IN-DEPTH ANALYSIS

European Parliament

The EU's regulatory and supervisory response to addressing non-performing loans

Building on earlier EGOV papers, this briefing addresses the evolution of non-performing loans (NPLs) over time, the EU regulatory and supervisory approaches to manage NPLs and highlights areas where gaps may still be observed. Renewed interest in asset management companies as a possible instrument to deal with NPLs is discussed in an annex. Concerns around NPLs are growing, as the impact of COVID-19 crisis related responses on banks' balance sheets begin to be further scrutinised. This briefing will be updated in light of relevant developments.

I. Introduction

Non performing loans (NPLs) are expected, at some point, to invert the descending trend observed since the last financial crisis. The COVID-19 crisis and the policy reactions to avert its damaging economic and social effects have exposed banks to further deterioration of their assets. Effects on banks' balance sheets are yet to be felt and quantified. A 2016 paper from the European Banking Authority (EBA) notes that macroeconomic conditions affect NPLs buildup and materialisation: "*Trends in credit quality and NPLs are clearly affected by group-management, but they also depend on the general economic conditions in the local markets. As a matter of fact, there is a vast empirical literature that confirms the interaction between the macroeconomic conditions and asset quality*". The EBA refers in particular to decline of stock prices, increases in lending interest rates and to exchange rates (in particular situations). Across the borders, policymakers are stressing that the EU needs to prepare and endow itself with instruments to deal with the possible surge.

Differently than NPLs that were built and materialised after the financial crisis, the new wave of possible NPLs may require different tools than the ones currently available. Researchers at the European Central Bank (ECB) and International Monetary Fund (IMF) published a paper that documents some notable differences, drawing insight from a new dataset on yearly NPL evolution during banking crises observed since 1990.

Their results point to factors that can make NPL resolution in the EU after the COVID-19 crisis different from that after the 2008-2012 financial crisis. On the one hand, the fact that the COVID-19 situation was not sparked by a credit boom is from their point of view conducive to NPL resolution, as it implies that post-COVID-19 NPLs may relate to viable illiquid firms rather than unviable zombie firms. On the other hand, they consider that NPL resolution may become more challenging given substantially higher levels of government debt, the fact that banks are considerably less profitable than in the past, and given that many corporate balance sheets are weak. However, an open question not covered by that paper is whether the COVID-19 crisis will have more lasting effects on some specific industries, stemming from profound changes of

Economic Governance Support Unit (EGOV)
Authors: Rebecca SEGALL, Cristina DIAS,
Kristina GRIGAITĖ, Marcel MAGNUS
Directorate-General for Internal Policies
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consumer preferences, industry supply chains, traffic volumes, work place arrangements etc; NPLs related to industries subject to more profound changes might require a different approach if they are to be resolved.

Non-performing loans, as they are usually referred to, or non-performing exposures, to use the technically speaking more correct expression[1], are loans that are more than 90 days overdue, or that are unlikely to be repaid. The level of NPLs serves as a key indicator for the quality of the banks' loan books. From the systemic risk point of view, the European Systemic Risk Board (ESRB) has identified that *"A significant increase in NPLs throughout the system can have a negative impact on the resilience of the banking sector to shocks, thus increasing systemic risk. NPLs may also be associated with higher funding costs and a lower supply of credit to the real economy. This may result from negative market sentiment towards banks with high levels of NPLs, which decreases banks' ability to access liquidity and capital markets (potentially leading to credit supply constraints)."* Persistently high levels of NPLs affect the health of the banking sector (reducing profitability), and potentially financial stability at large (through contagion effects), and can have macroeconomic impacts (through the reduction in lending[2]).

This paper builds on earlier briefings addressing non-performing loans (see here, here, here and here). It details the evolution of NPLs overtime (section II), the regulatory and supervisory approaches (section III) and highlights areas where gaps may still be observed (section IV). Annex looks at the role of asset management companies as a possible instrument to deal with NPLs.

II. The past evolution of non-performing loans in the EU

A steady decline of NPLs since the peak in 2013

Following the global financial crisis, many EU Member States grappled with high stocks of NPLs, with the IMF estimating that NPL levels in the EU more than doubled between 2009 and 2014.

From its peak in 2013 until the middle of 2020, the asset quality of EU banks has improved substantially, following a number of legislative and other initiatives (see Section III). The most recent edition of the "supervisory banking statistics"[3] published by the European Central Bank (ECB) on 13 January 2021 illustrates the aggregate performance of the largest banks in the euro area ("significant institutions"), based on data for the third quarter of 2020. Such data shows that the aggregate NPL ratio fell to 2.8% in the third quarter of 2020, which marks the lowest level since that dataset was first published by the ECB in 2015[4]; that ratio is 0.6% lower than in the third quarter of 2019. An analysis of the underlying data shows that the

[1] In the past, a comparison of NPL ratios was complicated by the fact that the definition of NPLs was not harmonised. In 2013, the EBA started a harmonisation process regarding the definition of NPLs respectively non-performing exposures (NPEs), concerned that the asset quality assessment across the EU, particularly regarding the line drawn in the different jurisdictions between the performing and non-performing categories, was not consistent. The related EBA implementing technical standard regarding forbearance activities and non-performing exposures became binding and applicable for supervisory reporting in all Member States by the Commission Implementing Regulation (EU) 2015/227, published in the Official Journal on 9 January 2015. "NPL" is a as a shorthand term often used when discussing the overall subject, even if in technical terms the EBA definition of NPEs is meant. The ECB, for example, uses the terms "NPL" and "NPE" in its guidance to banks on non-performing loans of March 2017 interchangeably.

