
Stemming the rise of non-performing loans

Although there is obviously no 'magic formula' that can be applied to stop the rise of NPLs, the Cypriot banks will need to employ innovative approaches that can provide short and long-term solutions. These approaches are mostly new and outside the 'normal' banking processes. Operationally, the banks have not had the experience of dealing with what is a very large portfolio of NPLs – both as a percentage of assets and as an absolute amount.

The traditional approaches, which include restructurings and write-offs (as per the Basel III guidelines) will of course always remain part of the solution. Disposing of the NPLs to specialized hedge funds is also a frequently used solution and could become part of the overall strategy here as well. But other, less "conventional", methods will have to be considered too:

- **Debt restructuring with concurrent management by the bank of the collateral assets/businesses** (under specific guidelines). Simply restructuring a NPL (without any other bank-driven action), in many cases merely provides for a postponement of the need for drastic action and in some cases exacerbates the problem.
- **Management of viable but insolvent businesses.** Subject to the terms of specific loans, the bank could take an active role in managing (or co-managing) viable business that is heavily indebted. This could take place with or without the voluntary cooperation of the Company, with the former being the preferred route. One example of this approach would be the co-management of a revenue-generating real estate asset, like a hotel.
- **Converting debt to equity.** In cases where the indebted Companies have a viable business model, converting part of the NPL into equity (with optional share buy-back scheme) could both enable the business to continue and maybe improve its profitable operations (thus paying off its debts in an orderly manner) and provide some upside for the bank as a shareholder. This strategy has been adopted in various cases across banks in Europe and it could be explored in Cyprus, especially in combination with other approaches such as the ones discussed above.

The banks will need to develop their technical competence and capacity in dealing with NPLs, as this will be a significant part of their operation for a number of years to come. Investment banking and venture capital approaches, tools and culture will be employed and the faster the banks move to tackle the NPL issues the more the already apparent return of confidence in the banking sector will accelerate. And with each NPL that will be resolved, activity and growth in the real economy will benefit.

Thankfully, the Cypriot bankers are well aware of the challenges and have lost no time in turning to experts that have the experience and technical know-how to help build a comprehensive system for dealing with NPLs. Take home message: The task of “cleaning up” the banks’ balance sheets will take time and a great deal of very specialized hard work.

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