BANCA D'ITALIA
EUROSISTEMA

Course on non-performing exposures (NPEs): legal and regulatory environment and operational approaches

Opening remarks by Paolo Angelini
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Thank you for your invitation to deliver the opening remarks to this course, which I find very useful at this juncture. First of all, I would like to briefly go over what happened in Italy in the last six years in terms of the management of non-performing loans (NPLs for short). I will then elaborate on possible developments in the stock of NPLs in the next two years. Finally, I will talk about the prospects for this sector.

1 The last six years

For major Italian banks (those classified as significant for supervisory purposes), the gap with the rest of SSM banks in terms of net NPL ratio essentially fell to zero: at the end of 2020, the average share of net NPLs in total loans was equal to 2 per cent, against 1.5 per cent for SSM banks. The gap was almost 7 percentage points at the end of 2015, when several respected observers pointed to Italian NPLs as a threat to financial stability at European level.

Numerous factors contributed to this positive outcome. A key role, albeit an indirect one, was played by macroeconomic developments. In fact, the exceptional accumulation of NPLs was caused by two back-to-back recessions affecting our country. With the gradual exit from the second recession, in 2014, the flow of NPLs started to decrease, and at the same time the amount of NPLs sold to specialist investors increased. This facilitated the reduction in the stock of NPLs.

The pressure put on banks by the supervisory authorities and by the market to encourage the proper management of NPLs was also essential. In 2016, the Bank of Italy instituted supervisory reporting specifically targeting bad loans, with the objective of prompting banks to get their databases in order. Databases that are complete, detailed, up-to-date and reliable are essential regardless of whether NPLs are to be recovered internally or sold. Low NPL prices in the market were in part due to insufficient information, which led buyers to ask for high risk premiums. To overcome this situation, we asked banks to provide us with very granular data: for each non-performing exposure whose amount exceeds €100,000 per individual borrower, numerous data fields were to be filled in (up to 50 for positions secured by real estate). Initially, banks were reluctant to comply, but it quickly became clear that our request was mainly in their own interest.

In 2017, the Single Supervisory Mechanism published guidance on NPLs for 'significant' banks, which the Bank of Italy subsequently extended (in abridged form) to 'less significant' banks, with the objective of identifying and promoting best practices.

This was followed by changes to the prudential and regulatory framework that introduced in Europe the 'calendar' approach,[1] which determines an increase in loan loss provisions (for both prudential and accounting purposes) to cover up to the entire amount of the position after a given time period. By reducing the risk that banks may adopt provisioning policies that are not very prudent and by contributing to enhancing the transparency of their balance sheets, this approach offers definite benefits for the stability of individual banks and for that of the system. However, this could have significant effects on banks' balance sheet, especially in countries marked by long recovery times, in which banks could find themselves recording losses and subsequent rebounds in value when the recovery procedure comes to a close. For this reason, pending administrative or legislative measures to expedite recovery procedures, the Italian authorities endeavoured in different venues – and were successful in doing so – to prevent loan loss provisions mandated by the calendar rules from building up too quickly, arguing that there existed an 'optimal speed'.[2]

Finally, some important measures were taken by the Government. The scheme for securitized bad loans (GACS) provides state-backed guarantees, at market terms, on the senior tranches of securitized bad loans. This permits the application of a prudential weighting of zero per cent on the guaranteed tranche, which is therefore often withheld by the banks initiating the operation. The junior and mezzanine tranches are placed on the market, with third-party investors pursuing risk-return combinations in line with their risk propensity. The GACS scheme, which was recently extended up to June of next year, provides for a series of arrangements, fine-tuned over time, to incentivize proper conduct

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1 The European approach is composed of two measures: the 'Addendum'('Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures', published in March 2018) and the 'prudential backstop' (Regulation (EU) 630/2019 on prudential requirements relating to minimum loss coverage for non-performing exposures). Both measures set – for prudential purposes only (and therefore, not for accounting purposes) – minimum loss coverage ratios for non-performing exposures, to rise with the number of years since their classification as non-performing. At the end of that period (which differs based on whether collateral is present or not), non-performing exposures must have been written off in full for prudential purposes (i.e. they must be fully covered by regulatory capital) or for accounting purposes. See 'European regulations on calendar provisioning and on the classification of customers by banks', testimony by the Governor of the Bank of Italy, Ignazio Visco, before the parliamentary committee of inquiry into the banking and financial system, Rome, 10 February 2021 (only in Italian).

