Romanian commercial banks and credit risk in financing SME

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Abstract

Romania's integration in the European Union brought about some major changes in our banking system. One of the direct consequences is the fierce competition between banks for supremacy on the market. According to this, the Romanian banks saw in the SMEs sector a true potential for reaching their goal and they proceeded to conquer it by conceiving unique products, specially designed to reach the financial needs of this segment. Moreover, banks often come up with new attractive offers and cost reductions for the SMEs (Small and Mediu Sized Enterprises) sector. In this context, some answers need to be done: the effective risk banks accept to take by providing the offers, specific risks in financing this sector, the problem of the balance between risk and profit return (or market share increase).

Keywords: credit risk, risk management*, *financing SME, bank policies

The Romanian banking sector has been lately the victim of some profound structural changes, generated by the perspective of integration in the European Union. This resulted in a monetary instability manifested through an increased volatility of the exchanges rates and of the capital flows as well as in a tough concurrence between financial institutions. This fierce competition between banks determined them to launch themselves in a real course of financing, by accepting more and more risky transactions.

The target segment of the credit institutions seems to be recently the SMEs (Small and Medium Enterprises) for some well-established reasons. Thus, SMEs represent one of the major sectors of all economies both from a market share point of view and from the fact that these firms contribute definitively to the creation of GDP (Gross Domestic Product) and engage a great part of the existent working force. Moreover, as the majority of the powerful corporations have already decided which financial institution they prefer to work with, the SMEs sector looks in this situation, as the cornerstone for the future development of the credit market, a field unexplored yet at its full potential.

Therefore, it is no doubt that, in order to attract an important share of the credit market, banks initiated an aggressive campaign of conceiving some products specially designed to meet the particular financing needs of the SMEs' sector.

Specific risks associated to SMEs financing

SMEs represent an important sector for all economies. Tough, in spite of the dynamics and of the importance of this segment for the economic development, SMEs continue to be faced with different problems linked to their access to credits. According to a study of the European Commission[1], concerning the SME sector in E.U., between 18% and 35% of the firms which asked for a credit were refused. Meanwhile, the same study shows that in Romania, the main source of financing new projects is represented by firms' own funds.

One of the reasons of SMEs difficult access to borrowed funds is the fact that these firms are perceived as being more risky than big companies. They present a high sensitivity to economic shocks while disposing of an inferior capacity to absorb variations. From this perspective, allotting medium and long time credits to these firms becomes problematic. Moreover, even short time credits are hard to be granted because of the monthly payment obligations risking to overpass the accepted debt capacity. In addition, in many of these cases, the monitoring costs reach unacceptable high levels as compared to the value of the granted credit.

On the other side, many SMEs are faced with the lack of some adequate collateral necessary to sustain a credit requirement while, in the meantime, banks feel reluctant in accepting personal guarantees. And finally, the Romanian legislation concerning debt recovery in the case of bankruptcy of SMEs is much more bureaucratic than in that of

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[1] SMEs in Europe, 2003, Report for România - Observatory of the SMEs in Europe, The European Commision, July 2003

some big, important firms, where more transparency is required.

Despite all risks related to SMEs financing, banks cannot ignore anymore this sector if they want to gain a comfortable share of the credit market. In this respect, financial institutions proceeded to develop new credit tools specially conceived to meet the financial needs of this segment. However, even these new products present their own associated risks - generated by the peculiarities they present – which finally add to the final risk banks accept to take when financing SMEs.

One way to cut the total risk is to analyze the specific risks born by these latest financing policies and then, to try to reduce them by appealing to some specific risk management tools, in order to establish a profitable balance between the risks accepted and the income brought by this extensive financing activity.

New credit products for SMEs and their associated risks

A great part of banks' profits comes from their financing activity. Actually, the credit segment represents a central concern for any financial institution and many of them are trying to develop and implement efficient policies in order to enhance the credit activity and thus, to increase profits.

If we are to also take into account the potential presented by the SME sector, we can understand the reasons which determined banks to launch themselves into a fierce campaign of conceiving new, quite permissive credit policies for SMEs. Moreover, the great concurrence between banks in allocating the attracted funds, determined them to overlook some of the risks incurred by the new financing tools.

