Sharon Donnery: Setting the standard: NPL workout in the euro area

Remarks by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at an event entitled "Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth", organised by Bruegel, Brussels, 3 February 2017.

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1. Introduction

Good morning, It is a pleasure to be here today at Bruegel to discuss the resolution of Non-Performing Loans (NPLs) in the euro area.

Different factors have contributed to the formation of non-performing loans across individual Member States. In Ireland and Spain, for example, NPLs were mainly driven by idiosyncratic shocks, namely the collapse of real-estate bubbles.[1] Conversely, the roots of Italian NPLs can be found in the prolonged deterioration of the economy more generally and in the persistent reduction of its competitiveness.[2]

Regardless, the deliberate and determined reduction in non-performing loans is essential for the viability of the European banking sector. It therefore constitutes a necessary condition for the recovery of the euro area economy.

The diverse causes underlying NPL formation, the multiple channels by which they can affect macroeconomic performance, as well as the high degree of heterogeneity across the European banking sector, call for a flexible approach in addressing Europe's NPL problem. However, saying that an appropriate response should take into account the different context in which euro area banks operate, does not mean that we cannot adopt a consistent approach to the supervision of non-performing loans. This includes applying a common framework for NPL resolution across the Banking Union.

The most effective response should turn best practices into common standards for NPL management across the banking sector, while at the same time recognising the need for a granular approach. In this context, the ECB Guidance 'sets the standard' for NPL management going forward.[3]

Today, in my brief introductory remarks, I will focus on how the Guidance provides a common standard for NPL management across the euro area, yet allows for the differing position of individual banks and takes into account the varying contexts in which they operate. I will highlight the necessity for experience and ownership at board level, the capacity gaps that exist in terms of implementation, and explain how we expect these to be addressed. Finally, I will briefly discuss a number of national practices that still pose a considerable challenge to the timely reduction in non-performing loans in some Member States. In this context, concerted action from all relevant stakeholders is needed to tackle this important issue.

2. The framework going forward

Following the Comprehensive Assessment in 2014, ECB Banking Supervision continued to focus on issues relating to asset quality through its ongoing supervisory engagement. Through the work of the SSM it became evident that different banks had been subjected to different intensities in the supervision of non-performing loans and that different Member States had implemented varying guidance in how banks should deal with workout and resolution. Therefore, the High Level Group on Non-Performing Loans – which I have the honour to chair – was mandated to develop a consistent supervisory approach to the treatment of NPLs. The Guidance – which represents ECB Banking Supervision's expectations going forward – is an important step towards NPL reduction across the euro area.[4]

The publication of the Guidance on NPLs was accompanied by an extensive consultation process which ended on 15 November 2016. We received nearly 700 comments on all chapters of the Guidance, all of which will be published. Since then, we have been reviewing both the comments submitted in written form and those provided during the public hearing, and we are now aiming to publish the final Guidance in Spring 2017.

Through the work of the High Level Group we identified a number of best practices relating to NPL management. These have been incorporated into the Guidance as the standard for NPL management going forward. A central principle of the Guidance is 'tone from the top'. The resolution of non-performing loans rests firmly with the institutions themselves.

Management bodies must take full ownership of this problem. This includes the development, and approval of a strategy and operational plan to deliver the progress required. Furthermore, frequent and regular reporting to the board is necessary to ensure progress versus agreed targets is achieved.

However, in order to develop ambitious, yet realistic strategies to reduce NPLs, boards first need to gain a clear understanding of the full context in which they operate. It is clear, at present, many boards have not yet established this. From the bottom up, banks also need to examine the drivers and scale of non-performing loans. In doing so, they are expected to adopt an extremely granular approach. A careful assessment of the external environment, the resources available to debtors, as well as the internal operational capacities, will contribute to the identification of the most appropriate strategy to reduce non-performing loans.

To ensure effective implementation, we also expect banks to review their governance structures and operational arrangements against the benchmark laid down in the Guidance. Drawing from international best practice, the Guidance prescribes that banks should establish dedicated NPL workout units, separated from the loan granting functions.

The main rationale for this important separation is the elimination of potential conflicts of interest and to ensure the presence of staff with dedicated expertise and experience in NPL management. This separation of duties should encompass not only client relationship activities (e.g. negotiation of forbearance solutions with clients), but also the decision-making process. In this context, dedicated NPL committees should also be established.

Given the existing heterogeneity across the European banking sector, setting generic quantitative targets for NPL reduction in the strategies would have inevitably resulted in unrealistic targets for a number of banks. By contrast, if adapted to suit all situations, targets would have not been very ambitious. Therefore, we explicitly decided not to set a single threshold for NPL reduction.

Rather, taking into account the specificities in which banks operate, targets are required to be set using a portfolio-by-portfolio approach. The standard – outlined in the Guidance – prescribes that banks must articulate their NPL targets along three dimensions – (i) across time, (ii) by portfolio and, (iii) by implementation option chosen to drive the projected reduction.

Clearly defined quantitative targets in their NPL strategy, approved by the management body, will ensure 'extend and pretend' situations will not persist. The targets will require banks to segment non-performing loans and effectively manage them towards likely resolution outcomes (depending on borrower cooperation and business viability). Retail NPLs can remain stubbornly high, and commercial debt resolution strategies are likely to be complex and take significantly more time to devise and implement. Therefore, a case-by-case assessment is required to develop and agree bespoke sustainable solutions with distressed borrowers.

Allowing for bank-specific quantitative targets for NPL reduction does not mean that ECB Banking Supervision will not implement consistent supervisory standards.

