NPL Conference: Challenges and Opportunities.
Regulatory requirements, strategies of banks and new operators

Non-performing loans: the market, the rules and a stronger system

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1. Introduction

In the debate at European level, the large volume of non-performing loans (NPLs) is still being used by those who would like a further reduction in banking risks as a prerequisite for greater risk-sharing (in relation to the launch of the European deposit insurance scheme). The data, however, indicate that the share of NPLs in total loans is rapidly shrinking, not only in Italy, and that the problem is being resolved; the idea that the high volume of NPLs held by Italian banks poses a problem for financial stability in Italy and in Europe is no longer sustainable.

In what follows I will focus first on the current state of the NPL market in Italy, highlighting some important structural changes that are improving operational features, transaction methods and, more generally, the 'thickness' of the market. I will then share some reflections on the changes that have recently affected the regulation and supervision of NPL management on the part of the banks, in both Europe and Italy. They are important changes, some of which are still being finalized, which may, if appropriately fine-tuned, make a significant contribution to the definitive resolution of the NPL problem. I will conclude with some reflections on the implications that recent developments could have for banks' business activities – implications that will have to be taken into account for them to ensure that their support to the economy can remain strong even in the new, more difficult regulatory environment.

2. The NPL market in Italy

The ratio between the stock of NPLs (including provisions) and all loans reached its peak in 2015 and subsequently began to decline. The latest data, from last June, show that Italian banks' gross NPL ratio was 10.2 per cent, against 16.5 per cent at the end of 2015. The corresponding amounts net of provisions were 5.0 and 9.8 per cent, respectively. For the 'significant' banks (SIs), there was a 4.1 percentage point decline in the gross NPL ratio in 2017 alone, greater than that programmed for that year in the three-year reduction plans (drawn up for the first time in 2016). Under the new plans, the net NPL ratio for SIs should fall below 4 per cent by 2020. More recently, the Bank of Italy asked the less significant banks (LSIs) with high levels of NPLs to produce similar reduction plans, which are currently being sent in. The average reduction in the gross NPL ratio recorded by these banks in 2017 was slightly less than that of the SIs but it was noteworthy at 3.0 percentage points.

The decline in NPLs in 2017 mainly reflects securitizations and sales on the market (€35 billion gross). These operations should amount to €65 billion this year.

The fall in the stock of NPLs is attributable to various factors. First, it reflects the cyclical improvement, which has helped to bring down the flow of new NPLs to similar or lower amounts than those observed before 2008 and has had a positive effect on the prices of positions with collateral, mostly in the form of real estate. The measures introduced in 2015 and 2016 to speed up foreclosure proceedings are also having an effect. The improvements are not yet visible in the latest official data published by the Ministry of Justice. In 2017 the average duration of bankruptcy proceedings was recorded as 8.5 years on average, similar to the duration recorded in 2014. Real estate foreclosures took 4.5 years in 2017, against 4.0 years in 2014 (Figure 1.A). These are nevertheless average values that are weighed down by procedures that began in years prior to the reforms; the effects of recent changes will be seen with a lag. Alternative indicators, based on data taken from the public access section of the Ministry of Justice's Online Services Portal, show signs of improvement, especially as regards the sale phase of real estate foreclosure proceedings. For example, before the introduction of the new rules, only 8 per cent of foreclosure proceedings completed the sales phase within a year of the start; after the reform the share was more than 20 per cent (Figure 1.B).[1] The effort to speed up credit recovery times can be spurred on by the 'best practices' published recently by Italy's *Consiglio Superiore della Magistratura* (CSM).[2]

As regards the sale of NPLs by the banks, there has been a significant improvement in the quality of the analytical databases underlying the

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1 S. Giacomelli, T. Orlando and G. Rodano, 'Real estate foreclosures: how the process works and the effect of recent reforms', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 448, 2018.

2 Consiglio Superiore della Magistratura (Supreme Judicial Council), 'Buone prassi nel settore delle esecuzioni immobiliari - linee guide' (in Italian only).

portfolios, which is essential for both the sale and the management of these assets. Anecdotal evidence suggests that the sale price can vary very significantly depending on the quality of the data that the seller is able to make available to potential buyers. The supervisory arm of the Bank of Italy contributed to this improvement in January 2016 by asking the banks for a detailed statistical report on bad debts.[3]

