BRIEFING

European Parliament

Non-performing loans in the Banking Union

Stocktaking and challenges

This briefing gives a short introduction into the topic non-performing loans (NPLs), takes stock of the current situation in the euro area, touches on the impact of NPLs on credit supply, and summarises the activities taken at European level to address the problem.

Context, terminology, and sources of information

The issue of **non-performing loans** (NPLs) is putting pressure on the European banking sector and is seen as one of the main reasons behind the low aggregate profitability of European banks, though the level of NPLs and outlook is very diverse across the euro area. As the level of NPLs stood at low or manageable levels prior to the financial crisis, the Council, the European Commission, the European Central Bank (ECB), and the European Banking Authority (EBA) have all taken action to address this issue and improve the situation.

NPLs are usually defined as loans that are either more than 90 days past-due, or that are unlikely to be repaid in full. Those two criteria hence look at both the debtor's past and assumed future performance. The predictive assessment of a debtor's future performance (or unlikeliness-to-pay) is either based on external indicators such as a registered bankruptcy, and on banks' internal judgements that in any case require clearly defined criteria as well. The classification of loans as non-performing is done independently of whether or not the debtor has provided collateral for the loan.

Another concept that is very close to NPLs is that of **non-performing exposures** (NPEs), a more encompassing term that in addition to loans also includes other debt instruments such as advances and debt securities, as well as financial risks from off-balance-sheet items. In practice, those two terms are often used interchangeably, not least in the daily interactions between banks and supervisors. For example, the ECB's Guidance to banks on NPLs mainly

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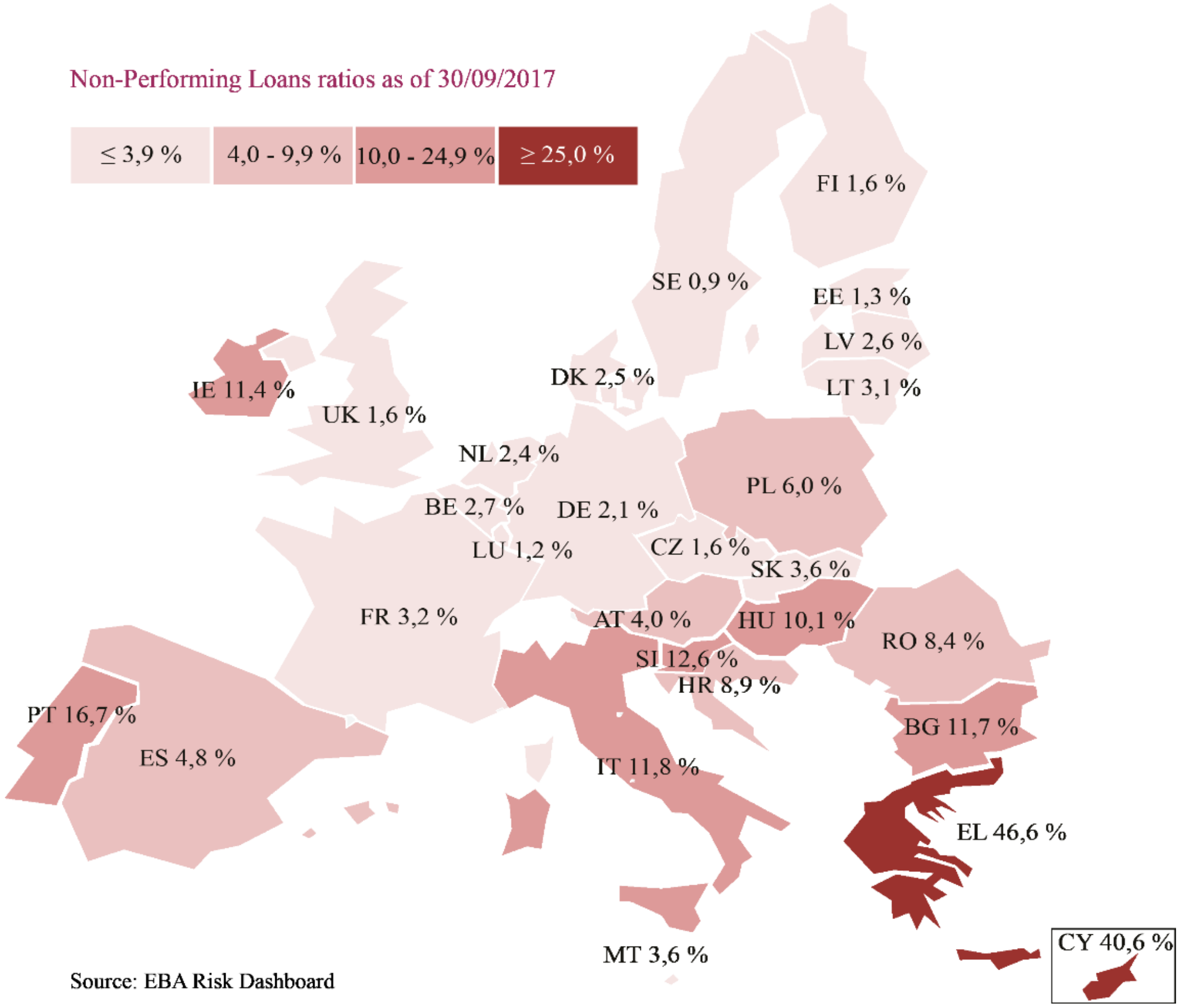
refers to NPLs as a shorthand term, though it acknowledges that - strictly speaking - it would often be more correct to use the term NPE instead.

