

Pierluigi Martino

**NON-PERFORMING LOANS
IN EUROPEAN BANKS**

**Management
and Resolution**

FrancoAngeli

Informazioni per il lettore

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TABLE OF CONTENTS

Introduction	pag.	11
1. Non-performing loans in European banks	»	15
1.1. Financial crises and non-performing loans	»	15
1.2. Determinants of NPLs: A literature review	»	19
1.2.1. Macro-economic determinants of NPLs	»	19
1.2.2. Structural drivers of NPLs	»	23
1.2.3. Studies that combine economic and structural determinants of NPLs	»	25
1.3. The implications of NPLs	»	29
1.4. NPLs in the EU: Overview and data	»	34
1.4.1. The data on NPLs in the EU: Trends from 2014	»	35
1.4.2. NPLs in Italy: Overview and data	»	41
1.5. Conclusions	»	44
2. Non-performing loans: The regulatory approach and the supervisory approach in the European Union	»	45
2.1. Introduction	»	45
2.2. The European Banking Union: General remarks and NPL issues	»	46
2.3. Europe-level NPL regulation initiatives	»	50
2.3.1. The EBA Technical Standards	»	50
2.3.1.1. Non-performing exposures	»	52
2.3.1.2. Forborne exposures	»	53
2.3.2. The ECB Guidance on NPLs	»	55
2.3.2.1. The ECB Addendum to the Guidance: Supervisory expectations for prudential provisioning of NPEs	»	67

2.4. The recent disposal on NPL regulation	pag.	70
2.5. The regulation of NPLs in Italy	»	73
2.5.1. The Bank of Italy’s classification of NPLs: The 7° updating of circular 272 (Matrice dei conti) of 30 July 2008	»	74
2.5.2. The Bank of Italy’s Guidance on the management of NPLs for Italian “less significant institutions”	»	75
2.6. The regulation of NPLs: Next perspectives	»	78
2.7. Conclusions	»	80
3. The management and resolution of non-performing loans	»	81
3.1. Introduction	»	81
3.2. The maintenance of NPLs on banks’ balance sheets	»	83
3.2.1. The internal management of NPLs by banks	»	84
3.2.2. The outsourcing of NPL management	»	86
3.3. Asset Protection Schemes	»	87
3.4. Sale of NPLs	»	88
3.5. Securitisation	»	91
3.5.1. Securitisation in Italy: The amendment to Law 130/1999 on securitisation	»	93
3.5.2. The introduction of a state guarantee system on the securitisation of NPLs (GACS)	»	94
3.5.3. The institution of the Atlante Fund	»	97
3.6. Asset management companies or bad banks	»	99
3.6.1. A European bad bank: The EBA’s proposal	»	101
3.7. Conclusions	»	104
4. A comparison of the non-performing loan resolution strategies of significant institutions	»	106
4.1. Introduction	»	106
4.2. The case of Portugal	»	108
4.3. The case of Spain	»	112
4.4. The case of Ireland	»	116
4.5. The case of Italy	»	119
4.6. Conclusions	»	131
Final remarks	»	133
References	»	139

LIST OF FIGURES AND TABLES

List of figures

Chapter 1

Figure 1.1 – NPL ratio, country dispersion (data as of December 2015)	pag.	36
Figure 1.2 – EU NPL ratio trend (December 2014 – June 2018)	»	37
Figure 1.3 – NPL ratio, country dispersion (data as of December 2016)	»	38
Figure 1.4 – NPL ratio, country dispersion (data as of December 2017)	»	39
Figure 1.5 – NPL ratio, country dispersion (data as of June 2018)	»	40
Figure 1.6 – NPL ratios of the EU and the U.S., 2009 to 2017 (in %)	»	41
Figure 1.7 – Italy's NPLs between 2006 and June 2018	»	42
Figure 1.8 – Italy's NPL ratios (%) between December 2015 and June 2018	»	43

