How to develop secondary markets for non-performing loans?

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The ECB seeks to increase trading in non-performing loans by reducing the pricing gap between prospective investors and banks. For this to happen, there need to be structural reforms aimed at reducing recovery times, as well as better access to information about loans and debtors. Only when the price offered by investors is in line with the price demanded by banks will we see more activity in distressed debt markets.

Introduction

Non-performing loans (NPLs) in the books of banks in some European countries have grown steadily during the financial crisis. Although countries such as Spain and Ireland have mostly resolved their NPL problem, Italian and Greek banks continue to hold high volumes of NPLs. In 2016, Italy had €276bn of NPLs, while Greece had €115bn, respectively 25% and 11% of Europe's gross NPLs. The total stock of NPLs in 2016 in Europe was over €1.0tn (European Parliament, 2017).

High levels of impaired exposures lower banks' profitability, reduce the amount of available capital (because banks must provision capital for potential losses) and increase banks' funding, monitoring and servicing costs. This constrains the growth of bank lending, particularly for SMEs which, in the case of Italy, contribute 2/3 of gross value added (Humblot, 2017a). The inability to offload NPLs can thus be a drag on growth and productivity. Reducing the level of impaired assets on banks' balance sheets is a priority for the ECB and the European Commission, which has recently conducted a public consultation to facilitate the development of secondary markets for NPLs.

In 2016, European banks' stock of NPLs amounted to €1tn. In Greece, Cyprus and Italy, NPLs represented respectively 45.9%, 44.8% and 15.3% of total bank loans compared to an EU average of 5.1%.

Although NPL levels in Europe are much higher than in the US, the level of transactions has remained very low compared to that in America. The NPL market in Europe is small notably because of the low valuations placed on NPLs and the significant pricing gap between the price asked by banks and the price offered by investors. This is a clear case of information and other barriers raising transaction costs in a way that severely constrains the market for NPLs.

Reducing recovery times would improve NPL valuations

Today, the value of NPLs in Europe is low notably because of lengthy recovery times. This is so because the probability that a failing loan will be repaid declines over time (Bank of Italy, 2017). For investors, the opportunity cost of capital compounds over time, meaning that they require larger haircuts the longer it will take to recover the asset. Thus, the longer the recovery time, the lower the recovered value – and the smaller the price that investors are prepared to pay.

To raise NPL valuations, EU member states need to shorten bankruptcy and foreclosure procedures. Europe needs to define a unified out-of-court insolvency regime.

Today, recovery times in Italy – the country with the most NPLs in Europe – are long. Corporate insolvency processes take seven and a half years on average (Garrido, 2016). The bankruptcy process takes, on average, more than six years; judicial foreclosures take more than four years (Bank of Italy, 2015). This is of particular relevance when 73% of Italian bad loans originate in the corporate sector (PWC, 2017). Lengthy procedures lead to an expected recovery rate for NPLs of only 37.7% in Italy, compared to 58% in Germany. Besides, lengthy bankruptcy procedures also increase the cost of recovering NPLs: they correspond to 23% of the amount of NPL debt in Italy, compared to an average of 16% in Germany, France, Greece or Portugal (Humblot, 2017a).

To increase bank and investor matching, it is vital to reduce recovery times. Reforms that were undertaken at the national level in this domain, however, largely remain insufficient. As an example, after numerous reforms in Italy, the Bank of Italy estimates that bankruptcy and foreclosure procedures will still take at least three years (Bank of Italy, 2015).

As judicial proceedings remain long and are difficult to reform, one solution to reduce recovery times would be to facilitate out-of-court restructuring as an alternative to insolvency proceedings. On a national level, Portugal in 2012 adopted a formal out-of-court restructuring regime targeted at SMEs (Bergthaler et al., 2015). At the EU level, the European Commission has put forward plans for an EU-wide out-of-court settlement called the accelerated loan security.

This EU measure would seek to equip European banks with a relatively swift out-of-court power to foreclose their collateral on the basis of the loan contract concluded with business borrowers. It would be particularly welcome for cross-border loans (European Commission, 2017). There, the fragmented legal framework and the inefficiency of judicial systems in the field of collateral enforcement represent a vulnerability for bank stability, which in turn negatively affects the capacity of the financial institution to lend.

