

## The reasons of non-performing loans and perspectives of economic growth

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**Abstract.** Sudden growth of NPL volume became one of the up-to-date problems of bank sector in late 2000s. Analysis of macroeconomic values of development of Eastern, Central and South Europe, CIS-countries showed that before financial crisis of 2007-2008 the situation with credit portfolios in most countries of the world were rather stable. However world financial crisis changed situation seriously in financial sector - the average quality of bank assets has deteriorated greatly and a number of general problems of development became clear. This article is devoted to analysis of main reasons of NPL growth in modern economy and the evaluation of effects of their influence on national economies. The article analyses the reasons of origination of bad assets (NPL) and considers them in terms of opportunities of national economies. Comparative characteristics of the factors and reasons for non-elimination and growth of bad assets in Russia, CIS-countries, European countries are provided.

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### Introduction

NPL became one of the most serious effects of world financial crisis for many countries of the world. Bank systems of Russia, Kazakhstan, CIS-countries, Central Europe and Eastern Europe countries experience big difficulties with timely return and servicing of loans. Catastrophic growth of NPL in many countries has become the reason for deterioration of economic situation and socio-economic sphere, which demands urgent measures to avoid further worsening and overcoming of crisis effects.

Since world economy faced strong recession and non-performing loan became wide spread and dangerous phenomenon in many countries, NPL problem is being discussed not only by narrow group of bank specialists [1] but by scientists as well - a lot of works devoted to this problem has appeared recently [2-7].

### Theoretic part

NPL (toxic asset) is understood as loan the original conditions of which has been violated. This means delay in payment of interests on loan for the use of money or delay in return of the loan itself.

World Bank's definition: "Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio (including nonperforming loans before the deduction of specific loan-loss provisions). The loan amount recorded as nonperforming should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue" [8].

IMF's definition: non-performing loans are those with delays in payment of interests and the loan itself of 90 days or more. Today NPL includes the other categories of loans as well if there are any doubts that they will be serviced or returned in time.

Volume of NPL in credit portfolio of separate bank and in general volume of credit portfolio of bank system of the whole country is one of the most important indicators of current state of modern bank sector because assets of the banks to a great extent consist of credit resources (in European countries and CIS-countries they stand for more than 1/2 of total assets). So, the share of NPL in portfolio signalizes about the "health" of finance sphere of big regions and even the whole countries.

### Methodology of study

The study is based on the analysis of statistical data about the state of bank system of Russia, Kazakhstan, CIS-countries, Eastern, Central and South Europe.

Methods of study: factor and structure analysis and econometric modeling. The modelled value is share of NPL in portfolio of different countries, and explaining variables are macroeconomic factors (GDP growth rate, interests rate, currency rates, inflation, volumes of mortgage loans, etc). Study is based on data of econometric analysis of bank credit risk is used, performed by National Bank of Spain on the country level [10].

Factual and analytical data were taken from the reports about bank sector state and socio-economic development of the countries for 2006-2013. We

used: Financial stability report of 2011 by ECB [11]; report of Sberbank of Russia of 2012 about the state of bank sector in the countries of Eastern Europe and CIS-countries in 2006-2011 [12]; annual reports of World Ban [1] and International Monetary Fund [13], Ernst & Young's analytical reports [14-15].

### Discussion

Number of NPL started to increase greatly in many countries of the world beginning with the end of 2007 when the problems in mortgage sector of the USA became evident. In 2009 NPL increased in many countries by 4-5 times, in the end of 2012 NPL level reached 20% in some countries (Table 1) (the source - [1])