Structural changes in the market also favoured the increase in sales of NPLs. A number of banks have decided to specialize in NPL purchase and recovery. Today, 5 specialized LSIs have €1.3 billion of NPLs on their balance sheets, corresponding to €20 billion in gross terms (also in the form of asset backed securities). Two years ago the equivalent sums were €700 million and €12 billion.[4] These banks also act as managers (the so-called 'servicer', that is materially responsible for recovering the value from the portfolio being sold). In the last two years, assets managed by special servicers have risen overall from €52 to €100 billion euros; those managed by master services from €4 to €88 billion. There is also a specialization by NPL type (consumer credit, business loans, covered or uncovered, etc.). There is, on average, a double digit return on capital for these banks. This is in line with the Bank of Italy's long held opinion: the book value of Italian banks' bad debts is, on average, in line with the values that the banks actually manage to recover; the banks must be ready to manage these assets in the best possible way, enhancing and accelerating recoveries as much as possible.[5]

There is also a flurry of activity among non-bank financial intermediaries. At the end of 2017, there were 16 specialized intermediaries listed on the special register created pursuant to Article 106 of the Consolidated Law on Banking (TUB), which were involved in buying and selling NPLs (4 of which belonged to banking groups) – 10 more than the previous year. The NPLs on their balance sheets had a net value of €680 million. In this sector there were also 9 companies specialized in servicing NPL securitizations, of which 3 belonged to banking groups.[6] The total amount of securitized loans

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[3] See Banca d'Italia, 'Nuova segnalazione delle esposizioni in sofferenza', January 2016 (only in Italian).

[4] These operations contribute to the fall in the gross NPL ratio of the sector, given that the gross amounts are replaced by net/sales prices, which are considerably lower.

[5] See I. Visco, Address to the Italian Banking Association (ABI) Annual Meeting, 8 July 2016.

[6] These are banks or financial intermediaries pursuant to Article 106 of the TUB, to which Law 130/99 reserves the business activities connected with securitizations (collection of receivables and cash and payment services) and the related guarantee functions in the interest of the holders of securities and of the market (verification that securitizations comply with the law and the prospectus).

managed by these companies was €28 billion compared with €18 billion the previous year. The sector of investment funds actively dealing in NPLs is also expanding. In the crisis years there were few of these funds, and they were mainly non-European, while by mid-2018 there were 21 Italian credit funds that had invested about €3 billion of net wealth in NPLs (most of which, however, attributable to a single fund). Lastly, it should be noted that in this sector there are also a good number of unsupervised entities at work.[7]

As regards market techniques, there has been a growth in securitizations and related transactions involving a significant transfer of risk. Several transactions featured the sale of both the NPL portfolio and the servicing platform; in some cases banks retained an interest in the platform. Even with the necessary caution in light of the limited number of transactions concluded so far and their noticeable lack of similarity, a preliminary review of the main characteristics of recent NPL securitizations is possible.

There is significant variance in the observed transfer prices (ranging from 16 to over 40 per cent of the gross portfolio value), due to the different quality of the underlying portfolio (share of collateralized positions, type of collateral, age of positions, size, etc.), and the differing conditions both of the market and of the individual originator (for example more recent transactions tend to benefit from a more mature market, while banks in difficulty may be penalized in negotiations). There are also differences in the amount sold (ranging from a minimum of a few hundred million to a maximum of €24 billion), mainly depending on the size of the intermediary. For now, there is no correlation between the volume of the sale and the price.

The thickness of the senior tranches of securitizations was between 60 and 90 per cent of the net value of the portfolio being sold. There is often a mezzanine tranche. Junior tranches accounted for between 3 and 13 per cent of the net value sold, mainly depending on whether mezzanine tranches were available.

A rating for the senior tranche was obtained in most transactions. A rating increases a tranche's chances of being sold; it also makes it easier to recognize

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[7] These are various entities, including foreign investment funds that only carry out investment activities in Italy without being marketed in this country. The Italian entities also include companies licensed for credit recovery activities pursuant to Article 115 of the Consolidated Law on Public Security.

a significant transfer of risk from the prudential point of view.[8] Obtaining a rating for the senior tranche appears to be relatively widespread in Italy, partly because it is a necessary condition for the state guarantee (GACS).

Banks often keep the junior and mezzanine tranches at the minimum required by law, which is 5 per cent (risk retention). The maximum limit on the portion of these tranches to be retained is not explicit, but it is implicit in order to obtain the deconsolidation of the securitized portfolio, an essential objective of the banks that carry out this kind of transaction.[9] Although the total retention of the senior tranche was observed in most cases, in others shares of up to 75 per cent of the tranche were placed on the market. In most transactions (including larger ones), the securities issued by the securitization vehicle were purchased by a single investor.

In all the operations observed so far, servicers are independent of banks (independence is a requirement for GACS). The rating agencies also evaluate how good a transaction is on the basis of the characteristics and reputation of the servicers. For similar reasons, servicers also play a fundamental role in the prudential analysis of transactions.

