

ADB Virtual Training Course on NPL Resolution for IPAF Members and DMC Officials

Session 10: COVID-19 Related Measures Impacting NPL Resolution

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Session Overview

1. Impact of lockdowns on NPL resolution
2. Impact of “low for long” interest rates on NPL resolution
3. Impact of government loan guarantees on NPL resolution
4. Impact of payment holidays and other means of loan forbearance on NPL resolution
5. Impact of bank forbearance on NPL resolution

Initial observations

1. The various measures undertaken by governments, central banks, and banking supervisory authorities to address the COVID-19 pandemic undoubtedly have an impact on the level and trend of NPLs.
2. The question before us is – do the measures have an impact on the resolution of NPLs?
3. We're going to assume that NPLs have been identified, but not necessarily accurately valued. ***Timely and accurate identification and valuation of NPLs is the starting point for quick and effective resolution. We can take into account the effect of the COVID-19 measures on the incentives banks have to identify and value NPLs timely and accurately.***
4. Government debt has significantly increased in many jurisdictions. Therefore, governments may be less able to support NPL resolution (such as providing start-up capital to AMCs) than in the past.

Impact of lockdowns and travel restrictions on NPL resolution

- **Lockdowns and travel restrictions had a disproportionate effect on sectors:**
 - Sectors hardest hit were real estate, retail, restaurants, oil and gas, equipment manufacturing, transport, travel, leisure, and hospitality sectors
 - Concentration of NPLs in sectors may allow for greater specialization and expertise in workouts and loan sales, leading to better recoveries
 - In commercial real estate, however, there may be a lingering impact from “work from home” leading to a glut of foreclosed properties
 - Assets related to aviation and shipping may also take a long time to sell
- But lockdowns and travel restrictions, if they last for many more months, may make market price trends hard to discern and appraisals and inspections of foreclosed properties hard to carry out, delaying NPL resolution.
- On the positive side, lockdowns may have produced a “savings glut” because consumers are unable to spend.

Impact of “low for long” interest rates on NPL resolution

- **Interest rates are low by historical standards in most jurisdictions, owing to the “savings glut” and accommodating monetary policy.**
 - **Low interest rates help distressed borrowers service their debts, aiding NPL resolution**
 - **Low interest rates may, however, disincentivize banks to collect on NPLs, because returns on other assets are low, decreasing opportunity costs, but –**
 - **Low interest rates, if they create extreme pressures on bank profitability, may incentivize banks to speed up NPL collection.**
- **The “savings glut” itself could make capital available to stimulate investments in NPLs**

Impact of government guarantees on NPL resolution

Government guarantees have been extensively used throughout the COVID-19 crisis.

Estimates in the Euro area are that €853b in new loans were distributed to SMEs in 2020 and a significant portion were government guaranteed.

In the U.K., £92b in government-guaranteed loans were distributed to 1.6m borrowers and it's estimated that 35-60 percent might default.

Some programs provide for the replacement of loans with grants, in which case there is no issue of NPL resolution, but there may be a heightened fiscal burden.

What could be the impact of these government guarantees on the resolution of these NPLs?

- Loans carrying a government guarantee may be difficult to resolve if the bank has been relying on the guarantee rather than originating the loan and monitoring the borrower's performance according to best practices of credit risk management. ***If the guarantee is then lifted, the bank could be stuck with a loan to a borrower about which little information has been collected and little monitoring has been performed.***
- Some jurisdictions have recently been reporting that banks have made conditions stricter for obtaining loans, even government-guaranteed loans. ***These loans should be easier to resolve.***

Impact of payment moratoria on NPL resolution

Let's start with a definition of default...

Possible definition: Guidelines on the new Definition of Default ('DoD') (EBA/GL/2016/07) by the European Banking Authority (EBA)

If either or both of these conditions are fulfilled, a loan is considered in default:

- Days past due (DPD): ***More than 90 DPD on any principal, interest, or fees***
- Unlikelihood to pay (UTP) indicators: ***Used to indicate a heightened concern that some or all of the amounts owed to the bank will not be paid.***
- Note: UTP indicators are sometimes oddly stated – refer to actions that the bank takes, rather than actions/inactions of borrower or financial condition of borrower

Impact of payment moratoria -- Unlikely to Pay criteria

The specific list of “UTP Indicators” includes mainly **the establishment of a specific credit risk adjustment (specific LLA)*, sale of the loan at a loss*, distressed restructuring*, and bankruptcy of the borrower.** Other indicators are as follows, with (*) denoting actions taken by the bank:

- (a) a borrower’s sources of recurring income are no longer available to meet the payments of installments;
- (b) there are justified concerns about a borrower’s future ability to generate stable and sufficient cash flows;
- (c) the borrower’s overall leverage level has significantly increased or there are justified expectations of such changes to leverage;
- (d) the borrower has breached the covenants of a credit contract;
- (e) the bank has called any collateral including a guarantee*;

Impact of payment moratoria -- Unlikely to Pay criteria (contd.)

