WORLD BANK GROUP
Finance, Competitiveness & Innovation

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COVID-19 and NPL Resolution in the ECA region

Lessons from the GFC for the pandemic

Karlis Bauze
Senior Financial Sector Specialist (FinSAC),

Miquel Dijkman
Team Lead and Lead Financial Sector Specialist (FinSAC),

Andrés F. Martínez
Senior Financial Sector Specialist (EFNFI), &

Valeria Salomao Garcia
Senior Financial Sector Specialist (FSI)

WORLD BANK GROUP
Finance, Competitiveness & Innovation

Financial Sector Advisory Center (FinSAC)

1

The COVID-19 pandemic prompted a series of unprecedented emergency measures:

- Travel bans, mandatory closure of non-essential business, limitations on gatherings, mandatory home-based work, border closures, et cetera.

2

The magnitude of the economic shock combined with limited macroeconomic policy space prompted most ECA countries to introduce some actions:

- Borrower relief measures to provide breathing space to distressed borrowers primarily through temporary payment moratoria.
- Short-term legal measures to flatten the bankruptcy curve, including through enforcement moratoria.

3

Over time, rising borrower distress will inevitably translate into renewed pressures on asset quality in the banking sector.

It is imperative that policymakers and banks prepare for the complex challenges of resolving increasing volumes of NPLs that lay ahead.

- **This presentation summarizes the main insights of a recent FinSAC policy note** that reviews the **ECA's experiences following GFC** and that draws lessons for the pandemic.
- **Overall, ECA countries are in a stronger starting position** than at the start of the GFC thanks to more **robust liquidity and capital buffers, regulatory definitions** for the identification of problem assets aligned with **international standards** and recent experience in working out large volumes of problem loans…
- … but the severity of the economic downturn leaves no room for complacency.
- Experiences during the GFC highlight the dangers associated with a delay in the initial policy response. Rising NPLs require a **prompt, proactive, and comprehensive policy response**.
- **Bankers and policymakers need to start preparing now** for the challenges that lie ahead.
- With **countries around the world** likely to experience **rising pressures on asset quality**, this **note has a relevance that goes beyond ECA region**.
- Policy note is publicly available on the **FinSAC website** (link).

Outline

1. **Experiences following the GFC**
2. Policy reforms in the aftermath of the GFC
3. Lessons for the COVID-19 era

A delayed policy response

The 2008 Global Financial Crisis

A build-up of vulnerabilities

- Plentiful and cheap **financing from eurozone-based parent banks (built-in currency mismatches)**(1)
- **Booming asset and real estate prices** and steep increases in household and corporate debt

2008 GFC

Triggering events

- **Funding shock in 2008 as external financial markets largely closed for banks** (euro bonds, wholesale funding, and syndications)
- **Steep decline in credit growth, asset and real estate booms went bust**, and sharp economic slowdown.
- **Steady increases in NPL ratios across the region**

- The Global Financial Crisis left an **enduring legacy of high NPLs in local bank-dominated financial sectors**.
- The high stock of NPLs made it **difficult for banks to effectively fulfil their intermediation function in the bank-dominated financial sectors in the region.**
- **High NPLs drove up the cost of finance**, **reduced banks' capacity to support the economy** with fresh finance and **bred allocative inefficiencies**, as a significant part of the credit stock got "locked up" in underperforming sectors (at the expense of more dynamic ones).
- **For nearly a decade, some countries got stuck in a vicious cycle of weak economic growth and lacklustre financial sector performance**.

