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PHD THESIS ABSTRACT

THE CLIENTS' CREDITWORTHINESS AND ITS IMPLICATIONS IN THE CREDITATION PROCESS

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KEY WORDS: the client's worthiness, creditworthiness indicators, credit documentation, credit scoring, corporate rating, corporate governance, surveillance authority, credit portfolio, minimal compulsory reserves, specific risk provisions, the debt service, judicial procedures initiation, overdue debts, economic-financial performances, bankruptcy risk, quantitative indicators, quality indicators, SWOT analysis, liquidity, solvency, indebtedness degree, financing capacity, critical point, break even point, goodwill value, „A" type scores, non-financial signals, score functions, EBITDA, ROA, ROE, working capital, non-performing loan, collateral rating, enterprise treasury, CRB, CIP, banking interdiction.

INTRODUCTION

As the crediting activity has the main role in any banking institution it is necessary to study and analyze it through several stages at micro and macro-economic level. Studying this theme which refers to the banking activity risks in general and to the crediting activity in particular is even more interesting because the way of approaching it in all EU member states tends towards a common ground which is the Basel agreement II.

Starting from these premises, we considered important to choose a research theme which refers to the risks involved in the crediting activity, emphasizing the analysis of the clients' creditworthiness both in the crediting decision in order to take the credit risk and in determining the financial-banking performances, defining at the same time the relation risk-performance in the banking activity.

Given the complexity of the risks existing in the banking activity in general, and the credit risk in particular, the clients' creditworthiness represents a very important research area, considering the current development stage of the Romanian banking system and the attempts to adapt it tp the requirements imposed by EU through The Basel Agreement II.

The objectives of the research theme, presented in this paper, are orientated especially towards:

- **presenting models, techniques and procedures which allow the assessment of the financial situation and the performances of an enterprise ;**
- **presenting the system of indicators for the creditworthiness of companies ;**
- **the banking methods used for analyzing the bankruptcy risk**
- **non-financial methods for analyzing the bankruptcy risk;**
- **score functions for determining the clients' creditworthines;**
- **the place and role of the quality indicators in assessing the clients' creditworthiness**
- **the implications of the overdue debts upon the clients' creditworthiness**
- **valorizing the accounting information in the crediting activity through the assessment of the credit applicants' creditworthiness;**
- **formulating possible solutions for increasing the objectivity of the creditworthiness assessment systems, used by the credit institutions in order to be aware of the risks assumed;**
- **positioning Romania in relation to other member countries of the European Union regarding the way of approaching risks in the banking activity.**

The objectives mentioned above reflect the fact that the paper is an interdisciplinary research based on a fundamental element of outmost actuality which characterizes the banking activity and that is t *the risk* its purpose being mainly to emphasize the role and the importance of the clients' creditworthiness in credit risk management.

Studies concerning the clients' creditworthiness in the credit risk management can be found in works such as: "*Monedă şi credit* by T. Roşca, *"Metode şi tehnici bancare"* by I. Trenca, "*Gestiunea riscurilor bancare"* by L. Roxin, "*Management bancar"* by M. Stoica, *"Tehnica şi managementul operațiunilor bancare"* by I Mihai or *"Managementul riscului bancar"* by I. Nițu.

The case studies start from the financial statements, respectively the balance sheet and the profit and loss account of a company and **tries to transpose these elements in the analysis systems of the credit applicants' creditworthiness of the three banks in order to identify the risk preference or the risk aversion reflected practically by the permissiveness of the creditation norms.** These case studies comprise practically an analysis of the economic-financial indicators, but also an assessment of the quality side of the company in discussion materialized practically in including the future debtor in one of the financial performance categories which are regulated (from A to E). Based on the analysis of each set of quantitative and quality indicators and the comparisons made between the evaluation systems used by the three credit institutions, these could be classified in a growing order according to *the risk preference,* drawing a series of conclusions at the same time. As a result of these studies and conclusions, we try to propose the elaboration of a *system of measurable quality indicators* which should include such assessment elements as the seniority of the economic agent in that activity segment, the experience and the seniority of the shareholding and of the management, the history of the creditation relation and the debts to the state, the technology degree expressed by the age of the equipments etc. Through such a system we could at least diminish , although not fully eliminate, the subjective character specific to these quality indicators, giving more realistic credibility to the whole way of analyzing the credit applicants' creditworthiness.

At present, at the international level, the responsibility for maintaining under control the banking activity risks on the financial markets was redefined as a partnership between the regulatory institutions and those who act effectively on these markets. Also, lately, there have appeared the concept of *corporate governance* which plays an important part in evaluating and diminishing the financial risks through their efficient management under the circumstances of a partnership with precise roles in avoiding, diminishing and administering these risks. This partnership is made of the regulatory and surveillance institutions, the banks' shareholders, the Board, the executive management, the internal audit, the external audit and the bank's clients.

CHAPTER I

THE CLIENT'S CREDITWORTHINESS – THE CENTRAL OBJECTIVE OF THE CREDIT DOCUMENTATION ANALYSIS

The financial-economic analysis has various practical applications, referring to a large range of users, the financial standing, the financial diagnosis representing technical modalities for determining the client's creditworthiness in the creditation process.

At the basis of the above mentioned analyses there is an informational support[1] meant to contribute to a general diagnosis analysis. Here we can mention:

A. Status documents

B. Financial documents;

C. Other information ;

D. Business plan;

Other documents for the analysis of investments.

A very important stage in the analysis of the client's creditworthiness is *the initial checking of the documents* presented by the applicant in order to prove their *legal value* and to create a starting point for assessing the client's creditworthiness and then for the negotiation of the creditation terms.

The client's creditworthiness is a trustworthiness state and it shows the quality of the activity performed by the clients before and at present, which is assessed by the banks through a thorough financial and non-financial analysis.

The financial performances reflect the economic potential and the financial solidity of an economic entity, obtained from the analysis of an assembly of quantitative factors (economic-financial indicators calculated on the basis of the data from the annual and periodical financial statements) and also quality factors.

In the creditation process according to B.N.R. Regulation no.3/2009[2], the quantitative factors will refer mainly to the following indicators: liquidity, solvency, profitability, and risk, including currency risk, and the quality factors will refer at least to aspects related to the way of managing the economic entity, the quality of the shareholding, the collaterals (others than those accepted in order to diminish the exposure to the debtor), the market conditions under which it runs its activity.

Knowing the activity performed by the client[3] in the previous period of time, as well as the future forecasts, give the bank the possibility to offer them the adequate banking products and services, and on the other hand to take measures for diminishing and preventing the risk in order to recover the credit and cash the interests. Consequently, in order to protect its own funds and the attracted ones, the bank has the duty to select its clients thoroughly, because its

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[1] *M. Bătrâncea, L. Bătrâncea-Standing Financiar-bancar, Ed. Risoprint, Cluj Napoca, 2006, pag. 10-12*

[2] *Regulament BNR nr.3/2009 – M.O. 200/2009*

[3] *Clara Ursuleac – Riscul în activitatea de creditare a agenților economici – BCR, 2003 pag.5*

performances depend on the efficiency of the credits. The most valuable collateral for the bank should be the client's creditworthiness and not the material collaterals.

The most frequent calculated and used **creditworthiness indicators** are the following[4]:

- **current liquidity rate** $= \dfrac{\textbf{current assets}}{\textbf{current liabilities}} \times 100$

- **Operating margin** $= \dfrac{\textbf{operating profit}}{\textbf{turnover}} \times 100$

- **net margin** $= \dfrac{\textbf{net profit}}{\textbf{turnover}} \times 100$

- **indebtness degree** $= \dfrac{\textbf{borrowed capitals}}{\textbf{total assets}} \times 100$

- **current assets rotation** $= \dfrac{\textbf{turnover}}{\textbf{current assets (average salaries)}}$

- **stock rotation** $= \dfrac{\textbf{turnover operating costs}}{\textbf{average stocks}}$

Besides the economic-financial performances, another aspect that banks take into account in order to place the client in a certain creditworthiness category, is represented by the **debt service,** which defines the debtor's capacity to pay his debt at deadline, expressed as number of delayed payment days since the deadline.
Although this an assessment based on the past, it emphasizes the client's behavior in relation to the bank, the morality and responsibility he invests in this partnership.

According to BNR regulation no.3/2009, placing clients in creditworthiness categories according to the debt service is made as follows:

- the **"standard"** category in case the client does not have delayed installments or interests which are older than 15 days;
- the **"in observation"** category in the case the overdue installments and interests are paid with a delay of 16-30 days ;
- the **"substandard"** category in the case the installments and the interests are overdue with 31-60 days;

[4] *Ioan Trenca – Metode şi tehnici bancare – Ed. Casa Cărţii de Ştiinţă Cluj-Napoca 2002 – pag. 188*

- the “**doubtful”** category in the case the installments and the interests are overdue with 361-90 days;
- the **“loss”** category – the client has overdue debts which are older than 90 days and he is unable to honor his obligations.