The overall effect of this series of cyclical and structural developments, set against the sharp increase in the supply of NPLs on the market, and therefore of sales, is that there has been no decline in prices. The latest calculations made using Central Credit Register data on 2016, indicate that recoveries by sale yielded an average of 23 per cent of the gross value (20 per cent in 2015).[10] The preliminary calculations for 2017 produce similar values.

The Bank of Italy is called upon to evaluate the securitization transactions promoted by the banks in order to ascertain if there has been a significant transfer of risk and that it is commensurate with the capital relief, avoiding regulatory arbitrage. The current approach is to evaluate each transaction on a case-by-case basis, bearing in mind the accounting choices made by the bank and taking them as a whole rather than relying solely on quantitative

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8 In the presence of NPLs, in fact, the mechanical tests envisaged by the CRR (e.g. the transfer of at least half of the mezzanine tranche) are not considered sufficient for the purpose of recognizing the significant transfer of risk.

9 More specifically, there are usually two objectives: prudential deconsolidation, which may reduce capital absorption, and accounting deconsolidation, which reduces the NPL ratio and avoids calendar adjustments which will be discussed later.

10 See F. M. Conti, I. Guida, A. Rendina, G. Santini, 'Bad loan recovery rates in 2016', Banca d'Italia, *Notes on Financial Stability and Supervision*, 11, 2017.

deconsolidation tests, which are currently not sufficiently robust. A recent discussion paper published for consultation by the European Banking Authority (EBA) has correctly highlighted the need for changes to the regulatory framework regarding significant risk transfer, in order to better adapt it to the characteristics of securitization transactions, especially those involving underlying NPLs, and to facilitate the harmonization of supervisory practices.[11]

3. Changes to the regulatory and supervisory framework for NPLs

In recent years there have been numerous developments regarding the regulation and supervision of NPLs. In what follows I review some of the main ones.[12]

The ECB's Addendum and the Commission's proposed regulation – With reference to supervision, on 15 March 2018 the European Central Bank (ECB) published the final text of its 'Addendum' to the guidelines on NPLs. The Addendum, which applies to 'significant' euro-area banks, specifies the ECB's prudential provisioning expectations for exposures classified as non-performing after 1 April 2018. Banks must adopt a calendar ('vintage') approach, which consists of gradually writing down new NPLs over time until they are fully written-off at the end of a given period, regardless of the actual recovery prospects and accounting valuation. More specifically, new NPLs, even those stemming from credit granted in the past, must be fully written-down within 2 years (if uncovered) or 7 years (if covered) from the time they are classified as such. The required write-down is prudential: banks are encouraged to make accounting adjustments as appropriate, and to deduct from regulatory capital any difference between the accounting adjustments and those emerging from the calendar approach. The Addendum does not

11 EBA, Discussion Paper on the Significant risk transfer (SRT) in securitisations, September 2017. The main topics covered by the Discussion Paper concern the process of verification of SRT by the authorities, the integration and modification of the quantitative thresholds envisaged by the CRR, the supervisory approach in the analysis of some structural features that may influence the actual transfer of risk (for example, amortization of tranches, cost of credit protection and call options) and the specificities of NPL securitizations.

12 A topic not discussed in this text, that would warrant a separate discussion, is the Directive of the European Parliament and of the Council on preventive restructuring frameworks, the second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures. The Directive does not directly concern NPLs, but by proposing the establishment of a harmonized minimal legal framework in the restructuring sector it should allow for better management of loans by companies in difficulty but not yet insolvent.

bind banks, which may deviate from its provisions if sufficient reason is given ('comply or explain').

In relation to the regulations, within the context of the measures in the action plan to tackle non-performing loans in Europe,[13] on 14 March the European Commission published a proposed regulation on NPL provisioning (the 'Regulation', to be included in the CRR 2-CRD 5 package which is in the process of being approved). It applies to all EU banks and provides that newly originated loans that subsequently become NPLs should be fully written-off within 2 years if they are uncovered and within 8 years if they are covered. For both types of loans, there is a lower write-off (80 per cent) for loans classified as 'unlikely to pay' (UTP) that are less than 90 days past due. The part of the write-off that is not entered in the balance sheet must be deducted from Common Equity Tier 1 (CET1).

Table A1 in the Appendix shows the main differences between the ECB Addendum and the proposed regulation. The Addendum does not distinguish between companies/debtors who, on the one hand, have suspended operations without the possibility of resuming them and therefore honour their debts and, on the other, companies in difficulty but still able to resume normal operations if properly restructured and assisted financially (the proposed regulation provides for at least a more favourable treatment of UTPs). This distinction, present in Italy (bad loans versus other NPLs) and in other countries ('going' versus 'gone' concern), was not provided for in the harmonized definitions officially adopted by the EBA in 2014.[14] Loans that have a chance of being reclassified as performing must therefore be subject to the same provisioning rules as bad loans.

