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Tackling Europe's crisis legacy: a comprehensive strategy for bad loans and debt restructuring

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Executive summary

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EIGHT YEARS AFTER the start of Europe's financial crisis, the legacy of non-performing loans and excessive private debt remains a key obstacle to the recovery of bank credit and investment.

WE ARGUE THAT efforts to reduce and remove NPLs from the balance sheets of creditors must simultaneously remove excess debt from the balance sheets of debtors. This is the only way to ensure that bank balance sheets are restored to health sustainably, and that both supply and demand for new credit revive.

A COMPREHENSIVE STRATEGY to tackle legacy assets should include national debt reduction strategies that guide bank NPL reduction targets, strengthen frameworks for restructuring and insolvency, simplify the engagement of specialist investors within the capital markets union and, crucially, create a blueprint for national asset management companies.

THERE IS A need to strengthen policies in four key areas:

FIRST AND FOREMOST, recapitalise banks to enable them to provision distressed loans adequately, and then actively participate in restructuring or writing off unviable loans.
SECOND, ENCOURAGE FURTHER legal reform that is also supported by adequate restructuring capacity within the banks and elsewhere in the private sector, including by attracting specialist investors.
THIRD, CREATE A tax regime and flexibility in revenue management that encourages the public sector to participate in debt restructuring.
FINALLY, ESTABLISH ASSET management companies that can overcome the various market failures in terms of removing distressed assets from banks' balance sheets.

NPLS ARE CONCENTRATED in particular countries but are a problem for the entire euro-area banking system given the many financial and real spillovers across the currency area. There is a clear need for national reforms that create a more supportive environment for debt restructuring and deleveraging. But many policies will also need to be coordinated within the euro area, and possibly within the single EU capital market.

Introduction

At a current value in excess of €1 trillion, non-performing loans (NPLs) have undermined the recovery in credit and economic growth in the EU since the 2009 financial crisis (Figure 1 and European Commission, 2017). In terms of bank regulation and supervision, the response was initially slow, though is now more decisive. Since 2013, the EU has had uniform standards for bank asset quality, and as of 2017 key euro-area banks will be forced to set targets for NPL reduction and to improve operational capacity to manage the workout (ECB, 2017).

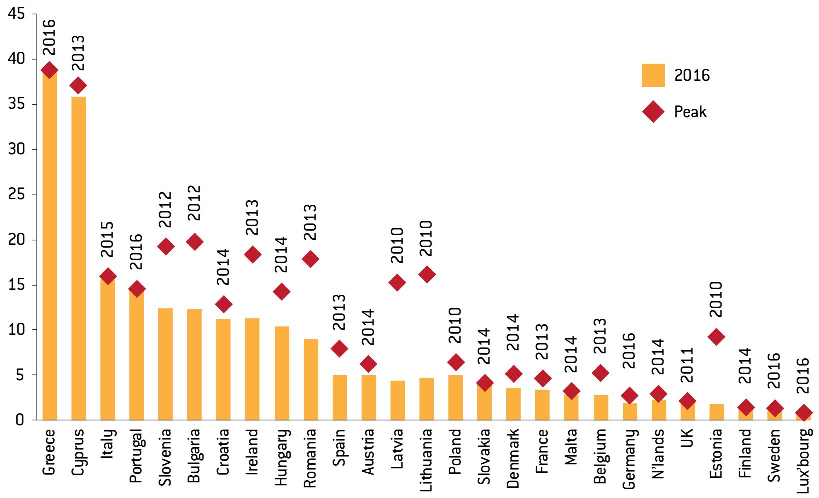
But it is often overlooked that loan delinquency is a symptom of debt distress in the private sector. And debt in excess of sustainable levels is even more widespread than NPL figures would suggest. At least eight countries within the currency bloc suffer from excess private debt on a scale that could potentially undermine their ability to recover sustainably.

This should be a concern for policymakers, including bank supervisors. Even loans that are so far performing might be held by companies that are not economically viable or households that are in distress. From 2018, the EU's new accounting standards will force banks to adopt a forward-looking assessment of borrowers' financial health. The impact of future write-offs and the benefits of early and well-coordinated debt restructuring on the current earnings and capital position will be much more apparent.

In most euro-area countries debt restructuring can be a market-driven process. Legal frameworks for restructuring and insolvency have been reformed, and capacity in judicial systems and local insolvency professions is improving.

However, at least four euro-area countries combine a toxic mix of excessive NPL levels, stagnant growth and persistent excess debt: Greece and Cyprus for households and companies, Portugal among large enterprises in particular, and above all Italy, with almost 30 percent of the total euro-area NPL stock. For these countries, gradualism would be counterproductive because protracted deleveraging is costly and capital remains tied up in businesses with unsustainable debt. Some enterprises might return to health following a comprehensive financial and operational restructuring, others will ultimately require partial or full liquidation. In these economies national frameworks and institutions need to be reformed further, and EU and euro area policies need to be strengthened to support comprehensive balance sheet restructuring.