- (f) for the exposures to an individual: default of a company fully owned by a single individual where this individual provided the institution with a personal guarantee for all obligations of a company;
- (g) for retail exposures where the default definition is applied at the level of an individual credit facility, the fact that a significant part of the total obligation of the obligor is in default;
- (h) the reporting of an exposure as non-performing in accordance with [reference to a specific European Commission regulation*];
- (i) significant delays in payments to other creditors have been recorded in the relevant credit register;
- (j) a crisis of the sector in which the counterparty operates combined with a weak position of the counterparty in this sector;
- (k) disappearance of an active market for a financial asset because of the financial difficulties of the debtor;
- (l) the bank has information that a third party, in particular another institution, has filed for bankruptcy or similar protection of the obligor

Impact of payment moratoria -- Unlikely to Pay criteria (contd.)

- (m) credit fraud;
- (n) default of a connected client with “contagion” to this particular borrower;
- (o) borrower’s source of income is no longer available;
- (p) borrower’s leverage has increased significantly;
- (q) borrower has given a guarantee to another borrower who has already defaulted;
- (r) there are significant delays in payment by this borrower to other creditors;
- (s) granting of concessions by the bank that do not meet the criteria of a “material distressed restructuring” (large lump-sum payment at the end, significantly lower payments at the beginning, significant grace period at the beginning, borrower has already experienced distressed restructuring)*

What is a “distressed restructuring”? First we need to talk about “forbearance”

Definition: A bank displays “forbearance” toward the borrower and the loan is considered to be “forborne” when:

- ✓ **The borrower is experiencing financial difficulties AND**
- ✓ **The bank agrees to a “concession” that it wouldn’t otherwise consider**

What is a “concession”? What forms can it take?

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Common forms of concessions extended to borrowers:

- ✓ **Extending the loan term (say, from 3 years to 5 years before principal is due)**
- ✓ **Rescheduling the dates of owed principal and interest**
- ✓ **Granting periods of non-payment (payment moratoria, grace periods)**
- ✓ **Decreasing the interest rate**
- ✓ **Adding missed payments to the loan balance (capitalization of interest)**

What is a “concession”? What forms can it take? (contd.)

Common forms of concessions extended to borrowers:

- ✓ **Forgiving or waiving (partial) interest or principal payments (decreases the outstanding principal balance of the loan, not permitted in some jurisdictions)**
- ✓ **Changing an amortizing loan (where principal is paid off in stages together with interest payments) to an interest-only loan with balloon payment at end**
- ✓ **Releasing collateral or accepting lower levels of collateral or lower quality of collateral**

Difference between restructuring and rescheduling

Restructuring and rescheduling are also not often precisely defined:

- **Rescheduling is viewed as a type of restructuring, but this language is not precise.**
- **Easier to think of *rescheduling* as pushing out required payments further into the future (without cutting payments fully or partially), while *restructuring* means actually cutting payments by lowering interest rate or waiving principal**

Bringing it back full circle: definition of “distressed restructuring”

