

# What lessons from Romania's early success in NPL reduction?

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*In 2014-2015, Romania made important progress in enhancing oversight of NPLs within the banking sector and countered some of the main impediments to NPL resolution and transactions. As a result, the NPL ratio for non-financial corporations declined by 5.7 percentage points from December 2013 to June 2015 (from 23.6 percent to 17.9 percent). The Romanian case therefore offers a number of lessons for other CESEE countries. This note focuses on some of the key factors which contributed to this rapid reduction in NPLs and to the progress realised through implementing systemic measures. The note also highlights some of the challenges that remain to be addressed by the regulator and the industry, particularly in regards to enhancing the level of out-of-court restructuring of companies, the continued development of a sound NPL market and achieving the right balance between rapidly improving bank balance sheets and stimulating new bank lending that will be essential for the broader economy.*

## 1. THE EVOLUTION OF NPLS IN ROMANIA<sup>2</sup>

In 2014-2015 the regulator encouraged banks to write-off and sell well-provisioned NPLs to remedy some of the excess of stock built up in the market. The evolution of Romania's NPLs therefore went through two distinct phases: a "build-up" and an "active resolution" phase.

### I. The "build-up phase" (2008-2013):

- The NPL ratio<sup>3</sup> went up relentlessly during the economic crisis, increasing by nearly four-fold over a period of 4 years, reaching 23.6 percent<sup>4</sup> in December 2013;
- Multiple factors contributed to the build-up of NPLs, including (i) a rapid expansion of balance sheets of banks coupled with fairly relaxed lending criteria; (ii) a fast increase of FX loans stimulated by the lower interest rates environment; (iii) the inadequacy of banks' strategies and capability to deal with NPLs; (iv) the economic downturn negatively impacting corporates; and (v) the drop in real estate collateral values.
- The rising NPL stock problem was, in part, amplified by IFRS accounting principles not yet being adopted in Romania and having more restrictive accounting rules in place in regards to write-off of NPLs by banks.

### II. The phase of "active resolution" (2014 to the present):

- The National Bank of Romania ("NBR") took several proactive steps in a short period in order to decrease the levels of NPLs on the banks' balance sheet through a series of recommendations and strengthening its oversight over the banks' distressed loans. The NBR actions were aimed at supporting the sustainable resumption of lending to the real

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<sup>1</sup> EBRD consultants. All views presented here are the authors' only. The authors wish to thank the staff of the Supervision and Financial Stability Departments of the National Bank of Romania (NBR) and the staff from commercial banks interviewed for their time and willingness to share their views. For more details, please contact [NPL@ebrd.com](mailto:NPL@ebrd.com).

<sup>2</sup> This section relies on the information and analysis of Romania's Financial Stability Report 2015, National Bank of Romania, 30 September 2015 unless otherwise stated.

<sup>3</sup> NPL ratios in this document are solely based on national definition for purpose of comparison (also impacting other relevant ratios such as "NPL Coverage Ratios"). The national definition considers loans overdue by more than 90 days and/or in which case legal proceedings were initiated. NPLs are recorded at gross value (i.e. book value, without considering collaterals or adjustments for impairment). It is however to be noted that new data gathered from September 2014 follow the EBA's "Technical Standards on supervisory reporting on forbearance activities and non-performing exposures". EBA's harmonised definition of NPEs includes: a) material exposures of over 90 days past-due; and/or (b) exposures in relation to which the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due. Please refer to note (7) for further explanation.

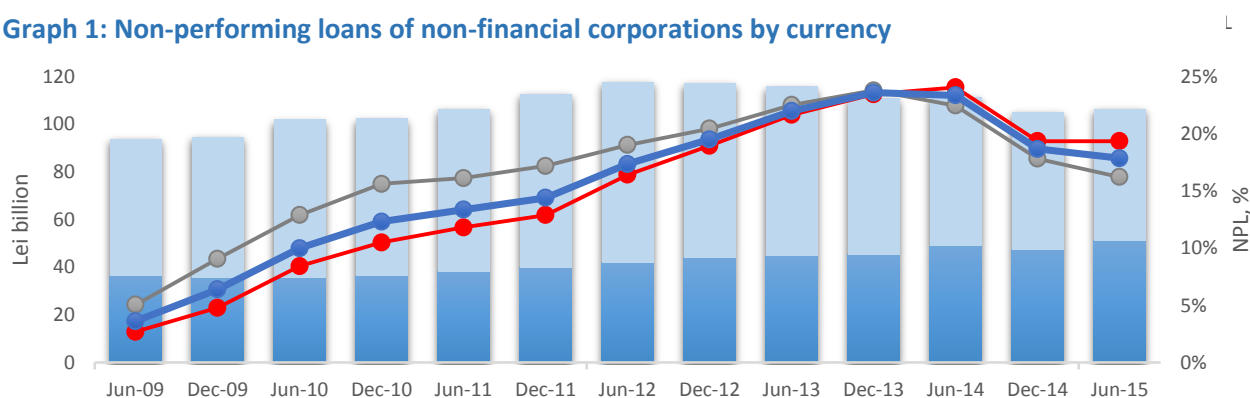
<sup>4</sup> Non-financial corporations only.

