STUDY

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Non-performing Loans - New risks and policies? What factors drive the performance of national asset management companies?

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Non-performing Loans - New risks and policies? What factors drive the performance of national asset management companies?

Abstract

As the COVID-19 pandemic hits all Member States severely, some initial signs are surfacing of what is likely to be a substantial increase in bank non-performing loans (NPLs) in the coming months. Strengthening the tools needed to face the problems caused by NPLs is therefore of foremost importance. This paper argues that asset management companies (AMCs) can be an effective tool in this direction. It further discusses the legal issues related to their implementation, presenting several examples from past experiences illustrating how such issues can be solved. The paper concludes that a network of national publicly funded AMCs, applying the same standards and procedures across all European Member States, would be an effective and feasible solution to the problems presented by NPLs.

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LIST OF ABBREVIATIONS

AECE	Accelerated Extrajudicial Collateral Enforcement
AMC	Asset Management Company
AMCO	Italian Asset Management Company
AQR	Asset Quality Review
BAMC	Bank Assets Management Company
BGB	Bürgerliches Gesetzbuch
BRRD	Bank Recovery and Resolution Directive
DUTB	Družba za upravljanje terjatev bank
EBA	European Banking Authority
ECB	European Central Bank
EMV	Estimated market value
ESRB	European Systemic Risk Board
FROB	Fund for Orderly Bank Restructuring
GACS	Garanzie sulla cartolarizzazione delle sofferenze
GDP	Gross Domestic Product
IAM	Impaired asset measure
IFRS	International Financial Reporting Standards
ITS	Implementing Technical Standards
MARK	Magyar Reorganizációs és Követeléskezelő Zrt.
MEF	Italian Ministry of the Economy and Finance
MEIP	Market Economy Investor Principle
MOU	Memorandum of Understanding
MPS	Monte dei Paschi di Siena
NAMA	National Asset Management Agency Investment Ltd.
NPE	Non-performing exposures
NPL	Non-performing loans
REV	Real economic value
SAREB	Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria
SGA	Società di gestione attivi
SPV	Special Purpose Vehicle
TFEU	Treaty of the Functioning of the European Union
UTP	Unlikely to Pay

EXECUTIVE SUMMARY[1]

The average ratio of non-performing loans (NPLs) over total loans is at historically low levels in the European Union (EU). However, while the Covid-19 pandemic is hitting all Member States severely, there are some initial signs of what is likely to be a substantial increase in NPLS in the coming months. Strengthening the tools utilised to address the problems caused by NPLs is therefore urgent and of foremost importance.

A crucial step to reduce the problems caused by the emergence of NPLs in banks' balance sheets is to recognise that they are *de facto* financial assets, which can be traded in a market. In principle, banks can therefore transparently account for the losses generated by uncovered NPLs by selling them and removing their potentially uncertain value from their balance sheets.

However, information asymmetries, fire-sales and excessive market power on the part of potential buyers may depress market prices. Banks may then prefer delaying the sale of NPLs, waiting for better times. In turn, this increases aggregate risk and depresses credit supply.

In recent years, the European legislator has addressed this problem by introducing strict prudential and accounting rules with the objective of ensuring the financial solvency and the transparency of the balance-sheets of credit institutions, such as the requirement of full prudential provisioning of new non-performing exposures (NPEs) two years after they become past-due. However, this may not be fully effective if short-term economic conditions cause an overstatement of the losses with respect to those that would have prevailed in the long run.

Creating a large and efficient market for NPLs can be a crucial step in reducing the impact of information asymmetries, in fostering competition and in driving market prices closer to the real economic value of each NPL – that is, the expected amount of money that will be recovered from the NPE. More banks would then take part in the market, reducing the risk that unavoidable losses are hidden in their balance sheets.

Although markets can develop autonomously, the process can be too slow, especially when faced with the urgent need thereof, as dictated by the recession caused by the COVID-19 pandemic. Active policies must therefore be put in place to foster the growth of NPL exchanges, possibly with the aim of having a single pan-European market.

Asset management companies (AMCs) can be a valuable tool in this respect. In addition, Member States can sustain AMCs with a longer investment horizon than those with the objective of maximising short-term profits, and which therefore apply prices that are close to the real economic value of NPLs. This overcomes the problem of the depressed market value of NPLs during recessions, attracting more banks into the market and increasing its depth.

Several legal issues influence the set up and operation of an AMC. First, discrepancies among the national laws on debt recovery procedures can hinder effective cross-border circulation of NPLs within a pan-European secondary market. In this regard, the implementation of a common "Accelerated Extrajudicial Collateral Enforcement" procedure (AECE) appears unable to guarantee a full and effective harmonisation.

Second, debtors' rights and protection must not be hindered when NPLs are sold by banks to external entities. In this regard, the legal framework on consumer protection already in place in the case of transfer of banks' loans to third parties, strengthened by many national laws, appears capable of ensuring that the most vulnerable categories of debtors, such are consumers, are properly protected.

[1] The authors would like to thank Claudia Giustolisi, Federico Pistelli, Mario Renna and Giulio Sandrelli for their valuable research assistance and Francesco Ferracci for his very helpful linguist review.

Third, and most important, NPL purchases by public AMCs could breach rules on State aid, pursuant to Article 107 TFEU, or call for the resolution of the bank. However, if realised at market conditions, purchases by a public AMC do not qualify as State aid, nor do they qualify as an "extraordinary public financial support" according to Article 32(4)(d) of the Bank Recovery and Resolution Directive (BRRD), and therefore do not require the resolution of the relevant banks.

Past experiences of AMCs set up in some European countries – FMS Wertmanagement in Germany, NAMA in Ireland, BAMC in Slovenia, SAREB in Spain, MARK in Hungary and AMCO in Italy – provide robust evidence of their effectiveness and versatility in managing NPLs. Although all these AMCs are at least in part supported by the State, the most recent cases show that they can operate without breaching State aid rules and without requiring that a bank selling its loans is deemed as failing or likely to fail. For example, the Hungarian MARK and Italian GACS show that state interventions at market prices fall within the rules. In the current COVID-19 crisis, if the short-term market price of NPLs were to fall significantly below the real economic value, it might be possible to consider a more flexible interpretation of the legal framework by the Commission, excluding the automatic classification of NPLs purchases at a price higher than the market price as State aid.

A final issue is whether it is possible or even desirable to have a European public AMC. While in abstract terms this may be optimal, in practice it may be difficult because of problems establishing an adequate allocation of country-specific risks, and envisioning sound financing and governance mechanisms.

A more feasible solution, on which political consensus could more easily be obtained, would be to set up a network of national publicly funded AMCs – applying the same standards regarding the scope of eligible loans, loan management, pricing, and servicing – which would be set at the European level, thereby favouring a more level playing field among national banking systems.

1. INTRODUCTION

One of the most dramatic consequences produced by the 2007-2009 financial crisis and the subsequent recession experienced in the EU was a substantial deterioration of banking loan portfolio quality. In the aftermath of the financial global crisis, the ratio of NPLs to total credit kept rising in the euro area, reaching a peak of 8% of total gross loans and advances in 2014 (ECB)[2], before slightly decreasing. Regulators at both the European and international level suddenly acknowledged the need to confront the unprecedented rise of NPLs in banks' balance sheets due both to the microeconomic implications for banks' profitability and the macroeconomic threat to the financial sector.

Since then, European authorities have taken initial steps towards the introduction of a wider strategy to deal with this issue from a European perspective. Above all, the European Banking Authority (EBA) and European Central Bank (ECB) Banking Supervision issued guidance to banks and financial institutions requiring more active management policies for NPLs', and, thereafter, legislation introduced stricter capital requirements to ensure a progressive increase in the minimum coverage of impaired assets. At the political level, the 2017 Action Plan of the European Council stressed the need to promote structural reforms of insolvency and debt recovery frameworks and for developing secondary markets in Europe for NPL transactions.

Among the market-based tools available to address the issue of NPLs in Europe, the design and set up of State-backed AMCs has been highly debated in the literature and has been at the centre of many policy proposals. Many authors have argued that a single EU platform or a network of national government-sponsored AMCs would provide significant benefits in terms of lower funding costs and higher operational efficiency, attracting new investors to this market (Enria et al., 2017; Lamandini and Lusignani, Muñoz, 2018; Gaffeo and Mazzocchi, 2019). Other complementary instruments have also been under consideration to address the issue of NPLs, such as asset protection schemes, NPL trading platforms, and direct sales (Fell et al., 2017). On the basis of the input received from stakeholders, the European Commission developed a blueprint for national publicly supported AMCs (European Commission, 2018) addressing a number of key issues, including the criteria to determine the appropriate asset classes to be acquired by the AMC, to identify which banks should offload NPLs to the AMC, an asset-size threshold, the asset valuation rules to comply with State aid rules, the capital structure and the governance of the AMC to maximise the recovery value of transferred assets.

However, despite the several experiences of national AMCs that have proven this tool effective and versatile in accelerating the process of repair in bank balance sheets, there is currently no uniform legal framework for the design and set-up of publicly funded AMCs. The COVID-19 pandemic has hit the stability and soundness of the European financial sector at a very delicate moment and requires a quick reaction to tackle an eventual sudden increase in the number of NPLs. Significant uncertainty still surrounds the future impact of the pandemic on the economy and financial markets, with a non-negligible probability of a further worsening of health and economic conditions. Both markets and regulatory and supervisory authorities lack a clear view on what the long-term impact of the COVID-19 crisis will be on the volume of NPLs. Nonetheless, according to the ECB estimates, in a severe but still plausible scenario, NPLs in euro area banks could reach €1.4 trillion[3] (roughly 13% of total outstanding loans to households and non-financial corporations at the end of 2020) a level even higher than that seen during the financial and sovereign debt

[2] ECB, Statistical Data Warehouse (code: CBD2.Q.U2.W0.11._Z._Z.A.F.I3632._Z._Z._Z._Z._Z._Z.PC).

[3] ECB, 4 December 2020, Letter from Andrea Enria, Chair of the Supervisory Board, to Mr Zanni, Ms Donato, Mr Grant and Mr Rinaldi, on non-performing loans (europa.eu).

crises.[4] In other words, NPLs in the more vulnerable economies of the euro area may have a substantial impact on banks' balance sheets (ESRB, 2021). In preparation for such an adverse scenario, the problem of NPL management needs to be addressed with proactive and concrete actions. The European Commission's most recent action plan (European Commission, 2020) contains proposals to harmonise marginal aspects of the legal framework that are not sufficient to give a robust boost to the growth of the secondary market of NPLs.

In the following paper, we seek to identify and evaluate how the issue of long-term management of NPLs' has been addressed by European legislation and the regulatory and supervisory authorities. In particular, we further investigate the role that national centralised AMCs can play to boost an efficient secondary market of NPLs. Due to the current severe recession, this function could be crucial to preserving financial stability in the long run. European experiences of national centralised AMCs show that, although some steps have already been taken to reduce the NPL legacy in the most affected countries of the Euro Area, much more needs to be done in terms of promoting a uniform legal framework for such companies to operate in the EU internal market. Indeed, the "wait and see" approach has proven to be the riskiest for fixing a systemic NPL overhang. To this end, we underline the benefit of designing and setting up a European network of coordinated public AMCs with the final aim of enhancing an effective secondary market for distressed assets.

2. THE ISSUE

With few exceptions, in June 2020, the ratio of NPLs over total loans was at historically low levels across Europe. However, although there is no clear evidence of growth in the amount of NPLs as an effect of the COVID-19 pandemic, the Risk Assessment of the European Banking System published by the EBA in December 2020 shows some signs in this direction, such as an increase in the share of loans classified as Stage 2 (according to International Financial Reporting Standards (IFRS) 9) in the last year, paralleled by a drop in those classified as Stage 1. Although the problem of an increase in NPLs because of the COVID-19 recession has not (yet) materialised, preparing for its potential emergence seems to be a safe strategy.[5] In the rest of this Section, we will argue that AMCs can foster the creation of a thicker market for NPLs and therefore contribute to the solution of the problem.

2.1. NPLs as a risky financial asset

From a strict economic perspective, NPLs are a financial asset promising an uncertain payment in the future. As is the case with all non-contemporaneous exchanges – i.e., those in which products, goods, or services are provided in exchange for the promise of payment to be made in the future – NPLs are inherently risky, because the creditor cannot be sure of the payment amount that will eventually be made, the more so since payments originally promised on the loan are already overdue. However, for the following analysis, it is easier to think of NPLs as any other financial transaction entailing the transfer of an asset in exchange for the promise of a transfer in the opposite direction at a given moment in the future.

The risk of non-contemporaneous financial transactions can be attenuated, but it cannot be eliminated, for the simple reason that nobody can perfectly foresee the future. When the time comes, if the debtor is unable to honour his obligations and the value of pledged guarantees is insufficient to cover these, the

[4] In this sense, see Supervisory challenges of the pandemic and beyond, keynote speech by Andrea Enria, Chair of the Supervisory Board of the ECB, at the Handelsblatt European Banking Regulation Conference on 3 November 2020.

[5] For a discussion of the problems facing the European banking sector in the aftermath of COVID-19 and, more specifically, on the possible role of AMCs, see also Angeloni (2021), Barba Navaretti et al. (2021), Beck (2021) and Campa and Quagliariello (2021).

creditor incurs a loss. Banks evaluate in advance what the predictable risk of a loan is. They then set aside funds to cover for the foreseeable losses in the form of loan loss-reserves, as prescribed by banking sector regulations.[6] If banks' ex-ante evaluations are unbiased – i.e., banks on average do not over-estimate or under-estimate the riskiness of the loans they grant – loan loss reserves, on average, fully cover ex-post realised losses.

However, two major problems can cause loan loss provisions to be insufficient. First, banks might set aside fewer reserves than what would be required by an objective evaluation of ex-ante riskiness, possibly with the aim of increasing their accounting profitability. This is a problem of distorted incentives, which can be addressed by stricter regulation and supervision.[7] Second, even if incentives are not distorted, a worse ex-post realisation of risk than what might have reasonably been foreseen ex-ante causes larger NPLs than predicted. This is the typical case of an unanticipated negative exogenous shock, of which the COVID-19 pandemic is a perfect example.

Should there be NPLs that cannot be covered by the available loan loss reserves, this is a major problem for a bank, even more so if the bank is thinly capitalised. This can cause a reduction in bank lending, at the very least, but it could also lead to the default of the bank if its capitalisation turned out to be insufficient. Independently of what caused the NPL problem, it is therefore vital that, when it does occur, it is addressed swiftly and effectively.

Policies addressing NPL problems often result in a redistribution of wealth across agents, as with the default of a single debtor.[8] However, some policies can effectively address the problem of NPLs without having redistributive effects. Since financial markets are characterised by the presence of externalities caused by information asymmetries, policies reducing these negative effect, for example, by increasing transparency, can go a long way in addressing the problems posed by NPLs.

In principle, one might posit that the best way to react to an unexpected negative shock is to promptly acknowledge it. According to this view, at the very moment that an NPL emerges, a bank should use all of its available reserves to cover the realised losses, as if NPLs were sold on the market, and, eventually, write-down those which remain uncovered. In some cases, however, the bank may find it preferable to avoid writing-down the potential loss. Since the value of a loan which has become non-performing is not unequivocally determined, the bank may prefer to delay registering a loss, waiting for better times (within the limits allowed by the prudential rules on provisioning).

When choosing between writing-down and waiting, the crucial issue is the identification of the actual value of the loss or, in other words, of the real value of the NPL. Unfortunately, bank loans are very opaque financial assets whose evaluation is plagued by information asymmetry problems.[9] Consider the following, simple example. Assume that a bank has a loan with a nominal value of € 100, which has become non-performing, and assume that, based on its information, the bank predicts that it will be able to recover € 60. In other words, according to the bank, the real economic value of the non-performing loan is precisely € 60. It should then write down a loss of € 40. However, since the prediction is based on private information,

[6] See section Annex IV.

[7] Asset Quality Reviews are conducted by ECB and national supervisors to check that banks are adequately capitalised and can withstand macroeconomic and financial shocks; see https://www.bankingsupervision.europa.eu/banking/tasks/comprehensive_assessment/html/index.en.html.

[8] However, even if the redistribution causes some agents to incur losses, if they are smaller than those that they would have incurred if no action had been taken, such policies should be enacted, because they improve welfare.

