

LOAN-PORTFOLIO QUALITY AND MANAGERIAL EFFICIENCY IN BANKING

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ABSTRACT: As poor management of loans of loans has often been the main cause of bank losses and failures in this area, this paper aims to make a parallel between the quality of loans from bank portfolios and the financial performance of banks. The study is divided into three parts. Thus, the first part refers to trends in the evolution of the quality of loans within EU countries, while the second half continues with an in-depth examination of the situation of non-performing loans in the Romanian banking system. The last part of the paper presents aspects regarding the performance of the Romanian banking system and performs a comparative study on the performance obtained in recent years by leaders of the Romanian banking market.

KEY WORDS: financial crisis, the quality of loans, non-performing loans, banking profitability, bank management.

JEL CODES: G21, G32, E44, F30

Introduction

Lending is the main operation of a bank through which banks provide their customers with funds requested by them, being a commitment to repay the lent amount of money with interest. Granting loans is a core activity that may generate significant profits for the bank, but may also lead to losses (Cocriș and Chirleşan, 2007). Lending is not an exact science; it is not possible to ensure that the amount lent to a customer will be repaid with interest by using a formula or applying a theory. Therefore, credit approval and granting must rely on prudential banking as fundamental principle (Trenca, 2008a), as well as on the analysis of business viability and realism in order to assess the borrower's ability to repay the loan plus the interest. In addition, on the occasion of granting a loan, the bank shall take into account the influence of external factors on projects proposed by credit applicants, namely non-financial aspects that can have unforeseen effects on doing business and loan repayment.

Loans can be granted from the bank's own resources, but mainly from attracted resources. Thus, experiencing losses due to a mismanagement of the lending activity adversely affects bank profits and the overall activity of the bank. In fact, the ways in which banks allocate funds for crediting can dramatically influence the business prosperity.

On the other hand, any bank assumes risks when granting loans and may register losses in the loan portfolio when certain borrowers cannot meet obligations under the credit agreement. Whatever the level of risk assumed, credit portfolio losses can be minimized through an effective management of the lending activity (Trenca, 2008b). The loan portfolio is generally the largest asset of a bank and the most important source of income, representing at the same time one of the main sources of risk. Thereby, a poor management of loans was and remains the main cause of the problems in this sector.

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Objectives and methodology

The present study intends, as a general objective, to provide an overall perspective on the main aspects of credit risk and loan portfolio quality and to address issues related to the profitability of the banking activity. The methodology used in this study refers to qualitative approaches based on data drawn from periodicals and occasional publications of the NBR, on studies and reports of other institutions involved, on the database and the research of the World Bank and other international organizations and consulting companies, as well as on works from the specialized foreign and Romanian literature. Extensive statistics, processed using analytical tools offered by scientific literature, led to relevant results that highlight the relationship between the quality of the loan portfolio and the performance of the banking system.

The quality of loans in the European banking systems

The recent financial crisis, which officially began on August 9th, 2007 along with the first money market tensions, left as legacy extremely high levels of non-performing loans (NPLs). In 2008, countries which relied their economic growth on a booming banking sector were faced with a sudden set-back of lending. The European banking system, as a whole, was faced and is currently dealing with a trend of continuous deterioration of the quality of loan portfolios, which is a common feature for the European financial market in the last period under the conditions of persistent crisis effects.

Thus, the difficult market environment in recent years across Europe, especially in Central and Eastern Europe, has led to a continuous decline in credit quality within the banking systems of several EU countries, such as Spain, Italy, Portugal and Malta, but the values recorded were slightly above the EU average. The banking systems in Cyprus, Greece and Ireland, where the rate of NPLs has reached alarming figures in the past three years, recorded an unusually high volume of non-performing loans and a notable increase in provisions for credit losses (Figure 1).

