Crossing borders – opportunities in Europe's NPL markets

NAJIB NATHOO, regional director at Hoist Finance (Region West Europe), considers the market for non-performing loans (NPLs) across Europe and uncovers a picture of mixed opportunities

Comparing the market for NPLs is a challenging exercise, since the maturity of each market can vary enormously.

In the UK, for example, where the market is already well developed and the most mature of all of the European countries, banks systematically sell early-stage NPLs. Compare that to the French market, which is characterised by the infrequent sales of older NPLs by relatively few banks, and the opportunity is set into sharp relief.

Not surprisingly, the UK market is expected to grow by only two percent annually to 2020; the French market, on the other hand, is expected to enjoy annual growth of around 15 percent, and looks to be one of the most interesting markets to evolve over the next five years.

As a debt purchasing market matures, sellers of NPLs establish more structured sales processes. This typically leads to NPLs being sold more frequently and at earlier stages. As sellers and buyers become more experienced they are typically also willing to engage in more complex transactions.

The early stages of a default cycle normally entail a higher likelihood of repayment that is less costly to collect. It is therefore common for banks to sell older NPLs while servicing fresh NPLs in-house. Since NPLs in earlier stages of the default cycle entail less risk and less cost to collect, these NPLs are typically sold at higher prices.

According to the European Central Bank (ECB) the market for consumer credit across the 10 key markets (France, Spain, the UK, Belgium, Greece, Italy, The Netherlands, Poland, Germany and Austria) totalled about €794bn in 2016. This market is expected to grow at a stable, average annual rate of around two percent during the next five years. A growing lending market will also lead to further growth in the NPL market.

Regulatory demands

Financial sector supervisory authorities' demands are also expected to intensify. The European Banking Authority (EBA) intends to conduct stress tests on a regular basis to assess banks' resilience to adverse market developments and associated systemic risks, and national supervisory authorities are expected to conduct stress tests more often.

Current supervisory mechanisms – via the SSM (Single Supervisory Mechanism), SRB (Single Resolution Board) and ESRB (European Systematic Risk Board) – are significantly more robust. Higher capital requirements under the Basel Rules (Basel III and IV) are extra drivers that increase the supply of NPLs, as banks find that they need to dispose of lower quality capital. New regulations and stronger incentives for banks to sell NPLs are expected to add momentum to growth.

The new accounting standard IFRS 9, which takes effect in 2018, will lead to increased provisions for credit losses on NPLs. The Basel Committee on Banking Supervision's standardised definitions, specifying when a loan is deemed delinquent within the EU, will result in greater comparability and transparency. Increased flexibility in personal insolvency laws will improve the capacity to collect debts, resulting in higher prices for NPLs and increasing banks' incentives to sell their NPLs.

European banks have not yet regained the profitability they had prior to the 2008 financial crisis, and some (notably those in Benelux) have been focussed on rebuilding their reputations. Average return on equity for European banks is currently 6.2 percent, compared with 17 percent pre-crisis. A large percentage of NPLs on financial institutions' balance sheets have a negative effect on profit and inflate capital requirements. Selling NPLs allows banks to reduce costs, relieve pressure on the balance sheet and focus on their core business.

Price trends

The price trend for NPLs has moved upwards due to the industry's greater market maturity. Hoist Finance's Annual Report for 2016 shows the average market price for acquired NPL portfolios increased an estimated 10.8 percent annually, during the 2013 to 2016 period.

As the market matures, the gap between the selling bank's anticipated deal value and the amount the purchaser is willing to pay is reduced, and the trend towards the sale of high-quality, fresh NPLs therefore increases.

Professionalism within the industry is similarly on the rise, as major European debt purchasers leverage their economies of scale, in-depth expertise and access to data combined with lower funding costs. All of this results in higher prices on the market and more NPL sales.

With economies of scale in operations, tailored expertise and greater operational efficiency, specialised companies are able to collect overdue debt at a lower cost than banks. They also have significantly higher recoveries for comparable NPL portfolios.

