Tackling Non-Performing Loans Seriously:
The Case for an EU Bad Bank

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Abstract: In the aftermath of the Covid-19 pandemic, European banks will face a likely increase in non-performing loans. Due to the high costs involved, the management of private non-performing loans is complicated, if not completely impractical. Therefore, public intervention is necessary to avoid further damage to the real economy and instability in the financial system. Nonetheless, national solutions are hampered by the EU regime related to banks' crisis management. Several proposals aim at rethinking this regime by introducing greater flexibility. These, however, involve numerous political obstacles. A "way out" to overcome this political impasse could be the establishment of an EU bad bank.

Keywords: Non-Performing-Loans, BRRD, Bail-in, State Aid, Burden Sharing, AMC, Bad Bank

JEL Classification: K2, K22, K23

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1. The expected dangerous increase in non-performing loans on European bank balance sheets

The measures taken to address the Covid-19 pandemic (including so-called lockdowns) have had the undesirable effect of creating significant economic turmoil. As a result and notwithstanding the strong recovery that took place during 2021, the number of non-performing loans (NPLs) on European bank balance sheets is bound to increase. This, together with the rigid application of prudential measures[1], may generate instability in the banking system.

At the EU level, despite comforting data coming from 2020[2], it is considered «vital to closely monitor the situation and possible risks to financial stability as well as ensure that banks can continue to play a constructive role in the recovery following the economic downturn. Further structural measures could be needed to prevent the accumulation of NPLs on banks' balance sheets over the medium term» in order to «increase the financial system's preparedness, thereby supporting financial stability and the economic recovery»[3]. Furthermore, it has recently been noted that «we do expect a rise in non-performing exposures, particularly once public support measures, such as payment moratoria, expire»[4].

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[1] Numerous interventions were taken to manage the crisis. For a detailed analysis, C. BRESCIA MORRA, *Banking supervision in times of uncertainty: the case of NPLs*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 197-218; on this point, see also R. HASELMANN - T. TRÖGER, *When and how to unwind COVID-support measures to the banking system?*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 25-60 e B. JOOSEN, *Releasability Combined Buffer Requirements after the COVID-19 pandemic*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 359-392.

[2] «The (gross) NPL ratio for the euro area as a whole, slightly over 3 percent at the end of 2019, continued to decline, reaching 2.8 percent in September 2020»: I. ANGELONI, *Non-Performing Loans: An Old Problem in a New Situation*, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2021), pp. 107-118, spec. p. 108. However, this trend may change. Indeed, it has been said that «recent surveys by the ECB suggest that this benign phase may be ending and the post-Covid "wave" of NPLs may now start» (*ivi*).

[3] EUROPEAN COMMISSION, *Tackling non-performing loans in the aftermath of the COVID-19 pandemic*, Comunication, Brussels, 16.12.2020 COM(2020) 822 final, spec. p. 2 (hereinafter "EC NPL").

[4] A. ENRIA, *Introductory statement*, Hearing at the European Parliament's Economic and Monetary Affairs Committee, via video conference, 27 October 2020; see also A. ENRIA, *Introductory statement*, Hearing at the European Parliament's Economic and Monetary Affairs Committee, Frankfurt am Main, 14 October 2021: «banks expect their ratio of non-performing loans (NPLs) to total loans to continue decreasing [in 2021] and in 2022. While NPL numbers still appear favourable, asset quality seems to be deteriorating … All in all, banks' NPL projections may be overly optimistic and banks should remain cautious with releasing provisions and ensure that they have adequate credit risk controls in place».

Similar considerations also apply to the individual Member States. For example, in Italy, the increase in NPLs is considered to be the most important risk facing Italian banks today[5].

2. The management of NPLs and the need for public intervention

Normally, banks bear the risk associated with the management of NPLs. Banking is by nature a risky business activity, and when banks bear this risk moral hazard is avoided[6] unless the risk involves negative externalities, such as systemic crises or credit crunches[7].

