Fiscal Council's opinion on the draft Government Emergency Ordinance amending and supplementing the Law no. 571/2003 regarding the Fiscal Code (granting a special deduction to income tax calculation for restructured loans)

On June 10th, 2014, the Fiscal Council (FC) received by e-mail from the Ministry of Public Finance (MPF) the letter no. 41314 dated June 5, 2014, requesting the opinion on the draft emergency ordinance amending and supplementing the Law no. 571/2003 (regarding the introduction of a special deduction to income tax calculation for restructured loans) under article 40, paragraph (2), letter e) of the Fiscal Responsibility Law (FRL) no. 69/2010. On June 19th and 20th, 2014, the Ministry of Public Finance sent by e-mail to the Fiscal Council updated versions of the proposed ordinance, the evaluation of Fiscal Council considering only the latest form of the draft amendment to the Fiscal Code. According to the above mentioned article of the FRL, among the main tasks of the Fiscal Council are the "*preparation of cost estimates and issuing opinions on the budgetary impact of the normative ordinances, other than the ones mentioned on (d) and the amendments made on the annual budget law during the parliamentary debates*".

In addition, given the negative impact on the budget revenues involved by the above mentioned ordinance, the legislative proposal submitted to the Fiscal Council falls also under the article 13 of FRL which stipulates that: "*Proposals for any legislation leading to a reduction of budgetary revenues must provide a financial statement according to article 15 of Law no. 500/2002, as amended and supplemented and meet at least one of the following conditions:*

(a) To have the endorsement of the Ministry of Public Finance and of the Fiscal Council, confirming that the financial impact was taken into account in the budgetary revenue forecast and does not affect the annual budget targets and medium term targets;

(b) To be accompanied by proposals for measures to compensate the financial impact, by increasing other budgetary revenues."

The case in question is covered by paragraph a) of FRB article cited above, given the fact that compensation measures have not been taken to offset the negative impact on revenues.

A brief description of the legislative proposal and of MFP estimates regarding the impact on revenues. General considerations

In the absence of the changes and amendments to the Fiscal Code introduced by the legislative proposal, individuals with incomes from salary or pension owe a personal income tax applied to a tax base equal to the gross income minus social security contributions. In the case of salary incomes, the computation base is the net income minus the personal deduction, union dues and any voluntary contributions to facultative pension funds up to 400 euros per year. The personal deduction of the employees depends on the number of their dependent persons and is granted to those with a gross monthly income up to 1000 lei, decreasing for those with incomes between 1001 and 3000 lei, while for incomes higher than 3001 lei there are not any deductions granted. For pension incomes, the computation base for the personal income tax is represented by the net income minus the monthly untaxable amount of 1000 lei. The legislative measure under review provides an additional monthly deduction for the personal income tax calculation corresponding to restructured loans of borrowers with a gross income less than or equal to 2200 lei, to be applicable during the period January 2016-December 2017.

The special deduction for loans is granted if the loan restructuring fulfills the following requirements:

a) is granted for credits with no payment delays or which are overdue for no more than 90 days;
b) leads to a decrease of at most by 35% of the debtor's monthly payment obligations, but no more than 900 lei, no matter if the loan was granted in lei or in foreign currency, for a period of maximum two years;
c) provides the extension of the initial credit period for which the payment obligations diminish, according to letter b);
d) the amount representing the reduction under letter b) and the corresponding financing price should be evenly distributed over a period equal to that which was given for the reduction of liabilities, starting with the date when the respective reduction no longer operates, under letter b);
e) the interest rate afferent to payment obligations during the extended period of the initial credit term scheduled under letter. c) cannot be greater than the interest rate stated in the contract at the date of credit restructuring request;
f) the lender does not increase the interest rate and other costs of financing and do not impose other charges otherwise than foreseen in the contract at the request of restructuring;
g) the restructuring scheme is achieved by January 1st, 2016.