Given that the use of different NPL definitions (and different accounting practices) made it difficult to compare the situation in different Member States, the EBA initiated a uniform definition of NPEs (Implementing Technical Standard on Supervisory Reporting / NPEs) which banks are encouraged to use, though it is only binding for supervisory reporting purposes.

Map 1: Non-performing loans in the euro area: where do we stand?



There are two European bodies that now regularly publish statistical information on the situation of NPLs, based on the input taken from the banks' supervisory reporting: With regard to the Banking Union as a whole, EBA publishes the Risk Dashboard, and specifically with regard to the situation of significant banks in the euro area the ECB publishes the Supervisory Banking Statistics.

EBA's Risk Dashboard is based on an EU-wide sample of large banks, covering more than 90% of the EU banking sector by total assets (the sample includes 152 banks for the third quarter 2017; the full sample of banks reporting to EBA is even larger, including a number of subsidiaries that are in this context not taken into account; over time, the composition of the sample is subject to changes, for examples due to mergers or the termination of business activities).

The ECB's Supervisory Banking Statistics, on the other hand, includes information on all banks in the euro are that are designated as significant institutions and hence directly supervised by ECB (in Q3 2017: 114 banks and banking groups).

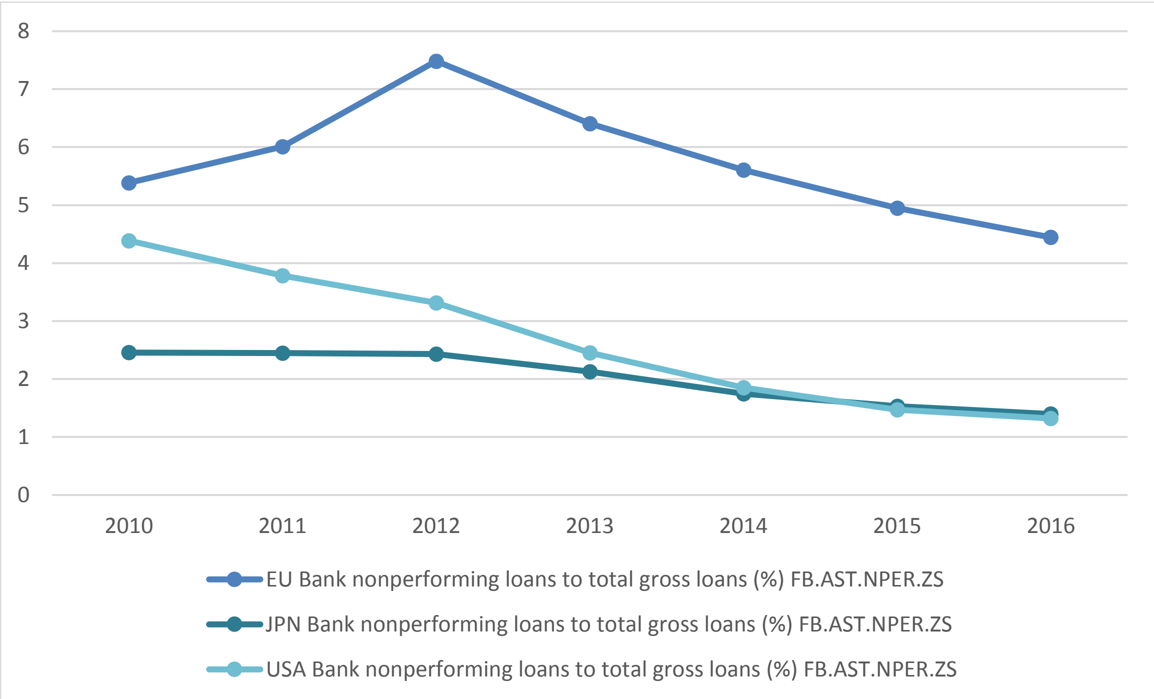
The focus of those two sources is in any case on large banks; small banks are underrepresented in those samples (in comparison to the totality of the European banking sector), which should be kept in mind since an analysis of the distribution of NPLs by bank size indicates that the level of NPLs in small banks tends to be higher than in large banks.

Country dispersion

In the EU, the average rate of NPLs is slowly but continuously decreasing, from 6.4% in December 2014 to 5.4% at the end of 2016, and 4.2% at the end of September 2017 (see Annex 1). That improvement is the result of a numerator and a denominator effect, namely the decrease in the amount of NPLs and the increase in the volume of total loans.

However, the current NPL level in the **EU is still higher than in other major developed countries**; in comparison, the World Bank reported NPL ratios (different from the EBA NPL definition) of less than 2% for the United States and Japan at the end of 2016 (see chart 1).

Chart 1: Comparison of NPL ratios of the EU, Japan, and US from 2010 until 2016 (in %)