Improving the quality and availability of data would reduce the pricing gap

Another reason for the low level of NPL transactions is that potential buyers place a lower valuation on NPLs than the original lender. This pricing gap exists because banks and potential buyers use different valuation criteria. Banks use a discount rate in accordance with the effective interest rate on the loans, as required by the international accounting standard IAS 39. Investors, because they have less information than the originating bank about the loan and the lender, tend to assume a lower quality of assets and use an internal rate of return (IRR) that typically exceeds 15% (Humblot, 2017b). In addition to this, investors deduct legal and servicing fees from the price offered for NPLs while banks internalise these costs.

Asymmetric information is compounded in a number of ways. Firstly, European countries often restrict the sharing of individual debtors' information for debt workout purposes (Aiyar et al., 2015). Secondly, in about 80% of the EU countries surveyed in a 2015 IMF report, credit bureaus usually did not include relevant information for debt restructuring, such as tax payments, social security contributions and payments to utility companies. Likewise, more than half of the surveyed credit registers did not have credit scoring for individuals and about half did not produce credit scoring for SMEs and larger companies. As SMEs are often not required to provide detailed financial statements, it may be costly and cumbersome to access good quality data. Moreover, monitoring costs may be high relative to the value of the loan because these are generally small firms. The one party with accurate information, namely the lender to the SME, has an incentive to inflate the value of the loan.

Asymmetry of information between sellers and potential buyers thus contributes to low NPL valuations. To bring bid and ask NPLs price closer and enable more NPL transactions, access to financial information on distressed borrowers and collateral valuations must be improved. To achieve this, one solution would be to extend the Bank of France firm rating system to other European countries.

The Bank of France currently assesses the ability of more than 256,000 French companies to meet their financial commitments over a three-year horizon (Bank of France, 2016). This usually includes companies with a turnover above €750k, but can also include smaller companies if the Bank of France possesses the necessary information. Thirteen credit ratings are available alongside the three-year default rates corresponding to each score (Bank of France, 2017). The Bank of France uses information such as the accounting and financial data of the company, data relating to trade bill payment incidents and loans as reported by credit institutions. It also uses legal information, data relating to companies' economic and financial environment, and qualitative data collected during interviews with company managers.[i]

The extension of this credit rating system to other EU member states, combined with better use of aggregate data for SMEs that are not rated, would allow for more accurate NPL valuations and potentially encourage more investors to enter the NPL market.

An EU-wide system of credit rating for firms, such as the one used by the Bank of France, would make it easier for investors to assess the financial position of firms and the various levels of risk associated with different NPLs.

NPL securitisation

One way for banks to remove NPLs from their balance sheets is securitisation. In securitisation, banks put their NPLs in a special purpose vehicle (SPV) which then issues bonds. Investors who buy the bonds will receive payments when the loans become re-performing or when the collateral is repossessed. Securitisations attract more investors compared to outright sales because they are diversified instruments. An investor thus needs to worry less about the default probability of any individual loan. Investors can either buy senior tranches, which are paid first, mezzanine tranches or junior tranches.

At a European level, a supportive framework is essential to revive the European securitisation market and to encourage more NPL securitisations. Although legislative action at the EU level has already started, vigilance is required after a proposal to create a specific framework for simple, transparent and standardised securitisation (STS) unintendedly planned to ban the securitisation of self-certified mortgages, before the error was corrected (Kerr, 2017).

On a national level, in Italy, investors can now buy a government guarantee for senior tranches of NPLs (MEF, 2016). This means that the Italian state will meet the payment obligations should the SPV fail to pay. The cost of this guarantee aims to reflect market prices. It is based on the market price of credit default swaps for Italian issuers whose credit ratings correspond to those of the notes being issued.

Additional structural reforms in this domain are needed: achieving risk transfers by securitising assets remains difficult in the current regulatory environment. The Commission will develop by summer 2018 a European approach to foster the development of secondary markets for NPLs, in particular, to remove impediments to the transfer of NPLs by banks to non-banks and their ownership by non-banks. Its work in this domain should be encouraged, and legislative proposals in this area should go through the accelerated procedure once in Parliament.

Conclusion

Because of different regulatory changes, such as the new international financial reporting standards IFRS9 and the measures proposed by the ECB in October 2017, banks with high levels of NPLs will have to hold more capital, meaning they will likely have to offload more of their NPLs. As European firms still primarily rely on banks for their funding, it is essential that banks be able to sell NPLs so capital can be released for productive loans.

A combination of structural reforms at the national and EU levels and greater information provision for investors will go a long way to resolve the NPL problem that EU banks face.

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[i] Companies can request a meeting if they estimate that their notation does not reflect the firm's situation.