Romania RIA Knowledge Transfer and Capacity Building Program

Regulation no. 3/2007 on restriction of the credit risk on credits granted to individuals

Policy Recommendations

Stakeholders consulted

National Authority for Consumer Protection
Commercial bank
Non banking financial firms

Team Composition

Participant	Authority
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Executive Summary

The Romanian regulators are participating in an initiative organized by World Bank's administered *Convergence Program*. The purpose of this initiative is to strengthen the participants' ability to use the disciplines of impact assessment (IA) in order to improve the way in which policy is made. IA does this by requiring policy makers to use evidence and economic analysis to justify and explain their proposals. Consultation with stakeholders is a key part of the IA process because it promotes public accountability and provides stakeholders with the opportunity to contribute to the evidence base that should underpin the policy making process.

The participants of this knowledge transfer and capacity building program are the following: National Bank of Romania (NBR), Prime Ministry's Unit, Ministry of Economy and Finance (MEF), National Securities Commission, Insurance Supervision Commission, Commission for Supervision of Private Pensions System and National Authority for Consumer Protection.

This IA training exercise involves the work group undertaking a retrospective IA on an existing piece of financial regulation. In this case, the financial regulation is the NBR's *Regulation no. 3/2007 on restrictions of the credit risk on credits granted to individuals*.

Section I – Procedural issues and consultation of interested parties

One phase of the Impact Assessment Exercise on the above mentioned regulation was represented by the consultation process which consisted in gathering the opinions of the key stakeholders affected by this piece of regulation.

The working group prepared a Consultation Questionnaire (Annex 1) and sent it to the stakeholders. The questionnaire was designed to provide evidence relating to: the nature of the problem that the regulation is seeking to address, and the costs and benefits incurred to banks and consumers taking into consideration four options.

The participants to the consultation process that filled-in the questionnaires were: one commercial bank, two non-bank financial institutions and the National Authority for Consumer Protection representing the consumers.

The working group summarised the results of the filled-in questionnaires (Annex 2 - Summary of Questionnaire Results) and elaborated the Consultation document to be discussed in the consultation meeting (Annex 3 - Consultation Document). Representatives of consumers and non-bank financial institutions took part at the consultation meeting and the conclusions ware gathered in the Summary of Consultation Feedback (Annex 4).

Section II – Problem identification

The working group suggested that there were two distinct elements to be considered:

a) the repeal of the 2005 regulation, and
b) the introduction of the 2007 regulation.

The 2005 regulation needed to be repealed because of EU competition. The NBR's 2007 regulation was introduced in order to:

- manage the potential market failure consisting in improper management of credit risk and:
- to ensure financial stability.

The stakeholders agreed that the **problem** was the above mentioned one. However, they raised some issues:

- the new regulation does not create a sound competitive market for credit institutions;
- consumers' interests seemed not to be taken into consideration.

Taking into account the possibility that the policy concerns that gave rise to the 2007 regulation could **have been corrected by the market in the short term**, stakeholders' opinions were the following:

- The market would have corrected some of the concerns, but it is hard to estimate if this would have happened on short or medium term.
- An intervention was needed, but the 2007 regulation's approach was not appropriate.
- Credit restrictions, such as imposing maximum credit limits had unintended consequences on the financial market, and, consequently, a negative impact on consumers.

- Credit restrictions are limiting the growth potential, and are affecting low income people's capacity of dealing with temporary difficulties, when they need small amounts, on short term.

- Maintaining credit restrictions affects the process of credit sector liberalization and does not lead to the results expected. Furthermore, statistical data show that economies without credit restrictions operate more efficiently than the ones where such restrictions exist.

Section III – Objectives

The working group identified the following objectives:

- **general objectives:**
  - the financial stability; and
  - the proper functioning of the credit sector.
- **specific objectives:**
  - developing responsible lending practices; and
  - provide enhanced access to credits to specific categories of clients.
- **operational objectives**:
  - banks' internal norms shall provide: specific rules regarding the risk profile of the clients, the eligible categories of clients, rules setting out the eligible incomes and the deductible expenses, the main criteria the internal norms should be based on; and
  - the NBR's validation process of the lenders' internal norms.

Section IV – Policy Options

1. Do Nothing Option - Maintaining the provisions of Norms No. 10 of July 27th, 2005 on mitigation of the credit risk related to credits granted to individuals. There would have been maintained restrictions imposed by NBR, the banks could not develop their own policies in this field.

2. Option 1 – The new Regulation no. 3/2007 on restriction of the credit risk on credits granted to individuals. The provisions of this new regulation included:

- responsible lending principles based on consumers' risk profile and risk management;
- no specified levels for indebtedness (lenders shall provide their own levels within their internal norms for each category of clients);

- the maximum indebtedness level is differentiated among eligible categories of clients; eligible category shall be assigned for each client based on default risk;
- categories of deductible expenses: at least living expenses and payment obligations other than credit agreements.

