

National Bank of the
Republic of Macedonia



Government of the
Republic of Macedonia



NON-PERFORMING LOAN RESOLUTION AND MANAGEMENT STRATEGY

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I. INTRODUCTION

This strategy is a paper aimed to contribute to improving the non-performing loan management¹ by banks. The ultimate objective of this paper is to identify and undertake actions and measures to improve the process of collection of these claims, and in particular to strengthen the legal and regulatory environment in order to promote business practices in the trade in claims.

For the banks, the level and dynamics of non-performing loans is facing direct consequences of any credit risk materialization, especially growth of accounting losses recognized for impairment of the loan portfolio. This tends to increase pressures on profitability and, accordingly, on the capital position of banks. The adverse effects of non-performing loans carry not only potential micro-prudential challenges, but also imply serious macro-prudential backdrops. Namely, non-performing loan issues drive banks away from credit markets, thus limiting investments and consumption, and accordingly, the growth in GDP. This can actually cause a negative feedback, i.e. additional limitation on loan supply due to the mutual causality. International analyses² indicate that the maintenance of non-performing loans in the banks' balance sheets and the long resolution process lead to debt overhang and inability to reduce leverage. This additionally restricts private sector investment incentives, tends to decrease credit demand and weaken debt repayment, all of which creates a new pressure on banks' profitability, their ability to reduce non-performing assets and ultimately, loan supply.

To maintain a sound banking system, but also to enable sustainable credit growth with all the consequent effects on the dynamics of total economic growth, it is crucial to urge activities and efforts to reduce the volume of non-performing loans, including systemic activities that tend to improve the overall non-performing loan management environment. Due to the nature of the factors that influence the dynamics of non-performing loans, as well as due to the connection of the measures and activities aimed to improve management and timely resolution of non-performing loans, the implementation of this strategy requires interdepartmental coordination and cooperation. The international experience says that when developing national non-performing claims management strategies, the proposed measures and activities should be focused on three key elements: (1) enhanced and more efficient bank supervision; (2) reforms in the legal system (bankruptcy proceedings, enforced collection system, pledge establishment and execution regulations, tax regulations, banking regulations, contract law, etc.) providing conditions for creating and developing a non-performing claim market. Notwithstanding, the implementation of any measures or activities for improving the non-performing claim management and reducing their volume in the banks' balance sheets requires the pursuit of sound economic policies that will continuously maintain the general macroeconomic

¹ In the banking regulation, a non-performing loan denotes a loan with outstanding claims longer than a specified period of time (90 days) after maturity.

² For more details, see the IMF Staff Discussion Note from September 2015, available on the IMF website.

equilibrium and ensure a stable environment for the economic agents. In addition, non-performing loans are a consequence of the banks' business behavior, i.e. (un)wise investment decisions by their management. Hence, strategies would not give long-term effects if the banks themselves do not become aware of the need to improve their operations and increase their internal capacity, especially in terms of credit risk management and corporate governance.

Furthermore, the strategy provides an overview of the key factors that influence the dynamics of non-performing loans, as well as the limitation on the non-performing loan management or their long persistence, a brief description of the non-performing loan balance in the domestic banking system and overview of the current legal solutions to facilitate the procedure for establishing and executing a pledge, enforced collection of due claims, introduction of an electronic communication with the competent institutions and the appropriate interventions in the NBRM bylaws. In conclusion, the strategy recommends measures and activities that would contribute to qualitative improvement of the non-performing loan management process.

II. FACTORS AFFECTING THE EMERGENCE AND THE DYNAMICS OF NON-PERFORMING LOANS

The emergence and dynamics of non-performing loans as well as their management depend on a number of factors and circumstances whose impact is complex and multidimensional. Such factors can be grouped into five general categories:

1) Economic factors. These macroeconomic and/or microeconomic factors as such cannot reduce the level of non-performing loans, but are necessary for the successful implementation of activities to reduce non-performing loans. Unstable macroeconomic environment or negative expectations of economic agents can be a significant obstacle for restructuring the non-performing loan portfolios, but also for the credit growth as an important factor for reducing the relative size of non-performing loans. In this light, a sustainable economic growth, stable and predictable inflation, profitable corporate sector, higher disposable income, conducive real estate market movements, conducive labor market movements, sustainable external equilibrium of the economy etc., is a requirement. In addition, this group also includes factors related to the quality of corporate governance, the level of competitiveness and innovation of domestic companies and the R&D perspectives.

2) Factors related to the legal system enforceability and efficiency. An effective legal system, that is observing the rule of law, is an extremely important factor that affects the business environment and the size of resources required by economic

agents for legal protection, dispute resolution and/or implementation of decisions³. Namely, an efficient legal and judicial systems ensure efficient implementation of contracts, which is an essential prerequisite for the existence and development of domestic credit market, and accordingly, domestic financial system, which directly contributes to sustainable economic growth. Almost all the elements that form the legal system of a country can have a direct or indirect impact on the quality of the non-performing loan management by banks. However, there is a special emphasis on the efficiency of the judicial system (such as a flexible regulatory framework for bankruptcy and bankruptcy proceedings, pledge establishment and execution, rationalization of procedures, appropriate execution costs), effective out-of-court mechanisms for restructuring a non-performing client, harmonized and quality civil legislation, especially on contracts. The various legal forms of transfer of non-performing claims (sale, yield of claim, factoring, etc.) as such, embedded in the contract law regulations, are one of the basic mechanisms used by banks to "resolve" such claims and remove from their balance sheets on a commercial basis.

3) Factors related to the the bank operation and supervision. This group of factors mainly includes different regulatory rules for banks, primarily in relation to the risk management process, in particular credit risk, accounting policies, compliance with disclosure requirements, collateral valuation techniques, claim restructuring treatment, need to comply with borrowers' protection regulations, bank secrecy or data protection in cases of transfer of claims to third parties etc. The quality of the supervisory process plays a special role in this group of factors, because quality and independent supervision is an important factor for the timely and objective identification, recognition and adequate provision of non-performing loans.

4) Factors related to the non-performing claim market development and operation. This group includes all factors that directly or indirectly limit the development and operations of the secondary claims market, primarily non-performing loans. Such restrictions generally affect the level of transaction costs required to conclude a transaction or the costs necessary to obtain information relevant to decision-making, which limits the market turnover and liquidity. They can also limit the market operation if for example, there is no market pricing mechanism or appropriate reference rate considered a risk-free yield rate.

