EUROPEAN CENTRAL BANK

EUROSYSTEM

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The Resolution of Non-Performing Loans

Asian Development Bank

Manila, 30 May 2017

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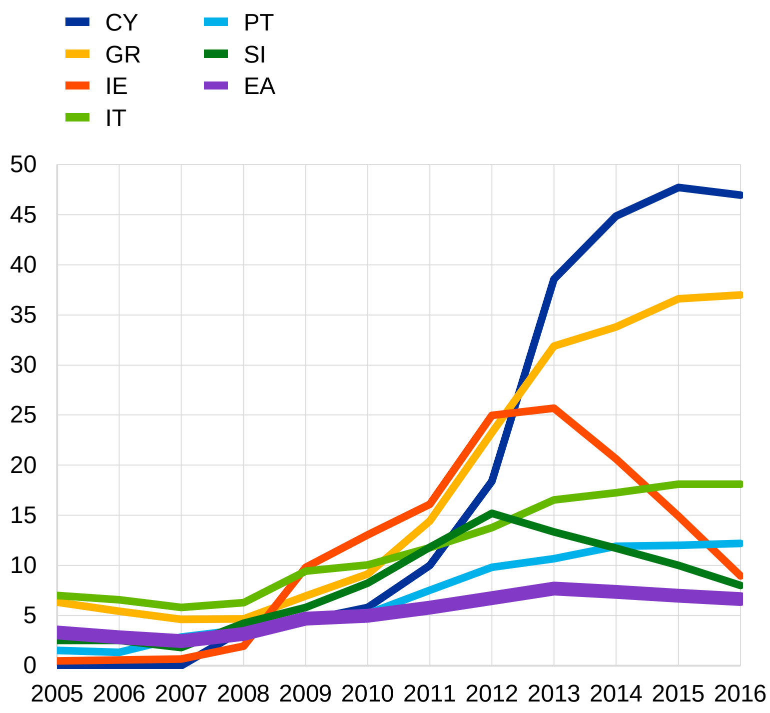
Outline

- The NPL problem in the euro area
- Why is NPL resolution in the euro area so slow
- Elements of a comprehensive solution
- Benefits from regional cooperation
- Conclusions

NPL resolution in the euro area has been slow

NPL ratios in Europe have slowly fallen from the 2013 peak



Source: World Bank, IMF Financial Soundness Indicators, ECB.

Note: Country samples and methodological differences related to NPL definitions or the consolidation scope can explain differences in ratios with respect to supervisory statistics.

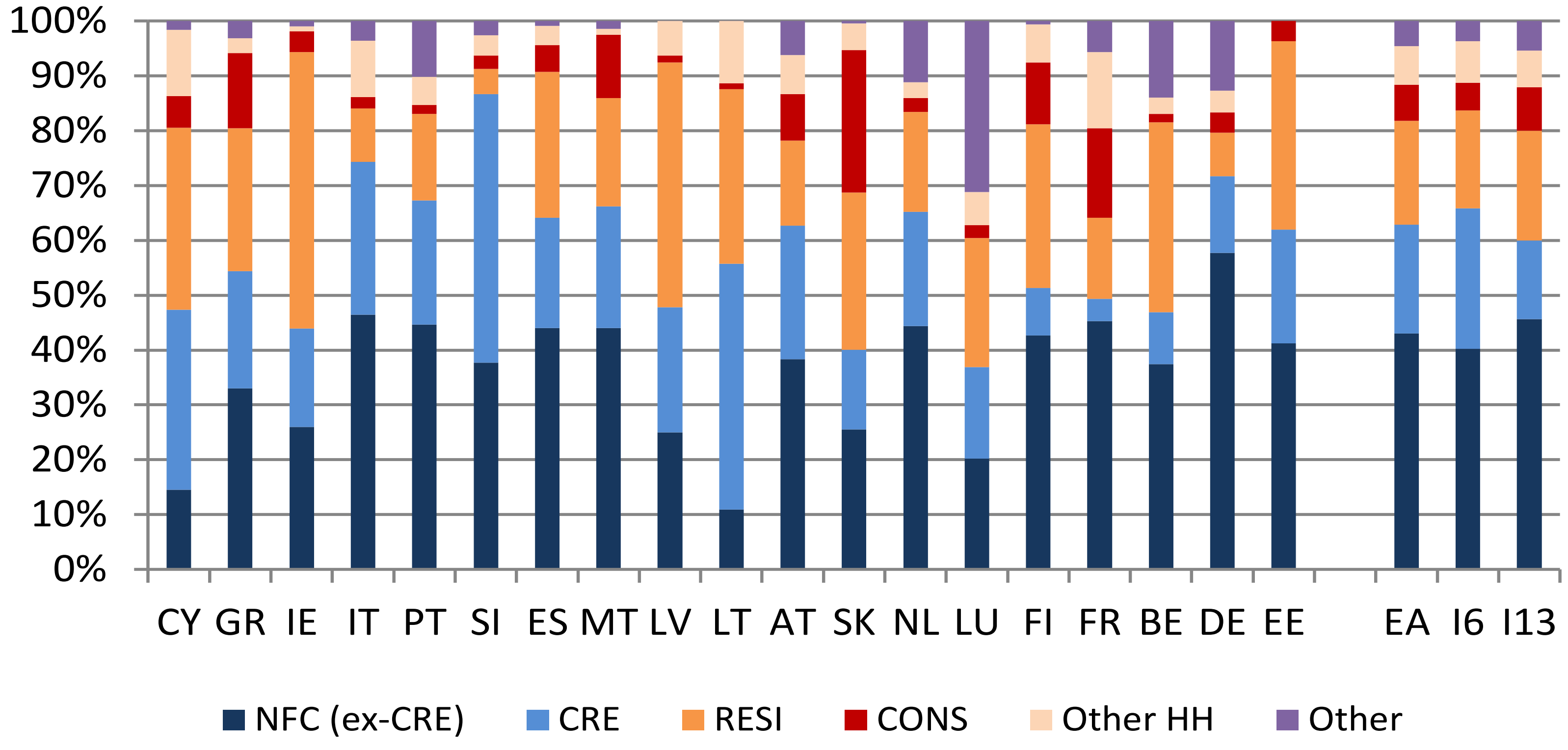
IMF data	Average NPL ratio (2007)	Average NPL ratio (2016)
6 EA countries	4.8	22.8
EA	2.4	6.6
UK	0.9	1.0
US	1.4	1.5