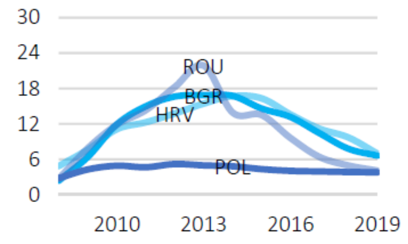
(1) Especially in CESEE countries

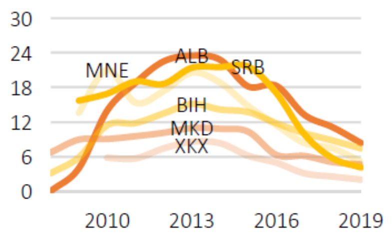
A delayed policy response

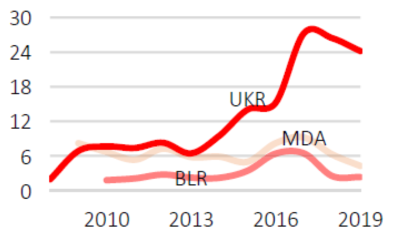
ECA region post-GFC

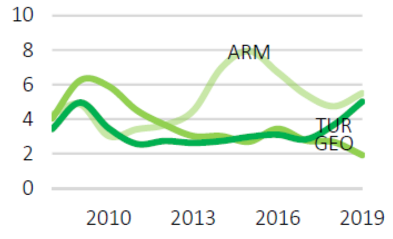
	EU Members	Western Balkans	Eastern Europe	South Caucasus & Turkey

NPLs ratios (%)

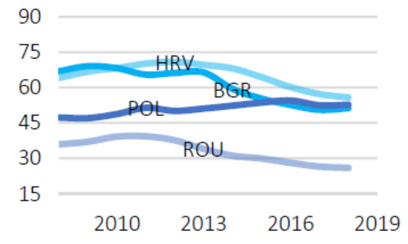


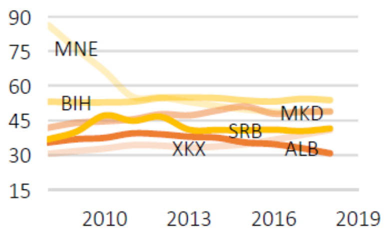


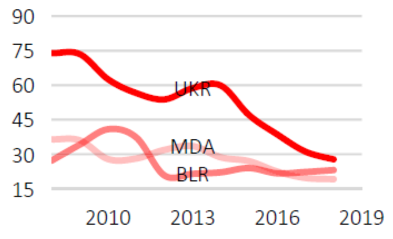


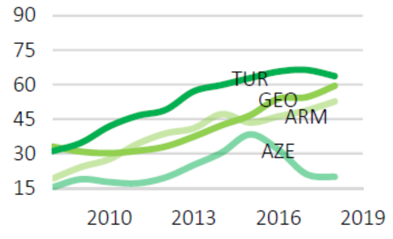


Credit to private sector (% of GDP)

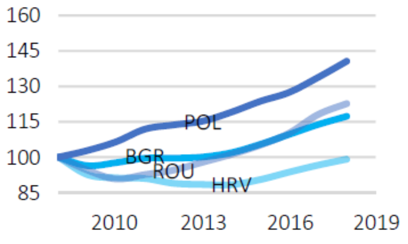


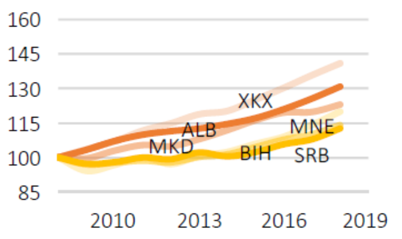


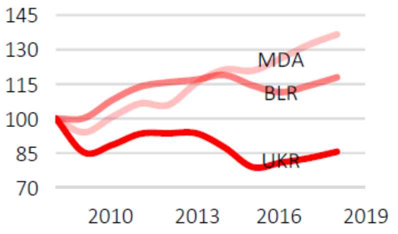


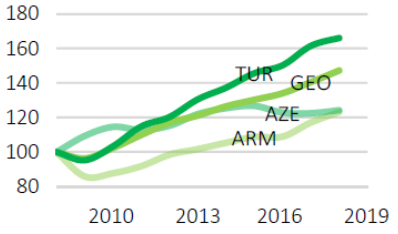


GDP growth (2008 = 100)









BGR = Bulgaria; HRV = Croatia; POL = Poland; ROU = Romania

ALB = Albania; BIH = Bosnia and Herzegovina; MKD = North Macedonia; MNE = Montenegro; SRB = Serbia; XKX = Kosovo

BLR = Belarus; MDA = Moldova; UKR = Ukraine

ARM = Armenia; AZE = Azerbaijan; GEO = Georgia; TUR = Turkey

A delayed policy response

Post-GFC: the reasons for a delayed policy response

- For a variety of reasons, **policymakers and bankers were slow off the mark** in responding to the rising pressures on asset quality which allowed the underlying problems to fester:

