THE IMPACT OF THE COVID-19 PANDEMIC ON NON-PERFORMING LOANS IN THE BANKING SECTOR

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When there are indications that the borrower is likely not to repay the loan or if more than 90 days have passed without the borrower having paid the agreed instalments, these loans are considered non-performing loans. This can happen when a person loses his job and therefore cannot repay a mortgage under the agreed conditions, or when a company is facing financial problems, which is common in the current situation. Thus, in the current conditions, an increase in the level of non-performing loans is inherent, in the absence of protection measures. In this article, there were analyzed the measures taken by the Central Banks of the European Union to mitigate the effects of the COVID-19 pandemic, the actions taken by the National Bank of Romania in this context, as well as the necessary measures to be taken further by credit institutions in order to preserve their capital and liquidity and implicitly for the management of the stock of non-performing loans.

Key words: pandemic; non-performing loan, banking sector, stability, risk.

JEL Classification Codes: M41, G30, L25.

1. INTRODUCTION

The Sars-Cov 2 pandemic broke out in an unpredictable manner and affected not just one country or a continent but the entire globe. This pandemic has been felt by most of the institutions and entities of the world, and has also made its presence felt including within credit institutions. This was primarily due to one of the main roles that a credit institution performs in society, which is to grant loans that allow companies to make investments and create jobs, and for individuals to purchase goods and services.

The Financial Stability Board published a report on 15th of April 2020 (ECB – European Central Bank), which showed that the banking system, including systemically important banks, was better prepared for the crisis than in 2008. The banking system absorbed macroeconomic shocks rather than intensifying them. The ongoing actions taken by governments and central banks have been aimed at providing liquidity to companies, in which the banking sector plays a key role. The scope of loans has been extended through decisions such as: reducing the interest rate, providing additional liquidity to the banking sector and reducing mandatory reserve requirements (FSB, Financial Stability Board, 2020).

A loan must be placed in the non-performing category when it becomes a certainty, so when its recovery becomes a problem for the credit institution or when the borrowing customers no longer provide conditions for repayment of the loan or the payment of interest, or both. The negative effects of this type of loans made it necessary to manage them separately, to be part of a portfolio of non-performing loans.

Non-performing loans affect credit institutions in two ways:

- Reduces the profitability of credit institutions, generating losses that reduce the income that banks obtain from lending activity.

- A bank with an excessive volume of non-performing loans cannot properly provide companies with the loans they need to make investments and create jobs. A situation in which a large number of banks are more widely confronted with this problem may affect the economy as a whole.

In this article, there were analyzed the measures taken by the Central Banks of the European Union to mitigate the effects of the COVID-19 pandemic, the actions taken by the National Bank of Romania in this context, as well as the necessary measures to be taken further by credit institutions in order to preserve their capital and liquidity and implicitly for the management of the stock of non-performing loans.

2. LITERATURE REVIEW

The banking sector is a critical component of any economy, without which it is impossible to restore the level of economic activity to the pre-pandemic state.

No one was really prepared for the effects of the COVID-19 crisis. After more than a decade of high and stable economic growth, banks have had time to accumulate enough reserves to prepare for the next recession. This is also supported by Schmieder et al. (2020) which states that the global banking sector has entered the COVID-19 crisis with an excess of own funds above the Pillar 1 requirement of around USD 5 trillion.

However, the need for additional assistance programmes to alleviate the economic pressure caused by the COVID-19 explosion and the inevitable economic recession has become a challenge for most countries in the world (Korzeb, Z., & Niedziółka, P.,2020).

Although many countries had experience of the 2008 economic crisis, the capacity of some countries to carry out large-scale aid programmes is becoming limited. The main reason being the high level of debt (Furceri and Zdzienicka, 2012 quoted in Korzeb, Z., & Niedziółka, P. (2020).

Korzeb, Z., & Niedziółka, P. (2020) stated in the article Resistance of commercial banks to the crisis caused by the COVID-19 pandemic: the case of Poland that the COVID-19 pandemic could become one of the most serious challenges that credit institutions will face, these being the main institutions that contribute to the granting of public aid.

Therefore, the stability of the banking sector is crucial in the context of the crisis affecting individual sectors, such as hotels, restaurants, transport, tourism offices, services, many industries, exhibitions, cultural, recreational activities, etc.

