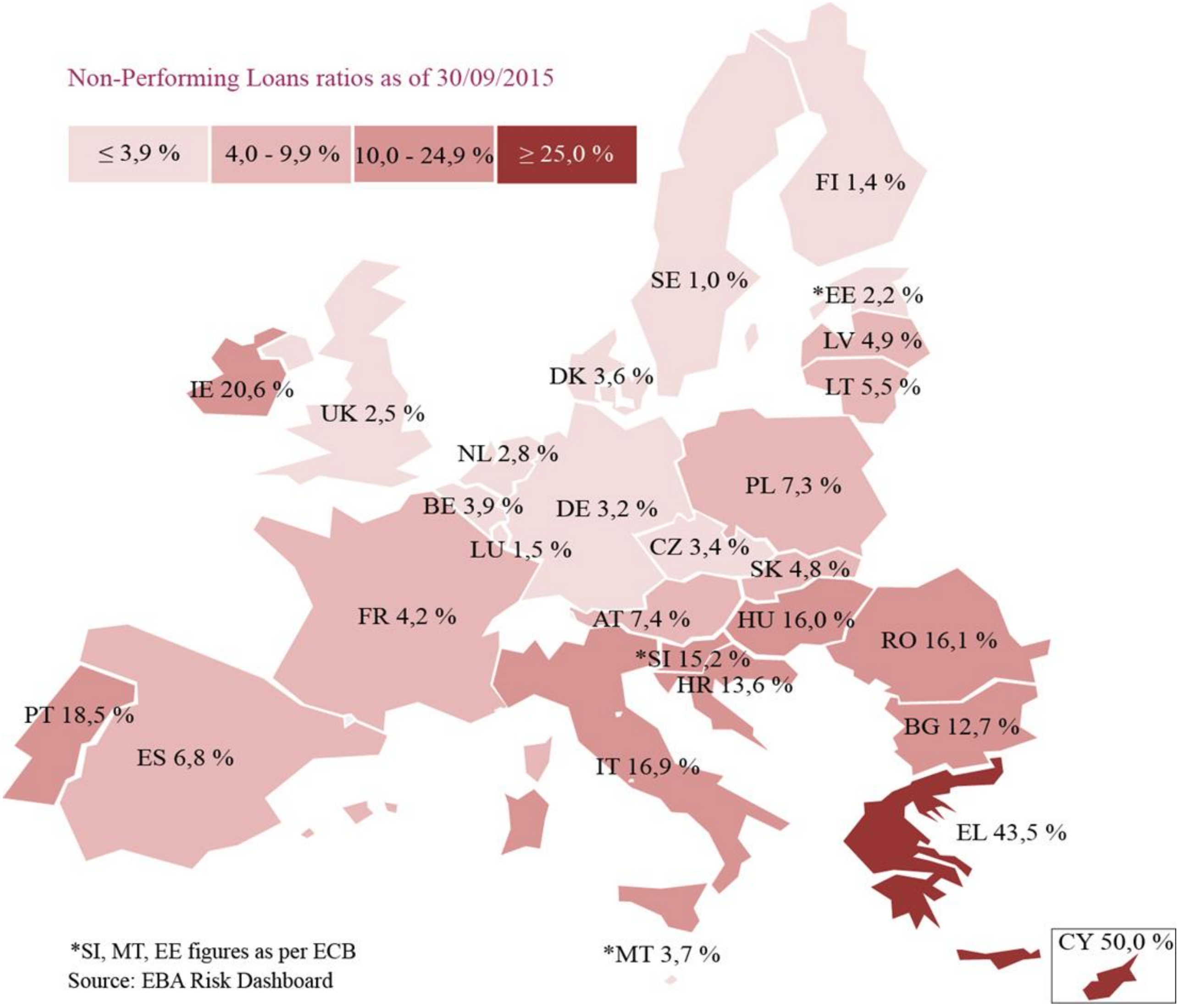
BRIEFING

Non-performing loans in the Banking Union: stocktaking and challenges

This briefing presents the state of play of non-performing loans (NPL) in the euro area, and provides an overview of the various measures implemented across Member States to facilitate their resolution.

The first section briefly presents the various levels of NPL ratios and coverage ratios in the euro area, across Member States, sectors, and groups of banks. The second section explains the detrimental impact of NPL on growth. The remaining sections present the various kinds of measures implemented across Member states to address the issue of non-performing loans: transferring NPL to dedicated bad banks, developing a secondary market for NPL, strengthening insolvency frameworks, as well as enhancing supervision and amending tax rules.

