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The Role of Banks' Management in the EU Resolution Regime for NPLs

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ABSTRACT

During the global financial crisis, the growth of nonperforming loans (NPLs) was partly a consequence of lack of regulatory oversight and poor bank internal processes. NPLs require intrusive monitoring tools: effective corporate governance is crucial in dealing with the deterioration of loans however, perverse incentives to delay their recognition leave the process at risk. The EU legislation has adopted a set of regulatory measures to resolve and restructure nonperforming exposures. While existing literature approaches NPLs from a regulatory and accounting perspective, this article advances a distinctive corporate view to conceptualise the NPL problem. It makes an original contribution by identifying the strategies through which senior management and shareholder incentives undermine regulatory objectives on NPL disclosure and by advancing an evidence-based approach to reconsider and settle these problems.
KEYWORDS: distressed loans, asset quality, NPL workout units, Banking Union.

I. INTRODUCTION

The recent episodes of failing banks, such as Banco Santander, Banca Monte dei Paschi di Siena, Piraeus Bank and Alpha Bank have raised criticisms regarding the resolving mechanisms for deteriorated assets in the context of the insolvency and resolution procedures for European banks.[1] The treatment of distressed loans has become a major

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[1] Thomas F. Huertas, 'Will bust banks be born again by bail-in?' (2019) 39 *Butterworths Journal of International Banking and Financial Law* 225.

concern for supervisory authorities and regulators.[2] During the global financial crisis,[3] the growth of nonperforming loans (NPLs) was a consequence, amongst other factors, of poor bank corporate governance and lack of effective managerial oversight.[4] NPLs play a central role in the linkages between poor lending practices and credit risk. A non-performing loan is generally considered a sum of borrowed money upon which the debtor has not made his or her scheduled payments for at least 90 days although a common definition of NPL is lacking among regulators and policymakers.[5] A high stock of NPLs is undesirable to investors and can lead to a dramatic decrease in the share price of a bank, to profitability loss and potentially to a distressed scenario.[6] These problems are likely to return to the forefront of regulatory policy in the immediate future as a result of the sharp recession that is expected during the pandemic crisis.[7] The rise of NPL problems seems evident in post-crisis recessions in particular for those countries with weak macroeconomic, institutional, corporate, and banking sector conditions.[8]

This article investigates the relationship between internal corporate governance structures and the timely recognition of NPLs examining, in particular, the impact of different bank share ownership structures on the incentives and capacity of senior

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[2] Basel Committee on Banking Supervision, 'Prudential treatment of problem assets – definitions of non-performing exposures and forbearance' (2017) Guidelines, available at http://www.bis.org/bcbs/publ/d403.htm.

[3] It is not possible to render justice to the extensive literature that examines the reconfiguration of European financial architecture after the 2007-09 global crisis. See e.g. Niamh Moloney, 'The legacy Effects of the Financial Crisis on Regulatory Design in the EU' in Eilís Ferran Jennifer Hill, Niamh Moloney and John C. Coffee (eds), *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge: Cambridge University Press 2012) 111–202; and Emilios Avgouleas, 'The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform' (2009) 6 *European Company and Financial Law Review* 440.

[4] EBA, 'Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses' (2017), Final Report EBA/GL/2017/06, available at https://www.eba.europa.eu/documents/10180/1842525/Final+Guidelines+on+Accounting+for+Expected+Credit+Losses+%28EBA-GL-2017-06%29.pdf.

[5] Andrew Campbell, 'Bank insolvency and the problem of nonperforming loans' (2007) 9 *Journal of Banking Regulation* 25, 27.

[6] Maria Demertzis and Alexander Lehmann, 'Tackling Europe's crisis legacy: a comprehensive strategy for bad loans and debt restructuring' (2017) Bruegel Policy Contribution, No. 2017/11, 1, available at https://www.econstor.eu/bitstream/10419/173107/1/PC-11-2017.pdf.

[7] For instance, it is estimated that the UK GDP will contract by 13-14% in the second quarter of 2020. See Emily Ferguson, 'UK recession warning: Staggering 14 PERCENT contraction in economy forecast by June 2020' Express (London, 10 April 2020), available at https://www.express.co.uk/finance/city/1267625/uk-economy-forecast-coronavirus-uk-GDP-contraction-second-quarter-recession. See also Laura Noonan, 'US banks brace for surge in loan losses', *Financial Times* (18 April 2020); Martin Arnold and Javier Espinoza, 'ECB pushes for eurozone bad bank to clean up soured loans', *Financial Times* (19 April 2020).

[8] Anil Ari, Sophia Chen and Lev Ratnovski, 'The Dynamics of Non-Performing Loans During Banking Crises: A New Database' (December 2019) IMF Working Paper WP/19/272, 5-6.

managers to identify, disclose and resolve NPLs. As such, the scope is limited to the recognition and resolution of NPLs while fully acknowledging the significance of corporate governance in broader contexts such as loan origination. Conceptually, this study builds upon previous work that demonstrates the cyclical nature of finance and the frequently procyclical nature of financial regulation and supervision that tend to be stricter at times of distress and laxer at times of expansion,[9] despite the counter-cyclical elements that have been added to the capital adequacy framework.[10] Indeed, NPLs tend to have their root causes in poor loan origination at times of expansion while they only become visible at times of distress. This can be observed in the experience of the current pandemic which is markedly different from the 2007-09 global financial crisis as regulators appear to be much more willing to suspend the normal application of various rules in order to facilitate the provision of credit. An explanation is that the pandemic-caused recession is entirely exogenous to the financial system and, therefore, banks are not carrying any of the blame for the crisis and hence regulatory suspension appear reasonable and legitimate.[11]

NPLs require intrusive monitoring tools: effective corporate governance mechanisms perform a fundamental role in evaluating the riskiness of banks and monitoring the deterioration of distressed loans. In this context, oversight by the board of directors is crucial. However, mismanagement in the assessment of NPLs can lead to lack of recognition of impaired loans in banks' balance sheets or delays in the reporting process. Further, senior management manifests incentives to hide NPLs to avoid negative signalling effects, as a high stock of NPLs is typically perceived as weakness of the financial conditions of a bank.[12] Managers face incentives to mask these exposures although this can exacerbate information asymmetries on asset quality. This is mainly due to the fact that disclosing NPLs and setting aside loan loss reserves

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[9] The relevant literature is rich. See e.g. Dirk Heremans and Alessio M. Pacces, 'Regulation of Banking and Financial Markets' in Roger J. Van den Bergh and Alessio M. Pacces (eds), *Regulation and Economics. Encyclopedia of Law and Economics*, Volume 9 (2nd edn, Cheltenham: Edward Elgar 2012) 596-598; Katharina Pistor, 'A legal theory of finance' (2013) 41 *Journal of Comparative Economics* 321; and Steven L. Schwarcz and Lucy Chang, 'The Custom to Failure Cycle' (2012) 62 *Duke Law Journal* 767.

[10] A primary example of such a measure is the counter-cyclical buffer under art 128 of the CRD IV. For a discussion of the relevant policy matters, see Jonathan S. Masur and Eric A. Posner, 'Should Regulation be Counter-cyclical?' (2017) 34 *Yale Journal on Regulation* 857.

[11] A detailed analysis of regulatory suspensions in the area of prudential regulation during the COVID-19 pandemic can be found in Iris H-Y Chiu, Andreas Kokkinis and Andrea Miglionico, 'Regulatory Suspensions in Times of Crisis: The Challenges of Covid – 19 and Thoughts for the Future' (2020) ECGI Law Working Paper No 517/2020, available at http://ssrn.com/abstract_id=3605423.

[12] For a detailed analysis, see below Section 3.2.

reduces, in the short-term, the profits of a bank and, as a result, leads to a reduction in performance-based remuneration for executive directors and senior managers. At the same time, in publicly traded banks diversified outside shareholders are risk-neutral investors seeking to maximise returns on their investment and primarily focusing on a short-term horizon.[13] Thus, capital market pressures to deliver profitability[14] influence managerial decision-making in the context of NPLs. In addition, managers' tendency to delay the recognition of NPLs can decrease the value of assets and affect the development of the market for NPLs, preventing potential buyers to acquire distressed assets.

This article takes a distinctive corporate governance view to address the NPL problem. It makes an original contribution to the debate by identifying the channels through which senior management and shareholder incentives undermine regulatory goals on NPL disclosure and resolution and by proposing an evidence-based approach to reconsider and settle these problems. Specifically, it is proposed that NPL workout units should be part of the general risk management function of each bank and should be led by the chief risk officer (CRO) who should sit on the board, supervised by the board risk committee. Further, we contend that banks should be encouraged to consider carefully whether to use internal ad hoc workout units or external specialised firms to reduce the negative impact of deteriorated loans on asset quality. To improve the alignment between senior management and regulatory goals, we advance a range of reforms in senior executive remuneration, that would be applicable only to high-NPL banks with a view to creating financial incentives to safeguard asset quality at the origination stage, disclose NPLs promptly and resolve NPLs efficiently. As such, our study offers an original insight by adding a significant parameter to the treatment of

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[13] Short-termism in the capital markets implies that the current price of securities does not fully reflect the long-term prospects of profitability. Evidence of shareholder myopia has led formerly unwavering supporters of the efficient capital markets hypothesis to adopt more nuanced views. See e.g. Michael C. Jensen, 'Agency Costs of Overvalued Equity' (2005) 34 *Financial Management* 5; and Ronald J. Gilson Gilson and Reinier Kraakman, 'The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias' in John Armour and Joseph A. McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (Oxford and Portland, OR: Hart 2006). For an overview of available evidence on the informational efficiency of capital markets, see Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford: Oxford University Press 2000). See also Marc T. Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 *Journal of Law and Society* 424, 426-427.

[14] This is an issue of increasing policy interest in the EU. See European Securities and Markets Authority, 'Undue short-term pressure on corporations' (December 2019) ESMA30-22-762 https://www.esma.europa.eu/sites/default/files/library/esma30-22-762_report_on_undue_short-term_pressure_on_corporations_from_the_financial_sector.pdf.

NPLs, and bears the promise of enhancing banks' asset quality while also contributing to the further development of the internal risk management function of banks. Our approach enhances and strengthens the concept of a polycentric regulatory space[15] that has emerged as the modern paradigm of prudential regulation that acknowledges the significance of enrolling banks' internal functions and entrusting them with a quasi-regulatory role.

