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"Asset *Management Companies and other alternative measures and policies to tackle Eurozone's Non Performing Loans under the EU legal framework*"

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LIST OF ABBREVIATIONS

AIFs	Alternative Investment Funds
AIFMs	Alternative Investment Fund Managers
AMC	Asset Management Company
APS	Asset Protection Schemes
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BRRD	Banking Restructuring and Resolution Directive
CCPs	Central Counterparties
CGFS	Committee on the Global Financial System
CMU	Capital Markets Union
COB	Conduct of Business
CoCos	Contingent Convertibles
CRR	Capital Requirements Regulation
CRD	Capital Requirements Directive
DGS	Deposit Guarantee Scheme
DGSD	Deposit Guarantee Scheme Directive
EAD	Exposure at Default
EBA	European Banking Authority
EBU	European Banking Union
ECB	European Central Bank
EIOPA	European Insurance and Occupational Pensions Authority
ELA	Emergency Liquidity Assistance
EMF	European Monetary Fund
EMU	Economic and Monetary Union
EMV	Estimated Market Value
ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
EU	European Union
FDIC	Federal Deposit Insurance Corporation *(United States)*
FPS	Forward Purchase Scheme
FSB	Financial Stability Board

GAAP	General Accepted Accounting Principles
GFC	Great Financial Crisis
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IAM	Impaired Asset Measure
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
LCR	Liquidity Coverage Ratio
LGD	Loss Given Default
MPIs	Macro-Prudential Indicators
MREL	Minimum Requirements of Eligible Liabilities
MTF	Multilateral Trading Facility
NBV	Net Book Value
NCWO	No Creditor Worse Off (principle)
NPL	Non-Performing Loan
NRPD	Non Refundable Purchase Discount
NSFR	Net Stable Funding Ratio
OTC	Over-The-Counter
OTF	Organised Trading Facility
PCC	Protected Cell Company
REV	Real Economic value
RWAs	Risk-Weighted Assets
SIFIs	Systemically Important Financial Institutions
SSFIs	Systemically Significant Financial Institutions
SSMR	Single Supervisory Mechanism Regulation
SRMR	Single Resolution Mechanism Regulation
SPV	Special Purpose Vehicle
TBTF	Too-Big-To-Fail
TLAC	Total Loss-Absorbing Capacity
UCITS	Undertakings for Collective Investment in Transferable Securities

INTRODUCTION

One can hardly find a topic more anecdotally contentious in the EU financial regulation than the (legacy) NPL resolution considerations, which have flooded the literature in recent years. Albeit the fact that until the burst of the pandemic crisis, the NPLs had ceased to be an actual systemic threat to Eurozone and were admittedly in a multi-year downtrend orbit, SARS COV-2 and its infamous variants seem to have rewritten the rules. The notorious (legacy) asset quality issues, the ones that fed voices demanding the inclusion of a proper fiscal backstop in the context of a more holistic crisis management framework, are arduously and obtrusively resurfacing.

While magnitudes of COVID-inherited NPEs may be comparable or even worse comparing to their "GFC peers", as we will establish later on, the chessboard, where regulators and supervisors have to act, is this time completely different. In the GFC, the epicenter of the crisis were the "sinful" banks themselves. Now, the banks are "victims" of an exogenous and unpredicted shock and as Augustin Carstens, general manager of the BIS, proverbially argued: "this time, banks are part of the solution, not of the problem"[1], by inter alia keeping credit channels open.

One could argue that supervisory and regulatory measures to deal with such an exogenous and unprecedented tail event, that no one in principle could see coming, should accordingly be different[2], legitimizing aberrations that range from regulatory and supervisory tweaks to fully-fledged institutional solutions. Put it simply, that arguably unforeseeable, when drafting the EU crisis management framework, tail event could constitute a quasi regulatory "rebus sic standibus", urging for action.

The NPL overhang is considered in literature as a festering sore, which hinders not only the completion of the Banking Union, but also the effort to **strengthen Europe's Economic and Monetary Union (EMU)[3].** In this context, apart from the dedicated NPL regulatory and supervisory initiatives, the big picture indicates that a more integrated financial system will enhance the resilience of the EMU to address adverse shocks by facilitating private risk-sharing across borders, thereby reducing the need for recourse to taxpayer money and tackle the bank-sovereign doom loop nexus[4]. **In order to achieve these objectives, the EU must now complete the Banking Union,** notably through the risk reduction and risk sharing measures set out in the Commission's Communication of 11

[1] See **Carstens A. (2020)**.

[2] See indicatively among others **Angeloni Ignazio (2021)**.

[3] Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank - further steps towards completing Europe's economic and monetary union: a roadmap, COM(2017) 821 final, 06.12.2017.

[4] In this vein, a notable initiative is the proposal regulation on sovereign bond-backed securities, which aims at breaking the bank-sovereign nexus and provide liquidity and diversification to the EU banking and capital markets sector, leading to market integration without debt mutualization. See in further detail **Gortsos, Ch.V. (2018b)**, **Huertas M. and Lyaskova K. (2018a) and Huertas M. and Lyaskova K. (2018b).**

October 2017[5] and commit to the **Capital Markets Union (CMU)** ongoing project, provided that no actual clear-cut solution could be achieved without a well functioning NPL secondary market.

In order to establish the necessity to tackle asset quality issues, a brief overview of the micro and macro- implications of the NPLs is in order[6].

In a nutshell, NPLs influence bank lending and solvency through three interrelated key channels[7]— profitability, capital, and funding. NPLs distress banks' profitability as they generate insufficient cash flows comparing to performing assets and result in increased provisions, which both in turn depress net income and consequently reduce profitability and liquidity and generate losses, which in extremis can erode bank's capital[8]. Low profitability disables capital formation through retained earnings and makes raising new equity and debt more difficult and more expensive. Most importantly, low profitability weakens their lending capacity and firepower. The EU has been suffering from such a self-reinforcing vicious circle since the GFC, as evidenced by stagnant bank lending, consequent anemic economic growth and inferior asset quality[9].

Furthermore, NPLs, even net of provisions, also tie up substantial amounts of both capital, due to the higher risk weights imposed on impaired assets[10], as well as human resources, thus hampering operational flexibility and crowding out funds that could be otherwise used for productive and profitable for the banks investments[11].

Finally, distressed balance sheets increase banks' funding costs due to higher risk and lower expected revenue streams. Sometimes, undermined investor confidence about a single bank's asset values spread across **the whole banking sector[12].** Together, these factors result in a poisonous mix of higher lending rates, reduced lending volumes, and increased risk aversion[13]. Banks' reduced lending capacity disproportionately affect SMEs that are more dependent on bank financing[14].

An anecdotal evidence indicating the current reluctance to lend, especially by high NPL banks, is the fact that since the beginning of the pandemic crisis, albeit keeping in principle the credit channels open thanks to relevant prudential relief measures, they exponentially prefer to channel(or "park") their excessive, due to the ECB's ultra-accommodative

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[5] Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union, COM(2017) 592 final, 11.10.2017.

[6] For further detail see among others **Lastra, R.M. and Ch. Goodhart (2015), Ayadi, R., G. Ferri, and R.M. Lastra, (2017).**

[7] **EC (2018), p. 5-9.**

[8] See **Jassaud/Kang (2015)**, **Balgova M., Nies M., Plekhanov A. (2016)**.

[9] **EC (2018), p. 5-9.**

[10] See **Aiyar S., et al. (2017)**.

[11] See **Linaritis (2020)**.

[12] **EC (2018), p. 5-9.**

[13] See **Demertzis/Lehmann (2017)**, with further therein extensive literature on NPLs ("financial pollution") negative economic impact, **Barseghyan (2010)**, **Bruno/Marino (2016)**.

[14] See by mere indication **Bergthaler, W., Kang, K. Liu, Y., and Monaghan, D. (2015)**.

monetary policy, liquidity back to the ECB, through excessive recourse to the latter's deposit facilities, albeit the negative interest rate imposed[15]. In other words, they prefer to "lose small" by lending to the ECB at a marginally negative interest rate(-0,50%), rather than "lose big" by risking to channel funds in a shaky economy(!).

Indeed and notwithstanding the above, empirical data prove that euro area banks with higher NPLs tend to be less profitable, have relatively weak capital buffers, face higher funding costs, and **lend less**, whereas, as regards the macro-financial effects of NPLs, reveal a robust relation between higher NPLs and weaker credit and GDP growth[16], with causality going both ways.

Notably, the deterioration of the credit institutions' lending capacity due to the NPL accumulation severely hinders the transmission of monetary policy, which a fortiori in the context of a monetary union results in the interception of conventional monetary policy measures[17]. Provided that the NPL issue is not even across Eurozone member states, this also amounts to significant discrepancies between member states regarding the transmission of monetary policy thereby leading to a malfunction of the single monetary policy and to the exacerbation of economic growth inequalities within the EMU. Namely, provided that inflation rate is measured at the EU level, states with steady macroeconomic environment and sound credit growth could easily reach the ECB's inflation target, whereas states with a stagnant macroeconomic environment facing a credit crunch due to the deterioration of their banks' lending capacity (and the absence of deep and inclusive capital markets), are sometimes in a deflation orbit. Thus, if the ECB is to further loose its monetary policy in order to meet the inflation target at the EU level, the first states could face increased inflation pressures. If not, the latter states would be trapped into a stagnant or anaemic growth within a deflationary environment coupled with credit crunch[18].

As a result, tackling NPLs is crucial both for completing the Banking Union and for strengthening the Economic and Monetary Union[19]and can only be achieved within a deep, liquid and integrated(*in terms of harmonisation and cross border activity*) secondary market, as part of the CMU.

Indeed, well-developed secondary markets of NPLs are also one of the building blocks for a well-functioning CMU[20]. Notwithstanding the CMU's primary goal to facilitate access

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[15] See among others, **Gortsos, Christos(2021a), pp. 59-61.**

[16] See among others **Jordà O. et al. (2021)**, **Schularick - Steffen – Tröger (2020)**, **Acharya V. et al. (2021).**

[17] See **Moor (2015)**, p. 36, ECB Opinion (CON/2018/31) par. 2.3.1

[18] This is not a furthermost fear anymore. It is a reality. The ECB's expansionary monetary policy has created legal and political implications, with cases brought before the CJEU concerning the circumvention of the article 123 TFEU's monetary financing prohibition. The ECB has already decided to slightly amend its inflation target policy, while uneven inflation pressures are beginning to rise.

[19] Indeed, it is empirically proved that there are important potential spill-over effects from Member States with high levels of NPLs to other EU economies and the EU at large, both in terms of economic growth and financial stability.

[20] Communication by the European Commission to the European Parliament, the European Council, the Council, the European Social and Economic Committee and the Committee of the Regions: Completing the Capital Markets Union by 2019 - Time to accelerate delivery, COM(2018) 114.

to and diversify non-bank finance for EU businesses, it also aims at enhancing banks' lending capacity, through inter alia enabling them to rapidly dispose of their (legacy) NPLs without excessive haircuts(bid-ask spreads), as well as strengthening their ability to redeem performing loans for liquidity management purposes[21] (diversifying its funding sources and reducing its funding costs).

Thus, high levels of NPLs must be addressed by a comprehensive approach. While the primary responsibility for tackling high levels of NPLs remains with banks and Member States, there is also a clear EU dimension, given the interconnectedness of the EU's banking system which can create spill-over effects from Member States with high NPL levels to the EU economy as a whole, both in terms of economic growth and financial stability[22].

Reflecting this EU dimension, the Council adopted in July 2017 an "Action Plan to Tackle Non-Performing Loans in Europe". The Action Plan sets out a comprehensive approach that focus on a mix of complementary policy actions in four areas: (i) bank supervision and regulation (ii) reform of restructuring, insolvency and debt recovery frameworks, (iii) developing secondary markets for distressed assets, and (iv) fostering restructuring of the banking system. Those actions are to be implemented in principle at national level, but also at Union level, where appropriate[23]. Some measures will have a stronger impact on banks' risk assessment at loan origination, while others will foster swift recognition and better management of NPLs, and further measures will enhance the market value of such NPLs[24]. These measures mutually reinforce each other and would not be evenly effective if implemented in isolation[25].

Obstacles to NPL resolution

1. **Prudential supervision**.

Albeit their average robust capital and liquidity position due to the enhanced microprudential, macroprudential and supervisory framework(Level 1 Regulation's requirements plus Supervisory measures under the Pillar II SREP process within the SSM) and the asset quality scrutiny through numerous and often highly granular asset quality reviews and stress tests, legal uncertainty as regards even the very definition of the NPE was manifest, whereas the lack of a coherent supervisory guidance and strategy concerning their recognition, accounting and prudential treatment, disposal

[21] The secondary market for credit covers both performing and non-performing credit. Actual market sales encompass credit portfolios, consisting of a mix of performing, under-performing and non-performing credit.

[22] See **EC (2018), p. 5-9.**

[23] For instance, at national level, Member States could be encouraged, perhaps in the context of the European Semester, to foster participation in the nascent European secondary markets for NPLs and to undertake necessary reforms towards remedying the private law issues of NPL non-transferability and other challenges to NPL work-out, including costs and time to enforcement and predictability of enforcement processes. Already, issues related to NPLs are closely considered in the European Semester and constantly analysed in several country reports and several country-specific recommendations (CSRs).

[24] See **EC (2018), p. 5-9, Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 73.**

[25] See **EC (2018), p. 5-9, Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 73.**

strategies, collateral valuation etc., in conjunction with the absence of time-bound operational targets for NPL reduction and the adverse accounting incentives (e.g. application of an incurred loss approach), left until recently too much room for discretion and led to a "rational apathy" and forbearance practices like "ever-greening", "extend and pretend". The EU's regulatory answer was the relevant ECB's qualitative NPL Guidance (2017) [26], supplemented by an addendum setting supervisory expectations for quantitative targets and write-off practices, which was the harbinger for the Prudential Backstop Regulation, as well the adoption of the novel IFRS 9 accounting regime for impaired assets.

2. **Legal obstacles.**

Although many countries had overhauled their insolvency regimes[27], reforms have been uneven across Member States and usually inadequate[28]. Out-of-court mechanisms were underutilized for corporates, personal insolvency regimes were nascent or non-existent and delays with debt enforcement and foreclosure were apparent[29]. The EU's response was namely the introduction of the Proposal Directive on the establishment of an accelerated extrajudicial collateral enforcement procedure and the Restructuring Directive.

3. **Distressed debt markets**.

Although there are few explicit restrictions on transferability of NPLs, yet distressed debt markets remain shallow or non-existent[30]. The impediments include notably information asymmetries and the manifest lack of licensing and regulatory regimes to enable nonbanks to own and service NPLs and result in significant bid-ask spreads. The EU's still pending answer in this context is the Proposal Directive on Credit Servicers and Purchasers and the prospect of establishing proper market infrastructure for NPLs, notably dedicated NPL platforms, clearing houses, central data hubs and repositories, as well as actions under the CMU action plan for broadening the investor base.

In the same vein, reforms facilitating structured finance transactions that remove NPLs from bank balance sheets and possibly establishing effective frameworks for public and

[26] Which inter alia includes enhanced supervision for high NPL banks and the strengthening the regulatory and sanctioning toolkit, including introducing a code of conduct for borrower engagement.

[27] Notably, the Italian Government introduced a new piece of legislation (Law No.132/2015), amending pro creditore the procedures for firms' liquidation and restructuring and foreclosure of assets, thereby increasing the speed and efficiency of insolvency procedures and property foreclosures. Another legislative initiative concerning NPL recovery has been introduced with the Italian insolvency law reform of 2016, notably as regards non-possessory pledge and private enforcement clauses in loan contracts with firms, allowing creditors to take ownership of collateral out-of-court in case of a debtor's default. See **Miglionico (2018a), p. 3.**

[28] See **Aiyar S., et al. (2017), p. 90.**

[29] Without prejudice to the above, in the context of national civil procedure laws, reforms regarding the establishment of simplified debt enforcement and foreclosure processes (e.g., to clearly specify enforceable titles, limit appeals, set short preclusive deadlines, introduce e-auctions platforms, eliminate super-priority claims and insert caps on public claims, increase the specialization of judges etc.), have not yet fully materialized.

[30] See **Aiyar S., et al. (2017), p. 90.**

private co-investment structures (including among others AMCs) to foster specialization and exploit economies of scale could be considered, provided that such structured transactions offer capital relief and high quality collateral(eligible to the Eurosystem's main refinancing operations) to the banks[31] and may lead to an improvement in bank profitability[32].

Heretofore, the EU's answer in this context has been the recent amendments to the Securitization Regulation, which inter alia have established a dedicated framework for NPE Securitizations (albeit the fact that those are not yet considered eligible for STS designation and the consequent capital and liquidity preferential treatment for the relevant securitization positions) and removed capital impediments as regards their capital treatment, as well as the introduction of dedicated framework for synthetic securitizations. As regards special co-investment structures, though, apart from an informal Commission's Staff working document, crystallizing best practices and providing guidance for the establishment of national AMCs, no other significant EU initiative has been observed, mainly due to the rigid provisions of the EU's State aid and (mainly) bank resolution framework, as well as structural legal impediments of the EMU and EBU, notably the manifest absence of a proper fiscal backstop for the banking union, fully incorporated to the EU's crisis management framework(*without prejudice to insufficient and in any case still pending measures, namely the EDIS and the ESM's backstop to the SRF*) and the demonization of debt or loss mutualization, which notwithstanding its significant legal dimension(namely article 125 TFEU, as authoritatively interpreted by the CJEU in the Pringle Case), has a clear political dimension. Although the EU's stiff stance seems to have slightly been mitigated in this context amidst the pandemic with the introduction of the EU Recovery Fund, it is more than clear that such concerns are still adamantly present.

4. **Tax and other obstacles**.

Some countries impose restrictions on deducting provisions and charge-offs for income tax purposes, lack loss carry-forward provisions (e.g. deferred tax assets) or subject debtors to capital gains tax upon forbearance measures bearing debt relief, thus disincentivizing NPL reduction[33]. Recovery rates are further depressed due to privileged (priority) claims of public creditors in debt restructuring and poor coordination between public and private creditors. In this vein, tax rules should be reviewed so as to encourage banks to provision and write-off and the debtors to accept debt restructuring or write-off deals[34]. Tax privileges (such as deferred tax credits and deferred tax assets) may also be used to absorb or offset losses and protect banks' capital position, albeit not immediately. Finally, according to **Hadjiemmanuil C. (2016),** governments may provide tax inducements and sweeteners for "private" solutions, whereby non-state investors either purchase or recapitalize the ailing

[31] See **Medina Cas and Peresa (2016)**, p. 9.
[32] See **Woo, D. (2000)**.
[33] See **Aiyar S., et al. (2017), p. 91.**
[34] See **Aiyar S., et al. (2017), p. 91.**

banks or buy NPE portfolios. Last but not least, a comprehensive approach should be adopted as regards the overall over-indebtness of the private sector.

The paper is structured as follows: Chapter I describes the current microprudential and macroprudential framework concerning NPEs, with particular emphasis on the IFRS 9 effect and the Prudential Backstop Regulation's impact and refers to and evaluates the main prudential relief measures adopted amidst the pandemic crisis. Furthermore, it presents the main (pending) regulatory initiatives employed by the European authorities in line with the NPL Action Plan.

Chapter II navigates through the State aid and BRRD/SRMR's provisions concerning the State's involvement in NPL resolution Schemes, focusing on market comfort(and thus, aid-free) model Asset Protection Schemes(hereinafter APSs), as crystallized through the lens of the relevant Commission's case-law(namely CACS, Hercules APSs), and other Impaired Asset Measures(hereinafter IAMs), which involve state aid and are therefore subject to the rigid precautionary recapitalization's preconditions. In this vein, after analyzing the existent legal framework and its inherent limitations, we focus on de lege ferenda proposals regarding the (temporary) amendment of the precautionary recapitalization framework amidst the pandemic crisis. Finally, after a concise presentation of the relevant literature, a critical contribution as regards the state of the art of the current EU crisis management framework is attempted.

Finally, Chapter III emphasizes on Asset Management Companies as the par excellence NPL resolution tool, envisaged in this paper. After a brief presentation of its pros and cons, we provide a comprehensive legal toolkit, covering the main aspects of its potential legislative framework. Finally, we venture a forward-looking perception of a possible EU-wide AMC, or at least an EU-wide network of national AMCs, mainly through the lens of distinctive relevant proposals in literature, whilst concurrently offering some critical reflections on them.

CHAPTER I

SECTION I

Prudential and Supervisory Framework regarding NPLs

The comprehensive package of the ECB's NPL[35] Guidance[36].

It is generally applicable to all significant institutions (SIs)[37] supervised directly under the Single Supervisory Mechanism (SSM), including their international subsidiaries in accordance with the principles of proportionality and materiality. Thus, some provisions may be more relevant for banks with high levels of NPLs ("high NPL banks")[38].

The NPL guidance is not legally binding. However, it is legally significant, as banks should explain any deviations upon supervisory request provided that it is taken into consideration in the SSM regular Supervisory Review and Evaluation Process (hereinafter "SREP") and non-compliance may trigger Pillar II supervisory measures.

The guidance does not intend to substitute or supersede any applicable regulatory or accounting requirement. Where binding laws, accounting rules and national regulations on the same topic exist, banks should comply with those[39]. Besides, as clarified below, some of the NPL Guidance' provisions have been amended, substituted and complemented by relevant Level 1 Regulation provisions[40].

The Guidance is of qualitative nature, including consideration of how the **"unlikely to pay" criterion** should be applied in practice, and how banks should utilize and monitor

[35] More precisely, the guidance addresses all non-performing exposures (NPEs) as well as foreclosed assets, and also touches on performing exposures with an elevated risk of turning non-performing, such as "watch-list" exposures and performing forborne exposures.
[36] See in detail ECB, Guidance to banks on non-performing loans, 2017, available at: https://www.banking-supervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf
[37] Naturally, banks not falling under its scope might still benefit from applying the full content at their own initiative or on request by supervisors, especially in the case of significant NPL inflows, high levels of forbearance or foreclosed assets, low provision coverage.
[38] For the purpose of this guidance, the ECB's banking supervision defines high NPL banks as banks with an NPL level that is considerably higher than the EU average level. A suitable reference to determine EU average NPL ratios and coverage levels is the quarterly published European Banking Authority (EBA) risk dashboard.
[39] See ECB, Bank Supervision, 'Guidance to Banks on Non-Performing Loans', March 2017, 6.
[40] See in detail below.

forbearance, handle write-offs and conduct proper collateral valuations, given the heretofore poor incentives for banks to proactively identify and address non-performing exposures[41].

In particular, the ECB exercising its statutory competence under Article 4 par. 3 SSMR, has required Eurozone banks to establish time-bound quantitative targets for NPL reduction[42], mainly through:

(i) hold/forbearance;
(ii) active portfolio reductions not just through sales but also by writing off provisioned NPL exposures that are deemed unrecoverable;
(iii) change of exposure type: this includes foreclosure, debt to equity swapping, debt to asset swapping, or collateral substitution;
(iv) legal options including insolvency proceedings or out-of-court dispute settlement mechanisms;

According to the ECB Guidance, these targets should be established at a minimum along the following lines:

(i) by time horizons: short-term (eg, 1 year), medium-term (eg, 3 years) and where possible long-term;
(ii) by main portfolios (eg retail mortgage, retail consumer, retail small businesses and professionals, SME corporate, large corporate, commercial real estate);
(iii) by NPL resolution tool.

Those targets should be granular and more specific especially for high NPL banks. Operation targets might refer to: coverage, cash recoveries, the quality of forbearance measures (eg re-default rates), the status of legal actions etc.

Moreover, the ECB within the SSM has mandated banks to commit to quantitative NPL reduction targets in line with the EBA's relevant Guidelines[43] on management of non-performing and forborne exposures, which were recently expanded to incorporate provisions for the loan origination, monitoring and internal governance[44].

In this context, they should establish a dedicated NPE strategy, which should be two-fold:

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[41] See European Systemic Risk Board, Resolving non-performing loans in Europe (July 2017), p.28 available at: https://www.esrb.europa.eu/pub/pdf/reports/20170711_resolving_npl_report.en.pdf

[42] See ECB, Bank Supervision, 'Guidance to Banks on Non-Performing Loans', March 2017, 12–13.

[43] See in detail EBA Final Report, 'Guidelines on management of non-performing and forborne exposures' 31 October 2018, EBA/GL/2018/06, available at: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2425705/371ff4ba-d7db-4fa9-a3c7-231cb9c2a26a/Final%20Guidelines%20on%20management%20of%20non-performing%20and%20forborne%20exposures.pdf

[44] See in detail EBA, Final Report, "Guidelines on loan origination and monitoring", 2020, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/Guidelines%20on%20loan%20origination%20and%20monitoring/884283/EBA%20GL%202020%2006%20Final%20Report%20on%20GL%20on%20loan%20origination%20and%20monitoring.pdf

1. define the credit institution's plan regarding NPE management to maximize recovery;
2. set out quantitative short-, medium- and long-term reduction targets in NPE stocks per NPE portfolio over a realistic but also stringent time horizon.

In this vein, credit institutions must assess their operating environment and external conditions[45], including an assessment of internal capabilities[46] to effectively manage and reduce NPEs and notably of the expected capital implications[47] of the NPE strategy. Critically, the EBA Guidance also mandates conduct requirements to 'ensure the fair treatment of borrowers'[48].

In particular, according to the ECB's relevant Addendum, supervised banks should fully understand and examine:

• the size and (non) linear advance of its NPL portfolios on an appropriate level of granularity, after proper portfolio segmentation

• the drivers of NPL in-flows and out-flows, by main NPL portfolio;

• other potential correlations and causations.

• Outcomes of NPL resolution measures implemented in the past

• Operational capacities (internal processes, policies and tools, data quality, IT/automation, staff/expertise, decision making), including but not limited to: • early warning and detection/recognition of NPLs; • forbearance; • provisioning; • collateral valuations; • recovery/legal process/foreclosure; • management of foreclosed assets (if relevant); • reporting and monitoring of NPLs and effectiveness of NPL workout solutions.

[45] According to Section 4.2 of the EBA Guidelines. External conditions mostly refer to the macroeconomic environment and structural factors as well as the tax implications of NPE write offs. Macroeconomic factors incorporate dynamics of the real estate market and NPE investor demand. However, as clearly pointed out in the Addendum, reduction can and should be achieved even in less favorable macroeconomic conditions. Structural factors include: 'The maturity of the NPE servicing industry and the availability and coverage of specialised servicers . . . [and] the regulatory, legal and judicial framework the average total costs associated with legal proceedings'.

[46] See **Augouleas E. (2020)**, pp. 382 et seq.

[47] As pointed out in the Addendum: " *capital levels and their projected trends are important inputs to determining the scope of NPL reduction actions available to banks. Banks should be able to dynamically model the capital implications of the different elements to their NPL strategy, ideally under different economic scenarios. Those implications should also be considered in conjunction with the risk appetite framework (RAF) as well as the internal capital adequacy assessment process (ICAAP). High NPL banks are expected to conduct quantitative and qualitative assessment of NPL developments under base and stressed conditions, always taking into consideration the potential impact on capital planning. Where capital buffers are slim and profitability low, high NPL banks should include suitable actions in their capital planning which will enable a sustainable clean-up of NPLs from the balance sheet*".

[48] See Augouleas E. (2020), pp. 382 et seq.

Banks should conduct periodical self-assessment checks and report their outcomes to the senior management and supervisory teams. Furthermore, NPL-related indicator levels and actions within the NPL strategy targets are incorporated into the recovery plan[49].

Where foreclosed assets are material, a dedicated foreclosed assets strategy should be defined or, at least, foreclosed assets reduction targets should be included in the NPL strategy[50].

EBA Guidelines require EU banks to implement an operational plan[51] to meet to fulfill the NPE strategy. This should be subject to regular reviews and independent monitoring. According to the EBA Guidelines[52]:

Its implementation should rely on apt internal policies and procedures and transparent governance structures, including escalation procedures and adequate technical infrastructure[53]. Credit institutions should report material deviations from the plan to the senior management and supervisors in a timely manner. The NPL strategy and operational plan are a vital part of the bank's strategy and they should be approved and monitored by the organization management body[54].

Furthermore, pursuant to the ECB Guidance, banks are required to form their own "internal bad banks", i. e dedicated NPL workout units (WUs) strictly separate from units responsible for loan origination to eliminate potential conflicts of interest[55]. The performance of

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[49] See ECB, Bank Supervision, 'Guidance to Banks on Non-Performing Loans', March 2017, 18.

[50] See ECB, Bank Supervision, 'Guidance to Banks on Non-Performing Loans', March 2017, 16.

[51] According the ECB's NPL Guidance, it should contain **at a minimum**: articulate time-bound targets; NPL resolution actions on a segmented portfolio basis; governance arrangements and reporting mechanisms; quality standards; staffing requirements; technical infrastructure enhancement plan, where relevant; granular and consolidated budget requirements for the implementation of the NPL strategy; interaction and communication plan with internal and external stakeholders.

[52] See ibid, Section 4.4.

[53] See EBA Guidelines, Section 4.2.1. These include, inter alia, information about current NPLs levels by main portfolios, their size and evolution; early arrears; exposure and collateral/ guarantee information and foreclosed assets management; monitoring tools, backed by IT infrastructure to track forbearance performance and effectiveness; status and outcomes of workout and disposal actions; (expected) cash flows deriving from (restructured) loan and collateral; data from central credit registers, land registers, and other relevant external data sources where necessary.

[54] ECB Guidance, 2017, ibid, p. 9. In particular, the bank's management body must:
(1) approve annually and regularly review the NPL strategy including the operational plan;
(2) oversee the implementation of the NPL strategy;
(3) define management objectives (including a sufficient number of quantitative ones) and incentives for NPL workout activities;
(4) periodically (at least quarterly) monitor progress made in comparison with the targets and milestones defined in the NPL strategy;
(5) define adequate approval processes for NPL workout decisions;
(6) approve NPL-related policies and ensure that they are understood by the bank's staff;
(7) ensure sufficient internal controls over NPL management processes (with a special focus on provisioning, collateral valuations and sustainability of forbearance solutions);

[55] ECB Guidance, ibid, 18 and 99, EBA Guidance, ibid, Section 5.

WU staff is periodically monitored within an appraisal system tailored to its idiosyncratic requirements. Apart from quantitative NPL targets and milestones, it may include qualitative measurements such as negotiations competence and quality of recommendations. The performance measurement framework for high NPL banks' management bodies and relevant managers includes specific indicators linked to the targets defined in the NPL strategy and operational plan[56].

Furthermore, the NPE strategy and operational plan should be fully embedded in the risk management framework under which the institution operates. Thus, credit institutions should ensure high level monitoring by the risk management functions[57], whereas staff and management involved in NPE workout activities should be provided with clear individual (or team) goals and incentives concerning their remuneration policies, career development objectives and performance monitoring frameworks 'geared towards reaching the targets agreed in the NPE strategy and operational plan'[58]. The monitoring and control of the execution of the strategy should be based on 'three lines of defence'[59].

The first 'line of defence' requires banks, especially high NPL banks, to incorporate the NPL strategy and operational plan to the bank's overall business strategy' and risk appetite[60]. In this stage, control mechanisms within the operational units, i.e. the NPL WUs, apply and the ultimate responsibility for their proper function lies with the WUs' managers.

The 'second line of defence' monitors the first line of defence's control mechanisms, namely risk control, compliance and other quality assurance functions, with particular emphasis to the quality and adequacy of early warning indications for NPLs[61]. It must be fully independent from the NPL WUs.

The 'third line of defence' mainly refers to the internal audit function, which is independent of the bank's business units and units carrying operational functions. To strengthen the NPL governance and accountability framework the ECB guidance provides that 'key outcomes of second and third-line' of defence activities and mitigating actions and progress 'should be reported to the management body regularly'[62].

Macroprudential Safeguards

A recent ESRB report on NPLs argued that macroprudential authorities should not mechanically rely on the countercyclical capital buffer (CCYB) to prevent the systemic macroprudential implications, but also focus on NPL-driven vulnerabilities. The aim is to

[56] See **Augouleas E. (2020),** pp. 382 et seq.
[57] See EBA Guidelines, ibid, Section 4.4.
[58] See EBA Guidelines, ibid, Section 4.5.
[59] See ECB Guidance, 2017, ibid, 27–9.
[60] See ECB Guidance, 2017, ibid, 27-8.
[61] See ECB Guidance, 2017, ibid, 28.
[62] See ECB Guidance, 2017, ibid, 28.

arm banks with 'excess' capital to create reserves that can be used to write off bank losses from NPLs at an early stage, allowing them to lend against the cycle, mainly through utilizing conservative Loan-To-Income (LTI) and Loan-To-Value (LTV) ratios[63].

Furthermore, the ESRB suggests that macroprudential authorities should utilize the systemic risk buffer (SyRB) to address as hoc potential increase of systemic risk caused by NPL accumulation that is centered around specific debtors or market sectors rather than situations of generalized credit growth[64].

Finally, the ESRB urged the macroprudential authorities to utilize capital measures to target excessive credit growth and tackle concentration risk, notably in any case systemic risk appears to be clog up specific sectors/asset classes, thereby tightening provisions for large exposures. Indeed, considering that the two most recent banking crises in the Eurozone were triggered by over-concentration on real estate loans and sovereign bonds, it becomes apparent that such macroprudential measures can in extremis avert a financial crisis[65]. To this effect, the ESRB points to the enhancement of the supervisory arsenal with an extra (penal) capital charge that 'to be applied by the designated authority in order to target asset bubbles in the residential and commercial property sector'[66].

Finally, the ESRB suggests that authorities should establish robust early warning systems (EWS) for NPLs[67], which constitute a macroprudential rather than a microprudential mechanism[68] and is supplementary to the microprudential tools provided in the SSM Guidance[69].

Microprudential Safeguards

From a microprudential perspective, we have a novel and stringent two-fold system: the first line of ex ante defenses against NPL losses is the full implementation of the IFRS 9. In addition to the IFRS 9 standard incorporated into the CRR II[70], new Regulation[71] inserts

[63] See in detail **Augouleas E. (2020),** pp. 382 et seq.
[64] See European Systemic Risk Board (ESRB) Report, 'Macroprudential Approaches to Non-Performing Loans, January 2019, 3 et seq.
[65] See **Augouleas E. (2020), pp. 382 et seq**.
[66] See European Systemic Risk Board (ESRB) Report, 'Macroprudential Approaches to Non-Performing Loans, January 2019, 3.
[67] See in detail ESRB, 'Macroprudential Approaches to Non-Performing Loans/The Role of Macroprudential Policy', 23–4.
[68] See **Augouleas E. (2020),** pp. 382 et seq.
[69] See **Augouleas E. (2020)**.
[70] See Regulation (EU) 2019/876 of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012.
[71] See Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

the infamous prudential "backstop", which mandates banks to follow a mandatory provisioning policy with a view to build, though the appropriate write-offs and other regulatory adjustments, capital cushions, which guarantee the bank's resilience to adverse shocks[72].

Namely, the Prudential Backstop Regulation requires banks to have adequate loan loss coverage (common minimum coverage levels) for newly[73] originated loans once these become non-performing exposures (NPEs). The Regulation defines as NPEs[74]:

(a) an exposure in respect of which a default is considered to have occurred (in accordance with Article 178 CRR);

(b) an exposure which is considered to be impaired in accordance with the applicable accounting framework;

(c) an exposure under probation, where additional forbearance measures are granted or where the exposure becomes more than 30 days past due: The Regulation defines as forbearance measure: "a concession by an institution towards an obligor that is experiencing or is likely to experience difficulties in meeting its financial commitments. A concession may entail a loss for the lender" and means

"(i) a modification of the terms and conditions of a debt obligation, where such modification would not have been granted had the obligor not experienced difficulties in meeting its financial commitments". It includes a more favorable change in the contractual terms or a partial debt write off.

"(ii) a total or partial refinancing of a debt obligation, where such refinancing would not have been granted had the obligor not experienced difficulties in meeting its financial commitments."[75]

(iii) an exposure in the form of a commitment that, were it drawn down or otherwise used, would likely not be paid back in full without realisation of collateral;

(iv) an exposure in form of a financial guarantee that is likely to be called by the guaranteed party, including where the underlying guaranteed exposure meets the criteria to be considered as non-performing.

In case a bank does not meet the applicable minimum coverage level, it has to deduct the shortfall from its Common Equity Tier 1 (CET1) capital, forcing the banks to act to adjust its regulatory capital or face the prospect of resolution/liquidation.

[72] See **Augouleas E. (2020).**
[73] These minimum levels apply to provisions covering potential losses on all new loans issued after 26 April 2019 and that would become non-performing (modification of CRR Article 469a).
[74] See Art. 1(2) Regulation (EU) 2019/630 inserting Art.47(a) into Regulation (EU) No 575/2013.
[75] See Art. 1(2) Regulation (EU) 2019/630 inserting Art.47b into Regulation (EU) No 575/2013.

The minimum coverage levels would increase gradually to 100% after eight years for secured loans and after two years for unsecured loans. According to the Regulation the "prudential backstop" minimum coverage requirement depend on two main variables:

• whether part or all of an NPE is secured by eligible credit protection (as defined in the CRR); and

• the time period for which an exposure has been classified as non-performing.

The coverage requirements for banks increase progressively up to 100%, after 3 years for unsecured NPEs, and after 9 and 7 years for NPEs secured by immovable property and for NPEs secured by other eligible credit protection. In turn, this means that he full coverage of NPLs secured by movable and other CRR eligible collateral will have to be built up after seven years. On the other hand, for unsecured NPLs not backed by collateral, the maximum coverage requirement would apply fully after three year to reflect the high risk of partial or non-recovery of loan value.

Moreover, the "backstop" fully accounts for the fact that "aged" NPEs are riskier even if they are secured. It is a common assumption that the longer NPEs remain on banks' balance sheets, the less banks tend to succeed in recovering their money[76].

The EU council advocates that the 'prudential backstop' is meant to foster private risk-sharing, further reduce dependence on public intervention and ultimately boost credit supply, even in adverse economic times ("lend against the economic cycle"), whereas the Commission argues that it will also address systemic risks and build sufficient loss coverage for NPEs, which is expected inter alia to eliminate the wedge between bid-ask spreads regarding NPL transactions and facilitate market comfort NPL disposals, therefore protecting banks' profitability, capital and funding costs in stressed times[77].

The key feature in the case of the statutory prudential backstop, introduced by the above mentioned ECB's Addendum to NPE Guidance and currently in force as a formal CRR provision with full legal force, is that it tackles discretion[78]- both supervisory and the respective bank management's discretion[79]- and ensures the uniform implementation of the

[76] See **Augouleas E. (2020),** pp. 382 et seq.
[77] See **Augouleas E. (2020)**, pp. 382 et seq.
[78] See **Miglionico A., (2020)**, pp. 23-28, deeming the "cascade of soft-law measures that create a grey area of non-binding provisions" as insufficient. Besides, as Andrea Miglionico, ibid, notice: "The timing of losses taken resulting from provisions or write-offs, and the level of loan loss provisions set aside for future NPLs on the balance sheet, are often part of a bank's strategy to smooth reported earnings and reported capitalization". See also respectively by mere indication **Beck Paul J. and Ganapathi S. Narayanamoorthy (2013)**, p. 64 and **Hasan Iftekhar and Larry D. Wall**, p. 151.
[79] As **Augouleas E. (2020)** points out: "Low liquidity and depressed markets mean that during financial crises these assets may only be sold with high haircuts, resulting in high charges on banks' capital buffers and serious erosion of their capital. Thus, to avoid excessive losses and/or postpone the recognition of losses, banks are likely to maintain the NPLs on their balance sheets. **Delayed recognition of NPLs may lead banks**

new provisioning regime. Indeed, non-discretionary backstop requirements (i.e. compulsory deductions from regulatory capital) can help to incentivize banks to address NPLs proactively and prevent their future accumulation on balance sheets[80]. It was deemed therefore necessary to complement the existing prudential rules in CRR relating to own funds with provisions requiring a mandatory deduction from own funds where NPEs are not sufficiently covered by provisions or other adjustments[81].

However, the decision to establish minimum loss coverage for non-performing exposures in the Level 1 Regulation (amending Regulation (EU) 575/2013) in not indisputable in literature, especially in times of external economic shocks(like COVID-19 recent pandemic) or long recession[82]. Concetta Brescia Morra[83] argues that the statutory nature can hinder supervisory flexibility and impede proportionality and calibration based on qualitative ascertainment[84], despite the fact that according to literature a reasonable degree of complementary judgement is in any case vital[85].

In contrast, the rules outlined in the ECB Addendum only imply a 'comply or explain' mechanism[86] and consequently leave vital space for reasonable and well-argued ad hoc divergence from the prudential provisioning expectations outlined in the Addendum, during the Supervisory Review and Evaluation Process (SREP). Thus, minimum legal coverage levels for loans incorporated into CRR lack any flexibility in responding to bank-specific conditions[87], as it does not allow authorities to tailor supervisory measures. That can be rather problematic, when supervising banking activity in times of uncertainty[88]. Not surprisingly[89], that was implicitly acknowledged by the introduction in the so-called the 'CRR quick fix" package[90] of the provision that the minimum capital requirements for non-

to practise 'evergreening', with negative repercussions on efficiency and stability". See in detail **Avgouleas Emilios et al. (2021).**

[80] EBA, Report on Statutory Prudential Backstops, Response to the Commission's Call for Advice of November 2017, p. 9.

[81] See Recital 5 of REGULATION (EU) 2019/630 of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

[82] Cf. in US, where the relevant provisions are not statutory but constitute supervisory measures. For a relevant cross-jurisdiction overview, see **Baudino P. et al. (2018)**.

[83] See **Morra C. B. (2021)**, pp. 197 et seq.

[84] See **Montanaro Elisabetta**, pp. 213-246 with further citations therein.

[85] See by mere indication, **Patrizia Baudino and Hyuncheol Yun**, p. 6-7.

[86] Besides, as already mentioned, the Joint Supervisory Team (JST) has in any case the statutory power to evaluate that the coverage provided by the individual credit institution is not sufficient to cover the expected credit risk and imposing the adoption of 'Pillar 2' measures, i.e the adoption of specific provisioning policy.

[87] See by mere indication **Angeloni Ignazio (2021), pp. 107 et seq.**

[88] See by mere indication **Wolf-Georg Ringe (2020).**

[89] See verbatim **Angeloni Ignazio (2021), pp. 107 et seq.**

[90] See in detail below.

performing loans (NPLs) under the 'prudential backstop' were amended to extend the preferential treatment of NPLs guaranteed by export credit agencies also to publicly guaranteed loans, subject to EU State aid rules[91].

Certainly, this rigid "statutory-based" approach is a fortiori suboptimal and in any case unnecessary in the context of the Banking Union in which there is a single supervisory mechanism, where exclusive competences have been delegated to a single authority (the ECB) - *to be implemented either directly in case of SI's or partly within a "decentralized framework"(i.e with distribution of competences and tasks between the ECB and the NCA's within the SSM) regarding LSI's*[92]- that ensures uniform application, eliminating the room for opportunistic behaviors and "race- to the bottom" regulatory arbitrage practices[93].

In other words, in a quasi-building blocks approach, the mandatory statutory prudential backstop consists for some the most radical and for others a rather unnecessarily rigid step towards sound and stringent NPE valuation, given that there are different tools in the current accounting and prudential frameworks to ensure the appropriate valuation of NPEs.

Indeed, as the accounting treatment is the basis of the prudential framework, institutions should recognise adequate loan loss provisions in accordance with the applicable accounting framework. The accounting and the prudential frameworks have complementary objectives. While the accounting framework is based on the principles of neutrality and faithful representation of losses, the prudential framework aims to ensure banks' resilience against unexpected losses that they may face[94]. Therefore, in addition to loan loss provisions recognized in accordance with the applicable accounting framework, an additional prudential measure may be considered appropriate. Thus, if provisions are not adequate, the prudential framework empowers CAs to require of institutions, within the limits of the applicable accounting framework, that they apply a specific provisioning policy in accordance with Article 104 of the CRD IV (Pillar 2), as further detailed under the SREP guidelines[95].

Moreover, if additional corrections to the value of the assets are deemed necessary (e.g. a prudent valuation of the assets), CRD IV empowers CAs to require institutions to hold additional own funds and/or to apply the necessary adjustments to own funds calculations (deductions and similar treatments)[96].

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[91] See amendment of Article 47c (4) CRR.

[92] See illuminatingly Case T-122/15 Landeskreditbank Baden-Wuerttemberg-Foerderank v. ECB, par. 54 et seq. On this case, see by mere indication **Annunziata F.(2019) and Chiti, M.P (2019), pp. 105 et seq.**

[93] **Morra C. B. (2021), p. 214.**

[94] See ECB's **Addendum to NPL Guidance (2018).**

[95] See ECB's **Addendum to NPL Guidance (2018).**

[96] See Commission's Report on the Single Supervisory Mechanism (2017), https://ec.europa.eu/info/sites/info/files/171011- ssm-review-report_en.pdf

However, these are supervisory measures and are applied by the CAs on a case-by-case basis, contrary to the prudential backstop, which would present a safeguard across all EU credit institutions on an equal basis. In this context, EBA clarifies[97] that the intention of the statutory prudential backstop is to be included in the Pillar 1 and not Pillar 2 requirements. This is exactly why its provisions were incorporated in the CRR. Besides, as recital 6 of the Prudential Backstop Regulation stipulates the prudential backstop should not prevent competent authorities from exercising their supervisory powers, including the power to require a specific provisioning policy or regulatory adjustments, in accordance with CRD IV/CRR, in cases where, despite the application of the prudential backstop, the NPEs of a specific institution are not sufficiently covered.

Excursus: The "IFRS 9 effect": Introducing stringent loan loss provisions for NPEs and impaired assets firstly from the accounting standards

Furthermore, the introduction of IFRS 9 and the potential impact of its gradual full endorsement should also be taken into account[98]. In 2014, the IASB issued the new standard IFRS 9 Financial Instruments (hereafter, IFRS 9), which contains a new approach to classify and measure financial instruments, a forward-looking impairment model, and hedge accounting. It is a principle-based framework, which purports to introduce a single impairment model. Its most radical feature is that it mandates reporting entities to incorporate, apart from information from past events and current conditions, reasonable and supportable forecasts in their measurement of expected credit losses (hereinafter ECL)[99]. IFRS 9 has been applicable since 1 January 2018 (replacing IAS 39) and will introduce an ECL model, which results to an earlier[100] recognition of credit losses, affecting more financial assets and at a higher amount.

In general, IFRS 9 is expected to make provisioning more reflective of expected NPLs, reducing the need for system-wide intervention or at least providing a larger capital buffer to absorb losses before authorities involve[101]. In this context, it is generally considered from the vast majority of literature as a welcome enhancement and advance of the IAS 39 regime in that it results to more proactive and stringent provisioning for NPEs firstly from the accounting perspective (a fortiori at the earlier impairment stages), although concerns have already been expressed in literature that its increased discretion regarding loan loss provisions (LLP) may be (ab)used for both risk(i.e *increase risk appetite*) and earnings

[97] EBA, Report on Statutory Prudential Backstops, Response to the Commission's Call for Advice of November 2017, p. 31.

[98] For a brief overview of the most recent relevant literature, see by mere indication **Kund, Arndt-Gerrit and Rugilo, Daniel (2018), Albrahimi, Albian (2019), Fatouh, M., Bock, R. and Ouenniche, J. (January 10, 2020), Opare, Solomon and Houqe, Muhammad Nurul and van Zijl, Tony (2019), Kund, Arndt-Gerrit and Neitzert, Florian (2020), Engelmann, Bernd and Pham, Ha, (2020), Beerbaum Dr., Dirk (2020**).

[99] **Albrahimi, Albian(2019),** ibid, p. 2.

[100] See by mere indication **Kim, J-B., Ng, J., & Wang, C. (2020).**

[101] See **Patrizia Baudino and Hyuncheol Yun,** p. 27.

management, i.e. banks can overstate (understate) loan loss provisions when earnings are expected to be high (low), as well as regulatory capital arbitrage, provided that general loan loss provisions are included in the Tier 2 capital[102].

In particular, the scope of the impairment requirements under IFRS 9 has been broadened. Under IAS 39, LLP could only be recorded for impaired exposures, on the basis of an incurred loss model. That is, credit losses were not recognized unless a credit event occurs[103]. On the contrary, ECL requires the LLP to be recorded for all credit exposures not measured at fair value through profit and loss('hold to sell' assets)[104], including exposures measured at amortized cost(*'hold to collect' assets)* and exposures at *Fair value through other comprehensive income (FVTOCI) category ('hold to collect and sell' assets)*[105].

Under ECL, it is no longer necessary for a credit event to occur before recognizing credit losses. The new model results in timelier recognition of expected losses by requiring a 12-month ECL allowance for all credit exposures plus a lifetime ECL if the credit risk deteriorates[106].

This implies that banks will provide users of financial statements with more timely and forward-looking information[107]. The ECL model is more information-sensitive than the IAS 39 impairment model as it requires entities to consider reasonable and supportable future forecasts of economic conditions[108]. For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses.

Further details regarding the IFRS 9 framework fall out of the scope of this paper. In a nutshell, the EBA, following Basel Committee's guidelines[109], has developed guidelines[110]

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[102] See by mere indication **Gebhardt, G., & Novotny-Farkas, Z. (2011), pp. 289– 333, Albrahimi, Albian (2019), pp. 3-4.**

[103] The ineluctable delay in the recognition of credit losses associated with loans and other financial instruments was identified as a key weakness during the GFC, see indicatively **Beatty, A., Liao, S. (2014)**.

[104] See **Seitz, Barbara & Dinh, Tami & Rathgeber, Andreas. (2018)**.

[105] The final version of IFRS 9 introduces a new classification and measurement category of FVTOCI for debt instruments that meet the following two conditions:

- **Business model test:** The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows *and* selling financial assets.
- **Cash flow characteristics test:** The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

[106] See **Albrahimi, Albian (2019), pp.** 3-4.

