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# Microeconomic perspectives on the market for NPLs

Roundtable: Main Challenges for  
Financial Stability and  
Macroprudential Policy at the  
Current Juncture

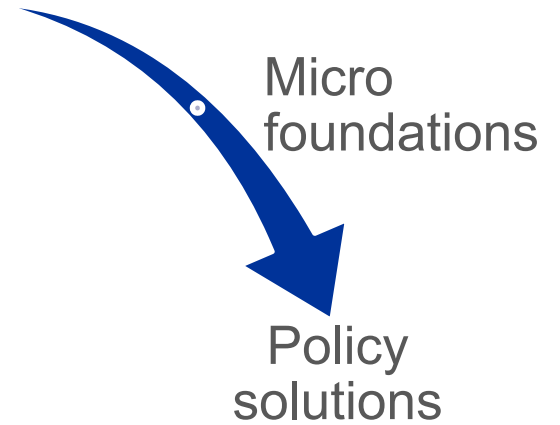
Conference on Financial Stability  
Banco de Portugal  
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Disclaimer: the views expressed in this presentation do not necessarily reflect the views of the European Central Bank or its Governing Council. I am grateful to Maciej Grodzicki, Reiner Martin and Edward O'Brien for helpful discussions in preparing this presentation.








# Overview

- 1 NPLs – a concern for Financial Stability
- 2 A role for markets – or market failure?
- 3 Policy options

Macro perspectives



# 1. ECB's May 2017 Financial Stability Review

RISKS FOR EURO AREA FINANCIAL SYSTEM	Current level and change*
1. Repricing in global fixed-income markets – triggered by changing market expectations about economic policies – leading to spillovers to financial conditions	
2. Adverse feedback loop between <u>weak bank profitability</u> and <u>low nominal growth</u> , amid structural challenges in the euro area banking sector	
3. Public and private debt sustainability concerns amid a potential repricing in bond markets and political uncertainty in some countries	
4. Liquidity risks in the non-bank financial sector with potential spillovers to the broader financial system	
pronounced systemic risk  medium-level systemic risk  potential systemic risk 	

\* The colours indicate the current level of risk, which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next two years, based on ECB staff assessment. The arrows indicate whether the risk has intensified since the previous Financial Stability Review.

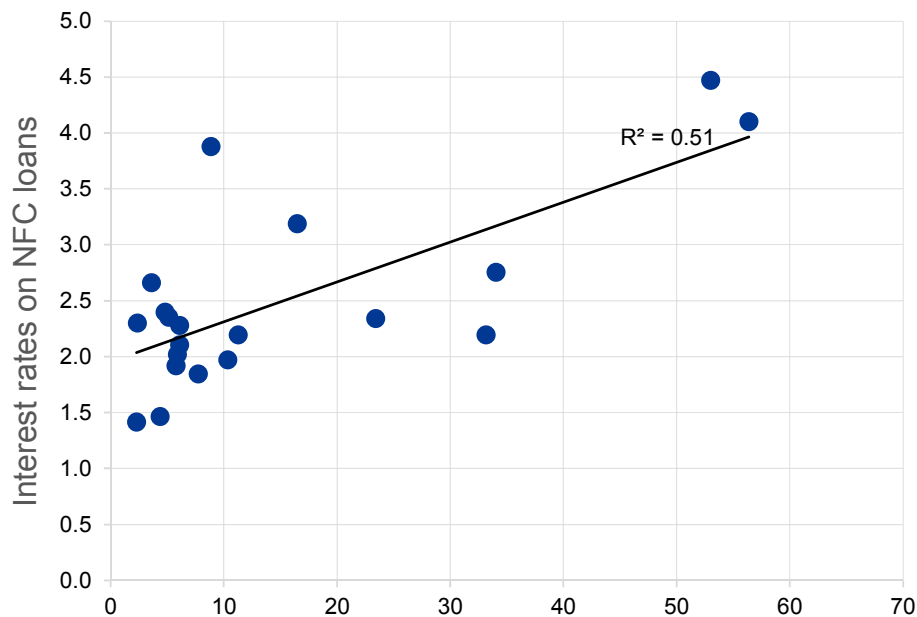
# 1. NPLs a concern for financial stability & macroprudential policy...