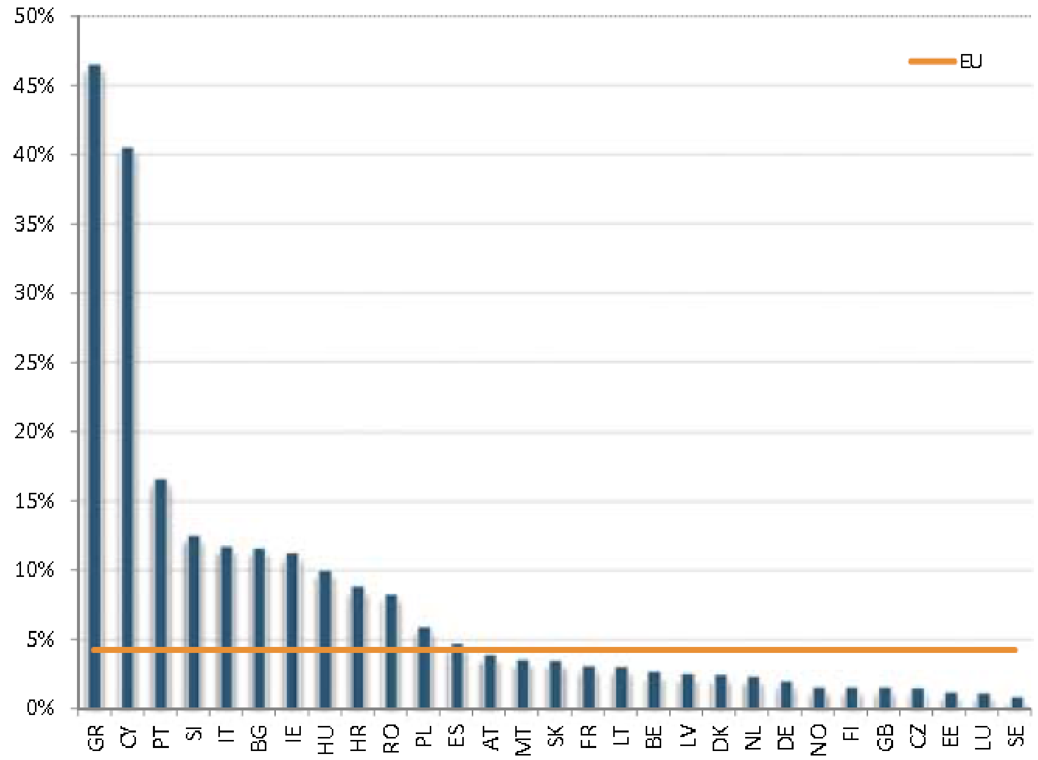


Source: The World Bank data on NPLs

Since the start of the financial crisis, the distribution of NPL has been very **unequal among EU Member States**, with crisis-hit countries suffering from major increases in NPL ratios[1]. By the end of September 2017 those two countries which had to implement strict capital controls at some point, Greece and Cyprus, still report NPL ratios of more than 40%, and several other Member States (Bulgaria, Croatia, Hungary, Ireland, Italy, Portugal, and Slovenia) all report NPL ratios between 10% and 20% (see map 1, annex 1, and chart 2).

