Market based solutions to bank restructuring and the role of State Aid Control: the case of NPLs

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1. Introduction

Good morning ladies and gentlemen.

First of all, I would like to thank the European Capital Markets Institute for organising this highly timely conference with so many impressive contributions in the four sessions today, and in particular for inviting me to speak about such an interesting and "hot" topic as the issue of non-performing loans (NPL) which are still accumulating in the balance sheets of some of the banks in Europe.

As you probably know, in the absence of other regulatory instruments, State aid control functioned during the crisis as the de facto resolution framework for the European financial sector in order to restructure and strengthen it when it needed public support. It, naturally, was a very incomplete and limited framework, not least since it is reactive in nature, but it presented the advantage of a harmonised European approach thereby enhancing predictability and protecting the level playing field in the internal market. Today, as a result of new legislation built on the lessons from the crisis we have a new and much more comprehensive framework, the Banking Union, including the Bank Recovery and Resolution Directive (BRRD), where we coordinate and work very closely with new institutions such as the SSM, the SRB and the national resolution authorities. State Aid control continues to play an important role in this context although the emphasis of our case work is evolving – I will return to this later.

It is important to remind ourselves just how much has been achieved in the last few years in the restructuring of the European banking sector. However, it is equally true that the financial sector is undergoing structural changes that challenge existing business models while offering new solutions and experiences to consumers and putting banks under particular pressure. Some banks have not been able to put the many years during which they suffered significant losses behind them and others are still characterised by high NPL ratios at a time when they need to adjust to operate in a 'new normal' environment of extremely low interest rates that compress intermediation margins, are obliged to restructure extensive branch office networks in view of large scale on-line banking and increasingly come under pressure from alternative suppliers of financial services (fin tech and other non-banking entities), e.g. in lending or payment services, further undercutting income streams. Banks are also having to adjust to new and more demanding regulatory and supervisory standards, with increased capital and liquidity requirements. Against this background, the very large number of banks and, particularly, bank branches, seems questionable from a viability standpoint, in particular in those Member States where the density of banking is much higher than the EU average. More generally, in this environment, a range of banking business models are unlikely to be viable in the longer run Banks that are unable to reduce their cost base or upgrade their technology offer to customers will not be able to regain structural viability, and should exit the market in a controlled way, freeing up market shares for the viable banks.

The discussion of NPL has to be seen in this wider context of a very challenging environment for banks which forces structural adjustment. Any measures to facilitate the resolution of the NPL problems should be considered and assessed against their contribution to fostering such adjustment and not preventing it, so that the European economy remains competitive in today's globalised world. This is, of course, particularly true for any State Aid that might need to be granted in this context as an option of last resort.

2. NPL in Europe

Turning now to NPL more specifically, by mid-2016, the gross carrying amount of NPL in the European Union amounted to over 1 trillion euros while the average weighted NPL ratio stood at 5.5% of liabilities, with a notable improvement compared to the 6.7% recorded in September 2014. While the situation is, therefore, improving, the level is still very high compared to other jurisdictions (US stands at 2%) and the situation before the crisis.

As you know, high NPL ratios tend to create difficulties for the functioning of a bank. They require large provisions, the build up of which consumes capital, they generate uncertainty about the value of the assets given the difficulty to price them properly, they often tie up management and, for all these reasons, hinder the bank in performing its key functions of lending to the real economy. If the situation affects large numbers of banks in a country then this might even have macroeconomic ramifications. So very high levels of NPLs are nearly always a problem for the bank in question and can also be a problem for the Member State concerned.

These problems are further aggravated when very few transactions take place in secondary markets since it further adds to the uncertainty about the underlying value of the NPLs, thereby depressing NPL prices which, in turn, negatively affects banks' balance sheets. I am not sure that this can be labelled an "externality", but it is clear that generating more NPL transactions would be beneficial for the system as a whole.

