finiz
Singidunum University International Scientific Conference
Međunarodna naučna konferencija Univerziteta Singidunum

FINANCE, BANKING AND INSURANCE
Scientific - review paper

EMPIRICAL EVIDENCE ON NPLS RESOLUTION: SERBIA AND CESEE COUNTRIES

Vladimir Mirković*,
Marija Vujičić

Economists Association of Belgrade,
Belgrade, Serbia

Abstract:

In past decade, joint impact of financial crisis and economic recessions, followed by inadequate loan disbursement practices, influenced on high NPLs ratios existence in certain countries. Negative effects of high NPL ratios on economic growth and credit lending activity signalized the necessity of urgent reaction in the direction of NPLs declining at satisfactory pace. This paper analyzes movements and trends in NPLs stock as a consequence of successful resolution of NPLs issue in Serbia and selected CESEE countries. Simultaneously, the paper highlights benefits, which are derived from successful implementation of NPLs resolution strategy, as well as the significance of preventing NPLs accumulation in financial systems. Due to avoidance of future emergence of new NPLs in significant extent (which could seriously deteriorate the stability of banking systems), authors concluded that within observed countries has been created a positive economic environment and sufficient incentives for further credit lending activity growth in prospective period.

Keywords:

NPLs (non-performing loans), resolution, Serbia, CESEE, strategic approach

INTRODUCTION

During credit boom in emerging and transition economies, there had not been sufficient caution regarding loan riskiness. As a consequences of inadequate risk management policies, those countries were faced with significant portion of non-performing loans (hereinafter: NPLs), which deteriorated their financial sectors at whole (Mirković & Knežević, 2014a). For mentioned countries, taking appropriate measures for NPL resolution was the biggest challenge. After global crisis emergence in 2008, economic recovery is additionally lingered by NPLs, which worsened loan portfolio quality and decreased the capital of banks (Mirković & Knežević, 2014b). At the same time, the category of NPLs represents the optimal connection between real and financial sector and it could be observed as paradigm for overview of CESEE economies as well as Serbian economy (Mirković & Knežević, 2013).

As Đukić (2012) noticed "The strategy of maintaining allegedly healthy and successful banking and financial sector in general, in circumstances of real sector distortion, is a priori adjudged to catastrophe". Effective and efficient functioning of banking system assumes identification and resolution of NPLs in the manner to provide and maintain the stability of economy as a whole. Issues regarding NPLs and its resolution with the focus on Serbia and CESEE countries are essential from the view of future development of banking industry. In this paper are elaborated efforts and results in Serbia and CESEE countries in the segment of NPL resolution, emphasizing its significant downward trend, as a prerequisite for the efficient and "health" banking system.

Correspondence:
Vladimir Mirković

e-mail:
vladamirkovic@orion.rs

DOI: 10.15308/finiz-2018-49-55

LITERATURE REVIEW

When NPLs are recognized as the main issue in various banking systems, it raised several new issues. One of the most important issues was the absence of unique definition for NPLs and the problem of harmonization between countries. A lot of countries (as well Serbia) accepted the NPL definition given by IMF (2005), but beside the fact that criterion for NPLs classification is mostly related to threshold of overdue days at the level of 90 days or more, there exists significant differences. Those differences are impersonated in other aspects of NPLs classification, such as: collateral treatment, treatment of restructured debts, treatment of other loans of the same debtor in case that debtor has several outstanding loans and obligations toward banks (Barisitz, 2011). It was necessary to harmonize the definition and coverage of NPLs between countries, so one of the solutions was given by European Banking Authority (EBA) with its incentive in October 2013 introducing the term of non-performance exposure (hereinafter: NPE). It should be noted that NPLs and NPEs are not identical terms, but with NPEs definition among EU countries (and those which are in the pre-accession phase to EU) there was made a huge step toward obtaining comparable data between countries.

NPE definition entered into the force as end of September 2014 in alignment with EBA's document "Final draft Implementing Technical Standards on supervisory reporting on forbearance and non-performing exposures". According to above mentioned document, NPEs are "those that satisfy either or both of the following criteria:

a) material exposures which are more than 90 days past-due; and
b) the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past-due amount or of the number of days past due" (European Banking Authority, 2014a).

