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New EU Measures on NPLs – Part 1: Statutory Prudential Backstop for NPLs Provisioning and ECB Addendum

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On March 14, 2018 the European Commission ("**EC**") published a package of proposals aimed at facilitating the reduction of the current stock of non-performing loans ("**NPLs**") held by European banks and mitigating their build-up in the future. The EC proposals include the introduction of common minimum regulatory provisioning levels for newly originated NPLs, harmonized provisions on out-of-court recovery of secured loans, credit purchasers and servicers and a blueprint on the set-up of national asset management companies ("**AMCs**") dealing with NPLs.

On March 15, 2018 separate guidelines on minimum regulatory provisioning levels for NPLs were published by the European Central Bank ("**ECB**") in the awaited addendum (the "**ECB Addendum**") to its one year old Guidance to banks on NPLs (the "**NPLs Guidance**").

The new measures are expected to significantly affect the NPL strategy of European banks, especially in countries with high NPL levels. But the consequences may be even more far-reaching, as these rules will likely affect the way in which lending is conducted and loans are collateralized and enforced in Europe.

Background

EU institutions have devoted significant attention to the NPL problem in the last few years and the measures taken at European and national level, coupled with a moderate growth pace, have progressively led to falling NPL ratios in nearly all EU Member States[1].

However, the legacy stock of troubled assets and distressed loans accumulated by European banks is still one of the major impediments to a full economic recovery and increase of credit supply in some EU Member States. The total volume of NPLs in the EU is in the region of EUR 910 billion and NPLs ratios diverge significantly across EU Member States[2]. The existing discrepancies among NPLs ratios in the Eurozone are

[1] Based on the data provided in the "Second Progress Report" on the reduction of NPLs published by the EC on March 14, 2018 (the "**Second Progress Report on NPLs**") the overall NPL ratio in the EU at the end of Q3 2017 declined to 4.4% of total loans (*i.e.* down by roughly 1% year-on-year, 0.2% quarter-on-quarter).

[2] See the data provided by the EC in the Second Progress Report on NPLs. While NPLs ratios at the end of Q3 2017 are close to 2-3% of total loans in a number of EU Member States (*e.g.* Belgium, Estonia, Germany and the Netherlands) or even lower in others (*e.g.* Luxembourg, Finland and Sweden), some of the countries that were significantly hit by the financial crisis are still undergoing the burden of substantial NPL ratios (*e.g.* 10-15% in Ireland, Italy and Portugal, with a peak of 32.1% in Cyprus and 46.7% in Greece).

also hindering the on-going political negotiations on the establishment of a European Deposit Insurance Scheme (EDIS), which is the missing pillar of the European Banking Union.

In response to these concerns and with a view to overcome certain structural inefficiencies of the internal market, on July 11, 2017 the Council approved its "Action Plan to tackle non-performing loans in Europe", promoting the adoption of a combined approach of different policy actions in the areas of regulatory supervision, insolvency and debt recovery frameworks, secondary markets for distressed assets, and restructuring of the banking system. Some of these actions have now been taken by the EC and the ECB through a package of measures that are expected to significantly affect EU banks.

Overview of the New EU Measures[3]

On March 14, 2018 the EC published:

- A proposal for a Regulation (the "**Proposed Regulation**") amending Regulation (EU) 575/2013 ("**CRR**") as regards minimum loss coverage for non-performing exposures ("**NPEs**") [4]. The Proposed Regulation will impose a "Pillar 1" minimum regulatory backstop for the provisioning of NPEs by EU banks – which is meant to apply to all exposures originated after March 14, 2018. Any failure to meet such provisioning floor will trigger deductions from Common Equity Tier 1 ("**CET1**") items.
- A proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral (the "**Proposed Directive**"). The Proposed Directive is aimed at developing the EU secondary market for NPLs and ensuring a more efficient value recovery for secured creditors through accelerated out-of-court enforcement procedures. The transposition deadline of the Proposed Directive is currently set on December 31, 2020.
- A blueprint on AMCs (the "**AMC Blueprint**") accompanying the EC's Second Progress Report on NPLs. The AMC Blueprint contains practical and non-binding recommendations on how national AMCs can be set up by EU Member States without infringing EU State aid rules, leveraging on the previous experiences of the EC and EU Member States with publicly-sponsored troubled assets relief programs.

