IN-DEPTH ANALYSIS

Requested by the ECON committee

European Parliament

Non-performing Loans - New risks and policies?

What factors drive the performance of national asset management companies?

External author:

Christos GORTSOS

Economic Governance Support Unit (EGOV)
Directorate-General for Internal Policies
PE 659.647 - March 2021

EN

Non-performing Loans - New risks and policies?

What factors drive the performance of national asset management companies?

Abstract

This paper develops, on the basis of a cost-benefit analysis,on the conditions that must be met for an Asset Management Company (AMC), established under the centralised approach in EU Member States, to efficiently facilitate the management and recovery of non-performing loans (NPLs). It concludes that public AMCs, even if optimally designed, should not be viewed as a 'panacea' but as one of several measures that can be taken to address the NPL problem and prevent bank failures.

This paper was prepared by the Economic Governance Support Unit (EGOV) at the request of the Committee on Economic and Monetary Affairs (ECON).

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR
Christos GORTSOS, Law School, National and Kapodistrian University of Athens, Professor of Public Economic Law

ADMINISTRATOR RESPONSIBLE
Cristina DIAS
Rebecca SEGALL

EDITORIAL ASSISTANT
Donella BOLDI

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Original: EN

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To contact Economic Governance Support Unit or to subscribe to its newsletter please write to:
Economic Governance Support Unit
European Parliament
B-1047 Brussels
E-mail: egov@ep.europa.eu

Manuscript completed in March 2021

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LIST OF ABBREVIATIONS

AMC	Asset Management Company
APSs	Asset Protection Schemes
BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
CMU	Capital Markets Union
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
ESRB	European Systemic Risk Board
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FMS	Financial Market Stabilisation
FOLF	Failing or Likely to Fail
GACS	Garanzia sulla Cartolarizzazione delle Sofferenze
GFC	Global Financial Crisis
IFRS	International Financial Reporting Standards
MREL	Minimum Requirements (for own funds and) Eligible Liabilities
NAMA	National Asset Management Agency
NCAs	National Competent Authorities
NCWO	No Creditor Worse Off
NPEs	Non-Performing Exposures
NPLs	Non-Performing Loans
RRF	Recovery and Resilience Facility
RTC	Resolution Trust Corporation
SAREB	Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria
SMEs	Small or Medium-sized Enterprises
SREP	Supervisory Review and Evaluation Process
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation
SSM	Single Supervisory Mechanism
SSMR	Single Supervisory Mechanism Regulation
STS	Simple, Transparent and Standardised (securitisation)
TARP	Troubled Asset Relief Program

EXECUTIVE SUMMARY

The aim of this paper is to develop on the institutional, governance and (to a certain extent) operational conditions that must be met for a public Asset Management Company (AMC), established under the so-called centralised approach in an EU Member State, to be able to efficiently facilitate the management and recovery of non-performing loans (NPLs), taking, in particular, account of the impact of the COVID-19 pandemic crisis. The paper is structured in four Sections:

Section 1 discusses the historical dimension of the NPL problem in the EU before the onset of the pandemic crisis (legacy NPLs) and the measures taken to address it, the characteristics, legal definition and regulatory implications of NPLs and non-performing exposures (NPEs) and the impact of the pandemic crisis, briefly presenting the measures taken by the European Central Bank (ECB) and the European Banking Authority (EBA) and the European Commission's 2020 NPL Action Plan.

The relatively longer **Section 2** firstly analyses, on the basis of a detailed literature review, the alternative approaches for setting up AMCs, the objectives, operational goals and structural issues of public AMCs established under the centralised approach, developing on their advantages and disadvantages, specific inherent incentive issues, as well as the conditions leading to the efficiency of AMCs as a tool to facilitate NPL management and recovery. This synthesis and, in particular, the cost-benefit analysis undertaken to identify advantages and disadvantages, allows the author to submit proposals on certain specific conditions for the efficient operation of national, public AMCs in the EU.

The first *interim* conclusion is that public AMCs set up in Member States under the centralised approach can, indeed, be efficient tools for facilitating NPL management and recovery, albeit upon the existence of a robust legal framework, which should clearly define, *inter alia*, their primary and secondary objectives, including social ones, specific safeguards of their operation, their limited lifespan. AMCs should be subject to the prudential supervision of national competent authorities (NCAs) as financial (not credit) institutions and their independence, transparency and, most importantly, corporate governance should also be embedded in the legal framework. Furthermore, appropriate policies regarding the selection of assets to be transferred and the pricing of such assets and sound strategic plan reviews for asset recovery should be in place, which would support the managerial factor, appropriately structured incentives and the commercial orientation of its operations.

Section 3 briefly presents other alternative measures and policies existing next to national AMC, such as the creation of an AMC at EU level, systematic securitisation-based schemes for NPLs and the precautionary recapitalisation of credit institutions by public funds, as laid down in the EU regulatory framework governing banking resolution, with due reference to selected recent academic studies and the proposals in the European Commission's 2020 NPL Action Plan. This leads to the second *interim* conclusion that resort to all these alternatives should carefully be considered on an *ad hoc* basis, duly taking account of merits and relative disadvantages on the basis of criteria such as effectiveness, feasibility and credibility.

Finally, **Section 4** discusses the bigger picture, developing on the role of supervisory and resolution authorities in preserving financial stability, the ultimate public policy objective, in view of the emerging new wave of NPLs due to the current pandemic crisis. The author argues that in this respect, of primary importance are the quality of prudential banking supervision and the (closely related issue of) monitoring credit institutions' own credit risk management policies, in particular in relation to the provision of new credit and loans to households and businesses. In this respect it is also noted that in several cases, corporates may be rather in need of own funds to increase their solvency, which cannot be covered by bank lending, which must also be taken into account in the context of credit risk management. In addition, of relevance are the EU-wide stress test exercises of credit institutions' portfolios to be conducted in 2021, the appropriate use by the ECB and NCAs, if necessary, of their specific supervisory and early intervention powers, as well as their (supervisory) approach to consolidation in the EU banking sector. Finally, another important element towards the preservation of financial stability is the progress to be further made in relation to resolution planning to attain the resolvability of credit institutions, including the build-up of minimum requirements for own funds and eligible liabilities (MREL).

In making his final concluding remarks the author notes that public AMCs, even if optimally designed, should not be viewed as a 'panacea' but as one of several measures that can be taken in order to address the NPL problem and prevent the adverse scenario where one or (more importantly) several credit institutions would reach the point of meeting the 'failing or likely to fail' criterion laid down in the EU resolution framework due to their exposure to NPLs. In such a case, it (or they) should either be resolved or wound up under normal insolvency proceedings.

1. THE PROBLEM OF NON-PERFORMING LOANS (NPLS) IN THE EU BEFORE AND AMIDST THE COVID-19 PANDEMIC CRISIS

1.1. Introduction: historical dimension of the NPL problem and measures taken to address it

(1) The problem of credit institutions' non-performing loans (NPLs), which form part of a wider set of non-performing exposures (NPEs),[1] is not new in recent European Union (EU) economic history. In the wake of the 2007-2009 Global Financial crisis (GFC) and the subsequent fiscal (debt) crisis in the euro area, their amounts increased exponentially in all Member States (albeit to a different extent).[2] During the following years, nevertheless, they gradually started to significantly decrease as a percentage of both their overall assets and their regulatory capital. This was due to a combination of accommodating macroeconomic conditions and the increase of credit institutions' regulatory capital resulting from the application of the micro- and macro-prudential components of the 2013 single rulebook, namely the so-called Capital Requirements Regulation and Directive (CRR and CRD IV,[3] as in force).[4] Furthermore, of significant importance was the targeted action taken by EU institutions, especially after the establishment of the Banking Union (BU) and particularly its first pillar, the Single Supervisory Mechanism (SSM).[5] The latter seems to have more effectively addressed the 'home bias' problem and led to significant improvement in the quality of micro-prudential banking supervision[6] carried out, since November 2014, for all credit institutions established in participating Member States, by the European Central Bank (ECB) and the national competent authorities (NCAs) *within* the SSM (in accordance with the provisions of Article 6 SSMR).

(2) Within this context, the ECB "Guidance to banks on non-performing loans" of May 2017 laid down best practices which constitute its supervisory expectation within the SSM,[7] while the Council adopted

[1] On the definition of NPLs and NPEs, see below, under 1.2.

[2] For a brief overview of the (vast existing) literature on the multiple causes of the GFC, see Gortsos (2012), pp. 127-129 (with extensive further references). On the causes of the euro area fiscal crisis and the related policy responses, see by means of mere indication (out of a vast existing literature as well) Zimmermann (2015), Hadjiemmanuil (2020a) and Piantelli (2021). For data on the development of NPLs after both crises, see Aiyar et al. (2015), pp. 6-9 (in particular, Figures 1, 2a and 2b), Lamandini et al. (2017), pp. 1-4, various contributions in Monokroussos and Gortsos (2017, editors) and Montanaro (2019), pp. 215-220.

[3] Regulation (EU) No 575/2013 and Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 (OJ L 176, 27.6.2013, pp. pp. 1-337 and 338-436, respectively).

[4] On this aspect, see also below, under 1.3.1.

[5] The SSM was established in 2013 by virtue of Council Regulation (EU) No 1024/2013 of 15 October 2013 (OJ L 287, 29.10.2013, pp. 63-89, SSMR) and constitutes the first BU pillar. Furthermore, since 2014, the EU bank crisis management framework has also been enhanced by the (new) banking resolution framework. This consists of Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 (OJ L 173, 12.6.2014, pp. 190-348, BRRD), which applies to all EU Member States and Regulation (EU) No 806/2014 of the same EU institutions of 15 July 2014 (OJ L 225, 30.7.2014, pp. 1-90, SRMR), which established the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF), i.e., the second pillar of the BU, and only applies to participating Member States. 'Participating' Member States means both those whose currency is the euro and those with a derogation, which have established a 'close cooperation' in accordance with Article 7 SSMR (Article 2, point (1)), such as, since October 2020, Bulgaria and Croatia.