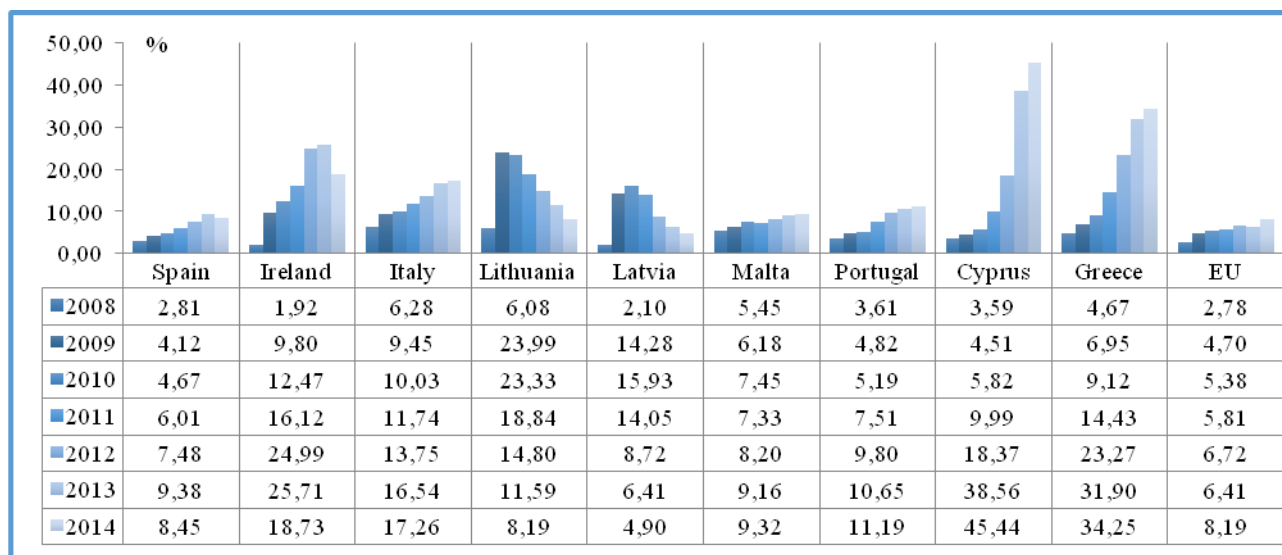


Figure 1. NPLs ratio in some EU countries, 2008-2014

Source: based on data from the World Bank's database

Unlike most EU member states, where banks have recorded a dramatic increase in the volume of NPLs due to the economic downturn caused by the financial crisis, there have still remained strong banking systems in Europe (such as Belgium, Luxembourg, Austria, Germany, France, UK, Nordic countries, and Estonia), generally in Euro-area countries that have managed to

maintain a good quality of loan portfolio and a reduced rate of non-performing loans, well below the average in this area (Figure 2).