CREDITWORTHINESS QUANTITATIVE INDICATORS

In the activity of financial programming, analysis and control of the financial phenomena from the Romanian economy we find 4 groups of indicators with specific destinations concerning the assessment of the firms’ financial[5] **creditworthiness:**

A. indicators of the financial situation of the companies

B. resource management indicators;

C. financial yield and profitableness indicators

D. indicators of the companies’ market value

THE ROLE AND IMPORTANCE OF THE NON-FINANCIAL ASPECTS IN EVALUATING THE CLIENTS’CREDITWORTHINESS

The non-financial aspects [6] refer to the client’s credibility as an essential psychological element that helps the bank develop convictions about the moral and professional qualities of the economic agents’management, of their reputation which is seen through the quality of their products and the way they fullfil their obligations towards their business partners.

The non-financial factors of the clients’activity can be:

1.Internal

2.External

The internal factors refer to:

a) The managerial quality (professional preparation, reputation, experience, the management structure, the quality of the informational system, the management rotation period, the succession etc.)

b) The shareholding structure

c) The quality of the client’s activity (the existence and the viability of the business plan, the activity character, the activity sphere, the market segment, the competitors, the relationships with the suppliers, the pricing policy, the human and material resources etc.)

d) The strategy (if it is realistic, achievable or with failure risk, the existence or lack of restructuring and financial recovery plans, achievement ways)

[5] *I.Trenca,Metode si tehnici bancare.Ed.Casa Cartii de Stiinta-Cluj Napoca,2002 pag.180*

[6] *T.Roşca – Monedă şi credit, Ed. Altipa, Alba Iulia 2001, pag. 224*

e) The history of the applicant's banking relations (the size of the client's turnovers through the bank at which he applied for the credit, the profitability of the past relations between the bank and the client, the existence of credits and contracts with other banks)

f)The volume, the structure and the liquidity degree of the collaterals received, the placement of the mortgaged goods (countryside or city,, central area or outskirts), the insurer's quality.

The external factors refer to the main forms which act in that field, the place of the client's activity in the general economic policy; the geographical position in respect to suppliers, clients, transportation means, the social characteristics of the dispatch market; the impact of the legislation upon tne client's activity etc.

Besides the financial analysis based on selective financial indicators, the non-financial analysis is also used more and more in the banking practice from our country. This has in view aspects which cannot be seen with the help of the value indicators but which can contribute to making the creditation decision, to the analysis of the client's creditworthiness.

CREDIT SCORING – A METHOD USED BY BANKS IN DETERMINING THE CLIENTS'CREDITWORTHINESS

For the creditworthiness analysis models to become relevant, Mireille Bardos considers that these must fullfill certain minimal conditions such as:

- „accuracy in the estimation of the probability and homogenity between the risk classes considered"
- stability in time for the risk classes
- the dependence of the risk size on the economic cycle;
- stability in the transition of the operation matrixes
- risk corellation

The group of methods resulting from this research is called *score functions* through which we assess the risk to which the investor, the bank or the enterprise are exposed in the future; there are two main categories:

- score functions based on financial reports ;

- non-financial methods for bankrupcy prediction .

The score functions basec on financial reports „represent external diagnosis methods which consist in measuring the risk to which the creditor is exposed, using report analysis"[7] or, as **Mark Schreiner** considers, represents „the quantitative measurement of the performances and characteristics of a credit in order to forecast the future performance of similar credits"[8].

The scoring methods were elaborated both abroad and in our country and there are several types:

A. Scoring models elaborated abroad: The „Credit-Men" method, The Altman model, The Conan-Holder, method, The Bank of France Model, The Yves Collongues Method, The French Commercial Credit Method and The Econometric Method.

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[7] Cristea Horia, Pirtea Marilen, Enache Cosmin, Determinarea situației financiare a întreprinderii. Studii şi probleme, Ed. Mirton, Timişoara, 2000, pag.132.

[8] Schreiner Mark, Credit Scoring for Microfinance: Can It Work?, Working Paper, Center for Social Development, Washington University in St. Louis, November 2000, pag.1.

B. Scoring models elaborated by Romanian economists: The Anghel model, The Băileşteanu model, The Ivoniciu model and the Statev model.

The bankruptcy risk analysis through type A scoring method – a proof of the importance of using non-financial aspects.

The bankrupcy risk[9] has been in the attentionof the researchers from the economic area and not only, as they have been trying to prevent companies'bankrupcy with the help of managerial methods.

The non-financial methods for predicting bankrupcy appeared as a necessity because as the business develops, the investors are interested in knowing their profit and loss chances.

In the '60-'70s, there were developed a series of models for estimating the bankruptcy risk based on financial reports and quantified coefficients through statistic determination methods.

In early '90s the conclusion was reached that not only the financial elements should be taken into consideration but also the non-financial ones such as: management, marketing, organizational culture etc. The most remarkable achievements in this area belong to Reynolds and Miller, Cooper, Lussier and Argenti.

However, in the banking sector, the commercial banks don not use any of the scoring methods illustrated above, developing their own versions, inspired from existing models, which differ from one bank to another.

The type "A" scores are concentrated on the **non-financial signals about the company failure.**

In the case of *Argenti* method it is suggested that an initial cause of the activity deterioration and bankruptcy is the bad management. Argenti considers that the so called material "dangers" will be found in the financial state of the firm.

Risk management

Flaws	Points
- Activity management a) the activity leadership	
-autocratic executive director	4 points
-the executive director is also the president of the company	4 points
-îeach manager is specialized in a particular field and does not collaborate with the other managers	2 points
-passive management staff	2 points
-poorly prepared financial manager	2 points
-lack of specialized vice-directors	2 points
b) in the accounting systems there are not or are insufficient	
- BVC control	4 points

[9] *I. Bătrâncea - Raportări financiare, Ed. Risoprint, Cluj Napoca, 2006, pag. 224, 225*

-the fund flow plan	4 points
-cost monitoring systems	4 points
c)adaptation to change	
-inadequate in matters of products, technology, markets, employees' experience, etc.	15 points
TOTAL possible flaws	43 points
Danger threshold	10 points
2. Risk factors	
-the increase of the activity volume above the real possibilities of the enterprise which determines the emergence of extra cash needs in order to expand sales	15 points
-unsuitable capital structure	15 points
-investments in too large or too many projects	15 points
TOTAL risk factors	45 points
Danger threshold	15 points
3. Bankruptcy symptoms	
-"Z" points deterioration	4 points
-creative accounting	4 points
-non-financial signals:	3 points
-the decrease of product quality;	
-sales reduction	
-other signals	1 point
-rumors	
-resignations	
-court actions from suppliers	
TOTAL possible bankruptcy symptoms	12 points
TOTAL flaws, risk factors and bankruptcy symptoms	100 points
Danger threshold	25 points

From the data above it results that a score up to 25 points inspires confidence in the enterprise indicating that its activity is proper.

CHAPTER.2

BANKING METHODS USED IN ASSESSING THE CLIENTS'CREDITWORTHINESS

- **THE ROMANIAN COMMERCIAL BANK'S METHOD**
- **THE ROMANIAN BANK FOR DEVELOPMENT'S METHOD**
- **THE BANCPOST'S METHOD**
- **THE RAIFFEISEN BANK 'S METHOD**
- **THE FOREIGN BANKS'METHOD.**

1. A COMPARATIVE STUDY OF A CLIENT'S CREDITWORTHINESS BETWEEN TWO METHODOLOGICAL MODELS AND RAIFFEISEN BANK.

In practice, the creditation policies of the credit institutions are very different, as they use a large range of quantitative and quality indicators in order to determine the potential clients' creditworthiness, reason for which an economic agent can be placed by different banks in different categories of financial performance, according to the rigor of the conditions imposed for granting credits.

In order to illustrate this aspect we can analyze an economic agent through different creditation conditions practiced by banks, emphasizing the different limits or the different indicators taken into account when determining the credit rating on the basis of quantitative criteria, but especially the different importance granted by the credit institutions to the qualitative criteria that can also be at the basis of the creditation decision.

To exemplify, we are going to analyze the case of a trading company with good reputation in its field, specialized in wood and construction material wholesale (code CAEN – 5153) in the country, which does not export, being considered eligible for certain credit categories.

The company shareholding is known by the bank for an average financial power, without existing any other information about the deterioration of its present situation. As its activity takes place only on the domestic market, the company does not enjoy international reputation. *The management* is ensured by the company's shareholders who have professional and managerial experience of less than 2 years. The management team, with average ability and experience, is elaborating a future business strategy, at the moment the company having only short-term objectives.

Taking into account the development of the construction field in our country, the company's development *plans and perspectives* are favorable, facilitating at least a relatively constant turnover, if not its increase, despite *the market conditions* which are considered relatively seasonable. The company owns an average *market share* having a concentrated portfolio of *clients and suppliers* of medium size and it has adequate infrastructure and production facilities. Over 50% of its turnover is achieved with maximum 3 clients, the number of suppliers who provide its products being also reduced (2-3 suppliers)

Concerning the extra *collaterals*, others than those accepted for diminishing the exposure to the debtor, the client is not willing to offer personal collaterals.

Concerning the *creditation history* the company has not registered arrears or credit restructuring until now, considered that it would have a good *reimbursement capacity* based on cash flow.

