

TRENDS AND EXPECTATIONS REGARDING LENDING ACTIVITY

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1. Introduction

Lending is one of the most profitable and most important investment activity of the credit institutions. Granting of any credit itself is preceded by an analysis phase of documentation, submitted by the client, then by his approval, according to the internal rules of each bank.

The banks, in order to maintain the manageable limits of the level of nonperforming loans, must detect a possible worsening of the client's situation and try to implement the recovery measures, through the performance of the guarantees or by initializing the bankruptcy proceedings.

To reduce the level of nonperforming loans and their impact on the profitability of the bank, the bank's lending policy should be prudent and efficient, leading both to prevent the occurrence of these loans and the possibility to recover them.

However, bad loans are an inevitable consequence of lending. Each credit may imply some unforeseen events, which turn to be difficult for the client when it comes to meeting the credit contract terms.

Some bad loans may result from the errors made by the credit officer. It is possible that a loan officer, evaluates improperly the client's character or he may incorrectly interpret the figures in the financial analysis. These, like other similar cases which lead to bad loans, can and should be minimized.

A bad loan can occur even when the loan officer does not commit any mistake in any of the stages of the credit evaluation. For example, a credit officer

can't foresee a bad period which will stop the development of new technologies or the loss of some economic activities due to technological progress.

2. Factors that cause bad loans

The banks under NBR regulations and under their own rules, will consider all loans held by a client or legal person, to be non-performing loans, if the following conditions are met:

- the customer has bank debts for over 90 days;
- against the client was initiated the foreclosure proceedings and / or the bank received the notification of the opening of insolvency proceedings under the law.

When reporting non-performing loans, the banks are required to establish full provisions - 100% - the total exposure – balance of the credit and interest owed - which may be deducted up to 25% of the real guarantees provided in favor of the creditor.

The causes which may determine such a situation could be:

- Lack of liquidity on a longer period, even when we face a better economic situation, due to a mismatch between receipts and payments;
- Unfavorable changes of the economic and financial environment, after the credit is granted, which make the Borrower unable to achieve his goals (general or sectoral economic crisis, the disappearance of domestic or foreign markets, accelerated depreciation of national currency, the explosive growth of bank interest, etc.);

- Not knowing very well the clients and the poor tracking of the use of credit, according to the approved destination;
- The improper management of the credited company, inadequate changes of the management and of the organization;
- Make a superficial analysis based on inadequate or incomplete documentation, a misinterpretation of the financial results and customer's creditworthiness, the use of an incomplete analysis or failing to take into account some risk factors.

3. The management of bad loans

Credit institutions are organized this way, in order to achieve a proper management of the bad loans, because, according to the standards of recovery, the existing guarantees must be profitable, or other measures should be taken in order to limit the losses.

Lending process is, by nature, imperfect. Credit analysis may be incomplete or based on erroneous data, the credit officer can ignore the true condition of a debtor; this way the debtor's ability to refund can change after the credit was granted. If the management focuses exclusively on eliminating all the risks, then a bank will not grant credits anymore, profits will be restricted, and the clients' needs will remain unsatisfied.

Creditors can't completely eliminate the risk, this way some credit losses may appear. The objective of a bank is to find the best relation between risk and income. In order to efficiently administer the assets and the liabilities, each bank has an Assets and Liabilities Committee.

The credit review procedures are supposed to identify the moment when the credit starts to deteriorate and help to establish the right actions. Most of the problems can be restructured through an efficient use of the time, till the financial conditions of the debtor improve. Thus, when a credit is

analyzed, what really counts is to find the problem and to improve the reimbursement perspective.

The credit officer constantly monitors the circumstances of each Borrower, in order to detect any credit problems, before they become impossible to correct. He informs about the quality of the financial data, the credit history, prepares the loan documentation, and the value of the guarantees. If there are weaknesses, he can classify the loan as substandard, doubtful or as a loss. In this case, the bank must allocate some percentages (proportional to the credit), in order to cover potential losses.

