Think Ahead ACCA

Tackling Non-Performing Loans

Lessons from the National Asset Management Agency (NAMA)

The Background

- Banking is a systemically important sector in any economy
- Providing credit is essential to develop commercial activity
- Interest on loans is the income generator for banks
- Providing a safe repository for deposits and savings is important
- It's a critical source of funds for banks
- These two functions (savings and loans) are complementary
- These are all the core functions of banks in an economy
- Being focussed on core functions, measuring and managing risk is the essence of good banking practice

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Banks are fragile

- Many banks collapsed e.g. Lehman, Anglo Irish Bank, Veneto Bank
- Even apparently strong banks are fragile e.g. BNP Paribas
- BNP Paribas has €40 billion of equity which is a big number in isolation
- BNP Paribas has assets of €1.69 trillion
- BNP Paribas has liabilities of €1.65 trillion
- However a deterioration of less than 2.5% of its assets would erase its equity
- The estimated value of subprime at the start of the collapse was $1 trillion
- Its not hard to see why this become a real crisis
- Maybe the €40 billion doesn’t seem so big now?

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Banking gone wrong

- Subprime lending
- Securitisation
- Lend to originate not to hold
- Herd mentality of lending
- Lack of focus on concentration risk
- Poor credit pricing – volume not rate lending
- Long term lending on short term sources of funds
- Collateral based credit decisions and not cash flow lending

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History of banking

Then

- Goes back to Venice in 1157
- Oldest existing bank is Monte dei Paschi di Siena - 1472
- Modern banking began in 1694 – Bank of England

Now

- Banking is in crisis – the oldest bank in the world recently needed a bail out
- Many European Banks (Italy particularly) still dealing with NPL's and undercapitalisation

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Key challenges in banking now

- Being able to lend sensibly – borrower appetite weak
- Keeping NPL and loans in default low
- Managing impaired assets optimally – ideally without default
- Meeting political desire to lend / employ / keep branches open
- Attracting deposits and capital
- Keeping pace with technology and reducing the cost base
- Generating a decent return to capital providers – difficult now
- Maintaining investor / money market confidence in capital position
- Optimally structuring capital – have enough but not too much!
- Deal with the demands of Basel III and IFRS 9

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Other peoples money

- Bad credit decisions can lead to the loss of other peoples money
- Burden sharing with bondholders and depositors has and will continue to happen – maybe!
- In other countries it has been the tax payers
- In Ireland the final cost of the bank recovery plan will be over €70 billion – landed on the taxpayers

- In Cyprus, depositors with more than €100,000 lost 47.5% of their deposits over and above the €100,000
- Pretty devastating for savers lodging money to the Bank of Cyprus

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State of banks

- Low expectation of future profitability in Europe
- Cost of equity will be high – 10% or greater
- Banks need higher margins, more technology, fewer branches, lower headcount – not all politically desirable!
- European banking RoE was 5.4% in 2016
- The return required is significantly higher than banking returns on equity
- Share prices likely to remain under pressure
- The poor margins in banking are down to a variety of factors

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Reasons for poor bank profitability

- Subdued macro-economic conditions
- Low interest rate environment
- Lower revenue from non interest income e.g. asset management, investment products
- Lower net interest income i.e. interest from loans net of funding costs
- High loan losses
- Increasing impairment provisions
- More expensive capital
- Greater levels of capital required

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Bank restructuring in Europe – a fudge?

- ECB said taxpayers should not be the first point of recourse for troubled banks
- They brought in new rules surrounding distressed banks
- Key is to determine if a bank is systemically important
- If S.I. then capital providers will face a bail in if public funds are injected
- If not S.I. then doesn't require to go through European Bank Recovery & Resolution Directive – so a bail in can be avoided! => can go to the taxpayer
- BRRD process mandates at least an 8% of all liabilities of a failing bank be covered before using public funds "bail in"
- Two Italian banks recently didn't have to get bail in => bonds and deposits were protected

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The banking crisis - why

- Political objectives which were overly ambitious – housing ownership
- High capital tax income from property boom
- Aggressive lending on foot of good returns on investment
- Credit risk relaxation
- Regulatory risk relaxation
- Banker incentives to lend and borrow more and more
- Weak regulatory control
- Low interest rates encouraging consumer confidence
- Asset price rises encouraging investment leading to a **BUBBLE**
- Fundamentally erroneous calculation of risk and credit rating
- A globally interconnected banking system – money markets being too accessible

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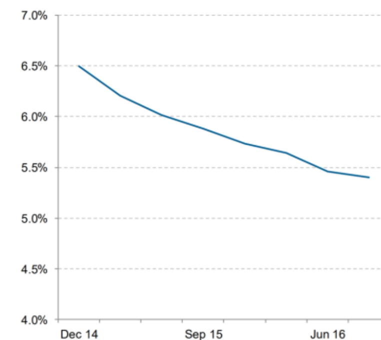
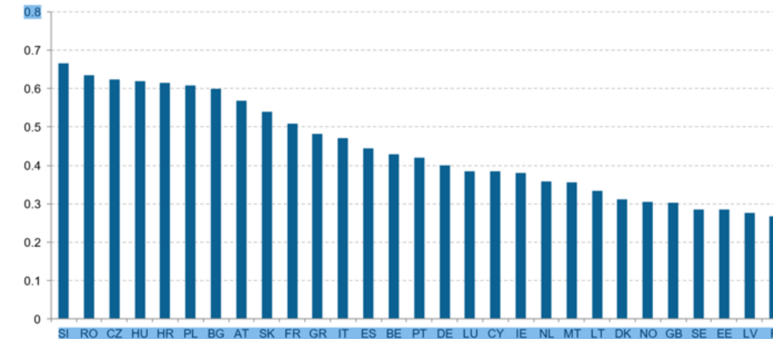
NPL’s in Europe

- Average rate of NPL’s in Europe is 5.4% of total loans
- US and Japan is about 2%
- Large variations in Europe – Finland c. 1% but Greece >50%
- Around Europe €921 billion of NPL’s (September 2016) – 9.2% of euro area GDP!!!
- Remains a real problem in European banking
- NPL’s take more monitoring & management, legal costs and funding costs
- Important to normalise NPL levels quickly



Source: EBA, own calculations



Source: EBA
Note: The coverage ratio is the share of the face value of the loan covered by loan loss provisions.

