ARTICLE – Non-performing loans in the euro area and financial stability

The banking sector in the euro area has for a long time suffered problems with high costs, low profitability and large volumes of non-performing loans – a situation that risks worsening because of the pandemic. Many banks in Europe have also increased their provisions for loan losses during the pandemic. At the same time, support measures have been introduced to secure the supply of credit and maintain economic activity. Authorities in the EU, for instance, have introduced temporary amendments to regulatory frameworks, which imply that banks no longer need to disclose and make provisions for non-performing loans in the same way as before. The volume of non-performing loans may therefore be larger than is apparent from the financial reporting. If non-performing loans increase in the euro area, this could lead to stability risks that can spread to Sweden through the Swedish banks' cross-border operations.

High ratio of non-performing loans in the euro area even before the pandemic

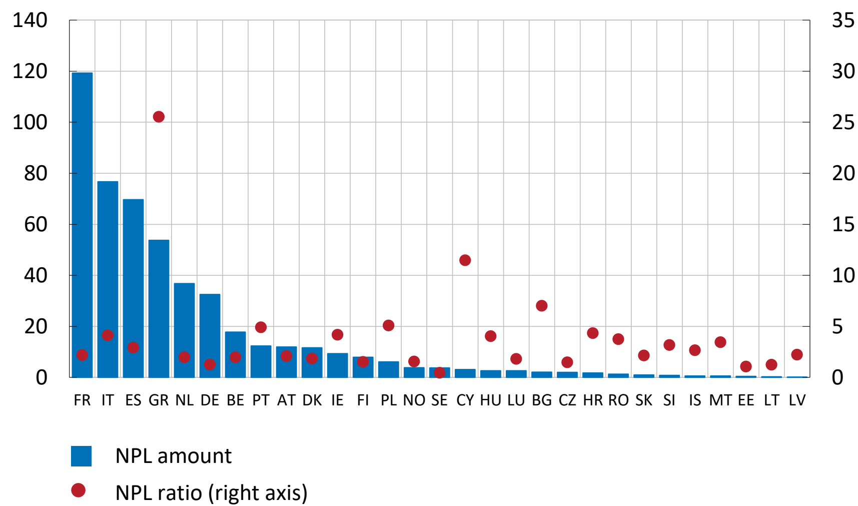
The ratio of non-performing loans, NPLs, has been a major problem for many banks in Europe since the global financial crisis 2008-2009, especially in Greece, Italy and Spain (see Chart 46).[119] The levels have declined, but relatively slowly (see Chart 47).[120] The number of companies suffering financial problems now risks increasing in the wake of the pandemic. This should lead to the number of non-performing loans at the banks increasing again, something that has also begun to show in the reporting of loan loss provisions. The market has also been valuing shares for several European banks lower than the book value of their equity for a long time (see Chart 48). This differs from the major Swedish banks, where the market value exceeds the book value somewhat instead.

[119] A non-performing loan is a loan where the borrower has stopped paying the bank according to the terms of the loan, or where there is some other indication that the borrower will have difficulty repaying the loan. Normally a loan should be classified as non-performing 90 days after a payment is missed. Non-performing loan is a regulatory concept, unlike expected loan losses, which is an accounting concept. For a discussion on non-performing loans and how banks manage them, see O. Fredriksson and N. Frykström, (2019), "Non-performing loans and their effects on banks and financial stability", *Economic Commentaries*, no. 2, Sveriges Riksbank.

[120] The total volume of non-performing loans among European banks amounted to EUR 468 billion in the fourth quarter of 2020. This corresponds to about 2.6 per cent of the outstanding loans.