2 See 'The Italian banking system within the framework of European banking union', speech by the Deputy Governor of the Bank of Italy, Fabio Panetta, workshop organized by the Chamber of Deputies, 10 May 2018 (only in Italian); and 'Italian banks: where they stand and the challenges ahead', remarks by the Deputy Governor of the Bank of Italy, Fabio Panetta, Bank of America Merrill Lynch Italy Day Conference, 19 February 2018.

on the part of the players involved and to minimize the risk of the public guarantee being enforced.[3]

So far, 27 GACS-backed securitization operations have been completed, for a total gross book value of about €75 billion (accounting for about 40 per cent of all NPL sales carried out over the last five years). Developments in recoveries have been satisfactory overall, despite the pandemic: no losses have been allocated so far to the junior and mezzanine tranches, though some delays have been recorded in collections, due mainly to contingent factors (above all the 'closure' of the courts of law owing to the COVID-19 pandemic).[4]

A contributing factor to the reduction in Italian banks' non-performing exposures was the increased activity of AMCO SpA, an offshoot of SGA, a company established in the 1990s as part of the State's intervention for the recovery of Banco di Napoli and acquired by the MEF at the end of 2016. Today, AMCO is one of the main players in the sector. It oversees the whole NPL management process through agreements with partners specialized in credit recovery. As regards the management of unlikely-to-pay positions, it promotes restructuring operations to revamp Italian companies, including by granting new loans. AMCO intervened in numerous NPL sales, as part of the initiatives taken to streamline the banking sector and support the development of the NPL market.[5]

Dedicated tax incentives also played a part in encouraging the sale of NPLs. Decree Law 18/2020 ('Cure Italy' decree) introduced incentives for the sale of non-performing loans on the part of firms (both financial and non-financial corporations), which makes it possible to transform into tax credits a share of deferred tax assets (DTA) for an amount proportional to the value of the loans being sold. In 2020, this provision benefited sales made by banks for an amount of around €15 billion (as well as sales made by non-financial corporations for more than €1 billion). The recent 'Support-*bis*' decree law extended the incentives until the end of this year.

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3 To benefit from the guarantee, the senior securities must receive an external rating of at least BBB on the part of a leading rating agency. Moreover, the guarantee is provided by the State in exchange for remuneration at market terms. The fee is calculated based on the residual amount of the senior securities, and increases proportionally to the period covered by the guarantee. This encourages the players involved to accelerate the credit recovery process. Quantitative thresholds were included in this mechanism to ensure that the cash inflows are used above all for the full redemption of the senior tranche. If these thresholds are exceeded, the interest payments to the holder of the mezzanine tranche are suspended and the fees paid to the servicer of the securitization are reduced considerably and deferred. Servicers must submit quarterly data flows to the Ministry of Economy and Finance (MEF) to enable it to monitor the securitization operations.

4 See https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/2021-1/RSF_1_2021.pdf#p39.

5 The company ensures its funding by relying on self-financing and liquidity obtained in the market through the issuance of bonds reserved for institutional investors (as of today, securities totalling €3.6 billion were placed). As at end-2020, the gross value of the NPLs managed by AMCO rose to about €34 billion (€23 billion at end-2019), of which 58 per cent are bad loans and 42 per cent unlikely-to-pay loans. Owing to its being part of the public sector, purchases made by AMCO are examined by the European Commission's Directorate-General for Competition, under the EU rules on State aid, in order to rule out any economic benefits to the sellers.

