

ECB Targets Non-Performing Loan Provisions in 2021 Supervisory and Evaluation Process

IN SHORT

The Situation: The European Central Bank ("ECB") has announced that it will set bank-specific supervisory expectations for the provisioning of non-performing loans ("NPLs") in a consistent way across comparable banks, which will be part of the 2021 Supervisory and Evaluation Process ("SREP").

The Development: The ECB identified the reduction of NPL exposures as a supervisory priority and provided guidance on provisioning backstops.

The Impact: Banks need to have a successful NPL strategy to avoid capital add-ons under Pillar 2 and prepare for an intensified supervisory dialogue and reporting as regards NPL exposures.

The [ECB recently announced](#) further steps in its supervisory approach for addressing NPLs in the euro area. In particular, the ECB will set bank-specific supervisory expectations for the provisioning of NPLs that are guided by individual banks' current NPL ratio and main financial features. The decision builds upon the revised version of the ["Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures"](#) of October 2017, which applies to NPLs (or, more broadly, non-performing exposures, or "NPEs") classified as such from April 1, 2018, onward. With this Addendum, the ECB encourages banks to close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the applicable accounting standard.

While the Addendum itself is non-binding, it will serve as a basis for the supervisory dialogue, in which banks are expected to inform the ECB of any differences between their practices and the prudential provisioning expectations. The result of this dialogue will be incorporated for the first time in the SREP and may, in a worst case scenario, impact negatively on the Pillar 2 requirements set by the ECB. Banks should use the time to prepare themselves and also to review their credit underwriting policies and criteria to reduce generating new NPLs.



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Levels of Provisioning for Secured and Unsecured Exposures

The Addendum distinguishes between fully unsecured, fully secured, and partially collateralized exposures.

Fully unsecured exposures are those that do not benefit from the credit risk protection that comes from immovable property or other protection that fulfills the credit risk mitigation criteria, as set out in Articles 192 to 241 in the Capital Requirements Regulation ("CRR"). The level of provisioning for the unsecured exposures is 100 percent after two years of "NPE vintage"—the period from categorizing an exposure as non-performing to the relevant reporting or reference date.

Fully secured exposures are those which do benefit from the credit risk protection that is available for secured exposures. The level of provisioning for secured exposures is 40 percent after three years, 55 percent after four years, 70 percent after five years, 85 percent after six years, and 100 percent after seven years of NPE vintage.

Partially collateralized exposures will be split between secured and unsecured exposures with the consequence that for the unsecured balance the unsecured and for the secured balance the secured provisioning backstop applies.

If an exposure is reclassified as performing in line with the European Banking Authority's ("EBA") [Implementing Technical Standard \("ITS"\) on forbearance and non-performing exposures](#) (EBA ITS 2013/03) and Chapter 5 of the NPL guidance, the NPE vintage figure will be reset at zero.

Functioning of the Prudential Provisioning Concept

OVERVIEW OF THE PRUDENTIAL PROVISIONING CONCEPT



In order to fulfil the ECB's provisioning expectations, the sum of the following items forms the bank's supply:

1. all accounting provisions under the applicable accounting standard, including potential newly booked provisions, and
2. expected loss shortfalls for the respective exposures in default in accordance with Articles 158 and 159 CRR, and other Common Equity Tier 1 ("CET1") deductions from the bank's own funds related to exposures (unless other CET1 deductions are already reflected in the calculations of expected loss shortfalls).

To avoid cliff-edge effects, the expectations should be implemented in a suitably gradual way from the NPE classification toward the supervisory expectations.

Related Supervisory Reporting and Public Disclosure

The ECB expects reporting on compliance with the loan loss provisioning expectations at least annually. Under certain conditions, the ECB may accept deviations from the expected provisioning if explained coherently and satisfactorily.

The ECB further expects public disclosure of NPE coverage by type of asset and different NPE vintage, as banks should convey their credit risk profiles comprehensively to market participants.

THREE KEY TAKEAWAYS

1. The ECB will now start addressing NPLs by determining bank-specific supervisory expectations that will be based on benchmarking of comparable banks.
2. Banks carrying significant NPL exposures are subject to additional reporting requirements regarding their NPL stock and progress on the reduction of such exposures.
3. Compliance with the ECB's loan loss provisioning expectations may largely affect the Pillar 2 requirements and Pillar 2 guidance resulting from the 2021 SREP onward.



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