Renegotiated loans in the Czech Republic

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Introduction

Renegotiation of loans has become an important phenomenon in banking in recent years Renegotiation is a process whereby clients either agree to repay the lender the outstanding amount of their loans under new terms and conditions or move their loans to another lender offering better conditions. Renegotiated loans have gained importance thanks mainly to low market interest rates and the end of the period of fixed interest rates on many loans, especially those in the housing area.

The interest in monitoring the amounts of, and interest rates on, renegotiated loans is based primarily on the needs of financial stability authorities, who track information on renegotiated loans transferred from other institutions in order to monitor the "wooing of clients" between banks. Loan renegotiation is also of great interest to monetary policy makers at both national and European level.

Information on renegotiated loans has not previously been monitored at the banking sector level in the Czech Republic. Some banks have published estimates based on non-standardised methodology. The Czech National Bank is the source of information on total new loans, or new loan agreements, in a given period for the entire banking sector in the Czech Republic. However, under European Central Bank methodology, these loans include both new loan agreements, which specify the interest rate for the first time, and renegotiations of existing loans. It was therefore impossible to use these data to determine the share of renegotiated loans in total new loans.

The first part of this paper describes the reasons for introducing collection of renegotiated loans data and discusses the methodology for renegotiated loans and key items on the agenda of the working group set up to introduce collection of such data in the Czech Republic. It also defines the most difficult steps in implementing the data collection requirements. The alignment of national requirements with those based on EU legislation is then discussed.

The second part of the paper analyses the first available data reported by banks to the Czech National Bank in the first few months of 2014. The data are analysed in categories by client sector and by purpose of the loan. Outputs relating to renegotiated loans for house purchase in the Czech Republic are an important part of the paper.

Reasons for introducing collection of data on renegotiated loans

Internal requirements of the Czech National Bank

Some data on renegotiated loans were available on the websites of various organisations, and some estimates were released by banks. The former were acquired by the organisations concerned from selected banks only. However, the methodology for these data releases was not standardised and could not be applied to the entire banking sector in the Czech Republic. Integrated information on renegotiated loans was thus not available from any source. The first requirements for the collection of such data were raised by the Czech National Bank's Financial Stability Department (FSD). These requirements were formulated in the first half of 2012 as part of the standard preparations for bank reporting for 2013. Users from the Monetary Policy Department soon joined their colleagues in requiring such data. The FSD justified its requirements by the fact that renegotiated loans, particularly in the housing area, have become an important part of the credit market in recent years. The FSD expects this trend to continue in the years to come. This is mainly because the period of fixed interest rates on loans is coming to an end and interest rates are still low. Another reason is the competitive environment in the area of loans for house purchase. This is a purely positive phenomenon from the financial stability point of view, as lower interest rates reduce the burden on households. On the other hand, if clients are able to increase their borrowing again, household debt may grow further. According to the FSD, the risk may consist in households underestimating the increase in their debt burden. From the banks' perspective, "wooing of clients" and provision of low interest rates may lead to falling returns on housing loans as a whole. However, this competition may have a positive effect on banks overall, particularly where clients migrate to other banks with other banking products such as current accounts.

Requirements of the European Central Bank

The standard process of amending the relevant statistical regulations issued by the European Central Bank started at roughly the same time as bank reporting for 2013 was being prepared. These amendments are made approximately once every five years and serve as the basis for the collection of harmonised statistical data in EU Member States. The requirements raised included a strong interest in monitoring renegotiated loans. However, the ECB raised its requirements one year later than the CNB's internal users, so that data collection under the amended regulation was not scheduled to start until 2014. At that stage, the methodology had not been finalised and the new requirements regarding the collection of data on renegotiated loans were still in the preparatory phase at Member State level. A requirement for renegotiated loans to be monitored as a sub-item of new business as defined by the ECB regulation concerning statistics on interest rates was raised during this phase for both households and non-financial corporations. It was not clear, however, whether increases in loan amounts would be taken into account and whether contracts originally provided by another institution would also be regarded as renegotiations. In the interest rate statistics, new business means any new agreements between the bank and the customer. The customer's active involvement in negotiations is a necessary condition for new business. All financial contracts that specify the interest rate for the first time and all renegotiations of existing contracts are deemed to be new business.