*NPLs can impact*

- *profitability – assets earning little or no income*
- *capital – provisioning requirements may erode capital*
- *growth – impaired borrowers do not invest / are not creditworthy*

**NFC NPL ratios vs interest rates on NFC loans by country**

Q1 2017; Jul. 2017; percentages.

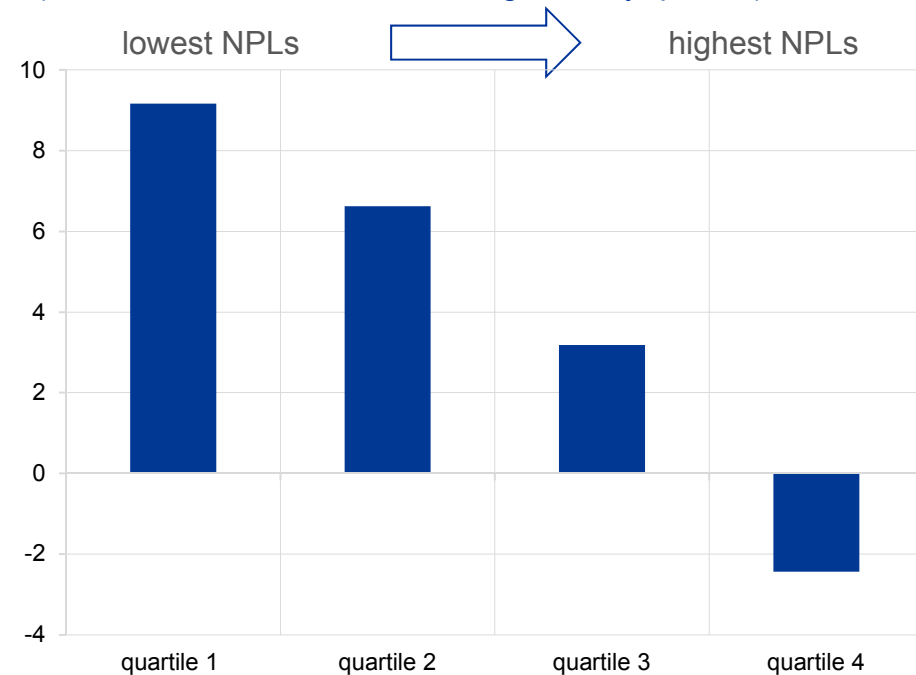


Source: ECB.

Note: Bank NFC lending rates (y-axis) and NFC NPL ratios (x-axis).

**Loan growth by NPE ratio quartiles**

(Q4 2015-Q1 2017; median loan growth by quartile)



Source: ECB.

Note: Based on Q4 2015 total NPE ratios and growth of performing loans between Q4 2015 and Q1 2017.

## 2. Why have markets not solved the problem – market failure?

Large stocks of NPLs have built-up on bank balance sheets, but secondary markets not very active

Structural inefficiencies and informational asymmetries drive a wedge between book and market values for NPLs – bid-ask spreads

Market failure  $\equiv$  market inefficiency

Microeconomic theory – three main sources of market failure

### **1. Exchange Costs**

- transaction or exchange costs erode gains from trade
- agency problems
- informational asymmetry

