NPLs in Europe

Cyprus 5th February 2016

Lars Nyberg

NPL development

- Crisis countries that cut NPL ratios (peak of crisis to end 2014)
  - Latvia (18 to 5)
  - Lithuania (25 to 8)
  - Iceland (18 to 5)
  - Ireland (30 to 20)
  - Romania (25 to 15)
- Crisis countries that did not
  - Greece (35 to 35)
  - Cyprus (45 to 45)
  - Italy (20 to 20) ?

…so there are differences in crisis management

Falling bank incentives

- Why should banks lower their NPL ratios?
  - Lack of capital? But banks that survived are now recapitalized to meet all legal requirements.
  - Lack of liquidity? But the ECB monetary policy makes liquidity affluent.
  - Rating agencies care? Relevant for banks that borrow in the international market.

For many banks incentives to sell NPLs have decreased over the last years

Society incentives remain

- If corporate NPLs are not restructured "zombie" companies slow up economic recovery
- Banks with high NPL ratios are vulnerable in a future crisis – and that risk is pushed over to the state

If NPL ratios are to come down governments will have to take action

Obstacles recognized by IMF
(IMF September 2015)

Weak economic recovery

but also

- Prudential supervision
- Informational obstacles
- Tax and other obstacles
- Legal obstacles
- Distressed debt markets

Prudential supervision

- Rules for provisioning
  - Unclear application of accounting standards
- Collateral valuation
  - Thin real estate markets
  - Inferior assessment of valuation practices
- Operational targets
  - NPL action plans lack credibility

Information and taxes

- Information
  - Limitations in credit registers
  - Real estate transaction registers
  - Information restrictions due to consumer laws
  - Quality of documentation in banks

- Tax disincentives
  - Deductions for loan write-offs may not be permitted
  - Same for deductions for collateral sales below book value
  - VAT on domestic NPL sales
  - Privileged role of public creditors

Legal obstacles

- Ineffective insolvency regimes and debt enforcement
  - Average time to foreclosure up to ten years (Cyprus)
- Slow and inconsistent implementation of new legal structures

"The ability to enforce claims (in particular, through foreclosure on real estate collateral) is essential to efficient workouts as it enables creditors to enforce their claims against debtors in a predictable, equitable, and transparent manner." (IMF report)

The balance between borrower and lender interest is crucial to NPL resolution. This is a political problem!

Legal obstacles cont.

- Insufficient possibilities to limit shareholder´s influence and to change management in debt restructuring
  - Debt-equity swaps
- Lack of out-of-court procedures that work in practice
- Slow judicial system
  - Special courts?
  - Training of judges?

Distressed debt markets

The US market is much bigger than the European, but the volume of NPLs is lower. Why?

- Incomplete credit information on borrowers
- Framework for nonbanks to manage NPLs missing
- Overvalued collateral in banks
- No liquid real estate market
- Low recovery values due to long court procedures
- Inadequate provisioning of NPLs
- Risk of political interference

The pricing gap between buyers and sellers of NPLs is too big

The IMF recommendations

- Assertive supervision
  - Swift loss recognition necessary. Clear write-down targets (Romania a good example). The SSM has a role here
- Insolvency reforms (and practices)
  - Liquidation of non-viable debtors, rehabilitation of viable. Rapid foreclosure. Specialized courts and administrators
- Development of a distressed asset market
  - AMCs or equivalent efficient workout procedures

Supported by changes in tax regimes and reforms to improve access to information

All of these measures were used by the countries that successfully brought their NPL ratios down

Why AMCs?

- Help management and board of a bank to focus forward on new lending instead of looking backwards at the old NPLs
- Clean balance sheets increase transparency, reduce uncertainty and help restore credibility – make the good bank look better
- Help build the market for distressed assets
- Workout of NPLs often requires different skills than in banks. Bankers should not run AMCs
- Efficient workout may require ownership and investment in the course of restructuring
- Bank regulation may clash with efficient workout

The transfer problem

- Market values are often below bank book values (net of provisions)
- This difference is often referred to as “the hole”
- If assets are transferred to an AMC at market prices the hole will appear in the bank – and the hole will have to be filled
- If assets are transferred at book values the hole will have to be recognized in the AMC – and eventually filled
- If assets are not transferred the size of the hole can be kept secret for a long time

AMC or internal workout?

- In the beginning of a crisis, a bank can choose between creating an AMC or establishing an internal workout unit
- The higher the NPL ratio, the better the argument for creating an AMC
- Once an internal workout unit is established and competence is built, the reasons for establishing an AMC are weaker. But they still exist, particularly if the NPL ratio is high
- Transfer of assets to an AMC will uncover “the hole” and increase transparency – for good and for bad

A national AMC?

- Should have a clear mandate to maximize recovery value of acquired assets (no political mandate)
- Should be majority private, not public, to avoid political interference. A public minority share is acceptable
- IFIs could supply part of the capital. The government could guarantee the bonds to be issued
- Must acquire the assets at “market value” to avoid state aid and bail-in discussions
- Transfer of assets at market values will make “the hole” visible in the banks. Is this acceptable?

Securitization (Italian style)

- Bundle bad loans into portfolios
- Structure the portfolios in a number of tranches
- The senior tranche should be investment grade
- The government will guarantee this senior tranche only
- The banks will pay for the guarantee
- The fee for the guarantee will increase over time to encourage a speedy recovery
- Issue bonds securitized by the loan portfolios
- Hope that investors will buy the bonds

Loans remain in the bank but the market for distressed debt may be stimulated. And DG Comp has blessed the idea…

Thank you

And remember:

1. No innovations will work to bring down the NPLs unless the debt enforcement and insolvency regime is fixed in a way that works in practice
2. Successful restructuring will be politically controversial – regardless of who does it