Fifth BdE-CEMFI Conference on Financial Stability

Discussion of: Bank Supervision and NPL cleansing

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Summary

- Question: What are the consequences of non-performing loan (NPL) provisioning?
- Setting: ECB announcement of new guidelines in 2018 ("comply or explain")
  - Increases NPL exits from registry (more for more profitable banks)
  - Reduces lending (+ real effect)
- Preferred interpretation/mechanism
  - Unclear

Discussion

- Take results as given
  - Reasonable/plausible research design
- Describe the simplest journey of a loan from issuance to write-off, through the lens of the capital adequacy ratio

$$CAR = \frac{Capital}{Assets^{RW}}$$

Performing $\rightarrow$ Non-performing $\rightarrow$ Provisioning $\rightarrow$ Write-off

Example loan

- 10 million Euro principal $\rightarrow$ A $= 10$ (book assets)
- Ex ante safe $\rightarrow$ risk weight $= 20\% \rightarrow A^{RW} = 2$
- Target CAR $= 10\%$

Question: how much capital required to restore target CAR after each transition?

Performing $\rightarrow$ Non-performing $\rightarrow$ Provisioning $\rightarrow$ Write-off

Performing $\rightarrow$ Non-performing

- **Performing**
  - $A = 10$; risk weight $= 20\%$; $A^{RW} = 2$

$\Downarrow$ (90 days late or unlikely to be repaid)

- **NPL**
  - $A = 10$; risk weight $= 150\%$; $A^{RW} = 15$
  - $\text{CAR} = \frac{Capital}{Assets^{RW}(\uparrow 13)}$

$\rightarrow$ Must raise 1.3 million capital to keep CAR constant

Non-performing $\rightarrow$ Provisioning

- **NPL**
  - $A = 10$; risk weight $= 150\%$; $A^{RW} = 15$

$\Downarrow$ (due to regulation, accounting, business)

- **Provisioning**
  - A $= 10$; counter-A=-10; risk weight $= 50\%$; $A^{RW} = 5$
    (CAR $= \frac{Capital(\downarrow 10)}{Assets^{RW}(\downarrow 10)}$)

$\rightarrow$ Must raise 9 million capital to keep CAR constant

Observations

- Magnitude. Provisioning affects CAR numerator, so capital requirement consequences are an order of magnitude larger than those of NPL alone
  - $\Rightarrow$ Without provisioning, NPL avoids the regulatory cost of realizing the loss
  - $\Rightarrow$ With provisioning, NPLs' regulatory cost is high

- Heterogeneity
  - Banks: Cost of deviating from target ratio, raising equity, or adjusting lending
  - Loans: Safer loans have lower risk weights (with r.w.=20%, must adjust lending by 45 million)

Provisioning $\rightarrow$ Write-off

- Provisioning
  - A $= 10$; counter-A=-10; risk weight $= 50\%$; $A^{RW} = 5$

$\Downarrow$

- Write-off
  - A $=$ counter-A $= 0$; $A^{RW} = 0$
    (CAR $= \frac{Capital}{Assets^{RW}(\downarrow 5)}$)

$\rightarrow$ Marginal benefit from cleaning provisioned NPLs: Relaxes capital constraint

