Box: A secondary market for NPLs

Non-performing loans (NPL) remain an issue that some EU Member States continue to deal with. As part of the CMU mid-term review, the European Commission (EC) will assess the case for the development of the secondary market of NPLs.

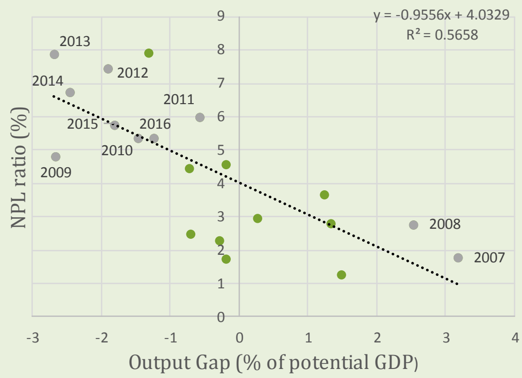
This Box summarises the recent trends in NPLs, state of play of NPL secondary markets and existing policy proposals to kick-start the market.

NPL adjustment

The 2007-08 global financial crisis and the subsequent sovereign debt crisis had long-standing adverse economic consequences in Europe, including rising NPLs.

As shown in chart 1.18 for Euro area countries, an increasing negative GDP output gap (difference between GDP and GDP potential) was mirrored by a growing NPL ratio. In 2007, euro area countries had an NPL ratio of 2.8% with a positive output gap of c3%. As the economic consequences of the crises unfolded, the NPL ratio rose to 8% in 2013 when the output gap was -2.6% while more recently the ratio has fallen to 5.4%. The adjustment of the euro area NPL ratio has been slow, albeit consistent with its historic relationship with macro performance and, specifically, with the adjustment of the GDP output gap.

1.18 Euro area NPL ratio and output gap: 1997-2016



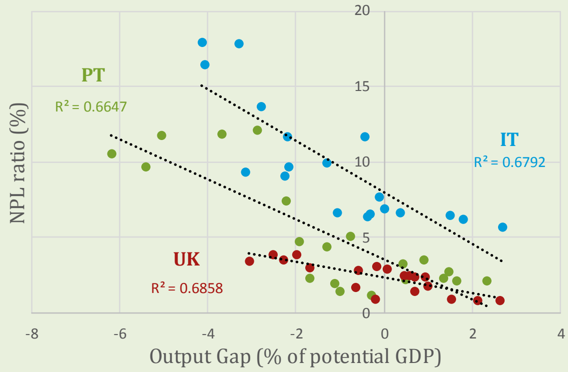
Source: *IMF and World Bank*

The relationship between NPL and GDP is notably two-sided: adverse macroeconomic performance increased NPLs but also persistently high NPLs have stifled credit growth and economic activity.

Some European countries were hit harder than others by the crises and endured, in consequence, a more prominent increase in their NPL ratios.

However, there are country-level differences in the NPL dynamic that would suggest that other factors apart from macroeconomic performance may have contributed to rising NPLs. For example, in the United Kingdom, a negative output gap of 3% was accompanied by an NPL ratio of c4.8% while in Italy a similar output gap was met with an NPL ratio of between 10% and 14% (see chart 1.19). The structural factors behind a slow NPL adjustment may relate to, for example, the quality of insolvency regimes, tax and accounting differences, or also the depth of secondary markets of NPLs.

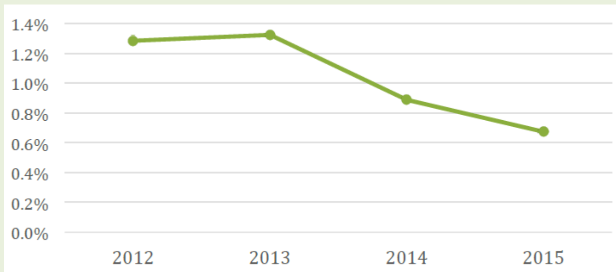
1.19 NPL ratio and output gap for selected EU countries: 1997-2016 (or latest)



Source: *IMF and World Bank*

The continued high NPL ratios have affected bank profitability and capital build-up. However, notwithstanding the difficulties of legal and restructuring proceedings in some countries and limitations of unharmonized insolvency regimes for debt resolution, European banks have already put NPL strategies in place and actively manage NPL portfolios, including extensive reporting to supervisors. This is proven to be effective as shown in the downward trend in the cost of risk (loan loss provisions/average gross loans) for Tier 1 SSM banks over the past years.

