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Outlook on non-performing loans

The lasting effects

The bad loan situation

Non-performing loans (NPLs) remain a concern in Europe. As a consequence of the financial crisis, the disruption of the economic growth incapacitated the banks' balance sheet by the increase of NPLs in the EU. NPLs have a negative impact on the financing of the economy and are a big drag on banks' profitability, due to the costs they generate, such as recovery, provisioning and refinancing.

European banking sector still continues to maintain a high NPL rate, as a result, European banking supervisors marked NPL issue as one of the top priority regulatory focus points for the upcoming years. Since then there was a significant reduction of NPL ratios across Europe.

What is a NPL?

Let's go back a few steps and recapture what a non-performing loan actually is and why this residues a negative impact on banks. A NPL is an exposure where it is likely that the counterparty will not be capable of repaying all or a portion of the outstanding amount or the interest. However, for reporting purposes, the European Banking Authority (EBA) defined the notion of Non Performing Exposures (NPE), which was subsequently taken up by the European Central bank (ECB). [1] NPEs are exposures that meet at least one of two criteria: (1) Past due: an exposure is due when the late payment of 90 days; (2) Unlikely to pay (UTP): this criterion implies that the debtor is considered to be very reluctant to pay all of its credit obligations, regardless of the collateral and regardless of the existence of any late payment amount or the days past due.

The EBA definition can be in order words, NPLs are bank loans that are subject to late repayment or are unlikely to be repaid by the borrower.[2] Despite that, NPL and NPE definitions are commonly used as synonyms, the NPE term also includes other debt instruments such as advances, debt securities and off-balance sheet items.

Why are NPLs still an issue?

Many do not realize but the impact of NPLs is important for people and businesses as these loans weigh on banks' profitability and consume costly resources. Furthermore, a high level of NPLs force banks to keep a higher amount of regulatory capital and pay risk premium on liquidity markets therefore prevents their ability to obviously continue on with granting new loans. Meaning NPLs can cap banks` lending availability. Too large quantity of bad loans as a problem in the banking sector can quickly spread to other parts of the economy, harming the outlook for jobs and growth of the real economy. Therefore, the ECB and the European Council supports banks in tackling this issue in line with their responsibility to help ensure the safety and soundness of the European banking system.[3]

European banks held €685bn euros worth of NPLs by the end of 2018 according to the EBA. This is 3.2% of the total loan portfolio (Figure 1), it is the lowest level since the NPL definition was harmonized across the EU. [11] Significant improvement can be seen in the size of NPL portfolios across Europe, as banks had nearly €1 trillion worth of NPLs at the end of June 2016, which accounted to 5.5% of total loans. [7]

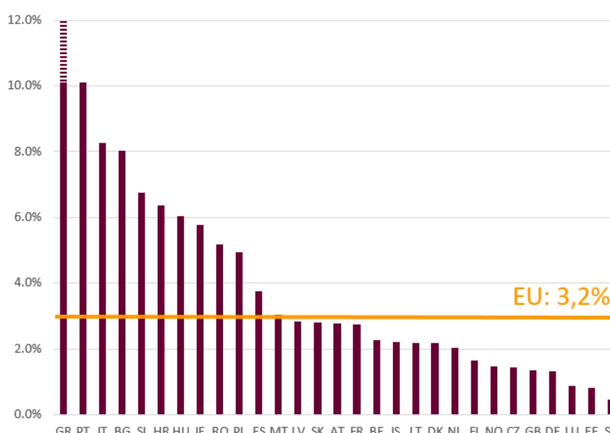

Figure1. NPL ratios across Europe
Source: EBA risk dashboard Q4 2018

In comparison to the high European numbers, other advanced economies such as the United States, Australia or Canada had only about or below 1% ratio at the end of 2017.[10]

The situation is very different among European countries, the southern countries (Spain, Italy, Greece) being more impacted by high NPL ratios than those of the north (France, Germany, United Kingdom). By far Italy has the largest NPL portfolio, the outstanding Italian loans are accounting to 10,1% of the total loans. Greece, on the other hand, has nearly 41% of its loans non-performing while Germany has its ratio at 1.3% by the end of 2018.

