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Europe reaches for a new normal on NPLs

Will recent regulatory developments have their desired impact on the NPL market across Europe?

Europe reaches for a new normal on NPLs

European Central Bank and European Commission measures reflect a real determination to tackle non-performing loans (NPLs). But will recent regulatory developments have their desired impact on the NPL market across Europe? **Debashis Dey**, **Dennis Heuer**, **Stuart Willey** and **Laura Kitchen** of global law firm White & Case LLP discuss.

NPLs are a hot topic, high on the European supervisory authorities' agenda. Legislative and prudential requirements to reduce NPLs are rapidly evolving. In March of 2018, the EC published a package of reforms aimed at reducing European banks' NPL stocks and preventing their future build-up.

The ECB's and EC's measures at tackling NPLs reflect a real determination to improve the position. So what can we expect to see from the NPL market in 2019 and beyond?

In Q1 2018, the NPL ratio across European banks stood at 4.81 per cent; a not-insignificant reduction of 1.09 per cent since Q1 2017 when the ratio was 5.90 per cent. What occurred between Q1 2017 and Q1 2018 that resulted in that reduction?

Getting proactive in NPL management

The emerging consensus among NPL market participants is that the gradual shift away from banks' 'wait and see' approach, towards proactive NPL management is a direct result of recent regulatory and supervisory pressures to move distressed debt off of balance sheets. Ten years on from the global recession, supervisory authorities and policymakers are sending a clear message: Banks should focus on resolving legacy issues and bolstering their core businesses.

The ECB's Guidance on NPL Management as supplemented by the ECB Addendum in March 2018, urged significant institutions to make full provisions for NPL losses, making it more expensive for banks to hold onto bad loans. This created a real financial incentive for the largest banks to offload their NPLs.

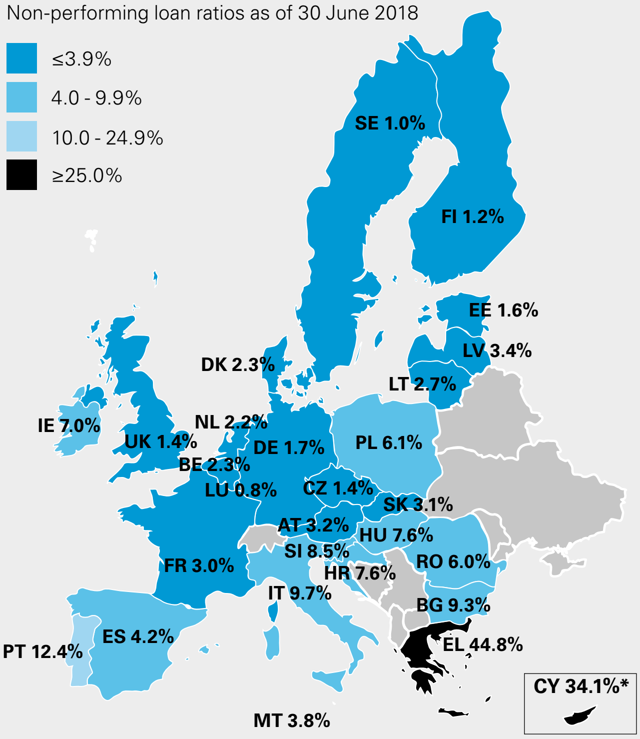
4.81%

NPL ratio across European banks in Q1 2018

> **The gradual shift away from banks' 'wait and see' approach towards proactive NPL provisioning is a direct result of recent regulatory and supervisory pressures**

Non-performing loans in the euro area: Where do we stand?

