BRIEFING

European Parliament

Thematic digest: Non-performing loans and asset management companies

This document presents summaries of seven external papers commissioned by the European Parliament in November 2020 upon request of the Economic and Monetary Committee (ECON). Papers were delivered, analysed and published in March 2021. ECON has requested its Banking Expert Panel to address the topic of "**Non-performing Loans – New Risks and Policies**".

Some of the experts focused on the possible developemts of non-performing loans (NPLs) following the COVID-19 pandemic and the main differences to previous crises.

Conceding that it might be (too) early to clearly identify long-term trends and profound changes as a result of the COVID-19 crisis, and bearing in mind the (then) expected Commission Action Plan, experts were asked to look into hypothetical scenarios that they consider relevant from the NPLs resolution perspective, illustrating what the potential quantitative impact of those hypothetical scenarios could be. Experts should also consider, if feasible and relevant, the socio-economic and gender distribution of NPLs as well as any consequences from different strategies for NPL reduction on those dimensions.

Other experts of the panel focused on what factors drive the performance of national asset management companies in view of resolving NPLs.

In view of recommendations from the Single Supervisory Mechanism (SSM) to expand the use of Asset Management Companies (AMCs) to deal with COVID-related non-performing loans (NPLs) and the (then) upcoming new Commission Action Plan on NPLs, the panel experts were asked to analyse:

a) whether they share the perception that AMCs are efficient tools for facilitating the management and recovery of NPLs, and if so,

b) what the performance drivers of AMCs could be (paying particular attention to a number of questions outlined in the specifications detailed in the annex).

Experts were also asked to pay attention to the question of whether the use of AMCs can have significant socio-economic consequences, or raise concerns from the gender point of view. In such case, experts could provide recommendations on how to mitigate such concerns.

On a general note, one may highlight the following:

- **Most authors point to relevant differences between NPLs resulting from the global financial crisis (GFC) and those that may materialise following the COVID-19 crisis** (de Haan, Bertay and Huizinga, Kasinger et al.). These differences stem from the fact that euro area banks were better capitalised going into the current crisis (albeit less profitable), the various initiatives undertaken since

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the previous crisis aimed at removing obstancles to NPL resolution, and the public support measures undertaken by Member States during the pandemic acting as an *"indirect bailout of the banking sector"* (Bertay and Huizinga, see also Haynes et al.). As noted by Haynes et al. , *"The deleveraging of the corporate sector, build-up of bank regulatory capital and the development of NPLs skills and actors in the NPL market since the global financial crisis (GFC) in 2008 should help to support the recovery process post COVID-19 compared to the GFC. However, some forward-looking indicators, such as rating actions, and the below-average number of insolvencies last year, would tend to indicate an expectation for an increase in corporate defaults and NPLs in the coming years, once the government support tails off"*.