Chart 46. Amount and share of NPLs in Europe

EUR billion, per cent

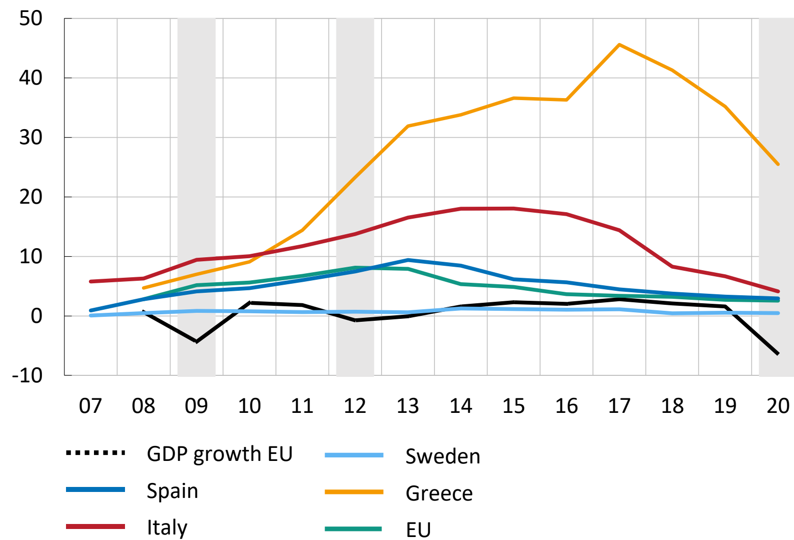


Note: The share of NPLs in the banks' lending. Refers to amount and proportion at end of December 2020.

Source: European Banking Authority (EBA).

Chart 47. The share of NPLs in the banks' lending and GDP growth

Per cent

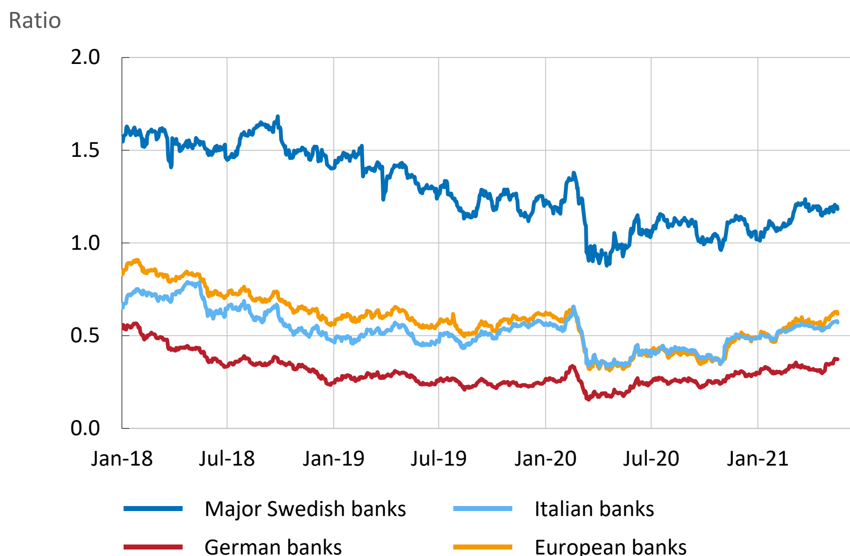


Note: The shaded areas correspond to the financial crisis, the European banking crisis and the coronavirus pandemic.

Sources: European Banking Authority (EBA) and Eurostat.

Chart 48. Price-to-book – market value in relation to equity

Ratio



Note: Average for banks in different countries. Price-to-book refers to the stock market value in relation to the book value of the banks' equity. If the price-to-book value is lower than 1, the market values the company less than the book value.

Source: Bloomberg.

High levels of non-performing loans reduce the banks' profitability and limit their capacity to provide new loans, at the same time as they must reserve capital for future losses on non-performing loans.[121] Non-performing loans also risk impairing long-term economic growth and increase uncertainty in the banking system, resulting in elevated financial stability risks. European authorities have therefore worked actively to address the large volume of non-performing loans in Europe.

To reduce the amount of non-performing loans on banks' balance sheets after the financial crisis, the authorities in Europe introduced several measures (NPL action plan)[122]. For instance, they have introduced stricter transparency requirements with regard to non-performing loans and produced a model (blueprint) for setting up a company to manage non-performing loans, a so-called asset management company (AMC).[123] Last year, the EU also introduced new, more generous capital requirement rules for securitisation of non-performing loans.[124] For example, Italy has in recent years been working on reducing the percentage of non-performing loans by using an AMC and improving its administrative processes for managing non-performing loans.

[121] When referring to non-performing loans, it is also relevant to consider the level of provisions made by banks for non-performing loans. The coverage ratio refers to how much funding a bank has set aside in relation to the nominal value of the non-performing loans. There are substantial differences among the EU countries. The average coverage ratio for the EU has been stable in recent years, and was 44.9 per cent at the end of 2020. See *Risk Dashboard*, Q4 2020, European Banking Authority.

