Addendum to the ECB Guidance to banks on non-performing loans (NPLs): prudential provisioning backstop for non-performing exposures

European Central Bank (ECB)

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Introduction

In October 2017, the ECB launched a consultation on the draft addendum to its guidance to banks on non-performing loans (NPLs), specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for non-performing exposures (NPEs)

Introduction

Despite NPLs have started to decline, a number of banks in Member States across the Euro area are currently experiencing high levels of NPLs which ultimately have a negative impact on bank lending to the economy. In this regard, addressing asset quality issues is one of the key priorities for ECB banking supervision.

In March 2017, the ECB published its Final Guidance to banks on NPLs which clarifies supervisory expectations regarding identification, management, measurement and write-offs of NPLs. This guidance stresses the need for timely provisioning and write-off practices related to NPL as these serve to strengthen the balance sheet of banks enabling them to (re)focus on their core business, most notably lending to the economy.

- In this context, the ECB launched in October 2017 a **consultation on the draft addendum to its guidance to banks on NPLs**, specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for NPEs. These expectations should be seen as prudential provisioning backstops aimed at a prudent treatment of NPEs and therefore avoiding the excessive build-up of non-covered aged NPEs on banks' balance sheets in the future. In particular, this addendum covers the following aspects:
    - **Definitions** applied in the addendum.
    - **Prudential provisioning backstop**.
    - Related **supervisory reporting** and **public disclosure**.
- This addendum does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from the existing EU regulatory framework.

This Technical Note includes an analysis of the main content of this addendum.

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Executive summary

This addendum to the ECB's Final Guidance to banks on NPL provides information about the definitions applied on it, the prudential provision backstop, and the related supervisory reporting and public disclosure

Executive summary

Scope of application	Regulatory context	Next steps
• This addendum is applicable to **all significant banks** directly supervised by the ECB[1]. • The **backstops** are applicable at a minimum to **new NPEs** classified as such from **January 2018** onward.	• **ECB Guidance on NPL**, published in March 2017. • **EBA GL on credit risk management practices and accounting for ECL**, published in May 2017.	• Comments should be submitted by **8 December 2017**. • This addendum will be applicable as of its **date of publication**.

Main content

Definitions applied in this addendum

- This addendum sets out some definition to be considered, such as new NPEs, NPE vintage, eligible credit protection to secure exposures, or the definition of secured and unsecured parts of NPEs.

Prudential provisioning backstop

- It provides the following information regarding the prudential provision backstops: functioning, adjustments, deviations, categories , and calibration.

Related supervisory reporting and public disclosure

- According to this addendum information on data to be reported to Joint Supervisory Teams (JSTs), and on public disclosure is provided.

(1) Despite this addendum is non-binding, banks are expected to explain any deviations from it and report on the compliance with the prudential provisioning backstop.

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Definitions

This addendum sets out definitions to be considered, such as new NPEs, NPE vintage, eligible credit protection to secure exposures…

Definitions (1/2)

New NPEs

- All those exposures that are reclassified from performing to non-performing **after 1 January 2018** irrespective of their classification at any moment prior to that date.
- Exposures classified as NPEs and cured before 1 January 2018 that are reclassified to a non-performing status after 1 January 2018 should be treated as **new NPEs** for the purpose of the guidance, with the NPE vintage count starting at zero.

NPE vintage

- The NPE vintage concept is used for the application of backstops and is defined as the **amount of days** (converted into years) from when an exposure was **classified as non-performing to the relevant reporting or reference date**, regardless of the trigger of the NPE classification. In this regard, the addendum provides that:
  - The vintage count for **unlikely to pay** and **past due exposures is the same**.
  - For exposures moving from **unlikely to pay** to **past due**, the counting continues and is **not reset**.
  - If an exposure returns to a **performing classification**, the NPE vintage count will be **re-set to zero**.

