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

REGULATION AND PRUDENTIAL SUPERVISION OF FINANCIAL INSTITUTIONS
Bank regulation and supervision

CONSULTATION DOCUMENT

STATUTORY PRUDENTIAL BACKSTOPS

ADDRESSING

INSUFFICIENT PROVISIONING FOR NEWLY ORIGINATED LOANS THAT TURN NON-PERFORMING

Disclaimer

This document is a working document of the Commission services for consultation and does not prejudge the final decision that the Commission may take. The views reflected on this consultation paper provide an indication on the approach the Commission services may take but do not constitute a final policy position or a formal proposal by the European Commission. The responses to this consultation paper will provide important guidance to the Commission when preparing, if considered appropriate, a formal Commission proposal

You are invited to reply **by 30 November 2017** at the latest to the **online questionnaire** available on the following webpage:
https://ec.europa.eu/info/consultations/finance-2017-non-performing-loans-backstops_en

Please note that in order to ensure a fair and transparent consultation process **only responses received through the online questionnaire will be taken into account and included in the report summarising the responses**.

Responses will be published unless respondents indicate otherwise in the online questionnaire.

Responses authorised for publication will be published on the following webpage: https://ec.europa.eu/info/consultations/finance-2017-non-performing-loans-backstops_en#contributions

CONTENT OF THE CONSULTATION DOCUMENT

Introduction

Non-performing loans (NPLs) have piled up in parts of the EU banking sector in the aftermath of the financial crisis and ensuing recessions, with significant adverse impacts on banks' profitability, viability and ability to lend. High levels of NPLs across a substantial number of banks pose risks to the financial system at large and the overall economy of the EU. While tackling NPLs is primarily the responsibility of affected banks and Member States, there is a distinct European dimension, as clearly manifested in the Commission Reflection Paper on the Deepening of the Economic and Monetary Union[1] and fleshed out in the Commission Communication on completing the Banking Union[2]. Furthermore, the Council concluded a comprehensive action plan to tackle NPLs in Europe[3] inviting the Commission and other actors to act on several fronts to reduce the risk to financial stability, both by addressing the existing stock of NPLs and by preventing the emergence and accumulation of NPLs in the future. The Commission takes active part, together with other European stakeholders and Member States, in the realisation of this Action Plan.

One of the key policy areas in this context is prudential regulation and supervision to be applied to the newly originated loans, which should ensure, inter alia, that new loans that turn non-performing are recognised timely and provisioned adequately in order to prevent loss forbearance and enhance NPL resolution. If sufficiently high provisions[4] for credit losses will be made, restructuring, selling or dismissing non-performing assets and non-recoverable collateral will require less, if any, additional capital and will become potentially easier. If, on the contrary, new loans that turn non-performing will be insufficiently provisioned, they are more likely to remain on banks' balance sheets in an attempt by banks to avoid or delay loss recognition. This may cast doubt over banks' future profitability, solvency and long-term viability. In addition, heightened risk perceptions on the part of investors and depositors usually translate into higher funding costs.[5] Together, these factors result in higher lending rates, reduced lending volumes, and increased risk aversion. Experience in several countries[6] that have dealt with NPLs suggests that binding requirements on NPL recognition and provisioning made a significant contribution to the resolution of NPLs.[7]

As announced in its Communication on completing the Banking Union, and as a follow-up to the July 2017 Conclusions of the Council on tackling NPLs in the EU, the Commission is preparing a report on tackling potential under-provisioning for new loans

---

1 *COM*, Reflection Paper on the Deepening of the Economic and Monetary Union (2017), https://ec.europa.eu/commission/publications/reflection-paper-deepening-economic-and-monetary-union_en.

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

3 *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/.

4 The terms 'impairments', 'provisions' and 'value adjustments' effectively have the same meaning. To be more accurate, 'impairments' refer to the losses for on balance sheet exposures under IFRS more commonly, 'provisions' refer to the losses for off-balance sheet exposures under Directive 86/635/EEC (Bank Accounting Directive)and 'value adjustments' to the impairment for loans and advances on balance sheet under the same Directive.

