Sharon Donnery: NPL workout and resolution in the euro area

Address by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at the Peterson Institute for International Economics, Washington DC, 6 October 2016.

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Introduction

Good morning, it is pleasure to be here at the Peterson Institute to discuss the topic of Non-Performing Loans (NPLs).[1]

The effective workout and resolution of NPLs is central to both bank viability and macroeconomic performance. On 12 September 2016, ECB Banking Supervision published its Draft Guidance to banks on NPLs, for consultation. In addition, it also published a Stocktake of national supervisory practices and legal frameworks relating to non-performing loans.[2]

Given Ireland's recent experience in addressing the high level of non-performing loans, as well as my role as Chair of the ECB's High Level Group, in my remarks today, I would first like to discuss some macro-financial aspects of high levels of NPLs. I will then provide a brief overview of how we in Ireland progressed to put the trend on a sustainable downward trajectory.

Drawing on some of those lessons, I will then give you an overview of the recent publication of ECB Banking Supervision's Draft Guidance. I will conclude by discussing the accompanying stocktake which highlights some of the impediments to NPL resolution in certain euro area Member States. This report highlights the multifaceted nature of the resolution of non-performing loans; how supervisory powers alone cannot solve this issue, and how concerted action is required from all stakeholders to address this problem over the coming years.

Macro-financial and micro prudential aspects to NPLs

To frame this issue at a macroeconomic level, it is useful to think about the two way linkages between macroeconomic developments and the financial sector.

The link between macroeconomic indicators and NPLs has been well established. GDP developments have been one of the main drivers of NPLs over the last decade.[3] In addition to being a driver of NPLs, macroeconomic conditions can also inhibit speedy NPL workout and resolution.

This is because sharp increases in NPLs can weaken macroeconomic performance, and can activate a spiral that exacerbates macro-financial vulnerabilities leading to reinforcing downward effects between banking system distress and deteriorating economic activity.[4]

Economic growth in some parts of the euro area, including Ireland, continues to be hindered by the debt undertow resulting from the recent crisis. While the stresses have abated, household and non-financial sector deleveraging strengthens the headwinds faced by some Member States' banking sectors.[5]

In this context, high levels of NPLs can constrain both credit growth and economic activity.[6] NPLs tie up bank capital and can restrict banks' ability to undertake new lending to the economy. Banks also need to hold additional provisions against NPLs, which lower net income and can reduce profitability.

In addition high levels of NPLs also cause uncertainty as to banks' actual financial position given the inherent judgemental nature of provisioning. This may create profit and loss volatility and vulnerability, as provisions are typically connected to the value of the underlying collateral which can fluctuate. These factors can also contribute to higher cost of funding and negative or volatile investor sentiment.

The capitalisation of banks across the euro area has increased considerably over recent years. However the structure of profit and loss accounts across banks is quite heterogeneous. For some banks, impairment charges continue to be a drag on profitability. Coupled with continued pressure from the low interest rate environment, and squeezed lending margins, these dynamics can threaten long-term viability. Therefore banks potentially need to adapt their business models to the changing environment and risks.[7]

A fully functioning euro area banking sector is needed to support investment, growth, and employment. Removing impediments to this critical economic function underpins the rationale for reducing NPLs and supervisory actions to accomplish this.

Moreover addressing this issue should also support the expansion of credit, in line with the objectives of monetary policy.

Given these challenges, high levels of NPLs require deliberate and sustained action. Aggregate figures mask considerable heterogeneity across Member States and across banks.

In Ireland, for example, in the corporate sector the overall NPL rate has fallen to 13 per cent, the lowest rate since end-2010. For some of the banks which hold these non-performing loans, there is substantial variation in NPL rates within this category. The construction sector has by far the highest rate of NPLs with almost one half of all loans classified as non-performing. The hotel and restaurant sector also has a relatively high rate of NPLs at about 20 per cent. Loans to the manufacturing sector have a relatively lower NPL rate at 7 per cent.[8]

Therefore, a bank by bank, portfolio by portfolio strategy is needed to see a sustained reduction in non-performing loans across the board.

