European Bank
for Reconstruction and Development

Panel Discussion on Corporate Governance and Non-Performing Loans

Background

The existing stock of Non-Performing Loans (NPLs) in Europe – estimated at over EUR 1 trillion - remains a serious concern for European regulators and national competent authorities. NPLs impact banks' profitability, divert banks' resources from ordinary lending activities and reduce new lending into the economy. This ultimately holds back the country's potential for growth and, in high NPL countries, can even threaten the financial stability of the banking system as a whole. Given the financial interconnectivities in Europe, the threat of potential spillovers between countries is considerable. NPLs need to be tackled on a number of levels, starting with the establishment of robust corporate governance practices and NPL management within banks, oversight and emphasis by regulators on robust lending processes and harmonisation of laws and regulations in Europe to support sound governance and efficient NPL resolution.

On 3 May 2017, the Financial Law Unit of the EBRD Legal Transition Team (LTT) hosted a panel discussion to explore the relationship between NPLs and poor corporate governance, to consider how deficiencies in corporate governance and legal frameworks may have exacerbated and prolonged the NPL crisis, and to propose the ways in which such weaknesses may be addressed. The panel consisted of:

- **Mary Ellen Collins**, Non-Executive Director and former EBRD Director and Head of Corporate Recovery
- **Stephen Harris**, Executive Director and Insolvency Practitioner, Ernst & Young
- **Stilpon Nestor**, Managing Partner of Nestor Advisors and corporate governance expert
- **Loren Richards**, Partner, Clifford Chance LLP, Frankfurt

The panel discussion was chaired by Gian Piero Cigna, Corporate Governance Senior Counsel and Catherine Bridge Zoller, Insolvency and Restructuring Senior Counsel, Legal Transition Team of the EBRD.

Discussion

The discussion considered the role of corporate governance in the origins of the NPL crisis, NPL management and resolution by banks, the environment and dynamics of NPL management and concluded with observations by the panellists on the greater role of regulation in the area of NPL management in the future, especially following the introduction of the new European Central Bank's (ECB) Guidance to banks on NPLs[1] (the "**ECB Guidance on NPLs**").

Corporate governance as a contributing factor to the high stock of NPLs in Europe

Weak corporate governance of banks – albeit not the sole or the primary culprit – was generally considered by all panellists to be a contributing factor to the origins of the current NPL crisis. Poor standards of borrower corporate governance were also held to be a contributing factor.

[1] Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

Nevertheless, the roots of the NPL crisis and the role played by corporate governance were fact-specific, varying from jurisdiction to jurisdiction, and influenced by various factors such as the characteristics of the banking systems – including the (lack of) clear accountability lines in banks and oversight capacity of boards - market structure, industry concentration and underlying macro-economic robustness. For example, a primary contributing factor in the U.S. sub-prime crisis was arguably the market structure itself, which involved a disconnect between origination and ownership of credit risk thatwas compounded by a lack of focus on macro-prudential issues by the regulatory authority. Meanwhile the Greek crisis was largely due to a macro-economic collapse (shrinkage of GDP by 27% in 6 years). Conversely, the NPL crisis in countries such as Spain, Ireland and to some extent Slovenia,[2] could be attributed to weaknesses in bank governance.

Corporate governance-related weaknesses identified as part of the discussions in the origin of high NPLs within banks included, amongst other matters, inadequate credit governance practices, weak risk management and controls (including the lack of group-wide risk management structures in banks), competitive pressures leading to a magnified risk appetite and lack of effective board oversight and limited expertise of board members in managing the business downturn. Additionally, in some countries, lack of independence at board level and vested interests of senior management led to detrimental lending practices involving lending to related parties (including associates, powerful clients and politically-connected businesses). This was sometimes coupled with the limited oversight by regulators which mainly focused on quantitative financial data and less on the qualitative practices adopted by institutions. This is evidenced by the fact that the the SSM Supervisory Manual, Processes, Procedures and Methodology for the Supervisor of Significant and Less Significant Institutions (the Rulebook for banking supervision in the Euroarea) does not address internal governance and credit risk in any detail.

Management by banks of existing NPL stock

The recently-introduced ECB Guidance on NPLs recommends that management personnel in high NPL banks should approve an NPL strategy which lays out the "*bank's approach and objectives regarding the effective management (i.e. maximisation of recoveries) and ultimate reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio*."[3] While the NPL guidance is non-binding in nature, banks in Eurozone countries will have to explain and substantiate any deviations upon request by the banking supervisor. Good corporate governance is achieved where there is sufficient pressure or incentive to comply from all sides. Because of previously "weaker" regulatory pressure, some banks may not have seen the need to implement better practices regarding management of NPLs. However, with the potential for additional supervision of NPL management, at least in Eurozone countries, arising in the future the approach to corporate governance and NPL management may improve, albeit with time. The ECB Guidance on NPLs also mainly concerns the stock of NPLs, to which measures are also expected by the European regulators to also tackle new, future NPL flows.

