Institutions

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The institutional framework for defining non-performing loans

The recent global crisis has left many banks across Europe with a high volume of non-performing loans (NPLs hereafter) in their balance sheets. NPLs in the European Union grew significantly between 2009 and the time of writing this note, and their levels remain particularly high in the southern part of the Eurozone, as well as in several eastern and southeaster European countries (Aiyar et al., 2015). Consequently, the problem of NPLs has been classified as a regulatory priority by the European Central Bank (ECB hereafter), the Joint Supervisory Teams, and the national competent authorities (ECB, 2017a,b). One of the problems has been the lack of uniformity and clarity of how to recisely define a NPL. This is important because it resulted in the general recognition that banks did not appropriately provisioned and recorded credit losses, i.e. they did it "too little, too late," which contributed to post-crisis instability.

The debate about **forbearance** as a strategy of credit risk management is still under debate. This concept is referred in different manners across jurisdictions and banks around the world. EBA (2013) defines "Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments (financial difficulties)". The definition of forbearance builds on existing accounting and regulatory frameworks (EU Directive 2006/48, Regulation EU 575/2013, the ITS on supervisory reporting, the European System of Accounts, the ECB Regulation

2008/32 which is no longer in force) and encompasses transactions which are generally based on concessions or modification of the terms and conditions of loans (EBA, 2013).[7]

As for **banks' accounting standards**, Basel II makes less attractive for the internal rating-based banks to use the discretion in provisioning implied by the International Financial Reporting Standards (IFRS hereafter) to smooth income-increasing loan loss provisions than those using the standardized approach (Hamadi 2016).[8] The International Accounting Standards Board (IASB) published the final version of the **IFRS 9 Financial Instruments** in July 2014. The final version of IFRS 9 will replace IAS 39 *Financial Instruments: recognition and Measurements*.[9] The accounting standards IFRS 9 are built under a forward-looking expected credit loss model, which will result in more timely recognition of loan losses, and is a single model which is applicable to all financial instruments subject to impaired accounting (ECB, 2017b). Expected credit losses are an estimate of credit losses over the life of the financial instrument. In this regard, an entity should consider: (i) that the expected credit loss should represent neither the best or worst case scenario, (ii) the time value of money, and (iii) reasonable and supportable information that is available without undue cost or effort. The new standards will come into effect between January 2018 and 2021 (Cohen and Edwards, 2017; IASB, 2014).

Discussing the foremost proposals for resolving NPLs

Addressing asset quality issues is one of the main priorities for the ECB banking supervision. The ECB's objectives were targeted after the 2014 comprehensive assessment comprising two main pillars: an asset quality

7. When talking about forbearance, it is essential to consider a twofold perspective. On the one hand, 'good forbearance' may enable borrowers during temporary difficulties to sustain the capacity to pay their debts, thus being a tool for risk management of problematic loans. On the other hand, 'bad forbearance' would be a strategy to bring NPLs or problem exposures down to avoid negative attention, thus reducing bank's incentives to minimise credit risk portfolio and to improve financial stability (BIS, 2016).

8. Whereas Basel I has been criticized of being backward looking in which a decreased in loan loss provisions results tend to increase income of NPLs, Basel II requires banks to compute forward-looking measures of expected losses on their loan portfolio and to deduct the difference between this expected measure and the actual loan loss provisions (Aiyar et al., 2015).

9. The existing model in IAS 39 is a 'incurred loss' model which delays the recognition of credit losses until there is evidence of a trigger event (Cohen and Edwards, 2017).

review, and a stress test. The ECB released in 2017 the **Guidance for addressing NPLs** within the meaning of Article 4 (1) of Regulation (EU) 575/2013 (CRR). The guidance is applicable to the whole significant institutions supervised directly by the Single Supervision Mechanism (SSM hereafter), including their international subsidiaries (EBA, 2016; ECB, 2017a)[10].

The High Level Group on Non-Performing Loans at ECB was mandated to develop a consistent supervisory approach to the treatment of NPLs. Through the work, a number of best practices have been incorporated into the Guidance as standard for NPL management going forward at the bank level. This proposal requires banks to set ambitious and credible **portfolio-by-portfolio targets**, after having assessed the context in which they operate (Donnery, 2017). These targets are embedded in a comprehensive **NPL strategy and operational plans** which should be approved and steered by banks' management body. These plans should review annually the strategy, define management objectives, define processes for NPL workout decisions, include borrowers' affordability assessment before granting any forbearance measures, and ensure enough internal controls over NPL management process (ECB, 2017a).

The establishment of a bad bank or **asset management company** (AMC hereafter) or special purposes vehicle has been proposed by several voices as a plausible overcome for the question of NPLs (Avgouleas and Goodhart, 2016; Lucchetta and Parigi, 2016; Enria, 2017 and the articles in this Issue of European Economy).[11] As discussed at length in this Issue, concentrating NPLs in a single AMC can create economies of scale because it could realize profits, whilst freeing banks' balance sheets at the same time avoiding fire-sales in illiquid markets thus limiting the need and costs of restructuring banks.

