



## **Whitepaper**

### **NCLs and NPLs – Ticking time bombs?**

#### **Promoting a focused approach to non-performing loans**



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## **Executive summary**

As European banks face the huge task of cleaning up their balance sheets, they are grappling to cope with increased pressure from regulators and the market to demonstrate how they comply with the new stricter regulatory requirements. Within two weeks of the combined Asset Quality Review (AQR)/stress test results being disclosed by the European Central Bank (ECB) (October 2014), banks will have to submit capital plans detailing how shortfalls will be covered in the subsequent six to nine months.

It is estimated that identified non-core assets in the European banking sector exceed €1.3trn whereas research by PwC has shown that non-performing loans (NPLs) of European banks amounted to more than €1.25bn at the end of 2013. Reported NPLs have continued to increase mainly driven by countries in Southern Europe, especially Italy, Spain and Greece, along with Ireland. Six countries – Germany, the UK, Spain, Ireland, Italy and France – are reporting NPLs in excess of €100bn in their banking system at the end of 2012. The size of Dutch NPLs is estimated at €57bn. It is estimated that correcting the balance sheets of European banks may take more than 10 years.

With a fragile economic climate and the looming risk of a triple dip, any meaningful reduction in NPLs is unlikely and reported NPLs are expected to continue to rise over the next years. Not surprisingly, it is beyond the scope and capacity of banks to manage these ailing credits. Their focus seem to be on the existence, valuation and foreclosure of existing collaterals, as a result of which less attention is being paid to explaining the anomalies between the funds provided and the actual value of the collaterals.

Forensic investigations carried out by Holland Integrity Group (HIG) revealed that banks' credit portfolios face considerable problems. In dozens of projects, a substantial amount of the funds provided, totalling €3.5bn, were used for purposes other than those agreed with banks. Due to its nature, scale and impact, this type of abusive behaviour or crime is detrimental to the economy, to financial and reputational interests, to the taxpayer's position and further undermines public confidence in the financial sector.

From a stakeholder perspective, action will need to be taken to investigate (and prosecute) abusive behaviour with regards to non-core loans (NCLs) and NPLs. This white paper, which has a focus on Ireland, intends to promote a focused approach to NCLs and NPLs and provides tools to support banks in gaining insight into and solving this serious situation.



## Introduction

Currently, the uncertain combined AQR/stress test outcome hangs over the growth forecast for the Eurozone economy. Experts have been warning that a genuine real estate crisis is looming.<sup>1</sup> A huge part of the currently dormant problem is caused by NCLs and NPLs.

On various occasions, the Basel Committee on Banking Supervision (BIS) has noted that the recognition of credit risks and losses in outstanding loans was '*too little, too late*' in recent years. Various studies have shown that many banks were unable to assess the size of the lending problem. As a result, debt write offs were incorporated too late in their annual financial results. Often, decision making on whether or not to accept write offs of outstanding loans was based on poor or at least insufficient information.<sup>2</sup>

Based on its expertise and experience, HIG states that far-reaching loss events in banks boil down to three factors:

1. Unlawful actions committed by bank clients (mostly project developers).
2. Failure to identify possible irregularities at an early stage.
3. Lack of expertise in investigating possible irregularities.

This white paper deals with the nature and scale of NCLs and NPLs, its causes and possible solutions, with a focus on Ireland.

## NCLs and NPLs in Europe

Reports from PwC show that in the years 2010 through 2013 NPLs with total amounts of €11bn, €36 bn, €46bn and €64bn respectively changed hands in Europe – which is a fraction of the total number of NPLs.<sup>3</sup> European banks identified a staggering amount of €2.5tn (which equals €2500bn) as NCLs by the end of 2012, €1.187tn of which were deemed non-performing.<sup>4</sup> The current anomaly between demand and supply of NPLs has a negative impact on the pricing of individual NPLs, as shown by the discounts of 50% to 60% given by European banks in recent years when selling NPLs. In this respect, Irish banks have led the way in Europe, registering high shares of NPLs and giving discounts of up to 75% or in some cases 90%.

