



EUROPEAN CENTRAL BANK

EUROSYSTEM

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The Resolution of Non-Performing Loans in the euro area

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This presentation is based on joint work with John Fell, Edward O'Brian and Maciej Grodzicki (all ECB).

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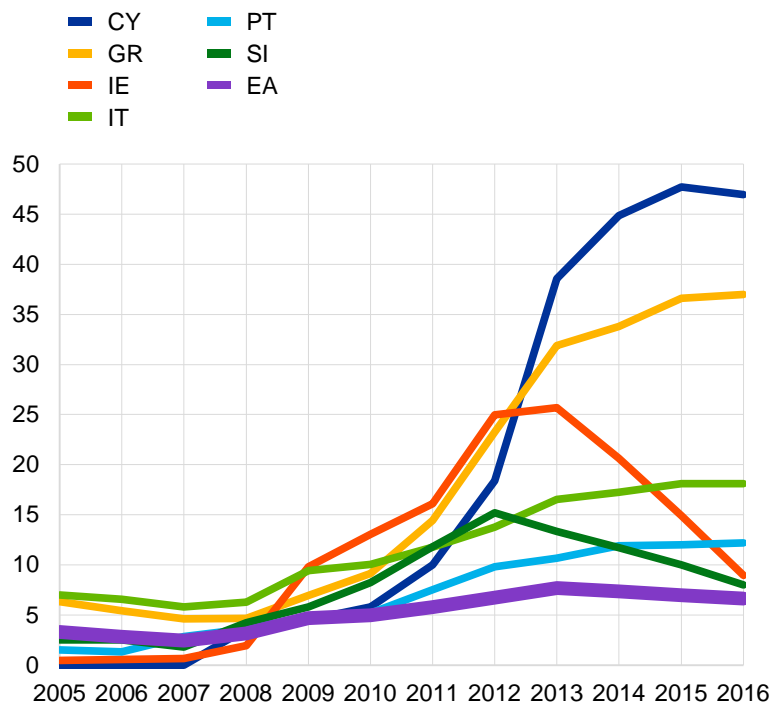
Outline

1. Introduction – why are NPL's a problem for the euro area?
2. Why have markets not solved the problem? Microeconomic considerations
3. Elements of a comprehensive solution
4. Conclusions

1. Introduction

NPL resolution in the euro area has been slow

NPL ratios in Europe have slowly fallen from the 2013 peak



Source: World Bank, IMF Financial Soundness Indicators, ECB.

Note: Country samples and methodological differences related to NPL definitions or the consolidation scope can explain differences in ratios with respect to supervisory statistics.

IMF data	Average NPL ratio (2007)	Average NPL ratio (2016)
6 EA countries	4.8	22.8
EA	2.4	6.6
UK	0.9	1.0
US	1.4	1.5

- NPL stock: a legacy from the crisis
- Peak NPL level in the euro area reached in 2013
- NPL resolution is slower in many countries facing high NPL levels

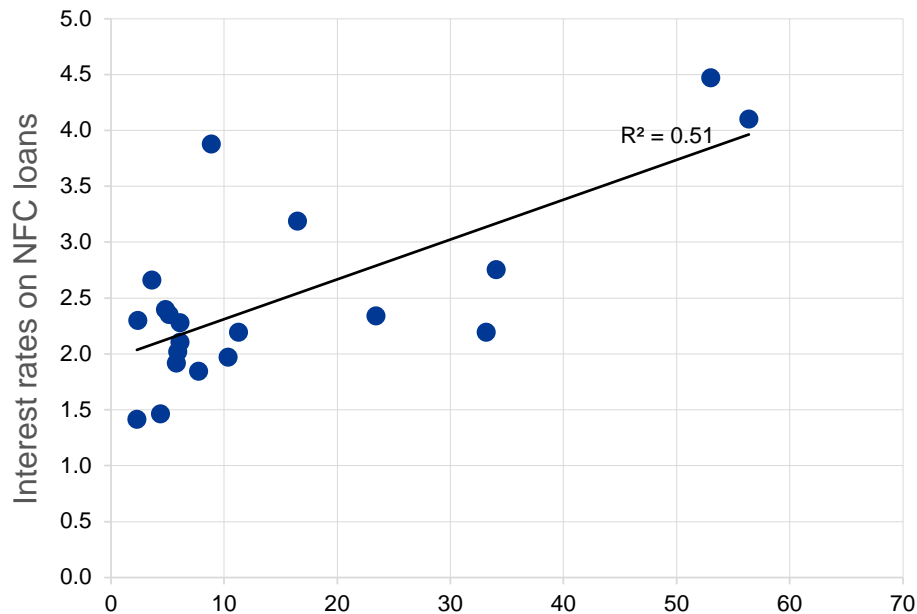
1. Introduction

NPLs can impact

- profitability – assets earning little or no income
- capital – provisioning requirements may erode capital
- growth – impaired borrowers do not invest / are not creditworthy

