



COVID-19 and NPL Resolution in the ECA region

Bank-led and systemwide NPL reduction strategies



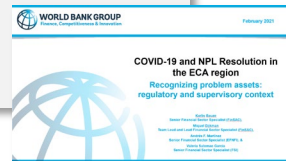
COVID-19 and NPL Resolution in the ECA region

Lessons for the COVID-19 era

- 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**:

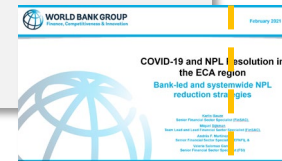
Recognizing problem assets – regulatory and supervisory context:

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



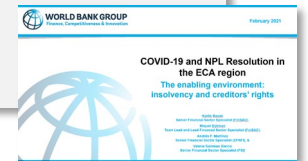
Bank-led resolution strategies:

- **Strengthening of banks' operational readiness** to work out rising volumes of problem assets
- Possibly complemented with **system-wide response**



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

7 Coordination between stakeholders

5 Legal and institutional frameworks

6 Bridge gaps between insolvency framework and actual practices

Agenda

1. **NPL reduction measures**
2. Banks' NPL reduction strategies
3. Systemwide NPL resolution strategies

Banks can employ a variety of measures to lower reported NPLs

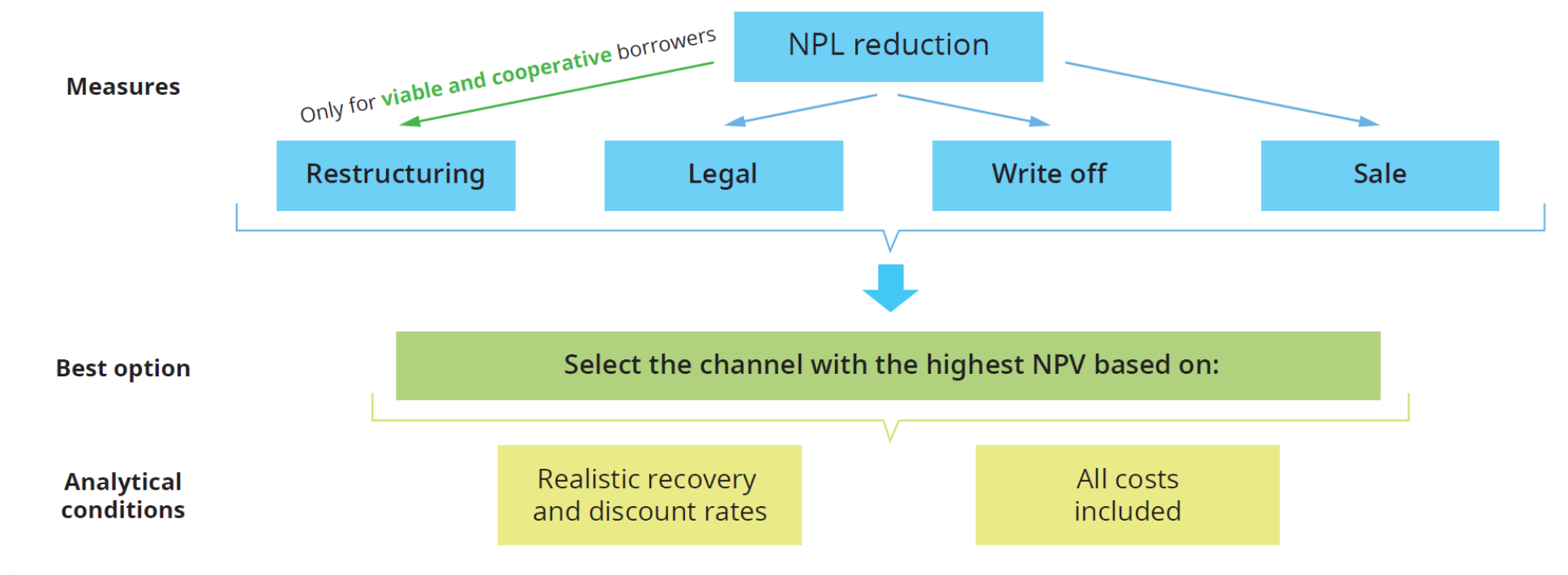
		Description	Upfront eligibility requirements?		
1	Loan restructuring	Short-term, temporary	<ul style="list-style-type: none"> ➤ Deferment of borrower's debt service obligations to a future date, in a NPV- neutral manner 	<ul style="list-style-type: none"> ➤ Borrower is experiencing short-term liquidity difficulties ➤ Borrower is cooperative 	Resolution
		Long-term, permanent	<ul style="list-style-type: none"> ➤ Loan restructuring that entails a NPV reduction 	<ul style="list-style-type: none"> ➤ Borrower is distressed but viability can be restored with restructuring that entails debt relief ➤ Borrower is cooperative 	
2	Legal actions	Collateral enforcement	<ul style="list-style-type: none"> ➤ Enforcing the collateral or guarantee pledged against the loan in or out of court 	<ul style="list-style-type: none"> ➤ No 	Collection
		Insolvency process	<ul style="list-style-type: none"> ➤ Initiation of an insolvency petition against the debtor to ultimately force a reorganization or liquidation of the borrower. In other cases, the debtor may voluntarily file for insolvency, in which case the bank will need to prove its claim 	<ul style="list-style-type: none"> ➤ No 	
3	Write-offs	Write-off	<ul style="list-style-type: none"> ➤ Fully provisioned NPL is moved off-balance sheet ➤ Borrower's debt remains 	<ul style="list-style-type: none"> ➤ Banks may need to demonstrate that all measures have been exhausted 	Disposal
4	Sale	To a third party	<ul style="list-style-type: none"> ➤ Sale of NPL on commercial terms to an investor ➤ Investor continues collection effort 	<ul style="list-style-type: none"> ➤ No 	
		To a public AMC	<ul style="list-style-type: none"> ➤ Transfer of NPLs to a centralized agency that manages recovery efforts ➤ Used in systemic crises, complementing individual banks' efforts 	<ul style="list-style-type: none"> ➤ No 	

These measures are not mutually exclusive, and can be used together in different moments of the process



NPL reduction measures

Schematic overview of the various stages in the NPL workout process



Loan restructuring is a concession granted to the contractual terms of the loan in response to repayment difficulties that otherwise would not be considered by the lender

Short-term loan restructuring measures

- Designed to **help liquidity-distressed borrowers** navigate transient **temporary repayment difficulties** by allowing the borrower to **pay later**.
- **Debt service obligations** can be **deferred in whole** (i.e. moratorium) **or part** (e.g., temporary switch to interest-only payments or a temporary reduction in amortization obligations).
- Generally **do not lead to bank losses in NPV terms**.
- The **impact on NPVs** can be **neutralized by extending maturities** and/or through the **capitalization of deferred payments**.

VS.

Long-term restructuring measures

- Meant for **borrowers** that are facing **deeper-rooted solvency difficulties**.
- The borrower is **distressed but the expectation is that the borrower can be rehabilitated with long-term** loan restructuring measures.
- In practice, this often entails a **reduction in debt in NPV terms** and thus an element of **debt forgiveness for the borrower** and **credit losses for the bank**.
- **Measures** include (among others):
 - Conditional **debt service forgiveness**.
 - **Permanent reduction** in **interest rates**.
 - **Loan splitting** (e.g., differentiating the amount that can be repaid from sustainable cash flow from the “excess debt”).
- In practice, **various long-term loan restructuring measures are often combined**.

Loan restructuring is often used interchangeably with “forbearance”. Both refer to concessions provided by lenders in response to the financial difficulties of borrowers, although standard setters issued guidance at the beginning of the pandemic that loans benefitting from short-term loan restructuring measures (e.g. payment moratoria) should not be automatically considered as “forborne exposures”. For this reason, we use the term “loan restructuring”

Under normal circumstances, it is not considered good practice to restructure exposures owed to non-viable or uncooperative borrowers, given that there is a high likelihood of recurrent payment delinquencies....

... but the exceptional circumstances of the pandemic necessitated a more flexible approach



- The **need to get support out quickly and broadly**, as part of a package of COVID-19 emergency measures, meant that **the usual requirement** - banks' confirmation that borrowers are viable and cooperative before considering loan restructuring measures – **could not be applied for the duration of the payment moratorium**.
- **Major uncertainty** when measures were introduced regarding duration and severity of the pandemic and the economic recovery trajectory
- In addition, **some countries** have introduced **legislative payment moratoria** that establish a **legal obligation for banks to provide a loan payment holiday to eligible borrowers across the board, regardless of borrower viability and cooperation**.
- **Other countries** may face **political pressures** and public opinion that lead to a **similar outcome**.

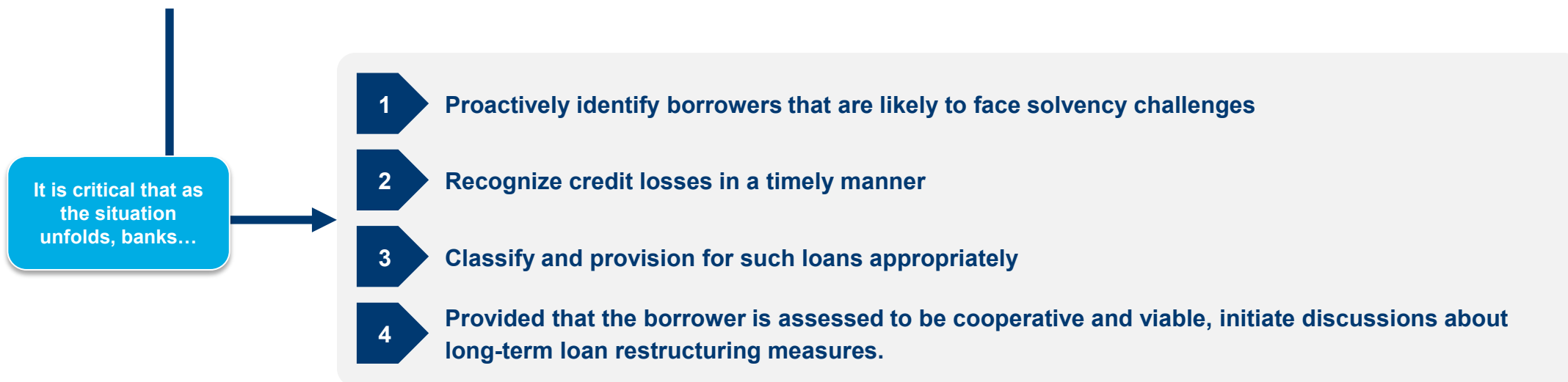
Over time, banks will need to revert to their usual practice of confirming borrower viability and cooperation prior to considering loan restructuring

