The Portuguese Banking Crisis

Looking for a Solution for Portugal's Non-Performing Loans

MACEDO VITORINO & ASSOCIADOS
Sociedade de Advogados, RL

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Introduction

Portugal is experiencing a persistent banking crisis that translates into high levels of non-performing loans.

The causes of this crisis are now clear: the slow growth of the economy, the excessive weight of the State, the high levels of public debt, corporate debt and individuals' debt, which began in the nineties and accelerated without control in the first decade of the new millennium.

These factors combined with the global financial crisis of 2008 triggered a serious financial and economic crisis, which would culminate in the request for international aid in 2011.

Following the sovereign debt crisis in 2010, the European banking authorities have imposed more stringent stress tests, the strengthening of the banks' own funds and the contributions of shareholders and creditors for the recapitalisation of distressed banks.

However, the bank resolution mechanism, now in force in Europe, does not respond to the less critical situations where imbalances result from the difficulties in disposing of non-performing loans, which can become more serious when they reduce the liquidity of banking institutions and undermine the confidence of depositors.

Six years following the Troika intervention and three years after the end of the Portuguese bailout program, the banking crisis continues despite the concentration of banks and the reorganisation of the sector.

Public and private indebtedness remains high and banks accumulate non-performing loans in their balance sheets and in vehicles they indirectly control.

The Portuguese government and international institutions, like the IMF, the OECD, the European Commission, the EBA and the ECB recognize the problem and agree that banks should be freed of non-performing loans. However, they do not agree on the urgency of the problem and on whether State and/or European intervention are needed. While the EBA, the IMF and the OECD have been advocating the creation of an European mechanism for the disposal of bad loans, the EU Commission and the ECB prefer a softer approach.

€17,755 million

Volume of non-performing loans in Q2 2017

In 2011, the sovereign debt crisis uncovered the excessive indebtedness levels of the Portuguese economy as a whole. The debt of families, corporations and the government had reached an impressive 432% of Portugal's gross domestic product.

From 2011 to 2017, the total debt of families and companies decreased from 255% of GDP to 218% as a result of a contraction in the loans extended by banks of €63,444 million, including €23,841 million in the loans to families and €39,603 million in the loans to companies.

	2012	2013	2014	2015	2016	2017 (Q2)
Total financial debt of non-financial companies (% of GDP)	127%	123%	115%	110%	105%	N/A
Loans provided by banks operating in Portugal to non-financial companies (annual change)	-7.2%	-5.5%	-4.9%	-2.1%	-2.6%	-4.0%
NPLs of non-financial companies (% of total loans to non-financial companies)	10.0%	13.4%	15.0%	15.5%	15.2%	14.9%
Total non-performing loans	€16,493	€18,477	€19,446	€19,246	€17,524	€17,755

Source: Bank of Portugal (amounts in € mln)

However, the deleveraging of the Portuguese banking system is far from complete. Corporate debt remains at an unsustainable level of 105% of GDP, despite the reduction of 22% in relation to 2012. Corporate NPLs represent 14.9% of all corporate loans granted by banks. In 2017, the overall volume of Portuguese NPLs reached a staggering amount of € 17,755 million.

This poses issues for banks and their shareholders, which face increasing capital demands, and hinders the prospects of many viable companies and the economy as a whole, which remain overburdened with unpayable debts and cannot reach their true growth potential.

Why banks do not resolve their NPL backlog

In 2016 bad loans recognised by banks accounted for 15.2% of all corporate loans and 4.6% of all loans to individuals, which compares to 10.6% for companies and 4.1% for individuals in 2012.

The total value of troubled loans was €17,524 million in 2016, which compares to €13,243 million in 2011 and €10,292 million in 2010.

According to the OECD, in 2016 Portugal had the fourth highest non performing loan rate (as a percentage of the total credit) in Europe, only behind Ireland, Italy and Greece.

In its February 2017 post-program monitoring report on the Portuguese economy, the IMF warns that a comprehensive clean-up of banks' balance sheets and reduction in corporate debt is critical to break the vicious circle of weak banks, high levels of non-performing loans and low growth.