NFC NPL ratios vs interest rates on NFC loans by country

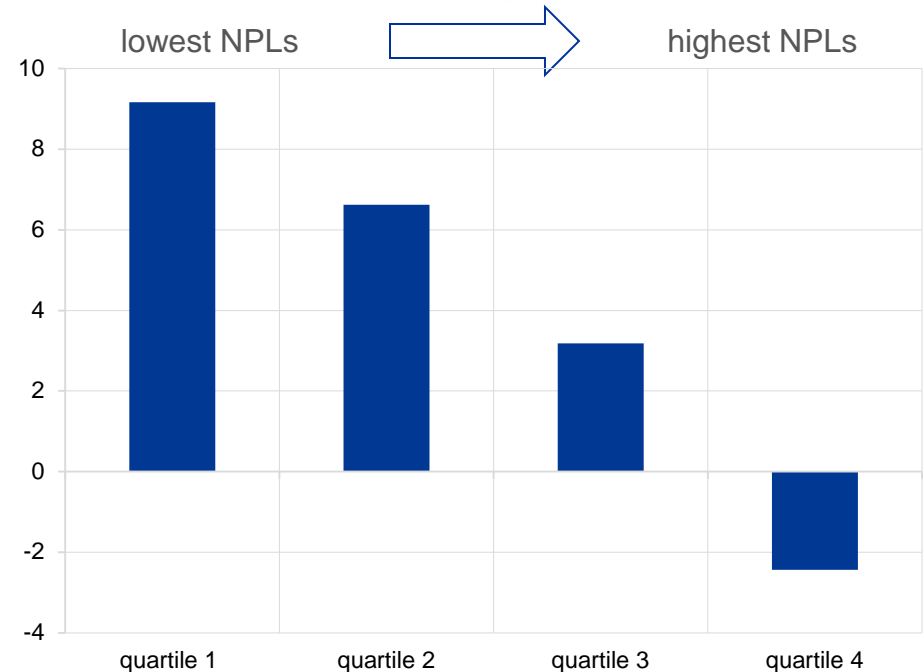
Q1 2017; Jul. 2017; percentages.



Source: ECB.

Note: Bank NFC lending rates (y-axis) and NFC NPL ratios (x-axis).

Loan growth by NPE ratio quartiles (Q4 2015-Q1 2017; median loan growth by quartile)



Source: ECB.

Note: Based on Q4 2015 total NPE ratios and growth of performing loans between Q4 2015 and Q1 2017.

1. Introduction

- **High NPL levels are an issue for the entire euro area due to important cross-border spillovers**
 - Bank lending channel. Impact on cross-border bank lending flows activities
 - Confidence channel. Negative market sentiment about banking systems in affected countries may impact also other countries.
 - Financial channel. Loss of bank equity value and debt claims by residents of affected countries has negative wealth effects
 - Trade channel. Macroeconomic deterioration in high-NPL countries impacts other countries through lower import demand
- **Monetary policy transmission can be negatively affected.**

