Cracking the EU's NPL reforms

A package of reforms aimed at tackling non-performing loans will have far-reaching consequences for European banks.

In March 2018, the European Commission published a package of measures aimed at reducing the current stock of non-performing loans held by European banks and mitigating their build-up in the future. Separate guidelines on minimum regulatory provisioning levels for NPLs were published by the European Central Bank (ECB) through the addendum to its 2017 NPLs Guidance.

The new measures will have a significant impact on the NPL strategy of European banks, especially in countries with high NPL levels, but at the same time they will also affect the way in which lending is conducted and loans are collateralized and enforced in Europe.

NPL ratios may be falling across the EU, but the legacy stock of troubled assets and distressed loans of European banks is still one of the major impediments to a full economic recovery and increase of credit supply in some EU Member States. The total volume of NPLs in the EU is in the region of €910 billion, according to the European Commission.

Ratios diverge significantly across EU Member States. At the end of the third quarter of 2017, NPL ratios were close to 2 to 3 percent of total loans in a number of EU Member States (e.g. Belgium, Estonia, Germany and the Netherlands) or even lower in others (e.g. Luxembourg, Finland and Sweden). But in some of the countries that were most adversely affected by the financial crisis, NPL ratios are much higher—from between 10 percent and 15 percent in Ireland, Italy and Portugal, to a peak of 32.1 percent in Cyprus and 46.7 percent in Greece.

Over the past few years, the EU institutions have taken a number of initiatives to tackle NPLs. In July 2017, the European Council published an action plan to help reduce NPL levels and prevent their future build-up. In October, the commission issued a communication on the completion of the Banking Union and promised a package of measures designed to tackle NPLs in the spring. On March 14, 2018, the European Commission duly presented its package of measures, which comprised:

- A proposed regulation amending the Capital Requirements Regulation (CRR) regarding minimum loss coverage for non-performing exposures (NPEs)
- A proposed directive on credit servicers, credit purchasers and the recovery of collateral, which shall be transposed by Member States by December 31, 2020
- A blueprint on asset management companies (AMC)

Meanwhile, on March 15, 2018, the European Central Bank published the final version of its Addendum to the ECB Guidance to banks on NPLs.

Total volume of NPLs in the EU

Proposed regulation on NPL provisioning

Under the current regulatory and accounting framework, credit institutions enjoy a degree of discretion in determining NPE coverage levels. Such discretion has led to under-provisioning and loss forbearance in certain cases, as some credit institutions have adopted a "wait and see" approach in order to avoid or delay loss recognition—thereby reducing or postponing any negative impact on their common equity tier 1 (CET1) ratios.

The proposed regulation amendment will impose a "Pillar 1" minimum regulatory backstop for the provisioning of NPEs by EU banks. The minimum regulatory provisioning level shall be calculated by multiplying the value of each NPE by the factors indicated in the proposed regulation (see table 1).

The required provisioning level will depend on whether the NPE is past

Table 1: **EC minimum regulatory provisioning level (in %)**

	After year	1	2	3	4	5	6	7	8
Secured	Past due	5	10	17.5	27.5	40	55	75	100
	Non-past due	4	8	14	22	32	44	60	80
Unsecured	Past due	35	100	100	100	100	100	100	100
	Non-past due	28	80	80	80	80	80	80	80

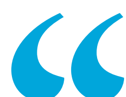
Table 2: **ECB quantitative supervisory expectations (in %)**

After year	1	2	3	4	5	6	7
Secured	N/A	N/A	40	55	70	85	100
Unsecured	N/A	100	100	100	100	100	100

due or has been classified as NPE despite the fact that the institution still receives full payment from the debtor without excessive (i.e. 90-day) delay. It will also depend on the number of years after the date on which the exposure was classified as NPE, and whether the NPE (or part of the NPE) is classified as "secured" or "unsecured" exposure in accordance with the criteria specified in the proposed regulation.

Credit institutions will be allowed to meet the minimum regulatory requirement through provisions recognized under the applicable accounting framework and other eligible items indicated in the proposed regulation (including own funds reductions deriving from higher deductions applied by credit institutions). If such items are not sufficient to satisfy the minimum regulatory provisioning level required under the proposed regulation, the shortfall shall be deducted from the CET1 of the credit institution.

The above regime will only apply to exposures originated after March 14, 2018. However, where the terms and conditions of an exposure incurred prior to March 14, 2018 are modified by the institution in a way that increases its exposure to the debtor, the exposure shall be considered as having been incurred on the date of the modification and will fall under the new regime.



