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Resolution of NPLs in the Euro area

Asian Development Bank – ECB Workshop on NPL resolution

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Overview

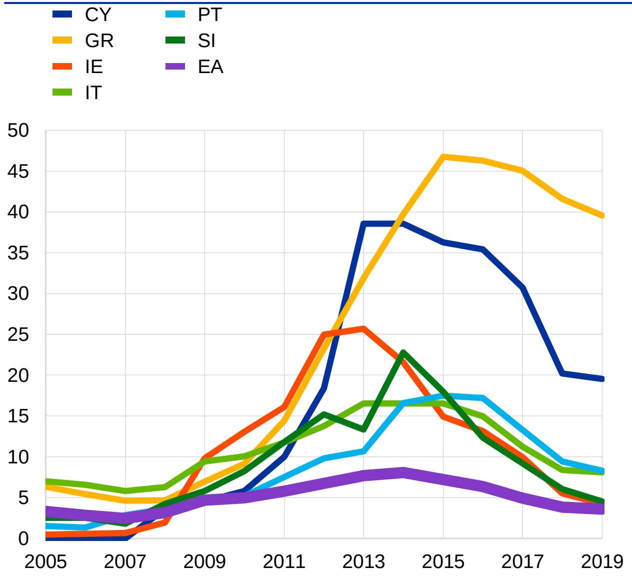
1. NPLs in Europe: a long echo of the financial crisis
2. Why was NPL resolution in the euro area slow?
3. Elements of a comprehensive solution
4. Regional cooperation

1.

NPLs in Europe: a long echo of the financial crisis

12 years after the crisis began, NPLs remain above pre-crisis levels and other advanced economies

NPL ratios in the euro area peaked in 2013-2015

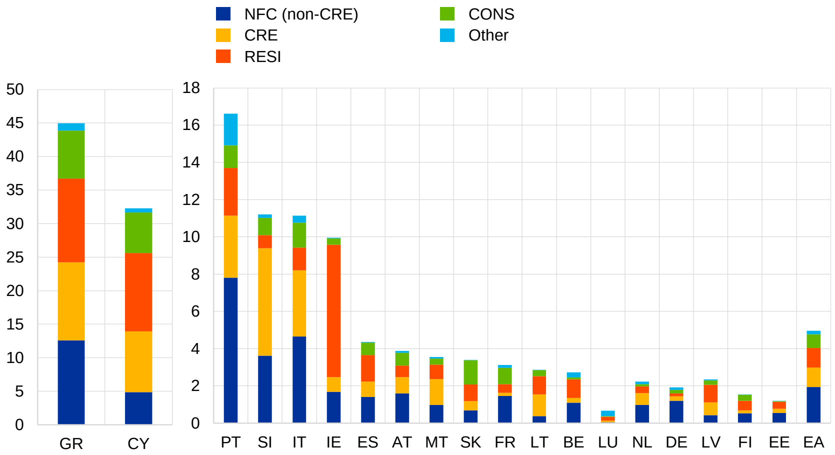


Source: World Bank, IMF Financial Soundness Indicators (until 2013), ECB Consolidated Banking Data (2014-Q2 2019).

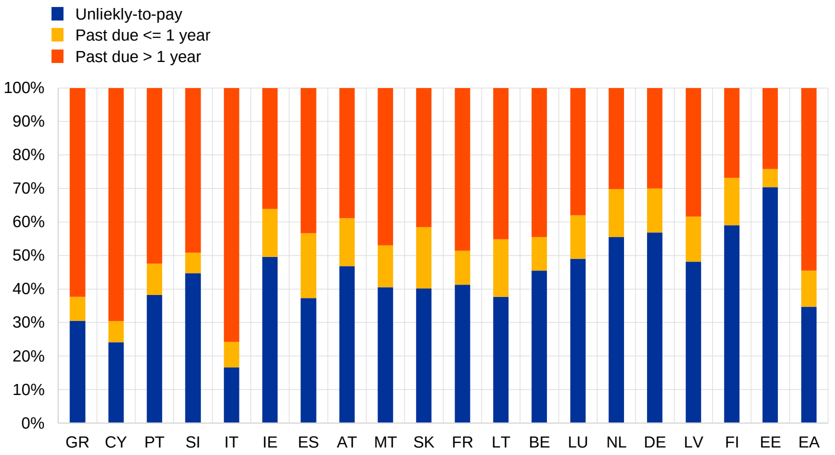
	Average NPL ratio (2007)	Average NPL ratio (mid-2019)
6 EA countries	4.8	11.0
EA	2.4	3.6
UK	0.9	1.0
US	1.4	0.9

