EUROPEAN CENTRAL BANK

EUROSYSTEM

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# Lessons learned from NPL resolution in euro area countries**

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***The views presented in this paper are exclusively those of the authors and not necessarily those of the ECB.*

# Outline

- Motivation and stylised facts
- Impediments and Comprehensive strategy for NPE resolution
- On-balance and off-balance sheet NPE resolution
- Towards the “right” NPE resolution strategy / tools

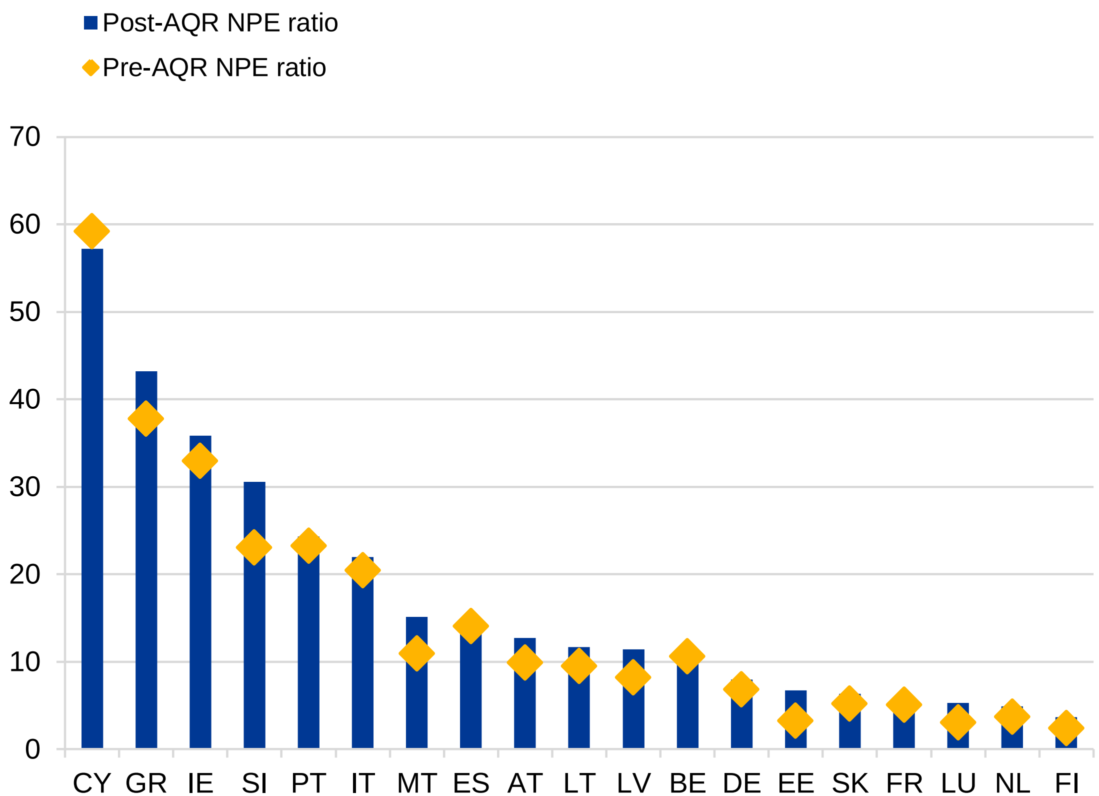
# Motivation and stylised facts

# NPE problem

- The 130 largest euro area banks held close to €900 billion [9% of euro area GDP] of NPEs at end-2013;
- Considerable heterogeneity across euro area countries: NPEs as share of total banking sector assets range from 4% to 57%;
- High level of NPEs is a serious macroprudential problem that may lengthen the period of subdued economic activity:
  - Over-indebtedness depresses consumption and investment, weakening economic recovery.
  - Banking sector resources [capital, funding, operational capacity], are absorbed by legacy assets and cannot support new viable investment projects.
- NPE resolution is needed to improve the soundness of the banking sector and can bring about significant economic benefits ….
- …success crucially depends on timely actions and selecting the appropriate solutions!

