



National Bank of Romania's experience in dealing with the NPLs challenge

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REGIONAL HIGH-LEVEL WORKSHOP ON NPLs RESOLUTION

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I. Romanian banking system: current condition (March 2016)

I.1. Main features of the Romanian banking sector - March 2016

Banking system size:

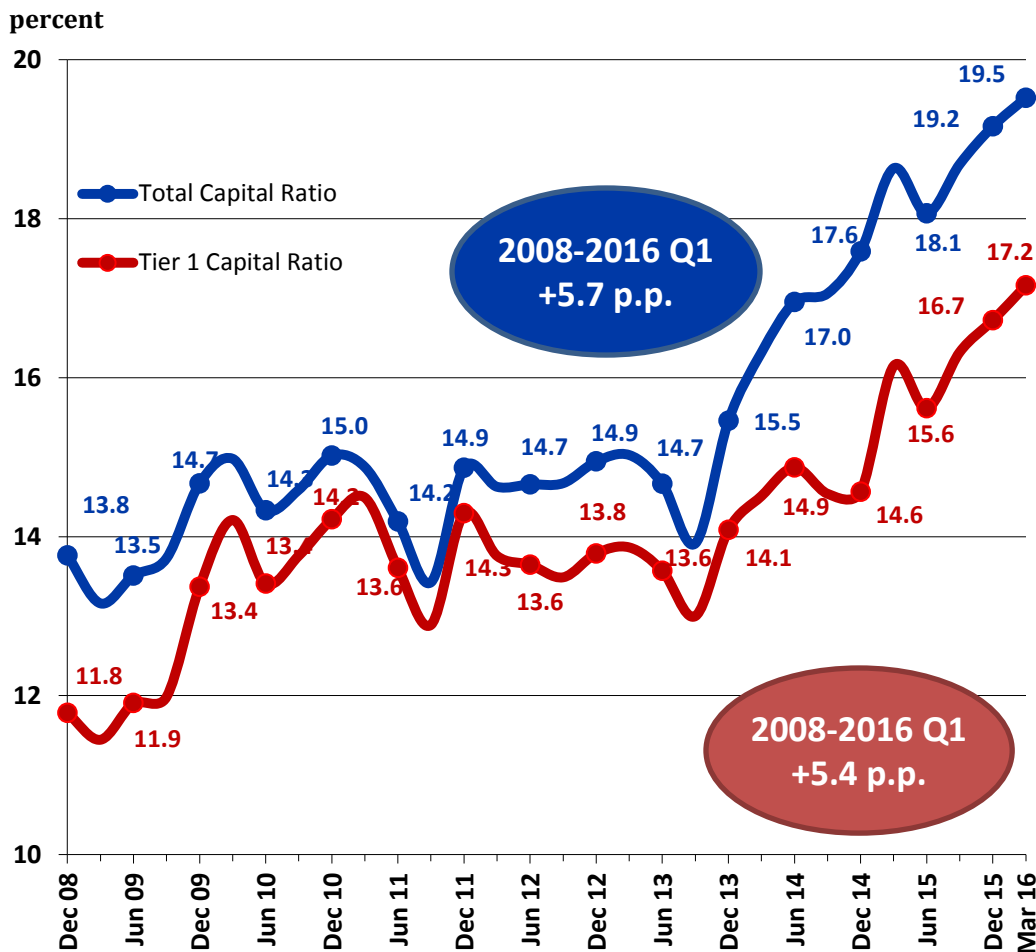
- ❑ **Number of credit institutions: 36**
(out of which **7 branches of foreign banks**)
- ❑ **Bank intermediation level:**
 - ✓ **Loans to private sector: 31% of GDP** (38% in 2008)
 - ✓ **Net Assets: 53% of GDP** (61% in 2008)
- ❑ **Loans granted to non-banking clients: 51 bn. EUR equiv.**
- ❑ **Deposits of non-banking clients: 59 bn. EUR equiv.**
- ❑ **Loan-to-Deposit Ratio: 87% (122% in 2008).**

Banking system main ratios:

- ❑ **Adequate level and quality of capital** (Total Capital Ratio - TCR: 19.5%; Common Equity Tier 1 and Tier 1 Ratio: 17.2% → lack of hybrid capital instruments) and **prudent level of liquidity**
- ❑ **Decline of NPL ratio** (EBA definition: 21.5% at September 2014 and 13.5% at March 2016)
- ❑ **Considerable coverage with provisions of NPLs: 58.2%** (EBA definition, IFRS provisions)

- ✓ **No bank failure** recorded since onset of the financial crisis and **no public funds** have been used to support the banking sector

I.2. Capital adequacy ratios (solvency) have been well above the regulatory levels



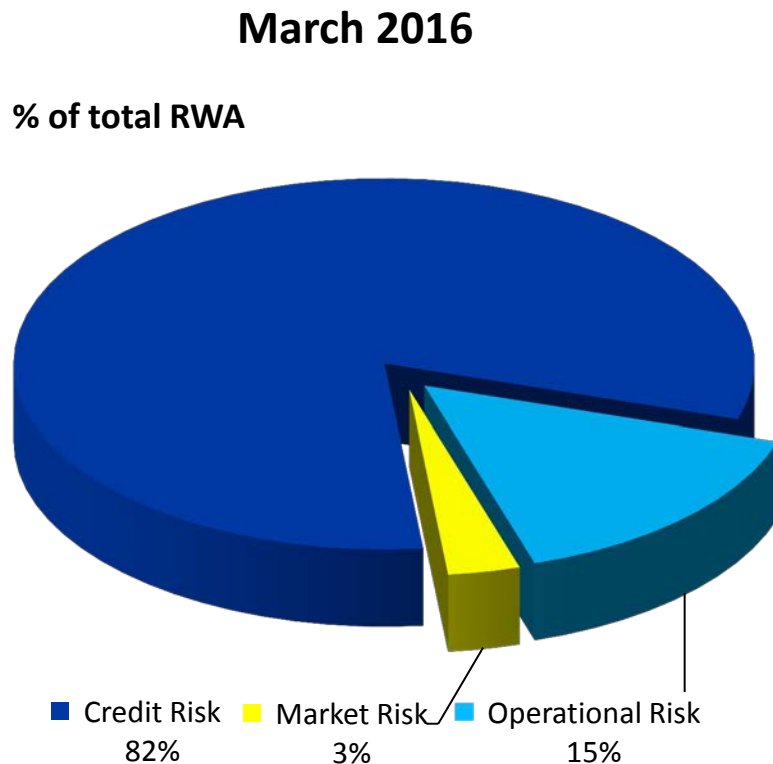
□ The strengthening of the capital base with 12 bn. lei after 2008, due to the proactive NBR approach, supported both:

