



FINANCE

EQUITABLE GROWTH, FINANCE & INSTITUTIONS NOTES

How Insolvency and Creditor/Debtor Regimes Can Help Address Nonperforming Loans

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High non-performing loan (NPL) levels can threaten financial stability and also have a significant negative impact on credit, inflation, and real GDP. As such, efforts are commonly undertaken to contain the growth of NPLs and to help resolve them when they reach problematic levels. Insolvency and creditor/debtor rights (ICR) regimes are one of the complementary tools in the policy maker's arsenal for these purposes. This note reviews the empirical literature on the impact that effective ICR regimes can have on NPLs. Specifically, it highlights the potential impact of (i) effective ICR on increasing loan repayment probability; (ii) effective enforcement mechanisms on lowering banks' cumulative losses from NPLs; (iii) efficient pre-insolvency mechanisms and (iv) stronger insolvency frameworks on adjusting NPL levels faster; and (v) targeted NPL reform—including ICR reform—on fostering economic growth.





Introduction

Non-performing loans (NPLs) erode the profitability and can threaten the solvency of banks, and when a sufficiently large volume of loans is affected, they can potentially threaten financial sector stability. Efficient legal regimes that promote effective insolvency and creditor/debtor rights (ICR) are important tools that facilitate debt recovery, reduce the cost of credit, increase access to finance and, as a result, help improve NPL levels.

This Policy Note examines the relationship between effective ICR systems and NPL levels. In particular, it identifies relevant empirical studies that illustrate how effective ICR systems can help mitigate the rise in NPLs and resolve existing NPLs, potentially strengthening overall financial sector stability and limiting credit misallocation. The scope of this note is limited to the relationship between ICR regimes and NPL levels, although it is important to note that ICR regimes are only one possible set of complementary tools for dealing with bank NPL problems and that broader institutional, regulatory, and legal reform are likely to be needed for a more comprehensive NPL

resolution strategy. For instance, some of the main tools of NPL resolution include (i) debt restructuring; (ii) write-offs; (iii) direct sales; (iv) securitization; (v) asset protection schemes; and (vi) centralized asset management companies (Baudino and Yun 2017; World Bank FinSAC 2016). As pillar (i) conveys, strengthening ICR regimes is an integral component of this broader NPL resolution strategy, even with the challenges of legal reform during a time of systemic crisis (Baudino and Yun 2017).

It is also important to note that the impact of NPL levels is only one positive outcome of improved ICR systems. Strengthening a country's ICR system has also been shown to have effects associated with a lower cost of credit; an increased availability of credit; increased returns to creditors; job preservation through reorganization frameworks; and promotion of entrepreneurship. These other benefits of a sound ICR system have been explored in more detail in earlier publications (World Bank 2014a).



High Levels of NPLs Can Impact Financial Sector Stability

In modern economies, banks are typically the primary financial intermediaries and are fundamental to a stable financial system, one that is “capable of efficiently allocating resources, assessing and managing financial risks, maintaining employment levels close to the economy’s natural rate, and eliminating price movements of real or financial assets that will affect monetary stability or employment levels” (World Bank 2016a). When banks are not able to recover the money lent, the financial system and the economy at large may suffer.¹

Despite standardization efforts by international standard-setting bodies (Basel Committee on Banking Supervision 2017), NPLs are still defined in various ways.² In most jurisdictions, NPLs are defined as bank loans that have been delinquent for more than a specified number of days, usually more than 90, or which are deemed unlikely to be paid according to predefined criteria -known as “unlikely to pay” or “UTP” criteria- (Basel Committee on Banking Supervision 2017).³ NPL levels — calculated as the ratio between NPLs and total bank loans — are largely driven by macroeconomic conditions (Ari, Chen, and Ratnovski 2019), but they can themselves have significant impact on the economy through strong feedback effects (Klein 2013, Section IV; Beck, Jakubik, and Piloiu 2013). In particular, high NPL levels undermine bank lending and, more generally, the supply of credit, with disproportionately negative effects for small and medium-sized companies (Klein 2014; Cucinelli 2015). High NPL levels also hamper investment by overleveraged firms

(Inaba et al. 2005), as more income is channeled into debt servicing (Aiyar et al. 2015a; European Banking Coordination “Vienna” Initiative 2012, Section 2). Increases in NPL levels are accordingly associated with a significant negative impact on credit, inflation, and real GDP (Klein 2013, Section IV).