sector of the economy:<sup>5</sup>

- Starting in September 2013, the supervisor sent four letters to the banks which encouraged commercial banks to write-off or sell non-collateralized, fully-provisioned, NPLs past due for over one year or delinquent loans undergoing legal (insolvency or bankruptcy) proceedings.
- NBR required credit institutions to develop accounting policies (complying with IFRS) concerning the removal from their balance sheets of the carrying amount of unrecoverable loans, fully or partly covered with adjustments for impairment.<sup>6</sup>
- It encouraged the banks to recognize the market value of collaterals, and provision accordingly to cover expected losses. Banks were asked to use external professional appraisers to value the collateral periodically (e.g. minimum yearly for corporate) and request an opinion on the process from their external auditors to ensure compliance with international valuation standards. NBR on-site inspections can now review and question these valuations.
- It further tightened reporting requirements on all restructured loans, asking for monthly reporting and centralized restructuring decisions at the banks to reduce the scope of authority at local branches.

As a result of NBR’s recommendations for active resolution, a period of fast-paced balance sheet clean-up followed, starting in Q1-2014. Banks took action to write off and sell a large volume of NPLs<sup>7</sup>, greatly reducing their NPL ratios, but also recognizing losses for delinquent loans much earlier. This was combined with improving economic and market fundamentals, stricter new lending standards by banks and further implementation of loans restructuring. As a result, NPLs for non-financial corporations (“NFCs”) decreased by 5.7 percentage points from December 2013 to June 2015 (from 23.6 percent to 17.9 percent).<sup>8</sup> FX loans to NFC had a higher NPL ratio of 19.4 percent (while representing 56.4 percent of total NFCs’ NPLs) compared to 16.2 percent for loans in lei. The NPL coverage ratio of corporate NPLs with IFRS provisions stood relatively high at 68 percent as of June 2015.

**Graph 1: Non-performing loans of non-financial corporations by currency**



Source: NBR

The remaining NPLs in the banks’ books continue however to present further challenges. Considering that around 80 percent of NPLs have payments overdue for more than 360 days and the rehabilitation of

<sup>5</sup> In addition, other legislative initiatives introduced aimed at i) addressing issues related to the significant depreciation of the LEU against major currencies in which loans were originated prior to the financial crisis, ii) limiting the amount of profit that could be obtained following the buying and resell of distressed assets and/or iii) giving debtors the option to swap their outstanding debt for residential real estate collaterals (i.e. for mortgage loans).

<sup>6</sup> Romania’s Financial Stability Report 2015, National Bank of Romania, 30 September 2015, p. 85

<sup>7</sup> In 2014 alone, credit institutions sold a total of lei 8.9 billion NPLs.

<sup>8</sup> Starting December 2015, NBR adopted the EBA standards for compilation of NPL ratio (as defined in footnote (3)). This led to a significant broadening of what loans are considered to be “non-performing”. As a result of the new definition, a new NPL ratio series was compiled starting with data from September 2014. Based solely on this definition, NPL ratio was adjusted by 7.9 percent (13.6 percent down from 21.5 percent) over the period of the new data series (i.e. between September 2014 and December 2015).

distressed loans to classes of lower risk is very low, further efforts would be needed throughout the industry to solve the problem at a system-wide level.

## 2. OBSERVATIONS, LESSONS LEARNED AND CHALLENGES AHEAD<sup>9</sup>

The positive steps undertaken in Romania directed at reducing its NPL ratio confirm the importance of addressing impediments to NPLs in a multi-faceted approach<sup>10</sup>. Key lessons can be learned from the Romanian experience:

- I. *National data and information systems must be accessible, consistent, complete and reliable.*
- II. *Regulators must encourage the clean-up of banks' balance sheets to avoid building up NPL stocks.*
- III. *Banks must professionalize their NPL management operations to prevent further deterioration.*
- IV. *Relevant and applicable insolvency and enforcement frameworks must be in place in conjunction with robust out-of-court restructuring practices.*
- V. *Tax structures must encourage adequate banks' behaviours and stimulate the desired level of NPL transactions.*
- VI. *The development of a sound and receptive private distressed debt market is essential to allow banks deleveraging part of their NPL portfolios when necessary.*

Below are observations on the progress achieved until now in Romania for each of these key items and on some of the wider actions remaining to thoroughly resolve the country NPL challenges.

