Country Case Studies on Resolving Problem Loans in Europe: Crises, Policies and Institutions

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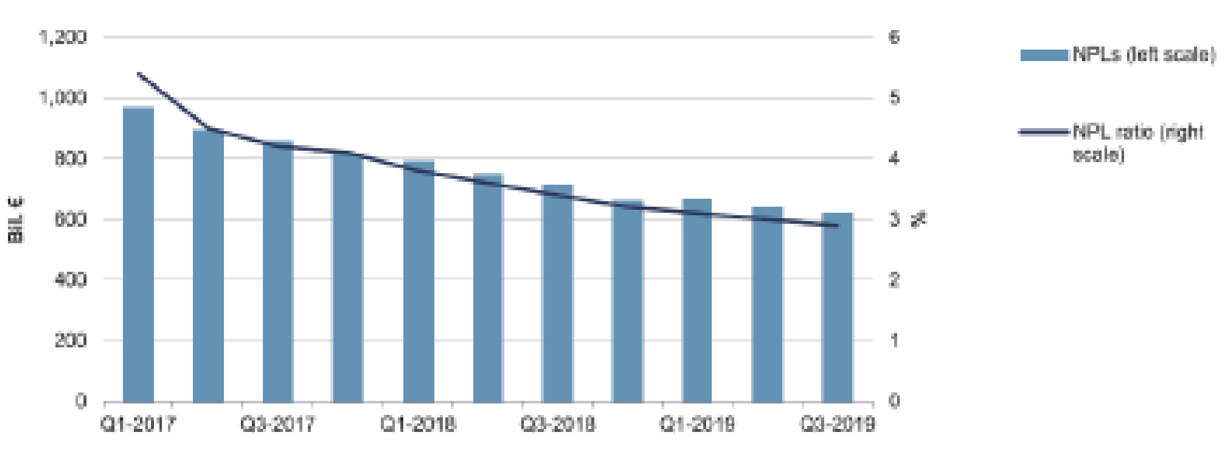
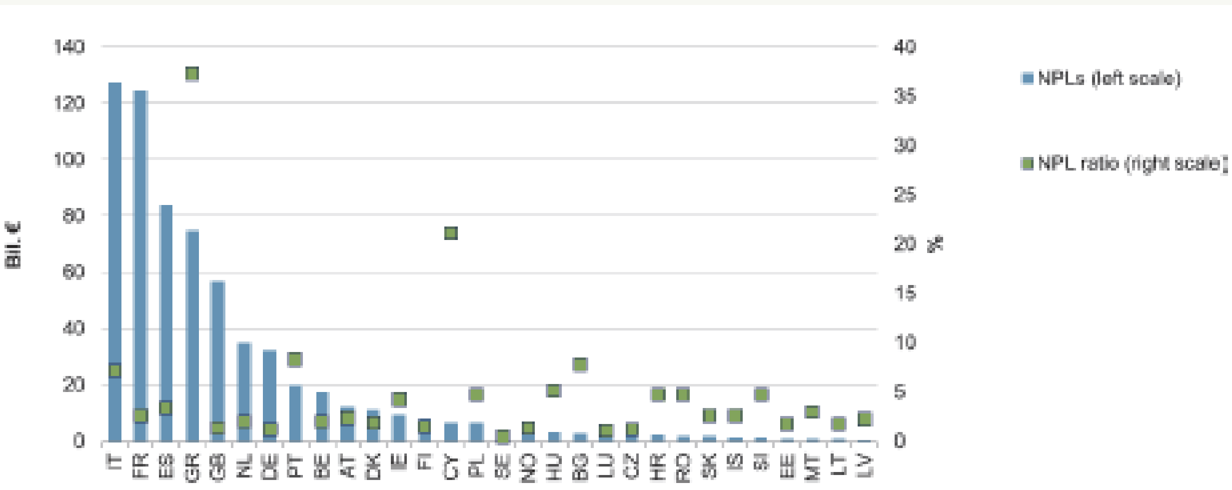
European NPLs in mid-2019





Source: European Banking Authority

Questions for this chapter:

- Given the evolving EU and euro area framework, what has been the scope of *national* NPL policies?
- Were national NPL strategies timely, well-defined and coordinated within countries?
- What were the priorities in terms of internal bank-led resolution vs. market-led resolution?
- What success can be attributed to national policies, and do best-practices emerge?

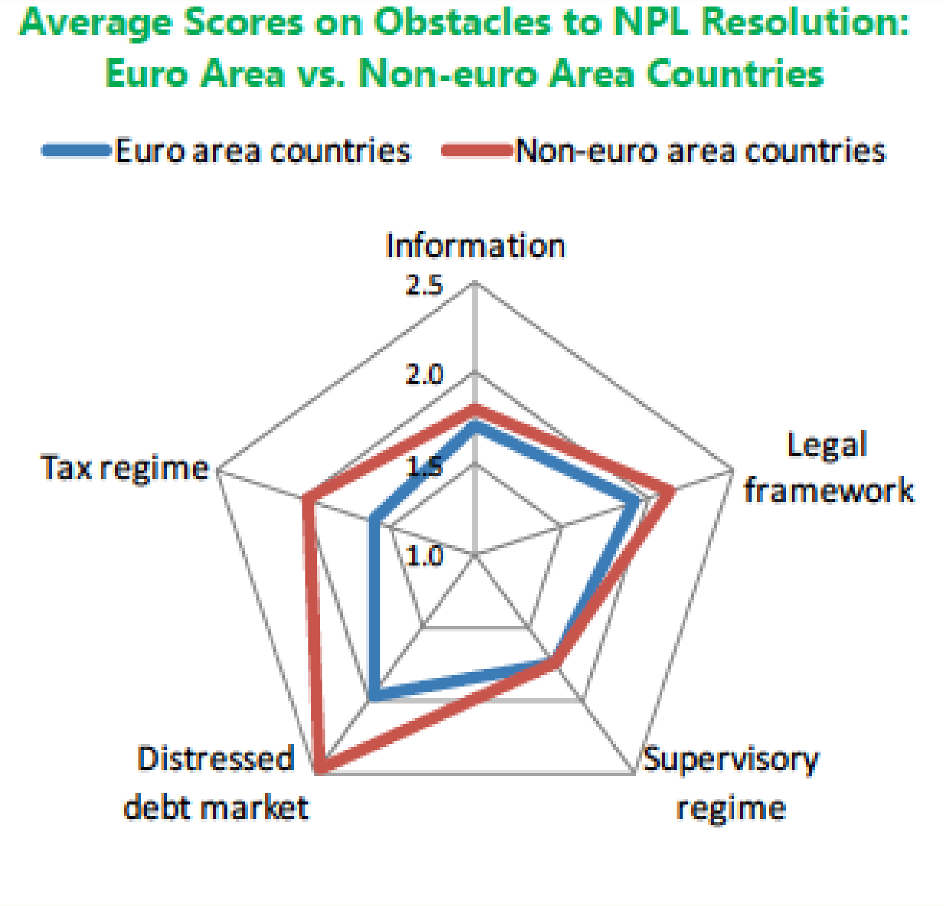
Why do national NPL resolution frameworks remain important within common EU regulation and euro area supervision?