- **NPL stock: a legacy from the crisis**
- **Peak NPL level in the euro area reached in 2013**
- **NPL resolution is slower in many countries facing high NPL levels**

Composition of NPL portfolios is diverse but broadly aligned among high- and low-NPL country groups

High-NPL countries (I6) and EA:

- **broad alignment in terms of NPL-portfolio composition**
- **60% of NPLs relate to corporate and CRE lending**

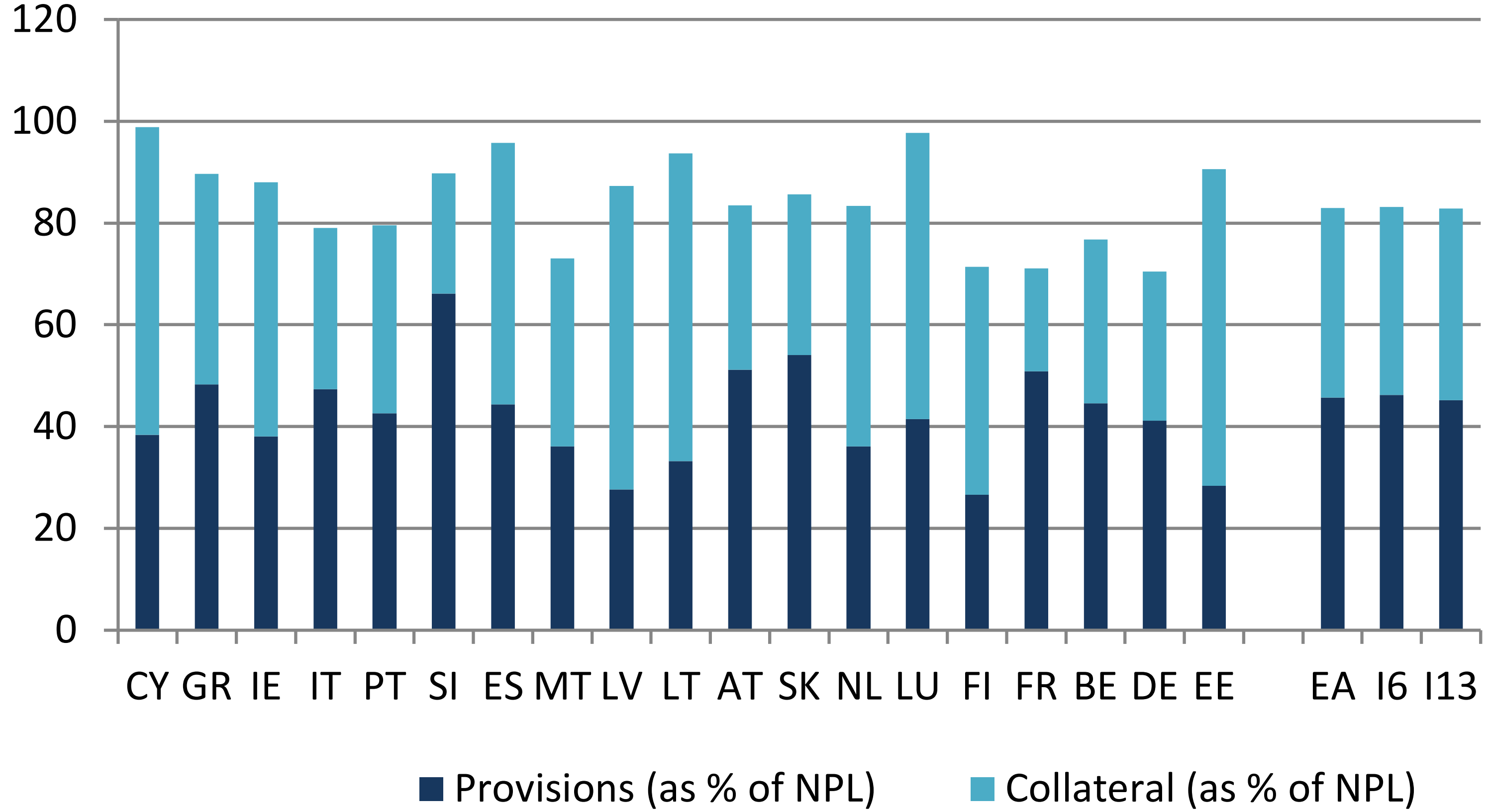


Source: ECB Supervisory statistics.

Provisioning and collateral

High-NPL countries (I6) and EA:

- **broad alignment in terms of coverage ratios and collateral**
- **On average, 46% of NPLs is covered by provisions and 36% by collateral**



Notes: data in the consolidated perspective, i.e. by home country of the banking group. Collateral values capped at the total exposure size at the level of individual exposure. I6 group represents GR, CY, IT, PT, IE and SI – countries with high NPL ratios (over 10%). I13 refers to other euro area countries. Countries are ordered by total NPL ratio.

Source: ECB Supervisory statistics.

Cross border spillovers of NPL

- **High NPL levels, despite being present only in a subset of EU countries, are an issue for the entire EU / euro area**
- **This is due to a number of important cross-border spillovers**
  - **Bank lending channel. Impact on cross-border bank lending flows activities**
  - **Confidence channel. Negative market sentiment about banking systems in affected countries may impact also countries.**
  - **Financial channel. Loss of bank equity value and debt claims by residents of affected countries has negative wealth effects**
  - **Trade channel. Deterioration of the macroeconomic environment in high-NPL countries, impacts other countries through lower import demand**
- **Monetary policy transmission can be negatively affected.** Differences in supply and demand of credit as well as negative confidence effects in some euro area country may impede monetary policy transmission in the euro area.