[107] See **Albrahimi, Albian(2019)**, pp. 3-4.

[108] See in detail International Accounting Standards Board (2014), Financial Instruments, International Financial Reporting Standard 9.

[109] See Bank for International Settlements (2015), Guidance on accounting for expected credit losses. Basel Committee on Banking Supervision, available at: https://www.bis.org/bcbs/publ/d350.pdf

[110] See EBA(2017), Final Report: Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses, available at: https://www.eba.europa.eu/sites/default/docu-

on credit risk management practices and accounting for ECL, which provide supervisory expectations for credit institutions related to sound credit risk management practices associated with implementing and applying an ECL accounting model.

Last but not least, taking into consideration that the application of IFRS 9 may lead to an abrupt increase in expected LLP and consequently to a cliff-edge decrease in institutions' Common Equity Tier 1 capital, transitional arrangements were introduced in Level 1 Regulation("CRR")[111] to mitigate that potentially significant IFRS ECL-driven negative impact on Common Equity Tier 1 capital. These provisions are of paramount importance amidst the pandemic crisis, as voices in literature warn that in such stressed macroeconomic scenarios, IFRS 9 expected loss provisioning could fuel procyclicality[112].

In this context, where the IFRS 9 application leads to a significant decrease in Common Equity Tier 1 capital due to increased ECL provisions, including the loss allowance for lifetime ECL for financial assets that are credit-impaired[113], banks are allowed[114] under stringent preconditions and safeguards[115] to include in its Common Equity Tier 1 capital a portion of these increased ECL provisions for a certain transitional period[116].

In conclusion, loan loss provisions concerning NPEs have become remarkably more stringent both from the accounting("IFRS 9 effect"), as well as the statutory prudential regulation perspective (mandatory prudential backstop provisions combined with ad hoc super-

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ments/files/documents/10180/1842525/d769d006-d992-4202-8838-711a034e80a2/Final%20Guidelines%20on%20Accounting%20for%20Expected%20Credit%20Losses%20%28EBA-GL-2017-06%29.pdf?retry=1

[111] See Regulation (EU) 2017/2395 of 12 December 2017 (…) as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any Member State [2017] OJ L 345/ 27. On the implications for financial stability, see European Systemic Risk Board, *Financial stability implications of IFRS 9*, July 2017, available at: <https://www.esrb.europa.eu/pub/pdf/reports/20170717_fin_stab_imp_IFRS_9.en.pdf.

[112] See among others **Abad Jorge, Javier Suarez (2020).**

[113] As defined in Appendix A to IFRS 9, as set out in the Annex to Commission Regulation (EC) No 1126/2008 ('Annex relating to IFRS 9').

[114] Institutions should decide whether to apply those transitional arrangements and inform the competent authority accordingly. During the transitional period, an institution should have the possibility to reverse once its initial decision, subject to the prior permission of the competent authority which should ensure that such decision is not motivated by considerations of regulatory arbitrage, see Recital 6.

[115] In particular, institutions that decide to apply transitional arrangements should:

1.publicly disclose their own funds, capital ratios and leverage ratios both with and without the application of those arrangements in order to enable the public to determine the impact of those arrangements,

2.adjust the calculation of regulatory items which are directly affected by expected credit loss provisions to ensure that they do not receive inappropriate capital relief.

3.ensure that the portion of expected credit loss provisions that can be included in Common Equity Tier 1 capital will decrease over time down to zero to ensure the full implementation of IFRS 9 on the day immediately after the end of the transitional period. The impact of the expected credit loss provisions on Common Equity Tier 1 capital should not be fully neutralised during the transitional period.

[116] That transitional period should have a maximum duration of 5 years and should start in 2018.

visory Pillar II measures, if applicable). Thus, holding an NPE in a credit institutions balance sheet has hence become more costly in terms of capital management, funding cost and profitability[117]. Considering the current partial erosion of main capital buffers for several credit institutions and the binding(*postponed during COVID-19 pandemic by the SRB, but still existent*) MREL targets to be met, which are expected to further burden banks' profitability through increased funding and capital costs, it is rather obvious that disposing NPEs-both "legacy" and "new-pandemic inherited" NPEs- is becoming an urgent necessity. This is not expected to be a walk in the park, as EU regulators opted to apply quasi-penal prudential (capital) charges and write-off requirements before ensuring that a fully-fledged NPL secondary market to orderly dispose those assets exists.

Covid-19-driven regulatory and supervisory relief measures[118]

Capital and liquidity buffers are by design destined to assist banks to withstand stressed situations like the COVID-19 pandemic. The European banking sector has fortunately built up a significant amount of such buffers enabling ECB[119] to adopt measures aiming at providing banks the leniency to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), until at least end-2022, the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). Those measures were reinforced by the appropriate relaxation of the countercyclical capital buffer (CCyB) by the national macroprudential authorities[120].

Banks were also allowed, prior to the relevant scheduled amendment of the Capital Requirements Directive (CRD V)[121][122], to partially use capital instruments that do not qualify

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[117] See by mere indication **Ertan, A. (2020), Kund, Arndt-Gerrit and Neitzert, F. (2020).**

[118] For a comprehensive overview of all fiscal and monetary measures, which fall out of the scope of this paper, see in detail **Gortsos, Ch.V. (2020b), Gortsos (2020d), Busch, D. (2020), pp. 3-42, Hadjiemmanuil (2020), p. 189 et seq.**

[119] For the relevant SRB's measures, mainly regarding the flexibility in meeting the MREL targets, see the relevant SBR's decisions, available at: https://srb.europa.eu/en/node/965 , https://srb.europa.eu/en/node/966 and https://srb.europa.eu/en/node/967 and overall on the implications of the current crisis on the application of EU banking resolution framework, see **Gortsos, Ch.V. (2020c).**

[120] See ECB, 'Macroprudential measures taken by national authorities since the outbreak of the coronavirus pandemic' (19 April 2021), available at: ecb.europa.eu/pub/financialstability/macroprudential-measures/html/index.en.html. While the ECB has no competence to initiate such relief measures, it has the power to apply more stringent buffer requirements than adopted nationally, see SSM-Regulation, Article 5. Therefore, not interfering with Member States' supervisory relief decisions after notification indicates that the ECB agrees with the underlying macroprudential policy. For a comprehensive analysis on the distribution of macroprudential competences within the SSM, see **Gortsos, Christos (2015e).**

[121] See Directive (EU) 2019/878 of 20 May 2019 amending Directive 2013/36/EU (…) [2019] OJ L 150/253.

[122] The P2G ranges are designed to reflect an adequate level of capital based on recent supervisory experience, ECB Banking Supervision's risk tolerance and the severity of the stress test scenarios. With the revised P2G methodology, ECB Banking Supervision aims to strengthen the link between the P2G and the stress test results while focusing on CET1 capital, a bank's highest quality capital. The methodology is simple in design yet ensures a level playing field and consistency. See in detail, ECB revisiting approach to Pillar 2 guidance, 18 August 2021, available at: https://www.bankingsupervision.europa.eu/press/publications/newsletter/2021/html/ssm.nl210818_4.en.html

as Common Equity Tier 1 (CET1) capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R).

Furthermore, the ECB eased the provisioning for credit risk[123]. Notably, a favorable treatment of loans backed by public support measures was endorsed: even in arrears, these loans need not be qualified as non-performing. In the same vein, the ECB encouraged banks to apply the **transitional** IFRS 9 provisions so as to avoid excessively procyclical cliff-edge effects[124]. More precisely, the ECB endorsed a flexible approach towards significant increase in credit risk (SICR), allowing banks to factor- after relevant supervisory acquiescence- less acute long-term macroeconomic and other relevant critical assumptions[125] into their forecasts[126].

Notably, EBA's Guidelines[127] set detailed criteria to be fulfilled by legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, which, if fulfilled, prevent the classification of exposures under the definition of forbearance or as defaulted under distressed restructuring. COVID-19-induced payment moratoria are not considered forbearance measures and need not be qualified as NPLs. However, they do not suspend banks' general obligation to assess the credit quality of exposures and to qualify them as defaulting once the borrower becomes unlikely to pay (CRR, art 178(1)(a)). As **Rainer Haselmann & Tobias Tröger (2021)** note: "*moratorium schemes have to be blind regarding benefactors' creditworthiness, but banks are nevertheless expected to closely watch the solvency of individual borrowers*".

Moreover, in order to avoid significant procyclical detrimental impact in the European banking sector solvency, liquidity and financial stability, JSTs have exercised flexibility as

[123] See ECB, 'ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus' (Press Release, 20 March 2020), banking supervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.e n.html.

[124] See ECB, 'IFRS 9 in the context of the coronavirus (COVID-19) pandemic' (Letter of the Chair of the Supervisory Board to all Significant Institutions, 1 April 2020), bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/ 2020/ssm.2020_letter_IFRS_9_in_the_context_of_the_coronavirus_COVID -19_pandemic.en.pdf.

[125] Those were namely that (i) 'a sharp rebound in economic activity could be expected once the social restrictions have been lifted', (ii) this rebound 'might occur within 2020', and (iii) the 'mean reversion can be assumed earlier than under normal conditions'.

[126] See in further detail and critically **Haselmann Rainer & Tobias Tröger (2021).** While arguing that those measures are overall necessary, they express concerns for some of them, reminding that contrary to the buffers' inherent cushioning function in unexpected stress scenarios and their consequent natural release, lenience towards insufficient provisioning is a far more risky tool to camouflage the deterioration in asset quality, provided that they lead to opaqueness regarding the banks' current CET1 ratios and in general its capital position, hindering the much-needed for the disposal of NPLs transparency and consequent investor confidence. In this vein, they call for an immediate return to realistic reporting methodologies under IFRS 9.

[127] See Final report, Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, lastly updated on 02 December 2020, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/GL%20amending%20EBA-GL-2020-02%20on%20payment%20moratoria/960349/Final%20report%20on%20EBA-GL-2020-02%20Guidelines%20on%20payment%20moratoria%20-%20consolidated%20version.pdf

regards the implementation of NPL strategies and notably the time-bound qualitative reduction targets on a case-by-case basis[128]. In addition, the ECB adopted further prudential relief measures[129] and adopted "a pragmatic approach" in the 2020 supervisory review and evaluation process (SREP) that also sought to avoid additional pressure on banks' lending capacity[130].

Finally, amidst the current pandemic crisis, the CRR (as in force) was amended by the '**CRR quick fix**"[131] as regards adjustments in response to the COVID-19 pandemic to sustain credit institutions' lending capacity in line with the above-mentioned initiatives by the ECB and the EBA. It mainly covers the following aspects:

- The minimum capital requirements for non-performing loans (NPLs) under the 'prudential backstop' have been amended to extend the preferential treatment of NPLs guaranteed by export credit agencies also to publicly guaranteed loans, subject to EU State aid rules.[132]
- The abovementioned arrangements relating to the implementation of the IFRS 9;[133]
- For credit institutions using the internal ratings based (IRB) approach, exposures to central governments and central banks are assigned a 0% risk weight only under Article 114(2) or (4) CRR
- The system of rules governing unrealised gains and losses measured at fair value (Articles 467-468 CRR) has been totally amended for a 'period of temporary treat-

[128] See **Linaritis (2020)**, p. 8.

[129] The ECB allowed banks to operate temporarily below the 100% liquidity coverage ratio (LCR) requirement until at least end-2021. Furthermore, the ECB rescheduled on-site inspections and extended deadlines for remedial actions arising from recent on-site inspections and internal model investigations were extended. Similarly, the ECB also extended the deadline for complying with the supervisory review and evaluation process (SREP) 2019 qualitative measures by six months. Additionally, the ECB used the stick and recommended banks to preserve capital and liquidity and not to pay dividends or conduct share buy-backs in order to be able to support households, small businesses and corporate borrowers and/or to absorb losses on existing exposures to such borrowers. See in further detail **Haselmann Rainer & Tobias Tröger (2021).**

[130]see ECB, 2020 SREP aggregate results (28 January 2021). Euro area banks also gained some leeway to master the operational challenges posed by the pandemic when the EBA decided to postpone the 2020 annual EU-wide stress test to 2021, see EBA, 'EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector' (12 March 2020).

[131] See Regulation (EU) 2020/873 of 24 June 2020 (…) as regards certain adjustments in response to the COVID-19 pandemic [2020] OJ L 204/4 (hereinafter: CRR quick fix).

[132] Amendment of Article 47c (4) CRR.

[133] Amendment of Article 473a CRR.

ment' until 31 December 2022, allowing credit institutions to remove from the calculation of their Common Equity Tier 1 unrealised gains and losses measured at fair value through other comprehensive income.[134]

- By way of derogation and for a limited period of time, new provisions apply for the (temporary) treatment of public debt issued in the currency of another Member State, the (temporary) exclusion of certain exposures to central banks from the total exposure measure.[135]

- The calculation of credit institutions' leverage ratio has been modified on a targeted basis,[136] while the date of application of the leverage ratio buffer for G-SIIs has been postponed (by 1 year) to January 2023.[137]

Banks are expected to use these capital relief measures to "keep the lending channel open". In this context, dividend distributions, share buybacks or variable remuneration[138] were prohibited. In any case, banks should continue to apply sound underwriting standards, pursue adequate policies regarding the recognition and coverage of non-performing exposures (albeit in loosened NPL recognition under IFRS 9[139]), and conduct solid capital and liquidity planning and robust risk management.

However, pressing banks to continue lending[140] into a recessionary environment in order to cushion economic impacts could prove to be a rather risky option and give rise to a second potentially devastating wave of new COVID-inherited NPLs[141], albeit with a time-lag[142]. Indeed, the loosened accounting and prudential requirements in conjunction with the broad recognition of moratoria in prudential regulation has the potential to camouflage impending losses and delay the recognition of sharp deterioration of asset quality. This is exactly why concerns arise regarding the reveal of the actual size and potential of the new

[134] Deletion of Article 467 CRR on unrealised losses measured at fair value and replacement of Article 468 on unrealised gains measured at this value.

[135] New Articles 500a-500d CRR.

[136] Amendment of Article 429a CRR.

[137] As already mentioned, this buffer is governed by Article 92(1a) CRR (see above, under Paragraph 1.6.4.1).

[138] See PRESS RELEASE, ECB Banking Supervision provides temporary capital and operational relief in reaction to coronavirus, 12 March 2020, available at: https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200312~43351ac3ac.en.html

[139] See **Mullin K., (2020).**

[140] Indicatively, offering TLTRO III as low as -75bp for eligible counterparties, keeping liquidity taps open via standard LTRO facilities, easing collateral standards, and offering sovereign loan guarantees in conjunction with the abovementioned capital relief measures to ensure banks' lending capacity, create a macroeconomic environment characterized by almost unlimited liquidity.

[141] See **Ignazio Angeloni (2021), pp. 107 et seq.**

[142] See **Mullin K., (2020)**, passim.

wave of COVID-inherited NPEs only after the lift of these moratoria and prudential relief measures. Therefore, banks experience for the time being an artificially depressed level of loan defaults. Once these indirect national measures or their preferential prudential treatment expire, loan defaults will inevitably accelerate[143]. Banks will be mandated to adjust their provisions to the current macroeconomic environment and comply with the full-fledged capital requirements, including buffers and P2G, once more. This is expected to result in a significant deterioration of banks' capital ratios[144].

Excursus: why these measures were of paramount importance?

1. The ECB will allow banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G) and the capital conservation buffer (CCB) plus the appropriate relaxation of the countercyclical capital buffer (CCyB) by the national macroprudential authorities:

In a nutshell, the capital ratios that a supervised credit institution should meet are the following:

a. the Total SREP Capital Ratio (TSCR), which consists, under the SREP framework, of the two elements: the (above-mentioned) total capital ratio (TCR, 8%), and the Pillar2 (additional capital) requirements (P2R) for each credit institution separately, which is variable and determined on a case-by case-basis.

b. the Overall Capital Requirement (OCR), which consists, under the SREP framework, of two elements: the TSCR and the combined buffer requirement the combined buffer requirement, meaning the total CET 1 capital required to meet the requirement for the capital conservation buffer extended by the following, as applicable: an institution-specific CCyB (0-2.5%) and the higher of the other buffers(G-SIII vs. systemic risk or O-SII vs. systemic risk).

c. Finally, the Pillar 2 guidance (P2G), established under the SREP as well, is an additional capital buffer: it indicates to credit institutions the adequate level of capital to be maintained in order to have sufficient capital as a buffer to withstand stressed situations, in particular as assessed based on the adverse scenario. The P2G, which

[143] Based on ECB's recent quantitative data, NPLs are expected to rise sharply and based on an adverse scenario, could even amount to 1.4 trillion euros, which would lead to a CET1 ratio depletion of up to 5.7 percent. Interestingly, **Ignazio Angeloni (2021)**, reminds that between 2007, the last pre-crisis year, and 2013, the peak year, the NPL ratio in the euro area rose by roughly 6 percentage points, while NPLs in nominal terms increased by over 600 bn. euros. See in further detail See ECB Economic Bulletin, various issues. https://www.ecb.europa.eu/pub/pdf/ecbu/ecb~b6a4a59998.eb_annex202101.pdf. And ECB supervisory statistics, https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html.

[144] In fact, **Rainer Haselmann & Tobias Tröger (2021)**, argue that without the abovementioned relief measures, a new banking crisis would probably had already emerged.

relies on a wide range of information and is on top of the OCR, is not binding, but the European Central Bank (ECB) expects compliance therewith.

The drop of the capital ratio below:

i. the TSCR + 1.5% of RWAs, may trigger intervention measures.

ii. an add-on over the OCR➔ "recovery trigger" set by credit institutions themselves[145].

iii. the OCR, applicable are CRD's supervisory measures, notably the restrictions on distributions (i.e., dividends, bonuses, payments on AT1 coupons).

iv. the P2G, it must submit a capital plan to restore compliance. Non-compliance could also potentially trigger further capital increasing and more stringent supervisory measures (in accordance with Article 141 CRDIV), including an increase of the P2R, in case the institution simply disregards the P2G, does not incorporate it into its risk management framework or does not implement capital action within the time-frame provided by the ECB.

With the abovementioned measures, crucial temporary capital relief is ensured and the credit institutions are allowed to keep lending to the economy without such severe supervisory and early intervention measures overhang.

2. Banks will also be allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 (CET1) capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R):

Considering that the drop of the capital ratio below the TSCR may trigger a "failing or likely to fail" determination by the ECB or the NCA and below the TSCR + 1.5% of RWAs, may trigger intervention measures, it is clear that, without those measures, any credit institution unable to meet the TSCR would be deemed FOLF and placed in resolution or liquidation and TSCR +1,5 % RWAs would be subject to early intervention measures(!).

[145] In that case, the senior management may decide the application of recovery option(s) provided for in the recovery plan (e.g., share capital increase, divestments, cost reduction).

Section II

Notable legislative measures(adopted or pending) for the NPL Resolution

Why a dedicated coherent and EU-wide harmonized framework for Credit Servicers and Purchasers is necessary and how the Proposal Directive pending is going to help.

In case banks are unable to efficiently manage their NPLs, thereby recovering less value than would otherwise be possible, the best option would be to either outsource the servicing of these loans to a specialised credit servicer or sell the credit agreement to a purchaser that has the necessary risk appetite and expertise to manage it[146]. For these reasons, the Proposal Directive on credit Servicers and Purchasers purports to remove undue impediments to credit servicing by third parties and to the transfer of credits.

As stipulated in its Recitals, currently, credit purchasers and credit servicers cannot reap the benefits of the internal market due to barriers posed by divergent national legislations in the absence of a dedicated and coherent regulatory and supervisory regime.

It is indicative that in some Member States they are not regulated at all, while in others they can face various requirements, sometimes amounting to full banking licences. In any case, national authorisation regimes impose different requirements, whilst, in some cases, require local establishment, thereby hindering the provision of cross-border services[147]. This is why purchasers mostly operate in a limited number of Member States, which results in an overall limited competition in the internal market, which is dominated by few large buyers with ultra bargaining power.

In particular, on the investor side, there are about 120 debt managers that invest in distressed debt in North America and Europe, of which about 70 are active in the EU. In Europe, almost 40 % of the transaction deals was accounted for by the biggest five buyers. Most buyers are investment firms, but also a few banks bought loans, mostly from other banks. About 70 % of the market share in the EU is controlled by 20 % of investors. **The market is highly fragmented by national borders[148]**.

AS Recital 11 of the Proposal Directive illuminatingly stipulates, the limited anaemic participation of non-credit institutions in the NPL market has resulted in low demand, weak competition[149], low bid prices for portfolios of credit agreements on secondary markets and

[146] See **EC (2018), p. 8-9.**
[147] See **EC (2018), p. 8-9.**
[148] See **EC's Staff Working Document on NPL trading Platforms (2018)**.
[149] As Recital 15 of the Proposal Directive stipulates, the lack of competitive pressure on the market for purchasing credit and on the market for credit servicing activities results in credit servicing firms charging credit purchasers high fees for their services and leads to low prices on secondary markets for credit. This reduces incentives for credit institutions to offload their stock of NPLs.

high credit servicing fees, which is a disincentive for credit institutions to sell non-performing credit agreements. Therefore, it is essential to establish **markets for credits granted by credit institutions and sold to non-credit institutions**.

Providing an EU-level framework would ensure uniform entry conditions for credit purchasers and servicers and a passport for carrying out their activities throughout the Single Market. This would result in particular for more competition between potential investors in bank loans and would allow banks to sell them at more competitive prices.

The currently pending Proposal Directive is supposed to apply to purchasers and servicers of credit originally issued by a credit institution or its subsidiaries, irrespective of the type of borrower concerned. It shall not apply to purchasing and servicing of a credit agreement carried out by a credit institution and its subsidiaries in the EU or to purchasing and servicing of credit agreements issued by other types of creditors than credit institutions and their subsidiaries.

In particular, it contains the rules for the authorisation of credit servicers, the **maximum** set of requirements that need to be fulfilled by credit servicers[150](*as well as their senior management and shareholders with qualifying holdings*[151]) to be authorised in their home Member State, the procedures for the authorisation and the cases when the authorisation may be withdrawn[152]. The set-up of a public register of authorised credit servicers in each Member State is envisaged. The relationship between the credit servicer and the creditor is required to be based on a written contract which, among other issues, includes a clear

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150 Indicatively, in order to ensure compliance with debtor protection as well as personal data protection rules, it is necessary to require that appropriate governance arrangements and internal control mechanisms and recording and handling of complaints, are established and subject to supervision. Moreover, credit servicers should be obliged to act fairly and with due consideration for the financial situation of the borrowers. Where debt advice services facilitating debt repayment are available at national level, the credit servicers should consider referring borrowers to such services.

151 As Recital 24, ibid, states: " *To avoid a reduction in debtor or borrower protection and in order to promote trust, the conditions for granting and maintaining an authorisation as a credit servicer should ensure that credit servicers, persons who hold a qualifying holding in the credit servicer or who are part of the management of the service provider* ***have a clean police record*** *in relation to serious criminal offences linked to crimes against property, to crimes related to financial activities or to crimes against the physical integrity* ***and that they are of good repute***. *Similarly, these persons as well as the credit servicer* ***should not be subject to an insolvency procedure or have not previously been declared bankrupt****, unless they have been reinstated in accordance with national law*".

152 According to article 7: " *Member States shall ensure that the competent authorities of the home Member State may withdraw the authorisation granted to a credit servicer, where such a credit servicer either:*

(a) does not make use of the authorisation within 12 months of its grant;
(b) expressly renounces the authorisation;
(c) has ceased to engage in the activities of a credit servicer for more than six months;
(d) has acquired an authorisation through false statements or other irregular means;
(e) no longer meets the conditions set out in Article 5(1);
(f) *commits a serious breach of the applicable rules, including the national law provisions transposing this Directive*".

reference to the obligation to observe Union and national law applicable to the credit agreement. The agreement shall provide at least for a detailed description of credit servicing activities to be carried out by the credit servicer, remuneration arrangements, the extent to which the credit servicer can represent the creditor in relation to the borrower and consumer protection considerations.

Article 10 regulates the outsourcing of activities by credit servicers and demands that they remain fully responsible for all obligations under the national provisions transposing this Directive in order to ensure that outsourcing does not result in undue operational risk or non-compliance with any national or Union legal requirements or impede supervisor to perform its duty and safeguard borrower rights[153].

As regards the provision of credit servicing cross-border, Article 11 requires Member States to ensure the freedom to provide services in the Union for authorised credit servicers. To this end, specific provisions on procedures and communication between home and host authorities are set in the Directive, namely exchange of information, while preserving confidentiality, on and off-site inspections, the provision of assistance, the notification of results of checks and inspections and of any measures taken[154]. Article 12 stipulates how such cross-border servicers shall be supervised and distributes supervisory competences between home and host competent authorities[155].

As regards credit purchasers[156], Article 13 provides that creditors shall provide all necessary information to a credit purchaser prior to entering into a contract, with due respect to personal data protection rules. When the first transfer of the credit takes place from a credit institution to a non-credit institution purchaser, the supervisor of the credit institution shall be informed thereof. Article 14 **mandates the use by credit institutions of EBA NPL data templates**.

Since the valuation of a portfolio of non-performing credit is complicated and complex, actual buyers on secondary markets are sophisticated investors. These non-banks credit purchasers are not creating new credit, but are buying existing credit at own risk, they do not cause prudential concerns neither anyhow contribute to systemic risk. Therefore they

[153] See Recital 25, ibid.
[154] See recital 27, ibid.
[155] In particular, inter alia article 12 par. 11 states: "*Member States shall ensure that where, after having informed the home Member State no adequate measures were taken in a reasonable time or despite measures taken by the competent authorities of the home Member State or in an urgent case, the credit servicer continues to be in breach of the obligations under this Directive, the competent authorities of the host Member State are entitled to take appropriate administrative sanctions or penalties and remedial measures in order to ensure compliance with the provisions of this Directive within its territory after informing without delay the competent authorities of the home Member State*".
[156] According to article 3: " 'credit purchaser' means any natural or legal person other than a credit institution or a subsidiary of a credit institution which purchases a credit agreement in the course of his trade, business or profession".

are not subject to authorisation or other stringent special prudential requirements. Their regulatory regime is mainly based on conduct and transparency requirements[157].

In this vein, consumer protection rules and borrowers' rights continue to apply irrespective of the transfer. Imposing an obligation on the representative of the third-country purchasers **of consumer credit** to appoint a credit institution or a credit servicer authorised in the Union for servicing a credit agreement ensures that the same standards of consumers' rights are preserved after the transfer of the credit agreement. **This representative will be responsible for the obligations imposed on credit purchasers under the Directive**. Article 18 sets the rules concerning the enforcement of a credit agreement by the credit purchaser directly and the information obligations set on the credit purchasers and the competent authorities. Article 19 introduces information obligations of the purchaser in case the purchaser transfers the credit agreement.

Article 20 sets obligations of on-going compliance with the national provisions transposing this Directive and the designation of competent authorities responsible for carrying out the functions and duties set by the national provisions implementing the Directive. Article 21 details the supervisory powers of the competent authorities while Article 22 provides for the rules on administrative penalties and remedial measures.

Finally, in order to ensure efficient and proportionate supervision across the Union, Member States should grant the necessary powers for competent authorities to carry out their duties under this Directive, including the power to obtain necessary information, to investigate possible breaches, to handle borrowers' complaints and to impose sanctions and remedial measures, including the withdrawal of the authorisation. Where such sanctions are applied, Member States should ensure that competent authorities apply them in a proportionate manner and give reasons for their decisions and that in addition those decisions should be subject to judicial review.

Broadening the investors' base as part of the CMU project

In recent years, the stricter capital requirements have impeded the lending capability of banks. The gap has been only partially and in some jurisdictions been filled by the development of alternative funding providers[158], such as crowdfunding platforms[159] and investment funds[160].

[157] Without prejudice to the above, they could be regulated and supervised as financial institutions, according to the applicable EU legal framework, irrespective of their capacity as credit purchasers.
[158] On the various types of investment funds as alternative funding providers and co-investment structures, see among others **Zhang Chi (2020), pp. 123-126, Athanassiou Phoebus (2012), pp.1–12**.
[159] See **Ferrarini Guido and Eugenia Macchiavello, ch 10**.
[160] See **Ronzel Nicolas (2019)**.

In this respect, several significant CMU action plan's reforms[161] to bolster cross-border investment and structured financial transactions have been introduced, namely:

- Regulation (EU) 2017/1991 amending Regulation (EU) No 345/2013 on European venture capital funds, Regulation (EU) No 346/2013 on European social entrepreneurship funds[162], which inter alia expand the range of eligible investments;
- the 'STS Securitisation Regulation' and its recent amendments to the CRR[163] establishing an STS framework for synthetics and a dedicated framework for NPE securitizations;
- the Directive (EU) 2019/1160, amending the UCITS IV Directive and the AIFMD, governing the cross-border distribution of collective investment funds and Regulation (EU) 2019/1156 (amending also the EuVeCaR, the EuSEFR and the PRIIPs Regulation) aiming at the facilitation of such a distribution and
- Regulation (EU) 2019/2160 amended the CRR "as regards exposures in the form of covered bonds" and Directive (EU) 2019/2162 governs "the issue of covered bonds and covered bond public supervision" and amends the UCITS IV Directive and the BRRD.

Notably, a highly relevant market player could prove to be a real game changer in the establishment of a distressed debt market: the so-called nascent credit funds.

According to the IOSCO's relevant Report on Loan Funds - Final Report[164], there are generally two different types of credit funds: loan-originating, and loan-participating funds.

A 'loan-originating fund' is identified as any type of fund that its investment strategy includes granting and restructuring loans. According to IOSCO, **loans may either constitute a minor part of the given fund's investment strategy, or may be the only asset class in which an AIF may invest**. On the other hand, 'loan-participating funds' are funds that acquire, and eventually restructure (partially or entirely) existing loans originated by banks and other institutions, either by acquiring them directly from the lender or on secondary markets. If a fund engages in both activities, IOSCO considers it to be a loan-originating fund[165].

Since credit funds would qualify in the current EU landscape as alternative investment funds, they will be regulated the AIFMD. However, due to **the AIFMD agnostic approach**

[161] For a brief overview, see **McCarthy Jonathan (2020)**.
[162] In addition to the new rules, the Commission launched in 2018 a Pan-European "Venture Capital Fund-of-Funds" program in support of innovative investments.
[163] See also the Commission's Delegated Regulation (EU) 2015/35 of 10 October 2014 adopted by virtue of Directive 2009/138/EC of 25 November 2009 "on the taking-up and pursuit of the business of Insurance and Reinsurance" ('Solvency II' Directive'), i.e., the main source of EU insurance law), in order to facilitate investments in STS securitisations and infrastructure by insurance companies as well.
[164] See IOSCO, Findings of the Survey on Loan Funds – Final Report (IOSCO, 2017). On the topic **Hooghiemstra, S.N. (2019)**, passim.
[165] See in further detail **Filippo Annunziata (2021)**, passim.

to product regulation, credit funds are already regulated according to divergent national approaches[166].

In the context of the AIFMD framework, an exception should however be made in relation to **EuVeCa, EuSEF and ELTIF funds**, **whose regulations explicitly allow for loan origination**. Not insignificant, not enough.

A more harmonized and comprehensive approach[167], optimally included in a revised AIFMD product regulation, could really make a difference in establishing a proper distress debt market and diversify funding sources in the EU, thereby reducing the overdependence on bank financing[168]. On 10 June 2020, the Commission published a report assessing the scope and the functioning of the AIFMD[169] merely making a vague reference "on the case for setting common standards for loan-originating AIFs", followed by a relevant Commission's staff working document[170]. The first one to put "flesh to the bone" was ESMA in its letter to the Commission containing recommendations regarding the review of the AIFMD[171] and encompassing **the first EU comprehensive proposal for the creation of a specific framework for loan origination funds within the AIFMD**. It includes details on the types of funds (closed-ended vehicles), eligible investors (complying with ELTIF rules), as well as the organizational and prudential requirements (e.g. leverage, liquidity, stress testing, reporting, etc.) that would be applicable under such a regime. However, the Commission's consultation[172] on its proposals to amend the AIFMD (closed on 29 January 2021), did not include detailed information on the matter.

In the author's view, their regulation should be light and targeted, aiming at governance rules, unitholders protection considerations, robust internal risk management systems and controls (including internal audit and compliance), leverage and diversification requirements, as well as standards of proper conduct, prevention of conflicts of interest, transparency, accountability and strong mechanisms for the supervision.

The Commission's later Communication on NPLs was silent on the topic. This is unfortunate. In the author's view, credit funds could possibly be the vehicle to establish a private

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[166] For the consequent legal uncertainty due to the national divergent approaches, AIFMD's product regulation agnostic approach and the partial overlap with other EU Legislation, namely Securitization Regulation, see among others **Heinzmann Andreas and Ronze N. (2017), pp. 247 et seq and Filippo Annunziata (2021), ibid.**

[167] See **Dorin Philippe and Vojtko M. (2018), pp. 385-396.**

[168] See **Huertas M. and Marta Zuliamis (2018), pp. 185-188.**

[169] See Report from the Commission to the European Parliament and the Council assessing the application and the scope of Directive 2011/61/EU of the European Parliament and of the Council on Alternative Investment Fund Managers of 10 June 2020 (COM/2020/232 final).

[170] See Commission Staff Working Document, 10 June 2020 (SWD(2020) 110 final).

[171] See ESMA34-32-550.

[172] See Commission, 'Public Consultation on the Review of the Alternative Investment Fund Managers Directive (AIFMD)', available at: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_ finance/2020-aifmd-review-consultation-document_en.pdf.

investor-led distress debt market. They could, in fact, perform similar functions to those of proper state-banked AMCs, albeit without public subsidies. Since credit funds are not subject to prudential regulations applicable to credit institutions, they might prove to be a more flexible vehicle than AMCs[173].

Furthermore, credit funds would attract new investors with more risk- tolerant profile and interested in becoming unitholders on the private (mostly institutional or professional) market, significantly broadening the investor base. With their high expertize, backed by the transparency requirements of the Securitization Regulation and the currently pending initiatives for NPL market infrastructures, they will standardized the NPL due diligence and establish a market-led state of the art for the relevant transactions. This, per se, should result to **a more transparent and efficient price-formation mechanism for NPLs** on the secondary market, reducing information asymmetries and other market frictions.

Even more importantly, the development of an active market for credit funds would also **act as a stimulus for the subsequent re-transfer of portfolios of NPLs and interact with established AMCs**, thus contributing to increasing the liquidity of secondary markets[174]. This might ultimately result in collective portfolios of NPLs with a lower risk profile and significant diversification, more robust risk- management and, ultimately, higher rates of return for investors[175]. Further incentives might be provided by other factors, such as taxation, by inter alia providing tax incentives for novel distressed debt investors entering the EU market.

Establishing the proper market infrastructures: namely the case for an EU-wide trading platform and central data hub.

A European platform for NPLs, as envisaged in **EC's Staff Working Document on NPL trading Platforms (2018),** would be **an electronic marketplace and a data warehouse** where banks and investors could trade individual NPLs and NPL portfolios. A well-functioning transaction platform could create active, liquid and efficient secondary markets for NPLs and contribute to reducing its notorious market failures, helping to address information asymmetries, increase creditor coordination, and broaden the investor base, thus leading to improved market pricing of NPLs[176]. Indeed, information asymmetries in the absence of such market infrastructures can be overcome only through costly investor due diligence, which is in the case of securitization transactions mandatory[177]. As few investors can afford such costs, which in turn indirectly impose entry barriers to the already nascent

[173] See **Annunziata F. (2021), pp. 29-32.**
[174] For the importance or the liquidity in EU capital markets as a key goal of the CMU project, see among others **Ugeux G. (2016), pp. 314-330.**
[175] See **Annunziata F. (2021), pp. 29-32.**
[176] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.1-2.**
[177] See **Fell, J., Grodzicki, M., Martin, R. and O'Brien, E. (2016), pp. 134-146, and Fell, J., Moldovan, C. and O'Brien, E. (2017b), pp. 158-174.**

and illiquid NPL secondary market, which consequently bears the features of an **oligopsony**, where established investors enjoy a market-power bargaining premium which can broaden the bid-ask spread even further[178].

In essence, all loan types would be eligible for inclusion on the platform, i.e including performing loans[179]. The NPL platform would also be open to all types of sellers and professional buyers and its geographical scope of operation should be wide, preferably Union-wide, as in this case, costs could be shared and reduced and economies of scale and scope could be achieved[180].

Secondly, in order to reduce transaction and search costs, **the NPL platform would ensure data sharing and a high degree of data standardisation and thereby foster** NPL data quality by providing data completeness and plausibility checks, and defining standards for data validation that would be performed by banks[181].

Moreover, it could **facilitate transactions by offering a price discovery mechanism**-given that currently price data of private bespoke NPL transactions are not in principle disclosed- for participants to use **and by intermediating between investors and third-party service providers** such as appraisers, **loan servicers**, and transaction advisers[182].

To avoid legal risk, including issues related to insolvency and enforcement regimes, an NPL platform would never own or service any of the loans traded therein nor engage in trading on its own account. Equally, settlement of transactions would be conducted bilaterally between seller and buyer without involving the platform. In that sense, the "dedicated" NPL platform **would be more a Crowdfunding-likened platform rather than a more complex "NPL MTF".**

Since the platform would neither provide settlement services, nor at any time assume ownership of the assets transacted so as to face any financial risks, there are no legitimate reasons to subject them to formal authorisation as an exchange or other type of regulated marketplace as that would likely trigger an excessive level of regulatory scrutiny and associated compliance requirements[183].

[178] See **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a).**
[179] **EC's Staff Working Document on NPL trading Platforms (2018), p.1.**
[180] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.1-2.**
[181] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.1-2.**
[182] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.1-2.**
[183] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.1-2.**

Currently, several private[184] companies offer part of these services[185] in a selection of EU Member States. However, **they offer limited geographic scope and the loan data used is not standardised across the market**. The supply of NPLs via existing platforms has been, until now, rather limited, albeit the relatively significant investor interest. Indeed, none of the existing players offers the full scope of services that the NPL platform should offer. Some players provide loan data warehouse and auction platforms, including data analytics and valuation services, while others are less comprehensive and focus only on creditor coordination or specific market segments. For these reasons, among others, the potential benefits of a European NPL platform remain largely unrealised[186].

The NPL platform would have some features of a market infrastructure and therefore it should be regulated and supervised accordingly. There is no common international standard as regards the ownership of marketplaces or market infrastructure. Some critical market infrastructure providers are publicly owned (e.g. payment systems such as TARGET2), yet others are for-profit private companies (e.g. many stock exchanges) or industry initiatives operating in a not-for-profit (European Data Warehouse) or cooperative form (SWIFT). Several forms of ownership and governance can be considered for an NPL platform, including (1) public ownership, (2) private ownership, (3) private ownership combined with standard setting and oversight by a not-for-profit 'standard setting body'[187]. The platform could even be set up by the very banks that intend to use it for placing NPLs on the secondary market and possibly be sponsored by the ECB, thus following the model of the European Data Warehouse[188].

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[184] The most notable benchmark is the **ECB's ABS loan-level initiative** to improve transparency in ABS markets by requiring loan-by-loan information to be made available and accessible to market participants and to facilitate the risk assessment of ABSs as collateral used by Eurosystem counterparties in monetary policy operations. See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 83.**

[185] NPL platforms with different functions exist across many Member States and have various shapes, functions, institutional setups and ownership structure.

In Portugal, a private coordination platform PNCB (Integrated Bank Credit Trading Platform) was launched in early 2018 by three major Portuguese lenders CGD, BCP Millennium and Novo Banco to manage the negotiation of non-performing claims and guarantees. The clear purpose of this platform is to maximise the value of the non-performing loans and research the market for best bidders to allow for a swift sale of the credits.

An online platform was also recently (back in summer 2017) setup by the well-established Spanish AMC SAREB. Its new strategy aims at both providing transparency to loan sales processes and opening them up to a much broader investor base than large institutional investors targeting big-ticket items. SAREB's platform is targeting transactions and works in parallel with three of independent servicers, which also sell NPLs via their own online platforms.

In Greece, the four systemic banks have established a common platform, called Project Solar, to focus on curing and maximizing recoveries from non-performing loans of SMEs that have exposures towards two or more banks. The four systemic banks have also established a cross-bank coordination platform called 'NPL Forum' to work on the agreement and implementation of common approaches.

[186] See **EC's Staff Working Document on NPL trading Platforms (2018), pp. 5-8, 14 onwards.**

[187] See **EC's Staff Working Document on NPL trading Platforms (2018), p.11-13, 23.**

[188] See **John Fell, Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a).**

Public ownership of an NPL platform may mean ownership by a specific Member State or by a Union body. Cross-border operations of a platform owned by a specific national government would be highly sensitive from a political and communications perspective, and might also pose challenges under the EU State aid framework[189].

Pan-European public ownership would fit better with the European scope of the platform and avoid most potential State-aid issues, as long as it averts political interference, manages the potential conflicts of interest between the Union institutions and agencies in their various regulatory and executive roles and achieves the same operational efficiency as a private enterprise could do[190].

The Commission's Staff Working Document opts for privately owned NPL platforms that would meet predifined quality criteria, established by an industry body with major stakeholder involvement and possibly with the participation of competent Union agencies and institutions as observers.[191]

In this context, all private platforms would seek a 'seal of approval' by an industry body tasked with developing industry standards and assessing if NPL platforms abidingly comply with these criteria. In exchange, a compliant platform could be recognised as a European NPL platform[192].

If the 'seal of approval' process leads to multiple platforms operating in the marketplace, they could optimally link their data warehouses, to avoid market fragmentation and provide investors access to the market through a single point of entry.[193]

In any case, a licensing (EU-wide passporting) regime under predefined in dedicated legislation criteria and on a non-discretionary basis and in the strict context of a review of legality, is always an option. Besides, the abovementioned industry-based procedure, which maximizes stakeholder involvement and market-likened direction of the platform, can always be used when defining the conditions and qualitative requirements of the "licencing regime".

[189] See **EC's Staff Working Document on NPL trading Platforms (2018), p.11-13, 23.**
[190] See **EC's Staff Working Document on NPL trading Platforms (2018), p.11-13, 23.**
[191] In doing so, it would be essential to make sure that the European authorities' involvement would be properly structured to avoid any legal implications of responsibility.
[192] See **EC's Staff Working Document on NPL trading Platforms (2018), p.11-13, 23.**
[193] Financial market infrastructures are allowed to establish links between themselves, and such links are widespread among central counterparties and securities' depositories. See for example ESMA (2015), Final report on the extension of scope of interoperability arrangements, https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1067_-_report_on_io_extension_0.pdf .

As regards the oversight competence, apart from the industry-based default option, in the view of the author, a centralised oversight competence appointed to ESMA- given its relevant direct supervisory competences over trade repositories(thus, potential synergies, economies of scale and scope, maximum credibility)- could be considered.

In any case, irrespective of whether the 'seal of approval' or a "traditional" licensing (EU-wide passporting) regime is adopted, rules regarding fit and proper assessments of platform members' management body using existing standards for internal governance and operational risk management[194] should be in place, whereas the MiFID II/ MiFIR (possibly enhanced with targeted EMIR-likened provisions) regime regarding the organizational requirements of such comparable marketplaces/ market infrastructure could be proportionately used as a benchmark. Similar extension of the EU governance requirements could be considered in the field of market conduct requirements.

In order to be eligible for a 'seal of approval', the platform should directly offer at least the following services[195] across EU Member States:

Data review and validation: ideally, a platform would provide data that are quality-assured and subject to a range of checks. Investors can use such validated and harmonised data in the financial due diligence and valuation process on a cost-efficient basis. However, full data validation would be costly and possibly impeded by personal data protection rules.

Data warehousing: the platform would operate **an electronic database**, regularly updated with new snapshots of NPL loan-level data, and **provide access to investors**.[196]

Matching buyers and sellers of NPLs: the platform should allow investors to contact the NPL sellers and to bid for selected NPLs or NPL portfolios. The platform could also offer matching and bundling of (small) similar loans instead of prepacked portfolios put up for sale by the banks. Furthermore, through its user agreements, the NPL platform could make public a database of investors interested in the purchase of various types of NPL, thereby generating a pool of investors that banks could approach.

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[194] See e.g. EBA Guidelines on internal governance, and Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body.

[195] The transaction platform could also be developed in stages to ensure that the concept can be launched quickly. Alongside an introduction of the data validation function in stages, the ancillary services may be phased in after the basic functions of the platforms are operational. See in further detail **EC's Staff Working Document on NPL trading Platforms (2018), pp. 16 et seq.**

[196] However, the industry body could also consider promoting a **hub-and-spoke model where the data warehousing function is centralised, but the remaining services are provided by various private entities**, subject to licensing agreements that would ensure uniformity across all platforms. Akin to the concept of links between clearing houses and securities depositories, such a model would allow multiple transaction platforms to emerge and connect with each other, all operating on the same basis and accessing centralised data.

Other, ancillary services[197] to be possibly provided by third parties and offered through the platform may include the following:

- Intermediation of **credit servicing**
- **A broad range of analytics and valuation services** provided by third parties. On the platform, the internal IT system could offer some standard quantitative tools, for loans and for the underlying collaterals, and data that can be used for benchmarking purposes based on similar past transactions. This could be coupled with more bespoke advisory services given by third parties. These could include corporate valuation, individual real estate appraisal, etc.
- **various data analytics tools** (either directly or through third-party providers) helping sellers to arrive at their own valuation and hence to determine potential asking prices, or access to pre-selected deal advisers that could help buyers to prepare sales proposals and data, and to identify potentially interested investors.

Furthermore, there are a number of EU regulations and directives (existing as well as pending) that could be applicable to an NPL transaction platform[198].

Since a platform could comprise a multi-country electronic marketplace matching buying and selling interest, the MiFID II/MiFIR[199] framework could, in principle, be applicable, insofar their respective services and activities could fall within the scope of Section A of Annex I of MiFID II. In this context, rules regarding MiFID/MiFIR's organisational requirements, market transparency, trade data, disclosures, integrity and conflict of interest rules (if applicable), access rules and supervision, competences, sanctions should be taken into consideration.

Under certain conditions, the circumstances of a specific NPL-related transaction may amount to using 'inside information". Under such circumstances, the following considerations are apposite: transparency requirements (disclosing the specific piece of inside information vs delaying the disclosure), certain safeguards and prohibitions (e.g. prohibition on insider dealing), public disclosures, insider lists, managers' transactions, etc.

In any case, governance and management requirements and requirements for credit, market and operational risk apply[200]. In this context, **operational risks resulting from the use of transaction platforms appear most relevant**.

While the main purpose of the platform would not be to facilitate securitisation of NPLs, or to trade (performing) securitised loans, **the data provided via the platform may be**

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[197] See **EC's Staff Working Document on NPL trading Platforms (2018), pp.16 et seq.**

[198] See in further detail **EC's Staff Working Document on NPL trading Platforms (2018), pp. 24 et seq.**

[199] Directive 2014/65/EU and Regulation (EU) No 600/2014

[200] Directive 2013/36/EU, Regulation (EU) No 575/2013.

very helpful in securitising loans[201]. If securitised loans would be considered eligible for inclusion on the platform, the securitisation framework would apply[202], notably its transparency requirements for the issuer, in particular disclosing information on the underlying exposures on quarterly basis. **NPL securitisation would require disclosure of information to securitisation repositories as well**. Therefore, information disclosed on the NPL transaction platform should in principle follow the established format for reporting to securitisation repositories[203].

Possible issues arising from insolvency and recovery regimes

The platform could provide general information about insolvency systems and on the status of insolvency proceedings, to the extent practically possible. Since the enforceability of the loans present on the platform constitute an important feature for the pricing of these, the platform could make available up-to-date generic information about the loan enforcement and the relevant insolvency regimes[204]. However, all parties would have to be made aware that the legal enforceability remains a characteristic of each individual loan, since besides statutory law, it may depend on agreements between the creditor and the debtor in the loan agreement.

Platform Rulebook[205]: this includes rules on **trading methods and terms and conditions for various actors, including sellers, buyers and third-party service providers, admission to trading, trading arrangements and the products (asset classes, single or bundled** etc.). Before assuming their roles (putting assets for sale, or commencing bidding process), **all users of the platforms would need to agree/sign the terms of conditions for their roles, including agreeing to the steps of the bidding process** (receiving teasers, expressing interest, submitting a non-binding offer, submitting a binding offer etc.).

Introducing a common EU extrajudicial collateral realization mechanism

Although Member States have already established various extrajudicial enforcement procedures based on domestic rules, they do not lend themselves for cross-border transactions. Given the differences in the efficiency of existing national procedures and the lack of such procedures in many Member States[206], the Proposal Directive ensures that banks or other undertakings authorised to grant credit in all Member States could have recourse to such a procedure. AECE is designed as a distinct mechanism, contractually agreed upon between creditor and business borrower for movable and immovable assets posed as collateral and therefore falls outside of the scope of **the Financial Collateral Directive (FCD)**[207], which

[201] See **EC's Staff Working Document on NPL trading Platforms (2018), pp. 25-26.**
[202] Regulation (EU) 2017/2401 and amendment to Regulation (EU) No 575/2013.
[203] See **EC's Staff Working Document on NPL trading Platforms (2018), pp. 25-26.**
[204] See **EC's Staff Working Document on NPL trading Platforms (2018), p. 28.**
[205] See **EC's Staff Working Document on NPL trading Platforms (2018), p. 29.**
[206] See **EC (2018), pp. 26-29.**
[207] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (http://eur-lex.europa.eu/legal-content/en/txt/?uri=celex%3a32002l0047).

introduced a European regime for the provision and enforcement of collateral under the form of securities, cash and credit claims.

To this end, the proposal purports to guarantee[208] that consumer protection rules[209], namely the rights granted to consumers under the Mortgage Credit Directive[210], the Consumer Credit Directive[211] and the Unfair Contractual Terms Directive[212] in relation to a credit granted by a credit institution, would continue to apply in order to ensure the same level of protection[213], irrespective of who owns or services the credit.

