An EU strategy for tackling NPLs

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Possible areas to be covered

- ✓ Terminology
- ✓ Actual situation/trends
- ✓ Causes, effects, European dimension
- ✓ Possible areas of reform
- ✓ EU legal framework
- ✓ EU strategy: actors, achievements so far, ECOFIN Action Plan

Terminology (1)

1.	**Impaired assets**	Accounting definition (IFRS and/or local GAAP)
2.	**Defaulted assets**	Prudential (CRR) definition
3.	**Non-performing exposures (NPEs)**	EBA definition (ITS) for supervisory reporting

Increasingly comprehensive / conservative

Terminology (2)

1. A debtor in financial difficulty unlikely to repay a loan is to be classified as **impaired** (but if over-collateralised might be excluded).

2. An unlikely to pay debtor to be classified as **defaulted**.
   Further, 90 days (180 for some asset classes) past-due loans are automatically classified as defaulted.
   No consideration of collaterals.
   → default asset definition wider than the impaired definition.

3. A debtor classified as impaired or defaulted to be also classified as **non-performing**.
   Further, all 90 days past due loans are non-performing.
   Also "pulling effect": if a significant part of the exposure towards a debtor is non-performing, then also the remaining parts of respective exposures are to be considered as non-performing.
   → NPE definition most comprehensive and conservative metrics.

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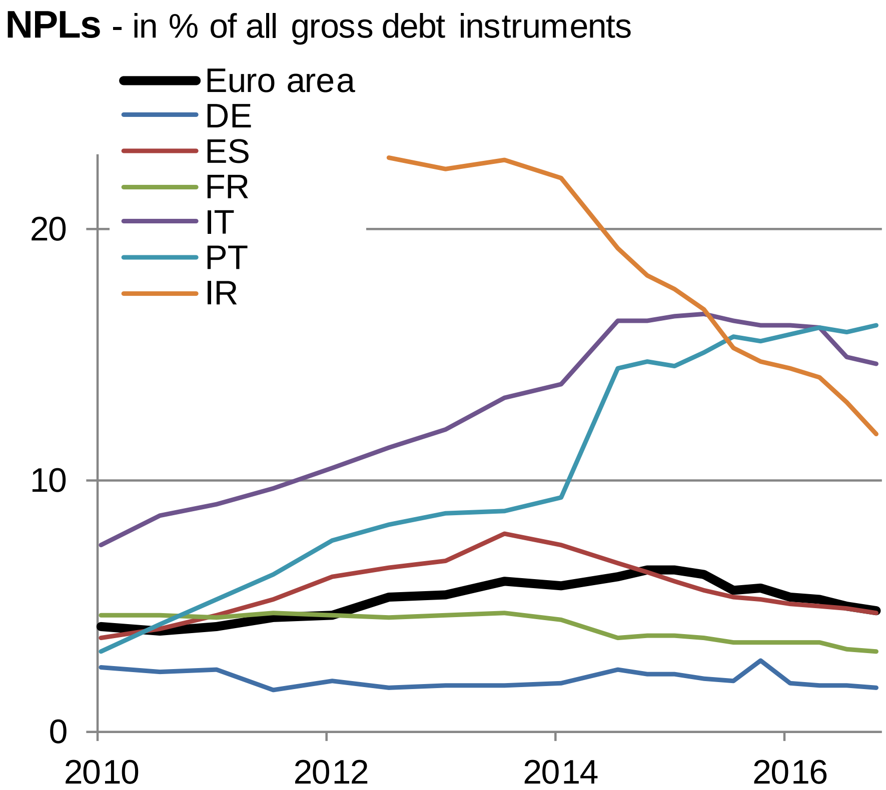
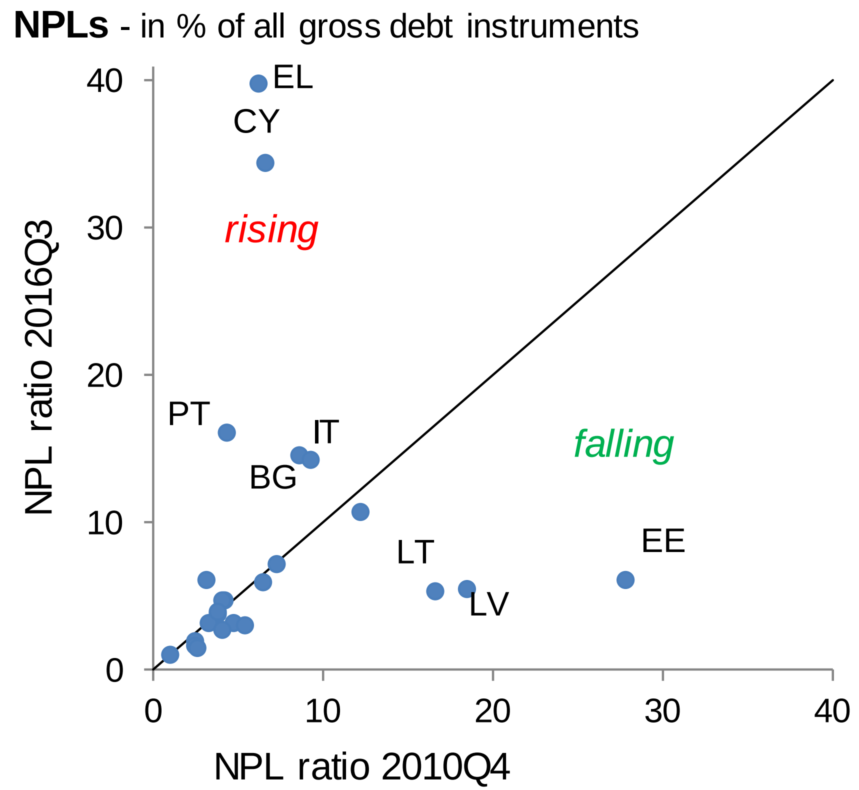
Actual situation

