Group Work: Developing a National NPL Resolution Strategy

Economic Framework Conditions

Your country has been struggling with growing financial imbalances. A decade of strong economic growth was accompanied by the rapid growth of credit to non-financial companies and households alike. House prices peaked in 2018 but started to decline in 2019, dropping 5% from the peak, and demand for new houses has shrunk. Property developers started to face an increasing stock of unsold homes and banks have become more cautious in originating new mortgage loans. In the fourth quarter of 2019, the economy started to contract (by 0.5% year-on-year) and unemployment started to pick up.

During the years of strong growth, public finances have improved, with public debt falling to 65% of GDP. However, tax inflows started to decrease in late 2019, in line with falling economic activity.

In late 2019, most analysts considered this period of economic weakness temporary and expected growth to return to over 2% in 2020. These expectations changed abruptly after the outbreak of COVID-19 in early 2020. The government imposed strict social distancing measures and forced many small firms to close temporarily. As a result, GDP contracted by 10% in 2020 and is expected to shrink by another 6% in 2021 before increasing again by 5% in 2022. Public debt increased to over 85% of GDP by the end of 2020 and is expected to peak close to 100% of GDP in 2021.

The Debt Management Agency (DMA) is very concerned about upcoming debt redemptions. Total financing needs (covering the deficit and rolling over existing debt) over the next 12 months stand at almost 25% of GDP. So far, the DMA has managed to roll over maturing bonds. The benchmark 5-year bond yield increased, however, by 150 basis points to 500 basis points between 2019 Q4 and 2021 Q1. Average cover of bond auctions by investors declined from 2.5x in 2019 Q4 to about 1.2x in 2021 Q1. The share of domestic banks in the take-up at auctions doubled from 35% to 70%.

Financial Stability and Banking Issues

Economists at the Central Bank are very concerned about the severe and protracted slowdown of the economy, including the state of the property market. Internal notes from the Financial Stability Department suggest that the net flow of new mortgage loans has been negative since late 2019, and that residential (commercial) real estate transaction prices (as opposed to listed prices used to compile the official index) declined by more than 20% (35%) from the peak in highly illiquid markets. They conclude that bank-provisioning ratios may not reflect the expected drop in residential real estate (RRE) and commercial real estate (CRE) prices, suggesting that further losses have already crystallized in bank balance sheets, but are not yet recognized in financial statements.

According to official data by the Banking Supervision Department of the Central Bank, asset quality in the banking sector is of increasing concern. The NPL ratio was estimated at 9% of total loans before the outbreak of the pandemic.[1] There are, however, clear indications in the market that, since 2019, banks have restructured loans on a significant scale to avoid payment defaults. It is questionable whether these restructuring were conducted in a sustainable manner.

At the start of the pandemic, the government introduced far-reaching payment moratoria that are still in place, significantly reducing the signalling properties of data on early arrears and NPL flows. There is, however, market intelligence that restructuring activity further intensified during the pandemic. In real estate markets, several large property developers are struggling to make payments to suppliers and these struggles have attracted public attention. Defaults of small- and medium-sized enterprises have gone up too, with about 7% of loans to SMEs being non-performing in late 2019. Since the start of the pandemic, around 40% of all SMEs already made use of the governmental payment moratorium.

Three major banks dominate the market and account for 90% of total assets of the banking system. An on-site inspection by the Central Bank, which is also the national bank supervisor, of Omnibus Bank in late 2019, a major universal bank and the third largest player in the market, found that Omnibus Bank systematically misclassified problem loans as performing loans and advanced funds to property developers in dubious financial condition. The inspection team also concluded that the bank has no experience and capacity to manage problem loans. Some of these findings have been leaked to the press. Reports about other banks, alleging that these banks did not follow prudent banking practices either, also have surfaced in the media. Since the start of the pandemic, the Central Bank suspended all on-site inspections, including follow-up work on the irregularities at Omnibus Bank and the suspected malpractices at other banks.

The developments in late 2019 led to a bout of risk aversion in financial markets. Local currency has come under selling pressure, and lost almost 20% of its value versus the US Dollar until 2020 Q2. The exchange rate has stabilized since and banks have been able to roll over foreign funding, on which they became increasingly dependent during the boom years. Rolling over foreign funding was greatly facilitated by a US dollar funding facility by the Central Bank. Large redemptions of foreign funding are, however, due next year and the Central Bank indicated that it is likely to scale back its US dollar funding support towards the end of 2021, in view of declining foreign currency reserves.

You have the following supervisory information about the situation of the three major banks in your country. Further information is available in the data pack at the end of the handout.

Omnibus Bank

Several years of fast growth and acquisitions have left the bank strongly reliant on wholesale funding. This has been obtained mainly from foreign sources using short-term commercial paper and medium-term notes. The bank has about 4 billion of foreign funding maturing by the end of 2021, and another 8 billion in the subsequent year.

[1] NPLs are defined as loans 90 days past due, or loans that have been impaired under the accounting standards.

The bank has been profitable and has been able to distribute dividends each year until and including 2019 (the Central Bank prohibited dividend payments in 2020). Equity investors have praised management at the recent Annual General Meeting, although some concerns about the future ability to pay dividends were expressed. The investors were also concerned about the slow pace of operational integration of two smaller banks acquired in 2018 and 2019, which has been delayed by the pandemic.

