



**European Bank**  
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# In the wake of the crisis: dealing with distressed debt across the transition region

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## **Summary**

This article reviews the origin and spread of the distressed debt problem in the transition region. We argue that while the crisis was triggered abroad, the current high level of distressed debt in various transition countries mainly reflects home-grown vulnerabilities. As in the West, the root causes of the debt problem were abundant and cheap funding and a gradual relaxation of banks' lending standards – in particular an excessive reliance on rising real estate values. We document a strong positive relationship between pre-crisis house price increases, house price collapses during the crisis and subsequent increases in non-performing loans (NPLs). Policy options to deal with distressed debt range from decentralised approaches in which banks restructure NPLs on a case-by-case basis to more centralised options, such as a “London approach”, bad banks, or asset management companies. Centralised options may be called for if case-by-case debt restructuring is suboptimal from a system-wide perspective because of negative externalities or capacity constraints in either the banking or the judicial system.

Keywords: distressed debt, insolvency, financial crisis

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## INTRODUCTION

It is more than two years since the transition region was first hit by the global financial turmoil. While the US sub-prime crisis spilled over quickly to western European banks, some of which were directly exposed to toxic US mortgages, contagion to emerging markets was delayed. By March 2008 only a couple of countries were affected: Kazakhstan, the Baltic states and a few south-eastern European countries. After the intensification of the global crisis in September 2008, however, the crisis spread quickly throughout the transition region, leading to the largest output loss since the recession at the start of transition 20 years ago.

In this article, we provide a broad overview of why and how the crisis has affected credit quality across the transition region. We argue that while the crisis was triggered abroad, the current high level of distressed debt in various transition countries mainly reflects home-grown vulnerabilities. Most debt problems in the region are also surprisingly similar to debt problems in Western countries. For both regions, the period from 2001 to 2007 was characterised by abundant liquidity, low interest rates, relaxed lending standards, very rapid credit growth, and, in some cases, asset bubbles. While there are clear differences, there are also some striking similarities between a financially overstretched suburban borrower in California with a “ninja” mortgage (“no income, no job, no assets”) and an over-indebted herder in rural Mongolia. Both are victims of a period of over-optimism and lax lending standards.

The remainder of this article is structured as follows. In section 1, we review some of the recent literature on the relaxation of lending standards. Section 2 then gives an overview of the development of NPLs across the transition region, after which section 3 summarises lessons from earlier crisis periods about effectively and efficiently dealing with NPLs. Section 4 concludes.

## 1. BACKGROUND: THE ORIGINS OF DISTRESSED DEBT

Now that as of early 2010 an economic recovery (albeit still weak and uneven) is under way in large parts of the world, economists and policy-makers are trying to identify what went wrong. It is recognised that the crisis was to a large extent caused by a protracted period of low interest rates, high securitisation activity and a relaxation of banks' lending standards in an environment of weak banking supervision. These developments mutually reinforced each other. The pre-crisis period, sometimes referred to as the "Great Moderation", was characterised by high and stable growth combined with low inflation. This allowed central banks to keep interest rates low, which further boosted economic activity. Low interest rates increase the demand for credit while also driving up the value of collateral that firms and households possess. Higher collateral values make banks more willing to lend as the underlying risk profile of clients improves.

In addition to these well-known transmission mechanisms of monetary policy, it has become increasingly clear that low interest rates also induce banks to take on more risk. There are various reasons for this. Banks increasingly search for yield in a low interest rate environment. When interest rates are low and most borrowers thrive, the benefit of screening borrowers is reduced and lenders have less of an incentive to screen adequately (Ruckes, 2004). Consequently, lending standards are relaxed during business cycle upswings and are tightened during a negative economic shock (Rajan, 1994). Similar empirical evidence is emerging for the recent "boom-bust" period. Low short-term interest rates induced European banks to lend to more risky borrowers (Jiménez et al, 2009; Maddaloni et al, 2009). There is also evidence of an erosion of screening standards in the US mortgage market in the period leading up to the crisis (Dell'Ariccia et al, 2008) and that the onset of the crisis pushed banks to increase their screening and monitoring of loans, suggesting that pre-crisis lending standards had been relaxed (De Haas and Van Horen, 2010).

The rapid development of securitisation in the pre-crisis period exacerbated these trends.<sup>1</sup> Securitisation has been shown to have reduced the incentives of lenders in the US mortgage market to screen prospective borrowers (Keys et al., 2009). Borrowers whose loans were sold in the secondary market underperform their peers, suggesting that the move to an originate-to-distribute model contributed to a relaxing of credit standards (Berndt and Gupta, 2009).