NPLs have been diverse in terms of sectors and age

NPL ratio, contributions by sector



NPL stock, by age

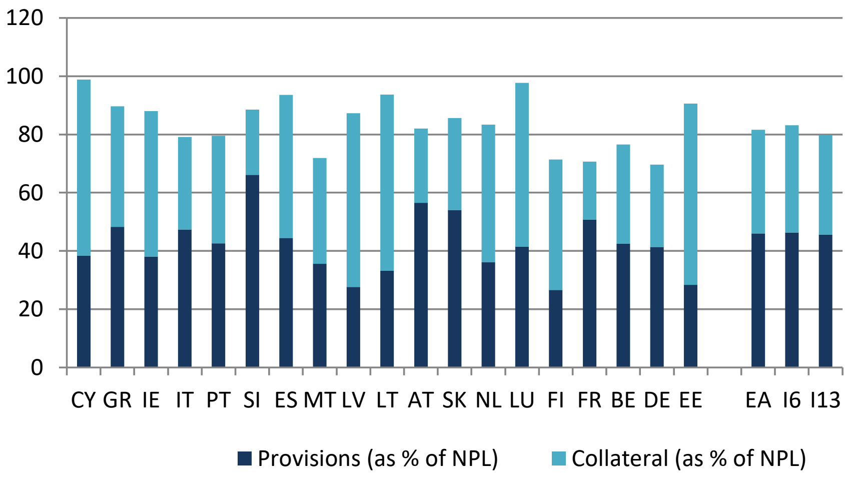


Source: ECB supervisory data, Q2 2018.

Note: CRE – commercial real estate; RESI – residential mortgages; CONS – consumer loans.

Most of NPLs were covered by provisions or collateral

Provisions and collateral coverage of gross NPLs

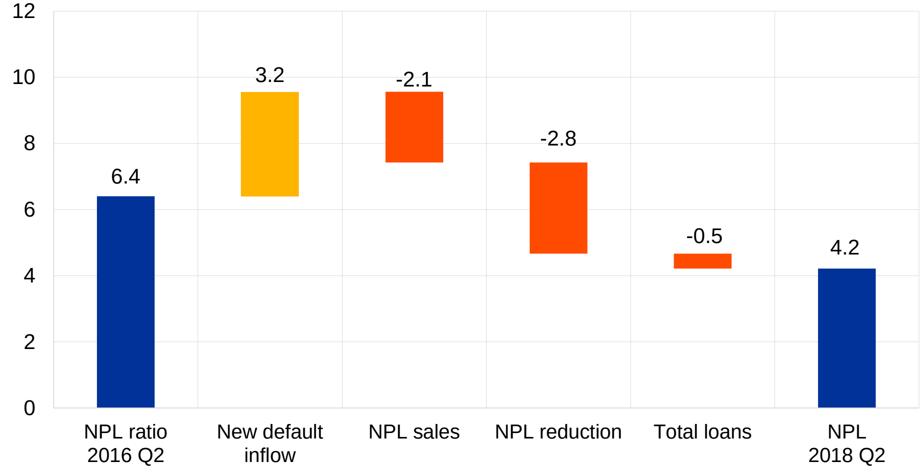


Source: ECB supervisory data, Q2 2016.

Note: I6: six high-NPL countries (CY, GR, IE, IT, PT, SI). I13: remaining euro area countries

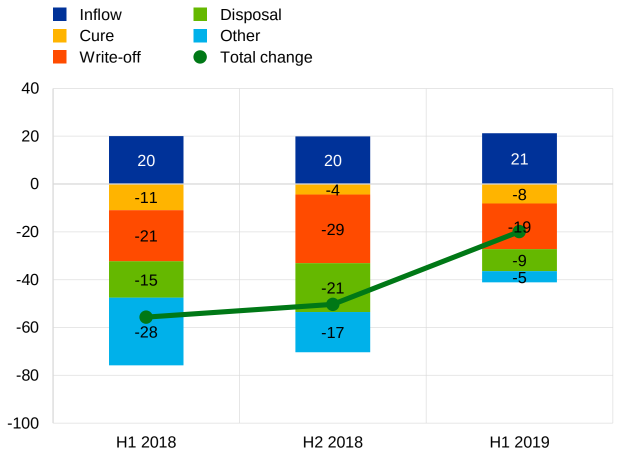
Sales drove declines in NPL ratios but progress has slowed down recently

NPL ratio, decomposition of changes Q2 2016 – Q2 2018 (percentage points)



Source: ECB supervisory data, KPMG, Deloitte, company announcements.
Note: based on a balanced sample of 70 Significant Institutions. Data on sales collected from a variety of non-supervisory sources.

Change in corporate NPL stock January 2018 – June 2019 (EUR billion)

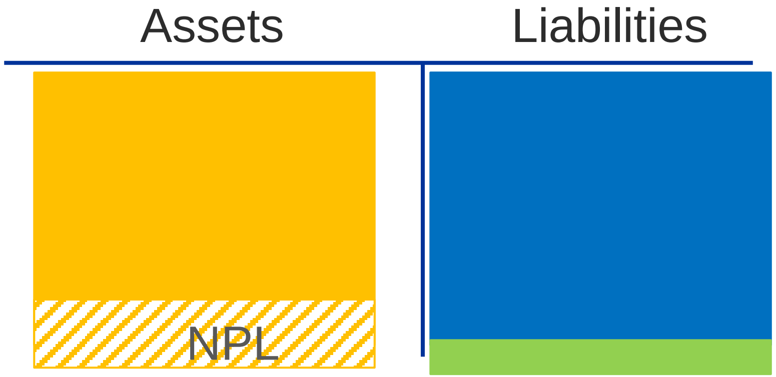


Source: ECB calculations.
Notes: Based on a balanced panel of 89 significant institutions. Inflows are proxied by total gross book value of loans entering IFRS 9 Stage 3. Outflows are broken down into cures (i.e. loans transitioning from stage 3 to stages 1 and 2), write-offs, and disposals. The latter are proxied by write-off of loan loss provision undertaken due to disposal of the underlying NPL or collateral. This is a lower bound of the actual scale of NPL sales as it excludes cash recoveries from sales. Other causes are a residual item which includes recoveries from sales, partial repayments of NPLs and accrual of unpaid due interest.

