



CROATIAN NATIONAL BANK

NPL Resolution – State of Play Croatia

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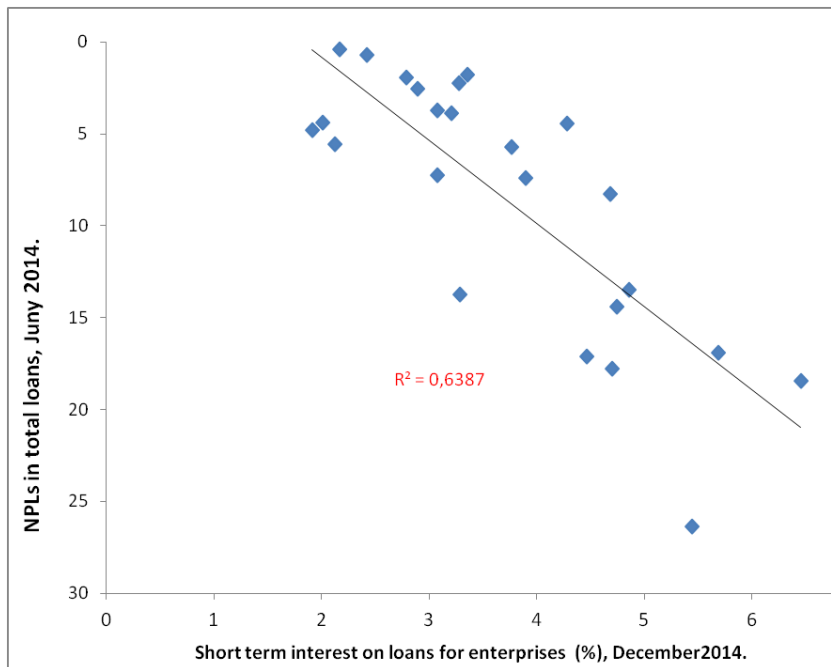
Why is NPL resolution so important?

- NPL isn't accounting or financial problem, but it has significant impact on competitiveness of “real” sector

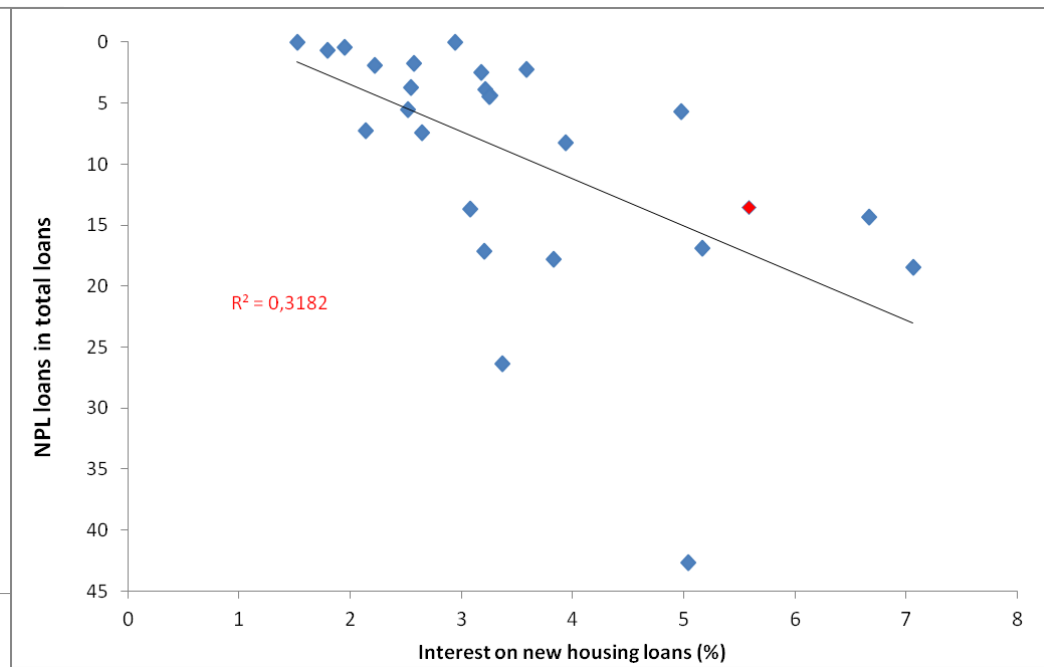
- Three major distortions caused by high NPL:
 - Higher interest costs for performing debtors
 - Suboptimal use of real economy resources
 - Higher risks and negative impact on corporate governances – moral hazard