It also ensures **full consistency with pre-insolvency and insolvency proceedings initiated under Member States' national laws and regulations** through the principle that the extrajudicial enforcement of collateral would be possible as long as a stay of individual enforcement actions, in accordance with applicable national laws, is not applicable. Moreover, this proposal would also ensure full consistency and complementarity with the Directive on preventive restructuring frameworks[214] (Restructuring Directive).

In particular, **the Proposal** clarifies its nature as an instrument agreed between the secured creditor[215] and business borrower, subject to additional conditions[216], laid down notably in

[208] See article 2 par. 3 of the Proposal.

[209] Either stemming directly from the initial credit contract or from other rules applicable to credits delivered to consumers or related to the general consumer protection rules in force in the Member State of the consumer. The above mentioned rules and safeguards also include the measures of mandatory or voluntary character provided for the protection of consumers in the Member State of their habitual residence, in particular the formal or informal debt-recovery procedures put in place by public or private bodies providing debt-advice to over-indebted households, aimed to their debt-recovery.

[210] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34)

[211] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC, OJ L 133, 22.5.2008, p. 66–92.

[212] Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts, OJ L 95, 21.4.1993, p. 29–34.

[213] In this context, similar to Article 17 of the Consumer Credit Directive, in the event of assignment of the creditor's rights to a third party, the Mortgage Credit Directive will be amended to state that the consumer shall be entitled to plead against the assignee any defence which was available to him against the original creditor.

[214] Proposal for a Directive European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU**,** COM/2016/0723 final, 22.11.2016.

[215] According to article 3: "secured credit agreement means a credit agreement concluded by a credit institution or another undertaking authorised to issue credit, which is secured by either of the following collateral;
(a) a mortgage, charge, lien or other comparable security right commonly used in a Member State in relation to immovable assets;
(b) a pledge, charge, lien or other comparable security right commonly used in a Member State in relation to movable assets;

[216] According to article 2 par. 4, excluded from its scope are: "*secured credit agreements concluded between creditors and borrowers who are consumers as defined in point (a) of Article 3 of Directive 2008/48/EC***,** *secured credit agreements concluded between creditors and business borrowers who are non-profit making companies, secured credit agreements concluded between creditors and business borrowers which are secured by the following categories of collateral, financial collateral arrangements as defined in Article 2(1)(a)*

Article 23. The relevant written agreement(*not necessarily in the form of notarised format*) should **comprise a directly enforceable title**, enabling the direct execution of the collateral through AECE without any further judicial proceedings, provided that certain predefined safeguards are met inter alia to **ensure that creditors afford borrowers a reasonable period of time for execution** of payment to avert abusive practices[217].

In this context, the envisaged accelerated extrajudicial collateral enforcement mechanism seeks to balance the interests of creditor and business borrower[218]. It is not available for enforcement of loans granted to consumers, and even for business owners, would not be available to enforce collateral which consists in the first residence of the business borrower. Where the business borrower has paid off the major part (85%) of the sum outstanding under the credit agreement already, he would have to be given additional time to effect payment before collateral could be enforced[219].

Article 24 requires Member States to have in place at least one enforcement procedure which may be used for the purpose of the accelerated extrajudicial collateral enforcement mechanism. Member States **may choose among public auction[220], appropriation of the asset procedures and private sale procedures** which are commonly used to realise collateral[221]. Member States have discretion is deciding upon the type of enforcement procedure, given the multiple links of collateral enforcement with private and public laws, and, in particular, depending on the type of security right which is used to secure collateral.

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of Directive 2002/47/EC and immovable residential property which is the primary residence of a business borrower".

[217] See recitals 44 et seq, ibid.

[218] See **EC (2018), pp. 26-29.**

[219] See **EC (2018), pp. 26-29.**

[220] According to article 25, when the realisation of collateral is conducted by means of public auction the following shall apply:

(g) the creditor shall publicly communicate the time and place of the public auction at least 10 days prior to that auction;

(h) the creditor has made reasonable efforts to attract the highest number of potential buyers;

(i) the creditor has notified the business borrower, and any third party with an interest in or right to the asset, of the public auction, including its time and place, at least 10 days prior to that auction;

(j) a valuation of the asset has been conducted prior to the public auction;

(k) the reserve price of the asset is at least equal to the valuation amount determined prior to the public auction;

(l) the asset may be sold at a reduction of no more than 20% of the valuation amount where both of the following apply:

(i) no buyer has made an offer in line with the requirements referred to in points (e) and (f) at the public auction;

(ii) there is a threat of imminent deterioration of the asset.

2. Where the asset has not been sold by public auction, Member States may provide for the realisation of the collateral by private sale.

[221] In order to ensure that collateral realisation doesn't lead to its fire sale(i. e at an unacceptable discount to its real economic value) to the detriment of the borrower, in addition to the article's 29 safeguard mechanism, article 24 mandates Member States to ensure that the creditor organises a valuation of the assets,

Furthermore, article 28 gives the borrower the right to challenge the use of this accelerated extrajudicial collateral enforcement procedure before national courts. In order to protect the borrower, Article 29 requires **the creditor to pay the business borrower, in case of excessive amount recovered**[222] through this accelerated extrajudicial collateral enforcement procedure as compared to the outstanding debt.

Article 32 ensures full consistency and complementarity of this extrajudicial mechanism with pre-insolvency or insolvency proceedings initiated in accordance with Member States' laws as well as with the Restructuring Directive by stating that secured creditors of a company or entrepreneur that is subject to a restructuring proceedings, are subject to the stay of individual enforcement actions. More precisely, it should be left to national law whether secured creditors have preferential access to the collateral under this accelerated mechanism even once insolvency proceedings are open[223]. Furthermore, **as regards competing security rights**, article 30 stipulates that the priority attached to competing security rights in the same collateral is not affected by the enforcement of one of those rights by means of the national provisions transposing this Directive.

Article 33 requires Member States and, in case of credit institutions, credit institutions' supervisors to collect, on an annual basis, data on the number of secured loans which are enforced through out-of-court procedures, the timeframes and value of recovery rates, and to transmit this data to the Commission annually.

Article 34 for specific safeguards for consumers in case of modification of the credit agreement and in Article 35 for the handling of complaints both by the credit servicer and by the competent authorities. Article 36 reaffirms the observance of personal data protection rules.

in order to determine the reserve price in cases of public auction and private sale, and that the following conditions are met:

(m) the creditor and the business borrower agree on the valuer to be appointed: where the parties cannot agree upon the appointment of a valuer for the purposes of realising the collateral, a valuer shall be appointed by a decision of a judicial court, in accordance with the national law of the Member State in which the business borrower is established or is domiciled;

(n) the valuation is conducted by an independent valuer;

(o) the valuation is fair and realistic;

(p) the valuation is conducted specifically for the purposes of the realisation of the collateral after the enforcement event;

(q) the business borrower has the right to challenge the valuation before a court in accordance with Article 29.

[222] According to Recital 47: "Where less than the sum outstanding of the secured credit agreement is recovered through this accelerated enforcement, Member States should not prevent the parties to a secured credit agreement from expressly agreeing that the realisation of collateral by means of AECE is sufficient to repay the credit".

[223] See recital 50, ibid.

The Restructuring Directive

The **Directive** complements [224] the Recast Regulation on Insolvency Proceedings [225] and builds on earlier Commission initiatives, most notably the 2014 Recommendation[226] on a new approach to business failure and insolvency[227]. It is part of the Capital Markets Union Project and is mutatis mutandis reminiscent of the United States Code 11 (the Bankruptcy Code)[228]. The aim is to establish legal procedures that further **going-concern restructuring rather than meagre piecemeal liquidation**, in the sense that premature liquidation of firms that might otherwise have remained viable after some restructuring and re-organization may lead to a destruction of economic value[229].

Furthermore, it is part of the comprehensive package regarding EU legacy NPLs' resolution[230], which inter alia addresses structural issues such as the efficiency of the judicial system, insolvency procedures and out of court restructuring, provided that the lengthier the recovery procedures, the wider the ask/bid spread, with an adverse effect on the banks' incentives to dispose of NPLs.

The Restructuring Directive is reminiscent of the US Chapter 11 reorganization plan procedure. In the event of a "likelihood of insolvency", the debtor may put forward a **restructuring** plan to all or some of its creditors and/or shareholders. In the course of the negotiations and **restructuring** process, the debtor remains in control of the company's business ("debtor in procession"[231]) and the negotiations may be reinforced by a stay on individual

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[224] As regards the prima facie partially overlapping scope of the Restructuring Directive and the Recast Insolvency Regulation, see among others **McCormack G. (2020), pp. 11-22.** From the CJEU's case-law concerning the Insolvency Regulation's scope, see Eurofood IFSC Ltd (C-341/04) EU:C:2006:281; [2006] Ch. 508, Bank Handlowy w Warszawie SA v Christianapol sp z oo (C-116/11) EU:C:2012:739; [2013] Bus. L.R. 956 at [33]–[35], Ulf Kazimierz Radziejewski v Kronofogdemyndigheten i Stockholm (C-461/11) EU:C:2012:704.

[225] See Regulation 2015/848 on insolvency proceedings (recast) [2015] OJ L141/19 replacing Regulation 1346/2000 on insolvency proceedings [2000] OJ L 160/1.

[226] See also Commission Communication, A New European Approach to Business Failure and Insolvency, COM (2012) 742. For discussion of the recommendation see, inter alia, **McCormack G. (2017), Madaus S (2014) and Eidenmüller H. and K. van Zweiten (2015).**

[227] The Directive does not apply to financial institutions, i.e. credit institutions (banks), insurance undertakings, investment firm and collective investment undertakings. However, it applies also to natural persons who are entrepreneurs, whereas article 1(4) allows Member States to extend only the debt discharge provisions to insolvent consumers or confine the benefits of the intended new restructuring framework to legal persons.

[228] See among others **Madaus (2018), p. 636** with further references therein.

[229] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017),** pp. 71 et seq. C.f for a rather critical perspective on the merits of **restructuring** versus liquidation see **Baird D. and R. Rasmussen (2002)**, p. 758.

[230] See Recital 3 Restructuring Directive.

[231] Apart from the "debtor in procession" norm, it is equally important to note that in this stage the mandatory appointment of a restructuring practitioner is not in principle required and in any case is limited to that of assisting the debtor and creditors in negotiating and drafting the restructuring plan, not amounting to strict "management displacement" with the existing board of directors losing their management responsibilities. In this context, Article 5 clearly states that debtors remain at least partially in control of their assets and day-to-day operation of their business. See Recital 5 Restructuring Directive.

enforcement actions[232] and the temporary ban on any insolvency proceedings application[233]. Creditors subject to the stay are precluded from withholding performance, or terminating or otherwise modifying essential executory contracts solely because the debts had not been paid(**ipso facto clauses**) on the condition that certain appropriate safeguards are met[234].

The directive also ensures that **new and interim financing** is not prohibited[235] and that the grantors of such finance do not incur civil, administrative or criminal liability merely because the financing is detrimental to the general body of creditors[236]. The protection can be restricted to **restructuring** plans that have been confirmed by the court. According to article 2(7), this financial assistance, deemed necessary to implement a **restructuring** plan could be provided during the stay of individual enforcement actions and should be reasonable and proportional, allowing the debtor's business to continue operating or avoid any unnecessary loss of value (e.g. through fire sales).

In principle, each class[237] of affected creditors must endorse the **restructuring** plan before its approval by the competent judicial or administrative authority[238]. Pursuant to the Directive's innovative provisions, no unanimity within each class is required, as the dissenting members of the class can be "crammed down"[239]. A fortiori, in some cases judicial or administrative approval could be granted even if all the affected classes of creditors have consent to the plan, leading to a cross-class creditor cram-down[240] provided that the "best interests of creditors" and "feasibility" tests are met[241].

In particular, confirmation of the plan by a court or administrative authority is mandatory, where the plan either affects the claims or interests of dissenting affected parties; provides for new (interim) financing or results to a loss of more than 25% of the workforce[242]. In order for judicial approval to be granted, the plan must abidingly comply with the "best interest of creditors" test, even if the class as a whole has accepted the plan[243].

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[232] Article 6 envisages a more tailored, discretionary stay of individual enforcement actions, which could under the court's permission cover all claims including secured claims and preferential creditors provided that it does not unfairly prejudice the rights or interests of any affected parties. The stay may be limited to one or more creditors or categories of creditors and is revocable if it no longer supports negotiations on a restructuring plan or if it has caused insolvency on the part of a creditor.

[233] See Recitals 30-32 Restructuring Directive.

[234] See Recitals 34-36 and ad hoc 40 Restructuring Directive.

[235] See critically **De Weijs R. J. and M.E. Baltjes (2017-08).**

[236] See Recitals 67-68 Restructuring Directive.

[237] As regards the "class formation" criteria, see in brief Recital 44 Restructuring Directive.

[238] See Recitals 44-47 Restructuring Directive.

[239] See Recital 53 Restructuring Directive.

[240] See among others **Richter Tomáš & Adrian Thery (2020).**

[241] See Recitals 49-52 Restructuring Directive.

[242] See Recital 30 Restructuring Directive.

[243] See **Richter Tomáš & Adrian Thery (2020).**

This means that no dissenting creditor is worse off under the plan than they would be if the normal ranking of liquidation priorities were applied either in a: (i) liquidation; (ii) going concern sale; or (iii) in the next best alternative scenario, save for the restructuring plan. Valuation should be conducted by independent qualified experts, whereas each dissenting affected creditor has the procedural right to challenge valuation matters[244].

The relevant judicial/administrative authorities are also required to refuse confirmation[245] of the plan if it does not pass a "feasibility test", i.e. if it does not have a reasonable prospect of **preventing** insolvency or ensuring the viability of the debtor's business.

Whilst the US Bankruptcy Code opts for absolute priority rule, i.e. a senior class of dissenting creditors should be full compensated before junior classes or shareholders receive or retain any value, the Directive goes a step forward[246] and introduces the possibility of "relative priority"[247], i.e. a **restructuring** plan may be approved "*if a senior class is treated more favorably than a junior class even if the senior class is not paid in full*"[248].

Under the "relative priority" model[249], "*dissenting voting classes of affected creditors are treated at least as favorably as any other class of the same rank and more favorably than any junior class*"[250]. However and without prejudice of the "no creditor worse-off principle", that favorable treatment does not amount to preferential or secured creditors receiving a full distribution[251].

Why opt for "relative priority"

The premises are the following[252]: first, the debtor is not actually insolvent when he enters the **restructuring** process; secondly, incentivizing existing managers and shareholders to make use of the **restructuring** process; and thirdly, the valuation uncertainties[253].

Indeed, if a debtor is insolvent when it enters the **restructuring** procedure, then his assets fully belong from a financial point of view to his creditors. Shareholders are not entitled to any value due to their subordinated status and therefore they should be deprived of the right to veto any **restructuring** plan.

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[244] See Recitals 50-56 Restructuring Directive.
[245] See **Payne Jennifer (2018), pp. 124-150, Fannon et. al. (2020)**, passim.
[246] See **Lubben, (2016),** pp. 595-598.
[247] See **Seymour & Schwarcz (2021), Mokal & Tirado (2018–19).**
[248] See **De Weijs R. J. (2018), pp. 403–444; and R. de Weijs and M. Baltjes, (2018), pp. 223–254.**
[249] In any case, Member States are not obliged to implement a relative priority regime. They may adopt absolute priority instead. Absolute priority tempered, in particular with the unfair prejudice qualification, may be the best way forward.
[250] See article 11 Restructuring Directive.
[251] See in further detail article 11 Restructuring Directive.
[252] See generally **Paterson S. (2016)**, pp.718–720.
[253] See **Paterson S. (2016)**, pp.718–720.

If the debtor is not yet insolvent however, then from a purely economic point of view, the equity still has residual value[254]. Expropriating shareholders and wiping junior creditors may conflict with due process rights and a fortiori the fundamental right of sufficient compensation that lie behind the protection of private property[255]. Besides, since the restructuring proceedings are designed to **prevent** insolvency, one should not mechanistically apply insolvency law rules and procedures, such as absolute priority[256].

One might argue in response[257] that these provisions alter existing contractual rights of affected parties[258] outside the procedural safeguards of fully fledged insolvency proceedings. In this context, **De Weijs, Jonkers and Malakotipour (2019)** have argued that such relative priority principle is "to jettison the most fundamental rule of reorganization", whereas **Tollenaar (2017)** [259] argued that these procedures- albeit their designation as preventive mechanisms- are in effect quasi insolvency procedures. In his view, "*if it's not called a duck, but looks like a duck, swims like a duck and quacks like a duck, it probably is a duck*".

In this context, there exists a trade-off between giving opportunities to viable businesses and protecting the vested rights of secured creditors[260].

Besides, as Recital 58 acknowledges, especially in SMEs, continued management of equity owners is paramount, as the separation of ownership and control may not be feasible because of the size, nature, or location of the debtor's business and the necessity of maintaining pre-distress goodwill. In this vein, giving them an ownership stake in the **restructured** entity seems the only feasible and effective way to incentivize them to resort to the preventive restructuring tools-envisaged in this Directive-as early as possible.

The recent amendments to the EU's Securitization Framework: establishing a dedicated NPE securitization framework and rationalizing its capital treatment, whilst refusing the so desired "STS" designation.

1. *What are the potential (regulatory) benefits for the originator credit institution and the investors in high quality securitizations*?

[254] See the US Supreme Court decision in Czyzewski v Jevic Holding Corp (2017) 580 US 137 S Ct 973. For a discussion of the underlying principles see **Madaus (2018), Wessels B. and S. Madaus (2017), p.334 and Stanghellini L., R. Mokal, C. Paulus and I. Tirado (2018), pp.45–47**, but for a somewhat different perspective see also pp.32–33.
[255] See **Rolef J. de Weijs (2017).**
[256] See generally **Paterson S. (2016)**, pp.718–720.
[257] For the underlying issue of redistributing effects within insolvency proceedings, see **Garrido JM., (2011) and Armour J. (2008).**
[258] See for some sharp criticism **Eidenmüller (2019)**, who concludes at p.565 that the Directive is "an inefficient and harmful piece of legislation".
[259] See also **H. Eidenmüller (2017).**
[260] See generally **Paterson S. (2016)**, pp.718–720.

Securitization has been defined as "the process of turning assets into securities", or as a "method of achieving a structured finance transaction", whereby debt is raised against, and based (solely) upon, an underlying pool of assets[261]. Securitization transactions, albeit their demonization[262] amidst the GFC and the highly punitive[263] capital and prudential treatment until the introduction of the BCBS's STC novel securitization framework and the Securitization Regulation, when the "the punitive regulatory period" was partially terminated, are an inherent part of well-functioning financial markets insofar as they contribute to diversifying the funding and risk allocation mechanisms of credit institutions and releasing regulatory capital[264] which can then be reallocated to support further lending, in particular the funding of the real economy[265]. Securitization has even been deemed in literature as a catalyst to 'restore the impaired monetary policy transmission mechanism'[266]. They also ameliorate the liquidity position of the originator as they can under stringent preconditions be calculated in the LCR/ NSFR ratios and be eligible as collateral[267] in the Eurosystem's main refinancing operation[268].

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[261] See **Paterson S. and Zakrzewski R. (2017b), p.747, Penn and Papadogiannis(2021), p. 225, Baig S. and Moorad Choudhry (2013), p.4; Fabozzi, Davis and Choudhry (2006), p.119 et seq.**

[262] On the fact that the European Securitization Market performed better and gave rise to significantly less systemic risk compering to its US peer market, see among others **Raines (2018), Fabbri(2017), Schwarcz S. L. (2016), pp. 134-135, Kastelein (2018), pp. 467-468, Penn Graham and Papadogiannis T.(2021)**, p. 234-235. On the consequent result that the regulatory response to the notorious Securitization Market's market failures and the regulatory arbitrage risks of OTD system should be tailored, proportionate, "sober and rational", striving for standardized simplicity and not unnecessarily impede financial innovation , see **De Larosière Report (2009), pp.13–14. FSA, Turner Review (2009), p.43.**

[263] See among others **Penn Graham and Papadogiannis T.(2021), Ferran E. (2012), p. 9, Moloney (2012). p. 116**. For a brief overview of the historical advance of the Securitization and relevant Capital Requirements Regulation in the EU after the GFC and before the migration to the herein discussed novel Securitization Framework, see among others, **Penn Graham and Papadogiannis T.(2021), pp. 237 et seq., Raines(2018), pp. 534- 535, Leonard NG (2010), Mccormick R. and Stears C. (2018), pp. 168-169, Kastelein (2018), passim, Chiu and Wilson(2019), pp. 371-372, Schwarcz S. L. (2018b), pp. 58-59, Wall R., Thind R. K. and Zhang K. (2019), Kiff J., and M. Kisser (2014), Cerasi V., and J. C. Rochet (2014), Bank of England and European Central Bank (2014).**

[264] See **Sarkisyan A., B. Casu, A. Clare and S. Thomas (2013), passim, Panetta F., and A. F. Pozzolo (2010), Michalak T. C. and A. Uhde (2010), Maddaloni A., and J.-L. Peydro' (2011), Loutskina E. (2011), passim, Almazan A., A. Martin-Oliver, and J. Saurina (2015), Affinito M., and E. Tagliaferri (2010).**

[265] As recital 3 of SR stipulates, securitization can create a bridge between credit institutions and capital markets with an indirect benefit for businesses and citizens (through, for example, less expensive loans and business financing, and credits for immovable property and credit cards).

[266] See among others **Bindseil, U. (2015),** pp. 15–19.

[267] For the relevant Securitization's function as a collateral creation mechanism for liquidity management purposes, see among others **Scopelliti Allesandro D.(2017), Fabbri Andrea(2017)**, pp. 172 et seq. For the ECB's initiatives to stabilize the Securitization Market and the impact of its Quantitative Easing Programs(QEs) on them, see Braun (2020), passim. See namely ECB's Decision ECB/2014/45 as regards ABS Purchasing Program ("ABSPP") in the secondary market aimed to the outright purchase of Asset-Backed Securities.

[268] On the ESCB's collateral framework concerning main refinancing operations(as well as within the ELA) and its eligibility preconditions see among others **Gortsos, Ch.V. (2020a), Gortsos, Ch.V. (2021a).** For a coherent presentation of the applicable regime during and shortly after the GFC, see **Fabbri Andrea(2017),**

Furthermore, the carve-out of especially opaque, illiquid and impaired assets clogging up the originator's balance sheets in exchange for liquid, rated and usually tradable assets increases transparency, reduces the so-called external finance premium and cost of funding and gives the opportunity to use the released capital resources to more profitable investments, boosting lending capacity and profitability. Furthermore, the disposal of granular assets also reduces operational costs and allows banks' staff and management to concentrate to their primary job, thus making money, instead of being consumed with in essence servicing and debt collection activities. Besides, the existence of a liquid secondary market for illiquid loans, fueled through securitization transactions' inputs, provides a quasi "put option" to the originator, who can easily liquidate his investment and thus be less exposed to the inherent to maturity transformation function risks, namely interest rate and liquidity risks. Those risks are usually transposed to the end- borrower in the form of extra interest charges("premia"), making the dominant in Euro area bank-financing costly and thereby hindering credit growth. As a result, securitization proves also to the benefit of the end-borrowers. As pointed out in literature, used legitimately, securitization becomes 'one of the dominant means of capital formation'[269].

Furthermore, securitizations provide institutions and other market participants with additional investment opportunities, thus allowing portfolio diversification and facilitating the flow of funding to businesses and individuals both within Member States and on a cross-border basis throughout the Union.

A general overview of the Securitization framework in the EU.

The coherent EU Securitization package consists of the Securitisation Regulation and related changes to the capital adequacy framework(CRR). It has a quasi two-fold structure:

p. 172-174 referring mainly to Guidelines ECB/2016/31, ECB/2016/32, ECB/2016/33, Guideline (EU) 2015/510 (ECB/2014/60), **Scopelliti (2016), pp. 14 et seq, Scopelliti A. D. (2014), passim, Nyborg K. G. (2017), Fecht F., K. G. Nyborg, J. Rocholl, and J. Woschitz (2016) .**

[269] See **Schwarcz (2018a), Schwarcz (2012b)**, p. 1295–98.

1. an uniform set of rules for all securitization schemes(*namely risk retention*[270][271] *requirements, due diligence requirements*[272] *for institutional investors*[273]*, transparency requirements*[274]*, in principle fulfilled through dedicated Securitization Repositories, . credit granting/ loan origination/ underwriting criteria*[275]*, resecuritization ban etc*), in the EU and their relevant prudential treatment(not confined in capital adequacy rules, but also liquidity rules); and

2. Criteria for designated high quality securitisations[276] that are eligible to be labelled "STS" – simple, transparent and standardized, which benefit from a more favorable

[270] See article 6 SR, as amended by Regulation 2021/557 and currently in force.

[271] Before Securitization Regulation came into force, such requirements were introduced by Commission Delegated Regulation (EU) No 625/2014 of 13 March 2014 supplementing Regulation (EU) No 575/2013 by way of regulatory technical standards specifying the requirements for investor, sponsor, original lenders and originator institutions relating to exposures to transferred credit risk (OJ L 174, 13.6.2014, p. 16). Those rules were firstly incorporated in Section 941 of the 2010 Dodd–Frank Act in the US and Article 122a of the Capital Requirements Directive (CRD II) in the EU. On the relevant Dodd-Frank's provisions, see by mere indication **Hoffman (2012), passim, Thompson (2011), passim, Wall R., Thind R. K. and Zhang K. (2019)**, p. 14. For an in-depth analysis, see **Chouliara and Martino(2021), passim, Akseli(2013)**, passim. The securitization regulation introduced an uniform risk retention rule, replacing several sectoral provisions of CRR, AIFM, Solvency II, which is directly applicable('Direct approach') to all relevant parties falling into its scope, notwithstanding the indirect obligation set forth by article 405 CRR for institutional investors. See in detail **Messina P.(2019)**, chapter 2, passim.

[272] See Article 5 SR. It has been argued that SR's stringent due diligence requirements, including requiring investors to perform regular **stress tests** on the cash flows and financial asset values supporting the underlying securitization exposures, albeit in principle fit to deter another investor 'feeding frenzy' for securitization products, as occurred prior to the financial crisis, have been criticized as disproportional and paternalistic. See in brief **Segoviano M., Jones B., Lindner P. and Blankenheim J.(2015), p. 5, Schwarcz S. L.(2018)**, par. 2242.

[273] An interesting feature is that the Securitization Regulation is the only EU legislation defining the meaning of institutional investors, as MiFID II stipulates only "professional" investors and "eligible counterparties", see article 2 par. 12 SR.

[274] See Article 7 SR. See critically **Bryan (2021)**, pp. 198-199, 201.

[275] See Article 9 SR, as amended by Regulation 2021/557 as regards NPE Securitizations. See in detail below.

[276] In the author's view, if someone was to briefly clarify the STS added value, he should focus on its impact in the inherent in securitization transactions complexity, which can hinder the effectiveness of all other regulatory requirements. Indeed, complexity is the highway to regulatory arbitrage. In this context, in the author's view, neither stringent or even punitive capital charges, nor disclosure and brute risk retention requirements suffice. The "game changers" are standardization and simplicity.

Indeed, requiring increased disclosure in securitization transactions is ea ipsa insufficient. Even prior and during the GFC, the risks associated with complex securitization transactions and their underlying exposures, including subprime mortgage loans, were fully disclosed, but that was not enough to prevent the tail event in the securitization markets. The reason is that complexity makes understanding harder, which, according to **Steven L. Schwarcz (2018)**: "increases the chance of panics and also, like the Delphic Oracle, makes people prone to see what they want to see".

Complexity and its derivative opaqueness also hinders the efficiency of the risk retention requirement in ameliorating financial asset quality and interest alignment. Certainly, even during GFC, the market itself has always mandated risk retention and consequently originators and sponsors of securitizations usually retained a "first loss tranche" to signal the ABS's soundness and ensure its investment grade rating. The catch, however, was that originators and sponsors, as well as credit ratings and end-investors, generally overvalued those assets. That resulted to a 'mutual misinformation' market failure and instead of tackling perceive incentives, it made investors even more kin in assuming risky or mezzanine securitization positions, as the

capital adequacy and in general prudential treatment, namely the qualification, subject to certain additional requirements, **as "2B assets" for credit institutions' liquidity requirement purposes**[277], whereas especially state-guaranteed senior notes constitutes a high quality Level 1 component of the LCR, with a favorable risk stable funding factor for the purposes of NSFR calculations.

The ultimate goal is also two-fold: revive a stagnant securitization market while in the same time arguably pushing more opaque and highly complex securitisations out of the market[278].

The latter is also accomplished in a calibrated way in order to avoid unnecessary stonewalling as regards financial innovation.

Firstly in the general securitization framework, rules are introduced to tackle the notorious market failures that led to the demonization of the securitization schemes in order to ensure that excessively complex and opaque structures, driven by speculative or regulatory arbitrage incentives, to the detriment of investors and financial stability in general, are precluded. However and without prejudice to the above, the new STS branding exercise should not unintentionally create a stigma for non-qualifying STS transactions[279].

"first loss tranche" was usually withheld by originators with significant market stature. Indeed, frenzy may have clouded the market, but investors did not suddenly became irrational. That is a rather simplistic spin. Insofar the default rates of the underlying exposures were contained, an investor holding an investment grade rated securitization position, sponsored and quasi implicitly "guaranteed" by a huge investment bank(i.e Lehman or other), usually withholding the "first loss tranche" and arming the SPV with endless liquidity through their liquidity puts/credit lines, can hardly be deemed to act irrationally.

The EU's disclosure approach, tied to the standardized simplicity of STS securitizations seems to tackle the relevant financial hazard at its root without unduly restrict the economic utility of securitization and hinder financial innovation[**cf. however Penn and Papadogiannis (2021)**, p. 244]. The STS approach does not require pro forma standardization but merely rewards standardized simplicity—and it appears to contemplate a significant degree of market flexibility in achieving that simplicity.

The ultimate goal is to revive the basic types of securitization transactions initiated in the 1980s and dominant during the 1990s, when the SEC described them as 'becoming one of the dominant means of capital formation in the United States', i.e the the securitization as a cost-effective funding, balance-sheet optimization and capital management mechanism before being infected and mutated by the perverse, arbitrage-driven financial engineering that led to the GFC. See in a nutshell **Peen and Papadogiannis(2021), Schwarcz S. L. (2009), Schwarcz S. L. (2012a), Gorton, G., and Metrick, A. (2012).**

[277] See critically on the disproportionate haircuts for certain securitization positions, which are significantly higher than the ones applied to similar structure finance tools such as covered bonds and type 2A assets, in the context of the LCR, albeit the fact that the relevant CRR's provision are less acute and rigid in comparison with the relevant BCBS's standards, **Daley M. (2021), passim. Penn and Papadogiannis (2021)**, p. 247. The same applies to the Solvency II's spread risks for securitization positions and the CRR's risk weights, as well as for the haircuts imposed on securitisations that are used as collateral in non-centrally cleared OTC derivative contracts.

[278] See **Paterson S. and Zakrzewski R.(2017), pp.47–48, Moloney N,, Ferran E. and Payne J. (2015)**, p.4.

[279] This is exactly why market participants are expressing concerns that it may circumvent a proper securitisation market recovery if "everything but STS securitisations" are still seen as toxic, e.g. see "European Small Business Finance Outlook", The European Investment Fund Working Paper 2016/35 (June 2016), p.64.

Notwithstanding the above general safeguards, the novel "STS label" inserts additional safeguards, which decisively tackle complexity, thereby promoting legal certainty and standardized simplicity. Finally, the dedicated CRR provisions "award" the STS schemes, in the context of a more risk-sensitive prudential framework[280], incentivizing credit institutions to embrace them and implicitly recognizing once more the value of securitisations in the economy[281].

It is also worth noting that without prejudice to the abovementioned micro and macro prudential considerations, the novel STS framework with its standardization provides legal certainty and ensures a level playing field, thereby enabling cross-border transactions, eliminating regulatory arbitrage opportunities and bolstering in this way the creation of an EU-wide single market for STS securitisations.

Amidst the pandemic crisis and with a view to incentivize and facilitate NPL disposal, the Securitisation Regulation and related capital adequacy regulations were amended by Regulations 2021/557[282] and 2021/558[283], so as to introduce a distinct "STS label" for synthetic securitisations and facilitate the securitization of nonperforming exposures ("NPEs"). Those amendments were anchored in the relevant EBA's opinions[284].

A few considerations on Synthetics

The Capital Requirements Regulation (CRR) as per Article 242(11) and article 2 par. 10 of SR, defines synthetic securitisation as a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees, structured to mimic the financial performance of a reference portfolio of assets[285], and the exposures being securitised remain exposures of the originator institution[286].

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[280] See recital 2 of the Securitization Regulation.

[281] See **Philippe Dorin Martin Vojtko (2017)**, p. 300.

[282] See REGULATION (EU) 2021/557 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 31 March 2021 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis.

[283] See REGULATION (EU) 2021/558 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 31 March 2021 amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 crisis.

[284] See EBA, Report on STS Framework for Synthetic Securitization, EBA/OP/2020/07, 06 MAY 2020, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20proposes%20Framework%20for%20STS%20Synthetic%20Securitisation/883430/Report%20on%20framework%20for%20STS%20syntetic%20securitisation.pdf and Opinion of the European Banking Authority to the European Commission on the Regulatory Treatment of Non-Performing Exposure Securitisations, EBA-Op-2019-13 23 October 2019, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library//Opinion%20on%20the%20regulatory%20treatment%20of%20NPE%20securitisations.pdf

[285] See **Penn and Papadogiannis (2021)**, p. 225.

[286] In the same context, article 2 par. 26, as amended by Regulation 557/2021, states that: "*credit protection agreement" means an agreement concluded between the originator and the investor to transfer the credit*

Financial guarantors (in the case of financial guarantees) or swap counterparties (in the case of credit derivatives) agree to compensate the losses suffered by the owner of the reference portfolio if a credit event (e.g. a payment default) occurs in relation to those assets. In return, the owner of the reference portfolio agrees to pay the financial guarantor or the swap counterparty a premium based on the perceived probability of credit events occurring on the reference exposures in the portfolio. As a result, the financial guarantor or the swap counterparty gain exposure to the credit risk attached to the reference portfolio **without title or any rights in these assets passing to them**. In a synthetic securitisation, the actual extent of risk transfer depends on the creditworthiness of the originator's counterparty in that contract.

In other words, synthetic securitization mimics 'true sale' (i.e. traditional) securitization in terms of the nature of the underlying assets, credit risk tranching and capital structures, but uses different ways to transfer credit risk from the originator to the investor.

A major distinction arises with respect to the objectives of the transaction, whereby two main types of synthetic securitisations can be identified: 'balance sheet' synthetic transactions and 'arbitrage' synthetic transactions.

The EU framework embraces exclusively the on balance sheet transactions, where the originating credit institution uses financial guarantees or credit derivatives to transfer to third parties, namely insurance companies, other credit institutions as well as unregulated entities, the credit risk of a specified portfolio of assets that it holds on its balance sheet[287].

Unlike 'true sale' securitisation, synthetic securitisation does necessarily provide the originator with funding. This renders the synthetic mechanism more flexible, cheaper and quicker to arrange, as the latter is freed from the legal and operational difficulties concerning the transfer of ownership of the underlying exposures, given that even in cases of funded synthetic transactions[288], the set up of an SPV for the issuance of notes (i.e. **credit-linked notes**) is not strictly necessary.

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risk of securitised exposures from the originator to the investor by means of credit derivatives or guarantees, whereby the originator commits to pay an amount, known as a credit protection premium, to the investor and the investor commits to pay an amount, known as a credit protection payment, to the originator in the event that one of the contractually defined credit events occurs".

[287] According to recital 14 of Regulation 2021/557: "*the object of a credit risk transfer should be exposures originated or purchased by a Union regulated institution within its core lending business activity and held on its balance sheet or, in the case of a group structure, on its consolidated balance sheet at the closing date of the transaction.* ***The requirement for an originator to hold the securitised exposures on the balance sheet should exclude arbitrage securitisations from the scope of the STS label***".

[288] As **Dorin P. and Vojtko M. (2017, p. 300)** point out, provided that market conditions—largely stemming from the ECB's accommodating monetary policy of recent years—allow banks to benefit from abundant and competitive access to funding, traditional securitisations and its distinctive funding feature seems less attractive financially to originators than in the past.

Therefore, from a policy perspective, synthetic securitisations can achieve cross-border efficiency and contribute to the development of the EU capital markets union provided that they can be structured almost seamlessly across various jurisdictions[289].

Simple, transparent and standardized synthetic securitization

Synthetic securitisations were, before Regulation 2021/557 came into force, classified as non-STS[290], notwithstanding article 270 CRR[291]. On 6 April 2021, the EU Securitisation Regulation[292] (SR) was amended pursuant to the Regulation (EU) 2021/557 of the European Parliament and the Council[293] (SR Amendment Regulation) and the Regulation (EU) 2021/558 of the European Parliament and the Council[294] (CRR Amendment Regulation) (together, SR Amendments) with effect as of 9 April 2021.

The recently introduced amendments extend the scope of the Simple, Transparent and Standardised framework (STS framework) from "true sale" securitisations to on-balance sheet synthetic securitisations and remove existing regulatory barriers to the securitisation of non-performing exposures (NPEs) in order to assist EU banks in their efforts to tackle the increasing NPE levels on their balance sheets caused by the pandemic.

The special considerations for NPE Securitizations

The assets backing NPE securitisations are financially distinct from those of "performing" transactions which underpin the Securitization framework, notably in the type of secu-

[289] See **Philippe Dorin Martin Vojtko**, op. cit.

[290] Indeed, as recital 24 SR, prior its amendment, stated, synthetic securitizations introduce an additional counterparty credit risk and potential complexity related in particular to the content of the derivative contract. For those reasons, the STS label was not initially available for synthetics, whilst the EBA was mandated to determine a set of STS criteria specifically applicable to balance-sheet synthetic securitisations.

[291]However, Article 270 CRR allowed banks that retain, subject to certain conditions, senior positions of SME balance sheet synthetic transactions to benefit from the lower STS capital requirements. In line with the EBA's report on synthetic securitisation (2015), it extended the STS capital requirements to senior synthetic tranches of SME portfolios that banks decide to retain **when transactions benefit from financial guarantees by public bodies or credit protection arrangements by private investors that are fully cash collateralised**. The EBA advised on the criteria that should determine eligibility of balance sheet synthetic transactions, specifying, among others, under which conditions originator banks may transfer the risk of eligible transactions to public or private investors.

[292] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012, OJ L 347, 28.12.2017, p. 35–80.

[293] Regulation (EU) 2021/557 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation to help the recovery from the COVID-19 crisis, OJ L 116, 6.4.2021, p. 1–24.

[294] Regulation (EU) 2021/558 of the European Parliament and of the Council of 31 March 2021 amending Regulation (EU) No 575/2013 as regards adjustments to the securitisation framework to support the economic recovery in response to the COVID-19 crisis, OJ L 116, 6.4.2021, p. 25–32.

ritised risk, as the assets in NPE securitisations are already defaulted or deemed as defaulted and are therefore securitised at a discount on their nominal or outstanding value, which reflects the market's valuation of the "workout" process to cover the net value of the NPEs (that is, their nominal or outstanding value minus the non-refundable purchase price discount or "NRRPD"[295]).

In this context, the SR Amendments, in line with the EBA's opinion on the regulatory treatment of NPE securitisation[296] and proposed a framework for STS synthetic securitisation[297], remove existing regulatory impediments and reduce regulatory costs. In particular:

- permit the servicer, who is expected to have a more substantial interest in the recovery value of the NPE portfolio, of an NPE securitisation to act as the risk retainer, provided that he demonstrates the required expertise as well as adequate policies, procedures and controls in place to perform these tasks (Article 6 SR)
- allow for the risk retention in an NPE securitisation to be calculated on the basis of the net value of the NPEs (Article 6 SR).
- replace the requirement to assess credit origination and underwriting standards of the exposures with the requirement to assess criteria for selection and pricing at the time of their acquisition (Article 9(1) SR).

Securitization and CRR

Step 1: Ensuring Deconsolidation and De-recognition

Notwithstanding the significant risk transfer requirements from an accounting and state aid perspective, for the purposes of de-recognition/ deconsolidation of the transferred assets and the activation of the State's guarantee in the model Asset Protection Schemes under

[295] In this case, the originator will adjust accordingly in its balance sheet the amount of its own-calculated loss provisions and other specific credit risk adjustments ("SCRAs") to reflect the amount of the NRPPD.
[296] EBA, Opinion on the regulatory treatment of non-performing exposure securitisations, 23 October 2019, available at: https://www.eba.europa.eu/eba-publishes-opinion-regulatory-treatment-non-performing-exposure-securitisations.
[297] EBA, Report on STS framework for synthetic securitisation, 6 May 2020, available at: https://www.eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation

the Commission's case-law respectively, the significant risk transfer requirements of Articles 244-246 CRR, as further analyzed from the most recent EBA Report[298] and Guidelines[299] on Significant Credit Risk Transfer relating to Articles 243 and Article 244 of CRR, have to be met in order for the originator credit institutions to be permitted to exclude the underlying exposures from the calculation of risk-weighted exposure amounts and expected loss amounts and calculate the risk weighted exposure amounts exclusively for the securitization positions.

Step 2: Defining the appropriate risk weight to NPE securitization exposures within the regulatory caps and floors of CRR, as amended namely by Regulation 2017/2401 and Regulation 2021/558

The cost of capital[300] can be reduced[301] for a lender (originator) if a portfolio of credit exposures[302] is transferred from that lender to a separate legal entity in exchange for either zero risk-weighted cash or- in case of pay-in kind transactions- securitization notes with a relatively lower risk weight(compared to the risk weights of the underlying exposures transferred)[303].

Indeed, notwithstanding the relevant CRR's risk weights, such Asset-Backed Securities are structured to obtain **for some tranches** a higher rating level and consequently lower RW compared to the underlying asset pool **on a standalone basis[304]** due to specific structural methods known as "credit enhancements"[305] which can be both internal(tranching, excess spread, overcollateralization) and external (i.e. supplied by a third party, namely first-demand guarantees, credit derivatives, insurance coverage etc.).

[298] See EBA, Report on Significant Risk Transfer in Securitization under Articles 244(6) AND 245(6) of CRR, EBA/Rep/2020/32, available at: https://www.eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20calls%20on%20the%20EU%20Commission%20to%20harmonise%20practices%20and%20processes%20for%20significant%20risk%20transfer%20assessments%20in%20securitisation/962027/EBA%20Report%20on%20SRT.pdf?retry=1

[299] See EBA / GL / 2014 / 05, available at: https://www.eba.europa.eu/sites/default/documents/files/documents/10180/749215/5355e9d3-a565-4c58-bd93-0e888407306e/EBA-GL-2014-05%20Guidelines%20on%20Significant%20Risk%20Transfer.pdf?retry=1

[300] See **Plosser, Matthew C. and Santos, João A. C (2018), passim, Jagannathan, Ravi, Liberti José, Liu Binying and Meier Iwan (2017), p. 260.**

[301] See **Göthlin (2021)**, p. 19.

[302] See by mere indication **Neisen and Roth (2018)**, passim.

[303] See CRR Arts. 122-126. Also see **Wood (2019a), p. 605.**

[304] See **Wood (2019a), p. 659.**

[305] Securities issuances can also take advantage of interest rate and currency hedging strategies. Further protection to Investors can be supplied through collateral, or through performance triggers supplied by third parties, which can modify the cash flows "waterfall structure" of the securitisation deal during periods when the structure is under stress. Capital reimbursement and interest distribution can vary from deal to deal, as defined in the waterfall structure.

However, **the total risk** of potential losses **deriving from an asset portfolio** is neither better nor worse[306] merely because of the assets having been transferred to a new legal entity and subject to tranching[307]. Notwithstanding any- other than tranching- credit enhancement arrangements and structural features, what leads to a different risk weight is the investment into a particular tranche[308].

Furthermore, Regulation 2401/2017[309] complementing the Securitization Regulation as regards regulatory capital requirements for originators, sponsors and institutional investors holding securitization positions, amended CRR so as to adequately reflect the specific features of STS securitizations, address notorious relevant regulatory failures of the pre-GFC securitization framework and terminate the irrationally punitive- due the securitization's post crisis "demonization narrative"- capital treatment of certain securitization positions. In this vein, it introduced a more risk sensitive approach, tackled excessively low risk weights for highly-rated securitization tranches and, conversely, excessively high risk weights for low-rated tranches and mitigated **mechanistic reliance on external ratings[310]**.

3. Capital requirements for positions in a securitization under CRR

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[306] This is explicitly stipulated in the current regulatory framework, see the "look through" provisions of CRR Art. 267. This wasn't always the case. For instance, under Basel I, banks could easily resort to regulatory arbitrage and merely securitise a package of loans and retain the related credit risk - through tranche retention or credit guarantees –with the advantage of reducing significantly the amount of capital to keep for such exposures. This was mainly due to the difference in regulatory treatment under Basel I between assets held in the banking book (like loans), and assets held in the trading book (like securities), as in principle capital requirements were significantly higher for banking book assets, compared to trading book assets**, see Gleeson Simon(2018), pp.239–241, Graham Penn and Thomas Papadogiannis, (2021), p. 227.** This became an issue after the 1996 Market Risk Amendment of Basel I (Basel Committee on Banking Supervision, "Amendment to the Capital Accord to Incorporate Market Risks" (January 1996) available at: https://www.bis.org/publ/bcbs24.pdf?noframes=1 . In simple words, by merely "converting" their loans into securities (via securitisation) banks could reduce their capital requirements. See also see **Fabozzi, Davis and Choudhry (2006), p.295; Chiu and Wilson (2019), p.336.**

[307] See however recital 9 of the Securitization Regulation, according to which investments in or exposures to securitisations not only expose the investor to credit risks of the underlying loans or exposures, but **the structuring process of securitisations could also lead to other risks such as agency risk, model risk, legal and operational risk, counterparty risk, servicing risk, liquidity risk and concentration risk**

[308] See **Göthlin (2021)**, p. 20.

[309] Taking into consideration that capital relief is vital not only for credit institutions and investment firms, but also for many institutional investors, the EC also expanded its STS preferential capital treatment to insurance and reinsurance undertakings. The distinction made in the Solvency II framework between Type 1 and Type 2 securitisations no longer applies, and the crucial distinction is now between STS and non-STS securitisations. See Regulation 2018/1221 of 1 June 2018 amending Regulation 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertakings [2018] OJ L227/1 (hereinafter Regulation 2018/1221) introducing amendment to art.178 of Regulation 2015/35. Surprisingly, the EC has not expanded its STS capital relief to pension funds. Pension schemes were after all excluded from the scope of Solvency II, despite relevant talks, see Lexisnexis, "Solvency II and Pensions Practice Note" available at: https://www.lexisnexis.co.uk/legal/guidance/solvency-ii-and-pensions.

[310] See **Chiu and Wilson (2019)**, p. 360, 371-372.

- Calculation method

In order to tackle mechanistic reliance on external ratings, Regulation 2401/2017 favored the calculation of regulatory capital requirements in principle according to the Internal Ratings Based Approach (the 'IRB Approach'), provided that the institution has supervisory permission to apply the IRB in relation to exposures of the same type as those underlying the securitization and is able to calculate regulatory capital requirements in relation to them as if these had not been securitized ('KIRB'), in each case subject to certain pre-defined inputs (the Securitization IRB Approach — 'SEC-IRBA').

A Securitization Standardized Approach (SEC-SA) should in principle be available only to institutions that are not able to use the SEC-IRBA in relation to their positions in a given securitization. The SEC-SA should also rely on a formula using as an input the capital requirements that would be calculated under the Standardized Approach to credit risk in relation to the underlying exposures as if they had not been securitized ('KSA').

When the first two approaches are not available[311], institutions should be able to apply the Securitization External Ratings Based Approach (SEC-ERBA). Under the SEC-ERBA, capital **requirements should be assigned to securitization tranches on the basis of their external rating.** Upon notification to the competent authority, institutions should be allowed to use the SEC-ERBA in respect of all rated securitizations they hold when they cannot use the SEC-IRBA.

Besides, the SEC-IRBA is expected to be used primarily by originators, since outside investors may lack the necessary data for the underlying assets in a securitization[312], making CRA ratings paramount for institutional investors to feed into their mandatory- as regulated entities- capital adequacy calculations and fulfill their statutory due diligence requirements[313]. In any case, the calculation of risk weighted exposures uses the credit quality mapping from external ratings as an input, where available. Given the importance of rating for securitization transactions, most tranches, especially the senior ones, will have been assigned an external rating[314]. Certainly, Regulation (EC) 1060/2009 high-level provisions[315] further allows reliance on supervised credit ratings and their inputs[316] albeit **the**

[311] See recital 4 of Regulation 2017/2401. However, institutions should always use the SEC-ERBA as a fallback when the SEC-IRBA is not available for low-rated tranches and certain medium-rated tranches of STS securitisations identified through appropriate parameters. For non-STS securitisations, the use of the SEC-SA after the SEC-IRBA should be further restricted. Moreover, competent authorities should be able to prohibit the use of the SEC-SA when the latter is not able to adequately tackle the risks that the securitisation poses to the solvability of the institution or to financial stability.

[312] See **Neisen, Martin and Roth, Stefan (2018), p. 180.**

[313] See **Dalhuisen, Jan H. (2019), p. 937.**

[314] See **Wood (2019a), p. 625 and Wood (2019b), pp. 171 and 183.**

[315] For the relevant § 943 of the Dodd-Frank Act provisions, see in brief **Steven L Schwarcz (2018a), De Bruyne Jan(2016), Schwarcz (2018b), pp. 58-59.**

[316] See Regulation (EC) 1060/2009, Recital (35) and **Altman, Edward I. and Kalotay, Egon A (2014), p. 116.**

rating agencies tendency to impose caps on ratings linked to sovereign ratings, which could raise concerns as to volatility and fragmentation of the market[317].