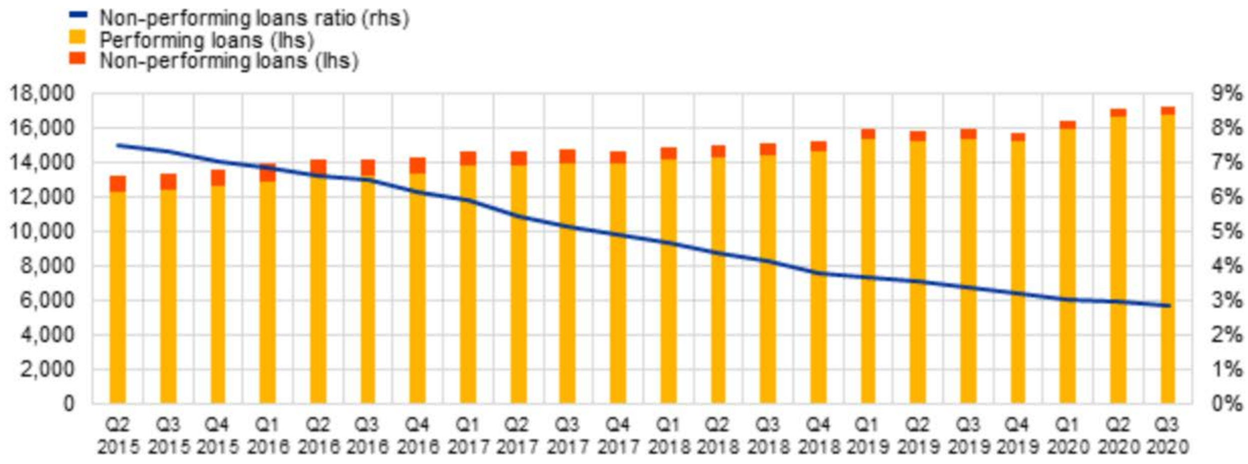
[2] The results of empirical research in that respect are not unambigous, though. A research paper published by Banco do Portugal (Silva, Martinho, Marques (2020): *Non-performing loans and bank lending: Evidence for Portugal*) for example finds that there is no evidence that NPL ratios per se constrained bank loan supply to performing corporates in the 2009-2018 period when controlling for loan demand and several bank characteristics.

[3] There are different sources of information available regarding the NPL ratios of European banks. In this briefing, the data sources are mostly either the EBA or the ECB; the choice usually depends on which of those two institutions has published the most recent data. The main difference between those two sources is that EBA data usually refers to a sample of large banks from all Member States of the EU, not only those that use the euro as their currency, while the ECB supervisory banking statistics only include banks from the euro area, all of which are directly supervised by the ECB, a few of them being comparatively small.

[4] Aggregate NPL ratios for EU Member States relating to the period before the ECB started to publish the "Supervisory banking statistics" can for example be found in EBA's series of "Risk Dashboard" publications, starting in 2013.

improved ratio can be attributed to both a numerator effect (i.e. a decline in the total stock of NPLs by EUR 58 billion, y-o-y; on numerator and denominator effects, see box 1) and, more importantly, a denominator effect (i.e. an increase in the total amount of loans by 8%, or EUR 1.240 billion, y-o-y).

Figure 1: Non-performing loans by reference period



Source: ECB.

Box 1: Changes of the NPL ratio - numerator and denominator effects

The NPL ratio is calculated as a share of the outstanding amount of the loans that have been qualified as impaired or overdue (following the definitions of NPLs as described in Section I above) compared to the full outstanding loan portfolio. Therefore, mathematically, the changes in the ratio can be caused by changes of either the numerator or the denominator (or both); in other words, the NPL ratio might for example improve - even if the volume of non-performing loans remains unchanged - just because the volume of total loans has increased. A decomposition of the effects indicates to what extent changes of the NPL ratio result from loan growth, and to what extent they result from changes of the impairment situation.

$$NPL\ ratio = \frac{Volume\ of\ NPLs\ (numerator)}{Total\ outstanding\ loan\ portfolio\ (denominator)}$$

COVID-19 crisis and expectations related to NPLs - a turning point?

The November 2020 monitoring report on risk reduction indicators prepared for the Eurogroup notes that the impact of the COVID-19 pandemic is only partially reflected in the most recent data. Firstly, it must be noted that the data includes cash balances in the denominator of the NPL ratio[5]. Thus, rising levels of central bank liquidity in the banking sector may have reduced the NPL ratio. Adjusting for cash balances, the aggregate gross NPL ratio for the Banking Union would increase to 3.5% (+0.6 pp). Secondly, a number of policy measures have been introduced to support operational and liquidity challenges faced by borrowers during this crisis. At the aggregate level, the report finds that "*As of Q2 2020, the total number of loans benefiting from all three [moratoria, forbearance, guarantees[6]] measures related to about EUR1004 billion or 7.0% of total gross loans of Banking Union Significant Institutions. 5.3% of these loans related to loans benefiting from EBA-compliant moratoria, 1.3% to loans benefiting from state guarantees, and 0.4% to loans benefiting*

[5] The monitoring report states that "*non-performing exposures ratios always include cash balances as part of debt instruments in the denominator*"; in contrast to that statement, however, the EBA Guidelines on disclosure of non-performing and forborne exposures, published in December 2018, state that "*The gross NPL ratio is the ratio of the gross carrying amount of NPLs and advances to the total gross carrying amount of loans and advances subject to the NPE definition. For the purpose of this calculation, loans and advances classified as held for sale, cash balances at central banks and other demand deposits are to be excluded both from the denominator and from the numerator*".