Regarding the non-performing bank claim market, market frictions mostly relate to the banks' reluctance to sell non-performing claims at an open market price, as they will face losses from the credit decisions made in the past. In other words, there are significant differences in the expectations of the banks as sellers and of the potential

³ For more details about the significance of the legal system for the business environment and the preconditions created by an effective and effective legal system for sustainable economic growth, see the World Bank's Doing Business for 2015 and 2016. For illustration, in the enforcing contracts section of the 2016 report, a quality index for judicial process has been constructed for the first time, which clearly demonstrates a positive correlation between the level of this index and the level of development of countries expressed through per capita income. The analysis concludes that a better quality of the judicial system a country has and better court practices it applies the more it can count on faster and less expensive contract enforcing.

buyers (investors) regarding the market value of the non-performing assets. This creates so-called pricing gap between banks and potential investors.

The non-performing loan management and the possibility of concluding transactions in these loans largely depends on the legal framework that concerns contracts⁴, as a common source of legal bases for transactions in claims, including non-performing loans.

In the context of the sale of claims and in general the implementation of the credit process, special attention is paid to the assessment regulations. It is extremely important that banks have collateral valuation policies in place, taking into account the differences in the types of properties accepted as collateral. In addition, it is necessary to have a control mechanism in place and capacity for independent assessment, as well to revise the methodologies used by certified appraisers, especially in order to comply with the international and European assessment standards. The European Central Bank⁵ recommends that the assets value assessments (including real estate) are not based exclusively on the replacement cost method (as is the case of the Republic of Macedonia), but as wider use of discounted cash-flow approach and market comparable approach as possible.

A good legal framework for establishing and operating specialized investment funds is a prerequisite for the encouragement of market participants willing to buy non-performing claims, primarily due to the fact that they are not legal entities, which brings tax benefits. There may be a certain form of market friction due to unclear regulations concerning the issuance of securities or non-compliance of such regulations with the trade legislation.

A closely related issue in this context is also the transparent tax treatment of the trade in claims, i.e. the need to define (non)taxation of trade in claims in a concise and unequivocal manner, regardless of the entities engaged in the trade. This would avoid various interpretations between taxpayers (banks, but also other stakeholders) about the tax consequences of the transactions in claims, which may be a potential obstacle to concluding such transactions.

5) Factors related to the banks' internal capacity for non-performing loan management⁶. These factors relate not only to the non-performing loan management process but broader to the other phases of the life cycle of exposures, before they become non-performing. Hence, this group of factors indirectly shows the quality of

⁴ In our legal system, this is the Law on Obligations that does not limit any transfer or sale of claims, including non-performing bank loans, and according to previous experiences, this law is not an obstacle to concluding such transactions. A non-performing claim can be transferred to a third party, without requiring a borrower's consent. By concluding the agreement (claim transfer or sale agreement) between the bank as the original creditor and the third party - the buyer, the bank's claim, including any subsequent collateral rights (the right of priority payment, mortgage, pledge, interest rights, contractual penalty, etc.) are transferred to the buyer.

⁵ See item 7.4. of the Draft Guidance to banks on non-performing loans, ECB September 2016.

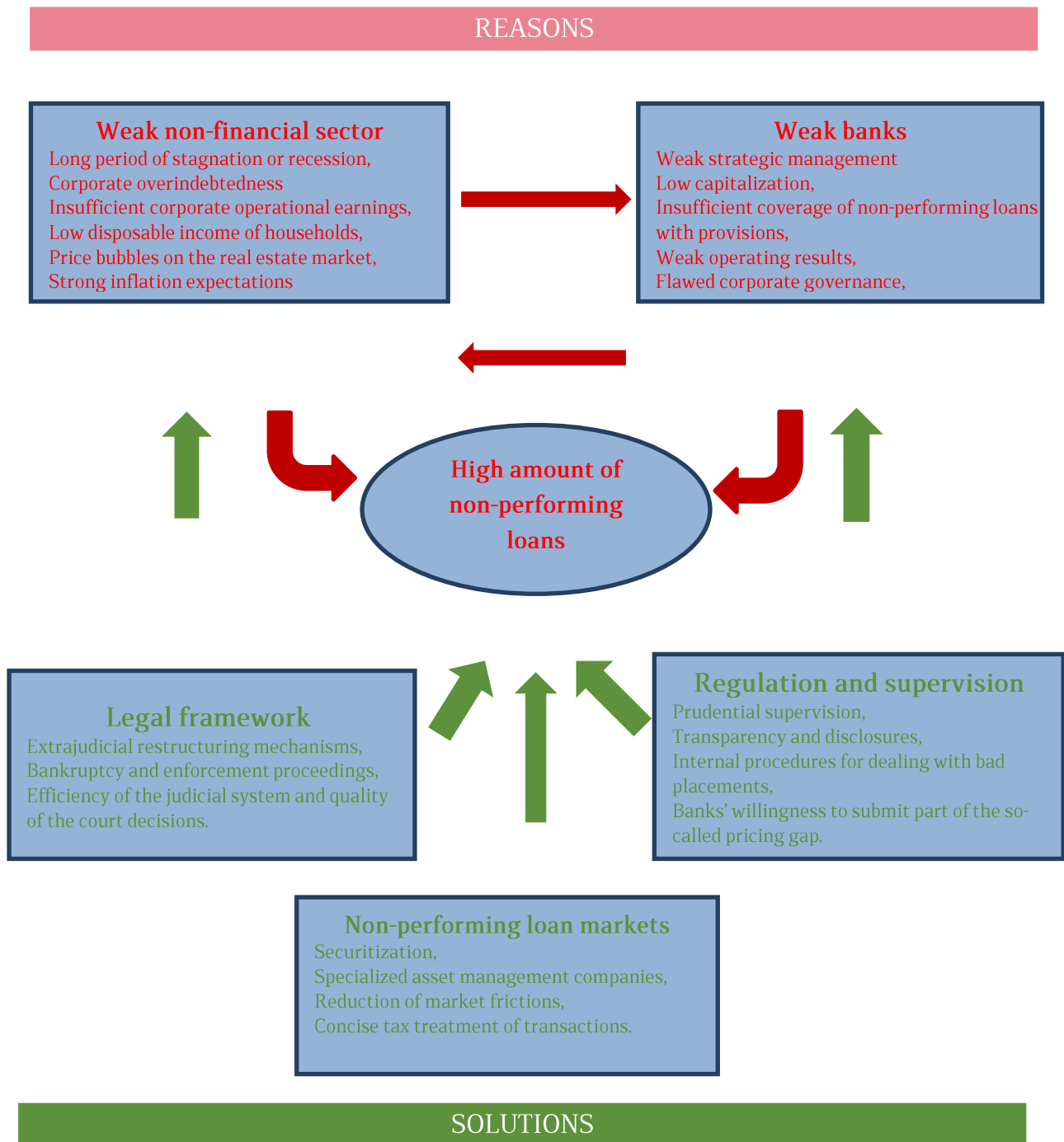
⁶ For more information about the non-performing bank loans processes, see *Draft guidance to banks on non-performing loans*, European Central Bank, September 2016.