[6] As noted in the Report drawn up on 25 February 2009 by the *de Larosière* High-Level Group (available at: https://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf), the financial system of several states was not exposed (at least primarily), or were less significantly exposed, to the GFS not only because they were equipped with a strong institutional and regulatory framework, but also because micro-prudential supervision of their banking sector (system) was, admittedly, suitable; and that was not the case throughout the EU. For an overview of this Report, see Ferrarini and Chiodini (2009) and Louis (2010).

[7] Available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf. The ECB Guidance is based on the Guidance of the Basel Committee on Banking Supervision (BCBS) of 4 April 2017 on the "Prudential treatment of problem assets – definitions of non-performing exposures and forbearance". These international financial standards were adopted with a view to promoting global harmonisation in the measurement and application of two important measures of asset quality, non-performing exposures and forbearance and complement the existing accounting and regulatory framework for asset categorisation (available at: https://www.bis.org/bcbs/publ/d403.htm).

in July 2017 an "Action Plan to tackle non-performing loans in Europe".[8] Furthermore, the Commission Communication of 11 October 2017 "On completing the Banking Union",[9] which was broadly based on the conclusions of its Reflection Paper "on the deepening of the economic and monetary union" of 31 May 2017,[10] laid down six priorities, which can be categorised in two groups: while the *first* contained 'risk reduction' measures, including, *inter alia*, the undertaking of actions to address NPLs in accordance with the 2017 Council Action Plan, the *second* group comprised two 'risk sharing' measures (the adoption and implementation of which should follow the efficient application of the risk reduction ones), namely the establishment of the European Deposit Insurance System (EDIS), the still missing third pillar of the BU, and the creation of a 'common backstop' to the (Single Resolution) Board for the Single Resolution Fund (SRF).[11] These initiatives were without prejudice to other regulatory measures adopted for the enhancement of financial stability,[12] including the international accounting standard 'IFRS 9' on the classification and measurement of financial instruments, applicable since 1 January 2018.[13]

(3) The follow-up Progress Reports of the Commission on the Council Plan are also of importance, and, in particular, the Commission Staff Working Document "AMC Blueprint"[14] (hereinafter the 'AMC Blueprint (2018)') accompanying the Commission's Communication of 14 March 2018 "Second Progress Report on the Reduction of Non-Performing Loans in Europe".[15] Relevant are also the "Guidelines on management of non-performing and forborne exposures" of the European Banking Authority (EBA) of 31 October 2018 (EBA/GL/2018/06)[16] and Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 "amending the [CRR] as regards minimum loss coverage for [NPEs]".[17]

1.2. Characteristics, legal definition and regulatory implications of NPLs and non-performing exposures (NPEs)

(1) In their capacity as financial intermediaries, credit institutions (banks) perform transformations: 'credit risk transformation', by assuming the credit risk of the borrowers they finance, transferring the risk of their own solvency to positive savers; 'size transformation', by converting liabilities of even small nominal value (e.g. household deposits) to large-value (e.g. industrial) loans; and 'maturity transformation', by converting short-term liabilities (e.g. sight deposits) into long-term (e.g. housing)

[8] See at: https://www.consilium.europa.eu/en/press/press-releases/ 2017/07/11/conclusions-non-performing-loans. For a detailed overview, see Montanaro (2019).

[9] COM (2017) 592 final.

[10] Available at: https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en.

[11] The priority character of the above-mentioned actions was further reinforced in the Commission Communication of 6 December 2017 "Further steps towards completing Europe's Economic and Monetary Union: A roadmap" (COM (2017) 821 final, 6.12.1017, pp. 11-12), which outlined a comprehensive package of proposals to strengthen the EMU – including the BU and the Capital Markets Union (CMU).

[12] For an overview of the various definitions of this term, see Gortsos (2020a), pp. 14-15, with extensive further references.

[13] On this accounting standard and its implications for financial stability, see European Systemic Risk Board (2017). Relevant is also Regulation (EU) 2017/2395 of the European Parliament and of the Council of 12 December 2017 amending the CRR as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any Member State (OJ L 345, 27.12.2017, pp. 27-33).

[14] COM (2018) 133 final.

[15] COM (2018) 822 final.

[16] Available at: https://www.eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-management-of-non-performing-and-forborne-exposures. The EBA, an integral part of the European System of Financial Supervision (ESFS), was established by virtue of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 (OJ L 331, 15.12.2010, pp. 12-47).

[17] OJ L 111, 25.4.2019, pp. 4-12.

loans.[18] Their ability to perform those transformations is concurrently the main cause of their (structural) exposure to credit, (income) interest-rate and liquidity risks, respectively, and hence the main reason underlying their management. It also constitutes the rationale for their prudential regulation aimed at ensuring the stability of the banking sector, which can be threatened due to excessive risk exposure (arising from the above financial risks or from other financial and/or non-financial risks).[19] According to traditional banking theory,[20] a key function of banks is to act as 'delegated monitors' and appropriately assess and price credit risks (*inter alia*, by adequately pledging assets as collateral and taking guarantees). The accumulation, thus, of NPLs (bad loans, impaired assets) on their balance sheets is considered to be a pathological development in relation to this function, even though loan workouts are part and parcel of normal banking business, if the size of NPLs reaches systemic proportions (in which case alternative measures should be taken to deal with the problem, not the least of which is to ensure that corporate restructuring occurs). An NPL is a loan in which the borrower is in default and has not paid the monthly principal and interest repayments for a specified period (typically over 90 days).

(2) The above-mentioned EBA Guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06) define NPLs as loans and advances as (further) defined in Annex V to Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 "laying down implementing technical standards with regard to supervisory reporting of institutions according to [the CRR]"[21] and classified as non-performing in accordance with this same Annex V. On the other hand, NPEs are defined as exposures classified as non-performing in accordance with Annex V to the same Commission Implementing Regulation. Beyond loans and advances, such exposures include other debt instruments, such as a debt security, an advance and a demand deposit. Credit institutions are also required to report the NPL ratio as a measure of their exposure to credit risk and the quality of outstanding loans. In calculating this ratio, the gross carrying amount of NPLs and advances is divided by the gross carrying amount of total loans and advances pursuant to the NPE definition.[22]

(3) As soon as a loan is classified as non-performing, the likelihood of receiving repayments is lowered. This has a negative impact on banks' cash flows; since less earning income is available to generate new loans and cover operating costs, banks' liquidity, profitability and financial performance, as well as the market price of their equity, if publicly traded, are negatively affected. The prudential regulatory framework requires banks to make (loan loss) provisions for credit risk arising from NPLs to cover expected losses in case write offs, also affecting their capital adequacy. In an adverse scenario, a bank might fail to meet its minimum capital requirements and thus prompt the competent authorities to take crisis prevention, or even crisis management, measures.[23]

[18] For a detailed presentation, see Allen and Santomero (1999), Allen (2001), Allen and Gale (2001) and Gorton and Winton (2002).

[19] For a review of the literature on this aspect, see Gortsos (2020a), pp. 14-27.

[20] On this, see the seminal paper by Diamond (1984).

[21] OJ L 191, 28.6.2014, pp. 1-1861.

[22] EBA Guidelines (2018), p. 17.

[23] See on this Miglionico (2020), p. 24 (with further references).

1.3. The impact of the COVID-19 pandemic crisis

1.3.1. General overview and the robustness of the EU banking sector before the onset of the COVID-19 pandemic crisis

(1) The current COVID-19 pandemic crisis (hereinafter the 'pandemic crisis') was triggered by a low-probability non-financial risk.[24] In that respect, its root cause is different from the GFC, which was caused by failings (mainly albeit not exclusively) of the financial sector, and of the subsequent fiscal crisis in the euro area, which is attributed to poor fiscal policies in some Member States and banking instability in others. From an economic point of view and from the outset of the pandemic crisis, the focus has been on the rescue of companies in the real sector of the economy. As noted, *inter alia*, by Andrea Enria, Chair of the ECB Supervisory Board: "*Unlike in the 2008 financial crisis, banks are not the source of the problem this time. But we need to ensure that they can be part of the solution*".[25] Threats to financial stability and particularly to the stability of the banking sector (system) are also apparent. In accordance with its two sets of actions, published on 6 and 27 March 2020,[26] the General Board of the European Systemic Risk Board (ESRB), the EU agency entrusted with macro-prudential oversight in the EU,[27] addressed five major financial stability issues.[28] Nevertheless, even though the accumulated stock of NPLs before the pandemic crisis (the so-called 'legacy NPLs'[29]) has (as already noted) been significantly reduced, an additional stability-related issue, of primary importance, is the emerging new wave of NPLs caused by the pandemic crisis.

(2) Just before the onset of the pandemic crisis, the EU banking sector was quite robust. EU credit institutions, several of which were at the centre of the GFC, were much better capitalised and with stronger liquidity, while financial stability has also been overall enhanced, as manifested, *inter alia*, by the quarterly EBA Risk Dashboard of 14 April 2020, which covered data from the 4th quarter of 2019.[30] This is not only due to the enhanced supervisory framework in force but also (and primarily) to the so-called "Basel III impact", namely the fact that credit institutions benefited from having implemented macro-prudential buffers and liquidity ratios, which were introduced, as international financial standards, by the so-called 2010 'Basel III regulatory framework' of the Basel Committee on Banking Supervision (BCBS).[31] These buffers are currently available to allow them to effectively contribute to the short- and longer-term financing of economic activity and recovery in the EU without putting at stake their minimum capital adequacy requirements, and complement the higher quality of capital, which has also been a by-product of the Basel III regulatory framework, as applied in the EU in accordance with the provisions of the CRR and the CRD IV.

[24] Low-probability (frequency) financial and non-financial risks tend to expose credit institutions to 'disaster myopia'; see on this Guttentag and Herring (1986).