3. Option 2 - Self Regulation (e.g. A Voluntary Code elaborated by Lenders Professional Association).

4. Option 3 – Bring amendments to Norms no. 10 / 2005 in order to keep uniform limits at the level of all financial institutions, but at the same time, adjusted to different categories of consumers (incomes).

Section V – Analysis of qualitative and quantitative impact

Taking in consideration the options outlined before, the related impacts in terms of **costs and benefits** were identified and described by the stakeholders. The relevant issues are summarised in this section.

1. Do Nothing Option

Costs to regulated banks

The implementation of the old norms had some unintended consequences that caused distortions on the market:
- Lending on longer terms (to ensure that the monthly repayment rate is under the maximum limit), with a negative impact credit risk;
- Bureaucracy - reference point 100;
-Asymmetric impact – especially on NBFIs – some are treated like banks;
- Some market segments (low income) could not be served;
- Limited offer for high income market segments.

Benefits to regulated banks

Theoretically, there was a lower credit risk because of the maximum indebtedness levels, but has to be taken into consideration that banks did not report positive information.

Market impact

This option created an unfair competitive environment for NBFI's, who were treated like banks, even though they can not be compared to banks in terms of assets (NBFIs are not allowed to attract deposits) or in terms of portfolio of products.

- Quality of products offered:
    - ❖ Banks: low

- Consumers: low

- Variety of products:
  - Banks: low
  - Consumers: low
  - NBFIs: low
- Efficiency of competition:
  - Banks, Consumers, NBFIs: low

<u>Costs to consumers</u>

- Limited consumers' access to lending; - A shift of costs from interest rates to loan fees and commissions;
- Favored lending on longer terms, which increased the costs for the consumers;
-Low income consumers were excluded, which encouraged illegal lending;
- Low competition meant higher costs to consumers.

<u>Benefits to consumers</u>

- The lending limits could protect consumers against over-indebtedness:
  - Banks: No, as long as there is no nationwide database
  - Consumers: Yes
  - NBFIs: Yes

<u>Unintended consequences</u>

- Negative consequences:
  - Limited the access of consumers to mortgage loans (the regulated 25 % downpayment)
  - Limited the access of medium and high income customers to loans with higher value.
- The unintended consequences of the old and current credit restrictions in Romania are:
  - Lending on longer terms, with a negative impact on costs and credit risk
  - Financial exclusion of low income categories
  - Anti-competitive market.

<u>Impact on competition</u>

- All the non Romanian banks (branches of foreign banks) will not be legally bound to observe the NBR regulations, and will grant loans according to their mother bank risk policy. Competition on the market is affected.
- NBFIs should not be subject to the same regulations as banks, as they do not compare to banks in terms of assets (NBFIs are not allowed to attract deposits) or in terms of portfolio of products.

<u>Social impact</u>

- Categories of consumers on low income are financially excluded, which could encourage illegal lending.
- Prices of houses could not increase too much, because customers were not able to access large value loans.

2. Option 1

<u>Costs to regulated banks</u>

- Compliance costs (elaboration of internal norms, IT costs, training and personnel costs, validation costs):
    - ❖ Banks: 21.800 EUR
    - ❖ NBFIs: 43.200 EUR.
- Bureaucracy – 200 (one-off); 100(ongoing).

<u>Benefits to regulated banks</u>

- More responsible lending.
- Risk management improved.

<u>Market impact</u>

- Quality of products offered:
    - ❖ Consumers/NBFIs: medium
- Variety of products:
    - ❖ Consumers/NBFIs: low
- Efficiency of competition:
    - ❖ Consumers: medium
    - ❖ NBFIs: low

<u>Costs to consumers:</u>

- ❖ Limited consumers' access to lending (for customers with monthly income below 350 EUR and supporting a family of at least 3 members)
- ❖ Difficulties when comparing the credit offers
- ❖ Lending costs will increase (due to implementation and compliance costs)
- ❖ Lower income consumers will be disadvantaged because of taking in consideration the deductible expenses (living)
- ❖ Meal tickets are not considered as a part of the monthly income, even if these instruments are fully regulated.
- ❖ Consumers would need to use more resources (time, the documents needed to obtain the credit could vary very much form one bank to another, own rules of banks could become stronger) in order to gather information and to obtain the credit.
- ❖ Banks will probably try to compensate the shrinking of the customer base with higher fees/commissions (not necessary higher interest rates) applied to loans.

<u>Benefits to consumers:</u>

- ❖ Improved access to lending for certain categories of consumers;

- Wider range of products.