Why do NPLs matter?

1 Lower bank profitability

- Provisioning and write-offs



2 Higher vulnerability of banks

- Impact on funding costs
- Difficulty to generate capital from internal or external sources
- Contingent state liability

3 Impact on bank debtors

- Deteriorating viability of distressed debtors
- Weaker payment culture

4 New lending held back

- Delays economic recovery
- Weakens monetary transmission

Why do NPLs matter?

Country	Peak NPL ratio*
Greece	46.8
Cyprus	38.6
Ireland	25.7
Slovenia	22.8
Portugal	17.5
Italy	16.5
Spain	9.4

*Peak NPL ratio, 2008 to 2019

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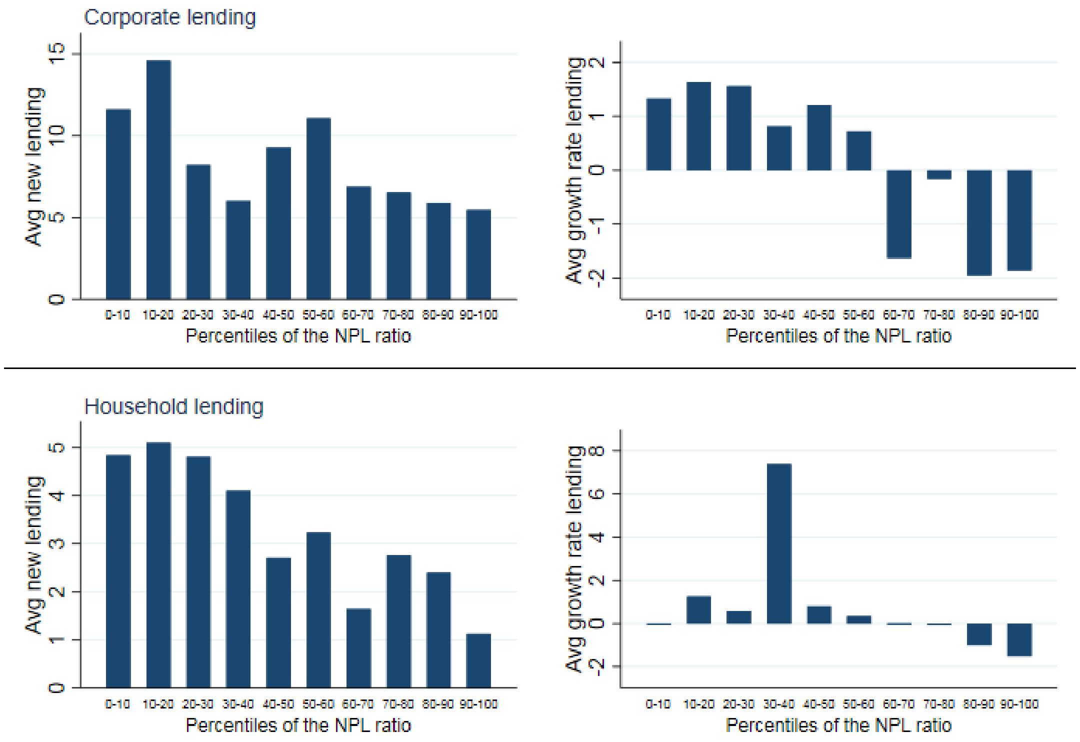
*Peak NPL ratio, 2008 to 2019

Banks with more NPLs lent less during the recovery of 2014-2018



Cross-border spillovers of NPL issues

High NPL levels, despite being present only in a subset of EU countries, were 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 lending flows
- Confidence channel: negative market sentiment about national banking systems may impact other banks or sovereigns
- Wealth channel: losses on bank debt and equity may have wealth effects
- Trade channel: deterioration of macro conditions in high-NPL countries impacts other countries through lower demand for imports

Transmission of single monetary policy can be negatively affected

2.

Why was NPL resolution slow?