A Misguided optimism

- **Bankers and policymakers viewed the increase in NPLs as short-lived**:
  - Unfounded beliefs that the mere passage of time would make things better (spoiler alert: it didn't then and it is highly unlikely to do so now!)
  - Over time, **recovering collateral values** would naturally recover
  - Aggressive efforts to quickly recover problem loans would force them to **acknowledge transient losses** related to depressed collateral values
  - **Questionable loan restructuring** to avoid the recognition of inevitable credit losses

B Weak legal frameworks for enforcing creditor rights

- Recovery prospects overshadowed by deep-rooted weaknesses in the overall credit environment:
  - **Highly unpredictable and time-consuming court decisions**
  - Limited or **non-existent business rescue culture** and frequent procedural delays
  - Reluctance to initiate legal action vis-à-vis distressed borrowers

Non-viable borrowers

- **Questionable loan restructuring** instead of forcing non-viable borrowers towards an orderly exit
- Low interest rates, long grace periods, bullet payments, and frequent rescheduling

Distressed but potentially viable borrowers

- **Often did not received the loan restructuring and debt relief necessary** to restore their commercial viability
- Prematurely pushed towards a formal or informal liquidation process.

A delayed policy response

Post-GFC: the reasons for a delayed policy response (cont.)

- For a variety of reasons, **policymakers and bankers did not respond immediately** to the rising pressures on asset quality:

C Lack of capital space

- Banks often also lacked the capital space for a full and proactive **acknowledgment of NPLs**.
- Banks often opted to **constrain total risk-weighted assets** to **strengthen the capital adequacy ratio**
- This set the stage for a **credit crunch**, that exacerbated the economic downturn.
- Following the GFC, the cost and availability of parent bank capital and funding took a turn for the worse

D Lack of skills to deal with an increase in NPL volumes

- While banks in ECA were used to dealing with incidental NPLs, the GFC was the **first time that they were faced with a systemwide increase in NPLs** following a drastic turn of the financial cycle.
- Significant increase in NPLs across the board was thus the **first serious test of people, systems, and procedures**.
- Banks **lacked dedicated workout units** and did not have the skills and IT systems needed to respond effectively.

Post-GFC: the consequences of the delayed policy response

1

- Matters got worse with the passage of time.

2

- The problem was progressively worsening as **rising NPL volumes** set in motion a **negative feedback loop between lacklustre financial sector performance and a weakening real economy.**

3

- Large stock of unresolved NPLs made it **difficult for banks to fulfil their intermediation function** in the bank-dominated financial sectors in the region:

The worst affected countries got trapped in a bad equilibrium

1. **Credit got locked up in underperforming sectors at the expense of more dynamic ones**
2. **Reduced availability of fresh credit (illustrated by decreasing or stagnant credit-to-GDP ratios)**
3. **Weakening economic growth**

Outline

1. Experiences following the GFC
2. **Policy reforms in the aftermath of the GFC**
3. Lessons for the COVID-19 era

Overview

Eventually, the notion settled in that a **higher level of ambition** was urgently called for

A selection of key milestones in the reform process

1. **Vienna Initiative Working Group on NPLs in CESEE (2012)** advocating deepening and acceleration of reform efforts
2. **Strengthen the enabling legal and tax environment** for the resolution and sale of large volumes of NPLs in ECA
3. **Asset Quality Reviews (AQRs) and EU wide stress tests** in the run-up to the establishment of the Single Supervisory Mechanism (SSM) in 2014
4. **EBA Implementing Technical Standards (ITS)** in 2013 which established harmonized regulatory definitions of non-performing and forborne exposures

1. Vienna Initiative Working Group on NPLs in CESEE (2012)

The Vienna Initiative's working group on NPLs made a strong case that accelerating the rate of NPL resolution in the CESEE required major reforms

- **Removing obstacles while leaving NPL resolution to banks**
- **Establishing a legal framework to NPL resolution**
- **Removing tax impediments**
- **Removing regulatory obstacles**
- **Enabling out-of-court restructuring**

Policy reforms

2. Reforms to strengthen the enabling environment for resolving large volumes of NPLs

1. **Strengthen creditor rights**
2. **Improve the functioning of the judiciary**
3. **Establish or strengthen insolvency and collateral enforcement frameworks**
4. **Set up frameworks for out-of-court workouts for financially distressed but viable borrowers**
5. **Fostered the development of markets for portfolios of NPLs**
6. **Improve collateral enforcement and to establish a tax environment that is more conducive to NPL resolution**
   - ✓ Facilitating tax deductibility of loan provisions and write-offs
   - ✓ Exempting asset sales from VAT