[122] The European Commission introduced a preliminary NPL action plan in 2017, with the purpose of managing the large volume of non-performing loans in the European banking sector.

[123] See *Commission staff working document AMC*, swd/2018/072, 2018, European Commission.

[124] See "Coronavirus response: How the Capital Markets Union can support Europe's recovery", 24 July 2020, European Commission.

The risk of a new wave of non-performing loans has led to the EU producing a new action plan for managing such a potential wave now.[125] It involves, for instance, developing secondary markets for non-performing loans in the EU, supporting the development of national AMCs and improving the regulatory framework for managing insolvency. Institutions within the EU, such as the European Banking Authority (EBA) and the ESRB, are working on solutions to the problems regarding non-performing loans and the effects of support measures on financial stability.[126]

Unexpectedly few bankruptcies during the pandemic

The number of bankruptcies largely follows the development of the economy; when economic activity declines, the number of bankruptcies increases. However, developments have not followed this pattern during the pandemic (see Chart 49). Instead, the number of bankruptcies in developed countries has declined in relation to earlier comparable periods. The picture in the euro area is similar (see Chart 50).

There may be several explanations for this. For instance, the administration around bankruptcies and the management of insolvent companies has come to a halt in several countries because of the pandemic.[127] This has led to a delay in the reporting of the number of companies that have become insolvent, which probably indicates that the number of bankruptcies will increase in the future.[128] Another explanation is the support measures the authorities have introduced during the pandemic, which have helped many companies to survive.

[125] The European Commission launched a second NPL action plan in 2020 to manage non-performing loans in the wake of the pandemic. See “Action plan: Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic”, 16 December 2020, European Commission.

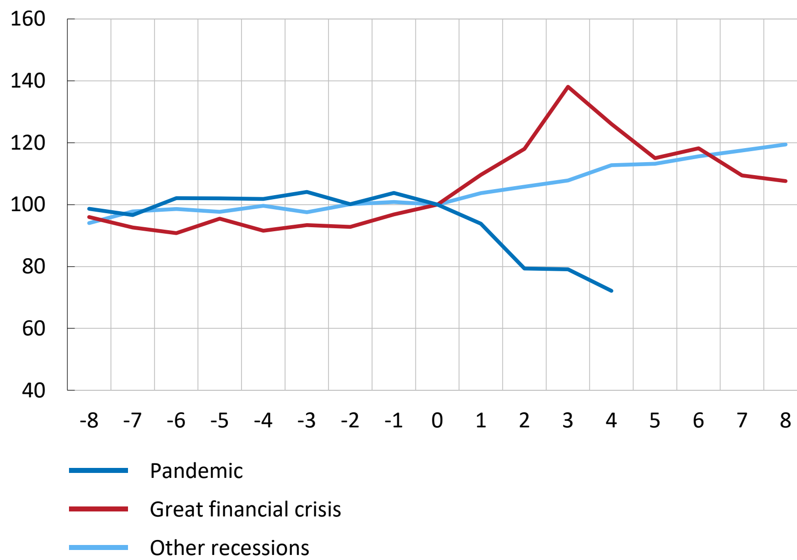
[126] See “Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic”, February 2021, European Systemic Risk Board.

[127] See B. Becker and M. Oehmke (2021), “Preparing for the post-pandemic rise in corporate insolvencies”, *ASC Insight* no. 2, European Systemic Risk Board.

[128] Allianz research (2020) is assuming that the number of insolvent companies will increase by 35% (globally) during 2021.

