# Progress in the Reduction of Non-Performing Loans in Europe

The Commission is presenting its First Progress Report on the Action Plan to tackle non-performing loans (NPLs) in Europe, which Finance Ministers agreed on in July 2017. In this context, the ECOFIN Council agreed to come back to the topic regularly – the first time after six months – to assess progress, based on the Commission's stocktake.

Today's progress report, which takes the form of a Communication and technical Staff Working Document, also provides an update on the Commission's ongoing work to deliver on the elements of the ECOFIN Action Plan, for which it has direct responsibility. The Commission has pledged to put forward a comprehensive package of measures to tackle NPLs in the spring of 2018.

**What are NPLs and who is responsible for reducing NPLs?**

The term "non-performing loan" refers to loans where the borrower – either a company or a physical person – is not able to repay a bank loan, i.e. is unable to make scheduled payments to cover interest or capital reimbursements. When the payments are more than 90 days past due, or the loan is assessed as unlikely to be repaid by the borrower, it is classified as an NPL.

The inability of borrowers to pay back their loans was aggravated during the financial crisis and the subsequent recessions when more companies and citizens went bankrupt or faced continued payment difficulties. This was particularly acute in some Member States.  As a consequence, many banks saw a build-up of NPLs on their books.

High stocks of such NPLs can weigh on a bank's short- and longer-term performance in two ways:

- First, NPLs require higher levels of provisioning to cover incurred and expected losses. Such loan provisions reduce bank profitability and reduce the bank's regulatory capital. In the most severe cases, the necessary accounting for NPLs can put in question the viability of a bank with potential implications for financial stability.

- Second, NPLs tie up significant amounts of a bank's resources, both human and financial. This reduces the bank's capacity to lend, including to small and medium-sized enterprises which rely on bank lending to a much greater extent than larger companies. This affects economic growth and job creation.

For these reasons, the EU has continuously stressed the urgency of addressing the risks related to NPLs. Tackling NPLs is primarily the responsibility of the affected banks and of Member States, which are and will remain competent for many of the required policy tools. At the same time, the NPL issue has a European dimension. Weak growth in some Member States, due to high levels of NPLs, might affect economic growth elsewhere in the EU. Investors' perception of the value and soundness of all EU banks may stem from weak balance sheets in just some banks. So, national authorities and European institutions need to join forces to address high NPL ratios. This was recognised by Member States in the ECOFIN Action Plan.

**NPLs are a legacy of the crisis. What has been done so far to tackle them?**

Over the past years, the Commission has been working constructively with the concerned Member States to reduce banks' NPLs, including through the European Semester. Some Member States have already made great strides in cleaning up bank balance sheets since the crisis. It is important to build up on these efforts, consolidate the trend and prevent the build-up of new NPLs, with a comprehensive set of actions agreed at the ECOFIN that both European institutions and Member States.

**What does the latest progress report show?**

The data presented in the progress report shows that risk reduction is taking hold in the European banking system: in nearly all Member States, NPL ratios have been falling in recent years. This has been the result of stabilising economies in concert with various pro-active measures, including sales of NPL portfolios.

The report shows that the total volume of NPLs has continued its steady decline. The quality of banks' loans portfolios also continued to improve. The latest figures confirm the downward trend of the NPLs ratio, which decreased further to 4.6% (Q2 2017), down by roughly 1 percentage point year-on-year. As a result, the ratio reached its lowest level since Q4 2014. The provisioning ratio has also risen, amounting to 50.8% (Q2 2017).

Despite the ongoing downward trend, the total volume of NPLs remains high (€950 billion). NPL ratios are very uneven with the EU – ranging from 0.7% to 46.9% – and some countries are making only slow progress, which are a source of concern.

There are still impediments to further reductions. Among others, activity on secondary markets for NPLs is not yet sufficient to substantially contribute to NPL reduction efforts, notwithstanding the recently increasing volume of NPL sales. Moreover, debt restructuring, insolvency and debt recovery processes are still too slow and unpredictable in some cases.