Non-performing loan ratios as of 30 June 2018



Greece	43.4%
Cyprus	34.1%*
Portugal	12.0%
Italy	9.4%
Bulgaria	8.7%
Slovenia	7.9%
Hungary	6.9%
Ireland	6.8%
Croatia	6.7%
Romania	6.0%
Poland	5.3%
Spain	4.1%
Malta	3.5%
Latvia	3.2%
Austria	3.1%
Slovakia	3.0%
France	2.9%
Lithuania	2.5%
Denmark	2.3%
Belgium	2.1%
Netherlands	2.0%
Germany	1.6%
Estonia	1.5%
UK	1.4%
Czech Rep	1.4%
Finland	1.2%
Sweden	0.9%
Luxembourg	0.8%

*Data not available for Q3.

Source: EBA Risk Dashboard

Previously, there was little desire to crystallise capital holes in balance sheets and self-induce further capital pressure.

Although the ECB's Guidance is non-binding, failure to comply may also trigger Pillar 2 measures (e.g., additional capital requirements or close supervision) which puts significant institutions under considerable pressure to adhere to the practices.

The European Council's Action Plan in July 2017 introduced several new initiatives for implementation within a very short time period. The EC has responsibility for implementing the Action Plan and, in March 2018, proposed a comprehensive approach focusing on four complementary policy actions at the national and (where necessary) EU level: (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, bank restructuring.

The EC's proposals entail additional implementing measures to further its aims: (i) a regulation amending the Capital Requirements Regulation to ensure sufficient loss coverage by banks for future NPLs; (ii) a new directive on credit servicers, credit purchasers and recovery of collateral; and (iii) a blueprint on asset management companies.

The proposed amendment to the CRR introduces a new 'statutory prudential backstop' to prevent the risk of the under-provisioning of future NPLs. If a bank failed to meet the applicable vintage-based minimum coverage standard, deductions from own funds would apply. This should ensure that the financing available to households and businesses is less pro-cyclical by ensuring that institutions have sufficient loss coverage. After a provisional agreement on the text had been found in December 2018, the final compromise text was published by the European Council on 3 January 2019. The compromise text envisages that only such exposures, which are originated (or amended) after the new regulation has entered into force, shall be affected. As the plenary vote for the amendment regulation is scheduled for 14 March 2019 we expect that the new regulation will enter into force in April 2019.

The proposal for a new directive on credit servicers, credit purchasers and the recovery of collateral may have far-reaching consequences for data sharing in the primary and secondary loan markets. It encourages enhanced disclosure of 'all necessary information' to enable a new lender to value the credit agreement and assess its recoverability, which should address current information asymmetry in secondary NPL markets (albeit only if the practical implications of increased disclosure, e.g., data protection and market abuse issues, are successfully worked through).

The directive further proposes the establishment of an out-of-court enforcement procedure in each Member State, designed to facilitate banks' dealings with NPLs. Importantly, it acknowledges that NPL transferees should not become subject to banking licencing requirements by virtue of their NPL activities by urging Member States to remove any national law restrictions on the transfer of NPLs to non-banks.

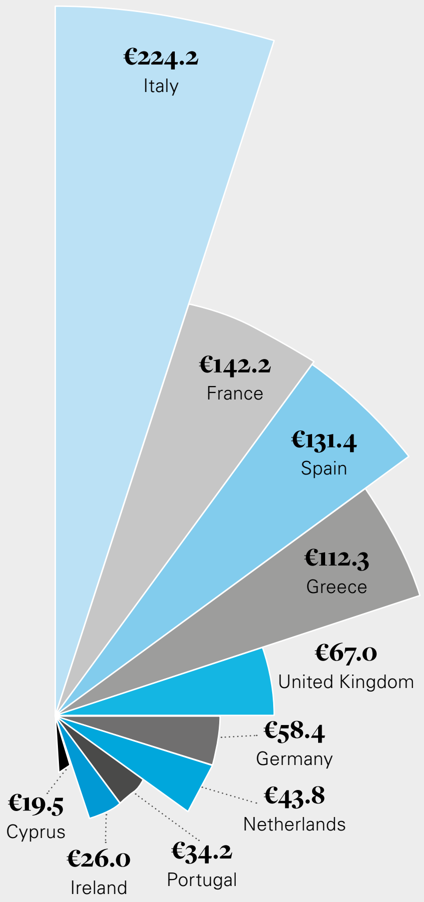
IFRS 9

The introduction of IFRS 9 in January 2018 complemented the March 2017 ECB Guidelines by indirectly creating additional financial incentives for banks to transition NPLs off of balance sheets as early as possible. IFRS 9 requires banks to make provisions on their balance sheets for future anticipated losses.