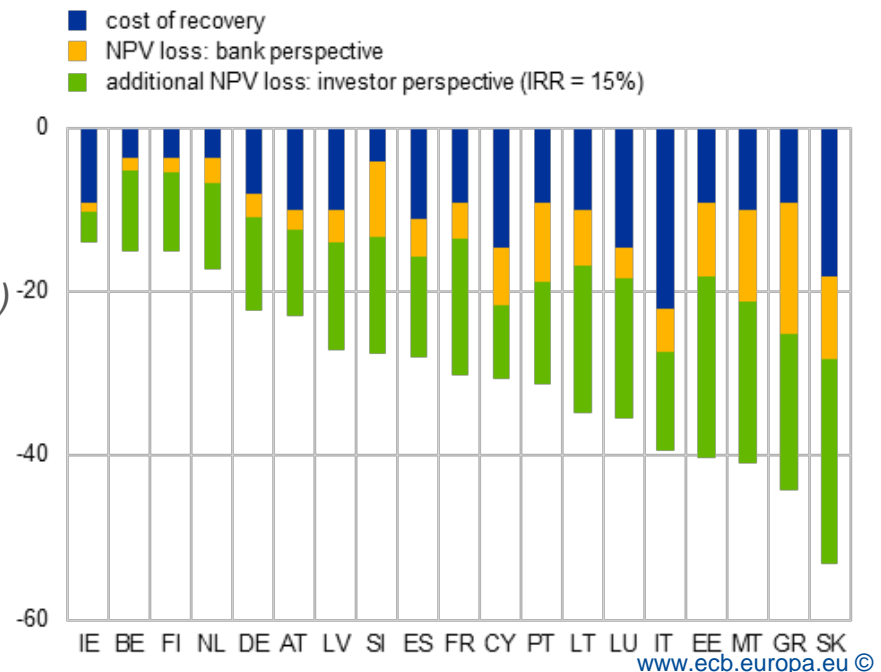
Differences in supply and demand of credit as well as negative confidence effects in some euro area country may impede monetary policy transmission in the euro area.

2. Why have markets not solved the problem?

- Banks were often slow to act but also secondary markets in the euro area are not very active
- Structural inefficiencies and informational asymmetries drive a wedge between book and market values for NPLs – bid-ask spreads
- Chart shows hypothetical NPV losses on NPLs (Doing Business data), using discounted future cash flows

- The pricing gap consists of:

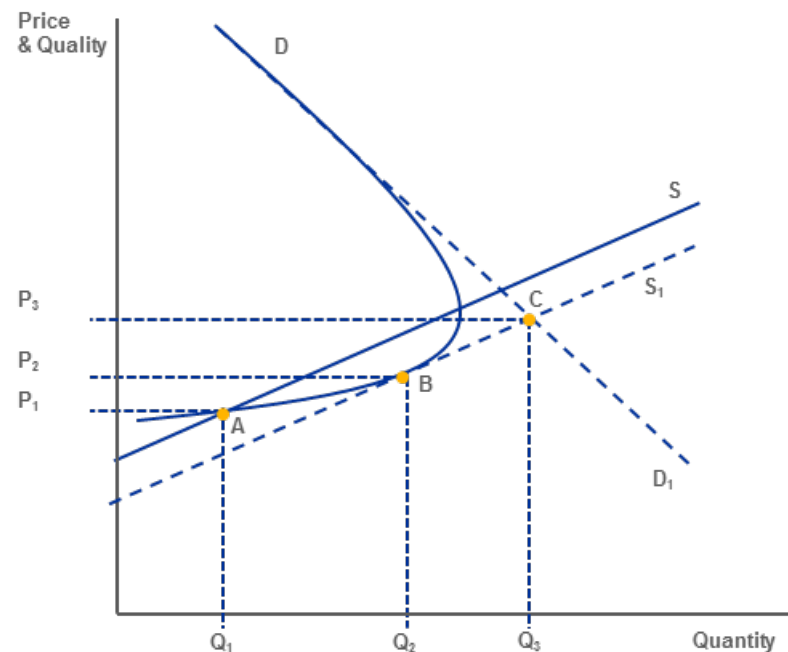
- *Cost of recovery*
 - (average cost of enforcing a claim)
- *Time to recovery*
 - NPV loss 1 (original effective interest rate)
 - NPV loss 2 (investors IRR)



2. NPL Market failure 1 – a market for ‘lemons’

Market for complex, secured NPLs may be characterised as a Lemons’ market

- Informational asymmetries challenge buyers (demand)
 - *insufficient or costly data; ineffective legal frameworks; capacity constraints; cherry-picking behaviour*
- Akerlof’s (1970) market for lemons
 - *demand is a function not only of price, but also of average quality of goods being traded*
- Evidence in NPL markets?
 - limited market activity relative to supply
 - Mainly unsecured consumer loans are traded - at very low prices