The proposed directive aims to remove the current impediments to the cross-border performance of credit servicing activities

ECB Addendum

The ECB Addendum indicates the non-binding supervisory expectations of the ECB in respect of the supervisory provisioning levels applied by "significant credit institutions" that are subject to the direct supervision of the ECB under the Single Supervisory Mechanism (SSM). These supervisory expectations will apply to all exposures classified as new NPEs after April 1, 2018. However, the compliance with such supervisory expectations will be assessed by the ECB only from 2021 onwards.

The approach taken by the ECB is very similar to that envisaged under the proposed regulation, but the minimum coverage levels required by the ECB (see table 2) are more stringent than those provided under the proposed regulation.

Compliance with the supervisory expectations indicated above will be assessed on a case-by-case basis by the ECB in the context of the supervisory review and evaluation process (SREP)—starting from 2021. If the ECB considers that the prudential provisions do not adequately cover the expected credit risk, supervisory measures under the Pillar 2 framework might be adopted.

Credit Servicers, credit purchasers and recovery of secured loans

Rules on Credit Servicers. The proposed directive looks to introduce a common framework for credit servicing activities, with a view to removing the current impediments to the cross-border performance of such services. Under the proposed directive, a credit servicer is defined as any natural or legal person (other than a credit institution or a subsidiary thereof) who carries out one or more of the following activities on behalf of a creditor:

- Monitoring the performance of the credit agreement;
- Collecting and managing information about the status of the credit agreement, of the borrower and of any collateral used to secure the credit agreement
- Informing the borrower of any changes in interest rates, charges or payments due under the credit agreement

Table 3: **Summary of the main differences between the EC proposed regulation and ECB addendum**

	EC Proposed regulation	ECB addendum
Nature	Binding EU regulation.	Non-binding supervisory expectations.
Scope of application	All credit institutions established in EU Member States.	Significant institutions subject to direct ECB supervision within the SSM.
Affected NPEs	Exposures originated after March 14, 2018.	NPEs classified as such after April 1, 2018.
Entry into force	The proposal shall follow the EU ordinary legislative procedure and its ultimate content and the date of entry into force are still uncertain.	The ECB Addendum does not require any further implementation. However, banks will be asked to inform the ECB on any differences between their practices and supervisory expectations from early 2021 onwards within the context of the SREP.
Approach	Pillar 1 minimum requirement.	Pillar 2 approach—i.e. supervisory dialogue and analysis of bank-specific circumstances to be incorporated into SREP decisions.
Non-past-due exposures	Different coverage levels between past due exposures and other NPEs.	No distinction between past due exposures and other NPEs.
Coverage levels	Less stringent calendar over an 8-year period.	More stringent calendar over a 7-year period.
Treatment of shortfall	Automatic deduction from CET1.	Pillar 2 measures adopted on a case-by-case basis.

- Enforcing the rights and obligations under the credit agreement on behalf of the creditor, including administering repayments
- Renegotiating the terms and conditions of the credit agreement with borrowers, where they are not a "credit intermediary"
- Handling borrowers' complaints

The definition is broad in scope and will likely capture a number of services and activities that are currently not subject to specific regulation in some EU Member States. Under the proposed directive, credit servicers operating on behalf of a credit institution or a credit purchaser in respect of a credit agreement issued by an EU credit institution (or its EU subsidiaries) shall be authorized to operate as such by the competent authorities of their home Member States.

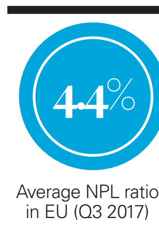
The license granted under the proposed directive will allow credit servicers to operate on a cross-border basis under the right of establishment or freedom to provide services in accordance with the customary principle of EU financial law.

The proposed directive also specifies certain requirements applying to credit servicers, including with respect to the content of the credit servicing agreement, the record-keeping obligations and the outsourcing of services to third parties.

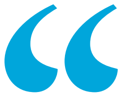
Rules on Credit Purchasers. The proposed directive encourages the development of a secondary market for NPLs by introducing common rules for credit purchasers—which includes any natural or legal person purchasing a credit agreement in the course of its trade, business or profession. These new rules will apply to cases where the credit agreement was issued by an EU credit institution (or by its EU subsidiaries) and the credit purchaser assumes the creditor's obligations under the credit agreement. The provisions of the proposed directive will not apply to the purchase of a credit agreement by an EU credit institution (or its EU subsidiaries).

Each creditor must provide the credit purchaser with all information necessary to assess the value of the credit agreement and the likelihood of recovery prior to entering into a contract for the transfer of the credit agreement. Certain information duties towards competent authorities are then provided in relation to credit purchasers.

Credit purchasers that are not domiciled or established in the EU shall designate in writing



Average NPL ratio in EU (Q3 2017)



One of the key goals of the proposed directive is to facilitate the recovery of secured loans through accelerated extrajudicial enforcement procedures

a representative who is domiciled or established in the EU to ensure compliance with the new rules. The designated representative will then appoint a credit institution (or a subsidiary) established in the EU, or an authorized credit servicer to perform credit servicing activities in respect of credit agreements concluded with consumers.