[9] Here we leave aside the better information that the borrower has regarding his financial conditions with respect to the bank, because in this framework the crucial asymmetry is between the bank and the external investors.

it can claim that it expects to recover € 80 and write-down only € 20.[10] In this way, it registers lower accounting losses and increases short-run profitability, even if in reality it has only postponed the problem. Eventually, the loss needs to be registered, and if the bank has extensively followed this policy, its capital may be insufficient to cover all its losses, causing its bankruptcy.

In the case of listed banks, the possibility of registering accounting losses of € 20 instead of the true predicted value of € 40 can have a negative effect even before the true losses actually materialise. As has been shown convincingly in the economic literature, information asymmetries cause what is known as a "lemon discount" effect. Applied to the case described above, the effect implies that external investors over-estimate the value of the perspective loss, causing a drop in the stock market price of the bank, which in turn may cause a contraction in lending.

2.2. Markets for NPLs

In principle, the optimal policy to address the problem described above would be that the bank writes down what it truly predicts to be the value of the loss caused by the NPL. In practice, this is easier said than done, because the truly predicted loss is based on the private information of the bank, which cannot be verified by an external observer. A feasible alternative option would be to require that the bank sells the NPL on the market, forcing it to register a loss equal to the difference between the nominal value of the loan and the sale price.[11] However, this option only works if the equilibrium market price coincides with the true predicted value of the NPL: only in this case would the bank be in exactly the same position as if it had registered the true predicted value of the loss in its balance sheet.

Unfortunately, the "lemon discount" effect described above also affects the sale of the NPL in the market, with the consequence that the potential buyer of the NPL will only be willing to pay a price that is lower than the NPL's real economic value, the extent of which depends on the degree of asymmetry in the information available to the bank and to the external investors.[12]

At the root of the problem in dealing with NPLs are the information asymmetries between the bank and potential buyers. More efficient markets are better able to produce and spread information, as more potential buyers collect information, and this is eventually translated into market prices. Therefore, building an efficient market for NPLs helps to reduce the "lemon discount" and allows banks to sell their problematic loans at a price that is closer to their real economic value.[13] In turn, this reduces the incentive for banks to avoid writing down the potential losses and pile-up NPLs, or "betting-for-resurrection", making it less likely that the sudden emergence of bank losses triggers insolvency.

Remarkably, the relationship between the efficiency of the market for NPLs and its transparency (that is, the reduction of information asymmetries) goes in both directions. Higher transparency attracts more

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[10] Indeed, the bank may even decide to grant a new loan to the non-performing borrowers, hiding the emergence of the NPL. The literature on zombie-lending has extensively studied this problem, providing robust empirical evidence of its diffusion and of its negative effects on competition and growth.

[11] One additional step, followed in the recent approach taken by the ECB rules on calendar provisioning expectations (see Annex IV), is to force the bank to fully write down the nominal value of the loan a few years after its recognition, thus increasing the incentives to sell the loan as soon as possible, to avoid the risk of having to register a loss equal to the full nominal value.

[12] This happens because the buyers have less information than the bank and therefore are willing to pay only what is expected to be the average price of NPLs. As a result, banks will not sell the NPLs that they predict to have the highest recovery value, thus reducing the average quality of the loans in the market. In turn, this is anticipated by the buyers, who will bid even lower. Gorton and Pennacchi (1995) have shown that, in this situation, the equilibrium price is lower than what would emerge with perfect information. This problem is exacerbated when the supply of NPLs on the market increases rapidly, causing what are known in the literature as fire-sales, a band-wagon effect in which the fear of further decreases in the price of NPLs causes an increase in sales, which further depresses their market price.

[13] Focalult et al. (2013) provide an introductory but thorough presentation if the relationship between market structure and information production.

sellers, because the "lemon discount" is smaller and the sale price is closer to the real economic value of the NPL, thus increasing the depth of the market. At the same time, a deeper market enlarges the number of buyers willing to extract information on the value of NPLs, increasing transparency. Thicker markets also help to reduce the market power of buyers, which often consist of a small number of large and specialised financial intermediaries (such as the US investors who have become very active in the European markets in recent years).

The question that follows is therefore how to help increase the efficiency of the market for NPLs. A first step is to reduce information asymmetries. All policies requiring the standardisation of information on NPLs move in this direction: the introduction of AECE procedures, the standardisation of servicing activities and the creation of the market for providers of these services, the harmonisation of regulations on access and trading in the market across all European countries.[14]

A second step is to provide guarantees on the value of the NPLs sold in the market. NPLs are risky and buyers cannot be sure to fully recover the price paid for their purchase. Aside from the distorted incentives caused by information asymmetries that we have already discussed above, this may simply be due to the occurrence of unforeseen events which cause the actual recovery value of the NPL to be lower than the predicted real economic value. As argued above, this risk cannot be eliminated and, as with all risks, it has a price. If buyers incur the full risk on the recovery value of an NPL, they will bid a lower price. If, instead, part of the risk is retained by the seller, buyers will be willing to bid higher prices. Since the optimal allocation of risks depends on many factors, in some cases it may be preferable for a third party to intervene, providing a guarantee to the buyer of the NPL's value.[15]

A third step is to reduce the buyers' market power, for example by increasing transparency on bank loan characteristics, reducing the cost of acquiring information on the characteristics of NPLs, and making it easier to enter the market. Competition would also increase if non-profit maximising buyers entered the market offering a price close to the perfectly competitive bid price. These buyers could either be large consortia of banks, government agencies, or public-private partnerships (which would perform in practice a role similar to that of an AMC).

2.3. AMCs as a useful tool in addressing NPLs

Cerruti and Neyens (2016) define an AMC as *"a public, private, or joint entity that manages non-performing assets removed from the financial system with the goal of maximizing the recovery value of these assets."* In light of the analysis above, an AMC can have a substantial effect in fostering the efficiency of the NPLs market, especially by reducing information asymmetries and the market power of external investors.[16]

Two aspects are interesting from our perspective: first, the differences between AMCs and other investors willing to buy NPLs; second, their organisation and financial structure.

An AMC is a financial entity specialised in buying NPLs (or, in some cases, performing loans). The main difference with respect to other investors willing to buy NPLs is its specialisation in this specific class of financial assets (and in all related activities). Investing in NPLs is not the same as investing in stocks and

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[14] See section 5.1 and Annex IV for a thorough analysis of these issues from a legal perspective.

[15] Diamond (1984) argues for example that banks should hedge all risks for which they have no comparative advantage.

[16] In fact, a large enough AMC could even make the market for NPLs useless, substituting all potential buyers. However, unless one is willing to believe that such AMC would behave like the benevolent dictator of economic theory, it is unlikely that this is the optimal solution. Most likely, such AMC would become either a monopolist, aiming at profit maximisation and failing to maximise the recovery value of NPLs, or a government agency, using public money to sustain banks. Indeed, since none of the two options seems satisfactory, we will not consider this as an option.

bonds, because the return from the investment depends on the ability to recover the value of the loan. The activities required are radically different from managing a performing asset portfolio, because they typically involve taking part in bankruptcy procedures or repossessing collateral and selling it. A specialised entity can be in a better position to perform this activity than unspecialised investors can.

From an organisational perspective, an AMC is a financial corporation,[17] whose internal organisation and management need to ensure they have the ability to assess the real economic value of NPLs.[18] A central issue is its financial structure. Purchases of NPLs need to be financed and, as we have extensively discussed above, the business of an AMC is risky. The liability side of an AMC therefore needs to be able to sustain such risks, either with adequate capitalisation or by transferring this risk to third parties.

The first option, requiring a solid capitalisation of the AMC, capable of absorbing losses which might potentially emerge because of unpredicted events, would transfer most of the risk of the NPLs to stockholders (and eventually to holders of subordinated bonds). For such investors, the advantage with respect to acquiring the NPLs directly from a bank comes from the wider possibilities of diversification, which help reduce the idiosyncratic risk of smaller and more specialised loan portfolios, and from the value added provided by the activities of the AMC.[19] The second option is for the State to play a direct role in an AMC, an issue that we will discuss in the below section.

3. THE STATE OF THE ART

3.1. Empirical evidence: the cases of publicly funded AMCs set up in Europe after the global financial crisis

Evidence from national centralised AMCs in the EU shows the effectiveness and versatility of such entities in managing and disposing non-performing assets over a medium- and long-term horizon. Annexes I and II present an analysis of the main features of some publicly supported AMCs, including a reference to the national regulation, the type of ownership, the mandate, the type of transferred assets, the governance, and the legal basis upon which the Commission decided on the compliance of the individual entity with State aid rules.

Empirical analyses shows that main nation-wide and centralised AMCs are either fully owned by the State or that the State is the majority shareholder. Most cases are also characterised by a broad mandate, which covers not only the management and recovery of NPLs but also the restructuring of banks facing severe solvency or liquidity problems and other more general objectives (for example, promoting affordable housing). The types of transferred assets also reflect the versatility of such tools in managing a wide array of non-performing exposures (i.e., real estate, property loans, and property development loans).

[17] AMCs do not necessarily need to have a commercial bank license, because they do not accept short-term retail deposits. Article 4(1) of Directive 2006/48/EC defines credit institutions (i.e., banks) as financial intermediaries *"whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account".* Although some AMCs may have a business model which implies performing activities which require a banking license, this is not central in our analysis of the benefits of AMCs for creating a larger market for NPLs. For a discussion of how AMCs may be subject to supervision, see Section 5.1, below.

[18] The Commission Staff Working Document, AMC Blueprint Accompanying the document, Communication from the Commission to the European Parliament, The European Council and The European Central Bank, Second Progress Report on the Reduction of Non-Performing Loans in Europe {COM(2018) 133 final, Brussels, 14.3.2018 SWD(2018) 72 final, suggests that the lifespan of AMCs should be finite; however, this appears to be related mostly to the potential problems caused by state participation, which we will discuss below.

[19] It would also be possible to require that some of the potential losses be incurred by the bank which sells the NPLs, i.e., that banks be required to retain some skin-in-the-game. This can take the form of a direct participation in the capital of the AMC. However, this would imply that the risk of the NPLs would remain with the banks, resembling more a window dressing of banks' balance sheets than a true solution to the NPL problem.

Additional reasons detailing the effectiveness of AMCs can be found in the legal acts on which the decisions of the European Commission regarding their compatibility with the State aid rules are grounded. In particular, the Commission has in some cases explicitly recognised that this instrument is useful to preserving financial stability; in others, the reasons put forward by the States in their request to the Commission, to ascertain if the measures constitute State aid, clarify how AMCs can be useful to help reduce the level of NPLs by national credit institutions.

Within this framework, a broad distinction can be drawn between: (*i*) AMCs set up right after the onset of the 2008 global financial crisis to specifically address the sudden deterioration of the credit market (namely, FMS Wertmanagement, NAMA, BAMC and SAREB); and (*ii*) AMCs set up at a later stage to boost the secondary market for NPLs and enhance the economic recovery (MARK, AMCO).[20]

In the context of the global financial crisis (2008-2011), several countries opted for the design of systemic government-sponsored companies to address the sudden deterioration of the credit market, in particular against the fallout from crises that stemmed from rapid credit expansions or real estate crashes (Medina Cas, Peresa, 2016). The European Commission considered the set-up of FMS Wertmanagement, NAMA, BAMC and SAREB to be compatible with the internal market by qualifying the State intervention as an *"aid to remedy a serious disturbance in the economy of a Member State"*, according to Article 107 (3)(b) of the Treaty of the Functioning of the European Union (TFEU). Based on this rationale, the Commission recognised the AMCs as an appropriate instrument to deal with disturbance in the economy caused by crises (see Annex II).

At a later stage, some Member States took actions to tackle the issue of NPLs, including by setting up publicly funded AMCs, but with a different operating mechanism. We refer here to the publicly funded AMCs set-up in Hungary in 2014 (MARK) and to the Italian State guarantee scheme to support the securitisation of NPLs, approved by Italian authorities in 2016. Those initiatives aimed at reducing the overhang of NPLs from national banks through an alignment with (hypothetical) market conditions. The Hungarian authorities expressly declared that when managing the acquired assets, MARK will maximise their value and that if NPLs will be sold, MARK will do so via open, transparent and non-discriminatory processes with a view to maximise the sale price.[21] The Italian authorities considered that the distressed debt market was at that time underdeveloped, lagging behind those in the euro area countries such as Spain or Ireland. Thus, a guarantee scheme, in parallel with other reforms, such as Italian insolvency law, would have favoured the work-out of NPLs. The State guarantee was provided to the securitisation structure at market terms. Furthermore, the NPL management was transferred to an independent servicer to increase the likely recovery and to reduce the risk of the work–out not being performed in the most efficient way.[22] On the basis of this, in both cases the European Commission decided that, based on the information provided by both the Hungarian and Italian authorities, the notified measures did not constitute aid within the meaning of Article 107 (1) TFEU because the Market Economy Investor Principle (MEIP) had been respected (see more on this point in section 4.2.1).

Given this context, it is arguable that the most recent European experience has shown two distinct models of publicly funded AMCs whose activity has been considered compatible with the State aid legal framework. The first model is represented by an AMC set-up to rescue a single credit institution or to recover a sector of the financial system, known as *bad banks*. That kind of AMC buys NPLs at book value or

20 Further details for the comparison of AMCs are shown in Annex I.

21 See European Commission Case SA.38843 (2015/N) – Hungary - Asset purchase programme by the Magyar Reorganizációs és Követeléskezelő Zrt., a Hungarian Asset Management Company Brussels 10.2.2016, C(2016) 820 final, p. 3.

22 See European Commission Case SA.43390 (2016/N) - Italy - Italian securitisation scheme, Brussels 10.2.2016, C(2016) 873 final, p. 2 and 10.

at a price higher than the prevailing market prices,[23] *de facto* accepting as a plausible outcome that the company may suffer losses that will be borne by taxpayers. The second model consists of AMCs set-up to promote a higher volume and more efficient secondary market for NPLs. In the latter case, the State intervention takes place under the same conditions as those of private investors, both in terms of acquisition price and risk remuneration.[24] The business model of those AMCs aims to make profits, like any private company.

3.2. Some lessons learned from the Italian experience

Italy provides an interesting example of a versatile AMC, operating in the NPLs market in a variety of contexts. AMCO S.p.A. (Asset Management Company, formerly named *Società per la gestione di attività* – SGA S.p.A., hereinafter, AMCO or SGA) is an asset management company whose share capital is currently entirely owned by the Italian Ministry of the Economy and Finance (MEF).

AMCO originated in 1989 as part of the bailout plan of Banco di Napoli. It benefitted from public support to acquire the Banco di Napoli's NPLs, approved by the EU Commission under Article 92 (3) (c) (now Article 107(3)(c) TFEU) (Commission decision of 29 July 1998 - C(1998) 2495). In 1997, the then-SGA was enrolled as "financial intermediary" under the Italian Banking Act,[25] thereby receiving authorisation to exercise lending activities *vis-à-vis* the public. In the following years (1997-2002), SGA expanded its business and acquired other NPLs from other Banco di Napoli Group's distressed companies (€ 1.3 billion), as well as shareholdings in other companies, such as Graal S.r.l., a leasing servicer.[26] In 2014, Banco di Napoli engaged SGA as direct servicer for the entire loan portfolio (about € 3 billion). In 2016, a Law Decree[27] mandated the transfer of the entire share capital of SGA to the Italian Ministry of Economy and Finance (which previously only owned a share pledge). Moreover, SGA's corporate purpose was widened to encompass the purchase of loans, interests and other financial assets on the marketplace. In 2019, the company anglicised its corporate name into AMCO (Asset Management Company) and launched a new industrial plan aimed at developing new business initiatives.

Relying on the wide scope of its corporate purpose, as provided in its articles of association, AMCO has progressively opened up its activity to three main areas of operation: (i) investment in NPEs, in the context of de-risking plans implemented by solvent banks, (ii) intervention in banking crises as an NPE purchaser (although not as a "bad bank" in the context of situations relevant under the Bank Recovery and Resolution Directive (BRRD[28]), and (iii) as a credit servicer for NPE management (for a more detailed description of AMCO's business, see Annex III).