# Non-performing exposures amount to some 13% of euro area banks credit exposures

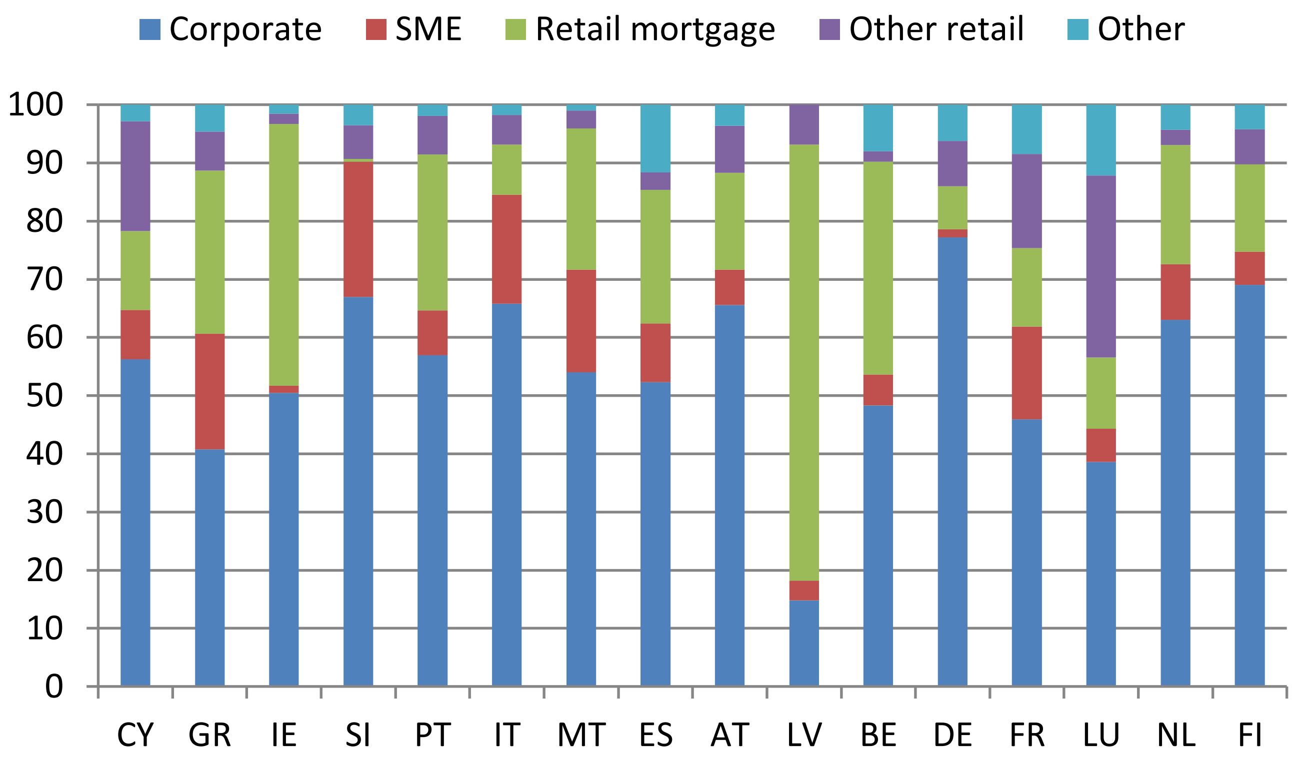
AQR findings: NPEs concentrated in a few countries




Source: ECB Financial Stability Review May 2015, based on end-2013 AQR data.

# Corporate and mortgage portfolios contribute most to the NPE ratio

Portfolio breakdown of NPEs held by largest euro area banking groups




Source: EBA, ECB calculations.
Note: portfolio segmentation may not be fully harmonised across jurisdictions. “Other” includes governments, financial institutions, equity exposures and securitisations.