However, an obstacle that a European AMC should take on is the prohibition article 125 of the Treaty of Functioning of the European Union (TFEU) of receiving any public support. Accordingly, the EBA's Eurozone AMC proposal is envisaged to buy NPLs at an assessed price, i.e. the real economic

10. This Guidance does not endeavour to substitute or supersede any applicable regulatory or accounting requirement from existing EU regulations or directives and their national transpositions or equivalent, or guidelines issued by the European Banking Authority (EBA). The Guidance is a supervisory tool with the aim of clarifying the supervisory expectations regarding NPLs identification, management, measurement and write-offs in areas where existing regulations are silent or lack of specificity (ECB, 2017a).

11. Other AMCs have been set up at the national level in Ireland (NAMA in 2009), Germany (FMS in 2010), and Spain (Sareb in 2012) (see Bruno et al., 2017).

value, despite their market price which might probably be lower. Then, banks should only incur in losses equal to the amount by which the book value exceeds the real economic value. Otherwise, the amount by which the real economic value exceeds the market price would be a pre-financing of future recovery. The AMC would be to set a timeline of three years to exit and sell the NPLs at the real economic value. If the AMC is unable to do so, the selling bank would have to compensate the AMC for any shortfall, the so-called recourse mechanism. The proposal includes clawbacks to protect public investments in the event of losses, i.e. when sales price is lower than the transfer price to the AMC (Enria, 2017; Habben and Quagliariello, 2017).

The European Commission is working on a comprehensive approach to solving the issue of NPL in Europe. It identifies four policy areas, (i) supervision, (ii) structural issues, including insolvency, (iii) secondary markets, and (iv) restructuring of the banking system. The aim is to address the urgency of the current issue but also to make the EU financial system resilient to the NPL phenomenon in the future. It sets relevant policy objectives and develop options for policy-making on the four areas of intervention. Of particular relevance is the Policy Option C.6: "Consider in a pragmatic approach the setting-up of AMCs to segregate bad assets and facilitate restructuring, to the extent that the conditions of success are met and AMCs bring added value to the working-out of loans. Invite the Commission to develop a blueprint for the permissible design of national AMCs." The development of a blueprint for national AMCs will have to address a number of key issues: how to determine the appropriate asset classes to be acquired by the AMC, which banks should offload NPLs to the AMC, the asset-size threshold, the asset valuation rules to comply with BRRD and State Aid rules), the capital structure of the AMC avoiding to increase the government debt, the governance and operations of the AMC to maximise the recovery value of transferred assets.

Another common proposal is the creation of **securitisation schemes** which are able to involve private investors with a certain level of risk instead of requiring public funds. Furthermore, securitisation schemes can reduce the gap between book value and market value (Bruno et al., 2016).[12] This bid-ask

12. The bad bank and securitisation schemes are thought to remove NPLs from banks' balance sheets. Both proposals are equivalent in the sense that both require the creation of a vehicle: an AMC or a special

spread is mainly explained by information asymmetry that can be reduced through public initiatives such as enhancing transparency regarding the state of NPLs in general and associated factors, e.g. real estate collateral valuation, which will ultimately facilitate the sales process leading to lower discounts in the secondary markets (Garrido et al, 2016). Supervisors would have to monitor securitisation efforts of banks closely to detect adverse developments.

Market for NPLs needs a certain critical mass, so an EU-wide framework is required (EBA, 2016). In this regard, Enria (2016) proposes (i) promoting a single EU platform, or a network of national framework, to favour the interaction between banks and investors in a market for NPLs based on consistent data, and (ii) overcoming the plethora of national restrictions on purchasers in order to reduce the costs for new entrants to local markets.

The ECOFIN is exploring initiatives to develop a secondary market for NPLs under the guidance of EBA in developing NPL data standardisation, which may remove any possible obstacle for private secondary buyers and loan servicing companies (European Commission, 2017).

Asset relief can be also obtained with guarantees (asset protection schemes) which are also subject to State aid rules. Since 1 January 2016, the bail-in procedure of the BRRD applies and then public bad banks and asset protection schemes are subject the conditions of restructuring the aided bank, transferring or guaranteeing at a price reflecting the real economic value of assets, and some burden sharing of subordinated creditors.

Reforming tax rules can also enhance incentives for adequate provisioning and loan write-offs (ECB, 2017a). The credit hierarchy applied to secured and unsecured private creditors and public authorities should ensure that the whole creditors are equally incentivized to support debt restructuring, and enforcement liquidation options. Thus, tax laws should be amended in areas where creditors may be discouraged to from provisioning or writing-off loans or from participating in collateral markets. Similarly, tax rules inhibiting debtors from accepting restructuring or write-off deals should be also amended (Aiyar et al., 2015).

The Subgroup on NPLs of Council of the European Union's Financial

purpose vehicle. The main difference is that the AMC creates a market for NPLs, whilst the securitisation scheme creates also a market for structured securities guarantees (Bruno et al., 2016).

Services Committee was established in July 2016 to assess the state of NPL in Europe and propose possible solutions. The Subgroup is composed of representatives of Member States, the European Commission, the ECB, the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Investment Bank (EIB) and the Single Resolution Board (SRB). The Subgroup has produced a draft in March 2017[13] with policy recommendations.

Reducing the weight of NPL on banks' balance sheets is essential for restoring the health of the European banking sector. Since impediments to reduce NPLs are often interlinked, a comprehensive strategy is suggested by several authors and international organizations to address the NPL issue. This strategy is based on four fundamental pillars: (i) enhancing supervision, (ii) harmonizing insolvency rules across jurisdictions, (iii) developing distressed markets throughout a Eurozone AMC and securitisation schemes, and (iv) reforming tax rules.

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