A Strategy for Resolving Europe's Problem Loans

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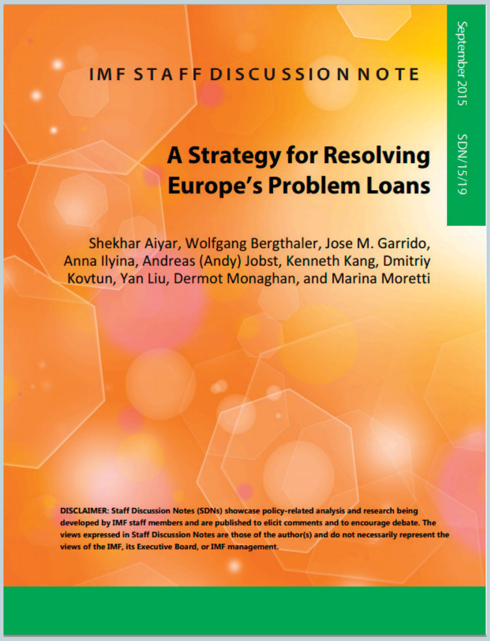

- **Scale of the NPL problem**
- **Macro-financial implications**
- **Institutional obstacles to NPL resolution**
- **A strategy to tackle high NPLs**

Europe's NPLs after the Global Financial Crisis

(scale; persistence)

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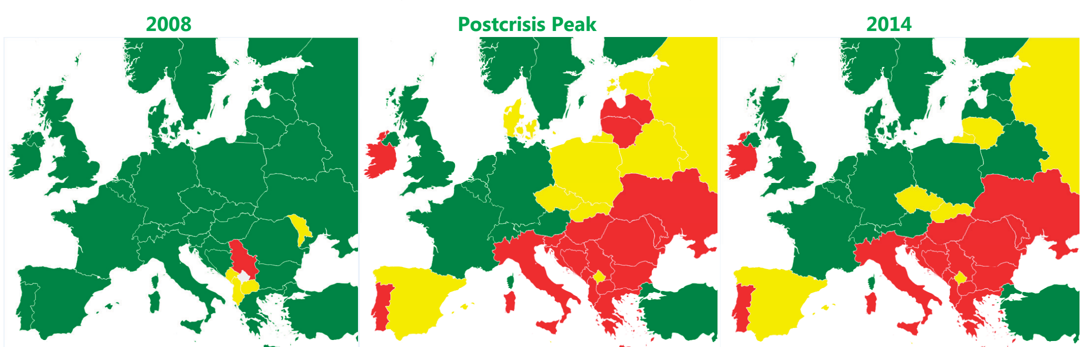
Nonperforming Loan Ratios, 2008–14

Green = less than 5% ; **Yellow** = between 5% and 10%; **Red** = above 10%



Sources: FSIs and country authorities.
Note: The FSIs are computed using consolidated bank data and therefore do not reflect only domestic NPLs. For example, in Spain the postcrisis peak and 2014 figures based on domestic data only are above 10 percent (13.5 percent and 12.5 percent, respectively).

NPLs: Euro Area vs. Non-Euro Area Countries
(mostly the same banks in both EA and non-EA high NPL countries)

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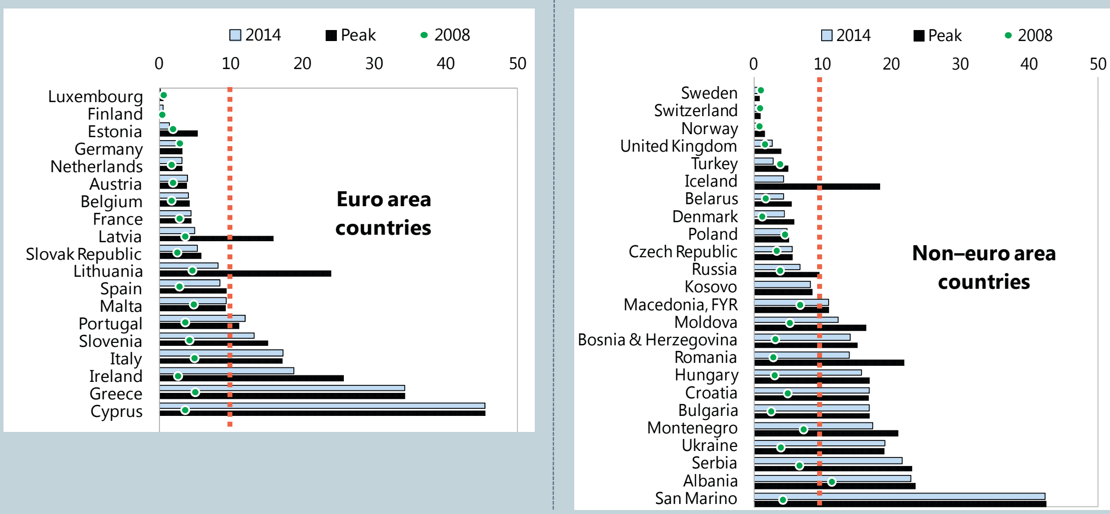
***Europe*: Gross NPLs, 2008-2014** (*in percent of total loans*)



