Addendum to the European Central Bank guidance on Non-Performing Loans (NPLs)

Supervisory expectations for prudential provisioning of Non-Performing Exposures (NPEs)

On 15 March 2018, the European Central Bank (ECB) published an Addendum to its ECB guidance to banks on NPLs following the public consultation which ran from October to December 2017.

The Addendum supplements the original NPL guidance of March 2017. It specifies the ECB's supervisory expectations for prudent levels of provisions for new NPLs. Loans that are reclassified from performing to non-performing in line with the EBA's definition after 1 April 2018, irrespective of their classification at any moment prior to that date are in scope. The Addendum is legally non-binding but will serve as the basis for supervisory dialogue between significant institutions and the Single Supervisory Mechanism (SSM).

In effect, the Addendum requires banks to hold a 100% provision for 'newly classified NPLs' where such exposures continue to be non-performing for two years in the case of unsecured exposures and seven years in the case of fully-secured exposures, introduced on a phased basis from the third year of non-performance.

Prudential provisioning expectations

The Addendum notes that the quantitative prudential expectations may go beyond, but do not stand in contradiction to, the applicable accounting rules. Consequently, if the applicable accounting treatment is not considered prudent from a supervisory perspective, the accounting provisioning level should be fully integrated in the bank's 'supply' in order to meet the supervisory expectation. The sum of the following items form the bank's supply:

- all accounting provisions under the applicable accounting standard, including potential newly booked provisions (ie classified as non-performing from 1 April 2018);
- expected loss shortfalls for exposures in default in accordance with Articles 158 and 159 of the Capital Requirements Regulation (CRR); and
- CET1 deductions from own funds under the bank's own initiative in accordance with Article 3 of the CRR.

The bank's supply of NPEs is then to be addressed through a bank-specific three step approach, namely:

- prudential provisioning expectations;
- supervisory dialogue; and,
- Supervisory Review and Evaluation Process (SREP) decisions following supervisory dialogue.

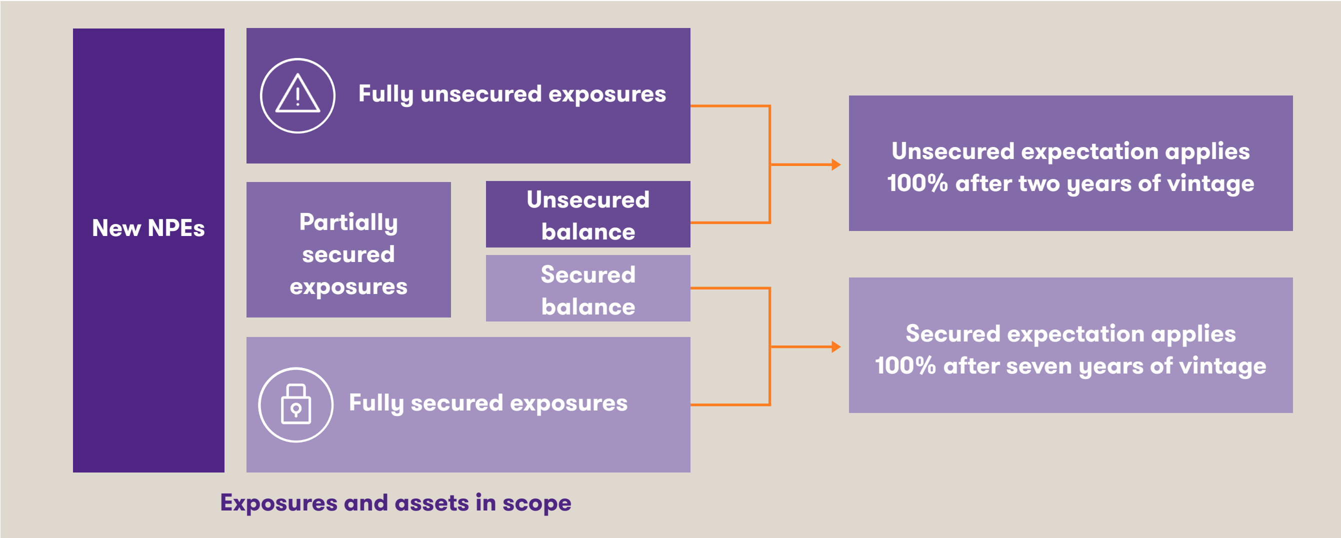
Banks are encouraged to close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the applicable accounting standard. If the applicable accounting treatment does not fulfil the prudential provisioning expectation, banks should then adjust their CET 1 capital of their own initiative under Article 3 of the CRR. It seems likely that this supervisory dialogue will increase required provisions.

Calibration of provisions

The Addendum distinguishes between secured and unsecured NPEs, parts thereof and a blended approach is recommended for partially secured exposures, as illustrated below.

In this respect, the following types of credit risk protection are considered as either fully or partially securing NPEs:

- all types of immovable property collateral; and
- other eligible collateral or other forms of credit risk protection that fulfil the criteria of credit risk mitigation set out in the CRR, irrespective of whether an institution uses the standardised approach or the internal-ratings-based approach.



For fully and partially secured exposures, banks are expected to regularly review the collateral value in line with the NPL guidance and take any changes into account in a timely manner.

Credit protection must be capable of being realised in a timely manner. Where collateral has not been realised after several years following the classification of the underlying exposure as non-performing, either due to internal issues or issues beyond the bank's control, the collateral is expected to be treated as unsecured in the context of the Addendum. In this respect, it is expected that new NPEs meet the expected provisioning levels set out in the table below, in order to avoid cliff-effects during the seven year period.

NPE vintage	Unsecured part	Secured part
2+ years	100%	
3+ years		40%
4+ years		55%
5+ years		70%
6+ years		85%
7+ years		100%

The ECB considers that prudent provisioning implies the continuation of booking accounting provisions in line with banks' assessments and existing accounting principles. 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.

Next steps for banks

SSM banks are expected to inform their Joint Supervisory Teams (JSTs) of NPE coverage levels by vintage for NPEs classified after 1 April 2018, with deviations to be carefully scrutinised.

The ECB will discuss with each bank divergences from the prudential provisioning expectations laid out in the Addendum. After this dialogue, and taking into account the bank's specific situation, JSTs will decide, on a case-by-case basis, whether and which supervisory measures are appropriate.

Although the incidence of new NPEs should be relatively low, the addendum introduces a new level of complexity into the provisioning approach adopted by banks and also creates two stocks of NPEs subject to different provisioning treatment.

Disclosures to the market will become more complex. In addition, this move by the ECB is also a challenge to the external auditors of SSM banks.

Banks will need to revisit their provisioning policies as well assess the impact on the broader suite of credit management policies. Once again, data challenges may also arise.

The outcome of the supervisory assessment will be taken into account and formally incorporated for the first time in the 2021 SREP. Banks are advised to use the intervening period to review current underwriting policies and criteria to reduce the population of new NPLs.

Contact

Grant Thornton has considerable experience on the topic of NPEs and the supervisory dialogue around such.
NPL management is critical to for almost all Irish directly supervised SSM banks. Should you require any further information or advice in relation to the challenges of NPE management, please feel free to contact a member of the Financial Services Advisory team.

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