- Relative high level of NPLs in EU.
- Level has risen continuously after the crisis up to 2015/16
- This development has been in contrast to other major economies
- Member States are very unevenly affected.

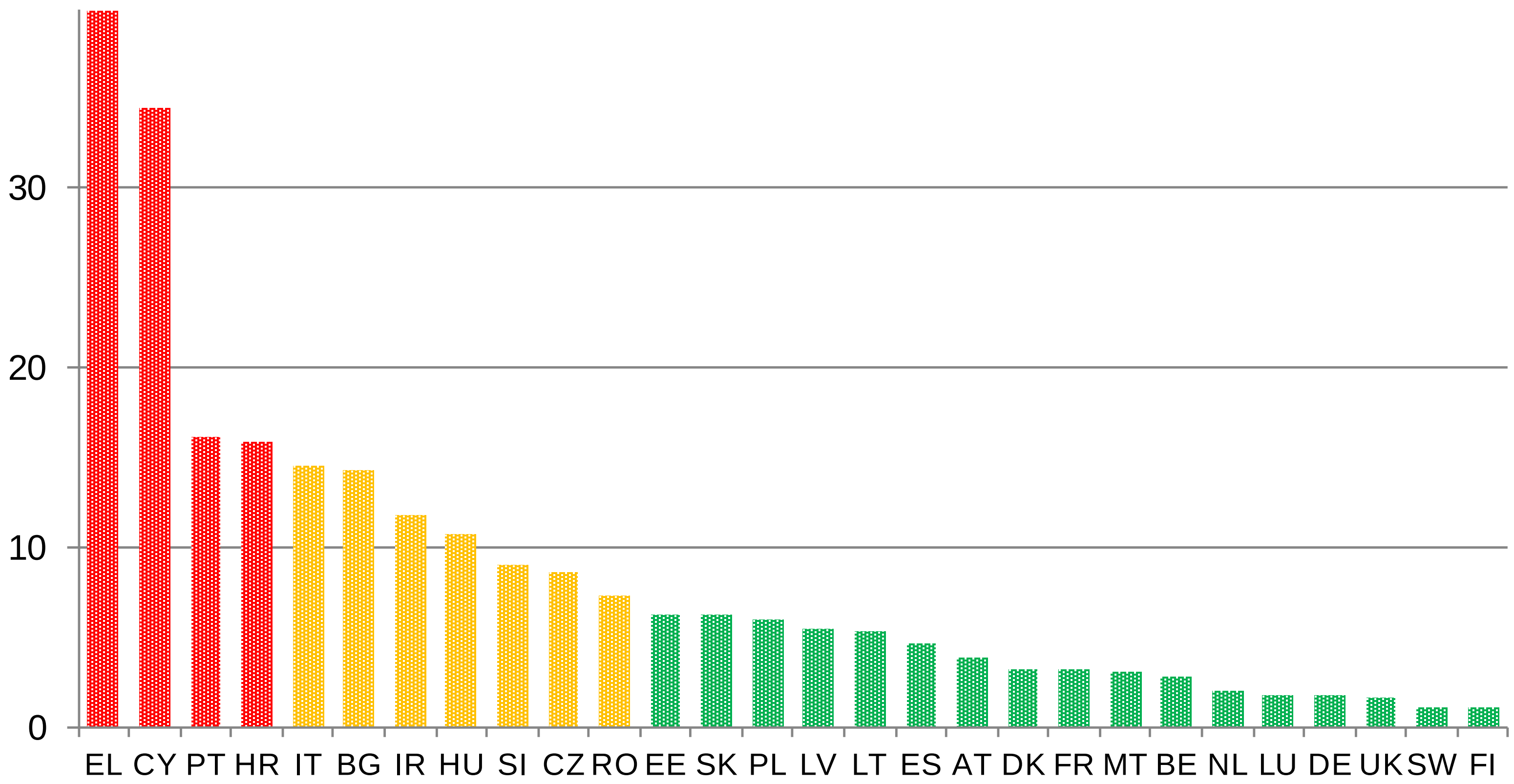
Actual situation: trends





Actual situation: Member States (1)

