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Introduction to Secondary NPL Markets

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ADB Virtual Training Course on NPL Resolution

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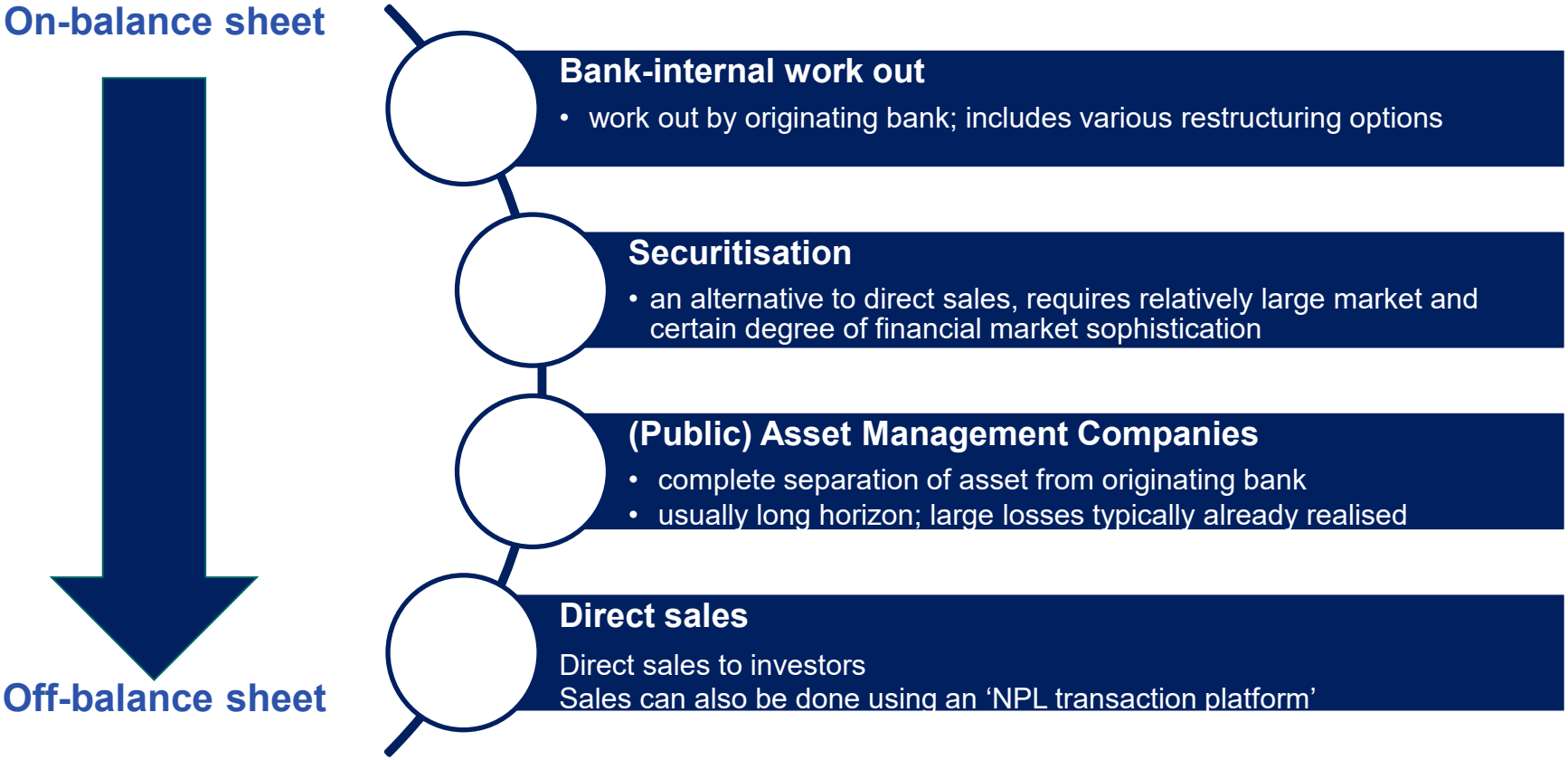
The views expressed here are exclusively those of the presenter and to not necessarily reflect the position of the JVI or the ADB.