Chapter 2

Figure 2.1 – Illustration of the umbrella approach to the definitions of forbearance and NPEs	»	51
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Chapter 3

Figure 3.1 – A non-exhaustive taxonomy of options for addressing NPLs	»	82
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List of tables

Chapter 2

Table 2.1 – Overview of the quantitative expectations » 69

Chapter 4

Table 4.1 – Sample of significant institutions » 107

LIST OF ABBREVIATIONS

Abbreviations

ABS/s	asset-backed security/ies
AECE/s	extrajudicial collateral enforcement procedure
AMC/s	asset management company/ies
APS	asset protection scheme
AQR/s	asset quality review(s)
BCBS	Basel Committee on Banking Supervision
BRRD	Bank Recovery and Resolution Directive
BU	Banking Union
CAP	capital adequacy ratio
CDS/s	credit default swap(s)
CEE countries	central and eastern European countries
CESEE countries	central, eastern and south-eastern European countries
CET 1	Common Equity Tier 1
CMU	Capital Markets Union
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EBU	European Banking Union
EC	European Commission
ECAI/s	external credit assessment institution(s)
ECB	European Central Bank
ECL	expected credit loss
EDIS	European Deposit Insurance Scheme
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ESFS	European System of Financial Supervision
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union

FBE/s	forbearance exposure/s
FBL	forborne loans
FINREP	financial reporting
FSC	Council's Financial Services Committee
FSR	Financial Stability Report (by the Bank of Italy)
GAAP	Generally accepted accounting principles
GACS	<i>Garanzia sulla cartolarizzazione delle sofferenze</i>
GCC region	Gulf Cooperative Council region
GDP	gross domestic product
ICAAP	internal capital adequacy assessment process
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IT/s	information technology/ies
ITS/s	Implementing Technical Standard/s
KPI/s	key performance indicator(s)
MEF	Ministry of Economy and Finance
MPS	<i>Monte dei Paschi di Siena</i>
NAMA	National Asset Management Agency
NPE/s	non-performing exposure(s)
NPL/s	non-performing loan(s)
NSA/s	national supervisory authority/ies
OECD	Organisation for Economic Co-operation and Development
RAF	risk appetite framework
REOCO/s	real estate owned companies
ROA	return on assets
ROE	return on equity
RON/s	representative of the noteholder(s)
SAREB	<i>Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria</i>
SEE	South-eastern Europe
SI/s	significant institution/s
SME/s	small and medium-sized enterprise(s)
SPV/s	special-purpose vehicle/s
SRB	single resolution board
SREP	Supervisory Review and Evaluation Process
SRF	single resolution fund
SRM	single resolution mechanism
SRMR	single resolution mechanism regulation
SSM	single supervisory mechanism
STC	simple, transparent and comparable
STS	simple, transparent and standardised
TUB	<i>Testo Unico Bancario</i>
U.S.	United States of America

INTRODUCTION

The subprime mortgage financial crisis erupted in 2007, along with the subsequent sovereign debt crisis, has severely undermined European Union banks' stability, raising macro-economic concerns among EU institutions. Thus, over the past decade, the EU has taken various measures to reduce the risks in its banking sector, with the aim to strengthen banks' solvency, leverage and liquidity positions and, therefore, to restore the sector's soundness and stability.

A critical area of intervention by EU authorities to reduce risks in the banking sector has been the reduction of non-performing loans (NPLs).

The financial crisis and subsequent recessions that hit the EU have led to more widespread inability among borrowers to pay back their loans, as more people and companies faced payment difficulties and even bankruptcy. Thus, many EU banks experienced huge increases in NPL stock, generally defined as loans that are either more than 90 days past due or that are unlikely to be repaid in full. Specifically, these are exposures to customers (e.g. companies, families, etc.) which, owing to the deterioration of their economic and financial situations, have difficulties meeting all or part of their contractual obligations.

