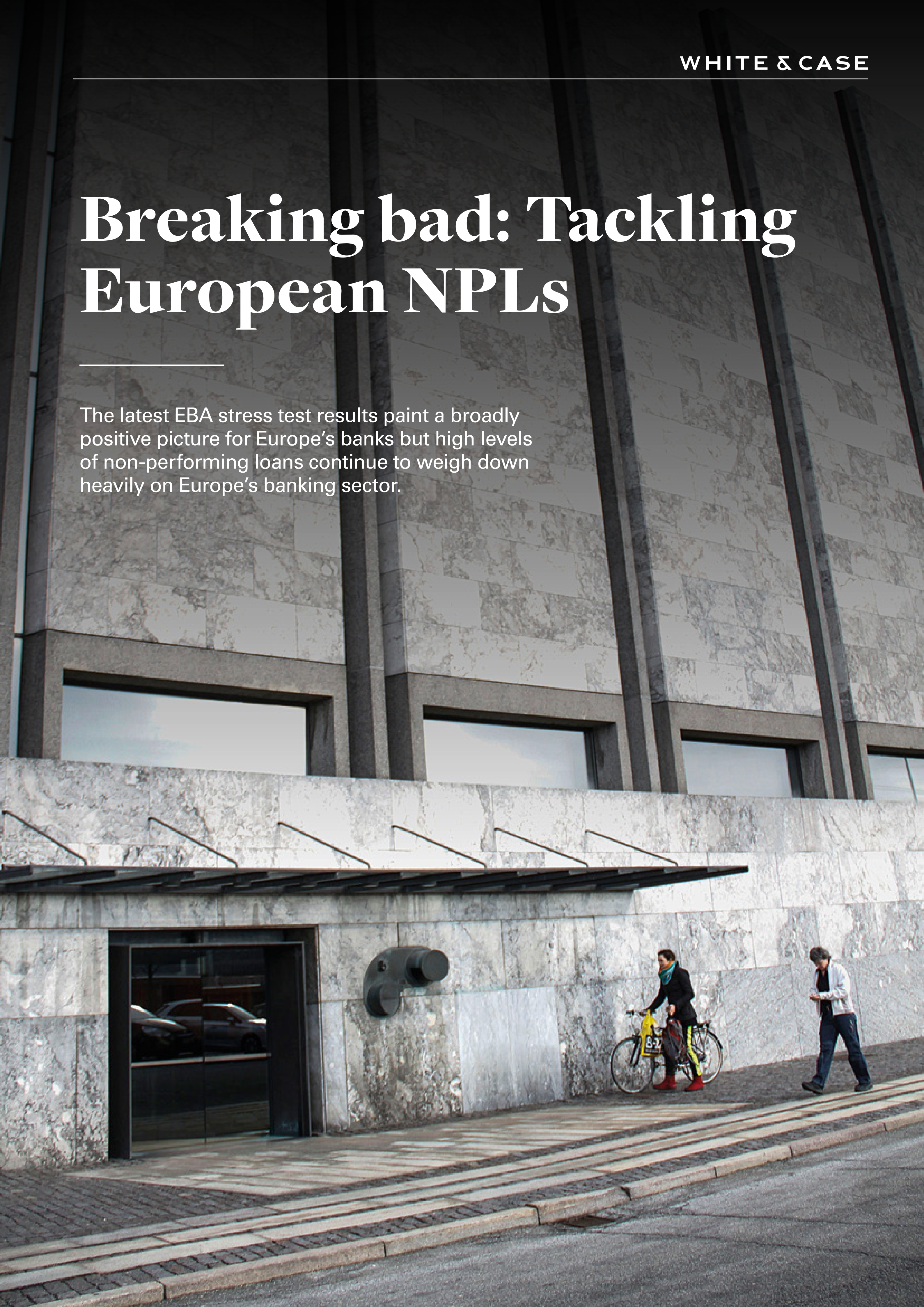
WHITE & CASE

Breaking bad: Tackling European NPLs

The latest EBA stress test results paint a broadly positive picture for Europe's banks but high levels of non-performing loans continue to weigh down heavily on Europe's banking sector.