EBA makes differences between transaction approach (which classifies only specific loans as NPEs, e.g. retail customers) and debtor approach (where all exposures assigned to the same debtor are classified as NPEs) in dealing with NPEs. As the portion of NPLs in total loan portfolio deteriorates the picture of the bank's stability, from the bank's point of view it is necessary to improve the quality of its loan portfolio through minimization of NPLs share in total loans.

Robust and complex process (as asset quality review, shortly AQR) has an extraordinary importance for banking systems on national and global level. Results of conducted assessments are the best indicator of financial systems "health" and the starting point for improvements of supervisory activities and practices, all together for the purpose of banking industry maintenance. Starting from 2014, European Central Bank (ECB) jointly with national supervisory authorities, conducted the control of financial "health" in banks, which they directly supervised. That comprehensive analysis from ECB side is performed in order to assess whether banks are adequately capitalized and how they would face with future extraordinary events (financial shocks). Comprehensive AQR process is conducted on regular or ad hoc basis. During regular assessment of asset quality in banks, there are conducted initial controls of status in banks, which are classified as systemically important banks according to latest classification. AQR on ad hoc basis means that controlling and monitoring in banks is conducted occasionally, i.e. when some unusual events emerge (Mirković, Dudić B. & Dudić Z., 2016). In 2014, ECB conducted comprehensive AQR, which included 130 banks within euro area, making approximately 82% of total bank assets and involving 26 national supervisory institutions. AQR process resulted in aggregate adjustment of 47.5 billion EUR (based on financial statements of banks as of 31 December 2013). NPE status was increased by 135.9 billion EUR, with identified a capital shortfall of 24.6 billion EUR related to 25 participating banks (European Central Bank, 2014b).

Further, in 2015 ECB continued with AQR process in 9 banks, which are chosen based on criterion of significance. It means that selected bank should had total assets over 30 billion EUR or total assets which exceeded 20% of state GDP; that selected bank is one of the 3 most significant banks in observed state EU member and that banking group's cross-border activities are significant. The total assets of each of 9 participating banks range from 2.6 billion EUR to 57.4 billion EUR, placing them among the smaller institutions subject to direct ECB supervision. AQR process resulted in aggregate adjustments of 453 million EUR based on financial data as at 31 December 2014. Comprehensive assessment identified a capital shortfall of 1.74 billion EUR across 5 participating banks (European Central Bank, 2015).

In 2016, ECB conducted AQR process on the following four banks: Abanka d.d. (Slovenia), Akciju sabiedrība "Rietumu Banka" (Latvia), Banca Mediolanum S.p.A. (Italy) and Citibank Holdings Ireland Limited (Ireland). The AQR component was performed based on the methodology applied in the 2014 and 2015 exercises. Also, the threshold ratios applied for identifying capital shortfalls were maintained at the same levels as in 2014 and 2015. None of the three mentioned banks (excluded the bank from Latvia, which results are not included) do not face capital shortfalls as a result of the comprehensive assessment. Nevertheless, the banks will be expected to undertake actions to address qualitative findings of the AQR such as deficiencies in policies and processes and weaknesses in data systems (European Central Bank, 2016).

Due to necessity for detailed analysis of asset quality in domestic banks, within stand-by arrangement with IMF, National bank of Serbia also conducted AQR process. The scope of analysis was 14 the largest banks in Serbia, which together make 88% of total assets in Serbian banking sector. The purpose of conducted exercise was determination whether capital adequacy on reference date (March 31, 2015) was in line with regulatory requirements. AQR process in Serbia was established on main principles that ECB has already used, followed with certain specifics and differences (National bank of Serbia, 2015a). Banks were chosen by criterion of systemically importance, while realization of AQR process required cooperation between various institutions, such as: audit companies (Deloitte, Price Waterhouse Coopers, Ernst & Young and BDO), appraisal companies (JLL, CBRE, Colliers, Danos, NAI Atrium and Coreside) and National bank of Serbia, as central bank institution with main responsibility for independent control of business, monitoring, analysis and testing the results (Mirković, Dudić B. & Dudić Z., 2016).