Large NPL stock is a primary challenge to EU banks and to the EU as a whole, given that high NPL levels have several implications for banks, which can be transmitted to the real economy. Indeed, the deterioration of banks' asset quality not only financially destabilises the banking system, but also reduces economic efficiency, impairs social welfare and lowers economic activity. In particular, high NPL levels on banks' balance sheets reduces their profitability, increases funding costs and ties up their capital, all of which negatively impact on credit supply and, ultimately, economic growth.

To reduce the high NPL stocks on EU banks' balance sheets, the EU authorities – namely the Council, the European Commission (EC), the

European Central Bank (ECB) and the European Banking Authority (EBA) – have all undertaken initiatives and measures to address NPLs and to improve the high-NPL situation across EU member states.

As a recent European Commission report (November 2018) noted, the quality of banks' loans portfolios has now improved, and NPL stocks continue to decrease among EU member states, owing particularly to efforts by the EU's banks and the key roles of the EU authorities and EU countries' national governments in ensuring favourable conditions for banks to dispose of NPLs, supported by improvements in the EU's economy. Despite this, NPLs continue to put pressure on the EU's banking sector by posing risks to economic growth and financial stability, with the total NPL volume across the Union still at €747.5 billion (EBA Risk Dashboard, June 2018), a level higher than other major developed countries. Further, uneven NPL ratios across the EU – ranging from 0.8 % to 44.8 % – and slow progress in some member states remain a source of concern.

In this book, I analyse NPL issues in the EU context, with a specific focus on Italy, given the high NPL levels in Italy's banking system. In particular, I examine the origins of NPLs in the EU, as well as their implications for banks, outlining the EU measures and actions undertaken in the EU to address NPLs and discussing the different solutions to address NPLs, namely NPL management and resolution strategies.

To address these issues, I have structured the book as follows. In Chapter 1, I provide an overview on the NPL issues in the EU context, outlining the origins of the problem, its implications for banks and the problem's magnitude. Specifically, I review the literature on the determinants of NPLs in the EU and discuss the different implications of NPLs for banks and for the EU economy. Finally, I present an overview of the NPL levels across the EU, with a specific focus on Italy.

In Chapter 2, I discuss EU institutions' approaches to NPLs. In particular, after outlining the developments that led to the European Banking Union after the global financial crisis, I discuss all the initiatives and measures that have been undertaken by the EU authorities in response to the NPL problem; these include: the EBA Final Technical Standards (ITS) on supervisory reporting on non-performing exposures and forbearance, whose aim was to harmonise the definitions of NPLs across the euro area countries; the ECB's measures, namely *Guidance to banks on non-performing loans*, which provides a number of best practices for NPL management, the *Addendum to the Guidance on supervisory expectations for prudential provisioning of non-performing exposures*, and the European Commission's measures package to address high NPL levels.

I also focus on the measures undertaken by the Bank of Italy in response to NPLs in Italy, in line with the aforementioned EU initiatives. Specifically, I focus on the following two most significant provisions by the Bank of Italy: the 7^o updating of circular 272 *Matrice dei conti* of 30 July 2008, which introduces the EBA's ITS on the definitions of *NPEs* and *forbearance* – and the Bank of Italy's Guidance on the management of NPLs for Italy's "less significant institutions".

Finally, in this chapter, I present the next perspectives concerning NPL regulations in the EU and outline measures in development.

In Chapter 3, I examine EU banks' main tools to address NPLs, as well as the interventions by EU authorities and EU member states in ensuring favourable conditions for banks to dispose of NPLs. To address high NPL stocks, banks have several strategic options available to them; these can be categorised as either on-balance sheet or off-balance sheet resolution methods, with the former involving the internal workout of NPLs by a bank, and the latter involving outright sales to private investors or a centralised workout. In between, there is a range of options such as asset protection schemes, securitisation and the creation of asset management companies. Each of these tools has different implications for a bank in terms of costs, risks and returns.

