EUROPEAN BANKING AUTHORITY

EBA/CP/2021/25

24 June 2021

Consultation Paper

On Draft Regulatory Technical Standards on the specification of the calculation of specific credit risk adjustments

Amending Delegated Regulation (EU) No 183/2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, with regard to regulatory technical standards for specifying the calculation of specific and general credit risk adjustments

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1. Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 24 September 2021. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EU) 1725/2018 of the European Parliament and of the Council of 23 October 2018. Further information on data protection can be found under the Legal notice section of the EBA website.

2. Executive Summary

The 16 December 2020, the European Commission published its action plan on *Tackling non-performing loans in the aftermath of the COVID-19 pandemic*[1], where it indicated the need for a revision of the treatment of defaulted assets under the standardised approach for credit risk (SA). Section 2.5 of the Commission action plan asks the European Banking Authority to consider the appropriate prudential treatment of the risk weight (RW) for defaulted exposures following the sale of a non-performing asset. In particular, it is noted that a 100% RW – compared to the normal RW of 150% - can be applied when provisions cover for more than 20% of an exposure, however '*only provisions/write-downs (so-called 'credit risk adjustments') made by the institution itself can be accounted for, not write-downs accounted for in the transaction price of the exposure'.* [2]

The proposed amendments allows for the recognition of such *write-downs accounted for in the transaction price of the exposure*, which are retained by the seller, in the credit risk adjustments recognised for the determination of the RW of defaulted exposures applied by the buyer under the SA. This is done via the introduction of an amount (that could be seen as a "discount") that would have to be added to the amount of specific credit risk adjustment used to determine the appropriate RW under Article 127(1) of Regulation (EU) No 575/2013. As a consequence, the amount used to determine the RW under Article 127(1) of Regulation (EU) No 575/2013 is designed in such a way that the purchase of an asset with a discount equal to the amount of specific credit risk adjustments that were assigned to the exposure by the seller does not change its RW.

EBA has taken the step to implement this change through an RTS amendment, as this will ensure that regulatory treatment of sold NPL assets will be clarified. The EBA will however also recommend that the treatment set out in this RTS is included in the considerations of the Commission as part of the CRR3 proposal, which is expected at a later stage.

Next steps

This CP is issued for a consultation period of three months. The final draft RTS will be subsequently submitted to the Commission for endorsement before being published in the Official Journal of the European Union

[1] See https://ec.europa.eu/info/publications/201216-non-performing-loans-action-plan_en. The EBA press release related to this plan can be found here: EBA welcomes European Commission's action plan to tackle NPLs in the aftermath of the COVID-19 pandemic | European Banking Authority (europa.eu).

[2] See annex 1 for an extract of the communication and an example of the unwarranted increase in RW; the relevant CRR provisions are presented in annex 2.

3. Background and rationale

The 16 December 2020, the European Commission published its Action Plan on *Tackling non-performing loans in the aftermath of the COVID-19 pandemic*, where it indicated the need for a revision of the treatment of defaulted exposures under the SA. This request is part of the comprehensive action plan by the Commission to tackle the expected rise of non-performing loans (NPLs) on banks' balance sheets following the outbreak of the COVID-19 pandemic. EBA has been given a number of tasks and one of the requests is for the EBA to address regulatory impediments to NPL purchases.

Section 2.5 of the Commission Action Plan asks the European Banking Authority to consider the appropriate prudential treatment of the risk weights for defaulted assets following the sale of a non-performing exposure. In particular, it is noted that a 100% risk weight– compared to the normal RW of 150% - can be applied when provisions cover for more than 20% of an exposure, however '*only provisions/write-downs (so-called 'credit risk adjustments') made by the institution itself can be accounted for, not write-downs accounted for in the transaction price of the exposure'.* [3]

The proposed amendments allow for the inclusion of, in particular, any write-downs accounted for in the transaction price of the exposure which are retained by the seller as realised loss, in the credit risk adjustments recognised for the determination of the RW of defaulted exposures applied by the buyer under the SA at the sale date. This is done via the introduction of an amount (that could be seen as a "discount") that would have to be added to the amount of specific credit risk adjustments used to determine the appropriate RW under Article 127(1) of Regulation (EU) No 575/2013. As a consequence, the amount used to determine the RW under Article 127(1) of Regulation (EU) No 575/2013 is designed in such a way that the purchase of an asset with a discount equal to the amount of specific credit risk adjustments that were assigned to the exposure by the seller does not change its RW. However, the discount is defined in a dynamic way, in order to take into account any future revaluations of the exposure.