Outline

1. Secondary NPL Markets – A taxonomy
2. Supply and Demand Side Constraints, Market Failures
3. Bid-Ask Spreads and Policy Approaches

1. SECONDARY NPL MARKETS – A TAXONOMY

Policy options and impediments



2. SUPPLY AND DEMAND SIDE CONSTRAINTS, MARKET FAILURES

Supply- and demand-side constraints

- **Supply-side impediments**
  - Insufficient provisioning and inability to absorb losses (breach of capital thresholds);
  - Lack of internal bank capacity to resolve NPLs;
  - Reputational costs for first-movers;
  - Accounting rules allowing recognition of interest income on NPLs (which may be high when predating the current low-interest environment);
  - Tax disincentives (when provisions and write-offs are not tax-deductible);

Supply- and demand-side constraints

- **Demand-side impediments**
  - Lack of available, high-quality, standardized data; asymmetric information in favour of banks;
  - Barriers to entry for new buyers, limiting market deepening;
  - Lack of sufficient servicing capacity: only concentrated on large portfolios and mature markets;
  - Tax rules:, transfer tax, VAT on loan servicing

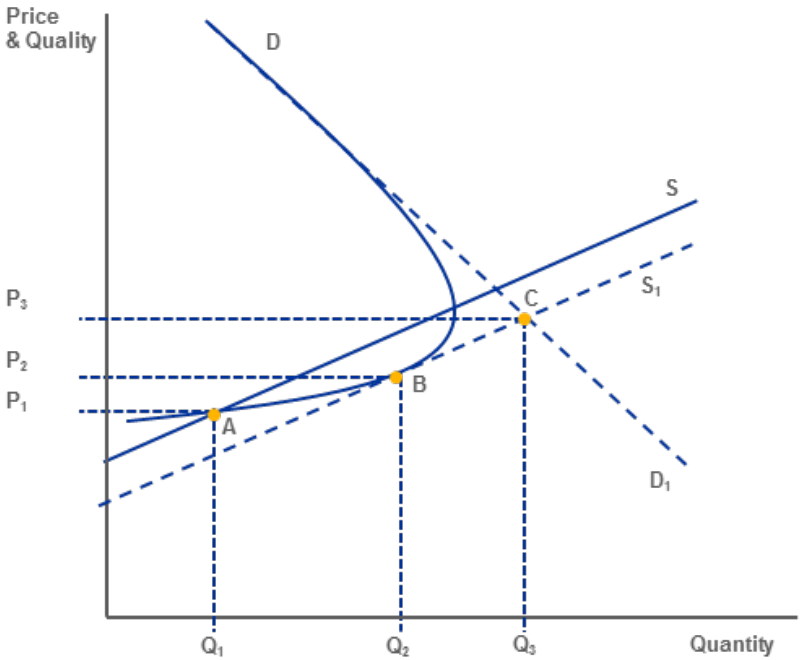
- **Structural impediments**
  - Supervision and regulatory regime;
  - Legal regime: insolvency laws, collateral enforcement etc.;
  - Capacity and knowledge of judges and insolvency office holders.

Market failures - NPL markets for 'lemons'

- **Akerlof's (1970) market for lemons**
  - demand as function of price and average quality of goods being traded

- **Informational asymmetries**
  - insufficient or costly data; ineffective legal frameworks; capacity constraints for servicers; cherry-picking behaviour

- **Evidence in NPL markets?**
  - Until recently, limited market activity relative to supply
  - Initially mainly unsecured consumer loans traded - at very low prices



