Non-Performing Loans: lessons learned - and challenges ahead

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The views expressed in this presentation are solely those of the author.
Outline

1. Key lessons from previous crises

2. Challenges and policy proposals
Europe went through an NPL surge pre-COVID

NPL ratios for EA, in %, latest datapoint 2021Q2

Source: IMF
NPL resolution curbed by multiple impediments

Supply Side
- First mover disadvantage
- Unwillingness to realize losses
- Accounting recognition of cost of recovery
- Bans/restrictions on loan sales
- Lack of expertise in asset management and asset valuation

Demand Side
- Information asymmetries
- Barriers to investor entry
- Imperfect excludability: creditors compete with each other

Structural & Legal Issues
- Weak and unpredictable insolvency frameworks
- Opaque and lengthy collateral enforcement
- Lack of debt enforcement capacity

Source: ADB (2021), Non-Performing Loans in Asia and Europe - Causes, Impacts, and Resolution Strategies.
Different problems require different solutions

- Country-specific conditions determine the right combination of NPL solutions
- Resolution by banks always part of the solution mix
- Market-based solutions often suffer from market failures - also in the euro area at the beginning of the last NPL wave

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<th>Nature of shock</th>
<th>APS</th>
<th>Public AMCs</th>
<th>Securitization</th>
<th>Direct Sales</th>
<th>Debt Restructure</th>
<th>Out-of-Court Workout</th>
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Source: ADB (2021), Non-Performing Loans in Asia and Europe - Causes, Impacts, and Resolution Strategies
COVID NPLs: “This time was / is different”*

- Banks in Europe better prepared (e.g. higher capitalisation / loan loss provisioning)
- Much better understanding of NPL management and resolution approaches
- “Whatever-it-takes” policy mix with “European characteristics”:
  - Massive anti-cyclical policy mix that integrated also macroprudential/regulatory policies in a systemic way
  - ECB’s monetary policy easing
  - EU-level easing: suspension of the fiscal, state aid and competition rules
- More willingness to support the banks; crisis didn’t originate from the financial sector

* Based on R. Martin, Nagy-Mohacsi, P., Ribakova E., Fortun-Vargas, J. M. (2022), The COVID Non-Performing Loan 'Tsunami' that Never Happened and How to Avoid it Now, SUERF Policy Brief No. 276, February
Outline

1. Key lessons from previous crises

2. Challenges and policy proposals
NPLs: challenges going forward

- ‘Legacy NPLs’ (in some countries)
- Unwinding of remaining COVID support measures
- Economic impact of the war in Ukraine(!):
  - Trade disruptions - goods and services (including e.g. tourism)
  - Energy and food price increases
- Inflation and the end of the long period of (highly) accommodative monetary policy
- Overvalued asset prices (including in real estate)
- Increased indebtedness
Housing prices & private sector indebtedness

Source: OECD data.
Policy proposals

- Key lesson of the last NPL wave is that speed is of the essence when dealing with strong NPL increases
- Need to close remaining gaps in ‘NPL infrastructure’
  - Review loan enforcement regimes and insolvency frameworks
  - Remove remaining obstacles to the functioning of secondary NPL markets, incl. the use of NPL securitization schemes
  - Review and revise EU regulatory framework to make Asset Management Companies (AMCs) a realistic NPL resolution again
  - Reconsider AMCs at the EU level, in case of a substantial increase in NPLs.
Success factors for systemic AMCs

- AMCs have a strong track - if properly designed and managed!
- Normally don’t require large start-up costs; publicly owned AMCs are, however, (contingent) liabilities
- Key determinants for AMC success
  - Appropriate transfer prices; key to avoid moral hazard problems
  - Asset selection; CRE and property development particularly suitable; corporate loans also suitable
  - Operational independence and professional management!
- AMCs in Asia often seen as part of ‘crisis infrastructure’; complement to ELA, Deposit Guarantee Fund etc.
Thank you!