The experience of AMCO seems to highlight certain advantages of a large-scale player operating in a variety of banking restructuring and de-risking transactions. Managing a large portfolio of assets may enhance economies of scale and allow efficiency gains in the recovery and restructuring procedures. Furthermore, specialisation in these activities, achieved in the long period since its establishment (the

[23] As regards the acquisition price, for NAMA, SAREB the transfer price was higher than the prevailing market values, but below the real economic value and required burden sharing of bond, equity and subordinated debt holders. In contrast, FMS acquired assets at book value, exceeding the real economic value. Nevertheless, the Commission has declared it compatible with the State aid criteria given the partial claw back and the in-depth restructuring.

[24] See Annex 2.

[25] Article 107 of Italian Legislative Decree No. 385 of 1 September 1993 (in force at the time).

[26] See Corte dei Conti, footnote 22, at 3.

[27] Law Decree No. 59 of 3 May 2016, converted into Law No. 119 of 30 June 2016, Art. 7.

[28] Directive no. 2014/59/EU of the European Parliament and of the Council of 15 May 2014.

acquisition of the credit package of Banco di Napoli dates back to 30 years ago), has allowed AMCO to acquire deep market expertise, thus improving its management efficiency.

At the same time, the establishment of AMCO has given rise to criticisms, based on alleged competition threats posed by its public ownership. According to this view, State support would allow the AMC to bid higher prices for the NPL portfolios, with an undue advantage to the selling banks and a detrimental effect to the competitors of the AMC. We consider that AMCO's State control has been key to reaching the current volumes of NPEs under management: the appointment of AMCO as "bad bank" in the context of the Banco di Napoli and the Banche Venete liquidations (see Annex III) was the outcome of an *ad hoc* legislative process (as public interest concerns were implicated). However, such an appointment – as well as the terms and conditions of the NPL transfer – was scrutinised and approved by the European Commission under State aid regulation, which is conditional upon specific operative restrictions. A critical lesson learnt from the Italian experience is that it is crucial that State aid controls and sound corporate governance procedures provide the necessary safeguard to curb potential distortions deriving from the State control of the AMC.

4. AMCS AND THE ROLE OF THE STATE

Having described some successful past experiences of AMCs, we now turn to the role of the State and of the possible legal constraints defining the scope of its intervention.

4.1. Pros and cons of a publicly funded AMC

There are many reasons why State intervention can be pivotal in setting up an AMC. First, before a large market for NPLs develops, governments may initially have stronger incentives than private entrepreneurs to set-up an AMC, because ultimately the costs of a large NPL crisis would fall on them (as we have seen from many past experiences, strong financial crises always require public interventions). In turn, the creation of an AMC can help to enlarge the market and to make it profitable, including for fully private AMCs. Second, governments can credibly make a greater commitment to focus on making zero losses rather than maximising profits, thereby avoiding the exploitation of their market power and bidding a price closer to a fair prediction of the NPLs' value. This would reduce the bid-ask spread and favour the growth of the market.

Last, aside from the limitations imposed by State aid rules, governments can credibly provide guarantees on the value of the NPLs. This is a sensitive issue because it may be used as an indirect way of mutualising banks' losses. While the costs and benefits of providing a public backstop in the event of a major financial crisis have been discussed extensively, for the purpose of the present analysis, if an AMC is fully owned by the State, the risks are ultimately held by the taxpayers. However, this could provide distorted incentives. Governments could help their banks clean up their balance sheets, acquiring their NPLs at a price above a fair prediction of their value. In turn, this could exacerbate the doom-loop problem of the sovereign-bank nexus. However, as we will discuss in detail below in Section 4.2.1., regulations on State aid are very strict on this issue.

In principle, governments must therefore acquire NPLs at a price that does not exceed their real economic value. However, the many reasons discussed in section 2 make it impossible to uniquely define this value, which depends on the prediction of what can be recovered from the NPL.[29]

[29] In fact, both methodologies proposed by the European Commission in the Staff Working Document on AMC Blueprint (2018) contain a component which reflects a prediction on what can be recovered: the required credit spread with respect to the risk-free rate in the case of

Despite the impossibility of uniquely defining the real economic value of an NPL, methodologies such as the two identified by the European Commission in the Staff Working Document on AMC Blueprint (2018) can help in setting a benchmark to guide external evaluations. A comparison of the market price of an NPL, or the one applied by an AMC, with the value obtained when applying these methodologies, using either the credit spreads required on similar assets or the historical values of the expected losses, can make it easier to uncover sizeable misalignments.[30]

Failing to apply a price close to a credible estimate of the real economic value of the NPL would not only imply a breach of the rules on State aid, but it would also hinder the development of a transparent market for NPLs, because banks would only be willing to sell to the public AMC, willing to pay higher prices. Within the limits imposed by State aid rules (see section 4.2), if governments decided to help clean up banks' balance sheets, it would be preferable to do so by providing external guarantees on the value of the NPLs and assessing transparently the cost of such guarantees.[31]

An additional problem is that, while managers of private AMCs are free to decide what NPLs to buy and at what price, this may not always be the case for public AMCs, whose managers may not have full discretion, because of the substantial impact that their decisions can have on the financial stability and the profitability of individual banks. In theory, it is possible to limit managers' discretion by requiring them to set transparent pricing standards to be applied to any seller of NPLs with given characteristics. However, this may be more easily said than done, due to the large differences across NPL portfolios. Public AMCs can thus be a powerful catalyst for the development of large and efficient markets for NPLs, but their activities need to be carefully regulated to avoid distorted incentives.

A final remark on the issue of State participation in AMCs should be made. While it is essential to do everything that is possible to remove any incentive to use such participation as a mean to sustain banks, it would be a mistake to draw any conclusion from the ex-post performance of the AMC. As argued above, the ex-post realisation of risks – and the related share of the nominal value of NPLs that is recovered – depends on events that cannot be fully predicted ex-ante. This implies that the real economic value of an NPL predicted ex-ante could be different from the ex-post realisation. What is needed to achieve a fair allocation of risks is that the ex-ante prediction of the real economic value, which is the upper bound of the price at which the AMC should buy NPLs, is not biased upwards, to favour banks, or downwards, to favour investors. In such a case, AMCs can help to reduce the portfolio of NPLs without making any economic loss on average.

4.2. A publicly financed AMC: the legal framework constraints

In this section, we assess how to build a centralised publicly financed AMC given the legal constraints present in the current European regulatory framework. In particular, we refer to the rules on State aid and the rules contained in the BRRD.

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cash-flow based method, and the expected loss (the product of the probability of default and the loss given default) in the case of expected-loss method. Notably, the two measures are not even truly alternative, because they both depend on the prediction of what can be recovered from the NPL: any investor anticipating a larger expected loss on a financial asset would require a higher credit spread.

[30] A related issue is that in some all cases an equilibrium market price cannot even be observed. The Commission Staff Document on AMC suggests that an "expected market price" can be calculated defined using adjusted benchmarking to correct the price observed for the sale of assets that have some similarities with the assets in question. While this adds an additional element of estimation, the discussion above is unchanged assuming that the estimated market value is used when the market value is not available.

[31] This can be done for example referring to the price of credit default swaps, as in the case of GACS, described in Section 3.2 and in Annex III below.

4.2.1. Conditions for NPLs transfer to AMCs and compatibility with the State aid regime

To assess the real effectiveness of AMCs on the market for NPLs, it is necessary to examine their compatibility with the State aid framework.

The purchase of impaired banks' loans by a publicly funded AMC could be classified as State aid under Article 107(1) TFEU if the State uses its resources[32] to bring an economic advantage that banks[33] would not have received in the normal course of business,[34] thus affecting the competition in the common market (Kociubiński, 2020).[35]

In the context of the global financial crisis, as described in section 3 of this paper, the European Commission has deemed the set-up of FMS Wertmanagement, NAMA, BAMC and SAREB compatible with the internal market, despite all the conditions to qualify their interventions as State aid. It found this to be so because in those cases the aid was needed *"to remedy a serious disturbance in the economy of a Member State"* according to Article 107 (3)(b) TFEU (Lynch Fannon, 2016).

The set-up of those AMCs took place in the years 2008-2012 *when "financial stability has been the overarching objective for the Commission"*.[36] For this reason, the Commission, in response to the financial crisis (in its "Crisis Communications"),[37] on the one hand, ensured that State aid was kept to a minimum and imposed that an appropriate contribution to restructuring costs should be supplied by the aid beneficiary (so-called *burden sharing*). On the other hand, it took into account the need to prevent major negative spill-over effects for the rest of the banking system which could flow from the failure of a credit institution as well as the need to ensure that the banking system as a whole continued to provide adequate lending to the real economy. The 2013 Banking Communication,[38] taking account of the evolution of the crisis from one of acute and system-wide distress towards a situation of more fundamental economic

[32] State aid rules cover only measures involving a transfer of State resources (including national, regional or local authorities, public banks and foundations, etc.). See *inter alia* Cases T-214/95 Het Vlaamse Gewest (Flemish Region) v Commission of the European Communities [1998] ECR II-717; 323/82 SA Intermills v Commission of the European Communities [1984] ECR 3809; C-102/87 France v Commission of the European Communities (Fonds industriel de modernisation) [1988] ECR I-4067.

[33] State aid must be selective and thus affect the balance between certain firms and their competitors. Selectivity is what differentiates State aid from the so-called general measures (e.g. most nation-wide fiscal measures). See *inter alia* Cases C-143/99 Adria-Wien Pipeline GmbH and Wietersdorfer & Peggauer Zementwerke GmbH v Finanzlandesdirektion für Kärnten [2001] ECR I-8365; T-55/99 Confederación Española de Transporte de Mercancías (CETM) v Commission of the European Communities [2000] ECR II-3207; C-200/97 Ecotrade Srl v Altiforni e Ferriere di Servola SpA (AFS) [1998] ECR I-7907, para. 36; C-290/87 Netherlands v Commission of the European Communities (Fisheries quotas) [1989] ECR I-3083, para. 22-23.

[34] See *inter alia* Cases T-214/95 Het Vlaamse Gewest (Flemish Region) v Commission of the European Communities [1998] ECR II-717; 323/82 SA Intermills v Commission of the European Communities [1984] ECR 3809; Joined Cases 296 and 318/82 Netherlands and Leeuwarder Papierwarenfabriek BV v Commission of the European Communities [1985] ECR I-809; C-102/87 France v Commission of the European Communities (Fonds industriel de modernisation) [1988] ECR I-4067.

[35] Aid must have a potential effect on competition and trade between Member States. It is sufficient if it can be shown that the beneficiary is involved in an economic activity and that he operates in a market in which there is trade between Member States. See *inter alia* Joined Cases T-298/97, T312/97, T-313/97, T-315/97, T-600/97 to T-607/97, T-1/98, T-3/98 to T-6/98 and T-23/98 Alzetta Mauro and Others v Commission of the European Communities [2000] ECR II-2319, para. 81 and Case T-288/97 Regione Friuli Venezia Giulia v Commission of the European Communities [2001] ECR II-1169, para. 41.

[36] See Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favor of banks in the context of the financial crisis ('Banking Communication') (Text with EEA relevance) 2013/C 216/01, p. 7.

[37] Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis ('2008 Banking Communication') (OJ C 270, 25.10.2008, p. 8); Communication on the recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition ('Recapitalisation Communication') (OJ C 10, 15.1.2009, p. 2); Communication from the Commission on the treatment of impaired assets in the Community financial sector ('Impaired Assets Communication') (OJ C 72, 26.3.2009, p. 1); Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules ('Restructuring Communication') (OJ C 195, 19.8.2009, p. 9); Communication from the Commission on the application, from 1 January 2011, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2010 Prolongation Communication') (OJ C 329, 7.12.2010, p. 7) and Communication from the Commission on the application, from 1 January 2012, of State aid rules to support measures in favour of financial institutions in the context of the financial crisis ('2011 Prolongation Communication') (OJ C 356, 6.12.2011, p. 7).

[38] Communication on the application of the rules on State aid to banks in crisis (2013/C 216/01).

difficulties in parts of the Union, with a correspondingly higher risk of fragmentation of the single market, established more stringent rules imposing a more effective restructuring process and strengthening burden sharing requirements.[39]

Therefore, outside the context of the financial crisis, the Commission considered lawful the activity of publicly funded AMCs when the specific contractual conditions governing the transfer of the NPLs showed that the interventions do not constitute State aid under Article 107(1) of TFEU.

The interventions do not constitute State aid if they respect Market Economy Investor Principle,[40] namely if a Member State intervenes as a private investor would have accepted and is remunerated for the risk assumed in a way a private investor would have accepted. The State intervenes as a private investor if the impaired assets are bought by the publicly-supported AMC at the asset's market price, i.e., the price which private investors would pay for the same assets at the same time (impaired asset measure or IAM). Since the assets at stake are often not traded and their price cannot be directly observed, the market price must be estimated based on observable transactions for similar types of assets, yielding the Estimated Market Value (EMV) (Cyndecka, 2017).

Therefore, in those cases, the Commission's control is limited to verifying that the State does not bear any more risk than a private investor would have taken and paid for. These considerations were used to approve the Hungarian[41] MARK in 2016 and the Italian Securitisation Scheme.[42]

Concerning the Italian State guarantee scheme to support the securitisation of NPLs, the Commission's assessment showed that the State guarantees on the senior notes was remunerated at market terms according to the risk taken, i.e., in a manner acceptable for a private operator under market conditions.[43] Furthermore, according to the Commission, the appointment of an independent servicer reduced the risk that the work-out of NPLs underlying the securitisation structure was not performed in the most efficient way, and it increased the likely recovery of the NPLs.

The same considerations applied to the Hungarian "bad bank". In addition, in this case, the Commission assessed that the MARK methodology to determine the transfer price ensures a market conform valuation since three conditions were met. First, the granular valuation models developed by MARK for each asset category established prices at market conditions. They were based on prudent parameters and generally accepted valuation methods. Second, MARK hired an independent assessor to appraise the valuation models, which were double-checked by a qualified validator. Third, additional safeguards, including a cap on the transfer price and ex-post verification of transactions, further ensured that the actual transactions did not involve State aid.

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39 See https://ec.europa.eu/commission/presscorner/detail/en/IP_13_672.

40 The statement of this criterion dates back to the mid-1980s; among others it refers to the sentences of the Court of Justice Cases 234/84, Kingdom of Belgium v. Commission of the European Communities, Cases C-301/87, French Republic v. Commission of the European Communities, Cases C-303/88, Republic of Italy v. Commission of the European Communities, Cases C-261/89, Republic of Italy v. Commission of the European Communities, Cases C-278/92 a C-280/92, Kingdom of Spain v. Commission of the European Communities. Recently European Commission Cases SA.43390 (2016/N) – Italy- Italian securitisation scheme.

41 European Commission Case SA.38843 (2015/N) – Hungary.

42 European Commission Case SA.43390 (2016/N) - Italy - Italian securitisation scheme.

43 This was in particular ensured by the following elements: i) the risk for the State was limited since the State guarantee only applies to the senior tranche; ii) the risk distribution of the tranches and the set-up of the securitisation entities were tested and confirmed by the market before the State assumed any risk. The State guarantee on the senior tranche only became effective if at least more than half of the non-guaranteed and risk-bearing junior tranche was successfully sold to private market participants; iii) the State's remuneration for the risk taken was at market terms. The guarantee fee was based on a market benchmark (a basket of credit default swap prices of Italian based companies) and corresponded to the level and duration of the risk the State takes in granting the guarantee. This means that the guarantee fee paid increases over time in line with the duration of the State's exposure.

Does a "market conform valuation" exclude the possibility to consider the *"long-term economic value of the loan"*? [44] Indeed, a transfer price taking into account the long-term economic value could incentivise the transfer of NPLs to an AMC. In a depressed and illiquid market such as the one in a post-COVID-19 scenario, this would avoid transfers at very low prices, not reflecting the expectations of recovery in a time frame that extends beyond the crisis.[45] In the AMC Blueprint published in 2018,[46] the European Commission stated that, in circumstances where there is no liquid market and no directly comparable transaction taking place at the same moment, the Commission may, in order to establish the market value, use adjusted benchmarking to correct the price observed for the sale of assets that have some similarities with the assets in question. The adjustment is based on the difference of the characteristics and quality of the two sets of assets (the EMV). In the same document, the Commission has added that if markets are seized up by lack of information and illiquidity, the Real Economic Value (REV) – defined as the "underlying long-term economic value of the assets, on the basis of underlying cash flows and broader time horizon" – usually exceeds the market price (or EMV). We suggest that, in the current exceptional circumstances due to COVID-19– as recognised by the Commission with the Temporary framework for State aid measures, that has been introduced precisely to support the economy in the current situation[47] – a transfer price based on an EMV that uses pre-COVID-19 benchmarks, therefore closer to the REV, ensures a "market conform evaluation" thereby avoiding the qualification of the transfer price as a State aid.