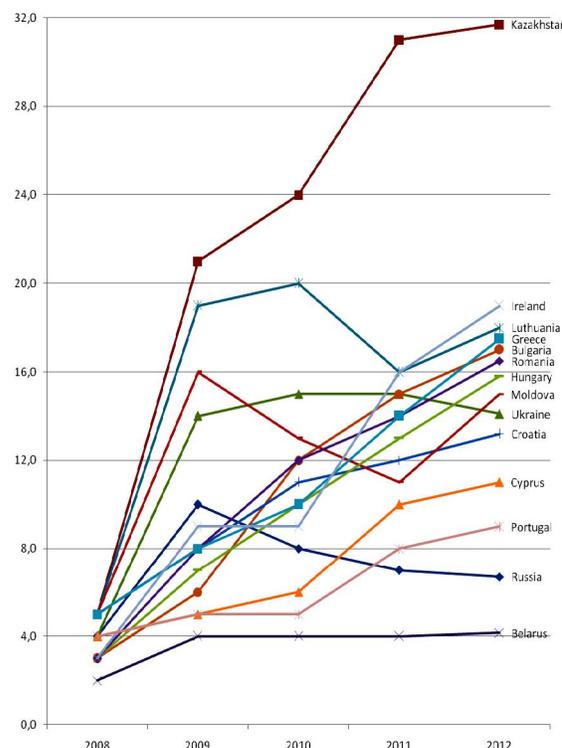
**Table 1. Proportion of NPL in total volume of loans portfolio**

Country	2006	2007	2008	2009	2010	2011	2012
Russia	2	3	4	10	8	7	6,7
Kazakhstan	...	...	5	21	24	31	31,7
Ukraine	4	3	4	14	15	15	14,1
Belarus	3	2	2	4	4	4	4,16
Lithuania	1	1	5	19	20	16	18
Bulgaria	2	2	3	6	12	15	16,9
Croatia	5	5	5	8	11	12	13,2
Moldova	4	4	5	16	13	11	15,2
Hungary	3	2	3	7	10	13	15,8
Romania	2	3	3	8	12	14	16,8
Iceland	1	...	...	42	40	23	...
Greece	5	5	5	8	10	14	17,2
Cyprus	...	...	4	5	6	10	11
Ireland	1	1	3	9	9	16	18,7
Portugal	1	3	4	5	5	8	9

The most serious situation has formed in Kazakhstan where, in accordance with KFL's data, the share of NPL in total volume of credit portfolio in 2012 reached 36%. The differences in results obtained from IMF and KFN is explained by difference in used methods.

Table 1 demonstrates that the indicator grows all the time in all Eastern and South Europe countries and CIS-countries except for Russia where high rise of NPL in 2011 was stopped and even reduced in 2012-2013. In all other countries annual increment of NPL is observed which grows with rather high speed (Figure 1).

So, the highest increase in NPL in 2012 in comparison with 2008 was observed in Kazakhstan (6,2 times), Ireland (6,2 times) then in Bulgaria and Romania - 5,6 times, Hungary - 5,3 times, Lithuania - 3,6 times, Ukraine - 3,5 times, Greece - 3,4 times, Moldova - 3,0 times, Cyprus - 2,8 times, Croatia - 2,8 times, Portugal - 2,3 times. The lowest (2 times and less) was in Belarus and Russia (1, 7).



**Picture 1. Bank nonperforming loan to total gross loans (%)**

Such high speed of NPL growth and their big proportion in total volume of credit portfolio of banks negatively influences socio-economic and financial stability of the countries, especially in terms of their credit ranking. This eliminates economic incentives for development, hinders overcoming of crisis trends. Reduction of additional foreign investments into real and financial sectors of the countries with highest NPL proportion (Kazakhstan, Iceland, Cyprus, Greece) resulted in further reduction of very weak credit base (Kazakhstan) or even triggered default (Iceland, Cyprus, Greece). Much more unpleasant situation has formed in those countries where foreign banks fearing for their assets started to withdraw them from bank system of these countries. For example, in November of 2011 Austrian bank supervising body ordered its banks to reduce limits of crediting for the Eastern Europe and Italian banks - 110% of increment in deposits of branches in a number of Eastern Europe countries [12]. The fears were reasoned by the fact that in the end of 2011 aggregate assets of 3 biggest banks of Austria belonging to the group UniCredit in Eastern Europe and Central Europe were higher than Austrian GDP. In case of deterioration of situation with loans in these countries this could negatively influence bank system of Austria – because, in spite of seeming

independence of national bank systems, their interdependency is very strong.