Non-performing loans in the euro area: where do we stand?

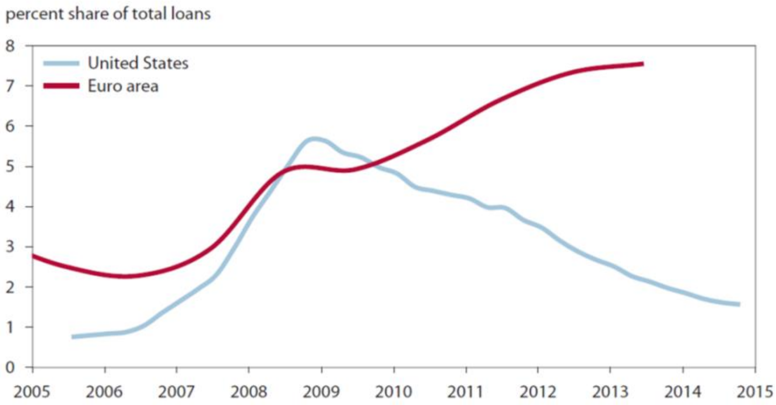


Authors: B.Mesnard, A.Margerit, C.Power and M.Magnus

Since the start of the crisis, the distribution of NPL has been highly unequal among Member States, with crisis-hit countries suffering major increases in NPL ratios. At the end of September 2015, the two countries which had to implement strict capital controls, Greece and Cyprus, reported NPL ratio of more than 40%[1]. Bulgaria, Croatia, Hungary, Ireland, Italy, Portugal, and Romania all report gross NPL ratio between 10% and 20%[2]. According to the EBA, among those countries, five reported an increase in NPL ratio in the third quarter of 2015: Greece (+1.5 pp), Cyprus (+0.4 pp), Portugal (+0.4 pp), Hungary (+0.1 pp), and Italy (+0.1 pp). Accounting practices may also differ across jurisdictions and have, to a lesser extent, some impact on the relative levels of NPL.

In the EU the average rate of non-performing loans is slowly decreasing, from 6.4% in December 2014 to 5.9% at the end of September 2015. However this level remains higher than in other major developed countries. As comparison, the World Bank reported NPL ratios of less than 2% for the United States and Japan at the end of 2015. Figure 1 presents the evolution of NPL ratios in the United States and in the euro area from 2006 to 2014. While NPL ratios rapidly increased in both areas in both areas from 2007 to 2009, the trends diverged radically from 2010 to 2014, with a rapid resolution of NPLs in the United States while Euro area banks continued piling up bad debts.

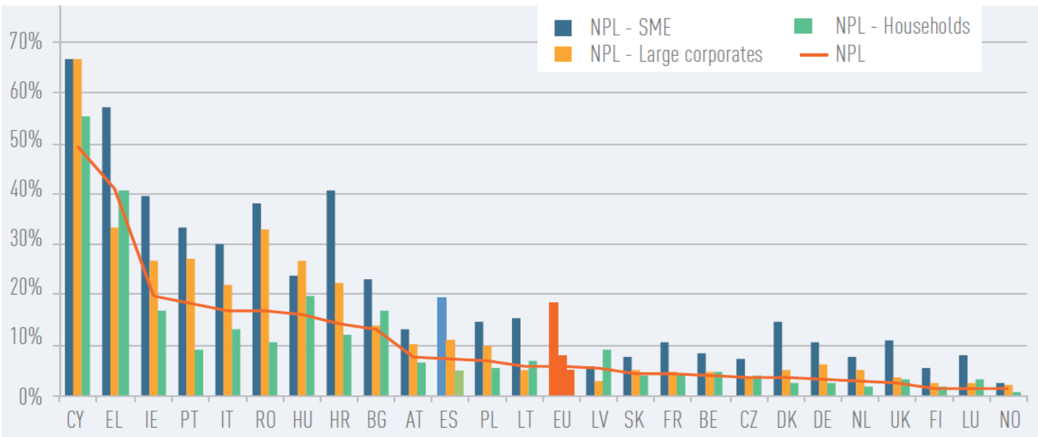
Figure 1: The evolution of NPL ratios in Europe and in the US



Source: PIIE, 2016, p24

In terms of sectors, the NPL ratios also differ greatly from one country to another, albeit they tend to be higher for SMEs compared to large corporate and households (see figure 2 below).