Establishment of a working group

Based on the requirements raised internally and by the ECB, the Statistics Department prepared a document containing a methodological description of renegotiated loans and a proposal for renegotiated loan data collection starting in 2013. This document was submitted to the Czech Banking Association for approval. However, banks flatly rejected this proposal, mainly due to its high costs and the time needed to prepare their internal systems. At the same time, banks expressed an interest in establishing a working group to clarify the methodology so that the requirement could be met as part of the preparation of bank reporting in 2014. As the ECB had not entirely clarified its requirements and might change them in the future, the Czech National Bank agreed to the establishment of the working group. A document prepared for the working group described the breakdown of existing new business into other sub-items by original lender and according to whether the loan amount was increased during renegotiations (see the proposed collection method below). This breakdown was compliant with both national and European requirements.

The proposed collection method

It was proposed to divide the original collection of data on new loans in the *total* category into the following sub-categories:

<u>Refinanced new loans – excluding increase/extension</u> – this sub-category includes loans provided earlier by another institution and for the outstanding amount of which a new loan agreement has been signed with the reporting bank. In cases where the loan was increased when it was refinanced, it was proposed to include only the non-increased portion of the new refinanced loan in this category. This sub-category also includes consolidated loans whose original lender was another institution.

<u>Refinanced new loans – increase/extension</u> – this sub-category contains only the increased portion of the new refinanced loan which previously existed with another institution and for the outstanding amount of which a new loan agreement has been signed with the reporting bank.

New loan agreements – this sub-category contains loan agreements which entered the economy in the given month for the first time – so-called net new loans.

Other renegotiations of existing loans excluding increase/extension – this sub-category contains loans which were previously provided by the reporting bank and have merely been renegotiated. It also includes consolidated loans whose original lender was either another institution/other institutions in addition to the reporting bank, or only the reporting bank.

Other renegotiations of existing loans – increase/extension – it was proposed to include in this sub-category only the increased portion of the loan which previously existed with the reporting bank and for the outstanding amount of which a loan agreement has again been signed with the reporting bank. This category will also include increases in consolidated loans whose original lender was either another institution/other institutions in addition to the reporting bank, or only the reporting bank.

Issues concerning the renegotiated loans methodology

Definition of refinanced loans:

The first point on the agenda was clarification of the term *refinanced loan*. The working group members agreed that, for the purposes of collection of the new data, refinanced loans would consist solely of loans whose original lender was another institution. Loans refinanced only within the bank and loans with multiple lenders would be deemed other renegotiations of existing loans. These two categories would together make up renegotiated loans. The main purpose of separating the original lender was to meet internal users' need to monitor the wooing of clients between banks/institutions.

Relationship between refinanced loans/other renegotiations and restructured loans:

Banks also raised the question of whether restructured loans should be reported as a sub-category of refinanced loans/other renegotiations. The CNB informed them that these were two different and mutually independent terms. Restructured loans are defined as claims for which the bank has provided relief to the borrower after judging that it would probably incur a loss if it did not do so. For economic or legal reasons relating to the borrower's financial situation the bank is has thus provided the borrower with relief that it would not have granted otherwise. Such relief consists, for example, in revising the repayment schedule, lowering the interest rate or waiving late charges. A claim arising from the renewal of a short-term loan for current assets is not considered a restructured claim if the borrower has met all her payment and non-payment obligations arising from the loan agreement.

These loans are subject to collection but are not disclosed under new business. This is due to their interest rates, which do not usually correspond to the current situation in the loan market and might impair the times series of released data.

