Tackling non-performing loans in Europe [1]



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ABSTRACT

The issue of non-performing loans (NPLs) in Europe continues to be a focal point of attention for the banking system, both at national and European level. This article explores the origins and causes of the accumulation of NPLs in Europe and explains why they have been and continue to be an important challenge that needs to be tackled. The reduction of NPLs in the EU banking sector is in fact encouraging and substantial progress is being made. Nevertheless, NPLs remain a significant challenge to the profitability and viability of EU banks, and economic growth at large. Attention also needs to be drawn to the clear and important EU dimension to reducing NPLs, as well as preventing their renewed build-up in the future, given the interconnectedness of the banking system of the EU and particularly of the euro area. In this respect, there is a clear connection with the "Action Plan to Tackle Non-Performing Loans In Europe", which was endorsed by finance ministers in the ECOFIN Council in July 2017. The contribution also touches upon the link with the wider agenda of advancing risk reduction and risk sharing in the EU. Most importantly, the contribution elaborates upon the actions that the European Commission has taken to address NPLs, what their main objectives are and how they could affect the EU banking sector.

[1] *The information and views set out in this publication are those of the authors and do not necessarily reflect the official opinion of the European Commission. The Commission does not guarantee the accuracy of the data included in this study. Neither the Commission nor any person acting on the Commission's behalf may be held responsible for the use which may be made of the information contained therein.*

Introduction

The financial crisis and subsequent recessions led to a more widespread inability of borrowers to pay back their loans, as more companies and people faced continued payment difficulties, or even bankruptcy. This was particularly so in Member States that faced long or deep recessions. Consequently, many banks saw a build-up of non-performing loans (NPLs) on their books. NPLs are loans where the borrower has difficulties to make the scheduled payments to cover interest and/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.

Elevated levels of NPLs may affect financial stability as they weigh on the viability and profitability of the affected institutions and have an impact, via reduced bank lending, on economic growth. More specifically, high stocks of NPLs can weigh on bank performance through two main channels:

1. NPLs generate less income for a bank than performing loans and thus reduce its profitability, and may cause losses that reduce the bank's capital. In the most severe cases, these effects can put in question the viability of a bank, with potential implications for financial stability.
2. 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. In turn, this negative effect in terms of credit supply also reduces the capacity of businesses to invest, affecting economic growth and job creation, hence creating a tangible effect on the real economy.[2]

For these reasons, the Commission and other EU authorities have long highlighted the urgency of taking the necessary measures to address the risks related to NPLs. In order to reduce the high NPL stocks, the EU agreed on a comprehensive set of measures outlined in the "Action Plan to Tackle NPLs in Europe"[3], which is currently being implemented. The on-going decline of NPLs has been and continues to be one of the key areas for reducing risk in the European banking sector. Still, high NPL ratios remain an important challenge, for some Member States in particular. In response, the Commission and other authorities (at national and at EU level) have introduced targeted measures to further reduce the current stock of NPLs and to prevent their renewed accumulation in the future.

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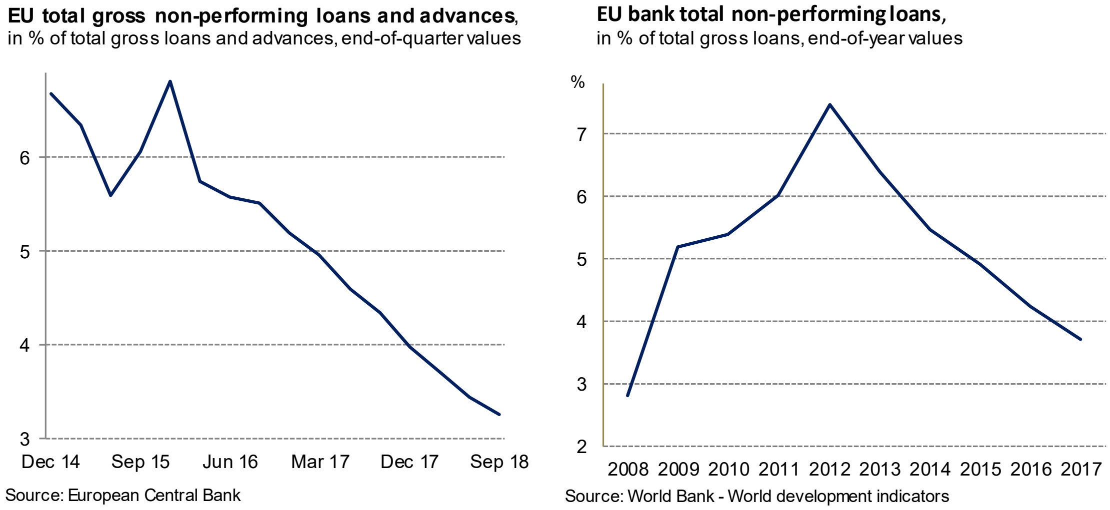
[2] Report of the FSC Subgroup on Non-Performing Loans.
See http://data.consilium.europa.eu/doc/document/ST-9854-2017-INIT/en/pdf.

[3] See the Council conclusions on Action plan to tackle non-performing loans in Europe, 11 July 2017:
https://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/.

1. THE CURRENT SITUATION

Over the past years, NPLs and NPL ratios have declined markedly. The overall quality of banks' loans portfolios has shown a sustained improvement. The latest figures show that the gross NPL ratio for all EU banks has declined to 3.3 % (Q3-2018), down by 1.1 percentage points year-on-year (see Figure 1). The ratio has thus continued its downward trend since Q4-2014. Additional data sources shows that the NPL ratio is approaching pre-crisis levels (see Figure 2). The provisioning ratio[4] has also improved and stood at 59.4 % in Q3-2018.

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



NPL ratios have fallen in nearly all Member States. However, the situation continues to differ significantly between countries (see Table 1). At the end of Q3-2018, 14 Member States had NPL ratios below 3 %, while some still have considerably higher ratios – 3 Member States had ratios above 10 %.

