

AQRs: just the first step...

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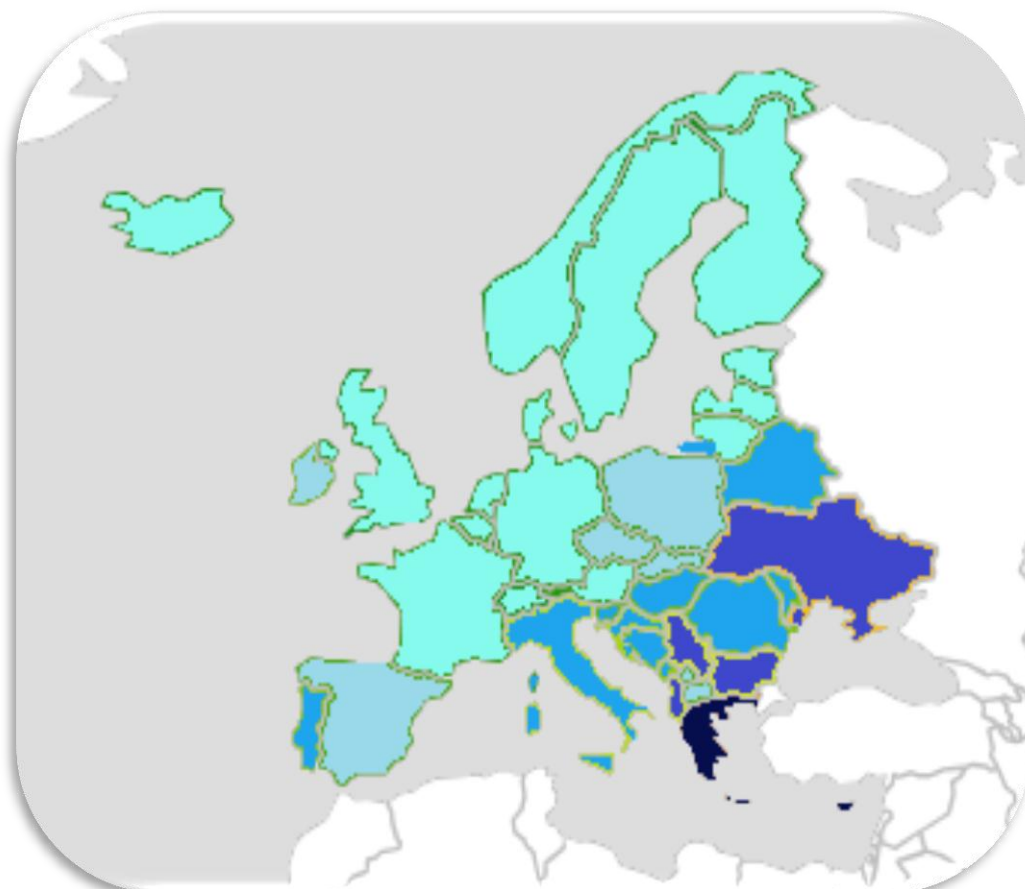
Outline

- 1 NPLs in Europe have been in the news for a while, but are likely to emerge in other large economies.
- 2 There can be various causes for NPLs, which have bearings during resolution/sale. Longstanding NPLs distort bank behaviors' and hamper growth.
- 3 NPLs should be recognized and adequately provisioned. AQRs are a tool to ensure proper provisioning and can be helpful in certain circumstances.
- 4 Legal and judicial system, taxation, size of the market, capital market development have important repercussions on NPLs resolution and transfer
- 5 Although complex, it is possible to bring down NPLs in a relatively short time with careful policy design.



