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Resolution of Nonperforming Loans in the Euro Area

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7.1 Introduction: The Nonperforming Loan Problem in the Euro Area

In the wake of the global financial crisis and the euro area sovereign debt crisis, the large stock of nonperforming loans (NPLs) became an important cause for concern for policy makers in the euro area. Addressing this matter effectively remains a priority for the European Central Bank (ECB) and for the Council of the European Union. Although the average NPL ratio has gradually declined from a peak of 8% in 2013 to 2.9% by end-2020, it remains almost three times above the equivalent ratios in the United States, the United Kingdom, and Japan. Moreover, differences across euro area countries remain stark, with four countries having NPL ratios above 5%—significantly so in some cases.²

Large NPL stocks are problematic for a number of reasons. First, bank resources are tied up by assets that tend to produce—at best—less income than initially envisaged and at worst no income at all, which adds to bank profitability challenges.³ At the same time, high stocks of NPLs create uncertainty about the health and prospects of the banking sector, increasing bank funding costs and the costs of new credits. Ultimately, this impedes

¹ This chapter should not be reported as representing the views of the European Central Bank (ECB) or the Joint Vienna Institute (JVI). The views expressed are those of the authors and do not necessarily reflect those of the ECB or the JVI.

² As of end-2020, these countries are Cyprus, Greece, Italy, and Portugal. The source is European Central Bank Supervisory Banking Statistics.

³ On productivity developments in the euro area banking sector, see for example ECB (2016) and Huljak, Martin, and Moccero (2019).

the scope for new lending to productive ventures and undermines the transmission of monetary policy.⁴

Second, high stocks of NPLs usually indicate underlying solvency and debt overhang issues affecting both households and the corporate sector. Excessive indebtedness often implies that corporate investment remains below the desirable level to support recovery in the real economy.⁵ Moreover, keeping over-indebted and ultimately nonviable firms alive by not resolving NPLs in a timely fashion generates artificial and unhealthy competition for firms that are actually viable.

Third, given the strong financial and economic interlinkages between euro area countries, the high NPL stock gives rise to euro-area-wide financial stability and macroprudential concerns. This is notwithstanding substantial variability across countries and the fact that not all euro area countries have significant NPL problems.

Against this backdrop, the case for swift resolution of NPLs is clear. Caution is needed to avoid NPL fire sales, however, which are not conducive to recovering maximum value from the underlying assets and thus put additional pressure on bank capital.

Following the global financial crisis, accelerating the initially unsatisfying speed of NPL resolution in the euro area required a comprehensive approach comprising supervisory, macroprudential, and structural measures and, involved some degree of coordination at the European level. Appropriately robust supervisory guidance, as published by ECB Banking Supervision (ECB 2017), was essential to improving banks' NPL management. However, this must be complemented by structural reforms to enhance recoveries and increase the net present value of NPLs and by complementary measures to facilitate the development of NPL markets. Work on many of these reforms has been completed under the umbrella of the European Council Action Plan on NPLs, which—among other objectives—aimed to review licensing requirements for NPL investors, addressing transferability restrictions, and to create a harmonized legal instrument to enforce collateral out of court. Only when banks have the full set of potential NPL resolution tools available can they optimize the speed of resolution.

⁴ See Aiyar et al. (2015) for discussion of the possible impact of NPL resolution on bank capital and lending capacity.

⁵ For example, see Goretti and Souto (2013), Nkusu (2011), Balgova and Plekhanov (2016) for evidence that a high stock of NPLs is associated with weaker economic growth.

The rest of this chapter reviews in more detail the main obstacles to NPL resolution in the euro area and the elements of a comprehensive NPL resolution strategy, with a particular focus on asset management companies (AMCs) and the benefits of regional cooperation.

7.2 Why Was Nonperforming Loan Resolution So Slow in the Euro Area?

A striking aspect of NPL developments in the last decade in the euro area is that secondary NPL markets were initially not very active, although they gained traction over the years, driven among other things by the strong cyclical upswing in the euro area economy. Around the time NPLs peaked in the euro area, Deloitte (2016) and KPMG (2016) highlighted that even with a stock of some €2,000 billion in noncore assets on bank balance sheets (of which about 50% were NPLs), annual transactions only amounted to slightly more than €100 billion.

