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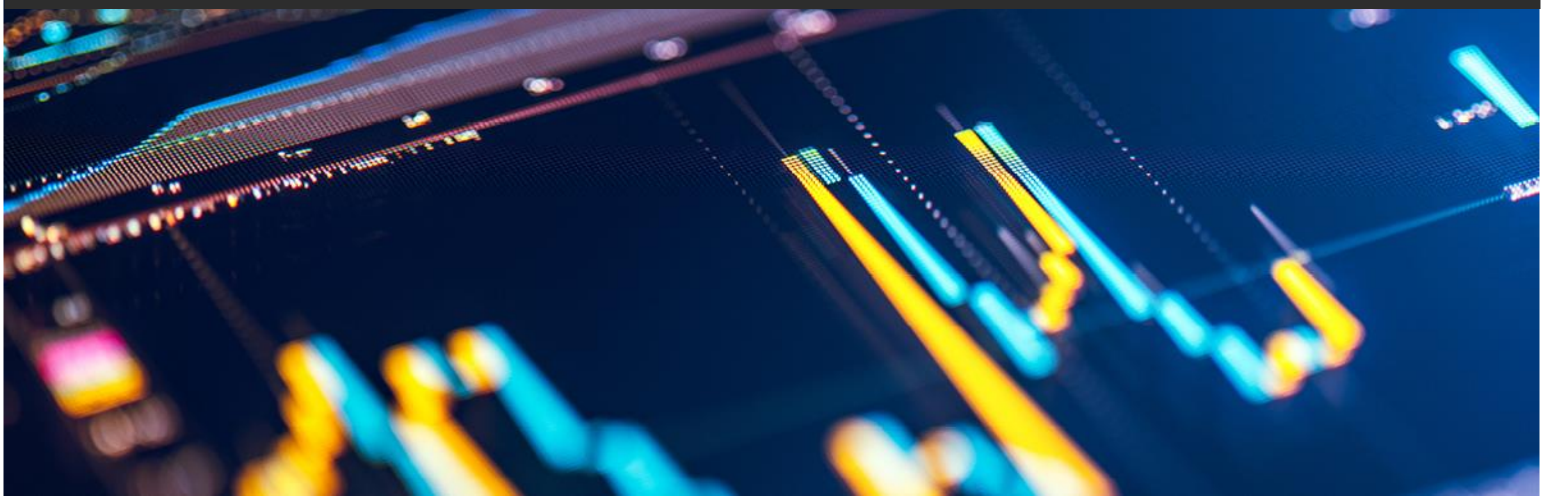

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NPL: The European Commission's Strategy to Tackle the Coronavirus Crisis

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1. Introduction

On December 16, 2020, the European Commission ("**EC**") issued a communication outlining its strategy to tackle non-performing loans ("**NPL**") in the aftermath of the COVID-19 pandemic (the "**Communication**"), also known as the **2020 NPL Action Plan**.[1]

In such document, at the outset, the EC stressed that banks played **a key role** in limiting the impact of the pandemic on households and businesses by guaranteeing a liquidity flow. In this respect, EU Member States took decisive actions by adopting support schemes, including public guarantee schemes and payment deferrals, which alleviated the difficulties that arose as a consequence of the pandemic and the restrictions implemented by national governments to prevent the spread of the disease.

[1] Communication from the Commission to the European Parliament, the Council and the European Central Bank on Tackling non-performing loans in the aftermath of the COVID-19 pandemic, COM(2020) 822.

Such initiatives were supported by the EC, which has adopted a **Temporary Framework** to enable Member States to use the full flexibility foreseen under State aid rules to support the economy in the context of the COVID-19 outbreak.[2]

Although the financial health of the EU banking sector remains strong, the EC stressed that all Member States have been meaningfully affected by the pandemic. As such, banks have been exposed to business and individuals who became financially weaker, specifically small- and medium-sized enterprises (SMEs) and companies operating in sectors heavily affected by the crisis, such as transport, tourism, and hospitality. Therefore, the quality of banking activities and, as a consequence, their ability to keep lending, may deteriorate.