The remaining of this paper is structured as follows. Section two examines the EU resolution framework for NPLs in the light of recent reforms adopted by supervisory authorities and analyses the resolution tools for nonperforming exposures (NPEs). Section three draws a novel link between NPLs and banks' corporate governance. It applies for the first time in the context of NPLs an agency costs analysis and demonstrates how different types of share ownership structure lead to misaligned incentives and poor managerial skills regarding NPLs. Section four critically challenges the current EU framework for the internal governance of NPL classification and workout schemes so as to prepare the ground for proposals for reform. Section five advances a proposal to amend NPL guidelines on corporate governance focusing on remuneration reforms and internal monitoring processes at both board and senior management level, taking into account the persistent NPL problem in each bank and its type of share ownership structure. The last section provides conclusive remarks.

II. THE EU SUPERVISORY AND RESOLUTION FRAMEWORK OF NPLS

Our analysis looks at the EU-wide legal framework for NPLs with emphasis on the regulatory framework applicable to the Banking Union. The restructuring of credit institutions with the adoption of the bail-in resolution tool, the public financial support of precautionary recapitalisation and the policy objective of burden sharing to allocate the costs of failure, has increased the risk of internalisation of unexpected losses in the banking sector. The EU bank resolution regime (i.e., Single Resolution Mechanism[16]

[15] On enrolling private actors to perform regulatory functions, see Julia Black, 'Enrolling Actors in Regulatory Systems: Examples from UK Financial Services Regulation' (2003) *Public Law* 63. On the concept of the decentred regulatory space see Julia Black, 'Critical Reflections on Regulation' (2002) 27 *Australian Journal of Legal Philosophy* 1.

[16] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund [2014] OJ L225/1.

and Bank Recovery and Resolution Directive)[17] has introduced a laudable legislative framework although it does not fully consider the implications of defaulted subordinated debts for financial stability. Addressing the rise of NPLs has been a constant concern of the Banking Union as the supervision of distressed debts requires comprehensive action to deal with these types of bad loans sitting on banks' books.[18] The European Central Bank (ECB) has established a prudential regime for NPLs to strengthen the capital rules and banking supervision, since NPLs represent a major systemic threat as they may rapidly lead to bank and borrower insolvencies, as evidenced by the experience of several euro area Member States.[19] The architecture of Single Supervisory Mechanism (SSM) has introduced a set of monitoring tools to assess banks' balance sheets through on site-inspections, stress tests and asset quality reviews.[20] Article 16(2) of the SSM Regulation provides that the ECB can apply 'specific provisioning policy or treatment of assets in terms of own funds requirements'.[21] These supervisory actions consist of requiring credit institutions (1) to hold additional layers of funds in excess of the capital requirements to cover unexpected losses; (2) to set strategies and internal mechanisms to foster compliance with

[17] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms [2014] OJ L173/190.

[18] David Bholat, Rosa M. Lastra, Sheri M. Markose, Andrea Miglionico and Kallol Sen, 'Non-performing loans at the dawn of IFRS 9: regulatory and accounting treatment of asset quality' (2018) 19 *Journal of Banking Regulation* 35, 35-36.

[19] The question of asset quality classification has become prominent since the divergence in practice between firms and regulators in defining "non-performing" has hampered the need for NPL harmonisation. Within the NPL category are comprised: (1) bad loans; (2) default loans; and (3) distressed debt. The classification depends on several factors and varies across jurisdictions. In some countries, nonperforming means that the loan is impaired while in others can mean that payments are past due. Nevertheless, a rather common feature of nonperforming loans appears to be that a payment is "more than 90 days" past due, especially for retail loans. The classification of the loan as nonperforming by the bank and when the loan becomes "bad debt" depends on domestic regulations. Further, the rising discrepancy between banks' overdue loan ratios and NPL ratios makes difficult to identify deteriorated loans that are not formally classified as nonperforming. This problem is particularly evident in the Chinese banks where the fragility of loan loss provisions does not help to mitigate the NPL classification issue. See Yuan Yang, 'China banks in stand-off with regulators on loan loss provisions', *Financial Times* (30 October 2016).

[20] ECB, 'Stocktake of national supervisory practices and legal frameworks related to NPLs' (2017) 3-4, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.stock_taking2017.en.pdf. Stress tests are indicators that assess the financial stability of banks. They examine the three-year period following a recent reference date and include a baseline macroeconomic scenario together with the adverse scenario, which assumes the impact of one or more particularly severe shocks. The EU stress test exercise is coordinated by the European Banking Authority (EBA) under the direct supervision of the ECB. The results of stress test are used by the competent authorities to assess the capacity of a bank to meet the regulatory requirements in severe scenarios on the basis of common methodologies and assumptions.

[21] Article 16(2) of the SSM Regulation No 1024/2013.

supervisory requirements; (3) to implement specific provisioning policies to reduce excessive exposures and systemic risk transactions; and (4) to enhance information disclosure on remuneration policies, profits distribution and liquidity requirements.

In March 2017 the ECB issued qualitative guidance on nonperforming loans, including consideration of how the 'unlikely to pay' criterion should be applied in practice and how banks should manage and monitor forbearance, write offs and collateral valuation.[22] This supervisory toolkit aims to address the issue of identification and allocation of past-due loans in the EU banking sector. The NPL guidance has been further developed in the prudential treatment for distressed assets through supervisory expectations on the classification of NPLs.[23] The ECB's supervisory expectations supplement the NPL guidance by specifying required regulatory actions when assessing a bank's levels of prudential provisions for NPLs. The prudential provisioning expectations complement the EBA Guidelines on the SSM Supervisory Review and Evaluation Process (SREP) that aim to oversee the asset quality and capital coverage of banks.[24] These guidelines are laid down according to the Capital Requirements Directive IV (CRD IV)[25] and 'constitute the clearest indication of the link between the supervisory and the resolution function'.[26] The SREP regime provides key indicators for the monitoring of institutions such as: business model analysis; assessment of internal governance and institution-wide controls; assessment of risks to capital; and assessment of risks to liquidity and funding.[27] These indicators are based on qualitative and quantitative evaluations and rely on data provided by the banks and supervisory judgements about the level of risk. The business models and credit risk indicators of the SREP respond to the regulatory instances of timely classification of non-performing

[22] ECB, 'Guidance to banks on non-performing loans' (2017), 49-50, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

[23] ECB, 'Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures' (2018), 2, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf.

[24] EBA, 'Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)', EBA/GL/2014/13, 19 December 2014, available at https://eba.europa.eu/sites/default/documents/files/documents/10180/935249/4b842c7e-3294-4947-94cd-ad7f94405d66/EBA-GL-2014-13%20(Guidelines%20on%20SREP%20methodologies%20and%20processes).pdf.

[25] See articles 97-101 of the Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [2013] OJ L176/338.

[26] Christos V. Gortsos, 'The application of the EU banking resolution framework amidst the pandemic crisis' in Christos V. Gortsos and Wolf-Georg Ringe (eds), *Pandemic Crisis and Financial Stability* (EBI Press 2020) 378, fn. 43.

[27] EBA (n 24) 21.

assets: competent authorities are responsible for monitoring the non-performing rates, the distribution of exposures, foreclosed assets and NPL portfolios.[28] The SREP framework reveals wide divergences at the national level among competent authorities although the EBA has consistently sought to limit the discretionary nature of the supervisory assessment on the adequacy of capital and leverage ratio.[29]

The ECB regulatory initiatives have been followed up by the Commission's proposal for a Regulation on a minimum loss coverage for NPEs adopted in March 2018 that complements the CRD IV[30] and establishes a 'case-by-case' approach in the application of the prudential backstop for NPEs.[31] The EU legislation implemented the Commission's proposal adopting a set of regulatory measures to monitor and resolve NPEs. Regulation No 630 of 2019 introduced minimum loss coverage layers of capital for NPEs to address newly formed losses providing that "a forbearance measure granted to a non-performing exposure should not discontinue the classification of that exposure as non-performing unless certain strict discontinuation criteria are fulfilled".[32] In addition, Directive No 1023 of 2019 provided a degree of harmonisation for restructuring distressed debts.[33] The new legislation improves the supervisory toolkit and the classification of loan quality: the need to ensure consistency in the resolving

[28] See the SREP 2019 aggregate results (28 January 2020), available at https://www.bankingsupervision.europa.eu/banking/srep/srep_2019/html/aggregate_results_2019.en.html.

[29] EBA, 'Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing', EBA/GL/2014/13, 19 July 2018, at 10, available at https://eba.europa.eu/sites/default/documents/files/documents/10180/2282666/fb883094-3a8a-49d9-a3db-1d39884e2659/Guidelines%20on%20common%20procedures%20and%20methodologies%20for%20SREP%20and%20supervisory%20stress%20testing%20-%20Consolidated%20version.pdf.

[30] Article 104(1)(d) of the CRD IV states that '[…] competent authorities shall have the powers to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements.'

[31] Commission's proposal for a regulation on a minimum loss coverage for non-performing exposures, Brussels COM(2018) 134 final.

[32] See Recital 7 in the preamble to Regulation (EU) No 630/2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures [2019] OJ L111/4. For a commentary see Carla Stamegna, 'Minimum loss coverage for non-performing loans', European Parliamentary Research Service (March 2019), 6, available at https://epthinktank.eu/2019/03/11/minimum-loss-coverage-for-non-performing-loans-eu-legislation-in-progress/.

[33] See Recital 3 to Directive No 1023 of 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 that provides "the availability of effective preventive restructuring frameworks would ensure that action is taken before enterprises default on their loans, thereby helping to reduce the risk of loans becoming non-performing in cyclical downturns and mitigating the adverse impact on the financial sector".

mechanisms of defaulted debts and to create a harmonised monitoring regime has been recognised by the EU authorities in the regulatory approach to NPLs.

Although the ECB guidance can be considered a form of principles-based regulation,[34] these initiatives have provided a substantial degree of harmonisation which permits cross-border comparisons of the asset side of banks' balance sheet, and a unified concept of both loan classification and the definition of NPLs. The gains from a harmonised approach include improving the comparability of firms, quantifying forbearance and, ultimately, reaching a better understanding of the relation between NPLs, economic growth and financial stability. However, the main outstanding problem is the lack of a coordinated framework to assess the obligors' ability to repay and thus whether a loan has indeed become nonperforming, which opens the gate to unviable forbearance, as will be explained in the next section.[35]

Furthermore, the ECB has focused on creating a common classification of the asset quality standard that should complement a classification of sources of banks' funding, i.e. equity and debt, and has incentivised ad hoc resolving options to deal with NPLs swiftly, for example securitisation schemes in some EU countries (e.g. Italy and Greece).[36] In parallel, the Commission has adopted a set of regulatory measures to reduce the level of bad loans and strengthen the lending system in the Eurozone.[37] NPLs have become a persistent phenomenon in financial institutions and have dragged on economic activity, especially for Member States that rely mainly on bank financing, as is the case in the euro area.[38] For instance, the Italian banking sector reported an outstanding stock of €147 billion of gross NPLs mostly accumulated during the financial and sovereign debt crises period.[39] In Italy important reforms have changed the procedures for firms' liquidation, restructuring and for the foreclosure of assets.[40]

[34] The NPL guidance contains soft law recommendations not binding and not enforceable that leave discretion to national authorities for their implementation at the domestic level.

