Non-Performing Loan Write-Offs: Practices in the CESEE region

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Objective

The objective of this brief is to provide insights into non-performing loan (NPL) write-off practices in the world and in the CESEE region specifically. It will suggest potential policy actions by prudential regulators to reduce the outstanding stock of NPLs.

Background

Europe and Central Asia (ECA) stands out as the region worst affected by the global financial crisis. The crisis left a lasting legacy of high NPLs in many countries, which in some cases exceed 50 percent. The buildup of NPLs was a clear indication of deficiencies in loan underwriting and NPL resolution frameworks, and a failure by banks and authorities to recognize and respond in a timely manner to the growing problem.

Many authorities failed to implement strict regulation on NPL recognition that consequently delayed the resolution of NPLs. Ambiguous and inconsistent NPL definitions across countries and regulatory environments that allowed banks to be too slow to recognize the true state of asset quality were indications of insufficient rigor in authorities’ attempts to implement adequate prudential regulation based on good practice. This protracted and complicated the resolution of banks’ asset quality, which in many cases was further complicated by deep-rooted weaknesses in the insolvency framework.

On many occasions, banks were not willing and/or able to recognize the scale of the asset quality problem. This was due to i) expectations that the economy, including asset prices, would recover in the foreseeable future, ii) lack of capital space and/or negative earnings that would crystalize in the case of proper recognition and provisioning of impaired assets, or iii) the limitations of the International Accounting Standards (IAS), in particular IAS 39. Together with regulatory forbearance practices in certain jurisdictions adopted for similar reasons, this led to a delay in NPL resolution in the ECA region.

By 2019, the European Single Supervisory Mechanism (SSM), the European Banking Authority (EBA), and the Basel Committee finished work on i) a common definition of NPLs and non-performing exposures (NPEs), ii) rules for NPL migration between credit risk

1 With thanks to Miquel Dijkman, Juan Ortiz, and Valeria Salomao Garcia for their comments on this brief.
2 Central Europe and South-East Europe
3 For example, Greece and Ukraine.
5 Established in 2014.
categories, upgrades in particular, and iii) operational aspects of NPL resolution. In addition, SSM and EBA elaborated on i) NPL provisioning rules and ii) collateral valuation frameworks. Regulation and/or guidance on NPL write-offs were not, however, addressed extensively. Regulators might have felt that this particular aspect should be left purely for banks to decide and they opted for mandatory rules on loan write-off in only a limited number of cases, mostly in countries where the NPL problem was systemic.

The transition towards expected credit loss (ECL) models, as part of International Financial Reporting Standard (IFRS) 9 effective from January 2018, should in principle help to promote the recognition and adequate provisioning of problem assets at an earlier stage. The standard requires provisioning based on a forward-looking ECL model to compare with the incurred loss model under IAS 39.

1. **What is a write-off and why it is necessary?**

A write-off is an accounting term for the formal recognition in the financial statements that a borrower’s asset no longer has value. Usually, loans are written off when they are 100 percent provisioned and there are no realistic prospects of recovery. These loans are transferred to the off-balance sheet records. IFRS 9 requires a whole or partial write-off if “an entity has no reasonable expectations of recovering the contractual cash flows on a financial asset”.

A write-off does not preclude the bank from enforcing, selling, or transferring the credit to another entity. Writing-off a loan does not entail forgiving the debt. The borrower still owes money to the bank; however, the bank has derecognized this asset from its financial statements due to uncollectibility. In case the borrower resumes servicing its debt, or the exposure is sold, a recovered amount would be directly recorded in the profit and loss (P&L) account.

While the exact timing of a write-off is not defined in accounting standards, the prudential regulator might impose regulatory requirements or set supervisory expectations for write-off based on quantitative (e.g., days-past-due) or qualitative parameters. If the NPL problem is of a systemic nature the regulator might introduce such a framework more forcefully and quickly.