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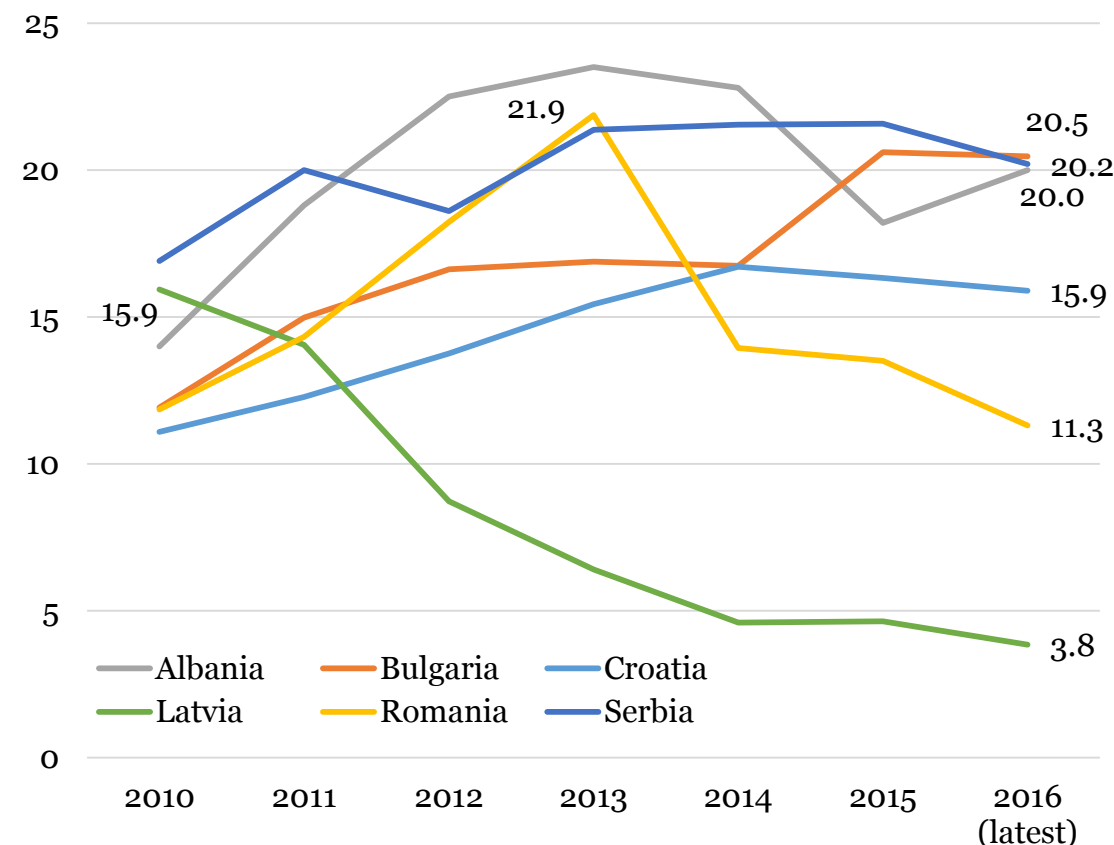
NPLs in Europe have been in the news for a while...



Source: IMF FSI

Light blue	Up to 4%
Medium blue	4.01% to 9%
Dark blue	9.01% to 20%
Very dark blue	20.01% to 30%
Black	30.01% and above

