

C Resolving the legacy of non-performing exposures in euro area banks¹³⁷

The weight of non-performing exposures (NPEs) on the balance sheets of European banks is a cause for concern for policy-makers; yet resolving the issue presents a number of challenges. This special feature presents an overview of the scale of the NPE problem, highlights several operational aspects that are critical for effectively resolving the problem, and outlines the merits of various resolution strategies.

Introduction

Financial crises or prolonged economic contractions often trigger a rapid and substantial increase in non-performing exposures (NPEs) on banks' balance sheets, as asset valuations decrease and borrowers become unable to service their debt. In the European context, macro-financial stresses over recent years have resulted in a significant stock of NPEs: the 130 largest euro area banks held close to €900 billion of impaired assets at the end of 2013. More recent data, though not comparable across countries, indicate that the figure has risen since then.

A number of different approaches are available to address the NPE problem and these are presented here. Strategies vary between on- and off-balance sheet approaches, with the former involving the internal workout of NPEs by the banks concerned, supported by regulatory guidance on provisioning, loan restructuring and the protection of borrowers, whereas the latter may involve outright sales to private investors, or a centralised workout, possibly by a government-sponsored asset management company. Regardless of the approach, the legal and judicial frameworks must be conducive to the swift and efficient resolution of NPEs.

The resolution of systemic NPE problems requires a comprehensive strategy, encompassing necessary improvements in the operational environment and the selection of appropriate resolution strategies. Recent experience shows that tailored approaches, based on a thorough understanding of the country-specific dimensions of the NPE problem and driven as much as possible by the private sector, are the most effective means to tackling system-wide surges in NPEs. Depending on the prevailing circumstances, it may be that the state's role is best confined to contributing to an operational environment that facilitates NPE resolution, although in other cases, greater intervention may be warranted.

Non-performing exposures in the euro area banking sector

The measurement of NPEs in Europe has long suffered from a lack of harmonisation and transparency. Prior to the financial crisis, there was no single, harmonised EU-wide definition of NPEs. In addition, banks could use loopholes in existing national

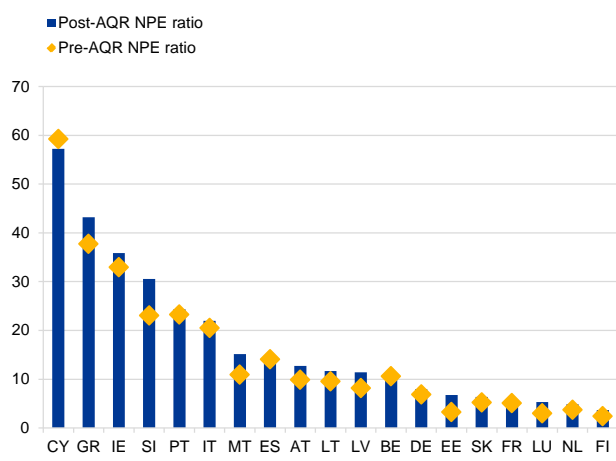
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definitions to conceal forbearance. As a result, policy-makers and external stakeholders alike faced difficulties in trying to establish a true picture of credit quality in EU banks, both within and across jurisdictions.

Chart C.1
NPEs in individual countries

NPE ratio as determined by the ECB's comprehensive assessment

(Dec. 2013; percentage of total exposures)



Source: ECB calculations.

Notes: The NPE ratio was aggregated from bank-level data using total exposures to retail and corporate customers as weights. AQR stands for asset quality review.

The European Banking Authority (EBA) has only recently adopted a common definition of an NPE, which fully harmonises the disclosure of such exposures, including, in particular, forbore exposures.¹³⁸ The ECB's 2014 comprehensive assessment used a simplified version of the EBA's NPE definition and found that – following adjustments made to the classification of loans in the course of that exercise – significant euro area banks held NPEs totalling €879 billion at the end of 2013, equivalent to about 9% of euro area GDP.¹³⁹ These aggregate results mask, however, considerable heterogeneity across euro area countries: NPEs as a share of total banking sector assets range from 4% to 57% across national banking sectors (see Chart C.1).

