Dealing with Non-Performing Loans

European Versus Czech Perspective

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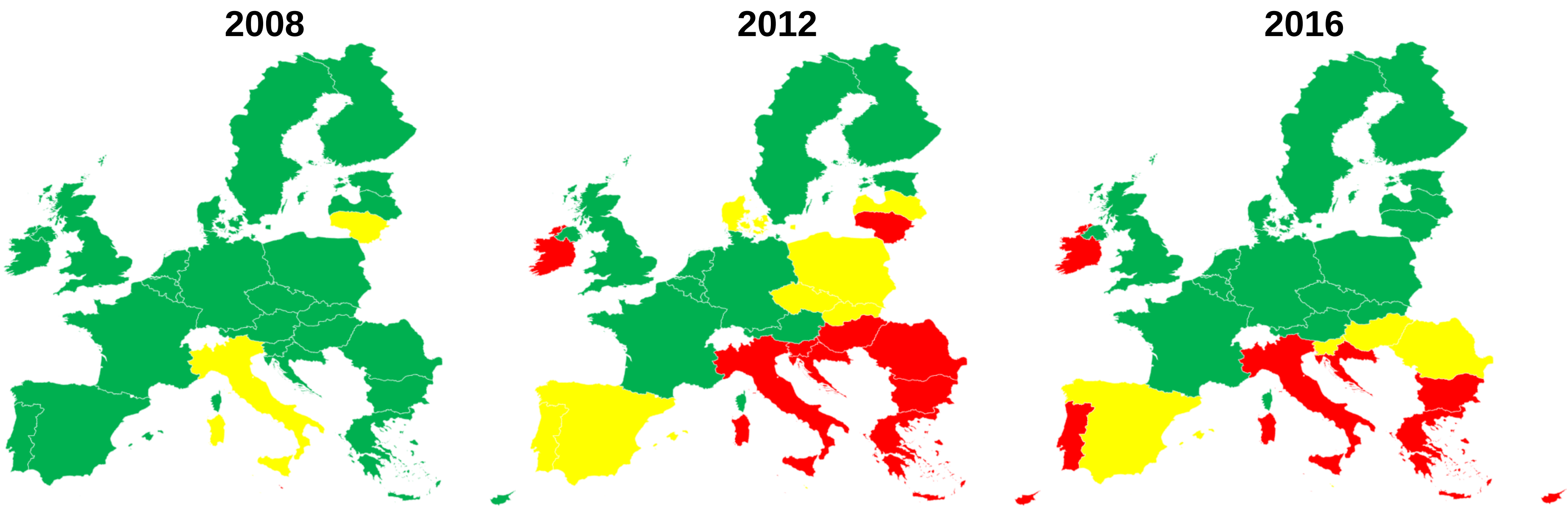
Non-performing loans ratio 2008–2016