Costs of new data collection:

According to banks, obtaining information on increases in the loan amount for refinanced loans, i.e. loans originally granted by another institution, was the most expensive part of the implementation of the new requirements. This information was not available in banks' internal systems. It was very costly to implement, as a new field had to be added to enable manual entry of the information into the system. The implementation costs were assessed as follows:

a) information on refinanced loans – costs not too high
b) information on increases in the loan amount for refinanced loans – very high costs
c) information on the original lender (within or outside the bank) – significant costs

An analysis of the 2014 Q1 data

All the charts and tables below are based on the data for 2014 Q1. The data concerned are sum totals or – in the case of the rates for 1/2014, 2/2014 and 3/2014 – weighted averages. Restructured loans are excluded and all the amounts are in CZK millions for all currencies in total (CZK, EUR and USD). The data do not cover revolving loans, debit balances on current accounts and credit card debt. For these "fast-moving instruments" the stock concept is used, so data on new business is not collected. Non-negotiable debt securities are excluded.

New loans to the household sector

Chart 1 illustrates the percentage of net new loans for consumption, house purchase and other purposes overall, including increases and all renegotiated loans. These include both refinanced loans and other renegotiations. Renegotiated loans account for 36% of total loans and net new loans make up the rest.

Chart 1 – New loans provided to households for consumption, house purchase and other purposes – share of renegotiated loans

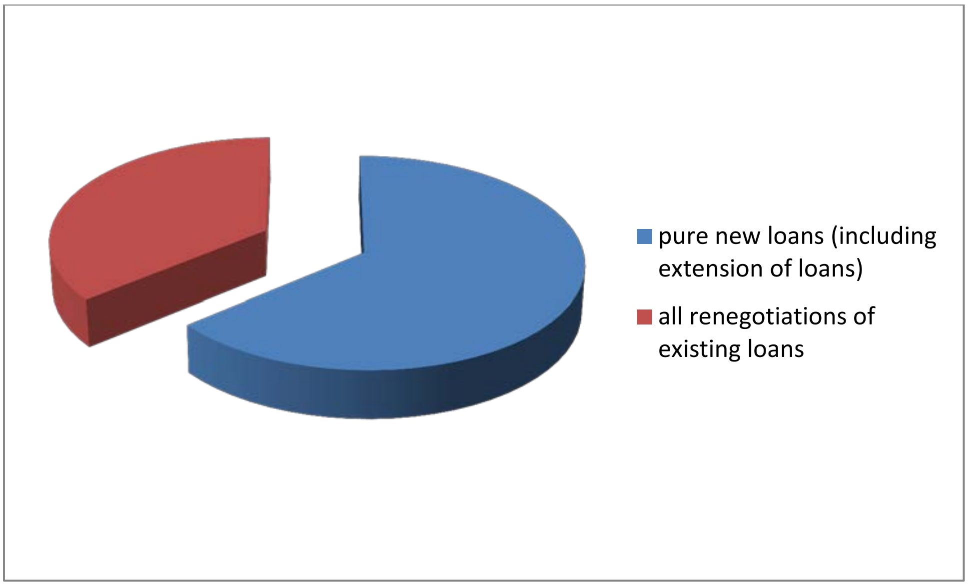
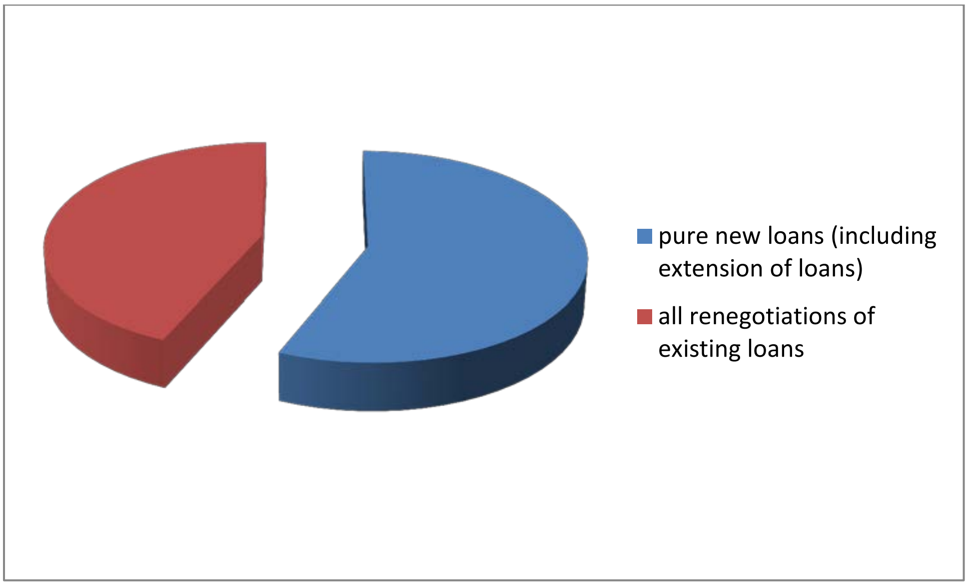