An ambitious NPL write-off policy provides several benefits for banks and the financial system. Firstly, by resolving NPLs banks can focus on core business (i.e., financial intermediation) in terms of time and resources. By efficiently dealing with NPLs, including writing off, the bank can allocate its productive resources to new lending, instead of becoming an asset management company of “bad assets”. Secondly, while the main aim is the liquidation of assets with low recovery prospects, the consequence of an NPL write-off typically is a decrease of the NPL ratio in banks. Country experience shows that this is a particularly efficient way to decrease the NPL ratio quickly (see country examples in section 2.3.). Thirdly, there are no negative effects on financial statements, provided that loans are already fully provisioned and losses already recorded in the P&L statements. Fourthly, a decrease in NPL ratio should improve a ratings agency assessment of credit risks in the bank or in the financial system.

Often banks, and sometimes regulators, raise arguments against write-offs, these can include:

a. By writing-off a loan, banks are giving up their enforcement right on the borrower. This is incorrect. Banks maintain their legal position against the borrower, even after a write-off, if they have fulfilled certain actions during a collection period, which is usually three years in European jurisdictions. The legal term for this action is “statute of limitations”.

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6 With transition periods in some jurisdictions.
7 IFRS 9, Article 5.4.4.
8 It is assumed that banks write off NPLs and sell uncollectable loans to debt collection agencies. If banks decide to hold assets over a short term (1 year) in their off-balance sheets, the efforts to collect those debts are less than during the initial NPL workout process (collaterals have been perfected, court processes initiated).
9 Statute of limitations is a defense that may be asserted by the borrower to defeat collection actions brought against him by creditors after the appropriate time has elapsed. In these cases, it is understood that the creditor has waived his right to pursue collection of the debt if no action is brought within a certain period.
b. Banks will encounter additional loss through additional provisioning in case they hold collateral against a loan, which in many cases is overvalued. This is a valid point as usually banks should provision for the uncollateralized part of an exposure only. The European Central Bank’s (ECB) initiative introducing phase-out periods for collateral treatment for provisioning purposes (see more in section 2.1.) partly addresses this issue. A common problem in ECA countries is collateral overvaluation\textsuperscript{10}, which leads to inappropriate provisioning of NPLs.

c. Judicial and tax impediments are preventing banks from writing off problem assets fully. In many jurisdictions, judges’ interpretations and ambiguous or restrictive tax rules constrain banks from writing off NPLs. A more detailed discussion on specific cases is provided in section 3.

An effective write-off can take place if a loan loss provisioning framework in a country is robust and allows for realistic loss recognition in a timely manner. Regulatory forbearance practices, which can be observed in a few countries, do not facilitate an efficient NPL write-off.

While the loan is in an active restructuring phase, there is more chance of the borrower’s financial liabilities being restructured in a holistic and meaningful way capable of restoring financial viability. After writing off, the chances of the borrower’s revitalization decrease. Country experiences show (Greece\textsuperscript{11}, Albania\textsuperscript{12}, Ukraine\textsuperscript{13}) that in cases with high national NPL ratios many companies are classified as “zombie companies”, and a meaningful restructuring of their debts is constrained, mainly due to non-viability of business. Additional constraints for NPL restructuring include: i) inefficient in- or out-of-court resolution, ii) complicated multi-lender cases, or iii) strategic defaulters\textsuperscript{14}. On a system-wide basis, this means that borrowers might not be “bankable” and resources are used sub-optimally.

Regulatory requirements for writing off NPLs stimulates NPL resolution as can be seen in country examples in section 2.3. However, it is vital to avoid situations where written off NPLs remain off-balance sheet for a long time without further action, which can be observed in few CESEE countries. A viable option for these assets is a sale, even at a very low price, instead of keeping assets with a low recovery value for many years, in extreme cases even over 15 years.

