Solving Non-Performing Loans in Europe to speed up the recovery

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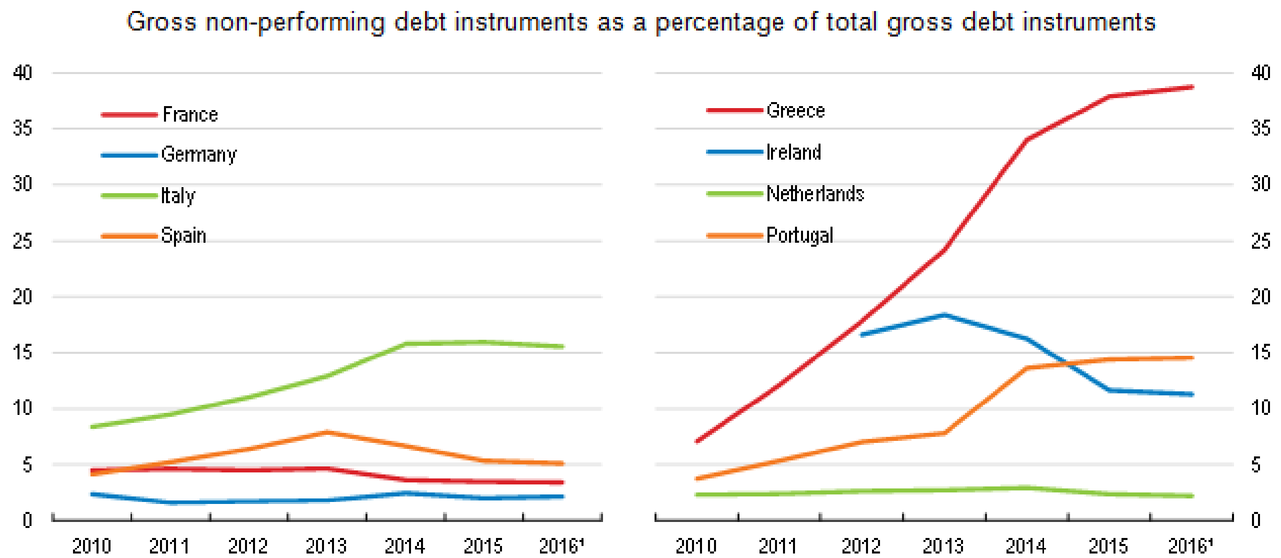
Almost 10 years after the outset of the financial crisis in summer 2008, European growth remains modest, constantly underperforming the OECD average. Several factors explain this disappointing performance. The pace of fiscal consolidation was rapid in the countries most affected by the crisis while structural reforms were not sufficiently pursued in other countries. One key factor that may continue to cripple growth is the persistently high level of non-performing loans (NPLs or impaired assets) in several countries (Figure 1). Impaired assets are a legacy of the crisis, but also a cause of the weak recovery as they limit bank capital available to more productive and innovative firms (Aiyar et al., 2015; European Commission, 2017). The negative impact of impaired assets on bank credit may worsen from 2018 as the new accounting standards (IFRS9) and more forward-looking provisioning rules should lead to faster recognition of losses (Constâncio, 2017).

Given this context, it is urgent to pursue a more aggressive policy to resolve NPLs, preferably at the European level. This requires introducing more flexibility in EU rules, including state aid rules, which may otherwise block the most ambitious options to resolve NPLs, as discussed below and outlined in the last OECD economic survey on the euro area (OECD, 2016).

Figure 1. Non-performing loans

Gross non-performing debt instruments as a percentage of total gross debt instruments



1. Average of first three quarters.

Source: ECB (2016), "Monetary and financial statistics", *Statistical Data Warehouse*, European Central Bank.

To free-up maximum capital for new lending, banks need to sell NPLs at a sufficiently high price. This is tricky since potential buyers not knowing the exact level of risk associated with NPLs are likely to offer the lowest possible price and banks may consider the offered price too low, ending up in no transaction. The longer NPLs stay on the books, the lower is the value obtained after removal from the bank, which could make transactions increasingly difficult overtime.

