Non-performing loan management

Best practices and implications for non-performing loan management and setting up a workout unit

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Content

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Executive summary

The global COVID-19 pandemic has had a severe negative impact on economies across the globe. Increasingly, banks expect to face the consequences of companies' bankruptcies and cash shortages. During major economic crises, commercial banks experiencing rising non-performing loans (NPLs) are challenged to minimize the impact on the core business and to secure the most value possible from the NPL portfolio. This Report describes three key options a bank can pursue to minimize the impact of NPLs on the core business and discusses the strategic considerations for choosing among these three options:

1. **Continue business as usual.** Keep NPLs on the bank's balance sheet and follow standard procedures and processes for dealing with delinquent loans.
2. **Set up a workout unit.** Set up an independent unit with proximity to the risk and commercial banking areas and task it with mitigating the negative impact of the NPL portfolio on the ongoing business both financially and operationally.
3. **Create a bad bank.** Segregate NPLs into an external organization, operationally, financially, and legally.

Banks must carefully manage NPL portfolios, as elevated ratios can severely hurt a financial institution's financial and operational activities. Significantly higher-than-normal NPL levels can wipe out a commercial bank's profits and dividends for years. The capital market's view and uncertainty of the NPL portfolios' performance and value also can severely reduce a bank's market share and ability to raise capital. In severe cases, NPL issues can result in regulatory capital requirement challenges that are difficult to resolve when the capital market looks unfavorably to the bank's prospects.

To set up a workout unit, banks must take the following key dimensions into consideration:

1. **Collection process.** The key responsibility of the workout unit is the collection, which includes all processes related to managing loans that are in default. The collection process starts at the time of default and ends with the settlement and asset liquidation. It consists of NPL transfer, management, and asset liquidation.

2. **Structure.** To effectively execute its NPL management and resolution tasks, a workout unit should be established as a dedicated NPL unit, the structure of which depends on each bank's context, including its target customers. A typical organizational structure consists of NPL management, asset liquidation, and support functions.

3. **Governance.** The workout unit may either be centralized or decentralized. In the centralized form, the unit is located in one location (usually the headquarters) and handles all NPL cases. In the decentralized approach, the unit is located in multiple locations. For banks serving wide geographical areas and dealing with increased legal complexity of cases due to local regulations, we recommend the decentralized approach.

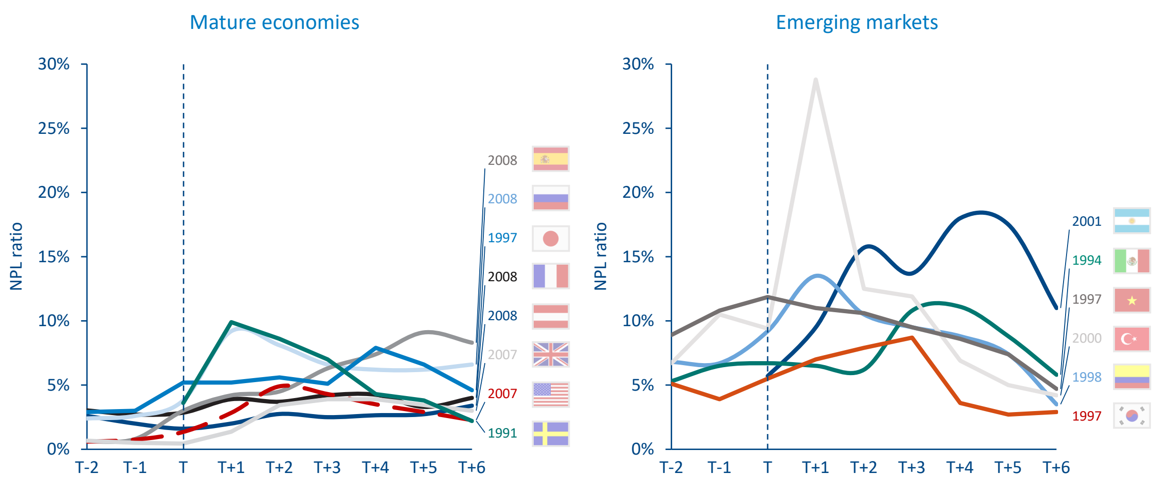
It is crucial that banks decide on the right strategy going forward. The NPL wave will hit all banks with significantly higher volumes of NPLs, impacting them financially and operationally. As managing NPLs is very time sensitive, banks should decide strategically which model of NPL management suits them best, build their capabilities, and ramp up resources well ahead of time. The banks that address their NPL situation first in their market will have the best chance of getting out of the crisis, recovering more quickly than the competition and having better access to the capital they might need.

