LATVIJAS BANKA
EIROSISTĒMA

PRACTICAL LESSONS FROM THE NPL RESOLUTION IN LATVIA

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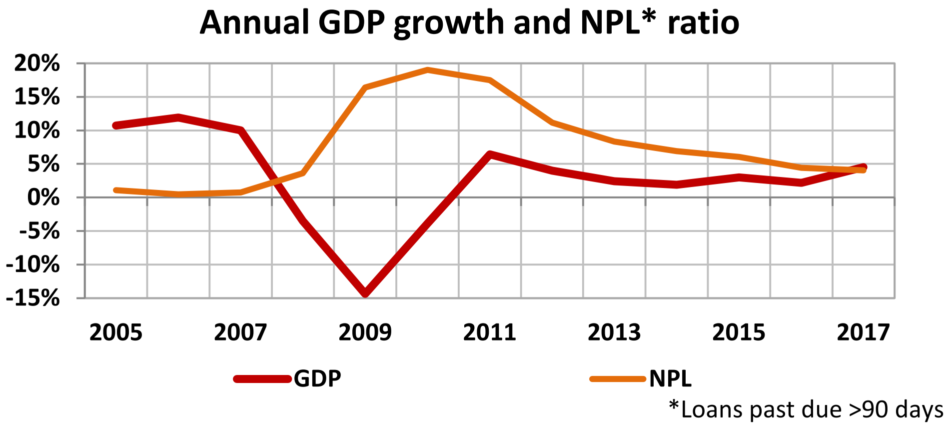
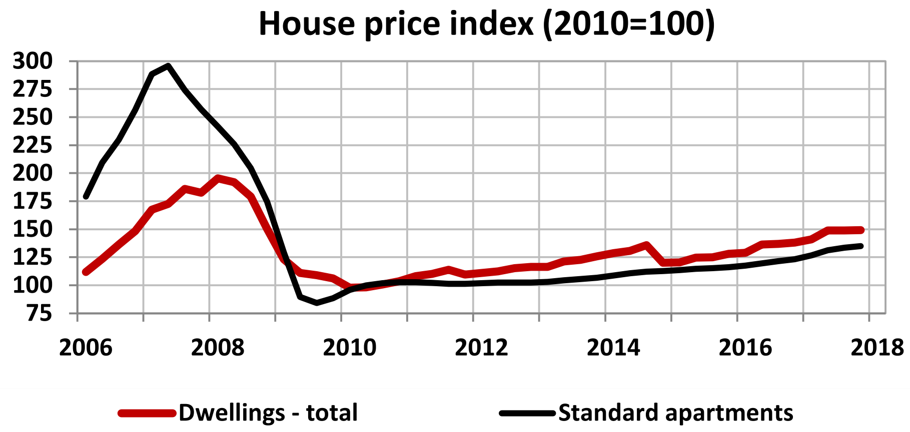
May 2018

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





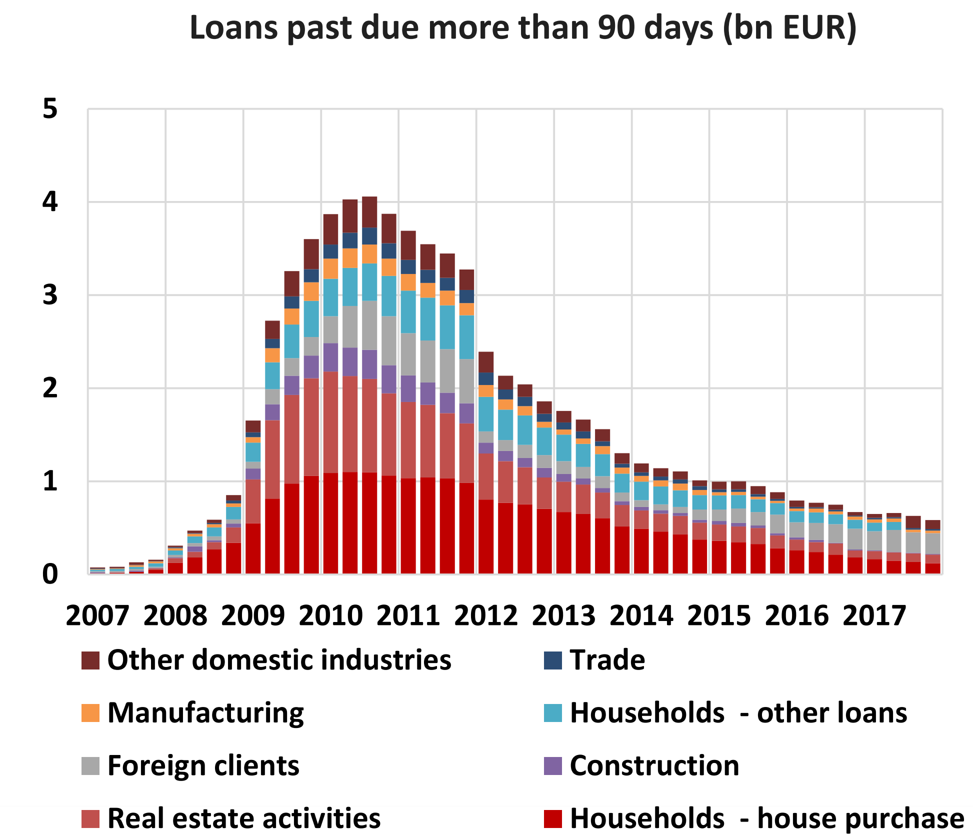
Source: CSB, FCMC, Latio, Arco real estate, Oberhaus

