WORLD BANK GROUP
Finance & Markets
Financial Sector Advisory Center (FinSAC)

NONPERFORMING LOANS IN CESEE:

MACROECONOMIC DIMENSION & RESOLUTION STRATEGIES

81st EAST JOUR FIXE

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NPLs in CESEE

•The enduring legacy of the global financial crisis:

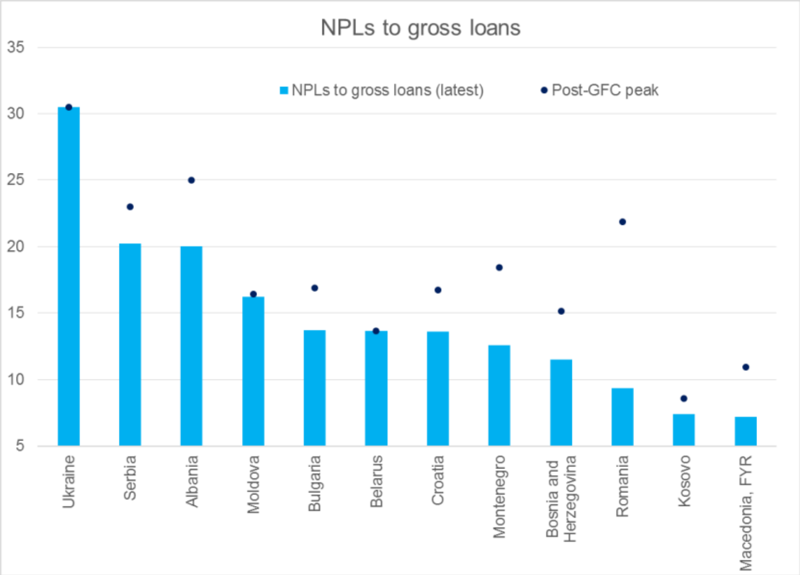
- The global financial crisis has made itself felt in the CESEE countries in the form of a structural deterioration of asset quality
  - Sharp economic slowdown + overleveraged borrowers = pressures on asset quality
- Ten years later, the CESEE financial systems continue to be affected by a combination of high NPLs, low bank profitability, and weak credit growth
- Banking sector weaknesses have also weighed on economic performance
  - *Deleveraging:* Balance sheet repair through a decrease or restraint in the growth of risk-weighted assets, leading to reduced lending volumes, particularly for asset classes that carry a high risk weight on banks' balance sheets (e.g. small and medium-sized enterprises)
  - *Allocative inefficiencies*: Banks' exposures to unviable, loss-making sectors compromise their capacity to service the needs of new, more vibrant ones.
  - In some countries, income convergence vis-à-vis EU averages has come to a virtual halt
- The weakness of economic performance then leads to renewed stress on the banking system
  - Countries got trapped in a vicious cycle between financial sector weaknesses and lackluster economic performance that is difficult to break

NPLs in CESEE

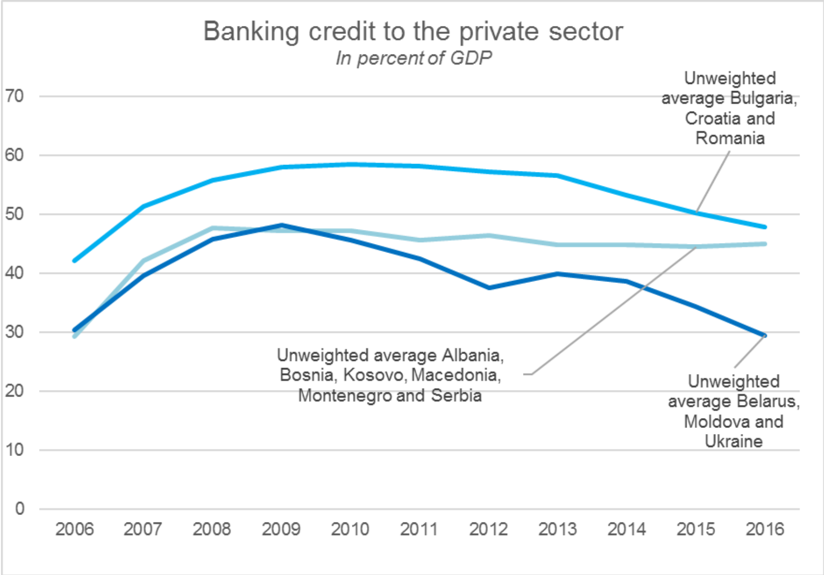
- Modest improvements have occurred in the majority of CESEE countries since 2015
  - Overall NPL volume has decreased by € 4.7 billion; overall NPL ratio dropped by 0.9 pp
    - The decrease in NPL volumes is mostly attributable to an increase in sales of NPL portfolios
    - Three countries – Romania, Croatia and Hungary – account for nearly 80 percent of the NPL sales volumes registered over the last 18 months
  - The economic outlook has improved in the CESEE on the backdrop of a strengthening eurozone
  - Credit growth has also recovered somewhat in the CESEE, but in most cases remains below pre-crisis levels