2 The outlook for NPLs ...

The economic crisis of 2020 is bound to lead to a new increase in NPLs. Since the fourth quarter of 2020, the new non-performing loan rate has risen for both households and firms. For now, the figure remains very low, below the average levels for the period 2006-07. Moreover, there is a steady growth in the loans classified as Stage 2 under the IFRS 9 accounting standard, i.e. performing loans for which banks have reported a significant increase in credit risk since initial recognition. At the end of 2020, these loans amounted to just under €240 billion, or about 10 per cent of total non-performing loans.

Today, it is especially difficult to make reliable forecasts of developments in credit quality, owing to the numerous uncertainty factors. On the one hand, Italy is among the European countries in which the loss of GDP in 2020 was most significant. On the other hand, the policies adopted to support the economy – monetary, fiscal and prudential policies – were outright exceptional and were carried out in a coordinated manner. This has no doubt contributed significantly to curbing insolvencies.

The extensive use of debt moratoriums is contributing to the uncertainty of the current situation. These operations have constituted an effective form of temporary support to customers, who have taken them up in sizeable numbers, but they have also contributed to reducing the reliability of the indicators of bank riskiness during the current crisis situation. We estimate that, since March 2020, banks and financial corporations operating in Italy have received and approved applications for debt moratoriums totalling almost €280 billion.[6] As at 4 June 2021, there were still active moratoriums accounting for €136 billion, mostly ascribable to firms. The fact that around half of the moratoriums have expired and that, meanwhile, the flow of new NPLs has not increased significantly, suggests that debt moratoriums have fulfilled their role of helping borrowers to overcome temporary difficulties. On the other hand, the loans for which the moratoriums are still active, while falling sharply, are showing an increase in the share ascribable to borrowers currently in distress or who are likely to face future difficulties ('forborne loans').

Decree Law 78/2021 ('Support-*bis*' decree) stipulates that the legislative moratoriums that expire on 30 June may be extended until December upon explicit request by the borrower, to be submitted by 15 June. The measure requires borrowers to resume payments on the interest component.

We will soon know how many borrowers applied for an extension. These data, together with those on credit that will become available in the coming months, will help to outline more clearly the riskiness situation of Italian banks.

Overall, there are reasons to be cautiously optimistic about the credit outlook, if the recovery continues to follow the expected path. While it is likely that NPLs will rise over the next 12-24 months, such an increase should be markedly lower than that recorded in

6 This includes legislative moratoriums, moratoriums activated by the financial sector with characteristics that are similar to legislative moratoriums, and other moratoriums. See https://www.bancaditalia.it/focus/covid-19/tabelle-moratorie.pdf (only in Italian).

the aftermath of the two previous crises (the global financial crisis of 2008-09 and the EU sovereign debt crisis), for a number of reasons.

First, the two previous crises were followed by a slow and uncertain recovery, whereas we now expect annual GDP growth of around 4.5 per cent in 2021-22. The Government's support to households and firms – timely and targeted to those hit hardest by the crisis – has contributed to mitigating insolvency risk. The financial commitment has been significant: subsidies, tax credits, and grants to firms and self-employed workers exceeded €20 billion in 2020; taxes amounting to more than €25 billion were deferred or reduced. The support is continuing this year, funded by resources comparable to those of 2020.

Second, the two previous great crises led to the exit from the market of a large 'tail' of weak non-financial corporations, leaving in business companies that were relatively solid, with lower leverage than in the past.

Third, the procedures governing the management of NPLs – both within and outside the banking system – and their sale are much more developed today than they were ten years ago.

Fourth, in recent years, banks have adopted considerably stricter criteria for granting credit, incorporating new regulations and observations made by the supervisory authority.[7]

Fifth, in recent years, efficiency gains have been made in judicial proceedings relating to credit recovery, one of the main reasons behind the accumulation of NPLs in Italy. The reforms passed in 2015-16 introduced online platforms for judicial auctions and amendments to the Italian Code of Civil Procedure that reduced credit recovery times for some assets and improved the rules governing the auctions. It has been estimated that the average time necessary to sell foreclosed assets has decreased by about 40 per cent.[8] Conversely, no improvements were registered on the bankruptcy proceedings front, their duration being almost twice the EU average.