Reducing the stock of European NPLs

Amid rising bad loans and steadily shrinking profits, banks need to take a good look at the state of their financial health. But all is not bleak, argue **Dennis Heuer**, **Michael Immordino**, **Laura Kitchen** and **Gavin McLean**.

As European banks' balance sheets remain clogged with the aftermath of several years of recession, the volumes of non-performing loans (NPLs) in the EU have risen to around €1.2 trillion—more than double the level in 2009. Greece and Cyprus report NPL ratios of more than 40 per cent, with Bulgaria, Croatia, Hungary, Ireland, Italy, Portugal and Romania all reporting gross NPL ratios of between 10 and 20 per cent.

Non-performing assets in these countries typically include large amounts of small and medium-sized enterprise (SME) and household debt. The political and economic implications of strictly enforcing SME loans would be severe: SMEs in the EU account for more than 99 per cent of non-financial enterprises and nearly two thirds of employment.

Italy's banking sector, in particular, is feeling the strain of NPLs, which have increased by approximately 160 per cent since 2009 and equate to 18 per cent of the country's total loans.

Such NPL levels have had a marked effect on investor confidence and have contributed to a sharp decline in banks' share values across Europe. Italian lender Banca Monte dei Paschi di Siena, for instance, has seen its value plummet to less than a tenth of its worth at the beginning of the year.

A reduction in the stock of NPLs would free up a considerable amount of lendable bank capital to be injected into the real economy. According to the IMF, if NPL levels were reduced to their historical averages of 3 to 4 per cent, approximately €550 billion could be released to support new lending in Europe. Unsurprisingly, in that context, Eurozone banks' ability to absorb and deal with their NPLs has attracted increased focus from the ECB. In September 2016, the ECB published for consultation guidance on NPL reduction. The guidance recommends that banks with high NPL levels establish clear strategies that include quantitative portfolio targets, detailed implementation plans and appropriate governance and operations structures to effectively manage and reduce their NPL stock in a credible, feasible and timely manner.

€1.2 trillion
current volume of NPLs in the EU

Source: European Central Bank

18%
Italy's NPL ratio

Source: World Bank

4.3%
Average global NPL ratio

Source: World Bank

Difficulties with the traditional approach to NPL reduction

There are serious and interrelated impediments to NPL resolution across Europe that have led to much lower levels of write-offs in Europe than in the United States, despite Europe's much higher stock of NPLs. Deficiencies in the legal framework and underdeveloped distressed debt markets are the two main obstacles to NPL resolution in Europe, and neither of these issues have quick-fix solutions.

The traditional model of selling NPLs to the market is not easy during distressed periods when time is of the essence and investor appetite is low. The European Banking Authority (EBA) has noted that the majority of national authorities across Europe consider the local distressed asset market to be either non-existent or ineffective.

Across Europe, bank share prices have plunged this year, which makes raising equity particularly difficult. In addition, if recapitalisation comes by way of state aid, it risks running into problems regarding untested bail-in principles under the Bank Resolution and Recovery Directive (BRRD). The bail-in tools under the BRRD that became fully applicable at the beginning of this year raised serious questions over the ability to recapitalise using state funds.

The role of the state: Insolvency reform, credit enhancement and sharing the responsibility

The flurry of governmental and regulatory intervention in the European banking sector during the past year is entirely logical in that context: There is a direct correlation between the average time to foreclosure and NPL levels across Europe, with the highest ratios belonging to Greece, Italy and Cyprus. An EBA study published in July 2016 also noted a link between the expected duration of insolvency proceedings and coverage ratios, which seems to confirm that provisions strongly depend on collaterals posted, recovery rates and the speed of the recovery process.

