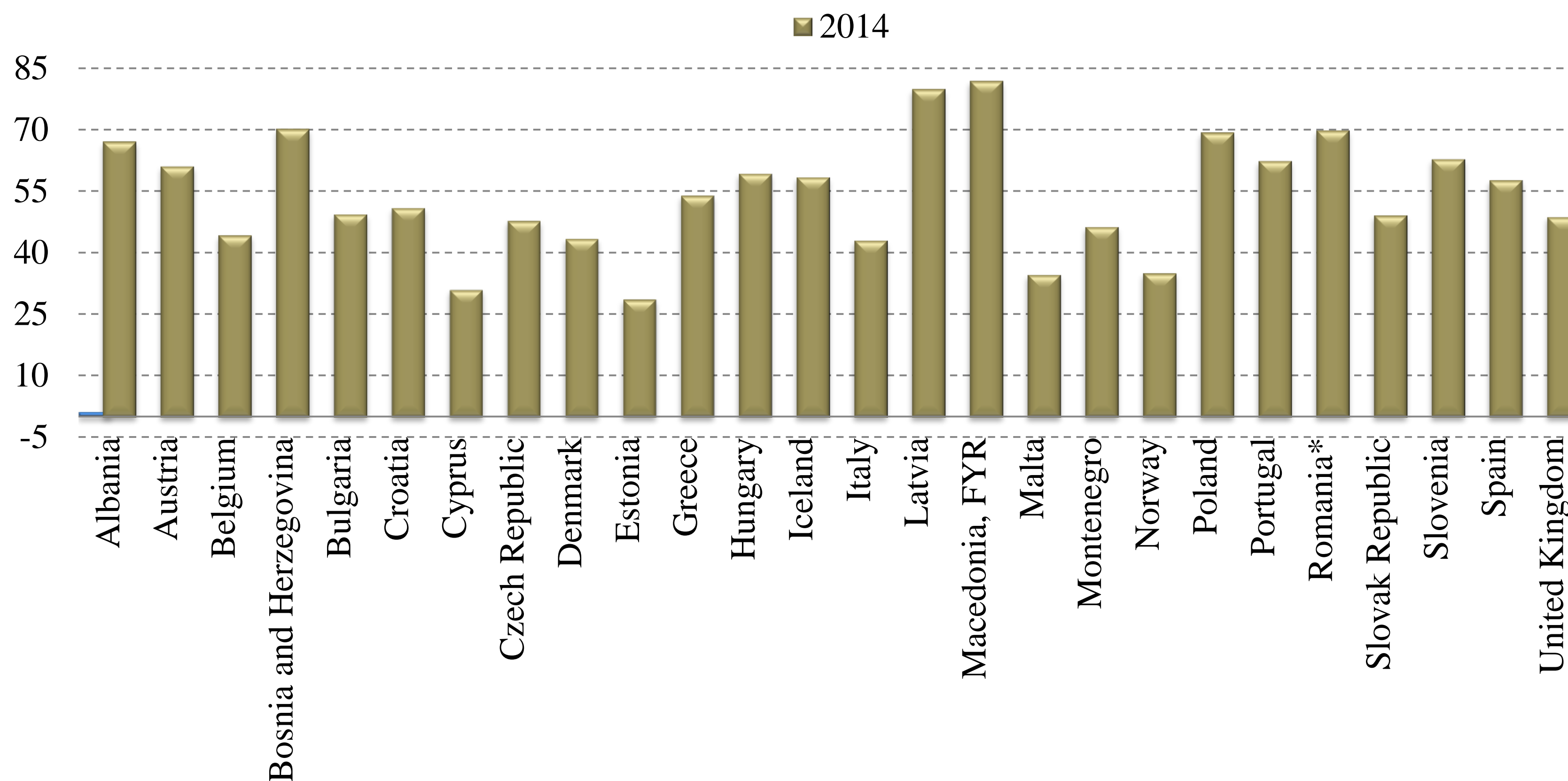


International Comparison



Source: International Monetary Fund (Financial Soundness Indicators, FSI Tables, April 2015)
** Based on accounting data, after to submission of balance sheet.*