NPLs - Gross non-performing debt instruments; % of total gross debt instruments; 2017 Q1



Actual situation: Member States (2)

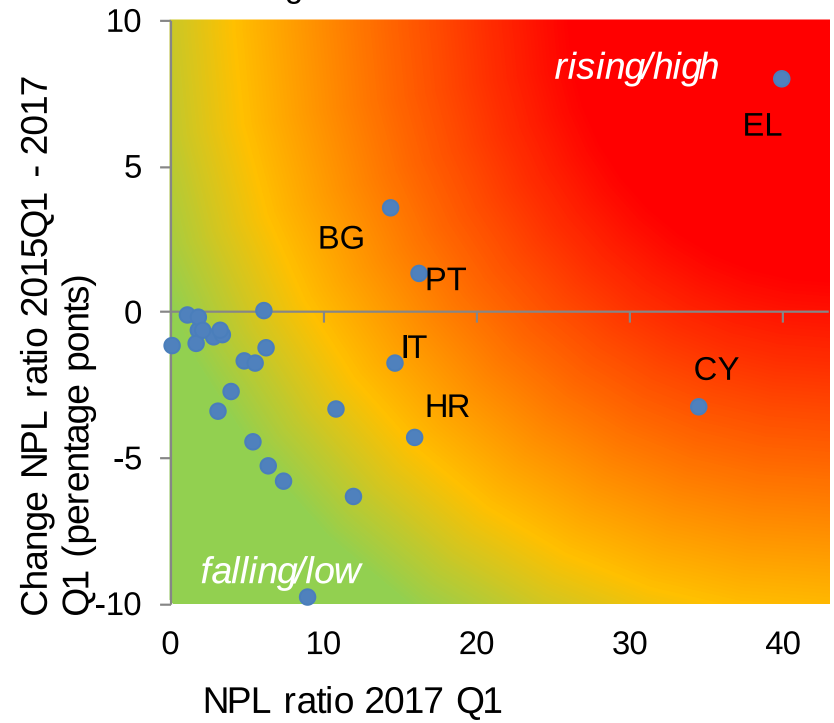
Most Member States have low or moderate NPL ratios (2017Q1):

- 12 MS < 5%
- 5% < 8 MS < 10%
- 10% < 6 MS < 20%
- 20% < EL, CY

Recently, overall positive trend:

- In 24 Member States, NPL rates fell over past 2 years.
- In EL, BG, PT, PL, rates rose