Is there a way out for NPLs in Europe?

The million dollar question! The European and the national regulatory authorities are concerned with the repercussions of the increase of NPLs. Most importantly their concern lies with how this might influence the economic structure of the European countries and resulting it in a negative impact in the welfare on peoples lifestyle. As of 2017, the European Council have presented the roadmap, which consists of enhanced supervision and reforms in the restructuring, insolvency and debt recovery frameworks as to increase recovery value from NPLs.

Several initiatives were delivered on national and EU level recently as NPL`s are focus points for ECB and the European commission (EC) as well. (Figure 2)

Last year by now the Commission followed up on the Economic and Financial Affairs Council configuration (ECOFIN) Council conclusions, which was asked to look into the possibility to amend EU legislation by introducing prudential backstops to address potential under-provisioning of new loans. As of December 2018, the EU lawmakers agree on a backstop for NPLs. [8] How does this help you ask?

If there are insufficiently provisioned NPLs, they often pile up on banks' balance sheets, which displays doubt on the bank's future profitability, solvency and also its long-term viability. Even though the average of provisions have increased in various countries with a high NPL stock, loss recognition is overall too low and lagging to effectively resolve those NPLs. Therefore a statutory prudential backstop against NPLs, arising from newly-originated loans, would set common minimum levels for the amounts set aside by banks to cover incurred and expected losses on NPLs. This would pump the brakes on new NPLs by ensuring sufficient loan loss coverage. Banks would need to continue to recognize provisions in line with their assessment. These provisions would be fully taken into account for the purposes of the prudential backstops. The purpose of statutory prudential backstops would then prevent the build-up of future NPL stocks with insufficient loan loss coverage, therefore ensuring banks' financial soundness. This is an