ECB analysis (ECB 2018) and market intelligence suggest that investors had considerable interest in acquiring bank-held NPLs, but that the prices they were willing to pay tended to be substantially lower than what would be at least neutral for the capital positions of banks. This so-called “bid-ask spread” can be explained by a number of factors. First, investors may have faced market frictions and more significant information challenges than better-informed banks, which significantly increased their required returns and discount rates.⁶ Second, differences in the contractual position between banks and investors may have contributed to this spread, as banks usually cannot adjust lending rates in line with the deteriorating creditworthiness of a borrower. However, this can be captured by investors who buy loans at a discount. Finally, many banks may not have fully incorporated the costs of working out impaired assets in their provisioning, while bid prices on the secondary NPL market reflected such costs.

In sum, seen through the lens of Akerlof (1970), the secondary market for NPLs in Europe can be characterized as a “market for lemons” (where investors have insufficient knowledge of the quality of the assets), and as a situation where informational asymmetries impede market functioning because buyers know less about asset quality than sellers. Buyers therefore fear that the assets are of low quality and bid at a correspondingly low price. The sellers, being able to distinguish between low- and high-quality assets, trade only the former—the lemons—whereas the market for the remaining

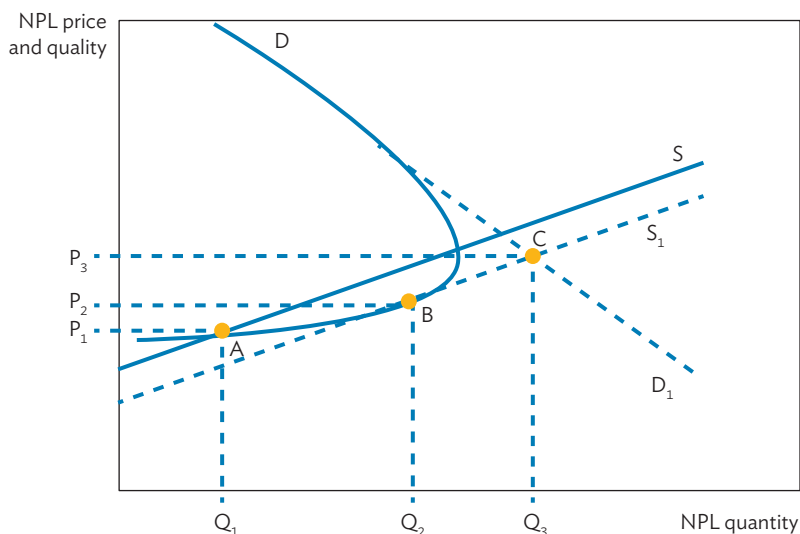
⁶ The cost of overcoming the information challenges will ordinarily reduce the price bid by the investor.

good-quality assets fails. In the NPL context, sellers may also not have perfect information about their assets, but the informational asymmetry remains because buyers cannot know whether sellers are revealing all available information.

Akerlof shows that in a “market for lemons,” demand depends not only on price, but also on the average quality of the goods. As a result, the demand curve contains a kink so that multiple equilibria can arise (Figure 7.1). The figure shows that the NPL supply curve positively intercepts the price–quality axis at a level commensurate with banks’ ability to dispose NPLs at a given price—in effect, the intercept represents banks’ price floor.

The “bad” market equilibrium depicted as “A” is consistent with market conditions in which only a small quantity of “lemons”—low-quality NPLs—is traded at low prices. In this framework, improving supply (i.e., a rightward shift of the supply curve), such as by exerting supervisory pressure on banks to dispose of NPLs, leads to an improved market equilibrium (labeled as “B”) but the overall gains remain limited because additional NPL supply will not be fully absorbed.⁷

Figure 7.1: Asymmetric Information and the NPL Market



NPL = nonperforming loan.
Source: Fell et al. (2016).

⁷ See Fell et al. (2016), for example.

Overcoming informational asymmetries has greater potential to respond to the market failure. If these asymmetries are addressed, the shape of the demand curve changes from “D” to the more standard “D₁” and equilibrium “C” can be achieved. Akerlof shows that mechanisms which restore buyers’ “trust”—for example, guarantees, licensing, and branding—can reduce informational asymmetries and improve demand.

A number of key impediments are at the heart of the “trust” problem between buyers and sellers in euro area NPL markets. First, the absence of high-quality NPL data can compromise valuation methods, resulting in heightened uncertainty about asset values and additional data collection costs.