While a sale of written-off assets is one of the three main avenues for NPL resolution, there are cases where borrowers themselves repurchase banks’ written-off assets at a low price (e.g., Ukraine, Serbia, and Greece). Anecdotal evidence suggests that strategic defaulters avoid servicing their debts, wait for (sometimes even facilitate) the debt to be written off, then buy (directly or via auctions) those assets at substantial discount to the nominal amount. This creates a moral hazard problem. State-owned banks (SOB) and related party loans are two categories particularly vulnerable to this issue.

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\textsuperscript{11} PWC study (2015). 50 percent of companies were classified as zombie and almost zombie companies in Greece. These companies accounted for 43 percent of total revenue, 58 percent of capital employed, and 79 percent of net debt.

\textsuperscript{12} Deloitte study (2018). 54 percent of companies were classified as low and almost low performers relating to financial health rating statistics.

\textsuperscript{13} National Bank of Ukraine Financial Stability Report. Issue 3. June 2017. The top-20 business groups accounted for 49 percent of gross corporate loans, while 49 percent of this debt is accumulated in non-operating companies.

\textsuperscript{14} Borrowers hiding their true wealth or using or abusing legal frameworks in place. The term willful defaulters is also used with the same meaning.
2. Non-performing loan write-off – international experiences.

International experiences regarding NPL write-off differ. According to a Bank for International Settlements (BIS) survey\(^\text{15}\), most jurisdictions\(^\text{16}\) do not prescribe a timeline for loan write-offs, leaving this at the discretion of banks. In some jurisdictions, a loan assignment to the lowest credit risk category – Loss – prompts a write-off obligation; however, the timeline differs or is not specified.

2.1. Non-performing loan write-off practices in the EU and the US.

In the European Union (EU), the regulator (EBA) does not provide mandatory NPL write-off rules but some jurisdictions have introduced local guidelines in this regard (e.g., Portugal, Ireland, Slovenia, and Spain\(^\text{17}\)). In most cases, these guidelines are principles-based. Moral suasion has been used by a few regulators and supervisors to write-off NPLs. To facilitate full provisioning and consequent write off, the ECB has issued a guidance manual on prudential provisioning backstop\(^\text{18}\), providing that unsecured loans should be fully provisioned after two years and secured loans after seven years since recognition. The ECB considers NPL write-off practices as part of banks’ NPL resolution strategies and intends that it is included in the SSM’s supervisory review and evaluation process (known as SREP, or Basel pillar 2).

In the US, the loan should be written off within the same month that it is placed in Loss category. Under the US regulatory classification, the loan is classified as Loss when its collectability is questionable.

2.2. Non-performing loan write-off practices in Latin America and the Caribbean and Asia\(^\text{19}\).

Based on the BIS survey, two of 11 countries in Asia\(^\text{20}\) and six out of 10 in the Latin America and the Caribbean (LAC) region\(^\text{21}\) set a requirement for mandatory NPLs write-off when the loan is classified in Loss category and is considered unrecoverable. The time limits set for write-offs in six LAC countries range from seven to 24 months, sometimes depending on the original maturity of the loan.

![Write-offs and NPLs Path](chart.png)

Source: see in footnote 20.

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\(^\text{15}\) BIS study (2018).
\(^\text{16}\) Survey included: 11 countries from Asia, 10 from the LAC region, 19 from the EU, and the US.
\(^\text{17}\) EBA. Country stocktake (2017).
\(^\text{18}\) ECB. Addendum to Guidance on NPLs (2017).
\(^\text{19}\) Data from BIS (2018) survey.
\(^\text{20}\) For example, Hong Kong SAR.
\(^\text{21}\) For example, Argentina, Brazil and Panama.
2.3. Non-performing loan write-off practices in the CESEE region.