The Irish experience

In some ways, NPL resolution is similar to endurance running. Both require defining clear goals, ensuring the correct strategy and processes are in place, and effective preparation. However, plans and processes alone are not sufficient for success. Achieving the required distance requires continued resolve over an extended period of time and developing endurance on the ‘hard road’.

In Ireland, our first step was to diagnose the scale of the problem, and ensure the deployment of appropriate resources commensurate with the challenge. An important milestone was the work conducted by the Central Bank of Ireland during the Financial Measures Programme (FMP), in particular the loan loss forecasting exercises and the stress tests conducted as part of Prudential Capital Assessment Review (PCAR) in 2010/2011.

More recently, similar exercises have been undertaken by the Central Bank of Ireland, or jointly with the ECB, including the Balance Sheet Assessment in 2013, the Comprehensive Assessment in 2014, and the IMF FSAP and EBA stress tests in 2016. These types of exercises will continue to be a key component in our supervisory toolkit going forward.

Banks must have credible portfolio-specific resolution strategies and appropriate governance structures. These must be married with operational capabilities (including distressed debt workout skills), appropriate IT infrastructure and decision analytics, and well-developed restructure types appropriate to the portfolios being restructured.

In the following years, the Central Bank of Ireland therefore changed emphasis to ensure these elements were adequate to deal with the rising level of NPLs. A major milestone in this regard in

2012 was undertaking Distressed Credit Operations Reviews (DCOR). The output of this was a benchmarking of actual operational capacity to execute NPL strategies.

Supervisory follow-up in 2012/2013 monitored the effectiveness of banks' operations through regular on-site inspections. Loan file reviews and interviews with bank staff were an important supervisory tool in understanding if a bank's strategy was actually being implemented on the ground. Deficiencies in both strategies and operations were required to be remediated.

All of these steps were important preconditions for success. However, the willingness of institutions to resolve NPLs in a sustainable fashion can be lacking, on occasion.

In my view, successful debt restructuring means sustainable debt restructuring. Over-reliance on short-term forbearance such as interest-only arrangements and rising levels of mortgage arrears was one of the reasons why we imposed Mortgage Arrears Resolution Targets (MART) in Ireland in 2013.

The mortgage arrears targets forced lenders to move from short-term forbearance towards sustainable solutions. Although the targets were not made public, we also had a similar strategy for SMEs. Supervisors could then benchmark progress against these targets. Combined with an established economic recovery, it resulted in significant reductions in the level of arrears.

In terms of measuring progress, retail (primarily residential mortgages) NPLs reduced by 21% in 2015, continuing their downward trend. In terms of Irish mortgage restructuring activity, about 120,000 owner occupier residential mortgages have been restructured.[9] Of these restructured loans, 88% of these loans are meeting the terms of the restructure, up from 81% two years ago. This suggests restructures performance is improving. Non-retail non-performing loans (to SMEs, corporates, etc.) reduced by 44% in 2015 – falling by €16.5bn.[10]

Economic recovery, and determined action have meant that progress is clearly established and moving in the right direction. It's important to recognise this, to note the distance travelled on the journey, and to maintain progress. Why? It's worth remembering the road that lies ahead.

In Ireland eight years after the financial crisis, €45 billion of NPLs remain on Irish retail banks' balance sheets and represent 19% of their combined loan books.[11] This remains the case following the transfer of €74 billion of loans to the State Asset Management Company-NAMA, the restructuring of billions of debt, and the sale of dozens of portfolios.

While macro and micro-financial risks have been reduced due to these efforts, it is clear that vulnerabilities remain and the domestic challenge in Ireland is still significant.

ECB Banking Supervision draft guidance on NPLs

Ireland has not been alone in the euro area. Many other Member States also took significant steps to addressing such issues in their respective banking sectors. Moreover, addressing asset quality issues has also been one of the key priorities for ECB Banking Supervision since its inception.

In 2014 a Comprehensive Assessment encompassing an asset quality review (AQR) assessed the appropriateness of the valuation of NPLs under existing accounting standards, using a sampling approach. Shortcomings in bank accounting practices and policies identified in that exercise led to additional provisioning needs. Banks' balance sheet valuations were then corrected to fully assure the values of NPLs were accurate, at that point in time. Over the last two years the Joint Supervisory Teams (JSTs) have continued to address these issues through ongoing supervisory engagement with firms.