This would be a general description of the main characteristics of the company, of the shareholding and of the management, of the market conditions of its activity, of the business strategy, of the future perspectives and plans. Knowing these general aspects in detail is very important is assessing the *qualitative side* which is at the basis of establishing the client's financial performance.

In order to assess the *quantitative side* it is necessary to elaborate a more complex analysis based on financial indicators which is based on the data from the balance sheet and from the profit and loss account.

The study consists in determining the credit rating according to the actual corporate credit rating system used by in comparison with two methodological models that can be used by banks in order to diagnose the economic and financial point of view the enterprises which apply for credits.

The comparison has in view the normative model and two methodological models promoted in the modern credit risk theory.

Methodological variant no.1:

The quantitative criteria) used in order to establish the credit rating are:

Nr. crt.	Indicator's name	Calculation formula	Balance sheet elements/ CPP	Value	Score
1	Current liquidity	*Current assets* / *Current debts*	rd.9 / rd.11 balance sheet	1,05	8
2	Immediate liquidity	*Current assets – stocks* / *Current debts*	rd.9-5 / rd.11 – balance sheet	0,72	8
3	Solvency	*Current assets* / *Total debts*	rd.9 / rd.11+14- balance sheet	0,80	10
4	Indebtedness degree	*Total debts* / *Total assets*	rd.11+14 / rd.4+9+10- balance sheet	0,79	8
4	Profitability	*Net profit* / *Total assets*	rd. 29 or 30 / rd.4+9+10- balance sheet	0,09	8
6	Currency risk	-	-	0	0

The qualitative criteria used in order to establish the credit rating are:

- *The management quality,* more precisely the professional and managerial experience of the team expressed in years of seniority;

- *The shareholding quality:* the reputation they have in the local or national business environment and considering the information or the references about their capacity to sustain the company financially or to worsen the existing situation;
- *The quality of the commercial policies*, with an emphasis on the concentration on the company's suppliers and clients;
- *The market conditions* of the company's activity and the degree in which they can afford or not to increase their turnover;
- *The collaterals* received, others than those which are accepted to diminish the exposure to the debtor.

The credit rating is determined by summing up the scores between 0 and 10 granted to the quantitative indicators calculated, respectively between 0 and 8 for the qualitative ones. As it can be seen from the scoring grid, the quantitative criteria have a weight of maximum 60% of the final score while the qualitative ones were allocated a percentage of maximum 40%.

The connection between the calculated credit rating and the corresponding financial performance is presented below:

Credit rating	*Financial performance*
80 - 100	A
60 - 79	B
40 - 59	C
20 - 39	D
<20	E

In conclusion, the economic agent given as example registers *a credit rating 59,5 points*, corresponding to the *financial category performance C.*

Methodological variant no.2:

The objective factors used in order to establish the credit rating are expressed through the following indicators:

Nr. crt.	Indicator's name	Calculation formula	Balance sheet elements / CPP	Value	Score
1	General liquidity	*Current assets* / *Current liabilities*	rd.9 / rd.11 – balance sheet	1,05	5
2	Immediate liquidity	*Liquid assets* / *Current liabilities*	rd.9-5 / rd.11 – balance sheet	0,72	4
3	Equity rate (%)	*Equity* / *Total assets*	rd.32 / rd.4+9+10 balance sheet	20,48%	3

4	Interest coverage degree	*E B I T D A* *Interest expenses*	rd.64-65+62+63+46-45+44-31+30-23+22-20+19 / rd.46 - CPP	5,05	5
5	Indicator – currency risk	*Currency cash flow* *Turnover*		0	1
6	Economic profitability - ROA (%)	*E B I T* *Total assets*	rd. 64-65+63+62+46-CPP / rd.4+9+10 – balance sheet	14,4%	5
7	Financial profitability - ROE (%)	*Net profit* *Equity*	rd. 29 or 30 / rd. 32 – balance sheet	44,48%	5
8	Sales dynamics	*Turnover – year N* *Turnover – year N-1*	rd.1 (year 2008) / rd.1 (year 2007) - CPP	1,16	5

The subjective factors used in order to establish the credit rating are:

- *The industry characteristics*;
- *The company characteristics,* by analyzing the local market share, the production facilities, the infrastructure, the suppliers and the clients;
- *The shareholding and the management* emphasizing the quality of the shareholders, the management experience, the strategies and the achievements of the firm under the respective management;
- *The company's future plans and perspectives*;
- *The client's creditation history,* with special reference to arrears and credit restructuring

The correspondence between the credit rating and the corresponding financial performance is presented below*:*

Credit rating	*Financial performance*
4,20 - 5,00	A
3,40 - 4,19	B
2,60 - 3,39	C
1,80 - 2,59	D
1,00 - 1,79	E

In conclusion, the economic agent used as an example registers a credit rating of *4,08 points, corresponding to the financial performance category B.*

The Raiffeisen Bank Method

The quantitative indicators used in order to establish the credit rating are presented in the table below:

Nr. crt.	Indicator's name	Calculation formula	Balance sheet elements / CPP	Value	Score
1	General liquidity	*Current assets (Ch. in advance)* / *Current liabilities*	rd.9+10 / rd.11 – balance sheet	1,07	3
2	Solvency	*Total assets* / *Total debts*	rd.4+9+10 / rd. 11+14 – balance sheet	1,26	1
3	Current activity profit margin (%)	*Current activity profit* / *Operating incomes*	rd.33 or 34 + rd.50 or 51 / rd.10 – CPP	6,48%	1
4	Interest coverage coefficient	*Operating result* / *Interest expenses*	rd.33 or 34 / rd.46 - CPP	3,36	2
5	Equity rate (%)	*Equity* / *Total assets*	rd.32 / rd.4+9+10 – balance sheet	20,48%	1

The qualitative indicators used in order to establish the credit rating are:

- *The management quality* and especially the experience it proves, the business future strategy and the received collaterals (others than those accepted to diminish the exposure to the debtor);
- *The shareholding structure*

The correspondence between the calculated credit rating and the corresponding financial performance is presented below:

Credit rating	*Financial performance*
1,00 - 2,00	A
2,01 - 3,00	B
3,01 - 4,00	C
4,01 - 4,50	D
4,51 - 5,00	E

In conclusion, the economic agent taken as an example registers *a credit rating of 1,82points, corresponding to the financial performance category A.*

From the examples presented above we can notice the fact that the criteria used in assessing the financial performances of the credit applicants differ especially when it comes to *the qualitative factors* which by their nature are more subjective. Although all the three assessment variants grant the same importance to the qualitative factors in establishing the final rating, their weight being of 40% we can notice that the analysis made by Raiffeisen Bank is not so detailed as the first two. Thus, it uses only two assessment criteria: the management quality and the business strategy, correlated with the received collaterals, others than those accepted to diminish the exposure to the debtor, as well as the shareholding structure.

The methodological variant no.2 grants a bigger importance to the qualitative factors in assessing the client's creditworthiness making a more detailed analysis of the company characteristics, the shareholding and the management. Moreover, a very important criterion in assessing the reimbursement capacity of a potential debtor used by this credit institution is the creditation history, referring both to the results registered in the past and to the potential credit restructuring.

The analysis made according to the first methodological variant can be considered the most relevant in what concerns the qualitative factors, trying to assess as much as possible all the non-quantifiable aspects which, by their nature, are subjective. Thus the management quality was assessed through professional and managerial experience quantified through the seniority expressed in number of years. Similarly, the quality of the financial policies was assessed according to the concentration on suppliers and clients, expressed through their number and the weight they have in the turnover. Moreover, this methodological variant, like Raiffeisen Bank ,took into consideration the collaterals received for guaranteeing the credits, others than those accepted to diminish the exposure to the debtor, which are considered the second reimbursement source of any credit.

So, concerning the subjective side, the first two methodological variants proved to have a healthy creditation policy which aims at knowing the client more thoroughly and a more detailed analysis which is not limited by the aspects connected to the shareholding and the management as in the Raiffeisen Bank case.

Regarding the *quantitative indicators*, although mainly the same (connected to *profitability, solvency, liquidity and risk),* their calculation manner differs in some cases. The weight they have in the final rating calculation is 60% for all the three variants. Also we can notice that the first two variants use a very important *currency risk indicator* which is the degree in which the client is covered naturally for this risk, that is if he makes sufficient currency incomes when he wishes to get or already has credits in foreign currency.

Another relevant indicator for quantifying risk which is used only in the first methodological variant is the *indebtedness degree* which allows the bank to evaluate the firm's real possibilities to engage another credit according to the present amount of debts.

Also for quantifying risk the last two models calculate *the interest coverage coefficient*. As it is noticed, the calculation manner of this indicator is different. Thus, by determining the interest coverage coefficient from the operating result, this coefficient obtained by Raiffeisen Bank was lower, the bank proving to be more cautious than the second variant which used at the equation numerator the total result before taxation, depreciation and amortization a (EBITDA), and granted the maximum score in its assessment.

