



European Banking Coordination “Vienna” Initiative

Working Group on NPLs in Central, Eastern and Southeastern Europe

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DISCLAIMER

This document summarizes the discussions in the Working Group on NPLs in Central, Eastern and South-Eastern Europe (CESEE), established under the European Bank Coordination Initiative (EBCI). The group was jointly chaired by Sophie Sirtaine (World Bank) and Christoph Rosenberg (IMF). Key contributions were made by Christoph Kligen (IMF) and Leyla Castillo (World Bank) and staff from these two institutions, EIB, EBRD and ECB. Inputs were received from banks, regulators, and central banks represented in the Working Group. The findings do not, however, represent the view of the Executive Board or the management of any of the participating institutions. As any EBCI product, this report's recommendations and conclusions are voluntary, non-binding, and public.

EXECUTIVE SUMMARY AND RECOMMENDATIONS

1. The boom-bust cycle has left a legacy of high non-performing loans (NPLs) in various countries in Central, Eastern and Southeastern Europe (CESEE). Very high credit growth during 2003-08 gave rise to an unsustainable boom that ended abruptly with the global financial crisis of 2008/09. The deep recession that followed brought many of the accumulated underlying problems to the fore, including poor quality of some loans on banks' books. NPLs now average some 11 percent in the region. Countries with particularly pronounced boom-bust cycles are considerably worse off. Moreover, data deficiencies and possible underreporting of bad loans in some countries might mean that the true NPL problem is even bigger than official statistics suggest.

2. The key concern is now that a festering NPL problem could become a drag on economic growth. Experience from past financial crises suggests that lasting recovery requires a clean-up of the financial sector, including bringing down NPLs. Empirical evidence from CESEE countries confirms that NPLs on banks' balance sheets indeed create uncertainty and weigh on their ability to resume lending, and thereby aggregate demand and investment. Moreover, unresolved NPLs suppress economic activity of currently overextended borrowers and trap resources in unproductive uses.

3. NPL resolution has been proceeding at too slow a pace so far, despite efforts by banks, as well as the official sector. NPL ratios continue to increase in Southeastern Europe, where the economic recovery has been weak, and in Hungary, where in addition to subpar growth a large share of mortgages is denominated in strongly-appreciated Swiss francs. Elsewhere, NPL ratios seem to have peaked but any reduction tends to be small and is bound to face headwinds from the renewed slowdown of the global economy. This limited progress is despite considerable efforts by banks, most of which have set up internal dedicated workout units equipped with additional and more senior staff. Banks are flexible in adjusting the payment terms of cooperative distressed borrowers, but generally avoid interest capitalization or refinancing. The sale of problem loan portfolios and outsourcing of collection remain relatively rare. A few governments, such as those of Latvia, Romania, Serbia, Moldova, Russia, Estonia, and Poland have also undertaken to overhaul their corporate or household insolvency regimes or encouraged out-of-court restructurings. Others have opted for more direct intervention in dealing with the NPL problem, although some schemes recently introduced (notably the early mortgage repayment scheme in Hungary) have imposed large losses on the banking system and are problematic.

4. A long list of obstacles in the legal, judicial, tax, and regulatory areas is holding up NPL resolution. A survey of international institutions and banks operating throughout the region has identified the following issues, which do not necessarily apply to every country:

- In various countries, the enforcement of collateral tends to take too long and rely heavily on cumbersome judicial processes. Often multiple auctions with prescribed minimum bidding prices are required, execution of collateral is held up by debtors escaping the delivery of default notices (or by fictitious leases in the case of residential real estate), ownership of collateral might be difficult to establish, or the rights of secured lenders might be undermined by retroactive bankruptcy declaration or debtors' ability to sell collateral during enforcement procedures.
- Underdeveloped frameworks for going-concern restructurings mean that potentially viable firms end up in lengthy liquidation, with low recoveries on loans. The benefits of potentially safeguarding part of the economic fabric and employment are therefore lost.

- Out-of-court restructurings as a speedy and cost-efficient tool to achieve debt settlement are underutilized.
- Many CESEE countries lack an insolvency framework for natural persons. Even financially responsible individuals cannot be given a “fresh start” and their debt lingers on banks’ books. Under the circumstances, countries sometimes resort to burdensome administrative procedures instead, such as mortgage foreclosure moratoria.
- Weakness and inefficiencies in the legal institutional framework further delay NPL resolution. In many countries, overloaded court systems, lengthy and costly judicial proceedings, as well as inconsistent and unpredictable court decisions are seen as key obstacles.
- Tax systems can militate against NPL resolution in multiple ways. Tax deductibility of loan-loss-provisions and write-downs of loans is often limited; there might be restrictions on loss carry-forward provisions, especially in the context of mergers and acquisitions; net present value (NPV) reductions in the context of debt restructurings might subject debtors to income tax, and assets sales or transfers sometimes attract VAT. Moreover, tax authorities are often substantial creditors of distressed companies but are rarely in a position to participate in a restructuring. The same is sometimes true of state-owned banks.
- In the regulatory area, lax banking supervision can create serious disincentives for NPL resolution. If realistic loan classification and provisioning is not properly enforced, losses will come to the fore only at the time of NPL resolution and banks will naturally try to delay the day of reckoning. Furthermore, in some countries, regulations might also restrict banks, especially foreign-owned ones, from owning or operating businesses or real estate. All this complicates taking collateral or resolving NPLs through debt-equity swaps.
- Finally, underdeveloped markets for distressed assets limit the scope for NPL resolution. Sales of distressed assets to workout specialists offer a number of advantages, including their specific skill set that is different from that of banks, the ability to tranche together attractive portfolios, and to create distance to loan originators that might have ongoing relationships with the borrowers. Yet, in the current environment, there is a substantial gap between the minimum price that sellers demand and the maximum price that potential buyers are willing to pay, so that very few transactions actually take place in CESEE countries. To some extent this reflects the many obstacles enumerated above, notably optimistic valuation of NPLs on banks’ books. Problems specific to distressed asset sales are restrictive banking secrecy and data protection laws that inhibit good faith attempts to purchase debt. Many countries also lack a proper legal structure for asset management companies, forcing them to incorporate as factoring firms or subjecting them to onerous capital requirements.

5. **A coordination problem further aggravates unduly slow NPL resolution.** Banks’ incentives to resolve NPLs fail to reflect the many associated positive knock-on effects for the economy at large, including on asset quality and collateral valuation. To the extent that NPL resolution involves recognizing additional losses, individual banks might also be reluctant to go ahead unless their competitors do the same. The result is a coordination failure: with each bank following its own interests, NPL resolution appears to be slower than is desirable for banks collectively and for the economy.

6. It therefore takes a pro-active, cooperative approach to deal with the NPL problem and thereby strengthen economic performance. The subdued economic outlook for the region means that delinquent borrowers will continue to struggle and that collateral values will remain at depressed levels for some time. Various impediments and coordination failures inhibit NPL resolution. It would thus be a mistake to expect the NPL problem to resolve itself automatically within a reasonable timeframe. Subpar economic performance would be the result. Instead, a coordinated push is recommended. It cannot be ruled out that additional losses come to the fore in the process, but current provisioning levels, generally adequate capitalization, and generally robust pre-provisioning income should provide sufficient cushions against risks to financial stability. In any event, the process will need to be managed carefully as some banks may face constraints at a parent level to recognize losses in the current market environment and the effect of the changing regulatory requirements (Basel III) still remains to be seen in full. A pick-up of private sector credit growth in the wake of NPL resolution would be welcome, considering the positive effect on economic activity, the generally still low credit penetration in the region, and the absence of overheating pressures in the region (except in Turkey).

7. The working group recommends a comprehensive approach to addressing the NPL problem. This is particularly pertinent for countries with very high NPL ratios and/or low provisioning levels. Countries where NPLs are relatively low and are expected to remain so can afford a more selective approach, although they too would benefit from removing obstacles as they apply. Given the multiple dimensions of the NPL problem, efforts should be pulled together in a national plan under a private-public task force that makes NPL resolution a priority. Besides the banking association, the task force should comprise regulators, tax authorities, the central bank and the ministry of justice. The specific agenda and emphasis will depend on country circumstances and progress already made.

- Regulators should tighten supervision appropriately, with an emphasis on realistic collateral valuation and asset classification. Ensuring adequate classification and provisioning of restructured loans to avoid ever-greening and ensure resolution to all truly nonperforming assets will be particularly important. The write-off of fully provisioned NPLs should also be encouraged. Such a proactive supervisory approach needs to be mindful of interactions with recent regulatory and funding pressures facing banks in Europe.
- Tax authorities should move quickly to end discrimination against NPL resolution in tax codes. Any changes should be implemented upfront, so as not to create disincentives for NPL resolution in anticipation of future tax relief. Associated tax revenue losses will need to be assessed as they might necessitate compensatory measures elsewhere. Key features of a non-discriminatory tax code are: close alignment of the income tax treatment of provisioning, restructuring, and asset sales with their treatment for regulatory and financial purposes; exemption of asset sales or transfers from VAT; and provisions to ensure that debt relief in genuine restructurings does not attract income tax.
- Debt enforcement should be strengthened. Shortcomings that need most urgent addressing will be country-specific, but common themes are: allowing more “self-help” enforcement, introducing simplified procedures to enforce secured claims efficiently, and encouraging the use of small claims procedures.

- Regulatory reforms should target the removal of restrictions on taking control of collateral and other corporate assets by debtors and asset management companies, as well as removing obstacles to the creation of Asset Management Companies and Special Purpose Vehicles.
- Going-concern restructurings should be facilitated. In this regard, fast-track court approval for consensual restructuring agreements reached before initiation of insolvency proceedings, stays on all enforcement actions while safeguarding secured creditors' interests, and priority status for new financing are all critical. Clear filing thresholds for initiating insolvency proceedings would encourage early action and thereby increase the chances of successful rehabilitation.
- Out-of-court restructuring frameworks should be improved. Governments should develop guidelines in line with best international practices (the "London Approach" and INSOL Principles). Information campaigns to encourage out-of-court restructurings should be considered.
- To improve the resolution of household debt, personal insolvency laws should be enhanced to provide financially responsible individuals with the opportunity for a "fresh start." The introduction of debt counseling services and information campaigns to encourage debtors to approach their banks early to find a solution to their payment problems should also be considered. More generally, financial consumer protection should be strengthened so as to guard against households purchasing unsuitable financial products or taking on excessive risk in the first place.
- The efficiency of insolvency systems and proceedings should also be ascertained, to facilitate the efficient exit of unviable firms, enable the reallocation of economic resources to more productive uses, and avoid undue loan recovery losses.
- The institutional capacity of the justice system should be strengthened. This would naturally be a continuous medium-term effort. In the shorter run it would help to set and enforce statutory deadlines for court proceedings, along with conducting an audit of backlog cases and collecting data on court performance to pinpoint particular bottlenecks. Longer term, the emphasis should be on encouraging the use of alternative dispute resolution, and establishing a well-regulated system of professional enforcement officers, bailiffs and insolvency administrators. Better training judges on financial matters—possibly with support of EU funds—would also be useful.
- Banks should continue to seek a speedy work-out of NPLs, with operational support from their parents. As part of this effort, adequate provisioning, valuation of collateral and capitalization must be ensured. Banks should be prepared to (partially) write off NPLs when their recovery is unlikely.
- Local banking associations, in concert with the public sector, should push the collective effort to resolve NPLs forward. They should pledge to attain ambitious, time-bound targets. Their authority and peer pressure would serve to galvanize the membership into action.

8. **Direct government intervention into NPL resolution should be avoided.** The role of governments is to establish a conducive environment for private debt resolution, including clear and

predictable rules under which to conduct private renegotiations of debt. Direct government intervention risks incurring substantial fiscal costs if NPL resolution is subsidized, or if it is not, undermining credit culture by retroactively changing the terms of credit contracts through government fiat. While circumstances can arise where such direct intervention is justified, the bar for bringing them into play should be set high, and their structuring should aim to avoid market distortions and moral hazard. Similarly, governments should avoid giving signals, including in public communications that may affect the payment culture, such as of potential bail outs.

9. NPL resolution should be accompanied by heightened data transparency and cross country comparability, so that progress can be tracked and analysis improved. Unless they do so already, central banks or supervisory authorities should publish monthly data on NPL ratios with a breakdown into the main categories, such as corporate loans, consumer loans, and mortgages, as well as currency denomination. Given the absence of an international standard for NPL definition, it would be instrumental to accompany such data releases with metadata that explain in some detail what is considered an NPL for the purposes of national reporting. Financial stability reports could usefully put an emphasis on NPL developments and keep track of progress in removing obstacles. Efforts to harmonize NPL definition across jurisdictions would facilitate their understanding and avoid misinterpretation of risk levels.

EBCI Working Group on NPLs in CESEE Countries—A Concerted Approach

Banks

- Continue to seek speedy work-out of NPLs, with operational support from parent banks as necessary
- Ensure adequate provisioning, capitalization, and valuation of collateral
- (Partially) write down NPLs if their recovery is unlikely
- Participate in collective efforts (public-private task force) to resolve NPLs

Home Country Financial Regulators

- Push for proper provisioning and capitalization, including in CESEE subsidiaries
- Cooperate closely with host country regulators in supervisory colleges

Host Country Financial Regulators and Central Banks

- Tighten supervision where necessary, enforce proper provisioning and capitalization
- Remove regulatory obstacles to NPL resolution (e.g., on asset management companies)
- Work towards improving and harmonizing reporting of NPLs
- Cooperate closely with home country regulators in supervisory colleges
- Participate in collective efforts (public-private task force) to resolve NPLs

Host Country Governments

- Strengthen debt enforcement
- Improving consumer protection, including through debt counseling and information campaigns
- Improve insolvency legislation as necessary, including for out-of-court restructuring
- Strengthen institutional capacity of the justice system
- Remove tax impediments to NPL resolution
- Avoid direct intervention into NPL resolution; avoid bail-out signals

Supra-National Institutions

- Provide forum for international coordination (“Vienna 2.0”)
- Provide technical assistance (legal, tax, regulatory)
- Work toward developing best practices for NPL reporting
- Be active in impaired asset portfolio sales

CHAPTER 1: BACKGROUND AND OBJECTIVES

10. Participant institutions of the Full Forum Meeting under the European Bank Coordination Initiative (EBCI) decided to establish two working groups at the meeting held in March 2011. A first group would focus on the implications of selected regulation proposed under Basel III on CEE financial systems and, a second would focus on the management of nonperforming loan portfolios. The EBCI was originally launched in 2009 at the height of the global financial crisis to help maintain financial stability in CESEE countries, including by encouraging cross-border banking groups to maintain their exposure to the region and ensure adequate solvency levels of their subsidiaries. Throughout, the initiative benefitted from strong participation by commercial banks active in CESEE countries, by supervisors from both banks' home countries and host countries in which they operate, by the European Commission and by a range of international institutions, including the IMF, World Bank, EIB and EBRD.

11. The NPL working group aimed to analyze the framework for dealing with NPLs of households and corporates in the aftermath of the financial crisis. Key objectives included (i) to identify legal, regulatory and institutional barriers to effectively managing and resolving portfolios of NPLs in banking systems in CESEE countries; (ii) to develop best practices to achieve an efficient resolution of NPLs in a way that minimizes the destruction of asset values and is consistent with macroeconomic and systemic banking stability; (iii) to work toward developing standards for asset quality reporting to be able to better assess systemic risk; and (iv) to enhance the analysis of the linkages between the macroeconomic environment and dynamics of asset quality. Specifically, the working group sought to identify what national authorities, commercial banks, financial supervisors, and international financial institutions can do to ensure such an outcome. While the report focuses on CESEE countries, it brings out examples from other countries in Europe and Central Asia, and many of its policy recommendations are relevant in these jurisdictions as well.

12. The objective was to cover systemic issues that cut across countries, as well as to identify specific legal, regulatory, or other issues affecting NPL management in specific countries. Focus countries included those where major banking groups represented in the EBCI are active, such as Latvia, Hungary, Romania, Bulgaria, Serbia and Ukraine. Priority topics included: (i) the scale of the problem, (ii) banks' practices in dealing with NPL, (iii) data reporting, (iv) legal frameworks, taxation and supervisory issues, and (v) government intervention.

13. The present document summarizes the main findings and recommendations discussed within the working group. It has been prepared based on contributions received from all stakeholders. The working group met on May 26 and on October 4, 2011 in Vienna.¹

14. The recommendations of the report need to be seen in conjunction with other initiatives by European regulatory authorities, home and host regulators, and IFIs, to strengthen financial stability and economic recovery in the region overall.

¹ The meetings and working groups were chaired jointly by the World Bank and IMF. Attendants included representatives from central banks and supervisors from major home and host countries, representatives from regionally operating banks, as well as IMF, World Bank, EBRD, EIB, IFC, ECB and European Commission. A list of participants is included in Annex 1. This report was coordinated by Christoph Rosenberg (IMF) and Sophie Sirtaine (World Bank).

CHAPTER 2: NPLS AND THE MACROECONOMY²

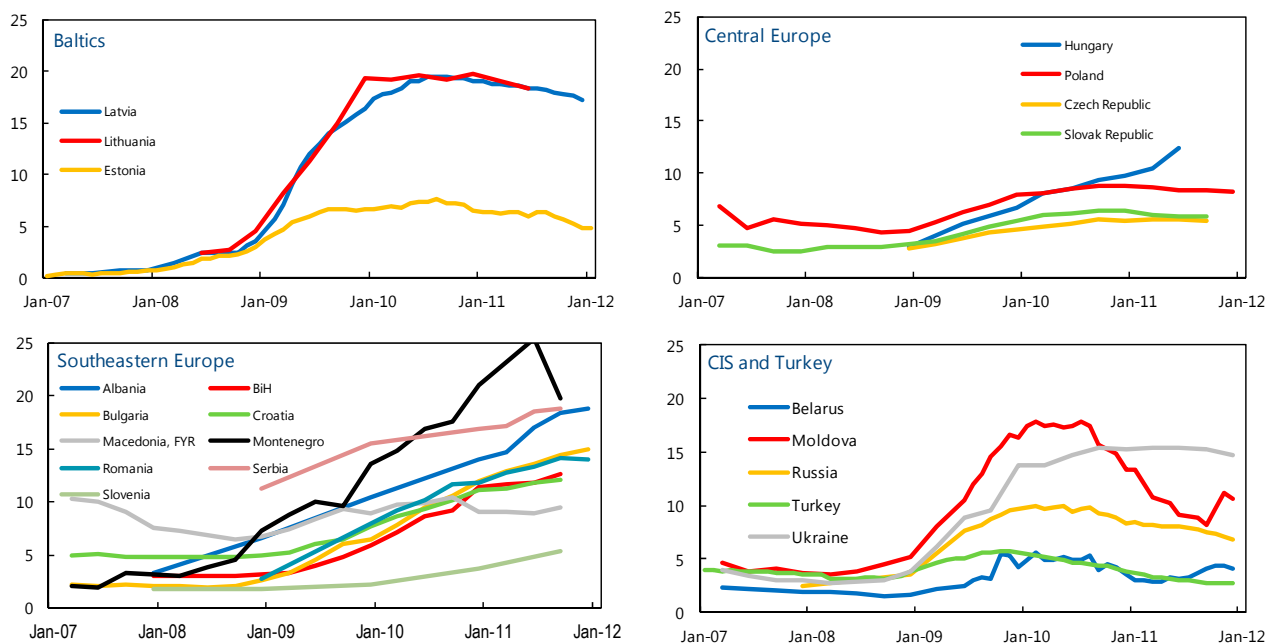
The boom-bust cycle in CESEE countries has left a legacy of non-performing loans (NPLs) in the region. In some countries NPLs reach levels comparable to those seen in the wake of earlier financial crises. Although the problem is serious, there are important differences in its gravity across countries and sectors and it is not found to be on a scale where it would imperil financial stability or where it would be symptomatic of a generalized debt overhang in the countries of the region. Rather, the danger lies in lingering NPLs becoming a drag on economic growth as they weigh on credit growth, which remains subdued in most of the region. More generally, unresolved NPLs tend to mute activity of overextended borrowers and hinder the reallocation of their assets to more productive uses. The clouded economic outlook for CESEE countries suggests that “growing out of the NPL problem” is probably not a realistic option for the region. Instead, a more pro-active and cooperative approach to NPL resolution is needed. This holds the promise of improved growth performance, with positive knock-on effects on banks’ asset quality and credit demand.

2.1. NPL developments in CESEE countries

15. Following the crisis of 2008/09, NPLs increased rapidly across CESEE countries, sometimes to reach very high levels comparable to those seen in the wake of earlier financial crises. When the global financial crisis reached CESEE countries in the fall of 2008, the era of easy, foreign-financed credit came to an abrupt halt and export markets collapsed, plunging the region’s economy into a deep recession. Problems with the quality of banks’ assets emerged soon thereafter and NPL ratios rose sharply from 3½ percent before the crisis and stood at over 11 percent at end- 2011 for the region on average (Figure 1). Unsurprisingly, NPL problems became most acute in those countries where the economic slump was particularly deep and where the pre-crisis credit boom had been the most extreme: NPL ratios reached some 20 percent in Latvia, Lithuania, and Montenegro. In a large number of countries NPL ratios came close to those seen during other crises, such as the Asian crisis in 1997/98 (Figure 2). In contrast, countries that avoided recession, such as Poland, or overcame it very quickly, such as Turkey, experienced a more modest rise of NPL ratios, to peaks of 8.8 and 5.7 percent, respectively.

² Prepared by Gregorio Impavido, Christoph Klingen, and Yan Sun (all IMF, European Department).

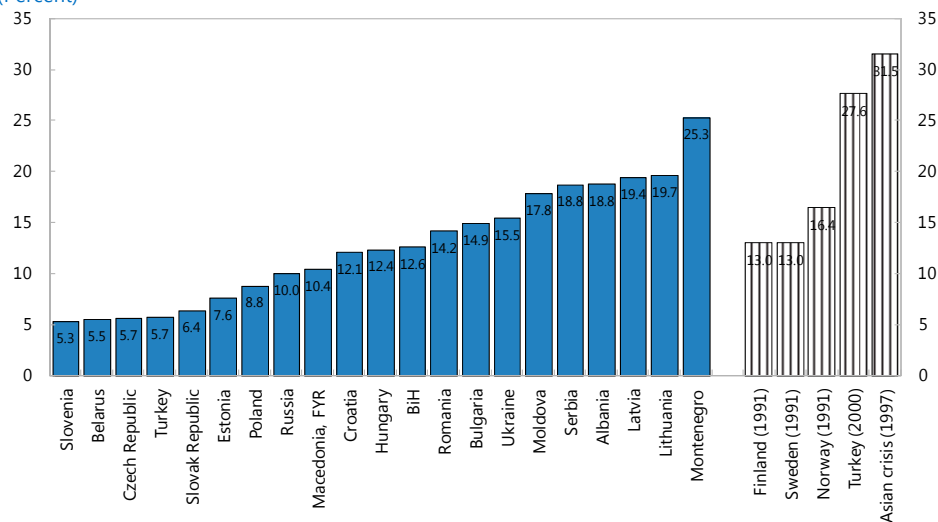
Figure 1. CESEE: Bank NPLs to Total Loans, Jan:2007–Jan:2012*
(Percent)



Sources: Country authorities; IMF country desks; and IMF, Statistics Department.

* Data are not fully comparable across countries due to differences in national classification practices.

Figure 2. CESEE and Previous Crises Countries: Peak NPL Ratios*
(Percent)

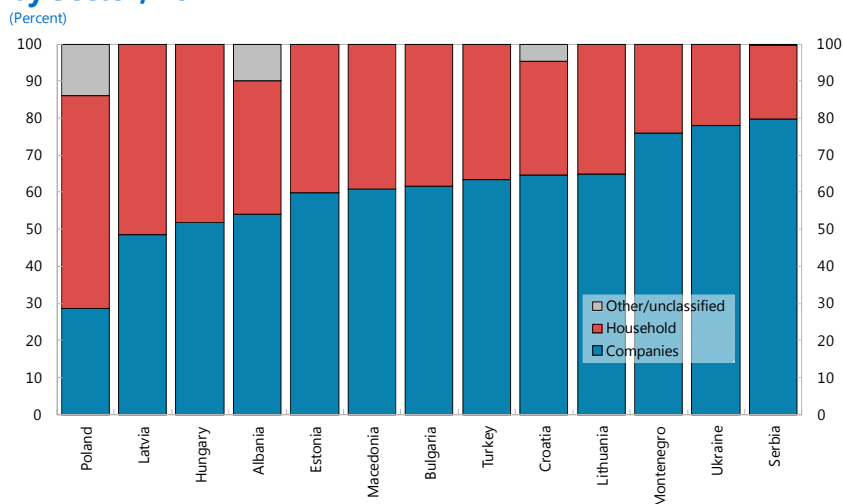


* For CESEE peak ratio during 2009-2011. Data are not fully comparable across countries due to differences in national classification practices.

