4. European strategy on Non-Performing Loans

Currently, there is around €1 trillion of Non-Performing Loans (NPLs) in the EU. They constitute a problem because NPLs are expensive to maintain, imply a misallocation of capital, could exacerbate the bank-sovereign link, impair the monetary policy lending channel and could reduce new lending. Moreover, NPLs will become more costly after the entry into force of IFRS 9 and the new Bank of Spain regulation (*Anejo IX*) in Jan-2018.

There are several ongoing European initiatives in order to tackle NPLs. In particular, in the Capital Markets Union mid-term review NPLs were included as a new priority action. Additionaly, the Council Action Plan identifies future work streams, their deadlines and the European authority in charge of them. Currently, policy options are focused on three areas:

1. Enhanced supervision

The EBA has worked towards a common EU definition of NPLs and the ECB has published its “Guidance to banks on tackling non-performing loans”, which is applicable to all significant institutions under the Single Supervisory Mechanism (SSM).

The Council action plan invites the European Commission to interpret existing supervisory powers as regards banks’ provisioning policies (to ensure immediate action if necessary) and to consider introducing prudential backstops to new loans in the ongoing review of the CRR/CRD (possibly deductions from own funds). In that regard, the ECB has issued a consultation on an Addendum to its Guidance (applicable to significant banks under the SSM) that sets the minimum provisions coverage required, and enables bank to decide whether to cover the deficit via provisions or a deduction from own funds. More recently, the European Commission issued a similar consultation that enables banks to decide whether to covwer the deficit via a deduction on shareholders’ equity or reduce the collateral assets’ value.

Additionally, the ESRB has been mandated by the Council to develop macro-prudential approaches to prevent system-wide NPL problems by the end of 2018.

2. Reform of the insolvency frameworks

The Commission proposed in 2016 a directive on insolvency frameworks aiming at facilitating debt restructuring and that potential buyers of NPLs can have better information around insolvency outcomes (average recovery values, timing and cost of proceeding, etc..). The Council action plan invites the European Commission to publish the results of the benchmarking exercise on national loan enforcement, and Member States to consider carrying out peer-reviews on insolvency regimes in the EU.

On July 2017 the Commission launched a public consultation that considers the introduction of an ‘accelerated loan security’, which is a swift, out-of-court procedure so that the bank would have the right to acquire ownership of firms’ encumbered assets with a view to sell them.

3. Development of secondary markets for NPLs

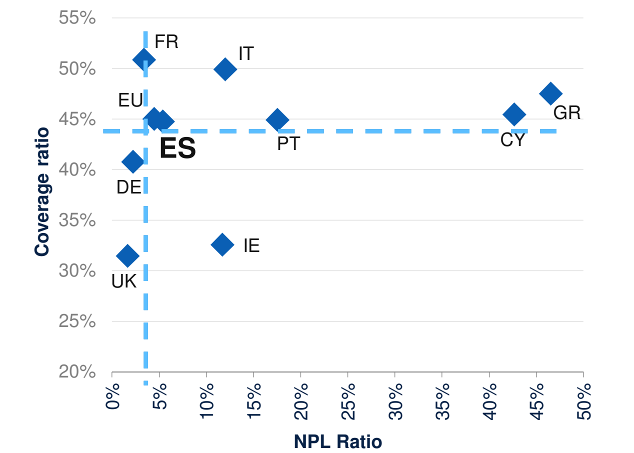
Direct sales of impaired assets to an outside investor can be a quick way to reduce the NPL stock. However, currently the bid-ask spread in the market is wide and there is a reduced number of transactions.

The Commission launched a consultation (closed on 20th October) which includes initiatives on this issue, aiming at fostering the transfer of loans, the functioning of third party servicers and on removing other constraints. On this regard, on January 2017 the EBA presented its proposal for an EU-wide asset management company (AMC or "bad bank"). Some of its disadvantages are the heterogeneity of national assets and procedures, the short term costs for banks and the mutualization of risks. More recently, the idea of a single European AMC seems to be discharged and the Council action plan invites the European Commission to develop a blueprint for national AMCs by the end of 2017.

Transparency could foster the development of the market. In the Council action plan EBA, ECB and European Commission are invited to propose initiatives on this, including the setting-up of NPL centralized data platforms, so that access to this information is easier, there is a single point of contact for potential investors and it is feasible to make packages of assets from different banks.

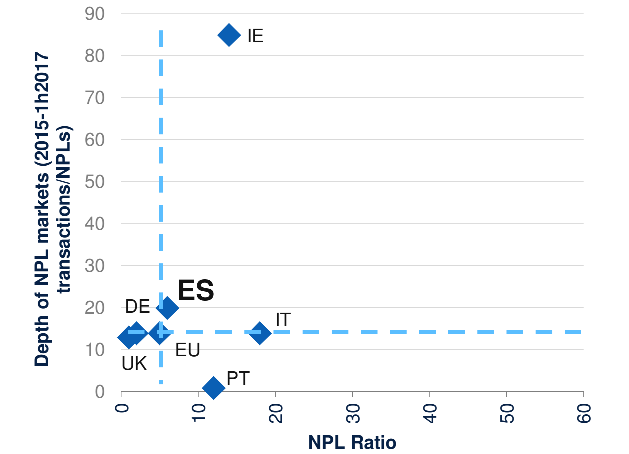
NPL securitisation and sale may additionally be an appropriate tool to remove more granular SME loans or unsecured loans (credit cards, consumer loans) from bank balance sheets. EBA has launched a Discussion Paper 'On the Significant Risk Transfer in Securitisation', which asks the industry on the best way to regulate NPL securitisations so as to foster the market. One of the main obstacles for a secondary market are the elevated transaction costs, which include taxes (like stamp duty) and registry costs. In any case, the introduction of a single European regulatory framework or the homogenization of rules among Member States (or even across regions in one country) will be crucial to eliminate regulatory uncertainty.

Figure 5 Non-Performing Loans ratio and coverage Jun-17 (%)



Source: EBA

Figure 6 Non-Performing Loans ratio and depth of NPL markets (%)



Source: KPMG and World Bank. Includes completed NPL portfolio transactions that are pooled with performing loans in the same loan deal.

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