First, after the loan portfolio is classified, the level of provisions is calculated and registered; these reserves must be covered according to the financial performance of the banks. Then, taking into consideration the criteria outlined above, the credits are declared nonperforming and those customers with full documentation are directed towards specialized departments. On this occasion, the existing guarantees are revaluated as well as their level of conservation and the way they are used. Each client has a file, supervised by the credit analyst, who follows certain things, such as:

- The historical performance, current and future;
- The financial flows within the group of companies, the analyst reviews the possible contamination of the client and the difficulties faced by another company from the group;
- The evolution of the debts and bonds in terms of seniority and volume, and the perspective to collect them;
- The perspective of improving the customer's payment;
- Identifying the customer-owned assets, other than the guarantees, which can be exploited, to recover the loans.

In banking practice there are many solutions to recover the credits with problems: choosing the appropriate method of recovery depending on the

particularities of each case, the nature of the bad loans, the amount of the debt, the identification and quantification of all risk elements, the nature and value of pledged guarantees.

The amiably recovery is possible if the debtor can and wants to pay the debt according to a collaboration with the bank. Amiably recovery can be done several ways, depending on the customer's ability and willingness and on the flexibility to negotiate the unpleasant situation which may appear when a credit is granted. One solution could be the bilateral agreement of financial restructuring between the customer and the bank. Another option could be the customer commitment to pay the credit institution.

Recovery litigation

Banks use this method of debt recovery when the analysis suggests that there is no other way of recovery or when other measures would be less efficient, as well as when the amiably recovery fails. It is desirable to result as soon as possible in order to avoid the risk of prescription or the right of enforcement, as well as to avoid the disappearance of real guarantees.

In banking practice there are several methods of recovery in litigation, so, the banks can proceed to the enforcement of the debtor's assets or guarantees.

This transaction allows the bank to find the best ways to recover and to act quickly when decides to proceed to the enforcement of real guarantees. A problem at this stage is the lack of a sufficiently developed market which enables a quick sale and the recovery of the debts. Another aspect is related to the disappearance of banking executors and the increase of enforcement costs through the use of judicial executors.

Insolvency proceedings are another option of recovery litigation for debtors and guarantors and may be an obstacle for the bank if the debtor is not

closely monitored. This procedure initiates when:

- the bank considers that it is necessary to start such a procedure
- the procedure has been initiated by the debtor or by a third party borrower.

The recovery of the debts by selling them to specialized companies

This method of recovery appeared in Romania in the past two years. A big problem for the banking system is the selling of debt problems to the companies from the same financial group. This, allows the credit institution to clean the balance sheet, but keeps in the same time (at a group level) the risks, without an appropriate level of provisioning. This is a rapid recovery solution of a part of the loan, but it is far from the optimal reimbursement of the credit, under normal conditions.

Credit problem management is particularly important especially in the current economic situation. A competent management allows the bank to minimize the risks, generated by the global financial crises.

4. Loans and credit risk in the Romanian banking system

The deterioration of the domestic economic climate since the last months of 2008 and the continuing downturn in the first quarter of 2010, led to a reduced demand for loans and to an increased percentage of bad and overdue credits. The growth of the credit from the private sector fell considerably during 2009. The credit quality remains relatively good, however, during 2009 the deterioration process generates concerns.

The measures taken by the Central Bank during the past 12 months (flexible banking prudential rules relating to the provisioning for credit risk, including the interim profits in the funds, reducing to zero the reserve ratio for foreign currency liabilities with a maturity residual greater than two years, reducing reserve requirements for liabilities in lei at

15%, and those in two years with maturities under 25%), contribute to the improvement of the banking financial and prudential position, with beneficial effects on non-government credit recovery and hence on the real economy.

