



EUROPEAN COMMISSION

Directorate-General for Financial Stability, Financial Services and Capital Markets Union

Call for advice to the EBA for the purposes of considering statutory prudential measures to address insufficient provisioning for newly originated loans once they become non-performing

Context

As announced in the Communication on completing the Banking Union¹, and as a follow-up to the Council's request in the context of its action plan to tackle non-performing loans (NPLs) in Europe², the Commission is preparing a report that will consider introducing statutory prudential backstops in the form of compulsory and time-bound prudential deductions of NPLs from own funds in order to address potential under-provisioning of new loans that turn non-performing and prevent the build-up through future loans of insufficiently covered NPL across EU Member States and banks. As furthermore announced in the aforementioned Communication, the Commission in this context also considers introducing a common definition of non-performing exposures (NPEs) in accordance with that already used for supervisory reporting purposes³ in order to provide a sound legal basis for and ensure consistency in the prudential treatment of such exposures.

A consultation document (CD)⁴ in this regard has been published on 10 November 2017 to gather stakeholders' views on the possible introduction as well as the potential functioning, scope, design and calibration of statutory prudential backstops addressing insufficient loan loss coverage for newly originated loans once they become NPLs (referred to as "new NPEs" in the this call for advice)⁵.

¹ COM, Communication on completing the banking union (2017), http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf.

² ECOFIN, Action Plan To Tackle Non-Performing Loans In Europe (2017), <http://www.consilium.europa.eu/en/press/press-releases/2017/07/11-conclusions-non-performing-loans/>.

³ Commission Implementing Regulation (EU) No. 680/2014.

⁴ Please refer to https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf.

⁵ The prudential backstops would address non-performing exposures (NPEs). However, the terms NPE and NPL are often used interchangeably (also in this document) as the latter term is well established and commonly used in the policy discussion.

The statutory prudential backstops set out in the CP and underlying this request would consist of two main elements: (i) a requirement for institutions to cover incurred and expected losses on new NPEs up to common minimum levels ("minimum coverage requirement"), and (ii) where the applicable minimum coverage requirement is not met, a deduction of the difference between the level of the actual coverage and the minimum coverage from Common Equity Tier 1 (CET1) items.

The following items would be eligible for compliance with the minimum coverage requirements provided they relate to the new NPEs:

- a) provisions recognised under the applicable accounting framework ("credit risk adjustments")⁶,
- b) additional value adjustments in accordance with Articles 34 and 110 CRR,
- c) other own funds reductions, and
- d) for institutions calculating risk-weighted assets (RWAs) using the internal ratings-based approach, negative amounts resulting from the calculation of expected loss laid down in Articles 158 and 159 CRR.

Only where the sum of the amounts listed under a) to d) (i.e. the "actual NPE coverage") does not suffice to meet the applicable minimum coverage requirement, the prudential backstops would apply and require deduction of the difference between the two from CET1 items.⁷

These prudential deductions for new NPEs would be introduced into the own funds part of the CRR together with the necessary amendments to related provisions on credit risk⁸ in order to ensure consistency and coherence of the prudential framework.

The Commission is seeking technical advice from the EBA to assess the potential impact for EU banks from adopting such statutory prudential backstops for new NPEs.

Considering the relatively short timeframe available for producing the report, the Commission Services are neither expecting the EBA to collect new data nor to publicly consult on its findings.

Scope of the EBA's work

In this context, the **Commission Services would like to invite the EBA to:**

- **provide country-by-country estimates on additional/accelerated capital needs triggered for EU banks by the prudential backstops** (as described above and in conjunction with the design and calibration options set out below) taking into account, to the extent possible, expected increases in provisions as a result of the application of IFRS 9.

In particular, the EBA should assess the potential impact of the prudential backstops on newly originated loans (i.e. loans which have been granted after a certain cut-off date, such as the date of the publication of a possible legislative proposal introducing

⁶ "Credit risk adjustment" means the amount of specific and general loan loss provision for credit risks that has been recognised in the financial statements of the institution in accordance with the applicable accounting framework" (Article 4(1)(95) CRR).

⁷ This deduction would thus ensure that the risks associated with NPLs are reflected in banks' CET1 capital ratios one way or another.

⁸ Such as the provisions on the "Exposure value" (Article 111 and 166 CRR), "Exposures in default" (Article 127 CRR) and the "Treatment of expected loss amounts" (Article 159 CRR).

prudential backstops, the date of adoption of the new requirement or the date of entry into force of the new requirement⁹) that thereafter turn non-performing.

In this context it is important to also consider counter-balancing effects on bank capital which would follow from increased provisions/deductions (such as an increase in Tier 2 Capital in the form of “excess” provisions/deductions or the relief on capital requirements for institutions applying the standardised approach for credit risk as a result of reduced exposure values).