Although the current borrower relief measures were originally intended as short-term restructuring measures, the distinction between short- and long-term measures is becoming blurred while measures have been extended



Given the uncertainty of the economic outlook, distinguishing borrowers with transitory liquidity difficulties from those with deeper-rooted solvency problems is a challenging task

- This distinction has **far-reaching ramifications for the type of appropriate restructuring measures that banks should consider.**
- In this regard, a crucial factor is the **bank's assessment of whether and when the troubled borrowers' income and cash flows can be expected to fully recover.**
- **Current uncertainty** should **not discourage banks from proactively identify borrowers that are likely to face solvency challenges.**



This time around, it will be important to aim for quality in undertaking long-term loan restructuring

Challenges in the aftermath of the GFC

- **Poorly functioning debt recovery and insolvency systems** and the **absence of secondary markets for NPL** portfolios made legal enforcement comparatively unattractive.
 - Low and uncertain expected recoveries
- Consequently, **banks frequently engaged in dubious loan restructuring measures to delay the recognition of inevitable credit losses**
 - Perfunctory or absent **assessments of borrower viability** and future capacity to generate free cash flows available for debt service payments.
- **Piecemeal loan restructuring approaches** such as:
 - Capitalization of unpaid interest and principal, or
 - Restructuring loans with long grace periods and/or bullet payments
 - Widespread “extend-and-pretend” practices



- A **lack of quality in restructuring** resulted in a misallocation of credit, exacerbating the economic **downturn following the GFC**.
- **Non-viable borrowers were kept afloat** and lingered around...
- **...while distressed but potentially viable borrowers often did not get the depth and quality** of long-term restructuring measures they needed to fully recover.
- Consequently, **banks' credit stock got stuck in underperforming sectors**, at the expense of newer more dynamic sectors.
- **A repetition of this scenario would significantly depress economic prospects in the years to come.**

Once banks have determined that a distressed borrower is uncooperative or non-viable, the next step is usually the initiation of legal actions to recover the debt

➤ This can entail **judicial enforcement against the debtor**, including, among others:

✓ **Collateral enforcement** (in the case of secured loans).

Typically entails the initiation of legal actions, in-court, aimed at the repossession and subsequent sale of the collateral.

✓ The **enforcement of third-party guarantees**.

✓ A petition to request the opening of **insolvency proceedings**.

Involve all creditors of the distressed borrower, subject to court supervision.

The initiation of insolvency proceedings requires that conditions stipulated in the insolvency law are satisfied.

Requested by both creditors and the debtor itself.

➤ The Global Financial Crisis exposed serious weaknesses in ECA countries' legal systems, which in some cases became seriously **strained under a heavy burden of litigation cases and bankruptcies**

➤ Time-consuming procedures, uncertain outcomes and unpredictability in the application of laws..

➤ ...which made the initiation of legal actions vis-à-vis uncooperative or unviable borrowers a comparatively unattractive option

➤ Far-reaching reforms in the decade after the Global Financial Crisis

A write-off is a formal recognition in a bank's financial statements that a borrower's asset no longer has value

How does a write-off work?

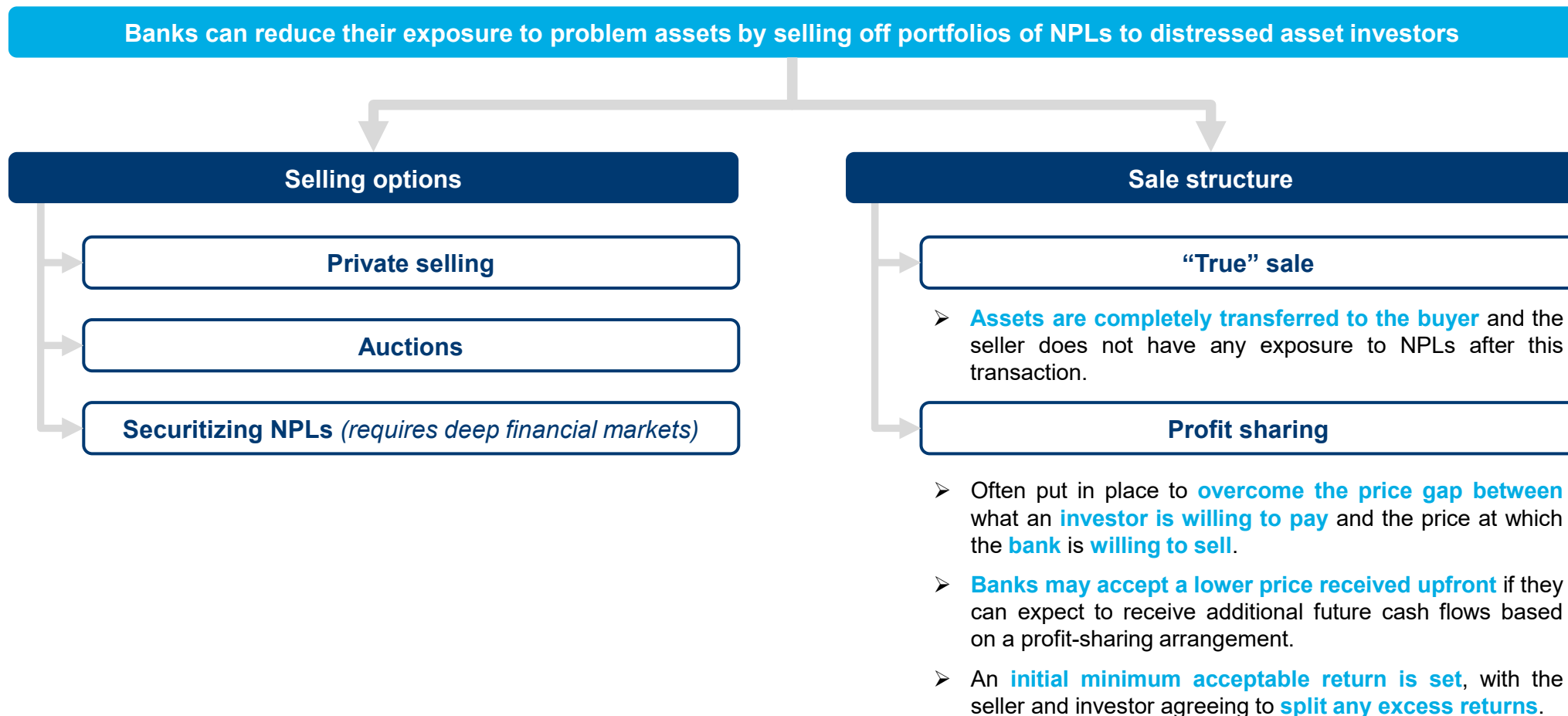
- Loans can be written-off **once credit losses are fully provisioned for and there is no realistic prospect of recovery.**
- Banks **derecognize written-off loans from their financial statements on account of uncollectability.**
- Written-off loans are transferred to the **off-balance sheet records.**
- **A write-off does not automatically imply debt forgiveness for the borrower!**

Large scale write-offs can lead to situations where banks are warehousing large volumes of written-off loans on their off-balance sheet records. The momentum for working them out or selling them off tends to fade after transfer to the off-balance sheet records.

In the absence of significant debt forgiveness, the **borrower remains trapped** with an unaffordable debt burden and no prospect of an exit

Post-GFC: banks in the ECA region have relied heavily on write-offs to lower reported NPL ratios

- In countries such as **Albania, North Macedonia, Romania,** and **Serbia,** the **removal of legal and taxation impediments** paved the way for large scale write-offs (including by streamlining onerous requirements that banks exhaust all other options before write-offs are allowed), **allowing banks to:**
 - ✓ Quickly **reduce reported NPL ratios.**
 - ✓ **Refocus on their core business** of providing new lending rather than the management of bad assets⁽¹⁾.
- As was the case in some EU countries, **local regulators exerted increasing pressures on banks to write off legacy problem loans,** and in some cases introduced limits as to how long banks could keep fully provisioned NPLs on their balance sheets.

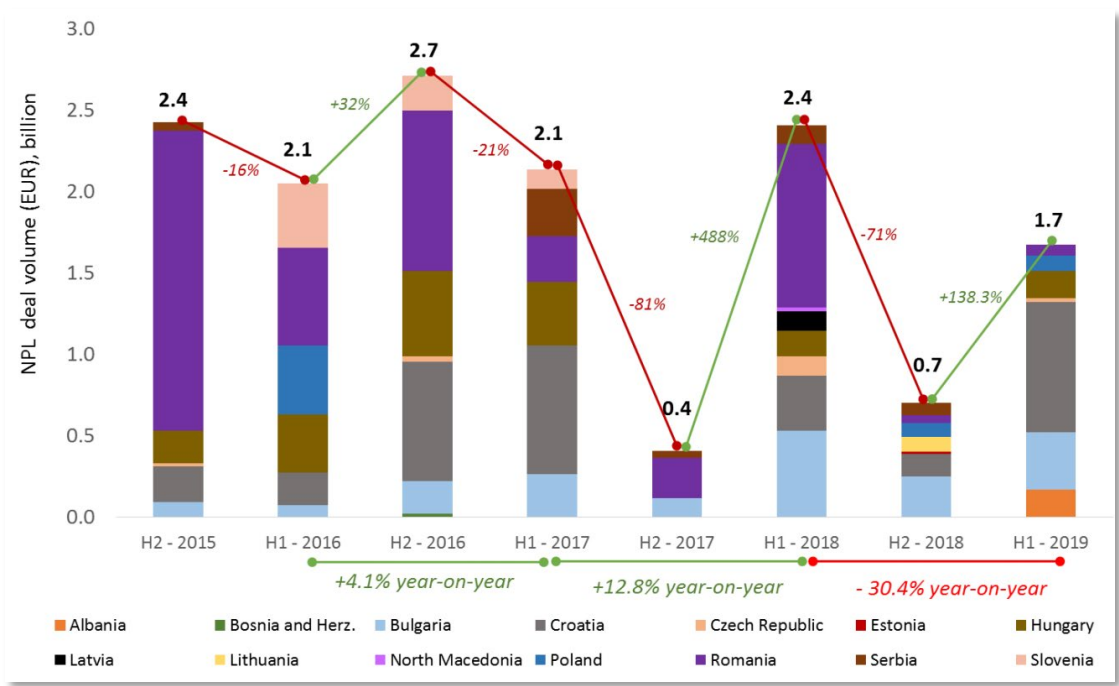



Irrespective of the structure of the sale, the investor may significantly increase collection efforts vis-a-vis the borrower