Chart 49. Development of bankruptcies in earlier recessions

Index

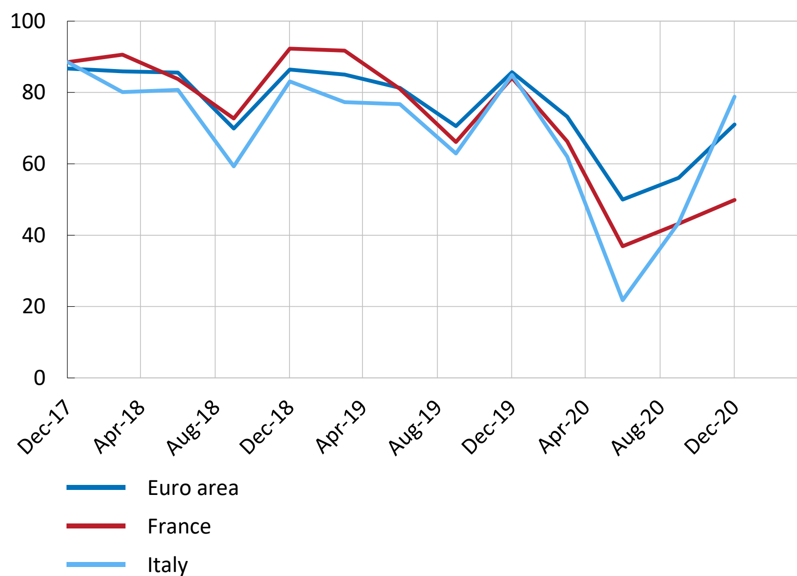


Note: Recession quarter. Index, the most recent quarter prior to recession = 100. This development refers to data from 13 countries during the period of 1990 Q1 to 2020 Q3. The lines refer to the average number of bankruptcies for the respective category per quarter. 'Other recessions' refers to periods of negative growth two quarters in a row during the periods of 1990-2006 and 2009-2019.

Source: International Monetary Fund.

Chart 50. Development of bankruptcies in the euro area 2017-2020

Index, 2015 = 100



Source: Eurostat.

Support measures have been introduced to maintain credit supply

To dampen the economic effects and support credit supply during the pandemic, extensive fiscal policy stimulation programmes have been combined with measures by central banks and other authorities. Many EU countries have introduced temporary programmes, where the state guarantees loans to companies.[129] However, the design of the programmes differs between countries. For instance, some countries guarantee the entire loan, while others only guarantee a part of it. Within the EU, loans guaranteed by a state receive a lower risk weight than otherwise, which helps to reduce banks' capital requirements. Several European countries that have had a positive countercyclical capital buffer have lowered it, and many have recommended that banks be restrictive regarding dividends.[130]

Authorities have also introduced temporary relaxation of the regulations on reporting loan losses pursuant to IFRS 9.[131] For example, they have introduced a two-year extension of the phase-in arrangements for IFRS 9 into the capital requirement regulations.[132] In addition, the EBA has issued guidelines on moratoriums, according to which loan payments that are subject to deferral due to the pandemic should not automatically be classified as non-performing loans. This measure implies that banks do not need to reserve capital just because, for example, a company does not make the payments on its loan. However, banks must continue to monitor borrowers who may experience long-term financial difficulties and classify these exposures according to the current regulations. The measures cover moratoriums that were granted up to the end of March 2021.[133]

The share of loans with moratoriums in the EU amounted to around 6 per cent of all loans in the second quarter of 2020.[134] The total volume of loans with moratoriums to the corporate sector was EUR 495 billion in the second quarter of last year.[135] Loans

[129] The Swedish loan guarantee programme applies to loans granted up to 30 June 2021. It is aimed at small and medium-sized enterprises and means that the state bears 70 per cent of the risk. The guarantee framework was reduced at the start of the year from SEK 100 billion to SEK 50 billion. The loans are issued via the banks' ordinary credit process.

[130] The ESRB has issued recommendations that banks shall be restrictive with dividend payments up to the end of September 2021.

[131] With effect from January 2018, banks must apply IFRS 9, see N. Frykström and J. Li (2018), IFRS 9 – New reporting standard for financial instruments, *Economic Commentaries* no. 3, Sveriges Riksbank.

[132] Under these arrangements, the application of which is voluntary, the effect of IFRS 9 on CET 1 capital will be phased in over several years. The reported capital adequacy will thus be higher during the phasing-in period than would otherwise have been the case.

[133] Moratoriums granted prior to March 2021 apply until the respite comes to an end. The respite runs at different time intervals, but the number of loans with moratoriums will decline over time, as no new loans with moratoriums can be granted after March 2021. In Sweden, FI has decided that the respite will end on 31 August 2021. At the end of the first quarter of 2021, around 230,000 households in Sweden were granted an exemption from the amortisation requirement