- ✓ the increase of Risk Weighted Assets (RWA) → more capital requirements
- ✓ the assets quality deterioration → higher provisions and lower profits

□ The most important annual increase of TCR was recorded in 2014: + 2.1 p.p. in terms of Total Capital Ratio, from 15.5% (end-2013) to 17.6% (end-2014)

✓ No bank under 10% for Total Capital Ratio at end-March 2016

I.3. Risk Weighted Assets structure reflects the dominance of credit risk



❑ **Credit risk with 82% continues to be the most relevant** in the Romanian banking system risk profile



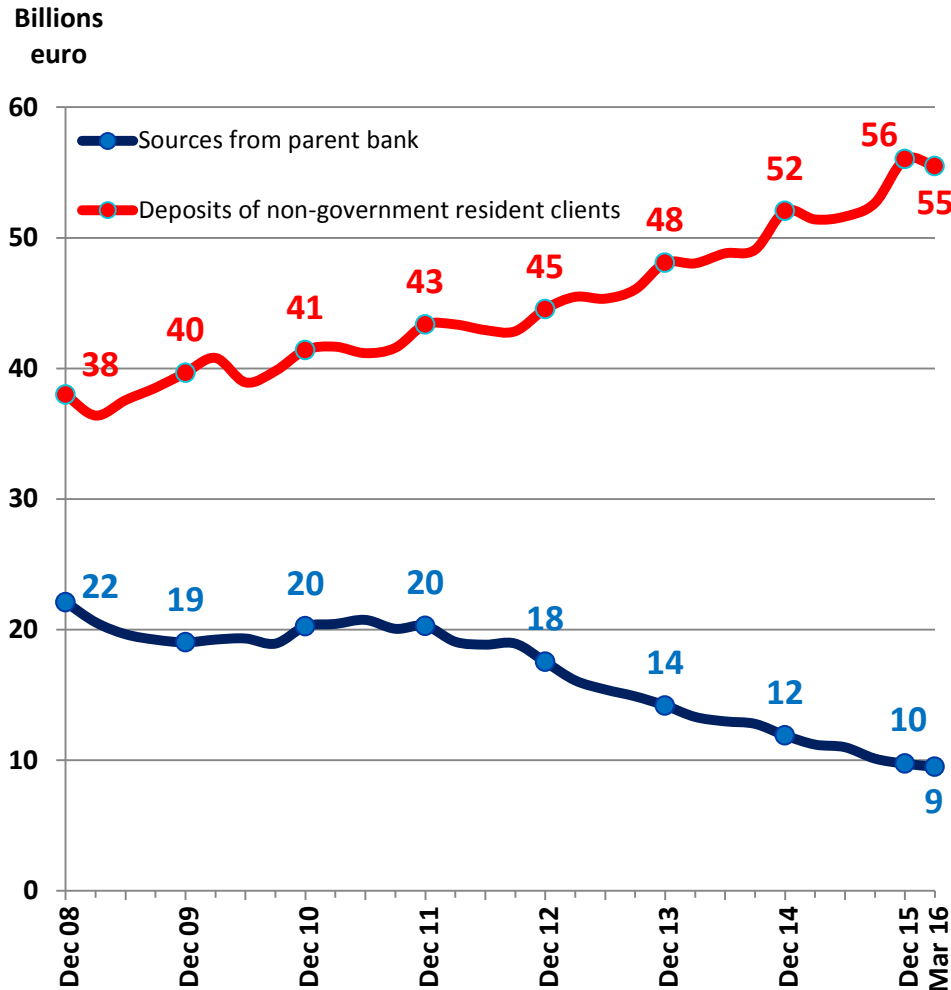
❑ But **operational risk with 15%** (legal, internal/external fraud, IT security, AML/CFT etc.) is increasingly present, especially as a legal risk



❑ **NBR requested banks to have both structure and level of capital in line with their assumed risk profile, according to the new EBA guidelines → Supervisory Review and Evaluation Process (SREP)**

