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MEETING DOCUMENT

From:	Presidency
To:	Financial Counsellors - ECOFIN preparation
Subject:	Non-performing Loans

Delegations will find attached the Presidency Issues Note for Session 1 on Non-performing Loans at the Informal meeting of EU Finance Ministers on 7-8 April 2017 in Valletta.

Non-performing Loans

Informal EU Finance Ministers' Meeting, 7-8 April 2017, Valletta

Presidency Issues Note

Background

1. The financial crisis and ensuing recessions, together with poor loan origination practices and other structural factors, have left the banking sector in some European countries with high levels of non-performing loans (NPLs)[1].

2. NPLs in the EU remain at historically high levels and are much higher in the EU than in other jurisdictions[2]: they amount to over EUR 1 trillion, which is over 7% of EU GDP and 5.4% of total bank loans.

3. The EU average hides a huge divergence across countries, in terms of magnitude (ratios vary between 1% and 47%, with ratios above 10% in 10 EU Member States), dynamics (while in a number of Member States NPL ratios have dropped in recent years, in others they are still rising or remain flat at significant levels), root causes, and sectors concerned (in some countries, NPLs are concentrated in certain sectors e.g. real estate, while in others they are scattered across the economy).

4. Although it is clear that high NPL ratios are concentrated in some Member States and result from general macroeconomic developments as well as from idiosyncratic causes, high NPL ratios can generate negative spill-over effects for other EU countries, e.g. related to holistic market perceptions of the European banking sector (especially within the Banking Union)[3]. On the other hand, NPL resolution could generate positive externalities, which would be beneficial for the EU as a whole, e.g. through further reducing financial fragmentation and thus facilitating capital flows across the EU.

5. Persistently high NPL levels pose a problem, as they:

- are a drag on bank profitability due to administrative costs of NPL management and higher funding costs for banks, while provisioning needs deplete banks' capital base.
- pose a risk for the viability of high-NPL banks;
- lock up of capital in banks to back unproductive assets. This has crippling effects on the bank lending channel for the transmission of the common monetary policy and on the financing of the economy.

6. Given its magnitude, the NPL problem will not solve itself, even in the context of economic recovery. Significant steps have already been taken in Member States to tackle the NPL issue, including in the context of financial assistance programmes. More is needed however to bring the NPL ratio down to sustainable levels.

Ongoing work

[1] In broad terms, NPLs are exposures that are 90 days past due or unlikely to be paid without collateral realization.
[2] At the end of 2015, the NPL ratio was 1.7% for the US and 1.6% for Japan, although figures are not fully comparable in the absence of a global definition.
[3] Other negative externalities may stem from contagion effects in the context of a possible financial distress, and from potential costs for the common banking crisis management mechanisms.

7. A subgroup of the Council's Financial Services Committee was established to deliver 'possible options supporting a significant and sustainable reduction of NPL levels, based on the current diverse situations assessed'.

8. While the work of the subgroup is still underway, it is clear that, given the interconnectedness of the issue, a multi-faceted approach combining a mix of policy actions, at national and possibly European level, is the most adequate way to address the NPL problem.

9. Actions should be undertaken in particular in all of the four following policy areas: (i) supervision, (ii) structural issues, including insolvency, (iii) secondary markets, and (iv) restructuring of the banking system, not only in order to help to address the current high levels of NPLs, but also to render the EU financial system resilient to the reappearance of the NPL phenomenon in the future.

10. With regard to supervision, efforts could concentrate on increasing supervisory oversight on banks to proactively manage NPLs and accelerate balance sheet repair for high NPL banks. The supervisory tools necessary for NPL management should be enhanced in order to entrust the supervisors with the necessary instruments to oversee the management of NPLs by banks and foster sound credit originating standards. Supervisory practices fostering the convergence in the treatment of the NPL problem should be promoted across all European supervisors (including non-SSM countries and for SSM countries, national supervisors for banks within their direct oversight) to ensure consistent supervisory outcomes and to avoid any kind of supervisory forbearance.