1. Development of non-performing loans

During past crises, banks have experienced a short-term rise in defaults on NPLs, with a long-lasting impact not only on their balance sheet but also on their stock prices and future ability to raise capital (see Figure 1). The global financial crisis of 2007, for example, tripled the share of NPLs versus total loans (i.e., NPL-ratio) within just two years from the beginning of the crisis. The impact is typically larger on banks in emerging markets where government bailouts and support are less prevalent.

The current crisis is expected to hit banks hard. While the 2007 financial crisis banking sector problems led to liquidity issues in the overall economy, the severe GDP shrinkage following pandemic lockdowns will have devastating effects on the credit worthiness of companies as well as retail customers. Initial forecasts by credit rating agencies hint at one of the highest growths in NPLs in recent years. Credit-rating agency Fitch forecasts NPL ratios rising to as much as 3.5% from 1.5% in the first half of 2019.[1] The NPL ratios will rise even higher in emerging markets, according to S&P global's banking outlook, which forecasts NPL ratios to double in developing economies like the Czech Republic (to 5% in 2021) and Azerbaijan (to 12%-15% in 2021).[2]

Figure 1: Evolution of NPLs around various past national financial crises (T = beginning of crisis)



Source: European Central Bank, IMF, Arthur D. Little analysis

1 "Coronavirus Pandemic Exacerbates China's Credit Card Non-Performing Loans." FitchRatings, 24 April 2020
2 Global Banking Country-By-Country Outlook Midyear 2020: More Or Less Resilient To COVID-19 Shocks." S&P Global Ratings, 9 July 2020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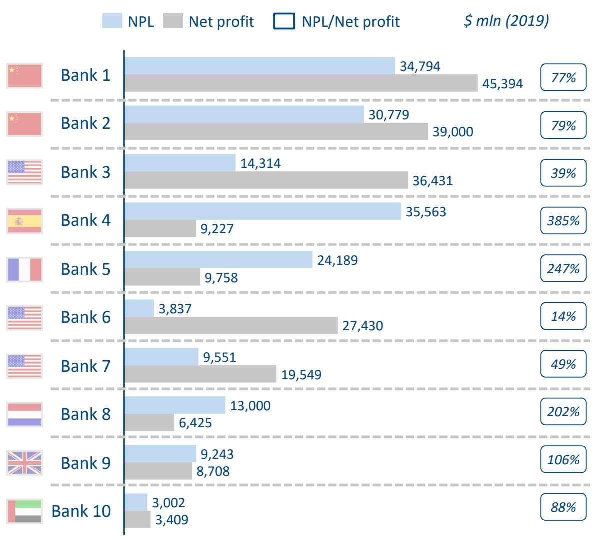
2. Strategic considerations for managing large NPL portfolios

Banks must carefully manage NPL portfolios, as elevated ratios can severely hurt a financial institution's financial and operational activities. Significantly higher-than-normal NPL levels can wipe out a commercial bank's profits and dividends for years. Figure 2 highlights how several large banks' profits scale to their NPL provisions. The capital market's view and uncertainty of the NPL portfolios' performance and value also can severely reduce a bank's market share and ability to raise capital. In severe cases, NPL issues can result in regulatory capital requirement challenges that are difficult to resolve. High NPL levels also divert attention of staff from their normal commercial activities, which may result in missed market opportunities.