5 Cf. *ESRB*, Resolving non-performing loans in Europe (2017); *IMF*, A Strategy for Resolving Europe's Problem Loans (2015).

6 Cf. *IMF*, A Strategy for Resolving Europe's Problem Loans (2015); *World Bank*, Report on loan classification and provisioning (2014); *Inter-American Development Bank*, Report on provisioning requirements in Latin America (2011).

7 Cf. *IMF*, A Strategy for Resolving Europe's Problem Loans (2015).

that turn non-performing. That report will consider the possibility of introducing statutory prudential backstops in the form of compulsory and time-bound prudential deductions of NPLs from own funds to prevent or reduce the future build-up of new NPL stocks with insufficient coverage across Member States and banks. As also announced in the aforementioned Communication, in this context the Commission will also consider introducing a common definition of non-performing exposures (NPEs)[8] in accordance with the one already used for supervisory reporting purposes[9] with the view of providing a sound legal basis for the prudential treatment of such exposures and ensuring consistency.

The Commission services launch this targeted consultation to gather stakeholders' views on the possible introduction of statutory prudential backstops against insufficient loan loss coverage for new loans that turn non-performing, as well as on the potential functioning, scope, design and calibration of such prudential backstops.

The rationale for statutory prudential backstops

Loan loss provisions recognised by banks for NPLs in accordance with the applicable accounting framework might not always be adequate from a prudential perspective, which has a different scope, objective and purpose. While for instance International Financial Reporting Standards (IFRS) apply to undertakings from various industries and are based on the principles of neutrality and faithful representation of the underlying economic transactions at the reporting date, the Capital Requirements Directive and Regulation (CRD/R) only apply to credit institutions and investment firms and take a risk-based approach, ultimately aiming at the stability of individual institutions through the economic cycle and of the financial system as a whole.

IFRS 9 is expected to bring much closer alignment with the prudential standards than IAS 39, and to contribute to address the issue of delayed and inadequate provisions as it operates on an "expected loss" approach.[10] However, the new standard still leaves room for discretion in the valuation of NPLs as well as of the underlying collaterals[11] and, by consequence, in the determination of provisions.[12]

Prudential regulation[13] empowers however the bank supervisor to influence a bank's provisioning level (including as regards NPLs) within the limits of the applicable accounting framework and to require specific adjustments to the own funds calculations of that bank if, for example, accounting provisioning is not sufficient from a supervisory perspective.[14] Binding measures and requirements, however, can only be applied by the supervisor on a case-by-case basis depending on the individual circumstances of the bank (so called Pillar 2 measures).

[8] The definition of "NPE" includes NPLs. Still, this consultation paper generally refers to "NPLs" (as synonym for NPEs) as this term is well established and commonly used in the policy discussion.

[9] Commission Implementing Regulation (EU) No 680/2014.

[10] IFRS 9 requires banks to make provisions against performing (and not impaired) assets from the date of origination leading to higher amounts of provisions.

[11] The lack of standardised valuation approaches was found being detrimental for the quality of impairment calculations (cf. Report of the FSC Subgroup on Non-Performing Loans [2017]).

[12] Cf. *IMF*, A Strategy for Resolving Europe's Problem Loans (2015) and *IMF*, Supervisory Roles in Countries implementing IFRS (2014).

[13] Article 104(1)(d) CRD and Article 16(2)(d) SSM Regulation, respectively.

[14] See *COM*, Report on the Single Supervisory Mechanism (2017), https://ec.europa.eu/info/sites/info/files/171011-ssm-review-report_en.pdf.