Green: less than 5%; Yellow: 5–10%; Red: above 10%

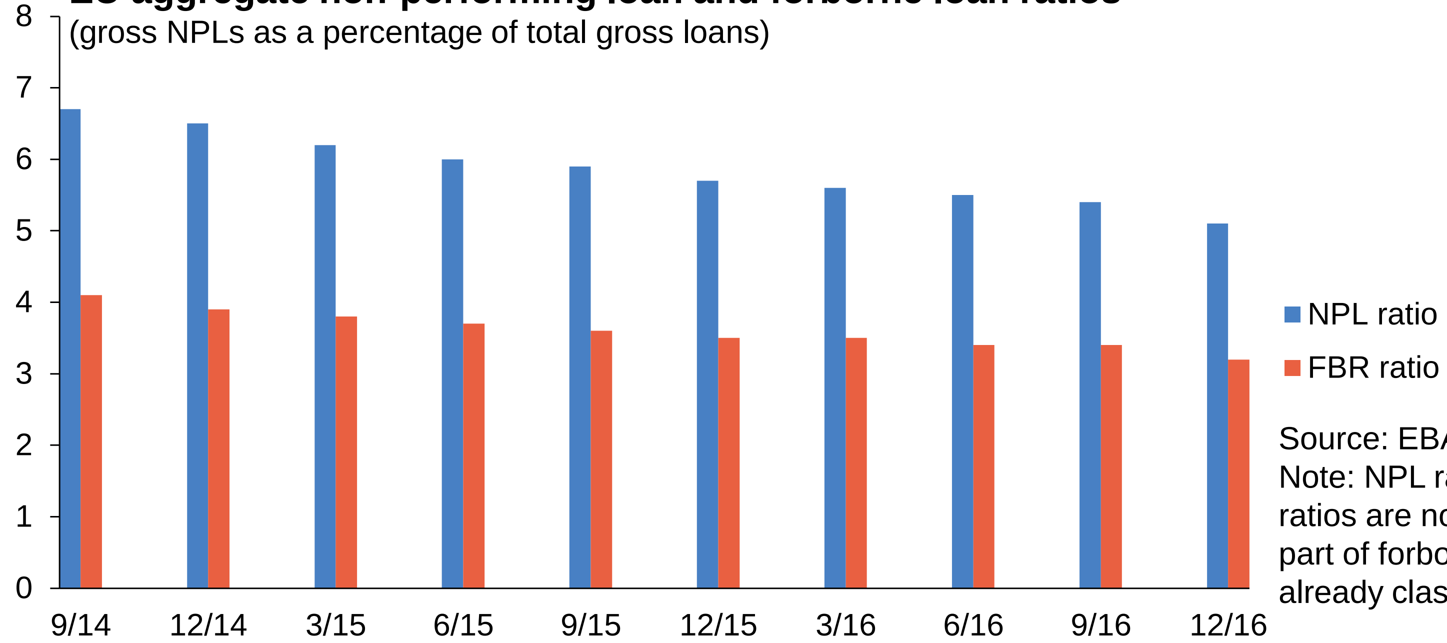


Source: International Monetary Fund: Global Financial Stability Report, April 2017; EBA: Risk Dashboard, October 2017.
Note: Gross NPLs as a percentage of total gross loans.

Slow NPL Reduction in the EU

- The gross carrying amount of NPLs in the EU at the end of 2016 amounted to €1.0 trn, with a net carrying amount of €560 bn
- Gross NPLs amounted to 5.1% of gross loans in the EU at the end of 2016 (7.3% of EU GDP)
  - High figure by historical standards
  - Higher than in other jurisdiction (US, Japan ~ 1,5%)

EU aggregate non-performing loan and forborne loan ratios
(gross NPLs as a percentage of total gross loans)



Source: EBA.
Note: NPL ratios and forborne ratios are not additive. Some part of forborne ratios are already classified as NPLs.

NPLs in the EU by Country and Sector

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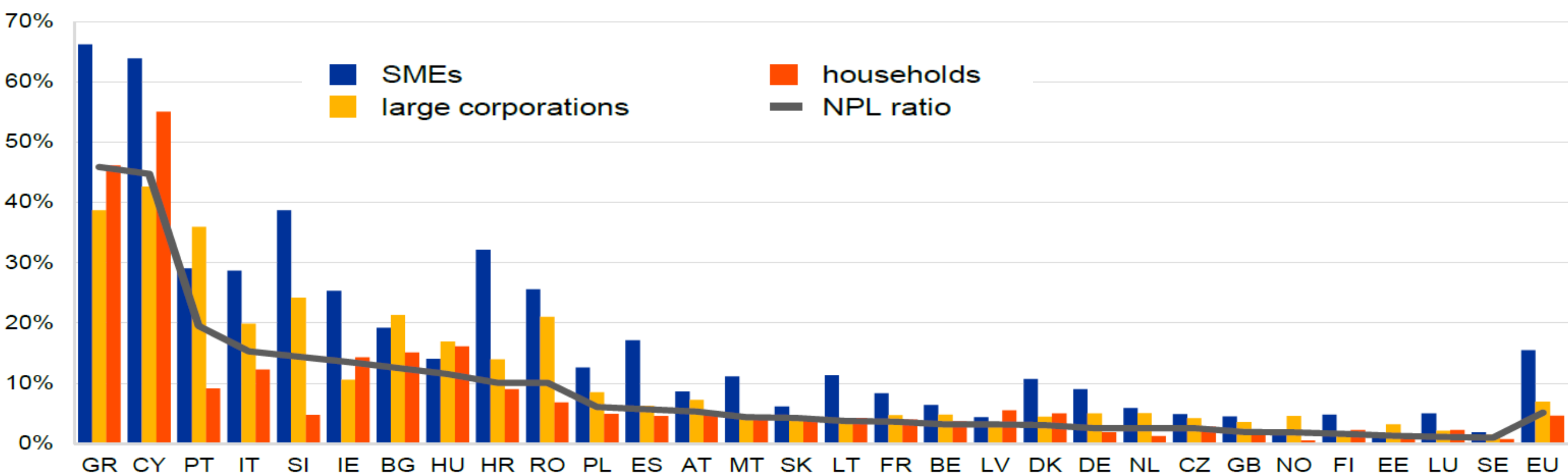
- NPL ratios differ significantly across EU countries (1% – almost 50%)
- On average, the NPL ratio of exposures to SMEs is higher (15.5%) than that of large corporates (7.0%) and households (4.6%)
  - More than half of EU countries have NPL ratios in SMEs of over 10%
  - NPLs resulting from FX loans to households are still in banks' balance sheets in some countries