Lowering the SA risk weight where at least 20% of a defaulted exposure is covered by specific credit adjustments acknowledges a shift from unexpected losses (UL) to expected losses (EL), which is the same reason for the decrease in IRB risk weights above certain PD levels. Unlike for the IRB approach, there is no prudential measure of EL under the SA for credit risk, instead specific credit risk adjustments under the applicable accounting framework serve as proxy for the prudential EL level.

Relying on this EL proxy does not work, however, for the buyer of NPLs. Via a purchase price discount, not only previous specific credit risk adjustments made by the seller but also any bargain power loss effects are retained by the seller as realised losses. This loss retention by the seller justifies taking the purchase price discount into account for identifying the EL level of a purchased NPL. On the other hand, it is also necessary to continue identifying any decrease in EL after the purchase, as this could shift more credit risk back to UL, which could require increasing the SA risk weight after the purchase, also

[3] See annex 1 for an extract of the communication and an example of the unwarranted increase in RW; the relevant CRR provisions are presented in annex 2.

because, all other things being equal, the same increase in SA risk weight would also have occurred for the seller.

A decrease in EL can happen when the buyer recognises some of the purchase price discount as increasing CET1 capital when no CET1 reductions exist for an exposure. Still treating the full purchase price discount as EL indicator could therefore cause double recognition, first by increased CET1 capital and again by reducing the risk weight due to incorrectly still indicating a shift from UL to EL. Avoiding such double recognition requires dynamically adjusting the amount treated as discount, in order to recognise only that portion of a purchase price discount which has not already been recognised by increased CET1 capital. This is achieved by the proposed definition which limits the amount treated as discount to the gap, if any, between on the one hand the maximum CET1 reduction on the defaulted exposure, indicated by total still outstanding credit obligations (i.e. before any recoveries), and on the other hand the sum of already existing CET1 reductions, indicated by specific credit risk adjustments, and the maximum future CET1 reduction if the exposure were fully written off.

Limiting discounts to the still existing gap to outstanding credit obligations, by considering both the existing CET1 reductions and the maximum future CET1 reduction, avoids double recognition of the same relative increase in CET1 capital.

- Where CET1 reductions exist for an exposure, any decrease in the amounts recorded under the applicable accounting framework related to credit losses on an exposure, e.g. due to an impairment gain, first reduces the existing CET1 reductions for this exposure by the same amount. While this increases the maximum future CET1 reduction if the exposure were fully written off, the discount nevertheless remains unchanged because the increase in one part of the sum is accompanied by the same decrease in the other part of the sum used for determining the gap to outstanding credit obligations.

- Only where no CET1 reductions exists any more for the exposure (or did not exist from the outset e.g. where the exposure has been classified as purchased credit-impaired asset under IFRS 9 using the purchase price as fair value), any further relative increase in CET1 capital (due to improvements in loss assumptions under the applicable accounting framework) starts shrinking the discount. While further increasing the maximum future CET1 reduction if the exposure were fully written off, the amount of existing CET1 reductions for the exposure is already zero and therefore remains zero. Consequently, the sum of the two amounts increases and therefore reduces the gap to outstanding credit obligations, thus reduces the discount.

This mechanism of the discount definition ensures that the same improvement in loss assumptions under the applicable accounting framework can only be recognised either as reducing existing CET1 reductions or as reducing the discount, which prevents any double recognition of the same relative increase in CET1 capital from the outset. Moreover, this mechanism ensures that a discount can only shrink where and to the extent to which an amount of the initial purchase price discount has increased CET1 capital where no CET1 reductions exist for an exposure.

