A Strategy for Resolving Europe's Problem Loans

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Abstract

Persistently high non-performing exposures (NPLs) in several European countries pose significant challenges to financial stability and are likely weighing on credit growth and economic activity. This paper, which summarizes a detailed IMF analysis (IMF SDN/15/19), examines the structural obstacles that discourage European banks from addressing their problem loans. It argues that a comprehensive approach comprising three pillars is needed to accelerate balance sheet clean-up: (1) intensified banking oversight, to incentivize write-off or restructuring of impaired loans, including fostering more conservative provisioning and time-bound restructuring targets on banks' NPL portfolios; (2) enhanced insolvency and debt enforcement regimes, and more developed out-of-court restructuring frameworks; and (3) the development of distressed debt markets by improving market infrastructure and, in some cases, using asset management companies (AMCs) to jump-start the market. A variety of facilitating measures could support these three main pillars, including better public registers, the removal of tax disincentives, and debt counseling services.

42. International Monetary Fund.

1. Introduction

Many European countries continue to grapple with large stocks of impaired assets almost a decade after the onset of the global financial crisis. The deep and prolonged economic downturn has weakened borrowers' debt service capacity, particularly for those borrowers that were overleveraged, leading to an increase in loan defaults and large corporate and household debt overhangs. NPLs in the European Union (EU) stood at about €1.1 trillion (or over 9 percent of the region's GDP) at mid-2016, more than double the level in 2009. Ten EU countries registered NPLs of ten percent or higher as of June 2016. A similar number of non-EU countries, mainly in central, eastern, and southeastern Europe (CESEE) experienced peak NPLs above that threshold[43]. The NPLs are mostly concentrated in the corporate sector, notably in SMEs, which contribute almost two-thirds of Europe's output and employment, and tend to be more reliant on bank financing than large firms.

High NPLs so many years after the crisis reflect the slow pace of restructuring, disposals, and write-offs, with only a handful of countries showing lower NPL ratios at mid-2016 compared with their post-crisis peaks. While economic conditions have gradually stabilized across Europe, NPL ratios continue to increase in some stressed economies, albeit at a slower pace. Given the need to support Europe's still nascent recovery, quickly resolving NPLs to promote new lending is of first-order macroeconomic importance.

2. Macro-financial implications of high NPLs

NPLs influence bank lending through three interrelated key channels—profitability, capital, and funding. Bank profitability suffers because high NPLs require banks to raise provisions, which lowers net income, while NPLs carried on banks' books do not usually generate income streams comparable to performing assets. NPLs, net of provisions, also tie up substantial amounts of capital due to higher risk weights on impaired assets. Deteriorating balance

43. Differences in definitions complicate comparisons of NPL ratios across countries. The EBA introduced new definitions of non-performing exposures (NPEs) and forbearance in 2013, but their application beyond the larger euro area banks has been uneven.

sheets increase banks' funding costs due to higher risk and lower expected revenue streams. Together, these factors result in a combination of higher lending rates, reduced lending volumes, and increased risk aversion.

The data shows that euro area banks with higher NPLs tend to be less profitable, have relatively weak capital buffers, face higher funding costs, and lend less. Empirical analysis generates similar findings for a sample of CESEE banks. A growing literature on the macro-financial effects of NPLs finds a robust relation between higher NPLs and weaker credit and GDP growth, with causality going both ways. Banks' reduced lending capacity undermines the growth prospects of viable firms, and is also likely to disproportionately affect SMEs that are more dependent on bank financing.

Persistent NPLs are linked to unresolved private debt overhangs. On average, the corporate NPL ratio and the level of corporate debt overhang are positively correlated. Corporate debt overhangs are also associated with weaker investment and delayed recoveries. Analysis using firm-level data shows that firms' employment and investment decisions in response to positive or negative shocks depend on their level of indebtedness. Mutually reinforcing feedback loops exist between bank NPLs and excessive corporate debt. Overextended companies have little incentive to invest because returns must be allocated to debt service. This also implies that their demand for credit is weak, which further weighs on banks' profitability and makes it more difficult for them to dispose of impaired assets. Thus, when NPLs are large and persistent, they are unlikely to be worked off through a normal cyclical economic recovery. Concerted efforts are therefore needed to address both NPLs and the private sector debt overhang to ensure that a large stock of distressed debt does not hold back growth.