While we recognise that the workout of NPLs will take some time, a harmonised and transparent supervisory approach is necessary. Therefore in 2015 the High Level Group on NPLs was mandated by the Supervisory Board of the ECB to develop a consistent supervisory approach to dealing with this problem.

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In September 2016 we published, for consultation, the Draft Guidance on NPLs, accompanied by a stocktake of national practices and legal frameworks related to NPLs. These measures are important milestones on the journey towards the sustainable reduction of NPLs across the euro area.

The draft guidance sets out ECB Banking Supervision's expectations on NPL workout and resolution and is focussed on addressing the issues surrounding the stock of NPLs that has piled up in the balance sheets of a number of euro area banks.

The structure of the guidance follows the life cycle of NPL management. This begins with a strategy for the effective management and ultimate reduction of NPL stocks in a clear, credible, and feasible manner for each relevant portfolio.

The primary responsibility for the reduction of NPLs stands with the Boards and management of banks. The guidance requests banks to implement clear NPL strategies including operational plans. Gaps in the strategies and deviations from the stated objectives can then be identified by supervisors who can also benchmark accordingly.

Core building blocks of a strategy should include an assessment of the operating environment, including internal NPL capabilities, external conditions impacting NPL workout, and capital implications.

Clear bank-defined targets for both the development of operational capabilities and projected NPL reductions over the short, medium, and long-term time horizons must also be put in place. Strategies should include any necessary changes in the organisational structure of the bank and be fully embedded in management.

Closely linked to the strategy is the governance structure and operational set-up – without which banks will not be able to address their NPL issues in an efficient and sustainable way. Key elements in the guidance relate to steering and decision-making, ensuring an effective NPL operating model, internal control frameworks, and monitoring and early warning processes.

The promotion of appropriate recognition and classification criteria and practices that are consistent across banks is an important goal for banking supervisors. Adequate processes facilitate the timely and effective management of problem loans, thereby reducing their negative effects. The proper classification of loans is also essential for the correct representation of the banks' situation to stakeholders including external investors and market analysts. It is desirable therefore that banks adopt and apply common prudential principles.

In this context, the guidance focuses on clarifying further NPL classification issues which have been identified during ongoing supervisory work, for example triggers for 'Unlikely To Pay', 'Days Past Due' counting, and links to forbearance.

The ECB does not have explicit accounting powers. Moreover, existing standards do not contain specific rules regarding the modalities of write-offs. Some supervisors have issued NPL write-off guidelines with a view to promoting timelier NPL disposal and, more generally, the development of a market for distressed debt. They are – with few exceptions – principles-based, in accordance with the recovery expectations. The guidance is that when loans are deemed uncollectable or unrecoverable, they should be written off in a timely manner.

The guidance also addresses qualitative aspects with regard to approaches to assessing provisions on an individual and collective basis. Furthermore, it puts emphasis on the quality of internal documentation, reporting and disclosures for the processes surrounding this.

The use of robust and accurate collateral valuation methods is essential for the proper valuation of NPLs and for their effective management. It also contributes to the promotion of an active NPL market by reducing uncertainty relating to asset values. Moreover, a conservative approach to the valuation of collateral ensures that the NPLs are adequately provisioned, is a key element for the soundness of institutions.

In most (in-scope) Member States, specific rules govern collateral valuation for the financial sector, especially for real estate collateral. Typically, these rules are related to professional requirements, but in some cases other specific rules have been drafted pertaining to, for example, appraiser independence, performance and limits on institutions' reliance on individual appraisers. In some cases, appraisers are also subject to the supervision of banking or financial market authorities.

In this context, the guidance addresses qualitative aspects with regard to governance and procedures linked to valuing collateral, the frequency of valuation updates for NPLs as well as use of market values plus adequate discounts (e.g. for liquidation costs). The valuation of foreclosed assets is also covered.

Banks should be given incentives to identify problematic cases in a timely manner such that loans which are considered viable can be restructured promptly and recovery steps can be taken for non-viable exposures. Supervisory guidance can increase the priority given to NPL management and governance within banks.