According to the Dutch Central Bank (DNB)<sup>5</sup>, Dutch banks have approximately €80bn in outstanding loans to Dutch real estate companies. It is unknown whether this figure includes amounts loaned to foreign real estate companies. Based on annual accounts and reports published by banks and publications from regulators, PwC calculated that an amount of €57bn at Dutch banks must be designated non-performing at year-end 2012.

It is likely that an unknown percentage of the outstanding performing loans could also be designated as NPLs. In other words, the actual amount of NPLs could be higher. Practice shows that in the context of restructuring, new arrangements are made with project developers regarding the repayment date or deferred payments of interest and repayments, or other conditions are agreed on. As a result, in a technical sense, these loans are no longer designated as NPLs. In reality, however, some of these do qualify as NPLs. Due to the financial and technical bankruptcy of project developers, real estate projects are unlikely to be sold or rented out. Legal proceedings will also have a material adverse impact on the financial or operational situation. Here, the definition from the IMF and ECB applies: '*(...) when there are good reasons to doubt that debt payments will be made in full*'.



## Valuation of NCLs and NPLs

BIS wrote in its letter<sup>6</sup> of 21 June 2013 to International Accounting Standards Board (IASB) that the recognition of credit risks and losses under the existing Incurred Loss Model (ILM) valuation model was *'too little, too late'*. BIS was of the opinion that the valuation methodology must not exclude any relevant data, but should take into account *'past events, current economic conditions, and reasonable and supportable forecasts of future events and economic conditions'*. BIS expressed its concerns that under the existing ILM, expected losses were only adequately recognised and taken into account when significant credit deterioration had taken place. This raises the question whether all available relevant facts and circumstances had been taken into account in the assessment and determination of loss events or only part of it.

Seeing that substantial losses on the grounds of various *'past and future events'* have been foreseeable in some cases but were not formally recognised, it may be argued that this cliff occurred in recent years. In many other cases, investigations made by HIG revealed that vital data on relevant events were not available or not well structured. As a result, recognition of credit risks was not possible, required insight was lacking and deterioration of individual credit records could take place unnoticed.

At her inauguration<sup>7</sup>, Professor A. Vanstraelen, professor of Accounting and Assurance Services at Maastricht University, emphasised that the quality of financial reporting is determined *'by the reliability of the underlying data which are used for the valuation of assets and obligations, which is dependent on properly functioning markets with a sound infrastructure for delivering reliable and relevant data in good time'*.

The observations made above lead to two imperatives:

1. Evaluate existing portfolios of NCLs and NPLs to identify losses and to be able to take necessary measures at an early stage. This can lead to instituting measures and/or initiating investigations of possible irregularities and recovering assets from individuals who abuse bankruptcy (laws) by transferring assets or income at a time of insolvency, or at a time when significant liabilities (such as tax liabilities) are anticipated.
2. Improve existing procedures and the bank's information position on the identification of loss events in order to prevent late identification of possible future losses.

## Focus on Ireland

### Introduction

There is a huge gap between the ways in which European countries are coping with their financial and real estate sector challenges. In view of the IFRS international accounting rules and the strong cooperation between central banks within the ECB context, a coordinated and uniform approach would be beneficial. The sole advantage of having different approaches across European countries is the early visibility of differences in causes, approaches and consequences.

From the onset of the financial crisis in 2008, Anglo-Saxon banks have taken considerable losses at an early stage by making considerable write-offs in their loan books. The British and Irish governments were obliged to support local banks with considerable capital injections to prevent them from going bankrupt. In the United Kingdom and Ireland, banks and the National Asset Management Agency (NAMA) sold significant parts of loan books at considerable discounts in order to clean up balance sheets and free up financial resources for new financing activities.