Market failures - Oligopsonistic markets

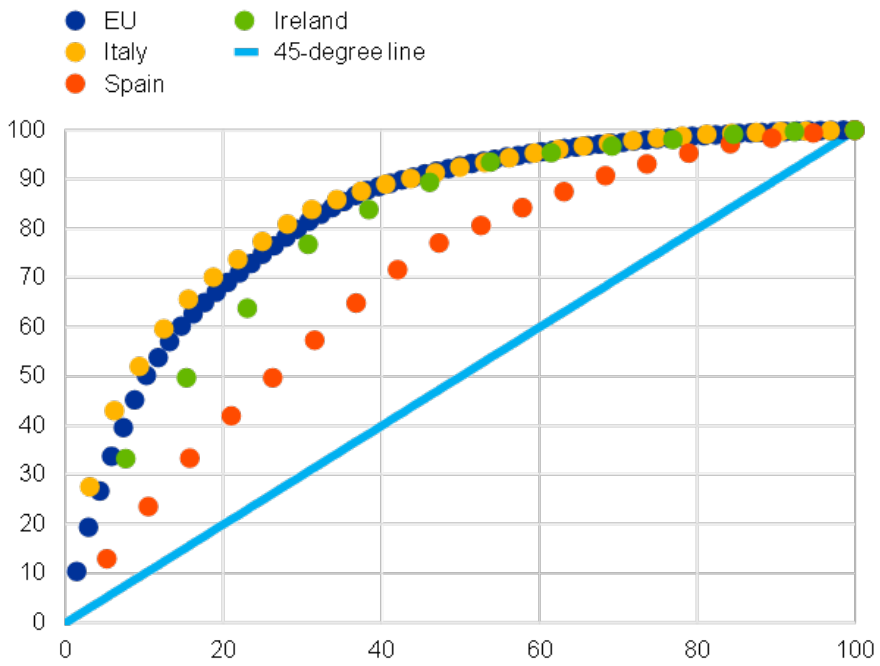
Oligopsony:

- Market dominated by few buyers
- Concentration of market power
- Significant barriers to entry,
- Significant due diligence costs
- Typically lower traded prices
- BUT, limited alternatives for banks (internal workout often costly, supervisory pressure, capital shortage)

Evidence for oligopsony in NPLs?

- Small number of large buyers

Cumulative market share of investors in NPLs (2015-2017)
x-axis: percentage of investors,
y-axis: percentage of turnover)



Market failures - Imperfect excludability

Effective control of NPL often not conferred to a single individual, given that:

•The NPL's debtor may have multiple creditors; performing & non- performing loans

•The buyer of the impaired loan may not have exclusive access to the resources of the debtor, but may have to compete with other creditors

•Coordination among creditors tends to be complicated (misaligned incentives) & costly

Evidence in NPL market:

•NAMA, Ireland's Asset Management Company, successfully employed debtor-level approach, capturing all exposures of a single debtor, including performing and out-of-scope (non-CRE) exposures

Bringing it all together

Large parts of the NPL market (especially for more complex NPLs) are intransparent.

This creates high costs for investors and substantial barrier to entry.

In addition, investors can often not be sure of exclusive rights to debtors.

Implications of the combination of these three market failure are:

- wide bid-ask spreads and low market liquidity / limited transaction volume
- banks without sufficient managerial capital buffers to take the losses associated with NPL sales may not be able to afford to sell

