PRUDENTIAL SUPERVISION OF NON-BANKING FINANCIAL INSTITUTION: DEVELOPMENTS AND PROSPECTS[1]

Ph.D. Univ. Reader Adrian COSTEA
Academy of Economic Studies, Bucharest

Abstract

This study addresses the practice of the supervision authority relating to performance evaluation of non-banking financial institutions from a prudential supervision perspective. First, it is described how non-banking financial institutions' activity is regulated in the European Union and the current status of non-banking financial institutions' sector in Romania. Then, the study presents the challenges and opportunities faced by the supervision authority when evaluating the performance of non-banking financial institutions and, finally, defines a set of indicators based on which these institutions can be benchmarked against each other.

Keywords: prudential supervision, non-banking financial institutions, evaluation systems, CAAMPL, performance indicators.

***

Improving supervision systems' efficiency is a central theme of European politics. According to the *de Larosière* report [1], the European Commission proposed a legislative package of financial supervision at EU level. The mandate of the expert group chaired by Jacques Larosière was to analyze the causes of financial crisis and making recommendations to the Commission on strengthening the EU supervisory arrangements for financial sector components, to achieve an integrated European surveillance system and more efficient. The final report was presented on 25 February 2009 and was a comprehensive analysis of the causes of financial crisis, accompanied by a series of recommendations and solutions, both for improving the EU regulatory framework and restructuring the current supervisory formula. New supervisory architecture aims at creating an effective and integrated European system of supervision and crisis management, able to meet the requirements of cooperation and exchange of information between the new EU supervisory authorities and between them and their counterparts [2]. The proposed structural reform of the current supervisory framework covers both macro-prudential supervision through the establishment of the *European Systemic Risk Board* (*ESRB*) and micro-prudential supervision through the establishment of three European authorities for the supervision of individual financial institutions (*European Supervisory Authorities* - *ESA*) and the formation of the *European System of Financial Supervisors* (*ESFS*).

1 This work was supported from the European Social Fund through Sectoral Operational Programme Human Resources Development 2007-2013, project number POSDRU/89/1.5/S/59184 „Performance and excellence in postdoctoral research in Romanian economics science domain".

However, in order to improve the efficiency of supervisory activity, the central bank set up multilateral cooperation agreements (in 2009 there were cooperation agreements with 13 financial groups), and bilateral cooperation agreements with supervisors in other European countries. Furthermore, National Bank of Romania has signed in July 2007 along with seven other countries the regional cooperation memorandum between the countries of Southeast Europe. Subsequently, on 08 February 2008, the Multilateral Memorandum was extended by joining three other states. The objectives of the memorandum include: *"to support supervisors in carrying out a joint assessment of the risk profile of banking groups in the region."*

Also, in the report issued in February 2010 [3], the International Monetary Fund have made some recommendations with regard to banking supervision system: *"(...) National Bank of Romania should continue to move toward an increasingly risk-based approach to regulation and supervision, recognizing that developing the necessary skills for effective implementation will take time and deliberate effort."* (p. 5). In the same report, the IMF representatives admitted that the NBR has moved somewhat towards a more principles or risk-oriented system of supervision, but *"the present system is still heavily rules-based"* (p. 21). *"On the other hand"*, the report also states that "*the NBR has adopted a risk rating system, which helps to determine the frequency and scope of onsite inspections, and performs peer group analyses. The results of the peer group analysis are shared with credit institutions. Input from the industry indicates the current approach by the NBR is more useful than in the past. Inevitably, this change in culture will take time to become fully integrated."* (p. 21).

Currently, at least in Romania, NFIs performance evaluation is done manually by consulting their prudential reporting. At the level of supervision department there are no performance evaluation (rating) models, unlike the case of credit institutions for which Supervision Department developed the Uniform Assessment System –CAAMPL. [4]

Therefore, we need a new approach to the prudential supervision activity with respect to the evaluation systems for the performance of financial institutions, in general, and the performance of non-banking financial institutions, in particular. Next, we present how non-banking financial institutions' activity is regulated in the European Union and the current status of non-banking financial institutions sector in Romania. Then, we describe open issues regarding the practice of supervision for non-banking financial institutions.