High shares of NPEs constitute a serious macroprudential problem and are likely to have far-reaching macroeconomic consequences. First, a large stock of NPEs indicates that households and non-

financial firms are excessively indebted and impaired, which may depress consumption and investment, and thus delay economic recovery. Second, scarce resources in the banking sector, capital, funding, as well as operational capacity, are absorbed by legacy assets and cannot be deployed to support new viable investment projects. This, in turn, may lengthen the period of subdued economic activity, further aggravating the NPE problem for the banking sector and the economy as a whole.

Key aspects of the operational environment for NPE resolution

A supportive operational environment is a necessary precondition for effective NPE resolution. This environment is rather complex, involving a large number of stakeholders, including banks, supervisors, various ministries, consumer protection authorities, as well as non-governmental bodies, such as banking associations.

¹³⁸ See EBA final draft *Implementing Technical Standards on Supervisory reporting on forbearance and non-performing exposures under Article 99(4) of Regulation (EU) No 575/2013* (<https://www.eba.europa.eu/documents/10180/449824/EBA-ITS-2013-03+Final+draft+ITS+on+Forbearance+and+Non-performing+exposures.pdf>).

¹³⁹ Significant in this context refers to banks which, under the criteria of the Single Supervisory Mechanism Regulation, are directly supervised by the ECB.

The operational environment tends to be quite country-specific. Generally speaking, however, it will normally encompass a number of key “building blocks”, the two most important of which are reviewed below.¹⁴⁰

Legal framework and efficient judicial system

A key aspect of the operational environment needed for successful NPE resolution is an effective legal framework and judicial system. Experience shows that these systems are often unable to cope efficiently with a substantial increase in the number of defaulting credits and may thus represent a major impediment for efficient NPE resolution.

For corporate NPEs, insolvency legislation in many euro area countries tends to emphasise liquidation rather than the restructuring of viable businesses. Moreover, corporate bankruptcy procedures are usually very protracted, which render the rehabilitation of viable distressed debtors less likely and can destroy the value of a company’s assets. Voluntary, out-of-court workout frameworks, based on the consent of a binding majority of creditors, can thus in many cases offer a useful alternative to lengthy judicial procedures, court backlogs and a lack of experienced insolvency judges and practitioners. Moreover, the implementation of fast-track judicial procedures is a necessary addition to support the functioning of out-of-court workout frameworks.

With respect to household NPEs, an effective personal insolvency regime is important, so that the right incentives are provided for debtors and the number of judicial procedures is minimised. The insolvency regime should enable banks to foreclose on NPE collateral within a reasonable timeframe, while remaining cognisant of social considerations and providing cooperative borrowers with restructuring alternatives. Out-of-court dispute resolution mechanisms, consumer protection initiatives and debt counselling programmes can enhance the fairness and accessibility of the process. These are important in order to ensure that the political appetite for resolving less socially-sensitive NPE portfolios is not undermined.

Support from the sovereign

Another important aspect influencing the operational environment for NPE resolution is the willingness and ability of the sovereign to support the process. Fiscal limitations often play an important role here. Countries experiencing protracted economic downturns may lack the fiscal space to recapitalise their banking systems should the capital losses arising from NPE resolution exceed the available buffers.¹⁴¹

There are also important political and legal constraints to the support that the sovereign can render to the banking sector. Besides possible national limitations, which tend to be linked to political considerations, the EU state aid framework restricts a state’s ability to provide support for the NPE resolution process. The

¹⁴⁰ Other important elements of the operational environment relate to the development and/or improvement of the functioning of NPE markets and real estate markets by, for example, optimising taxation-related incentives and decreasing real estate transaction costs.

¹⁴¹ Furthermore, the sovereign should provide the right incentives to the banking sector in cases where distressed debtors also have significant tax debts. The ranking of the sovereign versus private sector claims and possible restructuring of tax debts play a key role in this context.

requirements of the Bank Recovery and Resolution Directive (BRRD) may make state support less attractive for certain portions of the banking sector.

Ensuring a supportive operational environment for NPE resolution is a key role for the state, regardless of the specific nature of the NPE problem. Where circumstances allow, this should be the extent of the sovereign support and private sector solutions should dominate. However, in some cases, the role of the sovereign may be broader, encompassing capital support.

Different approaches to tackle the NPE problem

The various available approaches to tackle NPEs can be categorised as either on-balance-sheet or off-balance-sheet resolution, although both types of approach may be usefully employed in parallel. In the former, the risk related to future recoveries remains with the originating bank. In the latter, the bulk of the risk may be transferred to another entity.

