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COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL AND THE EUROPEAN CENTRAL BANK

Fourth Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL AND THE EUROPEAN CENTRAL BANK

Fourth Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union

INTRODUCTION

A fully-fledged Banking Union is essential to make sure that the Economic and Monetary Union becomes more resilient to future adverse economic shocks by enabling more risk sharing across borders. As outlined in the Communication "Deepening Europe's Economic and Monetary Union: Taking stock four years after the Five Presidents' Report", completing the Banking Union would significantly boost confidence in the banking sector and more widely in the Economic and Monetary Union.

In order to enable such progress, the Union and its Member States have made significant efforts to reduce risks. As elaborated in this progress report, this has borne fruit. This progress report shows the determined action that has been taken over the past years to address the challenge of non-performing loans (NPLs), one of the key areas for reducing risk in the European banking sector. Due to various reasons, including the financial crisis and subsequent recessions, but also imprudent lending and inadequate creditworthiness assessment, many borrowers (people as well as companies), particularly in Member States that faced long or deep recessions, faced an inability to repay their loans and even bankruptcy. As a consequence, many banks were confronted with an accumulation of NPLs on their balance sheets.

The efforts taken over the past years and the fruit they have borne (and will continue to bear) have their roots in the comprehensive set of measures outlined in the ECOFIN Council's "Action Plan to Tackle NPLs in Europe"[1] This Action Plan is close to being fully implemented. In response to this Action Plan and going beyond the 2016 Council Roadmap, the Commission presented a dedicated and comprehensive package of measures in March 2018 to further reduce NPLs. The Council also agreed to revert to the issue of NPLs on a regular basis and to assess the progress made on the basis of a stock-take by the Commission. This Communication is the Commission's fourth progress report in this context. It is therefore a contribution to the European Council in June, which will discuss the EU's Strategic Agenda for 2019-2024, including the Economic and Monetary Union.

Important strides have been made to reduce the existing stock of NPLs and to help prevent a renewed build-up in the future. While NPL stocks remain high in some Member States, it should be underlined that progress is being made in addressing them. It is critical that all relevant stakeholders uphold these efforts in order to put the issue fully behind us over time.

1 https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/.

1. THE BROADER CONTEXT: RISK REDUCTION IN THE UNION

Over the last decade, the Union and its Member States have made substantial efforts to reduce risk in the banking sector.[2] A wide range of measures introduced since the financial crisis: (1) have strengthened banks' solvency, leverage and liquidity positions in significant and practical ways; (2) have substantially improved governance within and supervision of the banking sector; and (3) have significantly enhanced banks' resolvability. The average Tier 1 capital ratios[3] of euro area banks directly supervised by the Single Supervisory Mechanism have remained stable, amounting to 15.54% in Q4-2018, compared to 15.63% in Q4-2017.[4] These stronger capital positions are also reflected in higher leverage ratios. The average leverage ratio[5] remains well over the requirement of 3%, standing at 5.28% in Q4-2018, compared to 5.41% in Q4-2017. Euro area banks also maintained their resilience to liquidity shocks, as the liquidity coverage ratio stands high at 145.61% in Q4-2018, compared to 143.56% in Q4-2017. This all testifies to the determined action taken to reduce risk across the euro area.

As outlined in its 2017 Banking Union Communication[6] and confirmed by its Second and Third Progress Report on the Reduction of NPLs[7], the Commission has put forward further substantial and complementary measures to reduce risk and enhance the resilience of the European banking sector. In particular, in addition to the specific measures on NPLs referrred to in more detail below, some major stepping stones have been put in place over the past months that are part of the Commission's efforts:

- First, the European Parliament and the Council agreed upon the "banking package", effectively putting in place a more robust framework to regulate and supervise banks.[8] This marks a major milestone in the implementation of international standards, and the completion of the post-crisis regulatory agenda. It increases the resilience of EU banks and improves their lending capacity to support the EU real economy; and
- Second, co-legislators agreed upon the Directive on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures, building on those systems that already work

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[2] See also: 'Monitoring report on risk reduction indicators': https://www.consilium.europa.eu/media/37029/joint-risk-reduction-monitoring-report-to-eg_november-2018.pdf.