The Commission's proposed regulation is now being reviewed by the European Council and Parliament. In line with the main objectives of the regulation, and bearing in mind the need to avoid regulatory arbitrage, it would be advisable to: exclude secured NPLs from the measure, provided that the assessment of the collateral is updated and consistent with the EBA methodology (or, provide for a maximum write-off of less than 100 per cent); provide for a maximum write-off of 90 per cent (instead of 100

[13] Council of the European Union, 'Council conclusions on action plan to tackle non-performing loans in Europe', press release of 11 July 2017.

[14] Debtors with loans that have a chance of returning to performing status are found in nearly all the NPL classes recognized by the EBA: non-performing forborne loans; unlikely to pay; and past due. They are most likely found among non-performing forborne loans and loans that have recently become past due.

per cent) for uncovered NPLs, and extend the time frame within which to reach the maximum coverage level; and adopt a less stringent approach for the write-down of loans which might return to performing status.[15]

These proposals take into account the statistical data available on NPL prices.[16] They would decrease the risk (particularly high in jurisdictions characterized by relatively long credit recovery times) of distortions in the allocation of profits over the credit recovery period, or the risk of excessive volatility of regulatory capital (depending on whether banks decide to apply the calendar approach by making accounting adjustments or capital deductions) which could follow a request to fully write-down positions.[17]

More importantly, these proposals would mitigate the risk that the new regulation may encourage banks to withhold financial support from firms that, if provided with adequate assistance, have a chance at recovering. From what has been said above, it is clear that banks should write down their debt positions vis-à-vis these firms, while at the same time supporting the firms in the restructuring phase. Therefore, incentives to abandon these companies may emerge, even in the presence of significant 'signs of life', in order to recover the maximum amount in the shortest possible time (for example, by recovering collateral). The potential negative consequences would not be limited to banks' balance sheets; they would extend to economic growth and employment.

The available data confirm that a minority, but significant, share (about a quarter) of firms with loans classified as non-performing in our country manage to return to performing status within 4 to 5 years (Figure 2).[18] Therefore, there is a risk that the reform will translate into a reduction of this share, with adverse effects on the economy as well as on banks' balance sheets.

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15 This is also consistent with the Report of the Subgroup on Non-Performing Loans (NPLs) prepared by the European Council's Financial Services Committee.

16 For example, even for uncovered positions, the selling prices found in recent market transactions are always largely positive, while the internal recovery rates of banks are over 20 per cent. See F. M. Conti, I. Guida, A. Rendina, G. Santini, 'Bad loan recovery rates in 2016'. Banca d'Italia, *Notes on Financial Stability and Supervision*, 11, 2017.

17 For example, a bank that was able to make good an uncovered position after four years should record, within the first two years, accounting losses (or capital deductions) equal to the entire position, and a profit from the recovery of value (or an increase in regulatory capital) in the fourth year.

18 This value is affected by the long economic crisis that affected our country. An estimate made over a period not influenced by exceptional events would most likely produce a higher value.

The changes to the Italian law on securitization vehicles. – In 2017, amendments were made to Law 130/1999 to extend the operational reach of securitization vehicles. The vehicles can now issue new loans to assigned debtors, acquire holdings from the conversion of securitized NPLs, and purchase and manage properties (or other assets) pledged as collateral for these NPLs. These changes facilitate the securitization of NPLs for which there are prospects of returning to performing status and encourage participation in bankruptcy auctions.[19]

The amendment on the LGD estimate. – Under current regulations, the losses recorded following the disposal of an NPL raise the estimate of the loss given default (LGD) of banks that use internal models to calculate their capital requirement for credit risk. Due to this mechanism, massive disposals of NPLs, which significantly reduce a bank's risk exposure, also translate into a significant increase in capital absorption. To eliminate this paradox, within the context of the negotiation on the CRR 2/CRD 5 package, the European Parliament approved an amendment that would introduce a transitional rule concerning transactions carried out from 2017 and up to 5 years after the entry into force of the law. If certain conditions are met, it would be possible to eliminate or mitigate the effect of massive NPL disposals on LGD.[20] To become operational, the law will have to be approved during the negotiations between the Commission, Parliament and Council.