On-balance-sheet approaches

A priori, the resolution of NPEs is a normal part of the banking business. Nonetheless, banks are usually not well prepared for widespread, systemic deteriorations in credit quality and typically lack the necessary capacity and expertise when confronted with a large-scale problem. As a result, investments in human resources, organisational processes and information systems are needed to develop or upgrade in-house capacities. Practice from euro area countries suggests that it can take up to three years to implement sufficiently strong improvements in banks' internal workout capacity for dealing with systemic NPE problems. This highlights the importance of reacting quickly to a growing NPE problem and of implementing pre-impairment monitoring. Moreover, achieving sufficiently strong enhancements in workout capacity often requires a considerable push from the competent authorities to avoid widespread and excessive forbearance.

An appropriate starting point for enhancing internal workout processes is a diagnostic exercise for NPE-related operations, to determine which areas need improvement and which measures should be prioritised. Banks can conduct such an exercise on their own initiative or they may need to be incentivised by the competent authorities to do so. Following up on such an exercise, banks should develop clear quantitative objectives, or "key performance indicators", including both operational variables (e.g. staffing indicators or case numbers) and financial variables (e.g. default rates or migration rates from performing to non-performing loan categories).

Competent authorities may provide guidelines on the specific tools and strategies employed by the banks. Such guidelines should not be overly prescriptive. However, they should also not give leeway for excessive forbearance. Meaningful portfolio segmentation of the NPE stock should normally be part of the requirements, given that specific solutions should always be tailored to individual portfolios. Solutions should also be tailored to the duration of arrears. From the very early stage of arrears, decision-making should be based on a viability assessment of the borrower,

to minimise the risk that forbearance be extended to non-viable entities, which should instead be swiftly resolved.

Competent authorities may also want to provide clear and appropriate guidance on the minimum expected degree of conservatism in NPE provisioning and the prudent recognition of losses. This pertains, in particular, to assumptions regarding collateral valuation, timing of recovery cash flows and discount rates. While such guidance may initially increase the capital needs of banks with large NPE stocks, it has a number of important benefits. First, it helps to prevent “extend and pretend” approaches by banks and the negative macroeconomic consequence of forbearance at a systemic level. Second, it provides buffers for sustainable loan restructuring and, third, it helps to restore market confidence in banks’ financial reporting, which in turn may reduce banks’ funding costs and facilitate capital increases, if needed.¹⁴²

If on-balance-sheet solutions are dominant and large exposures are left on the balance sheets of originating banks, there may be a need for coordination of actions among lenders. Otherwise, incentives for lenders are often misaligned owing to differences in collateralisation and seniority of their exposures, which may lead to very different recovery rates for the same borrower. Without such coordination, a minority of creditors may block a sustainable solution leading to socially suboptimal outcomes.

There are two options to overcome these kinds of “coordination failure”: (i) privately-led coordination; and (ii) public sector-led coordination, which can both ensure that banks’ collective incentives are better aligned and ensure a proactive approach. Ideally, the privately-led approach, which can involve a banking association or a third party as a hub supporting negotiations between creditors and debtors, should be applied.

On-balance-sheet approaches to NPE resolution can be supported by partial risk transfer, either to the private sector (e.g. synthetic securitisations) or to the public sector (e.g. asset protection schemes). In such cases, part of the tail risk is transferred to a third party. However, the bank remains responsible for servicing the NPEs and for the resulting losses up to a given threshold.

Off-balance-sheet approaches

Off-balance-sheet approaches, using various means of asset separation, have been shown to be an effective policy response to a build-up of NPEs under specific conditions. Asset separation may be achieved with public sector support, through the provision of guarantees, for example, or by private means, in its simplest form, through the direct sale of assets.

¹⁴² In nearly all circumstances, the sustainable restructuring of a loan implies a reduction in its net present value and, consequently, in the book value. A bank which has not built up provision buffers to absorb this reduction would be dis-incentivised to engage in sustainable restructuring, and would prefer short-term “extend-and-pretend” forbearance.

Asset management companies¹⁴³, often referred to as “bad banks”, have, in numerous cases, been established to manage assets that were removed from banks’ balance sheets. Historically, asset management companies were established to manage assets that remained in the case of a bank failure (a single bank case) or to address system-wide, but asset-class-specific, distress. In recent years, examples of the latter include the NAMA in Ireland and SAREB in Spain, both established to deal with legacy assets arising from distress among commercial real estate assets, as well as BAMC in Slovenia, which was established to deal with impaired corporate loans.