The borrowers who opt for loan restructuring will be granted a special deduction from the personal income tax, **monthly, after the end of the period of rate reduction, equal to the new rate, but not more than 900 lei per month**. Also, the deduction is granted only within the period January 2016-December 2017. Consequently, a borrower who agreed with the credit institution a decrease of the rate during July 2014 - June 2016, respectively for the maximum period set by the legislative proposal will benefit from the application of an income tax deduction only during July 2016 - December 2017, respectively for 18 months.

The current legislative measure aims to support the borrowers with an income below and close to the average, having difficulties in the repayment of their debts to credit institutions and non-banking financial institutions, but also to stimulate consumption. The substantiation note attached to the regulatory document estimates a loss of budget revenues from the income tax in the amount of 725.5 million lei in 2016 and 757 million in 2017. Furthermore, the MPF states in the same substantiation note that the budgetary impact will be included in the Fiscal strategy for the period 2015-2017 and will be taken into account when drafting the budget law for 2016 and 2017. As a matter of fact, the budgetary impact of the application of the ordinance would have to be known with a high degree of preciseness at the time of elaborating the draft budget for 2016, given the fact that among the conditions for accessing the facility includes restructuring the loan until 1 January 2016.

The assessment of the budgetary impact of the proposed legislative measure

The starting point of the Fiscal Council's assessment is based on the data for loans to individuals ordered from the perspective of income installments, regarding the number of borrowers, the number of loans, the average residual maturity, the value of outstanding loans (total exposure), and the average interest rate. Considering the legislative proposal, the analysis focuses on loans granted to individuals whose gross incomes do not exceed 2,200 lei per month. The total exposure on loans granted to this category of borrowers is equal to 31.81 billion lei or 36.93% of the total loans to individuals, while the maximum number of borrowers covered by the proposed legislation is about 985,000, representing 48.84% of the total loans contracted to physical persons for real estate investment and consumption purposes.

In order to determine the budgetary impact of the proposed legislation, and also to illustrate the options available for an eligible debtor in the case of the loan restructuring, we use a numerical example for a loan characterized by the features placed on the average of the data considered (hereinafter "representative credit"). The opinion includes two versions of the reimbursement schedule for the representative credit, defined as having a residual value to be reimbursed of 26,651 lei, an average interest rate of 10.2% and a residual maturity of six years, one version corresponding to current conditions (without diminishing rate, rescheduling and additional tax deduction), and the second version given that the monthly payment is reduced by 35% for a period of two years (the maximum period permitted by the legislative proposal), while granting an extension for the maturity of 24 months; in the latter case, the new monthly installment payment after the expiry of the two years in which the rate is reduced will be recalculated taking into account the residual value to be reimbursed and the new repayment period of time.

According to the present situation, a representative individual borrower (physical person) pays a monthly rate of 496.42 lei for a period of 72 months, the average interest rate is 10.2% and the total interest paid is 9087.37 lei. Assuming a 35% rate reduction, the maximum allowed by the legislative proposal and in the conditions occurring while extending the maturity by 24 months, the monthly rate diminishes to 322.68 lei for the first two years and increases to 448.97 lei for the following 6 years (4 years related to the original maturity plus two years corresponding to the extension of the maturity); even with this increase, the monthly rate applicable to the period after the reduction by 35% expires, remains lower than the rate in the absence of the grant facility introduced by the legislative proposal. In this latter case, given that the total interest paid in 8 years amounts to 13,419 lei and that the borrower benefits also of a reduced income tax equivalent of savings of 1293.03 lei (corresponding to a monthly savings equal to the new rate of 448.97 * 0.16 = 71.84 lei for 18 months, given the application deadline facility is December 2017 and assuming that the loan restructuring would start from July 1, 2014), the annual equivalent cost of the credit should be 9.62% per year. In principle, a representative borrower has to opt between a loan for six years at a cost of 10.2% per year and a loan for eight years at an annual equivalent cost of 9.62% per year, the total interest paid is obviously higher in the latter case, but with the State bearing a part of the supplementary costs. It is obvious that in practice, depending on the parameters agreed bilaterally for the loan restructuring (the period of time for which the annuity is reduced, and the moment of time when the restructuring agreement occurs), the equivalent annual cost of the loan may be different, but compared to the cost in the absence of restructuring, is lower.