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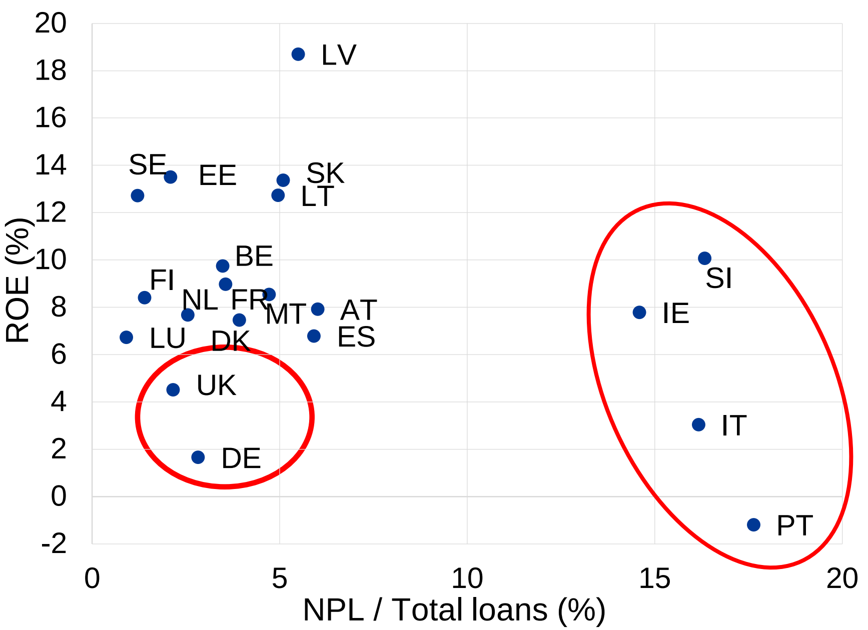
Reasons for lower NPL rates in the US vs. Europe

- **Role of US Government-sponsored Entities**
- **Accounting standards as implemented across European countries create weaker incentives to resolve NPLs than in the US;** situation will change with future implementation of IFRS 9
- **Non-recourse mortgages in the US**
  - In the US, about half of the States have non-recourse rules for mortgages, where a loan is secured by a pledge of collateral but the borrower is not personally liable
  - Together with strict time-bound rules for writing-off NPLs, this creates incentives for lenders to seek a timely resolution of NPLs
- **European market for distressed bank debt relatively small**, especially compared with the size of the outstanding stock of NPLs.

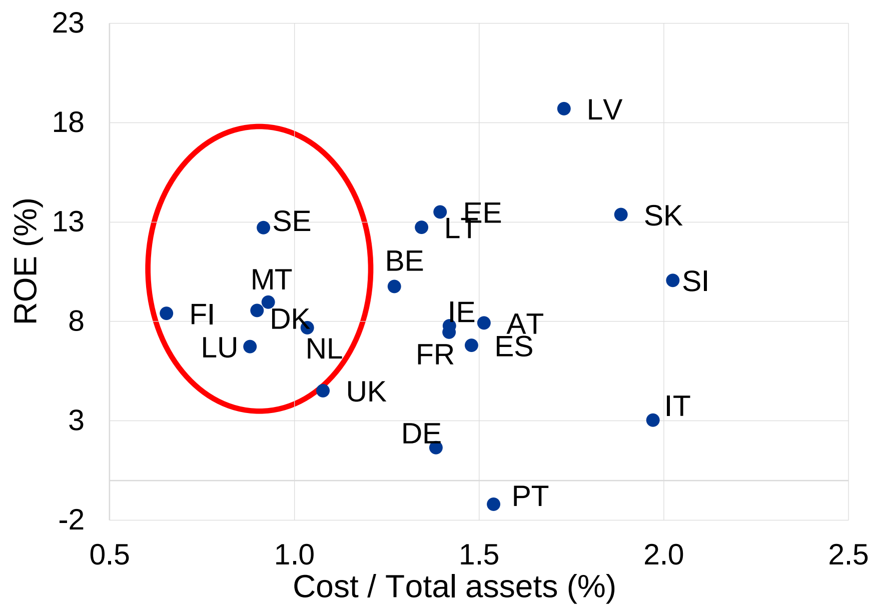
Low profitability not only because of high NPLs

Return on equity and non-performing loan (NPL) ratios in EU countries
(Q2 2016, percentages)



Source: ECB Consolidated Banking data and ECB calculations

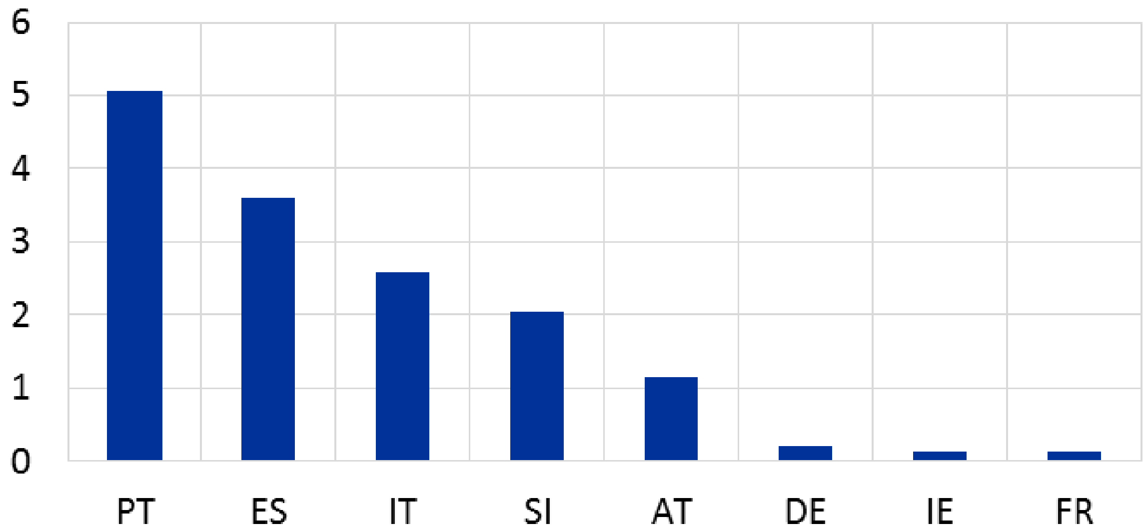
Return on equity and costs to total asset ratios in EU countries
(Q2 2016, percentages)



