Grant Thornton

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Non-Performing Loans Solutions

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Resolving the issue of Non-performing Loans (NPLs) is not just a regulatory problem to address but a way to manage a bank's balance sheet and increase profitability. Sound management of non-performing loans means that these would be replaced by new, sound exposures. Interest income would be boosted as a result, as rates charged on new business would substitute for the lower earnings from non-performing loans. Other benefits would include lower funding cost or lower capital requirements that would be forthcoming from a reduction of NPLs.

The need for a strategy

A clear strategy is essential to deal with the NPL problem. This entails the following:

1. Operational assessment

The operational assessment involves assessing the internal capabilities and resources within the bank to deal with the problem. Often external help is sought. In addition, an assessment of the external environment is conducted to analyse the conditions and market appetite for NPLs as for any solution the bank to consider the balance sheet implications. Besides analysing the regulatory implications, the accounting treatment has also to be considered. With the introduction of IFRS 9 and more forward-looking provisioning rules could be conducive to faster recognition of losses.

2. Strategic development

The NPL strategy must include specific targets to be achieved over different time horizons, typically short, medium and long terms. Both qualitative and quantitative targets should be set. Detailed quantitative modelling allows the bank to not only set realistic targets but also consider the changes in Risk Weighted Assets and other important implications.

3. Implementation planning

As a direct result of the operational assessment, the operational plan is implemented and may not only include bolstering the internal resources but even altering the internal organisational structure of the bank.

4. Embedding the strategy

Embedding the strategy entails having a proper governance structure within the bank to have the necessary management processes to enable regular reviews and independent monitoring.

Introduction of revised supervisory expectations with regards to Non-Performing Loans

The European Central Bank (ECB) recently introduced some amendments related to supervisory expectations for prudential provisioning of new non-performing exposures. Decision was taken after considering the adoption of a new EU regulation, that came into effect on 26 April 2019. It outlines Pillar 1 treatment for NPEs and is complementary to the existing prudential rules and requires a deduction from own funds when NPEs are not adequately covered by provisions or other adjustments.

The changes which were being made to the supervisory expectations disclosed in Addendum to enable treatment of NPEs more coherent are as follows:

- NPEs resulting from the loans originated from 26 April 2019 onwards are subject to Pillar 1 treatment, with the ECB closely monitoring the risks from them.
- There is an alignment of the relevant prudential provisioning time frames, the gradual path to full implementation and division of secured exposures, along with the treatment of NPEs guaranteed or insured by an official export credit agency, with the Pillar 1 treatment of NPEs listed new EU regulation.

At the start of ECB Banking Supervision, in November 2014, the volume of NPLs maintained by substantial institutions amounted to around €1 trillion. This had dropped by nearly half until the end of March 2019, to €587 billion (an NPL ratio of 3.7%).
Even after witnessing the latest progress, the ECB considers it of paramount importance that level of NPLs is further reduced, thereby resolving them in a rapid manner while the economic conditions are still promising.

Notably, the commission urges the European Parliament and the Council to swiftly agree on all elements of the overall package of legislative measures proposed in March 2018 to deal with NPLs. This package, together with the marked advances in the reduction of NPLs, in collaboration with EBA, the ECB and the European Systemic Risk Board, is essential to support the ongoing collective work to help reduce remaining risks in the European banking sector and would ease, specifically, the completion of the Banking Union.

<u>Note:</u> Pillar 1 refers to minimum capital that all banks are legally required to hold under the Capital Requirements Regulation.

Potential solutions to the NPL problem

Banks with more than 15% in NPLs are now considered to have a high NPL position. Although there are different ways to reduce this percentage, a clear process must be followed to reach an optimal decision. Internal workout by the bank originally holding the impaired asset marks one end of the spectrum of options and should always feature highly in any broader resolution scheme. On the opposite end, direct sales to investors offer an opportunity to dispose of NPLs quickly. At one end of the spectrum there is an "on-balance sheet" solution, while at the other end lies an off-balance sheet one.

These include:

- Internal workout
- Asset protection scheme
- Securitisation
- Asset Management Company
- Direct Sale

Improvements to bank practices and to data quality and availability are also going to take time before progress becomes tangible.

