PRACTICAL LESSONS FROM THE NPL RESOLUTION IN LATVIA

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Background information

- In 2009 ~72% of the banking system owned by foreign capital (out of it 78% – by Nordic banks)
- 72% of total domestic loans were issued by Nordic banks
- Loans collateralized by real estate formed 75% of all loans
- Sharp economic downturn accompanied by real estate price adjustment (~70%) and collateral value deterioration

Source: CSB, FCMC, Latio, Arco real estate, Oberhaus
NPL concentration predominantly in real estate related sectors

- Sectors with the highest NPLs were household mortgages and real estate developers
- Due to the real estate price adjustments, value destruction in these sectors was the highest
- Export oriented sectors were performing better

Loans past due more than 90 days (bn EUR)

Source: FCMC
Regulator's response – prompt recognition of NPLs and adequate provisioning

Supervisory authority issued a regulation on asset quality measurement and provisioning in 2009 III:

- If one loan is NPL, others debtor's loans should treated as impaired
- Loan in the restructured category can be upgraded only after at least one year from the first payment day after restructuring
- Recognize income from NPLs only on reasonable grounds
Efficient judicial system and insolvency regime – highly important for successful NPL resolution


• Personal bankruptcy introduced in 2008

• Improvements done over the time:
  ✓ facilitating restructuring
  ✓ simplifying procedures (↑speed) and being cost efficient
  ✓ the introduction of Insolvency Register and electronic communication (time and costs ↓)

<table>
<thead>
<tr>
<th>Year</th>
<th>Recovery rate (cents per dollar)</th>
<th>Insolvency cost (% of estate)</th>
<th>Time (years)</th>
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</thead>
<tbody>
<tr>
<td>2018</td>
<td>40.1</td>
<td>10</td>
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</tr>
<tr>
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<td>10</td>
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</tr>
<tr>
<td>2016</td>
<td>48.1</td>
<td>10</td>
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</tr>
<tr>
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<td>48.2</td>
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<tr>
<td>2007</td>
<td>34.8</td>
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</table>

In Europe and Central Asia, average recovery rate is 38.0, cost – 13.1% and time – 2.3 years.
Banks recognized NPLs promptly and worked them out steadily.

Source: FCMC
Internal asset management companies were used for NPL management

- To clean the banks' balance sheets and have more specialized workouts, banks used internal "bad banks" for NPL management

- In many cases, auctioned collaterals from defaulted loans were bought by ancillary companies to avoid value destruction. These companies specialized at real estate management and turnaround

- Banks' and mother banks' daughter companies managed real estate assets – ~23% of the respective banks' NPLs at their peak level
Banks' high capitalisation (especially of Nordic banks) facilitated orderly resolution of bad loans

Bank capitalization (% of risk weighted assets)

NORDIC banks

other banks

* Capital adequacy is not directly comparable for pre- and post- (CRR) January 2014. ** Tier 1 ratio for data before 2014.

Source: FCMC
Early injection of capital for NPL resolution was crucial

- Early recapitalization of the banks provided a platform for effective NPL resolution
- International initiatives (i.e., Vienna initiative), regional cooperation and integration facilitated supportive actions of investors

Source: FCMC
• The European Bank Coordination “Vienna” Initiative is a framework for safeguarding the financial stability of emerging Europe;
• The Initiative was launched at the height of the first wave of the global financial crisis in January 2009;
• It brought together all the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe, which own much of the banking sectors in that region and also hold a significant part of government securities;
• The Initiative has provided a forum for decision making and coordination that helped prevent a systemic banking crisis in the region and ensured that credit kept flowing to the real economies during the crisis;
• The Initiative specifically sought to limit the negative fallout from nation-based uncoordinated policy responses to the global crisis and to avoid a massive and sudden deleveraging by cross-border bank groups in emerging Europe.
Lessons learned – key components for successful NPL resolution in Latvia

• Prompt recognition of problem assets
• Adequate loan loss provisioning
• Transparency on NPLs from authorities' side
• Timely recapitalisation, strong and supportive shareholders
• "Internal" specialized asset management companies for work-out of bad assets
• Structural reforms, particularly with regard insolvency regime and judicial system