NPL policy action: supervising in the rear-view mirror?

EU policymakers have gone to great lengths to deal with what they continue to see as banking's bête noire: non-performing loans. But given the dramatic improvement in the overall NPL situation, there is a danger that policy, regulatory and supervisory endeavour in this area is being over-engineered in order to complete Banking Union rather than because of intrinsic concerns over bank balance sheets.

"NPLs clearly remain a major problem … Carrying the residual problems of the crisis to the next downturn is not a viable option," warned ECB Supervisory Board Chair Daniele Nouy at the ECB Banking Supervision annual press conference on February 7. Copious official output on NPLs in 2017 (see Appendix 1) has given birth to a relentless calendar of expected action in 2018 (see Appendix 2).

The resolute focus from policymakers is nominally attributed to grave concerns over the propensity of NPLs to threaten financial stability, impact the viability of the banks affected, undermine profitability, and deflect the time and resources of bank management. The over-arching aim of policy action is not just to cut legacy stocks but also to prevent future NPL build-up and minimise under-provisioning.

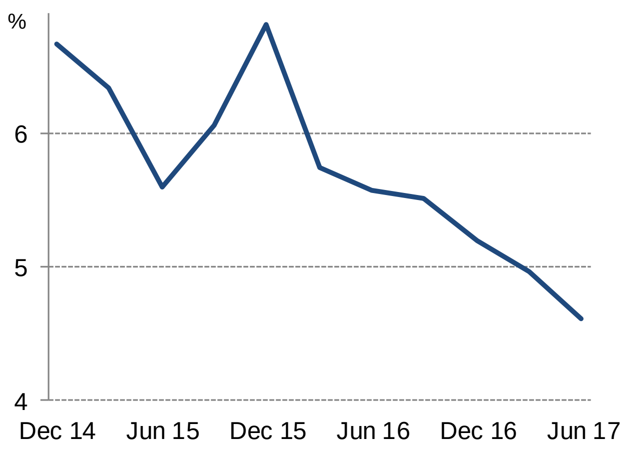
The stock of EU NPLs – at €950bn As of Q2 2017 – may be optically high, but country-by-country data is highly dispersed: NPLs as a percentage of gross loans and advances range from 0.7% to 46.9% across the EU. That tells the story not of an entrenched region-wide problem but an idiosyncratic one largely affecting banks operating in a nucleus of semi-core and peripheral EU countries recovering from macroeconomic shocks.

At the February 7 press conference, Daniele Nouy acknowledged that euro-area NPLs had decreased by over €200bn over the past few years to €760bn in the third quarter of 2017. The European Commission had previously acknowledged improvements in its January 18 Progress Report on the Reduction of Non-Performing Loans in Europe and the accompanying January 23 staff working document.

Those first granular attempts at a factual stock-take of developments since the NPL action plan was adopted last July found lower aggregate NPL ratios, higher coverage ratios, and better-quality loan portfolios.

Non-performing loans in the EU

Figure 1: Total gross non-performing loans and advances, in % of total gross loans and advances, end-of-quarter values



Source: European Central Bank

Author

Keith Mullin
k.mullin@scopegroup.com

Analysts

Guillaume Jolivet
g.jolivet@scoperatings.com

Marco Troiano
m.troiano@scoperatings.com

Press Contact

André Fischer
an.fischer@scopeanalysis.com

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Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

In the circumstances, imposing stringent conditions on the entire EU banking sector looks heavy-handed. Particularly items such as possible amendments to the Capital Requirements Directive that will impose statutory prudential backstops against NPLs arising from new loans. In an IFRS 9 world, banks have already shifted to front-loaded assessments for expected credit losses from ex-post action.

Imposing stringent conditions on the entire EU banking sector looks heavy-handed.

“The supervisory focus on NPLs at this point in the economic cycle is like looking in the rear-view mirror,” said Marco Troiano, executive director in Scope Ratings’ banking team. “One of the criticisms I have of the current approach is the rush to push banks to get rid of NPLs as fast as possible whatever the cost. This is putting pressure on them to sell into a market with a limited number of buyers and contributing to depressed secondary prices that can sometimes create capital problems.

“Take Italy as an example. You have a banking sector that is barely profitable. With few exceptions banks are generating returns on equity in the low single-digits area but are selling at prices implying 15%-20% internal rates of return for buyers. This transfer of value from the banks to the non-bank sector is not necessarily good for stability.