Eligible credit protection to secure exposures

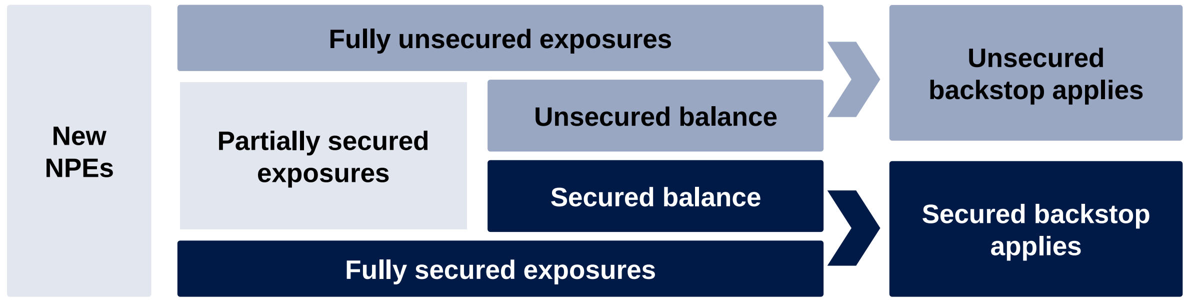
- The addendum applies **prudential principles** to define the eligibility criteria for credit protection used in determining which parts of NPEs are to be considered secured or unsecured and, consequently, whether to apply the secured or unsecured backstop.
- The types of collateral or other forms of credit risk protection accepted for either **fully or partially securing NPEs** are the following:
  - All types of **immovable property** collateral. Their valuation should be carried out in accordance with the ECB Guidance on NPL.
  - Other eligible collateral or other forms of credit risk protection that fulfil the criteria of **credit risk mitigation** of the CRR, irrespective of whether an institution uses the standardised approach or the internal ratings-based approach.

…and secured and unsecured part of NPEs, which include fully unsecured NPEs, fully secured NPEs, and partially secured exposures

Definitions (2/2)

Secured and unsecured parts of NPEs

- The addendum distinguishes between the unsecured and secured (parts of) NPEs as follows:
  - **Fully unsecured NPEs**, if they do not benefit from credit risk protection. These exposures should be assessed with a unsecured backstop.
  - **Fully secured NPEs**, if the credit risk protection exceeds the current drawn and potential undrawn credit facilities of the debtor[1]. These exposures should be assessed with the secured backstop.
  - **Partially secured NPEs**, if the value of eligible credit risk protection does not exceed the current drawn and potential undrawn credit facilities. Once the bank has established the value of its credit risk protection, the exposure should be split into the following two elements:
    - **Secured balance**, which are valued by the bank according to the credit risk protection outlined above for fully secured exposures.
    - **Unsecured balance**, which will be equal to the original drawn and potential undrawn credit facilities minus the secured balance of the exposure.
- For fully and partially secured exposures, the collateral value should be **regularly reviewed** in line with the ECB Guidance on NPL, and any changes should be taken into account in a timely manner.



ECB, 2017

(1) However, undrawn credit facilities need not be included if they may be cancelled unconditionally at any time and without notice. Collateral values should represent the value reported in line with FINREP instruction whereas the valuation of immovable property should be done according to the ECB Guidance on NPL.

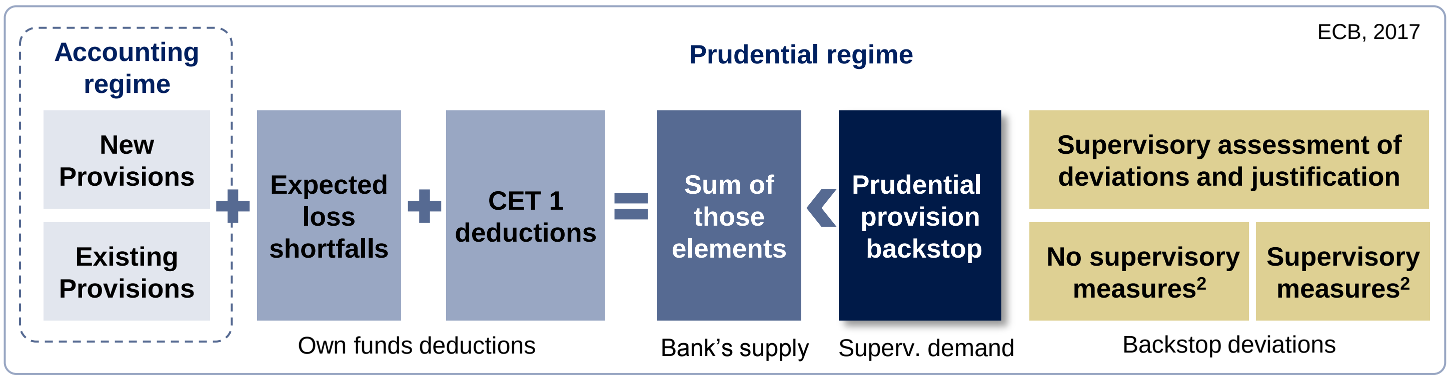
Prudential provisioning backstops

Further, this addendum provides the following information regarding the prudential provision backstops: minimum level, adjustments…

