ECB Guidance on NPLs Addendum proposal: prudential provisioning backstop

December 2017

ECB Addendum to the Guidance on NPLs

Client briefing

Summary

One of the key supervisory priorities of the European Central Bank (ECB) has been to bring down the level of Eurozone banks non-performing loans (NPLs), currently standing at close to €850bn. Eliminating NPLs is challenging and an uneven task, particularly as Eurozone countries have different, and sometimes lengthy, foreclosure periods.

The ECB has recently set its broad expectations in its Guidance to banks on non-performing loans, *Guidance to Banks on non-performing loans*[1], published on 20 March 2017. This would be the framework upon which banks' NPL plans will be reviewed and supervisory measures considered.

As an additional step, on 4 October 2017, the ECB issued a consultation on a draft addendum[2] to its March guidance.

The addendum specifies supervisory expectations for minimum levels of prudential provisions for **new** NPLs or Non Performing Exposures (NPEs)[3]. These expectations are based on "vintage" (length of time an exposure has been classified as non-performing) and collateral held. Legacy portfolios are not in scope; however, it is likely that the ECB will consider them early in 2018.

The addendum introduces "prudential provisioning backstops" that supplement the NPL Guidance, by specifying quantitative supervisory expectations. In particular, banks are expected to provide full coverage for the unsecured portion of new NPLs after two years at the latest, and for the secured portion after seven years at the latest. The

[1] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf
[2] https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf
[3] As in the NPL Guidance and addendum 'NPLs' and 'NPEs' are used interchangeably

Building a better working world

underlying assumption seems to be that not realising any value from the collateral within seven years defeats the purpose of having one in the first place.

The ECB is issuing this addendum now aiming to take advantage of the benign Eurozone economic environment, which should render the new requirements more palatable.

As this proposal is being finalized, with an imminent implementation date at the beginning of 2018, European banks should assess its potential impact, even if the actual date is likely to be delayed by a few months.

This briefing note looks at the proposal in relation to its regulatory and accounting implications, as well as considering the overall broader impact.

The consultation has been running until 8 December 2017 including a public hearing on the 30 November 2017.

The initiative is part of a wider set of proposals by European authorities to manage current NPL or NPE stock and prevent excessive build-up of non-covered aged NPLs or NPEs.

Contents

Background

Asset quality at banks in the Eurozone area has been a key priority for ECB banking supervision, since the formation of the Single Supervisory Mechanism (SSM) in 2014. Data from the ECB shows a stockpile of NPLs of nearly €850bn.[4] In a number of Member States more than 10% of total loans are still non-performing.

NPLs of this magnitude require particular focus, from policy reviews to looking at what banks are doing to reduce such exposures and to prevent loans tipping further into the NPL category. The intent of an increasingly coordinated approach among European authorities is to ensure that banks are well capitalized and able to support the growth in credit that is necessary to sustain the recovery in the Eurozone economy that has finally gotten under way.

This note focuses on the prudential provisioning requirements proposed in October by the ECB as an Addendum to the overall Guidance on NPLs that the ECB published in March.[5] The addendum applies to loans that are initially classified after 1 January 2018 as non-performing.[6] Even if it doesn't explicitly assign automatic actions, it virtually sets a "comply-or-explain" standard for prudential purposes for provisions against NPLs and will serve as a further inducement for banks to improve their credit monitoring and work-out capabilities. The addendum, therefore, supplements the EU's efforts to standardize reporting, improve insolvency frameworks and strengthen supervision.

Even if not explicitly, the addendum reinforces the need for banks to implement IFRS 9 both promptly and thoughtfully. Under IFRS 9, banks will have to identify NPLs and NPEs, and take provisions adequate to cover expected loss after taking into account any collateral pledged to the bank. Thus, IFRS 9 can provide the basis for banks to comply with the addendum or explain why an exception is merited.

The ECB is working to ensure that in addition to accounting, Pillar 1 controls and limits as well as Pillar 2 supervisory measures, its NPL policy includes a conservative backstop that is uniform and streamlined.

Proposal overview

The addendum specifies quantitative supervisory expectations with regards to the minimum levels of provisions within the prudential regime, "prudential provisioning backstops". These are measures additional to the NPL Guidance issued earlier in 2017.

The addendum is designed to apply "at a minimum" to all exposures newly classified as non-performing (EBA definition[7]) after 1 January 2018. The underlying aim and emphasis are to ensure that going forward NPLs or NPEs are subject to sufficient provisioning and taken in a timely manner. As of early December 2017, a decision had not yet been taken on the approach towards the existing NPL or NPE stock, this being expected in Q1 2018.

The addendum proposal differentiates between secured and unsecured exposures. In addition, it only touches upon one tool used for NPL reduction (write-off), while the other two (sales and cure) remain outside the scope of this paper.

[4] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisorybankingstatistics_second_quarter_2017_201710.en.pdf - Q2 2017
[5] ECB's March 2017 NPL guidance is such a step taken towards tackling NPL issues across Europe as it covers a broad scope from definitions, to risk models, provisioning, and interaction with IFRS 9, governance, organisation, segmentation, products and reporting.
[6] By the end of the first quarter of 2018, ECB Banking Supervision is expected to present its consideration of further policies to address the existing stock of NPEs, including appropriate transitional arrangements.