# Euro area countries where the ECB has been involved in NPL resolution processes

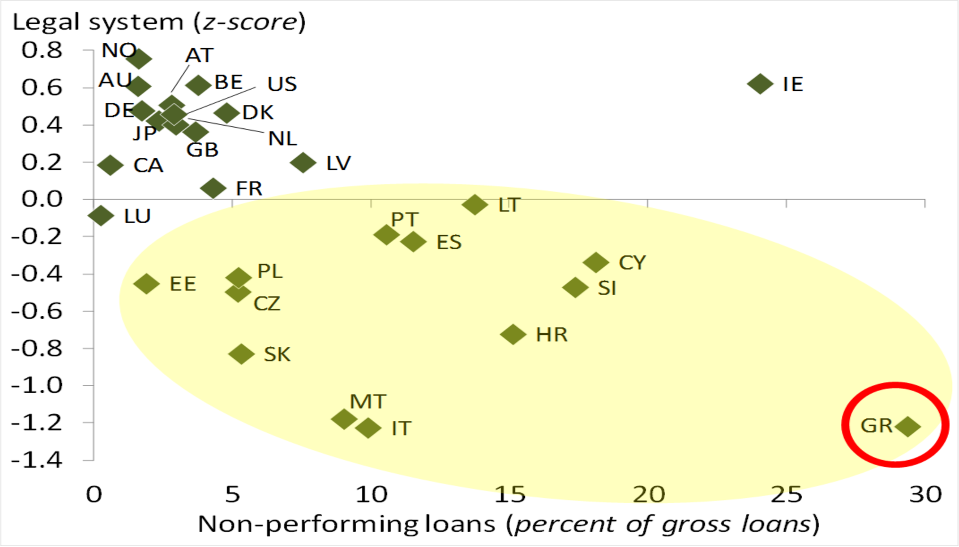
Overview of main portfolios affected and approaches applied

| | Main portfolios affected | Main approaches applied |
|---|---|---|
| **Cyprus** | Retail, SMEs, corporates, CRE/property developers | Internal work-out |
| **Greece** | Retail, SMEs, corporates | Internal work-out |
| **Ireland** | CRE/property developers, mortgages, SMEs | AMC, internal work-out and outright sale of NPLs |
| **Slovenia** | Corporates | AMC |
| **Spain** | CRE/property developers, residential mortgages | AMC and internal work-out |

# Impediments and Comprehensive strategy for NPE resolution

# Impediments to NPE resolution

- After a surge of NPEs neither banks nor operational environment is usually ready to deal with the problem due to the barriers:
  - **Economic** (e.g. insufficient bank capital, limited restructuring toolkit in banks, inadequate NPE monitoring, economic uncertainty)
  - **Legal** (e.g. inefficient/inadequate judicial system, weak insolvency regimes leaning towards liquidation rather than restructuring, inadequate enforcement)



# Impediments to NPE resolution (cont.)

- **Information** (e.g. inadequate public registers, data protection, poor financial data for credit assessment (e.g. SMEs), debtors awareness/knowledge)
- **Prudential** (e.g. ineffective supervision, unprepared banks, inadequate regulations)
- **Tax or accounting disincentives** (e.g. income tax and tax deductibility of provisions/write-offs, transaction taxes on real estate)
- **Market** (e.g. restriction on ownership/servicing of NPEs, barriers to creation of AMCs, shallow asset markets)
- **Policy** (e.g. lack of awareness about the importance of the issue, unwillingness to move, lack of coordination, excessive debtor protection)

# Need for a comprehensive and coordinated approach

- A comprehensive strategy and implementation plan is needed to address these impediments [diagnosis, prioritization, implementation]
- Coordination among stakeholders (banks, supervisors, various ministries, consumer protection authorities, banking associations) is key
- All key impediments need to be addressed before NPE resolution can gain traction [e.g. time-bound NPE disposal guidelines are not of much help if other factors do not allow banks to move]

- **It is key that this process starts as early as possible!**

# Operational environment for NPE resolution

- It is a key role for the State in the NPE resolution process to remove impediments in the operational environment
- Insolvency and judicial systems are often unable to cope efficiently with a substantial increase in NPEs.
- Voluntary, out-of-court workout frameworks can be helpful. Such frameworks benefit from fast-track judicial/liquidation procedures, which provide the right incentives
- Full revamp of insolvency and judicial system, if necessary, should proceed in parallel, but normally takes years
- Specialised investors may provide know-how and/or capital to resolve some types of NPEs [regulatory changes may be needed]
- Consumer protection, debt counselling and social safety nets need to be provided to distressed households