In December 2015, Greece introduced additional debt restructuring options as a quick-fix alternative to bankruptcy. Among other things, its new 'NPL Law' allows asset management companies (AMCs) to initiate legal action and any other judicial action necessary to collect debts which they manage. However, despite these attempts at insolvency reform, there is still a long way to go. According to the IMF, Greece still has one of the longest foreclosure periods—five years—and lowest rates of return on NPLs in Europe.

State-owned asset management companies

At the height of the financial crisis, a number of state-sponsored "systemic" AMCs were established by regulators in a bid to deal with the rising NPL levels. NPL loan sales to AMCs or other special purpose vehicles (SPVs) have been favoured because of the "clean break" from bank ownership and management responsibility that such sales involve. This approach was taken in Spain with its Management Company for Assets Arising from the Banking Sector Reorganisation (Sareb) and in Ireland with its National Asset Management Agency (NAMA). Both are considered to have achieved moderate success in reducing NPL levels. In March this year, NAMA exceeded its target to repay 80 per cent of its €30.2 billion senior bonds by the end of 2016 by taking advantage of a surge in demand for Irish real estate to redeem the bonds earlier than anticipated.

Private sector to the rescue?

A number of alternative private sector solutions are being explored by market participants such as securitisations, joint ventures and on balance sheet management of assets and NPL portfolio sales.

In July 2016, Bayside Capital and Italian private equity firm Idea Capital Funds launched a new fund, Idea Corporate Credit Recovery I, which intends to acquire NPLs from seven Italian banks including UniCredit, Banca Popolare di Vicenza and Banca Monte dei Paschi di Siena SpA. The fund works by offering the Italian banks a stake in the fund in return for the banks contributing their NPLs. The vehicle will also provide money to the underlying borrower companies in order to support their turnaround and growth.

> “Deficiencies in the legal framework and underdeveloped distressed debt markets are the two main obstacles to NPL resolution in Europe

US private equity firm KKR also launched its restructuring platform Pillarstone in 2015, which provides portfolio companies with new capital. Pillarstone's Italian platform is fully operational, and in May 2016, it announced the launch of its Greek platform.

However, despite interest from potential private buyers, banks have experienced great difficulties offloading their NPLs. This is primarily due to banks overvaluing their NPLs and a fierce reluctance to sell at a loss—heavy markdowns would 'formalise' capital holes in balance sheets and create further capital pressure.

Private sector solutions on their own will not be enough to tackle Europe's NPL problem. The role of national governments and the European Commission remains critical.

Hybrid public-private solutions

In a bid to bridge the gap between high levels of NPL supply and low investor demand, governments across Europe have been stepping in with hybrid public-private solutions. Italy's state guarantee scheme aims to facilitate investors' acquisition of NPL portfolios by guaranteeing senior notes issued in the context of a securitisation transaction. The scheme works by Italian banks selling their NPL portfolios to SPVs which in turn pool the NPLs and issue asset-backed notes to third party investors. The senior notes are guaranteed by the state if they are investment grade rated and at least 50 per cent of the junior notes have been issued to investors. The issue proceeds are used to fund the acquisition of the NPL portfolios from the banks.

Earlier this year, Italy also introduced its €4.25 billion bail-out/backstop Atlas fund to mop up unsold shares in the recapitalisation of distressed lenders. While a government initiative, it is funded by Italy's largest banks, such as UniCredit and Intesa San Paolo, along with contributions from majority state-owned bank Cassa Depositi e Prestiti.