Chart 2 illustrates the percentage of net new loans for house purchase including increases and all renegotiated loans. The chart shows that in the case of housing loans, previously existing loans account for almost half (44%) of net new loans in the economy.

Chart 2 – New loans provided to households for house purchase – share of renegotiated loans



It is apparent from Chart 3 that in the case of consumer credit the share of renegotiated loans is nowhere near as high as in the case of loans for house purchase. Previously existing loans account for a negligible proportion (12%) of net new loans.

Chart 3 – New loans provided to households for consumption – share of renegotiated loans

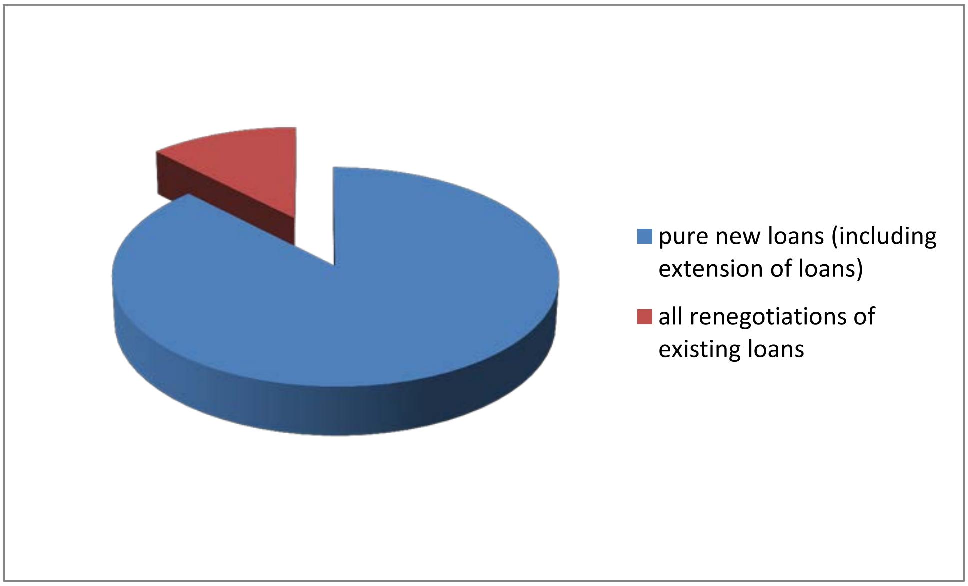


Chart 4 illustrates in more detail the share of refinanced loans and other renegotiations for both consumer credit and loans for house purchase. As regards loans for house purchase, clients tend to stay with the original bank rather than renegotiate their loans with another institution. However, these loans are not negligible either – they account for about one-quarter of previously existing loans.

Chart 4 – Loans for house purchase and consumption by new loan category (in CZK millions)