# On-balance and off-balance sheet NPE resolution

# On-balance approaches – Bank internal workouts

- Enhancing the internal workout capacity often requires:
  - NPE portfolio segmentation to identify the necessary tools and capacities
  - Investment in human resources, organizational processes and IT systems
  - NPE service firms can be a complementary / alternative solution
- Supervisors may provide guidelines on:
  - Organisational requirements
  - Specific tools and strategies applied by banks
  - Provisioning and write-off guidelines to avoid excessive forbearance
  - Enhanced reporting on NPEs, restructurings, write-offs etc.
  - Adequate capital buffers to recognise losses and retain room for manoeuvre
- Coordination among lenders needs to be ensured in case of common borrowers [possible minority blocking interests to be addressed]

# Off-balance sheet approaches – AMCs

- Allow fast cleaning of bank balance sheets, enables sale of assets at long-term economic value instead of depressed market values
- Features of the asset portfolio: economies of scale
  - Small number of large non-core exposures, often gone concerns
  - Specific industries/portfolios (e.g. CRE) to develop in-depth expertise
  - Room to consolidate exposures held by multiple creditors
- Governance
  - Commercial principles, involvement of private stakeholders in management
  - Clear and transparent eligibility criteria
  - Accountability and 'contained' political influence (if any)
- However, no panacea for NPL problems [mixed evidence, 'low-hanging fruit' approach, Asian AMCs' benefitted from strong recovery]
- New state-aid rules and BRRD constrain establishment of AMCs in the European Union countries

# Off-balance sheet approaches – outright sales

- Secondary market should be fostered sufficiently in advance
- Regulatory flexibility and homogeneity of assets with a critical size of the market are key factors for attracting investors
- Uncertainty about the economic outlook and NPE formation dynamics hinder the development of NPL market
- Price convergence is usually difficult to achieve at the peak of the crisis [disposal of assets by bad banks or state AMCs may help]
- Special vehicles (e.g. SPVs) may be also used for the efficient disposal and restructuring of common exposures of banks to larger corporate entities and groups.

# Towards the “right” NPE resolution strategy / tools

# NPE resolution strategies/tools

- Identification of best NPE resolution approaches requires a good understanding of:
  - current NPE resolution solutions applied and their effectiveness;
  - the characteristics of NPE portfolios;
  - the condition of distressed debtors;
  - the condition of lenders, work-out practices and capacity to absorb losses.
- "Non-standard" information may be needed to remove asset value uncertainty [e.g. a system-wide AQR and ST]
- A range of factors need to be considered before deciding on the right mix of on- and off-balance sheet tools:
  - *The structure / size of the banking system and individual institutions.*
  - *The composition and heterogeneity of NPE portfolios.*
  - *The state of the real estate market.*
  - *The availability of private capital for off-balance-sheet solutions.*
  - *Consumer protection and social issues.*

# NPE resolution strategies/tools

- Based on recent experience tailored, country-specific solutions driven as much as possible by the private sector, are the most effective
- Irrespective of the selected approaches problems, strengthening the banks' internal workout capacity is essential as for some portfolios this is the only feasible option
- Development of the NPL market is supplementary and has to start early [but investor interest likely to pick up only once recovery gains traction]
- Given the diversity of euro area NPE portfolios, a broad-based carve out of NPEs may not be an optimal solution
- NPL resolution ofter implies the need to restructure many non-financial corporates and SMEs

# Background slides

# Off-balance sheet approaches – other

- Securitization (true sale)
  - Enables the use of alternative external funding and frees up valuable liquidity and capital, while ensuring external expertise
  - Supportive accounting and tax treatment is important in developing a market
  - Similar prerequisites as for direct loan sales
  - State policies promoting the emergence of the market should be well focused (servicing, helping the market create sustainably sized tranches, closing the pricing gap, taxation incentives)

- Synthetic securitization

  Although still an on-balance sheet solution it can still be useful:
  - To overcome the pricing gap in securitization by sharing upside price potential is by both sides
  - But does not bring the benefit of funding relief.