Figure 1: Gross non-performing debt instruments in the EU, % of total gross debt instruments



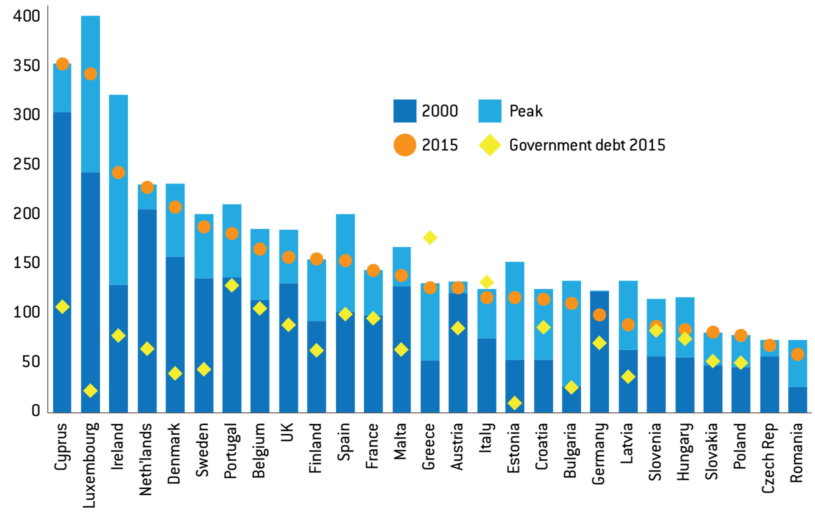
Source: ECB. Note: peak year to 2016 Q2.

In this Policy Contribution we describe the supply and demand sides of debt. We then take stock of the process of private debt deleveraging in Europe and identify the institutional reforms made by countries that underwent systemic debt resolutions successfully in the past. Given the many financial real spillovers within the currency area, there is a case for policy coordination at the euro-area level and, in more focused areas, in the capital markets union.

1 Private debt: a problem with two sides

World Bank (2011)[1] demonstrated how debt has become more important for the functioning of modern economies over the last 20 to 30 years. More and more people and firms use debt to finance growth. However, and as World Bank (2011) emphasises, the procedures followed to resolve debts, when borrowers default, have not adapted to match the increased prevalence of debt. As a result, the inability to resolve debts as they become unproductive has led to the accumulation of high stocks of private debt. Europe is not different in this respect. Figure 2 shows that it is the levels of private debt (not fiscal debts) that remain high, and possibly too high.

Figure 2: Private sector (households and non-financial corporates) debt, % of GDP



Source: Bruegel based on Eurostat, Irish National Central Bank Statistics. Note: Private debt data for Ireland is based on central bank statistics (CCB indicators), which are based on national bank credit data, thereby excluding the debts of foreign affiliates.

The exact level at which indebtedness distorts growth remains unclear. The European Commission's Macroeconomic Imbalance Procedure (MIP) uses a threshold of 113 percent of GDP as a signal for deeper investigation of private indebtedness. In a separate study (European Commission, 2013) that compared private (household and firm) debt levels to historical positions, the Commission estimated deleveraging needs of over 30 percent of GDP in Greece, Cyprus and Spain and about 20 percent for Dutch households.

But the range of estimates of such thresholds is wide and disputed. Cecchetti *et al* (2011) found that corporate and household debt in excess, respectively, of 90 and 85 percent of GDP is detrimental for growth. Arcand *et al* (2011) found that even private debt at 100 percent of

1 World Bank (2011) refers to personal insolvency.

GDP exerts a significant drag on growth. Caution therefore is important when attempting to categorise a level of private debt as excessive.

1.1 The two effects of excessive debt

Irrespective of whether we know the exact point at which debt becomes excessive, we can recognise two ways in which excessive debt has detrimental effects on the economy.

The first impacts the supply of credit. Excessive debts are typically non-performing. When creditors have a level of NPLs on their balance sheet, they do not issue new credit, thus putting a cap on the credit supplied to the economy. There are several channels through which NPLs can affect creditors. NPLs erode bank earnings because of the higher risk weights in calculating capital costs, provisioning and diminished returns on delinquent assets. European Central Bank simulations suggest that simply replacing existing NPLs with sound exposures would lift return on equity in the most affected countries by several percentage points (Constâncio, 2017). Higher capital requirements for NPLs also tie up banks' resources and crowd out new credit. This similarly applies to human resources given that monitoring and management of NPLs requires more effort and ties up specific skills that are usually scarce within banks. Finally, high NPLs are a source of uncertainty leading to higher costs of funding and possible greater risk aversion by investors and depositors (Diwan and Rodrik, 1992).

Figure 1 showed current NPL levels in the EU compared to peak levels. While a number of countries have made progress in removing NPLs from bank balance sheets, a number of others clearly have not. The eight euro-area countries with the highest NPL ratios account for just under 70 percent of the NPL stock in the currency area. These eight 'high-NPL' countries also have elevated private debt ratios, in particular in relation to businesses. Interestingly, however, countries like Denmark and the Netherlands, which have low NPL levels, also had private debt in excess of 200 percent of GDP at the peak.

Excessive debt also suppresses the demand for new credit. This second effect, known as the *debt overhang*, has been less prominent in the European discussion. Debt overhang is a situation in which high debt levels act as a disincentive to new investment (Myers, 1977). When a firm has debts that create a non-trivial probability of defaulting, it becomes reluctant to demand more credit to finance new investments. This is irrespective of whether new investments would generate sufficient profits to finance themselves. The existing stock of debt weighs in on firms' economic decisions because any new profits will go to service old creditors first, and will only thereafter accrue to equity holders. This 'tax' on new investment distorts the willingness to invest and to grow out of debt. This phenomenon is the same for firms, households and countries, as pointed out by Krugman (1988).