Second, ineffective legal frameworks for debt recovery and collateral enforcement can create additional information asymmetries. To the extent that buyers and sellers have diverging views about the merits of such frameworks, buyers may require steep discounting of future NPL cash flows to offset the risks of inordinately long and unpredictable recovery times and rates, penalizing the original asset owners in jurisdictions where legislation is least effective.

Asymmetric information may also give rise to imperfect excludability, which forms another source of market failure. Investors may not be able to gain access to the full resources—cash flows or assets—of the debtor, which may have been financed by other parties, such as banks or suppliers. This further increases uncertainty about future recovery rates and may restrict the range of workout options available to an investor. The resulting creditor coordination problem, with often misaligned incentives between various classes of creditors, may even bring workout efforts to a standstill.

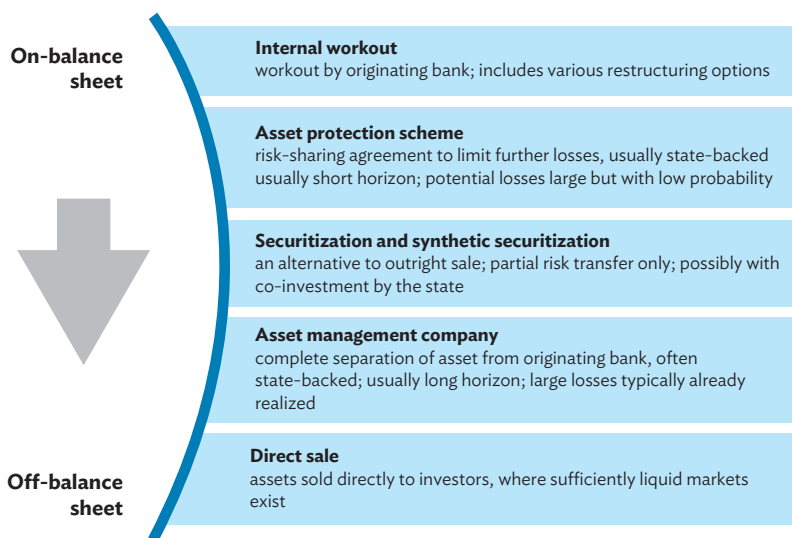
These impediments to NPL transactions point to a number of levers that can be used to lower information asymmetries, restore buyers’ trust, and ultimately lower bid-ask spreads. First, improved data availability for buyers is key to enabling a better distinction between “lemons” and good assets, thereby attracting more buyers. Second, credible actions that increase market confidence in NPL valuation by instilling more certainty about cash flows and recovery values could be useful.⁸

⁸ Improved recovery rates may also be achieved through reforms that increase the transparency of procedures related to repossessions and insolvency. Furthermore, benefits may be derived from increased transparency in collateral auctions, measures that lower transaction costs for properties purchased under foreclosure or insolvency, and creditor-friendly measures that encourage out-of-court restructuring in a value-maximizing manner. Faster cash flow may result from shorter in-court judicial processes and related administrative insolvency procedures, out-of-court debt restructuring, and faster enforcement of collateral.

7.3 Elements of a Comprehensive Solution

The resolution of NPLs in the euro area that followed the global financial crisis required a comprehensive, multipronged approach that took country-specific circumstances into account. Generally speaking, a wide range of possible, often complementary, responses to address large NPL stocks is available (Figure 7.2).

Figure 7.2: Elements of a Comprehensive Approach to NPL Resolution



NPL = nonperforming loan.
Source: Fell et al. (2016).

The internal workout by the bank originally holding the impaired asset marks one end of the spectrum of options and should feature highly in any comprehensive resolution scheme. It requires banks to maintain or build necessary expertise but, at the same time, may allow them to recover more value for themselves than from an asset disposal and maintain potentially profitable client relationships. Notably, highly granular, small-ticket retail exposures may be best worked out internally or sold directly to investors. Bespoke products, which require detailed knowledge of borrowers and their business, may also be best kept on the balance sheet, given the sunk costs of acquiring that knowledge.

At the other end of the spectrum, the direct sale of NPLs to investors is the most rapid resolution mechanism for banks, but it is also the costliest. The extent to which direct sales can be used depends, among other things, on provisioning levels relative to market prices, the size of banks' capital buffers, and the presence of liquid NPL markets. In between, a range of options exists. These include asset protection schemes, securitization, the creation of AMCs (which are often referred to as "bad banks"), and the development of NPL platforms with little or no involvement of the state. Each of these options has different requirements, costs, and benefits.