Figure 2: NPL ratio by debtor category (June 2015)



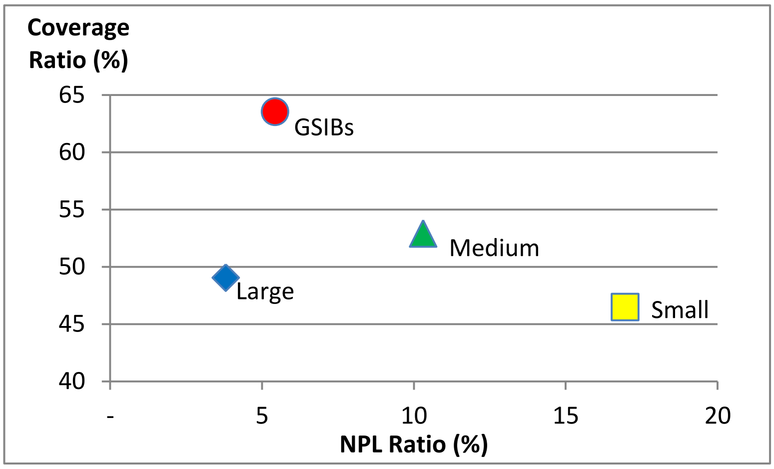
Source: EBA, 2015, p30

[1] The NPL ratio refers to the ratio of non-performing loans to total gross loans. Figures refer to non-performing loans as reported in the EBA risk dashboard (that is to say they take into account impaired loans and forborne loans as well as the contagion effect). For figures on loans which are 90 days past due only, see annex 1.

[2] The EBA does not report NPL figures for Slovenia, Estonia and Malta. Their respective NPL ratios as per the ECB were 15.2%, 2.2% and 3.7% respectively as of 30 June 2015.

As to the impact of the size on banks' performances, a previous EGOV briefing had already underlined that, at the end of June 2015, small and medium banks report higher NPL ratio than large banks and GSIBs. In addition small banks reported lower coverage ratios on that date.

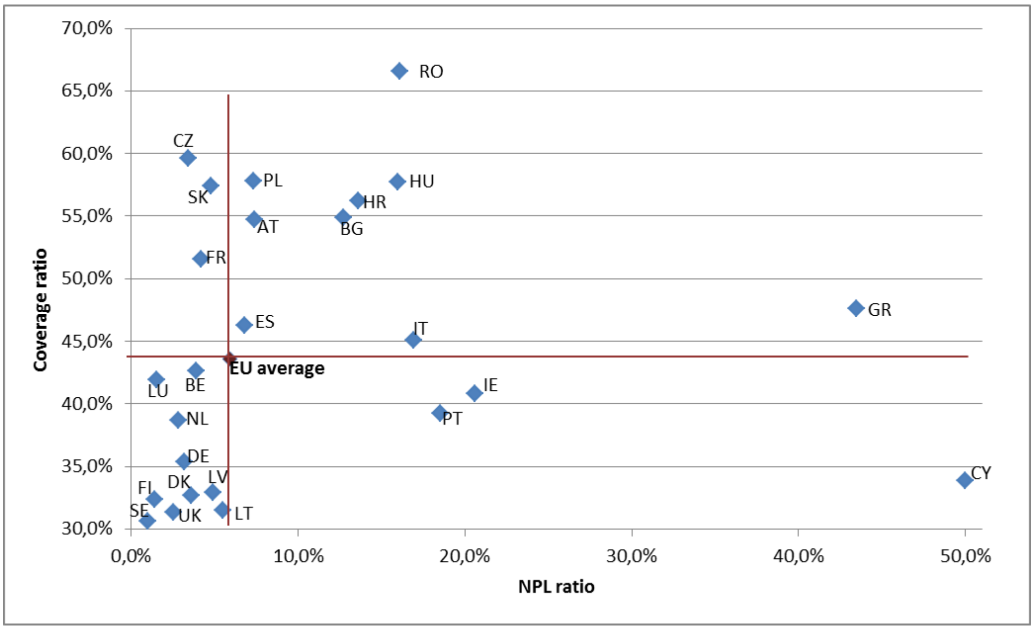
Figure 3: NPL ratios, coverage ratios[3] and size of SSM banks (June 2015)



Source: EGOV calculation based on Bankscope

Coverage ratios also differ significantly from one Member State to another, ranging from 31% to 67%. Differences may reflect various levels of collateralisation (depending on lending practices as well as to segments most impacted by NPLs) as well as heterogeneous accounting practices.