European Parliament and European Council Directive no. 48/2006 on credit institutions [5] established that they consolidate non-banking financial institutions daughter companies; however classical non-banking financial institutions are not subject to consolidated supervision.

In Europe, since the second half of the past decade, countries have started developing their own regulations regarding the solo supervision of NFIs activity. For example, in Germany the first regulations were issued in December 2008, covering the activities of financial leasing and factoring. Until August 2010, Germany, approved under the new legislation, 800 companies, another 100 being in the process of consent [6]. Since 2006 Romania has adopted legislation on solo supervision of NFIs:

Government Ordinance no. 28/2006 regarding some financial and tax measures, together with a set of rules issued by the National Bank pursuant to the provisions of the said ordinance. In 2009, Romania has contaminated the legislation regarding NFIs through the issuance of Law no. 93/2009 on non-banking financial institutions [7] and National Bank of Romania's Regulation no. 20/2009 on non-bank financial institutions [8].

In Italy a distinction has been made between operational and financial leasing, the companies which included the latter in their activities being subject to prudential supervision (like Germany). France oversees companies engaged in financial leasing.

Spain includes the financial leasing activities as being classical credit operations and adopted a supervision model in the case of NFIs similar to that applied in the case of credit institutions.

Great Britain has not developed regulations on the solo supervision of non-banking financial institutions. NFIs companies that are subsidiaries of credit institutions are supervised on a consolidated basis via the banking group to which they belong.

In Romania, non-banking financial institutions are those entities other than credit institutions, which engage in lending activity on a professional basis, as determined by law. Non-banking financial institutions can perform the following lending activities: granting of credits, including but not limited to: consumer credits, mortgage credits, real estate credits, microcredits, financing commercial transactions, factoring, discounting, forfeiting operations; financial leasing; issuance of guarantees, undertaking guarantee commitments, undertaking financing commitments; granting of credits with receipt of goods as pledge or pawning through pawn shops; granting of credits to the members of non-profitable association organized based on the free consent of the employees/pesnsioners, in view of these entities, organized under the form of mutual aid funds, supporting their members by financial loans; other form of financing of credit nature.

Except pawn shops and credit unions which are included in the Evidence Register, other non-banking financial institutions are entered in the General Register of non-banking financial institutions. Another register opened and kept by the central bank is the Special Register, which included only those non-banking financial institutions from the General Register that meet certain criteria of performance in terms of loans and borrowings. Non-banking financial institutions which are included in the Special Register remain entered in the General Register as well. Year 2006 was the year in which the first regulations specific to non-banking financial institutions were issued.

In October 2007 the process of licensing of all non-banking financial institutions that have submitted documentation to the central bank in 2006, 2007 has been completed. Thus, it ended with a number of 38 institutions listed in the Special Register, 218 in the General Register and 4600 entered the Evidence Register.

By these rules has been established that the central bank will monitor non-banking financial institutions registered in the General Register, will prudentially supervise those in the Special Register and will keep track of those registered in the Evidence Register. Below we will refer only to the non-banking financial institutions registered in the General and Special Registers, given their importance in the total non-banking financial institutions (NFIs).

The evolution of NFIs by different categories of activities from 2008 to the current date are as follows:

The distribution of NFIs by types of activities

Table no. 1

millions lei

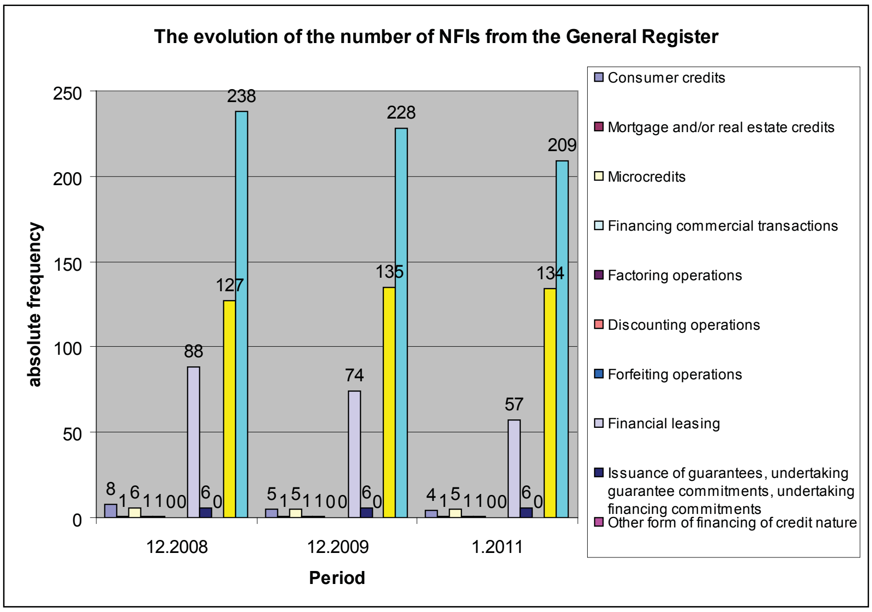
Types of activities	31.12.2008						31.12.2009						25.01.2011					
	Special Register		General Register*		General Register		Special Register		General Register*		General Register		Special Register		General Register*		General Register	
	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%	abs. val.	%
Consumer credits	1	1.89	7	3.78	8	3.36	1	1.69	4	2.37	5	2.19	1	1.85	3	1.94	4	1.91
Mortgage and/or real estate credits	1	1.89	0	0.00	1	0.42	1	1.69	0	0.00	1	0.44	1	1.85	0	0.00	1	0.48
Microcredits	0	0.00	6	3.24	6	2.52	0	0.00	5	2.96	5	2.19	0	0.00	5	3.23	5	2.39
Financing commercial transactions	0	0.00	1	0.54	1	0.42	0	0.00	1	0.59	1	0.44	0	0.00	1	0.65	1	0.48
Factoring operations	0	0.00	1	0.54	1	0.42	0	0.00	1	0.59	1	0.44	0	0.00	1	0.65	1	0.48
Discounting operations	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
Forfeiting operations	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
Financial leasing	20	37.74	68	36.76	88	36.97	17	28.81	57	33.73	74	32.46	16	29.63	41	26.45	57	27.27
Issuance of guarantees, undertaking guarantee commitments, undertaking financing commitments	1	1.89	5	2.70	6	2.52	1	1.69	5	2.96	6	2.63	1	1.85	5	3.23	6	2.87
Other form of financing of credit nature	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00	0	0.00
Multiple lending activities	30	56.60	97	52.43	127	53.36	39	66.10	96	56.80	135	59.21	35	64.81	99	63.87	134	64.11
Total	53	100	185	100	238	100	59	100	169	100	228	100	54	100	155	100	209	100

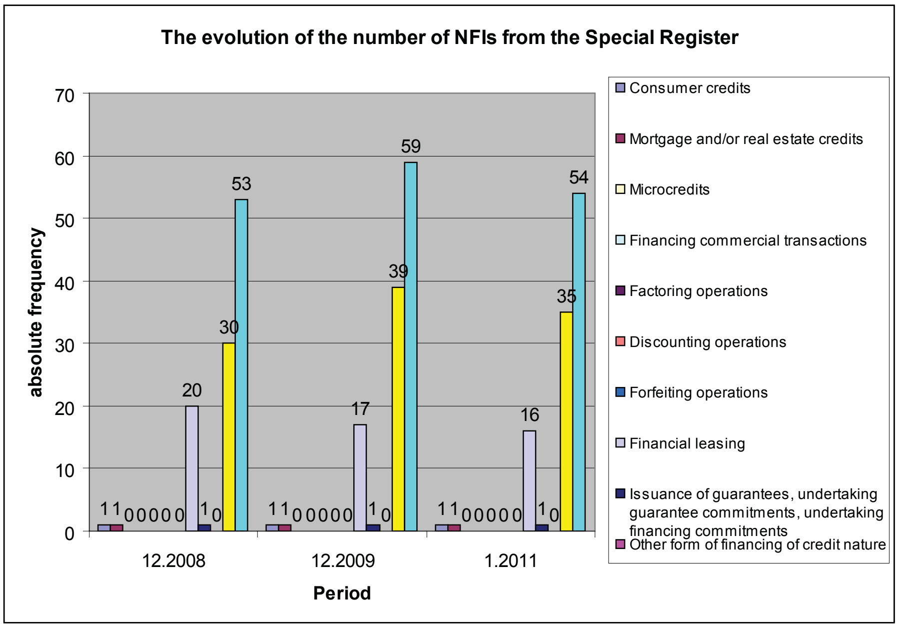
** without NFIs from the Special Register*