The Joint Supervisory Teams (JSTs) will treat all banks in the same way when assessing both the degree of implementation and the ambitiousness of banks' strategies. Furthermore, using peer analysis tools and techniques:

(i) we will analyse all banks strategies in a comparative context,

(ii) we will compare granular sets of indicators, allowing for a single and relative view on progress, and

(iii) we will benchmark by portfolio, by peer group and by Member State, to assess progress.

Our intrusiveness will depend on the scale and severity of the NPL challenges different banks face. With the JSTs, we will also organise regular onsite inspections of banks with high levels of NPLs to gauge progress. However, we will also take a proportionate approach where necessary. For example, banks with a high NPL concentration in certain parts of the business will be asked to put in place portfolio-specific non-performing loan reduction strategies, despite having an overall NPL level not considerably above the EU average.

Should supervisors find that the NPL strategies are either not appropriately implemented nor sufficiently ambitious, additional supervisory measures can be triggered on a case-by-case basis. Although the Guidance at present is non-binding in nature, any deviations from it will need to be explained. Supervisory expectations can be turned into binding requirements by implementing them as part of the Supervisory Review and Evaluation Process.

We expect the Guidance to become embedded in the ECB supervisory manual, thereby becoming business as usual supervision. We also expect markets to exert pressure on banks to take action, resulting from greater disclosure.

3. Capacity gaps

Looking at the operational capacity of banks, it is clear that many deficiencies exist. Turning first to the important issue of 'tone from the top', in some cases, the skills to deal with this issue at board level are significantly lacking. Board members will either need to upskill, or people with the appropriate skill-set will need to be appointed.

This is essential to ensure NPL strategies get sufficient attention and drive, and become fully embedded in the overarching objectives of banks.

Similarly, at an operational level, some institutions simply do not have enough people with effective arrears management experience to deal with this problem. Centralised specialist resources are needed. Therefore, realistically, some banks will have to bring in outside expertise. We saw this previously in some programme countries.

In terms of management and decision-making, full consideration of all available long-term options is necessary. However, this requires segmentation aligned to NPL workout. It also demands accessible documentation and considerable financial analysis, as well as frequent site visits to verify business and collateral. Complete and up-to-date data to assess performance and track KPIs is also essential to monitor workout progress and is critical to the effective implementation of the NPL strategies more generally.

However, it is clear considerable gaps in IT infrastructures also exist in some banks. In many cases data is simply not reliable or granular enough. For example, a key issue reported between the bid/ask price is data. Loan tapes need to include all the necessary information relating to the collateral and legal process to allow for cross-section and segmentation analysis.

The standard we have set in the Guidance, prescribes that all non-performing loan related data are securely stored in central IT systems. Where systems are not ‘fit for purpose’, banks will have to quickly put in place remediation plans to address these capacity gaps. As you know IT infrastructure plans can take some time to implement and require investment. Those plans will therefore also be subject to scrutiny by our Joint Supervisory Teams.

4. Coordinated response

Tackling Europe’s non-performing loan problem, however goes beyond the supervisory domain. Some reductions in non-performing loans have been noted across the euro area and a number of countries have taken proactive and coordinated prudential, judicial and other measures to tackle the issue. However, as shown by the Stocktake report, in some Member States a number of national practices and legal and judicial aspects still pose a considerable challenge to timely NPL reduction.[5]

The inefficiencies of judicial systems are considered by the majority of the countries surveyed, as an obstacle to the speedy resolution of non-performing loans, due to capacity constraints of the courts. Other aspects that need to be addressed include (i) the lack of a modern legal framework for enabling timely out-of-court settlement, (ii) challenges related to both the corporate and the household insolvency system, and (iii) factors – such as the taxation regime or the accounting framework – that can also discourage NPL resolution.

The focus of the Guidance is on workout. And working out NPLs can create a pipeline for future sales, where possible. However, the underdevelopment of secondary debt markets also impedes non-performing loan resolution in most of the countries surveyed. Specific obstacles in the legal and regulatory framework appear to be the cause of such a market stagnation. This despite the fact that the majority of jurisdictions surveyed appear to have a framework favourable to transfer non-performing loans to third parties.

Joint action from all relevant stakeholders – including Member States, the Commission and EU fora – is therefore critical. In this context, we welcome initiatives – such as this – to connect the market, policy, and supervisory discussions on this topic and promote a dialogue between respective professional communities to define a shared agenda for NPL workout and resolution.

5. Conclusion

To conclude, we were given a clear mandate to deliver a consistent supervisory approach to the treatment of non-performing loans across the euro area. The Guidance delivers on this objective, by setting the standard for NPL management going forward. It ensures supervisors have the necessary tools available to them, and banks have the necessary capacity to tackle NPL problems.

However, publishing the Guidance is only the first step. Implementation is our next challenge and this will not happen overnight. We also need strong and clear support from Member States to tackle legal and related issues.

Boards will play a crucial role in developing, owning, and implementing bank specific strategies, and we expect pro-active engagement going forward.

As Madame Nouy has repeatedly emphasised, this will be reinforced by tough but fair supervision.

Thank you for your attention, I look forward to the discussion.

1 For Ireland see 'The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003–2008. A Report to the Minister for Finance by the Governor of the Central Bank. For Spain, see for example Cuerpo, Carlos and Pontuch, Peter, (2013), 'Spanish housing market: adjustments and implications', European Commission–ECFIN, 10(8).

2 See Garrido, José, Anke Weber, and Emanuel A. Kopp, (2016), 'Cleaning-up Bank Balance Sheets: Economic, Legal, and Supervisory Measures for Italy', IMF Working Paper WP/16/135.

3 The Draft Guidance to banks on non-performing loans can be found here.

4 See 'The hard road: NPL workout and resolution in the euro area', address by Sharon Donnery at the Peterson Institute for International Economics, 6 October 2016.

5 The ECB Stocktake of national supervisory practices and legal frameworks related to NPLs can be found here.