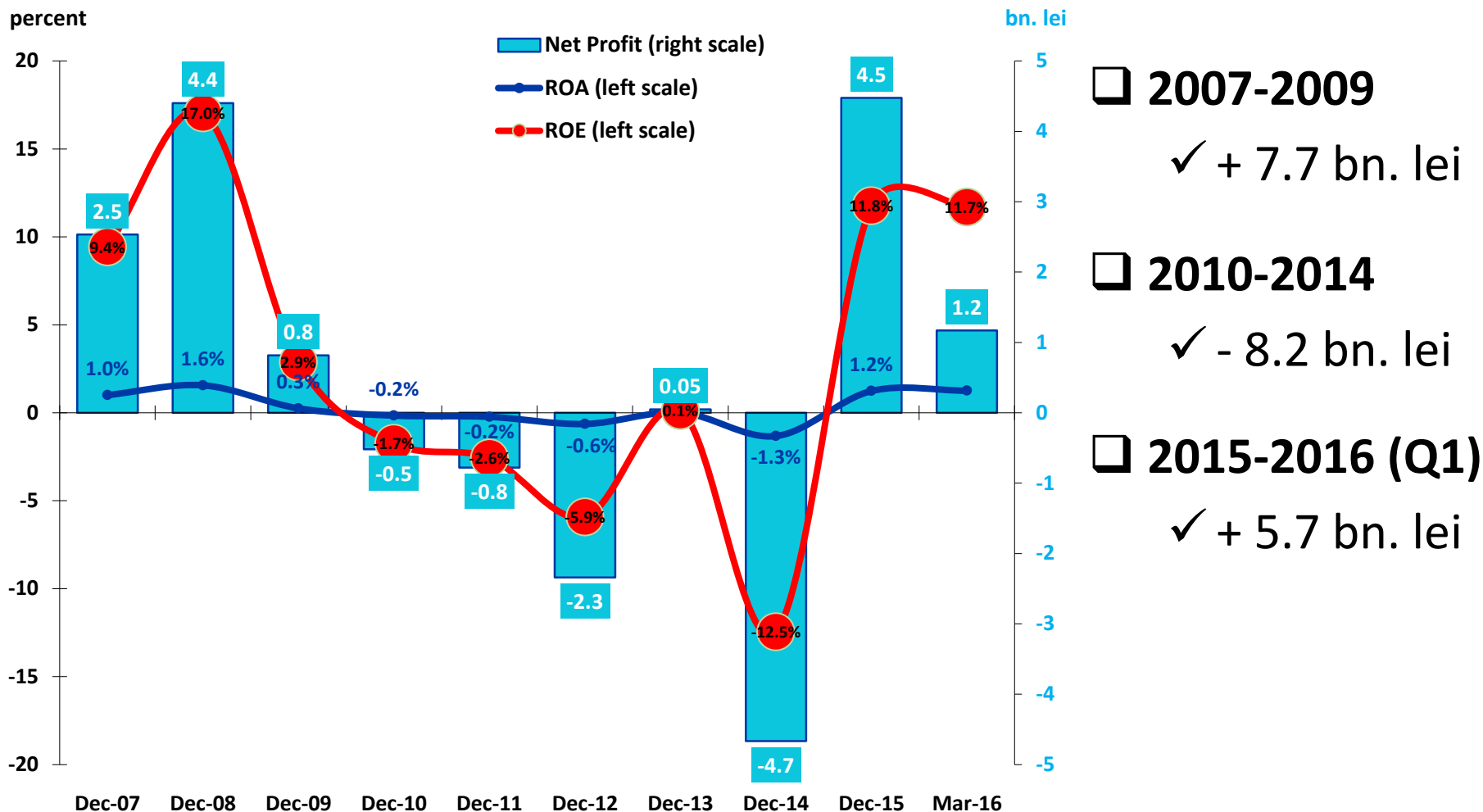
✓ **Share of operational risk capital requirements in total RWA is higher than EU average → In Romania the level was 15%, while in EU was 10% at end-December 2015**

I.4. Banks funding structure shows gradual shift between external resources and domestic savings (2008 and March 2016)