It is difficult to quantify the share of borrowers who will be interested in this scheme, as it depends, among other things on the ability of the borrower to pay the debt service in the present, on his preference for extending the loan maturity given that at the end of the period he should pay a higher amount of money to the lending institution (even if the equivalent annual cost decreases slightly) and on the administrative form-filling imposed by appealing to the provisions of this legislative measure.

The decision on the restructuring of a loan also requires the approval of the lending institutions and it is difficult to assume *ex ante* that they will be interested to offer to all borrowers the possibility to pay their loans with restructuring plans, under the circumstances that the corresponding credits are not included as not performing loans. Therefore, the actual number of restructured loans can be found at the intersection of the preferences of debtors and creditors. However, it can be appreciated that there is a reasonable chance that the legislative proposal to be less attractive for borrowers who do not have payments delays (90% of total eligible borrowers have overdue payments for less than 15 days), provided they are not going to achieve additional indebtedness, and at the same time more attractive to those who already recorded significant delays in the debt service (but up to 90 days). Moreover, in the latter case there is the possibility of more interest from banks for the agreement on the loan restructuring.

Given the aforementioned uncertainties regarding the number of loans to be restructured and which would benefit from the fiscal facility, the assessment of the budgetary revenue loss should be presented as a range, whose ends correspond to some implausible assumptions, but however, with a non-zero probability of appearance. The lower edge of the range is obviously zero and corresponds to a highly unlikely scenario where either no debtor would be interested in the restructuring of loans or any financial institution would agree to a restructuring proposal. The upper edge corresponds to the situation also unlikely that all eligible borrowers opt for a 35% rate reduction for a period of two years, and the financial institutions will approve all the requests for restructuring: while the extension of the maturity for the representative credit will be 24 months and would occur on 1 July 2014, the budget revenue loss for the period January 2016 - December 2017 would be 448.97 (corresponding to the rate after the 2 years equivalent to additional tax deduction) * 18 months * 0.16 (income tax) * 1,193,670 (number of credits) = 1, 543 billion lei, corresponding to an annualized impact of -771.73 million lei in the revenues, a level close to the estimate included in the note accompanying the legislative proposal. Therefore, income tax receipts will be lower by an amount between 0 and 771.73 million lei per year (maximum representing about 0.1% of the projected GDP for 2016).

The Fiscal Council considers that there is a high probability that the net budgetary impact to be at the bottom of the aforementioned range. This is in line for the optional nature of the facility given that the attractiveness is potentially low for those borrowers who do not register arrears in their debt service (about 90% of those with less than 90 days overdue are overdue less than 15 days) and also for the possible positive effect on the economy during the reduction of the monthly payment due to the extra temporarily disposable income. Under the most optimistic assumption that all eligible borrowers would opt for and benefit from rescheduling, the disposable income would increase by a maximum of 5 billion lei and the positive economic impact has the potential to be substantial given that the measure targets the consumers with incomes close to and below the average and therefore with high marginal propensity to consume in a period when there is a shortage of aggregate demand. The Fiscal Council considers that, however, the probability of a scenario close to these parameters is very low to materialize.

Under these conditions, the loss of revenue should be easily accommodated within the budget plan so that the annual and medium term targets are not affected. In addition, at the time of finalizing the draft budget for 2016, uncertainties relating to the size of the budget revenue loss will be clarified, and the amount of the budgetary revenue losses can be assessed accurately and appropriately compensated. In these circumstances, the Fiscal Council approves favorable the draft emergency ordinance amending and supplementing Law no. 571/2003 (regarding the introduction of a special deduction to income tax calculation for restructured loans).

The above opinions and recommendations of the Fiscal Council were approved by the Chairman of the Fiscal Council, according to Article 43, paragraph (2), letter d) of Law no 69/2010, based on the vote of the Fiscal Council members in the meeting 26th June 2014.

