



CROATIAN NATIONAL BANK

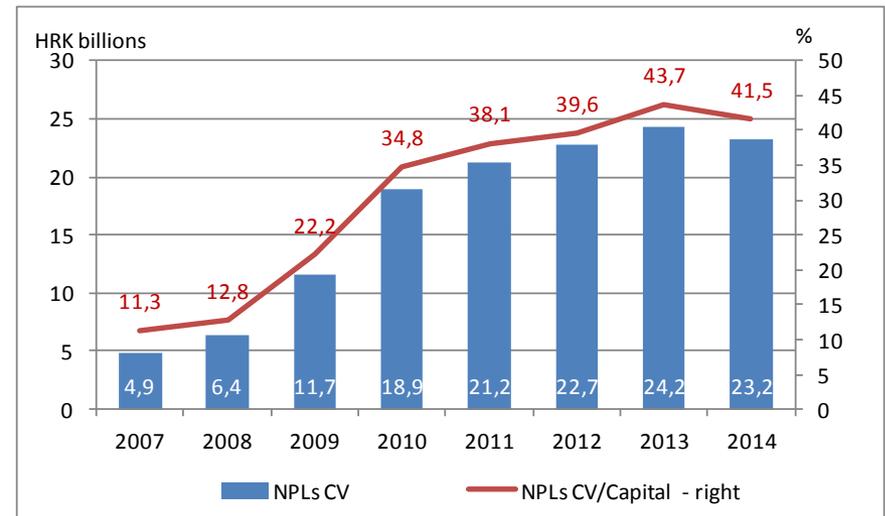
NPL resolution – practical issues

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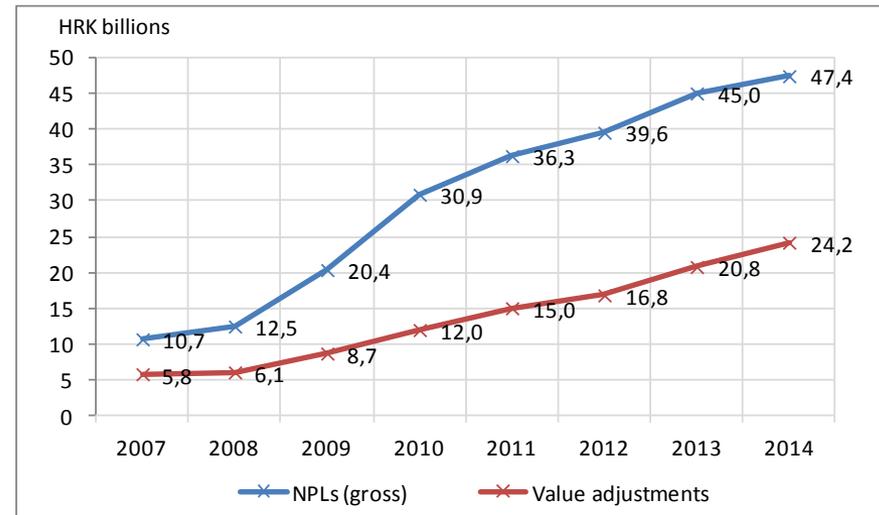
NPLs – time to move

- NPLs represent a visible burden on banks' balance sheets and P&L
- More effective NPL resolution requires practical and workable solutions, designed for individual segment and product
- Those solutions should work now and here, activating idle assets and removing any accounting overhang