Source: ECB Consolidated Banking data and ECB calculations

Replacement of NPLs by performing assets may significantly improve profitability

Improvements in aggregate ROE over a 3-year horizon may be quite high for some countries



- **Simulation:**

aggregate ROE could improve substantially in some countries (up to 5%)

Note: The simulation assumes that NPL would be gradually replaced over the 3-year period by performing assets, with the same composition and rates as projected under the baseline scenario of the 2016 EU-wide stress test.

Source: ECB and ECB calculations.

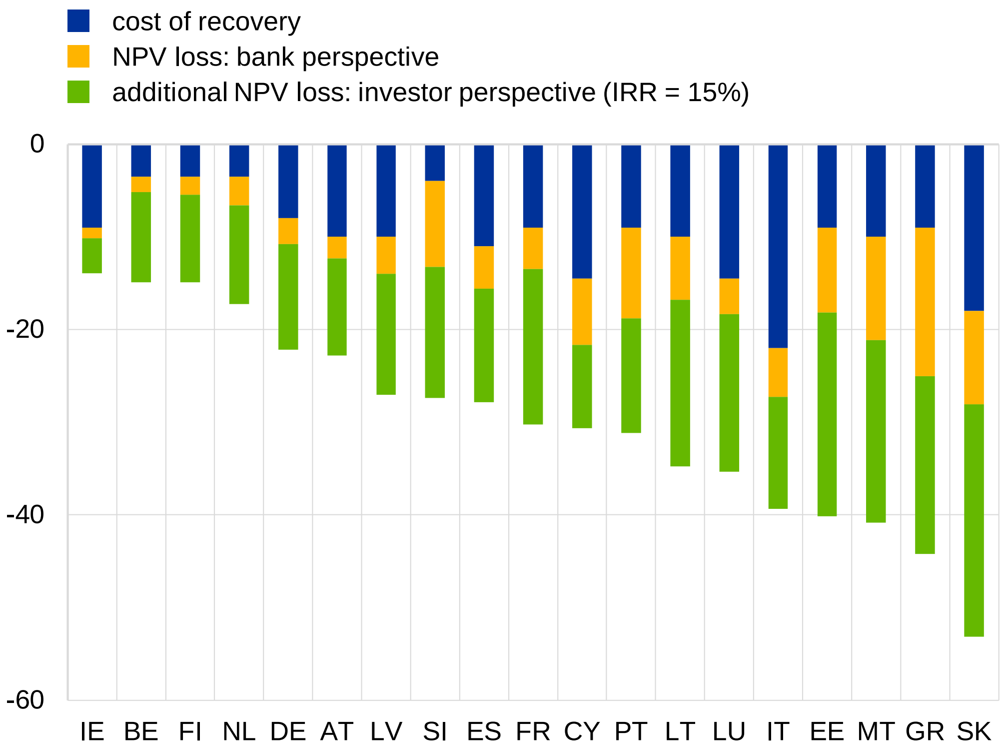
Market failure and regulation in NPL markets create impediments to demand and supply

Demand-side impediments	Supply-side impediments
• Information asymmetry • Inefficient and uncertain debt enforcement frameworks • Licensing requirements • Restrictions on transferability of loans	• Unwillingness to realise losses • First-mover disadvantage • High cost of debt recovery not recognised in NPL book values

A wide bid-ask gap may be caused by these impediments

Market values of NPL are likely to stand below book values

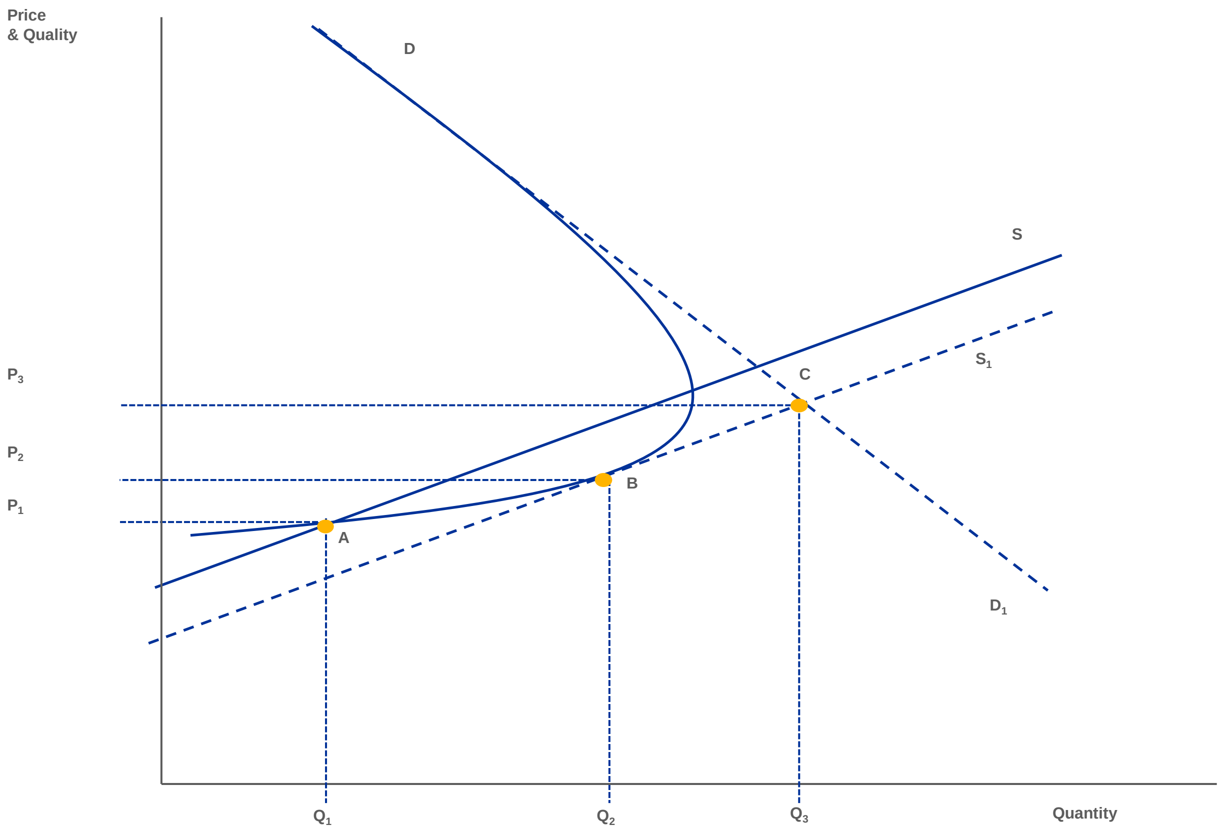
(Reduction in net present value of collateralised NPL, percentages)