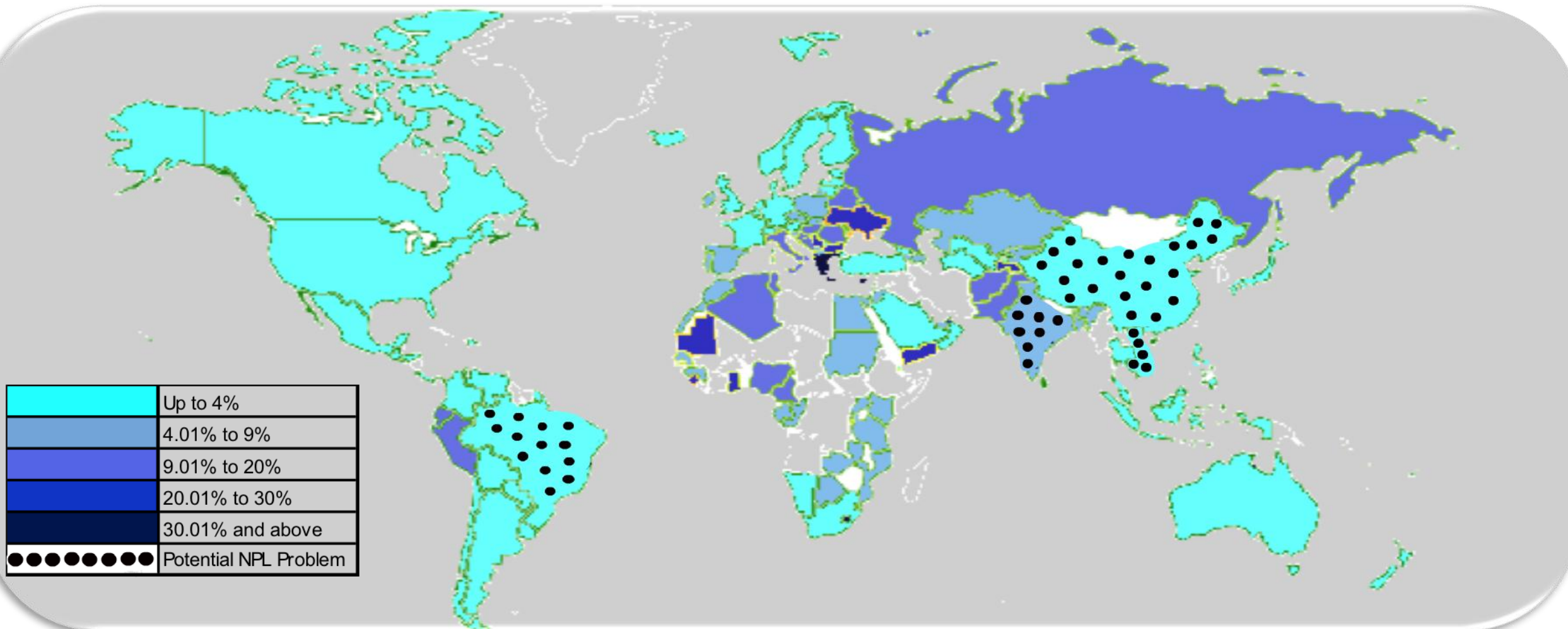
NPL evolution in selected countries (%)



Source: IMF FSI, National sources

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...but are likely to emerge in other large economies