Figure 4: NPL ratio and coverage ratio in EU Member States (September 2015)



Source: EBA Risk dashboard

[3] The coverage ratio is the ratio of loan loss reserves to impaired loans. A low coverage ratio does not necessarily imply a risk of under-provisioning, since it could also reflect rigorous lending practices (high collateralisation of exposures) or a strong insolvency framework (where collateral repossession is easy for creditors).

The impact of NPL on growth

According to an IMF Staff Discussion Note published in September 2015, NPL constitute a drag on economic activity, especially for countries that rely mainly on bank financing, as is the case in the euro area. High NPL reduce profitability, increase funding costs and tie up bank capital, which negatively impact credit supply and ultimately growth.

Using different country samples, all recent studies find that higher NPLs tend to reduce the credit-to-GDP ratio and GDP growth, while increasing unemployment. This is consistent with the data for Euro Area banks over the last five years (See notably *European Investment Bank, 'Unlocking lending in Europe'*, October 2014). According to an IMF study (See *'Euro area policies, selected issues: policy options for tackling non-performing loans in the euro area'*, IMF country report, No 15/205, July 2015), credit growth remains slow in countries where banks report a high level of impaired assets and insolvency procedures are weak. Euro Area banks with higher NPLs ratios in 2012-2013 have been lending less than banks with average asset quality operating in the same country under the same demand conditions.

More specifically, the presence of non-performing debt on banks' balance sheets weighs on their ability to lend to the real economy through essentially three channels:

- ***Lower profitability***: NPLs imply higher provisioning needs, which in turn lower banks net operating income. Profits are further reduced by the increased amount of human resources needed to monitor and manage high NPL stock;
- ***Higher capital requirements***: NPLs are risky assets which attract higher risk weights than performing loans; High NPLs tie up banks' resources and crowd out new credit; IMF calculations suggest that given the current level of impaired assets a timely resolution could release as much as € 42 billion (or 0.5 % of selected countries 2014 GDP) of additional capital, which could unlock new lending of more than 5 percent of GDP.
- ***Higher funding costs***: Investors and other banks are less willing to lend to banks with high NPLs levels, leading to higher funding costs for these banks and a negative impact on their capacity to generate profits.

All these channels mutually reinforce each other and ultimately result in a dampening of the credit supply. Bank's reduced lending capacity is likely to disproportionately affect SMEs that are more dependent on bank finance. According to a Commission study (See Commission, DG ECFIN, *Quarterly report on the Euro Area*, Volume 14, no 4, special edition*)*, the shift between investment in the tradable sector and the non-tradable one -which is conducive of a higher growth potential- has not taken place or has taken place at a much lower pace in countries that experienced a higher or more persistent surge in NPLs (See box 1 below: "Non-performing and investment in the tradable and non-tradable sector")

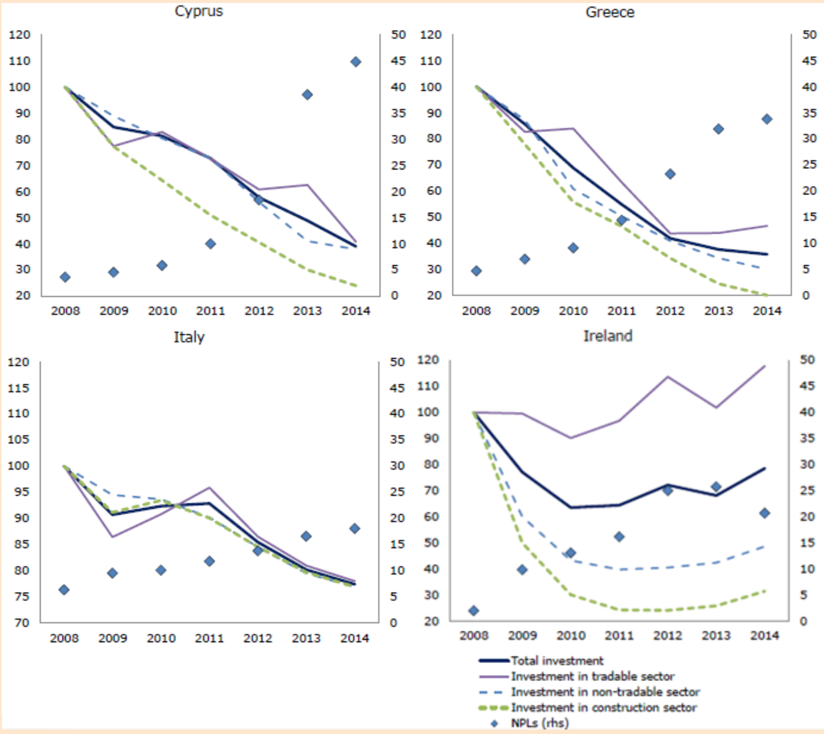
Reducing NPLs appears therefore crucial in order to support credit growth:

- It is vital for SMEs that are more reliant on bank financing;
- It should encourage corporate restructuring and overall reduce the private sector debt overhang; NPL resolution would allow the debt of viable firms to be restructured while hastening the winding down of unviable firms;
- It may enhance monetary policy transmission, i.e. banks that are concerned about capital adequacy and rising loan loss provisions are indeed likely to be less responsive to changes in the policy rate.

Box 1: Non-performing and investment in the tradable and non-tradable sector

(2008-2014, in %))

In CY and EL, investment fell by more than 60 % between 2008 and 2014 while NPLs increased to 45 % and 34 % in 2014 respectively. In Italy, the continuous increase in NPLs between 2008 and 2014 (reaching 18 % in 2014) coincided with a fall of more than 20 % in investment in the tradable sector. Conversely, in Ireland total investment in 2014 was still lower than in 2008 but had been on an upward trend since 2010. A decrease in NPLs has started since 2013.



Source: Commission, DG ECFIN, Quarterly report on the Euro Area, Volume 14, no 4, special edition

According to the IMF authors, different kinds of measures can help resolving the NPL issue. They are complementary as their simultaneous implementation ensures a stronger impact. Most of them were introduced in crisis-hit countries, in particular those which experienced financial assistance programmes such as Greece, Cyprus, Ireland, Spain, Portugal. However other countries with acute NPL problems have also implemented such reforms to various extents, as Slovenia and Italy. The following sections provide some examples of the measures taken to date in each area. All implemented measures were either bank-specific or country-wide schemes. No European-wide or euro area-wide solution has been envisaged so far.

Impaired asset measures

Addressing the NPL issue implies allocating losses within the system. No matter the scheme, losses have to be borne either by banks' customers, banks themselves, investors or States. Various countries decided to create asset management companies or special purpose vehicles in order to relieve banks from the burden of NPLs and to avoid fire-sales in illiquid markets, thereby minimizing losses and reducing the cost of restructuring failing banks. Similar asset relief can be achieved through a guarantee on a specific portfolio of assets (asset protection scheme, "APS"). In both instances (physical transfer or APS), the design of the mechanism may involve State aid. Below are listed different types of impaired asset measures implemented in the euro area since the start of the crisis.

Transfer of assets to individual bad banks

Various banks have opted for segregating toxic assets from their ongoing business of since the start of the financial crisis. Where there was no private solution the State had to set up a public bad bank to take over the assets from a private bank, as in the case of Erste Abwicklungsanstalt and FMS Wertmanagement in Germany (respective bad banks of West LB and Hypo Real Estate), or KA Finanz in Austria (bad bank of KommunalKredit austria AG) which were all publicly owned. Similarly, bad banks were created out of banks which were already publicly owned, such as Hypo Alpe Adria in Austria).

System-wide bad banks

Ireland (NAMA), Spain (SAREB) and Slovenia (BAMC) set-up system-wide bad banks were non-performing assets were transferred from banks under restructuring. This can create scale economies in the management of illiquid assets, through the recruitment of NPL workout specialists for example. As for individual bad banks, the pricing of such transfers is key in assessing the amount of State aid involved, and the capital structure of the bad bank has also a decisive impact on public finances, since a publicly owned bad bank is accounted for as public debt and not as contingent liability. While NAMA and SAREB are both mainly privately owned, the Slovenian bad bank is fully publicly owned.

State guarantees on asset portfolios ("asset protection schemes")

One alternative to the physical transfer or distressed assets is the provision of guarantees to cover the losses related to a specific portfolio of assets. Such schemes cap the losses borne by banks through an insurance mechanism until market conditions recover. The advantage is that no upfront funding is needed from the State while the bank continues to manage the assets (which requires specific skills and IT systems). Many banks in Germany, Austria, Spain as well as Dexia benefited from such asset protection schemes.