### **Irish government**

In 2009, the Irish government decided to transfer loans with a total gross value of €70bn (and with an individual value in excess of €50mn) to NAMA at a discount of approximately 50%. This government body, established in November 2009, popularly referred to as '*bad bank*', was founded by the Irish government to address the serious problems which arose in Ireland's banking sector as the result of excessive property lending. A criticism often heard with regards to the settlement of NPLs by NAMA is the incompleteness of the records transferred by the banks to NAMA and the fragmented approach pursued by NAMA in handling sizeable and complex records. The latter is illustrated by the informal allegation that NAMA issued only limited instructions for pursuing partial investigations to contracted investigators, legal advisers and accountants, in which context only limited data are made available to investigative professionals.

### **Irish banks**

Irish banks have been returning to health since their bad debts forced the Irish government to accept a €85 billion bailout in 2010. A combination of steadily rising asset and property prices, banks tackling impaired loans and healthy tier 1 capital ratios under a Basel 2.5 framework point to this recovery. However, acute challenges remain. Acute financial sector challenges include an estimated banking sector NPL ratio in excess of 40%, some 36% of owner-occupier mortgages in restructuring or not performing, and a proliferation of low-yielding tracker mortgages that creates a drag on Irish banks' net interest margins, according to Deutsche Bank (November 2013)<sup>8</sup>.

### **Irish real estate sector**

Today, the Irish real estate market, on which the majority of its lending was secured, is presenting a mixed picture, with some stabilisation and even growth in certain areas – notably Dublin – and continued depression in value outside of the capital. Significant volumes of deals are now being pushed into the marketplace<sup>9</sup>, partly as a result of this calmer property picture. A key driver of this flow is the shape of the banking sector following its wholesale restructuring and the creation of Irish Bank Resolution Corporation (IBRC) and NAMA. As with the UK, property-backed debt (both CRE and residential), represents potential opportunity, while demanding rigorous due diligence.

#### **Looking into the numbers**

On December 15 2013, Ireland became the first EU country to exit the rescue programme by the Troika of EU Commission, European Central Bank (ECB) and International Monetary Fund (IMF). While Ireland received €67.5bn in bail-out funds since the end of 2010, funds amounting to €89.5bn were transferred from the country to the financial sector during the same period:

- €18.1bn were used to directly recapitalize Irish banks.
- €55.8bn went to creditors of the Irish state. €37.5bn of these were used to repay maturing government bonds and €18.3 billion to pay interest for outstanding bonds.
- €1.6bn were spent by NAMA to buy bad real estate assets held by Irish banks.
- €14bn were used so far for the liquidation of IBRC, the merger of two bankrupt nationalized banks. €12.9bn of these were used by NAMA to buy the remaining IBRC assets. Another €1.1bn was paid to the bank's creditors as the result of a government guarantee.



### **Current status**

In Ireland, high-profile criminal investigations into possible large-scale irregularities by leading project developers have started. In October 2014, the Central Bank of Ireland revealed the names of a high-powered inquiry panel to investigate allegedly rogue banks and bankers. The first case expected to be reviewed by the inquiry will be Irish Nationwide whose collapse cost taxpayers €5.4bn. It will examine not just unorthodox lending practices but also consider the activities of its former managing director who was awarded a €1mn bonus by his board in his final year in charge<sup>10</sup>.

Another banking inquiry, chaired by Labour TD Ciarán Lynch, will concentrate on the 2008 guarantee, the role of the European Central Bank and the ‘psychology’ of the crisis. The banking inquiry will be carried out in two steps: a context phase, to frame the scope of the investigation; and a nexus phase, to identify key questions to be addressed in public hearings, conduct such hearings and write the final report. The context phase will tackle five topics:

- Findings and recommendations of previous reports.
- International, EU and domestic policy context, including key findings of reports of international monitoring agencies.
- Relationships between State authorities, political parties, elected representatives, supervisory authorities, banking institutions and the property sector.
- Early warnings, divergent and contrarian views.
- The role of the media.