This effect is difficult to measure directly, but can be identified in different ways. Companies that are highly leveraged find it difficult to take advantage of an improvement in demand, and may even continue to de-lever as a recovery takes hold (IMF, 2015a). In Europe, it is estimated that the debt overhang explains about a third of the decline in investment observed during the crisis (Ozcan *et al*, 2015). It is likely that the number of firms originally affected by this distortion is significant, making it a systemic obstacle to recovery[2].

1.2 Alternative paths to debt adjustment

Our main observation is that while there has been progress in removing NPLs from bank balance sheets, the reduction in total private indebtedness is still at an early stage. Total private debt in the EU (Figure 2) remains at an unweighted average of almost 150 percent of GDP. Removing NPLs from bank balance sheets remains necessary, though it does not imply a one-to-one reduction in private debt. For loan delinquency to be reduced sustainably, debt also

2 Jordà *et al* (2013). There are also other arguments relevant in this respect. Acharya *et al* (2016) argued that the ECB's early unorthodox instruments stimulated lending by banks but that this lending was primarily directed to existing, rather than new, clients and these borrowers exhibited poor credit quality. What they characterise as 'zombie lending' sustained firms with non-viable debt burdens and further distorted markets.

needs to be brought down to sustainable levels.

A significant obstacle to this adjustment has been the EU's anaemic growth and almost zero inflation, at least until recently. Because the real value of debt does not adjust, it is the nominal value of debt that needs to come down. In principle, there are two alternative paths to such an adjustment:

- **Deleveraging,** as debtors put aside resources to repay existing debt. This however, depresses growth and investment as lenders rebuild liquidity in the absence of a more comprehensive improvement in the debt situation. Repressing investment and consumption also has considerable and long-lasting implications for income – a result of so-called hysteresis effects that last beyond any adjustment period, because of impacts on skills, employment and productivity given the depressed path of capital accumulation. European Commission estimates point to a permanent reduction in GDP of almost one percentage point for every ten-percentage point reduction in the private debt ratio (Pontuch, 2014).
- **Re-structuring and/or write-downs.** This form of adjustment would involve wide-ranging modification of loan terms to recognise the value loss relative to the original terms in credit contracts, and to share this value loss between creditors and equity holders. In most of the eight euro-area countries with high NPLs, balance sheet restructuring has been slow. This is mostly because of coordination problems, market failures in the pricing of claims and the lack of bank capital that is needed once banks absorb losses. Only a few countries have engaged in more systemic restructuring, through recapitalisation and consolidation of the banking sector, guarantees or separation of delinquent loans from bank balance sheets (we review some case studies in section 2).

1.3 A framework for thinking about bad debt

For levels of private debts to fall meaningfully, financial restructuring in debt-distressed borrowers needs to become more prominent. The emphasis needs to be on rescuing what is productive through restructuring and writing off what is non-productive as quickly as possible. This principle would in our view allow sufficient consideration to be given to restoring financial viability of debtors, and would be a crucial complement to the process of NPL resolution that is already underway.

A guiding principle for resolving NPLs should that viable debt remains serviced, while non-viable debt gets resolved. But this is not the same as resolving non-performing debt while holding on to performing debt. It helps therefore to apply two criteria when categorising loans: borrower viability and ability to service[3]. Performing loans are those being serviced in line with the original contractual loan terms. Viable loans are those extended to borrowers whose future stream of profits will exceed scheduled debt service obligations.

With these criteria, loans can be divided into four categories (Table 1)

- **Good loans,** which are both productive and are being serviced;
- **Bad loans,** which are delinquent, and also where the prospective earnings stream (viability) is questionable;
- **Unproductive loans**, which are still performing, but are similarly not viable[4];
- **Temporarily distressed loans or strategic defaults.** This includes either debts that are

3 The former is essentially an assessment of solvency or positive net worth, the latter an assessment of delinquency and forbearance, which has been defined by the European Banking Authority (EBA).

4 An interesting example here is household debt in the Netherlands, where despite a big house price correction and a big income drop, the level of NPLs has remained low. The European Commission, in its last country report for the Netherlands alludes to strict insolvency rules as a possible explanation, which effectively force households to comply with bank payments, even though defaults arise elsewhere, such as in health payments (European Commission, 2016).

temporarily in distress but could return to being performing[5] or loans that are non-performing by choice. The latter are the result of moral hazard where debtors choose not to pay back debt even when economically feasible. This loan segment is significant in a number of euro-area countries, in many cases because of the anticipation that a restructuring solution would become widely available[6].

Table 1: Loans: viability and servicing

	Viable	Non-viable
Performing	Good loans	Unproductive loans
Non-performing	Temporarily distressed or 'Strategic' defaults	Bad loans

Source: adapted from Bricongne *et al* (2016).