Most of these forces were not only at work in the United States – the centre of the sub-prime mess – and western Europe but also to varying degrees in the transition region. First, lending rates charged to borrowers across the transition region had decreased significantly since 2001. The period between 2005 and 2007 in particular was characterised by a boom in cheap credit.

Second, the availability of abundant cheap funding from foreign lenders made domestic local banks relax their lending standards. The EBRD's 2009 edition of the *Transition Report* describes how collateral ratios for new mortgage lending declined, although this was not the case everywhere. In some countries (Poland, Romania, and the Baltic states)

<sup>1</sup> Similarly, Maddaloni et al. (2009) find that securitisation contributed to the erosion of lending standards of European banks.

regulators started to impose stricter maximum loan-to-value (LTV) ratios in early 2007. Other components of lending infrastructure were often missing as well, in particular credit bureaus. This meant that banks found it difficult to check whether loan applicants had defaulted on previous loans or had been refused credit by competitor banks. In some countries customers were able to apply for loans from several banks at the same time, leading to over-indebtedness. Rapid credit growth and a gradual relaxation of lending standards was also stimulated by intense bank competition, spurred by foreign banks that had entered the market and tried to gain market shares (De Haas and Naaborg, 2006).

Third, although various transition countries made good progress with upgrading supervisory standards, banking supervisors across the region are still relatively inexperienced. Moreover, in some countries the funding of supervisory authorities was inadequate, making it difficult for the authorities to attract and retain high-quality staff lured by a booming and well-paying commercial banking sector. Labour-intensive onsite inspections of banks suffered in particular.

A final problem more specific to the transition region was the widespread use of lending in foreign currencies (FX), mostly in euros and (in Central Asia) US dollars, but increasingly also Swiss francs and yen.<sup>2</sup> Interest rates on these foreign currency loans were considerably below the rates on local currency loans – reflecting limited, or insufficiently entrenched, macroeconomic stability in a number of transition countries – and thus attractive to those borrowers that did not realise or properly consider the presence of exchange rate risks. Exchange rate risks were in many cases either ignored because of the implicit guarantees that accompanied hard currency pegs or because of expected adoption of the euro in the medium term. By lending in foreign currencies, banks exposed unhedged customers to significant currency risks. Indeed, the presence of foreign banks and the availability of abundant foreign financing appear to have led to more aggressive pricing of loans in foreign currencies.

The high levels of “euro-isation” also reflect the broader development model that many transition countries followed during the last 15 years: importing substantial amounts of foreign capital to fund consumption and investment. This resulted in high cumulative current account deficits and in some countries in substantial upward pressure on wages and inflation, gradually eroding countries’ competitiveness. Vulnerabilities were thus not only building up at the microeconomic but also at the macroeconomic level.

In contrast to the United States and to a lesser extent western Europe, lending standards in the transition region were only to a limited extent eroded further by securitisation. Securitisation only emerged slowly at the height of the credit boom: after Latvia issued a residential mortgage-backed security (RMBS) in 2004, mortgage-backed securities were also issued in Russia, Ukraine and Kazakhstan in 2006-07. In Kazakhstan, residential mortgages were securitised by BTA Ipoteka, the consumer lending subsidiary of BTA, a bank that would subsequently default on its debt obligations in 2009. Covered bonds – where banks use on-balance sheet mortgages as collateral to issue bonds – were more popular in transition countries than mortgage-backed securities (where the risk of the mortgage is separated from the originating bank) (EBRD, 2007). This may have limited the agency problems associated with securitisation that were the undoing of the sub-prime market in the United States.

<sup>2</sup> See Brown et al. (2009), Basso et al (2007), and Zettelmeyer et al. (2010). In various countries, widespread FX lending mirrored a similar dominance of foreign currencies in banks’ deposit base.

## 2. THE DEVELOPMENT OF DISTRESSED DEBT DURING THE FINANCIAL CRISIS

During the last quarter of 2008 and the first quarter of 2009 lending flows to the EBRD region contracted significantly. Domestic banks, confronted with less foreign funding, started to reduce their lending as well. This reduced production of “fresh loans” had an immediate impact on banks’ NPL ratios. The outstanding loan stock gradually seasoned and more and more problem loans appeared.<sup>3</sup>

Because NPL definitions differ widely, data on NPLs are difficult to compare across countries.<sup>4</sup> We therefore mostly compare *changes* in NPL levels, rather than the level itself. Moreover, the NPL numbers presented in this paper only present the official picture: rating agencies have repeatedly emphasised that true NPLs may be substantially higher in a number of countries. An important reason for the sometimes diverging official and unofficial statistics is that some banks pre-emptively restructure or roll-over bad loans before they are classified as “non-performing”. In such cases official NPL figures are edging up only slowly.