### **2. Market Structure**

- market power
- barriers to entry

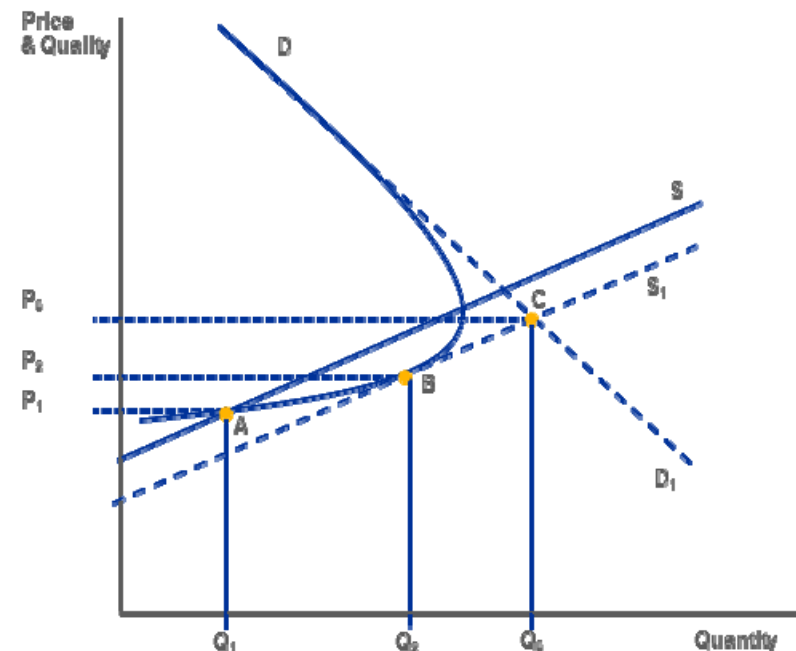
### **3. Nature of the Commodity**

- imperfect excludability
- non-transferability

## 2. NPL Market failure 1 – a market for ‘lemons’

Market for complex, secured NPLs may be characterised as a Lemons’ market

- Informational asymmetries challenge buyers (demand)
  - *insufficient or costly data; ineffective legal frameworks; capacity constraints; cherry-picking behaviour*
- Akerlof’s (1970) market for lemons
  - *demand is a function not only of price, but also of average quality of goods being traded*
- Evidence in NPL markets?
  - limited market activity relative to supply
  - unsecured consumer loans actively traded at very low prices



## 2. NPL Market failure 2 – oligopsony

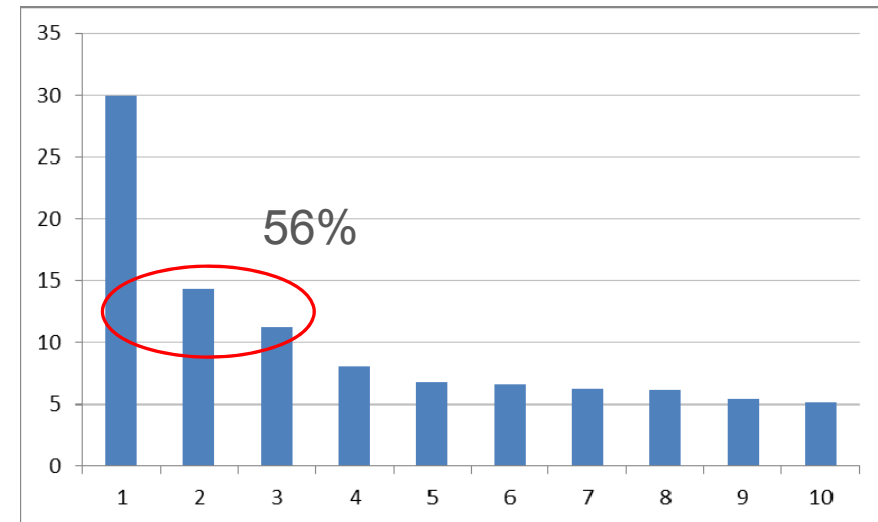
Oligopsony is a situation where:

- market is dominated by a few buyers (buy-side control)
- concentration of market power (bargaining power)
- typically resulting in lower traded prices

Oligopsony and NPL markets - evidence?

- small number of large buyers (see chart)
- limited alternative outlets for sellers
  - sale – lemons market and oligopsony
  - internal workout – supervisory pressure, workout costs
  - write-off – capital
- barriers to entry (information, experience, scale)
  - sunk costs of due diligence
  - limited capacity of independent servicers

Market share for the Top Ten Buyers in European Loan Portfolio sales 2015-2017



Source: Deloitte.

## 2. NPL Market failure 3 – the nature of the goods traded

Imperfect excludability

*effective control of commodity is not conferred on a single individual*

In an NPL context...