Non-performing loan ratios by country and sector

(gross NPLs as a percentage of total gross loans)



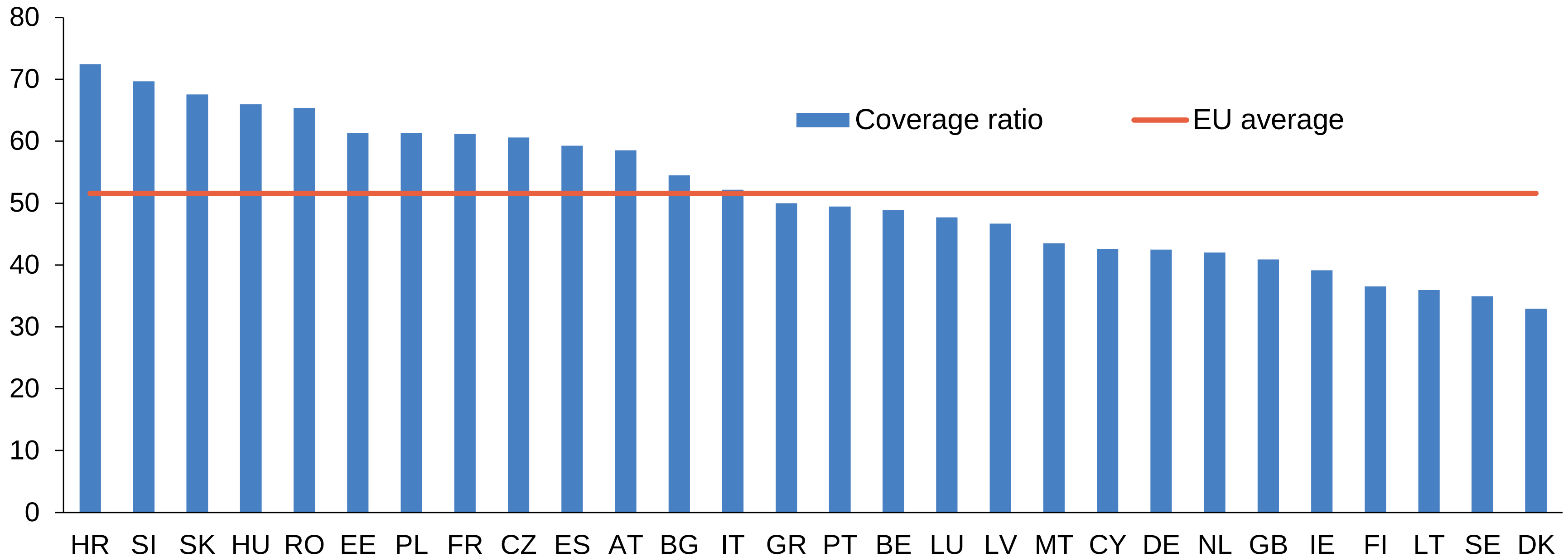
Source: ESRB: Resolving non-performing loans in Europe, July 2017.