NPLs - in % of all gross debt instruments

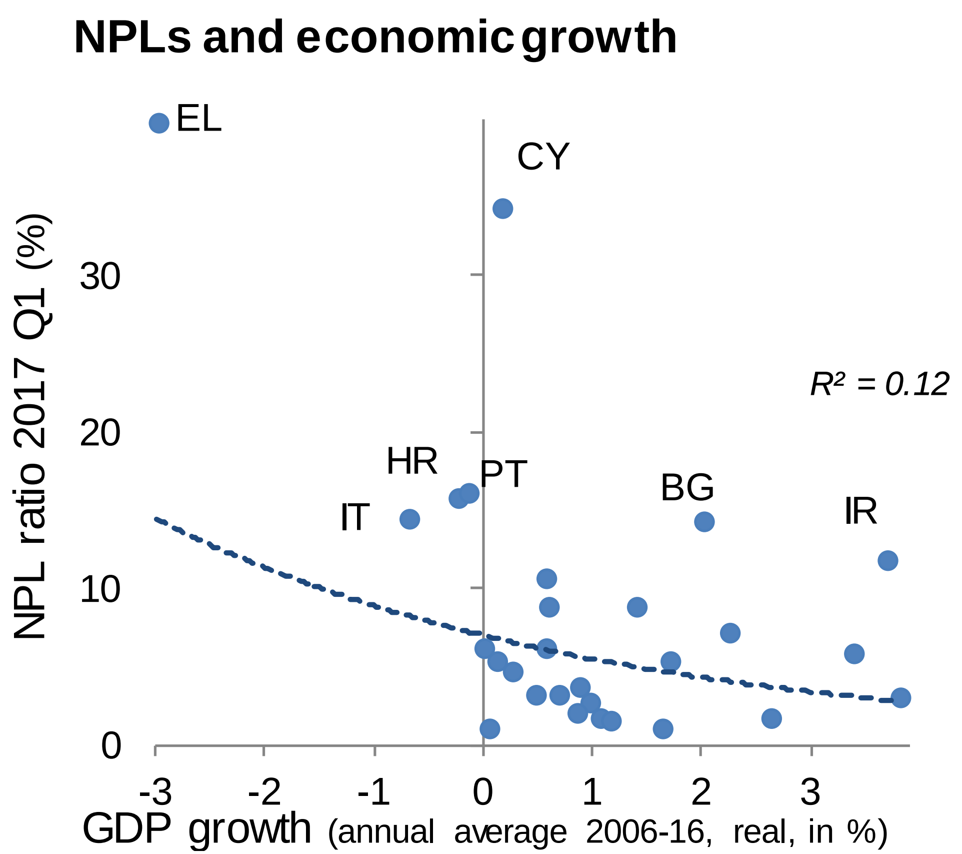


Causes

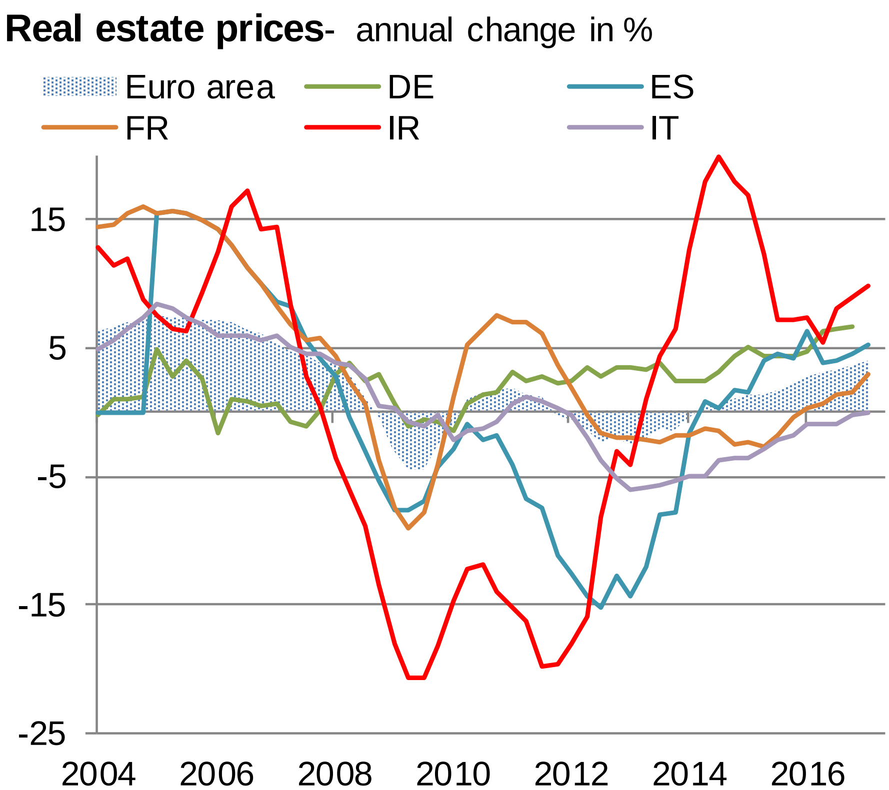
Causes for high and rising NPLs are often country, sector or lender specific. In general, the following (interacting) factors have played a role in Europe over recent years:

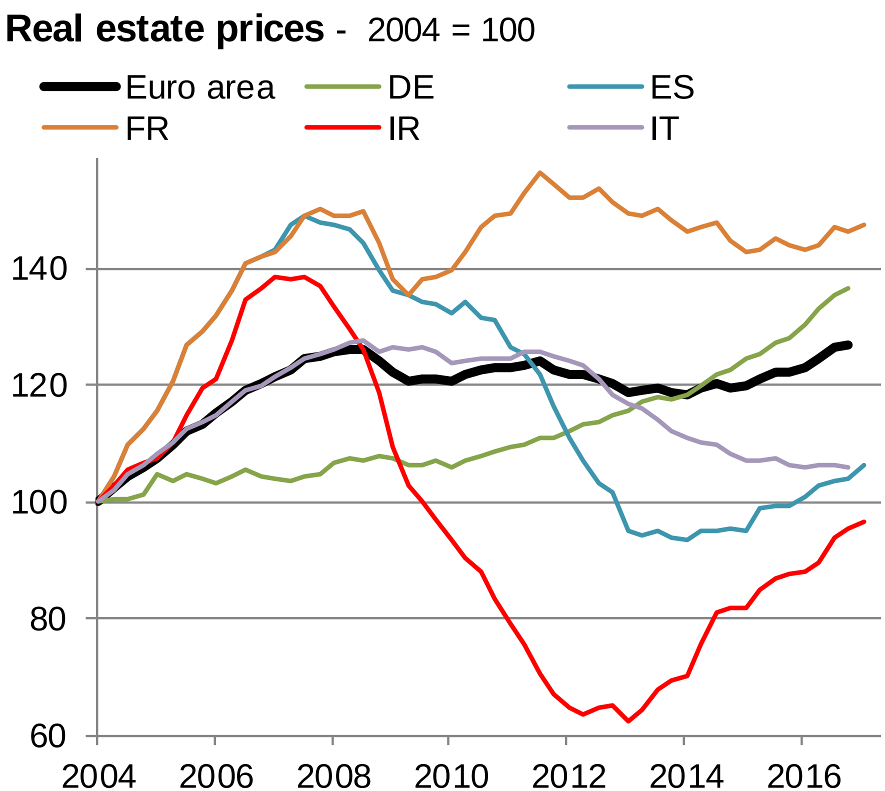
1. Subdued **economic growth** / low inflation
2. Bursting of **real estate bubbles**
3. Weaknesses in **business models and governance of banks** (credit underwriting, NPL management, …)
4. Ill-functioning **secondary markets for NPLs**
5. Weak (supervisory, accounting ..) **incentives for banks** to reduce NPLs
6. Not often **pro-active banking supervision**
7. **Insolvency law and insolvency procedures**