The proposed directive on managers and purchasers of NPLs and on collateral recovery. – The proposal developed by the Commission aims at promoting the development of a pan-European secondary market for NPLs and facilitating out-of-court guarantee enforcement. For these purposes, the directive regulates three central aspects. The first concerns purchasers. It lays out harmonized rules on the market entry requirements for purchasers and on their supervision so as to overcome possible obstacles to cross-border operations and the full development of competition. Purchasers would not be subject to authorization, but only to limited requirements regarding

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19 See D. Albamonte, 'Recent changes to Law 130/1999 on securitization of loans'. Banca d'Italia, *Notes on Financial Stability and Supervision*, 10, 2017.

20 The amendment also defines as 'massive' those transactions carried out over several years, based on a specific plan notified to the supervisory authority which provides for the disposal of a minimum percentage of all the NPLs in the portfolio. For a discussion of the mechanism that links the sale of NPLs to capital absorption and an estimate of the effect, see M. Gangeri, M. Lanotte, G. Della Corte, G. Rinna, 'Why exceptional NPL sales should not affect the estimated LGDs of A-IRB banks', Banca d'Italia, *Notes on Financial Stability and Supervision*, 6, 2017.

notifications to supervisory authorities, even if they operate in EU countries other than their own. The second aspect concerns servicers, for whom a limited set of rules regarding authorization and supervision is provided (organizational and fit and proper requirements), as is a European passport. The third concerns the accelerated extra-judicial collateral enforcement (AECE) mechanism, which is similar to the Marciano pact (Article 48-*bis* of the TUB). There are also two means of enforcement: public auctions and private sales.

The proposal's overall objectives are commendable. Harmonized rules can help to bring about a larger, more competitive and efficient NPL market and to improve banks' ability to recover guarantees. However, the proposal can be improved upon.

First, the proposed rules on purchasers and servicers apply indiscriminately to both NPLs and performing loans. Taking into account the fact that the goal is to rid the banking system of NPLs, the possibility of limiting the scope of the Directive to NPLs issued and sold by banks or other financial intermediaries subject to prudential supervision (e.g. intermediaries in the single register provided for by Article 106 of the TUB), and excluding the sale of performing loans, is currently being discussed in the negotiations. In fact, there is a risk of encouraging asset migration to unregulated intermediaries (shadow banking) and of weakening the incentives for the proper assessment and monitoring of credit risks by banks.[21]

A second point concerns the supervision of servicers, which will be able to use powerful tools such as the AECE and play a fundamental role in managing credit relationships with clients holding loans classified as unlikely-to-pay, that may require new financing. Further reflection is needed on minimum safeguards for the authorization and supervision of servicers, which must be proportionate to the risks assumed and be suitable for monitoring credit assessment processes, preserving market integrity and protecting consumer rights.

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[21] By allowing banks and other supervised intermediaries to freely transfer performing loans to the purchasers envisaged by the Directive (that do not have to comply with prudential requirements and are not subject to supervision), the Directive may encourage the transfer of assets and risks to the unregulated sector. Furthermore, incentives for banks to properly evaluate and monitor the credit quality of debtors could be weakened. It should be noted that, unlike securitization, sales to purchasers do not entail risk retention mechanisms to keep incentives aligned.

Finally, as far as the AECE is concerned, the risk of abuse should be kept in mind. This is a very powerful out-of-court tool, which should be limited to adequately supervised entities, such as banks and other intermediaries (including servicers, provided they are subject to appropriate prudential requirements and controls).

4. Implications of the changes and prospects for the management of NPLs

Despite the improvements seen thus far, much remains to be done by banks on the NPL front. Major efforts are still needed to reduce the stock of NPLs, especially in cases where it is still relatively large. The work being done to improve NPLmanagement must continue.

The adoption of the new IFRS 9 accounting standard based on the concept of 'expected loss', in force since January this year, requires that all banks (including those that use the standardized method for calculating capital requirements for credit risk) use models capable of estimating expected losses both over the next twelve months and over the entire expected life of the position. This is an important change whose implications, also in terms of the procyclicality of write-downs, will have to be assessed over the next few years.[22] Banks were given the option of adopting a transitional regime, through which the extra provisions caused by the transition to IFRS 9 are reflected in the capital ratios only gradually.[23] Those who have chosen to use this mechanism will have to provide for adequate prudential margins in the face of unforeseen events.

The most significant impact will probably come from the calendar approach which – in the version in the Addendum or in that of the Regulation – will cause banks to reach very high write-down rates within pre-established times, regardless of the credit recovery times. For Italy, problems can emerge at both country level, given our position within Europe (Figure 3), and local level, taking into account the disparate average duration of credit recovery procedures in the various courts.

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22 The issue of the procyclicality of IFRS 9 is widely debated. See ESRB, 'Financial stability implications of IFRS9'.