[6] The EBA's COVID-19 disclosure package categorises measures as (i) EBA-compliant moratoria, (ii) other COVID-19 forbearance measures and (iii) state guarantees.

from other COVID-19 forbearance measures." Aggregate levels, however, as mentioned before hide significant dispersion at the Member State level. The percentage of loans benefiting from COVID-19 measures over total loans were the highest for Cyprus (42.3%), Portugal (20.7%) and Greece (12.5%), and the lowest in Netherlands (3.5%), Luxembourg (1.6%) and Germany (1.5%).

Despite the measures in place, the overall ratio of NPLs as a percentage of total loans benefiting from COVID-19 measures stood at 0.2% as of Q2 2020. The report concludes that it *is "difficult to gauge which proportion of the performing loans is likely to be reclassified as non-performing in the future (...) the impact is likely to depend on macroeconomic factors, such as the severity of the COVID19 pandemic, the extent to which economies can mitigate its impact, the speed of economic recovery after the crisis, as well as bank-specific features, such as diversification, large exposures and the quality of the loan book".*

Recent assessment of risks and vulnerabilities for 2021 by the Single Supervisory Mechanism (SSM) highlight *that "credit risk is considered one of the main challenges for the banking sector and supervisors ... NFCs [non-financial corportations] in some sectors have seen a sharp deterioration in profits as a result of the lockdown measures, and hence a higher risk of insolvency ... at the same time, households ... are likely to face the prospect of a worsening labour market situation, which could, in turn, affect their debt servicing capacity ... banks therefore need to prepare for an increase in non-performing loans and, as a minimum, need to mitigate cliff effects resulting from the temporary nature of the support schemes".* As a result of credit risk being identified as one of the main challenges for the banking sector, the SSM established the management of this risk as one of the key priority areas for 2021.

III. Regulatory and supervisory efforts to tackle NPLs

The European Council 2017 Action Plan on NPLs remains, to date, the EU comprehensive response to tackling non-performing loans. The Council recognised that *"the negative effects of current high NPL ratios in a substantial number of Member States can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole, especially within the Banking Union".* The Action Plan was based upon a report of the Council's Financial Services Committee on NPLs and earlier Commission proposals. The report proposed a number of coordinated actions in four axis: (i) supervision, (ii) structural issues, including insolvency, (iii) secondary markets, and (iv) restructuring of the banking system. The Action Plan proposes 14 specific actions to holistically deal with NPLs and, in particular, defines a regular reporting on evolution of the NPLs stocks, the restructuring of banking sector and the development of secondary markets for NPL transactions.

Following this call to action from the Council, the Commission announced a package of measures aimed at addressing NPLs in its October 2017 Communication on completing the Banking Union. This was followed by a further package of measures tackling NPLs in March 2018, which included two legislative proposals[7] in addition to a Blueprint for Asset Management Companies (AMCs) (see Annex).

The Council further agreed to assess the stock of NPLs and progress made in regards to the Action Plan on a regular basis. On 18 January 2018, the Commission presented its first progress report on the Action Plan. That report *inter alia* points out that the primary responsibility for tackling high NPL ratios remains with the affected banks and Member States, mentions that there is evidence of progress in reducing NPL ratios in

[7] A proposal for a regulation amending the capital requirement regulation and introducing common minimum coverage levels for newly originated loans that become non-performing. The introduction of minimum coverage levels makes banks set aside funds to cover the risks associated with future NPL.The proposal for a directive on credit servicers, credit purchasers and the recovery of collateralprovides banks with an efficient mechanism of out-of-court value recovery from secured loans and encourages the development of secondary markets where banks can sell their NPLs to investors and make use of specialised credit servicers.

Member States (due to a combination of policy actions and economic growth) but also cautions that NPLs continue to pose risks to economic growth and financial stability.

The Commission published the most recent progress report, its fourth, in June 2019, where it assessed that most of the measures foreseen in the Action Plan are complete (see Table 1 below). It should be noted that while many of the actions are marked as accomplished, many of these initiatives, such as the need to develop secondary markets for NPLs, require ongoing efforts.

Table 1: Progress in implementing the Council Action Plan

No.	Initiative of the Action Plan	No.	Initiative of the Action Plan
1	Interpretation of existing supervisory powers in EU legislation as regards NPL provisioning	8	Improving loan tape information required from banks
2	Addressing potential under provisioning, via automatic and time-bound provisioning	9	Strengthening data infrastructure for NPLs, including potential transaction platforms
3	Extended Single Supervisory Mechanism NPL guidelines to small banks	10	Develop a Blueprint for asset management companies
4	Adopting EU-wide management guidelines for non-performing exposures	11	Develop secondary markets for NPLs
5	New guidelines on banks' loan origination, monitoring and internal governance	12	Benchmarking of national loan enforcement and insolvency frameworks
6	Develop macroprudential approaches to tackle the build-up of future NPLs	13	Develop the focus on insolvency issues in the European Semester
7	Enhanced disclosure requirements on asset quality and NPLs for all banks	14	Enhancing the protection of secured creditors

Accomplished **Imminent** **Ongoing**

Source: European Commission (2019).

Since the publication of the progress report, the EBA published its Guidelines on loan origination and monitoring in May 2020, aimed at addressing initiative 5. Moreover, in response to a call for advice from the Commission, the EBA published a report on the benchmarking of national insolvency frameworks across the EU in November 2020 (initiative 12) (see EGOV briefing for a discussion of this report).