[35] Bholat et al. (n 18) 9.

[36] European Central Bank, 'Stocktake of national supervisory practices and legal frameworks related to NPLs' (September 2016), 52 and 85-86, available at https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/stock_taking.en.pdf.

[37] European Commission, 'Communication from the Commission: Completing the banking union' COM(2017) 592 final, 6, available at https://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf>.

[38] International Monetary Fund, 'A Strategy for Resolving Europe's Problem Loans', Staff Discussion Note, SDN/15/19 (2015), 9, available at https://www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf.

[39] Bank of Italy, 'Financial Stability Report', No. 1 (April 2020), 35. It is reported that the coverage ratio—provisions in relation to the whole stock of NPLs—reached 52.4 percent.

[40] Luisa Carpinelli, Giuseppe Cascarino, Silvia Giacomelli and Valerio Vacca, 'The management of non-performing loans: a survey among the main Italian banks', Bank of Italy Occasional Papers No 311,

Specifically, the Italian government has taken initiatives concerning NPL recovery such as public guarantee schemes and banks' workout mechanisms.[41]

Another case in point regarding national special regimes for NPLs is provided by Greece whose banking sector has faced several waves of recapitalisation, mostly as a result of the country's sovereign debt crisis. Greek Law No 4354/2015 regulates the assignment and transfer of nonperforming loan claims.[42] This statute provides specific rules on: (1) obtaining a licence from the Bank of Greece for Debt Management Companies and Debt Transfer Companies (DTCs) for NPLs; (2) the agreements on assigning the management of claims; and (3) the sale and transfer of claims arising from NPLs and credit agreements. The law adopts a 90 day past due threshold to define nonperforming assets, however the NPL figures do not provide information about the level of provisions held against these loans by banks. In addition, the Bank of Greece has introduced supervisory practices and guidelines for the management of NPLs requiring banks to implement resolution procedures with distressed borrowers and standardise the loan workout process.[43] The Commission introduced an asset protection scheme ("Hercules") to reduce the amount of NPLs in the banking system without State aid intervention.[44] The scheme aims to support banks in managing NPLs under market conditions: it is a private solution mechanism in which a securitisation vehicle buys nonperforming loans from the relevant bank and sells notes to investors.[45]

Overall, the new supervisory toolkit implemented in the Banking Union aims to improve the classification of asset quality and establish common practices to prevent a high ratio of NPLs to total loans. However, managerial involvement in the assessment

(February 2016), 8, available at http://ssrn.com/abstract=2838708. See also Anke Weber, 'Bank Consolidation, Efficiency, and Profitability in Italy', IMF Working Paper WP/17/175 (2017), 9.

[41] Luca Ciavoliello, Federico Ciocchetta, Francesco Maria Conti, Igino Guida, Anna Rendina and Giovanni Santini, 'What's the value of NPLs?' (2016) Bank of Italy Notes on Financial Stability and Supervision 9.

[42] Law 4354/2015, 'Non-performing loans management, wage provisions, and other urgent provisions concerning the implementation of the fiscal goals and structural reforms agreement' (Government Gazette A΄176).

[43] See the Executive Committee Act (ECA) No 42/2014 on the supervisory framework for nonperforming exposures, thus introducing a harmonised framework and accelerating efforts of banks regarding efficient NPE management. See also the ECA No 47/2015 establishing a comprehensive prudential reporting framework for NPEs in Greece; and the Code of Conduct on NPL management by virtue of Decision 116/25.8.2014 issued by the Bank of Greece Credit and Insurance Committee according to Law 4224/2013.

[44] European Commission, 'State aid: Commission approves market conform asset protection scheme for banks in Greece', IP/19/6058, (10 October 2019), available at https://ec.europa.eu/commission/presscorner/detail/en/IP_19_6058.

[45] According to this mechanism, the State will provide a guarantee for the senior tranche of the notes in exchange of a fee on market terms.

of asset quality and forbearance options raises concerns in terms of resolution tools for NPL recovery.

III. THE PERVERSE INCENTIVES TO CONCEAL NPLS

Although NPLs have been the focus of several studies, the relationship between ownership structure, agency costs and NPLs remains unexplored. This section fills that gap by providing an in-depth analysis of the incentives and role of shareholders and senior managers with respect to NPL recognition and workouts; it thus exposes the misaligned incentives and tensions between shareholder and managerial interests, on the one hand, and regulatory objectives, on the other. In this section, we demonstrate how perverse incentives, inadequate flows of information and ineffective internal procedures can play a major part in the accumulation of NPLs, as evidenced by the recent experience of several European banks. Our analysis focuses on the *ex post* phase of identifying, reporting and resolving NPLs. We draw on existing empirical studies and brief case analysis to substantiate the correlation between senior management behaviour and NPL accumulation, and put forward a new understanding – on the basis of agency theory – that illustrates the incentives of senior managers in the context of loan origination, NPEs characterisation and NPL resolution.

1. The role of bank corporate governance for NPLs

Bank corporate governance poses distinct policy challenges that are quite different, at least to a considerable extent, to those posed by corporate governance in general.[46] [47]

[46] The general policy maker conception of corporate governance, at least in the UK and most European countries is as a field of market enforced soft law that complements corporate law with a view to protecting shareholder interests, minimising agency costs and maximising shareholder value in the long-term. This is in line with contractarian academic analyses of corporate law, while stakeholder views highlight the need to equally protect the interests of all stakeholders.

[47] On the soft law "comply or explain" approach of corporate governance, see John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Assessment' in Alessio Pacces (ed), *The Law and Economics of Corporate Governance: Changing Perspectives* (Cheltenham: Edward Elgar Publishing 2010); Andrew Keay, 'Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight?' (2014) 34 *Legal Studies* 279; and Marc T. Moore, 'Whispering Sweet Nothings: The Limitations of Informal Conformance in UK Corporate Governance' (2009) 9 *Journal of Corporate Law Studies* 77. On the contractarian view of corporate law, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge MA: Harvard University Press 1991); and Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439. For a critical assessment of corporate contractarianism, see Marc T. Moore, 'Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism' (2014) 34 *Oxford Journal of Legal Studies* 693. For alternative interpretations of

Due to systemic risk[48] and the ensuing high probability that individual bank failures lead to significant negative externalities, bank corporate governance is not exclusively focused on the minimisation of managerial agency cost and the alignment of management with shareholders.[49] Rather, bank corporate governance takes a distinguished regulatory stance and is now seen as part of the micro-prudential framework that seeks to mitigate the risk of failure of individual financial institutions.[50] Bank corporate governance is not the sole or even the most influential ultimate cause of NPL accumulation. Macro-economic factors, particularly GDP growth, the rate of unemployment and lending rate have been empirically confirmed as the main determinants of NPL volume.[51] However, idiosyncratic features of each bank have also been shown to matter.[52] As bank corporate governance structures are much more susceptible to regulatory intervention than the macroeconomic factors that influence NPLs, they provide an appropriate target for regulatory intervention even if they are only one of the many causes of high NPLs.

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corporate law and the corporate objective, see e.g. Andrew Keay, 'Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model' (2008) 71 *Modern Law Review* 663; and Margaret Blaire and Lynne Stout, 'A Team Production Theory of Corporate Law' (1999) 24 *Journal of Corporation Law* 751.

[48] See Steven L. Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown Law Journal* 193 and 'Information Asymmetry and Information Failure: Disclosure Problems in Complex Financial Markets' in William Sun, Jim Stewart and David Pollard (eds), *Corporate Governance and the Global Financial Crisis: International Perspectives* (Cambridge: Cambridge University Press 2011).

[49] The relevant literature is very rich. See e.g. Ross Levine, 'The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence' (2004) World Bank Policy Research Working Paper 3404, at 2-3, available at https://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-3404; Marco Becht, Patrick Bolton and Ailsa Röell, 'Why bank governance is different' (2011) 27 *Oxford Review of Economic Policy* 437, 444-445; John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer and Jennifer Payne, 'Bank governance' in Armour et al. (eds), *Principles of Financial Regulation* (New York/Oxford: Oxford University Press 2016) 375-376; and Andreas Kokkinis, *Corporate Law and Financial Instability* (Abingdon: Routledge 2018) 21-33.

[50] See Klaus J. Hopt, 'Corporate Governance of Banks after the Financial Crisis' in Eddie Wymeersch, Klaus J. Hopt and Guido Ferranini (eds), *Financial Regulation and Supervision: A Post-crisis Analysis* (Oxford: Oxford University Press 2012); Emilios Avgouleas and Jay Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (2014) 41 *Journal of Law and Society* 28; and Iris H-Y Chiu and Joanna Wilson, *Banking Law and Regulation* (Oxford: Oxford University Press 2019) ch 12.

[51] For an overview, see Dimitrios P. Louzis, Angelos T. Vouldis and Vasilios L. Metaxas, 'Macroeconomic and bank-specific determinants of non-performing loans in Greece: A comparative study of mortgage, business and consumer loan portfolios' (2012) 36 *Journal of Banking & Finance* 1012, 1014-1016. For empirical evidence confirming the effect of the economic cycle on NPLs, see Mario Quagliarello, 'Banks' riskiness over the business cycle: a panel analysis on Italian intermediaries' (2007) 17 *Applied Financial Economics* 119; and Vicente Salas and Jesús Saurina, 'Credit risk in two institutional regimes: Spanish commercial and savings banks' (2002) 22 *Journal of Financial Services Research* 203.

[52] Idiosyncratic causes of NPLs are applicable only to a specific bank in contrast with systemic and macro-economic causes that manifest at the level of the financial system.