Chart 1 shows the increase in NPLs in the transition region since June 2008 (an index of 500 means that NPL ratios are five times the June 2008 level). It shows large cross-country differences in the rate of increases in NPLs compared with pre-crisis levels, with relatively moderate increases in central Europe and much faster rises in countries such as Kazakhstan, Latvia, Mongolia and Russia. Georgia is an interesting outlier in the sense that NPLs doubled immediately after the armed conflict with Russia in August 2008, continued to increase at a slower pace, and recently started to taper off.

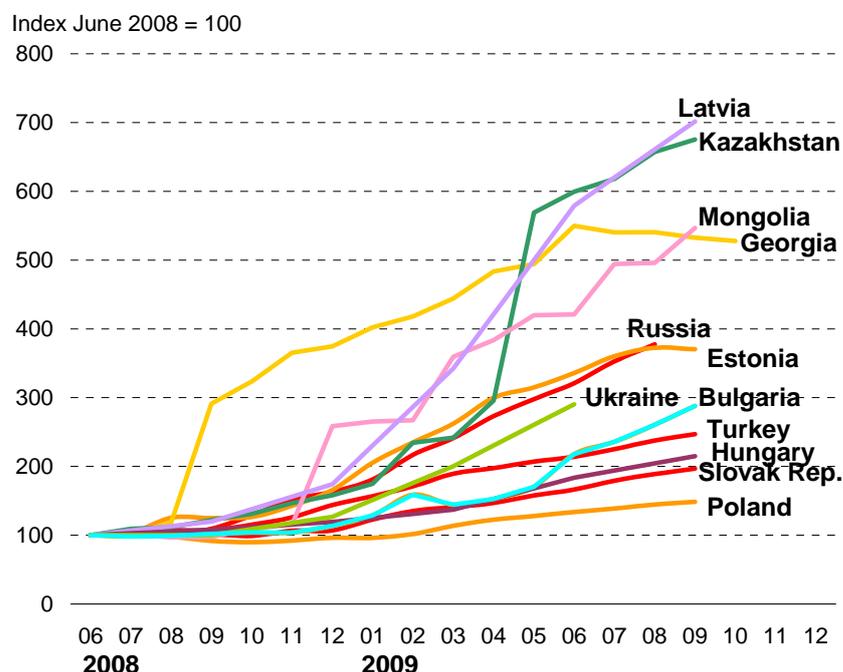
Mongolia saw a very sharp increase in NPLs from 2.8 per cent in June 2008 to 15.1 per cent in September 2009. The country has been hit by a liquidity and solvency crisis in its banking system in the wake of a protracted period of very high inflation, increasingly over-indebted borrowers, togrog depreciation and a slump in the construction sector. The absence of well-functioning credit bureaus in Mongolia meant that many rural borrowers were able to take out several consumer loans at the same time, leading to over-indebtedness and repayment difficulties when meat and cashmere prices fell during 2008-09. In addition, large-scale fraud and mismanagement in some banks went undetected due to weak supervision, leading to the failure of two banks.

<sup>3</sup> NPL *ratios* increase particularly fast as they combine the effect of weaker loan quality in the numerator with lower loan growth in the denominator.

<sup>4</sup> Only half of the transition countries use 90 days as the threshold after which an overdue loan is considered non-performing. For six countries there is no methodological information and nine countries do not offer monthly or quarterly data.

**Chart 1 Distressed debt in selected transition countries**

(June 2008 = 100)

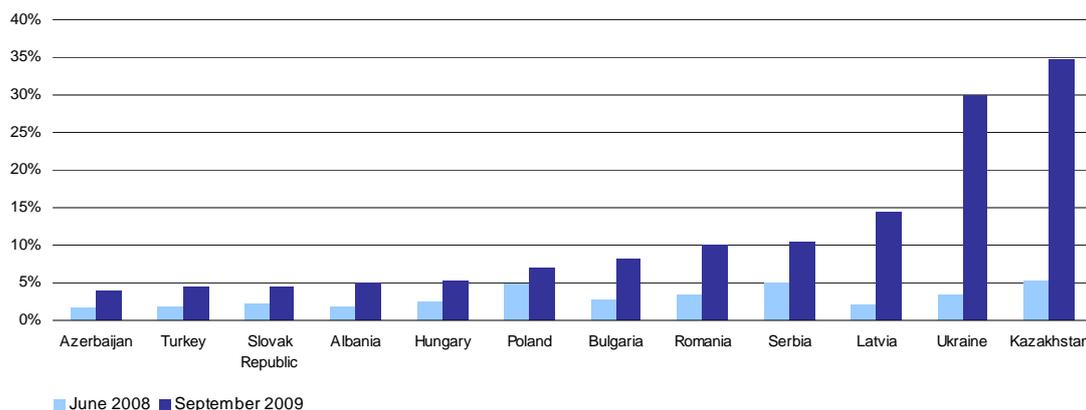


Note: Ratio of non-performing to total loans, expressed as an index where 100 = NPL ratio in June 2008. Underlying definitions and overdue thresholds for non-performing loans may differ between countries.  
Source: National central banks, financial supervision agencies, CEIC Data Company.

