EPFSF Briefing

“THE NON-PERFORMING LOANS ISSUE”

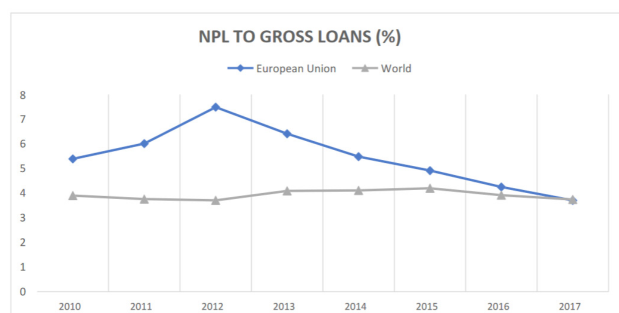
16 OCTOBER 2018

Background

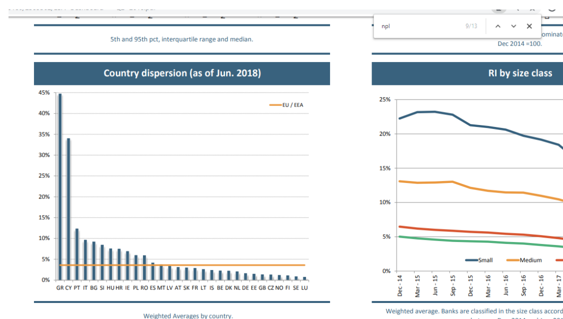
• A high-level of Non-Performing Loans (NPLs) was a legacy of the last crisis, depressing banks’ capital levels and resulting in reduced lending at a time when support of the EU economy was needed.

• However, in recent years there has been a significant decline in the level of outstanding NPLs across the European Union both in absolute terms and as a percentage of total EU bank lending. This can be attributed to improved in-house management solutions and more aggressive write offs together with NPL assets disposals by banks facilitated by their much-improved bank capital positions and increasing investor appetite for such assets.

• As ECB and EBA figures show, European NPLs at 3.6% of outstanding loans are now below the world average of 3.74% (see the below graph). Despite the low average level of NPLs, several European countries still have NPLs well above this level with the gross ratio of 3 countries still in double figures and 11 countries above the EBA’s suggested level for high NPLs of 5%.



Source: EBF, based on World Bank and IMF Data



• Notwithstanding the significant overall decline in the level of NPLs, more forward looking provisioning requirements under IFRS9 and enhanced scrutiny procedures in pillar 2, finance ministers in July 2017 unanimously agreed on a Council Action Plan to tackle NPLs. This has been followed by a series of initiatives from the European Commission published in March 2018 aiming at:

1.Ensuring that banks set aside capital to cover the risks associated with new loans that may become non-performing.
2.Encouraging the development of secondary markets and external servicing of NPLs, where banks can sell their NPLs to nvestors.
3.Facilitating debt recovery and the enforcement of collateral, as a complement to the insolvency and business restructuring proposal put forward in November 2016.
4.Assisting Member States that wish to facilitate the restructuring of banks, by providing non-binding guidance – a blueprint – for establishing Asset Management Companies (AMCs) or other measures dealing with NPLs.

More specifically, the NPL package of March 2018 included two legislative proposals:
•An amendment to the Capital Requirements Regulation introducing a common Pillar 1 requirement for minimum coverage levels for newly originated loans that become non-performing.
•A proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral.

NPL LEGISLATIVE INITIATIVES

1. The Introduction of a prudential backstop

This statutory prudential backstop aims to address the risk of banks not having sufficient funds to cover losses on future NPLs and prevent their accumulation. It is worth noting that the ECB published on 15 March 2018 the final version of the addendum to its NPL guidance which addresses the same problem (but with some relevant differences in the approach and temporal scope).

There is a concern that this proposal fails to recognise the heterogeneous nature of NPLs and the need therefore for a bespoke or pillar 2 approach to the issue.

Furthermore, if inappropriately calibrated there is a serious risk that the proposal leads to a more restrictive lending policy by credit institutions, with a negative impact on the supply and pricing of credit lent to the real economy and, especially to low rated counterparties, such as retail customers and SMEs. To put it in another way, •the new framework may lead banks to limit their lending to the best credit quality counterparties (i.e. counterparties with a huge collateral availability instead of cash flows that represent a majority of recoveries).

Several features of the proposal need careful scrutiny, most notably the interaction with Pillar 2 requirements set out by the ECB in their addendum, new accounting provisions coming into force under IFRS 9, additional reporting and disclosure mandated by the ECB and EBA and the determination of collateral. In addition, due consideration should be given to the date of application which at the moment is retroactive applying to all loans originated after 14 March 2018, whereas the ECB Pillar 2 was applying to new NPLs from 1 April 2018 and will only be effective under the Supervisory Review and Evaluation Process due to take place on 2021.

2. The proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral

The Commission's Directive seeks to increase the efficiency of debt recovery procedures by establishing the framework for a common accelerated extrajudicial collateral enforcement procedure as well as to encourage the development of secondary markets for NPLs.

Specifically, the Directive aims to (i) remove barriers that impede the provision of cross-border loan servicing activities (intra-EU); (ii) set a framework for licensing and supervision of credit servicers; (iii) set standards for the information that creditors shall provide to credit purchasers for the transfer of performing and non-performing loans; and (iv) establish a new common legal framework for an accelerated out-of-court collateral enforcement procedure (AECE).

The provisions setting registration and information standards for loan disposals seek to improve the quality and amount of information of loan transactions. However, they will also create timing consequences for performing and non-performing loan disposals, syndicated loan transactions, securitisations, and secondary trading of loans.

The proposed Directive should make clear the consistency between national insolvency procedures and any enforcement rights held under an AECE and specify how this will work in practice and what effect it would have on the effectiveness of any AECE mechanism. In addition, the AECE mechanism should be consistent with other legal frameworks, including, most importantly, the Commission's proposed Directive on EU insolvency, as well as existing insolvency regimes and any legal guarantees or other credit support that might already be in place.

CONSISTENCY WITH OTHER NPL INITIATIVES

There are relevant links between the legislative proposals (Directive and Regulation) and other NPL and risk reduction initiatives currently under discussion.

The Commission's Pillar 1 proposed Regulation and the ECB's guidance on NPLs (March 2018) which sets a Pillar 2 supervisory expectation, both seek to encourage banks to set aside capital against non-performing loans under a pre-established timeline. It is expected that banks will operationally have to run two processes to comply with a measure intended to have the same outcome.

The AECE mechanism and the Commission's proposed Directive on preventive restructuring and second chance (i.e. insolvency reform) seek to improve creditor rights and increase the efficiency of debt recovery procedures. It is important that the AECE mechanism is consistent with any related provisions of the proposed Insolvency Directive. In particular, stay provisions, creditor rights and enforcement mechanisms, among other areas, must work together in a way that decreases confusion or uncertainty. The provisions relating to AECE should also be consistent with any other potentially applicable areas of law (e.g., contract law, data protection, collateral, property law, etc.)

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