METHODOLOGY

Due to stricter write-off policies and strategic approach to NPL resolution, NPL situation has improved in CESEE countries, with NPL volumes reaching their lowest level in 7 years i.e. 42.8 billion EUR as of 30 September, 2017 for the region (Vienna Initiative, 2018). Most jurisdictions have continued to implement reforms to resolve the remaining impediments to NPL resolution and sales. Moreover, the EU regulators have also been very active in introducing a broad range of new initiatives around NPLs. These are expected to put further pressure on adjacent countries to the EU to align with these European best practices, particularly for accession countries and where subsidiaries of European banks are present. NPLs declining at satisfactory pace in Serbia and CESEE countries confirmed efficiency of strategic approach in NPL resolution issue.

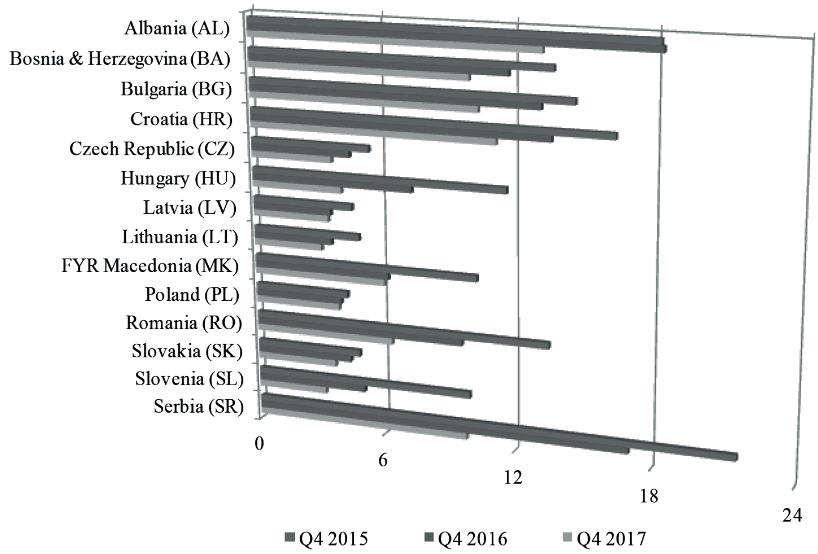
In this paper authors are focused on selected sample of 14 CESEE countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Latvia, Lithuania, FYR Macedonia, Poland, Romania, Slovakia and Slovenia) including Serbia, based on publicly available data on IMF website and website of National bank of Serbia. Authors applied comparative analysis between countries for the observed period (between 2015 and 2017), with general conclusion that gross NPL ratio level (obtained as NPL stock divided by total loans) has continuous decreasing trend in all countries (Table 1 and Figure 1).

Table 1. Gross NPL ratio in selected sample of CESEE countries between 2015 and 2017

Country:	Q4 2015	Q4 2016	Q4 2017
Albania	18.2	18.3	13.2
Bosnia&Herzegovina	13.7	11.8	10.0
Bulgaria	14.6	13.2	10.4
Croatia	16.3	13.6	11.2
Czech Republic	5.5	4.6	3.7
Hungary	11.7	7.4	4.2
Latvia	4.6	3.7	3.5
Lithuania	4.9	3.7	3.2
FYR Macedonia	10.3	6.3	6.1
Poland	4.3	4.0	3.9
Romania	13.5	9.6	6.4
Slovakia	4.9	4.4	3.7
Slovenia	10.0	5.1	3.2
Serbia	21.6	17.0	9.8

Source: IMF (http://data.imf.org/regular.aspx?key=61404590)

Figure 1. Gross NPL ratio in selected sample of CESEE countries between 2015 and 2017