Sources: Country authorities; IMF country desks; IMF Statistics Department; and Laeven and Valencia (2008).

16. Asset quality problems beset both loans to households and loans to companies. In contrast to earlier crises where NPL problems afflicted almost exclusively the corporate sector, this time in CESEE countries bad loans to households account for a sizeable share of the problem (Figure 3). This reflects the rapid rise of consumer and housing loans in the run-up to the crisis. Hence, tackling CESEE countries' NPL problem means finding solutions that encompass both corporate debt and different types of household debt.

Figure 3. Selected CESEE Countries: Contribution to NPLs by Sector, 2011



17. **High NPLs are a crisis legacy that is unlikely to be resolved by economic growth alone.** The resumption of economic growth in the second half of 2009 led to a slowdown in the rise of NPL ratios and in the better performing economies they seemed to have peaked sometimes in 2011. However, they are generally still at high levels and the asset deterioration continues in a large number of countries, such as those in Southeastern Europe where the recovery came late and is weak, or in Hungary, where loans denominated in the appreciated Swiss franc continue to cause problems. Moreover, the economic outlook for the entire region is clouded by the crisis in the euro area. Current projections are for a pronounced drop of growth in 2012, with further downside risks. Hopes for strong tailwinds from economic recovery that would allow delinquent borrowers to resume full debt service or that would substantially lift collateral values are bound to be disappointed.

18. **High NPL ratios are a cause for concern for several reasons.** Most immediately, they may give rise to financial stress, especially if banks' provisioning is inadequate, their capital buffers are low, and further NPL rises are in the offing. Furthermore, high NPLs might reflect a deeper problem of general over-indebtedness in the household and corporate sectors. In this case, a combination of deleveraging and debt restructuring would be called for and robust credit growth going forward would be problematic. The third concern is that lingering weakness in loan portfolios becomes a drag on economic growth. The rest of this chapter explores to what extent these concerns apply in CESEE countries, preceded by a few words of caution about the quality of NPL data.

2.2. *The quality of NPL data*

19. **NPL data are notoriously difficult to interpret, hard to compare across countries, and sometimes unreliable.** This hampers the analysis in this report but, more importantly, it clouds the assessment of the financial sector by investors, regulators, and other policy makers, with the potential for costly mistakes. There are two layers of data problems.

20. **First, there is no internationally accepted standard for NPL measurement.** National supervisors tend to follow different definitions for loan classification (Barisitz, 2011, Moody's Investor Service, 2003, and Laurin and Majnoni, 2002). A survey carried out for purposes of this report underscores that this shortcoming continues to persist in CESEE countries (Box 1). While all

but one of the participating countries apply the 90-day overdue threshold and report the total amount of defaulted loans as non-performing, practices regarding the treatment of collateral, restructured loans, criteria other than the overdue period, and multiple loans by the same defaulted borrower vary widely. Rules and practices regarding roll-over and re-aging may also differ. The IMF has made an effort to collect and disseminate internationally comparable financial soundness indicators (FSIs), which include NPLs.³ In principle they should conform to the definitions set out in the compilation guide (IMF, 2006), but in practice many countries find themselves unable to fully comply and the NPL definition in the guide leaves room for interpretation.⁴

21. A second layer of problems arises from supervisors' difficulties to enforce NPL reporting by banks in line with national rules. Ever-greening and other practices to keep reported NPLs down might be more prevalent in some countries than in others. Financial Sector Assessment Programs (FSAPs) by the IMF and the World Bank often find instances of NPL underreporting, and the countries of CESEE are no exception.

22. Against this background, efforts by country authorities to be transparent about their NPL definition and moves toward more harmonized reporting are highly welcome. In the meantime, awareness of the pitfalls is needed and analysis based on current data comes with wide confidence intervals.

Box 1. Improving Transparency in Asset Quality Reporting*

For the purposes of this report a survey on NPL definitions and reporting standards was conducted. It aims to highlight the prevailing heterogeneity within the region and clarify the actual practices on the ground. All 21 CESEE countries were invited to participate on a voluntary basis. Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Romania and Slovenia followed the invitation. This corresponds to a response rate of 62 percent. This box summarizes the results, which are provided in more detail in the Appendix.

NPL definition

All countries responded that their NPL definition is based on loans gross of provisions, accounts for the total amount of defaulted outstanding loans, employs a 90 days overdue threshold, and covers non-financial corporations and private households. Most of the countries consider also other elements than the number of days overdue as NPL classification criteria (10 out of 13). The survey further revealed very heterogeneous practices in dealing with collateral. It is taken into consideration in more than half of the countries (8 out of 13). The use of loan classification for NPL definition also differed widely (7 out of 13). Where the NPL definition is based on loan classification, NPLs usually comprise the categories "substandard," "doubtful," and "loss" loans (5 out of 7), and less often just "doubtful" and "loss" loans (2 out of 7). Different treatments of restructured loans prevail. These loans retain the same overdue status as before restructuring in some cases (5 out of 12). Moreover, there is sometimes a period after which the restructured loan reverts to "standard" status (6 out of

³ See <http://fsi.imf.org/>.

⁴ The analysis of this chapter focuses on NPLs as compiled and reported by supervisors for regulatory purposes. One would not expect a one-to-one match of regulatory NPL data with data on loan impairment compiled under IFRS for accounting purposes. Loan classification under IFRS tends to rely heavily on the judgment of banks and their auditors (IAS 39.58: "A financial asset or group of assets is impaired, and impairment losses are recognized, only if there is objective evidence as a result of one or more events that occurred after the initial recognition of the asset. An entity is required to assess at each balance sheet date whether there is any objective evidence of impairment. If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognized."). Nonetheless, it raises red flags when loan quality according to IFRS is significantly lower than regulatory data suggest, such as in Russia or Ukraine.

12). Another difference in NPL definitions arises from some countries following the customer view while others adopting the product view. Under the customer view all loans of a customer are automatically considered non-performing if at least one of his loans has gone into default. All countries responded that they applied the customer or product views consistently to non-financial corporations and households.

The surveyed countries provided the following short descriptions of their NPL definitions:

Country	Definition
Bosnia	NPL are loans, which do not provide revenues. Bank has to consider loans as NPL if: a) the principal and/or interest are due, and have not been collected for over 90 days after the original maturity date, therefore they are classified as: Substandard, Doubtful and Loss and b) beneficiary's interest debt, due for over 90 days after the original maturity date, is capitalized.
Bulgaria	Standard loans are defined as past-due less than 30 days, and watch loans as past-due between 31 and 90 days or when the debtor's financial state may deteriorate to an extent that calls the full repayment of the obligation into question. Non-performing loans are defined as past-due 91 to 180 days or when the debtor's financial state has substantially deteriorated and may result in inability to repay his obligations. Loss loans are defined past-due over 180 days or when the debtor suffers a permanent shortage of money other conditions providing grounds to consider that the risk exposure becomes uncollectible.
Croatia	NPLs are 1) placements for which evidence of partial impairment is identified, i.e. partly recoverable placements (risk categories B-1/B-2/B-3), and 2) placements for which evidence of impairment is identified, equal to their carrying amount, i.e. fully irrecoverable placements (risk category C). Placements mean financial assets in a form of granted loans, debt instruments and other receivables, classified by a credit institution into categories of financial instruments designated as "loans and receivables" and "held-to-maturity investments".
Estonia	Loans which are past due more than 90 days or loans placed in the default category by the lending bank based on other information.
Hungary	Non-performing loans are transactions with more than 90 days delinquency. In the case of corporations we apply a customer view while in the case of households we apply both a customer and a contract view.
Kosovo	NPLs are defined as the loans that are past due over 90 days, that include the "Doubtful" and "Loss" category of loans. According to the Central Bank of the Republic of Kosovo definition doubtful loans include loans that are overdue in repayment 91-180 days and loss loans include the category of loans that are overdue in repayment over 180 days.
Latvia	No explicit definition of NPLs. For analysis purposes loans with 90 days overdue are considered as NPLs.
Lithuania	NPL = not impaired but past due >61 days loans + impaired loans + individual specific allowances + collective specific allowances
Macedonia	The claim (any claim -principal, interest, fees) which has not been collected for more than 90 days after the maturity date, the bank shall record on a special account for non-performing claims - credits, interest, and other claims. The claim may be excluded from the category of non-performing claims only if the portion of the claim that fell due has been collected.
Moldova	Assets/contingent engagements classified as substandard, doubtful and compromised are considered nonperforming
Montenegro	NPLs are considered as loans past overdue more than 90 days, but that is not the only criterion. NPLs correspond to "substandard", "doubtful", and "loss" loans.
Romania	NPLs = Loans past due more than 90 days and/or with legal proceeding initiated. NPL s ratio = Loans and interest past due more than 90 days and/or with legal proceeding initiated, gross exposure per Total loans and interest classified
Slovenia	NPLs cover classified claims with delays over 90 days. Classified claims include financial assets at amortised cost and some risk-bearing off-balance-sheet items on which a payment liability could arise. NPLs definition accounts for the total amount of classified claims (in case that the amount of the overdue customer's liabilities to the bank exceeds EUR 1.000, the number of delays has to be started to count and the entire exposure to customer has to be assigned as non-performing - not only the overdue part).

NPL reporting

NPLs statistics are publicly available in central bank or regulatory authority statistics in almost all countries for non-financial corporations and for private households (11 out of 13). Where NPL definitions are based on loan classification, statistics on the particular categories are made available as well. In some cases a sectoral breakdown for NPLs of non-financial corporations is also on hand (5 out of 13), as well as NPLs for foreign

currencies loans and their decomposition into non-financial corporations and private households (5 out of 13). NPL statistics for household mortgages are published in about half the cases (6 out of 12) as well as NPL statistics on consumer loans (7 out of 13). The survey further showed that statistics on restructured loans are sometimes publicly available (4 out of 12); so are statistics on the stock of provisions with a breakdown into non-financial corporations and private households (3 out of 12). Less than half of the countries (5 out of 13) report NPLs on an unconsolidated basis, i.e., not covering NPLs of foreign subsidiaries, while the rest reports on a consolidated basis. For financial stability assessments information on gross inflow of NPLs would be useful, but none of the countries makes such information public.

Credit registers

Most countries have credit registers (11 out of 13). However, in many cases they are not fully utilized for monitoring aggregate NPL dynamics and producing public NPL statistics despite a very high coverage (100 percent in many cases and more than 80 percent otherwise). A possible reason could be the fact that credit registers are often primarily used as a credit risk management tool for the credit register participants (i.e., credit institutions). This drives the type of information stored in the register and the design of tools available for NPL analysis. The survey revealed that although credit registers could be used to generate required aggregate statistics on NPL developments—and interface and tools for obtaining timely statistics are available in half of the cases—registers are not typically used to generate aggregate statistics on NPL development for published statistics. In some cases only negative information is stored in the registers and their usefulness for credit risk monitoring is accordingly very limited. It is also worthwhile noting that credit registers could be considered as a relatively new phenomenon in most CESEE countries with many of them only recently established. The NPL data time series available in registers could therefore be too short for robust analysis.

* Prepared by Petr Jakubik (ECB) with inputs from Deniss Titarenko (ESRB Secretariat). The survey was conducted in cooperation with European Systemic Risk Board (ESRB) and European Banking Authority (EBA).

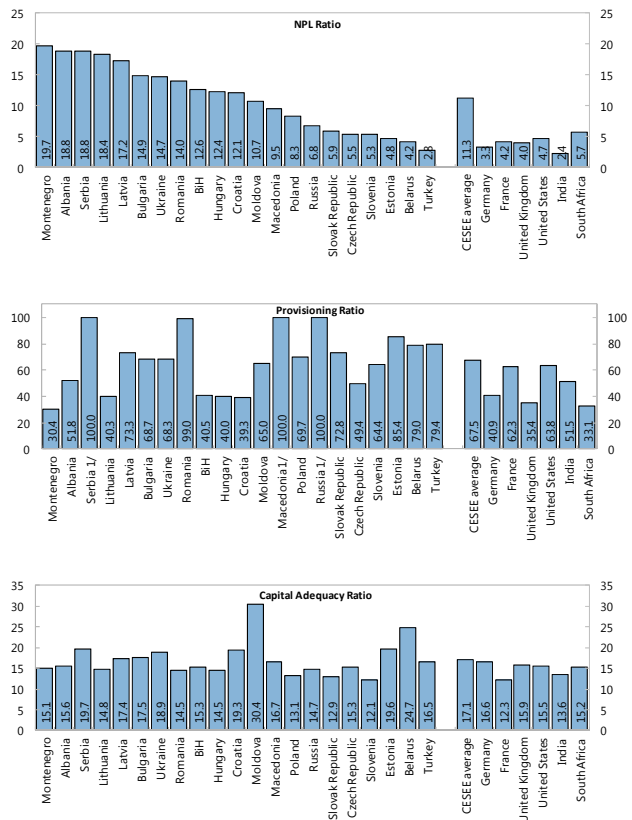
** Some countries did not provide answers to all questions contained in the survey.

2.3. NPLs and financial stability

23. High levels of NPLs can be a threat to financial stability. Banks' earnings suffer if eventual recovery rates on NPLs disappoint relative to provisioning. Outright losses can arise that weaken banks' capital base, potentially giving rise to insolvency or illiquidity. Overall financial stability would be at risk if such problems were to arise in a substantial part of the banking system.

24. In CESEE countries, high capital adequacy ratios and relatively high provisioning provide important buffers (Figure 4). An average capital adequacy ratio of about 17 percent puts CESEE countries' banking systems at the top end of the spectrum in international comparisons. At two thirds of NPLs, provisioning is at levels typically considered prudent. However, capitalization and provisioning varies considerably across the region—Serbia for example has fully provisioned for its NPLs and the capital ratio stands at close to 20 percent, while Montenegro's coverage ratio barely exceeds

Figure 4. CESEE and Selected Comparators: Financial Soundness Indicators*



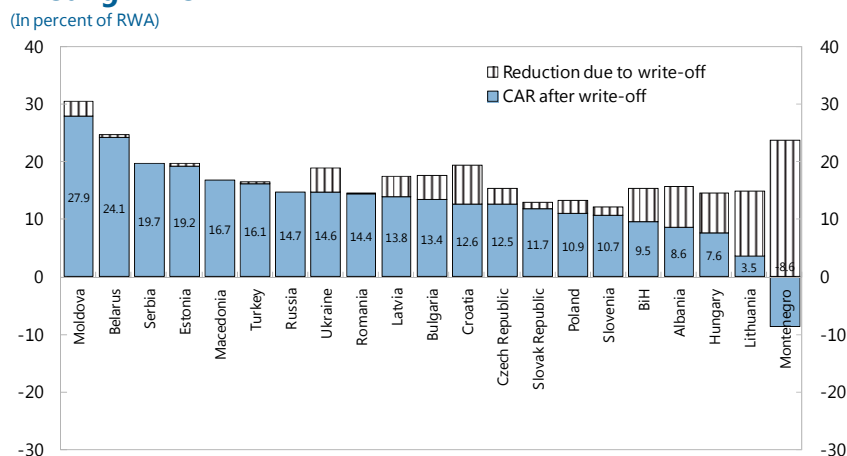
Sources: Country authorities; IMF country desks; IMF Statistics Department.
 * Data relate to end-2011 or latest available. Data are not fully comparable across countries due to differences in national classification practices.
 † Data shown capped at 100 percent. These countries report provision ratios above 100 percent, reflecting inclusion of general provisioning or provisions related to loans extended by non-resident parts of banking groups that also operate domestically.

30 percent and capitalization is below average. Where important parts of the domestic banking system are made up by subsidiaries of cross-border banking groups, financial soundness indicators at group level warrant additional consideration.

25. Sensitivity analysis suggests that low recovery rates on existing and recognized NPLs would be manageable in most CESEE countries. The analysis considers what would happen to capital adequacy ratios if all existing and recognized NPLs had zero recovery value, i.e., if NPLs, net of provisioning, were immediately written off in full against capital. These are tough assumptions—in reality loans would be written off over time with pre-provisioning income cushioning the hit to capital and at least some recoveries from NPLs could be expected, especially considering pervasive the extensive collateralization of loans in CESEE countries.

- Aggregate data for the banking systems of the region tentatively suggest that the NPL write-off would result in significant capital shortfalls only in Montenegro and Lithuania** (Figure 5). On the basis of FSI data, capital adequacy would remain above regulatory minima in all countries, except Montenegro, Lithuania, Hungary, and Bosnia-Herzegovina. With capital adequacy falling to less than 4 percent, Lithuania’s banking system would be in need of significant recapitalization, although this amount is likely biased upward by Lithuania’s unusually strict NPL definition. Capital of Montenegro’s banking system would become deeply negative. Capitalization of Hungary’s banking system would dip slightly below the 8 percent threshold. At 10½ percent, capitalization in Bosnia-Herzegovina would remain rather strong though short of the local regulatory minimum of 12 percent.⁵ One drawback of using data aggregated across the entire banking system is that capital shortfalls in weaker banks may not be captured to the extent that the high capitalization of stronger banks compensates. As such, sensitivity analysis based on aggregate data provides only a first-pass estimate of true capital shortfalls and need to be supplemented with analysis of bank-level information.

Figure 5. CESEE: CAR Under Complete Write-off of Existing NPLs*

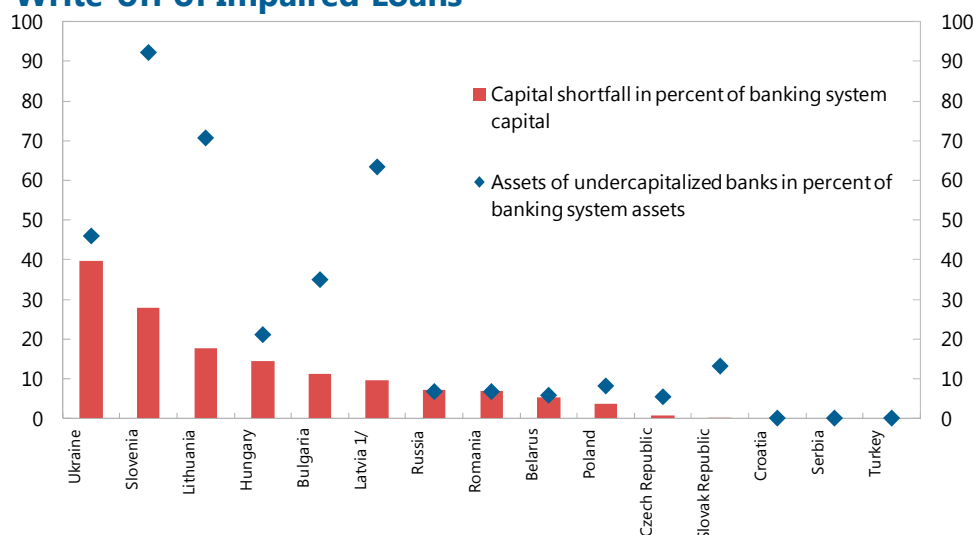


Sources: Country authorities; IMF country desks; and IMF Statistics Department for CAR, NPL ratio, provisioning ratio; Bankscope for RWA/loans; and IMF staff calculations.
 * Based on data for end-2011 or latest available. Results not fully comparable across countries due to differences in national FSI data. Provisioning ratio capped at 100 percent for the purposes of this exercise.

⁵ Minimum capital adequacy is set at 8 percent of risk-weighted assets in most countries of the region. However, a few have opted for higher ratios: 10 percent in Estonia, Russia, and Ukraine; and 12 percent in Bosnia-Herzegovina, Bulgaria, Croatia, and Serbia.

- **Bank-by-bank data tentatively suggest that capital shortfalls could also arise in Hungary, Slovenia, and Ukraine** (Figure 6). These calculations use data from Bankscope, a commercial provider of data from bank statements, for all countries for which an acceptable coverage of the banking sector is available. NPLs are proxied by impaired loans. In Hungary, capital injections equivalent to about 15 percent of bank capital would be required to bring all banks back to a capital adequacy ratio of at least 8 percent. The calculations suggest much higher recapitalization needs in the case of Ukraine and Slovenia, reflecting bank-level data that indicate a much larger NPL problem than banking system aggregates. Sensitivity analysis based on Bankscope data take into account heterogeneity within the banking system but are not without drawbacks: data limitations allow only partial system coverage, the data are compiled for financial accounting rather than regulatory purposes, etc. An analysis based on the full information available to national supervisors would paint a more accurate picture.

Figure 6. CESEE: Banks with CAR<8 Percent after Complete Write-off of Impaired Loans



Sources: Bankscope Database and IMF staff calculations. End-2010 data. Albania, Bosnia-Herzegovina, Estonia, Macedonia, Moldova, and Montenegro are excluded due to insufficient data.

1/ Excludes Parex Bank, which is a government-owned work-out unit for problem assets. The high share of undercapitalized banks reflects conservative loan classification and respective provisioning by a large bank in 2010, which proved to be overestimated and was partly reversed in 2011.

- **All other things remaining equal, the capitalization of the large western banking groups which dominate many banking systems in CESEE countries would generally not be greatly affected by the NPL write-off in the host-country subsidiaries.**⁶ At the group level, even a full write-off of all NPLs in CESEE countries would hit capitalization by between $\frac{3}{4}$ and $2\frac{1}{4}$ percentage points for the major western players. The size of the effect depends primarily on the share of activities in CESEE countries in groups' overall operations. Smaller western banking groups with a very strong emphasis on CESEE countries could however suffer considerably more.

⁶ It is important to note however that there are important cross-country and bank-by-bank differences in provisioning levels. In addition, whether or not a capital shortage would result from additional NPL provisioning will also depend on various developments such as the impact of the forthcoming CRD/CRR regulation as well as potential global/domestic SIFI add-ons.

26. More significant capital shortfalls could arise if existing NPLs were seriously understated. Repeating the exercise of the first bullet but assuming in addition that NPLs are much above officially reported levels would unsurprisingly suggest potentially significant capital shortfalls. This is primarily because there are no specific provisions against these “unreported” NPLs to cushion the blow to capital.

27. Assessing pressures on banking systems from sources other than existing NPLs is beyond the scope of this sensitivity analysis. Specifically, a deepening euro area crisis could drag CESEE countries into another recession and put downward pressure on exchange rates—the latter a particular concern in countries with significant loans denominated in safe-haven currencies.⁷ Strains from the provisioning for new NPLs that would likely arise under the circumstances would come on top of those from low recovery rates on existing ones. Compliance with new capital requirements under Basel III and the EBA target of a 9 percent core tier 1 capital ratio, jittery funding markets, and policy-induced losses, such as those from the Hungarian government’s early repayment scheme for foreign-currency mortgages of September 2011, are all additional challenges for banks.⁸

2.4. NPLs and generalized debt overhang

28. High NPLs could reflect an economy-wide problem of over-indebtedness or more isolated instances of overextended borrowers. The underlying reason matters. If there is a generalized debt overhang, a revival of robust credit growth would only compound the debt problem and ultimately hinder rather than support economic recovery. On the other hand, if some borrowers are overextended while the debt burden is light for most households and companies, revival of robust credit growth would help spur economic recovery and would therefore be desirable. In which category do CESEE countries fall?

29. CESEE countries’ credit boom sharply pushed up indebtedness. The credit extended by the regions’ banks to households and companies grew much faster than economic activity. The ratio of private sector credit to GDP jumped from 27 percent in 2003 to 60 percent in 2010 (Figure 7). The same is true of broader measures of indebtedness, which also takes into account loans extended by foreign banks, loans from foreign parent companies, and debt securities issues by firms (Figure 8).⁹

30. Aggregate indicators do not point to households and companies in CESEE countries being overly saddled with debt. In essence, the credit boom took off from a very low base of financial depth. While rapid credit growth caused severe problems in terms of economic overheating and poor credit allocation, financial depth and household and company debt remained low relative to comparators in Western Europe.¹⁰

⁷ Swiss-franc denominated loans correspond to some 20 percent of GDP in Hungary and about 10 percent of GDP in Croatia and Poland. The appreciation of the Swiss franc against the Hungarian forint typically increased the local currency value of Swiss-franc denominated loans by around 60 percent between inception and end-2011 (IMF, 2012).

