EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Addendum to the ECB Guidance to banks on non-performing loans: ~~Prudential~~supervisory expectations for prudential provisioning ~~backstop for~~of non-performing exposures

This document has been generated for the sole purpose of facilitating a comparison of the pre-consultation document with the final guidance. Only the final guidance is authentic.

March 2018

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Contents

1 Background

On 20 March 2017 the ECB published its ~~final guidance~~Guidance to banks on non-performing loans[1] (NPL Guidance). The NPL Guidance ~~is a supervisory tool that~~ clarifies supervisory expectations regarding the identification, management, measurement and write-~~offs~~off of NPLs in the context of existing regulations, directives and guidelines.

The NPL Guidance stresses the ~~need for~~importance of timely provisioning and write-off practices related to non-performing loans[2], as these serve to strengthen ~~the~~banks' balance ~~sheet of banks~~sheets, enabling them to (re)focus on their core business, most notably lending to the economy.

This ~~addendum thus reinforces and~~Addendum supplements the NPL Guidance by specifying ~~quantitative~~the ECB's supervisory expectations ~~concerning the minimum~~when assessing a bank's levels of prudential provisions ~~expected~~ for non-performing exposures (NPEs)[3]. ~~The expectations are based on~~As detailed further below, the ECB will in this context assess, among other things, the length of time an exposure has been classified as non-performing (i.e. ~~the~~its "vintage") as well as the collateral held (if any). ~~The measures should~~ The ECB's supervisory expectations set out what the ECB deems to be ~~seen as "prudential provisioning backstops" aimed at~~ a prudent treatment of NPEs ~~and therefore avoiding the~~. Its aim is to avoid an excessive build-up of non-covered aged NPEs on banks' balance sheets in the future, which would require supervisory measures. This ~~addendum~~Addendum does not ~~intend to~~ substitute or supersede any applicable regulatory or accounting ~~requirement or guidance from existing EU regulations or directives and their national transpositions, applicable national regulation of accounting, binding rules and guidelines of accounting standard setters or equivalent, or guidelines issued by the European Banking Authority (EBA).~~ requirements.

1 ~~Available on the ECB's banking supervision website.~~ Guidance to banks on non-performing loans.

2 See Section 6.6 of the NPL ~~guidance~~Guidance.

3 As in the NPL Guidance, "NPL" and "NPE" are used interchangeably within this ~~addendum~~Addendum.

2 General concept

2.1 Scope~~ and applicability~~

In line with the NPL Guidance, this ~~addendum applies~~Addendum specifies the ECB's supervisory expectations relating to ~~all~~the significant banks directly supervised by ~~the ECB.~~ it.

~~While the addendum is non-binding,~~This Addendum does not bind banks~~ are expected to explain any deviations and should report on the compliance with the~~ , but serves as a basis for a supervisory dialogue. The ECB will assess any differences between banks' practices and the prudential provisioning ~~backstop~~expectations laid out in this ~~addendum~~Addendum at least annually~~ as outlined~~.

The ECB will link the supervisory expectations in ~~Section 5.~~ this Addendum to new NPEs classified as such from 1 April 2018 onwards. Taking into account the specificities of the supervisory expectations (see Section 4.2), banks will thus be asked to inform the ECB of any differences between their practices and the prudential provisioning expectations, as part of the SREP supervisory dialogue, from early 2021 onwards.

~~This addendum will be applicable as of its date of publication. Finally, the backstops are applicable at a minimum to new NPEs classified as such from January 2018 onward.~~

~~2.3 Regulatory basis~~

2.2 General prudential framework

As also outlined in Chapter 6.1 of the NPL Guidance, the existing prudential framework requires supervisors to make decisions as to whether banks' provisions are adequate and timely.

The Basel Committee on Banking Supervision (BCBS) highlights ~~supervisory responsibilities in assessing~~the responsibility of supervisors to assess banks' processes for credit risk management control and asset valuation, as well as ~~in ensuring~~to ensure that they have sufficient loan loss provisions, particularly from the standpoint of the assessment of credit risk exposures and capital adequacy. This is reflected in the respective guidelines, including:

- BCBS "Guidance on credit risk and accounting for expected credit losses" (2015) and EBA "Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses" (2017);

- BCBS "Core Principles for Effective Banking Supervision" (2012), and Basel II, Pillar 2 (2006).