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NPL management better sooner than later – why?

- A huge overhang of NPL's means:
- Zombie Banks – not lending but trying to self repair NPL's
- The overhang of bad assets at high carrying values will not allow that to happen
- Assets half finished (deteriorating) - no credit to finish them
- Proper bank stress tests will not be passed
- Banks will come to government and ask for liquidity support
- If they don't get it there will be a run on the banking system
- But usually its solvency as well as liquidity is the issue
- So banks need to be cleaned up and not allowed to reoffend!

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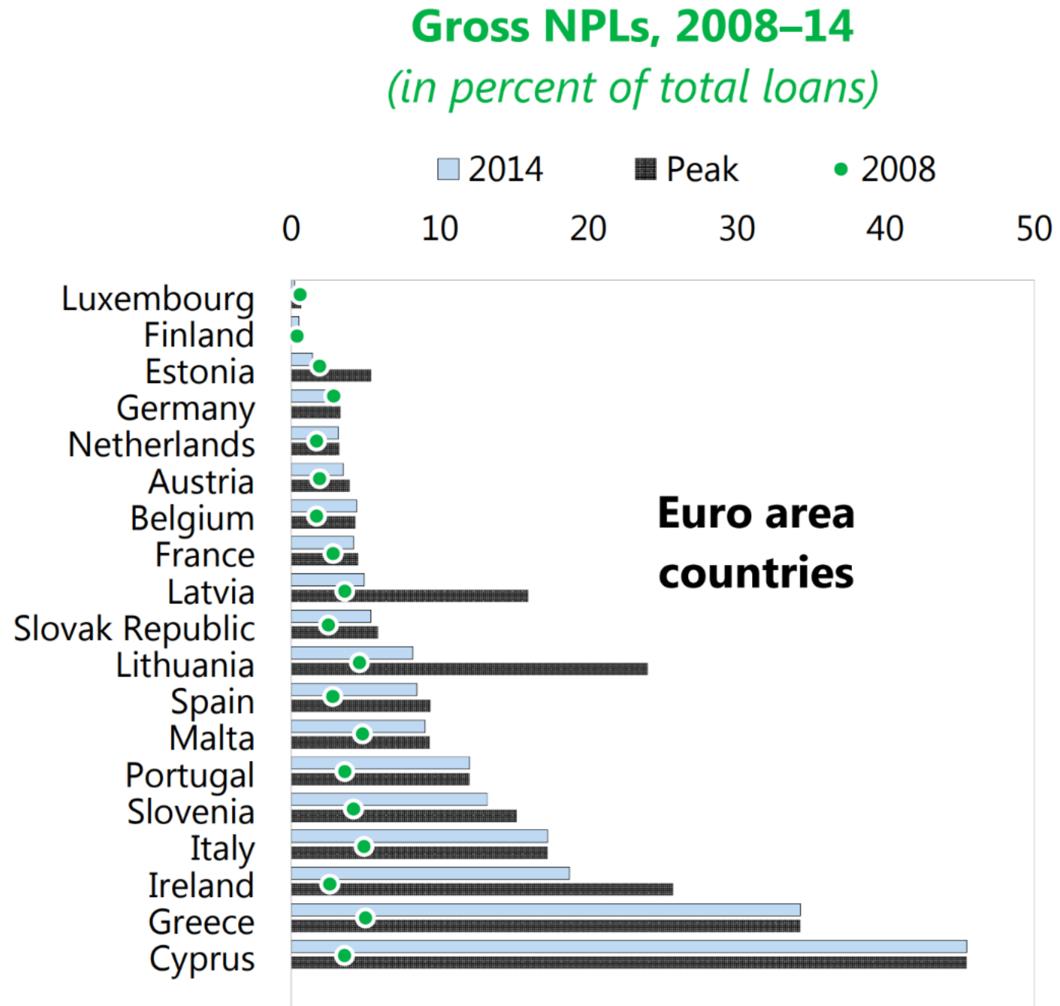
NPL Denial Ireland!!



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NPL – Irish Owned Pillar Banks Today

- €26 billion remain as NPL's – even after €74 billion taken out in 2010
- This represents 15.7% of total loans for these systemically important banks
- Other international banks also have high levels of NPL's
- Even in a European Country where the most decisive action was taken the NPL problem is prevalent
- 70% of those NPL have some level of impairment
- => 30% do not have an impairment provision
- ECB needs to ensure these loans are managed out in a timely way to normal levels

New Resolution Mechanism Euro Area – European Banking Authority

- Resolution occurs at point of failure or likely failure
- In compliance with EU Bank Recovery & Resolution Directive (BDDR)
- During GFC banks restructured using public funds “too big to fail”
- In future banks to be more stable & if not to be allowed to fail in an orderly manner if needs be – not taxpayers money
- Objective is to have a fast and predetermined basis of to protect critical stakeholders e.g. depositors, payments system, taxpayer
- Shareholders and debt holders will be first and predominately exposed
- Single Supervisory Mechanism part of Single Resolution Mechanism