[3] The tier 1 capital ratio is the ratio of a bank's core tier 1 capital – i.e. its equity capital and disclosed reserves – to its total risk-weighted assets.

[4] The data in this section derive from the ECB's supervisory banking statistics.

[5] i.e. the fully loaded leverage ratio (dividing Tier 1 capital by the bank's total assets) that is calculated in a more stringent manner and presented before 2019, when the transitional phase ends. The softening effect of the transitional implementation period is ignored.

[6] COM(2017) 592 of 11 October 2017.

[7] COM(2018) 133 of 14 March 2018.

[8] In November 2016, the Commission proposed a significant legislative package reviewing the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR), the Capital Requirements Directive IV (CRDIV) and the Capital Requirements Regulation (CRR), with the objective of further reducing remaining risks in the banking sector. See http://europa.eu/rapid/press-release_IP-16-3731_en.htm.

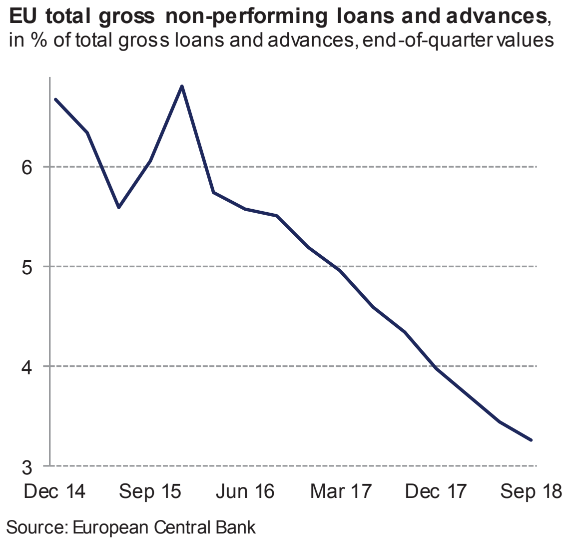
well in Member States.[9] It will encourage viable businesses to restructure early so that value can be better preserved and more jobs saved. It will also give honest entrepreneurs a second chance to start a new business instead of being penalised for business failure. This means that a crucial step has been taken, as effective restructuring and insolvency rules are essential for preventing and reducing NPLs.

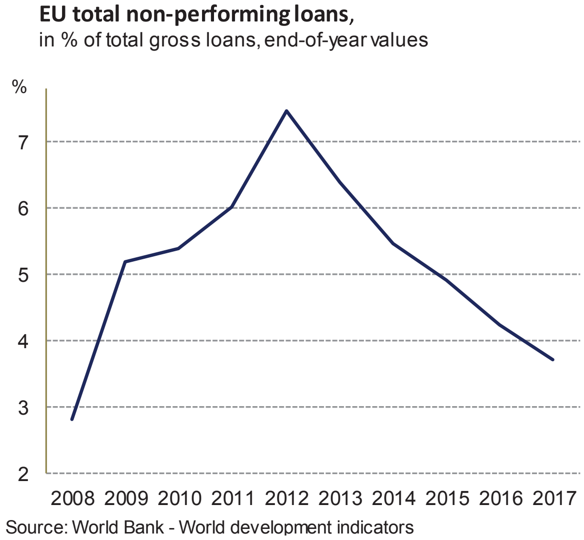
The Commission welcomes the adoption of both of these proposals and calls for their timely implementation.

2. RECENT DEVELOPMENTS OF NON-PERFORMING LOANS

NPL ratios continued to decline in the third quarter of 2018. The latest figures show that the gross NPL ratio for all EU banks further declined to 3.3% (Q3-2018), down by 1.1 percentage points year-on-year (see Figure 1). This followed and confirmed the overall downward trend since Q4-2014. The NPL ratio for the average of the EU is thereby approaching pre-crisis levels (see Figure 2). The provisioning ratio[10] has also further increased and stood at 59.4% (Q3-2018).

Figures 1 and 2: Non-performing loans ratio in the Union





The most recent quarterly figures show that NPL ratios continued to fall in nearly all Member States. However, the situation continues to differ significantly between Member States (see Table 2). At the end of Q3-2018, banks in 14 Member States had rather low NPL ratios of below 3%, while some had still considerably higher ratios – three Member States had ratios above 10%.[11] Even in Member States with relatively high NPL ratios, in most cases there is encouraging and sustained progress due to a combination of policy actions and economic growth.

