

# INSOLVENCY AND BANK FINANCIAL POLICY

Mihaela GÖNDÖR\*

**ABSTRACT:** *Insolvency is one of the most often used actions in the economic intern environment. This can be used by companies as a tool for obtaining the restructuring of bank loans or to provide shelter to enforcement. For banks, that means serious problems because they are forced to fully provisioned credit granted to companies that enter into insolvency, even if the rates are paid to date or with small delays, any guaranties was held. In this situation, for banks in Romania, the perception of risk is very high which blocks the credit.*

*The purpose of this paper is to show how insolvency affects banking risks, with serious consequences on the national economy. The paper highlights the need to improve the regulations in order to make a better national business environment.*

**KEYWORDS:** *Banking Risk, Risk Management, Insolvency, Credit Tightening*

**JEL CLASSIFICATION:** *K20, K34, G 00*

## 1. INTRODUCTION

The exposure to credit risk continues to be the leading source of problems in banks world-wide. (BIS, 2011). The issue became more severe during the crisis due to the deterioration in the credit standing of the bank's counterparties, leading banks to improve the financial policy in order to reduce their credit risk exposure. The increase in the number of enterprises undergoing insolvency during 2008-2011 continues to represent a serious threat for banks, given that more and more companies have not been able to return the received bank loans. Moreover, in accordance with the Regulation of National Bank of Romania no. 3/2009 on loans and investments classification and on the establishment, adjustment and use of credit risk provisions, banks are forced to fully provisioned credit granted to companies that enter into insolvency, even if the rates are paid to date or with small delays, any guaranties was held, reducing their liquidity and profitability (NBR, 2009).

This situation is more difficult because of the excessive length of the insolvency proceedings causing delays for banks in both situations: in obtaining their receivables from debtors and in cancellation of risk credit provision. In this situation, for banks in

---

\* Associate professor PhD., "Petru Maior" University of Tîrgu-Mureş, Faculty of Economics, Law and Administrative Sciences, ROMANIA.

Romania, the perception of risk is still very high, continuing to be a factor for blocking the lending process, with negative influences on economic environment.

In these conditions the aim of this paper is to analyze the provisions of the Regulation of National Bank of Romania no. 3/2009 corroborate with the procedures regulates by Law 85/2006 and Law 169/2010 to be undertaken by entities subjects of insolvency and their effects on the banking financial policy.

Considering important to clarify some conceptual issues general valid related on insolvency and Banking Risk Assessment and Management Systems, this study is based on logical analysis and not focused on empirical, contextualized one.

As a result, the methodology used in this study has an abstract character, based on evaluations of consistency, completeness and consistency of notions, classifications and their regulations interpretations.

This paper is structured as follows: Section 1 Introduction presents the study objectives, the study methodology and the paper structure. Section 2 presents some empirical data regarding insolvency in Romania being analyzed as a risk factor for the banking system. Section 3 studies the Bank Financial Policy: Risk Assessment and Management Systems. Section 4 embodies Bank Financial Policy Challenges in Crisis Times and Section 5 concludes.

## 2. INSOLVENCY AS A RISK FACTOR FOR THE BANKING SYSTEM

In Romania, the effects of the global economic crisis first became visible in the last quarter of 2008, worsened in 2009 and 2010 and only beginning with the second quarter of 2011 registering a modest economic growth<sup>1</sup>. In 2008-2011 ONRC reported the increase of the number of enterprises undergoing insolvency<sup>2</sup>. A lot of complex factors occur causing such increasing phenomenon. The present study is not focused on the factors, but on the effects for the banking system.

Table no.1 presents statistics regarding the enterprises which became insolvent during the period January 2007 to October 2011.

*Table no. 1 Number of Insolvency Proceedings (IP), IP Index (IIP) and Relative IP Growth (%IP) during 2008-2010 in Romania*

	01-06 2008	01-12 2008	01-06 2009	01-12 2009	01-06 2010	01-12 2010	01-09 2011	IIP <sub>2010/2008</sub> (%)	% IP <sub>2010/2008</sub> (%)
IP	7.493	14.483	10.435	18.421	11.221	19.809	15.767	136,77	36,77

*Source: Authors calculations based on (Coface, 2009), (Coface, 2010) and (ONRC, 2011) reports*

<sup>1</sup> www.insse.ro

<sup>2</sup> www.onrc.ro

After rising from 14.483 insolvency proceedings in 2008 to 18.421 in 2009, there were 19.809 insolvency proceedings in 2010, representing a 20 per cent average annual rise. The total number is likely to increase in 2010 in comparison with 2007 by 36,77 %.