These reports by the EBA complement its other work on NPLs in line with the Council and Commission priorities. The EBA developed NPL transaction templates in late 2017 to improve data standardisation and comparability, with an updated version published September 2018. Moreover, in 2018, the EBA published a report on statutory prudential backstops and guidelines on the management and disclosure of non-performing and foreborne exposures. It also published an Opinion, addressed to the Commission, on the regulatory treatment of non-performance exposures securitisation in October 2019.

In response to initiative 6, the ESRB published its macroprudential approaches to non-performing loans in January 2019. The report identifies the triggers, vulnerabilities and amplifiers of system-wide increases in NPLs, and the mitigating role macroprudential policy can play. Overall, the report concludes that no fundamental change to the existing macroprudential toolkit is required, but that some refinements, in the areas of sectoral capital buffers and the development of borrower-based measures, should be considered (please see a broader discussion in the Section below, as well as dedicated EGOV briefing on macroprudential instruments).

Regarding initiative 13, developing the focus on insolvency issues in the European Semester, the Commission has issued Country-Specific Recommendations (CSRs) on this topic to a number of Member States in recent years (see EGOV briefing for more details). For the 2020 CSRs, however, the focus has been on addressing the health and socio-economic crisis as a result of the COVID-19 pandemic. As such, only Bulgaria received a CSR relating to their insolvency framework.

On the supervisory side, the ECB Banking Supervisor continues to consider addressing NPLs as a priority. Over the years, the ECB has provided banks with guidance in dealing with NPLs, most notably in its March 2017 NPL Guidance, which clarified supervisory expectations regarding the identification, management, measurement and write-off of NPLs. An Addendum, published in March 2018, specified the supervisory expectations in assessing a bank's level of prudential provisions for non-performing exposures. While non-binding, both the Guidelines and Addendum form the basis for supervisory dialogue. In July 2018, the ECB indicated that it will engage with banks to define bank-specific supervisory expectations regarding NPLs. As outlined in its 2019 Annual Report, *"the ECB asked [Significant Institutions] with higher levels of NPLs (...) to submit their NPL and foreclosed asset reduction strategies and to define their portfolio-level reduction targets over the medium term. In 2017 those SIs communicated their NPL reduction strategies to the ECB for the first time and have updated them twice since".*

On 22 August 2019, the ECB published a Communication on supervisory coverage expectations for non-performing exposures[8]. This follows the adoption of the legislative proposal amending the CRR as regards minimum loss coverage for NPEs. The Communication clarifies the revision of the ECB supervisory expectations regarding prudential provisioning of new NPEs, in light of the new Pillar 1 treatment for NPEs (see previous EGOV briefing for a comparison of the ECB's versus Commission's approach). Moreover, the Communication clarifies aspects relating to the EBA guidelines on the management and reporting of NPEs, noting that there are no contradictions in terms of substance between the guidelines and supervisory expectations.

In response to the COVID-19 crisis, ECB Banking Supervisor Chair Enria sent a letter to directly supervised banks on 28 July 2020 providing supervisory expectations regarding the operational management of asset quality deterioration during the crisis period. This was followed by a letter on 4 December 2020 providing banks with addition guidance on the identification and measurement of credit risk. The ECB has also indicated that it will extend flexibility to banks where appropriate: *"the ECB will, within its own remit, and within the context of the ECB Guidance on NPLs and the Addendum, extend flexibility on the automatic classification of obligors as unlikely to pay, when institutions call on the coronavirus related public guarantees (...) The ECB also extends flexibility to the NPL classification of exposures covered by qualifying legislative and non-legislative moratoria (...) The stock of NPLs accumulated prior to the outbreak is not the focus of our current mitigation measures. However, the ECB is fully aware that current market conditions may make the agreed reduction targets difficult to attain and somewhat unrealistic. In this vein, the [Joint Supervisory Teams] will be fully flexible when discussing the implementation of NPL strategies on a case-by-case basis."* The ECB further postponed the deadline for the submission of updated NPL strategies to end-March 2021.

The European Parliament has welcomed efforts to reduce the stock of NPLs in the EU. Most recently, in the 2019 Banking Union Annual Report, the European Parliament *"points out that the level of non-performing loans still remains high in certain institutions and that further efforts are needed to address this issue; takes note of the ongoing legislative work on the directive for credit servicers and credit purchasers, and stresses the need to make sure that the development of secondary markets for loans and the creation of an extrajudicial enforcement mechanism include appropriate consumer protection".*

[8] As noted by the ECB, NPE and NPL are used interchangeably in this context.

Box 2: A European bad bank?

The debate on a European-level AMC predates the current crisis. In a a 2017 conference, then-EBA Chair Andrea Enria presented his proposal for an EU-level AMC to be established with government support, with banks transferring some segments of their NPLs to the AMC at their real economic value. The AMC would then have a set number of years to sell their assets at the real economic value, or take the financial hit. In response, Chair of the European Stability Mechanism (ESM) Klaus Regling welcomed the plan as a *"valuable policy proposal"*, but acknowledged the complexities of setting up such an institution, including the difficulty of moving such a large volume of already exsting NPLs to the AMC. In a later interview, however, he did not see the creation of a European bad bank as feasible given the heterogeneity of NPLs across the euro area. Then-Chair of the SSM, Danièle Nouy, considered the proposal one of many tools available, and noted that it would reduce stigma in the market and improve the bargaining power of banks selling their NPLs. Despite this, the Commission did not pursue such a proposal, given state aid concerns (see Annex).