Unintended consequences

- It will take time for consumers to familiarize with the new rules.
- Low to medium income customers will get no or less credit than under the previous regulations. Prices of houses may increase.
- Significant distortions in the market due to:

- timing differences between the registration of certain NBFIs with the Special Register (and hence the application of the crediting constraints);
- the existence of two level of supervision for different players (those in the Special Register and those in the General Register)
- the existence of other passporting EU firms which do not fall under the NBR supervision.

Impact on competition

- On one hand it would increase competition between Romanian credit institutions, on the other hand, it would determine the distortion of competition between Romanian credit institutions and other passporting EU firms which are not subject to the regulation.
- NBFIs shall no be subject to the same regulations as banks, as they do not compare to banks in terms of assets (NBFIs are not allowed to attract deposits) or in terms of portfolio of products. The current regulations are discriminatory also because NBFIs in the Special Registry have to comply with stricter rules that those in the General Register. The passporting rules are likely to increase unfair competition, because credit restrictions do not apply to the NBFIs set up in Romania by credit institutions based in other EU countries.

Social impact

- The over indebtedness of certain customers, bad debts followed by debit execution.

3. Option 2

Costs to regulated banks

- Compliance costs to regulated banks.
- Significant resources (people, systems, processes) engaged in the elaboration process, that will be reflected in credit costs.
- For responsible lenders, lower costs than implementing mandatory legal provisions – this is already a benefit

Benefits to regulated banks

No estimation provided.

Market impact

- Quality of products offered:
    - ❖ Consumers, Banks: medium
- Variety of products:
    - ❖ Consumers, Banks: medium
- Efficiency of competition:
    - ❖ Consumers, Banks: medium

Costs to consumers:

- ❖ Lending costs could increase, but, at the same time, if competition increases, then this could be surpassed.

Benefits to consumers:

- ❖ Diversity of products.
- ❖ A more customer oriented approach may be taken, more related to credit risk assessment and credit behavior.
- ❖ Banks may develop special loan products for customers with smaller incomes, if the credit behavior assessment would score a good mark (risk scoring, positive data from credit bureau, etc).

Unintended consequences

- ❖ Distortion of competition: lowering the level of protection of consumer against over-indebtedness;
- ❖ Loan values can be adjusted according to the individual income and risk management;
- ❖ Some banks may risk too much, breaking responsible lending practices, in order to gain market share at any cost;
- ❖ Regulation in itself is not 100% effective in preventing companies from breaking or bending the rules. If NBFIs agree to a strong code of practice, there is actually less chance of an individual company breaking it. A code of practice could cover all NBFI's.
- ❖ Romanian market and consumers are not prepared for a Self Regulation at the moment.

Impact on competition

- ❖ This option would ensure a fair market for all the players: Romanian credit institutions, European credit institutions

Social impact

- ❖ This option is the least likely to exclude socially disadvantaged individuals.

4. Option 3

<u>Costs for regulated banks</u>

Option 3 would have not been significantly different from Option 1

<u>Benefits for regulated banks</u>

No estimation provided.

<u>Market impact</u>

- Quality of products offered:
  - ❖ Banks, Consumers: low
- Variety of products:
  - ❖ Banks, Consumers: medium
- Efficiency of competition:
  - ❖ Consumers: low

<u>Costs to consumers:</u>

- ❖ Consumers with low monthly income would have had very limited access to loans or no access at all
- ❖ The quasi-monetary incomes like meal tickets are not considered as a part of the monthly income, even if these instruments are fully regulated

<u>Benefits to consumers:</u>

- ❖ For some categories of consumers the access to lending could be improved
- ❖ More protection for consumers against over-indebtedness.

<u>Impact on competition</u>

- ❖ All the non Romanian banks (branches of foreign banks) will not be legally bound to observe the NBR regulations, and will grant loans according to their mother bank risk policy. Competition on the market affected.

<u>Social Impact</u>

- Depends on the limits imposed by the new regulation.

<u>Further impacts not considered</u>

- Depends on the limits imposed by the new regulation.

