Macroeconomic implications of non-performing loans

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In my short intervention I will focus on the macroeconomic implications of non-performing loans.

In the wake of the 2008 financial crisis, many EU countries experienced substantial increases in the ratios of non-performing loans (NPLs), as their economies entered into deep recessions. Despite numerous efforts to address the problem, impaired assets have reached unsustainably high levels in some Member States.

How serious is the NPL problem? At European level, non-performing loans as a share of total bank loans (NPL ratio) currently amount to almost 6%. This average, however, hides a significant difference across Member States. Most large EU countries have managed to contain their NPL ratios at around 3% or less. By December 2015 non-performing loans in Romania amounted to about 15% of total loans. The NPL ratios in Romania's peers for the same reference period were comparable: 13% in Croatia, 14% in Bulgaria and in Hungary. Since then, the NPL ratio in Romania has decreased further to currently 13.5%. Non-performing loans in Greece were about 47% of total loans by December 2015, in Cyprus 49%. In absolute numbers non-performing loans in Europe are close to 1 trillion euro or 9% of EU GDP.

Due to the significant order of magnitude of impaired bank assets and their extensive macroeconomic impact, non-performing loans are at the centre of the discussion on economic and financial stability risks in the EU.

Their resolution is important not only to spur credit growth, but also for the creation of jobs and to promote sustainable growth.

In this regard the Romanian example is very telling. Faced with rising NPLs, Romania has managed to achieve a strong reduction in distressed assets. This experience can be a good basis for the good-practice discussions in the panels today.

Now moving on to the macroeconomic impact of NPLs:

Non-performing loans weigh on the supply of credit and thus on investment and growth via a number of channels: (i) locking-in bank capital into unviable projects, (ii) reducing bank profitability, and (iii) distorting capital allocation.

Non-performing loans lock in bank capital in the financing of non-productive assets for long time periods. This results in less available funding for new lending. Reducing NPLs is therefore crucial for freeing up bank capital and making resources available for credit growth, especially to small and medium-sized enterprises which usually rely more on bank financing.

NPLs also reduce bank profitability, which results in higher funding costs and consequently in subdued loan supply. The need to provision for NPLs and higher capital requirements on the non-provisioned part lead to lower returns on NPLs compared with performing loans. In addition, the costs of monitoring of distressed loans and borrowers increase the operating costs of banks. Furthermore, the risk premium on debt issued by banks with a high level of impaired assets is higher.

High NPL ratios are associated not only with lower credit supply, but also with a poorer allocation of credit. Banks – even those with a sound capital position – often lack the proper incentives to tackle non-performing loans. To delay loss recognition, banks may decide to wait for economic growth to improve their NPLs ratios. But delaying loss recognition also delays growth.

Banks are often also tempted to give prominence to loans that might otherwise become non-performing over new loans. Credit then ends with "zombie" companies at the expense of credit supply for new, viable projects.

Highly leveraged positions of households and corporations are the counterpart to NPLs in banks' balance sheets.

In Romania, as in many other EU countries with high NPL ratios, overdue loans are mostly concentrated in the corporate sector. In general, debt overhang weighs on firms' operating profits and depresses the incentives to invest, even in profitable projects. High debt not only makes companies more vulnerable to negative shocks. It also suppresses their readiness to invest in response to positive shocks. Low investment and the associated low aggregate demand imply low revenues for firms and therefore low income streams for both households and governments.

Empirical evidence shows that there is a significant and strong relation between the high levels of NPLs and credit and economic growth. On the one hand, credit supply constraints seem to reinforce the factors behind weak credit demand: the tightening of credit supply due to high NPL ratios raises the capital costs for households and firm and thus intensifies the private-sector debt overhang. Weak credit demand, on the other hand, reduces banks' profits and contributes to the persistence of non-performing loans.

Progress with NPL resolution could therefore free resources from non-viable companies and allocate these resources back to the capital market. Thus, addressing the high level of NPLs is crucial to boosting investment and supporting the economic recovery and growth in Europe.

Historically, high levels of NPLs have often declined over time as a result of inflation and economic growth. The current low growth and low inflation environment in the EU, however, makes the reduction of NPLs much more difficult. It weighs on bank profitability and reduces the availability of bank funding for investment.

High NPL levels thus remain on banks' balance sheets due to the unfavourable interplay between four factors: (i) low growth, (ii) cumbersome resolution processes, (iii) a lack of properly functioning secondary markets for NPLs and (iv) constrained financing positions of non-financial corporations, households and banks.

High NPLs levels also impair the monetary transmission mechanism to the real economy. As a result, despite the current unusually accommodating monetary policy, credit flows in most euro area countries remain subdued, thus weakening investment levels and growth.

The appropriate recognition and resolution of non-performing loans would free the bank lending channel and support credit growth. This is essential for restoring the health of the banking sector and supporting the recovery in the EU.

Turning back to the Romanian case, the implementation of the 2014 plan of the National Bank of Romania on the resolution of non-performing loans led to the significant decline of the NPL ratio at system level. In 2014 and 2015 the Romanian market was one of the most buoyant markets in Central and Eastern Europe for sales of impaired assets.

Despite the headway made at both national and European level, a number of structural obstacles to the successful resolution of non-performing loans in the

EU remain. Deficiencies in the supervisory and in the legal frameworks, underdeveloped markets for distressed debt, along with tax and informational obstacles have so far hindered banks in dealing more resolutely with NPLs.

The role of prudential supervision in encouraging banks to build higher capital buffers and to increase their coverage ratios by building up provisions is crucial for increasing banks' incentives to address NPLs. Thin capital buffers constrain banks' capacity to increase provisions and diminish the incentives to recognise existing losses.

Of even bigger concern for most banks are the difficulties in realising the collateral given weak debt enforcement frameworks and thin real estate markets.

Also, many banks lack the experience, resources and specialized skills to deal with the restructuring of certain types of bad loans. To address this problem, supervisors in several EU countries have issued formal guidelines on NPL management practices.

Among the legal obstacles to swifter debt resolution, the most serious shortcomings are inadequate insolvency regimes and ineffective debt enforcement. The efficiency of the institutional framework – in particular of the judiciary – also plays an important role here.

There are still no simplified and cost-effective corporate insolvency frameworks for SMEs. Personal insolvency regimes are also absent in many countries, mostly in the non-euro area countries. In addition to this, the implementation of insolvency laws is often slow and inconsistent. In this context, the Commission intends to propose new legislation on business insolvency by the end of 2016. The Economic and Financial Committee of the ECOFIN agreed last

week during its meeting in Helsinki to examine policies to improve insolvency frameworks.

Debt enforcement may take up to five years in some EU Member States. Weak debt enforcement raises the legal costs of debt restructuring and impairs the ability of banks to seize the loan collateral.

The European distressed debt market remains underdeveloped. One of the main reasons for the limited number of transactions is the large pricing gap between potential buyers and sellers of NPLs.

Information deficiencies and the lack of debt counselling also hinder the effective resolution of NPLs.

Finally, unfavourable tax treatment and in some instances even tax disincentives for loan write-offs hamper the adequate provisioning and resolution of non-performing loans. In addition, the privileged role of public creditors in debt restructuring may discourage banks from restructuring or foreclosing on a distressed debtor.

All these obstacles are closely intertwined. As a consequence, any successful strategy to deal with NPLs in EU Member States will likely need to contain a combination of several measures to remedy the situation.

In this sense, I'm very much looking forward to the presentations and the discussions today, to our debates on the good practices from the region and potential effective policy responses to non-performing loans in the EU.