3. Obstacles to NPL resolution

In 2015 two IMF surveys were conducted of European countries and banks[44] where the aggregate NPL ratio exceeded 10 percent during 2008–

44. The "country survey" was completed by 19 countries (Albania, Bosnia and Herzegovina, Croatia, Cyprus, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Lithuania, Macedonia, Montenegro, Portugal, Romania, San Marino, Serbia, Slovenia, and Spain). The "bank survey" was completed by 10 banks (Alpha

2014. These revealed some common themes on structural obstacles to NPL resolution. Deficiencies in the legal framework and underdeveloped distressed debt markets were the two most severe obstacles, but information, supervision, and tax regimes were also found to be lacking in several respects:

1. **Prudential supervision.** While bank capital buffers were found to be of medium concern, collateral-related issues registered as a medium or high concern. Many countries had begun to allocate more supervisory attention to impaired assets through asset quality reviews, but many banks lacked the expertise, capacity, or tools to deal with NPLs on a large scale, and time-bound operational targets for NPL reduction was rare. Accounting standards were found to weaken incentives to resolve NPLs due to several reasons, including application of an incurred loss approach; leaving too much room for judgment; lack of specificity on write-off modalities; accrual of interest income from NPLs; and lack of guidance on collateral valuation.

2. **Legal obstacles.** Although many countries had overhauled or upgraded their insolvency regimes, reforms have been uneven and progress slow. Prepack processes and out-of-court mechanisms were underutilized for corporates and there were no personal insolvency regimes in over one-third of surveyed countries. Worrying findings include the slow and inconsistent implementation of insolvency laws; the lack of effectiveness of, and delays with debt enforcement and foreclosure; and the poor efficiency of institutional frameworks (especially judicial systems).

3. **Distressed debt markets.** The survey found there are few explicit restrictions on sales of NPLs, yet distressed debt markets remain shallow or nonexistent. The impediments included incomplete credit information on borrowers; lack of licensing and regulatory regimes to enable nonbanks to own and manage NPLs; overvalued collateral and lack of liquid real estate markets; low recovery values, partly related to lengthy court procedures; and inadequate provisioning of NPLs. These factors contributed to large pricing gaps between potential buyers and sellers.

4. **Informational obstacles.** Rules preventing sharing of debtor information and limitations of asset registers and real estate transaction

Bank, Intesa, NBG, Piraeus, Pro Credit, Raiffeisen, Societe Generale, Unicredit, Eurobank, and Erste Group). Both surveys were completed by June 2015.

registers were seen as significant obstacles. Credit bureaus typically do not include crucial information for debt restructuring, such as tax payments, social security contributions, and payments to utility companies. Most credit bureaus do not have credit scoring for individuals or for SMEs and larger companies. Debt counseling services were also limited, with few countries offering budgeting or legal advice services for households, and less than half of countries providing credit management training and advice for SMEs.

5. **Tax and other obstacles.** Some countries impose restrictions on deducting provisions and charge-offs for income tax purposes, thus disincentivizing NPL reduction. Others lack loss carry-forward provisions (e.g. deferred tax assets); or subject debtors to capital gains tax upon debt relief. Debts that involve private and public creditors are often subject to specific problems including privileged (priority) claims of public creditors in debt restructuring; limits on debt relief by the public sector; and poor coordination between public and private creditors.

The different types of obstacles were found to be interlinked, with difficulties in one area compounding challenges in other areas. Empirically the survey-reported severity of structural obstacles tends to be associated with worse NPL outcomes.

4. Tackling high NPLs

A comprehensive strategy for NPL resolution in Europe would combine more robust supervision, institutional reforms to insolvency and debt enforcement regimes, and the development of markets for distressed debt. These measures should be supported by changes to the tax regime and reforms to improve access to information.