Section VI – Comparison of the options

Impacts	Do Nothing Option	Option 1	Option 2	Option 3
Costs to regulated banks	• Lending on longer terms (to ensure that the monthly repayment rate is under the maximum limit), with a negative impact credit risk. • Limited offer for high income market segments. • Bureaucracy – 100	• Estimated compliance costs (elaboration of internal norms, IT costs, training and personnel costs, validation costs): Banks: 21.800 EUR NBFIs: 43.200 EUR. • Bureaucracy – 200 (one-off); 100(ongoing).	• Compliance costs to regulated banks • For responsible lenders, lower costs than implementing mandatory legal provisions – this is already a benefit	• Option 3 would have not been significantly different from Option 1
Benefits to regulated banks	• Lower credit risk because of the maximum indebtedness levels.	• More responsible lending. • Risk management improved.	• No estimation provided	• No estimation provided
Market impact	• Quality of products offered: ❖ Banks: low ❖ Consumers: low • Variety of products: ❖ Banks: low ❖ Consumers: low ❖ NBFIs: low • Efficiency of competition: ❖ Banks, Consumers, NBFIs: low	• Quality of products offered: ❖ Consumers/NBFIs: medium • Variety of products: ❖ Consumers/NBFIs: low • Efficiency of competition: ❖ Consumers: medium ❖ NBFIs: low	• Quality of products offered: ❖ Consumers, Banks: medium • Variety of products: ❖ Consumers, Banks: medium • Efficiency of competition: ❖ Consumers, Banks: medium	• Quality of products offered: ❖ Banks, Consumers: low • Variety of products: ❖ Banks,Consumers: medium • Efficiency of competition: ❖ Consumers: low
Costs to consumers	• Limited consumers' access to lending • Low income consumers were excluded, which encouraged illegal lending • Low competition meant higher costs to consumers	• Lending costs will increase (due to implementation and compliance costs). • Limited consumers' access to lending (for customers with monthly income below 350 EUR and supporting a family of at least 3 members)	• Lending costs could increase, but, at the same time, if competition increases, then this could be surpassed	
Benefits to consumers	The lending limits could protect consumers against over-indebtedness	• Improved access to lending for certain categories of	• Diversity of products. • Banks may develop special	• For some categories of consumers the access

		consumers; • Wider range of products.	loan products for customers with smaller incomes, if the credit behavior assessment would score a good mark (risk scoring, positive data from credit bureau, etc).	to lending could be improved. • Protection for consumers against over-indebtedness.
Unintended consequences	Lending on longer terms, with a negative impact on costs and credit risk	• Significant distortions in the market due to: - timing differences between the registration of certain NBFIs with the Special Register (and hence the application of the crediting constraints); - the existence of other passporting EU firms which do not fall under the NBR's supervision. • House prices may increase	• Some banks may risk too much, breaking responsible lending practices, in order to gain market share at any cost. • Romanian market and consumers are not prepared for a Self Regulation at the moment.	**-**
Impact on competition	• All the non Romanian banks (branches of foreign banks) will not be legally bound to observe the NBR regulations, and will grant loans according to their mother bank risk policy.	• On one hand it would increase competition between Romanian credit institutions; on the other hand, it would determine the distortion of competition between Romanian credit institutions and other passporting EU firms which are not subject to the regulation.	• Competition could be quite fair for both Romanian and non Romanian banks.	• All the non Romanian banks (branches of foreign banks) will not be legally bound to observe the NBR regulations, and will grant loans according to their mother bank risk policy.
Social impact	• Consumers were not able to access large value loans.	• Low to medium income customers will get no or less loans than under the previous regulations. • Above medium income customers will aces higher volumes of loans than under the previous regulations	• This option is the least likely to exclude socially disadvantaged individuals.	• Depends on the limits imposed by the new regulation.

Section VII – Policy recommendations

Based on the evidence shown above, on the feed-back provided by stakeholders, and taking into account the objectives of this policy: financial stability and improved consumer access to credits, the recommended policy option is Option 1.

The reasons that stand behind this decision are:

- in terms of costs incurred by regulated credit institutions:
    - Option 1 seems to be more expensive than the other options but this is due also to the fact that the main stakeholders did not provide the relevant information needed to assess the costs for Option 2 and Option 3.
- in terms of benefits of regulated credit institutions:
    - Option 1 offers more responsible lending and improved risk management than the other options;
- in terms of market impact:
    - Option 1 generates a low variety of products, the efficiency and the quality of products offered is low as well;
    - Option 2 seems to be offering an improved quality and variety of products, and a more efficient competition. However, Option 2 seems unlikely to be favored at this moment due to a different mentality necessary to implement "voluntary regulations";
- in terms of costs supported by the customers:
    - Option 1 may lead to increased credit costs (due to implementation and compliance costs). However, the increased competition between regulated credit institutions may reduce these costs in long term;
- in terms of benefits to consumers:
    - Option 1 provides improved access to lending for certain categories of consumers and a wider range of products then the other options;
- in terms of impact on competition:
    - Option 1 increases the competition on the credit market, and in the end the consumers are the main beneficiaries.

There is no doubt that the NBR's Regulation nr. 3/2007 has brought an improvement in terms of access to credit, risk management, development of the credit market. However, there are still some aspects that need to be corrected like creating the conditions for a sound competitive market for credit institutions, and an enhanced emphasis on consumers' needs and protection. Taking into consideration the objective of maintaining financial stability, the problems related to the distortion of competition can not be corrected at the moment. Regarding the consumers' needs and protection, this issue can be corrected if the internal norms calculate the amount of living expenses according to the different categories of consumers.