“Given that asset quality is a lagged function of the economic cycle, it takes a few quarters after a country comes out of recession before you start to see improvements in dynamics that ultimately result in NPL improvements. Focusing on asset quality is, again, like looking in the rear-view mirror. We try to be forward-looking, thinking about whether the economic recovery will hold; and focusing on longer-term banking trends such as business-model changes and banks’ ability to adapt,” Troiano said.

For Scope, NPLs are becoming more marginal from a credit analysis perspective: “we assess how long a given bank will be forced to continue provisioning against NPLs and to what extent they are likely to impair profitability but it’s not the main element of our analysis,” added Troiano.

Active deal flow

Improvements in the overall NPL picture have been driven principally by portfolio sales (approximately €72bn gross value in Italy alone in 2017) but there was a flow of public NPL securitisations too, mainly in Italy but in other high NPL countries too.

Indeed, on the same day as the ECB Banking Supervision press conference, UniCredit announced the completion of the final phase of its €17.7bn Project Fino NPL disposal, comprising some of its retained exposure in Class B, C and D Notes previously issued by the Fino 1 and Fino 2 Securitization vehicles (the bank’s position is now below 20%); and placement of €617.6m in GACS-Guaranteed Senior Notes issued by Fino 1.

In Italy, we expect a sharp increase in GACS-eligible securitisations.

Scope Ratings has a very optimistic outlook on NPL securitisation: “In Italy, we expect a sharp increase in GACS-eligible securitisations to €40bn-€45bn in gross book-value NPL sales in 2018. Developments since we framed our initial outlook at the end of last year suggest activity could exceed our initial expectations,” said Guillaume Jolivet, managing director in Scope’s structured finance team.

“The extension of the GACs scheme is a key development and will encourage more players into the market. Since timing uncertainty, asset depreciation and additional legal costs affect the value of NPLs, improving the efficiency of the enforcement framework for defaulted secured loans i.e. the legal procedures to enforce security or the ability to resolve a situation out-of-court will also help, as they will make NPLs more valuable on the basis that you can recover more quickly.”

Beyond Italy, Jolivet thinks more deals could emerge, particularly towards the end of 2018, in Spain, Portugal and Greece. “For deals in other jurisdictions to emerge, the loan servicing market needs to develop,” he said. “In Italy, there is a universe of well identified specialists involved in a number of significant projects. Other jurisdictions need to demonstrate similar capacity.”

Market-structure improvements will help boost activity in 2018

There has been movement on this issue: more than a dozen first-time servicing licences were granted in Greece and Cyprus last year. Activity is also likely to be boosted by key legal amendments and market-structure adjustments in various countries adopted in 2017.

Amendments to Law 130/1999 governing loan securitisation in Italy were implemented, for example, widening the scope for manoeuvre of SPVs. This is expected to make it easier to securitise certain categories of loans (such as Unlikely to Pay) and encourage participation in foreclosure auctions.

Further, Greece’s out-of-court electronic settlement platform (Law 4469/2017) became effective last August, followed by the first auctions of foreclosed properties. The platform is designed to facilitate the restructuring of arrears owed by around 300,000 private-sector companies to banks, government, suppliers and employees.

Boosting secondary trading

Among structural impediments to cutting NPLs on an accelerated schedule, the Commission is preoccupied by what it sees as insufficient secondary market activity and a paucity of buyers relative to the stock of NPLs so wants to broaden the market ecosystem.

Beyond lowering barriers-to-entry for loan servicers and recovery agents (already in play), they plan to create incentives for smaller investors to bid for smaller loan portfolios held by small and medium-sized banks. They are also working on uniform standards for asset management companies (AMCs).

Policymakers are preoccupied by insufficient secondary market activity are pushing hard to establish a transaction platform

And they are pushing hard to establish a private sector-led transaction platform to improve the transparency, availability and comparability of NPL data. The thinking is that the platform can take care of data warehousing, trade reporting and potentially even trade execution, thereby eliminating information asymmetries and contributing to growth in trading by lowering barriers to entry to new investors and narrowing bid/offer spreads.

A central platform can also support securitisation by providing transparency around underlying pools. Among other things, the hope is that a platform can act as an efficient offload channel for AMCs. Scope analysts are not convinced: “The information gap has a cost and leads investors to demand higher returns, so more transparency and better data quality will help. But the heterogeneity of loans and loan collateral are an issue,” said Jolivet.

“Loans are deeply rooted in local markets that function differently; they have security models and origination practices that differ not only from market to market but from bank to bank. Having a database that is rigorous and reliable enough to perform benchmarking analysis will be a huge challenge.”

