NON-PERFORMING LOANS AND CORONA

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KEY ISSUES

Context: The 2008 financial crisis gave rise to a sharp increase in the proportion of non-performing loans (NPLs) on banks' balance sheets. This has since been significantly reduced although to very differing degrees in the various Member States. High NPL levels hinder bank lending and represent a political obstacle to the Banking Union.

Objective of the Communication: The Commission wants to prevent the proportion of non-performing loans from rising once again as a result of the corona crisis.

Affected parties: Banks, buyers of non-performing loans, banking supervisors.

Pro: (1) The creation of liquid secondary markets for NPLs may increase the incentive to sell NPLs. The Commission is therefore rightly pressing for the acceptance of its proposal for a Directive.

(2) The fact that the Commission has refrained from proposing an EU-wide bad bank is appropriate because, in view of the very varied starting positions of the Member States as regards NPLs, this harbours a significant risk of redistribution.

Contra: (1) It is doubtful that information asymmetries and low availability of data are responsible for the lack of development of secondary markets. The obligation for banks to publish "essential data" on NPLs is therefore unconvincing.

(2) The rules on subsidies and workout requirements for banks cannot be de facto invalidated in order to allow state asset management companies (AMCs) to reduce NPL stocks using tax revenue.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Communication COM(2020) 822 of 16 December 2020: **Tackling non-performing loans in the aftermath of the COVID-19 pandemic**

Brief Summary

► **Background**
- Having fallen continuously since 2016 (4.8%), the proportion of non-performing loans (NPLs) rose slightly in the EU in 2020 to 2.6%. The proportion of NPLs varies considerably within the EU. In Greece, the level is 30%, in Cyprus 15.2%, in Italy 5.1%, in France 2.2% and in Germany 1.1%.
- So far, economic policy relief measures taken by the Member States during the corona crisis have prevented a sharp rise in NPLs. NPLs could increase rapidly, however, depending on how the corona crisis develops.
- In its Communication, the Commission sets out the steps required to prevent another rise in NPLs.

► **Secondary markets for NPLs**
- Liquid secondary markets make it easier for banks to sell non-performing loans. This frees up equity and increases the banks' lending capacity. The Commission is pressing for rapid acceptance by the EU Parliament and the Council of its proposal for a Directive to promote these secondary markets (see cep**PolicyBrief**). A Regulation to simplify the securitisation of NPLs was only passed in December 2020 (see cep**PolicyBrief**). [p. 6]
- The Commission wants to reduce the information asymmetries between buyers and sellers of NPLs. It is considering whether to make it obligatory for banks to disclose certain "critical data" about new NPLs in a standardised format. The European Banking Authority (EBA) will simplify its template in this respect. [p. 7].
- The Commission argues in favour of a European platform ("data hub") for NPL data and wants to hold a public consultation on this in 2021. One option would be to provide the hub using the private European DataWarehouse GmbH which offers a similar platform for securitisations. The platform will collect data about transactions that have taken place, and the prices. Data on the cash flows attained from the purchased NPLs will be provided later. [p. 8]
- The Commission and the EBA particularly want to provide smaller banks with non-binding guidelines on best practice for selling NPLs [p. 8].

► **Asset management companies (AMCs) acting as bad banks**
- Asset management companies (AMCs) remove NPLs from banks' balance sheets and try to extract the most value from them. AMCs can act as bad banks and

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  - buy up NPLs and sell them with a time delay or
  - securitise NPLs and sell the securitisation – with or without a state guarantee – to investors.
- AMCs may be private or (partly) publicly funded. Depending on the design, public funding from the EU Commission would have to be approved as State aid. [p. 11]
- National AMCs may be set up according to the needs of the domestic banking sector. The Commission intends to support Member States that want to set up a national AMC. [p. 12]
- A network of national AMCs could be established "at EU level" [p. 12]:
  - The AMCs could set up a shared, EU-wide transaction platform to facilitate the sale of NPLs to investors.
  - When the AMCs register their holdings and the performance of NPLs via the "data hub", market efficiency will rise; NPLs can then be priced appropriately.
- The Commission will continue to explore the advantages and synergies of an EU network of AMCs [p. 13].

► **Debt restructuring and recovery, insolvency law**

- The Commission is urging swift acceptance of its proposal for accelerated extrajudicial collateral enforcement (see cep**PolicyBrief**) and transposition of the Restructuring Directive [(EU) 2019/1023] which regulates the restructuring process and could thus prevent the build-up of NPLs [p. 13-14].
- As part of the Capital Markets Union Action Plan, the Commission envisages "targeted harmonisation or convergence" of core aspects of national insolvency law. It will initiate a consultation on this soon. [p. 14]

► **Tackling NPLs and the rules on State aid and bank resolution**

- According to the rules on EU bank resolution, a Member State can also, in exceptional cases, support solvent banks if it is necessary to prevent serious disturbance in the economy or to preserve financial stability. The Commission considers whether this complies with State aid rules. [Art. 32 (4), Directive 2014/59/EU]
- The Commission now clarifies that [p. 15-16]
  - the corona crisis permits the activation of this exception,
  - permitted support may include not only the acquisition of NPLs by state financed bad banks (AMCs), but also acquisition by the state of loan losses for a fee ("asset protection schemes", APSs).

Policy Context

Since 2019, all banks in the EU have to provide new NPLs with more coverage from own funds [Regulation (EU) 2019/630]. At the same time, the ECB has published much stricter (officially non-binding) "expectations" for the coverage of new NPLs from own funds. In 2018, the Commission submitted a proposal for a Directive on the development of secondary markets for non-performing loans [COM(2018) 135, see cep**PolicyBrief**], which included a European extrajudicial enforcement procedure intended to make national enforcement procedures more effective. The proposal met with substantial opposition in the Parliament and the Council, which is probably why the Commission does now want to harmonise the "core aspects of substantive insolvency law".