This reduction has been facilitated by determined action – by bank management and policymakers – particularly in Member States with relatively high NPL levels. There has been a trend across Member States towards further improving risk management practices (especially in vulnerable banks) and strengthening provisioning of NPLs, hence improving banks' capital positions. For instance, in Spain, following the resolution of Banco Popular in 2017, other banks accelerated the clean-up of their balance sheets. In Cyprus, NPLs have continued to fall since the end of 2015 and are declined more sharply in the second half of 2018, when a sizeable NPL portfolio was removed from the banking system, supported by a considerable volume of NPL sales. The continued use of NPL securitisation schemes also

[4] 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).

provides an impetus for NPL reduction. In Italy, the securitisation scheme supported by state guarantees (known as the *Garanzia Cartolarizzazione Sofferenze* or GACS) was introduced in 2016 and extended for another six months in September 2018. Several other market infrastructure initiatives also support addressing NPLs. For example in Portugal, initiatives to promote coordination between creditors (to accelerate credit restructuring or NPL sales) are a welcome addition to the policy mix.

Table 1: Non-performing loans and provisions by Member State. [5]

	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)

[5] *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).

Generally speaking, the environment in which banks can work out their NPLs has improved significantly since the crisis. As a result, banks have been able to build on restored stability in the financial system, partly with the aid of better and clearer regulatory and supervisory frameworks. The stability has enabled banks to enhance their internal capacity to manage and resolve NPLs. In several cases, banks have developed these activities into dedicated stand-alone entities. Banks have also taken advantage of an expansion in available third-party loan services, which have supported the increased outsourcing of NPL resolution activities. The market for NPL servicing has clearly grown and become more developed throughout Europe.

Yet a truly sustainable solution for the remaining NPL problem in Europe depends on putting further effort into innovative and collaborative approaches. Some are already emerging in the market, as partnerships have been taking shape between different market participants, for instance between banks and specialised third-party servicers. This increasingly allows them to share knowledge and information. In this way, banks and other market players are able to make further strides in digitalisation and platform initiatives (e.g. creditor coordination or data repositories). These developments hold the potential to reduce the cost of NPL management and make it easier to transfer NPLs, when appropriate, from banks to businesses that are better equipped to carry the relevant operational and financial burden. Continued specialisation among market participants will further improve efficiency in managing and resolving NPLs from different asset classes.

These improvements are crucial in order to address the current stock of NPLs effectively. So far, efforts have concentrated strongly on NPLs secured by collateral and – to a lesser extent – on unsecured retail NPLs. A large portion of the remaining exposure consists of NPLs to corporate and small and medium-sized enterprises, particularly in Member States where NPLs have been the result of economic recession rather than of a crisis of real-estate markets. In general, NPLs related to corporates and small and medium-sized enterprises are more heterogeneous in nature and can often prove more complex to tackle.

The management of NPLs can be seen as being at an inflection point. It has steadily matured from a crisis activity into a more structural and functional approach. The commercial, technological and regulatory advances are falling into place. They could then serve as stepping stones to enable the system to evolve into a fully sustainable structure that is able to efficiently resolve existing stocks of NPLs as well as manage – and hence prevent – future accumulation.

There is hence evidence of encouraging progress in tackling NPLs, due to a combination of policy actions and economic growth. Despite such advances, NPLs continue to pose risks to economic growth and financial stability. The total volume of NPLs across the Union still stands at EUR 786 billion.[6] Structural impediments continue to hamper a faster decline in NPL stocks. Among other elements, debt restructuring, insolvency and debt recovery processes continue to be a significant hurdle in some cases, as they remain too slow and unpredictable. Activity on secondary markets for NPLs is growing in some Member States, supported by relevant policy actions (as explained above), although it is not yet sufficient to substantially contribute to NPL reduction efforts on a structural basis. That being said, the development of the secondary market is encouraging, as it has sustained continued momentum in several Member States, with banks selling large portfolios. Interest from investors is rising and the volume of NPL-related transactions is increasing.

2. The broader context: risk reduction in the EU banking sector

Following the financial crisis, the regulatory framework for banks has changed substantially. The European Union has taken the lead in implementing reforms agreed globally at the level of the G20 and in the Basel Committee with the objective of reinforcing financial stability, reducing risk in the banking sector, and avoiding that taxpayers have to contribute financially to the costs of failing banks. In addition to significantly more stringent capital and liquidity requirements for banks, as well as the obligation for all banks to hold sufficient amounts of “bail-inable” capital for the purpose of resolution, the institutional arrangements for the supervision and resolution of banks in the Union, and notably in the euro area, have been strengthened fundamentally with the establishment of Banking Union and two of its three pillars, the Single Supervisory Mechanism and the Single Resolution Board.[7] As a result of these measures, the EU banking sector is in a much better shape than in previous years.

Over the last decade, the EU and its Member States have indeed worked hard to reduce risk in the banking sector.[8] A series of measures taken since the financial crisis have strengthened banks’ solvency, leverage and liquidity positions in significant and practical ways, have substantially improved governance within and supervision of the banking sector and have significantly enhanced banks’ resolvability. The average Tier 1 capital ratios[9] of euro area banks directly supervised by the Single Supervisory Mechanism have risen, from 15.32 % in Q3-2017 to 15.40 % in Q3-2018. This strengthening of capital

[6] Source: European Central Bank.

[7] The third pillar of Banking Union, the European Deposit Insurance Scheme, was proposed by the Commission in November 2015. In October 2017 the Commission, in its Communication on Completing the Banking Union [COM(2017) 592], gave new impetus to the negotiations on the European Deposit Insurance Scheme (EDIS).

[8] 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.

[9] 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.

positions is also reflected in higher leverage ratios. The average leverage ratio[10] remained stable around 5.11 % in Q3-2018, compared to 5.17 % in Q3-2017. Euro area banks also maintained their resilience to liquidity shocks, as the liquidity coverage ratio increased slightly from 140.34 % in Q3-2017 to 140.93 % in Q3-2018. This all testifies to the determined action taken to reduce risk across the euro area. As a result, risks have been more effectively and evenly addressed. The recent stress test further shows that banks' efforts to build up their capital base in recent years have strengthened their resilience and capacity to withstand shocks, underlining the health of the European banking system.

One of the key areas for reducing risk in the European banking sector is the further decline of NPLs. Addressing high stocks of NPLs and their possible future accumulation is essential in this context of driving further risk reduction in the EU banking sector, with the clear objective of rendering the latter more resilient to potential adverse shocks. Delivering such risk reduction functions as a key building block to complete the Banking Union.[11] Also the further development of a well-functioning Capital Markets Union would benefit from strong secondary markets of NPLs. Such elements form a key priority under the EU's agenda to deepen the Economic and Monetary Union.[12] Moreover, an integrated financial system will enhance the resilience of the Economic and Monetary Union to adverse shocks by facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing.