bank corporate governance, which ultimately comes down to whether and to what extent the bank management makes economic profit⁷ from the bank's operations. Given the fact that non-performing loans are in fact a "product" of the quality of the overall credit process, a well-conceived credit policy of the bank, as well as well-established standards for credit analysis of the clients, is of particular importance. Credit analysis usually focuses on assessing the client's creditworthiness, the quality and value of collateral, deciding on the application of the so-called safeguard clauses and client's background regarding the settlement of liabilities. An analysis of the ability of the corporate client management to implement its plans is particularly important in assessing the client's nature and is the starting point for assessing the bank's exposure to the risk of unethical behavior of the client, which can also be an important determinant of the movement of non-performing loans. An important factor within this group can also be the need for a bank-wide strategy for non-performing exposure and/or client management. The strategy would set strategic objectives for reducing non-performing loans within a reasonable timeframe, improve the early-warning system, establish prompt identification and coverage with provisions, and develop operational plans for achieving strategically set objectives. Of course, the quality performance of the supervisory function is extremely important, as a key precondition for preventing and/or reducing the moral hazard and increasing the responsibility of the banks' governing structures for the decisions taken.

The interdependence and intertwining of these factors in a coherent whole of causes of non-performing loans and possible solutions could be schematically shown as follows⁸:

⁷ Economic profit is a different concept of the accounting profit and takes into account the opportunity costs of the bank shareholders. For a bank to create value for its shareholders, its accounting profit should be at least identical to the rate of return required by the shareholders.

⁸ Adjusted according to *A Strategy for Resolving Europe's Problem Loans*, IMF Staff Discussion note, September 2015.



III. NON-PERFORMING LOANS IN THE BANKING SYSTEM OF THE REPUBLIC OF MACEDONIA

The increased non-performing loans in banks' balance sheets is one of the important challenges faced by most European countries in the post crisis period and especially after the emergence of debt problems of some euro area countries. This problem was

more pronounced in the countries of Central, Eastern and Southeast Europe, where non-performing loans significantly increased in the post crisis period⁹. The recessions that these countries faced as a consequence of the global financial crisis and the public finance crisis of some euro area countries and the consequences of these unfavorable macroeconomic developments on the ability of the real sector to repay their debts were a crucial drivers of growth of the non-performing loans. Also, the high and unsustainable credit growth in most countries before the crisis had an impact on the growth of non-performing loans. In some countries, the growth of non-performing loans was triggered by the depreciation of their domestic currencies against the euro or the Swiss franc, which amid significant lending with currency component materialized the indirect credit risk. In addition, the banks' ability to resolve non-performing loans and the development of local markets for trade in claims are important factors that can cause significant differences in scope, growth and persistence of non-performing loans in some countries. There are other disparities among countries, such as in defining non-performing loans, available mechanisms for their resolution, in the legal system, tax treatment of transactions in non-performing loans, etc. Such disparities, to a certain extent, hamper the essential comparison among countries of the way their institutions resolve non-performing loans, as well as from the aspect of using a uniform "recipe" to tackle the volume of non-performing loans. This means that the steps needed to increase the non-performing loan resolution capacity either of the banking systems as a whole, or of individual banks, are specific for each country.

In the period 2008-2014, the share of non-performing loans in the banking system of the Republic of Macedonia grew slower compared to other countries in Central Eastern or Southeastern Europe¹⁰. An important factor was that the credit growth in the Republic of Macedonia in the period before the global crisis was double-digit only in a relatively short period and far smaller compared to other countries. This, together with the relatively good coverage of non-performing loans with impairment, were the main reasons why the global financial crisis and the resulting economic slowdown was not a concern for the Macedonian banks compared to some other countries¹¹. The reasons behind the slower growth of non-performing loans, unlike in most countries of the immediate surrounding, are given below:

- banks' act more conservatively in the credit market, partly because of the stricter supervisory standards for recognition and derecognition of non-performing bank loans in the period 2008-2013¹², but also due to the more

⁹ For more details, see *A Strategy for Resolving Europe's Problem Loans* (IMF Staff Discussion Note) from September 2015, available on the IMF website.

¹⁰ The country-by-country comparison of the non-performing loans to total loans ratio is available in *A Strategy for Resolving Europe's Problem Loans* (IMF Staff Discussion Note), available on the IMF website.

¹¹ In the Republic of Macedonia, the share of non-performing loans at the end of 2008 was 6.8% (11.4% at the end of 2014). Precisely one-half of the increase in the share of non-performing loans in total loans occurred in 2009 as the initial effect of the global economic crisis. For illustration, in some neighboring countries, the share of non-performing loans in total loans at the end of 2014 was over 30% in Greece, over 20% in Albania and Serbia and around 17% in Bulgaria. In every country mentioned above, the increase in this share is measured in times, compared to 2008. Source: *A Strategy for Resolving Europe's Problem Loans* (IMF Staff Discussion Note) from September 2015, available on the IMF website.