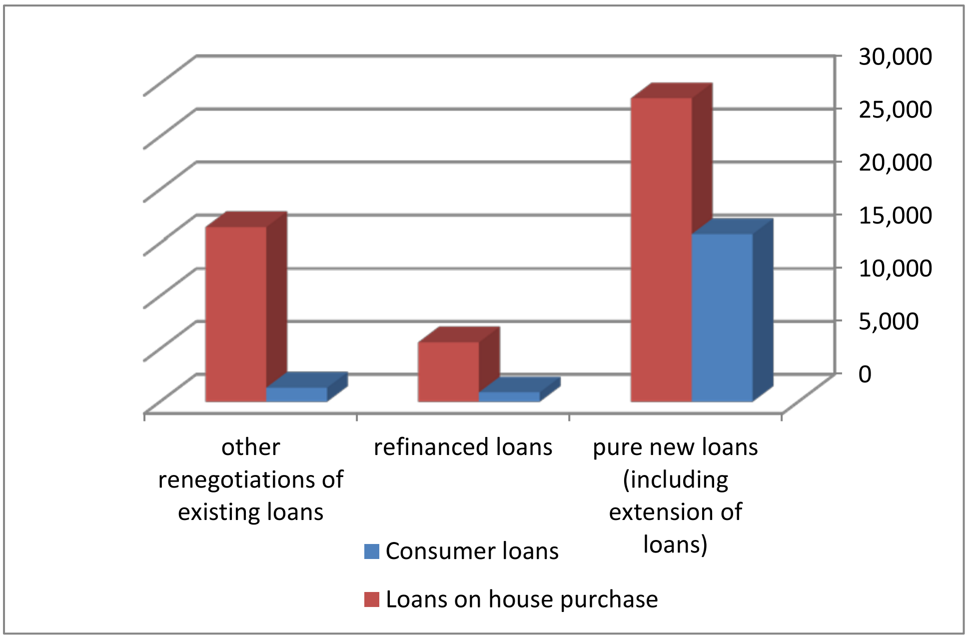
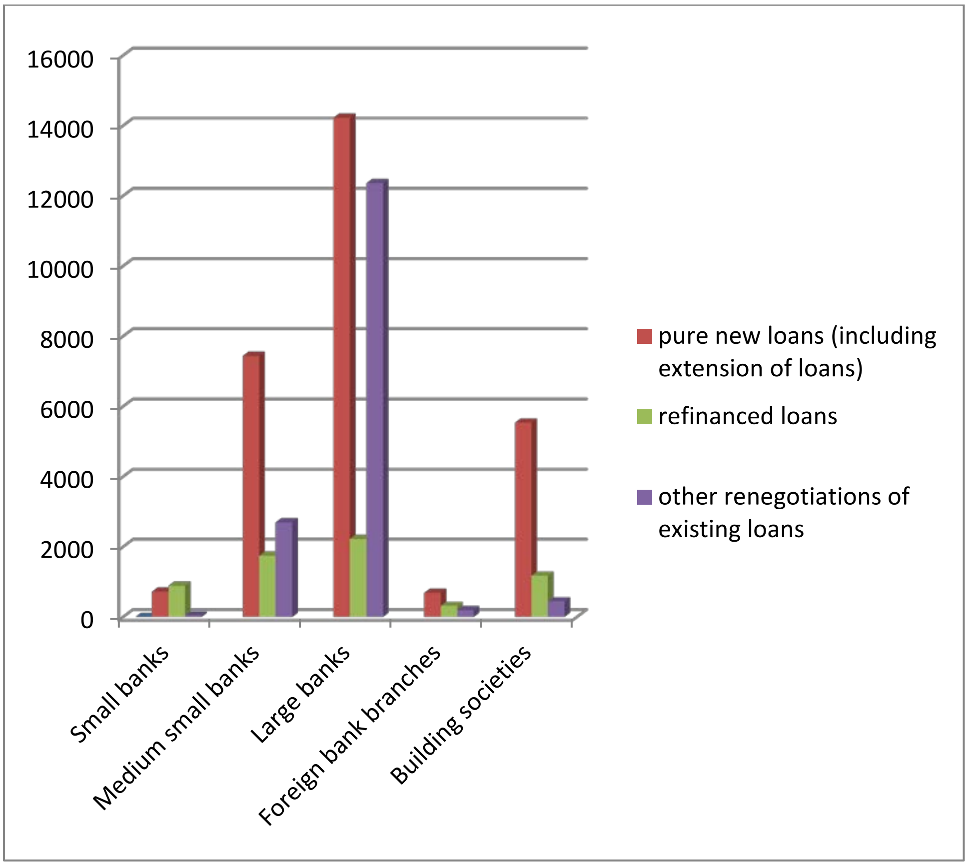


Chart 5 shows the shares of bank groups in each category of new loans for house purchase. As expected, large banks account for the largest proportion in all categories. Refinanced loans are the only category where medium-sized and small banks have comparable shares. Medium-sized banks are almost equal to large banks in this category.