⁸ Basel III related issues are discussed extensively by the EBCI Working Group on Basel III implementation in emerging Europe.

⁹ The broader measure of debt is available only for a subset of CESEE countries on a comparable basis. However, the derived conclusions are likely to extend to the countries not covered.

¹⁰ One important lesson from the credit boom-bust in emerging Europe is that low financial depth does not necessarily imply that fast credit growth is unproblematic (Becker et al, 2010).

31. With the possible exception of Estonia, Latvia, and Slovenia, private sector credit to GDP ratios remain substantially below those in the euro area (Figure 7 below). But for many countries, including Poland, Romania, Russia, and Turkey, financial depth is only half or less of that in Western Europe.

Figure 7. Selected European Countries: Private Sector Credit, 2003 and 2010

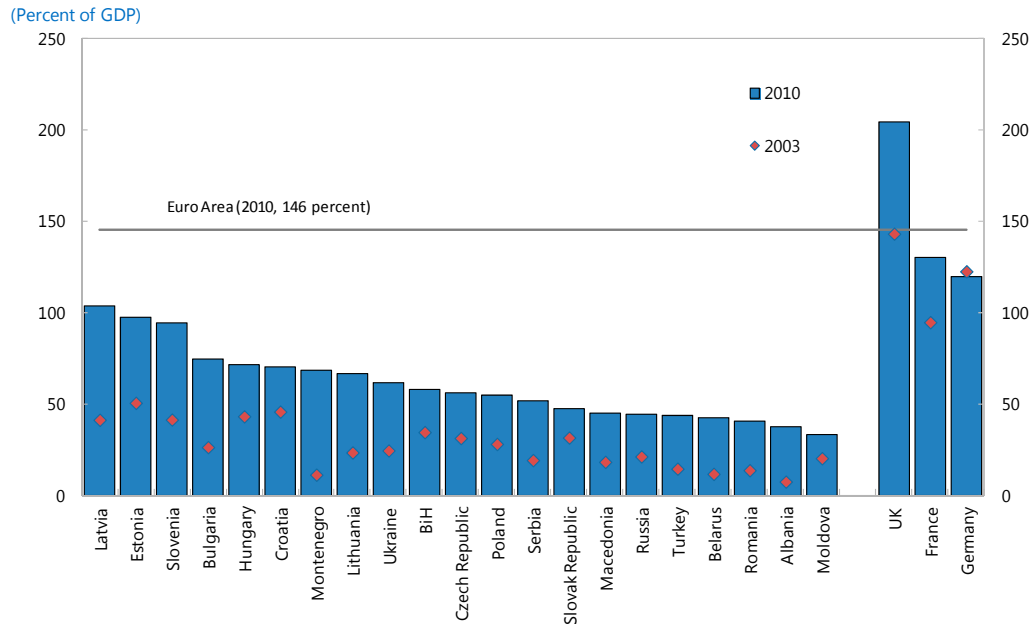
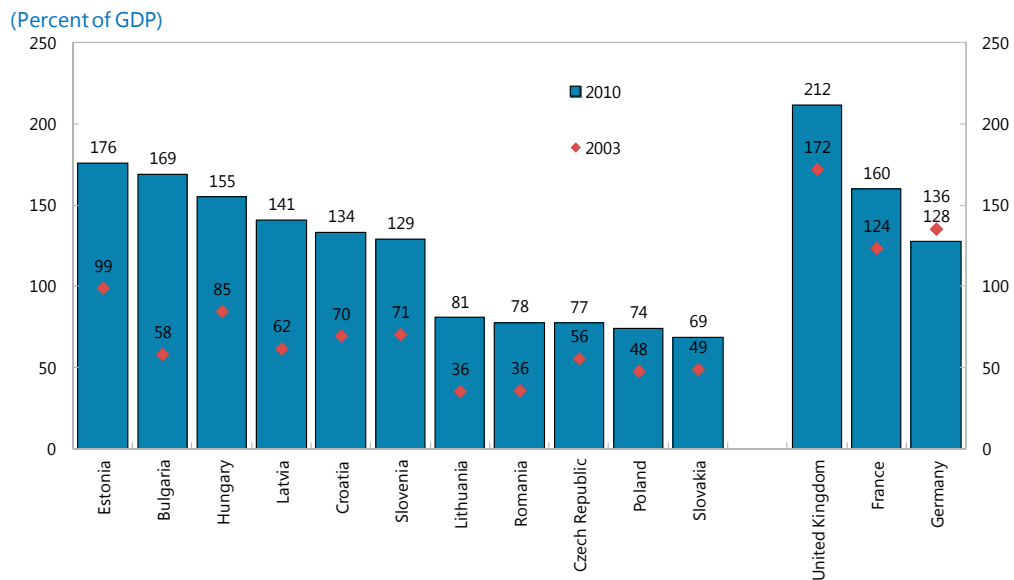
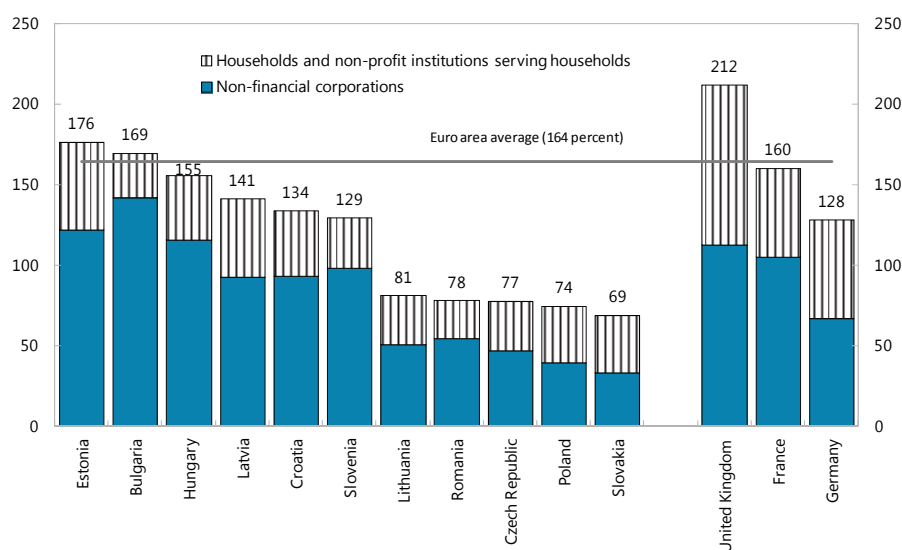


Figure 8. Selected European Countries: Debt Levels, 2003 and 2010*



32. **Broader measures of indebtedness confirm the findings based on private sector credit** (Figure 9). Considering all loans taken out by households and enterprises, as well as debt-securities issued by enterprises, indebtedness in CESEE countries looks again considerably lower than in the euro area. In particular, in the Czech Republic, Poland, Slovakia, and Romania, debt stands at less than half of euro-area levels. Relatively low indebtedness is primarily due to households, often reflecting underdeveloped mortgage markets rather than particularly low consumer loans. Bulgaria, Estonia, and Hungary stand out as countries with indebtedness close to western levels at first sight, but an important qualification applies.

Figure 9. Selected European Countries: Debt Levels, 2010*
(Percent of GDP)



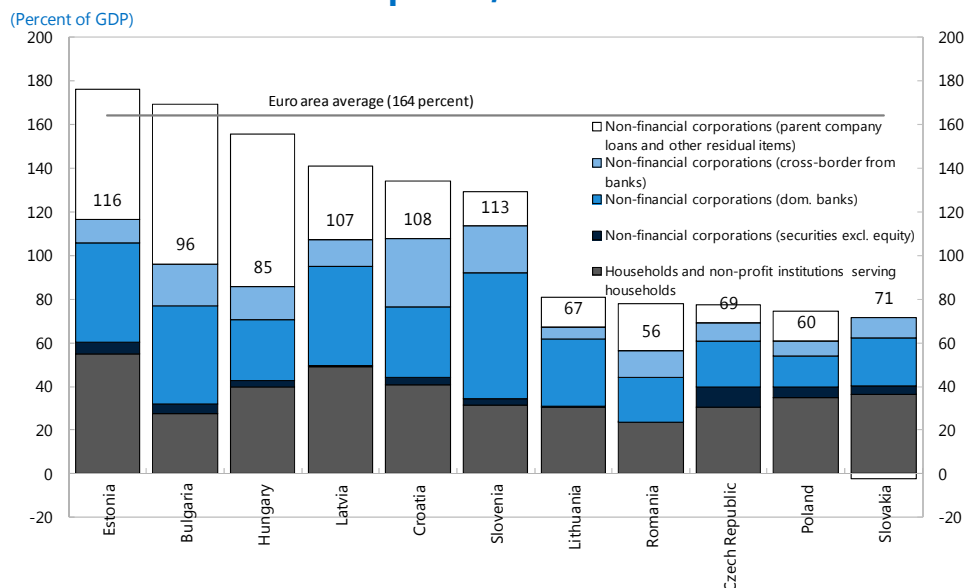
Sources: Eurostat and IMF staff calculations.

* Loans in the case of households; loans and securities excl. shares in the case of non-financial corporations.

33. **Much of companies' debt seems to be vis-à-vis parent companies in the west and therefore arguably in economic nature closer to equity than debt.** Roll-over risk is much lower than for debt owed to unaffiliated entities and parents are likely to tie their local firms over in difficult times rather than pushing them into bankruptcy. Excluding this type of debt would reduce the remaining indebtedness of all countries in CESEE countries well below euro-area levels (Figure 10).¹¹

¹¹ The approximate size of parent company loans can be estimated as total loans taken out by companies (as per EuroStata data) minus loans extended by domestic banks to companies (as per CEIC data) minus cross-border loans extended by BIS-reporting banks to domestic non-banks (as per BIS data). This approach overestimates parent company loans to the extent loans from foreign non-banks to domestic companies such as independent suppliers are important. It underestimates them to the extent that domestic banks extend considerable credit to foreign companies. A case study for Estonia confirms the importance of parent company loans (IMF, 2010).

Figure 10. Selected European Countries: Debt Levels and Loans from Parent Companies, 2010



34. Measures of the debt service burden do not generally point to a generalized debt overhang. Household interest payments relative to disposable income seems elevated only in Estonia, and to a lesser extent in Hungary and Latvia. Bulgaria and Hungary are the only countries where the ratio of companies' debt to net value-added ratio is above the euro-area average, but this may again reflect equity-like loans from parent companies rather than an overly heavy debt burden.¹²

35. Several reports by the World Bank confirm the absence of a generalized debt overhang (Mitra et al, 2010, Brown and Lane, 2011, Sugawara and Zalduendo, 2011, and Gill et al, forthcoming). Only a handful of countries have private credit-to-GDP ratios above what one would expect on the basis of their economic development, and very moderate debt in the form of corporate bonds further mitigates any concern. Moreover, micro data show that debt tends to be rather concentrated on those better able to bear it: financially sophisticated firms and higher-income households. As a result, the corporate and household sectors show a rather high degree of resilience in stress tests.

36. In most CESEE countries, concerns about a generalized debt overhang appear unwarranted and should not stand in the way of efforts to achieve robust credit growth in support of the region's economic recovery. Estonia, Latvia, and Slovenia are potential exceptions and policy makers and lenders will need to tread more carefully here. More generally, other

¹² Large financial assets might also be considered an offset for a heavy debt burden. While debt-to-GDP ratios are generally lower in emerging Europe than in the euro area, so are financial assets-to-GDP ratios. Indeed, financial assets (currency holdings, deposits, debt securities holdings) net of financial liabilities (loans and debt securities issued) are around -50 percent of GDP for both, the euro area and the average of the eleven CESEE countries for which comparable data are available. However, since the highly indebted households and firms are typically not those also highly rich in financial assets, such measures of net financial assets are only of limited relevance for the assessment of debt burdens.

macroeconomic or microeconomic speed limits to the extension of credit might apply. The return to the credit boom of 2003-08 would not be advisable but most countries stand to benefit from faster credit growth than they currently experience.

2.5. *NPLs and economic recovery*

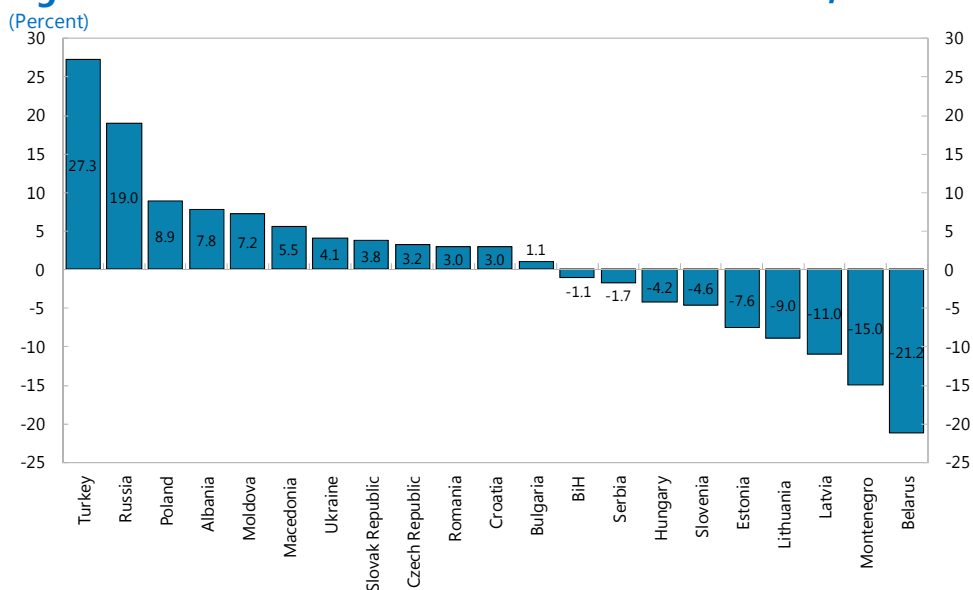
37. The final concern with persistently weak loan portfolios is the potential drag on economic growth. There are two main channels through which NPLs could hold back economic recovery. First, banks saddled with NPLs might be ill-placed to extend fresh credit. Second, overextended borrowers face reduced incentives to invest and assets remain under their control rather than being reallocated to more productive uses.

2.5.1. *Credit supply channel*

38. It may seem a foregone conclusion that high NPLs delay economic recovery. Japan's lost decade following the bursting of the bubble in the early 1990s is commonly attributed in large part to unduly delaying the cleaning up of banks' balance sheets (Inaba et al., 2003). Similarly, Krueger and Tornell (1999) blame the slow recovery of Mexico's nontradables sector following the 1994 crisis on a credit crunch by domestic banks with impaired portfolios. More generally, recoveries after financial crises are found to be particularly protracted because they tend to be "creditless" due to impaired financial intermediation (Abiad et al., 2011). A credit crunch obviously weighs on aggregate demand, but it is also bound to affect aggregate supply and sectoral change as investment suffers. The many countries in CESEE that have to reorient their economies toward the tradables sector will find it difficult to do so if financing to pay for the required investment remains scarce.

39. More than three years after the height of the global financial crisis, credit growth remains subdued in much of CESEE (Figure 11). Indeed, strong credit growth is confined to a few countries: Turkey which came through the 2008/09 crisis very well, due to few pre-crisis imbalances, is posting very rapid credit growth that is a cause for concern; Poland, the only EU country that avoided a recession in 2009 and where the deterioration of asset quality remained confined, seems not to be credit constrained; and Moldova experienced a revival of credit growth in the wake of a strong reduction of NPLs. Credit growth is also fast in Russia despite high NPLs, perhaps reflecting widespread state ownership in the banking sector that may override the usual dampening effect from poor asset quality (Raiffeisen, 2011). Elsewhere credit growth remains weak. While subdued credit dynamics certainly reflect low credit demand in a generally soft economy, credit supply weakened by high NPLs likely also played a significant role. Moreover, weak credit demand and weak credit supply are closely intertwined: a credit crunch is bound to weaken macroeconomic performance and this will in turn weaken credit demand.

Figure 11. CESEE: Real Private Sector Credit Growth, 2011*



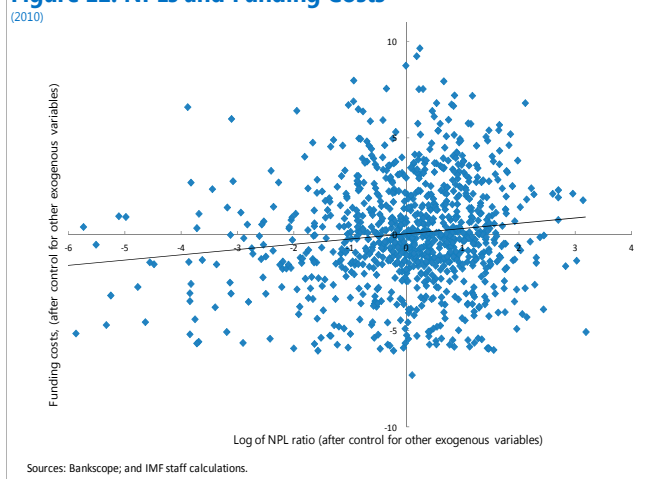
Sources: IMF-IFS; IMF-ISN; and IMF staff calculations.

* Twelve months to December 2011 or latest available. Derived from stock data in domestic currency, adjusted by CPI inflation. May include valuation effects from foreign-currency denominated loans.

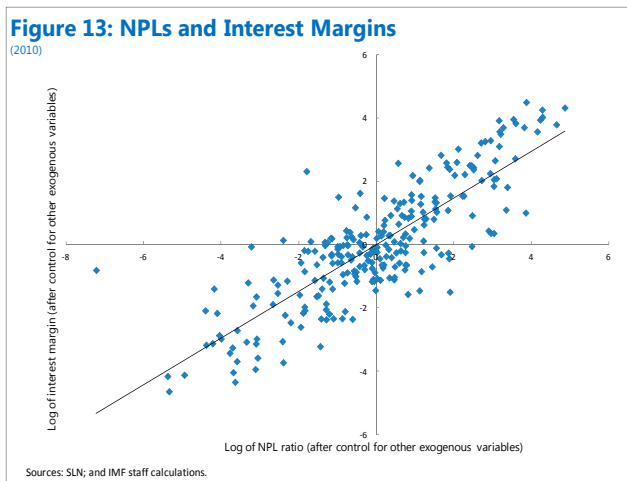
40. **One can think of several mechanisms through which NPLs affect credit supply.** Apart from psychological effects that make lenders naturally reluctant to extend new loans just when they see old loans go sour, NPLs will influence the supply of credit through their effects on funding costs, bank efficiency, and capital.

- **Funding costs.** As NPLs rise so does uncertainty about the true capitalization of a bank, because provisioning might or might not be sufficient to cover the eventual loan loss. This greater uncertainty will be reflected in a higher risk premium on banks' funding and reduced access to financing (Diawan and Rodrik, 1992). To the extent that it is passed through to banks' lending rates, credit supply declines. Empirically, there is indeed a positive relationship between funding costs and NPLs in a large sample of CESEE banks (Figure 12).

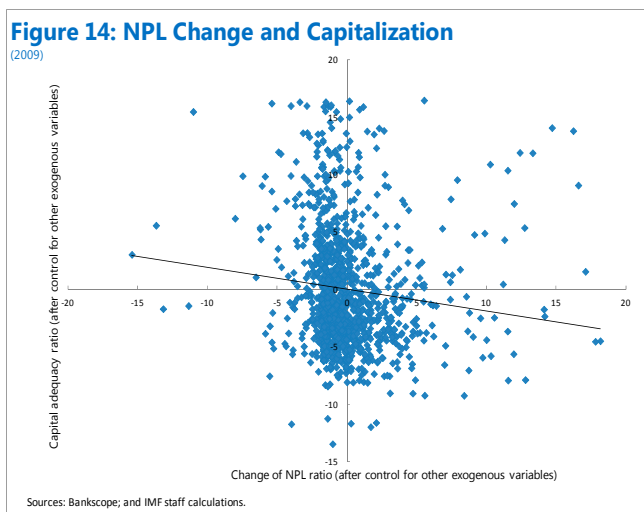
Figure 12: NPLs and Funding Costs



- Efficiency.** Bank efficiency is typically proxied by interest margins. The sample of European banks exhibits a very clear positive association between NPLs and interest margins (Figure 13). This might reflect the costs of managing NPLs that banks have to shoulder (Mohd et al., 2010). In addition, banks might also try to recoup some of their loan losses through raising interest margins. In either case, lending rates will be higher and credit supply lower. The close association of asset quality and interest margins is clearly visible in a sample of banks in Western Europe and CESEE countries.



- Capital.** Rising NPLs require provisioning which reduces banks' income. Unless fully matched by reduced dividend payments, bank capital will be lower than it would have been in the absence of the NPL increase. Lower capitalization in turn reduces banks' capacity to lend. Unless banks recapitalize immediately or had excess capital to begin with, actual credit supply will suffer. Although more difficult to clearly establish empirically, the sample of banks in CESEE countries exhibits a negative association between capital ratios and the change of NPLs (Figure 14).



41. Evidence from CESEE countries confirms that NPLs affect credit supply. While there is a clear economic rationale for expecting a negative link between NPLs and credit supply, whether such an effect plays in practice is ultimately an empirical question. Several studies for different periods and parts of the world find such a link, although it is generally not easy to establish, considering the many other factors affecting banks' propensity to extend loans.¹³ An empirical analysis for CESEE countries during 2009-11 carried out for the purposes of this report finds that any 5 percentage point increase of the NPL ratio reduces credit growth by some 2 percentage points through credit supply effects (Box 2).

¹³ In a sample of 26 advanced economies during 1998-2009, Nkusu (2011) finds that a rise of NPL ratios by some 5 percentage points reduces the credit to GDP ratio by 4.5 percentage points in the first year. Based on bank-by-bank data for Asia, the US, and Europe during 1998-2005, Hou (2007) concludes that NPLs have non-linear negative effects on bank lending behavior. According to Espinoza and Prasad (2010) an increase of NPL ratios by 2 percentage points reduces credit growth by 2¼ percentage points after three years, based on evidence from bank-by-bank data for the countries of the Gulf Cooperation Council during 1995-2008.

Box 2. An Empirical Analysis of Loan Growth in CESEE Countries

The analysis seeks to explain loan growth at the bank level with bank-specific financial indicators and key macroeconomic variables that affect the entire banking industry of a country. Data are at annual frequency, covering the years 2008-10 and for all countries of the region. Bank-level data are from Bankscope and include gross loans, non-performing loans, bank capital, as well as other income-statement variables. Macro-economic data are from the IMF's International Financial Statistics and World Economic Outlook. They include real GDP growth, inflation, exchange rates, and the share of foreign-currency loans in total lending.

The analysis allows distinguishing between supply and demand effects on credit growth. On the one hand, loan growth is driven by banks' own financial conditions, such as their individual lending growth in the past, the prevalence of non-performing loans on their books, and the level of their capitalization. All these variables capture effects on credit supply. On the other hand, loan growth depends on credit demand. It is proxied by real GDP growth, although changes in unemployment would be a valid alternative specification. With real GDP growth largely independent of individual banks' lending, it can be treated as exogenous for estimation purposes. The analysis also seeks to control for valuation effects on credit growth.

The analysis finds a significant negative effect of NPLs on credit growth and all other variables have the expected impact. A dynamic panel estimation approach, originally proposed by Arellano and Bond (1991), is used to explain individual banks' loan growth in local currency terms (Table). Real GDP growth and inflation have significant positive effects, with any 1 percent decline of GDP reducing loan growth by about 0.85 percent. Loan growth is also positively auto-correlated. The NPL loan ratio clearly affects loan growth negatively—a 10 percentage point increase reduces loan growth by some 4 percent, before considering any dynamic effects or feedbacks running through GDP growth. The role of banks' financial strength is somewhat less clear. Capital has a significant positive effect (at least when measured relative to beginning-period assets, rather than end-period assets, to reduce contemporaneous bias) but profit-related indicators are not, although coefficients do have the expected sign.* Coefficients of key variables such as the NPL ratio or real GDP growth are stable across different model specifications. The diagnostic tests (for errors and instrument variables) are all satisfactory, suggesting a generally adequate fit.