However, the NPL situation differs greatly across European countries and across individual banks. In particular, the fact remains that even though the overall level of NPL is lower than 6% and decreasing, in ten Member States, the NPL ratio is still above 10%. According to our estimates, more than 40% of the total stock of NPL in the EU is concentrated in the five countries with the highest NPL levels (Cyprus, Greece, Slovenia, Portugal and Italy). Moreover, despite the decrease in aggregate levels of NPL stocks in the EU as a whole, they actually increased in some Member States since September 2014, such as Greece, Portugal and Italy. The actual scale and characteristics of the NPL problem depend largely on the macroeconomic situation of the countries concerned as well as the domestic legal framework of each specific Member State. Clearly, this is not a generalised problem at the level of the EU and, consequently, when assessing the design of specific solutions, it is necessary to recognise that a one-size-fits-all approach does not seem appropriate..

Moreover, even when looking at the available data from specific Member States, we can see that there are also big differences between NPL levels in individual banks. Those differences are not in itself surprising as they reflect idiosyncratic choices and management decisions, different credit risk standards and provisioning policies, not only in the years prior to the crisis, but also during the crisis and still today. They should serve as an important reminder that NPL issues are not independent from the individual institutions but to a large extent driven also by decisions at the level of individual banks.

On balance, one can observe important differences between banks in the same Member State which reflect different choices made by private institutions and I believe that we need to be careful with developing policy strategies that are not fully informed by these realities and which might, inadvertently, reduce or even remove the incentives to deal with the problems at the level of the individual institutions. In that sense, we must not forget that the NPL problem is first of all the responsibility of each individual bank.

3. Policies and actions for helping banks to offload NPLs

Having said that, appropriate policies and regulations can and have to be developed and deployed in order to help banks to manage their stocks of NPL. Here, I see chiefly three main areas: provisioning policies, legal and judicial reforms and removing existing impediments to the functioning of secondary markets for NPL.

Regarding provisioning policies, higher provisioning levels tend to facilitate the sale of NPL, in particular because higher coverage ratios lead to smaller differences between offered transaction prices and net book values (the so-called "price gap"). That reduced gap makes banks less reluctant to sell NPL as they do not have to face important losses at the moment of the transaction. Here, the work of the SSM and national supervisors performing comprehensive Asset Quality Reviews and strengthening their supervisory control and guidance towards NPLs management is of the utmost importance to improve asset quality in the European banks and, as you know, significant action is being taken in this respect.

Regarding legal and judicial systems, it is important to recall the current diversity of legal regimes between Member States within which European banks as well as secondary market investors for NPL operate. In fact, inefficiencies in insolvency regimes and judicial overhang seem to be one of the main reasons for the high level of NPL in a number of countries in Europe. This is directly reflected in the market prices for NPL in secondary markets. Therefore, where necessary, legislation and procedures for liquidation and restructuring of companies and the foreclosure of assets need to be amended with the aim of increasing speed, efficiency and legal certainty of insolvency procedures and property foreclosures. This has a direct impact on higher recovery rates for creditors which will serve to reduce the price-gap further. On this point, work is currently ongoing both at the level of individual Member States as well as the Commission where I would like to highlight the mapping exercise of national insolvency regimes as well as the forthcoming proposal on insolvency frameworks. While it is important to recognise the significant improvements that some Member States have already made, further work is clearly still required as an essential precondition for solving these issues.

Finally, apart from inefficiencies in some legal and judicial systems, there are some further important impediments to the development of sufficiently liquid secondary markets for NPL: the lack of expertise in dealing with large volumes of NPLs in particular in small and medium-sized banks but also in the wider economy, the complexity of some of the asset classes (such as e.g. SME loans), the lack of adequate IT systems to hold and provide qualitative and quantitative data for the loans, the borrowers and the collateral, as well as the general asymmetry of information and the lack of transparency of the markets. All of those factors play a role in explaining the limited number of transactions.