3. The EU-coordinated Response: The Council's NPL Action Plan

The primary responsibility for tackling high NPL ratios remains with the affected banks and Member States. However, there is also a clear EU dimension to reducing current NPL ratios, as well as preventing any build-up of NPLs in the future, given the interconnectedness of the banking system of the EU and particularly of the euro area. In particular, there are important spillover effects from Member States with high NPL ratios to the EU economy as a whole, both in terms of economic growth and financial stability.

The Commission and other institutions and bodies at EU level have therefore devoted significant attention to addressing the issue of NPLs since the outset of the financial crisis in 2008/9. For banks, whose viability was threatened by high NPL ratios, the Commission has assisted Member States in setting up ad-hoc and system-wide measures with the objective of reducing NPL stocks (sometimes as part of a financial assistance programme) through solutions compatible with State aid rules such as specific impaired assets measures for banks, winding down vehicles and/or market compatible structures, which

[10] 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.

[11] The latter should be completed by achieving risk reduction and risk sharing in parallel, as they complement and reinforce each other. Progress in the various domains, including agreement on the backstop to the single resolution fund and a European Deposit Insurance Scheme, should therefore take place in parallel.

[12] European Commission Reflection Paper COM(2017) 291 on the deepening of the Economic and Monetary Union.

entailed a substantial reduction of the stock of NPLs present in the banking sector. In this way, it has incentivised banks to manage and reduce their NPLs via market mechanisms and thus protected tax payers from bearing the costs via adequate burden sharing and in-depth restructuring. The need to take determined action to address high NPL ratios has also been underlined in the European Semester recommendations to relevant Member States. The European Central Bank (ECB) in its supervisory capacity (the Single Supervisory Mechanism), national competent authorities and the European Banking Authority (EBA) have also played an important role in enhancing the supervision and reporting of NPLs in Europe, while the ECB has had an integral part in safeguarding financial stability in the EU.

Reflecting this EU dimension and building on the high level of agreement on the need to continue and extend the actions already initiated by the Commission and others, the ECOFIN Council adopted in July 2017 an "Action Plan To Tackle Non-Performing Loans in Europe" (see Annex). This Action Plan calls upon various institutions – including the Commission – to take appropriate measures to further address the challenges of high NPL ratios in Europe. It does so by setting out a comprehensive approach, focusing on a mix of complementary policy actions in four core areas: (i) bank supervision and regulation; (ii) further reforms of national restructuring, insolvency and debt recovery frameworks; (iii) developing secondary markets for distressed assets, and (iv) fostering, as appropriate and necessary, restructuring of banks. Action in these areas should be at national level and at Union level where appropriate.

Since the adoption of the Council Action Plan in July 2017, important strides have been made towards full implementation of the Action Plan (see Table 2).

Table 2: Progress in implementing the ECOFIN Council Action Plan.

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

Accomplished
Imminent
Ongoing

Source: Commission Services (DG FISMA).[13]

4. Commission measures

Despite good progress in tackling the NPL challenge in Europe, further legislative measures appeared necessary to address the remaining issues linked to high levels of NPLs. In this context, a comprehensive approach is needed and should focus on a mix of complementary policy actions. Continuing its commitment to tackle NPLs, the Commission therefore adopted a comprehensive package addressing the four areas described above, thereby fostering financial stability in the EU. With this package of measures, the Commission delivered a large part of those elements of the NPL Action Plan that are under its direct responsibility (see Figure 3).

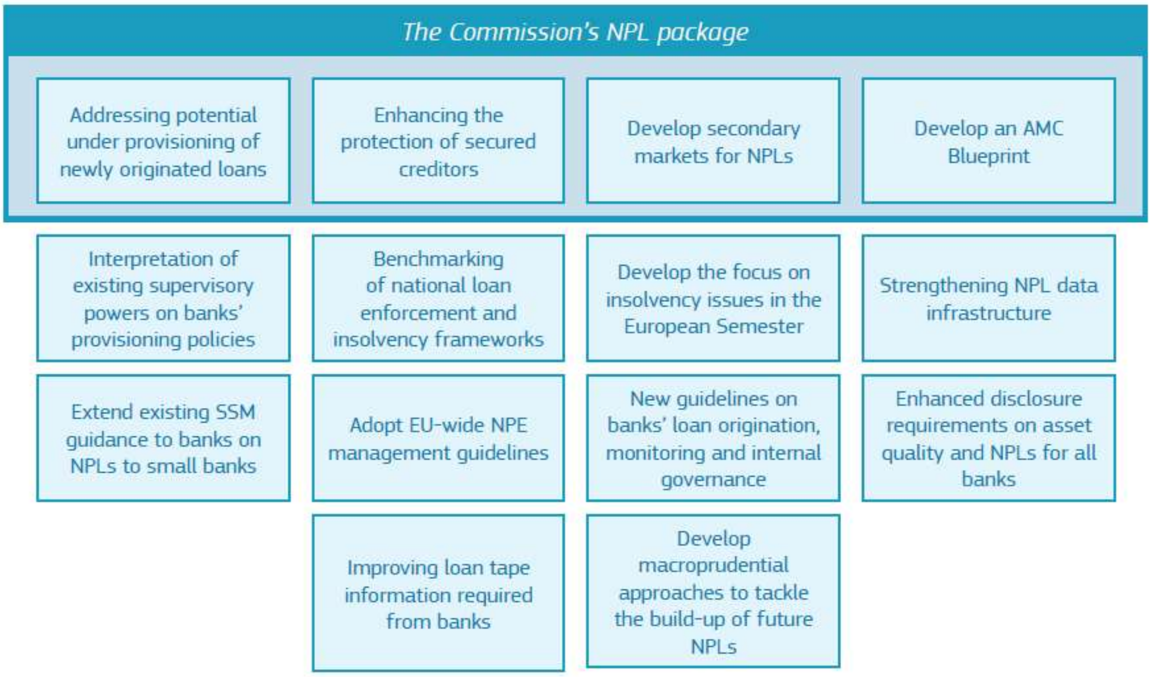
The proposed action will enable banks and Member States to address NPLs in an even more determined way than before and avoid excessive build-up of NPLs in the future.