Chart 2 shows data on the *level* of NPL ratios for those transition countries that use an NPL definition that is relatively similar (overdue loans of three months or more) and for which recent data (September 2009) are available. It shows that in absolute terms NPL levels are now highest in Kazakhstan, Latvia and Ukraine (based on IMF estimates).

In Kazakhstan, NPL levels increased from 5.1 per cent in June 2008 to 34.7 per cent in September 2009, the highest level across the region. Three factors have contributed to this sharp recent increase. First, some of the large banks have been in debt restructuring talks and therefore had to reveal their portfolio quality. Although Kazakhstan was hit by the crisis as early as August 2007, NPL ratios did not move much for about a year, a period in which some banks rolled over past-due loans to both corporate and retail clients. Second, the February 2009 tenge devaluation of about 25 per cent has gradually been feeding through the real economy as unhedged foreign currency borrowers had difficulties repaying loans. Third, the increasing NPLs also reflect sharp declines in real estate prices. The real estate sector was characterised by speculative investments in pre-paid apartments (Investquartiras) and left the main Kazakh banks overexposed. The real estate bubble burst in mid-2007, freezing the construction sector and bankrupting some of the largest construction companies. Real estate prices fell by 50 per cent in Astana and 30 per cent in Almaty from peak values in August 2007. Risk management practices were not on a par with the (over-) ambitious growth strategies of some of the banks.

**Chart 2 NPL levels in selected transition economies, June 2008 and September 2009**

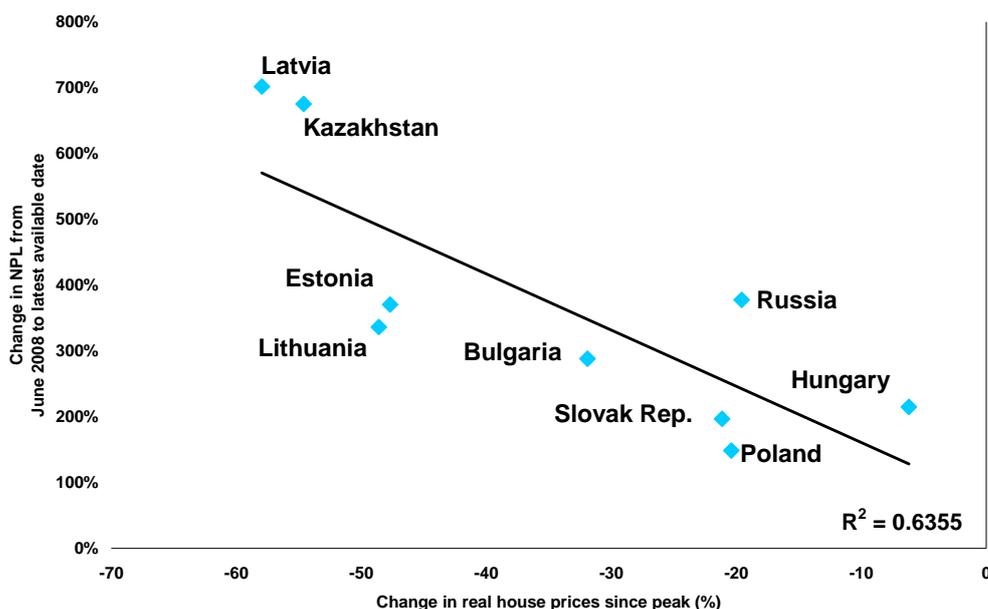


Note: Non-performing loans in per cent of total loans. Non-performing loans are defined as loans overdue three months or more. Apart from the overdue threshold, definitions may vary depending on the different methodologies used by country authorities. The NPL ratio in Turkey refers to consumer loans only. The NPL ratio of 30 per cent for Ukraine reflects the most recent IMF estimate; the officially reported number is 9.6 per cent for June. Various countries that are included in Chart 1 are not shown in Chart 2 because their NPL definitions are not comparable.  
Source: National central banks, financial supervision agencies, CEIC Data Company.

