Non – Performing Loans: Are we moving in the right direction?

The sharp increase in non-performing loans (NPLs) at the Cypriot Banks is not a unique or a novel phenomenon. The United States financial crisis that threatened to bankrupt banking giants that were deemed "too big to fail" and the bank run on Northern Rock in the UK are but just two famous examples where the balance sheets of banks were found loaded with "toxic loans".

In Cyprus, the process of dealing with the challenge of the NPLs started upon the arrival of the Troika to Cyprus in 2012. The first important step in this process was to acknowledge the problem and understand its size and contributing factors. An arrears Management framework and a banking code of conduct were quickly put in place, while the focus of the banks in granting new loans shifted almost exclusively on repayment capacity of the borrower rather than collateral value.

The Troika mandated that the necessary framework be put in place to enable the banks and their non-performing customers to come together to the negotiating table and find lasting solutions. The Banks were guided to establish specialised internal units that became operational on the basis of the arrears management framework previously introduced. With the help of professional consultants, the banks realised that the workout and management of NPLs would be a major component of their operations for years to come and efficiency and cost-effectiveness in this process would be key to their sort term viability and profitability.

The main goal of any measure aiming at addressing the NPL challenge needs to discourage strategic defaults*, a major contributor to the exorbitant and disproportionate rise in the NPLs: Economists found that the rise of the NPLs in the last 12-18 months is disproportionately high considering the scale of the economic recession and the rise in unemployment (in comparison with other countries impacted by the financial crisis, like Ireland, Spain and Greece). * Borrowers stop repaying their loans even when they have the means to do so in the expectation that, for example, the banks will be forced to accept lower amounts for repayment.

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Not surprisingly, the classic "carrot and stick" approach will have to be employed. The banks need to be able to liquidate the collateral of an NPL in a reasonable amount of time (currently more than 7-10 years). At the same time, they should stop raising the interest rates on non-performing loans (sometimes to 13-15%!), as this is a recipe for increasing the amount of NPLs and further dissuading the borrower to walk away from the negotiating table.

Viable borrowers should be supported and provided with various incentives in the form of "discounts" to the interest margins payable and maybe even "haircuts" on the loan balance for (e.g.) early repayment. This process is not and cannot be generally applicable to all borrowers; rather – to be effective – it needs to be customised to the specific circumstances of each borrower and even of each loan.

It is clearly not in the interest of the banks to acquire the loan collaterals (almost always real estate assets). The banks have neither the financial incentive nor the expertise to acquire and manage properties. Without going into technical details, by adding real estate assets to their balance sheets, the banks can be worse off in both profitability and capital adequacy. In almost every single case, a negotiated settlement is the better solution for both parties.

The effectiveness of the process of restructuring NPLs will be key to the successful recovery of the Cypriot economy. It should not be seen as a process that benefits the banks; the implications of a successful implementation of the NPL management framework will be much broader: the banks will – by necessity – come out of the process more efficient, able to offer better service and better pricing to "performing" borrowers. And foreign direct investment will be more likely to flow when the investors will know that the risks they are taking in investing in Cyprus can be accurately assessed and quantified. The disposal of bank assets (loans) to local or foreign funds could provide much added liquidity to the local market that is currently "dry".

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