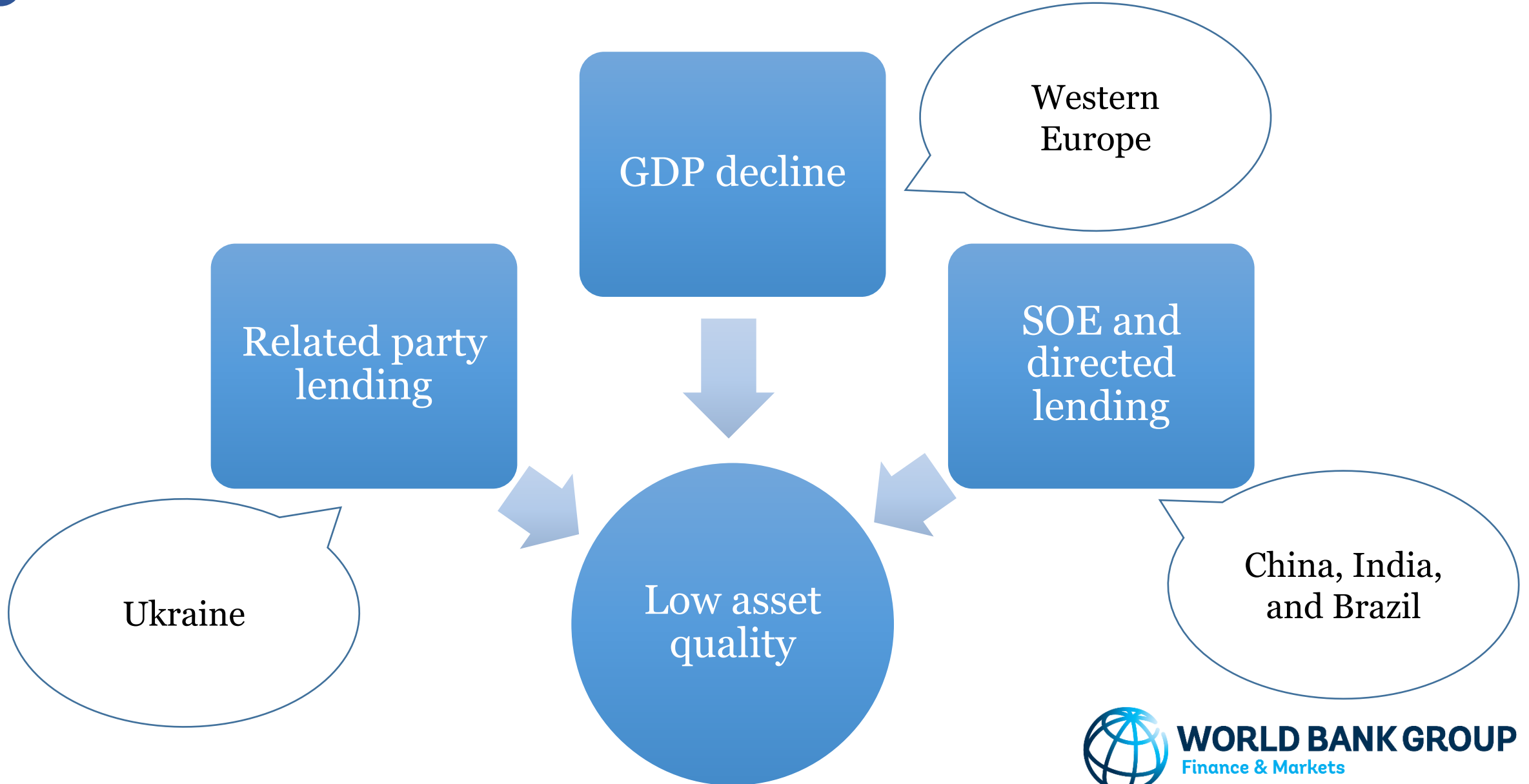


Countries with a potential NPL problem represent 20% of world GDP.



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There can be various causes for NPLs