3. Supervisory comprehensive assessments of banks

The establishment of the Single Supervisory Mechanism (SSM) in 2014 contributed to greater transparency in asset quality problems, that were not always recognized in reported NPL ratios

2014
Establishment of the Single Supervisory Mechanism (SSM)

2014
EU-wide stress test, asset quality review (AQR) and supervisory risk assessment of 130 banks

2016
EU-wide stress test of 51 banks

2018
EU-wide stress test of 48 banks

2020
EU-wide stress test Postponed to 2021 to allow banks to prioritize operational continuity

Various ECA countries undertook AQRs of their own, including **Albania** (2014), **Belarus** (2016), **Bosnia** (2014), **Serbia** (2015), **Ukraine** (2015-2017), and more recently Bulgaria and Croatia as part of their entry into the SSM.

Policy reforms

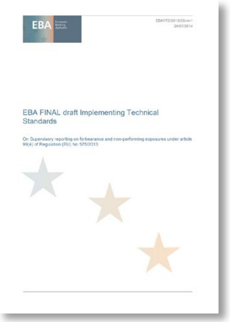
4. Harmonized regulatory definitions of non-performing and forborne exposures

High level of NPLs in EU

- The GFC and the subsequent sovereign debt crisis led to **soaring NPL ratios in several EU member states** (e.g., Cyprus, Greece, Ireland, Italy, Portugal, Slovenia, and Spain)

Key regulatory reforms in the EU

- The **European Banking Authority** issued in 2013 an implementing technical standards stablishing uniform regulatory definitions of:
  - ✓ **Non-performing** exposures:
    - ✓ >90 days past due, or
    - ✓ Full repayment unlikely without recourse to collateral
  - ✓ **Forborne** exposures:
    - ✓ Concessions in response to or anticipation of repayment difficulties



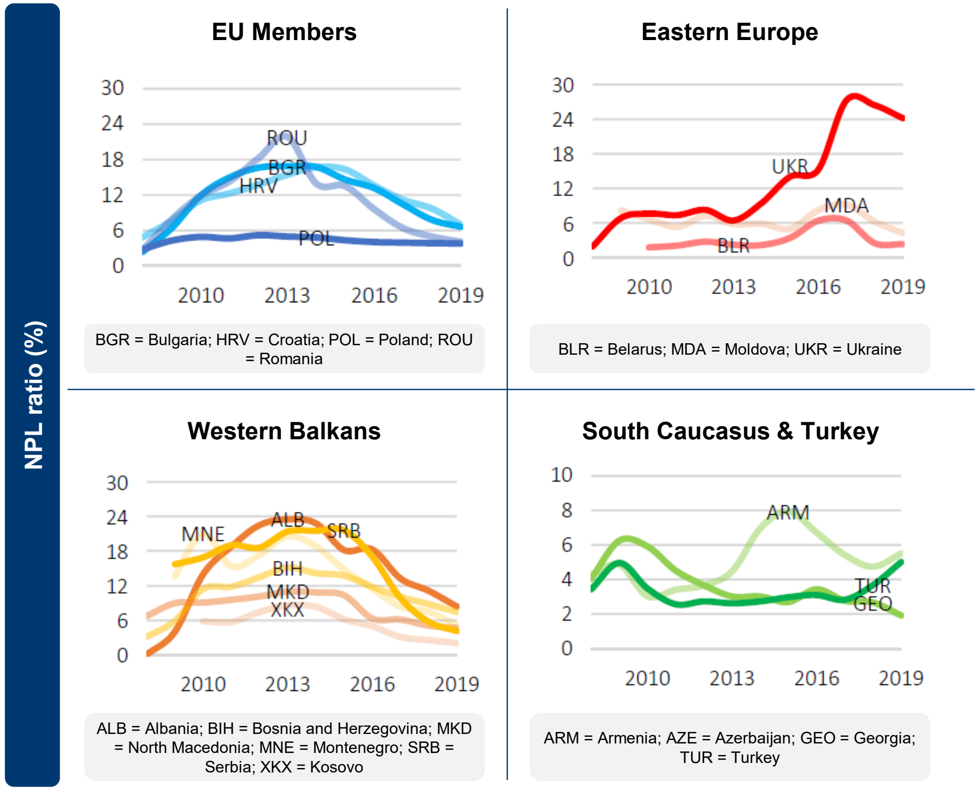
Enabling monitoring by policymakers

- The introduction of internationally agreed regulatory definitions by banks and supervisors led **policymakers monitor and assess banks' asset quality** in a more consistent manner
- It also facilitated **timely action to address** rising asset quality **problems**