The panellists concluded that there was no one-size-fits-all solution to whether NPLs should be managed in-house or externally. NPL portfolios could be dealt with internally, transferred to a third

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[2] See, for instance: OECD, Banks' Restructuring and Smooth Deleveraging of the Private Sector in Slovenia. Economic Department Working papers No. 1059, by Olena Havrylchyk, page 8 (http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2013)51&docLanguage=En)

[3] ECB Guidance on NPLs, pg. 8

party or sold to so-called “bad banks” or asset management companies (private or publicly funded) depending on the context. In countries such as the UK, which experienced a rise in NPLs in the 1980s, banks did not manage NPLs on their own. Instead, they drew on law firms and accounting firms to buttress the expertise and resources that they lacked. Internal management of NPLs by a bank requires a lot of resources and expertise, which can be very costly. This is particularly an issue where NPLs relate to SME-type exposures as there is little incentive to devote a high level of resources for small recovery amounts. Discussions also highlighted that a proper remuneration scheme, including bonuses, is critical to attract the right profile of people for NPLs workout. This may nonetheless prove to be a challenge in small countries where relevant expertise and know-how is scarce. As a result, small banks with limited resources but high NPL levels may not be in the best position to handle and manage NPLs on their own and alternative solutions should be explored.

Generally, the type of governance structure employed by banks for NPL management varies according to the size of the bank and the type of NPL stock. When the level of NPLs in the system is low, NPLs are usually managed internally by specialised workout units within banks. It is generally-accepted good practice to transfer management of NPLs to a separate team within the bank, as the originating team is typically conflicted (for example where there is a long-standing business relationship with the distressed borrower) and often does not have the required expertise to manage and to resolve NPLs. Nonetheless once NPLs become a systemically important part of a bank’s books, it may be that NPL portfolios have to be transferred to a separate legal structure (within the bank or fully deconsolidated).

When the levels of NPLs in the banking system as a whole are very high, a wider, systemic solution may be needed. This can potentially take the form of an asset management company (AMC) that absorbs credit risk from the system. This, however, comes with its own challenges, such as the notion of state aid and burden sharing. In the absence of such system-wide AMC, banks in the worst cases are left to manage high levels NPLs which can account for large portions of their balance sheet. This is the current situation in Greece, for example, where NPLs account for nearly half the balance sheets of local banks. In addition to significant reputational damage in Greek society, Greek banks risk intensifying downward pressures on asset values if they were to try too hard to execute on NPL collateral. Clear rules for regulating the recognition and migration of credit from performing to non-performing should thus be established and consideration given to bank-specific, as well as to wider systemic solutions.

The way that NPLs are managed within the bank’s internal governance structure is very important. In some cases risk committees within banks have assumed the role and responsibilities of “NPL committees.” In order to maintain impartiality in decision-making, NPL committees should be separated from the actual risk committee functions, which are responsible for the broader risk profile of the bank. In Greece, local legislation now requires that the boards of sysytemically important banks should include at least one board member with “*relevant expertise and international experience of at least five years in the risk management or management of non-performing loans. This board member will focus on and will have sole responsibility for management of non-performing loans at board level and chair a specific board committee of the credit institution that deals with NPLs*.”[4]

[4] See Art. 10(8) of Law no. 3864/2010, as amended, lastly by Law no. 4346/2015.

Importance of the legislative and institutional framework

Since the 2008 financial crisis, there has been a noticeable improvement in the European jurisdictions as regards the introduction and development of effective tools and mechanisms for corporate recovery.

Nonetheless, the concept of "corporate recovery" and the use of restructuring and reorganisation procedures is still under-developed in many countries, with social and cultural differences having an important impact. More needs to be done to help certain countries master the basic elements of corporate recovery. An important starting point would be addressing the potential for so-called 'hold-out creditors' to disrupt and ultimate frustrate a restructuring process. Another key point would be to clarify conduct rules for directors and corporate management where the borrower enters into the so-called "zone of insolvency". Not only would this provide legal certainty to all involved parties, but it would also equip directors with a significant tool to force their creditors to the table.

Institutional systems and enforceability are also key to achieving an effective restructuring and need to be addressed at the same time as the legislative framework. Countries with strong institutional systems are well-positioned to tackle the NPL problem through either legislative or regulatory solutions.

Looking forward

Ultimately there needs to be a consensus across Europe among national competent authorities and a clear strategy which lays out specific goals and timelines to address the NPL issue in relevant jurisdictions. Important progress is being made at the European regulator level but more efforts are needed to tackle root issues. Improving and homogenising the regulatory environment would be a catalyst for reducing NPL stock and improving management of NPLs going forward. In addition, efforts must continue to address the asymmetry between the pool of the experts available in different jurisdictions and the size of the NPL problem. In some countries, it may be beneficial for example to bring in external expertise to manage NPLs and to train local personnel.

Clearly, weaknesses in corporate governance are at least partially accountable for the high level of NPLs. Corporate governance is, nevertheless, only one of a number of interlinked contributing factors and variables. Further research is required on a country by country level to identify the exact corporate governance variables that have the greatest impact on the performance of banks and the size of their NPL portfolios.

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The video and audio recording of this panel session can be found in the following links (Video / Audio).