The backlog of non-performing corporate loans remains high because it has been difficult for banks and investors to find a balance between the banks' price expectations and the buyers' valuation of the assets and return requirements.

This gap persists due to the following factors:

- The tax and accounting impact of a sale of assets below their balance sheet value;
- Banks' expectations of a future valuation of unprofitable assets which undermines investors' return requirements; and
- The lack of incentives and pressure from regulators for banks to sell troubled assets.

To bridge this gap banks and investors must change their approach to potential deals.

An European problem?

The Portuguese NPL problem is akin to that of several European countries, such as Italy, Greece, Ireland and Cyprus. According to the ECB, at the end of the third quarter of 2016, the volume of bad loans of banking institutions with significant importance in the Eurozone amounted to €921,000 million.

The high levels of non-performing loans in some European countries have led international institutions to advocate the creation of public and private vehicles for the management of bad loans. The EBA proposed a roadmap leading to the creation of an European asset management company to acquire non-performing loans.

The European Commission proposes the harmonisation of the legal framework regarding the treatment of non-performing loans and insolvency regimes in Europe to facilitate the creation of a secondary market. However, the European Commission lacks the conviction to force banks to sell their non-performing loans.

The ECB has also rejected to play a more central role in the solution of the problem and argues that it is up to the governments to change the legal and judicial framework of each country to facilitate the reduction of bad loans. The ECB is against a centralised European solution and prefers a gradual and decentralised solution. The ECB recommends that credit institutions implement realistic and ambitious strategies with a view to developing a "holistic" approach, including areas such as governance and risk management, which should ensure that managers are encouraged to reduce banks' backlog of non-performing loans.

However, the ECB does not set quantitative targets for the reduction of non-performing loans that could serve as an incentive for national authorities to take a more proactive role in resolving the problem.

The soft approaches of the European Commission and the ECB show the lack of support from countries, such as Germany, that do not face high levels of NPLs and have no interest in an European solution.

Although the creation of an European asset management vehicle for NPLs with the recourse to EU funding is not essential, the lack of European mechanisms that promote an uniform approach to the problem of bad loans inhibits national governments from taking stronger steps, including incentives and penalties to force banks to sell troubled assets.

The Portuguese government's response

At the time of its appointment in 2015, the Portuguese government defended that urgent and resolute actions for cleaning-up banks balance sheets were needed and that the creation of a "bad bank" with the government's support would contribute to free banks from non-performing loans.

This position contrasted with the position of the previous government, which believed that, as the economy improved, banks would be able to solve the problem on their own by selling bad loans and strengthening their capital structure.

More recently, the government has abandoned the proposal of creating a bad bank and reverted to the previous government's belief that the system has the tools to solve the problem on its own.

There are several reasons for the government to change its position:

- Firstly, a significant part of bad loans has been recognised by banks as impairments and provisioned for and/or covered by guarantees, which limits the problem of non-performing loans to an amount between €15,000 million and €20,000 million;

- Secondly, banks have access to the liquidity made available by the ECB and the market which gives banks the means to continue financing the economy;

- Thirdly, the creation of a bad bank could be considered by the European Commission as State aid, which would prevent the government from giving financial support, even in the form of a State guarantee. As a result, transfers of non-performing loans would have to be priced at market value, which is presently below the value recorded in the banks' balance sheets, triggering additional losses and the need for new capital;

- Fourthly, any potential restructuring/recovery of bad loans would ultimately benefit investors and not the banks.

The government now proposes to improve the legal framework to speed up corporate restructurings and the setting up of private, voluntary and non-exclusive management companies to manage non-performing loans.

A step in the right direction?

The government's proposals fall far short on its promises. To achieve an effective reduction of banks' troubled assets, banks and investors must be lead to agree on the price of the assets. The creation of privately owned asset management companies can be a step in the right direction, but it does not ensure an effective resolution of the problem, as it is dependent on the adherence of banks.