Asset protection schemes are not discussed in detail here, given that they have proven particularly useful when potential losses from declining asset valuation and the associated uncertainty about the health of the financial sector are large but are unlikely to actually occur. Broadly speaking, such schemes are more useful in the early stages of a financial crisis than in the aftermath.

Turning to securitization schemes, Akerlof shows that one solution to the "market-for-lemons" problem is for sellers of "good" assets to offer a performance guarantee to create or restore trust in the quality of the goods sold. Appropriately structured securitization schemes, with an element of public support, could deliver this guarantee and help overcome the "lemons" problem. For these schemes to be effective, public support should target the riskiest tranche in a securitization structure.⁹ This can have two important effects. First, it signals that the underlying asset quality may be better than currently perceived. Second, it signals a commitment of the state to structural reforms that can influence NPL valuations (for example, through the time and costs to recovery), given that the state becomes exposed to risk.

A junior guarantee on securitization could be offered bilaterally on the equity tranche in a true-sale NPL securitization.¹⁰ It may be structured as a total return swap, essentially exposing the state to the same risk/return profile as a private investor. The scheme closely aligns the interests of investors and the state and offers investors the possibility of an enhanced risk/return profile due to the state's direct exposure to the same risks and its resulting vested interest in avoiding losses. It can be offered flexibly, allowing investors in the junior tranche to choose their own level of protection, if any.

⁹ By tranching funding across different risk categories, securitization generally achieves a lower average cost of funding.

¹⁰ For further details, see Fell, Moldovan, and O'Brien (2017).

It may also open the way to increasing the number and types of investors in the junior tranche by allowing a partial de-risking of that tranche.¹¹ The scheme also offers important advantages from the state's perspective—it requires no upfront investment, it is priced at market levels, and the fact that the tranche investor remains exposed to the performance of the underlying NPL portfolio ensures that moral hazard and the risk to the state remain contained.¹²

AMCs have often been used to manage distressed assets arising from systemic financial sector stress (Cerruti and Neyens 2016; Medina Cas and Peresa 2016) and have a proven record in making significant contributions to the clean-up of banking sectors suffering from NPL problems. Examples include AMCs established in the aftermath of banking crises in Sweden in the early 1990s (Jonung 2009); in the Republic of Korea in the late 1990s (He 2004); and, more recently, in the euro area countries Ireland (2010), Spain (2012), and Slovenia (2013). One of the common features of these banking system-wide AMCs is that governments have been deeply involved in their creation by providing capital, facilitating funding, and passing legislation that governs their design and operations.¹³

The main function of systemic AMCs is to “bridge” the intertemporal pricing gaps that emerge when market prices for NPLs and the underlying collateral are temporarily depressed due to heightened risk aversion and reduced liquidity in the market. The gap is bridged by removing a significant share of NPLs—usually belonging to a specific asset class such as commercial real estate or residential property development—from bank balance sheets and working them out over a specific period to maximize their recovery value. The transfer price that a government-sponsored AMC pays a bank is usually set at long-term (“real economic”) value, thus avoiding a fire sale when NPLs are sold into illiquid markets. Shielding banks from fire sale conditions can be especially beneficial if several banks are attempting to resolve their NPLs at the same time. In other words, systemic AMCs can provide an important coordination role. Other benefits of AMCs are related to a swift reduction in uncertainty surrounding the profitability and solvency of banks once NPLs are transferred to the AMC. This has a positive impact on banks' funding and capital costs.

¹¹ In particular, the scheme could play a catalyst role in widening the investor base in the junior NPL securitization tranches.

¹² Pricing at market levels is a key element for smooth implementation of the junior guarantee. This also opens up the possibility of using it free of state aid, subject to assessment by the European Commission.

¹³ AMCs may also be created in the process of restructuring or resolving a single bank, often without government support. Such bank-specific AMCs do not normally have a systemic reach and do not offer the benefits discussed in this chapter and, as such, are not covered here.