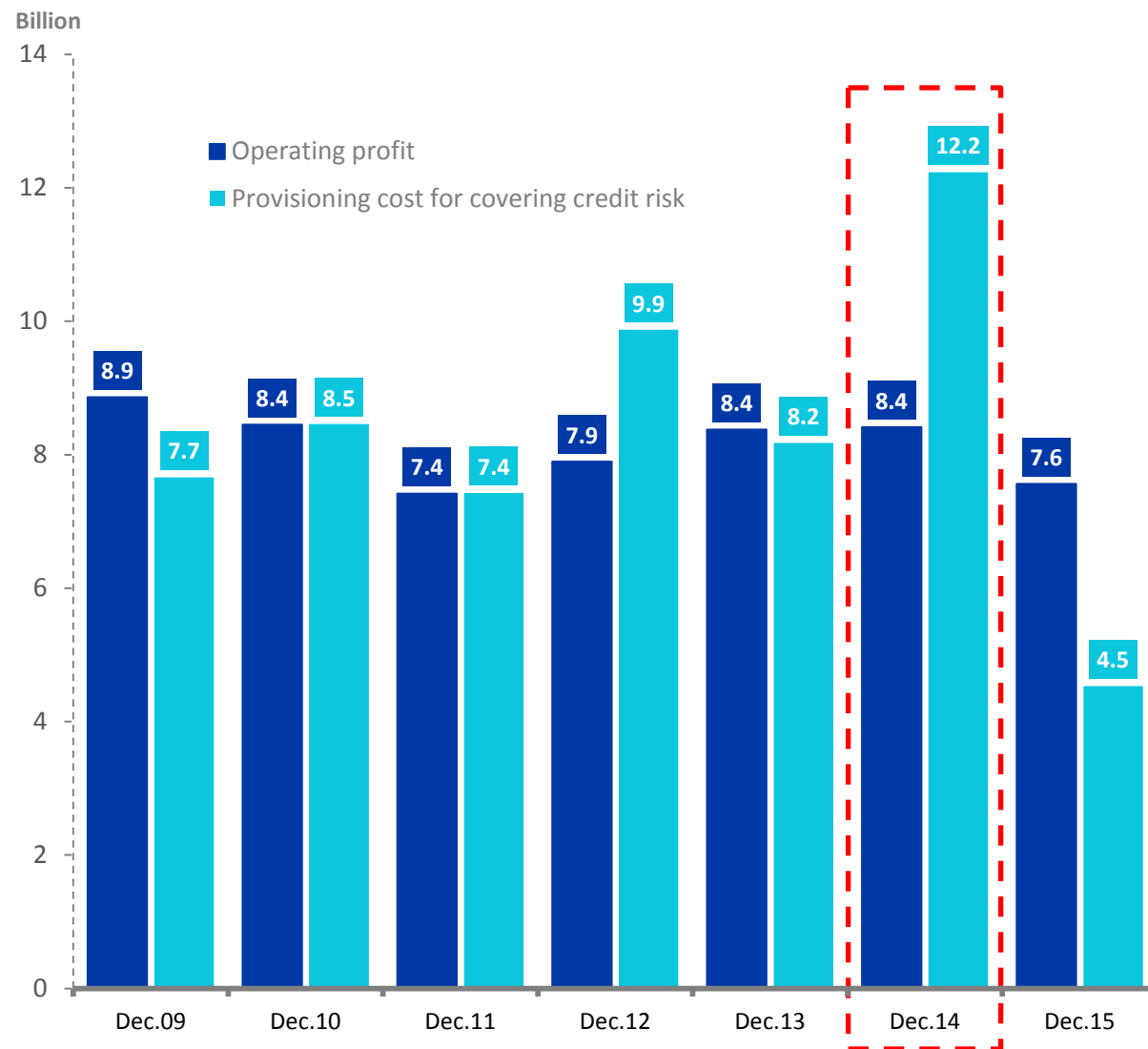


- Divergent evolution of banks external and domestic resources, especially starting with 2012
- Resources from mother banks declined to more than half of the December 2008 level (-13 billion euro or -57%)
 - ✓ reduce the dependence on the mother banks
 - ✓ decrease of the foreign contagion risk
- Gradual replacement of the external funding with domestic resources
 - ✓ Deposits of companies and individual clients increased considerably (+17 billion euro or + 46%)

I.5. After showing consistent pre-crisis profitability, the Romanian banking system recorded significant losses between 2010 and 2014, while since 2015 turned to profits



I.6. NPLs costs were reflected in high losses in 2014



- The peak of the difference between the provisions cost and operating profit was reached in 2014
 - ✓ provisions → +45% (+3.8 bn. lei) above operational profit
- Level of the provisioning cost as average
 - ✓ 2009-2011: 7.9 bn. lei/year
 - ✓ 2012-2014: 10.1 bn. lei/year (+25%)

I.7. Most key risk indicators of the Romanian banking system are placed in the less risky area (green band) of EBA standards

KRIs for Romanian banking system based on EBA threshold and calculation methodology

No.	INDICATOR	ROMANIA		EU	THRESHOLD FOR KRIs
		31.12.2015	31.03.2016	31.12.2015	
SOLVENCY					
1	TIER 1 CAPITAL RATIO	16.7%	17.1%	14.8%	>15% [12%-15%] <12%
2	CET1 RATIO	16.7%	17.1%	13.6%	>14% [11%-14%] <11%
CREDIT RISK AND ASSET QUALITY					
3	RATIO OF NONPERFORMING LOANS AND ADVANCES (NPL RATIO)	13.5%	13.5%	5.8%	<3% [3%-8%] >8%
4	COVERAGE RATIO OF NONPERFORMING LOANS AND ADVANCES	57.7%	58.2%	43.8%	>55% [40%-55%] <40%
5	FORBEARANCE RATIO FOR LOANS AND ADVANCES	8.4%	8.5%	3.6%	<1.5% [1.5%-4%] >4%
PROFITABILITY					
6	RETURN ON EQUITY	12.0%	11.0%	4.7%	>10% [6%-10%] <6%
7	COST-TO-INCOME RATIO	58.5%	59.8%	62.8%	<50% [50%-60%] >60%
BALANCE SHEET STRUCTURE					
8	LOAN-TO-DEPOSIT RATIO FOR HOUSEHOLDS AND NONFINANCIAL CORPORATIONS	78.2%	80.3%	121.0%	<100% [100%-150%] >150%
9	DEBT TO EQUITY RATIO	8.2	7.7	14.8	<12x [12x-15x] >15x

- ❑ Romanian banking system prudential indicators (solvency, coverage ratio, profitability, balance sheet structure) register, generally, better levels than the EU averages (yellow band).
- ❑ ... with two exceptions (red band)
 - ✓ NPL ratio
 - ✓ Forbearance (restructuring) ratio

II. NPL definitions

II. NPL Definitions

- ❑ There was no harmonized definition of NPLs across countries, as different countries applied various national definitions until EBA methodology was issued.

NBR methodology

- ❑ ***NPL definition used by Romania before EBA ITS was the IMF definition***

- ✓ For reporting purposes to IFIs, the NPLs was defined according to IMF guidelines as loans overdue more than 90 days or/and legal procedure initiated

- ❑ **NPL Ratio formula based on NBR definition:**

- ✓ **Numerator** - the sum of the gross value of loans 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