More specifically~~, in the existing regulatory framework applicable for significant institutions~~, the following articles of the Capital Requirements Directive (CRD)[4] are relevant.

- Article 74 requires banks to have *"adequate internal control mechanisms, including sound administration and accounting procedures, […] that are consistent with and promote sound and effective risk management"*.
- Article 79(b) and (c) ~~require~~requires the competent authorities to ensure that *"institutions have internal methodologies that enable them to assess the credit risk of exposures to individual obligors ~~(…)~~[…] and credit risk at the portfolio level"* and *"the ongoing administration and monitoring of the various credit risk-bearing portfolios and exposures of institutions, including for identifying and managing problem credits and for making adequate value adjustments and provisions, is operated through effective systems"*.
- In addition, Article 88 includes the principle that *"the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards."*
- In accordance with Article 97(1), the competent authorities must review the arrangements, strategies, processes and mechanisms implemented by institutions to comply with the CRD and the Capital Requirements Regulation (CRR)[5]. Article 97(3) of the CRD IV further specifies that *"…the competent authorities shall determine whether the arrangements, strategies, processes and mechanisms implemented by institutions and the own funds and liquidity held by them ensure a sound management and coverage of their risks."*
- In this regard, Article 104(1) enumerates the minimum powers that the competent authorities must have, including, under (b), the power *"to require the reinforcement of the arrangements, processes, mechanisms and strategies implemented in accordance with Articles 73 and 74"*, and, under (d), *"to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds ~~requirements'~~requirements"*. This is also reflected in the EBA's "Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)", paragraph 479(a) of which states that ~~"~~the competent authorities may require the institution to *"apply a specific provisioning policy, and – where permitted by accounting rules and regulations – require it to increase provisions"*.

[4] 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 (OJ L 176, 27.6.2013, p. 338).

[5] 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 and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Therefore, as part of the current regulatory regime, supervisors need to determine whether banks have effective provisioning methodologies and processes, which should ensure that NPE-related risks are adequately covered. ~~Where provisioning levels are~~Furthermore, the ECB is allowed "*to require credit institutions to apply specific adjustments (deductions, filters or similar measures) to own funds calculations where the accounting treatment applied by the bank is* considered ~~to be inadequate for prudential purposes, supervisors are obliged to ensure that banks reassess and increase respective risk coverage in order to meet prudential expectations.~~ *not prudent from a supervisory perspective.*"[6]

As part of this process, supervisors ~~need to~~should provide guidance as to their expectations. The ~~addendum~~Addendum is to be seen in this context.

~~2.4~~2.3 Functioning of the ~~prudential provisioning backstop~~supervisory expectations