[25] Available at: https://www.bankingsupervision.europa.eu/press/interviews/date/2020/html/ssm.in200623~e668f871fa.en.html.

[26] Available at: https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200514~bb1f96a327.en.html and https://www.esrb.europa.eu/news/pr/date/2020/html/esrb.pr200608~c9d71f035a.en.html, respectively.

[27] The ESRB, another part of the ESFS, was established by virtue of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 (OJ L 331, 15.12.2010, pp. 1-11). On the (significant) role of the ECB therein, see Gortsos (2020a), pp. 371-373.

[28] These were in addition to its Recommendations in the field of financial macro-prudential oversight to address pandemic-related systemic vulnerabilities; see at: https://www.esrb.europa.eu/home/search/coronavirus/html/index.en.html.

[29] On legacy NPLs as a market failure problem, see Lamandini *et al.* (2017), pp. 5-6, with extensive further references.

[30] According to this Dashboard (available at: https://eba.europa.eu/eu-banks-sail-through-corona-crisis-sound-capital-ratios), which summarised the main risks and vulnerabilities in the EU banking sector ahead of the crisis, EU credit institutions' capital ratios and asset quality had (on average) constantly improved (even though return on equity had worsened).

[31] On this framework, as in force, see at: https://www.bis.org/bcbs/basel3.htm; on its evolution, see, by means of mere indication, McNamara and Metrick (2014a) and (2014b), Bodellini (2019) and Gortsos (2021).

1.3.2. Measures taken by the ECB and the EBA and the European Commission's 2020 NPL Action Plan

(1) Immediately after the onset of the pandemic crisis, the EU developed a coherent strategy, which has taken into account the spill-overs and interlinkages between EU economies and the need to preserve confidence and stability. The measures adopted in order to deal with health emergency needs, support economic activity and employment, preserve monetary and financial stability and prepare the ground for recovery, contain a combination of government fiscal *stimuli*[32] (with extensive resort to the principle of solidarity), emergency liquidity and monetary policy measures by the ECB, applying both its conventional (interest rate) and unconventional (mainly, balance-sheet) measures,[33] as well as measures relating to financial stability.

(2) The financial stability-related measures taken by the ECB within the SSM (which were designed as temporary) include[34] the relaxation of some macro-prudential buffers and the adaptation of the composition of specific capital requirements;[35] the reduction of capital requirements for market risk (to maintain their ability to provide market liquidity and continue their market-making activities); the application of flexibility regarding, mainly, the regulatory treatment of NPLs; and *finally*, the recommendation to credit institutions (on the basis of the 'comply or explain principle') to refrain from making dividend distributions and performing share buy-backs aimed at remunerating shareholders during the duration of the pandemic to maximise the support to the real economy.[36] The EBA's stance was complementary. Following its initial statement, of 12 March, on actions to mitigate the impact of COVID-19 on the EU banking sector (the date on which it also decided to postpone the 2020 EU-wide stress test exercise to 2021[37]), it then provided clarity on the flexible application of the prudential framework in light of COVID-19 measures,[38] while calling for heightened attention to ensuing risks.[39] Finally, in accordance with Article 16 of its founding Regulation, it also issued a set of Guidelines, including those of 2 April "On legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis" (EBA/GL/2020/02),[40] to application of which was then further extended.

(3) It is finally noted that on 16 December 2020, the European Commission published its Communication "Tackling non-performing loans in the aftermath of the COVID-19 pandemic",[41] which set out its new NPL Action Plan, intended to prevent a future build-up of NPLs across the EU due to the pandemic (hereinafter, the '2020 NPL Action Plan'). The strategy proposed contains four pillars: *first*,

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[32] On the early fiscal stimuli, see Hadjiemmanuil (2020b). Notable is in this context the recently adopted "Next Generation EU" fiscal package, including as key element the Recovery and Resilience Facility (RRF, established by Regulation (EU) 2021/241 of the European Parliament and of the Council of 12 February 2021, OJ L 57, 18.2.2021, pp. 17-75*)*, which aims to boost aggregate demand, support the most hard-hit Member States and strengthen EU economic growth.

[33] For a detailed presentation, see Gortsos (2020c). For an overview of the framework governing the ECB's conventional monetary policy measures ("general framework" in its terminology) (just) before the pandemic crisis, see Gortsos (2020a), pp. 286-297; on unconventional monetary policy measures and the framework governing such ECB measures (the "temporary framework"), see *ibid.*, pp. 12-14 and 297-300, respectively.

[34] In addition, the ECB also fully supported the adoption of Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending the CRR and Regulation (EU) 2019/876 of the same institutions of 7 June 2019 (OJ 150, 7.6.2019, pp. 1-225, CRR II) as regards certain adjustments in response to the COVID-19 pandemic (OJ L 204, 26.6.2020, pp. 4-17). On this legislative act, see Wojcik (2020).

[35] For a more detailed presentation, see Joosen (2020) and Gortsos (2020c), pp. 248-253. Equivalent initiatives were undertaken at global level by the BCBS in accordance with its Report of 3 April 2020 "Measures to reflect the impact of COVID-19" (available at: https://www.bis.org/bcbs/publ/d498.htm).

[36] ECB Recommendation of 15 December 2020 (ECB/2020/62, OJ C 437, 18.12.2020, pp. 1-3), currently in force.

[37] Available at: https://www.eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector.

[38] Available at: https://eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector; https://eba.europa.eu/eba-provides-clarity-banks-consumers-application-prudential-framework-light-covid-19-measures; and https://eba.europa.eu/eba-provides-additional-clarity-on-measures-mitigate-impact-covid-19-eu-banking-sector.

[39] Available at: https://eba.europa.eu/eba-provides-further-guidance-use-flexibility-relation-covid-19-and-calls-heightened-attention-risks.

[40] Available at: https://eba.europa.eu/eba-publishes-guidelines-treatment-public-and-private-moratoria-light-covid-19-measures.

[41] COM (2020) 822 final.

the further development of secondary markets for distressed assets; *second*, the reform of the EU's corporate insolvency and debt recovery legislation; *third*, the support of the establishment and cooperation of national asset management companies (AMCs) and eventually a cross-border network among national AMCs at EU level; and *fourth*, the implementation of precautionary public support measures to ensure the continued funding of the real economy under the BRRD and State aid frameworks.[42]

2. ASSET MANAGEMENT COMPANIES (AMCS) AND EFFICIENCY IN FACILITATING NPL MANAGEMENT AND RECOVERY

2.1. On the ecosystem of AMCs: objectives, operational goals and structural issues

2.1.1. General remarks

(1) In comparative terms, there are three main asset management objectives of AMCs (also referred to as 'bad banks') within a crisis management process: *first*, the resolution of insolvent banks;[43] *second*, the restructuring of distressed but viable banks, serving as a vehicle for removing NPLs from their balance sheet; and *third*, the privatisation of government-owned banks.[44] In the context of this study, only the second objective is of interest (note that the first is also set out in the EU resolution framework as one of the available resolution tools, which can only be applied in combination with another resolution tool[45]). In relation to this, AMCs may, under conditions, be an effective measure when NPLs affect a large part of the banking sector (which eventually could lead to a systemic crisis).[46] Social objectives may also be added to their objectives.[47]

(2) The effective operation of AMCs requires clearly defined operational goals. Typically, their primary operational goal is to remove NPLs from banks' balance sheets and maximise their value by active workouts and a recovery in asset prices over time, while at the same time preventing moral hazard in terms of borrowers' credit discipline. In this respect, the priority target of AMCs, the duration of which is usually finite, should be to dispose of the NPLs as quickly as possible (to avoid, *inter alia*, further deterioration in value) and minimise operational cost. Their asset management and disposition strategies, including the valuation of assets, funding strategy and speed of asset disposition, should be primarily a commercial decision and their operations should be guided by a profit maximisation or loss

[42] All these pillars are further discussed below as appropriate (in the following Section 2 on AMCs, which is the focus of this paper, and then in Section 3 (briefly) on all the other).

[43] Unlike in the previous Section (with the exception of Sub-section 1.2) and in the following Sections 3 and 4, in the present Section the author prefers to use the term bank instead of the (synonymous) term credit institution, since the latter is only used under EU law.

[44] See details in Woo (2000), pp. 11-17. In the recent past, notable examples of AMCs set up to serve the first objective include the US Resolution Trust Corporation (RTC) and the Thai Financial Sector Restructuring Agency. For an historical overview of public AMCs established at a global level (in the wake of a systemic crisis), see Enoch *et al.* (1997), Klingebiel (2000), pp. 8-22, Noussia (2010) and Arner *et al.* (2020), pp. 30-35 (in relation to the GFC), Cerruti and Neyens (2016), pp. 13-14 and 51-130 (distinguishing between three generations of public AMCs), as well as Medina Cas and Peresa (2016) and Lamandini *et al.* (2017), pp. 14-20 on recent EU experiences.

[45] The asset separation resolution tool is governed by Article 42 BRRD and Article 26 SRMR. This aspect is also covered by the analysis in the AMC Blueprint (2018), but (as just mentioned) not further discussed in this paper. Furthermore, in the context of insolvency proceedings and, national law permitting, the failed bank may also be split by transfer of certain impaired assets to an AMC in order to sell the 'good' part. This dimension is not further discussed herein either (see AMC Blueprint (2018), p. 6, under scenario 3).

[46] AMCs may also be established in order to deal with other "toxic assets" held in banks' portfolios, as was the case during the GFC. See on this Noussia (2010), as well as van Suntum and Ilgmann (2011), on the AMC set up in Germany in 2009.