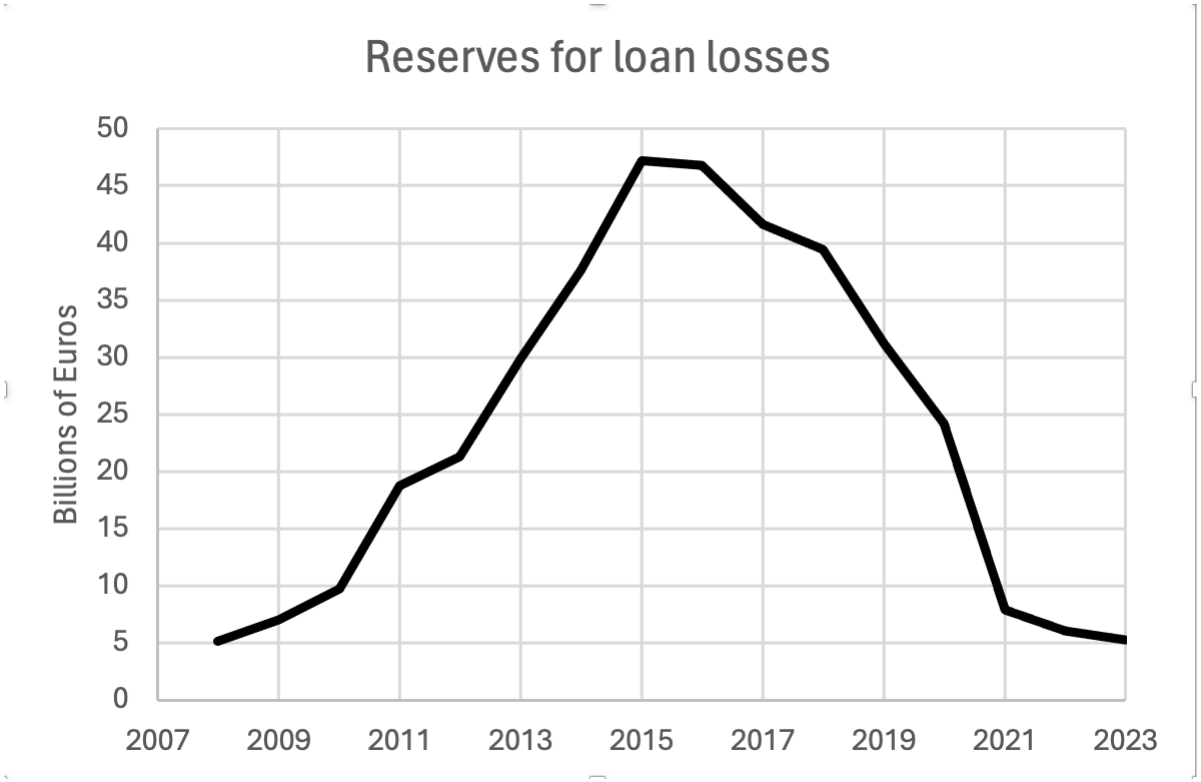
Implications

Performing → Non-performing → Provisioning → Write-off

- Risk discovery
  - Provisioning increases NPL recognition cost → incentives to evergreen
  - Two problems:
    1. Evergreening can cause NPL exit
    2. NPL disposal ratio may increase because entry of new NPLs drops
- Regulatory forbearance
  - What does the regulator push if provisioning according to guidance would bank to violate minimum capital requirement?
  - Bad banks: do they dispose fewer NPLs because they are excused from provisioning by the regulator?

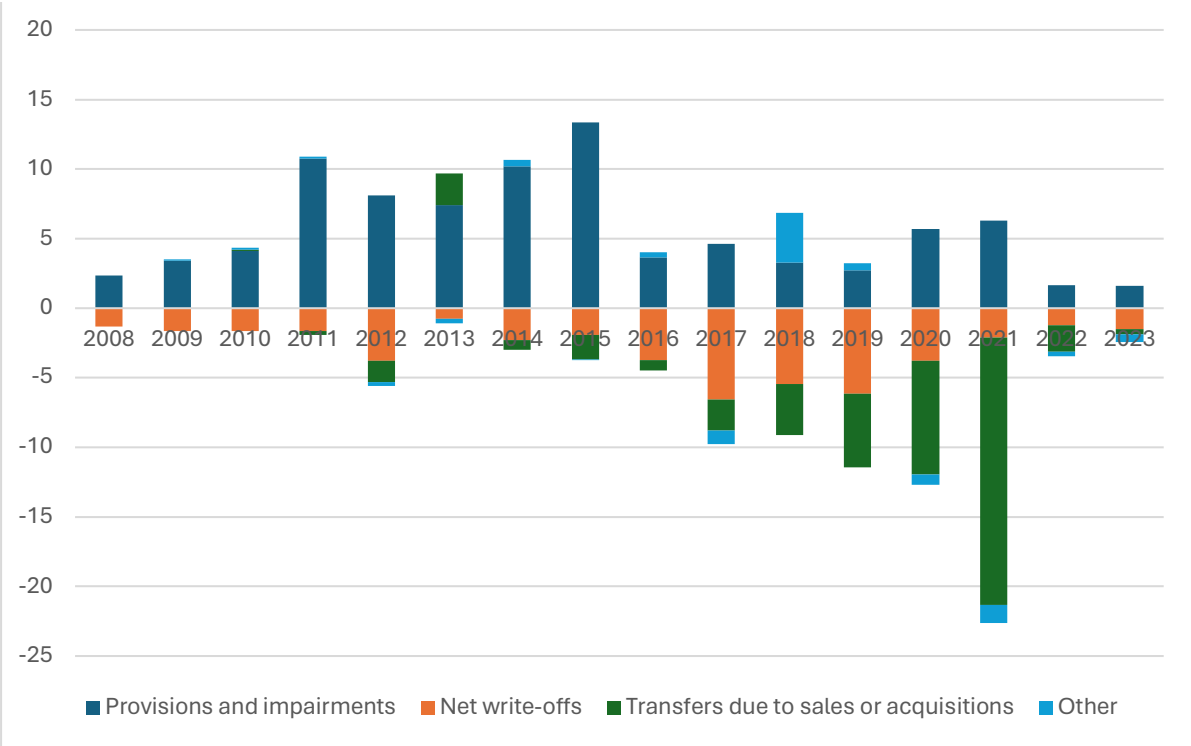
Example: Greece

- Consolidated balance sheets of the 5 systemic banks
- Reserves against Future Loan Losses



Example: Greece

- Consolidated balance sheets of the 5 systemic banks
- Changes in "Reserves against Future Loan Losses"



Overall

- All results seem consistent with a capital regulation cost mechanism
  - You have the regulatory data to calculate all the numbers in my example for every NPL
- Characterize full NPL dynamics implications
  - Look at ex ante incentives to disclose NPLs