Theoretically, the relationship between cost efficiency and NPLs can go both ways. Low cost efficiency may be associated with higher levels of NPLs as it is the result of poor management which means that there is weak appraisal and monitoring of potential borrowers. Conversely, it could be the case that banks with higher cost efficiency tend to have more NPLs as economising on valuable resources to screen borrowers and monitor loans can increase cost efficiency but may also lead to higher stocks of NPLs. The low-cost-efficiency explanation is essentially one of bad management and raises corporate governance issues of directorial and managerial skills (e.g. the screening of potential borrowers at the point of loan origination, monitoring of credit quality during the life of the loan and awareness of available restructuring options for NPLs), experience and expertise, quality of oversight, and robustness of internal control procedures. The high-cost-efficiency explanation is one of banks taking excessive credit risk in order to boost short-term profitability to the benefit of shareholders and managers via their performance-based remuneration. In corporate governance terms, it is an illustration of the tension between the profit maximising tendencies of banks that are often listed on a public market and find themselves under severe market pressures to deliver shareholder value, and the safety and soundness of the banking system.

Empirical evidence lends ample support to the low-cost-efficiency explanation (frequently described in the literature as the bad management hypothesis).[53] This, however, does not exclude the possibility that deliberate risk taking may have contributed to the accumulation of NPLs. Indeed, there is evidence of a correlation between alignment of management with shareholder interests and poor bank financial performance at times of crisis, which implies that alignment leads to higher risk taking in line with the risk appetite of diversified institutional investors.[54] As the two effects are opposite, what the evidence shows is that – on balance – it is banks with lower cost effectiveness that tend to have higher stocks of NPLs. Empirical studies have also found

[53] Allen N. Berger and Robert DeYoung, 'Problem loans and cost efficiency in commercial banks' (1997) 21 *Journal of Banking and Finance* 849, 852-853; see also Jirí Podpiera and Laurent Weill, 'Bad luck or bad management? Emerging banking market experience' (2008) 4 *Journal of Financial Stability* 135, 136-137.

[54] For empirical evidence on the link between shareholder value maximisation and risk of failure in banks, see David H. Erkens, Ming Yi Hung and Pedro Matos, 'Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide' (2012) 18 *Journal of Corporate Finance* 389, 391-392; and Daniel Ferreira et al., 'Measuring Management Insulation from Shareholder Pressure' (2016) LSE Law, Society and Economy Working Papers 01/2016, 8; and Andrea Beltratti and René Stulz, 'The credit crisis around the globe: Why did some banks perform better?' (2012) 105 *Journal of Financial Economics* 1, 2-3.

support for the moral hazard hypothesis according to which banks with lower capitalisation have higher amounts of NPLs as their managers (and shareholders) face stronger incentives to increase the riskiness of their portfolios.[55] This is clearly a matter of incentives and goes back to the tension between short-term profitability and prudent risk management or lending to affiliated firms in the case of banks with controlling shareholders as explained in detail in the next section.[56]

It follows that bank corporate governance is one of the determinants of the size of NPLs and that there are two mechanisms through which internal governance structures can lead to a higher volume of NPLs: poor management of the lending, monitoring and NPL restructuring processes, on the one hand, and incentives to pursue short-term profitability on the other. In this regard, especially vis-à-vis the aspect of identifying, reporting and resolving NPLs *ex post*, the situation can be usefully analysed through the prism of the agency costs of overvalued equity theory. The equity of a listed company is overvalued when the prevailing market price of its shares exceeds the fundamental underlying value, for instance, in cases where the capital market is not strongly efficient because it lacks the same level of management information. In such cases, management faces strong incentives to display their power to maintain and feed the bubble. As Jensen succinctly put it:

> To appear to be satisfying growth expectations you use your overvalued equity to make acquisitions; you use your access to cheap debt and equity capital to engage in excessive internal spending and risky negative net present value investments that the market thinks will generate value; and eventually you turn to further manipulation and even fraudulent practices to continue the appearance of growth and value creation.[57]

A listed bank with a high but undisclosed stock of NPLs, which is not known to the market and regulators, is a prime example of a company with overvalued equity. If the

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[55] Berger and DeYoung (n 53).

[56] This is consistent with prior economic studies examining relevant incentive effects. See e.g. Philippe Aghion, Patrick Bolton and Steven Fries, ‘Incentive Effects of Conditional Bank Recapitalisation: Lending and Disclosure of Non-Performing Loans’ in Hiroshi Osano and Toshiaki Tachibanaki (eds), *Banking, Capital Markets and Corporate Governance* (Palgrave Macmillan 2001) 32-33; Thomas Flanagan and Amiyatosh Purnanandam, ‘Why Do Banks Hide Losses?’ (2019), available at https://www.fdic.gov/bank/analytical/cfr/bank-research-conference/annual-19th/papers/28-flanagan.pdf; and Marina Balboa, Germán López-Espinosa and Antonio Rubia, ‘Nonlinear dynamics in discretionary accruals: An analysis of bank loan-loss provisions’ (2013) 37 *Journal of Banking & Finance* 5186, 5187-5188.

[57] Jensen (n 13) 10.

market was aware of the true quality of the bank's assets, the share price would be significantly lower. Thus the management of such a bank faces perverse incentives to take risks even with a negative net expected value[58] and resort to unethical or even illegal practices in order to satisfy the unrealistic expectations of the market and delay the emergence of the truth regarding the bank's value.

A case in point is the 1980s savings and loans crisis that manifested the operation of perverse incentives on behalf of bank managers when making judgements with regard to borrowers' ability to repay.[59] Mortgage-providing banks and mortgage co-operatives with low levels of capital preferred to resort to forbearance and very slow intervention, which allowed losses to mount.

The issue of poor corporate governance as a determinant of high NPL ratio can also be evidenced in the failures of Italian unlisted mutual banks, Veneto Banca and Banca Popolare di Vicenza.[60] These banks provided 'kissing shares' – borrowers were granted loans that otherwise would not have been granted or would be granted on less favourable terms under the condition that they would buy shares in the banks. As a result, both banks were simultaneously expanding their capitalisation, shareholding base and their loan portfolio.[61] Because the banks were not listed, the price of their shares was determined on an annual basis by management, endorsed by the board, validated by auditors and submitted for approval to the shareholders' meeting, including those shareholders that benefitted from the loans.[62] Share prices were calculated at 1.5 times the banks' net assets, while other banks were at the time pricing their shares at 0.5 times. It was clear that the lack of sustainability and soundness of the lending practices associated with the 'kissing shares' accelerated the deterioration of credit risk, including the creditworthiness of borrowers and the value of collaterals.

[58] Such risks are not in the interests of shareholders. Senior managers may take such decisions because in the good scenario the returns will be high enough to satisfy the unrealistic market expectations on the firm's financial performance.

[59] George Kaufman, 'The U.S. Banking Debacle of the 1980s: A Lesson in Government Mismanagement' (1 April 1995) FEE, available at https://fee.org/articles/the-us-banking-debacle-of-the-1980s-a-lesson-in-government-mismanagement/.

[60] Benoit Mesnard, Anne Claire Duvillet-Margerit and Marcel Magnus, 'The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza' (25 July 2017), European Parliament, Economic Governance Support Unit, 3-4.

[61] ECB, 'ECB deemed Veneto Banca and Banca Popolare di Vicenza failing or likely to fail', 23 June 2017, available at https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html.

[62] Silvia Merler, 'Bank liquidation in the European Union: clarification needed' (December 2017), Bruegel Policy Contribution No 32, 2-3, available at http://bruegel.org/wp-content/uploads/2018/01/PC-32_2017.pdf.

Another case of mismanagement as a cause of a high stock of NPLs is found in the failure of Italian Banca Carige which accessed the GACS backed securitisation scheme, a form of state guarantee of banks' senior tranches of securitised NPLs.[63] Specifically, Carige reported a level of forborne loans around 3% of the total loan book (and a gross NPL ratio of 27.5%) despite previous rights issues in 2014 and 2015 (the latter after failing the ECB's stress test) that raised €800 million and €850 million respectively.[64]

At this point, it is pertinent to explain the ways in which banks can avoid classifying a problematic loan as an NPL within the current regulatory framework. Banks are entirely permitted and to an extent encouraged by ECB guidance, to apply forbearance either before a loan has become non-performing or after a loan has become nonperforming. In the case that a loan has not become an NPL, because the debtor has not defaulted yet but has disclosed to the bank the financial difficulty or because the debtor has defaulted but the 90 day period has not lapsed, the bank may decide to renegotiate the loan terms to facilitate the debtor's performance. For instance, a payment moratorium may be granted, payments may be reduced for a certain period of time, the loan's repayment may change to interest only, the interest rate may be reduced, the term of the loan may be extended, several debts may be consolidated, and new credit may be advanced.[65] The ECB guidance requires banks to consider carefully whether in such cases they should classify the loan as an NPL but leaves the decision at their discretion.[66] Thus banks can use forbearance to prevent a loan from becoming an NPL in the first place. If the debtor fails to keep up with the new terms of the loan, it will then become an NPL. Once a loan has become an NPL, forbearance can be used to return it to performing status, a process known as curing the loan.[67] Regulatory rules require that, for the loan to be restructured and declassified as NPL, one year must lapse

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[63] The Guarantee on Securitization of Bank Non-Performing Loans (GACS) introduced by Italian Law No 49/2016 is an aid-free scheme aiming to assist Italian banks in securitising and moving NPLs off their balance sheets. The State guarantee consists in remunerating the senior notes at market terms according to the risk taken, i.e. in a manner acceptable for a private operator under market conditions. See Thomas Hale, 'The curious case of Banca Carige', *Financial Times* (2 January 2019).

[64] Cristina Dias, Jérôme Deslandes and Marcel Magnus, 'Recent measures for Banca Carige from a BRRD and State Aid perspective' (January 2019) European Parliament, Economic Governance Support Unit, 2.

[65] See European Central Bank, 'Guidance to banks on non-performing loans' (2017) [4.2] available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf (to be referred to forthwith as the "ECB NPL Guidance").

[66] Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to CRR [2014] OJ L191, Annex V, para 178.

[67] Vicki Been, Mary Weselcouch, Ioan Voicuc and Scott Murff, 'Determinants of the incidence of U.S. Mortgage Loan Modifications' (2013) 37 *Journal of Banking & Finance* 3951, 3968-3969.

after the forbearance action is taken during which the debtor must fulfil its obligations in full.[68] Forbearance measures in this context include those mentioned above as well as capitalisation of arrears.