[13] See also the European Commission Communication COM/2018/766 final/2 to the European Parliament, the European Council, the Council and the European Central Bank on Third Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union. The table was updated in this publication.

Banks will be required to put aside sufficient resources when new loans become non-performing, creating appropriate incentives to work out NPLs at an early stage and avoid too large accumulations of NPLs.

If loans, nevertheless, become non-performing, more efficient enforcement mechanisms for secured loans will allow banks to work out NPLs, subject to appropriate safeguards for debtors and with the exception of loans granted to consumers.

Figure 3: Elements of the Council "Action Plan to Tackle Non-Performing Loans in Europe", including the Commission's NPL package of measures. [14]



Source: Commission Services (DG FISMA).[15]

If despite the measures above, NPL stocks become too high – as is currently the case for some banks in certain Member States – banks will be able to sell NPLs to other operators on

[14] Note on abbreviations: AMC (Asset management company), SSMR (Single Supervisory Mechanism Regulation) CRD IV (Capital Requirements Directive IV).

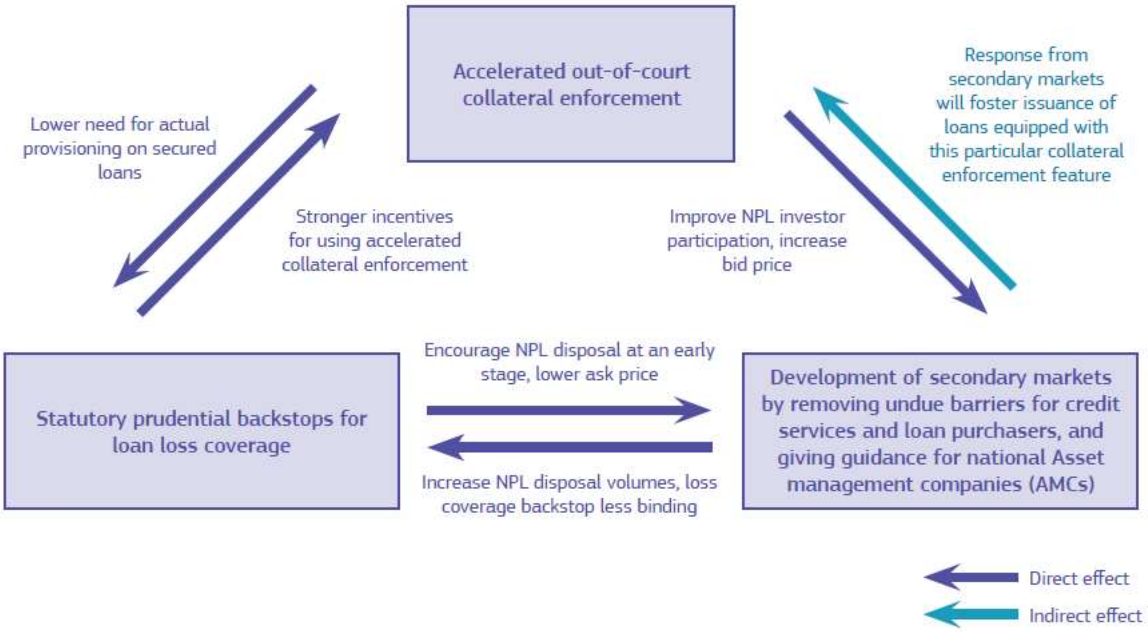
[15] See also the Factsheet attached to the European Commission Communication (COM/2018/0133 final) to the European Parliament, the European Council, the Council and the European Central Bank on Second Progress Report on the Reduction of Non-Performing Loans in Europe. Link: https://ec.europa.eu/info/files/180314-non-performing-loans-factsheet_en.

efficient, competitive and transparent secondary markets. Supervisory authorities will guide banks in these endeavours, based on their existing bank-specific – so-called Pillar 2 – powers under the Capital Requirement Regulation.[16]

Where NPLs have become a significant and broad-based problem, Member States that so wish may set up national Asset Management Companies (AMCs) or other measures under current State aid and bank resolution rules.

The proposals in this package mutually reinforce each other and would not be as effective if implemented in isolation (see Figure 4). The statutory prudential backstop will ensure that credit losses on future NPLs are sufficiently covered, making their resolution or sale easier. These effects are complemented by the push to further develop secondary markets for NPLs as these would make demand for NPLs more competitive and raise their market value. Furthermore, accelerated extrajudicial collateral enforcement as a swift mechanism for recovery of collateral value reduces the costs for resolving NPLs.

Figure 4: NPL Package: Reinforcing effects between actions.



Source: Commission Services (DG FISMA).[17]

[16] 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.

[17] See also the Factsheet attached to the European Commission Communication (COM/2018/0133 final) to the European Parliament, the European Council, the Council and the European Central Bank on Second Progress Report on the Reduction of Non-Performing Loans in Europe. Link: https://ec.europa.eu/info/files/180314-non-performing-loans-factsheet_en.

In addition to this package, Commission services published, in November 2018, a staff working document on the potential set-up of NPL transaction platforms, drafted jointly with staff from the ECB and EBA. It outlines how such vehicles could work in practice. They could be an important element in the policy mix and further stimulate NPL secondary markets by mitigating market failures.

Furthermore, the Commission presented in November 2016, in the context of the Capital Markets Union work, a proposal for a Directive on restructuring, second chance and efficiency of insolvency[18]. The key features of this proposal, in particular the availability of restructuring procedures enabling viable companies in financial difficulties to avoid insolvency as well as measures to enhance the effectiveness of restructuring and insolvency proceedings, would contribute to reducing NPLs as well as preventing their accumulation in the future. The Commission also clarified in the Single Supervisory Mechanism Review Report, accompanying the Communication from October 2017, the interpretation of the relevant Articles of the Capital Requirement Directive (CRD) and the Single Supervisory Mechanism Regulation. The Commission confirmed that the supervisory powers enshrined therein allow the competent authorities to influence a bank's provisioning policy with regard to NPLs within the limits of the applicable accounting framework and to apply specific adjustments where necessary for prudential purposes.[19]

4.1. Sufficient Loan Loss coverage by banks for future NPLs

A Regulation amending the Capital Requirements Regulation[20] was successfully adopted in March 2019, after discussions with the Council and the European Parliament reached a positive conclusion. It will require banks to have sufficient loan loss coverage for newly originated loans if these become non-performing exposures. The amendment introduces a ‘statutory prudential backstop’ in order to prevent the risk of under-provisioning of future NPLs. Such a backstop amounts to minimum coverage levels of provisions and deductions from own funds that banks will be required to have for incurred and expected losses on newly originated loans that later turn non-performing. In case a bank does not meet the applicable minimum level, deductions from own funds would apply.