Sources: FSIs; country authorities; and IMF staff calculations.
Note: EA average NPL ratio = 10.4%; non-EA average NPL ratio = 11.2% as of end-2014

Banks with higher NPLs are less profitable, have lower capacity to generate capital, have higher funding costs and lend less

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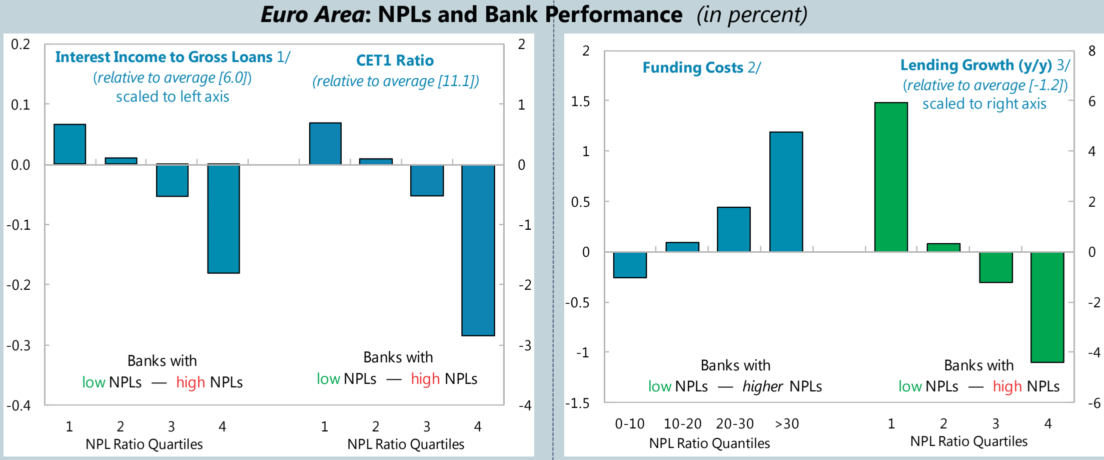
***Euro Area*: NPLs and Bank Performance** (*in percent*)



Sources: Bloomberg L.P.; EBA; SNL; Amadeus database; national central banks; Haver Analytics; Bankscope; and IMF staff calculations.
Note: CET1=common equity tier 1 capital ratio. 1/ the annual interest income to gross loans, for over 100 euro area banks, relative to the annual average for banks with the same nationality, over the period 2009–13. 2/ the average funding cost for each bank, which was defined as [interest expenses/(financial liabilities-retail deposits)]-sovereign bond yield (5-year average); 3/ annualized lending growth relative to average lending growth in the same country, using data from the European Banking Authority for a sample of more than 60 banks over the period 2010–13.

High NPLs also reflects weak **corporate or HH balance-sheets** (debt overhang), which weigh on investment and consumption

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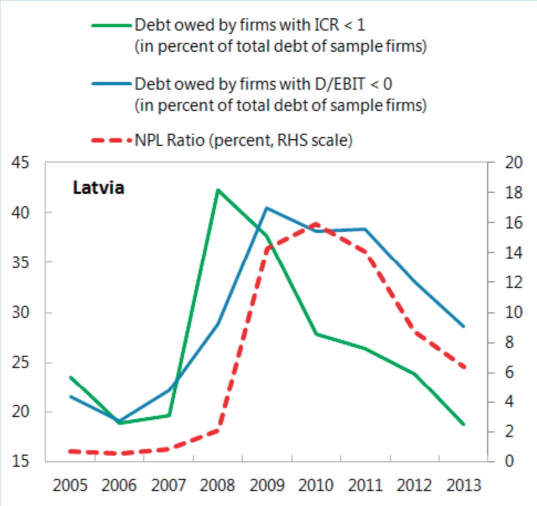
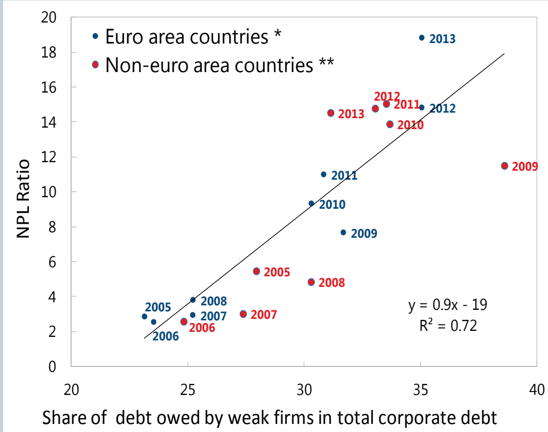
***Europe*: NPLs vs. Corporate Debt-at-Risk** *(in percent)*