Table. Emerging Europe: Credit Growth—Loan growth (in local currency terms), 2008-2010^{1/}

VARIABLES	(1)	(2)	(3)
Loan growth (in local currency terms), (t-1) %	0.134** (0.0523)	0.113* (0.0590)	0.177*** (0.0677)
GDP growth (log change) %	0.813*** (0.196)	0.778*** (0.242)	0.917*** (0.225)
Non-performing loans / Gross loans %	-0.419*** (0.157)	-0.390* (0.207)	-0.410** (0.201)
Fx share*Depreciation	0.661** (0.255)	0.730** (0.281)	0.590** (0.252)
Inflation %	0.305 (0.345)	0.831*** (0.241)	0.719*** (0.269)
Capital ratio (% of beginning period assets)	0.749** (0.310)		
Pre-tax operating income / Avg. assets %		0.747 (0.539)	
Return on avg. equity %			0.0415 (0.0642)
year = 2008	0.0172 (2.972)	-2.169 (2.489)	-4.057* (2.294)
year = 2009	-3.480 (2.805)	-3.018 (3.090)	-3.281 (2.994)
Constant	0.144 (4.101)	6.871** (2.822)	7.165** (3.025)
Observations	424	313	446
Number of idBS	194	149	200
Arellano-Bond test for AR(1)	0.000189	0.00134	0.000307
Arellano-Bond test for AR(2)	0.436	0.612	0.876
Hansen over-identification test	0.870	0.985	0.955

Data source: Bankscope, IMF International Financial Statistics, IMF World Economic Outlook (September 2011).

1/ All equations are estimated using Stata's xtabond2 program. The instruments used are: GMM type instruments which include lags of the independent variables, and if not present, lags of growth in non-performing loan stock, pre-tax income ratio, tier 1 ratio, capital as a ratio of beginning period assets, and (quasi-)exogenous instruments such as year and country dummies, depreciation, share of foreign currency loans. Standard errors are presented in parentheses, and significance level are indicated as follows: *** p<0.01, ** p<0.05, * p<0.1.

* While not reported here, other regressions generally find no significant effect of various bank-level variables, such as the tier 1 capital ratio, the loan-to-deposit ratio, the cost-to-income ratio, etc.

2.5.2. *Non-credit supply channels*

42. NPLs can also weigh on economic developments through channels other than credit supply. Overextended borrowers invest too little and supply too little labour, even in the absence of financing bottlenecks. There may not be an economy-wide debt overhang in CESEE countries, but the very existence of NPLs means that many borrowers owe more than they can repay. Unless repayment difficulties are temporary or purely strategic, all the distortions identified by the extensive literature on debt overhang arise: overextended companies have little incentive to invest because any return is effectively shared with the banks holding the NPLs (Myers, 1977); overextended owners will show little enthusiasm in maintaining or improving the houses or apartments that they might lose in any event (Meltzer, 2010); and overextended households are unlikely to work harder and longer if the additional income remains insufficient to escape the debt trap (Mulligan, 2008). All this reduces economic activity to inefficiently low levels. Debt restructuring and partial debt forgiveness that reduce the debt burden can unlock efficiency gains with scope for debtors and creditors to both benefit.

43. Failure to resolve NPLs also tends to trap resources in unproductive uses. Loans might have become non-performing because too much credit has gone into particular sectors, to underperforming entrepreneurs, or to poorly selected projects. In this case, the efficient way forward may involve recovering remaining resources from these failed investments quickly with a view to redeploying them in more promising areas. A prolonged hold out for a recovery of existing projects, or of the value of the collateral backing them, might be inefficient and hold back economic recovery more broadly.

2.6. *Overcoming inertia in resolving NPLs*

44. NPL resolution tends to proceed more slowly than desirable because of positive macroeconomic externalities and reputational effects. The above analysis suggests that successful NPL reduction will help revive credit growth, spur activity of hitherto overextended borrowers, and free up resources trapped in unproductive uses. All of this will lift overall macroeconomic performance creating benefits throughout society, including for the banking sector at large through improved asset quality and collateral values. However, as these broader benefits accrue primarily to others, individual banks have insufficient incentives to take them into account when considering the resolution of their NPLs. The result is a coordination failure where NPL resolution, left to its own devices, proceeds at an unduly slow pace. Reputational effects could exacerbate the coordination problem further. To the extent that NPL resolution entails additional loss recognition, banks might be especially reluctant to face up to this prospect unless their competitors do the same.

45. Voluntary private sector cooperation would be the preferred way to address this coordination failure. Accelerating NPL resolution to a more desirable pace requires a pro-active approach. While incentives of individual banks to move ahead are suboptimal, collective incentives by banks are better aligned. Therefore, existing structures, such as local banking associations, should be harnessed to step up NPL resolution. They should embrace the goal of speedy NPL resolution in a high profile manner, agree on indicative time-bound targets for individual banks, and use peer pressure to implement them. The public sector can play a catalytic role and do its part to remove obstacles to NPL resolution.

46. Direct government involvement in NPL resolution is a double-edged sword and should be reserved for exceptional circumstances. For sure, governments have a role in improving framework

conditions so as to facilitate NPL resolution. As discussed at length in the subsequent chapters of this report, there is ample scope in CESEE countries to improve pertinent legislation, strengthening the capacity of the judicial system, remove obstacles in the tax and regulatory areas, and sharpen incentives for NPL resolution by phasing out any regulatory lenience in collateral valuation or loan classification. Resorting to more direct government intervention risks incurring substantial fiscal costs, if NPL resolution is subsidized, or, if it is not, undermining credit culture by retroactively changing the terms of credit contracts through government fiat. While circumstances can arise where such direct intervention is justified, the bar for bringing them into play should be set high (Box 3).

Box 3. Considerations and Experience with “Government Coordinated” Household Debt Restructuring

Though usually not necessary, government intervention in household debt restructuring can be appropriate. Traditionally, banks deal with a non-performing asset by either modifying the terms of the loan or writing off the loan altogether and taking any residual loss after recovering collateral. However, particularly when the banking system faces a sudden, sharp, and widespread (systemic) deterioration in portfolio quality, this normal approach of dealing with NPLs can become suboptimal. As noted in Laeven and Laryea (2010), the quantity of needed restructurings can clog the courts, individual bank incentives may conflict with helping the economy recover, and the cost of restructuring can swamp bank buffers.

Partially to overcome such problems, several governments in the recent crisis have intervened in the banking system to coordinate restructurings. The global economic downturn of recent years was triggered in part by a bursting of bubbles in household credit. In the aftermath, fears that the impact on both the financial sector and the real economy pressured several governments to intervene in standard bank procedures and coordinate top down restructurings.

- United States (2008)—Refinancing at subsidized rates; write-offs to approved loan-to-value ratios.
- United Kingdom (2008)—Payment deferral; limited government guarantees of deferred interest payments.
- Iceland (2010)—Payment freeze on FX loans; fast track write off of most of negative equity.
- Hungary (July 2011)—Mortgage servicing at preferred FX rate, reschedule difference with grace period for borrower; quota on foreclosures; national asset management company buys some distressed properties.
- Croatia (2011)—Extension of repayment period and debt service at preferential FX rate.
- Hungary (Sept. 2011)—A law, passed without any consultation with stakeholders, permitted full prepayment of mortgages at preferred FX. As part of a later agreement with the Banking Association in Dec. 2011, 30 percent of the associated bank losses are offset against the special bank tax.
- Hungary (Dec. 2011)—A comprehensive agreement with the Banking Association, concluded in the aftermath of the government’s unilateral scheme of September 2011, included: Conversion of delinquent FX mortgages below a certain threshold into HUF at a discount of 25 percent; interest subsidy at a sliding scale for the first 5 years; re-defaulted mortgages to be purchased by the National Asset Management Company. Relief for performing FX mortgages along the lines of the July-2011 scheme, but government to cover costs on FX appreciation above a certain level and to pay some interest on the rescheduled part of the mortgage during borrower’s grace period.

Several key design principles have emerged that can help the benefits of such involvement outweigh the costs. Restructuring should occur when there is a systemic risk to the economy and provide targeted relief at the most distressed assets. If borrowers are insolvent, an NPV negative restructuring is usually needed and burden sharing with the government can be appropriate provided it is consistent with debt sustainability. Finally, the proposals should be designed in conjunction with the banks and participation should be voluntary.

- *Clear Systemic Risk.* In the US, nearly 30 percent of all mortgages are underwater and in Iceland, household debt is 130 percent of GDP. It is less clear whether Hungary and Croatia faced a debt overhang with systemic implications.
- *Targeted Relief.* In Iceland, the focus is reducing loan to value ratios to sustainable levels. In the UK, eligibility required income and mortgages below certain thresholds and proof of payment difficulties.
- *Appropriate Burden Sharing.* In the UK, the government guaranteed the deferred interest payments for banks participating in the program. Only the scheme introduced in Hungary in September 2011 imposed the burden of restructuring entirely on the banking sector. In the December 2011 scheme government shoulders part of the burden.
- *Collaborative solution.* Participation in the US, UK, Croatia, and Iceland schemes was voluntary both for the banks and the debtors. In contrast, the scheme introduced in Hungary in September 2011 implied the retroactive revision of private contracts without consulting the banking sector, which may have inflicted large and lasting damage on its reputation among investors. The December 2011 scheme was negotiated with the Banking Association, albeit under threat of further government action.

	US (2008)	UK (2008)	Hungary (July 2011)	Hungary (Sept. 2011)	Hungary (Dec. 2011)	Croatia (2011)	Iceland (2010)
Strong case for intervention	✓	✓	×	×	×	×	✓
Collaborative solution	✓	✓	✓	×	?	✓	✓
Impact on NPV	✓	✓	×	✓	✓	×	✓
Burden sharing	✓	✓	✓	×	✓	✓	✓

2.7. Conclusions

47. **Speedy NPL resolution holds the promise of removing an important drag on economic growth in CESEE countries.** Experience from past financial crises suggests that lasting recovery requires a clean-up of the financial sector, including bringing down NPLs. Data from CESEE countries confirm that NPLs indeed weigh on credit growth. Moreover, NPL resolution would likely unleash economic activity of currently overextended borrowers and free up resources now trapped in unproductive uses. It would thus not only strengthen domestic demand but also bolster the supply side of the economy.

48. **Any short-term strains from a swift NPL resolution on financial soundness appear manageable in the vast majority of countries, although the results of the sensitivity analysis presented here would need to be confirmed by national supervisors.** Additional bank losses from debt restructuring cannot be ruled out, but they should generally be manageable given generally adequate provisioning and strong capitalization. Considering the data limitations besetting the underpinning sensitivity analysis and concerns about possible underreporting of NPLs, verification by national supervisors is important. A pickup of credit growth following the NPL resolution would be welcome as levels of indebtedness of households and companies in CESEE countries is still generally low and economic overheating is currently not an issue in most of the region.

49. **Achieving swift NPL resolution requires a proactive and cooperative approach.** Individual banks have too little incentives to resolve NPLs due to a collective action problem.¹⁴ Moreover, the subdued economic outlook for the region means that delinquent borrowers will continue to struggle and that collateral values will remain at depressed levels. Relying on a decentralized approach and otherwise wait for economic recovery to take care of the NPL problem will therefore lead to suboptimal economic performance. A pro-active cooperative approach would avoid such an outcome.

50. **It is recommended that a public-private task force take the lead in pushing for faster NPL resolution.** Faster NPL resolution is in the collective interest of the banking sector as it has positive knock-on effects for the economy and thus for asset quality and collateral values generally. Banking associations would be well placed to employ their organizational structure and the required authority with their members to implement an ambitious collective effort to forcefully address the NPL problem. The public sector can do its part, including by initiating the task force. Alternatively, the collective action problem could also be overcome by direct government intervention, but this has the downside of potentially large fiscal costs or retroactive change of private contracts by government fiat. This should therefore be confined to truly exceptional circumstances. That said, governments should do their utmost to remove obstacles that currently stand in the way of speedy NPL resolution.

¹⁴ This may be partially compensated however by the fact that there might be a first-mover advantage in early NPL resolution with regards to enforcing the collateral, as early movers might be able to extract higher values.

CHAPTER 3: BANKS' STRATEGY FOR DEALING WITH NPLS¹⁵

51. An anonymous survey was conducted among banks to identify their views and practices regarding NPLs in CESEE countries.¹⁶ Due to the extensive coverage in terms of geographical scope and market share, the survey findings provide a broadly representative overview of major banks' approaches to NPLs in the region.

3.1. Banks' general handling and monitoring of NPLs

52. A number of countries in the region are experiencing their first credit crisis following the change of the political landscape in the 1990s. In the years preceding the global economic crisis of 2008/09, many countries in the region had experienced several years of sustained economic growth and banking expansion. In many countries there was an explosion of credit, particularly consumer lending, including in a number of markets where consumer lending had previously been nearly non-existent, and, often, to first-time borrowers. Mortgage lending also expanded rapidly, including in markets with little pre-existing mortgage lending.

53. At the beginning of the crisis, experience in CESEE countries with NPLs was thus limited and expertise had to be brought in. As most countries had not gone through a full economic cycle, the recent increase in NPLs was the first real test of people, systems and procedures. While in some cases an adequate framework was in place, many banks had to adapt approaches that had worked reasonably well for the incidental NPLs in the past to suit the higher current volumes. Frequently, expertise from parent banks or other subsidiaries was brought in. For example, one bank designed a strategy for the region based on its experience with NPLs in Poland during 2000-02. Other banks moved senior staff to subsidiaries in CESEE countries or had senior managers from the parent bank set up work-out units.

54. Internal procedures were updated and standardized to identify non-performing clients at an early stage. Banks became more disciplined in NPL reporting. Information on NPLs is now communicated to senior management with a higher level of detail and on a more frequent basis. In addition, banks improved their portfolio monitoring tools and adjusted their models. Parameters, for example regarding recovery rates, were updated with new data that became available during the crisis. Standardized solutions were typically implemented to automate the process. Banks also improved the ability to segment non-performing clients, which enabled them to be more effective in offering various restructuring solutions. Often early-warning systems were introduced or enhanced as well. The warning indicators on (still) fully performing loans allowed banks to identify problematic cases at an earlier stage. Using these updated tools, full assessments of both corporate and retail portfolios

¹⁵ This section was prepared with contributions from Emanuel Maravic (EIB), Marta Mueller Guicciardini (IFC), Debora Revoltella (EIB), and Sanne Zwart (EIB).

¹⁶ The survey was conducted by the EBRD, EIB, IFC and IMF. During June-September 2011, 13 banks with large regional presence were interviewed. Questions focused both on banks' perceptions of the environment they are operating in, as well as on their strategies for dealing with NPLs. The interviews were typically held with the Global Head of the Work-out Unit, the Chief Risk Officer or alternatively the Board Member in Charge of Global Risk Control. Guaranteeing that the results would be processed on an anonymous basis facilitated an open and frank interview climate. The results presented in this chapter are thus mainly representative of the practices of large international groups, and not of those of local banks, many of which also have large NPL portfolios.

were conducted. In many cases, credit authorization policies for new loans were also updated to reflect banks' lower risk appetite and the changed macroeconomic environment.

55. Due to the higher scrutiny of portfolios, banks are confident that they have a good oversight of their actual and potential NPLs. Banks argue that in the absence of a significant deterioration in macroeconomic conditions, all problematic cases are identified by now. While they acknowledge that a second round of economic hardship will lead to an increase in NPL volumes, they point out that they are now better equipped to closely follow (potentially) problematic loans. Due to improved monitoring, banks have a good overview of their portfolios up to a fine granularity and have a good overview of what to expect. These abilities are not only relevant during the current period. Most banks believe that NPL ratios in the CESEE region will not return to their very low pre-crisis levels.

3.2. *Banks' internal organization regarding NPL handling*

56. Most banks mentioned the importance of an internal separation of business origination and the work-out and recovery functions. Few banks went so far as to set-up a legally independent "bad bank," but most isolated their NPLs at least management-wise. The standard arguments that staff and units not involved in the origination of a particular non-performing loan are better able to handle its resolution –as they have less at stake– are seen as particularly relevant for this region. In particular, relationship managers may be less objective in assessing the creditworthiness of long-standing clients. Moreover, a clear separation gives local offices more resources to identify new profitable lending opportunities, a task which is often referred to as challenging under the current difficult circumstances. In one bank, though, the original client executive remained involved alongside special credit management staff. In this way the work-out staff could benefit from the client specific knowledge, while the bank's client would continue to work with familiar people.

57. No uniform internal structures were adopted to deal with NPLs. Approaches varied from centralization to local or regional decentralization and everything in between. Some banks created multiple special work-out units in each individual country, which are reporting into an already existing central unit. Others centralized the entire handling of NPLs to standardize the process. Many only centralized the handling of distressed loans to large corporates, while leaving local agents with in-depth knowledge of the prevailing conditions to work with SMEs and consumers. Sometimes, large corporate cases were co-managed with the international head office. In general, reporting lines with head offices were shortened as management levels were reduced. This structure also emphasized that the bank's CRO was ultimately in the lead.

58. Populating the strengthened work-out units proved challenging due to the nature of the job and the limited experience around. As dealing with NPLs is not necessarily a pleasant job, many banks had difficulties to internally transfer staff to work-out units. The required skills are also rather different as is the general mind-set in these units. In one bank, the work-out unit was described as being populated by lawyers who are paid on the basis of what they recover and intuitively go directly for the asset instead of restructuring. Nevertheless, many banks have shifted personnel from origination to work-out units as it turned out to be difficult to find experienced bankruptcy practitioners externally. In these cases, staff had to be trained extensively to deal with their new responsibilities. External recruiting remains important. The persistent need for qualified professionals has led to increased competition among banks to the extent that staff is poached from competitors.

59. Regardless of the organizational structure, banks are univocal that one has to be "quick on the ball." When a payment is past due, typically some 30 percent of the value has vanished after 90

days. It is therefore important not to lose momentum. Weaker clients are often transferred quickly to work-out units. Tasks and procedures are separated in such a way that there is no lingering of files. Tight deadlines for forwarding files to the next level are set to ensure that staff does not become too lenient. Actively following the files is essential to keep pressure on the clients.

3.3. Banks' approach to resolving NPLs

60. Given the economic situation, banks have no incentive to hastily clean up their books and incur losses. While banks are serious in addressing their NPL portfolios, resolving problematic loans as quickly as possible is not their overriding aim. Given the current risk-aversion in financial markets, banks are not eager to post a large loss. Also, all banks mentioned that dealing with NPLs is a relatively inefficient and sometimes frustrating process. In addition, the current economic conditions are not supportive of resolutions. For example, there is no demand for disposed assets of commercial loans while widespread unemployment limits households' availability to repay loans. However, sometimes insolvency proceedings are used as a way to postpone an inevitable liquidation and not to restructure or reorganize a distressed but viable company. Similarly, not all homeowners with renegotiated loans are likely to ever repay in full.

61. Banks generally prefer a slow approach based on amicable solutions in addressing their NPL portfolios, but strategies differ. Most banks prefer a “friendly solution” in addressing their NPLs. One of the reasons is that it is better to be paid something than to own the asset. Several banks also point out that given the generally negative view of the public (and legislators) toward the banking industry at large; it appears not to be the right moment to be overly aggressive. In addition, a rather aggressive approach would not be feasible at the moment given the prevailing economic conditions. Most banks therefore focus on amicable solutions—while protecting collateral—instead of taking over a company or real estate. These banks prefer to slowly address their NPLs in order to smooth potential losses. Several others, though, recently increased their provisioning or took capital hits after writing down assets. These banks tend to be more aggressive in terms of pushing clients to auction and putting assets on their books.

62. The “friendly” approach favoured in NPL resolution emerged naturally. There are no sector-wide standards when it comes to managing NPLs, but the toolkit of available solutions is of course similar. The trend of customer friendliness emerges naturally for the reasons mentioned above, helped by lengthy and costly (court) procedures. Full benchmarking with best practices, performing a GAP analysis and developing subsequent implementation plans would not have been feasible during the short time span. However, quick wins are already implemented everywhere. One exception to the absence of sector-wide standards is, at least in some countries like Latvia and Romania, an adherence to the London Rules for workouts.¹⁷ These prescribe a standstill environment during which the multiple creditors can try to reach an out-of-court settlement.

63. Banks emphasize the importance of working closely together with clients in managing NPLs. Each case needs to be managed diligently and customers' individual situations need to be accommodated. This is hard work that closely involves both the creditor and the debtor. It is important to bring action quickly to the client after a first payment is missed. Several banks already involve customers at an earlier stage and start with (pre-emptive) restructuring even on the performing part of the portfolio. By making moderate changes to the principal amortization schedule,

¹⁷ See section 4.3 for more details.

which can be classified as an ordinary restructuring, the loan can remain in the performing part of the portfolio. While many clients with NPLs are cooperative, others oppose the banks' proposed solutions. Especially when a bank deems it necessary for a firm to attract new equity, the existing owners resist as it implies a dilution of their rights. As a matter of principle, most banks do not make deals outside of court with uncooperative consumer and retail clients.

64. Most solutions of NPLs are aimed at normalizing repayments, which keeps the client engaged while providing a “way out.” For retail clients, banks prefer soft collection methods using call-centers or SMSs. The focus is on recovery of the outstanding part of the loan. For corporate clients the focus is on restructuring. Banks in the region have limited experience in dealing with distressed corporate situations on a “going concern” basis. In practice, however, they try to avoid break-up or liquidation scenarios. The overruling aim is to keep the accounts current, even if that requires lower interest rates or extended repayment periods.

65. The wide range of methods followed to resolve NPLs includes almost anything short of equity participations. Banks start by putting pressure on debtors who missed a payment. They contact them regularly and push them to honour their obligations. In case of temporary problems, repayments are rescheduled so that they meet the cash flows of clients. When it is clear that the difficulties are of a long-term nature, banks use various methods to normalize repayments including: identifying additional collateral sources, extending tenure, lowering repayments, lowering interest rates, introducing or extending grace periods, introducing or extending overdraft allowances for strong borrowers, and converting foreign-exchange lending. All these methods have their pros and cons and finding out which of them are most suitable for a particular case is labour intensive and needs close cooperation with the client. There are clear limits though how far banks want to go. Many are, in general, not willing to incur write-offs. Most banks also tend not to capitalize interest or refinance interest rate payments themselves, but nevertheless notice that some banks in the region are willing to follow these avenues. Banks tend to refrain from equity participations, although they notice that in many cases this is precisely what is needed for a successful voluntary restructuring. Debt-equity swaps are also used rarely.

66. Banks are not eager to go after collateral when not strictly necessary as current market conditions lead to low recovery rates. Almost all credits in CESEE countries are collateralized, primarily by real estate assets. In current market conditions, collateral values are difficult to determine and, in turn, to verify, with the result that loans are often under-provisioned based on uncertain or overly optimistic collateral value. The actual value of collateral is often very different from the value assumed when the contract was signed. Partly this is due to incorrect, or optimistic, valuations in the past. While banks agree that ultimately it is their responsibility, they point out that appraisal firms in the region have a varying degree of quality, which in the spirit of the boom years might have added to the inflated pre-crisis valuations. The current economic reality is in sharp contrast with the optimistic pre-crisis valuations. There are few buyers for real estate outside the capital cities. In land abundant regions, plots are also worth substantially less than anticipated. Values of cars are close to zero even before factoring in auction costs. Several banks also mention weaknesses in the institutional and legal frameworks for collateral registration and execution in part of the region. While not the preferred route, banks sometimes need to exercise their claims on collateral. Some banks have set-up special SPVs to take over collateral to signal to their clients that they are serious in going after it when necessary. In case it comes to an auction, many banks have a subsidiary participating in the bidding to avoid a non-sale as this would require holding another auction.

67. Several banks outsource the collection of overdue debt, but many cite internal or external reasons for not doing so. Banks that use debt collection agencies argue that it allows them to concentrate better on fresh business. But many banks see a clear lack of reliable and reputable agencies. This is partly due to the often small size of the countries involved and the absence of significant NPL levels in the past. It is also due to the absence of: (1) adequate regulation and licensing of debt collection companies, and (2) legal prohibition of abusive debt collection practices. In addition, sometimes banks experimented with outsourcing, but found the performance of the debt collection agencies unsatisfactory. Other banks highlighted the reputational risks involved, as agencies are almost free to choose the collection method but act in the name of the bank. Several banks do not use agencies as a matter of principle as they consider debt collection as part of the business and an integral part of their service provision. Banks also highlight that the outsourcing of legal services is difficult in many countries. As there is little experience with receiverships or bankruptcies in the region, outside legal services available to banks are often limited.