The problem of carrying value

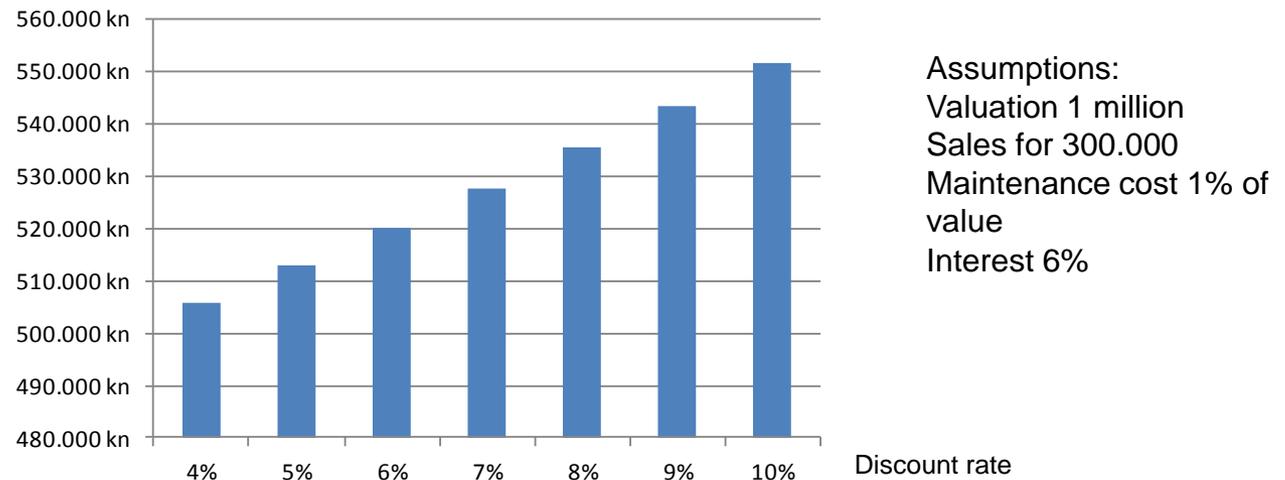
- Provisioning lags behind the NPL growth. The risk recognition is slow, as banks perform regulatory arbitrage using overly optimistic assumptions in application of IAS 39
- The whole issue of valuation is based on usage of “once upon time” value of real estate. Usually, “market value” should be derived from assumptions as for some asset classes there were no relevant transactions for years
- Faster resolution and more aggressive haircut seem to be a superior policy from shareholders’ perspective



Resolving corporate loans

**Liquidity
breeds
liquidity!**

Equivalent value of firesale for 30% compared
with 6 years sales process



- ❑ fast resolution creates value for shareholders, even if a radical haircut is applied
- ❑ “holding” strategy increases the reported capital, but most likely after liquidation shareholders will be worse off
- ❑ resolution creates additional business “around assets”, increasing economic activity and banks’ income
- ❑ 1: company that can’t service a million, can service 300.000.
- ❑ 2: helping debtors to resolve problems will enable them to help banks earn money
- ❑ 3: in reality a **bank can’t under-value a NPL, as the market will provide correction fast.**

NPL resolution – corporate – ways forward

- ❑ In a temporary distorted market protecting the accounting value of property by **limiting its liquidity** could be a reasonable approach. Nevertheless, a temporary situation can't last for seven years. Therefore, the market value of a pledged real estate should be, as quickly as practical, recognized through a final transaction with unrelated party
- ❑ The NPL resolution and/or provisioning removes old risks from balance sheets, creating a capacity for a new credit activity (and, consequently, new income)
- ❑ Possible regulatory support:
 1. Changing the tax treatment of haircut
 - haircut given to corporate clients could improve their solvency and alleviate credit risk. Precondition for its wider use is making it tax-deductible, even if legal proceedings weren't initiated.
 2. Improving the legal process – still slow and uncertain, full of surprises for creditors

Issues obstructing the housing NPL resolution

- ❑ In case of retail, optimal strategy seems to be different from the one in case of corporate.
- ❑ A significant collection through market-based foreclosure would cause low collectability ratio, as negative demographic trends and 17% of empty housing units create one-sided market;
- ❑ Once the foreclosure is completed, it isn't realistic to expect further collection from the debtor. Legal enforcement of "recourse" creates more cost than value;
- ❑ Aggressive foreclosure would demotivate parts of population to participate in legal economic activity and would have negative impact on consumption of most households due to the wealth effect.

Housing – resolution modalities

- ❑ Gradual exposure of repossessed collateral to the market would most likely be preferred
 - ❑ In most cases rescheduling of loans, even with a haircut, increases the expected present value of future receivables compared with repossession
 - ❑ When foreclosure is unavoidable, *legal costs* could be significantly decreased by offering mutually acceptable solutions - keeping the debtors in the property for a reasonable period of time and giving them an opportunity to buy it later at the market price; in case of all real estate units except most liquid ones, the advantage for the creditor is quite obvious
 - ❑ It would be beneficial if major banks would standardize their policies on rescheduling/haircut/foreclosure and require the *government* to support them by administrative and tax measures
- this would enable avoiding *negative PR* and help with underwater debtors

Possible regulatory support

- ❑ Defining the income tax treatment for haircut or repossession without recourse, removing any tax uncertainty from banks and debtors
- ❑ Creating the transaction tax shield in case of sale and leaseback arrangement with the current tenant
- ❑ Extending such tax shield on cases when the same tenant buys back the property in future