NPLs in CESEE

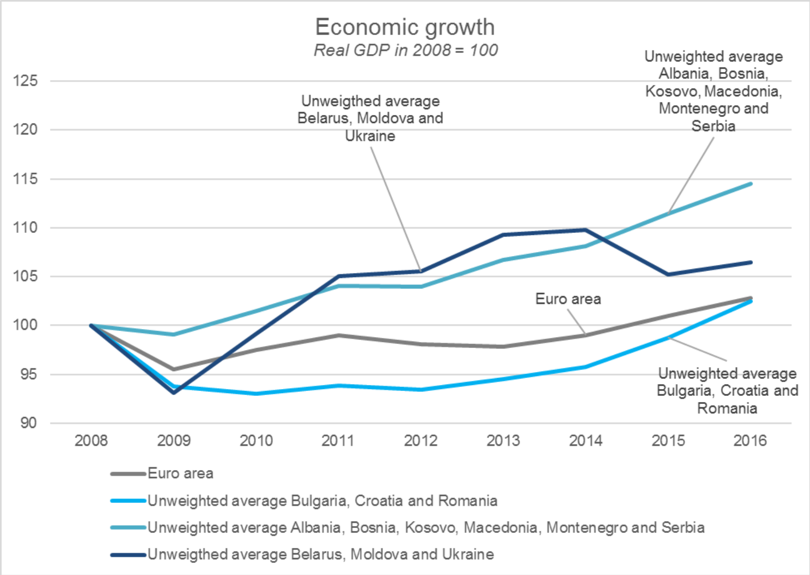
In most countries NPLs have fallen from their post-GFC peaks, though in most cases only slowly and modestly



Credit growth has been weak across the region, as illustrated by the stabilization or decrease in the credit-to-GDP ratio



Despite recent improvements, economic growth has been sluggish



Source: World Development Indicators (WDI)

NPLs in CESEE

- Increasing recognition that banks will not just grow their way out of the NPL problem
- Financial sector regulators in the CESEE region have adopted a more proactive policy stance, which is also encouraged by regulatory developments in the EU
  - **Strengthening of regulatory and supervisory frameworks:** particularly with respect to loan-loss classification, provisioning and eligibility criteria for restructuring of loans
  - **Asset quality reviews; stress tests**; to ensure that banks' reported data on asset quality and capital strength better reflect economic realities
  - **Balance sheet repair** for those banks that are facing capital shortages
  - **ECB guidance to banks on NPLs**: measures, processes and best practices which banks should incorporate when tackling NPLs
- In addition, there has been an acceleration of legal work to strengthen the enabling environment, so that creditors can realize their claims in a timely and predictable manner that protects and maximizes value for all parties involved
  - This is an area where many challenges are still reported
  - Among others, this requires a robust insolvency framework, a well-functioning judiciary, and appropriate regulatory and tax treatments
- Development of markets for NPLs as an alternative channel for offloading non-performing assets
  - Lack of scale is an important factor hampering investor interest