4.2.2. State intervention and the BRRD

Legal constraints on the use of a publicly funded AMC for the purchase of NPLs from the banks' balance sheets arise not only from the discipline of State aid but also from that of the resolution of banks in crisis. As we will see, the two sets of legislative provisions are closely intertwined. The main drawback is represented by Article 32(4)(d) of the BRRD,[48] which states that a bank receiving "extraordinary public financial support" should be put into resolution.

Pursuant to the combined provisions of Article 32 (4) (d) and Article 2 (1) (28), two conditions should be met to put a bank receiving public aid into resolution: the financial support is qualified as State aid (regardless of whether it is provided by a Member State or at a supranational level); and public support is provided in order to preserve or restore the viability, liquidity or solvency of an institution.

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[44] As was envisaged in the paper published in 2017 by A. Enria, P. Haben and M. Quagliariello, Completing the Repair of the EU Banking Sector. A critical Review of an Asset Management Company, in European Economy, 2017-1, https://european-economy.eu/2017-1/completing-the-repair-of-the-eu-banking-sector-a-critical-review-of-an-eu-asset-management-company/.

[45] In the MARK decision, this point is not mentioned among the assessment criteria of whether the pricing methodology ensured a market conform evaluation, even if the time horizon of MARK's investment is limited by the clause providing for its liquidation or privatisation by the end of 2025.

[46] The EU Commission in the Commission Staff Working Document, AMC Blueprint Accompanying the document, Communication from the Commission to the European Parliament, The European Council and The European Central Bank, Second Progress Report on the Reduction of Non-Performing Loans in Europe {COM(2018) 133 final, Brussels, 14.3.2018 SWD(2018) 72 final, affirmed that any impaired asset aid granted in the context of a transfer of NPLs from a bank to a publicly-supported AMC constitutes extraordinary public financial support; then a bank benefitting from such an impaired asset measures (IAM) should thus in principle be resolved or liquidated.

[47] Temporary Framework as adopted on 19 March 2020 (C(2020) 1863) and its amendments C(2020) 2215 of 3 April 2020, C(2020) 3156 of 8 May 2020, C(2020) 4509 of 29 June 2020, C(2020) 7127 of 13 October 2020, and C(2021) 564 of 28 January 2021 are those published in the Official Journal of the European Union.

[48] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, OJ L 173, 12.6.2014, pp. 190–348.

With regard to the first condition, as recalled in the previous section, the Commission considered that if a Member State intervenes as a private investor would, and is remunerated for the risk assumed in a way a private investor would have accepted, then such an intervention does not constitute State aid.

Thus, if the State intervention is not qualified as State aid pursuant to Article 107 TFEU, there is no "extraordinary public financial support" according to Article 32(4)(d). Otherwise, according to the Commission in the AMC Blueprint, any impaired asset aid granted in the context of a transfer of NPLs from a bank to a publicly-supported AMC constitutes extraordinary public financial support.[49] Consequently, a bank benefitting from such an impaired asset measures should thus in principle be resolved or liquidated because it constitutes "extraordinary public financial support" according to Article 32(4)(d).

Moreover, the AMC Blueprint states that, "*subject to a case-by case assessment, precautionary recapitalization may be used to enable a removal of impaired assets from beneficiary bank's balance sheet. Such a transaction, if properly structured, may achieve exactly the same recapitalization objective for the beneficiary bank as a straight-forward injection of own funds or purchase of capital instruments. In case of an impaired asset relief measure, the bank is allowed to sell the NPLs at a price higher than market price (but not exceeding the assets' real economy value (REV)). Therefore, the capital position of the bank is preserved by reducing the upfront loss*".

On this last point, we note that precautionary recapitalisation as it is currently envisaged by the BRRD is not the right tool to deal with NPLs in the post-pandemic scenario, for three main reasons. First, the precautionary recapitalisation tool is tailored to deal with a bank-specific situation. Indeed, the overall amount of precautionary recapitalisation shall be limited to the specific capital shortfall that emerges after a stress test. Second, only banks without a capital shortfall post-stress test are eligible for a precautionary recapitalisation. Third, and most important, the precautionary recapitalisation should not be used to offset losses that the institution has incurred or is likely to incur in the near future. In particular, precautionary recapitalisation under the BRRD is conceived as a tool to *"prevent a potentially damaging loss of confidence in a solvent credit institution given that the results of a stress test or equivalent exercise have put into question its' forward looking viability in case of materialization of an unlikely scenario."*[50]

The above conditions can hardly be found in cases of banks transferring NPLs to AMCs. In particular, the pandemic and the resulting increase in the level of banks' NPLs was an unexpected event, but when the transfer of NPLs from banks' balance sheets to an AMC will take place, the losses to be offset will already have been incurred or will be likely to incur.

On the other hand, an analysis of the reasons underlying Article 32(4)(d) suggests that the case of the transfer of NPLs from solvent banks to a publicly funded AMC is excluded from its scope of application. According to the combined provisions of Article 32 (4) (d) and Article 2 (1) (28), public support is qualified as an "extraordinary public financial support" only if provided to preserve or restore the viability, liquidity or solvency of an institution. The rule aims to prevent resolution rules, requiring a failing or likely to fail bank to be resolved, from being circumvented. This is not the case with the aid granted in the context of a transfer of NPLs from a "solvent bank" to a publicly financed AMC. In this case, the public support is provided to address the inter-temporal pricing problem by overcoming market illiquidity issues. Of course, any circumvention of this rule must be avoided. Rules governing a centralised publicly funded AMC should

[49] Any impaired asset aid to a going-concern bank must comply with the general requirements applicable to restructuring aid, laid down in the Commission's Banking Communication of 2013 and the Restructuring Communication of 2009. In particular, the following general requirements must be met before the aid is granted: restoring the bank's long-term viability; limiting State aid to the minimum necessary through burden-sharing and own contribution; limiting distortions of competition.

[50] Bassani (2021) at 460. The author underlines that the logic of precautionary recapitalisation *"…is that only in a case of perspective capital shortfalls deriving from the materialisation of unlikely events can public money legitimately be used in order to reassure the markets that the banking system, and its individual components, can withstand also an extreme crisis."*

exclude that it could buy NPLs from banks which are insolvent or close to insolvency, providing specific controls to prevent this from happening. On the contrary, the transfer of NPLs from a bank which is insolvent or close to insolvency to an asset management vehicle could take place, according to Article 42(2) of the BRRD, only as part of a resolution procedure.

4.3. Pros and cons of a European AMC

So far, our analysis has shown that, from a legal perspective, under certain conditions, there is room for AMCs to be set up and to operate according to the European legal framework. From an economic perspective, it has been argued that AMCs can provide substantial support in tackling NPL problems, facilitating a clean-up of banks' balance sheets, in particular following the increase expected due to the COVID-19 crisis. One issue that is still missing in this picture is whether it is desirable that AMCs operate at a national or at the European level.[51]

In the case of public AMCs, there are at least three main reasons why an initiative at the European level would be desirable.

First, it would be a significant step towards the realisation of a truly integrated single market in Europe, where the same rules, practices and opportunities are offered to all banks, independent of the Member State where they are established. In fact, if banks established in some Member States were in a better position to sell their NPLs in large and efficient national markets, which had developed thanks to the presence of national public AMCs, and other banks could not, the former would benefit from a competitive advantage as compared to their competitors.

Second, in an area with strong economic and financial integration such as the European Union and the euro area, NPL problems cannot be confined to single Member State, and must therefore be approached with a European perspective, taking into consideration the effects of contagion and negative spillovers. This will be even more the case with the economic fallout triggered by the COVID-19, which is responsible for the worst recession since the Great Depression of the 1930s and is likely to have a severe impact on EU banking markets. The need for common actions has been largely recognised at the European level, for example with the Next Generation EU plan, and responses to preserve financial stability should also be decided and coordinated at the European level.

Third, standardising the behaviour of public AMCs at the European level would help the development of a large European market for NPLs, attracting even more private investors. In addition to introducing stronger competition and transparency across all Member States and benefiting from economies of scale, a public AMC would also apply the same pricing policies everywhere in Europe, levelling the playing field even more for all banks operating in the area.

A more complicated issue would be the organisation of a single European public AMC. In fact, three main objections have been raised in this regard. First, there is a possibility of a redistribution across Member States of the risks of NPLs in each country. Second, the fact that the loss-given-default on NPLs is rather different across European countries causes some issues in the pricing of otherwise similar NPL portfolios. Third, there are difficulties in establishing financing and governance mechanisms.

On the first objection, one must consider that, if the price at which the AMC purchases NPLs is close to their REV (as it needs to be to avoid breaching State aid rules), an AMC would only incur the ex-post risk that the loan recovery is less than the price paid because of some unexpected events. Aside from the fact that the mutualisation of ex-post losses that are not the results of bad incentives or moral hazard on the part of the

[51] The case of a private non-European AMC acquiring NPLs from European banks is also possible. While we do not discuss this case here in detail, it is crucial that such an AMC be subject to European rules, so as to avoid the risk of regulatory arbitrage.

banks can even be seen as a desirable outcome within an integrated area, it is nonetheless possible to devise a legal mechanism, which allocates losses in the jurisdiction in which the exposures were generated. Moreover, after the global financial crisis and the sovereign debt crisis, most objections raised to the mutualisation of bank losses across European states were based on the need to limit the impact of legacy issues. However, the crisis caused by the COVID-19 pandemic is an entirely new and unexpected event, which calls for collective action, and is happening at a time when banking supervision is already conducted at the EU level.

The second objection is that the differences in the losses-given-default across European countries – caused by different bankruptcy procedures and credit recovery rules – could make it difficult for a European AMC to price NPLs. Portfolios of NPLs that appear similar, granted to firms which are comparable in terms of size and sector of economic activity, could have a different real economic value depending on the country where the firm is incorporated. As a result, they would be priced differently. While at first sight this may appear unfair, such differences in the prices applied by a European AMC would similarly emerge from a comparison of the prices that each national AMC should apply to be compliant with State aid rules. As long as an identical and transparent methodology is applied across countries (for example, the cash-flow method mentioned in Section 4.1), recognising that some legal systems have better bankruptcy and recovery procedures than others should not be a reason to exclude the feasibility of a European AMC. On the contrary, it could even be seen as providing an important incentive for reforming the most inefficient systems.

The third objection relates to the issue of financing and governing a new European body. From an organisational perspective, choosing where the European AMC will be based, appointing the president and board members, and hiring the staff may be too time-consuming given the current situation. From the point of view of financing, allocating capital shares across each Member State might require a not-so-easy-to-reach agreement at the political level. For this reason, a quicker and easier solution could be to set up a network of national AMCs. These would be required to apply the same standards to the scope of eligible loans, loan management, pricing, and servicing, which would be set at the EU level, but they would remain independent national entities. For the reasons discussed in Section 2, common standards would still increase the level of transparency and foster efficiency of the internal market, favouring an effective level playing field among national banking systems.

A final issue with the creation of a public European AMC is that such an organisation would have very strong market power, possibly becoming a monopoly. In fact, a similar criticism could also be raised for a national public AMC. Indeed, if a public AMC were to offer the real economic value of each NPL, so that it can be predicted that on average it would make zero profit, no other players would find it profitable to enter the market. Nevertheless, considering the need not to breach State aid rules, the public European AMC should set the price at a level close but below the expected market value, then leaving room for competition. Clearly, a system of national AMCs would cause fewer problems of excessive market power, possibly leaving room for some competition if national AMCs were willing to bid for NPLs in other Member States.

5. THE NEED FOR A UNIFORM LEGAL FRAMEWORK TO SUPPORT THE EFFECTIVENESS OF AMCS

At the onset of the global financial crisis, international and European authorities acknowledged the need for developing a common strategy to deal with the massive sprawling deterioration of financial institutions' principal assets and the unprecedented increase in NPLs in banks' balance sheets. A broad consensus has been reached among European and international authorities that high levels of NPLs can negatively impact the economy both in terms of financial stability and economic growth. The commitment of the European legislator to tackle NPLs has been strengthened in recent years, in particular by addressing this issue in two main directions: on the one hand, by introducing strict accounting and supervisory rules (supervisory reporting and provisioning expectations) aimed at ensuring the financial solvency and transparency of balance-sheets of European credit institutions (see Annex IV); and, on the other hand, by promoting a package of measures aimed at fostering a secondary markets NPLs.[52]

Although prudential measures and rules indented to boost a secondary market for NPLs are two complementary tools, the former have been properly implemented, but the proposals relating to the latter, contained in the European Commission's Action Plan 2017 regarding secondary market for NPLs, are not yet in place.

Prudential supervisory measures have certainly improved the ability of banks to efficiently manage risks and have accelerated the cleaning of banks' balance sheets from bad loans, with undisputed advantages to the solvency of individual intermediaries. Moreover, the decisive action of authorities aimed at harmonising the accounting rules and those relating to supervisory reporting and provisioning expectations have fostered a level playing field, which is critical for effective competition between intermediaries and the reduction of strong segmentation among national credit markets still existing in the EU. Nevertheless, the study of both sets of regulations shows that a system of inflexible rules can make the NPLs issue more acute from a macroprudential point of view in the current phase of deep economic recession caused by the pandemic. It puts pressure on banks to dispose of NPLs, thus operating on the supply side as a factor contributing to the depreciation of the impaired assets (see Annex IV). This problem will not be solved by the national government measures (such as moratoria of payments for loans and state guarantees on new loans) or by the emergency framework designed by EU and international authorities aimed at allowing government measures to be fully recognised in risk-based capital requirements for banks (see Annex IV). In fact, both sets of rules are extraordinary measures to handle the current economic crisis. They are therefore temporary in nature.

Moreover, the uncertainty with respect to the outlook for the pandemic makes the development of an efficient secondary market for NPLs more crucial. In this perspective, we note that the core discipline of AMCs is still mainly provided for by national legislation, and this very fact stands in the way of making such tools effective to allow for the creation of a secondary market for NPLs at the EU-wide level. Structural impediments, related to legal, judicial and taxation systems have a crucial impact on debt recovery and collateral enforcement. Foreclosure and debt enforcement practices vary considerably across EU countries in terms of effectiveness and length. Moreover, complex legal systems and discrepancies among judiciary proceedings across different countries are a discouraging factor to invest in distressed assets.

Given this context, a uniform legal framework for the design, set-up and supervision of AMCs outside of the resolution framework could significantly contribute to a sound management and an efficient operation of such entities, in particular those that are publicly funded. Some steps in this direction have been taken with the proposal for a Directive on credit services and credit purchasers put forward by the Commission, as further elaborated in the following section.

[52] See on this point also the report presented by the ESRB in response to a Council of the European Union request to develop "*macroprudential approaches to prevent the emergence of system-wide NPL problems, while taking due consideration of procyclical effects of measures addressing NPLs' stocks and potential effects on financial stability*" (https://www.esrb.europa.eu/pub/pdf/reports/esrb.report190128_macrOtheropudentialapproachestonon-performingloans.en.pdf). One of the key proposals of the report was the inclusion by Member States of borrower-based measures in their national macroprudential toolkits, given the important role these instruments play in mitigating the vulnerabilities underlying the first stage of the lifecycle of a potential NPL, and their potential to lessen the adverse effects associated with credit misallocation.

5.1. A minimum set of legal interventions at the European level to favour an efficient secondary market of NPLs, avoiding significant socio-economic consequences to debtors

We consider that to foster an efficient secondary market for NPL's in Europe and to contribute to the creation of conditions for a potential cross-border circulation of NPLs, some legislative reforms are needed. Those reforms are envisaged in 2017 Action Plan adopted by the Commission. In the following sections we highlight the strengths of the Plan, but also some weaknesses.