[1] The NPL ratio refers to the ratio of non-performing loans to total gross loans.

Chart 2: Country dispersion of NPL ratios in the EU (Sep. 2017)



Source: EBA Risk Dashboard (data as of Q3 2017), p. 10

Size effect

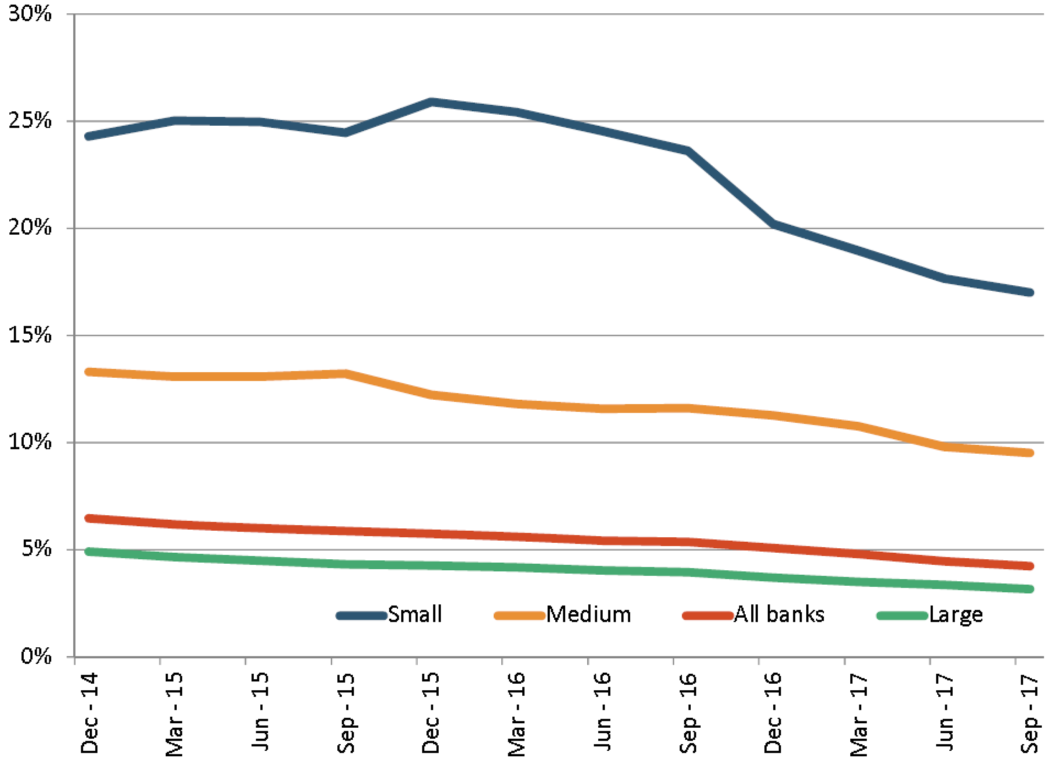
The statistics show that **small and medium-sized banks report higher NPL ratios** than large banks and GSIBs. That effect can be seen both in the ECB sample (see table 1) and in the EBA sample (see chart 3). While the NPL ratio improved in recent years across all bank-size classes, the improvement in the category of small banks was the most distinctive.