Higher interest costs

Corporate

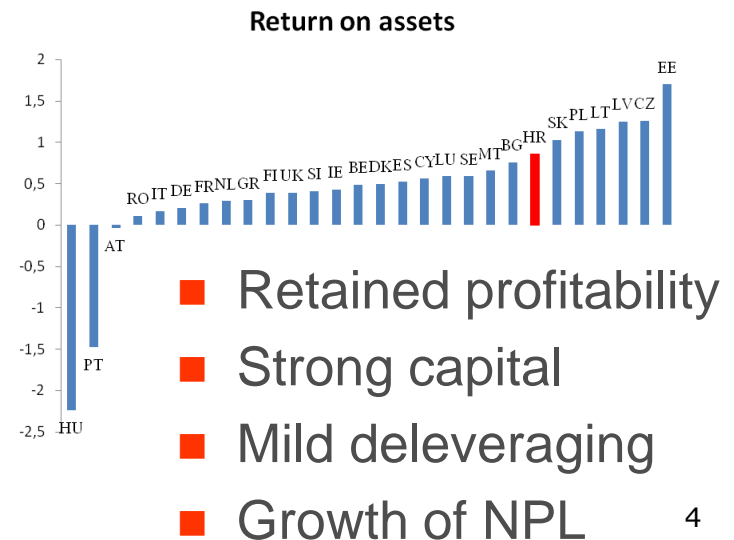
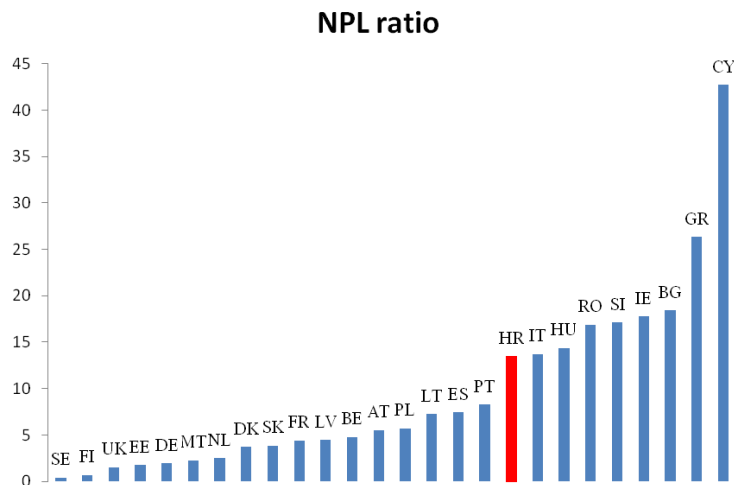
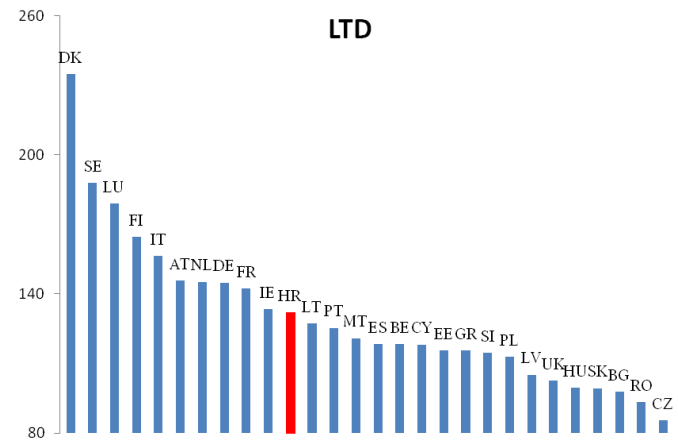
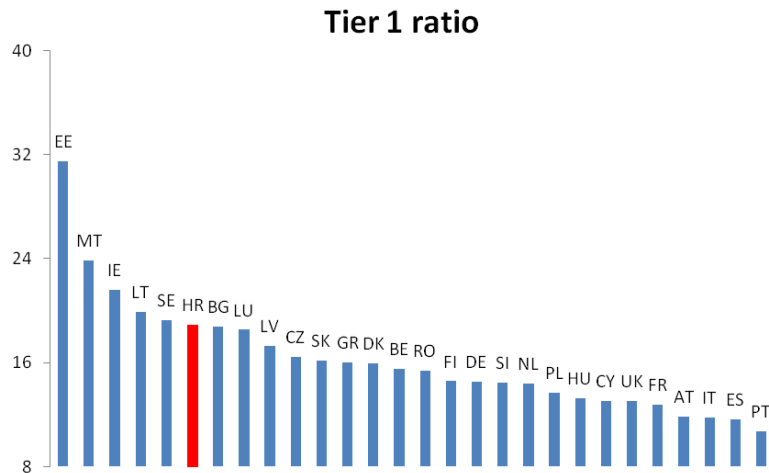