In such a complex scenario, the EC appears specifically concerned that **banks may accumulate an excessive volume of NPLs** in their balance sheets. Although the NPL volumes and NPL ratios (in % of total gross loans and advances) strongly decreased since 2015, in recent months the decrease in NPL volumes has decelerated or stopped. Therefore, according to the EC, **it is necessary for Member States to take actions to prevent the build-up of NPLs**. In this respect, it is essential for banks to soon identify potential NPLs and debtor distress, in order to timely engage in the NPL resolution and disposal process.

Such objective was clearly stated by Valdis Dombrovskis, Executive Vice-President for an Economy that Works for People, on the grounds that, based on past experiences, *"it is best to tackle non-performing loans early and decisively, especially if we want banks to continue supporting businesses and households"*.

This said, the EC considered it necessary to monitor the situation in order to ensure that banks are financially sound and capable to keep playing a constructive role to foster the recovery of the EU economy. Therefore, in September the EC organized a roundtable with stakeholders to discuss a potential **strategy to prevent an accumulation of NPL in banks' balance sheets**.

It is noteworthy that the EC had already proposed measures aimed at reducing NPL levels. Indeed, following the issuance by the ECOFIN Council of an Action Plan to tackle NPLs in July 2017, the EC had already announced a package of measures in October 2017[3], which were then presented in March 2018. The package included the following measures:

- a proposal for a Regulation introducing a **statutory prudential backstop** in relation to NPL, requiring banks to set forth **minimum loss coverage levels for new lending** (adopted in April 2019);
- a **proposal for a Directive** on credit servicers, credit purchasers and the recovery of collateral, aimed at fostering the development of secondary markets for NPLs and improving the enforcement of loans secured by collateral;
- a technical blueprint on how to set up a national **asset management company** (so called AMC Blueprint).

[2] Communication from the Commission, Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 2020/C 91 I/01, and subsequent amendments.
[3] Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of Regions, on completing the Banking Union, COM(2017) 592.

The proposed directive is currently under discussion before the European Parliament and, according to the EC, approval of the latter is of paramount importance to tackle the NPL accumulation issue.

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Nevertheless, as emerged in the roundtable, the EC believes it necessary to complement the initial 2017 Action Plan by introducing key measures specifically aimed at addressing NPLs derived from the COVID-19 crisis as early as possible. The proposed strategy, which recalls some of the guidelines previously formulated, would be based on four pillars:

(i) **fostering the further development of secondary markets for distressed assets**;

(ii) **reforming the insolvency and debt recovery frameworks at the EU level**;

(iii) **promoting, at the EU level, the establishment of national asset management companies and their cooperation (so called "AMCs")**;

(iv) **use of precautionary tools** provided for by the EU bank crisis management directive and the State aid framework in the context of COVID-19.

The overall aim of the strategy would be to remove NPLs from banks' balance sheets, contextually ensuring sufficient safeguards for debtors and an adequate balance of interests between creditors and debtors. In particular, the EC stressed the need to provide a **strengthened protection to consumers and vulnerable borrowers**.

Before focusing on the four key measures listed above, it is useful to recall that the EC has already taken or proposed actions aimed at tackling NPLs following the COVID-19 outbreak, such as:

(i) a package of measures for the banking sector, which introduced flexibility in certain EU rules, such as those regarding risk assessment on borrowers in the context of the pandemic and prudential rules on classification of NPL where public relief measures have been granted;

(ii) the package on the capital markets recovery, aimed at fostering investments, also by removing regulatory impediments to NPL securitizations;

(iii) a list of "best practices" between the financial sector, consumers, and businesses aimed at further alleviating the impact of the pandemic.

2. Developing secondary markets for distressed assets

As mentioned above, the development of a secondary market for distressed assets is considered **crucial** to enable banks to reduce their NPLs, allowing them to free-up space in the balance sheets for new lending.

According to the Communication, an essential step is to **quickly reach an agreement on the EC's proposal for a Directive** on credit servicers, credit purchasers, and the recovery of collateral adopted in March 2018.[4]

[4] COM (2018) 0135 final – 2018/063 (COD).