- **Bid-ask spread in NPL markets is not directly observable**
- **A private investor may require a discount above 40% even on fully secured loans according to estimates**
- **Gap arises mainly from asymmetric information and time and cost of recoveries**

Source: Fell, Grodzicki, Martin and O'Brien (2016), "Addressing market failures in the resolution of non-performing loans in the euro area", Special Feature B in *Financial Stability Review*, ECB, November 2016.

Secondary NPL market is characterized by asymmetric information (a ‘market for lemons’?)



Source: Fell, Grodzicki, Martin and O’Brien (2016), “Addressing market failures in the resolution of non-performing loans in the euro area”, Special Feature B in *Financial Stability Review*, ECB, November 2016.

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Elements of a comprehensive solution

On-balance sheet

Internal workout
workout by originating bank; includes various restructuring options

→ Targeted by SSM guidance

Asset protection scheme
risk-sharing agreement to limit further losses, usually state-backed
usually short horizon; potential losses large but with low probability

Securitisation & synthetic securitisation
an alternative to outright sale; partial risk transfer only
possibly with co-investment by the state

→ Covered by FSR Special Feature

Asset management company
complete separation of asset from originating bank, often state-backed
usually long horizon; large losses typically already realised

→ AMC Blueprint

NPL trading platforms
investors able to build their own NPL portfolios from multiple banks

→ Ongoing work (ECB, EBA)

Direct sale
assets sold directly to investors, where sufficient liquid markets exist

Off-balance sheet

Sources: Constâncio (2017), "Resolving Europe's NPL burden: challenges and benefits", speech at Bruegel, 3 February 2017; Fell, Grodzicki, Martin and O'Brien (2016), "Addressing market failures in the resolution of non-performing loans in the euro area", Special Feature B in Financial Stability Review, ECB, November 2016.

Sequencing of measures

- **Clean-up of NPLs from banks with short term effect**
  - **Improving bank practices and policies accompanied by Supervisor’s pressure (SSM Guidelines!)**
  - **Transfers to AMCs**
  - **Securitization schemes**

- **Measures that are effective more in the medium term**
  - **Introduction of IFRS 9 and more forward-looking provisioning rules**
  - **Improving data quality and availability**
  - **NPL clearing houses**
  - **Reduction of duration and costs of debt enforcement**
  - **Reforms of insolvency laws**