An example may be useful to illustrate the calculation of the discount and its different components. The illustration is based on a defaulted loan observed at three different moments:

- **Phase 1: the loan is owned by an institution that intends to sell it ([4]).**

This phase is useful to illustrate the calculation of the discount before the sale and check that its value is 0 (as the discount will only occur after the sale on the buyer's side).

- **Phase 2: the loan is sold and therefore owned by another institution.**

For simplicity, the price of the transaction is assumed to be the new fair value of the loan. This phase is useful to illustrate the calculation of the discount in the case where the selling price is retained as the fair value.

- **Phase 3: the buying institutions revaluates the loan.**

This phase is useful to illustrate the calculation of the discount in the case where the selling price is not retained as the fair value. This is the stage where the different wording compared to Article 47c(1)(b)(v) will be highlighted.

In practice, the following values are used:

1) **For all phases:** amount owed: 100;
2) **Phase 1**: Credit Loss reflected under the appropriate accounting standard (before the sale, estimated by the seller): 25;
3) **Phase 2:** Selling Price: 60, Credit Loss reflected under the appropriate accounting standard (after sale, estimated by the buyer on the 60): 1 *(i.e. in time of the purchase, the buyer expects that the obligor will only pay 59 instead of 100)*;
4) **Phase 3:** revaluation of the loan by 30, Credit Loss reflected under the appropriate accounting standard unchanged.

It should be noted that this example is designed to illustrate the calculation of the discount in a simple manner. As such, it does not discuss the methods used for the (re)valuation of the loan and for the recognition of credit losses, which should be done according to the applicable accounting framework. In addition, the example illustrates the impact of the discount on the risk weighted exposure amount (RWEA) calculation. It is important to note that the revaluation has in this example an impact directly on the CET1 of the institutions via a profit. In the example, while the RWEA increase between phase 2 and phase 3 from 59 to 133,5, which e.g. increases the own funds amount required for the 8% minimum total own funds ratio from 4,7 to 10,7, the CET1 of the buyer will also increase by 30 due to the revaluation. Therefore, the solvency position of the buyer will be overall improved in phase 3 compared to phase 2.

[4] The example is based on the case of fully unsecured loan.

		Phase 1	Phase 2	Phase 3
		Amounts before sale	**Amount after sale / before revaluation**	**Amount after sale / after revaluation**
A	***the total outstanding amount of credit obligations on the exposure***	100	100	100
B	***the additional own funds reduction if the exposure was written-off fully, excluding already existing own funds reductions***	75	59	89
C	***any already existing own funds reductions related to this exposure***	25	1	1
	Discount [A – (B+C)]	**0** (100-(75+25));	**40** (= 100-(59+1));	**10** (= 100-(89+1));
Memo	**Coverage (SCRA + Discount)**	**25** (25+0)	**41** (1+40)	**11** (1+10)
	Total credit obligation still outstanding (exposure value if those specific credit risk adjustments and deductions were not applied	**100**	**100**	**100**
	Coverage Ratio for article 127(1)	**25% (≥20%)**	**41% (≥20%)**	**11% (<20%)**
	Associated RW	**100%**	**100%**	**150%**
	Exposure Value (EAD)	**75**	**59 (= 60 – 1)**	**89 (= 60 – (1 - 30))**
	RWEA	**75**	**59**	**133,5**
	RWEA applied to the	**Seller**	**Buyer**	**Buyer**

Question 1:

Do you agree with the proposed amendment to Commission Delegated Regulation (EU) No 183/2014

Additional considerations

EBA has taken the step to implement this change through an RTS amendment, as this will ensure that regulatory treatment of sold NPL assets will be clarified. The EBA will however also recommend that the treatment set out in this RTS is included in the considerations of the Commission as part of the CRR3 proposal, which is expected at a later stage.