*The reasons of NPL growth and their influence on economic development.*

Analysis showed that growth of NPL was determined by multiple structural problems in national economies, caused by crisis [17].

Comparison and analysis of the changes taken place in the structure of Russia and CIS-countries economies in crisis time and in the beginning of post-crisis period allowed to identify the following key factors which influenced NPL dynamics, structure, stood for reasons of growth.

1. Annual growth of real GDP which is important indicator of economic activity in the country. Here the link between economic cycles and efficiency of crediting is proved by numerous studies and the experience of development of many states. By universal consent one of the reason of high NPL in many countries is slow recovering of economy and population incomes after crisis of 2008. And taking into consideration high dependency of economic activity of CIS-countries on each other and on external demand from Europe experts believe that negative dynamics of incomes and employment in many countries will increase the NPL volumes, especially in retail sector. All this can be referred to situation in Kazakhstan and Russia. So, in Kazakhstan in 2012 average per head monetary incomes of population grew by 7,2% and average wages - by 6,9%. In the same time physical volumes of trade increased by 13,4%. In 2013 the gap was even more: in first half of 2013 increment in average wages was only 0,5%, per head income - by 0,2% while trade turnover grew by 12,5%.

But some segments of consumer's market saw colossal growth: sales of new cars in the first half of 2013 in comparison with analogous period of 2012 grew by 72% [18]. It is explained by very high growth of consumer crediting, which in conditions of stagnation of incomes will result in further NPL growth.

2. State of non-financial sector of economy.

NPL growth was caused by recession in non-financial sector of economy which is still going on in all analyzed countries. Problems in non-financial sector result in keeping and even increase in losses on the earlier given loans. This feedback loop deteriorates banks' reporting results and makes them to establish stricter conditions of loans which deteriorates the crediting in corporative segment and worsens situation in non-financial sector of economy.

3. State of bank sphere in pre-crisis period

This factor is complex and its influence is manifested in several aspects. Analysis showed that changes of NPL volumes in crisis and post-crisis

period were stronger in those countries where in the middle of 2000s too extensive credit growth was observed and the bubble on credit market appeared - predominantly Central Europe and Eastern Europe countries.

Another important reason of NPL growth in some countries was high ratio of credit to GDP, without appropriate support by domestic depositary base. For example in the beginning of crisis the share of foreign borrowings in passives of Kazakhstan banks was about 50%. Strong influence of this factor in the beginning of crisis resulted in gradual reduction of credit volumes in foreign currency in Kazakhstan: by 2011 credits in foreign currency reduced to 3 099,7 billion of tenge (by 3,4%) while in national currency - increased to 5 681,6 billion tenge (by 29,6%) and this fact, in experts' opinion, can positively influence credit sector as a whole and NPL volumes in particular. [19].

4. Interest rates established by national and foreign banks. Here we observe also very transparent and clear dependency: increase/reduction of rates results in increase/reduction of debt costs which influences the amount of current costs of borrowers.

5. Changes (especially depreciation) of exchange currency rates of national money in regard to leading world currencies. This factor is very significant for those countries where proportion of loans in foreign currency is very high, and the incomes of borrows are linked to national currency. This factor is also significant for the countries with flowing exchange rate of national currency engaging the strategy of targeted inflation in their monetary policy. In particular it is tenge weakening, in specialists' opinion, which is regarded the main risk for Kazakhstan economy and financial sector [20].