Source: Annual Reports, National Bank of Romania

The evolution of IFNs' number between years 2008 and 2010

Figure no. 1





As it can be seen in Fig. no. 1 the number of IFNs decreased steadily from a value of 238 institutions by the end of 2008 to 209 today. IFNs in category "Financial Leasing" recorded the most drastic decrease (from 88 institutions in 2008 to 74 institutions at the end of 2009, reaching 57 in January 2011), amid the crisis that has hit auto sales.

The greater decrease for IFNs in category "Financial leasing" (31 = 88-57) than the overall decrease (29 = 238-209) is explained by the reorganization of IFNs in category "Financial leasing" and passing them in the category "Multiple lending activities". Moreover, this phenomenon can be seen in the increasing number of NFIs in category "multiple lending activities", although the category "Financial leasing" decreased.

The main economic indicators of non-banking financial institutions

Tabel no. 2

milioane lei

Economic indicator	31.12.2008			31.12.2009		
	Special Register	General Register*	General Register	Special Register	General Register*	General Register
Equity capital	1646.4	667.1	2313.5	2383.8	660.6	3044.4
Total assets	39578,6	2986,6	42565,2	34315.3	2060.5	36375.8
Loans granted (net value), from which:	32833.5	1987.2	34820.7	28837.0	1500.5	30337.5
- financial leasing	26417.9	1297.3	27715.2	20076.1	593.3	20669.4
- other form of credits	6415.6	689.9	7105.5	8760.9	907.2	9668.1
Past due and doubtful loans	1705.6	34.9	1740.5	856.2	40.7	896.9
Provisions (related to past due and doubtful loans)	914.3	234.1	1148.4	1387.1	170.8	1557.9
Profit/loss	-378.4	-134.9	-513.3	-1391.4	-137.8	-1529.2
Total assets NFI / GDP	8.4%			7.4%		

** without NFIs from the Special Register*

Source: Annual Reports, National Bank of Romania

There is a reduction in the percentage of total assets in the gross domestic product in 2009 compared to 2008, about one percentage point, the indicator reaching at the end of 2009 the level of 7.4%. An estimator of the same indicator as in [10] for 31.12.2010 is 9.89%, a growth due, among others, to the contraction of gross domestic product. Equity capital has seen a considerable increase (31.6% compared to 2008), mainly due to capital increases by NFIs in the Special Register so that they meet prudential requirements relating to own funds and high exposures.

This trend continued also in 2010, the capital requirements increasing as a consequence of increased levels in the same period of past due and doubtful loans, which generated an increase in provision expenses. Loans decreased in 2009 compared to 2008 with 12.88% for NFIs from General Register, the "Financial leasing" suffering the most drastic adjustment (25.42%) than other types of loans that encountered even a significant increase (36.07%). As a proportion of total loans granted, financial leasing is still significant in 2009 (68.13%), although it encountered a slight decrease as compared to 2008 (79.59%). For other types of loans, which account for 32 percent of total loans, consumer loans and mortgages have the most significant weights, 6.9% and 2.6%, respectively. Past due and doubtful loans decreased from one period to another, especially because of the entrance in the “loss” category of the loans for which debt service exceeded 90 days or for which legal proceedings have been initiated. The decrease in 2009 compared to 2008 of the past due and doubtful loans has been 48.47%. The transfer of the loans in the “loss” category has had the effect, among others, of an increase in the costs of provisions. Provisions related to the past due and doubtful loans have increased from 1148.4 millions lei in 2008 to 1557.9 millions lei in 2009 (an increase of 35.66%). On the whole, NFI sector registered a substantial increase in loss (by 197.92% or nearly three times), reaching a value of -1529.2 millions lei at the end of 2009.