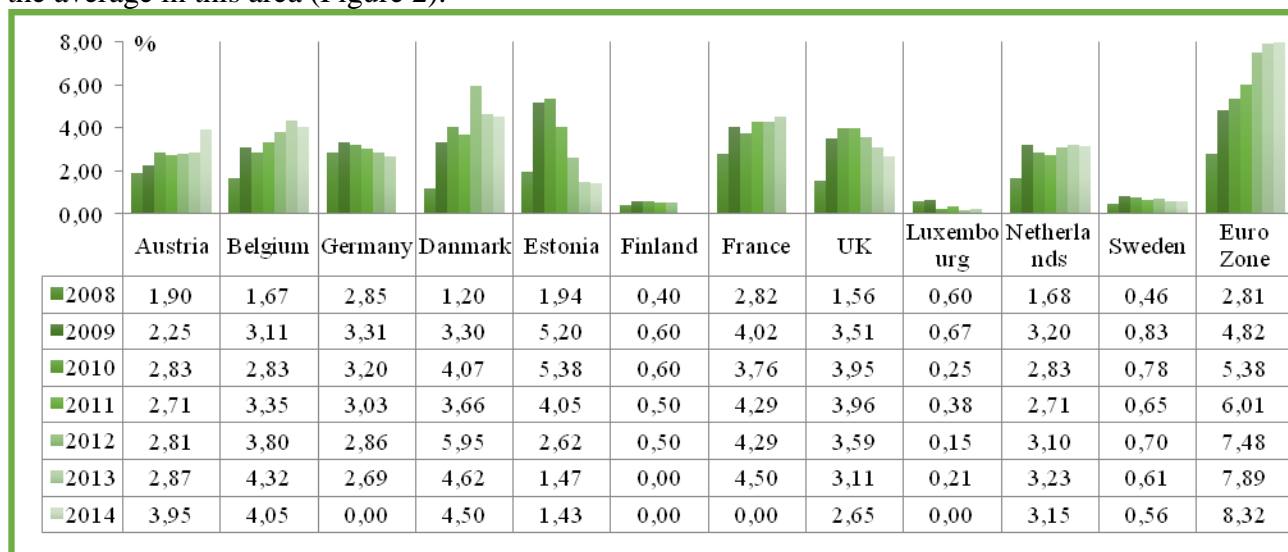


Figure 2. NPLs ratio in some EU countries, 2008-2014

Source: based on data from the World Bank's database

Note: Germany 2014 – N/D, Finland 2013, 2014 – N/D, France 2014 – N/D, Luxembourg 2014 – N/D

The trend of deterioration in the quality of loan portfolios was lately a common characteristic of the Central and Eastern European banking market, with few exceptions. As a result of the 2008-2009 crisis, NPLs grew rapidly in these countries, reaching very high levels comparable to those generated by previous financial crises. The eight CEE countries, members of the EU, can be, in fact, divided into two groups (Figure 3). In three countries such as Poland, the Czech Republic and Slovakia, the rates of NPLs registered much lower values than in the other countries (varying below 6% in 2013), being stable in post-crisis or even showing some improvement. In the other five countries (Slovenia, Croatia, Hungary, Bulgaria and Romania) NPLs ratio were substantially higher and did not show signs of improvement (reaching in 2013 significant figures: 13.31%, 15.43%, 16.74%, 16.88% , 21.87%).