The development of secondary markets for NPLs has emerged as a topic of considerable interest to policymakers

Realized NPL portfolio transactions in CESEE (July 2015 to June 2019)¹



- In a bid to **diversify the range of NPL disposal channels**, policymakers in the euro area have made a concerted effort to develop such markets.
- NPL sales have played a **critical role in reducing NPL ratios in EU countries** with serious asset quality problems.
- Usually **unsecured problem loans** are the **first to be traded in secondary markets**.
 - ✓ **Unsecured loans** are typically **straightforward to work out** and there is **transparency for investors concerning their value given the absence of collateral**.
 - ✓ Due to the unsecured nature of these assets and the corresponding high levels of provisioning, **sales typically take place at very low prices relative to book value**, making it easier for investors to achieve their targeted returns.
- By contrast, **secondary market activity is more limited for complex, secured loans** in part **due to information asymmetries between buyers and sellers of such loans**.
- So-called **data tapes with standardized data templates** are helping to overcome these information asymmetries in recent years. 

(1) EBCI: Vienna Initiative - NPL Monitor for the CESEE region – H2 2019 ([link](#)). Note: The figures are mostly based on disclosed transactions from public sources. As a result, they may not include all transactions closed in the market and are estimations for indicative purposes only. The sourcing methodology changed for the deals from the second half of 2018 onwards. Source: Central bank reports, the EBRD network, the KPMG network and S&P Global Market Intelligence

Larger, more developed countries have been most successful in building markets for NPLs

Markets for NPLs to support policymakers in resolving rising volumes of bad assets

Transparency regarding the identity of prospective NPL buyers to contain moral hazard

- Between 2015 and 2019, total **NPL sales in the Vienna Initiative countries amounted to €14.5 billion**.
- Bulgaria, Croatia, Hungary, Romania, and Slovenia account for the bulk of the transactions, while **smaller deals have also taken place in frontier markets in the Western Balkans**.
- As is the case in the euro area, **secondary markets have developed first for unsecured retail and credit card loans**.
- Western Balkan countries: **prospective investors** in distressed assets will need to make **sizable upfront investments in the due diligence of markets**. The **opportunities to recoup these upfront costs are limited** by the small size of domestic markets.

- **Legacy NPLs** that have been **written off** and that have been **transferred to banks' off-balance sheet** records could be an obvious candidate for sales.
- **Recovery prospects** for such loans are **generally poor and further deteriorate over time**, while **banks have often shied away from taking action to resolve them**.
- In practice, **potential deals often fail to materialize on account of a persistent pricing gap**.
- **Banks** may have **unrealistic expectations regarding the market value** of such written-off loans and may also **not always fully account for the costs of carrying such assets**, including the costs of any collection efforts.

- In some countries, **willful defaulters have been known to strategically default on their debts, wait for the loan to be written off by the bank, then buy back these loans at a fraction of the nominal amount**.
- Willful defaulters have often used a **variety of techniques** (e.g. purchase by affiliates or complicated chains of sales) to **obscure the identity of the investor**. Close monitoring is needed to avoid these types of practices.

Agenda

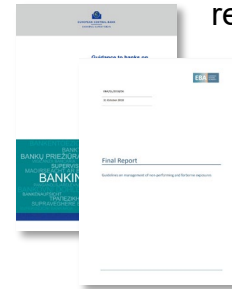
1. NPL reduction measures
- 2. Banks' NPL reduction strategies**
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Normal times

- In **normal times**, banks:
 - ✓ Routinely **manage incidental NPLs**.
 - ✓ Are usually **best positioned to manage early arrears and incidental NPLs**, particularly for large corporate exposures.
 - ✓ **Know their clients and their capacity to repay**, thus they are **best prepared to restructure, collect, and sell NPLs**.

After a turn in the credit cycle

- When **credit cycle turns and the volume of NPLs significantly increases**:
 - ✓ There has been growing recognition that **regulatory requirements** can play a key role in ensuring that **banks get ready for the task of working out rising volumes of bad debt**.
 - ✓ **ECB and EBA** have **required banks** with asset quality difficulties to articulate **NPL reduction strategies**, with detailed regulatory guidance on recognition, provisioning, reporting, and workouts:
 - ✓ **Banks present comprehensive NPL reduction strategies** and agree with the supervisory agency on **quantitative NPL reduction targets**.
 - ✓ **Strategies** should be **embedded in banks' risk and capital strategies**.



With NPL volumes set to increase significantly across the board, banks will likely again be expected to articulate NPL reduction strategies and agree with supervisory agencies on NPL reduction targets



The operationalization of banks' NPL reduction strategies has important repercussions for organization and resources

- While banks' strategies provide a roadmap, **banks will need to revisit their business model** as part of a broader shift in emphasis **from selling new loans to reclaiming past ones**.
- In order to **monitor interim performance and take corrective actions** to ensure that the overall reduction goals are met, banks will need to take more granular decisions on the:
 - **Internal organizational structure**.
 - **Allocation of internal resources** (human capital, information systems, and funding).
 - **Design of proper controls** (policies and procedures).



1

Establishing workout units

- Executing the **NPL reduction strategy requires the set-up of dedicated workout units**, in charge of handling problematic exposures

2

Portfolio segmentation and the borrower viability assessment

- As the first step in **developing a cost effective and efficient approach to NPL resolution**

3

Selecting the appropriate NPL reduction measure

- The appropriate measure can be selected **once the borrower's viability and cooperation has been assessed**

4

Following up on long-term loan restructuring


- If the bank's workout unit decides to opt for long-term loan restructuring, it will need to **agree with the borrower on a revised repayment schedule** that the borrower can realistically meet

Executing the NPL reduction strategy requires the set-up of dedicated workout units, in charge of handling problematic exposures



Workout unit: operational department in charge of handling bank's problem assets

- Separated from loan origination departments to avoid confirmation bias after the initial extension of credit.
- In charge of a more intensive oversight and resolution of problematic exposures.
- Internal triggers signaling when loans should be transferred to the workout unit need to be established:
 - 90 dpd: most frequently used.
 - Clear indication of financial distress other than payment arrears.
- Critical role in selecting the appropriate course of action for NPLs, with separate teams responsible for the management of:
 - Early arrears (< 90 dpd).
 - Late arrears, restructuring, and forbearance.
 - Legal actions, focusing on borrowers whose financial condition or cooperation level does not allow for restructuring.
 - The management of foreclosed assets.

Workout unit may also recommend disposing of NPLs through sales, or by outsourcing the recovery process to a specialized third party (e.g. a servicing company) which may be able to manage the recovery more efficiently 

Prerequisites for effective workout units

1 Implementation time

- As **establishing a fully functional workout unit takes time**, it is **recommended that**:
 - Banks without an NPL** workout unit start **putting in place a functional workout unit**.
 - Banks that have downscaled significantly their workout units** against a backdrop of decreasing NPL ratios, **start reversing this trend**.
 - Banks that have disbanded workout** units altogether should **reestablish them as a matter of urgency**.
- **Regulatory guidance** may also be useful to ensure that banks follow up as required.

2 Staffing workout units

- **Training staff for resolving problem assets takes time**, as showed in the aftermath of the GFC, when ECA countries experienced serious shortages of seasoned workout experts.
- In the aftermath of the GFC loan **origination staff was retrained to loan restructuring**, as well as **external experts** were involved on a contractual basis.
- **Currently**, banks in **ECA countries have recent NPL resolution experience** and it may prove an **important advantage**.
- **Subsidiaries of EU-based** banks could be better positioned for NPL workout given their access to HQ-based resources, expertise and systems.

Prerequisites for effective workout units

3

Commit the human and financial resources necessary

- It is often observed in ECA countries that **workout experts are assigned an excessive number of cases**, potentially **backfiring the collection effort** in the form of:
 - Lower recoveries.**
 - Longer recovery terms.**
- The reluctance to properly staff the workout unit often stems from overly optimistic expectations regarding the recovery of collateral values and future credit losses.
- **Regulatory guidance** can play a useful role in overcoming this kind of resistance.

4

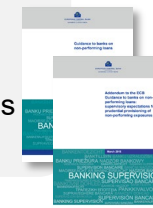
Adequate information systems

- The **low level of loan file digitalization** and **poor internal management information systems** in banks were among the **impediments to more rapid NPL resolution** in ECA after the GFC.
- **Particularly** challenge for **small local and state-owned banks**.
- While most new loan files may be adequately digitalized by now, some pieces of **information necessary for detailed NPL analysis is often missing** (e.g., details on collateral, details of contacts, and previous correspondence with the borrower).

5

Policy manuals establishing standard timelines

- The **longer a borrower remains past due**, the **less likely repayment becomes**.
- Successful resolution, therefore, requires that the **workout unit adheres to a tight but realistic timetable to ensure that the debt is restructured, sold to a third party, or collected through legal proceedings** in a **timely manner**.
- The **ECB Guidance on NPLs** requires that a **bank's policies and procedures with respect to NPL borrowers** are documented in a written policy manual that covers **recommended timelines and other aspects** related to the resolution of NPLs



2 stages

Portfolio segmentation

- Involves **dividing a large heterogeneous group of NPLs** by grouping borrowers with similar characteristics, allowing the bank to better tailor resolution strategies to the requirements of each group.
- Portfolio segmentation is **best undertaken** early on, **upon transfer of the loan to the workout unit**.

1

Portfolio filtering and borrower cooperation

2

Assessment of borrower's viability

- **Focused on filtering out exposures for which further analysis is not opportune**. This can include:
 - Exposures that are **already in legal proceedings** (assigned to the team working on legal recovery within the workout unit).
 - **Small outstanding loan amounts** (either promptly written-off with full provisioning and/or sold in batches to a third party).

