



Annex: Chapter 2

Annex 2A

Nonperforming loan resolution in Central, Eastern, and South-eastern Europe following the global financial crisis

The Central, Eastern, and Southeastern European countries (CESEE) were badly affected by the 2007–09 global financial crisis.¹ Before the crisis, when financing from euro area parent banks was plentiful and cheap, the CESEE countries experienced a credit boom funded mainly by parent banks in the European Union (EU). The rapid growth in cross-border banking and a lack of domestic savings contributed to a heavy reliance on funding supplied by parent banks to local subsidiaries and widespread currency mismatches. Lending was often provided in foreign currencies, such as euros and Swiss francs, to borrowers with incomes mostly denominated in local currencies. Rapid credit growth was accompanied by rising asset and real estate prices and mounting household and corporate debt. Country-level aspirations of reaching EU living standards outpaced the debt-shouldering capacity of borrowers.

Following the collapse of the US financial services firm Lehman Brothers in 2008, external financial markets were generally closed to EU banks, triggering a funding shock among CESEE subsidiaries that had relied on funding from parent banks to meet refinancing needs. Credit growth went into reverse, and economic growth slowed sharply, creating the conditions for a steady rise in nonperforming loan (NPL) ratios across these countries.

Policy makers and bankers were slow to respond to the rising pressures on asset quality. The prevailing attitude in the early stages of the global financial crisis was that the repayment capacity of borrowers, as well as their collateral values, would recover. Because the losses were assumed to be transient, banks did not initiate aggressive recovery efforts (such as by foreclosing on loans that had become nonperforming), in part because of weaknesses in creditor rights and the legal and insolvency framework that left banks exposed to unpredictable and time-consuming court procedures and low and uncertain recovery values. Thus instead of encouraging nonviable borrowers to make an orderly exit, banks often resorted to questionable loan restructuring practices (such as long grace periods, bullet payments, and frequent rescheduling) to circumvent the poorly functioning judicial system.

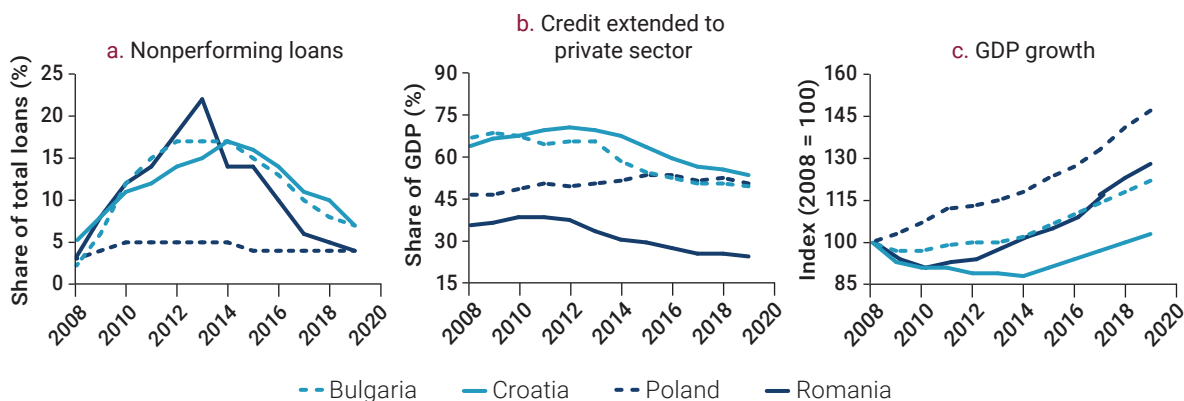
Meanwhile, banks often lacked the capital buffers and operational readiness to respond proactively to deteriorating asset quality. They feared that full acknowledgment of NPLs would reveal capital shortfalls—something difficult to replenish because parent banks were facing their own financial difficulties—and trigger regulatory intervention. Banks then frequently countered by restricting lending to strengthen their capital adequacy ratios, thereby disrupting the credit supply and exacerbating the economic downturn. Over time, the growth in NPLs became a serious test of people, systems, and procedures, and banks were unprepared because they lacked dedicated workout units and the workforce skills needed to respond effectively.

¹This annex is adapted from World Bank (2020).

The delay in the initial policy response allowed the problems to fester. Rising NPL volumes set off a persistent negative feedback loop between lackluster financial sector performance and weakening economies (figures 2A.1, 2A.2, 2A.3). This experience is a cautionary tale for the post-COVID-19 (coronavirus) era. Within a context of bank-dominated financial sectors, a large stock of unresolved NPLs can erode bank capital and lending capacity, which compromises access to finance for new and dynamic sectors, reduces the availability of fresh credit, drives up the cost of finance, and weakens economic growth.