2. NPL Market failure 2 – oligopsony

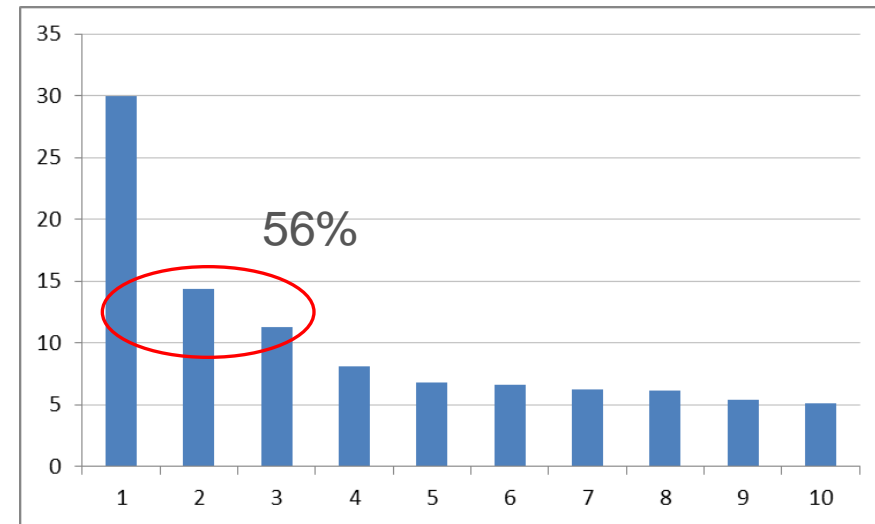
Oligopsony is a situation where:

- market is dominated by a few buyers (buy-side control)
- concentration of market power (bargaining power)
- typically resulting in lower traded prices

Oligopsony and NPL markets - evidence?

- small number of large buyers (see chart)
- limited alternative outlets for sellers
 - sale – lemons market and oligopsony
 - internal workout – supervisory pressure, workout costs
 - write-off – capital
- barriers to entry (information, experience, scale)
 - sunk costs of due diligence
 - limited capacity of independent servicers

Market share for the Top Ten Buyers in European Loan Portfolio sales 2015-2017



Source: Deloitte.

2. NPL Market failure – the nature of the goods traded

Imperfect excludability

effective control of commodity is not conferred on a single individual

In an NPL context...

- an impaired loan is linked to a debtor
- debtor may have multiple creditors; performing & non-performing loans
- a buyer of the impaired loan may not have exclusive access to the resources of the debtor, but may have to compete with other creditors
- coordination among creditors complicated (misaligned incentives) & costly

Evidence in NPL market...

- NAMA, Ireland's Asset Management Company, successfully employed debtor-level approach – capture all exposures of a single debtor, including performing and out-of-scope exposures

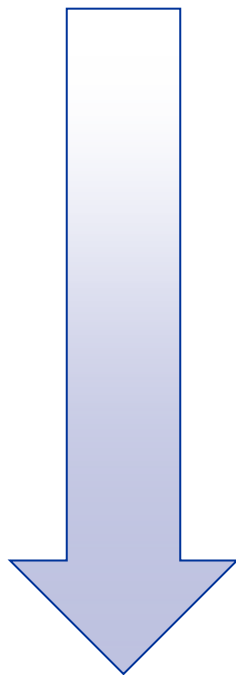
2. A trilogy of market failures – bringing it all together

- Lemon's market is intransparent
- Cost of overcoming intransparency is high for investors
- Few investors can absorb such costs; barriers to entry
- Even when they can, cannot be sure of exclusive rights to debtors
- Creates oligopsony, crystallises low prices associated with lemons market
- Eliminates price competition
- Implications of market failure:
 - banks generally can't afford to sell
 - many investors excluded from the marketplace
 - wide bid-ask spreads; low market liquidity

3. Elements of a comprehensive solution

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

Direct sales

- assets sold directly to investors, where sufficient liquid markets exist
- NPL transaction platform

Off-balance sheet

Public support may be required for some of these schemes; internal work-out will always feature in NPL resolution.

SSM NPL Guidelines

- “Guidance for banks on non-performing loans” published in Spring 2017
- Guidance covers the following main elements:
 1. NPL strategy (*including inter alia the request to establish targets by portfolio*)
 2. NPL governance and operations (*e.g. management oversight and establishment of separate NPL workout units*)
 3. Forbearance (*e.g. assess viability of forbearance options*)
 4. NPL recognition (*e.g. application of EBA definition, alignment of regulatory and accounting definitions as far as possible*)
 5. NPL impairment measurement and write-offs (*e.g. conservatism in collateral / cash flow estimation, going vs. gone concern definition*)
 6. Collateral valuation of immovable property (*e.g. at least annual collateral valuation updates and market value as valuation base*)

3. Elements of a comprehensive solution – AMCs

Market failure?