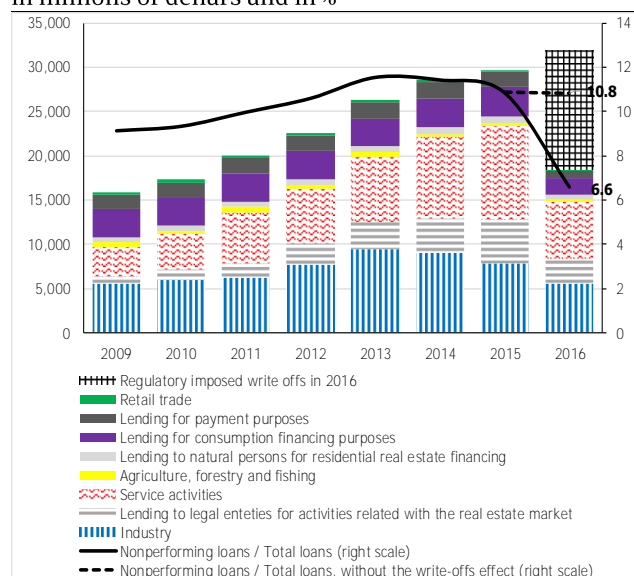
¹² Until December 2013, the Decision on credit risk management was into effect (Official Gazette of the Republic of Macedonia No. 17/08, 31/09, 91/11 and 127/12), whose provisions were more stringent in terms of abandonment of the

stringent regulatory requirements for provisioning the performing loan portfolio,

- banks are cautious in the accounting recognition of the credit risk losses,
- relatively favorable macroeconomic developments in this period,
- minimum utilization of low-cost sources of financing from foreign parent entities in Swiss francs and, consequently, almost no lending (in particular to households) in Swiss francs,
- pronounced banks preferences to hold liquid financial assets,
- improved labor market indicators that enhanced the household creditworthiness.

Additional factor contributing to the lower level of non-performing loans in the banking system of the Republic of Macedonia, compared to other Southeast European countries, is the efficiency of the enforcement procedure after the implementation of the system reform of 2005¹³. Thus, part of the increase in non-performing loans in the banking system of the Republic of Macedonia was actually absorbed through the increase in the amount of foreclosed assets by banks. In the period after 2013, the foreclosure by banks was slightly lower, mainly due to changes in the regulatory treatment of such assets. Namely, in 2013, a requirement was introduced for compulsory impairment of 20% p.a. of the estimated value of the foreclosed

Chart 1
Amount and structure of non-performing bank loans to non-financial entities in millions of denars and in %



Source: NBRM, based on data submitted by banks to the Credit Registry.

non-performing status, compared to the period after December 2013. Namely, the classification by the level of credit risk previously was made for client instead of credit agreement as it was after 2013; to leave the non-performing status, a client was required to settle all past due exposures to the bank. Hence, after 2014, the amendments to the credit risk management regulations that required the classification to be made by credit agreement, rather than by client, and consequently, the application of this system to exposures leaving the non-performing status, can contribute to slower growth and lower total volume of non-performing loans in the Republic of Macedonia, compared with the countries that retained or have in the meantime established a system for classifying exposures by client (such as the case of the EU member states).

¹³ The main target of this reform was to move the enforcement proceedings from courts to professional enforcement agents. More precisely, legal grounds were set for the enforcement agents to take all necessary enforcement actions for successful and quick execution of the right established by the enforcement title, to carry out the enforcement process independently and autonomously, but also to charge for their costs.

assets and ban on recognizing the released impairment of a "collected" claim as income (but as a revaluation reserve). In this way, the National Bank encouraged the process of prompt sale of the assets foreclosed by the banks.

However, the level of non-performing loans in the Republic of Macedonia is persistent. The long period of retention of non-performing loans in the banks' balance sheets is a signal that there is room for improvement, both in the non-performing claim management process and in general, in the credit risk, as well as in the general environment in which the banks as creditors exercise their rights, mainly by avoiding solutions that have proven to be ineffective, inefficient, imprecise or obsolete. Hence, noticing the banks' lack of initiative regarding the non-performing loan management, the National Bank passed a regulation¹⁴ introducing a mandatory accounting write-off of those non-performing bank claims that have been completely covered with impairment for more than two years (accounting write-off). This measure started to apply on 1 January 2016 and as a result, about 42% of the non-performing loans were removed from the banks' balance sheets by the end of 2016. As a result, at the end of 2016, the share of non-performing loans to total loans considerably decreased (6.6%, vs. 10.8%, excluding the effect of written-off claims)¹⁵. This also confirmed the National Bank's findings for the non-performing bank loan persistence (high self-persistence of these loans)¹⁶. This measure can be partially supported by the fact that the accounting treatment of fully provisioned loans (especially for exposures not backed by collateral or where the collateral is not eligible in terms of value and/or other features) in the domestic banks shows significant differences, compared to banks from more developed countries, which make a full provision and/or deregistration from the balance sheet in a relatively short period of time. Hence, the implementation of this measure also improved the comparability of the share of non-performing loans to total credits of the Macedonian banking system with the same indicator for other countries. Such a mandatory write-off does not mean a substantial reduction in the volume of non-performing loans (in terms of resolving operational or financial problems of the debtor), nor improvement in the banks' credit risk management process, but improves the quality indicators of the banks' loan portfolio.

In the period before the global financial crisis, until 2010, there was a strong correlation between the change in non-performing loans and the real economic growth, while in

¹⁴ Decision amending the Decision on credit risk management, Official Gazette of the Republic of Macedonia No. 223/15.

¹⁵ Analyzed by sector, at the end of 2016, the share of non-performing loans in total loans to non-financial entities was 9.9% (15.6%, excluding the effect of mandatory write-offs), and 2.6%, for households (4.9%, excluding the effect of write-offs).

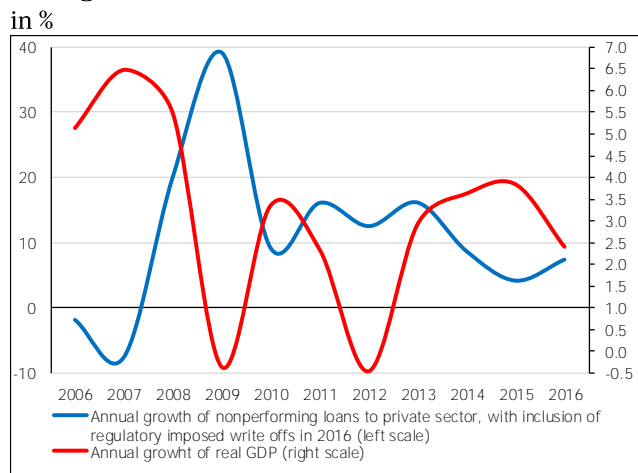
¹⁶ One of them is the fact that in more than half of the non-performing loans (as of June 2014), the initial contractual maturity date of loans expired, indicating that these were loans approved in the past and after maturity, although not collected, were kept in the balance sheets for a long time. For more details on these indicators as well as on the structural features of non-performing bank loans, see Vaskov, *Concentration and Structural Features of the Non-Performing Loans in the Banking System of the Republic of Macedonia*, available on the NBRM website http://www.nbrm.mk/ns-newsarticle-nivo_na_kontsientratsija_i_strukturni_karakteristiki_na_niefunkcionalnitie_kriediti_vo_bankarskiot_sistiem_na_riepublika_makedonija.nspix.

the period from 2011 to 2014, this correlation weakened¹⁷. This points to the important role of idiosyncratic factors in the credit risk materialization, at the expense of the influence of factors for economic activity in determining the scope and movement of non-performing loans. However, given its importance for the total credit growth, the real GDP growth is the main macroeconomic variable for the movement of the share of non-performing loans to total loans¹⁸.