Table 1: NPL ratios by size class in the ECB sample (weighted averages)

Category (Q3 2017)	Non-performing loans ratio
Banks with total assets	
Less than €30 billion	*11,72%*
Between €30 billion and €100 billion	*10,48%*
Between €100 billion and €200 billion	*6,95%*
Between €200 billion and €300 billion	*2,83%*
More than €300 billion	*4,38%*
G-SIBs	3,54%
Total	*5,15%*

Source: Supervisory Banking Statistics, third quarter 2017, table T03.07.3

Chart 3: NPL ratios by size class in the EU (weighted averages)



Source: EBA Risk Dashboard (data as of Q3 2017), p. 10

To what extent, however, the size effect is actually driven by a country effect is difficult to judge, as the underlying data is not made available on entity level.

Coverage ratios

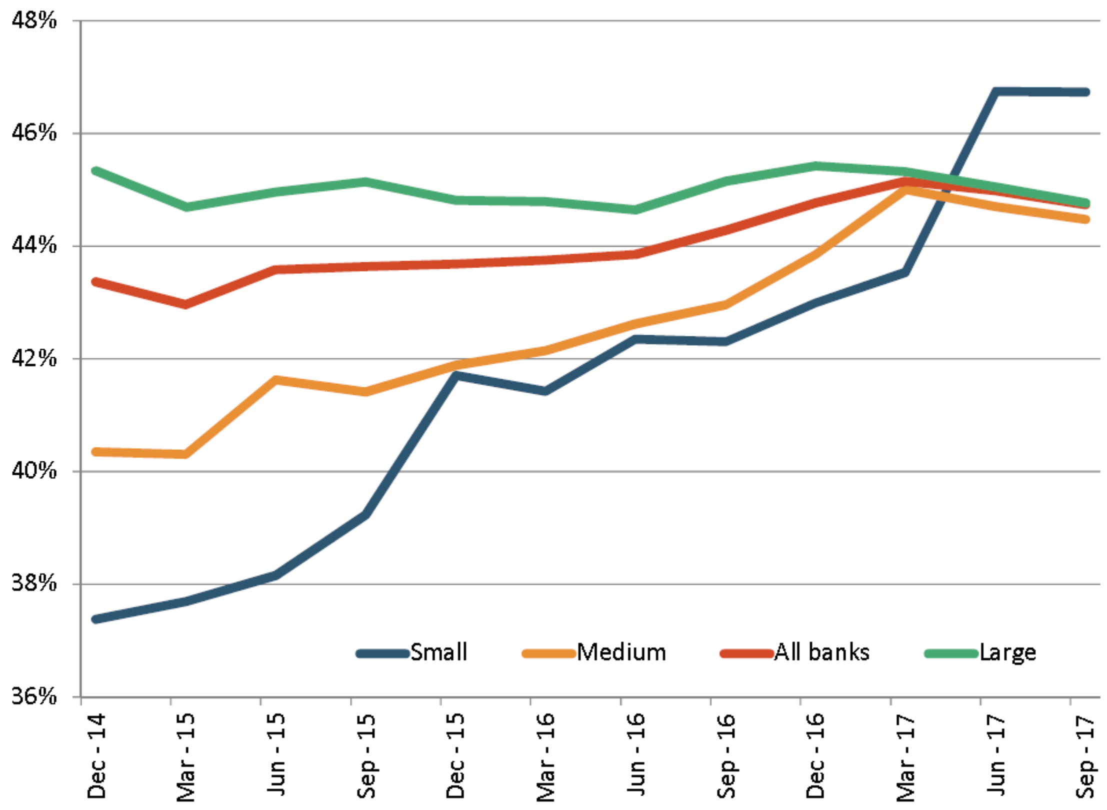
To what extent NPLs actually pose a risk to banks' balance sheets depends on whether **potential future losses are adequately covered** for.