Despite these advantages, AMCs are no panacea for systemic NPL problems. Their success depends on their design and the prevailing economic circumstances. Experience suggests that several success factors should be present for an AMC to accomplish its objectives. First, AMCs tend to be best suited for particular asset classes. Second, asset valuations and the resulting transfer prices should be realistic. A well-designed governance structure, with a strong mandate, is another essential ingredient. Finally, a basic premise for the success of AMCs is that asset values start to recover in the medium term. This, in turn, implies that authorities pursue sound macroeconomic and financial policies.

In the EU, the scope for establishing banking system-wide, government-sponsored AMCs is restricted by the EU legal framework governing state aid to the financial sector, as well as by other institutional and—notably in some countries—fiscal constraints. More specifically, the Bank Recovery and Resolution Directive and the state aid communications of the European Commission¹⁴ regulate the participation of governments in AMCs. The complexity of these rules and their interplay was one of the reasons for the initiative launched by former ECB Vice-President Vítor Constâncio (Constâncio 2017) to develop a joint European Commission, ECB, and European Banking Authority (EBA) blueprint for banking-system-wide, government-sponsored AMCs in the EU (European Commission 2018).¹⁵

Looking in more detail at considerations for setting up successful AMCs, the main issues are the asset perimeter, the participation perimeter, the asset valuation, the capital and funding structure and, last but certainly not least, the governance of AMCs. The description below is cross-country in nature and accounts for the interconnectedness between the various issues, international best practices, and EU-specific legal constraints.

Considering first the assets, a strong argument can be made to limit transfers to asset classes where AMCs have a track record of having recovered value, such as commercial real estate, large corporate exposures, and syndicated

¹⁴ See Communication from the Commission on the treatment of impaired assets in the community banking sector (Impaired Assets Communication, 2009/C 72/01) and Communication from the Commission on the application, from 1 August 2013, of state aid rules to support measures in favor of banks in the context of the financial crisis (Banking Communication), OJ C 216, 30.7.2013, 1–15.

¹⁵ Besides clarifying relevant EU legislation, the “AMC blueprint” discusses, based on international experience, many important aspects that are relevant for successfully setting up and running of system-wide AMCs.

loans.¹⁶ The volume of asset transfers should balance the benefits from economies of scale with the risk that the AMC may be overburdened by having to work out too many assets within a relatively short time, particularly if they are insufficiently homogenous. It would appear useful that only assets above a predetermined gross book value are transferred to avoid burdening the AMC unduly with the administrative challenge of too many small exposures. Finally, it is often very useful to transfer all loans of a (partially) nonperforming debtor to the AMC.¹⁷

Participation in the AMC should not normally be left entirely to the discretion of banks. The case for AMCs rests on gaining a critical mass of assets, and a fully voluntary approach is unlikely to achieve this. First, a voluntary approach may result in inaction due to first-mover disadvantages. Voluntarily participating banks may endanger their client relationships by being seen as unduly tough. There may also be a cherry-picking of NPLs, with participating banks trying to transfer their lowest-quality NPLs to the AMC, while keeping on their balance sheets those bad loans with the best chance of being cured. Fully voluntary participation may also jeopardize the advantages of the debtor approach already mentioned. If a debtor is making good on loans to some banks but not to others, no (apparent) incentive exists for the banks holding the “good” loans to transfer them to the AMC. The authorities should therefore introduce sufficiently strong incentives to transfer assets to the AMC, be it through moral suasion, supervisory or accounting measures, or by sharing gains resulting from recovery values above the transfer price with the banks.

Conducting a valuation exercise is an indispensable part of the setup process. Generally, the aim of this exercise is to establish both the market value and the real (“long-term”) economic value of the assets. The valuation should start once the possible asset and participation perimeters have been determined. The assumptions of the valuation should be realistic, and the valuation should include a viability test on the underlying assets and debtors to identify assets that need to be liquidated rather than transferred to the AMC for recovery. In the EU, state aid rules require that a valuation exercise be conducted in agreement with the European Commission, as the relevant competition authority, before the transfer of assets to the AMC.

¹⁶ Recent AMCs in the euro area have often been set up and associated with particular asset classes, such as the National Asset Management Agency in Ireland and the *SSociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria* in Spain.

¹⁷ Experience has shown that such a debtor-specific approach is warranted. A debtor may have an NPL with one bank but performing loans with another. By taking all of the outstanding debt of a specific debtor, subject to respecting the perimeter of the AMC, the positions may be quickly resolved.

The valuation is a key input into the approval of the state aid that the commission gives to either the AMC or participating banks.