In Latvia, NPLs increased particularly fast, from 2.1 per cent in June 2008 to 14.5 per cent in September 2009, a level which is still considerably below both Kazakhstan and Ukraine. One reason for this difference in levels is that while the Kazakh tenge and Ukrainian hryvnia depreciated by a considerable amount, the Latvian lat was not devalued. Although this lack of nominal exchange rate flexibility may have increased the adjustment burden in other areas, it has prevented massive distressed debt problems for borrowers with unhedged foreign currency risk exposures (90 per cent of Latvian loans are foreign currency-denominated). The country has nevertheless been hit particularly hard by the crisis and economic output is expected to have dropped 16 per cent in 2009 alone. Parex Bank, one of the largest banks in the country, was nationalised in November 2008.

In Latvia and in Kazakhstan NPL levels have been driven in particular by a sharp drop in real estate prices, a sector to which banks were heavily exposed. More than half of all NPLs in Latvia are linked to mortgages, construction or real estate projects. More generally, there is a strong positive correlation between NPL increases and house price collapses in transition countries, as shown in Chart 3.

**Chart 3 Correlation between house price collapses and relative change in NPLs**

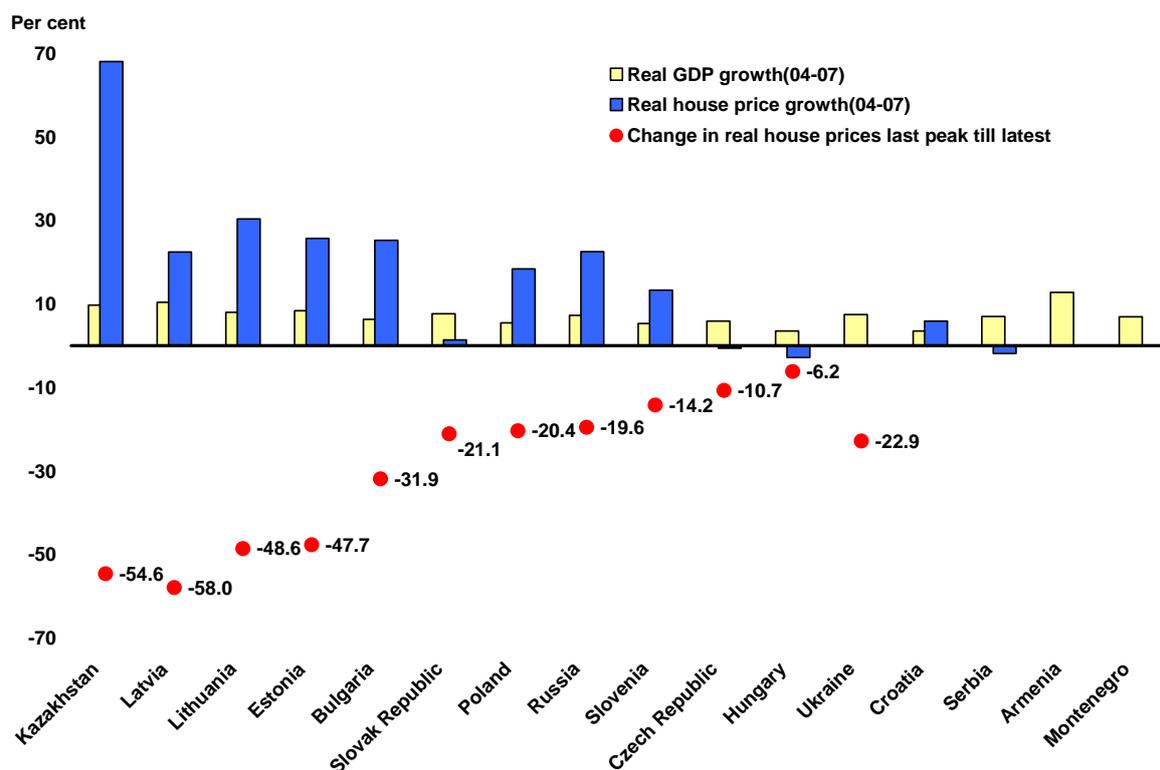


Sources: Central banks, statistical offices and real estate agencies for house prices; CEIC Data Company, central banks and financial supervision agencies for the data on NPLs. Note: Real house price change is defined as the annual average nominal price change of dwellings per square metre adjusted by annual average CPI.

In turn, the severity of house price collapses that drove the increase in distressed debt can be largely explained by the size of pre-crisis housing price bubbles in various countries, which were fuelled, particularly in the Baltic states, by a very rapid credit expansion.<sup>5</sup> Rapidly increasing real estate values, which served as collateral for mortgage loans but also for many corporate loans, gave banks a false sense of security and made them rely too much on collateral and not enough on cash flow analysis. In addition, Western banks were willing to provide loans to many banks across the transition region whose risk management systems were not yet on a par with international practice. Faced with a sudden abundance in available funding, local banks were tempted to spend money on seemingly straightforward projects such as large-scale residential real estate developments and office blocks. Chart 4 shows that the collapse in real estate prices was most severe in countries where real house prices increased much faster than real income levels.

