EBA EUROPEAN BANKING AUTHORITY

AMCs and the cleansing of EU banks' balance sheets

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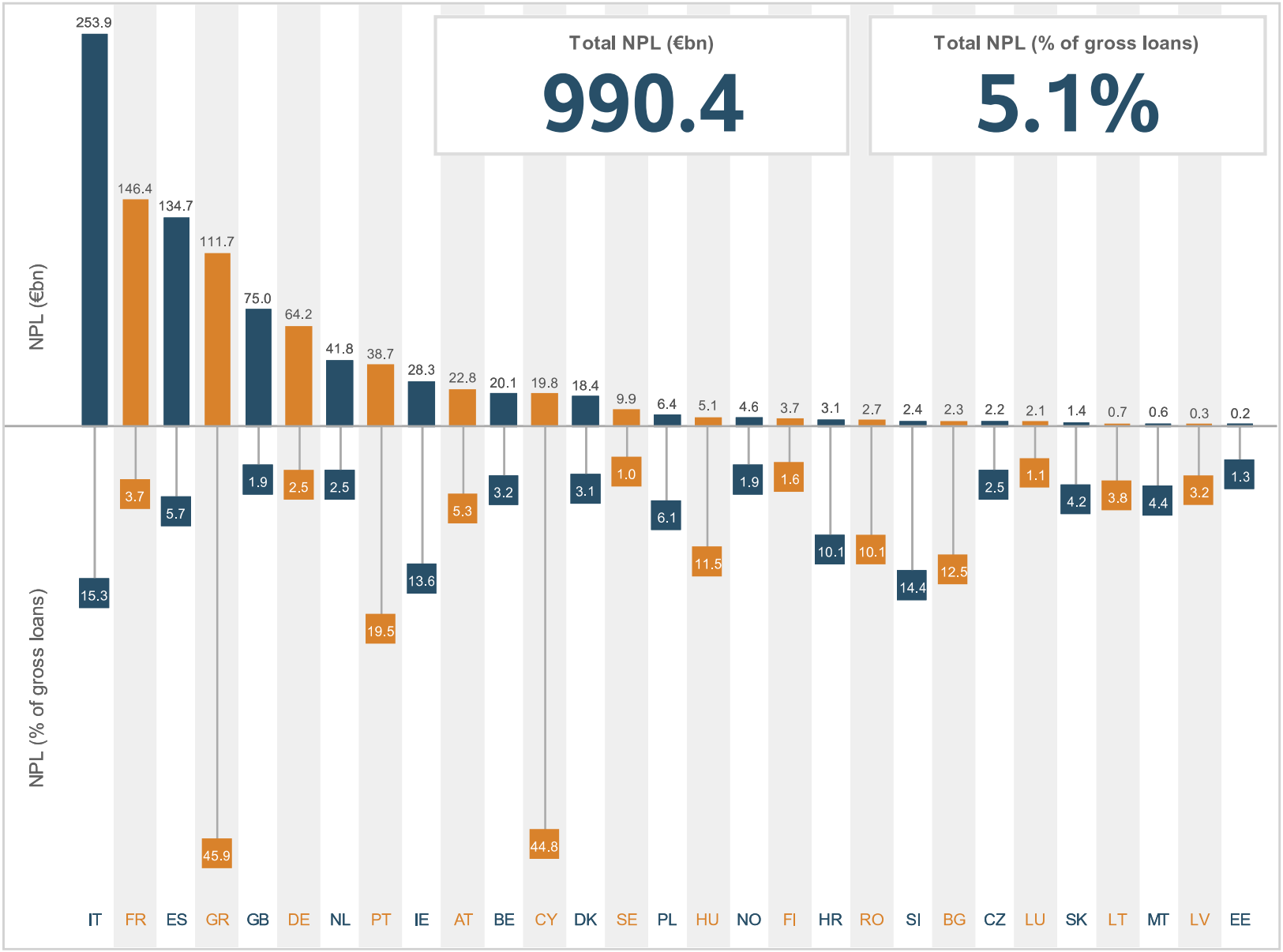
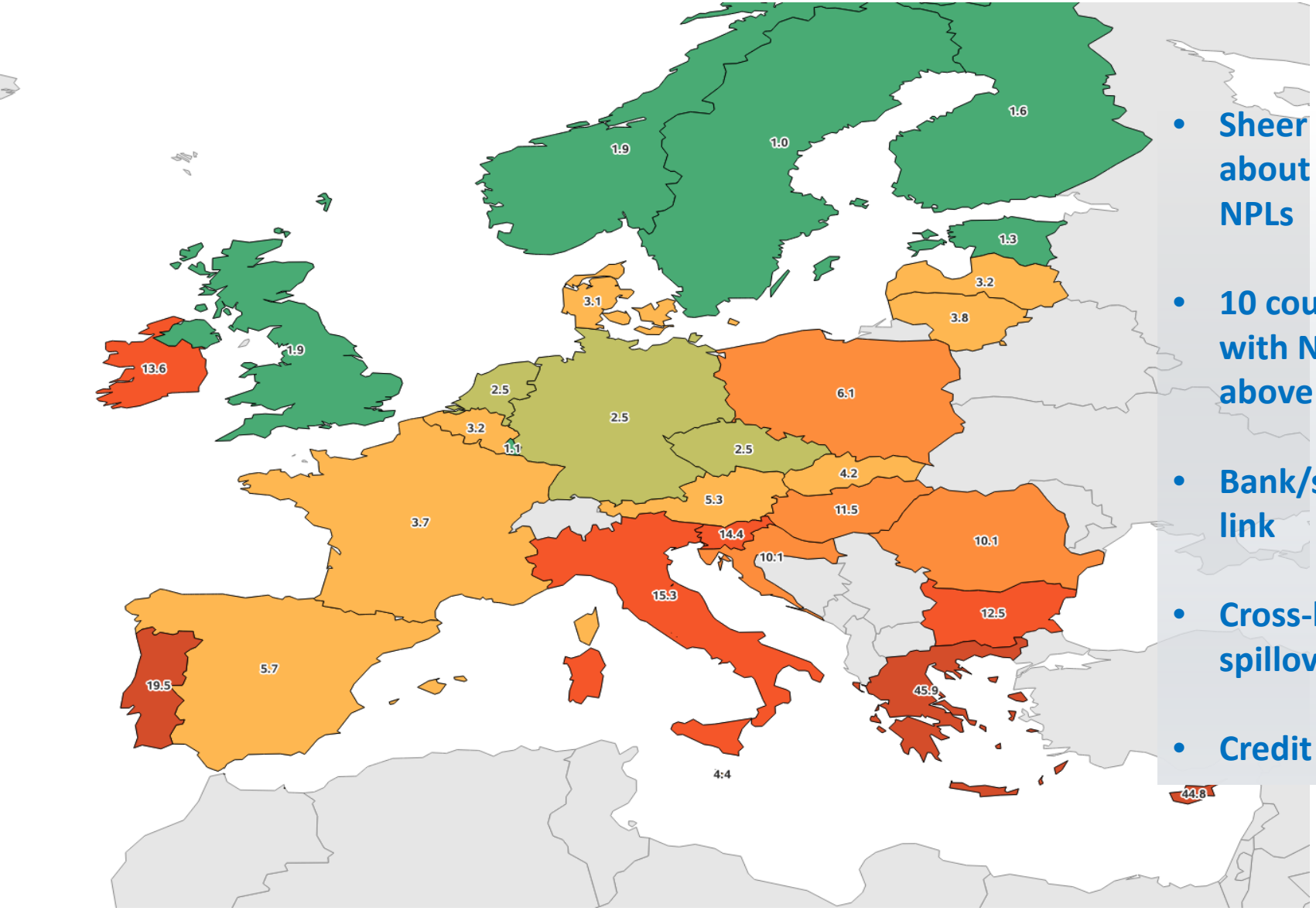
Nearly EUR 1tn of NPLs in the EU