5.1.1. Rules on credit servicers, credit purchasers and the recovery of collateral

The 2017 Action Plan for the reduction of NPLs in Europe adopted by the Commission encompassed a Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral (COM (2018) 135 final) (hereinafter referred to as the Proposal). The Proposal aims at fostering the development of secondary markets for NPLs by tackling undue obstacles to credit services (Claeys et al., 2017).[53]

This section of the paper delves into whether the tools provided for by the Proposal are sufficient in the current European outlook of economic recession caused by the COVID-19 pandemic.[54]

The aims of the Proposal are threefold: developing secondary markets for NPLs, transferring bank loans to third parties across the EU ("passporting"), and improving the enforcement of loans secured by collateral. First of all, it should be noted that the three aspects are closely intertwined, since discrepancies due to national legislation in debt recovery procedures and in enforcement of loans secured by collateral can hinder effective cross-border circulation of NPLs and the functioning of a secondary market. Indeed, the reform of insolvency and debt recovery frameworks, using several different instruments, is considered a strategic step in the policies for tackling NPLs in the current economic scenario.[55]

Whereas the proposed Directive provides important tools for the achievement of the first two aims, the third is more problematic. As will be discussed in more depth in Section 5.1.2, the effectiveness of the instrument for the enforcement of collateral contained in the Proposal (the so-called AECE only applicable to corporate loans and on the basis of a prior voluntary agreement) can be called into question. This puts the overall efficacy of the Proposal in achieving its intended goals at risk, even if some important results, such as creating a harmonised regulation of the secondary market, or the potential reduction of information asymmetries, which create a "lemon discount" effect on the NPL secondary market (see section 2.2, above), should nonetheless be welcomed. Indeed, the Proposal standardises the regulatory regime (definition, authorisation, supervision, and conduct rules) for credit servicers and credit purchasers, which is currently diversified along national boundaries of Member States, contributing to market fragmentation.

By laying down common standards for authorisation and supervision of credit servicers (Chapter I) and imposing rules for cross border credit servicing across the EU (Chapter II), this regulatory harmonisation aims at allowing greater competition among servicers, lowering the cost of entry for potential loan purchasers by increasing accessibility to and reducing the costs of credit servicing. Regarding the problem of information asymmetries, that in the case of secondary markets for NPLs is between the banks and the

[53] European Commission, Final Report, Bruegel, FISMA/2016/032/B1/ST/OP, "Analysis of developments in EU capital flows in the global context", G. Claeys et Al., 2017, p. 70.

[54] See the Communication from the Commission on Tackling non-performing loans in the aftermath of the COVID-19 pandemic of 16.12.2020: https://ec.europa.eu/finance/docs/law/201216-communication-non-performing-loans_en.pdf.

[55] See the Communication from the Commission on Tackling non-performing loans in the aftermath of the COVID-19 pandemic of 16.12.2020.

external investors (see Sections 2.2-2.3 above), the Proposal (Title III) requires creditors to provide all necessary information to a credit purchaser prior to entering into a contract, using technical standards for NPL data to be further developed by the EBA. This policy (and, more specifically, improving data quality and comparability and establishing a data hub at the European level) is further encouraged in the latest proposals for tackling NPLs communicated by the Commission in 2020, as a measure to support price discovery and render the markets more efficient.[56]

It should additionally be noted that the Proposal imposes legal safeguards and transparency rules to ensure that the transfer of loans does not affect the rights and interests of debtors (Titles VI and VII) (see *infra* section 5.1.3), so as to safeguard consumer protection obligations regardless of how NPLs are resolved. Credit purchasers and credit servicers will have to comply with EU law on consumer protection applicable to the initial credit agreement (see *infra* section 5.1.3). These are also ensured by the requirements for authorisation of credit servicers set forth in Article 5 of the Proposal (such as being of sufficiently good reputation; having a clean police record or other equivalent in relation to serious criminal offences relating to property, financial activities or physical integrity; not being currently subject to insolvency procedures or previously declared bankrupt). In the light of the social impact that the current COVID-19 crisis has had and will have on households and SMEs, it seems that the Directive proposal adopts important safeguards for the protection of the most vulnerable categories of debtors (such as consumers).

The rules listed in the Proposal are furthermore applicable to other entities, such as AMCs, wishing to operate in the secondary market for NPLs. Indeed, the object of the activity and the nature of AMCs falls within the scope of the proposed Directive (see, for a definition of the subjects and their activities, Articles 3(7) and 3(8) of the Proposal). These rules should also apply to publicly financed AMCs.

AMCs could also benefit from the rules on transparency and information to support better pricing of NPLs, especially if reinforced with further data infrastructure as mentioned above.

Given the above considerations, it seems that the proposed Directive could prove important in the regulatory harmonisation of the rules on access, supervision and operation of credit servicers in the secondary market, thus contributing to the creation of conditions for a potential cross-border circulation of NPLs. However, notwithstanding this positive outcome, we think that the Proposal contains some weaknesses, which are further analysed in Section 5.1.2., with suggestions on how to ensure an efficient functioning of a secondary market for NPLs.

5.1.2. Discrepancies in national substantive insolvency laws and their impact on the secondary market of NPLs

An efficient NPLs secondary market highly depends on the time and cost of debt recovery and on the recovery rate resulting from the enforcement procedures (Valiante, 2016).

In the mix of complementary policy actions contained in the Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral, a crucial role is played by the rules aimed at increasing debt recovery efficiency through the implementation of a common AECE.

The adoption of these out-of-court mechanisms (whose goal is to accelerate the collection of the collateral's value) by Member States would certainly help credit institutions more easily sell NPLs to credit purchasers and, as a consequence, clean up their balance sheets more rapidly.

[56] Communication on Tackling non-performing loans in the aftermath of the COVID-19 pandemic, points 2.1 and 2.2.

If the implementation of AECE procedures is certainly beneficial in establishing an efficient NPLs secondary market, the next question is whether this proposal is sufficient to cope with the discrepancies currently present among Member States in the time and cost of enforcement, and in the resulting recovery rates for NPLs.[57]

Indeed, the implementation of AECE procedures is not sufficient if it is not accompanied by a more comprehensive harmonisation of Member States' insolvency laws[58] for the following reasons.

First, the Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral expressly provides that AECE procedures are possible only as long as applicable national laws do not provide for a stay of individual enforcement actions. In other words – as provided by Article 32, paragraph 2, of the Proposal – when insolvency proceedings are initiated, AECE procedures are stayed (and therefore neutralised) as a result of the application of national insolvency laws.

Consequently, AECE procedures are not able *per se* to overcome the significant variability across Member States in the effectiveness of national insolvency procedures as measured by recovery rates, time and cost of debt recovery.

Second, the proposed Directive on the recovery of collateral also ensures full consistency and complementarity with Directive (EU) 2019/1023 of the European Parliament and of the Council on preventive restructuring framework. Pursuant to Article 32, paragraph 1, of the proposed Directive, Article 6 of Directive (EU) 2019/1023 prevails, meaning that AECE procedures are once again stayed (and therefore neutralised) in case the debtor accedes to a preventive restructuring plan.

Provided that both Directive (EU) 2019/1023 and the proposed Directive on recovery of collateral do not attempt to harmonise substantive aspects of national insolvency laws, the vast differences in insolvency frameworks across Member States will continue to affect the time and cost of debt recovery as well as the recovery rate, thus hindering the effective cross-border circulation of NPLs and the development of an efficient pan-European market. Indeed, *"diverging time-limits and lengths of procedures as well as diverging overall procedural efficiency make it more difficult to anticipate the outcome for value recovery, making it harder to price risks, including for debts instruments"*.[59]

The high degree of divergences among national insolvency laws severely impacts sellers' and purchasers' ability to correctly price NPLs and hinders the development of an efficient NPL secondary market.

In light of the above analysis, a well-functioning market for NPLs requires to address, at the EU level – as the Commission proposed in its Inception Impact Assessment of 11 November 2020 – the major discrepancies still present in national substantive insolvency laws with a particular regard for the following aspects: ranking of claims and order of priorities; avoidance powers (i.e., the possibility of nullifying certain transactions that the debtor engaged in before the commencement of the insolvency proceedings); mechanisms to realise the collateral (i.e., public auction, private sale, creditors' appropriation of the collateral, etc.).

Given that the convergence of national substantive insolvency laws is a difficult and lengthy process (as the Commission expressly highlighted in its Inception Impact Assessment of 11 November 2020), a

[57] See EBA, Report on the Benchmarking of National Loan Enforcement Frameworks, available at https://www.eba.europa.eu/eba-publishes-report-benchmarking-national-insolvency-frameworks-across-eu.

[58] See Communication from The Commission to the European Parliament, the Council and the European Central Bank – COM(2020) 822 final, at p. 2

[59] As pointed out by the Commission in its Inception Impact Assessment of 11 November 2020 available at https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12592-Insolvency-laws-increasing-convergence-of-national-laws-to-encourage-cross-border-investment, at p. 1

possible alternative path could be to reconsider the abovementioned solution currently offered by Article 32, paragraph 2, of the proposed Directive (i.e., to reconsider the relationship between AECE and insolvency proceedings). In particular, instead of providing a permanent stay of the AECE procedures once insolvency proceedings are initiated, the Proposed Directive should aim at coordinating the AECE mechanism with national insolvency frameworks, so as to allow AECE procedures to continue within, and in coordination with, the insolvency proceedings.

5.1.3. From a legal point of view, are debtors' rights towards AMC equal to those they enjoyed under the original contract vis-à-vis the bank?

This is a crucial question to assess the socio-economic consequences of the use of AMCs to acquire impaired loans from banks. An efficient secondary market for NPLs increases banks' liquidity, thus favouring new credit to households and businesses. Ensuring enough credit lines to firms, small businesses, as well as corporations, may mitigate the effects of economic downturn due to the COVID-19 pandemic. The assignment of creditor's rights to a third party and the following management of NPLs through an AMC aim to facilitate more bank lending to the economy but, at the same time, should not jeopardise the protection of the debtor. In this section, we argue that the current legal framework at the European and national levels provides enough safeguards for debtors of a bank, in particular in case they are "consumers" pursuant to the European directives, meaning natural persons who act for purposes, which are outside their trade, business, or profession. Those safeguards could also be expanded, as provided for by the Commission proposal. To the extent that these safeguards are in place , we believe that an increase in the use of AMCs to buy impaired banks' loans produces significant socio-economic consequences, because it provides benefits to banks and the real economy without making the debtors/consumers worse off from a legal perspective.

The analysis of the rules contained in the Consumer Credit Directive (Directive 2008/48/EC) and in the national transposition laws (see Annex V) shows that, in the case of credit transfer from a bank to an AMC, creditors, if they qualify as consumers under the EU rules, continue to benefit from the same rights they had vis-à-vis the bank on the basis of the original contractual relationship. Indeed, the current European legal framework also aims at protecting debtors/consumers rights following the transfer of the credit to a third party. On this background, the subjective change of creditor must not lead to a reduction of the debtor's rights (Grasmann et al., 2019). Therefore, the assignment of credits by a bank to an AMC does not entail a reduction in the legal protection of bank's debtors/consumers.

The legal framework on consumer protection already in place in case of transfer of banks' loans to a third party is reinforced by the Commission's support for the fast approval of the already-mentioned Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral.[60] This is a crucial point in the Commission's plan to ensure that the most vulnerable debtors are properly protected.

The Proposal is without prejudice to the consumer safeguards already in place, including the case in which the original creditor is replaced by a non-credit institution (COM(2018) 135 final). The credit purchasers and credit servicers will have to comply with EU law in respect of consumer protection applicable to the initial credit agreement. In the same way, all the consumer protection rules in force in the Member State of the consumer – either stemming directly from the initial credit contract or from other rules applicable to credits delivered to consumers or related to the general consumer protection rules in force in the Member State of the consumer – will continue to apply. Therefore, the Proposal encourages the development of secondary markets for NPLs without prejudice to national law provisions (Schuijling et al., 2019).

[60] "Tackling non-performing loans in the aftermath of the COVID-19 pandemic" [COM(2020) 822 final].

Moreover, the Proposal ensures that rules governing the transfer of bank loans to an AMC established in a third country will be consistent with the EU rules aimed at guaranteeing a high level of consumer protection, thereby introducing an additional safeguard mechanism in case of assignment of the creditor's rights to a third party. As set out in Recital 34, third-country credit purchasers may make it harder for EU consumers to rely on their rights and for the national authorities to supervise the enforcement of the credit agreement. In this regard, Article 15 of the Proposal imposes an obligation on the representatives established in the Union of credit purchasers not established in the Union to use an authorised credit servicer or a Union credit institution in case of credit agreements concluded with consumers. Furthermore, where a transfer of the credit agreement has been concluded, the third country purchaser designates a representative established in the Union. This representative will be responsible for the obligations imposed on credit purchasers (Article 17). The provision ensures that the same standards of consumers' rights are preserved after the transfer of the credit agreement.

We conclude that the new regulation of the management of NPLs will allow the application of the current rules on consumer protection, irrespective of who owns or services the credit and irrespective of the legal regime in force in the Member State of the credit purchaser or the credit servicer.[61] Credit purchasers and credit servicers should comply with Union law as applicable to the initial credit agreement and debtors/consumers therefore shall retain the same level of protection as provided under Union law or as determined by Union or national conflict of law rules regardless of the law applicable to the credit purchaser or credit service. Furthermore, the special consumer protection scheme implies that the AECE will not be applicable to credits towards a debtor/consumer.

6. CONCLUSIONS AND POLICY IMPLICATIONS

This paper analysed whether AMCs are efficient tools for facilitating the management and recovery of bank NPLs.

To answer this question, the focus is on the role that these entities could play for the proper functioning of the secondary market for NPLs. No comparative assessment has been carried out between this and other instruments, since all instruments can be used as complements in addressing the NPL problem. Neither, of course, does the study assume that AMCs can provide an alternative to prudential supervisory measures. In fact, it is precisely within a regulatory framework ensuring sound accounting and prudential rules that a deep and transparent secondary market can facilitate the dismissal of NPLs by banks, avoiding fire sales at depressed market prices in times of a recession, such as that we are experiencing as a result of the COVID-19 crisis.

Based on the economic analysis carried out in Sections 2 and 4.1 and on the study of the experiences gained so far, we conclude that AMCs are a useful tool to increase the transparency and efficiency of the secondary market for NPLs, the more so in the case of publicly funded AMCs.

According to the economic analysis, the larger volume of transactions generated by an AMC increases the overall market size, attracting both new sellers and new buyers. With a higher number of buyers, the amount of information collected on the value of the NPLs increases, reducing information asymmetries. This information is then transferred into prices, pushing them towards levels which would prevail in the long run if markets were fully efficient. In turn, this attracts new sellers, further increasing the size and efficiency of the market. The initial benefits in terms of market efficiency are larger in the case of a publicly

[61] In particular, the rights granted to consumers under the Mortgage Credit Directive, the Consumer Credit Directive and the Unfair Contractual Terms Directive will remain in force. In fact, the agreement that governs the contractual relationship between a credit servicer and a creditor shall provide an undertaking by the parties to comply with the Union and national laws applicable to the credit agreement, with particular reference to consumer protection (Article 9 (d)).

funded AMC. Indeed, before a large market for NPLs develops, governments may have stronger incentives than private entrepreneurs to set-up an AMC. In turn, the creation of a publicly funded AMC can help enlarge the market and make it profitable to set up fully private AMCs. This positive outcome can be also seen where the public AMC acquires NPLs at prices which do not exceed their "real economic value", applying pricing models which allow predictions of what can be recovered in line with market best-practices. The added value of State intervention comes from its position, acting as a "patient investor" who is not constrained by short-term profit targets.

The empirical evidence on publicly funded AMCs set up in some Member States shows two distinct patterns. First, there is the case of entities set up by a government or by a public body, commonly referred to as *bad banks,* whose mission is to rescue a single credit institution (as was the case of SGA dealing with the Banco di Napoli crisis) or to deal with a systemic crisis of the financial system (NAMA in Ireland and SAREB in Spain are the most significant examples). In these cases, the purchase price is set regardless of market prices (they are usually acquired at "book value" or at a price higher than prevailing market prices). Second, there is the case of publicly funded AMCs set up to buy NPLs, as a rule, from solvent banks at "market price" (i.e., adopting selection methods and pricing models that would lead to "market price"). This is the case of MARK in Hungary and AMCO in Italy (AMCO activity includes a wide range of operations; in some cases, it functions as a *bad bank* and in others as a market operator). The goal of these entities is not to rescue intermediaries in difficulty but to help improve the non-performing loan market efficiency.