In this latter case, if there is a liquid secondary market, direct sales of NPLs can be the quickest option for banks needing to deal with them[8]. However, secondary markets for NPLs have not been very active in Europe[9] and therefore this may not be a viable option. The sale of NPLs in the secondary market provides immediate income, but it is often lower than that

[5] See I. VISCO, *Le norme europee sul* calendar provisioning *e sulla classificazione della clientela da parte delle banche*, Audizione del Governatore della Banca d'Italia, Commissione Parlamentare di inchiesta sul sistema bancario e finanziario, Roma, 10 febbraio 2021, spec. p. 3. More specifically, in Italy the moratoria on outstanding loans, the freezing of layoffs, and guaranteed loans have avoided a possible credit crunch and delayed the emergence of NPLs, the number of which should grow with the cessation of these initiatives. In 2022, with the end of the moratoria, the default rate, i.e. the ratio between new bad loans and the stock of loans entered into, may reach 3%, up from 1.4% in 2021 but still far from the 4.5% of 2013. In 2022, the stock of UtP is expected to exceed that of NPLs: cf. BANCA IFIS, *Npl meeting*, Comunicato Stampa, 24 settembre 2021. Similarly, from an international perspective, it has been recognized that «once moratoria and other support measures will be unwound, the real economy and banks may be heavily affected and NPL levels will eventually rise», J. KASINGER - J. P. KRAHNEN ET AL, *Non-performing Loans - New risks and policies? NPL resolution after COVID-19: Main differences to previous crises*, SAFE White Paper, No. 84, 2021, pp. 1-42, spec. p. 11.

[6] On this point, cf. C. GALAND - W. DUTILLIEUX - E. VALLYON, *Non-Performing Loans and State Aid Rules*, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2017), pp. 137-160, spec. p. 137 f. and M. MAGGIOLINO - R. MORGAN - M. L. PASSADOR, *The State-of-the-Art of NPLs in the Post COVID World: An Ongoing Concern for the Future*, in 10 *Law and Economics Yearly Review* (2021), pp. 108-141, available at SSRN: *https://ssrn.com/abstract=3931491*, spec. p. 110.

[7] «It is the normal duty of banks to assess the risk of the assets they acquire and to make sure they can cover any associated losses. Asset relief may, however, be considered to support financial stability»: EUROPEAN COMMISSION, *Communication from the Commission on the treatment of impaired assets in the Community banking sector*, 2009/C 72/01 (hereinafter "Impaired Assets Communication 2009"), spec. par. 15, p. 4.

[8] J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 21.

[9] J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 21; cf. also M. MAGGIOLINO - R. MORGAN - M. L. PASSADOR (fn. 6), p. 124. Indeed, the European legislator intends to develop secondary NPL markets: cf., on this point, EC NPL, p. 6 ff.

which can be obtained through debt collection[10], since in the case of illiquid markets the buyer can exploit the needs of the seller. Thus, in this situation NPLs are sold at disadvantageous prices for the benefit of private buyers who are able to exploit the emergency in the banking sector.

Alternatively, NPLs can be managed internally. However, if the value of NPLs exceeds banks' liquidity and capital buffers, this option may be infeasible; furthermore, effective internal management of NPLs requires efficient systems of justice and well-designed insolvency resolution frameworks, both of which are at present gaps that need to be filled[11]. Hence, the banks that bear this risk would be discouraged from lending, and the losses they would be forced to bear may generate risks of instability in the financial system[12].

Thus, because traditional tools are not completely effective in solving the current NPL problem, the risk of NPL management should be borne by a public entity that assumes the risk of negative externalities. It should also be noted that (1) in the current situation, the increase in the number of NPLs is not generally attributable to incompetent management of banks, but rather to the consequences of Covid[13]; and (2) public intervention is aimed at addressing a market failure[14] (*i.e.*, the depreciation of the value of NPLs due to a market that is not yet efficient).

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[10] See M. LONGO, *Npl, tremano le garanzie statali. Verso il cambio dei recuperatori*, in *Il Sole 24 Ore*, October 14, 2021.

[11] J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 20.

[12] On this point, see M. MAGGIOLINO - R. MORGAN - M. L. PASSADOR (fn. 6), p. 111.