We are not arguing that forbearance is necessarily a manifestation of the managerial agency problem and that is always against the long-term interest of banks and financial stability. On the contrary, forbearance is often the suitable strategy to maximise the chances of full repayment of the loan or to minimise the bank's losses by avoiding unduly aggressive enforcement against borrowers. It may also be beneficial for borrowers and the real economy, as is the case during temporary exogenous shocks such as the one caused by the COVID-19 pandemic.[69] Therefore, it is important to distinguish between forbearance for legitimate business reasons and non-viable forbearance. We observe that non-viable forbearance, particularly in circumstances that there is no realistic prospect of payment, leads to a delay in taking more appropriate steps to resolve NPLs such as legal enforcement and sale to a specialist entity with the effect of increasing banks' losses. ECB guidance provides that forbearance should only take place when it is viable and contains several high-level principles to that effect. Regarding the risk of misuse of forbearance, the ECB guidance highlights the need for any forbearance measures to have as their primary aim to return distressed exposures to a state of sustainable repayment. The supervisory experience suggests that in many cases, forbearance measures granted by banks "are not fully in line with that objective and thus may delay necessary actions to tackle asset quality issues and lead to a misrepresentation of asset quality on the balance sheet." [70]

In this context, it is often impossible to distinguish *ex ante* between viable and non-viable forbearance. Forbearance measures that at the beginning appear fully

[68] See EBA Implementing Technical Standards on supervisory reporting on forbearance and nonperforming exposures under Article 99(5) of the CRR. Based on Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 laying down implementing technical standards with regard to supervisory reporting of institutions according to CRR [2015] (OJ L48/1).

[69] In the UK, banks have been required by the FCA to provide a 3-month repayment holiday to any mortgage holders who claim that they have been adversely affected by the pandemic. See FCA, 'Mortgages and coronavirus: our guidance for firms' (20 March 2020) available at https://www.fca.org.uk/firms/mortgages-coronavirus-guidance-firms. The UK is no longer a member of the European Union and the applicability of EU law to UK banks after the end of 2020 remains uncertain. However, as for the time being EU law still applies to the UK, references will be made to UK law and regulation where appropriate throughout this paper. In parallel, the EBA has also encouraged banks to take a liberal interpretation of forbearance and refrain from characterising loans as non-performing during the pandemic. See EBA, 'EBA statement on actions to mitigate the impact of COVID-19 on the EU banking sector' (12 March 2020), available at https://eba.europa.eu/eba-statement-actions-mitigate-impact-covid-19-eu-banking-sector.

[70] ECB NPL Guidance [4.1].

commercially justified may, as the situation unfolds, need to be reassessed in the light of changing circumstances of the borrower or of the economy at large. A case in point is provided by the current COVID-19 pandemic. Forbearance measures offered to borrowers (often with regulatory encouragement or compulsion) were at the beginning of the crisis probably entirely legitimate, as it appeared that the crisis would have a short duration. But as the situation persists and its impact on the economy becomes clearer a more cautious approach by banks is warranted. From a regulatory perspective it is inevitable that bank management will retain a broad margin of discretion in making forbearance decisions. Therefore, direct regulation of NPL recognition by adopting a clear definition of NPLs and mandating disclosure is not in itself sufficient, as forbearance feeds back into the definition of NPLs. Strengthening the current framework must thus encompass enhancing the applicable incentives and decision-making processes. This justifies the corporate governance focus of the reform proposals adopted in this study.

2. Shareholders' and managers' incentives in the NPLs scenario

This part provides an original analysis of the manifestation of the managerial agency problem in the context of NPLs which brings to light a previously identified raison d'être behind high-NPL incidence and will form the basis for the reform proposals advanced in the following section. As our discussion intends to apply to large EU banks in general,[71] and in view of the wide range of banks that exist, it is helpful to explore certain distinct categories of banks from a corporate governance perspective. A useful typology would be the following: (1) listed banks with dispersed share ownership; (2) listed banks with at least one significant private-sector block-holder; and (3) listed banks where the State is a significant block-holder. Non-listed banks will not be considered as part of this study.

In the case of listed banks with dispersed share ownership the main agency problem is between management and shareholders in general. Managers may transfer wealth from the company to themselves or put suboptimal effort in discharging their duties.[72]

[71] The scope of our analysis covers large EU banks that are domestically systemically important; for countries that are part of the Banking Union these banks are directly supervised by the ECB.

[72] This concept was first applied to a corporate context by the seminal paper of Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 308, 309-310.

For listed banks with at least one significant private-sector block-holder, there is the additional agency problem between the block-holder and the other shareholders the extent of which depends on the voting power of the block-holder (e.g. super-majority, majority, blocking minority). For instance, controlling block-holders may extract private benefits of control from companies.[73] In banks where the State is a significant block-holder there is the additional agency problem between the State and other shareholders. This case is distinguished from the previous because governments are likely to pursue public policy or political goals beyond profit-seeking and, therefore, their behaviour as block-holders is likely to differ from that of private sector block-holders.[74]

We first consider the manifestation of incentives in banks with dispersed share ownership. It is necessary to distinguish between loan origination and NPL management. As far as loan origination is concerned, the long-term interests of rational bank shareholders are likely partially to diverge from regulatory policy. To the extent that bank shareholders are risk-neutral, and this will typically be the case in banks with dispersed share ownership, the level of risk that they will be content for the bank to take is the one that maximise the current net expected value of the bank and not the one that minimises insolvency risk.[75]

This is well-established and serves as the main justification for regulatory rules (e.g. capital, liquidity and leverage ratios and remuneration rules)[76] that constrain the ability of banks to take risks, even if such risks are desirable form the perspective of their shareholders. Rational shareholders may prefer a strategy of expansion of their loan portfolio, which increases the bank's insolvency risk and hence is not in line with regulatory expectations of prudent management of the bank's business. However, this is not to state that the managerial agency problem is not relevant. First, managers face

[73] Indeed, empirical evidence from the 1978-1982 period suggests that blocks of shares in listed American corporations amounting to at least 5% of voting rights were sold at a premium averaging 20% above market value; this reflect the private benefits of control. See Michael J. Barclay and Clifford G. Holderness, 'Private benefits from control of public corporations' (1989) 25 *Journal of Financial Economics* 371. For a discussion of the effects of concentrated share ownership from a continental European perspective, see Luca Enriques and Paolo F. Volpin, 'Corporate Governance Reforms in Continental Europe' (2007) 21 *Journal of Economic Perspectives* 122, 123.

[74] State-owned banks' business strategy is likely to be influenced by the political interest of government officials and government ownership of banks is not, generally, conducive to financial or economic development. On this discussion see Rafael La Porta, Florencio Lopez-De-Silanes and Andrei Shleifer, 'Government Ownership of Banks' (2002) 57 *The Journal of Finance* 265, 281.

[75] See Kokkinis (n 49) 14.

[76] For an overview of these regulatory rules see Iris H-Y Chiu and Joanna Wilson, *Banking Law and Regulation* (Oxford: Oxford University Press 2019) 579-580.

incentives to approve loans to borrowers of low creditworthiness even in cases where this is against the interests of the bank and therefore its shareholders. This may be due to suboptimal executive remuneration structures that unduly incentivise revenue growth and a bank's market share. Second, poor quality management can lead to origination of loans business units advancing loans to borrowers in circumstances that the credit risk undertaken is not fully compensated by the interest rate charged. Such loans are both value-decreasing for shareholders and increase a bank's insolvency risk. Therefore, both shareholders and regulators have a common interest in effective and expert management of the loan origination process.

Further, we turn our attention to the analysis of incentives in banks with controlling shareholders, as is the case with most banks in continental Europe. Significant block-holders (either public or private) are less likely willingly to support the same level of risk-taking as dispersed shareholders, as they are not diversified and, therefore, tend to be risk-averse. At the same time, they may influence management to divert loans towards other companies in which they hold a controlling stake, particularly in the case of banks that are part of a corporate group controlled by a block-holder, such as the Portuguese Banco Espirito Santo.[77] Such banks, moreover, may be more prone to ineffective management, as they are not under the same institutional investor pressure for effective governance as banks with dispersed share ownership.[78] The risk of ineffective management also applies to banks where the State is a significant block-holder. Moreover, for these banks there is a risk of political interference with lending decisions that can lead to lending to non-creditworthy but politically connected individuals and firms and hence to poor asset quality.[79]

Turning to the management of NPLs, the long-term interest of bank shareholders, including private block-holders, is to recover as much as possible the value of NPLs in order to minimise losses. This is also in the interest of regulators and financial stability

[77] Banco Espírito Santo (BES) secretly lent money to its controlling shareholder routing undeclared loans to Espírito Santo International (ESI) through Panama. The collapse of BES was mainly determined by the fact that the lender was not insulated from the problems of the Espírito Santo family's holding companies. See Miles Johnson and Peter Wise, 'Banco Espírito Santo secretly lent funds to controlling shareholder', *Financial Times* (11 September 2014); 'Banco Espírito Santo: Family fortunes', *Financial Times* (11 September 2014).

[78] This observation rests on the assumption that the disciplinary effect of capital markets mitigates agency costs. This disciplinary effect is stronger where capital markets are more informationally efficient. On the concept of capital market efficiency see Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *The Journal of Finance* 383, 413-414.

[79] LaPorta et al. (n 74) 282.

as loss minimisation reduces banks' insolvency risk. However, it is in the interest of any shareholders who invest following a short-term arbitrage strategy for a bank to conceal NPL. This is because such investors prefer the bank's shares to remain overvalued, so that they can "ride the bubble" in the hope that they will have sold their shares and realised their gains before the bubble bursts. In parallel, the state as a block-holder may also put pressure on bank managers to conceal NPLs by resorting to unviable forbearance, due to the political cost of enforcement action by banks against borrowers, especially in the case of residential mortgages.

Furthermore, in the typical case, it is in the interest of bank managers to mask problematic loans even if this eventually increases losses to the bank. A bank with a high stock of problematic loans that have not been formally categorised as NPLs would suffer a sharp decrease in its share price if management changed policy and categorised them as NPLs. For loans that are not only NPLs but also qualify as loans in default under Capital Requirements Regulation (CRR),[80] the bank will have to increase its capital which further harms shareholder value. For loans that further qualify as impaired,[81] the bank should reflect this on its balance sheet, thus directly reducing its net income and shareholder equity. Such a decrease in share prices, even if in the long-term interests of shareholders, is not in the interests of bank directors and senior managers.

Executive directors and managers are paid to a large extent by variable remuneration[82] and, in the UK, also receive fixed pay allowances in shares.[83] This generates a powerful incentive to deliver shareholder value and means that a sharp decrease in the share price leads to the loss of large amounts of remuneration (loss of

[80] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms [2013] OJ L176/1, art 178. The Capital Requirements Regulation has been amended by the EU Regulation 2019/876 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 ('CRR 2').

[81] Under the International Accounting Standard (IAS) 39.