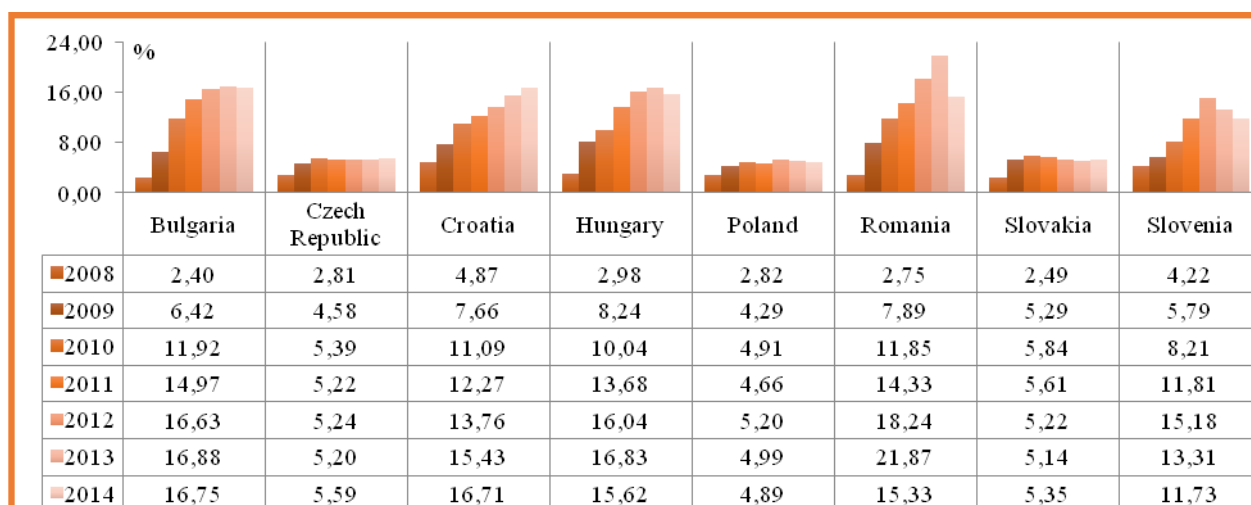


Figure 3. NPLs ratio in CEE countries, 2008-2014

Source: based on data from the World Bank's database

However, after several years of increases, the year 2013 represented the year of stabilization of the NPLs ratio at an average level of 12% in this area. But, if we exclude the healthier banking systems from Poland, the Czech Republic and Slovakia, CEE figures for 2013 show an average of nearly 17% for the NPLs ratio. According to experts, such particularly high values, delay the return to a sound lending activity and economic growth (Deloitte, 2014). The highest rate of non-performing loans from the CEE region was registered in 2013 by the Romanian banking system which continues to be almost twice the average in this area since 2009.

Although hesitant signals of levelling the growth of non-performing loans have emerged in some CEE countries, the turning point seems to have not been reached yet. Moreover, despite the efforts of the bank management and regulatory authorities, NPLs remain high in Eastern and Central Europe, especially compared with the advanced economies of Western Europe.

The quality of loans in the Romanian banking systems

In the last decade, the evolution of several emerging economies has been characterized by a rapid growth of loans, especially in countries where the level of loans is considered to be excessive in relation to the GDP, leading to high financial stability risks. Among the top ten such countries one may find Romania, alongside Brazil, the Czech Republic, Mexico, Turkey, Russia, China, Chile and Hungary (ECB, 2014). The deterioration of the economic potential and the evolutions of the currency market, materialized in the depreciation of the national currency, have diminished the safety degree of loans within the Romanian banking system, while the quality of loan portfolios of banks has registered a continuous decline.

According to data released by the National Bank of Romania, based on prudential reporting, the quality of loan portfolios remained vulnerable due to the pressure put on the financial standing of borrowers by the financial crisis, the restraint in lending and the still fragile economic growth. Quality evaluation of credits shows that loan quality has been deteriorating since the end of 2008. Thus, the exposure of the Romanian banking system to loans granted to non-financial corporations has shown an increase in the share of credits from the categories “doubtful” and “loss” during 2008 and 2014, while the share of credits from the categories “standard” and “watch” have recorded a continuous downward trend (table 1).

Table 1

The evolution of the quality of the loan portfolios of banks, 2008-2014

	Chain indexes				
	Standard	Watch	Sub-standard	Doubtful	Loss
dec.2009/dec.2008	0.8705	0.9069	1.2089	1.6570	2.6592
dec.2010/dec.2009	0.8742	0.9633	1.2346	1.2886	1.3820
dec.2011/dec.2010	0.9872	0.9074	1.0102	1.0498	1.1373
dec.2012/dec.2011	0.9328	0.8175	1.0055	1.3901	1.2586
dec.2013/dec.2012	1.0016	0.9367	0.8814	0.7225	1.1709
apr.2014/dec.2013	1.0030	0.9906	0.9431	0.9657	1.0269
	Fixed-base indexes				
	Standard	Watch	Sub-standard	Doubtful	Loss
dec.2009/dec.2008	0.8705	0.9069	1.2089	1.6570	2.6592
dec.2010/ dec.2008	0.7610	0.8736	1.4924	2.1353	3.6749
dec.2011/ dec.2008	0.7513	0.7928	1.5076	2.2415	4.1794
dec.2012/ dec.2008	0.7008	0.6481	1.5159	3.1159	5.2601
dec.2013/ dec.2008	0.7019	0.6071	1.3361	2.2512	6.1592

apr.2014/ dec.2008 | 0.7040 0.6014 1.2600 2.1739 6.3251

Source: processed based on data from the NBR's Monthly Bulletins, 2008-2014

From a prudential perspective, the NPLs ratio is the key loan portfolio quality assessment indicator and it is determined based on prudential reports on loan classification. In the Romanian banking system, this indicator has been on an upward trend over the past few years, driven by the persistence of the financial blockage as a result of slow economic recovery from an extended crisis, as well as by the new wave of national currency depreciation.