[47] See on this further below, under Section 2.3.1.

minimisation goal, acting as a market participant and fully taking into account market conditions and funding cost considerations.[48]

(3) There are two different approaches with regard to the number of AMCs to be established: under the centralised approach, there a single (system-wide), national AMC; under the decentralised approach there is a number of competing AMCs offering targeted, bank-specific approaches. AMCs can be either public (state-sponsored), typically when the centralised approach has been opted for, or private, typically under the decentralised approach, in which case AMCs are set up as subsidiary companies of the banks selling the NPLs and without involvement of their management.[49]

(4) Public AMCs under the centralised approach (the focus of this paper) should be established by law and could be set either *ad hoc* or by conferring relating tasks to an existing public agency,[50] such as the ministry of finance or the deposit insurer.[51] The case for establishing such an AMC is, *inter alia*, stronger when the amount of NPLs is substantial, the transfer must be effected over a short period of time (in which case private investors would not be willing to be involved unless government guarantees covering the future value of the asset portfolio would be provided) and the depth of the market for assets is not substantial. Since, however, no single model of AMCs fits all circumstances, they should be set up according to the needs and the structure of the domestic banking sector. Furthermore, while participation in an AMC can be voluntary or mandatory for banks, dominant is the mandatory transfer of NPLs by setting up mandatory participation schemes relying on public support conditionality.[52]

2.1.2. Advantages and disadvantages – inherent incentive issues

(1) Dealing with NPLs under the centralised approach, by establishing a single public AMC as a vehicle for getting NPLs out of distressed banks, has certain advantages and disadvantages.[53] On the one hand, such AMCs can (under conditions) obtain economies of scale (and scope) in recovering value from specific types of NPLs by procuring and consolidating scarce workout skills and resources (e.g., in the fields of real estate and liquidation of firms), which are different from those for bank lending, and by achieving creditor coordination at a higher level.[54] The managerial factor (including strong leadership) is of critical importance in this respect since weak management may reduce the effectiveness of an AMC's operations and eventually lead to a generalised deterioration of credit discipline. *Furthermore*, public AMCs may also be in a better position to improve the collectability of loans and force the

[48] This "rapid asset disposition" operational goal should be distinguished from the "restructuring" goal of achieving broader corporate restructuring of borrowers; see on this Klingebiel (2000), pp. 6-8. During the savings and loan crisis in the 1980ies, the US adopted by statute the goal of maximising the net present value of the assets to be managed by the RTC and the Federal Deposit Insurance Corporation (FDIC) in order to force asset managers to recognise the time value of money in making decisions regarding assets; see Ingves *et al.* (2004), pp. 5-6.

[49] See Ingves *et al.* (2004), pp. 8-10, Klingebiel (2000) and Cerruti and Neyens (2016), pp. 14-16. According to Aiyar *et al.* (2015) (p. 30, at 56) larger banks are in a better position to establish their own private AMCs. On a proposal to give bank shareholders the option to set up an AMC and finance it by requiring the bank to issue bail-inable bonds (without any government intervention) see Lucchetta *et al.* (2019). For a cost-benefit analysis of the decentralised approach, see Ingves *et al.* (2004), p. 9.

[50] Preferably, AMCs should not be set up within the central bank (or as its subsidiary), since the monetary authority's balance sheet should not be made unwieldy by taking on large amounts of NPLs of the banking sector (see Ingves *et al.* (2004), pp. 7-8). On the other hand, in the author's view, banking supervisors (including central banks if financial supervisory tasks have been conferred upon them), should be responsible for the prudential supervision of AMCs as to specific aspects; see on this below, under 2.3.1.

[51] Deposit insurers could be eligible to the extent that their statutory functions would cover such cases as well (i.e., beyond their primary 'payout (or paybox) function'); on this aspect, see Gortsos (2020d), p. 6.

[52] See Cerruti and Neyens (2016), pp. 18-19.

[53] On the advantages and disadvantages of a centralised public AMC, see Klingebiel (2000), pp. 3-6 and Ingves *et al.* (2004), pp. 8-10. The latter also note (pp. 10-11) that during the Asian financial crises of the late 1990ies, centralised, typically state-owned AMCs were set up in Indonesia, Korea, and Malaysia, while in Thailand a more mixed approach was applied, including the establishment of a public AMC to purchase residual assets (for more details on this, see also Adams *et al.* (2000, editors) and Arner *et al.* (2020), pp. 19-29).

[54] As the number of assets and debtors increases economies of scale may diminish, while significant economies of scope for various asset classes are rarely achievable for AMCs; see AMC Blueprint (2018), p. 8.

operational restructuring of distressed banks, allowing them, by removing their legacy NPLs to resume their primary lending function to companies and households. *Finally*, by centralising ownership of collateral they can potentially provide more leverage over debtors and manage the collateral more effectively.

On the other hand, disadvantages are also apparent and may significantly undermine the efficiency of public AMCs. *First*, and most importantly, unless safeguards are in place, insulation from political pressure may be difficult, especially when the amount of NPLs is large, in which case NPLs and collateral may be long-term "parked" in an AMC and not liquidated. *Furthermore*, informational advantages embedded in the long-term bank-firm relationships (banks collecting information on their borrowers) may be compromised. *Finally*, further aspects to be addressed are the determination of transfer prices (which may prove a challenging task, especially in the absence of market values[55]) and the control of operating costs (which may be higher).

(2) Closely related to this (cost-benefit) analysis are some inherent incentive issues. The first derives from the fact that AMCs (in general) are in the "business of going out of business", being self-liquidating entities after they have liquidated the assets under their management. Hence, the design and application of appropriately structured incentives for their board members is necessary in order to prevent them from becoming "NPL warehouses" and counterbalance the motivations of their staff to unnecessarily prolong the life of the AMC. Another incentive issue is the means to motivate employees and managers to maximise outcomes consistent with the goals set. Taking as a starting point the assumption that AMCs should essentially work on a *quasi*-commercial basis, their ability to attract and retain employees with appropriate skills and motivate them to maximise recoveries on NPLs as quickly as possible is also essential (e.g., by having two components in the compensation package, salary and performance-based bonuses).[56]

2.2. On the efficiency of AMCs as a tool to facilitate NPL management and recovery

2.2.1. Institutional architecture: supporting legal framework and governance issues

Taking into account the above-mentioned, the efficiency of public AMCs as a tool to facilitate NPL management and recovery mainly depends on the following conditions:[57]

First, the legal framework governing AMCs should provide for clean transfers of titles in asset transactions and remove potential legal obstacles for the transfer of assets; legal protection for the management in the execution (in good faith) of their responsibilities should also be considered, in order to avoid undue delays in asset disposition by perceived potential legal liabilities; clearly defining the rights of ownership and the legal obligations imposed on debtors and creditors; and endowing the AMCs with legal powers, as appropriate, to facilitate asset recovery and restructuring.

Furthermore, the independence and transparency of AMCs are also necessary conditions to assure their efficiency and should explicitly be anchored in the legal framework governing them. Independence is the best means for AMCs to be insulated from political interventions in the disposition and restructuring of assets, given that the very nature of this asset management process invites such

[55] See also below, under 2.2.2.

[56] See Ingves *et al.* (2004), pp. 17-18.

[57] See Ingves *et al.* (2004), pp. 13-15 and Cerruti and Neyens (2016), pp. 15-18 and 24-27.

intervention, especially when large volumes of NPLs are involved. Transparency with respect to their operations and performance should also be part of their governance to maintain public trust in the fairness and objectiveness of the liquidation process.

Finally, corporate governance issues are vital as well and should also be anchored in the relevant legislation. AMCs' governance structure should support their operational goals and ensure that they can be attained by the management. Accordingly, their management body should have a clearly defined mandate and uphold well-established principles of corporate governance, such as selection of its members on the basis of fit-and-proper criteria, distinction between executive and non-executive (including independent) members of the management body, 'independence of mind' of the members and appropriate remuneration policies.[58]

2.2.2. Operational and funding issues

There are two main operational issues for public AMCs. The *first* relates to the perimeter of assets to be transferred. To the extent that a public AMC would buy assets from all distressed banks, the asset perimeter should be flexibly defined as to maximise potential and upside, framed, however, on the basis of the constraint that the management of some asset classes and the recovery of value from them are more difficult.[59] In order for the AMC to achieve sufficient recoveries, of significant importance is also the collateral attached to the NPLs transferred. Furthermore, the purchase should (in principle) be a one-off, since an open-ended transfer arrangement could create moral hazard problems, undermining the credit discipline of the banks. The *second* operational issue concerns the valuation of assets, to be carried out preferably on the basis of market values (prices) (which, nevertheless, may be absent or, depending on the conditions prevailing in the economy at the time of transfer, significantly depressed[60]), sound accounting rules,[61] strict loan classification and provisioning standards and/or at discounted present values.

A final related aspect is that of the funding process, which is necessary in order for AMCs both to meet their objectives (starting with the purchase of NPLs) and to finance their operations (within the constraints set out in their budget). These funds should be in the form of (loss-absorbing) equity capital coupled with guarantees or (preferably) market funding without a guarantee (e.g., funding from the issuance of bonds).[62]

[58] This aspect is analysed in details below, under 2.3.2.

[59] See also further below, under 2.3.3.

[60] This can also apply to the value of collateral at the time the NPLs have been transferred.

[61] For details on this aspect, see Bholat *et al.* (2016), pp 33-41; see also Miglionico (2020), p. 25.

[62] On these operational issues, see Ingves *et al.* (2004), pp. 19-23, supporting, *inter alia*, the argument that the transfer of assets to AMCs should be executed at fair market value and that rigorous recognition of loan losses is an important element of an effective strategy for dealing with NPLs, as it creates the right incentives for banks to restructure their loans, foreclose on collateral and precipitate bankruptcy reorganisations. On the funding issue, see *ibid.*, pp. 23-24. See also Cerruti and Neyens (2016), pp. 20-23 and 27-28, respectively.