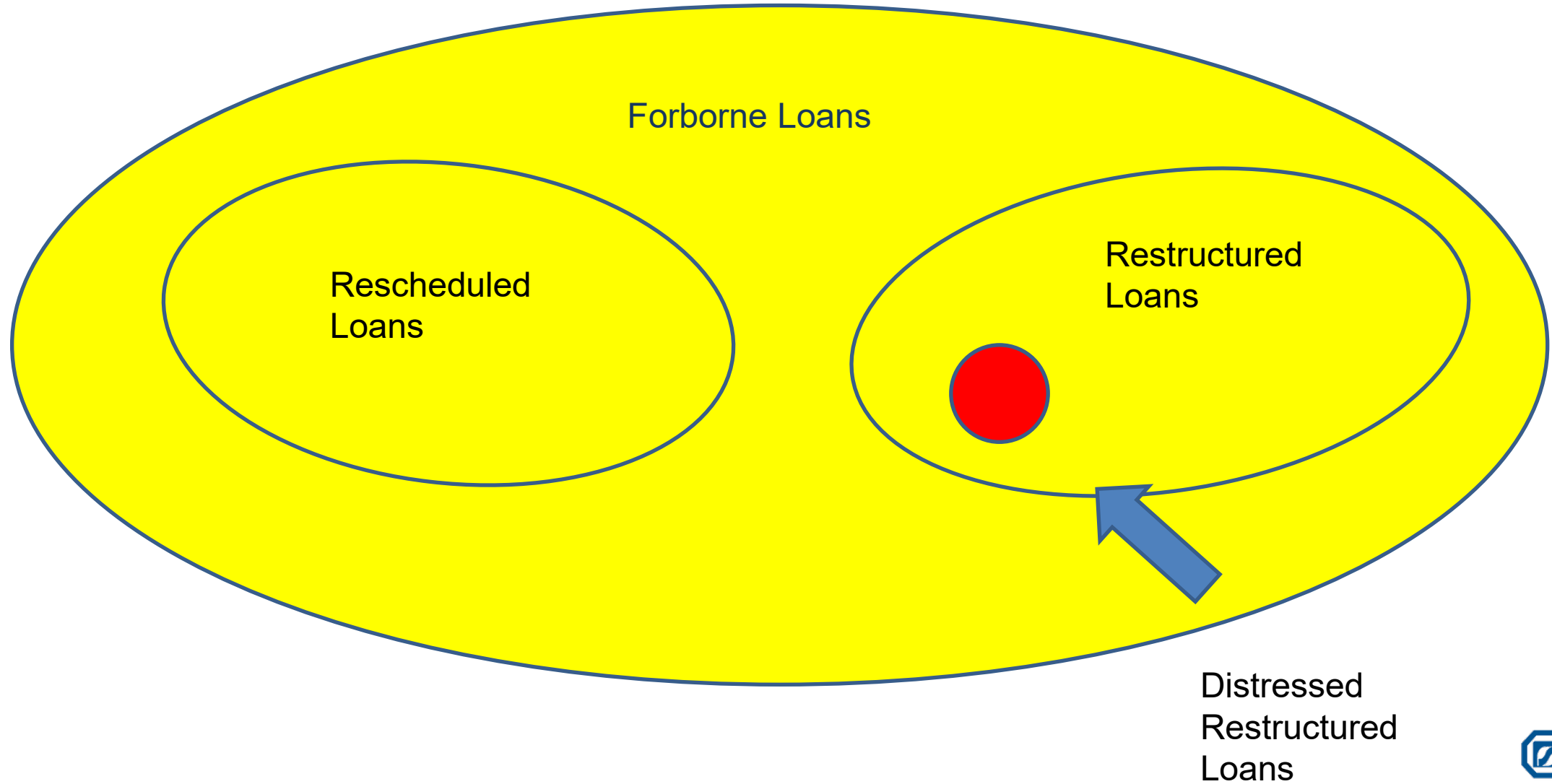


Illustration of “diminished financial obligation: a review of NPV

Net Present Value										
Discount Rate	10.0%									
Year	1	2	3	4	5	6	7	8	9	10
Discount Factor	0.91	0.83	0.75	0.68	0.62	0.56	0.51	0.47	0.42	0.39
Undiscounted Cash Flow	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	11,000
Present Value	909	826	751	683	621	564	513	467	424	4,241
Net Present Value	10,000									
Discounted Value	91	174	249	317	379	436	487	533	576	6,759

This is a 10-year loan for SSP 10,000, with interest payments of SSP 1,000 at the end of each year, including the last year when the principal is repaid. NPV = SSP 10,000. No diminished financial obligation.

Illustration of “diminished financial obligation: payment deferral

Net Present Value										
Discount Rate	10.0%									
Year	1	2	3	4	5	6	7	8	9	10
Discount Factor	0.91	0.83	0.75	0.68	0.62	0.56	0.51	0.47	0.42	0.39
Undiscounted Cash Flow	-	-	-	-	-	2,000	2,000	2,000	2,000	12,000
Present Value	-	-	-	-	-	1,129	1,026	933	848	4,627
Net Present Value	8,563									
Discounted Value	-	-	-	-	-	871	974	1,067	1,152	7,373

Same loan for SSP 10,000, but interest payments of SSP 1,000 have been deferred for the first five years, and made up in the last five years. NPV = SSP 8,563, more than a 1% decline. Diminished financial obligation and distressed restructuring/default declared.

Illustration of “diminished financial obligation: payment deferral but additional payments made

Net Present Value										
Discount Rate	10.0%									
Year	1	2	3	4	5	6	7	8	9	10
Discount Factor	0.91	0.83	0.75	0.68	0.62	0.56	0.51	0.47	0.42	0.39
Undiscounted Cash Flow	-	-	-	-	-	2,610	2,610	2,610	2,610	12,610
Present Value	-	-	-	-	-	1,473	1,339	1,218	1,107	4,862
Net Present Value	9,999									
Discounted Value	-	-	-	-	-	1,137	1,271	1,392	1,503	7,748

Same loan for SSP 10,000, but interest payments of SSP 1,000 have been deferred for the first five years, and made up with some additional payments in the last five years. NPV = SSP 9,999. No diminished financial obligation, therefore no distressed restructuring and no default.