Retail



Banking System as of June/2014

Croatia about EU Average

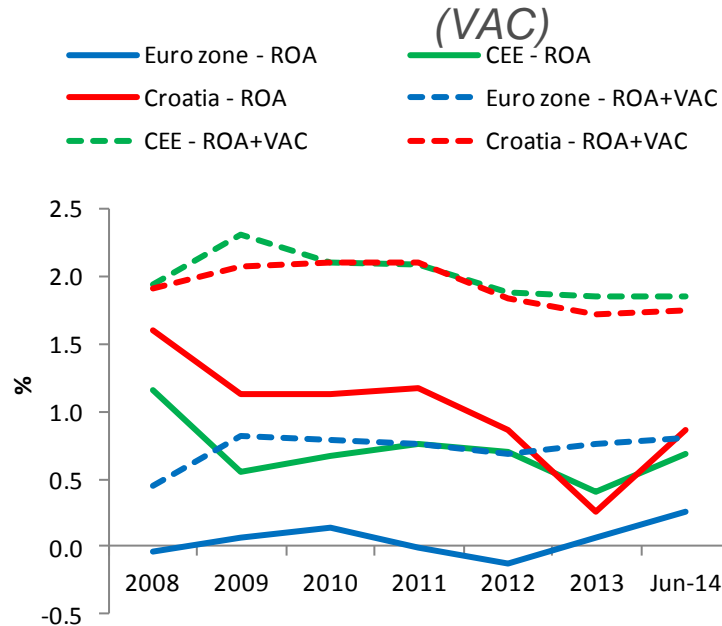


Izvor: ECB (Consolidated banking data), Lipanj 2014.

*LTD ratio is ratio between total loans and non-banking deposits

Banking is in overall good shape

ROA before and after Value adjustment costs



Source: ECB (CBD)

- ❑ Profitability of Croatian banks (ROA) is higher compared with CEE and Euro-zone countries.
- ❑ However, the difference from Euro-zone is even greater when operating profitability is observed, indicating that the credit risk is “eating” higher margins of CEE banks.

Three phases in NPL resolution

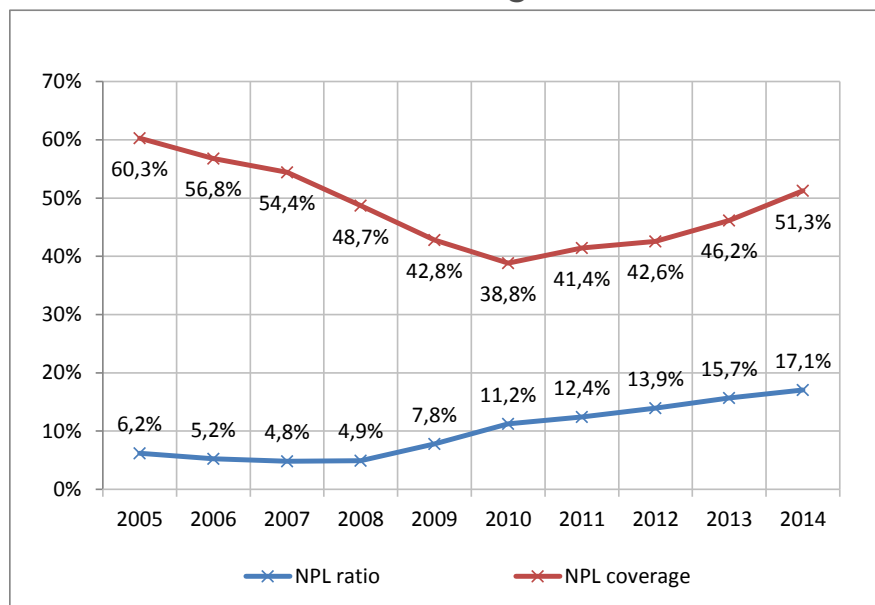
1. Recognition and accounting
2. Workout
3. Write-off