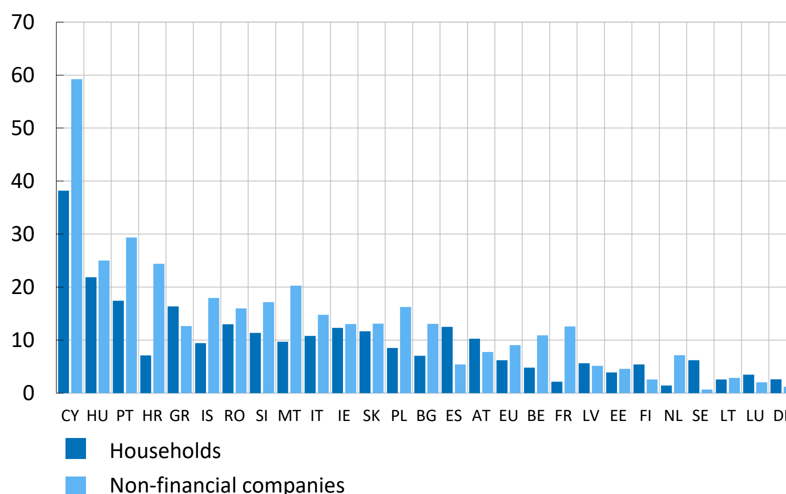
[134] See "Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic", February 2021, European Systemic Risk Board.

[135] Small and medium-sized enterprises (SMEs) accounted for a significant percentage of this support, namely EUR 387 billion. Around 16 per cent of all SME loans were reported to be with moratoriums.

with moratoriums to households amounted to EUR 365 billion.[136] The way that moratoriums are used differs substantially between countries and banks (see Chart 51).[137] In Cyprus, for instance, around 60 per cent of all loans to companies had moratoriums. Some banks report that more than 40 per cent of all loans to households and companies had a grace period on payment.[138] In countries where the share of non-performing loans was high even before the pandemic, many borrowers have requested moratoriums.

Chart 51. Share of loans with moratoriums per household and company

Per cent



Note: Refers to the share of loans with moratoriums at the end of June 2020.

Source: European Banking Authority (EBA).

At the end of 2020, the total volume of loans with moratoriums in the EU had declined to EUR 318 billion. In Sweden, the use of moratoriums and loan guarantees[139] has been relatively low. The major Swedish banks had around SEK 250 billion under moratoriums during the fourth quarter. The largest share refers to exemption from amortisation requirements with regard to mortgages, and only a very small share refers to companies.

Support measures can lead to non-performing loans being postponed

The support measures introduced to maintain credit supply and alleviate the economic effects of the pandemic may also increase the vulnerabilities in the financial

[136] See *Risk Dashboard*, Q3 2020, European Banking Authority.

[137] The percentage of loans that are under renegotiation, that is, where the loan is modified (forbearance), has also increased. These loans are not with moratoriums. This indicates that banks change the loan terms and conditions to make it easier for borrowers who do not have moratoriums. See *Financial Stability Review*, November 2020, European Central Bank.

[138] See *First evidence on the use of moratoria and public guarantees in the EU banking sector*, November 2020, European Banking Authority.

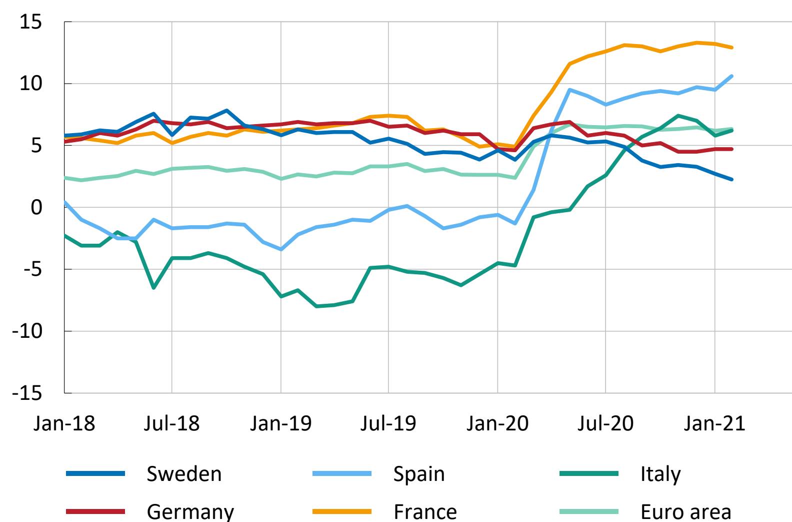
[139] See Företagsakuten, Swedish National Debt Office.

system. For instance, they may lead to an increase in sovereign debt, and many companies have increased their indebtedness to remain liquid during the pandemic. The liabilities make everyone more sensitive to changes in economic conditions.