In parallel with the above proposals – and notwithstanding the objections raised by the European Parliament on the draft version of the document published in October 2017 – the ECB issued its controversial ECB Addendum on March 15, 2018, supplementing the NPLs Guidance and detailing the ECB supervisory expectations as regards the minimum levels of NPLs provisioning. While the goals pursued by the ECB under the ECB Addendum are the same as those underlying the Proposed Regulation, there are some significant differences between the EC and ECB measures on NPLs which need to be reconciled.

Proposed Regulation on Statutory Prudential Backstop for NPLs Provisioning

NPL Provisioning under the Current Accounting and Regulatory Framework

Provisions on NPEs must be made by credit institutions in accordance with the applicable accounting principles. In January 2018, the new IFRS 9 kicked in, requiring credit institutions to make impairments on loans and other financial assets on the basis of expected credit losses. Considering the harsh impact that the IFRS 9 was expected to have on regulatory capital ratios, a 5-year phase-in regime was introduced by EU institutions in order to mitigate the effects on CET1 deriving from expected credit loss accounting[5].

The new accounting regime does not provide for minimum provisioning levels for NPEs though. Credit institutions still have a certain degree of discretion in determining expected credit losses and NPE coverage levels. As a part of the Supervisory Review and Evaluation Process ("**SREP**") or as a consequence of on-site inspections or other supervisory activities, competent authorities may require credit institutions to apply a specific provisioning to their NPEs by exercising their Pillar 2 supervisory powers in accordance with EU rules, but this does not ensure the application of common minimum levels throughout the EU, as supervisory approaches may differ.

[3] This client alert is focused on the rules and indications respectively set forth in the Proposed Regulation and the ECB Addendum on the minimum regulatory provisioning requirements for NPLs. A separate client alert will focus on the Proposed Directive and the AMC Blueprint.

[4] Under the current framework, NPEs include NPLs, non-performing debt instruments and non-performing off-balance-sheet items. However, in this alert the two words are used interchangeably.

[5] Article 473a of the CRR, introduced under Regulation (EU) 2017/2395 of December 12, 2017.

The discretion granted to credit institutions has led to under-provisioning and loss forbearance in certain cases. Some credit institutions have tried to avoid or delay loss recognition also in order to reduce or postpone its negative impact on regulatory capital ratios ("wait-and-see" approach).

Although IFRS 9 should discourage such approach, the EC is willing to impose a Pillar 1 common minimum requirement – supplementing the application of accounting principles and the use of institution-specific Pillar 2 measures – to create a minimum provisioning level as a backstop (so-called "**Statutory Prudential Backstop**").

Calculation of the Minimum Regulatory Provisioning Level

Under the Proposed Regulation the minimum regulatory provisioning level shall be calculated by multiplying the value of each relevant NPE[6] within the portfolio of the credit institution by the factors indicated in the Proposed Regulation – which are represented in the table below.

These factors differ depending on (i) whether the NPE is more than 90-day past due ("**Past Due Exposure**") or has been classified as NPE notwithstanding the fact that the institution still receives full payment from the obligor without excessive (*i.e.* 90-day) delay, (ii) the number of years after the date on which the exposure was classified as NPE (so-called "vintage"), and (iii) whether the NPE (or part of the NPE) is classified as "secured" or "unsecured" exposure in accordance with the criteria set forth in the Proposed Regulation[7].

EC Minimum Regulatory Provisioning Level (in %)									
	After Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Secured	*Past Due*	5	10	17.5	27.5	40	55	75	100
	Non-Past Due	4	8	14	22	32	44	60	80
Unsecured	*Past Due*	35	100	100	100	100	100	100	100
	Non-Past Due	28	80	80	80	80	80	80	80

As clarified by the EC, the above factors reflect the circumstance that (i) secured NPEs are in general less risky than unsecured NPEs, due to the ability of the credit institution to enforce its claims on the collateral asset(s) or against the guarantor(s), and (ii) the credit risk is generally expected to be lower for NPEs where the obligor is not past due for more than 90 days. The lower the risk connected with the relevant NPE based on such criteria, the softer the provisioning calendar that the institution shall follow (and vice versa).