In many CESEE region countries, regulators are not setting specific rules for writing off NPLs beyond accounting standards (i.e., IFRS 9 or IAS 39). Thus, leaving banks themselves to create internal guidelines for write-off actions. However, in a few countries (Albania, Serbia, Macedonia, and Romania) regulators have decided to impose prudential regulation rules as a backstop to accounting practices. Albania, Serbia, and Romania, as part of their national comprehensive NPL reduction plans, introduced time-bound rules for NPL write-offs.

In 2014, the Bank of Albania (BoA) amended the regulation on “Credit Risk Management” by introducing a new requirement for NPL write-off after three years of the loan being classified in Loss category. Following this amendment, the NPL ratio in the banking system fell from 22.9 percent in March 2015 to 18.2 percent in December 2015\(^\text{22}\). The action by BoA was well justified due to the considerable build-up of Loss loans during 2012-2014.

An additional measure taken by the BoA in 2016, as part of the national Action Plan for NPLs\(^\text{23}\), aimed to facilitate the return to the economy of assets repossessed during loan collateral enforcement by banks. The new regulation required gradually increasing provisioning for repossessed assets which are held in bank’s off-balance sheet for too long - a five percent provision after one year and 100 percent after seven years for immovable assets and full provisioning after one year for movable assets\(^\text{24}\). The measure aimed to avoid a situation where banks become asset management companies of repossessed assets.

The National Bank of Serbia (NBS) issued a regulation on loan write-offs in August 2017 to tackle the NPL stock in the country. The regulator requires an immediate accounting write-off of NPLs when allowances for impairment equals 100 percent of its gross book value\(^\text{25}\). Partly due to this action, the NPL ratio in the country dropped from 12.2 percent in Q3 2017 to 7.2 percent in Q2 2018\(^\text{26}\).

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\(^{23}\) https://www.bankofalbania.org/Supervision/Action_plan_for_non-performing_loans/


\(^{25}\) NBS regulation (2017).

The National Bank of the Republic of Macedonia (NBRM) introduced amendments to credit risk management in December 2015. According to these amendments, banks must write off fully provisioned loans after “two years have passed from the date as of which the bank had been required to make impairment or allocate special reserve in the amount of 100 percent”. Mostly due to this measure, the NPL ratio decreased from 10.8 percent at the end of 2015 to 6.6 percent at the end of 2016. The NBRM estimated that loans in the amount of 4.8 percent of the total loan portfolio were written off during 2016.

In 2014, the National Bank of Romania (NBR) issued a set of recommendations to banks to clean the system of seasoned NPLs. The following recommendations were introduced: i) write-off or sale of fully covered uncollectable NPLs; ii) provisioning for all exposures after 360 days-past-due and for which no legal proceedings have been initiated; iii) the establishment of IFRS provisions for exposures to debtors of insolvent legal entities; iv) performing an external audit of the provisioning process for the loan portfolio as of June 30, 2014, and v) collateral valuation to be in compliance with international valuation standards. The outcome of these actions was a drop in the NPL ratio from 22.3 percent in March 2014 to 13.9 percent in December 2014.

2.4. Examples of non-performing loan write-off practices in Africa.

The regulators of Kenya and Uganda have opted for regulatory measures to prevent the accumulation of uncollectable loans on banks’ balance sheets. In 2013, the Central Bank of Kenya issued Prudential Guidelines requiring the write-off of loans classified as Loss within 180 days since classification and no recoveries within this period. The Bank of Uganda requires banks to write off fully provisioned loans in Loss category within 90 days since the date of classification. Both countries introduced these measures despite low NPL ratios at the time of adoption.

3. Tax and legal and judicial impediments for non-performing loan write-off.

One of the problems for efficient NPL write-offs is related to tax issues. In some jurisdictions, both internationally and in the CESEE region, local tax regulations play an important role in the timing of write-offs. In many cases, tax regulations i) require exhausting all possible measures, including legal, for loan recovery before the loan is fully provisioned and written off, or ii) do not recognize write-offs for tax deductibility purposes at all or in full (for example by introducing caps). One reason for such practice is tax authorities’ concern that banks will overprovision to minimize corporate income tax.