At the end of 2009, the countries with most significant shares in the capital of non-banking financial institutions were the Netherlands (38.63%), Belgium and Luxembourg (16.92%), Italy (10.77%), France (10.17%) and Austria (5.66%) [2]. With the exception of Turkey and the United States of America, all shareholders of non-banking financial institutions were from the European Union. Romanian capital in total capital share decreased from 41.74% to 27.60% because most of the increases in capital contribution made by foreign shareholders were significantly higher than the contribution made by Romanian shareholders.

The main causes leading to the decrease of activity of non-bank financial institutions were:

1) the decrease of the demand for loans given that the main activity for these entities is financial leasing for auto vehicles;

2) the decrease of external credit lines, most non-banking financial institutions being dependent on this funding;

3) the increase of the number of bad loans amid the economic downturn.

Non-banking financial institutions from the Special Register became reporting entities with the Credit Register at the time of entering into force of NBR’ Regulation no. 8/2009 amending and supplementing NBR’ Regulation no. 4/2004 on the organization and operation of the Credit Register. At the end of 2009, 12.4% of total debtors were detained by non-banking financial institutions. The percentage due to NFIs at 31.12.2009 was 9.5%. Also, the percentage of past due loans to NFI by the total past due loans was 14.5%. [2]

Besides reporting on the criteria for inclusion in the Special Register and the classification of credit exposures and determination of specific provisions for credit risk, NFIs are required to report quarterly (for those included in the Special Register) or half-yearly (for those entered in the General Register) so-called periodic financial statements (PFSs) in accordance with the Order of the National Bank of Romania no. 18/2007 for the approval of the models of periodic financial statements and the approval of the detailed procedures for preparation and use of these models, applicable to non-banking financial institutions.

Periodic financial statements contain a number of raw indicators for NFIs' performance which are analyzed manually by inspectors. Until now it is not possible to perform a comparative analysis of several NFIs or a dynamic analysis of one of these based on the indicators of the SFPs, except by considerable effort from the inspectors of the Supervision Department. This is due to the complexity of the problem involving dynamic analysis (for a considerable number of quarters) of all NFIs included in the Special Register (about 54) in terms of a set of 10 to 15 performance indicators.

Unlike the supervision of NFIs, in the case of credit institutions Supervision Department has developed a system for evaluating the performance of credit institutions called the Uniform Assessment System – CAAMPL [4]. This system uses the financial reports of credit institutions and based on them it evaluates six components that reflect in a consistent and comprehensive manner the performance of banks in concordance with the banking laws and regulations in force: capital adequacy (C), quality of ownership (A), assets' quality (A), management (M), profitability (P), liquidity (L).

Besides the fact that it is not suitable for performance evaluation of NFIs, CAAMPL system presents a number of disadvantages:

- uses simple linear techniques for discriminating the multidimensional space that represents the performance of financial institutions. In fact, the discrimination model is not a multivariate discrimination model (i.e.: a model that takes into consideration more than one discriminating variable at a time), but a sequential combination of univariate models;

- the selection of independent variables (performance criteria) that determine a rating (a specific class of performance) is not based on scientific rigor, but on the experience of members of the supervisory authority;

- as a result of this heuristic selection it is difficult to substantiate the various limits for the explanatory variables that determine the performance indicator (rating), which leads to a significant increase in the analyst's subjective involvement in establishing it;

- CAAMPL evaluation system by which the performance of the credit institutions is assessed (the ratings are established) is based mainly "on rules" as emphasized by the IMF in [3] and does not imply any form of quantitative methods for assessing the performance, such as statistical and econometric methods or the so-called computational-intelligence methods.