- Some authors also point that, **contrary to the GFC, banks are not the source of the problem but should be (and are being) part of the solution.** As noted in Haynes et al., *"the banking sector has so far not been tested in the COVID-19 crisis"*. However, they caution that regulatory forebearance should be time-limited, given the experience of the GFC, and that incentives are put in place to ensure banks have adequate provisions as soon as possible.
- **It is difficult to predict whether (expected) high levels of NPLs due to COVID-19 will materialise, and if so, when and which impacts they will have.** On the basis of econometric analysis, de Haan (cautiously) concludes that NPLs may not be as severe as after the GFC, but various factors - notably some outside of banks' control - play a relevant role. Nevertheless, based on their analysis Kasinger et al. conclude that there is a *"substantial heterogeneity across countries, both in terms of the size of NPLs as well as in the relation of NPLs to bank capital"*, suggesting that in countries with lower GDP per capita, a larger share of bank equity capital consists of NPLs, making them more vulnerable to a potential future increase in NPLs.
- As found by Bertay and Huizinga, in the pandemic crisis, **there is a tendency for low-profitability banks to provision too little in order to cushion the impact on their capitalisation.** The authors warn that this issue should be addressed by the European Central Bank (ECB) in order to ensure that asset deterioration is recorded as accurately as possible. This is neccessary to facilitate NPL resolution going forward.
- Haynes et al. model that **it is likely that the COVID-19 crisis will result in an increase in ''zombie firms''** (firms with already sustained periods of underperformance), which can crowd out investment and innovation. The authors caution, however, that *"Some of these will have been zombies before the crisis hit. However, others will have only just become zombies, or will be at risk of soon becoming zombies, as a result of COVID-19 imposed restrictions. The NPL resolution mechanisms that will be implemented by bank managers and debt investors, and will be overseen by policymakers and supervisors, should distinguish between these groups"*.
- **AMCs have been assessed in isolation whilst their efficacy in managing NPLs depends on being combined with other NPLs-management tools** (Ramos and Lamandini); therefore, these authors suggest addressing deeper issues around AMCs' performance through an open discussion on "*first, the possibility for state-owned or state-sponsored AMCs to negotiate with disposing banks less discounted transfer prices ... Second, to ensure that AMCs can use open, competitive processes to enlist third-party expertise to aid servicing, recovery or restructuring efforts, or even real estate development when needed, and that contacts with public authorities are fluid, but also open and accountable. Third, to explore the synergies between AMCs ... and mechanisms like securitisation ... Fourth, to strengthen information gathering on the NPLs market, recovery rates and trends, with special attention to the social and gender impact, to make AMCs part of a broader, technically sound strategy that maximises economic value while bolstering social trust*".
- Along similar lines, Gortsos points out that "*the various above-mentioned alternative solutions for managing and disposing of NPLs ... including the operation of AMCs, should not be considered separately but in conjunction (and eventually per Member State, since they depend on various factors, such as the type of assets, the structure of the banking sector and available management capacity of banks and in the public sector, which may vary from Member State to Member State)*".

- **The authors found it difficult, in particular due to the lack of quantified data, to assess whether AMCs have more severe (negative) social or economic consequences than banks directly managing their NPLs portfolios**. Ramos and Lamandini found that "*Studies point out that AMCs are not more efficient at restructuring assets, and enforcement and foreclosure seem to depend more on the efficiency of a country's legal system (positive side of efficiency)*", and that "*there seems to be no evidence of AMCs' aggressive recovery or enforcement strategies*". But these authors note that there seems to be a "*tendency of policy initiatives to sidestep the social dimension [of NPLs]*" that "*NPLs to people are messy, and thus AMCs should not get involved with them*" and that "*However, the approach on NPLs policies seems to be gender-neutral (to an advocate) or gender-blind (to a critic)*." Other authors (Avgouleas et al.) point that the "*AMC should therefore aim to collect the debt, while ensuring that the individuals retain a minimum living wage. Similarly, the longer-term viability of businesses should also be considered in the context of debt collection ... Although this approach can have a negative impact on the recovery values and operational efficiency of the AMCs, it is not necessarily the case because this approach also increases the earnings and thus repayment capacity of both individuals and businesses. To avoid a potential financial loss for the government, the methodology for the real economic value calculation would have to consider the winding down of the NPLs following this approach*".
- Pointing at difficulties in the overall managing of NPLs after a crisis, Avgouleas et al. note that **relevant side effects** (short-term effects of asset foreclosure on asset prices or on borrowers' activity, or the impact of NPL disposal on banks' capital and hence on their lending capacity) should be looked at. "*Relevant externalities range from possible fire sale prices to the economic disruption and social distress to affected borrowers (or their customers, suppliers, workers, etc.) caused by foreclosure, especially if the number of foreclosures is very high*".

The summaries were drafted by the Economic Governance Support Unit (EGOV) in own responsibility. Further conclusions on the authors' views require consideration of the full papers.

The hyperlink on the title of the papers listed in this document takes to the studies as published in the ECON homepage.

The *Economic Governance Support Unit* provides expertise in view of supporting the European Parliament and its relevant committees and bodies, notably in their scrutiny-related activities on economic governance and banking union. EGOV is part of the Directorate-General for Internal Policies of the Union (DG IPOL).

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This document is available on the internet at: www.europarl.europa.eu/supporting-analyses

What factors drive the performance of national asset management companies?

