REDUCING THE BURDEN OF NON-PERFORMING LOANS WITH THE HELP OF THE VIENNA INITIATIVE

Non-performing loans (NPLs) are a millstone around the neck of emerging Europe's banking system that is preventing the region from achieving its full growth potential. NPLs – meaning loan agreements with a non-payment default extending over a certain period, typically 90 days – are a legacy of the global financial crisis and accounted for €53 billion in the economies of central, eastern and south-eastern Europe (CESEE) at the end of June 2016. These high and still-rising levels of loan delinquency act as a constraint on banks' ability to provide fresh funds to businesses for working capital and investment, thereby limiting economic growth.

Resolving NPLs is a priority for governments, financial institutions and multilateral organisations in emerging Europe – as well as in much of western Europe. The severity of the problem led the EBRD to join forces with the International Monetary Fund (IMF), the World Bank and others to launch an NPL Initiative to promote corporate NPL resolution.

This work falls under the scope of the European Bank Coordination "Vienna" Initiative, which was established at the height of the global financial crisis in January 2009 to safeguard the financial stability of emerging Europe. The Vienna Initiative brings together major international financial institutions as well as European Union (EU) institutions and public and private stakeholders of EU-based cross-border banks active in the region. Since 2014, NPL resolution has been the major focus of the Vienna Initiative.

The EBRD manages the NPL Initiative on behalf of its fellow international institutions and undertakes a wide range of activities as part of this endeavour, including promoting in-country dialogue, capacity building and knowledge sharing. A new website set up by the EBRD acts as a central point of information and knowledge-sharing on NPL resolution among Vienna Initiative countries (http://npl.vienna-initiative.com).

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LEGAL REFORM AND NPL RESOLUTION

The EBRD's Legal Transition Programme (LTP) contributes to the NPL Initiative by analysing the legal and regulatory impediments to swifter corporate NPL resolution and by working with public officials and other stakeholders on the legal reforms necessary to remove these. The Bank recognises that weak corporate restructuring and insolvency frameworks hamper the efficient restructuring of corporate NPLs and the return of these loans to performing assets, as well as the realisation of NPL recoveries by creditors in the case of borrower liquidation.

"Inefficient resolution frameworks mean that corporate NPLs tend to sit on banks' balance sheets for much longer than they would do if these countries had more effective restructuring and insolvency mechanisms," says Catherine Bridge Zoller, the LTP Principal Counsel leading EBRD efforts in this field. "High NPL levels reduce profitability and, because of capital requirements, limit the extension of new credit.

"As many countries in the CESEE region rely heavily on banks to provide the financing that companies need to grow, restrictions on the availability of bank credit have a disproportionately large impact on levels of corporate investment, compared with economies where non-banking sources of financing are more developed, for example through capital markets."

Banks can resolve corporate NPLs in various ways. They can seek to restructure or enforce the bad loans and, to the extent necessary, write-off any non-recoverable portion of the loans. Alternatively they can sell the NPLs at a discount to other investors who would then take over responsibility for strategic management of the NPL including any restructuring or enforcement of the loan.

NPL SALES

Selling NPLs on the secondary market has the advantage of freeing up the capital, liquidity and human resources that banks require to manage these loans in-house. Furthermore, NPL purchasers (and servicers) typically have more experience than banks of resolving NPLs. They also usually have more resources for these activities.

In practice, however, banks in some emerging European economies do not use this option readily and debt sales markets are not well-established in these countries. This is partly due to regulatory

hurdles that make it cumbersome for banks to transfer distressed corporate loans to non-banking investors and less attractive for those investors to enter the market in the first place. In Hungary, for example, NPL purchasers need to be licensed financial institutions subject to regulatory oversight, but the process of obtaining such a licence is reportedly very time-consuming. It is also more difficult to package corporate NPLs for sale, compared with retail NPLs, since corporate NPLs often require a case by case treatment.