With this objective in mind, the Commission already proposed, in November 2016, measures to help companies in financial difficulty to restructure early on so as to prevent bankruptcy. In order to tackle the remaining obstacles, the Commission is fully committed to deliver on the elements of the ECOFIN Action Plan for which it has direct responsibility.

**What is the Commission going to do about NPLs?**

In line with the ECOFIN Action Plan, the Commission announced in its Communication on Completing the Banking Union in October 2017, a comprehensive package for tackling high NPL ratios by spring 2018. Significant progress has already been made, and delivery of the package of measures – including 3 legislative proposals – is on track for spring 2018.

The package will consist of the following measures:

- A Blueprint for how national Asset Management Companies (AMCs) can be set up in compliance with existing EU banking and State aid rules by building on best practices learned from past experiences in Member States.
- Measures to further develop secondary markets for Non-Performing Loans, especially with the aim of removing undue impediments to loan servicing by third parties and the transfer of loans.
- Measures to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans through Accelerated Extrajudicial Collateral Enforcement (AECE). This refers to an expedited and efficient out-of-court enforcement mechanism which enables secured lenders to recover value from collateral granted solely by companies and entrepreneurs to secure loans.
- Introduce statutory prudential backstops to prevent the risk of under-provisioning of NPLs. Such backstops, on newly originated loans that later turn non-performing, would amount to minimum levels of provisions and deductions from own funds that banks would be required to make to cover incurred and expected losses. In this context, the Commission will also consider introducing a common definition of non-performing exposures (NPE), in accordance with the one already used for supervisory reporting purposes.
- A way forward to foster the transparency on NPLs in Europe by improving the data availability and comparability as regards NPLs, and potentially supporting the development by market participants of NPL information platforms or credit registers.

**What are Asset Management Companies (AMCs) and why do we need a European blueprint?**

Experience in several Member States has demonstrated that national asset management companies (AMCs) are an effective tool to help banks clean up their balance sheets. Transferring bad loans from banks to an AMC allow viable banks to focus on their core task of lending and offering services to households and firms.

AMCs can be set up to deal with NPLs from individual banks or to manage bad loans from many banks in a Member State. An AMC can be privately or publicly owned and can receive various degrees of public support. Public support can only be given if it complies with European state aid and bank recovery and resolution rules.

AMCs can perform a useful role for society and contribute to the repair of the banks' balance sheets. They can also take a pivotal role in selling NPLs to private investors by:

- improving information and transparency in the secondary market for NPLs; and
- encouraging new investors to enter the market, which is currently dominated by a few large buyers with sometimes significant pricing power.

By making use of the existing market experience, we need to develop a solution that Member States can implement in line with the EU legal framework. The ECOFIN Action Plan tasked the Commission with developing a blueprint on how to best devise national asset management companies (AMCs). The blueprint will set out best practices on how AMCs can be established and managed, drawing on the experience and expertise gathered in some Member States during the crisis.

**Why do you want to develop secondary markets for NPLs? What obstacles are you targeting?**

A functioning secondary market would allow banks to clean their balance sheets by selling NPLs. In the absence of such a market, banks are obliged to keep NPLs on their balance sheets until they are fully written off. This reduces their profitability and their capacity to lend to new customers.

Currently there are too few investors willing and able to buy NPLs relative to the large amount of NPLs on European banks' balance sheets. Market entry is difficult for new investors because the business of loan sales is complex and the relevant rules differ considerably across Member States. The Commission is therefore analysing how to facilitate access to this market.

There is also a need to review entry conditions for loan servicing firms. Usually, NPL investors do not ask the bank from which they bought the NPLs to continue administering and collecting the loans. Instead, they often delegate these activities to independent firms called loan servicers. A lack of loan servicers discourages NPL investors from entering the market. Therefore, entry conditions and conduct rules for loan servicers play a crucial role in developing a secondary market for NPLs.