Further measures recommended by the Communication are listed below:

- **improving the quality and comparability of data on NPLs** by expanding the use of the templates developed by the European Banking Authority (EBA) in 2017 to create a common dataset for NPL transactions. In order to promote the use of said templates by market players, the EC considered, at least initially, to make such templates mandatory only for new NPLs. Additionally, the EC aims at requesting that EBA review the templates in 2021 following a consultation with market participants;
- **creating a data hub at the EU level** to collect and store anonymized data on NPL transactions, which could then be provided to market participants. In this respect, enhanced transparency would be key to support price discovery and render markets more efficient;
- **leveraging existing data sources** by granting market participants access to key datasets such as the ECB's Analytical Credit Dataset, the securitization repositories, and data reports by banks on recovery timing and rates;
- **developing recommendations** on "best execution" sales processes for transactions on secondary markets;
- **addressing, together with EBA, the remaining obstacles for banks buying NPLs** in the secondary market, generally connected with the regulatory treatment of purchased defaulted assets and the risks that banks need to weigh to calculate capital requirements under the Standardized Approach for credit risk.

3. Asset management companies (AMCs)

Asset management companies (or AMCs) are essentially "**bad banks**" established to purchase NPL from banks, enabling the latter to free up capacity for new lending. Allowing banks to keep lending is indeed crucial for economic recovery and is a top priority for the Commission to ensure that European citizens and businesses undergoing financial difficulties due to the pandemic continue to receive the necessary support from the banking system.

Asset management companies are **effective mechanisms to remove NPLs from banks' balance sheets** and extract the most value from them by credit collection procedures aimed at achieving a gradual recovery in asset prices. AMCs can be either private or publicly funded. In the latter case, the use of public funds does not entail the granting of State aid provided that the State behaves in a similar manner as an investor operating under market conditions.

In any case, the EC also recommended alternative impaired assets measures to tackle NPLs. For instance, the Communication mentions bank-driven initiatives, securitization-based approaches, guarantees or asset protection schemes as well as ad hoc AMCs common to a limited number of banks. Interestingly, the EC stressed that the systemic securitization solution implemented in Italy, the *Garanzia sulla Cartolarizzazione delle Sofferenza* (GACS), a scheme not entailing an element of aid, has been successful.

The EC pointed out that, to efficiently tackle NPLs, AMC would need to be endowed with **substantial financial resources**. A publicly funded AMC would likely receive an equity injection combined with government-guaranteed funding. A similar funding structure would be subject to a State aid assessment, which would focus on several factors such as the conditions attached to the capital injection and the level of remuneration of the guarantees, which should be broadly in-line with market criteria.

Interestingly, the Communication encourages the creation of a **cross-border network** of national AMCs at the EU level. The most significant advantages of such cooperation would be the economies of scale in dealing with information, the aforementioned centralized data hub, and the possibility of sharing best practices between the different AMCs. Moreover, national AMCs could also set up a joint transaction platform dedicated to sales by participating AMCs. However, the EC stressed that the positive outcome of such cooperation ultimately depends on the degree of homogeneity and the number of AMCs. For this reason, the EC encouraged Member states to design AMCs in compliance with the "AMC Blueprint"[5], in order to ensure that each AMC is properly set up by adopting a unitary approach.

Despite acknowledging that it would be difficult to establish a single European bad bank, the EC showed its willingness to support Member States in the creation of national AMCs as well as in exploring synergies and cooperation at the EU level. In this respect, any cooperation within said network would be carried out in compliance with EU competition law rules prohibiting exchanges of confidential information.

4. Insolvency, debt recovery and restructuring frameworks

Actions aimed at improving the insolvency, debt recovery and restructuring frameworks include:

(i) reaching an agreement on **the legislative proposal for minimum harmonization rules on accelerated extrajudicial collateral enforcement**, by establishing AMCs and with the exclusion of consumers from the application of said procedures, currently under scrutiny by the Council and European Parliament;

(ii) **the benchmarking exercise of loan enforcement regimes** as regards recovery rates and timing, to facilitate a better assessment of the efficiency of the legal framework in Member States in terms of defaulting or insolvent debtors in relation to bank loans;

(iii) **the transposition of the Directive (EU) 2019/1023 on preventive restructuring frameworks**, to promote the adoption of efficiency raising and monitoring measures aimed at preventing default situations and alleviating the risk that exposures become non-performing in connection with negative market trends;

(iv) **the Recovery and Resilience Facility (RRF)**, which will incentivize and support reforms to reduce NPLs, to improve the efficiency of national insolvency frameworks.