Both models of AMCs have proven useful in favouring an efficient secondary market for banks' NPLs, helping to avoid fire sales at depressed asset prices. A critical lesson learnt from the experience of publicly funded AMCs is that it is crucial that State aid controls and sound corporate governance procedures provide the necessary safeguards to curb potential distortions deriving from the State control of the AMC.

With this background, the authors have assessed how the legal framework interacts with the issue at hand, considering various points of view. First, the activity carried out by publicly funded AMCs is examined to assess the compatibility with the State aid legal framework and with the BRRD. Second, the main regulatory interventions carried out in recent years are summarised to verify to what extent they have achieved positive results for the reduction of the high level of NPLs recorded following the financial crisis, and whether they are sufficient and adequate today to address the increase in NPLs post-COVID-19.

With regard to the first point, the legal framework on State aid, *bad banks* providing public aid to banks in difficulty can operate only if the Commission states that the conditions for considering the aid compatible with the State aid legal framework are met (Article 107(3) TFEU). Differently, the European Commission has deemed that the activity carried out by public AMCs like MARK and AMCO, acting as market operators, does not constitute aid within the meaning of Article 107(1) TFEU. This model of AMC has the advantage of not encountering legal obstacles during its operation even in contexts other than those of a systemic financial crisis.

The application of the State aid discipline is strictly connected with that established in the BRRD. Indeed, according to Article 32(4)(d) of the BRRD, a bank receiving "extraordinary public financial support" should be put into resolution. According to the law, two conditions should be met to put a bank receiving public aid into resolution: qualification of the financial support as State aid (regardless of whether it is provided by a Member State or at a supra-national level) and the public support provided is given in order to preserve or restore the viability, liquidity or solvency of an institution. Then, when the publicly funded AMC buys the loans at a market price agreed by the Commission, the measure does not constitute State aid and then not even Article 32 of the BRRD applies. Furthermore, we think that the analysis of the reasons underlying Article 32(4)(d) suggests that the case of the transfer of NPLs from solvent banks to a publicly funded AMC is excluded from its scope of application. The rule aims to prevent resolution rules, requiring a failing or likely to fail bank to be resolved, from being circumvented by granting exceptional public aid to the bank. This is not the case in the context of a transfer of NPLs from a "solvent bank" to a publicly financed AMC. In this case, any public support is provided to address the inter-temporal pricing problem by overcoming market illiquidity issues and not to preserve or restore the viability, liquidity or solvency of the institution. Of course, any circumvention of this rule must be avoided. Rules governing a publicly financed AMC should exclude that it could buy NPLs from banks which are insolvent or close to insolvency, providing specific controls to prevent this from happening. On the contrary, the transfer of NPLs from a bank which is insolvent or close to insolvency to an asset management vehicle could take place, according to Article 42(2) of the BRRD, only as part of a resolution procedure.

In conclusion, we believe that a public AMC operating with a medium- to long-term time horizon is a very useful jump starter of a market for banks' NPLs. Indeed, a transfer price taking into account the long-term economic value could incentivize the transfer of NPLs to an AMC. In a depressed and illiquid market such as the one in a post-COVID-19 scenario, this would avoid transfers at very low prices, which do not reflect the expectations of recovery in a time frame that extends beyond the crisis. The Commission, in its 2018 AMC Blueprint, affirmed that if markets are seized up by lack of information and illiquidity, the Real Economic Value – defined as the *"underlying long-term economic value of the assets, on the basis of underlying cash flows and broader time horizon"* – usually exceeds the market price (or EMV).[62] We suggest that, in the exceptional circumstances of the COVID-19 scenario – recognised also by the Commission with the Temporary framework for State aid measures, that has been introduced precisely to support the economy in the current situation – a transfer price based on an EMV that uses pre-COVID-19 benchmarks, thus closer to the REV, would ensure a "market conform evaluation" thereby avoiding the qualification of the transfer price as State aid.

We also highlight that an initiative at the European level would be desirable because it would standardise the behaviour of national public AMCs and introduce strong competition and transparency across all Member States. Standardising the activity of public AMCs at the European level would help the development of a large European market for NPLs, attracting even more private investors. Benefiting from economies of scale, a public AMC would also apply the same pricing policies everywhere in Europe, further levelling the playing field for all banks operating in the area. What is more complicated is the organisation of a single European public AMC. In fact, three main objections have been raised against this solution. First, there is the possibility of a redistribution across Member States of the risks of the NPLs in each country. Second, there is the fact that the loss-given-default on NPLs is rather different across European countries, causing some pricing issues of otherwise similar NPL portfolios. Third, difficulties in establishing financing and governance mechanisms could arise. Although these objections can be overcome by setting up an appropriate legal framework, a solution for which political consensus could more easily be obtained would be to set up a network of national AMCs. These would be required to apply the same standards to the scope of eligible loans, loan management, pricing, and servicing, which would be set at the EU level, thereby increasing the level of transparency and fostering efficiency of the internal market. This would favour an effective level playing field among national banking systems.

On the point concerning the legal framework for NPLs, it should be noted that, in recent years, the legislator has addressed the problem at the microeconomic level on the one hand, by introducing strict accounting and prudential rules aimed at ensuring the financial solvency and transparency of the balance-sheets of the European credit institutions and, on the other hand, by promoting a package of measures aimed at

[62] Commission's Blueprint on Asset Management Companies, 2018, p. 50.

fostering NPLs secondary markets (EU Commission Action Plan 2017). Accounting and prudential rules have been properly implemented but measures fostering the NPLs secondary market are still not in place.

One year after the outbreak of the pandemic, the total level of NPLs has not yet increased so as to put financial stability at risk.[63] Notwithstanding this data, when pandemic-related public guarantee schemes and payment deferrals come to an end, it is reasonable to expect a robust build-up of new NPLs. Moreover, it should be noted that the prudential supervisory measures (accounting, supervisory reporting and provisioning expectations) have certainly improved the ability of banks to efficiently manage risks and have accelerated the cleaning of banks' balance sheets from bad loans with undisputed advantages in order to preserve the solvency of the individual intermediary. Nevertheless, these rules establish a system of inflexible constraints which can make the NPL issue more acute at the systemic level, especially in the current phase of deep economic recession caused by the pandemic, thereby putting pressure on banks to dispose of NPLs, and thus operating on the supply-side as a factor leading to the depreciation of the value of impaired assets. This will make the approval of measures to foster a secondary market for NPLs more urgent.

The revised Action Plan on NPLs that was made public on 16 December 2020, stating that the secondary market of NPLs lies at the core of the Commission's strategy, does not foresee any significant change in respect to the 2017 Action Plan. In particular, the Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral (COM (2018) 135 final) could prove important in the regulatory harmonisation of the rules on access, supervision and operation of credit servicers in the secondary market, thus contributing to the creation of conditions for a potential cross-border circulation of NPLs. However, notwithstanding this positive outcome, an efficient secondary market for NPLs strongly depends on the time and cost of debt recovery, and on the recovery rate resulting from the enforcement procedures. The Proposal aims to mitigate the inefficiencies in debt recovery through the implementation of a common AECE procedure. Nevertheless, the paper shows that this extrajudicial procedure does not play a decisive role in the absence of a more far-reaching legislative intervention on national bankruptcy laws.

Considering the above reasons, the regulatory approach adopted in the revised Action Plan (2020) may not be enough to alleviate the NPL burden on the banks' balance sheets to the degree needed for banks to continue financing the real economy in a severe recession.

Finally, in response to the question of whether the use of AMCs can have significant socio-economic consequences, it has been shown that the use of AMCs may have a positive impact on the economy, facilitating a clean-up of banks' balance sheets. Banks would then have new resources to finance the economy, mitigating the negative consequences to the real economy of the pandemic. Moreover, the consumer protection legal framework at the EU level, as well as at the national level, provides enough safeguards for debtors of a bank, in particular when they qualify as consumers, in case of the assignment of the creditor's rights to a third party. Lastly, we conclude that the increase in the use of AMCs to buy impaired banks' loans has significant positive socio-economic consequences, because it provides benefits to banks and the real economy without making the debtors, in particular the most vulnerable, worse off.

[63] See Communication from the Commission to the European Parliament, the Council and the European Central Bank, *Tackling non-performing loans in the aftermath of the COVID-19 pandemic*, Brussels, 16.12.2020 COM(2020) 822 final, stating that "*In Q2-2020, the average Tier 1 capital ratio for all EU banks amounted to 16.4%, and the average NPL ratio stood at 2.8%. The liquidity coverage ratio for significant financial institutions stood at a comfortable 165.5%.*" See also EBA (EBA Dashboard – Q3 2020).

ANNEX I The AMCs in Europe: legal and operational aspects

AMC		Foundation	National Regulation	Mandate	Type of Ownership	Equity Holders	Type of Asset Transferred	State aid
DE	FMS Wertmanagement	8 July 2010	FMStFG (Financial Market Stabilization Fund Act) FMStBG (Financial Market Stabilization Acceleration Act) FFMS (Financial Market Stabilization Act, "Bad bank Act)	Achieving maximum value in winding up the portfolio and the DEPFA group	100 % public	100% Financial Market Stabilisation Fund (SoFFin)	Commercial real estate, commercial real estate-workout, infrastructure, public sector and structured products	Commission Decision on State Aid C 17109 by Germany for the Restructuring of Landesbank Baden- Wiirttemberg, 2010 O.J. (L 188) 1.
HU	Magyar Reorganizációs és Követeléskezelő Zrt. (MARK)	November 2014	Act CXXXIX of 2013 on the National Bank of Hungary	Purchase, at market prices, of CRE NPLs and repossessed CREs from solvent financial institutions or their subsidiaries that are active in Hungary and that are either registered in Hungary or in the European Economic Area.	Initially 100% public, then opened to private ownership	Initially 100 % NMB, then shared with private investors	Collateralised by commercial real estate and commercial real estate collateral	Commission Decision on State Aid SA. .38843 (2015/N) – Hungary Asset purchase programme by the Magyar Reorganizációs és Követeléskezelő Zrt., a Hungarian Asset Management Company, C(2016) 820 final (Feb. 10, 2016).
IT	Asset Management Company (AMCO)	Originally SGA (1996) then AMCO (2019)	Legislative Decree no. 385 dated 1 September 1993 (Consolidated Law on Banking)	Management and recovery of NPLs	100 % public	100% Ministry of Economy and Finance	NPLs not limited to specific asset types	Commission Decision on State Aid – Conditionally approving the aid granted by Italy to Banco di Napoli, o C(1998) 2495, (July. 29, 1998). Commission Decision on State Aid SA 45664 (2017/N)– Orderly Liquidation of Banca Popolare di Vicenza and Veneto Banca (June 25, 2017).

AMC		Foundation	National Regulation	Mandate	Type of Ownership	Equity Holders	Type of Asset Transferred	State aid
IR	National Asset Management Agency Investment Ltd. (NAMA)	December 2009	National Asset Management Agency Act 2009 (the NAMA Act) Irish Bank Resolution Corporation Act 2013 (the IBRC Act)	Debt reduction % residential housing	51% private, 49% public (last check 2016)	51% three private companies loans 49% National Asset Management Agency (NAMA) (last check 2016)	Loans properties as securities for land and development and associated loans	Commission Decision on the Establishment of a National Asset Management Agency (NAMA), in Case N72512009 (Ireland), C (2010) 1155 final (Feb. 26, 2010).
SL	DUTB (Družba za upravljanje terjatev bank) also known as BAMC (Bank Assets Management Company)	March 2013	Law on bank stability (ZUKSB) December 2012	Debt restructuring % asset management	100 % public	100 % Government	Equity, real estate, claims	Commission Decision on State aid SA.32261 (2011/N) – Slovenia Rescue recapitalisation in favour of NLB, C(2011) 1565 final (Mar 7, 2011). Commission Decision on State aid SA.35709 (2013/N) – Slovenia Restructuring of Nova Kreditna Banka Maribor d. d. (NKBM) – Slovenia, C(2013) 9634 final, (Dec 18, 2013)
SP	Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria (SAREB)	July 2012	Memorandum of understanding on Financial Sector Policy Conditionality (2012)	Disinvestment 15 Years (prolonged) & affordable housing	55% private, 45% public	14 national banks 2 foreign banks 10 insurance companies property 45% Fund for Orderly Bank Restructuring (FROB) (last check 2016)	Property develoment loans, property	Commission Decision on State Aid SA.35253 (20121N) Spain, Restructuring and Recapitalisation ofthe BFA Group, C (2012) 8764 final (Nov. 28, 2012).

ANNEX II National AMCs

Germany

The **FMS Wertmanagement (FMS-WM)** was established in July 2010 to manage NPLs of a specific group, the "Hypo Real Estate (HRE) Holding". The transfer of NPLs was made via a division, and for this very reason the ownership of the credit institutions originator of the NPLs was reflected in the *bad banks*' ownership. The establishment of the FMS was built on the basis of the principle of company cleavage (Spaltung), which enables a company and its shareholders to split the company, provided that they retain joint liability for the activities of the entities resulting from the division. In Germany, a bad bank can be set up via demerger: privately, under regional state law, or under federal law.[1] The most important aspect of the German case is that the *bad bank* was backed by a state guarantee Fund ("SoFFin"), which in turn was backed by a guarantee of the federal government, allowing the transfer of NPLs to the *bad banks* at their book value. For the assessment of compatibility with State aid rules, the European Commission based its evaluation of FMS on IAM requirements. In particular, the Commission asked for a clear functional and organisational separation between the beneficiary bank and the assets, to prevent conflicts of interest and, in case the burden sharing could not be ensured ex ante, the introduction of claw back clauses and completion of in-depth restructuring. Moreover, the Commission confirmed that any pricing of the asset relief includes adequate remuneration for the state, taking into account the risks of future losses exceeding those projected in the determination of the real economic value of the portfolio.

Hungary

The **Hungarian asset management company (MARK)** was formed in 2014 to allow solvent financial institutions in Hungary to sell, on a voluntary basis and at market price, a specific pool of non-performing loans, backed by commercial real estate. The ownership was initially 100% public, but then it was opened to the private sector. In conducting the assessment of the compatibility with the State aid rules, the Commission has confirmed that MARK's methodology to determine the transfer price ensures a market conforming valuation of transferred assets and therefore the measure is free of State aid within the meaning of Article 107(1) TFEU. In particular, the Commission pointed out that the granular valuation models developed by MARK for each asset category establish prices at market conditions, based on prudent parameters and generally accepted valuation methods. In addition, MARK policies on transfer price require a double-check independent valuation. Lastly, additional safeguards, including a cap on the transfer price and ex-post verification of transactions, would further ensure that the actual transactions do not involve State aid.

Ireland

In Ireland the bad bank in charge of managing NPEs was set up in December 2009 by the **National Asset Management Agency Act 2009 (NAMA Act)**. The Act provides the power for the Ministry of Finance to issue binding written guidelines to NAMA and imposes upon the Agency an obligation to

[1] In practice, the private solution was never applied. Instead, a regional state solution was chosen in Hamburg (HSH Nordbank) and a federal solution was applied to WestLB and HRE. The federal solution was based on the principle that the original owners were liable for the wind-down agencies (Erste Abwicklungsanstalt and the FMS Wertmanagement)..

submit an Annual Statement and a quarterly report on its activities. NAMA holds 49% of the National Asset Management Agency, while the majority stake is held by private institutions. Funding was ensured through securities issued by National Asset Management Limited (NAML), which provides a State guarantee. With regard to the value of acquisition of bank assets, various factors are taken into account: the long-term economic value of the loan, including the current market value of the security, the long-term economic value of property and the market value of the bank asset. In relation to compliance with EU State aid rules, the European Commission found that the asset relief scheme was apt to address a serious disturbance in the Irish economy, in application of Article 107(3)(b) TFEU. According to the Commission's assessment, the implemented measures abided by rules on burden sharing of the costs related to the transfer of assets between the government and the banks' shareholders and creditors, and by the rules on remuneration.