[13] The observation may be found in M. LEHMANN, *Mothballing the economy and the effects on banks*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 453-474, spec. p. 466; see also, A. ENRIA, *Flexibility in supervision: how ECB Banking Supervision is contributing to fighting the economic fallout from the coronavirus*, ECB Supervision Blog, March 27, 2020: «unlike in the 2008 financial crisis, banks are not the source of the problem this time. But we need to ensure that they can be part of the solution»; moreover, «NPLs derived from Covid cannot be regarded as a "legacy" of past errors by bankers or attributed to national supervisors, as had been the case in the past. These NPLs are the result of a common shock which hit all countries and was outside of their control»: I. ANGELONI (fn. 2), p. 117; see also A. LEHMANN - R. MARTIN, *Economic recovery after COVID-19 requires a clear vision for a healthy banking sector*, in *Bruegel Blog*, December 16, 2020, stating that «current problems are rooted in a real sector crisis, rather than bank risk management failures».

[14] «In our view, market failures provide sufficient arguments for extending the access to State backed AMCs also to healthy banks, particularly until strictly market based instruments like trading platforms achieve sufficient scale and transparency»: G. BARBA NAVARETTI - G. CALZOLARI - A. F. POZZOLO, *Getting Rid of NPLs in Europe*, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2017), pp. 11-30, spec. p. 13, which goes on to summarize the market failure as follows: «because of asymmetric information, uneven bargaining power between buyers and sellers, and the rapid disposal of legacy assets frequently required by regulators, there is a large gap between bid and ask prices for NPLs and also between the resulting market price and the real value of the assets» (p. 15); also on this point, see A. ENRIA - P. HABEN - M. QUAGLIARIELLO, *Completing the Repair of the EU Banking Sector- A*

In this perspective, numerous proposals have been made[15], including—in addition to the securitization mechanism[16] and the possibility of providing public guarantees[17]—the establishment of an asset management company (AMC). Well-designed and professionally managed AMCs can help speed up the credit recovery process while preventing unnecessary losses; they have the potential to overcome the temporary problem of selling off in depressed markets; and finally, they may prevent premature insolvencies and provide the ability to restructure the pool within a single institution[18]. Despite

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Critical Review of an EU Asset Management Company, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2017), pp. 59-70, spec. p. 62.

[15] Among others, J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 20 f.

[16] «Our findings demonstrate that securitization is the deleveraging strategy that permits the issue of securities showing the most attractive risk-return profile … Moving to the banks' perspective, our findings reveal the opportunity to proceed with bad loan disposal through securitization, which significantly reduces the cost of deleveraging»: E. BOLOGNESI - P. STUCCHI - S. MIANI, *Are NPL-backed securities an investment opportunity?*, in 77 *The Quarterly Review of Economics and Finance* (2020), pp. 327-339, spec. p. 328.

[17] For example, in Italy the Garanzia sulla Cartolarizzazione delle Sofferenze (GACS) was used (see legislative decree no.18 of February 14, 2016 and, for the latest renewal granted by the European Commission, EUROPEAN COMMISSION, *State aid: Commission approves prolongation of market conform Italian guarantee scheme for non-performing loans*, Daily News, 14 June 2021). While the GACS has had some positive effects [it has been noted that the Italian and Greek regimes «have been successful and … new transactions are being planned»: EC NPL, p. 11; and «In 2019, about 90 per cent of the value of the bad loans sold through securitisations was backed by GACS»: I. VISCO (fn. 5), p. 26], the GACS are not able to definitively solve the problem: some recent studies show that «of the 26 transactions surveyed by Scope Ratings, as many as 17 perform worse than expected in the original Business Plans. Some are even more than 50% below» [M. LONGO (fn. 10)]; if, therefore, «the GACS have certainly saved the bank balance sheets and with them the country» [M. LONGO (fn. 10)], (through the guarantee mechanism the GACS intend to reduce the bid-ask price spread, *i.e.*, the difference between the price requested by the originators—the banks—and the price that investors are willing to pay, favouring transactions in the NPL market, but in practice, the GACS would have contributed to the increase to 36% from 27% of the 2019 average price of transactions on secured NPLs and 30% from 24% of the 2019 average price of mixed secured and unsecured portfolios: BANCA IFIS, *Market Watch*, January 2021, spec. p. 15), it is not possible to have the same certainty with respect to the following, i.e., the current, wave of NPLs: in light of recent experience the market may be "less accommodating" concerning the valuation of new NPL securitisations.

