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Banks should heed ECB guidance on bad loans

Europe is stooped under the weight of its non-performing loans. However, the European Central Bank has now issued detailed guidance on managing NPLs that could be adopted as bank strategy, says **Conor Houlihan** of law firm Dillon Eustace.

With an estimated €1000bn of non-performing loans (NPLs) on the balance sheets of European banks, resolving NPLs should be one of the banks' highest priorities.

NPLs have had a corrosive effect on Europe's banking sector since the financial crash, reducing profitability, consuming capital, tying up resources and affecting the cost and supply of credit. Indeed, the European Commission's latest quarterly eurozone report reveals that they continue to be a material brake on economic growth.

As the European Banking Authority's risk dashboard for the fourth quarter of 2016 showed, the EU's average rate of NPLs of 5.1% is much higher than that of major developed countries such as the US or Japan. Among member states, the average rates of NPLs vary greatly, with 11 member states exceeding the average. It is against this backdrop that the European Central Bank (ECB) published its final guidance on March 20, 2017, on resolving NPLs.

Managing NPLs

Although the ECB guidance is non-binding and only addressed to the significant institutions that are supervised directly by the ECB, the expectation is that it will immediately become part of the supervisory engagement between the ECB and relevant institutions – particularly those institutions that have a greater NPL problem.

The ECB guidance calls on banks to establish a strategy for the effective management and ultimate reduction of NPLs. The development of such a strategy will require an assessment of the operating environment of a particular bank.

As well as internal factors, such as operational capacity, this will include consideration of external conditions – for example, the dynamics of the real estate market and trends in the NPL investor market. The latter two factors seem particularly pertinent in the case of the Irish market, where there is an apparent chronic undersupply of real estate and a well-established (albeit recent) track record of successful NPL investment from some leading international players.

Combating the issue

Whatever the strategy, it must be underpinned by an operational plan, which should include timebound objectives and goals, governance arrangements, staffing/resources requirements and so on. In other words, processes for efficiently dealing with NPLs should be clearly defined and documented and embedded at all levels of the organisation.

In 'high NPL banks' the strategy and operational plan must become a vital part of the overall strategy, and should therefore be approved and steered by its management (for example, the board).

The ECB guidance includes detailed provisions regarding appropriate NPL control and monitoring frameworks and early-warning processes, all of which may require significant organisational changes, including human and technical resources and customer engagement.

It also features a chapter on forbearance options and their viability, as well as chapters on NPL recognition, measurement and write-offs, and real estate collateral valuation. The development of suitable guidelines in these areas, and the consistent application of such guidelines across relevant institutions, should aid the prompt and appropriate recognition of problem loans, thereby enabling earlier and more effective resolution of such loans, as well as more accurate reporting to external stakeholders.

The exact strategy will vary from bank to bank; however, in many cases it seems likely to include a range of options. Internal solutions such as workout/restructuring may be the answer for some. However, in the case of high NPL banks, it seems that – for a variety of reasons (including legal process or capacity issues, etc) – more rapid and extensive intervention may be needed in the form of loan sales or risk transfer/securitisation transactions.

Securitisations likely

It does not seem realistic to expect that the necessary reduction of the substantial level of NPLs that remain on European bank balance sheets can be achieved within the required timeframe without the use of loan sales or other off-balance-sheet options.

Recently, there have been examples of private equity buyers successfully using securitisation to exit large NPL portfolios that were purchased during the early stages of the current bank deleveraging cycle. Some European jurisdictions – in particular Ireland – already have attractive legal structures and systems to undertake such transactions, which could be used elsewhere.

Of course, there are myriad issues for a bank to consider in undertaking any deleveraging transaction – not least capital implications. However, if the ECB's guidance succeeds in bringing the European banking industry a few steps closer to creating the right environment and conditions to enable – and the necessary regulatory impetus to complete – such transactions, European banks, economies and citizens will undoubtedly be better off.

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