(Some) reasons for lower NPL ratios in US vs EA

Role of US Govt-sponsored entities

Different incentives provided by accounting standards

- IAS 39: incurred loss model
- US GAAP: time-bound charge-offs

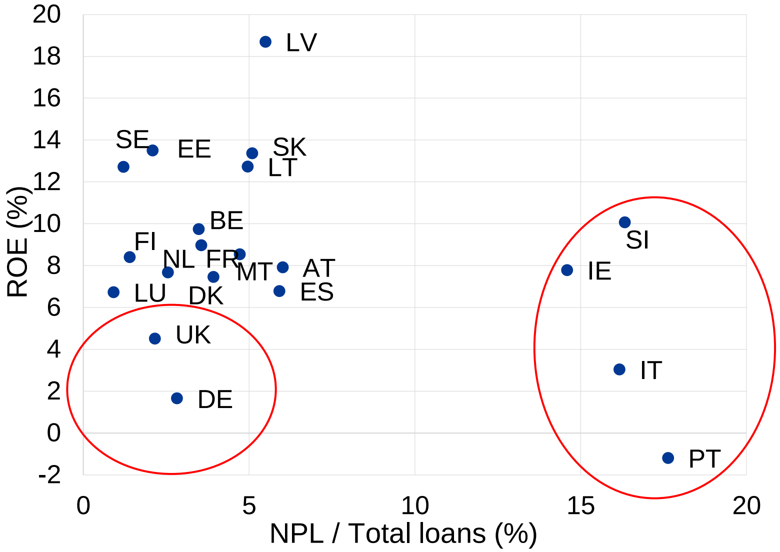
Non-recourse lending in the US

- 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 accounting rules, this strengthens the incentive to seek quick resolution of NPLs

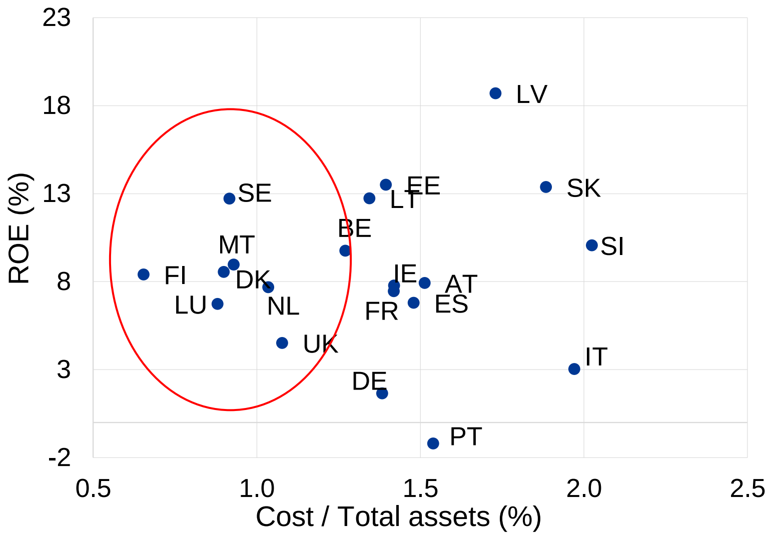
Deeper and liquid market for distressed debt in the US

Weak bank profitability – not only due to high NPL

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



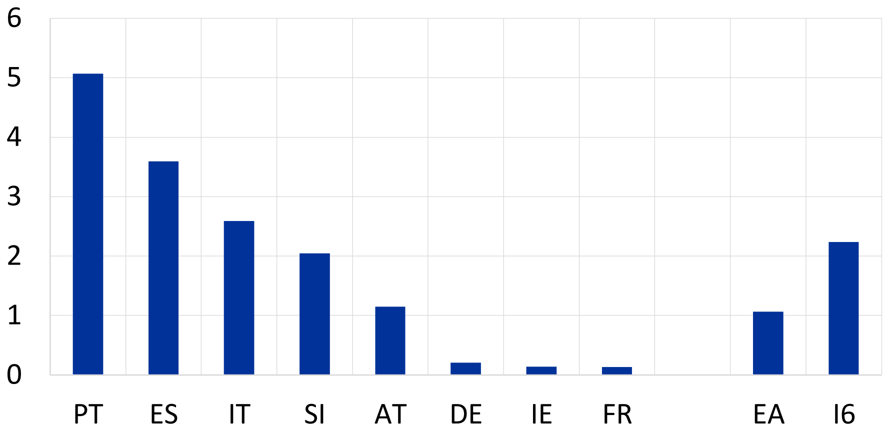
Return on equity and costs to total asset ratios in EU countries (percentages, 2016)



Source: ECB Consolidated Banking data and ECB calculations

Replacement of NPLs by performing assets may significantly improve profitability

Aggregate ROE in the euro area over a 3-year horizon may improve by about 1 pp



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. For some EA countries, cures of NPL would yield a negative impact on ROE given the higher interest rate accrued on NPL than on performing assets. Results are only showed for countries with positive impact on ROE.
Source: ECB and ECB calculations.

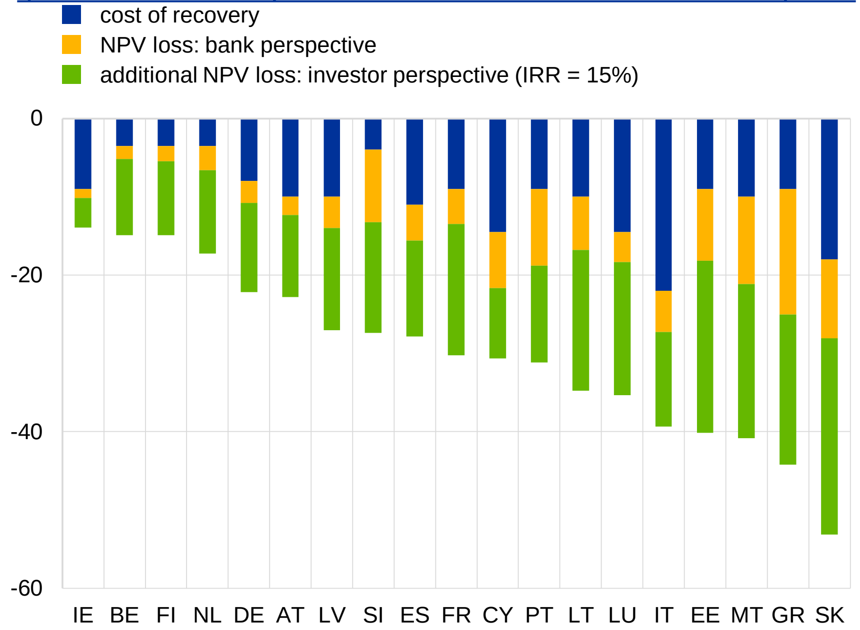
Market failure and regulation in NPL markets created impediments to demand and supply