Causes: economic development

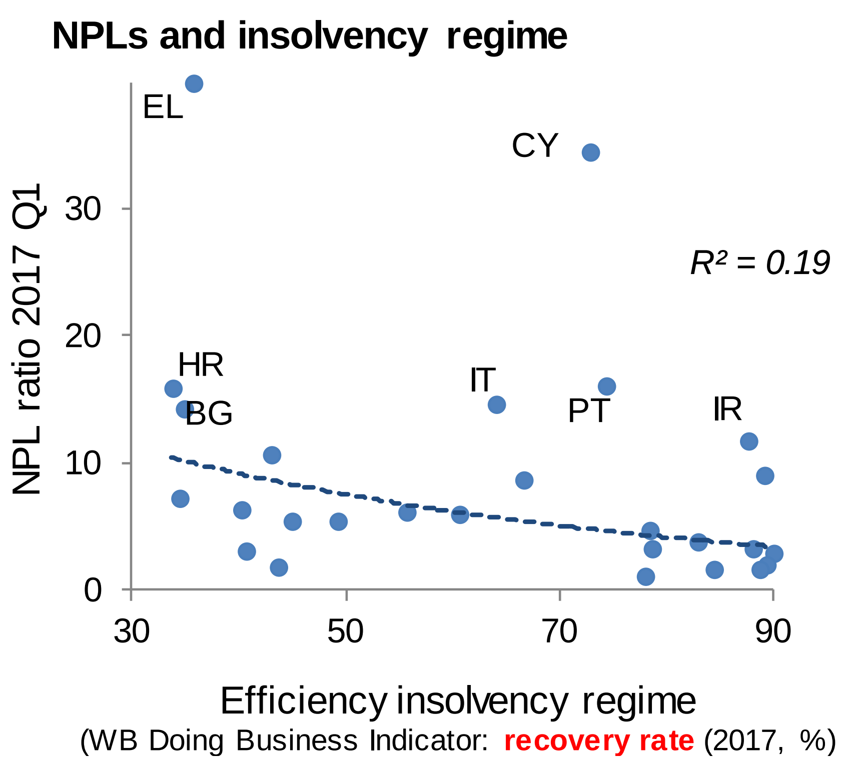


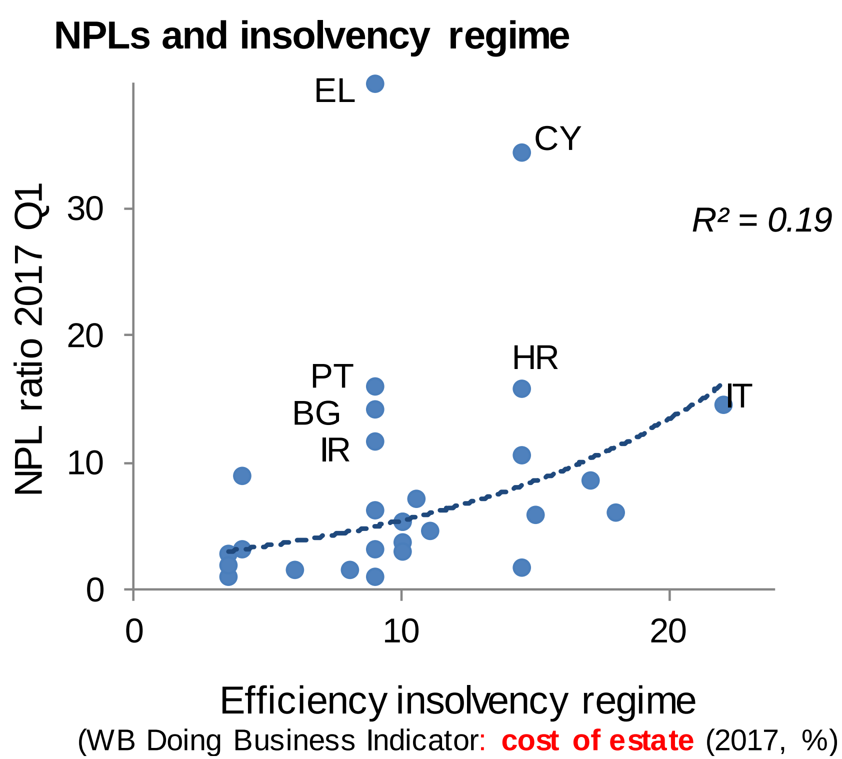
Causes: property markets





Causes: insolvency regimes





Effects of high NPLs

Compression of bank profits

- Direct credit losses
- Higher capital needs
- Higher refinancing costs
- Specific management costs for NPLs

