International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2017 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

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Trends in the Irish Non-Performing Loan Market

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Synopsis

Ireland's non-performing loan ratio was the sixth highest in the European Union, however, the number of non-performing loans on Irish Bank books has halved since 2014.

The European Central Bank is closely monitoring Irish Banks to insure they meet a 5% non-performing loan ratio by 2020 in line with European norms. As regulatory pressure to off-load non-performing loans increases, Irish Banks have intensified their efforts to rectify the high ratio of non-performing loans. Various legislative and regulatory polices implemented by the Central Bank of Ireland and Irish Banks alongside secondary loan market sales has significantly reduced the level of non-performing loans on Irish Bank books.

1. Introduction

The number of non-performing loans on the books of Irish credit institutions[1] (hereinafter referred to as 'Banks') has significantly declined year on year, having previously risen to one of the highest levels in Europe.

High levels of non-performing loans ('NPLs') put pressure on an economy, reduce profitability, increase funding costs and negatively affect credit supply. NPLs tie up bank capital needed to absorb potential losses which can constrain new lending. According to the European Banking Authority ('EBA') high levels of NPLs and low profitability constitute some of the main risks to European banks now and in the coming years.[2]

According to the EBA, a loan is classified as non-performing when repayments are more than 90 days past-due and or the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.

2. Ireland as a comparator

Although, every member state in the European Union has experienced a downward trend in NPLs, the European Commission remains cautious and recently reported there are 'remaining risks to financial stability and to economic growth, stemming from the still elevated level of NPLs'.[3]

Ireland's NPL ratio was the sixth highest in the European Union but Ireland has experienced the fourth largest reduction in its NPL ratio compared to other member states.[4] The Irish stock of NPLs has halved since 2014.

Although NPLs are falling, the aggregate loan book of Irish Banks remains one of the most distressed in the EU.

3. The Irish situation

3.1 Past

The 2008 financial crisis had a profound impact on the global economy and Ireland was certainly no exception. Ireland faced its own domestic banking crisis when the property bubble burst. The property boom caused unsustainable real estate prices and massive exposure to property related lending in the commercial real estate ('CRE') sphere alongside the residential market.

The dramatic drop in property values combined with a declining macro economy resulted in borrowers' incapacity to service their debt and a consequential rise in NPLs. Borrowers were unable to find employment and were unable to make repayments. NPLs drastically increased in all of the major Irish Banks.

Notes

1 Credit Institution is defined within the meaning of Article 4(1) of Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/ 2012.
2 EBA Risk Assessment Report – December 2016
3 European Central Bank Financial Stability Review May 2018
4 Ratio of non-performing loans compared to total gross loans.

3.2 Present

The ECB's single supervisory mechanism ('SSM')[5] is closely monitoring Irish Banks to insure they meet a 5% NPL ratio, in line with European norms. As regulatory pressure increased, Irish Banks intensified their attempts to off-load NPLs and rectify their balance sheets which remain burdened by poor lending practices that existed before the 2008 financial crisis. The SSM and the Central Bank of Ireland ('CBI') wrote to the major Irish Banks in 2015 outlining their expectations in relation to each Banks' respective strategy to sustainably reduce the level of NPLs on their loan book.

Under ECB and CBI scrutiny, Irish Banks have sold NPLs with a gross value of EUR 6.5bn to US investment vehicles owned by Cerberus, Goldman Sachs and Lone Star Funds.[6]

4. Comprehensive solution in Ireland

As economic recovery advances, GDP growth and employment resumes. Unemployment in Ireland in Q4 2018 stood at 5.7%.[7] The CBI has implemented a macro prudential policy framework to restore Ireland's economy and mitigate future credit boom-busts. The ECB's NPL Stocktake Report on National Practices[8] noted that a particular focus was placed on supervisory activities in Ireland, especially on-site inspections, in order to assess Banks' practices and issue recommendations to drive NPL workout strategies. Irish Banks under guidance of the CBI and ECB adopted a multifaceted approach to reduce the number of NPLs on their loan book.