It is not yet clear if NPLs that are expected to arise from the current pandemic crisis are different in nature to those of the previous crisis, and if so, whether AMCs are likely to be effective in dealing with them. Nevertheless, in the October 2020 hearing before ECON, Chair of the Supervisory Board Andrea Enria warned that authorities should prepare for a rise in NPLs and that AMCs have been *"proven to be efficient tools for facilitating the management and recovery of NPLs"*. Instead of advocating for a EU-level AMC, however, he suggested that *"a European initiative, for instance connecting in a network national AMCs, via common funding mechanisms and harmonised pricing, could be a useful tool for addressing the expected rise in NPLs and ensuring a level playing field within the banking union"*. He further outlined his proposal for a network of EU national AMCs in an opinion for the Financial Times published on 26 October 2020. In a letter dated 14 January 2021, Enria has however clarified that *"ECB Banking Supervision has not developed any official proposal on this issue. I can also confirm, therefore, that the ECB has not submitted any plans for the creation of a European asset management company to the European Commission [or] the Single Resolution Board..."*.

The Chair of the Single Resolution Board, Elke König, remains cautious on the issue of an EU bad bank. As she remarked in a October 2020 hearing before ECON: *"Whether then in the end a European bad bank or national bad banks are the solution or whether we should not rather focus on very much tailor-made bank specific solutions remains to be seen ... That I have always been very sceptical about the European bad bank, I think is reasonably known. I find it a bit too big of a baby to be managed"*. In an earlier hearing, she elaborated a bit more on her scepticism: *"this is a concept that was floated in 2017 and we were more than sceptical at that time, and this has not changed. The reasons are manifold: starting from valuation and not ending with questions of management and disposal of such a mixed basket. In recent years some national bad bank concepts have emerged that look more promising to me; but even here numerous questions remain"*.

IV. The current framework: what gaps remain?

On 15 December 2020, the Commission presented an action plan that is aimed at preventing a future build-up of NPLs, in the context of the pandemic crisis. Ensuring that EU households and businesses continue having access to funding needed and banks support EU's economic recovery were the crucial elements of the strategy.

"The NPL strategy has four main goals

1. *further develop secondary markets for distressed assets, which will allow banks to move NPLs off their balance sheets, while ensuring further strengthened protection for debtors*
2. *reform the EU's corporate insolvency and debt recovery legislation, which will help converge the various insolvency frameworks across the EU, while maintaining high standards of consumer protection*
3. *support the establishment and cooperation of national asset management companies (AMCs) at EU level*
4. *implement precautionary public support measures, where needed, to ensure the continued funding of the real economy under the EU's Bank Recovery and Resolution Directive and State aid frameworks."*

Under the first objective of developing secondary markets for distressed assets, the Action Plan proposes various new initiatives. Some of these are criticised in a recent working document of the European Economic and Social Committee as means of further incentivising "vulture funds".

First, to improve data quality and comparability, the Commission aims to mandate EBA in early 2021 to review the dataset templates for NPL transactions in the EU. Consequently, the EBA launched an online survey regarding the review of its NPLs data templates, with the deadline for input 15 March 2021.

Second, the Commission will launch a public consultation in the first half of 2021 to explore several alternatives for establishing a data hub at the EU level and the neccessary next steps. No reference is made, however, on how to finance the setup of such database (the Commission alludes, notwithstanding, to the possibility of the network of national AMCs combining effords to establish such platform).

Third, to improve the availability of information for market participants, the Commission has committed to "*explore in early 2021, together with relevant stakeholders, how (...) existing datasets could be mobilised and made available to market participants in suitably aggregated forms to ensure bank and borrower confidentiality*". Fourth, the Commission aims to consult stakeholders on the potential review of Pillar 3 disclosure requirements under the CRR in the first half of 2021 to allow compilation of additional data such as cure rate and time to recovery. Fifth, the Commission, in cooperation with the EBA and other stakeholders, wishes to develop guidance on what constitutes a "best execution" sales process for transactions on secondary markets.

Lastly, in an effort to address regulatory impediments to NPL purchases by banks, the Commission and EBA intend to develop a "suitable approach" to the regulatory treatment of purchased defaulted assets and the risk weights on purchased defaulted assets. In addition, the Commission urges the adoption of the legislative proposal on credit servicers and credit purchasers, which ECON voted in favour on in January 2021.

Under the heading of supporting the establishment and cooperation of national AMCs, the Commission does not present any new initiatives, but merely states that it *"stands ready to support Member States in setting up national AMCs – if they wish to do so – and would explore how synergies and cooperation could be cultivated by establishing an EU network of national AMCs, jointly with existing national AMCs, the ECB and the EBA"*. The Commission also does not suggest ways to further incentivise national AMCs. In any case, one would need to asses to what extent AMCs could be useful in dealing with COVID-related NPLs, as their features might be different than those arising from previous crises.

Similarly, the Action Plan does not propose new initiatives to reform the EU's corporate insolvency and debt recovery frameworks. Instead, the Commission urges for an agreement between the European Parliament and Council on the Directive on the minimum harmonisation rules on accelerated extrajudicial collateral enforcement and notes that it will "*carefull analyse*" whether a more regular benchmarking of national loan enforcement frameworks is warranted. This Directive, alongside that on credit servicers and purchasers, is identified as a joint priority for 2021 by the three EU institutions. Relevant divergences remain at national level and this may hinder an effective handling of NPLs (see previous EGOV briefing). The Commission points, to this effect, that the recently agreed Recovery and Resilience Facility may be used to finance reforms improving insolvency, judicial and administrative frameworks. The Techical Support Instrument can also be used to foster Member States' capacity to deal with NPLs.