Borrower cooperation

- Loan restructuring is unlikely to succeed with non-cooperative borrowers.
- Workout units should therefore:
 - Define **non-cooperative borrowers**.
 - Document their non-compliance**.
- **Particular attention** needs to be paid to **willful defaulters**:

Non-cooperative borrowers are debtors that repeatedly fail to respond to the bank's request for meetings, financial information, and access to their premises, books, and records, and who do not engage constructively with the lender (e.g. those that are generally unresponsive, consistently fail to keep promises, and/or reject loan restructuring proposals out of hand).

1

Portfolio filtering and borrower cooperation

Problems faced when trusting only on banks' own policies and methodologies

- × While it is difficult to set a general framework for the viability assessment, a **fully bank-driven approach can lead to widely diverging practices across the industry.**
- × **Banks may also lack the incentives for a rigorous borrower viability assessment**, instead opting for perfunctory analyses driven by the objective to avoid the recognition of credit losses.



2

Assessment of borrower's viability

Regulators bid to overcome these problems

- **Requirements for banks to develop internal methodologies**, which can be embedded in the bank's NPL reduction strategy.
- **High-level regulatory guidance** for the design of these methodologies.
- **Light-touch monitoring** of banks' practices through **day-to-day supervision**.

The viability assessment is most challenging for corporate borrowers, particularly under the current uncertainty

- The assessment includes an **analysis of the borrower's financial ratios**, such as:
 - Debt-to-Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) ratio > 5**
 - Interest rate coverage ratio** (i.e. EBIT/interest expense) **< 1 for a sustained period of time (e.g. two years)**
 - Operating income Persistently negative**
 - Indicate threshold values need to be set, but **professional judgment** is required
- In addition, a **more qualitative assessment of the borrower's business model and the economic environment needs to be undertaken.**
- **Under the current circumstances, sectors hit heavily by the crisis** such as tourism, travel, air-transportation, and commercial real estate (office space and hotels) **warrant particular attention.**

Current uncertainty of the economic outlook significantly **exacerbates the challenges of predicting earnings and operating income.**

1

Portfolio filtering and borrower cooperation

2

Assessment of borrower's viability

“Marginally viable borrowers”

- After filtering out borrowers that are manifestly non-viable, the **remaining group of borrowers will need to be analyzed further**.
- There will inevitably be **borrowers for whom the initial viability assessment does not yield an unequivocal outcome**.
- Such “**marginally viable borrowers**” will need to be assessed and evaluated further before a final decision can be taken, which will likely also **involve considerable qualitative judgment**.

Viability assessment of retail borrowers based on financial and behavioral analysis

- The following **financial indicators** could be considered for the viability analysis of retail borrowers:
 - Loan to income.**
 - Debt to income.**
 - Debt service to income.**
 - Loan-to-value (LTV).**
- **Debt service** (interest + principal) **to income should be < 30%** and **LTV, at origination, should be < 80%** (mortgage loans).
- **Behavioral indicators** play an **important role** in the credit scoring of retail borrowers, e.g.: usage of credit lines for credit cards and debt servicing patterns.
- **SMEs** (particularly micro) not preparing extensive financial statements **could be treated as retail exposures**.

When the appropriate measure shall be selected

- If the borrower become distressed, **viability and cooperation needs to be analyzed** which determines the range of suitable measures.
- **Restructuring should only be considered for borrowers that are viable and cooperative**

	Viabile and cooperative	Non-viable or non-cooperative
Legal actions	✓	✓
Write offs	✓	✓
Sales	✓	✓
Restructuring	✓	✗

How to select between measures

- Banks' decisions on the choice of NPL resolution channel should be guided **by comparison of expected recoveries using NPV calculations**:

$$NPV = \sum_{t=0}^T \frac{NCF_t}{(1 + EIR)^t}$$

- **Based on the concept of time value of money**, i.e. money received in the future is less valuable than money received today.
- Comparing NPVs for different resolution options **allows banks to identify the option with the highest expected pay-offs**, factoring in the time value of money and **fully accounting for costs**, including opportunity costs.
- NPV calculations and comparisons can also **help to justify a bank's measures in case these are scrutinized ex post**, as often occurs in state-owned banks.

NPV calculations should be based on conservative estimates for recoveries, discount rates, and carrying costs

1 Recoveries

- It is extremely important to have realistic expectations about recoveries.
- **Poorly functioning insolvency regimes**, for example, directly **translate into lower recovery** rates which will need to be properly reflected.
- Such **low recovery rates make legal enforcement comparatively unattractive**, which may have the unintended side effect of incentivizing banks to steer problem loans, including cases of questionable viability, towards restructuring.
- In practice, banks' **decisions to pursue legal enforcement are often based on optimistic, unrealistic assumptions** regarding the **time this can take**.

2 Discount rates

- **Tend to be quite high**, reflecting that the value of **distressed assets erodes very quickly** over time.
- Can be **established by first setting a standard base rate with specific surcharges depending on the characteristics of the loan**, such as past delinquency status and documentation deficiencies.

3 Carrying costs

- **Banks often underestimate the carrying costs** of maintaining NPLs.
- Banks will need to **realistically account for all the costs**, including:
 - ✓ Costs **incurred during the enforcement process** (e.g., taxes, fees, maintenance, legal costs).
 - ✓ Costs **associated with collection efforts**.

If the bank's workout unit decides to opt for long-term loan restructuring, it will need to agree with the borrower on a revised repayment schedule that the borrower can realistically meet

- In a best-case scenario, the **bank and the borrower arrive at a consensual solution that satisfies both parties** and results in a successful long-term loan restructuring.
- The bank will need to develop a **thorough understanding of the borrower's financial position** to calibrate the loan restructuring proposal, including (1) **borrower's affordability**, (2) **cash generating capacity**, and (3) **available collateral**.



1
An affordability assessment is key to draft a viable long-term restructuring plan

	Action	Information source	Output
Corporates	Assessment of borrower's total liabilities. Analysis of borrower's leverage (the ratio of debt-to-EBITDA)	Bank's internal information, credit bureaus, other registries, borrower's financial statements	Borrower viability assessment
	Future cash flows, adjusted for expenses and taxes. Analysis of borrower's ability to service the debt (ratio of EBIT/debt interest payments)	Borrower's financial statements, reliable GDP and sectoral growth forecast	Sustainable level of debt service capacity to allow for company's growth
Retail loans	<ul style="list-style-type: none"> ➤ For the purpose of retail loan restructuring the concept of reasonable living expenses can be introduced: <ul style="list-style-type: none"> ✓ The bank can determine a debt level that is consistent with the borrower's debt-shouldering capacity and a decision can be made about the amount of debt relief in NPV terms that needs to be provided. 		

2

The repayment obligations of the restructured loan should match expected cash/income flows of the borrower

- To optimize the chances that the borrower stays current on payments of the restructured loan, **banks need to consider future income flows of the borrower.**
- The **new repayment schedule should be calibrated to include this analysis.**
- For example, the **expected retirement age should be considered for retail borrowers** or an expiry of a patent or license for a corporate.

3

Assessment of any pledged collateral

- Banks should review if the **existing collateral is correctly registered** and **whether it will be easily enforceable in the case on non-payment.**
- Banks might opt for **additional collateral if feasible.**
- According to good practice, **revaluation of collateral** should be performed **prior to loan restructuring** to ensure the amount of collateral pledged against the loan remains adequate.

Performance of the restructured loans (under new loan terms)

- Banks should **closely monitor the borrower's repayment behavior following restructuring**, and respond quickly in the event of recurrent payment difficulties
- Loans can only be **moved back to the performing** loan category after the borrower has rebuilt a **track record in servicing the rescheduled debt.**
- This is to **ensure that loan 'evergreening' practices**, previously often used by banks, **are discontinued.**



Agenda

1. NPL reduction measures
2. Banks' NPL reduction strategies
3. **Systemwide NPL resolution strategies**

While banks have primary responsibility for the management of distressed loans, circumstances can arise that require more direct public policy measures, complementing banks' NPL reduction efforts

- Direct **public policy interventions** may be warranted when:
 - i. Banks' exposure to problem loans jeopardizes their capacity to finance the real economy or **threatens the stability of the financial system**.
 - ii. Banks are **unable to recognize their losses due to thin capital positions** or lack the necessary skills to work out large volumes of problem loans.
 - iii. The **legislative framework for debt enforcement and insolvency is weak** or unable to accommodate a large number of cases.
- In these circumstances, public policy measures can play a useful role in overcoming obstacles and significantly accelerate the rate of NPL reduction.



1

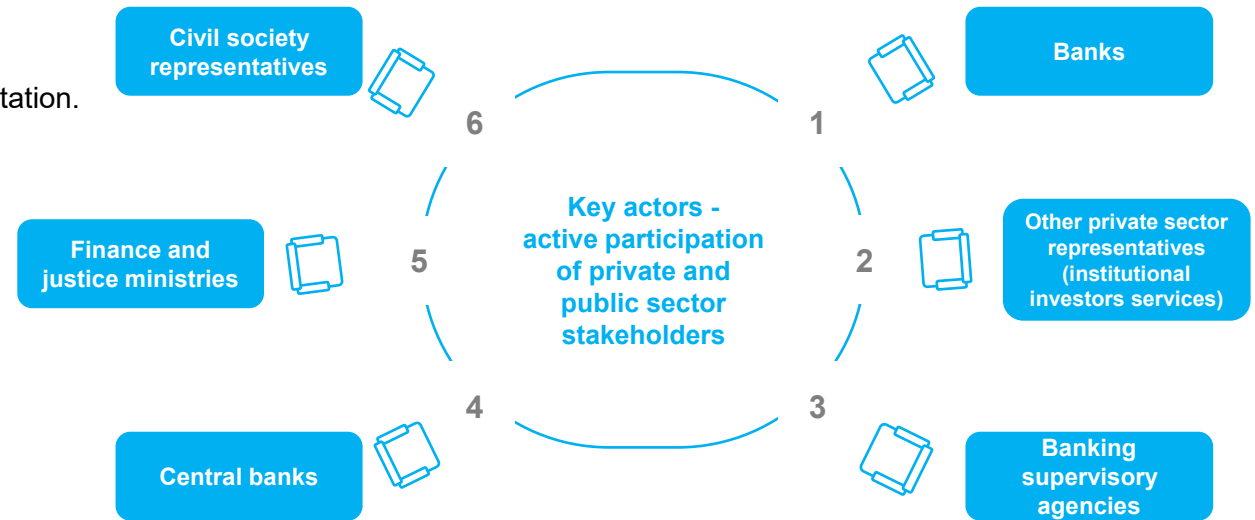
Coordinated NPL reduction strategies

2

Public Asset Management Companies (AMCs)

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, have played an important role in several ECA countries in **accelerating the rate of NPL reduction** following the GFC
- These stakeholders can be represented in a national high-level working group
- The **mandate** of the **high-level working group** should be:
 - ✓ Fully diagnose the obstacles to NPL resolution.
 - ✓ Set reform priorities.
 - ✓ Ensure that all stakeholders are clear on their role in implementation.



