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"The fallout from the Covid-19 crisis will likely create a surge in insolvencies and bankruptcies resulting in mounting bad loans."

DAWN OF A NEW NPL CYCLE IN EUROPE

Non-performing loans (NPLs) are an integral part of the lending cycle. During an expansion phase, banks provide more loans, and relax lending conditions; when the cycle turns, a portion of those loans becomes non-performing or defaults. NPLs are invariably bad news for banks as they consume capital, time and resources, and so are considered as a bad omen for the real economy. Banks saddled with large stocks of bad debt subsequently reduce their lending activity, and NPLs become a direct threat to economic growth and financial stability. The fallout from the Covid-19 crisis will likely create a surge in insolvencies and bankruptcies resulting in mounting bad loans. The European Commission (EC) and the European Banking Authority (EBA) understand how critical it is to have an adequate framework and a coordinated response to tackle this upcoming problem. What are the proposed measures to prevent banks from being clogged with bad debt?

NPLs are a very complex issue for banks and can become a torment if not effectively addressed. Firstly, banks are not sufficiently operationally organised to deal with NPLs, as servicing pools of bad loans require specific tools and skillsets, hence the existence of special servicing platforms. Additionally, the pricing of NPL portfolios is a major obstacle to selling on the secondary market due to wide bid-ask spreads; banks that have not aggressively taken loan loss provisions have therefore little incentive to become sellers. The existence of a significant spread originates mostly from initial assumptions, recovery scenarios, information asymmetry and cost of capital for the buyer.

ADDRESSING THE CHALLENGES

In mid-December, the EC unveiled a plan to address the above issues, with the EBA, already expressing its full support to the Commission's proposal. The plan is centered on three key elements that are recognised as essential to accelerate NPL resolutions.

Firstly, the EC recommends strengthening and supporting the creation of secondary markets for NPLs. Since secondary market transactions are usually the easiest route for banks to offload their pool of bad loans, the existence of a robust and transparent secondary marketplace is crucial, not only for banks to act as sellers, but also for buyers to invest with increased confidence. This requires the standardisation of data available allowing comparisons, post-trade information creating transparency, as well as execution standards attracting new entrants to improve the competitive bidding process.

The second pillar supports the creation of Asset Management Companies (AMCs), also known as 'bad banks'. AMCs are an effective tool to free up banks from bad loans. Europe has had two very successful AMC interventions in the last decade with NAMA in Ireland and SAREB in Spain. Due to the different insolvency laws and jurisdictions in Europe, introducing an AMC is always a national initiative. Andrea Enria, Chair of the ECB's Supervisory Board, suggested that Europe could go further by creating a network of AMCs via a "common funding mechanism and harmonised pricing". Indeed, the idea of greater collaboration within Members States dealing with NPLs seems to be gaining momentum across Europe but still faces many hurdles Before harmonised funding becomes a reality comes to life, the creation of a network of AMC allows the potential for potential synergies, exchange of best practices and standardisation of data.

Finally, the Commission proposes converging insolvency frameworks across the EU, either through a legislative or non-legislative process. Although this process appears important in the long term, if the goal is to address the Covid-19 crisis economic fallout as soon as possible, it is most likely that the EBA will focus in the short term on the Commission's first two proposals. None of those proposals are mutually exclusive: an example of a strong secondary market currently exists in Greece, and the Greek government is already discussing the creation of an AMC.

WHAT LIES AHEAD

Unlike most crises, the NPL cycle has some predictability due to the inertia of loans-related losses. The recovery from the Covid-19 crisis will undoubtedly depend on both the fiscal and monetary response provided, and also on how successful banks are in dealing with their bad loans. Now is the time for banks to make realistic assumptions on loan losses and prepare for an increase in NPL. Planning ahead while there is still time is crucial.

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