4.1 Regulatory interjections

In attempting to deleverage their loan books, Irish Banks were required to restructure loans and engage with borrowers and offer alternative sustainable repayment solutions. The following policies are worth noting:

4.1.1 Code of Conduct on Mortgage Arrears ('CCMA')

Devised by the CBI, the CCMA established procedures to regulate how Irish Banks are required to treat borrowers in arrears and pre-arrears. The CCMA provides for a strong consumer protection framework in Ireland and applies to all regulated mortgage lenders including any outsourced mortgage lending activities.[9] The CCMA applies only to mortgages on principal residences. All cases must be handled fairly on a case by case basis. The CCMA requires Banks to have a dedicated Arrears Support Unit that assess all cases and have an established appeals process that borrowers can invoke.

4.1.2 Mortgage Arrears Resolution Process ('MARP')

By virtue of the CCMA, Irish Banks were required to implement MARP and adhere to a specific four stage process for borrowers who fall into arrears on their mortgage. The stages include;

- Communication with borrowers;
- Financial information to be obtained from borrowers;
- Objective assessment of the borrowers' case; and
- Resolution in which the lender must explore all options for alternative repayment arrangements.

4.1.3 Consumer Protection Code 2012 ('2012 Code')

The 2012 Code outlines rules and principles that all regulated financial entities must adhere to when providing financial products and services to consumers, including buy to let mortgages, personal loans and credit card loans. The 2012 Code does not apply to mortgages in respect of primary residences which are covered by the CCMA and MARP. The 2012 Code regulates how consumers in arrears should be treated and how best to consistently assist them to resolve their arrears.

4.1.4 ECB Guidelines in increasing oversight on NPL management

The ECB published its original guidance on NPLs in March 2017 and supplemented this guidance with an addendum on 15 March 2018. It is a non-binding guideline that aims to identify best practices in reducing NPLs on Irish Banks' balance sheets. Its aim is to clarify supervisory expectations relating to the identification, management, measurement and write-off of NPLs in the context of existing regulations, directives and guidelines.

Notes

5 The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe, comprising the ECB and the national supervisory authorities.
6 https://www.ft.com/content/1899a8f4-a512-11e8-8ecf-a7ae1beff35b
7 https://www.cso.ie/en/releasesandpublications/er/lfs/labourforcesurveyquarter42018/
8 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.stock_taking2017.en.pdf
9 By virtue of the Consumer Protection (Regulation of Credit Servicing Firms) Act 2015 the CCMA now applies to credit servicing firms.

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4.2 Alternative Repayment Arrangements

Irish Banks were required to incorporate alternative repayment arrangements and offer sustainable solutions to distressed borrowers. Options include arrears capitalisation, warehousing part of the mortgage through a split mortgage, term extension and/or deferring repayments. Debtor engagement is essential if a Bank is to offer an alternative repayment arrangement and the most suitable arrangement depends on the means and requirements of the debtor and the underlying reason for default.

As of September 2017, 120,000 current principal dwelling home ('PDH') accounts have been restructured. Restructure has taken the form of a split mortgage in 25% of cases, whereby a portion of the mortgage is warehoused at a lower interest rate for future payment. The majority of these restructured accounts are meeting the terms of the restructuring agreement.[10]

4.3 Repossession and realisation of collateral

If a debtor is unable to maintain an alternative arrangement, repossession may be the only viable option. Irish courts were and are traditionally reluctant to enforce repossession orders, particularly when it concerns a PDH. Significant enforcement delays in Ireland have held up the process and the realisation of the underlying asset.

5. Secondary loan market

5.1 Improving market

Increasing property prices has improved investor sentiment. Whilst NPL sales continue to dominate the market, a number of recent sales have included performing and sub-performing loans. The market has not yet seen a significant number of onward or secondary sales.

5.2 Most prominent players

The Irish portfolio transaction market is dominated by a small number of key players. NPL sales constitute the vast majority of portfolio sales in the Irish market. As regulatory pressure to off load risk increases, portfolios have begun to diversify and contain not only commercial real estate ('CRE') but also residential real estate.