A successful strategy must build on robust coordination and interaction among these actors to ensure that their actions and measures are well-aligned



Policy coordination at the international level can usefully complement domestic efforts

The Vienna Initiative (January 2009) played a key role when the GFC hit with full force. It brought together public and private sector stakeholders

While the immediate focus was on preventing disorderly withdrawals by foreign parent banks from ECA countries, over time the emphasis shifted towards resolving the legacy issues exposed by the GFC, including NPL resolution

Following the launch of an influential report in 2012, that identified the many obstacles for NPL resolution in the region, the Vienna Initiative established an NPL workstream that draws on work within public sector participants

In the aftermath of the pandemic, it has significantly stepped up its activities with a renewed emphasis on financial stability, including NPL resolution



What is an AMC?

An AMC is an entity that manages non-performing assets removed from the financial system with the goal of maximizing the recovery value of these assets



Public AMCs accompanied by publicly funded bank recapitalization schemes

- Full recognition of NPLs can cause weak banks to fall below capital requirements
 - Publicly funded bank recapitalization schemes can help to **overcome capital space constraints** that impede efforts to increase transparency and clean up banks' balance sheets.
 - This has been the case in, for instance, **Malaysia and Spain**.
 - Banks that had been **weakened due to the burden of NPLs** were given a **one-off opportunity to recapitalize with public support** so that they continue to comply with capital requirements.
 - In exchange, banks that benefitted from the scheme underwent **significant restructuring to secure their long-term viability**.
-

Supervision of public AMCs

- There is **no clear consensus on whether public AMCs should be supervised**.
- Where banks are financially exposed to AMC bonds (received in exchange for transferred problem loans), **supervision can be justified to ensure that the AMC remains financially sound**, to avoid losses on banks' portfolios of AMC bonds.
- However, **supervisory agencies may not be equipped to understand and supervise an AMC**.
- Bringing an AMC under financial supervision may also **send a message that it is a permanent fixture**, even though it is intended as an exceptional and temporary tool.

Effectiveness of public AMCs depends on a (long) series of preconditions

- Most **likely to be effective** if they have a **clearly articulated, narrow mandate** (e.g. resolving NPLs), with **measurable goals**, a **sunset clause**, a **commercial focus**, and **robust governance, transparency, and disclosure arrangements**.
- Acquisition of loans needs to be **time-bound and at realistic prices**.
- Funding of the public AMC should **provide time to realize the underlying value of the assets** while preventing a permanent warehousing of bad loans.
- More **likely to be effective when**:
 - i. **Embedded in a broader comprehensive NPL resolution strategy**.
 - ii. With strong **political will to recognize losses** and undertake comprehensive reforms.
 - iii. Supported by detailed, accurate, and up-to-date information on banks' exposure to troubled assets.
 - iv. Underpinned by robust bank resolution, debt recovery, and creditors' rights frameworks.

Designed and managed public AMCs

Potential advantages

- ✓ Public AMCs can **promote transparency in banks' exposure to problem assets by forcing them to recognize losses**.
 - ✓ Public AMCs that are accompanied by bank recapitalization schemes help to overcome capital space constraints, that can hinder full recognition of problem assets.
- ✓ **Economies of scale in the management of distressed assets**, and greater cost-efficiency owing to their size and specialization.
- ✓ **Gathering a large volume of homogeneous distressed assets, packaging them for sale** to outside specialist investors, while also **benefitting from enhanced bargaining power** with both purchasers and borrowers.
- ✓ Transfer to a public AMC **provides time to realize the value of these assets**, thereby avoiding unnecessary losses associated with fire sales.
- ✓ **By carving out a set of large, relatively homogeneous exposures**, public AMCs **take some of the pressure off banks' workout units** and help the bank to refocus on new lending.
- ✓ By **consolidating loans to a distressed borrower with a single party**, public AMCs effectively **eliminate complex multi-creditor issues** that typically involve substantial costs and delays.



Potential disadvantages

At the same time, poorly designed and managed public AMCs can do more harm than good. Among the **main problems observed** in practice:

- × **Political interference**, pressuring the public AMC to support well-connected borrowers or strategic sectors with no clear link with financial stability
- × **Staffing** that prioritizes political connections over commercial expertise
- × **Weakening credit discipline**, when **willful defaulters can buy back their original debt at a fraction of the original value**
- × **Acquisition of problem assets at inflated prices**, discouraging prudent loan origination by banks and jeopardizing the financial sustainability of the public AMC.
- × A **non-transparent buildup of contingent liabilities** for the government that is funding the public AMC.
- × **"Warehousing"**, i.e. a failure to dispose of acquired assets in a timely manner.

Some of these design features are covered in EU regulations for establishing AMCs

- According to these regulations, **AMCs can be established either**:
 - ✓ **Without involvement of public resources** (i.e., private AMCs).
 - ✓ **With public support** that is compatible with the EU Treaty (Art. 107).
- To **comply with state aid rules**:
 - ✓ The **transfer price of assets** to the AMC may be above the market price as long as it **does not exceed the real economic value**, defined as the “underlying long-term economic value of the assets, on the basis of underlying cash flows and the broader time horizon”.
 - ✓ The **transfer** of assets at **book value is not permitted**.
- If the **transfer price exceeds the applicable market value of the assets**, then the **existence of state aid** (to the bank that is selling the distressed assets) **is presumed**.

EU Banking Recovery and Resolution Directive (BRRD)

- Under the BRRD, **such public support would usually trigger the bail-in of the bank’s junior creditors** and hybrid instruments holders and **requires the implementation of a restructuring plan** for the bank to return to long-term viability.
- In **exceptional circumstances**, exemptions to the restructuring and bail-in requirements could be granted, for example on the grounds that the public support addresses a market failure or remedies a serious disturbance in the economy or threat to financial stability.



European Commission has published guidance on the design and set-up of a public AMC



Policy Note “**COVID-19 and Non-Performing Loan Resolution in the Europe and Central Asia region**” is available:

- on the FinSAC website ([link](#)).

Policy Note “**Borrower Relief Measures in ECA Region**” is available:

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

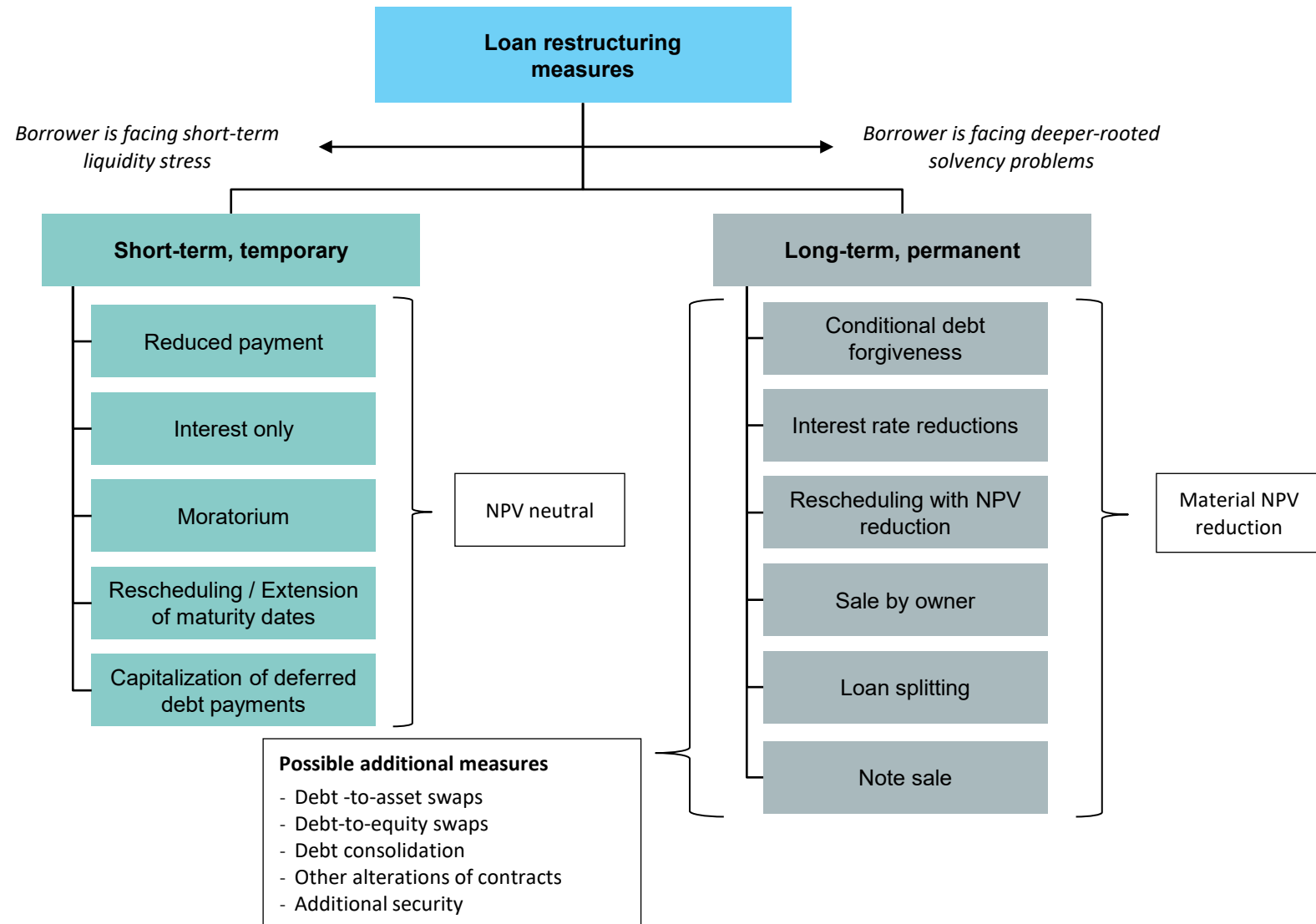
Thank you!

