

What Factors Underpin Bank Disintermediation and How Can We Stimulate the Lending Activity?

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Translated from Romanian by "Intartdesign" SRL

This publication has been funded by the British Embassy in Chisinau, through the Good Governance Fund. The content of this publication is the sole responsibility of the author and does not necessarily reflect the views of the British Government.

Defining the issue

Even though the 2014-2015 crisis from the banking sector has not been transposed into a significant recession of the Moldovan economy, it caused a strong uncertainty among banking institutions and the real economy. The crisis revealed the risky and fraudulent activity of some banks, the concentration of loans to high-risk economic groups related to shareholders, the flawed corporate governance or even high-level of political interference. This mix of elements proved to be extremely risky for the stability of the national financial system, and without the injection of public funds, i.e. taxpayers' money, the outcomes would have possibly been much more disastrous. Though initially the authorities aimed to stabilize the banking sector, especially its vital functions, the collateral effects of the crisis seem to emerge and materialize in the form of lower trust of business entities and the population in the perspectives of the national economy, and lower trust of banks in the quality and viability of investment projects.

Thus, part of the business entities did not initiate new investment projects and did not extend the existing ones due to their mistrust in the improvement macro-economic situation. On the other hand, inspired by the attractive interest rates on state securities at the end of 2015, banks focused their attention on less risky placements. This way, the lending process and the identification of new potential viable clients supporting a healthy lending activity respectively was pushed into the background. Consequently, the results of 2016 lending activity are quite modest with the stock of loans representing only 47.7% of the banking sector's assets. Besides, it is quite difficult to channel the liquidity surplus into the real economy. Moreover, amid these negative trends we witness a process of bank disintermediation, with a decline in the volume of granted loans to only 27% of GDP, while at least 16% of them are categorised as non-performing. At the same time, a crucial element of the lending activity is the low proportion of loans granted to SMEs – only 26%, while the large business entities account for over 56%. This also explains the business model of many banks that are oriented to a portfolio of corporate clients and low costs of loan management, without sufficient risk diversification.

In order to identify the mechanisms/tools that could be used by NBM, banks and Government to overcome this lack of confidence and resume the lending activity, Expert-Grup committed to facilitate the dialogue between commercial banks, NBM, experts and other stakeholders. *How we can stimulate the lending activity and bring back trust in the bank-customer relationship* study was developed for this purpose¹. This document focused on two subject lines. On the one hand, the study aims to identify the actual causes that fuel the bank disintermediation and the constraints that hinder the expansion of bank loans, on the other hand – to present solution how to foster this activity. In addition, in order to explore the actual situation, the *Questionnaire for Assessing the Lending Activity* was developed and sent to banks. This tool allowed forming a much clearer picture of the constraints affecting the demand and supply by types of loans. In the end, the results were discussed at a round table attended by representatives of commercial banks, Government, top management of NBM and other economic experts. The presence of all the stakeholders around the same table allowed to express the inside vision on this phenomenon **and this note comes to synthesize and to totalise the results of the actions conducted by Expert-Grup in order to identify the factors underlying the bank disintermediation and the solutions regarding the stimulation of lending activity.**

What factors hamper the expansion of bank loan?

Based on the results of lending activity by economic sectors and by bank entities, it is essential to identify the actual causes that hamper the expansion of bank loan, though the possible recommendations are based on their objective character. According to the aggregated results of the activities carried out by Expert-Grup on this topic, the main negative determinants on the demand of loans derive from the overall condition of the national economy that is affected by an inappropriate investment climate, lack of reliable information, pessimism in business environment and political divergences generating internal and

¹How can we stimulate the lending activity and bring back trust in the bank-customer relationship, Expert-Grup, 2017, <http://www.expert-grup.org/en/biblioteca/item/1380-cum-putem-impulsiona-activitatea-de-creditare-si-readuce-increderea-in-relatia-banca-client/1380-cum-putem-impulsiona-activitatea-de-creditare-si-readuce-increderea-in-relatia-banca-client>

external uncertainties. On the other hand, with the supervisory interventions and remedial measures taken by NBM in the largest banks in the sector, certain regulatory constraints, taken to reduce the risk appetite, decrease implicitly the supply of loans (e.g. reserve requirements, shorter grace period, upper limit for loan(s) granted to related groups).