Prudential provision backstops (1/2)

Minimum level of provisions

- The prudential provisioning backstops supplement the NPL Guidance by specifying **quantitative supervisory expectations** with regard to the **minimum levels of provisions** within the prudential regime.
- These expectations may go beyond, but not stand in contradiction to, accounting rules. Therefore, if the applicable accounting treatment is not considered prudent from a supervisory perspective, the **accounting provisioning level is fully integrated in the banks' supply** to meet the supervisory demand.
- In order to fulfil the full prudential provisioning backstop, the sum of these items forms the bank's supply:
  - **All accounting provisions** under the applicable accounting standard including potential newly booked provisions.
  - **Expected loss** shortfalls for the respective exposures in default.
  - **CET 1 deductions** from own funds under the bank's own initiative.



Adjustments

- Banks are encouraged to close potential gaps relative to the prudential minimum expectations by booking the **maximum level of provisions** possible under the applicable accounting standard.
- If the applicable accounting treatment does not fulfil the prudential provisioning backstop, banks should **adjust their CET 1 capital on their own initiative**, applying stricter requirements set out in the CRR[1].

(1) Those deductions are to be reported in the COREP template C01.00 in row 524.
(2) No supervisory measures, if deviations acceptable; or supervisory measures if deviations not acceptable.

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Prudential provisioning backstops

…deviations, categories and calibration. In this regard, the addendum establishes that the application of the backstop should be implemented in a gradual way by banks from the moment of NPE classification until the moment when 100% prudential provisioning is expected

Prudential provision backstops (2/2)

Deviations

- **Deviations** from the prudential provision backstops **are possible** if a bank can demonstrate in the course of a periodic comply-or-explain process[1], and on the basis of acceptable evidence, that:
  - The **calibration of the backstop is not justified** for a specific portfolio/exposure.
  - The **application of the backstop is not reasonable** in justified circumstances (e.g. pulling effect on a debtor's performing exposures).

Categories[2]

- **Unsecured backstops**, that apply to fully unsecured NPEs and to the unsecured balance of partially secured NPEs.
- **Secured backstops**, that apply to fully secured exposures and the secured balance of partially secured exposures.

Calibration

- The application of the backstops should not result in cliff edges effects, but should rather be implemented in a gradual way by banks from the moment of NPE classification until the moment when **100% prudential provisioning** is expected.
  - For **unsecured backstops**, building up to 100% over **two years**.
  - For **secured backstops**, banks should assume at least a linear path for the backstop, building up to 100% over **seven years**.
- The backstop should not to be seen as a best practice timetable for provisioning, but rather as a **supervisory tool** for addressing outliers to ensure that banks are not building up aged NPEs with insufficient provision coverage. Therefore, banks need to continue booking accounting provisions in line with their assessment and existing accounting principles which, in the vast majority of cases, should result in the backstop not having any effect.

(1) The comply-or-explain process will be followed by a supervisory assessment of the deviations and related justifications. The outcome of this assessment will be considered in the SREP.
(2) The foreclosed assets are not currently in scope of this addendum.

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Related supervisory reporting and public disclosure

Finally, this addendum provides information on data to be reported to JSTs, and on public disclosure

Supervisory reporting and public disclosure

Supervisory reporting

- All banks should **report to their respective JSTs** at least on an **annual basis** the coverage levels by NPE vintage, regarding to the newly classified NPEs after 1 January 2018, and should explain deviations to the supervisor.
- In this regard, the JSTs will provide banks with further details on this process, and the related templates, sufficiently in advance.

Public disclosure

- A public disclosure of NPE coverage by vintage is an important tool for banks to **convey their credit risk profiles** comprehensively to market participants.

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This addendum will be applicable as of its date of publication and comments should be submitted by 8 December 2017

Next steps

- Comments to this draft addendum should be submitted by **8 December 2017**.
- This addendum will be applicable as of its **date of publication**.
- The backstops are applicable at a minimum to new NPEs classified as such from **January 2018** onward.