

## **THE MANAGEMENT OF CREDIT RISK FOR INDIVIDUALS AND COMPANIES LOANS**

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**Abstract.** *The paper discusses recent changes in the Romanian financial system, with a particular emphasis on the Romanian banking system, and on the credit granting procedures. The factors influencing these mechanisms are classified and analyzed, with the view of mitigating credit risks for both individuals and companies.*

**Keywords:** banking system, credit risk, risk management.

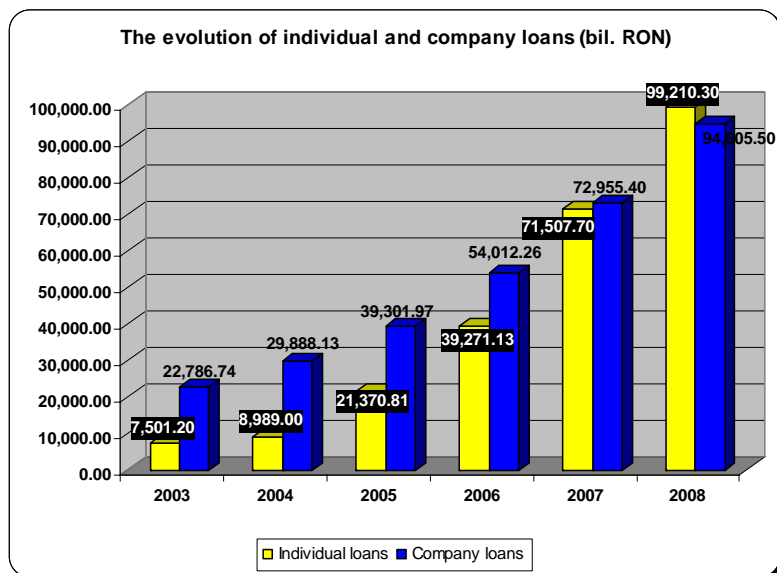
### **Introduction**

The Romanian banking sector, predominant component of the financial system encountered a continuous evolution in the previous years (2002 – 2007). This evolution was mainly due to the following factors: strongly growth of the financial intermediation, both on demand but also on the offer side; sustainable growth of the banking assets and of the non-governmental loans (for individuals and companies); continuously decrease of the ratio deposits to loans which became subunit, and in the same time the request of the local banks for external financing. The deposits made by the companies and population became an important source for financing the banking activities.

### **Financial evolutions**

In Romania, the volume of the banking activity increased significantly starting with 2003, when the important disparity concerning financial intermediation in comparison with the EU countries diminished gradually ensuring in the same time a proper risk management at the level of the banking system. The dynamic of the Romanian banking market was predominantly determined by the growing evolution of the non-governmental loans (for individuals and companies). The loans for individuals represented the most dynamic segment, the growing pace being above the evolution of corporate loans.

In the figure below is presented the evolution of individuals' loans in comparison with the corporate loans during the period 2003 – 2008. From this figure, it can be noticed the dynamic growth of the individual loans, respective an increasing from a balance of RON 7.501,20 billion in dec. 2003 to a balance of RON 99.210,3 billion in dec. 2008.



Source: National Bank of Romania, own calculations.

Figure 1. The evolution of individual and company loans

This evolution of the non-governmental loan was determined by: the numerous loan offers made by banks (through aggressive marketing campaign); the relaxation of the loan conditions mainly because of the growing competition on the banking sector; the increasing demands as a result of a consumption that was strongly repudiated in the years before '90; the improving of the population's perception regarding the future evolution of the incomes. It has to be mentioned that the evolution of the loans portfolio was made without affecting the quality of this portfolio or the liquidity of the banks.

In the same time, the increase of the lending activity was supported by the improvement of the macroeconomic stability given by the positive trend of the main fundamental indicators of the economy: economic growth, disinflation, the forecast over evolution of the foreign exchange rate and interest rates.

In this respect, in the table below are presented several fundamental indicators for the evolution of the macroeconomic conditions during 2003 – 2007.

