EVOLUTION OF NON-PERFORMING LOANS IN THE EUROPEAN UNION AND ROMANIA

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ABSTRACT

The financial crisis caused the debtors' inability to repay their loans, which led to an increase in the level of non-performing loans (NPLs). The high stock of non-performing loans prejudice to the performance of commercial banks by generating a low level of income, reducing their profitability and decreasing the capital levels. Amid this development, during the post-crisis period, one of the main objectives of the banking sector, both at European Union and national level is to eliminate the potential risks by decreasing the rate of NPLs. This paper seeks to perform an analysis of the evolution of NPLs, and also highlighting the main tools used by commercial banks and central authorities to diminish the level and the impact of such credits.

KEYWORDS: *non-performing loans, NPLs rate, commercial banks, provisions, credit restructuring rate*

1. INTRODUCTION

In the post-crisis period, one of the main objectives of the banking sector at both the European Union and the national level was to establish and maintain a stable financial system. In accord with the optics of the Central European Bank (CBE), the stability of a financial system is meant to reduce the impact of financial shocks and corrections and imbalances on real economic activity. Every intermediary in the financial sector is actually an effective contributor to achieving financial stability. In this direction, it also enrolls the approach of all commercial banks to reduce risks by decreasing the rate of non-performing loans. [1]

Non-performing loans have resulted in high risk management costs, with the maximum level achieved in the case of credits passed on at loss. The latter were covered by provisions or by the use of the Reserve and Risk Fund. (Dumitru, 2009).

Representatives of the International Monetary Fund (IMF) claim that the high level of the NPLs rate had negative effects especially in the case of countries in Southeastern Europe, where the main source of financing is the banking sector. A high level of non-performing loans reduces the commercial banks' profitability and increases the cost of financing, diminishing the credit supply. The high stock of non-performing loans (NPLs) affects the performance of commercial banks, generating a low level of income, reducing banks' profitability and diminishing capital levels, which in the last instance leads to reduce the capacity to grant loans to both the private and public sectors.

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2. EVOLUTION OF NONPERFORMING LOANS

2.1 EVOLUTION OF NON-PERFORMING LOANS IN THE EUROPEAN UNION

Due to the financial crisis the debtors, natural and legal persons, encountered serious difficulties, failing to pay or even bankruptcy, which was translated by increasing the portfolios of NPLs at commercial banks' level. The payment capacity of debtors is influenced by the degree of financial indebtedness and the level of disposable income. (Boss, 2002)

The inability to pay has characterized the states in which the recovery period has been extended, due to barriers of structural nature, such as the lack of prudential measures, regulatory deficiencies and an inadequate legislative framework. The measures taken in the post-crisis period and to date have essentially led to strengthening the solvency of commercial banks and increased the possibility of resolution of banks. [2]

Credit risk materializes the loss incurred by a bank by non-compliance with the contractual obligations assumed by a debtor. Credit risk management is based on principles such as continuous monitoring of exposure levels at both individual and group level, the use of a system for the identification and management of NPLs, as well as the a system of indicators to enable them to identify and manage them. A high level of non-performing loans affects commercial banks at State level, given that in order to mitigate them, they will have to constitute provisions. These can lead to a decrease in net incomes and profitability.

According to the data published by the European Commission, from 2014 to the end of 2018, the share of NPLs in banks' portfolio operating in the European Union decreased by more than 50%. [3] However, according to the data provided by the European Parliament, at the level of 2018 the NPLs rate at EU level, it was higher than that in the USA and Japan, where an average level of 1% was registered.

The rate of non-performing loans of the institutions under the direct supervision of the central bank decreased to 4.4%. This rate shall be measured by the ratio between the value level of NPLs which records a payment delay of more than 90 days and the value of all credits. Despite the reduction and volume of NPLs at EU level from 1.2 trillion euros in 2016 to 820 billion euros in 2018, it can be appreciated that it is still a high one. [4]

A factor that was at the basis of the stability of the banking sector was to improve the rate of provisions. As a rule, banks constitute provisions in order to cover losses caused by the systematic non-payment of appropriations. However, a high level of the provisioning rate determines the decrease in the net operational income of commercial banks and falls to the level of their profitability. During 2014-2018 the rate of provisions was stable supporting the capitalization of commercial banks and leading to increased bank resilience to market shocks. This evolution has been concurrent with strengthening the regulatory and supervisory framework of the banking sector. In 2018, the highest level of the provisioning rate was recorded in Germany, followed by Romania and Croatia. On the other hand, for Greece, the level of provisions was close to the NPLs rate at 40%.