(December 2016 data)



NPLs: significant differences across countries, but an EU problem

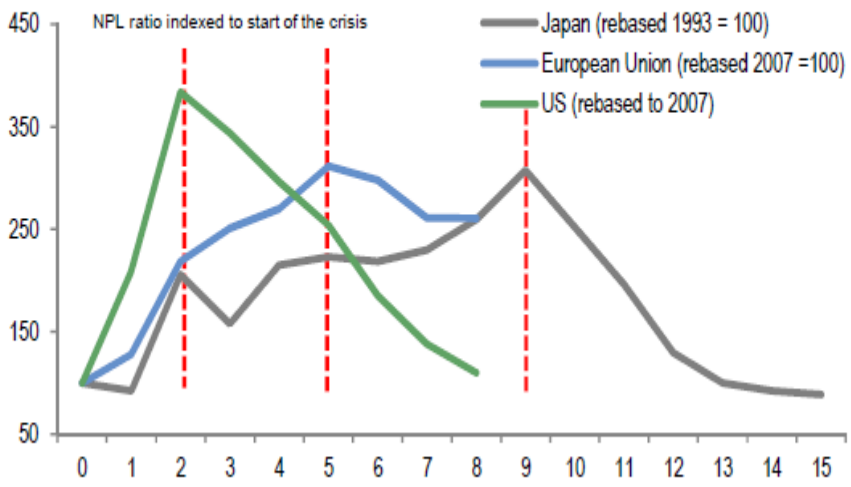
(December 2016 data)



- **Sheer size, about 1 trillion NPLs**
- **10 countries with NPL ratio above 10%**
- **Bank/sovereign link**
- **Cross-border spillovers**
- **Credit channel**

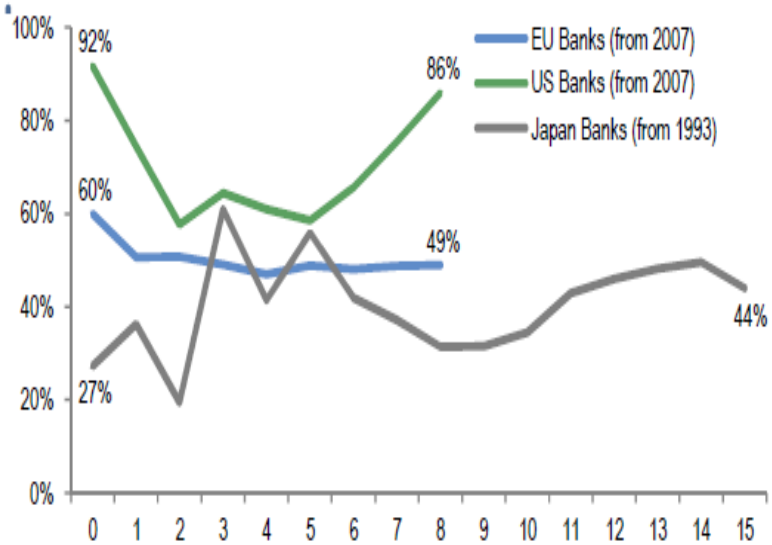
International comparison: need to accelerate

European Banks' NPL recognition faster than Japan early 90s crisis but slower than US banks