Sources: Orbis; IMF's FSIs; and IMF staff calculations.



Sources: Orbis; IMF's FSIs; and IMF staff calculations.
Notes: (*) Cyprus, Greece, Iceland, Italy, Portugal, and Spain; (**) Bulgaria, Croatia, Hungary, Latvia, Lithuania, Serbia, and Slovenia. The x-axis shows the total debt owed by firms reporting a negative debt-to-EBIT ratio in percent of total debt owed by sample firms in each country and each year.

Write-off rates in Europe are too low

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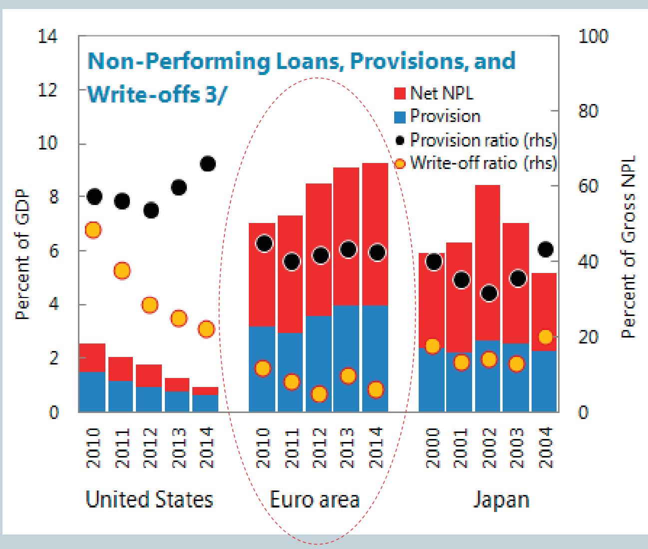

Sources: ECB; National central banks; IMF, Financial Soundness Indicators; and IMF staff calculations.

Institutional factors matter:

NPL disposal, pricing gap and capital relief/loss.

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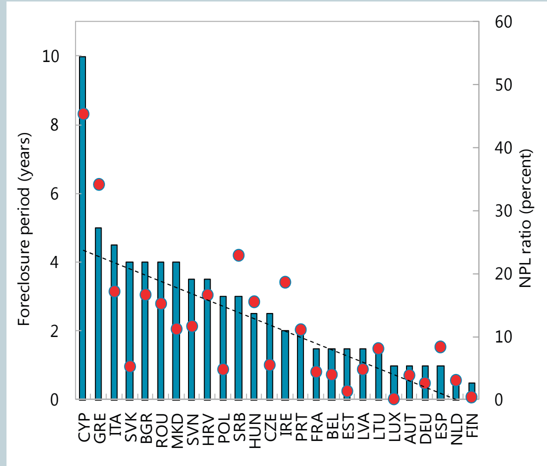
Simulation: Capital Relief from NPL Reduction – Aggregate Results

	Capital relief	
	EUR bln	% of banks' total assets
Uniform haircut		
10% haircut	-6	0
5% haircut	24	0.1
no haircut	54	0.2
Country-specific haircuts, based on		
10% internal rate of return (IRR) and full foreclosure time	-10	0
10% internal rate of return (IRR) and foreclosure time reduced by 2Y	19	0.1
5% internal rate of return (IRR) and foreclosure time reduced by 2Y	62	0.2

Average Foreclosure Times and NPL Ratios

(years/percent)



Sources: Bankscope; EBA; ECB; Haver Analytics; ECB; World Bank Doing Business Survey (2014); RBS Credit Strategy; European Mortgage Federationnational central banks; and IMF staff calculations. Note: The assumption of a uniform haircut highly simplifies the impact of the pricing gap. In practice, the selling price would reflect the expected foreclosure time and expected return for distressed debt investors. Calculations are based on bank-by-bank data from the EBA Transparency Exercise (2013). The sample comprises 22 European countries (14 euro area, six non-euro EU, and two non-EU countries). Results for Cyprus are not shown for formatting reasons. No capital relief for Germany, since net NPLs are below their historical average. The whiskers indicate the results for a +/–5 percentage point deviation from the 5 percent haircut assumption.