"These barriers to investors entering the secondary market for NPLs – combined with the inherent risks of NPL resolution owing to a country's legal, tax and regulatory framework – also mean that there is less competition between potential buyers," says Catherine. "They are therefore able to offer banks lower prices for their distressed loans than they would be likely to offer in a vibrant secondary market.

"At the same time, banks are frequently reluctant to accept the impact on their balance sheet arising from a discounted sale. This so-called 'pricing gap' creates a further disincentive for banks to sell their NPLs to other investors."

In 2016 the LTP carried out extensive work on improving NPL resolution in Hungary, Serbia and Ukraine as part of the NPL Initiative. In Hungary and Ukraine, efforts to date have focused on strengthening the mechanisms for out-of-court corporate restructuring and consensual settlement. In Serbia, the programme concentrated on analysing barriers to the sale of NPLs and the development of a debt sales market in order to set a broader agenda for reform.

HUNGARY

The EBRD has been engaged in work to address Hungary's high NPL levels for several years. In the wake of the financial crisis of 2008-09, the NPL ratio (including corporate and retail NPLs) reached a peak of 20 per cent, although as of June 2016, this had fallen to 10 per cent. The scale of the problem prompted the Central Bank of Hungary (MNB) to approach the EBRD in early 2014 with a request for technical assistance in combating rising NPL levels.

This resulted in a technical cooperation (TC) project consisting of an analysis of the Hungarian legal and fiscal framework for corporate restructuring and insolvency. The findings of this analysis, which was conducted by the EBRD with assistance from professional services company EY and law firm White and Case, were published in February 2015.

The report identified a large number of areas for improvement and potential remedies. These included: re-examining the existing licensing requirement for NPL purchasers, in line with other countries in the region (such as Romania where these restrictions do not exist); considering tax relief and other incentives for debt cancellation; giving banks a more significant role as creditors in the bankruptcy and liquidation procedures; requiring debtors to draw up a professional reorganisation plan in order to file for bankruptcy; and promoting greater cooperation among banks to promote early out-of-court restructuring.

Also in February 2015, the government of Hungary and the EBRD signed a Memorandum of Understanding aimed at strengthening the country's financial sector, including by addressing the challenge of NPLs. Around the same time, the Hungarian authorities amended the Personal Bankruptcy Act (in 2015) and established the asset management company MARK to purchase NPLs.

Catherine notes that "there have so far been no significant changes to the legal, tax and regulatory framework to implement the recommendations from the EBRD report in favour of NPL resolution, particularly the amendments needed to the Bankruptcy Act, although the MNB and banks recognise that these reforms are very much needed."

In 2016, the EBRD conducted a second TC project in support of NPL resolution in Hungary. Extensive discussions with 16 banks, MNB and MARK resulted in a recommendation that MNB take a more active role in promoting out-of-court restructuring by issuing non-binding guidance on international best practice for this process in relation to corporate loans. The TC project looked at global best practice in the field of corporate turnaround and insolvency, including the principles established by the International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL), and approaches within the EU. It also carefully evaluated what guidance was needed in the Hungarian context.

A key aim of the MNB guidance, which was due to be issued in the first quarter of 2017, is to help lenders adopt a more collaborative approach on restructuring and consensual security enforcement, with a view to managing NPLs and preventing a similar situation of high NPLs in the future.

"The MNB guidance is aimed at encouraging early action by banks and avoidance of potentially value-destructive insolvency procedures," says Catherine. "Hungary already has a set of principles on multi-creditor out-of-court restructuring – known as the Budapest Approach – but these are rarely followed in practice, hence the need for new best practice guidelines approved and promoted by the regulator MNB."

Márton Nagy, MNB Deputy Governor, adds that: "in our view, out-of-court restructuring is an integral part of financial stability. The principles underlying the guidelines have the ultimate goal of providing a framework and predictability for both the debtor and creditor in a restructuring process."