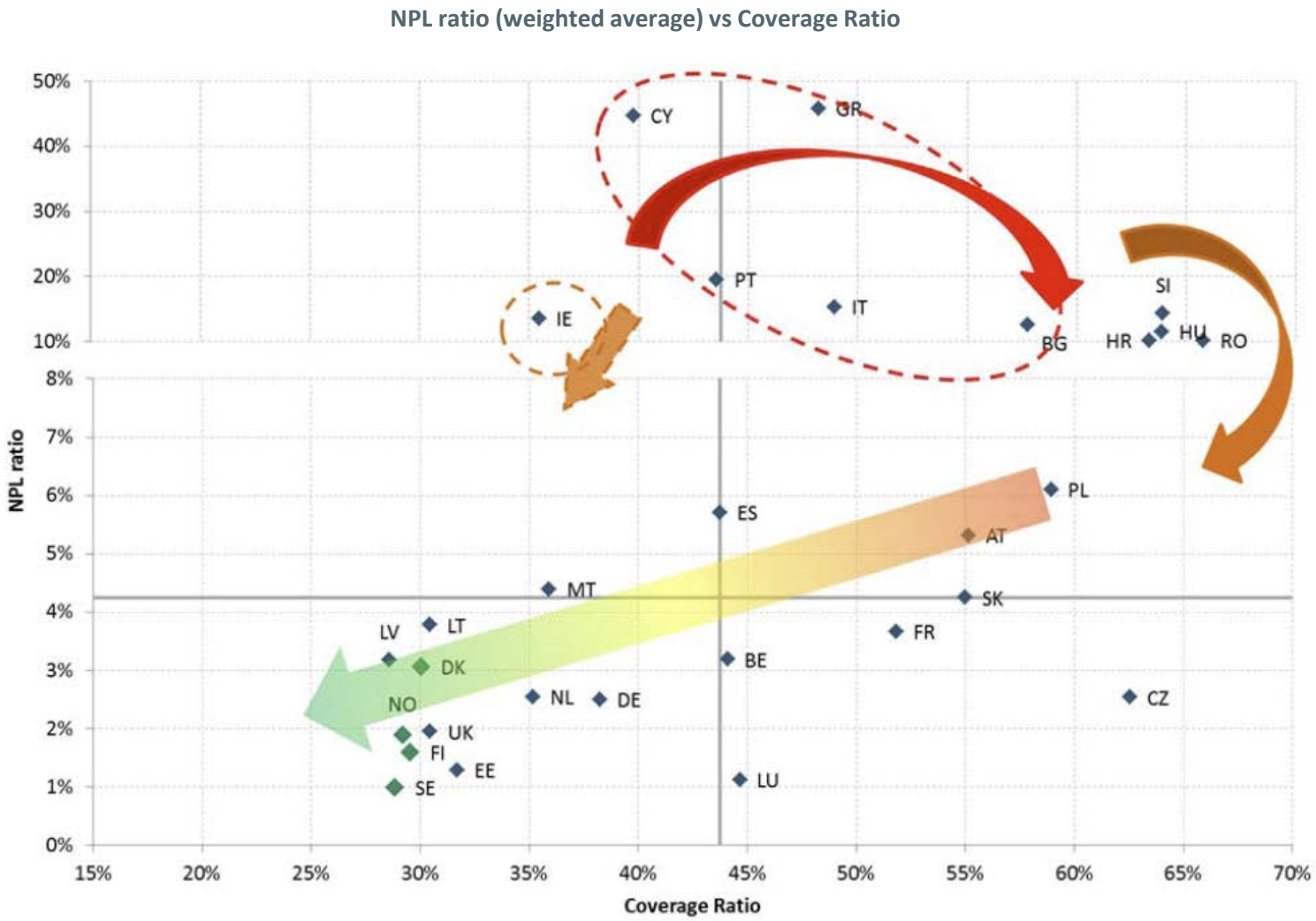
Source: FDIC, FSA Government of Japan, World Bank, J.P. Morgan estimates for EU 2015e data. NPL ratio defined as Non Performing Loans as % of total loans.

European banks' NPL coverage too low to clear



Source: ECB, FDIC. Note: FDIC insured institutions; All Domestic Banks for Europe. NPL coverage defined as provisions as % of NPLs

A snapshot on the adjustment process



Three areas require action

1) Supervision: a precondition for any NPL action

- Banks to develop strategy to tackle NPLs :
  - Improve arrears management with **independent work out units**
  - improve risk management with **quantitative and qualitative targets**.
  - **increase provisioning and assess collateral valuation**.
  - Foster higher levels of **NPL resolution**, which may require additional capital in some banks.