[7] http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32015R0227&from=EN – Paragraph 145 – Annex V, Part 2

The secured exposures for which the collateral has not been realized seven years after their being classified as non-performing will be treated as unsecure. Consequently, full prudential provisioning is required after seven years, regardless of the reasons for the delay in realizing the collateral.

For the unsecured exposures as well as the unsecured part of the secured exposures, banks would need to ensure that provision levels are as per the table below.

	Unsecured part	Secured part
After two years of vintage	100%	
After seven years of vintage		100%

The application of the backstops is deemed to be implemented gradually, assuming at least a linear path for the secured exposures, over the seven-year period.

The addendum will apply to all significant banks directly supervised by the SSM. It will likely be implemented as a general expectation, where deviations can be acceptable, if justified. Therefore, should a bank deviate from it, it would need to evidence why the two and seven years respectively are not the right answers for its NPL portfolios in question. Failing to provide acceptable justifications or adhere to the new guidance may result in impact on its SREP evaluation and supervisory measures, including capital charges, enhanced and potentially more frequent reporting, revised valuations, and so on.

Prudential expectations may be expected to go beyond, "but not stand in contradiction to", accounting rules; as should accounting provisions not be considered prudent, then the ECB would observe additional quantitative expectations.

What would be the impact on capital?

In part, the intention of the guidance is to create a harmonized framework for the recognition of NPLs. As mentioned, this is currently not defined in full in either accounting or regulatory regulation and thus varies across jurisdictions, firms and over time. These divergences most notably arise from differing treatment and valuations of collateral or guarantees, varying treatment of restructured loans; variation in forbearance treatment and the differing capital implications of impairments for firms on IRB or standardized approaches.

The guidance indicates a direction of travel from the ECB and by laying out an expectation around NPL recognition and prudential provisioning designed to ensure full provision of impaired loans within defined periods it should encourage those firms or jurisdictions to become more aligned over time. Since that alignment will differ by firm and jurisdiction, banks will need to assess the potential impact individually based upon their specific impairment policies.

The addendum scope is primarily for new NPL stocks from 1 January 2018. But, the broader guidance requires firms to ensure that they have in place an NPL strategy that addresses their existing NPL stocks both within their capital plans and reportable to their JSTs annually. Shortfalls here may trigger Pillar 2 supervisory action with a consequent impact on capital.

What are the implications with regards to accounting policies?

The entire NPL topic is complex, with a prudential framework that may implicitly interact with a credit institution's accounting framework. Any guidance would need to be clear on this partial correlation and where a dividing line is drawn.

The draft addendum references "prudential provisions," which may be interpreted as a supervisory steer on accounting methodology. It is important to highlight that IFRS 9 does not permit overly conservative calculations; the basis of conclusion for the standard notes that faithful representation of expected credit losses (ECL) means they are neutral and free from bias (IFRS 9, BC5.86).

While the addendum notes that it "does not intend to substitute or supersede any applicable regulatory or accounting requirement," it is unclear if all of the proposed application is in accordance with IFRS in all situations. For example, the comment in the draft guidance to "close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the applicable accounting standard" could be misinterpreted as a bias towards negative scenarios in the assessment of collateral held, resulting loss given defaults (LGDs). As IFRS 9 does not include any provisioning backstops, we would welcome the ECB to clarify in the addendum that the prudential provisioning backstops are not expected to be applied as such when assessing accounting provisions under IFRS 9.

Additionally, the addendum refers to write-offs within the background section. We understand that this does not refer to the accounting definition of "write-off" under IFRS 9, and would also welcome this to be clarified in the final version of the addendum.

At the 30 November public hearing, the ECB reiterated that the addendum is non-binding and as such does not conflict with accounting or regulatory policy. In responding to concerns around over-reach, it also reiterated that they are within their right as supervisors to publish quantitative guidance.

In addition, the ECB addressed industry concerns around higher provisions. The intention is not higher, but better and faster provisioning; quoting evidence that earlier cure is beneficial to the economy and the guidance would facilitate one-to-one dialogue with banks to support this.

What are the operational challenges?

Overall, we do not expect significant operational issues in calculating the regulatory capital requirements under the new rules proposed by the draft addendum. Thus, the enhanced loan-level data set in place for the implementation of IFRS 9, FinREP, CoREP, and Anacredit should ease the collection of data to apply the prudential backstops on NPLs or NPEs as required by the draft addendum.

Collateral data (type, value) is already core to the assessment of LGDs in the calculation of IFRS 9 ECL and capital requirement assessments. The NPL vintage for the new NPLs post 1 January 2018 can be monitored by a system field capturing the date of first classification as NPL or NPE.

However, the further disconnect between regulatory returns and accounting returns introduced by the draft addendum via the application of backstops (and linear path for secured exposures) will result in more complex reconciliations between the two set of figures. Best practice will include disclosures comparing regulatory LGDs with accounting LGDs.