Another element that decreased the demand for bank loans is related to the aggressive competition by client segments and the migration of demand to the non-bank loan (less regulated) granted by microfinance institutions, leasing companies or by individuals. The lack of prudential requirements and specific *know-your-customer* procedures puts these companies at an advantage, as they need less time to process the loan applications. As well, in contrast to the banking statistics, the poor quality of data on the loans granted by microfinance institutions and leasing companies distort the competition between them and banks on certain niches of customers.

However, a number of legislative acts hamper in a certain way both the loan granting and the loan recovery if the debtor fails to make payments. Thus, banks mention the tough provisions of the *NBM Regulation on Assets and Conditional Commitments Classification* and of the legislation on collateral and insolvency. The current model for enforcement and use of collateral generates additional costs for banks, which supplement the risk premium and determine the high interest rates on loans. Besides, the maximum term within which the pledged values can be transmitted into the lender's ownership is deemed unreasonable, which increases the final costs of the granted loans. This is very important, taking into account the banks' unwillingness to restructure the non-performing loans by potentially extending their duration or changing the contractual terms.

Moreover, the increasing portfolio of non-performing loans decreased the lending capacity of some banks, which are forced to practice higher bank margins and a risk premium that would cover the foregone revenue. This phenomenon represents the business model of domestic banks, most of which are oriented to big corporate clients that generate low costs of loan management, but without ensuring a sufficient distribution of risks. However, the non-performing loans reflect the state of national economy, while the current pro-cyclic prudential requirements are further reducing the appetite of banks for granting loans. As a result, banks are focused on safe placements in state securities.

Last but not least, the financial intermediation is affected by serious structural deficiencies. Although the banks accumulate surplus of liquidities, they continue to be relatively expensive, with short maturities and finally being unattractive for the real economy. In this respect, the issue concerning the maturity of financial instruments can be divided in two separate subjects: on the one hand – the reduced supply of financial instruments with a longer maturity, on the other hand – the lack of long-term financial resources from the population and other participants in the economy. In these conditions, banks seek to offer loans mainly for the working capital, which depletes businesses from liquidities and forms resources for possible investments.

What shall be done?

Once the main constraints hampering the banking intermediation are identified, in order to boost this activity and to ensure an efficient funding of the national economy, the authorities should intervene in a targeted manner, where appropriate. Thus, starting from the assumption that the level of loans in the economy depends not only on commercial banks, we find that achieving the proposed objectives requires the involvement and coordination of actions by key institutions with a decisive role in maintaining the stability of the domestic financial sector, as the banking crisis proved that the stability of the financial system largely depends on the stability and soundness of banks. Hence, the Government, NBM and commercial banks need to coordinate their decisions under the platform of the national macro-prudential body (currently the National Financial Stability Committee), which must facilitate the communication and coordination among members, exchange of information and promotion of actions to identify and manage the possible risks to the national banking system.

As regards the activity of commercial banks, including the lending activity, though being considered a private business that tends to regulate itself on the basis of free economy principles, the distortions generated during the crisis raise serious doubts regarding the sector's power of self-stabilization and self-regulation. Thus, according to the new international approach to financial stability, the sector's self-

regulation and the public policies should complement each other, and if they are not correlated properly the national authorities should monitor and intervene through policy adjustments. Hence, the role of the national macro-prudential body is to identify the main constraints hampering the expansion of bank loan, both at the bank and customer level, and to offer clear recommendations to responsible institutions regarding the adjustment of the regulatory and legislative framework or other actions that stimulate an efficient dialogue between the supply and the demand.