3.4. Limited market for distressed debt¹⁸

68. Many banks in CESEE countries reckon that NPLs are better handled in-house; banks are best placed to maximize recovery as they know the client best, and NPL problems are manageable and under control. Even though most originating banks develop a separate asset recovery unit focused only on debt management, statistics still indicate that outside investors are more capable of maximizing recoveries for the following reasons:

- A frequently used recovery strategy for investors is to offer borrowers a discount on principal in exchange for payment rescheduling; such an option presents moral hazard for the originating bank, particularly if it has an ongoing relationship with the borrower.
- Recovery skills are significantly different from business development skills and lending staff pressed into service on loan work-out does not optimize use of skills or recovery proceeds.
- Restructuring of credits requires specialized skills including developed negotiating skills.
- Outside firms divide portfolios into tranches of loans with similar characteristics with different recovery strategies for different tranches of loans with similar features, leaving aside loans where recovery expectations are very low. In banks, loan originators are frequently reluctant to admit to a credit gone bad and will continue to work or pursue the borrower in situations where the return does not justify the cost of recovery.

69. As a result, there have been very few sales of NPL portfolios in CESEE countries outside of the non-collateralised retail/consumer asset class. The reasons underlying and contributing to the inertia in the market are multiple, each with varying degrees of impact on the impasse. Among the more significant factors contributing to a dearth of portfolio sales are (i) collateral valuation problems, (ii) lack of distressed asset servicers, and (iii) limited investor base for distressed assets, especially given the small sizes of portfolios for sale in the region.

¹⁸ This section is based on the working group analysis, and does not result from the bank survey.

70. There is a notable difference however in all markets in the approach adopted by foreign owned banks with experience in previous financial crises and dealing with distressed assets than from the approach of locally owned banks experiencing their first full economic cycle. Foreign owned banks are more inclined to prepare and auction portfolios or outsource for servicing and collection; domestically owned banks tend to retain portfolio servicing in-house, not having previous outsourcing experience. Local servicers with less experience and of smaller size have limited access to liquidity which limits the size of portfolios that can be purchased; the small size of portfolios offered for sale, in turn, limits the interest of more liquid foreign investors to enter new, higher risk markets.

3.4.1. Collateral valuation problems

71. Except for the retail/consumer asset class, almost all loans in CESEE countries are collateralized, with collateral primarily some form of real estate, be it personal or business-related assets. In most environments, provisioning requirements for collateralized assets are less onerous and the dearth of real estate transactions means a recent benchmark does not exist upon which to base collateral values. There is also a lack of officially available robust data on price levels of residential and commercial property. It is a problem for borrowers, banks and regulators with prices neither immediately apparent nor transparent. The large margin of manoeuvre that banks have in assigning collateral values under such circumstances means that many underlying assets are overvalued and, therefore, loans under-provisioned, reducing charges to capital but also incentives for sale.

72. The positive values assigned to collateral limit provisioning but also contribute to the existence of a price gap between buyers and sellers of loan portfolios. Banks are overly optimistic on recovery estimates, while investors are sceptical that effective asset recovery can be done. It is not uncommon to find collateral valuations that pre-date the crisis. Frequently, those that have been re-valued have been done on a generalized basis, applying a standard discount to values of similar collateral based on a selected benchmark. With book values of loans based on overvalued collateral, sales of loan assets at “market value” are unlikely.

73. The above factors, plus others, have led to a significant price-gap between sellers and buyers, making sales difficult, with banks optimistic on recovery expectations and investors pricing in low economic growth, increasing unemployment, lower real estate values, uncertain legal regimes, bankruptcy inexperienced judicial systems, and time value of money. The price gap is of a magnitude that structures used elsewhere to bridge differences are of limited use. Above all, with inadequate provisioning, banks are unwilling to bear the effect on capital of NPL portfolio sales at today’s market prices.

74. As a result, few, if any, sales of collateralized distressed assets have taken place in CESEE countries. The ability to arbitrage collateral values combined with restructuring techniques may imply that some banks are likely underreporting non-performing loan volumes and, as a result, under-provisioning. A balance sheet hobbled by quasi-performing credits requires an anxious surveillance of capital and, of course, inhibits extension of new credit to any borrower. When “quasi-performers” become too significant, banks can turn to the off-balance sheet solutions, moving assets off the bank’s balance sheet at non-market price levels and for deferred compensation. Ireland argued effectively with the European Commission that “long-term economic value” represented a fair price at which to transfer assets from banks but such assumptions proved too optimistic within a year of establishing NAMA, Ireland’s centralized Asset Management Company. In Russia, ZPIFs, close-in mutual funds, were used to park assets off bank balance sheets, taking advantage of a securitization law that did not

contemplate the securitization of distressed assets and allowed for transfer at nominal value. The Russian regulator brought an end to the attractiveness of the scheme by requiring appropriate capitalization of the fund else there be continued provisioning on the part of the transferring bank. Conversely, in Ukraine the authorities are considering approving a similar mutual fund structure to the benefit of local players believing that shares in such funds can find investors, hence, creating a liquid market in distressed assets.

75. Where there have been sales, these have been primarily of non-core assets, many of which are performing or have been portfolio sales by banks permanently exiting certain markets no longer considered as “core” or strategic. Both auctions and bilateral sales of non-performing loan portfolios have been conducted by banks in the region, but banks, both perplexed and disappointed by prices offered, have often cancelled auctions and walked away from earn-out schemes that would, in theory, achieve their targeted sales price.

76. Part of the price gap is due to the fact that frequently banks do not fully consider the total cost of their own recovery efforts in terms of personnel costs, opportunity costs, legal costs and time value of money—i.e., the funding costs for loans booked but non-performing. Although the gap in recovery expectations of the selling bank and investor may not be so far apart, the banks neglect to price in all the costs and years of recovery, leading to a price gap between seller and buyer. With overvalued collateral, book values are far from market prices and banks do not want to take the hit to capital of a sale of even a portion of their portfolio—and risk potential regulatory scrutiny of similar assets remaining on their books.

3.4.2. Lack of distressed asset servicers

77. In many countries, the local markets lack distressed asset servicers with significant experience and knowledge of international best practice, making banks reluctant, for reputational reasons, to outsource portfolios for servicing. Restructuring skills are generally in short supply in the region and banks are looking to reinforce staff and resolution efforts with new hires have difficulty finding appropriate skills.

3.4.3. Limited investor base for distress asset purchases

International investors

78. A number of distressed asset players active in the Asian debt crisis have disappeared or exited the market, including such important participants as Lehman Brothers, GE Capital, and AIG. Other well-known names consider CESEE countries too challenging for investment. In addition, NPL levels are at historic highs in the US, UK, Germany and other environments where sellers are more familiar and adept with the sales process, bankruptcy legislation is more evolved, and legal systems are navigable and, ultimately, more predictable. With a shortage of investment capital and abundant opportunity, it is challenging to make the case for investing in distressed assets in CESEE countries.

79. The biggest impediments to experienced distressed investment are the local legal and regulatory environments, opaque judicial processes, and a lack of restructuring and resolution skills in local markets, both at law firms and in the servicers themselves. Developing a servicing platform is a challenge but surmountable if an investor sees a steady future flow of transactions. In addition, portfolios on offer tend to be of a size that does not interest an investor unfamiliar with a

market—small size and little potential for future flow do not justify the legal, tax and accounting due diligence required for a large fund manager with obligations to investors.

80. A recent KPMG report on global debt sales notes that banks, with greater capital restrictions, are seeking to exit non-core portfolios but “have yet to see the emergence of any real strategic buyers.” In many cases, the assets being sold (commercial real estate loans, thinly priced residential mortgages) are no more “core” to potential buyers as they are to potential sellers. The report goes on to note that traditional investors in Residential and Commercial Mortgage Backed Securities (RMBS and CMBS) are slowly changing strategy toward investments with increasing interest in direct and indirect investments in loan portfolios.¹⁹

Local investors

81. In a number of markets, local investors are quite active, mostly local servicers with some access to liquidity. In many markets, such as Russia and Ukraine, the majority of servicers are domestic, with international players only slowly entering the market.²⁰

82. Since 2007-08, the majority of sales of 90 day past due consumer and retail loans was to local servicers purchased with excess liquidity skimmed from outsourcing operations. Portfolios were small to accommodate servicers’ limited liquidity. Even in markets where larger players/investors are now present, banks divide portfolios into smaller sub-portfolios to reduce the purchase payment amount in order to attract a greater number of bidders, thereby increasing competition and securing better prices. The number of servicers that have sprung to life in number of markets—with fixed cost for call centres to cover—causes many to offer higher prices for portfolios just to keep the operational servicing machine supplied and active. Usually these players lack deep legal and restructuring skills and avoid moving into more expensive, more complicated collateralized asset classes such as mortgages or SME and corporate credits.

83. Increasingly, local servicers are turning to small local boutiques or private equity funds, as well as to small European private equity funds, capable of investing in smaller distressed asset pools that would not be of interest to larger players. This has the effect of introducing more complicated financing and structuring techniques but has not really stimulated the markets yet.

¹⁹ “Given the relative absence of foreign and local strategic buyers, the emergence of these ‘new’ buyers will be critical if European banks are to successfully deleverage over the next five years.” (KPMG, “Global Debt Sales” October, 2011)

²⁰ “While banks have started to sell retail NPLs over the past three years, much of the activity [in Russia] has been centred on collection agencies (Sequoia Credit Consolidation, Morgan & Stout (East Capital) and EOS Group to name a few.” (KPMG, “Global Debt Sales” October, 2011)

CHAPTER 4: OBSTACLES TO FASTER NPL RESOLUTION²¹

Public policy generally recognizes the need for and benefits of speedy resolution of non-performing assets, particularly in the face of a financial crisis. The authorities in CESEE countries that were most affected by the 2008-09 global financial crisis moved quickly to adopt a variety of anti-crisis measures including strengthening their banking systems, as and where needed, and improving their insolvency regimes. Several adopted guidelines to facilitate informal out-of-court settlements. In spite of these efforts, however, resolution has been slow and non-performing loans remain at substantially elevated levels. Much of the delay stems from the inability to utilize common restructuring techniques due to the failure to properly align legal, tax and regulatory (both prudential and corporate) regimes. Truly effective asset resolution requires that all elements of the framework are mutually reinforcing and work together in a timely and efficient manner to facilitate the restructuring of non-performing assets, both in and out of formal court proceedings. Failure to do so may make a restructuring transaction economically unfeasible for one or both parties. As a result, many debtors who could otherwise be restructured as viable entities are forced to enter formal insolvency proceedings, increasing the likelihood of their liquidation, as well as the loss of economic value and jobs.

4.1. Improving the legal framework

84. An orderly and robust legal framework for the enforcement of creditor claims, including collective enforcement through corporate insolvency law, plays a critical role in facilitating debt resolution. Collateral enforcement procedures should provide a credible means of speedy execution and enforcement, including through non-judicial self-help processes, so as to maintain credit discipline and support new lending. An effective insolvency system should achieve two general objectives: (i) to allocate risks among market participants in a predictable, transparent and equitable (not necessarily equal) manner so as to provide confidence in the credit system and foster economic growth, and (ii) to protect and maximize value for the benefit of all interested parties and the wider economy. Achieving these objectives typically requires liquidating enterprises that have no prospect of recovery, whilst restructuring distressed but viable businesses. An effective insolvency legislation, soundly implemented, could produce significant results, such as: (i) expansion of access to credit at affordable rates (in particular, for small and medium size enterprises); (ii) efficient use of judicial resources; (iii) encourage foreign and local investment; (iv) preservation of jobs; (v) preservation financial stability and enhanced economic growth.

85. An effective legal framework relies on a strong institutional infrastructure and in particular an independent and competent judiciary that applies the law in a transparent, predictable and consistent manner. Since delays in court adjudication can have an adverse effect on asset value or viability of an enterprise, procedures must be put in place to ensure that court hearings are held quickly and decisions are rendered swiftly through, e.g., setting clear deadlines. Specific and objective criteria in critical areas of the law could be established to help reduce the scope for judicial discretion that may result in inconsistent and unpredictable decisions. Given the central role of judges, bailiffs and administrators in enforcement proceedings, it is important that they have adequate knowledge of the law and experience in commercial and financial matters. Judges may also support

²¹ This chapter was prepared with contributions from Michaela Erbenova (IMF, Monetary and Capital Markets Department), Yan Liu (IMF, Legal Department), Ruth Neyens (World Bank), and Adolfo Rouillon (World Bank).

out-of-court proceedings, for example by: (i) effectively dealing with borrowers objections so that out-of-court enforcement can swiftly resume; and (ii) issuing timely and consistent judicial decisions that contribute to create a predictable legal system that favors out-of-court debt restructuring.

4.2. Debt enforcement

86. While data on credit enforcement cases in CESEE countries is patchy, anecdotal evidence collected through the bank survey suggests that in several countries the current legal framework and its implementation, are inadequate to facilitate, and in some cases hinders, orderly and efficient debt resolution. Although a number of countries in the region have already adopted out-of-court enforcement mechanisms, in more than a few countries, foreclosure still relies heavily on cumbersome judicial procedures; multiple auctions are required with a prescribed minimum bidding price for each auction; the procedural requirements for auctions are complex and burdensome; the auction process lacks transparency and is slow partly due to extensive court involvement. Furthermore, out-of-court enforcement mechanisms assume that the debtor will facilitate enforcement by delivering the possession of the encumbered asset to be sold. If the debtor does not cooperate, however, it will be necessary to call for the intervention of a formal authority (usually a judge or other judicial authority) so that the enforcement can be carried out without upsetting the peace. In some countries, as deep-rooted cultural traditions may hinder the adoption of purely out-of-court enforcement mechanisms, intensified efforts to improve judicial enforcements would be needed. Moreover, in all cases it is advisable to study the possibility of adopting expeditious procedures and enforcement mechanisms with minimum judicial intervention, where such intervention ensures that the right to enforce has been verified and the dispossession of the encumbered asset does not upset peace. However, such minimum judicial control should not entail a complete contradictory judicial procedure (which usually delays enforcements) allowing, in turn, to overcome constraints of out-of-court mechanisms if the debtor does not cooperate or if those out-of-court mechanisms are not easily implemented in certain jurisdictions. Finally, special rules on enforcement may be appropriate for intangible assets such as accounts receivables.

87. To improve the legal framework for debt enforcement, consideration should be given to international best practices.²² In particular, the legal framework should provide for predictable,

²² For example, see: the UNCITRAL Legislative Guide on Secured Transactions 2007 (http://www.uncitral.org/uncitral/en/uncitral_texts/payments/Guide_securedtrans.html), and its Supplement on Security Rights in Intellectual Property 2010 (http://www.uncitral.org/uncitral/en/uncitral_texts/payments/ip-supplement.html); the World Bank Principles for Effective Creditor Rights and Insolvency Systems 2001 and revised versions as of 2005 and 2011 (www.worldbank.org/gild); the European Bank for Reconstruction and Development (EBRD) Model Law on Secured Transactions 1994 (<http://www.ebrd.com/downloads/research/guides/secured.pdf>); the EBRD Core Principles for a Secured Transactions Law 1997 (<http://www.ebrd.com/country/sector/law/st/core/model/core.htm>); the Organization for Harmonization of Business Law in Africa (OHADA) Uniform Act Organizing Securities 1997 (<http://www.jurisint.org/ohada/pres/pres.04.en.html>); the study on secured transactions law reform in Asia, prepared by the Asian Development Bank (ADB) in 2000 (http://www.adb.org/documents/others/law_adb/lpr_2000_2.asp?p=lawdevt); the United Nations Convention on the Assignment of Receivables in International Trade 2001 (http://www.uncitral.org/uncitral/en/uncitral_texts/payments/2001Convention_receivables.html); the UNIDROIT Convention on International Interests in Mobile Equipment 2001 (<http://www.unidroit.org/english/conventions/mobile-equipment/mobile-equipment.pdf>), and the relevant protocols thereto (<http://www.unidroit.org/english/conventions/mobile-equipment/main.htm>); the Hague

transparent, and accessible collection and enforcement systems. If the debtor is not subject to insolvency proceedings, this requires effective collection and individual enforcement mechanisms (non-judicial, judicial or mixed) for secured credits and unsecured credits. If the debtor is insolvent, the law should provide for reliable and effective insolvency proceedings (reorganization and liquidation), designed to work in harmony with the systems of security interests and individual enforcement, and promote the use of out-of-court debt restructuring. In particular, the following measures may be considered for improving the legal framework for debt enforcement:

- **Collect and publicize data on enforcement cases to help assess effectiveness of the current framework.** Information on, inter alia, the number and duration of cases, and recovery rates should be collected and published regularly (e.g., quarterly).
- **Improve and speed up foreclosure procedures and allow “self-help” enforcement** (i.e., without extensive court involvement). The bank survey indicates that priority needs to be given to streamlining service of process rules, establishing more flexible minimum sales price rules for public auctions, eliminating provisions that lead to delays and limiting court involvement. These measures, coupled with other legal reform, could help strengthen credit discipline and incentivize debtors to participate in debt negotiation by making swift collateral execution and enforcement a credible threat.
- **Improve efficiency of enforcement of secured claims through simplified and expeditious procedures, without dispute.** Where self-help remedies are unavailable, the law should enable parties to obtain enforcement based on summary, accelerated proceedings for recovery and sale collateral, either through the judicial process or by way of public auctions. Enforcement by seizure and sale of collateral should be expeditious and inexpensive, with rules or incentives encouraging the recognition of good value for the collateral. Rapid recovery ensures that market values are realized and avoids the loss of value due to delayed enforcement. Secured creditors should be entitled to apply the proceeds from the disposition of assets against their claims as early as possible. Lithuania provides one successful example in the region: subject to claim by the creditor, if the borrower does not repay in 20-30 calendar days after judicial notification, the mortgage judge orders foreclosure through a bailiff. The debtor can challenge the creditor’s claim initiating a reverse (costly) lawsuit. In principle, this lawsuit does not stop the mortgage execution unless the debtor requests an injunction demonstrating *prima facie* the reasonability of its arguments. According to anecdotal evidence, debtors very rarely resort to the mentioned reverse lawsuit and injunction, and most Lithuanian creditors are satisfied with the average recovery time of secured loans (4-7 months).
- **Set up and encourage the use of small claims procedure to expedite debt resolution.** In line with the EU Directive, efforts should be made to establish, and encourage the use of, simplified and accelerated procedures for small claims for a sum less than EUR 2000. This provides a

Conference on Private International law (HCCH) Convention on the Law Applicable to Certain Rights in respect of Securities held with an Intermediary 2001 (http://www.hcch.net/index_en.php?act=conventions.pdf&cid=72); the Organization of American States (OAS) Model Inter-American Law on Secured Transactions 2002 (http://www.oas.org/DIL/CIDIP-VI-securedtransactions_Eng.htm); and, the EBRD study on Mortgages in Transition Economies 2008 (<http://www.ebrd.com/pages/research/publications/guides/mortgages.shtml>).

cost-effective, speedy and accelerated means of debt resolution, thereby alleviating the burden on the court system.

4.3. Corporate insolvency

88. In general, corporate insolvency procedures are geared toward liquidation in many CESEE countries. In the vast majority of cases, insolvency proceedings result in liquidation and reorganization is scarcely used (and where utilized it rarely ends up with successful implementation of rehabilitation plans). This could be attributed mainly to debtors' late resort to insolvency procedures; inadequate treatment of secured creditors; absence of effective procedures to support early rescue of viable firms such as fast track court approval procedures; lengthy liquidation proceedings; limitations on asset sale modalities; and insolvency professionals (including administrators, lawyers and turn-around experts) and judges' insufficient knowledge of and experience with insolvency law and related business matters. Recognizing the importance of insolvency law in addressing corporate debt distress, a number of CESEE countries such as Latvia, Romania, Serbia, Moldova, Russia, and Hungary have improved or are in the process of improving their insolvency regimes. However, effectiveness of these reform efforts is yet to be seen. In Latvia, however, some early results of the recent legal reforms are positive, namely: (i) there is an increase in the use of the new reorganization procedures; (ii) the refined liquidation process seems to be working faster than in the past and a number of liquidation cases would have been completed in 7-8 months; and (iii) administrative expenses in liquidation have been reduced from (average) 15 percent to 9 percent of the assets realization proceeds.

89. Despite these reform efforts, refinement of corporate insolvency law is still needed in many CESEE countries to better support early rescue of viable firms, and speedy exit of nonviable ones. These refinements, which should be in line with international best practice, could include:^{23,24}

- **Clear filing thresholds** such as a missed payment which can be used in practice by creditors and debtors alike to initiate insolvency proceedings. In particular, debtors should be required to take appropriate action sufficiently early on in their financial difficulties so as to increase the chances of a successful rehabilitation. Such actions would include filing for insolvency proceedings unless good-faith workout negotiations are being conducted for a reasonable time period (such as recent amendments to the Romanian insolvency law specified).
- **Fast tract court approval procedures** for restructuring agreements reached by parties in a consensual manner before the initiation of an insolvency proceeding, leveraging the efficiency of the out of court negotiation process with the expeditious bind-in of dissenting creditors under the insolvency law (which allows a rehabilitation to be approved by a requisite majority of creditors). These procedures help minimize the cost and delay associated with formal insolvency proceedings.

²³ For example, the UNCITRAL Legislative Guide on Insolvency Law (www.uncitral.org/uncitral_texts/insolvency/2004Guide.html), The World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (www.worldbank.org/ifa/ipg_eng.pdf); and IMF Orderly and Effective Insolvency Procedures (www.imf.org/external/pubs/ft/orderly/-249k/HTML).

²⁴ This list summarizes weaknesses that are present in more than a few countries in the region. However, it does not substitute for a country-by-country in-depth diagnostic and the elaboration of recommendations tailored to each particular situation, which are both indispensable.

- **A stay on all enforcement actions** while adequately safeguarding secured creditors’ interests by allowing them to request a relief from the stay under certain specified conditions (e.g., their interests are adversely affected or their collaterals are not needed in the restructuring).
- **Priority status for new financing** to ensure a successful restructuring as it provides the much needed interim capital to keep the company going.
- **Swift liquidation procedures** that affords flexibility in the modality for the sale of a debtor’s estate. Where feasible, selling the business as a going concern should be the preferred method for realizing the insolvency estate in liquidation. Insolvency administrators should be incentivized to conduct the sale in a speedy manner that maximizes the value for all parties by, e.g., setting an appropriate compensation scheme.
- **Cross-border insolvency** to mitigate inefficient delays of insolvency proceedings of enterprises with assets and liabilities in different countries, and to facilitate reorganization of multinational entities or groups of enterprises, in line with the UNCITRAL Model Law on Cross-Border Insolvency.
- **Rules to govern, in both domestic and cross-border contexts, the treatment of insolvency proceedings** of one or more enterprise group members within the context of the enterprise group to address the issues particular to insolvency proceedings involving those groups and to achieve a better, more effective result for the enterprise group as a whole and its creditors.

4.4. Household insolvency

90. **Many CESEE countries do not have a personal insolvency legal framework to address household indebtedness including consumer debt and mortgages.** When faced with household debt problems, CESEE countries take different approaches to tackle them. A few countries such as Latvia, Estonia, and Poland have sought to adopt or enhance their personal insolvency legal framework. Several countries have looked beyond the personal insolvency law and resorted to burdensome administrative measures, for instance, a temporary moratorium on foreclosure (e.g., Hungary), and conversion of foreign currency denominated mortgages into local currency (e.g., Hungary (temporarily)). However, these measures, which are of temporary nature, interfere with contracts and undermine credit discipline.

91. **The challenge facing these countries is to find a workable solution to the household debt problem that reduces the debt burden on households while limiting adverse effects on banks’ balance sheets.** Consideration could be given to the following measures:

- **Adopt or enhance personal insolvency law to provide a “fresh start” to financially responsible individuals.** The law should provide a fair allocation of the risk between debtors and creditors and offer an equitable, efficient, cost-effective, accessible and transparent settlement and discharge of individual debtors (Box 4). The cross-country experience indicates some general principles that could guide the design of a personal insolvency law: (i) provide a “fresh start” through discharge of financially responsible debtors (acting in good faith) from the liabilities at the end of insolvency proceedings; (ii) set an appropriate filing threshold to make the procedures accessible to individuals while minimizing abuse; (iii) impose an automatic stay on enforcement

actions with adequate safeguards of creditor interests; (iv) modify the terms of debt to reflect the debtor's capacity to repay to ensure an effective fresh start; (v) establish conditions in a manner that strikes an appropriate balance between the need to maintain credit discipline and need to give the debtor a fresh start; and (vi) recognize foreign proceedings and enable cross-border cooperation. Such legal frameworks must be supported by the appropriate institutional arrangements including skilled and efficient administrators. It should be recognized that it takes time to put in place a well-functioning and efficient personal insolvency regime even in normal times.