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9 COM/2016/0723 - 2016/0359 (COD).

10 This ratio indicates the extent of funds a bank has kept aside to cover loan losses. Source: European Central Bank. Due to the unavailability of provisioning data for loans, the provisioning ratio for the EU was calculated by considering impairments and NPLs for all debt instruments (loans and debt securities).

11 Meanwhile, the NPL ratio in PT is expected to have declined below 10% by the end of Q4-2018. That being said, the ECB is currently still in the process of validating these end-of-quarter data for all Member States.

Table 2: Non-performing loans and provisions by Member State [12]

	Gross NPLs and advances (% of total gross loans and advances)		**Private sector NPLs*** (% of private-sector loans)		**Total loss provisions (loans)**** (% of total doubtful and non-performing loans)	
	2018Q3	2017Q3	2018Q3	2017Q3	2018Q3	2017Q3
Belgium	2.2	2.7	3.0	3.9	54.6	50.1
Bulgaria	8.6	11.5	13.6	18.6	64.3	56.6
Czech Republic	2.1	2.6	4.0	5.0	65.2	54.2
Denmark	2.3	2.7	2.8	3.0	36.7	39.6
Germany	1.6	2.1	2.6	4.0	85.5	42.6
Estonia	1.7	2.0	2.2	2.7	41.0	42.9
Ireland	7.8	11.2	10.9	15.4	37.2	37.2
Greece	43.5	46.7	47.3	50.4	51.0	49.1
Spain	4.0	4.7	5.1	-	63.0	-
France	2.8	3.2	3.9	4.5	65.3	60.3
Croatia	7.9	10.8	12.3	15.8	74.2	69.0
Italy	9.5	12.1	12.4	15.7	59.3	53.6
Cyprus	21.8	32.1	37.4	51.3	52.3	47.3
Latvia	6.0	6.0	8.1	9.0	39.2	44.1
Lithuania	2.9	3.7	3.7	4.9	35.7	34.4
Luxembourg	0.9	0.7	2.1	1.7	43.6	52.4
Hungary	6.1	9.6	8.1	14.1	78.1	67.1
Malta	2.9	3.4	-	5.7	51.8	44.7
Netherlands	1.9	2.2	2.6	2.9	35.1	37.2
Austria	2.8	3.8	3.8	5.3	66.8	63.8
Poland	6.5	6.6	7.1	7.2	68.0	57.9
Portugal	11.3	14.6	12.6	15.6	58.8	50.2
Romania	5.7	8.1	7.4	10.3	77.4	70.1
Slovenia	6.9	10.8	9.1	13.9	70.1	70.9
Slovakia	3.6	4.1	3.9	4.6	86.0	70.4
Finland	1.1	1.2	1.9	2.1	33.5	31.8
Sweden	1.2	1.2	1.5	1.4	35.6	34.5
United Kingdom	1.2	1.6	2.1	-	50.1	41.2
European Union	**3.3**	**4.4**	**-**	**-**	**59.4**	**50.7**

Source*:* European Central Bank, Consolidated Banking Data. Calculations by Commission services (DG FISMA).

Determined action by banks and policymakers, particularly in Member States with relatively high NPL levels, has facilitated this reduction in NPLs and NPL ratios. Furthermore, the

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[12] *Notes:* Figures correspond to domestic credit institutions and foreign-controlled subsidiaries and branches.

* Sector-specific data for the EU, for Malta (i.e. Q3-2018) and for Spain (i.e. Q3-2017) are not available. Sector-specific data (i.e. total exposure to households and non-financial corporations) for Bulgaria, Germany and Hungary are only available in carrying amount.

** Data for the provisioning of loans are unavailable for Bulgaria, Germany, Spain (with the exception of Q3-2018), Hungary and the EU. In these cases, figures are based on impairments for all debt instruments (i.e. loans and debt securities).

Commission has continued to work constructively with Member States to enable case-specific solutions for banks within the framework of EU State aid and banking rules, with a clear objective of limiting costs to taxpayers whilst making sure depositors remained fully protected at all times. This has enabled transactions that removed some EUR 112 billion of gross NPLs from the balance sheets of banks over the last three years (including around EUR 82 billion in Italy; around EUR 24 billion in Portugal; around EUR 6 billion in Cyprus).