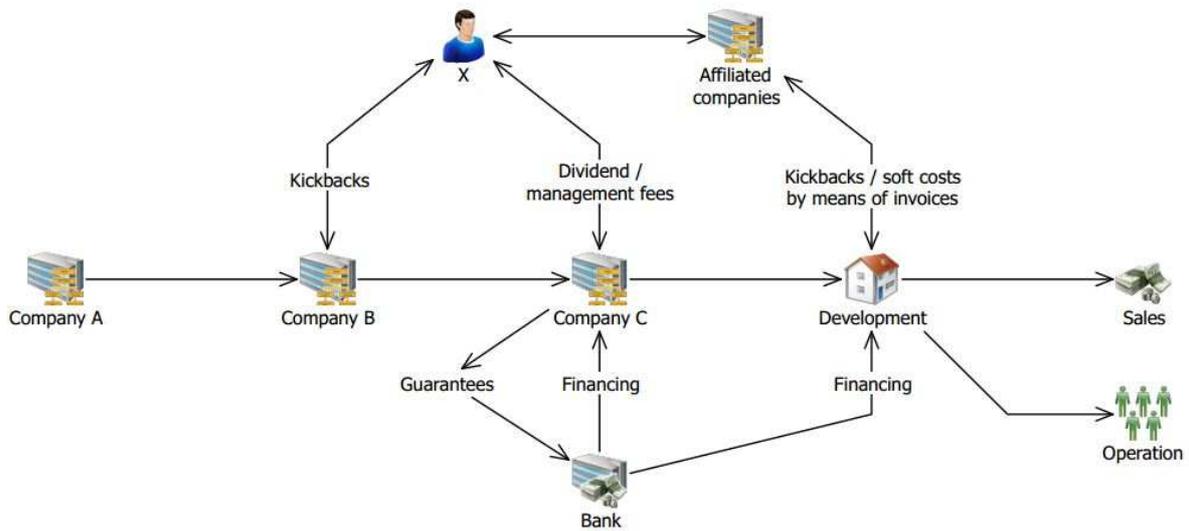
To date, efforts made by NAMA seem not have resulted in the successful recovery of missing funds and seem to be focused primarily on the foreclosure of collaterals for the loans taken over. Various hedge funds have come forward as potential buyers.

### **Findings from forensic investigations**

Dozens of investigations made by HIG revealed that in the property development sector, project developers deliberately presented incorrect facts prior to, during and after the completion of construction projects. As a result, substantial financial funds were misused or misreported. The irregularities observed can be qualified as both civil law and criminal irregularities. In many cases, the investigation and confiscation strategy was targeted at initiating civil law and criminal proceedings to gather information, hold the individuals involved liable and recover missing assets. In various projects, reports were made based on provisional findings to the responsible public prosecution departments in several countries, after which criminal investigations were initiated. In other projects, recommendations to report crimes were verified and authorised by the lawyers involved.

#### **Three common approaches were pursued in the investigated projects:**

1. Artificially driving up the price of the underlying real estate prior to the eventual purchase by the project partnership Party C.
2. The withdrawal of financial funds from project partnership Party C during the development stage of the project by means of dividends, management fees and other ‘*soft costs*’.
3. Taking over NPLs or the physical collaterals from the banks at considerable discounts at the end of the financing stage.



### ABC constructions

HIG found out that in many cases the object to be financed by the bank was not purchased from an independent third party, but from an affiliated party. The sole purpose of these so-called ABC constructions was to substantially increase the value of the object to be financed prior to the bank's financing, without any tangible value increase having taken place. Investigations also revealed that project developers often provided surveyors with incorrect data with regards to rental, rental periods and discounts.