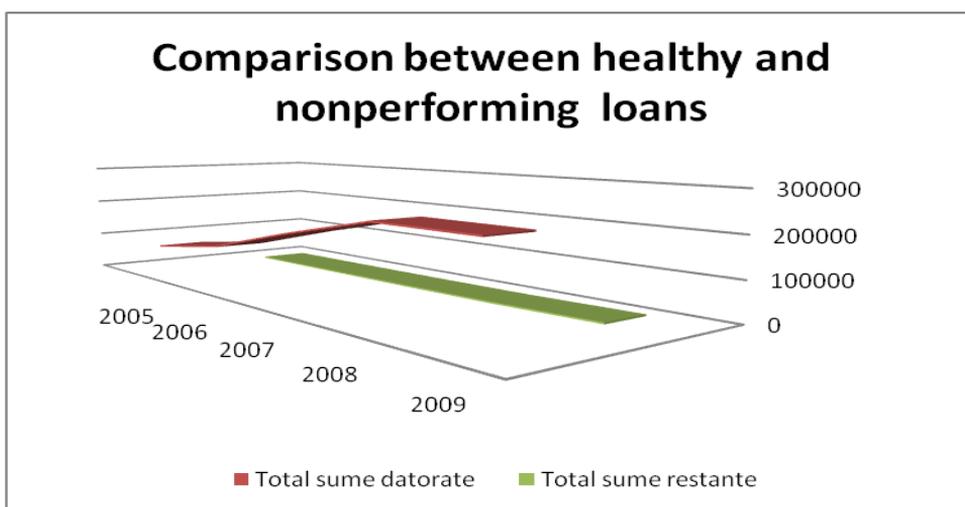
The banking system in 2009 achieved a net profit of 772.3 million Lei, by 5.7 times less than in 2008, in the context of a loss of about 69 million Lei, reported in the last month of the year.

The loans offered to the population advanced 1% in nominal terms in 2009, to 100.7 billion Lei, while

the outstanding loans to legal entities grew by 2.1% to 105.7 billion Lei.

At the end of last year, overdue and doubtful net debts, amounted to 3.8 billion Lei, 3.7 times more than in 2008, while reserves have nearly doubled from 7.6 billion to 14.96 billion Lei.

The share of the loans classified as doubtful and as losses, as well as the interests, on the total number of loans, increased more than doubled, from 6.53% at the end of 2008, to 15.25% in December 2009.



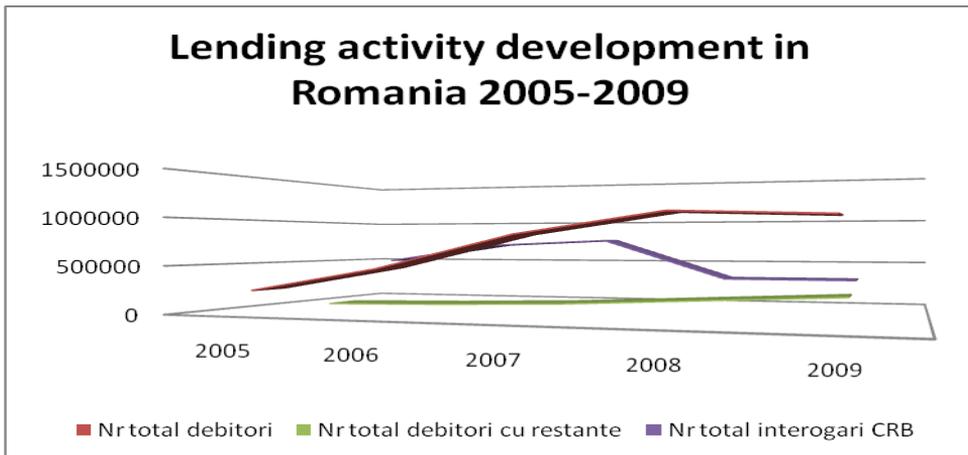
Source: www.bnro.ro

Currency depreciation in early 2009 had negative implications for borrowers, who have engaged themselves in foreign loans. The relative stabilization of the Leu, recorded on the second half of last year, in the context of a standby commitment, signed with the IMF and the EU, resulted in a relative reduction of the currency risk.