Previously, bank and investor perspectives have been misaligned: Banks preferred to sell NPLs at a late stage to minimise losses, whereas investors preferred to buy NPLs at an early stage to maximise value. Consequently, the ECB estimated that the gap between bid and ask prices for a fully collateralised NPL stands at more than 40 per cent. However, IFRS 9 helps to bridge that gap by bringing banks' and investors'

The big leagues

Italian banks are sitting on Europe's largest pile of non-performing loans (€ billions)



Source: European Central Bank, FINREP banks

40%

Estimated gap between bid and ask prices for a fully collateralised NPL

Source: ECB

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Lack of quality, reliable, standardised NPL data remains one of the largest hurdles in NPL resolution

approaches more in sync by forcing banks to recognise losses at an earlier stage and thus making NPL portfolio sales more attractive, which meets NPL buyers' interests.

Criticisms of IFRS 9 have focussed on the principle-based approach and the increased subjectivity. Different valuations of collateral and different treatment of trigger events amongst banks, auditors and regulators allow greater potential for variation and lack of comparability, increasing the need for standardisation in data templates.

Blueprint charts a new course on NPLs

The Action Plan invited the EC to develop a 'blueprint' for national asset management companies to deal with NPLs. The AMC Blueprint, published in March of 2018, sets out non-binding guidance on how national AMCs can be established to work out NPLs without infringing EU state aid rules. It urges the alignment of an AMC with relevant structural reforms and to have a predefined lifespan.

Countries with higher rates of NPLs, such as Greece, Cyprus and Portugal, are likely to feel the benefit of AMCs most strongly.

Need for standardisation

The European Banking Authority's (EBA's) revised data template issued in September of 2018 addresses a major issue in NPL sale transactions across Europe: a lack of market-standard, comparable data. Currently, NPL data is held across a wide range of jurisdictions and banks and is not easily comparable.

Although a framework for consolidated banking data has been in place since the end of 2014, there are still large gaps in the reporting of financial information and the extent to which banks are subject to national reporting requirements.

The EBA's standardised set of data templates provides a common data set for the screening, financial due diligence and valuation during NPL transactions across Europe. In time, this should translate into a highly useful tool for NPL buyers and sellers.

If it ain't broke, don't fix it

As AFME suggested in its June 2018 Position Paper, policy makers should not attempt to fix what is not broken and should instead focus their measures on the areas and market actors in most need of action.

A lack of quality, reliable, standardised NPL data remains one of the largest hurdles in NPL resolution. Policy makers and market participants will push for increased information sharing and minimum data standards in the near future.