[18] On this point, see A. LEHMANN - R. MARTIN (fn. 13); for an analysis of the strengths, weaknesses, opportunities and dangers presented by AMCs, cf. E. AVGOULEAS - R. AYADI - M. BODELLINI - G. FERRI - B. CASU - W. P. DE GROEN, *Non-performing loans: new risks and policies*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 153-196, spec. p. 157 ff.; see also T. BECK, *Banking and COVID-19 Through the Crisis and Beyond*, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2021), pp. 75-88, spec. p. 79 f. and J. FELL - M. GRODZICKI - R. MARTIN - E. O'BRIEN, *A Role for Systemic Asset Management Companies in Solving Europe's Non-Performing Loan Problems*, in 1 *European Economy. Banks, Regulation, and the Real Sector* (2017), pp. 71-86, spec. p. 73; E. AVGOULEAS - C. GOODHART, *Utilizing AMCs to Tackle the Eurozone's Legacy Non-Performing Loans*, in 1 *European Economy. Banks, Regulation, and*

the fact that the four AMCs in operation in the eurozone «have had a good track record of loan restructuring and value recovery»[19], for AMCs to be more effective, public aid would be appropriate to avoid excessive losses that would discourage participation by the banks[20].

3. A national AMC and compliance with the EU regime applicable to banks' crisis management

Imposing NPL risk on a national AMC to assist banks involves an assessment of whether it complies with the European regime relating to the management of banking crises and state aid.

From this perspective, an «impaired asset aid granted in the context of a transfer of NPLs from a bank to a publicly-supported AMC constitutes extraordinary public financial support»[21]. In turn, a bank receiving «extraordinary public financial support» shall be deemed to be «failing or likely to fail» [FOLF: art. 32, para. 1, let. a, and para. 4, let. d, Directive 2014/59/EU, Bank Recovery and Resolution Directive (BRRD); a similar discipline is provided by the Regulation (EU) No 806/2014, Single Resolution Mechanism Regulation (SRMR) within the Banking Union. Throughout this paper, references to the BRRD include those to the SRMR].

The FOLF determination involves either the beginning of a resolution procedure if «a resolution action is necessary in the public interest» (art. 32, para. 1, let. c, and para. 5, BRRD) or the beginning of insolvency proceedings «in an orderly manner in accordance with the applicable national law» if «a resolution action would not be in the public interest» (art. 32b BRRD).

Nevertheless, if it is necessary «to remedy a serious disturbance in the economy of a Member State and preserve financial stability», the bank will not be deemed to be FOLF. It may, instead, receive a precautionary recapitalization (art. 32, para. 4, let. d, co. 1, no. iii, BRRD)[22]. In this case,

the Real Sector (2017), pp. 97-112, spec. p. 100 ff.; for a comparative analysis, Impaired Assets Communication 2009, spec. Annex II, p. 13 ff.

[19] A. LEHMANN - R. MARTIN (fn. 13).

[20] Indeed, «the current accounting regime allows banks to assign book values for NPLs that generally exceed NPL market values. NPL sales then lead to accounting losses and reduce the equity capital of banks, thus deteriorating capital adequacy figures and possibly leading to a reduction of lending capacity»: J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 24; public intervention, on the other hand, may help because «the State has a longer investment horizon rather than the objective of maximising short-term profits will help to overcome the problem of the depressed market value of NPLs during recessions, attracting more banks into the market and increasing its depth», C. BRESCIA MORRA (fn. 1), p. 209.

[21] Cf. EUROPEAN COMMISSION, *AMC Blueprint*, Accompanying the document "Second Progress Report on the Reduction of Non-Performing Loans in Europe", Brussels, 14.3.2018 SWD(2018) 72 final, spec. p. 6 and 28 (hereinafter "EC AMC Blueprint").