When NPL levels rise, banks are required to raise provisions and hold more regulatory capital, impairing their balance sheets (Miglionico 2019). The balance sheet impact is often aggravated by the associated private sector debt overhang problem, as weak demand for credit also contributes to shrinking bank profits (Council of the European Union 2017, Chapter 2). These compounded effects often lead to bank failures (Lu and Whidbee 2013), and can represent a significant threat to the stability of the financial sector (Bottazzi, De Sanctis, and Vanni 2010).

It is therefore important to adequately understand all forces affecting NPL levels and what measures can be put in place to decrease them once they rise. The importance of this understanding is heightened at a time when the COVID-19 pandemic threatens to trigger liquidity and solvency crises around the globe (Adrian and Natalucci 2020; Ari, Chen, and Ratnovski 2020a), particularly as NPL levels were seen to sharply increase during previous crises (Ari, Chen, and Ratnovski 2019). The rest of this note focuses on the role that ICR systems have in mitigating the rise of NPLs and in facilitating their resolution.

1. Deterioration in asset quality is not the only channel of potential financial instability. Importantly, others relate to the liability side of banks’ balance sheets (for instance, when liquidity problems morph into solvency issues). We thank Pietro Calice for this comment.

2. Moreover, the rigor of actual enforcement shows important differences, even between jurisdictions with similar regulatory definitions. The authors thank Miquel Dijkman for suggesting this addition.

3. Again, these criteria vary across countries and institutions. As such, the IMF states that loans may be classified as NPLs when (unspecified) “evidence exists to reclassify them as nonperforming even in the absence of a 90-day past due payment, such as when the debtor files for bankruptcy” (see International Monetary Fund 2019, 192). Similarly, the European Central Bank also includes in its NPL definition loans for which “the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past-due amount or of the number of days past due” — without specifying how that “unlikeliness” is to be evaluated and noting, instead, that it is for banks to have clearly defined internal criteria to identify indicators of unlikeliness to pay (UTP). See European Central Bank 2017, 50.