Individually tailored supervisory measures following a case-by-case assessment by the competent supervisor are appropriate for dealing with the specific NPL-related risks of individual banks[15]. In order to effectively address on a systematic and EU-wide basis the potential under-provisioning for new loans that become non-performing, a prudential minimum treatment acting as a backstop, which would be directly applicable to all EU institutions (so called Pillar 1 measure), might be considered. By requiring all institutions[16] established in the EU to set aside capital to cover incurred and expected losses on newly originated loans that turn non-performing at a common prudential minimum level - irrespective of the applicable accounting standards and the location of the bank and its supervisor -, such "prudential backstops" would put on automatic EU-wide brakes on the build-up of future loans that turn non-performing with insufficient loan loss coverage. Statutory minimum coverage requirements can also be expected to provide strong incentives for banks' management to prevent the accumulation of NPLs altogether through better NPL restructuring and stronger origination standards. Finally, minimum requirements set at EU level would not carry national stigma and could rather foster a consistent treatment across Member States and help to restore confidence in the EU banking sector as a whole.

[15] The ECB Banking Supervision is currently consulting on how Pillar 2 powers could be applied to address under-provisioning of NPLs (cf. *ECB*, Addendum to the ECB Guidance to banks on nonperforming loans, https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf).

[16] As defined in Article 4(1)(1) CRR.

The functioning, scope, design and calibration of statutory prudential backstops

Functioning

Statutory prudential backstops would consist of two main elements: (i) a requirement for banks to cover up to common minimum levels the incurred and expected losses on loans originated after the entry into force of the regulatory requirement once such loans become non-performing ("minimum coverage requirement"), and (ii) where the 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 new loans that turn non-performing:
a) provisions recognised under the applicable accounting framework ("credit risk adjustments")[17],
b) additional value adjustments in accordance with Articles 34 and 110 CRR,
c) other own funds reductions, and
d) for banks calculating risk-weighted assets (RWAs) using the internal ratings-based (IRB) approach, negative amounts resulting from the calculation of expected loss laid down in Articles 158 and 159 CRR (“regulatory expected loss shortfall”).
Only where the sum of the amounts listed under a) to d) does not suffice to meet the applicable minimum coverage requirement, the prudential backstops would apply and require deduction of the difference between the two (uncovered exposure amount or “coverage gap”) from Common Equity Tier 1 (CET1) items. This deduction would thus ensure that the risks associated with NPLs are appropriately reflected in banks' CET1 capital ratios one way or another.

Prudential nature of the backstops and interaction with accounting provisions

These time-bound prudential deductions for new loans that turn non-performing would be introduced into the own funds part of the CRR together with a common definition of the term 'non-performing exposure' (NPE), which is already used for supervisory reporting purposes,[18] and the necessary amendments to related provisions on credit risk[19] in order to ensure consistency and coherence of the prudential framework. Unlike

[17] "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).

[18] The definition was established by the European Banking Authority (EBA) in the Implementing Technical Standard (ITS) on Supervisory Reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) 575/2013, which was adopted by the Commission as amendment to its Implementing Regulation (EU) No. 680/2014. According to this definition, NPE is every exposure that is 90 days past due or unlikely to be paid without collateral realisation, even if it is not recognised as defaulted or impaired. Defaulted and impaired exposures according to Article 178 CRR and the applicable accounting framework, respectively are always considered as non-performing. In addition, any exposure to a debtor has to be considered non-performing when its on-balance sheet 90 days past-due reaches 20% of the outstanding amount of total on-balance sheet exposure to that debtor (‘pulling effect’). Furthermore, NPEs that are forborne only exit this classification if the debtor has proven its ability to meet the restructured conditions for one year, even if forbearance has led to the exit from default or impairment classes. The total NPE is given by the sum of non-performing loans, non-performing debt securities and nonperforming off-balance-sheet items.

[19] 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).

accounting provisions, prudential deductions would not influence a bank's Profit & Loss, since they neither reduce its income nor its accounting equity but solely its regulatory own funds with the adjustments being reflected in supervisory reporting and own funds disclosure. Banks would need to continue to recognise accounting provisions following their credit risk assessment and in accordance with applicable accounting standards. Those provisions would be taken fully into account for the purposes of the prudential backstops, including potential increases in provisions as a result of IFRS 9.