Looking ahead

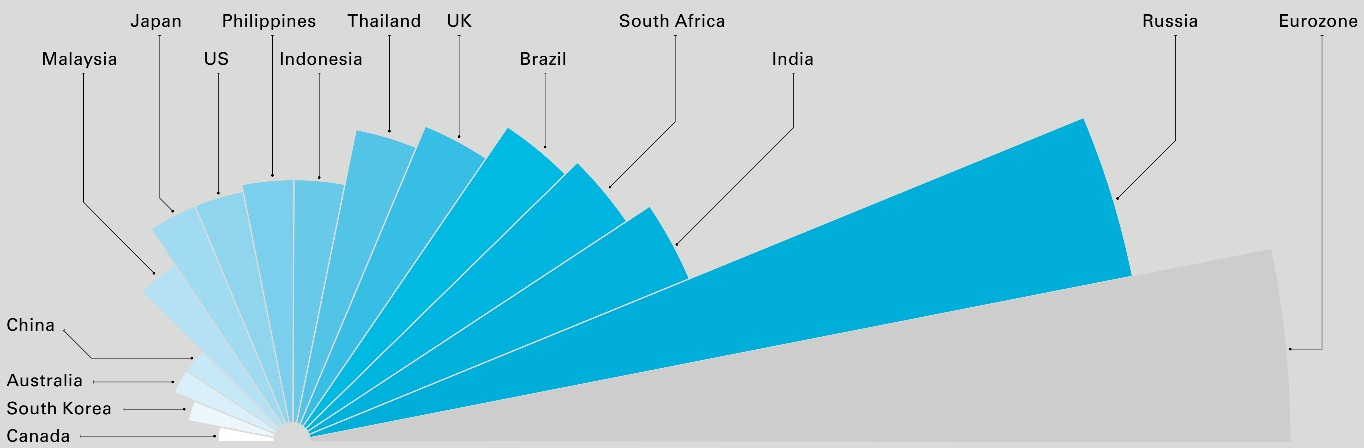
Long-term insolvency and regulatory reform is overdue and necessary in many European countries but the need to tackle NPLs is current and urgent. Recognising the importance of the issue, national regulators have started to request dedicated arrears management units within banks to deal exclusively with NPL resolution and high-risk clients.

However, NPL resolution has so far proven to be easier said than done. It will be interesting to see the results of the ECB's consultation and how banks respond to its NPL guidance and increased scrutiny.

Banks, AMCs and distressed debt investors need to work together to create efficient and effective liability management procedures and NPL purchase and management strategies. To ensure that state aid remains a last resort in any distressed bank situation, national authorities across Europe will no doubt be keeping a watchful eye over banks' NPL resolution strategies as they take shape over the coming months.