- **Establish a mechanism for debt counseling services to assist individual debtors in solving their debt problems.** Such mechanism should ensure availability of sufficient competent and independent debt counseling to debtors before and after insolvency proceedings. Debt counselors should be licensed and supervised by the court or an independent body and codes of conduct should be developed to guide practices so as to ensure proper assistance to debtors. In addition, it would be advisable to publish household debt restructuring guidelines (as was done in Latvia and Romania) to guide individual borrowers in debt negotiations. In this regard, consumer protection centers (operated, for example, by consumer associations) could play a very useful role in disseminating these guidelines and leaflets to customers who seek advice on their debt problems.
- **Strengthen consumer protection more generally.** Consumer protection ensures that consumers receive information that will allow them to make informed decisions, are not subject to unfair and deceptive practices; have access to recourse mechanisms to resolve disputes when transactions go awry, and are able to maintain privacy of their personal information. Financial literacy initiatives give consumers the knowledge, skills, and confidence to understand and evaluate the information they receive and empower them to purchase those financial products and services which meet their needs and those of their families. Together consumer protection and financial literacy can help prevent households from purchasing unsuitable financial products or taking on excessive risk in the first place. It would also offer safeguards against abusive collection practices. Good Practices for Consumer Protection and Financial Literacy are summarized in Box 5.
- **Avoid imposing moratoria on enforcement actions or other measures interfering with private contracts.** These measures should be used in very limited circumstances and for a specified short period. The length of the moratorium should strike a balance between allowing sufficient time to put in place measures to address distressed mortgages and eroding credit discipline.

Box 4. Insolvency of Individual Persons*

In January 2011 and in consultation with the IMF, UNCITRAL, EBRD and other international partners of the World Bank Insolvency and Creditor/Debtor Regimes Initiative, the ICR Task Force was convened to discuss a number of insolvency-related issues arising in the wake of the global financial crisis. As part of this discussion, the Task Force was asked to consider, for the first time, the topic of the insolvency of natural persons, an issue brought into sharp relief in the wake of the global financial crisis and characterized by divergent regulatory treatment afforded under national laws, with implications for financial stability, economic development and access to finance. Prior to the January 2011 meeting, the World Bank conducted a preliminary survey on consumer insolvency laws in existence around the world. The survey covered 59 countries, of which 25 are high-income economies and 34 are low-income and middle-income economies. The countries surveyed covered 67.5 percent of the world population. The main objective of the survey was to find out about the existence of legislation addressing consumer insolvency. The survey revealed that more than half of the middle and low income countries surveyed have no system at all.

The recent financial crisis has highlighted the potential systemic risk that consumer insolvency entails in many countries and the consequent need for the modernization of domestic laws and institutions to enable countries to deal effectively and efficiently with the risks of individual over indebtedness. The importance of these issues to the international financial architecture has been recognized in various ways by the G-20 and by the Financial Stability Board. It is important to recognize the diversity of policy perspectives, values, cultural preferences and legal traditions that shape the way countries may choose to deal with the problems of individual over indebtedness. Yet recent events suggest that the expansion of access to finance, the extension of modern modes of financial intermediation, and the mobility and globalization of financial flows may have changed the character and scale of the risk of consumer insolvency in similar ways in many different economies (see: *Best Practices in the Insolvency of Natural Persons*, by Professor Susan Block-Lieb, at http://siteresources.worldbank.org/EXTGILD/Resources/WB_TF_2011_Consumer_Insolvency.pdf).

In response to these concerns, a Task Force Special Working Group of expert academics, judges, practitioners and policy-makers is currently identifying the various policies and general principles that underlie the diverse legal systems that have evolved for effectively managing the risks of consumer insolvency and individual over indebtedness. The Working Group has produced a first draft of a reflective document on this matter, suggesting guidance for the treatment of the different issues involved, and taking into account different policy options and the diverse sensitivities around the world. The draft document was discussed in a Task Force meeting held on November 2011 at the World Bank Headquarters in Washington DC. It is expected that a final version of the document will be publicly available in 2013.

* Prepared by Adolfo Rouillon (World Bank, Legal Department).

Box 5. Good Practices for Consumer Protection and Financial Literacy*

The Good Practices for Consumer Protection and Financial Literacy (see Rutledge, 2010) were developed as part of the World Bank's global program to assess financial consumer protection in emerging markets and developing countries. The Good Practices are based on detailed analytical reviews in 16 countries, including eight CESEE countries. They also provide useful guidance for policy-makers in applying the G20 High-Level Principles for Financial Consumer Protection, developed by the OECD Task Force on Financial Consumer Protection.

These Good Practices are based on four key concepts: (1) consumer disclosure should be simple, easy to understand and comparable; (2) abusive business practices by financial service providers should be prohibited; (3) consumers should have an easy, inexpensive and speedy method of resolving disputes with financial institutions; and (4) financial education should be available to consumers so that they can understand financial services and products and make informed decisions. A well-functioning regime of financial consumer protection provides effective safeguards for financial consumers while empowering consumers to exercise their legal rights and fulfill their legal obligations. A well-designed financial consumer protection framework would incorporate the following 39 Good Practices.

Consumer Protection Institutions

1. The law provides clear consumer protection rules regarding financial products and services. The necessary institutional arrangements are in place to ensure thorough, objective, timely and fair implementation and enforcement of the rules.
2. A code of conduct for sector-specific financial institutions is developed by the sector-specific association (in consultation with the financial supervisory agency and consumer associations if possible). Monitored by a statutory agency or an effective self-regulatory agency, this code is formally adhered to by all sector-specific institutions. The code may be augmented by voluntary codes of conduct devised by individual financial institutions for their own operations. These codes are widely publicized.
3. Prudential supervision and consumer protection supervision¹ can be placed in separate agencies or lodged in a single institution, but the allocation of resources between prudential supervision and consumer protection is adequate to enable the effective implementation of consumer protection rules.
4. All legal entities that provide financial services to consumers are licensed and supervised regarding their market conduct (i.e. their business practices in relation to retail customers) by the appropriate supervisory authority.

5. The judicial system ensures that the ultimate resolution of any dispute regarding a consumer protection matter in respect of a financial product or service is affordable, timely and professionally delivered.
6. The media and consumer associations actively promote financial consumer protection.

Disclosure and Sales Practices

7. Before a financial institution makes a recommendation to a consumer regarding a specific financial product or service, it gathers sufficient information from the customer to ensure that the product or service is likely to meet the needs and capacity of that consumer.
8. For all financial products or services, consumers receive a short one-two page (or electronic equivalent) summary (such as a Key Facts Statement), presented in a legible font and written in plain language, describing the key terms and conditions, and based on industry-agreed standards for the minimum types of information to be published for each type of financial product or service. Summaries should be distributed by financial institutions.
9. Before a consumer purchases a financial product or service, the financial institution provides a written copy of its general terms and conditions, as well as those that apply to the product or service.
10. Financial products or services with a long-term savings component—or those subject to high-pressure sales practices—have a “cooling-off” period during which the consumer may cancel the contract without penalty. Nothing prevents a financial institution from recovering any processing fees incurred. Although the purchase or sale of securities and derivatives-related financial products is not subject to a cooling-off period, although service providers are subject to the anti-fraud and investor protection provisions of relevant laws, government regulations and rules of self-regulatory organizations.
11. Whenever an individual borrower is obliged by a financial institution to purchase any product as a pre-condition for receiving another product or service from the financial institution, the borrower is free to choose the product or service provider.
12. In their advertising, financial institutions disclose that they are regulated and identify the relevant regulatory agency.
13. Staff of financial institutions who deal directly with consumers receive adequate training, suitable for the complexity of the products or services they sell.

Customer Account Handling and Maintenance

14. Financial institutions prepare a written or electronic confirmation of the terms of each customer’s transactions and regular statements for each customer account regarding key details of the customer’s financial transactions. For investment products, customers receive periodic statements of the value of the assets in their account.
15. Customers are individually notified in writing (or by electronic means) of changes in interest rates, fees, and charges as soon as possible.
16. Financial institutions maintain up-to-date customer records and provide customers with ready access to their records either without charge or for a reasonable fee.
17. Clearing of customer transactions is based on clear statutory and regulatory rules—or is subject to effective self-regulatory arrangements.
18. Financial institutions are prohibited from employing abusive collection or debt recovery practices against their customers.

Privacy and Data Protection

19. The law sets out basic rules of information sharing among participants of the credit reporting system, including credit registers, reporting institutions and users of credit reports.
20. For credit registries, the law provides consumer rights regarding information sharing, including access, rectification, blocking and erasing of errors and outdated personal information.
21. The law specifies the extent and timeliness of the updating of customer information in credit registries, gives customers ready and free access to their credit reports from credit registers (at least once a year) and provides procedures for correcting mistakes in credit reports.
22. Financial institutions are required to protect the confidentiality and technical security of customer data. The law states specific rules and procedures concerning the release of customer records to any government authority.
23. Every financial institution informs each of its customers of its policies for the use and sharing of the customer’s personal information.
24. Credit bureaus are subject to oversight by the appropriate government (or non-government) authority.

Dispute Resolution Mechanisms

25. Financial institutions have a designated contact point and clear procedures for handling customer complaints. Financial institutions also maintain up-to-date records of all complaints they receive and develop internal dispute resolution policies and practices, including time for processing, complaint response and customer access.
26. Consumers have access to an affordable, efficient and professionally qualified and respected mechanism for dispute resolution, such as an independent financial ombudsman or equivalent institution with effective enforcement capacity. The institution acts impartially and independently from the appointing authority, the industry, the institution with which the complaint has been lodged, as well as any consumer or consumers' group. Decisions by the financial ombudsman or equivalent institution are binding on the financial institution.
27. Statistics of customer complaints –including those related to breaches of codes of conduct– are periodically compiled and published by the ombudsman or financial supervisory authority.
28. Regulatory agencies are legally obliged to publish statistics and analyses related to their activities regarding consumer protection—and propose regulatory changes or financial education measures to avoid the sources of systemic consumer complaints. Industry associations also play a role in analyzing the complaint statistics and propose measures to avoid recurrence of systemic consumer complaints.

Guarantee and Compensation Schemes

29. The law ensures that the regulator can take appropriate measures in the event of the financial distress of a financial institution.
30. Any law on financial insurance or a guarantee fund is clear on the insurer, the classes of depositors who are insured, the extent of insurance cover, the contributor(s) to the fund, each event that will trigger a payout, and the mechanisms to ensure timely payout to all insured depositors.
31. Depositors, life insurance policyholders and pension fund members enjoy higher priority than other unsecured creditors in the liquidation process of a relevant financial institution.

Consumer Empowerment

32. A broad-based program of financial education and information is developed to increase the financial capability of the population.
33. A range of organizations—including government, state agencies and non-governmental organizations—are involved in developing and implementing the financial capability program. The government appoints a ministry (e.g. the Ministry of Finance), the central bank or a financial regulator to lead and coordinate the development and implementation of the program.
34. Initiatives are undertaken to improve people's financial capability. This includes encouraging the mass media to provide financial education, information and guidance.
35. Government and state agencies consult consumers, industry associations and financial institutions to develop proposals that meet consumers' needs and expectations. They also undertake consumer testing to try to ensure that proposed initiatives, including those regarding consumer disclosure and dispute resolution, are likely to have their intended outcomes.
36. The financial capability of consumers and the impact of consumer empowerment measures are measured through a broad-based household survey that is repeated from time to time.

Competition

37. Financial regulators and competition authorities consult with one another.
38. Competition policy in financial services considers the impact of competition issues on consumer welfare, and especially planned or actual limits on choice.
39. Competition authorities conduct and publish periodic assessments of competition among retail financial institutions and make recommendations on how competition among retail financial institutions can be optimized.

¹ Consumer protection regulation/supervision is also called “market conduct” regulation/supervision.

* Prepared by Sue Rutledge (World Bank, Global Program on Consumer Protection and Financial Literacy).

4.5. Institutional framework

92. Weaknesses and inefficiencies in the institutional framework have been identified as a main obstacle to debt resolution in most CESEE countries. In many cases, the court system is overloaded; judicial proceedings are lengthy and costly; court decisions are inconsistent and unpredictable; and transparency in court proceedings is not often guaranteed. These problems are exacerbated by the perceived lack of well trained and regulated enforcement officers, bailiffs and insolvency administrators with the requisite experience in commercial and financial matters, as well as by the lack of experienced turnaround advisors and lawyers. Many judges in the region are still perceived as being not sufficiently competent or independent. Strengthening the institutional capacity and improving the efficiency of judicial process is urgently needed in CESEE countries. While recognizing that institutional reform takes time to implement, measures that could contribute to such reform include:

In the Short Term

- **Conduct an audit of backlog cases.** A diagnostic study of the nature of the backlog cases assisted by the audit is critical to the development of an appropriate action plan to tackle the delay in the judicial process.
- **Improve data collection and publication.** Data on, e.g., court performance, costs of cases and recovery rates as well as out of court restructuring process, should be collected and published on a regular basis.
- **Set and enforce statutory deadlines for court proceedings,** supplemented by adopting measures to prevent the abuse of the appeal system and publication of court decisions in a timely manner.

In the Medium Term

- **Improve the court system** by introducing a judicial time management system to benchmark and measure court performance so as to inform personnel and budget allocation, establishing specialized commercial courts to handle insolvency cases and mandating on-going training for judges.
- **Establish a well-regulated system of professional enforcement officers, bailiffs and insolvency administrators,** including setting clear qualification criteria, certification examination and on-going professional education and appropriate selection and removal process. In EU member states, such institution building efforts could be supported by EU structural funds.
- **Encourage the use of alternative dispute resolution** (e.g., mediation and arbitration) to alleviate the burden on the court system.

4.6. Out-of-court restructuring

93. As an alternative to court-supervised insolvency proceedings, voluntary out-of-court restructurings provide a speedy, cost-effective and market-friendly tool to achieve debt settlement. Debtors and their creditors voluntarily participate in debt negotiations with a view to

reaching a mutually satisfactory solution. From the debtor's perspective, this could help avoid the stigma and uncertainty about its control over management of the firm resulting from in-court insolvency procedures. From the creditor's perspective, this could help achieve better returns through collective efforts to support an orderly rescue of a firm in distress and minimize the cost and delay associated with insolvency proceedings. In addition, out of court debt restructuring affords flexibility in restructuring tools that could be used in workouts.

94. As out-of-court restructuring takes place in the shadow of the in-court insolvency regime, it is critical to put in place an effective insolvency law that clearly defines the rights and obligations of relevant parties. The insolvency law provides incentives for out of court restructuring in at least two respects. First, the threat of the initiation of liquidation is needed to bring debtors to the table. Second, the voting provision of the rehabilitation under the insolvency law is needed to threatened potential holdouts. In addition, other laws need to be supportive of out of court restructuring: tax laws should create incentives for voluntary debt restructurings or at least eliminate any existing disincentive for debt restructuring; foreclosure procedures should facilitate speedy debt resolution; and corporate law should prevent corporate fraud and support restructuring.

95. Recent experience shows that CESEE countries take different approaches in facilitating out of court restructuring based on the legal and business culture. Some countries such as Latvia and Romania resorted to nonbinding guidelines on corporate and consumer mortgage out of court restructuring (Box 6). Serbia, on the other hand, chose to establish a legally binding mechanism with voluntary participation in out of court restructuring. Despite their different modalities, both approaches adopt guiding principles based on the London Approach and INSOL Principles with some modifications tailored to the specific circumstances of the country. Anecdotal evidence suggests a positive impact of these principles though there is no data linking them to the increase of out of court restructuring cases. For instance, in Latvia, the principles and guidelines for workouts have been successfully used in 90 per cent of out-of-court debt restructurings.

Box 6. Latvia: Out of Court Company Debt Restructuring Principles*

Principle 1: Debt restructuring is a compromise, not a right - Out of court debt restructuring must be initiated only if the debtor's financial problems can be solved and their business can continue in the long term. A debtor should turn to the creditors in order to discuss available options.

Principle 2: Good faith - Negotiations between the debtor and the relevant creditors must take place in good faith in order to create a constructive solution.

Principle 3: Unified approach - The interests of all parties should be observed if a unified approach is taken to solving the issues. Creditors may facilitate coordination of the issues by forming a coordination work group. In more complex situations, the parties should consider the option of inviting professionals who can consult with and advise the parties and the relevant creditors.

Principle 4: Negotiation with the debtor - The creditors must appoint one person (usually it is the creditor which has the largest claim against the debtor, with experience in negotiating debt restructuring, or it may be a neutral third party), who will conduct negotiations with the debtor, and will ensure that the relevant creditors receive the information provided by the debtor. It must be taken into account that if necessary, in the event that there is a dispute between the interested parties, they may turn to an arbitration procedure.

Principle 5: Moratorium period - All relevant creditors must be prepared to cooperate with the debtor as well as with each other in order to provide the debtor with enough time (identifying a deadline) in which to prepare options for solving financial problems (hereinafter – moratorium period). Granting this moratorium period is not the right of the debtor, but is a concession granted by the creditors. The beginning date is called the first date of the moratorium period. It is necessary to identify the length of the moratorium period, providing enough

time to prepare the plan as mentioned in Principle 11, or to constitute how much time would be necessary to prepare such a plan.

Principle 6: Priority of new resources - If, during the moratorium period, or in accordance with the suggestions put forth as a part of the restructuring process, additional assets are given to the creditor, then the grantor of this loan shall have the option to request security for the loan.

Principle 7: Creditors do not take action during the moratorium period - All relevant creditors do not take any actions to submit court claims against the debtor or to reduce their claims against the debtor during the moratorium period.

Principle 8: Debtor's pledge to the creditors during the moratorium period - During the moratorium period, the debtor promises not to take any actions which may negatively affect the proposed debt repayment to the relevant creditors (to all, or either of them individually) in relation to the state at the beginning of the moratorium period.

Principle 9: The debtor's complete transparency during the moratorium period - During the moratorium period, the debtor shall provide the relevant creditors and advisers with access to all information regarding assets, liabilities, and business transactions and forecasts.

Principle 10: Information confidentiality - Information regarding the debtor's assets, liabilities, and business transactions and forecasts, as well as proposals for solving the problems must be available to the relevant creditors and must be confidential, unless it is publicly available information.

Principle 11: Debt restructuring plan - It is the obligation of the debtor and his advisers to prepare proposals for debt restructuring which are based on a business plan that contains information regarding the necessary steps that need to be taken to solve the debtor's financial problems. The business plan must be based on sound and feasible forecasts, which indicate the debtor's ability to increase cash flow to the point that is necessary to execute the debt restructuring plan (and not delaying the insolvency process).

Principle 12: Settlement proposals correspond with the party's rights - When creating proposals for solving the debtor's financial difficulties, the parties must take into account the rights of the creditor and the amount of outstanding obligations at the beginning date of the moratorium period.

* http://www.tm.gov.lv/en/jaunumi/tm_info.html?news_id=3305

96. **The out-of-court restructuring framework in CESEE countries needs to be improved to facilitate out-of-court workouts.** In addition to the refinement of the insolvency law and strengthening of the institutional framework discussed above, consideration could be given to the following:

- **Develop out-of-court restructuring guidelines in line with international best practices** (e.g., the INSOL Principles) to provide sufficient guidance on collective restructuring negotiations, thereby helping foster local market practices. These guidelines should be developed in a consultative manner to get buy-ins from all stakeholders and, depending on the country's legal culture, may be issued by a state agency or through a law or regulation.
- **Remove legal impediments and create legal incentives for out-of-court restructuring.** For example, in some jurisdictions it is uncertain whether a creditors' agreement establishing a stand-still period during out-of-court negotiations would be enforceable or legally valid. Some laws do not make easy debt-to-equity swaps or assignment of credits, which are measures typically used in workouts. The law may also contemplate provisions that facilitate workouts, such as: (i) protecting fresh working capital through a legal priority, or validating good faith

agreements that create a contractual priority for the new money; (ii) allowing cram-down clauses on minority creditors, previously agreed upon by creditors participating in a workout; (iii) creating accelerated and simplified procedures for judicial confirmation of a workout plan approved by a legally defined majority of creditors, so that dissenting creditors be bound by the confirmed plan.

- **Remove tax impediments for out-of-court restructuring** to minimize recourse to the insolvency law. For example, in line with international practices, banks should be allowed to deduct the loss arising from debt write-off or cancellation.²⁵
- **Encourage the tax and social security authorities to participate in debt restructuring.** These agencies should be legally permitted to participate and accommodative arrangements based on clearly defined guidelines such as write-off of penalty interest on tax claims and rules-based settlement of tax claims could be developed to alleviate these agencies' concern about liability.
- **Review and modify corporate and business laws** to, inter alia, strengthen director, officer and business owner accountability and liability, prevent abusive practices in opening and closing businesses to avoid enforcement, and provide for avoidance and recovery of fraudulent transfers. Other insolvency law provisions are also fundamental for enabling (or discouraging) informal debt restructuring activities. In this regard, an adequate insolvency law should enable the parties to engage in out-of-court restructuring negotiations without incurring any legal liabilities and to reach agreements that are protected from subsequent avoidance actions. For example, in 2010 Romania eliminated a number of obstacles that prevented parties from engaging in out-of-court debt restructuring negotiations, namely: (i) transactions performed by the debtor in good faith as a result of a collective out-of-court restructuring negotiation or plan will be exempted from avoidance and will not bring about debtor's management or directors liability in a subsequent liquidation proceeding; and (ii) the time period established for the debtor's management to file for commencement of an insolvency proceeding will be considered extended in cases where, after insolvency occurred, the debtor has been engaged in good faith and for a reasonable period in out-of-court restructuring negotiations.
- **Launch an information campaign to raise public awareness of the credit enforcement legal framework.** This campaign, which could include organizing workshops for stakeholders and publishing articles on the improved legal framework, could help change the business and legal culture toward early rescue of viable firms.

4.7. Tax impediments

97. **Tax rules pose significant obstacles to successful non-performing loan resolution.** Tax rules are designed to safeguard government revenue. As such, they are designed to accelerate income recognition and minimize deductions. Accordingly, they tend to contain a broad definition of income, basically all amounts received (either in the form of currency or tangible assets) regardless of the source (i.e., wages, gifts, inheritances, prize or gambling winnings, etc.) while allowing limited deductions to recognize the cost of doing business (or in the case of individuals the cost of living

²⁵ See section 4.4 for a full discussion.

expenses) or to promote socially acceptable actions such as home ownership through the deductibility of mortgage interest expense. And the taxing authorities are generally given broad collection powers with minimal ability to compromise amounts due. These rules presume that tax payers (corporate and individuals) are operating profitably and have sufficient income to meet their obligations. If this is not the case, particularly in periods of financial crisis, the tax code is likely to have a perverse effect on resolution options. Most restructuring techniques, including but not limited to debt forgiveness, lowering of interest rates, extensions of tenor, loan sales, and mergers and acquisitions of assets or firms, will give rise to taxable income. During times of financial crisis, troubled borrowers are strapped for cash, unable to pay their existing obligations let alone a tax burden arising from a restructuring. In these cases, creditors may well decide that they will receive a greater recovery from liquidation of the assets rather than the restructure of an otherwise viable company.

98. Tax impediments to non-performing loan resolution fall into three broad categories: income recognition, treatment of losses, and miscellaneous issues, including other taxes (Box 7). Common resolution techniques give rise to significant tax issues. In many cases, changes in the structure of the debt via an extension of tenor, revision of the payment schedule, or interest rate adjustment (commonly known as “financial engineering”) are not sufficient. Instead, deep structural changes, or “corporate restructuring” is required. This is likely to involve the merger or acquisition of all or part of the company, disposition of non-productive assets, or equity injections or debt -equity swaps. Each of these techniques will generate income or losses or result in transaction taxes, the treatment of which may well determine the feasibility of the transaction.

Box 7: Common Tax and Regulatory Impediments to Effective Non-Performing Loan Resolution

Income Recognition

- Creation of a taxable event by debt forgiveness or other restructuring techniques.

Treatment of Losses

- Tax treatment of loan losses incurred by banks or other institutional investment vehicles.
- Inability to deduct losses in a debt-equity swap when there is a difference between the face value of the debt and the “equity” value of the shares received.
- Inability to carry forward losses in the context of mergers and acquisitions.