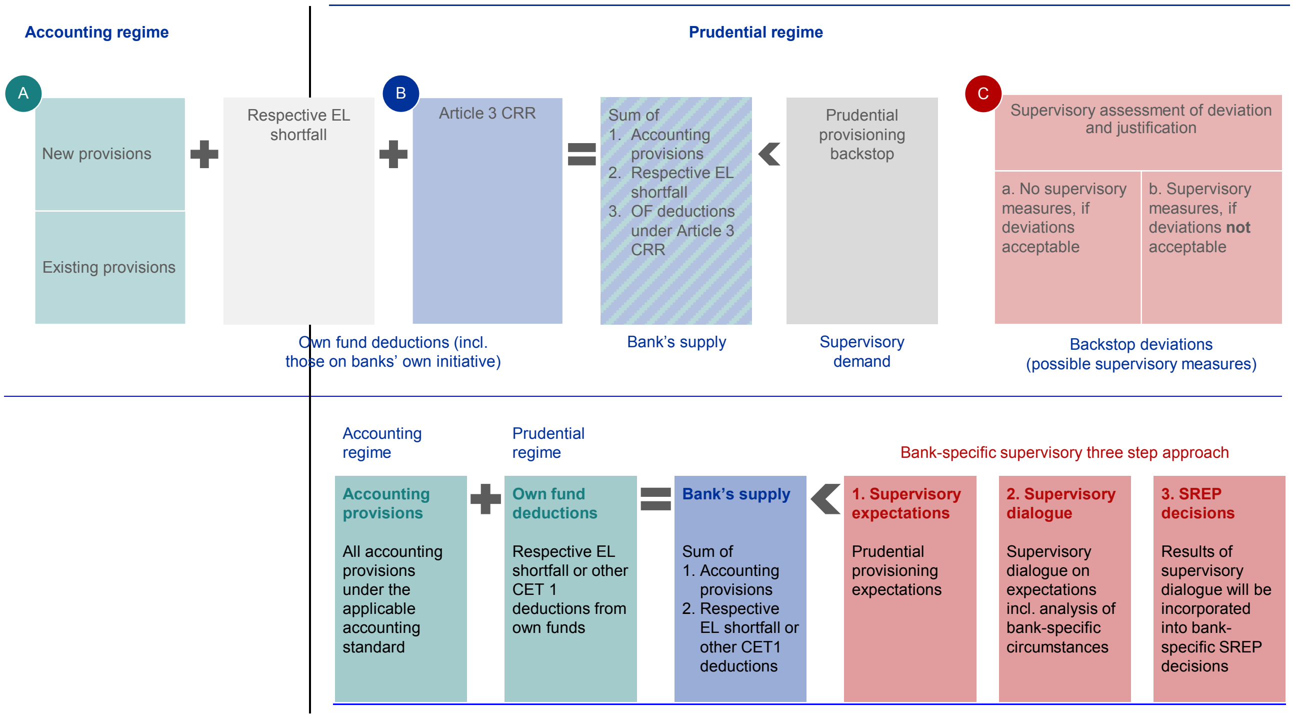
The prudential provisioning ~~backstops~~expectations outlined in this ~~addendum~~Addendum supplement the NPL Guidance by specifying ~~quantitative supervisory expectations with regard to~~what the ~~minimum~~ECB deems to be prudent levels of provisions~~ within the prudential regime.~~. Figure 1 provides an overview of the prudential provisioning concept.

~~The underlying aim is to ensure that NPEs are subject to sufficient provisioning, taking~~In its assessment of a bank's levels of provisions for NPEs, the ECB will take into account the level of existing credit protection and, crucially, the NPE vintage category. Section 3.2 ~~clarifies~~specifies which forms of collateral or other forms of credit risk protection ~~are accepted~~will be considered by the ECB to be adequate from a prudential perspective~~ in this addendum.~~. The~~ minimum~~ prudential provisioning expectations are defined in ~~Chapter~~Section 4.

[6] See footnote 8 of the Report from the Commission to the European Parliament and the Council on the SSM (COM(2017) 591 final).

Figure 1

Overview of the prudential provisioning concept



The quantitative prudential expectations may go beyond, but not stand in contradiction to, accounting rules. 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.~~ expectation.

~~In order to fulfil~~A bank's supply for the ~~full~~ purposes of the prudential provisioning ~~backstop, the sum~~expectations is made up of the following items ~~forms the bank's supply~~:

1. all accounting provisions under the applicable accounting standard including potential newly booked provisions~~;~~[7];

2. expected loss shortfalls for the respective exposures in default in accordance with Articles 158 and 159 of the CRR~~; and~~, and other CET 1 deductions from own funds related to these exposures.[8]

~~2. CET 1 deductions from own funds under the bank's own initiative in accordance with Article 3 of the CRR.~~

Banks are encouraged to close potential gaps relative to the prudential ~~minimum~~ expectations by booking the maximum level of provisions possible under the

[7] Partial write-offs made since the most recent NPE classification can also be included where relevant.

[8] Unless other CET 1 deductions are already reflected in the calculations of expected loss shortfalls.

applicable accounting standard. If the applicable accounting treatment does not ~~fulfil~~match the prudential provisioning ~~backstop~~expectations, banks ~~should~~also have the possibility to adjust their Common Equity Tier 1 capital on their own initiative~~,~~ ~~applying Article 3 of the CRR on the application of stricter requirements.~~[9] .[10]

~~Banks should report on~~During the ~~compliance~~supervisory dialogue – at least annually in the context of the SREP – the ECB will discuss with banks any divergences from the prudential provisioning ~~backstop~~expectations outlined in this ~~addendum at least annually and explain deviations to the supervisor (see Section 5 on supervisory reporting).~~ Addendum.