The exhaustion of all possible measures to collect a loan, in some jurisdictions, means getting a final ruling of the court. In some countries getting even a first ruling might take a period of up to four years, which could subsequently be appealed. Furthermore, anecdotal evidence shows that some judges in CESEE countries have gone as far as denying banks’ access to the collateral if they had fully provisioned or written off the loan. They argued that the claim did not, or only partially, exist. The requirement to undertake judicial process is particularly burdensome for banks that hold many NPLs with small nominals outstanding (e.g., SME or retail loans). Opening a judicial process for each of these loans is a costly and time-consuming process.

In many instances, the enforcement of borrower’s liabilities, involving national judicial systems, takes an excessively long time. It means that a write-off could be delayed due to legal or judicial constraints which are beyond the reach of financial sector regulators. Hence, the removal of these impediments is an important precondition for an effective NPL resolution and requires the involvement of many local authorities.
A Vienna Initiative study on tax impediments in the CESEE region shows that in most of the five countries studied (Romania, Croatia, Hungary, Montenegro, and Serbia) tax deductions for NPL write-offs are allowed but require the fulfillment of many preconditions. For example, in Serbia, a write-off was eligible for tax purposes if two years have elapsed from the past-due date and the bank has provided evidence of debtor’s insolvency.

A few CESEE countries have applied remedial measures in response to identified tax and judicial impediments either by the Vienna Initiative study or other initiatives. For example, in response to the identified tax impediments for NPL write-off, the Ministry of Finance of Serbia amended the Corporate Income Tax Law in December 2017. This action was part of a comprehensive national NPL Resolution Strategy initiated in 2015.

4. Potential actions by prudential regulators.

IFRS 9 provides general terms for a write-off which could be interpreted by banks and auditors in different ways. Therefore, prudential regulators may issue additional (more calibrated) requirements for a loan write-off. The rationale for such a regulation can be justified by a need to clean up bank balance sheets more forcefully and quickly. This might be particularly important for countries with i) a protracted NPL problem, ii) a high national NPL ratio, or iii) a systemic NPL problem.

Concern about banks’ capital is a common issue inhibiting regulators in the ECA region from setting a stricter regulatory framework, including mandatory loan write-offs. In several jurisdictions there is regulatory forbearance due to concerns about banks’ ability to raise the additional capital required, which could crystallize after proper provisioning of problematic assets.

4.1. Options available for loan write-off rules.

The country examples illustrate that there are two types of write-off regulations available: i) with reference to time spent in Loss category (e.g., Albania), or ii) with reference to 100 percent provisioning (e.g., Serbia). It seems that the former framework might be more efficient as Loss category is usually defined in the respective credit risk regulation, while full provisioning depends on banks’ internal rules that can be stretched if needed.

Regulators should have the discretion to decide on the form of regulation. It can be either mandatory regulation or guidance (based on an obey or explain principle). Country experience shows that guidance does not work in certain countries. SREP might not work well in countries where financial market development is at an early stage or good governance principles are not working. In these countries, clear regulations are the most effective way to implement prudential regulation rather than guidance. Empirical examples show that guidance is simply ignored by banks in some jurisdictions.

In addition, regulators might introduce differentiated periods for write-offs based on the original maturity of the loan. To facilitate write-offs, regulators should consider introducing phase-out periods for collateral treatment for provisioning purposes (e.g., EU - see also section 2.1). However, phase-out periods should be conservative (much shorter than currently in the EU regulation) and collateral valuations should be based on realistic net-present recovery values discounted by enforcement and maintenance costs. Each country, and sometimes even each region within a country, has different collateral enforcement periods and associated costs. This is related to the effectiveness of the local judicial system. Phase-out periods for collateral treatment should be aligned with the real collateral enforcement period in a country. The practice of a phase-out period that is two-times longer than a real collateral enforcement period is hard to justify.

