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EU POLICY INITIATIVES TO ADDRESS NON-PERFORMING LOANS

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BOX 1: EU POLICY INITIATIVES TO ADDRESS NON-PERFORMING LOANS

High levels of NPLs are a recurrent feature of financial crises. High NPLs have an adverse impact on a country's economic growth prospects as banks' capacity for allocating credit, particularly to SMEs is hindered. Although the average NPL ratio in the European Union has dropped by more than a third since 2014, the aggregate stock of NPLs remains elevated. Progress in NPL reduction has remained slow in certain EU jurisdictions due to a number of factors. Asymmetric information in the NPL market, structural inefficiencies in debt and collateral enforcement, all contribute to the slow resolution of NPLs.[1,2] Elevated stocks of NPLs need to be addressed by means of a comprehensive policy response at both the national and EU level. As per EU Council Action Plan, National and European authorities joined forces to address this issue and accordingly embarked on a number of initiatives.[3] Domestically, in 2016 the Central Bank of Malta and the MFSA had implemented further measures to incentivise credit institutions to resolve their NPLs and maintain a maximum NPL ratio of 6.0% or lower.[4] Banks subject to the reduction plan are managing to reduce their NPL ratios below this threshold. The NPL ratio of domestic banks has been following a downward trend since 2014 Q2 and reached a level which is in line with the EU/euro area average. This Box aims at providing an overview of EU initiatives dealing with to NPLs.

On 11 July 2017, the EU Council established a comprehensive European strategy to address high levels of NPLs in Europe by implementing a mix of policy actions (see Chart 1). The Council identified four main policy areas: (i) banking supervision (ii) insolvency and debt recovery laws (iii) secondary markets for distressed assets, and (iv) restructuring of the banking system. A number of actions have already been taken with respect to these four areas.

On 20 March 2017, the ECB published its non-binding guidance to banks on NPLs (NPL Guidance) with respect to banking supervision.[5] The NPL Guidance clarifies supervisory expectations regarding the identification, management, measurement and write-off of NPLs in the context of existing regulations, directives and guidelines. The NPL Guidance sets out the minimum capital provisioning required for prudential purpose for exposures that are newly-classified as NPLs as of 1 April 2018. Accordingly, the ECB expects banks to provide full coverage after two years at the latest for the unsecured portion of the new NPLs and after seven years at the latest for the secured portion of new NPLs with a linear path starting from year three onwards. Furthermore, the ESRB will be developing macroprudential approaches to mitigate the emergence of system-wide NPL problems. In addition, the EBA in consultation with European Securities and Markets Authority, and competent authorities are committed to implement, by the end of 2018, enhanced disclosure requirements on asset quality and NPLs to all banks. The disclosure templates proposed are aimed at enabling potential bidders to perform a detailed analysis of the assets, widen the investor base, lower entry barriers to potential investors, support price discovery, improve data and availability, thereby facilitating the development of a secondary market for NPLs. Moreover, the EBA is developing guidelines on management of NPLs and forborne exposures that provide supervisory guidance and set rules to be applied by credit institutions.

With regards to insolvency and debt recovery laws, EU Governments are to review their insolvency laws to soften the burden of resolution of NPLs. In Malta, work is underway to address this issue

1 European Commission Banking Union: 'First Progress Report on the tackling of non-performing loans to support the risk-reduction agenda'.