Note: Data refer to end-2016.

NPL Coverage in the EU

- Dispersion of the provision coverage ratio across countries and banks is significant
  - EU average slightly above 50% with values in the range of 32% to 72%
  - Factors: NPL structure, regulatory rules, supervisory process, expectation of banks, willingness of banks to realise losses

Coverage ratio of banks in EU Member States
(% of gross NPLs)



Source: ESRB: Resolving non-performing loans in Europe, July 2017.
Note: Data refer to Q1–Q4 2016 depending on the data availability for each country.

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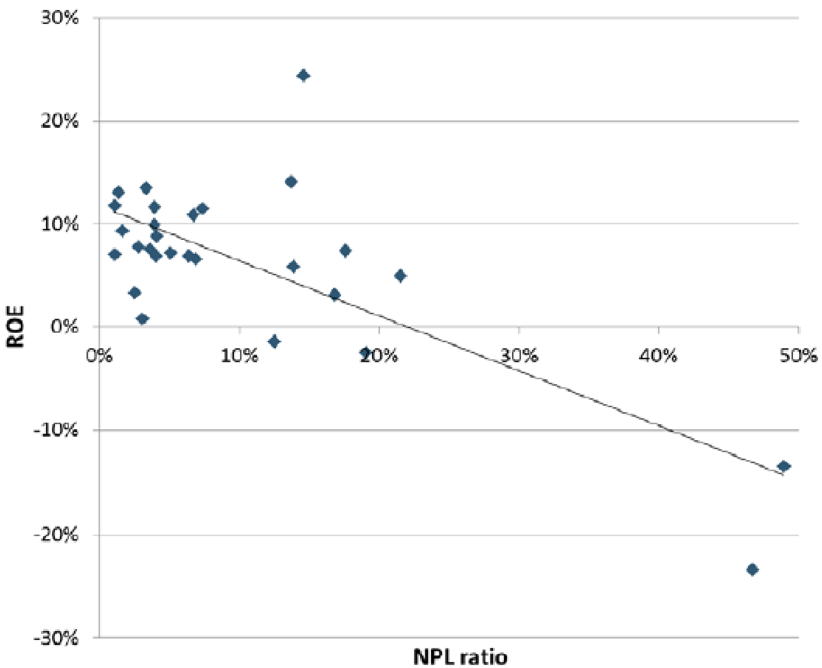
High Stock of NPLs – Why Is It a Problem?

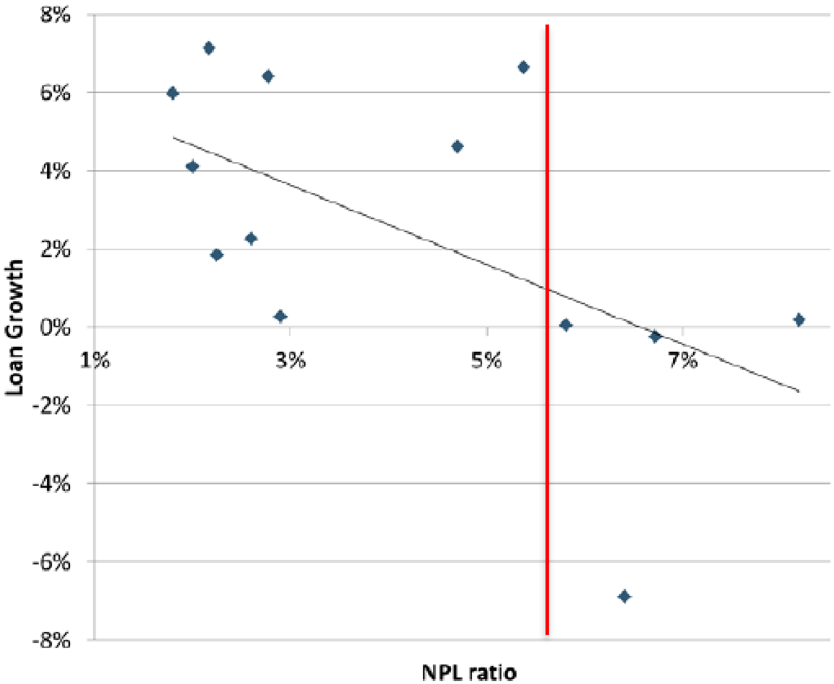
- High stock / slow resolution of NPLs negatively affect:
  - Resilience of the banking sector to shocks and hence increase the systemic risk
  - Bank profitability
  - New lending
  - Economic growth