34 Vienna Initiative. Tax impediments to the sale of NPLs in the CESEE. September 2016.
36 In jurisdictions where the NPL ratio is high or is increasing for more than 5 years. The average NPL resolution period is 5-7 years, according to an IMF study.
37 Jurisdictions in which almost all banks have high NPL ratios.
38 For example, Greece.
39 World Bank Doing Business Index subcomponent “enforcing contracts” could provide some guidance.
Country experiences show that often banks do not write off loans due to collateral pledged against the loan. Even if this collateral is worth 1 cent, banks might argue that a loan should not be 100 percent provisioned; hence, it cannot be written off.

The introduction of prudent provisioning and write-off rules during a period of economic stability or growth would be easier and would provide a necessary counter-cyclical buffer.

4.2. The most efficient way to deal with NPL stock.

To deal with NPL stock most efficiently, a holistic approach to NPL resolution should be applied. In this regard, a comprehensive review of existing impediments and a time-bound strategy for eliminating them should be undertaken. It is important to have the right sequence of envisaged works. The amount of NPL write-offs will be small if provisioning and loan migration rules are loose, and tax and judicial impediments are not removed.

The regulator should consider implementing the following steps to achieve good results:

1. Introduce a strict provisioning framework based on forward-looking expected credit loss models, where feasible\(^{40}\). It is of utmost importance that prudent loss given default rates are used and conservative collateral value estimates are applied. A strict cure period after loan restructuring (with meaningful principal and interest repayments during it) should be implemented. The EBA Guidelines on the management of non-performing and forborne exposures\(^{41}\) provides good practice in this regard. In addition, a penalizing loan provisioning system where multiple loan rescheduling not returning the borrower to viability might be considered.

2. A conservative phase-out of collateral treatment for provisioning purposes should be implemented to avoid situations where NPLs are only partly provisioned for an extended time due to collateral value, which in many cases is overestimated. These actions should ensure that viable loans are restructured in a meaningful way and non-viable loans are efficiently enforced and/or written off.

3. Mandatory NPL write-off rules should be implemented based on a specific (short) period recorded in Loss category. If tax and judicial impediments for NPL resolution are removed, a short quantitative criterion (number of days) for loan write off would provide an efficient way to tackle NPL stock. Applying a qualitative criterion for this purpose might create unnecessary ambiguity.

4. In countries with an acute related-party lending problem, tight governance arrangements should be in place for monitoring the write-offs of related-party NPLs.

5. Countries with SOBs should consider introducing detailed laws or regulations on how NPLs are resolved in SOBs. This will facilitate SOBs managers to take NPL resolution decisions, including write-offs, minimizing concerns that state prosecutors will sue them for the mismanagement of state property.

6. Regulators should require banks continuing monitoring written-off loans to decide on the best way to achieve a final resolution. Binding reporting periods (e.g., reporting every six-months to management) could maintain active pressure on the ultimate resolution of NPLs. In addition, banks should maintain detailed records of all NPL write-offs performed.

7. To avoid a situation where banks become asset management companies of repossessed assets, including after write-offs, a regulator should require progressive provisioning of repossessed assets after a certain (conservative) period.

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\(^{40}\) The introduction of expected credit loss models might be premature in countries with insufficient historic data and/or lacking supervisors skillful enough to review sophisticated internal credit risk models.

\(^{41}\) EBA. October 2018.
8. An opening of the NPL market in a specific jurisdiction will enable the sale of written-off or repossessed assets in the secondary market. A vibrant secondary market would ensure that competitive bids are available to banks in case they decide to sell written-off loans. Although prices for seasoned uncollateralized or poorly collateralized loans most probably will be very low, this will provide banks with an important NPL resolution tool. Experience shows that with NPL market development higher credit quality loans are traded there at a later stage. While the opening of the NPL market is desirable it is not, however, always feasible.
References


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