Acknowledging the methodological difficulties and data limitations, the Commission Services is not expecting the EBA to quantify expected positive changes in banks’ behaviour and legal/economic circumstances, and therefore consider the quantitative impact estimates eventually provided in the report as upper bound, in particular as regards new NPEs. However, it would be appreciated, if the EBA’s report could include a qualitative analysis of the (positive) effects statutory minimum coverage requirements may have on banks’ incentives to prevent the accumulation of new NPEs through, inter alia, better loan restructuring and stronger origination standards.

- **assess the impact under the following design and calibration options.**

Option 1. Institutions would be required to fully cover with CET1¹⁰ their *unsecured*¹¹ (parts of) new NPEs after 2 years and their *secured*¹² (parts of) new NPEs after 6/7/8/9/10 years, if the collateral/guarantee has not proved to be effective from a prudential perspective^{13, 14}. Which parts of new NPEs are to be considered secured and under which conditions would have to be determined in accordance with the rules on credit risk mitigation provided by the CRR.

Option 2. As Option 1, but applying a gradually increasing scaling factor to the minimum coverage requirements, whereby banks would have to follow a *linear* or *progressive* path towards the required minimum coverage level in order to avoid cliff-edge effects and limit potentially pro-cyclical effects while also leaving sufficient time for possible recoveries (in particular from collateral held for new NPEs). To this end, the EBA is invited to consider possible options for the scaling factor.

⁹ Please see also question 3. of the CD.

¹⁰ This means via provisions, additional value adjustments, other own funds reductions, regulatory expected loss shortfall and additional deductions (see items a) to d) listed above in the context of the functioning of statutory prudential backstops).

¹¹ I.e. not covered by eligible credit protection.

¹² I.e. covered by eligible credit protection.

¹³ Where the collateral/guarantee has not been realised after a perennial period (of 6 to 8 years) following the classification of the underlying exposure as non-performing, the credit protection would be considered ineffective from a prudential perspective (due to insufficient evidence as to its recoverability and enforceability) and by consequence, the exposure would be treated as unsecured for the purposes of the backstops irrespective of the collateral valuation and deducted within the applicable time period (of 2 years).

¹⁴ This means, where the backstops apply, institutions would have to deduct from CET1 items (i) the uncovered exposure amount of unsecured (parts of) NPEs after 2 years (ensuring a full prudential loss coverage of unsecured [parts of] NPEs) and (ii) the entire uncovered exposure amount of secured (parts of) NPEs after 6+2 to 8+2 years (ensuring a full prudential loss coverage of secured [parts of] NPEs, i.e. including also the collateral, if there is not sufficient evidence as to its recoverability and enforceability).

Option 3. Institutions would be required to fully cover with CET1¹⁵ their *unsecured* (parts of) new NPEs after 2 years. To *secured* (parts of) new NPEs specific minimum levels of prudential haircuts¹⁶ on collateral/guarantee values (as determined in accordance with the applicable accounting standards and prudential requirements) would apply in order to address risks associated with the effectiveness of credit protection for new NPEs in a more targeted way. The EBA is invited to consider possible options for common minimum haircut levels beyond those put forward in the CP.

- **do a sensitivity analysis for the key parameters of the prudential backstops** as describe above (such as the time horizons to reach full coverage of unsecured/secured new NPEs, different linear/progressive scaling factors, different haircut levels on most important forms of credit protection etc.).
- **assess, to the extent possible, the potential impact of the prudential backstops on EU banks' profitability.**
- **provide, to the extent possible, an analysis of the effects the prudential backstops would potentially have, if they were applied in an adverse economic scenario** (such as the economic downturn following the global financial crisis).
- **highlight any technical aspects that are of relevance to the functioning, scope design and calibration of statutory prudential backstops.**

Final considerations

The Commission is aware that time and resource constraints may restrict the range of analysis methodologies to be used by the EBA in certain aspects of the Call for Advice. Should this be the case, the EBA should highlight these limitations in its final report.

It is recalled that the analysis provided will not prejudge the Commission's final decision. Moreover, in accordance with the established practices of the Commission Expert Group on Banking, Payments and Insurance, the Commission will continue, where appropriate, to consult the experts appointed by the Member States in the preparation of its proposal.

In order to complete its report, accompanied if appropriate with the necessary legislative proposals, within the timeframe given in the Banking Union Communication (Q1 2018), the Commission Services would need to receive the EBA's final report by 27 November 2017.

¹⁵ This means via provisions, additional value adjustments, other own funds reductions, regulatory expected loss shortfall and additional deductions (see items a) to d) listed above in the context of the functioning of statutory prudential backstops).

¹⁶ Prudential haircut means applying a reduction in the value of the protection recognised for prudential purposes.