The sectoral distribution of non-performing loans shows prevalence of such loans to the corporate clients, whose share is growing. Thus, at the end of 2009, their share in the total non-performing loans was about 65%, and at the end of 2016, it reached 82.13%. Most of the non-performing loans to the corporate sector were loans granted to utilities, followed by loans granted to companies in the industry. Considering the specifics of corporate lending, it is expected that the subjective factors will have greater significance when lending to the corporate sector. This primarily reflects the differences in the approach of banks in assessing the creditworthiness criteria for clients, the differences in assessments of a project or activity that the bank finances and the differences in the credit risk taking/aversion that banks have incorporated in their credit policies. Hence, usually idiosyncratic factors play a greater role and importance for the movement of non-performing loans and their share in total loans for the corporate sector. A particularly important factor related to the companies' operation is the quality of their (corporate) governance and their ownership structure. This factor comes to the fore when non-performing loans occur as a consequence of voluntary decisions of the borrower or sometimes, unethical behavior of the management or the owners of a corporate client. Such events are often beyond prediction or control, and in essence jeopardize the premise of the assumption that the business entity will continue to

Chart 2

Non-performing loan growth rate and real GDP growth



Source: NBRM, based on data submitted by banks to the Credit Registry and the State Statistical Office.

¹⁷ For illustration, the coefficient of correlation between the rate of GDP growth and the rate of growth of non-performing loans calculated using an annual series of data for the period 2006-2016 was -0.66, while for the period 2011-2016, it was -0.38, which indicates a weakening of the correlation between the dynamics of non-performing bank loans and GDP. It should be emphasized that the correlation by itself does not imply causality between these two variables, and its determination implies implementation of more complex analyses that are beyond the scope of this paper.

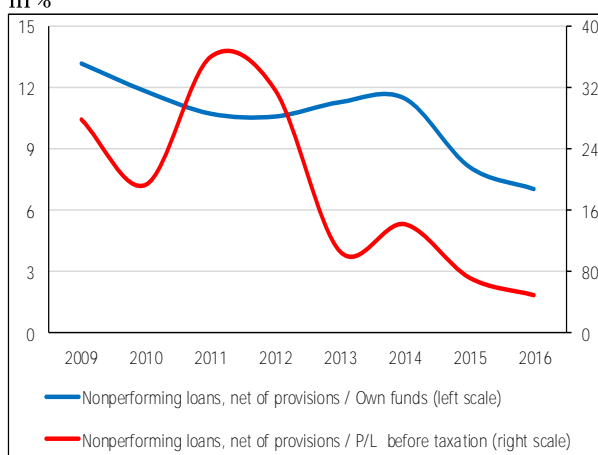
¹⁸ The National Bank carried out internal analyses to identify determinants of the share of non-performing loans to total loans for both the corporate sector and the households. For more details, see Vaskov (2017), *Macroeconomic and Bank-Specific Determinants of Non-performing Loans in the Macedonian Banking System - Panel Data Analysis*, an analysis whose publication is underway.

operate as a going concern, which relies on the system of modern financial reporting and the preparation of financial statements¹⁹.

On the other hand, the criteria for assessing the creditworthiness of natural persons are more precisely defined in the banks' acts (e.g. precisely defined indices of the level of indebtedness). Approval of loans to clients-natural persons who do not meet the set standards²⁰ is rather an exception than a rule, which in turn requires a clearly defined procedure for decision-making, registering and monitoring loans. In addition, lending to households is characterized by lower amounts and higher dispersion of loans and is generally a "younger" loan portfolio, compared to the corporate portfolio. For illustration, some corporate non-performing loans originate from the early transition years, while lending to households started after 2005, especially in the period of faster credit growth (2006-2008). Hence, in the household lending, the significance of idiosyncratic factors in assessing the creditworthiness and the movement of non-performing loans is slightly weaker, thus the migration of such loans from regular to non-performing seems to be more influenced by the general economic movements, and particularly the labor market situation and movements. Thus, the reduction in unemployment rate and the growth of disposable income of the households are extremely important factors for the absence of greater materialization of the credit risk in the households and growth of non-performing loans. Accordingly, in the period 2009-2015, the share of non-performing loans to households in total non-performing bank loans decreased from 35% to 20%, and at the end of 2016, after the mandatory write-offs, it was 17.9%. Also, the share of non-performing loans to households in total household loans is low (at the end of 2016, it was 2.6% after the write-offs, while in 2009 it was around 8%). More than half of these non-performing loans are consumer loans, and about a quarter are loans approved for payment purposes²¹.

The existing volume of non-performing bank loans is not a significant risk to the stability of the banking system, because of the relatively high coverage with impairment. As of the first half of 2014, more than half of the non-performing loans were fully covered with impairment, while the share of loans covered below 50% of their gross amount with impairment was 14.7%. At the end of 2016, this share was relatively identical, with 48% of non-performing loans being fully covered with impairment, which can potentially be written-off in the future, as required by law. On the other hand, the

Chart 3
Non-performing loan indicators
in %



Source: NBRM, based on the data submitted by banks.

¹⁹ For more details about this assumption, see the framework of international financial reporting standards.

²⁰ The most common example is the loan repayment to natural person's income ratio.

