Is a pan-European asset management company a panacea to Europe’s growing NPL problem?

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On 30 January 2017, the Chairman of the European Banking Authority ("EBA") Andrea Enria outlined his proposal for tackling the large number of non-performing loans ("NPLs") that have increasingly troubled European banks and authorities. In his speech regarding general risks and recovery in the EU banking sector, Enria suggested that banks could sell their NPLs to a centralised, European asset management company ("AMC") in order to alleviate the burden that such NPLs present to banks’ balance sheets.

However, whilst a pan-European approach to NPLs is an encouraging (and no doubt highly anticipated) development, how would such solution work in practice, and what is the likelihood of a future notable—and long-lasting—reduction in European NPL levels?

As noted in our September 2016 alert "Breaking Bad: Tackling European NPLs", banks across Europe have repeatedly struggled to offload a significant portion of their NPLs due, in part, to deficiencies in legal frameworks and underdeveloped distressed debt markets. Ten countries across the European Union reported NPL ratios above 10% during the second quarter of 2016. Consequently, the EBA has identified NPLs as an “urgent and actionable” priority.

Functioning of the AMC

The proposed AMC could help resolve the approximately €1 trillion of NPLs that are currently still sitting on European banks’ balance sheets. In his speech at the European Stability Mechanism ("ESM") Seminar Enria explained that the AMC is envisaged to buy (non-performing) loans at an assessed price (the "real economic value") rather than at their (presumably much lower) market price. As a consequence, banks would only have to incur losses equal to the amount by which the book value exceeds the real economic value. In contrast, the amount by which the real economic value exceeds the market price would constitute a pre-financing of future recovery amounts by the AMC.

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1 Source: EBA Supervisory Reporting Data (Q2 2016).
2 Source: 30 January 2017 speech, slide 5.
With regard to the public sector support needed for the scheme, Enria did not give any details. It remains to be seen where it would be based and who would operate it as well as who the shareholders will be. According to the current plan, the AMC sets 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 must compensate the AMC for any shortfall (“recourse mechanism”). Consequently, it could be argued that there would be no risk of losing any EU money through the creation of the AMC; a feature that ESM’s managing director Klaus Regling described as essential for political feasibility.

State aid?

Prior approaches to solving the NPL issue attempted to overcome the high levels of NPLs on a purely national level — for instance, the establishment of Atlante, a €4.25 billion back-stop fund sponsored by Cassa Depositi e Prestiti, banks, insurers and other institutional investors such as the Italian banking foundations (see our July 2016 alert “Italian banks: Thoughts on recapitalisation and sharing the burden”). However, as no sufficient private sector funds are available to enable affected banks to exit from NPLs at current market prices, these national solutions also have to rely on additional support from the public sector.

Public sector support, in return, needs to comply with the European state aid and resolution rules, which is challenging to say the least. In that context, Enria pointed out, that “while the EU has recognised the bad debt crisis facing its banks faster than Japan did after its ’lost decade’ in the 1990s, it is now at risk of addressing the problem even more slowly than Tokyo did”3 — another indicator of the need for an efficient pan-European solution.

The new proposal envisages that stress tests would identify the difference between the current market value of the respective NPLs and the real economic value (at which the AMC would buy the NPLs). It is currently not fully clear but it seems that the purpose of such stress tests would be to estimate a possible eventual state aid bill for each Member State. Once the assessment of the real economic value is completed, the AMC would have to be established. Whilst Enria stated that the AMC would be created by using government support, he also anticipated that the necessary funds would be raised by “crowdfunding” from private investors. It is therefore not yet clear to what extent governments across Europe would be expected to contribute financially.

However, based on the assumption that the AMC would be established as an independent body or agency, it might not fall foul of European state aid rules as the resources (notwithstanding potential Member State funding) would not be imputable to any particular Member State. Further, the theoretical extent of potential state aid might qualify as permissible precautionary recapitalisation.

Nonetheless, it is likely that the European Commission would insist that the AMC adheres to the same principles set out in EU regulation and state aid law as they apply to Member States.

Real economic value?

Beside the practical constraints to correctly determine the “real economic value”, the suggested recourse mechanism raises some questions.

The proposal provides for a recourse mechanism which entails an obligation of the bank to compensate for any shortfall that occurs if the real economic value cannot be realised after three years. Even though the proposal does not contain an obligation of the bank to take back the NPL at the end of the AMC’s set time period, the suggested recourse mechanism calls into question the extent to which Enria’s proposal would trigger off-balance sheet treatment of the bank’s NPLs. As the bank is (from an accounting perspective) only able to de-recognise the asset if an actual transfer of the economic risk of the asset took place, any recourse to such bank has to be capped at the original market value. Otherwise, the bank would remain exposed to the risk that the market value falls below the original market value.

In addition, it needs to be reviewed in more detail if and to what extent the potential recourse of the AMC may result in a contingent liability for a bank that has sold assets to an AMC that cannot be sold for at least the real economic value. Regulators may require banks to hold sufficient capital to provision the contingent liability under Pillar 2. Such a contingent liability could also be subject to bail-in under resolution rules if the bank were to be resolved during the set time period.

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3 Source: FT 30 January 2017: “EU needs to create ’bad bank’ for €1tn toxic loan pile, says EBA chief”
Outlook

The advantages of a pan-European AMC are undeniable and its establishment would “send a strong signal to investors that Europe is serious about tackling bad loans” according to Eleni Panagiotarea, a research fellow at the Hellenic Foundation for European and Foreign Policy. However, creating such a cross-regional entity to deal with a broad mix of asset classes might prove harder than it seems at first glance.

After certain Member States criticised the EBA’s proposal on the grounds that bad loans are concentrated in just a few countries, the European Central Bank’s vice president, Vitor Constancio, relativized the far-reaching proposal in a speech on 3 February 2017 by calling only for a European Union “blueprint” to create AMCs compliant with EU rules against bailouts.

Considering other entities dealing with bad assets in the past (such as NAMA in Ireland or SAREB in Spain) were focused solely on single jurisdictions, the proposed AMC would face unprecedented challenges. Decisions with regard to the type of assets to be transferred, the valuation framework and the portfolio strategy would have to be made. Another difficulty would be the variety of banking law and insolvency throughout European countries.

Nonetheless, Enria’s novel and far-reaching proposal underlines the frustration of European authorities and arguably marks a step in the right direction towards pan-European collaboration in resolving the escalating problem of NPLs. Bold action of this kind is needed and should merit further work.

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4 Source: Sophia Furber: “Pan-EU „bad bank” proposal fraught with challenges

5 Source: ekathimerini.com “ECB calls for national bad banks”