Goodell (2020) stresses that in times of crisis, the banking sector is vulnerable to the risk of a sharp deterioration in the quality of the loan portfolio and a massive withdrawal of deposits. This is also supported by Dev and Sengupta (2020), who, looking at the impact of the pandemic on India's banking sector, conclude that the risk of destabilisation of the banking system in question is amplified by the deterioration in the quality of the loan portfolio.

Research dedicated to the impact of the pandemic on the banking sectors in certain countries included an analysis of Nepal, carried out by Paudel (2020, quoted in Korzeb, Z., & Niedziółka, P.). The author pointed out that the banking sector belongs to the group of industries that suffered the most during the crisis. The situation is aggravated by a decrease in confidence in banks, manifested by an increasingly dynamic action of deposit withdrawals.

Selvan and Vivek (2020) also examined, but in a descriptive way, the impact of the virus on India's banking sector. Their study was based on data contained on websites and articles in economic periodicals. The authors concluded that the pandemic will force the process of digitalization of banking services to accelerate, it will result in a decrease in employment due to the reduction of sales through the traditional channels of distribution of banking products, but at the same time the big challenge will remain the protection of banking systems against cybercrime. This is particularly relevant given that 2018 proved to be a period of unprecedented losses of the banking sector due to cybercrime (Selvan and Vivek, 2020 quoted in Korzeb, Z., & Niedziółka, P., 2020).

The wave of non-performing loans expected to develop in the area of the banking system as a consequence of the COVID-19 pandemic, although it may not be too different in size from the one observed after the financial crisis (2008), is different in nature and will therefore require different remedies. This is also supported by Ignazio Angeloni, in his paper Non-performing loans: an old problem in a new situation (2021).

The National Bank of Romania specified in its report on financial stability of June 2020 that in the pandemic context, two severe risks of Romania's stability are stimulated, namely: the increase in global uncertainty and the rapid reduction of investors' confidence in emerging economies, respectively the deterioration of domestic macroeconomic balances, including from the perspective of the structure and cost of financing the budget deficit.

3. DATABASE AND METHODOLOGY

In order to carry out this study, various research methods were used, such as: analysis, synthesis, argumentation, comparison and inference. Thus, the study and analysis of the specialized literature, the presentation of the synthesis of the obtained results, the argumentation of the necessity of certain measures were carried out. The informational basis of the investigations is the analyses carried out on this subject by international organizations, such as: the European Central Bank (ECB), the European Economic and Social Committee (EESC), the European Banking Authority (EBA), etc., as well as the information available on the official website of the National Bank of Romania (NBR) on the measures taken in the context of the COVID-19 pandemic to ensure the stability of the banking system and the management of the credit stock non-performing.

4. RESULTS AND DISCUSSION

When there are indications that the borrower is likely not to repay the loan or if more than 90 days have passed without the borrower having paid the agreed instalments, these loans are considered non-performing loans. This can happen when a person loses his job and therefore cannot repay a mortgage under the agreed conditions, or when a company is facing financial problems, which is common in the current situation. Thus, in the current conditions, an increase in the level of non-performing loans is inherent, in the absence of protection measures.

In order to minimise this growth, the ECB (the European Central Bank) has repeatedly pointed out that, even in difficult times, banks must lend only to those customers who have the capacity to repay them. It also reminded banks to closely monitor risks in order to identify and address NPLs at an early stage.

Banks under the direct supervision of the ECB (European Central Bank) recorded over EUR 550 billion of non-performing loans (NPL) in mid-2020, which represents almost 3% of the total amount of loans granted. The value of non-performing loans has steadily decreased from the peak of around EUR 1 000 billion in 2016.

However, the economic crisis caused by the coronavirus pandemic is likely to generate a sharp increase in non-performing loans: In a severe but plausible scenario, they could reach levels of up to EUR 1 400 billion by the end of 2022. (ECB, 2020)

Non-performing loans (non-performing credits) are loans classified as inadequate loans, doubtful loans and non-performing loans (Hariyani, 2013).

The non-performing loans ratio is an important indicator in the analysis of non-performing loans.

This rate indicates the ratio between the nominal value of non-performing loans and the value of all loans, indicating the degree of deterioration in the quality of loans granted by banks. The higher it is, the lower the asset quality, and therefore the higher the expected losses.

The expectations of the NBR are to increase the rate of non-performing loans (NPLs), especially during 2021, as a result of the gradual elimination of the protection measures aimed at improving the effects of the pandemic (implemented through public and private motions), due to the uncertainties related to the economic recovery.