Figure 2: NPL volume to net profit in 2019, selected examples

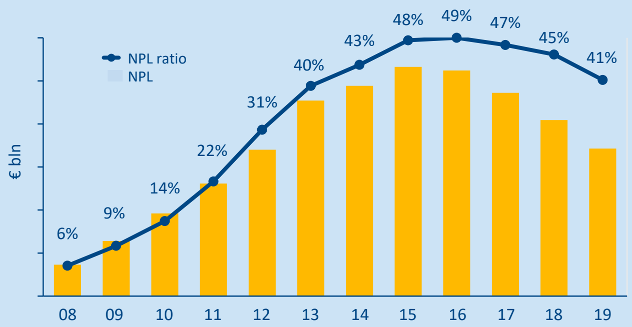


Source: European Central Bank, IMF, Arthur D. Little analysis

Case study: implications of mismanagement of NPLs

The Greek economy was the one hit hardest by the latest European crises. The economy suffered an exponential rise of NPLs. Governments and private investors aimed to protect the financial industry and underwent three rounds of recapitalization between 2010-2015, the final one for a total sum of € 43 billion. Despite these efforts, NPL ratios soared in 2016 and stood at close to 50%.

Figure 3: Development NPL ratio (2008-2019)



Source: Arthur D. Little analysis

To reduce their exposure to NPLs, Greek banks commenced an aggressive collection strategy. As a result, the NPL ratio reduced significantly from 49% (2016) to 41% (2019). As most of the efforts were against loan collaterals, the collection strategy also created a real estate blast with over 20,000 owned and managed properties in Athens. The vast property portfolio not only created additional expenses for the banking entities but also created a drop in the property prices due to increased supply.

There are three key strategic options for handling a large NPL portfolio, differing in extent of isolation as well as resources required:

1. Continue business as usual. Keep NPLs on the bank's balance sheet and follow standard procedures and processes for dealing with delinquent loans.

2. Set up a workout unit (operational separation). Set up an independent unit with proximity to the risk and commercial banking areas, and task it with mitigating the negative impact of the NPL portfolio on the ongoing business, both financially and operationally.

3. Create a bad bank (operational, financial, and legal separation). Segregate NPLs into an external organization, operationally, financially, and legally.

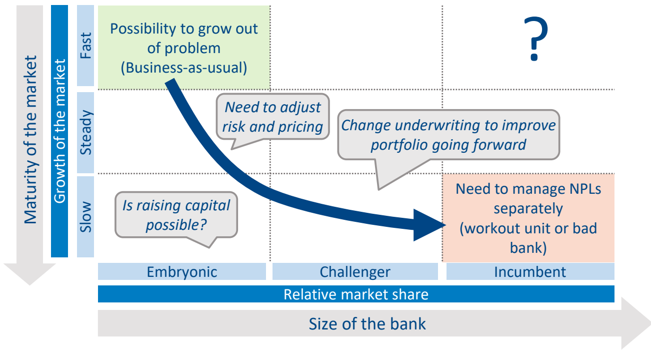
All lending institutions have processes and procedures in place to deal with delinquent loans, so these institutions already have functions and departments to deal with NPLs on a business-as-usual basis. The difference with a separate workout unit is that it is temporary in nature to deal with a unique situation. The workout unit also is separate from the rest of the organization, allowing it to manage a portfolio of NPLs (or even other assets) with little consideration for the continuous commercial activities of that institution, so it can focus fully on value optimization of the portfolio.

A bad bank can be seen as an extreme case of a workout unit that is placed outside the organization legally. Though various forms of bad banks exist in literature, for the purposes of this article, the term refers to a legally, operationally, and financially separated entity into which NPLs are offloaded.