According to the data provided by the Central European Bank, although the rates of NPLs decreased in most Member States, significant differences are being made between Member States. At the end of the second quarter of 2018, 12 states had rates with a level of about 3% (Germany, Estonia, Luxembourg, the United Kingdom of Great Britain and Northern Ireland, Sweden, Finland, Netherlands, Denmark, Austria, Malta, Lithuania, France), following others had high rates, three of which exceeded 10% (Cyprus, Portugal and Greece-with a maximum level of 44.9%). According to Table No 1, both at the level of 2018 and of 2017, Greece was the state that recorded the highest level of the NPLs rate, exceeding the threshold of 40%, and the lowest level was registered in Luxembourg, below 1%, being followed by Finland. It is worth noting that Romania recorded in 2018, a rate of 5.9%, with about 3 percentage points lower than the previous year, occupying 16th place alongside Latvia, surpassing countries such as Poland, Hungary, Croatia, Italy. [5]

Table 1- Level of Non-Performing Loans in the EU

	Gross non-performing loans and advances as% of total loans and gross advances			Non-performing private sector loans as% of private sector loans		
	2018	**2017**	**2016**	**2018**	**2017**	**2016**
BELGIUM	2.40%	2.80%	3.4%	3.40%	4.00%	4.4%
BULGARIA	9.20%	12.10%	13.7%	14.50%	19.20%	22.0%
CZECH	2.20%	2.90%	4.3%	4.10%	5.30%	6.3%
DENMARK	2.50%	2.90%	3.4%	2.90%	3.20%	3.9%
GERMANY	1.70%	2.30%	2.7%	2.80%	4.30%	4.9%
ESTONIA	1.80%	2.00%	1.9%	2.30%	2.50%	2.6%
IRELAND	8.50%	11.60%	14.4%	11.80%	15.80%	18.6%
GREECE	44.90%	46.90%	47.4%	48.40%	50.80%	50.3%
SPAIN	4.10%	5.30%	5.8%	5.20%	-	7.5%
FRANCE	2.90%	3.40%	3.9%	4.00%	4.60%	4.9%
CROATIA	8.70%	11.70%	11.3%	13.30%	16.50%	16.7%
ITALY	10.00%	12.20%	16.1%	12.90%	15.90%	19.9%
CYPRUS	28.10%	33.40%	36.8%	44.70%	52.70%	55.5%
LATVIA	5.90%	5.90%	6.2%	8.50%	9.30%	10.1%
LITHUANIA	3.10%	3.70%	4.4%	3.90%	4.90%	5.9%
LUXEMBURG	0.60%	0.70%	1.0%	1.80%	1.80%	2.3%
HUNGARY	6.70%	10.40%	13.7%	9.20%	15.30%	21.7%
MALTA	3.20%	3.70%	4.4%	-	6.70%	6.8%
NETHERLANDS	2.00%	2.30%	2.4%	2.70%	3.00%	3.1%
AUSTRIA	2.90%	4.10%	5.8%	4.00%	5.70%	7.2%
POLAND	7.00%	6.60%	6.6%	7.50%	7.20%	7.3%
PORTUGAL	11.70%	15.50%	17.7%	12.90%	16.20%	17.7%
ROMANIA	5.90%	8.50%	10.2%	7.60%	11.00%	13.5%
SLOVENIA	7.40%	11.40%	14.4%	9.90%	14.70%	18.8%
SLOVAKIA	3.80%	4.10%	4.9%	4.20%	4.70%	5.4%
FINLAND	1.10%	1.40%	1.4%	2.00%	2.10%	2.1%
SWEDEN	1.30%	1.20%	1.2%	1.50%	1.40%	1.4%
UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND	1.30%	1.60%	2.1%	2.30%	2.50%	2.5%
EUROPEAN UNION	**3.40**	**4.60**	**5.5%**	**-**	**-**	**5.5%**

Source: Central European Bank, and European Commission

It can be noted from the table above that the reduction was substantial at the level of the States which recorded rates higher than 10%. For example, this reduction is in the case of Portugal of about 4 percentage points, and for Cyprus of 5 percentage points. Also, at the level of these countries, in the case of particularly vulnerable banks, an improvement in the risk management process and the consolidation of provisions has been recorded. In 2018, according to CEB statistics, the EU's small and medium-sized banks, with an asset level between 3-100 million dollars, have an average level of non-performing credit rates of 12.45%, compared to banks with an asset level exceeding EUR 300 million that are Around 3%. Small banks tend to be less profitable considering they face high funding costs.

