Resolving Non-Performing Loans:

Selected International Experience

- Summary of Results -

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Berlin/Minsk, May 2017

Structure

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    - Asset separation
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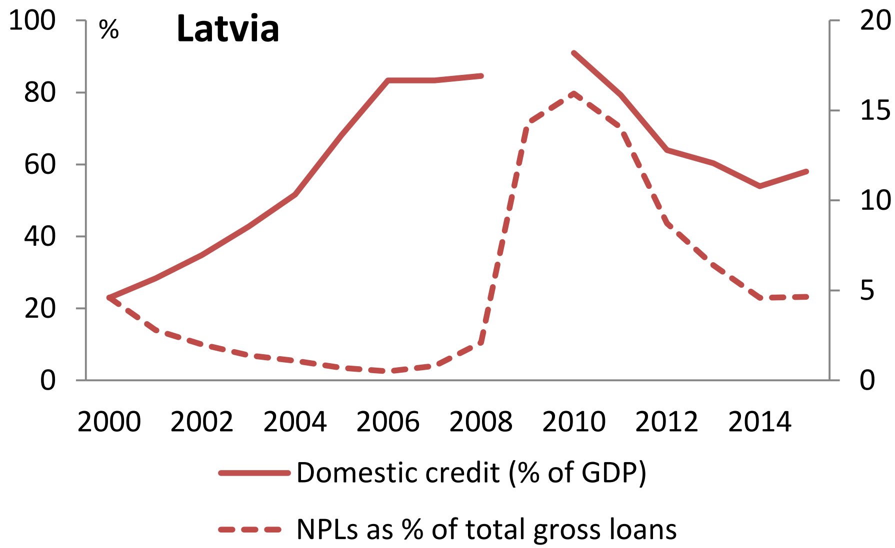
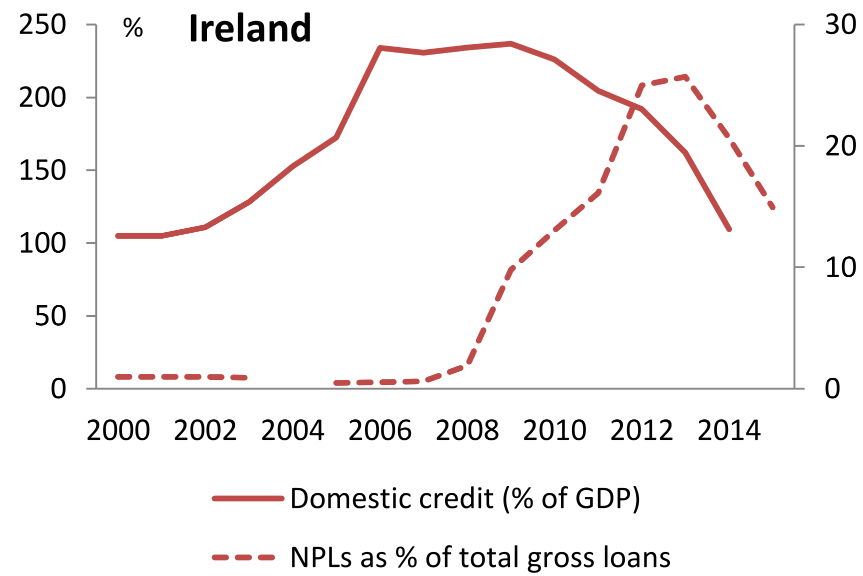
1. NPLs in the financial cycle

Domestic credit and non-performing loans: Latvia and Ireland



Source: World Bank; Note: no data available for domestic credit as % of GDP for 2009



Source: World Bank; Note: no data available for NPLs as % of total gross loans for 2004

➢ **High NPLs levels are a regular feature of the financial cycle**

2. Determinants of NPLs

Probability of default	Loss given default
Cyclical determinants	
• Economic growth	
• Interest rate shock	
• Exchange rate shock, if unhedged exposures in Households/Non-financial corporations	
Structural determinants	
• Poor lending standards/risk management within banks	
• Expectation of general forbearance/forgiveness	
	• Poor restructuring mechanisms
	• Poor credit registers/collateral valuation
	• Poor creditor coordination
	• Delays in restructuring and courts