23 The transitional measure introduced by Regulation 2017/2395 of the European Parliament and of the Council allows banks to include in CET1 a portion of the increased loss provisions required by IFRS 9, applying the following percentages: 95 per cent for 2018, 85 per cent for 2019, 70 per cent for 2020, 50 per cent for 2021, 25 per cent for 2022, zero thereafter.

It is conceivable that banks will pay more attention to collateral and its suitability for the purposes of applying the calendar approach. A recession that suddenly increases the flow of new NPLs could result in significantly higher provisioning for uncovered loans than in the past which, coupled with the effects of IFRS 9,[24] might be difficult to meet.

Banks will also need to consider whether to review their NPL management strategies. Will it be preferable to maintain positions until the recovery procedure has been completed? Or dispose of them as soon as the write-down has reached a level that is consistent with market prices? From an analysis of the significant risk transfer operations carried out thus far, an NPL management model seems to emerge that can be summarized as follows: (i) in partnership with an external investor, the bank creates a special company and transfers to it its stock of NPLs in whole or in part; the company acquires ownership and manages the NPLs; (ii) in compliance with the conditions necessary for the accounting and prudential deconsolidation of NPLs, the bank acquires the largest possible share in this company (up to a maximum of 49 per cent), to secure a substantial share of its profits. This model could align two conflicting needs – that of reducing the proportion of NPLs in a bank's balance sheet and that of limiting the transfer of value outside the bank. It could be suitable for medium-large banks, or consortia of smaller banks (for example, through multi-originator operations). However, the experience gained so far is insufficient to draw definitive conclusions on this issue.

A third important question for intermediaries who chose not to sell their NPLs is whether to manage them internally or entrust them to a servicer. The guidelines prepared by the European Central Bank for SIs and the Bank of Italy for Italian LSIs do not contain binding instructions in this regard.[25] However, from the above it is clear that credit recovery is a specialized activity. Intermediaries who decide to manage NPLs internally must invest adequate human and financial resources in this activity.

Finally, banks must review their management strategies for NPLs that are not classified as bad loans. As mentioned above, both the Addendum

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[24] In reference to the increased provisions connected with the transfer of credit positions from stage 1 to stage 2 provided for by the accounting standard.

[25] See ECB, 'Guidance to banks on non-performing loans', 2017; Banca d'Italia, 'Guidance on the management of non-performing loans for Italy's "less significant institutions"'.

and the proposed Regulation pay insufficient attention to the distinction between debtor firms in an irreversible crisis situation and those that have the possibility of returning to performing status. It is possible that the calendar approach will incentivize banks to abandon the second type of firm even in the presence of significant signs of life. Every possible measure must be taken to prevent this from happening.

Today, the outlook for businesses facing financial difficulties is already less than optimal. As shown in Figure 2, about a quarter of firms in difficulty are able to recover. Debt restructuring agreements in Italy often do not provide an impetus that is sufficient to ensure the firm's recovery; as such, after a few years the difficulty turns into an irreversible crisis.[26] This depends on many factors. Among them are the unwillingness of creditors to accept drastic debt cuts, which would solve problems of over-indebtedness, and the widespread practice of multiple lending: the presence of a large group of creditors with uniform exposures (by size, presence of collateral, etc.) makes it difficult to reach an effective and timely agreement, capable of reversing the crisis situation.

The development of turnaround funds could provide an important contribution to the recovery of firms in financial difficulty.[27] To date, a limited number of these funds operate in Italy. The reforms carried out in 2015-16 have increased the bargaining power of financial creditors vis-a-vis firms, providing them with important tools to increase the recovery plan's likelihood of success.[28] The development of restructuring funds is desirable, including in partnership with the banks. Pending a clear improvement in the rapidity of the justice system, banks must make greater recourse to out-of-court recovery methods, and pursue improvements in the latter.

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26 See L. Carpinelli, G. Cascarino, S. Giacomelli and V. Vacca, 'The management of non-performing loans: a survey among the main Italian banks', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 311, 2016.

27 See I. Visco, Address to the Italian Banking Association, 8 July 2016. Restructuring funds are investment funds (equity or with a low degree of leverage) that can contribute to restructuring firms in difficulty. The typical operator in this class is able to provide the firm with both entrepreneurial and financial support. The latter can be of various kinds, from risk capital to super-senior debt.