JAN 2018

January 2018

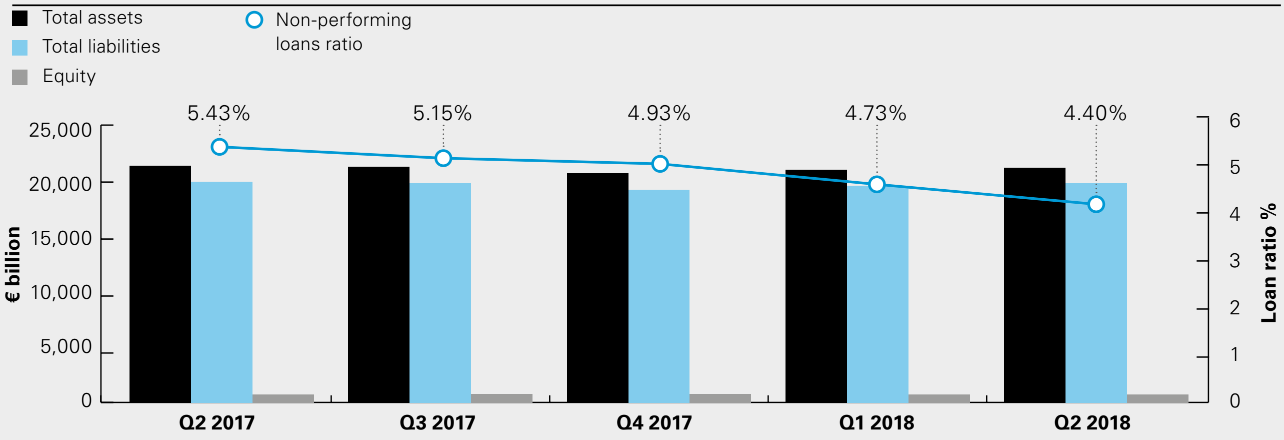
IFRS 9 introduced

Fintech solutions may take centre stage in facilitating NPL data management and collaboration. Digital tools and online platforms could assist NPL decision-making capabilities by coordinating restructuring actions across different banks and assisting information sharing by consolidating data and embedding the ECB's NPL data templates.

To have a lasting impact on Europe's NPL market, supervisory authorities must continue to adopt a holistic approach to addressing deficiencies in the restructuring framework, data quality and market access to a broad range of investors, as well as ensuring that such efforts are applied proportionally and consistently to create a level playing field.

> **"Supervisory authorities must continue to adopt a holistic approach in addressing deficiencies**

Balance sheet composition (€ billions; percentages)



Source: ECB. Cut-off date: 30 September 2018

NPL servicing platform for the Greek SME sector

Take, for example, the move in August of 2018 by four systemic banks in Greece—Alpha Bank, Eurobank, National Bank of Greece and Piraeus Bank—to establish a servicing platform for the common management of NPLs granted by the banks to small- and medium-sized enterprises (SMEs). The banks' aim was threefold: reduce exposure to common customer NPLs; provide access to potentially new sources of funding for SMEs; and support the recovery of the Greek economy.

The four banks and doBank, as servicer, established the servicing platform using a servicing agreement that governs the relationship between the four banks and doBank, and facilitates a rapid start of operations for the platform. On-boarding of the common SME NPLs has already started. Once complete, doBank will manage recoveries of the NPLs of more than 300 Greek SMEs with a total gross book value of approximately €1.8 billion. The platform will facilitate sourcing and implementing viable restructuring solutions for the SMEs, accelerate the decision-making process and provide access to new sources of financing for sustainable SMEs.

US$1.8bn

Total nominal value of the NPLs of more than 300 Greek SMEs under doBank's management

Context	Maximise value and reduce NPEs	Facilitate SME sustainability	Enable asset deconsolidation
▫ Greek-specific initiative, led by the four systemic Greek banks ▫ Setup of a platform operated by an external servicer which will manage a selected pool of common SME NPE exposures	▫ Make uncooperative borrowers cooperate through credible and coordinated legal pressure ▫ Speed up decision making ▫ Reduce costs from duplicated activities	▫ Develop additional capabilities across the entire NPE management value chain ▫ Provide potential access to new funding to SMEs under debt restructuring	▫ The servicing agreement allows for the development of a recovery track record which will enhance future asset deconsolidation

The approach taken

The systemic Greek banks

- ~€1.8 billion of common SME NPE debt allocated to doBank
- Defined recovery and liquidation framework to maximise recoveries

Servicing agreement to regulate the relationship between the banks and doBank

Servicer doBank

- Defines and executes debtor-level recovery plans according to framework
- Has clear incentives to increase recoveries, linked to fee model

Delegated authorities defined in the servicing agreement to allow doBank to manage the SMEs

SME clients

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