In addition, a significant share of inefficient enterprises still diminishes the safety degree of granting credits. In the entire sector of real economy, SMEs were the most affected by the economic and financial crisis; unlike corporations, they found it harder to cope with the crisis. This fact influenced the quality of loan portfolios of banks. If the SMEs, with a great degree of indebtedness, have recorded a high ratio of NPLs due to loss-generating activities, corporations with a generally reduced degree of indebtedness, have recorded low rates. Thus, according to data released by the NBR, the ratio of NPLs granted to SMEs is maintained throughout 2008 and 2013 at a much higher level than the NPLs ratio for corporations (Figure 4).

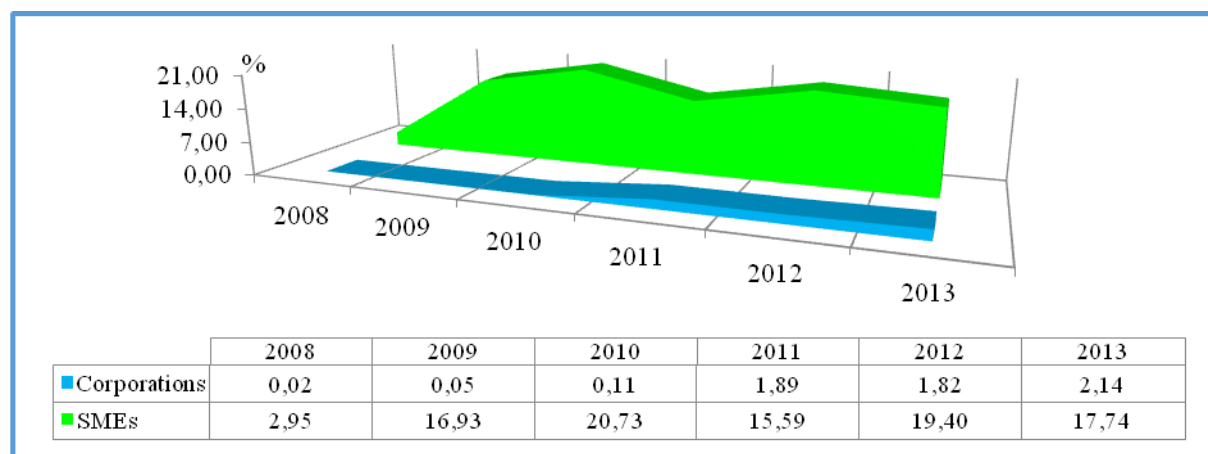


Figure 4. Stock of non-performing loans generated by SMEs and corporations during 2008 and 2013

Source: NBR, Financial Stability Report, 2014

The high level of NPLs is becoming a growing problem even for banks that hold leading positions on the Romanian banking market. In fact, the market leader BCR is the top of the banks with the highest levels of non-performing loans, the NPLs ratio reaching a historical value of 29.2% by the end of December 2013, a rate nearly 7.5% higher than the one registered by its direct competitor, BRD (Figure 5). Although at the end of the third quarter of 2014, the value of the indicator dropped to 26.5%, it is still more than 4% above the average value registered by the Romanian banking system.

If for two consecutive years (2010 and 2011), the NPLs ratio registered by BRD dropped below the average of the Romanian banking system, at the end of 2012 the indicator exceeds by almost 2% this average. The highest level of 21.8% was reached by the end of December 2013, however in the next period the NPLs ratio of BRD diminishes to 18.2% at the end of the third quarter of 2014.