- I. **National data and information systems must be accessible, consistent, complete and reliable.**
  - Collateral registry in Romania is considered as one of the most modern in the region, particularly in regards to movable collaterals<sup>11</sup>. Tangible progress has been made in the last years to improve standardisation of practices between operators and enhancing the overall robustness of the system. Further improvement may still be necessary, such as allowing electronic registration of real estate transactions and providing online search access in the Cadastre and Real Estate Publicity Office to third parties (currently only accessible electronically by notaries).<sup>12 13 14</sup>
  - A project is underway to centralise collateral valuations data and consequently decrease the opacity of information for collateral valuations and transaction prices currently prevailing in the market.
  - In addition, the NBR participates in the broader European ECB project “Analytical Credit Dataset” (AnaCredit). Once effective, it will allow harmonising definitions and concepts used by credit registers and collect granular credit data.
- II. **Regulators must encourage the clean-up of banks' balance sheets to avoid unduly building up NPL stocks.**
  - The NBR recommendation to the banks which encouraged a write-off of uncollateralized, well provisioned vintage NPLs was a first step to prompt the banks to start cleaning up their balance sheets. This has resulted in timely NPL write-off and sales. This aids in preventing the accumulation of vintage NPLs in the banking system (flow problem) and the subsequent risk of undue erosion of NPL recoverability and value. In addition, NBR has put in place necessary safeguards to ensure that claims and other legal rights are preserved in the event of loans write-offs by banks.
  - Valuing assets according to market values in the banks' books is an important pre-requisite for adequate provisioning for expected losses. This is also key to narrowing the gap between loan book

<sup>9</sup> This section relies on the information and analysis of the “Romania’s Financial Stability Report 2015, National Bank of Romania, 30 September 2015” unless stated otherwise.

<sup>10</sup> Features for successful NPL resolutions are pointed above are well grounded in a recent IMF research in the European context “IMF, Staff Discussion Note, “A Strategy for Resolving Europe’s Problem Loans”, SDN/15/19, September, 2015”.

<sup>11</sup> “Electronic Archive for Security Interests in Movable Property”, <http://www.aegrm.ro/en>

<sup>12</sup> Doing Business 2016, Economy Profile 2016 - Romania, World Bank, 2016.

<sup>13</sup> Collateral, Where Does Reform Stand Today?, Ivor Istuk and Ahmed Meziou, EBRD, 2015

<sup>14</sup> “Romania - Real Estate 2016”, International Comparative Legal Guides, Chapter by Pachiu & Associates

values and investors' bids for such assets. The new NBR requirements in regard to professional appraisals of collateral values (i.e. frequent, audited, controlled and challenged) is commendable.

### III. Banks must professionalise their NPL management operations to prevent further deterioration.

- **Banks have begun improving their NPL management operations.** Romanian banks have taken some steps with their internal arrears management and NPL work-out. This is particularly true of the larger banks and subsidiaries of foreign banks which have incorporated international best practices into their operations and structures. Many banks have, for example, created independent NPL units and improved control and monitoring of distressed borrowers. Support and capacity building, particularly for smaller banks, may however be required due to lack of expertise in recognizing what actions must specifically be implemented. In addition, more qualified and experienced expertise in NPL restructuring may be necessary in some instances (e.g. foreign specialist recruiting, external specialised consultants).
- **The implementation of sustainable and long-term solutions for distressed but viable corporate borrowers seems to be sub-optimal overall.** Banks are still opting mainly for short term options (e.g. loan rescheduling) and sale of NPLs rather than undertaking more advanced restructuring solutions. Directives, guidelines, “strategy templates” and/or tools may be required to prompt best international restructuring practices to the market to avoid value destruction.
- **Multi-creditor restructuring also remains a key issue for banks.** Romania’s 2010 Corporate Debt Restructuring Guidelines, which are based on the INSOL Principles, provides some direction to creditors to achieve consensual debt restructuring.<sup>15</sup> Based on the feedback from some banks, it appears that issues of coordination between creditors remain, and mostly informal and ad hoc approaches are applied. Amendments to the guidelines may therefore be required, in consultation with the industry, to improve the framework and make it more practicable and accepted by the market while providing sufficient flexibility to allow creditors to implement their own formal mechanisms when necessary (e.g. enhance restructuring and/or hybrid solutions).<sup>16</sup>
- **Centralised guidelines and tools at banks are required for handling distressed micro-enterprises and SMEs, which present high risks.** The NPL ratio for micro-enterprises still stood above 40 percent as of June 2015.<sup>17</sup> Such loans present different challenges to corporate exposures due to the high number of clients, the lack of sophistication of borrowers and the fact that the actual management of the files is mostly performed by banking staff within the branches. Banks’ portfolios must therefore be clearly understood at a segment level (e.g. localization of business, industry, type of loan, financial indicators) and adequate guidelines and decision tools per clusters of risk are advisable to be defined centrally in order to promote implementation of sustainable actions across the portfolio.