²¹ Overdrafts of natural persons are also considered loans for payment purposes.

share of non-performing loans covered below 50% with impairment was around 13.9%, which shows that the banks did not make significant changes in the way they assess the potential collections of non-performing loans at the end of 2016. The share of non-performing loans not covered with impairment in banks' own funds has been steadily decreasing in the period after the global economic crisis. At the end of 2016, the amount of non-performing loans not covered with impairment accounted for 7.1% of own funds. Any full coverage with impairment would mean absorbing about half of the amount of profit after taxation in 2016, and the effect on capital adequacy would be insignificant.

After the global crisis and its consequences on the banking systems, the standards for non-performing loans were strengthened in the EU. Due to the differences in the default and consequently, in the non-performing loan definitions, between the domestic regulatory framework and the definitions that have been applied in the European Union²² since 2014, the amount of non-performing loans with domestic banks could increase, once these new standards apply. The main difference in these definitions that can increase the volume of non-performing loans with domestic banks is the definition of obligor level. Practically, this means that if a client receives a non-performing status with a materially significant part of his/her debt to a bank, all bank's balance sheet and/or off-balance sheet exposures to that client should also receive a non-performing status. The stringent requirements for an exposure no longer to be considered a non-performing are also factors that can increase the amount of non-performing loans or limit their downsizing. Namely, a non-performing client can again become "performing" when it fulfills its due liabilities on exposures to the bank, but also if it continues to regularly settle its liabilities for a period of at least three months²³. The differences are even more pronounced in the definitions of a non-performing claim that has been restructured, because in such a case it can not "leave" the non-performing status for a period of at least one year.

IV. OVERVIEW OF THE NON-PERFORMING LOAN RESOLUTION ACTIVITIES

Legislation

In recent years, several regulations have been adopted, which although not adopted primarily for this reason, still containing provisions that facilitate prompt or efficient non-performing loan resolution. They include:

- **Law on Enforcement**, which, among other things, has contributed to more efficient exercise of the rights of banks as major creditors, but also of the citizens and other legal entities and all participants in the procedure before an enforcement agent, by upgrading the system for prompt and efficient

²² Regulation No. 575/2013, Article 178 and the European Banking Authority titled Final Report: Guidelines on the Application of the Definition of Default under Article 178 of Regulation No 575/2013, released on 28 September 2016 and Final Draft Implementing Technical Standards: On Supervisory Reporting on Forbearance and Non-performing Exposures under Article 99(4) of Regulation (EU) No. 575/2013, released on 24 July 2014.

²³ This solution is similar to the requirements for classification of balance sheet and off-balance sheet asset items in force until 2008, that allowed for the client's loans to be excluded from non-performing loan category only if all due claims on those loans are collected.

implementation of the enforcement procedure and exercise of their rights as creditors.

To speed up the enforcement procedure and reduce the procedure costs, a project is underway for establishing electronic exchange of documentation between the enforcement agents and the banks (i.e. the National Bank) through the KIBS system;

- **Law on Contractual Pledge**, which sets forth the manner, the terms and the procedure for establishing, existence, exercise and termination of the contractual pledge right on movables, securities, claims and other rights (movable pledge) and on real estate (mortgage);
- **Law on the Notarial Practice**, which established a special institution - a notary practice as an autonomous, independent public service that performs activities such as public authorizations based on law, at the request of citizens, government authorities, legal entities and other stakeholders. Using notary public services, banks increased the efficiency in the establishment and exercise of their pledge right;
- **Law on Financial Discipline**, which lays down the timely fulfillment of monetary liabilities arising from the implementation of business/commercial contracts/transactions, which although not pertaining to the banks' credit operations, can still affect the liquidity of the corporate sector, and hence indirectly, the quality of the banks' credit portfolios.

From the aspect of other systemic solutions that have contributed to accelerating the procedures for exercising the pledge right, but also the sale of foreclosed assets, and hence the non-performing bank claim resolution process, we should emphasize the reform of the one-stop shop system, as well as the gradual introduction of electronic systems as a way of communication between the competent institutions, which significantly reduced the procedures and deadlines for their solution. Another activity that is of particular importance is the promotion of the cadastre and the establishment of a Registry of Prices and Leases (for concluded transactions in real estate) within the Agency for Real Estate Cadastre. Of particular importance for the banks will be the completion of the long-term project of the Agency for Real Estate Cadastre for the establishment of a system for mass valuation of the real estate value in the Republic of Macedonia. Banks would benefit not only when approving new loans with clients offering property as collateral, but also when deciding on forced collection of a claim on the basis of foreclosure.

Bylaws

Particular contribution to the establishment of an efficient non-performing loan resolution framework was made by the bylaws that rest with the National Bank. Thus, the amendments to the **Decision on the accounting and regulatory treatment of**

foreclosed assets (Official Gazette of the Republic of Macedonia" No. 50/13) of March 2013 enabled a more realistic presentation of the value of foreclosed assets in the banks' balance sheets and creating a greater incentive for the banks for their faster sale. It also helped avoiding the cyclical changes in the income statement and recognizing revenue when foreclosing assets and, consequently, recognizing gains or dividend payments. The new **Decision on credit risk management** (Official Gazette of the Republic of Macedonia No. 50/13, 157/13 and 223/15), which started to apply from 1 December 2013, prescribed several solutions that changed the definition of a non-performing claim, the treatment of collateral that can be taken into account when determining the impairment/special reserve, changes in the classification of credit exposures on an individual and group basis and changes to the limits of impairment/special reserve for each risk category. The amendments to this decision made at the end of 2015, allowed banks to write off, i.e. to transfer to the off-balance sheets, any credit exposures that have been fully booked (100% impairment) for at least two years, with the possibility for their collection.

Other activities

In October 2016, the National Bank of the Republic of Macedonia drafted a Questionnaire on the activities of banks for managing non-performing claims, aimed to summarize banks' views on causes and any regulatory/legal obstacles or disadvantages that influence the decision making of resolving non-performing loan exposures, as well as the reasons for the slow resolution of these exposures. The questionnaire consisted of several segments of the non-performing loan management process and the regulation that has an immediate impact on this process. The responses received from banks are taken into account when designing the measures and activities that are proposed to improve the non-performing loan management.