A similar situation can be observed in the case of determining and assessing the *liquidity*. Thus, while the first two methodological variants report the current assets to the current liabilities (with a maturity shorter than one year), Raiffeisen Bank assimilates the current assets and the expenses registered in advance. At the same time, we can notice that in the case of the same calculated financial indicator, the scoring grid is different. Thus, the general liquidity of 1,05 was granted 8 points in the first variant, out of ten, while the second variant offered it the maximum score. Raiffeisen Bank proved again the most cautious granting the general liquidity an average score of 3 points out of 5, which means that the company has the necessary capacity to transform its assets into available funds in order to face the short term debts.

Profitability or economic efficiency (ROA) also registers differences in the calculation formula and in the assessment grid in the first two variants which use these indicator to assess the client's creditworthiness. Thus, as the second variant uses a larger reporting basis (EBIT – the final result before taxation in respect to the net profit) it obtained a higher result (1,44 or 14,4%, in comparison with 0,09) and assessed the indicator once again with the maximum score. The second variant calculates additionally *the financial profitability (ROE) or the return on equity* allocating it also the maximum number of points. Through the value registered by the two indicators of assessing the economic and financial performance, we can draw the conclusion that the company has the necessary capacity to make profit from its entire economic-financial activity as a result of the invested capital.

Solvency, although determined differently, according to variant 1 (current assets/total debts) and Raiffeisen Bank (total assets/total debts), was assessed by both as very good which means that the company has a good capacity of transforming its assets into cash for paying all the debts.

The equity rate determined according to the second methodological variant and by Raiffeisen Bank, although the same (20,48% - result from the same calculation method), is assessed differently this time the second variant being more cautious as it assessed it with 3 points out of 5, in comparison with the maximum granted by Raiffeisen Bank.

From the analysis of the financial indicators calculated by the three variants we can draw the following conclusions:

- Although Raiffeisen Bank has proved to be more restrictive in assessing certain financial indicators (liquidity and interest coverage degree) than the other two, it finally placed the client the financial performance category A, because of the good assessment of the two qualitative indicators it used;
- The methodological variant A is considered the most cautious both for the quantitative factors where it was more strict in assessing liquidity and profitability than the methodological variant 2, and it assessed additionally at the risk factors category the client's indebtedness degree, and for the qualitative ones, where it tried to find as much as possible some objective criteria for assessing certain non-quantifiable aspects and eliminate subjectivity in their case.

In conclusion, by comparing the three models for determining the client's creditworthiness we cannot say that one is correct and the others are not. All we can say is that Raiffeisen Bank's creditation criteria are more permissive than the other two only for the qualitative factors, which proved to be decisive in this case, the proof being that the economic agent was placed in the financial performance category A through which it is exposed to a higher credit risk.

In comparison with this, the methodological variant 1 proved to be the most cautious both for the quantitative and for the qualitative side in particular, which proved to be the most efficient of the three variant analyzed, the same economic agent being placed in the financial performance category C.

The second methodological variant, although it benefits from the most complex assembly of economic-financial indicators, proved to be the most indulgent in their assessment. The qualitative indicators, although thoroughly analyzed with some assessment sub-criteria, maintain their subjective character. All these justify the placement of the analyzed economic agent in the financial performance category B.

Establishing the financial performance category based on the quantitative and qualitative assessment criteria stays at the bank's decision, being correlated practically with the attitude it manifests towards the risk. No matter if it is about a cautious credit institution a neutral one or one willing to take risks, the internal norms for establishing the applicants' creditworthiness must respect the minimal criteria imposed by the Romanian National Bank through Regulation no.5/2002 concerning the classification of the credits and investments, as well as the creation, regularization and used of the risk credit provisions with further modifications according to which[10]: "the quantitative factors will mainly refer to the following indicators there where they can be determined: liquidity, solvency, risk and profitability. The qualitative factors will refer to aspects related to the administration of the analyzed economic entity, the quality of the shareholding, the collaterals received (others than those accepted to diminish the exposure to the debtor) and the market conditions where it performs its activity"

[10] Regulamentul nr.5/2002 privind clasificarea creditelor şi plasamentelor, precum şi constituirea, regularizarea şi utilizarea provizioanelor specifice de risc de credit, cu modificările şi completările ulterioare, Cap. Clasificarea creditelor şi plasamentelor, art. 5, alin.2

CHAP.3

THE IMPORTANCE OF ASSESSING THE CLIENT'S CREDITWORTHINESS IN THE CREDIT RISK MANAGEMENT. THE REQUIREMENTS OF THE BASEL AGREEMENT II

THE CREDIT INSTITUTIONS APPROACH TO RISK EXOSURE THROUGH THE STIPULATIONS OF THE BASEL AGREEMENT II

The new Basel agreement has for objective to establish a more efficient framework for risk management and corporate governance for banks and implicitly the consolidation of the financial stability of the whole banking system.

The instruments for achieving this objective are structured on three pillars:

- Minimal capital requirements;
- The supervision process ;
- The market discipline.

The new agreement preserves the capital definition and the necessary minimum of 8% from the risk exposure but it perfects the risk evaluation methods.

$$\frac{\text{Total capital}}{\begin{array}{c}\text{Weighted assets}\\ \text{according to}\\ \text{the credit risk}\end{array} + \begin{array}{c}\text{Weighted assets}\\ \text{according to}\\ \text{the operational risk}\end{array} + \begin{array}{c}\text{Weighted assets}\\ \text{according to}\\ \text{the market risk}\end{array}} >= 8\%$$

Figure no. 1 – Basel I versus Basel II

BASEL I	BASEL II Pillar I	BASEL II Pillar II	BASEL II Pillar III
Rules for establishing the minimum capital level for covering: - The credit risk (The 1988 Agreement) - The market risk (The (1996 Amendment)	*Minimal capital requirements* - The credit risk - The market risk - The operational risk	*The supervision of the capital suitability* - The emphasis on the role of the supervision authority	*The market discipline* - Reporting requirements

Source: F. Georgescu, *Basel II - A new step for the modernization of the Romanian banking system*

THE IMPLEMENTATION OF THE BASEL II AGREEMENT IN THE ROMANIAN BANKING SYSTEM ÎN

The implementation strategy established by the Central Bank comprised **four stages:**

- ***Stage I*** – initiating the dialogue and exchanging information with the national entities (The Romanian Banks Association, The Public Finance Ministry, The National Commission for Movable Values) and international (other supervision authorities) involved in the Basel II process;
- ***Stage II*** – the development of the means for the supervision of the banking sector according to the standards imposed by Basel II, especially through:
- ***Stage III*** – the validation of the internal rating models of the credit institutions ;
- ***Stage IV*** – checking the application of the Basel II stipulations by the credit institutions .

The first three stages were successfully finalized between 2005 - 2006, the fourth stage started on 1 January 2007.

As any other change, the implementation of the Basel II Agreement has a series of positive aspects but also disadvantages at the level of the banking systems. Among the main *advantages* brought by Basel II at the level of the Romanian banking system we can enumerate:

- It monitors the specificity of each credit institution's activity and its risk profile;
- It leads to the development of the rating agencies market;
- It ensures the diversification of the methods concerning risk assessment and the establishment of the capital requirements from a simplified level to a sophisticated one;
- It determines the reduction of the capital requirements in the evolution context from a simplified approach to advanced ones:
- It stimulates transparency and market discipline;
- It involves the development of the human resources in order to:
  - Use efficiently the evaluation procedures of the rating agencies,
  - Develop the supervision process at the level of the Pillar 2 requirements;
  - Validate the internal models of the credit institutions by The Romanian National Bank.

Despite the advantages mentioned above, there are also *disadvantages*, the most significant one being the allocation of supplementary human and financial resources, costs which, on the medium term, are estimated to get compensation from diminishing the capital requirements.

THE NEW CORPORATE RATING SYSTEM AT RAIFFEISEN BANK- AN EXPRESSION OF THE BASEL II AGREEMENT STIPULATIONS

The new corporate rating system is elaborated according to the Basel II regulations concerning the internal approach to the rating system.

The corporate rating system is made of two sub-systems: the client's rating and the collaterals rating.

A corporate credit is usually defined as a company debt which can be reimbursed from the incomes generated from the company's basic activity. In this definition are included all the entities from the public sector for which we do not apply the criteria which are specific to the state credits.

In principle, all credits which are not covered by the definitions referring to the credits granted to the banks, the state and the physical entities are considered corporate credits.

1. The general system regarding the client's rating system

In supposes the calculation of six financial indicators, indicators which are then compared to the reference levels established for different industries and accounting standards, granting a rating (between 1,0 and 5,0). The six ratings are added an the sum is divided by 6.

The quantitative rating calculated in this way serves as a starting point for the qualitative analysis after which, considering a potential worsening or improvement, one gets the client's final rating.