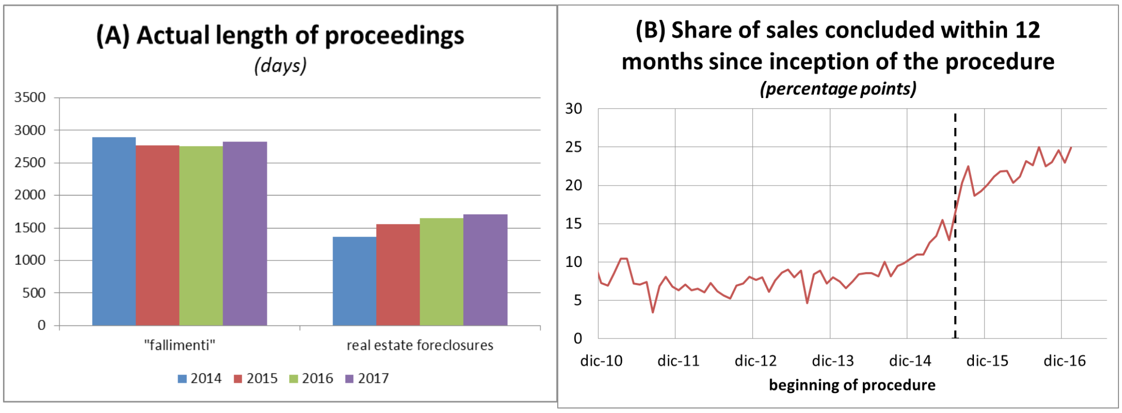
28 In particular, financial creditors who hold at least 75 per cent of a firm's total financial liabilities may enter into agreements that also become binding for the remaining creditors (previously these creditors retained the right to be fully repaid). In addition, creditors of a firm that has applied for a 'concordato preventivo' can submit to the court a competing restructuring plan to that prepared by the firm, provided they hold at least 10 per cent of its financial debt. This threshold can be reached by purchasing the debt from other creditors even after the request for a 'concordato preventivo'. See M. Marcucci, A. Pischedda and V. Profeta, 'The changes of the Italian insolvency and foreclosure regulation adopted in 2015', Banca d'Italia, *Notes on Financial Stability and Supervision*, 2, 2015.

In this new environment, a review of the approach adopted by the supervisor is also desirable. The Guidance published by the ECB in March 2017 places much emphasis on reducing the gross NPL ratio. In the presence of the new binding provisioning targets, this emphasis seems less defensible (positions that are largely or entirely provisioned no longer generate risks to the stability of the intermediary). Therefore, banks that respect the calendar approach should be given more freedom regarding the decision to keep or dispose of gross NPLs.

FIGURES AND TABLES

Figure 1

Credit recovery times in Italy: real estate foreclosure procedures

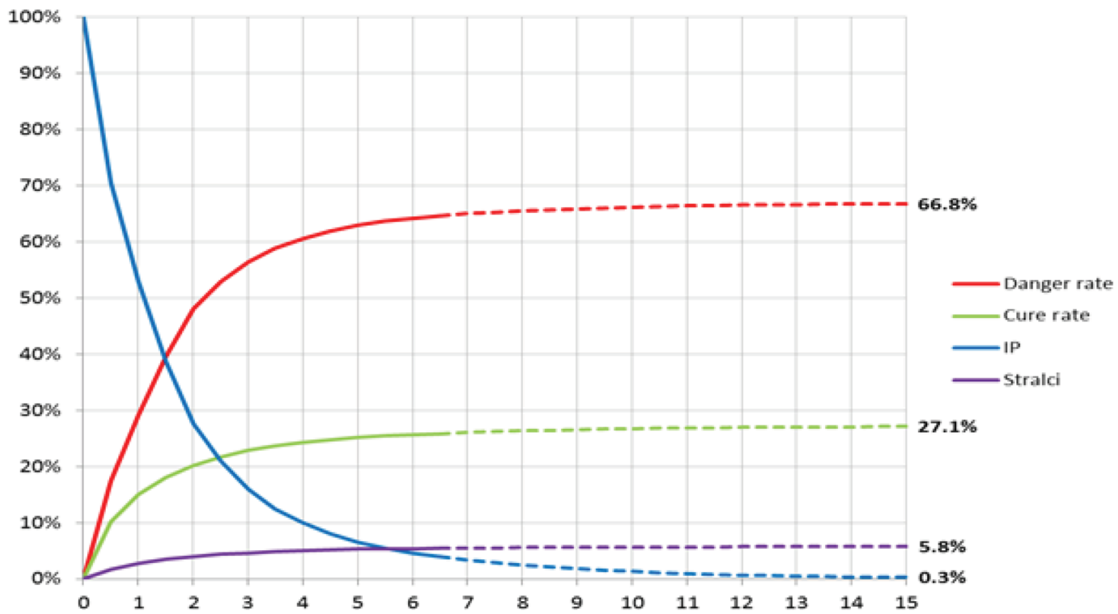


Note: The vertical dotted line in panel (B) indicates the date of entry into force (27 June 2015) of a package of reform measures for real estate foreclosure procedures. See S. Giacomelli, T. Orlando and G. Rodano (2018), 'Le procedure esecutive immobiliari: Il funzionamento e gli effetti delle recenti riforme'. Banca d'Italia, Questioni di Economia e Finanza, (Occasional Papers), 448.