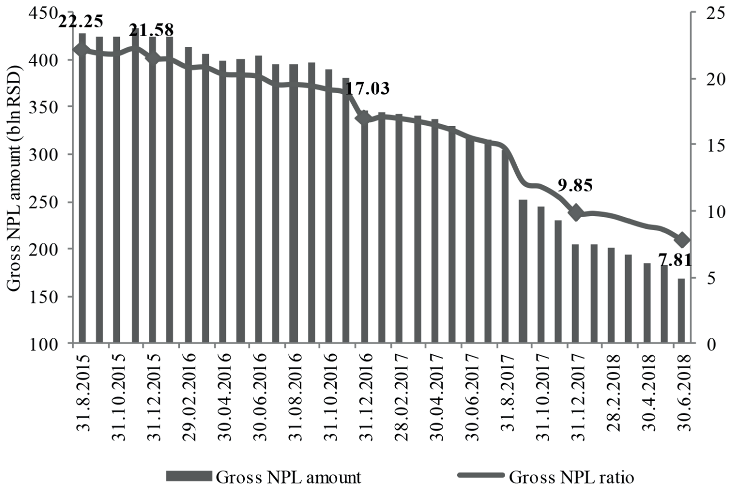


Strategic approach for NPL resolution in Serbia

Republic of Serbia acknowledged the need to impose comprehensive strategic approach for resolving NPLs, while not undermining the market principles. Although, various models for cleaning the balance sheets of banks could be seen in practice also including government intervention and establishment of the bad banks, the Republic of Serbia has chosen the model which corresponds to characteristics of domestic market. Chosen model is focused on enhancement of banks' capacities to resolve NPLs, ensuring the conditions for more effective collection and development of NPL market. In August 2015, the Government of the Republic of Serbia adopted the Strategy for NPL resolution (Ministry of Finance Republic of Serbia, 2015). In order to specify activities and monitor implementation of the Strategy, the Government and National bank of Serbia adopted Action plans in line with their competences, whereby it is envisaged for Strategy to be three-year continuous process. The National bank of Serbia has conducted all activities in line with its Action plan aiming to: enhance the banks' capacities to resolve NPLs, improve restructuring practices and accounting practices, enhance transparency of banks regarding assets quality, improve collateral management in banks and reporting to regulatory body regarding NPL structure (National bank of Serbia, 2015b). One of the key steps for successful resolution of NPL issue in Republic of Serbia was adoption and implementation of "Decision on the accounting write-off of bank balance sheet assets" (National bank of Serbia, 2017), which entered into a force as end of September 2017. The accounting write-off in terms of mentioned Decision means the transfer of a bank's balance sheet assets to off-balance sheet records.

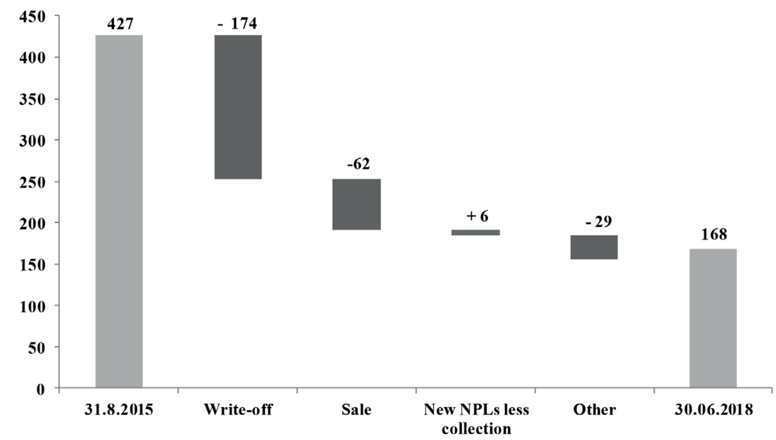
After almost three years, systemic, inter-institutional and coordinated approach envisaged by the NPL Strategy together with adoption of Decision, led to significant decrease of gross NPL ratio and bringing down on one-single digit. According to data as end of June 2018, gross NPL ratio reached 7.8% (the lowest level since pre-crisis period in 2008), which is down by 14.4 percentage points since Strategy adoption (Figure 2). In the same period, the absolute amount of gross NPLs was decreased by 61% (from 427.3 billion RSD to 168 billion RSD). The most significant channels in NPLs reduction are: direct write-offs and assignment of receivables (NPL sale). As end of June 2018, considering from the period of the Strategy adoption, the total NPL decrease which is owed to direct write-offs was 174.4 billion RSD with visible dispersion among all banks apart from their ownership structure. Moreover, as a direct consequence of adopted Decision, banks intensified the direct write-offs starting from September 30, 2017, so including data from June 2018 total direct write-offs stood at 109.4 bln RSD (that is 63% of total write-offs in previous three years). Since NPL Strategy adoption, the net effect of NPL sale (assignment of receivables) reached 83.1 billion RSD (National bank of Serbia, 2018).