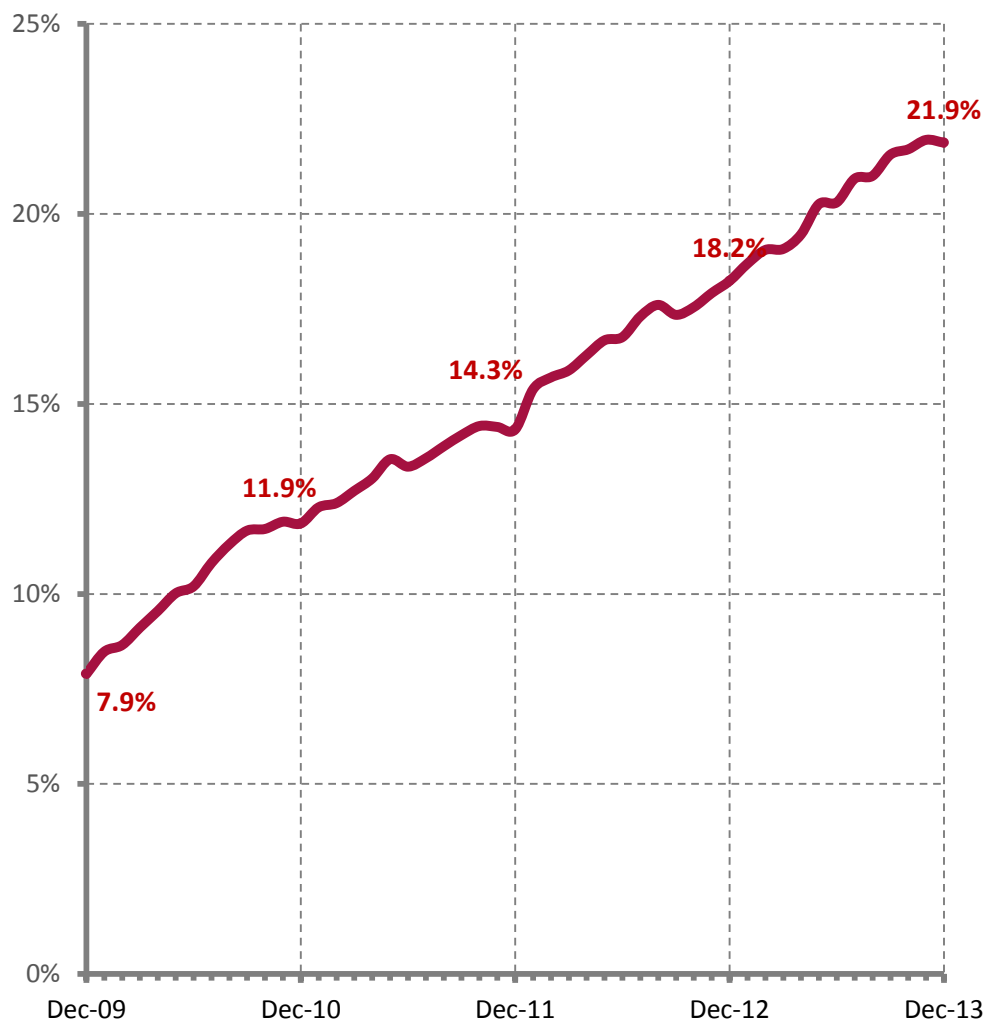
EBA methodology

- ❑ ***The new EBA ITS (Implementing Technical Standards) definition from September 2014*** → the national financial reporting framework implemented the EBA criteria to identify the non-performing exposures:

- ✓ exposure overdue more than 90 days
- ✓ unlikely to pay → debtors which registered a worsening of their payment capacity → unable to meet their obligations in full without realisation of collateral

III. The evolution of banks NPLs

III.1. Accumulation of NPLs (until 2013)



Factors leading to the NPLs increase in Romania from 7.9% in 2009 to 21.9% in 2013:

- ❑ **Increased competition among banks and fast expansion of the balance sheet mainly by granting loans to private sector on the back of foreign inflow of capital**
- ❑ **More flexible credit standards, at the beginning of 2007, as an obligation of the entrance in the EU**

III.2. Reducing NPLs appeared crucial in order to support credit growth

- ❑ The presence of non-performing debt on banks' balance sheets reduces banks ability to lend through essentially three channels:
 - ✓ *Lower Profitability* - NPLs imply higher provisioning needs, which in turn lower banks net operating income
 - ✓ *Higher capital requirements*: NPLs are risky assets which attract higher risk weights than performing loans
 - ✓ *Higher funding costs*: Investors and other banks are less willing to lend to banks with high NPLs levels, leading to higher funding costs for these banks and a negative impact on their capacity to generate profits

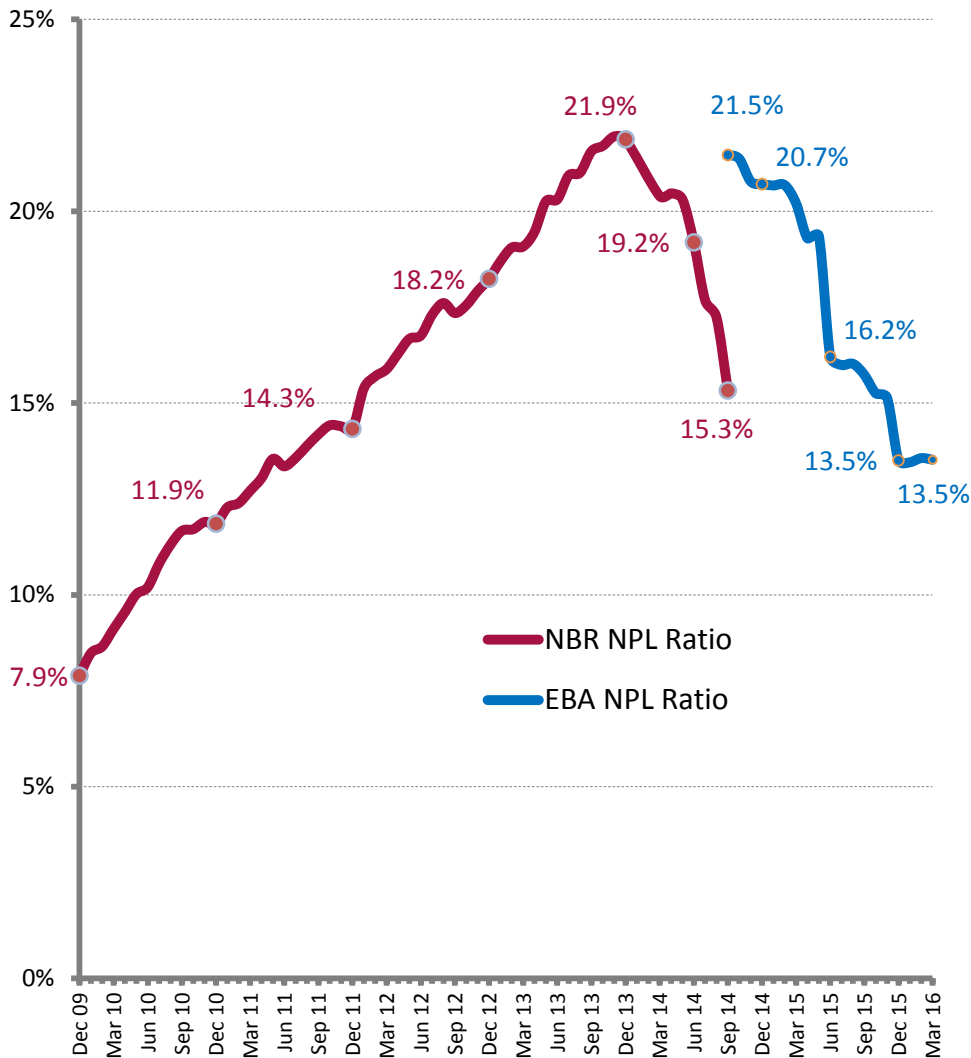
III.3. Reducing NPLs → NBR measures, taken since 2013 and still in place

