Carlos da Silva Costa: Addressing NPLs at a European level - leaving the crossroads

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, in the magazine of the Eurofi conference in Malta, 5-7 April 2017.

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Addressing the high level of NPLs was one of the SSM's supervisory priorities for 2016. It remains one of the major supervisory challenges in 2017.

Indeed, the overall stock of NPLs in the euro area is relatively high compared with other geographies, albeit with significant heterogeneity. Some Member States experienced a rapid surge in the NPL ratio subsequent to a burst of a real estate bubble. In other Member States, the increase occurred later and was widespread across sectors. This is the case of Portugal, for instance, where NPLs grew essentially in the context of the 2011–13 recession and are a manifestation of the ongoing economic adjustment process, characterized by a reallocation of resources towards the tradable sector and away from the construction and real estate sectors. The current setting mirrors these differences in pace and drivers, as well as the specificities of national economies: some jurisdictions report double-digit NPL ratios, while others report much lower levels.

In an integrated market, however, different ratios do not – cannot – mean different degrees of concern. Repercussions of high NPL levels cross borders: through banks' balances sheet cross-exposures, through economic spillovers in the face of subdued credit supply and hindered monetary policy transmission and inevitably through market perception. The systemic nature of such risks is heightened by widespread low bank profitability, increasing capital requirements and a still incipient NPL secondary market.

NPLs are, indisputably, a European problem. And a European problem calls for a European approach. But to what extent?

A European approach resides first and foremost on concerted action from all Member States. Enhanced efforts at national level, especially in what regards bank supervision and marked improvements in the legal/judicial/tax framework – notably to reduce the significant bid/ask spread in NPLs secondary market – are a necessary condition to address the high NPL stock and to build the foundations for a better management of flows. But they are certainly not sufficient. The abovementioned risks of contagion also require targeted and potent initiatives to reduce the NPL stock – and this is where a unified European strategy could prove more valuable.

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The first step for a unified European strategy is acknowledging its need. In the face of non-negligible risks to financial stability and financial integration, as well as the referred heterogeneity across banks and economies, a debate should be launched on the possible mismatch between the repercussions of high NPL levels and the current strictness of the EU legal and regulatory framework. In particular, the BRRD was designed for a steady-state, which is still far from the current situation in financial markets, and State aid rules, while placing financial stability at the core, seem to provide little flexibility to address the systemic nature of the problem. To reduce NPLs in a significant and swift way, these constraints must be addressed – but only a European approach can do so while ensuring the necessary level playing field, an essential precondition for the coordinated action that should follow.

This discussion – ideally complemented by enhanced flexibility – would provide decisive clarity on the rules of the game and likely pave the way for bolder solutions at national level, especially in countries where the NPL challenge is more pressing. It could also be the starting point for considering and conceiving a more ambitious strategy to effectively reduce NPL stocks across Europe. A strategy with the necessary firepower to enhance national efforts and complement ongoing initiatives in the SSM and other European fora. Some promising European approaches have been recently put forward and deserve to be further explored.