Spain

The **Sociedad de Gestión de Activos procedenets de la Reestructuración Bancaria (SAREB)** was created in November 2012. The creation of this company was set forth in the Memorandum of Understanding (MoU) that the Spanish government signed in July 2012, in order to receive financial aid for the banking sector. In terms of eligible banks, the MoU determined that any credit institution that obtained public financial assistance was obliged to transfer some of its real estate exposure to the SAREB.

The main objective of the Spanish AMC is to clean up the financial sector by focusing on the excessive exposure of the real estate sector. The majority of SAREB's share capital is private, 55%, whilst 45% is owned by the Fund for Orderly Bank Restructuring (FROB), the public entity (executive resolution authority) devoted to managing the banking sector restructuring process. SAREB was originally envisaged to be operational for 15 years. In the first three years of the company’s performance, the assets received have been reduced by 15% and it has sold more than 35,000 properties. With regard to the compliance of SAREB with the State aid rules, the European Commission found that the asset transfer was in line with State aid rules, because it was based on the estimated long-term REV of the assets and the application of a discount. The transfer price was below the projections of real economic value of the assets (about 5-10%), ensuring remuneration to the government in the form of a potential upside in asset value. Moreover, the Commission took positive note of the burden sharing of equity and subordinated debt holders of the banks, acknowledging that the capital need was further reduced through bank divestments.

Slovenia

The Law on Slovenia’s measures to strengthen bank stability entered into force in December 2012. With the objective of strengthening the stability of the Slovenian financial system, it provided for the establishment of a State-owned AMC and a number of stabilisation measures including: (i) the transfer of banks’ impaired assets to the Bank Assets Management Company (BAMC); (ii) the issuance of State guarantees for the liabilities of the BAMC; and (iii) the recapitalisation of banks by the State. According to this regulation, the **Družba za Upravljanje Terjatev Bank (DUTB)** – also known as (BAMC – was established in March 2013 with the main objective of facilitating the restructuring of banks with systemic importance facing severe solvency and liquidity problems.

The lack of a developed market for NPLs in Slovenia led to the establishment of DUTB, preferred to the creation of SPVs in individual banks and the sale of NPL portfolios. The company is fully owned by the Republic of Slovenia. In terms of the actual transfer, all corporate loans are eligible. DUTB is envisaged to be operational until the end of 2022. Its strategy encompasses the acquisition, management and restructuring of non-performing assets from four systemically important banks and other complementary asset acquisitions.

The Law on bank stability has also provided the criteria under which the BAMC may engage in the restructuring of companies of which it is a shareholder or creditor and allows the BAMC to carry out any legal transaction necessary for the successful restructuring of such companies, including providing loans to its debtors or guaranteeing its debtors' liabilities. In particular, the Law provides that the BAMC may require a bank, which was previously subject to stabilisation measures under the Law on bank stability, to transfer to the BAMC claims against or shares in a company in which the BAMC already holds shares or against which the BAMC already has claims, in exchange for cash compensation equal to the market value of the assets being acquired.

In December 2013, the European Commission approved in five separate decisions State aid measures in favour of five Slovenian banks. In particular, the Commission assessed the measures in favour of NLB, NKBM, Factor Banka, Probanka and Abanka under the State aid rules for the restructuring of banks during the crisis, and specifically the requirements of the 2013 Banking Communication. Given the need to absorb losses, all five banks had to fully write-down shareholders' equity and outstanding subordinated debts before they can receive new State support. The Commission concluded that this would ensure an appropriate contribution by the bank and its owners to the restructuring plan, in line with the 2013 Banking Communication. In particular, NLB is the largest Slovenian bank holding approximately 30% of domestic banking assets. Its restructuring plan includes a third State recapitalisation of € 1.558 billion and an asset transfer to the BAM) of € 2.300 billion (nominal amount). NLB limited the scope of its activities to its core business and improved its corporate governance and risk management policy. The transfer of a pool of non-performing loans and a list of equities to BAMC cleaned up its balance sheet and built a profitable business model that would contribute to its return to viability. The Commission therefore approved the measures.

ANNEX III. THE ITALIAN EXPERIENCE: SGA, AMCO AND REV-GESTIONE CREDITI S.P.A

The origins of SGA and its role in the Banco di Napoli bailout

SGA was originally established in 1989 as a company entirely controlled by Banco di Napoli, a long-standing bank with a public entity legal nature, which held a prominent stake in southern Italy's credit market.[2] In the early 1990s, Banco di Napoli experienced a severe crisis, related—*inter alia*—to extraordinarily soaring levels of non-performing loans and, in 1995, it entered into a complex rescue and privatisation procedure.[3]

The rescue plan followed the path already tested in other banking crises in Italy,[4] under the so-called "Sindona decree," based on State recapitalisations coupled with the central bank's cash advances to cover losses.[5] Among other things, the scheme provided for the transfer of an equivalent of an € 8.7 billion portfolio of bad loans and other NPEs from various entities of the group to SGA.[6] Simultaneously, all of the SGA shares were pledged to the Italian Ministry of Treasury (the predecessor of MEF), which acquired voting rights and control on the company. Thus, the original "mission" of SGA was focused on acting as an AMC in the context of a *specific* crisis.[7]

Meanwhile, in 1997 SGA was enrolled in the register of "financial intermediaries" under the Italian Banking Act,[8] thus becoming authorised to exercise lending activities *vis-à-vis* the public. In the following years (1997-2002), SGA expanded its business and acquired NPLs from other Banco di Napoli Group's distressed companies (€ 1.3 billion euro), as well as shareholdings in other companies, such as Graal S.r.l., a leasing servicer.[9] In 2014, Banco di Napoli engaged SGA as direct servicer for the entire loan portfolio (about € 3 billion).

SGA's intervention in the *Banche Venete* liquidation

The expansion of SGA's activity reached a turning point in 2016-2017, with the crisis of Monte dei Paschi di Siena and the dramatic collapse of Banca Popolare di Vicenza and Veneto Banca (the so-called "*Banche Venete*"), the second and third Italian bank turmoils in the aftermath of the 2008-2012 financial crisis (the first one being the simultaneous resolution of the four regional banks, described in paragraph [3.3.4], below).

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[2] See Corte dei Conti (Sezione del controllo sugli enti, *Determinazione e relazione sul risultato del controllo eseguito sulla gestione finanziaria di SGA S.p.A. – Società per la gestione di attività (ora AMCO – Asset Management Company)*, 2020, available at www.corteconti.it, at 2.

[3] The procedure eventually led, in 1997, to the acquisition of the institution by a group of newly-privatised financial entities (BNL and INA, respectively a bank and an insurance company) and, two years later, by Sanpaolo IMI Group.

[4] Namely, in the same period of time, that of Sicilcassa, another public entity-turned-corporation operating in Southern Italy, mainly in Sicily.

[5] Ministerial Decree 27 September 1974, after Michele Sindona, owner of Banca Privata Italiana, a financial group with branches in the US and several other countries, spectacularly failed in 1974 and was put under the procedure of compulsory administrative liquidation.

[6] See Corte dei Conti, footnote 1, at 3.

[7] As regards the structure of SGA's intervention (partly replicated in subsequent interventions: see para. 4, below), the company acquired the Banco di Napoli's NPEs on a no-recourse basis (*pro soluto*) at a price equal to their book value. SGA did not pay the transfer price up front, but benefited from a sort of vendor loan advanced by the seller. The gradual reimbursement of such loan was based on the actual recoveries, with the backing of a public guarantee. See Art. 3 of Ministerial Decree dated 14 October 1996.

[8] Article 107 of Italian Legislative Decree No. 385 of 1 September 1993 (in force at the time).

[9] See Corte dei Conti, footnote 1, at 3.

a. The crisis of the *Banche Venete*

During the first phase, the Italian government explored the intervention of a private investment fund (Atlante)—sponsored by the State with the participation of prominent national institutional investors—with the twofold mission of (i) relieving the banking system from the burden of its stock of NPLs and (ii) recapitalising banks with negative results from ECB supervisory assessments. Atlante acquired control of both *Banche Venete* in 2016, while a twin fund (Atlante II, thereafter renamed Italian Recovery Fund – IRF) was set to invest in distressed bank assets, at market conditions consistent with the EU State aid constraints.

At the same time, the government paved the way to an evolution of SGA as a State-owned AMC with a macroeconomic mission. First of all, a Law Decree mandated the transfer of the entire share capital of SGA to the Italian Ministry of Economy and Finance – MEF (which had previously only owned a share pledge).[10] Second, SGA's corporate purpose was broadened to encompass the purchase of loans, interest and other financial assets on the marketplace. SGA started its new deal with an investment in IRF (valued at € 502 million).[11]

As the intervention of Atlante proved insufficient to relieve the *Banche Venete* (which meanwhile were sliding towards insolvency), in June 2017 the Italian government, in coordination with the European Commission, elaborated a complex turnaround of the two institutions. The *Banche Venete* were put into compulsory administrative liquidation[12] and Intesa Sanpaolo purchased an aggregated compound of their assets and liabilities. The transaction was supported by a package of State aid (up to about €17 billion)—authorised by the European Commission under Art. 107(3)(b) TFEU as necessary to avoid a serious disturbance in a Member State's economy[13]—including direct contributions to the purchaser as well as guarantees for potential liabilities stemming from the transfer.[14]

The transfer to Intesa Sanpaolo expressly excluded from the transaction's perimeter all the NPEs (including NPLs, "unlikely-to-pay" or "UTP", and "past due" positions), which remained with the two failed banks. In addition, Intesa Sanpaolo reserved the right to re-transfer to the sellers certain "high risk" positions, if reclassified as NPEs in the 3 years following the transfer.

b. The intervention of SGA

In this context, SGA was designated to purchase the entire NPE portfolio of the *Banche Venete*, with the aim of long-term management and value enhancement of receivables due by debtors still capable of some form of recovery or restructuring. From a legal standpoint, the MEF Decree[15] set forth a segregation of the *Banche Venete* NPEs within SGA's assets, through the creation of two *patrimoni destinati* (i.e. "assets dedicated to a specific business"[16])—each referring to the portfolio acquired from each failed bank—so as to fully separate the newly-acquired assets from the pre-existing business of the company. The assignment of the NPEs to SGA (on a no-recourse basis) included all the related contracts and accessories, as well as the above-mentioned "high risk" positions. Loans issued by foreign subsidiaries of Veneto Banca were also included, together with a number of securitised positions,

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[10] Law Decree No. 59 of 3 May 2016, converted into Law No. 119 of 30 June 2016, Art. 7.

[11] See Corte dei Conti, footnote 1, at 44.

[12] As the Single Resolution Board ascertained that there was no "public interest" justifying the opening of a resolution procedure, the two institutions were liquidated in accordance with national law, without applying the BRRD.

[13] See *SA. 45664 (2017/N) - Italy - Orderly Liquidation of Banca Popolare di Vicenza and Veneto Banca Liquidation Aid (June 25, 2017).*

[14] For a detailed description of the Banche Venete crisis, see, e.g., Mesnard et al. (2017); Ventoruzzo & Sandrelli (2019), at 293 ff.

[15] MEF Decree of 11 April 2018.

[16] See Art. 2447-*bis* ff. of the Italian civil code.

where SGA took over from the previous servicer. In the aggregate, the portfolio totalled €18.3 billion (gross book value).[17]

The price for the acquired portfolio was set at the aggregate book value of the NPEs (as resulting from the *Banche Venete*'s accounts, therefore not relying on the market value benchmark), but subject to adjustment on the basis of the actual recovery of the loan exposures. Furthermore, SGA made no payment up front, but agreed to pay the (gradually adjusted) consideration over time, under a "pay-as-you-can" scheme, and reserved the right to deduct certain costs and fees borne by the company in its management activities.[18]

In fact, the transaction created a "pass-through" mechanism, whereby SGA acts as exclusive servicer for the two failed banks, bearing limited credit risk and earning management fees partly aligned with the outcome of the recovery activity.[19] However, as a recovery of the exposure below its face value triggers a downward adjustment of the consideration, the risk ultimately lies with the two procedures of compulsory administrative liquidation (acting on the basis of special rules governing the bankruptcy of banking businesses in accordance with domestic rules).

The untested complexity of this transaction and the special context of the *Banche Venete* liquidation have given rise to a variety of legal issues, also involving SGA, especially in connection with more elaborate banking transactions, departing from plain vanilla loans.[20]

From SGA to AMCO: Recent developments and looking forward

At the time of the acquisition of the *Banche Venete* portfolios, SGA underwent a change of management and a significant strengthening of its governance and organisational structure.[21] In 2019 the company anglicised its corporate name into AMCO and launched a new industrial plan aimed, on the one hand, at significantly increasing the average recovery rate of its portfolio (from 27% to about 37% for gone concern positions) and, on the other hand, at developing new business initiatives.

Thus, AMCO has undergone a transformation, playing a new role as a participant in a competitive NPE market. It no longer limits its interventions to specific banking crises, but operates among a variety of de-risking transactions, also in cooperation with external partners, and contributes to the expansion of an NPE secondary market in Italy. At the end of 2019, the total assets under management exceeded € 23 billion euro.[22]

AMCO's most recent interventions may be grouped along four lines of strategic intervention, where the company profits from its roles as both an asset manager and an equity investor:

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[17] More precisely, € 7.7 billion (42,000 debtors) from Veneto Banca, € 9 billion (61,000 debtors) from Banca Popolare di Vicenza and € 1.8 billion (900 debtors) as loans arising from "*baciate*" transactions (see below in the text) (source: AMCO, *Management Report* for the 2019 financial year, at 32), adding to the € 1.7 billion still outstanding from the Banco di Napoli restructuring.

[18] The agreements entered into between SGA and each of the *Banche Venete* are on file with the authors. A summary of certain provisions may be read in Corte dei Conti, *supra* footnote 1, at 35 ff.

[19] SGA has outsourced part of the recovery activities to third party servicers, especially with respect to "gone concern" NPLs not exceeding € 200,000. See SGA strategic guidelines 2019-2023, in Corte dei Conti, *supra* footnote **Error! Bookmark not defined.**, at 42.

[20] With respect to the *Banche Venete*, AMCO's activity is restricted by specific commitments assumed by the Italian government. For example, AMCO, being publicly owned, is prohibited from "*sell*[ing] *new products or enter*[ing] *into new contracts with any clients related to the NPE portfolio*" acquired from the *Banche Venete*. This limitation is justified in the light of the relevant injection of Italian taxpayer funds in connection with the liquidation of the two failed banks, as well as the terms and conditions of the NPL assignments to SGA (see above). Such restriction on the entering into of new contracts represents a significant barrier to the granting of new finance to restructured debtors.

[21] AMCO has now 233 employees. See AMCO, *Financial statements* relating to the 2019 financial year.

[22] *Id.*, at 30.

(i) "Traditional" direct acquisition of NPEs (no recourse) – An example is the purchase of an NPE portfolio (€2.3 billion gross book value) from Banca Carige in December 2019;

(ii) Securitisation – AMCO invests in a number of newly-originated NPE securitisations (e.g., the acquisition of portfolios from Banca Popolare di Bari and Banca del Fucino in 2019) by subscribing junior and mezzanine notes issued by the securitisation vehicle, also within the Italian State guarantee scheme;[23]

(iii) Investments in credit funds – In 2019, AMCO participated in the creation of a multi-originator platform for the long-term management of UTP loans from a number of Italian banks. The "Cuvée" project sequences (a) a securitisation of NPEs, (b) the subscription of the securitisation notes by Back2Credit, a credit fund reserved for professional investors and managed by Prelios SGR, and (c) the subscription of the fund's units by the loan originators (including AMCO). AMCO will also act as master and special servicer in the transaction;

(iv) Transformational transactions – In 2020, AMCO sponsored a complex de-risking transaction of Monte dei Paschi di Siena (MPS, a listed company currently controlled by the MEF). This transaction was innovatively implemented through a corporate de-merger of the bank. More specifically, MPS realized a partial, non-proportional de-merger, whereby (a) AMCO was assigned an NPE portfolio of 8.1 billion euro (including NPLs and UTP), (b) against such transfer, AMCO issued new (non-listed, non-voting) shares reserved for MPS shareholders, and (c) the MPS shareholders were granted an "asymmetric option" to refuse the subscription of the new AMCO shares and remain shareholders of MPS, with a parallel increase of the MEF's stake in AMCO.[24]

Leveraging on the above transactions, AMCO is heading towards a consolidation of its role as the top-ranking player in the Italian NPE market (where NPL-specialised financial intermediaries and investment funds also operate). While operating in a relatively competitive market of private NPE managers, AMCO currently holds a leadership position in the UTP market, where seizing and elaborating restructurings (such as refinancing of complex and syndicated debt exposures, debt-to-equity swaps in the context of compositions with creditors, etc.) requires sophisticated skills. Market consolidation leads to significant advantages in this market, as it increases the share of common debtors in various managed portfolios. This, in turn, accelerates the recovery procedures and allows for standardised strategies for clusters of portfolios in the same geographic areas.