Authors: David RAMOS and Marco LAMANDINI

The authors focus on strategies for dealing with an expected surge in NPLs as a result of the COVID-19 crisis, specifically the efficiency of AMCs as a possible element of those strategies, and, if so, their performance drivers. Even if NPLs have been a concern ever since the outset of the latest financial crisis, the COVID-19 crisis has turned NPLs into a priority for the Commission again, which emphasised in its December 2020 Communication on NPLs the importance of well-functioning secondary markets, securitisations and AMCs. AMCs have also been echoed as a possible crisis-response by the Single Supervisory Mechanism (SSM) Chair, Mr. Andrea Enria, who has advocated for an EU-level AMC or an EU network or mechanism of national AMCs. Yet, as the authors point that, NPLs crises, NPLs strategies in general, and AMCs in particular are controversial, and despite the different nature of the current crisis (exogenous and not self-inflicted), the tensions felt during the last financial crisis may resurface again.

The authors conclude that the current conceptual framework to assess AMCs is, to a certain extent, insuficient (as it is compartmentalised, "microprudential", short-to-medium term and focused on rates of recovery and disposal, with less attention given to social impact or side effects) to recognise its value as an alternative to banks managing their NPLs portfolio or securitisation individually. The authors thus support a more comprehensive approach which could combine:

(i) key principles to provide clarity in the AMC design (AMC independence and professional management, timely recognition of losses, creation of secondary NPLs markets);

(ii) a role for AMCs that exploits their advantages (centralisation, operational consistency, limited improvisation, possible lower funding costs and less aggressive profit maximization mandates – i.e. more moderate expected rates of return on capital – which translate into less punitive transfer prices for disposing banks); but also

(iii) the search for synergies with other mechanisms (e.g., enlisting individual banks' expertise with a competitive allocation of servicing; using securitisation's pooling and tranching to facilitate NPLs' distribution etc.);

(iv) to insert AMCs and accompanying mechanisms within a more comprehensive NPLs strategy which reconciles the emergence of EU-sized secondary NPLs markets, with a technically sound approach to maximize economic and social returns, and focus on the long term value.

The authors recognise that the drivers of AMCs' performance may be linked to policy choices (e.g., ownership and governance), while others depend on the nature of the crisis. Thus, rather than a one-size-fits-all approach, AMCs should fit different types of crises. The authors conclude that "*AMCs are adequate tools to deal with NPLs, but their efficiency varies between simpler tasks (e.g., disposal) and complex ones (e.g., restructuring)*" and point that "*Less attention has been given to the need to fit AMCs to the actual NPLs crisis*" and that "*The perceived advantages and disadvantages of AMCs are partly influenced by an approach that focuses on AMC in isolation, when their performance is largely determined by their combination with other NPLs-management tools*".

The authors recommend, nevertheless, a cautious approach to their findings, as these are based on a technical assessment, to the best of the knowledge of the authors, of past NPLs crises and AMCs' experience, based on the (limited) publicly available information.

What factors drive the performance of national asset management companies?

Authors: Emilios AVGOULEAS, Rym AYADI, Marco BODELLINI, Barbara CASU, Willem Pieter DE GROEN and Giovanni FERRI

Based on the existing literature and EU experiences of national AMCs created in the aftermath of the GFC, the paper discusses AMCs' advantages and disadvantages when dealing with NPLs and considers the key elements in their design.

The authors point out that there are several (potential) advantages in transferring and pooling the NPLs of several banks to an AMC instead of managing large portfolios of NPLs on balance sheets or through private sales. The authors argue that AMCs can (i) increase the efficiency and effectiveness of the NPL resolution (by bridging the intertemporal valuation gap, scaling advantage, pooling expertise, and reducing funding costs); (ii) clean bank balances, thereby reducing uncertainty about the financial strength, and increasing the ability to continue lending to the real economy; and (iii) contribute to the promotion of secondary markets for NPLs.

Nevertheless, the authors also point to a number of important disadvantages. These are that (i) the transfers of NPLs from the issuing bank to the AMCs can result in the loss of – especially tacit – knowledge about the debtor; (ii) the lack of a clear mandate and inconsistent adherence to it may reduce the effectiveness of AMCs; and that (iii) too-high NPL acquisition prices can result in taxpayer losses.

