The OeNB's 81st East Jour Fixe: Nonperforming loans in CESEE – macro-economic dimension and resolution strategies[1]

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On September 18, 2017, the Oesterreichische Nationalbank (OeNB) hosted its 81st East Jour Fixe. Organized at irregular intervals since 1991 by the OeNB's Foreign Research Division, the East Jour Fixe provides a platform for national and international experts to discuss topics related to Central, Eastern and Southeastern Europe (CESEE). The 81st East Jour Fixe discussed nonperforming loans (NPLs), a highly topical issue which has moved center stage in the European policy discussion after the global financial crisis.

In her introductory statement, *Doris Ritzberger-Grünwald*, Director of the OeNB's Economic Analysis and Research Department, pointed out that the debate on NPLs involves many major institutions – such as the Bank for International Settlements (BIS), the European Bank for Reconstruction and Development (EBRD), the European Central Bank (ECB), the European Union (EU) and the International Monetary Fund (IMF) – as well as regulators at the national level and the banking industry. Many related initiatives, such as the Vienna Initiative 2.0, have been launched since the crisis. Ritzberger-Grünwald emphasized that the OeNB's Foreign Research Division has also contributed importantly to the ongoing debate by producing various research papers and country studies. Turning to the dimension of NPLs, she noted that Cyprus, Greece, Italy, Ireland as well as Portugal currently post the highest NPL ratios in the euro area. While the situation looks more favorable in most CESEE countries, some of them (e.g. Bulgaria, Croatia and Romania) still record elevated NPL ratios. Still, NPL ratios have decreased in most CESEE countries since the crisis. Regarding the economic impact of NPLs, Ritzberger-Grünwald stressed that bad credit quality may be both a stumbling block to economic development and a threat to financial stability. In this respect, NPLs may influence individual country ratings, as has been the case in various instances recently. She also highlighted that there is still a lack of comparable data on NPLs, which would be needed to effectively tackle the problem.

Session 1, chaired by *Doris Ritzberger-Grünwald*, focused on definitions of NPLs, NPL developments and marcroprudential responses to NPLs. Stephan Barisitz, Senior Economist at the OeNB's Foreign Research Division, discussed the problems related to comparable analytical NPL definitions. According to Barisitz, the quantitative NPL criterion used by the IMF – classifying loans as NPLs if principal or interest payments are 90 days or more overdue ("90 days+") – should be extended by additional qualitative criteria. He concluded that the CESEE countries largely comply with the usage of primary elements of classification (such as the "90 days+" rule) for defining NPLs but the treatment of secondary elements, e.g. the treatment of collateralized loans, in defining NPLs still differs across countries. However, national NPL definitions are slowly converging at least in the CESEE countries and in the euro area, thereby increasing the usefulness of NPL data for banks and policymakers.

[1] *The presentations and workshop program are available at www.oenb.at/en/Monetary-Policy/Research/workshops.html.*

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Reiner Martin, Deputy Head of the ECB's Macro-Financial Linkages Division, stated in his presentation that the resolution of NPLs in the euro area has been slow, in particular in countries with high NPL levels. He explained that NPLs negatively affect banks' profitability and capital as well as economic growth in general. Moreover, high NPL levels are also an issue for the entire euro area due to cross-border spillovers, e.g. via bank lending or trade. Furthermore, NPLs can have a negative impact on monetary policy transmission. Martin raised the question why the market has failed to solve the NPL problem and gave several reasons such as asymmetric information or an oligopsonic market structure. Subsequently, he discussed the advantages and disadvantages of a wide range of policy responses available to tackle the stock of NPLs, ranging from internal workouts, asset protection schemes, securitization and asset management companies to direct sales. Martin concluded by emphasizing that structural reforms, e.g. the compilation of standardized NPL data, are critical to resolving the NPL problem in the euro area.

Miquel Dijkman, Coordinator at the Financial Sector Advisory Center (FinSAC) of the World Bank Group, focused on recent developments and the resolution of NPLs in CESEE. He found that the stock of NPLs in CESEE has decreased since 2015. Dijkman argued that financial sector regulation in CESEE has become more proactive as policymakers realized that banks will not be able to cope with the NPL problem on their own. Furthermore, banking regulation in CESEE is also supported by regulatory changes in the EU, e.g. by the ECB's "Guidance to banks on non-performing loans." Regarding the more practical work of the FinSAC, he highlighted recent technical assistance projects in Albania, Slovenia and Ukraine. These projects cover e.g. the operationalization of the above-mentioned Guidance with regard to small and medium-sized enterprises (SMEs) in Slovenia, the development of a debt resolution program in cooperation with the Albanian authorities or the drafting of a law for multi-creditor debt restructuring in Ukraine. Summing up, Dijkman mentioned three lessons learnt from the World Bank's experience with tackling NPLs: first, the urgency of addressing the challenges related to structurally increasing NPLs are usually underestimated; second, NPLs are complex and call for a comprehensive approach; and third, an extensive restructuring of corporate borrowers is needed to effectively resolve the problem of NPLs.