### IV. Relevant and applicable insolvency and enforcement frameworks must be in place in conjunction with robust out-of-court restructuring practices.

- **The corporate insolvency regime was improved with the “2014 insolvency law”,<sup>18</sup> created pursuant to the recommendations and advice of the World Bank.** The ineffective and inefficient corporate insolvency regime prior to 2014 led to insolvent companies not being handled adequately and a high unattended stock of NPLs.<sup>19</sup> The new law includes best practices which are expected to improve speed and predictability, such as limiting the observation period to 12

<sup>15</sup> Source: Romania’s Financial Stability Report 2015, National Bank of Romania, 30 September 2015

<sup>16</sup> Refer to “Jose M. Garrido, Out-of-Court Debt Restructuring, World Bank Study, 2012” for more details on enhance restructuring and/or hybrid solutions to multi-creditor debt restructuring.

<sup>17</sup> Source of section: Romania’s Financial Stability Report 2015, National Bank of Romania, 30 September 2015

<sup>18</sup> Refer to “A Strategy for Resolving Europe’s Problem Loans, Technical Background Note”, IMF, SDN/15/19, September, 2015: ““The 2014 insolvency law significantly overhauled the insolvency regime, consolidated all insolvency related matters, and introduced ad hoc mandate proceedings (i.e., a confidential pre-insolvency debtor-in-possession procedure initiated by the debtor) and the concordat preventive (i.e., debtor initiated debtor-in-possession proceeding which includes a temporary stay and majority creditor voting) and the judicial reorganization and bankruptcy under one piece of legislation.”

<sup>19</sup> Idem at 13

months and introducing coordinating procedures for group companies.<sup>20</sup> Moreover, the creation of the National Union of Enforcement Officers aims at accelerating recoveries, simplifying rules, limiting appeals and reducing graft opportunities.

- **A new personal insolvency law has also been recently approved, but secondary legislation is still pending.** “The 2015 personal insolvency law introduces procedures namely the debt repayment plan and the asset liquidation (which can also be requested by creditors). It also establishes (regional and central) administrative committees for processes before court adjudication in order to screen cases for judicial processes. The law also includes a simplified insolvency procedure (debtors who have lost 50% of the work capacity or are eligible for retirement).”<sup>21</sup> Sufficient State budget and supporting infrastructures will be required to make this new law a success, with for example the need of a strong centralised network of personal insolvency practitioners (currently only for corporate loans) with adequate fee structures and specific training available.
- **While the new laws on insolvency in Romania are expected to speed up and clarify the resolution of insolvencies, there is still work required for the operational implementation of these new laws and to counter the shortcomings within the country’s court system.** According to NBR’s Financial Stability Report 2015, Romania has a greater frequency of company insolvency proceedings than other European countries<sup>22</sup> and demonstrates a lower efficiency than most.<sup>23</sup> The low efficiency of insolvency proceedings is also linked to the process being relatively lengthy.<sup>24</sup>
- **The success of the corporate and personal insolvency laws will prove critical in the next phase of NPL resolution,** which is likely to involve significant financial restructuring of bank debtors (corporations and individuals). Nevertheless, the impact of the legal changes will be felt over the longer term, given that a significant number of companies declared insolvent still fall under the scope of former regulations (out of 45.2 thousand insolvent companies in June 2015, only 26.4 thousand firms entered insolvency proceedings in January 2014 – June 2015). Consequently, the clean-up of unviable businesses and the reduction of NPLs via insolvency arrangements will most likely proceed at a slow pace.
- **Out-of-court workouts remain rare, with only a small portion of insolvency proceedings being annulled. Once in insolvency, restructuring of companies is also rarely used.** Only 5.9 percent of companies have entered into insolvency proceedings between January 2014 and June 2015 have been subject to a judicial reorganisation procedure. Usually only larger companies are restructured which present a lower level of indebtedness. Improvement with both out-of-court restructuring for cooperative borrowers and actual reorganization of companies when insolvency cannot be avoided will be essential to effectively tackling the broader NPL problem and limit potential contagion within industries. To ensure sustainable restructuring of the more complex companies, access to international independent restructuring experts may be required (at least initially) to introduce best practices to the market.