3. Definitions and accounting standards

NPL measures must be seen in context of national insolvency regime

But an asset classification that is consistent and internationally comparable is important:

- Incentive for banks to address deterioration at an early stage
- Incentive for supervisors to address potential capital shortfall
- Helps coordinate assistance by international organizations
- Investors and rating agencies reassured

World Bank and Vienna Initiative (2012) found extensive variation in CESEE:

- Treatment of forbearance (restructuring or refinancing of troubled loans)?
- Accounting of NPLs on loan basis or customer basis?
- Gross or net of provisions?

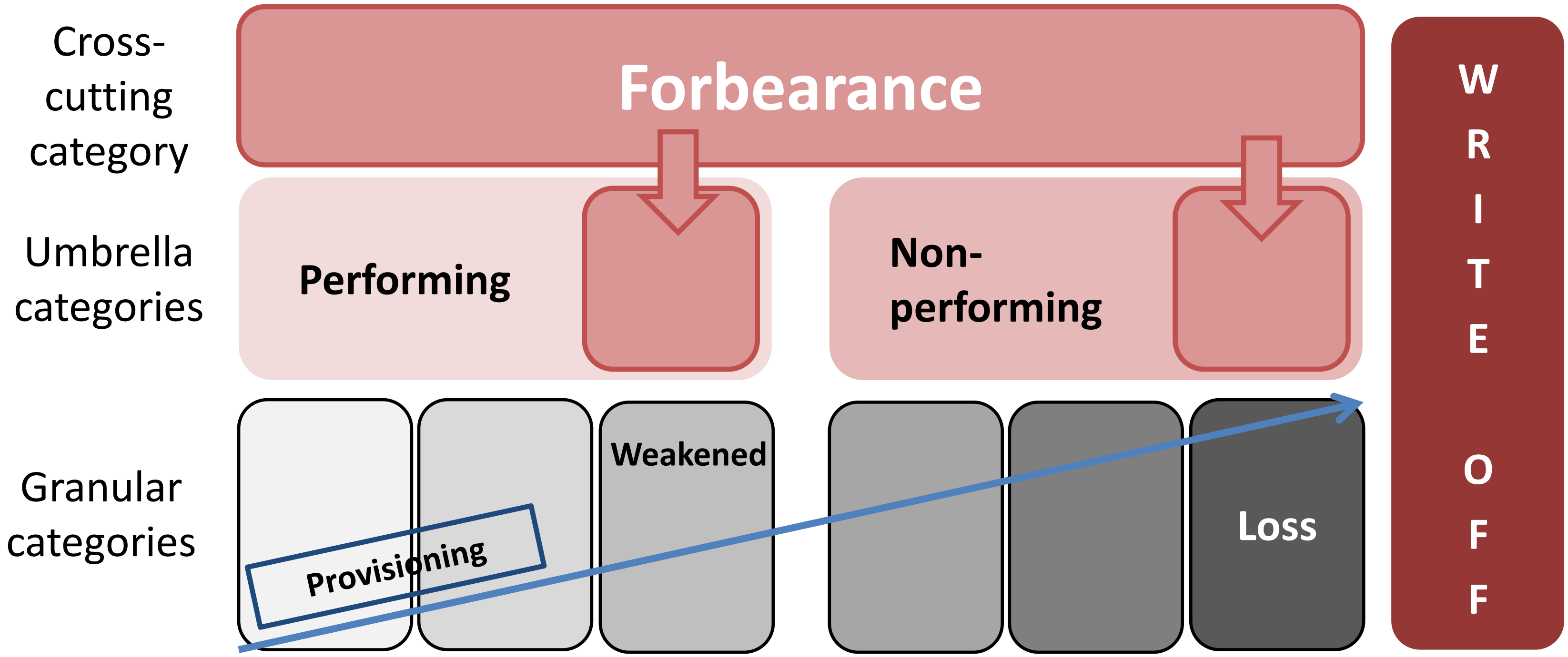
Definitions and accounting standards

Good judgement is needed, though there is now a better agreement among regulators of key concepts:

- ➢ interaction of forbearance with non-performing exposures
- ➢ use of collateral and guarantees
- ➢ Material exposures and the debtor approach

Financial Stability Indicators, 2006	European Banking Authority, 2015	Basel Committee, 2017
• Basic definition, around the 90 days past due criterion	• Forbearance=non-performing, unless performing for a year • Debtor approach for material non-retail exposures ➢ Relevant for countries with large ownership shares by EU banks	• Equally wide definition • non-performing if full repayment unlikely without realization of guarantee • More discretion in recognising forborne loans as performing • Likely the new standard for most emerging markets

Definitions and accounting standards



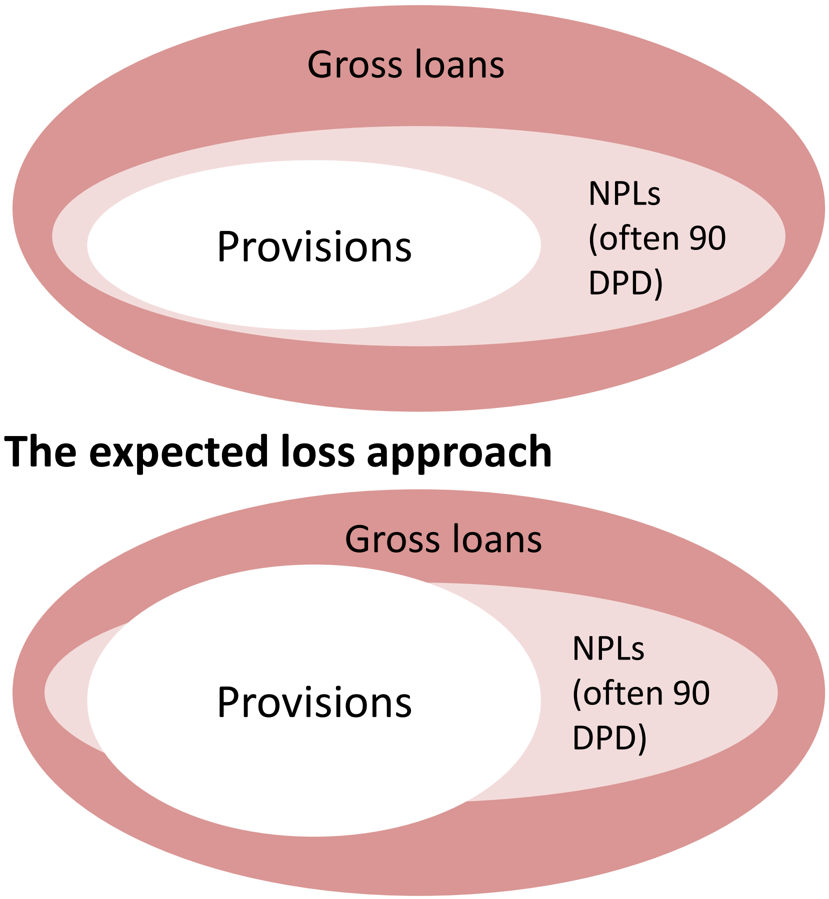
Source: BIS

Accounting standards vs. supervisory definitions

- What matters for bank soundness are future expected losses
- EU banks will move to IFRS9 from 2018, which will require new types of risk models.
- Evolution of NPLs and impairments will be de-linked
  - Negative where there is predominance of ‘ever-greening’
  - Income recognition where recovery has cured loans that are as yet classed as impaired

The incurred loss approach

The expected loss approach



Source: Bholat et al. (2016)

4. Implications for the financial system

- Diminished interest income
- Loan-loss provisions
- Higher operating costs from workout, and legal costs