In the ensuing discussion, participants objected to the notion that the problem of NPLs is mainly attributable to loans that should not have been granted in the first place and that result from bad business decisions. Therefore, it would be challenging to solve this issue ex ante, via regulatory measures, rather than letting the government step in ex post. One remark touched the issue of moral hazard that arises if banks know that the government will assume responsibility and therefore grant loans that actually should not be granted.

Furthermore, the question arose why the secondary market works better in the U.S.A. than in the EU. Several reasons were given for this phenomenon, e.g. the better comparability of NPL data available in the U.S. secondary market, the different treatment of NPLs in accounting and the fact that banks can exit the market more easily in the U.S.A. Finally, the question was raised why Romania had been able to successfully reduce its stock of NPLs. Apparently, in this specific case, peer pressure on banks largely contributed to the positive NPL developments.

Session 2 discussed the determinants and economic impact of NPLs both from a microeconomic and a macroeconomic perspective and was chaired by

Helene Schuberth, Head of the OeNB's Foreign Research Division. *Elisabeth Beckmann*, Senior Economist at the OeNB's Foreign Research Division, presented joint work with *Helmut Stix*, Senior Expert at the OeNB's Economic Studies Division, addressing the following questions: how do household, loan and bank characteristics affect households' repayment difficulties and how do these three dimensions interact? For their empirical analysis, Beckmann used data from the OeNB Euro Survey and merged these survey data with variables measuring bank proximity, bank concentration and credit supply. She concluded that household, loan and bank characteristics can indeed explain repayment difficulties. Accordingly, income and income shocks are the most important determinants of households' NPLs but bank relations and bank proximity were found to also affect the probability of arrears. Furthermore, Beckmann explained that loans issued prior to 2008 are more frequently in arrears and that exchange rate shocks increase the probability of arrears.

Peter Grasmann, Head of Unit, EU/Euro area financial system, DG for Financial Stability, Financial Services and Capital Markets Union of the European Commission, provided a short overview of the current situation concerning NPLs in the EU. He first discussed the main causes of the emergence of NPLs, pointing out that high and rising NPL levels are often country-, sector- or lender-specific. Grasmann discussed the main areas where reforms would be necessary to tackle the problem of NPLs and highlighted that the resolution of NPLs always implies an allocation of losses. He also pointed to negative spillovers of NPLs via the banking sector or economic developments, even for countries that do not have high NPL ratios. Despite contagion risks, many areas in need of reforms, e.g. insolvency regimes, fall under the responsibility of individual countries. Turning to EU Member States' achievements in bringing down NPL stocks, he explained that the situation has improved somewhat, driven by economic recovery, proactive policies by banks and policy measures taken by the Member States, the ECB's Single Supervisory Mechanism (SSM) and the European Commission. The Ecofin Council e.g. adopted the EU action plan on NPLs in July 2017. This ambitious plan comprises a number of actions to be taken by various public stakeholders in Europe.

Finally, *Tomislav Ridzak*, Director of the Financial Stability Department at the Croatian National Bank, talked about the case of Agrokor and its impact on Croatia's banking system and economy. Following a brief presentation of the overall economic development in Croatia – the economy continues to grow, particularly the tourism sector, and the use of EU funds is increasing – he explained that the NPL ratio has increased considerably since the crisis (peaking in 2015 at 17%). However, loan quality in Croatia has been improving since 2015, and the NPL ratio currently stands at 13.2%. Turning to Agrokor, Ridzak argued that the financial problems in the Agrokor Group may have a stronger adverse effect on economic growth than currently projected but that stronger-than-expected growth in the exports of tourist services will compensate for such an effect. By way of conclusion, he pointed out that the main risks to Croatia's GDP growth projections are balanced over the forecast horizon of 2017 and 2018.