~~Deviations from the backstops are possible if a bank can demonstrate in the course of a periodic comply-or-explain process, and on~~When assessing such divergences, the ~~basis of acceptable evidence, that~~

~~the calibration of~~ ECB will consider specific circumstances (e.g. pulling effect) which may make the prudential provisioning ~~backstop is not justified~~expectations inappropriate for a specific portfolio/exposure ~~(e.g.~~. Such circumstances might include, for example, a situation where a debtor verifiably makes regular partial payments amounting to a significant portion of the initial contractual payments, ~~or~~if those payments enable the exposure to be cured[11] irrespectively of whether it is past due or unlikely to pay, or where the application of the ~~backstop~~supervisory expectations would ~~result in covering more than 100% of the exposure~~ , in combination with Pillar 1 capital requirements for credit risk~~), or~~ , result in more than 100% of the exposure being covered, or any other relevant circumstances. In this context, any portfolio-specific robust evidence can be used to inform the supervisory dialogue.

~~( )~~ In the ~~application~~course of the ~~backstop is not reasonable in justified circumstances (e.g. pulling effect on a debtor's performing exposures).~~

~~The comply-or-explain process will be followed by a~~ supervisory ~~assessment of~~dialogue the ~~deviations~~ECB will assess any differences between the ECB's supervisory expectations and ~~related justifications~~an individual bank's provisioning approach. This process might include off-site activities such as deep dives performed by the respective Joint Supervisory Team (JST), on-site examinations or both. The outcome of the supervisory assessment ~~of deviations~~ will be taken into ~~consideration~~ account in the Single Supervisory Mechanism SREP~~, and non-compliance may trigger~~. If, after giving due consideration to the specific circumstances presented by a bank, the ECB is of the view that its prudential provisions do not adequately cover the expected credit risk, a supervisory ~~measures based on the supervisory powers specified in the European and national regulatory frameworks~~measure under Pillar 2 framework might be adopted.

~~9 Those deductions are to be reported in the common reporting (COREP) template C01.00 in row 524 "(-) Additional deductions of CET1 Capital due to Article 3 CRR".~~

10 Where banks decide to make deductions from CET1 capital on their own initiative, those deductions are to be reported in the common reporting (COREP) template C01.00 in row 524 "(-) Additional deductions of CET1 Capital due to Article 3 CRR".

11 Also taking into account Chapters 4 and 5.3.3 of the ECB NPL Guidance.

The general relevance of the Addendum is to be assessed on exposure level (i.e. the date of the last NPE classification and respective NPE vintage). The starting point of the supervisory dialogue will be an assessment performed at the applicable consolidation level (solo, sub-consolidated or consolidated in line with the SREP approach). This could be followed by further supervisory analysis on a more granular level if need be.

3 Definitions applied in this ~~addendum~~Addendum

3.1 Definition of new NPEs and vintage count

~~New NPEs in~~For the ~~context~~purposes of this ~~addendum~~Addendum, "new NPEs" are all those exposures that are reclassified from performing to non-performing in line with the EBA's definition[12] after 1 ~~January~~April 2018, irrespective of their classification at any moment prior to that date.

This ~~addendum~~Addendum uses an "NPE vintage" concept for the application of the ~~backstops.~~supervisory expectations. In this context, ~~NPE~~an NPE's vintage is defined as the ~~amount~~number of days (converted into years) from ~~when~~the date on which an exposure was classified as non-performing to the relevant reporting or reference date, regardless of ~~the trigger of~~what triggered the NPE classification. Thus, the vintage count for "unlikely to pay" and "past due" exposures is the same, and for exposures moving from "unlikely to pay" to "past due" the counting continues and is not reset. If an exposure ~~returns to a~~is reclassified as performing ~~classification~~ in line with the EBA's Implementing Technical Standards[13] and also taking into account Chapter 5 of the NPL ~~guidance~~Guidance, the NPE vintage count ~~will~~for the purposes of this Addendum is deemed to be re-set to zero.