The amount of capital of the AMC should be calibrated to ensure that the equity layer is sufficient to absorb unexpected losses on assets. Equity requirements when setting up an AMC should, however, normally remain well below those typically required for a troubled bank. As long as the asset transfer price is based on a thorough valuation, the AMC should not be expected to endure major losses during its lifetime.

A public–private partnership model may also help. First, it can alleviate some of the burden for countries with limited fiscal space, where a majority private ownership may allow the deconsolidation of the AMC from the balance sheet of the public sector.¹⁸ Second, the scope for government interference in operations of the AMC is considerably reduced when the private sector holds an equity stake of more than 50%. That is the case for the National Asset Management Agency in Ireland, and for *Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria*, Spain’s banking-sector-wide AMC.

The AMC funding structure should minimize costs and liquidity risks. This can be achieved by issuing government-guaranteed senior bonds, which can be used as payment-in-kind to buy NPLs from banks. Senior bonds may be short-dated (1-year), with restrictions on transferability and an implicit guarantee to mitigate rollover risks. In the euro area, senior bonds may be structured to meet eligibility criteria for Eurosystem credit operations. Other central banks may consider a similar arrangement.¹⁹

Strong and sound governance is critical to the success of an AMC. The right balance is needed between business flexibility and constraints that prevent diversion from the core AMC mandate. It appears best to establish the AMC through legislation laying down its objectives, the form of its decision-making bodies, and its rules on transparency and accountability. Experience suggests that AMCs should be free from political interference and budgetary

¹⁸ In a European Union context, a majority of privately owned AMC, may be classified outside the government sector, and therefore not drive an increase in government debt, provided a number of conditions are met. According to the rules by which Eurostat compiles government deficit and debt statistics, an AMC which is majority privately owned, may be classified as outside the government sector even if its liabilities have received a government guarantee, provided that it is established for a temporary duration, has the sole purpose of addressing the financial crisis, and that its expected losses are small in comparison with the total size of its liabilities. For further details, see O’Brien and Wezel (2013).

¹⁹ The scope of central bank involvement in the funding of an AMC depends crucially on the mandate and legal framework governing the permissible activities of the central bank. In the EU, Article 123 of the Treaty on the Functioning of the European Union prohibits monetary financing by the ECB.

pressures, although public authorities should oversee some aspects of their operations, in particular those relating to compliance with its mandate and applicable regulations.

The AMC should have a clear primary mandate to maximize the recovery values of NPLs on a commercial basis. Its operational overheads should remain light and, wherever possible, the AMC should be allowed to outsource services such as property management, legal services, or collections to independent providers at market prices. More generally, it should be permitted to use any relevant legal tool or workout strategy to achieve its goals, regardless of political or vested interests.

Turning to NPL trading platforms, these may be a way to realize some of the benefits of an AMC while avoiding the costs—notably the upfront fiscal costs and financial risks for the public sector—that tend to be associated with the setting up of systemic AMCs, even though a well-designed and well-managed AMC may not result in a net loss for the taxpayer once the AMC has completed its task.

Like AMCs, trading platforms, can be designed in different ways and for different purposes. As a minimum, an NPL platform can serve as a vehicle to collect NPL-related information from different banks. This provides a number of advantages, which, returning to Akerlof's concept above, are likely to narrow bid-ask spreads in NPL markets by reducing information asymmetries.²⁰

First, “shoe-leather” costs for potential investors are reduced by having a centralized port of call for information about (parts of) the NPL supply. This is particularly useful in countries with a large share of multi-lender and/or syndicated loans, which are often particularly difficult to resolve.

Second, and very importantly, NPL platforms will require standardized information from banks that would like to use their services. High quality, standardized data will, in turn, reduce the time and cost of due diligence for potential investors, likely increasing the investor pool interested in acquiring such assets. As the value of NPLs becomes clearer, the rate of return expected by NPL investors should also decline. Participation in such a platform may also provide a welcome push for banks to solve possible NPL data problems.

²⁰ See Fell, Grodzicki, Krušec, Martin, and O'Brien (2017) for a more detailed exposition of the transaction platform concept.

In principle, NPL platforms can provide additional services, for example, selling assets on behalf of participating banks or acting as an interface between the banks and third-party NPL service firms.