Annex

1. Short-term versus long-term loan restructuring
2. Legal frameworks in the aftermath of GFC
3. EBA NPL templates
4. Willful defaulters
5. Working out MSME loans in Slovenia
6. Stages in the NPL workout process
7. An example of comparative NPL analysis
8. NPV estimation
9. National NPL reduction strategies
10. Public Asset Management Companies (AMCs)

Annex: short-term versus long-term loan restructuring

Borrower relief measures taxonomy



- It is **generally challenging** to distinguish between borrowers that are temporarily liquidity-distressed and those that are facing deeper-rooted solvency problems
- This difficulty is currently exacerbated by **uncertainty regarding the unwinding of emergency measures** and the **economic recovery trajectory**

Annex: short-term versus long-term loan restructuring

Main characteristics of measures (1 of 2)

1

Short term

Definition	Measures	Main characteristics
	<p>Reduced payments</p>	<ul style="list-style-type: none"> ➤ Company's cash flow is sufficient to service interest and make partial principal repayments.
	<p>Interest only</p>	<ul style="list-style-type: none"> ➤ Company's cash flow can only service its interest payments, and no principal repayments are made during a determined period of time.
<ul style="list-style-type: none"> ➤ There is reasonable expectation that the borrower's sustainable cash flow will be strong enough to allow the resumption of its existing payment schedule at the end of the forbearance period. 	<p>Moratorium</p>	<ul style="list-style-type: none"> ➤ Agreement allowing the borrower to temporarily suspend payments of principal and/or interest for a clearly defined period, usually ≤ 90 days. ➤ It is also often used in the beginning stages of a workout process (especially with multi-bank borrowers) to allow the bank and other creditors time to assess the viability of the business and develop a plan for moving forward.
	<p>Rescheduling/Extension of maturity</p>	<ul style="list-style-type: none"> ➤ Extension of the maturity of the loan allows a reduction in installment amounts by spreading the repayments over a longer period.
	<p>Interest and capitalization of repayment</p>	<ul style="list-style-type: none"> ➤ Adds deferred payments and/or deferred interest to the outstanding principal balance for repayment under a sustainable revised repayment program.

Annex: short-term versus long-term loan restructuring

Main characteristics of measures (2 of 2)

2

Long term

Definition	Measures	Main characteristics
<ul style="list-style-type: none"> ➤ Permanently reduce borrower's debt. ➤ Most borrowers will require a combination of the options mentioned below to ensure repayment. ➤ (Bank) Need to demonstrate that the borrower's projected cash flow will be sufficient to meet the restructured payment terms. 	Conditional debt forgiveness	<ul style="list-style-type: none"> ➤ Bank forfeits the right to legally recover part or the whole of the amount of an outstanding debt upon the borrower's performance of certain conditions.
	Interest rate reduction	<ul style="list-style-type: none"> ➤ Permanent (or temporary) reduction of the interest rate (fixed or variable) to a rate that is more sustainable for the borrower.
	Rescheduled payments	<ul style="list-style-type: none"> ➤ The existing contractual payment schedule is adjusted to a new sustainable repayment program based on a realistic assessment of the borrower's cash flows, both current and forecasted
	Sale by owner / assisted sale	<ul style="list-style-type: none"> ➤ Borrower voluntarily disposes the secured assets to partially or fully repay the debt. ➤ Usually combined with the partial repayment option or conditional debt forgiveness.
	Loan splitting	<ul style="list-style-type: none"> ➤ Used to address collateral and cash flow shortfalls. ➤ Debt is split: (i) amount that can be repaid from sustainable cash flow (maturity ≤ 5 years); and (ii) the remaining portion "excess debt" (which can be subordinated).
	Note sale	<ul style="list-style-type: none"> ➤ New investor wishes to restructure a company's overall debt burden on commercially acceptable market terms. ➤ Usually combined with conditional debt forgiveness.
	Debt-to-asset swap	<ul style="list-style-type: none"> ➤ Converts the loan, or a portion of the loan, into "other assets owned" where the ultimate collection of the original loan requires the sale of the asset.
	Debt-to-equity swap	<ul style="list-style-type: none"> ➤ Converts the loan, or a portion of the loan, into an equity investment. Generally used to strengthen the capital structure of large highly indebted corporate borrowers
	Debt consolidation	<ul style="list-style-type: none"> ➤ Combines multiple exposures into a single loan or a limited number of loans (more common for retail exposure).
	Other alterations of contract/covenants	<ul style="list-style-type: none"> ➤ When entering a restructuring agreement, it is generally necessary to revise or modify existing contracts/covenants to meet the borrower's current circumstances



Annex: legal frameworks in the aftermath of GFC

Weak legal frameworks for enforcing creditor rights in the aftermath of GFC

- The **increase in NPLs in the aftermath of the GFC exposed serious shortcomings in ECA countries' legal systems**, which in some cases became seriously strained under a heavy burden of litigation cases and bankruptcies:

Poorly prepared to deal with a major surge in NPLs

- Introduced significant **uncertainty regarding ultimate recovery prospects** due to:
 - **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 unviable borrowers towards an orderly exit
- Low interest rates, long grace periods, bullet payments, and frequent rescheduling

Potentially viable borrowers

- **Often did not received the loan restructuring necessary** to restore their commercial viability
- Pushed towards a formal or informal liquidation process.

Suspension of the right of creditors to enforce

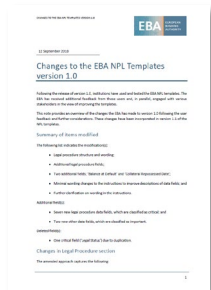
- Although these measures helped to flatten the bankruptcy curve, they also contributed to a **proliferation of strategic defaulters that were financially capable to repay but opted not to**, knowing there would be no enforcement.

Willful defaulters

- Even when **such moratoria were lifted**, these issues lingered on, as **courts had only limited capacity to deal promptly with their cases** (or could be influenced to delay the proceedings).
- In hindsight, the **increase in NPLs following the GFC** was not only driven by a deterioration in the financial standing of borrowers, but **also by moral hazard associated with willful defaulters.**

These experiences underscore the importance of ensuring that borrowers pay according to their financial capacity





- In 2017, the EBA issued NPL templates to reduce information asymmetries between prospective buyers and sellers.
- Their main purpose was to stimulate the development of a functioning secondary NPL market in the EU.
- There were developed two sets of templates: (i) NPL portfolio screening templates and (ii) NPL transaction templates.
- The latter was more granular and aimed at enabling prospective buyers to conduct detailed financial due diligence on loan files for loan valuation purposes.

➤ The EBA NPL transaction template **includes the following data categories:**

- | | |
|---|---------------------------------------|
| i. Portfolio. | vi. Forbearance. |
| ii. Counterparty (group). | vii. Property collateral. |
| iii. Loan. | viii. Non-property collateral. |
| iv. Historical collection and repayment schedule. | ix. Forbearance enforcement and swap. |
| v. External collection. | |

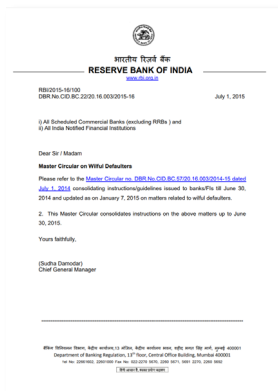
- Under **each category, additional data points are included** (for example, collateral location, legal status, enforced date, and so on).
- Each data point is assigned a **mark for its criticality during the valuation process**: (i) critical, (ii) important, and (iii) moderate. **Some of the data points are attributable to corporate loans while others only to residential mortgages.**

Example of regulators providing a definition of willful default

- Rather than leaving the definition of willful defaulters to banks, regulators can also provide a definition.
- Establishing a regulatory definition has the advantages of:
 - Promoting greater consistency in industry practices.
 - Allowing banking supervisors to address instances where banks' practices fall significantly short of regulatory requirements.
- As an example, in July 2015 the Reserve Bank of India issued a Master Circular on Willful Defaulters to strengthen the Regulation on Problem Assets.

Events that were identified as indications of willful default

- The unit **has defaulted** in meeting its payment/repayment obligations to the lender **even when it has the capacity to honor the said obligations.**
- The unit has defaulted in meeting its payment/repayment obligations to the lender and **has not utilized the finance from the lender for the specific purposes for which finance was availed of** but has diverted the funds for other purposes.
- The unit has defaulted in meeting its payment/repayment obligations to the lender and **has siphoned off the funds so that the funds have not been utilized for the specific purpose for which finance was availed of**, nor are the funds available with the unit in the form of other assets.
- The unit has defaulted in meeting its payment/repayment obligations to the lender and has also **disposed of or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.**



1

Challenges that workout of MSME loans presents to banks

- MSME NPLs are large by numbers but small by nominal amounts. Based on these parameters, the workout of MSME NPLs is a labor-intensive and a costly process.
- Therefore, MSMEs account for the majority of businesses worldwide and are important contributors to job creation and global economic development. They represent about 90 percent of businesses and more than half of employment worldwide.
- Formal MSMEs contribute up to 40 percent of national income in emerging economies.

2

WB assisted the Bank of Slovenia in developing a handbook

- After resolving many NPLs of large corporates through a national AMC established in 2013, the emphasis gradually shifted towards the workout of MSME NPLs.
- According to the Bank of Slovenia, in mid-2016 MSME loans accounted for more than 70 percent of banks' remaining NPL stock, totaling €1.5 billion or around 4 percent of national income.
- MSME NPLs were often small (36.5 percent had nominal amounts of less than €10,000) and frequently heavily in arrears, as many small loans had not been serviced for a long time.
- Handbook developed, as part of an EU-funded technical assistance project completed in 2016, aimed to provide guidance to banks in working out MSME NPLs.