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SERBIA

In neighbouring Serbia, the ratio for corporate and retail NPLs remains very high at 20.2 per cent as of June 2016. The country has the highest NPL ratio and the highest level of corporate sector indebtedness out of the five partner countries of the Vienna Initiative (the others being Albania, Croatia, Hungary and Montenegro). The Serbian authorities are engaged in a range of activities aimed at addressing this issue. The government is implementing an NPL Resolution Strategy and accompanying Action Plan that were adopted in 2015. Legislators approved amendments to the Banking Act that same year to make it easier for banks to transfer NPLs to asset management vehicles, among other improvements. Further amendments to the Bankruptcy Act aimed at strengthening creditors' rights were expected in early 2017.

In 2016, the EBRD prepared an analysis of impediments to the sale of NPLs in Serbia. The study, conducted with assistance from KPMG, recommended a wide range of legislative and regulatory changes to facilitate NPL market development. These include modifying the licensing requirements for NPL investors; possibly exempting NPLs from banking secrecy restrictions to allow investors to perform due diligence on a target portfolio; and improving the tax regime for NPL write-offs. The analysis also looked at non-regulatory impediments to NPL sales in Serbia, such as high levels of bureaucracy and ineffective court and law enforcement practices.

UKRAINE

Owing to the effects of the global financial crisis, the situation in eastern Ukraine and the resulting devaluation of the hyrvnia, Ukraine is one of the European countries worst affected by high levels of distressed loans. The corporate and retail NPL ratio stood at 30.4 per cent as of June 2016 and the escalating problem has led to many bank failures as well as business bankruptcies and closures.

In 2014 the EBRD launched a package of crisis-response measures to help support the Ukrainian economy, including investments and policy dialogue activities aimed at stabilising and restructuring the Ukrainian banking sector and reinvigorating lending to businesses. In addition, the IMF has provided a series of loans to Ukraine since the start of the financial crisis.

A condition of the IMF programme is that the country develop an effective mechanism for out-of-court restructuring as a means of tackling the problem of rising NPL levels. An EBRD adviser, appointed in 2014, helped the Ukrainian government develop a new legislative framework for out-of-court restructuring. A Law on Financial Restructuring (LFR), approved by lawmakers in June 2016, came into force in October. The LFR offers parties certain tax incentives for restructurings concluded under its auspices, which are voluntary. The EBRD's Legal Transition Programme initiated a TC project to support implementation of the new law.

"Under this project, we have helped the Ministry of Finance draft by-laws on arbitration for disputes arising under the LFR procedure," says Catherine. "We are also assisting the Independent Association of Banks of Ukraine (NABU) with the setting up, operation and financing of a secretariat to administer applications to use the procedure and of an arbitration committee established by the LFR to resolve any disputes." The framework is expected to be operational in the first half of 2017.

WIDER EBRD EFFORTS ON NPL RESOLUTION

The NPL Initiative is also active in the Vienna Initiative partner countries of Albania, Croatia and Montenegro where the EBRD works closely with the World Bank. The EBRD undertakes NPL resolution work in other countries in its region of investment, including Greece, which is a participating Vienna Initiative country, and Tunisia, which falls outside the Vienna Initiative but is also beset by high NPL levels. In Tunisia, LTP assistance consists of support for a new regulatory framework for the insolvency office holder profession and capacity building for key insolvency players. This aims to raise professional standards and promote training for insolvency office holders and judges.

The new NPL Initiative website provides stakeholders with the latest information on national reform commitments, support from international institutions and the latest industry publications. The Bank publishes a biannual NPL Monitor for the CESEE covering the five Vienna Partnership countries. This features the latest available data on NPL ratios and summarises efforts to resolve barriers to NPL resolution on a country-by-country basis. The EBRD is also responsible for overall NPL Initiative coordination efforts.

CONCLUSION

"Our legal reform work and our other activities aimed at promoting NPL resolution are contributing to the recovery of the financial sector in emerging Europe, especially when combined with the efforts of fellow international institutions, governments and other stakeholders," says Catherine. "This recovery is essential for lending to the real economy to increase, for businesses to grow and for the region to finally emerge from the shadow of the global financial crisis."