In Croatia generally phase 1 is completed
Phases 2 and 3 would require significant additional effort

1. Recognition and accounting

Dynamics of NPL recognition 2005.-2014.

Share and coverage of NPLs



Source: HNB

- ❑ Decrease of coverage was consequence of inflow of new NPLs and application of very optimistic assumptions;
- ❑ In period 2010-2012 on site supervision increased provisioning, but with high cost in terms of supervisory resources;
- ❑ After implementation of new regulation in 2013 coverage dynamically increased.

Decrease of NPL coverage began already in 2005.

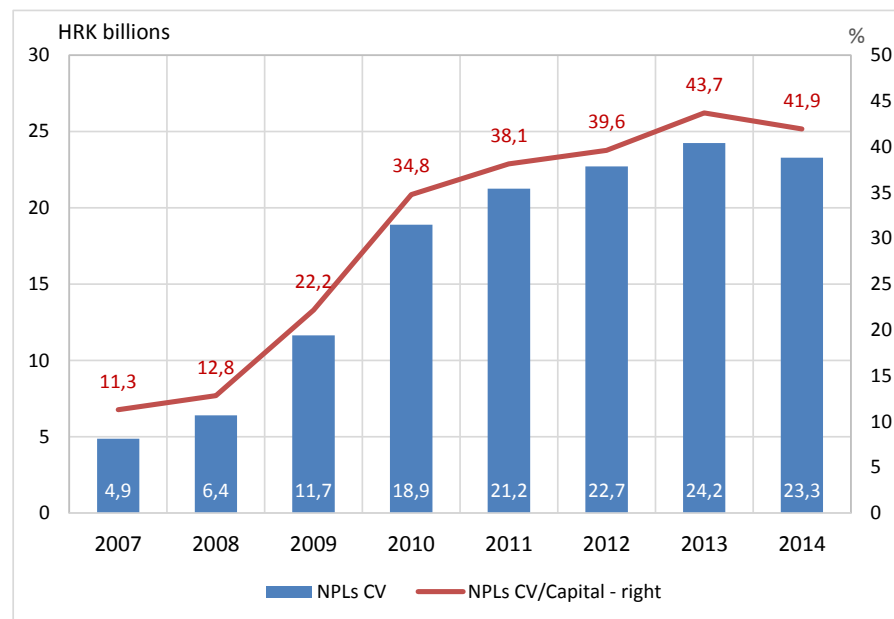
As after beginning of the crisis coverage plunged below 40%, change of regulation become necessary.

Change of regulation

- ❑ in 2013 amendments to the Decision on the classification of loans were adopted
- ❑ those amendments made the following changes:
 - compulsory provisioning was regulated in detail:
 - ❑ compulsory 10% provisioning 90 days past due (delinquency), if no collateral was activated
 - ❑ compulsory 20% provisioning one year after delinquency, if adequate collateral was not activated
 - ❑ compulsory 30% provisioning two years after delinquency, regardless of legal action taken to activate a collateral;
 - after accounting for 30%, **each 6 months an additional 5%** compulsory provisioning
 - minimum of 1% provisions was established for NPLs
 - regulation of restructured loans (how to treat them after restructuring, criteria for their rehabilitation into performing loans)
 - **compulsory minimum haircuts and collection periods** were introduced for real estate and movable property
- ❑ consecutive compulsory provisions (10%, 20%, 30%) were aimed at motivating banks to timely start foreclosure, while the additional 5% provisioning was a kind of “lump sum” correction for all other noticed aberrations from best practice; others are meant to adjust NPL & forbearance definition to the new definition approved by EBA BoS (ITS on supervisory reporting regarding forbearance and non-performing exposures)