Scope

The prudential backstops represent a preventive measure that would only apply to new NPEs[20]. In line with the July 2017 Council conclusions[21] solely newly originated loans (i.e. loans which have been granted after a certain cut-off date, such as the date of adoption of the new requirement or the date of entry into force of the new requirement) that thereafter turn non-performing would be captured.

Design and calibration

The minimum coverage requirement would be a function of (i) the time period an exposure has been classified as non-performing (so called "vintage") and, where available, (ii) the level of credit protection (collateral and guarantees) held for this new loan that turned non-performing, applying the relevant eligibility criteria set out in the CRR for credit risk mitigation purposes.

To ensure that the valuation of collateral/guarantee follows a prudent approach, in particular regarding assumptions pertaining to recoverability and enforceability,[22] and leads to consistent outcomes across banks, a common methodology, including possible minimum requirements for re-valuation in terms of timing and ad hoc methods, would have to be developed[23] (e.g. by the European Banking Authority). Accordingly, if no prudent collateral valuation has been performed or where the valuation has not been updated on a timely basis, the exposure would be treated as unsecured from a prudential perspective. However, where the collateral/guarantee has not been realised within a certain perennial period 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.

[20] NPLs are part of NPEs. As noted earlier, this consultation paper generally refers to "NPLs" as this term is well established and commonly used in the policy discussion. In technical terms, the prudential backstops would address NPEs.

[21] *ECOFIN*, Action Plan To Tackle Non-Performing Loans In Europe, http://www.consilium.europa.eu/en/press/press-releases/2017/07/11-conclusions-non-performing-loans/.

[22] Deficiencies in the approaches employed by banks have been found most notably for immovable property collateral (cf. *ECB*, Aggregate Report on the Comprehensive Assessment [2014]).

[23] *EBA*, Report on the dynamics and drivers of non-performing exposures in the EU banking sector (2016).

Following the suggestions of the Financial Services Committee (FSC) Subgroup on NPLs[24], which drew on the experience of the United States and the practices applied in other jurisdictions, in and outside the EU, banks could be required to fully cover with CET1[25] their *unsecured*[26] (parts of) NPLs within a pre-defined time period (e.g. two years). This means, where the minimum coverage requirement is not met and the backstops apply, banks would have to deduct from their CET1 items the uncovered exposure amount[27] of unsecured (parts of) new loans turned non-performing after this pre-defined period (ensuring a full prudential loss coverage of unsecured NPLs).

Regarding the treatment of *secured*[28] (parts of) these new loans that turn non performing two different approaches seem conceivable from the Commission Services' point of view.

1. <u>Deduction approach</u>. In line with the suggestions of the FSC, banks could be required to fully cover with CET1[29] the secured parts of new loans turned non-performing after a pre-defined time period (e.g 6 to 8 years) if the collateral/guarantee has not proved to be effective from a prudential perspective. This means that if the minimum coverage requirement is not met and the backstops apply, banks would have to deduct from their CET1 items the entire uncovered exposure amount of the secured parts of those NPEs after the defined time period (ensuring a full prudential loss coverage of the secured parts, i.e. including also the collateral/guarantee, if there is not sufficient evidence as to its recoverability and enforceability).

   In order to avoid a too abrupt and potentially harmful impact and limit potentially pro-cyclical effects while also leaving sufficient time for possible recoveries (in particular from collateral held for those loans), a gradually increasing scaling factor could be applied to the minimum coverage requirements, whereby banks would have to follow a linear or progressive path towards the required coverage level. Assuming banks would have 2 years to fully cover unsecured new loans that turn non-performing and effectively at least 8 years (i.e. 6 + 2 years)[30] for secured ones, until full coverage of the gross exposure amount has to be reached, coverage levels could for instance be set as shown in Table 1.