The government's response also does not solve the problem of indebted companies, which will continue to be burdened by high debts (except when banks and/or the asset management companies decide to ease the debt burden) instead of incentivising speedy restructurings and the equitization of debts.

In many cases, the creation of bank-owned asset management companies may serve to postpone recognising impairments and may not prevent or reduce banks' losses, as experience shows that banks have, in the past, exhausted the resources of viable companies in weary and protracted corporate restructurings and allowed many non-viable companies to continue trading.

To effectively reduce the volume of non-performing loans, banks must dispose of bad loans, which will only occur if they are incentivised to do so and penalised if they do not.

For asset management companies to effectively contribute to the reduction of the banks' non-performing loans' backlog, they must be independent from banks as regards the appointment of their managers and in the decision taking process in relation to the assets that they may acquire.

Management companies may be successful in reducing banks' non-performing loans, but this should not be used to avoid taking difficult measures and recognising losses. Therefore, the remuneration structure cannot be dependent on the volume of assets under management and should reward the results obtained, which should include the recovery rate as well as the speed restructured debtors are put back in the market.

Management companies' decision taking process regarding the acquisition, management and disposal of assets must be market driven.

A solution for Portuguese NPLs

The current situation calls for a determined action to promote the deleveraging of the Portuguese banking system as a means to avoid future crises and reduce potential risks to taxpayers and depositors of being called to bailout banks.

International experience shows that troubled assets purchase programs backed by public money can be successful if banks are required to sell the assets to independent investors and retain no prerogatives regarding the management of the assets.

To be successful, any program supported by taxpayers money should be based on four pillars:

- First, the measures adopted should be definitive. The solution should aim to bring closure to the problem and not serve to park the assets. Any State intervention should ensure that the relationship between the banks and the troubled assets is severed, so that viable companies may be restructured and freed of their debts and those that are not viable are liquidated;

- Second, the solution should be balanced, *i.e.* the proposed measures should be sufficiently strong to make banks dispose of their distressed assets without imposing excessive and punitive costs on them and/or on their shareholders;

- Third, the solution should be neutral. A State intervention cannot cause distortions in competition or on the relative position of banks in the market, benefiting some in detriment of others;

- Finally, the intervention should not entail costs for taxpayers.

Asset management companies could be financed by the banks, by their shareholders and/or by private investors, provided that they act independently from the originating banks.

The State could provide guarantees or contribute funds to ensure that the price gap can be bridged, but this intervention cannot entail the transfer of losses to the taxpayers. Any future losses should be absorbed by banks and private investors.

Looking forward

The latest developments show that the intention of creating a public program for the purchase of non-performing loans, in the form of a bad bank or other, is dying off.

In the absence of a public intervention program, it is up to the banks and the private investors to bridge the buy-sell price gap. This gap results from the conviction of banks selling non-performing loans that the assets' valuation will improve in the future.

However, this will hardly happen if the management of the assets is entrusted to management companies created, owned and controlled by the banks, which are more interested in preserving the assets than in improving their value.

Private investors mistrust the bank's valuation of the assets that are available for sale and fear that the recovery potential of the assets in contrast with the sellers' ask price will not generate the desired returns for the level of risk they are assuming.

The market for the purchase of non-performing loans of companies in distress is not a liquid market; in other words, in the distressed companies' market, each asset has its own value which, in many cases, cannot easily be compared with other similar domestic or foreign companies. As a result, it is more difficult to use the same selling or buying strategy that is used for selling or buying other non-performing loans, such as non-performing consumer loans and residential mortgages.

Therefore, the approach to these opportunities must be made on case-by-case basis. Each deal must be supported by a legal, financial and operational due diligence on each asset and by a credible recovery strategy, which may involve taking control or liquidating the asset.

The specificities of non-performing corporate loans make it difficult for sellers and buyers to reach an agreement, in many cases, on the right value for the asset and on the expected recovery rate.

The differences in the expectations of buyers and sellers can be bridged through partnerships that generate an interesting return to reward the buyers' investment and give the sellers some of the upside on a future sale/recovery of the assets.

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