Figure 2. Gross NPL ratio in Serbia since NPL Strategy adoption till June 2018



A further decline of NPLs is expected not only due to the undertaken activities, but also due to the extension of activities of the National bank of Serbia, Government and other market participants aimed to resolving existing NPL stock and preventing the development of new NPLs. Simultaneously, it is important to emphasize that there was not noticed any significant inflow of new NPLs (see Figure 3), which could crucially change the existed picture of NPL stock and movements in Serbian banking sector.

Figure 3. Channels of NPL reduction since NPL Strategy adoption



Additionally, in June 2016 the Executive Board of National bank of Serbia adopted the Decision Amending the Decision on the classification of bank balance sheet assets and off-balance sheet items, which envisages introduction of NPE definition in line with technical standards published by EBA. In accordance with this decision the bank shall classify the exposures as NPEs, if one of the following conditions has been met:

a) the borrower is more than 90 days past due on such exposure;

b) the bank's assessment of the borrower's financial position and/or creditworthiness indicates that the borrower will not be able to settle its obligations in full without realization of collateral, regardless of whether the borrower meets its obligations timely or not;

c) default on obligations has occurred, in accordance with the decision governing bank capital adequacy;
d) the amount of impairment of the exposure has been determined through assessment on an individual or group basis, except for exposures where such amount cannot be identified at the level of a single receivable within a group (National bank of Serbia, 2018b).

The first regular reporting date for NPEs was December 31, 2016. Introduction of NPE definition did not revoke reporting requirements in accordance with the previous NPL definition, as well. Parallel reporting has been retained to ensure continuity of NPL data series and it is obvious downward trend in NPE as it is already confirmed for NPLs.

CONCLUSION

Extraordinary high level of NPLs in Serbia and CESEE countries represented large threat for future survival of financial systems. As it was clear that high level of NPLs is not sustainable on long-run, the crucial point was time framework in which NPLs issue was recognized and the resolution starts with selected method. Applied method of NPL resolution differs across countries, but obviously those strategies gave the positive final result impersonated in rapidly decreased gross NPL ratio in all observed countries. By focusing on market approach of NPL Resolution and regulatory changes directed to further strengthening of bank's capacities, in Serbia were created conditions for bank's balance sheet "cleaning" and opening the path for new lending, i.e. growth of credit and economic activity in the Republic of Serbia. In that way are justified joint efforts of Government of Republic of Serbia, National bank of Serbia and all other relevant participant in removing of main causes and drivers for NPL increase that were inherent in the past.

As central banks and other regulatory bodies (such ECB) realized the importance of "health" and secure banking system, they focused on prevention and correction of anomalies which could negatively effect on long run stability. However, high portion of NPLs is an indicator of inadequate loan portfolio quality, so regulators conducted in previous period various exercises regarding asset quality review, with main objective to analyze the stability of financial systems. Results of asset quality review showed the stability of observed banking systems and provided valuable help for further improvements in the process of NPLs resolution. NPLs are not problems of a financial system alone, but a drag on the overall economy as well, since their high share negatively affects credit activity, which may slow down or postpone economic growth. Serbia and group of CESEE countries efficiently resolved the NPLs issue and significantly decreased their level on more than satisfactory level, creating opportunity for credit lending growth in near future and prospective development of banking sectors.

LITERATURE

Barisitz, S. (2011). Nonperforming Loans in CESEE - What Do They Comprise?. *Vienna: Focus on European Economic Integration, Q4/11*, Österreichische Nationalbank.

Đukić, P. (2012). Agonija i šanse za oporavak realnog sektora: Ekonomska politika Srbije u drugom talasu krize. *Privreda Srbije u drugom talasu krize – izgledi za 2012* (Đukić, P. & Đukić, Đ., Eds.), Beograd: Naučno Društvo ekonomista Srbije sa Akademijom ekonomskih nauka i Ekonomski fakultet u Beogradu, pp. 53-77.