As compared to the two market leaders, the situation of BT is substantially different in terms of non-performing loans, the values recorded by this bank being way below the average of the banking system throughout the 2010-2013. By the end of 2013, for example, NPLs of BT accounted for 12.57% of the total loan portfolio, with more than 9% below the average value of the Romanian banking system for that year (21.87%). After the first nine months of 2014, the NPLs ratio of BT is

still well below the average of the Romanian banking system, the indicator reaching the value of 11.47%.

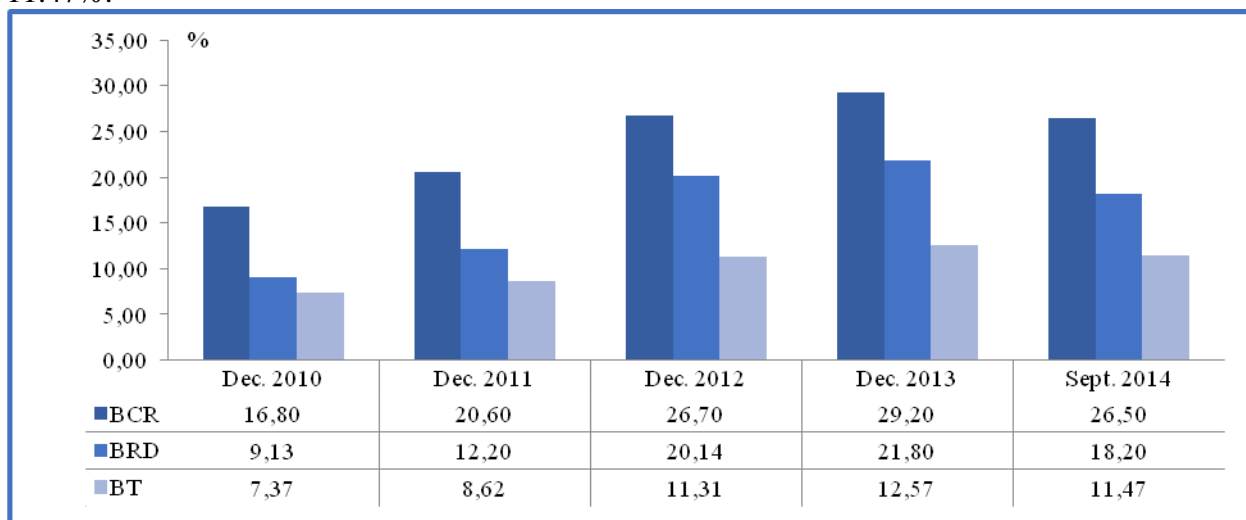


Figure 5. Rate of non-performing loans registered by leaders of the Romanian banking market during December 2010 and September 2013

Source: processed based on data from the Financial Results of BCR, BRD and BT, 2008-2014

Profitability of the Romanian banking system

A major concern in recent years for bank management has been managing the losses caused by non-performing loans. Domestic and external adverse macroeconomic developments have also influenced the financial results of credit institutions within the Romanian banking system. Bank profitability has been affected by higher expenses for credit risk provision, as well as by a significant decrease in net income from interests.

Although in 2008 the Romania banking system was the most profitable in Central and Eastern Europe, the deterioration of loan portfolio, high net costs of provisioning and deterioration in operating results led profitability to enter negative territory in March 2009. However, the financial result registered by the end of the same year still remained positive due to banks that were able to recover some of the losses accumulated. Moreover, the weakening of results continued, the Romanian banking system ending the following three years on loss (2010: -516 million lei, 2011: -777 million lei, 2012: -2.3 billion lei).

Although lending was somewhat resumed in 2012, the banking system remained on loss due to the depreciation of financial assets and the re-evaluation of collateral on loans. Large banks which have experienced a better operating profitability and lower costs associated with credit risk, however, recorded positive financial results. In 2013, the Romanian banking system returned to profit thanks to a slowdown in accumulating NPLs and a positive growth rate of operating profitability, given the fact that 23 banks had reported profits, a while 17 banks had registered losses (Figure 6).