To ensure consistency in the prudential framework, the Commission also introduces a common definition of non-performing exposures (NPE), in line with the one already used for supervisory reporting purposes. The prudential backstop will reduce financial stability

[18] European Commission proposal COM/2016/0723 final - 2016/0359 (COD) for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU.

[19] European Commission Report COM (2017) 591 to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013.

[20] 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.

risks arising from high levels of insufficiently covered NPEs, by avoiding the build-up or increase of such NPEs with spillover potential in stressed market conditions. It will also ensure that institutions have sufficient loss coverage for NPEs, therefore protecting their profitability, capital and funding costs in stressed times. In turn, this would ensure that stable, less pro-cyclical financing is available to households and businesses.

The prudential backstop would work as a function of two main input variables

- the level/quality of credit protection (collateral/guarantee) held for the NPE, if any ("secured NPEs"); and
- the time period for which an exposure has been classified as non-performing.

The coverage requirements for banks are to increase progressively up to 100%, i.e. after 3 years (for unsecured NPEs) and 9 / 7 years (for NPEs secured by immovable / other credit protection, respectively) (see Table 3). This approach reflects the increased risk resulting from "aged" NPEs: the longer NPEs remain on banks' balance sheets, the less banks succeed in recovering. The objective is to incentivise pro-active and timely NPE management. This is important as successful loan recoveries and viable forbearance measures usually happen during the first years after classification as non-performing.

Table 3: Final coverage calendar for different categories of NPEs.

Timeframe	Unsecured NPEs	NPEs secured by immovable collateral	NPEs secured by other eligible credit protection
Between 0 and 2 years	-	-	-
Between 2 and 3 years	35%	-	-
Between 3 and 4 years	100%	25%	25%
Between 4 and 5 years	100%	35%	35%
Between 5 and 6 years	100%	55%	55%
Between 6 and 7 years	100%	70%	80%
Between 7 and 8 years	100%	80%	100%
Between 8 and 9 years	100%	85%	100%
After 9 years	100%	100%	100%

Source: Commission Services (DG FISMA).[21]

[21] Table based on the adopted text of the Regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures (COM(2018)0134 – C8-0117/2018 – 2018/0060(COD)).

4.2. A proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral

The proposed Directive enables banks to deal in a more efficient way with loans once these become non-performing by improving conditions to either enforce the collateral used to secure the credit or to sell the credit to third parties. Accelerated extrajudicial collateral enforcement as a swift mechanism for recovery of value would reduce the costs for resolving NPLs and would hence support banks in recovering value. In cases where banks face a large build-up of NPLs and lack the staff or expertise to properly service them, the proposed Directive facilitates the outsourcing of the servicing of these loans to a specialised credit servicer or the sale of the credit agreements to a credit purchaser that has the necessary risk appetite and expertise to manage it.

The two avenues for banks to deal with NPLs facilitated by this proposed Directive reinforce each other. Shorter time of resolution and increased recovery, as expected with accelerated extrajudicial collateral enforcement, increases the value of the NPLs as well as bid prices in possible NPL transactions. It is also easier to price a collateralised NPL than an unsecured one in secondary markets because the value of the collateral sets a minimum value of a NPL. Hence, credit purchasers will 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.

4.2.1. Further develop secondary markets for NPLs

The proposed Directive would contribute to the further development of secondary markets for NPLs by removing undue impediments to loan servicing by third parties and to the transfer of loans to loan purchasers, while fully respecting the existing Union civil law acquis and Member States’ consumer protection rules.

Currently, banks are not always able to manage their NPLs in an effective or efficient manner. In such cases, banks will recover less from their portfolio than would otherwise be possible. This may occur, for example, when banks face a large volume of NPLs and are unable to properly service their NPLs. Banks may also find themselves with a portfolio of NPLs where the nature of the loans falls outside of the banks’ core expertise to recover. In these instances, the best option may be to either outsource the servicing of these loans to a specialised loan servicer or sell the credit agreement.

For these reasons, the proposal creates a common set of rules that credit servicers need to abide by to operate cross-border within the Union. The proposal sets common standards to ensure proper conduct by and supervision of loan purchasers and credit servicers across the Union, while allowing more competition by harmonising market access rules across Member States. This will lower the cost of entry for potential loan purchasers by increasing the accessibility of credit servicing and by reducing the costs of credit servicing. A higher number of purchasers on the market means a more competitive market, leading to higher demand and transaction prices.

In order to have a sound secondary market for NPLs and a solid framework for credit servicers, clear rules are proposed to protect consumers' rights and interests. The proposal includes legal safeguards and transparency rules, making sure that the level of consumer protection is not impacted by the transfer of the debt. Particular attention is paid to the most vulnerable and over-indebted consumers. For example, credit servicers should have appropriate policies in place for dealing with borrowers and, where needed, should refer the consumer to debt-advice or social services.

To prevent possible new NPLs in the context of consumer loans, Member States are also invited to put in place rules for the assessment of consumer affordability. The preparatory work on creditworthiness assessment envisaged in the Consumer Financial Services Action Plan [22] is ongoing, and the Commission will continue the work with Member States to define best practices and guiding principles for credit institutions when assessing the creditworthiness of consumers.

4.2.2. More efficient value recovery from secured loans

The proposed Directive will also provide secured creditors with a more efficient method of value recovery from secured loans through an accelerated extrajudicial collateral enforcement. This refers to an expedited and efficient out-of-court enforcement mechanism that enables secured lenders to recover value from collateral granted solely by companies and entrepreneurs to secure loans. Such mechanisms already exist in 25 Member States (yet in half of these, the scope of such mechanisms is limited to either movable or immovable assets).