2. Rating indicators

$$\text{1.Interest coverage} = \frac{\text{Profit before deductions with expenses and taxes (EBIT)}}{\text{Interest expenses}} \times 100$$

$$\text{2.Ordinary incomes margin} = \frac{\text{Ordinary incomes}^{11}}{\text{Total incomes}} \times 100$$

$$\text{3. EBTDA margin} = \frac{\text{Ordinary incomes + depreciation \& amortization}}{\text{Total incomes}} \times 100$$

$$\text{4.Equity rate} = \frac{\text{Equity– treasury shares– amounts owed to shareholders – goodwill} \pm \text{manual adjustment}^{1}}{\text{total assets-in execution production advances - off-balance sheet leasing} \pm \text{manual adjustments}} \times 100$$

[11] *Ordinatry incomes = EBIT + financial incomes– financial expenses*

$$5.\text{Asset turnover} = \frac{\text{Annual ordinary incomes + interest expenses}}{\text{total assets – in execution production advances - off-balance sheet leasing} \pm \text{manual adjustments}} \times 100$$

$$6.\ \text{Debt amortization period} = \frac{\text{Interest carrying debt– cash and bank deposits – short-term investments}}{\text{Ordinary incomes + depreciation \& amortization}} \times 100$$

3.Qualitative assessment

The new rating model comprises the following qualitative parameters:

- Property / Management
- Industry
- Business environment
- Financial flexibility
- The client's relation with the bank

THE CLIENT'S CREDITWORTHINESS – A CRITERION IN THE CLASSIFICATION OF THE CREDIT PORTFOLIO AND IN DETERMINING THE SPECIFIC CREDIT RISK PROVISIONS

The client's creditworthiness category determined by the correlation of the economic-financial performances with the debt service represents the basic criterion in granting and classifying credits.

The financial performance categories will be noted with A to E, in the decreasing order of its quality.

In the case of the debtors from the credit institutions sector, the financial performance goes directly in A category.

In the case of the debtors who are physical entities, the assessment of the financial performance[12] is made according to the criteria established by the credit institutions through internal norms, starting from the classification procedure of the clients based on non-reimbursement risk categories elaborated by them.

The evaluation of the financial performance of an economic entity outside the credit institutions will lead to its placement in one of the five financial performance categories. This

[12] *Regulament BNR nr. 3/2009, M.O. nr. 200/2009*

evaluation will be made according to the internal norms of the credit institutions based on scores given to quantitative and qualitative.

The creditworthiness indicators are calculated on the basis of the data from the financial statements of the economic entity, designed according to the regulations issued by the Public Finances Ministry or by similar competent authorities from other countries, and the financial performance category which is determined contributes to the establishment of the classification category for credits in the next month after the bank is presented the respective reports

In the case the banks find it impossible to evaluate the financial performance of a client who is a legal entity, outside those from the credit institutions sector, this will placed directly in category E.

The frequency with which we determine the financial performance category of an economic entity will coincide with the frequency with which financial statements are drawn up. In order to classify credits during the period comprised between drawing up two financial statements we preserve the last financial performance category which was determined.

- ***The client's creditworthiness a criterion in determining the specific credit risk provisions***

Determining the financial creditworthiness represents a method for analyzing enterprises through the risk they represent for the investor, for the banks or for the business partners, classifying the firms into good and very good financial creditworthiness enterprises, satisfactory and weak, as well as into enterprises which are exposed or not to the financial difficulties, eventually to bankruptcy

Another implication of the client's creditworthiness in the creditation process consists in determining the necessary specific risk provisions for a credit or investment which is achieved through the following stages[13]:

1. the classification of credits and/or investments:

1.1. identifying, from all the sums registered in the credit/investment accounts all the extracts which represent exposures from the operations with a certain debtor and for each exposure, the identification of all the other necessary attributes for making the provisioning operation;

1.2. the classification of these exposures by applying simultaneously the following criteria:

a) in the case of credit institutions:

-the debt service;

-the financial performance;

-the initiation of legal procedures.

b) in the case of non-banking institutions :

-the debt service;

-the initiation of legal procedures.

1.3. the re-classification of these exposures in one single category, on the principle of de-classing by contamination (we take into account the weakest individual classification category)

[13] *Regulament BNR nr. 3/2009, M.O. nr. 200/2009*

2.determining the necessary credit risk provisions :

2.1.optional stage – diminishing the exposures which are guaranteed as follows:

a)by deducing from the bank's exposure to the debtor the collaterals accepted in the case of a credit which is classified as "standard", "in observation", "substandard", "doubtful" and "loss ", in the situation there are not legal procedures in initiation or the sums of the respective credit register a debt service of maximum 90.

b)by taking into consideration of the whole exposure no matter the collaterals in the case of a credit classified as "loss", in the situation in which legal procedures were initiated or at least one of the sums of the respective credit registers a debt service which is longer than 90 days.

2.2.The application of the provisioning coefficient on the calculation base which is obtained.

3. re-taking stages 1 and 2 for all the other debtors towards whom the borrower registers exposures from credits/investments

Provisioning coefficients for each classification category

Provisioning coefficients / Credit/investment classification categories	Credits registered in currency granted to physical entities debtors exposed to currency risk	Credits/investments others than those from the previous column
Standard	0.07	0
In observation	0.08	0,05
Substandard	0.23	0,2
Doubtful	0.53	0,5
Loss	1	1

Setting specific credit risk provisions refers to their creation and it will be made by including in the expenses the sum representing the necessary level of specific credit risk provisions.

THE IMPLICATIONS OF THE CLIENTS'CREDITWORTHINESS IN DETERMINING THE INTEREST LEVEL FOR BANKING CREDITS

As the interest practiced by banks also comprises a measure of the creditation risk it is recommended that it should be differentiated according to the client debtor's financial situation and respectively to the risk category where the credit is placed.

In this context it is useful to operate with an adequate working instrument[14] which should allow the correlation between the interest practiced and the risk to which the bank is exposed by granting the credit.

It starts from a basic interest to which is added a risk margin expressed in percentage points which increases as the credit becomes more risky. In a way it is considered that the differentiated interest, which is calculated and then negotiated especially in the case of risky credits must play an inhibiting role, to diminish the credit appetite of the less cautious enterpriser through the high level of the price paid for the borrowed resource.

Such a working instrument can be conceived in the following way

Credit category	The perceived interest
Standard	Normal interest
In observation	Normal interest + 3 percentage points
Substandard	Normal interest + 5 percentage points
Doubtful	Normal interest + 10 percentage points
Loss	It is not credited

Considering that besides the direct earnings, which are immediate and quantifiable, comprising the interest and the charges, under the circumstances of increasing competition on the banking market, the importance of the indirect earnings increases, although they are not quantifiable and uncertain. Among these we mention the initiation or the perpetuation of the relations with the clients, the increase in deposits and of the demand for banking services. etc. **In this sense, we consider necessary that the banks, together with the periodical analysis of the clients' financial statements, should reduce the interest they established when granting the credit in the case the indicators which were at the basis of the credit and of the interest, have improved.**

We also consider it necessary that the banks should treat their clients as real business partners, not just like a source of profit; they should be informed both about the possibility of negotiating the interest, the conditions and the limits of this negotiation, this aspect being more theoretical, and about the total costs (DAE) that a credit involves.

[14] I.Trenca –*Metode şi tehnici bancare, Ed. Casa Cărţii de Ştiinţă Cluj-Napoca 2002,pag.192*

CHAP. 4.

THE MANAGEMENT OF THE DOUBTFUL CREDITS PORTFOLIO. THE IMPLICATIONS OF THE CLIENTS'CREDITWORTHINESS

THE DEPRECIATION OF THE CLIENTS'CREDITWORTHINESS A SIGNAL OF THE APPEARANCE OF INEFFICIENT CREDITS

It is difficult to predict when *the fall* of a company takes place. If we could project an anticipation mechanism for a company's failure then:

- Either the failure didn't take place anymore due to the corrective measures taken, which will give certainty about this thing;
- Or the prophecy fulfilled itself because the bankers would withdraw the creditation facilities.

The failure can be interpreted in many ways, depending on the problems that it involves or the situation the firm is confronted with, not necessarily the collapse and the dissolution of a firm.

The main cause of a company's failure is represented by ***bad financial management*** both for short term and concerning the impossibility of financing the investments from long-term sources. This aspect leads to exhausting the working capital, with the purpose of solving the activity flaws. There are multiple causes which can bring the firm in such a situation:

- The incapacity of recovering the liquidities from debtors;
- The withdrawal of loans;
- Investments in fixed assets used short-term finances and not being able to make immediate profit;
- The increase of stocks (voluntary or involuntary)
- Forced payment of credits in order to maintain the supply at the desired level and in order to preserve the confidence in the firm;
- The inability to limit the administrative costs according to the activity volume;
- Non-economical pricing policies.

The signs which can be identified from the study of the financial reports of a firm can be grouped in:

1. Easily identifiable signals :

- The massive increase of the creditors account (debts) which represents the incapacity to maintain the previous payment system;
- The substantial increase in stocks represents the incapacity to sell the products;
- The reduction of the available liquidities, so there are problems at the operational level (cost, production volume or price) ;
- The increase of borrowed sums for short-term can be a problem in the case of a fluctuating exchange rate;

- The increase of the borrowed sums for long term at a longer period of time and at fixed rates;
- The reduction of future investments – which is influenced more by the lack of liquidities than by the real needs of the activity;
- The reduction of paid dividends – a signal which warns about the lack of trust in the firm's future;
- The relation between the size of the accounts (creditors, debtors, sales, profit) can be suggestive. Taken separately, each means something, but together they can indicate the way in which the firm interacts with the market in the short term.