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)



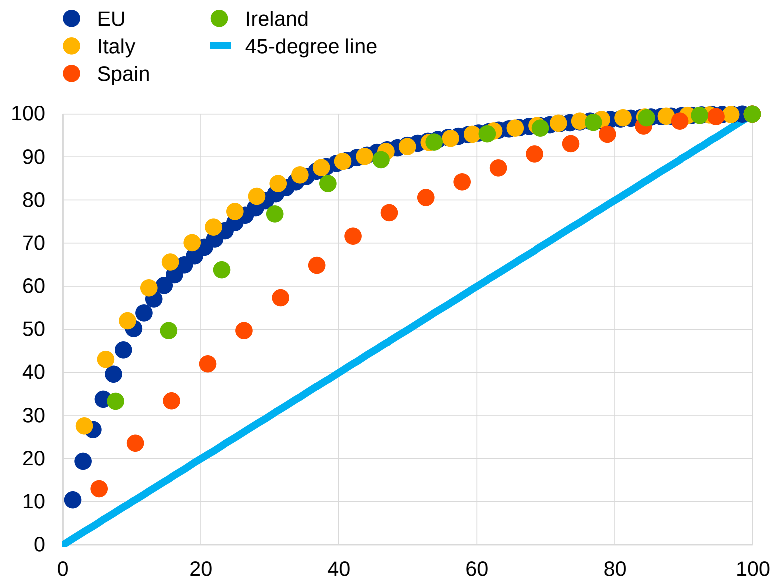
- Bid-ask spread in NPL markets is not directly observable
- A private investor may require a discount above 40% even on fully secured loans according to estimates
- Gap arises from asymmetric information and time and cost of recoveries

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.

A triad of market failures afflicted the NPL market

- **Market for lemons**
  - Investors are uncertain about true quality of the NPLs
  - Cost of overcoming intransparency is high
  - Few investors can absorb such cost → barriers to entry
- **Imperfect excludability**
  - Investors cannot be sure of exclusive rights to debtors
- **Oligopsony**
  - Very few buyers present in the market → little price competition

Cumulative market share of investors in NPLs (2015-2017, x-axis: percentage of investors, y-axis: percentage of turnover)



3.

Elements of a comprehensive solution

A taxonomy of policy options

Wide range of policy responses to address large NPL stocks: a brief overview of frequently-employed options…

On-balance sheet

Internal work out
- work out by originating bank; includes various restructuring options

Asset Protection Scheme
- risk-sharing agreement to limit further losses, usually State-backed
- usually short horizon; potential losses large but with low probability

Securitisation
- an alternative to outright sale

Asset Management Companies
- complete separation of asset from originating bank, often State-backed
- usually long horizon; large losses typically already realised

Transaction platforms
- Investors able to build their own portfolio from multiple banks

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

Off-balance sheet

Source: Fell, J., M. Grodzicki, R. Martin and E. O'Brien (2016)

Sequencing of measures

Quick clean-up of NPLs from banks

- Transfers to AMCs
- Securitisation schemes

Medium-term perspective

- Improving bank practices and policies
- Improving data quality and availability
- NPL transaction platforms
- Introduction of IFRS 9 and more forward-looking provisioning rules
- Reforms of insolvency laws

Improving bank practices and policies

ECB Banking Supervision Guidance on NPL management (March 2017)

- Recognition, measurement and write-off of NPLs
- NPL strategies, governance, and operations
- Forbearance
- Valuation of collateral

Addendum to Guidance (March 2018)

- Supervisory expectations for provisioning on new NPLs
- Divergences from expectations discussed in the context of SREP

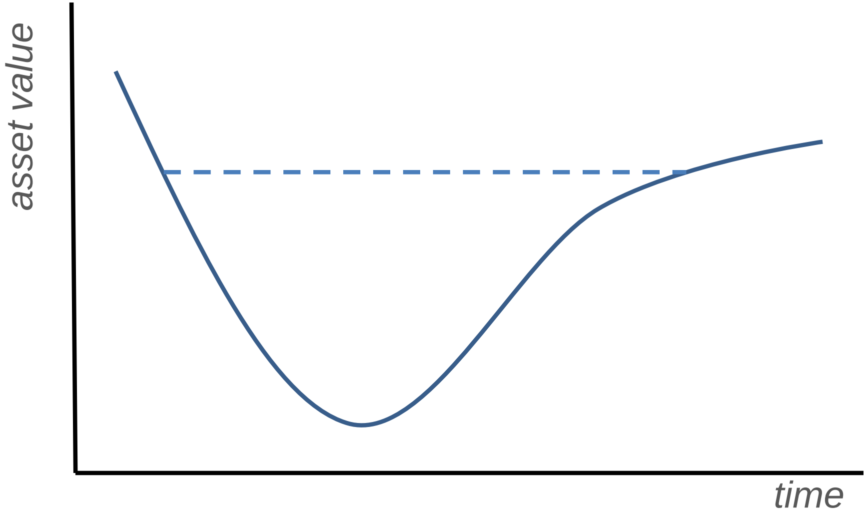
Pillar 1 provisioning calendar (April 2019)