Exposures classified as NPEs and cured before 1 ~~January~~April 2018 that are reclassified ~~to a~~as non-performing ~~status~~ after 1 ~~January~~April 2018 ~~should~~are considered to be ~~treated as~~ new NPEs for the purpose of this ~~guidance~~Addendum, with the NPE vintage count starting at zero.

3.2 ~~Eligible credit~~Credit protection to secure exposures

This ~~addendum~~Addendum applies prudential principles to define the eligibility criteria for credit protection which are used ~~in determining~~to determine which parts of NPEs are to be ~~considered~~deemed secured or unsecured and, consequently, whether to ~~apply the~~ consider supervisory expectations for secured or unsecured ~~backstop~~exposures. This is based on the ~~principle~~premise that ~~the prudential regime has to deviate from~~ risk coverage may have to be increased if the accounting treatment ~~if that treatment~~ is not considered prudent from a supervisory perspective, as outlined above.

12 This also includes off-balance-sheet exposures as well as NPEs held by the international subsidiaries of significant institutions. For purchased NPEs, the supervisors will take into account evidence from the related due diligence process.

13 Final draft Implementing Technical Standards on forbearance and non-performing exposures (EBA ITS 2013/03)

For the purposes of this ~~addendum~~Addendum, the following types of collateral or other forms of credit risk protection are ~~accepted for~~ considered by the ECB as either fully or partially securing NPEs.

(a) All types of immovable property collateral. ~~Valuation of immovable property collateral should be carried out in accordance with the NPL Guidance, Chapter 7.~~

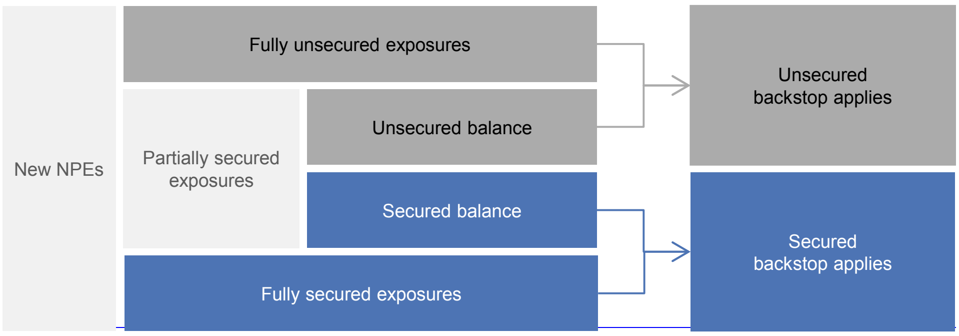
(b) Other eligible collateral or other forms of credit risk protection that fulfil the criteria of credit risk mitigation ~~of~~set out in Part Three, Title II, ~~Chapter~~Chapters 3 and 4 of the CRR, irrespective of whether an institution uses the standardised approach or the internal-ratings-based approach. In this way, a level playing field is ensured for all banks.

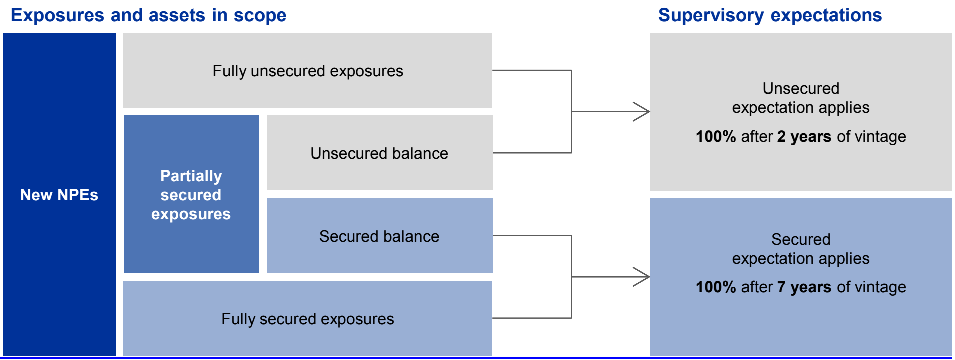
3.3 Definition of secured and unsecured parts of NPEs

The supervisory ~~guidance contained~~expectations set out in this ~~addendum distinguishes~~Addendum distinguish between secured and unsecured (parts of) NPEs as described below.

