Vítor Constâncio: We need a coordinated European NPL strategy. How to deal with Europe's market for lemons?

Opinion piece by Mr Vítor Constâncio, Vice-President of the European Central Bank, 5 July 2017.

* * *

One of the most pressing issues for euro area banks is the nearly €1 trillion of non-performing loans (NPLs) on their balance sheets. While the average euro area NPL ratio has declined gradually from a peak of 8% in 2013, it still remains at 6% and differences across countries are marked: six countries still have NPL ratios of more than 10%, significantly more in some cases. This is not just a problem for banks. The flip side of NPLs is over-indebtedness among households and firms, and this poses a macroeconomic challenge – banks restrict credit supply and distressed firms curtail investment, which in turn hampers economic growth.

Asset quality issues were exacerbated by the global financial crisis. When the crisis hit, the surge in NPLs blocked the ability of many banks to deal with distressed debt.

NPL resolution, though not a panacea for all banking problems, could bring significant benefits. It is not easy to estimate the effects of resolving NPLs. However, scenario-based analysis indicates that replacing NPLs with performing assets could increase the aggregate return on equity of euro area banks by more than 1 percentage point, with some countries' banking sectors gaining up to 5 percentage points.

It is therefore essential to find a solution to the NPL problem, but we must recognise that it will take time and no single instrument is likely to be a "magic bullet". Rather, it will require a comprehensive strategy involving a panoply of instruments. The ECB is already working on this and has issued clear guidance to the banks it directly supervises. But supervisory action is not enough on its own. The private sector and national and European authorities also have roles to play.

Several significant impediments affect the prices of NPLs, to varying degrees across euro area countries. The market for distressed debt can be characterised as a "market for lemons". This is a situation where investors demand a premium to protect themselves from the uncertainty that better-informed banks will try to sell them assets whose credit quality is worse than it may seem on the surface. This results in limited market activity, as the prices that investors are prepared to pay for NPLs are much lower than the prices banks would be prepared to sell them for.

Structural inefficiencies in debt and collateral enforcement also contribute to the lack of market turnover. The legal procedures for collecting a simple claim take too long and cost too much in many euro area countries. On the demand side, investors are also deterred by high uncertainty around recoveries and their timing, and by barriers to entry such as licensing requirements.

These symptoms of market failure, aggravated by legal constraints, call for a public policy response. European and national authorities should launch a comprehensive strategy that combines a range of suitable tools to deal effectively with Europe's NPL problems. A key aspect of that strategy will be aligning incentives between the parties involved: banks, investors and the authorities.

A number of tools look particularly promising. National asset management companies (AMCs), if designed correctly, have been successful in relieving banks' NPL burdens and recovering asset value. A blueprint for national AMCs in the euro area – essentially, a manual for setting up an AMC – would save authorities time and money. In addition to clarifying in detail how AMCs can be made compatible with the EU legal framework, such a blueprint should identify international best practices for key aspects of AMCs such as eligible asset classes, participation requirements, asset valuation, capital and funding structures and governance.

Apart from AMCs, securitisation schemes also have the potential to kick-start the NPL secondary market, but may require public intervention to signal that governments are determined to follow through with structural reforms that will improve asset valuations. NPL trading platforms or clearing houses should also be fully explored, even at euro area level, to increase NPL transparency and stimulate transaction activity.

To be successful, however, all of these options require a considerable push for structural reforms related to debt enforcement and a reduction of information asymmetries.

If these measures become credible, investors will recognise the shift in policy and should ultimately be willing to pay higher prices for NPLs. The European Commission has recently announced that it will come forward with a proposal for a comprehensive and coordinated strategy to deal with NPLs, including a blueprint for national AMCs. It will be then imperative that all relevant authorities act rapidly and decisively to implement the necessary measures to overcome the NPL problem thereby strengthening the ongoing European recovery. Much hard work is needed, on many fronts, to deliver these benefits. But neither partial solutions, nor further delays, are viable options if we want to tackle the NPL burden and avoid a renewed build-up of NPLs in future cyclical downturns.