Statutory Prudential Backstop and CET1 Deduction

The following items may be used by credit institutions to satisfy the minimum regulatory provisioning level:

- provisions recognized under the applicable accounting framework in the financial statements of the credit institution (*i.e.* specific credit risk adjustments);
- additional value adjustments for fair-valued assets (in accordance with articles 34 and 105 of the CRR);
- other own funds reductions (*e.g.* deductions applied by the credit institution higher than those required by the regulation);
- for institutions calculating RWAs using the IRB approach, the regulatory expected loss shortfall which is already deducted from own funds.

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6 The Proposed Regulation provides for the introduction in the CRR of a new definition of NPE, which is largely based on the current framework set forth in Commission Implementing Regulation (EU) No 680/2014, laying down the implementing technical standards with regards to supervisory reporting of credit institutions according to the CRR. Provisions are added in the CRR to define the notion of "forbearance measures" as well as in relation to cases where NPEs subject to forbearance measures shall cease to be classified as NPEs.

7 Under the Proposed Regulation, "secured" exposures are exposures that are covered by a funded or unfunded credit protection eligible in accordance with the CRR. If there is no such eligible credit protection, the exposure shall be classified as "unsecured". Exposures that are only partly secured are considered to be secured for the part that is covered by eligible collateral, while the unsecured part corresponds to the difference between the value of the exposure and the secured part.

If the aggregate amount of the above items is not sufficient to satisfy the minimum regulatory provisioning level, the Statutory Prudential Backstop applies – meaning that any shortfall (so-called “insufficient coverage amount”) shall be fully deducted from CET1 items.

Treatment of Legacy Loans

The Statutory Prudential Backstop shall only apply to exposures originated after March 14, 2018 and not to prior legacy exposures. However, there is a practical important exception to the rule: the Proposed Regulation specifies that where the terms and conditions of an exposure which was incurred prior to March 14, 2018 are modified by the institution in a way that increases the institution’s exposure to the obligor, the exposure shall be considered as having been incurred on the date of the modification so that such exposure becomes subject to the new regime including the Statutory Prudential Backstop.

Accordingly, the new rules will not affect NPLs that were originated by EU credit institutions before March 14, 2018, even if such exposures are refinanced or subject to other forbearance measures, unless a modification is made which may increase the institution’s exposure to the obligor. The derogation for past loans is of course without prejudice to the possibility for competent authorities to impose specific provisioning on the existing stock of NPLs by exercising their Pillar 2 supervisory powers.

ECB Addendum

Nature and Scope of the ECB Addendum

While the Proposed Regulation is aimed at introducing common provisioning requirements applying to credit institutions established in all EU Member States, the ECB Addendum specifies the ECB’s (non-binding) supervisory expectations for “significant credit institutions” directly supervised by the ECB under the Single Supervisory Mechanism (“**SSM**”).

These supervisory expectations will apply to all exposures classified as new NPEs after April 1, 2018 (*i.e.* the scope will also include legacy exposures originated before such date, if and when they turn into NPEs). However, the compliance with such supervisory expectations will be assessed by the ECB only from 2021 onwards.

ECB Supervisory Expectations

Similarly to the EC approach, the ECB considers the following items for the purposes of determining whether the level of NPLs coverage is sufficient: (i) all accounting provisions under the applicable accounting standard (including potential newly booked provisions), (ii) expected loss shortfalls for the respective exposures in default under articles 158 and 159 of the CRR and (iii) other CET1 deductions from own funds related to these exposures.

The level of NPLs coverage should meet the quantitative expectations of the ECB, which are calibrated on the basis of (i) the length of time an exposure has been classified as NPE (*i.e.* vintage) and (ii) whether the NPE is secured by eligible collateral. The table below summarizes such quantitative expectations.

ECB Quantitative Supervisory Expectations (in %)							
After Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Secured	N/A	N/A	40	55	70	85	100
Unsecured	N/A	100	100	100	100	100	100

The ECB reserves to discuss on a case-by-case basis any divergences from the prudential provisioning expectations outlined above in the context of the SREP. Each bank shall inform its joint supervisory team (“**JST**”) on the coverage levels by NPE vintage. The JST will assess any differences between coverage levels and supervisory expectations through off-site activities, on-site examinations or both. The outcome of the supervisory assessment will be taken into account in the SREP.