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union
Committees of the European Parliament:	Economic and Monetary Affairs, Rapporteur: TBA
Federal Ministries:	Finance (leading)
Committees of the German Bundestag:	Finance (leading)

ASSESSMENT

Economic Impact Assessment

Non-performing loans can paralyse the lending capacity of banks by tying up scarce equity capital. It is currently too early to give a reliable forecast of whether, as a result of the corona pandemic, the NPL problem will become so severe as to require coordinated European measures. The relevant variables in this regard are difficult to evaluate and are to a certain extent dependent on each other, such as the epidemiological development, the intensity of lock-down, the rapid availability of a vaccine and national economic policy relief measures, which prevent loans from becoming non-performing in the first place.

The economic incentives for banks to either offload non-performing loans or keep them on the balance sheet, are dependent on various factors. Firstly: The own funds requirements for NPLs and the opportunity costs – i.e. sacrificing new lending which requires the sale of NPLs – determine the costs of keeping NPLs on the bank's balance sheet. The own funds requirements have recently been somewhat relaxed (see cep**PolicyBrief**). During the corona pandemic, the opportunity costs are likely to be low due to the gloomy economic outlook.

Secondly: The revenues attainable from the sale of NPLs depend on the price that can be obtained for them. **The creation of liquid secondary markets for NPLs,** being pursued by the Commission, contributes to efficient pricing and

may thereby **increase the incentive to sell NPLs. The Commission is therefore rightly pressing for the acceptance of its proposal for a Directive** (see on this cep**PolicyBrief**). The newly passed simplifications for the securitisation of NPLs (see cep**PolicyBrief**) also provide additional incentives for the sale of NPLs.

It is doubtful that information asymmetries between buyers and sellers of NPLs **and low availability of data** regarding transactions and NPL prices **are responsible for the lack of development of secondary markets.** At least those sellers of NPLs, who consider the price offered on the secondary markets to be too low, will have a vested interest in reducing information asymmetries. Banks also have a legitimate interest in not having to publish detailed information about their NPLs. In addition, sellers of NPLs are professional investors who are not in need of protection. **The obligation to publish "critical data" on NPLs is therefore unconvincing.** Instead, NPL sellers should be able to decide for themselves whether they – like the European DataWarehouse – collect and publish NPL transaction data.

Guidelines from the EBA and the Commission **on the sale of NPLs may reduce the transaction costs of smaller banks** that are inexperienced in the sale of NPLs. They **must however remain non-binding** and not force banks to sell NPLs. National supervisory authorities remain responsible for the supervision of smaller banks.

An alternative to the sale of NPLs on secondary markets is the sale to asset management companies (AMCs). Purely private AMCs are unproblematic. Considering the scope of the NPL problem, state (re-)financed AMCs are likely to be highly relevant.

The fact that the Commission has refrained from proposing an EU-wide bad bank is appropriate because, in view of the very varied starting positions as regards NPLs, and other developments, **in the Member States, this harbours a significant redistribution risk**, irrespective of whether it is financed by the banking sector or from public funds, e.g. via the European Stability Mechanism (ESM). There is no apparent reason why taxpayers in other Member States should bear the resulting costs.

The incentive for Member States to link their national AMCs up to a network is therefore limited primarily to the setting up of a shared transaction platform. This may actually be beneficial. NPL transaction platforms bring buyers and sellers of NPLs together, reduce transaction costs and thus contribute to efficient NPL pricing. However, the subsequent costly cross-border assignment of claims limits the potential of these platforms (see cep**PolicyBrief**).

Harmonisation of core aspects of national insolvency law would reduce the transaction costs of NPL sales – whether on the secondary market or via AMCs – and allow NPL prices to rise. Political willingness for this has, however, been extremely low in previous years.

The rules on subsidies and workout requirements for banks [BRRD-Directive 2014/59/EU] **cannot be de facto invalidated in order to allow state AMCs to reduce NPL stocks using tax revenue.** The BRRD Directive permits the use of public funds by AMCs for solvent banks only where "these measures [are] of a precautionary and temporary nature and proportionate to remedy the consequences of the serious disturbance and [are] not used to offset losses that the institution has incurred or is likely to incur in the near future." [Art. 32 (4) (d)]. The latter, as well as compliance with State aid rules expressly required by the Directive, hinder the use of AMCs for reducing NPLs as, with some banks, there are likely to be significant differences between the book and market value of NPLs. A sale of NPLs at the market value and the associated write-downs of capital are, however, likely to be unaffordable for some banks.

Legal Assessment

Legislative Competency

Dependent on the actual design of any legislative measures.

Subsidiarity and Proportionality with Respect to Member States

Dependent on the actual design of any legislative measures.

Compatibility with EU Law in other respects

Any public support for NPLs to be taken on by asset management companies must be compatible with EU State aid law.

Conclusion

The creation of liquid secondary markets for NPLs may increase the incentive to sell NPLs. The Commission is therefore rightly pushing for the acceptance of its proposal for a Directive. It is doubtful that information asymmetries and low availability of data are responsible for the lack of development of secondary markets. The obligation for banks to publish "essential data" on NPLs is therefore unconvincing. Guidelines on the sale of NPLs may reduce the transaction costs of smaller banks, but must remain non-binding. The fact that the Commission has refrained from proposing an EU-wide bad bank is appropriate because, in view of the very varied starting positions of the Member States as regards NPLs, this harbours a significant redistribution risk. The rules on subsidies and workout requirements for banks cannot be de facto invalidated in order to allow state AMC to reduce NPL stocks using tax revenue.