On the basis of their analysis, the authors then conclude that "*To a large extent, the **design** of publicly supported AMCs determines their effectiveness and efficiency.*" To that end, the authors recommend keeping in mind a number of variables when designing (successful) AMCs:

- "*In order to maximise economies of scale, the **portfolios of NPLs** transferred to AMCs should be quite homogeneous*";

- "*The financial performance of AMCs largely depends on the **transfer price**, which, to limit the losses for the sponsors, including governments, should not be higher than the real economic value*";

- "*The **capital and funding structure** is essential to ensure low funding costs and arrange appropriate burden sharing, which limits moral hazard. Most of the AMCs created after 2014 ensure this through ownership by both the banks transferring NPLs and the government.*" Limited publicly available information does not allow the authors to explain the drivers behind the financial performance of recent AMCs experiences. A lack of reliable data is, in fact, one of the factors the Commission reflects upon in its December 2020 Communication on NPLs;

- "***Independent governance and control** is also important to protect the AMCs from political intrusion or financial stress, and this has mostly been ensured by putting the AMC at some distance from the government*".

The authors also point that that "*A certain amount of public support will be needed for AMCs to be able to successfully operate and this also seems to be the view of the Commission.*" Looking at alternatives, the authors consider that "*it is questionable whether precautionary recapitalisation would be a suitable tool to handle the widely predicted surge in NPLs affecting many banks in the Union.*" due to it being "*primarily conceived to face single (or a limited number of) idiosyncratic crises through the injection of public money with a view to increasing the capital of individual banks.*" and that "*it might fall short if many institutions needed to offload large portfolios of NPLs at the same time*".

Looking to the future, the autors argue that private third parties may not be willing to acquire NPLs at a price that reflects their real economic value, thus pointing to a possible market failure. To overcome that issue, the authors suggest complementing efforts by the Commission and others "*to promote effective and efficient AMCs*" by a "*revision of the existing State aid regime application*" by further specifying that the "***real economic value should be based on a responsible winding down of the NPLs**, whereby the remaining minimum income for households and the long-term viability of businesses is considered*".

Bolded instances above are as per the authors' paper.

What factors drive the performance of national asset management companies?

Author: Christos GORTSOS

The author discusses the institutional, governance and (to a certain extent) operational conditions that must be met for a public (centralised) AMC to be able to efficiently facilitate the management and recovery of NPLs, taking, in particular, the impact of the COVID-19 crisis into account. To that end, the author discusses the historical dimension of the NPL problem in the EU before the onset of the pandemic crisis (legacy NPLs) and the measures taken to address it; alternative approaches for setting up AMCs and policy alternatives to AMCs in dealing with NPLs; and develops on the role of supervisory and resolution authorities in preserving financial stability, the ultimate public policy objective, in view of the emerging new wave of NPLs due to the current crisis.

On the basis of this analysis, the author concludes that:

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

- looking at alternatives to centralised AMcs (notably, securitisation, bank-specific AMC, other impaired asset measures, precautionary recapitisations): "*AMCs should carefully be considered on an ad hoc basis, duly taking account of merits and relative disadvantages ... it is questionable if, depending on the depth of national markets, securitisation-based approaches should be applied along with the operation of public AMCs*";

- "*The quality in the exercise of prudential banking supervision is of primary importance in addressing the NPL problem ... the EU-wide stress test exercises of credit institutions' portfolios, to be conducted in 2021 by the EBA and the ECB, are necessary to identify potential weaknesses in the current* juncture" and that "*the progress made (and to be made further) in relation to resolution planning to attain the resolvability of credit institutions*" is of importance.

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

Non-performing Loans – Different this Time?
NPL resolution after COVID-19: Main differences to previous crises

Author: Jakob DE HAAN

On the basis of econometric estimates for the NPL ratio in the euro area, the paper aims at providing new insights about the drivers of NPLs. Such insights can be used to develop scenarios for the future evolution of the NPL ratio, notably to what extent NPLs will increase in a similar fashion as after the GFC. The author uses an empirical model for NPLs for a very large sample of banks in countries in the euro area over the period 1995-2019. The Netherlands is used as a test case to assess which bank-specific factors play a role as drivers of NPLs.