- Minimum provision coverage requirement depending on age and collateral

Benefits of asset management companies

"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



Benefits of asset management companies

Funding liquidity impact

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

AMCs in the post-crisis regime: EBA/EC/ECB blueprint

Old and new constraints

- Financial envelope / public debt and deficit
- State aid rules
- Bank resolution and recovery directive

“NAMA solution” vs full government ownership

- Private vehicle with significant minority public equity participation or a State-owned vehicle
- State guarantee on senior debt funding in both cases

Feasibility under the post-crisis regime?

- Fully private solution preferable
- Compliance with EU framework: combination of impaired asset measure (state aid rules) and precautionary recapitalisation instrument (BRRD)

AMCs in the post-crisis regime: EBA/EC/ECB blueprint

Some key process elements

- Robust and independent asset valuation
- Debtor-level approach
- Viability test on debtors to inform workout strategy
- Real economic value estimation in line with State aid rules
- (System-wide) stress test exercise complying with the BRRD

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

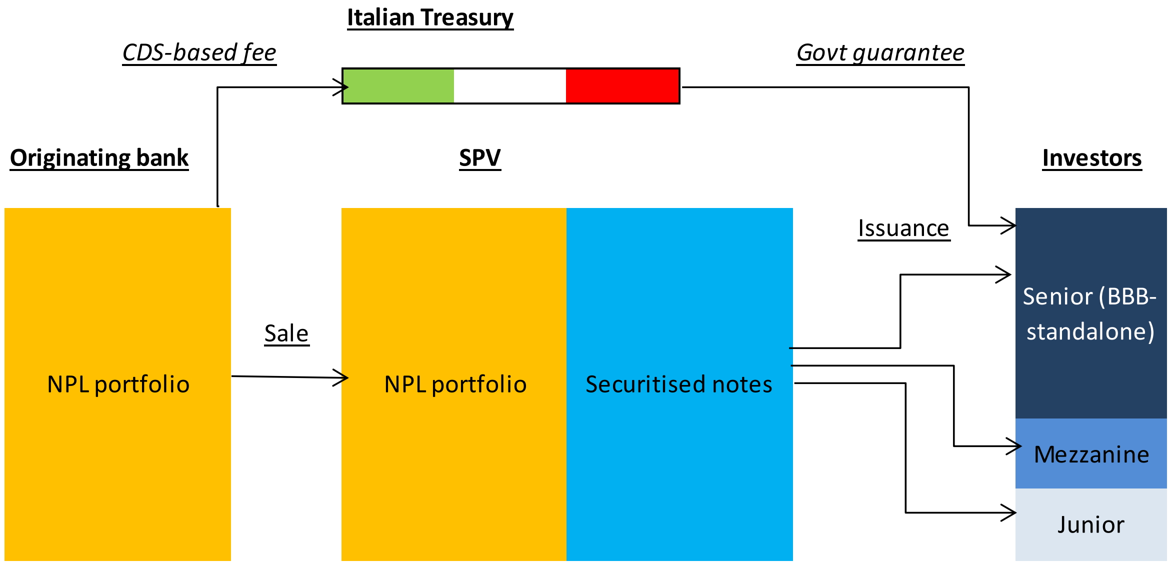
AMCs in the post-crisis regime: EBA/EC/ECB blueprint