In accordance with Art. 3 of Law no. 85/2006 on Insolvency Proceedings, insolvency is defined as “a situation in which the debtor has insufficient assets to be able to clear their debts”<sup>3</sup>. Law no. 85/2006 regulates two procedures to be undertaken by entities subjects of insolvency as follows: the judicial organization procedure aiming to rescue the debtor and the bankruptcy procedure aimed at liquidating debtor’s assets for paying his debts.

From practical experience results that the bankruptcy procedure takes at least one year during which creditors can’t recover their receivables. (Musat, 2011) According to the same authors (Musat, 2011), in case of a potential prior reorganization, the period might extend up to three years, even in condition of substantial changes of Law no. 85/2006 made in two consecutive years, 2009 and 2010. The aim of the law changes was to accelerate the insolvency procedures. The Law no. 169/2010 which modifies the Law 85/2006 has reduced some proceeding terms as presented bellows<sup>4</sup>:

- the term within which the creditors may file an opposition to the debtor’s request to open the insolvency proceedings from 15 days to 10 days as of the receipt of the notification from the judicial administrator/liquidator
- the deadline for the registration of the petitions for admitting creditors’ receivables with the debtor’s amount of claims from maximum 60 days to maximum 45 days as of the opening of the procedure.
- the observation period of the debtor from 60 to 50 days,
- the second appeal term from 10 to 7 days as of the communication of the decision,
- respectively the hearing date of the second appeal from 30 days to 10 days as of the registration of the file with the court of appeal,
- the term for grounding the decisions awarded by the syndic-judge is expressly regulated, respectively 10 days as of the awarding of decision,
- the legal administrator/liquidator reporting period becomes 20 days maximum.

In order to accelerate the procedure for the approval of the reorganization plan, the stage of the syndic judge’s approval in principle was eliminated. In order to reduce the amount of the applications for the initiation of the insolvency proceedings, Law 169/2010 amends the threshold value of the receivable held by the creditor entitled to request the initiation of the insolvency proceedings from RON 30,000 to RON 45,000. In addition, the receivable has to be certain, liquid and payable for more than 90 days, instead of 30 days, as provided before by Law no. 85/2006. Law 169/2010 expressly regulates the fact that as of the opening of insolvency proceedings against the debtor all the judicial, extrajudicial or forced execution measures, for covering the receivables

<sup>3</sup> Law no. 85/2006 on insolvency proceedings, published in the Official Part I, nr.359, 2006

<sup>4</sup> Law no. 169/2010 amending and supplementing Law no. 85/2006 on the insolvency proceedings (“Law 169/2010”), published in the Official Gazette no. 505 of 21 July 2010.

towards the debtor and its assets are suspended, irrespective of the stage of jurisdiction of the respective actions.

According to the insolvency specialists, the reduction of the proceedings terms provided by the Law 169/2010 does not solve the problem because the courts are overloaded, having insufficient resources, as a result being very difficult to respect the shorter deadlines.(Gradinescu, 2011). Moreover, many of these terms have been established without a correlative procedural noncompliance sanction affecting the proceedings length.

For banks, that means serious problems because, in accordance with the regulations of National Bank of Romania, they are forced to fully provisioned credit granted to companies that enter into insolvency, even if the rates are paid to date or with small delays, any guaranties was held<sup>5</sup>.

### **3. BANK FINANCIAL POLICY: RISK ASSESSMENT AND MANAGEMENT SYSTEMS**

Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. (Basel Committee, 1999). The goal of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization.

According to some researchers (Fiordelisi et al, 2010), the credit risk can be measured by the value of non performing loans.

Different definition of non performing loans (NPL) lead to the facts that NPL may be understated comparing to international standards as follows:

Thomas Fitch (Fitch, 1990): Loans and other assets are classified as NPL when the payment representing the principal and interest record a debt service of more then 90 days.

Moody's (Moody's, 2004): Are considered to be non-performing loans the followings:

- Loans to households if at least 60 days debt service is recorded
- Any loan for which there are clear indications of distress

IMF Guide (IMF, 2004): Loans are classified as NPL when the payment representing the principal and interest record a debt service of 90 days or more. In addition, NPL includes also the loans recording less then 90 days of debt service, but giving clear signals of bankruptcy.