1.20 Cost of risk – Tier 1 SSM banks



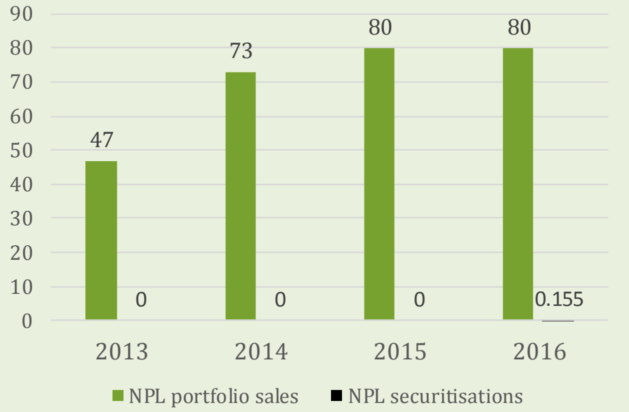
Source: *Weighted average cost of risk (loan loss provisions/average gross loans) for 10 SSM banks. Data taken from Reuters: Deutsche Bank, Commerzbank, BBVA, Santander, BNP Paribas, Credit Agricole, Société Générale, UniCredit, Intesa San Paolo and ING. Does not include Commerzbank in 2012 and 2013 and ING in 2012 due to missing data*

A deeper secondary market of distressed debt

Deeper secondary markets of NPLs can contribute to accelerate the NPL adjustment process as banks continue internal workout towards restructuring their NPL portfolios.

The volume of NPL secondary market transactions continues low compared to the outstanding amount of NPLs, with €80bn in 2016 in market transactions[24] (against €1tn of NPLs in the EU) with most activity traded in the form of NPL portfolio sales and to a lesser extent as NPL securitisations[25] (only €155m issued in 2016). According to the EBA[26], since 2013, NPL transactions (including securitisation) were observed in only 13 (CZ, DE, GB, HR, IE, IT, LV, NO, PL, PT, RO, SI, ES) out of 27 European countries surveyed.

Chart 4: Size of secondary market of NPLs: NPL portfolio sales and NPL securitisations (€bn)



Source: PwC (NPL loans) and AFME (Securitisation). NPL loan sales are estimates as usually portfolio sales include performing and non performin g loans. NPL Securitisation data does not include re-performing pools

Market impediments and policy proposals

The development of secondary markets of distressed debt has been analysed by policy makers, Central Banks and multilateral agencies like the IMF and the EBRD.

The identified impediments for a more active secondary market have converged around six common themes, including i) "poor" data quality of the assets behind the transaction; ii) quality of legal and insolvency frameworks (including limitations to a rapid execution of collateral); iii) subdued securitisation market; iv) lack of licensing and regulatory regimes to enable nonbanks to own and manage NPLs; v) tax (dis)incentives relating to transfer of NPL portfolios and loan loss deductibility and accounting standards; and vi) lack of economies of scale for small banks, heterogeneity of loans and role of AMCs in that context.

Among the proposals to develop the market, in 2015 the IMF suggested[27]:

- **Securitisation:** a more active involvement by the EIB/EIF through investing in senior tranches or providing guarantees on mezzanine tranches of NPL securitisation transactions.
- **Participation of non-banks:** facilitate licensing of non-banks for restructuring (or participation off non-banks in purchasing NPLs), which would lower the cost of entry into this market and allow for greater specialization; and
- **AMCs:** recognised the importance of AMCs to kick-start the market, although acknowledged that any public involvement should be compatible with state aid rules[28].

The European Commission, in the context of the CMU mid-term review asked stakeholders feedback on the development of secondary market of NPLs. The consultation can help the Commission in developing a strategy that establishes how the CMU project can contribute to facilitate the process of NPL resolution through market-based instruments. The consultation can also help as an initial diagnosis of the functioning of the market, where further analysis will be needed to provide evidence of possible existing market failures and evaluate the costs and benefits of existing policy proposals.

[24] PwC estimates that in 2016, 2016 European loan sales accumulated €120bn of which around €80bn were NPL volumes. In 2013, total loan sales accumulated €64bn of which around €47bn were NPLs.
[25] AFME data. Does not include re-performing pools. Market information (deals on the pipeline) indicates that issuance volume should substantially increase in 2017.
[26] EBA Report on the Dynamics and Drivers of Nonperforming Exposures in the EU Banking Sector (June 2016)
[27] IMF Staff Discussion Note (2015) "A Strategy for Resolving Europe's Problem Loans"
[28] Andrea Enria, Chairperson of the EBA, has recently put forward a proposal on a European AMC. Further information on this proposal available in: https://www.esm.europa.eu/speeches-and-presentations/esm-seminar-andrea-enria-eba-chairperson and in: http://www.centralbanking.com/central-banking-journal/opinion/2481794/why-the-eu-needs-an-asset-management-company