A short introspective into the new credit products launched on the market by different Romanian banks proves some common features. One important aspect is for example, the non-bureaucratic formula of documentation analysis and credit allotment. The answer is given in maximum 24 hours in response to SMEs pressing needs for short time, accessible funds, in order to cover their temporary account overdrafts. The analysis is based on some basic financial and non-financial indicators. In the first category we can include: a minimum existence period of the company on the market (which might vary from six months to up to one or two years) or the requirement of not figuring in CIP (The Office of Payment Incidents) with payment delays for a certain period of time. As concerns the financial indicators took into account in establishing the eligibility of a SME for a credit granting, these are: a positive turnover trend, a positive operating profit and financial stability – the company must be classified in the A or B risk class according to the bank's internal policies concerning the evaluation of the financial performance of firms.

The schematic analysis helps in gaining accessibility and improves the volume of the granted credit. The new slogan seems to be: "quantity before quality". And in many instances this is true, in the sense that banks rely on allocating an important volume of credit with the thought that these profits – resulted from volume - might compensate for some damages occurred in the case of any default payment. Anyway, as many might observe, the probability of risk occurrence is quite small. Even tough, such permissive conditions bear many risks and banks should balance the need for diversifying their credit portfolio - and thus gaining better market shares or profits – with the risks they assume. Among the risks inherent to the allocation of credits we would only mention: the risk of adopting a wrong financing decision. The pressure for a rapid analysis of the credit documentation and the scarcity of the indicators taken into account during this study, do not allow for a better knowledge of the firm and of its risk profile. Consequently, it is quite probable that the bank's exposure to risk might increase by accepting such a financial request and this might lead in turn to a future increase in the banks costs of monitoring and provisioning.

The advantages granted by the new credit products are countless. Actually, the variety of credit tools available on the market is meant to satisfy any of the customers' needs in terms of: accessibility, rapidity, payment flows, etc. In this respect we would mention another product, the "0 Interest Rate Credit" specially conceived to cover for some of the firm's short term, temporary needs. For example, a company has to pay for a cheque in three days time but it will receive the money in two weeks. Or, an industrial equipment is expected to arrive at the customs but the importer is confronted with a temporary illiquidity, lets say for four days. In this case, both debtors can access a rapid credit like the "0 Interest Rate Credit" which effectively answers their temporary needs and which is really cost efficient.

The new product seems to be of real interest because SMEs can get the financing in real time and more importantly, they will not be obliged to pay any interest rate, just a monthly commission. For firms confronted with temporary illiquidity this is cost efficient as they can better manage their cash flows while avoiding the payment of some high interest rates. Moreover, if they succeed to cover their debt on a monthly basis, the commission will drop significantly.

From the banks' standpoint however, this type of credit bears many risks. Funds do not necessarily have a certain destination, fact that prevents banks from controlling their use. If the credit is allocated to an inefficient activity or if they are used for purposes not serving the real interest of the firm, the risk of that company's default payment is much higher. This adds to the risks associated to granting a rapid credit and generates an increase of the overall risk taken by the financial institution.

Other methods of financing offered by the Romanian banks are factoring and the procedure of discounting financial instruments. As for discounting, risks are that the financial instruments (for example cheques, promissory notes) are post-dated or that they present some restrictive clauses like the right to protest or to initiate regression actions. If these financial instruments are offered to the bank in blank to serve as a guarantee and the bank does not pay enough attention to such clauses, the risk is that the debtor will default sooner or later in its payment obligations.

Risk management policies implemented by the Romanian banks: present and perspectives

Credit risk is inherent to any bank. Actually, credit allocation is one of the main activities of banks and the one which brings much of its turnover. But the greater the incomes brought by the credit activity, the greater are the risks assumed by the banks. In this respect, one of the greatest challenges of all financial institutions is to find an efficient balance between the risks incurred by their financing activity and achieving an increase in their profits.

From this perspective, the credit policy of the Romanian banks should include common objectives like: the efforts of selecting secure credits with a maximum probability of reimbursement, insurance of the efficient use of the attracted funds or a development of credits to meet the specific needs of the clients who operate on those markets where banks have a well-established presence. Moreover, in order to prevent risks, credit institutions should establish themselves a strategy of credit granting, they should pursue this strategy and adapt it periodically to the changes interfered into the market.

Risk might appear in any stage of the process of credit allocation from the incipient phases of documentation analysis up to the final stages where the debtor enters into liquidation and the guarantees must be sold to pay out the debt. Consequently monitoring is required throughout the entire process of financing.

