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**NOTE**

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From: General Secretariat of the Council  
To: Delegations  
Subject: Report of the FSC Subgroup on Non-Performing Loans

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Delegations will find attached the above-mentioned Report.

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# SECTION I: STATE OF PLAY AND CURRENT WORK STREAMS

## 1. Introduction

### 1.1. Mandate and composition of the FSC Subgroup

1. The Subgroup on Non-Performing Loans (NPLs) of the Council's Financial Services Committee (FSC) was established in July 2016 in order to "assess the state of play regarding current NPL stocks and related developments in Member States and at EU level, as well as the relevant legal framework at national and EU level" and to deliver "possible options supporting a significant and sustainable reduction of NPL levels, based on the current diverse situations assessed".
2. The objective of the Subgroup, being a preparatory body of the Council, is to prepare a comprehensive discussion in the Council through building a common understanding of the issue and relevant policy options. The objective and the addressees of this report are therefore different from the ones of other work streams currently working on the NPL issue: this report therefore further builds upon other work done by the Single Supervisory Mechanism (SSM), the European Systemic Risk Board (ESRB), the European Banking Authority (EBA) and the International Monetary Fund (IMF).
3. The Subgroup is composed of representatives from all interested Member States, the European Commission, the European Central Bank (ECB), the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Investment Bank (EIB) and the Single Resolution Board (SRB). Furthermore, the Chairwoman of the SSM Task Force on NPLs participates in the work of the Subgroup as observer.
4. The Mandate of the Subgroup established by the FSC (see Annex 5) divided the work in three sections:
  - A. Stocktaking;
  - B. Analysis of current policies; and
  - C. Establishing policy options and areas for action.
5. The interim report, which was established in December 2016, covered sections A and B above.
6. Following the endorsement of the interim report by the FSC, the work on establishing policy options and areas for action (section C of the Subgroup's mandate) was launched with a view to submitting a final complete draft of the report to the FSC for discussion and endorsement in Spring 2017.

### 1.2. Methodology

7. The Subgroup has drawn to the largest extent possible, on existing work streams, available analytical work and input in particular from the Commission, the ECB, the ESRB, the EBA, EIOPA and ESMA, the European Stability Mechanism (ESM) and the SRB, as well as the SSM Task Force on NPLs, so as to avoid duplication of work with these institutions and work streams.
8. Furthermore, in its work the Subgroup extensively used data and analyses published or made available by third parties, including international organisations (notably the International Monetary Fund), representatives of the private sector and academia.

9. When examining the problem of NPLs, the Subgroup applied the definition of non-performing loans<sup>1</sup> established in the EBA “Implementing Technical Standard on Forbearance and Non-Performing Exposures”<sup>2</sup>. In the context of this report, an NPL is mainly every exposure that is 90 days past due (quantitative criteria) or unlikely to be paid without collateral realisation (qualitative criteria), even if it is not recognised as defaulted or impaired for capital or accounting purposes respectively<sup>3</sup>. This NPL definition was built on the accounting definitions of "impairment" and "credit-impaired" according to International Financial Reporting Standards (IFRS) and prudential definition of default in Regulation (EU) No 575/2013<sup>4</sup>.
10. Analyses referred to in this interim report, unless stated expressly otherwise, are based on data collected by the EBA, at the highest level of consolidation (FINREP templates 18 and 19) which cover 166 banking groups from all 28 EU countries and Norway, representing more than 80% of the EU banking sector total assets (hence a larger sample than the 2016 EU-wide stress test). The figures present the evolution of these ratios in the period September 2014 - December 2016, as comparable<sup>5</sup> data on NPLs and forbore loans<sup>6</sup> (FBLs) across the EU is available only since the introduction of the EBA ITS in late 2014
11. Finally, unless stated otherwise, all point-in time data are reported as of December 2016 and are weighted averages.

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<sup>1</sup> More precisely, an NPL is every exposure that is 90 days past due or unlikely to be paid without collateral realisation, even if it is not recognised as defaulted or impaired. In addition, any exposure to a debtor has to be considered non-performing when its on-balance sheet 90 days past-due reaches 20% of the outstanding amount of total on-balance sheet exposure to that debtor. Furthermore, NPLs that are forbore do not exit this classification before one year over which the debtor has to prove its ability to meet the restructured conditions, even if forbearance has led to the exit from default or impairment classes.

<sup>2</sup> The ITS was established in application of Article 99(4) of Regulation EU No 575/2013 and is mandatory for FINREP reporting banks within the EU since September 2014. It covers loans and debt securities except held for trading, and off-balance sheet commitments.

<sup>3</sup> Please note that data referred to in this report concerning the EU and Norway and covering period after September 2014 is based on these criteria. Data concerning the EU in period before September 2014 and third countries is not based on standardised criteria.

<sup>4</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (so-called Capital Requirements Regulation - CRR).

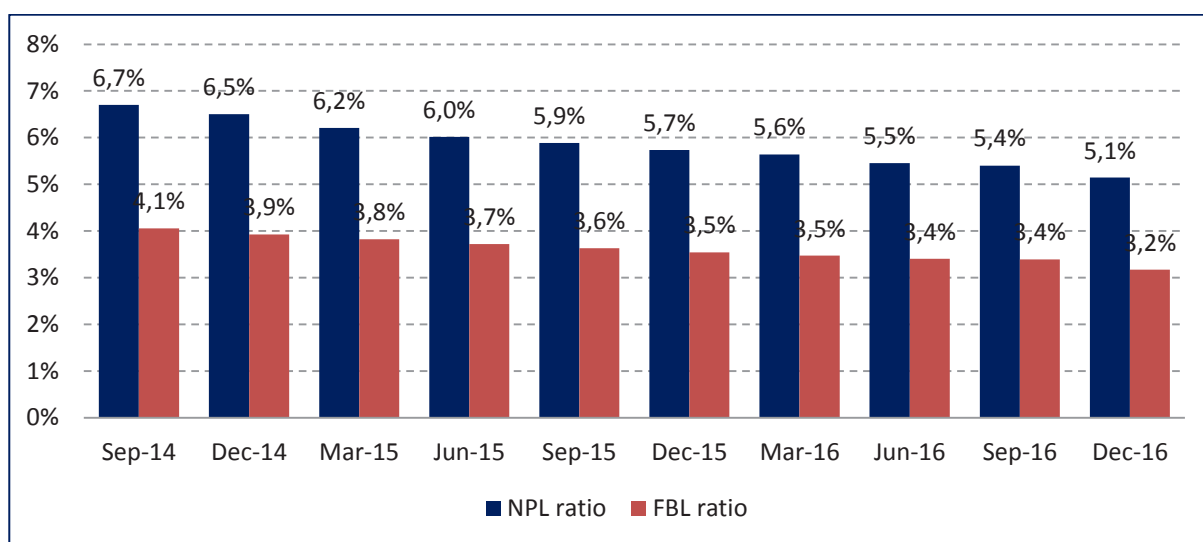
<sup>5</sup> It should be noted that the recent EBA definition may imply some subjectivity aspects (for instance the unlikely to pay criterion) and, in this context, different traditions across Member States may require an adjustment period. However those differences in implementation will diminish over time.

<sup>6</sup> Forborne loans are debt contracts in respect of which forbearance measures have been extended. Forbearance measures are concessions towards a debtor facing or about to face financial difficulties; a forbore exposure can be performing or non-performing (see EBA Implementing Technical Standard on Forbearance and Non-Performing Exposures).

## 2. Understanding the NPL issue in Europe

### 2.1. Overview

12. The financial crisis and ensuing recessions have left some European countries with high levels of NPLs, and, in some cases, large corporate and household debt overhangs. Nevertheless, many Member States, that together represent a clear majority of EU bank assets, have not experienced significant NPL issues during and after the financial crisis.
13. The gross carrying amount of NPLs in the banking system in the EU at the end of 2016 amounted to just below EUR 1 trillion (EUR 990.4 billion), or roughly 6.7% of EU GDP, while the net amount, taking into account provisions, stood at EUR 548.7 billion.
14. A large quantum of NPLs (37.6%) are in Member States banks which have an NPL ratio below the EU average of 5.1%, while another 46.5% of NPLs reside within Member States which have an NPL ratio greater than 10%, though these are very concentrated within a few Member States. More than 90% (92.2%) of NPLs in the EU are located in ten countries, nine of whom are in the euro area.<sup>7</sup>
15. In December 2016, the weighted average NPL ratio<sup>8</sup> in the EU and in the euro area (EA) amounted respectively to 5.1% and 6.4%, which for the EU average represents a notable decrease compared with 6.7% in September 2014 (see Figure 1)<sup>9</sup>. The decline is slightly lower in the EA (the ratio stood at 8.2% in September 2014). At the same time, for more than one-third of EU countries this figure stands at more than 10%. NPL trends diverge among Member States over the last years (see Figure 2), as detailed below.



**Figure 1: EU aggregate non-performing loans and forborne loans ratios<sup>10</sup>**  
(Source: EBA)

<sup>7</sup> The share of NPLs was calculated by the FSC Secretariat, using EBA data. The total NPLs of a Member State represent the sum of NPLs from all consolidated banking groups from that Member State.

<sup>8</sup> Average of NPLs/total loans weighted by total loans.

<sup>9</sup> Net weighted average NPL ratio in the EU decreased to 2.8% in December 2016 from 3.9% in September 2014.

<sup>10</sup> It is important to point out that NPL ratios and forborne loan ratios are not additive, as some part (normally a majority) of forborne loans are already classified as NPLs. Thus, by doing so, we would indeed be double counting these exposures.

16. Nevertheless, the average weighted NPL ratio in the EU remains high by historical standards and is still much higher in the EU than in other comparable jurisdictions: at the end of 2015 the NPL ratio amounted to 1.7% for the US and 1.6% for Japan, although figures are probably not fully comparable due to the absence of a global definition<sup>11</sup>.
17. At the same time, when analysing the NPL problem, the gross carrying amount is not only what matters, but also the coverage ratio, i.e. the level of loan loss provisions already booked in bank's balance sheets to account for the losses associated with the exposures. In that vein, high NPL ratios should be less of a concern if they come together with high coverage ratios. Therefore, both NPLs and coverage ratios have to be analysed together in order to see the whole picture (see below). However, assessing if coverage ratios are high enough to offset the NPL problem and reduce asset quality uncertainty, while comparing them across banks and jurisdictions is not always straight forward, as special consideration should be given to e.g. the different types of collateral in place and also valuations issues. In order to do that, very granular data would be necessary, which is not always currently available.

## **2.2. Distribution of NPLs and importance of adopting a granular approach**

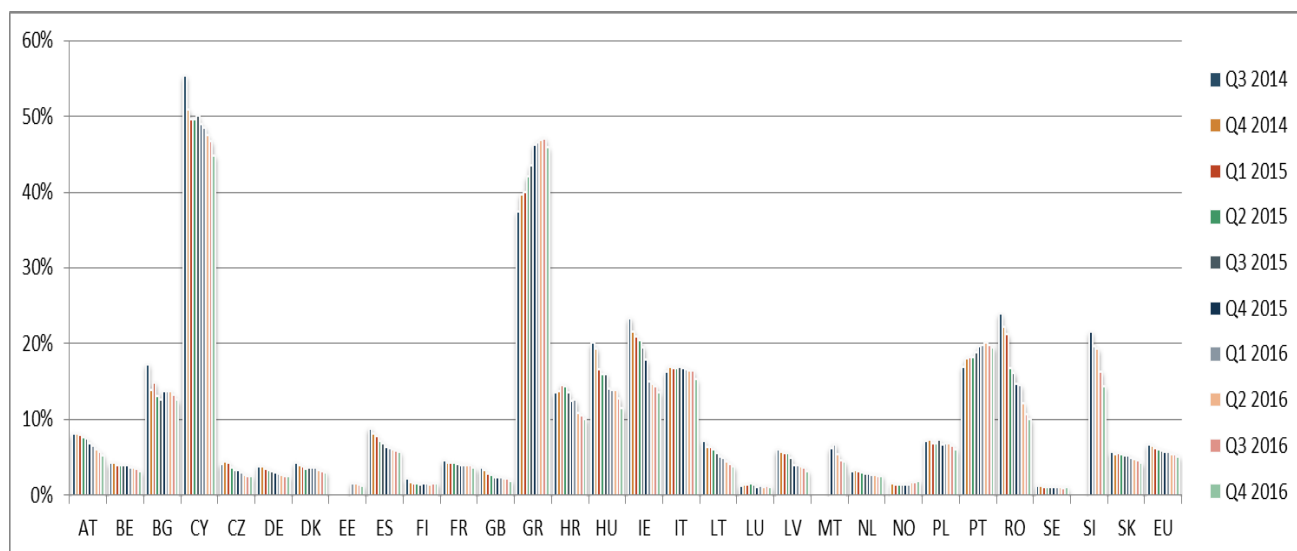
### **2.2.1. Trends in the NPL ratio**

18. Looking at EU aggregate NPL ratios, alone, does not provide the adequate picture of the problem. The weighted average NPL ratio is highly dispersed across EU countries (Figure 4), with the highest NPL ratios observed, in general<sup>12</sup>, in Member States that were more financially stressed i.e. those most hit by the economic crises from 2008 onwards, which reflects the impact of the economic downturn. For example, NPL ratios in Cyprus and Greece amount to roughly 45% while the NPL ratios for Sweden and Luxembourg are as low as 1%. Forborne loans (FBL) ratios show a similar pattern.
19. Similarly, differences between EU countries can be observed with regard to trends: while in 26 of 28 Member States, NPL ratios have been decreasing since September 2014, albeit at a different pace, in a few Member States the NPL ratios have risen as illustrated in Figure 2, and in two Member States remain at over 40%. It should be noted that data usually refers to NPL ratios, but NPL stocks may differ from NPL ratios due to the denominator (total loans) rising or falling in case of deleveraging.

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<sup>11</sup> World Bank / IMF data. Comparisons at the global level should be interpreted with caution because there is no global definition of NPLs yet. This is currently under consultation in Basel: <http://www.bis.org/bcbs/publ/d367.pdf>.

<sup>12</sup> With a few exceptions, such as Spain.



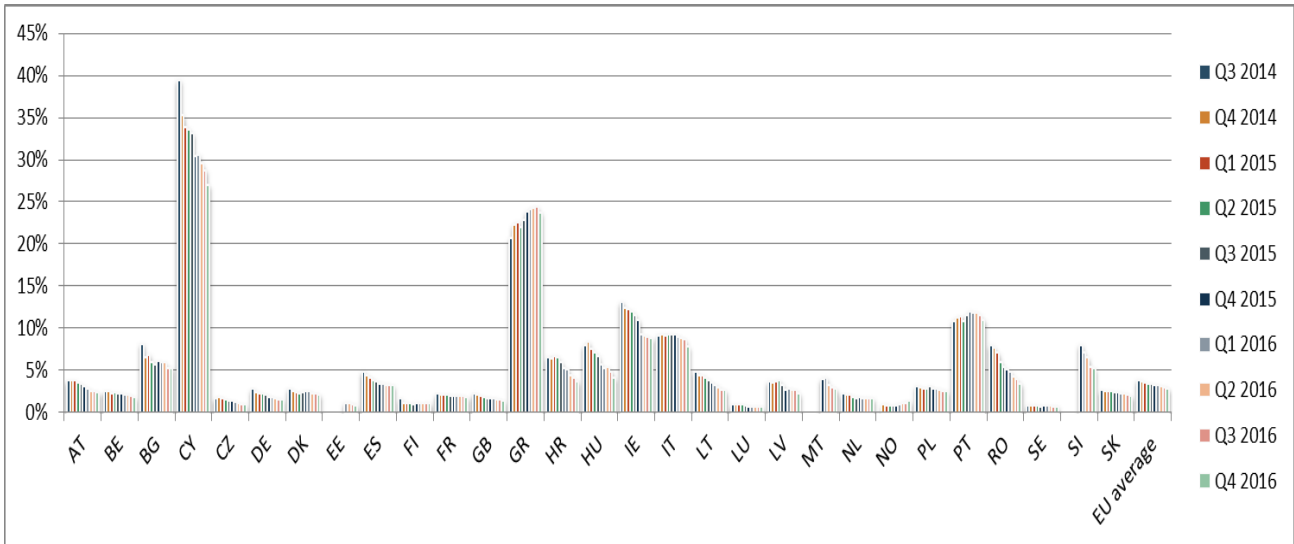
**Figure 2: Evolution of gross NPL ratios in individual EU Member States and Norway.**  
(Source: EBA data)

| MS        | AT    | BE    | BG    | CY    | CZ    | DE    | DK    | EE    | ES    | FI    | FR    | GB    | GR    | HR    | HU    |
|-----------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Q3 14 (%) | 8.11  | 4.20  | 17.26 | 55.28 | 4.14  | 3.86  | 4.26  | 2.46  | 8.83  | 2.20  | 4.57  | 3.57  | 37.40 | 13.52 | 20.05 |
| Q4 16 (%) | 5.31  | 3.19  | 12.53 | 44.77 | 2.53  | 2.54  | 3.07  | 1.29  | 5.71  | 1.60  | 3.66  | 1.95  | 45.86 | 10.11 | 11.52 |
| Var. (%)  | -34.5 | -24.2 | -27.4 | -19.0 | -38.8 | -34.1 | -28.0 | -47.7 | -35.3 | -27.4 | -20.0 | -45.4 | 22.6  | -25.2 | -42.5 |

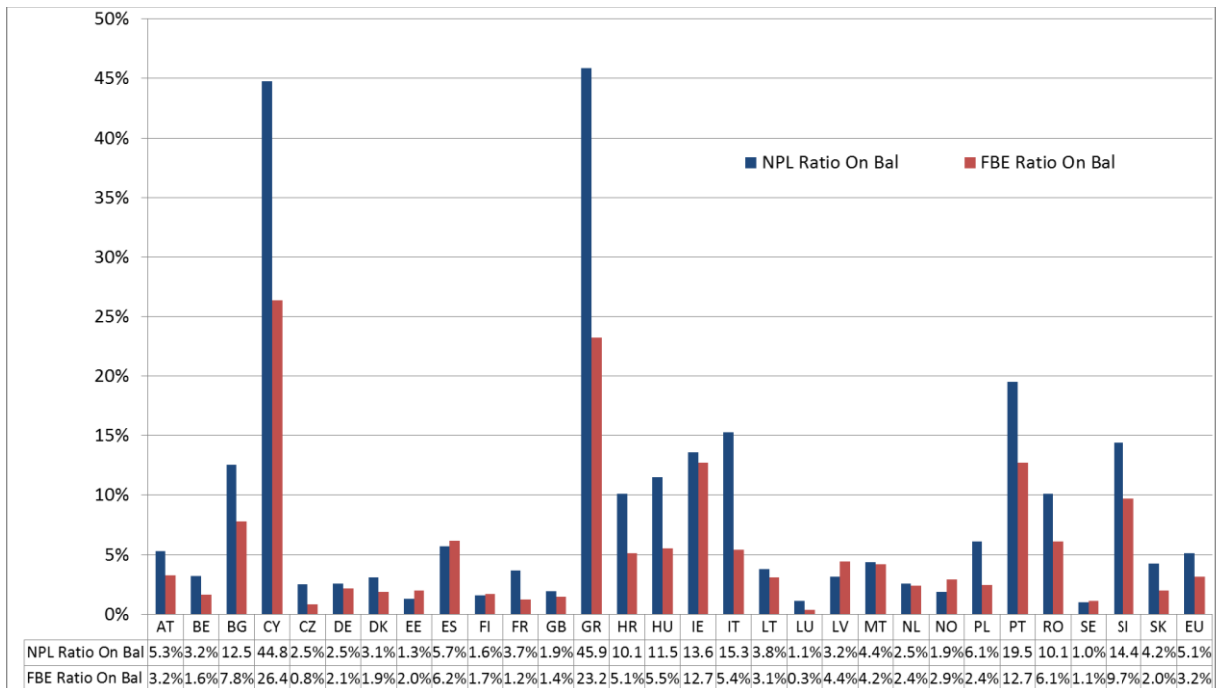
| MS        | IE    | IT    | LT    | LU    | LV    | MT    | NL    | NO   | PL    | PT    | RO    | SE    | SI    | SK    | EU average |
|-----------|-------|-------|-------|-------|-------|-------|-------|------|-------|-------|-------|-------|-------|-------|------------|
| Q3 14 (%) | 23.33 | 16.26 | 7.19  | 1.48  | 6.04  | 8.65  | 3.14  | -    | 7.14  | 16.98 | 23.90 | 1.29  | 28.96 | 5.71  | 6.70       |
| Q4 16 (%) | 13.57 | 15.30 | 3.78  | 1.12  | 3.18  | 4.39  | 2.54  | 1.89 | 6.10  | 19.52 | 10.09 | 0.99  | 14.41 | 4.25  | 5.14       |
| Var.(%)   | -41.8 | -5.9  | -47.5 | -24.1 | -47.4 | -49.2 | -19.0 | -    | -14.5 | 15.0  | -57.8 | -23.1 | -50.2 | -25.7 | -23.3      |

**Table 1: Evolution of NPL ratios of non-performing loans in EU MS and Norway**  
(Source: EBA data)





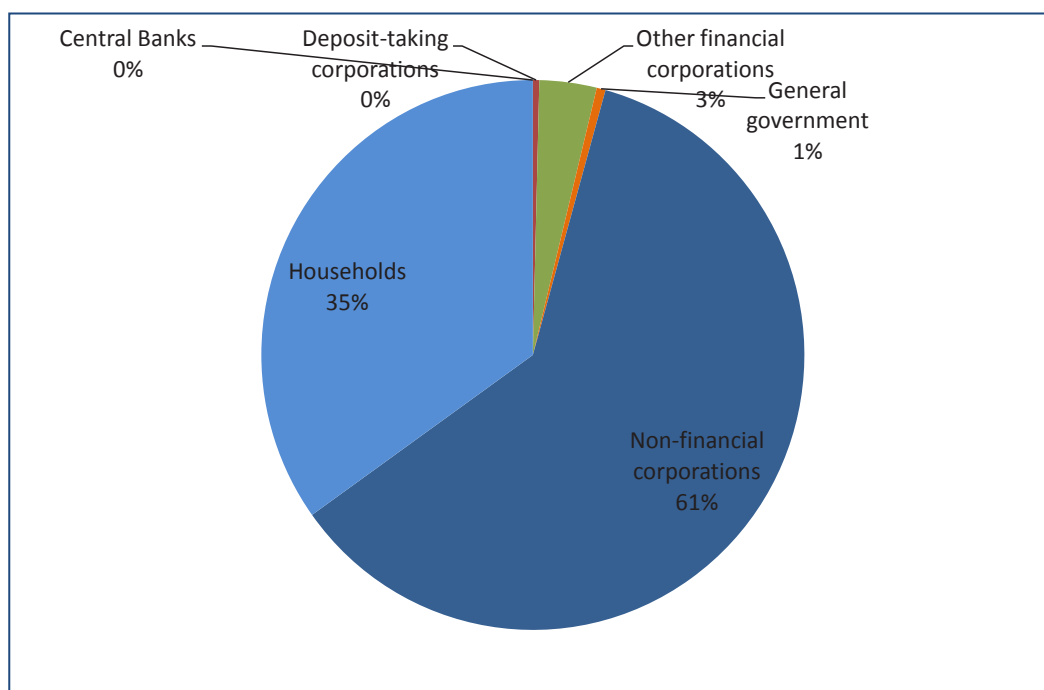
**Figure 3: Evolution of net NPL ratios in individual EU Member States and Norway.**  
(Source: EBA data)



**Figure 4: Non-performing loans and forborne loans for total on-balance loans and advances per country of origin of the bank (December 2016)**  
(Source: EBA)

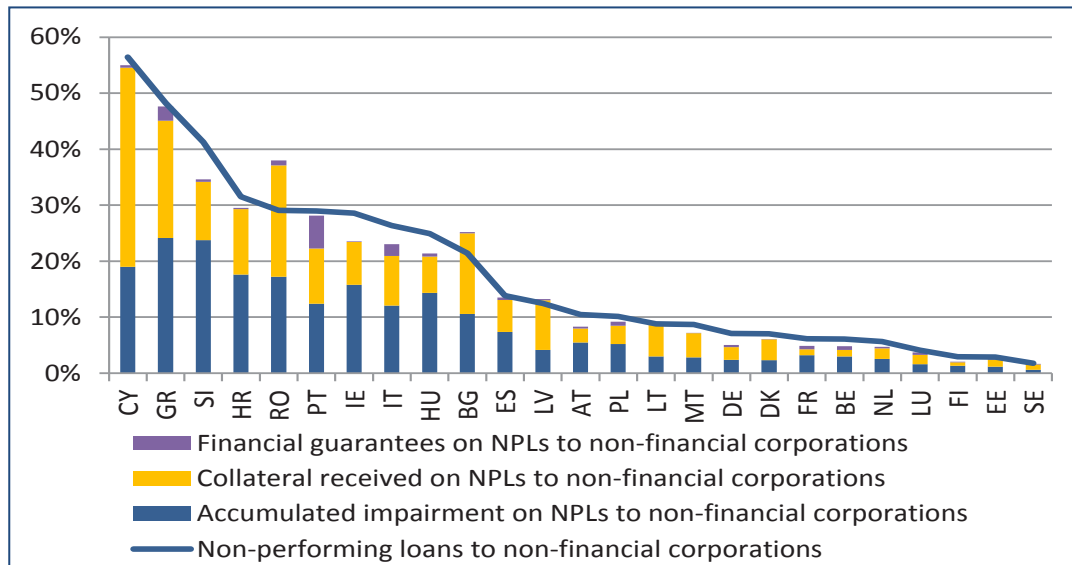
20. The stocks of NPLs in the EU concern almost exclusively (96%) loans granted to non-financial corporations (NFCs) and households (see Figure 5).

21. The NPL ratio of exposures towards small and medium-sized enterprises (SMEs) is higher (16.7%) than for exposures towards large corporates (7.5%) and households (4.7%). Higher NPL levels in SME lending may be related e.g. to their greater reliance on bank financing, lower diversification, and more difficult financial situation. Additionally, recoveries on SME lending may be lower due to, among other factors, for instance the fact that enforcing collateral on SMEs can be much more complex than on households (as a large part of household debt is secured by mortgages) when enforcement is the adopted strategy. Probability of default rates are also higher for SMEs than for larger corporates.
22. Whereas in some countries NPLs, while being a general issue, are concentrated in some sectors (e.g. real estate in Ireland and Spain), in others impaired assets are scattered across several asset classes (including also SMEs, state-owned enterprises, etc.).
23. As can be determined from the data above the characteristics of the NPL stock differ across Member States. Therefore a granular approach to the analysis of banks NPL stocks is necessary, which requires distinguishing NPLs according to main portfolios (e.g. retail mortgage, retail consumers, retail small businesses and professionals, SME corporate, large corporate, commercial real estate).



**Figure 5: Composition of the stock of NPLs (%)**<sup>13</sup>  
 (Source: ESRB Secretariat based on Consolidated Banking Data (ECB))

<sup>13</sup> Data refers to Q4-2015 and covers domestic and stand alone banks in the EU.



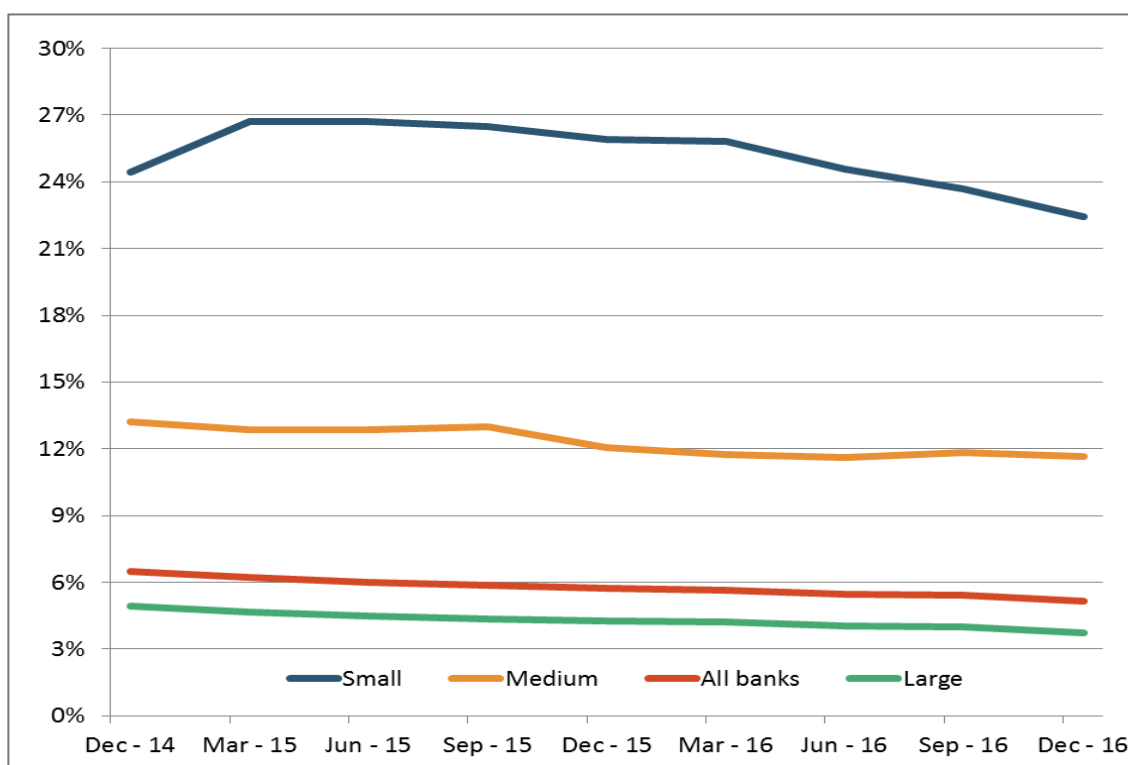
**Figure 6: Non-performing loans to non-financial corporations and coverage (% of total gross loans to non-financial corporations)<sup>14</sup>**

(Source: ESRB Secretariat based on Consolidated Banking Data (ECB))

24. Within the EBA sample, which in general covers the largest EU banks, the NPL ratio is higher for smaller banks (22.4%) and lower for large banks (3.7%) (see Figure 7). It should be noted that size can also reflect the country of origin of the banks. In fact, most smaller banks in the EBA sample are from countries where NPLs are higher (Cyprus, Greece, Italy, Portugal, Ireland). The dispersion of the coverage ratio across different sizes of banks has recently narrowed, but is still slightly lower for small banks (42.4%) and higher for large banks (45.3%)<sup>15</sup> (see Figure 9). Huge dispersion is observed also among different banks and jurisdictions (see Figure 8) which could suggest that, beyond differences in riskiness of NPL portfolios, there may be some persistence of different approaches to the recognition of losses among banks and supervisors.
25. Similarly, there are notable differences in NPL ratios for foreign and domestic banks. Banks' strategic decisions about the geographical diversification of their business can significantly influence their NPL levels (see Annex 1 for more granular analysis). In this context, it is important to note that banks' deleveraging of foreign assets to meet deleverage or restructuring plan targets will often increase their NPL ratios as their performing loans – affecting the denominator – will reduce.

<sup>14</sup> Data refers to Q3-2015. No data for Czech Republic, Slovakia and the United Kingdom. Member States are ordered according to the ratio of non-performing loans to non-financial corporations to total loans to non-financial corporations.

<sup>15</sup> The definition of small vs. medium vs. large banks is based on total assets: small banks are those below the first quartile, large banks are those above the third quartile. The threshold are roughly about EUR 30bn and EUR 190bn (changing over time). It should be noted that the really small banks are not included in the analysis as they are not covered by the EBA sample.



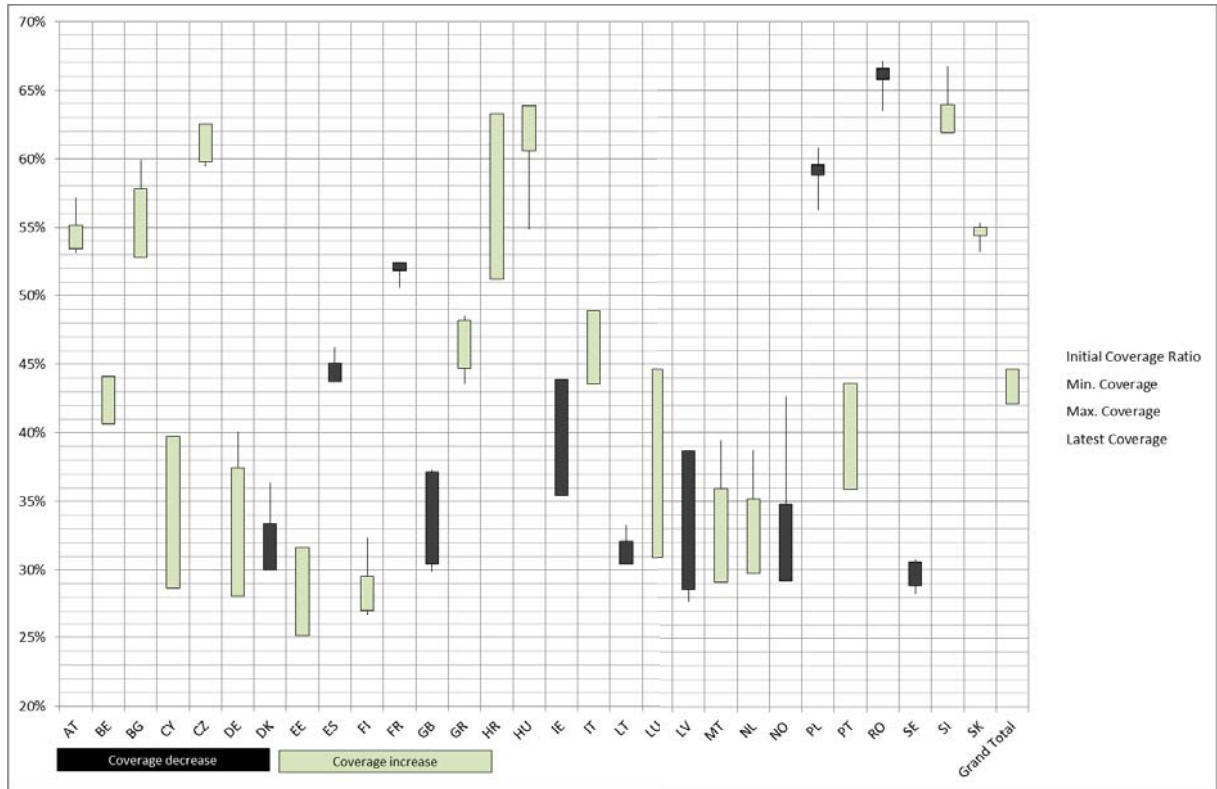
**Figure 7: Weighted average NPL ratio by size class of a bank**  
(Source: EBA)

### 2.2.2. Trends in the coverage ratio

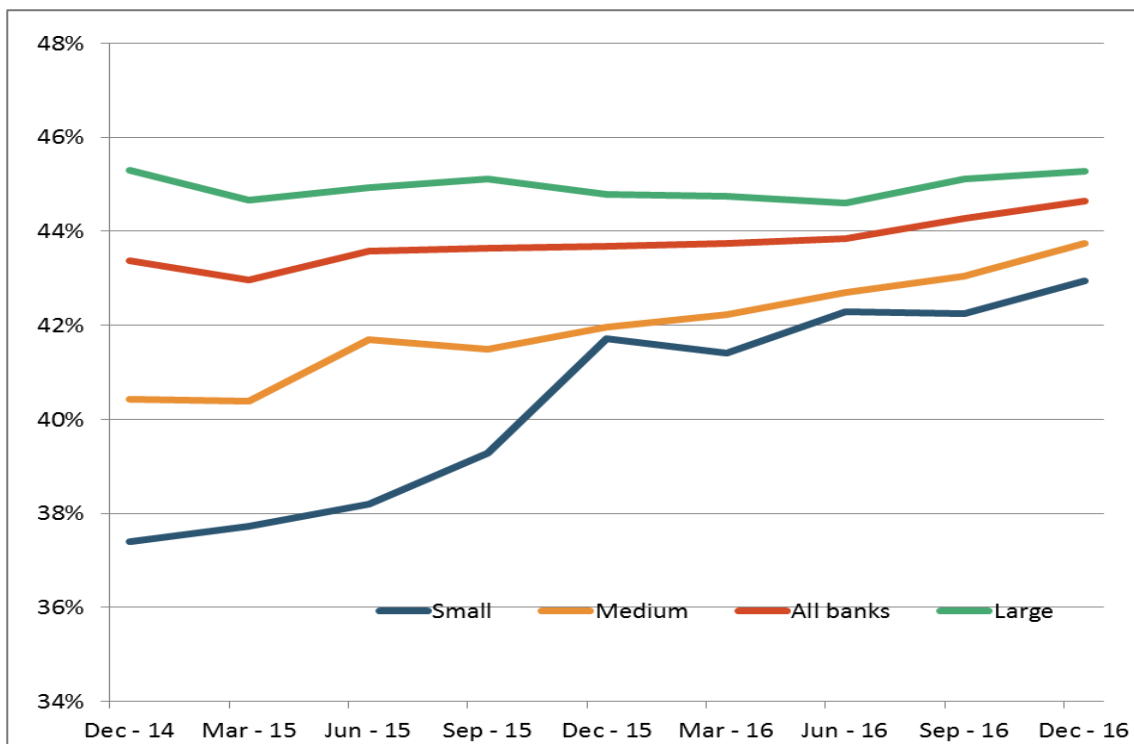
26. Coverage ratios, i.e. the share of NPL that is covered by loan loss provisions in individual banks balance sheets to account for the expected losses associated with NPLs, differ across banks and Member States both in terms of level and evolution (Figure 8), and also according to the size of banks (Figure 9). Comparing coverage ratios across banks and jurisdictions is however not always a meaningful way to assess the level of residual risks that banks derive from their NPL portfolios, as heterogeneity may relate to a number of factors, such as expected recovery rates, collaterals available and the length of the recovery process<sup>16</sup> or different provisioning policies and incentives. Over time, these coverage ratios have increased among most Member States facing high NPL ratios<sup>17</sup>.
27. The level of NPLs could also be linked to banks' provisioning policies, since higher provisions make the disposal of assets potentially easier. Figure 8 shows the evolution of coverage ratios per bank's home country since September 2014. The increase in the coverage ratio, while not large, is evident in many countries since September 2014, and may be the result of higher supervisory and regulatory scrutiny in relation to the asset quality reviews, (AQRs), increased market pressures, as well as negative developments of collateral values leading to an increase in impairment.