According to the results of the stress test exercise of the banking sector carried out by the NBR at the end of 2020, under the basic scenario, the NPL ratio would reach 9.2% in December 2021, respectively 9.9% in December 2022 (the assumptions of the exercise also take into account the operations of balance sheet cleaning as well a off-balance-sheet operations), what would lead to a repositioning of the indicator in the high risk category, according to the approach used by the European Banking Authority, as the NBR claims in the annual report for 2020.

According to a communique of the European Commission in Brussels on the area we are interested in, namely non-performing loans, the situation is as follows: after a gradual improvement in recent years, the NPL ratios in the EU (European Union) have experienced somewhat of a reversal of the trend due to the impact of the COVID-19 pandemic. The decrease in the European level of these loans, which started in 2014, was interrupted by the Covid pandemic, so from 2.6% at the level of 2019 they experienced an increase of 0.3%, reaching the level of 2.9% at the beginning of 2020 (Figure ne x).

This put an end to the overall downward trend since the fourth quarter of 2014. In the second quarter of 2020, the average NPL ratio for all EU banks remained at 2.8%. (Council of the EU, Brussels, December 2020)

It is vital to address the root causes of non-performing loans. The EESC (European Economic and Social Committee) stresses that the most effective ways to stop the accumulation of high volumes of non-performing loans are: constant efforts to improve competitiveness, a focus on ensuring business continuity and economic recovery, building strong social security systems, combating poverty, over-indebtedness and unemployment, guaranteeing adequate wages and implementing counter-cyclical measures of economic policy in times of crisis. (EESC, 2021) The EESC also argues that pre-COVID-19 NPLs should be managed in a very different way from non-performing loans after the COVID-19 pandemic (those caused by the pandemic) due to completely different circumstances before and after March 2020.

The COVID-19 pandemic has generated an increase in total gross loans and advances at UE[1] level according to Figure No. 1.

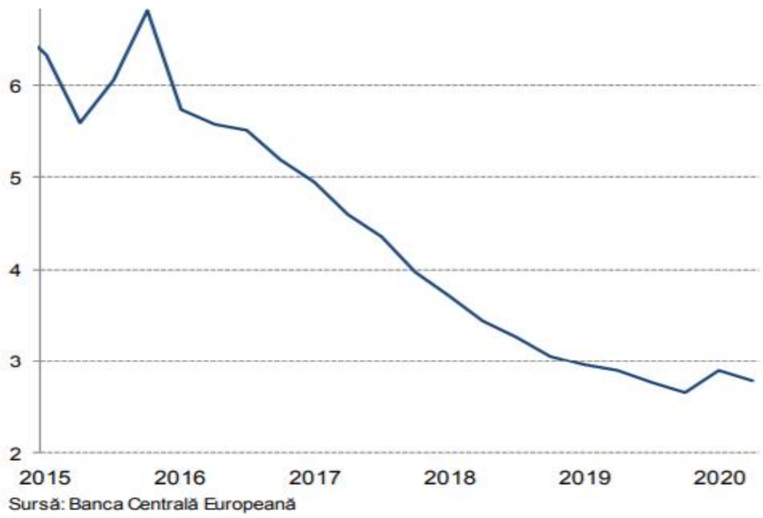

Figure no. 1 Total gross non-performing loans and advances at EU level

Source: European Economic and Social Committee

The decreasing trend of the NPL ratio, respectively of the restructured loans ratio, slowed down during 2020, amid the health crisis, but was favored by the moderate resumption of the balance sheet cleaning process, starting with the third quarter of the year, and the increase in lending. Asset quality indicators place the banking sector in the intermediate risk category according to EBA criteria (European Banking Authority)

The absolute value of non-performing loans (gross value) for all banks in the EU amounts to €588 billion (second quarter of 2020), compared to €585 billion in the first quarter of 2020 and €646 billion in the fourth quarter of 2019 (ECB, 2020).

In the case of Romania, we are talking about an increase in non-performing loans in the total loans granted from 4.4% to 4.8%, respectively a decrease in the provision for losses expressed as a percentage level in the total non-performing loans from 93% to 83.6%. This increases the risk to which credit institutions are subject.

Maintaining the stability of the Romanian banking sector, in the conditions of the COVID-19 pandemic, is both the responsibility of the National Bank of Romania, which has the responsibility to apply or relax various monetary policy instruments and supervisory measures, as well as in the responsibility of the management of each credit institution, depending on the decisions adopted and the impact of these decisions on the continuity of the activity.