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

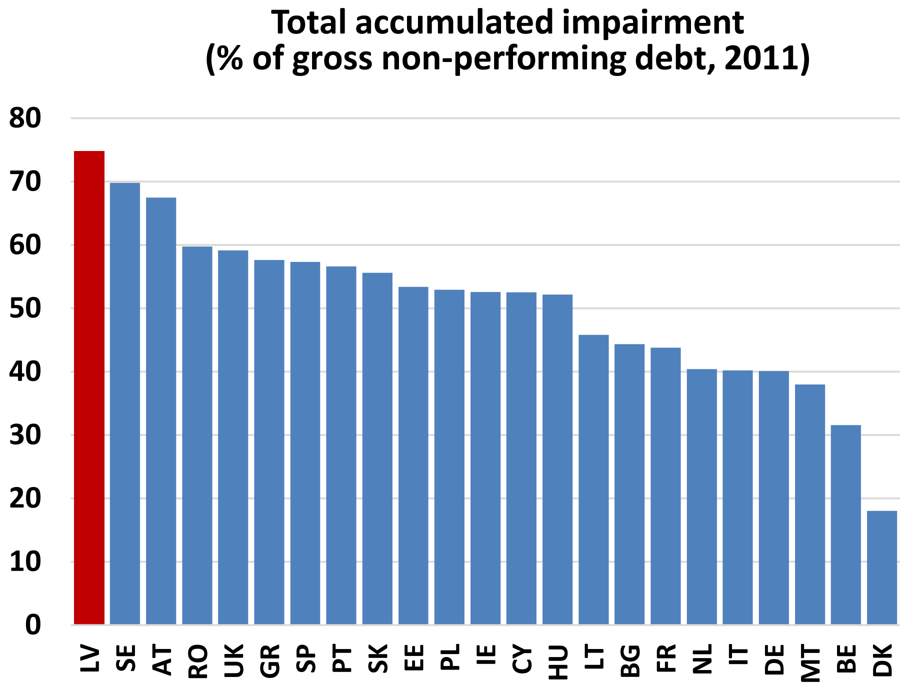


Source: FCMC

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



Source: ECB (CBD data)

Efficient judicial system and insolvency regime – highly important for successful NPL resolution