Effective ICR Regimes Facilitate Debt Recovery and Affect NPLs

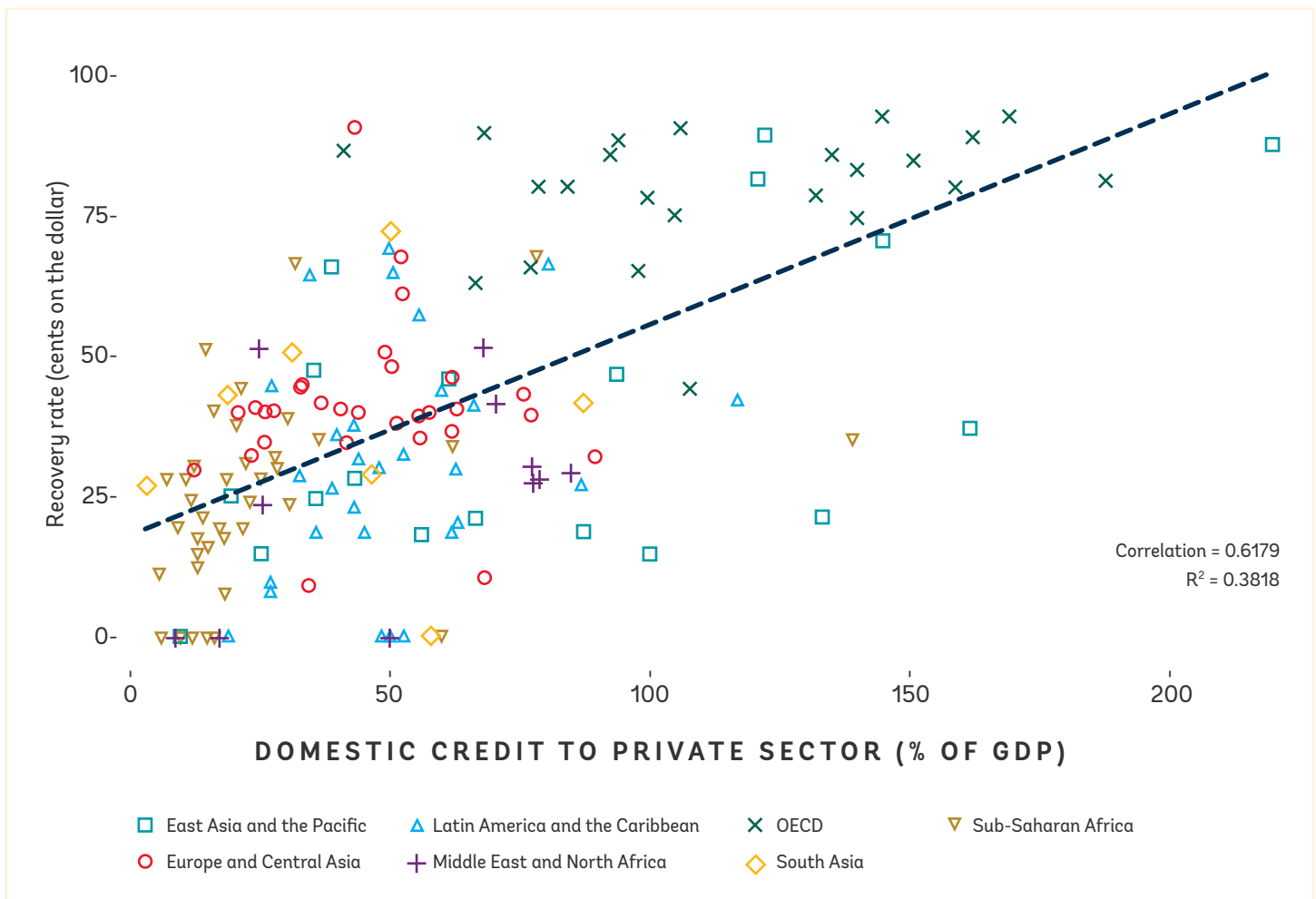
In this note, ICR is broadly defined as the set of prerogatives that supply “efficient, transparent, and reliable methods for recovering debt, including the seizure and sale of immovable and movable assets and sale or collection of intangible assets” (World Bank Group 2016b). Debt recovery methods include bilateral debt enforcement processes — both in and out of court — as well as the insolvency system. The latter include tools ranging from informal out-of-court workouts and pre-insolvency proceedings to formal proceedings and provide for an “orderly process for the reorganization or liquidation

of insolvent entities in a collective manner,”⁴ while trying to accommodate a balance between creditor recovery and debtor protection (La Porta et al. 1998).

ICR regimes have an impact on both the likelihood of a borrower defaulting as well as on the tools that banks can use to maximize creditor recovery when a borrower does default. Data shows that increased creditor recovery is positively associated with higher levels of credit to the private sector (Figure 1).

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FIGURE 1 - Recovery Rate and Domestic Credit to Private Sector



Source: World Bank Group Indicators and Doing Business 2020

4. See Menezes 2014, the previous World Bank Group Viewpoint on debt resolution and business exit, describing, among other things, the positive association between more effective ICR regimes and wider access to credit and the negative relationship of the former with the cost of credit.

Additional analysis on strong ICR regimes' positive effects on private sector development, particularly credit, entrepreneurship, and growth have been set out in related notes (World Bank Group 2014a). Moreover, other World Bank publications describe specifically the benefits of ICR systems in crisis situations, including to address debt overhang, facilitate restructurings, preserve employment, and ensure micro and small businesses are able to effectively exit the market (World Bank Group 2020a, 2020b, 2018, 2017).