Credit risk can be determined by errors occurred at the superior levels, the so-called strategic errors, or they might be as well the result of some operating errors. Strategic defaults concern the bad conception of the bank’s policies and of its short and long term strategies concentrated in the form of some rigid internal norms related to the process of credit selection, analysis, granting and monitoring of the process. This category of risks is essential in the way that, if the policies and the strategy of the bank are wrongly conceived and pursued, the entire process of financing has to suffer and the banks will head towards disaster. But the fail of a bank has a domino effect upon the entire banking system of the country by reducing the population’s confidence in this system. For this reason, the policies and strategies of any financial institution, their internal norms as well as any changes operated on them must receive the approval of the central bank. However, there are also some strategic decisions which do not necessarily need to be accepted by the NBR (National Bank of Romania) but which might cause serious problems. In this category we can include the market strategy of the bank or establishing the limits of their credit portfolio diversification.

Promoting very risky credit products or credits denominated in a currency for which the bank does not have enough resources might, for example, prove to be fatal for the bank.

In order to prevent the risk of financing, a good credit strategy is not enough. It must be also sustained by operational efforts. Operational errors that might appear during the process of financing can be divided into the following categories:

- Errors linked to the credit documentation: editing errors, overlooking some important clauses, etc. which need sustained attention and trained personnel;

- Errors occurred during the processing (when introducing information about the credit into the system) and the administration of credits;
- Errors in monitoring the credit like: defaults in pursuing regular analysis of the financial situation of debtors, the flow of funds through the debtor's accounts opened at the bank and the provenience of these funds, debtors' relationships with their suppliers, customers and partners, the evolution of the markets where these debtors operate, if they pay in time their debts, etc. Any fault in observing real time changes that might interfere at this level might lead to future debtor defaults.
- Errors appeared during the monitoring process of the credit portfolios concerning their evolution as a whole and the evolution of each credit product respectively, or when determining the periodic correlation of the volume of credit granted for different destinations with the limits initially established by the specialized commissions. This type of errors has important consequences as the central bank requires regular reports with the maximum exposure of banks for groups of debtors and for debtors situated in special relationships with the financial institutions. Any excess of this kind of exposures will trigger about penalties. In this case, banks must proceed to a restructuring of the credit portfolio in order to meet the bank's strategy and the regulations applying to this sector.
- Errors triggered by the deficient monitoring of the guarantees and the calculus of risk provisions. Defaults that might appear in this case link to establishing the right market value of the guarantee or evaluating the market trend for the object brought as a guarantee.

Besides these risks, which are inherent to any credit activity, banks are also confronted with some specific risks, generated by the new credit products they offer to different categories of firms: like the credit tools specially conceived for the SME sector. The risks associated with these products are determined by the financing facilities that banks offer to this particular sector, in their efforts to attract an important share of a yet unexplored market.

The new credit tools present the great advantage of being very flexible. Thus, the rapidity of documentation analysis (24 hours in most of the cases), the full financing of the project - without any initial own contribution from the part of the debtor - , the existence of credits which do not require mentioning a certain initial destination or the possibility of presenting as credit guarantees some promissory notes in blank, are just as many opportunities of risk enhancing. In this context, a question remains to be answered: which are the management techniques used by the banks in protecting themselves against such risks?

The promptitude in granting a credit might bring banks many risks related to a deficient knowledge of their clients, of their capacity and their willingness to pay back their debts. The reduced number of the analyzed financial indicators represents another reason of the default risk of the counterparty. In this situation banks should pay an increased attention to the preliminary discussions with the client. The credit analyst must question the history of the client's relationship with the bank – actually old clients whose financial and payment record is already known should be preferred to a new client.

In conclusion, a good policy in this sense could be represented by the cross-selling products or by the marketing policies trying to attract clients which act on specific markets on which the bank has an important presence or which develop affair relationships with the old clients of the bank. This way, the analyst can keep a track on the new client by disposing of supplementary information about their financial capacity and their character. Moreover, the analysts should maintain a climate of mutual trust and understanding for their clients; they should periodically monitor the debtors' activity and announce their superiors of any changes that might appear. Thus, any worsening of the economic and social conditions of the debtors will be handled in real time and the probability of default is substantially reduced.

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