Operationally, NPL platforms will face a number of challenges, for example, data confidentiality restrictions have to be overcome. Banks will normally be required to finance the platform, so they have to be convinced of its merits. Encouragement from bank supervisors to participate in the platform may be very helpful in this regard. On the positive side, the government will not normally have to commit resources. In the EU context, this has the added benefit that states aid rules do not apply—although general competition rules may come into play. A precedent for such a platform already exists in the EU, with a rather similar rationale, even though it does not directly relate to NPLs.²¹

At the time of writing, several private companies were already operating NPL platforms in a number of EU Member States. However, they offered limited geographic scope and the loan data used is not standardized across the market. Despite significant investor interest, the supply of NPLs to these existing platforms has thus been rather limited so far and the potential benefits of a European NPL platform remained largely unrealized.²²

7.4 The Benefits of European Regional Cooperation

The EU—and even more so, the euro area—is a closely integrated group of countries: financially, economically, politically, and institutionally. This needs to be kept in mind when assessing the challenges associated with NPL resolution in the euro area and when designing appropriate approaches to speed up NPL resolution.

In recent years, high NPL ratios were present only in a subset of euro area countries. This notwithstanding, high NPLs in one country can impose significant externalities on others due to important cross-border spillover channels within and beyond the banking sector. Banking spillover channels relate to banks' cross-border lending and cross-border ownership links. Spillover channels to the real economy relate to the potential deterioration of

²¹ The ECB led an initiative to improve transparency in asset-backed securities markets by requiring loan-by-loan information to be made available and accessible to market participants and to facilitate the risk assessment of such securities as collateral to be used by Eurosystem counterparties in monetary policy operations. The asset-backed securities loan-level initiative sought to enhance access to more timely information about the underlying loans and their performance in a standard format.

²² For further details on this, see European Commission (2019a).

the macroeconomic environment in countries with high NPLs, which affects other countries through lower import demand (the trade channel), and a loss of value of equity and debt claims on residents in the affected countries (the financial channel). Finally, the differences in supply and demand of credit and the stigma attached to some EU countries with high NPL ratios may impede the transmission of monetary policy (European Systemic Risk Board 2017).

Whereas these spillovers increase the negative impact of the NPL problem in the EU and the euro area, the close institutional cooperation between the euro area countries is an important asset when it comes to solving the problem.

Looking first at cooperation among bank supervisors, the European Banking Authority (EBA), the EU agency in charge of coordinating banking sector regulation and supervision across the EU, agreed in 2014 to a uniform definition of NPLs (also called nonperforming exposures or NPEs) across all EU jurisdictions. This significantly strengthened the measurement and comparability of NPLs, even though the application of the EBA's NPL concept may not yet be fully harmonized across all countries and banks.²³

The comprehensive assessment conducted by the ECB in 2014—before the launch of the Single Supervisory Mechanism (also known as ECB Banking Supervision), which unified banking supervision across all member states of the euro area—already applied the EBA NPL concept (ECB 2014). Comprising an asset quality review and a solvency stress test for 130 significant euro area banks (81.6% of the total euro area balance sheet at the time), the comprehensive assessment identified €135.9 billion of previously unaccounted NPLs across the banks it covered. This was a significant step toward creating transparency in the euro area banking system and strengthening its resilience to adverse developments.

In March 2017, the Single Supervisory Mechanism published its guidance to banks on nonperforming loans (ECB 2017). This document outlines the measures, processes, and best practices banks should incorporate when tackling NPLs and urges banks with high NPL ratios to treat this as a priority. More specifically, the guidance calls on banks to implement realistic and

²³ Any exposure that is at least 90 days past due, or unlikely to be repaid without recourse to collateral, is considered to be nonperforming. Additionally, exposures which have been restructured, or forborne, may be classified as nonperforming subject to common criteria laid down by the EBA. Forborne nonperforming exposures remain classified as such for a cure period of at least 1 year, even if the debtor complies with the new schedule of payments and all the criteria for a loan to be classified as performing.

ambitious strategies to work toward a holistic NPL approach, including areas such as governance and risk management. For instance, banks should ensure that managers are incentivized to carry out NPL reduction strategies. The ECB Banking Supervision did not stipulate quantitative top-down targets to reduce NPLs but asked banks to devise strategies that include internal targets, based on a range of policy options such as NPL workout, servicing, and portfolio sales. In 2018, the ECB Banking Supervision published an addendum to its 2017 guidance document, clarifying supervisory expectations for prudential provisioning of nonperforming exposures. Without prejudice to accounting or Pillar 1 prudential standards, unsecured (secured) exposures are expected to be fully provisioned when older than 2 (7) years. Divergence from these expectations is to be discussed with banks as part of the annual supervisory review and evaluation process and may lead to the adoption of supervisory measures under the Pillar 2 framework. A similar time-bound provisioning requirement was introduced for loans originated after April 2019 in the Pillar 1 framework.

