Non-Performing Loans (NPLs) – Regulators’ strategy to find a new balance

The New Regulatory Landscape for Non-Performing Loans (NPLs) in 2025: A Deep Dive into EU and Swedish Rules

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Recent years has been dominated by significant market volatilities, all from long period of low and even negative swap rates followed by strongly high interest rates. This in combination with several other factors, has impacted the behaviour of customers’ repayment and banks’ credit granting strategy and their strategy to manage their loan portfolio, in particular their Non-performing Loans (NPLs).

Non-performing loans (NPLs) have long been a focal point of regulatory reforms in Europe as banks and financial institutions seek to reduce risks associated with bad debts. With the advent of new rules that will take effect in early 2025, both at the EU and national member state levels, institutions handling NPLs face a significantly altered regulatory environment. These changes are designed to streamline NPL management, improve transparency, and ensure adequate capital and liquidity buffers are in place. This article will explore the key aspects of the upcoming changes, focusing on both EU-wide regulations and specific rules in Sweden.

The Context of NPLs and Their Impact

Non-performing loans, defined as loans where the borrower is unable to meet repayment obligations for an extended period (*or overdue by 90 days as defined in CRD IV/CRR II*), pose significant risks to financial institutions. If unchecked, NPLs can lead to capital erosion, lower profitability, and, in extreme cases, financial crises. During the aftermath of the 2008 financial crisis and the European sovereign debt crisis, NPL levels soared, prompting regulators to focus on reducing NPL exposures across European banks.

Over the past decade, regulatory frameworks have aimed to incentivize banks to clear NPLs off their balance sheets through sales or other mechanisms. However, with the financial environment continually evolving, the European Union and national regulators, including Sweden, have developed a set of reforms designed to further strengthen the management of NPLs starting from 2025.

Key EU Regulatory Changes on NPLs in 2025

The European Union has been at the forefront of developing comprehensive regulations around NPLs. The overarching goal is to reduce the financial system’s vulnerability to distressed assets while maintaining a balance between effective NPL management and the sustainability of credit markets. As such, in the spirit of fostering a market for NPLs by establishing standards for servicing and buying credit originated in another EU country, EU has introduced:

- the Securitization Regulation (EU) 2017/2402 which established a framework for Simple, Transparent, and Standardized (STS) securitization and covers requirements for Securitization process, Risk retention, Transparency, and Due diligence,

- and Directive (EU) 2021/2167 on Credit Servicers and Credit Purchasers (also known as the *Credit Servicers and Purchasers Directive*), with the purpose of regulating credit servicers and credit purchasers, particularly in the context of NPLs and aiming to foster an EU market for NPLs by setting standards for servicing credits and establishing standards for purchasing credit originated in other EU countries.

Furthermore, to facilitate the NPL management:

- EBA published Guidelines on NPL Management which provides practical recommendations for managing NPLs within banks (specially for significant institutions) and covers areas such as

Governance, Forbearance strategies, and Restructuring strategies,

- as part of the wider regulatory framework, both NPLs and Securitization have been considered by introducing specific provisions for capital treatment of securitization exposures are included in in the CRR and CRD which affect the Risk-weighting of securitization positions and the capital requirements for banks holding or issuing securitizations, and
- the Bank Recovery and Resolution Directive (BRRD) has been updated to considers NPLs and other distressed assets within the bank restructuring and resolution process with the aim to provide a broader perspective on managing distressed assets during bank recovery and resolution.

Capital and Liquidity Requirements

One of the most significant changes under the new EU rules relates to capital adequacy and liquidity coverage requirements for institutions dealing with NPLs. These reforms build on existing rules such as the CRR/CRD but introduce stricter requirements for credit institutions that hold large portfolios of NPLs.

Institutions will need to meet higher Common Equity Tier 1 (CET1) capital requirements to provide a stronger buffer against potential losses which is a consequence of that NPLs attract higher risk weights under the CRR, leading to increased RWA, which in turn require more capital to meet the minimum requirements. Additionally, liquidity requirements under the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) will be adjusted to ensure that banks have adequate liquidity to cover short-term and long-term obligations, especially in times of stress as NPLs strain liquidity due to reduced asset quality and the difficulty in liquidating NPL portfolio quickly.