Jolivet’s comments are echoed by Marco Troiano: “NPLs are not commodities. You can’t compare one NPL with another. It depends on who originated the loans and to what origination standards. You have different levels of collateralisation, different documentation quality; and there are differences not just between countries but within the same country,” he said.

"In Italy, whether loans were originated in one province or another can make a big difference in the time it takes to execute on things like security; some courts are more efficient or have better procedures than others. NPLs are a complex product and recovery strategies are highly tailored. Putting them on a platform can be helpful at the margin but will it be a game changer? I don't think so."

Efforts are in play to bring more investors into the market. Securitisation could be the channel to make this happen

On the issue of enticing more investors into the NPL market, Jolivet thinks securitisation will be the channel to make this happen rather than an influx of new portfolio buyers. "If you go for a portfolio sale, you need to find a qualified investor. That investor will be highly sophisticated, will scrutinise your portfolio and generally be very demanding. But a sale can be arranged relatively quickly," he said.

"Securitisation provides a higher level of transparency to the market and you can reach out to a broader investor base, even though deals take longer to arrange because they involve several third parties including rating agencies and the definition of a liability structure. In the case of GACS transactions, it's reasonable to expect that deals done in 2017 will open the way to more in 2018 because issuing banks can get a better price for the assets due to the lower discount rate and therefore reduce losses on the sale.

"Hedge funds may dislike GACS because it reduces the pricing power they had before the scheme was introduced but more GACS issuance will likely expand the investor base. Less sophisticated buyers seeking higher returns may be willing to look at rated NPL securitisations, for example, and buy if they're investment-grade."

Summary

Non-performing loans in Europe represent an idiosyncratic problem rather than a broad region-wide one. NPL ratios are high at a relatively small nucleus of banks in jurisdictions that suffered macroeconomic shocks.

The NPL situation is generally thought to have ceased being a source of region-wide systemic instability; transmission effects from resolution situations in 2017 were extremely limited.

Market-structure improvements and legal amendments in various EU countries – including Italy, Greece and Cyprus – are likely to facilitate deal flow across portfolio sales and securitisation. Activity is generally expected to be robust in 2018.

Against this improving backdrop, the raft of policy initiatives and actions expected in 2018 look heavy-handed.

There seems to be little confidence that the much-vaunted NPL transaction platform will make much of a difference and accelerate loan transfers.

Securitisation is likely to be the channel to bring more investors into the NPL market; rather than an increase in the number of portfolio buyers.

Figure 1: Non-performing loans and provisions by Member State

	Gross NPLs and advances (% of total gross loans and advances)		Private sector NPLs (% of private-sector loans)		Total loss provisions (loans) (% of total doubtful and non-performing loans)	
	2017Q2	2016Q2	2017Q2	2016Q2	2017Q2	2016Q2
Belgium	2.8	3.5	4.0	4.5	50.1	48.6
Bulgaria	12.1	14	19.2	22.4	54.8**	53.2**
Czech Republic	2.9	4.6	5.3	6.7	53.1	45.4
Denmark	2.9	3.6	3.2	4	38.4	39
Germany	2.3	2.8	4.3	5	43.6**	42.4**
Estonia	2	2.1	2.5	2.7	44.6	50.2
Ireland	11.6	14.6	15.8	18.9	37.6	42.2
Greece	46.9	47.2	50.6	50.1	49.2	49.8
Spain	5.3	5.9	7.1	7.7	59.9**	59.8**
France	3.4	3.9	4.6	4.9	59.7	60.2
Croatia	11.7	11.6	16.5	16.9	68.8	71.8
Italy	12.2	16.2	15.9	20	52.9	49.5
Cyprus	33.4	37.6	52.7	56.2	47.1	38.8
Latvia	5.9	5.5	9.3	8.9	43.8	53.6
Lithuania	3.7	5.0	4.9	6.5	36.3	37.5
Luxembourg	0.7	0.9	1.8	2.3	51.6	39.2
Hungary	10.4	15	15.3	23	66.4**	63.8**
Malta	3.7	4.6	6.7	7.4	41.8	44.3
Netherlands	2.3	2.6	3	3.1	38.3	41.8
Austria	4.1	6	5.7	7.5	62.6	59.1
Poland	6.6	6.7	7.2	7.3	58	60.5
Portugal	15.5	17.6	15.5*	17.6*	49.4	47.6
Romania	8.5	11.3	11	15.3	69.4	62.3
Slovenia	11.4	16.3	14.7	21.2	70.4	70.1
Slovakia	4.1	5.1	4.7	5.7	68.9	63.4
Finland	1.4	1.4	2.1	2.1	31.9	35.8
Sweden	1.2	1.2	1.4	1.5	34.8	34.5
United Kingdom	1.6	2.2	2.5	2.2*	40.6	39.4
European Union	**4.6**	**5.6**	**4.7***	**5.6***	**50.8****	**47.6****