V. ACTIVITIES AND MEASURES TO IMPROVE NON-PERFORMING LOAN MANAGEMENT

The non-performing loan management would not be possible without macroeconomic stability and sound policies that underlie stable and predictable overall work environment for the banks and other economic agents. In addition to the macroeconomic preconditions, the corporate performance, the quality of corporate governance and the manner in which the banks assess their clients' creditworthiness are of particular importance. Therefore, any reform of the legal or tax system, or of the wider regulatory framework, would not as such lead to positive results in the non-performing loan resolution, if there are weaknesses in the credit process and inadequate risk management by banks and, also if those weaknesses are not timely and effectively detected by the competent supervisory authority. The harmonization of general legal and regulatory framework, legal system functionality, clear tax regulation and the level of development and functionality of market segments are areas that can improve non-performing loan management. Yet, they cannot be a substitute for the quality governance and operation and the increase in the capacity of financial institutions as well as the corporate debtors.

Hence, legal security and trust in the legal system are particularly important, and come to the fore mostly through efficient judiciary and effective enforcement of court decisions. The underlying assumption for successful business is the expectation that the contracting parties will meet their commitments. In this way, business entities can adjust their expectations and plans for their future investment activities. Hence, a continuous process of improving the efficiency of the court work is required, as well as constant alignment of the legislation with the practice, which would identify and reduce any market frictions.

Activities and measures proposed for improving the non-performing bank loan management, regardless of whether they are specific activities or initiatives for future cooperation between the competent institutions, are based on the **principle not to use public financial resources**, that is, the funds from the state budget of the Republic Macedonia, for such a purpose. All actions and measures taken in the past and those that would be taken as a result of this paper cannot dispute the fact that **the ultimate responsibility, and the consequences of the occurrence, scope and growth of non-performing loans should always be borne by those that have made decision to approve the loan, that is the banks**. After its independence, the Republic of Macedonia enabled the privatization of the banking sector and created prerequisites for free entry of foreign capital into the banking system, without interference in the ownership, management and decision-making on lending. Its involvement in taking over the "bad" loan portfolio of banks would spur the so-called moral hazard of financial institutions and would create a basis for generating expectations among the public, including the owners and banks' governing structures, for further state interventionism for the socialization of private losses.

- I. **Activities for improving the quality of financial reporting and corporate governance of companies, as well as for the consistent application of tax regulation**
 1. The Ministry of Finance and Public Revenue Office will initiate activities for raising transparency and clarifying all dilemmas of market participants regarding tax treatment of transactions with claims. This would allow an appropriate application of the tax regulation in trading with non-performing claims in terms of capital gains taxation and tax treatment of so-called "permanent write-off", as well as amid taxation of profit tax and/or treatment of taxation amid taking over the collateral in the form of real estate by creditors.
 2. The Ministry of Finance, Securities and Exchange Commission and Macedonian Stock Exchange will initiate activities for improving the corporate governance and quality of companies' financial reporting, while taking measures for consistent

publication of financial reports, improvement of corporate governance and disclosing financial and non-financial information.

II. Regulatory amendments and initiatives for further improvement of the management of non-performing loans

3. The National Bank of the Republic of Macedonia will analyze the possibility and need of regulating the conditions, manner and procedure for performing market transactions with claims, including non-performing claims, whether in the form of transfer due to collection or permanent transfer/sale (between banks or with and between third parties). This activity could be in the form of an explicit requirement for the banks in their internal acts to elaborate in detail the process of sale/permanent transfer or temporary transfer due to collection of claims of other entities, regardless whether it relates to individual claims or portfolio claims, including the right for forcible collection of claims. In the internal acts, banks shall also predict other aspects related with such transactions, such as the accounting treatment of the principle of the transferred claims and their impairment, disclosure of financial reports, conducted sale report, registration in the credit registry, obligations to comply with the regulations regarding the protection of the rights of borrowers (e.g. consumer rights, personal data, banking secret), decision-making competences for individual transactions etc.

If the analysis determines the need of an appropriate legal basis, the matter of transfer of the claim can also be regulated with an appropriate bylaw adopted by the competent institution that would apply to all entities that could appear as potential vendors and/or buyers of the claims. Examples of such acts exist in some countries in the South East Europe region.

4. The National Bank will reconsider the need for amending the regulation for credit risk management for accounting write-off of claims vis-a-vis debt write-off, in order to enable their equal understanding and application i.e. enable larger volume of regular write-offs of uncollected claims of the banks. Changes will also be made on the full transposition of the definition of “default” from the relevant European Union regulation, provisions for restructured claims and their regulatory treatment.
5. The National Bank shall proceed to analyze the possibility for amending the Decision on the contents and manner of functioning of the Credit Registry in order to enable appropriate registration of the purchased claims by a third party (e.g. company for purchasing claims) or on its behalf its registration can be conducted by the bank - seller as a separate item in the credit registry.

6. The Ministry of Finance and the National Bank of the Republic of Macedonia will initiate an appropriate legislative amendment, for example in the Banking Law (in part XI. Banking Secret), and in the Decision on publishing reports and data by banks, in order to introduce an obligation for the banks at certain dynamics (e.g. once a year) publish the names of ten largest debtors - legal entities, which have or have acquired non-performing status in the relevant period (e.g. in the past year). Despite the name of the debtor, its final owners shall also be published. Such transparency shall raise the discipline among banks' borrowers.
7. The Ministry of Justice in cooperation with the Ministry of Finance and the National Bank shall upgrade the solutions from the Law on Enforcement and Notary Public Law which are applied since 1 January 2017. The need of improving the relevant provisions of these legal solutions stems from the reactions and remarks of several stakeholders (Banking Association within the Economic Chamber of Macedonia, Organization of Employers, Notary Chamber etc.) for the restricting factors from the new laws. The following can be distinguished as specific remarks: increased costs of participants in the procedures, inability of companies to use their internal legal capacities on the account of mandatory engagement of lawyers in procedures before notary or enforcerment agent under determined conditions, enforcement based on a pre-registration list, problems with enforcement based on increments and decline of pledged property which is not inscribed in the debtor's property list. Also, the rationalization of the competences and procedures can also be considered, primarily due to overlapping the provisions regarding the right of pledge, with two individual laws (Law on Enforcement and Law on Contractual Pledge). Regarding the Law on Enforcement, the Ministry of Justice will investigate the possibility of eliminating the administrative price limitation under which real estate cannot be sold amid public bidding in the enforcement procedure, as well as the number of bids that can be conducted.
8. The Ministry of Economy will analyze the possibilities for a more comprehensive application or amendment of the Bankruptcy Law, in order to harmonize it with the best practices in this area, especially considering that it is in the final phase of the project "Strengthening the administrative capacities for implementation of the legal framework for bankruptcy and liquidation of companies" funded by IPA funds. It is also necessary to increase the efforts for the application of the regulation for out-of-court settlement between the debtor and its creditors (e.g. bilateral out-of-court settlement or collective restructuring of claims from the debtor by several banks through mutual arrangement). However, such a joint approach to the debtor in out-of-court procedure requires culture of trust and cooperation among creditors which cannot be acquired and upgraded on a short run.
9. The Ministry for Justice and other competent institutions shall review the legal framework and bylaws in the area of valuation. Complete acceptance and consistent application of both the international valuation standards and the European