The coverage ratio essentially puts the banks' provisions for bad debt (loan loss reserves), made under applicable accounting standards, in relation to their NPLs. Potential losses that are not covered by provisioning should be balanced out by expected future recoveries, usually by the expected realisation (sale) of collateral, which in practice, however, often turns out to be a lengthy and costly process.

On average, the coverage ratio in the EU stood at 44.7% in the third quarter of 2017. The coverage ratios, however, **differ significantly from one Member State to another**, currently ranging from 23.8% in Estonia to 68.8% in Romania (EBA data, see annex 2). Differences may reflect various levels of collateralisation (depending on lending practices as well as to segments most impacted by NPLs) as well as heterogeneous accounting practices, but may also point to different levels of residual risk.

Looking into the coverage ratios in different bank-size classes, there is a notable positive trend in the group of small banks: While their coverage ratios were significantly lower than that of medium-sized and large banks in December 2014, they have caught up over the recent years and currently even stand higher than those of their larger peers (see chart 4); that development is also driven by a denominator effect, the stark improvement of NPLs.

Chart 4: Coverage ratios by size class in the EU (weighted averages)



Source: [EBA Risk Dashboard (data as of Q3 2017)](), p. 11

The impact of NPL on growth

An IMF [Staff Discussion Note]() published in September 2015 set out that NPLs constitute a drag on economic activity, especially for countries that mainly rely on bank financing, as is the case in the euro area. High NPLs reduce profitability, increase funding costs and tie up bank capital, which negatively impact credit supply and ultimately growth.

More specifically, the presence of non-performing debt on banks' balance sheets weighs on their ability to lend to the real economy through essentially three channels:

- ***Lower profitability***: NPLs imply higher provisioning needs, which in turn lower banks net operating income. Profits are further reduced by the increased amount of human resources needed to monitor and manage high NPL stock;
- ***Higher capital requirements***: NPLs are risky assets which result in higher risk weights than performing loans; high NPLs therefore tie up banks' resources and crowd out new credit;
- ***Higher funding costs***: Investors and other banks are less willing to lend to banks with high NPL levels, leading to higher funding costs for those banks and a negative impact on their capacity to generate profits.

Those channels can mutually reinforce each other and ultimately result in a dampening of the credit supply. Moreover, banks' reduced lending capacity is likely to disproportionately affect SMEs that are more dependent on bank finance.

Activities at European level addressing the problem of NPLs

European Parliament

In its Annual Report on the Banking Union 2016, published on 2 February 2017, the European Parliament inter alia expressed its concerns regarding the high level of NPLs and welcomed the efforts already made to reduce the level of NPLs in some Member States, noting, however, that the issue had so far mainly been addressed at national level. In the same context the European Parliament also recommended that the Commission should assist Member States in the establishment of dedicated asset management companies ('bad banks') and enhanced supervision, and called on Member States to improve their relevant legislation, especially with regard to the length of recovery procedures, the functioning of judicial systems, and more generally their legal framework concerning the restructuring of debt.