<sup>5</sup> See Egert and Mihaljek (2007) and Sirtaine and Skamnelos (2007).

**Chart 4 Pre-crisis house price booms and post-crisis house price collapses**

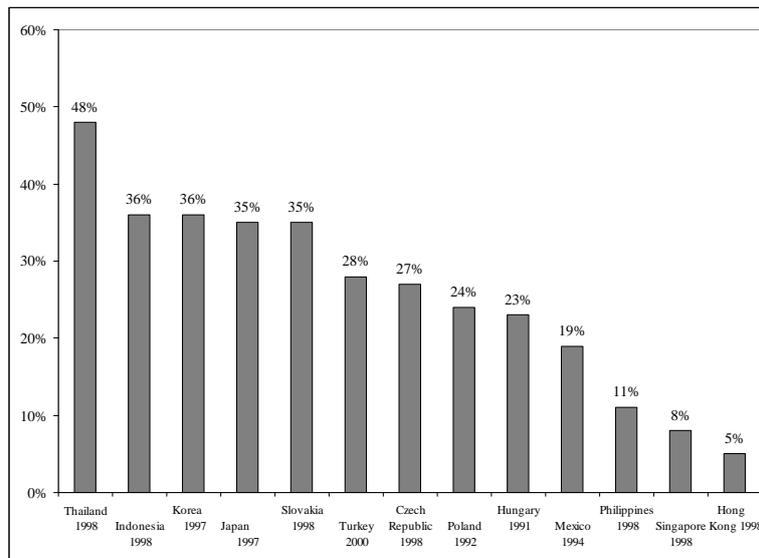


Note: Real house price change: annual average nominal price change of dwellings per square metre adjusted by annual average CPI. Data for Armenia, Estonia, Hungary, Romania and Ukraine refer to the capital.  
Sources: National statistical offices and central banks, real estate companies in Armenia, Hungary, Lithuania and Ukraine (and Czech Republic and Poland in 2006).

In Ukraine, NPL levels rose quickly from 3.3 per cent in June 2008 to 9.6 per cent in June 2009, according to official statistics. However, banks have been rolling over non-performing loans partly because of negative tax incentives on write-downs (see section 3) and this has kept official NPL statistics relatively low. The International Monetary Fund (IMF) estimates that at the end of 2009 NPLs amounted to about 30 per cent – close to the level of Kazakhstan (Chart 2). The high level of Ukrainian NPLs can partly be explained by defaulting unhedged retail clients that were exposed to foreign currency risks after the hryvnia lost almost 40 per cent of its value against the US dollar between September 2008 and June 2009. About 60 per cent of all loans were denominated in foreign currency.

In 2010 regional NPL levels can be expected to rise further, in particular for consumer and mortgage loans, as economic recovery will likely be slow and unemployment levels will continue to rise. Against this background, Chart 5 shows peak values for a number of other countries that experienced severe financial system stress in the past. While NPLs in Kazakhstan and Ukraine are close to the levels that some countries experienced during the 1997-98 crises, a comparison of Charts 2 and 5 shows that there is still a large distance between peak values in earlier crises and current NPL levels in most transition countries. To what extent – and how fast – these countries will reach similar peak levels will not only depend on the swiftness of the economic recovery but increasingly also on the options that are available to banks to efficiently restructure non-performing loans.

**Chart 5 NPL ratios: some historical benchmarks from previous crisis episodes**



Source: Deutsche Bank, BIS.

### 3. HOW TO DEAL WITH DISTRESSED DEBT

When an economic and financial crisis leads to a sharp increase in distressed debt throughout the economy, governments can choose from three basic policy options: decentralised, semi-centralised and centralised approaches to debt restructuring.

First, in a decentralised approach the ownership and management of bad assets remains completely with the originating banks. This may be beneficial since banks usually possess relationship-specific knowledge which allows them to decide on the optimal strategy to privately restructure loans.<sup>6</sup> Governments may thus take a hands-off approach and let creditors and debtors work out the problems related to defaulting firms on a case-by-case basis, using the existing insolvency legislation and the court system. The government may also take a more activist stance. While still opting for a decentralised approach, it can facilitate a system of large-scale voluntary work-outs between banks and debtors outside of the official court system (the so-called “London approach”). This involves setting up a general framework or template that groups of creditors can use to organise voluntary out-of-court solutions when a firm defaults. Creditors cooperate in steering committees under the guidance of a lead bank to restructure defaulting firms in a coordinated fashion. The majority of the creditors need to agree on the work-out plan and implement it. When it works well, this approach may allow a relatively large proportion of firms that need financial restructuring but are fundamentally sound, to continue as a going concern. Company failures due to excessively costly, burdensome and lengthy court procedures are avoided. However, paradoxically, this approach will only work in so far that creditors can at least to some extent threaten defaulting firms with more formal liquidation procedures in case of insufficient cooperation. It is thus not a full substitute for imperfect formal insolvency procedures through the court system.