Perhaps the most important aspect regarding the development of evaluation models for the performance of NFIs based on their financial reporting is the fact that these models would enable the identification, in an early stage, of the NFIs that are ineffective from a financial and operational viewpoint or show adverse trends, calling for a higher attention of the supervisory authority and, also, enabling its optimal allocation of available resources.

However, these evaluation models would be useful to other players in financial markets: from managers to creditors and investors, all business players are interested in obtaining accurate and current information about an economic entity.

In what follows, we present a series of indicators based on which we can analyze comparatively the non-banking financial institutions in terms of capital adequacy (C), assets' quality (A) and profitability (P). Two of the other dimensions of performance applicable to credit institutions, namely: the quality of ownership and quality management are quality dimensions and involve a distinct approach. Another dimension of performance, liquidity is not applicable to non-banking financial institutions, given they do not have deposit of the population-like activity.

The main factors in determining capital adequacy are the types and size of significant risks that the non-banking financial institution is subject to, such as credit risk, operational risk, market risk and reputational risk. Following analysis of the PFSs of NFIs included in the Special Register, we detected the following indicators for assessing the degree of capitalization:

1. Equity ratio (Leverage) = own capital / total assets (net value)
2. Own capital / equity
3. Indebtedness sources = borrowings / own capital

Regarding the evaluation of the assets' quality of non-banking financial institutions, this is done , generally, based on the level of loans granted, as well as based on the nonperforming loans. A system of indicators for assessing the assets' quality is the following one:

1. Loans granted to clients (net value) / total assets (net value)
2. Loan granted to clients (net value) / total borrowings
3. Past due and doubtful loans (net value) / total loans portfolio (net value)
4. Past due and doubtful claims (net value) / total assets (net value)
5. Past due and doubtful claims (net value) / own capital

Profitability is measured by classical indicators, namely:

1. Return on assets (ROA) = net income / total assets (net value)
2. Return on equity (ROE) = Net profit / own capital
3. The rate of profit = gross profit / total revenues
4. Activity cost = total costs / total revenues

The next step in performance evaluation of non-banking financial institutions is to collect the data necessary to calculate these indicators. The collection began with the development of Excel formula based on which we will calculate the indicators for non-banking financial institutions registered in the Special Register, quarterly, for 2006-2010. Dataset has to be looked at dynamically in that new indicators can be added or new items may be added once they become available.

Conclusions

This study presents the current status of one of the most important financial sectors: the non-banking financial institutions' sector. At the same time, we presented the challenges facing the central authority in the monitoring and prudential supervision activities of these institutions, starting with the regulatory and evaluation frameworks. We have, also, described the regulatory framework for the activity of these institutions in some European Union countries and stressed the need for new approaches regarding the evaluation systems for the performance of financial institutions. In this sense, we have defined performance indicators based on which these new evaluation systems would be developed.

Bibliografie

[1] de Larosière J., Balcerowicz L., Issing O., Masera R., Mc Carthy C., Nyberg L., Pérez J şi Ruding O., *The Report of the high-level group on financial supervision in the EU*, Bruxelles, 25 February 2009.

[2] National Bank of Romania, *Annual Report 2009*, ISSN 1453 – 3936.

[3] International Monetary Fund, *Romania: Financial Sector Stability Assessment, February 2010*, IMF Country Report No. 10/47.

[4] National Bank of Romania, *Uniform Evaluation System - CAAMPL*, 2008.

[5] European Parliament and Council, *Directive No. 48/EC/2006*.

[6] Schiedermair C., *Passporting of Finance Leasing and Factoring Institutions (LFI´s)*, 7th Meeting of European Passport Experts, 23 September 2010, Oslo.

[7] Romanian Parliament, *Law No. 93/2009 regarding non-banking financial institutions*, 2009.

[8] National Bank of Romania, *Regulation No. 20/2009 regarding non-banking financial institutions*, 2009.

[9] National Bank of Romania, *Annual Report 2008*, ISSN 1453 – 3936.

[10] Financial Companies Association in Romania (ALB), *Financial leasing industry market in Romania*, 2010. http://www.alb-leasing.ro/Documents/statistici/2010/09.30-10.00%20-%20Bas%20Hoekstra.pdf.