System-wide State aid free mechanisms

The European Commission approved public bad banks and asset protection schemes subject to strict conditions, including (i) the restructuring of the aided bank, (ii) a transfer (or guarantees) at a price which reflects the *real economic value* of assets, and (iii) burden sharing requirements (including the bail-in of subordinated creditors for those aid measures notified after 1 August 2013). Since 1 January 2016, the bail-in required under the BRRD applies fully and makes it even less attractive for banks and governments to provide such restructuring aid. Therefore some Member States decided to design mechanisms which do not involve State aid. On 10 February 2016 the Commission approved an asset protection scheme in Italy, as well as a public bad bank in Hungary. In both instances, the Commission concludes the transfers of assets (Hungary) or risks (Italy) would be done at market prices, and hence involve no State aid.

Facilitating the sale of NPL on the secondary market

The sale of NPL portfolios to investment funds requires a minimum level of liquidity in the market. However, according to the IMF staff discussion note, at the end of 2013 the volumes of transactions on distressed debt was only EUR 64 billion in Europe while it amounted to USD 469 billion in the United States, where the stock of distressed debt is much smaller. While the volumes are increasing, as observed for example in Italy (from EUR 5 billion in 2013 to EUR 20 billion expected in 2016), the sale of NPL on the secondary market remains underdeveloped compared to the US market.

When looking at the reasons explaining this situation, the IMF staff discussion note highlights several factors:
- *incomplete credit information on borrowers*;
- regulatory frameworks where non-banks are not allowed to purchase and manage NPL;
- *overvalued collateral and lack of liquid real estate markets*;
- *low recovery values due to lengthy court procedures*;
- *inadequate provisioning of NPLs*.

Some of those factors directly relate to the supervision of banks (provisioning policies, overvalued collateral, incomplete information on borrowers), other to the insolvency frameworks (lengthy court procedures, time to recovery). Measures in those areas are analysed in more detail below. However some legal impediments are specific to the NPL market, as the prohibition in some countries for non-bank entities to purchase and manage NPL portfolios. Therefore the cost of entry in this market is high for NPL specialists and work out agencies, and banks can't easily deleverage their NPL portfolio. In addition, when they have to work out their NPL portfolios themselves, they are sometimes constrained by lengthy court procedures.

As an example at the end of 2015 Greece has passed law 4354/2015 (the "NPL Law") aiming at facilitating the sale of NPL portfolios to non-bank companies. The NPL Law provides that NPL asset management companies will be allowed take over NPL under minimum registration requirements, and provided that borrowers have been duly notified.

Similarly, Ireland introduced legislation in 2015 to protect borrowers (individual and SMEs but not corporates) whose loans are sold to unregulated entities, and a new regulated activity of 'credit servicing' was introduced to ensure that loans are administered in line with existing consumer protection codes. The legislation does not directly regulate loan purchasers but those firms servicing (managing and administering) loan agreements on behalf of purchasers so as not to discourage loan sales.

Facilitating the access of investors to recent information on borrowers, collateral and NPL sales could also facilitate bridging the gap between demand and supply on this market according to the IMF staff discussion note. A smoother functioning of markets for collaterals (auction mechanisms) is also expected to increase the recovery value of NPL, thereby facilitating divestments on the NPL market.

The IMF staff discussion note also suggests that specific institutions such as the EIB, EIF, or publicly owned asset management companies could help kick-start the market for distressed debt. They mention the possibility to provide guarantees on the mezzanine tranche of NPL securitization, or to invest in senior tranches, which is precisely the mechanism proposed by Italy and approved by the Commission on 10 February 2016.

The reform of insolvency frameworks

Insolvency frameworks are key for the efficient resolution of NPL, as they provide positive/negative incentives to all stakeholders. In particular, inefficient frameworks will make it difficult for debtors and creditors to agree on a timely restructuring of bad debts. The creation of out-of-court procedures and the acceleration of judicial procedures, by reducing the timeline for debt restructuring, also improve the value of NPL and reduce creditors' losses. Italy enacted such reforms in 2015.