11. Uncertainty and inefficiencies in insolvency regimes and judicial overhang are among the reasons for the slow pace of NPL resolution in several countries. These reasons are also factored in the economic value of NPLs in secondary markets. A number of reforms have been undertaken at national level and, at the end of 2016, the Commission presented a legislative proposal for a Directive on preventive restructuring frameworks, second chance frameworks and measures to increase the efficiency of restructuring, insolvency and discharge procedures. In addition, the Commission is currently conducting a thorough benchmarking exercise of insolvency regimes. In this context, additional policy measures could focus on increasing the efficiency of insolvency and loan enforcement frameworks to raise the value that can be extracted from NPLs and reduce uncertainty for banks and investors, for instance through enhancing the protection of secured creditors. Tackling judicial overhang and court backlog in some jurisdictions in order to ensure that legislative improvements swiftly bear fruit would also be of key importance.

12. Well-developed secondary markets for NPLs and distressed assets could have multiple benefits for banks facing high stocks of NPLs and seeking to engage in active NPL portfolio strategies. However, despite some momentum in recent years, those markets remain underdeveloped compared to certain third countries, as they tend to be characterized by large valuation gaps between buyers and sellers (bid-ask spreads). Transactions are hampered by a number of impediments, including the lack of reliable information on asset quality and asymmetries of information, the intrinsic differences of discount rates between buyers and sellers, and the poor liquidity in the market due to a fragmented network of sellers offering small transaction amounts. Lastly, insufficient servicing and valuation outsourcing capacities tend to discourage potential capital providers from entering the market.

13. Efforts to boost secondary markets could focus on dealing with market failures, such as information gaps on loan exposures and collateral. This could be achieved by increasing

transparency and disclosure, strengthening data infrastructure and possibly encouraging the set-up of state-sponsored platforms for NPL transactions.

14. The question of the appropriateness of the current regulatory framework for non-bank actors such as servicers or investors acquiring NPLs to encourage the entry of new actors should also be raised. There may be room for harmonisation at EU level, also in the context of the Capital Markets Union.

15. Experience suggests that setting up asset management companies (AMCs) can help to address high NPL stocks regardless of their capital structure (public, private or mixed). AMCs are most likely to have a positive effect on NPL workout to the extent that pooling NPLs will reduce asymmetries of information between buyers and sellers and, more importantly, generate economies of scale and give access to the market for the smaller banks. AMCs can also help to jump start or support a secondary market for NPLs, by establishing a track record of transactions and market practices with respect to the sale of NPLs. However past experiences show that this has not always been the case, with AMCs in some countries serving primarily as a buffer to offload NPL from bank's balance sheet, with limited sale in the wider market occurring at least in the initial timeframe. It is therefore important that the set up of an AMC meets certain key success factors, such as appropriate governance arrangements and the use of pro-active strategies to maximise portfolio value.

16. If secondary markets and AMCs are expected to play a greater role in NPL workout, the investments in distressed assets should be substantially boosted. Consideration should therefore be given to possible ways to encourage external investment, in particular intra-EU cross-border private investment in NPLs.

17. Public investors may also be part of the solution, in accordance with the EU legislative framework related to impaired assets measures (state-aid rules and the Bank Recovery and Resolution Directive). In this context, it is crucial to clarify how asset relief measures and asset management companies should be designed so that they are in line with the EU legislative framework.

18. Progress in NPL resolution also seems to be closely related to <u>structural features of the banking system</u>, such as internal and external capabilities to deal with the NPL work-out, along with the availability and ability to raise capital in affected banks. In particular, some banks seem to lack internal capacities to manage their NPLs as well as the critical mass to access a secondary market should they wish to off load NPLs from their balance sheets. Despite progress made since the setting-up of the Banking Union, fragmentation in the financial markets also limits private risk-sharing across the EU. Potential ways of fostering restructuring in the banking sector in the context of NPL resolution should therefore be further reflected upon.

Questions for Ministers

1. How can high-NPL banks be encouraged to write off or restructure impaired loans in a timely way? Should the supervisory tools be enhanced in this respect?
2. What can be done to lift impediments to the development of secondary markets? Should asset management companies be seen as a central element of a strategy to develop secondary markets and to foster the restructuring of affected banks and banking sectors?
3. How can we foster structural reforms of the banking sector so that it would be better equipped to manage the timely resolution of NPLs?
4. Given that current high NPL levels are mostly a legacy of the crisis, what policy sequencing should be adopted to manage the transition out of this legacy situation and prevent its re-emergence?