Miscellaneous Issues

- Value added or transfer taxes upon the transfer or disposal of assets. This issue may be particularly problematic in the context of the sale or transfer of distressed assets by a bank to a subsidiary SPV or independent asset management company.
- Stamp duties imposed on the restructuring or consolidation of debts and the creation of new security interests to protect new or existing debt.

99. Many restructuring transactions, such as debt forgiveness, business reorganizations, or even seemingly simple loan modifications or forbearance agreements produce “phantom” (income generated without any associated cash flow).^{26, 27} This income may be created either

²⁶ Tax codes consider loan proceeds to have been received on a temporary rather than permanent basis given the underlying obligation to repay. When that obligation is forgiven (or in some cases, severely modified), the amount involved is deemed to have been received permanently, thus triggering a taxable event for the borrower.

explicitly, i.e., by an outright grant of debt forgiveness, or implicitly by the nature of the transaction, i.e., a modification in terms which alters the legal rights and obligations to a degree that is “economically” significant.²⁸ While the income generated is generally for the account of the borrower, lenders and asset purchasers may also be forced to recognize income if they acquire an asset at what is deemed to be a “below market” value. And, in some jurisdictions with weak tax collection practices (e.g. Ukraine) the lender must not only absorb the loss involved in the transaction but also pay the taxes on behalf of the borrower. Therefore, tax consequences of a resolution transaction are critical for lenders, borrowers, and investors as well and may be so large as to effectively prohibit the transaction.

100. Debt restructuring transactions, including outright forgiveness, that occur within a bankruptcy or other legal, proceeding are generally exempt from taxation; however, equal treatment is not accorded to the identical transactions negotiated in an out-of-court proceeding. This asymmetrical treatment has a tendency to push otherwise viable borrowers into bankruptcy proceedings, thereby decreasing their chances for a successful restructuring. Some jurisdictions have attempted to correct this problem, in part, through the introduction of an expedited bankruptcy process whereby out-of-court settlements can be quickly approved by the Bankruptcy Court.²⁹ Others have chosen to amend their tax codes to give the same status to out-of-court and bankruptcy transactions. Latvia, for example, has amended its tax codes to waive gift tax provisions for a two year period beginning January 1, 2011 for the restructuring of mortgage debt on a primary residence incurred prior to January 1, 2009 for the purpose of acquiring, constructing, or renovating the primary residence.

101. Loan losses generally reduce a lender’s taxable income and for tax purposes are accounted for by use of either the reserve or charge-off method.³⁰ Banks and their regulators generally favour use of the reserve methodology, which conforms more closely to regulatory and financial accounting rules, as it discourages banks from under provisioning and provides current tax benefits. Many tax authorities, however, prefer the charge off method under which losses are more narrowly defined and allowed only when certain events take place as they are concerned that provisioning for loan losses significantly understates a bank’s income thus reducing the amount of taxes paid by the bank. This reduces the tax advantage resulting from loan write offs.

102. However, the definition of what constitutes a loss and when it is recognized varies widely across countries. Jurisdictions that follow the reserve method may allow full deductibility of a bank’s net loan loss expense (additions to reserves net of actual recoveries)³¹. Many, however, limit

²⁷ Business reorganizations must meet strict criteria to qualify as tax free transactions. As a general rule, these include the continuation of both the business activity and the interests of the shareholders. Some countries require that there be a *bona fide* commercial or business purpose for the transaction or other proof of the absence of tax avoidance. Reorganizations, regardless of the actual form they take under corporate law that fail to meet these criteria are taxable and are generally treated as sale/transfer of assets or shares for tax purposes.

²⁸ Such modifications may include, but are not limited to, changes to the yield of the transaction; substantial deferment in the maturity or scheduled payments; adding guarantor(s) or co-obligors(s); debt for equity swaps; or a change in payment priority.

²⁹ Expedited bankruptcy proceedings, more commonly known as “prepacks,” are more commonly used as a method to bind dissenting creditors to a majority approved restructuring plan.

³⁰ It should be noted that these restrictions also apply to the treatment of a corporation’s bad debt expense.

³¹ Under the reserve method, loan loss expense may be negative during periods where recoveries exceed new losses incurred.

the amount of net loan loss expenses allowed in any one year to a percentage of total net income, total net reserves, or a percentage of total outstanding loans. In addition, many limit the deductions to amounts tied to specific reserves not general reserves. The charge-off method is even more restrictive in that only actual losses (as defined) may be deducted for tax purposes. To limit abuse, many tax authorities require that regulators have classified the loan as a loss. Others require a higher level of proof of loss such as a signed formal contract granting forgiveness or a court document discharging the indebtedness. Other common requirements to substantiate a loss include bringing a civil action against the debtor, a declaration of bankruptcy, or death of the borrower. Box 8 provides examples of tax treatment of loan losses in several jurisdictions.

Box 8: Tax Treatment of Loan Losses in Selected CESEE Countries*

Czech Republic: Overdue claims only become tax deductible once the claim is more than 360 days past due and all the legal remedies (e.g., court proceedings and liquidation of collateral) have been exhausted.

Latvia: Latvia recently clarified that writing-down debts against reserves does not create income and amended its tax code for the taxable period that begins in 2011 and ends in 2013 to allow all taxpayers to establish bad debt reserves if the following conditions are met:

- debt obligation was due more than 6 months ago, but not sooner than on January 1, 2009;
- transactions with debtor were suspended at least 6 months ago and have not been renewed;
- taxpayer and debtor are not related enterprises or related persons;
- amount of increase of reserves shall not exceed 20 percent of the taxable income of the taxable period;
- taxpayer is able to provide proof that the debt is in the process of collection.

Slovakia: Debt receivable may only be written off in a legal proceeding or once all avenues of collection have been exhausted. However, banks are allowed to deduct for tax purposes amounts not covered by collateral as determined by IFRS as follows:

Days Past Due	Deduction Allowed
360	20% of unsecured amount
720	50% of unsecured amount
1,080	100% of unsecured amount

* Although Kazakhstan is not a CESEE country, it represents an example of how the tax treatment of bank losses impedes loan restructuring. Banks are allowed a tax deduction for the amount of loan loss provisions; however, they are forced to recognize as income any reduction in the provision (recovery or write-off of the loan against the provision), and if the transaction involves debt forgiveness, they are also required to pay the resulting tax on behalf of the borrower. This tax treatment has provided no incentive for the banks to engage in any meaningful loan restructuring and NPLs remain basically frozen.

103. Net operating losses (NOLs) are frequently a distressed company’s most valuable asset and may provide a bona fide purchaser with the opportunity to manage its current or future tax liabilities. NOLs can provide significant tax benefits by allowing a tax payer to: (i) recapture taxes paid in prior years by applying them against income reported in earlier years; or (ii) reduce future tax obligations by applying them against income earned in subsequent years. Both treatments may provide significant cash flow benefits either to a troubled borrower or a potential purchaser. However, their use has been subject to much abuse with profitable firms seeking to acquire or merge with loss making entities for the sole purpose of sheltering their profits from taxes. As a result, their use is generally subject to a number of restrictions. Restrictions on loss generating entities may include limitations on the number of years that losses may be carried back or forward, limitations on the amount of NOLs that may be used in any one year, and requirements that NOLs be applied first to

income taxed at the lowest rates.³² Restrictions in the context of mergers and acquisitions are likely to include requirements regarding the continuity of the acquired business for a specified period of time (generally five years), limitations on changes in ownership (generally no more than 25 percent) or the amount of losses utilized in any one year, and a shortened time-span for their use. Box 9 highlights various treatments of NOLs within the region.

Box 9. Treatment of NOLs in Selected CESEE Countries

- **Serbia:** Five year time limit on the use of tax loss carry forwards and no provision for offsetting against prior years' earnings.
- **Bulgaria:** Tax loss carry forwards allowed only in those cases where the reorganization is considered to be merely a change in form of the company as provided for under Article 264 of the Commercial Law. Their use is prohibited in the all other cases of acquisitions or mergers.
- **Hungary:** Beginning in 2012, losses carried forward will only be deductible up to 50 percent of taxable income and restrictions have been placed on their use in the case of corporate transformation or restructuring.

104. Banks are becoming increasingly aware that transfer taxes or other fees due on the transfer of assets to the bank or its subsidiary via foreclosure or in satisfaction of a debt may substantially increase the cost of resolution. This issue is of particular importance in emerging markets where substantially all bank lending is secured by real estate. Many banks feel that these costs are unfair as they are not truly buying the assets, but rather taking temporarily title (through the foreclosure process) in satisfaction of a debt. There is some precedent for this view as many jurisdictions with a public asset management company have chosen to defer these taxes and fees until the assets are sold to an unrelated third party.

105. Tax issues also arise with respect to loan sales to private AMCs, most notably in the areas of income/loss recognition and the treatment of the released reserves. Generally, the sale of a loan portfolio to a private AMC implies the realization of a loss for the seller; however, in some cases it may also result in income to the purchaser as they are considered to have received a “gift” in the form of purchasing assets for less than their book value. In addition, banks may be forced to recognize income from the release of reserves. In Latvia, recent amendments to the tax code provide that the transaction does not generate taxable income for the originating bank provided the debt is transferred to a third party in an arms-length transaction. The treatment is more complex in Ukraine. The purchase price of the assets will be considered income to the seller; however, if the underlying loans were originated by the bank, this income will be offset by a deduction in the amount of the face value of the loans sold and should result in a loss for the bank. In addition, income will be generated by the release of the provisions related to the sold portfolio and there is also a possibility that the seller will be required to release additional reserves as the outstanding loan portfolio has been decreased. The seller will need to take the additional taxes required by the income generation into account when evaluating the feasibility of the loan sale transaction. For those banks experiencing liquidity or capital constraints, this cost may preclude a sale of the portfolio.

³² Only a few jurisdictions allow a carry back facility to stimulate cash flow, as it is administratively complicated.

106. The tax authority is frequently a substantial creditor of a distressed company. Unpaid taxes, particularly real estate, employment, and other social taxes, are likely to represent a significant liability. And, as it is common practice to grant the tax authorities a priority position in payment, they have little incentive to participate in the timely resolution of the debts. Also, they may legitimately prefer different instruments or forms of debt restructuring than other creditors, or even liquidation in order to generate “income”. While they may have some limited ability to reduce or defer payments within the context of an insolvency proceeding most are unwilling to do so without the cover of court protection. This frequently results in forcing borrowers into otherwise avoidable court proceedings with all its attendant risks.

107. More recently, however, government arrears have contributed to the NPL problem. Governments facing falling revenues and under pressure to reduce expenses have begun to lengthen repayments to the private sector. In Albania, borrowers have encountered seriously delays in receiving VAT refunds and payments for goods and services provided to the government. While the exact amount of these payments is currently unknown, anecdotal evidence indicates that there is a direct correlation between this slowdown and increasing NPLs. In Hungary, recent amendments to the tax code have lengthened the time for payment of VAT refunds from 45 days to 75 days. Such delays put excessive pressure on already cash strapped companies and may force smaller businesses into liquidation.

108. And, finally the tax code, itself, may act as an impediment. Poorly written tax codes that are amended frequently or rely on rulings for specific undertakings or are scattered throughout multiple locations, including corporate regulations, act as an impediment to effective resolution as they create ambiguity, increase transaction costs and result in unnecessary delays in the resolution process. In addition, the failure to properly implement the tax code may prove problematic. In Albania, the tax code requires that transfer pricing issues be referred to a panel with specialized expertise but, to date, the panel has yet to be established. These issues which are of great importance particularly in the case of corporate reorganizations continue to be handled by the regular auditors who are poorly equipped to deal with the issue; thus, ensuring undue delays and inconsistent approaches.

109. If not already done so, the authorities may wish to consider the following measures to more closely align the tax code to support the goal of speedy loan resolution:

- Effectively eliminate taxation of debt forgiveness for loan restructuring negotiated in out-of-court proceedings by enabling offsets against losses;
- More closely align the recognition of loan losses for tax and financial reporting purposes;
- Clarify that loan sales to independent third parties at below book value does not create income for banks;
- Clarify that writing off loans against previously established reserves does not create income;
- Exempt transfer of property to banks via foreclosure or in settlement of debt from transfer taxes and other transaction fees.

4.8. Impediments in bank regulation

110. Weak regulation and lax supervision of banks constitutes a significant impediment to the timely resolution of distressed assets (Box 10). Regulation and supervision play a critical role by ensuring banks are well capitalized and losses are recognized in a timely manner through proper classification and provisioning. They also can provide incentives to engage in “real” rather than “cosmetic” debt restructuring by providing guidance as to what constitutes an appropriate

restructuring (including the information required to support such action) together with guidelines for the upgrade in loan classification and the return of a restructured loan to accrual status (Box 11). The exclusion of non-bank financial institutions with lending activities (shadow banking) from standard asset quality and provisioning regulation may also be problematic as it creates an uneven playing field with banks.

Box 10: Common Regulatory Impediments to Effective Non-Performing Loan Resolution*

- Failure to require adequate provision against impaired but not yet past due loans.
- Bank secrecy/confidentiality provisions which prohibit the sale of assets.
- Restrictions on banks that prevent them from owning or operating a business. Other rules may limit the amount and holding periods of equity that banks receive in debt/equity swaps. And, state banks (and in some cases, public AMCs) may be unable to write-off debt, due to statutory constraints. This is especially problematic when bankers can be held personally responsible for any losses incurred and adequate indemnity protection is not afforded for those acts undertaken in the normal course of business and within the rules and regulations governing such actions.
- Approvals for creditors, and especially foreign creditors, to acquire a substantial percentage of shares of designated companies or specific types of assets such as real estate.
- Multi-month waiting periods, during which creditors may object and demand immediate repayment of their claims, before corporate mergers and spin-offs become effective.
- Strict application of anti-state aid rules in cases where successful restructuring is dependent upon some form of assistance.
- Requirements for a compulsory takeover bid for acquisition of control which may force a large creditor(s) to launch a takeover bid, at an equitable price, for the entire capital of the listed company. Creditors, as significant shareholders of the restructured company, may also be subject to restrictions governing the sale of their share. Additional hurdles may include the need to issue a prospectus for the offering of shares or new debt instruments to creditors.

*Identified as impediments in NPL Survey conducted by NPL Working Group of the EBCI.

111. Requiring banks to strengthen their capital not only positions banks to absorb their losses, it also clearly signals to banks, borrowers, and the general public alike that the authorities have made asset resolution a priority. Banks entered the crisis with seemingly healthy balance sheets, but as NPLs rise, increasing loan loss provisions begin to take their toll on capital. As a result, bank recapitalization generally precedes successful NPL reduction. Since the crisis, supervisors throughout the CESEE region have moved aggressively to strengthen and enforce loss recognition and provisioning standards and most have issued capital calls, particularly to foreign bank subsidiaries. As a result, in several countries, most notably Romania, Bulgaria, Albania, and Serbia, the level of required provisions for foreign bank subsidiaries operating in these jurisdictions is 3-5 times higher than required by their internal standards which are based on IFRS accounting standards. This difference is accounted for by the fact that local standards require provisions to be established on the gross loan outstanding rather than on the loan net of the collateral value as in IFRS.

Box 11. The Treatment of Restructured Loans—Best Practice*

The appropriate treatment of restructured loans is an important component of maintaining bank soundness, not only under normal circumstances but also in the event of a systemic crisis. Banks should develop a policy regarding restructured loans to ensure that such loans are clearly designated, monitored and properly handled from both accounting and loan review standpoints. Bank supervisors should provide prudential guidelines on the treatment of restructured loans and monitor the extent of these loans carefully.

According to the definition of the Basel Committee's 1999 Loan Accounting Paper, a loan is "a restructured troubled loan when the lender, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider." The restructuring of a loan or other

debt instrument (hereafter referred to as a “loan”) may include: (i) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan; (ii) a modification of the loan terms such as a combination of the following factors: a reduction in an agreed-upon interest rate; an extension of the final maturity; a reduction of principal; or a reduction of accrued interest; or (iii) acceptance by the bank of the conversion of the borrower’s debt into equity to be held by the bank, in full or partial settlement of a debt.

When loans are classified and heavy provisions are required by accounting standards or supervisors, some banks may engage in extensive troubled loan restructurings in case this treatment minimizes the impact of nonperforming loans on their net income. However, such treatment could be often interpreted as only “cosmetic” by supervisors in the context of postponing recognition of the true extent of their portfolio losses.

All restructured loans should be subject to an assessment of risk according to criteria to determine their collectability at the time of the restructuring. They should, thereafter, be identified in the bank’s internal credit review systems regularly and monitored by bank management. When analyzing restructured loans, the credit reviewer should focus on the ability of the borrower to repay the loan in accordance with its modified terms both under normal circumstances and in the event of a systemic crisis.

Many supervisors provide specific criteria for banks to classify loans as restructured, and give more detailed guidance. Definitions of a restructured loan involve extending the loan’s maturity or lowering its interest rate or both. Although firm international best practices do not exist on this issue, the following elements could be regarded as good practices:

- A restructured loan should generally be classified as substandard or no better than its category prior to restructuring, such as “doubtful.” Otherwise, banks can exaggerate their credit quality by granting terms to borrowers that are considerably easier than normal commercial terms. A borrower’s compliance with the terms and conditions of the restructured loans for a certain specified period of time gives a fair indication of the improvement in the borrower’s debt repayment capacity, and warrants the restoration of the loan to a regular category.
- After a reasonable period of demonstrated payment performance, banks could upgrade a restructured loan. Clearly, a period of sustained performance is a very important factor in determining whether there is a reasonable assurance of repayment and performance according to the loans’ modified terms.
- If the substitute or additional debtor is related or affiliated to the original debtor, then the original loan classification cannot be changed unless subsequent debt servicing by the borrower improves sufficiently to warrant a fresh review of the classification. If the substitute or additional debtor is totally unrelated to the original debtor, then the subjective loan classification criteria can be applied to the substitute or additional debtor. This should be done in accordance with the general principle of the borrower’s ability to repay his/her debt in the normal course of business. If the new debtor is able to clear all interest arrears, then the loan classification can be upgraded accordingly.
- Regarding the minimum time period before restructured loans are upgraded, country practices vary widely. In Latvia, for example, restructured loans may be upgraded if they comply with their new restructured terms for at least one year. In other countries the period may be shorter or the upgrading requirements specified in terms of the number of repayments rather than the minimum period of remaining restructured loans.
- When troubled loan restructuring is arranged under more favorable conditions compared with market ones or the original terms of the loan, a cost should be assigned to this difference and provisioned in its full amount.
- When available information confirms that a specific restructured loan or a portion thereof, is uncollectible, this amount should be written off against the provisions for loan losses at the time of restructuring. Thereafter, the bank should regularly evaluate the collectability of the restructured loan as a part of the impairment assessment process and so as to determine whether existing provisioning is adequate and whether any additional amounts should be charged to provisions.
- Arguments could arise regarding the different treatment of restructured loans and associated provisions in a crisis situation as opposed to normal circumstances. Although there are no international best practices on this issue, it is suggested that prudential norms and practices for the classification and provisioning for

restructured loans be the same under normal circumstances as in the event of a systemic crisis, i.e., that the supervisor does not exercise forbearance on classification and provisioning. In classifying restructured loans even in a systemic crisis, the emphasis should be placed on the quality of the restructured troubled loan and the prospects for repayment. Problem loans have to restore first their track record of payments to be upgraded, even under a systemic crisis.

* Prepared by Michaela Erbenova (IMF, Monetary and Capital Markets Department).

112. Restrictions on debt collection functions are a problem in some countries. For instance, debt collection agencies are not allowed to operate in some countries, or data secrecy law may prevent banks from transferring necessary client information for them to be effective. In others, door-to-door or field collection is not permitted. Also, restrictions on the ability of banks to pay bonuses to debt collection staff are an impediment in incentivizing these agents. However, the need to encourage the development and use of these agencies should be balanced with the need to protect borrowers from abusive collection practices.

113. Inflated collateral valuation is a significant stumbling block to asset resolution. As has been referenced previously, almost all lending in the region is collateralized by real estate. With both borrowers and their banks currently uncertain regarding valuations, they are reluctant to accept what is viewed to be “fire sale” pricing. While this is a common problem in all crises, it is exacerbated currently by the generally low level of appraisal standards throughout the region. Supervisors should take the lead in establishing uniform standards for appraisers and appraisals to ensure greater consistency of valuations across the banking system and governments may consider establishing property price indices to serve as solid reference in the market (Box 12).^{33, 34}

Box 12: Property Valuation for Delinquent Mortgage Loans*

Valuing property which is used as collateral for a loan where payment problems have arisen should in most cases follow the same rules as ordinary valuations. A loan being in default will not necessarily have a direct impact on the actual market value of the property. The value of the property is still determined by whatever price can be obtained on the open market using International Valuation Standards Council (IVSC) methodology as applied locally. The reasons for the sale should not necessarily affect this. However, several further considerations should be taken into account:

- **Timing of Forced Sale** – if the lender has to resort to a forced sale process within a specified time frame through an auction process for example, the typical value achieved will be lower than through usual channels. The potential pool of buyers may be reduced or they may not be able to arrange finance in time for example.
- **Property Maintenance** – if the lender has to resort to eviction as part of a forced sale, in many cases the property is repossessed in a damaged condition. For example radiators, kitchens or plumbing may be damaged or removed. Also if the property is left empty for any period of time, it may be subject to vandalism or just lack of upkeep.
- **Neighborhood impact of forced sales** – in market downturns, there may be a large number of properties coming onto the market. There is evidence¹ to show that forced sales of properties tend to have a negative effect on their whole neighborhood, so a bank foreclosing on several properties could in itself create a

³³ Real estate valuation should be governed by the International Valuation Standards Council (IVSC)’s global standards.

³⁴ The BIS is currently working on this issue and future guidelines are expected from them in this regard.

downturn in values.

- **Forced sales in systemic crisis** - In extreme cases, such as recently experienced in Latvia, where the housing market is relatively small, a big influx of forced sales cannot be absorbed by the market and there are no willing buyers for the properties. In such cases banks have to take the assets and deeply discount their value.

These issues are addressed in different ways² with a haircut taken on the market value of 25 to 50 percent. In some cases this is mandated by laws or regulations others actually set a floor to the minimum price, with the bank having to buy the property at that price if no open market buyer is found. As examples, Romania has a 75 percent floor when going through auction process, in Hungary this value is 50 percent after two auctions have taken place. In Spain it is 70 percent as mandated by their Law of Civil Procedure.

For lenders wanting to evaluate their Loss Given Default (LGD) on mortgage portfolios, a haircut on the value of the collateral which will go to a forced sale should be factored in. Generally, any alternative resolution mechanisms including loan modification, time-bound principal or interest payments grace periods or voluntary sale agreements are preferable to forced sales both economically and from a social point of view.

* Prepared by Simon Walley (World Bank, Housing Finance).

¹ *Forced Sales and House Prices*, John Y. Campbell, Stefano Giglio and Parag Pathak, Working Paper 14866, <http://www.nber.org/papers/w14866>, NATIONAL BUREAU OF ECONOMIC RESEARCH.

² See European Mortgage Federation note on Valuation in Foreclosure Context, July 2011, www.hypo.org.

114. Restrictions that prevent banks from owning or operating foreclosed property or selling loan assets to third parties have slowed the resolution process. The business of banking is generally tightly restricted to the taking of deposits and the lending of money. Thus, in many jurisdictions, including the Baltic countries, banks are precluded from owning real estate or other assets, and operating businesses. This has necessitated the establishment of subsidiaries or special purpose vehicles (SPVs) to hold assets received through foreclosure or the voluntary settlement of obligations.³⁵ While the Scandinavian banks in the Baltic countries moved quickly to establish these entities with help from their parents, elsewhere valuable time has been lost in gaining approval for and making these entities fully operational. These entities, when wholly owned by the bank, should also be subjected to the same level of supervision as the bank to ensure that they do not become warehouses for impaired assets. Also, in some jurisdictions, prohibitions on the transfer of loans without the consent of borrowers or precluding the sale of loans based on intertwined bank secrecy and data protection laws have impeded the sale of NPLs.

115. Restrictions on the type, amount, and holding periods for assets, particularly real estate and equity, received in the process of debt resolution may not prove helpful.³⁶ These restrictions are designed to ensure that banks focus on normal banking activities. They may, however, have a perverse effect on the restructuring process, either slowing down the foreclosure process to avoid breaching the limits; reducing the interest of borrowers/investors/banks in entering into a debt for equity swap; or limiting the bank's ability to sell (and thereby reducing their ultimate recoveries) foreclosed assets as investors simply decide to wait until the deadline for disposition is approaching to

³⁵ A related issue is the inability to create trusts to facilitate the transfer NPLs to private AMCs.