According to a recent study (Popa, 2010), in different 15 countries the classification of credits is made by the simultaneous use of the following criteria:

---

<sup>5</sup> Regulation of National Bank of Romania no. 3/2009, Official Gazette, Part I on loans and investments classification and on the establishment, adjustment and use of credit risk provisions

- Debt service;
- Financial performance;
- Initiation of juridical procedures.

Only the first criterion differs as follows:

- More than 90 days for 12 countries (Romania, Bulgaria, Cyprus, Greece, Macedonia, Serbia, Hungary, Poland, Czech Republic, Ukraine, Latvia, Austria)
- More than 60 days for 2 countries (Estonia, Lithuania)
- More than 30 days for 1 country (Russia: more than 30 days – commercial lending and more than 60 days - households)

According to the same study (Popa, 2010), the loans registering more than 90 days debt service, considered as NPL, are classified in different categories as follows:

- Loss credits: 2 countries (Romania, Bulgaria)
- Doubtful credits and Loss credits: 4 countries (Serbia, Ukraine, Macedonia, Russia)
- Below standards credit, Doubtful credits and Loss credits: 3 countries (Hungary, Poland, Czech Republic)

According to Romanian regulations<sup>6</sup>, all gross exposure that record more than 90 days and/or have been initiated juridical proceedings are classified as “Loss credits” (Table no.2).

*Table no. 2 Romanian Credit Classification System*

Debts service	A	B	C	D	E	No juridical procedures/ With juridical procedures
<b>0 – 15 days</b>	Standard/Loss	Under supervision/ Loss	Below standard/ Loss	Doubtful/ Loss	Loss/Loss	
<b>16-30 days</b>	Under supervision/ Loss	Below standard/ Loss	Doubtful/ Loss	Loss/Loss	Loss/Loss	
<b>31-60 days</b>	Below standard/ Loss	Doubtful/ Loss	Loss/Loss	Loss/Loss	Loss/Loss	
<b>61-90 days</b>	Doubtful/ Loss	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	
<b>Min 91 days</b>	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	Loss/Loss	

*Source: Made by author in accordance with NBR Regulation no.3/2009*

*Note: A, B, C, D, E refers to financial performance of the credit requester, being established by bank after the analysis of their financial performance as shows in Apendix no.1.*

Comparing with the study mentioned above results that the Romanian classification criterion of loans according to the number of days of debt service is significantly more severe than that used in most countries. Moreover, in accordance with

<sup>6</sup> idem

Romanian regulations<sup>7</sup>, Loss Credits (LC) means Non Performing Loans (NPL) and must be fully provisioned by deduction of a factor of no more than 25% of the collateral. The formation of credit risk provisions means to include as expense the amount representing the provisions required by regulation.

By analyzing from the accounting perspective, the higher the provisions, the lower the bank's liquidity and profitability are.

By corroborating this result with the fact (as it results from the Table no.2) that banks in Romania are forced to fully provision credit granted to companies that enter into insolvency, even if the rates are paid to date or with small delays, any guarantee held, the logical conclusion is that the effect of the mentioned regulation is the reduction of banks' liquidity and profitability and as a consequence the worsening of the economic environment by reducing the lending process.

#### 4. BANK FINANCIAL POLICY CHALLENGES IN CRISIS TIMES

In 2009 and 2010, with the aim of encouraging bank lending and to maintain prudent broad monetary conditions at all times with regard to evolving economic environment, the National Bank of Romania took a series of measures to reduce the base lending rate and, at the same time, to reduce the reserves that the credit institutions have to deposit with the central bank<sup>8</sup>.

Policy rate decreased in 2009 from 10.25% to 8% and in 2010 to 6.25% on background of disinflation persistence: inflation reacting with a lag to substantial economic contraction; gradual decrease in minimum reserve requirements: from 20% to 15% for domestic currency liabilities, from 40% to 30% for foreign-exchange denominated liabilities (both w. residual maturities of up to two years); liquidity management important policy tool in its own right, on background of NBR move to net creditor position: enhances transmission of policy signals, firm management ensures adequate functioning of financial markets w/o negative spillovers into other areas<sup>9</sup>.