Given these four categories, understanding debtors' true ability to pay back debts and to restructure appropriately is crucial. Since 2013, the European Banking Authority standards on asset quality have provided uniform definitions of the state of a borrower's performance relative to its creditors. Financial regulators are now beginning to combine this with a parallel assessment of the severity of borrowers' debt distress, and their potential non-viability. New accounting standards that will come into force in 2018 will require a more forward-looking assessment of loan quality. In effect, accounting for loan quality (evident in NPL figures) will be de-linked from the evolution of value corrections on loans (impairments).

Once banks begin to take a deeper look at borrowers' financial health, this might have to recognise that certain companies are irredeemably insolvent, and no amount of restructuring will return them to viability. From the perspective of financial sector soundness, and also of growth prospects, such companies should be cut off from credit and banks should work towards the early and efficient liquidation of assets and collateral.

In several EU states insolvency laws and foreclosure rules do not allow such a resolution ('foreclosure'). A long history of continued lending to 'zombie' firms has tied up meagre bank capital, starved other sectors of access to credit and depressed productivity growth in the economy more widely[7].

2 NPL resolution and debt restructuring during European crises

Even before the most recent European crisis, a number of European countries experienced systemic distress in terms of private debt and bank NPLs. Two countries illustrate how addressing the poor quality of banks' assets needs to proceed in tandem with restructuring of private sector debt.

- Following a property market collapse, loan losses in **Sweden** in 1992 alone amounted to

5 This would include those where re-defined loan terms have restored viability (even though supervisors would still count such forborne loans as non-performing).
6 Asimakopoulos *et al* (2016) estimate that in Greece one out of six firms with non-performing loans are aiming at strategic default.
7 For instance, in analysis covering 2012 for Greece PwC (2015) suggested that 25 per cent of loans should be written off, and a further 16 per cent would require restructuring.

3.8 percent of GDP, and NPLs to 11 percent, both primarily related to commercial real estate and mortgages. Bank lending contracted by over 26 percent between 1990 and 1995. Recovery took ten years (Sandal, 2004). However, Sweden also stands out for having used a state-owned bad bank to deal successfully with a large overhang of distressed property loans. Following the capital injection in 1991, most bad assets from state-owned Nordbanken, the country's third largest bank, were transferred into a separate asset management company (AMC), Securum. A similar asset management company was set up for a much smaller private bank, and this was subsequently merged into Securum. The purpose of the two AMCs was to enable a clean break for the healthy part of the banking system, and to let specialists focus on restructuring and recovery of maximum value. A key element in the success of these bad-bank structures was that the government transferred to them only a relatively well-defined asset class of large commercial real estate exposures. Specialist restructuring expertise was required for these assets, but sensitive political discussions, such as in corporate restructuring, could be avoided. Professional management, political independence, and appropriate funding contributed to success. The recovery of the economy from 1994 and then in real estate markets was of course crucial in this regard. In the end, Securum sold or restructured all assets within five years.

- **Latvia** experienced a dramatic boom-bust cycle in the 2008-09 global crisis, with an overall GDP contraction of 18 percent, the largest of any emerging market. NPLs peaked at 22 percent for firms, and about 20 percent for households. Nearly 44 percent of corporate credit was in foreign currency, meaning that maintaining the peg throughout the very painful internal devaluation period prevented a more serious balance sheet recession. Even though the largely Nordic-owned bank subsidiaries were the principal culprits behind the excessive pre-crisis credit inflows, they were also instrumental in the successful workout effort that followed. Blanchard *et al* (2013) estimate that between early 2010 and mid-2013, one third of the Latvian stock of loans was restructured by the banks, and only about 7 percent written off. The experience of the Nordic banking crisis clearly shaped the engagement of the parent banks. Loan workout was centralised within the banks, or separate asset management companies were set up. Provisioning levels were maintained even as NPL levels quickly rose, and the subsidiaries were recapitalised repeatedly by their parents. Most voluntary debt workouts were designed on the basis of relatively efficient out-of-court restructuring guidelines, typically led by a single bank, which could ultimately apply fairly efficient foreclosure procedures. The courts managed a smaller number of restructurings, though this option was considerably less attractive (Erbenova *et al*, 2011).

Sweden's and Latvia's experiences underline that private debt restructuring is part and parcel of recovery from a banking crisis. Both countries succeeded by making specialist restructuring expertise available, in an asset management company in the case of Sweden, or in relatively experienced and well-capitalised cross-border bank groups in Latvia and elsewhere in the Baltics. In the case of Parex, the only significant local bank in Latvia, state ownership of a separate bad bank became necessary. These workout efforts succeeded relatively quickly within efficient legal frameworks, and, at least in Sweden, with the assistance of capable courts and related services.

By contrast, structural reforms to facilitate debt restructuring in the euro-area crisis countries have been piecemeal. Ireland, Slovenia, Spain and Portugal have seen tangible reductions in the private debt ratio (Table 2). But debt reductions have been miniscule in Greece, Cyprus and Italy. Strikingly they are also critically high, and near their peaks, in the Netherlands, France and Austria. It is far from clear whether these further debt reductions can take place in the absence of well-developed frameworks for debt restructuring.

Ireland, Slovenia and Spain are the only euro-area countries with **asset management companies** that cover several distressed banks (Germany and Austria are among those with institution-specific bad banks). The Irish, Slovenian and Spanish AMCs had a meaningful impact in terms of creating markets for distressed loans within their respective countries.