The reduction of NPLs and their rate has been facilitated in recent years by decisions taken at the level of commercial banks in EU member States for the purposes of the transfer/sale of non-performing claims to entities specialized in management of such portfolios. Since 2015, an active secondary NPLs' market has been registered. In the year 2016, more and more such transactions were finalized, with a value of about 7.2 billion Euros. In countries such as Croatia, Hungary and Slovenia, investors' interest in lending to the corporate sector has diminished over the past two years, focusing on secured claims and mortgages. According to a study by Deloitte in the first part of the year 2018 Romania dominated this market, holding about 42% of the total transactions in the region, and the main banks involved in these transactions were Transilvania Bank, Piraeus Bank and Raiffeisen Bank. In countries such as Bulgaria and Croatia, Unicredit was the main seller, followed by Alpha Bank. As regards the buyer's person, it was represented by the B2Holding group (which concluded transactions in Croatia, Bulgaria, Romania, and Serbia), followed by the KRUK group (which only concluded transactions in Romania). Despite the challenges made in terms of market conditions, transactions recorded in the first part of the year 2018 accounted at EU level, 41% of all claims traded over the past three years. [6]

The European Commission drafted in March 2018 a plan of measures at EU level whose aim is to mitigate NPLs and prevent the accumulation of a new stock of such credits. The plan contains policy measures in four areas: supervision and settlement of banks, continuation of reforms in relation to national restructuring, insolvency and debt recovery frameworks, development of secondary markets for assets and promoting, where appropriate, the restructuring of banks. Measures at national and EU level should be adopted within these four areas. Banks will have to reserve resources by setting up minimum coverage levels for the newly granted credits to use at the time when the credits granted will become non-performing. Moreover, commercial banks will be forced to reserve funds to cover the risks associated with future non-performing exposures in the form of prudential backstop. These will be in advance reserves to cover losses caused by future loans that may become non-performing. [7] In order to develop the secondary market for NPLs, at the level of 2018, there is a proposal for a Directive establishing the legal regime applicable to credit managers and buyers. In this respect, banks will benefit from effective mechanisms for recovering the values of off-balance sheet credits, in particular those guaranteed.

2.2 EVOLUTION OF NONPERFORMING LOANS IN ROMANIA

In the period 2014-2018 Romania had one of the fastest developments that aimed to improve the quality of commercial banks' assets by decreasing the level of the NPLs rate. Through an analysis of the Department of Financial Stability, the National Bank of Romania (NBR) identified the main causes that led to the level of the NPLs rate, starting with the year 2014. These include: a limited history of debtors' payment behavior, despite the Credit Bureau's database, a limited financial culture of debtors, the lack of predictable normative system, the instability of the course, and a relatively low level of provisions.

The supervisory and regulatory measures adopted by the National Bank of Romania (NBR), together with the individual shares of commercial banks to clean up their balance sheets, by decreasing this rate, have had significant effect starting with 2017. According to the risk scoreboard, submitted by the EBA, a level of NPLs of more than 8% of the total creditor falls on the red band, a level between 3% and 8% falls on the yellow band and their location below 3% fall on the green band. Like Croatia, Romania was 2017 on the red band of the risk scoreboard, and in 2018 on the green band.

The measures adopted by the Central Bank in order to reduce the level of NPLs included: maintaining a high degree of coverage of NPLs with provisions, maintaining a consensus at the level of financial institutions on lending level, obligation to reassess guarantees and the establishment of adequate guarantees with the amount of the granted credits. Following these measures the yield and quality of assets in recent years has improved significantly. At the end of 2018, Romania was ranked 6^{th} in EU, with a ROA (return of assets) value calculated as a ratio between the total level of net profit and assets, of about 0.4%.
According to Table No 2, since 2016 the NPLs rate was below the 10% threshold, approximately 3% below the level recorded in 2015. This level is placed, on the intermediate risk band, but is still superior to the average level registered in the EU. According to the data provided by NBR, in the first part of the year 2019, the NPLs rate recorded a record level of 4.7%. In 2018 the level of the NPLs rate for the first 10 banks operating on the market was between 8%-14%, which falls into the red threshold of signal, according to EBA. [8] In terms of the NPLs rate, at the level of 2018 the best level recorded the Raiffeisen Bank, with a value of 4.1%, declining by 2 percentage points compared to the previous year. It was followed by Transilvania Bank with 4.97% and BCR by 5.8%. Improving the quality of the credit portfolio characterized including the BRD portfolio, with a level of NPLs rate of about 6.4%. A comparative level had included Unicredit, with 6.16%.