Why are national frameworks important?

- NPL resolution belatedly became a central element of the euro area agenda of ‘risk reduction’ (reducing the legacy of the ciris). Hence concerted efforts in regulation and supervision, e.g.
  - Common NPL definition in 2013
  - ECB guidance to banks on NPL management in 2017
  - IFRS-9 with forward-looking provisioning since 2018
  - Accelerated provisioning also through the ‘prudential backstop’.
- But large swathes of the framework that determines speed and efficiency in NPL resolution is determined by national, not EU, law and supervision. Reform *within* EU states has been much more varied and protracted.
- Information on these obstacles is very patchy; there is no comparable or consistent indicator of policy (as e.g. the World Bank *Doing Business* indicators would offer).

National frameworks in Europe: the IMF survey of 2015

- 9 EA, and 10 other European countries.
- Matched responses by country authorities and bank groups
- Very detailed though country identity anonymized.
- Underlines importance of legal framework and judiciary.
- Distressed debt markets at that point still widely underdeveloped.



Source, IMF (2015).

National frameworks in Europe: the ECB ‘stocktake’ of 2017

- Covers all 19 EA members, building on the first round survey of 8 high-NPL countries only.
- Considerably more detailed than the IMF, though based on responses from supervisory authorities alone, and no private sector validation of responses from the authorities.
- Provided key input to drafting of the 2017 ECB guidance to banks on NPL management, a wide-ranging and assertive tool for ECB supervisors that superseded national practices.

ECB stocktake

I. Supervisory regime regarding credit risk and NPLs

- Is there specific guidance on the treatment of NPLs and forborne exposures; data collection requirements and exit criteria?
- Guidance on provisioning beyond accounting standards
- Guidance on collateral valuation, and requirements for appraisers and data collection
- Guidance on NPL governance and workout, covering internal strategy and internal governance, operational targets; outsourcing of NPL management and role of non-banks
- On-site inspections and thematic reviews on NPL management

ECB stocktake

II. Legal, judicial and extrajudicial framework

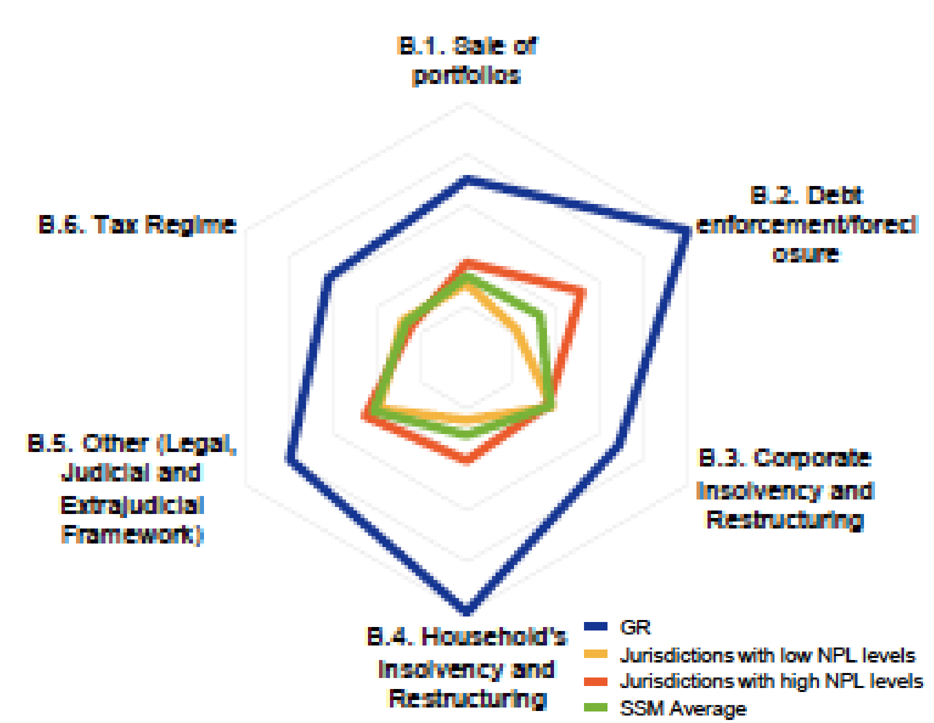
- Development of the NPL markets, impediments to the transfer of loans and to sales to non-banks and foreign investors; presence of AMCs
- Out-of-court enforcement of collateral; sales of repossessed assets, and bans on foreclosures
- Quality of corporate insolvency and restructuring framework
- Quality of the household insolvency and restructuring framework
- Features of the judicial system (e.g. specialized judges, time requirements)
- Main features of the tax regime