Chart 5 – New loans by bank group (in CZK millions)

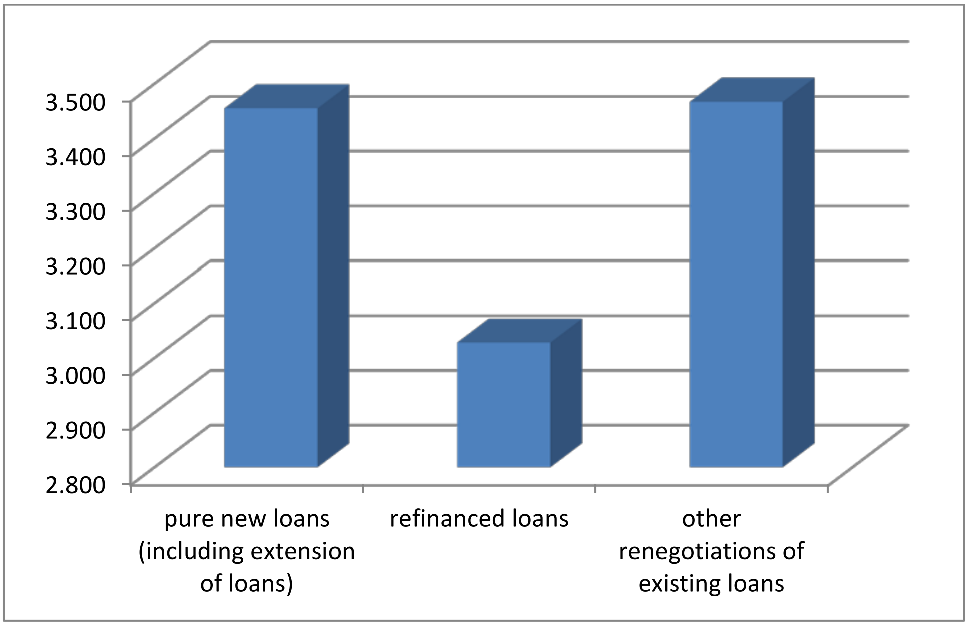


Interest rates on new loans to the household sector

Chart 6 illustrates interest rates on new loans for house purchase broken down by new loan category. The chart shows that the lowest rates are, as expected, offered for refinanced loans. In other words this means that if a client decides to renegotiate his/her mortgage with an institution other than the original lender, he/she will negotiate a rate that is about 0.4

percentage point lower. Interest rates on net new loans are almost the same as those on other renegotiated loans. This implies that if the client remains with his/her original lender when altering the terms and conditions of the contract (most frequently interest rate refixation), he/she obtains an interest rate that is comparable with that on net new loans in the economy.

Chart 6 – Interest rates on new loans for house purchase to households (in %)



As regards interest rates on loans for house purchase by bank group, Chart 7 shows that they are almost identical across all bank groups. Building societies are the only group that differs. However, building societies and the services they provide differ in nature from other banks. For example, they provide bridging loans, which are provided at higher rates than the usual rates on mortgage loans for residential property.

Chart 7 – Interest rates on new loans for house purchase by bank group (in %)