[22] On this point, cf. EC NPL, p. 16; for the statement that «in an extreme scenario of systemic risk (i.e. financial externalities), a market-driven, BRRD-tailored re-structuring processes is

however, the chosen measures «shall be conditional on final approval under the Union State aid framework» (art. 32, para. 4, let. d, co. 2, BRRD)[23]. Therefore, it is necessary to comply with the conditions set by the European Commission, among which is the bearing of losses by private individuals (so-called burden-sharing)[24]. Furthermore, despite the fact that it is normally used to provide an additional capital buffer, precautionary recapitalization can also be used in the case of a transfer of NPLs to a national AMC, provided that the additional conditions governing measures related to impaired assets are met[25]. Thus, «if the AMC buys assets at a price exceeding the estimated market value (EMV), the transaction involves State aid, in the amount of the difference between the actual transfer price (TP) and the EMV. The transaction has then to be approved by Commission before it can be implemented»[26], and «a first condition for authorising such aid is that the assets' TP cannot exceed their real economic value (REV). Losses resulting from the write-down of NPLs from their net book value to the transfer price cannot be covered by the impaired asset aid»[27]. More specifically, State aid may be equal to the difference between the current market price and the real economic value of the NPL[28]; in addition, if the net book value of the NPL is higher than the transfer price of the NPL, the bank's loss should be borne by private individuals[29].

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probably not feasible and direct government intervention to stabilise the banking system, for instance through an Asset Protection Schemes (APS) or an Asset Management Company (AMC), can be justified», J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 10.

[23] On this point, cf. EC NPL, p. 17 and A. LEHMANN - R. MARTIN (fn. 13).

[24] Indeed, «to limit distortions of competition between banks and across Member States in the single market and address moral hazard, aid should be limited to the minimum necessary and an appropriate own contribution to restructuring costs should be provided by the aid beneficiary»: EUROPEAN COMMISSION, *Communication from the Commission 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/C 216/01 (hereinafter "Banking Communication 2013"), spec. para. 15, p. 3; but see also EUROPEAN COMMISSION, *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/C 195/04 (so-called Restructuring Communication 2009), spec. para. 22, p. 13.

[25] EC AMC Blueprint, p. 34; cf. also EC NPL, p. 16 and, for the extension of the same rules to public guarantees of a portfolio of assets recorded in the balance sheet of a bank, EC NPL, p. 17.

[26] EC AMC Blueprint, p. 7 and 29; cf. also Impaired Assets Communication 2009, spec. para. 39, p. 8.

[27] EC AMC Blueprint, p. 7 and 29; cf. also Impaired Assets Communication 2009, spec. para. 40 ff., p. 8 f., and Annex IV, p. 20 f. and EC NPL, p. 17.

[28] A. ENRIA - P. HABEN - M. QUAGLIARIELLO (fn. 14), p. 64.

[29] «The transfer of assets to the AMC would hit in the first place the existing shareholders to the extent that the net book value of NPLs is above the transfer price to the AMC. 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»: A. ENRIA - P. HABEN - M. QUAGLIARIELLO (fn. 14), p. 64; in the perspective of a national AMC, J. FELL - M. GRODZICKI

Such a scenario would probably represent a difficult obstacle to overcome. If public intervention were to be limited and, at the same time, burden-sharing was imposed, many banks would be reluctant to participate in the scheme and the project would remain in vain: along these lines, it has been observed that burden-sharing is a «condition which evidently completely discourages the use of this tool», such that «the project, which has been under discussion for some time, does not seem destined to produce significant benefits»[30]. Furthermore, it should be added that (1) public intervention through precautionary recapitalization would be limited only to solvent banks of "public interest" that have shortcomings highlighted by stress tests (and therefore healthy banks could not receive the aid, which considerably limits the proposed solution[31]), and (2) banks that are not "in the public interest" cannot receive the precautionary recapitalization, and will therefore be wound up under the applicable national law (art. 32b BRRD)[32].

4. Political obstacles to greater flexibility and possible palliation provided by the Temporary Framework for State aid measures

Since the solution identified to cope with the increase in NPLs is apparently prevented by the rigid application of the regime relating to banking crises, there are numerous suggestions to change the rules to introduce greater flexibility[33]. Such attempts, however, face substantial political obstacles: the cases in which a revision of this magnitude is undertaken are few and far between.

