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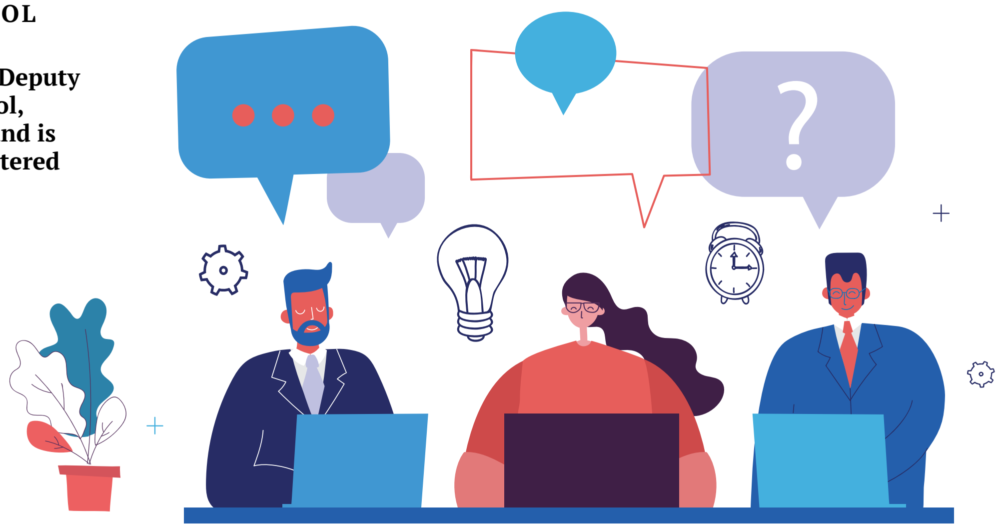

Non-performing loans: An international concern

Professor Owain ap Gwilym discusses the topical issue of bad loans and examines what further measures are needed to build on positive recent progress.

EVENTS during the global financial crisis of 2008 triggered increased attention on the issue of non -performing loans (NPLs) in the banking sector. Problems in addressing NPLs were especially severe in some Eurozone countries including Cyprus, Greece, Italy and Portugal.

In December 2018, European Union (EU) governments reached an agreement on new rules aimed at avoiding a future build-up of bad loans. Subject to ratification at national level, the rules will determine the provisions that EU banks will be required to set aside against potential losses from bad loans. Higher collateral requirements and levels of provisions are necessary steps to address one of the most challenging issues in the euro area banking system. Nevertheless, any uncertainty or discrepancies in the proposed rules might undermine their effectiveness in addressing the problem, while increasing pressure on lenders.

A global issue

However, these issues are not unique to large Eurozone banks and similar problems are becoming evident in other financial sectors and across the globe. RBS recently stated its expectation that bad loans would increase during 2019, citing political uncertainties and geopolitical tensions. While traditional banks have generally strengthened their balance sheets and asset quality in the context of post-crisis regulatory scrutiny, many commentators are concerned about potential problems in the shadow banking sector. As some big banks have been forced to pull back on lending, the alternative lenders have brought new risks to the financial system. In the US, for example, there has been a surge in non-traditional lending to already highly leveraged companies.

Recently, NPL problems reported in China have generated concerns. A UBS report estimated that RMB1.75tn (£200bn) of bad loans were disposed of by Chinese banks in 2018. Authorities in China are concerned about both financial and social stability if NPL problems are not dealt with effectively.

Spotlight on Italy

The Eurozone's largest banks disposed of €30bn (£26bn) of NPLs and advances in the third quarter of 2018. Total gross bad loans at Italian banks fell to €100bn in December 2018, the lowest since July 2011, after banks disposed of more than €17bn worth in December alone.

In the period between 2016 and 2018, several initiatives were undertaken by the Italian authorities to address the NPL problem, such as the creation of two private asset funds (Atlante 1 and Atlante 2) and the introduction of a state-backed guarantee on senior tranches of securitised bad loans (Garanzia Cartolarizzazione Sofferenze, GACS).

SNL reported in December 2018 that Iccrea Banca SpA had closed a securitization deal for NPLs with a gross book value of €2bn, composed of NPLs from 73 separate cooperative banks. To date, this was the largest Italian bad-loan securitization backed by the state guarantee scheme. In February 2019, Intesa Sanpaolo SpA reported that its NPLs were reduced by around €16bn in 2018, and non-performing exposures at Banco BPM SpA were reduced to 10% from 24% over the past two years.

Further actions

Policies aimed at improving economic conditions (in terms of growth and productivity) significantly contribute to easing the NPL problem. An upsurge in the unemployment rate or in the

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sovereign debt burden adversely impacts the debtors' capability to meet their contractual obligations, thereby raising levels of banks' NPLs.

Despite positive developments, including improved macroeconomic conditions and banks' determination to clean up their balance sheets, some challenges persist in the Italian context. Further actions aimed at improving the efficiency of the NPL market, the speed of recovery procedures and reducing the overall uncertainty are fundamental to underpin the positive achievements to date.

NPLs have the potential to cause substantial systemic difficulties and even social instability if not tackled promptly and effectively by the relevant authorities. Academic research can illuminate the factors that contribute to a build-up of NPLs and can identify successful policy initiatives. CB

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