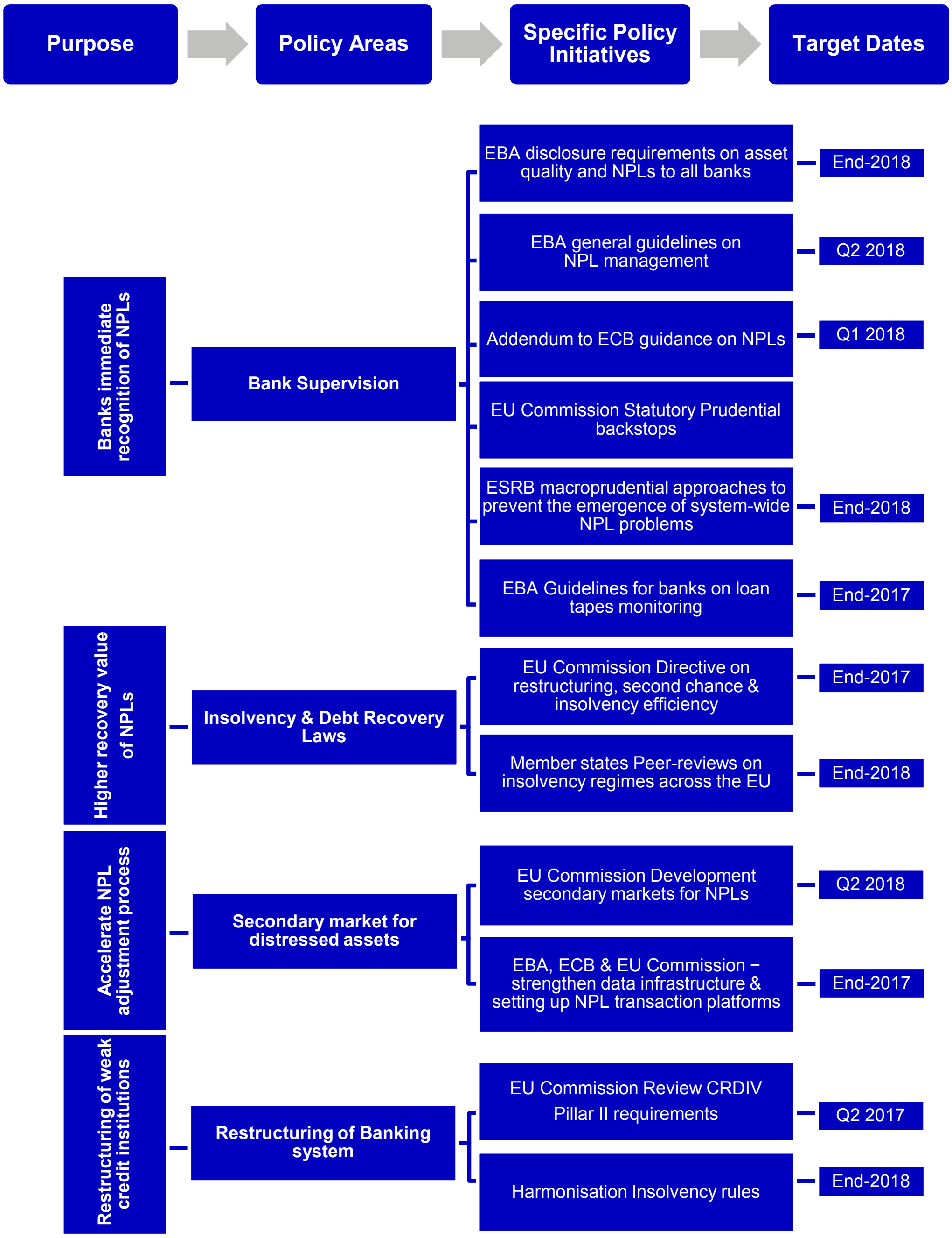
2 The problem of asymmetric information in the NPL context could arise as buyers would know less about asset quality than the sellers. For example buyers may feel that they are bidding for low-quality assets leading them to bid a low price compelling the sellers to trade in the low-quality assets only.

3 Council conclusions on Action plan to tackle NPLs in Europe, 11 July 2017.

4 Banking rules – 'Measures addressing credit risks arising from the assessment of the quality of asset portfolios of credit institutions authorised under the Banking Act 1994'.

5 ECB (March 2017): "Guidance to banks on non-performing loans".

Chart 1
OVERVIEW OF EU POLICY INITIATIVES TO ADDRESS NPLs



Source: Central Bank of Malta.

and amendments have been implemented in the Companies Act to expedite out of court settlements.[6] The European Commission published a consultation document on the development of a secondary market for NPLs and distressed assets and for the protection of secured creditors from borrowers' default. The purpose of the public consultation is to enable the Commission to evaluate the practical problems and legal restrictions that might currently hamper the development of secondary markets for NPLs and loan contracts. Furthermore, the consultation document discusses the potential introduction of a new "accelerated loan security" instrument.[7] This instrument may lead to faster out-of-court settlement. In this respect, a Directive was proposed by the Commission in March 2018.[8]

Further work is required to complete the EU Council conclusions on the restructuring of the banking system. EU legislators have to focus on specific issues to implement the appropriate framework, including the review of the CRD IV Pillar II requirements which comprise capital deductions, the implementation of a secondary market for distressed assets and harmonisation of insolvency rules. In this regard, the Commission is proposing to put in place a detailed mapping of national enforcement and insolvency systems to provide an overview of the range of procedures available to banks to recover the value from defaulting loans.