- **Setting capital caps and floors and addressing securitization's idiosyncratic risks with regulatory adjustments factors**

Furthermore, notwithstanding the abovementioned look-forward approach, **non-neutrality correction factors are introduced to capture the agency and model risks[318]** prevalent in securitisations. In order to capture those risks adequately, Regulation 2017/2401- amending the CRR- stipulates **a minimum 15 % risk-weight floor for all securitisation positions[319]**. In particular, **on top of the "Kirb**"(in case of SEC-IRBA) or **'KSA'** (in case of SEC-SA), the formulae then provide for a multiplier with a factor 'p', which reflects perceived additional risks relating to the securitization: credit risks to counterparties, agency risks, and structural risks[320].

An institution should not be required to apply a higher risk weight to a **senior position** than that which would apply if it held the underlying exposures directly, thus **reflecting the benefit of credit enhancement that senior positions receive** from junior tranches in the securitisation structure[321]. CRR provides relevantly for a 'look-through' approach according to which a senior securitisation position **should be assigned a maximum risk weight equal to the exposure-weighted-average risk weight applicable to the underlying exposures**[322].

In general, **an overall cap in terms of maximum risk-weighted exposure amounts** is available under the current framework for institutions that can calculate the capital requirements for the underlying exposures in accordance with the IRB Approach as if those exposures had not been securitised (KIRB)[323]. Insofar as the securitisation process reduces the

[317] See **Gerard Kastelein (2018).**

[318] See EBA, Opinion on Regulatory treatment of NPEs, ibid, p. 20.

[319] See recital 5 of Regulation 2017/2401. Resecuritisations, however, exhibit greater complexity and riskiness and, accordingly, only certain forms of resecuritisations are permitted under Regulation (EU) 2017/2402. In addition, positions in resecuritisations should be subject to a more conservative regulatory capital calculation and a 100 % risk-weight floor. Interestingly, as **Penn and Papadogiannis (2021), p. 245 and Kastelein(2018)** point out, even for STS securitisations, despite the fact that the reduction in risk weights that has been achieved is no less than 25% compared to capital surcharges for non-STS securitisations, the new risk weight floor is higher than previously applied.

[320] See **Gerard Kastelein(2018)**, par. 2173. According to EBA, Regulatory treatment of NPE securitizations, ibid, p. 19, the (p) factor is a capital surcharge on the tranches intended to produce a higher capital charge for an investment in the securitisation tranches than a direct investment in the underlying. Even though (p) is set at a minimum of 0.3 (30% capital surcharge) for SEC-IRBA (Article 259(1) of the CRR) and at 1 for SEC-SA (Article 261(1) of the CRR) (100% capital surcharge), it operates in practice as an upper limit for the capital surcharge.

[321] See recital 6 of Regulation 2017/2401.

[322] See recital 6 of Regulation 2017/2401.

[323] Indeed, such a 'very conservative tightening of capital standards' that investors in ABS will have to hold more regulatory capital than if they invested directly in the financial assets backing those securities has been

risk attached to the underlying exposures, this cap should be available to all originator and sponsor institutions[324].

As pointed out by the EBA, in its report on qualifying securitisation of July 2015, empirical evidence on defaults and losses shows that STS securitisations exhibited better performance than other securitisations during the financial crisis, reflecting lower credit, operational and agency risks. Therefore, CRR provides for an appropriately risk-sensitive calibration for STS securitisations, which involves, in particular, **a lower risk-weight floor of 10 % for senior positions[325][326]**.

4. Regulation 2021/558: towards a more rational capital treatment of NPE Securitizations

As pointed out by the EBA, in its Opinion on the Regulatory Treatment of NPE Securitisations, the EU prudential framework for securitisation, as initially envisaged, was designed and fit for performing loans securitizations. As a result, it led to disproportionate capital charges when applied to securitisations of NPEs because the SEC-IRBA and the SEC-SA were inconsistent with the idiosyncratic risk drivers of NPEs. The comparatively high capital requirements had rendered the framework very capital intensive, de-incentivizing CRR-regulated institutions wishing to invest in NPE securitisations, in particular in the senior tranches[327].

A specific treatment for the securitisation of NPEs was therefore introduced[328], building upon the EBA Opinion as well as internationally agreed standards[329].

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criticized as merely punitive against securitization, while industry representatives called for 'capital-neutrality'. See in detail See **Steven L Schwarcz (2018a). In the same vein, Penn and Papadogiannis (2021),** who argue that highly punitive regulatory framework that resulted in the virtual disappearance of the European securitisation market.

[324] See recital 7 of Regulation 2017/2401.

[325] See recital 8 of Regulation 2017/2401. As regards a brief coherent overview of the definitions of "tranche" in various cross-sectoral legislation until its uniform definition based in Securitization Regulation and its CRR counterparts(as currently in force), as well as for a delineation of the relevant "attachment" and "detachment" points, see among others **Göthlin (2021), p. 21 et seq**.

[326] According **to Penn and Papadogiannis (2021), p. 242-243**, if the requirements of both Regulation 2017/2401 and Regulation 2107/2402 are met, AAA-rated STS securitisations attract under the SEC-ERBA a risk weight of 10% (in short-term credit assessment, and long-term credit assessment in the case of senior tranches), whereas non-senior tranches are assigned a risk weight of up to 40%. BB+ and BB- rated STS securitisations attract a risk weight of 1250% (short-term) and 120–195% (long-term in the case of senior tranches). Non-senior tranches attract a risk weight of 405–740%. 193 Under the SEC-IRBA and the Standardised Approach (SEC-SA), STS securitisations are assigned a risk weight floor of 10%.

[327] See EBA, Regulatory treatment of NPE securitizations, ibid, p. 19 et seq.

[328] Notwithstanding the above, Regulation 2021/558 clearly states that the NPE securitisation market should be closely monitored and the prudential framework for NPE securitisation should be reassessed in the future in the light of a potentially larger pool of data in light of the gradual development of more deep and liquid NPE secondary market.

[329] See recital 6 of Regulation 2021/558.

In particular, according to EBA, the calibration of the pre-eminent securitisation methods, the SEC-SA and the SEC-IRBA, led to much larger capital charges for NPE securitisation than the SEC-ERBA, clearly disproportionate to the actual risk embedded in the transaction, taking into account the protection provided by the NPEs' non-refundable purchase price discount (hereinafter NRPPD).

On the other side, in the limited cases where the supervised institutions were allowed to use their own supervisory LGD levels under the SEC-IRBA and these were below the level of the NRPPD, the framework led to lower capital charges for NPE securitization positions than the SEC-ERBA, especially for the mezzanine and junior tranches. This an unintended consequence was mainly attributed to the fact that fixed LGD levels were not designed to deal with defaulted assets[330].

As regards the caps for NPE securitizations, pursuant to the dominant gross basis approach, the NRPPD was excluded from the calculation of ECL and the exposure value of the NPEs, as inputs to the caps, thereby resulting to excessive capital charges, undermining the very intended purpose of the caps as a safeguard against unduly high capital requirements[331]. Indeed, The NRPPD with its "first loss piece" function was treated merely as credit enhancement (overcollateralisation) to the securitisation tranche holders when the attachment (A) and detachment (D) points are applied on the SEC-IRBA or SEC-SA-derived capital requirements to assign risk weights to those tranches, thereby undermining the loss-absorbing effect of the NRPPD[332].

Indeed, notably within the SEC-IRBA, insofar as the transfer of the NPEs to the SPV is made at such a NPRD discount, that is sufficiently loss-absorbing and conservative enough to write off all expected losses in the transferred portfolio and protect the net value of the underlying exposures, it is unjustifiable, if not punitive, to refuse to net the NPE portfolio's "expected losses" and "exposure value" by the NRPPD, at least for the specific purposes of articles 267(3) and 268(1) CRR, provided that the NPE portfolio would be in principle-analogously to the traditional securitizations of performing exposures- subject only to unexpected losses. Another ex lege argument derives from the accounting treatment of the underlying NPE exposures in the SPV's balance sheet, pursuant to which their NRPPD is fully factored in the relevant calculations.

Finally, in the case of NPE securitisations, the (p) factor levels produced a very large increase in the capital requirements of the tranches compared to performing transactions

[330] See EBA, Opinion on the regulatory treatment of the NPE Securitizations, ibid, p. 23.

[331] See EBA, op. cit. Indicatively, in a relevant illuminative case study, EBA proves that the calibration of the advanced SEC-IRBA (own calculated LGD levels) (426% risk weight ("RW") for the senior tranche) and the SEC-SA (505% RW for the senior tranche) produced capital charges for all tranches greatly in excess of the capital that would be required under the SEC-ERBA (63% RW for the senior tranche) for the same tranches.

[332] EBA, Opinion on the regulatory treatment of the NPE Securitizations, ibid, p. 22.

again due to the dominant gross basis approach, necessitating a more risk sensitive calibration[333].

Based on these insightful EBA's considerations, the newly introduced Article 269a CRR:

1. defines the notion "NPE Securitization", building on the definition in point (25) of Article 2 of Regulation (EU) 2017/2402, "*as a securitisation backed by a pool of non-performing exposures the nominal value of which makes up not less than 90 % of the entire pool's nominal value at the time of origination*[334]*, where the non-refundable purchase price discount is at least 50 % of the outstanding amount of the underlying exposures at the time they were transferred to the SSPE*".

2. stipulates the calculation of the risk weight for a position in an NPE securitisation in accordance with Article 254 or 267 CRR, setting in principle a risk weight floor of 100 %, except when Article 263 CRR is applied.

3. sets a risk weight of 100 % to the senior securitisation position in a qualifying traditional NPE securitisation, except when Article 263 CRR is applied.

4. clarifies that banks applying the IRB Approach to any of the underlying exposures and are not permitted to use their own estimates of LGD for such exposures, shall not use the SEC-IRBA for the calculation of risk-weighted exposure amounts for a position in an NPE securitisation and shall not apply paragraphs 5 or 6 of Article 269a CRR.

5. States that for the purposes of Article 268(1) CRR, "expected losses" associated with exposures underlying a qualifying traditional NPE securitisation shall be included after deduction of the non-refundable purchase price discount and, where applicable, any additional specific credit risk adjustments, in line with the EBA's relevant opinion.

6. amends **Article 249(3) of CRR** to align it with the Basel III framework in order **to enhance the effectiveness of national public guarantee schemes that support institutions' strategies to securitize non-performing exposures (NPEs)** in the aftermath of the COVID-19 pandemic[335].

5. Mission not accomplished: the NPEs securitization are banished from the "STS label kingdom". And that costs.

Many of the capital and liquidity "sweeteners" that have the potential to boost the nascent securitization market apply to the STS designated securitizations. Despite the fact that Regulations 2021/557 and 2021/ 558 waived several regulatory burdens to enable NPE securitizations, it opted not to regulate NPE Securitizations as eligible for STS designation.

[333] See EBA, Opinion on the regulatory treatment of the NPE Securitizations, ibid, p. 23 et seq.
[334] And at any later time where assets are added to or removed from the underlying pool due to replenishment, restructuring or any other relevant reason.
[335] See recital 5 of Regulation 2021/558.

Thereby, without the State's guarantee to the senior securitization positions(which in any case will not amount to the benefits accompanying an STS state-backed securitization position), its marketability will significantly deteriorate, especially for regulated institutions.

In any case and without prejudice of the above, concerns have already been expressed in literature as regards the undue complexity of the capital and prudential treatment of NPE securitization positions, a fortiori the excessive complexity regarding their qualification as a 'level 2B HQLA', the preconditions for the assignment of the preferential capital treatment and the affirmation of significant risk transfer[336], rendering the extensive due diligence requirements[337] imposed to institutional investors[338] even more disproportionate. The various assessment criteria comprised in the STS Regulation, the CRR Securitization Amendment and the current LCR Delegated Regulation in order to obtain capital relief and eligibility for building a liquidity buffer are considerably complex and result in a significant compliance burden for banks wishing to use securitization positions as investment. Proportional application does not seem to be possible in the current framework and, therefore, concerns arise that this funding tool will remain to be preserved to the larger institutions in Europe[339].

[336] According to **Göthlin S. (2021), p. 15, Daley M. (2021), passim. Penn and Papadogiannis (2021), p. 247.**

[337] See by mere indication and among others **Kastelein (2018), See Lerario D. (2016)**, passim.

[338] Indeed, regarding the STS notification, the originator, sponsor, SSPE, and investors are exposed to liability and reputational risks for getting it wrong. Investors are also subject to a liability risk under the sanction regime of the Securitization Regulation. The European legislator acknowledged that this legal risk can scare off market participants from applying for an STS designation. In this context, according to SR, competent authorities will have the ability to grant the originator, sponsor, and SSPE a grace period of three months to rectify any erroneous use of the designation that they have used in good faith. 'Good faith' is present if the originator, sponsor, and SSPE 'could not know' that a securitization does not meet all the STS criteria to be designated as 'STS'.

[339] See **Joosen B. and Lieverse K. (2018)**, passim.

CHAPTER II

Consistency with EU legal framework (bank resolution and State aid)

Applicable regulatory frameworks

AMCs and other asset protection schemes need to be fully compliant with the existing EU legal framework, notably with:

- the bank resolution framework, consisting of the BRRD and the SRMR.

- the State aid framework, as crystallized in the Crisis Communications, lastly amended by the Temporary State aid Framework amidst the pandemic crisis[340].

Under the EU's bank resolution framework, a bank requiring in any form(i. e direct recapitalization, IAM etc) extraordinary public financial support may be declared "failing or likely to fail" (FOLF) by the competent micro-prudential or resolution authority. This triggers either the bank's resolution (if considered in the public interest by the resolution authority) or, alternatively, its liquidation under national ordinary insolvency proceedings.

The only exception in the EU resolution framework is the precautionary recapitalization tool. If all conditions for a "precautionary recapitalisation" are met, a bank will not be considered FOLF and thereby neither resolution nor liquidation under national ordinary insolvency proceedings is triggered[341].

Apart from precautionary recapitalization, extraordinary public financial support can be also provided in the current BRRD/SRMR framework within resolution through:

- ✓ the infamous government financial stabilization tools(GFSTs)[342] only "in the very extraordinary situation of a systemic crisis" and under the stringent preconditions of articles 37(10) and 56-58 BRRD (*namely at least 8% bail-in of shareholders and junior debtholders and as ultimum refigium, after any other resolution option has failed*) and
- ✓ in the context of liquidation under the national insolvency law to ensure smooth liquidation without endanger financial stability(liquidation aid)[343].

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[340] As **Hadjiemmanuil C. (2016)** points out, while the two regimes are adopted under different legal bases (TFEU, Art. 107 and TFEU, Art. 114, respectively) and have different legal force ("soft law" as against fully binding legal norms), they "*operate in tandem to erect barriers to further state-funded bailouts*".

[341] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 29.

[342] See **Gortsos, Ch.V. (2016a) and Gortsos, Ch.V. (2020c)**, passim.

[343] In this case, the standard practice would be to split the failed bank and perform an asset separation so that the "good" part can be sold, if legally feasible under the national insolvency framework. Liquidation aid may involve the utilization of public resources through the national deposit guarantee scheme (DGS) or other resources imputable to the State. It must still comply with the general principles of the 2013 Banking Communication, the Restructuring Communication (2009) and the Commission's Impaired Assets Communication of 2009, **albeit the REV cap- requirement is not rigid in this case**, as the residual entity will be facing constraints which limit distortions of competition and will totally exit from the market.

Moreover, until recently, a distinct ESM tool, the Direct Recapitalization Instrument (DRI)[344] could be used under even more rigid preconditions than precautionary recapitalization. It was never triggered and will be replaced by the ESM's fiscal backstop to the SRF pursuant the relevant amendments to ESM treaty[345]. In any case, the general principles of the EU's State aid framework continue to be fully applicable, alongside the applicable bank resolution framework's provisions.

Naturally, when the "bad bank model" is applied as a resolution scheme(*namely through sale of business tool in conjunction with the asset separation resolution tool, where the "bad assets" are transferred to a "Bad Bank" to be smoothly liquidated on a gone concern basis*), recourse to SRF's resolution financing is possible(*if incorporated in the relevant SRB's resolution scheme and adopted by the Commission in accordance with the Union*

Such liquidation aid should focus exclusively on facilitating the orderly exit of non-viable players without endangering financial stability and is subject to additional safeguards, such as • **limitation of liquidation costs**: In that sense, Member States could favor a pure exit of non-viable banks rather than their (partial) sale to competitors, which is subject to additional State aid requirements, as it **may entail State aid to the buyer**, unless the sale is organized via an open and unconditional competitive tender and the assets are sold to the highest bidder, see **EC's Staff Working Document on AMC Blueprint (2018), p. 26 et seq** ; • **limitation of competition distortions**: notably, the beneficiary ailing bank must neither actively compete on the market nor pursue any new activities as long as it continues to operate; • **burden sharing**: i.e the claims of the shareholders and subordinated debtholders must not be transferred to any continuing economic activity. See in further detail and with considerations regarding the non-harmonization of national insolvency frameworks, which in conjunction with such lenient liquidation aid could in extremis amount to "hidden resolutions", see **Asimakopoulos, Ioannis (2018)**, passim.

[344] In a nutshell, it has been operational since 8 December 2014 and is governed by the Guideline of the ESM Board of Directors "on Financial Assistance for the Direct Recapitalisation of Institutions" (DRI Guideline). It is available to euro area credit institutions, which are of 'systemic relevance' or pose a serious threat to financial stability, but cannot be used for the purpose of precautionary recapitalisation. It is only provided if the beneficiary credit institution is (or is likely in the near future to be) in breach of the capital requirements established by the ECB within the SSM; it is unable to attract sufficient capital from private sector sources to resolve its capital shortfall; and the contribution of the private sector by application of the 'bail-in' tool is not expected to address the capital shortfall fully. The contribution of the requesting ESM Member to the recapitalisation operation is determined by a burden-sharing scheme. The conditionality attached is detailed in a Memorandum of Understanding (MoU), in accordance with Article 13(3) ESM Treaty, addressing both the sources of difficulties in the financial sector and, where appropriate, the overall economic situation of the requesting ESM Member. See in further detail **Hadjiemmanuil, Ch. (2015)** and **Busch - Rijn – Louise (2019)**, **Gortsos, Christos (2016a).**

[345] The analysis of those reforms aiming at fortifying the EMU and EBU and the combustive political and academic debate in this context unfortunately fall out of the scope of this study. See in detail **Zaccaroni, Giovanni (2020)**, **Markakis, Menelaos (2020)**, **Pennesi, Francesco (2018)**, **Grund, Sebastian and Waibel, Michael (2021)**, **Micossi, Stefano and Peirce, Fabrizia (2020)**, **Dosi et al. (2020)**, **Smeets S., Jaschke A. and Beach D. (2019)**, **Busch, D. (2020)**. For a holistic and inclusive analysis of the perspective of a fiscal union, see among others **Berger H., Dell'Ariccia G., and Obstfeld M. (2018)**.

State aid rules[346] *and/ or Council according to articles 18 and 19 SRMR*), after a mandatory 8% bail-in has been applied *(and capped to 5% of total liabilities*[347]).

We will hereupon focus on the provision of extraordinary public financial support beyond the resolution and national liquidation procedures[348], provided that this paper focuses on NPL resolution strategies on a going-concern basis.

General principles of the State aid framework

Under the EU Treaty on the Functioning of the EU (TFEU), State aid[349] can be granted only after it has been authorised by the Commission. The first question when confronted with a transfer of impaired assets to a state-backed AMC is therefore to verify whether it contains State aid or not.

Scenario 1: No State aid

When the State (eg. a state-backed AMC) purchases NPLs from a bank at estimated market price[350] – i.e. the price which private investors would pay at the same moment for the same

[346] Although deposit guarantee funds employed to reimburse depositors do not in principle constitute State aid, as the funds derive from the private sector, they may constitute aid if they are under the control of the State and the decision to provide these funds belongs to the State("imputability precondition"), see in standard CJEU's case law, Petra Kirsammer-Hack v Nurhan Sidal, C-189/91, 30 November 1993, paragraph 16; Court of Justice of the European Union, Firma Sloman Neptun Schiffahrts AG v Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts AG, C-72/91, 17 March 1993, paragraph 19. See **Schütze R. (2015)**, p. 764. In this sense, it is irrelevant whether the aid is granted directly by public authorities or private bodies established or designated by the State with the mandate to administer it, see Court of Justice of the European Union, ENEA S.A. v Prezes Urzędu Regulacji Energetyki, Case C-329/15, 13 September 2017, paragraph 23, whilst in such case the Commission has the burden of proof to prove the indirect imputability, see **Craig, De Burca (2015)**, p. 1137. The mere public interest significance of the DGS does not suffice, see Court of Justice of the European Union, Servizi assicurativi del commercio estero SpA (SACE) and Sace BT SpA v European Commission, C-472/15, 23 November 2017, paragraph 26. Given the private origin of its resources, and that these resources are not managed by Member States but by an EU agency, the use of the SRF would not normally fall within the scope of the notion of State aid in light of Article 107(1) TFEU, see in detail the relevant landmark cases Court of Justice of the European Union, Italian Republic and Others v European Commission, Joined Cases T-98/16, T-196/16 and T-198/16, Luxembourg, 19 March 2019 and also **Vignini, A. (2019)**. Yet Article 19 of the SRM Regulation, which draws on the TFEU's State aid provisions, ensures that Fund aid is subject to the same regime as State aid to ensure the substantive coherence of EU law, that is, that different areas of EU law are mutually compatible. See by mere indication, **Gray J. and De Cecco F. (2017)**, p. 52.

[347] Alternative funding sources may be activated in extraordinary circumstances and only in the event that the 5% limit has been exhausted and after a full bail-in has been implemented.

[348] Besides, as **Goodhart, Ch. and E. Avgouleas (2016)** stipulate, it is rather questionable whether a state-backed AMC operating on the basis of a public guarantee(as is the default rule in most of this paper's proposals) would be functionable within the context e.g. of the GFSTs.

[349] The prohibition does not encapsulate only financial aid. See by mere indication Case T-613/97 UFEX and Others v Commission, [2000] ECR II-4055, Case C-126/01 GEMO, [2003] ECR I-13769.

[350] Under normal circumstances, the market price may quite straightforwardly be established in case of a directly observable trading price in a liquid market, in case of pari passu transactions or in case of competitive tender procedures in which private parties also participate. Otherwise, benchmarking to directly comparable transactions may serve valuation purposes well. See in detail **Galand, C. and Dutillieux, W. and Vallyon, E. (2017)**, p. 146.

assets – it acts as a market economy operator, thus providing no economic advantage to the ailing bank. Hence, neither State aid nor extraordinary public financial support is granted to the bank, and the measure is consequently not subject to the EU's State aid and bank resolution framework.

In brief, article 107(1) TFEU defines State aid as including any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods, insofar as it affects trade between Member States. In order for a measure to be classified as State aid, it has to fulfil cumulatively all the conditions set out in the Treaty provision[351].

In particular, the Court focused in its case-law on the criterion that State aid must be such as to confer an advantage on the recipient[352]. That scenario has already actualized and notably with remarkable hitherto success. The Commission's state aid decisions have created a standardized[353] case of model national Asset Protection Schemes, namely the Italian State guarantee scheme for the securitisation of non-performing loans ("Garanzia sulla Cartolarizzazione delle Sofferenze", GACS)[354] and Greece's State guarantee scheme for the securitisation of bank loans ("Hercules")[355].

The GACS/ HERCULES ASSET PROTECTION SCHEMES

[351] See **Ó Caoimh, A. and Wolf Sauter Herwig (2016)**, pp. 84 et seq.

[352] See eg Case C-280/00 Altmark Trans and Regierungspräsidium Magdeburg [2003] ECR I-7747, I-7788.

[353] On the importance of such standardization and proceduralisation of the MEIT (Market Economy Investor Test) criterion, see **Galletti G. M. (2014)**. Indeed, the Court of Justice has framed the Commission's discretion by determining the procedural steps to be followed for the purpose of the MEIT assessment thereby urging the Commission to standardize the context of the MEIT assessment, see Judgment in European Commission v Électricité de France (C-124/10 P) [2012] 3 C.M.L.R. 17 . See, inter alia, **Baeten and L. Gam (2013)**.

[354] The Italian State guarantee scheme for the securitisation of non-performing loans ("Garanzia sulla Cartolarizzazione delle Sofferenze", GACS) was established in 2016, by virtue of Decree 18/2016, amended and converted into law by L. 49/8.4.2016 (the "Italian Law"). It was initially available for eighteen (18) months, complemented by Ministry Decree 3.8.2016, then extended, following consultation with EU Authorities, by means of consecutive Ministry Decrees until 6.3.2019(Italian Decrees 21.11.2017, 10.10.2018). By virtue of Decree 22/25.3.2019 and converting Law 41/20.5.2019, following further assessment by European Commission[EC Decision 31.8.2018 State Aid Case SA. 51026 (2018/N) Second Prolongation of the Italian Guarantee scheme for the securitisation of non-performing loans, earlier EC Decisions State Aid SA. 43390 (2016/N), SA. 48416 (2016/N)], several amendments were introduced to that scheme, while its term was further extended by 24 months (with the possibility of an additional 12 months extension by Ministry subject to EC approval). The Commission by virtue of its decisions State Aid SA.53518(2019/N) and State Aid SA.62880 (2021/N) has further prolonged the scheme amidst the pandemic crisis.

[355] Greece's State guarantee scheme for the securitisation of bank loans ("Hercules"), was enacted in late 2019, by virtue of Law 4649/16.12.2019 (the "Greek Law"). Its scope covers credit institutions having permanent establishment in Greece (including subsidiaries of foreign banks). Similarly, it has been made available for eighteen (18) months following the relevant EC decision, also prolonged by the Commission amidst the pandemic crisis, see EC Decision 10.10.2019 State Aid Case SA. 53519 Hellenic Asset Protection Scheme ("Hercules") (2019/N) and State Aid SA.62242(2021/N) – Greece Prolongation of the Hercules scheme. Greece has made available State guarantees up to the notional amount of Euro 12 bn., which may be increased with Ministry of Finance decision, following approval by the European Commission.

Comparing to AMCs, such state-backed securitisation schemes are generally considered preferable, as they in principle rely less on upfront funding by limited investor types, but rather create an enhanced market for structured securities, attractive to a wider range of investors, thus, reducing the need for public funding[356].

Model APSs are voluntary and non-discriminatory[357] to the original lender/ originator[358] credit institutions aiming to exploit the credit enhancement provided by the conditional State guarantee[359] and, if the number of institutions has to be constrained, institutions with large concentrations of impaired assets could be given priority[360]. Notwithstanding the financial, structural and behavioral constraints imposed to the participating institution by the restructuring plan(embedded in the Commission's Decision approving such schemes), typically it would be reasonable to condition the public support schemes to some extra commitments, eg. to continue providing credit (especially to SMEs)[361] and appropriately meet demand according to commercial criteria[362].

They are typical true sale securitization transactions with mainly two distinctive features, i.e the assets transferred and the State's guarantee.

In particular, the transferred loan portfolios comprise mainly or exclusively non-performing loans[363] and *restructured exposures and sometimes even* performing loans[364] in order to obtain a higher weighted credit rating of those NPL portfolios by the competent agencies, which could plausibly result to bate bid-ask gaps. This feature has two main adverse regulatory consequences:

1. NPE securitizations cannot be labeled as STS, thus they cannot benefit from the relevant preferential capital and liquidity treatment;

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[356] See **Bruno B., Lusignani G., Onado M. (2018).**

[357] According to the Commission's **Guarantee Notice(2008)**, section 3.4 point g, in order to ensure transparency, the scheme must provide for the terms on which future guarantees will be granted, such as eligible companies in terms of rating and, when applicable, sector and size, maximum amount and duration of the guarantees.

[358] However, such institutions could still be eligible when acquiring the transferred assets from the originator institution, especially in the context of earlier merger or spin-off activity, or another bank resolution, implemented by means of transfer of assets and liabilities. See **Roussis (2013), p. 491**.

[359] See ECB Opinion on the (Italian) reform of cooperative banks, a guarantee scheme for securitizations of non-performing loans and the lending capacity of alternative investment funds (CON/2016/17).

[360] See ECB, Guiding Principles for bank Asset Support Schemes, 2009, available at: https://www.ecb.europa.eu/pub/pdf/other/guidingprinciplesbankassetsupportschemesen.pdf, p. 1.

[361] See **Ayadi, Rym and Ayadi, Rym (2015)**, investigating the role of a conditionality clause in granting State aid on SME lending.

[362] See ECB, Guiding Principles for bank Asset Support Schemes, 2009, ibid, p. 3.

[363] In addition, Italian Law has covered expressly non-performing receivables deriving from lease contracts, owed to banks and specified financial intermediaries.

[364] See article 1-2 L. 4649/19(model greek APS law) and L. 4354/2015, as currently in force. On the other hand, greek APS law provided for exemption of (non-performing or restructured) loans already guaranteed by State under various existing regimes(see article 2 respectively).

2. The model securitizations are not eligible for the Commission's Guarantee Notice "safe harbor" from a state aid law perspective.

As regards the State's guarantee**,** model APS national laws provide that it is **unconditional, irrevocable and at first demand**, in favor of the holders of *senior notes* of the Issuer[365]. It covers interest and principal payments of the senior notes and **endures until their full repayment**. The Guarantee agreement is governed by both special legislative provisions and the respective contract[366][367].

As regards the **legal nature of State guarantee**, Greek Law refers explicitly to the liability of State being established ***"as (that of) principal debtor".*** It could also be granted by means of an **"autonomous guarantee contractual obligation" *(Garantievertrag)*[368]*,*** in which case the State cannot raise any objections vis- a-vis senior noteholders, except only for those explicitly incorporated in the model APS law, the guarantee contract and in the documentation of the senior notes.

More specifically, the guarantee will become void and ineffective only in case the terms and conditions of the notes are amended in violation of respective law provisions[369] or in the case the guarantee was granted on the basis of untrue, inaccurate or incomplete statements[370].

On the other hand, it has been argued under relevant Italian L. 49/2016, that the single reference to "first demand" is not sufficient to determine the complete detachment of the

[365] On the critical importance of legal certainty over the concept and implications of such first demand guarantee, so that the Scheme attracts significant third party investor interest and disputes or litigation arising out of the validity, amount, duration or other features of the State guarantee are avoided, see ECB Opinion CON/2019/42, par. 3.1.

[366] See **Wood (2007)**, p. 347, **Andrews G. and Millett R. (2015)**.

[367] However, greek L. 4649/2019 annexed guarantee agreement template provides for greek governing law. See in detail **Linaritis (2020)**, p. 31.

[368] On the foremost importance of true construction of the actual words, in which each surety's (either guarantee or indemnity) obligation is expressed, under English law, see Vossloh AG v Alpha Trains (UK) Limited [2011] 2 All E.R. 307, 23-28, also analyzing the subcategory of "performance bond" (sometimes known as a "performance guarantee", "demand bond", "demand guarantee", "first demand guarantee"), in effect "a particularly stringent contract of indemnity").

[369] See 4 Art. 15 Greek Law. Yet, according to art. 8 of the Ministerial Decree dd. 3.8.2016, implementing the provisions of the Italian Law, State guarantee is also to be declared void in case of a decision of Issuer or noteholders to terminate the appointment of Servicer, which caused actually deterioration in the rating of senior notes by the approved rating agency. Even in the Italian context, it is observed that aforementioned provision clarify and specify exhaustively the cases where the guarantee may become ineffective. **Messina (2019)**, p. 63, **Linaritis (2020)**, p. 31.

[370] In the latter case, the State will have recourse against the Issuer, without prejudice to the enforceability of the issued guarantee.

guarantee (State) obligation from the main obligation of Issuer vis-a-vis the senior noteholders[371]. According to such interpretation, Italian law on CAGS does not create autonomous obligation of the State towards the holders of guaranteed notes, but simply reverses the burden of proof regarding potential objections[372].

Notably, greek model APS law explicitly stipulates that the State guarantee must qualify as **"eligible unfunded credit protection"** in accordance with art. 213-215 of Capital Requirements Regulation (EU) 575/2013[373]. In such respect, the State guarantee offers incontrovertible credit protection, not to be contested by any clauses outside the direct control of senior noteholders[374].

As per the applicable provisions, in the event of non-payment (even partial) of senior notes obligations, which lasts for specific term[375], holders of senior securities can submit, through their bondholder agent[376], to the State request for payment of the guarantee. Thirty days from the date of receipt of the request (assuming non-payment by the Issuer in the meantime) the State must pay the amount due to the holders of the senior notes, according to the terms of their securities, without legal interest or expenses[377]. After payment, the State is substituted in the rights of the holders of senior notes against the Issuer[378].

Applicable Law

Namely APSs are governed by:

1. the dedicated national framework mainly defining the preconditions for the State's guarantee(Model APS's national Law);
2. general EU and national securitisation rules(namely STSSR) and;
3. State aid rules and the relevant BRRD/SRMR provisions;

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[371] See **Messina (2019)**, p. 63, who refers to the classification of State enhancement as "first-demand guarantee" as "purely notional issue", see also **Linaritis (2020)**, p. 32 with further references therein.

[372] See **Linaritis (2020)**, p. 32

[373]See on relevant regulatory credit risk mitigation by means of guarantees and the latter's required elements, art. 213 CRR, Wood **(2019a)**, 633.

[374] In particular, the guarantee is not unilaterally cancellable by the Issuer and its cost cannot increase as a result of a deterioration in the credit quality of the protected exposure.

[375] See in particular aforementioned ECB Opinion, par. 3.1, on the importance of unambiguous and detailed law provisions not only for the submission of applications for a State guarantee, but also regarding the exact procedure from its call to its payment.

[376] In essence, investors are not allowed to enforce directly and individually the State guarantee, but only after requesting Issuer to pay, then, shall proceed to enforcement, acting in concert with other noteholders, typically represented by the bondholder agent. **Messina (2019)**, p.63, emphasizing the significance of national statutory rules with regard to bondholders meeting and the protection of rights of minority bondholders.

[377] On the significance of legal certainty over the latest time point for enforceability of State guarantee, see ECB Opinion (CON/2016/17) par. 3.2.2.-3.3.3.

[378] Thus, notwithstanding potential contractual limitations for the exercise of these rights, State substitutes the noteholders on their rights and claims against the Issuer for the amounts paid, along with the relevant legal interest accrued from the day of State payment up to the date of reimbursement and expenses incurred for recovery. See Italian Law art. 11§3, Greek Law art. 13§3.

4. CRR provisions mainly regarding the significant risk transfer requirements and the crucial NPLs' de-recognition/ de-consolidation from a prudential regulation perspective and the consequent capital treatment of each securitization position. One additional issue(which cannot be further analyzed in the context of this paper) is the potential eligibility of high quality senior securitization notes not only as collateral for the Eurosystem's main refinancing operations(as already mentioned) but also for the LCR and NSFR liquidity ratios.
5. IFRS/ EU accounting Directive rules regarding the conditions for the de-recognition/ de-consolidation from an accounting law perspective.
6. ultimately, each transaction's contracts and documentation.

The State Aid law perspective

Model state-guaranteed NPL securitisations involve a concrete risk of imposing an additional future cost on the States. In light of high level of exchanges and trade in the EU financial services markets, the relevant Asset Protection Schemes are considered as capable of affecting trade between Member States[379]. Therefore, in case that such risk is not remunerated through an appropriate premium, there exists both a competitive advantage[380] for the respective banks and a drain on the resources of the Member States[381].

Should a respective measure be deemed incompatible aid, then guarantee will be unlawful and unenforceable[382]. Nevetheless, even if the relevant measure is considered compatible aid, such impaired asset relief can only be approved by the Commission **in accordance with the established EU law restructuring aid conditions**[383].

[379] See **Galand C., Dutillieux W., Vallyon, E. (2017)**, p. 139, **Hadjiemmanuil C. (2016)**, 94, EC Decision State Aid Case SA. 43390, par. 45, EC Decision State Aid Case SA. 53519, par. 43.

[380] The benefit of a State guarantee is that the risk associated with the guarantee is carried by the State. Such risk-carrying by the State should normally be remunerated by an appropriate premium. Where the State forgoes all or part of such a premium, there is a benefit for the undertaking, even if the guarantee is never triggered and no payments are ever made by the State. The aid is granted at the moment when the guarantee is given, not when the guarantee is invoked nor when payments are made under the terms of the guarantee. See **Guarantee Notice (2008)**, p, 2.

[381] See EC Impaired Assets Communication, recital 15, **Galand C., Dutillieux W., Vallyon, E. (2017)**, p. 140, 143, 149. **Enria A., Haben P., Quagliariello M. (2017)**, p. 65, have alternatively proposed the issue of equity warrants to national governments at the time of the NPLs transfer to the AMC, with a penal strike price to be triggered if the (actual or estimated) sale price at the predefined date remains below the suggested transfer price, so that banks shareholders risk proportional dilution and State receives proportionate compensation for its support. See in detail below.

[382] While in the absence of relevant notification, any aid element is automatically void, resulting in both cases to restitution obligation and Member State measures to recover the aid from the beneficiary, as well as potential suspension and recovery injunctions, according to art. 108 par. 3 TFEU and art. 2, 13, 16 Regulation (EU) 2015/1589 laying down detailed rules for the application of art. 108 TFEU.

[383] See **Galand C., Dutillieux W., Vallyon, E. (2017)**, p. 152, **Avgouleas E., Goodhart C.A. (2017)**, p. 109, **Micossi, S., Bruzzone, G. and M. Cassella (2016), Linaritis (2020), pp. 33-34.**

European Court of Justice demands that the State acts as any other private investor[384]. In particular, recourse to the capital markets to obtain equivalent resources should be considered, so that State aid is not involved in case that funding source is made available on terms and conditions (including fees), which would be acceptable for a private operator, under the normal conditions of a market economy[385].

In order to facilitate this (ex-ante, on realistic terms) assessment for a given State guarantee scheme[386], the Commission has additionally set out a number of sufficient conditions[387]. In essence, according to the applicable ***Guarantee Notice (2008)***, guarantee schemes can be considered free of State aid under the following conditions, which should be fulfilled cumulatively:

(a) The scheme is closed to borrowers in financial difficulties[388];

(b) The guarantee amount can be measured when it is granted, i. e must be linked to a specific financial transaction, for a fixed maximum amount and limited in time;

(c) The guarantee cannot cover more than 80% of the outstanding financial obligation[389];

(d) The remuneration is based on a realistic assessment of the risk and the premiums paid so that the scheme can be considered self-financing;

(e) The level of premiums has to be reviewed at least every 12 months in view of the self-financing nature of the scheme;

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[384] See on the relevant Market Economy Investor principle, **Guarantee Notice (2008)**, section 4.2.

[385]See Case C-482/99, France v Commission (Stardust) [2002], I-4397, Joined Cases 296/82 and 318/82, Netherlands and Leeuwarder Papierwarenfabriek BV v Commission [1985] ECR 809.

[386] As for the broad definition of the notion "State guarantees" given directly by the State, namely by central, regional or local authorities, as well as guarantees given through State resources by other State-controlled bodies such as undertakings and imputable to public authorities, may constitute State aid. See indicatively C-482/99, France v Commission (Stardust) [2002] ECR I-4397, Guarantee Notice 2008, par. 2.1.

[387] Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees ("Guarantee Notice", 2008/C 155/02), Commission Regulation (EU) 651/2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 of TFEU.

[388] According to **Guarantee Notice (2008),** in order to decide whether the borrower is to be seen as being in financial difficulty, reference should be made to the definition set out in the Community guidelines on State aid for rescuing and restructuring firms in difficulty, see OJ C 244, 1.10.2004.

[389] According to the Commission, when the size of the secured financial obligation amortizes over time, the guaranteed amount has to decrease proportionally, in such a way that at each moment in time the guarantee does not cover more than 80 % of the outstanding loan or financial obligation. Moreover, losses have to be sustained proportionally and in the same way by the lender and the guarantor. Thus, first-loss guarantees, where losses are first attributed to the guarantor and only then to the lender, will be regarded as possibly involving aid. If a Member State wishes to provide a guarantee above the 80 % threshold and claims that it does not constitute aid, it should duly substantiate the claim, thereby forfeiting the safe-harbor, provided by the Guarantee notice.

(f) The premiums charged have to cover the normal risks associated with granting the guarantee, the administrative costs[390] and a yearly remuneration on the necessary capital[391].

Model State-guaranteed NPL securitisations obviously do not comply with certain of the above conditions, provided that those schemes may cover, partially, distressed borrowers and may in principle cover more than 80% of the outstanding financial obligation of the Issuer to the senior noteholders, since no maximum threshold of senior notes' "thickness" is established in the model APS national laws[392].

On those grounds, European Commission resolved that potential presence of state aid in the discussed schemes cannot be excluded in advance, on the basis of the Guarantee Notice's "**safe harbor**", requiring deeper analysis of the schemes[393].

Additional criteria and safeguards crystallized in the relevant national model APS laws and the Commission's decisions

In brief, the relevant preconditions and safeguards are the following:

1. **Obligatory involvement of independent non-performing loans servicers**. Could be a dedicated captive recovery unit of the Transferring bank, if acquired- after the transfer, in fulfillment of the latter's relevant divestment obligation- and controlled by private investors[394].
2. Part of the fees payable to the Servicer is set to be conditional upon specific performance targets[395].
3. In case of repeated underperformance[396] and call of State guarantee, **the Servicer can be replaced**[397] even by the State itself, on the grounds of the Guarantee agreement. However, since the possibility of being replaced or underpaid constitute serious **Servicer's business risk**, which may lead to **higher fixed servicing fees**, the

[390] According to the Commission, as regards administrative costs, these should include at least the specific initial risk assessment as well as the risk monitoring and risk management costs linked to the granting and administration of the guarantee.
[391] For further detail and the relevant benchmarks and thresholds, see **Guarantee Notice (2008)**, section 3.4.
[392] See **Linaritis (2020)**, p. 36.
[393] See **Linaritis (2020)**, p. 36.
[394] The disposal of that unit is effected after closing of relevant transaction (payment of price and transfer of shares), so that the private investor acquires control to such unit (licensed Servicer), according to International Financial Reporting Standards (IFRS 10).
[395] See Italian Law art. 1a, amended accordingly by virtue of Decree 22/2019, following respective EC Decision SA. 51026, **Messina (2019)**, p. 57, Greek Law art. 3§4.
[396] Underperformance (failure to achieve performance targets) is measured in comparison with the net NPL portfolio proceeds envisaged in the business plan, submitted and used by the credit rating agency for the purpose of senior notes' rating.
[397] See Italian Law art. 4§1(fii), amended accordingly by virtue of Decree 22/2019, following respective EC Decision SA. 51026, Greek Law art. 12. On the significant implications of Servicer's replacement and the relevant provisions of the service agreement, see **Messina (2019)**, p. 26.

model APS laws, stipulate that replacement should be attributed to the **Servicer's *fault***[398].

4. **Compulsory tranching of Issuer's notes and fully preferred status of the senior tranche**[399], which is in principle the only one guaranteed by the Member States. According to state aid rules, asset guarantees must never cover the entire potential loss associated with a certain asset. Typically, the first losses must be fully borne by the bank. The State guarantee will kick-in and lead to payment to the bank only if the cumulative losses on the guaranteed portfolio exceed an amount defined in the guarantee contract (the **"attachment point"**). In line with the concept of REV, the attachment point should be set such that all the existing and likely losses are borne by the bank, i.e. by the first loss tranche. This is why the state-guarantee shall accompany in principle only the senior tranches. This is why proposals[400] involving the State's guarantee to the junior tranche, offered bilaterally, in the context of both a true-sale NPL securitization or a synthetic securitization, structured as a total return swap, where the state guarantees up to 50% of the losses on the junior tranche, in return for any upside due to actual recoveries above initial estimations, are incompatible with the quasi standardized Commission's state aid case law on Asset Protection Schemes, which de facto(and not de jure pursuant to the Guarantee notice's "safe harbor") provides a "safe harbor" for approval. This mandatory structural credit enhancement ensures that junior and (optional) mezzanine tranches are to absorb all foreseeable losses, in case the securitised portfolio underperforms[401]. In this context, model NPL securitisation laws prescribe a detailed "payments waterfall", which inter alia takes into account the fact that Issuer may require additional funding through "liquidity lines" [402] or engage in hedging interest

[398] See **Linaritis (2020)**, p. 37.

[399] See in detail **Galand C., Dutillieux W., Vallyon, E. (2017)**, p. 147. In particular, any guarantees may only be granted for new issues of senior debt, thus excluding subordinated instruments; the debt instruments must be of short or medium duration (see 2013 Banking Communication, paras. 56-61 and **Hadjiemmanuil C. (2016).**

[400] See among others **Fell, J., Moldovan, C. and O'Brien, E.(2017)**, who propose, however, market comfort remuneration of the State's guarantee. They also propose **forward purchase schemes (FPS)** and other similar **vendor financing approach** – schemes designed to support direct NPL portfolio sales, with the state financing the "forward premium", that is the gap between distressed market prices and REV values, mainly in the form of a loan to investors. This approach cannot- if properly remunerated-be deemed per se incompatible with the state aid rules, but seems inefficient in this case, as the premise of the huge bid-ask spreads is not the lack of liquidity in the part of investors, but their conservative estimations regarding the NPLs' market value.

[401] In effect, the guarantee shall kick in only if the loss exceeds the "attachment point". The likelihood that the measure involves State aid is lower, if based on the assessment of likely portfolio losses, the likelihood that the attachment point is reached is very low. Guarantee fee should vary based on the probability of the attachment point reached, so the beneficiaries (or the senior noteholders) are protected only against losses due to only extraordinary and unforeseeable circumstances. See in detail **Galand, C. and Dutillieux, W. and Vallyon, E. (2017)**, p. 137, 146, 150, and **Louri H. (2017)**, p. 169.

[402] See **Wood (2019a)**, p. 648. On the role of securitisation sponsors typically providing backstop liquidity ("liquidity puts") to the Issuers, see **Armour J. et al. (2016)**, p. 464.

rate/currency derivative transactions. Issuer payments' sequential priority row has been established by law, as per the following "waterfall" order[403], after initial deduction of portfolio servicing, including legal expenses: (i.) Taxes, (ii) Servicing fees, (iii) Interest on the aforementioned potential liquidity line, (iv) Guarantee fees on the senior notes, (v) Payments to counterparties of aforementioned potential financial hedging agreements, (vi) Interest on the senior notes; (vii) Replenishment of the liquidity line (if utilized), (viii) Regular interest payments to mezzanine noteholders (without prejudice to potential deferral provisions), (ix) Repayment in full of senior notes; (x.) Repayment in full of mezzanine notes (if any), (xi) Repayment of junior notes[404].

5. **Mandatory partial deferral of interest payments to mezzanine noteholders**[405]**(**if any) is stipulated, when the NPL recoveries fall behind projected recoveries[406] in order to further mitigate the State's credit risk.
6. **"Thickness' of the state-backed senior tranche** must be adequately conservative, so that the senior tranche receives the required investment-grade rating. In essence, the slighter the senior tranche, the least dependent their repayment becomes on the ultimate NPL portfolio proceeds potential variation[407]. In such case and taking into consideration the additional safeguards regarding the structure and quality of the senior tranche, the State's guarantee may materialize only in the most adverse evolution of each eligible transaction in order to inter alia avoid the trigger of the *"diabolic loop between banking and sovereign risk"*[408].

[403] On the distinction between sequential payments and "pro rata" payments, it should be noted that where pro rata payment is permitted, the order of payments switches to a sequential basis in the occurrence of predefined "pay out events"(related to issuer's insolvency or in general credit quality deterioration), see in further detail **Wood (2019b)**, 7-010.

[404] See art. 7 Italian Law, art. 3 Greek Law.

[405] Art. 3§3 Greek Law, art. 4§1(d) Italian Law. ECB Opinion CON/2019/42 has suggested that the law should not over-restrict ranking of interest payment on the mezzanine tranche, nor preclude that full repayment of senior tranche might occur prior to any payment of interest on the mezzanine tranche, resulting in faster repayment of the senior tranche and, effectively, reducing the term of the guarantee. Similarly, **Messina (2019)**, p. 63, See **Linaritis (2020)**, pp. 36-37.

[406] Underperformance by 20% (or even lower percentage, if contractually agreed) results in deferral of 20% of mezzanine notes interest payments, subject to additional conditions (see art. 3§4 Greek Law and more austere art. 6§2 Italian Law, amended accordingly by virtue of 22/2019, following respective EC Decision SA. 51026. On the requirement that attachment point is set such that all the existing and likely losses are to be borne by the bank or the private portfolio purchaser, i.e. by the first loss tranche and the suggestion that those even bear a given percentage of the losses that exceed the attachment point (residual or "vertical slice" risk retention), see UK State guarantee and Belgium State guarantee measures in EC Decision State Aid N422/2009 - N621/2009 and N255/2009, N274/2009, respectively. See in further detail, **Linaritis (2020)**, p. 37.

[407] Analytical data on the State-guaranteed senior tranches, during the limited implementation of the Italian Scheme are referred in the EC Decision Case SA. 51026 (2018/N).

[408] See **Hadjiemmanouil C. (2016)**, 94, ECB Guidance to banks on non-performing loans, March 2017, **Psaroudakis (2015)**, p. 177.