III. Information framework

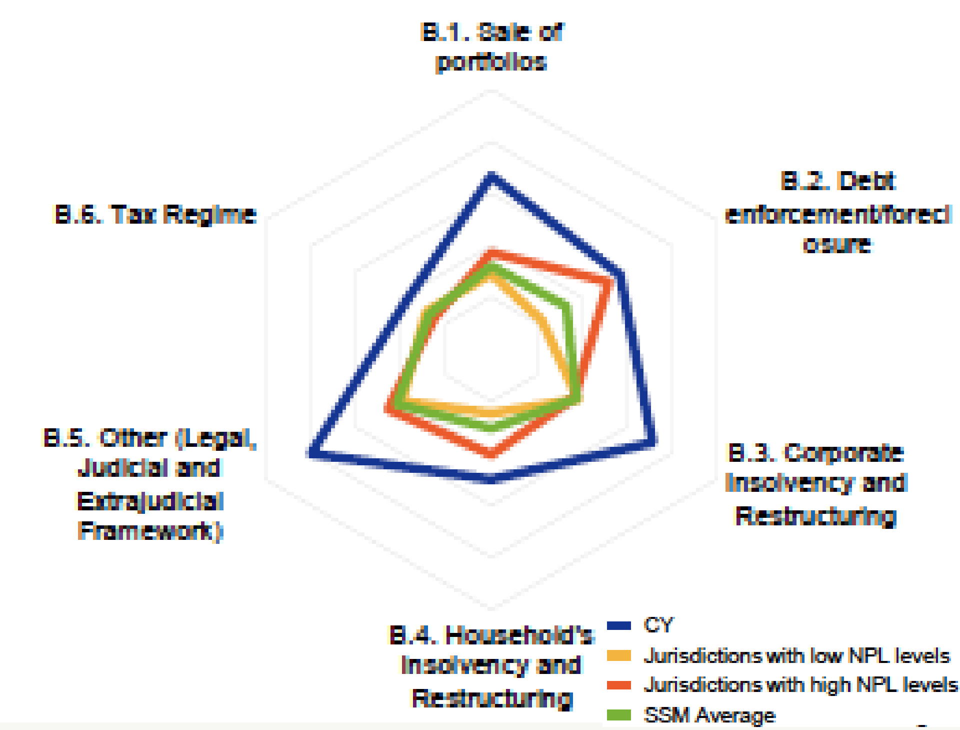
- Central credit registries and asset registers, debt counselling and impediments through excessive data and consumer protection

ECB findings on legal impediments

Greece



Cyprus



Source: ECB (2017a).

Resolution strategies in case study countries

	Supervisory guidance 1/				OECD indicator on quality of the insolvency and restructuring regime 2/		AMC		cumulative NPL sales 2015-17, EUR bn.
	NPL recognition	provisioning	collateral valuation	NPL governance	2010	2016	year established	initial portfolio, gross	
Euro area economies									
Greece	2	0	1	5	0.63	0.38			7.5
Italy	1	0	3	0	0.53	0.44			119
Portugal	2	4	4	0	0.52	0.31			4.8
Spain	3	2	4	1	0.39	0.31	2012	EUR 106 bn	43
Slovenia	3	2	3	5	0.58	0.33	2013	EUR 5.5 bn	1.4
Ireland	3	2	4	5	0.39	0.31	2009	EUR 74 bn	36
Germany	0	0	3	1	0.44	0.28	2010	EUR 252 bn 3/	15
Other EU countries									
Romania									5.6
UK					0.10	0.10	2010	GBP 75 bn 3/	53

1/ Based on ECB (2017a). The indicators represent the number of additional requirements in force in addition to current regulations in 2016 (out of 4, and out of 5 for NPL governance).

2/ lower indicators represent better regimes.

3/ bank-specific asset wind-down entity;
in the case of Germany two entities were set up in 2010 with initial portfolios of EUR 77 bn, and EUR 175 bn respectively.

National NPL resolution policies

Transparency of nat. policies remains relatively poor:

- IMF and ECB surveys only one-off
- EU country surveyance (European semester) reviews such policies, though not consistently

But some more detail in the semi-annual ‘Risk reduction indicators’ produced for the euro-group of the EU Council.

More than half of the 28 EU states have undertaken some form NPL resolution measures. Often as part of a broader bank restructuring, in reaction to a banking crisis, and not solely aimed at NPL workout. Key reform areas were:

- Insolvency and foreclosure
- NPL sales
- Establishment of AMCs
- Securitisation
- Improved workout and arrears management within banks.

Seven case studies of national resolution strategies

Seven case studies

- Two EU countries are reviewed that are outside the euro area (Romania, UK), and which could experiment more freely with policies. Restrictions on state aid would be a bigger constraint on public support today than was the case at the time.
- Five countries are covered from within the currency union (Spain, Portugal, Slovenia, Greece, Italy).
- This includes 5 of the 7 countries designated as ‘high-NPL’ jurisdictions by the ECB, and 4 countries with EU/IMF programmes (three in the euro area).

NPL ratios and private debt in case study countries

	NPL ratio 1/		coverage ratio, 2017 2/	corporate debt in % of GDP 3/		household debt in % of GDP 3/	
	2012	2017		2012	2017	2012	2017
Euro area economies							
Greece	23.3	45.6	46.9	65.9	60.6	64.6	56.4
Italy	13.7	14.4	50.6	73.6	60.3	43.3	40.8
Portugal	9.7	13.3	48.6	99.1	76.3	88.8	67.7
Spain	7.5	4.5	41.9	105.6	75	80.2	60.7
Slovenia	15.2	3.2	62.9	79.3	46.2	30.6	27
Ireland	25.0	11.5	29.5	175.1	190.1	98	47.2
Germany	2.9	1.5	41.3	40.7	40.9	55.8	52.2
Other EU countries							
Romania	18.2	6.4	67.6	51.4	34.8	20.6	16.1
UK	3.6	0.7	31.9	68.3	65.7	87.5	84.6

1/ World Bank, based on IMF Financial Soundness Indicators.