[82] Variable or performance-based remuneration is remuneration the amount of which depends on financial and non-financial performance at the levels of individual executives, business units and corporate groups. In banks, the use of variable remuneration is heavily regulated by CRD IV arts 92-94.

[83] These are forms of fixed remuneration that are designed to incentivise executives to deliver shareholder value in order to circumvent the bonus cap imposed by CRD IV. For an analysis see Andreas Kokkinis, 'Exploring the effects of the "bonus cap" rule: the impact of remuneration structure on risk-taking by bank managers' (2019) 19 *Journal of Corporate Law Studies* 167, 190-192. For a broader discussion of the regulatory framework on bank executive remuneration, see Marc T. Moore, 'Design and Control of Remuneration in UK Banks' in Iris H-Y Chiu (ed), *The Law on Corporate Governance in Banks* (Cheltenham: Edward Elgar 2015).

annual bonus for the year when it takes place, loss of value of unvested shares, loss of value of vested retained shares etc.). The CRD IV regulatory framework that requires deferral of a substantial portion of variable remuneration for a period of at least three years[84] has mitigated the short-term effects caused by variable remuneration. Still, in the case of NPL recognition senior managers tend to expect that they may permanently avoid certain loans being characterised as NPLs through the use of forbearance and therefore deferral is of little help to curb their incentives to mask NPLs. Furthermore, both executive and non-executive directors may be removed from office after a significant decline in the bank's share price due to a hostile takeover or as a result of the shareholders replacing them. The former scenario is more likely in banks with dispersed share ownership while the latter scenario is more likely in banks with significant block-holders. Bank CEOs and other senior executives may also be removed by the board if it consists of a majority of independent directors. In short, the risk of financial loss incentivises bank directors and senior managers to conceal problematic loans.

In parallel, masking NPLs may also be the result of irrational behaviour in the form of "end of the day" bias, which manifests when individuals have already suffered losses compared to an original reference point and then take excessive risks to compensate for their losses before the end of the relevant reference period.[85] Senior managers responsible for a loan portfolio with a high incidence of losses may be tempted to conceal the losses hoping that subsequent gains will outweigh them and, in doing so, they may engage in negative-net-value transactions that, if successful would provide sufficient profits to outweigh the existing losses.

Drawing the different strands of the analysis together, the following remarks can be made. In banks with dispersed share ownership, short-termist capital market pressures push senior management to delay and avoid recognition of NPLs. In banks with controlling shareholders, the private interests of the controlling shareholder or political considerations, such as social welfare and politically connected lending, in

[84] CRD IV, art 94(2)(m) and EBA Guidelines on Sound Remuneration Polices (2015) EBA/GL/2015/22, Guideline 15.2, available at https://eba.europa.eu/regulation-and-policy/remuneration/guidelines-on-sound-remuneration-policies.

[85] This bias was first observed in the context of horse racing. Gamblers who have made large losses during a racing day tend to make increasingly risky bets towards the end of the day as such bets, if successful, would allow them to return to the position they were at the beginning, which is seen as the relevant reference point. See Amos Tversky and Daniel Kahneman, 'Judgment Under Uncertainty: Heuristics and Biases' in Paul Slovic, Amos Tversky and Daniel Kahneman (eds), *Judgment Under Uncertainty: Heuristics and Biases* (Cambridge: Cambridge University Press 1982).

case the controlling shareholder is the government can lead to similar perverse pressures on senior management. An additional problem for these banks is the risk that controlling shareholder presence on, and influence over, the board can lead to reduced board competence and expertise. At the same time, through incentives created by variable executive remuneration and as a result of the fear of dismissal, senior managers face further incentives to conceal NPLs even in circumstances that this is not encouraged by the shareholders, particularly in the case of banks with dispersed share ownership. This is further exacerbated by behavioural biases that can affect senior managers' decision making. The value of examining these three types of bank share ownership separately is that – even if some of the resulting problems are identical – the reasons behind them differ and therefore the separate analysis is essential to refute potential arguments that perverse incentives arise only in banks with dispersed share ownership. At the same time, in banks with concentrated ownership there is a distinctive problem of senior management capacity.

IV. THE REGULATORY REGIME ON NPL DECISION-MAKING PROCESSES

This section analyses the European regulatory regime on the governance of lending and NPLs, including recent and on-going policy-maker initiatives, and assesses its adequacy. This assessment forms the ground on which to identify potential areas where reform may be needed. The regulatory regime in question comprises general regulatory rules on risk management, compliance and internal audit as well as specific European Banking Authority (EBA) guidelines on managing NPLs, and proposed guidelines on the management of the lending process.

To begin with, decision-making relating to lending is evidently connected to *ex ante* credit risk, while decisions on how to deal with distressed loans is connected to *ex post* credit risk. Thus, safeguarding asset quality by screening borrowers, monitoring loans and resolving NPLs is an integral part of a bank's risk management function which aims to set the risk appetite of each bank and ensure that business is conducted in a way consistent with it. In regulatory terms, boards are expected to approve and periodically review banks' policies on risk management, monitoring and mitigation.[86] Large banks

[86] CRD IV, art 76 (1).

have to establish risk committees consisting of non-executive directors, whose role is to advise the board on the formulation of the institution's risk appetite and strategy and to assist the board in the oversight of the implementation of the risk strategy by senior management.[87] Banks have to ensure the existence of sound reporting lines to the board covering all main risks, and that boards and risk committees have access to all necessary information.[88] Banks are required to establish and maintain a distinct risk management function, which should be independent from operational functions, sufficiently resources and able to report directly to the board.[89] Moreover, in large financial institutions the head of the risk management function, the CRO, should be a "an independent senior manager with distinct responsibility for the risk management function".[90] CROs must have a substantial degree of independence from CEOs, in the sense that they should only be removable from their post by approval of the board and must have direct access to the board. It is also worth noting that the EBA amended in 2017 its guidelines on firms' internal governance to further emphasise the risk oversight duty of boards and risk committees.[91]

The role of the compliance function on loan origination and NPL management is to ensure that applicable regulatory rules and complied with, including, as appropriate, soft law rules such as ECB and EBA guidance. In the context of monitoring compliance with the ECB guidance on NPLs, the risk management function is relied on as the second line of defence, while the senior management of the NPL workout unit in each bank is considered to be the first line of defence.[92]

The significance of the internal audit function with regard to NPLs lies in the identification and reporting of NPLs, which is a prerequisite for bank boards and regulators to be able to have a clear picture of the level of NPLs in a bank and to take appropriate action. Internal audit constitutes the third line of defence according to the

[87] CRD IV, art 76 (3).

[88] CRD IV, art 76 (2) and (4).

[89] CRD IV, art 76 (5).

[90] Ibid. For an early discussion of the role of chief risk officers see Andre P. Liebenberg and Robert E. Hoyt, 'The Determinants of Enterprise Risk Management: Evidence from the Appointment of Chief Risk Officers' (2003) 6 *Risk Management & Insurance Review* 37.

[91] See EBA, 'Final Report on Guidelines on Internal Governance' (EBA/GL/2017/11, 2017). The relevant consultation closed on 28 January 2017. See EBA, 'Consultation on Guidelines on Internal Governance (Revised)' (EBA/CP/2016/16, 2016), available at https://www.eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance-revised-/-/regulatory-activity/consultation-paper;jsessionid=6A0D7509AA06AA3B77369D0CF89014BD.

[92] ECB NPL Guidance [3.4.1] – [3.4.2].

ECB guidance.[93] In that context, the role of audit committees is crucial as they are tasked to oversee the effectiveness of the internal audit function and in particular to ensure that it is not unduly influenced by senior management.

Furthermore, it is pertinent to examine the ECB guidance on the role of bank boards and senior management on loan origination and NPL management and on the remuneration of relevant officers. In banks with high NPLs the board[94] is expected to approve annually and review regularly the NPL strategy and policies,[95] and operational plan, as part of its overall strategy-setting responsibilities.[96] It is also required to oversee and monitor the implementation of the strategy, and define adequate approval processes for major decisions which should include approval by the board itself in the case of major NPL exposures.[97] In terms of incentives, the board is given the task of setting appropriate incentives for those involved in NPL workout activities. In particular, the Guidance emphasises that:

> Staff and management involved in NPL workout activities should be provided with clear individual (or team) goals and incentives geared towards reaching the targets agreed in the NPL strategy, including the operational plan.[98]

Furthermore, ECB guidance contains the following principles that aim to ensure that forbearance is viable. Short-term forbearance should only be applied when the borrower has experienced an identifiable event that has caused liquidity constraints and only insofar as the borrower has maintained a good financial relationship with the bank and has shown clear willingness to cooperate. Every forbearance solution, either short-term or long-term must be affordable to the borrower. Furthermore, short-term forbearance measures must be truly temporary, and banks should not take multiple consecutive forbearance measures granted for the same exposure.[99] Sensible as this guidance may be, it remains entirely up to banks to apply it in practice and given the

[93] Ibid [3.4.3].

[94] The ECB Guidance uses the terminology management body to refer either to a unitary board or to the management board in Member States that follow or permit the two-tier board system. The discussion herein uses the term "board" to denote both the unitary board and the management board in two-tier systems.

[95] The ECB NPL Guidance Annex 5 requires banks to have the following NPL-related policies: (1) Arrears Management Policy; (2) Forbearance Policy; (3) Debt Recovery Policy; (4) Classification and Provisioning Policy; (5) Write-off Policy; (6) Multi-bank distressed debt Policy; (7) Collateral Policy; (8) Early warning/ watch-list Policy; (9) Outsourcing/ NPL Servicing Policy.

[96] ECB NPL Guidance [3.2].

[97] Ibid.

[98] Ibid [2.5].

[99] ECB NPL Guidance [4.1].

fluid nature of notions of affordability, good relationship and the non-binding nature of the guidance, the importance of effective internal governance processes and well-aligned incentives cannot be overemphasised.