5. Key developments in the Romanian credit market

In the context of an uncertain macroeconomic environment and the liquidity problems existing in international markets, the year 2008 marked a cooling rate of growth (in real terms) of the non-

government credit (26% compared with 50%, the one recorded in 2007). This situation, occurred in the context of a deceleration of the economic activity, visible in the last quarter of 2008. Moreover, the credit decline was moderated by the effect of credit accounting currency depreciation. Even in these circumstances, the 2008 non-government credit grew by 3 percentage points of the GDP, up to 39%, continuing to represent the determining factor in the development of the bank assets. Nongovernmental credit slowdown in late 2008 was due to a lower liquidity in the national and international banking system, to an increased risk aversion and to the currency devaluation.

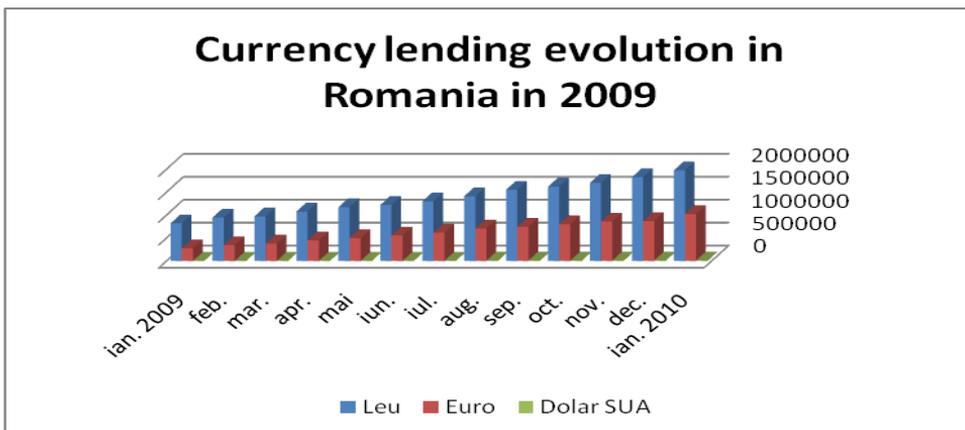


Source: www.bnro.ro

The year 2008 marked the increasing contribution of foreign currency loans, to about 58% of the non-government credit, a trend which appeared again in the first quarter of this year, due to the exchange rate movements. International and national market developments still show an increased risk for borrowers, with exposure to currency risk. Both components of the non-government credit in Lei and foreign exchange, recorded in this period, a moderate growth in the context of a difficult macroeconomic environment and a declining confidence in a swift economic recovery of the business sector and the public one.

Although, long-term loans have reinforced their leading position, reaching 56% of non-government credit in late 2008, in December 2009, the growth decreased greatly and reached the level of 57%.

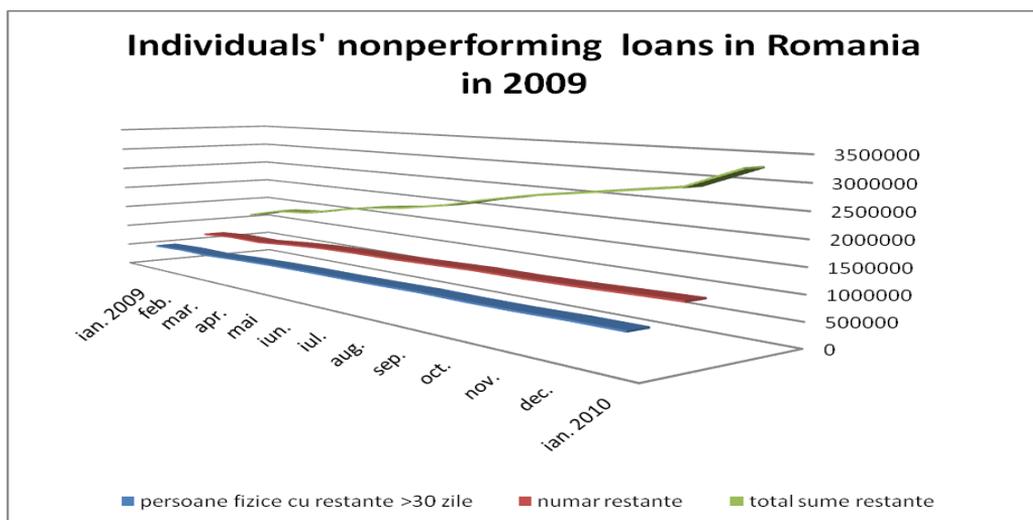
The years 2008 and 2009 continued the growth trend to higher long-term loans, denominated in foreign currencies (which came to contribute 66% to foreign non-governmental credit component); but in 2009 the rate was much reduced compared with the previous year. As regards the loans in lei, the long-term component gained two percentage points in 2009, up to 43% of total non-government credit denominated currency.