The upward trend of NPLs ratio has put pressure on the financial situation of the main banks within the Romanian banking system. Three years of consecutive loss (2010, 2011 and 2012) signals a problem for the banking system as a whole; the situation is even more serious given the fact that nearly three-quarters of the aggregate loss comes from the biggest players on the Romanian bank market, BCR and BRD, which managed to remain on profit until 2012.

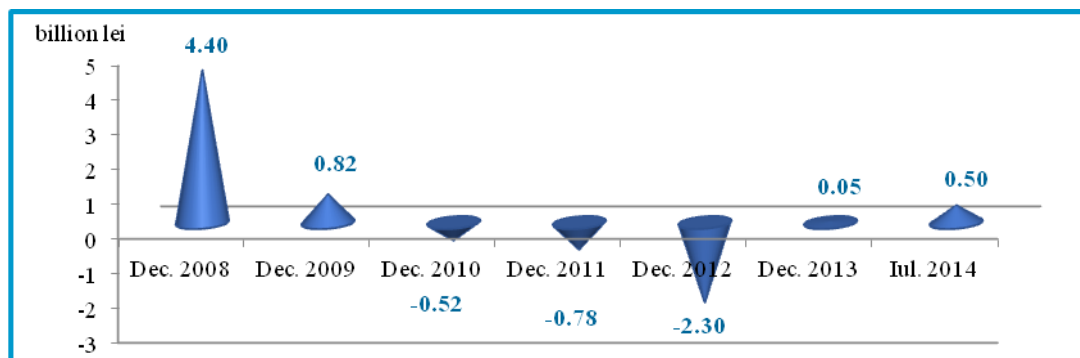


Figure 6. Evolution of the Romanian banking system profitability during December 2008 and July 2014

Source: processed based on data from the Financial stability reports of the NBR, 2008-2014

Therefore, BCR, the number one bank within the Romanian banking system according to its market share in terms of assets, after recording positive results at the end of 2011, reported an unexpected loss in early 2012, and thus its net profit fall to 70.9 million lei, a very modest result as compared with the values achieved by its rival, BRD, during the same period (Figure 7). Mostly, this was due to the high expenses for credit and bank’s receivables depreciation.