The NPL strategic assessment matrix in Figure 4 guides decision making on which option to select, considering the following dimensions:

- Size of the problem. How large is the portfolio of NPLs as a percentage of the bank's total balance sheet?
- Market maturity. What is the expectation of the growth of the bank's balance sheet in the years to come?
- Market dynamics. Is the banking market consolidated or fragmented?
- Market share. What is the bank's market share?
- Ability to raise capital. Can the bank raise capital from existing or new shareholders to fund growth?
- Capital/shareholder view of the bank versus its NPL portfolio. Is this view aligned with management view?

Figure 4: NPL strategic assessment matrix



Source: Arthur D. Little analysis

When to continue business-as-usual?

When NPL provisions and performances are manageable (i.e., impact on profitability is limited and/or accessibility to public and private recapitalization is not at risk), banks typically follow their standard procedures and processes for dealing with delinquent loans. By growing the balance sheet, the (relative) impact of the NPL portfolio can be mitigated (at least with respect to recapitalization opportunities).

When to set up a workout unit?

Setting up a workout unit requires major investments in the building of a separate unit and managing the change for a relatively short period of time (typically three to five years), yet these investments are well worth the risk when properly set up and managed. A rather small bank in a fragmented market with a medium-sized NPL portfolio that has access to capital might be better served by focusing on growing its balance sheet rapidly instead of setting up a workout unit.

When to create a bad bank?

When maximum risk transfer is required, banks should create a bad bank. This can be a complex operation requiring significant investments (typically significantly higher than for setting up a workout unit). A bad bank requires a separate legal entity and operational organization, which can be extremely complex, especially regarding impaired asset valuation. When other alternatives have proven insufficient, and in the right circumstances, the benefits of creating a bad bank can outweigh the investment required.

The main benefit of setting up a bad bank is that it splits the bank's assets and liabilities. The NPL portfolio's quality and value is hard to assess from the outside, and investors interested in a bank are often very different from investors interested in a "distressed" NPL portfolio. The separation of the NPL portfolio into a bad bank is fundamentally about making the bank attractive for investors by aligning its risk/return profile with investors' preferences.

3. Managing from the inside: setting up a workout unit

The key responsibility of the workout unit is collection, which includes all processes related to managing loans that are in default. The collection process consists of three steps:

- Step 1: NPL transfer. According to Basel III guidelines, loans become non-performing after being in default for 90 days, after which the loans should be transferred to a centralized collection unit.
- Step 2: NPL management. NPL management is core to the workout unit and involves activities such as forbearance, cash collection, and asset foreclosure.
- Step 3: Asset liquidation. In the case of asset foreclosure, the bank must liquidate the foreclosed assets as soon as possible to recover lost resources.

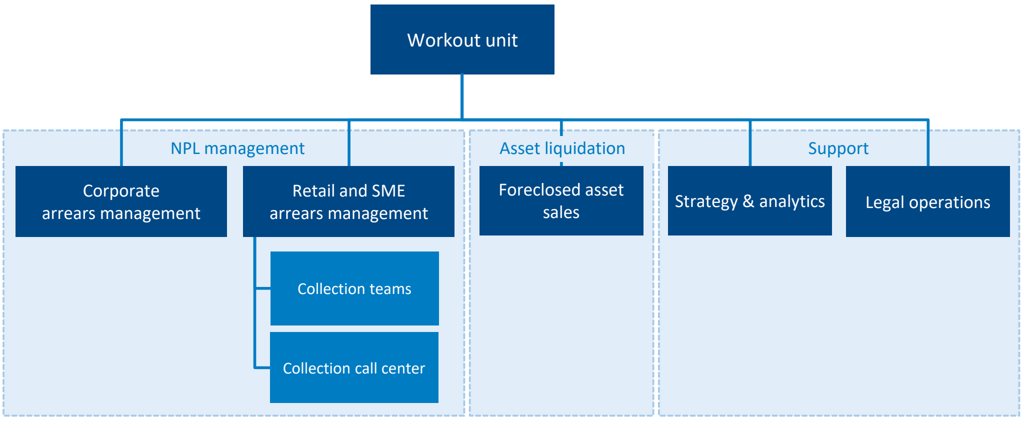
To effectively execute its NPL management and resolution tasks, a workout unit should be established as a dedicated NPL unit that is a permanent part of the banks' organizational structure reporting directly to the CEO and CFO and informing the risk management function. The workout unit must be kept separate from all loan originating units, since potential conflict of interest may exist between loan issuing agents and collection agents.