To address some of those issues, the idea of a so-called "Clearing House" has been put on the table since it would assist with the development of a liquid secondary market for NPL. The idea would be that a platform would be created at the level of the Member State or, indeed, at European level, which could be private or public, where all the interested banks could register those NPL which they would like to sell. This organisation would structure and homogenise the necessary data and would offer a one-stop shop to potential investors through standardised and predictable deal making processes. While the ownership of NPL would remain in the balance sheets of the banks, such a solution could serve to significantly increase the amount and quality of data available to the market as well as the transparency of transactions and prices. It would be also help those banks that do not have the management and operational expertise to properly organise the sale of their NPL portfolios. It is an interesting idea that would address some of the key impediments to the resolution of NPLs and facilitate a market driven approach that would facilitate price discovery and reduce transaction and search costs, leading to more liquidity and thereby potentially leading to higher market prices. The creation of such Clearing Houses could be undertaken in ways that are fully consistent with State Aid control and we in DG COMP stand ready to assist any Member State who would like to discuss this option.

4. AMCs and removal of NPLs from balance sheets in context – the role of State Aid control

AMCs have in the past been a very useful instrument when deployed as part of a larger toolkit for tackling the problem of NPL and often in the context of macro-financial assistance programmes. However, they should not be seen as a "magic" solution valid for all cases, and in any event should not be considered in isolation. We also have to recall the implications that AMCs may have from the point of view of the EU State aid framework and, most importantly, the BRRD.

A transfer helps removing the uncertainty of the value of certain types of banks' assets, thereby freeing up capital resources that are being consumed by those assets and improving the liquidity position of the bank that will usually receive

Government guaranteed bonds from the AMC in exchange for the assets. However, those advantages are present both where the recipient of the assets is an individual SPV or a systemic AMC.

Therefore, whether a systemic AMC will add value or not will depend on different factors such as the number of different asset classes, the number of assets, the availability of external management capacity for the transferred assets classes, the complexity of the regulation and the legal framework for the type of loans transferred and finally, the independence of the asset management process.

A systemic AMC is not always the right solution to an NPL problem in any country. For example, a systemic AMC has been a good solution in Ireland and Spain (NAMA and SAREB) because the assets were very homogenous, of large size, there was a limited number of borrowers and a dedicated legal framework (including higher provisioning requirements). On the other hand, the same does not seem to be true in the cases of Greece or Cyprus, for which a systemic AMC is not considered to be a good solution because of the very diverse types of NPLs including corporates, SMEs, households, the lack of economies of scale from dealing with those assets and the high complexity of the legal framework linked to restructuring and liquidation.

These issues would be present to an even greater extent in a European-wide AMC in particular because the heterogeneity of NPL across Europe and the fact that the management and work-out of NPL depends crucially on national legislation would make almost impossible to achieve sufficient economies of scale.

Moreover, tackling the problem of NPLs in Europe is not just an issue of taking them off from the balance sheets of the banks. That will not solve the problem, because moving them around will not make them disappear. And if nothing else is done, then the banks will start to accumulate new NPLs in their balance sheet the following day. That is also why I just said a moment ago that an AMC cannot be solution in isolation. Where appropriate, it has been and can be part of a comprehensive solution, but never as the only measure.

For example, in Ireland and Spain, the public support provided through impaired asset measures covered only a limited portion of the total capital needs of the banks and constituted only a minor part of the total public aid. The majority of public support was granted through recapitalisation aid. In addition, in Spain, part of the capital needs was covered by burden sharing of equity and hybrid holders. It is also worth bearing in mind that in Spain less than 20% of the sector was actually involved with the AMC.

In addition, significant restructuring of all aided banks was implemented in the context of sector wide restructuring and conditionality, with modification of the bank resolution frameworks, review and strengthening of regulatory and supervisory frameworks, with tougher provisioning requirements and implementation of stricter credit risk policies and standards, strengthening of the corporate governance for many of the institutions and also regulatory changes in the insolvency frameworks.

Therefore, I do not believe that an AMC will solve the problem if it is not properly accompanied by all those elements, in particular with both a bank specific and sector wide restructuring process. I would also like to recall here and stress again that such considerations will also have to take account of the more general adjustment processes that the sector is currently undergoing.

