Resolution of non-performing loans in the cross-border bank

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The bulk of CESEE NPLs are owned by European cross-border banks. Group policy in recognising asset quality, capacity in subsidiaries and constructive resolution jointly done by credit institutions in local markets will be essential in the workout effort. Succes elsewhere in Europe, including in the management of NPLs in the Baltic countries by Nordic bank groups, offers some lessons.

European bank groups have been instrumental in developing financial systems in central and southeastern Europe (CESEE). Extensive research has confirmed that the transfer of expertise, technology and management skills has supported widening access to credit and sustained credit growth in host countries. These benefits remain largely intact even when the after-effects of excessive lending and poor credit standards in a number of countries are taken into account, and even though the European financial crisis has exposed recipient countries to a protracted wave of deleveraging and the balance sheet repair within the European banks. CESEE economies are among the emerging markets that are most financially open and show the highest foreign ownership shares within banking systems. It is the only emerging markets region where a period of capital inflows – predominantly through these banking networks – have engendered sustained growth benefits.[2]

Since 2009 European financial flows have reversed, and the IMF estimates that foreign banks have cumulatively withdrawn about 15.5 per cent of host country GDP since then. Following the European recession and the sudden stop in credit expansion a substantial stock of non-performing loans has emerged within the CESEE region. Given the still dominant role of the European cross-border banks in the CESEE it is clear that these institutions own the predominant share of non-performing loans. Moreover, CESEE banking systems in the western Balkan region not only show very high foreign ownership shares, though also very high concentration of ownership. The organisation of the workout process within cross-border bank groups will therefore be essential to the success in dealing with the emerging Europe's bad loan overhang. What experience is there with regard to best practice in organising a group-wide workout?

Parent bank commitment is essential

A first, and obvious, pre-requisite for the workout effort is of course that the parent bank signals a clear commitment to their subsidiaries. In the Baltic countries, for instance, NPL ratios shot up substantially in the immediate aftermath of the 2008 financial crises. Nordic banks, which jointly owned the majority of the local banking

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[1] EBRD Consultant, and Lead Economist Central Europe, respectively. These findings are based on interviews with parent level and subsidiary workout units of a number of cross-border banks conducted by Lars Nyberg in 2015. All views expressed in this note are the authors' only.

[2] See Chapter 3 in EBRD Transition Report 2009: Transition in Crisis?

sectors in all the three Baltic countries, were surprised by the speed of the development, but they were also reasonably well prepared for the following workout effort, still remembering the financial crisis in Sweden in early 1990s. Even if the workout was done locally, the parent banks from the very beginning took firmly control of the process.

Today, the boards of the Austrian and Italian banks are focused on NPL ratios. Boards usually set high level targets for the NPL group workout effort, such as desired cash generation from restructuring and sales or even desired NPL ratios. There are other important targets that require board-level attention, such as high cost to income ratios in the domestic branch network or complicated governance structures, and consolidation of the subsidiary network. These issues may be as important as the NPL situation in the CESEE subsidiaries.

ECB supervision and market scrutiny reinforce a group-wide NPL strategy

All key European bank groups are considered systemically important as such have been subject to **SSM supervision** since October 2014. Under the SSM regulation, the powers of the single supervisor cover only credit institutions established in participating countries (as yet these are only eurozone countries, although also other EU countries which may decide to "opt-in"). However, according to the regulation the SSM is tasked to safeguard financial stability in the *entire* European Union and in each member country (whether participating in the banking union or not). The SSM will apply the so-called single rulebook, and thereby seek to ensure more consistency. This will entail a more uniform and impartial treatment of foreign host countries. Standards for NPL classification for regulatory reporting have been harmonised across the EU through the new EBA mandated asset quality definition. Banks that entered the SSM have also undergone a comprehensive asset quality review (AQR) and accompanying stress tests, thereby establishing residual capital needs. AQRs and stress tests were run on a *consolidated* basis, and included subsidiaries and branches *outside* the SSM area.[3]

Parent level commitment may be further reinforced by recent changes in **rating agency methodologies**, which have put NPLs much more squarely within their assessments. Moody's, for instance, in March 2015 announced a new methodology for bank ratings assessment, which spelled out substantial detail regarding problem loan definitions, adequate provisioning levels and collateral coverage. This seems to have set a new standard for addressing NPLs at parent and subsidiary level.[4]