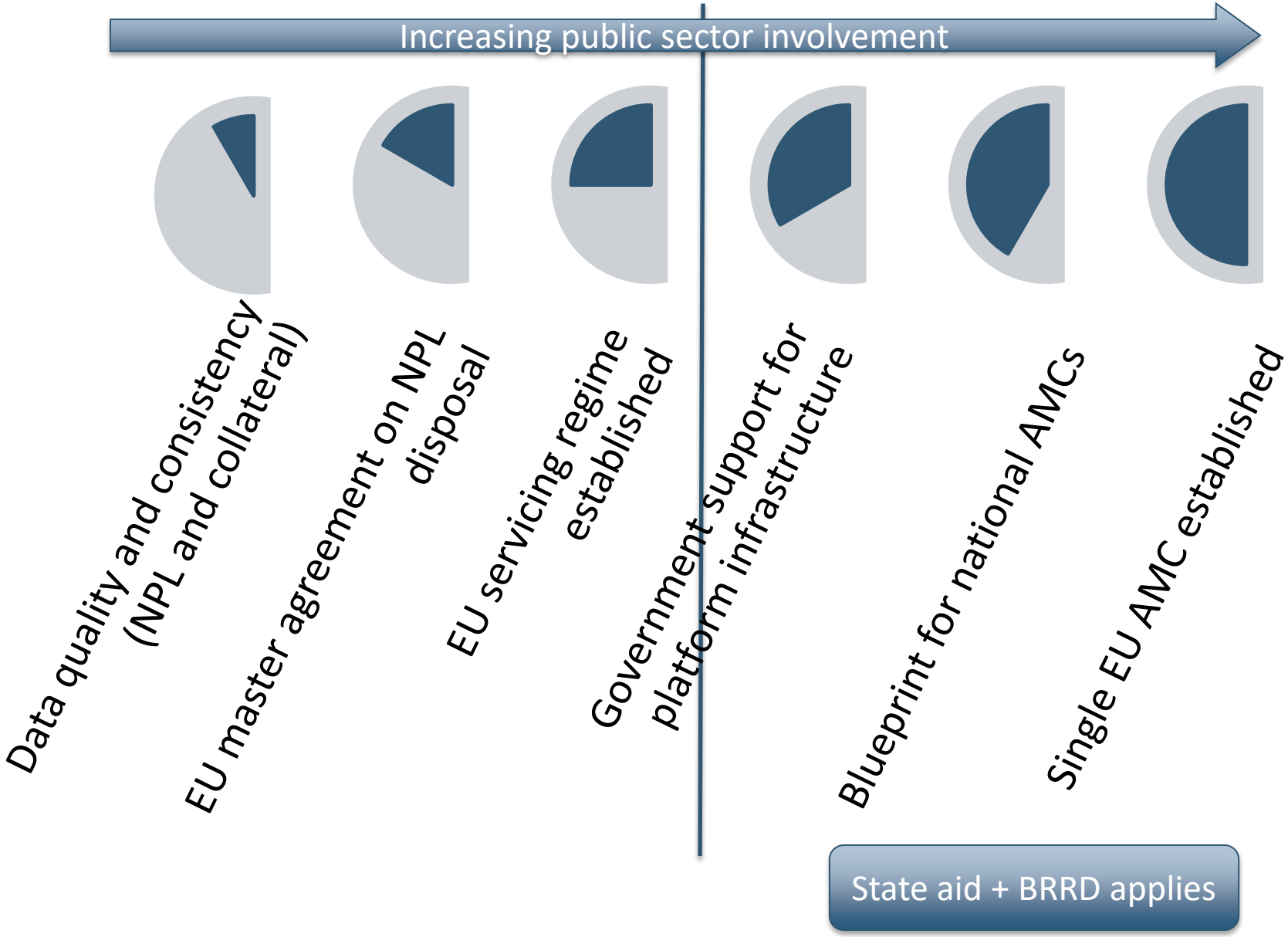
2) Structural changes: indispensable but beneficial in the medium term

- Medium term strengthening of **judicial systems and insolvency regimes are key**.
- Improve recovery processes in the near term by ensuring sufficient resources available
  - Support the use of **out-of-court restructuring if needed**
- **Accounting and tax incentives adjusted**