³⁶ In Albania, for example, banks may hold equity investments in commercial (non-bank companies) without the approval of the Bank of Albania provided each investments does not exceed 10 percent of the capital of the company; each investment does not exceed 15 percent of the bank's regulatory capital; and the total of all such investments does not exceed 60 percent of the bank's regulatory capital.

take advantage of the banks' need to sell at any price.³⁷ The authorities may wish to temporarily expand or suspend such limitations so as not to slow down the resolution process and then work with the banks to develop appropriate disposition strategies.

116. Inability of state banks and public AMCs to write-off debt due to statutory constraints has also slowed the process. The ability to write-off debt by public entities, such as state banks and public AMCs may be severely constrained as it is considered to be akin to creating a loss in state owned assets, a serious crime in most jurisdictions. For instance in Turkey during the 2001 crisis, the authorities introduced an expedited, out of court restructuring process known as The Istanbul Approach. Domestic banks, including the state banks, and the SDIF or public AMC holding the loans of closed banks, were parties to the Framework Agreement. Restructuring was not as robust as had been hoped in part due to the inability of the state banks and SDIF to grant debt forgiveness. This forced the other creditors to assume a larger portion of the losses than would otherwise have been the case if the restructuring transaction were to go forward. The sale of loan portfolios effectively avoids this problem. Although the portfolios are sold at a loss, which generally requires approval from the highest level of authority, it eliminates undue political interference and the moral hazard involved in granting debt forgiveness on a case by case basis.

117. Officers and staff may be reluctant to engage in resolution activities due to a lack of indemnification.³⁸ In many jurisdictions, borrowers have brought spurious legal actions against officers and staff, personally, rather than against the bank or resolution entity, in a desperate attempt to stop the foreclosure process. In many developed countries it is customary for the corporation to indemnify, or agree to either provide legal counsel or pay for the employees' legal expenses in such cases. The practice is not widespread in emerging countries and many are reluctant to introduce it. And, as few individuals have the financial ability to defend themselves in such circumstances, many will choose to slow or otherwise delay the resolution process.

118. The regulation of distressed asset resolution entities has been uneven. At present there is no consensus on if or how these private sector entities should be regulated nor even on the legal form they should take. The fact that they effectively remove the distressed assets from the banking system, tends to favour a "hands off approach" to regulation, leaving them subject only to the company regulations, or if they are classified as "factoring" companies, to the regulation of the non-bank financial supervisor.³⁹ Others have taken a more prescriptive approach, choosing to require minimum

³⁷ The other parties to a restructuring transaction need certainty with respect to who they will be dealing with in the future. Their willingness to enter into the transaction may be greatly diminished if they are faced with the prospect of an unknown partner in the immediate future. In addition, corporate regulation may restrict the amount of stock that a significant shareholder can dispose of at any one time so as to protect other shareholders from a substantial decline in price due to "dumping" a large block of stock on the market at one time.

³⁸ Indemnification, the reimbursement of legal expenses, is separate and distinct from immunity. In general, the law looks with disfavor on attempts to avoid liability for one's actions or to secure exemption from violations of law restricting immunity, or a complete bar to lawsuits, regardless of the individual's motive in acting, to government officials, diplomats and members of the judiciary so long as their actions are discretionary and within the scope of their official duties.

³⁹ This is a misnomer as they do not provide traditional factoring services, i.e., the outright purchase of a receivable at a discount reflecting the time value of money. Banks in some countries, such as Montenegro, have chosen to permanently remove distressed assets from their balance sheets by transferring them to already established factoring companies owned not by the bank but by its parent. These factoring entities, therefore, are not subject to consolidation at the bank level.

capital levels and licensing, in large part to ensure that the assets are purchased by reputable asset managers with an established track record rather than by companies established for the purpose of regaining control over the assets of certain special interest groups or are being used for the purpose of money-laundering. As a result of the crisis, however, many countries are thinking of bringing the non-bank credit institutions under the central bank as the guardian of financial stability and macro-prudential supervisor to be able to monitor and manage total credit growth. The degree of regulation is likely to be a function of the amount of assets held by AMCs. In cases where the amount is minimal in relation to total credit outstanding, regulation is likely to be limited. But when they hold a significant proportion of the outstanding credit, more careful regulation and monitoring may be warranted. Each country will need to balance the need for regulation with its possible effect on the attractiveness of the market to potential purchasers.

119. Regulatory forbearance should be at best avoided or at least used wisely to promote NPL resolution rather than problem avoidance. Banks, borrowers, and even regulatory authorities are likely to lobby for forbearance, particularly in the early stages of the financial crisis when they believe that the problems are temporary rather than permanent in nature. But as the crisis drags on, the call for forbearance is apt to become more strident as the parties wish to avoid the pain of the resolution process which may include the loss of their businesses, homes, banks or from the authorities and regulators perspective the political heat involved in bank failures or closures. Common examples of forbearance include failure to enforce proper classification and provision for loans in the process of restructuring; lowering appraisal standards; suspension of “mark-to-market” rules for asset valuation; and, failure to take “prompt corrective action” to force banks to bolster their capital positions. Less than full application of the provisioning rules weakens the transparency of capital ratios and obscures analysis of the banking sector’s financial strength. Importantly, forbearance on classification and provisioning will not ease the bank’s need for real cash income, regardless of what it may do for accounting income. In an extreme case, banks reporting nominal profits due to forbearance on provisioning or mark-to-market may face a liquidity crisis because they are consuming deposits to pay real expenses. These actions can lead to increased moral hazard and weaken credit standards as well as the repayment ethic. For this reason, implicit or unmonitored forbearance (i.e., turning a blind eye on noncompliance) should be avoided. However, experience suggests that explicit forbearance may be effective as one element of a comprehensive stabilization and restructuring program in cases of systemic crises, for example to provide time for banks to recognize their losses and raise new capital. In these circumstances, it should be time-bound, selective, transparent, and accompanied by conditions designed to minimize the incentives for banks to assume excessive risk.

120. If not already done so, regulators should tighten supervision appropriately with an emphasis on realistic collateral valuation and asset classification. Ensuring adequate classification and provisioning of restructured loans to avoid ever-greening and ensure resolution to all truly nonperforming assets will be particularly important. Such a proactive supervisory approach may need to also consider recent regulatory and funding pressures facing banks in Europe. More specifically, the authorities may wish to consider the following steps to more closely align prudential regulation to the goal of speedy NPL resolution:

- Force banks to recognize losses and strengthen their capital in a timely manner;
- Encourage the write-off of fully provisioned NPLs;
- Provide greater guidance for proper loan restructuring, upgrading classification, return to accrual status, and collateral valuation;

- Ensure banks have the ability to own foreclosed assets and relax holding periods for same in line with market conditions;
- Balance regulation of private AMC's with market share of total loans held by such entities and its effect on potential investors;
- Use forbearance wisely to promote proper restructuring rather than problem avoidance.

4.9. Impediments in corporate regulation

121. **Many common corporate actions undertaken during the course of the resolution process are subject to regulation.** These regulations generally take the form of restrictions on business activities and/or the transfer of ownership and required operating licenses. In addition, requests for approval of these actions generally involve the payment of fees. Lengthy delays to gain approvals and burdensome fees may result in the liquidation of a company as creditors or potential investors become discouraged and abandon restructuring efforts.

122. **Restrictions on foreign ownership of companies or specific types of assets, such as real estate, may limit restructuring opportunities.** Restrictions on outright foreign ownership are generally well known and serve to limit the pool of potential distressed asset investors.⁴⁰ A more subtle problem, however, arises when a creditor group which includes foreign banks attempts to foreclose on assets or restructure through the use of a debt for equity swap. The inability to gain approval may result in local lenders being forced to buyout foreign banks to avoid the transaction from collapsing.

123. **Restrictions on the sale, merger or transfer of a substantial portion of company shares may result in removing the restructuring decision from the hands of the creditors to third parties who have not participated in the settlement process.** This is particularly true in those cases where a large creditor willing to enter into a debt for equity swap or foreclosing on shares held as collateral is required to launch a compulsory takeover bid for the entire capital of a listed company. While originally intended to protect minority shareholders from a fraudulent transfer of the company, in the context of a restructuring, it puts approval power in the hands of the minority shareholders who may use the opportunity to extract concessions they otherwise are not entitled to. And in some cases, unsecured creditors can require that their debts are paid before a merger transaction can take place. Bulgaria has amended their regulations so that these creditors can only require payment of sums that are actually due and payable.

124. **Strict application of anti-state aid rules may prohibit or seriously delay restructuring efforts.** In times of financial crisis, survival of many companies is dependent upon some form of assistance. Strict application of anti-state aid rules may preclude the availability of these funds. Even if the authorities conclude that it is in the public interest to provide such assistance, the arduous nature of the process itself coupled with the lengthy timeframe required to gain approval may preclude this option.

125. **The authorities may wish to consider the following to remove impediments in corporate regulations to NPL resolution:**

⁴⁰ For example, foreigners may not own agricultural land in Ukraine.

- Expedite regulatory approval process to eliminate unwarranted delays;
- Relax restrictions on foreign ownership to allow banks to foreclose on assets;
- Eliminate provisions requiring a bank in the process of acquiring a majority ownership position in a company, either through foreclosure or debt for equity swap, to make a tender offer for the entire capital of the company or repay unsecured creditors.

4.10. Conclusions

126. **The goal of timely asset resolution although widely accepted has proven difficult to achieve in practice.** The authorities in countries hit by financial crisis have moved quickly to establish resolution frameworks based on international best practice including strengthening their insolvency regimes and introducing procedures for informal out-of-court debt restructuring. Yet their banks remain clogged with NPLs and economic growth remains sluggish.

127. **Global experience, however, provides useful insight into common problem areas.** While each country's individual circumstance is unique and requires tailor-made solutions, certain common problem areas have emerged. These include:

- Failure to force banks to recognize losses and strengthen their capital in a timely manner coupled with an unwillingness to close or restructure those that fail to comply;
- Failure to provide banks with the proper tools to effectively resolve loans including restrictions on ownership of foreclosed assets, issuance of guidelines for proper loan restructuring and greater guidance regarding the criteria to upgrade and return restructured assets to an accrual basis;
- Failure to allow borrowers who wish to restructure in an out-of-court proceeding to take advantage of certain treatments (debt forgiveness without the creation of phantom income, cancellation of leases, etc.) available in an insolvency proceeding;
- Restrictions relating to changes in corporate ownership as they relate to foreclosure by creditors;
- Lengthy delays coupled with excessive fees to obtain regulatory approval for corporate actions undertaken in the course of a restructuring.

128. **Despite country efforts, findings from the banks survey indicate that there are hurdles to effective out-of-court restructuring in several countries.** Reasons often cited for banks' reluctance to conduct workouts include adverse tax consequences of debt write-offs and debt forgiveness, legal prohibition against the tax and social security authorities (who are typically a major creditor) to participate in out-of-court workouts, prevalent corporate fraud (e.g., use of a shell or mirror company to hide assets), problems with multi-creditor coordination evidenced by inability to bind in holdouts, debtor's failure to provide all relevant information, lengthy and costly foreclosure procedures, lack of trust in the judiciary and other stakeholders such as insolvency administrators and bailiffs, distrust among parties especially of small borrowers vis-à-vis their banks, absence of debt-equity swap options, and absence of fresh working capital funds to finance firms during standstills.

129. The failure to properly align tax and regulatory regimes to support the restructuring process plays a significant role in impeding the process. This is particularly true in times of systemic crisis when there is the need to restructure a multitude of borrowers within a relatively short period of time. Tax and regulatory changes, therefore, should be addressed upfront and incorporated into the resolution framework. Failure to do so may make a restructuring transaction economically unfeasible for one or both parties. As a result, many debtors who could otherwise be restructured are forced to enter formal insolvency proceedings, increasing the likelihood of their liquidation.

130. Changes, however, should be targeted in nature and based on a thorough knowledge of the nature and dynamics of asset resolution, institutional capacity constraints, as well as an objective understanding of the underlying problems of the borrowers. During periods of systemic financial crisis, debtors and creditors alike will lobby for those revisions providing the most favourable treatment. Wholesale abandonment of existing rules and regulations is unlikely to be warranted. Rather, changes should be targeted in nature with a focus on the removal of key impediments. This requires detailed knowledge of the resolution process, the scope of distress, and the true nature of the distress. Resolution programs which are undertaken without such detailed knowledge seldom succeed as they are prone to frequent “ad hoc” revisions as unanticipated problems arise.

CHAPTER 5: RECOMMENDATIONS

5.1. Removing obstacles while leaving NPL resolution to banks

- **In most CESEE countries, concerns about financial stability or general over-indebtedness should not unduly stand in the way of swift NPL resolution.** Additional bank losses from debt restructuring cannot be ruled out, but they should generally be manageable given considerable provisioning and strong capitalization, although this would need to be confirmed by national supervisors. A pickup of credit growth following the NPL resolution would be mostly unproblematic given that in most sectors and in most countries levels of indebtedness of households and companies are generally low. Nevertheless, looking forward, ensuring the sustainability of credit developments throughout economic cycles will be an important issue on the policy agenda in CESEE countries.
- **Achieving swift NPL resolution requires a proactive and cooperative approach.** The subdued economic outlook for the region means that delinquent borrowers will continue to struggle and that collateral values will remain at depressed levels. Instead, debtors, creditors, and government authorities, including financial supervisors, all need to roll up their sleeves to address the NPL problem. There are substantial benefits from a cooperative approach. When a debtor is truly overextended, both, creditors and the debtor benefit from a partial debt write down. However, making it happen requires cooperation between the various creditors and the debtor, as well as regulatory, tax, and legal systems that do not stand in the way. More broadly, any restructuring spurs economic recovery, thereby also helping lift the value of collateral backing other loans.
- **The working group recommends a comprehensive approach to addressing the NPL problem.** This is particularly pertinent for countries with very high NPL ratios. Countries where NPLs are relatively low and are expected to remain so, can afford a more selective approach, although they too would benefit from removing obstacles as they apply. Given the multiple dimensions of the NPL problem, efforts should be pulled together in a national plan under a private-public task force that makes NPL resolution a priority. Besides the banking association, the task force should comprise regulators, tax authorities, the central bank and the justice ministry.

5.2. Establishing a conducive legal framework

- **Debt enforcement should be strengthened.** Shortcomings that need most urgent addressing will be country-specific, but common themes are: supporting more “self-help” enforcement, introducing simplified procedures to enforce secured claims efficiently, and encouraging the use of small claims procedures.
- **To improve the resolution of household debt, personal insolvency laws should be enhanced** to provide financially responsible individuals with the opportunity for a “fresh start.” The introduction of debt counselling services and information campaigns to encourage debtors to approach their banks early to find a solution to their payment problems should also be considered. More generally, financial consumer protection should be strengthened to help avoid that households purchase unsuitable financial products that give rise to problems down the road – including NPLs–.

- **It should be ensured that insolvency systems and proceedings are efficient and effective** so as to facilitate the efficient exit of unviable firms and the reallocation of economic resources to more productive uses, as well as avoiding undue low loan recoveries.
- **The institutional capacity of the justice system should be strengthened.** This would naturally be a continuous medium-term effort. In the shorter run it would help to set and enforce statutory deadline for court proceeds, along with conducting an audit of backlog cases and collecting data on court performance to pinpoint particular bottlenecks as well as data on out of court processes. Longer term, the emphasis should be on encouraging the use of alternative dispute resolution, and establishing a well-regulated system of professional enforcement officers, bailiffs and insolvency administrators. Better training judges on financial matters would also be useful.

5.3. Removing tax impediments

- **Tax authorities should move quickly to end discrimination against NPL resolution in tax codes.** Any changes should be implemented upfront, so as not to create disincentives for NPL resolution in anticipation of future tax relief. Associated tax revenue losses will need to be assessed as they might necessitate compensatory measures elsewhere. Key features of a non-discriminatory tax code are: close alignment of the income tax treatment of provisioning, restructuring, and asset sales with their treatment for regulatory and financial purposes; exemption of asset sales and transfers from VAT; and provisions to ensure that debt relief in genuine restructurings does not attract income tax.

5.4. Removing regulatory obstacles

- **Regulatory reforms should target the removal of restrictions on taking control of collateral and other corporate assets by debtors and asset management companies,** as well as removing obstacles to the creation of Asset Management Companies and Special Purpose Vehicles.
- **Regulators should move ahead with successively tightening supervision, with an emphasis on realistic collateral valuation and asset classification.** Ensuring adequate classification and provisioning of restructured loans to avoid ever-greening will be particularly important. In some cases, such a proactive supervisory approach may need to also consider recent regulatory and funding pressures facing banks in Europe.

5.5. Enabling out-of-court restructuring

- **Going-concern restructurings should be facilitated.** In this regard, fast-track court approval for consensual restructuring agreements reached before initiation of insolvency proceedings, stays on all enforcement actions while safeguarding secured creditors' interests, and priority status for new financing are all critical. Clear filing thresholds for initiating insolvency proceedings would encourage early action and thereby increase the chances of successful rehabilitation.
- **Out-of-court restructuring frameworks should be improved.** Governments should develop guidelines in line with best international practices (the "London Approach" and INSOL Principles). Information campaigns to encourage out-of-court restructurings should be considered.

5.6. General approach

- **Local banking associations should push the collective effort to resolve NPLs forward.** They should pledge to attain ambitious, time-bound targets. Their authority and peer pressure would serve to galvanize the membership into action. The public sector can do its part, including by initiating the task force.
- **Direct government intervention into NPL resolution should be avoided.** It risks incurring substantial fiscal costs, if NPL resolution is subsidized, or, if it is not, undermining credit culture by retroactively changing the terms of credit contracts through government fiat. While circumstances can arise where such direct intervention is justified, the bar for bringing them into play should be set high, and their structuring should aim to avoid market distortions and negative effects on the payment culture. Public communication should also avoid giving signals that may affect the payment culture.
- **NPL resolution should be accompanied by heightened data transparency, so that progress can be tracked and analysis improved.** Central banks or supervisory authorities should publish monthly data on NPL ratios with a breakdown into the main categories, such as corporate loans, consumer loans, and mortgages, as well as currency denomination. Given the absence of an international standard for NPL definition, it would be instrumental to accompany such data releases with metadata that explain in some detail what is considered an NPL for the purposes of national reporting. Financial stability reports could usefully put an emphasis on NPL developments and keep track of progress in removing obstacles. Efforts to harmonize NPL definition across jurisdictions would facilitate their understanding and avoid misinterpretation of risk levels.

ANNEX 1: WORKING GROUP PARTICIPANTS

Participant	Organization
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Markus Schwaiger	OeNB
Host countries	
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Vesselka Petkova	Bulgarian National Bank
Ludmila Vojevoda	Financial and Capital Market Commission, Latvia

ANNEX 2: DETAILED RESULTS OF THE NPL SURVEY IN AGGREGATED FORM

	No. of countries	
	Yes	No
1	<i>The summary of the answers to yes/no questions</i>	
	Participation rate 12/21 = 62 percent	
	<i>NPLs definition</i>	
2	13	0
	NPL definition accounts for the total amount of defaulted outstanding loans (not only for due instalments and interests, e.g. in case a loan becomes impaired, the entire loan has to be assigned as non-performing - not only the overdue part)	
3	13	0
	NPL definition employs 90 days overdue threshold	
4	10	3
	NPL's classification criteria takes into account also other elements than number of days overdue	
5	13	0
	NPLs include loans gross of provisions (not net of provisions)	
6	8	5
	Collateral and guarantees are not taken into account in the definition of NPL statistics	
7	7	6
	NPL's definition is currently based on classification of the loans *	
a	5	8
	NPLs correspond to "substandard, "doubtful" and "loss" loans	
b	2	11
	NPLs correspond to "doubtful" and "loss" loans	
c	0	13
	NPLs correspond to "loss" loans	
d	0	13
	NPLs correspond to "watch", "substandard", "doubtful" and "loss" loans	
8	Treatment of restructured loans	
a	5	7
	Restructured loans continue to have the same overdue status as before restructuring	
b	6	6
	There is a determined period after which the restructured loan returns to "standard" status (e.g. after 1 Y)	
9	Customer view for the NPL definition is employed (if the customer is in default in one transaction, other transactions with the customer are considered as defaulted as well)	
a	7	6
	Customer view for the NPL definition is employed for non-financial corporations	

b	Customer view for the NPL definition is employed for private households	6	7
10	Product view for the NPL definition is employed (if the customer is in default e.g. on unsecured loan, his mortgage is not considered as defaulted)		
a	Product view for the NPL definition is employed for non-financial corporates	7	5
b	Product view for the NPL definition is employed for private households	7	5
11	NPLs cover non-financial corporations	13	0
12	NPLs cover private households	13	0
13	NPLs cover also other (than private households and non-financial corporations) sectors (i.e. public sector, non-bank financial corporations, etc.)	11	0
<i>NPLs Reporting</i>			
14	NPLs statistics are publicly available in central bank/regulatory authority statistics	11	2
15	NPLs statistics are publicly available in central bank/regulator authority statistics in the form of data series	10	2
16	NPLs statistics are publicly available in central bank/regulator authority publications only in the form of charts	1	11
17	NPLs statistics are reported only within the financial stability report providing background numbers	1	12
18	NPLs statistics are reported only within the financial stability report in form of charts without background numbers	1	12
19	NPLs to non-financial corporations are publicly available	12	1
20	NPLs to private households are publicly available	11	2
21	NPLs for other (than private households and non-financial corporations) sectors (i.e. public sector, non-bank financial corporations, etc.) are publicly available	8	4
22	Split into categories according to loans' classification is available for current NPLs statistics	7	5
a	Watch loans are publicly available	6	6
b	Substandard loans are publicly available	8	4
c	Doubtful loans are publicly available	8	4

d	Loss loans are publicly available	8	4
23	Sectoral breakdown for NPL to non-financial corporations is publicly available (eg. agriculture, manufacturing etc.)	5	8
24	NPLs in FX (or linked to FX) are publicly available	5	8
a	NPLs in FX to non-financial corporations are publicly available	5	8
b	NPLs in FX to private households are publicly available	5	8
d	NPLs in FX to other (than private households and non-financial corporations) sectors (i.e. public sector, non-bank financial corporations, etc.) are publicly available	5	8
25	NPLs for different products are publicly available	5	8
a	NPLs for mortgages to non-financial corporations are publicly available	1	12
b	NPLs for mortgages to private households are publicly available	6	7
c	NPLs for consumer loans are publicly available	7	6
26	Gross inflow of NPLs is publicly available		
a	Gross inflow of NPLs to non-financial corporations is publicly available	0	13
b	Gross inflow of NPLs to private households is publicly available	0	13
c	Gross inflow of NPLs other (than private households and non-financial corporations) sectors (i.e. public sector, non-bank financial corporations, etc.) are publicly available	0	12
27	Statistics on restructured loans are publicly available	4	8
28	If restructured loans are classified as “standard loans” (after a certain period), are the data on total restructured loans published	3	9
29	Statistics on stock of provisions are publicly available		
a	Statistics on stock of provisions are publicly available for corporates	3	9
b	Statistics on stock of provisions are publicly available for private households	3	9
30	NPLs of the domestic banking sector are publicly available on unconsolidated basis (not covering NPLs by foreign subsidiaries)	5	7

Credit Register

31	Credit register is available	11	1
a	Credit register for non-financial corporations is available	11	1
b	Credit register for private households is available	11	1
32	Credit register for non-financial corporations is operated by the central bank/regulatory authority	9	3
33	Credit register for private households is operated by the central bank/regulatory authority	9	3
34	Credit register coverage (threshold on minimum loan sizes)		
a	100 percent coverage (no threshold on minimum loan sizes)	5	5
b	Coverage more than 80 percent (in terms of total outstanding amount)	4	6
c	Coverage more than 60 percent (in terms of total outstanding amount)	1	9
35	Credit register is used to generate aggregate statistics on NPL developments for publicly available statistics	4	9
36	Credit register can be used to generate required aggregate statistics on NPL developments (available interface and tools allow obtaining statistics in real time)	8	5

* Based on the proposal of the Institute of International Finance (IIF) aimed at helping to improve cross country comparisons, five categories of loans are commonly used for reporting purpose—standard, watch, substandard, doubtful and loss loans. Their precise definition varies, however, significantly among countries.

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