5. Precautionary measures

Even though the financial position of the banking sector is generally sounder now than in 2008, it might be still necessary, in some cases, for Member States to intervene to support banks, thus removing obstacles to post-pandemic recovery.

Although market-based support not entailing an element of aid is the preferred solution, both the EU bank crisis (BRRD)[6] and State aid frameworks allow **precautionary public support** to banking institutions, to the extent that said support is reserved for banks that were not experiencing viability issues before the pandemic. Precautionary measures represent the fourth and last pillar of the strategy outlined by the Communication.

[5] COM(2018) 133 final – 2018/72 (SWD).

[6] Directive 2014/59/EU, establishing a framework for the recovery and resolution of credit institutions and investment firms (OJ L 173, 12.6.2014, p. 190–348), and Regulation (EU) No 806/2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (OJ L 225, 30.7.2014, p. 1–90).

In its prior March 2020 Communication establishing a Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, the EC stressed that banks play a key role in limiting the effects of the pandemic. Therefore, Member States have already taken actions to directly and indirectly support financial institutions (for instance, by supporting the real economy through guarantees and moratoria, banks were indirectly protected from losses).

Precautionary support can **take many forms, including capital injection**. The EC has already confirmed that precautionary measures may be used to finance the transfer of NPLs to an AMC in its AMC Blueprint, provided that such transactions pursue the same objectives of capital injections and meet the same conditions.

As mentioned above, precautionary tools **need to comply with the EU banking crisis framework**, which outlines a set of measures that can be granted in favor of banks that are failing or likely to fail. However, the same framework provides for exceptional cases where public support may be granted to **solvent** institutions, without triggering a declaration that the bank is failing or likely to fail.

In particular, pursuant to point (iii) of Article 32(4)(d) BRRD, a capital injection or a purchase of capital instruments from a solvent institution to address a capital shortfall resulting from stress tests, does not automatically trigger the declaration that an institution is failing or likely to fail, **if it remedies, on a temporary basis, a serious disturbance in the economy of a Member State and preserves financial stability**.

In this respect, the EC has already confirmed that such exception applies during the COVID-19 crisis, which is considered as a "serious disturbance to the economy". Therefore, Member States are allowed to grant capital injections to banks suffering temporary adverse conditions due to the pandemic in order to restore confidence in the banking sector and safeguard financial stability.

Any measures granted under article 32(4) of the BRRD should be **authorized by the EC** pursuant to the EU State aid framework. As set forth by Article 32(4) of the BRRD, support measures under point (d)(iii) shall be limited to injections necessary to address capital shortfall established in the national, EU or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities. According to the Communication, the outcome of the vulnerability analysis carried out in July 2020 by the ECB could represent a starting point to inform the assessment of capital shortfalls suitable to justify support measures.

Finally, from a State aid point of view, public guarantees on a portfolio of assets on a bank's balance sheet as well as NPL transfers to a publicly backed AMC are considered **impaired asset measures** (IAMs), which are governed by the EC's Communication on the treatment of impaired assets (IAC).[7] As set forth under paragraph 40 of the IAC, to be compatible with the applicable State aid rules, the NPL transfer price can as a rule not exceed the Real Economic Value (REV), which should reflect the underlying long-term economic value of the assets on the basis of underlying cash flows and broader time periods, thus constituting an acceptable benchmark indicating the compatibility of the aid amount as the minimum necessary.

* *This GT Alert is limited to non-U.S. matters and law.*

[7] Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.3.2009, pp. 1–22

GT GreenbergTraurig

Authors

This GT Alert was prepared by:

- Edoardo Gambaro | + (39) 02.77197205 | Edoardo.Gambaro@gtlaw.com
- Alessio Gerhart Ruvolo | + (39) 02.771971 | Alessio.G.Ruvolo@gtlaw.com
- Massimiliano Pizzonia | + (39) 02.7719771 | massimiliano.pizzonia@gtlaw.com