While it remains premature to draw lessons from these relatively recent experiences, in particular for BAMC, the track record of these asset management companies, combined with the outcomes of other historical examples, suggests that they can be an effective means for dealing with particular types of NPE. Through the separation of assets, participating banks’ funding and liquidity conditions can be improved, concerns around asset quality can be ameliorated to a large extent, coordination problems can be resolved, and the feedback loop that may have emerged between funding and solvency problems can be reversed. In addition, participating banks’ operational capacity is relieved.

Since 2009 the ECB has published a number of documents outlining some relevant criteria for consideration in asset separation and the establishment of asset management companies.¹⁴⁴ In particular, asset management companies may be desirable where market prices and collateral values are depressed; where banks have lost access to funding markets; where banks lack the capacity to manage NPEs on the balance sheet; where economies of scale can be achieved by pursuing an off-balance-sheet approach; where credit origination may be improved by asset separation; and, finally, where adverse incentives are at play, affecting banks’ willingness to pursue creditors. Transparent and clear eligibility criteria for the selection of assets for separation must be laid down, in advance and in accordance with the policy objective. In addition, the asset management company must have reasonable prospects of being effective in working out the NPEs. This implies that it must have sufficient legal empowerments to foreclose on loan assets and to seize underlying collateral. It must also be able to quickly obtain all relevant information concerning the creditor and the collateral.

An important constraint in the establishment of asset management companies is the European state aid conditionality¹⁴⁵, as revised in August 2013, and the associated provisions of the BRRD, which became effective in January 2015. They come into

¹⁴³ This term should not be confused with the “asset management industry”, which manages financial investments on behalf of clients.

¹⁴⁴ ECB, *Guiding principles for bank asset support schemes*, February 2009; and O’Brien, E. and Wezel, T., “Asset support schemes in the euro area”, *Financial Stability Review*, May 2013.

¹⁴⁵ Pricing of NPEs and underlying collateral is often challenging in a distressed environment due to the illiquidity of the asset markets and heightened economic uncertainty. Asset prices are therefore lower than the long-term economic value of the assets. The transfer at market prices would crystallise the losses and therefore may not be desirable from a macroprudential perspective. In any event, the transfer pricing methodology, used in the absence of prices derived from a liquid market, may give the authorities some discretion to reduce the negative impact of the asset transfers on the participating institutions.

play when transfer prices of assets are set at the long-term economic value of the assets, which is higher than the estimated market value of assets. According to these rules, banks benefiting from state aid support are in principle required to bail in shareholders and subordinated creditors. These conditions, designed to reduce the risk that taxpayers' money is used to support the financial sector through burden-sharing with private creditors of troubled banks, effectively limit the role of asset management companies to periods of acute crisis and effectively deny banks and national authorities the potential to harness the available benefits of such schemes outside such a context.

An alternative off-balance-sheet approach for dealing with NPEs is the direct sale of assets onto a "secondary" NPE market, where specialised investors may provide the necessary know-how and capital to facilitate the resolution of at least some types of NPE. If, however, specific asset classes are systemically impaired, for example in the aftermath of a housing bubble, asset sales become more challenging. It may not be possible to avoid fire sales and banks' management may be unwilling or unable to realise the significant capital losses that are associated with sales at fire-sale prices.

Investor interest in distressed assets usually increases once the prospects for economic recovery become clear and uncertainty about the long-term value of assets subsides. Besides these economic considerations, the acquisition of NPE portfolios by specialised investors is often held back by legal and regulatory impediments, which authorities should review as part of the NPE resolution process. Possible impediments in this respect may include rules for the transfer of credit contracts, licensing requirements for the type of companies involved and targeted tax (dis)incentives. Therefore, measures to support the development of an NPE market are of the utmost importance, in order to support the direct sale of selected NPE portfolios.

Towards a comprehensive strategy for NPE resolution

The resolution of systemic NPE problems requires a comprehensive strategy, encompassing the necessary improvements in the operational environment and the selection of the appropriate approaches to be employed. While the impediments in the operational environment have to be removed before an effective NPE resolution process can get underway, the work on the identification, selection and implementation of approaches must start in parallel.