- ❑ The NBR took several decisions in order to decrease NPLs stock and strengthen the supervision of NPL evolution in the context of:
 - ✓ high level of fully provisioned NPLs in the on-balance sheet
 - ✓ critical volume of NPL mainly representing non-performing loans overdue more than 360 days and without legal proceedings (actually uncollected loans)
 - ✓ low banks interest in addressing NPL and poor recovery level
- ❑ The NBR action plan focused on *regulatory and supervisory measures* consisting in:
 - 1) **2013** → Requiring external audit for collateral valuation
 - 2) **2014** → Drawing-up of a specific regulation for ensuring separate evidence, within off-balance sheet accounts, of the NPLs fully covered by provisions → to reflect removal operations from *on* to *off balance sheet* without giving up by banks of the contractual rights for future cash flows on the respective loans, while avoiding the moral hazard generated by the debtors' expectation to be exempted from future payment obligations
 - a) Avoid derecognition of bad loans
 - b) Maintain the possibility for tracking bad loans through off-balance sheet accounts and to recover them

III.3. Reducing NPLs → NBR measures, taken since 2013 and still in place (continued)

- 3) 2014 → NBR recommendations for certain actions to be performed by banks**
 - a) Removal of uncollectable NPLs fully covered with IFRS provisions**
 - b) Fully 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 were taken against the debtors**
 - c) At least 90% coverage with provisions of all exposures towards debtors in insolvency**
 - d) External audit of the accounting methodologies used to determine the amount of IFRS provisions, including the second revision of the approaches taken for collateral valuation (compliant with International Evaluation Standards).**
- 4) 2015 → Collateral valuation - third revision**
- 5) 2016 → Recommendation for fully coverage with IFRS provisions for unsecured NPLs for which repayment of principal and/or interest was overdue by more than 180 days, followed by the removal of exposure from on-balance sheet**

III. 4. Sharp decline of NPLs ratio after 2013 proves the effectiveness of the NBR measures



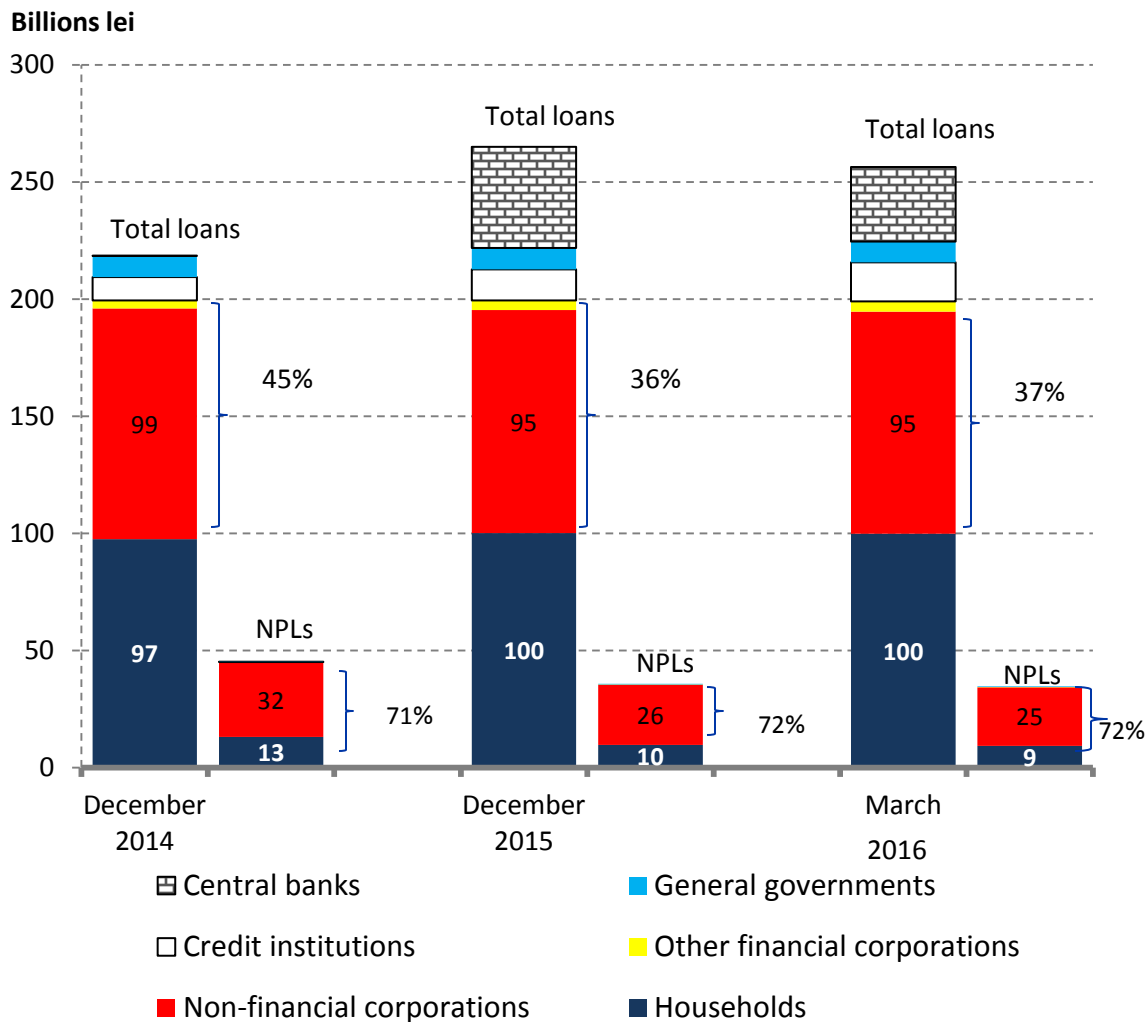
NPL went down significantly after NBR actions