- Exchange Costs ✓
- Market Structure ✓
- Nature of Commodity ✓

Asset Management Companies

- Can be a “Bridge to the future”, maximising recoveries over time and avoiding fire sales through transfers at real economic value
- Quick and (possibly) substantial reduction of NPL
- National AMC ‘blueprint’ concept advocated to provide clarity on design principles (EU legal framework) and to identify international best practices
- Key issues to tackle (inter alia): Asset valuation, asset transfer perimeter, debtor-level approach, bank participation, AMC governance and oversight.

3. Elements of a comprehensive solution – NPL platforms

Market failure?

Exchange Costs ✓

Market Structure ✓

Nature of Commodity ?

NPL transaction platforms

- Capture some of the benefits of AMC, without all of the costs, e.g. state aid issues
- Costs likely to be limited; leverage on existing credit registers?
- Central hub for NPL sales
- Facilitated by data transparency; transaction standardisation
- One-stop-shop for investors
- Reduce transaction costs; increase price competition

4. Conclusions

- NPLs are a financial stability and macroprudential concern in the euro area – and progress is slow
- Supervisory pressure necessary and helpful - but not sufficient
- Secondary market for NPLs held back by market failures – Off-balance sheet policy options should address them
- Structural reforms will be critical for these options to be successful
 - improving transparency around NPLs through standardised data reporting & contracts and better access to corporate financial information
 - cost and time to recovery (cost of and time to enforcement, judicial reform and capacity etc.)
 - licensing issues may need to be addressed – who can acquire assets, at what administrative cost, is there enough independent servicing capacity?

Thank you for your attention!

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Some references

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“A role for systemic asset management companies in solving Europe’s non-performing loan problems, ” *European Economy, Issue 2017.1*

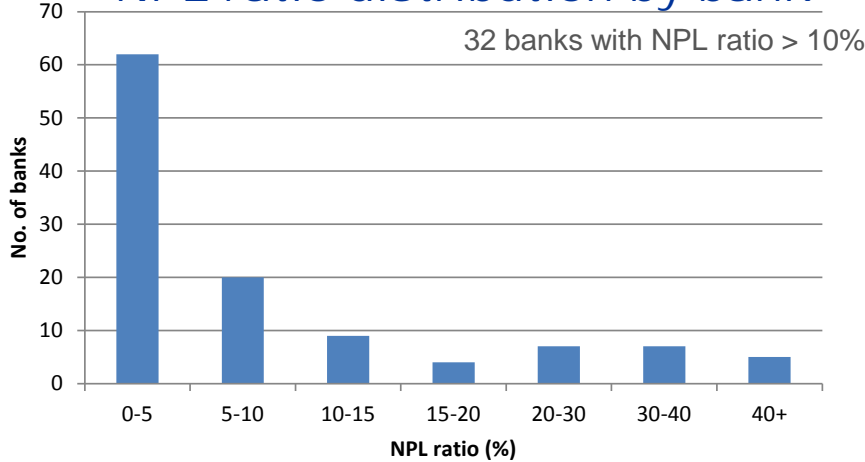
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A snap-shot of euro area NPLs