2.3. Proposals on certain specific conditions for the efficient operation of public AMCs in the EU

Taking account of the above literature review and analysis and, in particular, both the advantages and disadvantages of their operation, the following proposals are tabled with regard to certain specific conditions which, if appropriately designed and effectively implemented,[63] could contribute to the efficient operation of public AMCs in the EU.[64]

2.3.1. Addressing institutional issues

(1) Taking as a starting point that the 'one-size-fits-all' approach (model) does not apply in the case of public AMCs, these should be set up on the basis of national law, which should cater to the specific needs and structure of the domestic banking sector,[65] always taking account of the alternative measures available (including the setting up of an AMC at EU level).[66]

(2) The legal framework governing the AMC should, *inter alia*, clearly define its objectives and goals, its establishment as a one-off vehicle,[67] the time limits (and other safeguards) of its operation, as well as its lifespan (which should be limited).[68] The above-mentioned[69] legal aspects (i.e., clean transfers of titles, removal of any legal obstacles to the transfer of assets, legal protection for management in the execution (in good faith) of its responsibilities, clear definition of the rights of ownership and the legal obligations imposed on debtors and creditors and endowment of the AMC with legal powers to facilitate asset recovery and restructuring) should as well be dealt with in the legal framework, which, in addition, should also enable the AMC to adopt all policies and procedures which are necessary for its efficient functioning.

(3) Assets should be managed and disposed of in accordance with specific, clearly defined objectives, spearheaded by *first*, to maximise the recovery value of the NPLs transferred to the AMC[70] and *second*, to prevent the deterioration of borrowers' credit discipline. The profit-maximising goal guiding the valuation of assets, funding strategy, and speed of asset disposition should also be laid down as a primary one. Secondary objectives should be subordinated to the primary ones and could also include social ones. A notable example was the RTC in the US, which was required to promote social goals in the areas of affordable housing and historic preservation by developing programmes and giving preference to buyers meeting specific program goals.[71] This could alleviate any major socio-economic impact from the operation of AMCs, should, nevertheless, be designed in a way that the primary

[63] According to Cerruti and Neyens (2016) (pp. 24-26), the Czech Revitalization Agency is a typical example of a "good design overwhelmed by poor implementation". This reinforces the argument that better (legal, political, social and economic) institutions, including adequate enforcement mechanism, have an important impact on economic performance (see by means of mere indication the seminal work of Williamson (2000)).

[64] Reference is also made hereinafter, as appropriate, to the Summary of the AMC Blueprint (2018) (further developed in Sections I-V and the Annex) and the 2020 NPL Action Plan. Accounting and funding issues are not further discussed; on these aspects, see AMC Blueprint (2018), pp. 10-11 and 11-12, respectively. On this aspect, see also Cerruti and Neyens (2016), Medina Cas and Peresa (2016) (drawing on experiences from the NAMA, the SAREB and the German Financial Market Stabilisation (FMS) Wertmanagement), Fell *et. al.* (2017) and Lamandini *et al.* (2017).

[65] See AMC Blueprint (2018), p. 7 and 2020 NPL Action Plan, p. 12.

[66] On this aspect, see Section 3 below.

[67] See also just above, under 2.2.2.

[68] See also AMC Blueprint (2018), pp. 7-8 (on design and set-up), 12-13 (on safeguard mechanisms) and p. 14 (on closing).

[69] See above, under 2.2.1.

[70] See also AMC Blueprint (2018), p. 8.

[71] See Ingves *et al.* (2004), p. 6; see also Medina Cas and Peresa (2016) (at p. 27) in relation to the social mandates of the Irish National Asset Management Agency (NAMA) and the Spanish Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB).

objectives would not be compromised and, in particular, that credit discipline in the banking sector would not be undermined.[72]

(4) As already noted,[73] one of the strongest advantages of single, public AMCs is their ability to obtain (albeit under conditions) economies of scale by procuring and consolidating scarce workout skills and resources and achieving creditor coordination at a higher level. This critically depends on the managerial factor, appropriately structured incentives and the commercial orientation of their operations,[74] which, in turn, requires appropriate policies regarding the selection of assets to be transferred, the pricing of such assets, adequate funding and sound strategic plan reviews for asset recovery.[75]

(5) AMCs should be subject, as financial institutions,[76] to prudential supervision by the same national competent authorities (NCAs) which are also responsible for the micro-prudential supervision of credit institutions under national law.[77] This supervisory task should cover AMCs' compliance with their mandate, as well as with accounting rules and governance requirements and review of their business plan.[78]

(6) In order to insulate AMCs from political pressure, one of their (potentially) most important above-mentioned disadvantages if unaddressed (as already noted[79]), their independence should explicitly be enshrined in the legal framework governing them. Despite the fact that they are not public authorities, their independence should be structured taking into consideration the same principles set out for the independence of central banks, and mainly functional, financial (in terms of their operating budget, which should be separate from their funding for the purchase of NPLs) and operational.[80] On the other hand, in order to attain transparency, the legal framework should impose obligations on AMCs: *first*, to regularly publish reports on their performance in terms of progress towards their goal, which will allow its evaluation; *second*, to prepare their financial statements in accordance with accepted liquidation and accounting practices; and *third*, to be regularly audited and ensure that their financial statements are accurate and representations as to the value of assets are reasonable.[81]

2.3.2. In particular: addressing corporate governance issues

The existence of robust corporate governance arrangements is a condition of utmost importance to safeguard the efficient operation of AMCs and relevant rules should be enshrined in legislation. In

[72] See also AMC Blueprint (2018), p. 7. In any case, it is past experiences which support the view that, if objectives and goals are clearly defined and consistent, efficiency gains can exponentially increase.

[73] See above, under 2.1.2.

[74] See also AMC Blueprint (2018), p. 13 (on organisation and staffing).

[75] On the latter aspect, see also *ibid.*, p. 13 (on strategic planning).

[76] Under EU secondary law, 'financial institution' means an undertaking, other than a credit institution or an investment firm, the principal activity of which is to acquire holdings *or* to pursue any of the activities listed in points (2)-(12) and (15) of Annex I to the CRD IV (CRR, Article 4(1), point (26)). Bank-specific AMCs set up in accordance with the decentralised approach are usually treated by national legislation as financial institutions and are subject to prudential supervision as such.

[77] In the author's view, prudential supervision within the SSM (either directly by the ECB or directly by NCAs under the oversight of the ECB) could lead to efficiency enhancement; it would, nevertheless, require amendment of the SSMR and, in any case, be confined to AMCs operating in participating Member States.

[78] See also AMC Blueprint (2018), p. 13 (supervision), where it is also noted that if public funding is at stake, an observer function for the European authorities could be considered.

[79] See above, under 2.1.2.

[80] See also AMC Blueprint (2018), p. 8. This classification of the various aspects of independence (which also includes the personal dimension) is based on the seminal work of Louis (1989), pp. 25-28; on institutional independence, see also Lastra (2018), with extensive further references.

[81] In this respect, see also Ingves *et al.* (2004), pp. 14-15 and AMC Blueprint (2018), p. 13 (on internal controls and transparency).

particular (and taking into account the rules governing the arrangements applicable to credit institutions and investment firms,[82] which should apply *mutatis mutandis*[83]), the following is proposed:

First, the members of the AMC's management body should be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform its duties. The AMC should notify to the relevant NCA any change in the composition of its management body as far as managerial and supervisory functions are concerned. This 'fit and proper assessment' of the management body's members should form an integral part of the AMC's authorisation as financial institution, as well as of its ongoing operation. *Furthermore*, the AMC should ensure that the management body continuously and collectively possesses adequate knowledge, skills and experience to be able to understand the AMCs' activities, including the main risks.

Second, regardless of the board structure, the management body in its management function should engage actively in the business of the AMC and take decisions on a sound and well-informed basis, while the role of the members of the management body in its supervisory function should include monitoring and constructively challenging the strategy of the AMC. The management body in its supervisory function should include a sufficient number of independent members fulfilling specific independence criteria set out in legislation. *Furthermore*, the AMC should assess the existence of potential conflicts of interest in relation to the members of the management body that would impede its ability to perform its duties independently and objectively and take corrective measures as appropriate.

Third, acting with 'independence of mind' is a pattern of behavior, shown, in particular, during discussions and decision-making within the management body, and should be required for each member of the management body, regardless of whether or not considered as independent. All members should actively engage in their duties and should be able to make their own sound, objective and independent decisions and judgments when performing their functions and responsibilities.

Fourth, the AMC should develop and maintain a culture encouraging a positive attitude towards risk control and compliance, as well as a robust and comprehensive internal control framework. Under this framework, its business lines should be responsible for managing the risks it incurs in conducting its activities and have controls in place that aim to ensure compliance with internal and external requirements. As part of this framework, the AMC should have internal control functions with appropriate and sufficient authority and access to the management body to fulfil its mission, as well as a risk management framework. The internal control framework should ensure effective and efficient operations; prudent conduct of business; adequate identification, measurement and mitigation of risks; the reliability of financial and non-financial information reported both internally and externally;

[82] See ECB 2014 Guide to Banking Supervision of November 2014, paragraph 67. As regards the process and criteria used for this assessment, applicable are the Joint ESMA and EBA Guidelines of 21 March 2018 "on the assessment of the suitability of members of the management body and key function holders" (ESMA 71-99-598, EBA/GL/2017/12, available at: https://www.eba.europa.eu/regulation-and-policy/internal-governance/joint-esma-and-eba-guidelines-on-the-assessment-of-the-suitability-of-members-of-the-management-body), the EBA Guidelines of 21 March 2018 "on internal governance" (EBA/GL/2017/11, available at: https://www.eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance-revised), the ECB "Guide to fit and proper assessments" of May 2019 (at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.fap_guide_201705_rev_201805.en.pdf), the EBA Guidelines of 21 December 2015 "on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013" (EBA/GL/2015/22) available at: https://www.eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies), and paragraph 89 of the (above-mentioned) EBA Guidelines on the SREP (EBA/GL/2018/03). On this aspect, see Busch and Teubner (2019).