Structural/Institutional Obstacles to NPL resolution

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1. **Bank Supervision:** weaknesses in banks' NPL management capacity; collateral valuation/write-off modalities; capital adequacy and provisioning.

2. **Legal System:** deficiencies in the corporate and household insolvency/debt resolution regimes; debt enforcement and other aspects of the judicial system.

3. **Distressed debt market:** deficiencies in market infrastructure; restrictions on buying/selling distressed assets; (e.g., in the euro area, the distressed debt market was ~6.9% of NPLs in 2013).

4. **Information:** limitations of credit bureaus; cadastral system; real estate transaction registers; debt counseling; supervisory reporting, as well as information restrictions due to consumer/data protection laws.

5. **Tax Regime/other:** tax deductions for provisions/write-offs; role of public creditors.

IMF Survey on Obstacles to NPL Resolution in Europe: Design

Country survey: 19 countries* with peak NPL ratio>10% (2008-14)

/ Albania, Bosnia and Herzegovina (B&H), Croatia, Cyprus, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lithuania, Macedonia, Montenegro, Portugal, Romania, San Marino, Serbia, Slovenia, and Spain; (for B&H – separate responses from two jurisdictions)*

Bank survey: 10 banking groups** with operations in countries covered in the country survey

*/** Alpha Bank, Intesa, NBG, Piraeus, Pro Credit, Raiffeisen, Societe Generale, Unicredit, Eurobank, and Erste Group.*

Questions:

- ***Qualitative*:** level of concern about obstacles to NPL resolution in each of the five key areas on a 3-point scale:
  "3" = high, "2" = medium, and "1" = no concern
- ***Factual*:** specific obstacles in each area (country survey only)

IMF Survey Results (problems interlinked; worse in legal system and distressed debt markets)

IMF Survey-based Scores on Obstacles to NPL Resolution

(by country and by area; each score = max (country survey; bank survey))

Institutional Obstacles Scores

Countries	Information	Supervisory framework	Tax regime	Legal framework	Distressed debt market	Composite score
EA	2.6	2.5	3.0	3.0	3.0	2.8
NEA	2.0	2.3	1.6	2.5	3.0	2.3
NEA	1.8	2.0	2.8	2.1	2.7	2.3
EA	2.4	1.8	2.0	2.4	2.7	2.3
NEA	1.7	2.3	2.0	2.0	3.0	2.2
NEA	1.8	1.8	2.0	2.3	3.0	2.2
NEA	1.8	1.8	2.0	2.1	3.0	2.1
NEA	2.0	1.5	1.8	3.0	2.0	2.1
NEA	1.3	1.5	2.0	2.0	3.0	2.0
EA	2.2	2.0	1.0	2.5	2.0	1.9
NEA	1.8	1.3	2.0	2.0	2.5	1.9
NEA	1.8	1.5	2.3	2.0	2.0	1.9
EA	1.4	1.8	1.0	2.3	3.0	1.9
NEA	2.0	2.0	1.2	1.7	2.0	1.8
EA	1.8	2.0	1.3	1.4	2.0	1.7
NEA	1.8	1.5	2.0	1.7	1.0	1.6
EA	1.8	1.5	2.0	1.7	1.0	1.6
EA	1.0	1.3	2.0	2.0	1.0	1.5
EA	1.2	2.0	1.0	1.0	2.0	1.4
EA	1.0	1.0	1.0	1.0	1.0	1.0
Avg	**1.8**	**1.8**	**1.8**	**2.0**	**2.2**	

Note: Degree of concern: "3" = high, "2" = medium, and "1" = no concern

IMF Survey Results
(bigger challenges in non-euro area countries)