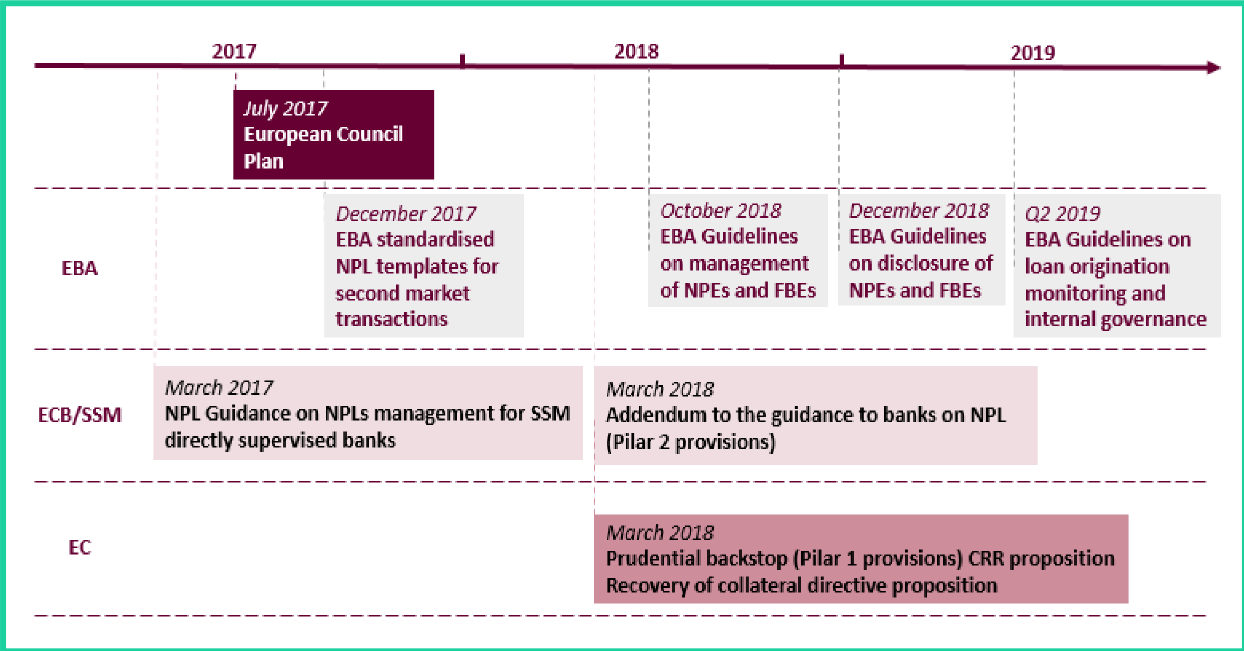

Figure 2. Recent regulatory publications

essential move towards the safeguard of financial stability and to reduce risks in the banking sector, which of course has a general impact on the economical composition.

On the other hand, the ECB recently published the NPL guidance. The Action plan identifies four main areas where further action is needed to tackle NPLs. It requires significant time and effort from banks to adequately address the issue. The regulatory supervision for NPLs will continue to have a considerable impact on banks. End of last year the EBA published the Final Report on Guidelines on disclosure of non-performing and forborne exposures. [6] It will help the market to have a clearer view of the quality of the banks' assets (including their non-performing and forborne exposures), and the value of the collateral backing those assets. These guidelines target high NPE banks with the aim of achieving a sustainable reduction to strengthen the resilience of their balance sheets and support lending into the real economy. By establishing an NPE strategy, this can then give focus to the European Bank to target a time-bound reduction of NPEs over a realistic but sufficiently ambitious time horizon.

Finally, the European Commission has also recently adopted a package on a measure including a proposal aimed at NPL secondary markets and easing collateral recovery from secured loans. [14] As a result, we expect to see more NPL portfolios for sale in the EU market over the coming years. More elaborate alternatives to the traditional “direct sales” are also likely to be used by banks to deleverage their NPL risks.

The resolution: NPL deals in EU

The European Commissions` proposed law changes would force banks to hold more regulatory capital against new NPLs and so force them to clear part of it from their books and at the same time aiming to ease on the debt servicers operations across the continent. This initiative wants to prevent banks from stocking up huge volume of bad loans by supporting a liquid secondary market for European NPL`s. In February this year, a new briefing was published by the European Parliament (EP) on the progress of the “Proposal for a directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral“. The proposal aims to foster secondary market for NPLs as ECB survey from 2016 suggested that secondary markets are not well developed across the continent (with exception of Spain, UK and Ireland). According to the briefing to EP, about 60% of the assets on the current secondary market are secured against residential or commercial real estate, it indicates that investors are insecure purchasing assets not backed by any collateral. [5]

Nevertheless, the European market for NPLs is becoming more and more active. The Eurozone market has increased to €205bn (total gross book value) in 2018. Deals from Italy and Spain accounted for most of the market in Europe. It is not surprising as Italy on its own had over €103 billion worth of deals in 2018. [12] Other countries such as Greece and Cyprus are recently active on the market. As result of the clean-up, huge part of the portfolios was sold to specialized hedge funds. [4]

The ECB`s Annual reports from 2018 did also highlight the significant improvement in reduction of the NPL portfolios in Europe. Their evidence shows that that the bulk of reduction was linked to liquidations and write-offs, Notwithstanding the more active secondary market for impaired assets had its contribution to NPL reductions, so did liquidations and write-offs. [13]

Overall, the bulk of NPLs remains a concern for European banking supervisors, with high risks with their creditworthiness, as these high rates of NPLs can very well weigh tremendously on a bank’ ability to positively contribute towards the economic growth of a country. However, the NPL issue becomes more and more a region and country-specific issue. There was a significant improvement realized since supervisors flagged this issue with high priority. For the upcoming years further positive changes and reduction NPL portfolios is expected across the continent, leaving the EU`s banking industry in a better shape to deal with the next recession.

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