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NPLs in CESEE

- The World Bank Group has supported to several CESEE countries in tackling the many challenges associated with high NPLs – a small selection of recent Technical Assistance (TA) projects in the region
  - **Slovenia:**
    - Preparation of a supervisory handbook for the Bank of Slovenia for the resolution of NPLs of micro, small and medium-sized enterprises (MSMEs); Operationalization of the ECB guidance on NPLs applied to MSMEs
    - Included an early warning system, segmentation, resolution options, creation of workout units, cost efficient resolution methods, legal templates
  - **Albania**
    - Developed a debt resolution program together with the Albanian authorities
    - TA to strengthen the insolvency framework
    - Capacity building (e.g., workshops and trainings for BoA, judges, prosecutors, businesses; action plans);
  - **Ukraine**
    - Draft a law for multi-creditor debt restructuring – “Ukrainian Approach”, in effect since October 2016
    - Draft the package of legislation for the special Asset Resolution Companies
    - Regulations on NPL resolution and risk management in banks
    - Strengthening collateral valuation frameworks
    - Comprehensive overview of existing impediments for NPL resolution in Ukraine
    - Combined with comprehensive TA on bank resolution and banking supervision

NPLs in CESEE

- A few lessons emerging from our engagements on NPLs (not just CESEE…)
  - **Lesson 1: The urgency of addressing the challenges related to a structural increase in NPLs are almost always underestimated**
    - There is a near universal tendency at the beginning of a turn in the credit cycle to believe that the downturn is just a short-lived dip in the business cycle; and that the mere passage of time will make things better
    - Banks reluctant to acknowledge the true amount of losses, and lacking the expertise, resources and information systems to respond effectively to early arrears
    - Pressures on regulators to relax regulatory requirements in order to bridge what is believed “a difficult year”
    - The natural consequence is that banks and authorities find themselves easily overwhelmed when an increase in NPLs is not mere cyclical but structural
    - Due to the delay in the policy response, problems can quickly spin out of control
    - Consequently, countries frequently get caught in a negative feedback loop between weak financial sector performance and depressed levels of real economic activity – which to varying degrees has occurred in the CESEE
    - Even in countries that did respond proactively, working out NPLs is time-consuming – on average 6 – 8 years

NPLs in CESEE

<u>Lesson 2: The multifaceted nature of the NPL problem calls for a holistic and comprehensive approach</u>

- Pillar 1: Regulatory and supervisory frameworks should promote timely recognition and proper provisioning for problem assets:
  - *Banks with limited capital space may be particularly incentivized to overstate asset quality*
- Pillar 2: Ensure operational readiness at the level of banks to respond early on to rising loan delinquencies
  - *Shift from originating new loans to recovering existing ones*
  - *This shift has important repercussions for the organization of business, processes, manpower, resources, required skillsets et cetera*
- Pillar 3: Strengthen the enabling environment, i.e. the body of laws, regulations, institutions and practices that collectively determine to what extent and how quickly creditors can potentially recover losses
- Pillar 4: Diversify the range of disposal options, including through the development of primary and secondary markets for troubled assets
- These pillars are mutually reinforcing; piecemeal approaches generally don't work

NPLs in CESEE

- **Lesson 3: An effective NPL resolution strategy often requires extensive restructuring of corporate borrowers**
  - Corporate borrowers are typically the largest borrowers in the financial system. The challenge is not just to maximize recovery values, but also to preserve economic activity *to the extent possible*
  - A distinction needs to be made between those corporate borrowers whose repayment capacity is permanently impaired, and corporates that are potentially viable
  - Ensure an orderly exit of unviable borrowers which is easier said than done
  - Corporates that are potentially viable should be encouraged to engage in thorough operational restructuring which is equally challenging
  - What we see in practice:
    - (i) Reluctance to make a clear distinction between unviable and potentially viable borrowers;
    - (ii) Frequent rounds of financial restructuring rather than true operational restructuring (e.g. redundancies and divestiture of unviable entities) aimed at addressing the root causes of the borrower distress
    - (iii) Often particular challenges surrounding State-Owned Enterprises (SOEs)

Thank you!

Q&A

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