2. Hardly identifiable signals:

- Capitalization norms – tend to eliminate the costs from the profit and loss account and to re-introduce them at the assets on the balance sheet

A typical example is including the interest for the borrowed money in order to buy a building in the final value of the fixed asset, or recording the cost of the work made by the employees as an element which adds value to an asset and not as an expense.

The application of such norms brigs about the modification of the profit value because of the increase of the capital investments, perceived positively as investments in the firm's future. Thus, in the cash flow statement the first signals are represented by the operational costs, turned into capital investments in this case which are immobilized until finishing the building and making it work;

- Frequent re-assessments of the assets – in case of high inflation and trying to improve the situation presented in the balance sheet, we can make often re-assessments of the assets and as a consequence will increase :
  - The amortization costs;
  - The expenses with the local taxes for the budget;
  - The capital.

3. Signals which appear without warning

Several clues regarding the potential liquidity problems of a firm are deeply buried in the figures representing the totals of the accounts (advertising costs or marketing in general). The financial reports which are published contain well-known information, but certain problems come out only when the chartered accountants have to sign the financial reports, so usually they are the ones who force the emergence of the problem. Unfortunately many such events are disclosed much too late.

4. Signals, others than those in figures which announce the appearance of an inefficient credit:

- Rapid expansion of : the volume, the main accounts, the engaged capital;
- The incapacity to draw up in time the financial reports and the accounts situation;
- Slowing down the rhythm of the period of recovering the sums to be cashed in;
- Frequent production interruptions;
- Losing one or several important clients with a solid financial situation;
- Selling the assets outside the usual business framework;
- Speculative inventory acquisitions which do not observe the normal acquisition practice;
- Combining the functions of president and managing director, especially when these functions are also associated with a big stock of equity shares;
- Frequent resignations from the board;
- Changes in the conduct of key persons;
- Lack of experience;
- Selling shares which belong to the owner or the manager of the company

- Passing from asset acquisition to leasing;
- Autocratic management behavior.

5. Warning signals from inside the bank:

- Not respecting the credit contract;
- Too often credit applications;
- The scope of the credit is not clear ;
- Problems in obtaining the collaterals;
- Big cash withdrawals;
- Trials and legal problems with other creditors etc.

PAYMENT ARREARS, THE BANKING SYSTEM AND THE FINANCIAL DISCIPLINE .
THE PAYMENT ARREARS

It is considered that there is a direct proportion relation between the inefficient credits (either banking, or inter-enterprise) and the deepening of the economic problems.

The economic operators must grant special importance to the financial position in general; the financing sources, indebtedness policy, treasury flows, as these influence both the financial-economic performances and the service debt and finally the creditworthiness category.

Between arrears and the client's creditworthiness there is an interdependence relation as they generate each other that is the arrears determine the deterioration of the creditworthiness category and implicitly more expensive credits or the impossibility to contract credits, a fact which creates at its turn new arrears.

By arrears[15] we understand overdue payments which are not honored through a corresponding transfer in the time period stipulated by contracts and in the legal norms concerning the settlements between the economic agents : firms, banks, governmental bodies.

The arrears lead to blocking the monetary flow and the purchasing power, they cause economic-financial blockages and the de-correlation of the nominal economy from the real economy.

THE IMPLICATIONS OF THE PAYMENT ARREARS UPON THE CLIENT'S CREDITWORTHINESS

The banking arrears influence the debt service[16] through which we understand the debtor's capacity to honor the debt at maturity expressed in payment delay days since the maturity.

According to BNR regulation no.3/2009, placing the clients in creditworthiness categories will be made according to the debt service as follows:

- The "**standard"** category in the case the client does not have any overdue installments or unpaid interests which are delayed with more than 15 days;
- The **"in observation**" in the case the mature rates and interest are paid with a delay of 16-30 days;
- The "**substandard**" category in the case the mature rates and interests are delayed with 31-60 days;

[15] Gh.Popescu-Interactiunea real-nominal în dinamica economiei româneşti-Publicații www.bnro.ro
[16] Reg. BNR nr.5/2002, MO nr. 626/2002

- The “**doubtful**” category in the case the rates and the interest are delayed with 61-90 days;
- The ‘**loss”** category – the client has overdue payments delayed with more than 90 days and is not able to honor their obligations

The debt service is a special aspect of the analysis that the credit officer performs for the existing bank clients. Although it is assessed on the past, it emphasizes the client’s behavior in relation with the bank, the morality and the responsibility that he invests in this partnership realtion.

As a result of matching the economic-financial performances and the debt service the bank will finalize the client’s **creditworthiness category** according to the matrix below:

The debt service / **The financial performance**	**Standard**	**In observation**	**Substandard**	**Doubtful**	**Loss**
A	Standard	In observation	Substandard	Doubtful	Loss
B	In observation	Substandard	Doubtful	Loss	Loss
C	Substandard	Doubtful	Loss	Loss	Loss
D	Doubtful	Loss	Loss	Loss	Loss
E	Loss	Loss	Loss	Loss	Loss

THE IMPLICATIONS OF THE REDITED CLIENTS’S ARREARS UPON BANKS

The credit portfolio of a commercial bank. The specific provisions for the credit risk .

The banks try to balance their credit portfolios and implicitly the rapport between risk and profit by dispersing the loans in various fields to which they associate different risk characteristics.

The diversification principle shows us that the effective losses of a credit portfolio can be forecasted more precisely and can be diminished as the number of separate credits from the portfolio increases and it is spread on different types of business.

The appearance of the inefficient credits, but especially their growth in time, creates for the bank a series of unwanted financial implications, which are to be seen most often in the recording of artificial incomes in accounting, which are taxed in their turn, in diminishing the profit-generating creditation sources as a consequence of the assets created, in the creation of new bigger reserves and provisions which lead implicitly to the decrease of the profit, smaller dividends, even equity losses.

To avoid the above situations each economic agent who applies for a credit from a commercial bank will be placed in a credit category. These credit categories have a corresponding percentage quota of the risk provision which must be created, a quota which is applied to the whole sum representing owed credits and interests.

Provisioning coefficients / **Credit/investment classification category**	**Foreign currency credits granted to debtors, physical entities exposed to currency risk**	**Credits/investments others than those from the previous column**
Standard	0.07	0
In observation	0.08	0,05
Substandard	0.23	0,2
Doubtful	0.53	0,5
Loss	1	1

Starting with the application of the Regulations no.2/2000 and of the specific methodological norms, beginning with November 2000, it has become compulsory to classify the credit portfolio according to other two criteria: - a) the debt service; b) the initiation of legal procedures – considered as extremely important criteria for characterizing the client's capacity to honor the debts to the bank. The criterion "the initiation of legal procedures" refers to at least one of the following situations:

- towards the client debtor the court accepted the application for starting the judicial reorganization procedure or the bankruptcy procedure, or the patrimony forced sale, in the case of physical entities, the application being made by a third party;

- through a final court decision the credit contract as well as the collateral contracts were invested with executory formula.

Taking into account the relevance of these criteria for the characterization of the financial performance of non-banking clients who benefit from credits, in the systematic classification action the commercial banks use the following matrix:

Debt service	**Judicial procedures**	
(payment delays)	**Not initiated**	**Initiated**
0-15 days	Standard	loss
16 – 30 days	Observation	loss
31 – 60 days	Substandard	loss
61 – 90 days	Doubtful	loss
minimum 91 days	Loss	loss

The inefficient credits can be defined as those banking loans granted to clients whose economic-financial situation deteriorated from various causes cannot provide total or partial reimbursement of the credit and the payment of the interest and charges which are owed.

When credits become inefficient, they generate a series of problems such as:

1. **From the bank's point of view:**

a) profit decrease;

b) recording taxable artificial incomes;

c) diminishing the profit-generating creditation sources

In the banking practice the compensation of an inefficient credit cost is made through carrying on efficient credits.

d) the increase of provisions;

e) the decrease of equity;

f) the decrease of the patrimony by placing it off balance-sheet.

For maintaining the solvency, the sums representing the inefficient credits will be taken from the profit or from another bank asset.

2. **From the client's point of view:**

a) the decrease of the turnover;

b) the increase of debtors;

c) the decrease of the profit;

d) the decrease of the capitals;

e) the increase of obligations and the generation of bankruptcy.

3. **From the macroeconomic point of view**:

a) illiquidity;

b) problems in the economy branches and sub-branches

c) the limitation of international trade through the limitation of imports and exports

d) Monetary deregulations.

From the creditation practice we can see that the majority of inefficient credits are based on the manager's inexact knowledge about the business he started and a weak analysis of the business made by the credit officer.

The business plan must have the following content:

- The general presentation of the company.

This refers to: the legal form, the level of the capital, the name of the owners or the shareholders, the address, the activity object, the activity type;

- The presentation of the business – the risks of the business.

The promotion of an efficient business and implicitly of quality credits depends on the quality of the investigation that the bank makes about the applicant's credit base. The banks must assess the risks they have to deal with when crediting a business, to research the reason for the loan and to identify the reimbursement sources which depend on the development of the business they credit, so if the business is profitable and if it generates enough profit in the future in order to reimburse the loans.