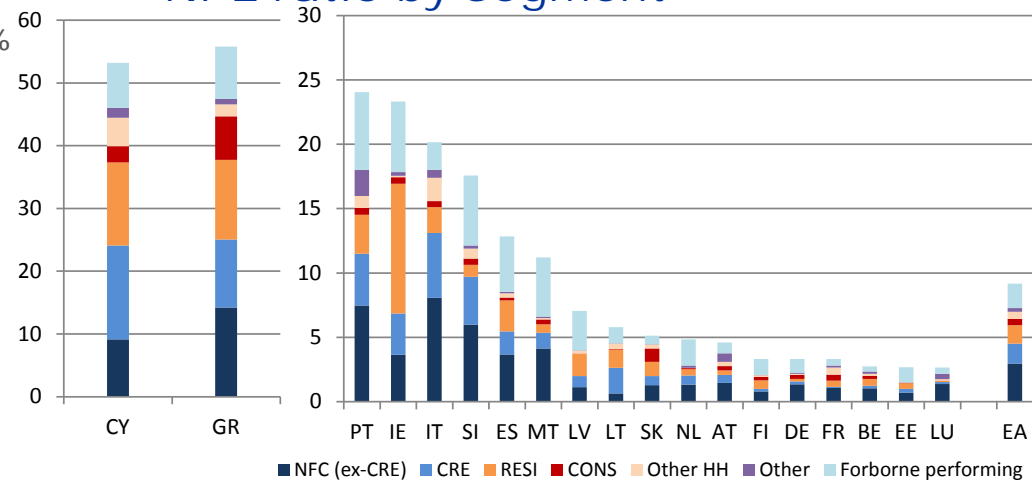
NPL ratio distribution by bank



Source: ECB Supervisory Statistics.

Notes: sample based on 115 Significant Institutions. Q4 2016 data.

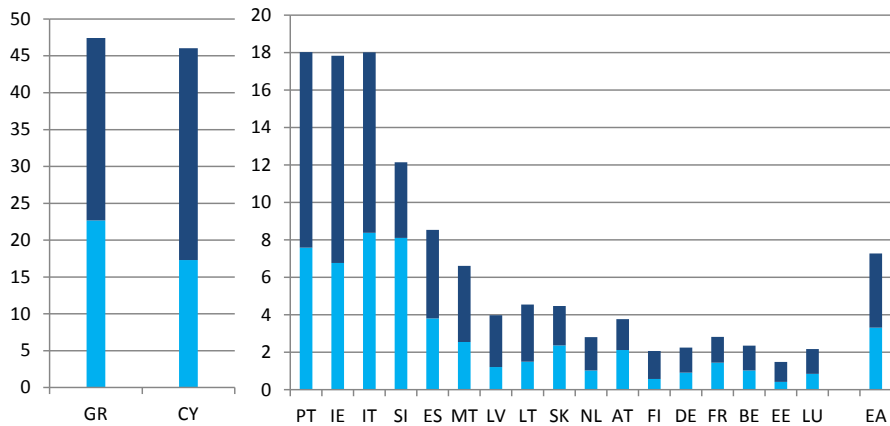
NPL ratio by segment



Source: ECB Supervisory Statistics.

Note: NPLs on locational basis e.g. ratio for BE includes loans of FI banks in BE. Q4 2016 data.

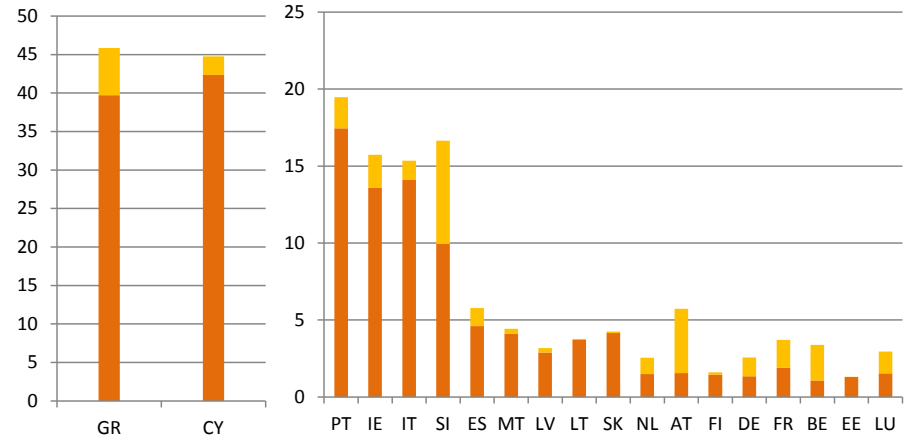
NPL coverage by provisions



Source: ECB Supervisory Statistics.

Note: Light blue bars - provision coverage of NPLs on locational basis e.g., Provisions allocated by FI bank for BE portfolio are included in BE ratio. Dark blue bars - NPLs not covered by provisions. Q4 2016 data.

Cross-border dimension of NPL



Source: ECB Supervisory Statistics.

Notes: NPL ratios by home country of reporting banks - consolidated e.g., NPL ratio for BE banks include all loans of BE banks in all jurisdictions. Q4 2016 data.