Also, the Banking Supervision Body of Romania (NBR) B and the Romanian State decided to appeal, in addition to the measures related to the postponement of the loan repayment and the temporary use of capital buffers and other measures: the postponement by 3 months, with the possibility of extension up to 6 months, of the deadline for collecting the annual contributions to the bank resolution fund for 2020; The National Bank of Romania was obliged to provide banks with uninterrupted cash flows for all operations, including liquidity for ATMs,

[1] calculated as a percentage of total loans and gross advances, quarter-end amounts

in case of increasing household demand; the reduction of the monetary policy interest rate in two stages and other such monetary policy measures.

In order to increase market transparency at a granular level, the Commission considers that it would be useful to set up a data center at EU level. Such a center would function as the data warehouse that underpins the NPL market. The Centre would manage a comprehensive (regularly updated) electronic database, assess information and provide access to market participants, in particular credit sellers, credit purchasers, credit servicers, NPL sellers and private NPL platforms. The Center would provide a platform for cooperation and coordination with a pan-European scope. It would ensure that such cooperation/coordination complies with EU antitrust rules, in particular as regards the exchange of confidential information. (Council of the EU, Brussels, December 2020).

Addressing, as soon as possible, a new accumulation of non-performing loans on banks' balance sheets is the main lesson learned from the last economic crisis. Therefore, in September 2020, the Commission organized a roundtable discussion with public and private stakeholders on the approach of non-performing loans in the wake of the COVID-19 pandemic to discuss different elements that could constitute an effective strategy.

Based on the exchanges within this roundtable, the Commission considers that an effective strategy should focus on a combination of complementary policy actions to: (i) further develop the secondary markets for non-performing assets, which would allow for the exclusion of NPLs from banks' balance sheets, while ensuring adequate protection of borrowers; and (ii) reforming insolvency and debt recovery frameworks, ensuring an appropriate balance between the interests of creditors and debtors.

The sooner banks identify and establish provisions for potential NPLs, the faster and easier the process of resolving and disposing of NPLs will be, avoiding harmful late effects in the future. Credit institutions should also be encouraged to identify in advance the difficulties faced by borrowers and to engage proactively with the borrowers in a timely and appropriate manner in restructuring procedures where necessary.

In particular as regards companies, banks should develop their ability to promptly assess changes in their debt service capacities and to distinguish between liquidity and solvency needs.

The Chairwoman of the European Economic and Social Committee, Christa SCHWENG, states that the COVID-19 pandemic is just one of many external shocks. Many more are yet to come. Policy measures to limit the far-reaching damage caused by these massive shocks should be based on universal principles that stand the test of time.

5. CONCLUSIONS

In the context of the coronavirus crisis, the application of sound lending standards, as well as the proper risk management and proactive management of non-performing loans, are particularly important, as repayment situations are likely to generate a sharp increase after the lifting of the measures taken to combat this crisis.

To help credit institutions cope with the crisis and maintain their lending activity, the ECB has given them some flexibility, including in the classification of loans to viable borrowers who are only temporarily in a situation of difficulty. However, this flexibility must be vigilant so that this flexibility does not lead to support for non-viable borrowers and a delay in the classification of their loans as non-performing. The ECB also provided guidance to banks on how to deal with non-performing loans and on the establishment of appropriate provisions.

The coronavirus crisis has been an unprecedented economic shock, with many companies making significant efforts to keep up their business. Not all of these businesses will survive the crisis and not all borrowers will be able to pay off the loans they took out before or during the pandemic. The level of the stock of non-performing loans may register an ascedent evolution during the pandemic period.

To reduce this stock a credit institution may take one of the following measures :

• the establishment of sufficient provisions

• attempting to resolve non-performing loans by renegotiating the loan conditions (granting a longer period for repayment).

• Selling non-performing loans to investors, who usually request the application of a discount on their value.

When none of the attempts to find a solution are successful, for example because the debtor is insolvent, banks may resort to legal means to try to recover at least part of the funds.

In some cases, credit institutions may redirect their non-performing loans to a so-called bad bank. Such a bank is an asset management company, usually set up by government authorities for the specific purpose of resolving non-performing loans. These companies allow banks to remove non-performing loans from their balance sheet and to restore their lending capacity more quickly.

The asset management company then manages the recovery of borrowed funds, the sale of loans to investors or other operations (footnote).

During 2020, the activity of the Romanian banking sector was marked by vulnerabilities stemming from the COVID-19 pandemic. However, solvency and liquidity indicators as well as the financial performance of credit institutions in Romania continued to show comparable or better levels compared to European averages, giving a good shock-absorbing capacity.

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