3. BID-ASK SPREADS AND POLICY APPROACHES

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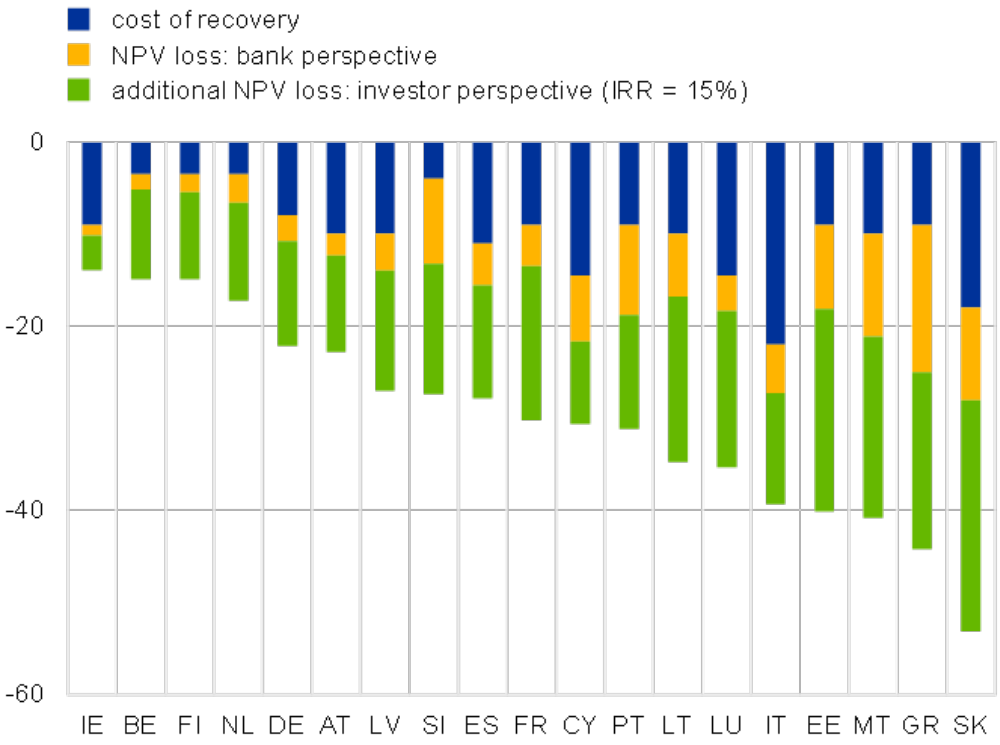
Bid-Ask Spreads in Secondary Markets - Europe

Difference between net book value and estimated bid price

- Bid-ask spread in NPL markets is not directly observable
- A private investor may require a discount above 40% even on fully secured loans according to estimates
  - Source: Fell, Grodzicki, Martin and O'Brien (2016), "Addressing market failures in the resolution of non-performing loans in the euro area", Special Feature B in Financial Stability Review, ECB, November 2016.



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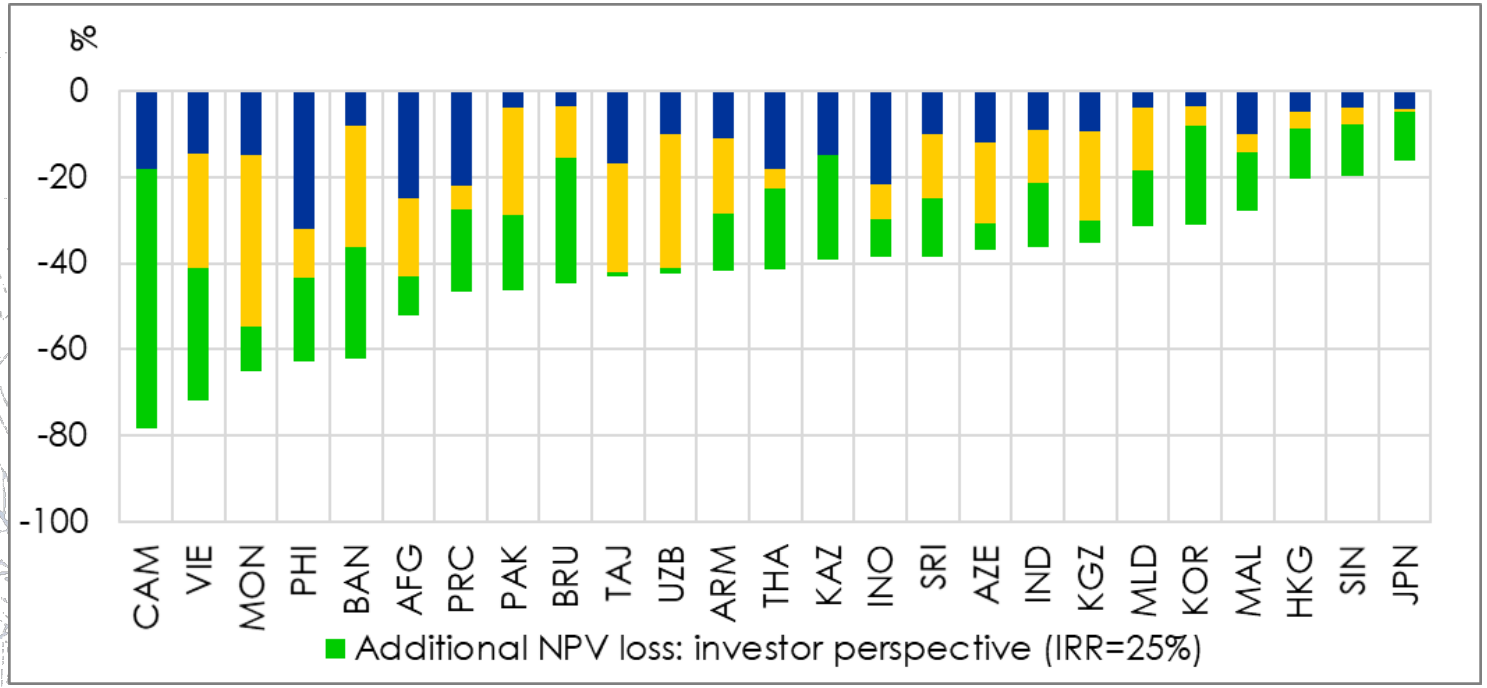
Bid-Ask Spreads in Secondary Markets - Asia