This factor most negatively influenced economies of Hungary and Romania, rather than other Eastern Europe and CIS-countries. In these 2 countries increase in loan portfolio in pre-crisis period was triggered by high volumes of foreign credits without corresponding growth of deposit base. In Hungary the situation was deteriorated by bubble in real estate market and high proportion of mortgages in general volume of bank credits (maximum among all represented countries - 25% of GDP) [12]. In Kazakhstan, after big outflow from the country of foreign bank capital in 2009-2010 this factor can be decisive. In particular, high level of integration of Kazakhstan into international activity and absence of financial flows from international investors can make Kazakhstan banks non-competitive in regard to world financial institutions (including bigger in size Russian banks) [16].

6. Situation in stock market. This factor dominates in those countries where stock market is

well-developed. Its influence on the quality of bank system credit portfolio is revealed in several ways:

-through direct dependency of commercial banks on the situation in stock market.

-effect of "wealth" among borrowers;

-through reduction of costs of loans' guarantee when the market is in good condition.

However in the countries with less developed stock market deterioration in this segment can also trigger growth of NPL. Kazakhstan is one of these countries. Difficulties in stock market result in wider number of bankrupt participators and turn into much higher banks' losses which is proved by KASE statistics. Today the number of companies which declared defaults on their loan securities in Kazakhstan is 35. Only 10 of them wanted to solve this problem trying to pay all the debt completely or through the process of restructuring of debt. If we take into consideration that bonds were issued mainly in the middle of 2000s for 5-7 year period, paying of the main debt must be finished in current period, which triggered high increase of NPL.

7. Credit policy of banks. Influence of this factor can be traced in several aspects. Firstly, these are particularities of credit expansion of banks carried out in previous years. This is the main reason of NPL growth and the most damaged countries are Kazakhstan, Ukraine, Hungary, Romania and Russia.

Secondly, structure of bank credits by categories of borrowers. Today they try to overcome high share of corporative NPL, and start to credit retail sector actively. For example, in Kazakhstan in July of 2013 the banks gave to their clients almost 1,3 billion dollars of loans (total number is 12,3 billion dollars) exceeding historical maximum of July 2007 - 1 billion dollars [16]. However the capacity of retail segment of bank market in Kazakhstan is not big.

In Russia in 2013 banks gave loans to legal entities and private persons in amount of 40 billion and 417,7 milliard roubles which is by 19% higher than in 2012. In the same time with high volume of crediting the volume of NPL grew as well - by 19% also and reached by 2013 the mark of 1 billion 398 milliard roubles. [21].

One more reason for keeping high share of NPL in the structure of bank credits of Kazakhstan is specific character of credit policy, carried out by some banks. Big banks trying to compensate the losses from NPL raise the percentage margin. This happens in Kazakhstan: CenterCredit Bank, Kazcommercebank, Khalyk bank and ATFBank [19].

Finally, special reason of NPL growth is that in many countries "toxic" loans are being serviced by bank system. This happened in Greece, this is happening in Kazakhstan now. As a result the

problem is not solved but just postponed for some time.

8. In some countries there are special factors and reasons which influence greatly dynamics and size of NPL. In Kazakhstan this special factor is frauds. This notion includes internal corruption in banks, and operations when non-return of loan is known beforehand. By experts' estimates, about 85% (12,7 billion dollars) of all NPL in Kazakhstan is caused by frauds and 15% can be explained by poor management [22]. The most damaged parties in this situation were foreign investors who lost about 15 billion dollars. Among Kazakhstan banks which caused biggest losses to foreign investors are BTA bank (about 10 billion dollars), Alliance bank (about 5 billion), Astana-Finance Bank (about 1 billion) [16].

### Inference

Today it is quite obvious for everybody that high amount of NPL is big obstacle which hinders greatly the recovering of economy. But the countries continue to increase crediting volumes not bothering to eliminate already existing NPL.

In 2012-2013 in Kazakhstan and in Russia the dangerous trend of increase of consumers' crediting is observed. However keeping of negative situation in economy, inflation growth and unemployment will inevitably increase the number of consumers' loans which will not be paid back in time (turn into NPL).

That is why all countries must take active measures for reduction of NPL.

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