- ❑ NPL Ratio, based on NBR definition, decreased sharply from 21.9% (end-2013) to 15.3% (September 2014)
- ❑ NPLs volume decreased by 27% (-12 bn. lei) at September 2014 against the end-2013

Similar decreasing trend in terms of EBA non-performing criteria

- ❑ NPL Ratio, based on EBA definition, declined significantly from 21.5% (September 2014) to 13.5% (March 2016)
- ❑ NPLs volume decreased by 26% (-12 bn. lei) at end-March 2016 against September 2014, the first reporting date

III.5. Surprisingly, non-financial corporations have got substantial higher NPLs ratio than households → signs of still high financial indiscipline



☐ Non-financial corporations and households loans held similar amounts while the first dominates (around 72%) in the stock of NPLs

✓ Loans: 99 bn. lei (45%) companies – 97 bn. lei (45%) households (end-2014); 95 bn. lei (37%) companies – 100 bn. lei (39%) households (March-2016)

✓ NPLs Ratio: 32% companies – 13% households (end-2014); 26% companies – 9% households (March-2016);

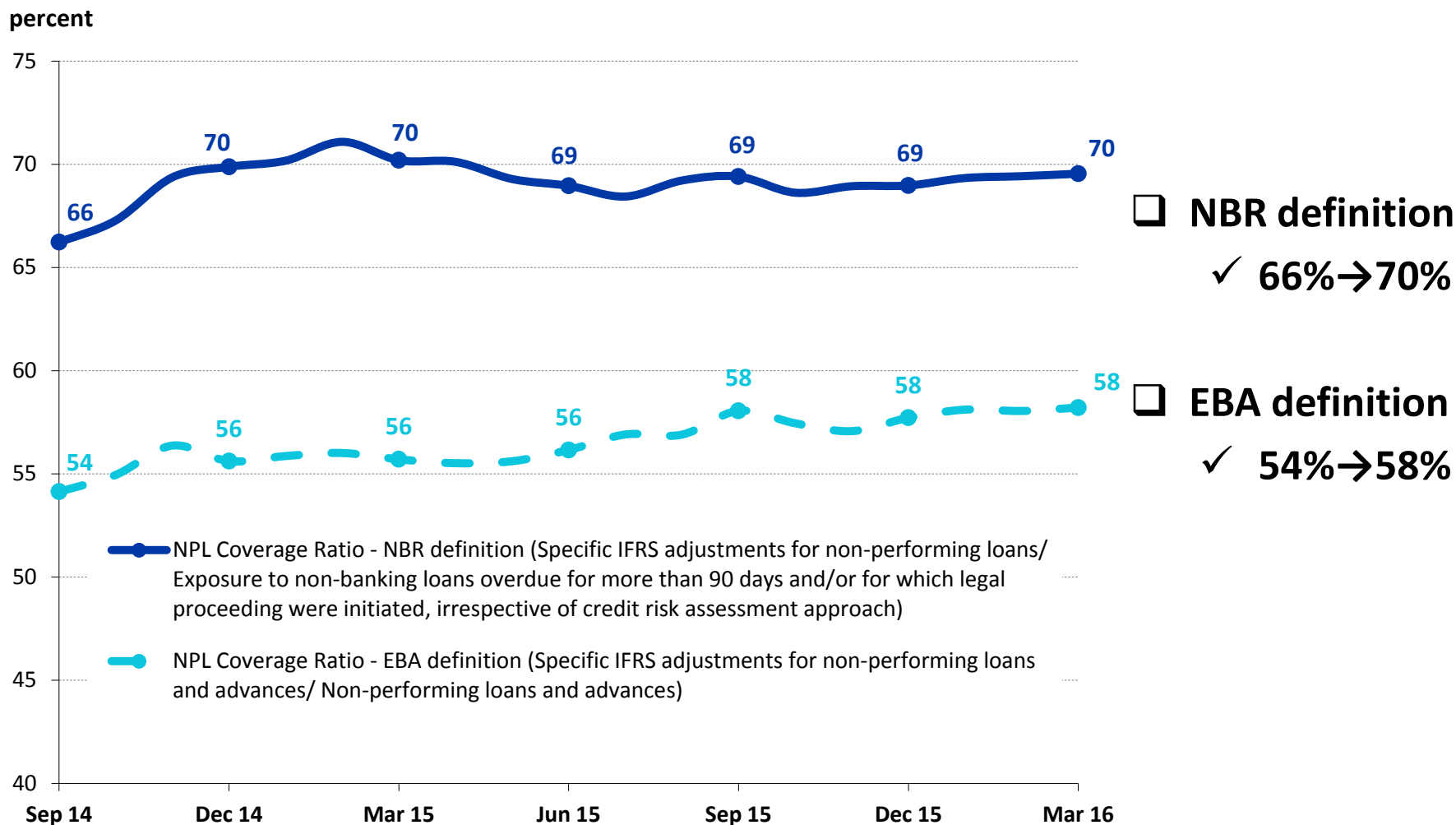
☐ General governments and other financial corporations have small amount of NPLs