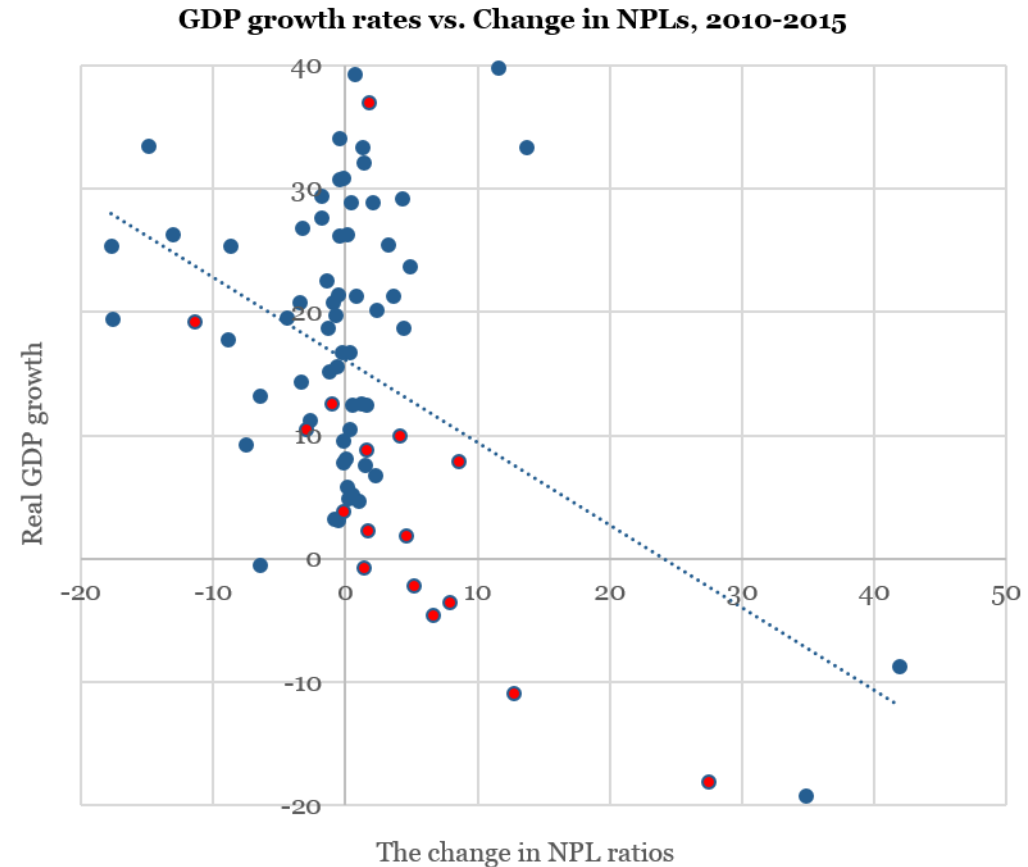


NPLs distort bank behavior and hamper growth

1. Not adequately provisioned NPLs may hide solvency problems, with potential stability implications.
2. Accumulation of NPLs reduces profitability and can lead to regulatory capital deficiency
3. This discourages banks to provide new loans, as they become more risk averse.

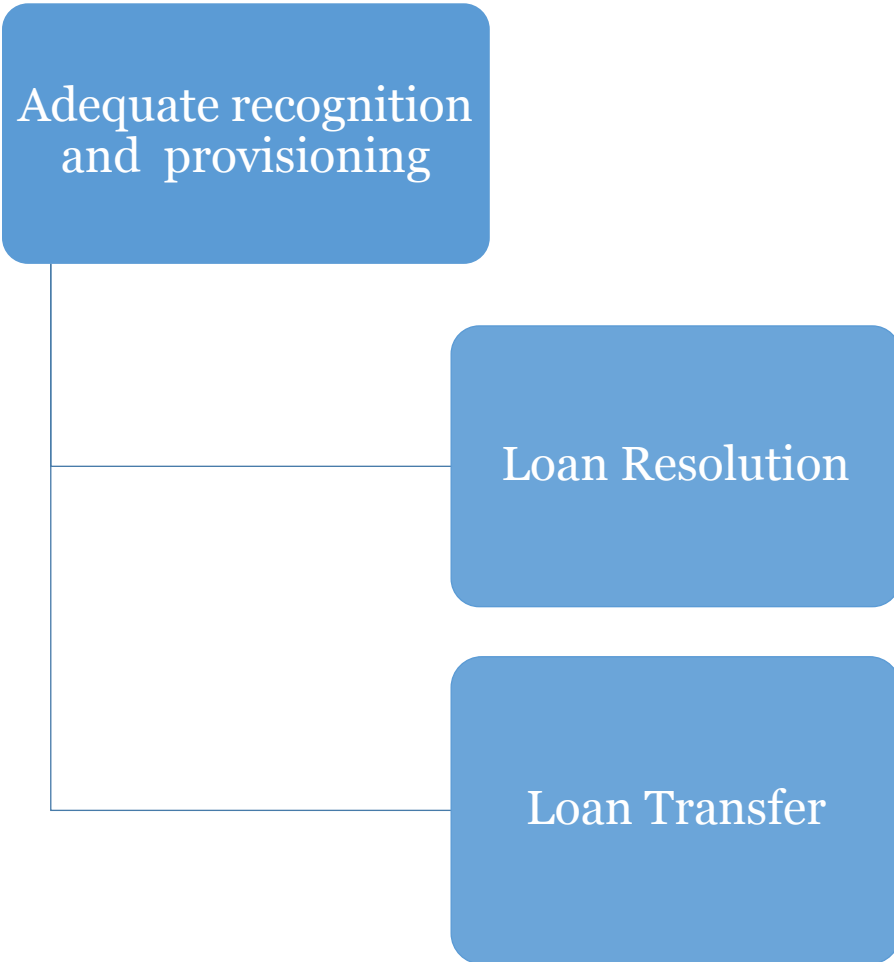
IMF estimates that EUR 24 billion (0.2% of GDP), could be freed up in capital of European banks if NPLs are sold with 5% haircut, supporting new lending for as much as EUR 247 billion (2.4% of GDP).