<sup>16</sup> EBA report on the dynamics and drivers of nonperforming exposures in the EU banking sector (22 July 2016).

<sup>17</sup> With the exception of Ireland and Spain since 2014, due to the provisioning and deleveraging processes started before September 2014 (start of EBA data) in these two Member States, as explained below.



**Figure 8: Change of coverage ratio for total loans and advances per bank's home country since September 2014**  
 (Source: EBA)



**Figure 9: Weighted average coverage ratio by size class**  
 (Source: EBA)

## 2.3. Key drivers of NPLs stocks

28. The drivers of NPL stocks are at the interplay of various factors largely depending on bank- and country-specific parameters, with ex-ante and ex-post effects, relating to the build-up of the initial NPLs and also to the pace of the reduction of NPL stocks.

### 2.3.1. Economic drivers

29. Increases in NPL stocks and persistence of high NPL ratios, as a legacy issue, are generally linked to the deep economic downturn following the global financial crisis and the slow recovery. Econometric analysis<sup>18</sup> has documented that real GDP growth is the main driver of NPL ratios, capturing to a large extent underlying drivers at a micro level (revenues of households or corporates, negative net present value of business projects, etc.). This is corroborated by a number of recent country-specific econometric analyses. For instance, a recent paper by the IMF<sup>19</sup> highlights the importance of cyclical developments in the build-up of NPLs in the wake of the crisis in Italy. Therefore, a drop in economic activity remains the most important general risk, as it weakens borrowers' debt service capacity, particularly for those borrowers that were overleveraged, leading to an increase in payment arrears and loan defaults and decrease in bank asset quality<sup>20</sup>.

30. At the same time, economic activity is not able to fully explain the evolution of NPLs across countries and over time. Empirical results suggest that additional economic factors may negatively affect asset quality in countries with specific vulnerabilities. In particular, the role of exchange rate effects, though differing among countries, has been highlighted by a number of studies: on the one hand, a depreciation of the domestic currency may lead to an increase of non-performing loans in countries with a high degree of lending in foreign currencies to unhedged borrowers<sup>18</sup> (this explanation may be relevant for a number of non-euro countries); on the other hand, in countries that do not run such currency mismatch, a depreciation of the exchange rate may lower the level of NPL due to an export-driven improvement of the financial position of the corporate sector (this explanation may be relevant for euro-area countries<sup>19</sup>).

31. In addition, empirical analysis<sup>18</sup> also finds bank asset quality can be negatively related with a decline of stock prices (in particular in countries with large stock markets relative to GDP) insofar as such decline may be a relevant proxy for a drop in corporate performance and the value of collateral which may also, in some countries, trigger negative wealth effects that hamper the ability of the private sector to repay. An increase in lending interest rates, having a direct effect on corporate defaults, is also an important driver of NPL stocks.

32. Most importantly, the rise in NPL levels can be influenced by one-time events or idiosyncratic shocks<sup>21</sup>, such as collapse of real-estate bubbles (e.g. in Ireland and Spain), and/or a prolonged, deterioration of macro-economic conditions<sup>22</sup>, affecting the competitiveness of the real economy including SMEs (e.g. in Italy), structural impediments and revenue prospects for the banking sectors and organic capital generation to offset potential credit losses.

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<sup>18</sup> ECB Working Paper No.1515 (February 2013): "Non-performing loans. What matters in addition to the economic cycle?"

<sup>19</sup> IMF WP/16/35 (July 2016): "Cleaning-up bank balance sheets: economic, legal and supervisory measures for Italy"

<sup>20</sup> IMF Staff discussion note SDN/15/19 (September 2015): "A strategy for resolving Europe's problem loans".

<sup>21</sup> Following the financial and economic crisis in Cyprus in 2012-2013, the NPL ratio increased significantly. It is difficult to estimate the possible impact of the bail-in on NPL levels in Cyprus given the financial crisis which was ongoing at the time.

Following the financial and economic crisis in Greece, the NPL ratio increased significantly, also during the implementation of the economic adjustment programme.

33. Low interest rates in conjunction with lax lending standards could play an important role in the building-up of asset bubbles, particularly real-estate bubbles, which have been especially responsible for the increase in NPLs, particularly in some jurisdictions. On the other hand, low interest rates could also make debts more affordable and avoid the build-up of new NPLs. At the same time, they also have an influence in the financing cost of NPLs for banks, and therefore as a side effect the ability to maintain NPLs in their balance sheets over time.

### 2.3.2. Structural drivers

34. In addition to economic drivers, NPL levels are significantly influenced by other factors, the impact of which is however difficult to quantify, due to the complexity of these factors as well as a lack of comparable and counterfactual data and country-specific or bank-specific features. These factors include, but are not limited to, banks' lending and monitoring policies, supervisory action, legal and judicial systems including insolvency frameworks, accounting standards, transparency of market for collateral assets, banks' capacity to deal with NPLs with the appropriate expertise, underdevelopment of distressed debt markets, tax regimes information asymmetries, as developed below.

35. Banks' lending and monitoring practices and strategies before the financial crisis seem to be one of the key drivers of the ex-ante build-up of the original stock of NPLs in a number of Member States. In the pre-crisis phase many banks focused on the expansion of business and reaching a competitive advantage, which came at the price of substandard loan origination and weak monitoring of clients, notably to debtors who could not offer sufficient collateral or to unsecured debtors who were not likely to pay back their loans in case of a severe deterioration of economic conditions. Some analysis suggests that an unsustainable expansion of the loan book in the 2000s resulted on average in lower asset quality with lasting effects<sup>23</sup>. Some research even suggests that undercapitalized banks used additional monetary capacity to engage in lending towards already distressed clients<sup>24</sup>, however research is not univocal in this respect<sup>25</sup>.

36. Banking supervision, in the case of supervisory forbearance associated with a narrower capital base prior to the prudential reforms following the crisis, may also have not been robust enough to offset these practices. In addition lack of fully developed macro prudential supervisory and policy frameworks were not able to prevent the formation of credit bubbles. Furthermore, despite significant progress made in the past, question arises if supervision was always able to identify exact bank shortfalls as a result of elevated NPLs. Nevertheless, AQRs or one-site inspections have been useful tools in this respect, even though they provide only a point-in-time view and are usually focused on specific portfolios only. Robust, proactive and intrusive supervision, including ensuring prudent NPL recognition, provisioning and strong capital buffers, is essential to enhance banks' incentives to recognise losses and thus influence the pace of NPL resolution and write-offs.

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<sup>23</sup> Albertazzi (2009, 2010).

<sup>24</sup> Acharya et al (2015) <https://www.imf.org/external/np/res/seminars/2015/arc/pdf/Eisert.pdf>

<sup>25</sup> See Bank of Italy's Financial Stability Report No. 1 – 2016, fig.2.4 p.19, which shows that lending to more financially fragile firms is decreasing.

37. Other major factors influencing NPL stocks are legal and judicial systems, within which banks and investors active in the secondary market for NPLs operate. As detailed in Chapter 4, legal and judicial systems can significantly affect the persistence of NPL stocks, by determining the contract enforcement and collateral repossession framework and also pre-insolvency and insolvency laws, with the corresponding tools to restructure loans, as these have, to a certain extent, a direct impact on the recovery value that can be extracted from an NPL and the timeline of this recovery. In addition, very lengthy foreclosure and legal resolution timelines could lead to an increasing number of strategic defaults as borrowers do not see any immediate consequences from failing to pay.
38. In addition, in some countries, the sharply rising numbers of bankruptcy or restructuring cases have strained the judicial system and caused long delays in judicial debt work-out or liquidation. This has led to NPLs being kept on bank balance sheets longer, and in turn to a more severe drag on bank profitability and long-term viability.
39. Accounting standards also can set different incentives on NPL resolution. Accounting standards, provide specific requirements for the recognition and measurement of losses associated to impaired loans, including loans that meet the NPL definition adopted in this report. Particularly, among other factors, the timing of impairment loss recognition may have an impact on a bank's decision to either dispose of or restructure NPLs. For example, up until now, the current accounting standard for financial instruments, IAS 39, may have created an incentive for entities to recognising impairment losses long after loans have become past due. Therefore, in this example, the accounting framework may have represented a disincentive to disposing of or restructuring NPLs. However, the new accounting standard for financial instruments, IFRS 9, contributes to addressing this issue as it requires that impairment losses are recognised on a more timely basis. For example, the new standard may result in impairment losses be recognised straight after a loan has become past due for a short period of time. Therefore, in this latter example, banks applying these standards will have an incentive to dispose of or restructure loans more rapidly than in the past. Another example is the time horizon for writing down NPLs to collateral value which is 6 months in the USA.
40. Lack of transparency of market for collateral assets and of standardised valuation approaches is detrimental for the quality of impairment calculations and therefore pose an obstacle to timely NPL resolution.
41. Given the severity of the recent financial and economic crisis, a number of severely affected banks may not be sufficiently equipped to deal with the observed surge of bad loans. For this reason, some banks, especially small ones, may lack the expertise, capacity, or tools to deal with NPLs on a large scale. Outsourcing of servicing may be an option, but that, in turn, depends on the capacity of the NPL servicing industry and of the costs associated with servicing fees, which could have a bearing on the administrative costs for banks as well as the capital depletion associated with the NPL portfolio.
42. Underdeveloped secondary markets for NPLs make it more difficult for banks to move bad loans off their balance sheets. Provided banks have the necessary capital buffers allowing for the sale of assets, distressed debt markets help reduce the burden on banks and can boost loan recovery values by providing a more cost-effective alternative to internal NPL management, especially for smaller banks or banks with scattered loan portfolios.



43. The European market for bank debt, even though steadily growing (+20% in 2015 to EUR 100 billion, with a an expected growth rate of over 30% in 2016<sup>26</sup>), remains relatively small compared with the size of the outstanding stock of NPLs, and focuses mainly on commercial and residential real estate as well as, to a smaller extent, consumer loans.
44. Tax systems may create disincentives for adequate provisioning and loan write-offs. Possible disincentives include e.g. capping tax deductions for loan loss provisions as well as not allowing tax deductions for loan write-offs or for loan principal reductions and collateral sales below book value.
45. Information deficiencies and constraints can also lead to the build-up and difficulties in resolution of high NPL levels. These include, for example, restrictions on sharing individual debtor's information for debt workout purposes and insufficient information available in the credit register. On the debtor side, lack of debt counselling (which is particularly important for both households and SMEs) can also be an impediment to the workout of NPLs.
46. Lack of creditors' coordination represents another bottleneck in solving the high stock of NPLs, especially in the non-financial corporation segment (firms, in contrast with households, usually deal with more than one bank leading to a more challenging situation involving creditors' coordination).
47. Finally, banks may not be willing to quickly resolve NPLs. This can be driven namely by already low profitability and, in some instances, thin capital buffers which constrain banks' ability to increase provisions and discourage the timely recognition of credit losses. Adequate and timely supervision can in some cases force banks to take action and resolve NPLs.

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<sup>26</sup> Deloitte estimations of loan sales transactions, the data is provisional and may include incomplete deals.

## 2.4. Persistence of an NPL problem in Europe

48. As exemplified in Chapter 2.3, the crisis had a substantial impact on the build-up of NPLs in the affected Member States, with substantial legacy issues to address. Therefore, the recovery underway in Europe should contribute to the reduction of the stock of NPLs and NPL ratios, by improving the servicing capacity of borrowers, as suggested by improvements of NPL indicators in many countries since 2014. However, given the slow pace of the recovery and inflation outlook weighing on the private sector's ability to service the loans, this process is likely to be lagged and protracted and also revenue prospects for the banking sectors and organic capital generation to offset potential credit losses, as the relatively low decrease of NPLs in recent years<sup>27</sup> suggests.
49. The cyclical dimension of the NPL build-up is exacerbated by a number of non-cyclical factors at the banking sector level, related to risk management practices, belated management of NPL stocks and lack of incentives for NPL recognition, as well as country-specific structural factors such as lack of efficient insolvency procedures and a significant work-overload of the judicial system. However, a low profitability environment, increasing capital requirements and relatively thin capital buffers in some banks<sup>28</sup> (see Figure 13 below comparing net NPLs to own funds and provisions) constrain banks' ability to increase provisions or recognize losses in a timely fashion thereby limiting NPL resolution. Increased supervisory focus on NPL management and provisioning, improved loan origination process, stronger incentives towards resolution, and capital build-up when necessary, can help to solve the problem, which is unlikely to be solved by itself.
50. In addition, mutually reinforcing feedback loops exist between macroeconomic and banking sector drivers, whose interplay may explain the scale of the high NPL ratio problem in the affected European countries. For instance, bank NPLs and excessive corporate debt mutually reinforce each other, as some economic evidence<sup>29</sup> suggest that overextended / overleveraged companies have little incentive to invest because any return has to be allocated to service their debt. This also implies that their demand for credit is weaker, which further weighs on banks' profitability and makes it more difficult for them to dispose of impaired assets since this might entail the realisation of further losses if the off-loading of NPLs is the adopted strategy. In addition, high stocks of NPLs weight on credit supply and NPLs lock bank capital and funding in the financing of non-productive assets leading to less balance sheet space available for productive assets (see below). Thus, when NPLs are large and persistent, while economic recovery can support their workout, high NPL levels are not likely to be worked out through a normal cyclical economic recovery alone, though some countries have made progress in this regard. Indeed, historical experience highlighted the vicious circles between economic growth and high NPLs.
51. Resolute efforts are therefore needed to address both NPLs and private sector debt overhang to ensure that a large stock of distressed debt does not hold back growth.

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<sup>27</sup> The average weighted NPL ratio in the EU dropped by 23% in December 2016 compared with September 2014. While in a number of Member States the NPL ratio decreased by more than 30%, in others the decrease was lower, ratios remained stable or, in some cases, increased.

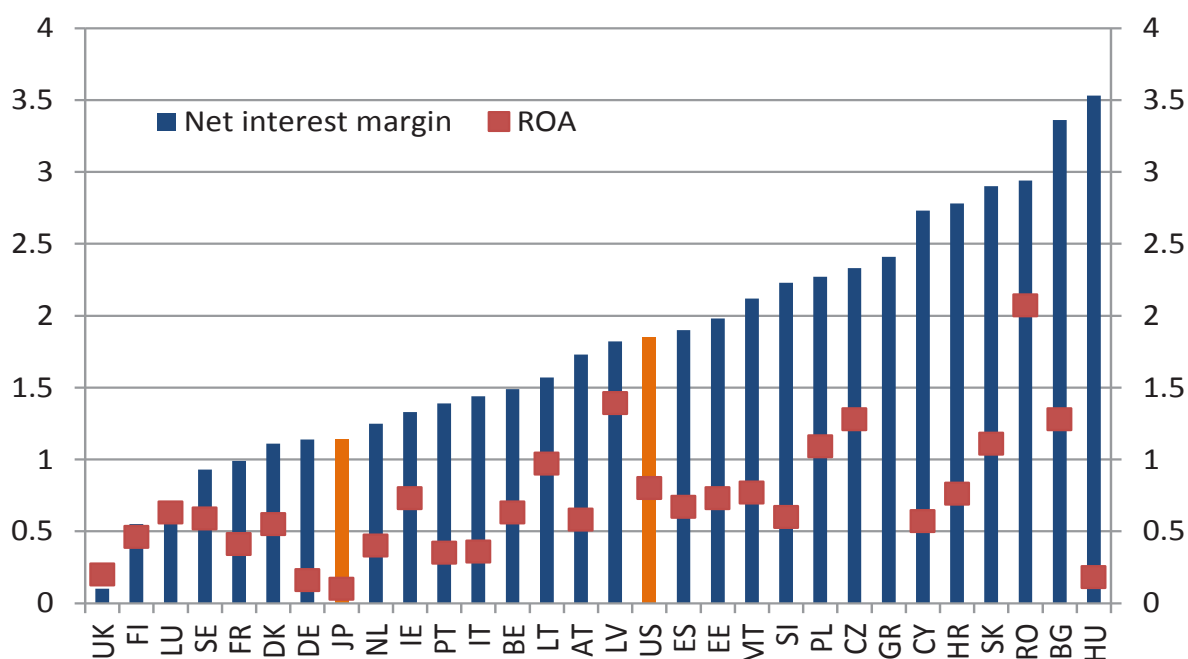
<sup>28</sup> IMF Staff discussion note SDN/15/19 (September 2015): "A strategy for resolving Europe's problem loans".

<sup>29</sup> Kalemli et al. (2015) find a substantial effect of this overindebtedness-related reluctance to invest for European corporates between 2000 and 2012. Melzer (2012) shows that such effect also arose for households in the US in the wake of the crisis.

### 3. Why NPL matter for the health of the banking sector at micro and macro level and the financing of the real economy

#### 3.1. Micro level: profitability of banks

52. In general, EU bank profitability has decreased significantly since the crisis. The main factors contributing to this trend have been (i) weak macroeconomic conditions, (ii) very low interest rates (particularly in recent years), (iii) deleveraging needs in the wake of the crisis, and (iv) structural changes affecting business models and the pace of restructuring of banking sectors. Despite moderate improvements in 2015, EU bank profitability remains below the pre-crisis levels.



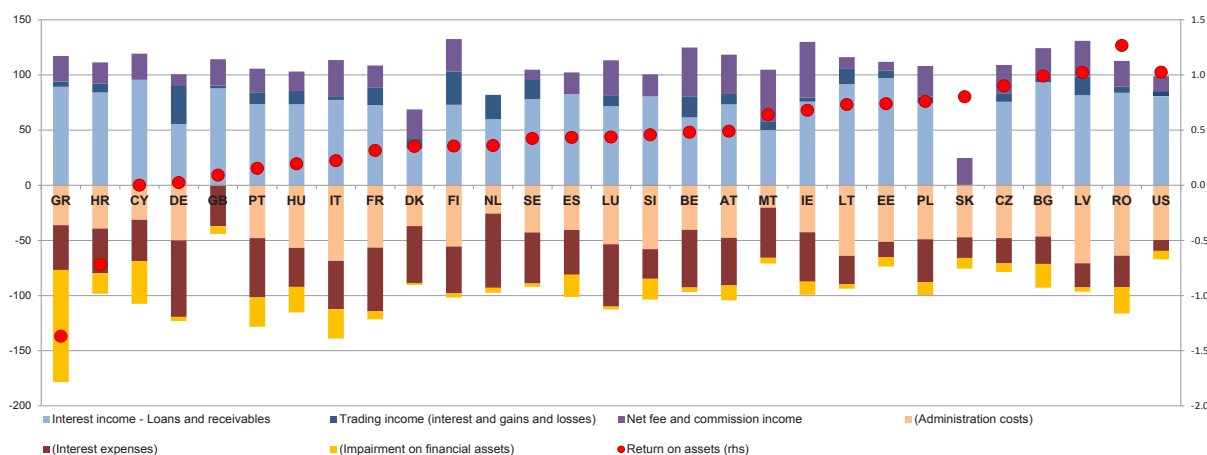
**Figure 10: Net interest margin and return on assets across EU Member States<sup>30</sup>**

Sources: ECB Consolidated Banking Data, FDIC (US) and OECD Banking Database (ESRB 2016, forthcoming)

53. Currently, key drivers of nominal bank profitability, besides NPLs, are the prolonged low interest-rate environment and structural challenges to adapt business models to the current macroeconomic situation and improve cost-efficiency. Net interest income is the main source of overall income of traditional banking (i.e. maturity transformation). The impact of low interest rates differs across institutions depending on their balance sheet composition, both on the asset and liability sides. However, in general, when interest rates are low and the yield curve is flat, the difference between the rate charged to borrowers and the rate of interest paid on bank liabilities can be under pressure to some degree, since banks may be constrained in their capacity to decrease the rate on deposits below zero.

<sup>30</sup> Note: Data for the EU banking systems refer to the first half of 2015. Japanese and US data refer to the average of 1989-2010. Return on Assets of Greek banks was negative in the first half of 2015 and is, for presentation purposes, not shown in the chart.

54. In this already challenging environment, NPLs imply higher provisioning or write offs needs to provide for expected credit losses associated to NPLs and therefore lower banks' net operating income, which results in capital needs to offset the capital depletion associated with NPL management. This holds true both in situations where NPL rates are increasing or where existing NPLs have not yet been sufficiently provisioned or offloaded. In certain circumstances, where NPLs are being sustainably restructured and falling there may be some positive effects on banks through the restoration of income streams, notwithstanding initial negative impacts. As Figure 11 shows, in a number of Member States, asset impairments alone can substantially dent bank profitability. In addition, NPLs carried on banks' books typically generate lower income streams as compared to performing assets<sup>31</sup>.



**Figure 11: Main components of the profit and loss account of EU banks (% of interest income and of total assets (rhs))<sup>32</sup>**

Source: Consolidated Banking Data (ECB), FDIC and ESRB Secretariat calculations.

55. A high stock of NPLs may, besides direct losses, also lead to increased administrative expenses and carrying costs for the monitoring and management of the NPLs. Increased administrative expenses have a significant fixed cost component, whose burden falls disproportionately heavily on smaller lenders or lenders with heterogeneous NPL portfolios, with little capacity to bundle the management and the workout of the loans.

56. High amounts of NPLs also weigh on banks' profitability through the funding channel. As a high amount of NPLs can cast doubts about the bank's future revenues as a result of losses of revenues and potential further losses on NPL valuations and thus its long-term viability investors could require an increased risk premium which translates into higher funding costs or contribute to higher volatility in banks' funding costs.

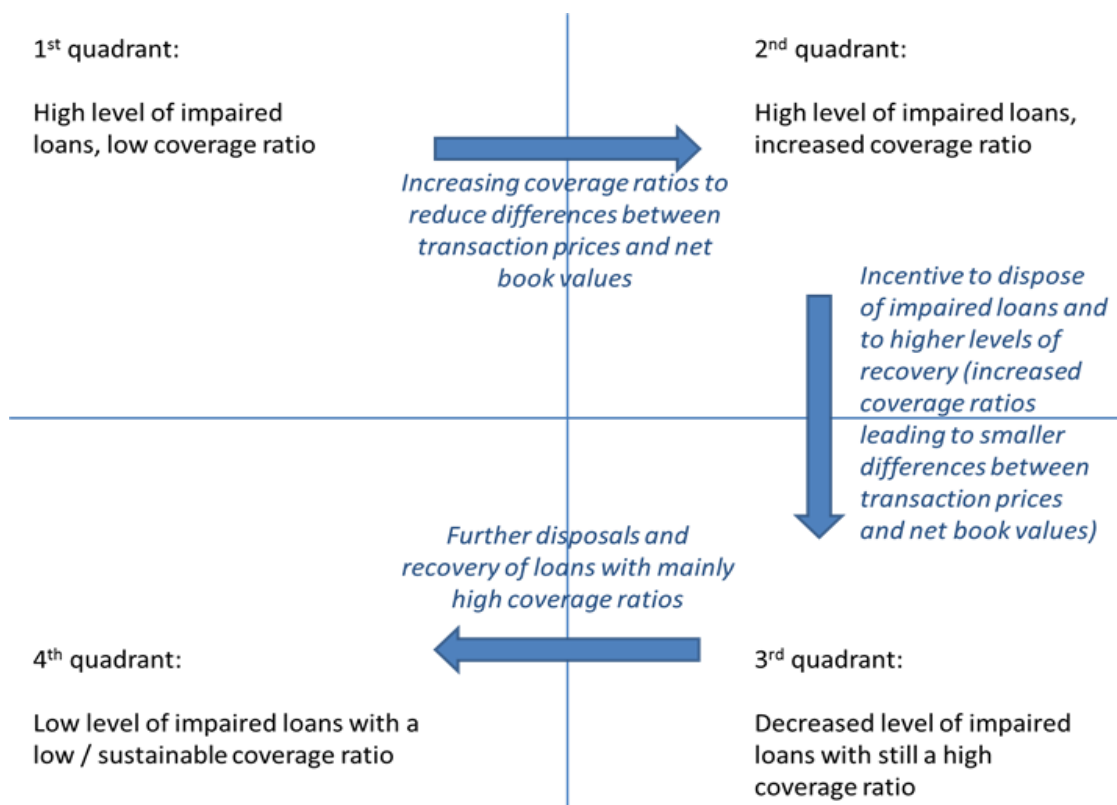
57. Another channel that weighs on banks' profitability relates to capital. As impaired assets carry a higher risk weight or may additionally lead to increased pillar 2 requirements, banks may be forced to forego interesting investment opportunities due to a scarcity of capital. Given the combined effects of these channels, in total a bank with large NPL stocks may struggle more

<sup>31</sup> In a number of Member States the recognition of interest from NPLs is not possible, either because including interest in profit and loss accounts is not allowed or because symmetric provisions to accrued interest on NPLs have to be incorporated, with a neutral effect on profit and loss.

<sup>32</sup> Note: Data refers to Q3-2015. Only banks reporting under IFRS are included. Austrian, German and UK figures may thus not be representative of the whole banking system. There is no reported data on administration costs and fee and commission income for the UK and no breakdown of interest income for Slovakia.

than others to return to profitability which in turn make very difficult for banks to resolve these non-performing assets.

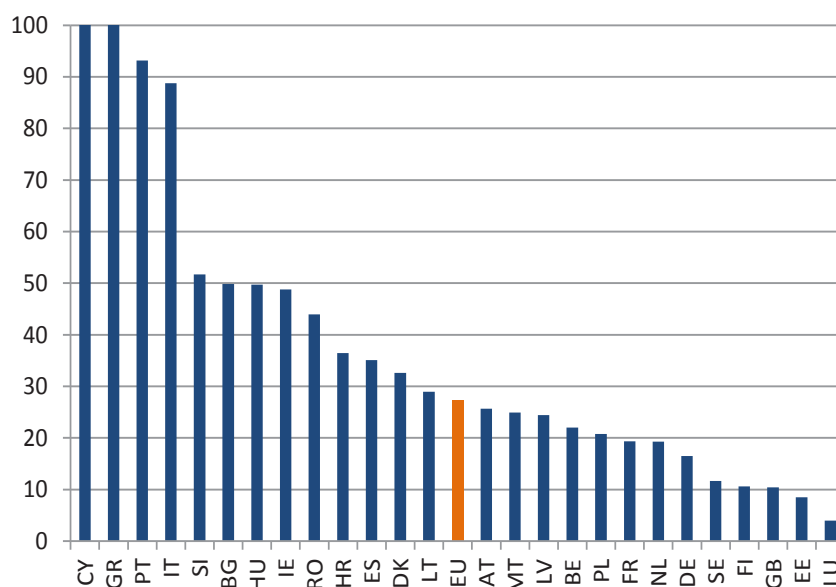
58. However, when assessing the impact of NPLs on banks profitability, one should also consider forward-looking effects, in the sense that even banks with adequate level of capital and provisioning (although to a lesser extent in this case) may suffer in the long term from a high level of NPLs on their balance sheets. Such levels divert management attention from developing new business, increase the lack of predictability of revenue levels and capital ratios (where valuation issues remain present because of persisting uncertainty around loan and collateral assessment and where sales of NPL portfolio risk rebasing risk weights in internal models), leading the overly conservative policies with respect to new lending or excessive risk-taking.
59. The impact on profitability also heavily depends on where an individual bank is positioned in the resolution process. If the bank is determined to seek a consensual restructuring of the NPL with the borrower, the bank will suffer a one-off loss provided the restructuring is viable. The same happens if the strategy is to seize the potential collateral and sell it. If the bank wishes to off-load the NPLs adopting a sale strategy, the impact on profitability varies depending on the "NPL disposal cycle", depicted as an illustration in Figure 12. Starting off with high stock of impaired assets and a low coverage ratio, banks may increase their coverage ratio to reflect the worsening condition of the NPL. As the gap between gross book value and sale price reduces, banks are better able to dispose of impaired loans (if the disposal is the adopted strategy). Moving from quadrant 2 to quadrant 3 would also benefit from an improvement in market valuations of NPLs, thus further aligning ask-bid spreads.



**Figure 12: The NPL disposal cycle**  
(Source: EBA)

### 3.2. Macro prudential risks for financial stability

60. High NPL ratios widespread among many banks can translate into doubts about the sustainability of individual financial institutions, which, depending on the contagion channels, can potentially escalate into doubts about the stability of the banking system as a whole. Independent asset quality reviews have sometimes proved to be effective in bringing credibility and transparency for investors.
61. Economic research suggests that many banking crises have their root in declining lending and monitoring standards as banks seek to increase profits and expand business during the height of the credit cycle. According to this argument, a critical threshold is reached at some point in the lending cycle, when the only way to accommodate further growth in assets is to allow the quality of those assets to decline. At this stage, the banking system transitions from so-called cash flow banking, where loans are made according to the value of the expected cash flow from productive investments, to collateral-based lending where loans are granted based on the value of their underlying security. Asset quality then becomes susceptible to a decline in the price of the underlying collateral. Moreover, at the peak of lending booms just before they go bust, some banks might start to engage in even riskier banking, granting loans with lower probability of repayment, but are still originated because the loans could be securitised and sold on secondary markets. This has and can lead to systemically important levels of NPLs in a banking system.



**Figure 13: Net NPLs to own funds (%)<sup>33</sup>**  
 (Source: ESRB using Consolidated Banking Data (ECB)).

<sup>33</sup> Note: Data refers to Q4-2015. No data for Czech Republic and Slovakia. Exact values for Cyprus (255.83%) and Greece (175.06%) are not shown in the chart for presentational reasons. The bar EU represents the median of the EU countries.

62. High NPL ratios, if provisions are not adequate, may put the solvency of a bank at risk even in the short term. If such a bank is of systemic relevance, or if provisions are too low across a substantial part of the banking sector, then financial stability may be at risk.
63. If adequately provisioned, high NPL ratios may not necessarily pose a short-term threat to financial stability. However they remain a symptom of strains in the corporate and household balance sheets, which weaken growth prospects and remain a drag on financial stability and the long term viability insofar as they can significantly affect bank profitability and economic growth.
64. High NPL ratios in a particular bank may increase difficulties to attract new capital through equity financing to address potential capital shortfalls and make that bank vulnerable to a sudden loss of confidence, thus - in case of systemic relevance (at the individual level or in case of simultaneous events related to group of banks) - creating potential financial stability risk.
65. High NPL ratios can potentially pose risks of cross-border spill-overs, depending on the scale of the problem, in terms of the overall economy and financial system of the EU. As mentioned in Chapter 2.1., total gross EU NPLs remain at around EUR 1 trillion (6.7% of EU GDP) and large parts of the banking system are affected in some Member States. Currently, funding conditions for financial institutions are currently benign. The prevalence of significant NPLs issues in some banking sectors could lead to wider fragility in other banking sectors. Financial interconnections between credit institutions across the banking union and crisis management mechanisms that exist across the whole banking union, lead to a more integrated perception of the whole banking sector of the EA by market participants, and sometimes, international institutions. Lastly, the macroeconomic effects of high stock of NPLs on the growth perspectives in individual jurisdictions can potentially spill-over to other jurisdictions in the EA because of the high interconnectedness between national economies. These potentially systemic aspects of the NPL problem suggests scope for an EU-wide discussion of risks to the economy and financial stability.

### 3.3. Macro economic implications

66. When looking at the macro-financial linkages, the analysis needs to take into account that there are usually a two directional dimensions of this issue in which difficulties on the financial and the macroeconomic side depend on each other and to some degree also influence each other. The first direction is from the macro economy towards the financial sector. Such linkages have been well established in the literature and are largely undisputed. These linkages have been described above. However, high NPL ratios can also create feedback effects to the macroeconomic environment. Banking regulation and supervision explicitly acknowledges the influence that a deteriorating macroeconomic environment can have on the (credit) risk profile of the banks' loan book. Households and companies can more easily get into difficulties to service their debt when economic growth is weakening, more likely leading to an increase in NPLs.

#### 3.3.1. Supply of credit

67. One of the main channels through which high NPLs can have a feedback effect on the macroeconomic environment is through their impact on bank lending capacity to the economy. This impact on the credit supply can be linked to several factors which are all, in one way or another, featuring into capital constraints of the affected banks.
68. NPLs can weigh on the supply of credit by locking in bank capital and funding in the financing of non-productive assets. This may lead to less balance sheet space available for new lending. Furthermore, NPLs can reduce the profitability of banks, which over time tends to additionally weigh on loan supply (e.g. through higher funding costs and increased credit constraints), all other things being equal.
69. High NPLs may imply a worsened allocation of credit, as non-viable firms are kept artificially alive or restructuring is unduly delayed. Banks may have an incentive to refinance or 'forebear' non-performing loans in order to avoid or delay loss recognition on these loans, or in the context of a close relationship with the client (also known as "extend and pretend"). This means that credit is allocated to barely surviving firms ("zombie companies") at the expense of firms that have a viable future. In this vein, Aiyar et al. (2015) assess the impact of NPL sales on the amount of capital that would be freed for a representative sample of European banks. Micro-level analysis on corporate-bank relations suggest that corporate investment is reduced both by self-restriction by corporates in debt overhang and by a change in behaviour of banks with weak balance sheets (Kalemli-Ozcan et al, 2015).
70. For conducting a bird's eye analysis, it is possible to divide Member States in different groups according to the degree to which they are facing NPL issues. The objective could be to look at the possible effects of NPLs on lending growth. This said, it must be noted that due to the high probability of confounding effects, the analysis only shows correlation and not causality.



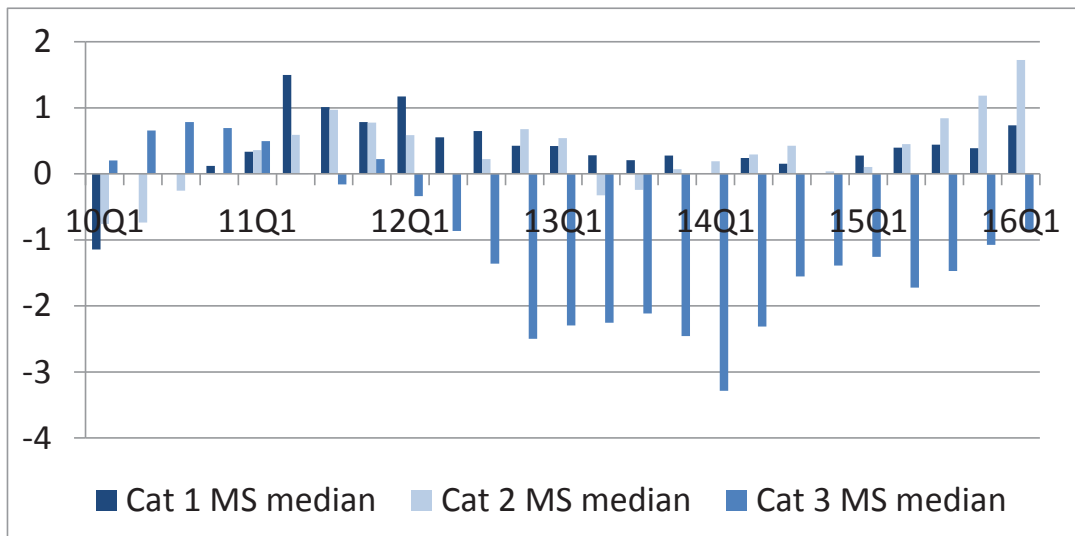
|         | <b>Group of countries<sup>34</sup></b>  | <b>Composition of the Group</b> |
|---------|---|---------------------------------|
| Group 1 | MS which are not showing high NPL ratios (>10% of banks' loan portfolio) and have not done so in the last 15 years  | 9 Member States                 |
| Group 2 | MS which are not currently showing a high NPL ratio (>10% of banks' loan portfolio) but have so in the last 15 years and/or in which NPL ratios rose strongly in a short period of time (at least a doubling between 2008 and 2013) | 9 Member States                 |
| Group 3 | MS which are currently showing an NPL ratio of >10% of banks' loan portfolio  | 10 Member States                |

**Table 2: Groups of member states with distinct NPL characteristics.**  
(Source: Commission services)

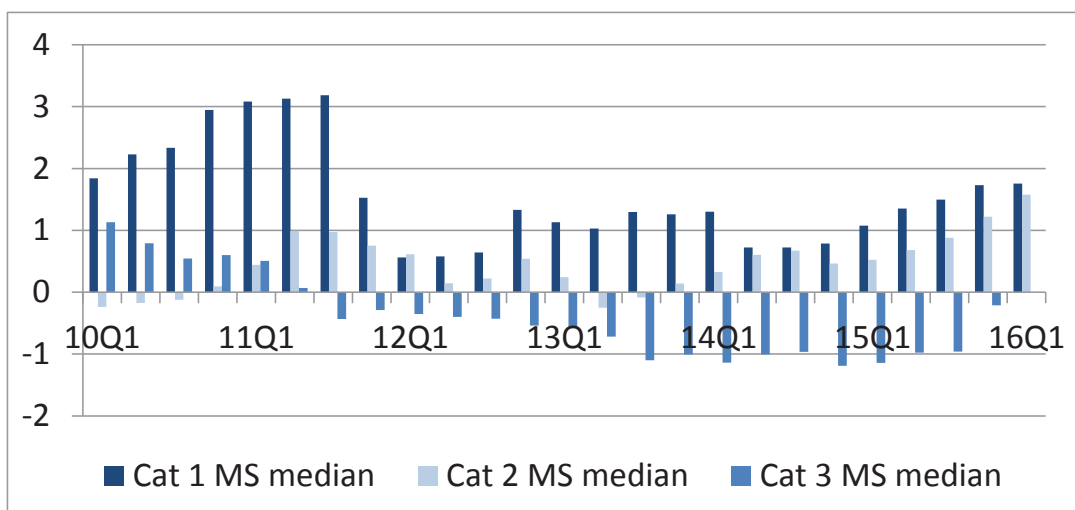
71. When looking at banks' lending to non-financial corporations (NFCs) and households, the data suggests that for the third group of Member States, the contraction in bank lending (assessed by the median of the different groups of Member States concerning bank lending to NFCs and households in percent of GDP) was particularly pronounced compared to the other categories (see figures 15 and 16)<sup>35</sup>. Furthermore, there has been a tangible decrease in lending activities by monetary financial institutions to NFCs in these Member States – somewhat stronger even than the decrease in lending to households. It is noteworthy that this decrease seems to have taken place after the spike in NPL ratios (2013) which suggests that the contraction has taken place at the time when banks had to build up their provisioning in reaction to an increase in NPL in their loan book. Lending to NFCs is since Q1 2015 picking up again in the second group of Member States in line with a closing of the output gap and decreasing overall NPL ratios.