4. Draft regulatory technical standards

COMMISSION DELEGATED REGULATION (EU) …/…

of XXX

amending Delegated Regulation (EU) No 183/2014 of supplementing Regulation (EU) No 575/2013 the European Parliament and of the Council on prudential requirements for credit institutions and investment firms, with regard to regulatory technical standards for specifying the calculation of specific and general credit risk adjustments

(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to 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[5], and in particular Article 110(4) third subparagraph thereof,

Whereas:

(1) This Regulation relates to the specification of the calculation of specific credit risk adjustments for the purpose of assigning a risk weight of the unsecured part of any item where the obligor has defaulted in accordance with Article 178 of Regulation (EU) No 575/2013, or in the case of retail exposures, the unsecured part of any credit facility which has defaulted in accordance with Article 178 of Regulation (EU) No 575/2013, as specified in Article 127(1) of Regulation (EU) No 575/2013.

(2) Article 110(4)(e) of Regulation (EU) No 575/2013 provides for an empowerment to the EBA to specify the amounts that need to be included in the calculation of credit risk adjustments for the determination of default under Article 178 of Regulation (EU) No 575/2013. In accordance with Article 127(1) of Regulation (EU) No 575/2013, the exposures to be risk weighted according to that article must be determined based on the default status as defined under Article 178. In particular, the risk weight of an exposure in default depends on the amount of specific credit risk adjustments related to this exposure. It is therefore necessary to specify the amounts that need to be included in the calculation of specific credit risk adjustments for the purpose of Article 178 read and applied in conjunction with Article 127(1) of Regulation (EU) No 575/2013.

(3) In accordance with Article 127(1) of Regulation (EU) No 575/2013, the risk weight of an exposure in default depends, among other, on the amount of specific credit risk adjustments related to this exposure. This risk weight should ensure that a sufficient amount of own funds can provide coverage for the unexpected losses on this exposure. The potential for unexpected losses depends on the extent to which credit

[5] OJ L 176, 27.6.2013, p. 1.

losses are already expected to occur on the considered exposure in default and therefore are recognised according to the applicable accounting framework in a way that has already reduced CET1 capital. They are therefore only marginally impacted, all other things including the applicable accounting framework being equal, by a sale of the exposures.

(4) However, based on the current definition of credit risk adjustment, only the expected credit losses reflected by specific credit risk adjustments made by the institution holding the exposure can be accounted for, not the ones accounted for in the transaction price of the exposure which are retained by the seller as finally realised loss. As a result, the risk weight applied to the exposure in default may change following a sale, even though the transaction price incorporates a discount for expected credit losses of an equal amount to the specific credit risk adjustments booked by the selling institution before the sale.

(5) In light of the COVID-19 pandemic, it is desirable to remove any impediment to the creation of secondary markets for defaulted exposures. In this context, a misalignment between the risk weight applied to defaulted assets and the potential for unexpected losses in relation to the level of already expected losses could create undue obstacles for credit institutions to move their non-performing loans off their balance sheets.

(6) It is therefore necessary to ensure that the specific credit risk adjustments recognised for Article 127(1) of Regulation (EU) No 575/2013 incorporate any discount in a transaction price that the buyer has not recognised by increasing CET1 capital. In addition, this discount should be defined in a dynamic manner, i.e. it should incorporate any potential future revaluation of the loan occuring after the sale in order to recognise only the amount which is not recognised by increased CET1 capital.

(7) This Regulation is based on the draft regulatory technical standards submitted to the Commission by the European Banking Authority.

(8) The European Banking Authority has conducted open public consultation on the draft regulatory technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the advice of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010[6].

(9) Commission Delegated Regulation (EU) No 183/2014 should therefore be amended accordingly,

[6] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2020, p. 12).