- R. MARTIN - E. O'BRIEN (fn. 18), p. 75; in the sense of the need for burden-sharing, see also E. AVGOULEAS - C. GOODHART (fn. 18), p. 99.

[30] I. VISCO (fn. 5), p. 8; similarly, for the statement that «the requirement to write down junior debt holders or forcibly convert debt to equity creates political obstacles to use new AMCs in the EU», A. LEHMANN - R. MARTIN (fn. 13); see also E. AVGOULEAS - R. AYADI - M. BODELLINI - G. FERRI - B. CASU - W. P. DE GROEN (fn. 18), p. 166 ff.

[31] «Banks that result having no capital shortages under a stress test, and which are not eligible for precautionary recapitalization (because they are healthy enough, not because they are moribund), cannot sell their impaired assets to State supported AMCs. Given that a large share of the NPLs is held by these banks, the scope of AMCs will be pretty limited»: G. BARBA NAVARETTI - G. CALZOLARI - A. F. POZZOLO (fn. 14), p. 19.

[32] EC AMC Blueprint, p. 6.

[33] C. BRESCIA MORRA (fn. 1), p. 213 ff.; similarly, stating that «legal rules have to be interpreted generously in the light of an economic emergency», W.-G. RINGE, *Lessons from the pandemic for European finance: A twin transformation towards green technology*, in C. V. GORTSOS - W.-G. RINGE (Eds.), *Financial Stability amidst the Pandemic Crisis: On Top of the Wave*, 2021, pp. 61-86, spec. p. 65.

Nonetheless, albeit temporarily[34], the European Commission has specified that, first, aid granted by the Member States to banks under art. 107(2)(b) TFEU (= «aid to make good the damage caused by natural disasters or exceptional occurrences») «to compensate for direct damage suffered as a result of the COVID-19 outbreak does not have the objective to preserve or restore the viability, liquidity or solvency of an institution or entity. As a result, such aid would not be qualified as extraordinary public financial support» under the BRRD, so the bank receiving the aid need not be deemed to be FOLF (art. 32, para. 1, let. a, and para. 4, let. d, BRRD)[35] and a resolution or liquidation of the entity need not have been initiated; second, «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[36], which sets out an exception to the requirement of burden-sharing by shareholders and subordinated creditors»[37].

Therefore, despite the fact that there is room for public intervention, such a regime is subject to stringent conditions[38] that are not always reconcilable with the needs of banks. Furthermore, it is temporary and therefore cannot offer a structural answer to the problem. Even in the event of renewal of the suspension (*i.e.*, at the end of the transitional period, they decide to renew the "Temporary Framework" for a further period of time)[39], in fact, the use of the state aid regime as a trigger—which does/does not allow public intervention from time to time— entails political risks that have repercussions in the internal market: the long period of time needed for the decision and/or the impossibility of proceeding after the veto of some Member States would generate uncertainty in the market which would penalize the possible aid beneficiary.

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[34] EUROPEAN COMMISSION, *Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak*, Communication, 2020/C 91 I/01 (hereinafter "EC Temporary Framework").

[35] EC Temporary Framework, para. 6 f., p. 2.

[36] «An exception to the [burden-sharing requirement] can be made where implementing such measures would endanger financial stability or lead to disproportionate results. This exception could cover cases where the aid amount to be received is small in comparison to the bank's risk weighted assets and the capital shortfall has been reduced significantly…»: Banking Communication 2013, para. 45, p. 8.

[37] EC Temporary Framework, para. 7, p. 2.

[38] Cf. EC Temporary Framework, para. 21 ff., p. 4 ff.

[39] Concerning the EU internal market in general, cf. J. ESPINOZA, *Brussels signals extension of looser Covid-era state aid rules*, in *Financial Times*, October 19, 2021. Indeed, the European Commission prolonged the EC Temporary Framework until 30 June 2022: see, EUROPEAN COMMISSION, *Sixth Amendment to the Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak and amendment to the Annex to the Communication from the Commission to the Member States on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to short-term export-credit insurance*, Communication, 2021/C 473/01.