<sup>34</sup> The criterion of looking back 15 years for determining the groups of Member States is primarily due to data availability and should not be interpreted as an indication of a particular preferred timeframe. Furthermore, the analysis was conducted with a different dataset as the previous analysis presented in this report (based on a subsample of FIs compiled by the EBA) with a view to reflect sector-wide aggregates.

<sup>35</sup> This is also backed by findings in the economic literature; see for example Aiyar et al. (2015) for an overview. While such studies find compelling evidence for such effects, it also shows the difficulties in conducting such an analysis. On the one hand, this is due to the difficulties in combining aggregated macroeconomic data with disaggregated lending data from individual financial institutions. On the other hand, the likely presence of non-linearities hampers the ability to identify stable relationships. Furthermore, more general developments, such as the overall deleveraging after the financial crisis, can mask and even dominate the influence of the described effects. Taken together, one must be cognizant that the analysis conducted in this report show primarily correlations while it is difficult to constitute causalities. Nevertheless, the identification of correlations can be a valuable first steps in substantiating presumptions.



**Figure 14: Monetary financial institution (MFI) lending to NFCs in % of GDP**  
 (Source: EBA, ECFIN calculations)



**Figure 15: Monetary financial institution (MFI) lending to households in % of GDP**  
 (Source: EBA, ECFIN calculations)

### 3.3.2. Demand for credit

72. A more complex question in this context is whether the presence of a high NPL ratio in the banking sector might have an influence on the investment behaviour, in particular in the corporate sector. The problems associated with a high ratio of NPLs in the banking sector might also have a bearing on the investment planning even before a concrete credit request is made. Nevertheless, these effects are not likely to be the main driver behind an investment decision but would rather tacitly have an influence of the decision-making process.
73. From a debt overhang perspective, non-financial corporations with existing arrears might have less incentives to invest in new projects regardless of how productive these may be when some of their debt is already in default, as any upside of new investment projects would necessarily need to be shared with creditors to service the debt in the first place.

74. Despite the low interest rate environment, higher lending interest rates may be applied by banks in jurisdictions where NPLs are at high levels owing to higher expected credit risk. This may imply high real rates if there is limited competition from other banks or lack of new entrants, which could weigh on credit demand, in particular in Member States facing low growth prospects and therefore subdued inflation dynamics.
75. Furthermore, higher bank lending costs encourage NFCs with strong balance sheets to turn to internal sources of financing while weaker NFCs continue to seek external financing; this lowers the average quality of credit demand and hence the “quality signal” banks (and other stakeholders) get from NFCs which seek bank lending. As a result, NFCs without sufficient internal financing capacity might thus have an incentive to avoid large investment projects which obliges them to request bank lending. NFCs with strong balance sheets and sufficient scale can also get access to low cost finance outside the banking system.
76. Finally, a banking sector experiencing issues with NPLs could have an effect on the risk aversion of NFCs: NFCs without existing arrears but high debt burden might be discouraged by less leeway for banks to show flexibility in case of difficulties. Hence, NFCs refrain from exposing themselves to the risk of becoming dependent on such flexibility by not engaging in possibly profitable but risky projects.

### 3.3.3. Less effective transmission channels for monetary policy and financial fragmentation

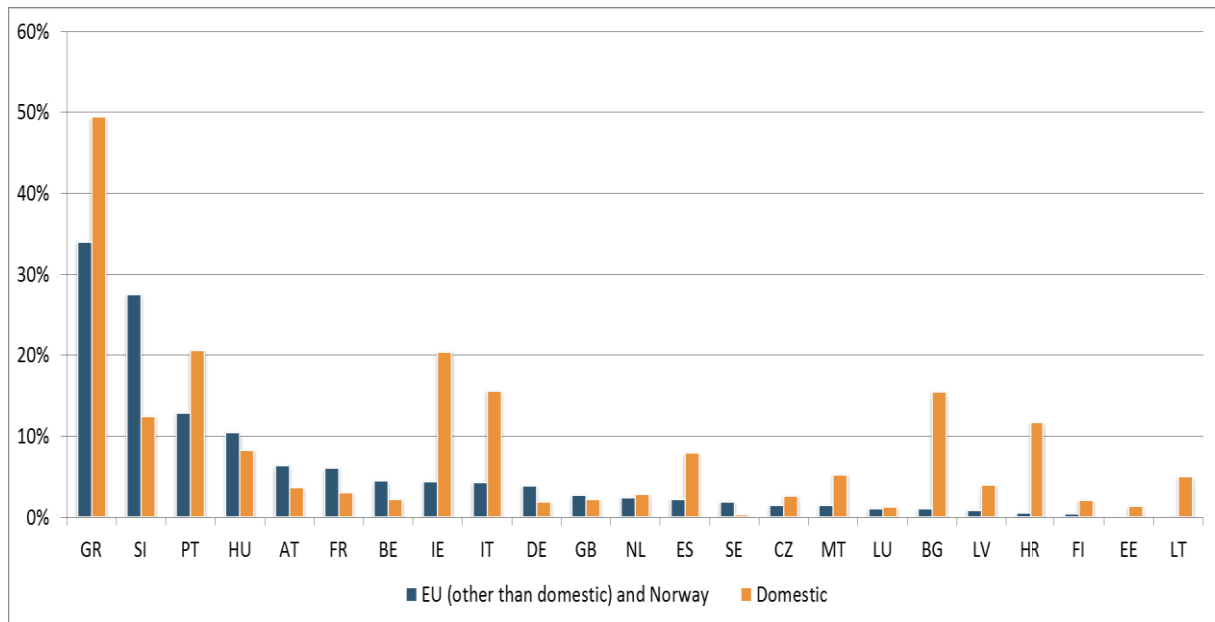
77. To the extent that high stocks of NPLs weigh on banks’ profitability, these may be forced to ration credit and therefore be less responsive to changes in the policy rate. In this respect, high NPLs are of particular concern for some Member States, as the single monetary policy may not be transmitted uniformly to all euro area Member States, in the sense that investors would face higher borrowing rates in those countries where NPL ratios have been high regardless of the profitability of their investment project<sup>36</sup>. This may lead to increased financial fragmentation and the crisis provides evidence of such supply-side driven financial fragmentation, as interest rates charged to private agents have continued to substantially diverge. However, as the interest charged for loans to the real economy are also determined by a number of other factors, it is very difficult to determine whether, and if so to what extent, the transmission of monetary policy has been impacted through this channel by the high stocks of NPLs in some countries.

## 3.4. Feedback loops and cross-border externalities

78. An additional aspect that should be considered when assessing the linkages between NPLs and the macroeconomic environment is the one of possible cross-border spill-overs. Spill-overs are usually expected in the context of crisis developments and the transmission of economic and/or financial shocks through the system. In a deeply integrated system, economic developments are always interlinked and difficulties in one Member State can therefore have a bearing on other Member States also outside of an acute crisis situation, especially when banks have incurred high NPL ratios stemming from their non-domestic EU activities (see Figure 16). Externalities can also occur across the Banking Union and, also, through market perceptions of the banking sector and its resilience from a cross-border (European) perspective.

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<sup>36</sup> A 2014 study by the EIB, based on a sample of 42 large banks of the Euro area demonstrates that, even when controlling for a number of macroeconomic conditions (such as the economic outlook or country-specific interest rates conditions) as well as bank-specific conditions (such as the capital ratio and the size of the bank’s balance sheet), NPL retain an important impact on credit growth: according to this study, a rise of 1 percentage point in the gross NPL stock yields a fall in corporate credit growth of 0.8 percentage point.



**Figure 16: Weighted NPL ratio for total loans and advances in different regions of EU banks' business activity (%)**

(Source: EBA)

79. Spill-over effects in the context of NPLs, subject to a debate on their scope and magnitude, can be due to either indirect or direct channels. The indirect channels relate either to the overall deterioration of the macroeconomic environment: subdued economic growth eventually translates into less import demand (trade channel) and a deterioration of the quality of cross-border holdings of equity and debt of NFCs in the affected Member States (financial channel). In the category of indirect effects one could also mention the transmission of spill-overs across banks in different Member States, e.g. through interbank lending.
80. Direct channels, on the other hand, relate to banks' cross-border lending activities and impact of financial fragmentation. Such lending can be associated either with outward or inward spill-over effects. Inward spill-overs, can occur when the increase in the NPL ratio is also affecting loans handed out by foreign banks (in the context of cross-border lending) and these banks are subject to the same heightened impairment rate. In that case, the foreign NPL exposure can tie up risk capital which is not available for lending activities in the banks home market. Outward spill-overs in this context could occur when banks in one Member States feel encouraged to cut back their cross-border lending activities due to the constraints they face with high NPLs in their home market loan book and thereby reduce credit supply in other Member States. So unless the impact on lending in the affected banks is not compensated by an increase in lending from competitors, both channels can lead to a situation in which problems associated with high NPLs in one Member States can have an impact on credit supply in other Member States.
81. In the context of the Single Resolution Mechanism of the Banking Union, other spill-overs relate to potential recourse to the Single Resolution Fund, if high NPL banks, with thin capital buffers, are proved failing or likely to fail, due to the amount of unprovisioned credit losses and capital shortfalls and if these institutions are put into resolution by the Single Resolution Board and funds from the Single Resolution Fund are mobilized as part of the resolution strategy, consistent with BRRD and SRMR.

## 4. Resolving the NPLs: work in progress

### 4.1. Initiatives to tackle the NPL problem

82. Waiting for a spontaneous resorption of the NPL problem is not a plausible strategy for Europe as it is very unlikely that the issue would be solved by itself in light of the scale and concentration of the problem and the context of sluggish economic recovery. Moreover, the largest macroeconomic challenges tend to be located in Member States that also have high NPL stocks. Mutually reinforcing feedback loops associated with weak incentives for banks to resolve the issue can lead to a vicious circle which can be broken only by means of a concerted multidimensional effort aimed at addressing various drivers of NPL stocks described in Chapter 2.3.
83. This evaluation is shared by policy makers both in individual Member States and at the EU level. Important efforts have been undertaken both at Member State and European level to address high NPL stocks and NPL ratios. A number of policy reforms have already been completed and have started to bear fruit. Other initiatives, such as the SSM supervisory guidance recently issued for consultation or the Commission's mapping exercise of national insolvency regimes, as agreed in the Eurogroup in April 2016 and the ECOFIN in June 2016, are currently underway. Experience shows that reforms aimed at tackling NPLs take time and need to be strengthened before they have a material impact on NPL levels.
84. This chapter develops on some initiatives undertaken or currently underway in individual Member States and at EU level.

#### 4.1.1. At Member State level

85. As mentioned before, Member States faced with the highest NPL ratios have introduced a number of policy measures and reforms aimed at reducing NPL stocks (sometimes as part of a financial assistance program). To illustrate some of the national measures implemented in Member States, by national Governments and supervisors, the report outlines below some initiatives which have been taken in two Member States mainly during assistance programs (Ireland, Spain) that have been discussed within the Subgroup. The measures pertaining to the transfer of NPLs to asset management companies (such as in Ireland, Spain and Slovenia) and subsequent recapitalisation aid to banks, involved state-aid approved by the Commission under the EU State aid framework, which were made prior to introduction of the BRRD. The Banking Communication from 2013<sup>37</sup> already introduced “burden sharing” of subordinated debt holders. The BRRD modified the distribution of losses, by further reducing the possibility to grant capital aid through public funds. This was done to shield taxpayers and require instead a higher contribution to loss absorption from shareholders and creditors.

#### Ireland

86. Ireland has taken a number of measures in this respect since 2010, in the wake of the financial crisis and the burst of the real estate bubble also in the context of a major downsizing and restructuring of the banking sector. These measures include creating an asset management company and several supervisory and legislative measures.

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<sup>37</sup> 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’ ).

87. One of the main messages from the Irish experience is that there is no single measure which would, taken in isolation, reduce the NPLs and that it takes time for the positive actions to give sustainable results. Figure 17 illustrates that only after years from when the first measure was introduced the level of NPL ratios started to decline. The delayed impact is understandable as each positive restructuring experience with a customer takes a long time to agree to legally document, following which trial periods and probation periods delay the return from forborne NPL to performing forborne status, and in some cases positive restructuring experience does not allow for a return to performing status. It is this type of case by case restructuring activity with customers which eventually delivers a reduction in NPLs.
88. In late 2009 an asset management company, namely National Asset Management Agency ('NAMA') was created with public and private capital, and with a Government guarantee on NAMA bonds used to pay for the transferred assets. During the crisis, Irish banks transferred EUR 74 billion of property-related gross loans to NAMA, with the transfer price of EUR 31.8 billion (slightly below their long term economic value - LTEV) entailing a 57% haircut as compared to book value. In the state-aid decision, DG Competition determined that NAMA paid EUR 5.6 billion of state aid to the banks, that being the difference between the transfer price of the loans (LTEV) and market value, compatible with state aid rules related to the treatment of asset relief measures set out in the Impaired Assets Communication from 2009<sup>38</sup>. Aside with the EUR 5.6 billion of state aid, the transfer price forced banks to crystallise losses, amounting to the difference between the book value of the loans and the transfer price. This definitive recognition and crystallisation of the losses led to increasing the potential capital shortfalls of the banks. NAMA was allowed to operate from a rebased asset valuation whilst also recognising the 10 year time horizon over which NAMA was given to work out the assets. NAMA was mandated to avoid fire sales and strike the best balance between a "warehouse" and a "workout" vehicle, seeking the best achievable financial return while dealing expeditiously course with its assets. NAMA also benefited from an initial mix portfolio of UK, US and Irish exposures, focusing initially on the sale of London-based assets, as the Irish real estate market only gradually improved and investor interest intensified thanks to the role of NAMA in catalysing price discovery.

**Figure 17: Evolution of NPL ratios in Ireland and timing of NPL-related supervisory measures.**  
(Source: Central Bank of Ireland)

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<sup>38</sup> Communication from the Commission on the Treatment of Impaired Assets in the Community Banking Sector, February 2009.

89. Ireland started with diagnosing the scale of the NPLs problem and carried out an asset quality review and PCAR<sup>39</sup> stress test in 2010/2011, in the context of the financial measures programme. This quantified the additional capital necessary to ensure that banks had sufficient resources to cover losses and return to viability. Banks with non-viable business models were shut down or integrated in more solid banks. For other banks, several subsequent recapitalisation and provisioning initiatives / reviews took place in the following years. Those recapitalisation initiatives gave a positive signal to the investors and the public that Irish banks had appropriate financial resources and associated restructuring ensured that they return progressively to profitability and were thereby again able to raise private capital and funding.
90. It was also important that the Irish banks had credible portfolio-specific NPL resolution strategies. In order to achieve this, the banks were required to establish well-developed and sustainable restructure types which corresponded to the portfolios being restructured, as well as to have in place effective data capture tools, IT infrastructure, expertise and decision analytics, which involved significant changes in the internal organisation of banks.
91. As from 2011, Ireland took a number of supervisory measures on banks' provisions, NPL classification and targets. Distressed credit operations review contained benchmarking of operational capacity to execute NPL strategies. This exercise led the Central Bank of Ireland (CBI) to issue in 2013 a framework for setting SME and mortgage arrears restructuring targets for certain banks. It is important to mention that these targets were for restructuring and enforcement activity, rather than a hard NPL or NPL ratio targets.
92. It is the combination of improved arrears management operations in the banks with strong supervisory challenge which has led to a strong reduction in NPLs in these banks since peak 2½ years ago, though the NPL ratio has fallen less due to deleverage. A large quantum of presumably sustainably restructured cases remain in NPLs at the present time due to probation periods<sup>40</sup>.
93. The Irish Government passed the Personal Insolvency act on 2012 which provided for the introduction of three types of debt resolution mechanism: the Debt Relief Notice (DNR), the Debt Settlement Arrangement (DSA) and the Personal Insolvency Arrangement (PIA). This legislation also introduced changes to the bankruptcy regime, including the automatic discharge from bankruptcy, subject to certain conditions, after three years (replacing a 12-year condition), releasing the bankrupt from his debts. Recent legislation has since reduced this to one year. The Personal Insolvency Act was amended in 2015 and introduced further changes to the insolvency process, including a strengthening of the powers of the Insolvency Service of Ireland and provisions which allow for a debtor to request a review by the court where a home loan PIA was rejected by creditors.

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<sup>39</sup> Prudential Capital Assessment Review

<sup>40</sup> While loan sales and enforcement have featured in the strategies of the banks the majority of the improvement has been made through consensual restructuring agreements between the banks and customers. It should not be understated how difficult and lengthy these agreements can take for a myriad of reasons including multiple borrowers, cross-secured properties and businesses, divorce, separation, emigration etc. In cases of consumers significant and appropriate protections are required which can also delay the process, but not the result.

94. According to Irish authorities, cultural change within the banks and their management is crucial for the timely and cost effective resolution of NPL stocks. Supervisory focus was needed to keep the momentum and to ensure that management's attention did not get diverted. While Irish banks have made positive progress on cash collection from NPLs, greater disclosure is required for investors and supervisors. The legal process of reducing NPLs is long for mortgages but has not delayed the banks reducing NPLs as they have adapted their strategies by widening the range of restructure types available. Further work is required to reduce NPLs but due to the sheer size and scale of the crisis in Ireland a return to a low level will be a protracted process.

## Spain

95. Spain has taken a broad number of measures to reduce the stock of NPLs, particularly since the beginning of 2012. Their focus has been mainly on NPL recognition, provisioning requirements and transparency. As a result, and despite the time necessary to bear fruit, the NPL ratios started to decline and have been continuously doing so since the beginning of 2014.

96. In 2012 Spain adopted a number of measures to increase the recognition of more realistic NPLs levels<sup>41</sup> and provisioning requirements, by virtue of two Royal Decree Laws. They focused on the main problem areas, notably the cleaning-up of balance sheets as regards real-estate development exposures. Enhanced requirements were put into place in two rounds: first, mainly as regards recognition and adequate provisioning of non-performing exposures and foreclosed assets related to that sector. Furthermore, additional provisions were required for performing real estate loans as they had the potential to end up in the problematic portfolios due to the burst of the real estate bubble.

97. During the same year Spain carried out an independent evaluation (by consultants, auditors, collateral appraisers) of the whole banking system, as part of the memorandum of understanding for the restructuring and recapitalisation of the Spanish banking sector, in the context of the financial assistance programme signed with the EU Commission and other EU institutions. During such evaluation, the adequate classification of NPLs (focusing again on real-estate development exposures and foreclosed assets, but also including the rest of the portfolio) and the sufficiency of provisions were revised (asset quality review), with an in-depth analysis of credit files and real estate appraisals. In addition, a two-fold stress test (top down and bottom up) was conducted to give transparency about where the pockets of vulnerabilities were and to disentangle them from the healthy part of the banking sector (the vast majority), also paving the way for a recapitalisation of the weakest part of the Spanish saving banks involving public funds. State recapitalization was associated with the implementation of in-depth restructuring, consolidation and sometimes integration into a more solid bank.

98. New stricter rules for balance sheet transparency were also imposed in order to improve quality and quantity of information provided by the banks (both to supervisors and markets). The enhanced disclosure requirements apply to all entities and as regards the key areas of their portfolios (restructured and refinanced loans, NPLs, provisions, foreclosed assets, sectorial concentration, particularly the real estate development sector, etc.).

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<sup>41</sup> To ensure the timely recognition of NPLs, the Bank of Spain has traditionally issued banking circulars ('Circulares') in order to regulate the accounting practices of credit institutions. The 'Circular 4/2004' (Annex IX) defines essential elements in order to force Credit Institutions to have a robust credit risk management and control system, at the time that establishes specific rules for credit portfolio classification and minimum allowances to cover the credit risk. This rule was reinforced throughout the crisis with stricter criteria, focusing mainly on earlier and more conservative recognition of credit losses. As an example, it was introduced a requirement to write down NPLs to collateral value in one year, with the application of conservative haircuts to collateral values.



99. An asset management company ('SAREB') was created at the end of 2012 from a mix of public and private funds, in order to transfer into this asset management company the most problematic exposures from the weakest banks. Real estate development loans (performing and not performing) and foreclosed assets for a total amount of EUR 51 billion (net book value) were transferred to SAREB, after an average discount of 53% based on the long-term real economic value found compatible with state-aid rules on asset relief measures. Similarly to the Irish case, assets were acquired with State-guaranteed bonds. This had a positive one-off effect on NPL volumes, leading to the restructuring of the banking sector. By the end of 2015, more than 15% of SAREB assets have been disposed. Contrary to Ireland, the vast majority of the Spanish banking sector measured by total assets did not receive state recapitalisation and did not transfer any NPL to the asset management company; they covered the capital needs resulting from additional provisioning (if any) through internal or external private resources, managed their NPL internally, and started to sell loans before SAREB did.
100. Within the framework for NPL recognition and transparency, Spain also established stricter classification criteria on forbearance in 2013, which was in line with the later EBA's definition. This resulted first in an increase of the number of NPLs. However, the new data requirements on FBLs have showed the notable improvement over the last couple of years.
101. At a later stage in the process, in 2014-2015 insolvency framework reforms were introduced. The aim of the reform was to increase the efficiency and legal certainty in insolvency procedures, while ensuring that non-viable debts were resolved quickly and that viable debts were repaid by companies that were able to continue with their activities. The reform, aiming at striking a proper balance between creditors and debtors, focused on three topics: enhancing out-of-court agreements, simplifying of in-court insolvency procedures and re-designing the judicial administration.
102. As the result of all those measures and of the improving macroeconomic outlook, Spain has managed to decrease the NPL ratios from 8.83% in September 2014 to below 6% in December 2016.

### Other experiences

103. To address the high levels of NPL, other Member States also carried out specific actions, though not discussed in detail in the Subgroup, also entailing a comprehensive menu. For instance in Slovenia, the package combined a comprehensive assessment in 2013 and recapitalisation plans, regulatory and supervisory measures, the setting-up of a public AMC (found compatible with the State aid rules) and insolvency reforms. In Italy, in August 2015, the government introduced a new legislation (Law No.132/2015), amending the procedures for firm's liquidation and restructuring and the foreclosure of assets, aiming to increase the speed and efficiency of insolvency procedures and property foreclosures, and to promote higher recovery rates for creditors. Further amendments to the insolvency and foreclosure framework aimed at reducing the recovery time of collateral were introduced in April 2016. In particular, a digital register on judicial property foreclosures and insolvency proceedings has been created, which will improve availability of information for the valuation of NPLs. Another initiative to support the securitisation of NPLs ('Garanzia Cartolarizzazione Sofferenze - GACS) was approved in February 2016, which envisages a state aid-free guarantee mechanism to be used to facilitate the removal of bad loans from the banks' balance sheet. It is a state guarantee scheme on the senior tranches issued by special purposes vehicles to be set up in order to securitise NPLs. The scheme is open to all banks on a voluntary basis and is priced at market value. In addition, the supervisory authority took several ad hoc steps, including a specific campaign on provisioning between 2011 and 2012 and the recent launch of a very detailed supervisory reporting on bad loans, aimed at promoting a proactive management of NPLs and the development of the NPL market.

104. In Portugal, in the context of the economic and adjustment program, some measures were also implemented namely (i) at the judicial and legal levels (e.g., two new procedures - one in-court and another out-of-court - were set up to deal with viable but financially distressed firms and an early warning system was developed to incentivize viable firms in financial distress to use those procedures at an early stage); and (ii) the supervisory level (e.g., on-site inspections leading to a significant increase in the amount of impairments recognized by banks and to a revaluation of the collateral; and the assessment of the recovery/restructuring units of the main PT banks).
105. In a similar vein, in Greece a number of initiatives have also been implemented within the context of the economic adjustment programme. At the supervisory level, the Bank of Greece has issued guidelines regarding the management of NPLs (corporate governance, portfolio segmentation, restructuring solutions, IT systems, etc.), enhanced the prudential reporting requirements, issued a Code of Conduct and established, in close cooperation with the SSM, a framework for NPE operational targets and monitoring indicators for banks. Furthermore, household insolvency regime was revisited to target protection to vulnerable households (by the introduction of income and wealth criteria, documentation requirements and a condition of borrower cooperativeness), the Code of Civil Procedure was simplified in an effort to accelerate legal proceedings and auctions and ensure a fair distribution of liquidation proceeds, and additional Judges were hired and trained to reduce bottlenecks and the framework for a secondary market for NPL servicing and sales was established.
106. In Cyprus, also in the context of the economic adjustment programme, a comprehensive strategy was implemented by the Cyprus authorities based on three pillars: strengthened regulation and supervision of banks, reform of the legal framework and development of a market for distressed assets. The reforms included an overhaul and modernisation of the insolvency framework and other legal reforms<sup>42</sup>, a number of supervisory and regulatory steps to improve NPL management and transparency, guidelines on valuation and accounting for NPLs, as well as the removal of obstacles to loans sales.

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<sup>42</sup> The establishment of a new foreclosure framework so as to minimize the time and cost of recovery from assets pledged as collateral, suspension of tax on real estate transfers agreed under debt restructuring so as to accelerate foreclosure through encouraging voluntary debt for asset swaps.

### Japan's strategy for tackling NPLs

During Japan's economic crisis, the economic downturn and price deflation in the 1990s contributed to the growing levels of NPLs, particularly in the late 1990s and the early 2000 (Fujii and Kawai, 2010). However, despite the low growth and low inflation environment<sup>43</sup>, the major Japanese banks were eventually able to reduce the ratio of NPLs held in early 2002 (8.4%) by half as of 2004 (Gomi, 2007), although there were delays in the recognition of NPL and significant capital depletion. This ratio fell below the 3% threshold in 2005, showing an improvement of the banks' assets structure in less than three years (Kawashima and Nakabayashi, 2014). Nelson and Tanaka (2014) consider that the enacted reforms were compelling and vital to allow the Japanese banking system getting back to a sustainable path for recovery.

The root cause of the NPL issue in Japan was the asset impairment that the Japanese banks suffered following the disruption of land prices in the country (Bank of Japan, 2002 and Inaba et al, 2005). The Bank of Japan (2002) detailed a list of foreseen principles to address the issue which were classified into three main categories: (i) conducting a relevant analysis of the economic value of NPLs, (ii) boosting the competitiveness of banks and firms, and (iii) securing the financial system stability. The Japanese Government subsequently undertook a series of actions in response to the NPLs problematic issue, divided into two main objectives: (i) supervision and restructuring of banks, and (ii) facilitation of the disposal of NPLs.

#### Supervision and Restructuring

In terms of supervision, the Japanese Financial Supervisory Agency (JFSA) was established in 1998 as an independent body (Kawashima and Nakabayashi, 2014) which took over the supervisory responsibility from the Ministry of Finance (Nelson and Tanaka, 2014). The JFSA carried out intensive inspections at major banks through a cooperation with the Bank of Japan (Gomi, 2007). The JFSA focused on strengthening the regulatory standards to improve the disclosure of NPLs and reinforced the provisioning standards against NPLs. Moreover, the JFSA created a financial inspection manual in 1999 in which it set out a standardised scheme to analyse the proportion of "*system-wide underprovisioning*" and put forward explicit guidelines for provisioning (Nelson and Tanaka, 2014).

Additionally, the Japanese Government made available up to JPY 30 trillion (approximately EUR 247 billion) of funds through the Deposit Insurance Corporation of Japan (DICJ), injecting public funds consecutively in 1998 and 1999 worth JPY 9.3 trillion (approximately EUR 77 billion). In 2003, the Japanese Government deployed an additional JPY 47.1 trillion (approximately EUR 356 billion), composed of capital injections (JPY 12.4 trillion - approximately EUR 95 billion) and monetary grants (JPY 18.9 trillion - approximately EUR 144 billion) (Fujii and Kawai, 2010). Monetary grants were used to implement an orderly closure for failed banks, comprising the costs relative to blanket deposit guarantees, while capital injections were used to recapitalise financial institutions. While nearly all the costs related to capital injections were recovered by 2008, more than 50% of the monetary grants were not recovered, resulting in costs to the taxpayer.

#### Facilitating the disposal of NPLs

The Japanese Government implemented a Financial Reconstruction Program (FRP) from 2002, aimed at repairing and rebuilding market confidence and allaying the existing instability. The FRP was based on three pillars: (i) a new framework for the financial system, (ii) a new framework for company reconstruction, and (iii) a new framework for financial administration (Gomi, 2007 and Endo, 2013). The first pillar focused on creating a monitoring system, the second increased the use of reconstruction programs and the third aimed to enhance the governance of banks and to raise standards for asset valuation (Endo, 2013).

<sup>43</sup> Japan experienced a low, but gradually increasing GDP growth in the 2002-2004 period (its GDP grew by 0.28% in 2002, 1.73% in 2003 and 2.32% in 2004). The country experienced negative or almost zero inflation during the same period (-1.31% in 2002, 0.17% in 2003 and -0.01% in 2004 (IMF database)).

Furthermore, the Resolution and Collection Corporation (RCC) was created by the Japanese Government as a subsidiary of the DICJ. The RCC was an asset management company which bought NPLs from failed banks from 1998 to 2005 worth JPY353 billion (approximately EUR 2.58 billion). Fujii and Kawai (2010) consider that the RCC allowed banks to eliminate troubled assets from their balance sheets, despite the lack of market demand.

In addition, the Industrial Revitalization Corporation of Japan (IRCJ) was created in 2003 to accelerate NPLs disposal with the aim of cutting the latter by half in two years (OECD, 2003). The IRCJ purchased loans obligations from the firms' non main banks to promote the restructuring of these troubled but viable firms. The objective was to leave the firms' main bank<sup>44</sup> and the IRCJ as the main creditors (Alexander and Dhumale, 2012) to help large firms restructure financially (IMF 2003). Before being shut down in 2007, the IRCJ even managed to generate a small profit (Kang and Syed, 2008).

By way of conclusion, as Fujii and Kawai (2010) put forward, a government-funded asset management company is necessary to remove impaired assets from bank balance sheets. This asset management company can be complemented through a recapitalization of viable but under-capitalized banks to reinforce market confidence and minimise taxpayers' costs.

### **Box 1: Japan's strategy for tackling NPLs**

#### **4.1.2. At European level / European framework**

107. In the last years, EU supervisors have taken several coordinated steps to improve asset quality, in particular starting with the 2013 EBA recommendation on EU-wide AQRs and ECB's Comprehensive Assessment in 2014 (Asset Quality Review - AQR and Stress Test) of 130 large European banks, which used the newly harmonized EBA definition allowing for better comparability and increased transparency.
108. As a result of the 2014 AQRs, a further EUR 135.9 billion of performing loans were re-classified as NPLs from EUR 743.1 billion to EUR 879.1 billion in SSM supervised banks. This shows that AQRs are very effective when it comes to assessing the health of bank balance sheets on a granular basis, as stress tests alone give less insight in this respect and tend to focus on a limited sample of banks. The 2014 and 2015 comprehensive exercises were important prerequisites and resulted in more clarity on bank exposures, sounder provisioning policy and have fostered, on average, a gradual reduction in the stock of NPLs. Still, the improvements are slow and uneven, also due to some structural impediments to the management and resolution of NPLs.
109. In many cases, there are already initiatives in place, and cooperation among EU institutions and supervisors in this field. After the 2014 ECB Comprehensive Assessment, supervisors have strengthened their regular monitoring of asset quality, with initiatives carried out by national competent authorities and, particularly, the SSM for the euro area banks, following the creation of the Banking Union.

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<sup>44</sup> A distinctive feature in Japan was that practically every large corporation used to maintain a business relationship over the years with a specific bank, the so-called main bank that monitored the firm and held equity holdings of the corporation (Wu and Yao, 2011).

## 4.2. Multiple work streams identified to overcome obstacles to NPL resorption

### 4.2.1. Implementation of new supervisory standards increasing supervisory expectations towards NPL management

110. On 12 September 2016, the SSM launched a public consultation on a guidance to banks on how they should tackle NPLs, acknowledging that NPLs remain a key supervisory priority in the Banking Union given the credit-risk associated with NPLs in the most affected euro-area banks. The consultation is open until 15 November 2016 and the final guidance for banks is likely to be published at the beginning of 2017.
111. The guidance is to be addressed to all significant institutions supervised directly under the SSM, including their subsidiaries, both national and international. Principles of proportionality and materiality apply, as parts of the guidance on NPL strategy, governance and operations may be more relevant for banks with high levels of NPLs, e.g. above the EU average published by the EBA. Currently the guidance is not addressed to less significant institutions directly supervised by national competent authorities (NCAs).
112. The guidance is a non-binding instrument; however, deviations should be explained by banks and substantiated upon supervisory request. The guidance will serve the supervisor as a basis for evaluating banks' handling of NPLs, as part of the regular supervisory dialogue and in the case of non-compliance, may trigger supervisory measures, including adjusting the pillar 2 requirement of the bank. It is said to be qualitative at this stage, as the supervisor does not set out quantitative requirements in the guidance on targets for NPL disposals, provisioning requirements or haircuts on collateral valuations.
113. The NPL guidance addresses the main aspects regarding strategy, governance and operations, which are key to successfully resolving NPLs and adapting the organisation of banks, loan quality monitoring and risk-management practices. The guidance provides recommendations to banks and sets out a number of best practices that the SSM has identified and that will constitute the SSM's supervisory expectations going forward.
114. The guidance recommends that banks with a high level of NPLs establish a clear strategy aligned with their business plan and risk management framework to effectively manage and ultimately reduce their NPL stock in a credible, feasible and timely manner. The bank's strategy should include the setting of quantitative targets over "realistic but sufficiently ambitious time-bound horizons" by portfolio (retail mortgages, retail consumer, retail small businesses and professionals, SME corporate, large corporate, commercial real estate) and a detailed plan by implementation option (e.g. cash recoveries from hold and forbearance strategy, collateral repossessions, recoveries from legal proceedings, revenues from sale of NPLs or write-offs).
115. The guidance urges banks to put in place appropriate governance and operations structures to deliver effective NPL workouts across the life-cycle of NPLs (e.g. early arrears, late arrears and restructuring, liquidation and debt recovery in legal proceedings, management of foreclosed assets) and also develop the appropriate infrastructure to apply a portfolio segmentation approach to group borrowers with similar characteristics. This should be done by closely involving the bank's management, setting up dedicated NPL workout units, with better staffing and possibly servicing agreements, and establishing clear policies linked to NPL workouts.

116. The guidance provides short-term and long-term options on viable forbearance solutions with the aim of returning the exposure to a situation of sustainable repayment following an affordability assessment for the borrower, thus avoiding “extend and pretend” arrangements. It guides banks on how to measure impairment and write-offs in line with international recommendations.
117. Finally, the guidance also outlines the policies, procedures and disclosures banks should adopt when valuing immovable property held as collateral for NPLs and updating valuations on market values.
118. When implemented, banks will be expected to apply the guidance proportionately and with appropriate urgency, in line with the scale and severity of the challenges they face.
119. In mid-term, the SSM intends to extend the scope of the guidance based on the continuous monitoring of developments concerning NPLs. As a next step in this regard, the SSM plans to gradually put a stronger focus on the timeliness of provisions and write-offs. It should also be ensured that less significant institutions are equipped with the adequate tools to deal with NPLs.

#### 4.2.2. Increased transparency on asset quality

120. Harmonised definition of non-performing loans introduced by the EBA in 2014 (see Annex 2 on asset quality metrics) and more extensive disclosure requirements related to default (capital framework definition) and impaired (accounting framework definition) loans in pillar 3 frameworks should improve the transparency and disclosure with regard to NPLs in financial institutions' financial statements, combined with the introduction of IFRS 9, providing market participants with more clarity and granularity on the quality of assets of European banks.
121. According to ESMA's 2013 review of accounting practices related to the comparability of financial statements of financial institutions, approximately three quarters of the financial institutions reviewed already included a reference to non-performing loans in their IFRS financial statements. Certain financial institutions made reference to defaulted loans but often such loans were similar to those classified as non-performing in other sets of financial statements. When both terms were used, the distinction between them was however not always clearly explained.
122. Furthermore, approximately two-thirds of financial institutions that referred to non-performing loans included an explanation of the relationship between non-performing loans and impaired loans. However, generally this disclosure was limited to a comment that non-performing loans are considered to be impaired.
123. In its report, ESMA encouraged financial institutions to provide a clear definition and explain the relationship between NPLs, defaulted exposures and impaired financial assets. Such clear presentation of this relationship enhances comparability and provides users and investors with valuable information regarding the quality of the loan book as a whole. ESMA also encouraged financial institutions to use the EBA definition of non-performing loans.
124. Financial institutions also used in their disclosures a wide variety of terminology when describing impairment. These practices might have an impact on the transparency and comparability of the financial statements among financial institutions. ESMA identified that financial institutions often referred to prudential requirements but provided insufficient disclosure to identify and understand the adjustments made to prudential parameters or provided the information on adjustments in an unclear manner.
125. Enhancements regarding the disclosure of information on NPLs using a consistent definition – the EBA NPE definition – and a consistent format, which ensures a common minimum level of granularity, have already been observed as regards regulatory disclosures.

126. Regulatory disclosures, known as Pillar 3 disclosures, are the set of information on risks that banks are required to disclose in accordance with the Capital Requirements Regulation. As part of these disclosure requirements, banks usually provide information on their impaired, past-due and defaulted exposures, as defined in Article 178 CRR.
127. Furthermore, in accordance with the EBA draft guidelines on disclosure requirements<sup>45</sup>, all banks (not only IFRS) will be required to publish data on NPLs and FBLs as part of Pillar 3 disclosures.
128. The Guidelines require banks to disclose information on performing and non-performing exposures as well as on their performing and non-performing forborne exposures. The respective template covers information about the exposure amount, past due status, valuation adjustments considered and information on collateral. Further information is required about impaired and defaulted exposures within NPEs, explanations for differences between these groups of assets, plus reconciliation of different definitions for the sake of transparency and comparability.
129. The Guidelines shall be applicable for all banks by year end 2017. Global Systemically Important Institutions (G-SIIs) and Other Systematically Important Institutions (O-SIIs) are encouraged to an early application by end 2016.<sup>46</sup>
130. At the international level, the Basel Committee has consulted on a definition for non-performing exposures, which is recommended for disclosures and in general consistent with the EBA definition<sup>47</sup>.
131. In parallel to the enhancement of the regulatory disclosure requirements, supervisors have already acted to make available consistent information on non-performing exposures following the EBA definition. In particular, the major European banks have disclosed on the EBA website a subset of the reporting templates on non-performing exposures and forbearance. These disclosures cover the amount of non-performing exposures, with the separate identification of defaulted exposures within, the amount of past-due performing exposures, as well as the outstanding value adjustments and collateral against non-performing exposures.
132. Disclosures have become a regular feature in the EBA stream of individual bank data disclosed centrally on its website, since data were disclosed for the 2015 Transparency Exercise (data as of December 2014 and June 2015), the 2016 Stress tests (data as of December 2015) and will also take place as part of the scheduled 2017 Transparency Exercise.