[83] The corporate governance rules to be applied to AMCs should take account of the specific features of their functions and operation, which to a certain extent (e.g., types of risk exposure) are different from those of credit institutions and investment firms.

sound administrative and accounting procedures; and compliance with regulatory and supervisory requirements and the AMC's internal policies, processes, rules and decisions.

Fifth, the AMC should have in place and implement a policy promoting diversity on the management body, in order to promote a diverse pool of members, taking into account gender, age educational and professional background. It should aim to engage a broad set of qualities and competences when recruiting members of the management body, to achieve a variety of views and experiences and to facilitate independent opinions and sound decision-making within the management body.

Finally, the AMC should apply remuneration policies that are consistent with and promote sound and effective risk management and do not provide incentives for excessive risk taking, while also taking into account the fact that AMCs should (as already mentioned[84]) be in a position to attract and retain employees with appropriate skills and motivate them to maximise recoveries on NPLs.

2.3.3. Addressing operational issues

(1) In order to ensure its overall effectiveness would not be impaired, specific selection criteria should be applied as to the perimeter of assets to be transferred to an AMC. Categories of assets likely to be managed more effectively by it include loans secured by commercial real estate, including those to SMEs, large corporate exposures even if not secured by commercial real estate, foreclosed properties, as well as (upon specific conditions, including a limited size) residential real estate mortgages and SME loans (which may be predominant during the current pandemic crisis).[85] On the other hand, loans with potential for in-house restructuring, those of customers with whom credit institutions would like to maintain their long-term relationships and small value, unsecured credits (whose recovery can be undertaken more efficiently at branch level) should be kept within them. In addition, to avoid moral hazard problems undermining credit institutions' credit discipline, open-ended, repeated transfer arrangement should be avoided.[86]

(2) In relation to the second major operational issue relating to the functioning of AMCs, NPLs should preferably be transferred on the basis of market values, which, nevertheless (as already mentioned[87]), may be absent or significantly depressed. If transfer at market values is not feasible, the transfer price could be determined at a higher level, in which case the amount by which it exceeds the market value would constitute State aid provided by the AMC; accordingly, all future cash flows and costs generated by the management of the NPLs should adequately be taken into account in this determination.[88]

(3) In order to address the problem that informational advantages embedded in the long-term bank-firm relationships may (as already mentioned[89]) be compromised in the case of the establishment of public AMCs, there must be mechanisms in place ensuring that credit institutions transfer to the AMC complete, accurate, reliable, consistent and timely data relating to their NPLs. Furthermore, a thorough data quality assurance should also be performed by the AMC before taking on NPLs, as well as, *ex-post*, data collection and clearing, categorisation and prioritisation of NPLs and regular quality assurance

[84] See above, under 2.1.2.

[85] A minimum size threshold could also be applied to the loans to be purchased. All banks could be eligible to sell their NPLs, but those with NPLs in excess of the threshold should be encouraged to reduce their NPL ratios.

[86] See also AMC Blueprint (2018), pp. 8-10.

[87] See above, under 2.2.2.

[88] See also AMC Blueprint (2018), p. 10, where it is stated that in setting transfer prices a balance should be kept between providing an optimal level of relief for the troubled bank and ensuring the capability of the AMC to adequately recover the costs implied by its operations. It is also stated that the price at which NPLs are purchased by the AMC should not exceed their real economic value.

[89] See above, under 2.1.2.

processes. *Mutatis mutandis*, the same applies to collateral related valuation data. Data sharing with potential investors should be based on specific rules including the protection of confidentiality.[90]

(4) Finally, the author supports the proposal of enabling a cross-border network of existing national AMCs at EU level (jointly with the ECB and the EBA). Such a network, which should comply with EU competition rules, notably on the exchange of confidential information, could create valuable synergies and increase collective effectiveness of national AMCs across the EU, especially in relation to the operational issues involved, through the exchange of best practices and experiences, the implementation of data and transparency standards and the coordination of creditor actions.[91]

2.3.4. *Interim* concluding remarks

(1) On the basis of the previous analysis, the author comes to the first *interim* conclusion that public AMCs set up in Member States under the centralised approach can, indeed, be efficient tools for facilitating NPL management and recovery, albeit upon conditions. These conditions relate to existence of a robust legal framework, which should clearly define the AMC's primary and secondary objectives and goals, its establishment as a one-off vehicle, specific safeguards of its operation and its (limited) lifespan. Furthermore, appropriate policies regarding the selection of assets to be transferred and the pricing of such assets,[92] adequate funding and sound strategic plan reviews for asset recovery should be in place, which would support the managerial factor, appropriately structured incentives and the commercial orientation of its operations.

(2) An AMC should be supervised, as a financial institution, by the same NCAs which are responsible for the micro-prudential supervision of credit institutions under national law in respect to its compliance with its mandate, as well as with accounting rules and governance requirements and review of its business plan. Its functional, financial and operational independence should explicitly be enshrined in the legal framework in order to insulate it from political pressure. Transparency relating to its operation should also be set out in the legal framework and impose on the AMC, *inter alia*, to regularly publish reports on its performance in terms of progress towards their goal, which will allow the public and the government to evaluate it.[93] Of utmost importance is finally the existence of an appropriate corporate governance framework, meeting all the conditions set out above.[94] The above-mentioned operational issues,[95] and most importantly the application of specific selection criteria and market valuation, to the extent possible, of the assets to be transferred, should also be addressed.

[90] See also AMC Blueprint (2018), p. 11.

[91] On this aspect, see 2020 NPL Action Plan, p. 12.

[92] See above, under 2.3.3.

[93] See above, under 2.3.1.

[94] See above, under 2.3.2.

[95] See above, under 2.3.3.

3. ALTERNATIVES TO A NATIONAL AMC

(1) Proper management and disposition of NPLs is one of the most critical and complex aspects of successful and speedy bank restructuring.[96] The setting-up of national, public (state-sponsored) AMCs under the centralised approach is only one among several alternatives to tackle the NPL issue.[97] The decentralised approach, whereby private AMCs are established by individual (usually large) credit institutions, is the first (albeit *per se* not sufficient) alternative.

Furthermore, the establishment of a pan-European AMC has also been proposed (especially for pandemic-induced NPLs).[98] Such an entity could resemble the US Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008 amidst the GFC and, in particular, at the height of the US subprime mortgage crisis. A similar proposal for the EU was aired in 2017 by Andrea Enria, in his former capacity as Chair of the EBA but has not been taken up.[99] The operationalisation of such a scheme is not likely in the short-term, if a decision is at all possible, given existing divergent approaches, *inter alia* on moral hazard considerations due to debt mutualisation, as well as differentiated recovery rates and levels of market transparency among Member States.[100]

(2) Other alternative impaired asset measures include, *inter alia*, guarantees or asset protection schemes (APSs)[101] and systematic securitisation-based schemes,[102] such as the Italian Garanzia sulla Cartolarizzazione delle Sofferenze (GACS) no-aid scheme and the Greek Hercules (to be further expanded).[103] In relation to the securitisation of NPLs a major public policy concern is whether the rules governing (retail) investor protection in accordance with the provisions of the STS Regulation are complied with and capital markets supervisors are in a position to identify non-compliance and, if this is the case, impose the relevant sanctions.[104]

[96] On the obstacles to NPL resolution in the EU, see Aiyar *et al.* (2015), pp. 13-25. On proposals for a comprehensive EU strategy on NPLs, see by means of indication Aiyar *et al.* (2015), pp. 25-32 and Montanaro (2019), pp. 232-238.

[97] For an empirical analysis on the extent to which AMCs (which are named by the authors 'impaired asset segregation tool') led to a recovery in the originating banks' lending and in a reduction in NPLs, on the basis of data covering 135 credit institutions from 15 European countries over the period 2000-2016, see Brei et al. (2020).

[98] See by means of mere indication Carracosa (2020).

[99] See Enria, Haben and Quagliariello (2017).

[100] On a Pan-European AMC with 'virtually' ringfenced national (country) subsidiaries to ensure burden sharing without debt mutualisation, see Avgouleas and Goodhart (2017). See also Lamandini *et al.* (2017), Huertas (2020), viewing the creation of an EU AMC as a necessary additional (fourth) pillar of the Banking Union and Scope Ratings (2020).

[101] AMCs and APSs pursue similar goals and can complement each other, thereby allowing for tailored approaches to the specific impaired asset situation in a Member State.

[102] On asset securitisation in the context of the 'originate and distribute' model, see European Central Bank (2008). Since the extent to which banks used this practice was a major cause of the GFC (see Borio (2008), pp. 1-13), in its aftermath the framework governing securitisations was substantially modified. Currently it is laid down in two legislative acts of the European Parliament and of the Council of 12 December 2017 (both as in force), namely Regulations (EU) 2017/2401 of 12 December 2017 which amended the CRR mainly on the treatment of securitisation positions, and Regulation (EU) 2017/2402 which laid down a general framework for securitisation and created a specific framework for simple, transparent and standardised securitisation (STS Regulation) (OJ L 347, 12.2.2017, pp. 1-34 and 35-80, respectively).

[103] On this aspect, see 2020 NPL Action Plan, p. 11. In accordance with the Commission's strategy, as laid down it its (above-mentioned) 2020 NPL Action Plan (pp. 6-11), further developing secondary markets for distressed assets will allow credit institutions to remove NPLs from their balance sheets, while ensuring further strengthened protection for debtors. *Inter alia*, with a view to removing existing regulatory obstacles, the Commission considers as vital the adoption of its proposal of March 2018 for a Directive "on credit servicers, credit purchasers and the recovery of collateral" (COM (2018) 0135 final). The objective of this proposed legislative act is to ensure that debtor protection across the single market is not weakened in case of sale of the loan in respect to the protection that the initial lending bank offered and that consumer protection obligations are upheld irrespective of how NPLs are resolved. In addition, and in order to prevent a renewed accumulation of NPLs over a longer time period, the Commission proposed targeted improvements to the securitisation framework for banks' NPEs, which are expected to provide crucial support in tackling the fallout from the pandemic crisis (COM (2020) 282 final and COM (2020) 283 final).