In this chapter, I discuss the main NPL management and resolution strategies adopted in the EU, highlighting their key features and implications in terms of advantages and limits.

In Chapter 4, I provide an overview of and discuss the NPL management and resolution strategies adopted by a sample of the EU's most significant banks. The sample comprises eight institutions from four member states: Portugal, Spain, Ireland and Italy, selected owing to their high NPL levels in relation to the EU average. I selected these banks based on their size (in total assets) from the ECB's *List of significant supervised entities* (as of 1 January 2018), which includes the significant and less significant credit institutions which are supervised entities on the basis of significance decisions by the ECB.

Specifically, in this chapter, I briefly outline on how EU banks have addressed NPL issues, highlighting the different approaches adopted to address NPLs and the resulting implications for banks.

In the final section – Final remarks – I provide a concluding discussion of my study.

1. NON-PERFORMING LOANS IN EUROPEAN BANKS

1.1. Financial crises and non-performing loans

The recent subprime mortgage financial crisis, together with the Eurozone sovereign debt crisis, has had negative consequences for financial systems and, thus, for economic systems around the world. Started by intense tensions in the financial systems of advanced economies, it unravelled into a dramatic contraction in global growth (Allegret et al., 2017).

In the EU, the financial crisis has had pervasive impacts on the real economy, which had adverse feedback effects on loan books, asset valuations and credit supply, generating heterogeneous and asymmetrical effects across European countries, especially in the Eurozone (Hristov et al., 2012). The financial crisis hit the various EU member states in different degrees, owing to their initial conditions and the associated vulnerabilities.

The provision of loans to high-risk borrowers (i.e. customers of poor quality) and the subsequent transfer of credit risk through securitisation and derivatives, together with the real estate market's downward trend, generated many defaults, which caused large losses in asset-backed securities (ABS) and credit derivatives (Colombini & Calabrò, 2011). Despite the first phase of the crisis – the subprime mortgage financial crisis erupted in 2007 in the United States (U.S.) owing to the large losses in the subprime mortgage market¹ – ended soon thanks to central banks' interventions, after the collapse of the large U.S. financial institution Lehman Brothers in late 2008 the financial

¹ Subprime mortgages are homeloans granted to borrowers whose credit histories are insufficient to qualify for prime mortgages, owing to their low credit scores or uncertain income prospects. These loans have relatively high interest rates designed to at least compensate for the higher risks involved in them.

crisis worsened, as it began to affect European countries as much as the U.S. through a spill-over process (Lane, 2012; Fiordalisi & Ricci, 2015).

At this stage, the crisis began to feed on itself: confidence collapsed, investors massively liquidated their positions, and stock markets went into a tailspin. As a result, banks were forced to restrain credit, economic activity plummeted, and loan books deteriorated, with banks forced to further cut credit. This financial distress was also soon transmitted to the real economy, with the credit restraint and sagging confidence affecting business investments and household demand, causing an economic downturn. The scarcity and high cost of credit led to the collapse of world trade and thus a sharp slump in production, followed by a fall in industrial companies' sales, which severely impacted on world economies and interrupted global growth (Cai-vano et al., 2010). According to the OECD's estimates, developed countries' GDPs fell by 4% between October 2008 and March 2009. In the EU, real GDP fell from 1% in 2008 to -4% in 2009 (IMF, 2010).

As a result, during this crisis period, EU governments and central banks adopted wide-ranging interventions, such as capital injections, liquidity provisions and debt guarantees, to support aggregate demand and bail out financial institutions, with the aim to prevent a larger collapse in economic activity (Neri & Roeple, 2013; Rangau & Burietz, 2013; Degl'Innocenti et al., 2017). Deposit guarantees were raised, central banks cut policy interest rates, and governments provided liquidity facilities to financial institutions in distress, together with state guarantees on their liabilities, followed by capital injections and relief for impaired assets. However, notably, national governments adopted these measures at varying degrees, since the crisis' impact on the EU varied notably between EU member states, owing to their initial conditions and the associated vulnerabilities.