Fully decentralised approaches are only feasible as long as the amount of non-performing assets in the banking system is relatively limited. A financial crisis may, however, lead to such a widespread rise in distressed debt levels that systemic stability is threatened. This will particularly be the case if a high level of NPLs threatens to overwhelm banks’ normal work-out procedures (or its capital base). Moreover, bankruptcy cases may be so numerous that local courts cannot cope with them in a reasonable amount of time. Even if both the banks and the courts would in principle be able to handle a very large number of case-by-case foreclosures of collateral, such an uncoordinated approach may still be suboptimal for the banking system as a whole because collateral prices may be depressed further.<sup>7</sup> A case can thus be made for more centralised debt restructuring programmes if there is evidence that the scale of the problem is sufficiently large to have economy-wide implications or if there is a clear lack of capacity in the judicial system (or in the banks themselves) to deal with defaulting firms on a case-by case basis (Laeven and Laryea, 2009).

<sup>6</sup> There may also be benefits for the risk-taking culture in banks if loan officers are exposed to the consequences of bad lending decisions and/or economic downturns.

<sup>7</sup> This holds not only for the large-scale sale of houses due to mortgage defaults. In rural Mongolia, banks are hesitant to realise collateral from herders (sheep and goats) because selling these animals would quickly depress their market price, further deepening the crisis. Instead, herder loans are restructured on a large scale. In March 2009 the Bank of Mongolia introduced a measure that allows banks to restructure their loans twice, instead of once as was done previously.

A second approach the government can follow is therefore a semi-centralised one in which distressed assets of a number of banks are spun off into an equal number of private or semi-private “bad banks”. The Swedish approach in the early 1990s is an example of this. Most of the large Swedish banks set up their own “bad bank”, with suitable names like Securum, Retrieva and Diligentia. Securum, the largest of the Swedish “bad banks”, is often cited as a successful example (Macey, 1999). After it was established in 1992, this state-owned asset management corporation took over 21 per cent of the assets of Nordbanken, one of Sweden’s largest banks at the time. The transfer of assets took place at low prices and the resulting gap in Nordbanken’s balance sheet was plugged with equity injections from the Swedish government (which had previously partially owned Nordbanken). Shareholders had to accept substantial losses.

Early interventions such as Sweden’s are desirable because they prevent asset quality from deteriorating. However, “early” usually means that there is still substantial disagreement over the actual value of assets. This was not the case in Sweden because at the height of the crisis it was possible to transfer assets unusually quickly and possibly at undervalued prices. This process was also helped by the government’s ownership stake in both Securum and Nordbanken. Time-consuming conflicts between the government and the banks were thus minimised. On a more practical level, Securum benefited from the fact that Nordbanken’s bad loans were large and mostly real-estate related. Smaller retail loans would have been administratively much more difficult to deal with.

Lastly, a third approach governments can follow in the case of widespread distressed debt is to set up a highly centralised and publicly owned asset management corporation (AMC). This centralised approach was chosen by many Asian countries in the aftermath of the 1997-98 financial crisis (Schaefer and Zimmermann, 2009). The main advantage of such a centralised approach lies in its economies of scale. Centralised AMCs are better able to consolidate and securitise similar assets and therefore can translate their size into greater negotiating power against large and politically influential borrowers. The Republic of Korea is a good example because its AMC became heavily involved in the restructuring of the large Daewoo conglomerate (He, 2004). This task would have been difficult to implement with a greater number of smaller institutions. There is also a managerial argument for a centralised approach. Where loan resolution expertise is scarce it might be easier to coordinate the recruitment and training of qualified people in a single institution rather than having several agencies compete for the same small pool of people.

Overall, the centralised system was reasonably successful in Asia. In China, Indonesia, Japan, Republic of Korea, Malaysia and Thailand the state-owned asset management agencies removed “a substantial part of NPLs from their respective banking systems” (Fung et al, 2004) and then recovered between 20 and 50 per cent of these assets, a figure roughly in line with recovery rates seen in other parts of the world. In general, strong political backing, clear mandates and a supportive legal environment seem to have significant influence on the speed of the resolution and on recovery rates.