[104] According to Article 3(1) of said Regulation, the seller of a securitisation position is not allowed to sell such a position to a retail client, unless the seller of the securitisation position has performed a suitability test, is satisfied, on the basis of this test, that the securitisation position is suitable for that retail client *and* immediately communicates in a report to the retail client the outcome of the suitability test.

(3) The implementation of precautionary public support measures to ensure an uninterrupted flow of credit to the real economy under the BRRD and State aid frameworks has also been referred to in the Commission's 2020 proposals.[105] Precautionary recapitalisation provided for in Article 18(4) SRMR (and Article 32(4) BRRD) is one of the few permissible alternatives for granting public financial support to credit institutions if specific (strict) conditions are met, upon fulfilment of which the credit institution concerned would not be deemed to be 'failing or likely to fail' (FOLF)[106] and, hence, the first condition for resolution would not be met.[107] *Inter alia*, necessary is final approval by the Commission under EU State aid rules[108] in accordance with the provisions of the 2013 Banking Communication,[109] which include the conversion of subordinated debt into equity ('burden sharing'), unless the exception to this requirement, as laid down in point (45) of that Communication, is met. In accordance with the Commission Communication of 20 March 2020 on the "Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak"[110] (as currently in force) this exception is deemed to be applicable if two conditions are met: *first*, a credit institution would need extraordinary public financial support[111] in the form of liquidity, recapitalisation or impaired asset measure *due to* this outbreak; and *second*, it is assessed that the conditions for precautionary recapitalisation are met and that such measures address problems *linked to* the outbreak.[112]

In this respect it is noted that in a recent (2020) study jointly written by the author,[113] the proposal was tabled to amend certain conditions laid down in Article 18(4) SRMR pertaining to the precautionary recapitalisation of credit institutions established in participating Member States, in line with the measures adopted by the Commission to facilitate public intervention to support the economy. In the authors' view, this amendment should apply for a limited period of time and be combined with a facility of the European Stability Mechanism (ESM), that would allow it to purchase hybrid instruments issued by the credit institutions to be recapitalised.[114]

(4) Pursuant to another recent (2021) study,[115] national public AMCs are assessed in comparison with selected alternative measures/policies, namely forbearance, public recapitalisation, asset sales/de-risking, AMCs at EU level and loan conversion by banks, on the basis of five criteria: effectiveness, feasibility, credibility, alignment with incentives of private players, and structural impact at the bank level.[116] The assessment indicates that national AMCs (and even more so, an EU AMC and loan

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[105] See 2020 NPL Action Plan, pp. 15-17.

[106] A credit institution is deemed to be in such a situation if one or several of the circumstances laid down in Article 18(4), first sub-paragraph (points (a)-(d), respectively) SRMR is met. The 2015 EBA Guidelines (EBA/GL/2015/07) (available at: https://www.eba.europa.eu/documents/10180/1156219/EBA-GL-2015-07_EN_GL+on+failing+or+likely+to+fail.pdf) further specify the first three of these circumstances, which are referred to as 'objective elements'.

[107] On the conditions for resolution, see also Section 4 below, under 4.2.

[108] SRMR, Article 18(4), second sub-paragraph.

[109] Communication from the Commission "on the application, from August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis" ('Banking Communication') (OJ C 216, 30.7.2013, pp. 1-15). This was adopted to support measures in favour of credit institutions in the context of the GFC.

[110] OJ C 91 I, 20.3.2020, pp. 1-9.

[111] In the meaning of Article 3(1), point (29) SRMR.

[112] Commission Communication (March 2020), point 7, as amended by point (17) of the second amendment to the Communication of 8 May.

[113] See Gortsos, Siri and Bodellini (2020).

[114] A similar proposal was tabled Schularick and Tröger (2020), albeit based on the provisions of Article 32(4) BRRD.

[115] See Boot, Carletti, Kotz, Krahnen, Pelizzon and Subrahmanyam (2021).

[116] Effectiveness is assessed as to the possibility of achieving overall objectives and effectively dealing with the problem at hand; feasibility as to whether the measure would be acceptable to legislators or the treasuries involved, the existence of a political mandate for it, the possibility that the measure can be executed and its degree of complexity; credibility as to whether the problem of 'regulatory capture' is addressed, the measure's resilience to the 'too-many-to-fail-problem' of policymaking and its time consistency; alignment with incentives of private players as to whether the right incentives and initiative for banks and firms are given *ex-ante*, in order to prevent 'zombification' of firms and/or banks, contain regulatory arbitrage, not weaken restructuring incentives and allow for sustainable flow of credit to firms, in particular SMEs; and structural impact at the bank level as to the impact on the longer-term challenges of the banking industry, such as

conversion) dominate the other alternatives, even though (as already noted[117]) informational advantages embedded in the long-term bank-firm relationships might be lost (less in the case of national AMCs) and, in terms of credibility, national authorities might find themselves 'captured' by domestic banks. Interestingly, the study concludes (and quite rightly) by stating that *"clearly, none of them are a panacea and there are positive and negative aspects to all of them"*.[118]

(5) On the basis of the previous (brief) analysis, a second *interim* conclusion can be drawn that resort to all the above-mentioned alternatives to the establishment of national (public) AMCs should carefully be considered on an *ad hoc* basis, duly taking account of merits and relative disadvantages on the basis of the criteria set out above. In particular, however, it is questionable if, depending on the depth of national markets, securitisation-based approaches should be applied along with the operation of public AMCs.

4. THE BIGGER PICTURE AND FINAL CONCLUDING REMARKS

4.1. *Conditiones sine quibus non* for financial stability and the role of supervisory and resolution authorities

(1) The resolution of the NPL problem, i.e. tackling existing ones and preventing new ones from building up, requires, apart from the above-mentioned alternative impaired asset measures, several other conditions to be met concurrently, including conducive legislation on corporate insolvency and debt recovery.[119] Nevertheless, in the author's view, of utmost importance are the role of supervisory and resolution authorities and the decisions they will take, which should be considered the *conditiones sine quibus non* for preserving financial stability in view of a new wave of NPLs as a result of the economic downturn. The ECB, the SRB, the EBA, as well as NCAs and national resolution authorities are alert on this front.[120]

Taking into account the existing set of tools available[121] in order to achieve the financial stability objective and the necessary flexibility that has to be (and is being) applied, the author argues that the effectiveness of the policy response under the current circumstances will be tested against two main

overbanking, market power of established institutions and positive 'renewal' in the financial system and the strengthening of the role of capital markets.

[117] See above, under 2.1.2.

[118] Boot *et al.* (2021), p. 4. In the same vein (albeit in a different context), Noussia (2010) also notes that the "good bank – bad bank" crisis management strategies should not be seen as uninteresting or unimportant, but they are not a "panacea".

[119] In this respect, *inter alia*, and the Commission calls in its 2020 NPL Action Plan (pp. 13-14) upon EU legislators to swiftly reach an agreement on the legislative proposal "for minimum harmonisation rules on accelerated extrajudicial collateral enforcement" (COM (2018) 0135 final), a legislative process from which consumers have been completely excluded, and upon all Member States to transpose the 2019 Directive of the European Parliament and of the Council on restructuring and insolvency (Directive (EU) 2019/1023 of 20 June 2019 "on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt (…)", OJ L 172, 26.6.2019, pp. 18-55), which would ensure that action is taken before enterprises default on their loans, thereby helping to reduce the risk of becoming NPLs in cyclical downturns. Improvements in the efficiency of national insolvency frameworks and administrative and judicial systems, including through capacity-enhancing investments, may also be induced by the RRF, supporting reforms to reduce NPLs.

[120] See "Risk Assessment of the European Banking System", EBA, December 2020 (available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Risk%20Analysis%20and%20Data/Risk%20Assessment%20Reports/2020/December%202020/961060/Risk%20Assessment_Report_December_2020.pdf) and "ECB Banking Supervision: Assessment of risks and vulnerabilities for 2021", 28 January 2021 (at: https://www.bankingsupervision.europa.eu/ecb/pub/ra/html/ssm.ra2021~edbbea1f8f.en.pdf).

[121] It is noted that in January 2021 the Commission issued a targeted consultation document on the "Review of the crisis management and deposit insurance framework" (available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2021-crisis-management-deposit-insurance-review-targeted-consultation-document_en.pdf), which will (very probably) lead to a formal Commission proposal.

benchmarks: *first*, how supervisory authorities will guide credit institutions towards appropriately balancing two of the primary objectives in the current policy agenda, which may, nevertheless, become conflicting: *on the one hand*, financially supporting the real economy (and hence employment) and, *on the other*, preserving financial stability; and *second*, how they will activate the triggers embedded in the framework in relation to the existing set of tools.

(2) The quality in the exercise of prudential banking supervision is of primary importance in addressing the NPL problem. On the basis of the single methodology and set of harmonised tools used pursuant to the Supervisory Review and Evaluation Process (SREP) framework,[122] both the ECB and NCAs within the SSM (and only the latter in the case of non-participating Member States) will be in a position to assess consistently all areas covered and, in particular, credit institutions' risks in capital.[123] Of equal importance is also the (closely related issue of) monitoring credit institutions' own credit risk management policies, which applies, in particular, to the provision of new credit and loans to households and businesses during the entire cycle of the pandemic crisis.[124] While demand (in particular, by corporates, including SMEs) for bank credit and loans has surged and is expected to further increase, it may (in several cases) not be fully supported by solid economic fundamentals on the part of (prospective) borrowers. In this context, it is also worth stressing that in several cases corporates may be rather in need of own funds in order to increase their solvency, which cannot be covered by bank lending, an aspect which must also be taken into account in the context of credit risk management.