→ **Risks for stability of financial system**

Reduction of bank lending

- *Loan supply:* reduced capital and management capacity for business development
- *Loan demand:* excess debt limiting further loan demand

→ **less financing of economy**
→ **lower growth** → **higher NPLs**
→ **"vicious cycle"**

A European problem? (1)

- **Extent, structure, causes and dynamics of NPL problem show vast differences across Member States**: most MS with low or moderate NPL ratios, and vast majority with recently falling rates.
- **Many approaches for addressing the issue are under the competence of Member States.**
- **Some Member States have over recent years already made progress:** they rather successfully addressed (often inflicting considerable adjustment burden on stakeholders) their national NPL challenges. This occurred typically in the context of a country adjustment programme

A European problem? (2)

but:

- **a large number of Member States is affected, among which at least one large and highly integrated one;**
- **risk of contagion / spillover via:**
  1. **banking sector:** generalised mistrust in balance sheets of banks leads to disadvantages also of banks with low NPLs
  2. **economic development:** lower growth in a problem country due to high NPLs affects entire EU

Possible areas of reform

Many areas of possible improvements, to address NPLs, have been identified, in particular in the areas of:

1. **Banking supervision**
2. **Bank restructuring**
3. **Secondary markets for NPLs**
4. **Insolvency frameworks**

1. Bank supervision

Pro-active bank supervision can induce banks to better manage NPLs and to faster sell them or write them down.

Possible ways forward:

- Application of SSM *Guidance on non-performing loans* (20 March 2017)
- Clarify or adjust CRD/CRR: clarifying supervisory powers as regards accounting, sunset clauses for write down?
- Macroprudential component / add-on to compensate for weak national framework conditions?

2. Bank restructuring

Banking sector has to advance its restructuring, adjust business models and further raise solvency. Overbanking must be reduced

Possible ways forward:

- Reducing structural hindrances for bank restructuring.
- Foster cross-border banking → NPL risk less concentrated and possible hindrances to domestic credit supply reduced.
- Orderly market exit of non-viable banks

3. NPL secondary markets

Secondary markets for NPLs are in Europe underdeveloped:

Low transparency, low demand / demand concentration
→ small trading volumes → steep discounts
→ little incentives for banks to sell

Possible ways forward:

- Reduce hurdles of loan servicers, domestically and cross-border
- Reduce obstacles to ownership transfer of NPLs
- Tax disincentives
- AMCs?

4. Insolvency regimes

Efficient insolvency regimes can

- o **support creditors in realising collateral and to better identify viable borrowers, and thereby**
- o **slow down a future build-up of NPLs and accelerate the addressing of legacy stocks.**

Possible approaches:

- Higher predictability, efficiency and speed of insolvency rules and procedures
- Harmonisation of certain elements (e.g. minimum level of creditor protection)
- Raising capacity in administration and judiciary
- Banking preference outside insolvency framework?

European legal framework

- ✓ **State aid – Banking Communication 2013**
  Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication') - 2013/C 216/01

- ✓ **BRRD** (Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms)

Banking Communication (1)

Condition: Restructuring

3.2 Rescue aid in the form of recapitalisation and impaired asset measures

50. Once the Commission begins to apply the principles set out in this Communication, a Member State will have to notify a restructuring plan to the Commission and obtain State aid approval before any recapitalisation or impaired asset measures are taken. However, such measures can exceptionally be authorised by the Commission to be granted by the Member State on a temporary basis as rescue aid before a restructuring plan is approved, if such measures are required to preserve financial stability.
If a Member State invokes this financial stability clause, the Commission . …. *(conditions for applying this cause)*

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Banking Communication (2)

Condition: Burden sharing

3.1.2 Burden-sharing by the shareholders and the subordinated creditors

41. Adequate burden-sharing will normally entail, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent. …

42. The Commission will not require contribution from senior debt holders (in particular from insured deposits, uninsured deposits, bonds and all other senior debt) as a mandatory component of burden-sharing under State aid rules whether by conversion into capital or by write-down of the instruments.

43. Where the capital ratio of the bank that has the identified capital shortfall remains above the EU regulatory minimum, the bank should normally be able to restore the capital position on its own, in particular through capital raising measures as set out in point 35. If there are no other possibilities, …, then subordinated debt must be converted into equity, in principle before State aid is granted.

