European Non-Performing Exposures are running out of time

On 15 March 2018, following a public consultation which ran from 4 October 2017 to 8 December 2017, the European Central Bank (the **ECB**) published the "*Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures*" (the **Addendum**)[1]. The Addendum supplements the "*Guidance to banks on non-performing loans*" (**ECB Guidance**)[2] released by the ECB on 20 March 2017 and is applicable to all significant institutions supervised by the ECB. The ECB Guidance is a tool which clarifies supervisory expectations regarding identification, management, measurement and write-offs of non-performing exposure (**NPEs**)[3] to foster more timely provisioning practices for NPEs in the context of existing regulations, directives and guidelines.

In particular, such supervisory expectations are deemed complementary to a proposal (adopted by the European Commission on 14 March 2018 (the **Proposal**) in line with the aim of tackling the high number of NPEs in the European Union) for a Regulation amending the Capital Requirements Regulation (the **CRR**) as regards minimum loss coverage for non-performing exposures. The Proposal provides for a statutory prudential backstop against any excessive future build-up of NPEs without sufficient loss coverage on banks' balance sheets in order to ensure that credit losses on future NPEs are sufficiently covered.

Scope of application

In line with the ECB Guidance, the Addendum specifies the ECB's supervisory expectations from the Banks when they assess their level of prudential provisions for NPEs management. It applies to NPEs which are classified as such from 1 April 2018 onwards and the results of the supervisory dialogue relating to its provisions will be incorporated, for the first time, in the 2021 Supervisory Review and Evaluation Process (**SREP 2021**).

1 Please see https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf.

2 Please see https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

3 According to paragraph 145 of Annex V of the EBA Implementing Technical Standard (ITS) on supervisory reporting "non-performing exposures are those that satisfy either or both of the following criteria: 1) material exposures which are more than 90 days past-due; and 2) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due."

The Addendum's main criteria

The prudential expectations set out in the Addendum consider:

- the length of time an exposure has been classified as a non-performing loan; and
- the collateral held (if any) in relation to any such loan.

With regards the length of time, the Addendum uses an "NPE vintage" concept (specifically, the number of days from the date on which an exposure was classified as non-performing) so that the compliance with the supervisory expectations depends on the length of time a loan has been classified as NPEs.

In respect of collateral, on the basis of the distinction between secured and unsecured exposures as described below, the Addendum applies prudential principles to define the eligibility criteria for credit protection which are used to determine which parts of NPEs are to be deemed secured or unsecured and, consequently, whether to consider supervisory expectations for secured or unsecured exposures. The aim is to avoid an excessive build-up of non-covered aged NPEs on banks' balance sheets in the future.

Secured and unsecured exposures

As indicated, the supervisory expectations distinguish between secured and unsecured (parts of) NPEs in accordance with the existence of certain form of credit risk protections. Specifically, the Addendum recognizes as potential collateral (a) all types of immovable property collateral; and (b) other forms of credit risk protection meeting the criteria of credit risk mitigation set out in the CRR.

Accordingly, the Addendum divides the NPEs into the following main categories:

Fully unsecured exposures: if no types of credit risk protection covers the exposures.

Fully secured exposures: if the exposure's amount is fully covered with collateral or any other form of credit risk protection.

Partially secured exposures: if the exposures are partially collateralised so that they may be further split into secured balance and unsecured balance which, then, shall be assessed in line with the relevant supervisory expectations outlined above.

The prudential provisioning expectations

The Addendum sets out an expectation that new unsecured NPEs will be fully covered after a period of two years from the date of their classification as NPEs (i.e. a loan that is classified as an unsecured NPE on 1 September 2018 should be fully provisioned for by September 2020).

For new secured NPEs, the provisioning of the exposures will take longer so a certain level of provisioning is expected after three years of being classified as a NPE which would then increase over time until the seventh year (i.e. it would be expected that a secured loan classified as an NPE on 1 September 2018, would be at least 40% provisioned for by September 2021 and totally provisioned by September 2025). Hence, secured loans should be fully provisioned for after 7 years and banks are expected to review the value of collateral on a regular basis.