3

Limitations of banks' to work out a large amount of MSME NPLs

- Considering the size of the country and its banking system, the scope for substantially expanding existing workout units was deemed limited. The problem was exacerbated by skills shortages.
- At the same time, access to NPL servicing and collection companies improved and NPL markets started to develop, with increasing interest from professional NPL investors.

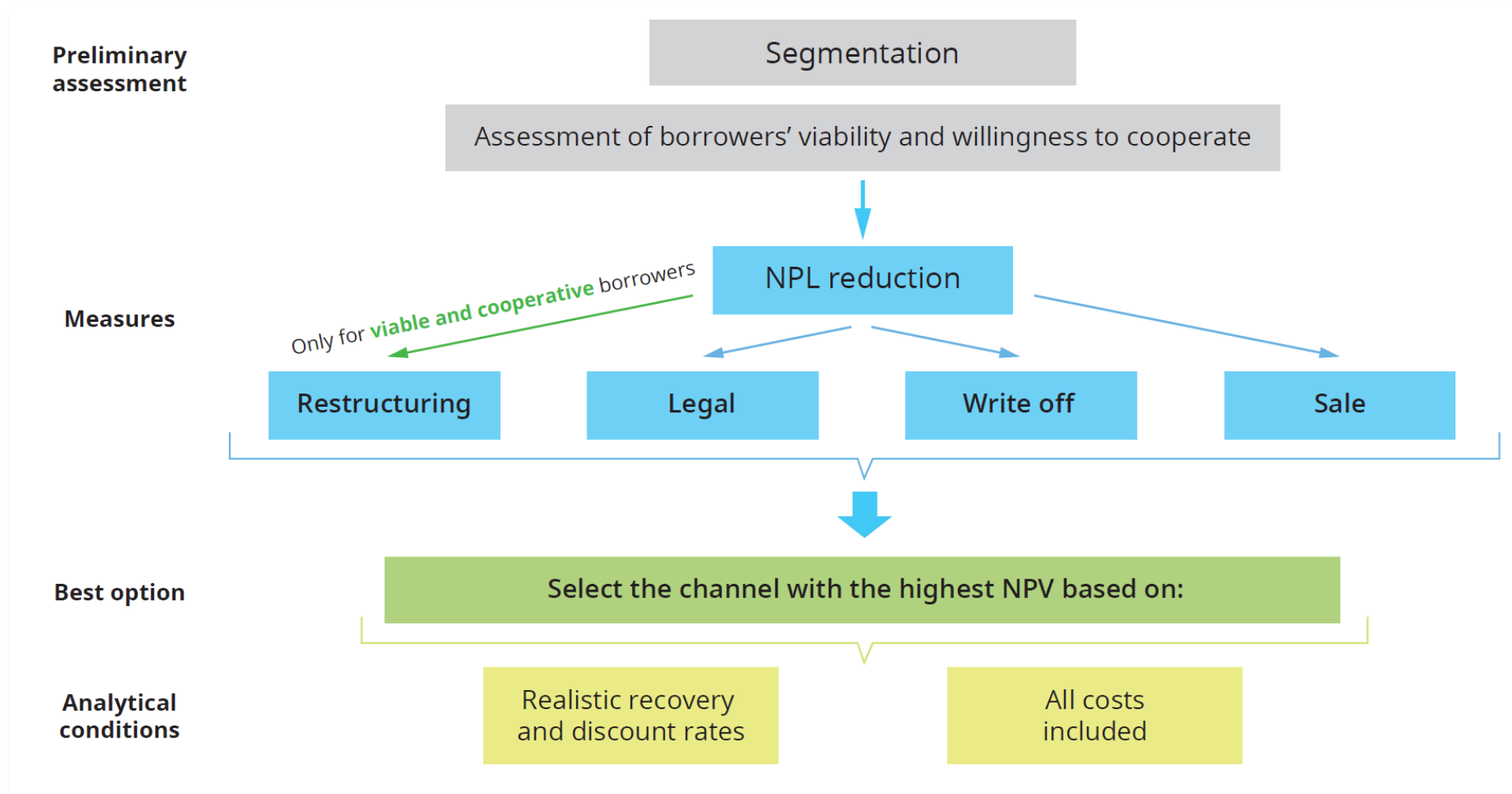
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Separating MSME NPLs below €10,000 into a separate portfolio

- The threshold at €10,000 was based on a careful analysis of the MSMS NPL portfolio in Slovenia.
- Given the very seasoned NPL stock, with very low expected recoveries, it was not considered rational to allocate scarce resources to design a tailor-made solution for these micro exposures.
- The handbook therefore recommended (i) a very simple, standardized workout approach, including a prompt write-off after full provisioning and/or (ii) a sale of portfolio to a third party for these exposures.
- The focus on a standardized approach or sale would allow the bank to focus on larger NPL cases requiring more resolution skills. In addition, it would allow NPLs to be resolved in a cost-efficient manner, which should be one of the main guiding principles in the workout process.

Annex: stages in the NPL workout process

Schematic overview of the various stages in the NPL workout process



Comparing NPVs (1 of 2)

Context

- In this highly simplified example, the **factory of an SME borrower has been severely damaged in a devastating flood.**
- The customer requests that its **currently outstanding € 1,000,000 loan be restructured** as follows:
 - ✓ **1 year interest only** with the **balance to be repaid in 4 annual installments.**
 - ✓ The **interest rate on the loan will be 5%.**
- Simultaneously, an **independent third-party investor offers to purchase the loan for € 825,000.**

Information for NPV calculation

- For the purposes of the NPV analysis, the **bank's standard risk adjusted discount rate is 7%.**
- The **collateral** was valued within the past month by the bank's internal appraisal staff at **€ 833,333** and a **10 percent discount** has been applied **to adjust the price to its estimated auction sale value in year 2 under the bankruptcy scenario.**
- The **value of the property** has been **reduced by additional 10 percent** if the bank **resorts to legal actions** to recognize the additional length of time to conclude these proceedings.
- **Expenses for the enforcement** proceedings are estimated to be **€ 2,500**, and the **expected duration is 3 years.**

Annex: an example of comparative NPL analysis

Comparing NPVs (2 of 2)

	NPV	Year 1	Year 2	Year 3	Year 4	Year 5
Restructure	812,155					
Principle		0	250,000	250,000	250,000	250,000
Interest		50,000	50,000	37,500	25,000	12,500
Cash Flow		50,000	300,000	287,500	275,000	262,500
Loan Sale	825,000					
Cash Proceeds						
Legal actions	548,811					
Sale at auction				675,000		
Cost of enforcement		-800	-950	-750		
Proceeds		-800	-950	674,250		

Some relevant aspects to keep in mind

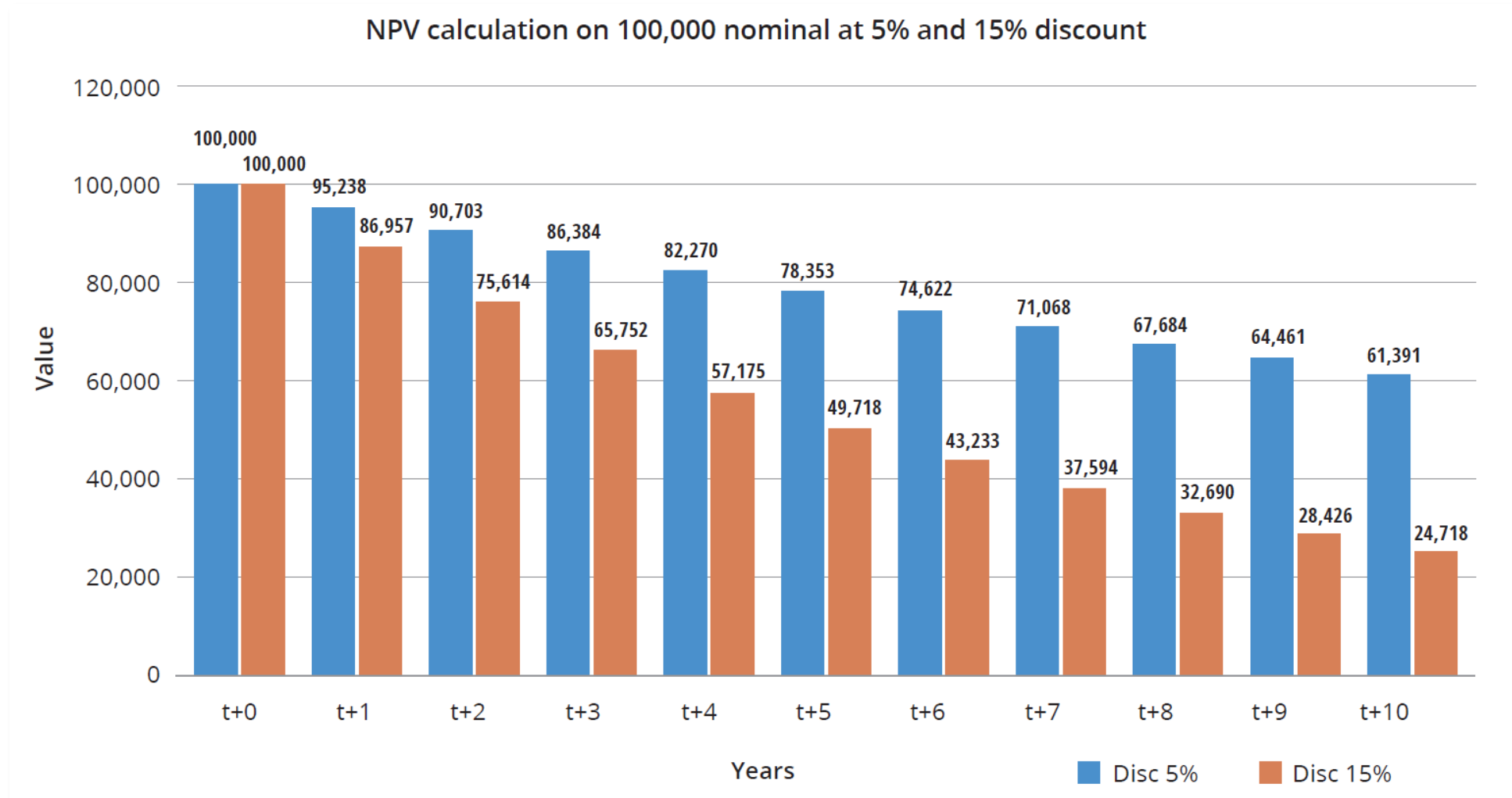
- The results are **highly sensitive to the choice of the discount rate**. Determining the rate is an art not a science and it should reflect both the riskiness of the borrower and a proxy for the cost of the workout.
- The assumption has been made that the **bank will use its internal legal staff for any enforcements** or insolvency proceedings. **No deductions are made**, therefore, to reflect these costs. If, however, the bank had chosen to use an outside counsel, that cost would have been reflected in the analysis as cash outflows, reducing the ultimate recovery value.
- Very importantly, the bank should keep in mind that **loan restructuring is associated with substantial expenses to prepare, negotiate, and monitor the restructuring agreement**. Banks can choose to adjust discount rates upward to more fully reflect these costs or consider using standard cost per year in the analysis so as to reflect the true costs of various workout solutions.