In assessing the degree of transparency of banks' balance sheets, one must take into account the entry into force, in 2018, of the IFRS 9 accounting standard, which enables banks to record loan loss provisions at the beginning of the business cycle (based on the 'expected loss' approach, which replaced the 'incurred loss' approach adopted by the previous IAS 39 standard). This, together with the rules on the prudential coverage of NPLs, brings forward the emergence of losses and encourages banks to work off these assets. The restrictions set by the supervisory authorities in relation to dividend distribution in 2020 contributed to creating space for the absorption of those provisions. In light of the heterogeneity registered in the field of loan loss provisions, in Italy and

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7 Further improvements on this front are expected from the entry into force, on 30 June, of the EBA guidelines on loan origination and monitoring.

8 See S. Giacomelli, T. Orlando and G. Rodano, 'Real estate foreclosures: the effects of the 2015-16 reforms on the length of the proceedings', Banca d'Italia, Notes on Financial Stability and Supervision, 16, 2019.

in Europe, banks will need to look very carefully at their provisioning policies and raise their coverage ratios, if below-average levels are not justified by a careful analysis of the composition of their assets.

3 … and for the development of the sector

The set of factors that I noted earlier has contributed to a significant development of the market for NPLs in Italy. In fact, the term 'industry' is probably more appropriate. It consists of a set of contractual rules and practices, and a number of entities that operate in this environment: banks selling NPLs; buyers (foreign investment funds, but nowadays Italian banks and funds as well); rating agencies specializing in evaluating NPL securitizations; financial intermediaries specializing in servicing; firms managing credit recovery; specialist law firms; entities conducting judicial auctions; and the courts and other entities involved in judicial proceedings.

The smooth functioning of this industry will benefit from the recent agreement reached between the European Parliament and the European Council on a proposal for a directive to introduce harmonized rules to encourage the development of a secondary market for NPLs. The new regulatory framework also provides protection for those borrowers whose loans have been transferred: they will have to be informed in clear terms of the loan's transfer and receive the contact information of the entities to which they should refer if necessary. Moreover, it will not be possible to penalize them by applying new fees or charges following the transfer of the loan. This proposal for a directive increases the debtor protection currently envisioned under Italian law in cases of transfers. At the moment, the latter only lays out some general rules, and does not stipulate a minimum information content to be made available to the borrower, nor does it establish a precise time frame for doing so. Furthermore, the rule that enables consumers to rely on the same defences they had against the seller of the credit also vis-à-vis the buyer, which is already in force for consumer credit, will be extended to property loans by the new directive. The existing practices will need to be adapted to the amended rules.

It remains crucial to enhance further the efficiency of the civil justice system. In this respect, the Next Generation EU funding is an exceptional opportunity that must be seized. The recently approved National Recovery and Resilience Plan (NRRP) sets out a detailed strategy for solving the main critical issues in the functioning of the civil justice system (the excessive duration of judicial proceedings and the considerable backlog of pending cases). The NRRP envisages the hiring of new staff with legal skills, on fixed-term contracts, to be used to create special units in every court, tasked with assisting judges; investments in ICT to complete the digitalization of the system; and the reform of the Code of Civil Procedure to simplify the rules governing judicial proceedings (including enforcement proceedings) and to encourage the use of alternative dispute resolution schemes. Overall, the reform has the potential to enhance the efficiency of the judicial system permanently. The focus on organizational aspects is important. The NRRP lays out explicit objectives for shortening the duration of judicial proceedings and monitoring tools to ensure these objectives are met. Its completion will be crucial, while managing the implementation risks that are inevitable in such a wide-ranging reform.

The key challenge for the banks and financial intermediaries operating in this sector will be to support firms that are facing difficulties but have a path to resuming regular business. Several banks are taking steps to identify and swiftly manage cases of borrowers in difficulty that have adequate prospects of recovery. Some banks have also drawn up operational plans to increase their staff numbers with a view to proactively managing distressed borrowers. We are calling on banks to close the gaps that have been accumulated.

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