Due to incompatibility with the foreseen conditions and/or alterations to the Commission's temporary position, therefore, the problem of the impossibility of the project would arise again (cf. *supra*, para. 3).

5. The "way out" involving an EU bad bank

A "way out" to overcome the political impasse could be the establishment of an EU bad bank (or AMC) that would manage NPLs in full compliance with the banking crisis management regime. In addition to the creation of a pan-European holding company to participate in the capital of national AMCs in collaboration with domestic banks that want to transfer NPLs to AMCs (to overcome any criticism that this initiative would cause the mutualisation of losses between Member States, the proposal suggests that the losses and profits of each AMC be offset at the national level)[40], the creation of a European AMC (or a network of national AMCs) has also been proposed[41], with the possible use of national guarantees to avoid the mutualisation of losses.

Despite cautionary words on this point[42], the European regime on banking crisis management—certainly applicable to a national AMC or for the provision of public guarantees within an NPL securitization system—is not relevant to the creation of a European AMC, since the latter would not

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40 E. AVGOULEAS - C. GOODHART (fn. 18).

41 Cf., for example, A. ENRIA, *ECB: the EU needs a regional 'bad bank*, in *Financial Times*, October 26, 2020 and A. ENRIA, 27 October 2020 (fn. 4); but see also A. ENRIA - P. HABEN - M. QUAGLIARIELLO (fn. 14), p. 63 ff., 66.

42 «The plan to erect a Bad Bank or Asset Management Company is certainly legally very controversial and may violate both competition law principles as well as the EU resolution directive BRRD»: W.-G. RINGE (fn. 33), p. 66. Regarding the proposal, for the statement that «but another obstacle would remain: the EU state-aid rules under article 107 TFEU», cf. E. AVGOULEAS - C. GOODHART (fn. 18), p. 108, and A. ENRIA - P. HABEN - M. QUAGLIARIELLO (fn. 14), p. 63 f., which indicate as the first step of the process the use of stress tests to identify the potential amount of State aid to be provided to each individual bank (as well as to identify, possibly, banks needing immediate resolution) in the context of a precautionary recapitalization; see also, J. FELL - M. GRODZICKI - R. MARTIN - E. O'BRIEN (fn. 18), p. 75. More cautious, however, is A. ENRIA, October 26, 2020 (fn. 42), according to which «we are convinced such an initiative can be designed by leveraging the flexibility of the EU's current legal framework and state aid rules. However, we must be prepared to make legislative adjustments, if necessary».

fall within the notion of State aid[43] as set forth by the European Commission[44]. Indeed, the measure «is not imputable to a Member State if the Member State is under an obligation to implement it under Union law without any discretion…»[45]; moreover, «if such resources are awarded directly by the Union … with no discretion on the part of the national authorities, they do not constitute State resources…»[46]. Consequently, it cannot even be considered as «extraordinary public financial support» (cf. art. 2, para. 1, no. 28, BRRD), which is the condition for triggering the discipline of the BRRD.

In addition to addressing the obstacles related to the State aid issue and the bank crisis management regime (BRRD), the creation of an EU bad bank would, from a microeconomic perspective, also allow the tackling of the problem of NPLs more effectively, with additional benefits beyond those of national projects[47]. From a macroeconomic perspective, this would make it possible to avoid the risk that substantial constraints (*i.e.*, the high ratio between public debt and GDP) will *de facto* prevent some States from applying this solution[48] (although individual States could theoretically act on their own, each must consider their structural situation; for example, a State with a high ratio of public debt to GDP will have less room for manoeuvre—

[43] And, if it does not fall within the definition of "State aid", compliance with any conditions is not necessary for the intervention: C. GALAND - W. DUTILLIEUX - E. VALLYON (fn. 6), p. 139. There are, in fact, alternative proposals which, instead of verifying the scope of the ban on State aid, consider possible exceptions to the regime for example, «a Treaty-compliant interpretation could be advanced on grounds of broader public interest. Namely, that in the post-COVID-19 period, public support would be used, not just for the benefit of single banks, but mostly to correct a system-wide market failure affecting the price formation of NPLs» and «this argument could be at least supported in the case of a pan-European system-wide AMC whose mandate would be to help clean up the banking system from the burden of NPLs generated by the COVID-19 crisis», E. AVGOULEAS - R. AYADI - M. BODELLINI - G. FERRI - B. CASU - W. P. DE GROEN (fn. 18), p. 190 f.