  → **Lower capital coverage**

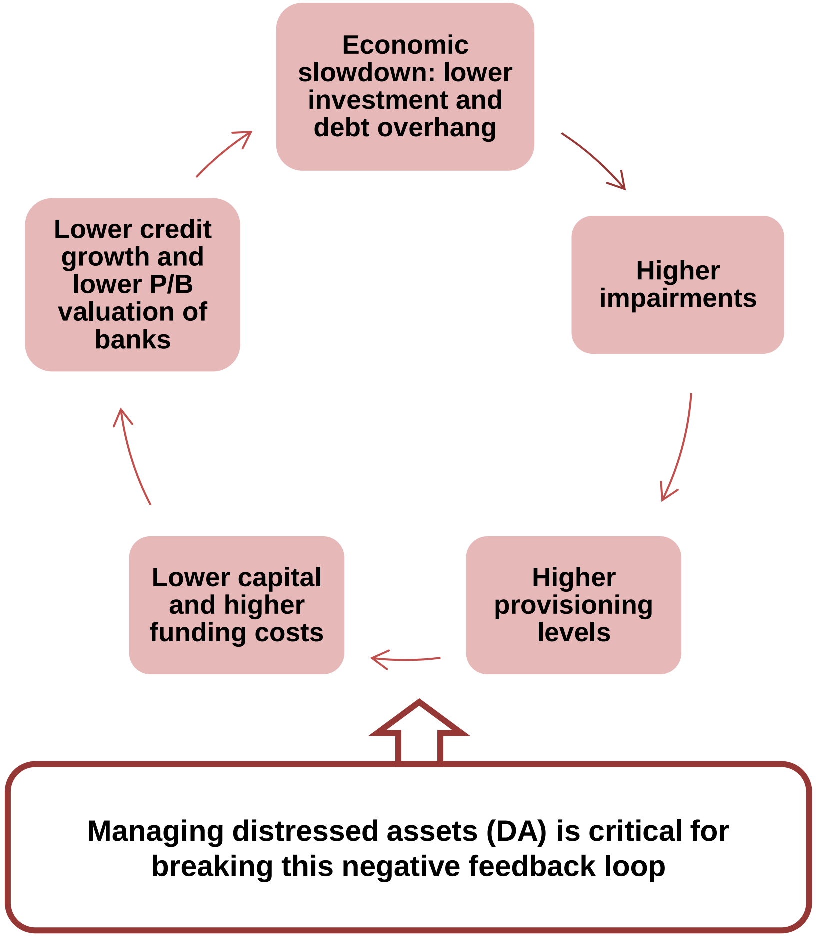
- Uncertainty -> risk premium on bank funding
- Management absorbed by workout
- Lower efficiency/higher interest margins dampens demand

  → **Lending tightened**

- Persistent NPLs – persistent excess debt
- New productive firms confront credit constraints