2/ EBA Risk Dashboard.

3/ Eurostat, based on consolidated reporting.

The UK

- First EU country to be impacted by the financial crisis in 2008, with a classic ‘bank run’, though no sharp increase in the NPL ratio.
- Nationalisation and good bank/bad bank split of Northern Rock. The bad bank wound down a GBP 50 billion portfolio of defaulted mortgages.
- State participation in two systemic banks (RBS and Lloyds) followed by restructuring and sale of legacy assets.
- RBS benefitted from an **asset protection scheme** under which the government guaranteed the portfolio value beyond a first loss covered by the bank.
- Later measures to reduce growth in the number of highly indebted households.

➢ Quick work out through comprehensive and swift bank restructuring.

➢ Liquid distressed debt markets and a good framework for insolvency and out-of-court restructuring underpinned resolution.

Romania

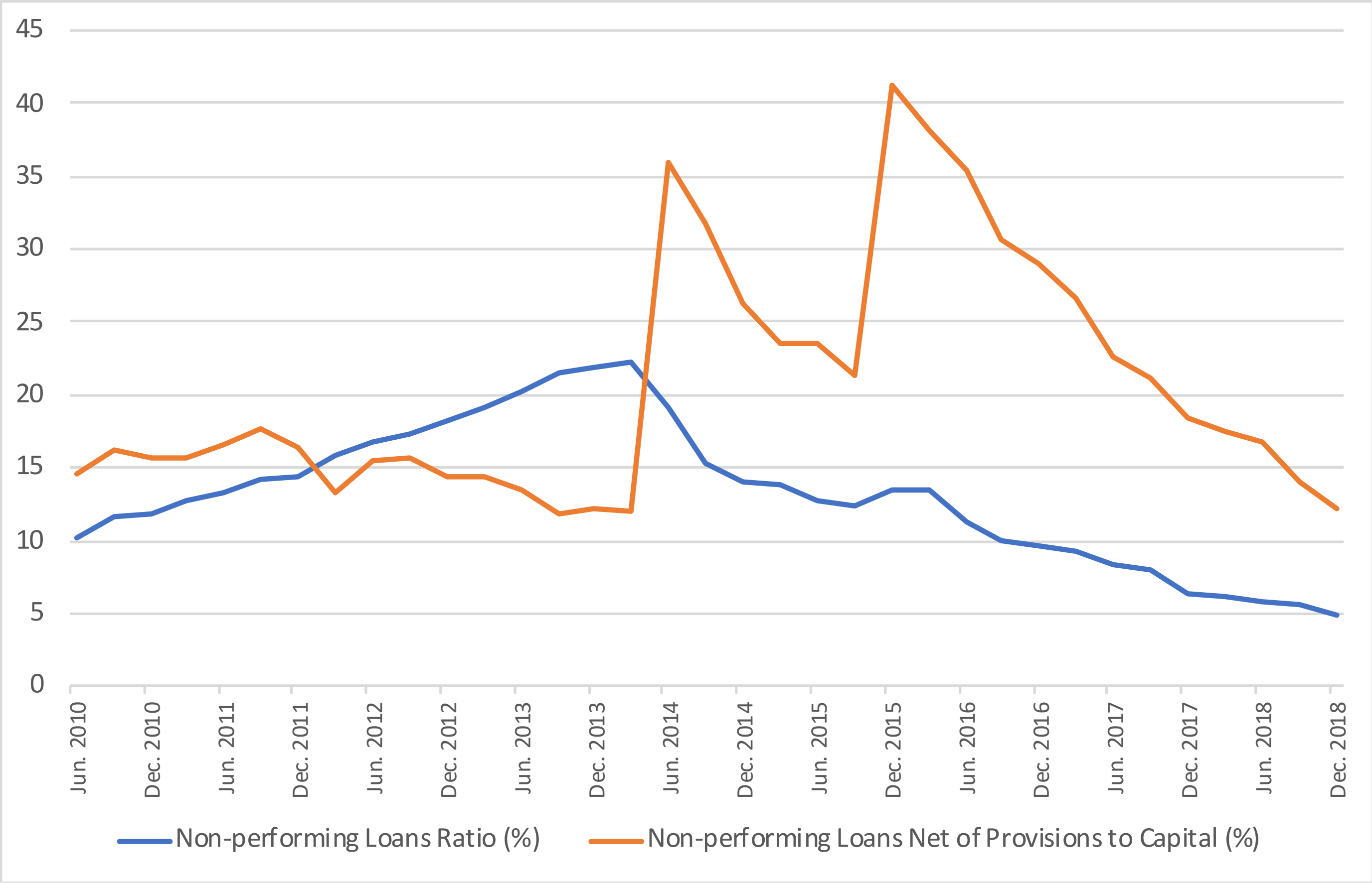
- Rapid financial liberalization following EU accession in 2007, featuring risky funding practices and fx-based lending.
- The peak NPL ratio of 22 per cent in 2013 the highest in the EU at the time. -- A key focus of the IMF programme.
- But local ownership strong, and IMF measures subsequently continued and broadened in national NPL resolution plan.
- In 2017 the central bank adopted innovative systemic risk buffers to equip high risk institutions to deal with a future rise in NPLs.

➢ High capital coverage allowed more aggressive provisioning guidance.