Table 2 Level of Non-Performing Loans Rate in Romania

Date	**Number of credit institutions**	**Foreign banks branches**	**NPLs rate According to BNR's definition**	**NPLs rate according to EBA definition**
	(No.)	*(No.)*	*(%)*	*(%)*
	34	7	-	4.74
June -19	34	7	-	4.90
March -19	34	7	-	4.96
2018	35	7	-	5.71
2017	36	8	-	8.32
2016	36	7	-	11.30
2015	40	9	12.80	16.20
2014	40	9	19.19	-

Source: National Bank of Romania

Since the end of 2017 the increase in the volume of new loans to the population has decisively contributed to reducing the rate of NPLs in Romania. The credits granted were both consumer credits and real estate purchases. In the year 2018 their level was 12% higher than the previous year. The rate of non-performing loans to the population, in the first part of the year 2019, decreased by 0.8 percentage points, compared to the previous year, as a result of the increase in salary revenues in recent years. With regard to loans of unsecured consumer needs, a non-performing credit rate was recorded in the year 2018, by 4%. In the last two years the rate of non-performing loans in national currency has diminished.
Another important factor that resulted in the reduction of the NPLs rate was the degree of coverage with the provision of NPLs. With a level of 58% at the end of 2018, Romania was placed in the EBA low risk signal band. According to the data provided by NBR, in the first part of 2019, around 22% of banks in the Romanian banking sector record a level of provisions that do not exceed the threshold of 40%, and those of the average category have the lowest level of coverage with provisions. In order to manage the risk, the level of provisions respects a prudent approach at the

level of the first five banks operating in the market. The coverage of non-performing loans with specific provisions and guarantees in the case of Transilvania Bank was 133.19%, followed by a Unicredit level with a level of about 127% and BCR of 100.3%. The lowest level was recorded by BRD of only 75.4%. However, about 22% of the banks operating on the Romanian market have a level of coverage with provisions of non-performing loans less than 40%

Cleaning of the balance sheet of commercial banks of non-performing credits by write-off total, supported the downward evolution of the NPLs rate. The sale of receivables plays a major role in reducing the level of the non-performing credit rate. In Romania most transactions were made at the level of 2016. At mid-2018, the gross value of the traded non-performing claims was about 1 billion Euros, decreasing by about 52% compared to the previous year. In March 2019 the cessions/sales were declining by 0.22 billion Lei, compared to the previous year. [9]

Since January 2018, the normative level has limited to 30% tax deductibility of expenditure on non-performing loans that banks sell on the secondary market. According to the DCA analysis, partner of B2Holding, this measure will be able to limit the positive effects of such transactions and will generate an additional cost for financial institutions. The effect was also surprised by the NBR, in the latest report on financial stability in 2019, and 75% of these are the result of the actions taken by only five banks. According to it, total write-off credits decreased by about 0.22 billion lei, compared to the previous year. Moreover, the quality of the portfolio offered for sale is very important. This is influenced by factors such as its value and structure, the quality and complexity of the information provided to the buyer regarding the nature and composition of the portfolio and, last but not least, the competition between investors acting on the secondary market for non-performing loans.

Another indicator, whose level directly influences both the level and the structure of NPLs is the rate of restructuring. It measures the degree of internalization of the non-performing lending component as a result of the measures offered to debtors with payment difficulties. The restructuring rate shall be determined as a ratio between the restructured appropriations and the total granted credits. In the year 2016 it exceeded the European average, recording a level of 6.4% and from 2018 to a level of 3.4%. Romania is thus placed in an intermediate risk category. At the beginning of 2019, banks continued their policies that support customers who are struggling with payment. However, NBR discourages the restructuring of non-performing clients' loans in order to avoid moral hazard, in which case good paying customers would choose not to execute their contractual obligations to benefit from a form of restructuring liability

Another factor that contributed to the consolidation of the Romanian banking system and maintaining the financial stability was the wide process of mergers and acquisitions, which emphasized the premises of intensifying the competition. Following the completion of the merger between Transilvania Bank and BancPost, the number of credit institutions in 2019 was 34. According to the data provided by the National Bank of Romania, the concentration of assets is a small one, with a level of market share of the first five banks of 62.1%, slightly increasing compared to the previous year, and of the Herfindahl-Hirschman index of 963. This evolution created the premises to diminish the non-performing character of the loans.