NPL ratio and profitability by country



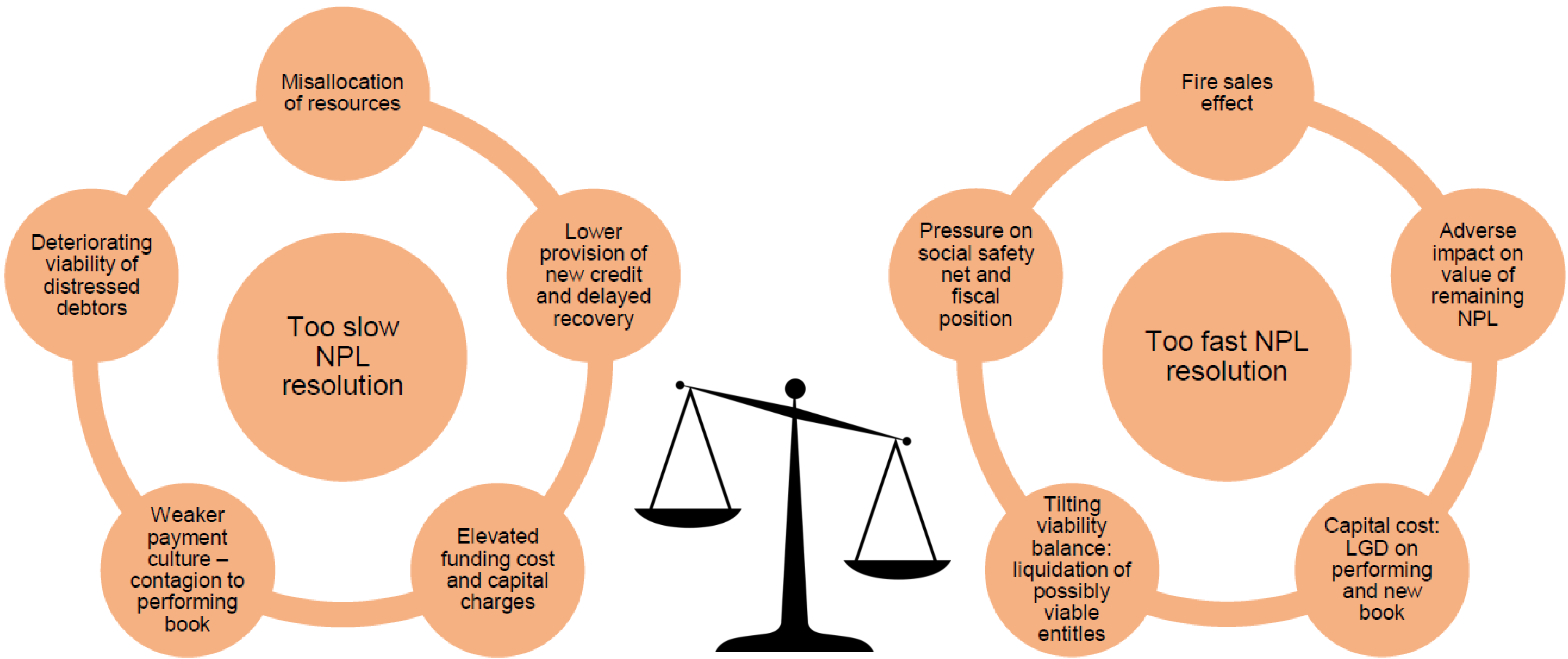
Source: EBA Risk Dashboard (YE 2015 data).