- an impaired loan is linked to a debtor
- debtor may have multiple creditors; performing & non-performing loans
- a 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 complicated (misaligned incentives) & costly

Evidence in NPL market...

- NAMA, Ireland's Asset Management Company
  - successfully employed debtor-level approach – capture all exposures of a single debtor, including performing and out-of-scope exposures
  - Overcame imperfect excludability



## 2. A trilogy of market failures – bringing it all together

- Lemon's market is intransparent
- Cost of overcoming intransparency is high for investors
- Few investors can absorb such costs; barriers to entry
- Even when they can, cannot be sure of exclusive rights to debtors
- Creates oligopsony, crystallises low prices associated with lemons market
- Eliminates price competition
- Implications of market failure:
  - banks generally can't afford to sell
  - many investors excluded from the marketplace
  - wide bid-ask spreads; low market liquidity

### 3. Policy options, addressing market failure

EU Council Action Plan on NPLs – mandate for action (14 points!)

ECB – key involvement in NPL transaction platform & AMC blueprint

#### NPL transaction platforms

Market failure?

Exchange Costs ✓  
Market Structure ✓  
Nature of Commodity ?

- Capture some of the benefits of AMC, without the costs
- Central hub for NPL sales
- Facilitated by data transparency; transaction standardisation
- One-stop-shop for investors
- Reduce transaction costs; increase price competition
- Ongoing ECB work on this

More ambitious, but consistent with Portuguese coordination platform!

### 3. Policy options, addressing market failure, *cont.*

Market failure?

Exchange Costs ✓

Market Structure ✓

Nature of Commodity ✓

#### Asset Management Companies

- National AMC 'blueprint' concept
- Provide clarity on AMC design principles (EU legal framework)
- Identify best practice

EU Council Action Plan on NPLs includes macroprudential mandate:

*the European Systemic Risk Board to develop, by the end of 2018, macro-prudential approaches to prevent the emergence of system-wide NPL problems, while taking due consideration of procyclical effects of measures addressing NPLs' stocks and potential effects on financial stability;*

To be delivered by ESRB's Instruments Working Group

## Conclusions

- NPLs a source of concern for financial stability and macroprudential policy
- Microeconomic characterization of market failure can explain macro outcomes
- Policy options should aim at addressing market failures (by cause)
- Structural reforms will be critical for these options to be successful
  - cost & time to recovery (cost of enforcement, time to enforcement, judicial reform, enhanced judicial capacity, consistency across countries, etc.)
  - improving transparency around NPLs through standardised data reporting & contracts and better access to corporate financial information
  - licensing issues may need to be addressed – who can acquire assets, at what administrative cost
  - independent servicing capacity in markets will be critical

## Some references

“Addressing market failures in the resolution of nonperforming loans in the euro area,” *Financial Stability Review*, European Central Bank, Nov. 2016

<https://www.ecb.europa.eu/pub/pdf/other/sfbfinancialstabilityreview201611.en.pdf>

“Resolving non-performing loans: a role for securitisation and other financial structures?,” *Financial Stability Review*, European Central Bank, May 2017

<https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfcfinancialstabilityreview201705.en.pdf?af953cafd6561fd288c85126163c7c04>

“A role for systemic asset management companies in solving Europe’s non-performing loan problems,” *European Economy, Issue 2017.1*

<http://european-economy.eu/2017-1/a-role-for-systemic-asset-management-companies-in-solving-europes-non-performing-loan-problems/>

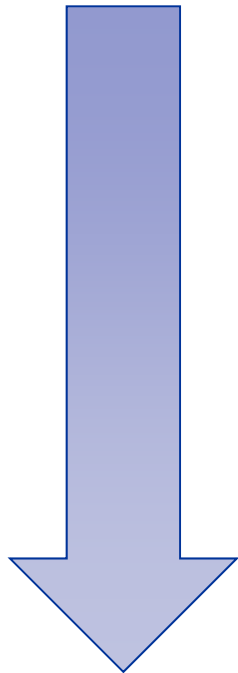
“Addressing the eurozone’s ‘lemons’ problem for NPLs,” *Quarterly Journal of Central Banking*, Vol. 28 (1), 2017