European Banking Authority (2014a). EBA Final draft Implementing Technical Standards on Supervisory reporting on forbearance and non-performing exposures. Available at: https://www.eba.europa.eu/documents/10180/449824/EBA-ITS-2013-03+Final+draft+ITS+on+Forbearance+and+Non-performing+exposures.pdf (12.06.2016)

European Central Bank (2014b). Aggregate report on the comprehensive assessment. Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/aggregatereportonthecomprehensiveassessmentexsum201410.en.pdf?7e232769b9508e18b653e6dffa1b1f8e (12.06.2016)

European Central Bank (2015). Note on the 2015 comprehensive assessment. Available at: https://www.bankingsupervision.europa.eu/pdf/ca/2015-11-14_note_comprehensive_assessment.en.pdf?e09834c6564ab84419970599701b5c9c (12.06.2016)

European Central Bank (2016). ECB concludes comprehensive assessment of four banks. Available at: https://www.bankingsupervision.europa.eu/press/pr/date/2016/html/sr161104.en.html (24.09.2018)

IMF (2005). The treatment of Nonperforming Loans. IMF: Statistics Department.

IMF (2018). IMF Data. Available at: http://data.imf.org/regular.aspx?key=61404590 (24.09.2018)

Mirković, V., & Knežević, M. (2013). Porast problematičnih kredita kao prepreka održivom razvoju bankarskog sistema. *XVIII Internacionalni naučni skup SM 2013,* 404-413., Subotica: Ekonomski fakultet u Subotici, UDK: 005.334:336.77, COBISS.SR-ID: 197749772.

Mirković, V., & Knežević, M. (2014a). Rešavanje problema nenaplativih potraživanja kao esencijalni faktor stabilnosti bankarskog sistema. *FBIM Transactions* (Čekerevac Z., Ed.), *2(2)*, 224-234. doi:10.12709/fbim.02.02.02.22

Mirković, V., & Knežević, M. (2014b). Sustainable development in the banking sector from the perspective of non-performing loans. Proceedings of International Scientific Conference *Financial Markets and the Real Economy: some reflections on recent financial crisis* (Marinković S. & Krstić B., Eds.), 133-150., Niš: The Faculty of Economics.

Mirković, V., Dudić, B. & Dudić, Z. (2016). Major aspects of asset quality review process in European Union and Serbia. Proceedings of International Scientific Conference *The priority directions of national economy development* (Đurović-Todorović, J. & Radosavljević, M., Eds.), 173-184., Niš: The Faculty of Economics.

Ministry of Finance - Republic of Serbia (2015). Strategy for NPL resolution. Available at:http://www.mfin.gov.rs/UserFiles/File/strategija%20krediti/1%20NPL%20Strategija%20%28srb%29%20-%20Rezime.pdf (25.09.2018)

National bank of Serbia (2015a). NBS vs ECB – Uporedni prikaz korišćenih metodologija. Available at: http://www.nbs.rs/export/sites/default/internet/latinica/55/55_0/2015_aqr_cmo.pdf (12.06.2016)

National bank of Serbia (2015b). Akcioni plan Narodne banke Srbije za sprovođenje Strategije za rešavanje problematičnih kredita. Available at: http: //www.nbs.rs/internet/latinica/55/npl/akcioni_plan.pdf (25.09.2018)

National bank of Serbia (2017). Decision on the accounting write-off of bank balance sheet assets. Available at: https://www.nbs.rs/internet/latinica/20/kpb/otpis_bilansne_aktive.pdf (25.09.2018)

National bank of Serbia (2018a). Available at: https://www.nbs.rs/internet/cirilica/80/index.html (25.09.2018)

National bank of Serbia (2018b). Available at: https://www.nbs.rs/internet/latinica/55/metodologija_obrazac_NPE_FBE.pdf (25.09.2018)

Vienna Initiative (2018). NPL Monitor for CESEE region – H1 2018. Available at: http://npl.vienna-initiative.com/wp-content/uploads/sites/2/2018/06/NPL-Monitor-H1-2018__.pdf (24.09.2018)