- The market analysis

We analyze if: the market is saturated, growing/declining market segment, obsolete product, fashion, distribution, cost, transportation, competition, advertising costs, client portfolio (as number and reputation).

- The production process.

We check the way the production process is organized, the stages and the requirements for each stage (staff, surface, equipments, transportation means, materials, access ways etc.), manufacturing types (series, at request, seasonal), the production characteristics (special, standard), the technology and the technological processes applied, the time, the quality control, the quality cost, the energy cost, the equipment deterioration, environment protection expenses.

In order for a company to be efficient it must take the best decisions about production and dispatch, to dispose of an organization which will allow it o obtain maximum results.

- Financial information:
  The financial statements for the previous and current periods, the financial projections. The debtor's ability to give back the credit depends on the financial situation. On the basis of the business plan presented by the company they will use the **SWOT** analysis which means the identification of the following elements: Strengths; Weaknesses-; Opportunities; Threats. It is based on the investigation technique, respectively on questionnaires[17].

Finally, all the information obtained is grouped on analysis components, finding as relevant the internal and external factors which influence the activity development and emphasizing the strong points, the weak points, the future possibilities, the threats. The results of the analysis of the external factors is concentrated on political and legal aspects, economic ones (product demand, distribution channels, tastes and fashion, price levels, consumer income, the level of imports and exports, currency exchange rate, tariffs etc), social aspects and last but not least the use of efficient and environment protection technologies.

The essence of its application consists in the cause-effect analysis, and the quality of the diagnosis depends on the degree of identifying the problem-generating causes.

The credit officers will analyze the client's *creditworthiness* situation[18] on the basis of a system of structure and performance indicators. The balance sheet indicators are statistical factors based on accounting data at a certain moment. This is why, for a better assessment of a client's situation and for understanding their activity, we have to analyze these evolution factors in comparison with other clients from the same activity field. Banks manifest a big dependence in their decision for granting the credit on the creditworthiness indicators and the applicant's collaterals, but these indicators do not express the reality entirely, they should be just a business card for the company, and the collateral should be regarded as an insurance measure, not as a certainty for recovering the credit through its value. The collateral risk results from the bank's uncertainty about the possibilities to recover its debts from the last source it has after exhausting all the other ones.

The collaterals for the credits granted can be classified into two categories: ***a) real collaterals and b) personal collaterals.***

The real collaterals are characterized by the mortgage of movable or immovable goods of the physical or legal entities who apply for a credit, goods which, in the case the credit is not reimbursed, will be used by the bank in order to recover all its claims. The forms of the real collaterals are ***the pledge and the mortgage***.

The personal collaterals refer to the fact that a third party, a physical or legal entity, guarantees the loan contracted by the debtor. In the case the borrower cannot pay the credit back, the third party has the obligation to pay the debt from their patrimony.

The personal collaterals are materialized legally speaking in the written engagement made by a legal or physical entity, through which they compel themselves to execute the main debtor's obligation in the case the latter is unable to do so.

The personal collaterals have two basic forms: **the fidejussion and the guarantee.**

[17] Ioan I. TRENCA, *Metode şi Tehnici Bancare*, Casa Cărţii de Ştiinţă, Cluj-Napoca, 2002, p. 217.

[18] „Prin ***bonitate a clientului*** care solicită şi obţine un credit înţelegem *capacitatea financiară* a acestuia de a rambursa creditul şi a achita dobânzile datorate la termenele convenite cu împrumutatorul" [Vasile MARIAN, *Monedă şi credit,* Cluj-Napoca, 2000, p.263].

THE RECOVERY OF THE OVERDUE CREDITS OR OF THE LITIGATED ONES.

The recovery of the bank's overdue claims is made either through the payment of the due sums by the borrower from their own initiative or, on the contrary, they will apply *specific recovery procedures.*

The recovery of the overdue credits can be done in two ways:

a)– the friendly way; b) – the legal way

The legal recovery way

After exhausting all the friendly ways (but not giving them up) through a Credit and risk Committee's decision the credit will be taken to *execution debt enforcement*. This imposes that the bank will hand in to the Credit Service a client's file with the moderator's and the service chief's signatures which will comprise se a copy all the documents that are necessary for supporting the litigation (contracts, collaterals, the correspondence with the client etc.)

SUPPORT INSTRUMENTS FOR PRUDDENTIAL SUPERVISION AND FINANCIAL STABILITY

a) Banking risk central (CRB) represents a specialized structure in the collection, stocking and centralization of the information about the exposure of each declaring person (credit institution or real estate credit company) from Romania to those debtors who benefited of credits or/and engagements whose level exceeds the reporting limit (20.000 RON), as well as the information about the frauds with cards produced by possessors. The data base of the Banking risk central is organized in four registers:

1) **The central credits register** contains banking risk information reported by the credit institutions and it is updated monthly;
2) **The overdue credits register** contains banking risk information referring to the deviations from the reimbursement graphs from the last seven years and it is filled up monthly by the central credits register
3) **The debtors group register** contains information about the groups of physical or legal entities who represent a single debtor and it is filled up monthly by the central credits register.
4) **The card frauds register** contains information about the frauds with cards produced by possessors and reported to the credit institutions which is updated on-line.

b) The payment incidents central (CIP)

The Payment Incidents Central *is an intermediation center which manages the information specific to payment incidents, for the public interest, including the scopes of pre-defined users.* The specific data for the payment incidents are transmitted, diffused and valorized on the basis of the information from the records and which are occasioned by acts and facts having fraud, litigated potential and/or producing non-payment risks, including those which can affect the end of the settlement. The Payment Incidents central organizes and manages a general interest file called The National File of Payment Incidents which is structured as follows:

- **The National File of cheques FNC;**
- **The National File of bills of exchange FNCb;**
- **The National File of the promissory notes FNBO.**

The national file of the persons with FNPR risk is an automatically filled up file FNIP with major payment incidents registered on the name of a physical or legal entity, including the bank.

The data bases of the Payment Incidents central can be accessed 24 hours out of 24 and contain information referring to:

- The payment refusal for cheques, bills of exchange and promissory notes;
- The declaration of the lost, stolen, destroyed or annulled cheques and the declaration of the lost, stolen or destroyed bills of exchange and promissory notes;
- The physical or legal entities which have banking interdiction for issuing cheques.

The information about the payment incidents are kept in the database of the Payment Incidents Central for a period of seven years.

The payment incident represents not fulfilling in time the participants' obligations, before or during the settlement of a payment instrument (cherub, bill of exchange or promissory note), obligations resulting from the effect of the law or the contract which regulate them whose unfulfillment is transmitted to the Payment incidents Central by the declaring entities to protect the public interest. *The major payment* incident represents the payment incident determined by one of the following situations:

- In the case of cheques;
- The cheque was issued without the drawee's permission;
- The cheque was refused because of the lack of availability in the case of payment presentation before the expiry of the presentation term;
- The cheque was refused for payment because of partial lack of availability in the case of payment presentation before the expiry of the presentation term;
- The cheques was issued with a false date or it lacks an obligatory mention;
- The traveler cheque was issued to bearer;
- The cheque was issued by a drawer with banking interdiction;
- In the case of the bill of exchange and the promissory note;
- The bill of exchange was discounted without the total/partial existence of the claim created through its cession;
- The bill of exchange/promissory note with short rate maturity was refused because of total lack of availability, in the case of payment presentation in time;
- The bill of exchange/promissory note with short rate maturity was refused because of partial lack of availability, in the case of payment presentation in time;
- The bill of exchange/promissory note with a certain short rate maturity, at a certain time from the issuing date or at a fixed date was refused because of total lack of availability in the case of payment presentation in time; ;

- The bill of exchange/promissory note with a certain short rate maturity, at a certain time from the issuing date or at a fixed date was refused because of partial lack of availability in the case of payment presentation in time.

In order to decrease the risk in using the debit payment instruments, the banking institutions teach their clients about their use according to the laws and the regulations which are applied and they also close with the clients conventions concerning the immediate declaration of lost, stolen, destroyed or annulled instruments.

The banking interdiction[19] represents the regime imposed by a bank to an account owner through which he is prohibited to issue cheques for a one-year period, according to mutual engagements applicable to cheque payments, as a consequence of major payment incidents produced with the cheque.

[19] *A. Socol – Tehnica bancară, Ed. Casa Cărții de Ştiință, Cluj Napoca 2006, pag. 179-180*

CONCLUSIONS

The present paper, according to the research motivation, of the proposed objectives and the results obtained is focused around an element of maximum importance in the banking system and that is the analysis of the clients' creditworthiness in the creditation process, in the dynamic and diversified context of the present market economy mechanisms, treating the credit risk as a conscious assuming of the reality and trying to find the best practices in order to mange it successfully.