Hoist Finance's Annual Report also found that companies that specialised in NPL collections recover 40 to 50 percent of their portfolios, while top-performing banks recover just 15 to 25 percent. An overwhelming majority of respondents to a study conducted among 53 leading European banks and industry experts anticipate that an increased volume of NPLs will be outsourced or sold to external parties within the coming two to five years. Three quarters (75 percent) of respondents believe that NPL portfolio sales will increase over current levels.

So what of the competitive environment?

A few large and well-known debt purchasing companies have emerged as the European debt purchasing market matures, although only a small number of these companies have a pan-European presence, operate across geographical platforms and compete in multiple markets.

Efficiency and cost absorption are high on the agenda for these companies and help fuel the consolidation trend. CS

MARKET VALUE - SALE OF UNSECURED CONSUMER NPLs

- The French market was estimated at €100m in 2015 and is expected to grow 15 percent annually until 2020. French banks are expected to downsize their risk exposure.
- The Spanish market was estimated at €275m in 2015 and is expected to grow five percent annually until 2020. The market is maturing rapidly with fresher NPLs and higher prices.
- The UK market was estimated at €1bn in 2015 and is expected to grow two percent annually until 2020. High activity levels are expected to continue.
- The debt purchasing market in Benelux was estimated at €150m in 2015 and is expected to grow eight percent annually until 2020. Mergers among smaller banks are increasing, leading to a greater sale of NPLs.
- The Italian market was estimated at €500m in 2015 and expected to grow seven percent annually until 2020. Banks are under regulatory pressure to clear their balance sheets of NPLs.
- The Polish market is estimated at €250m in 2015 and is expected to grow four percent annually until 2020.
- The size of the German market is estimated at €200m and is expected to grow eight percent annually until 2020. Current NPL sales fall well below the market's potential and are expected to increase.
- The Austrian market is expected to grow six percent annually until 2020. There is considerable regulatory pressure for Austrian banks to reduce their NPL ratios.

Change ahead in credit risk

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A lot has been written about IFRS9 recently. It seems the collections and recoveries world is waking up to the fact this is not just an accounting standard, but will also impact our process. Implementation is suddenly seeming imminent.

For those who don't read international accounting standards for fun, IFRS9 is a pending change to how impairment for loss is calculated. We are ticking down to implementation in January 2018.

So what's changing? Under the previous accounting standard (IAS39), recognition for credit losses was delayed until there was evidence of impairment. Additionally, this was calculated only on past events and considered only current conditions.

Under the new standard, credit losses will need to be recognised at each stage of the customer lifecycle, even if no credit loss events have taken place. Market conditions will also need to be taken into account. The portfolio will be split into two stages for a reserve calculation:

1. No significant increase in credit risk since inception – impaired at 12 month expected credit loss
2. Significant increase in credit risk (a risk event) – impaired at lifetime expected credit loss.

This is all designed to enable financial accounts to reflect better the inherent future losses for customers on the book today.

But what does this mean? Generally, it means losses will be recognised and more greatly provided for much earlier in the collections cycle. There will be a greater cost of holding customers deemed to be higher risk for whom there will be a significant step increase in provision (even at 30 days past due). As a result, largely the guidance being given is 'contact earlier' and 'more intensively', to prevent customers moving to lifetime credit losses at this higher rate. And this makes sense. Contacting earlier, including pre-arrears, will prevent forgetful customers falling into arrears and being considered as higher risk. But this is not the entire story. Although 30dpd is being used as a general criterion, any external indicator can be used to indicate increased risk, such as credit reference data, debt load and flagging of financial difficulties.

The exact criteria organisations will use will require judgement which we, as collections and recoveries professionals close to the portfolio on a day to day basis, need to be involved in. For example, flagging a customer who has affordability issues may now result in a greater hit to P&L.

As all of these dynamics need to be understood, it will be more important to find the right solutions for customers and ensure the risk assessment is correct. These will all help to ensure there is not an unpleasant surprise looming in 2018.