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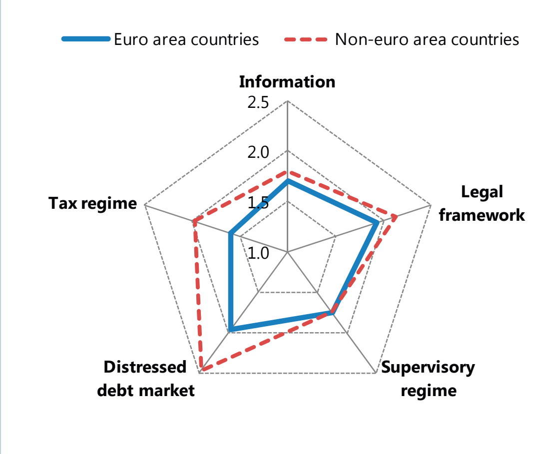
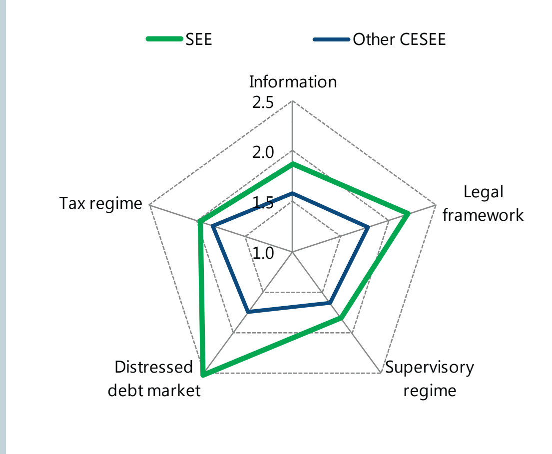
Average Obstacle Scores by Area: EA and non-EA countries





Note: Degree of concern: "3" = high, "2" = medium, and "1" = no concern

IMF Survey Results and NPL outcomes
(more severe obstacles worse NPL outcomes)

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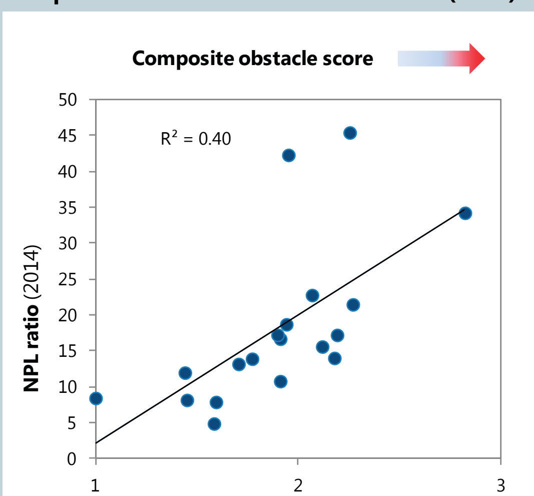
Composite Obstacle Scores vs NPL ratios (2014)



Notes: Composite score is a simple average of obstacle scores in each of the five areas;
Degree of concern: "3" = high, "2" = medium, and "1" = no concern

A Three-Pillar Strategy for Tackling NPLs

- **More assertive supervision**
  - International experience: swift loss recognition (Sweden, Korea).
- **Reforming debt enforcement and insolvency regimes**
  - International experience: (i) *liquidation* of non-viable debtors (Ireland, Indonesia, Thailand, Turkey, Japan, and Korea); (ii) *rehabilitation* of viable debtors through insolvency procedures/out-of-court workout
- **Developing distressed debt markets**
  - International experience: AMCs used for NPL disposal/corporate restructuring (Sweden, Indonesia, Malaysia, Korea, and Thailand; Spain (SAREB) and Ireland (NAMA))

Tighten regulation and accounting standards

More realistic accounting standards

Specific guidance on provisions.

Consistent, time-bound write-off requirements.

Conservative valuation of collateral.

Non-accrual principle past set delinquency.

Prudential measures

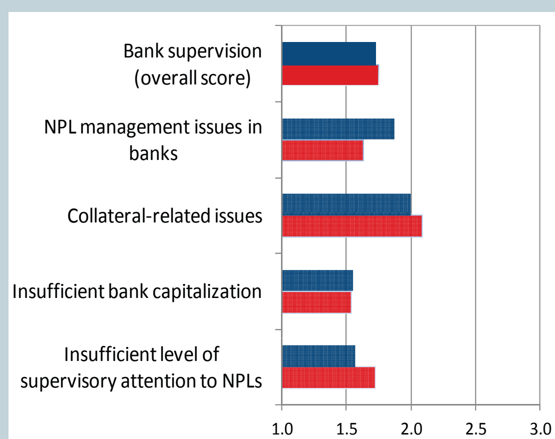
Time limits / write-down targets.