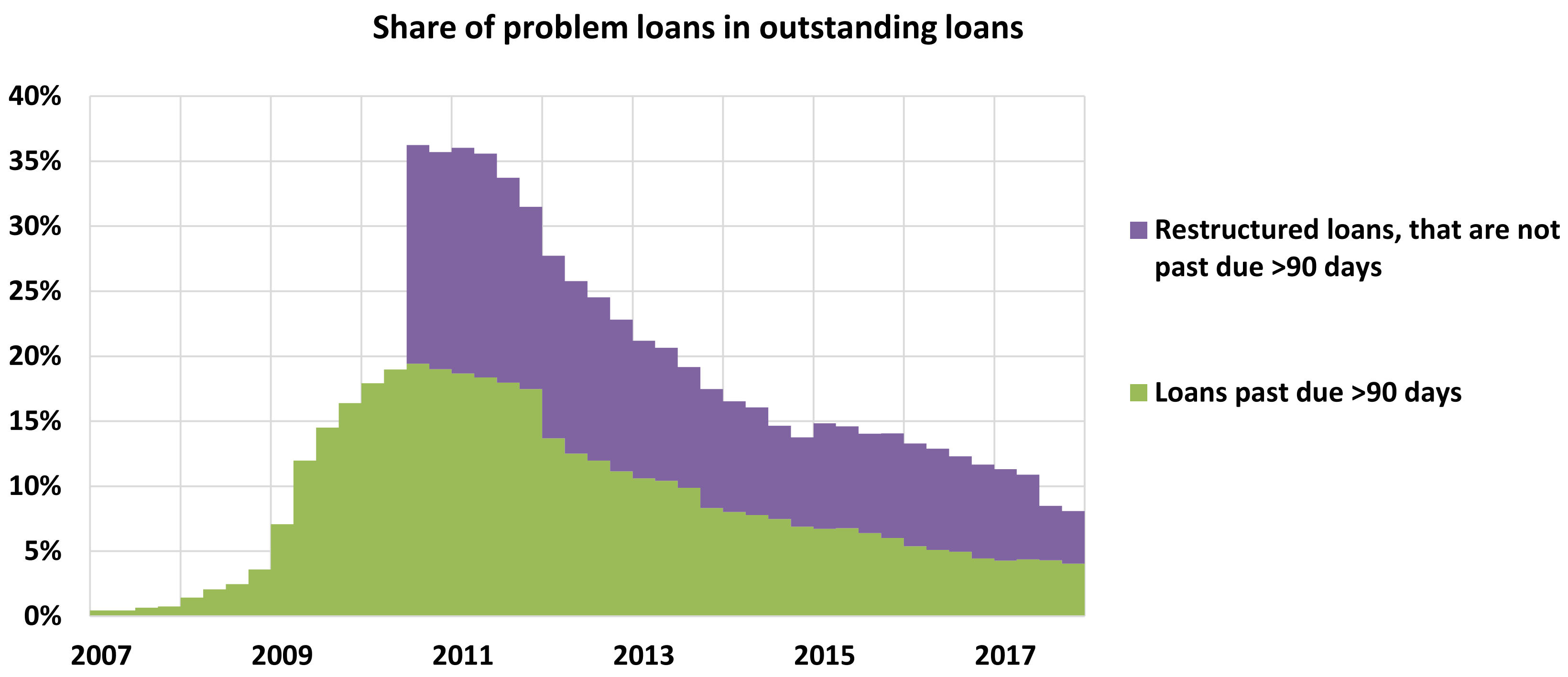
- Numerous amendments to Insolvency Law – in 1996, 2008, 2010, and ongoing
- Personal bankruptcy introduced in 2008
- Improvements done over the time:
  - ✓ facilitating restructuring
  - ✓ simplifying procedures (↑speed) and being cost efficient
  - ✓ the introduction of Insolvency Register and electronic communication (time and costs ↓)

Doing business index for Latvia – Resolving insolvency

	Recovery rate (cents per dollar)	Insolvency cost (% of estate)	Time (years)
2018	40.1	10	1.5
2017	49.1	10	1.5
2016	48.1	10	1.5
2015	48.2	10	1.5
2014	48.4	10	1.5
2013	47.8	10	1.5
2012	46.4	10	1.5
2011	31.9	13	3
2010	29.0	13	3
2009	29.0	13	3
2008	34.6	13	3
2007	34.8	13	3

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-out them 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

Specialized asset management companies acquire, manage and sell real estate in residential, retail, office and industrial segments