Provisioning Rules and NPL Backstop

The European Commission's "prudential backstop" for NPLs, introduced through Regulation (EU) 2019/630, will take full effect in the beginning of 2025. This backstop requires banks to set aside provisions for loans classified as non-performing, gradually increasing provisioning levels based on the loan's age and collateral status. The goal is to prevent the build-up of NPLs on balance sheets by ensuring adequate provisioning in a timely manner.

This automatic provisioning mechanism pushes banks to either resolve NPLs quickly or hold sufficient provisions, thereby reducing the systemic risks posed by a backlog of bad loans.

Regulatory Adjustments for High NPL institutions

In addition to the standard capital and liquidity rules, regulators may – as part of Supervisory Review and Evaluation Process (SREP) – apply additional capital and liquidity add-ons based on the bank's specific risk profile. Consequently, banks with high NPL levels may face stricter requirements to cover the heightened credit and liquidity risk. Furthermore, institutions with significant NPL portfolios often face additional reporting requirements, enabling supervisors to monitor their risk exposure, provisioning practices, and compliance with recovering strategies.

Exemption rules starting from 2025

Beginning in 2025, some institutions may benefit from specific exemptions under the *Credit Servicers and Purchasers Directive* and related regulatory adjustments, particularly when managing or holding NPLs through separate entities. This regulatory update is intended to reduce capital burdens on entities solely engaged in credit servicing or purchasing, helping them manage NPLs more efficiently with potentially lighter capital requirements. EU is now pushing for more transparent and efficient NPL markets. The revised framework includes specific guidelines for managing NPLs, allowing banks to offload their bad debts to investors and credit services more easily. This move seeks to improve liquidity in the secondary market for NPLs and reduce the burden on banks' balance sheets.

Transparency requirements are also being tightened, with institutions needing to provide detailed reporting on their NPL exposures, recovery strategies, and market transactions. This is designed to improve investor confidence in NPL securitizations and reduce information asymmetry.

Swedish National Rules on NPLs in 2025

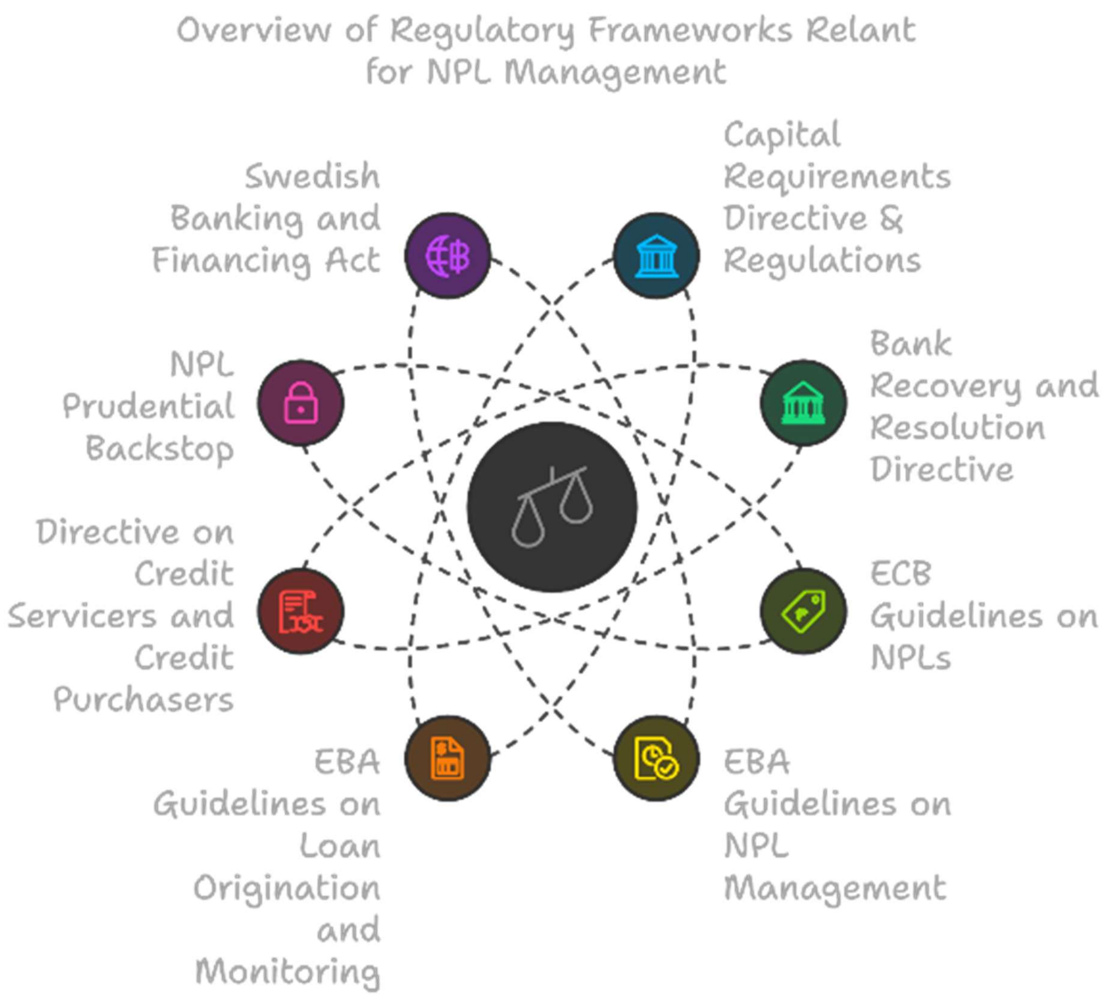
While the EU rules set the broad regulatory framework for NPL management, Sweden is introducing additional national regulations to align with its specific market context. Swedish banks have historically had lower levels of NPLs compared to some other EU countries, but as global financial risks evolve, the Swedish Financial Supervisory Authority (SFSA) has taken proactive steps to enhance the country's NPL framework.