The proposal would help banks to improve their current workout processes, and manage NPLs by increasing the efficiency of debt recovery procedures through an accelerated extrajudicial collateral enforcement. In the majority of cases, banks address their NPLs themselves by recovering value through workout. A large share of loans that become NPLs are loans secured by collateral. While banks are able to enforce collateral under national insolvency and debt recovery frameworks, the process can often be slow and lack legal certainty. In the meantime, NPLs remain on banks' balance sheets, keeping the bank exposed to prolonged uncertainty and tying up its resources. This prevents the bank from focusing on new lending to viable customers. Therefore, the proposal includes an efficient method for banks and other undertakings authorised to grant loans, in order to allow them

[22] European Commission Communication COM(2017) 139 to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on Consumer

Financial Services Action Plan: Better Products, More Choice.

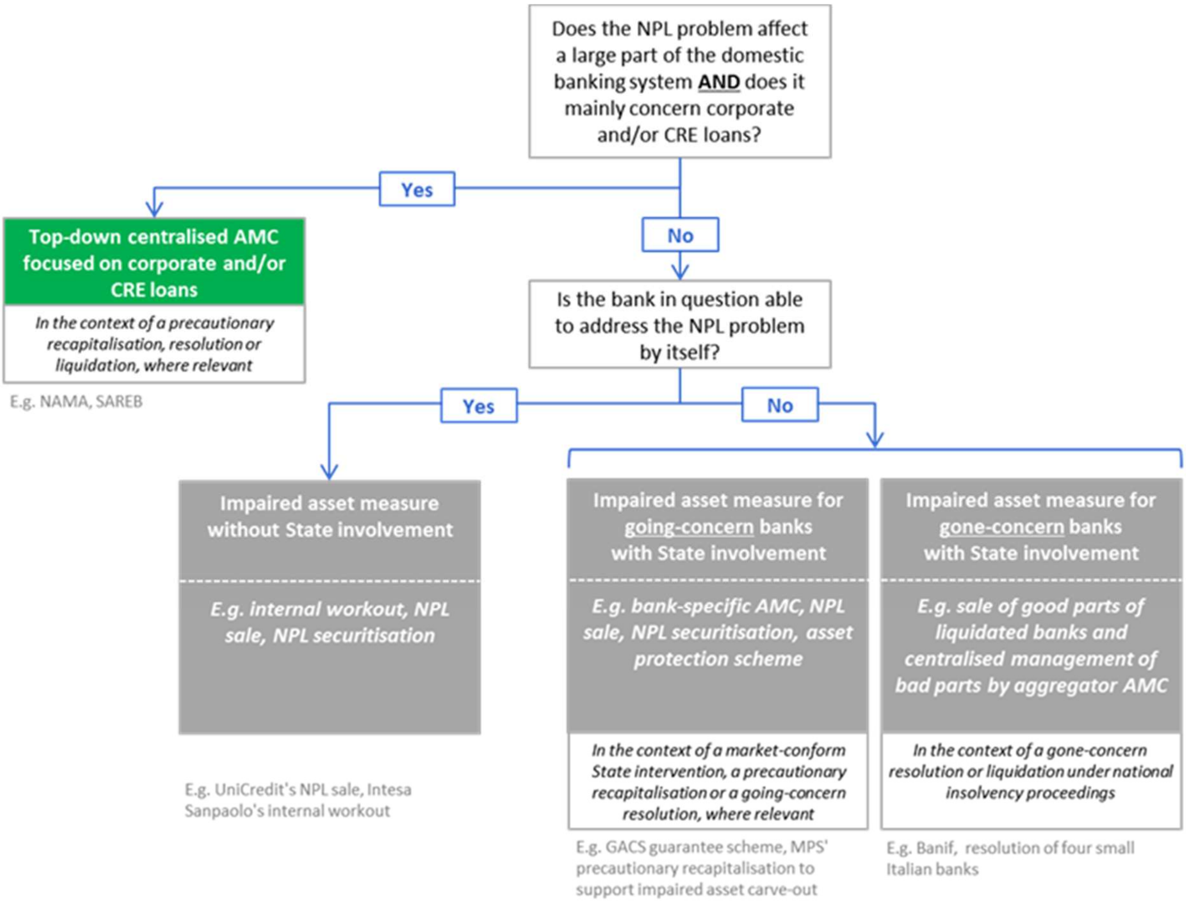
to recover their funds from secured loans to business borrowers, in an out-of-court procedure. This efficient extrajudicial procedure would be accessible when agreed upon in advance by both lender and borrower, in the loan agreement. It will not be available for consumer credits, and is designed to not affect early restructuring or insolvency proceedings. It will not impact the insolvency laws of the Member States on issues such as the hierarchy of creditors in insolvency.

Restructuring and insolvency proceedings prevail over the accelerated extrajudicial collateral enforcement procedure set out in this proposal. In order to ensure full consistency and complementarity with the Restructuring Proposal, the following principle will apply: the extrajudicial enforcement of collateral would be possible only as long as a stay of individual enforcement actions, in accordance with applicable national laws, is not applicable. The Restructuring Proposal already foresees that creditors, including secured creditors of a company or an entrepreneur that is undergoing restructuring proceedings, are subject to a stay of individual enforcement actions. In this case, the debtor in difficulty can negotiate a restructuring plan with creditors and avoid insolvency.

4.3. A technical Blueprint for how national Asset Management Companies (AMCs) can be set up

As part of the package, the Commission also provided Member States with non-binding guidance on how they can set up, if they so wish, national AMCs in full compliance with EU banking and State aid rules. The AMC Blueprint provides practical guidance for the design and set-up of AMCs at the national level, building upon best practices from past experiences in Member States, to the extent applicable. 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 not be seen as the default solution (see Figure 5). That said, considering AMCs with a State aid element as an exceptional solution, the Blueprint aims to clarify the permissible design for such AMCs, fully consistent with the EU legal framework, particularly the BRRD, the SRMR and State aid rules.