Table 2: NPLs and debt ratios in selected euro-area countries

	Aggregate NPLs				Sectoral NPL ratios in per cent 1/			Private debt, % GDP 3/				
	% of gross loans, latest 1/	percentage reduction since peak 2/	peak year	€bns, latest 1/	Households	Enterprises	SMEs	2015	Percentage reduction since peak	Peak year	Households	Enterprises
Greece	46.9	0.0	2016	115.1	46.4	37.4	66.2	126	-5.1	2012	62.4	63.9
Cyprus	47.4	-1.2	2013	21.4	55.9	61.1	64.7	354	-0.6	2014	129.2	224.6
Portugal	19.7	0.0	2016	40.8	9.3	35.6	29.0	182	-30.2	2012	77.5	104
Ireland 4/	15.4	-7.1	2013	32.8	14.9	13.1	30.2	243	-78.8	2010	70.9	172.4
Slovenia	19.2	-6.9	2012	3.3	7.0	29.0	47.6	87	-27.8	2010	27.8	59.5
Italy	16.4	-0.4	2015	276	12.9	20.6	30.4	117	-8.1	2012	42.2	74.8
Austria	6.0	-1.3	2014	21	5.4	7.9	9.8	126	-6.5	2010	52.3	74.1
Spain	6.0	-2.9	2013	141.2	4.5	7.7	17.4	154	-47.4	2009	67.8	86.2
Netherlands	2.7	-0.7	2014	44.6	1.5	5.0	5.4	229	-2.6	2009	111.2	117.7
France	3.9	-1.2	2013	148.4	4.2	5.0	9.1	144	0	2015	56.6	87.7
Germany	2.7	-0.8	2009	115.1	2.0	5.2	8.6	99	-24.4	2001	53.5	45.5
Latvia	3.5	-10.9	2010	0.3	6.7	3.1	4.5	89	-45.2	2010	24.5	64.3
Euro area (18 countries)	7.0	-0.6	2014	946	5.9	9.3	14.7	138.9	-6.4	2009	58.5	80.4

Source: Bruegel based on 1/ EBA; 2/ ECB Consolidated Banking data; 3/ Eurostat; 4/ Private debt data for Ireland based on central bank statistics (CCB indicators), which are based on national bank credit data, thereby excluding debt of foreign affiliates. Note: sectoral NPL data exclude other loans than the three mentioned asset classes (such as financial institutions and public sector loans), and therefore do not average to aggregate NPL ratios listed in the first column.

Ireland and Spain were among the most active secondary markets in Europe in 2016, with the Irish AMC, Nama, the most active seller[8]. Crucially, these bad banks also centralised debt restructuring, in particular of large distressed enterprises and real estate exposures. Loan servicing companies are an essential precondition for attracting investors into distressed debt (investors would typically sub-contract the servicing of borrowers). These companies were nurtured by the bad banks, but this sector has faced significant obstacles elsewhere, often arising from national restrictions on the transfer of loan titles (ECB, 2016).

Despite the relative successes in Spain and Ireland, the 'troika' programmes in Greece, Cyprus and Portugal did not contemplate the setting-up of AMCs, despite significant programme funds devoted to the recapitalisation of banks in Greece and Cyprus. This was because of the very complex frameworks for restructuring and insolvency, and the complexity of the various asset classes, spanning residential loans, SMEs and larger enterprises. Two factors have complicated the establishment of AMCs in Europe: starting in 2009, Eurostat put in place guidance under which most asset management companies would be considered part of the public sector and therefore subject to EU fiscal rules (Gandrud and Hallerberg, 2014). In addition, since 2015 when the EU's new framework for bank resolution came into effect, public ownership of asset management companies has become more complicated because it could potentially lead to a 'bail-in' of certain creditors.

Legal reforms have progressed in a number of the euro-area crisis countries, though restructuring solutions are generally held back by slow processes in the courts. In Italy, for instance, insolvency proceedings take on average more than six years (ECB, 2016). ECB country assessments point out that the number of foreclosures is generally limited. In Greece, corporate insolvency procedures remain lengthy and the system offers few incentives for early restructuring. The ECB assessment found a *de-facto* unlimited stay on enforcement against individual borrowers, which has encouraged large-scale strategic defaults. In Italy, enforcement is also notoriously lengthy, though three laws adopted in 2015 and 2016 have attempted to shorten this. Spain since 2013 has benefitted from an out-of-court restructuring procedure for SMEs, with restructuring facilitated by professional mediators. This has been subsequently extended to consumers.

Box 1: Reforms aimed at debt reduction in Spain, Ireland and Slovenia

Between 2012 and 2014 Spain utilised €40 billion out of a €100 billion euro-area financial sector programme to recapitalise and consolidate its municipal banks (cajas), following the earlier real estate bubble. The transfer of distressed mortgages into Sareb, the central asset management company, was compulsory for those banks that received public capital injections. This programme succeeded in stabilising the financial sector. By end-2015, the total private debt ratio still stood at 154 percent of GDP, the bulk of which in the corporate sector. This represented a substantial drop since the peak of the crisis, not least because of the pick-up in growth. Deleveraging continues in the construction and real estate sectors, though banks increasingly fund new companies with good prospects.