REV-Gestione crediti S.p.A, another AMC in public hands operating in the BRRD context

Italy has also experimented with a different model of AMC. When, in 2015, a banking resolution procedure – under the Italian law implementing the BRRD – was adopted in Italy, four regional banks were submitted to resolution, even though they had been already submitted, in the months leading up to the resolution, to the domestic procedure of extraordinary administration.[25]

Along with the submission of those banks to the resolution procedure, on the one hand, the relevant ministerial decrees provided for the setting up of a corresponding number of bridge-institutions (the

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[23] See Paragraph 4.2.

[24] From a State aid standpoint, thus far the European Commission has upheld AMCO's recent interventions (regarding them as realized at market conditions) also when, as in the MPS de-risking transaction, the Italian MEF was on both sides of the transaction, as controlling shareholder of both MPS and AMCO. See, e.g., Banca Monte dei Paschi di Siena, *Press release*, 29 May 2020, available at gruppomps.it.

[25] See Decree of the Italian Minister of Economy and Finance of 22 November 2015.

"good banks"),[26] which became the assignees of assets and liabilities from the banks in resolution and, on the other hand, the Bank of Italy provided for the incorporation of REV S.p.A. as a separate asset management vehicle, wholly owned by the same Bank of Italy.

In implementing the resolution plans, the Bank of Italy further provided for the assignment of the NPLs resulting from the balance sheet of the banks in resolution to REV, while REV later assigned NPLs to corporate vehicles in the context of securitisation transactions.

[26] On the bridge-institution tool under the BRRD, see, e.g., Guaccero (2017), at 355-356.

ANNEX IV. ACCOUNTING AND PRUDENTIAL MEASURES ON NPLS IN TIMES OF PANDEMIC

Accounting and supervisory reporting rules

With regard to reporting rules, the EBA fostered convergence within the EU on a common system of supervisory reporting on loan quality, establishing uniform criteria to define "NPE in its Implementing Technical Standard (ITS) on Forbearance and Non-Performing Exposures."[27] According to the abovementioned rules, NPLs or NPEs are assets that satisfy either of the following two criteria: (a) material exposures that are more than 90 days past due; or (b) the debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past due amount or of the number of days past due.[28]

The current definition of NPE is consistent with the accounting definitions of "impairment" and "credit-impaired" according to IFRS 9 and the prudential definition of "default" established in Regulation (EU) No 575/2013 on prudential requirements for credit institutions.[29] These rules reduce the discretion of banks in the valuation of individual risk positions, leading under certain objective conditions to the classification of a loan as non-performing, regardless of the assessment of a financed company's viability for the future (Montanaro, 2019). This approach aims at preserving the bank's soundness and solvency, but, at the same time, it inevitably reduces the space for banks to manoeuvre when assessing the debt positions of companies affected by the lockdowns imposed by public authorities for public health reasons. To fix this problem, the extraordinary measures adopted by national governments, regulators and supervisory authorities are not enough to mitigate the negative impact of the COVID-19 pandemic on the economy. We refer in particular to moratoria of payments on instalments and interest for loans and State guarantees on new loans approved by national governments and to the actions taken by international regulators and European authorities to favour the government measures to fully achieve the goal of providing support to the real economy. In particular, the Basel Committee,[30]

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[27] EBA Final Draft Implementing Technical Standards on Supervisory reporting on forbearance and non-performing exposures under Article 99(4) of Regulation (EU) No 575/2013, EBA/ITS/2013/03/rev1, 24/07/2014.

[28] According to paragraph 145 of Annex V of EBA ITS on supervisory reporting, an NPL is every exposure that is 90 days past due or unlikely to be paid without collateral realisation, even if it is not recognised as defaulted or impaired. In particular, an exposure to a debtor has to be considered non-performing when its on-balance sheet 90 days past-due reaches 20% of the outstanding amount of total balance sheet exposure to that debtor. Such definition also encompasses forborne exposure. Following paragraph 178 of Annex V of Commission Implementing Regulation (EU) No 680/2014, a forborne exposure can be performing or non-performing. When granting forbearance measures to performing exposures, banks should assess whether these measures lead to a need to reclassify the exposure as non-performing. According to EBA's ITS, NPEs that are forborne do not exit this classification before the debtor has proven its ability to meet the restructured conditions for at least one year, even if forbearance has led to the exit from default or impairment classes.

[29] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, OJ L 176, 27.6.2013, pp. 1–337.

[30] In April 2020, the Basel Committee published a document, "Measures to reflect the impact of COVID-19," aimed at interpreting the impact of extraordinary measures to alleviate the financial and economic impact of the COVID-19 pandemic on the current legal framework. In this context, the Basel Committee agreed that the risk-reducing effects of the various extraordinary support measures, namely government guarantees and different payment moratoria, taken in its member jurisdictions, should be fully recognised in risk-based capital requirements. To this end, the Committee clarified that when determining a bank's credit risk requirement for loans that are subject to sovereign guarantees, the relevant sovereign risk weight should be used (that differentiate sovereigns according to the rating for debt securities). Then, banks calculating their capital requirements take account of the risk-mitigating effect of the collateral, according to general principles established by the Accord (CRE22 and CRE32of the Basel Framework). Furthermore, the Committee, premising that the Basel Framework applies higher capital requirements to loans that are categorised as past due or defaulted, has agreed that payment moratorium periods (public or granted by banks on a voluntary basis) relating to the COVID-19 outbreak can be excluded by banks from the counting of days past due loans (whether payments on the loans are past due by more than 90 days).

the EBA,[31] the ECB,[32] and the European legislature's[33] initiatives aim at allowing the national government guarantees and different payment moratoria to be fully recognised in risk-based capital requirements for banks. By nature, these measures are temporary.

NPLs and banking supervision: The legal framework for prudential provisioning expectations

From the supervisory point of view, when a loan is classified as non-performing, its value must be reduced because the expected cash flows recovered from the distressed debtors, the sale of collateral or the disposal of claims on secondary markets are lower than contractual ones.

Therefore, EU authorities and, in particular, the ECB, have actively undertaken work on the optimal design of frameworks for NPLs resolution, including guiding principles on balance sheet clean-up, policy options for NPLs resolution, and the optimal sequencing of those measures.

A significant step to introduce a uniform European framework of provisioning rules for NPLs has been made by the ECB Banking Supervisor with the Guidance Addendum concerning the minimum coverage of NPEs,[34] followed by the publication of the final text on 15 March 2018.[35] In particular, the most recent version of the guidelines is focused on prudential provisioning expectations, according to which banks must adopt a calendar approach consisting of gradually writing down new NPLs over time until they are fully written-off at the end of a given period. More specifically, new NPLs, even those stemming from credit already granted in the past, must be fully written down within two years (when uncovered) or progressively within seven years (if covered) from the time they are classified as such.

This supervisory process[36] was introduced in first level legislation in 2019 through the amendment of Regulation (EU) 575/2013 containing rules on minimum loss coverage of NPLs. This intervention has

[31] During the months of March and April 2020, the EBA published several communications calling upon competent authorities to make full use of the flexibility embedded in the existing prudential regulation and to establish guidelines containing a number of interpretative aspects on the functioning of the prudential framework in relation to the classification of loans in default, the identification of forborne exposures, and their accounting treatment. On 21 September 2020, the EBA announced the phase-out of its guidelines on legislative and non-legislative payment moratoria as of September 30th, but this decision was followed by reinstatement of the guidelines on December 2nd. The revised guidelines will expire on 31 March 2021.

[32] On 12 March 2020, the ECB announced a number of specific measures to ensure that banks can continue to fulfil their role in financing the real economy as the economic effects of the coronavirus became apparent. The ECB introduced supervisory flexibility regarding the treatment of NPLs, regarding the classification of debtors as "unlikely to pay" when banks call on public guarantees granted in the COVID-19 pandemic context and regarding loans under COVID-19-related public moratoria. Moreover, the ECB adopted specific measures relaxing capital constraints, namely temporary capital, liquidity and operational relief measures to ensure that significant institutions are able to continue to support the real economy. According to the ECB guidelines, banks will benefit from relief in terms of the composition of capital for Pillar 2 requirements. Furthermore, banks are temporarily allowed to operate below the level of capital defined by the Pillar 2 guidance and the capital conservation buffer. During the summer of 2020, the ECB decided to extend the validity period of many extraordinary measures.

[33] On 28 April 2020, the EU Commission proposed a few targeted "quick fix" amendments to the EU's prudential banking rules (the Capital Requirements Regulation, CRR) in order to maximize banks' ability to lend and absorb losses related to the COVID-19 pandemic. On 18 June 2020, the European Parliament approved the amendments to Regulation (EU) 575/2013 (CRR) and Regulation 2019/876 (CRR2) to mitigate the economic consequences of COVID-19. The new rules establish exceptional temporary measures to alleviate the immediate impact of coronavirus-related developments by adapting the timeline of the application of international accounting standards to banks' capital, by treating public guarantees granted during this crisis more favourably, by postponing the date of application of the leverage ratio buffer and by modifying the way of excluding certain exposures from the calculation of the leverage ratio.

[34] European Central Bank, Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures, October 2017.

[35] European Central Bank, Addendum to the ECB Guidance to banks on nonperforming loans: supervisory expectations for prudential provisioning of non-performing exposures, March 2018. The Addendum only applies to significant euro-area banks and specifies quantitative supervisory expectations concerning the minimum level of prudential provisions for new NPLs (from 2018 onwards).

[36] The rules outlined in the Addendum only imply an "act or explain" mechanism, meaning that, during the supervisory dialogue in the context of the Supervisory Review and Evaluation Process , significant institutions are requested to justify any divergence from the prudential provisioning expectations outlined in the Addendum. Given the specific circumstances, the Joint Supervisory Team may

produced two important consequences. On the one hand, the new legal framework has strengthened the power of supervisory authorities to request targeted measures to credit institutions to identify and manage NPLs at an individual level. On the other hand, the setting of a detailed binding legal framework for prudential supervisory purposes has tightened the margin of flexibility to deal with the widespread deterioration of credit markets due to the systemic crises and macroeconomic uncertainty that we are currently experiencing during the COVID-19 crisis.

With a view to introduce a margin of flexibility to the abovementioned regulation, the ECB has announced, based on EBA Guidelines on moratoria,[37] additional actions regarding prudential provisioning expectations.[38] In particular, exposures that benefit from government guarantees issued by a Member State in the context of COVID-19-related public interventions should not automatically be qualified as "Unlikely to pay" when they meet the conditions outlined above. However, this preferential treatment for NPLs guaranteed by public measures does not contribute to solving the NPLs issue with a long-term perspective for two main reasons. In the first place, it does not exempt institutions from assessing the potential unlikeliness of paying off the obligor and must not affect the results of such an assessment. In the second place, these actions are only of a temporary nature and do not address the challenges that will emerge after the expiration of moratoria and supporting measures.

To this end, the regulatory framework on minimum loss coverage of NPLs incentivises the need for banks to remove NPLs from their balance sheets.

evaluate that the coverage provided by the individual credit institution is not sufficient to cover the expected credit risk, thus imposing the adoption of "Pillars 2" measures.

37 EBA Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, EBA/GL/2020/02, 2 April 2020, last amended by EBA/GL/2020/15, 2 December 2020.

38 FAQs on ECB supervisory measures in reaction to the coronavirus, last updated 1 February 2021.

ANNEX V. ASSIGNMENT OF CREDIT TO A THIRD PARTY AND CONSUMER PROTECTION: A COMPARATIVE ANALYSIS

Pursuant to Article 17 (1) of Directive 2008/48/EC of the European Parliament and of the Council (Consumer Credit Directive), *"In the event of assignment to a third party of the creditor's rights under a credit agreement or the agreement itself, the consumer shall be entitled to plead against the assignee any defence which was available to him against the original creditor, including set-off where the latter is permitted in the Member State concerned."* According to the Directive, an assignment of the creditor's rights under a credit agreement should not have the effect of placing the consumer in a less favourable position. Moreover, the consumer shall be informed of the assignment, except where the original creditor, by agreement with the assignee, continues to service the credit *vis-à-vis* the consumer (Article 17 (2)).

In many jurisdictions, these rules have been transposed in a manner compliant with the directive, and in many cases, additional protections have been provided for consumers.

In particular, in the Italian legal system Article 125-septies (1) of the Consolidated Law on Banking (*Testo Unico Bancario*), in derogation of the civil code, allows the consumer to always oppose to the assignee all the exceptions that he could invoke in the comparisons of the transferor. The consumer can also oppose the assignee that the debt has been offset in the dealings with the original creditor. The consumer could also oppose this exception for credits arising after the notification of the assignment. Any agreement derogating from this provision must be considered null and void where the position of the debtor/consumer is aggravated.

The Spanish, Austrian and Belgian legal systems establish rules very similar to those provided in Italy in terms of the rights of debtors/consumers of loans transferred to third parties.[39]

The provisions of the German Bürgerliches Gesetzbuch (BGB) are even more favourable to consumers (§496 Einwendungsverzicht, Wechsel- und Scheckverbot). First, any agreement by which the debtor/consumer waives his right, under §404, to make objections against an assignee of the obligation which he is entitled to against the lender is ineffective. Equally ineffective is any agreement by which the debtor waives his right under §406 to set-off against an assignee of the obligation to a claim he has against the lender (§496 (2)). Subsequently, in line with the layout of the European Directive, it is envisaged that if a lender's claim from a loan contract is assigned to a third party, or if the lender's identity is changed, the debtor must be notified of this without delay, including the contact data of the new creditor. Notification shall be dispensable with assignments if the previous lender has agreed with the new creditor that only the previous lender shall be identified in the relationship with the borrower (§496 (2)).

Differently the French legal system does not provide any specific rule in the *Code de la consommation*[40]. Nevertheless, the French Civil code establishes a similar protection mechanism for any debtor (not only for consumers). Indeed, the latter provides that in case of the assignment of rights arising from obligations, the debtor may set up against the assignee defences inherent in the debt itself, such as

[39] With regard to Spain, see Article 31 (*Cesión de los derechos*) of the Spanish Ley 16/2011, de 24 de junio, de contratos de crédito al consumo. The Austrian model, set forth in §17 (*Forderungsabtretung*) of *Verbraucherkreditgesetz* – VKrG, ensures full protection for the debtor in the event of assignment to a third party of the creditor's rights: the consumer retains the right to plead against the assignee any defence about the original creditor, already provided for in § 1396 ABGB, and this cannot be waived through an agreement. In the Belgian *Code de droit économique*, it is foreseen that the consumer shall be entitled to plead against the assignee any defence which was already available to him against the original creditor, including set-off: *toute clause contraire est réputée non écrite* (Article VII.104).

[40] *Crédit à la consommation* is regulated by Articles L312-1 - 312-94.

nullity, non-performance, termination or the right to set off related debts. He may also set up defences which arose from the relations with the assignor before the assignment became enforceable against him, such as the grant of a deferral, the release of a debt, or the set-off of debts which are not related [Article 1324 (2) Code civil].

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As the COVID-19 pandemic hits all Member States severely, some initial signs are surfacing of what is likely to be a substantial increase in bank non-performing loans (NPLs) in the coming months. Strengthening the tools needed to face the problems caused by NPLs is therefore of foremost importance. This paper argues that asset management companies (AMCs) can be an effective tool in this direction. It further discusses the legal issues related to their implementation, presenting several examples from past experiences illustrating how such issues can be solved. The paper concludes that a network of national publicly funded AMCs, applying the same standards and procedures across all European Member States, would be an effective and feasible solution to the problems presented by NPLs.
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