<https://www.centralbanking.com/central-banks/financial-stability/3269861/addressing-the-eurozones-lemons-problem-for-npls>

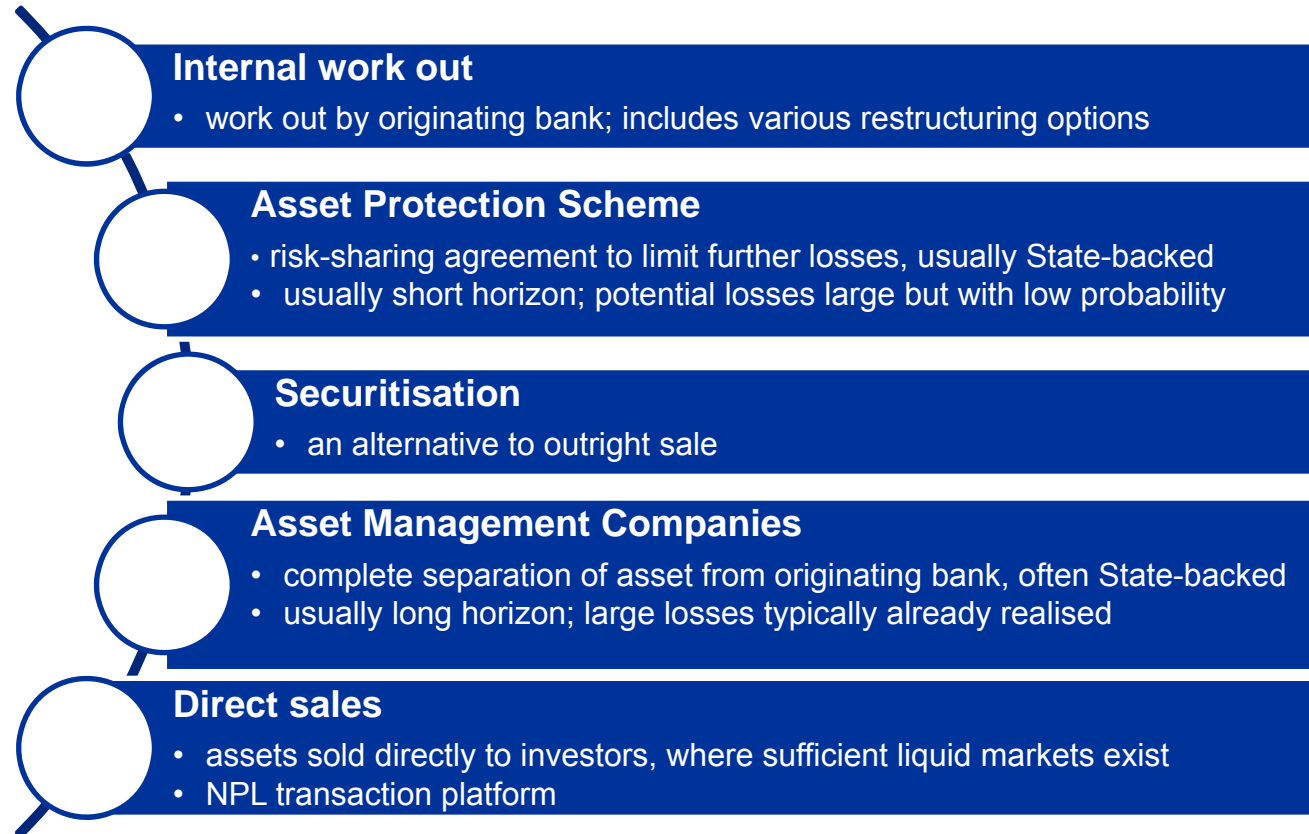
## Background: a taxonomy of policy options to address NPL market

Wide range of policy responses to address large NPL stocks: a brief overview of frequently-employed options...

On-balance sheet



Off-balance sheet



Public support may be required for some of these schemes; internal work-out will always feature in NPL resolution.

## Background: a blueprint for national AMCs

ECB's Constâncio (2017) introduced an AMC “blueprint” concept...