7. According to the applicable regime, **the purchase price of the portfolio cannot exceed its current net book value**[409]**.** Thus, the model APS scheme can be either neutral accounting-wise, or (most probably) entail accounting losses to the Transferring banks, ensuring that banks keep "skin in the game" and providing the structural credit enhancement feature of "overcollateralization", which bolsters the marketability of the issuing notes(especially the state-backed senior notes)[410][411].
8. **Rating at least of the state-backed senior tranche by one of the four "approved" External Credit Assessment Institutions**[412]**:** Credit agencies are set expressly to consider the following factors[413]: (a) The expected cash flows derived from the transferred assets and their timings; (b) Any cash-flows received or paid under the hedging agreements; (c) Servicing Fees; (d) "payment waterfall" structure; (e) Guarantee fees; (f) The thickness of the tranches; (g) the work-out capabilities of the appointed professional Servicer and relevant track record[414].
9. **The State cannot undertake additional NPL portfolio risk indirectly**[415], namely through subscribing for, or purchasing in the secondary market, or acquiring in any way, mezzanine and junior notes issued[416]. On the same grounds, the State should avoid vendor financing, especially as regards the mezzanine and junior notes[417].
10. The State guarantee is not immediately effective at the moment of its granting, but its activation depends on the transferring bank selling 50% plus one share of the junior tranches [418](and mezzanine, if any) to a private market participant at a positive price. Typically, some junior tranches might be structured as hybrid securities

[409] See Art. 4§1 Italian Law, 3§2(b) Greek Law. Legislative limitation should not be applied to each individual receivable of the portfolio but rather at portfolio level (i.e. to the aggregate gross value of all the receivables included in the portfolio, net of relevant depreciations or provisions). See **Linaritis (2020)**, pp. 36-37.
[410] See **Avgouleas E., Goodhart C.A. (2017)**, p. 98.
[411] See EC Decision State Aid SA. 48416 (2017/N), par. 25-26.
[412] On the importance of rating agency consultation, before securitization modifications may be made, see Fuller, ibid, 203.
[413] With regard to the specific CRA EU Regulation rules applicable for the ratings of such structured finance instuments, including express naming of principal methodology that has been used in determining the rating, see EC Decision SA. 53519, par. 28-31.
[414] See **Linaritis (2020)**, p. 37-38.
[415] See **Linaritis (2020)**, p. 37.
[416]Cf. in detail **Fell, J., Moldovan, C. and O'Brien, E.(2017)**, p. 163, proposing relevant increased risk-sharing combination with State participation in the upside of recoveries, in particular for the SME nonperforming loans segment, **Aiyar S., et al. (2017)**, p. 30, **Bruno B., Lusignani G., Onado M. (2018)**, also suggesting relevant EIB/EIF initiatives or ESM activity.
[417] On a proposition for relevant **"Forward Purchase Scheme" (FPS)**, similar to vendor financing approach, in essence for a state loan to the buyer of NPL portfolio, equivalent to the forward premium (i.e. the difference between current purchase price and its expected value at maturity), guaranteed by an investment grade institution, its detailed terms and features, see **Fell, J., Moldovan, C. and O'Brien, E.(2017)**, p. 168.
[418] Typically, such acquisition is expected to involve some ***anchor NPL investor*** **(specialized funds investing in NPLs) or consortium of investors**, interested in the higher risk part of the securitized portfolio. See **Linaritis (2020)**, pp. 37-38.

with prevalent debt features[419]. Transferring bank will examine whether NPLs qualify for de-recognition, firstly from an accounting perspective pursuant to IFRS rules[420], which mainly require the effective transfer of the rights to receive contractual cash flows to the Issuer so as the bank not *substantially* retaining risks and rewards, and in turn from a prudential regulation perspective (pursuant to articles 244-246 CRR). Apart from the accounting de-recognition from its financial statements, the transferring bank will in this case benefit from lower risk weights and capital charges as well as high collateral quality and liquidity significance assets. It is worth noting that because of the high priority of the relevant payments and the related lowest risk undertaking, the simple holding of senior notes by the bank is not considered material in the evaluation of control over the securitised portfolio. Thus, it should not prohibit its accounting de-recognition and deleverage.

11. As regards the pricing of the State guarantee[421], it has to be confirmed that it is market comfort[422] (arm's-length condition), notably using the widely accepted financial markets instrument of credit default swaps (CDS) appropriately adjusted[423], optimally credit default swap of similar senior tranche securities, issued and traded in regulated markets. However, in the default case that such swaps do not exist, suitable market benchmarks ensue. In the benchmark selection process, the anticipated duration of the State's Guarantee as well concentration and Country-specific risks[424] need to be taken into account. For example, in model Greek NPL securitisations, due to the lack of a liquid credit default swaps market in Greece for both

[419] See **Linaritis (2020)**, p. 22, noting that such tranche could take the form of Pay-In-Kind bonds, or Redeemable Preferred Shares offering fixed cumulative interest (rather than dividend) payments, in favour of their respective holders (preferred shareholders). See in further detail **Nijs (2014)**, p. 25 and **Linaritis, Ioannis (2019)**, passim. Indeed, junior noteholders resemble, in a sense, to a limited liability companies' shareholders and thus junior notes are often described as "the equity piece" of the securitized portfolio, in spite of the fact that, in most cases, they are not typically shareholders of the special purpose entity owning the receivables. In this context, investors could be entitled with special rights and prerogatives, namely the right to appoint a different Servicer, in order to achieve their expected investment objectives. Usually, junior notes are not rated. Nevertheless, those notes are not least attractive to NPL specialised equity investors, because they can be purchased at significant discount over their nominal value, thus, require limited financial resources. In addition, they provide for an excess interest spread over the reference rate, as an additional premium for the higher risk undertaken, and/or entitlement to receive whatever is left after the prior claims have been met.

[420] See IFRS 9.3.2, **Messina (2019)**, p. 25 referring to "transfer without recourse, creating firewall between transferor and receivables". See also Transparency Directive 2004/109/EC, as amended by Directive 2013/50/EU, and Accounting Directive 2013/34/EU, as amended by Directive 2014/95/EU (non-financial reporting Directive).

[421] See in further detail and comprehensive analysis regarding the determination of the guarantee premium, see See **Linaritis (2020)**, pp. 39-42.

[422] In case the senior notes of each Issuer have obtained more than one rating, only its lower rating is taken into account.

[423] See **Wood(2019a)**, p. 649.

[424] As the Commission stipulates, the guarantee premium is not set at a single rate, deemed to correspond to an overall industry standard. It is set ad hoc for each guarantees scheme.

corporate and financial institutions' bonds, model APS greek law opted for the Hellenic Republic Credit Default Swap. In both model APS cases, a **quasi-step-up mechanism** was introduced to incorporate maturity considerations, leading to an additional penalty rate after year 3, linearly increased so forth, to incentivize all securitisation private stakeholders to accelerate and timely achieve the work-out targets, avoiding "warehouse" servicing approaches[425]. Additionally, in the formula of Greek Law[426], the difference in the rating class of the senior tranche and of the average Hellenic Republic sovereign credit rating**("Adjusted Spread Ratio Factor")** is also taken into account**.**

12. Mandatory procedural steps, embedding safeguards, administrative tools, and remedies to the involved Authorities[427]. Namely:
    - The guarantee is granted by resolution of the competent Minister, following submission of documented application by credit institution within the specified time-frame. National laws provide the evaluation of applications by special governmental committees, which inter alia assess critical draft contractual terms, such as the transfer price, tranching, priority of Issuer's payments, inclusion of statutory rules in the servicing agreement[428].
    - The opportunity-window for granting guarantees under the aforementioned Schemes is expressly limited in terms of time and quantum.
    - The specified maximum notional amount of guarantees is granted in the chronological order of submission of appropriately documented applications ("first come, first served basis")[429].
    - National authorities are granted broad monitoring powers. In particular, they monitor the actual recoveries and liquidation proceeds from the NPL portfolios on a monthly basis[430] and compare them against the cash-flows projected in the business plan in order to timely detect early warning signs of portfolio underperformance or deviation from the abovementioned legislative and contractual terms of the model APS scheme, and address their

[425] Schematically, if the actual work-out times proves shorter than projected, the step-up mechanism will "award" the Issuer with lower guarantee fees, commensurate with the shorter duration of the State's credit exposure whereas if the work-out proves long, then the States will receive additional compensation though the penalty rate adjustments, exactly as a market economy operator would require. See in detail **Linaritis (2020)**, pp. 39-42.

[426] Especially regarding the Greek APS scheme, the Commission confirmed that, in order to avoid fire sales and undue pressure on the greek market, the ten years tenor provided in the greek guarantee fee formula is justified.

[427] See **Linaritis (2020)**, pp. 30-31.

[428] See **Linaritis (2020)**, p. 30.

[429] See **Linaritis (2020)**, pp. 30-31.

[430] Servicers should fulfill their reporting obligations through the European Securities and Markets Association Servicing Reports templates. In any case, the Issuer, Trustee or Bondholder agent and Paying agent bear parallel information duties to the State with regard to their available own data.

structural or circumstantial causes[431]. In extremis, they are entitled to take remedial actions against potential delays in payments, to reduce the chances of a potential State guarantee call[432]**.**

13. In addition, the implementation of each national Asset Protection Scheme is monitored closely, by an independent Monitoring Trustee, typically appointed by the European Commission, following national States' proposal, typically selected from the circle of the most reputable international auditing firms. The Trustee, in spite of being remunerated by the Issuer, is accountable to the national and European Authorities, to confirm that market economy standards continue to apply throughout the life of each NPL securitisation transaction[433].

Scenario 2: **Precautionary recapitalisation**

If the AMC purchases the transferred assets at a price exceeding the EMV, then the transaction involves State aid, which equals to the difference between the actual transfer price (TP) and the EMV. Thus, it should be approved by Commission in respect of the State-Aid Law and comply with the art. 32(4) BRRD/ 18(4) SRMR provisions to avoid the FOLF trigger.

In this context, according to **Auguleas et al. (2021a)**, the Commission review and reconsider the treatment of NPL purchases at prices that reflect their real economic value (REV). In their view, asset purchases at REV should not automatically qualify as illegitimate State aid, as, in principle, no financial loss for the government is expected. A Treaty-compliant interpretation could be employed on grounds of broader public interest[434].

Step 1: The Commission's approval in accordance with the state aid rules, as crystallized in the Banking Communications[435].

During the GFC, the Commission, in its capacity as a State aid authority, was forced to fill the void of any effective pan-European bank resolution framework[436] and prevent further segmentation of the single market and ensure that concerns about financial stability did not crowd out the importance of promoting competition – even in times of strain and distress

[431] Member States have been encouraged by ECB to authorize a qualified independent entity to monitor the compliance of the issued guarantees with stated conditions, independent servicer appointment and continuous performance, transfer of adequate mezzanine and junior notes to investors, as well as events potentially triggering their call. See relevantly ECB Opinion (CON/2016/17), par. 3.2.4, (CON/2019/42), par. 3.1 and See **Linaritis (2020)**, pp. 39-42.
[432] See **Linaritis (2020)**, pp. 30-31.
[433] See e EC Decision State Aid Case SA. 43390, par. 33-38 and Annex 2, EC Decision State Aid Case SA. 53519, par. 31-37, respectively.
[434] See **Augouleas Emilios et al. (2021a)**, p. 160 et seq.
[435] See **Ackermann T. (2014)**, p. 149, **Gerard (2013)**, p. 232; **Doleys (2012)**; **Quigley C. (2012)**; **Soltész and C von Köckritz (2011)**; **Gerard and Willemaers (2010)**; **Gerard (2008)**.
[436] See **Gray J. and De Cecco F. (2017)**, p. 22.

to institutions and systems[437]. State aid law performed a quasi financial regulatory role[438] that had not been originally envisaged[439]. Thereby, concerns were raised about the Commission's tendency to act as surrogate financial regulator that had de facto become a 'central crisis management and resolution authority'[440].

The EU gave Member States a wide discretion to support their domestic banking industry[441] but gradually introduced stringent conditions and safeguards, which **were inter alia considered crucial in ensuring a smooth transition to the future regime** under the Single Resolution Mechanism (SRM) and Banking Recovery and Resolution Directive (BRRD). By requiring bail-in as a pre-condition for State aid, the recent Commission practice under the 2013 Banking Communication has provided a dry run for the incoming[442][443].

Indeed, especially the initial Commissions' Communications have been criticized for being too permissive and also gave rise to the claim that: "*rather than keeping State aid at bay, the Commission's efforts were simply directed towards providing national interventions with a patina of legal respectability*"[444]. The Commission exercised excessive forbearance towards national bailout measures seems to be based on a narrow view of the purpose of State aid control, a view that sees the role of State aid law as preventing any form of State intervention that distorts competition[445].

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[437] See **Admati and Hellwig (2013)**; **Desan C. (2014)**, Ch. 8.

[438] See **Gerard (2013)**, p. 231, outlining how State aid rules have been relied upon as a coordination tool and a regulatory fix, see also **De Vito, J. M. (2011)**.

[439] See among others **Fomperosa R. A. (2012).**

[440] See **Almunia J. (2013)**.

[441] This interaction between State aid rules and the new regulatory framework is highlighted by the Commission's assessment of the compatibility of State aid with the BRRD even before the transposition into national law of that directive. Commission Decision in State aid SA.41503 (2015/N) Panellinia Bank [2015] OJ C325/1; Commission Decision in State aid SA.41924 (2015/N) (ex 2015/PN) Banca Romagna Cooperativa [2015] OJ C369/1. See also **Lucchini et al. (2016)**, **Hlista, J. (2019)**, **Kokkoris I. (2013)**, **Schiavo (2014)**, **Goodhart, Ch. and E. Avgouleas (2014)**, p. 65, **Gerard (2013), Merola, J. D. and J. Rivas(2013)**, **Lopez P. (2015)**, p. 221 ff.

[442] See among others **Babis, V. (2016)**, who demonstrate the continuing importance of State aid approval both in and outside resolution with reference to the CJEU's judgment in Kotnik and Others (Case C-526/14).

[443] According to **Gerhardt, M. and Vander V. R. (2016)**, those interventions failed to plausibly restore the beneficiaries' profitability and the efficiency of their business models, albeit the relevant preconditions of the Restructuring Communication, as reinforced from the 2013 Banking Communication. See also **Kakes, J. and de Haan, L. (2018)**.

[444] See **Gray J. and De Cecco F. (2017)**, p. 27. However, the same authors express the view that eventually a sort of forbearance would be politically inevitable given the scale and the systemic wide repercussions of the crisis. In particular, they claim that: "*had the Commission adopted a rigid interpretation of the rules, it is likely that Member States would have resorted to Article 108(2) TFEU (which gives the Council power to override a Commission State aid decision) – an avenue that would have led to undermining the normative authority of State aid control*".

[445] See op. cit, ibid.

This Commission's power is exercised both ex ante through Commission guidelines and communications, as well as ex post via highly detailed conditions set forth in State aid decisions themselves.

A brief overview of the Crisis Communications[446]

1. **2008 Banking Communication**[447]: The main change of the 2008 Banking Communication[448] is that it switched the legal basis form 107(2b) to 107(3)(b) TFEU, i.e. aid to **remedy** a serious disturbance affecting the whole of the economy of that Member State, or at least several sectors rather than one region or sector. The Commission has already prior to the GFC acknowledged that the existence of a systemic crisis cannot be denied merely due to the fact that the systemic threat derives from one institution(cf. "too-big –to fail" regime), even when it is deemed likely to fail due to the idiosyncratic risk yielded by the its extreme business model[449]. It provided guidance for the institutional design of guarantee and recapitalization schemes, the winding up of insolvent financial institutions and the provision of other forms of liquidity assistance (like the ELA granted by the central banks). It also established the general principles for the provision of aid: **non-discrimination** among ailing financial institutions; limitation in time (until market conditions were normalized) and quantum (the private sector should put skin to the game and the sate guarantees must be properly remunerated); behavioral commitments (to ensure that they are not exploiting public subsidies to engage in aggressive expansion to the detriment of the other competitors); and the requirement to draft a restructuring or liquidation plan (in case of default or structural measures).

2. 5 December 2008 – **Recapitalization Communication**[450]: established guidance for the pricing of State capital injections, calibrated the risk profile of each beneficiary bank, the eligible capital instruments and the safeguards accompanying the recapitalization to avoid abuse of the public funding (point 28). The pricing mechanism needs to incentivize banks to keep the duration and quantum

[446] See in further detail, **Gray J. and De Cecco F. (2017)**, passim, **Galand, C. and Dutillieux, W. and Vallyon, E. (2017)**, **Fomperosa R. A. (2012)**.

[447] See Commission Communication on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis [2008] OJ C270/8.

[448] See P Lowe, 'State Aid Policy in the Context of the Financial Crisis' (2009) Competition Policy Newsletter 3. For an analysis of the impact of the Communications see **Schiavo (2014)**; **Psaroudakis (2012)**; **Ahlborn and D Piccinin (2011)**, **De Vito, J. M. (2011)**.

[449] See Commission Decision concerning aid granted by France to the Crédit Lyonnais group [1998] OJ L221/28, Commission Decision on State aid NN 70/2007 Rescue Aid to Northern Rock [2008] OJ C43/1, Commission Decision on State aid C 14/2008 Northern Rock [2010] OJ L112/38.

[450] See Commission Communication on recapitalisation of financial institutions in the current financial crisis: limitation of the aid to the minimum necessary and safeguards against undue distortions of competition [2009] OJ C10/2. See in detail **Rodriguez-Miguez, J. and Ojo D. (2010)**.

of State aid to a minimum, utilizing notably step-up remuneration rates (point 29), as an exit incentive. Additional safeguards to ensure that no undue competition distortions arises apply (point 8). The recapitalization schemes were also subject to monitoring and reporting to the Commission on how the State capital had been used (point 40) with particular emphasis on an exit strategy for fundamentally sound banks and a restructuring plan for distressed banks (point 42).

3. 25 February 2009 – **Impaired Assets Communication**[451]. Provided guidance on asset purchases, insurance and hybrid schemes and guidelines for the treatment of impaired assets, addressed transparency, valuation methodologies and disclosure of impairments, required the burden sharing between the State, shareholders and creditors and provided incentives to participate in asset relief programs[452]. Notably, it stipulates that the assets should be transferred at their real economic value so as not to shelter the bank against its expected losses. The asset relief measure should only cover the unexpected losses[453]. Indeed, losses deriving from the write-down of NPLs from their net book value (NBV) and exceeding the REV are to be borne by the bank (i.e. by private means)[454] and are not covered by the impaired asset aid, which should only protect banks from the so called "tail risk" in statistics jargon[455]. The REV premium is defined as the "underlying long-term economic value of the assets, on the basis of underlying cash flows and broader time horizon", disregarding the additional haircuts which private investors require because of the relevant market failures. If markets are efficient and liquid, the REV of assets equals the assets' market price[456]. The valuation of impaired assets should be conducted by independent experts and validated by the competent authority based on the valuation provisions in the Communication[457]. IAMs are not freed from additional requirements concerning restructuring aid, laid down in the Commission's Banking Communication of 2013 and the Restructuring Communication of 2009(*or any*

[451] See Commission Communication on the treatment of impaired assets in the Community banking sector [2009] OJ C72/1.

[452] See by mere indication the Commission Decision on the restructuring of Royal Bank of Scotland following its recapitalisation by the State and its participation in the Asset Protection Scheme, (Case N 422/2009 and N 621/2009) [2010] OJ C119/1 (Commission Decision on the restructuring of Royal Bank of Scotland), the Commission Decision C(2011) 6483 on State aid granted by Germany to HSH Nordbank AG SA.29338 (Case C-29/09 (ex N 264/09)) [2012] OJ L225/1, the Commission Decision Fortis Banque Luxembourg and Fortis holding (Case N 255/2009 and N 274/2009) [2009] OJ C178/2, Commission Decision C(2009)9000 of on ING's Illiquid Assets Back Facility and Restructuring Plan (Case C-10/09 (ex N 138/09)) [2010] OJ L274/139.

[453] In that context, the difference between EMV and REV should be clawed back from the bank over time.

[454] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 29.

[455] See **Galand, C. and Dutillieux, W. and Vallyon, E. (2017)**, p. 146.

[456] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 50-51.

[457] See in detail the various valuation methods, employed by the Commission, as a State Aid authority, see **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 51-52.

other applicable State aid Communication depending of the state aid measure employed, e.g. Recapitalization Directive for any direct capital injection).

4. 14 August 2009 – **Restructuring Communication**[458]: incorporated guidelines which addressed the transparency and disclosure of impairment, aimed at the restoration of long-term viability, ensured adequate burden sharing (limitation of restructuring costs, significant own contribution) and frequent monitoring and compelled structural and behavioral remedies(namely requirements to divest subsidiaries or branches, portfolios of customers etc. and acquisition bans) in order to ensure that State aid would not be used to fund anti-competitive behavior[459].

5. 1 December 2010 – 2010 **Prolongation Communication**[460]: It tackled three main aspects: (i) the prolongation of the Restructuring Communication until 31 December 2011 and the continued applicability of Article 107(3)(b) TFEU; (ii) the advancement of the exit process; and (iii) the introduction of an uniform requirement to submit a restructuring/liquidation plan(irrespective of the beneficiary bank's financial situation), while urging for a gradual disengagement from the temporary extraordinary support.

6. 1 December 2011 – 2011 **Prolongation Communication**[461]: Introduced four main changes: (i) extended the rules beyond 31 December 2011; (ii) upgraded the remuneration requirements of State capital injections; (iii) allowed a more flexible approach concerning the Commission's assessment of the ailing banks' long-term viability amidst the sovereign debt crisis; and (iv) introduced a revised methodology on pricing of guarantees on bank liabilities.

7. **2013 Banking Communication**[462].

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[458] See Commission Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules [2009] OJ C195/9.

[459] See relevantly Commission Decision on the State aid C18/09 (ex N 360/09) implemented by Belgium for KBC [2010] OJ L188/24, Commission Decision on the restructuring aid to Fortis Bank and Fortis Bank Luxembourg [2009] OJ C80/7, Commission Decision C(2009)9000 on ING's Illiquid Assets Back Facility and Restructuring Plan (Case C-10/09 (ex N 138/09)) [2010] OJ L274/139, Commission Decision on the restructuring of Bank of Ireland (Case N 546/2009) [2011] OJ C40/9, Commission Decision on the restructuring of Allied Irish Banks plc and EBS Building Society (Case SA.29786 (ex N 633/2009), SA.33296 (2011/N), SA.31891 (ex N 553/2010), N 241/2009, N 160/2010 and C25/2010 (ex N 212/2010)) [2015] OJ L44/40, c.f. Commission Decision on aid granted by France to the Crédit Lyonnais group (Case C-47/1996) [1998] OJ L221/28.

[460] See Commission Communication on the application, after 1 January 2011, of State aid rules to support measures in favor of banks in the context of the financial crisis [2010] OJ C329/7.

[461] See Commission Communication on the application, from 1 January 2012, of State aid rules to support measures in favor of banks in the context of the financial crisis [2011] OJ C356/7.

[462] See Commission Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis [2013] OJ C216/1.

In order to avoid undue distortion of competition, it introduced two main changes[463] to the existing rules: (i) a more effective restructuring process, and (ii) strengthened burden sharing requirements. It also contextualized liquidation aid and introduced strict executive remuneration policies, setting a cap on total remuneration, as long as the entity is under restructuring or relying on State support in order to incentivize the bank's management to implement the restructuring plan and repay the aid. The Commission insisted on the need for a reduction of the banks' post-restructuring business activities[464], through divestments (such as the sale of participations and portfolios), reduction of business activities (reduction of branches, cessation of certain business activities and production areas, etc.) and greater balance sheet reductions compared to bank restructuring cases prior to the crisis.

In particular, contrariwise to the relatively more lenient provisions of Restructuring Communication[465], under which, once their bail-out had been achieved, the aid beneficiaries did not always have strong incentives to implement the restructuring measures, banks were required to adopt a restructuring/resolution plan[466], subject since the Banking Communication 2013 to **ex ante** approval by the Commission, i.e. before they can receive recapitalizations or asset protection measures. However, the option of rescue aid has not been totally abandoned and was permitted under exceptional and stringent preconditions[467].

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[463] See **Lienemeyer, C Kerle, and H Malikova (2013)**.

[464] Before the crisis, the Commission usually required reduction in business volume of restructured banks amounting to even more than 50 per cent, in cases banks benefit from IAMs, see Commission Decision in Case C-14/2008 on the State aid implemented by the United Kingdom for Northern Rock [2010] OJ L112/38 and Commission Decision in Case C-15/2009 – Hypo Real Estate – Decision to extend proceedings and temporary approval of capital injections [2010] OJ C13/58, 68. In some cases, the commitments imposed by the Commission on State aid measures conflict to some extent with the main objectives of banking functions(see Case T-319/11, ABN Amro Group NV v Commission, ECLI:EU:T:2014:186), provided that a reduction of a bank's balance sheet achieved by reducing the loans granted limits liquidity to the real economy and the imposition of significant divestments may lead to systemic effects and distortions of competition, see **Kokkoris I. (2017)**, p. 13.

[465] See in detail its relevant provisions regarding the newly then introduced restructuring plans, **Giannino, M. (2010)**.

[466] If long-term profitability is not a viable option for the bank, a winding down plan needs to be submitted and approved. In particular, Member States must provide a plan for the orderly liquidation of the credit institution. The institution must not compete on the market or pursue any new activities. In addition, any sale of a credit institution during an orderly liquidation procedure may entail State aid to the buyer, unless the sale is organized under the 'arm's-length' principle. If the sale is deemed to be State aid then this will be assessed by the Commission in accordance with the Communication. See in detail Banking Communication, paras. 72 and 88.

[467] A recapitalization or impaired asset measure can exceptionally be authorized by the Commission on a temporary basis as rescue aid before a restructuring plan is approved, provided that the conditions in point 50 are met, namely: i) the measure must preserve financial stability; ii) the competent supervisory authority has to confirm that there is an exceptional risk to financial stability which cannot be averted with private capital within a sufficiently short period of time or by any other less distorting temporary measure such as a State guarantee on liabilities; iii) that a current (not prospective) capital shortfall exists, which would force the supervisor to withdraw the institution's banking licence immediately if no such measures were taken. Finally, if the Commission provides temporary approval, the 2013 Banking Communication shortens the deadline by which a restructuring plan must be submitted from six to two months from the authorization date.

The restructuring plan has to guarantee the long-term viability and profitability of the beneficiary credit institution and includes a capital-raising plan, including capital raising measures by the bank and potential burden-sharing measures. Long-term viability is achieved[468] when a bank is able to cover all its costs including depreciation and financial charges and provide an appropriate return on equity, taking into account the risk profile of the bank[469]. The restructured bank should be able to compete in the marketplace for capital, abidingly comply with its regulatory capital requirements and redeem any State aid received over time.

As regards the strengthening of the Burden Sharing Requirements, the 2013 Banking Communication provides that before granting any public restructuring aid (recapitalization or impaired asset protection), all capital generating measures[470] including the conversion of junior creditors[471] **should be exhausted[472]**, notably via write-down and/ or conversion of equity, hybrid capital and **subordinated debt holders[473]** , provided that the '**no creditor worse off'[474]** principle is complied with. However, some have expressed concern that bail-in may run into insurmountable obstacles in the context of a systemic crisis, in particular, where large interconnected banks are concerned[475].

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[468] The sale of an ailing bank to another financial institution can contribute to the restoration of long-term viability, if the purchaser is-without recourse to state aid- viable and capable of absorbing the transfer of the ailing bank.

[469] See **Galand, C. and Dutillieux, W. and Vallyon, E. (2017)**.

[470] Such capital generating measures include namely rights issues, voluntary conversions of subordinated debt instruments into equity, liability management exercises, sales of assets and portfolios, securitization of non-core portfolios, and employee earnings restrictions (2013 Banking Communication para. 35-39).

[471] During the GFC and sovereign crisis, creditors were not mandatorily required to contribute to rescuing credit institutions as there were no burden-sharing requirements. It quickly became common sense that Member States faced significant fiscal difficulties in intervening to ensure financial stability. In response, they introduced a new legal framework to enforce stricter ex ante burden sharing requirements. Some Member States introduced bail-in requirements of investors or creditors, while others refrained from such measures. This led to divergent funding costs between banks depending on the perceived likelihood of a bail-in. See relevantly Banking Communication, 2013, ibid, para. 18.

[472] See Commission Decision on Restructuring of NLB which Slovenia is planning to implement for Nova Ljubljanska banka d.d. (Case SA.33229) (2012/C) (ex 2011/N) [2014] OJ L246/28; Commission Decision on Restructuring of Nova Kreditna Banka Maribor d. d. (NKBM) (Case SA.35709) (2013/N) [2014] OJ C120/3; Commission Decision on Orderly winding down of Probanka d. d. (Case SA.37642) (2013/N) [2014] OJ C69/18; Commission Decision on Orderly winding down of Factor Banka d. d. (Case SA.37643) (2013/N) [2014] OJ C69/18; Commission Decision C(2013) 9633 on rescue aid to Abanka (Case SA.37690) [2014] OJ C37.

[473]In order to tackle any concerns about potential bail-in of depositors, point 42 clarifies that the Commission will not require contribution from senior debt holders (in particular from insured deposits, uninsured deposits, bonds and all other senior debt). On the junior debtholder participation, see Commission Decision C(2015) 8930 of 4 December 2015 on the Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece (Case SA.43365)) and Commission Decision C(2015) 8626 of 29 November 2015 on the Amendment of the restructuring plan approved in 2014 and granting of new aid to Piraeus Bank (Case SA.43364).

[474] See **Gortsos, Christos (2021c)**, passim.

[475] See by mere indication **Goodhart, Ch. and E. Avgouleas (2014)**, **Micossi, S., Bruzzone, G. and M. Cassella (2014)**, **Ventoruzzo, M. and Sandrelli, G. (2019)**.

Under the 2013 Banking Communication, the Commission can make two exceptions to the burden sharing requirements, that is, when the implementation of writing down or conversion of subordinated creditors would lead to disproportionate results or would endanger financial stability (point 45). This could cover cases where the aid amount to be received is small in comparison to the bank's risk-weighted assets and the original capital shortfall has been significantly reduced through capital raising measures[476]. It should be noted that pursuant the Temporary State aid framework provisions[477]: "*If due to the COVID-19 outbreak, credit institutions would need direct support (…) in the form of liquidity, recapitalisation or impaired asset measure, it will have to be assessed whether the measure meets the conditions of Article 32(4), point (d) (i), (ii) or (iii) BRRD. Where the latter conditions were to be fulfilled, the credit institution receiving such direct support would not be deemed to be failing-or-likely-to-fail (…). To the extent such measures address problems linked to the COVID-19 outbreak, they would be deemed to fall under point 45 of the 2013 Banking Communication, which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors*".

In any case, the Banking Communications should be interpreted in accordance with the Treaty Principle of Proportionality[478]. In this context, Advocate General Wahl in the Kotnik case[479] argued that the only binding legal rule is Article 107. However, the Court of Justice laid down instead some guidance[480] on how the Communication should be interpreted holding it as binding.

Step 2: overcoming the barriers of Article 32(4) BRRD/ 18(4) SRMR preconditions.

[476] See Commission Decision C(2015) 8486 of 26 November 2015 on the Amendment of the restructuring plan approved in 2014 and granting of new aid to Eurobank (Case SA.43363), Commission Decision C(2015) 8488 of 26 November 2015 on the Amendment of the restructuring plan approved in 2014 and granting of new aid to Alpha Bank (Case SA.43366) and Commission Decision on the Amendment of the Restructuring of CEISS through integration with Unicaja Banco (Case SA.36249) (2014/N-3) [2014] OJ C141/1.

[477] See European Commission, Communication from the Commission, Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak, 8 May 2020, para 7. See among others **Brescia M. C. (2021)**, who analyzes why indirect aid, in the form of moratoria and public guarantees and subsidies to distressed due to the pandemic crisis borrowers, does not have the objective of preserving or restoring the viability, liquidity or solvency of the credit institutions, it cannot be considered an extraordinary financial support as defined in the BRRD.

[478] See **Micossi, S., Bruzzone, G., and Cassella, M. (2016)**. On the other hand, **European Court of Auditors' Special Report 21/2020**: Control of State aid to financial institutions in the EU: in need of a fitness check, it is noted that albeit market realities improved and that the regulatory framework had radically changed, the applicable State aid rules themselves have not been modified since 2013.

[479] See opinion of Advocate General Wahl, case C-526/14, Tadej Kotnik and Others v Državni zbor Republike Slovenije, 18 February 2016.

[480] According to **Avgouleas E., Goodhart C.A. (2017), pp. 109-110,** the Court's ruling, if read in conjunction with para. 45 of the Commission Banking Communication about exceptional circumstances, leads to the conclusion that exempting subordinated creditors from mandatory burden sharing will not endanger the legality of the scheme.

Precautionary recapitalisation is the only form of State aid that can be given under exceptional[481] circumstances, which – provided that the conditions set out in Art. 32(4)(d)(iii) of the BRRD are complied with – does not trigger a "failing or likely to fail" (FOLF) determination for the bank. Its premise is to provide an extra capital buffer to the beneficiary bank, which is likely to become distressed if economic conditions were to worsen materially[482]. The Commission has already used the exception under Article 32(4)(d)(ii) to approve **prolongation of existing guarantee schemes** in 2015 (the Cypriot[483], Greek[484], Polish[485], and Portuguese[486] guarantee schemes), albeit the most cited case is the infamous precautionary recapitalization of Monte Di Paschi Siena.

Article 32(4)(d)(iii) of the BRRD indicates that precautionary recapitalisation takes the form of "an injection of own funds or purchase of capital instruments", namely all CET1, AT1 and T2 capital instruments, as defined in the CRR[487]. Nonetheless, precautionary recapitalisation can also be used in the specific case of a transfer of impaired assets to a publicly supported AMC, where the objectives pursued by such a transfer are the same as in case of a direct capital injection[488], provided that the specific State aid conditions for impaired asset measures (IAMs) are also respected[489].

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[481] On the fact that rigid strict legislative rules could make it difficult for supervisors and resolution authorities to pursue their mandates to financial stability, see **Brescia M. C. (2019)**, pp. 349-380.

[482] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 34-35.

[483] See Commission Decision C(2015) 4819 on the Sixth Prolongation of Cypriot guarantee scheme for banks H2 2015 (Case SA.42080) [2015] OJ C277.

[484] See Commission Decision C(2015) 4452 on the Prolongation of the Greek financial support measures (Art. 2 law 3723/2008) (Case SA.42215) [2015] OJ C277.

[485] See Commission Decision C(2015) 5892 of 24.8.2015 on the Twelfth prolongation of the Polish bank guarantee scheme – H2 2015 (Case SA.42560).

[486] See guarantee scheme – H2 2015 (Case SA.42560), not yet published. 69 Commission Decision C(2015) 5084 on the Twelfth Prolongation of the Portuguese Guarantee Scheme (Case SA.42404) [2015] OJ C369.

[487] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 35.

[488] Cf. **Mesnard, A. Margerit and M. Magnus (2017b),** who following a de lege lata interpretation argue that such Impaired Asset Relief Measures fall out of the scope of the precautionary recapitalization, provided that the eligible extraordinary public financial support consists in "an injection of own funds or purchase of capital instruments".

[489] As **Reynolds, B. and Teo, E. (2016)** point out, there is no legal basis providing the resolution authority with the power to enforce burden sharing in the context of a precautionary recapitalization. The only potential tool under the BRRD would be the power to write down or convert relevant capital instruments under art.59 BRRD. However, precautionary recapitalisation can only be used if the mandatory circumstances set out in art.59(3) are not present at the time the precautionary recapitalisation is granted, thereby ruling out the use of art.59(3) to effect burden-sharing. Germany has identified this issue, which is why the German resolution authority have been explicitly granted the power to exercise write down or conversion powers to facilitate compliance with burden-sharing requirements arising from precautionary recapitalisation. On the other hand, as already evidenced from the English High Court ruling of Goldman Sachs International v Novo Banco SA [2015] EWHC 2371 (Comm) and the Munich Court ruling of Bayerische Landesbank v Heta Asset Resolution, LG München I (32 O 26502/12), NZG 2015, 1119, it is not legally clear whether such national provisions in BRRD's implementing laws which overshoot the BRRD minimum requirements and grant more powers to national resolution authorities will be recognised in other Member States under the mutual recognition provisions set out in BRRD art.66. Especially as regards the burden sharing of the junior debtholders, things get more complicated, as if the credit institution is not deemed FOLF, then in principle the junior

The precautionary recapitalisation is required "to remedy a serious disturbance in the economy of a Member State and preserve financial stability". In addition, the aid "shall be of a precautionary and temporary nature" and must be "proportionate to remedy the consequences of the serious disturbance".

In case of an IAM, the bank is allowed to sell the NPLs at a price higher than market price (but not exceeding the assets' real economic value (REV)) in order to mitigate the upfront capital impact. In order to comply with the temporary nature of the State aid, the extraordinary public financial support must be limited in terms of time and quantum.

According to the **EC's Staff Working Document on AMC Blueprint (2018),** to this effect, the following safeguards could apply(preferably, cumulatively):

1. a conservative assessment of the assets' EMV and REV to ensure that unlikely losses are correctly identified;
2. the AMC liability side should be designed in a manner that reduces the overall risk for the State (e.g. a preference for guarantees over direct financing to the AMC, attracting private capital and funding to the maximum extent possible);
3. a clear exit strategy for the State, usually through the utilization of hybrid capital instruments with a predetermined maturity date (namely contingent convertible bonds) or even shares, provided that the State commits to sell them in the secondary market within a restrictive timeframe. The term 'precautionary' suggests that the aid will result in the creation of prudential buffers in the bank to enhance its capital resilience against unexpected losses.
4. where the estimated market price cannot sufficiently reflect the risk of a [further] deterioration of the market situation, a mechanism ensuring that the State will not bear losses higher than the difference between the transfer price and the market value.
5. When the AMC is backed by public guarantees, the latter should be limited in terms of time and quantum and subject to conditionality and procedural safeguards. As already mentioned, remuneration clauses featuring a step-up mechanism on these guarantees could be added to incentivise the AMC to end its reliance on State support as soon as possible, hence further limiting the State's involvement.

debtholders(especially those senior to Additional Tier 2 capital instrument, including the bail-inable creditors of the infamous MREL), wouldn't be affected and thus the NCWO principle would render in principle any burden sharing involving them void. See **De Serière V. and Milione L. (2019), p. 80.** Interestingly, in the case of MPS, SNS Reaal NV in the Netherlands and of Banco Popular Español in Spain, retail junior debtholders were to be protected if and to the extent that they were misled as to the risky nature of their investment. See **De Serière V. and Milione L. (2019), p. 80, Götz M.R. and Tröger T.H. (2016), Resti A. (2016).** As regards the general controversy whether retail investment in core capital instruments issued by banks should be permitted at all, see **Tröger T.H. (2019).** Ad hoc on retail investment in bail-in-able liabilities consisting the MREL loss absorbing cushion, see article 44a BRRD.

The beneficiary bank's solvency pursuant to the BRRD/SRMR should be verified by the competent supervisory and, under certain conditions, the resolution authority. In past cases, the ECB has determined a bank as solvent based on the fact that it meets the own funds requirements (Pillar 1) set out in Art. 92 CRR[490].

In the context of a stress test and/or AQR[491], this implies that the bank should not have any shortfall of regulatory capital following the AQR and under the baseline scenario of the stress test (or the relevant shortfalls are covered by private means).

Furthermore, the beneficiary bank must not be deemed FOLF[492] based on the criteria set out in Art. 32(4)(a/b/c) of the BRRD, notably that: *(i) the bank does not (and is not expected in the near future to) infringe its authorisation requirements in a way that would justify the withdrawal of its license, (ii) the bank's assets are not (and are not expected to be in the near future) less than its liabilities, and (iii) that the bank is (and is expected to be in the near future) able to pay its debts or other liabilities as they fall due.*

Precautionary recapitalization budget in the presence of a transfer of NPLs to a state-backed AMC.

It must be determined to identify the total maximum aid that can be granted, quantified on the basis of the capital shortfall which emerged from the stress test/ AQR's stressed/ adverse scenario. In principle, if the precautionary recapitalisation budget has not been fully depleted by the impaired asset aid, the difference may be injected in the bank as direct recapitalisation aid**[493]**.

In this context, a precautionary recapitalisation "shall not be used to offset losses that the institution **has incurred or is likely to incur in the near future**", as defined in the context of Union or SSM-wide stress tests, asset quality reviews(**AQRs[494]**)or equivalent exercises by the European Central Bank, EBA or national authorities, conducted in line with the applicable EBA guidelines[495] to identify incurred or likely to incur losses[496] that cannot be covered by the precautionary recapitalisation. Banks should not have any shortfall of regulatory capital following the AQR and under the baseline scenario of the stress test, unless

[490] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 36.
[491] See EBA, Guidelines on the types of tests, reviews or exercises that may lead to support measures, 2014-09.
[492] See EBA, Guidelines on the interpretation of different circumstances when an institution shall be considered as failing or likely to fail, EBA/GL/2015/07 (2015).
[493] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 37.
[494] Critically on the mechanistic reliance to AQRs and the latter's creditworthiness, see Kasinger et al (2021).
[495] See EBA, Guidelines on the types of tests, reviews or exercises that may lead to support measures under Article 32(4)(d)(iii) of the Bank Recovery and Resolution Directive, EBA/GL/2014/09, 22 September 2014.
[496] In particular, while likely losses may include losses necessary to comply with the requests of the supervisor, they should not include losses stemming from competition measures necessary to authorize the State aid, see **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 37-38.

the relevant shortfalls are covered by private means[497], including capital generated by burden-sharing through the write-down or conversion of AT1 and T2 capital[498]. In case private means are insufficient to cover incurred and likely losses, precautionary recapitalisation cannot be granted and the ailing bank is deemed FOLF. Only the losses emerging from the **adverse scenario of a stress test conducted together with an AQR** (cleared from overlaps, if any, with those of the baseline scenario) could in principle be eligible to be covered by the precautionary recapitalisation as they correspond to unlikely losses[499] in order to render the ailing bank able to meet, after receiving the aid, its prudential requirements set by the CRR, including bank-specific extra capital charges imposed by its supervisor under Pillar II SREP. When the amount identified with the precautionary budget exceeds this threshold, an assessment should be made of whether aid up to the precautionary budget is needed and adequate to address the serious disturbance[500].

De Lege Ferenda Proposals for (temporary) amendments of the Precautionary Recapitalization framework and some considerations regarding the EU resolution and crisis management framework amidst the pandemic crisis

Gortsos et al. (2020)[501] argue that given the high bar[502] set in the recent past by the Single Resolution Board (SRB) for the submission of failing or likely to fail (FOLF) credit institutions to resolution[503], and the necessity to avoid massive credit institutions' liquidations-*possibly financed through public resources under the abovementioned liquidation aid*- a temporary, revised and standardised form of privately and publicly funded[504] precautionary

[497] They inter alia include CET1 capital in excess of Pillar 1 minimum requirements, cash deriving from asset sale proceeds, CET1 new issuances. On the most recent case of Greece, see **Bodellini (2016), Reynolds, B. and Teo, E. (2016).**

[498] See **EC's Staff Working Document on AMC Blueprint (2018)**, p.38.

[499] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 37-38.

[500] See **EC's Staff Working Document on AMC Blueprint (2018)**, p.38.

[501] See in detail **Gortsos, C., Siri, M. and Bodellini, M. (2020)**, passim. For similar considerations as regards the need to review the precautionary recapitalization framework, see **B. Mesnard, A. Margerit and M. Magnus (2017b), Véron N. (2017).**

[502] As **Meccati I. (2020)** craftily stipulate, "resolution is for the few, not the many. The so called "middle class" - less significant banks and significant not subject to resolution - will be liquidated under the national insolvency procedure (not-yet-harmonized).", cf. **Hadjiemmanuil, (2014),** arguing that resolution "would turn out to be the rule rather than the exception".

[503] See **Lastra - Russo – Bodellini (2019)**, **B. Mesnard, A. Margerit and M. Magnus (2017a).**

[504] The authors argue that given the activation for the first time ever of the so called 'general escape clause' of the Stability and Growth Pact (SGP) and the more lenient Commission's temporary state aid framework, which, however, is sparing as regards state aid granted to credit institutions, with the sole exception of the more lenient "burden sharing" waiver in conjunction with par. 45 of 2013 Banking Communication, the main legal constraints refraining Member States from supporting their economies through the use of public money are mitigated. See also in this context **Delivorias (2020)** and **Hadjiemmanuil (2020a)**, p. 189. The authors also argue that an other de lege ferenda argument is that it seems unfair to make shareholders and, even more so, creditors suffer losses, which they do not have responsibility for. This seems to clime with the established perception regarding Bail-in, as eloquently expressed by **Goodhart, Ch. and E. Avgouleas (2016): "** *(bail-*

recapitalisation, designed beforehand and operating on an quasi-automatic basis, is needed. In this context, they advocate a temporary amendment of the so-called precautionary recapitalization through a legislative reform[505] of the Single Resolution Mechanism Regulation (SRMR), with the major involvement of the European Stability Mechanism (ESM)[506], which should be kept in place until the pandemic crisis will be over[507]. The ultimate aim and the very premise for the ESM's involvement is to make this tool available on a larger scale, in essence for every (significant) credit institution under the SRB's remit whose resolution plan provides for resolution, irrespective of the fiscal capacity of their home Member State, in order to prevent novel "doom-loop" effects[508].

In particular, this should be combined with an ESM facility- namely based on the existing Enhanced Conditions Credit Line (ECCL)[509], given the member state's heretofore reluctance[510] to use the 'Pandemic Crisis Support' instrument[511]- allowing it to buy hybrid in-

*in) replaces the public subsidy with a **private penalty** (..) meant to force creditors to intensify bank monitoring, thereby helping to restore market discipline and become more alert about the levels of leverage a bank carries*". Indeed, in compliance with our legal culture, a penalty demands a fault on the part of the bank's shareholders or management. However, in the author's view, this doesn't have to be the case. Shareholders and junior creditors assume risks that also entail such tail events. The internalization of the relevant cost from the state merely due to the fact that its route cause did not derive from bank idiosyncratic failures or risks but from an exogenous macroeconomic shock does not seem persuasive. What it appears more than persuasive, is the point that the bail-in centred EU resolution framework have not yet been tested in the context of a systemic crisis, where the contagion interlinkages could create a real systemic threat and that taking into consideration the yet inadequate cushion of bail-inable instruments[*MREL, notwithstanding voices in literature that argue that even MREL is not enough, see among others **Tröger T. H. (2020)***)], **Carabellese (2019), Maragopoulos (2020)**], it seems unlikely to resolve such a systemic distress, see **Mayes D. (2017)**. Contrariwise, it could exponentially aggravate it. See in the same vein, **Gortsos, Ch.V. (2020c)**, **Tröger T. H. (2015)**; **Bodellini M. (2018),** passim. As **Goodhart, Ch. and E. Avgouleas (2014)**, point out: "*bail-in regimes will fail to eradicate the need for an injection of public funds where there is a threat of systemic collapse, because a number of banks have simultaneously entered into difficulties, or in the event of the failure of a large complex cross-border bank, except in those cases where failure was clearly idiosyncratic*", cf. **Kokkoris I. and Rodrigo Olivares-Caminal (2016)**, pp.304–305, arguing that the 8% threshold to be covered through bail-in according to the BRRD would in principle suffice, taking past EU bail-out cases into consideration.

[505] As the authors aptly stipulate, the alternative option to make the BRRD/ SRMR's rigid preconditions more lenient and flexible through praeter legem interpretations or even discretionary supervisory forbearance, fully disconnected from law provisions, should be overruled, as it creates unreasonable legal uncertainty and potentially leads to cross border discrepancies. See also **Bodellini – Lintner (2020)**.

[506] Since the role of the ESM is confined to Member States whose currency is the euro, the relevant part of the proposal is regrettably limited to credit institutions operating in the euro area.

[507] See **Tröger, T.H. (2018)**, arguing that the precautionary recapitalization tool was arguably envisioned by European legislators to fend off systemic crises where creditor loss participation through a bail-in would prove counterproductive. COVID-19 pandemic is a par excellence example of such systemic threat.

[508] See among others **Navaretti, G.B., Calzolari, G., and Pozzolo, A.B. (2016).**

[509] See among others **Forsthoff – Aerts (2020).**

[510] See also **Schularick - Steffen – Tröger (2020)**, p. 14-16. From their point of view, since the European Recovery Fund has superseded the ESM as a crisis-fighting tool, freeing up these financial resources, it is wise to redirect these resources to build a strong and integrated European banking system.

[511] It should be reminded that this new temporary instrument was made operational by the ESM Board of Governors pursuant to article 5 of the ESM treaty on 15 May 2020 as a response to the Covid-19 pandemic

struments issued by the credit institutions that would need to be recapitalized. In this regard, the ESM could raise the resources needed by issuing senior bonds on the market to be then used to buy contingent convertibles (CoCos) with characteristics enabling them to be included in the credit institutions' Common Equity Tier 1 (CET1) capital, as was the case in Greece in 2015[512], with a view to divesting as soon as the market conditions will allow it. In order to mitigate the potential financing mismatch (*provided that the senior bonds will have in principle shorter maturity than the high trigger CoCos, which are mainly perpetuities*) and de-incentivize early redemption of the senior bondholders, the issuing senior bonds could be stapled cum warrants, i.e. call options to buy, at pre-determined conditions, the CoCos previously purchased by the ESM. A further alternative could be to enable ESM bondholders to convert CoCos in ordinary shares of the credit institution after a given timeframe.

Special governance features should be incorporated to empower the ESM to monitor the credit institutions' activity against some targets designed to allow them, over time, to redeem the issued instruments. Such monitor tools and potentially penalizing mechanisms include the prohibition of dividend distributions, own share buying-backs and paying out bonuses and variable remunerations to senior management and material risk-takers for a given period of time and in any event until when the institution becomes able to repay the ESM's investment. In any case, such financial, structural and behavioral constraints would be imposed in the context of the Commission's approval in accordance with the above-mentioned state aid framework.

The involvement of the ESM should not, however, discourage private equity financing. Contrariwise, the authors adopt a polar inception, thereby suggesting that such a widespread presence of the ESM in the (regulatory) capital of several credit institutions in the BU, although without strong and formal prerogatives, could pave the way for a cross-border consolidation of the sector[513].

As regards the targeted temporary amendments[514] to the precautionary recapitalization framework amidst the pandemic crisis, the following shall apply:

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to enable investments in the health sector. For further detail on that instrument, see among others **Hadjiemmanuil (2020a)**, p. 198-206.