On the basis of this analysis, the author concludes that:

- "*macro-economic factors (GDP growth and the unemployment rate) are important and robust drivers of the NPL-ratio. According to the most recent forecasts of the European Commission, GDP growth in 2021 in the EU (euro area) will amount to 3.7% (3.8%). The unemployment rate stabilised in December at 7.5% in the EU (8.3 % in the euro area)*". From this perspective, the author's econometric results suggest that "*the NPL ratio may not increase to levels seen after the global financial crisis*";

- "*some bank-specific factors that have been found to be related to banks' NPL ratios, notably banks' capital ratios, are in a much better shape than after the financial crisis. So, if the economic recovery proceeds as forecasted, NPLs may not become as problematic as after the financial crisis*".

- but, nevertheless, that "*the full model only explains a small part of the variation of NPLs of the banks in euro area countries. This suggests that other factors play a role. One such factor is efficient legal enforcement. Recent research suggests that that the combination of weak bank balance sheets and inefficient legal enforcement leads borrowers to delay debt repayment. This implies that improving banks' ex post ability to enforce contracts (in court) improves borrowers' ex ante incentives to repay*". One may note that the December 2020 Commission Communication on NPLs highlights concerns around corporate insolvency and debt recovery legislation.

Having concluded that "*Other country-specific factors may also play a role*" as NPLs drivers, the author assesses the situation in the Netherlands and concludes that "*This analysis suggests that government guarantees will only shield a very small portion of bank loans. Furthermore, tax deferrals ... may, eventually, affect NPLs ... Extending the period over which tax deferrals and refunds are possible as well as more customized solutions by sector are crucial additional government measures to reduce bankruptcies (which will result in increasing NPLs). Finally, Dutch banks have issued payment deferrals (also known as moratoria), which temporarily allow customers not to pay interest and/or repayments on their loan. Banks expect for 29% of the customers' higher credit losses in the future. This, again, suggests that even if the recovery proceeds as forecasted by the Commission, the NPL ratio may still rise*".

The author cautiously points that his analysis needs to be considered in the context of great uncertainty as to the overall effects of COVID-19 crisis. The extensive array of measures taken in the fiscal, monetary and supervisory area to counter such impacts, some of which may affect the ability of governments to support the recovery, would also need to be factored in. On the other hand, the author points to the overall better position of banks to withstand a crisis, due notably to reforms enacted after the GFC.

Non-performing Loans – Different this Time?

NPL resolution after COVID-19: Main differences to previous crises

Authors: Ata Can BERTAY and Harry HUIZINGA

In this paper, the authors argue that, as compared to the GFC, the banking sector is better capitalised but less profitable. It is therefore difficult to use historical data to anticipate future NPL dynamics. In addition, they note that various legislative and non-legislative policy initiatives have been undertaken (at both the euro area and the EU level) to address obstacles to NPL resolution following the last crisis, and that many euro area Member States adopted loan guarantee programs during the pandemic to enable banks to provide new loans covered by public guarantees. Using ECB data, they find that by *"reducing credit impairments, the loan guarantee programs limit the negative impact of the COVID19 crisis on euro area bank capitalisation, acting as an indirect bailout of the banking system."* These different circumstances reflect the ECB's vulnerability analysis, in which it is noted that a systemic banking crisis will be avoided, given that significant credit impairments and losses are contained to 2020.

The authors then turn their attention to two of the proposals contained in the European Commission's communication on tackling NPLs in the aftermath of the pandemic. Firstly, regarding the idea of an EU hub for data on NPL transactions, they conclude that *"data on past NPL transactions, however, may not be very useful to price new NPLs in the case of opaque borrowers such as many small and medium enterprises (SMEs) ... an EU NPL data hub could advance the development of the secondary market in NPLs over time, if it enables participating selling banks to establish reputations for setting fair prices ... For this to work, the NPL data hub needs to include information on workout cash flows so that ex post rates of return to buyers of NPLs can be calculated. In addition, it will be necessary that the same sellers frequently sell similar NPLs, and that the identities of the selling banks are known"*.