These financial rescue packages sought to restore financial institutions' liquidity and capital and to provide guarantees in order to support the financial system and restore investor confidence. However, the interventions resulted in marked degradations of countries' public finances, leading to a transmission process of credit risks produced by the banking system to the public sector (Gerlach et al., 2010; Colombini & Calabrò, 2011). The huge interventions in response to the financial and economic crises, together with wasteful management of public resources over several years typical of most European countries, caused considerable increases in public expenditures and resulting imbalances in public finance in several European countries.

This triggered the emergence of the Eurozone sovereign debt crisis in early 2010 – owing to the widespread use of debt and the subsequently difficulties to refund it – and thus the start of phase three of the crisis

(Colombini & Calabrò, 2011; Rangau & Burietz, 2013; Degl’Innocenti et al., 2017). Fundamentally, the sovereign debt crisis concerns a country’s risk credit owing to its inability to repay its government debt without the support of third parties such as the ECB or the International Monetary Fund (IMF) (Colombini & Calabrò, 2011).

Particularly in the ‘peripheral’ countries of the EU (i.e. Greece, Ireland, Portugal, Spain and Italy), there was a considerable raise in deficit/GDP and debt/GDP ratios, together with increasing estimates of prospective banking sector losses on bad loans, which contributed to a sharp deterioration of the situation and a raising of the spreads on sovereign bonds between Germany and the ‘peripheral’ countries (Gerlach et al., 2010; Lane, 2012; Mody & Sandri, 2012).

The sovereign debt crisis and the resulting widening of the sovereign spread, which first affected Greece in early 2010 and then involved Ireland, Portugal, Italy and Spain, affected the entire Eurozone, assuming a systemic dimension (Albertazzi et al., 2012). As De Grauwe & Ji (2013) found, the government bond markets in the Eurozone became more fragile and more susceptible to self-fulfilling liquidity crises, since they were associated with negative sentiments that were strong at the end of 2010.

These tensions around sovereign debt later resulted in a broader financial and banking crisis, closing the vicious circle introduced by the subprime mortgage financial crisis which, started from the banking system and unravelled into the financial and economic system, went in the opposite direction, returning to affect the banking system (Reinhart & Rogoff, 2009; Colombini & Calabrò, 2011) through several channels, owing to government debt’s pervasive role in the financial system (Panetta et al., 2011). Since Europe’s banks hold large amounts of government bonds, their financial stability has been jeopardised owing to governments’ difficulties to repay their debts, leading to a deterioration in banks’ access to funding and therefore hampering their ability to provide credit to their economies. For instance, losses in the values of government bonds held in banks’ portfolios affected banks’ income and capital, increasing their riskiness, and impacting on banks’ funding ability, with a corresponding reduction in credit supply. Other channels transmitted the sovereign tensions to the banking system (see Panetta et al., 2011; Caruana & Avdjiev, 2012; Holton et al., 2012), which resulted in a rise in the cost of funding for national lenders and a reduction in its availability, with repercussions for lending costs and lending quantity to the economies and on banks’ profitability (Albertazzi et al., 2012; Allegret et al., 2017). This caused a credit crunch that negatively affected consumption and investments, slowing economic activity and leading to dramatic economic and social consequences in many European

countries (Neri & Ropele, 2013; Degl’Innocenti et al., 2017). Further, as a result of the deep and prolonged output contractions, tax revenues decreased, leading to a further deterioration of states’ fiscal situations (Reinhart & Rogoff, 2008, 2009; Allegret et al., 2017).