SSM NPL Guidelines

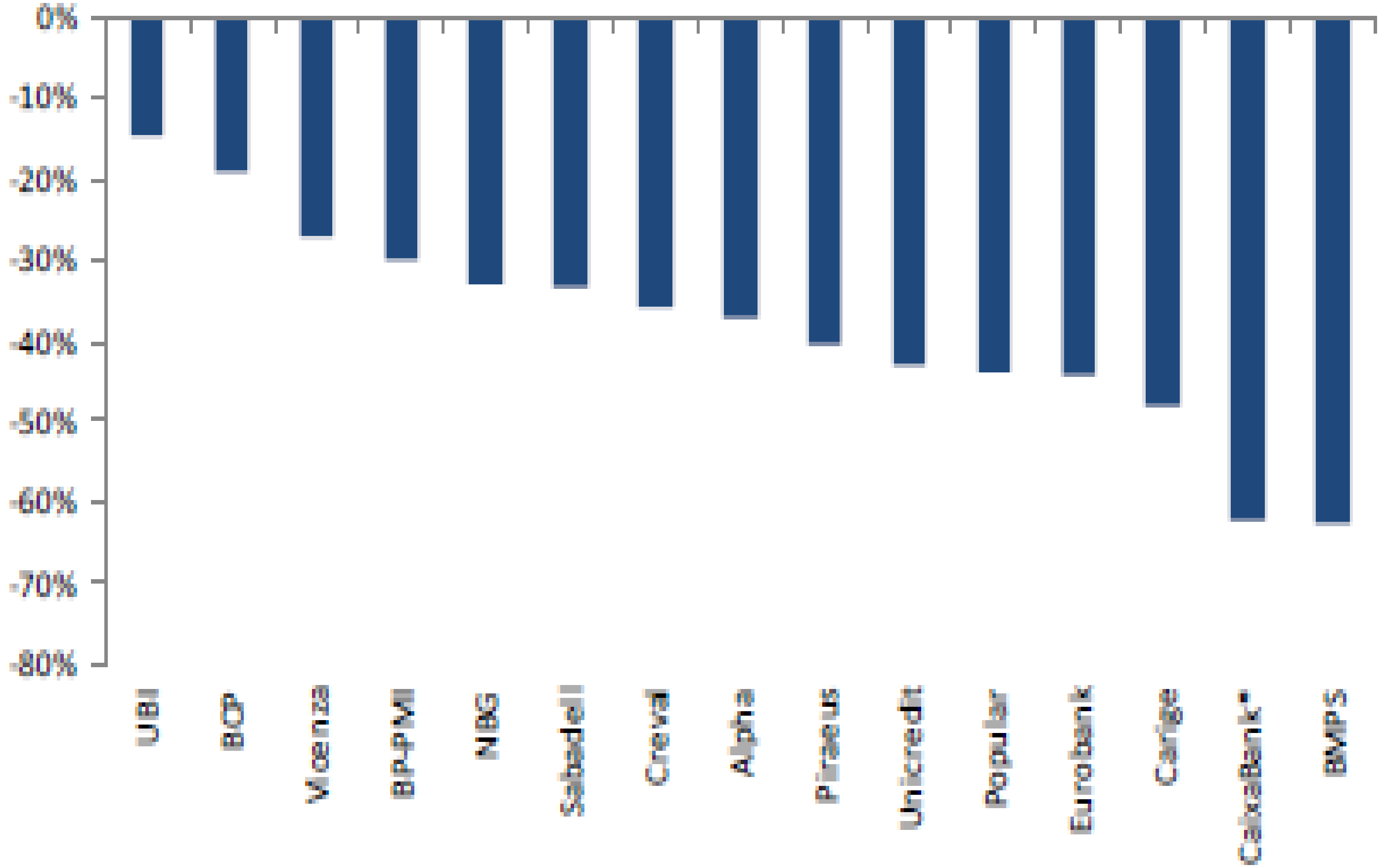
- "Guidance for banks on non-performing loans" published in Spring 2017

- Guidance covers the following main elements:
  1. NPL strategy *(including inter alia the request to establish targets by portfolio)*
  2. NPL governance and operations *(e.g. management oversight and establishment of separate NPL workout units)*
  3. Forbearance *(e.g. assess viability of forbearance options)*
  4. NPL recognition *(e.g. application of EBA definition, alignment of regulatory and accounting definitions as far as possible)*
  5. NPL impairment measurement and write-offs *(e.g. conservatism in collateral / cash flow estimation, going vs. gone concern definition)*
  6. Collateral valuation of immovable property (e.g. at least annual collateral valuation updates and market value as valuation base)

- Focus of SSM work shifts to 'supervisory dialogue' to implement the guidance

Several banks have announced ambitious NPE reduction targets, but implementation risks remain

NPE reduction targets for selected euro area banks
(percentage)



Source: Autonomous.

Note: Announced NPE reduction targets mostly apply for three-year periods.

Benefits of Asset Management Companies (AMCs)

- "Bridge to the future"
  - Maximising recoveries over the lifetime of the AMC
  - Avoiding fire sales through transfers at real economic value
  - Exploiting synergies from managing similar assets
- Quick and (possibly) substantial reduction of NPL
  - Bank can focus again on regular business
  - Reduced uncertainty around bank asset values and profitability
- Catalyst for NPL and collateral market development
  - Overcoming information problems and creditor coordination

Why a blueprint for national AMCs?

- Can reduce set-up costs and lead times by
  - Creating clarity on state aid rules
  - Leveraging on international best practices
- More realistic to implement than an EU/EA wide AMC
  - Limited synergies from working out multi-country portfolios
  - No risk sharing or liability mutualisation

Main elements of the AMC blueprint: scope

- Correct asset mix

Exposure class	Heterogeneity	Granularity	Collateral quality	Political sensitivity	Typical resolution approach	Suitability for an AMC
Commercial real estate	Low	Low	High	Low	Sell collateral	Yes
Residential property development	Medium	Low	Medium to high	Low	Restructure/ sell collateral	Yes
Large corporate	High	Low	Low to medium	Medium	Restructure/ liquidate	Depending on industry
Small and medium enterprises (SME)	High	High	Low to medium	Medium	Restructure/ liquidate	Depending on size and industry
Residential mortgage	Low	High	High	High	Restructure	In limited cases
Unsecured consumer	Low	High	None	Medium	Liquidate	No
Governments and government agencies	Low	Low	Low	High	Restructure	No

- Debtor-level approach with a minimum ticket size
- Voluntary bank participation with strong incentives from the authorities