Many ECA countries introduced these harmonized regulatory definitions

Reform dividends and unresolved challenges

Previous measures, together with an improving economic outlook in the EU and an acceleration in credit growth, helped to set the stage for a gradual reduction in reported NPL ratios



- In most cases, reported **NPL ratios were close to pre-GFC levels**, although in a few countries NPL ratios were on the increase in the run-up to the pandemic
- Banks disposed of NPLs through write-offs and sales of NPL portfolios after some reforms in the **enabling legal and taxation environment** that removed:
  - Onerous legal requirements to fully exhaust collection efforts through the legal system
  - Absence of tax deductibility for write-offs

- Banks significantly reduced their reported NPL ratios through write offs, but **borrowers were often left trapped with an unaffordable debt burden**
  - Write-off ≠ debt forgiveness for the borrower
- **Disconnect between banks' improving asset quality indicators and the financial condition of borrowers**: financially weak companies were often kept afloat with a combination of low interest rates and questionable loan restructuring practices, with limited progress in corporate restructuring to restore their commercial viability

Outline

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Main conclusions from the Policy note: overview of recommendations

Avoiding a repetition of the post-GFC scenario is a top priority, and requires timely and comprehensive policy action in the following areas

	Dos	Don'ts
1 Strong regulatory definitions robust supervision	➢ **Preserve past reforms** adopting internationally harmonized regulatory definitions ➢ **Robust supervisory enforcement** of regulatory definitions	➢ **Soften regulatory definitions** ➢ **Succumb to industry and political pressures**
2 Orderly exit from current borrower relief measures	➢ Phase out Borrower relief measures **as soon as circumstances permit** ➢ **Gradually wound down measures**	➢ **Perpetuate** borrower relief measures
3 Dedicated workout units	➢ **Separated from origination** departments ➢ Endowed with **adequate human, financial resources and IT systems**	➢ Delay establishment and operationalization of workout units ➢ Under-resourced teams
4 Avoid "extend-and-pretend" loan restructuring practices	➢ Focus on **distressed but potentially viable and cooperative firms** ➢ Rearranging the borrower's liabilities and **matching future repayment obligations with expected cashflows**	➢ **Keep non-viable borrowers afloat** with low interest rates, long grace periods, bullet payments, rescheduling, etc to delay the recognition of inevitable credit losses
5 Promote rehabilitation of distressed but viable borrowers	➢ **Facilitate the rehabilitation of potentially viable borrowers** (e.g., out-of-court workouts, enable debt reduction, incentivizing tax regimes, etc.) **and improve the system of liquidations**	➢ **Disincentivize restructuring** ➢ **Liquidation-bias**
6 Bridge gaps between insolvency framework and actual practices	➢ Prioritize **upgrading institutional framework** where significant gaps have emerged between legal frameworks and practices	➢ Embarking on a fresh round of **complex and time-consuming legal reforms** without allowing underpinning institutions to catch up
7 Coordination among public and private sector stakeholders (1)	➢ **Coordination and interaction among key actors** to ensure that timely actions are taken, and measures are well-aligned	➢ Relying solely on actors' **individual and non-coordinated actions**

(1) Including: banks; other private sector representatives (institutional investors services); banking supervisory agencies; central banks; finance and justice ministries; and civil society and representatives.

Main conclusions

1

Maintain strong regulatory definitions of non-performing and forborne exposures

- Effective NPL resolution requires the **availability of economically meaningful data about banks' exposure to problem assets** in order for **regulators and supervisors to**:
  - ✓ Gauge the **magnitude of the problem**
  - ✓ Inform their **NPL resolution strategies**
  - ✓ Ensure that banks **provision appropriately** for credit losses
  - ✓ Follow up with **banks with a high NPL exposure**

Need to focus on

- **Preserve past reforms** adopting internationally harmonized regulatory definitions – hard 90 day-past-due backstop
- Ensure that the qualitative "**unlikeliness to pay**" (UTP) criterion is enforced vis-à-vis borrowers whose financial stress likely transpose into longer term repayment difficulties
- **Proper use of forbearance measures** – viable borrowers only, and avoid cutting corners (e.g. by abolishing or shortening cure periods)
- **Robust supervisory enforcement of the regulatory definitions**, particularly in an environment where pressures on asset quality may incentivize banks to disguise the true extent of their difficulties
- **Weak banks** may be particularly incentivized to **engage in questionable practices** to present an overly optimistic picture on asset quality

These challenges may be exacerbated by industry and political pressures on the operational independence of regulators

Main conclusions (cont.)