### Soft costs

During the financing stage, project developers often extracted funds from the financing provided by using lower-quality materials or by submitting or increasing costs for management, acquisition, marketing and other 'soft costs'. Research showed that the quality of the financed projects did not correspond to the impression presented by the project developers. Some projects turned out to have serious structural flaws, while other projects were not finalized although the financing had been made available in full. In some cases, soft costs took up more than 40% of the financing made available.

### Taking over NPLs

As for NPLs, it turned out that project developers made attempts to take over NPLs or the physical collaterals from the banks at considerable discounts at the end of the financing stage. This was done by using third parties as intermediaries. HIG also observed that in some cases the rent income was not paid to contracted parties, but to other parties.

### Three investigation objectives

Practice shows that three investigation objectives must be addressed coherently and in the sequence stated for an effective implementation of forensic investigations:<sup>11</sup>

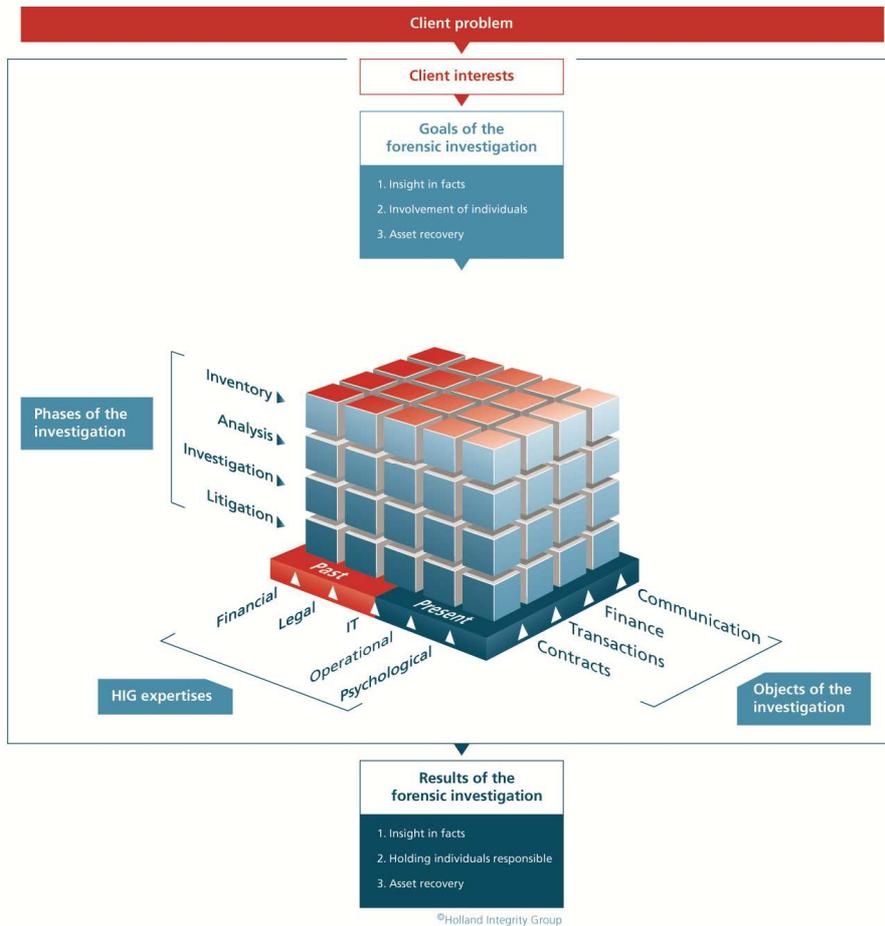
1. Gain insight into complex facts.
2. Hold accountable individuals and legal entities responsible for possible irregularities.
3. Trace illicit funds and recover hidden assets which have possibly been misused.