1. **Supervisory oversight** should be enhanced by: (1) issuing guidance on accounting treatment as in Ireland and Cyprus and recently by the ECB/SSM. The guidance should cover provisioning and write-off practices, it should halt accrual of interest for loans past a set delinquency threshold, and introduce time-bound write-off requirements for uncollectible loans where legally allowed; (2) collateral should be subject to enhanced supervisory

scrutiny to ensure accurate valuations (reflecting changes in market conditions, cost of sale, and delays in realizing proceeds) and require periodic valuation by independent experts; (3) micro- and macroprudential measures should be applied as necessary, such as time-bound targets for resolving NPLs and increasing risk weights according to NPL vintage; (4) banks with NPLs above a set threshold (e.g. 10 percent) should be subject to more intensive oversight including significantly enhanced quarterly reporting requirements and be required to develop an internal NPL management strategy, which includes ambitious operational targets for NPL reduction; and (5) strengthening the regulatory and sanctioning toolkit, including introducing a code of conduct for borrower engagement.

2. **Insolvency and debt enforcement.** The legal framework should consist of both legal tools designed to facilitate speedy in- and out-of-court solutions and an adequate institutional framework (including courts and insolvency practitioners) to support the consistent, efficient, and predictable implementation of the laws. Improvements should include: (1) facilitating the rapid exit of nonviable firms and the rehabilitation of viable firms and a fresh start for good faith entrepreneurs within reasonable time periods; (2) out-of-court frameworks with hybrid and enhanced features (e.g., stay on creditor actions, majority voting, mediation or arbitration, or a coordinating committee); (3) simplified debt enforcement and foreclosure processes (e.g., to clearly specify enforceable titles, limit appeals, set short preclusive deadlines, and to introduce e-auctions platforms) to enable swift process. (4) strengthen the judicial system by increasing the specialization of judges, rationalizing fees and introducing performance measures for professionals. (5) eliminate super-priority claims for public debtors, introduce caps on public claims, and provide guidance to public creditors to allow them to participate in and be affected by debt restructuring; (6) aim for convergence of insolvency regimes across Europe; and (7) unify and enhance data collection on insolvency and enforcement processes to enable adequate comparisons and proper assessments.

3. **External NPL management and distressed debt markets** should be enhanced by: (1) enabling specialist NPL servicing and legal workout agencies to participate through a licensing and regulation regime for nonbanks. (2) improving access to timely financial information on distressed borrowers,

collateral valuations and recent NPL sales; (3) facilitating structured finance transactions that remove NPLs from bank balance sheets, perhaps by involving European investment institutions to participate in securitization transactions; and (4) considering use of public and private special purpose vehicles (i.e. AMCs) to centralize creditor discussions, foster specialization, and exploit economies of scale. Public AMCs would need to have strong governance and be compatible with the EU's state aid rules.

4. **Additional supportive measures** should include: (1) centralizing and improving public registers. Credit registers should include arrears to utilities and tax and social security authorities and asset registers should contain sufficient information to accurately assess wealth. (2) debt advisory services should be introduced so debtors are well informed and confident to engage with creditors. Households should have access to free or subsidized budgeting and legal advice services and SMEs should have access to credit management training. (3) real estate transaction prices should be published on a website. (4) tax rules should be reviewed and amended to encourage creditors to provision, write-off, and sell collateral and encourage debtors to accepting debt restructuring or write-off deals.

In cases where NPLs exceed a systemic threshold, governments should consider establishing a coordination mechanism, such as a ministerial council. The mandate should be to fully diagnose the obstacles to NPL resolution, set reform priorities, and ensure that all stakeholders are clear on their role in implementation. A coordinated public communications strategy as well as a dedicated project management office would help ensure effective implementation.

5. Conclusion

Reducing the level of impaired assets is essential for restoring the health of the banking sector and supporting credit growth in Europe. High NPLs hold back credit supply by locking up capital that could be used to support fresh lending. Low provisioning and write-off rates hinder necessary corporate restructuring and prolong the debt overhang, depressing credit demand. Given

that impediments to NPL resolution are often interlinked, a comprehensive strategy is needed to address the NPL problem. Based on international experience, such a strategy should be based on three key pillars: (1) enhanced supervision, (2) insolvency and debt enforcement reforms, and (3) the development of a distressed debt market. Since European banks operate across multiple jurisdictions—both within and outside the euro area—a successful NPL resolution strategy will require close coordination between EU, euro area, and national competent authorities.

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