Despite of these measures, as a result of the financial crisis, the credit institutions substantially limited corporate lending and demanded high levels of security for borrowing and high interest rates. As it results from the Table no.3, during 2009, 2010 and even until the third quarter of 2011, Past Due and Doubtful Loans (% in total loans

---

<sup>7</sup> Regulation of National Bank of Romania no. 3/2009, Official Gazette, Part I on loans and investments classification and on the establishment, adjustment and use of credit risk provisions, art 13, al 1

<sup>8</sup> Regulation of National Bank of Romania and National Securities Commission no.29/10/2009 on supplementing Regulation of National Bank of Romania and National Securities Commission no.13/18/2006 concerning the determination of minimum capital requirements for credit institutions and investment firms and Regulation of National Bank of Romania No.26 from 15.12.2009 on the implementation, validation and assessment of Internal Ratings Based Approaches for credit institutions

<sup>9</sup> Government Emergency Ordinance no.25 dated 18 March 2009, *Published in the Official Gazette, Part I no. 179 dated 23/03/2009* on amending and supplementing of the Government Emergency Ordinance no. 99/2006 on credit institutions and capital adequacy and Law No.270/2009 approving the Government Emergency Ordinance no. 25/2009 amending and supplementing Government Emergency Ordinance no. 99/2006 on credit institutions and capital adequacy

and in total asset) sharply increased, causing the increase of NPL Ratio and of Credit Risk Ratio.

*Table no.3 Romanian Bank Financial Policy Statistics - Aggregate Indicators for December 2008 to September 2011*

Aggregate Indicators	Dec 2008	June 2009	Dec 2009	June 2010	Dec. 2010	June 2011	Sept 2011
Number of credit institutions	43	43	42	42	42	42	41
of which foreign banks' branches	10	11	10	9	9	9	8
Total net assets ( <i>RON bill.</i> )	314.4	328.9	330.2	330.4	341.9	338.9	343.9
Assets of private-owned institutions <sup>1</sup> (% in total assets)	94.8	93.2	92.7	93.4	92.6	93.3	92.7
Assets of foreign-owned institutions <sup>2</sup> (% in total assets)	88.2	85.9	85.3	86.1	85.1	85.4	84.6
Capital Adequacy Ratio ( $\geq 8\%$ ) (%) <sup>*</sup>	13.76	13.51	14.67	14.33	15.02	14.19	13.43
Leverage Ratio <sup>3</sup> (%) <sup>*</sup>	8.13	6.92	7.55	7.91	8.11	7.79	7.50
Past due and doubtful loans <sup>4</sup> (% in total loans)	0.32	1.03	1.45	2.17	2.23	2.51	2.45
Past due and doubtful claims <sup>5</sup> (% in total assets)	0.29	0.75	1.01	1.52	1.47	1.70	1.64
ROA <sup>6</sup> (%)	1.56	0.05	0.25	-0.15	-0.16	0.06	-0.31
ROE <sup>7</sup> (%)	17.04	0.64	2.89	-1.58	-1.73	0.62	-3.37
Operating income / operating expenses <sup>8</sup> (%)	179.56	148.75	156.53	168.89	154.20	148.24	151.35
Loan-to-Deposit Ratio <sup>9</sup> (%)	122.03	119.23	112.8	117.46	113.46	118.42	118.63
Credit Risk Ratio <sup>10</sup> (%) <sup>*</sup>	6.52	11.76	15.29	17.81	20.82	21.89	23.03
NPL Ratio <sup>11</sup> (%) <sup>*</sup>	-	-	7.89	10.20	11.85	13.35	14.18

*Source: Calculations based on NBR statistics report*

*Note: Indicators include all credit institutions (banks, foreign banks' branches and Creditcoop). Total assets and Own capital for Leverage Ratio, ROA and ROE are calculated as averages (see Appendix no. 2).*

As a result of the increase of the credit risk, the credit institutions substantially limited corporate lending and demanded high levels of security for borrowing and high interest rates. From this perspective, the amount of the credit risk provisions has a large influence on the activity banks indicators. Reducing these provisions would generate the increase of the liquidity and profitability of banks. In accordance with NBR, R3/2009, art. 22, the use of credit risk provisions refers to its cancellation by introducing on the bank income, in case of fulfilled one of the following conditions:

- Legal possibilities of recovery the receivables have been exhausted or/and time has reached the prescription term;
- Contractual rights related to this credit have been transferred.

The logical conclusion is that the shorter the insolvency proceedings, the shorter the period in which the banks are forced to maintain the credit risk provisions will be. As was analysed in a previous section, the reduction of the proceedings terms provided by the Law 169/2010 did not solve the problem because the courts are overloaded, having insufficient resources, being very difficult to respect the shorter deadlines. Moreover, many of these terms have been established without a correlative procedural noncompliance sanction affecting the proceedings length. As a result, the solution is to improve the regulations in order to accelerate the insolvency procedure.