Higher capital charges on long-held NPLs.

Triage approach. Standardized criteria for separating non-viable firms (liquidation) from viable firms (restructuring loans) (e.g., Korea).

IMF Survey

Average Scores on Obstacles to NPL Resolution
(by sub-category, euro area [blue] vs. non-euro area [red])



Note: Degree of concern: “3” = high, “2” = medium, and “1” = no concern

Reform debt enforcement and insolvency regimes…

Foreclosure/debt enforcement

Less costly and protracted procedures implies more effective and predictable asset recovery.

Limit appeals; short preclusive deadlines.

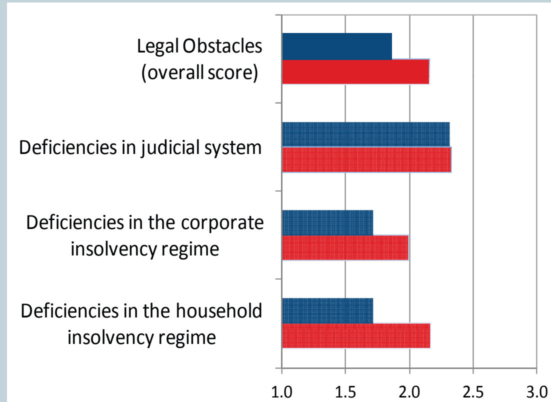
Institutional framework

Efficiency of institutional framework can be even more important than formal laws.

Specialized judges and insolvency administrators/ performance-based fee structure (metric: rapid return to productive value of assets).

IMF Survey

Average Scores on Obstacles to NPL Resolution
(by sub-category, euro area [blue] vs. non-euro area [red])



Note: Degree of concern: "3" = high, "2" = medium, and "1" = no concern

…and remedy other legal issues.

Tax regime

Tax deductibility of loan loss provisions / write-offs.

No taxation of debt forgiveness (i.e., no income recognition of concessions granted to distressed borrowers)

Public creditors

All creditors should be involved and affected by the restructuring process.

IMF Survey

Tax deductions for loan write-offs are not allowed in about 60 percent of surveyed countries.

Tax deductions for loan-loss provisions are allowed in most cases, but often subject to a cap.

Often public creditors have priority over private creditors claims, cannot provide debt write-off.

Often there are no effective mechanisms for info sharing between private and public creditors

Kick-start a market for distressed debt

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- **Reduce barriers to entry**
  - Licensing, legal impediments to bilateral sales and non-bank/foreign ownership, compliance cost, tax considerations, uncertainty about (duration of) asset recovery
- **Improve access to (consistent) debtor information**
  - Asset registers, credit bureaus.
- **Encourage a wide range of risk-sharing techniques**
  - Structured finance e.g., NPL securitization.
  - Asset Management Companies (AMCs) (private/public) …
    - *Economies of scale* (asset recovery, marketability, investor interest)
    - *Bargaining power* (size and centralization of collateral)
    - *Specialization* enables bank to focus on lending
- **Combine with robust supervision and insolvency reforms.**

An AMC would need to be compatible with EU state aid rules

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In some cases, **public support** may be needed to overcome the pricing gap…

- **EU state-aid rules**
  - Any transfer of public resources defined as state-aid.
  - Requires bail-in of creditors under BRRD (with systemic exemptions).
- **A state-aid compatible AMC model:**
  - Assets sales at market price (or using accepted pricing methodology where no market exists). Therefore no transfer of public resources.
  - Minority public stake
  - Voluntary participation
  - Clear mandate / Transparent governance

Conclusions

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- Europe has (too) **high NPLs** and (too) **low write-off rates**.
- This holds back **credit** and impedes **economic recovery**.
- Several **structural obstacles** hinder timely resolution.
- Combined action needed in **three areas:**
  - More assertive **supervision**.
  - Reforming **debt enforcement** and **insolvency** regimes.
  - Developing **distressed debt markets**.

Role of European Institutions: Issues for Discussion

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- **European Commission**
  - Guidance needed on *ex ante* permissibility of AMCs in cases when some public subsidy is necessary to close pricing gap.
- **European financial institutions** (EIB/EIF, EBRD)
  - Promote transparency/good governance
  - Help develop NPL resolution strategies
  - NPL securitization?
  - Support establishment of country-specific or regional AMCs for CESEE distressed debt ?