Figure 2

Blended approach for new NPEs in scope





Generally, the supervisory expectations are relevant to all drawn and undrawn credit facilities with non-performing status. However, they may be disregarded for undrawn credit facilities which may be cancelled unconditionally at any time and without notice, or that effectively provide for automatic cancellation owing to deterioration in the borrower's creditworthiness.

Fully unsecured exposures

~~In~~For the ~~context~~purposes of this ~~addendum~~Addendum, NPEs are considered fully unsecured if they do not benefit from credit risk protection ~~acceptable~~as described under Section 3.2. These exposures ~~should be~~are assessed ~~with the~~in the context of the supervisory dialogue using the supervisory expectations for unsecured ~~backstop~~exposures as further specified in Section 4.

Fully secured exposures

~~In~~For the ~~context~~purposes of this ~~addendum~~Addendum, NPEs are considered fully secured if ~~the~~they benefit from credit risk protection ~~acceptable~~, as described under Section 3.2, which exceeds the current drawn and potential undrawn credit facilities of the debtor. These exposures ~~should be~~are assessed ~~with~~ in the context of the supervisory dialogue using the supervisory expectations for secured ~~backstop.~~ exposures as further specified in Section 4.

~~The backstop is applicable to all drawn and undrawn credit facilities. However, undrawn credit facilities need not be included if they may be cancelled unconditionally at any time and without notice.~~

~~Collateral values used by the bank should represent~~Banks are expected to use as collateral values the collateral value reported for the exposure in line with the financial reporting (FINREP) instructions set out in Annex V[14] under "Collateral and guarantees received", corrected by deducting collateral and other credit risk protection not ~~acceptable~~considered for the purposes of this ~~addendum~~Addendum (see Section 3.2). With respect to the valuation of immovable property, ~~banks should be fully compliant with the criteria set out in~~ reference is made to Chapter 7 of the NPL Guidance, which spells out the supervisory expectations in this regard, including adequately prudent haircuts or adjustments.

Partially secured exposures

A blended approach is ~~required for~~applied to NPEs which are partially collateralised (i.e. the value of ~~eligible~~ credit risk protection as described in ~~accordance with~~ Section 3.2 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 regarded as split into the following two elements.

[14] Commission Implementing Regulation (EU) 2017/1443 of 29 June 2017 amending Implementing Regulation (EU) No 680/2014

1. **Secured balance:** ~~In~~in order to determine the secured balance of the NPE, the bank values the credit risk protection as outlined above for fully secured exposures. The secured balance ~~should be~~is assessed in line with the supervisory expectations for secured ~~backstop~~exposures.

2. **Unsecured balance:** ~~The~~the unsecured balance will be equal to the original drawn and potential undrawn credit facilities minus the secured balance of the exposure. The unsecured balance ~~should be~~is assessed in line with the supervisory expectations for unsecured ~~backstop~~exposures.

For fully and partially secured exposures, banks are expected to review regularly the collateral value ~~should be regularly reviewed~~ in line with the NPL Guidance, and ~~any changes should be taken~~to take into account any changes in a timely manner in the context of the provisioning ~~backstops~~expectations. Given the inherent execution risk in realising the value of collateral, banks should very carefully consider cases where the secured element increases over time. Such cases should be backed by solid evidence that increased valuations are sustainable, as also outlined for immovable property in the NPL Guidance.

4 Prudential provisioning ~~backstop~~expectations

~~4.1 Provisioning backstop categories~~

~~Unsecured backstop~~

4.1 Categories of provisioning expectations

Supervisory expectations for unsecured exposures

Fully unsecured NPEs and the unsecured balance of partially secured NPEs ~~are subject to~~will be assessed by the ~~unsecured backstop as set out~~ECB using the supervisory expectations outlined in Section 4.2.