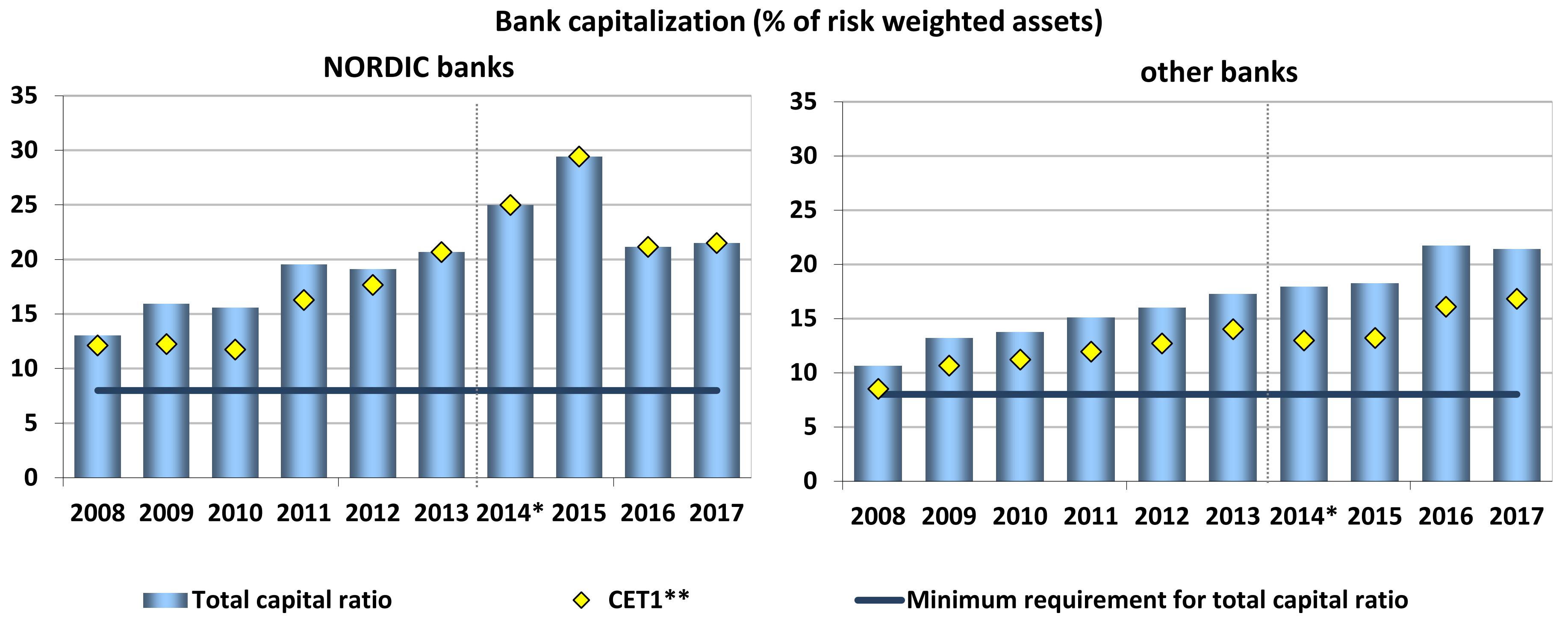
Swedbank → Ektornet

SEB → Latectus

DNB → SALVUS NEKUSTAMIE ĪPAŠUMI

Nordea → PROMANO

Banks' high capitalisation (especially of Nordic banks) facilitated orderly resolution of bad loans



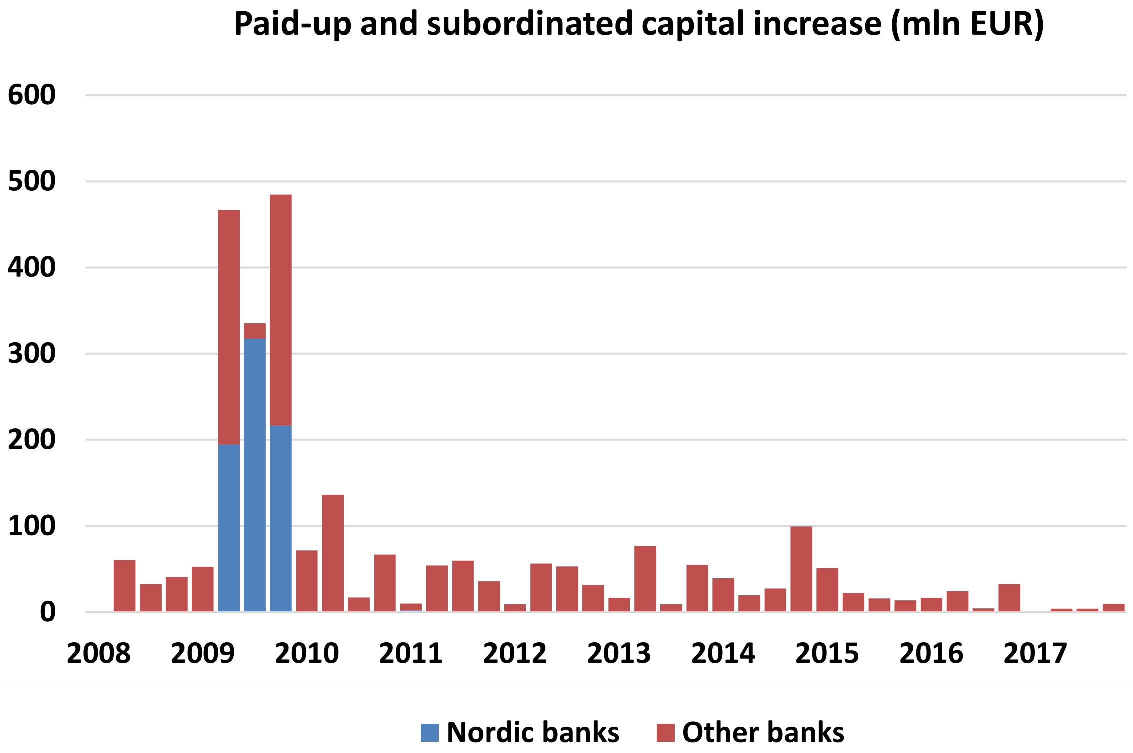
* Capital adequacy is not directly comparable for pre- and post- (CRR) January 2014. ** Tier 1 ratio for data before 2014.

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

EBCI Vienna Initiative

- 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