*“... a way forward could be the creation of a **European blueprint for AMCs to be used at national level**. This European blueprint should clarify what is possible within a flexible approach to the existent regulation ... in a well-defined time frame.”*

Source: <http://bruegel.org/2017/02/resolving-europes-npl-burden-challenges-and-benefits/>

...which was adopted by the EU Council (2017) “Action plan to tackle non-performing loans in Europe”

*“... develop, by the end of 2017, ... a “blueprint” for the potential set-up of national AMCs ...”*

Further details of the blueprint elaborated by ECB staff...

### **A Role for Systemic AMCs in Solving Europe's Non-Performing Loan Problems**

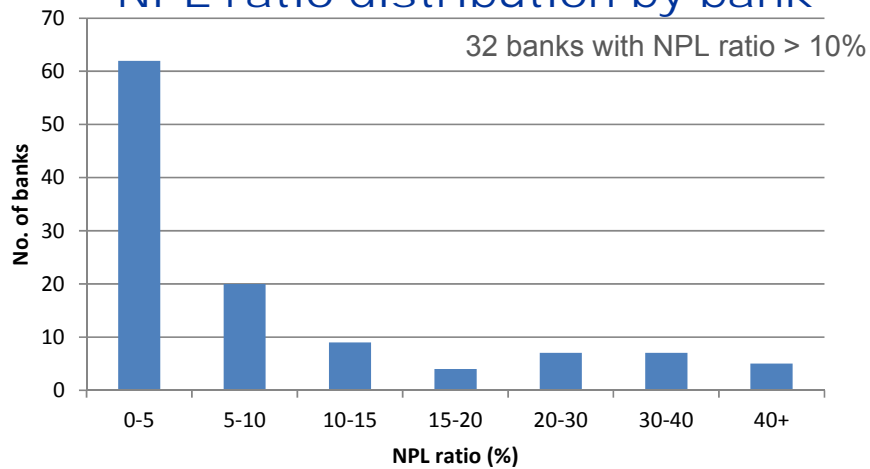
John Fell, Maciej Grodzicki, Reiner Martin & Edward O'Brien

**Abstract:** The large stock of non-performing loans (NPLs) held by euro area banks should be more swiftly resolved, while avoiding fire sales. We make a case for a comprehensive European solution, combining various NPL resolution tools. Within the NPL resolution toolkit Asset Management Companies (AMCs) may offer significant benefits by bridging inter-temporal pricing gaps for asset classes such as commercial real estate loans. We outline elements of an EU-wide blueprint for country-specific AMCs, including state aid aspects, asset and participation perimeters, asset valuation, capital and funding structure, and governance. In addition to AMCs, internal NPL work-out will always play an important role in NPL resolution, complemented by private information and trading platforms, and securitisation schemes.

<http://european-economy.eu/2017-1/a-role-for-systemic-asset-management-companies-in-solving-europes-non-performing-loan-problems/>