Coverage of non-performing loans in selected European Union countries

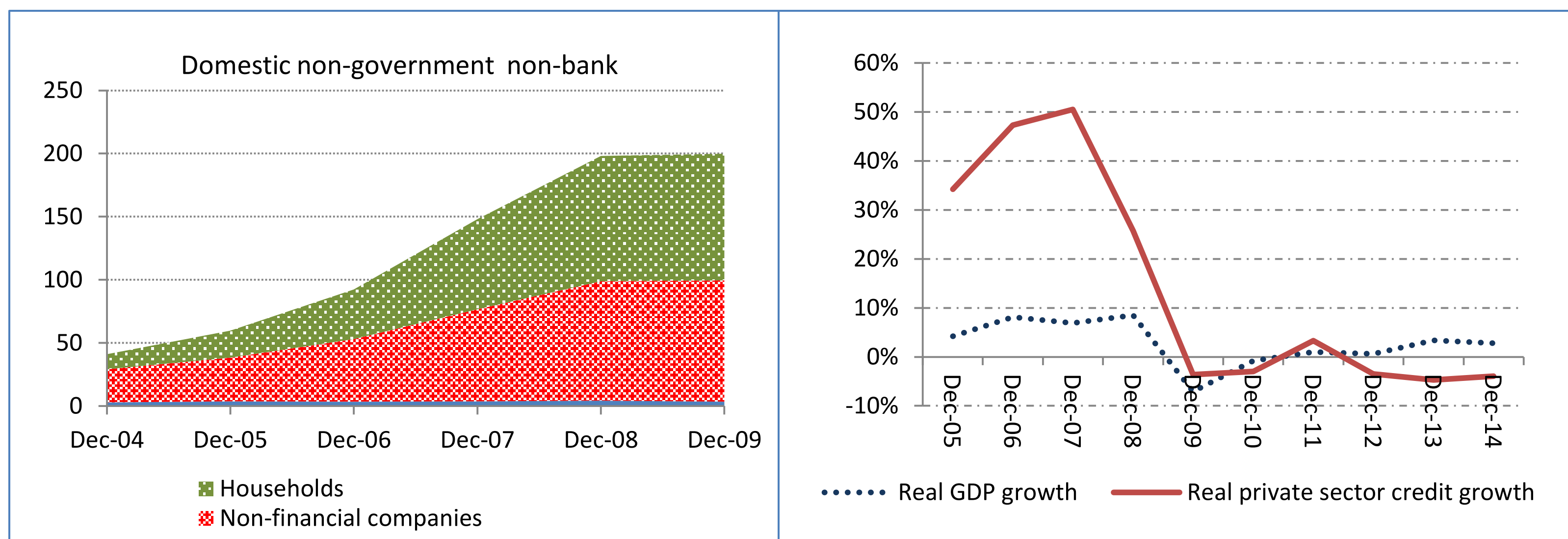


Sursa: Fondul Monetar Internaţional (Financial Soundness Indicators, FSI Tables, April 2015)
** Based on accounting data, after to submission of balance sheet.*

Why did the NPL ratio reach a very high level? (1)

Contributing factors pre-crisis:

❖ Fast expansion of the balance sheet of credit institutions, driven by loans granted to the private sector, at a pace far exceeding sustainable growth due to excessive build-up of leverage.



❖ Relaxation of credit standards, at the beginning of 2007, following entrance in the EU (DTI limits, previously limited by uniform regulation, allowed to be set by credit institutions)

Why did the NPL ratio reach a very high level? (2)

Contributing factors pre-crisis (continued):

- Fast increase of FX loans granted to households, also due to lower interest rates: while the NBR tried to prevent it, the need for a "level playing field" was invoked; this was to become an open door to FX lending to some of the riskiest debtors
- Limited history on new borrowers, despite a comprehensive Credit Register database
- Poor understanding of the effects of changing macroeconomic conditions on corporate business models (banks).
- Limited financial culture and lack of constraint, backward looking expectations as regards real estate developments, stability of exchange rates, income growth on the part of retail customers
- In some cases, predatory lending, oriented at portfolio growth, with little regard to the repayment capacity of the debtor, consequence of a poor corporate governance, leading to misaligned interests between the management of credit institutions (short-term) and its shareholders
- If fully covered with IFRS provisions, the NPL level is neutral from a risk perspective. At low coverage ratios, if the level is excessive, it can lead to suboptimal decisions in respect to new lending via capital shortfalls.