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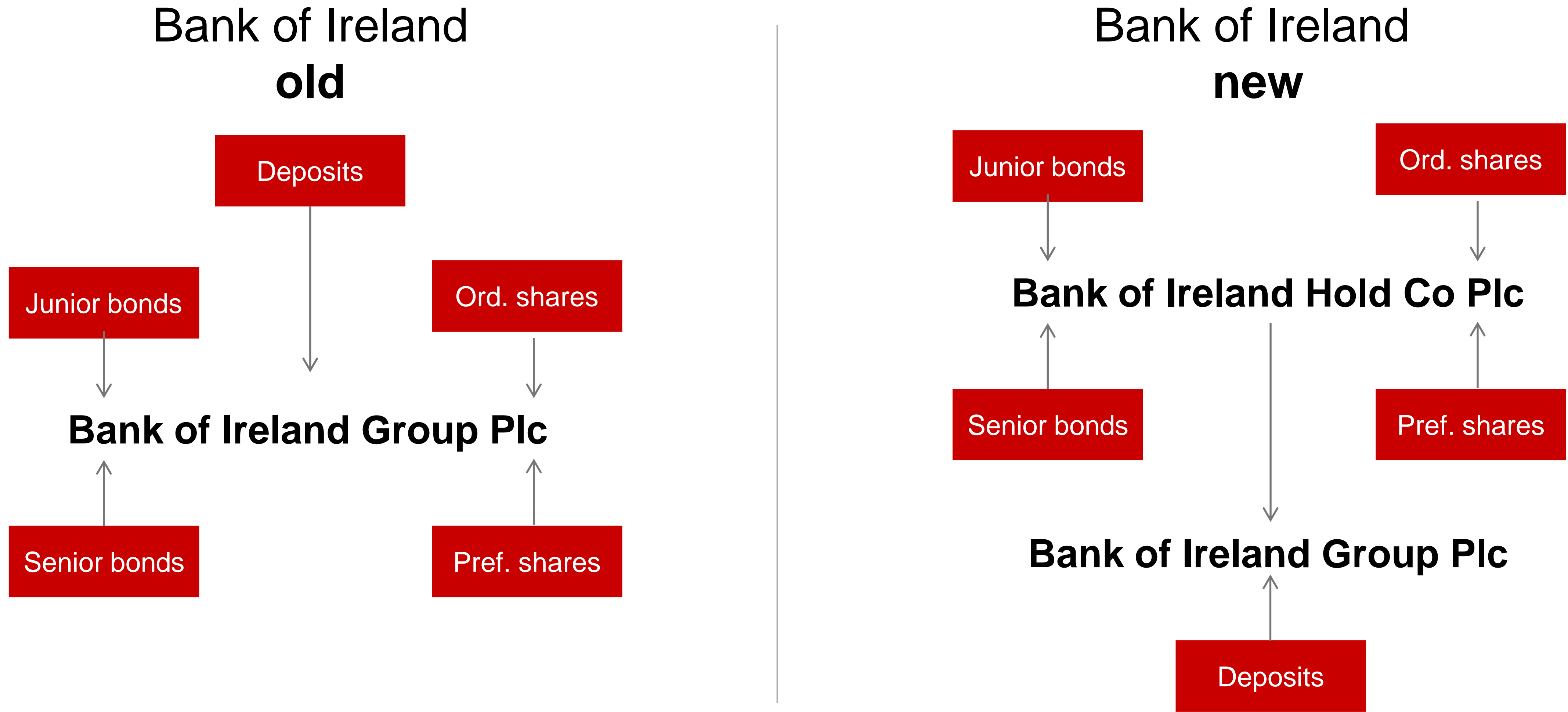
Example of Bank Restructuring required by EU Single Resolution Board



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BRRD – Key objectives

- Banks and authorities prepare for crisis
- National authorities are equipped with necessary tools to intervene
- National authorities have harmonised resolution tools
- Authorities co-operate effectively – particularly cross border
- Banks contribute to resolution financing
- Taxpayers are protected from bailing out banks in future
- Deposit holders are protected by not having them treated pari passu with senior bond holders

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Examples of interventions in EU through the EBA

Private sector acquisitions

- Parts of the bank an be sold to one or more purchasers without the consent of shareholders

Bail in creditors

- Cancel or reduce the liabilities of a failing bank, or convert debt to equity as a means of restoring the capital position

Use temporary structure

- Transfer business to a temporary structure (such as a bridge bank) to preserve essential banking functions and to allow continuous access to deposits

Separate good from bad

- Separate clean and toxic assets between 'good' and 'bad' banks through a partial transfer of assets and liabilities

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Strategies around NPL’s

The Bank’s strategy

- Banks may not be sufficiently capitalised to recognise loan losses
- They may want to wait for a recovery to make bad loans better
- They may choose to renew and restructure high risk loans to avoid taking the hit in the P&L and capital

European strategy ECB

- Improvement in insolvency regimes to expedite realisation of collateral & lower costs
- Encouragement of secondary market for distressed debt
- Enhanced bank solvency CET1 level of 13.4% and rising by 50 bps by end of 2016

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Considerations in NPL Management

- Step 1 – assess how bad NPL exposure is nationally
- Step 2 – look across all banks – same connections will borrow from many banks
- Step 3 – assess NPL work out (WU) capabilities
- Step 4 - Assess and plan for capital implications
- Step 5 – based on above develop NPL strategy including capability requirements and targets
- Step 6 – implementation of the plan
- If resolution is within banks ensure there is proper separation of performing and non performing divisions
- Ensure there is regular and deep oversight
- Ensure IT systems are strong to asset manage assets well

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NPL resolution environment

- Important to have an enforcement friendly environment
- Political will has to be supportive of clean up
- National or international NPL WU agencies have to be keen
- NPL WU firms bring the new capital and WU expertise
- Easier for NPL WU to implement enforcement than home banks
- Home banks often need new capital from Government anyway
- Ensuring there are not significant barriers to the enforcement to access underlying collateral
- Ensuring PG's can be pursued by the NPL acquirer – it can be important in loan work out.
- Important for banks / WU to take the opportunity while demonstrating forbearance of loan improvement e.g. security
- Important to have appropriate skills mix and ratio of asset recovery managers per connections

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Political challenges

- Developers with NPL's are often well connected politically
- They will resent any threats and acts of enforcement
- They will say NPL WU is fire selling the assets and not achieving value
- They will seek to get political intervention
- => legislative and governance support and framework for NPL WU has to be strong

- As the NPL WU does its job, the market will hopefully be in recovery
- This will by necessity mean some assets sold by WU will have increased for the purchaser
- Some will claim this is a sign of failure – it may in fact be the exact opposite
- Policy makers need to see and stick with the bigger picture
- Interference will lead to a disastrous outcome

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Means of Resolution – Separation & Nationalisation

Bradford & Bingley

Mortgage & investment portfolio nationalised

Sale of deposits & network

Queen as Sovereign – The UK Government nationalised Bradford & Bingley after selling off its deposits and branch network. UKFI a subsidiary of UKAR was until recently the 100% shareholder. Complete control of B&B was vested in the Government through its nominees. The Sovereign is in effect the capital underwriter / provider, as opposed to deposits and private shareholders.