**Why are you going to propose European rules to enhance the ability of secured creditors to recover value from loans?**

Enabling banks as secured creditors to recover value more swiftly from loans granted to companies and entrepreneurs is a priority action of the Mid-term Review of the Capital Markets Union Action Plan. Effective out-of-court enforcement mechanisms can help prevent the accumulation of NPLs, as they provide secured creditors with legal instruments to enforce their rights against collateral in a swift manner. However these solutions do not exist in all Member States. Recent work performed by the SSM shows that "the legal frameworks for collateral enforcement across the euro area Member States are divergent. One-third of those countries consider the topic as being a challenge for NPL resolution, largely due to the lack of a modern legal framework enabling timely out-of-court collateral enforcement".

**Why are you proposing accelerated extrajudicial enforcement for creditors?**

The purpose of a measure on an accelerated extrajudicial enforcement of collateral is to provide banks in all Member States with a swift and effective out-of-court mechanism to enforce secured loans against companies and entrepreneurs, subject to common agreement. This would complement and be consistent with the 2016 Commission proposal on preventative business restructuring and second chance, which is now being discussed by the European Parliamend and Member States. Secured loans include loans granted by credit institutions to companies and entrepreneurs secured by mortgages, pledges and other comparable contractual or legal instruments (excluding natural persons, householders, consumers, non-professional borrowers).

An accelerated extrajudicial enforcement of collateral would strengthen the EU banking system and prevent the accumulation of NPLs on banks' balance sheets in the future. Convergence in enforcement of secured loans in the EU would increase lending to companies, in particular to small and medium-sized enterprises (SMEs) which depend on bank loans to a greater extent than larger corporates. It would improve the functioning of the Single Market by improving the competitiveness of EU banks and providing incentives for the provision of cross-border loans to companies.

**Why are you working on introducing statutory prudential backstops against new NPLs? What would be their purpose and rationale?**

The Commission is following up on the ECOFIN Council conclusions, which asked it to look into the possibility to amend EU legislation and introduce prudential backstops to address potential under-provisioning of new loans.

Insufficiently provisioned NPLs often pile up on banks' balance sheets, which in turn may cast doubt on the bank's future profitability, solvency and thus its long-term viability. Although average provisioning levels have recently increased in certain Member States with high NPL stocks, loss recognition is sometimes still too low and slow to effectively resolve NPLs. So called statutory prudential backstops against NPLs, arising from newly-originated loans, would set, for the future, common minimum levels for the amounts set aside by banks to cover incurred and expected losses on NPLs. This would put EU-wide brakes on new NPLs by ensuring sufficient loan loss coverage. It would be a prudential tool (under the so-called "Pillar 1", i.e. potential prudential deductions directly applicable to all banks under the Capital

Requirements Regulation [CRR]). Banks would need to continue to recognise accounting provisions in line with their assessment and applicable accounting standards. Those provisions, including potential increases in provisions as a result of new and upcoming accounting standards for banks and the loans they extend (i.e. the International Financial Reporting Standard IFRS9), would be taken fully into account for the purposes of the prudential backstops. But without common prudential rules on provisioning for NPLs, loan loss coverage might vary across banks which essentially bear the same underlying risk. This can limit the comparability of capital ratios and undermine their reliance.

The purpose of statutory prudential backstops would be to prevent the build-up of future NPL stocks with insufficient loan loss coverage, thereby ensuring banks’ financial soundness.

**Does the report find that the ECB already has tools to address the existing NPLs?**

Existing supervisory powers already include several tools that can be and are used by supervisors to address NPLs in specific banks. Most notably, competent authorities can influence a bank’s provisioning levels within the limits of the applicable accounting framework. They can apply the necessary adjustments if accounting provisioning is not sufficient from a supervisory perspective.