Suitable 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

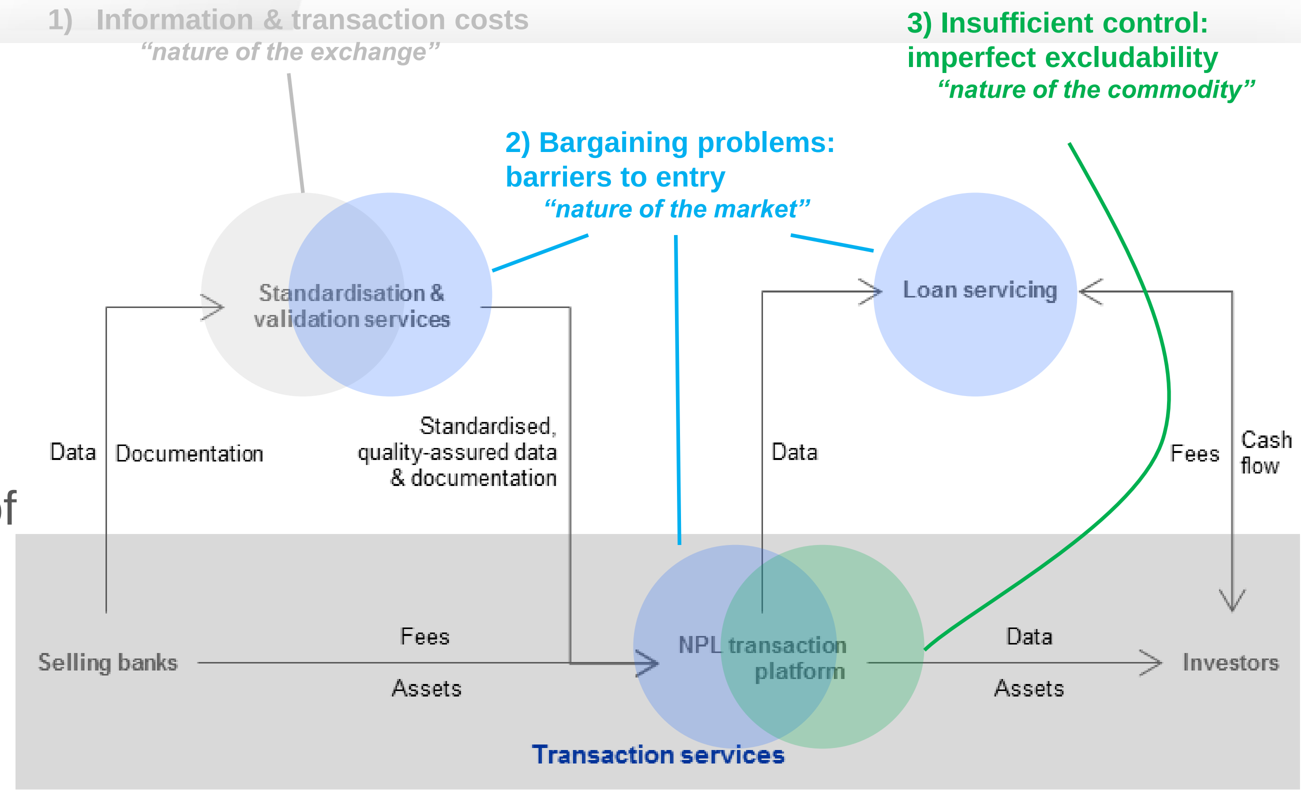
Securitisations may lead to similar outcomes as AMCs

- GACS: Italian securitisation scheme used to assist in disposal of NPLs
- >€60bn GBV of transactions in 2017-2019
- Scheme extended to 2021
- Conditions:
  - standalone external rating BBB- or higher;
  - guarantee remunerated on a market-consistent basis



NPL transaction platforms

- Complementary to other instruments
- Unlike AMC, cross-country scope and open asset perimeter
- Improved asset liquidity and velocity of capital – also for performing assets
- Ongoing discussions with industry