To facilitate transactions, setting up an asset management company (AMC) can be very effective. AMCs' expertise for valuing impaired assets allows banks, especially smaller ones, to get a better price. Establishing an AMC at the European level would maximize economies of scale and diversify asset recovery risks (OECD, 2016; Haben & Quagliariello, 2017; Constâncio, 2017). Since a European AMC could imply cross-country risk sharing, some financial sector conditionality could be imposed on countries benefiting from it, to make it acceptable to all Euro Area countries.

Another option would be to continue setting up AMCs at the national level. Public support (participation of the State in the capital of the AMC or guarantees granted) may be needed to

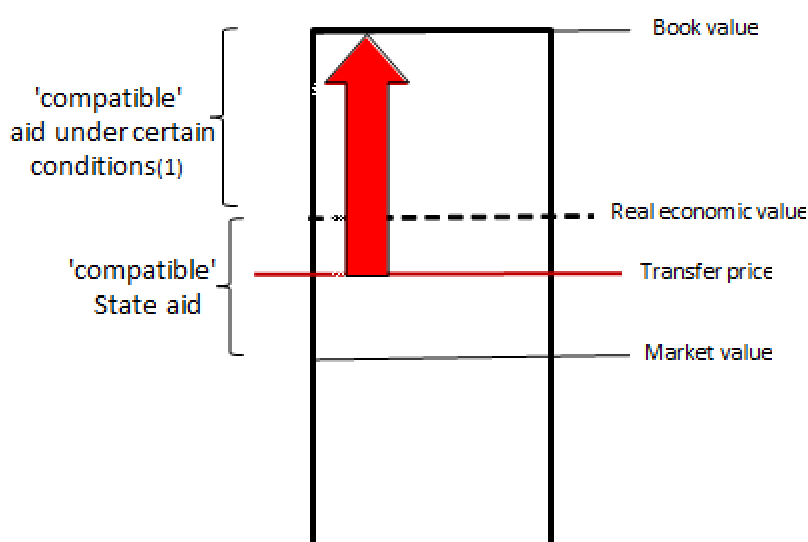
allow AMCs to buy impaired assets at a sufficiently high price and to reduce risks faced by private investors participating in the capital of AMCs. However, European rules could hinder such public support. Under the new bank recovery and resolution directive (BRRD), selling assets to AMCs above market price is considered state aid, and it triggers the implementation of a restructuring plan for the bank, a "bail-in" of junior creditors (i.e. their financial participation in the recapitalization of the bank) and, since January 2016, possibly a bail-in of senior creditors as well.

Hence, the combined application of the BRRD and state aid rules creates a significant hurdle for governments to participate in the setting up of AMCs since it could result in sizeable fiscal costs in the event of public bail-out of the bank, in addition to bail-in of private creditors. It could also create huge political costs if private creditors who participate in the bail-in end up being bank retail customers who were not aware of the risk when they purchased some financial products. It appears that several banks have misled their individual clients by selling such products as safe assets…

In this context, introducing flexibility in EU rules to solve NPLs without triggering bail-in and resolution procedures should be considered. A very high level of NPLs should be considered a serious economic disturbance and warrants a waiver of bail-in and resolution procedures. Alternatively, a more lenient definition of the price level triggering state aid – and hence resolution – could be used. Currently, the European Commission assumes state aid for any purchase of impaired assets by a state-supported AMC at a price above the estimated "market price" (Figure 2; Cas and Peresa, 2016). For example, when the market prices are uncertain and depressed by stressed conditions, resolution requirements could be applied only for prices above the "real economic value" or a level half way between the "market price" and the "real economic

value”. Member states benefitting from this exceptional treatment could in return be required to make their insolvency regimes more efficient, facilitating a faster recovery of collaterals and enabling the AMCs to get a higher price for impaired assets.

Figure 2. Valuation of impaired assets and state aid rules



(1) These conditions include claw-back clauses, in-depth restructuring and/or liquidation.

Source: Cas and Peresa, 2016

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