European Commission - Fact Sheet

Frequently asked questions: Action Plan on the Reduction of Non-Performing Loans in Europe

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What are non-performing loans (NPLs) and how do they affect the economy?

The term 'non-performing loans' refers to loans where the borrower - either a company or a physical person - is not able to repay a bank loan, i.e. is unable to make scheduled payments to cover interest or capital reimbursements. When the payments are more than 90 days past due, or the loan is assessed as unlikely to be repaid by the borrower, it is classified as an NPL.

During financial crises, the number of companies and citizens facing payment difficulties increases. This, in turn, means that fewer borrowers are able to pay back their loans to banks. As a consequence, banks are not able to recover the value of their loans as the amount of NPLs on banks' balance sheets increases. This has a negative impact on the economy as high levels of NPLs affect a bank's short and longer-term performance:

- First, banks need to set aside - or 'provision for' - more money to cover the NPLs' incurred and expected losses. These provisions reduce bank profitability and reduce the bank's regulatory capital, which may affect the bank's viability.
- Second, banks have to dedicate high amounts of their financial and human resources to dealing with NPLs. This reduces their capacity to lend, including to small and medium-sized enterprises (SMEs) which rely on bank lending to a much greater extent than larger companies. This in turn affects economic growth and job creation.

In the past, high levels of NPLs have led to particularly difficult situations in some Member States, negatively impacting financial stability.

What has the Commission done so far to tackle NPLs?

Since the financial crisis, making banks stronger has been one of the Commission's main goals. It has put forward over 50 proposals to increase the resilience of the financial sector and help protect the economy. Moreover, the Commission has been working together with Member States concerned to address banks' high level of NPLs, including through setting up ad hoc and system-wide impaired assets measures compatible with state aid rules, as well as through the European Semester. Member States,supervisors and banks themselves have made great progress in cleaning up bank balance sheets since the crisis. The Commission's First Progress Report on the Reduction of Non-Performing Loans in Europe, published on 18 January 2018, showed that risk reduction measures taken since the financial crisis have resulted in a significant improvement in banks' solvency, leverage and liquidity positions. It is important to build on these efforts, consolidate the trend and prevent the build-up of new NPLs.

More recently, the Commission has also put forward several further substantial measures to reduce risks and enhance the resilience of the EU banking sector. For example, in November 2016, the Commission proposed a significant legislative package to review the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR), the Capital Requirements Directive IV (CRDIV) and Capital Requirements Regulation (CRR) with the objective of further reducing risks in the banking sector. That same year, the Commission also adopted a proposal for a Directive on preventive restructuring procedures, second chance for entrepreneurs, and the efficiency of insolvency frameworks. Effective insolvency rules are essential for the reduction of NPLs and for a well-functioning Capital Markets Union. The Commission now, once again, calls on the European Parliament and the Council to show determination on these important files in order to facilitate their swift adoption.

In line with the ECOFIN Action Plan, the Commission announced in its Communication on Completing the Banking Union in October 2017 that it would present a comprehensive package for tackling high NPL ratios by March 2018.In addition, the Commission's EMU package of 6 December 2017 presented a roadmap and concrete proposals for the deepening of Europe's Economic and Monetary Union.

What is the Commission proposing today and why?

Today's ambitious package of measures is the Commission's response to the call by the Council for further measures to address the problem of non-performing loans in the EU as set out in its [Action Plan](#) of July 2017.

The proposal consists of the following key measures:

1. Ensuring sufficient loss coverage by banks for future NPLs
   - To prevent a future build-up of non-performing loans, the Commission is proposing a Regulation that amends the existing Capital Requirement Regulation (CRR) for banks. The proposal establishes common minimum levels for the amount of money banks need to set aside to cover losses caused by future loans that turn non-performing. In case a bank does not meet the applicable minimum level, deductions from own funds would apply.
   - The minimum coverage levels will act as a **statutory prudential backstop** for newly originated loans that become non-performing. The Commission further proposes to introduce a common definition of non-performing exposures (NPE), in accordance with the one already used for supervisory reporting purposes.
2. Providing more efficient value recovery from secured loans
   - The Directive on credit servicers, credit purchasers and the recovery of collateral will provide secured creditors with an efficient mechanism to recover the value from loans guaranteed with collateral when the borrower of a loan defaults.
   - Facilitating **out-of-court collateral enforcement** will allow banks to seize the collateral that underpins a loan in an expedited way, without going to court.
   - Out-of-court collateral enforcement is strictly limited to loans granted to businesses**. Consumer loans are excluded**. It is only applicable where the business explicitly agreed to it when concluding the loan contract.
3. Establishing a secondary market for NPLs
   - The Directive on credit servicers, credit purchasers and the recovery of collateral will also foster the development of **secondary markets** for NPLs by removing undue barriers to credit servicing and to the transfer of bank loans to third parties across the EU ('passporting').
   - The proposal defines the activities of credit servicers, sets common standards for authorisation and supervision and imposes conduct rules across the EU.
   - Purchasers of bank loans are required to notify authorities when acquiring a loan. Third-country purchasers of consumer loans are required to use authorised EU credit servicers.
   - Consumer protection is ensured by legal safeguards and transparency rules so that the transfer of a loan does not affect the rights and interest of the borrower.
4. Providing technical guidance on how to set up national Asset Management Companies (AMCs)
   - A non-binding **blueprint for how national Asset Management Companies** (AMCs) or other measures can be set up in compliance with existing EU banking and State aid rules, should they find it useful.
   - While considering AMCs with a State aid element as an exceptional solution, the blueprint clarifies the permissible design and state aid conditions of AMCs receiving public support.
   - The blueprint suggests a number of common principles, on the set-up, governance and operations of AMCs. The blueprint draws on experience and best practices from AMCs or other measures already set up in Member States.

In addition, the Commission is also presenting today its second progress report on the reduction of NPLs in Europe.

What does the latest progress report on NPLs show?

The second progress report published today shows that the trend of falling NPL ratios is continuing and that the quality of banks' loans portfolios improved. This is the result of continuing economic growth in the EU as well as the outcome of various pro-active measures, including sales of NPL portfolios.

Key findings:

- The latest data indicates that the NPL ratio dropped to 4.4% in Q3 2017, bringing it down by roughly 1 percentage point year-on-year and at its lowest level since Q4 2014. This is the result of a decrease in the volume of NPLs, as well as a rise of the volume of loans in the EU. The provisioning ratio has remained stable, amounting to 50.7% in Q3 2017.

- Nevertheless, the total volume of NPLs in the EU remains well above pre-crisis levels (€910 billion). Uneven NPL ratios across the EU – ranging from 0.7% to 46.7% – and slow progress in some Member

States remain a source of concern.

- Structural obstacles prevent a faster fall in NPL stocks: provisioning remains slow and insufficient to effectively resolve and prevent a future build-up of NPLs. Furthermore, the secondary market for NPLs does not yet substantially support the reduction of NPLs. At the same time, debt restructuring, insolvency and debt recovery processes are still too slow and lack legal certainty in some cases.

Why do you want to develop secondary markets for NPLs?

A functioning secondary market allows banks to clean their balance sheets by selling NPLs to interested buyers. Without this, banks have to keep NPLs on their balance sheets until they are fully written off. This reduces their profitability and capacity to lend to new customers.

There are currently too few investors willing and able to buy NPLs relative to the large amount of NPLs on European banks' balance sheets. Market entry is difficult for new investors because the business of loan sales is complex and the relevant rules differ considerably across the EU.

The Directive proposed today:

- specifies entry conditions for loan servicers. Usually, NPL investors do not ask the bank from which they bought the NPLs to continue administering and collecting the loans. Instead, they often delegate these activities to independent firms called loan servicers. A lack of loan servicers discourages NPL investors from entering the market. Therefore, entry conditions and conduct rules for loan servicers play a crucial role in developing a secondary market for NPLs;
- reduces legal uncertainty, by defining what credit servicers are and what activities they can perform;
- develops an EU passport, enabling actors to conduct business across Member States;
- helps credit purchasers in obtaining the information they need to properly analyse and value the portfolios they are interested in.

How will you ensure consumer protection?

Today's proposals strike an important balance between enabling banks to recover the value of loans they provided, while protecting European citizens and business from reckless credit enforcement. The proposal complies with existing legal standards, especially those related to borrower and data protection.