The EU/IMF Programme for Financial Support for Ireland included a **reform of personal insolvency laws**. Previously in Ireland, the only formal mechanism available to settle debts and get protection from creditors for persons deemed insolvent was bankruptcy. Three new debt resolution mechanisms were introduced under the Personal Insolvency Act 2012 for people who cannot afford to pay their personal and mortgage debts. In addition new measures to support people in mortgage arrears were introduced, including, as of November 2015, a court review where a mortgage lender rejects the borrower's personal insolvency proposal. Furthermore, Irish bankruptcy law was amended in 2016 to reduce normal duration of bankruptcy from 3 years to 1 year (up to December 2013 it was 12 years) to improve and streamline the process.

In 2014 Spain reformed its insolvency law to facilitate debt restructurings for businesses (write-off, maturity extensions, debt-to-equity swaps). Before the reform, almost 95 percent of companies that started insolvency proceedings used to end up in liquidation. Under the rules, companies need agreement from 60 percent of creditors only to extend debt by five years or to convert debt into participative loans, a hybrid of equity and debt. Individual creditors can also agree to refinance the company during preliminary bankruptcy proceedings, and further amendments were introduced in 2015 to modify out-of-court refinancing.

In 2015 Greece[4] also implemented a number of measures related to insolvency frameworks, in particular further amendments to the corporate and household insolvency laws in order to accelerate proceedings and address the excessive backlog of pending cases, the creation of the regulated profession of insolvency administrators, and the reactivation of the Governing Council of Private Debt to inform and advise indebted customers.

Reforming and harmonising national insolvency laws in the European Union has gained importance following the financial crisis and the implementation of financial assistance programmes in some Member States and, more recently, the priority of establishing a Capital Markets Union. The Five Presidents Report identified that harmonising national insolvency laws would be necessary to ensure integration of capital markets. The Banking Union Communication of the Commission issued on 24 November 2015 confirms the need for greater convergence in insolvency law and restructuring proceedings across Member States. In December 2015, following an open call for interest, the Commission set up an Expert Group consisting of 22 independent (non-governmental) experts, mainly legal professionals or academics. The Group will assist the Commission in the preparation of a potential legislative proposal containing minimum standards for a harmonised restructuring and insolvency law in the EU which has been announced for end 2016. In early March, the Commission published an inception impact assessment on the initiative.

In January 2016 the Eurogroup conducted a thematic discussion and published a subsequent statement confirming that it is agreed that this issue is "*particularly relevant for the euro area, especially in addressing the debt overhang, and also because the euro area economies are prone to spill-over effects*". The Eurogroup agreed that **a set of common principles and benchmarks** would be useful to improve efficiency and effectiveness of those frameworks, and agreed to continue the discussion in spring 2016.

[4] See Commission compliance reports of 14 August, 20 November and 21 December 2015.

The Small Business Act for Europe contains measures to assist SME development, including that Member States should have speedy second-chance procedures for insolvent companies. (Please see Annex 3 for further details of EU-level initiatives for more efficient insolvency proceedings.) 'Examinership' proceedings have been identified as an effective mechanism of enabling 'second chance' for insolvent or near insolvent companies with a reasonable chance of survival in the longer term - see the SME Performance Review Annual Report 2015.

Other measures to accelerate the deleverage of NPLs

Supervisory work on loss recognition and troubled assets management

Loss forbearance is a major obstacle to debt restructuring or asset sales, since banks may postpone debt restructuring or deleverage in order to avoid loss recognition. Supervisor can therefore take a tough stance and undertake asset quality reviews to check the classification of loans and the level of provisioning. Such exercise was carried out by the ECB before taking over supervisory powers.

Such efforts could take the form of supervisory guidance, as was done in Ireland and Cyprus. In Ireland, quantitative targets were imposed in 2013 and 2014 on the resolution of non-performing mortgage loans by the Central Bank of Ireland. In Greece, Cyprus and Ireland Codes of Conduct governing the interactions between banks and indebted customers were introduced to facilitate the case prioritization and the triage of customers.

In Greece, the supervisor also completed a thorough review of banks' practices regarding the management of NPL, which lead, inter alia, to the establishment of internal restructuring units in all large Greek banks. The MoU signed on 19 August 2015 also provides that the Bank of Greece will closely monitor NPL resolution through a set key performance indicators.

Amending tax rules

One other area of reform is the tax system, since full loan loss deductibility provides strong incentives for banks to adjust timely the book value of NPL. Indeed, if banks cannot deduct loan losses from their taxable income, they have no incentive to conservatively book loan losses reserves. In 2012 Italy shortened the timeline for full loan loss deductibility from 18 years to 5 years, and then in 2015 from 5 year to immediate full deductibility.