Figure 5: Example decision tree for authorities in the face of an NPL crisis



Source: Commission Services (DG COMP).[23]

The Blueprint suggests a number of common 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. In addition, the Blueprint describes certain alternative impaired asset relief measures that do not constitute State aid, such as market-conform State guarantees enabling the securitisation of NPLs. The Commission has in the past years also assessed other measures proposed by Member States to deal with legacy NPLs and will continue to do so in individual cases, in order to ensure that these measures fully respect the BRRD, SRMR and State aid rules.

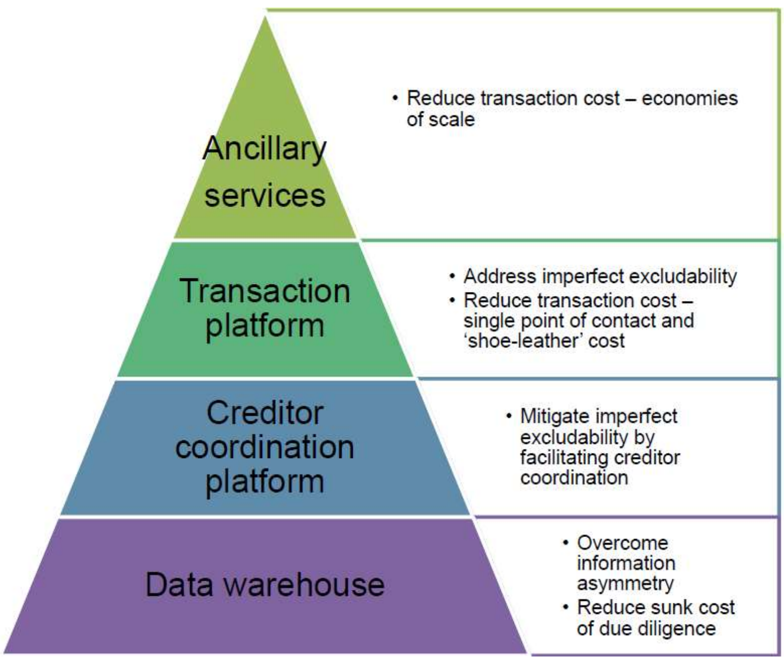
[23] European Commission Staff Working Document (SWD/2018/072 final) on AMC Blueprint accompanying the document Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank on Second Progress Report on the Reduction of Non-Performing Loans in Europe.

4.4. NPL transaction platforms

The Council Action Plan also called on the ECB, the EBA and the Commission to consider setting up an NPL transaction platform in order to stimulate the development of secondary markets. Commission services therefore published, end November 2018, a staff working document on the potential set-up of an NPL transaction platform, drafted jointly with staff from the ECB and EBA. It outlines the Commission services' view on how the arrangements for such a vehicle could work in practice.

A Union-wide NPL transaction platform would be an electronic marketplace where holders of NPLs – banks and non-bank creditors – and interested investors can exchange information and trade. Such a platform has 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 (see Figure 6). As a result, it could help banks increase sales and obtain higher sales prices than currently possible, ease investor access to NPL markets, and thereby allow banks to dispose of NPLs and clean up their balance sheets faster. Such a platform could help deal with current stocks of NPLs and provide a permanent channel for the efficient disposal of future NPLs as they arise. In this sense, it could be an important, yet low-cost, infrastructure investment preventing a new build-up of large stocks of NPLs in the future. It could therefore be an essential means of contributing to a sustainable solution to the NPL issue in Europe.

Figure 6: Potential functions for a platform.



Source: European Central Bank.

The Commission invited industry stakeholders to a roundtable in order to kick-start work on achieving Union-wide NPL platforms. A first meeting of this roundtable with industry experts took place on 15 January, delivering a useful exchange of information and views with, and between, private stakeholders. The objective is for stakeholders to 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, will therefore continue to play a key role in facilitating the taking of the necessary steps to promote the emergence of Union-wide NPL platforms by all relevant stakeholders.

5. Conclusion

In line with the overall significant progress on risk reduction in the EU banking sector, the stock of NPLs has seen a marked decline and is continuing this trend. Despite this positive development, high NPLs remain a challenge for the EU as a whole and for some Member States in particular. This affects the individual banks, hinders the proper functioning of Banking Union and affects the lending to the economy. Tackling this issue has in fact been supported by the economic recovery. In concert with targeted policy actions, this has led to declining NPL volumes and ratios across Member States, albeit at various speeds. Yet more is needed. Especially in some Member States, the current trends of NPL reduction ought to accelerate. Furthermore, a renewed build-up of NPLs needs to be prevented overall.

The Action Plan agreed by the Council in July 2017 was a major step in addressing the NPL challenge. Substantial progress has been made in its implementation. However, to be able to address NPLs in the most effective manner, the Action Plan should be fully implemented by all actors. This is crucial to addressing the challenge of high NPLs, both in terms of reducing existing stocks to sustainable levels and preventing a renewed future accumulation.

The comprehensive package of measures launched by the Commission in March 2018 constituted a significant step in implementing the Action Plan and hence in addressing NPLs across the EU, now and towards the future. Beyond this package, the Commission continues to follow up on this important topic, suggesting relevant policies, as appropriate, to tackle the problem at hand.

Also the other parts of the Action Plan are mostly well on track or completed. It is necessary to maintain this pace of progress in implementing all envisaged measures in the coming months and years, if the challenge of high NPLs is to be addressed both in terms of reducing existing stocks to sustainable levels and preventing future accumulation. Individual banks and Member States concerned need to maintain their efforts at a sustained pace, and the Action Plan's full implementation must remain the objective of all relevant stakeholders. This is essential to support the ongoing joint efforts to reduce risk in the European banking sector. As Europe and its economy regain strength, the momentum must be seized to further reduce risks in the European banking sector, accelerating the reduction of NPLs as well as preventing future build-ups of NPLs.