The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (the "Principles") and the UNCITRAL Legislative Guide on Insolvency Law (the "Legislative Guide") have been recognized by the Financial Stability Board as representing the international consensus on best practices for evaluating and developing national insolvency regimes, including enhancing creditor rights. The Principles provide best practice benchmarks for ensuring ICR regimes can facilitate the survival of viable but distressed firms, help reduce the risk associated with lending to such firms, and ease the exit of nonviable, insolvent firms (World Bank Group 2016b).

Policy makers are increasingly reaching consensus regarding the positive influence of effective ICR regimes on addressing NPL levels (Council of the European Union 2017, Chapter 4; European Banking Authority 2016, 34), and this note focuses narrowly on examining this issue.⁵ The evidence supporting ICR regimes' effects on both the likelihood of loan repayment and the frequency and magnitude⁶ with which bank loans become nonperforming ("NPL occurrence") is examined in section I below. Sections II through V review the extent to which ICR regimes facilitate the effective management or resolution of nonperforming loans ("NPL resolution").⁷

I. Effective ICR regimes can improve the likelihood of loan repayment, resulting in lower NPL occurrence.

Strong ICR regimes have been found to improve loan repayment and decrease borrowers' risk-taking behavior. Particularly when faced with stronger creditor rights (generally

seen as the enhanced protection of creditors' security interests), borrowers tend to diversify acquisitions, invest in high recovery assets, reduce cash-flow risk, and deleverage their balance sheets (Acharya, Amihud, and Litov 2011). Moreover, the adoption of effective ICR measures reduces default rates, resulting — at least in the short-term — in lower NPL occurrence (Padilla and Requejo 2000). For instance, India established Debt Recovery Tribunals ("DRT") — quasi-legal institutions introduced by the government in 1993 to improve the speed of debt resolution and creditor recovery in the country — that have been associated with reductions in loan delinquency. Indeed, a 2009 study analyzing long-term loan data from a large Indian bank found that the introduction of DRTs led to an increase of up to 11 percent in the likelihood that loans were repaid within 180 days (Visaria 2009, 59).

The evidence suggests that, all other conditions remaining the same, reforming ICR systems could help decrease NPL occurrence. This evidence is supported by a study on NPL determinants in 36 Middle East and African (MENA) banks finding that stronger legal rights (as measured by the legal rights index of the World Bank's Doing Business) are associated with lower NPL levels (Boudriga, Taktak, and Jellouli 2010).⁸ It is worth noting, though, that increases in ICR effectiveness have also been found to widen access to credit and to prevent the exclusion of lower-grade borrowers from the market (Jappelli, Pagano, and Bianco 2005; Haselmann, Pistor, and Vig 2009; Houston et al. 2010; Vig 2013). As these effects are associated with riskier lending, the aggregate effect of ICR frameworks on NPL occurrence might be described as ambiguous.

II. Effective and faster enforcement mechanisms reduce cumulative losses suffered by banks and are associated with lower NPL levels.

Effective ICR frameworks, which are often found in more developed credit markets, protect creditors by minimizing the time required for them to enforce their rights against defaulting borrowers (Dam 2006). By contrast, legal environments where contract enforcement — including enforcement of debt contracts — is slower, curtails creditors' ability to recover their loans.

5. Other World Bank Group publications address some of the legal challenges affecting NPL resolution. See, for example, Cerruti et al. 2019, Chapter 2.

6. The expected loss to banks from their loan portfolios is calculated based on both the probability of the loans defaulting and the magnitude of the losses experienced, if and to the extent that such loans default (see Heitz and Narayanamoorthy 2020).

7. At times, countries report NPL ratios that may to some extent distort the underlying economic realities. While this problem is especially relevant in the context of cross-country analysis, the papers reported in this policy note deploy a battery of econometrical tests to attempt to control for these distortions.