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Annex 1: ECB statistics on NPL (90 days past due)

ECB statistics refer to narrower definition of NPL than the EBA, which explains the discrepancies with the EBA data reported in figure 4 and in the map on page 1. The EBA includes impaired loans which are not 90 days past due, forborne loans and also performing loans to debtors which are not performing on other loans (contagion effect).

Table: Evolution of NPL ratios in the EU (2008-June 2015)

NPL ratio (%)	Dec-08	Dec-11	Dec-13	Jun-15
Austria	1,95	4,05	4,23	6,03
Belgium	3,94	4,18	5,27	3,08
Bulgaria	4,77	19,66	18,59	
Croatia			11,79	13,17
Cyprus	4,18	11,89	37,06	35,29
Czech Republic				
Denmark	1,62	3,02	3,87	3,89
Estonia	2,33	4,52	1,89	2,41
Finland	0,84	0,80	0,67	1,28
France	3,11	4,63	4,64	3,65
Germany	1,89	1,61	1,81	2,26
Greece	3,12	12,10	24,19	32,92
Hungary	3,74	12,80	14,03	12,64
Ireland			18,38	14,58
Italy	4,97	9,47	12,92	16,08
Latvia	2,72	10,13	5,56	7,49
Lithuania	3,58	13,38	8,50	6,42
Luxembourg	0,20			1,12
Malta	1,26	1,55	2,01	3,56
Netherlands	1,87	2,42	2,73	2,56
Poland	3,38	6,02	5,98	5,24
Portugal	1,65	5,33	7,79	13,58
Romania	1,47	11,36	17,87	12,66
Slovakia	1,73	4,02	3,75	4,13
Slovenia			17,14	16,58
Spain	2,56	5,23	7,91	5,93
Sweden		0,56	0,47	1,02
United Kingdom	0,98	2,17	1,78	0,35
Euro area 19	**1,96**	**3,42**	**4,30**	**4,45**
EU28	**1,76**	**2,90**	**3,63**	**4,23**

Source: ECB

Annex 2: EU Framework for Insolvency Proceedings

The current EU framework for insolvency proceedings consists predominantly of the EU Insolvency Regulation (Council Regulation (EC) No 1346/2000) which deals with **issues of jurisdiction, recognition and enforcement, applicable law and cooperation in cross-border insolvency proceedings**. The Regulation, which was updated and recast last year (Regulation 2015/848 of 20 May 2015 on insolvency proceedings), does not seek to harmonise the substance of insolvency laws; instead it provides a framework for cross-border recognition of participating Member States' national insolvency judgments. As the Regulation forms part of EU co-operation in the field of justice, Member States such as Ireland, the UK and Denmark are entitled to opt-out. However, both Ireland and the UK decided to opt in to its adoption and application due to the scope agreed, i.e. financial services were excluded. Denmark has remained outside the regime. Member States are required to provide information on their insolvency systems by 26 June 2016 through the European Judicial Network.

Previous initiatives in this regard include:

- Council Regulation (EC) No 1346/2000 (recast 2015) deals with **issues of jurisdiction, recognition and enforcement, applicable law and cooperation in cross-border insolvency proceedings**. However, the proposed amendment does not tackle the discrepancies between those procedures in national law.
- European Parliament Resolution of 15 November 2011 on **insolvency proceedings** in the context of EU company law included recommendations for harmonising specific aspects of national insolvency law, including the conditions for the establishment, effects and content of restructuring plans.
- Commission Communication on the Single Market Act II of 3 October 2012 undertook as a **key action to modernise the Union insolvency rules in order to facilitate the survival of businesses and present a second chance to entrepreneurs**. To this end the Commission announced it would analyse how the efficiency of national insolvency laws could be further improved with a view to creating a level playing field for companies, entrepreneurs and private persons within the internal market.
- The Commission Recommendation of 12 March 2014 proposed a new approach to **business failure and insolvency**. Its objective is to encourage Member States to put in place a framework that enables the efficient restructuring of viable enterprises in financial difficulty and give honest entrepreneurs a second chance, thereby promoting entrepreneurship, investment and employment and contributing to reducing the obstacles to the smooth functioning of the internal market with the aim of lowering the costs of risk assessment, increasing recovery rates for creditors and removing the difficulties of restructuring cross-border groups of companies. The Recommendation provides for minimum standards on preventive restructuring frameworks and discharge of debts of bankrupt entrepreneurs.