➢ Rapid emergence of an NPL market in part based on good data quality and investor engagement by the local subsidiaries of European bank groups.

➢ In the absence of a prospect for euro area membership, strong local ownership by Romanian authorities.

NPL ratio and provisioning ratio in Romania



Spain

- NPL issues concentrated in the property sector and savings banks (poor governance).
- 2012: comprehensive AQR and stress test, largely designed by IMF.
- EU financial sector programme granted up to EUR 100 bn. in support; put in place comprehensive sector restructuring, and establishment of the AMC.
- NPL ratio on a sustained downward trend, and currently only slightly above euro area average. Banking sector again profitable, and credit volumes are stabilizing as corporate lending demand has picked up amid solid growth.

➢ Comprehensive restructuring and recapitalization of the affected parts of the banking sector. Supervision of smaller institutions by the Bank of Spain considerably strengthened.

➢ SAREB played a crucial role in removing the affected assets, and narrowly focused on real estate assets. Early valuation for asset transfers likely too high, as it has suffered repeated write-downs. The 15-year lifespan has allowed to back-load sales as property markets recover.

➢ A dynamic NPL market emerged. SAREB's was effective in attracting investors, and building a local servicing sector.

➢ Legal reforms through the new personal and corporate insolvency regimes.

Portugal

- NPL stock originated in protracted low growth environment since euro accession, that brought large parts of the corporate sector into debt distress.
- Multiple bank relationships of large enterprises, and poor creditor coordination key problems.
- Resolution of two systemic banks brings large amounts of distressed assets to the market in 2014-15.
- IMF programme up to 2014 with a key focus on private sector deleveraging, but fails to make sufficient progress.
- Government scheme for out of court restructuring ineffective; no clear strategy for SMEs.

➢ Failure to conduct a comprehensive asset quality review undermined IMF programme, and subsequent reform. Resolutions of two large banks hence came fairly late, complicating private sector recovery further.

➢ Nature of the corporate debt and NPL problem rightly put private creditor (multi-lender) coordination and participation of fiscal bodies in restructuring centre stage.

Slovenia

- NPL crisis from 2012 rooted in corporate sector excess debt, and history of poor lending practices by state banks in 2012-13.
- Slovenia avoids the EU/IMF programme, though is closely guided by the institutions, as ECB supervision is imminent, and as asset transfers from banks to the AMC needed to be free of state aid concerns.
- Comprehensive AQR and stress test lead to resolution of two banks, and wide—ranging restructuring of the others.

➢ Close coordination between central bank and government, including to establish new insolvency and restructuring framework.

➢ Slovenia's AMC has been successful in recovering value from a portfolio of corporate assets, and in restructuring viable companies.

➢ Recovery in asset values and loan performance on the back of quick recovery and growth in the rest of the euro area, benefiting a highly export-oriented country.