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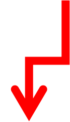
Means of Resolution – Capital Injection & Public Shareholding

Average Acquisition price £5.02



Current Share Price of £2.46

Management of good and bad loans left together.

RBS – briefly the world's largest bank. Needed additional capital. A rights issued failed and the Government injected £37 billion and acquired 81% shareholding. Today it still has over 70%. Pretty Glum alright.

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Means of Resolution – Good Bank & Bad Bank – Step 1

Worst nightmare

- 'Appalling' scale of the banking crisis revealed by Lenihan
- Will cost everyone €2,000 a year
- Insurance levy fear after Quinn goes into administration

INSIDE
Banks in crisis
Shoddy practices will cost us dearly
Lise Hand
In the land of Biffo-topia
Editorial
Comment

€74 billion of illiquid loans sold to new bad bank at CMV of €32 billion (this was in excess of CMV!!)

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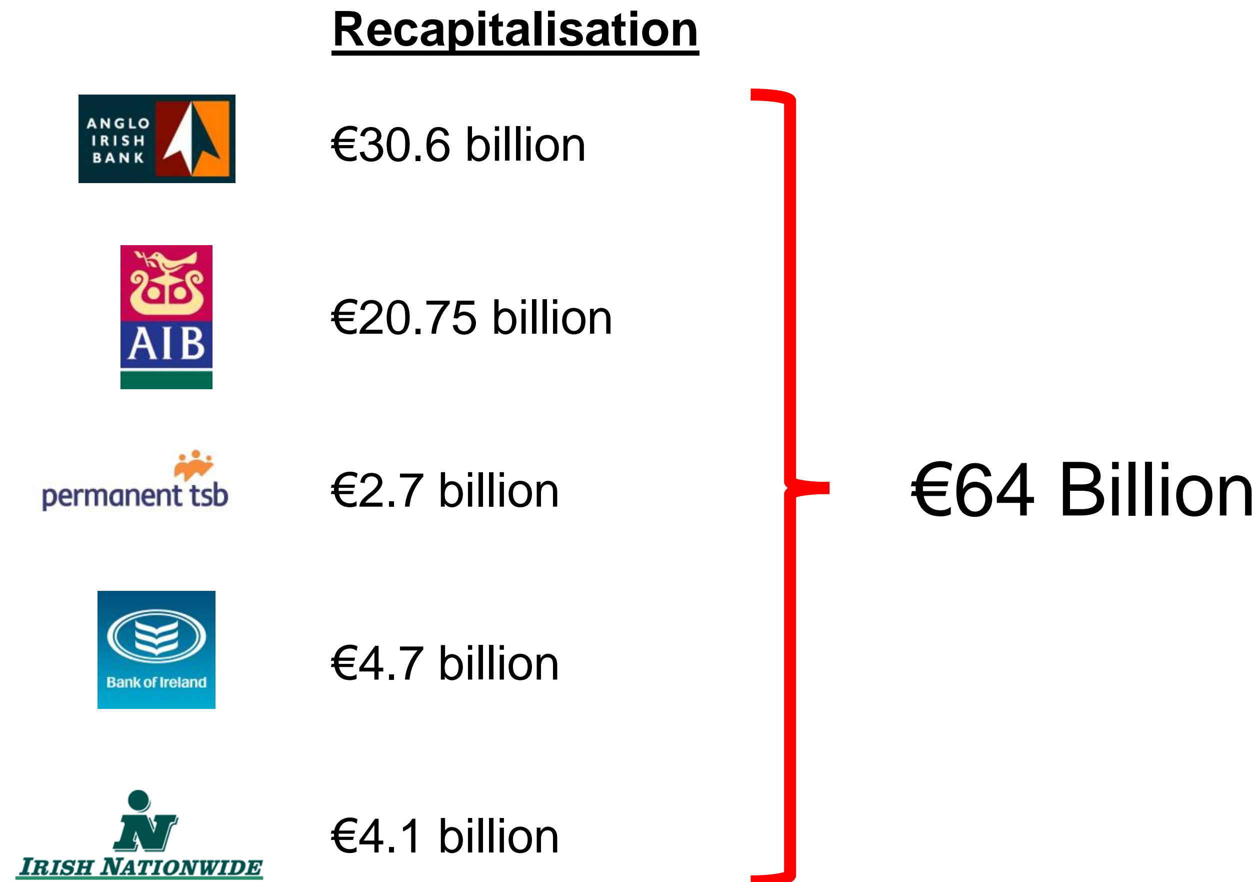
Means of Resolution – Good Bank & Bad Bank – Step 2



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Means of Resolution – Good Bank & Bad Bank – Step 2