Under stated circumstances, the analysis indicates that selling the loan to a third party offers the highest expected NPV



Annex: NPV estimation

NPV estimation at 5 and 15 percent discount

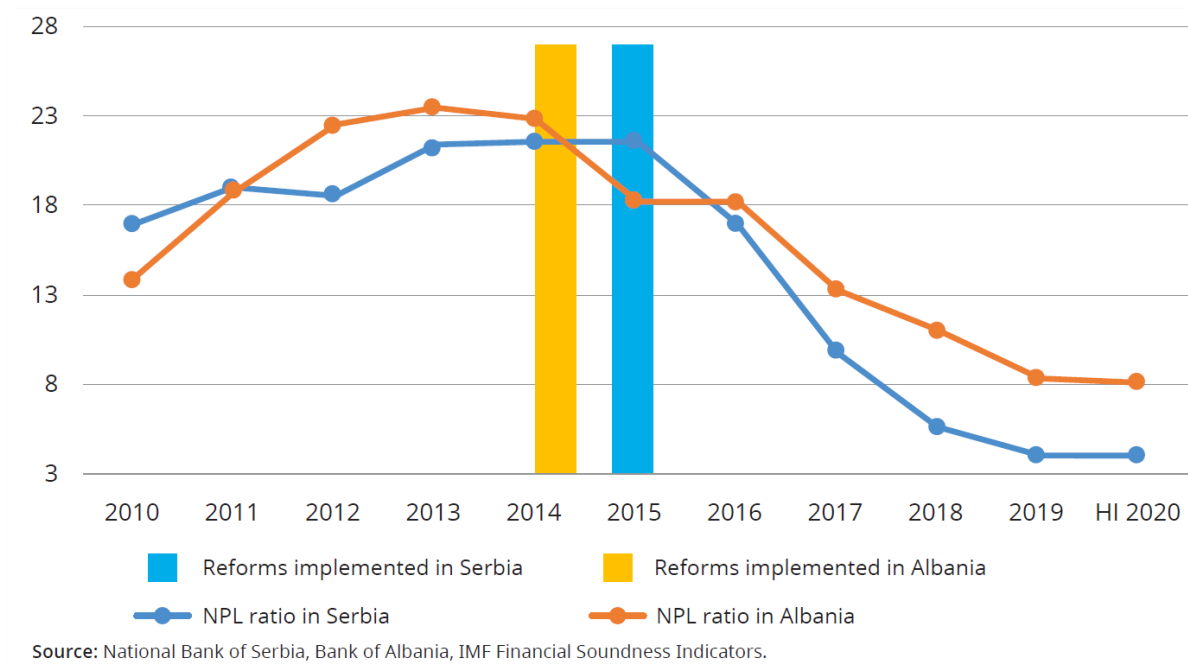


Annex: national NPL reduction strategies

The experiences of Albania and Serbia (1 of 3)

In the aftermath of the GFC, Albania and Serbia experienced a surge in NPLs, with NPL ratios well in excess of 20 percent.

- In both countries the GFC heralded a pronounced economic slowdown while a significant depreciation of local currencies led to the emergence of forex-induced credit risk.
- Serbia's NPL ratio peaked at 23.5 percent in 2013 with particularly elevated NPL levels in the construction (49 percent), real estate business (40 percent), and manufacturing and mining (25 percent) sectors. Asset quality pressures also contributed to the failure of five banks between 2008 and 2014.
- Albania's NPL ratio increased from 6.5 percent in 2008 to 24.9 percent by September 2014. The construction and real estate development sectors were the most exposed to asset quality problems.





Serbia

National NPL working group (May 2015) by Government decree

- The working group comprised participants from the Ministries of Economy, Finance, and Justice and the National Bank of Serbia as core members.
- It agreed that international financial institutions (IMF, World Bank, IFC, EBRD) would take an active role in the work of the working group and the design of the strategy.
- In addition, the Deposit Insurance Agency (as the manager of assets transferred from bankrupt banks) and the Chamber of Commerce were involved to address issues pertinent to their areas of specialization.

Working group to prepare and implement a comprehensive strategy for the reduction of NPLs

- The strategy consisted of four pillars: (i) improving banks' capacity in dealing with NPLs, (ii) enabling conditions for the development of the NPL market, (iii) improving and promoting out-of-court restructuring, and (iv) improving in-court debt resolution and mortgage framework.
- The strategy was informed by a KPMG study of the impediments to the sale of NPLs in Serbia. Two separate action plans were prepared to implement the strategy over the period of three years - one by the National Bank and one by the Ministry of Finance.
- The progress of reforms outlined in the action plans was reviewed and discussed at the working group on a quarterly basis. The mandate of the working group was extended by the government in the autumn of 2018 until 2020 to address remaining issues and to work on the prevention of NPLs in the future.
- Under this new program, FinSAC in cooperation with KPMG Serbia prepared a study on the corporate viability of Serbian enterprises, covering the period 2014-2018

Strategy contributed to a rapid decrease in the NPL ratio

- By September 2020, the NPL ratio had reached a historic low of 3.4 percent.
- The NPL ratio started to decrease in 2016 after the start of reforms envisaged in the strategy.
- However, despite the decrease in the NPL ratio, the corporate viability study conducted in 2019 showed that the number of companies with financial difficulties remained broadly unchanged, raising questions about the sustainability of the NPL reduction drive.



Albania

National NPL reduction strategy implemented in Albania

- An inter-institutional working group on NPL resolution in Albania was established with a decree issued by the Prime Minister in 2014.
- The Ministries of Economic Development, Tourism, Trade, and Entrepreneurship were made responsible for coordinating the work of the working group, which also consisted of the Bank of Albania and the Ministries of Finance and Justice.
- The IMF, IFC, and World Bank also supported the working group.

Comprehensive twelve-point NPL Action Plan prepared by the working group (August 2015)

- The Bank of Albania and the Ministry of Justice were to take the lead on the implementation of the reforms.
- The Bank of Albania was put in charge of the following reforms: (i) a revision of the credit risk regulation, (ii) addressing the 35 largest defaulting groups of corporates, responsible for more than half of the outstanding stock of NPLs, (iii) improving the licensing of NPL buyers, (iv) adopting a framework for out-of-court workouts, and (v) upgrading the Credit Register, among others.
- The actions planned by the Ministry of Justice were: (i) drafting a new bankruptcy law, (ii) amending the Code of Civil Procedure, (iii) amending the Law on Registration of Immovable Properties, and (iv) amending the Law on Securing Charges.

Regulation requiring to write-off NPLs classified as full loss > 3 years

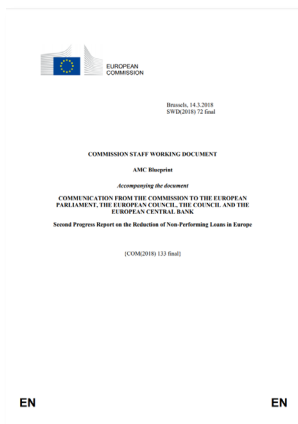
- This measure contributed to a significant increase in write-offs, which led to a decrease in the NPL ratio to 18.2 percent by end-2015.
- To address large corporate NPLs, the Bank of Albania issued a Guideline on Corporate Loan Restructuring in 2014, but this effort was less successful due to a lack of cooperation among banks and remaining weaknesses in the judicial framework.
- In 2019, the Bank of Albania issued a new regulation on the out-of-court treatment of distressed borrowers that gave banks enhanced incentives to resolve multi-lender NPLs, by establishing similar majorities as the ones envisaged in the recently adopted insolvency law.

The passage of a modernized insolvency law (110/2016) was a major step forward in the Albanian legal system. Reform to the Albanian civil procedure code partially improved the efficiency of auctions and judicial enforcement (however, not as significant as in other countries in the region)



Annex: Public Asset Management Companies (AMCs)

European Commission has published guidance on the design and set-up of a public AMC



- In March 2018, the European Commission published the AMC Blueprint to provide **guidance to Member States on the design and set-up of a public AMC**.
- It requires **AMCs to be fully compliant with the EU legal framework** including state **aid rules**, the **BRRD**, and the **Single Resolution Mechanism Regulation**.
- Furthermore, it elaborates on:
 - i. The suitability of assets to be transferred to an AMC.
 - ii. Asset valuation and transfer price aspects.
 - iii. The need for granular, timely, and accurate data on loans and collaterals.
 - iv. Funding aspects.
 - v. Safeguard mechanisms and proper supervision.
- The **AMC Blueprint** describes scenarios under which NPLs can be transferred from a bank to a public AMC. The European Commission envisages **four scenarios**:
 - i. **No state aid**: a publicly supported AMC purchases NPLs from a bank at market price (i.e. the AMC merely acts as a market maker).
 - ii. **Resolution**: in the context of a resolution of a failed bank, the use of the asset separation tool can require the creation of an AMC to take over and resolve the failed bank's estate.
 - iii. **Insolvency proceedings against a failing bank under national law**: separation of the "good" part of an ailing bank for sale, from the "impaired" part managed by an AMC, under ordinary insolvency proceedings.
 - iv. **Precautionary recapitalization**: exceptional state aid when a bank is not failing or likely to fail but is likely to become distressed if economic conditions were to worsen materially. Transfer of NPLs to an AMC can be associated with a state recapitalization of a bank under certain conditions.