8. Based on data collected from 36 commercial banks located across 12 MENA countries for the period 2002–2006 and information from the "legal rights index" of the World Bank Doing Business Report, the paper found that countries with more effective legal rights have lower NPL levels, a result that is highly statistically significant.

Few investigations have been made into the impact of alternative enforcement mechanisms on NPL levels. What evidence is available, however, suggests that out-of-court mechanisms for the enforcement of creditor rights might help reduce bank losses from NPLs. A 2014 article investigated the impact of regulatory and enforcement changes on mortgage lending and risk in India, where the introduction of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002 (SARFAESI) strengthened out-of-court enforcement rights. Specifically, following the reform, financial institutions and asset reconstruction companies may take enforcement actions without court intervention where a nonperforming asset is secured, is over minimum threshold amount (Rs. 100,000), and accounts for more than 20 percent of the borrower's outstanding debt. By looking into loan-level data from a large Indian mortgage provider and analyzing expected losses following short-term loan delinquency before and after the introduction of SARFAESI, the authors found a negative association between improvement in out-of-court enforcement rights for banks and losses from NPLs. The effect appears to be concentrated on the worst cases of delinquent debtors (Campbell, Ramadorai, and Ranish 2015).⁹

Faster court enforcement also links to NPL levels. After controlling for macroeconomic and bank-specific variables, a recent paper on the determinants of NPL levels in 140 large European banks found that the number of days required to enforce contracts in each jurisdiction can have a statistically significant impact on NPL levels. More specifically, a reduction of 30 days in the average time required to enforce a contract (as measured by the World Bank's Doing Business)¹⁰ is associated with a mean decline of the NPL ratio of 0.24 percentage points (Cerulli et al. 2017).

III. Efficient pre-insolvency mechanisms can increase the adjustment speed of NPL levels.

Pre-insolvency tools include various legal mechanisms that facilitate restructuring at a stage before a firm is legally insolvent and enters formal insolvency procedures. These mechanisms complement out-of-court workouts and core insolvency regimes (see section IV). While out-of-court workouts have come into wide use to facilitate NPL resolution during financial crises (Claessens 2005), their confidential nature has limited the development of an empirical literature

on their effects, particularly on NPL levels. The formal nature of pre-insolvency tools, in turn, has permitted an incipient accumulation of research on their effects on NPL ratios.

NPL data from EU Member States for the period 2007–2012 was analyzed in a 2015 paper in light of the level of pre-insolvency efficiency in the different Member States, as measured according to 12 indicators (Carcea 2015).¹¹ These indicators were designed to assess the ease with which firms in each jurisdiction can restructure debt before insolvency arises and reflect, in particular, four composite dimensions of pre-insolvency efficiency: (i) easiness/availability of preventive measures; (ii) efforts to facilitate continuation of debtors' operations; (iii) direct and indirect costs of the measures; and (iv) debt sustainability. The results show that more efficient pre-insolvency mechanisms increase the rate at which NPL levels decline and return to normal in the aftermath of macroeconomic shock. In particular, countries in the upper tercile of restructuring efficiency — which includes early-warning procedures, better majority decision options, and better debt discharge possibilities — increased the adjustment speed of the NPL rate by almost 14 percentage points relative to those in the lower tercile.

IV. Effective insolvency regimes can facilitate NPL resolution.

The role of effective insolvency regimes in strengthening creditor recovery has been clearly established in the literature. Insolvency regimes provide a range of tools facilitating firm restructuring and liquidation with the overall objective of maximizing creditor recovery and allocating risk among stakeholders in a predictable, equitable, and transparent manner (White 1994). Effective insolvency regimes can also play a positive role in facilitating NPL resolution.