Based on the constraints identified by Expert-Grup, we believe that the proposed solutions should focus on three distinct directions, namely:

- 1. Solutions to lower the cost of financial resources, to extend the maturity and to develop new financial instruments;**
- 2. Solutions to remove and/or reduce the portfolios of non-performing loans;**
- 3. Solutions to optimise the regulatory and procedural framework for the banking activity, including the lending process (the legislation on collateral and mortgage, the regulatory framework of valuers etc.).**

Direction No 1 – One of the main deficiencies of the national financial system is the lack of financial resources with a longer maturity, even if banks accumulate surplus of liquidities, they continue to be relatively expensive, with short maturity dates and unattractive for the real economy. About 92% of the deposits attracted in 2016 are due in less than one year. In order to recover and develop, the system needs modern mechanisms and instruments, especially long-term financial resources that could support long-lasting investment projects. In order to ensure such resources, the system of private pensions, the bond market, and the investment funds should be developed, and/or bank deposits should be used as collateral and long-term securities should be issued. Given that the trade sector contributed the most to the decreasing loan portfolio, it is essential to resume lending to this sector, which could be driven by applying and promoting random lending tools, much more adapted to the commercial activity, such as bill of exchange, factoring operations, import/export loan, letters of credit and other instruments specific to "trade finance" area.

Direction No 2 – The persistence of a high volume of non-performing loans in the banks' balance sheets is an element that, to some extent, does not allow decreasing the interest rates on new loans. A high level of non-performing loans causes lower profitability, higher capital requirements and higher monitoring and recovery costs. In these circumstances, to obtain the expected profit from operating activities, banks are practically forced to apply a higher net interest margin to cover the foregone revenue due to non-performing loans. Based on the European practice after the 2008-2009 financial crisis, NBM and commercial banks could start cleaning the balance sheets aiming, at the first stage, at provisioning fully the non-performing loans and subsequently their removal from the balance sheet (record as losses or sell to specialised companies). The experience of states like Romania shows that these actions had a positive impact on reducing the interest rates, and increasing the bank's ability to lend and, respectively, on profitability and stability of the banking sector.

Direction No 3 – As for the regulatory and legislative framework related to the lending activity, especially the current model of enforcement and use of collateral generates additional costs for banks, which supplement the risk premium and determine high interest rates on loans. These costs could be reduced with the development of extra-judicial mechanisms that would allow enforcing the collateral through specialised licensed agencies, in accordance with the models of Romania, Georgia, France and United Kingdom. Also, the insolvency law should be amended so that the maximum period in which the pledged values can be transmitted into the lender's ownership be reasonable in terms of reducing costs for banks. At the same time, the Law about bureau of credit histories is an essential element allowing the banks to obtain online information about the potential customers. Another change involves granting the CB the right to obtain information from legal entities of public and private law about movable and immovable assets, observance of obligations to the national public budget, and enforcement of final and indefeasible court judgements. Besides, it is essential to include the microfinance and leasing companies in the list of CB participants in order to standardise the requirements for financial service providers.

Starting a dialogue between the supply and the demand of loans may be one of the most important elements for now. It is important to know well the expectations of customers and bankers with regards to the characteristics of loan supply and demand, and secure a dialogue between them. In this respect, it is important to develop surveys (questionnaires) among banks and among the population / business entities, describing and presenting everyone's opinion about the lending process (lending standards, terms, risks, expectations regarding the supply/ demand for loan etc.). Knowing this information, both bankers and bank customers will be able to give an objective assessment of the overall lending situation, and NBM could form a much more objective image about this process, adjusting its respective policies and intervention tools. To support this process, the *Questionnaire for Assessing the Lending Activity of Commercial Banks*, developed by Expert-Grup, is presented in Annex 1. This tool can be used to improve the image of lending activity, by focusing on the constraints both related to the supply and demand.