Nevertheless, the Union and its Member States should not relent in their efforts. We should be aware of the potential effects of a downturn in the economic environment. The tackling of NPLs over the past years has received helpful tailwinds from a strong economic conjuncture. Maintaining our collective efforts will allow for NPLs to be addressed in the most decisive manner possible, hence increasing our resilience to potential negative shocks in the future.

The variation in NPL ratios across Member States reflects a persistent asymmetric impact of the financial crisis. Despite the overall encouraging progress, NPLs continue to pose a risk (even though diminishing) to the viability of the most affected banks and to economic growth and financial stability in some Member States. By further reducing NPLs, more convergence among Member States could be achieved. The total volume of NPLs across the Union now stands at EUR 786 billion.[13] Continued attention should be given to debt restructuring, insolvency and debt recovery processes, which could benefit significantly from further reforms in many cases. Efficient and predictable enforcement and insolvency frameworks are key to help banks tackle the stock of NPLs and to help avoid their build-up in the future. Tackling this important issue in an effective way would provide a strong push in support of further NPL reduction. Legislative harmonisation in this area is challenging given the close links with various areas of the law which are in the national remit and with public policy choices reaching beyond the NPL issue.

The sustained growth of secondary markets for NPLs is an equally vital factor. Collective efforts by Member States and EU authorities should not lose sight of the still untapped potential that resides in a well-functioning secondary market, not only in terms of addressing the current stocks of NPLs, yet also in providing an outlet for future flows, hence crucially preventing a renewed build-up of NPLs on banks' balance sheets. Relevant policy actions (see also below) should continuously be geared towards further developing the secondary market, in order to stimulate and sustain the present momentum in several Member States.

3. Progress in implementing the Council Action Plan

The Council agreed in its Action Plan to revert to the issue of NPLs on a regular basis, in order to take stock of their evolution in the Union and to assess the progress made in the implementation of the Action Plan, based on a stock-take from the Commission. Table 3 demonstrates that important strides have been made towards full implementation of the Action Plan.

[13] Source: European Central Bank

Table 3: Progress in implementing the Action Plan

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

Accomplished

Imminent

Ongoing

3.1. Sufficient loan loss coverage by banks for future NPLs

As part of its package of proposals on NPLs put forward in March 2018, the Commission proposed a Regulation amending the Capital Requirements Regulation ('CRR')[14], introducing a 'statutory prudential backstop' in order to prevent the risk of under-provisioning of future NPLs. The Regulation was adopted in April 2019[15].

The Regulation requires banks to have sufficient loan loss coverage (i.e. common minimum coverage levels) for newly originated loans if these become non-performing exposures (NPEs). In case a bank does not meet the applicable minimum coverage level, it has to deduct the shortfall from its own funds.

Under the prudential backstop the applicable minimum coverage requirement depends on two main input variables:

- whether part or all of an NPE is secured by eligible credit protection (as defined in the CRR); and
- the time period for which an exposure has been classified as non-performing.

[14] 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.

[15] Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

The coverage requirements for banks increase progressively up to 100%, after 3 years for unsecured NPEs, and after 9 and 7 years for NPEs secured by immovable property and for NPEs secured by other eligible credit protection, respectively. This approach reflects the increased risk resulting from “aged” NPEs even if they are secured: the longer NPEs remain on banks’ balance sheets, the less banks tend to succeed in recovering their money. The objective of the measure is to incentivise pro-active and timely NPE management by banks. This is important as successful recoveries and viable forbearance measures usually happen during the first years after the classification of an exposure as non-performing.

To ensure legal certainty and consistency in the prudential framework, the Regulation also introduces a common definition of ‘non-performing exposures’ (NPE), in line with the one already used for supervisory reporting purposes.

Overall, the prudential backstop will reduce risks to financial stability arising from high levels of insufficiently covered NPEs, by preventing the build-up or increase of such NPEs with spillover potential particularly in stressed market conditions. Conversely, it will also help ensure that institutions have sufficient loss coverage for NPEs, therefore protecting their profitability, capital and funding costs in stressed times. In turn, this would contribute to the provision of stable, less pro-cyclical financing to households and businesses.