This does not imply the three objectives must be followed one at a time. On the contrary, it is advised to work these out simultaneously and in an integrated manner to ensure the investigation is carried out



effectively, timely and expeditiously. Various laws state the necessary legal possibilities to impose attachment on evidence or assets on the basis of suspicions, or to bring a case to the attention of the public prosecution department. Practice shows, however, that forensic investigations and legal proceedings are often tackled in a fragmented, sequential manner by various parties. This has a negative impact on the end result. Also, legal authorities no longer wish to start a criminal investigation if the parties involved have already been approached in the context of a private investigation, or if the case has been dragging on for too long.

The objectives listed above shape the structure, planning and implementation of the activities performed by the investigators. The visual below highlights the complexities of the investigation process, from identifying the situation through to final settlement. Leaving out or skipping elements will lead to a limited scope or fragmented approach and a less successful end result. A project-based, multidisciplinary and integrated top-down approach is needed. In this approach, internal and external specialists collaborate on preventive recognition, identification and control of potential non-core risks, the prevention of incidents and a repressive approach as needed.



*A project-based, multidisciplinary and integrated top-down approach is needed to investigate NPLs*



## Conclusions

Within one week of the AQR results being disclosed (end October 2014), banks will have to submit capital plans detailing how shortfalls will be covered in the subsequent six to nine months. As the combined AQR/stress test outcome is not likely to reveal any comprehensive assessment on banks' exposure to NCLs and NPLs, a more drastic approach is needed.

It is advised, therefore, to perform an integrated forensic investigation aligned with ECB's day-to-day supervision from November 2014 onwards<sup>12</sup>. Investigations will need to be performed centrally, in close collaboration with other banks to ensure all relevant data are combined properly to provide an integrated 360 degree picture. Conducting a forensic investigation parallel to ongoing assessments will not disrupt daily operations or arouse attention.

It is HIG's experience that, if performed professionally and carefully, the yield of forensic investigations outweighs the costs of investigations. If done thoroughly and in an integrated manner, the outcome will be such that liable parties will be held responsible, missing assets will be recovered – wholly or partly – and, ultimately, public confidence in the financial sector will be restored.

NCLs and NPLs are ticking time bombs that pose huge systemic risks to financial stability. Therefore, facing the facts is vital. Otherwise, the downward negative spiral will continue and more incidents will surface. Without any tangible evidence of irregularities or fraud, project developers will easily enter into new fraudulent transactions with banks again. Costs will be passed on to taxpayers, while liable parties escape to continue their harmful activities unabated.

NPLs and NCLs need to be defused. It is high time for a focused approach and it is the responsibility of governments to take the necessary steps to follow this approach.

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### **About Holland Integrity Group (HIG)**

Holland Integrity Group is the leading independent investigation and advisory firm supporting profit and non-profit organisations in increasing their resilience to misconduct and violations of integrity, in investigating possible complex fraud and in the recovery of missing assets.

Website: [www.hollandintegritygroup.nl](http://www.hollandintegritygroup.nl)



## Definitions

### Non-performing loan (NPL)

Supervisors or at least general practice in the majority of Western European countries seem to endorse the rule that for a loan to be non-performing, at least one of two (primary) elements has to be present: (1) principal or interest 90 days or more overdue, and (2) existence of underlying well-defined weaknesses of loan or borrower. However, there are also other (secondary) elements that have an impact on NPL measurement and the comparability of definitions: the question whether a restructured loan is classified as NPL or not, whether the presence of a collateral or guarantee influences loan classification or not, whether the full outstanding value or only part of a loan is reported as nonperforming, and whether a bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired or not. While these elements may introduce upward or downward biases into some nations' NPL definitions and ratios, and these would need to be further investigated, the above-outlined NPL rule appears to constitute a feasible yardstick for most of the countries mentioned above. Moreover, this definition is also in line with a draft EU ruling for a Capital Requirements Regulation (CRR)<sup>13</sup>.