valuation standards²⁴ is required as a starting point to these amendments, including the methodological guidelines for valuation of various properties and cases when valuations are used. This would mean reviewing the existing legal decision on valuations, especially in the part of creating methodologies for the valuation of the property category, the cases when valuation and compliance with the international and European standards in this area are made²⁵. At the same time, in order to respect the principle of independence amid conducting valuations, an explicit requirement shall be established that the offices or banks' employees competent for valuation shall be independent from their business activities of the organizational part in the bank for which valuations are conducted (e.g. loans approval, collection through foreclosure or subsequent sale of foreclosed assets due to uncollected claims²⁶).

10. In order to facilitate the process of alienation of the foreclosed property by the banks due to uncollected claims and in order to ensure appropriate availability of information for potential investors, a separate register of properties owned by the banks that are foreclosed and subject to sale will be established. If assessed as necessary, other entities that have acquired properties amid collecting claims may participate in the registry. This more comprehensive registry may also include data on the properties that are for sale in the enforcement procedure and may also be kept by the Real Estate Cadaster Agency.

²⁴ The Council for International Valuation Standards is an independent, unprofitable organization which creates and secures the application of universally accepted valuation standards. This application has published the International Valuation Standards (available on <https://www.ivsc.org/standards/international-valuation-standards>) which include valuation procedures through using universally recognized concepts and principles and auxiliary directions for a consistent application of the specified principles. European Valuation Standards (EVS-2009/2012 BlueBook) are published by pan-European association of professional bodies from the field of valuations from 35 European countries. The last, eighth edition of these standards is published in May 2016 and among others contains guidelines for valuation for lending purposes _EVGN 2 (available on: <http://www.tegova.org/en/p4912ae3909e49>).

²⁵ In the Republic of Macedonia, pursuant to the Law on Valuation and applicable Methodology for estimating the market value of real estate, the valuation is entirely based on the application of the so-called cost approach valuation of real estates, through administrative determination of parameters which are used in this approach in the Methodology itself. Specifically, pursuant to this Methodology, the market value of real estate is determined by the accrual points per m² functional area for buildings and other construction objects and per m² land area, depending on the type of real estate and according to basic and additional elements specified in the methodology. Basic elements for determining the market value of buildings are: type of construction, inter-floor construction, roof construction, type of installations, elevator, floor underlayment, sanitation, facade carpentry (windows), doors, facade, isolation and exclusivity. The sum of the accrual points for each of the basic elements represents the building value at which the depreciation is calculated, up to ten years 0% depreciation and over ten years by 0.5% of the building value per year. Additional elements according to which the market value of the buildings is determined are: floors of the building, micro location, macro location and attractiveness of the building, percentage of utilization and level of visits, which are calculations for each individual criteria are added to the building value and represent the market value. The value of accrual points is determined in the Methodology itself.

²⁶ The existing solution in the Republic of Macedonia that banks through their employees that have appropriate authorization (so-called appraisal license) can conduct valuation of cases when they themselves are a contracting party (both amid credit operations and sale of foreclosed property), is in accordance with opinion of the European Supervisory Authority regarding the possibility of an authorized appraiser to be employed by a bank (relevant opinion of ESA is available on: https://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_1056), provided that in addition to the qualifications, it shall possess independence amid conducting valuation of banks' credit function.

III. Supervision and supervisory oversight of the management of non-performing loans

11. The National Bank, within its supervisory function will control the internal capacity of the banks for dealing with non-performing loans and specific factors which impact the level of non-performing loans in each individual bank. The controls will refer to the entire process applied by the bank, from the approval of the loan, monitoring of the loan and the measure related to resolving the non-performing loan. The qualitative supervisory grade of the bylaws of the banks and level of implementation will further be in the focus of supervisory controls of the National Bank while assessing the system of the banks of credit risk management.
12. In order to prevent the risks from possible unethical behavior of the client, it is necessary to improve the corporate governance framework, primarily among client of the bank - legal entities and among banks themselves. The National Bank will adopt a new Decision for the application of the rules for good corporate governance in the bank which will enhance the competences and responsibilities of banks' bodies, internal control mechanisms, and at the same time emphasize the importance of the so-called code of ethics and corporate governance code. Within these codes, among others, banks will be required to apply professional standards and ethical norms in their operation, define acceptable and unacceptable behavior of their employees and support the so-called "whistle blowers". It is important for the banks to have established a mechanism through which, in addition to the creditworthiness and nature/characteristics of the business venture of its client will also be able to recognize its character i.e. will be able to monitor and assess the corporate governance system for the client. This could reduce the risk of clients' unethical behavior, misuse of documentation and misleading disclosure of information.

IV. Market development activities for non-performing claims

13. The Ministry of Finance and the Securities and Exchange Commission will review the possibility for implementing the European Union directive regarding the so-called alternative investment funds and relevant additional regulations in this area. In terms of performing transaction with claims that are collateralized (primarily with real estate) or transactions where the subject of sale will be already foreclosed real estate from the collection procedure, as an option that will potentially be effective is establishing private investment funds, primarily due to the fact that they do not have the status of legal entity which is why certain tax benefits arise. The existing regulation in the Republic of Macedonia does not allow establishing

private investment funds through non-monetary investments from investors and allows the possibility for only establishing open private funds and not closed private funds. Through the implementation of the above-mentioned directive, the legal basis for the functioning of such entities would be enriched. Also, through amending the regulation for issuing securities, it is possible to introduce certain forms of investment funds that do not have the status of legal entity (such as private funds) to be able to issue securities. This would be a step towards the implementation of the procedure of the so-called securization of any type of property in the Republic of Macedonia, because such institution in our system could play the role of the so-called special purpose entities, without which the actual securization process cannot be carried out.