A similar approach has been proposed by the EBA with respect to the avoidance of conflicts of interest in the context of loan origination. The EBA Consultation Paper provides that any bank officer (including a director) who has a personal or professional relationship with a potential borrower or who is subject to a variable remuneration scheme that uses the growth of new business as a metric of performance, should be excluded from any functions concerned with loan origination and from the credit risk management function.[100] Moreover, the proposed guidelines suggest that any variable remuneration of staff involved in credit granting should be linked, among other metrics, to the long-term quality of credit exposures and, where financial performance metrics are used, these should include credit quality metrics and be in line with the bank's credit risk appetite. In parallel, according to the guidelines, variable remuneration should not incentivise mis-selling practices that harm the interests of consumers.[101]

In terms of the actual organisational structure of NPL workout units, the ECB guidance promotes the operating model of internal but independent workout units, without specifying whether these should be a business division of the parent company of the banking group or a wholly-owned subsidiary company. Use of outsourcing should only be resorted to, according to the ECB guidelines, in circumstances on which it is not possible or efficient to build in-house expertise and infrastructure.[102] The independence of NPL workout units entails that separate officers deal with all decisions relating to NPLs (e.g. forbearance, client relationship management, enforcement) and seeks to prevent conflicts of interest from arising. NPL workout units sit within the broader organisational structure of banks and must report to the risk management function, internal audit function and other enterprise-wide internal control systems. However, the guidance does not prescribe to whom should the NPL workout unit be responsible. Bank practice is not unanimous to this respect. For instance, NPL workout units in different banks are responsible to any of the following senior executives, the Chief Lending Officer (most commonly), the Chief Finance Officer (quite commonly),

[100] European Banking Authority, 'Draft Guidelines on loan origination and monitoring' (2019) EBA/CP/2019/04, available at https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-on-loan-origination-and-monitoring.

[101] Ibid [82].

[102] ECB NPL Guidance [3.3.1] – [3.3.3].

the Chief Risk Officer or, in the case of banks with very high NPLs, the Chief Executive Officer.[103]

Overall, banks face a range of agency problems in dealing with problematic loans, the exact nature of which being dependent on their share ownership structure. Such agency problems result in a misalignment between the interests of senior management and the long-term interest of banks with high NPLs. Regulatory rules on NPL-related decision-making processes and incentives are inevitably reliant on bank discretion for their implementation, as demonstrated in the discussion of the difficulties faced by regulators to *ex ante* distinguish between legitimate and unviable forbearance. This in combination with the non-binding nature of the current guidance (including the proposed guidance on loan origination) raises doubts in relation to the effectiveness of the current regime on the governance of NPLs. The next section advances a set of proposals to strengthen the applicable regulatory regime in terms of both processes and the regulation of incentives.

V. THE GOVERNANCE OF ASSET QUALITY AND NPL MANAGEMENT

We argue that a range of regulatory steps should be taken to strengthen the governance of NPLs in order to safeguard financial stability and further improve bank corporate governance. Empirical evidence suggests that weak risk management and controls, competitive pressures leading to excessive risk appetite and a lack of effective board oversight, and the limited expertise of board members in evaluating economic prospects can exacerbate the accumulation of NPLs.[104] Further, risk-management efficiency is related to the minimisation of NPLs.[105] As argued, ‘information risk and agency risk are relevant concerns in the context of a risk management system in terms of, for example, the reliability of information about firm risks and the risk taking of managers’.[106]

[103] Claudio Scardovi, *Holistic Active Management of Non-Performing Loans* (Cham: Springer International Publishing, 2016) 44-50.

[104] European Systemic Risk Board, ‘Macroprudential approaches to non-performing loans’ (January 2019) 17.

[105] Jean-Philippe Boussemart, Hervé Leleu, Zhiyang Shen, Michael Vardanyan and Ning Zhu, ‘Decomposing banking performance into economic and risk management efficiencies’ (October 2017) IÉSEG Working Paper Series 2017-EQM-09, 5.

[106] Sara A. Lundqvist and Anders Vilhelmsson, ‘Enterprise Risk Management and Default Risk: Evidence from the Banking Industry’ (2018) 85 *Journal of Risk and Insurance* 134.

The corporate governance reforms discussed in the following paragraphs would not be legally binding as they would form part of ECB guidance, but would have significant persuasive authority in view of ECB's strong regulatory powers and wide margin of discretion.[107] In general, taking an interventionist approach to bank corporate governance is consistent with the public interest in financial stability and the dissonance between profit maximisation and the prudent management of risk that is required by prudential regulatory authorities.[108] This means that relying exclusively on self-regulation and market forces in terms of bank corporate governance is undesirable, as the governance practices that are likely to emerge from private ordering are unlikely to be in line with the goals of the regulatory regime.

However, it is crucial to bear in mind that, although bank shareholders and senior managers face incentives to delay the recognition of NPLs, a complete removal of discretion in this area in favour of tight regulatory control would not be appropriate. Forbearance is often legitimate and continued reliance on discretion by banks is inevitable. Further, as is generally the case in corporate governance, each bank has distinct organisational characteristics and needs, and hence one-size-fits-all approaches are likely to be inefficient and lead to negative unintended consequences.[109] A balanced approach is required whereby banks are given sufficient scope to determine the optimal governance framework for NPLs under effective regulatory supervision. Such a balanced approach requires the ECB to take into account the type of share ownership of each bank (dispersed, private block holder, public sector block holder) in determining the intensity of measures that should be taken by each bank, as will be explained in the following analysis.

Our proposal relies on formulating detailed regulatory guidance blended with flexibility for banks to implement alternative – but equally effective – processes and is

[107] For a detailed discussion of the role of the ECB and its relationship with NCAs as part of the Banking Union, see Niamh Moloney, 'European Banking Union: Assessing its risks and resilience' (2014) 51 *Common Market Law Review* 1609, 1629-1630.

[108] See John Armour and Jeffrey N. Gordon, 'Systemic Harms and Shareholder Value' (2014) 6 *Journal of Legal Analysis* 35, 50-51; see also Kokkinis (n 49) 16-18. At the same time, it is worth noting that the global financial crisis has convinced commentators that broader reforms to the general corporate law and corporate governance framework are necessary. See e.g. William Lazonick, 'From Innovation to Financialization: How Shareholder Value Ideology is Destroying the US Economy' in Martin H. Wolfson and Gerald A. Epstein (eds), *The Handbook of the Political Economy of Financial Crises* (Oxford: Oxford University Press 2013).

[109] In corporate governance, the standard UK and EU regulatory approach is the "comply or explain" approach or its more recent variance the "apply and explain" approach. For a discussion of the effectiveness of "comply or explain" and a critical assessment see Keay (n 47) 281-293.

therefore likely to generate long-term benefits for both bank corporate governance and regulatory design through a mutual learning process. Banks' experimentation with alternatives will permit the gradual refinement of their approaches and, indeed, of the regulatory guidance which should be kept under review to reflect emerging optimal practices.[110] In this way, banks and their regulators will be involved in a continuing iterative process of experimentation, learning and negotiation of intended outcomes. This flexible approach mitigates the potential negative effects of extensive harmonisation of internal corporate governance that could in theory lead to banks becoming very similar and thus susceptible to the same type of risks and liable to face distress simultaneously thus undermining financial stability.[111] In any case, the measures proposed are not of such an extensive nature as to determine homogeneity among banks but rather they refer to specific aspects of their internal governance and many of them would only apply to banks with an NPL problem while others would apply more strictly to banks with certain share ownership structure.

The current regulatory guidelines are broadly phrased, and one might argue that the measures proposed herein could be implemented by the ECB as part of its discretionary supervisory powers within the current set of guidelines interpreted. That may be the case, but it does not reduce the importance of formulating more detailed and granular guidelines. Such guidelines would serve as clear and accessible guidance for banks and would thus enhance compliance and improve standards. They would also help frame the ECB's exercise of discretion and at the same time legitimise any interventions as they would be in line with previously promulgated principles. In general, broad regulatory discretionary powers do not undermine the need for certain and detailed *ex ante* rules which ensure that regulated entities understand what it expected of them thus facilitating compliance, contribute to the creation of social norms and institutional values in line with the rules, and serve as a framework that checks the exercise of discretionary power, legitimising it and mitigating the risk of both deficient and excessive enforcement.[112]

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[110] This is in line with the EU approach to regulating financial innovation that includes "multi-level dialogic frameworks for learning and coordination amongst various public and private sector actors". On this discussion, see Iris H-Y Chiu, 'Pathways to European Policy and Regulation in the Crypto-economy' (2019) 10 *European Journal of Risk Regulation* 738, 765.

[111] See e.g. Ian Ayres and Joshua Mitts, 'Anti-Herding Regulation' (2015) 5 *Harvard Business Law Review* 1, 32.

[112] Drawing from Nozick, we argue that explicit guidelines would set out principles that would perform two distinct functions: an interpersonal function of communicating these principles to the regulated entities and singling the regulator's commitment to enforce them, and an intrapersonal function

One further clarification is necessary. In the ensuing paragraphs reference will often be made to “banks with high NPLs”. This will be in the context of certain measures that should only apply to these banks and not to banks in general. However, by using this term we do not mean only banks that have already disclosed a high stock of NPLs, although such banks are evidently included. The term also encompasses banks that have resorted to widespread forbearance measures, perhaps viable perhaps not, that should be identified by the regulators and treated as banks with a potential NPL problem. By including these banks into the scope of measures, the immediate effect is to avoid the perverse incentives that would otherwise be created to elude the recognition of NPLs in order to circumvent the application of the additional measures. Identifying banks with high forbearance and thus with a potential NPL problem requires supervisory authorities to pay close attention to the data provided by banks and to exercise discretion, as this will inevitably entail qualitative judgement. It will also be necessary for the ECB guidance to provide a clear definition of a high NPL bank in line with our suggested proposals.

1. Procedural reforms of the internal governance of NPLs

With the above considerations in mind, we first highlight the pertinent issue of the location of NPL workout units within banks’ organisational structure. NPL workout units may currently be answerable to banks’ CFOs, CLOs or CROs and regulatory guidance simply states that distinct workout units should be established and that the board should have overall oversight of NPL strategy. Complete and up-to-date data to assess performance is essential to monitor the progress of workouts: in some banks data is simply not reliable or granular enough. For instance, loan documentation needs to include all the necessary information relating to the collateral and legal process to allow for cross-section and segmentation analysis.[113] Lehmann observed that ‘a workout group is an essential feature of any banking business, though it cannot salvage the

both at the level of the regulators and at the level of the senior management of the regulated entities whose future conduct may be constrained and influenced by these principles. See Robert Nozick, *The Nature of Rationality* (Princeton NJ: Princeton University Press 1993) ch 1.