2

Exiting from the current exceptional borrower relief measures and short-term legal measures

Risk of perpetuating relief measures

- There are several **hidden cost in prolonging exceptional borrower relief measures**, including:
  - Weakening of repayment discipline – borrower can pay, but chooses not to
  - Allocative inefficiencies associated with zombie borrowers that use these measures to renew their lease on life
  - Possible adverse impact on banks' liquidity
- There is a real risk that these measures are perceived as a new normal and become permanent fixtures

Exit strategies

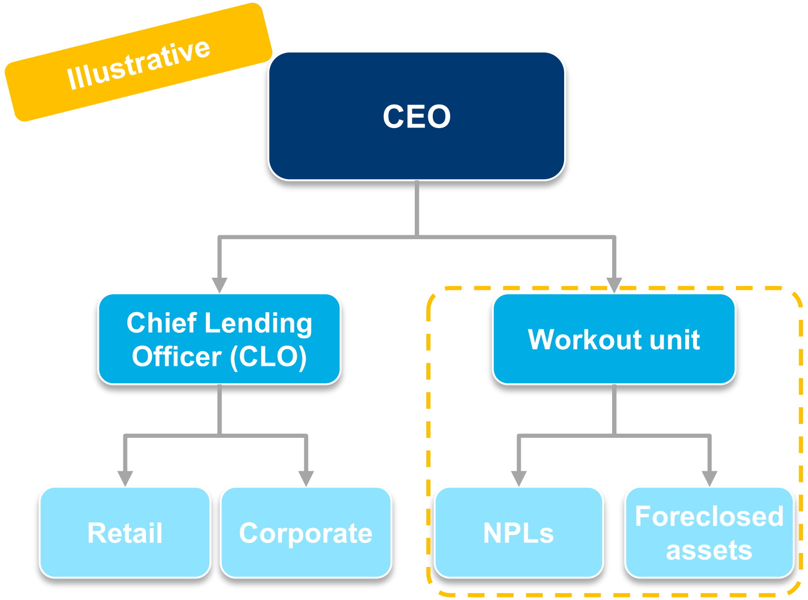
- Borrower relief measures should be phased out **as soon as circumstances permit** and with **careful consideration for the financial impact on banks**
- **Measures can be gradually wound down**: expiring schemes can be replaced with a set of more targeted and better designed measures, including by ruling out borrowers whose financial difficulties predated the pandemic and borrowers whose difficulties are likely to evolve into longer term repayment difficulties

While these measures are in place, banks should be expected to provide banking supervisors with reliable, frequent, up-to-date, and comparable information regarding loans that have benefitted from borrower relief measures

Main conclusions (cont.)

3

Banks need to establish dedicated workout units for resolving high volumes of bad loans



- **Adequate human and financial resources**
- **Robust information systems**
- **Robust bank-specific policies regarding the management and resolution of NPLs**

In the case of banks with high NPLs

- Regulatory requirements for high NPL banks to articulate **NPL reduction strategies**:
  - ✓ **Embedded in their risk and capital strategies**
  - ✓ **Approved** by the **bank's management body**
  - ✓ **Agreed** with the **banking supervisory** agency on **quantitative NPL reduction targets** and strategies to achieve these reduction

Main conclusions (cont.)

4

Ensure proper use of long-term loan restructuring measures

- It is important that despite the highly uncertain economic outlook, **banks make reasonable efforts to distinguish borrowers with transitory liquidity difficulties from those with deeper rooted solvency problems**, which has far-reaching consequences for the type of restructuring measures that banks should consider:

Viability of the borrower

Potentially viable borrower → **Possible candidate for loan restructuring – match future debt service obligations with expected cashflows**

Non-viable borrower → **Not a candidate for loan restructuring**
Write-off, legal measures or sale

Pressures to keep non-viable borrowers afloat should be resisted, to avoid locking up the credit stock in underperforming economic sectors at the expense of more dynamic borrowers

Loan restructuring should not be used as a tool to merely delay the recognition of inevitable credit losses related to exposures to non-viable or uncooperative borrowers, that should be steered towards an orderly exit

Main conclusions (cont.)