Credit servicers need to demonstrate an organisational structure that allows them to comply with borrower rights and data protection. They are also required to set up procedures to deal with vulnerable groups and borrower complaints and they need to inform borrowers about the supervisors that follow up on borrowers' complaints. Credit servicers are not allowed to request fees to deal with complaints. Supervisors are empowered to review this, to follow up on borrower complaints and to apply sanctions if necessary.

Furthermore, credit purchasers need to respect the rights and obligations of the initial credit agreement and have the obligation to inform supervisors whether they enforce the debt directly or delegate this to a dedicated credit servicer. If the loan purchaser is from a third country and bought consumer loans, it is obliged to use an EU-supervised loan servicer.

Why does the Action Plan foster the availability of out-of-court collateral enforcement?

Effective out-of-court enforcement can help prevent the accumulation of NPLs. It enables banks to recover value more swiftly from loans granted to companies and entrepreneurs. This is why it is also a priority action of the Mid-term Review of the Capital Markets Union Action Plan.

Out-of-court enforcement mechanisms provide secured creditors with legal instruments to enforce collateral more quickly. However, these solutions currently do not exist in all Member States for all types of collateral. Convergence in enforcement would increase lending to companies, in particular to small and medium-sized enterprises (SMEs) and across borders.

Today's proposal complements the 2016 Commission proposal on preventative business restructuring and second chance, which is now being discussed by the European Parliament and Member States.

How would the new out-of-court enforcement work?

The proposed new mechanism for out-of-court accelerated collateral enforcement would have to be agreed between a bank and borrower upfront, normally when the loan is granted. It is not available for consumer loans and for real estate serving as the borrower's primary residence.

Where this new mechanism has been agreed between the parties and if the borrower defaults on the loan, the collateral would be valued and then sold, with proceeds turned over to the creditor. The proposed rules aim to balance the creditor's and the borrower's interests in various ways. For example:

- The creditor needs to give the borrower a certain amount of time to make the due payments and avert enforcement.
- The valuation and sale would have to follow certain rules, e.g. be via public auction depending on what Member States choose, to ensure a fair price.
- The borrower has the right to go to court in case these rules are disobeyed.
- The creditor only gets to keep the proceeds to the extent necessary to cover the outstanding amounts on the loan. Excess proceeds are paid out to the borrower.
- Member States may decide that where proceeds from the collateral fall short of the outstanding amount on the loan, the loan shall nevertheless be considered as fully settled.

Why do we need a statutory prudential backstop?

If banks do not put aside – or provision - enough money for NPLs, they cannot write those loans off their balance sheets and bad loans can start to pile up. This can undermine the bank's profitability, its solvency and as a consequence its long-term viability. Although average provisioning levels have recently increased across Member States, loss recognition is still low and too slow to effectively resolve NPLs. This is why existing rules need to be complemented by a statutory prudential tool that acts as a backstop against future build-up of insufficiently provisioned NPLs.

How does the statutory backstop interact with existing accounting rules and supervisory powers?

Legally, the backstop is a minimum (i.e. "Pillar 1") requirement directly applicable to all banks that are subject to the Capital Requirements Regulation. Banks would need to continue to recognise accounting provisions in line with their assessment and applicable accounting standards. Those provisions, including potential increases in provisions as a result of new accounting standard IFRS 9, would be taken fully into account for the purposes of the prudential backstop.

Competent authorities already have several tools at their disposal that can be used to address NPLs in specific banks. Their supervisory powers concern bank-specific measures (i.e. "Pillar 2") in accordance with the Capital Requirements Directive. Most notably, competent authorities can decide on a case-by-case basis that, despite the application of the statutory prudential backstop, the NPLs of a bank are not sufficiently covered. In those cases they can require individual banks to increase provisioning levels.

With the view of ensuring consistency in the prudential framework, the common definition of non-performing exposures (NPE), which is already used for supervisory reporting purposes, would also apply in the context of the statutory prudential backstop.

How does the statutory backstop work?