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<sup>45</sup> Consultation Paper Guidelines on disclosure requirements under Part Eight of Regulation (EU) 575/2013 EBA/CP/2016/07.

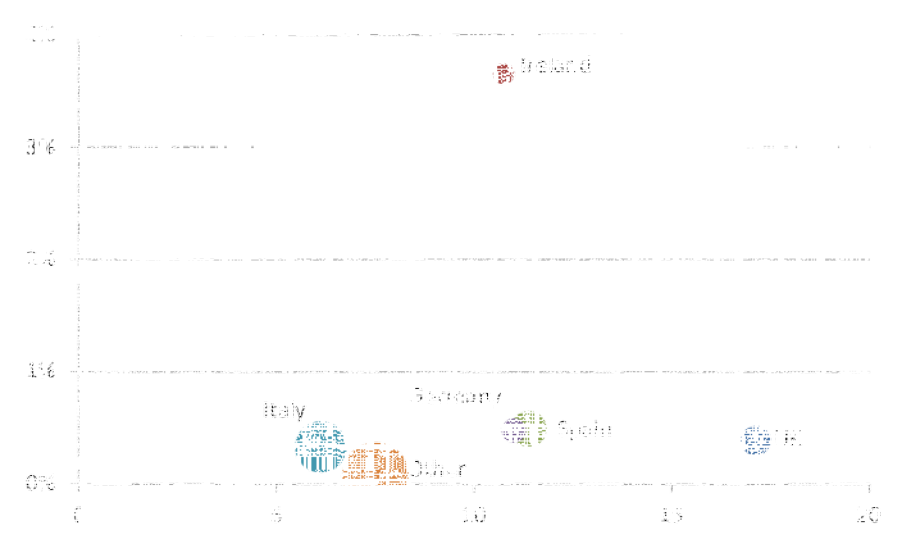
<sup>46</sup> The EBA intends to advice to do so for G-SIIs and refers to national supervisors to do so in respect of O-SIIs.

<sup>47</sup> Consultative Document Guidelines Prudential treatment of problem assets – definitions of non-performing exposures and forbearance <http://www.bis.org/bcbs/publ/d367.pdf>

### 4.2.3. Impediments to the developments of liquid secondary markets

133. Well-developed liquid secondary markets for non-performing loans and distressed assets could have benefits for banks facing high stocks of NPLs and seeking to engage in active NPL portfolio strategies. In particular, where the bank does not have the in-house expertise (in particular small and medium-sized banks) to tackle large volumes (or numbers) of non-performing loans, outside investors could bring in the needed capacity. Furthermore, the ability to offload NPLs, removes the uncertainty linked to the valuation of NPLs (including collateral) on the bank's balance sheet, providing market participants with more clarity on the situation of the bank and its asset quality. Finally, the sale of NPLs could free up regulatory capital for new lending activities, when the loss incurred by the difference between price and net book value is smaller than the gain in RWAs that results from the offloading of the impaired assets. Due to the high amount of NPLs present in some Member States, private secondary markets will probably not be able to absorb all NPLs. However, they may be an interesting option for some banks with high NPLs.
134. It is worth noting that the existence of a well-developed, liquid, secondary market for NPLs does not necessarily need to be limited to those jurisdictions where significant parts of the banking sector suffer from high NPL ratios, but can also be a useful tool for the ongoing active management of the balance sheets of banks, even in the absence of financial strains (i.e. when NPL ratios are low).
135. However, it is worth noting, also, that the sale of NPLs is not always the most appropriate course of action for banks with high NPL ratios. Provided those banks are sufficiently capitalised, that the loans are adequately provisioned, and the necessary specialist capacity to work-out the NPLs is available, the banks may wish to keep the NPLs on their balance sheets in a hold and restructuring strategy if this option maximises value in the medium term. Banks may also be unwilling to sell large volumes of consumer or SME loans given political sensitivities over the attitude of investment funds towards enforcement action. Alternatively, they can also keep the loans on the balance sheet and outsource the servicing of the loans, when they come to the conclusion that they lack the expertise to restructure and/or resolve the impaired loans. However, experience appears to show that maintaining NPLs on the balance sheet often creates uncertainties and undermines confidence.
136. Nevertheless, despite the number of possible benefits of secondary markets for NPLs, the number and size of transactions remain limited, throughout Europe, with the exception of the UK and Ireland. While transactions have shown some growth over the recent years, in particular in some markets (e.g. Italy), impediments for the efficient functioning of such markets remain.





**Figure 18: Transactions with loans in EU countries (billion EU and % of carrying amount of total loans and advances)<sup>48</sup>**  
 (Source: PwC Portfolio Advisory Group, Consolidated Banking Data (ECB) and ESRB Secretariat calculations)

137. NPLs markets are sometimes characterized by large bid/ask spreads and therefore it is often hard to establish a reference price. This is in part due to a tedious price-discovery process often related to the absence of liquidity. On the one hand, sellers of NPLs tend to be reluctant to accept heavy losses or can be overly optimistic regarding the final expected recovery value, sometimes linked to the underlying collateral or the sustainability of forborne loans and the valuation of loan management costs. On the other hand buyers may have limited information on the exact financial stance of the credit portfolio in question, and will thus be willing to pay less as they price in potential restructuring costs and an additional risk premium. At the same time investors normally aim for a higher internal rate of return than the discounting rate used by banks for a number of reasons, in particular intrinsic differences in the expected return and also differences in their respective funding costs. The effect on the valuation of NPLs due to different discounting rates used by banks or investors will be more important when the recovery procedure (judicial and extra-judicial) is long. Market evidence suggests that more predictable and shorter insolvency procedures can contribute to reduce the differences in valuation of NPLs.
138. Information asymmetries play a major role amongst the reasons for the limited number of transactions. One line of argument suggests that the market suffers from a 'lemons' problem. Through provisioning, banks bring the net book value of the NPLs held closer, although not equal, to their market value. However the loans most likely to be heavily provisioned are those least likely to have a reasonable recovery rate. As a result the selling banks may focus on really weak loans which investors are only willing to buy at deep discounts. After disposing of their worst loans, banks may wish to move on to higher quality assets, investors however would have become used to expect low quality assets and would only be willing to pay a low price, resulting in a large bid-ask spread.

<sup>48</sup> Note: The X-axis represent the average of the transactions with NPLs during the period 2012-June 2015, as reported by the PwC Portfolio Advisory Group. The Y-axis represent the percentage which these transactions mean over the total stock of loans, as of Q3-2015, as reported in the CBD. The size of each bubble shows the size of the stock of NPLs as of Q3-2015, as reported in the CBD.)

139. An alternative explanation for the large bid-ask spread posits that banks do not have realistic expectations regarding the selling prices of the NPLs, as not all relevant costs are provisioned. Banks may also be too optimistic regarding the recovery value of the loans, and where applicable, the underlying collateral. Anecdotal evidence suggests that banks rarely provision disposal and additional management costs, as they are included in operational expenses in the profits and loss, whereas a potential buyer would need to factor these costs in, thereby also contributing to a gap between bids and ask prices<sup>49</sup>.
140. In addition to the general information asymmetries, there are various impediments to the proper functioning of secondary markets, some of which are fully within banks control, others entirely external, and some only partly under the influence of banks.
141. The first internal impediment is the lack of management and operational expertise within banks to properly organise the sale of non-performing loan portfolios. Where such expertise is not available in house, for instance for smaller banks, such expertise may need to be brought in from outside (see also paragraph 114).
142. A second internal impediment is the lack of adequate data (both qualitative and quantitative) for the loans being sold. Poor loan tape quality can pertain to the terms and conditions of the non-performing loans themselves, the borrowers or the collateral. Insufficient data makes it harder for potential investors to adequately value the loans being sold, which in turn increases the uncertainty about the real value of the assets and the risk premium.
143. A final purely internal impediment could be a limited willingness to sell on the side of the banks. There could be various possible causes for this. On the one hand, if a bank is capital constrained, it could be unwilling to sell NPLs below net book value thereby potentially realising losses. Banks may also be willing to cherry-pick assets leading to adverse selection problems for the loans being sold, while seeking to maintain customer relationships. Finally, there may be a first mover disadvantage, where banks may be willing to wait for competitors to sell their loans first, thereby improving the secondary market for NPLs and lowering bid-ask spreads.
144. The first factor that is partly within banks influence is the availability and cost of debt financing for potential investors. In order to bridge the expectation price gap, distressed debt investors often look to leverage their investment, limiting the equity involved. To this end, banks selling NPLs can provide vendor financing, possibly on concessional terms in order to ease the sale of NPL and limit capital depletion associated with the offloading of the portfolio. However, the provision of vendor financing partly negates the value of a sale for the banks since they would replace the NPL with a credit exposure whose credit risk depends on the recovery value of the NPLs sold. The provision of vendor on concessional terms can have the mere effect of shifting losses from one category of assets (NPL) to another set (loans to funds).
145. The second factor partly in the hands of banks is the deal making process. As investors may want to deal with multiple banks, they hold a preference for a standard and predictable deal making process, rather than having an entirely ad hoc experience each time around.
146. A key external impediment is investors' expectations on the macroeconomic outlook. A recovery narrative is helpful, but not necessary, for potential investors to buy into the idea of purchasing NPLs. If the economy is expected to decline further, investors would rather wait and see or buy with a higher risk premium. Conversely, if the outlook is decisively positive, banks may have incentives to hold onto their NPLs in the hope that the assets would recover naturally.

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<sup>49</sup> For an analysis of the differential between book value and sale price see Ciavoliello et al.

147. Two interrelated external factors are the costs of recovery (valuation, work out costs, fees for intermediaries, etc.) and the time for recovery of non-performing loans and discount of the investment. The assets become less interesting the higher the costs (as the net amount recovered is lower) and the longer the time needed to recovery (time value of money). Related to the costs and time for recovery is the existence of potential legal and judicial issues. Long foreclosure procedures and the absence of specialised judicial capacity may quickly cause delays in loan and collateral enforcement.
148. Another important possible impediment is the availability of servicers able to manage the portfolio of loans on behalf of the potential investors, to enforce collateral or restructure loans depending on the investment strategy. While the market for NPLs is dominated by a number of large global players with servicing expertise, when moving to a new jurisdiction, such investors must be able to manage the pool of loans they acquire, hence needing the expertise of loan servicers in that specific jurisdiction. Where such services are not directly available, impediments for their establishment should be removed, allowing the potential investors to set up such services more quickly and efficiently.
149. A number of Member States have set up centralised asset management companies (AMCs) to tackle some of these impediments and contribute to kick-starting the market. As regards the internal impediments, by having to deal with the AMC rather than with a number of individual financial institutions, the deal making process becomes more straightforward, partly solving the creditors' coordination problem, and allows for the building of relationships over multiple transactions. Furthermore, AMCs tend to operate with a clear mandate to acquire and then dispose of NPLs (in general after having initiated the restructuring of the loans), thus addressing any willingness to sell issues, often being the first mover in the market. In addition the AMC could contribute to improving the availability and quality of data. In general, AMCs are perceived as more efficient if they focus on one asset class (with homogenous assets) and as they could bring in expertise for that specific asset class to all banks that do not have the capacity to develop in-house servicing of the required quality.
150. As regards the external impediments, the AMC will probably require external servicers with aligned incentives<sup>50</sup> to manage the loans it acquires, thereby putting in place strong incentives for the development of this industry (as in the case of SAREB in Spain). As a state-sponsored AMC would create a contingent liability on the government, there are strong incentives for the government to address issues related to the time and costs of recovering NPLs. Finally, so far many AMCs in Europe have been part of an overall macro-economic strategy (e.g. as part of a macroeconomic programme associated with European-funded financial assistance) and banking restructuring, which helps strengthen the macroeconomic outlook and often includes conditions to address some of the other impediments.

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<sup>50</sup> If NPL management is kept in the original credit institutions they would naturally tend to focus on their own NPLs and leave behind the AMC's NPLs.

151. AMCs can be private or state-sponsored and in that case may involve or not State Aid. In the wake of the crisis, a number of AMCs have been set up with private capital, generally in the form of work-out units set up by one or a few individual banks<sup>51</sup>, in some cases also with external capital and management capacities, and focusing on specific assets classes on a relatively small scale. Some AMCs have also been set up with State aid-free public capital, meaning that the public participation was priced at market price, consistent with the market investor principle<sup>52</sup>, and the purchase of the loans was at market price. AMCs can also be state-supported and involve a state-aid element. While such state aid-supported AMCs, usually of a larger magnitude, can help kick-start secondary markets for NPLs, they must abide by the EU's state aid rules. In the past in Ireland, Spain and Slovenia, the AMCs were allowed to acquire NPLs at a price above their current (estimated) market price. However the transfer price could not exceed the Real Economic Value (REV) of the loan (roughly corresponding to the discounted expected cash-flows net of recovery costs) to be found compatible with state aid rules on asset relief measures. Since the Banking Communication in 2013, such transfer also involves subordinated debt holders burden-sharing requirements, on top of the pre-existing requirement to implement a restructuring plan of the bank, with restructuring measures to minimise state aid, remedy distortions of competition and return to long term viability. The transfer price requirement means that banks would have to realise as a loss any difference between the net book value of the loan and the transfer price. The BRRD and SRMR introduced certain specific requirements for the provision of State Aid outside resolution. In particular, public support is allowed outside resolution only in specific forms. One of these forms is the provision of precautionary recapitalisation which must comply with the conditions laid down in Article 32(4) of the BRRD (e.g. the measure, confined to solvent institutions, cannot be used to cover losses that a bank has incurred or is likely to incur in the near future, so it can be used to cover only losses related to the 'adverse scenario' of a stress test). As a result, after entry into force of BRRD and SRMR the provision of Impaired Asset Measures (IAMs) outside resolution is only possible if the state support complies also with the provisions of Article 32(4). This may have an influence on the amount of aid that can be granted in this context.

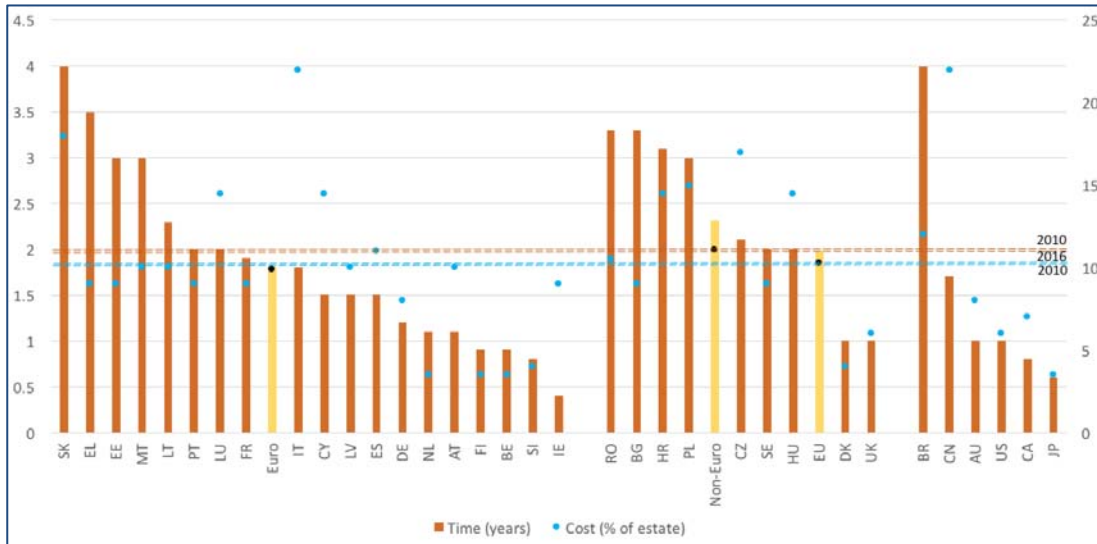
#### 4.2.4. Lack of predictability of insolvency, foreclosure and judicial frameworks

152. Inefficiencies in insolvency regimes and judicial overhang seem to be among the reasons for the slower pace of NPLs reductions in a number of countries in Europe and also negatively impact the banks' provisioning of NPLs and the market price of NPLs in secondary markets. Insolvency frameworks impact on different components, including legal mechanisms to enforce contracts, legal tools to resolve and restructure NPLs and more broadly the institutional setting and judicial capacity to manage large stocks of NPLs. Both individual loan enforcement before insolvency and recovery from insolvent debtors in actual insolvency procedures for all creditors collectively can be fraught with opportunities for debtors, in some cases, to delay foreclosure, collateral execution, or liquidation (where procedures to dispute creditors' actions and requests for deferment and appeal are not appropriately balanced between debtors' and creditors' rights).

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<sup>51</sup> A number of Italian and Greek banks have set up this kind of platform.

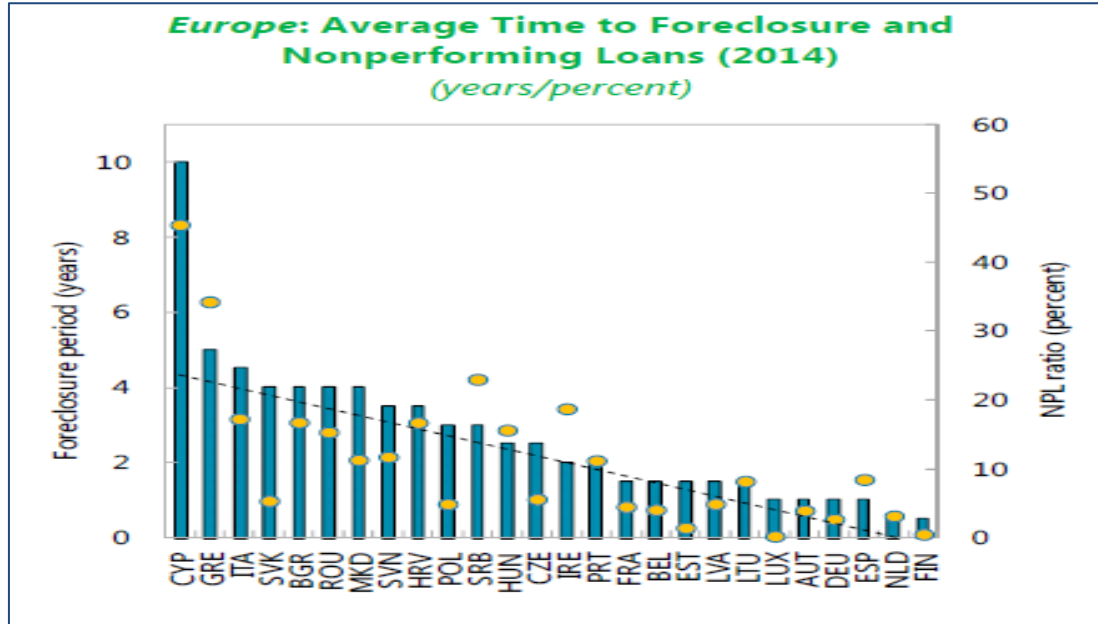
<sup>52</sup> Hungary has put in place a publicly-owned AMC (held by the Hungarian central bank) that bought NPL portfolios at market price.



**Figure 19: Resolving Insolvency**

(Source: CEPS/EP, based on World Bank Doing Business Report 2016)

153. The length of the foreclosure proceedings can vary from less than 1 year to up to 5 years (see Figure 19) in different Member States according to the available data. Creditors have less incentive to start the foreclosure proceedings if they know from the start that the proceedings may take years (with longer proceedings typically favouring degradation of collateral) and debtor discipline may be lower, as debtors may be less inclined to meet their payment obligations if loan enforcement is not a credible deterrent. IMF data tends to show that the level of NPLs is lower in the countries where the foreclosure period is shorter (see Figure 20).



**Figure 20: The average time of foreclosure and Non-performing Loans (2014)**

(Source: IMF SDN/15/19)

154. The length of the insolvency procedures can be dependent of the legal definition of insolvency and if there is a legal obligation for the management to start collective insolvency proceedings. Defining insolvency in many systems involves a prognosis on the viability of the business which by nature allows some kind of discretion and is therefore delicate to reconcile with the strict duty to file for insolvency. This is particularly an issue where over-indebtedness is used as a test (aka balance-sheet test). Directors could be under stricter duties to file for insolvency since they should be the first to realise the financial distress of the company. Furthermore, directors' duties may be accompanied by early warning and crisis detection tools and advice hubs to avoid further asset depletion and to enable restructuring, where possible. Further factors may contribute to the length of insolvency proceedings. For example difficulties in the liquidation of the debtor's assets or overcomplexity of avoidance actions which differ in Member States.
155. Rules on different rankings of creditors may also differ in Member States. Legal provisions aimed at protecting public finance are based on a super-priority of public sector creditors' claims (such as tax or social security claims) in insolvency and foreclosure processes with limits on debt relief by the public sector (in many cases public authorities cannot agree to any debt write-offs).
156. The more complex and burdensome the insolvency regime is, the more costly it can become. Costs of the insolvency proceedings is another element which can hinder the resolution of debt, as in some cases it deters the creditors from even starting proceedings. In some countries, the costs of proceedings can be extremely high, going up to 20 % of the claim.<sup>53</sup>
157. In some other countries, the remuneration of the insolvency practitioners is not dependant of the outcome of the proceedings. This can lead to the situation where the practitioners do not have much interest in finalising the proceedings as fast as possible.
158. Insolvency proceedings tend to be speedier in countries where out-of-court tools are available for debt resolution and / or where specialised bankruptcy courts or judges are used. In jurisdictions where insolvency proceedings are being dealt with by general courts / judges, the proceedings tend to take longer as they have to "queue" in line with all other matters taken to the court.
159. Publicly available data on the outcome of insolvency systems are scarce and comparability is generally limited. National official sources (e.g. justice ministries or national statistical institutes) generally provide information on the number of insolvency cases filed. However, the potential for cross-country comparison is limited due, in particular, to discrepancies between the existing insolvency procedures across the EU and structural differences in the composition of insolvency cases.
160. The World Bank Doing Business survey on corporate insolvency provides regularly-updated set of indicators but has some limitations. These indicators, which focus on corporate insolvency, are based on a common methodology which is applied consistently in various countries. However, the indicators only capture insolvency frameworks applying to a specific hypothetical business when measuring the potential outcome of insolvency.

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<sup>53</sup> Study on a new approach to business failure and insolvency: Comparative legal analysis of the Member States' relevant provisions and practices, Table 1, page 36.

161. This is the reason why the Commission has initiated a benchmarking exercise on the efficiency of national loan enforcement (including insolvency) regimes from a bank creditor perspective, as discussed in the Eurogroup in April 2016 and in ECOFIN in June 2016, in order to improve data availability on the recovery rates, cost and delay associated with loan enforcement before or in insolvency by banks throughout the European Union. This benchmarking will notably seek to gather additional data on the actual outcome of loan enforcement procedures (including insolvency) across Member States<sup>54</sup>. To the extent that primary data is available and sufficiently disaggregated, the benchmarking will notably assess the recovery rate under various procedures, their length and the costs associated. The results of the first round of benchmarking are expected in autumn 2017, with an interim report in the spring providing more clarity on the appropriate methodology for benchmarking insolvency frameworks.
162. In addition, the Commission's legislative proposal on business restructuring and second chance and measures to raise the efficiency of proceedings, including formal insolvency proceedings seeks to improve data gathering on insolvency indicators in the EU. The legislative proposal, which was published in November 2016, aims to set minimum harmonised standards on a number of key elements contributing to the strength of preventive restructuring and second chance frameworks and on enhancing court efficiency for both restructuring and insolvency proceedings.
163. To ensure monitoring and implementation of the rules, the proposal requires Member States to collect data based on a standard methodology, on indicators such as the number of filings for each type of procedure (restructuring, insolvency, second chance), length, outcome of procedures, administrative costs of procedures, recovery rates, and success of such procedures (measured as a function of re-applications by the same debtor in a period of 3 years from the first application). Data will be broken down by size and type of debtors. As opposed to the World Bank Index, which is based on expert assessment of the efficiency in each country, data collected under this proposal will permit an objective assessment of the effectiveness of procedures in the Member States.

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<sup>54</sup> Commission Communication of 14 September 2016 on Capital Markets Union – Accelerating Reform, COM(2016) 601 final.

## 5. A case for NPL resolution

164. The Strategic Agenda for the Union in times of change<sup>55</sup> adopted by the European Council in June 2014 sets out key priorities for the Union until 2020. The first of the five priorities identified in the document, is building a Union of jobs, growth and competitiveness. As developed under Chapter 3, boosting economic growth, investment and employment requires addressing high NPL levels in countries which struggle with this persistent problem and lasting effects of the financial crisis and slow economic recovery. Positive externalities of such progress could be felt across the EU, also in countries which seem not to be directly affected by NPLs due to spill-over effects and risks for financial stability.
165. Reducing NPL stocks and NPL ratios could serve achieving objectives of the Capital Markets Union and of the Banking Union and as such, in line with the Five Presidents' Report Completing Europe's Economic and Monetary Union<sup>56</sup> would be a step forward for achieving the first stage in the Roadmap Towards a Complete Economic and Monetary Union.

### 5.1. Consistency with Capital Markets Union objectives

166. A number of measures which have been taken and are being taken in the context of resolving high NPL stocks and high NPL ratios, such as boosting secondary markets, reducing financial fragmentation, increasing transparency, improving data comparability and insolvency frameworks are beneficial for achieving the objectives of the Capital Markets Union, including to remove obstacles to the free flow of capital across borders and to make the European economy more resilient<sup>57</sup>.
167. Furthermore resolving the problem of high NPL stocks and high NPL ratios would enhance the capacity of banks to lend, including to SMEs which is also one of the objectives of the Capital Markets Union<sup>58</sup>.
168. Finally, cleaning-up balance sheets would lead to increasing investor confidence in the financial sector across Europe and also free up capital. As such, addressing the NPL issue could also be beneficial to achieving a number of objectives of the CMU, such as boosting free flow of capital and an increase in private risk-sharing, which in turn would contribute to making the EU-28, including the euro area, more resilient to shocks.

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<sup>55</sup> See European Council conclusions of 26-27 June 2014 (doc. EUCO 79/14),

<sup>56</sup> [https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report\\_en.pdf](https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf)

<sup>57</sup> Commission Communication of 14 September 2016 on Capital Markets Union – Accelerating Reform, COM(2016) 601 final.

<sup>58</sup> See Council conclusions on the Commission Action Plan on building a Capital Markets Union, of 10 November 2015 (doc. 13922/15).



## 5.2. Consistency with Banking Union objectives

169. Importance of the work on addressing high levels of NPLs and high NPL ratios for completing the Banking Union is self-evident and has been expressed on numerous occasions and in various fora, including recently in the context of the June Council conclusions on the Roadmap to complete the Banking Union<sup>59</sup>.
170. Advances made in this field to date, notably in the field of common supervision and transparency, have already contributed to reducing risks in the financial sector. A holistic approach at the national level and the European level where appropriate, in line with State aid rules, the BRRD and the SRMR supporting a sustainable reduction of NPLs levels and also preventing their re-emergence, with measures undertaken by the most affected Member States, would contribute to more homogeneity in the distribution of credit risk across European banking sectors. Such an approach would also enhance the supervisory actions, standards and practices of competent authorities for significant and less significant institutions within the Banking Union. Further progress would be an essential contribution to the achievement of key objectives of the Banking Union, notably financial stability, reversing the fragmentation of financial markets and reducing the risk for the involvement of public financial means, and, through the enhancement of confidence on the health of the euro area banking sector, facilitate further steps to complete the Banking Union.

## 5.3. Work ahead

171. Section I of the present report has focused on building a common understanding of the NPL issue in Europe, as regards the scale of the issue, its drivers, impact, measures which have already been taken to address the issue as well as the initiatives which are underway.
172. The analysis shows that, while high NPL stocks and NPL ratios are not a system-wide problem across the EU financial system, its persistence in some European countries with substantial legacy issues to address and the overall size of NPLs in Europe could give rise to financial stability and macroprudential risks and undermine efforts to achieve sustainable growth both in these countries and across the whole EU.
173. The issue of high NPL stocks and NPL ratios is complicated, multifaceted and its drivers cannot be easily addressed by a handful of initiatives and policy measures, particularly as the banks play a central role themselves as they have the primary responsibility for restructuring NPLs.
174. This legacy issue must therefore be addressed urgently, in a comprehensive manner, but solutions may take time to bear fruit. The following chapters, which will complete the report, will therefore set out possible policy options and actions.

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<sup>59</sup> Council conclusions of 17 June 2016 (doc. 10460/16).

## SECTION II: POLICY OBJECTIVES AND RECOMMENDATIONS

175. The analysis in Section I shows that, while high NPLs inherited from the crisis are not a system-wide problem across the EU financial system, its persistence in some European countries, despite the ongoing recovery, and the overall size of NPLs in Europe, could give rise to financial stability and macro-prudential risks and undermine efforts to achieve sustainable growth both in high-NPL countries and across the whole EU.
176. The issue of high NPLs is complicated, multifaceted and its drivers can only be addressed by combining a variety of initiatives and policy measures. Banks are expected to play a central role in NPL resolution, as they have the primary responsibility for working NPLs out, but policy measures, at the national and European level, can provide incentives for banks to deal with NPLs, as well as address market impediments and structural inefficiencies.
177. The NPL legacy issue must be addressed urgently, in a comprehensive manner, as solutions to structural inefficiencies take time to bear fruit. To tackle the NPL issue, actions should be undertaken in four policy areas i.e. (i) supervision, (ii) structural issues, including insolvency, (iii) secondary markets, and (iv) restructuring of the banking system, not only in order to help to address the current high levels of NPLs and manage the transition out of this problem, but also to render the EU financial system resilient to the reappearance of the NPL phenomenon in the future.
178. To this end, the final chapters of the Report hereafter, set out policy objectives to be targeted and develop options for policy-making in the future in each one of the four areas mentioned above.
179. Going forward, precise and adequate communication about NPLs, reflecting properly the complexity and importance of this issue for the EU, outlining efforts and actions which have been and are being undertaken across Europe, as well as on the policy objectives and policy options set out below will be of key importance for tackling the NPL issue in Europe.

## 6. Enhancing supervisory tools to address the management of NPLs by banks

### 6.1. Policy objectives

- ✓ **Ensure that supervisors are equipped with necessary instruments to oversee the management of NPLs by banks and ensure their timely recognition and provisioning**
- ✓ **Promote supervisory convergence in the treatment of NPLs across all European jurisdictions to ensure consistent supervisory outcomes and avoid supervisory forbearance**
- ✓ **Provide for all relevant high NPL banks to implement a proactive NPL management strategy by increasing supervisory incentives for sustainable balance sheet repair and through enhanced public disclosure**
- ✓ **Foster and monitor sound credit origination standards, risk management and internal governance, to prevent the (re-)emergence of excessive levels of NPLs**

### 6.2. Case for action

180. Banks play a central role in addressing the NPL issue, as they are responsible for originating loans, managing credit risk and asset quality (including early warning and follow-up systems before reaching the non-performing status), as well as for ensuring timely recognition and adequate provisioning of NPLs together with the working out of non-performing exposures. The role of banking supervision is to oversee this process and to implement, where appropriate, supervisory measures. To that end, competent authorities have developed supervisory tools such as credit file reviews in on-site inspections, asset quality reviews (AQRs) and stress-testing exercises (STs) and are granted a number of supervisory powers to ensure the proper recognition of non-performing exposures (e.g. CRD IV Article 104<sup>60</sup>, SSM Regulation Article 16), although with some limitations as certain conditions need to be met<sup>61</sup>. As a result, the SSM and

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<sup>60</sup> This Article provides that "(...) competent authorities shall have at least the following powers: (a) to require institutions to hold own funds in excess of the requirements set out in Chapter 4 of this Title and in Regulation (EU) No 575/2013 relating to elements of risks and risks not covered by Article 1 of that Regulation; (...) (d) to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements;". Moreover, EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (EBA/GL/2014/13), drawn up pursuant to Article 107(3) of CRD IV provide that "When assessing portfolio credit quality, competent authorities should pay particular attention to the adequacy of the classification of the credit exposures and assess the impact of potential misclassification...". Similarly the assessment of the provisioning practices is described in paragraph 175 of the same Guidelines: "Competent authorities should assess whether the level of loan loss provisions and credit valuation adjustments are appropriate for the quality of the exposures and, where relevant, for the level of collateral".

<sup>61</sup> For the SSM for instance, for action to be taken, at least one of the conditions set out in Article 16(1) (a), (b) or (c) of the SSM Regulation has to be met. Those conditions state that either a) "the credit institution does not meet the requirements" or b) "the ECB has evidence that the credit institution is likely to breach the [prudential] requirements" or c) "based on a determination, in the framework of a supervisory review, that the arrangements, strategies, processes and mechanisms implemented by the credit institution and the own funds

national competent authorities have taken steps to address high NPL stocks in banks under their supervisory remit contributing to higher provisions for NPLs and stronger capital positions.

181. The SSM has recently adopted a qualitative "Guidance to banks on Non-Performing Loans" (NPL Guidance), sketching out the supervisory expectations towards NPL management by banks (see Chapter 4.2.1.). It will serve as a basis for evaluating banks' management of NPLs, as part of the regular supervisory dialogue. In the case of non-compliance by banks, it may trigger supervisory measures, e.g. via the SREP process. Quantitative provisions on targets for NPL disposals, provisioning requirements or haircuts on collateral valuations are not set out in the NPL Guidance.
182. The NPL Guidance addresses the main aspects regarding strategy, governance and operations, which are key to successfully resolving NPLs and adapting banks' internal organisation of NPL work-out, loan quality monitoring, risk-management practices and collateral valuation. Banks are expected to present NPL management plans, following a portfolio approach. The NPL Guidance recommends setting-up dedicated work-out units to eliminate potential conflicts of interests between those in charge of loan origination and those focusing on NPL work-out and to upgrade internal capabilities and expertise to deal with complex loan restructuring or enforcement procedures. The Guidance also invites banks to increase regular and granular disclosures on NPL portfolios and the result of actions taken to manage the exposures (see Chapter 8 and annex 7 of the NPL Guidance). These enhanced disclosures also include interest recognition from NPLs, with the amount of interest accrued on non-performing exposures and a comparison between the amount of interest accrued and the amount of cash collected on non-performing exposures.
183. The NPL Guidance is an important step towards a stronger supervisory focus on NPL management by banks, building on measures already undertaken by national supervisors and the SSM. Its scope is however limited, as it is addressed to significant institutions within the Banking Union under the direct supervision of the SSM. Supervisory convergence in the treatment of the NPLs across all European jurisdictions is necessary to ensure consistent supervisory outcomes and avoid supervisory forbearance. Therefore, to avoid loopholes and create a level playing field for EU banks, similar measures are warranted to be implemented, with proportionate adaptation where consistent with the goals pursued, in parallel by national supervisors for lenders outside the scope of the guidance (i.e. for smaller credit institutions and for banks outside the Banking Union, through for instance, EBA guidelines consistent with the level of ambition of the SSM Guidance).
184. Setting the right regulatory and supervisory incentives is key for a successful strategy for sustainable balance sheet repair. The framework applying to banks to perform proper maintenance of loan tapes and insure data quality on credit counterparties and exposures appears to be insufficient, leading to a large heterogeneity of outcomes among banks. Additionally, credit institutions may lack willingness (or internal capacity) to engage in proactive management of NPLs and, where necessary, write-offs. Banks may in some instances be overly optimistic regarding NPL recognition and their provisioning levels, depending on their

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*and liquidity held by it do not ensure a sound management and coverage of risk".* Therefore, in the most likely case of Article 16(1)(c) of the SSMR, the legal provision may not provide sufficient flexibility for JSTs to demonstrate that the level of provisioning of a specific asset or portfolio is not sufficient to ensure a sound management and coverage of risk and therefore this situation needs to be addressed by supervisory measures.

assessment of the final expected recovery value (including the underlying collateral) or the sustainability of forborne loans and the assessment of loan management costs for the bank. Lastly, banks may, in some specific cases, prioritise distributions to shareholders over NPL write-offs or increases in the coverage of NPLs through provisioning.

185. Enhancing the current European legislative micro-prudential framework, and the supervisory instruments available in EU legislation for supervisors, including in relation to the provisioning policies of banks and collateral valuation, in addition to the SREP analysis and own funds requirements, could be considered in this respect. This would enable addressing situations when the applicable accounting rules, focused on giving a neutral view on the accounts, with a level of discretion for the banks and auditors, and the concrete implementation of the supervisors' current powers (see above), do not result in a sufficiently conservative outcome from a prudential point of view.
186. An alternative approach to address the possible disconnect between the accounting and the desired prudential outcomes could be to consider empowering supervisors, with the capacity to enforce accounting adjustments as regards NPL recognition, provisioning and write-offs, and possibly to issue specific guidance on the accounting practices, while maintaining compliance with the IFRS framework. This issue has been raised when discussing the experience in Spain, where the supervisor complements the accounting framework for credit institutions, particularly in the area of credit risk, with binding standards compatible with the IFRS, and has the power to enforce accounting adjustments where necessary. Whatever the approach chosen, proper provisioning will ensure that no undue distribution of capital takes place when the solvency level are not sufficient to support the effective level of risk associated with NPLs.
187. Furthermore other measures have been implemented in the past by the national supervisors in the context of NPL supervision (including binding targets for NPL reduction by banks, comprehensive balance sheet assessments, on-site inspections, guidelines on provisioning) or by the SSM (with the 2014 and 2015 Comprehensive assessment) or the EBA (European stress-tests such as in 2016, this exercise was not combined with an AQR). Some supervisors have also developed guidelines on credit origination standards to set a framework for the origination of new loans and the assessment of borrowers to reduce the risk of emergence of new NPLs.
188. In addition to micro-prudential supervision, the macro-prudential approach focuses on reinforcing the financial system and on finding ways to prevent the emergence or materialization of system-wide risks which do not fall within the remit of the micro-prudential supervisors or which would require concerted action by authorities. Macro-prudential policies act on two dimensions: (i) preventing the build-up of imbalances (e.g. excessive growth in real estate prices and mortgage lending) and (ii) ensuring that the financial system is able to withstand stress when risks materialise. From an institutional perspective, the European Systemic Risk Board (ESRB) is responsible for the macro-prudential oversight of the EU financial system, while national designated authorities conduct macro-prudential policies at national level<sup>62</sup>. Coordination between Member States is ensured through a centralized mechanism in which the national designated authorities notify to the ESRB the use of macro-prudential instruments.
189. To the extent that high NPLs at system level can pose a threat to financial stability, competent authorities can use different tools to prevent the build-up of large stocks of NPLs or

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<sup>62</sup> The ECB holds top-up powers with the SSM.

address risks associated with the persistence of high levels of NPLs across the banking sector, while avoiding pro-cyclical effects. For instance to mitigate systemically relevant risks, measures may take the form of additional own funds requirements, which are expected to contain the excessive build-up of vulnerable exposures (that could turn into NPLs when stress hits) or to strengthen banks' resilience to the potential crystallization of high credit-related losses. In the European framework, higher risk-weights can be imposed on assets for targeting asset bubbles in the residential and commercial property sector (Articles 124, 164 or 458 of the CRR). National macro-prudential authorities could also activate the Systemic Risk Buffer (Article 133 of the CRD IV) in order to prevent and mitigate long term non-cyclical systemic or macro-prudential risks.