26th June 2014

President of the Fiscal Council

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ANNEX

Table no. 1: Information on Loans to Debtors with a Gross Monthly Income <=2,200 lei and with Less than 90 Days Overdue	
	Total (0-2,200]
Total exposure (lei)	31,812,520,850
No. of debtors	984,871
No. of loans	1,193,670
Average residual maturity (years)	6.0
Average initial maturity (years)	9.2
Average annual interest rate (%)	10.2
Average monthly debt service (lei)	512
Average value per debtor (lei)	32,301
Average loan value (lei)	26,651

Source: National Bank of Romania based on the information from the Central Credit Register, the Credit Bureau; NAFA

Table no. 2: Information on Loans to Debtors with Less than 90 Days Overdue	
Total exposure (lei)	86,139,711,435
No. of debtors	2,016,439
No. of loans	2,461,854
Average residual maturity (years)	6.2
Average initial maturity (years)	9.0
Average annual interest rate (%)	10.1
Average value per debtor (lei)	42,719
Average loan value (lei)	34,990

Source: National Bank of Romania based on the information from the Central Credit Register, the Credit Bureau; NAFA

Table no. 3: The Repayment Schedule of a Loan in the Absence of the Proposed Legislative Measure (lei)

No. of months	Annuity	Interest	Principal	Residual Value
1	496.42	226.53	269.89	26,381.13
2	496.42	224.24	272.19	26,108.94
…	…	…	…	…
72	496.42	4.18	492.24	0
Total	35,246.15	9,087.37	26,158.78	-

Source: Fiscal Council's calculations based on Table no. 1 data

General Assumptions in the Context of Opting for the Fiscal Facility
1. It was considered the case of a debtor with a gross monthly income <=2,200 lei and with less than 90 days overdue, who has an ongoing credit (consumer or mortgage), the average value being equal to 26,651 lei, with an average residual maturity of 6 years (72 months), having an average interest rate of 10.2%.
2. It was assumed that he will choose to restructure the loan as follows: - he chooses to reduce its rate with the maximum of 35% provided in the legislative proposal, for 2 years (during July 2014-June 2016), along with the maturity extension; - the deduction is granted only within the period January 2016 - December 2017; therefore, a debtor who agreed with the creditor the rate reduction during July 2014- June 2016, respectively for the maximum period provided in the legislative proposal, will benefit of the deduction application at the calculation of income tax only during the period July 2016- December 2017.
3. When assessing the financial impact of the proposed legislative measure on the general consolidated budget for the years 2016 and 2017, it was considered the number of consumer credits and mortgages (1,193,670) and also the revenue loss from the income tax corresponding to the considered average credit for the application period (18 months): 1,193,670 * 71.84 lei * 18 months.

Table no. 4: The Repayment Schedule of a Representative Loan in the Context of the Proposed Legislative Measure (lei)

No. of months	Annuity	Interest	Principal	Residual Value	Deduction	Saving from Personal Income Tax	Net Amount Paid
1	322.68	226.53	96.14	26,554.88	-	-	322.68
2	322.68	225.72	96.96	26,457.92	-	-	322.68
…	…	…	…	…	…	…	…
24	322.68	205.87	116.80	24,103.34	-	-	322.68
25	448.97	204.88	244.09	23,859.25	448.97	71.84	377.13
26	448.97	202.80	246.17	23,613.09	448.97	71.84	377.13
…	…	…	…	…	…	…	…
42	448.97	167.10	281.87	19,377.40	448.97	71.84	377.13
43	448.97	164.71	284.26	19,093.14	-	-	448.97
44	448.97	162.29	286.68	18,806.47	-	-	448.97
…	…	…	…	…	…	…	…
96	448.97	3.78	445.19	0.00	-	-	448.97
Total	40,070.02	13,419.00	26,651.02	-	8,081.45	1,293.03	38,776.99

Source: Fiscal Council's calculations based on Table no. 1 data

Table no. 5: The Cost of a Representative Restructured Credit vs. The Cost of a Representative Credit in the Absence of the Fiscal Facility	
Indicator	**Value**
Annual cost equivalent to the initial credit (% year)	10.20%
Annual cost equivalent to the restructured credit (% year)	9.62%
Overpaid interest (lei)	4,331.64
Saving from personal income tax (lei)	1,293.03
Difference (lei)	3,038.60

Source: Fiscal Council's calculations