[44] Cf. EUROPEAN COMMISSION, *Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union*, 2016/C 262/01 (hereinafter "EC Notion of State aid").

[45] EC Notion of State aid, spec. para. 3.1.2., no. 44.

[46] EC Notion of State aid, spec. para. 3.2.2., no. 60. The case would be different if there are «advantages granted directly or indirectly through State resources [which, instead,] can constitute State aid within the meaning of Article 107(1) of the Treaty»: EC Notion of State aid, spec. para. 3.2.1., no. 47. For the claims that «direct or indirect involvement of the state(s) in the funding of AMCs could trigger, depending on the transfer price, State aid restrictions» and «the main issue concerning public support is that every purchase of NPLs carried out by a publicly supported AMC at a price exceeding the estimated market value qualifies as State aid», E. AVGOULEAS - R. AYADI - M. BODELLINI - G. FERRI - B. CASU - W. P. DE GROEN (fn. 18), p. 174 and 188.

[47] Cf. A. ENRIA - P. HABEN - M. QUAGLIARIELLO (fn. 14), p. 63.

[48] About national AMCs, among the causes for which the so-called EC Blueprint has not been implemented is the non-explicit "relaxation" of the criterion on State aid, which, therefore, limits «its feasibility for countries facing public finance constraints (countries with public finance problems often have also high NPL levels)»: I. ANGELONI (fn. 2), p. 116.

especially in the Eurozone—without injury to its banking system[49]), with the consequences that some geographically constrained banks[50] will be damaged and that there will be an increased risk of creating national instabilities that may have repercussions beyond borders which would damage the integration of the EU internal market.

6. Conclusion

The proposal for an EU bad bank is part of a new "economic orthodoxy" that sees the change from a system of rigid fiscal consolidation to more significant public intervention in the economy to protect financial stability as beneficial[51].

Even this proposal is not without political obstacles, as it may involve the mutualisation of losses[52]. As the Eurogroup has pointed out[53], however, the banking crisis arising out of the pandemic may, prove to be an opportunity to support a greater integration of the European banking sector.

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[49] For a comparative analysis of the situation in the States of the European Union, cf. J. KASINGER - J. P. KRAHNEN ET AL (fn. 5), p. 14 f.

[50] Concerning the reasons for a European AMC, A. ENRIA, 27 October 2020 (fn. 4), p. 6, stated that «what is important is that we put banks in the banking union on the same footing and that we break the link with the sovereign, so that the funding of these initiatives is on the same footing at the European level and the pricing is also at the European level, so that there is no hidden benefit that advantages one bank against the other in our jurisdiction».

[51] M. SANDBU, *Keeping up with the new economic orthodoxy*, in *Financial Times*, October 7, 2021, describing a dynamic not unknown in the European legal system: see, for example, Banking Communication 2013, spec. para. 7 ff., p. 2 f.

[52] «Though an AMC does not in itself necessarily involve mutualisation of bank risks (this depends on how the scheme is designed), the proposal immediately faced opposition from some eurozone members, fearing that the proposal would allow countries with large amounts of legacy assets, preceding the launch of the single supervision, to offload part of the burden onto others»: I. ANGELONI (fn. 2), p. 116; see also G. BARBA NAVARETTI - G. CALZOLARI - A. F. POZZOLO (fn. 14), p. 16 and E. AVGOULEAS - C. GOODHART (fn. 18), p. 98.

[53] *I.e.*, given «the need to continuously improve our crisis management framework» and because « of the eventual expiry of the temporary state-aid framework after the pandemic», the Eurogroup «invite the Commission to review its state-aid framework for banks … with a view to … adequate burden-sharing of shareholders and creditors to protect taxpayers, and preservation of financial stability», EUROGROUP, *Statement of the Eurogroup in inclusive format on the ESM reform and the early introduction of the backstop to the Single Resolution Fund*, Press Release, 839/20, November 30, 2020.

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