4. Low credit growth as a result of high NPL levels has implications for economic growth. Demand for credit declines as a result of reduced investment opportunities and consumption, which in turn increases NPLs and depresses credit growth further.



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Tackling NPLs involves many actors



- Regulator
- MoF
- MoJ
- MoE
- Bank 1 and 2
- NPL investors
- Others
- Tax authorities
- External auditors
- Accounting standard setters

Adequate recognition and provisioning

Issues

- Loan loss provision is an expense set aside as an allowance for uncollected loans and loan payments
- Provisioning can be complex, with different interpretations in prudential regulation, local and international accounting standards
- Appropriate provisioning has a significant influence on the development of the NPL market
- Insufficient provisioning can be one substantial reason for pricing gaps (bid-ask spreads) in the NPL market

Challenges and Possible Solutions

- IAS 39 requires provisioning when losses are incurred instead of expected. Prudential provisioning can equate accounting provisioning in the EU. IFRS 9 focus on expected losses should help.
- Prudential provisioning may be deficient. In Central and Southeastern Europe, WB found no clear and consistent criteria for loans to migrate from performing to non-performing categories (and vice versa), and criteria for write offs. Clear rules for migration are key.
- No bank management attention to NPLs. Supervisor to require credible and time-bound NPL reduction targets monitored by the management of banks, and enforced by the supervisor.
- Remove caps on tax deductions for provisions.

Adequate recognition and provisioning (cont'd)

AQRs – Issues

- AQRs are only a possible starting point.
- The supervisor through its regular supervisory functions should perform this function and ensure adequate prudential provisions
- This said we have recommended AQRs when:
 - Weaknesses in bank supervision regulations and practices (e.g., related party lending, collateral valuation rules, etc.) that cause concerns about the accuracy of NPLs or when there is a new supervisor
 - Countries in the midst of a crisis where there are concerns about the ability of the banking system to withstand possible shocks
 - Countries that are exiting a crisis, in which there are concerns about the asset quality following the regulatory measures utilized during the crisis (e.g., forbearance)

Greece:

3 AQRs
Bank recap: €63 billion
NPEs: 45%

Challenges and Possible Solutions

- Need for clear process upfront on how to address AQR results, including legal validity of the same
- Stress tests to be combined in countries in the midst of a crisis or where there are concerns about asset price bubbles. In a crisis scenario, iterative approach should be contemplated
- Quality of the auditors. To avoid collusion, quality of the AQRs can be guaranteed by having jurisdiction in another country.
- The AQRs should be combined with improved regulations and revised regulatory framework to be used in the design of the AQR
- In non-EU countries, the ECB guidelines often are the starting point. Modifications are required especially with respect to collateral valuation



Loan resolution

Issues

- Loan resolution process includes five main actions: (i) forbearance, (ii) restructuring implementation in court, (iii) out-of-court settlement, (iv) collateral enforcement, and (v) write-off
- Loan forbearance includes – interest only payment, reduced payments, balloon payments, conditional debt forgiveness
- Out-of-court settlement is reached among lender(s) and borrower without lengthy and costly judicial process
- Collateral enforcement envisages full or partial realization of the loan collateral
- As a consequence of write-off bank recognizes unrecoverability of loan.