## 5. CONCLUSIONS

The strength of systemic crises puts extraordinary pressure on the authorities. They must respond quickly to developing events yet act with minimal information. Delays in response tend to aggravate the situation and may increase the eventual cost of the crisis. Under such circumstances, close coordination among policy makers as well as clarity on their respective roles is essential. The institutional framework can facilitate such coordination.

The Romanian authorities have to continue improve the regulations in order to meet the developments and changes that the Romanian business environment is constantly undergoing and the banks should become more aware of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

In our future work we intend to calculate and analyse the correlation between the evolution of aggregate credit risk and the evolution of number of insolvency proceedings during 2009-2011 period.

## REFERENCES

- Basel Committee on Banking Supervision, 1999, *Principles for the management of credit risk*, Consultative paper, Basel
- Bank for International Settlements (BIS), 2011, *Basel III counterparty credit risk*, Consultative paper, Basel.
- Coface Romania, 2009. *Study regarding the situation of the insolvencies from Romania during the first Semester of 2009*. Available at: [http://www.coface.ro/CofacePortal/ShowBinary/BEA%20Repository/RO/en\\_EN/documents/Stydyinsolvency](http://www.coface.ro/CofacePortal/ShowBinary/BEA%20Repository/RO/en_EN/documents/Stydyinsolvency)
- Coface Romania, 2010. *Study on the Status of Insolvencies in Romania in the first Semester of 2010*. Available at: [http://www.coface.ro/CofacePortal/ShowBinary/BEA%20Repository/RO/en\\_EN/images/st%20fal2010](http://www.coface.ro/CofacePortal/ShowBinary/BEA%20Repository/RO/en_EN/images/st%20fal2010)
- Fiordelisi, F, Marques-Ibanez, D & Molyneux, P. 2010, *Efficiency and risk in European banking*, ECB Working Paper, no. 1211, Frankfurt am Main
- Fitch, T., 1990, *Dictionary of Banking Terms*, Baron Business Guide, New York



- Gradinescu, L., 2011, *Considerations regarding Law no. 169/2010 amending and supplementing Law no. 85/2006*, DLA Piper Law Company
- IMF, 2004, *Financial Soundness Indicators: Compilation Guide*, in <http://www.imf.org/external/np/sta/fsi/eng/2004/guide/index.htm>
- Moody Investors Service, 2004, *Moody's Approach to Analyzing and Rating Emerging Market Banking Systems*, NY
- Musat & Asociatii, 2011, *Insolvency*, Bucuresti
- Popa, R, 2010, *Studii*, Colectia BNR

### ***Apendix no.1***

*A Category* – financial performances are very good and they afford to reimburse in due time the interest and the rate; their financial performance are likely to remain very high;

*B Category* – good and very good financial performance which will be not maintained at the same level for an extended period of time;

*C Category* – adequate financial performance, but with an explicit tendency of decrease;

*D Category* – low financial performance and an explicit cyclic tendency on short period of time;

*E Category* – the financial performance show losses and there are clear perspectives of not paying principals or/and interest.

### ***Apendix no.2***

\*) Indicators for banks and Creditcoop; foreign banks' branches do not report Capital Adequacy, Own Funds and Loans Classification Statement

<sup>1)</sup> Total net assets of credit institutions with majority private capital (including foreign bank branches) / Total net assets <sup>2)</sup> Total net assets of credit institutions with majority foreign capital (including foreign bank branches) / Total net assets <sup>3)</sup> Tier 1 Capital / Total average assets

<sup>4)</sup> Past due and doubtful loans / Total loans portfolio (net value)

<sup>5)</sup> Past due and doubtful claims (net value) / Total assets (net value)

<sup>6)</sup> Return on assets (Annualized net profit / Total average assets)

<sup>7)</sup> Return on equity (Annualized net profit / Average own capital)

<sup>8)</sup> Total operating income / Total operating expenses

<sup>9)</sup> Loans granted to clients (gross value) / Deposits from clients

<sup>10)</sup> Gross exposure of non-bank loans and interest classified as doubtful and loss / Total classified non-bank loans and related interest, excluding off-balance sheet items

<sup>11)</sup> Gross exposure of non-bank loans and interest classified as "Credit loss" that is overdue more than 90 days and /or for which legal proceedings were initiated against the debtor or against the operation / Total classified non-bank loans and related interest, excluding off-balance sheet items