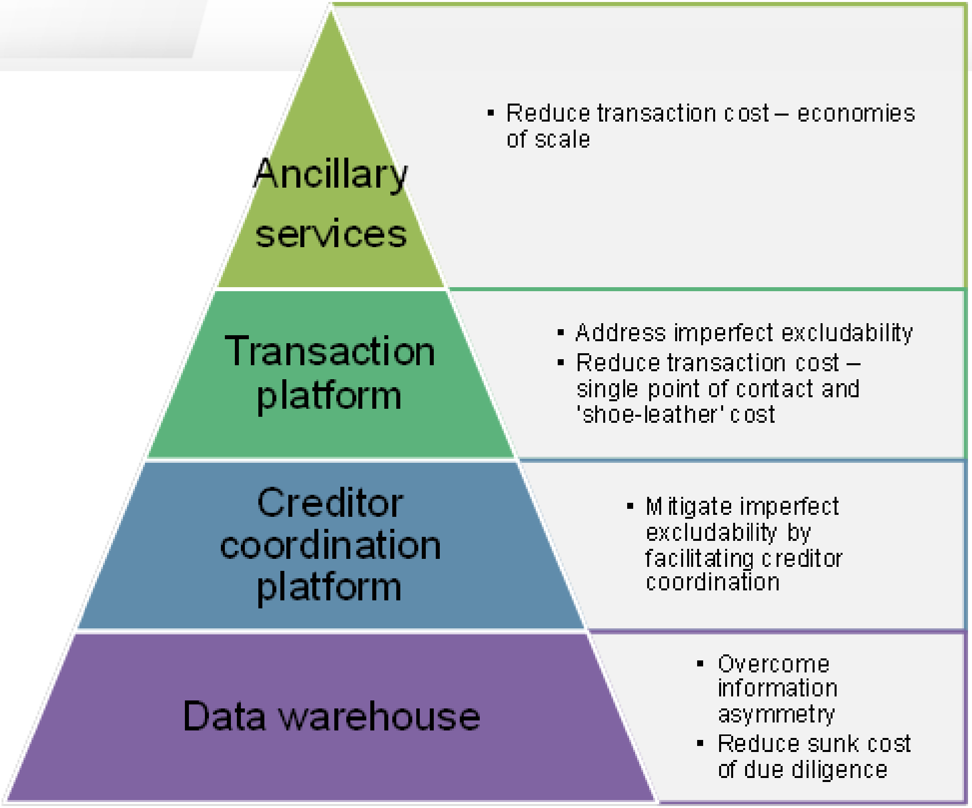


Source: ECB

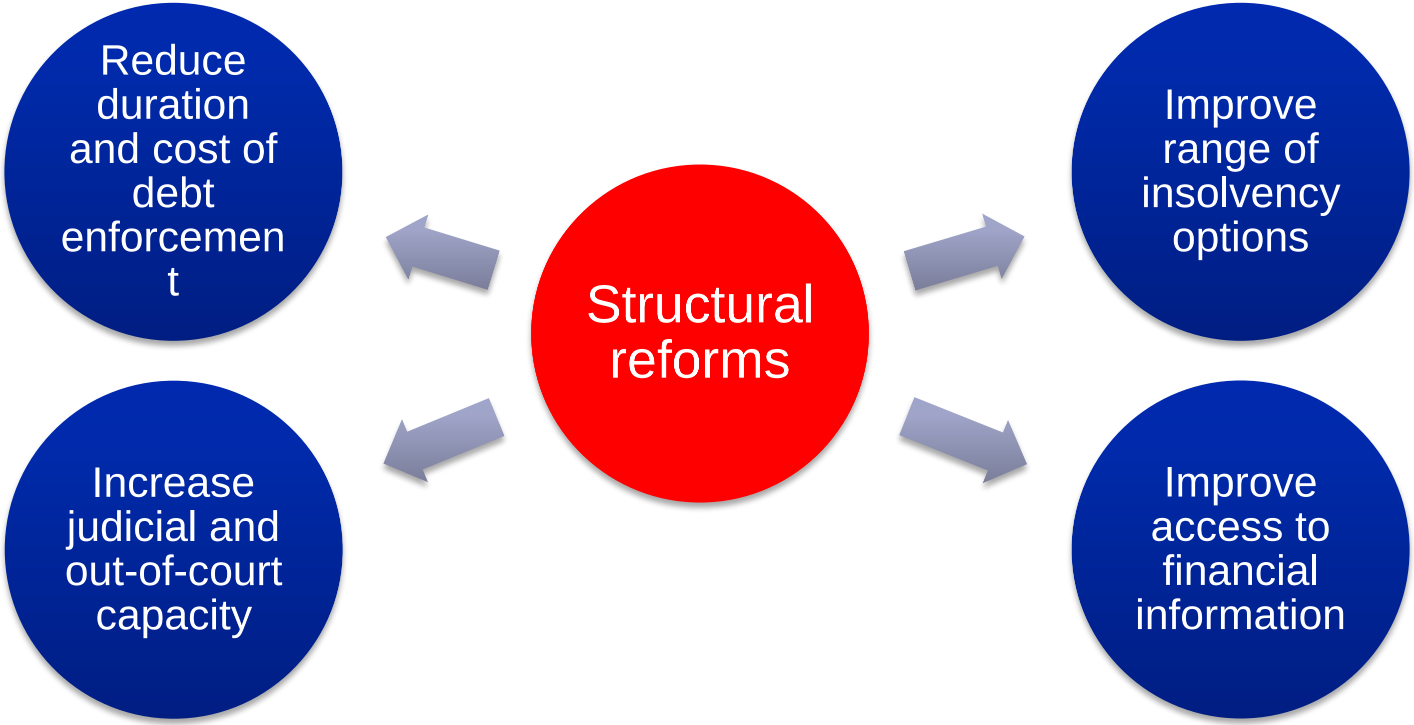
NPL transaction platforms

- Scope of services may vary depending on ambitions

- Push to improve data quality and transparency essential for the concept to work



Structural reforms



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Regional cooperation

Benefits from cooperation at the EU/euro area level

Common NPL definition (EBA, 2014)

- Key step towards transparency and comparability

Hard-wired by ECB Comprehensive Assessment (2014)

- AQR and stress test helped restore confidence in bank balance sheets prior to the launch of the SSM

Common ECB guidance on NPL management (2017)

- Harmonised supervisory practices and expectations
- Helped identify focus areas for improvement
- Prompted some banks to re-think operations and improve strategies

EU action plan (July 2017)

Supervision

- Clarify **supervisory powers** as regards bank provisioning policies (completed)
- Consider **prudential provisioning backstops** for new NPLs (completed – CRR amendment in April 2019)
- Implement **guidance on NPLs for LSIs** and for non-SSM member states (final EBA GL published in Oct 2018)
- EBA Guidelines on **loan origination and monitoring** (expected in Q2 2020)

Macroprudential solutions

- Develop approaches to **prevent the future emergence of system-wide NPL problems** (ESRB report in January 2019)
- Develop a **blueprint for national AMCs**, consistent with EU legal framework (State aid rules, BRRD) (published in March 2018)

Secondary markets

- Issue **disclosure requirements** on asset quality (EBA proposal)
- **Strengthen the data infrastructure** with uniform and standardised data templates for NPLs (published in Dec 2017)
- Consider the setting-up of **NPL transaction platforms** (COM SWD published on 28 Nov 2018)
- **Remove impediments to the transfer of NPLs** by banks to non-banks and simplify the licensing requirements for third-party loan servicers (new directive in trilogue stage)

Insolvency frameworks

- Publish the results of the **benchmarking** exercise on the efficiency of **national loan enforcement regimes**
- Consider to carry out dedicated **peer reviews of national insolvency regimes**
- Analyse the possibility of **enhancing the protection of secured creditors** (COM proposal)

5.

References

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