190. Depending on specific national provisions, direct intervention on credit origination standards by macro-prudential authorities could be another possible avenue to follow. Such action, which would consist of imposing limits to loan-to-value, loan-to-income and/or other similar variables, would aim to limit banks' exposures and/or limit households' vulnerability to economic shocks. Furthermore, in their actions to mitigate potential risks for financial stability posed by NPLs, macro-prudential authorities would capture other relevant structural factors affecting systemic risk, such as the congestions and shortcomings in the insolvency frameworks and judicial systems regarding loan enforcement (see Chapter 7).

191. The appropriateness of supervisory powers and tools in Europe is all the more important given that banks have less regulatory incentives to deal with NPLs proactively compared to the US, where the regulatory framework (accounting and fiscal rules) is more stringent in terms of marking down the value of non-performing exposures (see Box 2). Accounting rules on provisioning applicable in Europe are not very prescriptive and are based on principle-based standards that does not prescribe specific provisioning levels (such as percentage of provision (this is the case for both the IAS 39 and IFRS9 standards). Only some Member States (e.g. Spain) have established concrete provisioning rules (i.e. specific criteria for individual and collective assessment of loan loss provisions) while a few others have adopted provisioning guidelines. Hence, further guidance in this regard could be considered in order to ensure harmonisation and sufficient and timely provisioning levels and write-offs of loans. The European framework of supervision needs to set the right incentives for banks to deal with NPLs promptly and to avoid potential "extend and pretend" behaviour by banks as regards with unsustainable forbore loans.

### **International practices for provisioning and write-offs**

International experience<sup>63</sup> indicates that strict limits to NPL provisioning and more explicit provisions on NPL write-offs can be a strong tool to avoid NPL build up and extend and pretend strategies. Such limits can be implemented as prudential or accounting rules.

Banks in some countries are required to set aside a minimum level of specific provisions for problem loans. According to the IMF, supervisors in several countries also tighten supervisory requirements to speed up write-offs. Such measures impose a time-limit on NPL write-offs. In the United States, regulators have overlaid the accounting standard with detailed regulatory guidance that harmonizes the treatment of write-offs. The regulators acknowledge that management will have discretion in judging write-offs under U.S. generally accepted accounting principles. But to guide management, regulators have added detailed regulatory guidance that harmonizes the treatment of write-offs. Compliance with the guidance, in turn, is validated through onsite inspections. U.S. regulatory guidance has introduced time-limits on NPL write-offs, independent from the time needed to foreclose. For example, after 180 days past due, a mortgage loan is valued exclusively based on the underlying collateral (at market price with no adjustment for possible increase in value over time). Any loan balance that exceeds the value of the collateral, less the cost to sell, should be written off. This requirement is regardless of how long it takes to foreclose. That being said, it should be taken into account that mortgage loans in the US are non-recourse loans and therefore the market value of the collateral is a key determinant of the recovery value of an NPL.

Guidance on write-offs has also been introduced in other countries to help clean bank books from legacy assets. For instance, in Japan, the emergency economic measures of 2001 further accelerated the disposal of distressed collateral. A guideline required major banks to remove near-bankruptcy and lower quality loans ("bad debt") within three years after their recognition. This helped remove a book value of old loans worth 270 billion USD from bank balance sheets from 2001 to 2004. In Brazil, distressed loans (so called "H" loans) must be written off after six months. In Spain, loans must be written off after having been classified as NPLs for 4 years or after having been provisioned at 100% for 2 years, whichever comes earlier. They continue to be accounted for off-balance sheet, provisioned at 100 percent. Also Romania introduced a number of measures in this respect, including a recommendation for full coverage with provisions for unsecured NPLs for which repayment of principal and/or interest was overdue by more than 180 days, followed by the removal of exposure from on-balance sheet. Smaller Latin American countries, like Guatemala, also apply rules on write-offs for consumer loans.

### **Box 2: International practices for provisioning and write-offs**

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<sup>63</sup> Please refer to the following survey by the IMF: <https://www.imf.org/external/pubs/ft/wp/2015/wp1524.pdf>.

### 6.3. Policy options

**192. Policy Option A.1: Welcome and call for a swift implementation of the SSM NPL Guidance and seek further steps, including EBA guidelines covering all credit institutions in the EU**

193. As mentioned above, the responsibility for dealing with NPLs lies primarily with banks themselves; however assertive and intrusive supervision is necessary to overcome the wait-and-see approach, which some banks may be tempted to adopt, by providing the right incentives for banks to take the steps necessary to recognize and deal with NPLs.

194. Improving loan documentation and setting up processes for NPL work-out should be the starting point for banks in dealing with NPLs. In this respect and in the context of the SREP, the SSM is planning on a regular basis to conduct on-site inspections and off-site monitoring to oversee the implementation of its guidance and its prudential measures.

195. As the SSM NPL guidance provides recommendations to banks and sets out a number of best practices that are also very relevant for less significant institutions, national competent authorities should thus be invited to implement the NPL Guidance with regard to institutions outside the remit of the SSM direct supervision (i.e. less significant institutions in the Banking Union), with targeted adaptations where appropriate. For less significant institutions, the guidance should also take into account possible challenges for smaller lenders for which access to secondary markets is more difficult and complex, in-house capacity (in particular legal expertise) to deal with high levels of NPL more scarce, and administrative costs for NPL management relatively higher (due to a fixed costs component).

196. In addition, the EBA could be mandated to draft general guidelines on NPL management, consistent with the level of ambition of the SSM guidance, with an extended scope applying to all banks in the entire EU.

**197. Policy Option A.2: Enhance the usability of powers for supervisors as regards provisioning policy of banks as regards NPLs, through, in the very short term, clarifying the provision through a Commission interpretation to be followed where appropriate by a legislative change to the EU framework**

198. The usability of supervisory powers to require specific adjustments, filters or deductions from own funds for prudential purposes as regards NPL provisioning levels could be enhanced to address the shortcomings of the current framework and the own funds requirements. In particular, the usability of supervisory powers on the basis of EU legislation (in particular Article 104 of the CRD IV and Article 16 of the SSM Regulation) could be enhanced to support EU supervisors' willingness and capacity to act and to effectively prevent the build-up of high levels of NPLs for the future. This approach would contribute to ensure that: (i) non-performing, forborne and foreclosed assets are subject to sufficient provisions and valuation adjustments, taking into account the level of existing collateral and, crucially, the vintage of such exposures; (ii) the amount of own funds is indeed available to the institution for unrestricted and immediate use to cover unexpected risks or losses as soon as these occur. In this way the intrinsic risk of overstatement of bank own funds would be eliminated. This approach would contribute to a timely NPL recognition and provisioning of non-performing loans, or address under-provisioning where appropriate.



199. In terms of legal instruments granted to supervisors to seek the necessary adjustments, two options have been discussed in the Subgroup.
200. The first option is aimed at ensuring that supervisors have the powers to implement prudential deductions from own funds intended to fill the gap between bank accounts and the prudential expectation of supervisors (but within the applicable accounting framework), as regards the incurred or anticipated deterioration in asset quality or if loan-loss provisions do not fully reflect losses expected to be incurred. The instrument would introduce a prudential overlay dedicated to non-performing loans (effectively resulting in a decrease of CET1 capital with deductions from own funds), without adjusting the accounts. If pursued, this option, in the very short term could take the form of a Commission interpretation of existing powers under Article 104 of the CRD IV and Article 16 of the SSM Regulation, followed by, where appropriate, following a full pros and cons analysis an amendment to Article 104 of the CRD IV as regards supervisory powers, using the opportunity of the ongoing review of the CRR/CRD framework. The objective would be to ensure that appropriate powers are available in terms of provisioning policies of credit institutions, with an explicit and non-equivocal power to require credit institutions to apply specific deductions from own funds, after an assessment by the supervisor of provisioning levels of non-performing exposures, if the implementation by the institution is not adequate or sufficiently prudent from a supervisory point of view after a case-by-case assessment. This instrument would also address the shortcomings of the pillar 2 own funds requirements. Capital add-ons with the pillar 2 aim to address unexpected losses, while prudential provisions are intended to cover losses that are “expected” and avoid overstating banks' own funds or limiting the comparability of capital ratios. This instrument may also be a preventive instrument, as the banks would also have more incentives to adjust the accounting provisioning levels following the request of the supervisor.
201. Another option, significantly different in its approach, consists of providing banking supervisors accounting supervisory powers, allowing them to enforce adjustments to credit institutions' accounts when necessary for the timely recognition and provisioning of NPLs (see the solution adopted in Spain and described in Chapter 4.1.1.) and ensure that all expected losses are accounted for by the bank. From a methodological point of view, provisions are conceived for expected losses and losses from NPLs are mainly expected. These powers could be supplemented by an accounting mandate for the supervisor to adopt binding accounting regulations for banks, complementing the general accounting framework, by specifying the binding implementation of accounting standards. This approach would entail a more radical change in the current European framework as the supervisor would be granted the ability to request adjustments in the accounts of the banks, to enforce more prudent provisioning of NPLs and/or an accounting mandate. These supervisory powers would need to be weighed against the adequacy of supervisory powers to impose additional capital requirements to address "under" provisioning, the comparability of IFRS financial statements and the enforcement powers of national regulators, coordinated by ESMA at the EU level, over IFRS financial statements. However, this option would have to be carefully analysed since accounting rules and auditing practices have other different objectives than banking regulation. This option is not recommended at this stage. The harmonization of the implementation of accounting rules is however welcome<sup>64</sup>.

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<sup>64</sup> To this end consideration should be given to the possibility to use Article 24(2) of the CRR to better harmonize the implementation of the valuation of assets according to accounting standards across the EU.

**202. Policy Option A.3: Implement, after careful consideration, specific tools for future NPL flows in the steady-state regime**

203. While individual tailored solutions with a case by case assessment by the supervisor and taking into account the age of NPLs on the banks' balance sheets seem to be appropriate for dealing with the current high NPL stocks in some banks, for future NPL flows, more stringent approaches could be introduced, while leaving banks time to adapt. Several options have been discussed in the Subgroup in this regard.

204. For instance, prudential backstops addressing potential under provisioning risks of NPLs could be introduced in EU level 1 legislation, taking advantage, where appropriate, of the CRR/CRD IV review currently underway, in the form of automatic deduction from own funds. Such requirements would apply to newly originated loans, as soon as possible, e.g. as of 1 January 2018. These approaches could in particular take the shape of legislative provisions requiring compulsory prudential deductions from own funds of NPLs<sup>65</sup>, after an assessment of the most appropriate calibrations in line with international practice e.g. i) as a first step, after e.g. 2 years<sup>66</sup> for the amount of the non-performing exposures not covered by collateral (with a full prudential provisioning of unsecured NPLs and a prudential provisioning of secured NPLs covering the exposure net of the collateral value) and ii) as a second step after e.g. 6 to 8 years for the entire amount of all non-performing exposures (with a full prudential provisioning of secured NPLs also covering the collateral, if no independent external valuation has been performed<sup>67</sup>). In practical terms this would require an amendment to the CRR introducing specific deduction from own funds for non-performing loans acting, with a pillar 1 treatment based on the vintage of the NPLs, as a prudential backstop<sup>68</sup> to be implemented by banks, without prejudice of additional pillar 2 deductions at the discretion of the supervisor. It would also be consistent with the existing approach as regards prudent valuation for trading book positions<sup>69</sup>.

205. To secure the implementation of NPL management strategies by banks following the adopted strategy (i.e. internal work-out, legal enforcement, securitisation or outright sales), it was also suggested that the supervisory toolbox could be supplemented by additional quantitative tools in the steady-state regime, such as introducing binding net NPL restructuring and reduction targets set by supervisors for banks with high NPL levels. The sequencing of such measures would need to be assessed, as for these targets to be feasible, banks must, among other issues, have sufficient legal tools and operate in a jurisdiction where credit recovery procedures are rapid to work-out NPLs at their disposal. Otherwise, banks would not be able to deliver the required NPL reduction for exogenous reasons, and the targets would not be credible or may force alternative and unintended actions such as fire-sales or large volumes of home repossessions and liquidations of businesses.

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<sup>65</sup> These approaches should be further developed, e.g. to calibrate the requirements to specific circumstances related to the treatment of probation periods and non-performing exposures returning to the performing status.

<sup>66</sup> International practices are analysed in Box 2 above. In the case of the US these need to be written off after 180 days. International practices are analysed in Box 2 above.

<sup>67</sup> Further work would have to be conducted to ensure the external valuation is consistent with a methodology approved by competent authorities.

<sup>68</sup> In the current text of the CRR Article 32 and onwards deal with prudential filters and prudential deductions from CET1.

<sup>69</sup> Commission Delegated Regulation (EU) 2016/101 of 26 October 2015 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for prudent valuation under Article 105(14).

**206. Policy Option A.4: Enhance loan origination standards and upgrade credit management practices in banks by issuing supervisory guidelines and implementing higher supervisory scrutiny in the SREP in order to prevent the build-up of NPLs in the future**

207. As developed in Chapter 2.3.2. of the report, deteriorating macroeconomic conditions and banks' lending and monitoring practices and the internal governance of the bank are, key drivers of NPL build-up. While it is acknowledged that NPLs are a by-product of bank lending business and cannot be fully avoided, it is crucial for banks to implement sound loan origination standards and practices. These standards and practices should be clearly guided by the banks' overall strategy and tailored risk appetite statements/ limits. Simple and efficient internal bank loan origination practices which have been embedded into the risk culture of the banks (such as mandatory credit checks, income verification, internal guidance on maximal loan-to-value, loan-to-income or debt servicing ratio limits matched to the repayment capacity of borrowers, sensitivity analysis, contract covenants, and enforceable collateral) can all assist greatly in a bank's ability to manage NPL levels. Specifically, borrower affordability assessments should be based on the assessment of the borrower's cash flows to repay loans rather than solely refinancing or sale of collateral.

208. Once the loan origination has been finalised and loans are extended to borrowers, an active monitoring of the loans' performance is essential to ensure the loan contract terms are abided by borrowers. Best practice would show that efficient and effective monitoring controls and strong early warning indicator systems can greatly assist in the reduction of early arrears and the build-up of high NPLs over time. Strong governance and Board level oversight in respect of the culture of credit underwriting and risk management within a bank are also essential ingredients to successfully embed sound risk and loan origination practices with the view to preventing the future build-up of excessive NPLs<sup>70</sup>.

209. Given the lessons learnt from the recent past, supervisors should play a strong role in fostering sound loan origination standards and practices in order to prevent the build-up of high levels of NPL in the future. In this respect, the EBA should develop detailed guidelines on loan origination, monitoring and internal governance covering the main categories of exposures (SMEs, corporates...)<sup>71</sup> which could in particular address issues such as governance, transparency, and borrower affordability assessment<sup>72</sup>. Banks' compliance with these standards would then be scrutinised by the supervisors in the context of the SREP process and on-site inspections.

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<sup>70</sup> The SSM stocktake exercise has indicated that in a number of European countries there are no dedicated loan underwriting standards set by supervisors so far. However, some supervisors, for example in Cyprus, have issued detailed underwriting standards related to governance, information sharing/ transparency, borrower assessment, particularities related to products with special risk and collateral valuations. In Spain, the banking accounting circular by the Bank of Spain also incorporates loan underwriting standards and criteria for collateral valuation.

<sup>71</sup> In the context of the mortgage credit directive (MCD), the EBA has developed in the past guidelines on creditworthiness assessment, with a consumer protection focus, establishing requirements for verifying consumers' income, documenting and retaining information, identifying and preventing misrepresented information, assessing consumers' ability to meet their obligations under the credit agreement, considering allowances for consumers' committed and other non-discretionary expenditures, as well as allowances for potential future negative scenarios. EBA guidelines on loan origination standards would need to ensure consistency with this text.

<sup>72</sup> After taking stock of specific national provisions, it is understood that such guidelines should take into account these provisions on credit origination standards,

210. In addition, both banks and supervisors should be called to enhance the attention on risks associated to inefficient insolvency frameworks (see Chapter 7), notably as regards loan enforcement strategies of banks in their NPL management plans and collateral valuation. Such aspects are currently not explicitly taken into account and stress-tests do not include elements of stress associated to congestion in judicial systems limiting the ability to enforce contracts and foreclose assets and effectively recover values from NPLs or seized collateral. Supervisors could also be invited to draw on analysis of the business and legal environment, with possible insights on the risks faced by the banks, and take that into account in the context of the supervisory review and evaluation process (SREP).

**211. Policy Option A.5: Make use of supervisory tools specific to banks with high NPLs. Assessing incurred or likely losses requires proper asset valuations.**

212. Recent asset quality reviews, stress tests and transparency exercises have increased disclosure about the financial situation of banks. Such instruments have been applied in the past both at the EU level in the 2014 and 2015 Comprehensive Assessment, for large banks, and national level in various instances (e.g. see Chapter 4.1.1. and 4.1.2. for Spanish experience with credit reviews and the Greek Comprehensive Assessment of 2014), proving useful to increase transparency and enhance market confidence.

213. While stress tests show how resilient banks are to severe stress scenarios, they might be seen as not giving a full picture of the soundness of banks with respect to non-performing exposures, especially if incurred or likely losses are not properly reflected in the balance sheet. As a result, potential investors might still face difficulties in assessing the soundness of banks, which may limit their willingness to provide capital, high NPL banks may also, as a result, face greater difficulties to access secondary markets for their loans should outright sales be the chosen strategy.

214. AQRs and stress tests could be usefully complemented with continuous use of on-site inspections and off-site activities with a focus on NPL portfolios (credit files reviews). These could give supervisors more granular information on the banks / NPL portfolio and collateral valuation, to feed into the SREP process.

It should be noted that there are limitations when stress-tests are not combined with an assessment of asset portfolio quality. This is highly relevant for the issue of NPLs and foreclosed assets, because when stress-tests are not combined with a proper asset valuation of the bank at the loan book level, they may expose existing, incurred or likely losses only partially.

**215. Policy Option A.6: Mandate the ESRB to explore macro-prudential tools to prevent the build-up of high NPLs and macro-prudential approaches to deal with system-wide NPL problems**

216. A number of macro-prudential tools have been developed to tackle system-wide risks, to contain the excessive build-up of vulnerable exposures or to strengthen banks' resilience to the potential crystallization of high credit-related losses (see above). Such instruments are important to prevent the re-emergence of high NPLs. The ESRB would be mandated to explore instruments, such as for instance i) a system of dynamic provisioning for non IFRS banks<sup>73</sup>, where the amount to be provisioned depends on the situation of the economy in the financial cycle, ii) the establishment of an add-on on the provisions, based on criteria such as the time a specific NPL has been on the balance sheet of the bank (i.e. the vintage of exposures), while ensuring the appropriate coordination between authorities, iii) the application of general haircuts on the collateral attached to NPLs that supervisors consider potentially overvalued which may be particularly relevant in the case of a crisis stemming from a boom in real estate activities.
217. Such macro-prudential approaches may be explored to tackle the systemic risk associated with high NPLs stocks remaining in the balance sheet of banks for a long period of time (due to, among other reasons, uncertainties related to the value that can be extracted by banks in insolvency and debt recovery frameworks, structural impediments to credible loan enforcement and a congestion of courts - see Chapter 7), while taking due consideration of procyclical effects of measures addressing stocks and potential effects on financial stability. Macro-prudential measures may also lead to increasing the carrying capital costs of NPLs, thus contributing to increasing incentives to dispose of NPLs and reducing the bid-ask spread between sellers of NPLs (i.e. the banks) and buyers of NPLs (investors) in secondary markets (see Chapter 8), as uncertainty and volatility in insolvency outcomes may not be properly accounted for in the current valuation framework of banks.

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<sup>73</sup> For IFRS banks the instrument appears to be less relevant in the future, as the expected loss model in IFRS 9 is based on assumptions similar to dynamic provisioning.

## 7. Promoting structural reforms of insolvency and debt recovery frameworks

### 7.1. Policy objectives

- ✓ **Raise the awareness among policy makers of the financial stability implications of poor restructuring, insolvency and debt recovery frameworks**
- ✓ **Improve the predictability of insolvency and debt recovery regimes and incentivise out-of-court restructurings, where appropriate. This could both facilitate banks' internal management of NPLs and improve price discovery for NPLs in secondary markets**
- ✓ **Increase the efficiency of insolvency and loan enforcement frameworks in order to increase the recovery value from NPLs and reduce lead times of insolvency proceedings. Setting common principles or harmonising key elements of insolvency law such as introducing minimum standards for secured creditors protection could be beneficial**
- ✓ **In line with recent legal and administrative reforms introduced in many European countries, ensure that further initiatives are taken, to address capacity issues in the judiciary and court-case backlog**
- ✓ **Develop a macro-prudential focus on structural issues such as insolvency and legal frameworks given the potential financial stability risks associated**

### 7.2. Case for action

218. Loan enforcement and insolvency frameworks provide legal and operational mechanisms for creditors to realise their claims and to recover collateral. They are key to debtor and creditor discipline, in itself a central element to secure a good flow of credit to households and corporates. It is important to have in place high quality legal provisions governing the enforcement of contracts and foreclosure of assets, as well as legal tools to restructure viable businesses. Improving the restructuring process and insolvency framework would:

- a) facilitate the restructuring of viable debtors: well-functioning preventive debt restructuring frameworks allow for a timely restructuring of liabilities for solvent debtors in order to maximise economic value;
- b) strengthen debtor discipline: an efficient insolvency framework, where loan enforcement is a credible threat, would have a preventive effect on borrowers' credit discipline;
- c) facilitate the enforcement of claims: an efficient insolvency framework would reduce uncertainty for creditors in enforcing their claims effectively and give them more bargaining power with the borrower to restructure loans when the firm is viable. Both would enhance the provision of credit through better risk management for creditors and reduction of risk premia.

The design of the legal and judicial system is key for setting the right incentives for proactive NPL management, and there are significant financial stability implications if loan enforcement is

not a credible strategy for debtors and creditors, not the least through the reduction of incentives to restructure loans, in countries with high NPLs at a system-wide level.

219. To facilitate NPL resolution, it is equally important to have effective and efficient institutions and the judicial capacity to issue judicial/administrative decisions in a timely manner. An appropriate institutional setting also allows reducing some of the negative effects of judicial inconsistencies in the interpretation or application of insolvency laws within Member States<sup>74</sup>. A number of European countries have recently introduced reforms to upgrade their restructuring and insolvency regimes and to improve the transparency of procedures in line with best practices but reforms seem to have been uneven<sup>75</sup> and improvements in judicial systems may not have kept pace with legal changes<sup>76,77</sup>.
220. Well-developed and credible restructuring tools balancing the interest of debtors and creditors are key to avoid unnecessary liquidations of viable companies and allow for an effective internal work-out of the non-performing loans. Successful restructuring tools contribute to maximising the overall economic value, by keeping afloat viable businesses, restoring income streams for banks on restructured loans and also limiting the burden on courts dealing with formal insolvency proceedings. This requires however to have a solid assessment of the economical viability of firms in order to ensure that only viable companies have access to restructuring tools, while non-viable businesses are lead to insolvency proceedings.
221. The efficiency of insolvency proceedings has a direct impact on the recovery value that can be extracted from an NPL and, crucially, on the delays incurred in such recovery. Inefficiencies in insolvency regimes and court backlogs are among the identified reasons for the slower pace of NPLs resolution observed in a number of countries in Europe. The SSM<sup>78</sup> and the EBA<sup>79</sup> have pointed out that the enforceability of credit and collateral works as a default deterrent and underpins higher recovery rates from impaired credit exposures. Inefficiencies in insolvency regimes also negatively impact the market price of NPLs in secondary markets.
222. Improving the predictability of loan recovery timeframes (for both insolvency and foreclosure proceedings) is particularly important for a comprehensive NPL strategy. Leaving aside the underlying value of the recovery, the predictability of insolvency regimes (as regards the timeframe of the recovery and the recovery rates) is key for banks and investors in distressed assets since it allows expected delays associated with inefficient procedures to be appropriately discounted, reducing one of the important components of the risk premium in secondary markets.
223. Another element related to predictability and efficiency of the insolvency proceedings is the treatment of a secured creditor in the insolvency procedure. Secured creditors are creditors for whom specific assets of the debtor's estate are "earmarked" (through various legal techniques,

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<sup>74</sup> AFME, Potential economic gains from reforming insolvency law in Europe, February 2016, p. 19.

<sup>75</sup> IMF, A Strategy for Resolving Europe's Problem Loans, September 2015.

<sup>76</sup> SSM Stocktake of national supervisory practices and legal frameworks related to NPLs, Sept 2016.

<sup>77</sup> At the same time, it must be acknowledged that legal systems and insolvency frameworks differ widely between Member States, in accordance with the principle of national procedural autonomy. It must also be recognised that the independence of the judiciary in the organisation and delivery of court proceedings may be guaranteed in Member States' legal order.

<sup>78</sup> SSM Stocktake of national supervisory practices and legal frameworks related to NPLs, Sept 2016, p. 17.

<sup>79</sup> EBA Report on the dynamics and possible drivers of non-performing exposures in the EU banking sector, 2016, p. 31.

including outright transfer of ownership or granting of security rights) so that the assets, or the proceeds therefrom, serve first and foremost to satisfy the secured creditor, and not other creditors<sup>80</sup>. The secured creditor's privilege can have two facets, namely (i) the secured creditor does not have to share, i.e. that the proceeds from auctioning off or otherwise executing an asset securing the creditor's claim serves to satisfy only this creditor's claim, instead of falling in the overall estate and being distributed to all creditors; and (ii) the secured creditor does not have to wait, i.e. secured assets are sold/auctioned/repossessed or otherwise executed at the beginning of the insolvency proceedings before the possibly lengthy procedures of distributing the entire estate to the creditors at large are completed. In some national regimes, the preferential right of the secured creditor to the earmarked assets can get overruled in insolvency. However, an insolvency situation is precisely the case when the protection provided by the "secured" assets is most important because by then, the debtor's assets will most likely not be sufficient to cover all claims outstanding. Besides, secured creditors' protection will also be relevant for successful restructuring: if the chosen path in the insolvency procedure is not liquidation, but continuation of activity associated with a balance sheet restructuring, new financing will most likely be needed and will, given the distressed situation of the business, only be granted in the form of secured lending: a robust protection of secured lenders is crucial to make such new financing available. Thus, the preferential rights of secured creditors need to be properly upheld. This does not prohibit that their access to the collateral may be constrained, should the corresponding assets be necessary for continuation of activity. However, this raises the issue of the credibility of the plan supporting the continuation of activity which secured creditors need to be in a position to challenge effectively, as a non-credible plan would only lead to the depletion of the assets of the companies, leading to lower recovery rates for creditors where specific regimes, allowing employees rights and public exposures (tax and social contributions) to supersede secured creditors, exist in liquidation. Additionally, enhancing the protection of secured creditors will help foster the development of secondary markets for NPL, as those assets appear to be better marketable, especially regarding exposures to corporates.

224. One of the reasons for NPLs to accumulate relates to the lack of incentives, when there are no prospects for a successful renegotiation/restructuring, to file for insolvency proceedings over an insolvent debtor's estate. Where no formal steps to enforce the loan or to start the insolvency proceedings are taken, the non-performing loan will continue to stay on a bank's balance sheets, without much incentives for the bank to take any action to manage its stock of NPLs especially in the context where insolvency regimes deliver unpredictable/poor outcomes (however, without prejudice to any corrective measures taken by the supervisor). Among the reasons for such inaction, two deserve specific attention<sup>81</sup>: first, there is no clear definition of insolvency which would determine the moment where the company should be considered as not viable anymore; secondly, not all Member States currently have an obligation for the managers to assess the viability of the company and to file for insolvency when the company is considered not viable

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<sup>80</sup> In Italy, law of 30 June 2016 no. 119, converting law decree no. 59 of 3 May 2016, introduced mechanisms for out-of-court realisation of collateral, namely through the *pegno non possessorio* and the *patto marciano*. These allow a creditor secured by mobile collateral or real estate, respectively, by prior contractual agreement with the debtor and in the event of the latter's default, to sell the collateral/property autonomously, and to keep the proceeds (with proceeds in excess of the secured claim being turned over to the debtor), limiting court involvement in collateral recovery. Similar arrangements are in place in Germany and other Member States.

<sup>81</sup> Other reasons for such inaction could also be related to the lack of a flexible and efficient preventive restructuring frameworks that encourage debtors to resolve their financial problems, or the overall inefficiency of insolvency frameworks.



any more. Owners/managers do not have a natural incentive to file for insolvency if not obliged to do so by law; however, a timely launch of an insolvency proceedings by the directors or creditors (should national law entitle the latter to file) would be beneficial for the amount recovered, as delays may cause further reduction of the recovery rates through further operative losses and asset depletion, which can to a certain extent be averted if insolvency regimes are sufficiently efficient.

225. Currently, the policy debate on the comparative efficiency of insolvency regimes in different countries relies on the assessment performed in the World Bank's "Doing Business Indicators". These indicators provide a useful first impression of the extent of the differences across Member States in terms of the length of the procedures and recovery rates. However, the indicators are based on a number of simplifying assumptions (including outcomes on hypothetical "test cases"), based on reporting by national administrations, and lack granularity so that market participants (banks or investors) can hardly use them as an input to price the NPLs. In order to address this lack of comparable and reliable data, there is a need to build more reliable EU data sets based on concrete cases and a replicable methodology, also considering the bank creditor perspective. At European level, it is important to set appropriate EU benchmarks for enforcement regimes' efficiency and performance. This would allow comparing different jurisdictions, foster peer pressure to boost structural reforms and measure improvements in time. At the national level, granular information on insolvency outcomes would be helpful to benchmark the functioning of the judicial systems and improve available information for banks and investors on expected cash flows from NPLs after loan enforcement.

226. Reforming insolvency regimes presents challenges of both technical and political nature. Insolvency frameworks are primarily defined in national legislation, with close links to other areas of law in the national remit, such as property law and civil procedure. Insolvency regimes for households are generally less complex than for corporations<sup>82</sup> since household insolvencies tend to be less complicated, however, they present delicate problems of their own. The availability of assets for sequestration is generally limited (households' assets serve people's livelihood subsistence), furthermore, the extent to which these assets, in particular first residences, should be exempt from being seized is also a cultural as much as a legal issue and depends on public policy choices and the social safety net in the respective Member State. That is why the feasibility of a more harmonised European approach in that field is more debatable than for corporate exposures and would require additional work.

227. National rules on enforcing loans or collateral can generally not be changed retroactively, which may limit the impact of the insolvency reforms on the outstanding stock on NPL. This is not the case for improvements in the judicial capacity, which would have a direct impact on the stock of NPLs and should be a key focus for policy action in those Member States where performance is lagging behind.

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<sup>82</sup> IMF, A Strategy for Resolving Europe's Problem Loans, September 2015.

### 7.3. Policy options

**228. Policy Option B.1: Improve the transparency of insolvency outcomes in national proceedings and availability of data for banks, investors and servicers**

229. Relevant stakeholders, including banks and investors should be able to easily retrieve and access comparable information on procedural steps of the insolvency procedures in different Member States, as well as in different regional applications within one jurisdiction.

230. Similarly, information on the outcomes of the judicial procedure (average recovery values, time of proceedings, costs for proceedings) in different jurisdictions should be available for market participants. Such information collected from different Member States should be made as easily comparable as possible and be based to the extent possible on the methodology developed for the benchmarking exercise set up by the Commission across Member States (see below). Granular data published at the local level should be developed on the basis of a set of common indicators, to measure the regional applications on insolvency procedures.

**231. Policy Option B.2: Further develop the focus on insolvency issues in the European Semester to enhance incentives for reforms at national level (legal framework, as well as judicial and administrative capacity) and at European level, where appropriate, on the basis of the Insolvency Benchmarking exercise. Consider the setting up of dedicated peer reviews**

232. The benchmarking exercise set up by the Commission as mandated by the Eurogroup should be used proactively to focus on NPL related issues. It is important to have as precise metrics as possible for recovery rates, recovery times and recovery costs at national level. The results of the benchmarking exercise should be made publicly available.

233. Building closely upon the benchmarking exercise and following similar examples in Economic Policy Committee and at FSB for financial stability issues, dedicated peer-reviews on insolvency regimes across the EU should be considered. This would develop further the quantitative analysis brought forward by the benchmarking exercise with a qualitative and in-depth analysis, in particular of the institutional setting and judicial and administrative capacity. This would also promote best practices and enhance experience sharing among Member States, while providing an external assessment of policy developments and fostering further reforms, where needed.

234. Based on the results of the benchmarking exercise and targeted peer reviews, taking into account ongoing reforms, stronger focus on the improvement of insolvency frameworks should be given in the country-specific recommendations in the European Semester, especially in those countries where high levels of NPLs prevail.

**235. Policy Option B.3: Take note, as a first step, of the Commission's proposal on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures to harmonise certain elements of pre-insolvency procedures. Swift agreement on a general approach for this proposal should be sought**

236. The proposed directive presented in November 2016 aims principally to facilitate the restructuring of viable businesses in the pre-insolvency phase, so the scope does not focus on

the unviable businesses mostly associated to current high NPL stocks. The text is currently being discussed in the Council Civil Law working party. The Council conclusions on a roadmap to complete the Banking Union adopted in the ECOFIN in June 2016 underlined the importance of the work on this topic in the context of the Capital Markets Union and to support efforts to reduce future levels of NPLs<sup>83</sup>. The proposed measures represent a first step of harmonising certain elements of pre-insolvency restructuring procedures and second chance regimes. However, the proposal is not expected to have a direct impact on the current NPL stocks. Some horizontal aspects of the proposal would have a bearing on NPL resolution, like elements to strengthen the restructuring framework of loans and elements to improve the efficiency of procedures and institutional settings for loan enforcements. However, debt recovery and issues such as the position of secured creditors in insolvency proceedings are not part of the scope of the text (see below Box 3).

#### **Overview of the Commission proposal from the angle of NPL resolution**

The proposed directive aims principally to facilitate the restructuring of viable businesses where formal insolvency procedures leading to liquidation would be value-destructive and an unnecessary burden on courts. In addition, besides second chance/debt discharge for entrepreneurs, it includes more minor provisions which seek to increase the efficiency of restructuring and insolvency procedures. More specifically, it requires Member States to ensure that the members of judiciary and administrative authorities dealing with all procedures receive the required training and have the necessary expertise and specialisation. Use of electronic means of communication is also required for dealing with insolvency matters. These measures aim at reducing the excessive length of procedures in many Member States. As an important element of the proposed Directive the Commission would, annually, receive data from Member States on restructuring, insolvency and debt discharge procedures which will serve to generate reliable and comparable annual statistics and help to underpin regular monitoring and evaluation of national systems.

More effective preventive restructuring arrangements can also indirectly help to support the functioning of insolvency proceedings. If the number of companies becoming insolvent (through successful restructuring) falls, this should reduce pressure on courts handling formal enforcement/insolvency proceedings. On the other hand, restructuring tends to work best before a backdrop of efficient insolvency and enforcement regimes.

In this respect, the proposed directive intends to introduce:

- new elements to strengthen the restructuring framework of loans, which may contribute to a more efficient management of defaulting loans, with a key objective to reduce the most significant barriers to the free flow of capital stemming from differences in Member States' restructuring frameworks. As a side effect, it may reduce accumulation of non-performing loans on banks' balance sheets and help improving the residual value which can be expected by creditors by allowing an earlier and swifter restructuring or resolution for debtors facing financial difficulties (with preventive restructuring procedures), provided there is no misuse of the framework (e.g. there is no viability test before entering into a restructuring process; discharge for remaining debts for entrepreneurs occurs after three years without minimum conditions being required);
- new elements to improve the efficiency of procedures and institutional settings for loan enforcements (training and specialisation of judges, standards for insolvency practitioners, digitalisation of procedures, minimum rules on appointment, remuneration and supervision of insolvency practitioners).

<sup>83</sup> In a statement on common principles to promote investment on 7 April 2017, the Eurogroup refers to the role of effective judicial system and insolvency framework to support investment.

The scope of the proposal however does not focus on unviable businesses which make up a good part of debtors on NPLs. To ensure there is a real choice between voluntarily entering into restructuring negotiations or applying/waiting for regular insolvency procedure, insolvency procedures have to run effectively and creditors must expect their claims to be settled within a reasonable time span.

**Box 3: Overview of the Commission proposal from the angle of NPL resolution**

**237. Policy Option B.4: Consider further work on European approaches (including harmonisation with optional European regimes) on salient features of insolvency frameworks such as the protection of secured creditors of corporates, to facilitate the swift repossession of collateral (including out-of-court settlement mechanisms)**

238. Protection of secured creditors is highly heterogeneous across Member States both with respect to the applicable legal framework and the effective outcome in insolvency proceedings. While the scope for a more harmonised European approach may be questionable for loans to households, such is not the case for loans to corporates. Enhanced and more harmonised protection of secured creditors supports recovery rates, while minimising the time and costs associated with the recovery process, which in turn provides better incentives for financial institutions to develop their lending activities to the corporate sector and allows for better price discrimination among lenders. Such a harmonised approach is also consistent with the importance of cross border flows in corporate lending.

239. An enhanced regime would require that the collateral for secured claims is processed strictly prior to the claims of any unsecured creditors (taking into account the situation of public creditors). In order to further enhance the time efficiency of the recovery process and to ensure a more predictable and adequate repayment in terms of outstanding amount, the collateral should not form part of the insolvency estate. Instead, it should be possible to reclaim the collateral or – where applicable – to realise its value outside of the insolvency proceeding, regardless of the insolvency estate or other creditors, unless it is essential for the continuity of the economic activity of the company, where a credible continuation plan exists and provided secured creditors are put in the position to be able to challenge effectively the credibility of that plan. As a result, secured creditors could count on receiving at least the value of the collateral (limited to the amount outstanding on the claim).