[113] Sharon Donnery, ‘Setting the standard: NPL workout in the euro area’, speech at the event “Tackling Europe’s non-performing loans crisis: restructuring debt, reviving growth”, Brussels, 3 February 2017, 3-4, available at https://www.bis.org/review/r170206b.pdf.

business once loan distress has become systemic'.[114] Empirical studies have shown that the degree of specificity required to perform the workout tasks depends on the status of the underlying credit engagement.[115]

ECB guidance on NPLs should be amended to include more detailed standards on the governance of NPL workout units, while at the same time preserving essential flexibility in line with the principle that it is the responsibility of banks to design and maintain effective corporate governance procedures. In this regard, more flexibility should be granted to banks with dispersed share ownership, as banks with controlling shareholders or large block holders are more susceptible to inefficient organisational structures and pervasive senior management control over notionally autonomous business units. Consistently with the need to treat NPLs as an asset quality matter that can threaten the objectives of micro-prudential regulation, ECB guidance should require bank NPL workout units to be led by their CRO, the executive responsible for risk oversight and for ensuring that all activities are in line with a bank's risk tolerance profile, as set by the board.[116] This would mean that NPL workout units would form part of banks' risk management function which is headed by the CRO. The risk management function is one of the three internal functions in banks that perform a special regulatory role by serving both the interests and needs of the enterprise and regulatory objectives, the other two being the compliance function and internal audit.[117] The nascent distinct professional identity of staff working for the risk management function[118] can support the effectiveness of NPL management through their increased independence from other lines of business and their objectivity. In parallel, including NPL management within the scope of the internal risk management function would in itself increase the profile and powers of the risk management function in the organisation thus enhancing its ability to attract and retain talented staff and contributing to the development of a distinct professional identity.

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[114] Alexander Lehmann, 'Carving out legacy assets: a successful tool for bank restructuring?' (2017) Policy Contribution Issue n. 9, 5, available at https://bruegel.org/wp-content/uploads/2017/03/PC-09-2017-NPL-29317.pdf.

[115] Nico B. Rottke and Julia Gentgen, 'Workout management of non-performing loans. A formal model based on transaction cost economics' (2008) 26 *Journal of Property Investment & Finance* 59.

[116] See note 91 and accompanying text.

[117] For a detailed analysis of these three internal control functions in banks and an examination of their regulatory, organisational and professional dimensions, see Iris H-Y Chiu, *Regulating (From) the Inside: The legal Framework for Internal Control in Banks and Financial Institutions* (Oxford and Portland OR: Hart 2018) 41-42.

[118] Ibid., 108-109 and 274-275.

To further strengthen the role of the CRO, it would be advisable to require banks with high NPLs to have the CRO on their board as an executive director. This argument is supported by evidence that when CROs are members of the board their power in the organisation and ability to constrain risk taking increases.[119] That being said, the ECB should favour other organisational configurations if sufficiently explained and defended by high-NPL banks as, in corporate governance matters, flexibility is crucial. For some banks it might be preferable to have the CEO or CFO lead the NPL workout unit. However, in principle, the ECB should only accept alternative configurations where the NPL workout unit reports to a member of the board, for the same reasons as analysed above.

The responsibility of the CRO (or other executive director) for NPL management proposed raises the question of their liability under applicable regulatory regimes. In the UK, under the Senior Managers and Certification Regime individual senior managers must have clearly delineated areas of individual responsibility,[120] and are presumed to be liable for failures in their own areas of responsibility (reversed burden of proof).[121] Therefore, CROs to whom NPL workout units report would be likely to be found personally liable if NPL workout units failed to act diligently and in line with supervisory expectations. This would not be problematic, as it is in line with the rationale of our approach and ensures that senior management has a direct role in overseeing NPL workout units and faces incentives to seek to maximise the value of distressed portfolios. As a result, regulators must exercise discretion when deciding which enforcement cases to pursue so as to avoid excessive deterrence which would dissuade suitable individuals from undertaking the role of CRO or other executive responsible for NPLs.

In parallel, ECB guidance should clarify that risk committees[122] have a special duty to develop NPL strategy and make relevant recommendations to boards. To ensure that

[119] A study of a sample of 573 US banks found that banks whose CRO reported to the board rather than to the CEO performed better during the 2007-09 financial crisis. See Vincent Aebi, Gabriele Sabato and Markus Schmid, 'Risk Management, Corporate Governance, and Bank Performance in the Financial Crisis' (2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1942896.

[120] Financial institutions are obliged to accompany approval applications with a statement of responsibilities detailing the particular aspects of their affairs that the candidate is intended to undertake under the Financial Services and Markets Act (FSMA) 2000, Section 62A, inserted by the Banking Reform Act 2013, s 24.

[121] FSMA 2000, ss 66A-66B, inserted by the Banking Reform Act 2013, s 32.

[122] On risk management as part of corporate governance, see Marc T. Moore, 'The Evolving Contours of the Board's Risk Management Function in UK Corporate Governance' (2010) 10 *Journal Corporate Law Studies* 279.

in high-NPL banks boards and risk committees are well-equipped to perform their role on monitoring and resolving NPLs the regulatory guidance ought to require high-NPL banks to ensure that at least one independent non-executive director has expertise in NPL management.[123] These reforms would ensure that in banks with high NPLs the board takes a leadership role in monitoring and resolving the issue with direct input from the CRO and risk committee. The level of insulation of CROs and independent directors from shareholder pressure (either arising from the capital market or from private or public block-holders) could mitigate the problems identified in the previous section.

The other major procedural parameter in NPL governance is the potential role of independent NPL servicing companies that typically undertake to restructure and sell NPL portfolios and are paid via a fee that includes a flat component and a variable component that is usually set as a given percentage of the proceeds raised.[124] The use of such independent companies does not obviate the need for internal NPL workout units, as these are necessarily responsible for monitoring NPLs and ensuring appropriate categorisation of problematic loans. However, the use of servicing companies can bring benefits: it can reduce the risk of non-viable forbearance due to lack of expertise, perverse incentives or agency problems and can be efficient due to the specialisation and economies of scale that such companies benefit from.[125] This is not to say that this model is necessarily preferable to in-house restructuring. Evidently, this will depend on the resources of each bank and the special knowledge it has on the creditworthiness of borrowers. Regulatory guidance should require bank boards to make an explicit and justified decision on whether to use external NPL management companies, and to what extent, and supervisors should assess such statements and require amendments to be made if it appears that policies are not effective. As in the case of internal workout units, supervisors should devote closer attention to the justification provided for not using an independent company by banks with concentrated share ownership.

[123] In banks with two-tier boards, these could also be members of the supervisory board. For a discussion of German two-tier boards, see Klaus J. Hopt, 'The German Two-Tier Board: Experience, Theories, Reforms' in Klaus J. Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch and Stefan Prigge (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (Oxford: Clarendon Press 1998).

[124] Scardovi (n 103) 43-44.

[125] Ibid, 47-50.

2. Executive remuneration reforms for high-NPL banks

Finally, regulatory guidance on executive remuneration in high-NPL banks should be strengthened. This would be a selective policy applicable only to high-NPL banks (under the general obligation of banks as set in the CRD IV) to ensure that remuneration reflects the performance of the individual and of the business unit concerned, and that the measurement of performance includes an adjustment for all types of current and future risks.[126] It should be required that the variable remuneration of CROs in cases where they are responsible for overseeing NPL workout units is mostly tied to targets of NPL restructuring and other metrics of sound risk management rather than profitability. The same should apply to senior executives that lead NPL workout units and report to the CRO.

In relation to the variable remuneration of the CEO and other executive directors and top-layer senior managers in high-NPL banks, it should include NPL-related targets and asset quality targets at an adequate level, in proportion to the size of the bank's NPL portfolio. This approach would be likely to reduce the perverse incentives faced by incumbent senior executives to put pressure on subordinate officers to conceal the size of NPLs, e.g. through unviable forbearance practices. As any such metrics would reduce the sensitivity of senior executive remuneration to banks' profitability - hence engender a risk of increasing managerial agency costs to the detriment of equity investors - a balance must be struck between preventing perverse incentives in relation to NPLs and maintaining incentives to deliver good operational performance and revenue growth. This could be achieved by using metrics that measure a bank's financial performance before considering the provisions made to cover NPLs or the losses that result from writing off NPLs.

At the same time, regulators must also consider that action taken by individual banks to maximise the value of their distressed loan stock can have a negative cumulative effect on the stability of the financial system, if it leads to a deterioration of asset prices, as all banks try to sell off NPLs simultaneously. This is likely to happen in periods when many banks have a high number of NPLs, such as when an exogenous crisis or recession has led to a steep increase in NPLs across the financial sector. It follows that the macroprudential perspective[127] of assessing overall risks to financial

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[126] CRD IV, art 94 (1) (a) and (j).

[127] In the EU, the pinnacle of the macro-prudential framework is the European Systemic Risk Board, while in the UK, macro-prudential regulation is the responsibility of the Financial Policy Committee of

stability must prevail and that incentives created through regulation of executive remuneration for the timely and efficient restructuring of NPLs must not be permitted to undermine macro-prudential regulatory objectives. These measures should be applied more strictly in the case of banks with dispersed share ownership, as it is these banks that are likely to have executive remuneration packages that create a strong link between remuneration and financial performance, and independent remuneration committees strongly focused on shareholder value maximisation, as a result of market pressure from institutional investors.

VI. CONCLUSION

The timely and accurate classification of distressed loans and the avoidance of all types of non-viable forbearance are crucial for banks' asset quality, for the effective resolution of failing credit institutions and, more broadly, for financial stability. However, as bank senior managers inevitably tend to display broad discretion in determining which loans are classified as NPLs, the dynamics of their internal corporate governance typically create perverse incentives to conceal NPLs and may prevent banks from developing the necessary tools to deal with distressed assets.

To resolve such problems, we have advanced a set of guidelines pertaining to banks internal procedures and executive remuneration, parts of which would apply flexibly depending on whether a bank appears to have a significant NPL problem and on its share ownership structure. Regulatory guidance should require banks to incorporate NPL workout units into their general risk management function under the responsibility of the CRO and the supervision of the board's risk committee. It should also encourage banks to consider carefully whether they should use external NPL management companies. In parallel, regulators should ensure that, in high-NPL banks, the remuneration of senior executives does not create perverse incentives to mask NPLs, and that the remuneration of the CRO and other executives responsible for NPL workout units provides appropriate incentives to detect and restructure NPLs timely.

Strengthening the corporate governance mechanisms of NPL management can improve the disclosure of distressed assets and thus contribute to financial stability. At

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the Bank of England. For a discussion of the incremental transformation of macro-prudential regulation after 2008, see Andrew Baker, 'The gradual transformation? The incremental dynamics of macroprudential regulation' (2013) 7 *Regulation & Governance* 417, 424-425.

the same time, our proposals can advance the consolidation of the role of banks' internal risk management functions, CROs and board risk committees and can have positive ramifications on the quality of enterprise-wide risk management.