Sareb acquired €106 billion in real estate assets (mostly residential, loans and actual property) at book value, subject to an average 52 percent 'haircut' (though recently had to substantially correct this value through additional provisions). As the central asset management institution tasked with restructuring real estate assets, Sareb was a catalyst in building a market for distressed assets, and played a key role in attracting investors and servicers with restructuring expertise. It was given wide discretion to maximise value recovery during the 15 years of its lifetime (Medina Cas and Peresa, 2016, and EU Commission, 2016). Cumulative

8 Deloitte: *Deleveraging Europe* (2017). These rankings refer to the entire secondary loan market, where so-called 'non-core' portfolios are an important component. Also, this market is dominated by commercial and residential real estate portfolios, while SME and corporate assets are still a minor component.

losses over the four years of its operation have been € 750 million.

Legal changes in the years since the crisis substantially expanded the potential scope of both in-court and out-of-court arrangements. Pre-pack procedures exist for both corporate and individual borrowers. A code of conduct guides lenders in dealing with insolvent households, and the number of foreclosures has been very small (ECB, 2016).

Similarly to Spain, Ireland's central asset management agency, Nama, was instrumental in NPL resolution, which focused on distressed loans to property developers. Nama was set up in 2009 to pool distressed commercial property assets from the six banks that had benefited from a blanket guarantee and subsequent public capital injections. Nama's portfolio was considerably larger than that of Sareb, accounting for over 18 percent of GDP, though this also comprised large commercial real estate assets that Irish property developers had acquired in the UK and elsewhere in Europe. The central bank also set targets for banks to reduce mortgage arrears. Importantly, banks were to propose sustainable modified loan terms to customers, unless the customer had declared bankruptcy based on the revised personal insolvency law (which specified alternative paths to resolution, and shortened the debt discharge from 12 to ultimately only one year). Like in Spain, the number of foreclosures on households has been very low, and the various legal means to restore households and enterprises to viability remain underutilised. By end-2015, the private debt ratio stood at 243 percent of GDP (excluding the substantial foreign-owned sector), the second highest in the euro area.

The NPL crisis in Slovenia was primarily one of enterprises, not of households. Excess corporate debt emerged in the pre-crisis years when largely state-owned banks funded themselves in European wholesale markets, a source that dried up abruptly in 2009, and exposed the unsustainable debts of an increasingly uncompetitive and poorly managed corporate sector. The stress test of the country's principal banks, and their subsequent recapitalisation by the state in late 2013, provided the motivation for a more comprehensive strategy on NPLs and excess debt.

An official financial support programme was narrowly avoided, though the debt and NPL reduction was only partially successful. The 2013 revision of the insolvency law, and the later guidelines for multi-creditor restructuring were close to best practice. However, the government strategy was undermined by the essentially unchanged governance of the two largest state-owned banks, which did not actively participate in the restructuring. Also the newly established bad bank did not have full political support for controversial restructuring of large distressed enterprises. Finally, a lack of expertise and capacity in the courts and among private insolvency professionals frustrated many restructurings and resulted in lengthy proceedings. Total private debt fell from its peak in 2009 to about 87 percent of GDP in 2015, though it remained heavily concentrated in a small number of large enterprises. Given the preoccupation of domestic banks with the NPL workout, companies in the tradable sector, which are mainly profitable, have increasingly turned to cross-border borrowing.

3 Policy initiatives and their coordination

Previous NPL and debt crises show how good bank supervision and restructuring needs to be supported by structural reforms that return private borrowers to viability. From this experience we identify four key issues that need to be addressed to overcome Europe's high private debts. Some warrant coordinated policies within the EU or euro area, others depend only on national reforms.

Early bank restructuring and recapitalisation to enable banks to actively support debt restructuring.

Once banks' loss absorption capacities are bolstered through early capital injections, banks can sustain further impairments and write-offs. These are inevitable whether the restructuring solution is internal or whether executed by investors in the secondary loan markets. In other words, NPLs have not only eroded profitability but are also a symptom of thin capitalisation and the inability of banks to engage in debt restructuring that entails further write-offs.

More determined NPL clean-up and debt restructuring will therefore need to be a key part of the broader effort to boost bank profitability. Low profitability is of course a problem that plagues banking sectors across the euro area, including in markets with better bank asset quality, and is also a consequence of a combination of low margins on lending, competition from non-bank financial firms and outdated business models (ESRB, 2016). There is a risk that banks will respond to greater supervisory pressure for NPL workout and additional provisions with a relaxation in risk standards for new lending or forbearance on existing but problematic loans. Greater scrutiny of banks' NPL strategies will therefore require parallel efforts by supervisors to constrain credit risk, while allowing innovations in banks' business models that are sustainable within the emerging EU-wide capital market. This is clearly a euro-area priority.

National frameworks for insolvency and early restructuring need to be reformed and adequately resourced.