Table 1

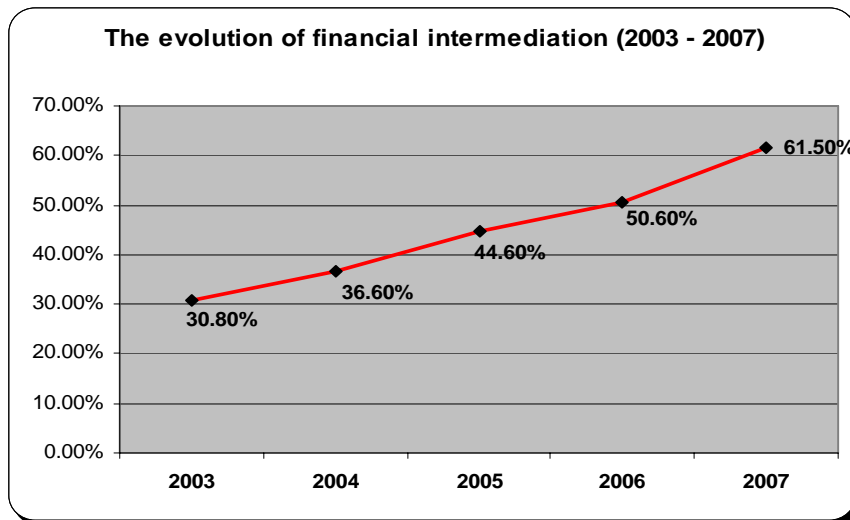
Fundamental indicators of the macroeconomic evolution

	2003	2004	2005	2006	2007	2008
Economic growth	5.20%	8.50%	4.10%	7.70%	6.10%	7.10%
Inflation rate	15.30%	11.90%	9.00%	6.56%	4.80%	7.85%
Reference interest rate	18.85%	20.16%	9.68%	8.45%	7.45%	8.76%

Source: National Bank of Romania; INS (National Institute for Statistics).

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In the figure below is presented the growing evolution of the financial intermediation (banking assets/PIB) in the period 2003 – 2007:



Source: National Bank of Romania.

**Figure 2. The evolution of the financial intermediation**

From this figure, it can be seen that financial intermediation grew from 30,8% in 2003 to 61,5% in 2007.

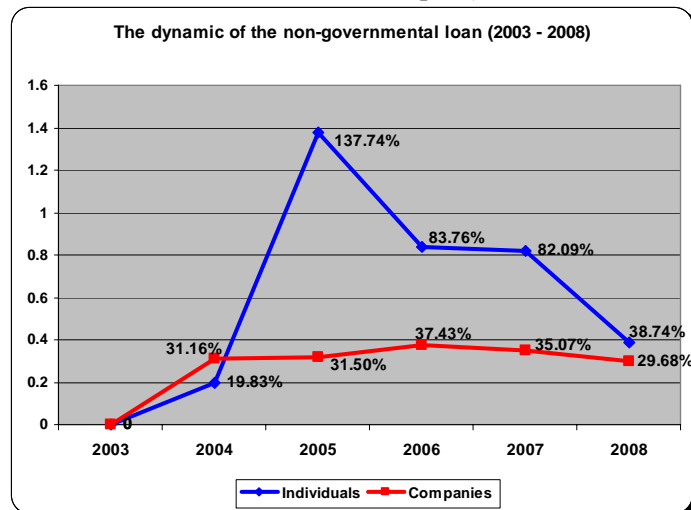
In the first part of 2007, the prudent policy of relaxing loans conditions adopted by the central bank (Regulation nr. 3/2007 regarding mitigation of the credit risk for the loans granted to individuals) had as main effects: growing of the banks' exposure, especially towards population, increasing of indebtedness capacity of those who want a banking loan, extending the maturity of the loans. The ascending tendency of granting loans was also due to external financing (deposits and loans) received by the local banks from their mother banks.

In the figure below is presented the dynamic of the loans and deposits (separate for individuals and companies).

According to the NBR (National Bank of Romania) data, in 2007, the non-governmental loan increased with 50,3% in comparison with 47,3% in 2006); as regards the ratio RON and EUR in the structure of the non-governmental loan, this ratio modified in the favor of loans denominated in foreign currency. Thus, the weight of the loans denominated in foreign currency in the structure of the non-governmental loans grew from 47,3% in 2006 to 54,3% in 2007. The increasing weight of the loans denominated in foreign currency in the structure of the non-governmental loans was determined by: the appreciation of the national currency in the first part of the 2007, the easy access to external financing of the banking institutions, cancelation of the exposure limits of the banks derived from granting loans in foreign currency (it has