NPL ratio and loan growth in the EU



Source: EBA, IMF.

Adverse Consequences of Suboptimal Pace of NPL Resolution



Source: ESRB: Resolving non-performing loans in Europe, July 2017.

Impediments to NPL Resolution in the EU

- Supply-side impediments:
  - Unwillingness to realise losses
  - First-mover disadvantage in the current EU secondary markets for NPLs
  - High cost of debt recovery not recognised in NPL book values
  - Accounting and tax rules regarding NPLs
- Demand-side impediments:
  - Information asymmetry (the lemons problem): unavailability of sufficient and reliable data on NPLs
  - Barriers to entry to the EU secondary NPL market for investors – licensing and other compliance requirements in some countries
  - Legal restrictions – consumer protection, data privacy
- Structural impediments:
  - Long and complicated debt enforcement process in some countries
  - Legal barriers to transferring the loans to a new creditor in some countries

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5. Conclusion

Step 1 – Proper Definition, Recognition, and Valuation

- The EU has developed harmonised definitions for NPLs (NPEs) and forbearance
  - CRR (art. 178): the 90 days past due condition for defaulted exposures
  - All EU banks should comply with the definitions
- Proper recognition as a pre-condition for tackling NPL issues
  - Concerns on potential misuse of forbearance to avoid recognition of impairment
- Valuation of NPLs and the underlying collaterals must aim to identify their real economic value
  - Optimistic valuations of loans have often been adopted by banks in some countries in the past in order to avoid recognition of losses

Step 2 – Restructure or Liquidate the NPLs?

- After the NPLs have been recognised and properly valued, they should be divided into the viable ones and the non-viable ones
  - The viable NPLs should be restructured
  - The non-viable NPLs should be liquidated through either (i) seizure and sale of the collateral, or (ii) bankruptcy and sale of the proceeds
- Different strategies can be put into practice regarding the NPL portfolios identified in this step:
  - Shift of NPLs to special work-out units
  - Securitisation of NPLs and creation of SPVs
  - Creation of asset management companies (AMCs) – either with or without the state participation
  - Transferring NPLs to a holding company and their direct sale

Step 3 – Bank Resolution and Liquidation

- The viability analysis in Step 2 may leave some banks non-viable in the long term
  - If the bank does not have sufficient capital or profitability to cover the losses stemming from the NPL resolution
- After the resolution of the NPL portfolios, some banks may need to be restructured, merged or sold
- If necessary, the bank would be resolved or liquidated
  - The policymakers have to take into account the fact that this could involve paying out the guaranteed deposits from the deposit guarantee schemes or the use of resolution funds

General Recommendations for NPL resolution

- Any potential solution must meet the following principles:
  - Cannot cause fire sales
  - In order to avoid moral hazard, costs of the solution must be borne primarily by the banks
- Addressing the inefficiencies of collateral enforcement and debt collection frameworks
- Facilitating the growth of third-party NPL servicing
- Tackling the information asymmetry between the banks and potential NPL investors:
  - Possibly by developing a common templates for NPL data that can be used by the AMCs or NPL investors.
- Developing an EU-wide NPL trading platform

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Dealing with NPLs after the Crisis – Case of the Czech Republic