Gradually and with various degrees of success and ambition, the CESEE governments strengthened their regulatory and supervisory frameworks to identify NPLs, built bank capacity to work out large volumes of problem debt, and established a legal and tax environment that was more supportive of NPL resolution. Eventually, these measures, an improving economic outlook in the EU, and an acceleration in credit growth contributed to a gradual reduction in reported NPL ratios and to a strengthening of economic growth across these countries. With the notable exception of Ukraine, reported NPL ratios in the region were in single digits at the onset of the pandemic.²

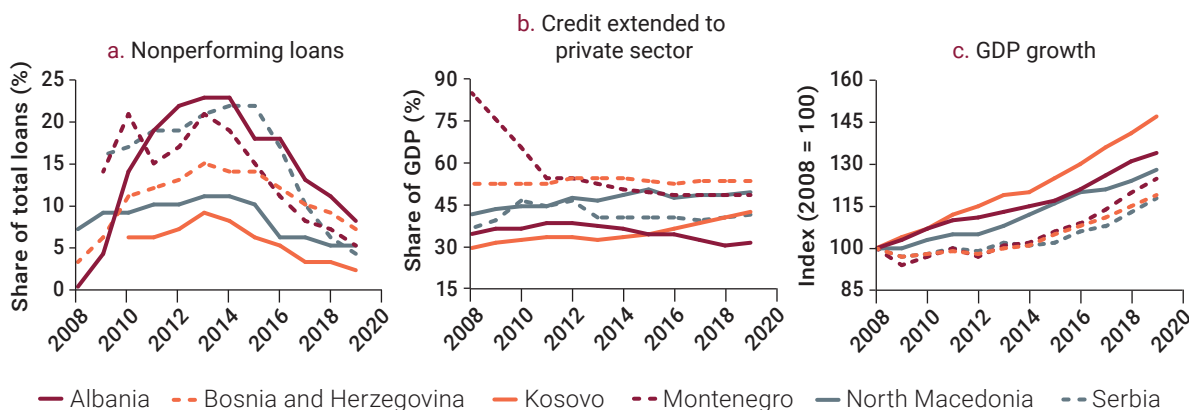
Figure 2A.1 Nonperforming loans and economic growth in EU member states, 2008–19



Source: World Bank, World Development Indicators (database), <https://databank.worldbank.org/source/world-development-indicators>.

Note: EU = European Union; GDP = gross domestic product.

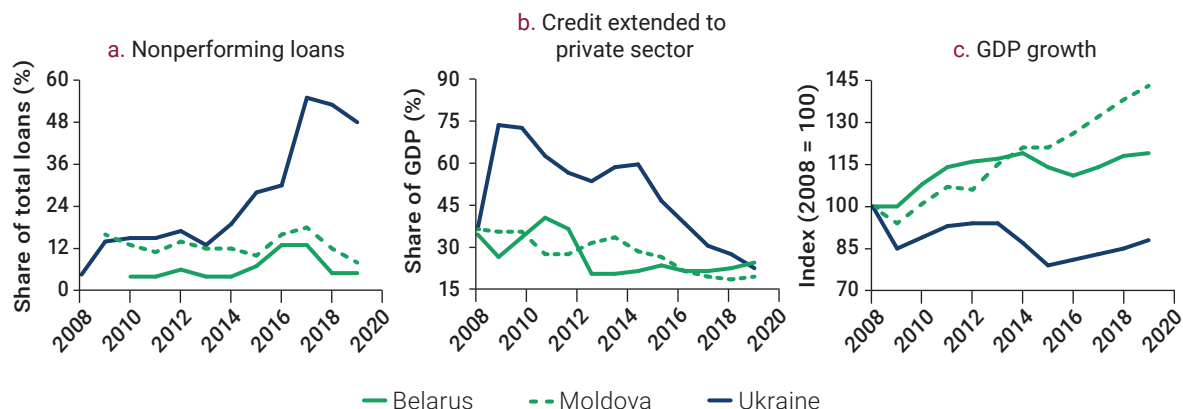
Figure 2A.2 Nonperforming loans and economic growth in the Western Balkans, 2008–19



Source: World Bank, World Development Indicators (database), <https://databank.worldbank.org/source/world-development-indicators>.

Note: GDP = gross domestic product.

Figure 2A.3 Nonperforming loans and economic growth in Eastern Europe, 2008–19



Source: World Bank, World Development Indicators (database), <https://databank.worldbank.org/source/world-development-indicators>.

Note: GDP = gross domestic product.

Notes

1. CESEE countries are Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, the Russian Federation, Serbia, the Slovak Republic, Slovenia, Turkey, and Ukraine.
2. Ukraine experienced a severe banking crisis between 2014 and 2016, when the licenses of more than half of

the country's 180 banks were revoked. The effects of a cumulative 16 percent real decline in the gross domestic product (GDP) in 2014–15, geopolitical tensions, and downward pressure on the national currency continued to drive up the NPL ratio, which stood at 48 percent of gross loans by the end of 2019 (NBU 2020).

References

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- World Bank. 2020. "COVID-19 and Non-performing Loan Resolution in the Europe and Central Asia Region:

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