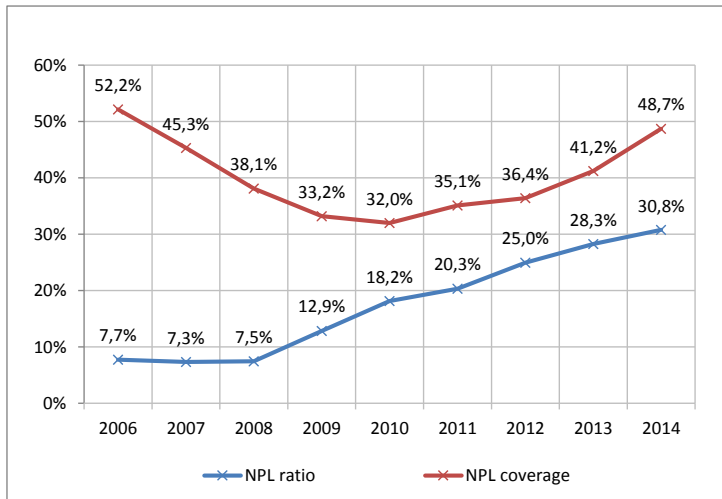
NPLs and regulatory capital

- ratio between carrying value of NPLs and regulatory capital more than tripled between 2008 and 2013
- implementation of new regulation in 2013 stabilized it about 40%
- on average Croatian banking system is able to maintain minimal capital requirements even with full write-down of NPLs