240. The Commission should be called upon to consider an optional European harmonised regime on collateral for lending to corporates, recalling the approach taken in the Financial Collateral Directive which achieved targeted harmonisation of a key aspect of financial transactions<sup>84</sup>. The aim of such a European initiative should be to enhance protection for the collateral taker from the effects of stays/freezes in national insolvency proceedings and to establish a uniform procedure for swift execution of such collateral and to exempt such collateral from different and potentially inefficient rules in national insolvency regimes.<sup>85</sup> This optional regime, limited to corporate lending, would be made available for creditors and borrowers for new contracts.<sup>86</sup>

**Example of targeted EU harmonisation: creation and enforcement of financial collateral for financial market transactions**

Collateral is given by a borrower to a lender to minimise the risk of financial loss to the lender if the borrower defaults on its obligations. With the Directive 2002/47/EC of the European Parliament and the Council of 6 June 2002 on financial collateral arrangements, a European regime was introduced for the provision of securities, cash and credit claims as collateral under both security interest (where the collateral taker receives a security right, e.g. a pledge or a charge) and title transfer structures including repurchase agreements (repos) (where the full title to the collateral is transferred to the collateral taker). In practice the collateral provided is to be in the possession or under the control of the collateral taker to minimise the credit risk and also protect the collateral taker from insolvency rules, including insolvency stays or freezes. The objective was indeed to strengthen the enforceability of the financial collateral by secured creditors (including central banks/the ECB or other financial institutions) against third parties, derogating to national insolvency proceedings, and remove obstacles to facilitate the movement of financial instruments across the EU.

**Box 4: Example of targeted EU harmonisation for the creation and enforcement of financial collateral for financial market transactions**

241. There are additional areas of insolvency proceedings which are particularly material from a banking creditor perspective. As regards insolvency triggers, a clear definition of the term "insolvency" could be introduced in Union law, harmonising national definitions. It is important to define the moment when debtor which finds itself in financial difficulty, is incentivised to take action. In such case, the debtor and its managers should take steps to minimise losses, protect stakeholders' rights and avoid further depletion of economic value. Such definition could trigger a concrete obligation on the debtor / its managers to file for insolvency proceedings and the obliged person should be liable and have to do so within a specified timeframe. The obligation to file for insolvency would render the debtor's financial situation explicit and thus send a clear signal for investors and banks to consider writing-down the loan on their balance sheets.

<sup>84</sup> Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

<sup>85</sup> It must be noted that whereas the Financial Collateral Directive provides for self-execution of the collateral which is in principle already in the creditor's possession, the proposed new regime would have to cater to situations where the collateral remains in the debtor's possession, since collateral other than financial collateral is often needed in the day-to-day operations of the business. Hence, the aim of the new regime would be swift execution and earmarking of the proceeds for the benefit of the collateral taker over the other creditors. A new regime would thus be quite different from the Financial Collateral Directive in many respects, starting from its scope, e.g. as regards the assets concerned.

<sup>86</sup> See footnote 77.

Furthermore, timely action should ensure better recovery rates than in cases where the triggering of insolvency proceedings was delayed and a timely settlement of claims for (secured) creditors. Besides, there is a likelihood that further NPLs are created if companies which actually are insolvent and unviable, but did not file for insolvency, enter into new loan agreements. With a clear definition of insolvency triggers and consequently a reduction of unnecessarily delayed insolvency proceedings, the risk of a further creation of NPL would be diminished.

242. Harmonisation of avoidance actions as well as clearly defined time periods covering actions to the detriment of the debtor's estate should also be considered. An efficient insolvency regime requires indeed a clear definition of both. As a consequence of a lack of such provisions, the insolvency estate may be significantly reduced, which results in lower recovery rates for creditors. Such provisions should be clear and comprehensible and attempt to cover relevant actions to the detriment of the insolvency estate to a large extent. When determining the adequate length of time periods, it may be useful to consider not only the objective criteria of the avoidance action but as well the subjective intention of the respective debtor at the time of the relevant action.

## 8. Developing secondary markets in Europe for NPL transactions

### 8.1. Policy objectives

- ✓ **At the bank level, address challenges related to the availability, comparability and quality of data as well as the lack of standardisation of loan tapes, in order to improve the marketability of NPLs**
- ✓ **Increase bank's incentives to sell and widen the investor base to acquire and manage NPLs in secondary markets, including through the securitisation of NPLs**
- ✓ **Lift impediments to third-party servicing and remove remaining barriers to the transfer of NPLs to third-parties while ensuring the right level of consumer protection**
- ✓ **Strengthen data and market infrastructures to address market failures in secondary markets, where appropriate.**

### 8.2. Case for action

243. Well-developed secondary markets would have multiple benefits for banks facing high stocks of NPLs and seeking to engage in active NPL portfolio sale strategies to clean up their balance sheets and, as loans are transferred from banks to investors, bring in external capital to support the work out of NPLs. Even though it is not the focus of this report, it is important to stress that the availability of a functioning secondary market for loans in Europe would also provide benefits, beyond circumstances where high NPL ratio exist, to all banks considering sales of non-core assets. The existence of such a broad based market would improve liquidity and reduce volatility when pricing NPLs, and diminish the "threshold" effect associated with the current state of play in secondary markets whereby banks seem to be "willing" to engage with buyers only when the NPL level has reached levels that are deemed undesirable or unsustainable.
244. There are different modalities for the development of secondary market transactions, depending on the bank's chosen strategy, the asset type, the net book value relative to market prices, collateral valuations, and the associated capital position of the banks selling NPLs, as well as the presence of liquid NPL markets and the risk appetite of potential buyers<sup>87</sup>: direct sales by banks to outside investors (possibly in parallel to a recapitalisation of the bank); securitisation, possibly involving asset protection schemes or guarantees<sup>88</sup>; use of asset management companies.
245. Outright sales of NPLs may increase the recovery value that can be extracted from loans, as banks and investors may face a different set of incentives and constraints when managing exposures. Banks may be reluctant to restructure loans to avoid moral hazard on the part of other borrowers and strategic defaults. Banks may also be reluctant to enforce collateral bearing in mind that this may carry along a reputational risk, especially as regards mortgages and

<sup>87</sup> Please refer to: Fell, J., M. Grodzicki, R. Martin and E. O'Brien, (2016) "Addressing market failures in the resolution of nonperforming loans in the euro area" ECB Financial Stability Review, November, pp. 134-146.

<sup>88</sup> See Chapter 4 of the interim report with a description of the GACS scheme in Italy.

property loans to households. Some conflicts of interests may arise within the different parts of a bank, between the origination of loans, the maintenance of customer relationship and proactive NPL management strategies. On the contrary, third-parties acquiring NPLs usually have customer relationships of a narrower scope and are therefore more likely to be immune to this type of risks. In addition, third-parties can bring enhanced management and servicing techniques to improve recoveries as compared to banks, in particular smaller lenders that may lack the required in-house capacities and internal processes. However, it must be stressed that the sale of a loan originated by a bank to a third party also entails loss of information on the counterparty<sup>89</sup> which can be a hindrance in the management of the exposure.

246. Outright sales contribute to strengthening banks' balance sheets (provided that any capital depletion that may be associated to the sale is addressed properly) and should as such support profitability in the medium-term, as the offloading bank would not incur the additional administrative expenses and potential additional losses related to the future management of the exposure. In addition, removing NPLs from a bank's balance sheet reduces the uncertainty around asset quality and loan valuations, as uncertainty on possible future losses associated with the NPL portfolio disappears. This enhanced transparency may, in turn, facilitate equity raising from the market, as suggested by some recent market developments. However, when divestitures of NPLs occur in illiquid markets at fire-sale prices, offloading NPL can entail large destruction of economic value for the seller and there are fewer incentives to access secondary markets. Whether sale of impaired loans should be the preferred option in such a situation depends on the sustainability of the situation of the high NPL bank. If financial stability is at risk or the business model is durably impaired, offloading of NPL or exit of the bank from the market seem the preferable option.
247. Despite some momentum in recent years, debt markets remain less developed in Europe compared to third countries (in particular the United States), as pointed out in Chapter 4 of this report. As it stands, distressed debt markets tend to be characterised by small trade volumes, a few specialised investors, and large bid-ask spreads.
248. These gaps reflect factors such as different required rates of return for banks and investors, data quality hurdles, different loan recovery expectations by banks and investors, depending on the experience and perception of the efficiency and predictability of the insolvency and debt recovery framework (associated with different risk premia), and the valuation of servicing costs which are not taken into account in provisions by banks but factored in the bid prices of potential buyers. Furthermore, the set of incentives from regulators and supervisors may not always play in the direction of good functioning secondary markets.
249. First, the large bid-ask spreads reflect impediments<sup>90</sup> to the well-functioning of secondary markets for NPL transactions and NPL securitization.
250. These impediments are linked to information asymmetries between sellers and buyers and coordination challenges, such as a possible first mover disadvantage, constraining to the price discovery process. Potential buyers tend not to have access to reliable, granular, readily

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<sup>89</sup> Be it the knowledge accumulated on the customer through the business relationship, or information at the disposal of the bank through associated services that it can perform for the client e.g. current account management.

<sup>90</sup> For a detailed account, please refer to the article "Addressing market failures in the resolution of nonperforming loans in the euro area" in the ECB Financial Stability Report, November 2016.



available standardised information on asset quality and loan tapes in banks. As a consequence, potential buyers may bid a purchase price that does not reflect the economic value of portfolios available for sale, thus hindering potential transactions. When banks are incentivised to decrease their NPL levels, they tend to sell loans that are provisioned the best in order to incur minimum losses. Such NPLs are likely to feature poor credit quality, thereby sending an overly pessimistic signal on the overall quality of the NPL portfolio to potential buyers (the so called “lemons” problem).

251. Therefore banks need to be incentivised to improve the data quality and to disclose more information on NPLs to potential buyers. To the extent that banks lack the capabilities to do so and since insufficient transparency on asset quality can create negative externalities, there could be a case for an initiative to establish a reliable data infrastructure to facilitate transactions, for example as it has been done with the European Data Warehouse (EDW) for European asset-backed securities deals.
252. Second, there are intrinsic differences between buyers and sellers in the way they value NPLs, due to different risk valuation methods, discount rates and capital structures.
253. On the seller’s side, a bank may be reluctant to sell (or equivalently set a reservation price for transactions, below which they will refuse any transaction), as outright sales of NPLs usually entail immediate losses for banks, with the sale prices tending to be lower than the net book values of the portfolios sold. The capital impact can however be mitigated if the provisioning and capital requirements associated with those loans are sufficiently conservative, all the more so as there are high fixed costs related to the marketing and data cleaning efforts that are prerequisites to the sale of a loan portfolio. With respect to provisioning policies, an important element is whether those policies incorporate a proper assessment of the volatility of the outcome of insolvency and loan enforcement proceedings (which should be reflected in the baseline valuation they use for impaired exposures and the discount rate they apply to those exposures). Regarding capital ratios, it is important to stress that NPL sales have multiple impacts beyond the possible depletion of own funds which occurs if the sale price is below net book value. The divestiture of NPLs also has a deleveraging effect on risk weighted assets (the denominator of the capital ratio). At the same time, for banks using advanced internal models, and depending on the degree of conservatism of the models used, there might be an additional indirect impact as the sales price acts as an input in the bank’s models’ estimation of loss given default (LGD) for credit risk. This impact can be very significant as it concerns the whole credit exposure of the bank falling within the same category, and may strongly disincentivise outright sales<sup>91</sup>.
254. On the buyers’ side, investors tend to require greater rates of return for their investment, therefore using a higher internal discount rate. They can be more conservative on the presumed outcome of restructuring and insolvency procedures. Additionally, investors are not able to leverage their balance sheets to the extent that banks can do, which entails a higher weighted average cost of capital. Differences in discount rates and funding structures can thus explain steady state gaps between bid and ask prices. The impact of differences in discount rates on loan valuations is multiplied when restructuring and insolvency proceedings are protracted, as NPL values are discounted over a longer time horizon.

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<sup>91</sup> Bank of Italy, Notes on Financial stability and Supervision, No. 6 - Why exceptional NPLs sales should not affect the estimated LGDs of A-IRB banks, January 2017.

255. Third, additional price distortions may arise from the lack of depth and liquidity of the market, which has a bearing on the price investors may be willing to pay for acquiring NPL portfolios as investors may ask for an additional liquidity premium.
256. Enhancing market liquidity by promoting the establishment of relevant infrastructures and incentives to generate transaction flows may therefore contribute to lifting impediments to a well-functioning secondary market. A fragmented network of sellers, insufficient servicing capacities, or legal barriers for potential non-bank market participants for the purchase and management of NPLs all have a bearing in that respect.
257. Against the background of low market liquidity, asset management companies can provide economic benefits to spur secondary markets and also thereby create a better environment for accelerating the restructuring of balance sheets (see Chapter 9). In that regard, such entities can be a valuable element in a broader strategy to address the problems in the banking sector in a timely and comprehensive manner. By bringing in skilled NPL management together with appropriate servicing capacities and larger volumes of assets to attract potential buyers, AMCs allow for pro-active strategies both in terms of sales (targeting potential investors, marketing portfolios, offering securitization schemes) and increasing the recovery value (gathering data and clearing loan tapes to reduce asymmetries of information, engaging in efficient servicing before selling loans, increasing the value of collateral once acquired before disposing of it).
258. AMCs may contribute to developing secondary markets and facilitating the deal-making process for future sales of NPLs, while avoiding coordination failures, such as fire sales, and bridging some time inconsistency challenges because they have a longer time horizon for the work-out of assets at their disposal (see Chapter 4.2.3.), giving more time for a recovery of the market for real estate for instance. Some advantages pertain to shared characteristics of AMCs with non-bank actors (segregation of assets in a dedicated vehicle, weaker lender-debtor relationship and a strong focus on management and servicing capabilities), other may arise from the mandate of AMCs, with generally a medium term horizon, and the benefits of asset pooling, contributing to diversifying risks and allowing for more flexibility in managing assets<sup>92</sup>, with losses on some portfolios offset by gains on other portfolios. However, AMCs may work best when they focus on a single asset class with possible economies of scale, as the examples reviewed by the subgroup show (see Section I).
259. While there are immediate benefits of accelerating balance sheet repair, time is necessary for structural reforms to have an impact on the functioning of secondary markets. A comprehensive strategy to stimulate distressed debt markets in Europe should therefore involve initiatives to increase the underlying recovery value of NPLs (e.g. through enhanced insolvency and debt recovery frameworks to extract more value from NPLs, see Chapter 8), as well as to reduce valuation asymmetries between buyers and sellers. The latter can be achieved both on the seller's side (e.g. by implementing proactive NPL plans also in regard to provisioning policies and collateral valuation, enhancing regulatory pressure to increase banks' willingness to sell, and improving information frameworks on NPL portfolios) and on the buyer's side (e.g. by removing impediments to the entry of non-bank actors, improving outsourcing capacities for NPL work-out, promoting the establishment of proper data and market infrastructures to encourage large scale transactions, which entail economies of scale, and improving the quality of data).

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<sup>92</sup> At the aggregate and individual level (as combining all debts of a particular borrower within a single entity can facilitate restructuring).

### 8.3. Policy options

260. **Policy Option C.1: Implement enhanced disclosures requirements on asset quality and non-performing loans to increase transparency on balance sheets with more granular information, across a broad spectrum of the banking sector.**

261. A number of steps have already been taken to improve disclosure and transparency regarding NPLs. Such steps include for example the Asset Quality Review in 2014, additional Asset Quality Reviews for certain Member States under a financial assistance programme, the EBA's transparency exercises and the pillar 3 framework. Recently issued Guidelines by the EBA adjusting the pillar 3 requirements will require Global Systemically Important Institutions (G-SIIs) as well as Other Systematically Important Institutions (O-SIIs) to disclose more information on their exposures, as of end-2017, using standardised and more granular templates<sup>93</sup>. The extension of these requirements by the EBA and competent authorities to a larger set of banks, given the prevalence of high NPLs across the banking sector independently of the size of the institutions, is desirable and would enhance the effectiveness of these disclosures<sup>94</sup>. Regular supervisory dialogue could also improve the quality of disclosures by banks and loan files management and cleansing efforts. The SSM NPL guidance<sup>95</sup> provides a set of granular disclosure items to be implemented swiftly by banks. Nevertheless, while the authorities can provide the right incentives and environment for banks' disclosures, ensuring the accuracy and credibility of disclosures remains ultimately the responsibility of banks themselves.

262. **Policy Option C.2: Mandate the EBA to develop guidelines for banks on loan tapes monitoring to standardise information in order to improve the readiness for sale of NPLs.**<sup>96</sup>

263. Given the large prevailing heterogeneities and the necessity to upgrade and standardize loan tape information to facilitate access to secondary markets, EBA should develop guidelines to specify what minimal detailed information is required from banks on their credit exposures in the banking book. In other words, the EBA would define the data quality terms of reference to be done by banks. These guidelines should reflect the justified needs of potential buyers. The implementation of this guidance would warrant specific monitoring by supervisors in high NPL banks.

264. Such steps would facilitate transactions and would be useful for potential distressed debt investors as the same standardised data would be available for all transactions. Furthermore, such standardised information would help boost the possibilities for securitising NPL assets, as it would ease the combination of NPL assets coming from different loan originators.

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<sup>93</sup> <http://www.eba.europa.eu/documents/10180/1507285/EBA-CP-2016-07+%28CP+on+GL+on+disclosure+requirements%29.pdf/4262be6c-3d0e-4b22-b197-1a15d0849141>.

<sup>94</sup> As developed in Chapter 4 (interim report), these enhanced disclosures about impaired and defaulted exposures would also contribute to the explanation and reconciliation of different definitions for the sake of transparency and comparability.

<sup>95</sup> Annex 7.

<sup>96</sup> The guidelines by the EBA should seek compatibility with the data format used by AnaCredit.

**265. Policy Option C.3: Strengthen the data infrastructure for secondary market transactions and consider the setting-up of platforms for NPL transactions to develop the secondary market and enlarge the pool of market participants.**

266. Data quality is a key hurdle for secondary market transactions. A first step to address this issue would be the issuance of guidelines by the EBA for banks on loan tapes monitoring, reflecting the needs of potential buyers (option C.2). To boost secondary markets for NPL transactions, centralised platforms (variously referred to as a data hub or clearing house for transactions), could strengthen the infrastructure of secondary markets transactions, improving the quality and comparability of available information on loans and counterparties for potential investors and facilitating the external assessment of the quality and the marketability of loans. The platform may act as a central hub for NPL sales. As such it must be a central data repository for data on NPLs from participating banks and counterparties. The data must be standardized and of sufficient quality for due diligence purposes. The platform must be enabled with uniform and standardised legal documentation and transactional services. Such platforms would reduce investor costs (through the standardisation of data and processes and the consolidation of sales in one data-infrastructure agency), support data cleansing efforts by banks and provide more transparency on completed transactions. The establishment of the platform could also provide impetus for the development third-party services, in relation to data quality improvements and loan servicing.

267. The Commission and other relevant institutions such as the EBA and ECB could conduct preparatory work on the potential designs of data infrastructures/hubs, taking into account previous experiences such as the ECB ABS loan level initiative and available projects such as AnaCredit (please see Box 5 below).

### **Data infrastructure experiences in Europe**

There are already positive data infrastructure experiences, notably with the establishment of credit registries across the EU, which provide information on the credit profile of counterparties, the ECB ABS Loan Level Initiative and the ECB's current AnaCredit project.

#### *The ECB ABS Loan Level Initiative*

The ECB previously led an Initiative to improve transparency in ABS markets by requiring loan-by-loan information to be available and accessible to market participants and to facilitate the risk assessment of ABSs as collateral used by Eurosystem counterparties in monetary policy operations. The ABS loan-level Initiative established specific loan-by-loan information requirements for ABSs to increase transparency and make available more timely information on the underlying loans and their performance to market participants in a standard format (in the past, assessments of asset-backed securities have been hampered by the lack of standardised, timely and accurate information). The European DataWarehouse (ED) was created in 2012 as part of the implementation of the Initiative. While the public sector is represented in its board, it is owned, operated and funded by the market and currently hosts data for over 1 000 ABS transactions and private portfolios belonging to several different originators across Europe. Originators, issuers, sponsors and servicers upload ABS data to ED, while data users including investors, data vendors, rating agencies and public institutions use ED data for monitoring and risk assessment purposes.

#### *The AnaCredit project*

The ECB's current AnaCredit project will establish a shared, multipurpose database that contains loan-by-loan information on credit to companies and other legal entities extended by credit institutions and their foreign branches on a monthly basis. Provided AnaCredit is implemented under its expected scope, it could indeed act as an important credit quality assessment tool (in particular for cross-border investors). Furthermore, AnaCredit would allow for analysing exposures at solo level, by industrial activity and by size of the firm, due to AnaCredit's interaction with the Register of Institutions and Affiliated Database (RIAD). AnaCredit will also collect data on any collateral, providing information not only on the collateral value at the time when the loan was originated, but also the current collateral value and the amount that can effectively be allocated to secure a given instrument (e.g. due to priority claims). Also, due to the monthly data frequency, AnaCredit would make it possible to analyse individual loans or portfolios over time. Finally, and subject to more hindsight, AnaCredit may be suitable for assessing the efficiency of various loan enforcement regimes by analysing the actual outcome of loan enforcement proceedings against the status of legal proceedings taking into account the duration of the recovery processes. It must however be noted that AnaCredit's first data transmission will take place in late 2018 and that the data may only be delivered to users for analysis towards mid-2019. It must also be noted that exposures amounting to less than 25.000 euros are excluded of the scope, and that national authorities may, under some circumstances, relieve small institutions from full reporting requirements. Finally, AnaCredit has been conceived as a database for policy makers. Its users are restricted to the ECB, NCBs, supervisory authorities, the Commission and, to some extent, reporting agents. While such restrictions are in line with privacy best practices, they prevent a number of distressed debt secondary market participants to have access to valuable information. While AnaCredit is not intended to be a market tool, given the number of constraints and safeguards so as to ensure consumer protection and privacy, it establishes a first standardised set of homogenous information on loan-by-loan basis that could be built on when establishing a centralized data warehouse for NPL as done for the European ABS market.

#### **Box 5: Data infrastructure experiences in Europe.**

268. These platforms would offer a tool that would allow interested banks to register all those NPLs that it would like to put up for sale and also contribute to more homogenous information on loan tapes contributing to support data cleansing efforts in banks on the supply-side. At the same time interested investors could have simplified access to standardised and panoramic data of all NPLs that are offered for sale, which could contribute to widen the market on the demand-side. So as to avoid duplication of reporting requirements that weigh upon banks and centralize information to the maximum extent possible, the banks could directly report to an NPL

data warehouse relying on the AnaCredit data definition and report templates. Additionally, the NPL platform could be granted an access to AnaCredit, as long as data protection is ensured and appropriate safeguards are established. This would provide the platform with a comprehensive view of the situation and the history of the counterparty, further facilitating due diligence and diminishing transactions costs.

269. Experiences from the European ABS market show that loan-level information and transactions platforms could be established by the private sector, but could also be state-sponsored. While state-sponsorship could involve state aid to for setting-up the platform, this support would not be regarded as state aid granted to banks wishing to sell NPLs through the platform.

**270. Policy Option C.4: Consider further work on European harmonised regulatory regimes for the transfer and ownership of NPLs to banks and non-banks as well as on simplifying and potentially harmonising the licensing requirements for third-party loan servicers.**

271. Investment funds play an important part in distressed debt markets, generally with special purpose vehicles (SPVs) purchasing and securitising loans. Initiatives have been taken to remove legal and regulatory impediments to transfers of NPLs both between banks but also with non-banks. Some barriers to acquisition by foreign entities that wish to acquire NPL have been lifted, for instance by allowing foreign bank subsidiaries to acquire NPLs<sup>97</sup>. Measures to facilitate the participation of investment funds in secondary markets for NPLs have also included the removal of restrictions for non-bank entities to acquire such loans, without requiring the prior consent of the borrower for the sale of the loan. However more subtle legal restrictions remain such as more stringent debtor consent rules for non-domestic buyers of NPLs. While concerns about consumer protection need to be taken into account, such consideration should not be used to justify barriers to new entrants, as appropriate safeguards can be put in place, see policy option C. 5. In addition, a number of countries have implemented exceptional legal regimes as regards the transfers of NPL whose counterpart needs to be protected (e.g. consumer loans, loans to SMEs, etc.) and there may be differences in the rights and obligations (including security rights) transferred to the party acquiring the NPLs from the originating bank. The ability of funds to restructure NPLs or swap NPLs against new loans, with or without a banking license may also be hindered. Remaining barriers have to be removed, in particular in a cross-border context.

272. The introduction of a European harmonised set of rules for the transfer, ownership and management of NPLs by both bank and non-bank investors could be considered, also in the context of the Capital Markets Union<sup>98</sup>. This regime would follow the following principles: first,

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<sup>97</sup> According to the SSM report “Stocktake of national supervisory practices and legal frameworks related to NPLs” *“the survey of 8 countries shows that the market stagnation is seldom caused by specific obstacles in the legal and regulatory framework as the majority of the countries have a favourable environment for NPL transfer and the entry of specialised investors into the local market. The few countries that still have legal impediments to the sale of portfolios, such as portfolio transfer restrictions on non-banking institutions or barriers to the entry of foreign investors, are currently amending their regulatory framework to overcome most of these issues”*.

<sup>98</sup> The ESMA has also conducted work on key principles for a European framework on loan origination by funds (available at: [https://www.esma.europa.eu/sites/default/files/library/2016-596\\_opinion\\_on\\_loan\\_origination.pdf](https://www.esma.europa.eu/sites/default/files/library/2016-596_opinion_on_loan_origination.pdf)).

the transfer of NPLs to another bank or to a non-bank should be possible, without any kind of barriers (consent of the borrower, domestic or non-domestic status); second, investment funds which acquire NPLs should have the ability to originate new loans to restructure the non-performing loans (provided an appropriate level of supervision is ensured).

273. A common European approach could also be considered to contribute to the development of the loan servicing industry<sup>99</sup>, as the maturity of this industry varies across local markets (this is and will remain a very local function), and clarify the legal and regulatory regime, which varies significantly across jurisdictions in terms of status (financial intermediary, debt enforcement or debt receivables companies) and licensing (by the central bank or the supervisor or registration with judicial authorities) and often relates to civil law. Servicers provide portfolio management and debt collection services for banks lacking in-house capacities or seeking to streamline and outsource the management of NPLs or non-banks investors focused on the securitisation and financing of assets. Currently, national regulations may restrict their ability to perform such services (e.g. licensing regime) or the development of this activity in some markets, which may be related to creditor protection or civil responsibility. To this end, lifting potential impediments to the third-party servicing and building a harmonized regime guiding servicing activities is warranted, dealing with servicers' licensing regimes, trade secrecy and consumer protection.
274. The Commission has recently launched a fact finding questionnaire on Member States' legal frameworks related to loan servicing activities and the sale and transfer of loans, which is seeking to collect information about Member States' legal provisions or regulation in this respect. This survey can serve as a first step in the above-mentioned work programme.

**275. Policy Option C.5: Develop codes of conduct for the transfer and management of NPLs for both bank and non-bank actors.**

276. In order to ensure that consumers are sufficiently protected, while avoiding imposing unnecessary burdens on banks or non-banks, a number of Member States have established codes of conduct for the transfer and management of NPLs. The establishment of such codes of conduct have helped to diminish the potential concerns regarding the practices of non-bank acquirers of NPLs, which could also give rise to negative reputation effects for the selling bank. Therefore it is recommended that Member States consider where appropriate the establishment of such codes of conduct, to ensure consumer protection, but also to avoid negative reputational effects for sellers and acquirers of NPLs.

**277. Policy Option C.6: Consider in a pragmatic approach the setting-up of AMCs to segregate bad assets and facilitate restructuring, to the extent that the conditions of success are met and AMCs bring added value to the working-out of loans. Invite the Commission to develop a blueprint for the permissible design of national AMCs.**

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<sup>99</sup> Such an approach would be helpful also outside the context of a secondary market for banks that wish to engage in "hold and restructure" strategies, for instance as regards non-performing property loans to households.

278. As described in Chapter 4, historically, and especially in the wake of the past crisis, AMCs have in many instances (NAMA, SAREB, BAMC recently) been an important part of the solution to clean up banks' balance sheets as a part of a wider package of reforms. Their main aim has been to remove troubled assets from banks' balance sheets to accelerate the restructuring of affected banks and thereby improving financial stability and removing a potential impediment to the flow of new credit to the economy.
279. At the same time, AMCs have also supported the development of a secondary market for NPLs, while being advantageous in avoiding fire-sales in the context of the burst of real estate bubbles (by acquiring unfinished projects of real estate and waiting for the real estate market to recover), alongside bank restructuring measures including the winding-down of some institutions. To the extent that AMCs can contribute to reduce NPL valuation spreads between sellers and buyers and availability of buyers, they may help kick-start a nascent secondary market for distressed debt or act as a market reservoir for future transactions, while allowing banks to segregate assets and clean-up expeditiously their balance sheet, thus facilitating future equity raising in the market<sup>100</sup>.
280. The set-up of an AMC entails benefits and costs independently of its funding and capital structure (public/private/mixed). A number of ideas of how AMCs could be structured have been floated in recent months, including at the EBA<sup>101</sup> and the ECB<sup>102</sup>. Rather than proposing a particular set-up this report aims to enumerate the potential merits and demerits of AMCs and explain under what circumstances AMCs have been successful in the past.
281. While the tool of AMCs should not be seen *per se* as a panacea, AMCs have five possible benefits: time, pooled expertise, scale, coordination as well as providing capital which is likely to be scarce in banks facing NPL challenges.
282. First, AMCs can help bridge the intertemporal valuation gap<sup>103</sup> for the necessary structural reforms to produce value on the price of NPLs in secondary markets and potentially maximise the recovery value of the loans
283. Second, AMCs can pool expertise to work out loans<sup>104</sup> (including packaging of loans for future transactions) of larger size and higher complexity. Centralised management of NPLs can add value as the lack internal capabilities and appropriate expertise to manage NPLs or access markets may benefit from economies of scale generated by pooled and outsourced NPL management in a centralised AMC, provided the AMCs meet key success factors. By bringing in skilled NPL management together with appropriate loan servicing and the required volume of assets to attract potential buyers, AMCs allow for pro-active strategies both in terms of sales (targeting potential investors, marketing portfolios, potentially offering securitisation schemes, diversifying asset classes, including across Europe) and increasing the recovery value

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<sup>100</sup> <http://bruegel.org/2017/03/carving-out-legacy-assets-a-successful-tool-for-bank-restructuring/>

<sup>101</sup> As proposed by the Chair of the EBA, see

<https://www.eba.europa.eu/documents/10180/1735921/The+EU+banking+sector+-+risks+and+recovery.pdf>

<sup>102</sup> Please refer to the article by Fell, J., M. Grodzicki, R. Martin and E. O'Brien, (2016) "Addressing market failures in the resolution of nonperforming loans in the euro area" ECB Financial Stability Review, November, pp. 134-146 and to the speech by the ECB Vice-President in Bruegel in February 2017 (available at: <https://www.ecb.europa.eu/press/key/date/2017/html/sp170203.en.html>).

<sup>103</sup> Bearing in mind however that data gathering and NPL workout in essence take time, the AMC would need to be granted sufficient a workout horizon.

<sup>104</sup> Either directly by the AMC or by third-party service providers.



(gathering data and clearing loan tapes to reduce asymmetries of information, engaging into efficient servicing before selling loans, increasing the value of collateral once enforced before disposal). This may contribute to increasing distressed debt market depth and liquidity, thus reducing market risk for potential buyers, and facilitating the deal-making process for future sales of NPLs, while avoiding coordination failures (be it fire sales or increased market risk aversion). Centralised AMC's can also act as the single point of entry for loan restructuring (coordination of creditors).

284. Third, AMC's might also address the situation of smaller lenders for whom access to secondary markets is complex (small transactions) or contribute to developing servicing capacities e.g. for SME's (deleveraging is more complex for SME's as compared to CRE's).
285. Fourth, AMC's can provide coordination benefits as AMC's could end up holding all the debt of a troubled debtor, thereby simplifying the restructuring of all loans of that debtor. This removes the coordination challenge where the loans are dispersed with multiple lenders (which is often the case for Commercial Real Estate loans and Non-Financial Corporations loans) and removes the first mover disadvantage to restructuring the loans of a particular debtor<sup>105</sup>.
286. Finally, AMC's may be a way to attract capital if the availability of market capital is limited. AMC's may attract private capital providers (possibly in combination with State support in line with the EU legislative framework and State Aid rules) that are seeking high yield exposure on a relatively long timespan and can afford lengthy recovery processes and allowing time for structural reforms to deliver. In this respect, the institutional and legal design of AMC's matter in term of banks' participation (free or mandatory) and mandate (sale of assets, collateral enforcement and disposal under appropriate return and timeframe constraints). Where the setting-up of an AMC involves state support with due conditionality, this conditionality may also foster loss recognition and appropriate restructuring in the banking sector, as past experience suggests (see Chapter 9). It is also important to note that the transfer to an AMC ensures that NPL's are effectively worked-out, while uncertainty is removed from the bank, which is not necessarily the case in a recapitalisation of the bank if provisions or losses are not taken and the NPL portfolio is kept passively on the balance sheets.
287. However, there are also limitations and transition costs associated with setting-up AMC's. First, it is only useful to move the NPL's outside the bank that originated the loan if the AMC is more efficient than the bank. The sale of loans to AMC's can involve a loss of information on the debtor and can impede restructuring when such restructuring involves extending new financing to the borrower under a credible restructuring plan. Due to this, it is more complex for an AMC to deal with heterogeneous asset classes and assets classes such as SME loans and residential mortgages, as compared to commercial real estate exposures and larger NFC exposures which are generally seen as the most suitable asset classes for AMC's

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<sup>105</sup> This holds in particular for Commercial Real Estate loans and Non-Financial Corporations loans.

288. Second, for AMCs to be able to extract value out of NPLs, it is crucial that AMCs have a clear mandate to work out the acquired NPLs. AMCs cannot act as an indefinite warehouse of troubled assets and it needs to be incentivised to work out NPLs it obtains. If an AMC does not act to work out the NPLs, it will not recover much value and therefore incur losses over time and furthermore the defaulted borrowers will not be liquidated or restructured, which means that these zombie companies will continue to weigh on the real economy.
289. Third, although benefits may arise from AMCs regardless of the nature of the capital (banks can set up private and internal AMCs) and the structure, in the past such structures have often been used to deliver state aid support (in the form of the transfer price of the loans, the AMC purchased impaired loans from banks at a price higher than the market price at the real economic value and the AMC, and the structure of the AMC, either due to public capital on the liability side of its balance sheet or due to state guarantees on its funding). Finally it should be noted that protracted discussions on the potential set-up of an AMC could provide less incentives to take swift action to solve NPL problems.
290. In this regard it is important to stipulate a blueprint of AMC set-up, which should clarify key success factors for national AMCs and in case of state-sponsored AMCs the permissible design, consistent with the EU legislative framework and State Aid rules, for state-supported asset relief measures and asset management companies. It is important to note that this option may be available inside or outside resolution, subject to compliance with the BRRD and the State Aid framework (see Annex 4).
291. The blueprint for national AMCs should contain a number of common principles in a concerted European approach (see Box 6 below), such as the relevant asset perimeter (how to determine the appropriate asset classes to be acquired by the AMC); the participation perimeter (which banks should offload NPLs to the AMC); the asset-size threshold (the minimum ticket); asset valuation rules (in order to be compliant with BRRD and State Aid rules); the appropriate capital structure (to avoid the AMC being statistically consolidated into the general government debt); and the governance and operations of the AMC (in order to maximise the recovery value). Such a blueprint could be elaborated by the Commission, working with all relevant institutions.

#### **Key issues to tackle in a European Blueprint for AMCs**

Past experience shows that AMCs have been a component of a broader strategy to tackle system-wide high NPLs, while providing a tool for the removal of assets from banks' balance sheets as mentioned above. A Blueprint for AMCs could be developed by the Commission, while working together with other institutions and building on these past experiences to determine the conditions of success of AMCs and the key features for private or state-sponsored AMCs. The Blueprint would also specify the permissible design of national AMCs as regards the EU Legislative and State Aid framework.

The following key issues would be covered by the Blueprint:

- **The asset perimeter and the asset mix for the AMC**

Centralized management of NPLs in AMCs provides economies of scale among other benefits, however all asset classes may not be suitable for AMCs and the heterogeneity of the asset mix may limit the efficiency of the AMC. The Blueprint could develop principles and processes to identify the most appropriate asset mix.

*Should AMCs focus on real estate exposures and large non financial corporates or to which extent can AMCs deal with specific asset classes such as SME loans? To which extent can AMCs deal with heterogeneous asset classes or should the asset mix be limited to a small number of asset classes? How can the AMC acquire all exposures of the banking system to a non performing debtor to provide the creditor with a panoramic view of the counterparty? Should floors be introduced, at the asset or portfolio*

level, to avoid burdening the AMC with many small exposures? Depending on if there is a threshold for assets, how can small lenders participate to the AMCs?

- **The participation perimeter**

The participation perimeter of the AMC could cover banks holding significant non-performing exposures, above a threshold to be determined and where appropriate requests from regulators to affected banks in a broader strategy to accelerate the balance sheet repair of affected banking sectors.

*Based on best practices, should participation to AMCs be voluntary or incentivised? What kind of instruments could be implemented to incentivize banks or require high-NPL banks to off-load to an AMC? Based on objective criterion, how could supervisors mitigate the impact of large NPL transfers on the estimation of the LGD in the internal models of participating banks, after a case-by-case assessment?*

- **The asset valuation rules for the transfer of NPLs to the AMC**

Market values for NPLs are usually depressed when AMCs are set up, whereas recoveries are expected to take place over time. This creates a risk for the AMC of overpaying the assets to be transferred and making future losses. The pricing of assets transferred to the AMC requires a robust methodology, based on a due diligence process to assess the value of assets and collateral.

*What are the recommended stages of the valuation process? If an AMC involves a State Aid element, what would be the requirements for the valuation process according to State Aid rules following a methodology approved by the Commission?*

- **The capital and funding structure of the AMCs**

Various options for the capital structure and funding sources of the AMC and the legal status (banking license or not) are possible and have different consequences in case of public ownership in terms of consolidation of the AMC's balance sheet with the State, making it more challenging for Member States with limited fiscal space to establish public AMCs. On the other hand private AMCs relying on (mandatory) participation of a national banking sector can contribute to burdening and weakening viable lenders.