### Non-performing loan: Pass, Special Mention, Substandard, Doubtful, and Loss

Presently, the five-tier system is the most popular risk classification method, or, in some cases, a dual system of reporting according to their domestic policy guidelines as well as the five-tier system. Non-performing loans comprise the loans in the latter three categories, and are further differentiated according to the degree of collection difficulties. According to BIS, the standard loan classifications are defined as follows:

- (1) Passed: Solvent loans;
- (2) Special Mention: Loans to enterprises which may pose some collection difficulties, for instance, because of continuing business losses;
- (3) Substandard: Loans whose interest or principal payments are longer than three months in arrears of lending conditions are eased. The banks make 10% provision for the unsecured portion of the loans classified as substandard;
- (4) Doubtful: Full liquidation of outstanding debts appears doubtful and the accounts suggest that there will be a loss, the exact amount of which cannot be determined as yet. Banks make 50% provision for doubtful loans;
- (5) Virtual Loss and Loss (Unrecoverable): Outstanding debts are regarded as not collectable, usually loans to firms which applied for legal resolution and protection under bankruptcy laws. Banks make 100% provision for loss loans.

Non-performing loans comprise the loans in the latter three categories, and are further differentiated according to the degree of collection difficulties.<sup>14</sup>



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1 DNB: Vastgoed wordt derde crisis [Real estate will be the third crisis], Interview with Jan Sijbrand, Director of Regulation at DNB, *Financieele Dagblad*, 3 February 2012

2 The 'loss event' definition is based on the terms used by the BIS and defined in the Sound Practices for the Management and Supervision of Operational Risk Report of the Basel Committee on Banking Supervision of February 2003. The events recognised by the BIS include the following:

- ✓ Internal fraud
- ✓ External fraud
- ✓ Clients, products and business practices

3 Market update, PwC Portfolio Advisory Group, January 2013 and Market update, PwC Portfolio Advisory Group, October 2013

4 €2.5tr equals €2500bn.

5 Overzicht Financiële Stabiliteit [Financial Stability Overview], Spring 2013, number 17, page 12, De Nederlandsche Bank, Spring 2013

6 Brief Exposure Draft (ED/2013/3) Financial Instruments: Expected Credit Losses from the Basel Committee on Banking Supervision to the International Accounting Standards Board, 21 June 2013

7 De rol van accounting and accountingonderzoek in de economische crisis [*The role of accounting and auditing in the economic crisis*], Dr. Ann Vanstraelen, School of Business and Economics, 11 September 2009

8 Bank capital: Irish bank weakness might undermine bailout exit - [www.euromoney.com/Article/3272342/Bank-capital-Irish-bank-weakness-might-undermine-bailout-exit.html](http://www.euromoney.com/Article/3272342/Bank-capital-Irish-bank-weakness-might-undermine-bailout-exit.html)

9 Approximately €20bn since 2008 footnote PwC, Market Update, 2013

<sup>10</sup>[www.irishtimes.com/business/sectors/financial-services/central-bank-to-name-financial-investigation-panel-1.1966716](http://www.irishtimes.com/business/sectors/financial-services/central-bank-to-name-financial-investigation-panel-1.1966716)

11 Forensisch onderzoek, geïntegreerde multidisciplinaire aanpak cruciaal [Forensic investigation, integrated, multidisciplinary approach crucial], F.J. Erkens and C. Jong RA, *Finance & Control*, December 2013

12 In particular, results will be factored into the ongoing assessment of banks' risks, their governance arrangements and their capital and liquidity situation as part of the Supervisory Review and Evaluation Process (SREP). <https://www.ecb.europa.eu/ssm/assessment/html/index.en.html>

13 Stephan Barisitz (Oesterreichische Nationalbank (OeNB) - Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions

14 BIS, [www.bis.org http://www.bis.org/repofficepubl/arpresearch201003.07.pdf](http://www.bis.org/http://www.bis.org/repofficepubl/arpresearch201003.07.pdf)