ANNEX: COUNCIL CONCLUSIONS OF 11 JULY ON AN ACTION PLAN TO TACKLE NON-PERFORMING LOANS IN EUROPE

The Council:

1. NOTES that the financial crisis and ensuing recessions, together with structural factors, sometimes accompanied by inadequate loan origination practices, have left the banks in some Member States with high ratios of non-performing loans (NPLs);

2. RECOGNISES that although in the majority of Member States high NPL ratios did not emerge in recent years, the negative effects of current high NPL ratios in a substantial number of Member States can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole, especially within the Banking Union;

3. STRESSES that while banks are primarily responsible for restructuring their business models and resolving their NPLs issues in a timely manner, further measures to address the existing stock of NPLs and to prevent the future emergence and accumulation of NPLs would be beneficial for the EU as a whole by contributing to enhanced growth and reducing financial fragmentation;

4. NOTES that, given their magnitude, the current high NPL ratios in some Member States may not decline at a satisfactory pace notwithstanding the context of economic recovery and WELCOMES the steps that have already been taken and significant progress made by certain concerned Member States and EU institutions and bodies to address this legacy issue and prevent its re-emergence; NOTES that supervisors have currently the ability to make use of specific tools, such as where appropriate, assessing incurred or likely losses through proper asset valuations; STRESSES that more efforts are needed to restore NPL ratios to sustainable lower levels and that incentives for all EU credit institutions to deal with NPLs pro-actively should be enhanced while at the same avoiding the disruptive effects of fire sales;

5. EMPHASIZES that EU post crisis regulatory reforms, including steps taken to establish the Banking Union, mark a change of system to protect taxpayers' money, ensure the preservation of financial stability in the euro area and the EU as a whole, and enhance market mechanisms in the banking sector, to which resolution tools and in particular bail-in are essential. Dealing with the issue of NPLs, which may entail lifting impediments to further restructuring in the banking sector, should be consistent with these rules, including Directive 2014/59/EU (BRRD) and State Aid rules;

6. STRESSES that a comprehensive approach combining a mix of complementing policy actions, at national level and at the European level where appropriate, is the most effective way to address the existing stocks of NPLs as well as the emergence and accumulation of new NPLs on bank balance sheets, in particular in all of the four following policy areas: (i) supervision, (ii) structural reforms of insolvency and debt recovery frameworks, (iii) development of secondary markets for distressed assets, and (iv) fostering restructuring of the banking system;

7. WELCOMES therefore the report on NPLs[24] produced by the Subgroup of the Financial Services Committee (NPL Report) and CALLS on Member States, EU institutions, bodies and agencies to take work forward on policy options included therein, on the basis of these Council conclusions;

8. In this context, INVITES in particular:

   - the Commission to issue, in summer 2017, an interpretation of existing supervisory powers laid down in EU legislation with a view to clarifying their usability as regards banks' provisioning policies for NPLs under Article 16 of Council Regulation (EU) No 1024/2013 and under Article 104 of Directive 2013/36/EU (CRD IV); following the Commission's interpretation, the Council will, if appropriate and following a full pros and cons analysis, consider an amendment to Article 104 of the CRD IV in the context of the ongoing review of the CRR/CRD IV, in line with policy options set out in the NPL Report;

   - the Commission to consider, within the framework of the ongoing review of the CRR/CRD IV, prudential backstops addressing potential under provisioning which would apply to newly originated loans; these statutory backstops could take the shape of compulsory prudential deductions from own funds of NPL, following an assessment of the most appropriate calibrations in line with international practice;

   - the ECB Banking supervision, together with national competent authorities within the Banking Union, to implement, by the end of 2018, with regard to less significant institutions in the Banking Union a guidance similar to "Guidance to banks on Non-Performing Loans" issued by the Single Supervisory Mechanism (SSM Guidance) for significant institutions, with targeted adaptations where appropriate;

   - the European Banking Authority (EBA) to issue, by summer 2018, general guidelines on NPL management, consistent with the afore mentioned Guidance, with an extended scope applying to all banks in the entire EU;

   - the EBA to issue, by summer 2018, detailed guidelines on banks’ loan origination, monitoring and internal governance which could in particular address issues such

[24] doc. 9854/17

as transparency and borrower affordability assessment; these guidelines should leverage on existing national experiences where relevant;

- the European Systemic Risk Board to develop, by the end of 2018, macro-prudential approaches to prevent the emergence of system-wide NPL problems, while taking due consideration of procyclical effects of measures addressing NPLs' stocks and potential effects on financial stability;
- the EBA, in consultation with the ESMA, and competent authorities to implement, by the end of 2018, enhanced disclosure requirements on asset quality and non-performing loans to all banks;
- the EBA to issue, by the end of 2017, guidelines for banks on loan tapes monitoring, specifying minimal detailed information required from banks on their credit exposures in the banking book;
- the EBA, the ECB and the Commission, to propose by the end of 2017, initiatives to strengthen the data infrastructure with uniform and standardised data for NPLs and consider the setting-up of NPL transaction platforms in order to stimulate the development of this secondary market;
- the Commission to develop, by the end of 2017, in cooperation with all relevant institutions and bodies and taking into account successful national experiences so far, a "blueprint" for the potential set-up of national asset management companies (AMCs), which would set out common principles for the relevant asset and participation perimeters, asset-size thresholds, asset valuation rules, appropriate capital structures, the governance and operational features, both private and public; it should also clarify the permissible design, consistent with the EU legislative framework, including Directive 2014/59/EU (BRRD) and Regulation (EU) No 806/2014 (SRMR) and State Aid rules, for asset relief measures and the use of AMCs;
- the Commission to develop, by summer 2018, a European approach to foster the development of secondary markets for NPLs, in particular to remove impediments to the transfer of NPLs by banks to non-banks and to their ownership by non-banks, while safeguarding consumers' rights, as well as to simplify and potentially harmonise the licensing requirements for third-party loan servicers and to take legislative initiative in this respect, as appropriate;
- the Commission to publish, before the end of 2017, the results of the benchmarking exercise on the efficiency of national loan enforcement (including insolvency) regimes from a bank creditor perspective, providing comparable metrics, as precise as possible, for recovery rates, recovery times and recovery costs across Member States, and to further develop the focus on insolvency issues in the European Semester, taking into account on-going reforms;
- Member States, to consider, while building closely upon the benchmarking exercise, by the end of 2018 to carry out dedicated peer-reviews on insolvency

regimes across the EU. acknowledging that legal systems and insolvency frameworks differ widely between Member States;

- the Commission to further analyse the possibility of enhancing the protection of secured creditors;

9. AGREES to revert to this issue regularly and initially after six months, in order to take stock of the evolution of NPLs in Europe, the restructuring of banking sectors in this context and the development of secondary markets for NPL transactions, to assess the progress made on the basis of a stock-take from the Commission, and to co-ordinate the communication on NPLs in Europe.