Recapitalisation

€30.6 billion

€20.75 billion

€2.7 billion

€4.7 billion

€4.1 billion

€64 Billion

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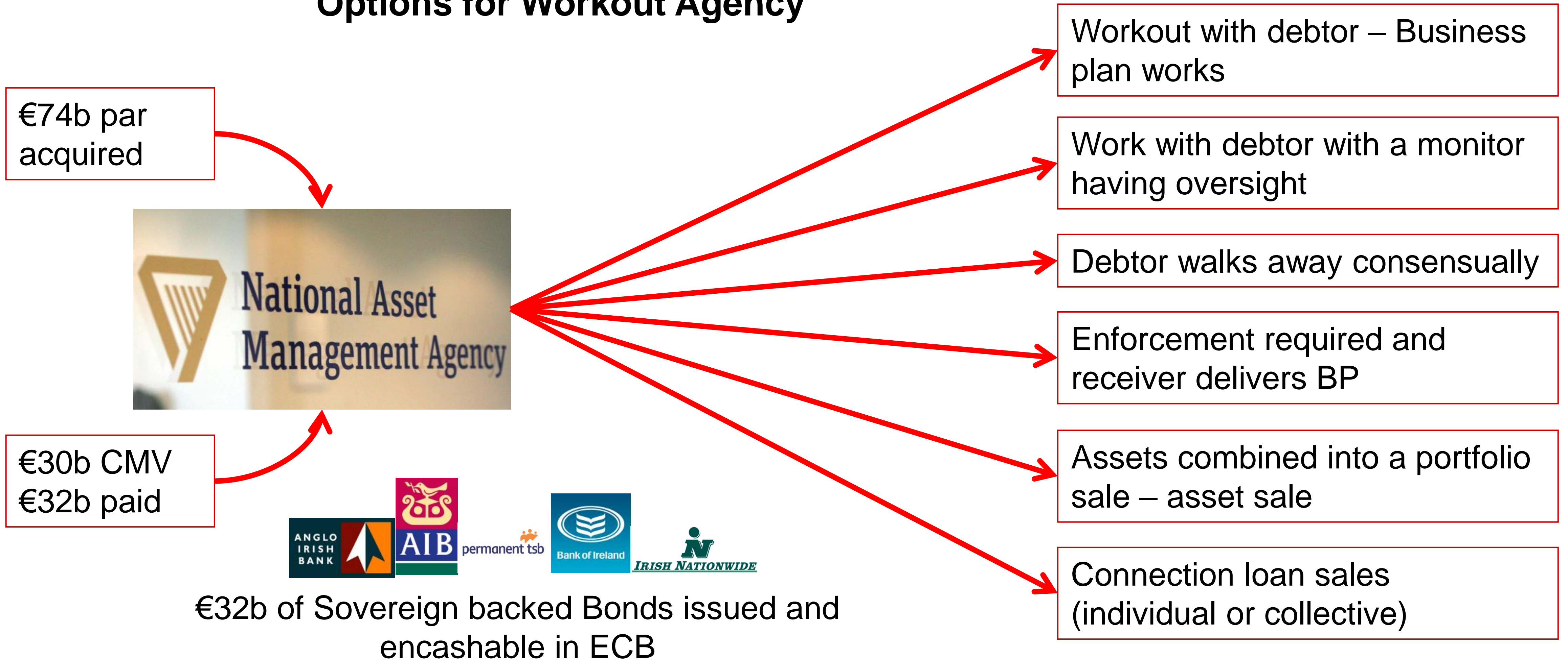
Means of Resolution – Good Bank & Bad Bank – Step 3



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Systemic responses to bank failure – Basel II – too little/too late

- Basel II was introduced in 2008 and was wholly inadequate
- It allowed S.I. banks to risk assess internally thereby determining regulatory capital themselves – they were overoptimistic and underestimated risk
- Capital requirements were too low for market related risk
- Capital levels were at c 7% in the banking sector and falling
- Leverage in banks was not controlled because risk assessment was optimistic
- Basel III had to be introduced in 2010 to reflect deficiencies
- Basel II was a poor attempt in 2008 to protect the banking system

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Basel III – main features – more capital and more monitoring

- Introduces higher levels of CET – Capital Conservation Buffer 2.5%
- Countercyclical capital buffer 0% to 2.5% - set nationally on a quarterly basis
- Additional buffers for systemically important banks
- Introduction of a leverage ratio to restrict excessive balance sheet leverage
- Introduces a liquidity coverage ratio to 30 days stressed cash holding
- Procedures and protocols for dealing with cross border resolutions

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Basel III and IFRS 9

- IFRS 9 is about accurate recording of financial assets and liabilities
- To accurately record assets impairment is a key consideration
- There is a relationship between increased impairment and capital ratios for banks – because of impact on reserves
- While not completely consistent in definition of key principles
- However they are closer than they were with IAS 39
- Basel III used the Expected Loss Concept as does IFRS 9

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Basel III – Three Pillar Approach to Bank Capital

Pillar 1

Minimum Capital Requirements

- Risk Weighted Assets
- Minimum capital ratios
- Liquidity Ratios
- Leverage Ratio

Pillar 2

Supervisory Review & Evaluation Process

- Concentration risk
- Portfolio & limits management
- Stress testing & simulations

Pillar 3

Market Discipline

- Enhanced Risk Disclosure

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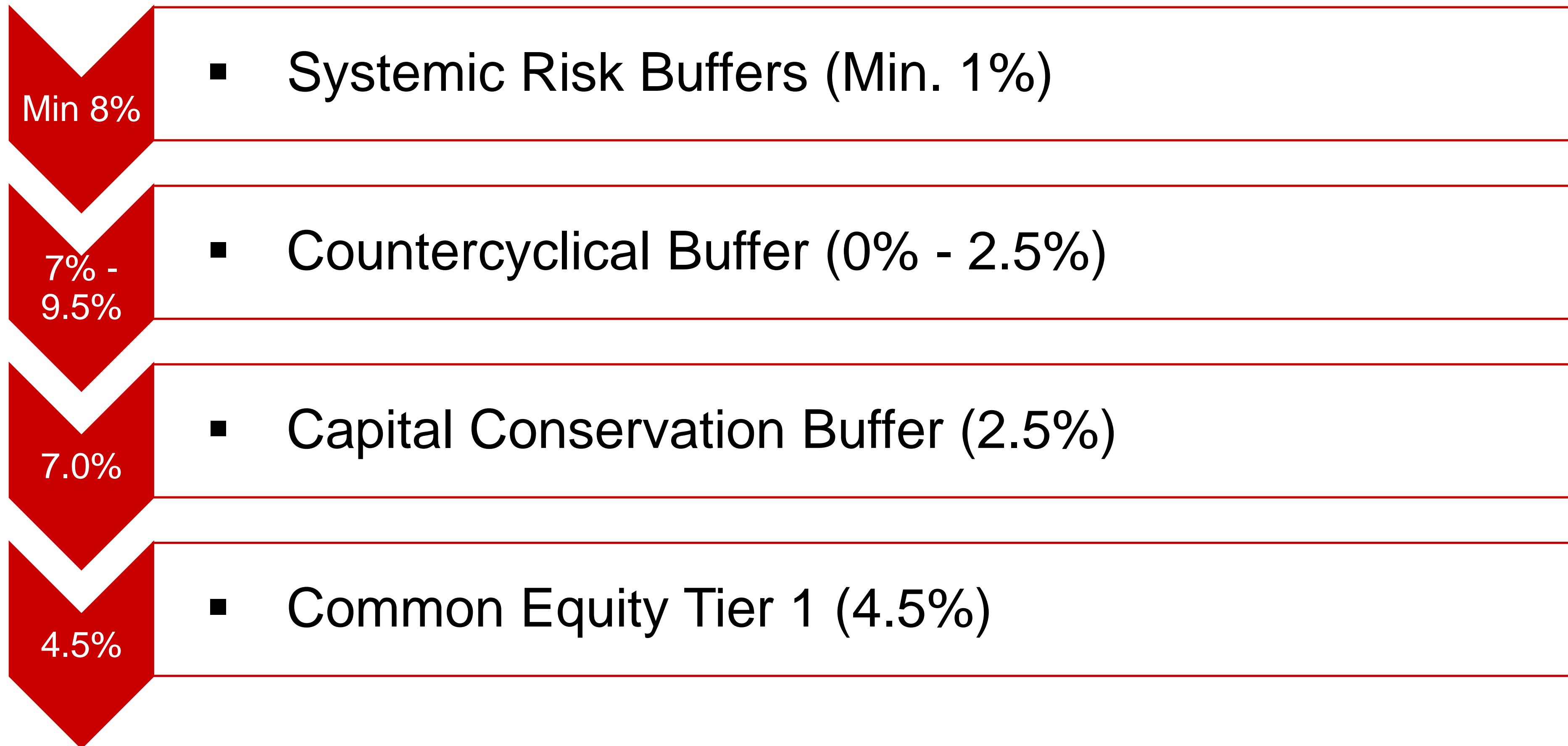
ICAAP – Internal Capital Adequacy Assessment Process