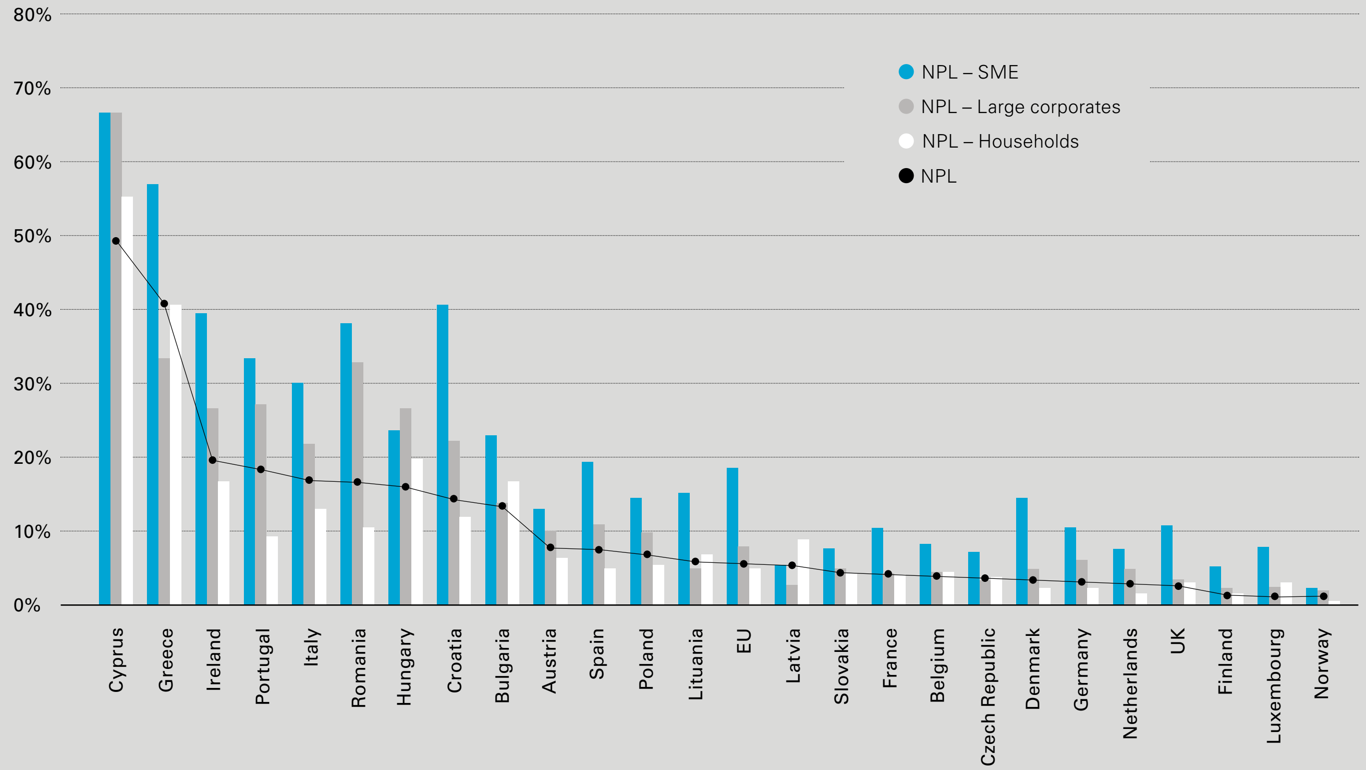
The global NPL landscape

Euro area NPL ratio remains high in a global context



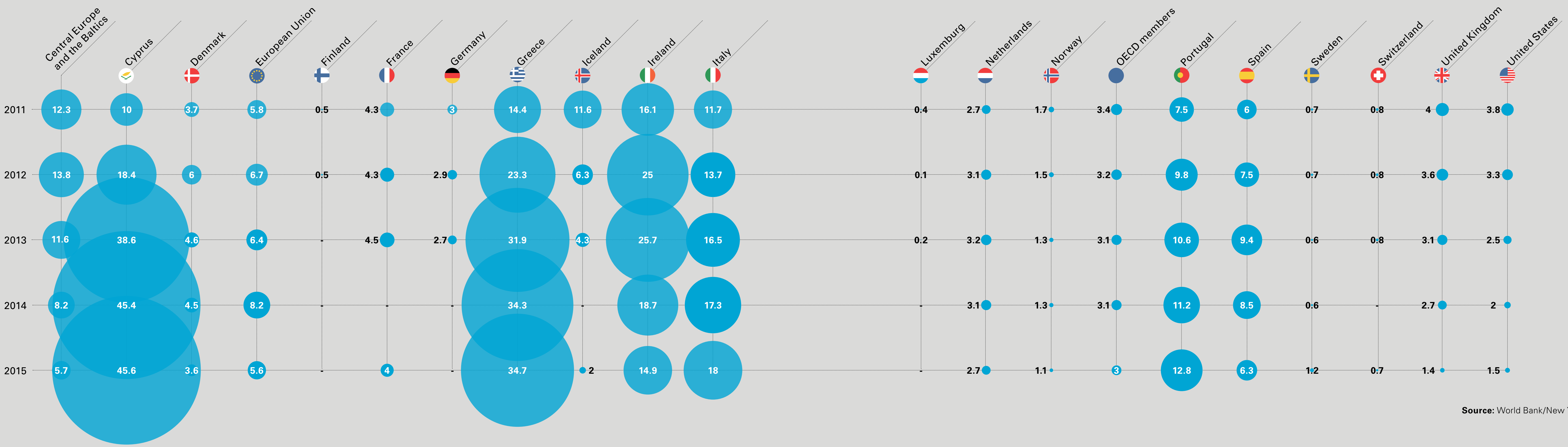
Source: World Bank

Non-performing loan ratios by sector, Q2 2015



Source: EBA supervisory reporting

Non-performing loan ratios in selected countries



Source: World Bank/New York Fed

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