How would it impact banks' behavior?

In and of themselves, prudential provisioning backstops to be applied to the new NPLs will not significantly alter banks' approaches to NPLs. Instead, they should be seen as part of the wider effort by regulators to increase the costs of holding NPLs, enhance transparency and avoid the future NPL accumulation.

As these combined changes start to flow through the system, we are seeing two significant effects.

Firstly, banks are accelerating their sell-off of legacy NPLs from the financial crisis. Greece's recent re-entry into the loan sale market, with Eurobank's disposal of a €1.5bn portfolio of unsecured loans (in October 2017) as a case in point. Moreover, we are seeing a more diverse range of asset classes emerging, with sellers increasingly confident in disposing of portfolios outside of the traditional and more marketable retail, and corporate and commercial real estate.

Secondly, we are seeing banks take a fresh look at embedding portfolio sales processes into their future operating models. There is an increasing interest in industrialising the process of identifying non-performing borrower segments, and creating a competitive market for their sale. Lenders are now taking a view of the data capture required for a portfolio sale in their origination processes.

Reflecting on these specific addendum proposals, they are likely to place particular pressure on banks to sell secured portfolios that might otherwise have been left off their balances sheets; such those with intractable legal cases or vulnerable borrowers.

As mentioned, the ECB's initiatives are part of wider coordinated effort, with authorities covering various parts of the cycle. In this respect, it is worth mentioning the EBA's efforts to standardise transaction reporting[8] in order to accelerate the formation of a functional secondary NPL market.

Addressing at the public hearing the fact that the addendum may potentially lead to imbalanced transaction incentives, the ECB was keen to highlight that any decision on the sale of NPLs is one for banks to take as there is nothing in the guidance that imposes this. However, it did not miss pointing out that the market is anyway imbalanced, given the high NPL levels that banks still hold.

Conclusion

The ECB is increasing the pressure on banks to reduce the amount of NPLs that they carry on their balance sheet. It is employing a variety of measures to ensure that the capital shown on banks' balance sheets remains available to cover unexpected future losses.

A step in this direction is to ensure that "NPL" stands solely for "non-performing loan" and not for "non-provisioned loan" as well. To this end, the ECB has issued for consultation the draft addendum to its *Guidance to banks on non-performing loans*.

The addendum has received a number of strong challenges, including legal opinions from the European Parliament and the Council of the EU legal services. At the same time, the European Parliament published an analysis[9] on European NPLs where the addendum is receiving significant attention.

[8] https://www.eba.europa.eu/risk-analysis-and-data/eba-work-on-npls
[9] http://www.europarl.europa.eu/RegData/etudes/IDAN/2017/602106/IPOL_IDA(2017)602106_EN.pdf

However, as mentioned in the 30 November public hearing, the ECB is determined to press ahead, even if with a likely delay, to ensure that they can respond to all comments. While reflecting the raised legal points, the expectation is that the substance would not change even if the language may be modified.

The ECB is unlikely to stop there. It is not about to let a good recovery go to waste. Banks should expect the ECB to use other measures to stimulate banks to also tackle the outstanding stock of NPLs.

In particular, the ECB is likely to use the forthcoming implementation of expected loss provisioning under IFRS9 to have banks increase provisions against longstanding NPLs. Via the stress test, the ECB is likely to require banks to hold capital now for loans in their portfolio that are likely to become non-performing (and therefore require provisioning) in the future. Finally, via TRIM the ECB is likely to mandate that banks assume a minimum rate of loss given default.

Overall, the ECB thrust will drive banks (especially the significant institutions under direct ECB supervision) away from "extend and pretend" toward "perform or provision."

Banks would do well to get ahead of this particular curve by:

- Reversing the expectation that NPLs can cure themselves without any additional action
- Recognising that forbearance is the grounds for provisioning, even where forbearance is the right strategy to preserve value
- assigning NPLs to workout units
- Taking steps to facilitate loan sales
- Taking steps to dispose of NPL portfolios
- Exploring the use of credit protection via derivatives or via issuance of write down bonds (with triggers linked to credit indicators for specific portfolios)

The addendum should not be considered in isolation, but rather as part of a package of measures to address the large stock of NPLs and prevent a future build up. Banks with NPL levels higher than the European average can expect continued scrutiny from the SSM.

Further information

For further information, please contact one of the following or your usual EY contact:

Ajay Rawal
Partner, Head of EMEIA Bank Restructuring
Ernst & Young LLP
T: +44 777 088 7918
E: arawal@uk.ey.com

Tom Huertas
Partner, Chair of EY Global Regulatory Network
Ernst & Young LLP
T: +44 20 7951 2556
E: thuertas@uk.ey.com

Dirk Auerbach
Partner, EMEIA FSO Germany
Ernst & Young GmbH Wirtschaftsprufungsgesellschaft
T: +49 160 939 17050
E: dirk.auerbach@de.ey.com

Yolaine Kermarrec
Partner, EMEIA FSO UK
Ernst & Young LLP
T: +44 746 903 6098
E: ykermarrec1@uk.ey.com