- Not a completely dissimilar evaluation to scenarios that need to be completed under IFRS
- Basel III says banks should have a process for assessing their overall capital adequacy in relation to their risk profile
- This process should incorporate stress testing and scenario analysis
- This is a dynamic that needs ongoing scrutiny
- An important area of oversight for Risk Committee of a financial institution

Components of Capital



IAS 39 & the GFC

- IAS 39 was not fit for purpose and a very complex standard
- The methodology was very formulaic didn't see "wood from the trees"
- In relation to impairment it was less forward looking than its replacement
- IFRS 9 provides for earlier provisioning of loans
- Could lead to greater losses in implementation
- Old IAS 39 blamed for clean audit reports on the eve of GFC
- New IFRS 9 will require lots of judgement of Auditors surrounding future scenarios and assumptions
- There would be less tolerance if audit profession got it wrong again

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IAS 39 – Financial Instruments: Recognition and Measurement

- Key clauses of objective evidence of impairment:
  - "can be reliably estimated"
  - Losses expected as a result of future events, no matter how likely, are not recognised – this is a really important part of the old standard
  - Terms such as "is becoming probable that the borrower will enter bankruptcy"
  - Observable data indicating that there is a measurable decrease
- The standard did make it difficult to impair in absence of a credit event e.g. past due
- Even when there were clouds on the horizon the bankers had plenty of cover in the standard not to impair.

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IFRS 9 – Financial Instruments

- Issued in response to call from G20 – IAS 39 “too little & too late” provisioning
- Implementation from 1st January 2018 onwards
- Comparatives not required
- The shift from an incurred loss model to an expected credit loss model is the most important change in IFRS 9 when compared to IAS 39
- The ECL will apply to all instruments held at amortised cost and at fair value through OCI
- In effect IFRS 9 provides for a return to having a “general provision”
- Stage 1 – refers to financial instruments whose credit risk has not increased since initial recognition – implies ECL’s from default events within next 12 months

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IFRS 9

- Stage 2 – refers to a financial asset whose credit risk had significantly increased since initial recognition and implies recognising ECL's over entire residual lifetime
- Stage 3 – Assets already impaired – recognising credit losses on a lifetime basis – same as IAS 39
- ECL's based in a broad range of credit loss information including forward looking macro-economic variables
- Different to credit losses in the past which was primarily based on realised events
- Banks using Standardised Approach internal credit risk monitoring systems will have to change to internal ratings based approach to determine capital requirements

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IFRS 9

- Huge importance on the judgement of auditors and regulators to determine ECL and by implication capital requirements e.g. What is "significant deterioration in credit risk"
- Impact of IFRS 9 could have procyclical effects e.g. a downturn prediction could increase ECL and this could dampen the faith in banking stocks and so on and on – almost self fulfilling prophecy
- All loans will have a level of provisioning and this is a significant change from IAS 39 (Stage 1) i.e. a general provision
- When reasonable and supportable information that is more forward looking than past due information is available without undue cost or effort, it must be used to assess credit risk

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IFRS 9 indications of credit risk change

- Change in the financial instruments credit rating
- Credit rating downgrade for the borrower
- Adverse changes to economic conditions that may affect the borrowers ability to meet their obligations
- Changes in the quality of underlying guarantees supporting a loan
- Changes in the underlying value of the collateral which may impact the borrowers economic incentive to repay e.g. non recourse residential loans
- Past due information e.g. past 30 days due rebuttable presumption that lifetime ECL should be recognised
- The rebuttable evidence must be the past due was due to for example an administrative error

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IFRS 9 considerations

- A credit loss occurs even if the payment are expected but need to be lengthened for instance
- Modifications of contractual cash flows may lead to the derecognition of the existing asset and recognition of a new financial asset
- IFRS requires ECL's to reflect an unbiased & probability weighted amount that is determined by evaluating a range of possible outcomes
- Stratification of financial assets into classes with similar characteristics will be important to be able to deal with assets collectively

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IFRS Considerations

- Entities need not undertake an exhaustive search for "Reasonable & Supportable Information" key words include "without undue cost or effort"
- Historic credit loss experience will inevitably be a high quality source of reasonable & supportable information to drive an assumption for the financial model, BUT it needs to reflect current observable data to reflect future conditions that are not reflected in historic data
- Financial models and the complexity of scenario testing and application of judgement will be enormous