The Commission's September 2020 Capital Markets Union Action Plan reiterates the need to increase convergence in national insolvency frameworks. According to Action 11 of the CMU Action Plan, *"the*

Commission will take a legislative or non-legislative initiative for minimum harmonisation or increased convergence in targeted areas of non-bank insolvency law. In addition, together with the European Banking Authority, the Commission will explore possibilities to enhance data reporting in order to allow for a regular assessment of the effectiveness of national loan enforcement regimes." The Commission indicates that a public consultation on the topic of convergence will follow, and that a group of experts will undertake technical work, without providing more concrete details. Lastly, the Commission has been raising the NPL issue and addressing related missing reforms in country specific recommendations during 2011-2019 European Semesters (see dedicated EGOV briefing). At the Member State level, reforms aimed at increasing the efficiency of collateral enforcement and court procedures can play an important role in reducing the exisiting stock and prevent the future build-up of NPLs (Kaskarelis & Siklos, 2019).

State aid concerns underpin various of the possible initiatives to deal with NPLs. That is more clearly the case for AMCs but the Commission recognises interactions of NPLs also with the regime of precautionary public support and thus, the resolution framework. On that specific context, the Commission considers that public support is possible - without automatically declaring a bank failing-or-likely-to-fail and the consequences of such assessment - in case that a viable bank finds itself with a capital shortfall that is caused by the impact of the COVID-19 crisis and that is determined on the basis of a stress test or equivalent exercise. The Commission further highlights in that context that the COVID-19 crisis has been recognised as a "serious disturbance" to the EU economy, a pre-condition for exceptional treatment, and that the July 2020 ECB vulnerability analysis can be used as the starting point to assess the capital shortfall, to be complemented with further stress tests.

On 19 January 2021, the Commission presented its Action Plan to the ECOFIN. Ministers *"agreed on the need to complete the implementation of measures outstanding from the 2017 action plan. The presidency highlighted its aim to progress quickly with the legislative proposals regarding secondary markets for NPLs and accelerated extrajudicial collateral enforcement, once the European Parliament was ready (...) Work will continue to build a common view in other areas".*

Beyond the Commission's Action Plan, the ESRB had identified a number of actions macroprudential authorities could undertake as part of the macroprudential approach to NPLs, some of which are still outstanding. The ESRB highlighted that "*further work is needed in areas relating to the use of sectoral capital buffers and the development of borrower-based measures (which are not harmonised at the European level)*". furthermore, the ESRB has strongly urged national macroprudential authorities to: (i) develop early warning systems to monitor the systemic risks; (ii) include borrower-based measures in their national macroprudential policty toolkits; and (iii) use capital-based macroprudential instruments (including countercyclical capital and systemic risk buffers) to address vulnerabilities that might later lead to significant build-up of NPLs. To emphasise the importance of macroprudential policy in mitigation of system-wide NPL increases, the ESRB recommended including this topic in its handbook on operationalising macroprudential policy.

One additional area that might merit a closer look is that of investor protection. Indeed, retail consumers may underlie some of banks' NPLs (mortgage and personal credit, for instance). Concerns have been voiced that retail debtors are often confronted with a different creditor than the bank with which they have initially established a relationship. The Commission's Action Plan recognises and echoes such concerns but fails to detail measures it could propose to alleviate them, besides advising that banks should engage early enough with their clients and proposing to organise a roundtable to assess the situation.

A rise in NPLs may reinforce concerns around banks' profitability (see SSM, 2018; Resti, 2019; Bruno & Carletti, 2019). Historically, high stocks of NPLs have constrained the profitability of European banks - especially weaker banks. In her remarks before the ECON Committee on 27 October 2020, SRB Chair König reiterated that *"banks that had weak business models before the arrival of the pandemic will not have become stronger in the meantime. So, while certain support measures by European authorities might be necessary right now, support for banks, or indeed for any business, should only be for those with a sustainable business model."* Addressing other impediments to profitability, such as barriers to consolidation, may therefore be warranted in order to prevent a rise in NPLs from threatening the stability of the European banking sector going forward.

Contact: egov@ep.europa.eu

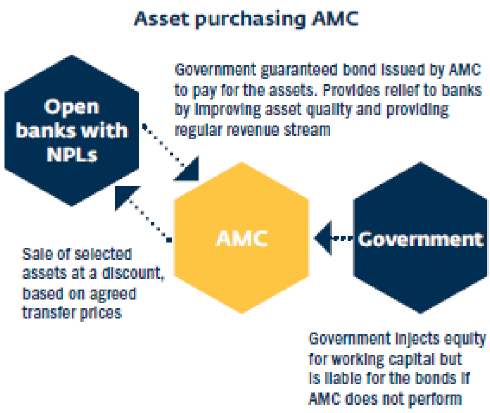
ANNEX: The role of asset management companies in cleaning up balance sheets

Asset Management Companies (AMCs) are a possible example of measures aiming at resolving impaired (or troubled) assets (impaired assets measures; asset relief measures). In 2009, following the financial crisis, the Commission published a Communication addressing the treatment of impaired assets through public funds[9]. That Communication refers to a number of possible ways of dealing with troubled assets clustered around (i) measures that segregate the troubled assets (either within a bank or the whole sector) and (ii) measures that insure banks against losses of such assets. These instruments or schemes require allocating losses (to the banks themselves and their shareholders, to banks' creditors, to the State). Therefore, all require some form of financing (or re-financing) of such losses. AMCs form part of the first set of such measures and are often referred to as "bad banks".