That message was reiterated in the Parliament's Annual Report on the Banking Union 2017.

Council

On 11 July 2017, the Council agreed an action plan to address the problem of NPLs in the banking sector, based on the recommendations in its Financial Services Committee report. The action plan outlines a mix of policy actions to help reduce stocks of NPLs and to prevent their future emergence.

The Councils action plan inter alia invites:

> the Commission to consider prudential backstops addressing potential under-provisioning;
> the Commission to develop, by summer 2018, a European approach to foster the development of secondary markets for NPLs;
> the EBA to issue, by summer 2018, general guidelines on NPL management for all banks in the EU;*
> and the EBA to issue, by the end of 2018, enhanced disclosure requirements on asset quality and NPLs.

* On 8 March 2018, the EBA launched a consultation on its general guidelines on how to effectively manage NPEs and forborne exposures, which runs until 8 June 2018.

European Commission

The Commission reflection paper of 31 May 2017 on deepening the Economic and Monetary Union points to the need for a European strategy for NPLs, calling them "*one of the most damaging legacies of the crisis*", which, if not tackled, would continue to weigh on the performance of the banking sector and remain a potential source of financial fragility.

In its Communication on completing the Banking Union, published on 11 October 2017, the Commission announced that it will propose a comprehensive package of measures to address NPLs by spring 2018, consisting of the following measures:

- a blueprint for how national Asset Management Companies can be set up,
- measures to further develop secondary markets for NPLs,
- measures to enhance the protection of secured creditors,
- a benchmarking exercise of loan enforcement regimes to get a reliable picture of the delays and value-recovery banks experience when faced with borrowers' defaults,
- a report, accompanied if appropriate with the necessary legislative proposals, on the possible introduction of minimum levels of provisioning for future NPLs,
- and a proposal to foster the transparency on NPLs by improving the data availability and comparability.

On 14 March 2018, the Commission then presented its package of measures to tackle high NPL ratios, which in particular proposes a regulation on a minimum loss coverage for new NPEs (integrating the EBA definition of NPEs into the CRR) that asks – depending on whether the loan is secured by collateral or a guarantee, or unsecured – for a gradual coverage over time and full coverage of secured NPEs after seven years.

On 18 January 2018, the Commission tabled its first progress report and on 14 March 2018 its second progress report on the reduction of NPLs in Europe. Both reports conclude that NPLs continue to decline in the Union, but that despite this positive trend, high NPL ratios remain an important challenge for several Member States and for the Union as a whole.

Those reports are in many parts identical, but are also some subtle changes in the displayed reasoning: While the first progress report argues that high stocks of NPLs can weigh on a bank's short- and longer-term performance since NPLs require higher levels of provisioning, the second progress report attributes the same effect to the cause that NPLs generate less income.

European Central Bank / SSM

In July 2015, the ECB mandated a high-level group to develop a consistent supervisory approach to NPLs and to identify a number of best practices in tackling NPLs. Those practices were summarised in the ECB's Guidance to banks on non-performing loans that was published in March 2017 and that from then on set out the related supervisory expectations.

That Guidance was complemented by a draft Addendum to the ECB Guidance to banks on NPLs, published on 4 October 2017, which aimed to reinforce the guidance with regard to fostering timely provisioning and write-off practices and in particular specified quantitative supervisory expectations for minimum levels of prudential provisions for new NPLs. On 9 October, the President of the EP sent a letter to the ECB, addressing the question which institution is legally responsible for setting quantitative provisioning targets, to which the ECB replied in a letter dated 13 October 2018.

On 15 March 2018, the ECB published the final version of its Addendum to the ECB Guidance to banks on non-performing loans, which sets out the supervisory expectations for the prudential provisioning of NPEs. That guidance, like the Commission's draft regulation on minimum loss coverage for NPEs, aims to avoid that there is another build-up of insufficiently covered NPEs in the future.