On 2 November 2016, the Commission introduced a proposal for a Directive on restructuring, second chance and insolvency efficiency, with the aim of reducing the number of unnecessary liquidations of viable companies whilst also protecting the legitimate interests of creditors.[9] According to the Commission, this approach would boost entrepreneurial activity in Europe and improve the effectiveness of all restructuring, insolvency and second chance procedures by reducing both the associated costs and the timeframes to settle such procedures.

Furthermore, on 10 November 2017, the European Commission published a consultation document on the statutory prudential backstops addressing insufficient provisioning for NPLs.[10] In this consultation document, the Commission put forward possible minimum coverage levels for unsecured and secured parts of NPLs. The consultation document propose a backstop linear approach for unsecured exposures with a minimum coverage of 50% after year 1 and 100% of coverage after year 2, whereas the proposed progressive approach provides a minimum coverage of 35% after year 1 and 100% after year 2 (see Table 1).

On 14 March 2018 the EU Commission issued a proposal for a regulation pertaining to the minimum loss coverage for non-performing exposures. In this regulation, the Commission proposes a progressive scalar calibration for unsecured exposures, to facilitate better early recoveries of loans.[11] The proposed prudential backstop would apply only to exposures originated after 14 March 2018. In this regard, the EBA undertook an impact assessment on a projected horizon of 20 years.[12] The EBA's estimates indicate that the option with a linear coverage path would lead to an average reduction

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[6] Chapter 386 Companies Act.

[7] An accelerated loan security instrument gives the lender the right to demand the entire loan amount (principal plus interest) to be paid at once, in case the borrower fails to make payments or gets into serious financial difficulties thereby not meeting the repayment obligations set in the loan agreement.

[8] Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral.

[9] 'Proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive' - 2012/30/EU https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN.

[10] 'Consultation document statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing' – https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf.

[11] 'Proposal for a regulation of the European Parliament and of the council on amending Regulation No 575/2013 as regards minimum loss coverage for non-performing exposures' – https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-134_en.

[12] The sample assessed by the EBA consisted of 129 EU banks, 98 from the euro area and 31 from non-euro area member states.

Table 1
MINIMUM COVERAGE LEVELS FOR UNSECURED AND SECURED PARTS OF NPLs

Vintage	Unsecured (parts of) NPLs			Secured (parts of) NPLs		
	No scalar	Progressive	Linear	No scalar	Progressive	Linear
Min. coverage after 1y	0%	35%	50%	0%	5%	12.50%
Min. coverage after 2y	100%	100%	100%	0%	10%	25%
Min. coverage after 3y				0%	17.50%	37.50%
Min. coverage after 4y				0%	27.50%	50%
Min. coverage after 5y				0%	40%	62.50%
Min. coverage after 6y				0%	55%	75%
Min. coverage after 7y				0%/35%/50%	75%	87.50%
Min. coverage after 8y				100%	100%	100%

Source: European Commission consultation document.

in EU banks' CET1 capital ratio of between 231 to 239 bps on a cumulative basis over 20 years. In contrast, applying a progressive coverage path would slightly lower the average impact, leading to an average reduction in EU banks' CET1 capital ratio of between 217 to 227 bps for the same time period. Furthermore, the regulation puts forward a distinction between non-performing exposures (NPE) where the obligor is past due more than 90 days and NPEs of 'unlikely to pay' obligors. In cases where the obligor is past due more than 90 days, a full coverage level would be necessary. NPEs of 'unlikely to pay' obligors would be required to cover up to 80% of the exposure value after two years for unsecured NPEs and after eight years for secured exposures.