Why did the NPL ratio reach a very high level? (3)

Post-crisis:

- ❖ Difficult write-offs: A decision taken in 2007 by the National Bank of Romania, requesting credit institutions to keep all NPLs in their balance sheet until all legal means to recover the loss were exhausted, leading to a steady build-up in the stock of NPLs. The decision was taken so that the balance sheet would be reflective of the lending performance (reversed after the introduction of IFRS).
- ❖ Lack of bank-level strategies aimed at addressing the problem of poorly performing exposures at a very early stage.
- ❖ Expectations regarding collateral value pick-up, leading to reluctance of credit institutions to recognize additional losses associated with sales.
- ❖ Significantly lower pace of the lending activity (both due to increased risk aversion and rethinking of business strategies and the need to preserve capital in order to cover losses, leading to a significant increase of the government bonds share in overall assets).

Why deal with NPLs?

Considering very high coverage levels, the NPL ratio is not an ongoing risk factor, but

- Low coverage with provisions coupled with high levels of NPLs lead to suboptimal decisions in respect to new lending via concerns in respect to the real solvency position of credit institutions.

- Because of capital costs, most efficient credit institutions prefer to operate at low levels of capital (compliant with regulatory requirements); volatility of collateral values requiring, in a downturn, increased coverage with provisions for existing non-performing loans would, at the margin, cause banks to avoid lending bearing high risk-weights, in order to avoid potential capital shortfalls.

- For supervisors, one of the main concern are losses stemming from a low interest rate environment, conducive of forbearance. Coupled with NPLs, it can lead to a substantial build-up of assets for which value adjustments can cause sudden drops in the level of regulatory capital.

- No such concerns were applicable in Romania's case, where existing capital is able to support a large increase of RWAs and the coverage with provision of NPLs is considered to be high. The restructuring practices of banks for the largest exposures are currently monitored to avoid ever-greening of non-performing loans.

Factors leading to a reduction of the stock and ratio of NPLs (1)

Accounting and fiscal measures leading to a reduced NPL ratio:

- The adoption of IFRS as accounting standards in 2012 gave credit institutions more flexibility in applying their internal policies in respect to "write-off" activities. When adopted, the amount of accounting provisions according to IFRS were lower than the former loan loss provisions according to the prudential regime. The difference, representing a capital surplus, was treated as a **prudential filter** (for prudential purposes, banks were not allowed to recognize the increase in the level of own funds due to lower provisions requirements). Under CRD IV, the filter is gradually being phased out until 2018.
- For fiscal purposes, companies buying NPLs were allowed to deduct the value of provisions from the gross value of the purchased loans when determining the taxable base.

Factors leading to a reduction of the stock and ratio of NPLs (2)

Economic factors and prudential policy

- Gradual improvement of the economic activity, leading to decreased default rates and slowdown of new NPLs;
- Tight lending standards and introduction of new macro-prudential measures (tightening of the rules applicable to DTI and LTV, also differentiated based on the lending currency).
- "Hands-on" supervision, with little forbearance, leading to early recognition of losses in the years after the crisis

Measures aimed at reducing the stock of NPLs (1)

Supervisory measures, taken in 2014:

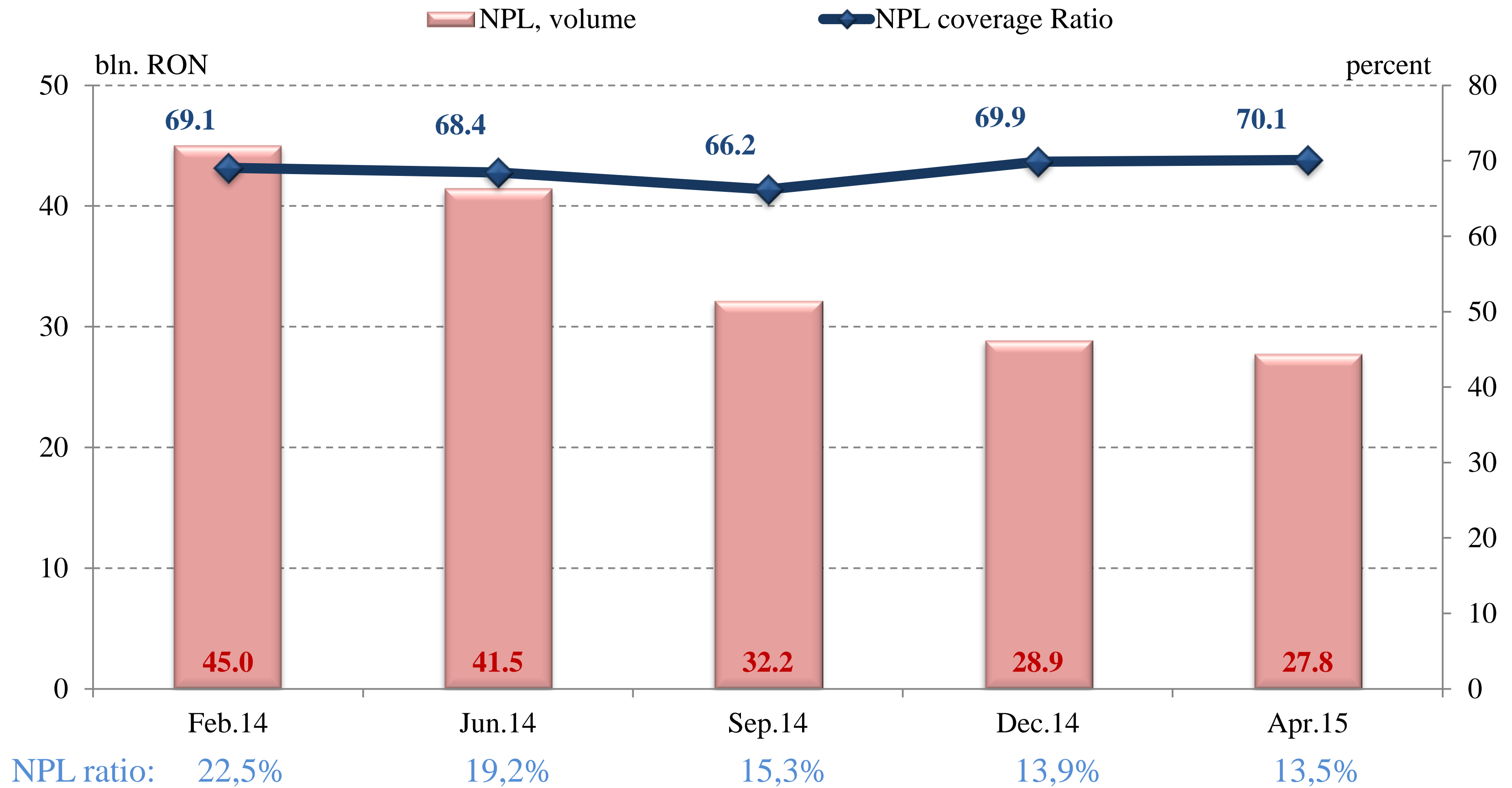
- Letters sent to credit institutions recommending the "write-off " of NPLs fully covered with IFRS provisions.
- Full coverage with IFRS provisions for all NPLs for which repayment of principal and/or interest was overdue by more than 360 days and no legal procedures where taken against the debtors. Where the credit institution chooses not to apply the measure, the accounting value of the exposure is applied a risk weight of 1250% (equivalent to demanding full coverage in terms of capital).
- For all exposures towards debtors in insolvency for which the value of the recovery was small, a coverage of at least 90% of the gross exposure was demanded. Credit institutions using a value of recoveries above 10% of the gross exposure in order to determine the amount of IFRS provisions to be recognized were demanded to provide the methodologies used to assess the amount of recoveries as well as to provide statistical data proving the accuracy of such estimations.

Measures aimed at reducing the stock of NPLs (2)

- Data provided by credit institutions were very granular nature: name of debtor, its fiscal code, code of the identification of exposures (as reported in the Credit Register), debt service, data on financial performance, IFRS provisions and prudential provisions, date at which the debtor applied for insolvency, total amounts repayed after insolvency, collateral values according to the last evaluation, an estimation of the maximum value of the exposure that could be repayed taking into consideration collateral values).
- External audit of the accounting methodologies used to determine the amount of IFRS provisions, including approaches taken for collateral valuation (compliant with International evaluation Standards).

Results: *In order to release capital that would have otherwise been locked by provisions, credit institutions preferred to sell some of the NPLs. Where fully covered with IFRS provisions, credit institutions generally complied with NBR's recommendations.*

"Write-off" activity and the sales of loans determined the significant reduction of the NPLs



NPL ratio: 22,5% 19,2% 15,3% 13,9% 13,5%