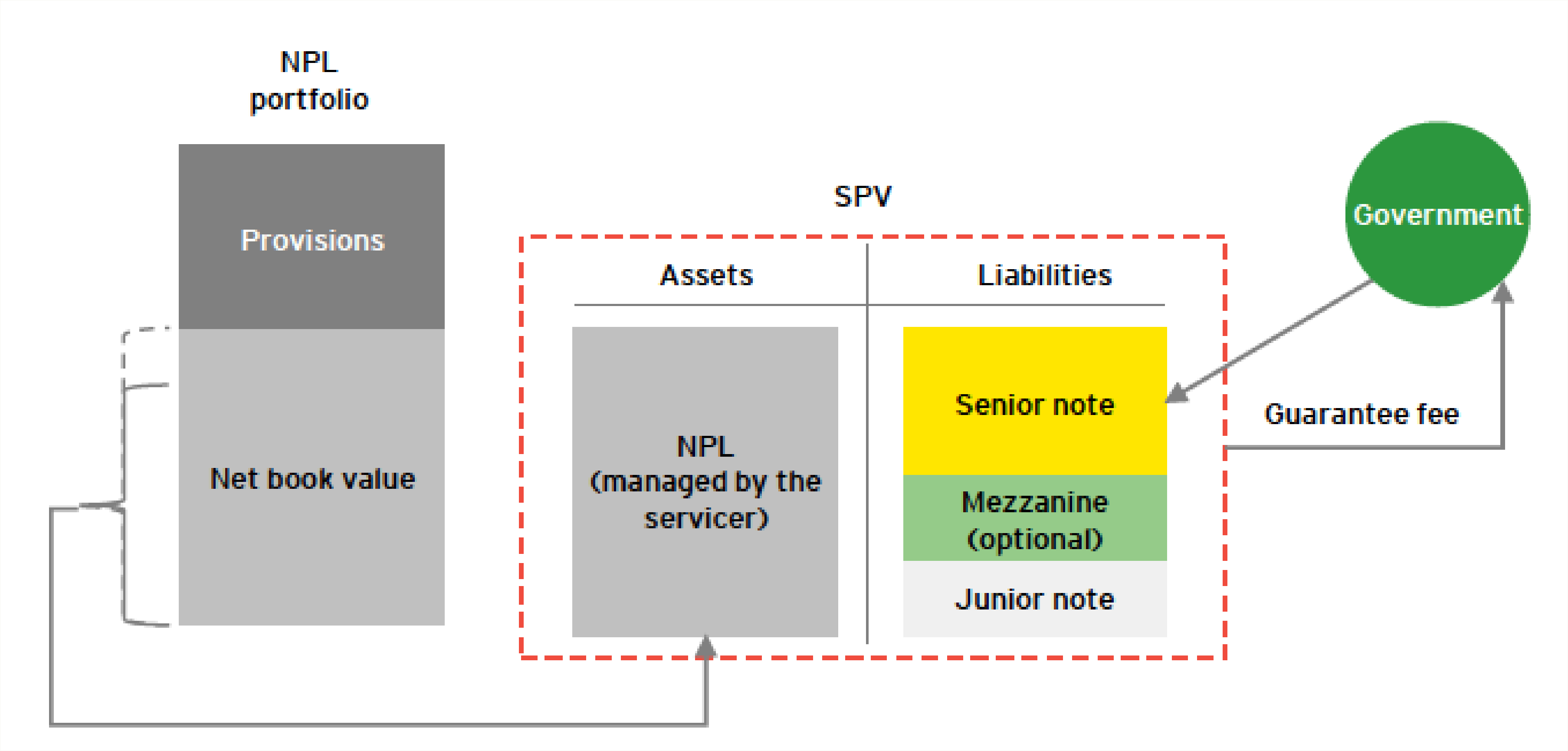
Italy

- 80 % of NPLs are in the corporate sector, which is dominated by SMEs. The combination of the corporate debt overhang and economic stagnation explain the rapid rise in NPLs.
- Several measures in 2015-16 during the reform-oriented Renzi administration: insolvency reform, collateral enforcement, reform of cooperative bank sector, and tax treatment of loan losses.
- ECB (2017) still found weak supervisory regime and legal framework.
- Key innovations: securitization of NPL portfolios with government guarantees for senior tranches – an important impetus to the NPL market (the largest in the EU); about EUR 63 bn. gross value moved by early 2019.
- an earlier private backstop facility to invest in NPL portfolios has been problematic in terms of governance.

➢ No IMF/EU programme, hence weak and intermittent ownership for debt/NPL reduction and bank resolution.

➢ Sovereign exposures and structural lack of profitability aggravate the challenge of NPL resolution.

The Italian GACS scheme



Source: EY.

Greece

- A sovereign debt crisis infected the banking sector from 2010. A deep and protracted recession, with GDP contracting 25 per cent, at the root of the NPL problem.
- NPLs evenly spread across households, SMEs and larger corporates. Many companies should be considered non-viable.
- Efforts in debt restructuring and foreclosure under the second IMF/EU programme frustrated by political interference (excessive borrower protection in residential real estate), and strategic defaults, amidst persistently high unemployment and economic contraction.
- Restructuring capacity within banks also poor, many restructuring solutions are not sustainable.

Greece: some lessons

- ➢ Liberalisation of loan transfers and servicing helped with the emergence of NPL sales, this market emerged much later than in other EA countries.
- ➢ ECB/SSM targets for NPL reduction in the four largest banks motivated a search for new institutions/processes.
- ➢ The 'Hercules' plan is set to become effective in early 2020 and closely resemble the Italian *GACS* scheme:
    - Government first loss guarantee on senior tranches;
    - Market-driven and no quota for individual banks;
    - external servicers required to maximise recovery prospects
    - compared to the Italian scheme weaker support from the sovereign, which is still rated sub-investment grade.