The financial analysis supposes a concrete analysis of the economic agent's creditworthiness based on indicators (liquidity, solvency, profitability etc.) and it is based on the financial information provided by the client (balance sheet, profit and loss account, trail balance, cash-flow etc.) ; on its basis the credit institutions will identify and quantify the client's performance risk, the liquidity risk and the risk related to the capital structure and financing. Apparently the client's performance risk presents the greatest importance to the creditor because it refers to the possibility that the debtor should not have a satisfactory performance, respectively should not generate acceptable profits which would ensure their own financing capacity and implicitly the reimbursement of the contracted loans. It must be retained as a fundamental principle the fact that any economic agent can survive for significant periods with low profits or even with losses, but he will never survive without cash. The capacity to pay the creditors and to honor their obligations at the due date has a special importance, because if this lacks the companies will head inevitably towards the payment incapacity, debt enforcement or/and liquidation/bankruptcy.

The degree in which a company had or will have the financing capacity to honor its debts and to cover the necessary investment expenses is the *cash-flow statement.* It offers vital information about the modification in time of the company's financial position, respectively the way the company is financing itself allocates funds that are mobilized.

Besides the cash-flow statement there are also other accounting synthesis documents – *the balance sheet and the result account*- financial statements which, through their role to reflect a true, clear and complete image of the patrimony and of the financial performance of an economic agent have a similar importance in assessing the applicants' creditworthiness. With the help of the financial statements we can identify the commercial links which exist between the members of a firm group, which must be granted a special importance in the analysis of a credit application because it represents a more important reality in the business area, but especially because it brings about risks connected with not respecting the credit destination, the purpose of these company being to grant each other help when the firms from the group are in difficulty.

The risk assessment should not stop at the mere analysis of the financial statements of a client, because these reflect a factual state at a certain moment, without forecasting the future of the business and which can be influenced by a series of factors, either internal, or external, This is why other aspects should be taken into account, which are different from the financial-accounting ones, in order to create an image about a future debtor.

Consequently the *non-financial analysis* comes as a confirmation of the results obtained from the financial analysis in order to clarify the question marks that remained and to obtain a more realistic image about a client. In this respect we also need an analysis on the quality of the management and of the shareholding, respectively of the ability and the experience in managing a business, but also the recognition and the prestige in the national and international business environment.

In the credit application assessment, the analyst must analyze the client in the context of the fluctuations of the economic activity, many economic agents being vulnerable to these. It is very important for the bank to know the clients' vulnerability to possible seasonal factors to structure their credits in such a way as these fluctuations of the economic conditions should be taken into account.

The credit officer must assess the client's development forecasts, to compare them with the perspective of the activity sector and to accept them only of the differences are justified. Also, he must consider the economic agent's strategy following the way of defining the objectives and their achievement stage.

These are only some of the qualitative aspects which can influence the future financial performances of a company and implicitly its capacity to reimburse the debts in the case of a credit. Despite the subjectivity that it involves it is desirable that the analysis of these qualitative aspects should not miss from the practice of the banking institutions. In order to be more eloquent and to give the possibility of making a more objective comparison the present paper tries to propose the elaboration of a qualitative indicators system for the credit institutions which will include assessment elements such as the seniority of the economic agent in the respective activity sector, the experience and the seniority of the shareholding and of the management, the history of the creditation relation and of the debts to the state, the technology degree expressed in the age of the equipments etc. Through such a system although we cannot eliminate totally, we could at least diminish the subjective character which is specific to these qualitative indicators offering a more realistic credibility to the whole creditworthiness analysis mode.

Moreover, any credit institution can contact other banks as well in order to find out what experiences they had with the respective client, they can find out if the payments were made in time, if the balance of the available funds and of the deposits were high, if there were payments delays and how long they were. The information referring to the overdue debits can also be obtained by consulting the databases of the Banking Risks Central and of the Credit Office.

It is considered that the main weaknesses in credit risk management are internal such as: bad file selection and improper internal supervision of the evolution (practically the involution) of the debtor's quality. This is why the credit institutions should be more careful when they approve a credit, by analyzing the maximum sum that can be granted to the client, the purpose of the credit, the collaterals he offers and the reimbursement possibilities, because the creditation decision coincides with the moment the credit risk is generated.

In reality, the importance given by the credit institutions to the quantitative and qualitative criteria in assessing the potential debtors' creditworthiness is different. Some put the emphasis more on quantitative factors, calculating a big number of economic-financial indicators for assessing the client's performances, taking into consideration even their evolution tendency in respect to the previous period. Others grant more importance to the qualitative factors which, also initially tend to offer a more subjective assessment, practically they ensure more detailed knowledge of the client's characteristics which cannot be quantified as a value or a percentage.

So, according to the importance granted by the credit institutions to the factors taken into account when calculating the credit rating for determining the financial performance, the same economic agent can be placed in different classification categories (from A to E), an aspect which was demonstrated practically in the paper though an example. This shows the fact that some credit institutions are more cautious, and others are willing to get exposed to a higher credit risk by accepting new clients with a less solid financial situation.

Analyzing the rating systems practiced by banks we can see an increase of the role of the non-financial analysis in selecting the credited clients, on one hand by considering a larger number of qualitative indicators, and on the other hand by the increase of the weight of qualitative criteria in the total weighted risk of the client.

For the qualitative indicators such as the quality of the collaterals and of the managerial act, the shareholding structure, the market conditions of the client's activity, the truthfulness of the accounting reports, the firm's strategy, the business seniority, the emphasis is more and more on placing the credit applicant in a creditworthiness category.

The importance given on a gradual scale to the non-financial aspects in the global context of the client's creditworthiness analysis depends on the prudence that the analysis manifests in managing the credit risk in banks.

The non-financial aspects usually have an impact on increasing the risk when the management quality is questionable or on becoming a safety factor when these mark in evolution considerable values increasing the certainty of a success in the partnership relation with the bank.

In our opinion it is recommended that under the circumstances of increasing competition the methodologies that the banks apply should contain more quantifiable non-financial aspects. The comparative study emphasizes the fact that the prudence margin and implicitly the creditation quality may increase if such elements are taken into account. Such an approach is in the context with the new requirements for perfecting the risk management in credit institutions as promoted in the Basel II Agreement.

Considering the banking practice from our country, in order to allow the emphasis of th real reimbursement possibilities as well as the interest and commission payment possibilities, the following are proposed in order to decrease the risk:

Using a set of indicators which differs for each activity sector and object, because the asset and capital structure differs from one sector to another.

Also, using the indicator "capital rotation" with its specific rates, expressed in number of rotations per year, is irrelevant in our opinion if it is calculated on the basis of the semester financial statement and not on the basis of the annual financial statements, or for the last 12 months because the asset volume is relatively constant during one year, and the turnover is calculated only for six months.

We also consider necessary to use increased rigor in the content of the credit files especially for the information quality, the reality of the financial statements, as in practice we encounter different financial statements for the "inland revenue and for the bank"

It is necessary to observe the "four eyes" principle required by Basel II and that is the person who calculates the rating must not be the same person who revises the rating. And ideally they should work in different departments. At least one of the two persons involved in the rating process must report to a member of the Board, respectively to the managing director who is in charge with risk management.

In order to diminish the economic-financial blockage and reduce the arrears we should generalize the modern forms of the commercial credit, simplify the settlement system, inject in the economy the necessary monetary mass in order to eliminate the arrears and the overdue claims.

In this sense we propose the setting of budget constraints (including bankruptcy) for bad payers, the legal and material liability with personal assets for the managers who managed in a fraudulent way the company assets in the disadvantage of the creditors, the modification of the law for the insolvency procedure (judge, receiver, assessor, DGFP representative, etc.), who will treat efficiently the firms which are in this procedure, taking into consideration the fact that by invoicing the delivered goods and services the crediting firms were registered with financial obligations, and according to art.138 art.138 from L.nr.571/2003 rep., in the case the counter value of the delivered goods and services cannot be cashed in because of the beneficiary's bankruptcy the adjustment of the taxation base will be allowed starting with the date when the court pronounced the decision L.nr.85/2006 concerning the insolvency procedure, which a final decision."

In order to protect the economic operators from the "non-recovery risk", which manifests more and more, we propose the creation of a site administered by ANAF through which will be published the economic agents who register arrears, both towards the consolidated state budget and towards the banking institutions and the trading companies, the value of these arrears, as well as the value of the immobilized and circulating assets.

Taking into account that the state institutions and the state-owned trading companies are the ones which generate most arrears, we propose as a short-term solution the compensation of the fiscal obligations of the economic operators (for whom the state perceives delay increases for not paying in time) with the sums they have to cash in from the state for the goods and the services delivered, although it is just a partial solution because often the firms which close contracts with the state have at their turn subcontractors who recover their claims with delays.

It is also necessary to find solutions for a an easier access of the economic operators at the compensation service from the Ministry of Economy, as they are frequently forced to appeal to consultancy firms in order to make the compensations and this involves big commissions.

Between the arrears and the client' creditworthiness there is a mutual dependence relation as they generate each other meaning that the arrears determine the deterioration of the creditworthiness category and implicitly more expensive credits or the impossibility to contract credits, which generates new arrears.

The economic operators must grant special importance to the financial position in general, to the financing sources, the indebtedness policy, the treasury flows, as these influence both the economic-financial performances and the debt service and finally the creditworthiness category.

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