Secondly, on the potential use of AMCs following the pandemic, it is noted that *"public AMCs will also face information asymmetries unless they perhaps buy entire loan portfolios ... As already mentioned, the pandemic will give rise to relatively many NPLs to SMEs, which will present informational difficulties that could be equally difficult to surmount for AMCs with public involvement. Public AMCs could well play a useful role in mitigating market illiquidity, but this will depend on the time, country, and asset class under consideration"*.

Lastly, the authors argue that to facilitate NPL resolution, regardless of the method used, banks must record any deterioration in asset quality as accurately as possible. Despite the accounting framework, such adequate accounting practices are not guaranteed. Using quarterly balance sheet and income statement data for more than 90 euro area banks, the authors examine whether loan loss provisioning remains positively correlated to bank profitability, as is suggested by the literature.

The authors find that here has been a considerable variation in loan loss provision and profitability across banks, with a positive relationship between the two variables, indicating that banks with higher pre-pandemic profitability provisioned more during the initial two quarters of the pandemic. Using a regression analysis, the authors then estimate the relationship between loan loss provisions during the pandemic and pre-pandemic profitability, while controlling for bank risk. They find that *"loan loss provisioning during the pandemic and pre-pandemic profitability are positively related after controlling for bank risk. This evidence should concern supervisors, as it suggests that low-profitability banks provision too little in response to the pandemic in order to cushion the impact of the pandemic on their capitalisation."* As such, they urge the ECB to actively work to counter this revealed tendency of banks.

Non-performing Loans – Different this Time?

NPL resolution after COVID-19: Main differences to previous crises

Authors: Jonathan HAYNES, Peter HOPE and Hugo TALBOT

This paper assesses the impact of COVID-19 on the EU corporate and banking sectors, and the extent to which lessons learned during the previous GFC are relevant for NPL resolution after the pandemic crisis. The authors argue that the pandemic crisis is different insofar as it stems from an exogenous shock. This time, the crisis did not start with a credit boom in the financial system, financial institutions went in with much stronger capital positions, the market for NPLs is now much more developed, and there has been a large and quick coordinated policy response.

Looking at corporates, the authors find that they are being cushioned by government support measures. However, once this tapers off, *"some forward-looking indicators, such as rating actions, and the below-average number of insolvencies last year, would tend to indicate an expectation for an increase in corporate defaults and NPLs in the coming years"*. They do, however, note that for corporates needing to refinance soon, corporate spreads remain low and collateral prices have shown to be resilient.

For the EU banking sector, the authors note that *"there is some uncertainty about the adequacy of the provisions"*, and that the full impact of the COVID-19 crisis may not yet be fully accounted for. Moreover, the papers highlights some key factors to consider for NPL resolution following the pandemic crisis, including, *inter alia*, the asymetric impact accress sectors, greater need for financial restructuring of SMEs, and managing the transition and tapering off of government support.

Another key challenge identified by the authors is the risk of stifling innovation by supporting "zombie firms" (firms with already sustained periods of underperformance). Using an empirical analysis of 3240 listed firms in the EU and UK, the authors find that *"15.3% (497 companies) are zombies based on the latest published company accounts (as at 15 January 2021). This is an increase from 14.4% (467 companies) based on the published company accounts in the previous year."* However, the authors suggest that the number of zombie firms is likely to be higher than estimated by their model, especially once the government support ends. Forward looking indicators suggest deteriorating credit conditions for many firms, especially those in hard-hit sectors, and firms having suffered credit rating downgrades are at a higher risk of becoming zombies in the future as they have difficulties covering their interest payments with their revenues. Going forward, the authors note the importance of distinguishing between firms that were zombies prior to the crisis, and are likely to remain such after; and those that were financially sound prior, have good long term prospects, but are likely to struggle for a few years as the situation normalises. Both categories will require different policy responses, with the authors arguing that any government support should be calibrated to support the latter category. Moreover, direct or indirect support for SMEs (via guarantees and tax relief, or improving incentives to lend to SMEs, respectively) may be needed.