Both semi-centralised and centralised solutions – if applied transparently and accompanied by an adequate recapitalisation of the banks – can prevent banks from becoming excessively risk-averse, and improve the environment for new lending. Just ring-fencing bad assets on banks’ balance sheets may, in contrast, not be sufficient to regain investors’ confidence and banks may consequently not be able to raise new capital.

Regardless of the level of centralisation, the government can also stimulate restructuring through auxiliary policies. First, liquidity support and deposit guarantees can prevent bank runs and provide distressed banks with the time they need to address elevated levels of non-performing loans. Second, granting tax breaks for write-offs may work as a “carrot” to persuade banks to deal swiftly with non-performing loans. On a more basic level, governments should ensure that incentives are supportive of debt restructuring. The current crisis has shown that this is not necessarily the case. In various transition countries, tax systems – and regulatory measures – have provided disincentives to write-offs. This stimulated banks to keep rolling-over bad loans (so-called “ever-greening”). In Kazakhstan, for example, Articles 88 and 90 of the Tax Code impede the adequate provisioning for and writing-off of bad loans because write-offs lead to double taxation: both the creditor and the debtor must pay income tax on the amount that is written-off. Moreover, when the bank actually realises a loss for which it had provisioned, this realisation is treated as “income” and is therefore taxable. Similarly, in Ukraine, Section 12.2 of the Law on Corporate Income Tax stipulated that commercial banks cannot deduct for income tax purposes any provisions created in excess of 10 per cent of the loan portfolio.<sup>8</sup> As in Kazakhstan, this meant that banks ended up paying income tax when writing off provisioned loans.

Third, to let the process of debt restructuring work efficiently, a well-functioning insolvency and secured transactions regime is indispensable. An effective insolvency regime allows banks to recover a higher portion of their exposure to defaulting clients, leading to smaller losses given a certain level of non-performing loans. Swifter insolvency procedures ensure, for instance, that firm owners have less time to strip the firm and move assets abroad (“tunnelling”). A full discussion of insolvency regimes goes beyond the scope of this article, but the example of Kazakhstan is worth mentioning. Before the outbreak of the crisis, the insolvency legislation in Kazakhstan required the consent of all creditors to a restructuring proposal. This meant that each individual creditor was able to block a restructuring even if a majority of creditors agreed with the proposal put forward. A change in the insolvency law effective as of August 2009 removed this obstacle, making restructurings easier from a legal perspective as a majority of the creditors can “cram down” a solution on minority creditors.

<sup>8</sup> As of January 2010 this percentage was increased to 80 per cent for non-bank financial institutions and – for a one-year period only – to 100 per cent for banks.

#### 4. CONCLUSIONS

This article has provided a broad overview of the genesis of the current distressed debt problem across the transition region, its severity across countries, and some of the policy options available when a case-by-case solution to non-performing loans is not possible or suboptimal from a system-wide perspective. Which approach to choose in a specific country will depend on the severity of the distressed debt problem, the extent to which NPLs are concentrated in specific institutions, and the quality and capacity of the judiciary. So far most transition countries continue to rely on a decentralised approach of case-by-case insolvency work-outs. This will be an interesting test case for the insolvency regimes and judicial capacity of these countries. Two exceptions are Latvia and Mongolia. In Latvia, a concentration of NPLs in Parex Bank led to its nationalisation and the start of discussions between the Latvian government and the European Commission on the possible split into a “good bank” and a “bad bank”. In Mongolia, the government nationalised Zoos Bank and took over its bad assets while creating a new “good bank” called State Bank.

We argued that, as in the West, the root causes of the current debt problems in the transition region lie in a combination of abundant and cheap funding and a gradual relaxation of banks’ lending standards – in particular an excessive reliance on real estate and the expectation that real estate values would continue to rise rapidly. On top of this, banks across various countries in the transition region have suffered from losses due to customers that defaulted on unhedged foreign currency debt.

During much of 2010 and perhaps 2011, the problem of distressed debt is likely to gain in importance in various countries. This is not only the case because NPLs tend to lag behind the onset of economic downturns, but also because in some countries banks have been relatively slow in recognising that large parts of their loan portfolios may ultimately not be performing. This has led to the rolling-over of bad debts and inadequate provisioning – in some cases in response to incentives imparted by tax codes and regulatory authorities – to boost profitability in the short term and postpone the raising of additional capital. Only when banks become sufficiently clear about their loan quality – for instance by publishing the results of stress tests – and take adequate measures to increase provisioning, will they be able to gradually regain market confidence and to access commercial funding sources. Still, even then bank funding will need to be structured in a more sustainable manner – more domestic deposits and less foreign borrowing – than in the previous decade.

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