  → **Debt deflation dynamics?**

Macro-financial impact of high non-performing loans



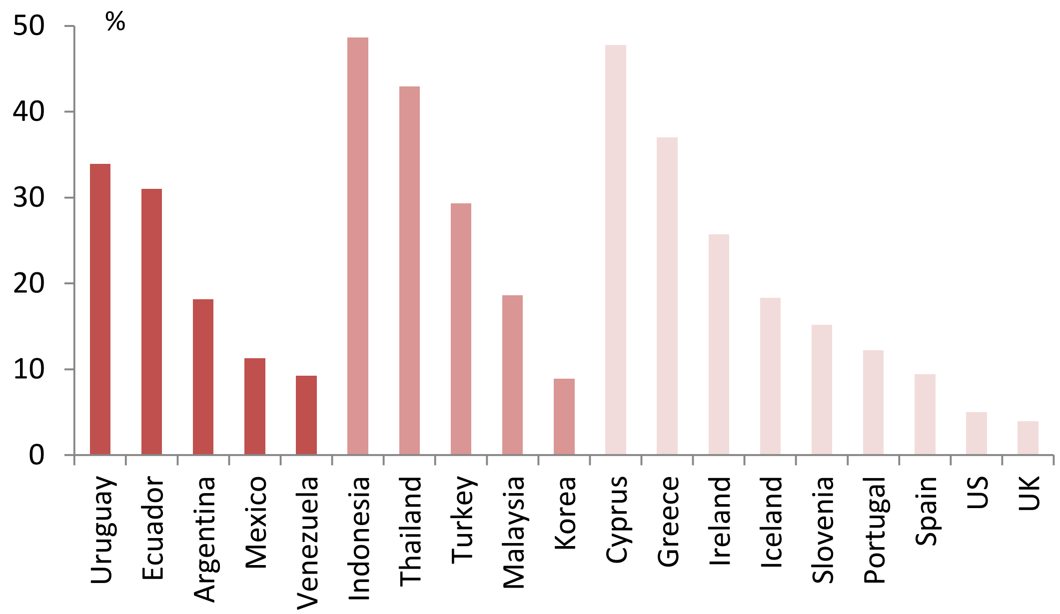
Source: World Bank

5. Experience in other countries

Other countries have experienced similar peaks:

- Sweden (1989-1992)
- Japan (1994-2003)
- Emerging Asia (1997-)
- Latvia (2007-2010)
- …. And later in the CESEE
  - Serbia
  - Romania
  - Slovenia
- Until today in the euro area
  - Greece/Cyprus
  - Spain
  - Ireland
- China?

Peak of NPLs in selected countries



Quelle: World Bank

6. Policy solutions I: Supervision

- More intense supervision and adequate **capital buffers** are a pre-condition for banks' engagement in restructuring and write-offs:
  - System of loan classification that forces swift loss recognition
  - Stop accrual of interest income from NPLs
  - Realistic collateral valuations

- Detailed scrutiny of banks' **NPL capacity**
  - Staff and skills in workout units?
  - Reporting of loan categories in different asset classes

- Bank-specific **NPL strategies** (e.g. Ireland and Cyprus, and now ECB)
  - Plans for capacity building
  - Engagement of investors?
  - NPL reduction targets in individual asset classes?

- Guidance or regulation on NPLs and **code of conduct** for specific asset types

Policy solutions II: Legal reforms

- Purpose of the **insolvency regime** is to allocate risk between creditors and borrowers, and provide credit discipline. The balance of rights varies between countries but needs to be predictable.

- **Legal framework** are regularly assessed against key standards (e.g. World Bank ICR principles):
  - Insolvency reform: Enable permanent deleveraging
  - Foreclosure regime to enable enforcement
  - Title, registration etc.

- **Out-of-court mechanisms** for debt restructuring led by banks
  - Enable consensual private debt restructuring, based on guidelines for the industry and light supervision

- **Capacity and skills**: Specialised judges and insolvency professionals, but also bank workout teams.

Policy solutions III: Asset separation

- Bank internal separation can be credible if backed by strong corporate governance:
  - Non-core division
  - Ring fencing (asset protection scheme)

- NPL sales can be effective for asset classes with straightforward servicing and foreclosure options:
  - Portfolio investors
  - Restructuring investors (private equity)

- Bank de-merger (‘good bank-bad bank split’)
  - E.g. Parex in Latvia after 2008

- Central asset management company (’bad bank’):
  - Consistent valuations of distressed assets
  - Concentrates restructuring skills, and accelerates restructuring

Policy solutions IV: Corporate financial restructuring

- NPL resolution can only succeed if backed by parallel corporate debt restructuring
- Up-front assessment of balance between market-based approach (banks and investors) and state-led approach. Limit moral hazard problems that result from comprehensive state-led debt restructuring.
- Triage: Determine criteria for viability and accept that irredeemably non-viable firms can go into foreclosures
  - May need to be done outside banking sector, through a separate entity
  - Needs to be backed by accurate financial information
- Loss recognition and burden sharing?
- Corporate governance reform and strengthened financial discipline

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