Challenges and Possible Solutions

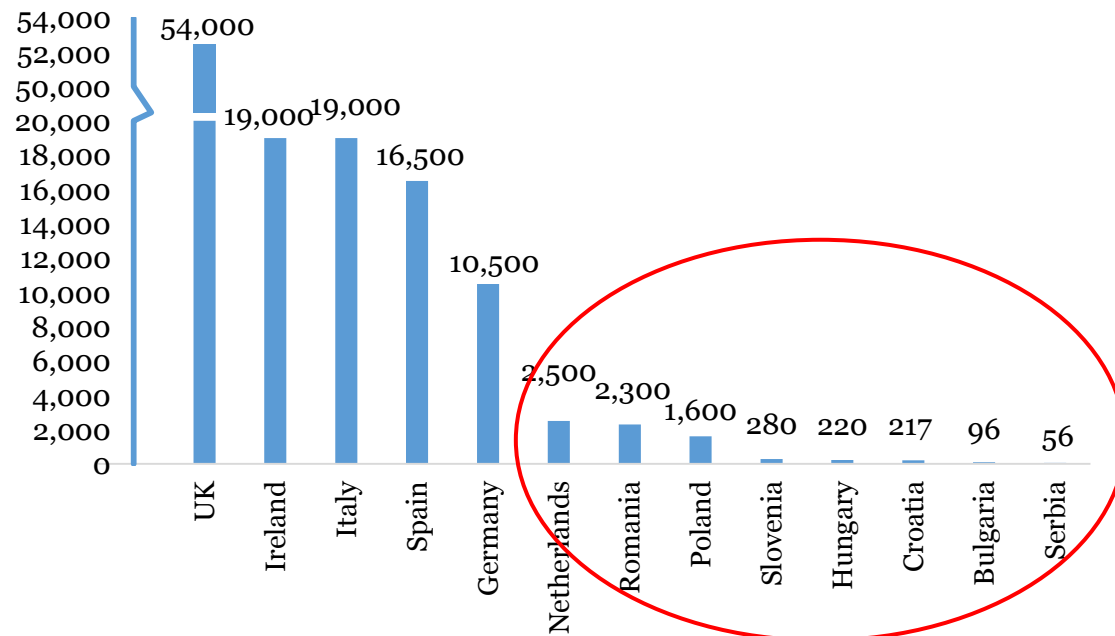
- Lack of efficient mechanisms for debt workout. Introduce out-of-court restructuring mechanisms, debt-to-equity swaps, options for financing during restructuring.
- Develop specialized courts, and improve training of insolvency practitioners, bailiffs (enforcement agent) and judges to address weak corporate insolvency legal framework..
- Non-existent or untested personal insolvency legal framework; social policy aspect.
- Disincentives for debt forgiveness: when treated as income (and therefore taxable) for the borrower.
- Establish clear rules to avoid reversal of tax deductions at write-off,

Loan transfer

Issues

- If a bank does not have an internal capacity and facility to deal with NPLs, it can decide to sell or transfer assets to third party entity.
- Credit files should be in good order and in digital format for the investors to be able analyze them.

Value of NPL transactions by country, 2015 (EUR million)