## **V. Tax structures must encourage adequate banks’ behaviours and stimulate the desired level of NPL transactions.**

- **Romanian banks already benefit from a 100 percent deductibility on provisions, without limit.** This is a best practice already prevailing which encourages banks to clean up their balance sheet.

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<sup>20</sup> “A Strategy for Resolving Europe’s Problem Loans, Technical Background Note”, IMF, SDN/15/19, September, 2015

<sup>21</sup> Idem at 16

<sup>22</sup> Creditreform Economic Research Unit, 2012

<sup>23</sup> Mihai, I. and Tarța, A. (2015) “The Role of the Insolvency Framework in Strengthening the Payment Discipline and in Developing the Credit Market in Romania”, Central Bank Journal of Law and Finance, No. 2/2015.

<sup>24</sup> According to the report *Doing Business 2016, Economy Profile 2016 - Romania*, World Bank, 2016”, recovery rate in Romania stands at 32.7% and time of recovery from insolvency is 3.3 years in average, compared to 2.3 regionally (Europe and Central Asia) and 1.7 for OECD.

**VI. The development of a sound and receptive private distressed debt market is essential to allow banks' deleveraging part of their NPL portfolios when necessary.**

- [The secondary market for distressed loan portfolios in Romania has gained some dynamic in 2014-2015.](#) New foreign and local firms specialised in recoveries have entered the market and successful transactions have been concluded. Local, regional and other international players have had an important and positive role in Romania and market participants expect that the market will continue to develop further in 2016 . This is promising and will be a condition to sustain investors' confidence that pricing gaps with banks can be bridged.
- [Predictability in the structure and timing of sales of distressed portfolios can support the development of the distressed asset market for some market segments.](#) For example, some banks have entered into medium-term agreements with specialized collection agencies, as well as a cooperative relationship between sellers and buyers, where data rooms are available prior to receiving indicative bids, ending with a transparent and frequent auction mechanism.
- [Pricing gaps remain difficult to assess.](#) Robust assessment of banks' loan loss provisions and understanding of the various factors affecting the market price of NPLs is essential to undertake realistic calculation of the "pricing gap" between sellers (i.e. banks) and buyers.<sup>25</sup> New and more robust rules regarding quality and frequency of collateral valuations are envisaged which may further narrow the difference in assessment of net present value (NPV) of relevant NPLs.
- [In a developing NPL market, such as Romania, it is essential to find a balance between protective measures to limit speculation and stimulating longer term investments.](#) Investors' confidence in Romania seems to have improved in the light of the recent and on-going NPL transactions in the market. Yet a number of measures that are under discussion in parliament could adversely impact the development of a market for distressed debt, as for instance the proposed minimum prices on the sale or re-sale of NPLs, limits on the recovery from re-sale of NPLs, or additional taxes on profits from these sales.

### 3. Conclusion and next steps

In recent years banks and the Romanian authorities have taken important steps to resolve the growing NPL overhang. This effort showed results in 2014-2015, as the most dynamic flow of new transactions in distressed loan portfolios in emerging Europe developed. There are still some obstacles in this market, including in the secondary market for NPLs. Transparency will need to be enhanced, including through an improved centralised data systems which would allow banks to better anticipate and manage risks. Market participants also need to develop skills to handle more complex asset classes, such as corporate portfolios.

Ultimately, loan sales are insufficient as a strategy to handle distressed borrowers. A more challenging phase in the NPL resolution process now lies ahead, which will require a different set of skills from banks, sustained investor confidence and participation of new players in the industry such as specialised corporate turnaround teams. Enhancing the process for out-of-court restructuring of viable but distressed borrowers must be a priority for both regulators and banks. In addition, banks' efforts in strengthening internal NPL capabilities, skills and operations must continue. Insolvency laws have seen a welcome upgrade but must now be consistently implemented, supported by qualified resources within the judiciary.

With these steps the Romanian banking system seems will be well poised to benefit from the now sound economic growth which is envisaged to bring further credit demand in time.

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<sup>25</sup> *A Strategy for Resolving Europe's Problem Loans, Technical Background Note* , IMF, SDN/15/19, September, 2015