The statutory prudential backstop would consist of common minimum coverage levels against which banks would need to compare the amounts of money they set aside to cover incurred and expected losses on newly-originated loans that become non-performing in future. In case the amounts set aside by a bank were below the applicable minimum level, the difference would be deducted from its own funds. This would prevent new NPLs from building up by ensuring that losses are sufficiently covered.

The common minimum coverage level would increase gradually depending on how long an exposure has been classified as non-performing. The annual increase of the minimum coverage requirement is lower during the first years after the classification of an exposure as non-performing. This gradual increase reflects the fact that the longer an exposure has been non-performing, the lower the probability to recover the amounts due.

Different coverage requirements apply, depending on the classification of the NPLs as 'unsecured' or 'secured'.

How does the classification of an NPL as 'unsecured' or 'secured' impact its treatment under the proposal?

- **Secured NPLs** are in general less risky than unsecured NPLs as they give the bank a specific claim on an asset or against a third party (i.e. the loan may be backed by collateral, for example a house, or covered by a guarantee from a third party). At the same time, depending on the type of collateral/guarantee provided, it can take some additional time to enforce that specific claim (for example, enforcing a claim on securities offered as collateral takes less time than securing a claim on a property offered as collateral).The proposal takes this into account by applying minimum coverage levels that increase gradually over time. Only if the bank has not been able to realise the collateral securing the loan after 8 years, the collateral would be seen as ineffective and the bank would be required to fully cover the secured NPLs.
- **Unsecured NPLs** require higher and timelier minimum loss coverage by the creditor bank than

secured NPLs because they are not secured by collateral or guarantees and are therefore considered riskier than secured NPLs. Consequently, the maximum coverage requirement applies as of the second year for unsecured NPLs.

	Minimum coverage level (in %)							
After year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Secured	5	10	17.5	27.5	40	55	75	100
Unsecured	35	100						

Does the backstop differentiate between NPLs also based on other types of characteristics?

The level of the backstop also depends on whether the debtor is still paying its instalments. A loan can be an NPL not only because it is past-due, but also because it is considered unlikely-to-pay in the future, albeit it is still paying currently. In cases where the bank still receives full payment from the borrower without excessive delay, the losses for the bank are in general expected to be lower and it is justified to apply a lower minimum coverage requirement (up to 80%, instead of up to 100%).

What are Asset Management Companies (AMCs) and why do we need a European blueprint?

Experience in several Member States has demonstrated that national asset management companies can be an effective tool to help banks clean up certain parts of their balance sheets under certain conditions. Transferring non-performing loans from banks to an AMC allows banks to focus on their core task of lending and offering services to households and firms.

These companies have proven useful and can contribute to the repair of the banks' balance sheets by:

- improving information and transparency in the secondary market for NPLs; and
- encouraging new investors to enter the market.

Generally, AMCs can be set up to deal with NPLs from individual banks or to manage bad loans from several banks in a Member State. They can be either privately or publicly owned and receive various degrees of public support, if set up in line with state aid rules.

A European blueprint helps Member States interested to set up national AMCs in full compliance with EU banking and State aid rules. It is based on existing market experience and sets out best practices on how AMCs can be established and managed.

What are the key guidelines set out in the blueprint?

The blueprint provides practical, non-binding guidance for the design and set-up of AMCs at the national level, building upon best practices from past experiences in Member States, to the extent applicable. AMCs can be private or (partly) publicly supported with no need for State aid, if the State can be considered to act as any other economic agent. The option of an AMC involving State aid should not be seen as the default solution.

That said, considering AMCs with a State aid element as an exceptional solution, the blueprint aims to clarify the permissible design for such AMCs, fully consistent with the EU legal framework, particularly the BRRD, the SRMR and State aid rules.

The blueprint suggests a number of common principles, such as:

- the relevant asset perimeter;
- the participation perimeter;
- considerations on the asset-size threshold;
- asset valuation rules;
- the appropriate capital structure; and
- the governance and operations of the AMC.

In addition, the blueprint describes certain alternative impaired asset relief measures that do not constitute State aid, such as market-conform State guarantees enabling the securitisation of NPLs. The Commission has in the past years also assessed other measures proposed by Member States to deal with legacy NPLs and will continue to do so in individual cases, in order to ensure that these measures fully respect the BRRD, SRMR and State aid rules.

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