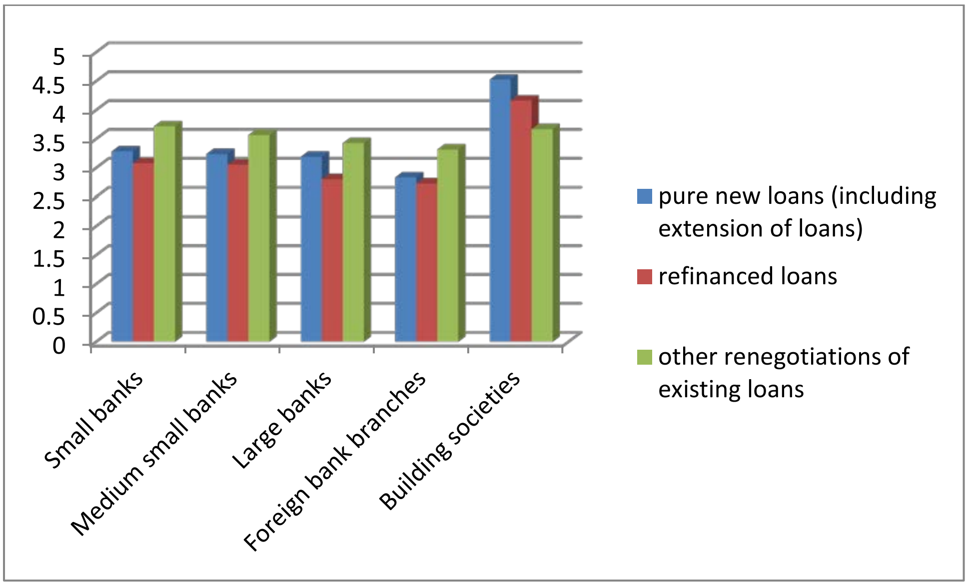
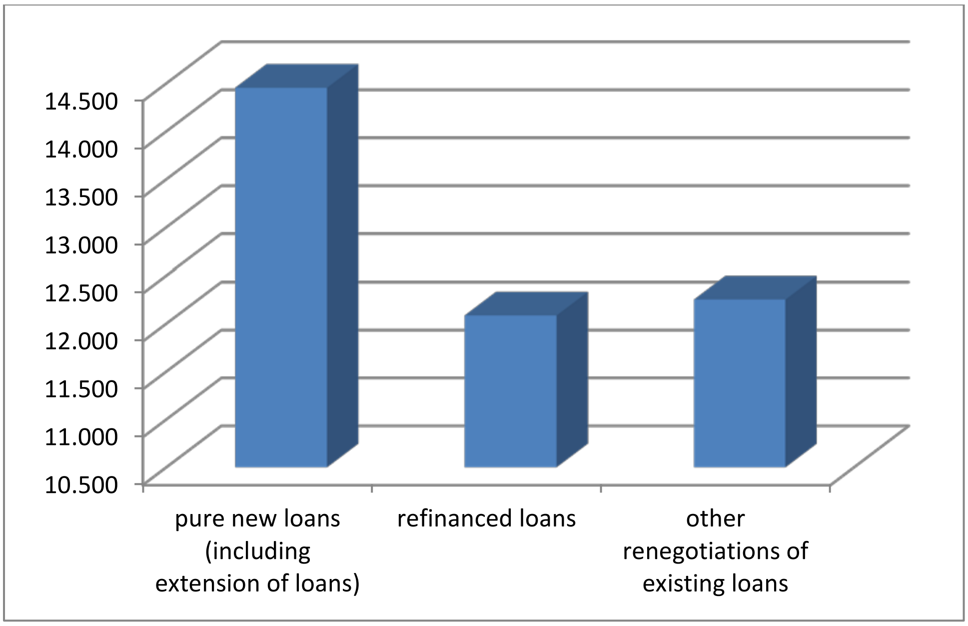


Chart 8 shows the differences in interest rates on consumer credit, again by new loan category. The highest consumer credit rates are charged on new loans. They are more than 2 percentage point higher than those on renegotiated contracts. If a client renegotiates his/her consumer credit with another institution or alters the terms and conditions of the contract with his/her original lender, he/she obtains a better rate.