CET1 outlook

- An expectation of increased requirement for Capital (Deloitte 2016)
- Capacity to shore up further is hampered by:
  - Low profitability
  - Limited organic capital generation
  - Low market valuations
  - Equity issuance expensive due to low share value
- Alternative is to reduce the asset base i.e. the loan book
- Banks will need to convincingly pass capital adequacy assessments
- Some of these are conflicting pressures

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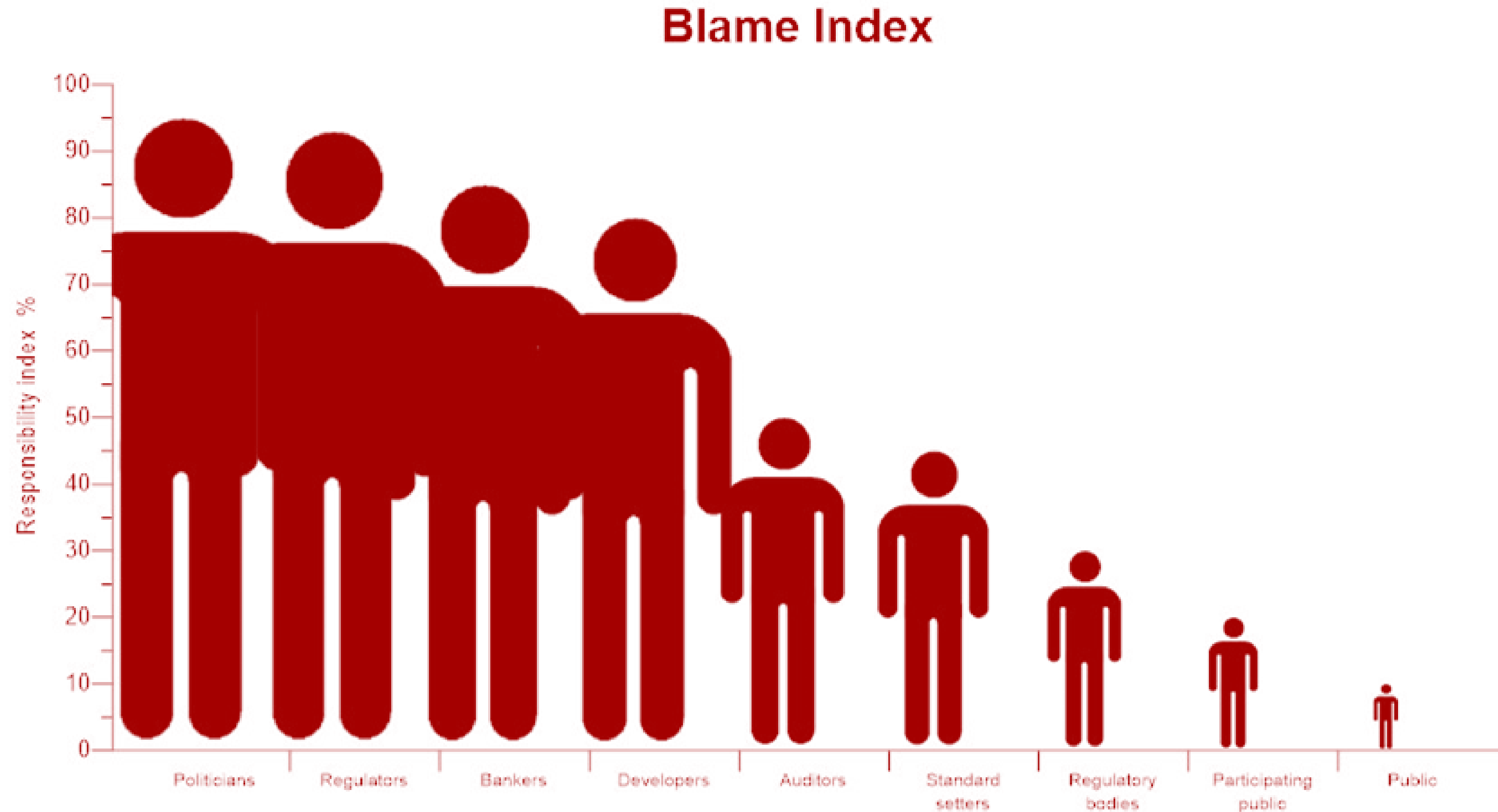
The key characters on the stage



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Banker remuneration & Corporate Governance

- Corporate Governance failure was a large cause of the financial crisis
- Qualified Board Oversight is vital
- Robust Risk Management is critical for what is a complex business
- OECD analysis was there was not enough focus on risk management
- Deficiency in internal risk management and quality of oversight
- Constructive Board Challenge is to be welcomed

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Standard Setters, Regulators and Auditors

- All bare some of the blame for sure
- IAS 39 didn't provided cover to ignore storm clouds
- Basel II was not fit for purpose
- Auditors missed some pretty bad practices – in many countries – window dressing
- The key is to learn the lessons and not to allow the horrific impact of the GFC to reoccur by allowing poor governance, short termism in profitability and reward, regulatory failure and weak external oversight

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NAMA Outcome

- €32 billion of bonds issued which needed to be repaid between 2010 and 2020
- They will be repaid by end of 2017
- NAMA has been asked by Government to asset manage the development of 20,000 housing units and develop large scale office developments in Dublin
- The Agency will make a profit of c. €4 billion
- It will be the most successful NPL WU in the world to date
- A hard and thankless job in a lot of ways
- The staff of the NPL WU have an objective to work themselves out of a job asap – retention bonuses will be important

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Two hugely important additional objectives given to NAMA

- Develop large scale advance office accommodation in Dublin Docklands to cater for banks and others leaving London – Brexit