*What impediments do private AMCs face? How can public-private partnerships be fostered? In case of state participation, what is the capital level that does not require consolidation of the AMC in the general government budget? How can equity investors in an AMC, independent from the banking system, be attracted to reduce the burden on the banking sector, be attracted? What kind of funding structure should be considered and how can government guarantees be used? What are the possibilities to set up AMCs inside and outside resolution?*

- **The governance and the mandate the AMC**

AMCs should have a clear primary objective to maximise the recovery value from NPLs with governance arrangements shielding the AMC from political interference or budgetary pressures and ensuring the AMC does not act as an indefinite warehouse of transferred assets, which may require a lifetime defined from the outset. The mandate should also enable AMCs to choose and use the most effective work-out strategies including loan enforcement.

*What are the most appropriate governance arrangements and should AMCs develop outsourcing of servicers to independent providers? What kind of oversight of the AMC by public authorities be introduced?*

## **Box 6: Key issues to tackle in a European Blueprint for national AMCs**

## 9. Fostering the restructuring of banks and European banking sectors in the context of NPL resolution

### 9.1. Policy objectives

- ✓ **As restructuring of banks and banking sectors could be a condition for sustainable NPL resolution, removing potential structural impediments for restructuring and for raising capital allows banks to deal more swiftly with NPL resolution.**
- ✓ **When the domestic banking sector is capacity-constrained, encourage cross-border and non-banking lending in the context of the Capital Market Union to alleviate potential impacts of domestic banks' restructuring on credit supply and ensure that other sources of credit are available to meet credit demand.**
- ✓ **Consolidate and clarify the framework, in consistence with the BRRD, to deal with orderly exit strategies of unviable banks according to national insolvency settings, if resolution is not the chosen strategy.**

### 9.2. Case for action

291. Restructuring of affected banks and banking sectors could be a condition for NPL resolution. Addressing NPLs implies that credit losses will have to be eventually absorbed over time and may entail deep restructuring of affected banking sectors. This involves a combination of several approaches. (i) Proactive management of NPL portfolios by the banks themselves, on the basis of clear defined strategies for restructuring through internal work-out or disposal of impaired assets, transparency on asset quality and, consequently, on effective capital levels. (ii) Cleaning-up and removal of loans from banks balance sheets (as it was done, for example, in Ireland, Spain and Slovenia but also in the Nordic countries in the 1990s) when deleveraging is the chosen strategy by banks (iii) Raising private or public capital, consistent with applicable rules, while assuring exit strategies for non-viable lenders, mobilizing the appropriate tools foreseen in the EU or national legislation.
292. Past experience suggests that there is no easy route out of the NPL challenge for affected banking sectors. Ignoring high NPLs or delaying their resolution in the interest of, presumably, sustaining the provision of credit would, at the opposite, lead to a “zombification” of parts of the banking sector (together with a similar phenomenon in the corporate sector as debt would not be restructured and debt overhang would not abate). It would thus hinder recovery and healthy credit provision, holding back growth below potential. When the domestic banking sector is capacity-constrained because of the prevalence of a high NPL stock or because it is undergoing a restructuring linked to the resolution of high NPLs, possible adverse effects on the supply of credit to the real economy need to be mitigated, in particular through cross-border lending or through alternative sources of financing in the context of the Capital Markets Union.
293. Experiences from some banking systems in the EU and from non-EU countries during previous crises show that, regardless of the instruments used for resolution of the NPLs by banks (internally or externally), it is unavoidable that banks themselves take a substantial part of the associated losses. However, parts of the European banking sector face enduring challenges

that hamper their ability to generate capital both internally (through retained earnings) and externally (through the raising of capital from the markets). These challenges might remain in place in spite of extensive restructuring in some banking sectors and the overall strengthening of the EU banking sector in the aftermath of the crisis. In such a challenging environment, banks with a deteriorating asset quality are most under pressure.

294. Restructuring will have to take place at bank level (internal restructuring) to foster proactive NPL management while reducing associated costs, as well as to generate new capital, as the responsibility for resolving NPLs lies primarily with the banks. A number of potential areas of progress, also developed in the SSM NPL Guidance, pertain to improving data quality, developing early warning systems to track arrears and internal expertise for loan restructuring and enforcement practices, so as to avoid that loans become non-performing. Later stages on NPL management could require setting up segregated non-core units to manage NPL efficiently and, where appropriate, engaging into servicing agreements with a third party. In the long run, such restructuring should raise banks' ability to extract value out of NPLs while reducing associated management costs.
295. However, a significant number of high NPL banks appear to be unable to meet NPL management best practices yet, and internal restructuring is likely to take time and, in the short run, entail additional costs that may prove unsustainable, especially for smaller lenders. Low profitability compounded by oversupply of banking intermediation in some countries means that, in order to clean their balance sheets by themselves, banks would need to raise capital externally, either from the markets or by taking part in merger and acquisition operations to achieve efficiency-driven consolidation and reduce overcapacities where appropriate. A number of strategies are possible in this respect and could be achieved in parallel, ranging from outright fund raising from the market (depending on the market conditions at that time), to setting dedicated NPL co-investment platforms or offloading NPL (e.g. to an external AMC), but these strategies are only available for lenders with sufficiently solid prospects on the medium term as regards profitability and business models, as well as trust from the markets to raise capital.
296. Non-viable banks bearing no critical functions need to exit the market so as to speed up NPL restructuring and free market share for viable banks. In the current challenging environment and given the enduring legacy of the crisis in terms of asset quality, a number of banks are unlikely to be able to strengthen profitability adequately to generate sufficient capital (either internally or externally).
297. To preserve financial stability and avoid unnecessary costs, restructuring needs to be implemented in an orderly fashion, minimizing risks to financial stability. For smaller banks, partnership with other market players, integration in larger groups or merger and acquisition with peer banks (efficiency-driven consolidation) may be instrumental to address high NPL issues, as these banks would benefit from economies of scale regarding NPL management, improved capital generation through operational restructuring and enhanced capacities to access external capital. This strategy has been implemented already in some countries. For instance, in Spain, some NPL relief measures (in particular through the deconsolidation of impaired assets and their transfer to an AMC) have been implemented along an extensive reform of the savings banks. In Italy, a reform of cooperative banks is currently being implemented to reduce fragmentation and facilitate the consolidation of the cooperative banking sector, including the fostering of mergers.

### **Experience of Italy and Spain in restructuring the banking sector and dealing with NPLs**

In Italy, during 2015 and 2016 a number of measures have been implemented to reform the largest cooperative banks ("banche popolari") and small mutual banks ("banche di credito cooperativo"). The vulnerabilities of these banks were linked to the rigid features of the cooperative governance framework that hindered the effective oversight of the banks' management by their shareholders and also undermined the attractiveness of banks for investors.

The 2015 reform of "banche popolari" required large cooperative banks with assets above EUR 8bn to transform into joint-stock companies. It also introduced more flexible voting rules for mergers and acquisitions and decisions on the change of legal form. All but two large cooperative banks, completed their transformation into joint-stock companies by the of 2016. The aforementioned mentioned two large cooperative banks delayed the transformation process in expectation of a positive outcome of the ongoing legal challenge of the banche popolari reform.

The reform of small mutual banks aimed to tackle the weaknesses of a sector of roughly 370 banks. It requires the small mutual banks to join a cooperative banking group as a pre-condition for maintaining the license to carry out banking activities in the form of cooperative credit. The cooperative holding groups will be established as a joint stock company with total capital of no less than EUR 1 billion (or EUR 250 million for a provincial group). The holding group will manage and coordinate the member banks. The latter will preserve their mutualistic nature and hold the majority of the group's capital. The remaining capital will be held by outside investors. The 18-months implementation period of this reform started in December 2016 and will end in June 2018.

In Spain, many measures have been taken over recent years to deal with the banking crisis and they have led to increasing concentration within the banking sector. The main rationale of the consolidation process has been the pursuit of synergies, improved corporate governance, access to capital, as well as economies of scale. The consolidation attempted to reduce operating costs to support profitability and to at least partially offset some of the losses coming from the increasing number of NPLs. At the same time, the increase in size has probably also enhanced internal capabilities to manage NPLs. These measures have led to a considerable concentration of the sector without a limited impact on competition.

Firstly, several measures regarding the Spanish savings banks ("cajas de ahorros") aimed at enhancing the ownership structure and corporate governance, following a progressive approach, and at restructuring the sector, in pursuit of synergies and economies of scale to make institutions more efficient. As a result, out of 43 savins banks existing before the crisis, only 8 groups remain and the process is probably not over yet. As a first step in this process, the regulation and promotion of institutional protection schemes – IPS (2008), facilitated mutual support without the need of a full integration. As a second step, savings banks have been required to transfer their banking business to commercial banks. Finally, savings banks have been compelled to transform into foundations (or banking foundations) and encouraged to abandon control and/or reduce their participation in the commercial banks. The measures taken in this respect enabled the participation of new private or public investors to their recapitalization, facilitated cross-regional integrations and contributed to a further professionalization of their management.

Secondly, there were measures to establish a public scheme compliant with State aid rules to recapitalise banks in difficulties. These included the setting-up of the Fund for the Orderly Bank Restructuring - FROB (2009), with the aim of facilitating the recapitalizations. Moreover, the Spanish authorities benefitted from an EU Financial Assistance Program (2012), which provided the bulk of some of the financial resources necessary for the restructuring and recapitalization of the Spanish banking sector in compliance with State aid rules.

Thirdly, Spain implemented measures to make a proper diagnosis of the NPL problem and increase provisions and capital requirements in order to absorb the upcoming losses, improving the capacity of banks to deal with impaired assets.

Fourth, as part of the NPL disposal strategy, an asset management company, which took over the impaired assets (mainly real estate and construction sector exposures) of banks recapitalised with public support was set up (see Chapter 4.1.1).

### **Box 7: Experience of Italy and Spain in restructuring the banking sector and dealing with NPLs**

298. Restructuring, consolidation or integration are clearly an issue for banks themselves and primarily market driven processes. However, policy makers and competent authorities have the role to ensure that these processes are accompanied by the right incentive framework to run as smoothly as possible. This can be done through various channels such as reconsidering structural impediments to the evolution of ownership structures and equity raising, shaping regulatory incentives, or the exercise of supervisory powers when assessing the viability of strategies to address high NPL levels.
299. To the extent that banks are unable to solve such issues themselves, orderly and viable exit strategies may be needed in the course of resolution or orderly liquidation proceedings. Should a bank be failing or likely to fail and the resolution criteria be fulfilled, it is upon the supervisor and resolution authority to take action. In such a case the resolution tools can be applied<sup>106</sup>.
300. State support can also be provided outside resolution, involving AMCs or other type of impaired assets measures, including through precautionary recapitalisations consistent with the Bank Recovery and Resolution Directive (BRRD/SRMR<sup>107</sup>), the Commission's State aid conditionality and the Competent Authorities' solvency assessment. Commission services find it conceivable that impaired asset aid, including use of AMCs, qualifies as precautionary recapitalisation (See Annex 4).
301. For credit institutions of limited size<sup>108</sup>, State aid rules allow for the so called orderly "liquidation aid schemes" provided they ensure compliance with the requirements on burden-sharing by shareholders and subordinated debt-holders and remove moral hazard and other competition concerns. These schemes can be applied if the institution receiving the aid leaves the market either through a gradual wind-down or through integration in the acquirer. Such orderly "liquidation" schemes, may allow some flexibility for Member States to implement measures they consider appropriate and also allow for the implementation of measures in more than one bank, provided that these comply with the criteria defined in the scheme.

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<sup>106</sup> Which comprise amongst other: (a) the sale of business tool; (b) the bridge institution tool; (c) the asset separation tool; and (d) the bail-in tool. Resolution financing arrangements, such as Single Resolution Fund could also be used according with BRRD provisions for the following purposes identified by Article 101 BRRD/Section 3 of the SRMR. These resolution tools also allow for the setting up of AMCs, subject to a case-by-case analysis.

<sup>107</sup> BRRD/SRMR provide specific conditions to allow precautionary recapitalisation: it shall be of a precautionary and temporary nature and proportionate to remedy the consequences of the serious disturbance in the economy, it shall be limited to amount necessary to cover the capital shortfall (from an adverse scenario of a stress test, AQR or equivalent exercise), it should not be used to cover incurred or likely losses and should be confined to solvent institutions

<sup>108</sup> The "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")" defines credit institutions of limited size as credit institutions with total assets of less than EUR 3 000 million. Aid given to institutions above this size must be individually notified for approval to the Commission competition authorities.

### 9.3. Policy options

302. **Policy Option D.1: Initiatives to adapt the structure of banking sectors and facilitate the raising of new capital and increase attractiveness for private investors should be welcomed and fostered.**

303. Several structural initiatives have been implemented or are currently under consideration in a number of Member States. They aim to remove material impediments to restructuring, encourage capital raising and where appropriate consolidation. Structural initiatives also aim to integrate other players or take the insolvent parts out of the market without impairing the profitability of healthy banks. These structural measures pertain in particular to the legal status and the organisation of networks of banks, the ownership structures and the governance framework.

304. In Italy, during 2015 and 2016 as part of the reform of large and small cooperative banks several measures have been implemented to improve effective oversight of the management of the largest cooperative and small mutual banks by their shareholders and also increase the attractiveness of these banks for potential investors (see Box 7). One of the aims of the reforms was to ensure that these banks have the necessary capacity to deal with distressed debts and withstand losses.

305. The measures taken in Spain during the banking crisis have helped to address NPLs, reduce fragmentation and improve governance (see Box 7). The main rationale for consolidation was to reduce overcapacities and to pursue synergies and economies of scale, in an attempt to lower operating costs and boost profitability, in order to, at least partially, offset some of the losses associated with increasing NPL levels. At the same time the increase in size and efficiency-driven consolidation has probably also enhanced internal capabilities to manage NPLs. In parallel, external capabilities for NPL management have been made available to the weakest banks through the creation of an asset management company (SAREB), to allow for the segregation of the non-performing assets.

306. **Policy Option D.2: Relevant authorities should enhance the supervisory focus on long term viability of institutions and shape the right incentives for bank restructuring and integration, including in a cross-border and pan-European context to further solidify the Banking Union.**

307. Noticeable steps have been taken in terms of supervisory scrutiny and the report develops policy options to enhance the instruments available for supervisors to accelerate the pace of the resorption of NPLs by banks (see above). The Banking Union can facilitate bank restructuring and help cross-border market integration restart again, on the basis of a restructured banking system segregated from the bulk of legacy problem assets. Since the crisis, banks have often reduced their geographic footprint, in certain cases reversing years of expansion. This retrenchment has reduced geographic diversification of risk. Cross-border lending can also contribute, together with the direct funding by capital markets and non-bank lending, to mitigate any potential negative impact on the supply of credit and on the financing of the economy during the restructuring phase of the banking system. The CMU may contribute to the diversification of funding sources available to the economy to diminish the impact of domestic restructuring and contribute to the removal of impediments to cross-border flows. The Commission assessment of Member States' legal frameworks related to the sale and transfer of loans, including in a cross-



border context (see chapter 8) is also an opportunity to further analyse and report more broadly on these impediments.

308. **Policy Option D.3: When resolution is not the chosen strategy, coordination should be increased in order to create the right strategy for an orderly exit of non-viable banks with no critical functions, if necessary with orderly "liquidation" State aid.**
309. As it has been obvious from the experience of all countries confronted with such issues, resolving the NPL issue will necessarily involve a number of banks unable to withstand losses or restructuring costs exiting the banking market, in compliance with the EU legislative framework (BRRD/SRMR, State aid rules). Therefore, policy makers have developed appropriate tools to ensure an orderly exit from the market.
310. The EU legislative framework (BRRD/SRMR) establishes a framework for restructuring and resolution. The Banking Union marks a change of system to protect taxpayers' money, ensure the preservation of financial stability and enhance market mechanisms in the banking sector, to which resolution tools and in particular bail-in are essential. Dealing with the issue of high NPLs should not imply any deviation from the rules of the Banking Union.
311. The objectives of resolution are to ensure the continuity of critical functions, to avoid adverse effects on financial stability, to protect public funds by minimising reliance on public support to failing institutions and to protect covered depositors, investors, client funds and client assets. Resolution allows for the application of numerous tools (see above). Where appropriate and consistent with the EU legislative framework, orderly liquidation aid may be granted to unviable banks that are not put in resolution. Consistent with the EU State Aid framework set out in the Commission's Banking Communication (2013), liquidation aid can be permitted for the termination of economic activity and the winding-down of the bank, irrespective of the national procedure, if it is clear that the bank receiving the aid will leave the market and perform no new business, thus avoiding any potential distortions to competition. The winding-down entails a number of requirements pursuant to the EU State aid framework. Moreover, liquidation must as much as possible aim at selling off parts of the business or assets by means of a competitive process. The orderly liquidation procedure requires that the proceedings of any assets contribute to the liquidation costs. Where liquidation concerns a significant share of small banks of a banking sector, liquidation aid can be approved, provided that it ensures compliance with the requirements on burden-sharing by shareholders and subordinated debt-holders and remove moral hazard and other competition concerns, under a liquidation aid scheme, where the Commission sets up the main principles that would ensure that the aid is consistent with the Single Market, but the monitoring of the compliance with the decision is delegated to national authorities. For larger banks individual decisions taken by the Commission will be required. The provision of liquidation aid and the associated prohibition to engage into new business does not preclude the institution to divest viable parts of its business to a third party market participant, if the latter would fully integrate it and provided that transfer is compatible with other State Aid requirements (e.g. it should involve no transfer of aid to the acquiring entity). Deposit taking activity can for instance be divested in that context.

### **State aid in national insolvency proceedings**

Resolution, under the BRRD/SRMR, provides a minimum harmonisation of tools to be used in resolution of credit institutions, as opposed to insolvency proceedings which are not harmonised by EU legislation and are therefore Member State-specific. Once a bank is deemed failing or likely to fail, the resolution authority has to carry out a public interest test, including whether winding up of the institution under normal national insolvency proceedings would not meet the resolution objectives to the same extent. If the bank is not put in resolution by the resolution authority, it is put into insolvency following rules applicable at national level. While insolvency in all cases entails withdrawal of the banking licence as far as new business is concerned, it usually implies a realisation of assets through sale and repaying creditors from proceeds.

The requirements contained in State aid rules do not depend on the type of legal proceedings under which an ailing bank is handled but depend on whether the aided institution will continue to compete in the market with other banks or not; it is therefore an economic assessment of the use of that aid. In this context, "restructuring aid" is defined as aid to keep a bank operating and competing in the market. Restructuring aid is therefore more distortive of competition than "liquidation aid" where aid is granted to finance the orderly wind down of a bank or its full integration into another bank operating in the market. Hence the conditions for authorising liquidation aid are less demanding than the conditions for authorising restructuring aid: under State aid case practice as confirmed by the 2013 Banking Communication, the main requirements for authorising liquidation aid are that shareholders and subordinated debt holders of the bank bear full losses and that the bank ceases to compete for new business (which can be achieved, as indicated, through an immediate sale to – and integration within – a trade buyer) whereas, in the case of restructuring aid besides the burden sharing measures described above, the bank has to implement a restructuring plan to restore its long-term viability and to take measures to ensure that the aid is not used to fund anti-competitive behaviour. Therefore, as long as those conditions are fulfilled, it seems legally possible, in particular, that liquidation aid is authorised to finance the sale of the business of a small bank to another bank in the framework of national insolvency proceedings. Since such aid would not be granted in resolution, but in the framework of national insolvency proceedings, it would not fall under the BRRD. Nonetheless, under State aid rules, aid in insolvency shall be limited strictly to what is the minimum necessary amount to finance the market exit of the bank, which would also contribute to avoiding circumvention of the principles of the BRRD/SRMR.

Finally, regarding the financing of the liquidation aid, different options are available such as through direct government funding, through support from a fund backed by bank's contributions or through support from a DGS. As regards, the use of the DGS in insolvency the legislative reference is Article 11(6) of the Deposit Guarantee Scheme Directive which allows the use of the DGS "to finance measures to preserve access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors of the credit institution concerned."

*Source: Commission services*

### **Box 8: State aid in national insolvency proceedings**

## Annex 1: Cross-border aspects of the NPL phenomenon

1. Focusing on the breakdown of NPLs by country of the counterparty, it is possible to better disentangle the determinants of the dynamics. Data shows that NPL ratios are significantly lower for counterparties in non-EU countries compared to EU countries.
2. Most of the banks' NPLs are generated domestically. 87% of all NPLs come from borrowers from EU plus Norway.
3. EU banks share of international business is relatively high, with the average domestic exposure for the banks in the sample at 53%, but with wide dispersion across countries.
4. For most banks, the NPL ratio varies widely among the regions they operate in. Especially the difference between "Domestic" and "EU plus Norway excluding Domestic" NPL indicates that banks' strategic decision about the geographical diversification of their business contributes significantly to NPL levels.

| Counterparty in | Foreign banks                                 |                                    | NPL                                       |  | Comparison                                   |
|-----------------|---|------------------------------------|---|--|--|
|                 | Banks from # foreign countries doing business | Foreign banks' exposure in country | Foreign banks' weighted average NPL ratio | Domestic banks' weighted average NPL ratio | Domestic banks' weighted average "advantage" |
| 1               | 4   | 37%                                | 1.3%                                      | 1.0%                                       | 0.3 pp                                       |
| 2               | 2   | 25%                                | 13.0%                                     | 10.7%                                      | 2.2 pp                                       |
| 3               | 3   | 40%                                | 2.5%                                      | 4.2%                                       | -1.7 pp                                      |
| 4               | 1   | 15%                                | 68.1%                                     | 59.2%                                      | 8.9 pp                                       |
| AT              | 6   | 29%                                | 6.2%                                      | 4.0%                                       | 2.2 pp                                       |
| BE              | 4   | 40%                                | 3.0%                                      | 2.6%                                       | 0.4 pp                                       |
| BG              | 2   | 29%                                | 26.7%                                     | 17.8%                                      | 8.9 pp                                       |
| CZ              | 3   | 41%                                | 3.2%                                      | 3.0%                                       | 0.2 pp                                       |
| DE              | 13  | 30%                                | 1.9%                                      | 2.3%                                       | -0.4 pp                                      |
| EE              | 1   | 46%                                | 2.3%                                      | 1.6%                                       | 0.6 pp                                       |
| ES              | 7   | 21%                                | 6.9%                                      | 9.1%                                       | -2.3 pp                                      |
| FI              | 2   | 35%                                | 2.4%                                      | 2.2%                                       | 0.2 pp                                       |
| FR              | 12  | 15%                                | 1.3%                                      | 3.2%                                       | -1.9 pp                                      |
| GB              | 14  | 36%                                | 1.7%                                      | 2.4%                                       | -0.7 pp                                      |
| HR              | 4   | 54%                                | 15.1%                                     | 13.8%                                      | 1.4 pp                                       |
| IE              | 4   | 45%                                | 11.8%                                     | 23.2%                                      | -11.4 pp                                     |
| IT              | 7   | 27%                                | 11.3%                                     | 21.4%                                      | -10.1 pp                                     |
| LT              | 2   | 50%                                | 4.9%                                      | 6.3%                                       | -1.4 pp                                      |
| LU              | 3   | 55%                                | 2.6%                                      | 1.4%                                       | 1.2 pp                                       |
| NL              | 7   | 18%                                | 2.0%                                      | 3.1%                                       | -1.1 pp                                      |
| PT              | 1   | 19%                                | 9.7%                                      | 20.5%                                      | -10.9 pp                                     |
| SE              | 5   | 11%                                | 0.9%                                      | 0.3%                                       | 0.6 pp                                       |
| SI              | 1   | 16%                                | 10.5%                                     | 18.1%                                      | -7.6 pp                                      |
| Average         | 4.7   | 28%                                | 9.1%                                      | 10.1%                                      | -1.0 pp                                      |

**Table 3: NPL per country of domicile in country of risk for total loans and advances across EU countries (based on data as of June 2016)<sup>109</sup>**

(Source: EBA)

5. For example, Austrian banks with a strong strategic focus on CEE countries within and outside the EU, report much lower NPL ratios domestically than abroad. On the other hand, a number of countries, such as Spain and Italy report a higher NPL ratio domestically than for their total exposures. Apart from that, there is no clear pattern as to the region in which the banks' loans and advances have the lowest or highest NPL ratio. The NPL ratios for "Selected non-EU

<sup>109</sup> The analysis of the "geographical breakdown of assets by residence of the counterparty" covers 116 banking groups in 26 countries, including Norway. Foreign banks are banks not domiciled in the country of risk.

Countries” and “RoW – Rest of the World” are 2% and 3.2%, respectively, and they are much lower than the one in the domestic markets.

6. Tables 3, 4 and 5 in Annex 1 show the difference (both volume weighted and average) between domestic banks’ NPL ratios and foreign banks’ NPL ratios in the same country<sup>110</sup>.

| Counterparty in | Foreign banks                                 |                                    | NPL                                       |  | Comparison                                   |
|-----------------|---|------------------------------------|---|--|--|
|                 | Banks from # foreign countries doing business | Foreign banks' exposure in country | Foreign banks' weighted average NPL ratio | Domestic banks' weighted average NPL ratio | Domestic banks' weighted average "advantage" |
| 1               | 2   | 43%                                | 1.9%                                      | 1.9%                                       | 0.1 pp                                       |
| 2               | 3   | 63%                                | 14.2%                                     | 14.2%                                      | 0.0 pp                                       |
| 3               | 2   | 39%                                | 5.4%                                      | 5.5%                                       | -0.2 pp                                      |
| 4               | 2   | 15%                                | 70.1%                                     | 66.9%                                      | -3.2 pp                                      |
| AT              | 1   | 23%                                | 5.8%                                      | 5.7%                                       | 0.1 pp                                       |
| BE              | 4   | 42%                                | 4.2%                                      | 4.9%                                       | -0.7 pp                                      |
| BG              | 3   | 34%                                | 32.4%                                     | 21.5%                                      | 10.9 pp                                      |
| CZ              | 5   | 59%                                | 4.6%                                      | 4.8%                                       | -0.2 pp                                      |
| DE              | 11  | 28%                                | 3.3%                                      | 5.4%                                       | -2.1 pp                                      |
| EE              | 2   | 55%                                | 2.5%                                      | 2.6%                                       | 0.0 pp                                       |
| ES              | 8   | 24%                                | 15.6%                                     | 17.8%                                      | -2.2 pp                                      |
| FI              | 2   | 38%                                | 2.5%                                      | 3.3%                                       | -0.8 pp                                      |
| FR              | 8   | 14%                                | 3.7%                                      | 5.0%                                       | -1.3 pp                                      |
| GB              | 11  | 31%                                | 4.3%                                      | 4.0%                                       | 0.3 pp                                       |
| HR              | 4   | 59%                                | 26.4%                                     | 28.9%                                      | -2.5 pp                                      |
| IE              | 6   | 48%                                | 13.6%                                     | 33.7%                                      | -20.1 pp                                     |
| IT              | 6   | 22%                                | 19.4%                                     | 33.0%                                      | -13.6 pp                                     |
| LT              | 3   | 55%                                | 5.3%                                      | 7.8%                                       | -2.5 pp                                      |
| LU              | 7   | 75%                                | 4.1%                                      | 2.3%                                       | 1.8 pp                                       |
| LV              | 1   | 48%                                | 6.4%                                      | 4.6%                                       | 1.7 pp                                       |
| NL              | 12  | 24%                                | 4.8%                                      | 6.8%                                       | -2.0 pp                                      |
| PT              | 1   | 15%                                | 21.3%                                     | 33.9%                                      | -12.6 pp                                     |
| SE              | 5   | 15%                                | 2.2%                                      | 0.5%                                       | 1.7 pp                                       |
| SI              | 1   | 23%                                | 12.4%                                     | 32.0%                                      | -19.6 pp                                     |
| Average         | 4.6   | 29%                                | 11.9%                                     | 14.5%                                      | -2.5 pp                                      |

**Table 4: NPL per country of domicile in country of risk for loans and advances to NFC across EU countries (based on data as of June 2016)**

(Source: EBA)

7. The three tables provide NPL ratios for domestic and foreign banks for a given country of the counterparty. Under the – admittedly strong – assumption that the only determinant on NPLs is the country of the counterparty, the NPL figures, both, from domestic and foreign banks, should be relatively similar, as they represent NPL ratios of banks domiciled in different countries but exposed towards the same counterparty-country.
8. However, foreign domiciled banks tend to have lower NPL ratios (NPL ratios 2.5 pp lower on average) than their domestic peers in the non-financial corporate (NFC) segment.
9. On the other hand foreign banks have higher NPL ratios than their domestic peers in the household area (NPL on average 0.6 pp higher). Therefore, the economic, financial and legal conditions in local markets are not the only aspects to affect credit quality.
10. There can be many reasons behind these differences, such as higher risk-taking in the household segment due to stronger competition, different business types (more consumer

<sup>110</sup> To limit outlier-effects, which might distort averages, in both tables 2 layers of thresholds were introduced into the calculation. First, only bank exposed to a country with more than 1% of its total exposures has been included in the calculation. Second, to exclude exposures that are insignificant in terms of a specific country’s total exposure, a second threshold was defined such that only banks with exposures exceeding 0.1% of the counterparty country’s total were considered.

finance rather than mortgage financing) or established links with domestic healthy corporations for the NFC segment.

| Counterparty in | Foreign banks                                 |                                    | NPL                                       |  | Comparison                                   |
|-----------------|---|------------------------------------|---|--|--|
|                 | Banks from # foreign countries doing business | Foreign banks' exposure in country | Foreign banks' weighted average NPL ratio | Domestic banks' weighted average NPL ratio | Domestic banks' weighted average "advantage" |
| 1               | 2   | 32%                                | 0.8%                                      | 0.5%                                       | 0.2 pp                                       |
| 2               | 1   | 22%                                | 18.4%                                     | 16.4%                                      | 2.0 pp                                       |
| 3               | 1   | 31%                                | 2.3%                                      | 4.1%                                       | -1.8 pp                                      |
| 4               | 1   | 15%                                | 64.0%                                     | 52.5%                                      | 11.6 pp                                      |
| AT              | 1   | 19%                                | 4.2%                                      | 3.4%                                       | 0.8 pp                                       |
| BE              | 3   | 42%                                | 2.9%                                      | 1.5%                                       | 1.5 pp                                       |
| BG              | 2   | 36%                                | 19.7%                                     | 17.5%                                      | 2.2 pp                                       |
| CZ              | 2   | 34%                                | 3.3%                                      | 3.5%                                       | -0.1 pp                                      |
| DE              | 5   | 31%                                | 3.5%                                      | 1.7%                                       | 1.8 pp                                       |
| EE              | 1   | 51%                                | 1.3%                                      | 1.5%                                       | -0.2 pp                                      |
| ES              | 5   | 15%                                | 5.4%                                      | 6.4%                                       | -1.0 pp                                      |
| FI              | 2   | 35%                                | 2.7%                                      | 1.8%                                       | 0.9 pp                                       |
| FR              | 2   | 2%                                 | 3.1%                                      | 3.6%                                       | -0.5 pp                                      |
| GB              | 7   | 25%                                | 2.1%                                      | 2.6%                                       | -0.5 pp                                      |
| HR              | 3   | 54%                                | 11.8%                                     | 11.2%                                      | 0.7 pp                                       |
| IE              | 3   | 32%                                | 28.0%                                     | 19.4%                                      | 8.6 pp                                       |
| IT              | 5   | 34%                                | 9.0%                                      | 15.1%                                      | -6.1 pp                                      |
| LT              | 2   | 52%                                | 4.6%                                      | 5.6%                                       | -1.0 pp                                      |
| LU              | 1   | 19%                                | 1.5%                                      | 1.8%                                       | -0.3 pp                                      |
| NL              | 1   | 3%                                 | 0.4%                                      | 1.5%                                       | -1.0 pp                                      |
| PT              | 1   | 22%                                | 4.8%                                      | 10.3%                                      | -5.5 pp                                      |
| SE              | 2   | 5%                                 | 1.0%                                      | 0.3%                                       | 0.8 pp                                       |
| SI              | 0   | 0%                                 |   | 7.4%                                       |  |
| Average         | 2.3   | 20%                                | 8.9%                                      | 8.2%                                       | 0.6 pp                                       |

**Table 5: NPL per country of domicile in country of risk for loans and advances to HH across EU countries (based on data as of June 2016)**

(Source: EBA)

11. In addition to direct exposures to NPLs, it is important to also assess the greater exposure of each country's financial system to other countries, to take into account the possibility for both inward and outward spill-overs. Table 5 describes the potential vulnerabilities due to inward spill-overs. On the basis of BIS data (on an ultimate risk basis) the numbers describe the cross-border bank exposure of foreign banks (in percent of GDP of their home Member State).
12. Table 6 describes the potential vulnerabilities due to outward spill-overs – though the analysis is considerably weakened by the limited availability of data. Most interesting here is that this table shows the risk of spill-overs from countries currently not normally considered to be experiencing problems with NPLs, were the stocks of NPLs there to increase significantly.