In the context of managing NPLs, a "bad bank" refers to a centralised[10] AMC set up to relieve banks' balance sheets within a given banking system from troubled assets (such as NPLs) and their associated risks. The World Bank defines centralised AMCs as *"a public, private, or joint entity that manages nonperforming assets removed from the financial system with the goal of maximizing the recovery value of these assets."* It further notes that in recent years, the trend has been to have public-private AMCs. If a public-private partnership is established where the majority stake is held by the private sector, the government does not have effective control, the majority of risks is borne by private actors, and the AMC remains unconsolidated with the general goverment sector. This in turn does not further burden Member States with limited fiscal space (Fell, Grodzicki, Martin & O'Brien, 2017).

While AMCs can also be set up to liquidate the assets of failed banks, the current debate regards using an AMC to purchase impaired assets from operating banks. In this case, *"the AMC purchases assets from banks that are still operating. These assets must meet certain characteristics as defined by the legislation or the AMC. A financial transaction takes place between the selling bank and the AMC, and usually the AMC issues a government-guaranteed bond to pay for the purchase (...) the value of the assets must be established by a prior assessment or valuation of the assets by the supervisor, or by the AMC through a transparent, market-based, due diligence process conducted by an independent third party experienced in valuation."* It is then expected that AMCs are able to recover value from the non-performing assets it acquires. AMCs will then need to dispose of the assets through sales, securitisation or workouts (see also FSI, 2017; IFC, 2019).

Figure **A: How AMCs work**



Source: IFC, 2019.

[9] The Communication addresses state aid implications of such asset relief measures and focus on issues such (i) transparency and disclosure requirements; (ii) burden sharing between the State, shareholders and creditors; (iii) aligning incentives for beneficiaries with public policy objectives; (iv) principles for designing asset relief measures in terms of eligibility, valuation and management of impaired assets; and (v) the relationship between asset relief, other government support measures and the restructuring of banks.

[10] Centralised or bank-wide, available to all banks of a given banking system. Specific asset separation tools can be set up at individual bank level. The former are not addressed here.

Centralised AMCs are able to benefit from economies of scale in restructuring, enforcement of collateral, the ability to apply uniform valuation criteria and the ability to lobby for necessary sectoral reforms. In a November 2017 speech, Andrea Enria, then Chair of the EBA, argued that *"AMCs may address, in a comprehensive manner, the numerous factors that determine the NPL inter-temporal pricing problem, i.e. the insurgence of a gap between the market value and the real economic value of NPLs. Recent experience has shown that AMCs could be very effective in addressing systemic asset quality problems and in 'buying time' during which the intertemporal gap could be tackled. Their effectiveness is maximised when public funds are leveraged to initially bridge the pricing gap."*

This, in turn, benefits the financial system as a whole. First, in forcing banks to recognise losses, they restore confidence in financial systems. Second, the purchase of NPLs from banks improves their asset quality, and possibly increases liquidity in the sector. Lastly, the restructuring of banks and exit of non-viable banks strengthens the overall financial system. The benefits of AMCs, however, require that the institution be well designed, with a clearly defined mandate, and ensuring that they are able to recover the value of NPLs which it aquires. This is important so as not to generate losses for the taxpayers in the case of a publicly-funded AMC (see Lehman, 2018; FSI, 2017; World Bank, 2016). As the above mentioned World Bank study reveals, AMCs have mixed performance track record[11] and there are certain preconditions that should be put in place[12].

National AMCs in the EU context

After the 2008 financial crisis, some Member States had set up similar state-backed bad banks to enable impaired asset transfers (see Box A). At that time, banks that intended to benefit from NPLs transfer had to get the Commission's approval and submit a restructuring plan that required an adequate compensation for the benefit received, though limited to a contribution by the banks' shareholders and junior bondholders. Nevertheless, as the analysis by Lehman (2018) highlights, there may be some value in establishing the framework for AMCs prior to a crisis situation.

However, since the previous crisis, the legal framework has changed: the introduction of the bank recovery and resolution directive (BRRD) aimed at avoiding the costs of bank failures would again be borne by taxpayers (providing 'bail-outs'), putting them instead on the private sector. 'Bail-in', the concept that entered into force in January 2016, stipulates that shareholders and a wider range of creditors have to contribute to the losses of an ailing bank; since, any form of government support is highly restricted, can only be part of an official resolution process, and requires the participation of the bank's creditors.

[11] Based on the analysis of nine AMCs case studies.

[12] According to the World Bank, these preconditions relate to: *"(i) a commitment to comprehensive reforms, (ii) a systemic problem and public funds at risk, (iii) a solid diagnostic and critical mass of impaired assets, (iv) a tradition of institutional independence and public accountability, and (v) a robust legal framework for bank resolution, debt recovery, and creditors' rights".*

Box A: National AMCs

A World Bank study published in 2016 aims at answering the question of whether public asset management companies (PAMCs) have been a successful tools for tackling non-performing loans. As part of the analysis, the World Bank studied 9 national PAMCs cases that were operational during different crises and in different geographical locations. All the cases were grouped into three "generations" of PAMCs - the "first generation" of PAMCs was operating in the late 80s' - early 90s' (examples of U.S. and Sweden were analysed), the "second generation" of PAMCs was operational during the asian crisis (therefore, almost all the examples analysed were from asian countries like Korea, Indonesia, etc.) and the "third generation" of PAMCs was set up in response to the financial crisis of 2008 (the majority of example of the third generation PAMCs were European companies set up in Ireland, Spain and Slovenia).