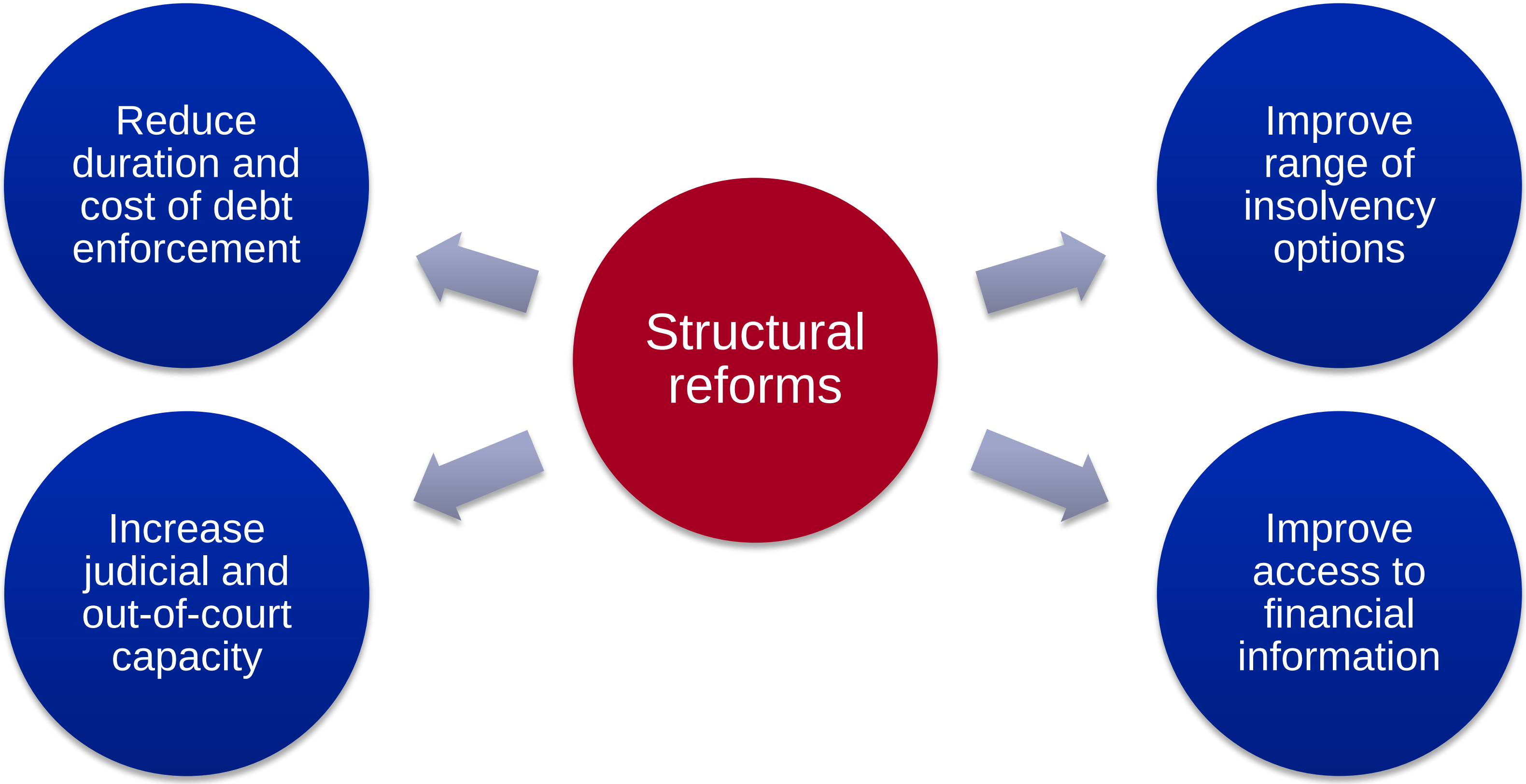
Main elements of the AMC blueprint: process

- Robust and independent asset valuation
  - Needed for real economic value estimation in line with State aid rules
  - Realistic inputs including all costs associated with recoveries
  - Viability test on AMC's debtors to inform workout strategy
- Strong governance grounded in legislation
  - Clear mandate to maximise recoveries over a defined lifespan
  - Budgetary and political independence
  - Flexibility to use any available legal tool for recoveries
- Capital structure: private/public partnership (as in NAMA & SAREB)
- Role for state aid
  - Fully private solution preferable
  - Minority participation in equity to avoid consolidation into government
  - Compliance with EU framework: combination of impaired asset measure (state aid rules) and precautionary recapitalisation instrument (BRRD)

NPL warehouses

- **Collect NPL data in a central warehouse.** Easier access for investors, rating agencies, consultants etc.
- **Leverage on existing credit registers**, if compliance with national data privacy laws can be achieved
- **Additional advantages**
  - Requesting participating banks could be asked to use standard data templates
  - Single point of contact for (potential) investors, enabling them to easily package assets from multiple banks ('clearing house‘)
  - Costs of the solution likely to be limited
- **State Aid issues can be avoided.** Ownership and risk transfer of assets to take place at the point of sale.
- **Robust governance standards needed.** Clearly defined responsibilities and sound internal procedures for accounting, data protection and administration.

Key structural reforms to facilitate NPL resolution



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Benefits from cooperation in the EU / euro area

- **Common NPL definition by EBA (2014)**
  - Important first step to improve transparency and comparability – even though not yet fully applied throughout EU

- **Hard-wired by Comprehensive Assessment (2014)**
  - SSM-wide AQR / stress test prior to the launch of SSM helped to restore confidence in euro area bank balance sheets

- **Common NPL guidelines by the SSM (2017)**
  - Likely to be particularly helpful in some of the high NPL countries, both backward- and forward-looking

Benefits from cooperation in the EU / euro area

- **On-going discussions in various EU / euro area fora**
  - Critical to raise awareness of the 'systemic' dimension of NPLs in the EU / euro area
  - Cross-country heterogeneity in NPL figures led to very different initial levels of awareness

- **European Systemic Risk Board (ESRB) Expert Group on NPLs**
  - Exploratory work on macroprudential tools to deal with NPLs.
  - Discussion on obstacles for secondary NPL market in Europe

- **EU Financial Services Committee Sub-Group on NPL (reporting to ECOFIN)**
  - Brings representatives of EU finance ministries to the table
  - Critical to muster political support for structural reforms and for initiative involving state aid (e.g. AMCs)

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Conclusions

- **The NPL problem is a legacy from the crisis,** it affects countries differently but is a pan-EU / euro area problem

- **Internal workouts** by banks and pressure by micro-supervisors are always **necessary but not sufficient**

- **Well-designed AMCs can help** to achieve more rapid progress

- **NPL "Clearing Houses",** may further contribute to overcome information and fragmentation issues in European NPL markets

- **NPL-related structural reforms** are needed for all elements of the 'NPL toolkit' but will likely take time

Thank you for your attention!