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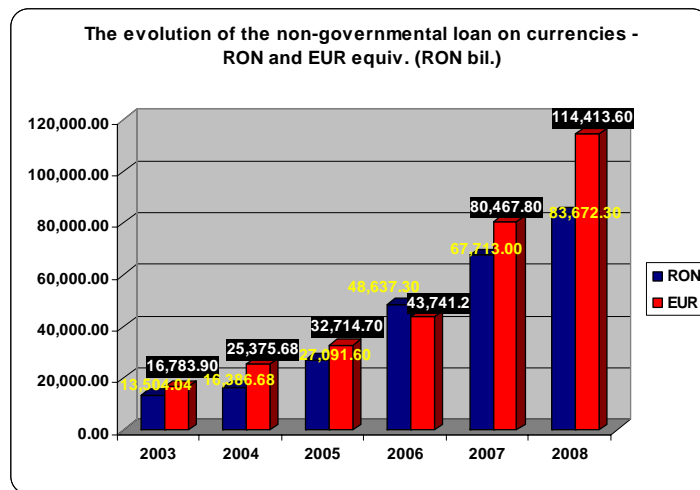
been canceled NBR Regulation nr. 11/2005 – according to this regulation, the banks exposure resulting from granting loans in foreign currency to individuals and companies can not exceed 300% of the bank's capital).



Source: National Bank of Romania.

**Figure 3. The dynamics of the non-governmental loan**

In the figures below are presented the evolutions of the non-governmental loans (in comparison RON and EUR) and the evolution of non-governmental deposits (RON and EUR) during 2003 – 2008.

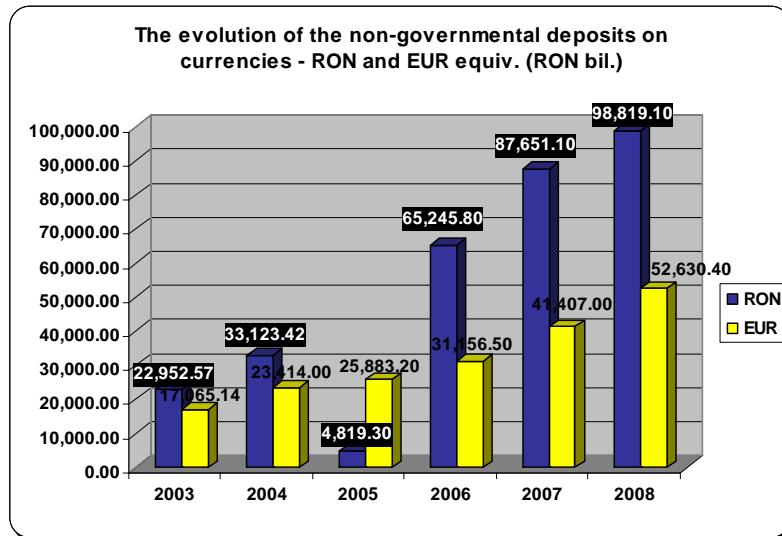


Source: National Bank of Romania.

**Figure 4. The dynamics of the non-governmental loans on currencies**

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From this figure, it can be noticed that the non-governmental loan in RON increased from a balance of RON 13.504,04 bil. in 2003 to a balance of RON 83.672,3 bil. in 2008. In the same time, the non-governmental loan in foreign currency increased from a balance of RON 16.783,9 bil. in 2003 to a balance of RON 114.413,60 bil. in 2008.



Source: National Bank of Romania.

Figure 5. The evolution of the non-governmental deposits in currencies

From this figure, it can be noticed that the non-governmental deposits in RON increased from a balance of RON 22.952,57 bil. in 2003 to a balance of RON 98.819,1 bil. in 2008. In the same time, the non-governmental deposits in foreign currency increased from a balance of RON 17.065,14 bil. in 2003 to a balance of RON 52.630,4 bil. in 2008.

From structural point of view, the loans for individuals had the main role in increasing the loan volumes. With an increasing weight in total loans from 42,5% in 2006 to 48,1% in 2007, the loan for individuals contributed with 62,5% at the increasing of the non-governmental loan. In the structure of the individual loan, the investment loan increased in 2007 with 100,9% in comparison with the consumer loan which increased with 79,9%. Anyhow, in absolute values, the consumer loans remained predominant in 2007.