* Due to the unavailability of sector-specific data for Portugal and the EU, NPL figures correspond to loans and advances to all sectors. NPL policy action: supervising in the rear the rear-view mirror? 13 February 2018 5/7

** Due to the unavailability of provisioning data for loans, the provisioning ratios for Bulgaria, Germany, Hungary, Spain, and the EU were calculated by considering impairments and NPLs for all debt instruments, including both loans and debt securities.

Notes: Figures correspond to domestic credit institutions as well as foreign-controlled subsidiaries and branches.
Source: ECB, Consolidated Banking Data (CBD2)

I. Appendix: 2017 selected official NPL-related reports and papers

- Progress in the Reduction of Non-Performing Loans in Europe,
  European Commission, January 2018
- Staff working document: First progress report on the reduction of non-performing loans in Europe,
  European Commission, January 2018
- EBA publishes its standardised data templates as a step to reduce NPLs,
  European Banking Authority, December 2017
- Overcoming non-performing loan market failures with transaction platforms,
  European Central Bank Financial Stability Review, November 2017
- Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures,
  European Central Bank, October 2017
- Communication on Completing the Banking Union,
  European Commission, October 2017
- Fact Sheet – Completing the Banking Union by 2018,
  European Commission, October 2017
- Resolving non-performing loans in Europe,
  European Systemic Risk Board, July 2017
- Council sets out action plan for non-performing loans,
  Council of the European Union, July 2017
- Stocktake of national supervisory practices and legal frameworks related to NPLs,
  European Central Bank, June 2017
- Inception Impact Assessment: Development of secondary markets for non-performing loans,
  European Commission, June 2017
- Mid-Term Review of the Capital Markets Union Action Plan,
  European Commission, June 2017
- Staff working document. Economic Analysis Accompanying the Mid-Term Review of the Capital Markets Union Action Plan,
  European Commission, June 2017
- Report of the FSC Subgroup on Non-Performing Loans,
  Council of the European Union, May 2017
- Guidance to banks on Non-Performing Loans,
  European Central Bank, March 2017

II. Appendix: Expected policy actions in 2018

- The ECB, EC and EBA expect to complete work on a transaction platform to strengthen the data infrastructure for NPLs within weeks.
- The EC is drawing up a European approach to develop secondary NPL markets.
- The ECB expects to publish by mid-March its final addendum to guidance that will specify how and when it expects banks to provision for new NPLs. The date from which the guidance applies to new NPLs has been shifted by a few months.
- The ECB is working with the EBA Task Force on NPLs and expects to devise – by summer 2018 – final guidelines on NPL exposure management. A public consultation is expected to go out by the end of March.
- Draft EBA guidelines on banks' monitoring of loan origination and internal governance are expected to be submitted for public consultation in summer 2018, with an end-2018 deadline for final guidelines.
- A decision is expected 2018 on whether the SSM's NPL guidance will be extended to Less Significant Institutions.
- By the end of 2018, the Ecofin Council has a mandate to implement enhanced disclosure requirements on asset quality and NPLs for all banks, including disclosure on gross carrying amount and accumulated impairments of performing, non-performing and forborne exposures, as well as collateral and guarantees received.
- Also on the radar are measures to enhance the position of secured creditors in recovering value from secured loans via out-of-court processes (Accelerated Extrajudicial Collateral Enforcement). A priority action under the Mid-term Review of the Capital Markets Union Action Plan, harmonising the legal frameworks governing collateral enforcement is designed to prevent future NPL build-up and, from a Banking Union standpoint, incentivise banks to make cross-border corporate loans.
- To prevent NPL build-up and discourage under-provisioning, the EC is considering amendments to the Capital Requirements Directive to introduce statutory (Pillar 1) prudential backstops against NPLs arising from new loans. These would set common minimum levels of capital to cover incurred and expected losses on NPLs.
- Results from a targeted consultation were presented to the Commission Expert Group on NPLs in December 2017. Based on this and EBA consultation, the EC is finalising its impact assessment. As part of this process, it is considering a common definition of non-performing exposures.
- The ESRB has a dedicated workstream focusing on macroprudential approaches to prevent the emergence of system-wide NPL problems.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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