[24] The Council's FSC submitted on 31 May 2017 its final report on NPLs, in which it analyses the situation of NPLs in Europe and the policies implemented so far and proposes to the Council a number of policy options going forward, http://data.consilium.europa.eu/doc/document/ST-9854-2017-INIT/en/pdf.

[25] 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).

[26] I.e. not covered by eligible credit protection.

[27] The uncovered exposure amount would be the accounting value remaining after specific credit risk adjustments, additional value adjustments, other own funds reductions and deduction of the regulatory expected loss shortfall related to the exposure (i.e. items a) to d) listed above in the context of the functioning of statutory prudential backstops).

[28] I.e. covered by eligible credit protection.

[29] 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).

[30] Where the collateral/guarantee has not been realised after 6 years following the classification of the underlying exposure as non-performing, the credit protection would be considered ineffective from a prudential perspective and by consequence, the exposure would be treated as unsecured for the purposes of the backstops and deducted within the applicable time period of 2 years.

Table 1: possible minimum coverage levels for unsecured and secured (parts of) NPLs applying no/progressive/linear scalar

Vintage	**Unsecured (parts of) NPLs**			**Secured (parts of) NPLs[31]**		
	No scalar	Progressive	Linear	No scalar	Progressive	Linear
Min coverage after 1y	0%	35%	50%	0%	5%	12,5%
Min coverage after 2y	100%	100%	100%	0%	10%	25%
Min coverage after 3y				0%	17,5%	37,5%
Min coverage after 4y				0%	27,5%	50%
Min coverage after 5y				0%	40%	62,5%
Min coverage after 6y				0%	55%	75%
Min coverage after 7y				0%/35%*/50%**	75%	87,5%
Min coverage after 8y				100%	100%	100%

* If a progressive scalar for unsecured (parts of) NPLs was applied
** If a linear scalar for unsecured (parts of) NPLs was applied

2. <u>Haircut approach</u>. In order to address risks associated with the effectiveness of credit protection for new loans that turn non-performing in a more targeted way,[32] specific minimum levels of prudential haircuts[33] on collateral/guarantee values (as determined in accordance with the applicable accounting standards and prudential requirements) would apply to their secured parts. More specifically, the applicable haircut would depend on the form of the credit protection and the actual length of time to its realisation. Those forms of credit protection for which credit assessments by a recognised ECAI[34] are available, that operate in liquid markets and show well-established, publicly available and sufficiently stable market prices, would be subject to relatively lower initial haircut levels. The level of haircuts could however gradually increase with every subsequent year[35] (additional haircuts) the longer the realisation actually takes thereby reflecting the increasing uncertainty as to the ultimate recovery values[36], accumulating maintenance costs[37] and discounting. For indicative purposes, Table 2 sets out possible minimum haircut levels/ranges for selected forms of collateral (including a concrete example for commercial real estate) based on international practice for a potential time period of 6 years.[38]

---

[31] For secured (parts of) NPLs the progressive and linear deductions would imply a flat discount on the collateral/guarantee value which increases with the length of the recovery process thereby reflecting the increasing uncertainty as to ultimate recovery values and maintenance costs as well as liquidation/selling costs.
[32] I.e. to capture more specifically valuation uncertainties and possible falls in value up to the realisation of the collateral/guarantee as well as maintenance costs and costs to exercise/sell/liquidate the collateral/guarantee.
[33] Prudential haircut means applying a reduction in the value of the protection recognised for prudential purposes.
[34] External Credit Assessment Institution.
[35] Starting from the second year after the classification of the underlying exposure as non-performing.
[36] Cf. *EBA*, Report on the dynamics and drivers of non-performing exposures in the EU banking sector (2016).
[37] Incurred by the bank in relation to the management and execution (including, where applicable, repossession and disposal) of the collateral/guarantee.
[38] See also ECB, Stocktake of national supervisory practices and legal frameworks related to NPLs (2017); *IMF*, A Strategy for Resolving Europe's Problem Loans – Technical Background Notes (2015); *World Bank*, Report on loan classification and provisioning (2014).