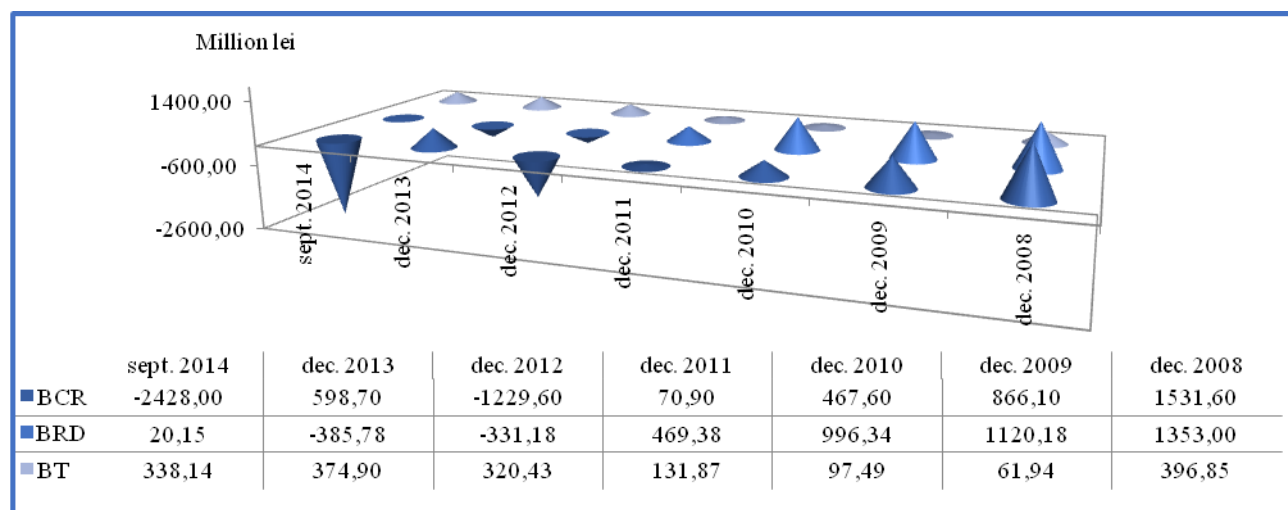


Figure 7. Evolution of net profits of the Romanian leaders on the bank market during December 2008 and September 2014

Source: processed data from the Financial results of BCR, BRD and BT 2008-2014, 2008-2014

Although BCR ended 2013 with a consistent net profit (of 598.7 million lei), the bank re-entered in negative territory after the first nine months of 2014, recording a net loss of 2428 million lei, because expenditure with credit risk provisions tripled, accelerating the process of cleaning up the balance sheet of non-performing loans.

On the other hand, BRD managed to be the most profitable bank in Romania in 2011, reporting a net profit of 469.38 million lei, having the most extensive network of subsidiaries of private banks; this reality provided BRD with a privileged position in case of any funding opportunities. Despite these results, its profitability registered negative values the next year, the bank ending both 2012 and 2013 with losses (331.18 million lei and 385.78 million lei respectively). After the first three quarters of 2014 the bank has recovered, but the net profit is still reduced (only 20.15 million lei).

Unlike market leaders BRD and BCR, BT, the third bank according to assets, has reported an upward trend regarding profitability after the difficult year of 2009, and in 2013 it nearly

returned to the net profit registered during 2008, the boom year for the Romanian banking system. In September 2014, Transylvania Bank reported a net profit of 338.14 million lei, increasing by 40% as compared to the same period of the previous year, which was mainly due to the increase of income from interests and commissions and the reduction of the rate of non-performing loans.

Cleaning the Romanian banking system of NPLs accumulated after five years of crisis, appears to be very costly. It is expected that like other banks, BCR, with a NPLs ratio above the system average, will record losses and will need additional capital. Moreover, non-performing loans also induce uncertainty and negatively influence the willingness and the capacity of banks to continue lending operations, affecting aggregate demand and investments.

Conclusions

In this paper we have tried to emphasize the importance of loan-portfolio quality and credit risk minimization in bank management, given the risks lending operations induce. In this respect, the data that shows the level of NPLs for both the European and the Romanian banking system is most significant, reaching the conclusion that the recorded values of NPLs ratio can be attributed to macro-economic conditions, as well as to some specific factors, such as the quality of bank management.

The recent financial crisis, which has caused many problems even to some strong banking systems, highlights the importance of prudent banking and the assessment of business viability and realism, but mostly the necessity to manage financial stability. The upward trend of non-performing loans due to continuing deterioration of the quality of loan portfolios is the common characteristic of European financial markets, exerting increasing pressure on profitability in the banking sector.

Just like in other countries, the main reason for the high level of non-performing loans within the Romanian banking system is the economic deceleration due to the economic crisis, and to an equal degree, the great volume of loans granted during the pre-crisis period compared with the repayment capacity of customers. Provisioning costs require banks to adjust other operating costs, since they are concerned with managing non-performing loan portfolios. Beyond the fact that the high level of NPLs continues to be a burden for the economy, particularly because of the tightening of credit, it is essential to perform a rapid but systematic cleanup of banks' portfolios. Until then, however, the resumption of sound lending and investments in the economy is delayed, which means that the domino effect continues in the next period in the economy, and companies do not have access to actual lending instruments that can ensure debt payment and activity resumption.

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