HAS ADOPTED THIS REGULATION:

Article 1

Amendements to Commission Delegated Regulation (EU) No 183/2014

In Article 1 of the Commission Delegated Regulation (EU) No 183/2014, paragraph 6 shall be added as follows:

6. To calculate the sum of specific credit risk adjustments in the cases referred to in Article 127, paragraph 1, points (a) and (b) of Regulation (EU) No 575/2013 for an exposure constituted by an item, where the obligor has defaulted in accordance with Article 178 of that Regulation, or in the case of retail exposures, constituted by a credit facility which has defaulted in accordance with Article 178 of that Regulation, institutions shall include any positive difference between the total outstanding amount of credit obligations on the exposure and the sum of (i) the additional own funds reduction if the exposure was written-off fully, and (ii) any already existing own funds reductions related to this exposure

Article 2

Entry into force

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

For the Commission
On behalf of the President

EUROPEAN BANKING AUTHORITY

5. Accompanying documents

5.1 Draft cost-benefit analysis/impact assessment

As per Article 10(1) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any regulatory technical standards developed by the EBA – when submitted to the EU Commission for adoption – shall be accompanied by an Impact Assessment (IA) annex which analyses 'the potential related costs and benefits'. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problems and their potential impacts.

A. Problem identification

Under Article 127(1) of Regulation (EU) No 575/2013, the RW of an exposure in default depends, among other, on the amount of specific credit risk adjustments related to this exposure. This RW should ensure that a sufficient amount of own funds can cover the potential additional unexpected losses on this exposure. The potential for additional unexpected losses depends on the extent to which credit losses are already expected to occur on of the considered exposure in default and therefore are recognised according to the applicable accounting framework in a way that has already reduced CET1 capital. They are therefore only marginally impacted, all other things including the applicable accounting framework being equal, by a sale of the exposures.

However, based on the current definition of credit risk adjustment, only the expected credit losses reflected by credit risk adjustments made by the institution holding the exposure can be accounted for, not the ones accounted for in the transaction price of the exposure which are retained by the seller as realised loss. As a result, the RW applied to the exposure in default may change following a sale, even though the transaction price incorporates a discount for expected credit losses of the same amount as the specific credit risk adjustments previously booked by the selling institution.

B. Policy objectives

As set up in the European Commission's NPL action plan, the intention is to prevent a future build-up of NPLs across the European Union as a result of the COVID-19 crisis. In particular, the NPL strategy intends, among other objectives, to further develop secondary markets for distressed assets, which will allow banks to move NPLs off their balance sheets, while ensuring further strengthened protection for debtors.

C. Baseline scenario

In the case of no change in the regulation, the unduly higher RW could create impediments to the creation of an NPL secondary market.

D. Options considered

In addition to the amendment proposed by this RTS, the alternative would be introducing the definition of discount in Article 4 CRR and amending Article 127(1) CRR by recognising discounts separately in addition to specific credit risk adjustments. Amending the CRR could, however, require more time which would be in conflict with the need for swift reaction to the COVID-19 crisis. Instead, amending Commission Delegated Regulation (EU) No 183/2014, by extending the scope of specific credit risk adjustment to be considered for the purpose of Article 127(1) CRR to include discounts, allows for a faster procedure and is therefore the preferred option, as proposed in this draft Regulation.

E. Cost-Benefit Analysis

The costs and benefits of the proposal are mainly expected on the amount of own fund requirements for credit institutions, as the IT related cost are assessed as marginal. The impact of this amendment is not expected to be material for most of credit institutions. This is because, even in the case of an unwarranted increase in the RW, the buyer would still have much lower overall capital costs than the seller because he normally pays a price lower to the net carrying amount of the assets in the seller, and therefore already a strong incentive to purchase non-performing loans.

However, for a small set of institutions with a business model focused on buying these non-performing loans, the impact could be very significant, as it would imply a relative diminution of the risk weighted exposure amount by a third (due to possible decrease in the RW from 150 % to 100 %).

Therefore, while the magnitude of the benefits is uncertain, the net impact of the proposal seems to be beneficial, as it would incentivise the disposal of non-performing loans.

F. Preferred option

Amending Commission Delegated Regulation (EU) No 183/2014, by extending the scope of credit risk adjustment to be considered for the purpose of Article 127(1) CRR to include discounts, is the preferred option.

5.2 Overview of questions for consultation

Question 1: Do you agree with the proposed amendment to Commission Delegated Regulation (EU) No 183/2014?