Annex 1: Recent evolution of NPL ratios (weighted averages) in the EU

EBA's Risk Dashboard is based on an EU-wide sample of large banks, covering more than 90% of the EU banking sector by total assets (the sample includes 152 banks for the third quarter 2017; the full sample of banks reporting to EBA is even larger, including a number of subsidiaries that are in this context not taken into account; over time, the composition of the sample is subject to changes, for examples due to mergers or the termination of business activities).

	NPL Ratio		
	Sep-15	Sep-16	Sep-17
AT	7,4%	5,8%	4,0%
BE	3,9%	3,4%	2,7%
BG	12,7%	13,7%	11,7%
CY	50,0%	47,4%	40,6%
CZ	3,4%	2,7%	1,6%
DE	3,1%	2,7%	2,1%
DK	3,6%	3,4%	2,5%
ES	6,8%	6,0%	4,8%
FI	1,4%	1,6%	1,6%
FR	4,2%	3,9%	3,2%
GB	2,4%	2,2%	1,6%
GR	43,5%	47,1%	46,6%
HR	13,6%	10,5%	8,9%
HU	16,0%	12,8%	10,1%
IE	20,6%	14,4%	11,4%
IT	16,9%	16,4%	11,8%
LT	5,5%	4,1%	3,1%
LU	1,5%	1,2%	1,2%
LV	4,9%	3,6%	2,6%
NL	2,8%	2,6%	2,4%
NO	1,3%	1,7%	1,6%
PL	7,3%	6,5%	6,0%
PT	18,8%	19,8%	16,7%
RO	16,1%	10,7%	8,4%
SE	1,0%	1,0%	0,9%
SK	5,2%	4,6%	3,6%
EE	n.a.	1,4%	1,3%
SI	n.a.	16,3%	12,6%
MT	n.a.	4,6%	3,6%
EU	5,9%	5,4%	4,2%

Source: EBA Risk Dashboard (data as of Q3 2015, Q3 2016, and Q3 2017)

Annex 2: Recent evolution of NPL coverage ratios (weighted averages) in the EU

EBA's Risk Dashboard is based on an EU-wide sample of large banks, covering more than 90% of the EU banking sector by total assets (the sample includes 152 banks for the third quarter 2017; the full sample of banks reporting to EBA is even larger, including a number of subsidiaries that are in this context not taken into account; over time, the composition of the sample is subject to changes, for examples due to mergers or the termination of business activities).

	NPL coverage ratio		
	Sep-15	Sep-16	Sep-17
AT	54,7%	53,5%	54,7%
BE	42,6%	43,0%	44,8%
BG	54,9%	59,9%	58,1%
CY	33,9%	38,4%	45,5%
CZ	59,6%	62,4%	62,0%
DE	35,4%	40,1%	39,8%
DK	32,7%	31,2%	30,5%
ES	46,3%	44,4%	41,9%
FI	32,4%	26,6%	25,6%
FR	51,6%	50,8%	51,1%
GB	31,5%	30,3%	32,4%
GR	47,6%	48,2%	47,5%
HR	56,2%	61,4%	57,9%
HU	57,9%	62,0%	64,0%
IE	40,8%	37,9%	32,2%
IT	45,1%	47,2%	50,1%
LT	31,5%	33,3%	30,2%
LU	41,9%	44,5%	40,4%
LV	32,9%	27,7%	29,5%
NL	38,7%	35,9%	32,1%
NO	42,7%	30,4%	32,5%
PL	57,8%	60,8%	59,8%
PT	39,0%	42,1%	45,3%
RO	66,6%	63,5%	68,8%
SE	30,6%	28,6%	29,2%
SK	55,3%	54,1%	59,8%
EE	n.a.	28,5%	23,8%
SI	n.a.	66,7%	65,1%
MT	n.a.	35,6%	37,1%
EU	43,6%	44,3%	44,7%

Source: EBA Risk Dashboard (data as of Q3 2015, Q3 2016, and Q3 2017)