In any case, a transfer of assets to an AMC must comply with EU State aid rules. In particular, where NPL are transferred to an AMC, the transfer price cannot exceed the Real Economic Value (REV) of the loan – in other words the value that could be obtained from the asset in the long turn. Our case practice shows that the REV is typically higher than the market price and, therefore, State Aid rules in principle allow state intervention to make a contribution to address the effects of low market transactions, high search costs and market illiquidity on market prices. However, it is clear that the REV is also normally significantly below the net book value. Any potential losses between the current net book value and the REV have to be covered by the bank. Under State Aid rules, such an intervention also requires appropriate burden sharing between the banks concerned and the public authorities. Our rules require that junior debt holders contribute – e.g. through conversion into equity – alongside equity holders. In addition, we also require the submission of a restructuring plan of the bank to ensure its return to long term viability and avoid State Aid being used to keep non-viable banks on the market. Usually – and as demonstrated in the cases of Spain and Slovenia – part of the losses can be addressed through State Aid while the remainder comes from burden sharing. In this manner, an equitable balance is struck to ensure that aided banks do not obtain an undue advantage over banks that resolve their NPL issues themselves.

In the new world of the Banking Union, the BRRD also includes rules that govern possible State interventions for banks and their consequences. In particular, the BRRD allows only limited capital aid under Member States competences outside resolution under so called precautionary recapitalisation exception. This may have implications for and could put constraints on the implementation of impaired asset measures involving State aid. Further legal analysis is taking place to clarify any limitations on the use of State Aid that flow from these BRRD rules.

Of course, the BRRD is the result of a political agreement on the choice to break the toxic feedback loop between failing banks and the sovereign and to redistribute losses away from taxpayers and pass them to shareholders and creditors of the bank in difficulty and to the industry. This choice is one of the fundamental pillars of the Banking Union.

Alternatively, asset transfers can be enacted without being considered State aid. This requires that the purchase of those assets happens at market price. Methodologies to calculate market prices were approved by the Commission under State Aid rules for example in the case of the Hungarian bad bank. The Italian Securitisation Scheme GACS is another example of a no-aid impaired asset measure in which the State provides guarantees on senior tranches of securitized NPLs, receiving in exchange a market conform guarantee fee. In both cases, the likely losses are carried by private parties allowing the Commission to conclude that the public intervention is free of State aid.

All in all, therefore, the State Aid framework continues to offer possibilities for Member States to design interventions to address NPLs. Member States have understood this and we have seen indications that some are recalibrating their intervention strategies by putting an increasing emphasis on exploring:

- Non-aid solutions – of which the Commission is asked to confirm the non-aid character - ,

- Interventions that provide a precautionary recapitalisation – therefore not leading to resolution and burden sharing under the BRRD;

- Possible interventions in liquidation, also outside the BRRD framework.

While not new, the renewed emphasis is significant and DG COMP is, therefore, also working to further clarify the application of State Aid rules in these conditions, together with other Commission colleagues to ensure consistency with the BRRD framework where the application of the BRRD and other banking rules are concerned.

5. Conclusion

To sum up, the financial sector today is in transition both economically, technologically and from a legal-regulatory perspective. It seems unlikely to me that the sector will have the same form in five to ten years. Any interventions have to take account of that environment and the ongoing transition processes.

NPL are an important issue in some Member States but any interventions need to take account of this context and focus on structural solutions. AMC can be a building block in such approaches but to be effective need to be complemented with wider structural measures at the level of the sector as well as individual banks which have the primary responsibility for addressing the issue.

Finally, State Aid rules continue to provide a tried and tested framework within which such policies can be developed in a manner that avoids undue reliance on the tax payer, incentivises banks to take their responsibility and protects the internal market. The State Aid rule book, therefore, remains part of the toolkit that can be deployed for developing solutions to address NPLs. The Banking

Union rules, notably the BRRD, enhance the legal framework in this respect and put an increased emphasis on private sector contributions.

Thank you very much for your attention.