~~Secured backstop~~

Supervisory expectations for secured exposures

As part of the prudential framework, a bank needs to be able to realise its ~~security~~credit protection in a “timely manner”. If collateral has not been realised after a period of several years from the date when the underlying exposure was classified as non-performing, because of failures in the internal processes of the bank or because of reasons beyond the bank’s control (e.g. the length of time it takes to conclude legal proceedings), the collateral ~~is~~ would in principle be deemed ~~to be~~ ineffective and as such, the exposure is expected to be treated as unsecured from a prudential perspective in the context of this Addendum. This means that full prudential provisioning is ~~required~~considered prudent after ~~seven~~a period of several years~~ as set out in Section 4.2. It is immaterial whether the delays in realising the security were due to reasons beyond the banks control (e.g. length of time it takes to conclude legal proceedings).~~.

Against this background, fully secured ~~exposures~~NPEs and the secured balance of partially secured ~~exposures are subject to~~NPEs will be assessed by the ~~secured backstop~~ECB in line with the supervisory expectations outlined in Section 4.2.

It should be noted that foreclosed assets ~~are~~do not currently ~~in~~ fall within the scope of this ~~addendum~~Addendum. However, ~~regarding~~Section 7.5 of the NPL Guidance addresses the valuation of foreclosed assets,~~ banks should be fully compliant with~~

~~the criteria set out in Section 7.5 of the NPL Guidance~~ including adequately prudent haircuts or adjustments. Furthermore, Annex 7 of the NPL Guidance also contains ~~clear~~ reporting and disclosure recommendations for foreclosed assets, including a breakdown by vintage.

~~4.2 Calibration~~

4.2 ~~All banks should ensure that~~Quantitative supervisory expectations in detail

The ECB will assess prudential provisioning levels of new NPEs as defined above ~~are compared with~~during the ~~below table.~~ supervisory dialogue described in Section 2.3 of this Addendum, taking into account the quantitative expectations summarised in Table 1.

Table 1
Overview of the quantitative expectations

	Unsecured part	Secured part
After two years of NPE vintage	100%	
After three years of NPE vintage		40%
After four years of NPE vintage		55%
After five years of NPE vintage		70%
After six years of NPE vintage		85%
After seven years of NPE vintage		100%

~~The application of the backstops should not result in~~

To avoid cliff edge effects, ~~but should rather be implemented in~~ a suitably gradual ~~way by banks~~path towards those supervisory expectations is important, starting from the moment of NPE classification ~~until~~. Therefore, the ECB will assess secured exposures in the ~~moment when 100% prudential provisioning is expected. For~~ context of the ~~secured backstop, banks should therefore assume at least~~supervisory dialogue, taking into account a linear path ~~for the backstop, building up to 100% over the seven years.~~ starting from year three onwards.

~~The backstop should not to be seen as a best practice timetable for provisioning, but rather as a supervisory tool for addressing outliers~~These expectations aim to ensure that banks ~~are~~do not ~~building~~build up aged NPEs with insufficient provision coverage. ~~Therefore, banks need to continue~~Therefore, the ECB considers that prudent provisioning implies the continuation of booking accounting provisions in line with ~~their assessment~~banks' assessments and existing accounting principles ~~which, in the vast majority of cases, should result in the backstop not having any effect~~. Only in the event that the accounting treatment applied is considered not prudent from a supervisory perspective may supervisors determine adequate measures on a case-by-case basis.

~~5~~ ~~Related~~During the supervisory ~~reporting and public disclosure~~

~~All~~dialogue all banks ~~should report~~are expected to inform their respective JSTs ~~at least on an annual basis the~~ of coverage levels by NPE vintage~~,~~ with regard to ~~the newly~~NPEs classified ~~NPEs~~ after 1 ~~January~~April 2018. In this context, deviations from the prudential provisioning ~~backstops~~expectations as outlined in this ~~addendum need to~~Addendum will be ~~duly explained~~carefully scrutinised. The JSTs will provide banks with further details regarding this process, ~~and the related templates,~~ sufficiently in advance.

Furthermore, in line with the recommendations contained in Annex 7 of the NPL Guidance, ~~a~~banks are also encouraged to include in their public ~~disclosure of NPE coverage~~disclosures the provisions by ~~vintage –~~type of asset and ~~thus the degree of alignment with~~different NPE vintages, as this ~~addendum –~~is an important ~~tool for banks to convey~~means of conveying their credit risk profiles comprehensively to market participants.