Companies in countries such as France, Italy and Spain have taken large loans during the pandemic (see Chart 52). This is probably due to the business sectors in these countries being relatively concentrated to the sectors that have been hit hardest - during the second quarter of 2020 these sectors had a lending growth of around 70 per cent on average in the EU. These loans have helped companies with liquidity problems and probably also helped to limit the number of bankruptcies.

Chart 52. Lending to companies in Europe

Per cent



Note: Refers to lending from Monetary Financial Institutions (MFIs) to companies.

Source: Statistics Sweden.

However, there is a risk that banks, during the pandemic, have eased their credit processes and granted loans that they would not normally approve, not least because the use of state loan guarantees has been relatively widespread in some countries.[140] This type of problem is made more difficult by the fact that the recovery in corporate sectors that have been hit hardest may take a long time and it is difficult to assess individual companies' future survival capacity.

Some individual measures, in particular moratoriums, may also contribute to difficulties in assessing the borrower's debt-servicing ability. As mentioned above, during the pandemic, banks do not automatically need to classify loans with moratoriums as non-performing loans, as the hope is that the pandemic is a temporary strain on companies. However, some of the companies with moratoriums will not be viable in the long run, and when the support is withdrawn they may default. This indicates that the banks' reporting of non-performing loans does not paint a very accurate picture of the actual credit risk in the banks' loan portfolios at present. One specific challenge during

[140] See *Risk Assessment Questionnaire – Summary of Results,* autumn 2020, European Banking Authority.

the pandemic is therefore to ensure that the banks' financial reports are sufficiently transparent regarding credit risk in the loan portfolios.

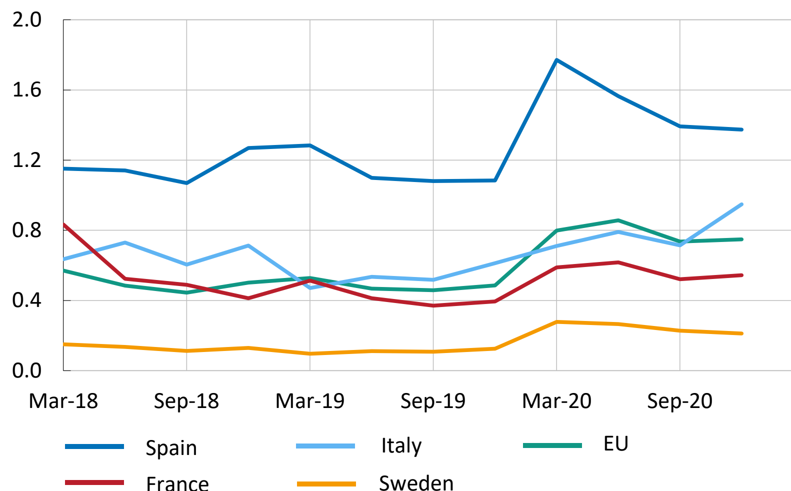
Reduced clarity in the banks' reporting of credit risks during the pandemic

According to the internationally agreed accounting regulations IFRS 9, banks should estimate their expected loan losses based on the forecasts of future macroeconomic conditions.[141] If the risks increase, the bank should reclassify its loans to a higher risk class. This should be the effect if macroeconomic prospects deteriorate. As a result of the considerable uncertainty, however, some relaxation in IFRS 9 was introduced at the beginning of the pandemic – for instance, banks can rely more on historical data in their assessment of future loan losses.

In Europe, there was an increase in provisions for expected loan losses at the beginning of the pandemic (see Chart 53). After that, the provisions in several countries declined and were only slightly higher in the fourth quarter of 2020 than they were prior to the pandemic. Banks in the euro area have also made much fewer provisions for expected loan losses than the ECB's forecast.[142] The ECB therefore believes that some banks' provisions for expected loan losses may be inadequate.

Chart 53. Loan loss provisions in relation to loans

Per cent



Note: Loan loss provisions in relation to loans (cost of risk).

Source: European Banking Authority (EBA).

[141] IFRS 9 allows banks to calculate their loan losses according to their own loan loss model. This means that banks will report loan losses differently if they make their own macroeconomic assumptions.