This separation of duties and responsibilities should cover the decision-making process as well as tasks. The workout unit should determine the most appropriate approach for collecting a loan with the bank's interest in mind.

The workout unit's exact organizational structure depends on each bank's context, including its target customers. For instance, a small bank serving mainly retail customers would require a dedicated collection call center as well as a retail and SME arrears management department. In contrast, a large bank with retail and large corporate customers requires dedicated departments for each segment and may need sub-departments to handle special cases (e.g., managing a case against a multinational company in four different countries).

Figure 5 illustrates a workout unit's typical organizational chart, with three main functions: management, asset liquidation, and support.

Figure 5: Example of a workout unit organizational structure



Source: Arthur D. Little analysis

NPL management functions

Staffing. Staffing is among the most challenging yet crucial activities of a workout unit. There are three options: internal sourcing, external sourcing, and a hybrid approach.

Common practice in internal sourcing is to reassign relationship managers (RMs) to the workout unit, which causes two major problems. First, due to the lack of NPL management capabilities, a bank will have to invest heavily in capability building through training. Second, RMs, with a customer-centric background, are often too soft on debtors and unable to make the hard choices NPL management requires.

External sourcing refers either to taking over a currently active collection agency or hiring people with a track record in debt collection. Although external sourcing solves the capability gap problem, it creates other major issues. Merging a collection agency into a bank creates a disconnect between banking activities and workout activities, as the new hires do not understand the banking operations; especially because the new organization limits the collection practices they can use. Furthermore, since workout units are typically temporary, employing people could cause issues in the medium- to long-term when the unit is disbanded.

We recommend a hybrid approach, allowing internal RMs and external collection agents to share best practices in both areas and creating a good foundation for performance.

Remuneration and incentive system for collection teams. Keeping top-performing collection agents motivated is a significant management challenge. A best practice is a quarterly incentive system, in which collection agents are paid a fixed monthly salary in line with the general salary level of RMs and agents in other units of the bank. At the end of each quarter, the bank creates a bonus pool based on key performance indicators (KPIs) of each department involved in the collection process, and each collection agent receives an additional bonus based on his or her contribution to that pool. This proposed remuneration scheme offers two major advantages:

- Collaboration. As the size of the bonus pool rests on overall performance of the departments, collection agents should collaborate on solving the cases, decreasing the risk of silo working.
- Competition. As each agent receives a bonus corresponding to his or her contribution to the overall unit performance, agents are incentivized to collect as much as possible to increase their share.

Best practices:

- Implement an independent workout unit reporting directly to CEO/CFO and informing the risk function.
- Allocate each case to one collection agent, responsible for the case from start to finish.
- Assign all cases of a single debtor to one collection agent.
- Review and adjust collection agents' portfolios based on workload and number.
- Invest in improving collection agents' negotiation skills and legal knowledge.
- Design a specific collection path for complex cases or cases with high exposure.
- Link collection agents' compensation to their individual performance.
- Do not design an aggressive incentive scheme as it might foster unethical activities that may harm the bank's image.

Asset liquidation function

According to accounting rules and regulations, banks should classify foreclosed assets as non-performing in their balance sheet. This reduces banks' lending capacity, which in turn decreases banks' interest revenue and eventually hurts the capital adequacy ratio. The asset liquidation function is responsible for selling all foreclosed assets to recover lost resources.

Foreclosed assets valuation. Asset valuation means setting a fair market value on all of a bank's repossessed assets. The valuation may be obtained from either official appraisers or market sources and databases. The bank must choose the right valuation frequency for all repossessed assets. As a rule, and in the absence of major market disruption, banks require the appraisal of all repossessed assets once a year, ideally at the registry anniversary of the collateral. Awareness of conflicts of interest, potential for fraud, and other issues are crucial. When the number of foreclosed assets grows, the bank's ability to manage these conflicts and ensure value diminishes, so special attention is required in the decision-making process.