Both regulation and market scrutiny are powerful incentives for an NPL strategy aiming at bringing the NPL ratio down. That said, bank groups continue to enjoy exceptionally low funding costs and high liquidity. Therefore the 'cost of carry' is limited. Banks can keep their NPLs on the balance sheet without greatly affecting the result as shown in the P&L account. If, on the other hand, they would sell the NPLs at market prices, which may be considerably lower than the book values, they would have to take losses that would eat into their capital. In countries where the judicial system allows for long periods

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[3] For details see Lehmann and Nyberg (2015): Europe's banking union in the global financial system: constructing open and inclusive institutions, EBRD Working Paper no. 175.
[4] Moody's (2015): Rating Methodology, Banks.

before possible foreclosure, sometimes up to ten years, market prices may be very low. In such cases, incentives for banks to keep the NPLs in their books can be substantial. If the cost of doing nothing is small and the gain of restructuring and selling even negative, banks will think twice before they bring their NPL ratio down. In the cross-border big bank, incentives may vary a lot between subsidiaries. The parent and the host, and home country supervisors will have to provide incentives.

The successful group workout depends on capacity in the subsidiaries

There are good arguments for taking non-performing assets outside the group balance sheet and into separate asset management companies. However, for the largest part the group workout effort will remain within the bank.

European cross-border banks have adopted a wide range of organisational models, from the highly centralized to those giving considerable autonomy to local subsidiaries.[5] This will typically be reflected in the organisation of the workout units as well. However, in this area there is a stronger case for a greater de-centralisation of resources to subsidiaries, which should all benefit from common standards and shared expertise.

When the financial crisis hit Europe in 2007-2008 and NPLs started to accumulate, most cross-border banks operating in the CESEE region were unprepared, both in the subsidiary locations and at parent level. Central units for handling NPLs at parent level were set up fairly quickly, but local units took more time to establish, partly due to the scarce availability of competence in each of the countries where subsidiaries worked. Today, NPLs that originated in subsidiaries are largely taken care of locally. Competent staff has been hired and trained locally and the local units work according to expectation.

The successful experience of Nordic bank groups and their networks in the Baltic countries suggests that central units should be responsible for the setting of subsidiary targets, determined by the group board. Parent level management needs to determine policies for subsidiary workout processes and get involved in decisions above certain limits. Central units should also provide support in more complicated cases and in cross border workouts.

Much progress has been made within the principal Austrian and Italian bank groups. Subsidiaries now seem to have adequate local workout units which take care not only of SME and retail NPLs, but also of corporates. This includes closer scrutiny of pre-NPL credits, particularly corporates, which are not classified as workout cases. The work on NPLs is typically separated from normal banking activities and customer relations, also in the subsidiaries. A 'Chinese wall' between banking and workout is respected and originating bankers are not transferred into workout assignments. There is restructuring staff in many of the subsidiaries and recovery units have typically been established.

[5] BIS (2014): Bank business models, BIS Quarterly Review, December.

That said, restructuring remains challenging for the subsidiary banks and key areas still require **capacity building**:

- Corporate workout is the most challenging area. Banks are familiar with different financial solutions, but operational restructuring is typically part and parcel of a restructuring plan.
- Taking an active role in viable companies, for instance following a debt-equity swap, is not a natural role for a bank. With immature systems for corporate governance in their host markets and just a subset of typical risk management functions having been developed, subsidiaries will need to build up this role.
- Banks may also come to acquire substantial portfolios of real estate, both residential and corporate, which may force them to take on roles akin to those of real estate managers. This will require special skills for restructuring and sales.

This agenda creates significant challenges for the **human resources policy** within the bank groups. Competence in the subsidiaries has been built gradually, but further training is needed. Moving people from traditional banking into workout units is usually not simple. Skills are different and the job may be seen as less attractive. Hiring competent local workout staff is difficult and time-consuming, particularly in countries with little restructuring experience. There is therefore substantial need for in-house training, both locally and at parent level. Knowing the legal procedures of each country and how they are used in practice is obviously needed. Out-of-court procedures are getting more extensively used in certain regions and taking advantage of such procedures requires training. Training in purely technical issues concerning instruments of financial as well as operative restructuring has also been in demand.

Finally, the build-up of NPLs poses challenges for the conduct of bank subsidiaries in negotiating workout solutions with their peers in **multi-creditor workouts**. INSOL principles work best when they can be applied to a number of cases simultaneously, and adherence to such principles is in the interest of the subsidiary in terms of value recovery and establishing a long term adherence to certain workout principles. Out-of-court restructuring principles are a key tool to overcome the collective action problem that is inherent in a multi-creditor workout. As yet, out-of-court procedures are difficult and mostly used in the more advanced CESEE countries, such as Poland, the Czech Republic, or Slovakia. These procedures embody a "gentlemen´s agreement" and hence require sufficient trust among banks and other creditors to be useful. Even in countries where there is an agreement reflecting the INSOL principles, banks are tempted to take advantage of a superior credit position. In these cases the parent can give guidance and support to subsidiaries, possibly in coordination with other parent banks, which is in the long term interest of its value recovery.