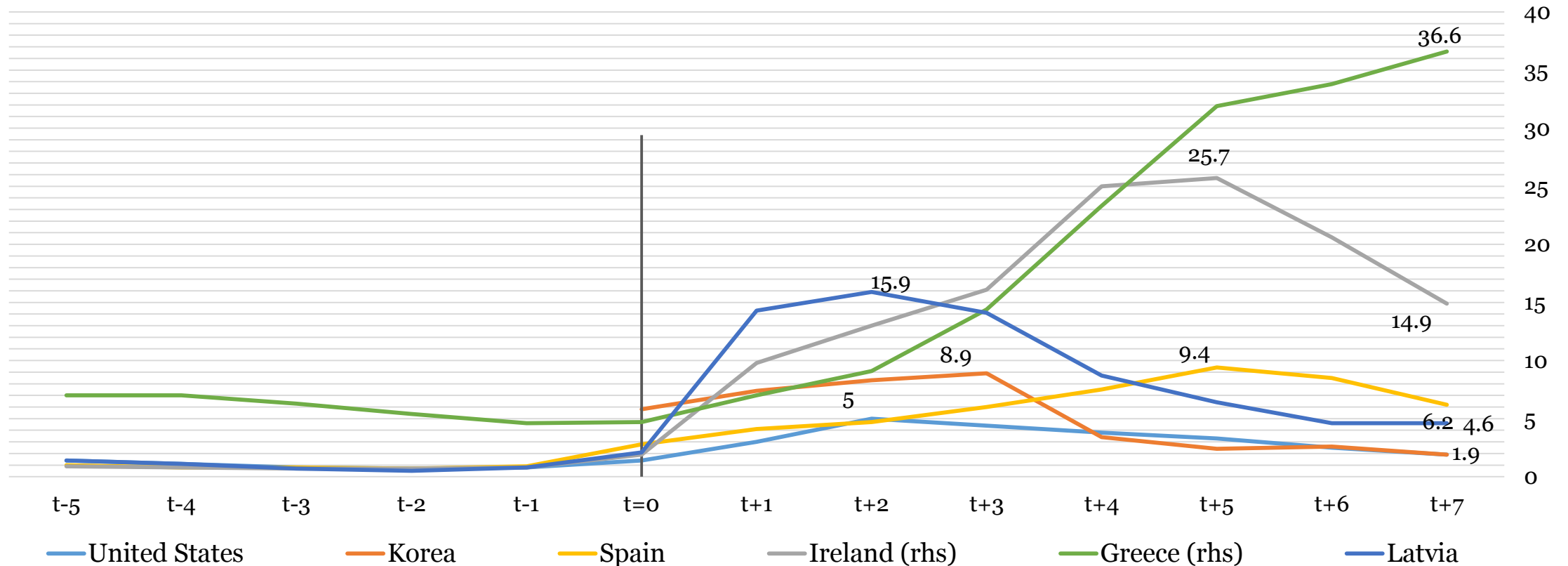


Challenges and Possible Solutions

- Pricing gap due to accounting standards focusing on incurred losses and inadequate prudential requirements (or their application), no historical data, ineffective legal and institutional framework for NPL workout.
- Small markets make participation of foreign investors less attractive, due to limited volumes, lack of historic data. Foreign investors cannot establish NPL servicing companies or buy distressed assets if they don't have a banking or financial company license.
- Tax disincentives for sale of assets (real estate transfer taxes, valued added taxes)
- In the case of systemic nature of the NPL problem, countries may opt for national asset management company for troubled asset administration. Mixed experience.

It is possible to bring down NPLs...

NPLs surrounding systemic banking crisis (%)



Note: t = 0 corresponds to the starting year of the crisis.

Source: IMF FSI, Laeven and Valencia (2012).

...with careful policy design

1. Upfront loss recognition – asset valuation (Ireland, Spain)
2. Additional capital from bank shareholders to give enough time for NPL workout (Latvia).
3. Strong enabling framework - orderly and effective insolvency process (Sweden).
4. Improvement of corporate governance of real sector facilitating mergers and acquisitions (Korea).
5. Deep liquid capital markets with investor appetite to buy distressed assets if price is attractive.
Availability of loan historical data makes easier for investors (United States).
6. Creation of a distressed asset market by attracting of foreign investors for asset purchase, and adopting international accounting standards allowing for better risk assessments (Korea).

Key takeaways

1. Adequate provisioning is the starting point and AQRs can be a useful tool in certain circumstances.
2. New IFRS 9 standards may increase provisioning, as losses will be recognized earlier → This may have a positive impact in market confidence, helping to reduce the NPL pricing gap
3. Banks need to be encouraged to establish action plans with time-bound targets.
5. Strengthening insolvency frameworks (laws and institutions).
6. Provision of incentives on NPL tax treatment and development of distressed asset markets
7. NPL pricing gap is major obstacle to sale of NPLs. Pricing gap has many sources: accounting, regulatory and market → Need to tackle the issue from every angle.
8. Size has an important implication for the development of distressed asset markets → Importance of developing a truly EU Capital Markets Union.



Thank you!

WB support in NPL resolution efforts in Europe

1. Good practice in NPL identification and early warning systems

Working paper: Loan classification and provisioning: current practices in 26 countries

<http://pubdocs.worldbank.org/en/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

2. NPL provisioning
3. Loan resolution frameworks (Montenegro, Albania, Croatia)
4. External NPL asset management models

Book: Public Asset Management Companies: a toolkit

<http://wbescso3.worldbank.org>

2. Toolkit for NPL resolution (Slovenia)
3. Corporate governance arrangements for NPL resolution