Foreclosed assets sales. Selling foreclosed assets poses a major problem for the workout unit, as no bank has the inherent capability of selling assets, especially at a significantly larger scale than is normal for its operating environment. To solve this challenge, management should build an external sales network by leveraging external agents, market analysts, and specialists. The network should be incentivized by a simple commission payment scheme.

Best practices:

- Set up a vendor management process.
- Set specific service levels for all vendors.
- Promptly notify the debtor and guarantors that their asset has been assigned to workout units.
- Update the bank's internal procedures to reflect valuation methodologies.
- Sketch a sales plan for each asset, especially valuable assets.

Support functions

Strategy and analytics (S&A). S&A has two major objectives: (1) build and manage a comprehensive database of NPLs, and (2) analyze the data and derive business insight to support other functions.

The workout unit requires an IT system that covers the collection process from start to finish. S&A should work closely with the IT department and external software providers to ensure the delivery and implementation of the collection software, which should have three distinct parts: (1) NPL management, (2) legal case management, and (3) foreclosed assets management. NPL management should identify loans in default, allocate them to collection agents based on predefined rules, and record actions taken on each case. Legal case management keeps track of all legal cases. Foreclosed asset management helps the workout unit to keep track of all repossessed assets and facilitates the liquidations process.

The difficult part of designing a collection system is matching NPLs with legal cases. As an example, a bank has granted a corporate customer a large loan that is now in default. It is reasonable to assume that the company had real estate as collateral, but the collateral does not cover all the debt. So, the bank files a lawsuit with the bankruptcy court. Now that NPL has generated two legal cases. Other cases may also be filed, such as appeals or even civil or criminal cases against management. Designing a system to cover all this complexity is an arduous task that should be managed by S&A.

Legal operations. Banks require legal advice and operation support across the collection process. Generally, the day-to-day legal tasks of the workout unit are straightforward and do not differ much from when the bank's NPL portfolio is less problematic. It should be noted, though, that developing an internal team to support workout unit activities does not imply that all legal work should be done internally. There are two reasons for the bank to retain external lawyers on its payroll. First, the more complicated cases should be handled by professional lawyers. Second, external legal counsels can support and guide internal paralegals in terms of handling legal cases that improve the internal teams' knowledge and expertise; this is especially important in initial phases of the setup.

For banks with a high number of NPLs, creating a degree of legal specialization is advisable by creating sub-departments to pursue cases in different areas (e.g., bankruptcy and mortgage enforcement). However, the number and formation of sub-departments should be defined in the context of each individual bank.

Best practices:

- Align S&A incentive system with workout unit's collection performance.
- Push for performance reports, especially during the initial phases of implementation.
- Invest in building S&A agents' data-handling and data analysis skills.
- Make S&A responsible for the accuracy of the workout unit database.
- Implement a vendor management function in the legal operations department.
- Set specific service levels for external vendors.
- Do not distract legal officers with non-NPL cases.
- Set periodic meetings between legal officers and collection agents to discuss cases; this helps in transferring know-how and designing new collection paths for cases.

Governance of the workout unit

The workout unit may either be centralized or decentralized. In a centralized form, the unit is located in one location (usually the headquarters) and handles all NPL cases. In the decentralized approach, the unit is located in multiple locations. For banks serving wide geographical areas and multiple countries that deal with increased complexity of cases due to local regulations, we recommend a decentralized approach.

Conclusion

The NPL wave will hit all banks, financially and operationally. As managing NPLs is very time sensitive, banks should decide strategically which model of NPL management suits them best, build up the capabilities, and ramp up resources well ahead of time. The banks that address their NPL situation first in their market will have the best chance of getting out of the crisis, recovering more quickly than the competition, and having better access to capital.

Notes

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