All restructuring options ultimately rely on adequate capacity in the judicial system. In the United States, a system of specialist courts and judges is supported by experts within the courts, and private-sector insolvency practitioners. This results in a high degree of certainty in the timeline for insolvency proceedings (AFME, 2016). The EU has different legal traditions. Core elements of national insolvency regimes – for instance whether owners continue to manage the business while formal proceedings are underway, or how soon individuals may discharge their debts and make a fresh start – still differ widely. As a result there are marked differences in terms of what the frameworks in the EU achieve (Figure 3). Furthermore, several EU countries lack a proper framework for private debt restructuring ahead of formal insolvency proceedings. Such provisions are crucial to overcome coordination problems between lenders, for the awarding of temporary protection from enforcement, in securing the ongoing operation of the business and in protecting new financing provided on the basis of restructured finances and a new business plan.

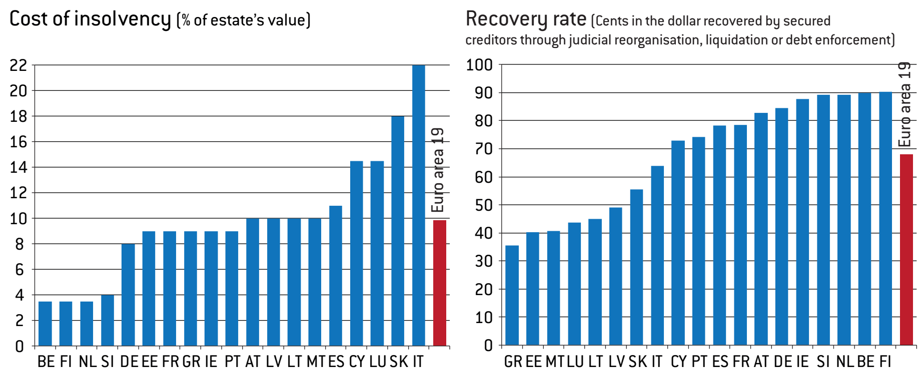
In November 2016 the Commission proposed a directive on preventive restructuring frameworks and insolvency procedures. This is a good start in addressing the diverging national practices. Common standards should provide a better framework for banks and investors. Standards should include limited stays on enforcement and rules for majority decisions by lenders that bind all lenders ('cram-down'). This directive, if adopted, would result in significant legal regime change in some key EU jurisdictions, for instance in establishing security for continuity in management or mandating protection for new financing.

A supportive framework for the involvement of banks in restructuring and the workout of their NPLs would be a clear benefit of this directive. It may also support greater capital market integration. Given the cross-border implications of business insolvency for suppliers and downstream industries, there is a single market aspect to insolvency (AFME, 2016). The call for more uniform insolvency standards is particularly relevant within the euro area with its additional requirements of banking sector soundness and the need for a greater degree of financial-sector risk sharing (European Commission, 2015).

Where debt distress in SMEs is significant, countries will need to establish pre-defined restructuring solutions for such companies, as was done in Spain, for example. SMEs account for about 30 percent of the euro-area NPL stock, though their situation at present is not addressed in the EU directive. SMEs are especially affected by complex insolvency regimes and their restructuring cannot be executed by the banks on a case-by-case basis (IMF, 2015b).

A further challenge for countries will be to ensure adequate capacity in the restructuring professions to support their revised legal regimes. NPLs and debt distress in several countries, such as Greece, Portugal and Slovenia, are concentrated among larger companies. Here, corporate debt restructuring needs to go hand-in-hand with operational restructuring, and possibly capital infusions. In many cases, financial distress in firms is a reflection of a broader loss of strategic direction, or poor or outdated business plans. Operational restructuring, possibly with new ownership and replacement of management, needs to be part of the financial recovery of the firm. This is not normally a concern for macroeconomic policy or financial supervision, but might well emerge as a constraint in designing sustainable restructuring and tackling corporate NPL portfolios. The relevant restructuring expertise needs to be attracted from investors who are specialised in restructuring. New, and more senior, creditors are often needed, and new owners may need to implement a changed business strategy.

Figure 3: Cost of insolvency proceedings and recovery rates in the euro area



Source: World Bank Doing Business 2017.

Governments will need to sustain temporary revenue shortfalls and write-offs of their own claims to support an economy-wide restructuring effort.

The public sector will need to participate in debt restructuring, alongside other banks, subjecting social security payments and other claims to a standstill and write down. Also, tax rules might need to be adapted as banks engage in restructuring or write-offs. In Italy, for instance, bank loan loss provisions were only made fully tax deductible from 2015. Public revenue will be foregone in the context of widespread corporate debt distress. Most options for debt restructuring – eg forgiveness, interest rate reductions, extensions of loan maturity, or merger of the distressed firm – give rise to taxable income on the side of the borrower. Giving such claims priority over other creditors in enforcement against a cash-constrained borrower in distress would accelerate insolvency. These immediate revenue shortfalls for the budget are likely to be insignificant in comparison to the long-term benefits in terms of growth and fiscal revenues that arise from comprehensive debt restructuring. Nevertheless, adapting national tax rules, and the facilitation of debt restructuring by fiscal authorities, will require flexibility under the common euro-area fiscal framework. Given the very limited fiscal space that exists, in particular in the countries with significant NPL problems, the issue remains politically difficult.

Finally, countries with systemic NPL problems should consider establishing central asset management companies, and where necessary, the EU should clarify the bank resolution framework to facilitate this.