BRRD (1)

State aid means (probable) failure in the meaning of BRRD.

Unless: Danger to financial stability

Article 32 – Conditions for resolution

(4) … an institution shall be deemed to be failing or likely to fail in one or more of the following circumstances:

…..

d) extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms:

i) a State guarantee to back liquidity facilities provided by central banks according to the central banks' conditions;

ii) a State guarantee of newly issued liabilities; or

iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution, …

In each of the cases mentioned in points (d)(i), (ii) and (iii) of the first subparagraph, the guarantee or equivalent measures referred to therein shall be confined to solvent institutions and shall be conditional on final approval under the Union State aid framework. Those measures shall be of a precautionary and temporary nature and shall be proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the institution has incurred or is likely to incur in the near future.

BRRD (2)

Resolution: losses to be borne by stakeholders

Article 34 - General principles governing resolution

1. Member States shall ensure that, when applying the resolution tools and exercising the resolution powers, resolution authorities take all appropriate measures to ensure that the resolution action is taken in accordance with the following principles:

(a) the shareholders of the institution under resolution bear first losses;

(b) creditors of the institution under resolution bear losses after the shareholders in accordance with the order of priority of their claims under normal insolvency proceedings, save as expressly provided otherwise in this Directive;

….

(f) except where otherwise provided in this Directive, creditors of the same class are treated in an equitable manner;

(g) no creditor shall incur greater losses than would have been incurred if the institution or entity referred to in point (b), (c) or (d) of Article 1(1) had been wound up under normal insolvency proceedings in accordance with the safeguards in Articles 73 to 75;

(h) covered deposits are fully protected; and

(i) resolution action is taken in accordance with the safeguards in this Directive.

BRRD (3)

If State aid: contribution to loss absorption by shareholders and other stakeholders of ≥ 8% of liabilities

Article 37 - General principles of resolution tools

…

(10) In the very extraordinary situation of a systemic crisis, the resolution authority may seek funding from alternative financing sources through the use of government stabilisation tools provided for in Articles 56 to 58 when the following conditions are met:

a). a contribution to loss absorption and recapitalisation equal to an amount not less than 8 % of total liabilities including own funds of the institution under resolution, measured at the time of resolution action in accordance with the valuation provided for in Article 36, has been made by the shareholders and the holders of other instruments of ownership, the holders of relevant capital instruments and other eligible liabilities through write down, conversion or otherwise

…..

What has been achieved so far?

Situation has globally somewhat improved, and more substantially in some Member States.

Drivers:

- **Economic recovery**
- **Pro-active policies by banks**
- **Policy measures taken:**
  - ✓ **In Member States** (especially in those under stress and programmes: AMCs, Insolvency reform, bank restructuring)
  - ✓ **European supervision :** SSM Guidelines for NPLs, EBA common definition of NPLs
  - ✓ **Commission:** Pre-insolvency, SRSS