Furthermore, the EU-wide stress test exercises of credit institutions' portfolios, to be conducted in 2021 by the EBA and the ECB,[125] are necessary to identify potential weaknesses in the current juncture. In cases of emerging problems, recourse by the ECB and NCAs to their specific supervisory[126] and early intervention powers[127] and/or to precautionary recapitalisation (pursuant to the above-mentioned) is also significant. For the medium-term horizon, of importance will also be their (supervisory) approach to consolidation in the (admittedly overbanked[128]) EU banking sector,[129] in which (*inter alia*) the varying business models will be tested as to their viability.[130]

(3) Last but not least, another important element towards maintaining the strength of the banking sector and preserving financial stability is the progress made (and to be made further) in relation to

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[122] Governed by Articles 97-101 CRD IV.

[123] See in this respect "2020 SREP aggregate results", 28 January 2021, available at: https://www.bankingsupervision.europa.eu/banking/srep/2021/html/ssm.srepaggregateresults2021.en.html#toc36.

[124] Of primary importance in this context are the EBA Guidelines of 29 May 2020 "on loan origination and monitoring" (EBA/GL/2020/06), which will apply from 30 June 2021 (available at: https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring).

[125] See the Press Releases of 29 January 2021 "EBA launches 2021 EU-wide stress test exercise" (available at: https://www.eba.europa.eu/eba-launches-2021-eu-wide-stress-test-exercise) and "ECB to stress test 38 euro area banks as part of the 2021 EU-wide stress test led by EBA" (at: https://www.bankingsupervision.europa.eu/press/pr/date/2021/html/ssm.pr210129~69d2d006ec.en.html). Applicable will be the common procedures and methodologies laid down in the EBA Guidelines of 19 July 2018 (EBA/GL/2018/03), adopted on the basis of Article 107(3) CRD IV (available at: https://eba.europa.eu/documents/10180/2282666/Revised+Guidelines+on+SREP+%28EBA-GL-2018-03%29.pdf).

[126] Article 104 CRD IV for NCAs and Article 16 SSMR for the ECB within the SSM.

[127] Articles 27 BRRD and 13 SRMR. On the significant importance of early intervention in preventing an identified weakness or deficiency of a bank from developing into a threat to financial stability and related policy recommendations, see Basel Committee (2015) and (2018).

[128] See Pagano *et al.* (2014).

[129] See the ECB's "Guide on the supervisory approach to consolidation in the banking sector" of 12 January 2021 (available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguideconsolidation2101~fb6f871dc2.en.pdf), which is not proposing any modifications to the existing regulatory framework but rather contains legally non-binding supervisory principles.

[130] In the adverse scenario of a credit institution meeting the 'failing or likely to fail' resolution criterion, supervisory authorities will be called upon to adequately assess whether this first resolution condition is met, paving the way for resolution action (see also just below, under 4.2).

resolution planning to attain the resolvability of credit institutions. It is well documented that resolution authorities are determined not to compromise on these targets, which they consider to be essential in terms of financial stability.[131] *Inter alia*, this includes the build-up of minimum requirements for own funds and eligible liabilities (MREL), which is central to resolvability, allowing credit institutions to build up sufficient regulatory capital to be used in case of resolution action. The SRB has already presented its approach with regard to resolution planning in view of the uncertainty and disruption caused to the economy by the pandemic crisis, setting out its remit on potential operational relief measures, its actions to support efforts to mitigate the economic impact of the crisis and its dealing with MREL targets. This has taken into account the fact that the resolution planning framework has been further enhanced in January 2021 when the revised rules laid down in the legislative acts which amended (in 2019) the initial ones (as set out in the BRRD II and the SRMR II) became applicable. Of particular importance in this respect is the prompt and appropriate application by credit institutions of the rules governing the MREL set out in Articles 45-45m BRRD and 12-12k SRMR, subject to write-down and conversion powers.[132]

4.2. The ultimate public policy objectives and final concluding remarks

(1) On the basis of the ECB aggregate results of its 'vulnerability analysis' of credit institutions that it directly supervises within the SSM dated 28 July 2020, the euro area banking sector was considered in a position to withstand the economic stress induced by the pandemic.[133] The overall resilience of the euro area banking sector still continues to be the basic scenario taking into account the forecasts included in the December 2020 "Eurosystem staff macroeconomic projections for the euro area",[134] despite ongoing challenges. Nevertheless, the path to recovery still remains uncertain (and is not expected to be smooth for all Member States[135]), while the expected increase in the ratio of NPLs, across the board in relation both to credits and loans granted to corporates and households before the onset of the pandemic crisis, to the extent that these will be affected by the severe slowdown of the economy, as well as to credit and loans granted during the current crisis (albeit in certain cases to ailing businesses covered by State guarantees) should not be underestimated.[136]

(2) The flexibility currently provided to credit institutions to prolong the periods for the classification of loans as non-performing is justified in terms of supporting the financing of the fragile real sector of the economy. Nevertheless, this entails the risk of accumulation of problems after the lapse of the 'moratoria' and public guarantees on loans,[137] the extent of which varies both among Member States (depending on the depth and duration of the economic downturn) and among credit institutions in each of them, depending on their business models[138] and the composition of their loan portfolio, mainly in relation to exposures on individuals and companies in sectors most severely affected.[139] It is

[131] This aspect is further analysed in Gortsos (2020b), pp. 363-367.

[132] For details on this aspect, see Maragopoulos (2020). Equal attention must also be paid to the application, amidst the crisis, of the framework governing banking resolution (the discussion of this aspect is beyond the reach of this paper; see Gortsos (2020b), pp. 370-371).

[133] Available at: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200728~7df9502348.en.html.

[134] Available at: https://www.ecb.europa.eu/pub/projections/html/ecb.projections202012_eurosystemstaff~bf8254a10a.en.html.

[135] See Georgieva (2021).

[136] On the most recent evolution in NPLs in the EU, see the "Monitoring report on risk reduction indicators" of the European Commission, the ECB and the SRB of November 2020 (available at: https://www.consilium.europa.eu/media/46979/2020-11-30-joint-risk-reduction-monitoring-report-eg.pdf), pp. 9-32.

[137] Recent data on these fiscal measures are available in the ESRB Report of 16 February 2021 "on the financial stability implications of COVID-19 support measures to protect the real economy", pp. 58-68 (available at: https://www.esrb.europa.eu/news/pr/date/2021/html/esrb.pr210216~4d9cec6a0b.en.html).

[138] On the various banks' business models (such as investment banking, wholesale banking, focused retail banking, and diversified retail banking) in the current EU and global financial system, see Ayadi, Arbak and de Groen (2012) and de Haan and Bruinshoofd (2015, editors).

[139] See on this Gortsos (2020b), p. 368.

hence reasonable to argue that, in the medium-term, the pandemic crisis may (in the EU and globally) have a negative impact on the banking sector (and eventually lead to large-scale bank restructurings, on top of corporate restructurings in the real economy). On the other hand, our premise is that the ultimate public policy objective, namely the preservation of financial stability, should not (and is not expected to) be compromised, rendering sound prudential, crisis prevention and crisis management policies imperative.

(3) Accordingly, and taking into account past experiences, in the author's opinion, the various above-mentioned alternative solutions for managing and disposing of NPLs, in order to clean up credit institutions' balance sheets and allow them to resume their normal lending activities to the benefit of corporates and households, including the operation of AMCs, should not be considered separately but in conjunction (and eventually *per* Member State, since they depend on various factors, such as the type of assets, the structure of the banking sector and available management capacity of banks and in the public sector, which may vary from Member State to Member State). As recently (and quite rightly) noted: "*Asset management companies/bad banks can be a valid tool – in fact, they are one of the tools in our toolbox – but they are not the magic wand that make losses disappear and only very few asset classes benefit from being managed through them. SME and retail loans for example will not be improved by being pooled together*".[140]

This conclusion is reinforced by the fact that, in terms of financial stability, a common denominator and the ultimate public policy objective of all measures adopted (and to be adopted) by credit institutions themselves, EU regulators, national and EU supervisory and resolution authorities, as well as national governments (when extending State aid within the limitations set out in EU competition legislation) is to prevent (notwithstanding idiosyncratic bank failures) the adverse (worst-case) scenario where one or (more importantly) several credit institutions would reach the point of meeting the FOLF criterion laid down in the SRMR and the BRRD due to their exposure to NPLs. If this condition were to be met, resolution authorities, including the SRB, would have to either apply resolution tools to or wind up the ailing institution(s) depending on whether the third condition for resolution, namely the 'public interest criterion',[141] is met or not.

[140] See König (2020).

[141] Articles 18(1), first sub-paragraph, point (c) and 18(5) SRMR and 32(1), point (c) and 32(5) BRRD. On the conditions for resolution under the SRMR, see Gortsos (2019), pp. 205-215, with extensive further references. Applicable in this case is also, *inter alia*, the so-called 'no creditor worse off (NCWO) principle' (or safeguard), which is regarded as a cornerstone of resolution regimes (on this principle, see *ibid.*, p. 189, with extensive further references as well).

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This paper develops, on the basis of a cost-benefit analysis, on the conditions that must be met for an Asset Management Company (AMC), established under the centralised approach in EU Member States, to efficiently facilitate the management and recovery of non-performing loans (NPLs). It concludes that public AMCs, even if optimally designed, should not be viewed as a 'panacea' but as one of several measures that can be taken to address the NPL problem and prevent bank failures.

This paper was prepared by the Economic Governance Support Unit (EGOV) at the request of the Committee on Economic and Monetary Affairs (ECON).

PE 659.647
IP/A/ECON- BU/FWC/2020-003/LOT2/C3

Print ISBN 978-92-846-7860-0 | doi: 10.2861/531827 | QA-02-21-276-EN-C
PDF ISBN 978-92-846-7859-4 | doi: 10.2861/33722 | QA-02-21-276-EN-N