The second half of 2007 was affected by 3 external factors:

- starting of the subprime crisis in USA (the crisis of the mortgage loans with high degree of risk) which changed the view of the investors as

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regards the economies from Central and Eastern Europe; massive funds were withdrawn from these economies;

- strongly increase in the food prices;
- significantly increase of the oil prices.

Due to the consequences of the crisis (lack of liquidity; bankruptcy of major banks such as: Lehman Brothers, IndyMac Bank, Washington Mutual, PFF Bank and Trust and many other American Banks; important write-off of bank assets for major big banks (over 1 billion USD: Merrill Lynch, Citi Group, Goldman Sachs, Morgan Stanley, UBS, Credit Suisse, etc.), the states governments and central banks intervened promptly. There were taken promptly measures such as: pumping urgent liquidities in the market use of other financing facilities than the current ones available through monetary policy and, in some situations, important decrease of the monetary policy rates.

In 2008, the Romanian banking system passed from excess of liquidity to liquidity deficit, respective passing from massive granting of loans through aggressive campaigns of drawing deposits at attractive interest rates, especially in the last quarter of 2008. In the last 4 – 5 years, lending registered an important growing, the banks setting up as strategic objectives increasing of the market share, diversifying the bank's offer of products and services, expansion of the territorial network. Having a surplus of liquidity, the banks offered in the previous years attractive interest rates for individual and companies loans and in the same time reduced their focus on drawing deposits. At the end of 2008, the banks began to move their interest towards deposits by offering very good interest rates, thus compensating the decrease of the external financing as a consequence of the financial crisis.

After the first half of 2008, when the dynamic of the non-governmental loan was decreasing from 55,5% in January 2008 to 50,5% in June 2008, in the last 2 quarters of 2008, this descendant tendency in the evolution of the non-governmental loans deepened. Thus, in December 2008, the dynamic of the non-governmental loan was half of the value registered in the first part of 2008, respective 25,8%. The main factors that determined this evolution were: the increasing of financing-cost from mother-banks, applying new regulations (higher coefficients for provisioning loans) for making banking provisions starting with March 2008, very restrictive loan conditions as a result of the lack of liquidity, especially in the last part of 2008.

Also, last quarter of 2008 brought the deterioration of the economical and financial conditions, the budget deficit and the current account deficit worsened significantly. This determined successive downgrade of the country rating and also massive withdrawal of the foreign capital from the economy. Subsequently, the situation of the liquidity worsened more and the national currency depreciated significantly.

Under these circumstances and taking into account the banks' prudence as consequence of the financial crisis, banks became more reluctant in granting loans in foreign currency because of the increasing cost of the financing sources mainly in the context of the turbulences from the international financial markets. Starting with the

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last quarter of 2008, the banks began applying more rigorous selections (through scoring models) for identifying the eligible customers in order to grant them loans.

Thus, in the fourth quarter of 2008, the financing condition for individual loans registered a slow decrease of the interest rate. Also, the dynamic of the individual loans tempered in the last quarter of 2008, while the population indebtedness degree diminished.

### **Conclusions**

As a conclusion, it can be said that in the context of the economical and financial crisis, of decreasing internal and external demand, of decreasing the consume, the year 2009 will bring a significant decrease in lending; also, taking into consideration the decreasing of the liquidity provided by mother-banks and the depreciation of the national currency in comparison with EUR, the weight of the loans denominated in foreign currency will be reduced in the favor of the loans in RON. The banks will not grant so easily loans in foreign currency just for the sake of increasing market share, but also taking into consideration a proper management of all bank risks, including credit risk. In the present conditions of a volatile financial market, the risks concentration increased; the correlation between different types of risks accentuated and became more complex. Thus, banks will try to keep their resources and customers, to ensure an appropriate management of the loan portfolio – verifying if the customers comply with the contractual condition of the loans, if they utilized the granted loans in accordance with the destinations approved, if the respective loans have guaranties, monitoring the default rate per individual/company and per loan portfolios. In this respect, banks must monitor and revise the eligibility conditions for individuals and companies who want to contract loans, the economic models utilized to determine the maximum indebtedness capacity of the customer. If in the previous years, increasing market share was the main objective for every bank, in 2009, the constraints of the internal and external economical environment will shape a new strategy for the banks: retention of the existing customers and a more active management of the banks risks.

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