Table 2: possible minimum haircut levels/ranges for selected forms of collateral over time

Form of Credit Protection[39]	*Initial Haircut Level*	*Additional Haircut per year to realisation*	*Applicable Haircut after 6 years*
Financial collateral	5%-30%	5%	30%-55%
Immovable property *(e.g. Commercial RE)*	20%-60% (30%)	5-10% (7,5%)	45%-100% (30%+5*7.5%=67,5%)
Other collateral	20%-50%	5-10%	45%-100%

Safeguards and review

Exposure amounts that had initially been deducted from CET1 items in accordance with the prudential backstops but were finally recovered by the bank would be added back to the CET1 capital up to the level of the recovered amount. Furthermore, a cap could ensure that the application of the statutory prudential backstops does not result in covering more than 100% of the exposure in combination with Pillar 1 capital requirements for unexpected losses on credit risk.

A review mechanism could be provided to take stock of the impact of statutory prudential backstops and ensure that they remain fit for purpose.

[39] As per the applicable eligibility criteria set out in the CRR for credit risk mitigation purposes.

Questions

In view of these considerations, stakeholders are invited to answer the following questions, giving explanations:

1. What are your views on the rationale for statutory prudential backstops as described above? In particular:

    a. Do you support the idea that statutory prudential backstops should complement the improvements that the application of IFRS 9 is expected to bring with regards to loan loss provisioning for the new loans that turn non-performing?
    b. Do you support the idea that statutory prudential backstops (Pillar 1 measure) should complement the use of existing supervisory powers to address through institution-specific measures the (under)capitalisation of NPLs (Pillar 2 measure)?

    Please explain the reasons for your answers.

2. Do you think that the statutory prudential backstops as described above are feasible?

    a. If yes, please explain your views.
    b. If not, what are the features that appear problematic to you and why?
    c. Is there any alternative design of backstops via prudential deductions that you could envisage for new loans that turn non-performing? Please provide details.

3. In your view, which should be the cut-off date for the origination of loans that will be covered by the prudential backstop: the date of publication of this consultative document, the date of the publication of a possible legislative proposal introducing prudential backstops, the date of entry into force of such possible legislative measure, a later date of application? Please explain.

    a. Would you see a need to address explicitly potential circumvention possibilities, for instance through prolongation of existing contracts? Please explain.

4. Do you think a full coverage of unsecured (parts of) NPLs after 2 years and of secured (parts of) NPLs after 6 to 8 years is appropriate?

    a. For secured (parts of) NPLs, do you think it appropriate to treat them as unsecured after 6 to 8 years, effectively adding two more years before full coverage?
    b. For secured (parts of) NPLs, do you think an alternative approach, such as the introduction of specific levels of haircuts on collateral/guarantee values, would be more appropriate?
    c. If none of the approaches work in your view, how should the backstops be alternatively calibrated?

Please explain the reasons for your answer.

5. Do you agree that prudentially sound collateral valuation is an important element for addressing NPL-related risks? In this context:

   a. Would a common (non-binding) methodology for collateral valuation suffice to foster consistent outcomes and transparency or would specific (binding) valuation rules be needed?
   b. More generally, should specific prudent valuation requirements apply to assets and off-balance sheet items accounted for amortised cost as it is already the case for fair-valued assets?

6. Do you agree that prudential coverage needs should ultimately depend on the actual recoverability rather than the valuation of the collateral to provide for a backstop?

7. Do you agree that the application of the statutory prudential backstops should not result in cliff-edge effects, but should rather be implemented in a suitably gradual or progressive way by banks from the moment of the classification of the exposure as non-performing?

   a. In particular, which approach (gradual or progressive) would you consider better suited and why?

   Please explain the reasons for your answer.

8. Would you see any unintended consequences due to the design and calibration of the prudential backstops?

   a. If yes, which measures would you consider necessary to prevent or address unintended effects (including double-coverage of risks)?

   Please explain the reasons for your answer.