3.2. DIRECTIVE ON CREDIT SERVICERS, CREDIT PURCHASERS AND THE RECOVERY OF COLLATERAL

The proposed Directive[16] would enable banks to deal in a more efficient way with loans once these become non-performing by improving conditions to either: (1) sell the credit to third parties on a secondary market; or (2) enforce the collateral used to secure the credit.

One of the central objectives of the proposal is to foster the development of secondary markets where banks can sell NPLs both at national level and across Member States while maintaining a high level of borrower protection. To achieve this objective, the Directive introduces a harmonised and less restrictive regime for credit purchasers and servicers and removes undue impediments to cross-border activity. It would stimulate the further development of a well-functioning secondary market and would therefore greatly contribute to the reduction of the current stocks of NPLs.

In order to attain the second central objective, the Commission proposed a supplementary mechanism for the accelerated extrajudicial recovery of collateral. The mechanism would allow banks and business borrowers (not consumers) to agree upfront by contract on a method of swift recovery of collateral by the creditor in case of the business borrower’s default. This mechanism would enhance secured creditors’ chances at value recovery and is designed to help to avoid the build-up of future NPLs.

Both avenues for banks[17] to deal with NPLs facilitated by this Directive would reinforce each other. Shortened work-out time and increased recovery values raise the value of the NPLs as well as bid prices in possible NPL transactions. It would also be easier to price a

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16 COM/2018/0135 final - 2018/063 (COD).

17 In addition to banks, the aspects of the proposal applicable to credit purchasers and servicers would also reinforce each other.

collateralised NPL than an unsecured one in secondary markets because the value of the collateral sets a minimum value of a NPL. Hence, this might also become a reason for credit purchasers to prefer NPLs with the accelerated extrajudicial collateral enforcement feature. This, in turn, would give additional incentives for credit institutions to use this feature at the origination of new loans. Moreover, the harmonisation achieved by accelerated extrajudicial collateral enforcement would foster the emergence of pan-European NPL investors, which would further improve market liquidity.

While the Council has reached a partial general approach regarding secondary markets, negotiations regarding the recovery of collateral are ongoing. Deliberations in the European Parliament on both aspectsshould be taken up as a priority once the new Parliament is settled in. Rapid conclusion of this file, which is part of the Council Action Plan, is of paramount importance to contributing to EU endeavours to successfully tackle the NPL issue across Europe. Therefore, the Commission calls on the co-legislators to swiftly reach an agreement on this important proposal.

3.3. BENCHMARKING OF NATIONAL INSOLVENCY REGIMES

The management of NPLs would benefit from more efficient and predictable loan enforcement and insolvency frameworks. The Commission services are therefore undertaking benchmarking of national loan enforcement regimes, encompassing both individual enforcement and collective enforcement or insolvency proceedings. The objective is to obtain a reliable picture of the delays and value recovery rates that banks face in case of borrowers’ defaults. These outcomes are heavily dependent on judicial capacity in the respective Member States. Progress on the benchmarking exercise was presented to and discussed with Member States at various meetings, last on 13 February and 10 April 2019, including the issue of lack of access to meaningful data. The Commission services in January 2019 launched a Call for Advice to the European Banking Authority to gather and analyse data from banks on recovery rates and speed in the various jurisdictions. This should be underpinned by qualitative data on cornerstone characteristics of the national enforcement and insolvency regimes. The Commission services requested Member States to provide qualitative data.

3.4. TECHNICAL BLUEPRINT FOR NATIONAL ASSET MANAGEMENT COMPANIES

As part of its NPL package, the Commission provided Member States with an Asset Management Company (AMC) Blueprint. This document gives non-binding and practical guidance on how they can set up, if they so wish, national AMCs, in full compliance with EU legislation. It builds upon best practices from past experiences in Member States, to the extent applicable. The Blueprint elaborated upon some core principles, such as the relevant asset perimeter, the participation perimeter, considerations on the asset-size threshold, asset valuation rules, the appropriate capital structure and the governance and operations of the AMC. Evidently, there might be a need to adjust some of the suggestions of the Blueprint to country-specific circumstances as appropriate.