5

Legal frameworks to incentivize restructuring (potentially viable) borrowers

- In addition to ensuring an exit of unviable borrowers, the timely rehabilitation of distressed but potentially viable borrowers is a top priority
- The **rehabilitation of potentially viable borrowers** entails not only **loan restructuring**, but **also operational restructuring**, i.e. fundamental changes in a company's operations aimed at restoring the commercial viability of ailing companies:
  - Encouraging **out-of-court workouts** for these borrowers
  - Legal frameworks need to **enable debt reduction** and should be **supported by tax regimes** that do **not unduly disincentivize restructuring**
  - In addition, consideration can be given to the introduction of **time-bound regimes that give debtors and creditors special one-off benefits in exchange for an agreed workout plan**
  - **Facilitate enforcement systems**, especially those out-of-court and enhance the protection of creditors' rights
  - **Improve and expedite liquidation systems**, facilitating orderly and quick exit of unviable companies, **to avoid the proliferation of zombies**

Main conclusions (cont.)

6

Bridge the gap that has emerged between modernized insolvency frameworks and actual practices

- This will require **continued investments** in the **institutions that underpin the functioning in practice** of these overhauled legal frameworks, and which have often struggled to keep up with legal reforms
- These **institutional capacity constraints may become acute** when faced with **renewed pressures on asset quality**, with the corresponding increase in debt and litigation cases stretching the capacity of creditors, debtors, advisors, and the judiciary

Where significant gaps have emerged between legal frameworks and practices, policymakers may prioritize upgrading the institutional framework over embarking on a fresh round of complex and time-consuming legal reforms

Main conclusions (cont.)

7

Policy coordination as a critical element of any strategy to address high NPLs

- **Nationwide NPL reduction strategies**, designed and implemented with the active participation of private and public sector stakeholders, can help to **accelerate the rate of NPL reduction**

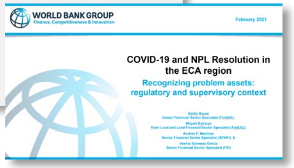
Government-initiated coordination mechanisms, including high-level working groups with senior representatives from participating agencies, can play a useful role in assessing obstacles to NPL resolution, setting reform priorities and ensuring that all stakeholders are clear on their role in implementation

What is next?

- It is critical that **bankers and policymakers respond to the challenges early on**, and proactively, to contain financial stability risks and enable banks to fulfil their basic intermediary function.
- This requires a decisive policy response in the **following three areas**
- Following this high-level presentation, we will be organizing three technical sessions that explore these areas in-depth

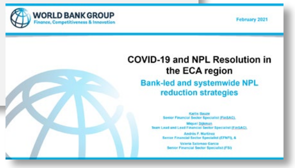
Recognizing problem assets – regulatory and supervisory context:

- **Robust banking regulation and supervision** needed to ensure the proper identification of NPLs and provisioning for credit losses



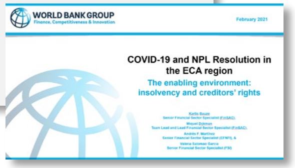
Bank-led and systemwide NPL Resolution strategies:

- **Strengthening of banks' operational readiness** to work out rising volumes of problem assets



The enabling environment – insolvency and creditors' rights:

- **Legal environment** that enables banks to work out bad loans and that avoids steering distressed but viable borrowers towards liquidation



1. **Strong regulatory definitions**
2. **Orderly exit from current borrower relief measures**
3. **Dedicated workout units**
4. **Loan restructuring**
5. **Legal and institutional frameworks**
6. **Bridge gaps between insolvency framework and actual practices**
7. **Coordination and interaction between involved actors**

Policy Note "**COVID-19 and NPL Resolution in the ECA region: ECA region post-GFC and pre-COVID-19**" is available:

- on the FinSAC website (link).

April 2020 FinSAC Policy Note "**Borrower Relief Measures in ECA Region**" is available:

- on the FCI internal website (link);
- on the FinSAC website (link).

Thank you!