European banks increasingly seek to divest distressed loan portfolios, especially now that NPL reduction targets will be set by the ECB. However, loan sales inherently suffer from two market failures. First, the bank as the seller that originated the loan and previously oversaw its servicing has access to a far greater level of information than the typically uninformed buyer (ECB, 2016). The AMC addresses this by establishing uniform valuation principles, and ensuring quality in loan documentation. A second market failure arises through the illiquid market for distressed debt in which there is the risk of a wide divergence between market valuations of assets offered for sale, and the long term economic value that will ultimately be realised. Here the AMC acts as a market maker, ie avoiding the risk of a 'fire sale'.

Crucially, AMCs also address the inherent skills shortage, and overcome coordination problems in defining restructuring solutions that will ultimately realise long term economic value. The experiences with Sareb in Spain and Nama in Ireland underline this potentially catalytic effect of asset management companies, though in both the Irish and Spanish cases this came on the back of a comprehensive bank restructuring and recapitalisation effort, and both entities dealt with relatively homogeneous asset classes. SMEs (which dominate Italian NPL portfolios) will require the ongoing involvement of banks, and larger corporates (as in Portugal) might require both a central asset management company and specialist investors.

Public involvement in ownership and funding of such institutions is inevitable, at least initially. This is now complicated by the EU Bank Recovery and Resolution Directive (BRRD) under which the transfer of assets above market prices to a public AMC could potentially lead to bail-in of certain creditors.

The discussion around a European AMC has nevertheless now revived. Constâncio (2017), for instance, called for a *"blueprint"* that would provide a clearer framework for asset transfers to AMCs that are permissible under the BRRD. There have been more ambitious proposals for an EU-wide AMC (Haben and Quagliariello, 2017). However, since the first proposals for such an institution, countries have proceeded at different speeds, and the benefits that could arise from the creation of such a jointly-owned institution have diminished.

4 Conclusions: more assertive bank supervision will need to be complemented by debt deleveraging strategies

In March 2017 the ECB issued guidelines on the management of NPL portfolios in the banks that are under its supervision. This was a much needed, and overdue, initiative to tackle legacy assets in the euro-area banking system and to prevent their re-emergence. However, as we have shown, in the absence of other supporting policies and reforms aimed at deleveraging, greater pressure by bank supervisors will likely be ineffectual and could be counterproductive. The low-interest rate environment provides a window of opportunity to accelerate this broader debt reduction but it might not be there for much longer.

This pressure by supervisors needs to be focused on seven high NPL countries: Greece and Cyprus where NPLs and private debt remain near their peaks; Portugal and Slovenia where the workout of corporate and SME NPLs will be protracted; Spain and Ireland with significant remaining problems in their mortgage sectors despite the good work of their respective bad banks; and Italy with almost 30 percent of the euro-area NPL stock.

In developing a comprehensive strategy to finally tackle legacy assets there is a clear need to strengthen four key policy areas. First and foremost, bank recapitalisation should enable banks to make further provisions and participate in restructuring and loan sales or to write off ultimately unviable exposures. Spain and Ireland demonstrated how essential adequate capital coverage and consolidation are in this process. Second, further legal reform should be supported by adequate restructuring capacity within the banks and elsewhere in the private sector, including through the involvement of specialist restructuring investors. Third, fiscal space should be allowed for the public sector to support debt restructuring. Finally, asset management companies that can overcome the various market failures in removing distressed assets from banks' balance sheets are an essential part of financial infrastructure. The legal and budgetary basis for such AMCs should now be put in place, and implementation of the BRRD with regard to asset valuations should become more transparent.

Above all, this agenda is one for national governments, which need to strengthen restructuring frameworks and equip their banks to handle restructuring. But there is also a need for coordination within the euro area: in the implementation of the ECB NPL guidelines and the associated reduction targets; in the supervisory strategy that ushers in a return to bank profitability; and in facilitating greater cross-border banking and financial integration. If nothing else, euro-area coordination is justified by the many distortionary effects that the common and still loose monetary policy has on companies with excessive debts.

It is less straightforward to define a common agenda for the EU. The proposed EC directive might establish a baseline for restructuring regimes and insolvency frameworks but given the different legal traditions of EU countries there is unlikely to be complete consistency of national regimes.

There have been three proposals for EU-level instruments that could support this NPL resolution. These are in decreasing order of political realism but increasing effectiveness: a NPL clearing house that would establish common standards for data quality in loan sales; a securitisation instrument at EU level that would provide a risk guarantee to senior tranches of NPL portfolios; and an EU-wide asset management company.

We find an EU-wide bad bank is sensible in theory, though its start-up would be protracted because a political consensus would need to be built, valuation principles established, and expertise hired, even if an existing EU institutions such as the EIB were to take on this role. Such a bad bank would have had great value-added at the peak of the NPL crisis in the euro area. Since then countries have advanced at different speeds, reducing the benefits that such a jointly-owned institution could bring. Italy and Portugal will continue to examine new strategies for distressed bank assets, and the BRRD should not act as a disincentive for a sensible public involvement.

Even in the absence of common institutions, much could be done to make sure that bank supervision is properly supported by national legal frameworks and debt reduction strategies. Above all, national political ownership is essential for a strategy that will entail difficult restructuring decisions within firms, and across industries.

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