[512] See among others **Bodellini (2016)**. See also European Commission, State aid: Commission approves aid for Piraeus Bank on the basis of an amended restructuring plan, Press Release IP/15/6193, 29 November 2015, https://ec.europa.eu/commission/presscorner/detail/en/IP_15_6193; and European Commission, State Aid SA.43365 (2015/N) – Greece, Amendment of the restructuring plan approved in 2014 and granting of new aid to National Bank of Greece, C(2015) 8930 final, 4 December 2015, https://ec.europa.eu/competition/state_aid/cases/261565/261565_1733770_121_2.pdf.

[513] See verbatim **Gortsos, C., Siri, M. and Bodellini, M. (2020)**, p. 17.

[514] See also **Olivares-Caminal R. and Russo C. (2017), pp. 10-11,** advocating the amendment of art. 32(4) BRRD, 18(4) SRMR, to allow recourse to the precautionary recapitalization tool in order to **avoid** a serious disturbance in the economy, alongside the remedial part, thereby providing greater flexibility to the authorities.

At first, the authors advocate potential supervisory forbearance and flexibility as regards even the FOLF criterion to incorporate the special needs resulting from the Covid-19 pandemic[515]. Besides, in any case, this capital relief and flexibility has already been incorporated in the EU banking regulation, taking into consideration the relevant CRR quick fix and CRD V capital and supervisory measures rules, as well the relevant ECB's supervisory microprudential measures and the relevant national authorities' macroprudential measures.

In this context, the authors propose the introduction of a timeline (i.e. the World Health Organisation's (WHO) pandemic declaration on 11 March 2020). For the purposes of the proposed revised precautionary recapitalisation, only loans which have become non-performing due to repayment defaults occurred after the WHO declaration will be relevant. Accordingly, credit institutions which already had less assets than liabilities before 11 March 2020 will not be considered solvent, while the ones whose liabilities have exceeded the assets as a consequence of their requalification as NPLs due to defaults occurred after the WHO declaration will keep on being considered solvent for the purposes of the proposed temporarily amended precautionary recapitalisation.

Secondly, concerning the condition that the capital increase should be limited to injections needed to address capital shortfall resulting from stress tests and asset quality reviews, a standardised, yet case-by-case, assessment of capital shortfall could be performed by supervisory authorities, as an alternative to system-wide stress tests, with a view to determining the amount of losses to cover.

Finally, as regards the criterion that the measure should not be used to offset losses that the institution has incurred or is likely to incur in the near future[516], this requirement should be either temporarily waived or at least exclude from its scope losses resulting from the Covid-19-inhereted NPLs which, when materialized, will have to be accounted and subsequently written off, thereby leading to losses(*which are considered at best as ' likely to incur in the near future', according to the wording of Article 18(4) SRMR*). As a consequence, losses arising from loans which have become NPLs due to repayment defaults occurred after the WHO declaration on 11 March 2020 would not be considered likely future losses relevant to rule out the application of such tool.

In this context, **Auguleas et al.(2021a)** propose an alternative way to overcome that issue through the utilization of precautionary recapitalisation alongside an AMC solution. Schematically, precautionary recapitalisation can follow the disposal of the- legacy or COVID-

[515] See also in the same context **Gortsos, Ch.V. (2020c)**, 384.

[516] According to **Hadjiemmanuil C. (2016)**, that provision is mainly the one that renders the precautionary recapitalization tool practically inapplicable for the restoration of banks that carry substantial amounts of NPLs, despite the fact that it is precisely these banks that are likely to initiate contagion. In this context, precautionary recapitalization "*cannot be credibly relied upon for the repair of a distressed national banking system as a whole, but only for the creation of a second line of defence in favor of stronger banks in the system. This may contain the troubles, but not prevent them altogether*".

inherited-NPLs(eg. to an AMC), so as to mitigate concerns that precautionary recapitalisation would be used to offset incurred losses. The flip side is that in this case no IAM (eg. AMCs/ APSs) could in principle benefit from further public backstop, according to the current state of the art of the State Aid rules.

This seems prima facie astute. Indeed, in this way banks who could under the baseline scenario absorb the losses and consequent capital depletions with their own funds, could be potentiated and armed with a paramount capital cushion which could allow them to keep lending to the real economy without posing any threat to financial stability.

However, this scheme-without the abovementioned legislative amendment and procedural standardization- could still raise concerns and create legal uncertainty as regards its compatibility with the precautionary recapitalization framework, provided that in this manner the abovementioned prohibition could be considered as obliquely circumvented.

And here is why.

Imagine that, instead of inflating the transfer price or ex ante provide credit institutions with precautionary capital cushions, we decide to let the participating bank to take the full hit with a transfer of NPLs to an AMC/ SSPE at market prices and then, when concerns about its actual capital resilience begin to arise, recapitalize them.

However, in this case, one endangers the potential eruption of a downslope spiral that could threat financial stability, as it is possible that many banks simultaneously will need recourse to such a public backstop(*whilst without the abovementioned amendments and procedural standardization, recourse to it would be assessed on a case-by-case basis, with the outcome of such assessments being at best questionable*). Notwithstanding the above, in this case the stringent precautionary recapitalization's preconditions-namely the no- FOLF condition- may not be complied with, especially for high NPL banks.

Indeed, if the credit institutions could in principle easily absorb the full hit of a transfer at **market(and not at REV premiums** pursuant to Asset Protection Schemes, provided that, as already mentioned, the "State aid envelope" would probably be exhausted) prices for most legacy and novel COVID-inherited NPLs and concerns would arise only for their ability to abidingly comply with the Pillar 2 Guidance (*or even the new capital requirements standard after the partial depletion of the combined buffer and the temporary amendments introduced by CRR quick-fix and CRD V*) requirements afterwards, everything would be easier and possibly access to private equity financing, which is always the default rule, could be feasible. However, this hardly seems to be the case, especially for some high NPL banks(and national banking systems).

Consequently, many banks would either not be deemed to surpass the baseline scenario, or could be deemed eligible for precautionary recapitalization, just because the actual full impact of the pandemic has not yet materialized, whilst they are actually not. In other

words, either both the "not FOLF" and " no likely losses offset" criteria would be circumvented(if not clearly breached), or a massive wave of resolutions/ liquidations could be triggered.

This is why such a standardized precautionary[517] backstop facility[518], preferably, in the author's view, in the form of guarantees and other contingent liabilities[519], enabling the disposal of all NPLs (above a certain threshold and certainly the COVID-inherited) seems the optimal. It would signal the temporary existence of a fully institutionally fledged backstop, smoothly incorporated in the existent EU regulatory framework, which alleviates concerns for financial stability and deteriorates- thanks to its "Europeanized" safeguards- concerns about excessive recourse to public funds. Last but not least, it would detach the stigma of resorting on a standalone basis to this institutional tool. Indeed, if communicated

[517] The temporary nature of this "emergency backstop facility" should by highlighted. The same applies for its very premise. We are not suggesting here the creation of a fully-fledged fiscal backstop as a permanent Pillar of the EU's crisis management framework. This the context of another more general debate of quasi existential nature for the EU resolution framework. Besides, in any case, as **De Serière V. and Milione L. (2019)** point out, the GFSTs provide a last refugium backstop if regular resolution tools prove insufficient. We are just highlighting the fact that the EU resolution framework has not been tested in the context of a systemic EU financial crisis and in the author's view, was not designed to do so. Indeed, when the BASEL IV reforms are finally fully incorporated and EU bank's have sufficient MREL and TLAC cushions, alongside their robust capital buffers and their significantly ameliorated asset quality, due to the effect of the Prudential Backstop Regulation, the IFRS 9 full implementation and the pressure imposed to supervised banks to dispose their NPL bulks(*in the context of the qualitative guidance of the ECB's NPL guidance and within the binding quantitative targets*) to a proper and fully-fledged dedicated secondary market, the EU resolution framework, possibly with the SRF and EDIF in full force and the ESM's backstop to the SRF in place, will be ready to address even such tail events. The issue here is that we are half of the way. And our controversial resolution framework, even if functional in its final version, has not reached the maximum of its regulatory arsenal.

[518] See **Tröger, T. (2014)**, reminding that establishing a common European backstop for the financial sector was the original rationale underpinning the banking union project, with common supervision and resolution only safeguarding incentive alignment and **Schularick - Steffen – Tröger (2020)**, p.14, reminding that although the direct bank recapitalization tool was never operationalized as an ESM instrument, it was envisioned — at least by the ESM's board of governors — to serve as a pan-European backstop to ward off systemic crises in which the fiscal capacity of individual member states proved insufficient. According to them, such a temporary backstop could assist in the smooth application of the recent rigid accounting and prudential standards(namely IFRS 9 on expected credit losses and prudential backstop requirements), while they argue that the ECB's current forbearing stance in this regard in fact seems motivated by the current lack of such a backstop. Besides the bail-in centred resolution framework with the stringent assessment of the "public interest criterion" and the liquidation option as a default rule does not itself rule out the possibility of a fiscal backstop. Several initiatives, like the DRI mechanism, the ESM's fiscal backstop to SRF etc. prove that this "tug-of-war" is ongoing. Besides, recent experience, notably the bail-in averse approach in the case of Monte Dei Paschi di Siena, despite the fact that according to **Hadjiemmanuil C. (2016)**, the Italian banking system had at the time a sufficient volume of bail-inable junior debt, thus making bail-in technically feasible, in conjunction with the extensive resort to the precautionary recapitalization mechanism or even the ELA last resort central bank funding are critical empirical indicators. For a robust and coherent overview of such considerations, see **Busch D. - Rijn – Louise (2019)**, passim with further references.

[519] Cf. **Acharya V. et al. (2021)**. In particular, the paper looks at the effects of regulatory forbearance and guarantees as an alternative to recapitalization. Fiscally constrained governments in Europe often opted for such form of support for the banking sector. They argue- quoting empirical data- that the consequent economic costs were substantial.

promptly, not only it would not disturb markets and depositors, but contrarily boost confidence[520] regarding EU banking sector's stability and firepower, forging the latter's lending capacity and creating the ultimate financial environment for economic growth.

Since such backstop cannot, without the abovementioned amendment, be legally fully-fledged, the proposed amendments seem necessary.

In the same vein and a fortiori, Schularick, Steffen and Tröger[521] propose **a precautionary recapitalization of the European banking sector, coordinated at the European level and ESM funded[522]** to avoid reentering the sovereign-bank doom loop that haunted Europe in the last crisis[523]. For that reason, instead of abandoning the capacity of the ESM to directly recapitalize banks in the ongoing reform of this intergovernmental institution, the ESM **could be reformed to become a viable backstop for the European banking system**. Provided that the ESM was always envisioned- in the context of the CMU optimization reforms- as becoming an institution within the framework of the founding Treaties, they argue that now could be the right time to make such a bold advance, not least because — significantly more modest — reforms of the ESM are currently under way.

Schematically, their proposal has the following context:

- recapitalization must be done for all major banks to avoid free riding and stigma. through a recapitalization fund, which could acquire stakes in the largest banks of all countries — even some healthy ones — to avoid coordination and signaling problems (i.e., a stigma for the weaker ones) and to avoid contagion.

[520] See in the same vein **Schularick - Steffen – Tröger (2020)**, p. 3, who argue that the recapitalization will increase the franchise value of the banking sector at large, improve the market access to capital and make banks less hesitant to use their buffers. Moreover, they consider such a precautionary direct recapitalization as superior to setting up a pan-European bad bank, although the two approaches can be complementary, as the latter doesn't solve the problem of capital shortfall in itself; instead, it only leads to loss recognition.

[521] See **Schularick - Steffen – Tröger (2020)**, passim.

[522] Other relevant de lege ferenda proposals opt not for the mere establishment of a fiscal ESM-centred backstop, but for the establishment of a revised coherent crisis management framework with the major involvement of the DGSs, which can play a fundamental role in both liquidation and resolution, focusing on the legal constraints arising from the existent legal framework (BRRD; DGSD, Banking Communication 2013) and suggesting some proposals to address and overcome them, see in detail **Meccati I. (2020)**, passim. For a comparison with the US crisis management framework, see among others **D'Intignano G., Dal Santo A., Maltese M. (2020)**.

[523] This doom loop could reemerge if the costs of the recapitalization would have to be borne by individual countries with high legacy public debt ratios. Countries with high public debt ratios would likely deliberately stall such measures, thereby imposing negative effects on the rest of the Union. At the same time, a European perspective opens opportunities for a restructuring of the European banking system that could emerge leaner and more competitive from the pandemic. The goal of recapitalization is not to perpetuate an unconsolidated and unprofitable European banking system. The pandemic provides an opportunity to untie the close links between banks and their home states to create an integrated European banking market. See in detail **Schularick - Steffen – Tröger (2020).**

- It **needs to be designed in a resolution-remote manner to ensure that**, when receiving ESM funds, no "failing or likely to fail (FOLF)" assessment of individual institutions is triggered, according to the EU resolution framework.
- **The trigger for the reorganization could be loss recognition**. The recapitalization fund purchases preferred stocks and warrants, i. e full-fledged equity capital, and sets an (accelerating) dividend that will compensate the taxpayer for the risks taken.
- **If the funds from the bailout scheme are not required, banks can choose to repay them, and restrictions will be lifted**, as long as they previously pass a stress test administered by the ECB and EBA in coordination with the European Systemic Risk Board.

In my view, this proposal in contrast with the former academic proposal is more policy-oriented. For instance, albeit the fact that the authors assume the resolution remoteness of their proposal, they omit to clarify how this could be done, which is why this proposal cannot stand without the legislative amendments of the preceding proposal. In addition, their proposal seem rather meager as regards the institutional checks and balances and in particular the ESM's safeguards and monitor tools, with the authors merely arguing that the ESM should exercise restraint in imposing restrictions and refrain from second-guessing the business judgement of bank managers.

In the author's view, the abovementioned proposals retain their value despite the fact that recently the SRB has adopted a broadened interpretation[524] of the public interest criterion in light of the current crisis by incorporating in the Public Interest Assessment policy (PIA) the novel- COVID-19-inhereted- financial stability considerations. Indeed, in its recent Addendum, SRB has revised its approach to the Public Interest Assessment policy (PIA) in **resolution planning** to take into account that a bank's failure may take place not only under an idiosyncratic scenario, but also under broader financial instability or system-wide events (SWE). This consideration strengthens the choice of the best resolution strategy in order to safeguard the resolution objectives. Thus, the assessment takes into account the circumstances at the time the bank is failing, and such a test may give different results if the bank fails under normal market circumstances or during system-wide events. It reflects

[524] Critically on the fact that the BRRD does not define the "public interest" and consequently on the broad discretion given to the SRB in this context, see **Mayes D. (2017b)**, **Tröger, T.H. (2018)**. In a similar vein, albeit from a slightly different perspective, **Merler S. (2018)** note that: " "in the absence of clarity on what constitutes a serious impact on the regional economy, the rules on liquidation aid leave room for governments to effectively re-instate at the local level the public interest that the SRB has denied at national (or, in the Italian case, even at the regional) level".

the effects of an underlying extreme but plausible macroeconomic scenario of severe deterioration affecting all banks simultaneously so as for the PIA to take into account the direct and indirect contagion effects caused by the failing bank[525].

Besides, even if the revised PIA assessment indicates that more credit institutions that are deemed FOLF by their supervisor could be placed in resolution[526], this does not change the

[525] See in detail SRB, "Addendum to the Public Interest Assessment: SRB Approach", 31 May 2021, available at: https://www.srb.europa.eu/system/files/media/document/2021-05-29_srb_addendum_to_public_interest_assessment.pdf

[526] In the same vein, **Schularick - Steffen - Tröger (2020**), p.16, note that in current circumstances, the Single Resolution Mechanism (SRM) should not be the first choice. While it ensures uniform practice in the execution and financing of resolutions, it is unsuitable for large-scale, system-wide recapitalizations and in general for addressing national-wide financial distress(see in the same vein **Tröger T.H. (2019) and De Serière V. and Milione L. (2019), p. 72**, highlighting the relevant tremendous political pressure in such circumstances and **Mesnard B. (2016)** arguing that the BRRD's rigid provisions, when confining the State's powers beyond the art. 107 par. 3 b TFEU threshold, could raise legal questions regarding their compatibility with the Treaty). According to **Hadjiemmanuil, Ch. (2017)**, in conditions of economic distress and system-wide banking weakness, bail-in as the preferred, and essentially mandatory, resolution tool can aggravate the situation, see also **De Grauwe (2013), Persaud (2014)**. That could be done through several contagion channels, provided that creditors who foresee a potential bail-in, or creditors of institutions with similar asset or regional characteristics will "rationally" run to withdraw deposits, (fire) sell debt, or hedge their positions through the short-selling of equity or the purchase of credit protection at an ever-higher premium, giving rise to a self-fulfilling and devastating downward spiral, probably for the whole national banking sector, especially in the presence of a systemic macroeconomic threat[see **Arnold and Hale(2016); Whittall (2016)]**. In the same vein, **Goodhart, Ch. and E. Avgouleas (2016),** note that "*Bail-in regimes will not remove the need for public injection of funds, unless the risk is idiosyncratic*". For the distinctive but rather relevant controversy of liquidity squeezes inherent in the current EU resolution framework(in conjunction with the US), see among others **Grund, S. (2020) and Goodhart, Ch. and E. Avgouleas (2016)** advocating that: "Exclusive reliance on creditor bail-in to recapitalize banks could even result in several rounds of creditor bail-ins even post-resolution" pointing to the relevant Portuguese Novo Banco case, while for a potential resolution liquidity facility(European Resolution Liquidity, ERL) within the resolution framework, see FSB, Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB"), 2016 and **Gortsos, Ch.V. (2019a)**, pp. 273 et seq. with further references. In the existent resolution framework, liquidity is also bail-in centred, see **Ringe, Wolf-Georg (2017)** and thus rather inadequate, given that as **De Serière V. and Milione L. (2019), p. 80** stipulate: "*although the conversion of subordinated debt to equity strengthens the capital base, it does not actually bring money to the table or help absorb existing losses. In that sense, the conversion may be regarded as no more than a "token gesture" in fulfilment of the principle*". Contrary to this meager bail-in centred system, FSB points out that authorities in charge of resolution planning should inter alia "identify the temporary public sector backstop mechanisms that could be used by a firm in resolution", "ensuring same day access to public sector backstop funds", and "develop exit strategies from temporary public sector backstop funding". The 2018 Euro Summit has already acknowledged that and opted for the abovementioned ESM's fiscal backstop to the SRF. However, as Chair Elke König noted in a conference in April 2018 "this will always be too little for any systemic bank". Liquidity financing was not seen as "the wisest use" of the SRF in that respect. As regards the potential for temporary and limited ELA financing even within resolution, see **Deslandes J. and Magnus M. (2019), p. 4**, cf. **Mersch Y. (2018)**, identifying the limits of central bank financing in resolution**.** Furthermore, as regards liquidity squeezes of solvent banks leading to FOLF concerns and taking into consideration the wide discretion of the NCB's when deciding to provide ELA or not, **De Serière V. and Milione L. (2019), p. 79,** propose a temporary European-based guarantee scheme to cover such shortfalls in a pre-insolvency scenario. For the astute arguments in favor of centralizing the ELA provision at the ECB level, especially within the Banking Union, see **Gortsos, Ch.V. (2015d).**

fact that an extreme amount of resolution financing could be needed[527], possibly exceeding the existent SRF's firepower[528] (*provided that multiple failed banks subject to resolution proceedings would foster EU-wide concerns about the whole banking system, especially in high NPL jurisdicitons, creating bank runs, fire sales for banks' impaired assets and liquidity squeezes*), considering that the ESM's fiscal backstop to the SRF is not yet in force, as the relevant amendments of the ESM's founding treaty are still pending[529].

Indeed, in this case, the fundamental Latin quote applies: " **Bis dat qui cito dat**"[530]. As a quasi argumentum ex lege, one could argue that based on the same premise[531], according to Article 11(2) DGSD, national DGSs must, inter alia, use their 'available financial means'(as further specified in Article 10 DGSD) also in order to contribute to the financing of credit institutions' resolution, where the conditions laid down in Article 109 BRRD are met[532].

[527] See in the same vein, According to **Lehmann (2020)** suggests that in this case extensive triggering under the BRRD of the GFSTs could pass off. Besides, apart from the fact that some Member States have not transposed the relevant Articles (56-58) into their national legislation (since that was under national discretion), their use during the pandemic crisis may be limited, because the contribution of the private sector through application of the 'bail-in' tool is a condition for resorting to them. See **Hadjiemmanuil C. (2015)**, p. 23.

[528] The Single Resolution Fund (SRF) is currently in the middle of its buildup phase (2016–2023) and is scheduled to reach the target level of at least 1% of covered deposits of all credit institutions in three years only. Therefore, the funds that are currently available (about €30 bn) are simply too small to make a dent in the shortfall, provided that the ESM backstop for the SRF is not yet operational.

[529] Notwithstanding the above references regarding the current ESM's "transformation", as regards the institutional issues and decision making implications relating to the incorporation of the backstop facility to the SRF within the resolution framework, see also **Lupinu, P. M. (2020)**, **Binder, J.-H. (2019)** and **Pennesi, Francesco (2018)**.

[530] In the same vein, for an enhanced role of the precautionary recapitalization, especially amidst the pandemic crisis, see **Gortsos, Ch.V. (2020c)**, **Ringe Wolf-Georg (2020)**, **Bodellini (2016)**, **Micossi – Bruzzone – Cassella (2016b)**, **Hellwig M.F. (2017)**, **Schularick - Steffen – Tröger (2020)**, passim, which will be presented in further detail below. Especially as regards to the "burden sharing waiver" provided in the temporary state aid framework and its necessity especially amidst systemic crises, see among others **Hadjiemmanuil C. (2016),** p. 91. For a thorough and comprehensive analysis, based on empirical data from the most GFC and Asian financial crisis, see **Arner et al. (2020)**, who deconstruct the established no-bail-out doctrine and prove that properly designed fiscal backstop schemes, especially national-wide AMCs or Asset Protection/ Insurance schemes, are extremely efficient and even loss-neutral(and sometimes profitable) for the taxpayer.

[531] See a relevant de lege ferenda proposal by **Bodellini M. (2020)**, p. 2-3. In the same vein, **Huertas, T. (2021)** calls for a radical review of the crisis management framework. In a nutshell, he urges for the transformation of the Single Resolution Fund (SRF) into the Single Deposit Guarantee Scheme (SDGS) with a backstop from the European Stability Mechanism (ESM) and argues that the transfer of responsibility for emergency liquidity assistance (ELA) from national central banks to the ECB to create a single lender of last resort is pivotal(see in the same context **Gortsos, Ch.V. (2015d)**. Finally, he proposes that national deposit guarantee schemes should become investors of last resort in the gone-concern capital of the failing banks to ensure the orderly liquidation uniformly to all banks, so as to complete the Banking Union.

[532] See **Gortsos, Ch. V. (2019c)**, p. 8.

However, this legal and policy view is far from being indisputable in literature. It has been argued that the use of restructuring and resolution options as stipulated in the banking resolution framework, i.e. through resolution tools as regards failing or distressed banks, does not only reduce taxpayer risks but also leads to a further stimulation of secondary NPL market liquidity and addresses another policy objective that has become more important in the post-COVID economy: the necessary restructuring and **consolidation** of the European banking industry[533]. In this context, Kasinger et al.(2021)[534] observe that the EC action plan seems to focus almost completely on the SSM, and grossly neglects the other pillar of the banking union: the SRM. In their view, apart from preserving taxpayers money and enabling the desired consolidation of the over-banked EU sector through e.g. sale of business tools, the fully-fledged resolution process with its transparency and procedural safeguards[535] would optimally contribute to the creation of a liquid and competitive NPL secondary market and enable "best practice sales process" contrary to the more opaque and bespoke private transactions, observed in the GACS/ Hercules APSs[536]. Therefore, they claim that the EC action plan should be supplemented with a stronger focus on, and integration in, the bank resolution regime[537].

However, they acknowledge that in the event of a systemic crisis, when all or many banks lose capital simultaneously and all banks are on the same sell side, forced to fire-sales, a self-enforcing process of falling secondary prices, lower loan asset values and loss of capital may develop that is destabilizing the financial system at large. In the event of systemic risk, the self-healing properties of the market cannot operate and the devastating externalities triggered call for a government bailout, as in this case a market-driven restructuring process tailored along BRRD rules might not be feasible anymore. However, even in this case, they opt for government support channeled not directly to banks but to viable firms and borrowers to prevent adverse incentives. In the author's view, that option seems to endanger taxpayer money more than a direct capital injection and be subject to significant political pressure.

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[533] As long as it does not lead to the infamous Too-Big-To-Fail("TBTF") trap, see in this context **De Weijs (2013)**.

[534] See **Kasinger et al. (2021)**.

[535] See in particular for sale of business tool, BRRD, Art. 39. See further EBA, Final Draft Guidelines on factual circumstances amounting to a material threat to financial stability and on the elements related to the effectiveness of the sale of business tool under Article 39(4) of Directive 2014/59/EU (EBA/GL/2015/04, 20 May 2015).

[536] Cf. **De Serière V. and Milione L. (2019), p. 79-80**, claiming that concerns as regards opaqueness and political interference are not absent even in the presence of a fully-fledged resolution process, noting that more than 99 cases have been filed against the SRB and the European Commission with the EU Court of Justice in Luxembourg in this regard.

[537] See also critically on the excessive recourse to precautionary recapitalization tool as a policy option, **Philippon, T. and A. Salord (2017)**, **Götz, M., J. P. Krahnen, and T. Tröger (2017)**.

In the same vein, Rainer Haselmann & Tobias Tröger (2021)[538] note that the current EU bank crisis management framework is in principle suited to address many of the EU banking sector's legacy problems of a lingering undercapitalization, anemic profitability and may ultimately lead to the desired consolidation[539] of the European banking sector. In their view, at last banks that stand no realistic prospect of fulfilling the prudential requirements (*especially after the termination of any transitional period for the full endorsement of the IFRS 9 and Basel's V final reforms, as well as rigid MREL targets*), even after economic conditions improve, should be forced to exit the market, i.e., be either put in resolution or be liquidated under national insolvency proceedings[540].

In their view, no leniency in the precautionary recapitalization framework is in principle excused, arguing that the fear that such a rigid application of the resolution framework could destabilize European banks seems less plausible after the ESM's backstop to the SRF(!), albeit the fact that is though not yet in force, adding that any case involving recapitalization "*from fiscally potent supranational coffers – will quell panic-driven contagion*"(sic). However, without prejudice to the above they too propose a TARP-likened backstop scheme, designed in a resolution-remote manner. In essence, they too endorse the above mentioned proposal for a COVID-19 specific bank recapitalization facility at the ESM under the precondition of strict conditionality.

In the same vein, Hellwig[541] (2017) takes a critical stand towards bank bail-outs, especially through AMC conduits and opts for the asset separation resolution tool within a fully-fledged resolution process, invoking the Swedish relevant "good bank approach". Under a good bank approach, the authorities would take over the bank as a whole, sort out the assets, and then sell whatever can be sold, including by privatization of a viable "good bank". The previous owners would retain their shares, and would therefore participate in any excess of the proceeds of the operation over the cost, but they would not get any upfront payment. In this context, the notorious "real economic value" is safely calculated ex post (in the Swedish case zero, because the proceeds did not cover the costs of paying off creditors)[542]. He also adds that the camouflaged "bank bail-out" frenzy, feeding approaches indicating the inflation of REV or the leniency of precautionary recapitalization framework

[538] See **Haselmann R. & Tröger T. H. (2021)**.

[539] On the crucial topic of the consolidation of the EU banking sector with the CRR's rigid capital requirements and their consequent compliance cost as a main driver, see among others **Maragopoulos, Nikos (2021)**. See also ASC (2014), Is Europe Over-Banked, Report 04/2014 of the Advisory Scientific Committee of the European Systemic Risk Board, https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_4_1406.pdf?5fb1382c5a560f243ecf1989.

[540] See also **Hellwig M. (2017b)**, who indicates that taking the continued existence of the originating bank for granted may imply that excess capacities in markets are not reduced, leaving competitive pressures high and depressing the profitability of (other) banks.

[541] See **Hellwig M. (2017b)**.

[542] See in detail **Englund, P. (1999)** and ASC (2012), Forbearance, resolution, and deposit insurance, Report 01/2012 of the Advisory Scientific Committee of the European Systemic Risk Board, https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1_1207.pdf?c4a55781325f99ef619100f7.

proves nothing but the lack of trust to the established resolution and in general crisis management framework. And admittedly, notwithstanding the de lege ferenda view that scholars, regulators or supervisors adopt in this prominent academic tug-of war, he is not wrong[543].

Chapter III

Section I: General Considerations, Special Features, Advantages and Disadvantages of an NPL resolution through an AMC.

AMCs[544] using public or bank funds to carve-out bad assets from bank books seems to prevail over decentralized or bank specific- separate measures, especially in times of systemic crises. Traditionally, centralized AMCs have been a part of a comprehensive policy response to an acute solvency and liquidity distress affecting entire national banking sectors[545].

Centralization of NPL management via AMCs has various advantages.

More specifically, as indicatively **Calomiris, C.W.,D. Klingebiel, and L. Laeven (2012)**, **Cerruti, C., and R. Neyens (2016)** and **Klingebiel, D. (2000)** show, they constitute a par excellence holistic and comprehensive NPL resolution tool with clear-cut deal making-process, whilst enhancing secondary market liquidity and curbing haircuts and bis-ask wedges and tackling any hesitance to sell issues. By pooling rare expertize and building on economies of scale and scope and by deploying expertise specific to distressed debt management and workouts[546], AMCs are more efficient, especially when focusing on a single asset class (with homogeneous assets)[547]. Furthermore, optimally structured AMCs can drastically address the debt overhang problem, promote financial stability and to restore market confidence.

Segura and Suarez (2019) characterize argue that publicly sponsored AMCs **tend to minimise the cost to the DGS and the taxpayers**. Similarly, **Arner et al. (2020)**, on the basis

[543] See among others **Miglionico A. (2018)** , noting that: "precautionary recapitalisation under the BRRD has deliberately been left as a loophole for cases where bail-ins cannot work. The liquidation of Venetian banks (Veneto Banca and Banca Popolare di Vicenza) demonstrates the willingness to avoid bail-in and seek public support". On the latter case, see **B. Mesnard, A. Margerit and M. Magnus (2017a).**

[544] The term "bad bank" mainly refers to impaired asset segregation tools analogous to AMCs within the resolution framework or generally on a gone-concern basis.

[545] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 26. **Medina Cas and Peresa (2016), p. 7, Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 74.**

[546] However, it should be reminded that the notable ECB's NPL Guidance(2017) that the supervised institutions are obliged to create distinct NPL Work-out Units(WUs) and employ a dedicated NPE strategy, fully incorporated within their business models, risk management, ICAAP etc. So they do nor really have a chance. They should enhance their distressed debt management focus and expertise.

[547] See **Medina Cas and Peresa (2016), p.7 and Auguleas et al. (2021b), p. 19-21, Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 74.**

of empirical data drawn from the Asian financial crisis, show that even government-backed AMCs proved a better way to restore banking sector stability and to boost national economy than internal loan restructurings accompanied by bank closures and bank mergers, without serious long-term losses for the sponsoring State, with **De Serière V. and Milione L. (2019)** adding that- if designed properly and under the right circumstances- those up-front costly for the taxpayer bail-outs can prove more efficient and long-term preferable. However, provided that the novel BRRD/SRMR regime has rendered outright bailouts, without extensive private burden-sharing, almost impossible[548] and in any case has rigidly capped the extent and firepower of such a bail-out scheme, extensive reference to vintage AMC-centred bounteous bail-out schemes like the ones envisaged in the Asian Financial Crisis or the relevant bail-out programs during the GFC in non-state-aid restricted jurisdictions(notably the US TARP program), seems unavailing.

Using data about NPL policies from over 190 countries over a period of 27 years, **Balgova, M., A. Plekhanov, and M. Skrzypinska, (2017)** find that a combination of AMCs and state-backed recapitalisation is a more effective way to resolve NPLs. Indeed, **Acharya V. et al. (2021)** show that **half-measures and passive muddling**[549] are at least inadequate, if not dangerous for financial stability, provided that governments tend to postpone the restructuring or resolution of distressed banks in times when the problem reaches systemic consequences for the whole banking sector[550]. In fact, they show that forbearance, employed by fiscally constrained states during the GFC or the sovereign debt crisis, caused undercapitalized banks to shift their assets from loans to risky sovereign debt and engage in zombie lending, resulting in weaker credit supply, increased risk in the banking sector, and, eventually, greater reliance on liquidity support from the European Central Bank, using its three-year Long-Term Refinancing Operation (LTRO) facility introduced in 2011 (a quasi "liquidity backstop"), which surprisingly almost eliminated their higher probability to default. Thereby, they conclude that timely, holistic and decisive policy response is of paramount importance.

More specifically, **Brei et al. (2020)** study whether bad banks and recapitalisation lead to recovery in the originating banks' lending and drop in NPLs, and find that bad banks are effective only if they combine recapitalisation with asset segregation securing a 'clean break' for the restructured bank[551].

They also find that bad banks are more effective when:

i) asset purchases are funded privately;
ii) smaller shares of the originating bank's assets are segregated, and

[548] See verbatim **Hadjiemmanuil C. (2016).**
[549] See in detail **De Haas R, Markovic B. and Plekhanov A. (2017)**, p. 128.
[550] See by mere indication **Acharya, V., & Yorulmazer, T. (2008)**, **Brown, C. O., & Dinc¸, I. S. (2011)**.
[551] See also **Skrzypinska, M. (2020).**

iii) they are located in countries with more efficient legal systems.

Bolognesi, E., P. Stucchi, and S. Miani (2020) show that AMCs may provide a benefit by helping develop the secondary market for NPLs, whereas **Skrzypinska (2020)** highlights the positive cross-border spillovers from reducing NPLs and shows that changes in the NPL stock of a parent bank affect the relevant NPL stocks of its foreign subsidiary banks(*leading on average to a 12% drop*).

Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b) argue that AMCs can tackle information asymmetries in the NPL market, thereby reducing transaction and due diligence costs, expand the investor base and solve coordination challenges. Although, the same authors acknowledge that such benefits could also derive form NPL transaction platforms, which seem less politically challenging and more cost-efficient[552]. In the same vein, **Gaffeo and Mazzocchi (2019)** argue that centralized, preferably EU-backed, AMCs can contribute in solving excessive information asymmetries between buyers and sellers but also, if designed optimally, also market power and collusion.

Suarez and Sánchez Serrano (2018) argue that AMCs specialized in buying and managing NPLs[553] address the coordination and collective action problems. Without such centralized solution, if creating a secondary market for NPLs requires set-up costs that can only be recovered if the volume of trade in such a market is sufficiently large, the economy may in extremis be trapped in a situation in which such a market is stuck because it is always too small for the individual agents deciding at the margin whether to establish it.

In any case, **Klingebiel, D. (2000) and Cerruti, C., and R. Neyens (2016)**, after examining a large international sample of countries, codify the following generic comparative advantages of archetypal public AMCs:

i) force banks to recognize losses and incentivize supervisors to proactively engage with early NPL resolution, thereby tackling supervisory forbearance[554] and restoring investor confidence in the financial system;

ii) ameliorate asset quality and liquidity (if bonds can be used for collateral at central bank) and provide in principle (albeit usually State-Aid inflated) capital relief to banks;

iii) strengthen the financial system, through the exit of non-viable banks, the restructuring of viable banks and the consolidation of the banking sector;

[552] See **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a)**, p.143.
[553] See **Avgouleas et al. (2021b)**, p. 19.
[554] See **Goodhart, Ch. and E. Avgouleas (2016).** Indeed, the behavioural impact of uncertain outcomes associated with the application of pure bail-in regimes seems to be the exact opposite of what was intended by the new resolution regime: earlier intervention. See in the same vein **Goodhart and Segoviano (2015)**.

iv) enjoy economies of scale and bargaining power to address the oligopsony failure on the buy side, which may contribute to more efficient asset sale and recovery process;

v) implement debt to equity swaps[555], due to minimum or limited capital requirements enabling the AMC to engage with (limited) interim equity financing[556], a distinct disadvantage facing banks engaging in this method of debt write offs[557].

vi) allow banks to focus on financial intermediation rather than asset recovery, thereby contributing to the restoration of their lending firepower.

On the other hand, concerning the role AMCs have in bank resolution, **Lehmann (2017)** with reference to past EU experience, proves its effectiveness, provided that certain preconditions regarding its asset size and parameter, as well bank participation are met. AMCs in the context of the asset separation can prove equally effective. He also argues that robust and dedicated AMC legal framework can be a catalyst.

Last but not least, **Ayadi, R., G. Ferri, and R.M. Lastra, (2017)** interestingly relate the AMC's function to the notion of the incomplete EMU employing the "multimum equilibria" theory[558]. In a nutshell, they argue that in such cases, thus in the absence of a fully fledged central bank determined to employ unlimited amounts of liquidity, if necessary to address speculative crisis and preserve financial stability or at least of a dominant fiscal backstop, multiple equilibria are possible to arise in a quasi self-fulfilling way and mainly depending on the investors' expectations.

Here a centralized fully fledged Eurozone response, i.e an EU-wide AMC or even a EU-wide integrated network of national AMCs armed by the mere presence of fiscal backstop, would apply the fair haircut and loss of value, as it would declare itself ready to intervene and buy in principle unlimited bulk of NPLs if needed to address speculative pressure or unacceptable market failure leading to unnecessary loss of value. This backstop would

[555] See **Wei Xinjiang (2002)**, who identifies various ancillary AMC's functions ranging from a central disposition agency to an independent contractor or an auction processor. In China, the AMC was armed with severe legal prerogatives, one of which was the right to exercise debt-to-equity swaps, which were, by derogation of the general Chinese contract law, automatically effective irrespective of the debtor's consent or even notification. These swaps were confined though only to State-Owned enterprises(SOEs). Indeed, this tool could be hardly compatible with the Member State's company, contract and insolvency laws, raising questions regarding the material breach of the debtor's fundamental rights and rendering the AMC a master creditor with undue preferential treatment to the detriment to other creditors with competing security rights. Another innovative element was the explicit provision in the dedicated AMC Regulation of interim shareholding and financing in order to render the AMC capable of extracting the maximum recovery value from distressed companies.

[556] On the contentious topic of easing the equity financing capital requirements for banks, especially to SMEs, as a distinctive goal of the CMU project, see among others **Joosen B. and Lieverse K. (2018).**

[557] See **Avgouleas, A & Goodhart, C (2017)**.

[558] See by mere indication **De Grauwe, P. (2016)**.

eventually anchor the market to the good equilibrium. As they peculiarly point out, in this context, sometimes and analogously to what happened with the Outright Monetary Transactions (OMT) program, the brute announcement of such a fully-fledged backstop may suffice. In this case, "the only damage would be for speculators" wishing to extract extraordinary profits by exploiting the fire-sale condition[559].

On the other hand, **Klingebiel, D. (2000) and Cerruti and Neyens (2016)** codify the following infamous AMC's disadvantages:

i) undue political interference, a fortiori in weak institutional environments, rendering AMCs as onerous vehicles to channel capital to cronies [560];
ii) "warehousing", which can be solved with sunset clauses;
iii) Altering the clear-cut NPL resolution mandate, incorporate other social policy considerations, which can be solved by using narrow mandate predefined in law and strict definition of eligible assets and rendering the AMCs as one-off vehicles.
iv) Weakening credit discipline with frequent sequential asset purchases at inflated prices that do not force banks to recognize losses, thereby providing adverse incentives concerning credit underwriting and in extremis reviving the OTD model[561]. This is why conservative using transfer price estimations under independent and due valuation process and robust servicing arrangements should be in place.
v) Public AMCs can generate significant losses for the taxpayer. From a macroprudential perspective, they should take into account the relevant side effects, such as the short-term effects of asset foreclosure on asset prices or on borrowers' activity, or the impact of NPL disposal on banks' capital and hence on their lending capacity[562].
vi) Public AMCs designed as conduits to dispose the credit risk derived from opaque distressed NPL portfolios to private investors though inflated bid prices[563] (mainly because of the opaqueness of the market and the employment of state's credit enhancement) that undermine the associated risks, can create considerable systemic risk for the whole financial system. As aptly pointed out in De Larosiere Report[564]: " *While securitised instruments were meant to spread risks more evenly across the financial system, the nature of the system made it*

[559] **Ayadi, R., G. Ferri, and R.M. Lastra, (2017)**, 194.
[560] See **Avgouleas et al. (2021b)**, p. 19, **Bueno-Edwards A. (2021)**.
[561] See **Avgouleas et al. (2021b)**, pp. 19-21.
[562] See **Avgouleas et al. (2021b)**.
[563] **Avgouleas et al. (2021b)**, pp. 19-21.
[564] See De Larosière Report, par. 86-97, available at: https://ec.europa.eu/economy_finance/publications/pages/publication14527_en.pdf

impossible ***to verify whether risk had actually been spread or simply re-concentrated in less visible parts of the system***"[565].

vii) **Hellwig M. (2017b)** highlights the importance of being honest as regards both the main drivers and mandates of an AMC resolution scheme. In particular, he makes the following distinction: If NPL bulks merely threaten bank funding and simply lead to asset liquidations at depressed prices, public funds may eventually not be needed. If they threaten the bank's solvency though, taxpayer support may be unavoidable. In such circumstances, where even systemic risk concerns begin to aggravate, no BRRD/SRMR framework seems in principle sufficient to prevent public intervention. In this cases, the notion of "real economic value" as the price at which assets should be transferred could be simply inflated so as to leave ample room for hidden public subsidies.

Section II: The AMC's legal toolkit.

1. Legislation, ownership mandate and powers

Excluding the case where the AMC is set up in a resolution context and consequently several relevant provisions in the existing framework on resolution[566] (BRRD and SRMR) are of course to be complied with, AMCs are typically created by **dedicated ad hoc legislation[567]** (whether a dedicated law or changes to previously extant provisions) that outlines their objectives[568], mandates, powers, roles, functions and main design features, funding options, institutional independence and public accountability, operational and procedural transparency[569], corporate governance, microprudential regulation as regards their risk management, capital and liquidity management and other regulatory safeguards,

[565] As **Hellwig M. (2017b)** illuminatingly points out: "*Once an impairment has occurred, there is little that can be done about it. In particular, a loss that has already occurred can hardly be made good again. However, the participants may try to use the lack of transparency in order to avoid taking responsibility or to change the allocation of the loss to their advantage. A simple device would be to delay its acknowledgement in the bank's books and to get someone else to buy the asset at its original value. Most prospective buyers would be afraid of falling victim to such a ploy and shy away from buying, except possibly at a large discount, at which point the originating bank may refrain from selling because a sale at a large discount would require it to take a substantial loss. This consideration provides one explanation for the illiquidity of such markets. The question is why a "bad bank" should be able to provide for an improvement – except of course if the "bad bank" is willing to pay a high price for the asset, effectively making a transfer of resources to the bank*".

[566] See among others **Schillig M. (2016), Gortsos, Ch.V. (2019a).**

[567] The need to establish special institutional framework seems to be a fortiori the case in Continental Europe civil law-oriented jurisdictions, such as Italy and Greece, where legal systems' architecture is based on statutes. See verbatim See **Linaritis (2020).**

[568] According to **Gortsos, Ch. V. (2021d)**, p. 14, AMCs are characterized as pursuing three main objectives: (i) supporting the resolution (or liquidation) of insolvent banks; (ii) the restructuring of distressed banks, removing NPLs from their balance sheets and (iii) the privatization of State-owned credit institutions.

[569] See **Klingebiel, D. (2000).**

potential liquidity lines[570] by eligible liquidity providers[571] and resolution or smooth liquidation arrangements, oversight, life span[572] and conduct requirements[573]. As regards the latter, special investor protection considerations could be introduced, in addition to the relevant MiFID II[574]/ PRIIPS Reg/UCITS V(if applicable) provisions, the Proposal Directive's conduct requirements on Credit Servicers and Purchasers and the Securitization Regulation's(if applicable) enhanced protection and limitations concerning the placement of securitization positions to retail clients, possibly reminiscent of the novel art. 44a BRRD, introduced by the BRRD II, containing enhanced qualitative layers of protection accompanied with quantitative limitations in favor of retail clients.

It is worth noting that a tailored legal framework within a robust institutional environment has been empirically proved inter alia a key factor for the AMC's success[575]. The legislative

[570] Liquidity risk is much more relevant in non-performing loans securitisations compared to the standard ones on performing assets. The underlying non-performing loans portfolio may not generate any cash flow for a certain period of time: in this case the SPV doesn't receive cash flows to cover senior expenses (according to the securitisation waterfall structure) and to make payment to the senior ABS holders. The commitment of the Liquidity Provider can be valid only during a certain period of the deal (e.g. first year or first two years) and it is usually aimed to payment of interest of the most senior notes only. **Fabri (2017), pp. 198-199, Linaritis(2020), p. 24**. On the role of securitisation sponsors typically providing backstop liquidity ("liquidity puts") to the Issuers, yet exposed to the tail risk of disruption of financial markets, and the systemic risk implications of high interconnection of wholesale funding, structured finance and OTC derivatives with the formal banking systems, see **ArmourJ et al. (2016), p. 464, Wood (2019a), p. 648, Fuller (2012), p. 204**. This liquidity lines were also an infamous method of implicit support from originators/sponsors, deterring the significant credit risk transfer requirements and leading to regulatory arbitrage, see **Higgins and Mason (2004) and Sarkisyan and Casu (2013)**. According to **Scopelliti(2016)**, this was mainly due to regulatory gaps of the previous relevant BCBS framework, where banks, by developing guarantees classified as liquidity facilities but effectively covering credit risk, could obtain some relief in terms of regulatory capital, whereas **Acharya, Schnabl and Suarez (2013)** empirically substantiate that liquidity-guaranteed ABCP was issued more frequently by banks with low capital. Indeed, under Basel I, banks could also securitise a pool of claims and provide liquidity facilities to the SPV, with the effect of being completely relieved from capital requirements for such positions, given that liquidity lines were considered to cover liquidity risk but not credit risk **(Acharya, Schnabl and Suarez, 2013)**. It was only until Basel II has changed the incentives for regulatory arbitrage in various aspects, by defining requirements for "Significant Risk Transfer" in securitisation, by ad hoc regulating the treatment of off-balance sheet securitization positions and by introducing a more risk-sensitive approach for such exposures, see **Scopelliti (2016), pp. 13-14, Wagner W. and I. W. Marsh (2006).**

[571] See among others **Fabri(2017), p. 198**, noting that given that counterparty risk is paramount for the creditworthiness of the Liquidity Put/Line, Liquidity Facility Providers are usually subject to a minimum rating to be considered eligible by Rating Agencies in their rating assessments as regards the securitization positions. However, in the case of an AMC which does not hold a banking license, those requirements should not in the author's view amount to the CRR's provisions for the eligible counterparties-providers of unfunded protection as credit risk mitigation technique.

[572] See **Bueno-Edwards A. (2021)**, 321-332.

[573] In case of NAMA and SAREB, detailed rules on how lenders should identify, mitigate and manage NPLs/NPEs in a proactive manner by offering borrowers and a menu of restructuring options were introduced. Importantly, this menu is applied prior to and as an alternative to the application of national insolvency law and for both the lender (i.e. in most cases a bank) to apply in dealings with the borrower. See in further detail **Huertas M. (2020)**, 434.

[574] See among others **Gortsos, Ch.V. (2017c)**.

[575] See **Avgouleas et al. (2021b)**, p. 19, **Cerruti and Neyens (2016)**, p. 16.

process around the creation of the AMC should maximize stakeholder involvement and allow for consensus-building regarding the entity and its functions and mandates[576]. It must also take the specific AMC design considerations into account so as to avoid frictions in the AMC's operations later on[577]. Any legislation needs to be drafted with the expectation that it will be tested and challenged in court[578]. Such processes may be useful in underlining the legitimacy of the AMC, as well as its mandate and powers[579].

There is not a default rule regarding the ownership and operation of AMCs[580]. They can be both public[581] and privately owned, lend themselves for various public/-private co-investment srtuctures[582] and **may** also **be established as private companies with public mandates**, **providing they do not require special powers[583]**. However, the Commission urged that the option of a publicly backed AMC should not constitute the default solution, and encouraged the use of decentralised, privately funded or public-private funded AMCs[584].

AMCs ownership structures varied across jurisdictions and seem to gradually swift over time from a public-centred to a more hybrid and private-centred ownership model due to the introduction of more stringent banking regulation requirements(namely BRRD/SRMR framework) and concers(aggrandized after the sovereign debt crisis) regarding the impact on public budgets[585]. Indeed, as **Gandrud, C. and M. Hallerberg (2016)** show, relevant Eurostat rules and the need to encourage private-sector involvement lead majority privately owned AMCs to acquire assets at higher haircuts. This realises losses sooner, avoiding the problem of zombie banks, and makes it more likely that the AMC itself will be profitable.

In particular, they identify three stages in the creation of European AMCs:

(1) before 2009, a phase characterised by a variety of AMC ownership types;

(2) 2009-2014, mainly public/private co-investment structures with a minimal majority share (51 %) of private ownership; and

[576] See **Cerruti and Neyens (2016)**, p.15.
[577] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 42.
[578] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 42.
[579] European Commission (2018), Commission Staff Working Paper, AMC Blueprint, ibid.
[580] According to **Annunziata (2021)**, p. 33., AMCs tend to have a private structure.
[581] Examples of 100% national government ownership are FMS/WM (Germany) and Družba za upravljanje terjatev bank, dd (DUBT) (Slovenia) and AMCO, owned by the Italian Ministry of Finance.
[582] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, pp. 71 et seq.
[583] See **Bueno-Edwards A. (2021)**, 321-332 and **Cerruti and Neyens (2016)**, p. 16.
[584] See Communication: Tackling non-performing loans in the aftermath of the COVID-19 pandemic COM(2020) 822 final, p.11.
[585] See in detail below.

(3) post-2014, where bailed-in shareholders of failed banks own the AMCs created to resolve them[586].