However, as the supervisory expectations are non-binding, the ECB will discuss with each Bank eventual divergences from the prudential provisioning expectations laid out in the Addendum (the so-called "comply or explain" approach). The results of such supervisory dialogue will be included for the first time in the SREP 2021 which, among the others, will also take into consideration the linear path in implementing the above-mentioned prudential provisions.

What about Italy?

On 30 January 2018 (after a consultation phase which started in September 2017), in line with the ECB's approach, the Bank of Italy published specific guidelines applicable to so called "less significant" institutions ("*Linee guida per le banche Less Significant italiane in materia di gestione dei crediti deteriorati*" – **BoI Guidelines**).

Scope of application

The BoI Guidelines set out the Bank of Italy's expectations and best practices on the management of NPEs by Banks to which the ECB Guidance does not apply (Less Significant Institution (**LSI**)). The BoI Guidelines (like the ECB Guidance) are non-binding in nature. They will not apply where other European or national laws and regulations already exist. Non-complying Banks may be required by the supervisory authorities to account for any failure to comply with the BoI Guidelines.

Main actions to be taken

The BoI Guidelines require the Italian LSI Banks to take certain actions, including:

NPEs strategy: to adopt a clear strategy for the management of the NPEs and to maximise the value of the recoveries. In particular, LSI Banks need to prepare operational plans for both short term (approximately 1 year) and medium/long-term (approximately 3/5 years) horizon, setting out the objectives to be achieved and the best combination of recovery actions (such as, inter alia, internal or externalized NPEs management, restructuring and forbearance measures, securitisation or other form of NPEs assignment resulting in the derecognition of the assigned assets). For such purpose, the LSI Banks shall fully involve the strategic supervising body (organo di supervisione strategica) in the implementation, update and assessment of the relevant plans.

Mitigation of the conflict of interests: to establish measures aimed at mitigating any conflict of interest which may arise in granting credit and managing NPEs.

Internal organisational measures: to put in place the relevant organisational measures for the classification, valuation (including write-off policies and collateral valuations) and management of NPEs (such as, inter alia, establishing internal procedures and early warning systems, reporting and monitoring systems, internal audit assessment).

Database: to manage and record material information from NPEs in a dedicated database, in order to allow timely management decisions and assist the decision-making process.

During the course of 2018, the Bank of Italy may supplement the BoI Guidelines to take into account any analogous initiatives which may be adopted within the context of the "*Council conclusions on Action plan to tackle non-performing loans in Europe*" published on 11 July 2017 and later approved by the ECOFIN Council.

Final thoughts

The Addendum's prudential expectations are all non-binding in nature and will serve as a starting point for a supervisory dialogue with each individual Bank on the adoption of adequate and timely provisions for NPEs.

As mentioned above, the Addendum applies only to new NPEs so the exact impact of its prudential provisioning expectations upon each Bank will mainly depend on the amount of NPEs' inflows which, actually, have been reducing across the EU in recent years. Nevertheless, given that managing NPEs by means of sales is expressly indicated as one of a number of possible tools to address high levels of NPEs, it is expected that one potential impact of the Addendum will be a further boost of the secondary NPE market activities (i.e. securitizations).

Contacts

Giulia Arenaccio
Counsel, Rome
T +39 06 6758 2394
giulia.arenaccio@hoganlovells.com

Corrado Fiscale
Partner, Milan
T +39 02 72025 2329
corrado.fiscale@hoganlovells.com

Annalisa Feliciani
Counsel, Rome
T +39 06 6758 2338
annalisa.feliciani@hoganlovells.com

Federico Del Monte
Partner, Milan
T +39 02 72025 2309
federico.delmonte@hoganlovells.com