A recent paper studied the link between insolvency frameworks and NPL resolution in EU and OECD countries between 2003 and 2016 (Consolo, Malfa, and Pierluigi 2018). The study constructed an insolvency framework index based on World Bank Doing Business data from three separate indicators (Getting Credit, Enforcing Contracts, and Resolving Insolvency). The findings suggest that jurisdictions with stronger insolvency frameworks are able to adjust NPL levels faster. Moreover, stronger insolvency frameworks are associated with faster private sector deleveraging, both for households and for nonfinancial corporations. These results highlight the potential of insolvency frameworks to facilitate economic recovery (Carcea et al. 2015).

9. Notably, a larger impact was caused by a change in the regulatory classification of NPLs (from 180 days delinquent to 90 days delinquent).

10. World Bank Group "Doing Business — Enforcing Contracts" data is available at <https://www.doingbusiness.org/en/data/exploretopics/enforcing-contracts>.

11. NPL data derives from the IMF Financial Soundness Indicators for the period 2007–2012. The IMF Financial Soundness Indicators can be found at <https://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA>.



V. Targeted NPL reform fosters economic growth.

In light of the evidence that high NPL levels have a negative impact on the economy and may, in certain cases, pose a threat to financial stability, it is not uncommon for policy makers to seek measures to reduce NPL levels — but, as discussed above, more than one policy approach can contribute to a comprehensive NPL strategy. Since NPL levels reflect the ratio between NPLs and total loans, policy makers can combat high NPL levels by specifically targeting defaulted bank loans — in particular by strengthening ICR regimes (“targeted NPL reform”) — or by fostering total loan growth.

A 2016 paper surveying a sample of 100 countries during the period between 1997 and 2014 sought to measure the relative impact of these two approaches to banks’ NPL problem. More specifically, a cross-country dataset was built containing 73 NPL reduction episodes (defined as events during which

the NPL ratios in a particular country fell by at least seven percentage points) and the responses associated with them. These NPL reduction episodes were then divided into two categories: (i) reduction episodes in which countries had adopted targeted measures for the active reduction in their stock of NPLs (including encouraging the move of NPLs into asset management companies, facilitating the restructuring of NPLs, and reforming insolvency laws); and (ii) reduction episodes in which countries enjoyed or engineered a growth in new loans. A control group was also compiled from countries that had experienced NPL ratios in excess of 7 percent for three years in a row but no action was taken to address them and, simultaneously, credit failed to grow (Balgova, Nies, and Plekhanov 2016, 3). The study found that countries that actively attempted to reduce NPLs during the sample period (category (i)) achieved more economic growth than countries (in the control group) that failed to take any action to combat their NPL levels; the differences revealed were as much as a 3 to 4 percentage point increase in GDP growth and a 13 percentage point increase in investment growth.¹²

12. These results were on par with those of countries that reduced NPL levels following a growth in new loans.



Conclusion

NPLs have significant negative impact on the financial system and the economy as a whole. In addition to affecting economic development through various supply channels — curtailing access to credit, discouraging investment, and aggravating unemployment rates — high NPL ratios also represent a significant threat to financial stability, with important systemic consequences.

The evidence described in this Policy Note suggests that ICR reform can be a powerful tool for combating the NPL problem. Indeed, a growing number of studies suggest that effective ICR regimes, particularly those promoting strong creditors' rights, have the effect of decreasing the frequency and magnitude with which loans become nonperforming. Evidence also shows that more effective ICR regimes can further contribute to improving NPL resolution. In particular, faster contract and out-of-court enforcement, more efficient pre-insolvency mechanisms, and

effective insolvency frameworks are all associated with a statistically significant positive impact on reducing NPL levels or accelerating the speed with which these levels are reduced — countries that take an active stance against NPL levels experience more growth than countries that fail to adopt any measures to combat these loans.

The lessons described above might be especially relevant as the world learns how to deal with the economic effects of the COVID-19 pandemic, which is expected to lead to a sharp increase in NPL levels in numerous jurisdictions (Laeven and Laryea 2009, 3; Jassaud and Kang 2015, Part III). Facilitating a faster and stronger economic recovery will require policy makers to mobilize the full range of tools available to them for addressing NPL levels, and in this context, the importance of effective ICR systems should be borne in mind.



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