Cross-border bank exposure (in % of GDP of home MS)

| Member State to which exposure is held | BG | HR | CY | GR  | IE   | IT  | RO | SI | MT  | PT  | CZ | PL | HU | SK | ES   | LV | LT | EE   | AT  | BE | DK | FI  | DE   | LU  | NL   | FR  | SE   | UK  |
|--|----|----|----|-----|------|-----|----|----|-----|-----|----|----|----|----|------|----|----|------|-----|----|----|-----|------|-----|------|-----|------|-----|
| BG                                     | -  | -  | -  | 3.9 | -    | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.8  | 0.2 | -  | -  | -   | 0.0  | -   | -    | -   | 0.0  | 0.0 |
| HR                                     | -  | -  | -  | 0.0 | 1.2  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 5.0  | 0.0 | -  | -  | -   | -    | -   | -    | -   | 0.0  | 0.0 |
| CY                                     | -  | -  | -  | 4.4 | 0.0  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.3  | 0.0 | -  | -  | -   | 0.1  | 0.1 | -    | -   | 0.3  | 0.0 |
| GR                                     | -  | -  | -  | -   | 0.0  | -   | -  | -  | 0.1 | 0.1 | -  | -  | -  | -  | 0.1  | -  | -  | 0.0  | 0.0 | -  | -  | -   | 0.2  | 0.2 | 0.0  | 0.0 | -    | 0.1 |
| IE                                     | -  | -  | -  | 0.1 | 0.3  | -   | -  | -  | 0.7 | 0.7 | -  | -  | -  | -  | 0.4  | -  | -  | 0.2  | 3.0 | -  | -  | -   | 0.9  | 1.4 | 1.3  | 0.1 | 3.1  |     |
| IT                                     | -  | -  | -  | 0.1 | 0.6  | 2.8 | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 3.3  | -  | -  | 1.5  | 1.7 | -  | -  | -   | 2.6  | 3.4 | 10.1 | 0.1 | 1.1  |     |
| RO                                     | -  | -  | -  | 5.8 | 0.5  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 5.8  | 0.0 | -  | -  | -   | 0.0  | 0.7 | -    | -   | 0.0  | 0.0 |
| SI                                     | -  | -  | -  | -   | -    | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 1.3  | 0.0 | -  | -  | -   | 0.0  | -   | -    | -   | 0.0  | 0.0 |
| MT                                     | -  | -  | -  | 0.3 | 0.0  | -   | -  | -  | 0.1 | 0.1 | -  | -  | -  | -  | 0.0  | -  | -  | 0.1  | 0.0 | -  | -  | -   | 0.1  | 0.1 | -    | -   | 0.0  | 0.2 |
| PT                                     | -  | -  | -  | 0.0 | 0.1  | -   | -  | -  | 0.1 | 0.1 | -  | -  | -  | -  | 4.5  | -  | -  | 0.1  | 0.1 | -  | -  | -   | 0.4  | 0.4 | 0.4  | 0.5 | 0.0  | 0.3 |
| CZ                                     | -  | -  | -  | 0.0 | 0.8  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 11.9 | 6.7 | -  | -  | -   | 0.2  | -   | -    | 1.2 | 0.0  | 0.2 |
| PL                                     | -  | -  | -  | 0.1 | 2.1  | 7.6 | -  | -  | 0.1 | 0.1 | -  | -  | -  | -  | 2.5  | -  | -  | 5.1  | 0.3 | -  | -  | -   | 1.2  | -   | 3.2  | 1.5 | 1.1  | 0.3 |
| HU                                     | -  | -  | -  | 0.0 | 0.7  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 3.9  | 1.6 | -  | -  | -   | 0.2  | -   | -    | -   | 0.0  | 0.1 |
| SK                                     | -  | -  | -  | -   | -    | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 1.3  | 0.0 | -  | -  | -   | 0.0  | -   | -    | -   | 0.0  | 0.0 |
| ES                                     | -  | -  | -  | 0.0 | 1.0  | 2.0 | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.6  | 1.5 | -  | -  | 0.0 | 2.3  | -   | 4.6  | 3.9 | 0.2  | 1.0 |
| LV                                     | -  | -  | -  | -   | -    | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.0  | 0.0 | -  | -  | -   | 0.0  | -   | -    | -   | 1.9  | 0.0 |
| LT                                     | -  | -  | -  | -   | -    | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.0  | 0.0 | -  | -  | -   | 0.0  | -   | -    | -   | 2.5  | 0.0 |
| EE                                     | -  | -  | -  | -   | 0.0  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.0  | -  | -  | 0.0  | 0.0 | -  | -  | -   | 0.0  | -   | -    | -   | 3.1  | 0.0 |
| AT                                     | -  | -  | -  | 0.1 | 4.1  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.3  | -  | -  | 0.4  | 0.3 | -  | -  | 0.2 | 1.3  | -   | 1.2  | 0.5 | 0.2  | 0.2 |
| BE                                     | -  | -  | -  | 0.2 | 0.3  | 0.4 | -  | -  | 0.2 | 0.2 | -  | -  | -  | -  | 0.3  | -  | -  | 0.4  | 0.1 | -  | -  | 0.4 | 0.7  | -   | 6.4  | 0.8 | 0.5  |     |
| DK                                     | -  | -  | -  | 0.0 | 0.1  | -   | -  | -  | 0.1 | 0.1 | -  | -  | -  | -  | 0.3  | -  | -  | 0.3  | 0.1 | -  | -  | 0.2 | 0.4  | -   | 0.6  | 0.3 | 33.6 | 0.3 |
| FI                                     | -  | -  | -  | 0.1 | 0.1  | -   | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.2  | -  | -  | 0.5  | 0.3 | -  | -  | 0.5 | 0.5  | -   | 1.1  | 0.3 | 20.2 | 0.4 |
| DE                                     | -  | -  | -  | 0.9 | 0.4  | 9.3 | -  | -  | 0.9 | 0.9 | -  | -  | -  | -  | 3.4  | -  | -  | 9.0  | 1.9 | -  | -  | 1.4 | -    | -   | 19.0 | 5.9 | 11.5 | 4.8 |
| LU                                     | -  | -  | -  | 0.7 | 1.0  | -   | -  | -  | 1.9 | 1.9 | -  | -  | -  | -  | 0.5  | -  | -  | 1.0  | 1.1 | -  | -  | 0.2 | 1.9  | -   | 2.0  | 3.0 | 1.3  | 0.8 |
| NL                                     | -  | -  | -  | 0.1 | 0.9  | 0.9 | -  | -  | 3.8 | 3.8 | -  | -  | -  | -  | 1.1  | -  | -  | 1.3  | 4.4 | -  | -  | 0.9 | 2.2  | -   | -    | 3.5 | 1.9  | 3.2 |
| FR                                     | -  | -  | -  | 0.5 | 1.9  | 2.1 | -  | -  | 2.0 | 2.0 | -  | -  | -  | -  | 3.2  | -  | -  | 2.2  | 4.6 | -  | -  | 1.0 | 4.3  | -   | 10.0 | 1.9 | 6.1  |     |
| SE                                     | -  | -  | -  | 0.0 | 0.3  | 0.1 | -  | -  | 0.0 | 0.0 | -  | -  | -  | -  | 0.3  | -  | -  | 0.3  | 0.1 | -  | -  | 1.6 | 0.7  | -   | 0.7  | 0.6 | 0.5  |     |
| UK                                     | -  | -  | -  | 4.7 | 32.4 | 2.1 | -  | -  | 1.3 | 1.3 | -  | -  | -  | -  | 29.9 | -  | -  | 2.9  | 3.4 | -  | -  | 0.6 | 10.7 | -   | 10.5 | 8.1 | 10.5 |     |

**Table 6: Cross-border bank exposures - inward spill-overs from foreign bank exposures to MS**  
 (Source: BIS consolidated banking statistics (ultimate risk basis, 2015Q2), IMF, ECFIN calculations; The colours differentiate different level of exposures where green describes low vulnerability (0-0.99% GDP), yellow medium vulnerability (1-4.99% GDP) and red high vulnerability (above 5% GDP))

Recipient MS of cross-border bank exposure (in % of GDP of recipient MS)

| Home Member State of Banks | BG  | HR   | CY   | GR  | IE   | IT   | RO   | SI   | MT   | PT   | CZ   | PL  | HU   | SK   | ES  | LV   | LT   | EE   | AT   | BE   | DK   | FI   | DE   | LU   | NL   | FR   | SE  | UK |
|----------------------------|-----|------|------|-----|------|------|------|------|------|------|------|-----|------|------|-----|------|------|------|------|------|------|------|------|------|------|------|-----|----|
| BG                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| HR                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| CY                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| GR                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| IE                         | -   | -    | -    | -   | 0.1  | -    | -    | -    | -    | -    | -    | -   | -    | -    | -   | -    | -    | -    | -    | -    | -    | -    | -    | 0.3  | 0.2  | 0.1  | 3.0 |    |
| IT                         | -   | 44.7 | 3.6  | 0.3 | 3.0  | -    | 6.0  | -    | 6.3  | 1.4  | 8.3  | 8.7 | 11.6 | -    | 3.1 | -    | -    | 0.4  | 20.4 | 1.6  | 0.5  | 5.3  | 2.2  | 1.6  | 0.4  | 1.7  |     |    |
| RO                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| SI                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| MT                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| PT                         | 0.0 | 0.0  | 0.0  | 0.1 | 0.6  | 0.3  | 0.0  | 0.1  | 1.7  | -    | 0.0  | 3.3 | 0.1  | 0.0  | 0.9 | 0.0  | 0.0  | -    | 0.0  | 0.1  | 0.1  | 0.0  | 0.1  | 1.0  | 0.2  | 0.0  | 0.1 |    |
| CZ                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| PL                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| HU                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| SK                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| ES                         | 0.1 | 0.1  | 0.6  | 0.3 | 2.2  | 2.2  | 0.4  | 0.1  | 2.8  | 28.0 | 0.1  | 6.6 | 0.2  | 0.0  | 0.0 | 0.0  | 1.0  | 0.8  | 1.2  | 1.0  | 1.3  | 1.8  | 1.6  | 0.7  | 15.7 |      |     |    |
| LV                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| LT                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| EE                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA |
| AT                         | 6.7 | 37.6 | 4.8  | 0.1 | 0.4  | 0.3  | 13.2 | 11.8 | 3.4  | 0.2  | 24.9 | 4.3 | 12.7 | 32.1 | 0.2 | 0.2  | 0.2  | 0.4  | 0.4  | 0.3  | 0.7  | 1.1  | 0.7  | 0.3  | 0.2  | 0.5  |     |    |
| BE                         | 2.4 | 0.1  | 0.1  | 0.0 | 6.8  | 0.4  | 0.1  | 0.3  | 0.3  | 0.2  | 17.3 | 0.3 | 6.3  | 9.6  | 0.6 | 0.4  | 0.2  | 0.4  | 0.4  | 0.1  | 0.6  | 0.3  | 2.7  | 0.9  | 0.1  | 0.7  |     |    |
| DK                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  |    |
| FI                         | -   | -    | -    | -   | -    | -    | -    | -    | -    | -    | -    | -   | -    | -    | -   | -    | -    | -    | -    | -    | -    | -    | -    | -    | -    | -    | -   |    |
| DE                         | 0.1 | -    | 15.7 | 2.6 | 14.1 | 4.7  | 0.5  | 3.8  | 26.5 | 7.3  | 2.9  | 9.0 | 4.8  | 2.1  | 6.4 | 1.2  | 1.1  | 0.8  | 11.9 | 5.0  | 4.5  | 6.5  | 10.0 | 5.9  | 4.6  | 15.4 |     |    |
| LU                         | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  | NA   | NA   | NA  | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA   | NA  |    |
| NL                         | -   | -    | 3.9  | 0.6 | 5.2  | 1.4  | 3.3  | -    | 7.6  | 1.5  | -    | 5.3 | -    | -    | 2.9 | -    | -    | -    | 2.5  | -    | 1.4  | 3.6  | 4.5  | 3.1  | 1.1  | 1.1  | 3.5 |    |
| FR                         | -   | -    | -    | 0.5 | 15.6 | 13.4 | -    | -    | -    | 6.1  | 15.9 | 8.0 | -    | -    | 8.0 | -    | -    | -    | 3.6  | 34.6 | 2.8  | 3.3  | 4.4  | 11.6 | -    | 3.0  | 8.5 |    |
| SE                         | 0.0 | 0.0  | 7.6  | -   | 0.3  | 0.0  | 0.0  | 0.0  | 0.8  | 0.0  | 0.1  | 1.2 | 0.1  | 0.1  | 0.1 | 35.0 | 30.7 | 69.0 | 0.2  | 0.8  | 57.0 | 42.7 | 1.8  | 1.2  | 0.4  | 2.2  |     |    |
| UK                         | 0.0 | 0.3  | 5.7  | 1.3 | 38.2 | 1.5  | 0.0  | 0.8  | 51.3 | 4.6  | 2.6  | 1.5 | 1.2  | 0.2  | 2.1 | 0.2  | 0.1  | 0.0  | 1.4  | 2.9  | 2.3  | 3.9  | 3.8  | 11.1 | 6.4  | 2.3  |     |    |

**Table 7: Cross-border bank exposures – outward spill-overs from MS to foreign banks**  
 (Source: BIS consolidated banking statistics (ultimate risk basis, 2015Q2), IMF, ECFIN calculations; The colours differentiate different level of exposures where green describes low vulnerability (0-0.99% GDP), yellow medium vulnerability (1-4.99% GDP) and red high vulnerability (above 5% GDP))

## Annex 2: Asset quality metrics

1. Asset quality can be measured according to different metrics based on accounting, prudential or supervisory reporting definitions:
  - Impaired assets, based on the accounting definition (IFRS and / or local GAAP)
  - Defaulted assets, based on the prudential (CRR) definition
  - Non-performing exposures (NPEs), based on the EBA definition (ITS) for supervisory reporting
2. Currently, the various definitions are meant for and target different users, and therefore could be considered complementary. Accounting definitions serve mainly the purpose of clarity and transparency of financial statements targeting a wider audience than supervisors (such as potential investors, lenders of the entity); prudential metrics are a key input for the estimation of internal models and the computation of own fund requirements; supervisory reporting aims at delivering consistent and comparable risk measures for feeding, for instance, supervisors' risk assessment systems.
3. The different definitions do not override but they can inform each other. While the definitions are not identical, they are all based on comparable concepts such as past-due status and unlikelihood to pay (a high level summary of the different definitions is provided in Table 8).
4. Before the introduction of the EBA definition of NPEs, there were several national supervisory differences in the actual implementation of these concepts, which made it difficult to compare and contrast banks across jurisdictions. In fact, the main aim of the NPE definition has been, building on existing concepts, to introduce a common standard for supervisory reporting in order to make data comparable across the EU and minimise the differences in the implementation of the default and impaired definitions.
5. A simple rule of thumb for reconciling the three definitions is the following:
  - A debtor in financial difficulty who is unlikely to repay a loan is to be classified as impaired (but if over-collateralised might be excluded),
  - Similarly, an unlikely to pay debtor should be classified as defaulted but, in addition, 90 days (or 180 for some asset classes) past-due loans are automatically classified as defaulted and there is no consideration of collaterals, which may make the default asset definition wider than the impaired definition<sup>111</sup>
  - A debtor classified as impaired or defaulted should be also classified as non-performing but, in addition, all 90 days past due loans (regardless of the asset class) are non-performing and there is also a pulling effect,<sup>112</sup> making the NPE definition the most comprehensive and conservative metrics<sup>113</sup>.
6. In that respect, as noted by the ECB-Banking Supervision in its "Draft guidance to banks on non-performing loans", the non-performing definition acted as a harmonised asset quality

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<sup>111</sup> When the automatic 90 (or 180) days criterion is not applied in accounting for classifying a loan as impaired. or over collateralization is taken into account for not classifying an unlikely to pay loan as such.

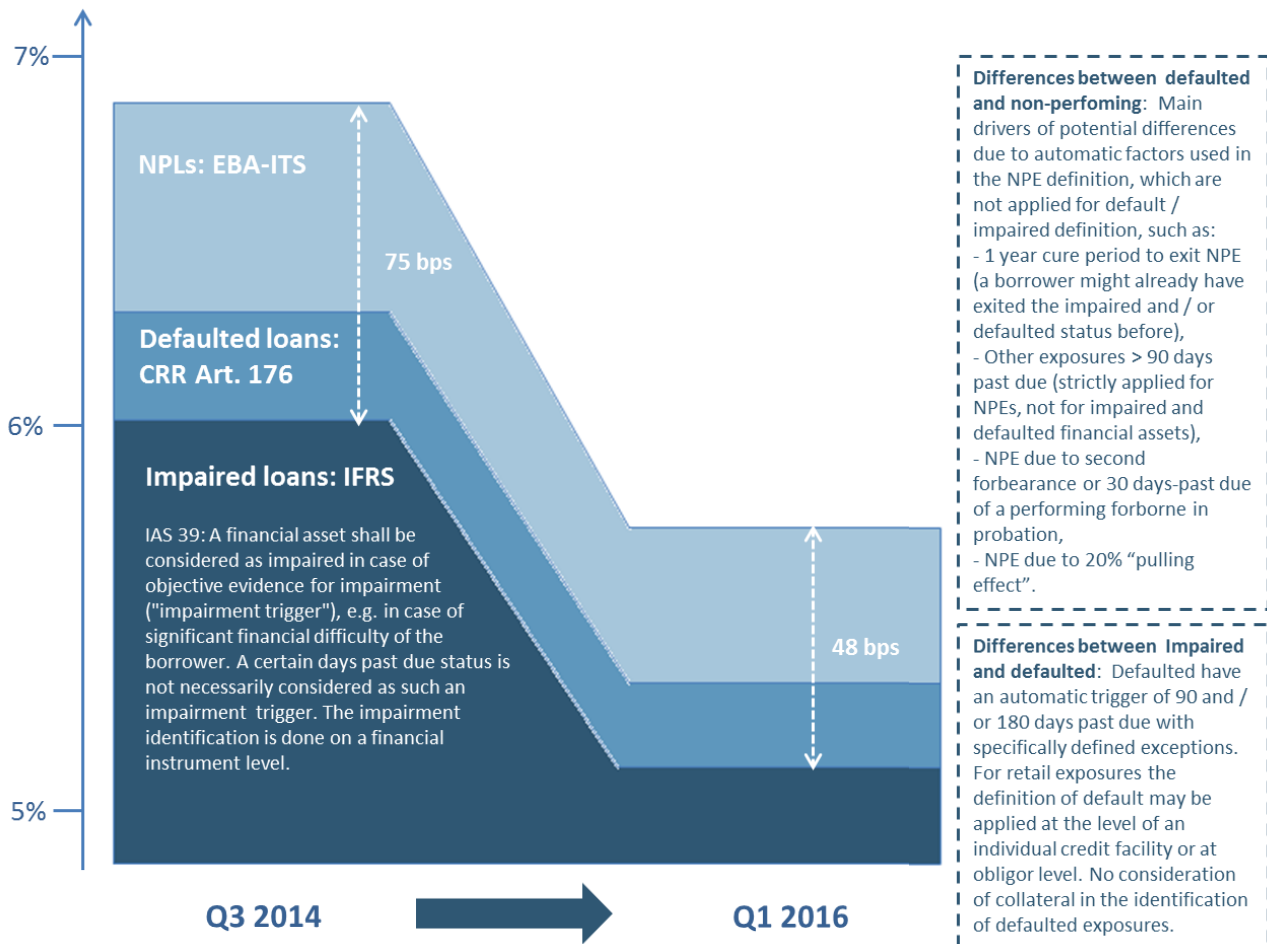
<sup>112</sup> The pulling effect clarifies that, if a significant part of the exposure towards a debtor is non-performing, then also the remaining parts of respective exposures are to be considered as non-performing.

<sup>113</sup> If a similar pulling effect is not used for the classification of a loan as impaired.



concept. Comparability at the global level is also one of the main drivers for the BCBS's harmonised NPE definitions (which are expected to be in line with the EU definition).

- As a side benefit, the NPE definition also contributed to the gradual convergence of the different definitions, since the presence of a harmonised EU benchmark for asset quality encouraged banks to assess more conservatively impaired and defaulted assets, also in connection with the EU-wide AQRs carried out in 2014.



**Figure 21: Dynamics of impaired asset metrics**  
(Source: EBA)

8. Figure 21 explains how the three definitions interact, and depicts the dynamics of the three metrics over time.<sup>114</sup> In Q3-2014, the first available reference date for NPLs, the ratio of impaired loans to total loans was 6% compared to 6.2% for the defaulted loans ratio and 6.7% for the NPL ratio. While different, they all clearly pointed towards an asset quality problem and triggered EU-wide AQR. All ratios declined since then, still remaining high, and interestingly the difference across them declined significantly from 75 to 48 basis points.
9. The introduction of IFRS 9 requires banks to make provisions against performing (and not impaired) assets from the date of origination leading to higher amounts of provisions. The main impact on impaired assets is linked to the fact that under IFRS 9 it is more explicit than under IAS 39 that collaterals will be no longer taken into account in the identification of a loan as impaired (but still will be included in the estimation of provisions), thus further contributing to the convergence of impaired and non-performing definition. In addition, the expected increase in provisions due to the move from an incurred to an expected loss model should make the disposal of NPEs easier in the future.

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<sup>114</sup> It should be noted that the chart focuses on loans since they are the largest part of impaired/defaulted/non-performing assets.

|   | Definition  | Differences  | Published by banks<br>(Financial statements<br>and P3)                                  | Ratio (EU weighted<br>average)*** |        | Spread to NPE ratio (EU<br>median)*** |          |
|---|---|--|---|-----------------------------------|--------|---------------------------------------|----------|
|   |   |  |   | 2014Q3                            | 2016Q1 | 2014Q3                                | 2016Q1   |
| <b>Impaired<br/>financial assets:<br/>IFRS*</b> | IAS 39: A financial asset shall be considered as impaired in case of objective evidence for impairment ("impairment trigger"), e.g. in case of significant financial difficulty of the borrower. A certain days past due status is not necessarily considered as such an impairment trigger. The impairment identification is done on a financial instrument level.   | The collateral may be considered in the identification of impaired assets (i.e. no impairment trigger in case of over-collateralisation).  | Financial statements for IFRS banks   | 6.0%                              | 5.2%   | -0.75 pp                              | -0.48 pp |
|   | IFRS 9: so called Stage 3 assets are those considered as credit impaired. The impairment triggers are in general similar to the ones in IAS 39.   | Collateral shall not be considered in the impairment identification. The identification may be done on the counterparty level (i.e. not necessarily on the level of the individual financial instrument).  |   |                                   |        |                                       |          |
| <b>Default: CRR Art. 176</b>                    | The definition of default includes among others a days past due criterion, indications of unlikelihood to pay etc. I.e. an obligor is considered as defaulted in case of being more than 90 days past due on any material credit obligation. Competent authorities may replace the 90 days with 180 days for certain exposures (residential property, SME commercial immovable property in the retail exposure class, exposures to public sector entities). | Automatic application of 90 and / or 180 days past due with specifically defined exceptions. For retail exposures the definition of default may be applied at the level of an individual credit facility or at obligor level. No consideration of collateral in the identification of defaulted exposures, as "default" is about the PD and not the LGD.   | All banks   | 6.2%                              | 5.3%   | -0.36 pp                              | -0.27 pp |
| <b>NPE: EBA-ITS</b>                             | Non-performing exposures are those that satisfy either or both of the following criteria:<br>1. material exposures which are more than 90 days past-due;<br>2. the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.<br><br>Impaired and defaulted exposures are automatically considered as non-performing.    | Main drivers of potential differences due to automatic factors used in the NPE definition, which are not applied for default / impaired definition, such as:<br>- 1 year cure period to exit NPE (a borrower might already have exited the impaired and / or defaulted status before),<br>- Other exposures > 90 days past due (strictly applied for NPEs, not for impaired and defaulted financial assets),<br>- NPE due to second forbearance or 30 days-past due of a performing forboree in probation,<br>- NPE due to 20% "pulling effect"**. | Included in EBA transparency exercise for larger banks. All banks (starting in 2016-17) | 6.7%                              | 5.7%   |                                       |          |

\* No additional consideration of local GAAPs, which might differ significantly among jurisdictions.

\*\* Pulling effect: when an institution has on-balance sheet exposures to a debtor that are past due by more than 90 days the gross carrying amount of which represents more than 20% of the gross carrying amount of all on-balance sheet exposures to that debtor, all on and off-balance sheet exposures to that debtor shall be considered as non-performing.

\*\* The ratios are calculated for loans since they are the largest part of impaired/defaulted/non-performing assets.

**Table 8: Asset quality metrics**  
(Source: EBA)

## Annex 3: Impaired asset relief measures/State aid rules

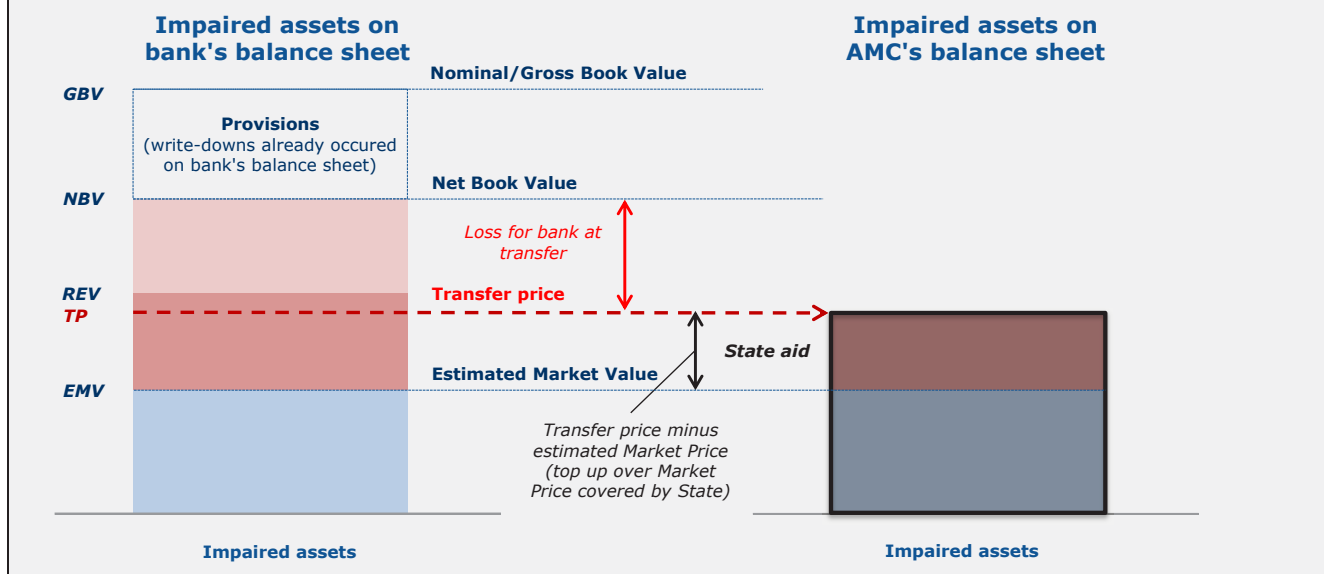
From the very beginning of the financial crisis, state aid rules introduced a discipline not authorising implementation of impaired asset relief measures which would shift existing or future **likely losses** on impaired assets (e.g. loans or structured credits) to taxpayers. Existing and future likely losses on loans and securities have to borne by the bank. They cannot be "hidden" by transferring them to the state. The state-supported bad bank can only protect against future unlikely losses, i.e. protect against tail risk. In other words, the state-supported bad bank can buy the impaired assets at a price higher than estimated market price only as far as the latter does not reflect anymore the losses expected on the assets and a reasonable premium but are temporary depressed by excessive risk premium (e.g. because the investor doubts about the real value of the assets and/or has temporary acute funding constraints).

This general principle has been translated in the following requirement: the maximum price at which the assets can be bought by the state-supported AMC is the present value of the cash flows these assets will likely generate discounted at a rate including a limited risk premium (so called Real Economic Value or REV). In other words, the price at which the banks were allowed to sell impaired assets to state-supported bad banks was low.

At the moment of the sale of the assets, the bank has to bear a loss amounting to the difference between the net book value of the assets and transfer price. Since the transfer price was capped at REV and hence relatively low, the bank has to acknowledge a lot of losses at the moment of the sale of the assets.

As a consequence, until now, all the approved impaired assets measures have systematically been accompanied by large amount of recapitalisation aid, allowing the bank to bear the burden of having to recognise the losses on the impaired assets.

Consistent with its general practice, the Commission has considered that the amount of state aid provided through impaired asset measures is the difference between the price at which the state-supported AMC buys the assets and the (estimated) market value (EMV). Since this purchase price was capped at REV, the delta between the purchase price and the EMV was not very large. The amount of aid granted through impaired assets have therefore been a limited portion of the total aid granted to banks, with the majority of the aid being granted through state recapitalisation.



Box 10: Impaired asset relief measures/State aid rules

## Annex 4: Precautionary recapitalisation and Impaired Asset Relief Aid

### Precautionary recapitalisation and Impaired Asset Relief Aid

As stated in recital 67 of BRRD and recital 73 of SRMR, an effective resolution regime should minimise the costs of the resolution of a failing institution borne by the taxpayers; this is achieved including through the use of the bail-in tool. The BRRD (Article 32(4)(d) and SRMR (Article 18(4)(d)) allow however the provision of State Aid outside resolution only in limited circumstances, i.e. when the State Aid (extraordinary financial support) is provided so as to remedy a serious disturbance in the economy of a Member State and preserve financial stability and takes one of the following forms:

- The provision of State guarantees on extraordinary liquidity assistance by a central bank
- The provision of state guarantees on newly issued liabilities
- An injection of own funds or purchase of capital instruments which satisfies the conditions set out in Article 32(4) BRRD/18(4) SRMR (precautionary recapitalisation).<sup>115</sup>

Article 32(4) BRRD / Article 18(4) SRMR prescribe that precautionary recapitalisation must fulfil several conditions<sup>116</sup> including:

- Be of a precautionary and temporary nature and be proportionate to remedy the consequences of the serious disturbance in the economy of a Member State.
- Be confined to solvent institutions
- Not be used to cover incurred or likely losses
- Be limited to the amount necessary to cover the capital shortfall resulting from a stress test, AQR or equivalent exercises
- Be conditional on final approval under State Aid framework.

The supervisor must comprehensively assess and confirm the solvency of the institution and the supervisor and resolution authority remain responsible to assess whether the bank is considered to be failing or likely to fail. Should the resolution criteria be fulfilled, it is the responsibility of the supervisor and resolution authority to take action.

If the conditions in Article 32(4) BRRD / Article 18(4) SRMR outlined above are met, it seems conceivable, based on the legislative text, to provide a credit institution with aid in the form of precautionary recapitalisation so as to finance an impaired asset measure.

With respect to the State Aid implications of a precautionary recapitalisation, it should be noted that the Treaty (Art. 107(1)) prohibits State Aid (i.e. aid from State resources and imputable to the State which provides a selective advantage to an undertaking and affects trade and competition) as a matter of principle.

However, State Aid can be allowed in specific circumstances subject to scrutiny and approval by the Commission to ensure a level playing field in the single market. With respect to the banking sector, detailed guidance is contained in several Commission communications and previous cases on State intervention. Rules pertinent to impaired asset measures (IAM), in particular are contained in the Impaired Assets Communication from 2009, the 2009 Restructuring Communication and the Banking Communication from 2013 introducing burden sharing on subordinated debt, which has been applied in every case since. State Aid provided in the form of Impaired Asset Measures would not trigger the conditions for failing or likely to fail only if it is provided as a precautionary recapitalisation and if the necessary conditions are met.

In order to operationalise the application of precautionary recapitalisation to finance an Impaired Asset

<sup>115</sup> In particular, the specific condition to allow precautionary recapitalisation are contained in letter d(iii) as well as in the second and third subparagraph of Article 32(4) BRRD/Article 18(4) SRMR.

<sup>116</sup> See for all conditions recital (160) of the Commission Decision in State Aid SA.43364 (2015/N) "Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank" ([http://ec.europa.eu/competition/state\\_aid/cases/261238/261238\\_1733314\\_89\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/261238/261238_1733314_89_2.pdf)) and recital (169) of the Commission Decision in State Aid SA.43365 (2015/N) "Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece" ([http://ec.europa.eu/competition/state\\_aid/cases/261565/261565\\_1733770\\_121\\_2.pdf](http://ec.europa.eu/competition/state_aid/cases/261565/261565_1733770_121_2.pdf)).

Measure containing an aid element for a credit institution, the notion of "maximum precautionary aid amount" could be employed.

In addition to compliance with State Aid rules, in particular the requirement to first attempt to tackle the problem with market based solutions, the BRRD introduced a maximum limit to the amount of aid that can be granted by the State to this credit institution as precautionary recapitalisation, provided all the requirements are met. Since precautionary recapitalisation cannot be used to cover the institution's incurred/likely losses (i.e. typically losses stemming from an Asset Quality Review and from the baseline scenario of a stress test) the maximum precautionary aid amount is for each credit institution quantified as the difference between the bank's shortfall in the adverse scenario of a stress test (i.e. unlikely losses) and the bank's capital shortfall resulting from the baseline scenario (if any and which must be met from private measures).

The implementation of the precautionary recapitalisation instrument may raise specific challenges in the absence of clear knowledge about existing and likely losses – which in principle include losses which have been booked by the bank since the cut-off date used for the stress test. In such circumstances, it is for the supervisor to quantify the amount of incurred and likely losses, and to provide the necessary information to the Commission. In this context the combination of a stress-test and proper asset valuation at the loan-book level is important to allow for an adequate quantification of these losses.

In principle, and provided that all conditions in the BRRD/SRMR and the State Aid framework are complied with, the precautionary aid could be used to:

- a) provide the bank with recapitalisation aid (i.e. State injection of capital in the bank).
- b) provide the bank with impaired asset relief aid, i.e. the bank's NPLs would be bought by an AMC supported by the state at a transfer price which can be higher than the estimated market price but not higher than their real economic value, provided this is equivalent to a temporary injection of own funds or purchase of capital instruments.

Under State Aid rules, such as the Impaired Assets Communication, it is a general principle that the State Aid provided as impaired asset relief amounts to the difference between the current market price of an asset and the price paid by the state or by a state supported entity. It should be noted that, for this impaired asset relief aid to be compatible with State Aid rules, the purchase price paid by the state supported AMC should not exceed the so-called "real economic value", which is a prudent estimation of the present value of the cash flows to be generated by the assets, net of all workout costs.

*Source: Commission services*

#### **Box 11: Precautionary recapitalisation and Impaired Asset Relief Aid**

## Annex 5: Mandate of the FSC Subgroup on Non-Performing Loans

### I. Mandate

1. The FSC Subgroup on Non-Performing Loans will first assess the state of play regarding current NPL stocks and related developments in the Member States and at EU level, as well as the relevant legal framework at national and EU level. It will also deliver, possible options supporting a significant and sustainable reduction of NPL levels, based on the current diverse situations assessed. Where feasible, preparatory work on options may be launched in parallel.
2. The Subgroup is therefore mandated, in particular, to:
  - A. Carry out a stock-taking, relying as much as possible on existing information and on-going workstrands, and an analysis of:
    - i. The **levels and ratios** of NPLs as well as other relevant related indicators (coverage ratios, cash collected from NPLs, Texas ratios, provisions and collateral ratios), foreclosed assets and forbore loans in the EU per Member State, including an analysis of the key drivers of high NPL stocks, flows and ratios and an assessment of NPLs by categories (such as asset class, duration, residence and type of borrower, namely, based on sector classification and economic/financial viability);
    - ii. The degree of **public disclosure** on the above;
    - iii. The **impact of NPLs** on the financial sector and the economy, having regard to the **macroeconomic and structural relevance** of NPL resolution and its effect on financial stability and market efficiency;
    - iv. Relevant **supervisory actions** and **policy measures undertaken in the Member States** to address impediments and disincentives to the resolution of NPLs, with a focus on legal, judicial, tax, institutional, public disclosure and data frameworks;
    - v. The **experiences and measures taken by select other jurisdictions** to address high levels of NPLs.
  - B. Present a reasoned overview of relevant national frameworks and EU legislation on:
    - i. **National enforcement/execution processes and insolvency laws and procedures at national and EU level**, insofar as they present possible impediments and disincentives to NPL resolution at the national and EU level, including legal, institutional, accounting rules and practices, process, tax impediments;
    - ii. **Impediments and disincentives to the development of a secondary market for NPLs**, foreclosed or other distressed assets, the setting up of Asset Management Companies (AMCs) or other **structures** to deal with NPLs, such as asset protection schemes, in line with the EU legislative framework;
    - iii. **Current supervisory practices** regarding asset quality reviews; the classification of assets as NPLs; the supervisory treatment of foreclosed assets and forbearance; methodologies for the calculation of their coverage and regulatory/supervisory frameworks in order to identify the best practices; application of IFRS principles and EBA standards;
  - C. On the basis of the analysis of the information gathered under A and B above:
    - i. **Identify possible policy options and appropriate action(s) incl. at EU level**, possibly

including clear milestones and regular monitoring, as well as identifying potential costs/benefits to:

- enhance the efficiency of national enforcement/execution processes and insolvency regimes aimed at maximizing recovery, and
  - modernise legal frameworks to incentivise the recognition and/or write-off or sale of NPLs and other distressed assets and to facilitate their management as well as out-of-court procedures, amongst other measures to address corporate impairments, while respecting existing state aid rules, the BRRD and the SRMR.
  - support the financial sector’s effort to resolve the high stock of NPLs;
- ii. **Identify potential mechanisms for progress tracking** on the above actions, as well as on governance structures/responsibilities and for interaction with all relevant stakeholders;
  - iii. **Identify potential ways to enhance the toolbox currently available to supervisors and resolution authorities** at national and EU levels with a view to dealing more effectively with NPLs and coming forward with potential best practices; and,
  - iv. **Consider measures at EU level, including the possible role of CMU** in fostering a secondary market for NPLs.
3. The Subgroup should as much as possible draw on existing work streams, available analytical work and input in particular from the Commission (e.g. the benchmarking of the efficiency of national insolvency regimes as per the Eurogroup statement of 22 April 2016), the ECB, the ESRB, the EBA, EIOPA and ESMA, the ESM and the SRB, as well as the SSM Task Force on NPLs. The Subgroup shall regularly report back on progress to the FSC for comments and guidance.
  4. Any additional policy measures analysed should take account of their implications for the broader regulatory and economic environment and for financial stability and the ability to finance the economy. Moreover, the preparation of policy options should be accompanied by market intelligence activities to understand the investor perspective and should also take into account investor and financial consumer protection.
  5. The activities of the Subgroup should also interlink with the various ongoing work streams on insolvency frameworks as well as with the work regarding the CMU.

## II. **Membership**

6. The Subgroup will be chaired by Corso Bavagnoli. It should gather representatives from all interested Member States participating on a voluntary basis, two ECB representatives (ECB and ECB Banking Supervision), three from the Commission (ECFIN, FISMA and COMP) and one from the ESRB, EBA, EIOPA and ESMA, the EIB and the SRB respectively. The Chairwoman of the ECB Banking Supervision Task Force on NPLs will be invited as observer.
7. The FSC Secretariat will act as the secretariat of the group, in close cooperation with the EFC Secretariat.



### III. Time table

8. A first interim report covering sections A and B under point I above should be presented to the FSC for agreement by November 2016, and thereafter to the EFC. A final report including conclusions on section C of the mandate should be submitted to the FSC for adoption by spring 2017, and thereafter to the EFC.
-

## Annex 6: List of background document distributed to the Subgroup

### 1. Publicly available documents:

- "EBA Report on the dynamics and drivers of nonperforming exposures in the EU banking sector"
- IMF staff discussion note: "A Strategy for Resolving Europe's Problem Loans" and Technical Background Notes to the note
- Commission's discussion paper no 36: "What Makes a Good 'Bad Bank'"
- Note from the Commission to the Eurogroup: "Benchmarking insolvency frameworks for non-financial corporations. Insights from the World Bank Doing Business Resolving Insolvency Indicators".
- Commission's discussion paper "Macroeconomic Relevance of Insolvency Frameworks in a High-debt Context: An EU Perspective" BIS working paper 311: "Resolving the financial crisis: are we heeding the lessons from the Nordics?"

### 2. Non-papers and background papers

- EBA background paper: "Summary of the main quantitative findings of the EBA report on dynamics and drivers of non-performing exposures in the EU banking sector"
- EBA background paper: "Asset quality metrics"
- ECB non-paper " AnaCredit and its potential for analysing NPEs"
- ESMA background paper "Public disclosure of NPL indicators"
- ESMA background paper "Application of IFRS principles for NPLs"
- ESRB Secretariat non-paper "Macroprudential tools and policies for non-performing loans"
- ESRB Secretariat non-paper "Resolving NPLs in the EU and structural banking reforms – a discussion from a macroprudential perspective"
- ECB Banking Supervision non-paper " NPL preventive measures and supervisory powers"
- Commission Services non-paper: "NPLs and their impact on banks' balance sheets"
- Commission Services non-paper: "Overview of Commission Services work relating to insolvency reform"
- Commission Services non-paper: "Features of loan enforcement (including insolvency) regimes with a bearing on bank stability in the context of NPL management"
- Commission Services non-paper: "Macroeconomic impact of high NPL ratios"
- Commission Services non-paper: "An NPL-Information Platform"
- Commission Services non-paper: " reforms to support the resolution of NPLs"
- Chairman's issues note on secondary markets
- Restructuring Europe's Banking Sector"
- Chairman's issues note on Insolvency
- Chairman's issues-note on supervision in the context of NPL resolution
- Chairman's issues-note on bank restructuring in the context of NPL resolution

- Chairman's issues-note "Follow-up discussion on Asset Management Companies"
- Non-paper from the German delegation "Position of secured creditors in Germany within insolvency proceedings"
- Non-paper from the Dutch delegation "Enhancing the role of supervision in view of addressing NPLs"
- Issues note by the Irish delegation " Mortgage Arrears Resolution Targets in Ireland"
- Non-paper from the Spanish delegation "Banking sector restructuring in the context of NPL resolution. The Spanish experience."

### **3. Presentations**

- Commission Services presentation: "NPLs & Insolvency"
- Commission Services presentation: "Non-performing loans: impact on banks' and beyond"
- Commission Services presentation: "The 'Macro View' on NPLs"
- Commission Services presentation: " Start-up Aid to An NPL Information Platform"
- Commission Services presentation: " Precautionary recap and IAMs. Practical application under BRRD and State Aid rules"
- Commission Services presentation: "Restructuring in Banking State Aid Cases that involve NPLs "EBA presentation: "Summary of the main quantitative findings of the EBA report on NPLs"
- EBA presentation "NPLs management in the EU: impediments and possible solutions"
- ECB presentation: "Impediments to the functioning of secondary markets for NPLs in Europe"
- ECB presentation: "AnaCredit and its potential for analysing non-performing exposures"
- ESRB Secretariat presentation: "The systemic dimension of NPLs"
- ESRB Secretariat presentation: "Resolving NPLs in the EU and structural banking reforms"
- SSM NPL Taskforce presentation: " SSM's NPL Taskforce and draft guidance for banks"
- Presentation from the representative of Ireland's Department of Finance "Discussion Materials - experience with NPLs, NAMA & Loan Sales"
- Presentation from representative of the Central Bank of Ireland "Non-Performing Loan Resolution"
- Presentation from the representative of the Spanish Treasury "Tackling the NPL issue in Spain"
- Presentation from Deloitte on secondary debt markets
- Presentation " Benchmarking National Loan Enforcement (including Insolvency) Regimes from Bank Creditor Perspective" (Blackrock Solutions)
- Presentation "Dealing with Non-Performing Loans, the banking lawyers perspective" (ABN AMRO)
- Discussion materials (Morgan Stanley)

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