How we can help

At Grant Thornton we have significant capabilities and expertise to assist you in managing your Non-Performing Loans portfolios across their life cycle.

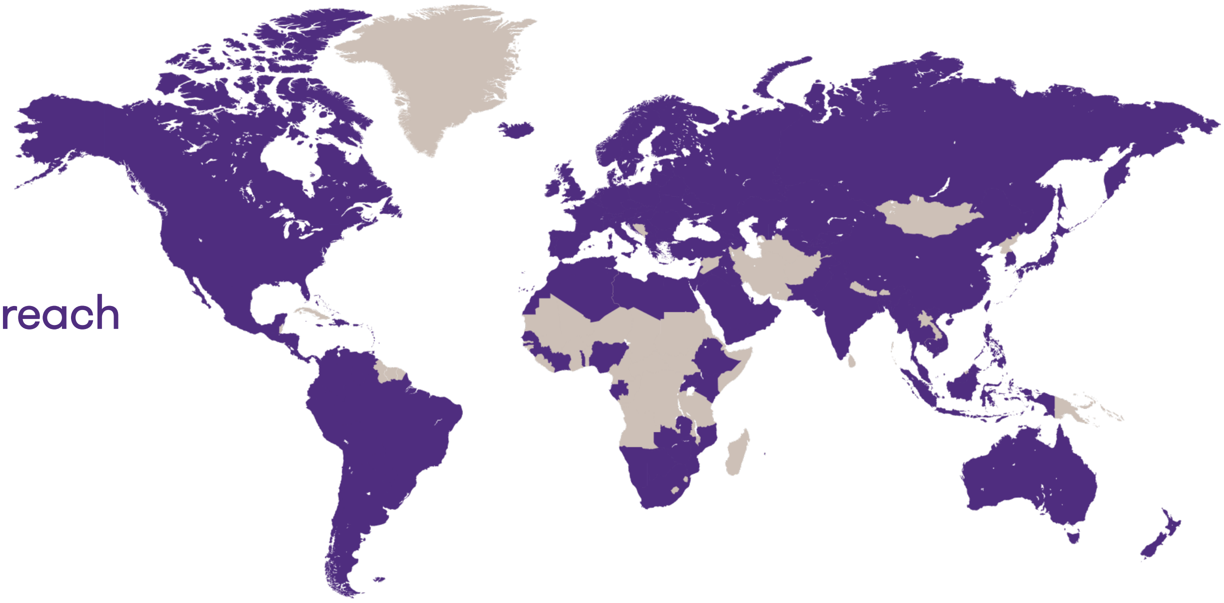
We are capable of combining our quantitative risk, capital markets, accounting, IT and regulatory expertise to provide insights and assist your organisation in several ways:

- Develop your NPL strategy and help you execute and implement it
- Restructure your NPL portfolios and transact accordingly
- Provide you with due diligence advice
- Build or validate your quantitative models and stress test these as necessary
- Provide you with support to assess the quality of your collateral
- Assist you in any regulatory reviews including the ECB's AQRs
- Specialist accounting support for financial reporting purposes

Our experience

Our professionals bring a wealth of experience which includes advising banks and regulators on NPLs and other troubled assets:

- Advised the European Commission on the implementation of the Asset Relief Programme for troubled European Banks in relation to the Global Financial Crisis, covering banks from the UK, Germany, France, Belgium and the Netherlands. Banks' exposures included retail and commercial loans to structured products (CDOs, CLOs, CDOs^2, CBMS and RMBS)
- Advised a European banking group on the acquisition of several distressed loan portfolios collateralised through real estate assets. Provided advice relating to the impact on risk-weighted assets, capital adequacy and liquidity of the bank as a result of the acquisitions and overall portfolio restructuring
- Advised a Southern European bank on balance sheet restructuring which included developing and executing a strategy to reduce NPLs. Part of the NPL portfolio was sold to a fund
- Expertise in segregating non-performing assets into a "Bad" bank
- Participated in several asset quality reviews across the Eurozone
- Calculation and verification agent for a number of securitisation vehicles in the UK for a Global Investment Bank. Underlying assets including RMBS and CMBS
- Due diligence and valuation of a portfolio of asset backed securities (CDOs, CLOs, RMBS and CMBS)* for an acquisition by a Japanese Securities House. Transaction was valued at USD400 Million
- Structuring transaction advice around the securitisation of a number of retail and commercial mortgage portfolios for Cypriot banks
- Acted as valuation agent for a number of European Banks owning Asset Backed Securities post the Lehman demise. Valuations were performed on a monthly basis for IFRS Reporting Purposes. Additional services were provided in relation to the disposal of some of these securities
- Provided independent valuation advice to the Board of Directors of a Swiss Hedge Fund in relation to the disposal of a portfolio of Asset Backed Securities
- Provided independent valuation services to a number of major US hedge funds regarding securities held within asset-backed structures on a quarterly basis for US GAAP Financial Reporting purposes
- Advised on the structuring of a CMBS for a US financial institution
- Appointed Expert to European Commission DG Comp to advice on the Implementation of the Asset Relief Programme in 2009 for troubled European Banks. Reviewed valuation and estimate of expected losses in portfolio of complex Asset Backed Securities owned by such bank across the EU. Advised on Balance Sheet Restructuring for such banks
- Advised a European Bank on the acquisition of a number of loan portfolio including corporate, SME, commercial and retail mortgages
- Model validation advice to a large Canadian Pension Fund in relation to trading in credit derivatives and synthetic CDO portfolios



A global reach

We discover what is important to you and make it important to us

Our culture is built on a genuine interest in our clients – their challenges, growth ambitions and wider commercial context. You get the attention you deserve from approachable, senior professionals who ask the right questions, listen and provide real insight and a clear point of view.

The bottom line

- A relationship-led approach with more time and attention from partners and senior advisers
- A deeper understanding of your business for more meaningful advice and recommendations.

Agile and responsive service

Our size and structure creates advantages for you. We adopt a flatter structure, with shorter decision-making chains, empowered teams and no complex chain of command. We have all the necessary processes and controls in a streamlined, efficient and responsive environment.

The bottom line

- A faster response when you need quick answers and clarity
- Anticipating the answers you will need before you ask.

Pragmatic solutions to help you improve and grow

Our teams bring ideas to the table, going beyond the technical issues to recommend ways to make your business better. We balance a desire to do what's best for you in the future with an experienced sense of what is going to help you now.

The bottom line

- Helping you think ahead and think more broadly
- Proactively identifying opportunities for improvement and growth

Collaborative teams with a different mindset

Our people are open, accessible and easy to work with. We work through the issues alongside you and challenge your ideas where necessary, whilst keeping an independent perspective. Our collaborative style also enables us to assemble teams across service lines, industries and geographies to tailor our capabilities to your requirements.

The bottom line

- Teams and solutions built around your needs not our structures
- A better working relationship with you and your team

USD5.45bn (2018 revenue) | **53,000+** people | **700+** offices | **135+** countries

Our distinctive client experience sets us apart

Key contact

Related expert

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George is a Partner in the Advisory arm at Grant Thornton. He holds a Bachelor of Arts (Honours) in Accountancy and a Masters degree in Business Administration (MBA) from Henley Management College (UK). He has over 25 years experience in corporate and project finance, research and development, strategic and project management.
As a partner in the Transaction Advisory Services at Grant Thornton, George leads a team of professional business advisors that provide projections, feasibility studies and cost benefit analyses, assistance in the preparation of business plans, business valuations, due diligences, assistance with mergers and acquisitions, project finance and corporate finance advisory services for a range of private sector and public sector organisations.

Grant Thornton Malta is an accredited Corporate Advisor on Prospects – the Multi-lateral trading facility established by the Malta Stock Exchange with the specific objective of widening channels that provide finance to SMEs.

George held a key management role in the Asset Quality Review carried out by MFSA for all significant Maltese banks. The project involved the valuation of a c.3k properties held as collateral for financial assets. George's role involved the construction of an extended hedonic pricing model to value the properties.

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