COVID-19, household financial fragility and non-performing loans (NPLs)

FSUG position paper – May 2021

The Financial Services User Group (FSUG) was set up by DG JUST and DG FISMA in order to involve users of financial services in policy-making. Its 20 members represent the interests of consumers, individual investors or micro-enterprises, and include individual experts with expertise in financial services from the consumer perspective.

FSUG Members expressed serious concerns about the rising levels of households' financial fragility. The current pandemic is worsening the situation of many indebted consumers and small businesses, given the sharp economic downturn in the EU and worldwide and, as a consequence, the fact that many households are tackling unemployment and a fall in income and most businesses are facing closures, disruption in supply chain, and reduction in demand. The result is a sharp increase in difficulties for the repayment of loans and situations of over-indebtedness. Besides, it is very likely that the post-crisis rebound will not be followed automatically by a sustainable recovery, and that household financial fragility will last for long.

A recent survey in 21 Member States[1] showed that since the start of the COVID-19 crisis a clear majority of respondent (6 in 10 consumers) have experienced financial difficulties in their own personal life which may lead to over-indebtedness. Such problems include a loss of income (30%), unemployment or partial unemployment (23%), using personal savings sooner than planned (21%), difficulties paying rent, bills or bank loans (14%) as well as difficulties having proper and decent-quality meals (9%). Besides, the impact of the crisis is regressive, with poorer households more likely to be negatively impacted.

To help indebted consumers and small businesses, Member States have implemented a set of relief measures, among which payment deferrals ('moratoria'), public guarantee schemes, and special credit lines for SMEs. The overall aim of these measures is to support borrowers with temporary liquidity problems due to the current pandemic in order to shield them from its impact.

However, the design and application of these measures were not uniform in the EU Member States. In some cases, public moratoria on credit implied that interest was accrued during the payment holiday period, which increased the overall interest

[1] European Union (2020). Uncertainty EU Hope. Public opinion in times of Covid-19. Survey commissioned by the European Parliament.

burden, in others moratoria only covered residential mortgages and then included other types of mortgages and consumer loans for specific purposes such as education; in others, banks applied their own moratoria etc…

Besides this, as the pandemic support programs are removed with no EU harmonized strategy many firms are likely to face bankruptcies and unemployment stands to rocket. Bankruptcies are costly as they destroy expertise, know-how, commercial relationships and assets. Similarly, unemployment destroys human capital and creates health and social distress. Bankruptcies and unemployment result in non-reimbursed borrowings, which fragilizes the financial sector and can trigger a financial crisis.

At the same time, and because of the impact of households' financial fragility on the banking system, EU regulators and supervisors have taken measures in favor of the financial system, such as relaxing certain supervisory requirements for financial institutions to avoid pro-cyclical behaviors, while the ECB is providing extra liquidity to the financial system. Specifically, the banking package adopted by the European Commission in April 2020 includes targeted "quick fix" amendments to EU banking rules, such as adapting the timeline of the application of international accounting standards on banks' capital, treating more favorably public guarantees granted during the pandemic, postponing the date of application of the leverage ratio buffer, and modifying the way of excluding certain exposures from the calculation of the leverage ratio.

The ultimate goals of these measures are, on the one hand, to ensure that banks can continue to lend money to support the economy therefore mitigating the economic impact of the pandemic, as well as to absorb losses related to the Coronavirus. On the other end, these measures are aimed at continuing ensuring the resilience of the financial system and preventing a rise in non-performing loans (NPLs).

The risk of a surge in NPLs is an issue directly correlated with the issue of an increase in financial fragility and over-indebtedness. Indeed, banks are exposed to companies and individuals that have become more financially vulnerable and this may threaten financial stability and reduce the possibility that banks can continue to play a positive role in the recovery following the economic downturn.

Given the relevance of the management of NPLs, among the "Capital Market Union for people and businesses - new action plan" there is a specific action - Action n.6 " Helping banks to lend more to the real economy" – which aims at "*strengthening the role of securitisation as an instrument available to banks to help them provide* *sustainable and stable funding to the real economy in a post-COVID-19 environment, with a particular focus on SMEs and the green transition. Particular attention will be paid to the capacity of the current framework to adequately reflect the effective riskiness of both STS*[2] *and non-STS securitisation instruments, including the appropriateness of disclosure requirements, the process for recognising significant risk transfer and the prudential treatment of cash and synthetic securitisation, while preserving the financial stability of the EU*".

Besides, the European Commission, in its Communication "Tackling non-performing loans in the aftermath of the COVID-19 pandemic" (COM(2020) 822 final, 16/12/2020), highlights the need for targeted measures to address a possible accumulation of NPLs over the medium term as a result of the COVID-19 pandemic and proposes a range of new measures to help address the upcoming flows of NPLs. When addressing the challenge of tackling NPLs, the European Commission also underlines the need to ensure that consumers, and especially vulnerable borrowers, are properly protected.

Recommendations:

While there are some principles set for the treatment of consumers in arrears, such as the EBA Guidelines on management of non-performing and forborne exposures and the EBA Guidelines on Arrears and Foreclosures, it would be crucial that a European Union plan is urgently designed considering the need to:

- authorize for further adjustment in time to allow for income recovery and ensure that mortgage contracts for main residence are not allowed to be foreclosed within a reasonable timeframe – depending on the still unknown duration of the pandemic - adapted to the exceptional pandemic related economic and social crisis;

- ensure that financial institutions are encouraged to display flexibility towards consumers with financial difficulties in the context of COVID-19 crisis, to extend moratoria with the ultimate goal to avoid payment defaults and foreclosures. This may also reduce debt collection practices, which in some cases are proved to have strong negative externalities;

- given the exceptional circumstances brought by the COVID-19 pandemic, ensure that banks take proactive actions to early identify financially vulnerable debtors and

[2] STS means Simple, Transparent, and Standardized. This is the link to the ESMA list of all securitizations that comply with the STS criteria set out in Regulation (EU) 2017/2402, as amended by Regulation (EU) 2021/557 (SECR). https://www.esma.europa.eu/policy-activities/securitisation/simple-transparent-and-standardised-sts-securitisation

households that remain in distress, to address the issue timely and with appropriate restructuring measures, without increasing costs;

- promote the use of asset management companies to facilitate the process of debt collection while addressing the obstacles inherent in the process. Debtors face a range of detriments resulting from the pressure to pay their debt. As was argued in a paper[3], the asset management companies should facilitate the collection of debt while ensuring the individuals retain a minimum wage. Moreover, the longer-term viability of small businesses should be considered in the context of debt collection, so that potential extensions, refinancing and write-offs can maintain jobs and economic activity;

- reinforce consumer protection, and to ensure that consumers receive all advice and information to make well-founded choices when signing for credit agreements;

- focus more on free and independent debt advice, to allow consumers to assess the best solutions for their case while ensuring a knowledgeable handling, as an effective way of helping over-indebted consumers to return to financial sustainability, while ensuring that creditors are repaid. Consumer organisations can play that role provided they are empowered with a mandate and resources to do so.

A more ambitious plan towards a recovery plan could foresee measures that are not debt based, such as the reconversion of debt to equity, the provision of liquidity with a no-refund policy and improving and harmonizing debt-restructuring procedures and national insolvency regimes.

[3] https://www.europarl.europa.eu/RegData/etudes/STUD/2021/651386/IPOL_STU(2021)651386_EN.pdf