For instance, SAREB was a centralised AMC, public-private partnership[587], and public for-profit limited company (sociedad anónima) with a public mandate and "with very few special provisions"[588]. It was incorporated in November 2012 by the Fund for Orderly Bank Restructuring (FROB) in accordance with Law 09/2012 as a private company in order to avoid consolidation into public accounts[589]. The same hybrid legal nature in the form of a public-private partnership applied also to NAMA[590].

Those are notable sovereign backed AMCs examples charged with wide-ranging powers, special legal status and ofttimes prerogatives[591], ensuring that the AMC's legal toolkit is not restricted in any meaningful way and that it shall be entitled with at least the same rights and powers as any other creditor. In particular, it should be allowed to enforce collateral and take collateral on its own balance sheet, also with a view of developing its assets to maximise their value (e.g., by finishing incomplete real estate projects).

On the other hand, usually an AMC is first and foremost not a typical investor. In this context, in specific cases, ad hoc exceptions may be considered to facilitate debt restructuring by the AMC as long as those provisions are compliant with the relevant EU and national law's provisions and namely they do not lead to unnecessary for the pubic interest preferential treatment of the AMC, which in turn distorts the competition in the single market. For example, this may relate to waiving the required mandatory take-over bids in the event where the AMC acquires a qualified majority stake in a company[592].

Furthermore, the primary objectives and mandate of the AMC must established in legislation – and communicated clearly. **Any secondary objectives[593] should be avoided unless clearly subordinated to the primary objectives [594].** The AMC should be empowered to implement design-based decisions, with respect to, for example, in scope

[586] See **Avgouleas et al. (2021b)**, p. 27.
[587] According to **Avgouleas et al. (2021b)**, the initial private shareholders were mostly Spanish banks, two foreign banks(Deutsche Bank and Barclays Bank) and and four insurers(Mapfre, Mutua Madrileña, Catalana Occidente and Axa). Other banks and insurance companies have subsequently participated.
[588] See **Hernández F. M. (2016)**, p.8, **Cerruti and Neyens (2016)**, p.124.
[589] See **Medina Cas and Peresa (2016)**, p.23, **Bueno-Edwards A. (2021)**, 321-332.
[590] See **Cerruti and Neyens (2016)**, p.113.
[591] See **Medina Cas and Peresa (2016)**, p. 15.
[592] See European Commission (2018), Commission Staff Working Paper, AMC Blueprint, ibid.
[593] Albeit AMCs could be employed to successfully achieve further public and social policy goals, namely the protection of mortgage consumers from enforcement actions resulting to their first residence's auction or the restoration of stability in the housing market and contribution to the socio-economic development (an explicit objective of the NAMA Act), Medina Cas and Peresa highlight that: "*combining this primary goal with other social initiatives, such as the provision of housing, can lead to conflicting goals for the entity*", see **Medina Cas and Peresa (2016)**, p. 9. See also **Ingves S., A. Seelibg S., and Dong He (2004)**.
[594] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 42.

asset classes, asset perimeter, and bank participation. **Legislation should also contain strong oversight elements** which will help insulate the objectives of the AMC from being disrupted and can ensure that the AMC's operations are free of influence or lobbying[595].

As regards design and financial stability considerations, legislation should ensure that AMCs be established as **one-off vehicles**. Thus, the asset transfers should be completed in a single round, and there should be no further opportunities for asset transfers to the AMC thereafter, save for exceptional circumstances.[596] Furthermore, it shall not engage with any other commercial activity, unless it is necessary for the fulfillment of its mandate.

As regards corporate law considerations, it could take the form of a special purpose entity (hereinafter "SPE", according to the relevant national corporate laws) with possibly more "cells", i.e protected cell companies(hereinafter "PCC"), or equally the form of a Master SPV owning and controlling several sub-SPVs(or even the form of a or a Holding Company with multiple subsidiaries, which could comprise of SPVs, AIFs etc), allowing further portfolio segmentation per portfolio or participating bank[597].

A PCC is a company whose patrimony consists on the one hand in assets contained in one or more cells, each constituting structurally separate parts of the PCC and containing so-called "cellular assets" and, on the other hand, in assets contained in the "core patrimony". In a nutshell, SPE- namely a securitisation entity- becomes a PCC as of the day its board of directors has created a cell containing a part of the assets and liabilities of such company. The only condition for the board to create such a cell is that the articles of incorporation must explicitly grant the board of directors such powers.

In the same context, NAMA and Sareb were established as limited liability companies that operate through one or several special purpose vehicles (SPVs). Indicatevely, NAMA operated through multiple SPVs controlled by a Master SPV, held by the National Asset Management Agency Investment Limited (NAMAIL, a public-private partnership). NAMA held a 49% stake in the Master SPV as well as **a veto over its strategic decisions**. FMS was by design structured as a single-purpose entity(SPV)[598].

In the default case[599] where the AMC has the legal form of a special purpose entity[600], the relevant provisions of the Securitization Regulation, mainly as regards the true-sale nature

[595] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 42.
[596] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 42.
[597] See indicatively **Rutsaert Q. (2007)**.
[598] See **Medina Cas and Peresa (2016)**, p. 15.
[599] See **Glister J. and Lee J., Hanbury & Martin (2015)**, pp.261–266, **Robinson L. K. and Young A. (2016)**.
[600] See relevant definition in Article 2 par. 2 of the Securitization Regulation: "'securitization special purpose entity' or 'SSPE' means a corporation, trust or other entity, other than an originator or sponsor, established

and the bankruptcy remoteness of the entity, have to be complied with. In this case a "thin capitalization"/ "capital-free approach regarding the SSPE's capital adequacy is followed[601].

According to Securitization Regulation, the SSPE must be an entity legally independent form the originator or the sponsor, so as to inter alia ensure the avoidance of the SSPE's consolidation in the Originator Bank's balance sheets under the relevant accounting rules, the fulfilment of the "significant risk transfer" condition according to article 243 CRR and the SSPE's bankruptcy remoteness precondition[602], which mandates that the asset pool cannot be implicated in the insolvency of the originator. In this context, in a true-sale securitisation, the transfer or assignment of the underlying exposures to the SSPE should not be subject to clawback provisions in the event of the seller's insolvency, without prejudice to provisions of national insolvency laws under which the sale of underlying exposures concluded within a certain period before the declaration of the seller's insolvency can, under strict conditions, be invalidated.

In contrast to borrowing directly against security over assets, true sale securitisation involves separating the revenue streams from underlying assets from the credit risk of the originator[603]. This highlights a key difference between securitisation and its capital markets twin, "covered bonds." A covered bond investor will hold a preferential claim in relation to a designated pool of assets but also an ordinary claim on the originator financial institution[604]. The "dual recourse" feature is captured in the new covered bonds framework under implementation(Directive (EU) 2019/2162, Chapter 1, Art. 4)[605].

As regards its (micro/ macro-)prudential regulation framework, things are less clear. There is mainly a certain trade-off: regulate like any other comparable market player, i. e a mere credit purchaser and/or servicer or tailor its prudential framework to its special features considering its functions and role in preserving financial stability and its

for the purpose of carrying out one or more securitizations, the activities of which are limited to those appropriate to accomplishing that objective, the structure of which is intended to isolate the obligations of the SSPE from those of the originator".

[601] See **Messina (2019)**.

[602] Moreover, the "true sale" legal nature of the securitization transaction and the consequent absence of any "severe clawback clauses" is considered a prerequisite for the STS designation, as part of simplicity requirements, according to article 20 SR, whereas article 20 par. 6 SR requires the seller to provide representations and warranties that, to the best of its knowledge, the underlying exposures included in the securitisation are not encumbered or otherwise in a condition that can be foreseen to adversely affect the enforceability of the true sale or assignment or transfer with the same legal effect.

[603] See **Göthlin (2021)**, p. 20.

[604] See **Göthlin (2021)**, p. 21.

[605] See **Messina (2019)**. Covered bonds do not lend themselves for risk transfer and reallocation, but solely serve as a high quality and cost-effective funding tool. For this reason, we will not include it in our proposals for NPL resolution tools.

potentially institutional veil, namely specific powers under private or public law deemed necessary for the AMC to fulfill its mandate.

One could argue that differentiating the AMC from other comparable credit purchasers/ servicers constitutes a discretionary treatment and violates the fundamental in financial regulation rule "same business, same risks, same rules", imposing excessive regulatory burden to the AMC, increasing its compliance costs and possibly unduly delaying its set-up. That could be the case for decentralised AMCs, owned and operated by private investors, without recourse to state aid and potential implications for financial stability. Conversely, state-backed centralised AMCs with considerable asset size, financial firepower, institutional stature and consequently an implicit quasi financial stability mandate or at least financial stability significance, cannot be regulated like any other credit purchaser, otherwise adversely violating the aboventioned "same business, same risks, same rules" principle.

Therefore, provided that it is widely accepted in literature[606] that an AMC should not obtain a banking or AIF/ UCITS manager license, a tailored microprudential framework should be designed, adding to the already imposed by the Proposal Directive requirements for credit purchasers/servicers(namely its conduct of business rules). It should set targeted capital adequacy[607], liquidity management, risk management and possible investment restrictions requirements inter alia ensuring that the risk-taking of the AMC will be limited to the areas that are strictly related to the work-out of its assets. For example, the AMC should not assume open foreign exchange positions, or interest rate risk positions with the exception of hedging purposes. In this context, the abovementioned ESMA's considerations as regards the forthcoming credit funds regulation could serve as another benchmark.

The AMC may also be able **to provide interim financing[608]** against strict criteria[609], without having to be granted a banking license or an asset management license, which would likely subject the AMC to bank regulation and supervision as well as stricter disclosure requirements.

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[606] See indicatively among others **Medina Cas and Peresa (2016)**, p. 15, who note that none of the EU's AMCs had a banking license or was subject to even tailored capital adequacy rules.

[607] However, as **Annunziata (2021), p. 31** stipulates, if not proportional, the relevant compliance costs, namely strict capital requirements for the AMC itself and cumbersome legislative procedures, can drastically hinder its efficiency.

[608] On the credit granting and interim financing competence of the SSPEs under the Italian Securitization Law, see among others **Iannò M. (2019)**.

[609] As **Annunziata (2021)** illuminatingly stipulates, there is no clarity as to what "granting credit" actually means in the EU legislative framework. One point is pretty clear: the mere granting of credit is not per se reserved to credit institutions under EU law. In the context of the CRD IV-CRR it could also be described as an "ancillary" activity, but it is not properly such: it is, more simply, an activity that is included in the list of those eligible for mutual recognition. It may be, nonetheless, subject to restrictions and limitations under national law.

Finally, the AMC should be designed with the objective to maximise the recovery value given certain constraints.[610] Assuming the objective of an AMC is to maximise the value of assets that it is endowed with, and based on an accurate asset valuation process, from the outset, **the AMC should therefore aim to cover its costs** (captured largely in valuations that led to the TP). If the AMC would be able to make significant profits, once all costs have been covered, it would imply that transfer prices of assets were too low, penalising banks and, potentially having imposed tax-payer costs associated with bank recapitalisations[611]. Equally, an entity set-up to make losses is not credible, not least from public finance perspective. More on that in the funding/capital structure section.

Notwithstanding limitations and impediments imposed by the EU state aid and banking resolution framework(already discussed above), some considerations regarding accounting implications and the impact on public finances and national accounts, when public funding is envisaged, are in order before moving on to crucial features of national AMCs, such as its optimal funding and capital structure, the determination of the transfer price and the interaction with the transferring banks.

2. Impact on public finances and national accounts

The extent of the fiscal impact of AMCs depends on their sector classification in national accounts. In national accounts, any given unit can belong to only one sector[612] and, as a general rule, units are not split. The choice is between financial corporations and general government[613].

AMCs would be classified as part of general government when the government is assuming risks and rewards associated with asset management and the incurrence of liabilities by the AMC.[614][615] In any other case, the AMC would be classified in the financial corporations sector[616]. This assessment is conducted on the basis of an "substance over form" approach, irrespective formal characteristics and the legal status of the AMC: it could be classified as part of general government albeit being privately-owned or maintaining a banking licence.[617]

Impact of losses related to impaired assets on government deficit and debt

[610] See **EC's Staff Working Document on AMC Blueprint (2018)**, section 5.2 for further details.
[611] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 42-43.
[612] See ESA 2010: 2.41
[613] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 63.
[614] See ESA 2010: 20.32-20.34, 20.46, 20.243-20.248.
[615] See ESA 2010: 20.02.b.
[616] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 63.
[617] See ESA 2010: 20.32-20.34.

If an AMC is classified inside general government, its operations impact the '**Maastricht deficit'** [618]. The largest impact usually derives from the transfer of the assets.[619] Indeed, any consideration/subsidy provided(*mainly though inflated transfer prices*) in excess of market or fair value of the assets is recorded as a **deficit-increasing capital transfer**.[620] Fair value or expected redemption value of the assets has to be valuated by an independent body on the basis of best pricing practices[621].

If the AMC is classified outside general government, **government guarantees** could be qualified as a deficit-increasing capital transfer to the extent that they exceed the estimated fair value threshold.[622] In any case, further deficit and debt impact are possible, even when an AMC is classified outside general government, but some transactions and associated liabilities are considered as done or incurred **on behalf of the government**[623].

The impact on debt when an AMC is classified as part of government is more straightforward, due to the gross nature of the '**Maastricht debt**'[624]: any obligation of such an AMC towards units outside general government (e.g. to originating banks) which has a nature of deposit, debt security or loan, will add to the government's 'Maastricht debt'[625]. Contrariwise, ccontingent liabilities are not treated as immediately affecting the public debt, but only count against the debt when the trigger event happens, such as a guaranteed bond not being paid back by the issuer[626].

Naturally, the impact of losses does not exclusively occur in the beginning of the process but may also crystallise at later stages. In cases when AMCs are classified inside government, this can occur when further losses on the assets are recognized, either due to new estimates or to the resale (or other transformation) of those assets, which- in case the IFRS accounting standards are followed by the AMC- could be significant[627].

Capital injections into banks and apportioned losses

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[618] "Maastricht deficit" or "Excessive Deficit Procedure (EDP) deficit" is defined in Protocol No 12 on the Excessive Deficit Procedure attached to the TFEU and in the subsequent legal acts and corresponds to net borrowing (net lending) of the general government sector, as defined in the European System of Accounts ESA 2010. It is used when assessing Member States' compliance with the requirements of the Stability and Growth Pact. For the significance of the EDP enforcement actions overhang, see **Sahil et al. (2014)** and **Grossman, E. and Cornelia Woll (2014)**.

[619] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.

[620] ESA 2010: 20.246-20.247

[621] Manual on Government Deficit and Debt: IV.5.2.3-IV.5.2.5

[622] ESA 2010: 20.245, 20.256

[623] ESA 2010: 1.78. See also **Allen, F., Carletti, E. and J. Gray (2013, editors) and Allen, F., Carletti, E. and J. Gray (2014, editors).**

[624] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.

[625] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.

[626] See **Gandrud and Hallerrberg (2016)**.

[627] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.

When government support to financial institutions takes the form of acquisition of equity or other forms of (regulatory) capital, payments that are destined to cover accumulated, exceptional or future losses qualify as **capital transfers** (with deficit impact)[628]. Contrariwise, when a government is acting as a normal shareholder (in the sense that it has a valid expectation of earning a sufficient rate of return), payments are recorded as **acquisition of equity** (without deficit impact but still increasing the gross debt if they are funded through government borrowing).[629]

Sometimes capital injections are combinations of the two above-mentioned forms of transactions[630]. The most notable case is when capital injections are made into corporations under restructuring or recapitalisation, provided that **forward-looking considerations** of future rate of return coincide with **past losses.** To address this, Eurostat proposed an implementation rule of '**apportioned losses**': part of the capital injection which corresponds to government's share in accumulated past losses is in any case to be recorded as a capital transfer (with deficit impact), while for the remaining amount usual considerations of sufficient rate of return and other arguments (e.g. participation of private investors) apply when determining the nature of the transaction[631].

3. Accounting aspects

First, accounting de-recognition from a bank's perspective require the transfer of the rights to receive contractual cash flows to the AMC and the bank not substantially retaining risks and rewards[632]. In the same vein, it must be ensured that none of the transferring banks would consolidate the AMC as otherwise the transferred NPLs would be included in the consolidated accounts of the transferring bank. According to IFRS, consolidation is mandatory, in case an investor controls another entity. Considering the AMC's clear-cut mandate to focus exclusively on recovering value maximization on a commercial basis and the governance and independence safeguards of the dedicated AMC's Law, such control is not in principle feasible[633]. However, the judgement is in any case ad hoc. Notably, in case the AMC includes assets from several banks, notably in case it has the form of a Master SPV, the examination of a need for consolidation at each bank will need to consider if it holds interests in a **"silo"**, i.e. a deemed separate entity within the AMC that includes its former assets[634].

From the AMC's perspective, in case the AMC is a non-listed limited liability company without a banking license, it has to draft its financial statements in accordance with national

[628] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.
[629] See ESA 2010: 20.198-20.199
[630] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.
[631] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 63-64.
[632] See IFRS 9.3.2.
[633] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[634] See **EC's Staff Working Document on AMC Blueprint (2018),** pp. 55-56.

Generally Accepted Accounting Principles (GAAP), in line with the EU accounting Directive and its specific requirements on valuation, presentation, disclosure, publication and statutory audit[635].

However, Member States have the option under the IAS Regulation to allow or require the use of EU endorsed IFRS[636] for companies or public interest entities (including banks)[637]. If the AMC issues securities (shares or debt securities) on an EU regulated market, the use of IFRS for its consolidated accounts is mandatory.[638] In any case, AMCs may voluntarily apply EU-endorsed IFRS, if feasible for non-listed companies, especially in the case where AMC issues bonds to third-party investors, with a view to prevent accounting mismatches between financial assets and liabilities or hedging instruments[639], given that the IFRS is the benchmark in the financial sector[640].

The applicable accounting framework should not hamper the objective of the AMC, enabling it to realize the LTEV premium. The choice of the accounting framework, if existent, should take into account the interaction with public accounting standards, and other idiosyncratic features of the AMC's funding and capital structure with a view to maximize the attractiveness to private investors[641]. In essence, a higher relative use of fair value in the accounting framework could lead to more volatility of the P&L or capital than the use of historic cost combined with credit loss provisions, which in extremis may lead to the AMC's insolvency to the detriment of financial stability and public finances[642].

There are essentially two notable accounting issues [643]:

1. **"Initial recognition"**

First time recognition of the NPL asset on the AMC's balance sheet shall be at its **fair value.** In the IFRS context, IFRS 9 and IFRS 13 assume that in principle the transaction price is normally the financial instrument's fair value at initial recognition. Assuming that

[635] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 54.
[636] If the IFRS option is used requirements on management reports, disclosures and statutory audit in the Accounting Directive continue to apply.
[637] Several Member States (including EE, IT, GR, HR, CY, LV, LT, MT, SI, SK) have used the IFRS option to require banks to prepare IFRS financial statements. Some other Member States (such as LU, NL, FI or UK) allow banks to use IFRS for the preparation of financial statements.
[638] See **EC's Staff Working Document on AMC Blueprint (2018)**, section 4.5.2.iii on the potential need to prepare consolidated accounts and the idea that the AMC might be considered as an investment entity in the meaning of IFRS 10.27.
[639] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[640] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 54-55.
[641] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 54-55.
[642] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 54.
[643] As regards the analysis of the special accounting issues, it is assumed that the AMC uses IFRS. The same apply mutatis mutandis, when the AMC uses national GAAP with rarely significant aberrations. Besides, several Member States have provisions in their national accounting laws requiring the use of IFRS in case an issue is not covered in their national GAAP.

the transfer takes places at the REV or at a price between the EMV and REV, it needs to be proven that the TP is the fair value. As the TP differs from the EMV – with the EMV estimated "based on observable transactions for similar types of assets" – such proof might be difficult[644]. If not feasible, according to IFRS 9.B5.1.2A, the difference would significantly impact the AMC's equity at initial recognition of the asset or deferred over time[645].

2. **Classification and subsequent measurement**

Although the amount of initial recognition of financial instruments is the same irrespective of their classification, the accounting classification leads to discrepancies in how financial instruments will be subsequently "measured" (valued) over their remaining life[646].

IFRS has three main classifications with specific subsequent measurement approaches: 1) "amortised cost", 2) "fair value" with fair value changes through Profit or Loss (FVPL) or 3) fair value with changes directly in equity (FVOCI).[647] The fall back classification in IFRS is fair value at profit or loss[648].

Most financial assets transferred to the AMC are likely to meet the test of having "solely payments of principal and interest" (SPPI). In that case, if the AMC's business model is to pro-actively manage (i.e. sell) these assets, then the transferred assets should be measured at fair value[649]. In case the AMC business model would be to merely collect contractual cash flows only, they would in principle be calculated at amortised cost[650]. The latter option generates generally less volatility than measurement at fair value but implies possible "impairment" charges[651] and does not allow showing profits if the fair value of the NPL portfolio would go up before actually selling the NPL portfolio[652].

Finally, in respect of the accounting treatment of its (sub-SPVs) subsidiaries, they are typically are measured at fair value, provided that the AMC is considered as an investment entity according to IFRS 10[653].

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[644] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[645] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[646] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[647] It is assumed in the following that IFRS 9 will be applicable when an AMC starts its operations. The classification of a financial instrument needs to be done at its recognition (IFRS 9.3.1.1). See also for more details IFRS 9.4.1, 4.2 and IFRS 9.4.15.
[648] The Accounting Directive also requires that Member States either require or permit the application of fair value accounting for certain financial instruments as well as other assets.
[649] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[650] IFRS 9.B.4.1.6. A third option would be the recognition of the financial assets at fair value through other comprehensive income, though hardly applicable in this case (see IFRS 9.4.1.2A).
[651] Given the nature of the assets, it is probable that the bulk of the assets would already be impaired prior to the transfer and be acquired at a significant discount with respect to the gross book value. The likelihood of future impairments would therefore be limited by the transfer price mechanism.
[652] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.
[653] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 55-56.

3. Funding and capital structure

The effectiveness of AMCs critically depends on their capital and funding structure[654].

AMC asset acquisition can be funded in a number of ways:

(i) through the issuance of debt securities with or without government guarantees placed with the participating banks;
(ii) through direct capitalisation by governments before or after the asset transfer at EMV;
(iii) though private investors' equity and debt financing and loss-sharing; and
(iv) through a combinationof public and private equity, guarantees and private loss sharing.

Although AMCs usually are (at least partially[655]) owned by the transferring banks to reduce moral hazard, they can still be either privately or publicly funded.

NAMA[656]: Funding consisted of EUR 30 billion in state-guaranteed senior bonds, EUR 1.6 billion in subordinated bonds and EUR 100 million in equity. The redemption value of NAMA subordinated debt payments depended on its performance, whilst the payment of the coupon was discretionary. The government would benefit from any profits made by NAMA while potential end-losses, after burden sharing by subordinated debt holders, would be borne by banks **by the imposition of a levy[657]**.

SAREB: Original funding was EUR 50.8 billion in state-guaranteed senior debt with maturity of one to three years and EUR 3.6 billion in subordinated debt (15-year callable bonds **convertible into equity**). In 2015, Sareb's initial shareholders' equity of EUR 1.2 billion was wiped out due the need to provision an additional EUR 2 billion following the new Bank of Spain accounting valuation framework, but the capital was restored by the conversion into equity of EUR 2.2 billion in subordinated debt. Following this, Sareb had EUR 953 million in equity and EUR 1.4 billion in subordinated debt. Since its creation in 2012, Sareb has **recorded pre-tax losses[658]**.

FMS Wertmanagement: Funding originally was EUR 124 billion of SoFFiN (government) bonds that were transferred to FMS together with the assets purchased from the HRE. The SoFFin bonds were replaced by own funding by 2011. The annual funding plan is based on EUR 2 billion in expected annual sale proceeds in addition to a mix of money market (**short-term funding or commercial paper and repos**) and capital market

[654] See among others **Avgouleas et al. (2021b)**, p. 23.
[655] In order to avoid consolidation and ensure the de-recognition of the transferred assets from the participating banks' balance sheets.
[656] NAMA first became profitable (after impairment charges and taxes) in 2011. As of June 2016, it expects to make a cumulative profit of up to EUR 2.3 billion by the time it winds down in 2020.
[657] See **Medina Cas and Peresa (2016), pp.15-19.**
[658] See **Medina Cas and Peresa (2016), pp.15-19.**

issuances (**long-term funding or bonds**). In 2014, capital market funding accounted for almost half of total funding (compared to about 14% in 2010/2011). As an issuer, **FMS benefits from an explicit sovereign guarantee** that results in a ranking equal to that of the Federal Republic of Germany. This ensures **favourable funding costs.** SoFFiN also has to compensate for all losses that FMS may make, **however FMS has been profitable** since 2012[659].

Option 1

In this case, which is also the Commission's AMC Blueprint proposal, the funding of the AMC could be structured following the examples of SAREB and NAMA.[660] Schematicaly:

1. The AMC would acquire assets by issuing senior unsecured bonds to originating banks[661]. The senior bonds would carry a full and irrevocable guarantee of the national Treasury[662], and would be structured in design to be eligible for use as collateral in Eurosystem credit operations by their holders[663]. The bonds will be bullet securities with a call option available to the issuer[664]. The guarantees, being a contingent liability of the government with a remote probability of being ever called due to the pricing of asset transfers and a capital cushion of the AMC, would not increase the stock of public debt[665].

[659] See **Medina Cas and Peresa (2016), pp.15-19.**

[660] This does not imply that funding approaches should be limited to those implemented in the cases of NAMA and SAREB. Similar, yet alternative, models could be applied, optimally adapted to Member States' specific characteristics. This type of funding solution could be structured in compliance with the BRRD and SRMR.

[661] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.

[662] According to the Commission's AMC Blueprint(2018): " *Market funding solutions without a guarantee should be explored as part of the national AMC design process and, if feasible, they may be preferred to the government-guaranteed funding*". However, this should not be done in the form of private investor's guarantees that substitute the central government's guarantee, as this would in any case seriously undermine the effectiveness of the abovementioned funding and capital structure for two main reasons: 1) it will hinder the ***eligibility of the senior bullet bonds for use as collateral in Eurosystem credit operations;*** 2) it will result to higher risk weights in the participating banks' balance sheets comparing to senior bonds guaranteed by the central government. Indeed, optimally banks should retain only the senior tranches stapled with the preferential prudential treatment "sweeteners" or the subordinated tranches that could not be absorbed by the private sector.

[663] However, as Fell et al. note pointing to the ECB's Guideline (EU) 2015/510 of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60), the ECB will ultimately decide on the relevant senior bond's eligibility on a case by case basis. See relevantly **Fell, Grodzicki, Martin, and Edward O'Brien (2017b)**, p. 80. For further analysis see **Gortsos, C. (2021a).**

[664] In a nutshell, a bullet bond is a debt investment whose entire principal value is paid in one lump sum on its maturity date, rather than amortized over its lifetime. Bullet bonds cannot by default be redeemed early by their issuer, unless they encompass a relevant call option. Those two elements makes them more expensive than other comparable amortizing bonds or non-callable bonds. This is exactly why they are usually issued by stable governments mirroring a relatively low rate of interest due to the negligible risk that the lender will default on that lump sum payment.

[665] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.

2. The large majority of the funding should consist of senior guaranteed bonds. Moreover, AMC would be required to have an equity stake to cover the expected Day 1 loss related to the initial recognition of assets at fair value with a buffer that would allow the AMC to work out assets and carry out the necessary hedging strategy without being at risk of falling into negative equity[666].
3. **The buffer could be financed through subordinated debt**-calibrated **to cover the unexpected loss on the assets- placed also with the participating banks[667]**. The stricto sensu equity stake cannot be covered in majority from thw participating banks as in this case concerns regarding the consolidation of the AMC as a subsidiary would arise. In such cases, the structural and operational division with the 'main' bank can be achieved in different ways, but the balance sheet remains consolidated[668]. Consequently, participating banks should optimally provide up to 20% equity contributions in exchange for preferrable shares without voting rights in order for the AMC ***to cover its initial outlays and working capital needs[669].*** The rest will be provided by the State[670] and private investors. Besides, since AMCs- especially under this structure- so significantly benefit from state guarantees, the government may be in a better position to (partly) own the AMC itself so as to benefit from any possible future price rise of the AMC's assets or amelioration of the initially expected recovery rates and related cash flows[671]. However, at least 30% of the residual capital need to be funded by private structures so as to avoid the consolidation of the AMC to the State's Balances and the ensued impact on the public finances(mainly the "Maastricht debt"). The AMC could confortably raise such an equity portion, provided that the transfer price is right and the subordinated creditors (i. e the participating banks) bear the first (unexpected) losses.
4. The benefit of the payment-in-kind would be that the liquidity needs of the AMC would be minimised, as the AMC would not need to raise cash to acquire the assets and could lock up the funding from originating banks[672]. Additionally, banks would benefit from swapping a high-risk non-performing asset for a low-risk, quasi-

[666] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.
[667] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.
[668] See **Medina Cas and Peresa (2016),** p. 8.
[669] In some jurisdictions banks are establishing dedicated rescue funds regulated under the EU Alternative Investment Fund Directive. A notable case is Italy's rescue fund "**Atlante**", which is in essence an Italian private equity fund that is dedicated to recapitalize Italian banks in need as well as purchase the securities of the junior tranches of their non-performing loans. See in further detail **Ugeux (2017)**.
[670] In order to avoid the upfront cost for the State, an alternative design could be considered: instead of directly injecting capital in the AMC, part of the State's contribution (*provided that at least a portion of the capital contribution needs to be injected upfront to fund its set-up and on-going operational costs*) to the AMC's capital could take the form of irrevocable commitment to immediately inject the additional capital whenever necessary, provided that such legal structure is compatible with the AMC's dedicated law and the relevant national corporate law provisions.
[671] See **Ingves S., A. Seelibg S., and Dong He (2004)**.
[672] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, pp. 79-80.

sovereign asset that would improve their funding position without tying up large quantities of regulatory capital, although their balance sheets would not shrink substantially[673].

On the other hand, the funding and capital structure should be designed so as to avoid the consolidation of the transferred asset to the particitipating banks' consolidated balance sheets. Thus, apart from ensuring that their participation to the AMC's capital will not exceed a certain threshold, the overall vast majority of bonds- both senior and subordinated- placed with transferring banks in addition with their equity stakes should not be such as to lead to consolidation either of the AMC's in whole or of the AMC's ring-fenced silos[674]. Therefore, a certain portion of senior state-backed bonds should- after the transfer(and the consequent pay-in kind financing of their acquisition from the AMC)- be transferred to private investors too. In particular, those senior state-guaranteed bonds could **countain a call option**, with which the AMC after a predifined time-frame could redeem in full the bond while selling the ring-fenced portfolio of NPLs consisting the collateral pool for the payment of the senior state-backed bonds to investment funds or other non-bank credit purchasers, namely when recovery rates are proved better than initially anticipated.

On the other hand, **this residual dependence, limited to a small part of the AMC capital and debt structure**, can ensure that banks put skin in the game and comply with their risk retention requirements under the Securitization Regulation(if applicable).

Moreover, the "thickness" of the subordinated bonds placed with the participated banks will depend on three conditions[675]:

1. The extent of the participating banks' immediate capital depletion after the transfer of the assets, i. e the size of the haircut(the gap between the assets' REV and EMV), considering the fact that those bonds will not be state-backed.
2. The gap between the transfer price and the EMV related to the "REV premium", i. the expected increase of the recovery rate and EMV of the transferred assets due to the AMC's active work-out. If a narrow gap exists, the AMC will not face difficulties to raise capital from private investors and thereby will need less such credit enhancement mechanisms.
3. The actual involvement of private investors in the AMC's capital so as to avoid excess exposure for the State.

If subordinated bonds are included in the AMC's capital structure, a GACS-likened payment waterfall would be agreed in advance ensuring the subordinated bonds should

[673] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.
[674] See in detail below.
[675] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.

only be repaid after all senior bonds will have been amortised[676]. Moreover, appropriate controls must be put in place **to ensure that AMC redeems (senior) debt**, **rather than building cash reserves or diverting resources to other interests[677]**. To ensure that an AMC's overarching goal – the timely wind down of its portfolio – is achieved and not diverted, strict guidelines should be laid down to ensure that an AMC reduces its outstanding liabilities at every reasonable opportunity, bearing in mind the natural priority of the capital structure, and does not run up large cash buffers[678].

From an opposite point of view, Kasinger et al. (2021)[679] note that it is a priori questionable why public funding is truly needed as numerous private investors stand ready to invest into NPLs under the right prices and market conditions and a growing number of NPL servicing companies (including AMCs) stand ready to assist by offering the necessary management capacities for NPLs. Thus, **one could argue that free markets should be sufficient to take over even large amounts of NPLs**. Besides, the Commission's own latest Action Plan argues that public funding may be needed in most cases without providing convincing arguments why public support is required. **Today's capital markets do not seem to be characterised by a shortage of capital supply**. If anything, current capital markets show phenomena such as the well-known "savings glut", caused by a significant increase in the global supply of saving over the last years. Public support of AMCs involves a substantial volume of public subsidies and thus is likely to distort market prices and hardly be compatible with the state aid framework. In the author's view the above could hold true, if the abovementioned market failures did not clog up the nascent oligopsony NPL market, thereby paving the way for speculative pressures from domimant investors with ultra bargaining power.

Option 2

This funding and capital structure would have the following, market confort form:

1. Conservative transfer price, close but at a discount of the NPLs' REV (overcollateralisation).
2. The AMC would be structured as a master SPV with so many sub-SPVs as the participating banks. Each SPV will have a thick senior tranche, a junior tranche and a slim equity stake.
3. The senior notes would be guaranteed by the State and thus enjoy a credit rating of at least investment grade. Those notes would have a low interest rate and be aimed at risk averse constitutional investors. Some of the senior assets could be withheld

[676] Similarly, the equity should be last to be repaid, after redemption of all debt instruments, although the significance of such a "default waterfall" diminishes, when all bonds are placed with the same participating banks.
[677] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, p. 80.
[678] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 60-62.
[679] See **Kasinger et al. (2021).**

by the participating banks for pure funding purposes(considering its relative low risk weights and eligibity under the abovementioned ECB's collaterall framework).

4. The junior unrated tranches will be placed in principle with investors who have a different risk profil and more risk tolerance(i.e AIFs, investment banks) as they will not be state-backed and consequently offer a higher return. Those notes will be designed as CoCo's. In this context, Santos (2019)[680] analyses the capital structure of private asset managers in which the acquisition of NPLs is funded with Contingent Convertibles (CoCos) placed with investors. The CoCos would contain put and call options to write down losses and write up profits respectively that arise from liquidation and restructuring procedures. As an extra sweetener, we propose the junior tranches to be stapled with attractively- priced equity warrants, allowing the private investors a joint in the upside, i. e the increased profitability, of each participating bank[681]. Any residual junior tranche will be placed as a last resort with the participating banks.
5. The equity tranche will be placed with private investors, the servicers and asset managers engaged in the work-out (to ensure interest alignment and market confort remuneration) and the participating banks(a comparably dainty stake) allowing them to also have a joint in the potential upside, considering the huge discount from the NBV("overcollateralization").

5 Conditions for bank participation

All NPLs should be properly identified and valued and bank solvency position tested against plausible scenarios from a forward-looking perspective. **Where appropriate, banks' participation can be organised based on a qualified mandatory basis,** without the consent of neither the shareholders of the transferring nor any third party, namely the distressed debtor[682]. Indeed, participation in the AMC should not normally be fully left at

[680] See in detail **Santos, M.A.O. (2019), passim**. On the the benefits of such contingent capital, see among others **Martynova, N. and Perotti, E.C. (2015), Pennacchi, G. (2010), Calomiris, C. W. and Herring, R.J. (2013), Perotti, E. and Flannery, M. (2011), Pazarbasioglu, C. et al (2011), Duffie, D. (2010), Flannery, M.J. (2005), Coffee, J.C. Jr. (2010).**

[681] A relevant de lege ferenda argument could be the following: As **Avgouleas, E. (2012), p. 414 and Schillig M. (2016), p. 256** stipulate, the premise of BRRD's provision that the asset separation tool may be applied only in conjunction with one of the other tools is based on the grounds that the toxic assets segregation from a bank's balance sheet may encourage a more risky investment strategy and increase the moral hazard problem. In this vein, the AMC scheme, analogously to its "resolution twin", i.e the asset separation tool, should ensure burden sharing, albeit not upfront(the "burden sharing waiver" introduced by the State aid temporary framework could provide the legal basis to skip such costly upfront burden sharing) in order not to aggravate the capital pressure to the ailing banks at the initial stage. This is why our proposal seems to compromise those two legit goals.

[682] See **Schillig M. (2016), p. 252.** On the implications of such mandatory statutory transfer of assets by a third country's law, see **Schelo, S. (2015)**, p. 144. For the relevant corporate law considerations, see **Linaritis(2020)**, p. 46 et seq. with further references therein. Especially on the fact that such loss-generating significant (NPL) transactions fall in principle within the exclusive competence of the Shareholders meeting and thereby can only be waived by explicit legislative provisions-provided that these provisions do not breach

the discretion of the concerned banks, at least not before ensuring that the AMC enjoys critical mass of assets[683]. Purely voluntary participation may result in inaction, on account of first-mover disadvantages, or cherry-picking of NPLs by participating banks[684]. The authorities should thus introduce incentives to transfer the assets, notably through SREP Pillar II supervisory measures (or other macro- or microprudential and accounting measures), or by offering a "sweetener" stake in the AMC's upside[685] (due to the structural overcollateralization and the AMC's servicing expertise)[686]. In particular, analogously to article 64 BRRD, the incorporation in the AMC's dedicated legal framework of the power to transfer equity and debt securities as well as other assets, free from any encumbrances or third party rights, and possibly after the removal of pre-emptive rights, is of particular importance[687]. Banks deemed by the diagnostic exercise to be in scope to transfer assets to a publicly supported AMC may hence need to be obliged via national legislation to do so at the identified transfer price, which cannot exceed the REV[688]. Such mandatory participation would impact their fundamental rights[689] and would therefore need to be justified in the public interest (e.g. for financial stability purposes). In the case of NAMA, mandatory asset transfer was considered but not adopted because of "significant public ownership of the Irish banking system"[690].

Banks in scope should address any shortfalls vis-à-vis their respective capital requirements resulting from the NPL disposal losses. Banks considered to be FOLF must be strictly forbidden to participate in the scheme and transfer assets to the AMC.

In the author's view, in order to limit the scope of the participating banks to the necessary to ensure financial stability threshold, a provision analogous to article 42(5) BRRD, as authoritatively interpreted by EBA, should apply. In particular, analogously with the BRRD's provisions applying to asset separation resolution tool, the AMC scheme should exclusively be used in respect of assets the liquidation of which, under normal insolvency proceedings, could have an adverse effect on the financial market due to fire sales wedging

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shareholders' fundamental rights, see **Linaritis(2020)**, p. 49, **Enriques L., Hansmann H., Kraakman R., Pargendler M. (2017), p. 87, Grundmann S. (2012), p. 274.**

[683] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, p. 78.

[684] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, p. 78.

[685] See **De Haas R, Markovic B. and Plekhanov A. (2017), pp. 132-133.**

[686] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, p. 78.

[687] See **Schillig M. (2016), p. 252.**

[688] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.

[689] As regards the administrative and judicial review of such intrusive and potentially unlawful ECB's (within the SSM) and SRB's(within the SRM) decisions mandating assets transfers or otherwise infringe TFEU/TEU, secondary EU financial law(namely SSMR, SRMR, BRRD, CRR, CRD IV), see by mere indication **Arons (2020)** and **De Paz (2018)** with extensive references to the CJEU's relevant jurisprudence therein. In case the decision is of direct and individual concern to the shareholders or other creditors of the credit institution, they may appeal against this decision as well, see indicatively Trasta Komercbanka and others v ECB [2017] (Case T-247/16). In any case, it should be recalled that Article 47 of the Charter of Fundamental Rights of the European Union (CFREU) provides that everyone whose rights and freedoms guaranteed by the EU law are violated has the right to an effective remedy before a tribunal.

[690] See **Cerruti and Neyens (2016)**, pp.109–110.

even further the bid/ask spread, or where the transfer is necessary to ensure the long-term viable asset quality of the participating institution, or to significantly maximize liquidation proceeds[691].

6. Interaction with transferring banks

To address moral hazard, banks need to share the potential losses that an AMC might face (at least in part). This should be achieved through withholding a portion of the junior(equity) tranches- as long as it does not surpass the threshold set in Article 244 et seq. CRR- on a mandatory basis. Clawbacks will also be strictly forbidden[692]- irrespective of whether the relevant provisions of Securitization Regulation are deemed applicable- after the transfer in order to ensure an effective risk transfer. Indeed, clawback provisions **create a contingent liability**. If this liability is put on the bank's balance sheet, the NPL transfer is not definitively eliminating the risk from the bank's balance sheet but is **merely shifting it from the asset side to the liability side of the balance sheet**.[693] Optimally, it should be a direct transfer taking the bank out of the decisions / activities post-transfer. Naturally, any transfer mechanism that envisages a securitisation process should fulfil the CRR's significant risk transfer prudential requirements, as well as the risk retention requirements of the Securitization Regulation[694].

Lastly, if possible, originating banks should not in principle be involved (or at least only with stringent governance safeguards) in the servicing of the loans beyond a certain interim period, as they are faced with an inherent conflict of interest, holding similar assets themselves.[695] Besides, the whole premise of the AMC solution is to appoint the active servicing of the loans to a "specialized" servicer and allow originating banks to concentrate on the lending activity.

7. Safeguard mechanisms

Historically the importance of these mechanisms has been more evident in countries with weak legal and institutional environments. In particular, the AMC should consider implementing time limits, in order to ensure that the AMC acts expeditiously, financial limits, to avoid that an AMC becomes a fiscal burden, risk management safeguards to ensure prudent risk management practices and institutional and governance mechanisms to ensure independence and market-likened operations[696].

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[691] See BRRD, Art. 42(5). See further EBA, Final Draft Guidelines on the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets under Article 42(14) of Directive 2014/59/EU (EBA/GL/2015/05, 20 May 2015).

[692] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.

[693] See **Hellwig M. (2017b)**.

[694] Article 244-246 CRR sets out the conditions under which a significant risk transfer ('SRT') by an originator institution is recognised. Furthermore, the EBA Guidelines on Significant Credit Risk Transfer (EBA/GL/2014/05) and the ECB Public guidance on the recognition of significant credit risk transfer provide further details on the recognition process.

[695] Leaving NPL management with the original credit institutions, the latter would logically tend to prioritise their own NPLs over the distressed assets owned by the AMC.

[696] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 65-67.

There may be a trade-off between a fully-fledged implementation of safeguard mechanisms and the effectiveness of an AMC. Therefore a thorough cost-benefit assessment should be performed before deciding the implementation of such mechanisms.

Time-limit safeguards

The temporary character of the AMC, according to State aid rules, requires the AMC to have a predefined lifespan[697], specified in the business plan and optimally contingent upon reasonable assumptions about key parameters of baseline macroeconomic and asset recovery scenarios[698]. However, past experience has proven that flexibility to extend the lifespan, under certain conditions, is necessary in order to enable tailoring to varying specifics across countries and/or asset classes[699]. This would ensure that the AMC does not act under pressure to sell its assets (subsequently leading to the fire sales). Nevertheless, the decision to alternate from the suggested lifespan should be duly justified and optimally dependent on its supervisor's acquiescence.

In any case, the state-backed AMCs should only legitimately exist to bridge the intertemporal pricing gap until market failures of the nascent NPL secondary market are promptly addressed and the abovementioned regulatory tools and market infrastructures are in place. **That could be a legitimate benchmark for the definition of the AMC's lifespan.**

Financial safeguards

They purport to ensure that the AMC does not become a fiscal burden. In essence, its size should be capped at inception with an overall limit on the total issued debt or total leverage[700] and possibly face some clear-cut or preferably principle-based investment restrictions (analogous to the Solvency II's "prudent investor" principle) to ensure its focus on the recovery maximization mandate. In order to protect the credibility of the AMC, the imposed limits should be strictly respected and adhered to[701]. Other ways of financial safeguards for an AMC would be to restrict the use of cash through sinking funds for the issued bonds, and/or set up repayment clauses and to promote financial transparency[702].

Risk management safeguards

An AMC is inherently exposed to credit, interest rate, liquidity and possibly currency rate risks. A separate and independent risk management unit should be in place that should be reporting directly to the board of directors. Risk management safeguards aim to limit risk

[697] The appropriate lifespan may differ, depending on the type of assets and the Member State's specific context. Nevertheless, a pre-set, reasonable timespan also underlines that the value of the NPLs and the underlying collateral will only decrease over time. An economic recovery could deliver an uplift. However, waiting longer than, e.g., 10 years for such a recovery to take place is not sensible either, since by that time it is unlikely that the AMC would be able to retrieve the loss in recovery value.

[698] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 65.

[699] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 65.

[700] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 65.

[701] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 65-66.

[702] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 66**.**

tolerance and set lower levels on accepted market (e.g. interest rate and foreign currency risks (i.e. open positions)), credit and liquidity risks. An AMC should utilise currency-hedging practices using derivative contracts to mitigate or manage the currency risk[703].
Liquidity risk needs to be actively managed, which may incorporate ongoing liquidity stress-testing and the maintenance of a minimum liquidity buffer or cash reserves. The buffer should be kept in line with the overall asset and liability management strategy, the expected cash-flow inputs and outputs and the prevailing market conditions[704].

Other safeguard mechanisms

Mechanisms are required to safeguard that the staffing of the AMC is done purely on the basis of merit and that the staff's remuneration remains at market prices[705]. Optimally, the AMC should opt for incentive based remuneration schemes, following best market practices[706]. Special CRD-likened corporate governance[707] provisions and MiFID –likened organizational requirements(mainly as regards conflict of interest management and product governance regarding the distribution of notes to investors) could be introduced for the senior management of the AMC- in addition to the relevant provisions of the Proposal Directive on Credit Servicers and Purchasers and the relevant established Commission's state aid case-law- to ensure proper fit & proper criteria[708] and "four eyes principle", transparency and disclosure requirements[709], accountability, institutional independence, lack of political interference and organizational requirements concerning the management of conflict of interests. As regards the highly contentious topic of granting corporate governance prerogatives to the State, it is the author's view that this should also be done, if necessary, in line with prevailing best market practices[710]. State's governance prerogatives and special rights are not essential when proper supervision and oversight is in place to monitor the AMC's abiding compliance with the tailored features of its dedicated legal framework. Contrariwise, they may trigger fears regarding undue political interference or render the AMC operationally ineffective and unattractive to private investors.

8. Supervision and oversight

An AMC would not attract any deposits or issue new loans, save for its interim financing for the purposes of the work-out process. It is therefore deemed unnecessary for it to obtain

[703] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 66.
[704] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 66.
[705] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 66-67.
[706] See **Parker D.C. (2011)**.
[707] See **Hopt (2021)**, **D. Busch/ Ferrarini G., van Solinge G**, passim, **Armour J. et al. (2016)**, Chapters 17, 26, **Ferran, Moloney, Hill, Coffee (2012)**, passim, **Hagendorff**, p. 139-159, **Fernandes, F. and Martins, M.,** pp. 236-256, **Berger, Imbierowicz, Rauch(2016)**, **Binder J. H. (2015c)**, **Laeven L. (2013)**.
[708] See among others **Busch, Danny (2016)**.
[709] Without prejudice of relevant duties deriving from the Securitization Regulation, if applicable.
[710] In standardized market practice, the junior noteholders are usually vested with exclusive voting rights in relation to all strategic decisions which may have an impact on their investment, while supermajorities requiring the favorable vote of senior noteholders are provided in relation to selected matters such as the so-called "basic term modifications" of the terms and conditions of the notes. See in further detail **Iannò M. (2019)**.

a banking license and adhering to banking supervisory regulations. **The AMC would hence be considered neither as a credit institution, nor as an investment firm**. It would subsequently not be subject to CRR/CRD supervision.

However, even though the AMC will not be under national banking supervision (competent authority), it still needs proper oversight by both EBA and ESRB, as regards prudential regulation and financial stability considerations, the conduct of the asset quality reviews, as well the scrutiny of the interaction with the transferring banks. In the author's view, the EBA-sponsored AQRs for systemically significant AMCs could boost transparency and investor confidence(especially at the initial stages). ESMA should be mandated to closely monitor developments in the nascent secondary market and exercise, if necessary for the investor protection and mainly the preservation of financial stability, its product intervention powers. It should also guide the AMCs in relation with its product governance requirements as product co-manufacturers, if applicable. Finally, the Commission should closely monitor abiding compliance with any preconditions set by its state-aid approval decisions. Additional oversight at a national level from the Central Bank or court of auditors should not be discouraged. Last but not least, a competent authority should be designated to supervise abiding compliance with AMC's legal toolkit. Naturally, if the AMC is an SSPE or securitization sponsor should comply with the relevant securitization regulation's requirements and be supervised by the relevant competent national authority. The same applies for the provisions set out by the Proposal Directive on Credit Servicers and Purchasers. Finally, if the AMC participates in trading venues, it should abidingly comply with the rules of the relevant regulated market set out by the market operator and the relevant MiFID II, MiFIR's provisions accordingly.

However, oversight should be strictly limited to compliance with regulation and the AMC's mandate and should not imply powers to change or challenge business decisions.

Notably, regardless if the AMC has public support or not it should operate as an independent legal entity, and not as a governmental agency. It should have full institutional, operational and budgetary independence and be protected from lobbying and undue political review[711]. Managerial appointments at the AMC should be merit-based and stay outside of political control, as the AMC requires highly specialised expertise in order to fulfil its mandate.

9. Resolution and liquidation arrangements

As regards proper resolution or smooth liquidation ex ante arrangements, a cost-benefit analysis applies.