Source: www.bnro.ro

The actual growth of the loans granted to the population has fallen significantly in 2008 (only 30.5%, compared with 71% in the previous year) and in 2009 (19%); the same trend was recorded in the case of credits granted to non financial institutions, but at a lower rate. Thus, the years 2008 and 2009 have recorded a growth of the population credits contribution, up to 50% of non-government credit, this trend was

influenced also by the large share of the foreign currency component (61% of total credit granted to the population in December 2009), in the context of currency depreciation. As a result, loans to non-financial corporations (representing approximately 49% of non-governmental credit in 2009) lost their dominant position, against a growth rate of only 22% in 2008 and 12.4% in 2009.



Source: www.bnro.ro

The adverse effect of slowing the economic activity, rising inflation and currency depreciation was acutely felt in late 2008 and early 2009, through a significant deterioration of the quality of banks' loan portfolio. Although, the volume of *questionable loans given to non-bank customers* (with both net and gross values calculated), continues to record relatively low share in the loan portfolio for this segment of customers, the fast depreciation rhythm of these indicators has become worrying.

During September-November 2009, the growth of the credit granted to the private sector continued to decrease; this means reaching a negative level, for the first time in eight years and a half (-1.4%). The recoil movement

characterized the deposits in Lei, which were reduced to minimum in the past eight years and half, and the currency, which registered the first negative percentage changes, for the last nine years and a half. However, the currency loan, expressed in RON, continued to record positive dynamics (still under a negative influence), so that the average share of foreign currency component of the total credit of the private sector reached the highest level since the second quarter of 2005 to the present (60.1%).

5. Conclusions

In these circumstances, both the dynamics of household borrowing and

the credit granted to the companies have been the first negative value of the last nine, respectively eight years and a half. In case of the population credits, the developments reflected the compression (in real terms compared to the same period last year), of the balance of consumer loans (in Lei and foreign currency), as well as the slowing growth rate for housing loans, particularly those in Lei. Although small, compared to the previous one, the growth of housing loans in foreign currency remained at a high level, among all categories of loans (7.3%), being supported, as suggests the significant increase in volume of the new loans in Euro for immovable properties, by the program "First Home". The decrease of the corporate loans continued to be relatively more alert than the population credits, the most affected being the RON component and the one with maturities under five years; on the other hand, the long-term loans in foreign currency registered an accelerated growth rate, probably produced by the

restructuring operations, intended to improve the ability of companies to honor the banks' debt.

The net credit of the Central Public Administration continued to support the monetary growth, reaching an absolute record, on the account of the negative variations of this sector's deposits in credit institutions; by contrast, the dynamics of government securities held by the credit institutions begun to moderate (nevertheless maintaining a high level), and the growth of Treasury deposits has accelerated.

In the context of a continued global recession during 2010, the management of bad loans becomes very important for all the credit institutions, because any delay or the borrowers' incapacity to pay, will increase. Healthy banks should seek loans carefully and advise better the borrowers, so that extreme situations of recovery (as the ones we mentioned above) can be avoided.

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