The Commission takes note that, since the release of this Blueprint, no Member State has yet initiated the set-up of an AMC at national level, along the lines described in the Blueprint. Nevertheless, informal discussions with some Member States indicated that such vehicles are being carefully considered. At any rate, it is imperative to bear in mind that an

AMC can only be successful if it would be supported by (1) a suitable legal and administrative framework, e.g. facilitating debt enforcement and access to collateral; and (2) sound macrofinancial policies supporting economic recovery. Furthermore, it is important to reiterate that the Blueprint clarifies the permissible design for AMCs with a State aid element (which need to be seen as an exceptional solution[18]), in full compliance with the EU legal framework, particularly the Bank Recovery and Resolution Directive, the Single Resolution Mechanism Regulation and State aid rules.

3.5. EUROPEAN NPL TRANSACTION PLATFORMS

The Council Action Plan also called on the European Central Bank (ECB), the European Banking Authority (EBA) and the Commission to consider setting up NPL transaction platforms in order to stimulate the development of secondary markets. End November 2018, a staff working document was published on the potential set-up of such platforms, drafted jointly with staff from the ECB and EBA. It outlines how such a vehicle could work in practice.

Union-wide NPL transaction platforms would be electronic marketplaces where holders of NPLs – banks and non-bank creditors – and interested investors can exchange information on and trade in NPL portfolios.[19] Such platforms have the potential to address several current sources of market failure in the secondary market for NPLs, including asymmetry of information between sellers and buyers and high transaction costs. As a result, they could ease investors' access to NPL markets and help banks increase sales of NPLs and thereby allow them to dispose of NPLs and clean up their balance sheets faster, and at higher sales prices than currently possible. Such platforms could help deal with current stocks of NPLs and provide a channel for the efficient disposal of future NPLs as they arise. In this sense, they could be an important, yet low-cost, infrastructure investment preventing a new build-up of large stocks of NPLs in the future on the balance sheets of credit institutions.

Following up on the staff working document, the Commission held a roundtable on 15 January with stakeholders from industry, EBA and ECB in order to kick-start work on achieving Union-wide NPL platforms. This meeting allowed for a useful exchange of information and views with, and between, stakeholders. In order to advance towards such platforms, private stakeholders should agree on the concrete forms for developing and issuing industry standards for European NPL platforms. With this objective in mind, the Commission, together with the ECB and the EBA, is continuing to play a key role in facilitating concrete progress towards the emergence of Union-wide NPL platforms. As a next step, the Commission will organise a second roundtable with stakeholders.

[18] AMCs can be private or (partly) publicly supported with no need for State aid, if the State can be considered to act as any other economic agent. The option of an AMC involving State aid should therefore not be seen as the default solution. In this respect, the Blueprint also describes certain alternative impaired asset relief measures that do not constitute State aid, such as market-conform State guarantees enabling the securitisation of NPLs.

[19] To the extent that the platforms process personal data, they will have to fully comply with the General Data Protection Regulation (GDPR). In particular, the design and functioning of the platforms would need to be precised in detail in order to ensure full compliance with the GDPR.

4. Conclusions

As shown clearly in this Progress Report, risk reduction in the EU banking sector has maintained the strong momentum, built up over the past years. Risks continue to be substantially and more evenly addressed across the Union, based on economic growth and relevant policy actions. This Progress Report therefore constitutes an important contribution to the European Council in June.

As elaborated in this Progress Report, NPLs in the Union are continuing their declining trend. The robustness of this downward move should encourage the Union and its Member States to keep up their collective endeavours in order to convincingly address remaining NPL stocks and prevent future accumulations thereof. Particularly in some Member States, NPL ratios remain a challenge and deserve continued attention.

All elements of the Action Plan agreed by the Council in July 2017 have either been accomplished or are ongoing. The Commission calls on all stakeholders, both at national and European level, to finalise the remaining ongoing actions without delay.

In particular, the Commission calls on the European Parliament and the Council to swiftly agree on all elements of the comprehensive package of legislative measures proposed in March 2018 to tackle NPLs. This package, together with the marked advances in the reduction of NPLs, in cooperation with the EBA, the ECB and the European Systemic Risk Board, is imperative to support the ongoing collective work to reduce remaining risks in the European banking sector and would facilitate, in particular, the completion of the Banking Union.