Difference between net book value and estimated bid price



Notes: AFG = Afghanistan; ARM = Armenia; AZE = Azerbaijan; BAN = Bangladesh; BRU = Brunei Darussalam; CAM = Cambodia; HKG = Hong Kong, China; IND = India; INO = Indonesia; IRR = internal rate of return; JPN = Japan; KAZ = Kazakhstan; KOR = Republic of Korea; KGZ = Kyrgyz Republic; MAL = Malaysia; MLD = Maldives; MON = Mongolia; NPV = net present value; PAK = Pakistan; PHI = Philippines; PRC = People's Republic of China; SIN = Singapore; SRI = Sri Lanka; TAJ = Tajikistan; THA = Thailand; UZB = Uzbekistan; VIE = Viet Nam.
For Cambodia and Kazakhstan, only the total NPV loss is reported without being separated between bank perspective and investor perspective. The bank lending rate data is not available in these countries.

Source: Lee, Park, Park, and Rosenkranz (2021)

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Policy Approaches to Reduce Bid-Ask Spreads

EU NPL Action Plan (2017)

Supervision

- Clarify **supervisory powers** as regards bank provisioning policies (completed)
- Consider **prudential provisioning backstops** for new NPLs (completed – CRR amendment in April 2019)
- Implement **guidance on NPLs for LSIs** and for non-SSM member states (final EBA GL published in Oct 2018)
- EBA Guidelines on **loan origination and monitoring** (expected in Q2 2020)

Macroprudential solutions

- Develop approaches to **prevent the future emergence of system-wide NPL problems** (ESRB report in January 2019)
- Develop a **blueprint for national AMCs**, consistent with EU legal framework (State aid rules, BRRD) (published in March 2018)

Secondary markets

- Issue **disclosure requirements** on asset quality (EBA proposal)
- **Strengthen the data infrastructure** with uniform and standardised data templates for NPLs (published in Dec 2017)
- Consider the setting-up of **NPL transaction platforms** (COM SWD published on 28 Nov 2018)
- **Remove impediments to the transfer of NPLs** by banks to non-banks and simplify the licensing requirements for third-party loan servicers (new directive in trilogue stage)

Insolvency frameworks

- Publish the results of the **benchmarking** exercise on the efficiency of **national loan enforcement regimes**
- Consider to carry out dedicated **peer reviews of national insolvency regimes**
- Analyse the possibility of **enhancing the protection of secured creditors** (COM proposal)

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Thank you for your attention!

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