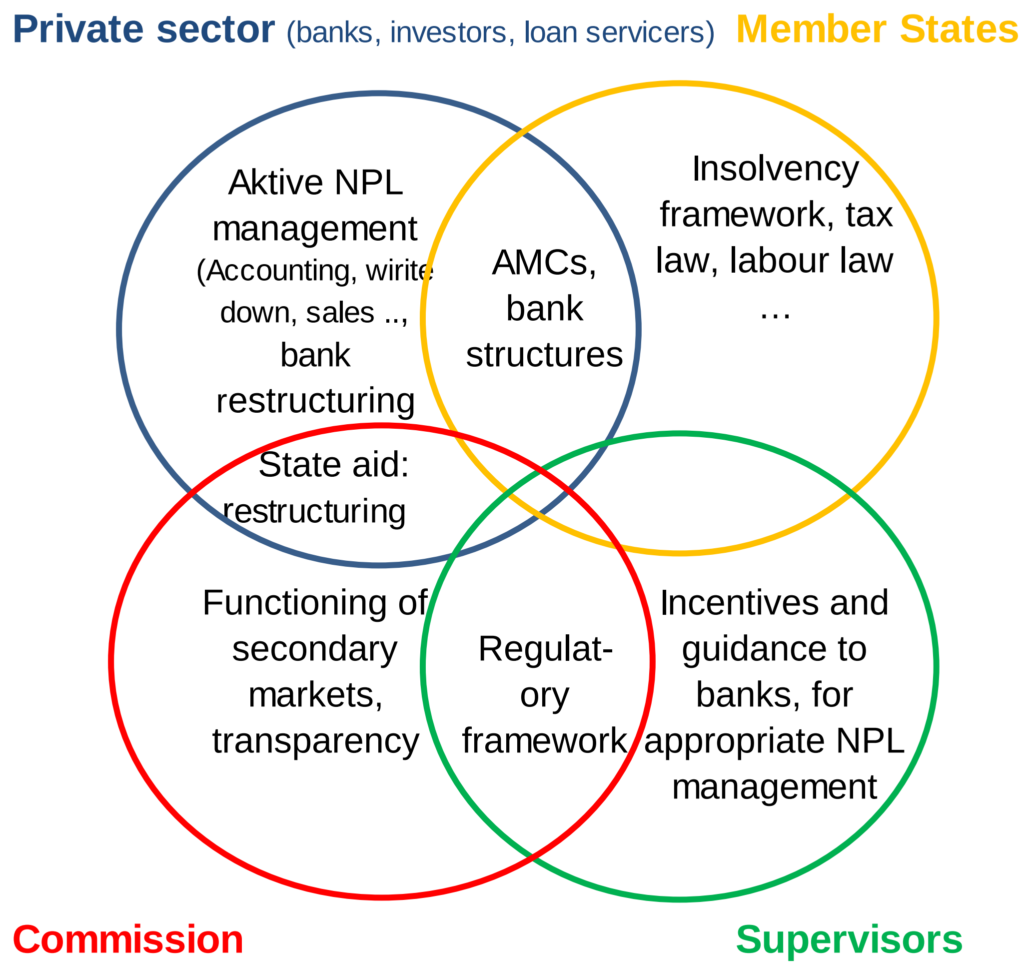
Actors of a viable strategy

Various levels and institutions have responsibilities and competences:

- **Private sector** (Banks, other institutional investors, servicers)
- **National authorities** (Finance and justice administrations, consumer protection …)
- **Bank supervision at EU, BU and national level** (SSM, EBA, ESMA, national competent authorities)
- **Other European institutions** (Commission, Council, ECB, SRB, ESAs, …)

A successful strategy must build on co-ordination and interaction of these.

Actors of an integrated strategy



EU Action plan on NPLs

- **The ECOFIN Council adopted in July 2017 an "Action Plan" on addressing NPLs in Europe.** (http://www.consilium.europa.eu/en/press/press-releases/2017/07/11-conclusions-non-performing-loans/)
- **It built in particular on the report of a dedicated Experts Group of the EU's Financial Services Committee this summer.**
- **It comprises 14 actions to be taken by various public stakeholders in Europe.**
- **It is rather ambitious in scope and timeline.**

EU Action Plan – specific measures (1)

	What?	By when?	By whom?
1	**Interpretation of existing supervisory powers** in EU legislation, clarifying their usability as regards banks' provisioning policies for NPLs. Council will, if appropriate, consider amendment to CRD IV	summer 2017	Commission
2	**Prudential backstops** addressing potential under-provisioning for new loans		Commission
3	**Guidance for less significant institutions in BU** similar to SSM "Guidance to banks on NPLs" for significant institutions in BU	end 2018	SSM + nat. supervisors
4	**General guidelines for all EU banks on NPL management**, consistent with above mentioned Guidance	summer 2018	EBA
5	**Guidelines on banks' loan origination, monitoring and internal governance**	summer 2018	EBA
6	**Macro-prudential approaches** to prevent emergence of system-wide NPL problems	end 2018	ESRB
7	**Enhanced disclosure requirements** on asset quality and NPLs to all banks	end 2018	EBA, in cons. with ESMA + competent auth.

EU Action Plan – specific measures (2)

	What?	By when?	By whom?
8	**Guidelines for banks on loan tapes monitoring** (minimum information required from banks on their credit exposures in banking book)	end 2017	EBA
9	Propose **initiatives to strengthen data infrastructure** (uniform and standardised data for NPLs); **consider setting up NPL transaction platforms**	end 2017	EBA, ECB, Commission
10	**Blueprint for national AMCs** (asset and participation perimeters, asset-size thresholds, asset valuation rules, capital structures, governance, operational features; permissible design, consistent with the EU legislation, for asset relief measures and use of AMCs)	end 2017	Commission
11	**Development of secondary markets for NPLs**, in particular remove impediments to transfer of NPLs by banks to non-banks and ownership by non-banks, potentially harmonise licensing requirements for third-party loan servicers, take legislative initiative, as appropriate	summer 2018	Commission
12	**Publish results of benchmarking exercise on the efficiency of national loan enforcement** (including insolvency) regimes, further develop **insolvency issues in European Semester**	end 2017	Commission
13	Consider to carry out **peer-reviews on insolvency regimes across the EU**	end 2018	Member States
14	Further **analyse possible enhancement of protection of secured creditors**		Commission

Further time line?
Chances for success?

- **Economic recovery helps to stabilise quality of bank loans, and so market pressure on banks.**
- **Work at political level has been accelerating at many levels.**
- **However, some stakeholders are still reluctant to embark in more pro-active reforms**
- **Also, many projects will take years to be finalised and have a material impact. Yet, expectation effects on prices of NPLs and volumes of transactions can materialise much faster.**

Thank you for your attention