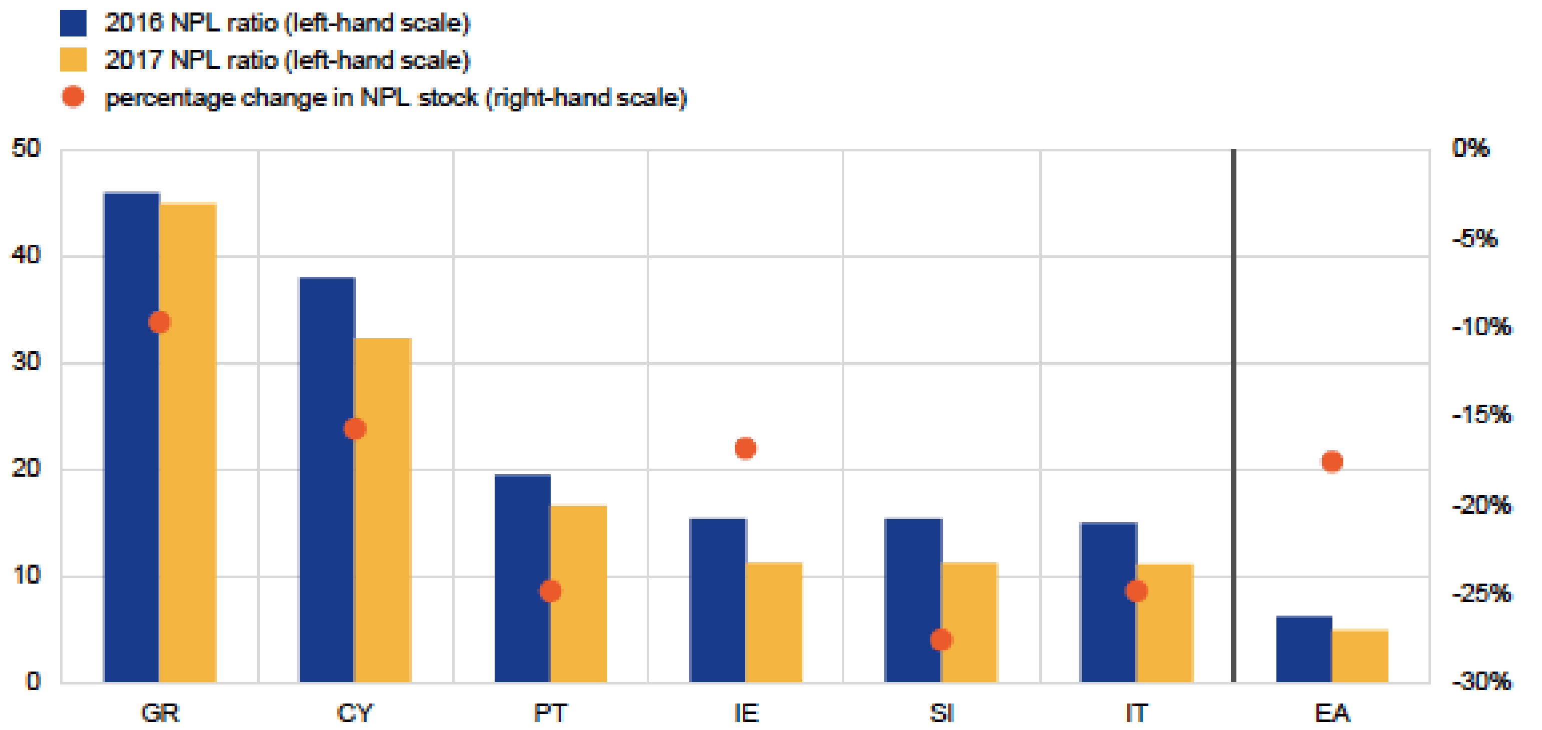
Impact of national reforms

Overall policy impact

- The combination of stricter ECB supervision of the largest euro area banks, EU-level standards for data quality, provisioning etc, and national policies seems to have been a success overall. But important caveats:
  - Greece, Cyprus, Italy, Portugal with more protracted workout histories.
  - Nature of NPLs is changing: NPLs in viable companies in need of restructuring, or SMEs rarely part of portfolio sales.
  - Restructuring solutions designed by banks show a high rate of ‘relapse’.
- NPL ratios are a poor measure of effectiveness of national resolution policies. Other factors matter, which are:
  - outside this NPL resolution strategy narrowly defined (e.g. bank restructuring and micro-prudential supervision more broadly);
  - or outside national control entirely (e.g. euro area financial conditions, cross-border exposures).

Overall policy impact

(2016-17, ratios, percentage changes)

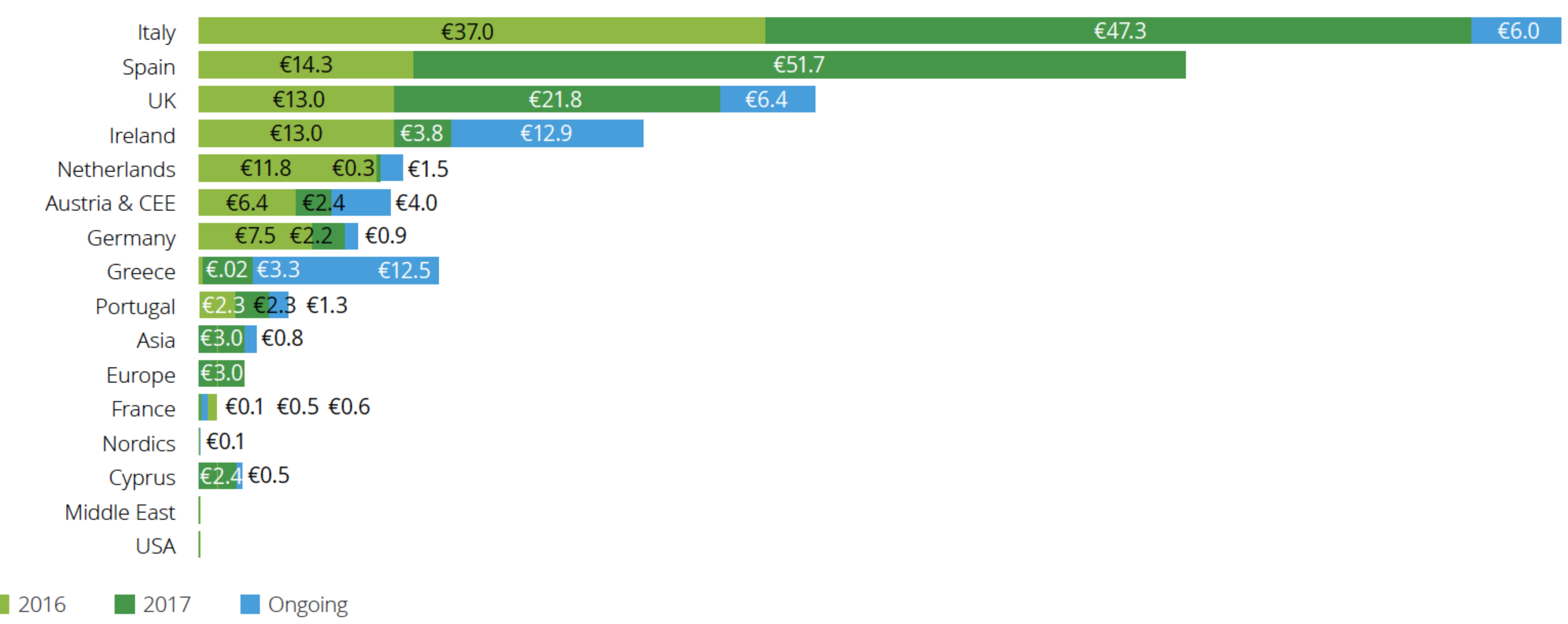


Source: ECB.
Notes: Based on country-level aggregates for SIs. In line with FINREP reporting on non-performing exposures, loans and advances also include cash balances at central banks and other demand deposits.

Specific impact on NPL markets

- NPL sales have been an important objective of both euro area/EU and national policies.
- Supply largely determined by supervision, in particular NPL reduction targets set by the ECB, which could not be met through bank-internal restructuring.
- But demand for distressed NPL assets, and for market activity overall, is squarely under the control of national authorities: e.g. restrictions on non-bank investors, loan servicers, quality of credit registry etc.
- Key markets developed on the back of national reforms: Italy, Spain, and now Greece.
- But market reaches limits of what can be easily absorbed by existing investor base
- More sustainable growth will require better transparency, e.g. through a transaction platform.