The identification of the best NPE resolution approaches requires a thorough understanding of: (i) current NPE resolution solutions applied and their effectiveness; (ii) the characteristics of NPE portfolios; (iii) the condition of distressed debtors; and (iv) the condition of lenders and their capacity to absorb future losses. In order to reach that understanding, a wide range of "non-standard" information may be needed, e.g. an external review of banks' internal workout practices and a system-wide asset quality review and stress test, to remove possible uncertainty about point-in-time and forward-looking asset values.

More specifically, a range of factors need to be considered before deciding on how to implement the favoured approaches. The most important determining factors include the following.

- *The composition and heterogeneity of NPE portfolios.* This is important when deciding between on- and off-balance-sheet approaches. If NPEs are concentrated in a specific asset class and include large ticket non-core assets, and a high proportion of debtors has become gone concern, so that recoveries would be made mainly from assets, an off-balance-sheet solution (e.g. an asset management company) may be most appropriate. Conversely, if NPEs are very heterogeneous, carving out NPEs may not be the optimal solution. Moreover, large stocks of SME and retail NPEs are typically better addressed using on-balance-sheet solutions.
- *The state of the real estate market.* This may be a big impediment in the resolution of NPEs, preventing the large-scale liquidation of collateral in a systemic crisis. A depressed real estate market has a strong impact on the bid-ask spread in the pricing of NPEs collateralised with real estate, which in turn increases the capital cost of NPE disposals and reduces the incentives of banks to do so voluntarily.
- *Consumer protection and social issues.* These aspects play an important role in the resolution of owner-occupied real estate. Moreover, if not properly addressed, social concerns may be used to prevent a successful NPE workout, even for portfolios that are not normally considered to be socially sensitive.
- *The level of concentration in the banking system and the size of individual institutions.* This is an important determinant for the effectiveness of coordination among banks and whether the banks can build sufficient internal capacity to resolve NPEs. In more concentrated banking sectors with relatively large institutions, it tends to be easier to work out NPEs internally. That said, a significant presence of common/interconnected borrowers may favour centralised, off-balance-sheet solutions, as the pooling of debt increases the negotiation power vis-à-vis the debtor. An important factor for dealing with common borrowers and ensuring a coordinated NPE resolution process is the presence of a strong and competent central coordination entity.
- *The availability of private capital for the establishment of off-balance-sheet solutions.* The absence of private capital makes the establishment of an asset management company more problematic: first, owing to the fiscal impact of a fully publicly-owned off-balance-sheet scheme; second, owing to possible governance concerns associated with a fully state-controlled asset management company; and third, owing to the possible complications arising from EU state aid rules and the BRRD.
- *Moral hazard.* This is a very delicate issue in the NPE resolution process. In situations where more drastic restructuring solutions may be considered (e.g. partial debt forgiveness), banks face a material risk of performing exposures being contaminated as well. This implies, first, a need to apply such

solutions only very selectively and with clear and stringent eligibility requirements. Second, banks could reduce the risk of contagion by implementing an organisational separation of performing and non-performing portfolios.

Ultimately, the decision about the best-suited NPE resolution approach (i.e. on- or off-balance-sheet approach, single approach only or combination of approaches, private sector only or with public sector involvement) will depend on the size and complexity of the NPE problem, which in turn tends to be related to the origin of the financial crisis in the country concerned (e.g. a burst real estate bubble versus a prolonged recession).

A combination of different solutions, driven as much as possible by the private sector, may be the most appropriate approach. First, a multi-pronged approach appears better suited to deal with the multifaceted nature of the NPE problem in most countries. Second, it minimises the fiscal costs, the moral hazard problems that may be associated with substantial state involvement, and the additional complexity arising from EU state aid rules and the BRRD. This general guidance notwithstanding, the complexity and heterogeneity of the NPE problem across euro area countries will normally call for tailored, country-specific solutions.

Irrespective of the selected approaches to deal with systemic NPE problems, strengthening the banks' internal workout capacity is always highly advisable. First, there will always be NPE segments that are better dealt with within banks, rather than being carved out, e.g. owner-occupied real estate. Second, strengthening internal bank NPE resolution capacity helps to prevent new episodes of systemic NPE formation, as banks will be able to act at an earlier stage of the NPE build-up process and provide solutions before the default. In this respect, improvements in the strategies, processes and tools to deal with early arrears are as important as the tools to deal with more long-term arrears that are usually a consequence of a prolonged crisis period.