Looking beyond banking supervision, the ECB has published contributions focusing on the secondary market for NPLs, including an analytical framework to look at information asymmetries between potential buyers and sellers (Fell et al. 2016, 2017a), the possible role of national AMCs (Fell et al. 2017b), and securitization schemes (Fell, Moldovan, and O'Brien 2017).

In July 2017, the European Systemic Risk Board, the EU agency in charge of coordinating macroprudential policy across the EU, published a report on resolving NPLs in Europe. The report identifies NPL-related macroprudential policy issues and develops ideas on possible macroprudential responses. Specific areas addressed include incentives for and potential impediments to the resolution of NPLs, policy experiences regarding AMCs, and the conditions of secondary markets for distressed assets in the EU (ESRB 2017).

That was preceded in May 2017 by a report on NPLs from a subgroup of the EU's Financial Services Committee (FSC 2017) which contained a range of policy objectives and recommendations covering supervisory tools, structural reforms relating to insolvency and debt recovery, development of secondary NPL markets, and restructuring of banks and the EU banking sector as a whole.

The range of discussions across EU and euro area bodies and in forums that preceded the publication of these reports helped raise awareness of the "systemic" dimension of the NPL problem in the euro area, in particular in

those countries where NPL ratios are relatively low and where the negative repercussions of high NPLs occur mainly through spillover effects. Moreover, these discussions helped to ensure that all relevant parts of European and national administrations, micro and macroprudential supervisors, competition authorities, finance and economics ministries, and so on, were involved. This is crucial for ensuring sufficiently broad-based political support to implement comprehensive solutions to the NPL problem.

The conclusions of the Financial Services Committee report have been endorsed by the Council of EU Finance and Economics Ministers and gave rise to the EU Council Action Plan, published in July 2017.²⁴ Since then, European institutions and governments have been engaged with follow-up activities such as the development of a blueprint for national AMC in the EU. In fact, at the time of writing this document, the implementation of the large majority of the measures outlined in the EU Council Action Plan was either completed or well advanced, with the exception of actions related to benchmarking and improving insolvency frameworks.

7.5 Conclusions

The high stock of NPLs in the euro area over the last decade is largely a legacy of the economic and financial crisis as well as the euro area sovereign debt crisis. However, it also exposed long-standing structural weaknesses in euro area countries, including, for instance, their insolvency and debt-recovery regimes. Although the NPL landscape varies considerably across the euro area, NPL problems are a source of concern for the euro area as a whole due to important cross-border spillover channels within and beyond the banking sector. These concerns are particularly relevant in the context of the COVID-19 pandemic.

Significant progress has been made by microprudential supervisors in improving NPL measurement and management by banks. That said, although internal workouts by banks and pressure by micro-supervisors are always necessary, these are unlikely to be sufficient to solve future problems. Comprehensive solutions, making full use of the various NPL resolution options and taking country-specific situations into account, offer the most promising approach. In particular, banking system-wide national AMCs may contribute to swifter reduction of large, systemic NPL stocks in Europe. In addition, other tools, including NPL transaction platforms and securitization schemes, could be usefully deployed.

²⁴ See European Council (2017) and for a recent update on the implementation of the Action Plan of the European Commission (2019b).

The COVID-19 outbreak and the associated recession in the euro area are likely to lead to resurgence of NPLs. This will put the newly developed frameworks to test. It is important to keep in mind that all of these tools can only be successful if they are supported by appropriate legal and administrative framework conditions that facilitate debt enforcement and access to collateral by sound lending standards that prevent the creation of new NPLs beyond a level that is customary and unavoidable in banking and by sound macrofinancial policies promoting economic recovery. Regional cooperation can help raise awareness of the euro-area-wide nature of the NPL problem, in establishing the right framework conditions, and in designing the best-suited instruments to solve it. Last but not least, regional cooperation can also help prevent a re-emergence of the problem.

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