Sound valuation principles across the group

CESEE banking systems still exhibit widely differing provisioning ratios. Coverage ratios in vary between 45 and 75 per cent (see the NPL Monitor).

The valuation of collateral is crucial in judging whether NPLs have been sufficiently provisioned for. A correct valuation of collateral, e.g. real estate (commercial and

residential), is difficult when no or very few transactions have been done in the market. No benchmark exists upon which to base collateral values. If anything, this tends to bias collateral values upwards rather than downwards, giving book values above market prices. Banks may be overly optimistic on recovery estimates, while investors are sceptical that effective asset recovery can be done.

It is also questionable whether banks take sufficient account of the internal costs of a long recovery period, including costs of maintaining the value of the collateral. Long recovery periods are a problem in countries with ineffective solvency regimes, where time to foreclosure often reaches five years and more.

Nevertheless a subsidiary may forcefully argue that keeping a loan or a collateral and working it out, perhaps after a minor financial restructuring, will be much better for the bank than selling at a depressed or very questionable market price. Typically, incentives to keep the NPLs on the book rather than selling them are high in most banks. The assets are rarely considered to be as bad as implied by the market. If the parent bank is serious in its NPL policy, it should supervise closely the actual valuation and provisioning in the subsidiaries.

EU and euro zone institutions have promoted common standards for provisioning and collateral valuation, as embodied in the 'Single Rulebook'. Parent banks have an interest in presenting their non-EU subsidiaries to adhere to an equivalent standard so that their subsidiary network is not seen as a liability of poorer asset quality.

Portfolio sales by subsidiaries need to be supported by a group-wide strategy

The sale of certain types of distressed loan portfolios should be a crucial component of banks' efforts to return their balance sheet to health. Yet, successfully selling a loan portfolio to a specialist investor in distressed loans is a complex process that requires careful preparation of the portfolio, and demands high standards of data availability and support to potential bidders. Overall, there is a new dynamic in the NPL market in emerging Europe, yet transactions have been concentrated in just a few markets, and many potential transactions ultimately failed.[6]

A key constraint has been the poor coverage of the CESEE markets by independent **loan servicers**, which handle the workout of the loans while still keeping them in the bank´s balance sheet. If permitted by law, which is the case in most, but not all, countries, loans can also be sold to such non-bank service companies. This is common for consumer and retail loans and sometimes also for SME loans secured by real estate. The service companies take over the responsibility for collecting interest and amortization and take legal actions if collection fails (foreclosure). If collateral – usually real estate - has to be taken over, this collateral is serviced and eventually sold. Some service companies may also buy bigger commercial loans or portfolios of commercial real estate to restructure and sell.

[6] See the Rocha (2016): NPL Resolution – sale of loan portfolios in the CESEE region, available on this website.

Given that very few transactions have been successfully launched in the CESEE region it is clear that capacity within the bank subsidiaries to prepare and support a successful loan process is limited. While the subsidiary will always be the point of contact for potential bidders, parent banks may be able to support this process through better interaction with potential bidders, ensuring a uniform data quality and investor support, and establishing a credible track record of successful sales that instils confidence among investors. Support to loan servicing companies that may be able to support the process across a number of markets could provide crucial scale and replicability.

Conclusion: successful NPL resolution in emerging Europe will depend on group-wide strategies

Substantial capacity has been established in workout units at both parent and subsidiary level. After further provisioning of portfolios some recent loan sales point to a greater convergence between book and actual market values. The principal European bank groups from Italy, Austria and Greece control a significant share of CESEE banking markets and own the bulk of distressed portfolios. An integrated strategy that applies across the entire group – whether the subsidiary is in the SSM area, other EU countries or outside the internal market – is crucial to a successful NPL workout in the region. Three key elements in such strategies now seem essential:

- Further capacity building within local workout teams, in particular in modern restructuring techniques, and in systems and processes that support potential sales;
- ensuring greater consistency in conducting multi-creditor workout discussions, specifically by adopting INSOL-type principles across the group and fostering locally relevant versions within each market;
- support to the establishment of local service companies, which may possibly operate across several markets.