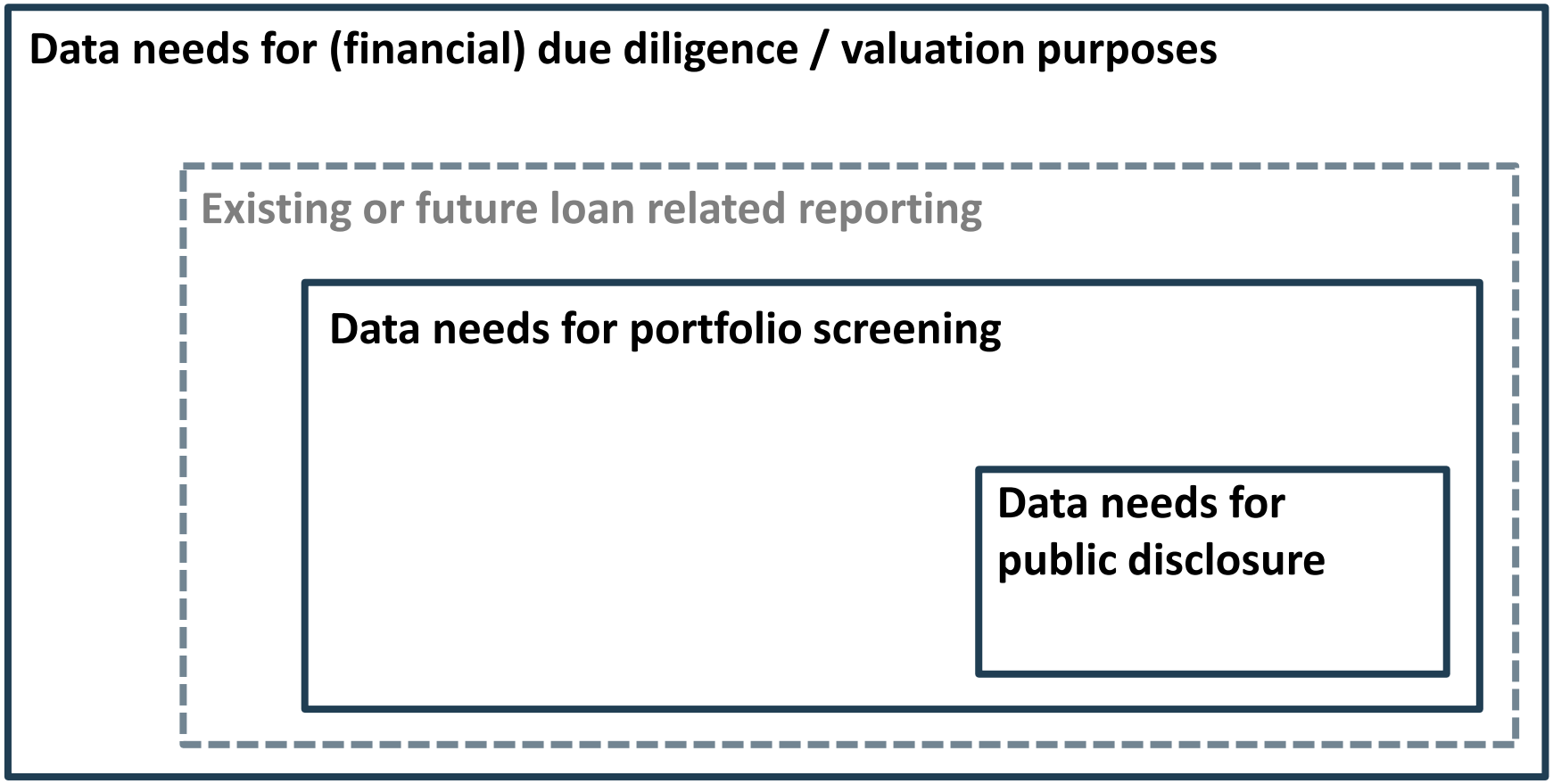
3) Secondary markets' efficiency: necessary for dealing with the legacy assets, following up supervisory actions

- Improvements needed in respect of
  - **Transparency**
  - **Price discovery**
  - Effective demand and the inter-temporal pricing problem
    - Supporting an establishment of **AMC solutions** (internally or externally).

There is a range of official sector actions



Improving data quality and consistency is one of the corrective actions to address market failures



AMC(s) some possible features – a single AMC or a blueprint for national AMCs

1. **Stress tests** are used to identify the total envelope of potential state aid for each bank

- e.g., capital shortfall against P2 minimum capital requirements under a three year adverse provisioning assessment reflecting stressed market prices.

2. Assessment of **real economic** value vs current market prices is designed, by asset class/geography.

3. The AMC(s) **established** with government support

- Capital (fully protected) is provided by the state (e.g. 8%) which crowds in funds from private investors.

4. Banks **transfer irreversibly** some agreed segments of their NPLs to the AMC at the real economic value

- Under due diligence from the AMC and accompanied by full data sets available to potential investors.
- The transfer of assets to an AMC would in the first instance hit existing shareholders at any transfer price below book value, restructuring and liability management exercises as required.
- The difference between current market prices and real economic value could be the theoretical extent of state aid under precautionary recap , but in this interim period financed by AMC capital and private investors.