Transactions concentrated in just a few countries

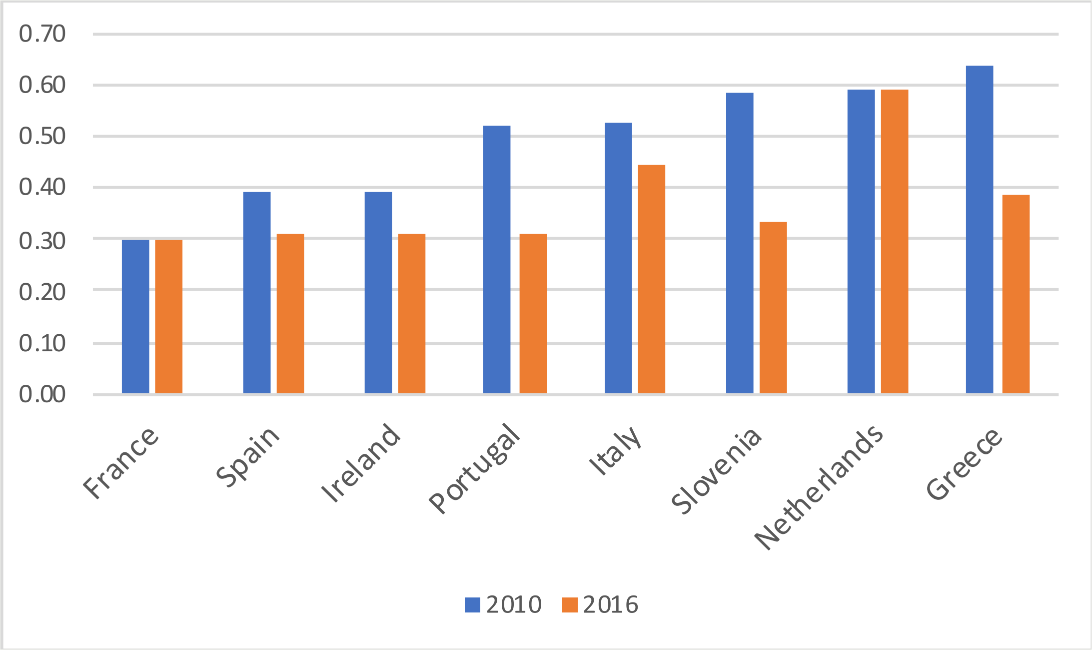


Source: Deloitte, Global Deleveraging Report, 2018.

Specific impact on insolvency frameworks

- European NPL crisis was closely linked to the incidence of unsustainable corporate debt.
- *National* NPL resolution strategies hence rightly focused on insolvency reform (in half of EU states with NPL measures). By contrast EU-level reform of insolvency and restructuring rules so far immaterial.
- Empirical studies (eg Consolo et al., 2018) underline that EU countries with better insolvency laws:
  - have lower NPL ratios to start with;
  - And manage a speedier resolution once an adverse shock hits.

OECD composite indicator of quality of insolvency law



Source: OECD. Lower scores represent better regimes. The composite indicator is based on a quantification of four aspects of insolvency laws, including treatment of failed entrepreneurs, prevention and streamlining regimes and restructuring tools.

Conclusions, and possible lessons for Asia

Some stylized findings from the seven case studies

1. NPL resolution typically seen as a by-product of a wider bank restructuring agenda provoked by the crisis. Explicit NPL strategies (eg Romania, but also Albania) are rare. Where NPLs are portrayed as a financial stability agenda only, coordination with related government agencies was therefore often poor (eg insolvency reform, licensing of loan servicers).
2. There has been an increasing dis-illusionment with banks' capacity and skills in internal workout. However, reliance on market sales constrained by reluctance to allow large investors into sensitive assets, in particular of course residential real estate.
3. EU banking sectors are much sounder today. Again, this cannot be attributed to NPL strategies alone. NPL resolution was a necessary condition for broader restructuring to be effective.

Some lessons from Europe which may be relevant for Asia

1. **AQRs and stress tests**, based on sound loan quality definitions are a precondition for effective resolution strategies. Early and rigorous in Slovenia and Spain; absent, late or inadequate in Portugal and Italy. This needs to be the basis for more aggressive **provisioning** and write-downs, in financial terms but also to garner political support.
2. More intrusive **supervision** to improve arrears management and NPL workout in banks is a key support to sustained resolution. ECB NPL guidelines were a game-changer in Europe.
3. **NPL sales** are an important relief mechanism. But investors generally focused on foreclosure and collateral liquidation. Restructuring solutions for corporate and SME assets that are still viable have been rare.
4. Policy must address market failures inherent in asset transfers. **AMCs** are effective but can be costly (eg in Spain). Once state bailouts became illegal in the EU, valuation favourable for the banks, and AMCs became unattractive.
5. **Securitisation schemes** with public guarantees can be a market catalyst (eg Italy, and now in Greece). Only for larger banks and granular portfolios are likely to benefit.
6. **Coordination between investors** seems to work poorly, and transaction platforms are limited to jurisdiction-specific asset pools.
7. Sound **insolvency frameworks** are essential for the complementary debt restructuring process. A necessary condition for sustainable NPLs reduction.

some constraints Asian NPL resolution may be able to circumvent

… equally :

- Disjointed effort between bank restructuring in the crisis, and the much more protracted reform of banks' governance and workout practices.
- No quick and comprehensive reform of loan transfers, serving, and restructuring/insolvency rules, where EU competences are weak, and monitoring only intermittent.
- EU state aid procedures resulted in lengthy delays in setting up AMCs, or clearing GACS in Italy or Hercules in Greece – this was costly for the underlying assets, as the costs from excess debt persisted and value recovery in future restructuring was depleted
- Even though cross-border spillovers were recognized there was no EU-wide financial support, dedicated to NPL workout.
- Market failures in distressed loan transfers warranted involvement of a supranational anchor investor, such as the EBRD.

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