At first, a decision should be made whether to incorporate this resolution arrangements within the context of the BRRD/SRMR. If that was to be pursued, then the AMC would have in principle to obtain a banking license or an investment firm[712] license[or at least be

[711] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 43.

[712] Indeed, namely for the investment firm's option, it can be argued that the extensive organizational and conduct of business requirements imposed by MiFID II and the microprudential regulation requirements

a (mixed) financial holding company[713] or financial conglomerate[714]] in order for it to fall within the scope of BRRD/SRMR. None of the above seems passable for the abovementioned reasons.

Why burden the AMC with the compliance costs and time-consuming weights of the recovery and resolution planning? Why oblige a stressed institution, which walks the tightrope of the distressed debt management within an illiquid and opaque secondary market, to build MREL and be burdened with the SRF's contributions? How could the AMC enjoy any flexibility when the early intervention powers of the competent resolution authority would overhang its efforts?

One prima facie legit argument would be that in this way, the road for possible SRF's resolution financing(reinforced by the ESM's fiscal backstop) could open. However, the recourse to SRF's funds is nothing but certain(as indicated by the heretofore SRB's decisions and the MREL framework adoption). The same applies for the very placement of the entity under resolution, which is subject to the stringent provisions of BRRD/SRMR. So albeit a dedicated resolution framework incorporated within the institutional veil of SRM could prima facie provide legal certainty, it is unnecessary, if not self-defeating.

In the author's view, specific resolution arrangements incorporated in the AMC's dedicated legal framework seem preferable.

In any particular, targeted resolution tools, BRRD or CCP Restructuring and Resolution Regulation's- likened, could be incorporated within the AMC's legislation as long as they do not provide recourse to state-aid(even in the controversial form of quasi "GFSTs") and guarantee the unexceptional application of the non-creditor worse-off principle("NCHO" [715]), in order to assure that no value is unnecessarily lost[716].

Finally, given the time and costs of recovery, and the potential for some collateral to be of limited re-sale value, orderly liquidations may be required. Banks – as well as AMCs – are not typically suited for this role[717]. Hence, proper NPL liquidation frameworks operated by a special purpose public entity specialized in liquidating loans that have no or very little recovery upside, i. e a 'central liquidator'[718] could accompany the dedicated AMC's law. If the AMC turns insolvent, the AMC rump, i.e its residual assets could be transferred to this 'central liquidator' to be worked-out, unless other ad hoc resolution tools, namely a BRRD-likened "sale of business tool"(usually after an asset separation tool) to other financial institutions or investment funds are feasible.

10. Asset valuation- Determining the optimal transfer price

imposed by CRR/ CRD IV or even IFR/ IFD, as well as the thorough on going supervision for abiding compliance with those provisions, is not the best fit for an AMC. It makes it operationally unlimber and expensive and disproportionally increases its compliance and capital costs and excessive reporting obligations.

[713] See in detail **Gortsos, Christos (2021b).**

[714] See among others **Gortsos, Ch.V. (2017e).**

[715] See in detail **Gortsos, Christos (2021c)**.

[716] See **Hadjiemmanuil C. (2013)**, p.13.

[717] See **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b)**, p. 82.

[718] See **Louri H. (2017)**, p. 170.

It is the responsibility of the Member State/AMC to perform a valuation of the impaired assets, in principle based on observable market inputs, to determine their possible transfer price. In this regard, it may not be possible to ex ante value every asset within due to the sheer number of assets subject to the transaction. An ex-post due diligence should ensue performed by an independent valuator with a full granularity and particular emphasis on assessing market-specific risk premia, the credit restructuring potential and the collateral recovery process[719]. In any case, it is recommendable to set prudent transfer prices to avoid/confine State-Aid and BRRD/SRMR's limitations[720], as well as potentiate the AMC with the necessary structural overcollateralization.

As regards best practices for the calculation of REV, it should be conducted on a case-by-case basis and take into account several elements: the type of the assets and the underlying collateral, the expected cash flows (and their expected timing), various costs (including servicing costs, funding costs, taxes and maintenance costs), the long-term macroeconomic outlook as well as the application of a discount factor that correctly reflects the risks and provides an adequate remuneration for the buyer (here a state-backed AMC)[721]. On the cost side, realistic assumptions should be made regarding the costs that an AMC will face over the course of its activity: funding costs, loan workout costs, operational costs, legal costs, servicing costs as well as fiscal charges[722]. Structural reforms that have a positive impact on the development of secondary market for impaired assets and on cash flows (e.g. insolvency or collateral enforcement reforms) need to be taken into account, albeit in a rather conservative manner in order to avoid artificial inflation of the REV or TP[723].

11. **Asset perimeter and size of the AMC**

The success of a centralised AMC critically hinges on its scope. Several principles are key for identifying, within a given market, the appropriate size[724] and scope of a centralised AMC.

The guiding principles[725] are as follows:

- By being the main holder and central counterparty of NPLs, without amounting to a MIFID II market maker, AMCs can achieve specific expertise and economies of scale and scope.

[719] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 49.

[720] Indeed, on the basis of that work by the Member State / AMC, the Commission – in its responsibility of enforcing State aid rules, and often with the help of external experts – will estimate the transferred assets' market value (estimated market value or EMV) to assess the presence of aid, as well as their REV in order to determine the cap to impaired asset aid.

[721] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 49-50.

[722] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 49-50.

[723] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 49-50.

[724] Interestingly, the largest AMC in terms of asset size was the German FMS Wertmanagement (FMS/WM), with a nominal value of assets of around EUR 175,700 million initially transferred, albeit established with the aim of taking over and winding up the risk positions and non-strategic operations from a single nationalised HREGroup.

[725] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 44-45.

- Centralised AMCs should work with specific asset classes, which lend themselves for active servicing. Irrespective of its archetypal asset perimeter, AMCs can potentially realise some such synergies by pooling all outstanding debt of larger debtors even if these debts are split along different creditors and asset categories (debtor level approach)[726].
- The economies of scale are likely to be diminishing as AMCs grow beyond a certain size and complexity. Put it simply, it should be large, but not too large[727].
- The wider the asset scope, the larger an AMC may become. Controlling the size and perimeter of the AMC will mitigate a range of serious impacts such as fiscal, funding[728] and capitalisation challenges.[729]

Asset perimeter

In general, experience suggests that commercial real estate (CRE) loans, corporate loans and large corporate exposures[730] (e.g. in Ireland, Spain, Korea, Sweden, United States) are suitable for the AMC's work-out. On the other hand, retail loans, small business (SME) loans, and loans to the public sector have rarely been worked out by AMCs with good results.[731] Furthermore, very complex financial assets are best left with the bank, since there is no obvious comparative advantage to the AMC managing this type of assets. The abovementioned debtor level approach tackles the multiple-creditor coordination problems by consolidating the total exposure of the banking system to a specific borrower in one entity. For this reason, multi-lender and syndicated exposures should be fully transferred to an AMC (even if the debtor performs well vis-à-vis some of the lenders, which will

[726] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 44-45.

[727] A minimum size threshold for loan transfers to the AMC may be beneficial as it would exclude the tail of small and granular exposures and retain only the more complex large-ticket exposures for the centralised AMC so as to avoid diminishing returns to scale. The optimal size-based threshold should be calibrated taking country- and asset-class specifics into consideration. Thresholds should be set at different levels, i.e. a debtor level threshold, corporate exposures and foreclosed real estate assets and buy-to-let mortgages thresholds etc. **Fell J., Maciej Grodzicki, Reiner Martin, and Edward O'Brien (2017b), p. 77.**

[728] A larger vehicle, assuming it relies on government guarantees, will create also create a contingent liability to the Member State. Equally, the larger the vehicle, the more capital it will require, which may lead to issues at the set-up of the AMC.

[729] If the AMC is classified as a defeasance structure and reflected as such in the national accounts, private equity will have to be raised; a large private equity portion will be proportionately more difficult to raise than a smaller one.

[730] Corporate exposures will typically be large and complex; being complex, they will require a high degree of work-out intensity. Viable corporates may also be most likely to benefit from debt re-structuring, which can be best achieved with a single counterpart, rather than multiple creditors.

[731] Performing residential mortgages and other retail loans have been in the scope of decentralized AMCs (e.g. UKAR) but not in centralised ones. Please see Annex 1 for further details. The excluded asset classes, mainly unsecured retail loans, are more suitable to other types of IAMs. The duration of these loans are often shorter offering less time for the AMC realising recovery and have the dual downside of potential political interference and very small individual loan sizes that lead to high complexity and costs related to servicing.

require robust legislation)[732]. **Exceptions to these principles could be considered in specific contexts[733].**

Strategic planning

The strategic plan should:

- Set an objective with the consideration of the mandate: maximise recovery value deriving from the disposal and management of the assets transferred to the AMC, while considering a number of constraints, namely the country-specific legal, macroeconomic and operating environment, its finite timeframe or conduct requirements(e.g. first residence auction bans)[734].

- Select an approach for reaching the objectives: There are two main general approaches in dealing with assets: **the warehouse approach ("wait and sell") and the factory approach ("repair and sell").**[735] The former is generally the best option when the economy is in its initial upswing (i.e. early boom cycle), notably for medium-term performing assets that are not very capital-consuming (illiquid long-dated assets or assets for which fixing and/or sale costs would be prohibitively high)[736]. If there is no visible near-term growth, which is often the case, the factory approach is more suitable[737]. In any case, highly capital-intensive[738] assets should be fixed (restructured or hedged) and sold as soon as possible, taking into consideration though that quick disposal of large volumes of assets might trigger a fire sale and destabilise the secondary market for NPLs and banks dependent on sales therein.

[732] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 45-46.
[733] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 45-46. For example, residential real estate mortgages and SME loans. These are, in general, unsuitable for AMC workout, but highly limited transfers could be considered in cases where highly evident synergies with the AMC could be identified. The flip side is that the work-out of residential mortgages through an AMC carries high risks of political interference, especially for primary residences (owner-occupied units) and usually foreclosure by a State-owned AMC bear significant political cost. Thus, leniency towards distressed homeowners could impede asset recovery through "active servicing". Political independence of the AMC would be a key criterion for considering the possible inclusion of residential mortgages.
[734] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 68.
[735] **Medina and Peresa (2016).**
[736] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 69.
[737] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 69.
[738] Generally, the key determinators are capital intensity, (il)liquidity of the market for specific assets in conjunction with the disposed assets' volume compared to the market, and fixed costs of repair/restructuring/sale.

- Assess performance and reviewing the whole process (strategic plan review)[739].Transparency with the general public and other stakeholders about the strategic plan is also very important in order to gain public support.[740]

Sale channels and marketing

Provided that the MiFID II's provisions regarding the provision of investment services and notably the product governance, conduct and organizational, requirements are met, AMCs should develop platforms to enable window-shopping and initial screening by potential investors, who would then engage bilaterally with the AMC for receiving information in order to perform a full due-diligence[741]. Such platforms would enable the build-up of portfolios, sale of assets in packages, securitisation or disposal of single loans[742]. This can be accomplished, as already established, through a common trading platform or data hub, facilitating access to data and encouraging cross-border disposal of assets[743].

However, in the author's view, they should not amount to robo advisors or multilateral trading marketplace.

12. **Asset and financial management**

i. Asset management

The main part of the asset management process is choosing the adequate disposal strategy for NPLs.

Figure: Loan restructuring process

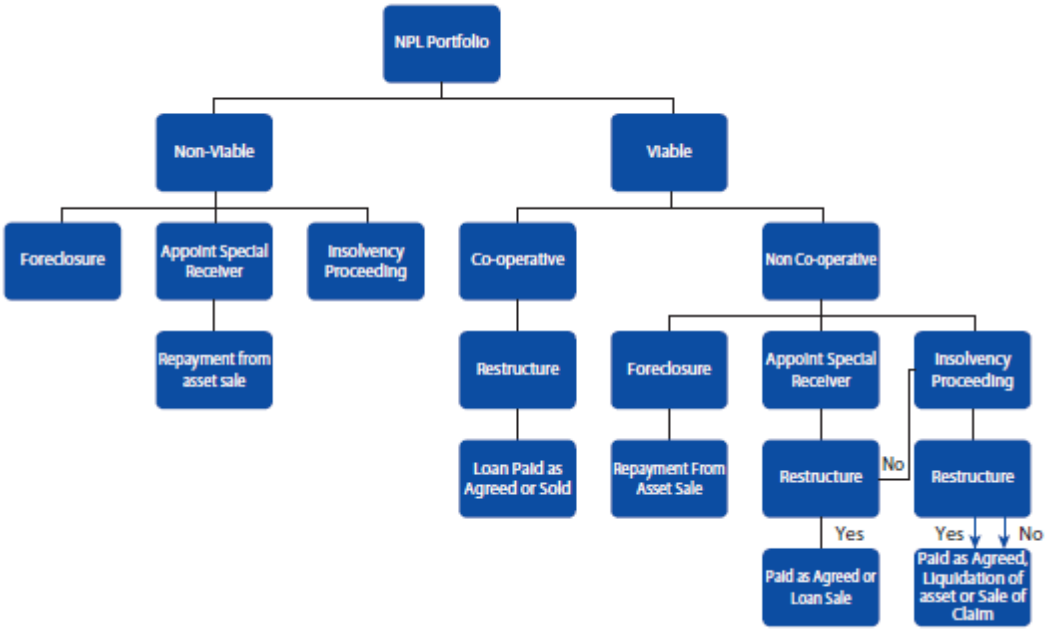
[739] Strategic plans should be reviewed annually in conjunction with annual business plans and revised only if the underlying fundamentals of the business or the macroeconomic scenario change. The strategic plan should be set in multiple stages, preferably by defining the number of years for each stage. For each stage, a milestone should be set, ideally by setting a threshold of disposed assets. Together with profit generation (also measured in recovery percentage), disposal speed will be the main performance measure. See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 69.

[740] **Cerruti and Neyens (2016).**

[741] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 70.

[742] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 70.

[743] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 70.



Source: World Bank

13. Options regarding loan servicing

AMCs may decide either to service the loans in-house[744] or to outsource pure servicing activities to independent external servicers, so as to focus on the analysis of the underlying exposure and decision-making. Despite the payment of servicing fees, AMCs are in a strong bargaining position to negotiate the terms and conditions of the assets servicing agreements with third party servicers[745]. Therefore, the AMCs' dedicated legal toolkit should enable them to outsource services to independent providers at market prices, thereby contributing to the development of the servicing industry[746] and attracting more foreign investors.

As already established, the servicing of the transferred NPLs should not be appointed to the originating banks except as ultimum refugium and bridge solution, provided that banks can demonstrate that the conflict of interest is well managed (e.g. through Chinese walls).

14. Data

The use of the "EBA NPL Templates[747]", providing increased transparency and comparability of respective data, should amount to a precondition for a transfer of loans from banks

[744] Although it may deliver advantages in terms of economies of scale, in-house servicing also requires more internal resources, capacity and staff.

[745] See **EC's Staff Working Document on AMC Blueprint (2018)**, p. 74.

[746] A clear positive example is the case of Spain after the creation of SAREB.

[747] http://www.eba.europa.eu/risk-analysis-and-data/eba-work-on-npls. They include templates for (1) financial due diligence and valuation purposes, and (2) portfolio screening. The templates are focused on collateral related data, differentiating real estate collaterals (including e.g. tenant related data) and other collaterals (incl. guarantees). They also cover data on historical cash collections, the status of legal enforcement (e.g. status in the insolvency process), forbearance related information etc. The templates also take asset class, country specific as well as confidentiality aspects into consideration.

to AMCs. Furthermore, AMCs should be expected to perform a thorough data quality assurance before taking on new assets or providing access to prospective investors, either for financial due diligence/valuation purposes or for the initial portfolio screening[748]. Immediate actions upon establishment of the AMC include data collection and clearing, categorization and prioritization of assets and the setting-up of specialised work-out teams[749]. Furthermore, data cleansing processes are very important for correct asset pricing and for the sale process[750].
Finally, AMCs should be subject to an approved Code of Practice[751], which would set out their obligations in respect of disclosure of interests and confidentiality[752] in conjunction with the provisions of Regulation (EU) 2016/679. The AMCs are also expected, when prompted, to make available the standardised data so that it could be stored on a centralised platform at European level.

Section III: Cherry-picking notable Proposals for an EU-wide AMC (either single or through an EU-wide network of national AMCs) from the current literature.

We will now navigate through literature and examine the prospect of an EU-wide AMC or an EU- coordinated network of national AMCs through the lens of three notable relevant notable proposals, which all underline the need for a coherent and comprehensive EU approach, ensuring a jurisdiction agnostic harmonized solution.

Avgouleas & Goodhart (2017) propose a pan-European Holding Company that would preside over quasi-ring-fenced country-based AMCs as subsidiaries, as an ESM-centred TARP-like arrangement, and offer a limited fiscal backstop to the European Banking Union (EBU)[753]. It would be a **separate corporate body with a finite lifespan** and under no circumstances **an inter-governmental or EU agency** or **ESM subsidiary**, as such a move **might trigger fears of debt mutualisation** and **conflict of interests issues** (given that under the proposed scheme the ESM would provide guarantees to each member state-based AMC through the member state concerned).

Its initial shareholders will be all EBU member states with a share-capital participation that would be a factor multiplied by the share of NPLs to total loans of the country's banking sector multiplied by a factor that represents the country's share of the EBU GDP.

[748] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.
[749] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.
[750] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.
[751] I.e. a code or general legal obligation could be sufficient, as for any other seller or investor. AMCs need to be bound by these obligations.
[752] See **EC's Staff Working Document on AMC Blueprint (2018)**, pp. 59-60.
[753] See verbatim **Goodhart, Ch. and E. Avgouleas (2016).**

The Holding Company would participate as a private investor (but with increased governance rights, *reminiscent of the Greek Financial Stability Fund's participation in major Greek banks' recapitalizations*) at a minimum[754] of 10% of member state AMCs' issued share capital (*as a quasi private equity limited partner*) with its potential losses firmly capped.

All member state banks wishing to transfer NPLs to the AMC would participate to the AMC's initial share capital with a share-capital of a minimum x 1 times the country's participation in the holding company, less if their share of NPLs over total loans is lower than the national average, more if their share is higher than the national average.

Country AMCs would resort to the European Investment Bank (EIB) for the calculation of the transfer price. In particular, to avoid excessive upfront recapitalisations as well as unmanageable long-term losses to the AMCs, they opt for a three-fold valuation approach. The NPLs would be transferred to the AMC at a price that is the weighted average (33% each) of the net book value, the long-term economic value of the asset as calculated by the EIB (LTEV premium) to ensure objectivity, and the market value[755] of the assets to be transferred.

The losses or profits of each AMC would be cleared at the level of each country subsidiary. Country AMCs' shareholders (i.e., the participating banks and the Holding Company) would first absorb losses. For the residual losses, the authors propose structured P&L agreements with participating banks with a floating claw back clause, that would optimally be linked with the losses emanating from ring-fenced NPL portfolios sold by each specific bank[756] with the aim to penalize a bank whose portfolio of transferred NPLs fall below AMC average in terms of recovery values, thereby incentivizing participating banks to engage in honest conduct with the AMC.

Any further residual losses would be covered up to 80% **by an ESM guarantee** that the country could procure at any time under the **indirect bank recapitalization instrument**.

These arrangements would leave AMC's private bondholders with very limited exposure to AMC losses, thus, they significantly boost AMC's chances to find private bond finance to fund its purchase of bank NPLs.

As regards governance and oversight arrangements, **the board** of the Holding Company **would publicly report to the SSM, the EU Commission, and the ESM every 6 months**

[754] The Holding Company's participation to the member state AMCs would represent, at a minimum, the country's participation in the holding company.

[755] The current market value could be calculated through holding an auction for a sample of assets comparable to the assets about to be transferred to the AMC, as long as the bids for the pre-transfer auctions reflect actual transfers and do not constitute fictitious bids, as in the Libor scandal.

[756] Put it simply, when those losses exceed the average level of losses the AMC has experienced in its overall NPL portfolio, then that bank (banks) would have to make further payments to the AMC, amortized over a period.

and appoint the board of country AMCs, holding an open tender, after informing the three supervising institutions.

Each member state would be able to exercise the percentage of voting rights that would correspond to its stake in the Holding Company's share capital. For significant decisions, **e. g. downstream liquidity to the Holding's country subsidiaries** a majority of 2/3 of Holding Company shareholders, based in this case on the principle of one share one vote, would be required. In the case that the board of the holding company cannot reach a decision, its articles should provide that in that case all shareholders' voting rights are automatically transferred to the EU Commission, the ESM, and the ECB whose decisions would have to be taken by a two thirds majority of their own votes bypassing the company's shareholders.

Each country-based AMC would have the freedom to decide how to meet its financing needs. The funding strategy would be determined through a resolution of the AMCs' shareholders in a process where the vote would be by majority and **the holding company would not enjoy supra-voting rights, as in the case of board appointments**.

On the other hand, the Holding Company would ensure that each country-level (ring-fenced) **subsidiary operates under the same conditions of governance, transparency, disclosure, and valuations.** In addition, **the holding company could establish and control transaction platforms**, as indicated above.

Such centralization of rules and operations would secure legal certainty, homogeneity and comparability, eliminate any excuses on behalf of national authorities and bank management to engage with proactive management and disposal of legacy NPLs and ameliorate governance and transparency discrepancies, since the matter of valuations would be handled by the EIB and the AMC's management would be appointed straight from the Holding Company. Finally, centralisation would create a single point of accountability and take the sting of moral hazard and unequal governance away from the provision of an ESM guarantee to the country-based AMCs.

Indeed, looking at the experiences of the TARP, NAMA and SAREB, **institutional oversight on the European level** could serve an invaluable role in preventing some of the governance problems and issues of political interference found in those programmes and promote accountability. With many EU Member States facing difficulties with corruption and rule of law, the creation of a national AMC without a European counterparty to act as a complementary single point of accountability could lead cronies in Member States to siphon off public funds[757].

Accordingly, the authors argue that the hybrid Euro-AMC scheme suggested complies with the EU State Aid rules, given that it secures a substantial amount of burden sharing and

[757] See verbatim **Bueno-Edwards A. (2021)**.

financial and behavioral constraints for the participating banks to ensure that the competition is not distorted.

Finally, the nature of any transfers via the ESM under the "precautionary recapitalization" scheme would be compatible with the spirit of Art. 125 TFEU, as authoritatively interpreted by the Court of Justice of the EU in the Pringle case[758]. Indeed, they argue that their "holding company approach" secures the capping and minimization of any fiscal transfers while it lays down the groundwork for a future EBU fiscal backstop for the banking sector. According to them, this approach is not only legal under the Pringle reading of Art. 125 TFEU, but could also dispel such legal concerns of debt mutualization and indirect monetary financing, given that it is supposed to "*relieve current pressure placed on the ECB in the context of sometimes controversial bank bond purchase programs*".

In the same vein, **Arqué G. and Fernández E. (2017)** also noted that this "US PPIP-likened structure" could be a model in which European AMCs, backed by national governments or entities like the EIB, could invest together with private investors[759]. The proposed ESM guarantee similarly reminds of AGP and TALF, in which minimal TARP funds guaranteed much larger exposures[760].

It has been argued that the overall innovative financial engineering demonstrated by Avgouleas and Goodhart purports to offer a degree of mutualisation[761] without actually triggering the red flag of mutualisation[762]. The authors also try to tackle deficiencies and interest conflicts stemming from maladministration, envisaging robust oversight mechanisms and shared competences in order to ensure accountability and political feasibility[763]. However, **Avgouleas et al.(2021a)** recently acknowledged that any transfer of NPLs at prices exceeding their fair market values qualifies as State aid and therefore triggers its designation as "failing or likely to fail" unless the stringent preconditions of precautionary recapitalization are met, adding that, in any case, precautionary recapitalization is a tool designed to face more limited crises affecting a more limited segment of the financial system[764].

Indeed, in the author's view, this is the key weakness of their proposal, which undermines its compatibility with the State-aid framework-as only slightly amended amidst the pandemic crisis- and the EU resolution framework. We have already established that without

[758] See Thomas Pringle v Government of Ireland, Ireland and The Attorney General Judgment of the Court of 27 November 2012, CJEU Case C-370/12, esp. paras 136-137. Reiterated in the more recent Peter Gauweiler and Others v Deutscher Bundestag (CJEU, Case C-62/14), paras. 135-136.
[759] See **Arqué G. and Fernández E. (2017)**, pp.6–7. They refer to **Fell, J., Moldovan, C. and O'Brien, E.(2017)**.
[760] See **Bueno-Edwards A. (2021)**, 321-332.
[761] See **Boot et al (2020)**, p.16.
[762] See **Bueno-Edwards A. (2021)**, 321-332.
[763] See **Bueno-Edwards A. (2021)**, 321-332.
[764] See **Avgouleas et al. (2021b)**, p.33.

a temporary amendment of the precautionary recapitalization framework and some of the state-aid rules stipulated by the Commission's case-law and Communications, i. e the definition of the EMV amidst a financial crisis or market distress, this proposal could hardly be implemented.

Notwithstanding the above, the P&L agreements and "severe" claw back clauses envisaged in their proposal can create legal frictions as regards the significant risk transfer requirements of the CRR, the accounting de-recognition and de-consolidation of the transferred assets(*otherwise merely shifting them from the asset side to the liability side of the balance sheet*) and the relevant requirements of the Securitization Regulation(if applicable)[765].

In a similar vein, **Enria A., Haben P., Quagliariello M. (2017)** propose an EU backed AMC, which is optimally segmented by asset class. Public support could be used to provide capital (say to 8% of total purchasing power), which would in turn crowd in private funding. They envisage an AMC purchasing up to a quarter of total outstanding NPLs and be capitalized to the tune of EUR 20bn.

Banks with NPLs ratios above a given threshold (e.g., 7% NPL ratio) would be required to transfer **certain specified assets** to the AMC by supervisors. The process for establishing the AMC would be the following:

Firstly, stress tests are used to identify the total envelope of potential state aid for each bank[766], i. e. the theoretical amount of state aid that would be allowed for each bank's precautionary recapitalization in order to bridge the intertemporal gap between the current market prices and real economic value of the assets.

An assessment of REV and EMV is carried out and banks transfer irrevocably some agreed segments of their NPLs to the AMC at their REV. At the time of the transfer to the AMC, the bank bears losses equal to the possible difference between the NBV and the REV[767].

If within a predefined finite timeframe the REV remains above the EMV, the AMC would be compensated by calling upon a guarantee issued by the government of the Member State where the bank transferring the assets is headquartered. To ensure that banks keep skin in the game and avoid moral hazard issues the government should be compensated in the form of participating banks' equity warrants with a penal strike price which would be triggered if the (actual or estimated) sale price at the predefined date remains below the transfer price.

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[765] See **Hellwig M. (2017b)**.

[766] Such a stress test could range from a full balance sheet assessment against complex adverse macro scenarios to more targeted assessments, such as the impact of increasing provisions to meet stressed market price target levels over a three year timespan. The stress test may also, in isolated cases, identify the need for the immediate resolution of some banks – for instance for banks failing in the baseline scenario.

[767] This may be accompanied by a liability management exercise and some bail in of junior debt to equity as determined by European Commission under State aid rules but the extent of this may be considered also in relation to the exercise of future warrants.

The warrants ensure that the AMC's capital is fully protected and any eventual cost must be borne by shareholders and if necessary national governments, thereby casting away concerns regarding mutualisation of risks or losses, which would not be politically acceptable at this stage.

The authors refute loss mutualisation concerns. They argue that the very aim of their proposal is precisely to garner all the of benefits that European action offers- notably clarity and simplicity in the application of the EU state aid and resolution framework, enhanced credibility, lower funding costs and higher operational efficiency, critical mass on both the supply and the demand side, broadened investor base etc. – but under no circumstances allowing mutualisation as the AMC would be in turn guaranteed by national governments, each remaining responsible for losses generated by banks headquartered in its jurisdiction.

They also argue that the establishment of an EU AMC is operationally feasible, clarifying that the EU AMC may not cover all asset classes nor all NPLs, but would pick up a critical mass of specific NPLs from relevant portfolios that lend themselves for "active servicing".

As regards the warrant mechanism, it has been pointed out the potential dilution effect, and associated uncertainty for equity holders could generate challenges in funding and equity raising. However, the authors riposte that the proposal would be so detrimental to bank funding, as the warrant would figure alongside other contingent liabilities in the balance sheet of the bank and could be priced fairly and accurately if sufficient information on the transfer process is provided to investors. Besides, after achieving a clean break for the bank, with a full sale bringing NPL levels down in a single shot and allowing its management to focus on restoring the sustainability of the business model, then banks' profitability, capital adequacy and market cap would be significantly ameliorated.

In any case and without prejudice to the warrant mechanism as the proposal's default rule, alternative options include compulsory insurance purchase by banks, the provision of bonds (or tranches of securitised instruments) to banks in exchange for NPLs, with interest held in escrow accounts until the final sale is completed, and the issuance of contingent convertible instruments (CoCos).

In the author's view, the key weakness of this proposal is once more its incompatibility with the BRRD/SRMR framework, as provided that it presupposes a transfer price exceeding the current market price, it entails state aid in the form of extraordinary financial support, which leads us back again to the conundrum of precautionary recapitalization's rigid preconditions.

A common blueprint for national AMCs

The question over whether a single European AMC would be appropriate vs a blue print for national AMCs is notably **about unnecessary centralization of functions at the EU**

level. **The subsidiarity test** clearly allocate the burden of proof to those proposing that certain policies should be pursued at the Union level. In their 1993 report, Making Sense of Subsidiarity, Begg et al[768] propose that centralization is excused -provided that **the risk of diminished accountability** is addressed- in the presence of two simultaneous failures of decentralisation:

• First, that non-cooperative policy-making yields results that are **significantly** worse than cooperative policy-making; and

• Second, that agreements to cooperate without centralising are not very credible.

In our case, some form of centralised policy seems to be necessary. The question is to what extent.

Albeit a single EU-wide AMC seems the most decisive and radically effective option[769] for cleaning up NPLs, even its most ardent adherents acknowledge that given the prevailing concerns regarding debt mutualization and the circumvention of the established(bail-in centred) EU resolution Framework, such network of national AMCs[770] is the only politically feasible[771] solution.

According to **Enria A., Haben P., Quagliariello M. (2017),** common EU AMC would provide clarity on State aid rules and consistency of approach and enhance credibility[772] by removing any uncertainty about political interference in national approaches. A truly common EU AMC would also attract significantly reduced funding costs, which would not materialize with various national approaches.

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[768] See **Begg D. and et al. (1993)**.

[769] According to **Huertas M. (2020)**, the choice of a single Eurozone AMC, ideally full institutionally fledged as a distinct Pillar IV of the Banking Union, is better suited for a Banking Union, whereas such an approach is also required to establish a fully fledged distress debt market in the context of the Capital Markets Union. In the some context, **De Haas R, Markovic B. and Plekhanov A. (2017)**, p. 125, note: " a Eurozone solution could be defended on the grounds that banks in this zone have a common regulator and access to a common lender of last resort while national authorities can do little to incentivize banks to deal with NPLs". See also **Beck T. (2017)**.

[770] However, as they clearly point out, these approaches should be "juxtaposed with the counter factual of doing nothing and sticking with the hodge-podge of differing national approaches that are currently in play".

[771] On the importance of the feasibility criterion, see **Boot et al (2020).**

[772] Recently, the European Banking Authority (EBA) has concluded that only 15 countries out of the EU-27 fulfil the legal and regulatory requirements for the utilization of the national Asset Management Company option. In this context, **Huertas M. (2020)** argues the Commission's AMC Blueprint, albeit in the right direction, it could have gone much further, adding that in light of recent COVID-19-derived developments, the AMC Blueprint needs updating. Besides, Commission's proposal from December 2020 for tackling COVID-19-related NPLs remains completely silent on the question of a single European AMC, instead offering other potential approaches, see in this context **Bueno-Edwards A. (2021)**. See also **Carrascosa A. (2020)**: "[a] European bad bank, or even a network of bad banks, will not make losses disappear … [P]inning all our hopes on bad bank as the solution every time the financial sector hits rocky ground is like putting our focus on the cure rather than prevention."

A common blueprint would however, have two distinct benefits over a common EU AMC. The first relates to perception as it would dispel any misunderstanding about mutualisation of risk for legacy assets across countries[773]. The second is allowing greater flexibility by country depending on the individual circumstances. But this in turn should be set against the trade-off between flexibility on the one hand, and consistency, clarity and credibility on the other.

In short, a common EU blueprint for national AMCs offers a reasonable sub set of benefits of a single EU AMC to achieve the objectives of addressing market failures in the secondary market for NPLs, making it a very good second best policy in and hastening the cleansing of balance sheets of the EU banking sector[774].

In a more integrated approach[775], these national AMCs could develop an EU-level cross-border network. **Such a network would be linked to an EU-level data hub, acting a data repository underpinning the NPL market,** and create a joint transaction platform at the European level to improve cooperation with third-party service providers. To that end, the Commission urges for uniform implementation of the 2018 blueprint across national AMCs as **discrepancies between AMCs could severely constrain any network benefits**. In order for the benefits of the cross-border network to be maximized, a considerable number of national AMCs as well as a degree of homogeneity and standardization between national AMCs seems crucial[776].

The use of an NPL platform could help cut some of the expense associated with the creation of an AMC, by reducing transaction costs related with expensive bespoke IT systems to standardise[777] and manage the acquired assets, addressing information asymmetries, enhancing credit coordination, expanding the investor base and improving market pricing[778].

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[773] Indeed, in 2017, Germany's relevant opposition was mainly on grounds of avoiding debt mutualisation and avoiding (perceptions) that German taxpayers would shoulder southern EU Member States' NPLs. The EU Commission's initial opposition in 2017 (and possibly still now) reflected its concerns whether national AMCs or an EU single AMC, would breach State aid rules, see **Enria (2017)**. In 2017 the debate regarding the establishment of an EU-wide AMC led to an open disagreement between the ECB and the European Parliament, see Letter by Antonio Tajani (President of the European Parliament) of 9 October 2017, and response by Danielle Nouy of 13 October 2017, available at: https://www.ecb.europa.eu/pub/pdf/other/ecb.mepletter171013_tajani_dn.en.p

[774] See **Enria A., Haben P., Quagliariello M. (2017)**, p. 70.

[775] See **Bueno-Edwards A. (2021)**.

[776] See Communication: Tackling non-performing loans in the aftermath of the COVID-19 pandemic COM(2020) 822 final, p.12.

[777] See Commission Staff Working Document: AMC Blueprint: Accompanying the document "Communication: Second Progress Report on the Reduction of Non-Performing Loans in Europe" SWD(2018) 472 final, p.11.

[778] See **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a)**, p.139.

The key factor that makes this proposal(i.e national-AMCs network combined with a single EU-wide NPL platform) attractive is that, albeit being considered[779] as almost evenly effective, at least to kick-start the nascent NPL secondary market, it is considered less complex, more politically plausible/ feasible(as it is not "infected" by fears of loss mutualisation) and less expensive, as it doesn't burden the state(nor the ESM) with direct capital injections to the initial capital of the single EU-wide AMC[780] or contingent liabilities deriving from / ESM's guarantees.

Indeed, the platform itself would be comparatively inexpensive to set up and operate than an AMC and, crucially, would not require State aid[781]. AMCs could thereby use the single EU-wide platform to offer their assets to a broadened EU-wide investor base with fully fledged cross border activity and with reduced transaction costs[782].

To sum it up, this proposal begins from empirical base: the current situation, in which most Member States do not have national AMCs and those that do are heterogenous in nature, does not lend itself to the establishment of a single EU-wide AMC. By contrast, the establishment of a network of homogeneous national AMCs, using a transnational transaction platform with a consolidated European data hub incorporating standardised data, paves the way for the subsequent creation of a single EU-wide AMC. Accordingly, that proposal is deemed to have in principle a transitional nature provided that the ultimate goal is to eventually establish an EU-wide AMC "that could sit on top of the entire construct, much like the ECB does over national central banks"[783].

To top it up, **Michael Huertas (2021)** goes one step further and envisages a fully-fledged institutional solution: a common and centralized AMC as the banking union's Pillar IV, in order to complete the banking Union with a proper fiscal backstop. Such a **Pillar IV[784]** introduces a **"*Single Temporary Assistance facility for the Management of Illiquid, Non-***

[779] See by mere indication **Bueno-Edwards A. (2021)** and **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a)**, passim.
[780] See relevantly Augoulea's and Goodhart's proposal, 2017, ibid.
[781] See **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a)**, p.140.
[782] See **Bueno-Edwards A. (2021)** and **Fell J., Maciej Grodzicki, Dejan Krušec, Reiner Martin and Edward O'Brien (2017a)**, p.143.
[783] **Bueno-Edwards A. (2021)**, 321-332. It is worth noting that this approach is reminiscent of the relevant M. Huerta's approach, which deems the SAMA within the STAMINAE as a distinct Pillar IV of the EBU. See in detail below.
[784] As Huertas M. points out, the current political stalling of **EDIS(as Pillar III of the EBU)** need not detract from a common AMC as banking union's Pillar IV. However, they somehow seem bound the same fate: As with EDIS, opponents of a common AMC have argued that such institutions are a prelude to the founding of a fiscal transfer union. It remains to be seen whether the Covid-19-driven famed 'Recovery Fund' actually indicates a general historic political step towards the mitigation of political aversion regarding loss mutualisation. Currently, opposition to the establishment of a single European AMC currently seems to be concentrated in the Commission and other European institutions over concerns around State aid. See in this context **Huertas M. (2021)**, pp. 433, 436– 437, **Bueno-Edwards A. (2021)**.

performing Assets and Exposures*"** or "*STAMINAE*" ***operated by a Single Asset Management Agency (SAMA). SAMA/STAMINAE, in conjunction with a **centralized access point for NPL transaction platform/clearing houses and a single dedicated central data hub** could together comprise the necessary institutional veil and market infrastructure for an effective cross border NPL secondary market. Such an approach would also likely drive maximum efficiencies in relation to the rules introduced by the forthcoming Credit Servicers Directive as well as the ECB's NPL Guidance and EBA's rules on loan origination[785]. Ultimately, such an approach could **provide a resilient backstop for the banking sector**.

SAMA and STAMINAE would need to rely on an EU rulemaking framework, **preferably an EU Regulation and a Directive that builds this organization and its powers** and centralized functions and notably be charged with the following duties:

- Provide legal certainty as regards its compatibility with inter alia, with the ECB's NPL Guide, the SRMR and the BRRD regime, and relevant national legislation;
- co-ordinate existing national AMCs by setting a common framework of rules (building upon but going beyond the EU's Blueprint and the Action Plan);
- Conditionally provide a **reinsurance backstop facility to existing national AMCs** in order to secure centralized funding.

STAMINAE should enjoy a longer-term horizon lifespan than most national AMCs, which is usually concentrated between a **10 and 15-year horizon**. In terms of its operational set-up and delineation of competences, SAMA and STAMINAE might **follow that of the Single Supervisory Mechanism's (SSM's) construction of a centralized hub and national spokes**.

SAMA could form the "hub" and thus coordinate existing Eurozone AMCs' participation in STAMINAE and their relevant activity but also act in a direct manner when needed or when requested by the "spokes" in the national Member States or by other banking union stakeholders. SAMA would serve as a centre of competence for STAMINAE as a whole while concurrently acting as "*a centralised node for inward-bound financing from interested investors and outward-bound investment*" in acquiring NPL portfolios.

Furthermore, **from a governance perspective, operating a single point of accountability** that reports to the European Commission, the European Parliament and national parliaments could improve decision-making, build inter-institutional bridges more efficiently with the European Supervisory Authorities (ESAs), the national supervisory authorities (NSAs) and the national central banks (NCBs), operating across a breadth of relevant mandates relevant to NPLs and NPEs.

[785] According to **Huertas M. (2021)**, this holistic view is absent from the dominant until now in literature abovementioned Avgouleas and Goodhart's proposal, who did not go into depth on is the ECB–SSM's NPL Guide as a Eurozone specific supervisory tool as well as the EBA's own rules.

In any case, STAMINAE should not engage with those troubled assets that are subjected to a BRRD resolution power and have been transferred to a bad bank to be liquidated. A clear delineation between STAMINAE and BRRD mandates is vital to ensure that STAMINAE does not purport to restructure the STAMINAE-covered institutions by circumventing the applicable resolution framework. Thus, SAMA and STAMINAE would need to operate separate from but prior to the trigger of the other banking union pillars and should be structurally separate under the direction of SAMA.

Accordingly, STAMINAE should be seen, like its national AMC counterparts, of adding to a fairer resolution process whilst facilitating a smoother continuity of operation. Indeed, institutional support from SAMA/STAMINAE would also likely preserve value from viable NPLs and thus reduce the cost of any BRRD/SRM Regulation measures.

Consequently, STAMINAE should be tasked with:

- setting common standards of conduct, operation and funding profiles of national AMCs, where they exist. Unless a national AMC complies with such common rules, it may be excluded from STAMINAE. According to Huertas "this would add some much-needed meat to the bones of the (meager) EU's Blueprint on AMCs";
- providing reinsurance to STAMINAE-covered eligible national AMCs, i.e. replenishing gaps in their firepower;
- in Huerta's view, engaging mainly with those troubled assets that national AMCs are unable to tackle, are cross-border in nature or have systemic implications in much the same way as NAMA is enabled to act but in a manner that is complementary to national AMC's activities.
- creating **dedicated collective investment funds**[786], which, in contrast to FROB (Fondo de Reestructuración Ordenada Bancaria), NAMA and other national AMC strategies, open up room for private co-investment by non-STAMINAE-covered institutions to tailored exposures instead of private sector investment being used "*for blanket leverage of the acquisition firepower*".

How might SAMA and STAMINAE be funded?

As with national AMCs, funding for STAMINAE's operating firepower, could come from a mix of:

1. risk-based, SRF-likened, contributions paid into STAMINAE by the participating Member States of the banking union in return for participation notes ranked in a

[786] In this vein, STAMINAE is expected to further segment its assets by asset class and jurisdiction specifics so as to provide useful distinguishing factors for STAMINAE's private sector investors, either in relation to the national AMCs and the relevant collective investment funds it would manage or in relation to standalone portfolios purchases (or segments thereof), held with STAMINAE from SAMA.

waterfall. The calculation could be based on the risks generated by relevant STAMINAE covered institutions (measured by available supervisory figures per individual relevant institution);

2. STAMINAE-issued financial instruments such as senior and/or subordinated bonds issued on commercial and arm's length terms with cash flows generated by disposal proceeds/receipts from acquired NPLs being applied to pay principal and coupons on issued bonds—which might also be subject to the guarantee and sovereign funding;
3. and/or in contrast to national AMCs, funding for STAMINAE could also come from:

(1**) private sector investment in STAMINAE-run collective investment funds** that are open to non-STAMINAE-covered institution-based investors wishing to invest in NPL portfolios **via a centralised point of investment**[787]; and

(2) public and private sector investment that is attracted to STAMINAE bolstered by an adjustable guarantee provided by the ESM to generate confidence in STAMINAE's operating firepower provided that such guarantee meets the conditions of arts 107 and 125 of the Treaty on the Functioning of the EU.[788]

[787] Given Ireland's jurisdictional benefits in terms of a strongly developed asset servicing and fund management community**, making Ireland a connecting point of entry (investment gateway) for non-EU investment,** seems astute. In this context, STAMINAE might be a catalyst by pulling together activity and centralising a fragmented and otherwise illiquid market for NPLs across 19 Eurozone Member States or currently an EU-28 within one jurisdiction, using Ireland's existing market infrastructure and its enhanced distressed debt market.

[788] The author also entails a role for a distinct EU agency, the Eurofound[788], with which, given that STAMINAE may also dedicate a fair share of its resources to retail originated NPLs, synergies could arise as well. See in detail Eurofound, "About Eurofound" (2019) available at: http://www.eurofound.europa.eu

CONCLUDING REMARKS

In the author's view, before naively embracing the AMCs as a quasi deus ex machina or irrevocably condemn any public- bail-out-likened- intervention, we have to be honest about the real function a national- a fortiori an EU-wide AMC- should accomplish.

From an economic analysis of law viewpoint, such state intervention- even when coupled with private investors' initiatives or declaring itself as market-likened- could be excused only in two main cases: in the presence of a natural monopoly or market failures that could in this scenario disturb or endanger financial stability (a public good) and give rise to systemic risk. Thus, in principle, these state-backed resolution measures should remain in full force until the market failures are tackled or unswervingly mitigated. Then, market- driven solutions should ensue.

So if the Commission's later NPL Communication is to be taken seriously, there are initiatives(either non- existent or at best nascent at the moment) that should they prevail, they could evenly address the abovementioned notorious market failures of the nascent NPL secondary market and thus limit the legitimacy, necessity and proportionality of such intrusive state- backed asset resolution measures[789].

For example, the optative elimination of information asymmetries regarding the credit quality of the (underlying, in case of securitizations or bulk portfolio NPL direct sales) NPLs and their really indicative market value, could be evenly pursued in the context of the abovementioned NPL trading platform which in combination with a central data hub/ NPL trade repository could cut-of transaction costs and facilitate due diligence, deteriorating the bid-ask spread. In the same vein, the volume of the NPL transactions could reliably establish a current market value.

Accordingly, transparency regarding the quality and fair value of the collateral would be enhanced partly due to the abovementioned NPL trading platform's functions and partly due to the new stringent collateral valuation requirements introduced by the ECB's NPL Guidance. Adding to the above, the introduction of the preventive restructuring and other out- of court collateral enforcement mechanisms(namely the abovementioned extra-judi-

[789] Albeit the fact that recent experience and political realism indicates that no market condition or EU secondary law provision (imposing stricter conditions than the political acceptable art. 107 (3b) TFEU threshold), could ea ipsa eradicate the inherent State's mandate to preserve financial stability and severe macroeconomic turbulence in its jurisdiction. Besides, given the wide discretion provided by the EU resolution framework and taking recent cases as MPS into account, the prima facie technocratic statutory resolution process has not yet been de-politicized.

cial collateral enforcement mechanism of the Proposed Directive) would expedite collateral realization and attenuate loss given default(LGD), whereas the introduction of the Credit Servicers and Purchasers Directive and other related measures in the context of the CMU Action Plan(*aiming at EU capital markets' further integration, cross border activity aggrandizement, market-based financing promotion, further financial inclusion and credit origination diversification etc*) would elaborate servicing and other related transaction costs, endorse competition and notably broaden the investors' base.

Furthermore, as regards the adequate, forward-looking stringent provisioning that is deemed to in practise adjust NBV to the fair value of the asset in a considerably conservative manner, the newly introduced Prudential Backstop requirements- in conjunction with the IFRS 9 effect- will indisputably suffice, thus eliminating the demotivating huge current bid-ask spread and blunting the gap between the NPL's NBV and EMV, under the common factor of the REV.

In other words, the NBV will attain the REV thanks to the prudential backstop and IFRS 9 requirements and the currently distressed market value will reach the REV thanks to the elimination of the current market failures.

In such an environment, arm's length transactions should dominate and no further public intervention would be excused.

Furthermore, one should also examine the "big picture". The transitional nature of any "emergency backstop facility" should be established on the premise of the very EU's transitional phase until the migration to a fully-fledged Banking Union, a well-functioning Capital Markets Union and a more resilient Economic and Monetary Union.

Indeed, when the BASEL IV reforms are finally fully implemented and EU banks have sufficient MREL and TLAC cushions, alongside their robust capital buffers and their significantly ameliorated asset quality, due to the effect of the Prudential Backstop Regulation, the IFRS 9 full implementation and the pressure imposed to supervised banks to dispose their NPL bulks(*in the context of the qualitative guidance of the ECB's NPL guidance and within the binding quantitative targets*) to a proper and fully-fledged dedicated secondary market, the EU resolution framework- possibly with the SRF and EDIF in full force and the ESM's backstop to the SRF in place-, would be arguably ready to address even such tail events. The issue here is that we are at the halfway point of the race. Thus, our controversial resolution framework, even if functional in its final fully-fledged version, has not yet reached the maximum of its regulatory arsenal.

Besides, we are not examining here the creation of a fully-fledged fiscal backstop as a permanent Pillar of the EU's crisis management framework. This is the context of another,

more general debate of quasi-existential nature for the EU resolution framework. We are just highlighting the fact that the EU resolution framework has not been tested in the context of a systemic EU financial crisis and in the author's view, was not designed to do so. In this vein, supervisory and regulatory measures to deal with such an exogenous and unprecedented tail event, that no one in principle could see coming, should accordingly be different, legitimizing aberrations that range from regulatory and supervisory tweaks to fully-fledged institutional solutions.

In any case, this time we have to be proactively ready as a Banking Union. As Ringe has aptly observed, this is not the time for legalistic views or political obsessions but rather the time of a possibly still dormant crisis during which even the notorious anti-mutualization frenzy was amplified, namely by the adoption of the Recovery Fund.

It is therefore the author's view that a standardized precautionary backstop facility, notably enabling the disposal of all NPLs (above a certain threshold and certainly the COVID-inherited) seems necessary and should be proactively and pre-emptively established so as to be at the immediate disposal of the competent EU authorities, **if** the magnitude of the COVID-inherited asset quality virus amounts to a proper systemic threat, thereby disabling our current meager bail-in centred lines of defence.

Even if (fortunately) never activated, it would signal the temporary existence of a fully institutionally fledged backstop, smoothly incorporated in the existent EU regulatory framework, which alleviates concerns for financial stability and deteriorates- thanks to its "Europeanized" safeguards- concerns about excessive recourse to public funds. Last but not least, it would detach the stigma of resorting on a standalone basis to this institutional tool. Indeed, if communicated promptly, not only it would not disturb markets and depositors, but contrarily boost confidence regarding EU banking sector's stability and firepower, forging the latter's lending capacity and creating the ultimate financial environment for economic growth.

In such circumstances, past experience, e.g. par excellence Mario Draghi's bold advertisement of the Outright Monetary Transactions (OMT) program, verifies that sometimes the brute announcement of such a fully-fledged backstop may suffice to temper shaky markets and restore investor (and depositor) confidence.

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