Turning to policy responses, the authors caution against the continuation of regulatory forebearance, arguing that it is hard to reverse the situation once the crisis abates. Rather, market based solutions, which create the right incentives to enable NPLs to be easily traded on secondary markets, should be encouraged, and regulatory impediments removed. Regarding corporate restructurings, the authors acknowledge that *"Getting the optimal balance between excessive continuation of firms and excessive liquidation of firms is critical to the success of any policy response ... For the large number of firms whose continuation values are likely to be greater than their liquidation values, there should be more support and flexibility. Policymakers should target support to those sub-sectors that have been most affected by the COVID-19 crisis and will be providing important services to consumers that will still be in high demand once the various restrictions are removed"*.

Non-performing Loans – Different this Time?

NPL resolution after COVID-19: Main differences to previous crises

Authors: Johannes KASINGER, Jan Pieter KRAHNEN, Steven ONGENA, Loriana PELIZZON, Maik SCHMELING and Mark Wahrenburg

In this paper, Kasinger et al. draw comparisons between the GFC and the recent COVID-19 crisis in order to find an effective and efficient strategy for dealing with potentially high NPL levels in the future caused by financially damaging lockdown measures. To establish the status quo of NPLs in Europe, the authors first develop a scenario analysis by utilising ECB data ending in Q2 2020 for a set of European countries and data on loans under a moratorium from the EBA. In both an intermediate and severe scenario regarding the percentage of loans becoming non-performing (25%; 50%), the authors find that *"equity capital exceeds by far the amount of NPLs and the aggregate banking sector seems comparably well capitalised in the current situation, even in a severe scenario"* but that there exists *a "substantial heterogeneity across countries, both in terms of the size of NPLs as well as in the relation of NPLs to bank capital"*. In countries with lower GDP per capita, a larger share of bank equity capital consists of NPLs, making them more vulnerable to a potential future increase in NPLs. Substantial heterogeneity is also observed across different sectors across countries; however, sectors' relative shares have not changed within the countries since the start of the pandemic. Keeping the limitations of these projections in mind, these findings suggest that the less capitalised national banking systems are vulnerable to credit crunch situations and could create systemic risk if the NPL proportion rises. There is a significant risk of zombie lending by banks to deal with a large share of NPLs and insufficient equity capital.

Kasinger et al. argue that, to mitigate the impact of COVID-19 on bank balance sheets, policies need to be aimed at: (i) avoiding financial instability and a banking crisis; (ii) minimising zombie lending; (iii) preserving the ability of the banking system to finance growth opportunities; (iv) minimising zombie banking, i.e. consolidating and addressing overbanking. In line with these objectives, the authors analyse the lessons learned from previous crises concerning NPL identification and their handling. The main arguments regarding such loans' identification assert that (i) NPLs should be identified and recognised in a fast and comprehensive manner in order to prevent zombie lending and bank zombification; (ii) with the CRR II and IFRS 9 introduction, banks should now have more incentives to implement the early and effective NPL identification; (iii) regulators and supervisors should ensure that banks assess current loan values realistically through effective Asset Quality Reviews, stress tests, adequate accounting rules and specific bank inspections, thereby incentivising banks to handle NPLs early and efficiently through either internal workouts or by selling them on secondary markets. The authors argue against forbearance or public bank recapitalisation since they provide adverse incentives to banks. Instead, they support internal workouts, direct sales and combinations of securitisation, Asset Protection Schemes, AMCs and government guarantees.

Lastly, Kasinger et al. support the European Commission Action Plan's argument that the secondary loan market for NPLs could lead to a more resilient banking system because a liquid and transparent market would allow banks to achieve higher prices when forced to sell NPLs, hence lowering their loss of capital even in critical times. They therefore advise policy makers to address barriers, such as information asymmetries. In this context, creating accessible data repositories is argued for, as well as the need for loan-level instead of portfolio-level data. The resulting increase in transparency is believed to enhance NPL recognition in banks' balance sheets as well. Nevertheless, a market-driven bank resolution process guided by BRRD guidance on restructuring is given primacy to recapitalisation or another rescue measure unless the crisis is not extreme in terms of the systemic risk. Even in such extreme events of systemic risk, the authors argue that rescue money should not be channelled to banks but rather to firms and borrowers, thereby endorsing the BRRD.