Further information:

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Annex slides

	For EA: ECB directly supervised banks (2016 Q3)				
Country	NPL ratios	NPL amounts (EUR bn)	NPL / Total Assets	Provisions / NPL	(Provisions + Collateral) / NPL
GR	47.1	114	38.5	48.2	89.6
CY	40.3	21	41.5	38.4	98.9
PT	19.8	36	14.2	42.6	79.6
IE	17.8	38	14.5	38.0	88.0
SI	16.8	3	12.4	66.4	90.6
IT	16.3	270	11.9	47.3	79.1
Sub-average	20.3	482	15.3	46.3	83.2
AT	6.1	21	4.2	56.5	82.0
ES	6.0	136	4.1	44.4	93.6
MT	4.6	1	3.1	35.6	71.9
LT	4.1	1	3.8	33.3	93.7
FR	3.9	150	2.1	50.7	70.7
BE	3.6	16	2.1	42.5	76.6
NL	2.6	44	2.0	36.1	83.4
DE	2.4	66	1.5	41.4	69.7
LU	1.5	1	1.0	41.4	97.7
FI	1.5	4	0.8	26.6	71.4
EA	6.4	921	4.1	46.0	81.6
UK	2.2	70	1.2	28.8	79.5
US	1.5	123	0.8	89.2	-

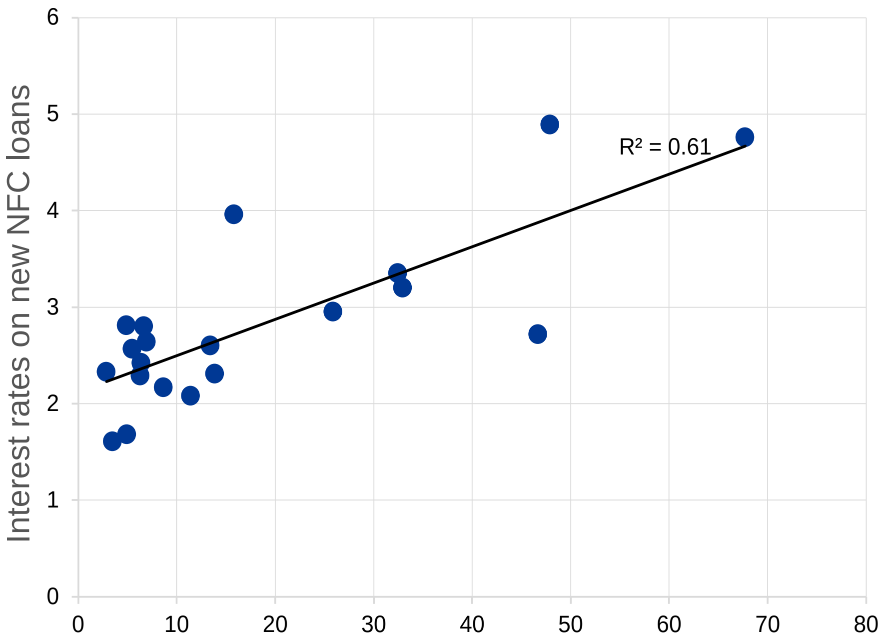
Source: ECB , FDIC, EBA.

Notes: 2016Q2 data for US (FDIC) and UK (EBA Transparency Exercise).

Possible benefits of NPL resolution

Large NPL stocks likely to impact lending, both in price and volume terms; importance of second-round effects.

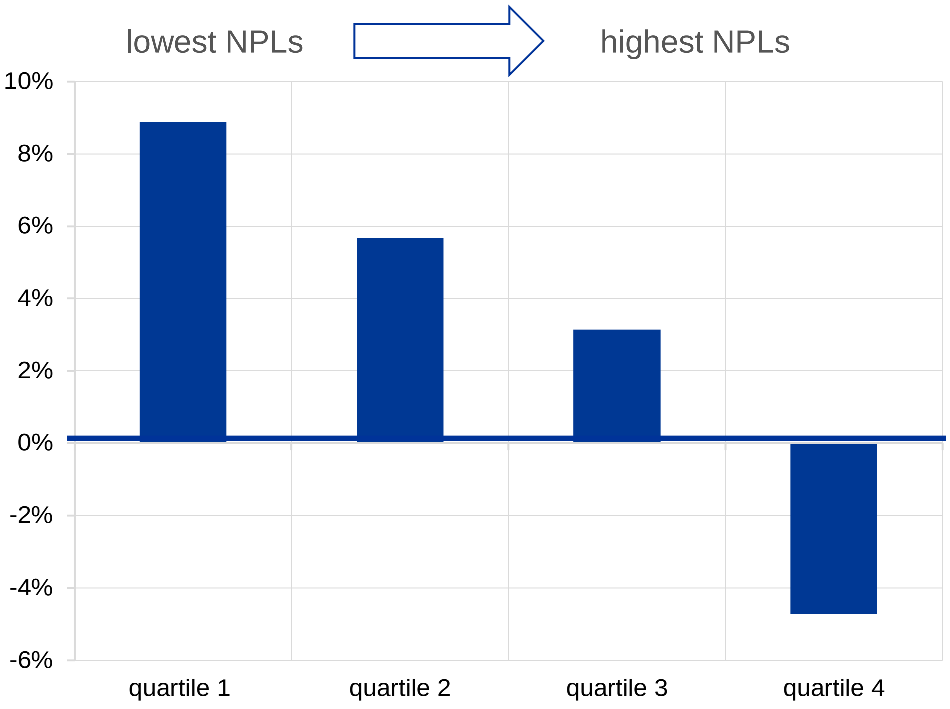
NFC NPL ratios vs interest rates on new NFC loans by country
Q3 2015; Jan. 2016; percentages.



Source: ECB.

Note: Bank NFC lending rates (y-axis) and NFC NPL ratios (x-axis).

Loan growth by NPE ratio quartiles
(Q4 2014-Q3 2015; median loan growth by quartile)



Source: ECB.

Note: Based on Q4 2014 total NPE ratios and growth of performing loans between Q4 2014 and Q3 2015.