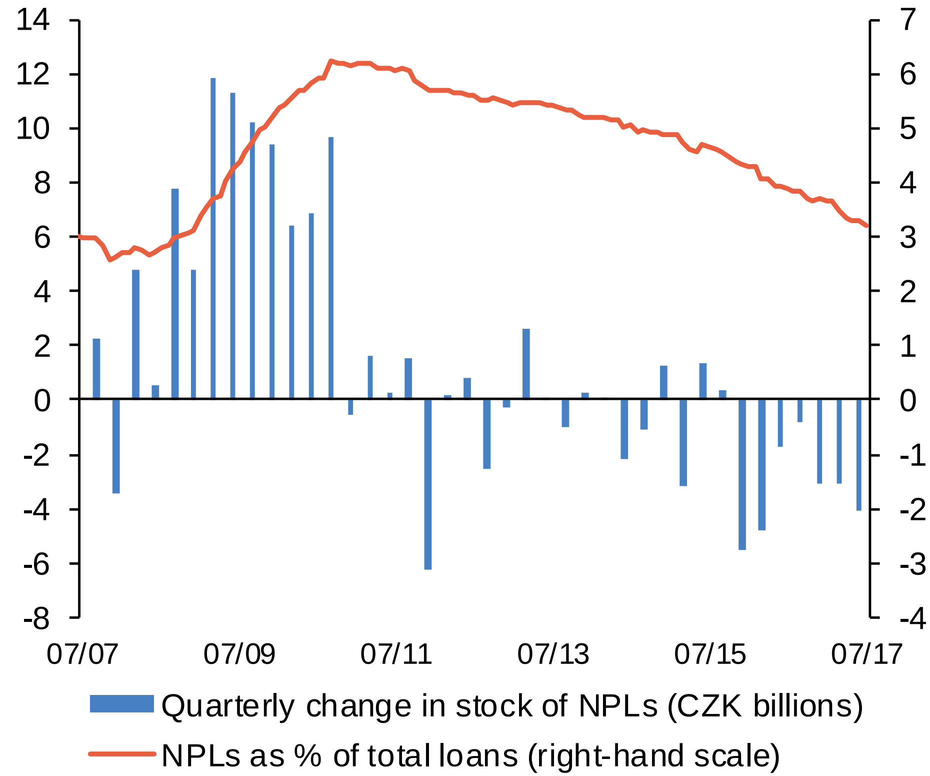
- Definition of NPL consistent with the definition of default, as specified in the CRR
- Proper NPL recognition and sufficient provisioning
  - Promoted by the banks themselves and enforced by the CNB
  - Important role of the CNB as the supervisory authority
  - Proper use of forbearance also enforced by the CNB
- Banks supervised by the Czech National Bank are required to have independent work-out departments
- Economic upturn and high profitability of Czech banks after 2013

Banks operating in the Czech Republic were able to significantly reduce the stock of NPLs (also in absolute terms) since its peak in 2010

NPLs in the Czech Banking Sector

- The NPL ratio declined from 6.3% in 2010 to 3.2% in July 2017
- The absolute stock of NPLs went down from €5.1 billion in 2011 to €3.8 billion in July 2017

NPLs in the Czech banking sector
(CZK billions; right-hand scale in %)



Source: ČNB

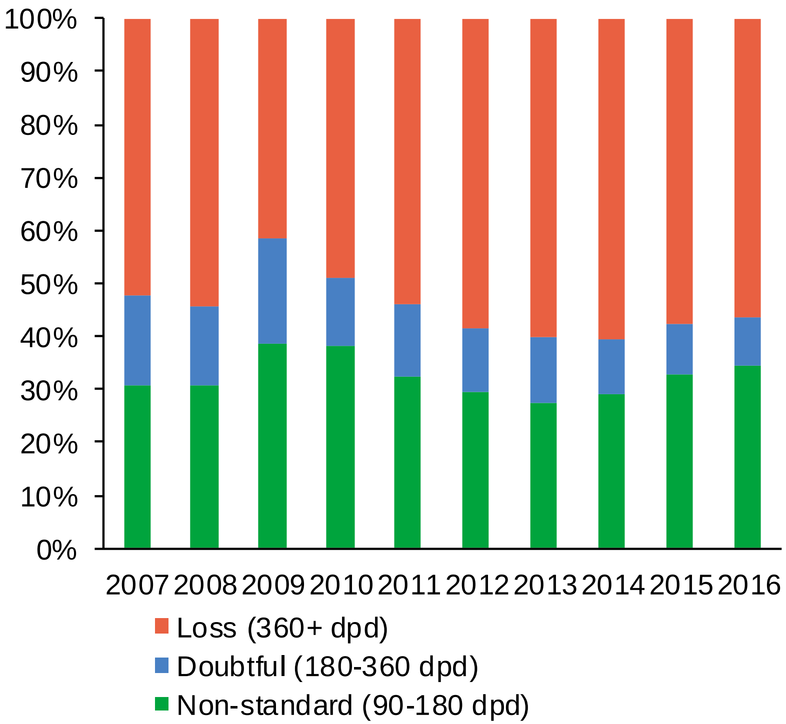
The Czech Export Bank and the Czech-Moravian Guarantee and Development Bank were excluded from the dataset. This is because these banks are wholly owned by the Czech state.