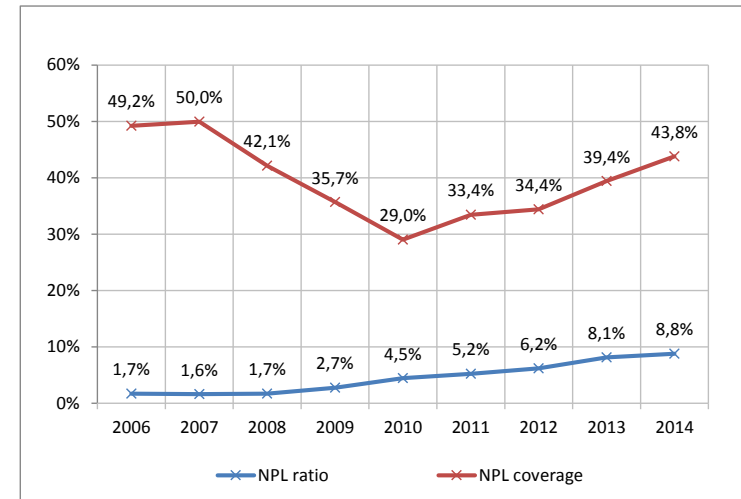


Product specific situation

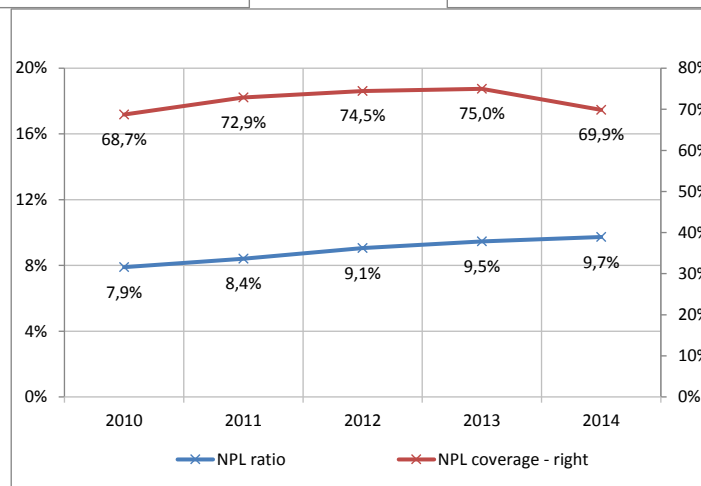
Corporates



Households – home loans

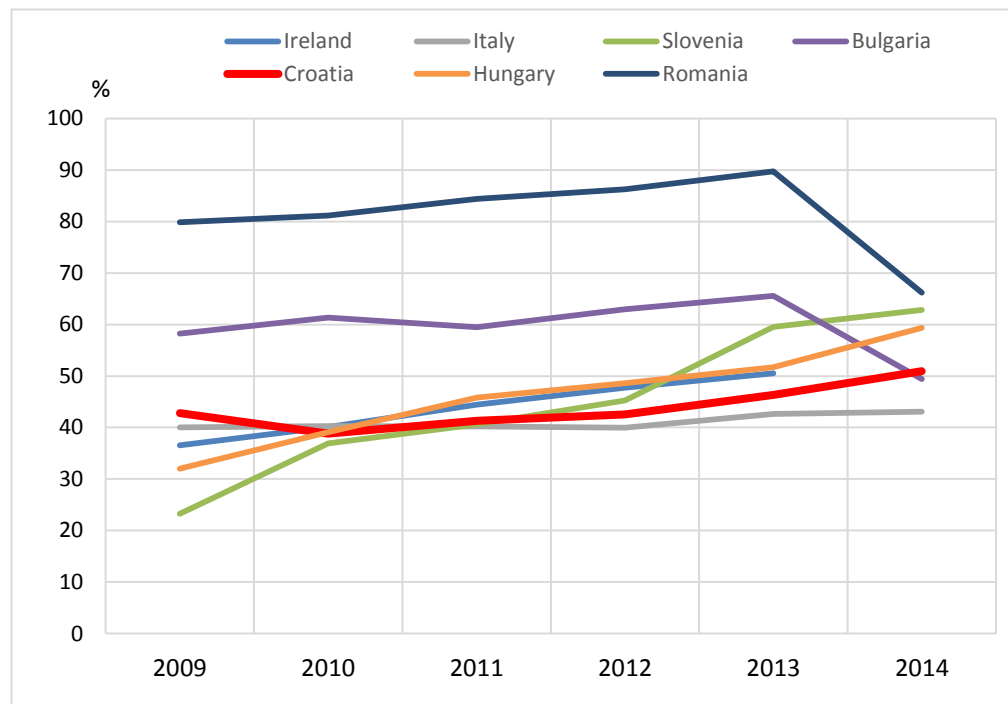


Households – general purpose cash loans



Comparative NPL Coverage

Comparison with countries having similar NPL ratio



Source: IMF, FSI data

2. Workout

Experiences with collection

- Corporate:
 - in period 2008 – 2014 only 18% of all initiated foreclosures on business properties were successful;
 - Out of that number, less than half occurred with third party, while remaining estates were bought by the bank;
 - Achieved average price was below 50% of initial evaluation
- Retail:
 - consumer loans are fully provided. Workout activities are significant and involve also portfolio sales.
 - we are in process of collecting systematic data on workout of housing loans. Existing evidences indicate that workout is very limited.
 - one middle-sized bank reported that in last 6 years they initiated 197 foreclosures. Of this number 10 was successfully completed, and 8 are pending.

Why is collection slow?

- ❑ Major reason is illiquid housing and real estate market. In 2012 real value of housing sales fell to 25% of 2008 figures.
- ❑ Collected data about resolution through sale of commercial real estates also indicate low turnover.
- ❑ NPL ratio in critical industries: construction and real estate development is over 60%, and it is all collateralized.
- ❑ Courts work slowly and sometimes unpredictable, but low marketability is major obstacle for collection.

3. Write-off

- ❑ One of reasons for high NPL ratio in Croatia is the fact that write-off isn't tax deductible if creditor didn't previously use **all** available legal means to collect;
- ❑ as using all legal means is time consuming process, significant part of 100% provided loans remain on balance sheet for extended period of time, creating unrealistic NPL “bulge”.

Conclusions

- **NPL resolution** is significant factor with **influence** on **competitiveness** of real economy, therefore on economic growth
- It is **necessary** to recognise and **properly account** for value of NPLs, and to **write them off** once preconditions were met
- For **positive impact** on real economy, effective **workout** is a key.