5.3 Servicing platforms for the secondary loan market

The Consumer Protection (Regulation of Credit Servicing Firms) Act 2015 ('the Act of 2015') introduced a regulatory regime in respect of a new type of entity known as a credit servicing firm.[11] The Act of 2015 required non-regulated loan owners to appoint a regulated credit servicer in respect of relevant loans and insured such firms come within the regulatory remit of the CBI and the activity of credit servicing firms is now a regulated activity in Ireland.

Credit servicing firms are, thus, regulated by the CBI. The rationale behind the passing of the Act of 2015 was to ensure that certain consumers and SMEs, whose loans had been sold to unregulated entities, continued to benefit from the various regulatory protection codes of conduct which applied to their loans prior to the sale.

In a very late development due to sustained political pressure, the Consumer Protection (Regulation of Credit Servicing Firms) Act 2018 ('the Act of 2018') was passed into law on 24 December 2018. The Act of 2018 expands the definition of credit servicing firm and in effect provides that loan owners will be required to comply with all relevant conduct of business rules including the protections stipulated in the CBI's various statutory Codes of Conduct. Entities that now fall within the expanded definition of a credit servicing firm must be authorised and regulated by the CBI.

The Act of 2018 includes carve outs and specifically excludes passive securitisation special purpose entities ('SPE') from the requirement to be regulated.[12] The rationale of this carve out is to facilitate traditional credit institution residential mortgage-backed securities.

5.4 Snapshot of recent portfolio transactions

1. A Cerberus-led consortium bought a EUR 1.1bn loan portfolio of commercial property, buy-to-let ('BTL') and land assets from AIB (71% state-owned bank).
2. KBC Ireland sold a EUR 1.9bn loan portfolio to a Goldman Sachs entity. The package consisted of non-performing corporate and BTL loans in Ireland, as well as performing and non-performing UK BTL loans.

Notes

10 OECD 2018 Key Policy Insights – Economic Survey Overview https://www.oecd.org/eco/surveys/Ireland-2018-OECD-economic-survey-overview.pdf

11 As defined under section 1 of the Consumer Protection (Regulation of Credit Servicing Firms) Act 2015 amending section 28 of the Central Bank Act 1997

12 Section 28(2A) of the Central Bank Act 1997

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3. AIB sold a EUR 400 million loan portfolio of non-performing loans to a Goldman Sachs entity.
4. Permanent TSB (75% state-owned bank) sold a portfolio of PDH and BTL loans with a gross value of EUR 2.1bn to Start Mortgages, an affiliate of Lone Star Funds.

6. The future

Irish Banks are under increasing pressure to deleverage their loan books. A potential deterioration in macro-economic conditions catalysed by Brexit could impinge NPL resolution in Ireland. A possible decline in GDP and increased interest rates could adversely impact NPL reduction. The CBI's 2018 Q2 Quarterly Review notes the main issue facing the Irish economy is Brexit and, in particular, the possibility of a disorderly Brexit occurring. A hard Brexit may cause a substantial reduction in exports to the UK and may effect employment in Ireland. A reduction in employment will likely impact distressed borrowers' ability to meet their repayment obligations. Irish Banks' loan books are concentrated in loans to Ireland and the UK and mainly concern the property market. Any adverse economic conditions arising from Brexit could reduce bank profitability and materially impact the credit quality of Irish retail Banks' loan portfolios.

The impact of Brexit on the Irish economy and the NPL transaction market remains uncertain, Irish Banks are exposed to any adverse shock that may result from a hard Brexit.. However, Moody's, the credit rating firm raised its outlook for Irish Banks to 'positive' in 2018 as the quality of loans improves with a growing economy. The ratings agency expects the impact of Brexit on the Irish market is likely to be 'contained'.[13]

Notes

13 https://www.irishtimes.com/business/financial-services/moody-s-positive-on-irish-banks-as-it-sees-impact-on-them-from-brexit-contained-1.3656944

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International Corporate Rescue

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