NPL Structure and NPL Coverage in the Czech Banking Sector

- Overall positive development over the last 4 years.
  - Since 2013, the NPL structure has improved while the coverage ratio remained stable / grew slightly.

NPL structure by categorisation

(% of gross NPL porfolio)

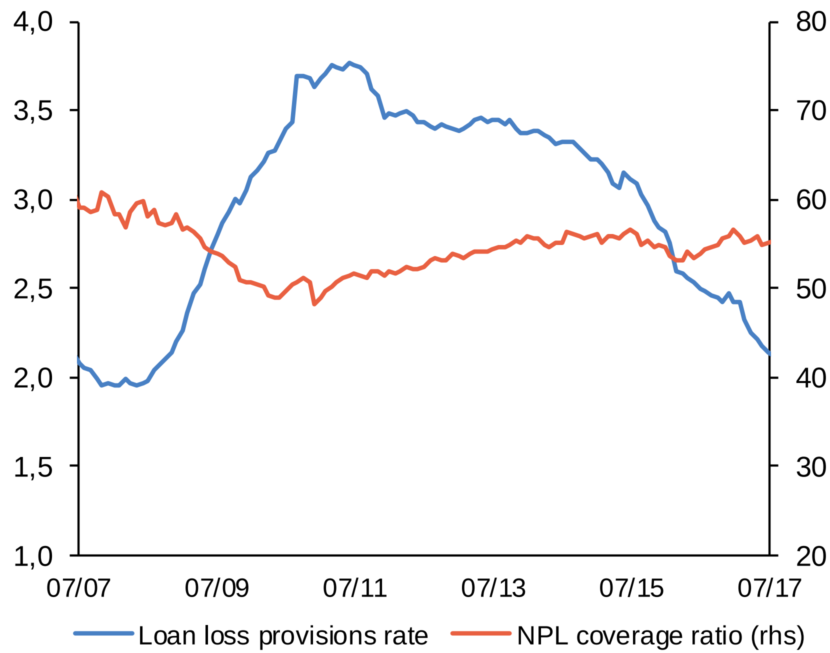


Source: ČNB

The Czech Export Bank and the Czech-Moravian Guarantee and Development Bank were excluded from the dataset. This is because these banks are wholly owned by the Czech state.

Provisions and coverage of NPLs by provisions

(%)



Source: CNB

The Czech Export Bank and the Czech-Moravian Guarantee and Development Bank were excluded from the dataset. This is because these banks are wholly owned by the Czech state.

What did not happen in the Czech Republic

- So far has not seemed necessary to introduce:
  - Centralized trading platform for NPLs: only a limited secondary market for retail NPLs exists in the Czech Republic
  - AMC(s): no AMC is currently in place
  - Third-party NPL servicing: no larger scale third-party servicing exists in the Czech Republic

- What should be further improved in the Czech Republic:
  - Legislative framework:
    - To enable better collateral enforcement and debt collection
    - To decrease the average duration of litigations

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Conclusions from the Czech Experience

- If:
  - Banks have sound credit risk and work-out management,
  - Banks are well capitalized,
  - Banks have sufficient profitability and are willing to bear losses,
  - Current national and European regulation is strictly enforced.
- Then the problem of NPLs can be gradually solved by the banks themselves without the need for:
  - Additional regulatory measures,
  - Setting up AMCs or NPL trading platforms,
  - Introducing new market players (third-party servicing companies, new types of NPL investors).
- The problem of NPL resolution in the EU can ultimately be simplified to asking the following question: How to make the banks willing and able to bear the costs related to the full NPL and impairment recognition?
  - Other specific aspects of the NPL resolution play only a secondary role

Thank you for your attention.

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www.cnb.cz

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