Omnibus Bank recently approached several private equity funds with an offer to buy some CRE-backed NPLs from its book. It received some bids standing between 30% and 35% of gross book value of these loans. The equity fund managers explained this low bid price, saying that they had no confidence in the estimated value of the underlying collateral given the lack of recent comparable transactions and doubts about the data accuracy of the underlying loans.

National Commercial Bank

The bank has been losing market share over the last few years to more aggressive players, who were more willing to use foreign short-term funding to fund new loan origination. However, it managed to build a very strong position in the CRE lending market, and is the largest provider of commercial property loans in the country. Although National Commercial Bank's reputation has traditionally been solid, its lending policies have been 'adjusted' (arguably loosened) since 2017/18 to maintain its share in the CRE market. The bank was the lead lender (around 60% of the loan) in several high-profile, multi-lender CRE deals at the peak of the market.

Just before the start of the pandemic, a Central Bank on-site inspection team arrived to review distressed loan exposures. They have been enquiring about loans to large developers, in particular, and have collected some tentative evidence that debt-restructuring practices were not prudent before the inspection was suspended due to the outbreak of COVID-19. Off-site follow-up work provides further indications of overvalued collateral estimations.

The bank has about 2 billion of foreign funding maturing over the next 12 months. Most of this is structured as covered bonds backed by residential mortgages. However, the bank is also using about 500 million in short-term funding via repos backed by government bonds, and a large book of domestic corporate deposits.

Progressive Bank

Progressive Bank has been very profitable and successful in gaining market share in the last few years. In fact, in 2018 it was awarded the title of Best Asian Bank by Ollie Layman, a management consultancy firm. It has been praised for its efficient use of capital and ability to offer competitive lending terms to customers.

However, since 2019, Progressive Bank has been having mounting problems. A Central Bank on-site inspection team required Progressive Bank to book additional provisions in 2019, and to increase its reported NPL ratio to 14%. This was related in particular to performing corporate and CRE loans for which Progressive Bank extended maturities to better match the cash flows to sales of the borrowing companies. The inspection team had a very pessimistic view on property valuations underlying the SME and CRE book.

Bank management, while having reservations about the findings, decided to comply with the request of the mission. That caused the Common Equity Tier 1 (CET1) ratio to drop to just above 9%. The Central Bank's Supervision Department is highly concerned about the upcoming roll-over of about 1 billion in medium-term notes maturing later this year.

Your Task

The Central Bank Governor recognized that asset quality issues in your country's banking system deserve further scrutiny.

Up to now, experience with NPL resolution in your country is rather limited. Unsecured consumer loans and loans to (very) small companies are normally resolved (mainly written off) by the originating institutions (often microfinance organizations). A smaller part is sold to specialized, small domestic NPL investors, which have a bad reputation for their tough recovery practices.

Foreign NPL investors have repeatedly considered entering the growing market in your country but are deterred by the low quality of loan data and the complex legal environment.

There are no public or private Asset Management Companies (AMCs) operating in your country and experience with securitization is very limited, although the Central Bank and the Ministry of Finance are generally keen to support the development of market-based finance.

Your working group is asked by the Governor to develop proposals for an appropriate policy response to the asset quality problems in your country and the expected further rise of NPLs due to the COVID-19 pandemic!

More specifically, you are asked to:

- **(i) Propose three to four policy actions to address the asset quality issues in the main banks of your country**
- **(ii) In doing so, you need to look at the impact of these measures:**
  - **On each of the three main banks**
  - **On public finances in your country (the Ministry of Finance needs to be 'on board')**
  - **On loan flows and the prospects for economic growth**

On the last day of the training, you should be prepared to briefly present your ideas and explain how they would help to deal with the NPL problem outlined in the case study.

For each group: Please prepare one 10 min presentation, for which you may use slides. You may choose to divide the delivery of the presentation among 1-3 members of the group.

Balance Sheet Data for the Three Main Banks in Late-2020

While over 50 banks are licensed in your country, the three largest institutions have a combined market share of over 90%. These three banks are universal institutions, owned by private domestic shareholders.

The minimum capital requirement used to stand at 6% CET1. In 2019, the Central Bank increased this to 8% to reassure the public and investors that banks are sound and in good condition.

Latest financial data of these three banks are available in Table 1 below. To put bank size and NPL stocks into perspective, the GDP of your country stood at 50 billion in 2020.

Table 1. Balance Sheet Data for the Three Main Banks in Late-2020

Ratio	**Omnibus Bank**	**National Commercial Bank**	**Progressive Bank**
Total assets	50bn	40bn	30bn
Of which			
Corporate and SME loans	*12bn*	*6bn*	*9bn*
CRE loans	*14bn*	*15bn*	*8bn*
Mortgages	*10bn*	*11bn*	*3bn*
Return on equity (12-month trailing)	6.4%	6.6%	2.2%
CET1 ratio	10.5%	13.2%	9.4%
NPL ratio	7%	8%	14%
Provision coverage ratio	37%	40%	48%
Loan-to-deposit ratio	154%	105%	122%
Insured deposits	23bn	19bn	14bn
Short term wholesale funding *	4bn	2bn	4bn
Change in share prices (last 3 months)	-17%	-14%	-29%

* Short-term = under 1-year maturity