Tougher Capital Buffer Requirements

Under the new Swedish rules, banks will face higher countercyclical capital buffer requirements for NPLs. This means that during periods of economic growth, Swedish banks will need to hold additional capital to cover potential future losses from NPLs. The aim is to prevent a build-up of risks during good times, ensuring that banks are well-capitalized when economic conditions deteriorate.

Swedish National Support for NPL management

Sweden is closely aligning its regulations with the EU's push for management of NPLs. The Swedish market is expected to see more activity in NPL management, particularly as international investors look to Sweden as a relatively stable market. The SFSA will provide guidelines to ensure that e.g. NPL securitizations are conducted transparently and that banks manage the risks associated with selling bad debts to third parties.



Enhanced Reporting Obligations

Swedish regulators are also imposing stricter reporting obligations on banks with NPL exposures. These include enhanced disclosures on loan classifications, recovery efforts, and timelines for NPL resolution. Swedish authorities have emphasized the need for clear, timely data to monitor potential risks in the financial system.

The Impact on Banks and Credit Purchasers

The regulatory changes entering into force in 2025 are set to significantly impact both banks and credit purchasers. Banks will need to adapt their capital and liquidity strategies to meet the new requirements while also accelerating NPL resolution efforts. The new provisioning rules and securitization frameworks offer opportunities for banks to clean up their balance sheets, but they also require significant operational adjustments.

Credit purchasers, on the other hand, will likely benefit from a more transparent and efficient market for NPLs. As more banks turn to securitization to offload bad debts, credit purchasers will have increased opportunities to acquire NPL portfolios at competitive prices. However, purchasers will also need to navigate the evolving regulatory landscape, particularly around due diligence and reporting requirements.

Conclusion

The changes to NPL regulations in 2025 mark a significant shift in how European and Swedish banks will handle non-performing loans. With stricter capital and liquidity requirements, enhanced provisioning rules, and a greater focus on securitization and transparency, the new regulatory framework aims to create a more resilient financial system. Both banks and credit purchasers must prepare now to ensure they can meet these new rules and take advantage of the opportunities they present. By adapting early, institutions can better manage risks while maintaining strong compliance in an increasingly complex regulatory environment.

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