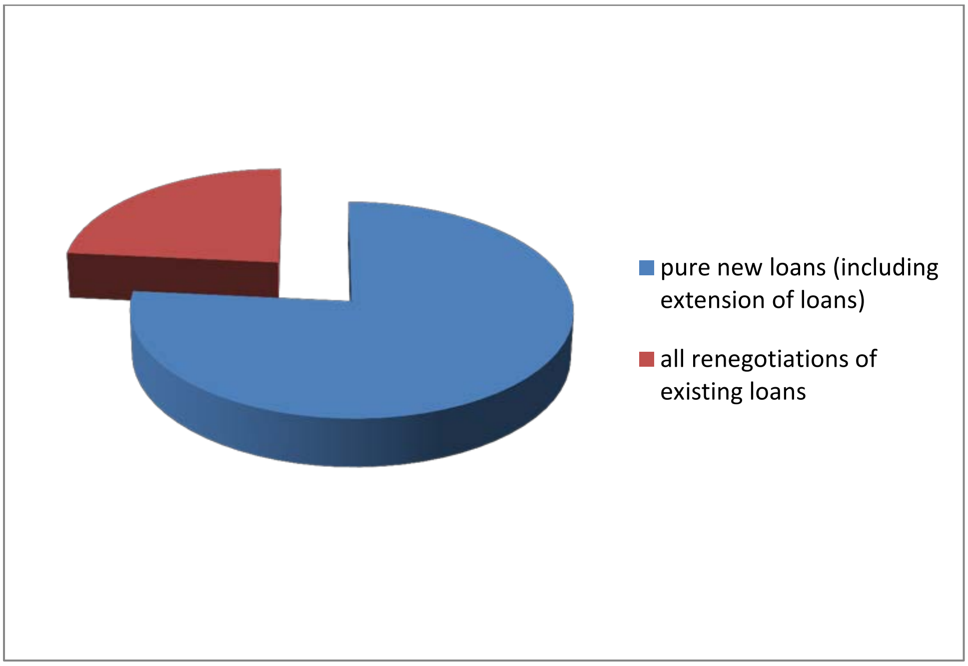
Chart 8 – Interest rates on consumer credit provided to households (in %)



New loans to non-financial corporations

The share of previously existing loans is much lower for non-financial corporations than it is for households. Such loans account for about 23% of total loans.

Chart 9 – Total new loans to non-financial corporations – share of renegotiated loans



It is clear from Chart 10 that in the case of renegotiation, borrowers tend to stay with their original lender when altering the terms and conditions rather than transferring their loans to another institution. Chart 11 shows, however, that the interest rates on these new loans are about 1.5 percentage points higher than those on refinanced loans, which are provided at the lowest rates. Commercial banks explain this mainly by the fact that clients usually buy other products when taking on a completely new loan, which allows them to obtain a lower interest rate than clients who are merely renegotiating existing loans with their banks.

Chart 10 – New loans to non-financial corporations by new loan category (CZK in millions)

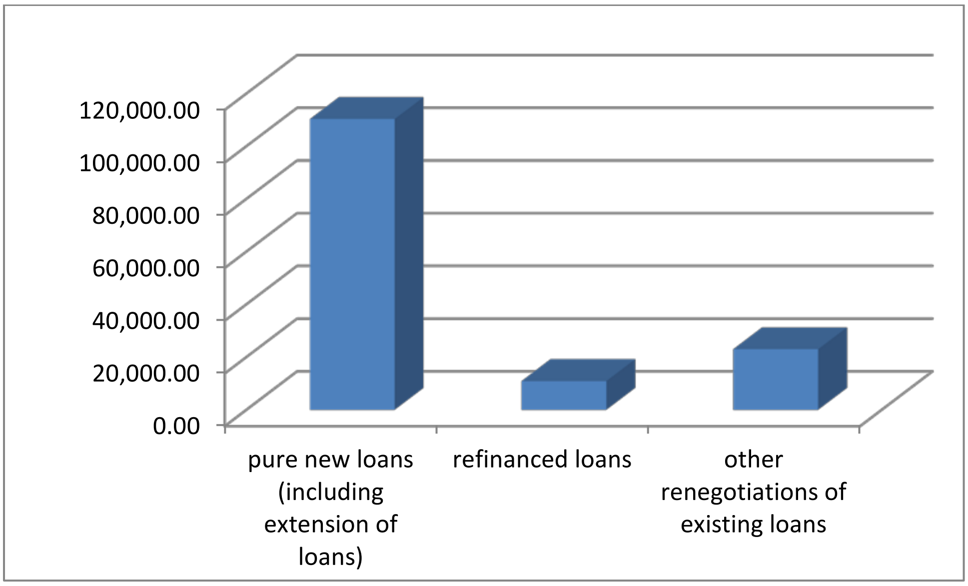


Chart 11 – Interest rates on new loans to non-financial corporations by new loan category (in %)