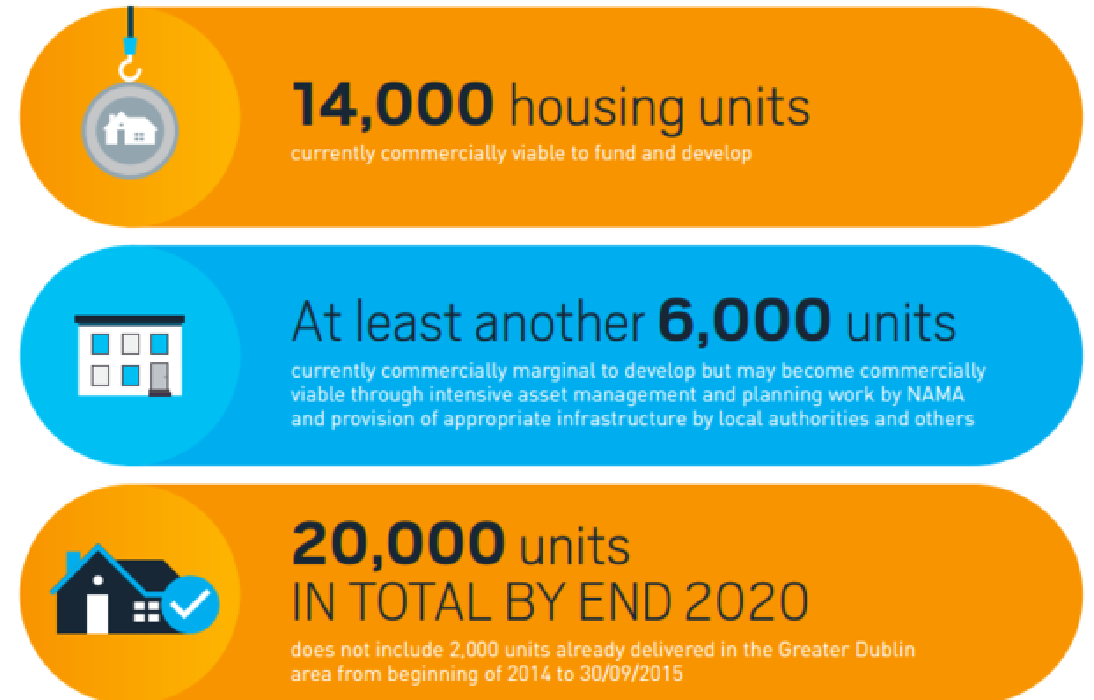
⇒ NAMA developing c. 3 million sq m of high spec offices – tenants include – Bank of America, Morgan Stanley, Facebook, Google, Twitter

⇒ Many being developed in JV structures with companies like Hines, Oaktree, Kennedy Wilson and others

- Very lucky this office development plan commenced in 2013 or we would not be able to benefit from Brexit

2nd major objective – housing & social housing

- As part of GFC and property collapse
- Housing completions fell from 90,000 units p.a. to 8,000
- Country needs c. 30,000 annually
- NAMA asked by Government to assist in developing housing and financing construction
- NAMA will complete 20,000 housing units by 2020
- Important socially and politically



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My view on the NPL WU

- If the NPL issue is severe – then don't leave NPL work out in the banks
- Remove it to a specialist agency
- Protect it from political and developer interference
- Give it a realistic mandate and timeline
- Give the WU strong powers to enable it
- Make sure there is competent but independent oversight
- Make sure there is accountability politically but not interference
- If WU are within banks ensure there is strong separation and public interest oversight

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2018 and beyond

- The impacts of the GFC will still be felt in many countries
- Basel III and IFRS 9 may necessitate more capital
- Some markets are already beginning to reduce regulation over banks
- IASB and FASB have not agreed on a common standard and so large global banks will have to operate under different standards
- US Bank remuneration packages are back up to €28 million in 2017
- Some bad practices are setting in again including the drive for more profits from non core activities
- After a terrible decade there are signs of learnings being forgotten

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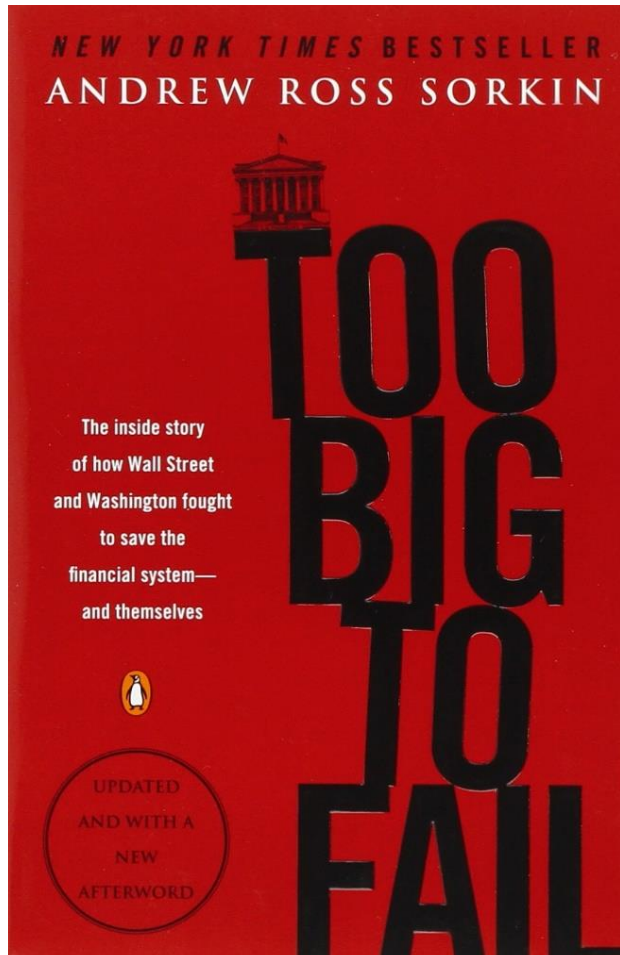
Too Big to Fail – So what to do?



- Allowing important banks to fail isn't really that plausible
- The banking system has to be protected from Contagion
- But a "Bail In" before a "Bail Out" should focus large creditor vigilance
- Depositors need protection over other creditors so in many countries they rank as super preferential / preferential creditor (at least to a certain value e.g. €100,000) – this is sensible
- Remuneration needs to be aligned to long term objectives
- Regulation needs to be strong if the taxpayer is ultimately on the hook!!
- Governance needs to be diligent and effective
- Regulation needs to be strong if the taxpayer is ultimately on the hook!!
- Governance needs to be diligent and effective

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Thank You

Brian McEnery

- ACCA Global President
- BDO Partner
- Director of NAMA