The subsequent discussion touched on the specific problems of the highly indebted banking sector in Cyprus. Against the background of the country's very large banking sector (in relation to GDP) and the high financing needs, bailing out the banking sector was not feasible for the state – a situation which was comparable to that of Iceland. With reference to the role of Russia in the Cypriot banking sector, participants explained that Russians rather acted as depositors than borrowers. With regard to Croatia, Ridzak clarified that the impact of Agrokor on NPLs should already have subsided. Furthermore, Ridzak highlighted that most of Agrokor's debt is foreign debt originating from foreign banks or foreign investors.

Session 3, chaired by *Michael Würz*, Head of the OeNB's Financial Stability and Macroprudential Supervision Division, focused on progress in NPL resolution. *Ines Rocha*, Associate Director of the Financial Institutions Department at the European Bank for Reconstruction and Development (EBRD), emphasized the work of the Vienna Initiative 2.0, recommending the Vienna Initiative's website, which provides in-depth information on NPLs. Rocha gave an overview of NPL dynamics in the CESEE region and presented a snapshot of developments in the NPL market in CESEE, pointing to high NPL volumes in Romania up to 2016 and increasing NPL volumes in Croatia since mid-2016. She elaborated on the different layers of intervention under the Vienna Initiative 2.0 and its NPL action plan. In general, the Vienna Initiative 2.0 is principally concerned with an impediment assessment of NPLs, a review of out-of-court restructuring, considerations of reforms to civil procedure and insolvency law, educating judges on the topic of loan restructuring, and knowledge sharing. When summarizing best practices with regard to NPL resolution, Rocha highlighted the need for clarity on bank secrecy rules, adequate provisioning policies, accurate collateral valuation, investor-friendly licensing requirements, the removal of tax disincentives and the training of judges.

Imre Balogh, CEO and Executive Director at DUTB, Slovenia's bank asset management company, discussed Slovenia's experience with NPL resolution. Putting NPLs into the context of Slovenia's boom and bust story, Balogh highlighted, in particular, excessive credit growth and the build-up of corporate indebtedness in the period before 2008. After 2008, public debt in Slovenia increased and NPLs rose. He went on to present comprehensive facts and figures on Slovenia's bank rehabilitation process, which involved i.a. state capital injections and the establishment of DUTB, which is fully owned by the government. He pointed out that as of November 2013, corporate exposures transferred to, or merged into, DUTB consisted of 60% of NPLs of domestic corporates. After providing some details on DUTB's portfolio structure, Balogh shared his views on corporate governance issues at DUTB and highlighted the importance of credibility for his institution.

Subsequently, *Anete Daukste*, Associate Director at KPMG AG's Global Portfolio Solutions Group, dealt specifically with the question how markets for NPL sales have developed in CESEE. She pointed out that Romania has managed to reduce its NPL volume most significantly, as banks successfully have sold sizeable loan portfolios. She went more into detail by pointing to some key transactions relevant for Romania. In her view, one reason for the vivid NPL market activity in Romania has been peer pressure. While NPL volumes are largest in Poland, transactions primarily took the form of industrialized small-scale NPL sales. It is worth noting that more recently secondary NPL sales have increasingly gained importance. Greece and Ukraine are generally seen as interesting new markets. Daukste also presented an overview of how supportive KPMG considers the NPL sales infrastructure in CESEE and elaborated on different strategic options of balance sheet optimization.

In the ensuing discussion, one topic of interest was the statistical treatment of NPLs after banks sell them to an investor. Experts explained that NPLs exit banks' balance sheets once they are sold and are not recorded as distressed assets at the buying institution. However, irrespective of the statistical treatment of NPLs, the fact remains that the corresponding delinquent borrowers are still present in the economy. Another issue under discussion was that a frequent impediment for more active NPL markets in smaller countries is the size of NPLs in absolute terms, as due diligence costs in preparation of NPL transactions are high. Moreover, difficulties in selling cross-border portfolios stem from legal differences between various jurisdictions.

In his concluding remarks, *Thomas Richardson*, Director at the Joint Vienna Institute, recalled the crucial importance of tackling the problem of NPLs: NPLs have a particularly strong adverse economic impact on SMEs because they largely depend on bank financing and, moreover, are very employment intensive. Furthermore, a high stock of NPLs in the banking sector can have negative repercussions on the monetary transmission mechanism.

The main takeaways of the OeNB's 81st East Jour Fixe are the following: efficient oversight and accounting standards are important for resolving the problem of NPLs; the valuation of collateral needs to be improved; the judicial system is crucial for bringing down NPL stocks and requires well-qualified staff; more efforts are needed to gain access to better and more comparable data; and finally, asset management companies seem to be an efficient option for dealing with NPLs as they can make use of economies of scale and have a certain bargaining power.