Figure 2

Effective and simulated evolution of Unlikely to Pay (UTPs)

(cumulated percentages)



No. of years since classification as NPL

Source: Based on Central Credit Register data

Note: Percentage of going concern firms in NPL status at date 0 that remain in NPL status (IP curve) or migrate to a different status (bad – Danger rate; Performing – Cure rate; or written-off) over time. Data estimated on average six-monthly migrations. The continuous parts of the curves refer to the actual evolution of the variables listed in the legend. The dashed lines represent extrapolations.

Figure 3

Dispute resolution times and increases in the NPL ratio in the euro area

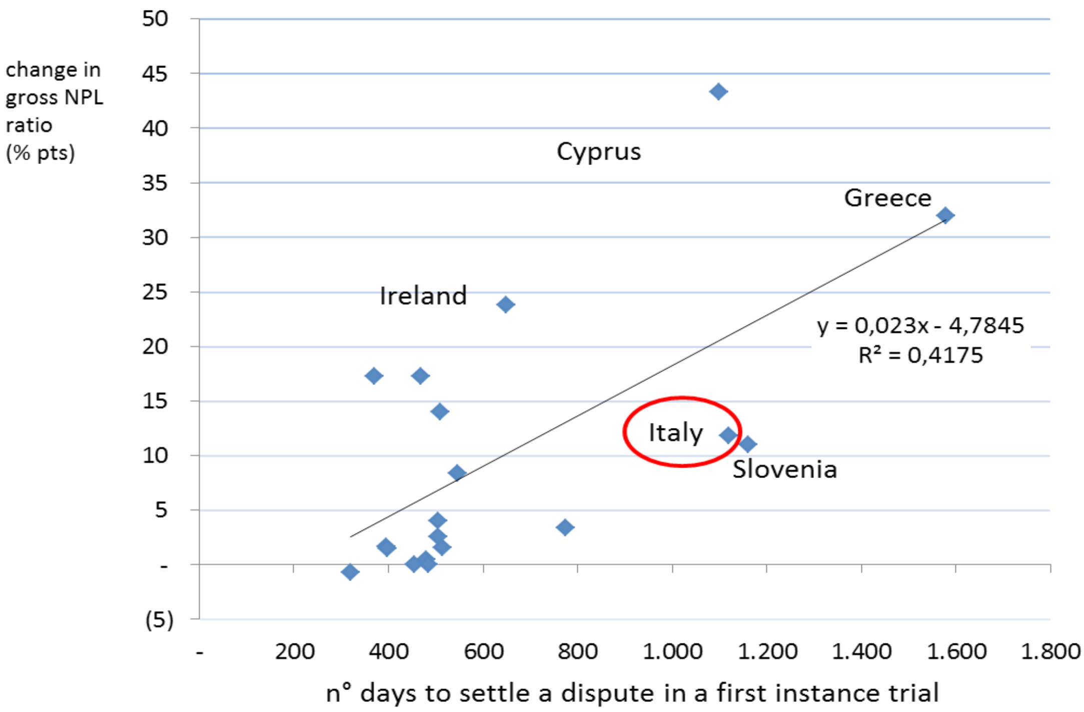


Table A1

Main differences beween the ECB's Addendum and the Draft Regulation

	ECB's Addendum	Draft Regulation
Type of bank referred to	Only 'significant' banks	All EU banks
Credit typology	Loans (regardless of date of issue) classified as non-performing as of 1 April 2018	Loans issued following the date of publication of the proposal (14 March 2018) subsequently classified as non-performing
Write-down period	7 years for covered loans 2 years for uncovered loans	8 years for covered loans 2 years for uncovered loans
Write-down percentages	For uncovered loans: 0% for the first two years; 100% after the second year. For secured loans: 0% for the first three years; linear growth (starting from 40%) after the third year.	Increasing progressively from the first year after classification as an NPL
Favourable treatment for UTPs with no past-dues of more than 90 days.	None	Maximum write-down of 80%
Type of measure	Pillar 2	Pillar 1

Note: for the Addendum, see *addendum_201803.en.pdf*.
For the draft Regulation, the table refers to the version at the following link: *https://ec.europa. eu/info/law/better-regulation/initiative/1183/publication/190913/attachment/090166e5b9388d30_en*

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