# Background: a snap-shot of euro area NPLs

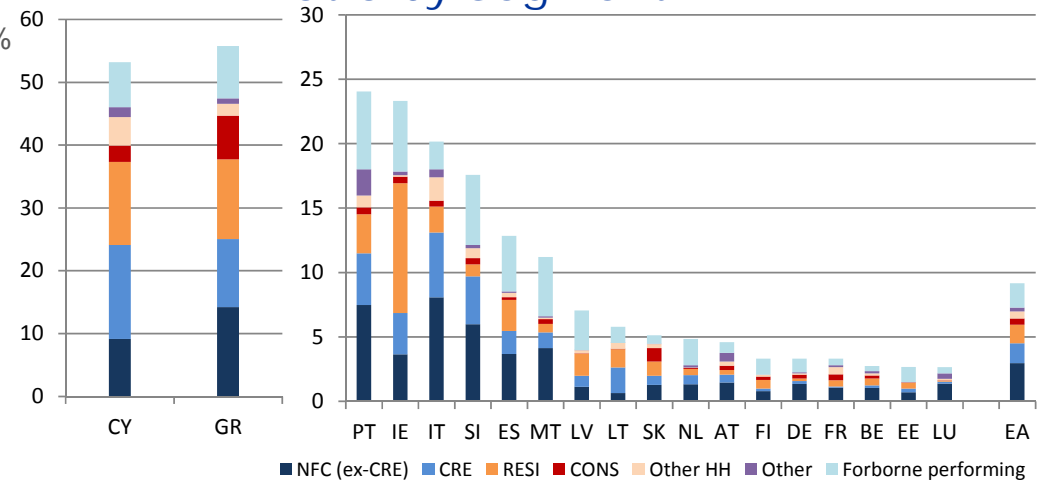
## NPL ratio distribution by bank



Source: ECB Supervisory Statistics.

Notes: sample based on 115 Significant Institutions. Q4 2016 data.

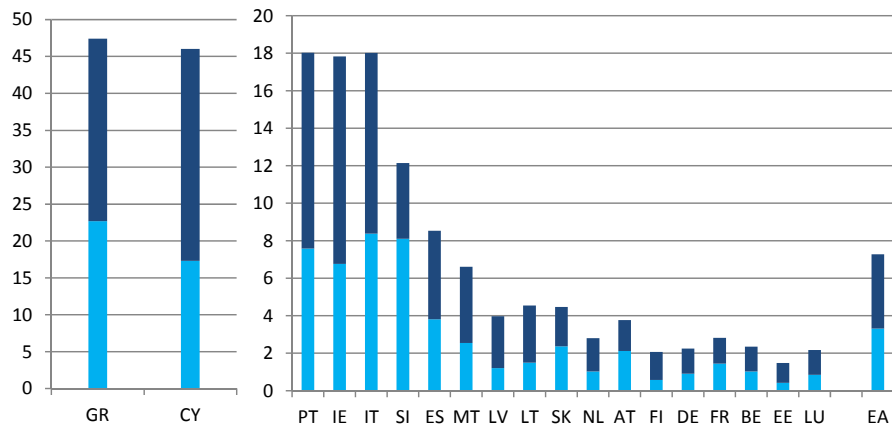
## NPL ratio by segment



Source: ECB Supervisory Statistics.

Note: NPLs on locational basis e.g. ratio for BE includes loans of FI banks in BE. Q4 2016 data.

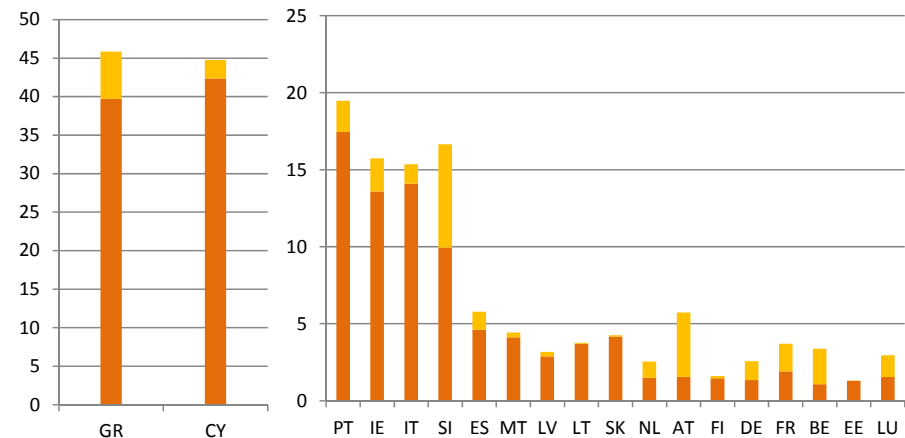
## NPL coverage by provisions



Source: ECB Supervisory Statistics.

Note: Light blue bars - provision coverage of NPLs on locational basis e.g., Provisions allocated by FI bank for BE portfolio are included in BE ratio. Dark blue bars - NPLs not covered by provisions. Q4 2016 data.

## Cross-border dimension of NPL



Source: ECB Supervisory Statistics.

Notes: NPL ratios by home country of reporting banks - consolidated e.g., NPL ratio for BE banks include all loans of BE banks in all jurisdictions. Q4 2016 data.



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