Rules on Out-of-Court Recovery of Secured Loans. One of the key goals of the proposed directive is to facilitate the recovery of secured loans (thereby reducing the risk of NPLs stock-piling) through the introduction of accelerated extrajudicial enforcement procedures. Such enforcement mechanisms may be used by creditors in connection with secured credit agreements entered into with borrowers that do not qualify as consumers (or non-profit-making companies).

The possibility to use the accelerated out-of-court enforcement procedures is subject to a number of conditions, including that the mechanism must be agreed in writing. The enforcement of the collateral can be made through a public auction or private sale. After the enforcement of the collateral, the creditor must pay the business borrower any positive difference between the proceeds of the sale of the asset and the sum outstanding under the secured credit agreement.

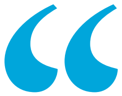
The business borrower may challenge the use of the these mechanisms before national courts where the sale of the assets provided as collateral has not been conducted in accordance with the rules set forth in the proposed directive.

The ACM blueprint

In essence, the AMC blueprint is a summary of the guidelines given and practice followed by EU institutions when dealing with State Aid cases in the banking sector during the last decade, particularly with respect to the use of publicly sponsored AMCs

Table 4: **Possible scenarios**

Purchase at market value	No State Aid or extraordinary public financial support pursuant to the bank recovery and resolution directive (BRRD) is granted, and the transfer of NPLs to the AMC is consequently not subject to EU State Aid and bank resolution framework.
Resolution	If the bank holding the impaired assets is under a resolution entailing State Aid or support through the resolution fund in accordance with the BRRD/SRMR rules, the AMC operates as the "bad bank" (asset management vehicle) in the context of the resolution. The use of the AMC—including as regards the valuation and transfer of impaired assets—is governed by the applicable resolution framework and the tool is ultimately managed by the resolution authority.
National insolvency proceedings	If the bank is not resolved but rather liquidated, NPLs can be transferred to AMCs as a form of State Aid in the context of national insolvency proceedings, provided that the principles of the State Aid framework are complied with. In this case, the relevant Member State is in charge of the management of the AMC.
Precautionary recapitalization	Precautionary recapitalization can be used in the specific case of a transfer of impaired assets to a publicly supported AMC, where the objectives pursued by such a transfer are the same as in the case of direct capital injection, and provided that the specific State Aid conditions for impaired asset measures are also respected.



The strengthening of NPLs coverage levels might induce EU banks to adopt a more prudent approach in their lending strategies

to clean up the balance sheet of credit institutions.

The blueprint does not innovate the current EU legal framework, but rather clarifies that AMCs can be used as an exceptional tool provided that the restrictions deriving from EU State Aid rules and the applicable resolution framework are complied with. Based on such legal and regulatory constraints, the AMC Blueprint identifies different scenarios where AMCs can be used (see table 4).

The AMC blueprint sets out the principles that should govern the design and set-up of publicly supported AMCs, their effective operations and disposal strategies, as well as the closing of the AMCs—which shall be established for a temporary period of time.

Change is coming

The combined effect of the EC and ECB measures and the entry into force of IFRS 9 may create incentives for EU banks to abandon the "wait and see" approach. The banks may sell their NPL portfolios in view of the forthcoming application of the minimum supervisory coverage requirements (and, for SSM significant banks, the ECB quantitative supervisory expectations on NPL coverage levels). Member States will be allowed to use national AMCs to support such processes, even though the current limits deriving from EU State Aid and the resolution framework are neither lifted nor amended under the AMC Blueprint.

The package proposed by EU institutions could also force EU banks to review their credit policies to incorporate the prospective impacts of NPL provisioning. It is yet to be seen whether this review will be beneficial and actually increase credit supply to SMEs—which is one of the goals underpinning the EC proposals. Indeed the strengthening of NPL coverage levels might induce EU banks to adopt a more prudent approach in their lending strategies, over-collateralize their loans or immediately enforce their claims as soon as the borrower becomes non-performing.

The proposals on the prudential backstop for NPL provisioning fail to recognize the existence of significant differences among EU Member States with respect to the average duration of debt recovery procedures. To a certain extent, European institutions are betting on the effectiveness of out-of-court accelerated enforcement procedures and other legislative proposals on debt restructurings to overcome these national differences. But the "one-size-fits-all" approach enshrined in the NPL provisioning calendar could ultimately result in an unlevel playing field for the internal market and the EU Banking Union, due to the different judicial systems and efficiency of national bankruptcy and enforcement procedures.

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