These developments are also shaping up against the background of the latest legislative changes, aimed at the protection of the debtors natural persons. In this respect, we recall the project on regulation and modification of the maximum limits on interest and penalties, in the case of credit agreements between consumers and credit institutions, the project on eliminating the enforceability of credit agreement, mortgage or any other document issued for the purpose of guaranteeing credit, as well as of leasing contracts concluded with consumers, and limiting the level of compensation, the project by which it is limited the amount that it may charge the transferee from the debtor who is a consumer to double the amount paid to the transferor lender. This last project has a direct impact on the secondary market of NPLs. The project to extend the law on giving in payment of credit to the "First House" credits and by defining the notion of unpredictability. Last but not least,

the modification of the legislative framework and the legal regime applicable to the taxation of bank assets constitutes a final project with direct impact on NPLs.
The uncertain and unpredictable legislative framework will have direct effects on the creditworthiness of debtors and implicitly of commercial banks. In the latest European Commission report on Romania, this risk was assessed as a severe one. The main vulnerabilities that are in close connection and amplify this effect are: lack of transparency in the legislative process, lack of effective consultation of the main affected actors, increasing the uncertainty of policies which leads to a reduction in investor confidence, and with direct implications for the efficiency of the banking sector in Romania. In the period 2014-2018, about 50 laws were adopted, of which five were declared unconstitutional in part or in all.
In order to prevent any non-payment risks, for low-income natural persons from January 1st, 2019, the National Bank of Romania adopted Regulation No. 6/2018 for the modification and completion of Regulation No. 17/2012 on some lending conditions. Thus, it set a maximum level of debt of 40% for consumer and mortgage credits. In the case of credits in foreign currency, the maximum degree may not exceed 20%.
In view of these developments NBR estimates that the default risk for debtors will increase by the end of 2019. The decrease in the payment discipline of unsecured consumer credits, at the same time with the stagnation of population incomes, will reduce the quality of credit institutions' portfolios.

3. CONCLUSIONS

The reduction in the rate and volume of NPLs represented from the perspective of commercial banks, both at European Union and Romania level, a double challenge. Thus, new granted credits must exceed the level of credits already considered non-performing and the activity of cleaning the balance sheets of commercial banks must continue in order to preserve their lending capacity and allow efficient use of financial resources.
With regard to the level of the NPLs rate both at Member State and Romania level, there have been favorable developments over the past years, however its level is still not below the 3% threshold values considered by EBA as low-risk. From 2014 to present the share of NPLs in EU commercial banks declined by more than half, registering at the end of the third quarter of 2018, slightly above the 3% limit. Therefore, the challenge of adopting and implementing measures with prudential purpose continues.
Continuing to maintain a high level of NPLs will result in an intensive use of capital to cover losses. The long term conservation of credit portfolios quality in the banking sector also entails maintaining a stable macroprudential framework, which would prevent the accumulation of NPLs in the future. Moreover, the lending activity must be based on a prudent assessment of the creditworthiness of debtors and the avoidance of successive restructuring of registered debts. The supervisory work of the central bodies still maintains its usefulness, thus avoiding the skidding at the level of commercial banks.

ENDNOTES

[1] According to EU Commission implementing regulation 2015/227 non-performing loans, those loans where the debtor can no longer make payments scheduled to cover the repayment of interest and principal. In order to be considered a non-performing credit, the payment deadlines should be exceeded by at least 90 days. According to the definition given by the European Banking Authority (EBA), implemented in the national framework by order of BNR No. 6/2014, non-performing exposures shall be those fulfilling any of the following criteria: (i) are significant exposures with a maturity exceeding 90 days; (ii) It is considered that, in the absence of enforcement of the collateral,

the debtor is unlikely to fully pay his credit obligations, irrespective of the existence of any outstanding amount or the number of days of late payment.
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[3] European Commission, Banking Union: volume of non-performing loans in EU continues to fall, July 12, 2019
[4] https://npl.vienna-initiative.com/resources/themes/npl/wp-content/uploads/sites/2/2018/11/NPL-Monitor-H2-2018.pdf
[5] https://www.consilium.europa.eu/media/31936/note-presenting-a-stock-take-of-financial-reforms.pdf
[6] PWC *study on increasing financial intermediation in Romania March 2019*
[7] https://www.moodysanalytics.com/regulatory-news/apr-25-19-eu-finalizes-regulation-on-prudential-backstop-for-bank-npes-under-crr
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