5. The AMC sets a **timeline** (e.g. three years) to reassess the valuation of assets.

- If REV value is not achieved, national government exercises warrants at penal strike rates with full conditionality.
- The assets are fully removed from banks balance sheet and no uncertainty on a sudden capital hole
- But dilution and full conditionality keep banks skin in the game.
- National government in turn protects the AMC capital.

A critical assessment

- ***Mutualisation between EU member states***
  - ➔ **No mutualisation was in the proposal.** But the perception remains
- ***Scale and heterogeneity of assets***
  - ➔ Concerns about scale led to questions about the technical feasibility of an EU AMC which may outweigh the economics of scale and critical mass
- ***Clarity on state aid rules and incentives for banks***
  - ➔ A clean transfer with warrants could be replaced with other mechanisms such as payment in bonds.
  - ➔ The extent of immediate liability management exercise could be reviewed against the potential exercise of warrants.

An EU blueprint for national AMCs

EU blueprint for national AMCs still requires detailed criteria if it is to achieve the objectives of promoting credibility and achieving critical mass

- **Common entry criteria**
  - Stress test in a precautionary recap determines state aid envelope
  - Mandatory NPL sales threshold
  - State aid implications & dealing with the initial capitalisation needs
  - Data requirements and due diligence
  - Pricing – market value / real economic value / transfer value/ book value
- **Common Operating and financing criteria**
  - Financing the AMC – equity, mezzanine and senior
  - Financing the transfer – i.e. cash for NPLs, Cocos for NPLs, bonds for NPLs
  - Servicing
  - Funding the AMC on an ongoing basis
- **Common Exit criteria**
  - Timeline for assessing whether the REV will be met
  - Possible exercise of (warrant) mechanism
  - Flexibility to AMC to complete sale/workout remains

EU AMC(s) vs EU blueprint -compared

EU blueprints for national AMCs

- **Consistency and standardisation** of data
- **Clarity** and simplicity in understanding the interaction with relevant State aid and BRRD rules
- **Credibility -** whilst ensuring that due process is followed in the implementation phase
- Some critical mass may be achieved via a network of AMCs, whilst **scale becomes more manageable**

EU AMC

- **Consistency and standardisation** of data
- **Clarity** and simplicity in understanding the interaction with relevant state aid and BRRD rules
- **Credibility -** whilst ensuring that due process is followed in the implementation phase
- **Critical mass and economies of scale** on both the supply and the demand side
- **Lower funding costs** and operational efficiency
- **Neutrality** from national pressures

Prudential rules are not obstacle to NPLs sales

Banks argue that losses experienced in NPLs sales should be considered "exceptional", sterilising the impact on risk parameters (LGD) and capital requirements. However:

- ***Post-crisis NPL levels and losses stemming from NPLs sales are in line with other past crisis episodes***

  →LGD estimates required to capture the **downturn of economic cycles** (distressed market sale as part of those cycles);
  → **All defaults should be used** in LGD estimation: what happened in the past may happen in the future.

- ***LGD estimation rules include counterbalancing mechanisms of NPL sales***

  →**Cure rates** (re-performing rates) ensure that the impact of losses is less than one-on-one;
  → **Workout scenarios** (supervisory-led NPL distressed sale is one of them) may be assigned probabilities for the purposes of LGD estimation;
  → **A change in scope of application** of the model should be reflected in the model development.

- ***Given difference in current national approaches to stressed LGDs, banks should be given sufficient breathing space to implement new rules***

  → Banks to incorporate **NPL sales in LGD estimates by 2021.**

The regulatory framework has sufficient flexibility. But a more comprehensive policy agenda is needed to ensure faster write down and balance sheet cleansing in future crises (e.g., US GAAP-like rules).

Conclusions

Although NPL ratios are falling, at the current pace we won't be able to reach pre-crisis levels for many years and ***the process has to accelerate***.

We need to

- **Enhance the quality and consistency of data** - EBA is already working on possible common templates and definitions for NPL due diligence
- **Push ambitious NPL strategies** including NPL disposal with ambitious targets defined by supervisors
- **Address legal systems' issues** as best we can in the near term.
- Address market failures in the secondary market via a **network of AMCs** with common data, entry criteria, operating and financing criteria, and exit criteria.

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