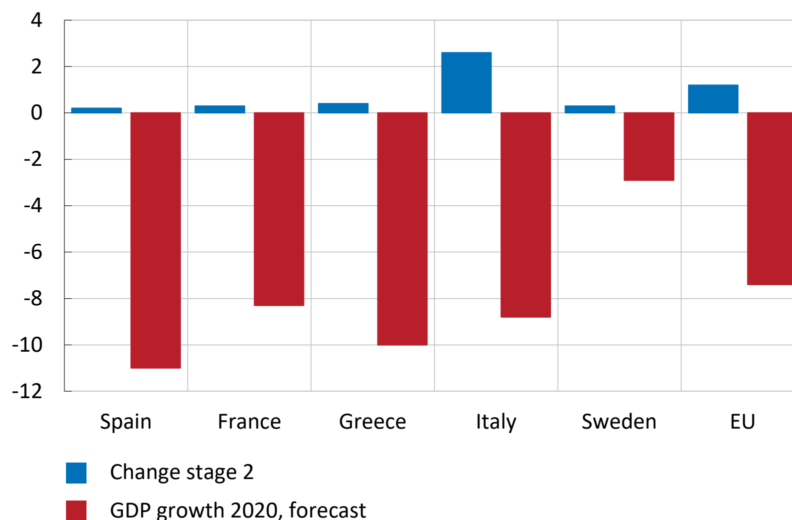
[142] See *Financial Stability Review*, November 2020, European Central Bank.

Nor is there any clear correlation that points to loans to a greater extent being reclassified to a higher risk class[143] (according to IFRS 9 from stage 1 to stage 2 or stage 3) in countries where the economic downturn has been severe.[144] Instead, several banks in countries that have been hit harder have reclassified their loans to a lesser degree than others. The link between loan loss reporting and the macroeconomic outlook is therefore less clear.

Overall, in the EU, the percentage of loans classified in the higher risk class (stage 2) declined between the second quarter (8.2 per cent) and third quarter of 2020 (8 per cent).[145] However, there are large differences between countries and banks, which may be due to structural factors and to different assessments of the future recovery. For instance, in Spain, France and Greece, loans in the higher risk class have increased marginally from prior to the pandemic to the third quarter of 2020, while GDP falls have been substantial (see Chart 54). The change in the highest risk class (stage 3) has been scarcely tangible during the same period.

Chart 54. Change in IFRS 9 stage 2 compared with GDP growth

Per cent



Note: Change in IFRS stage 2 refers to the change from 2019 Q4 to 2020 Q3. GDP growth refers to forecast for 2020. The risk class in IFRS stage 2 is for loans with increased credit risk.

Sources: Eurostat and European Banking Authority (EBA).

All in all, there is a risk that the financial reporting will not reflect the real credit risks in all banks. The loan losses may thus be larger, and it is possible that they will increase going forward.

[143] According to IFRS 9, loans are classified in three risk classes. Stage 1 is for loans that have not shown any signs of increased credit risk, stage 2 is for loans with increased credit risk, and stage 3 is the highest risk class for loans that have had a default event.

[144] See *Financial stability implications of support measures to protect the real economy from the COVID-19 pandemic*, February 2021, European Systemic Risk Board.

[145] See *Risk Dashboard*, Q3 2020, European Banking Authority.

Non-performing loans must be managed quickly

A high percentage of non-performing loans limits the banks' capacity to grant new loans and has a negative impact on economic development. As noted initially, the share of non-performing loans in the euro area increased after the financial crisis to very high levels and in many cases non-performing loans remained in the banks for several years before they were managed. If non-performing loans increase in the euro area, this could entail stability risks that can spread to Sweden through the Swedish banks' extensive cross-border operations.

The EU work on improving transparency regarding non-performing loans and their management is therefore important. As an example, the reporting of non-performing loans has some time lag. It is therefore important to implement measures that enable earlier detection of non-performing loans. At the same time, banks should have sound lending with thorough credit assessments and efficient loan monitoring with improved management of borrowers with payment difficulties. A transparent secondary market is also an important condition for better valuation of non-performing loans. This enables banks to sell portfolios with non-performing loans to a greater degree. In the long run, this can strengthen the European banks' financial situation and reduce potential future loan losses. Countries can also prepare and analyse how a potential national AMC could contribute to more efficient valuation and help banks to reduce the level of non-performing loans in their balance sheets. It is therefore necessary to take measures as soon as possible, both at EU level and nationally, to effectively manage the risks of non-performing loans.