The SSM has started to address in a consistent way a number of important qualitative aspects with regards to supervising NPLs. The guidance forms a solid foundation and clearly indicates the direction of travel for euro area banks on NPLs. Supervisors, will of course, monitor the implementation of that guidance once consultation is final, and take appropriate and proportionate steps should banks fail to comply.

A multifaceted problem

Peer analysis is a critical component of any micro or macro-financial risk assessment and a key strength of ECB Banking Supervision. The guidance builds on best practice across Member States. Furthermore, the stocktake report, which was published alongside the guidance, provides a comparative review of the existing national practices regarding NPL resolution in the eight countries where banks have significant levels of NPLs.

The stocktake was a judgement-based exercise largely completed by the National Competent Authorities (NCAs) on behalf of the ECB. It also built upon work conducted in a similar exercise by the International Monetary Fund (IMF) in the first half of 2015.

The stocktake provides information on the impediments to NPL resolution within several Member States. For example, banks are seldom encouraged to implement a write-off policy because of either country-related external impediments such as legal and tax issues, or idiosyncratic impediments linked to institutions' governance.

Tax deductibility of losses arising from write-offs is, in many countries, bound by strict constraints aimed at ensuring the definitive extinction of all legal claims against the debtor. These impediments often prevent banks from making write-offs even if NPLs are fully provisioned.

The stocktake also provides information on the types of NPL resolution actions which have been undertaken by the respective NCAs. These include, for example, the intensification of on-site inspections and thematic reviews on NPL management, to the issuance or publication of additional supervisory guidance and requirements.

Information on the legal, judicial, and extra-judicial framework as they relate to NPL resolutionis also contained in the stocktake. No doubt, this will be of interest to those analysing the underlying differences in financial structures and performance across the euro area.

These examples highlight how supervisory actions alone in the euro area cannot solve this problem. Recognising this interdependence and working together remains one of Europe's and European Institutions' greatest strengths. Concerted action on this issue is needed from all stakeholders in the euro area over the coming years.

Conclusion

As the recovery in the euro area growth continues at a moderate but steady pace, this should assist the capacity to address the problem of non-performing loans. Nonetheless, concerted action is needed by all stakeholders to ensure the sustained and determined reduction of the NPLs across the euro area. While the road may be hard, we must have the patience and resolve to do what is necessary.

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1 I would like to thank Trevor Fitzpatrick and Micheál O'Keeffe for their contributions to this speech. The opinions expressed are personal and do not reflect the views of the European Central Bank.

2 Both the draft guidance and the stock take can be found here.

3 See for example Beck, Roland, Petr Jakubik and Anamaria Piloiu (2015). Non-performing loans: what matters in addition to the economy cycle. ECB Working Paper Series No 1515. February 2015.

4 Nkuzu, Mwanza (2011). Nonperforming Loans and Macrofinancial Vulnerabilities in Advanced Economies. IMF Working Paper Series WP/11/161.

5 See ECB. (2016). Financial Stability Review. May 2016. European Central Bank. Available here.

6 See IMF (2015). A Strategy for Resolving Europe's Problem Loans. IMF Staff Discussion Note. September 2015. Other papers include Espinoza, Raphael A. and Ananthakrishnan Prasad. (2010).Nonperforming Loans in the GCC Banking System and their Macroeconomic Effects. IMF Working Paper Series WP/10/224. Also see Hou, Yixin and David Dickinson (2007). The Non-Performing Loans: Some Bank-level Evidences. Research Conference on Safety and Efficiency of the Financial System, August 2007. Klein, Nir (2013), 'Non-Performing Loans in CESEE: Determinants and Impact on Macroeconomic Performance, IMF Working Paper WP/13/72, International Monetary Fund.

7 See 'Risks and resilience – the European banking sector in 2016', Speech by Danièle Nouy, Chair of the ECB's Supervisory Board, Deutsche Bank – Bank Capital Forum, London, 23 February 2016. Available here.

8 See Central Bank of Ireland, "Macro-Financial Review 2016:1", available here

9 See Central Bank of Ireland Statistical Release 13 September 2016, Residential Mortgage Arrears and Repossessions Statistics: Q2 2016. Available here.

10 Central Bank of Ireland regulatory returns using EBA's harmonised definition of non-performing

11 Q2 2016 regulatory returns using EBA's harmonised definition of non-performing.