What's the relevance of these concepts for accounting and reporting?

- **A forbore loan will not necessarily be a defaulted loan or a non-performing loan.**
 - **New payment schedule should consider borrower's ability to pay**
 - **Loan is not defaulted if there has been no diminished financial obligation**
 - **Loan could still be non-performing, though – must go through “cure period” of at least 3 months to demonstrate that borrower can pay according to the new terms.**
 - **Bank should not modify loan in such a way that borrower is not required to make any payment for a long time.**
 - **“Performing forbore” loans will usually be in Stage 2 of IFRS 9 categorization, while “non-performing forbore” will usually be in Stage 3**
- **If a loan is considered in default and there is a diminished financial obligation:**
 - **IFRS 9 will require a specific loan loss allowance equal to the expected credit loss (on a present value basis)**
 - **The loan will be considered a non-performing loan for regulatory reporting purposes (and for disclosure in audited financial statements, if required)**

How do the COVID-19 loan modifications fit into this framework?

- **Many jurisdictions have offered voluntary loan modifications to borrowers as a result of COVID-19. These can be called payment holidays, or payment moratoria.**
 - **These payment holidays can be mandated by legislation or offered by central banks (or stand-alone regulatory agencies), bankers' associations, or even individual banks.**
 - **The borrower can continue to make the payments under the pre-COVID terms, if willing and able.**
 - **Banks usually required to distinguish between borrowers that were viable before COVID-19 (with good credit standing) and those that were not viable (or bad credit standing) – the latter should not get a payment holiday.**
 - **Durations of payment holidays usually 6-12 months – some are already expiring**
- **As payment holidays expire, banks are asked to grant forbearance more on a case-by-case approach.**

How do the COVID-19 loan modifications fit into this framework? (contd.)

- **There are several implications of the COVID-19 modifications:**
 - **Holiday periods are not counted toward days-past-due for those borrowers who accept the payment holidays.**
 - **Loans will not be considered as defaulted, forborne, or non-performing.**
 - **For IFRS 9 calculations of loan-loss allowances, auditors, regulators, and banks are encouraged to be “flexible” – but depends on structure of payment holidays (some will result in lower NPV of payments)**
 - **But banks must continue to assess borrowers’ ability to pay throughout the period, whatever payment schedule is agreed upon.**
- **Important: Many governments have provided loan guarantees (especially for SME loans). These may be taken into account in determining LLA, but NOT for categorization of loans as NPLs, forborne, defaulted, etc.**

Other difficulties posed by COVID-19 on NPL resolution

- **There may be limited access to borrower financial data and accurate collateral valuations. Some collateral resale markets (e.g., hotels) might have completely shut down.**
- **Banks may have to rely on alternative data such as monthly bank statements to show cash in/cash out and assess borrower liquidity.**
- **Government assistance programs to borrowers may be complex to analyze and may change often, resulting in frequent changes to loan-loss allowances and default probabilities.**
- **It's even more difficult than usual to predict cash flows and distinguish between solvent and insolvent borrowers.**
- **Foreclosure moratoria – otherwise justified on grounds of preserving neighborhoods, social stability, or maintaining households intact – may delay the final resolution of an NPL.**
- **Although vaccines have helped, the outlook for key industries is still very uncertain (especially hotel, restaurant, retail), as is the progression of the virus and the possibility of additional severe shutdowns.**

The impact of bank forbearance on NPL resolution

- **For this discussion, “bank forbearance” means that the supervisory authorities allow a bank to operate with less than the usual minimum amount of capital and/or liquidity (drawing down the buffers and even becoming undercapitalized).**
- **Undercapitalized banks may be reluctant to provision properly or to offload their NPLs and incur additional reported losses.**
- **Allowing banks to draw down their capital or liquidity buffers may also lessen pressure on banks to collect or work out their NPLs (banks are not as dependent on cash flows from collections or sales of foreclosed properties).**
- **To avoid these potential problems, supervisors should continue to pressure banks to address their NPL issues – through examinations asset quality reviews (if possible, given the constraints of no onsite work), stress tests, and transparent accounting rules.**
- **Instead of bank forbearance, supervisors and resolution authorities may elect to prioritize the takeover of weak banks by strong banks.**

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