These significant negative effects on European countries’ public finances triggered the introduction of more fiscal rules at national levels, in addition to those pre-existing at the supranational level, in order to reduce the deficits and stop the growing debt, with the aim to ensure the financial stability of EU member states and compliance with the requirements laid out in the Stability and Growth Pact and in the Maastricht Treaty. Nonetheless, these fiscal consolidation measures taken to restore confidence in the long-term sustainability of public debt have had short-term negative effects on the economy, unintentionally exacerbating the crisis. Indeed, these re-adjustment measures of public finance included a tax increase and/or a reduction of public expenditures, which caused a further decline in economic activity and a loss of employees, generating economic recessions over several years (Alesina & Perotti, 1996; Colombini, 2018).

Several years of economic recessions between 2007 and 2014, as a result of negative effects produced by the subprime financial crisis, together with the sovereign debt crisis, increased the number of non-performing loans (NPLs) – generally defined as loans that are either more than 90 days past due, or that are unlikely to be repaid in full (Magnus et al., 2017) – in the commercial banking context in several European countries (Colombini, 2018). Fundamentally, NPLs are exposures to customers (e.g. companies, families, etc.) which, owing to the deterioration of their economic and financial situations, face difficulties in meeting all or part of their contractual obligations. This is due to the severe economic conditions, which leave many borrowers (including companies, families, etc.) unable to repay their debt. Indeed, it has largely been acknowledged in the literature (e.g. Carey, 1998; Bofondi & Ropele, 2011; Nkusu, 2011) that, during recessions and periods of weak economic growth, companies and households have more difficulties repaying their debts, leading to an increase in the share of NPLs in banks’ balance sheets.

Thus, the financial crisis started in 2007, and the subsequent recession over several years have left many European countries, especially in the southern part of the Eurozone as well as in eastern and south-eastern Europe, with high NPL levels, which have more than doubled since the start of the financial crisis (Ayar et al., 2015). As reported in the European Stability Mechanism (ESM)’s annual report in 2015, during the crisis period, the NPL stock increased by more than 300% to €928 billion as of the end of 2015, from €292 billion as of the end of 2007.

1.2. Determinants of NPLs: A literature review

I have emphasised that the recent financial crisis was a primary cause of higher NPLs in the EU's banking system. Nonetheless, NPL levels were uneven across EU member states, with some countries experiencing a sharp rise in NPL stock during the financial crisis and others seeing a milder increase, thus reflecting various structural factors in different countries (Colombini, 2018).

Thus, although the financial crisis has played a major role in increasing the NPL stock in the EU banking system, other factors have also driven its evolution and can therefore explain the different NPL levels across EU member states. Indeed, the literature on the determinants of NPLs points out that the drivers of NPL stock are an interplay of various factors – ranging from macro-economic factors (e.g. lack of growth, increasing unemployment, high interest rate, increasing tax burden, etc.), to institutional factors (e.g. legal and judicial systems), to bank-specific variables (e.g. management skills and risk preferences) – with *ex ante* and *ex post* effects relating to the build-up of the initial NPLs and to the pace of NPL stock reduction (FSC, 2017). The recent financial crisis in Europe combined most of the above-mentioned factors and created conditions of heavy systemic stress in the banking sector, which led to the current high NPL stock (Louri, 2017).

Literature on the determinants of NPL has identified two main factor clusters to explain the evolution of NPLs across countries, one including economic drivers and the other covering structural drivers, which reflect two research streams on this topic. Most studies of the determinants of NPLs have focussed on either macro-economic factors or bank-specific factors, and not both, as explanatory variable (Louzis et al., 2012). Nonetheless, it is possible to identify a third research stream that combines both macro-economic and micro-economic variables to explain the NPL levels. I will now provide a literature review on the determinants of the NPLs, clustering studies into the three research streams.

1.2.1. *Macro-economic determinants of NPLs*

The first research stream on the determinants of NPLs covers studies focussed on economic drivers. These studies point out how NPL stock increases are linked to the overall macro-economic conditions that affect borrowers' capacities to repay their loans.

According to this research stream, the overall state of the economy, measured for instance in terms of GDP growth, is the most important factor influencing