III.6. NBR actions to improve the NPL coverage ratio

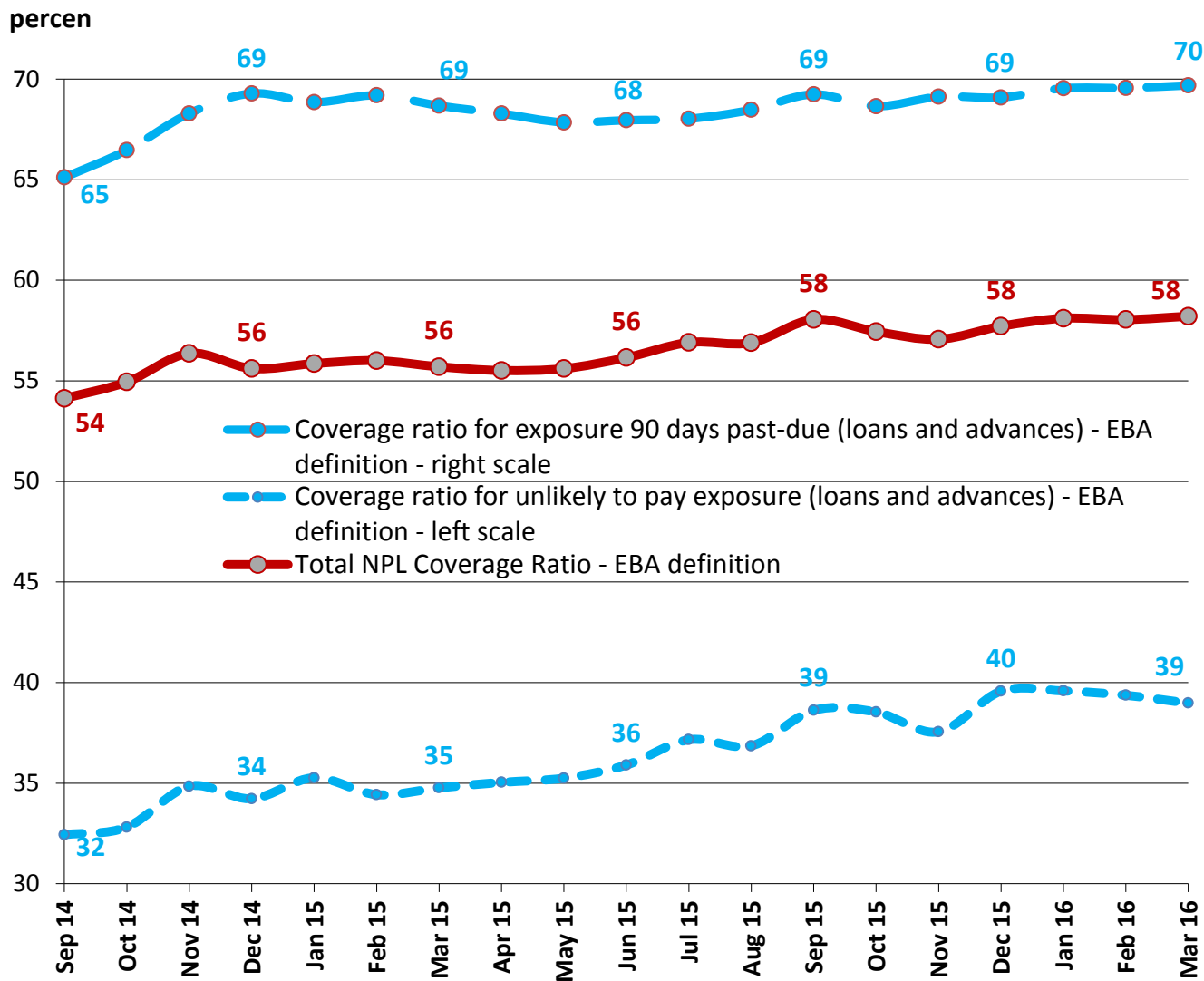
Banks were provisioning for their bad debt according with IFRS requirements

- NBR requirement for carrying-out external audit of the accounting methodologies used by banks to determine the amount of IFRS provisions**
 - ✓ **Based on the audit conclusions, substantial amount of provisions were booked by banks**
- The weak quality of the collateral market also increased the need for a higher level of provisions**
 - ✓ **Decline in market value and difficulties in the execution of collaterals**

III.7. NBR actions → Total NPL Coverage Ratio has improved since September 2014 for both NPL definitions (NBR and EBA)



III.7. NBR actions → Total NPL Coverage Ratio has improved since Sept. 2014 also in the structure of NPL based on EBA definition



☐ 90 days past-due
✓ 65%→70%

☐ Unlikely to pay
✓ 32%→39%

IV. Perspectives on the lending activity and of the NPLs

IV.1. Perspectives on the evolution of lending and of the NPLs

Factors leading to additional increase of NPL ratio

- ❑ **The main risk is the unpredictability of the legal framework**
- ❑ **At this moment, the implementation of debt discharge law represents the main concern for the banking industry**
 - *Law No. 77/2016 on discharge of mortgage-backed debts through transfer of title over immovable property (the "Law on Debt Discharge")* **was published on 28 April 2016 and entered into force on 13 May 2016**

IV.2. The NBR actions taken in the context of the debt discharge law

- ❑ The NBR monitors the correctly applying of the provisions stated in the **European Regulation No.575/2013** concerning the calculation of the capital requirements for credit risk, under new circumstances of the **Law No. 77/2016**
 - ✓ **Change in the status of exposure → additional capital requirements**
- ❑ The NBR initiated meetings with the **Big four external auditors in Romania** on the issues related to entering into force of the *Law No.77/2016 on the discharge of debt obligations*
 - ✓ The auditors' opinion was that **notification for debt discharge after entering into force of the Law constitutes a loss event** according to IFRS 39 provisions, **that demands additional provisions for mortgage loans impairments → negative impact on profitability → reduced capacity for further capital increases**

V. Conclusions

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- ❑ NPL Ratio has increased significantly until 2013, hampering the lending activity of banks
- ❑ The costly *write-off* procedure has been avoided by:
 - ✓ Drawing-up of a specific regulation to establish the distinct book-keeping records in off-balance sheet for the removed NPLs, which allows for ongoing tracking of receivables
 - ✓ Issuing specific recommendations for ensuring an orderly NPL reduction
- ❑ Credit institutions generally complied with NBR's recommendations
- ❑ Nevertheless, the NPL resolution is still an open issue and additional efforts are needed

V. Conclusions

- Between 2013-2015, NBR took important measures to address the NPL issue



NPL ratio decreased significantly, including under the EBA standards

Challenges still remain to be addressed by the banking industry



***On a short run*, we need to fulfill the objective of stability and predictability of the national legal framework in order to align it with the EU regulatory regime, as well as to achieve the right balance between the rapidly improving the banks balance sheets quality and relaunching the bank lending activity**



***On a long run*, responsible lending and sound risk management to avoid building up new NPLs stocks**

Thank you!