The ECB will consider specific circumstances which may make the prudential provisioning expectations inappropriate for a specific portfolio or exposure. If, after giving due consideration to such specific circumstances, the ECB is of the view that the prudential provisions do not adequately cover the expected credit risk, supervisory measures under the Pillar 2 framework might be adopted.

Even though the above assessment will start in 2021, it may be expected that the ECB will already start monitoring how banks are gradually aligning to the new requirements if these are not currently met.

Main Differences between the EC and ECB Requirements

As anticipated, the Proposed Regulation and the ECB Addendum differ in several respects, which are summarized in the table below.

	EC Proposed Regulation	ECB Addendum
Nature	Binding EU regulation.	Non-binding supervisory expectations.
Scope of Application	All credit institutions established in EU Member States.	Significant institutions subject to direct ECB supervision within the SSM.
Affected NPEs	Exposures originated after March 14, 2018.	NPEs classified as such after April 1, 2018.
Entry into Force	The proposal shall follow the EU ordinary legislative procedure and its ultimate content and the date of entry into force are still uncertain.	The ECB Addendum does not require any further implementation. However, banks will be asked to inform the ECB on any differences between their practices and supervisory expectations from early 2021 onwards within the context of the SREP.
Approach	Pillar 1 minimum requirement.	Pillar 2 approach – *i.e.* supervisory dialogue and analysis of bank-specific circumstances to be incorporated into SREP decisions.
Non-Past Due Exposures	Different coverage levels between Past Due Exposures and other NPEs.	No distinction between Past Due Exposures and other NPEs.
Coverage Levels	Less stringent calendar over a 8-year period.	More stringent calendar over a 7-year period.
Treatment of Shortfall	Automatic deduction from CET1.	Pillar 2 measures adopted on a case-by-case basis.

In line with the clarifications given by the EC on the purpose of the Proposed Regulation, the supervisory expectations contained in the ECB Addendum should be intended as a Pillar 2 guidance supplementing the common minimum standard set forth in the Proposed Regulation for SSM significant banks. Nonetheless, such banks may struggle to reconcile the requirements set forth in the Proposed Regulation and the ECB Addendum, as there are material differences in terms of concept, timely application and content.

Conclusions

The new measures of the EC and ECB will likely boost the volume of NPLs disposals by European banks, especially in those EU Member States with a high legacy stock of distressed loans and a higher average length of debt recovery procedures. The pressure on banks to enter into exposure-specific or portfolio-based transactions to reduce their risks relating to NPEs will significantly increase, as keeping NPEs on their books will ultimately result in a higher cost of capital.

In addition, the new regime will reduce the price gap between accounting value and market prices of NPEs, thereby facilitating the sale of NPLs portfolios. This trend will likely be fostered by the new impairment method under IFRS 9, and the phase-in regime introduced in the context of the IFRS 9 implementation – by mitigating over the time the impact of impairments on CET1 – might offer a blow of fresh air to those banks that are holding their breath underwater.

Yet the above mentioned differences between the EC Proposed Regulation and the ECB Addendum may lead to a fragmented world of NPE risk strategies – one for SSM-significant banks, one for other EU banks and another set for third-country banks (which may include UK banks in the future) – as well as to regulatory uncertainties and arbitrage. Further convergence should accordingly be sought by the EC and ECB to align the NPLs provisioning regimes provided under the Proposed Regulation and ECB Addendum.

Finally, the new measures of both the EC and the ECB fail to recognize the existence of significant differences among EU Member States with respect to the average length of debt recovery procedures. To a certain extent, European institutions are betting on the effectiveness of out-of-court accelerated enforcement procedures and other legislative proposals on debt restructurings[8] to overcome these national differences. But the “one-size-fits-all” approach enshrined in the NPL provisioning calendar could ultimately result in an unfair treatment of EU credit institutions due to the different efficiency of national judicial systems as regards bankruptcy and enforcement procedures rather than the mere quality of the exposures and collaterals.

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8 Such as, for instance, the proposal for a Directive on preventive restructuring frameworks published in November 2016.