Table **A.** Comparison of the main features of the "third generation" PAMCs

	NAMA (Ireland) 2008	AMCON (Nigeria) 2010	SAREB (Spain) 2012	BAMC (Slovenia) 2013
Mandate	Asset Management (AM)	AM; recapitalize failed banks; invest in equities	Asset management	Asset Management
Special powers	Yes (but not used)	Yes	None	None
Life span	Expected to close in 2020	None specified in the law	15 years	10 years (till 2022)
Asset transfer	Appraisals. REV uplift of 8.3% Discount from Book Value= 57%	Guidelines from Central Bank Discount = 54%	BoS+independent valuation. REV with uplift ~18% Discount = 52.4%	Independent valuation. REV with uplift~10% Discount = 68%
Eligible loans	Large real estate loans	Any loan reasonably expected to become substandard	Large real estate loans	Large loans multi-sector
Recovery (from face value)	54% (as of Dec 2017)	N.A.	20% (as of Dec 2017)	26% (as of Dec 2017)

Source: World Bank.

According to the above mentioned study, learning from the past lessons reveal that successful AMCs had a strong commercial focus, including professional asset management, strong governance practices, robust transparency requirements, strong internal controls and frequent external reporting. Another key attribute of successful AMCs were independent boards with strong private or even international presence. Not surprisingly, good governance features, such as internal staff rules, code of conduct, key performance indicators, proper documentation of key decisions made, external audits, were found to be a success contributing factor.

On the other hand, the study concluded that PAMCs in some instances ended up delivering more harm that benefits to the system. This was especially the case when the PAMCs were not designed properly and permitted changes in the mandate, preferential treatment of certain borrowers, inappropriate asset purchases and sales (strict rules were put in place for both the purchase and the sale of assets, in order to avoid purchasing assets at inflated prices and later "warehousing of band loans" as well as "firesales"), weakened credit discipline and undue political interference, among others.

At the same time, any form of government support must be compatible with the Commission's state aid framework. Public funding and ownership of systemic AMCs are likely given the need to incentivise private actors to take on such distressed assets and the coordination capacity of the state. From a state aid perspective, there is then the concern that the transfer of NPLs to a state backed AMC would give those banks a competitive advantage over other banks that do not. Nevertheless, the Commission notes in its 2018 AMC Blueprint (see Box B) that AMCs involving state aid should be seen as exceptional and not the default. Rather, other measures that do not constitute State aid should also be considered. As reiterated in the Commission's 2020 Action Plan: "*Even when (some) public funding is involved, it would not be State aid if the State can be considered to be acting in a similar way to a market economy operator. The option of an AMC* *involving State aid should not be seen as the default solution since AMCs can take multiple forms and can be structured and financed in several ways."*

Box B: Commission AMC Blueprint

The objective of the AMC Blueprint published by the European Commission in March 2018 is *"to provide practical guidance and recommendations for Member States when considering the design and set-up of centralised AMCs at the national level, building, where applicable, upon best practices from past experiences. The Blueprint therefore puts forward a number of non-binding principles, such as the relevant asset perimeter, the participation perimeter, considerations regarding the asset-size threshold, asset valuation rules, the appropriate capital structure, and the governance and operations of the AMC [...] The Blueprint clarifies the permissible design for AMCs supported with a State aid element that can be used as an exceptional solution. Such AMCs will remain fully consistent with the EU legal framework, particularly the BRRD, SRMR and State aid rules."*

Among critical aspects in setting designing and set-up of an AMC, the Commission lists such factors as: legislation, mandate and powers; ownership and governance, institutional dependence; asset perimeter and size; asset valuation principles; accounting aspects; data; funding; impact on public finances and national accounts; safeguard mechanisms and supervision, etc. Also, in order to make full use of an AMC, Member States may have to reform the banking sector and address issues that are not directly related to AMCs, including: *"(i) address the emergence of new NPLs, most notably by sound underwriting practices; (ii) address the piling up of already existing NPLs, most notably by sound NPL management frameworks, as addressed by the ECB's NPL guidance, and timely provisioning/ write-off practices; (iii) ensure a high degree of transparency and data availability on NPLs, based on the EBA data templates, to support other NPL workout measures, and to enhance market confidence more generally".*

The Blueprint argues that **past experience shows that AMCs are very effective when *"impaired assets affect a large part of the domestic banking system and mainly cover loans secured by commercial real estate and large corporate exposures".*** Alternative measures may be more suitable if other conditions prevail. Nevertheless, in its fourth progress report on the reduction of NPLs, the Commission notes *"no Member State has yet initiated the set-up of an AMC at national level, along the lines described in the Blueprint. Nevertheless, informal discussions with some Member States indicated that such vehicles are being carefully considered"*. It does not, however, go into the potential constraints limiting Member States in establishing AMCs.

According to the Commission, *"AMCs can also act as a catalyst to develop secondary markets for distressed debt. However, if poorly designed and/or managed, AMCs may also contribute to financial stability risks, including, in the case of publicly supported or guaranteed vehicles, potentially reinforcing the so-called sovereign feedback loop ... past experience has demonstrated that AMCs attain their objectives only when they are part of a wider and comprehensive strategy. Hence, AMCs should not and cannot be considered as a panacea".*