# Implementation of prudential backstop – amendments to the CRR as regards minimum loss coverage for NPEs

In 2019 the non-performing loan (**NPL**) ratio of the EU banking sector declined to 3%. At the same time, both EU legislators and the European Central Bank (**ECB**) have forged ahead with their determination to address the NPL issue effectively and have implemented and aligned prudential and supervisory backstops for NPLs.

According to the European Banking Authority (EBA) report on NPLs published on November 8 2019[1] (the **EBA Report**), the quality of the EU banking sector has significantly improved over the last four years. Total NPLs decreased from over €1.15tn in June 2015 (6% as a percentage of total loans) to €636bn as of June 2019. The NPL ratio declined to 3%, the lowest ratio since the EBA introduced a harmonised definition of NPLs across European countries. The average coverage ratio slightly increased from 43.6% to 44.9% over the same period.

The EBA Report identifies three main reasons that caused the overall reduction in NPLs. First, the clear policy stance of the EBA and the whole supervisory community, and the Council of the EU's action plan played a key role. Second, the banks made efforts to enhance their NPL management capabilities. Lastly, the reduction was also helped by positive economic growth, low interest rates and decreasing unemployment. Countries with high NPL ratios have led the de-risking process of banks' balance sheets.

The first reason mentioned in the EBA Report (i.e. the supervisory attention and political determination to address the NPL issue) was also accompanied by a significant improvement in the co-ordination of the European bodies' approaches to reducing the banks' levels of non-performing exposures (**NPEs**)[2] by implementing a prudential backstop (**Pillar 1**) followed by a corresponding alignment of the already existing supervisory backstop (**Pillar 2**).

## Implementation of prudential backstop – amendments to the CRR as regards minimum loss coverage for NPEs (Pillar 1)

Regulation (EU) 2019/630 of April 17 2019 amends the Capital Requirements Regulation (EU) 2013/575 (**CRR**) with regard to the minimum loss coverage for NPEs. On the basis of a common definition of NPLs, the new rules introduce a "prudential backstop" that is minimum loss coverage for the amount of money banks need to set aside to cover losses caused by future loans that turn non-performing.

The European regulatory bodies and legislators expect that the amendments will not only enhance the resilience of the Economic and Monetary Union to adverse shocks by facilitating cross-border private risk-sharing, but will also simultaneously reduce the need for public risk sharing. Furthermore, addressing potential future NPE accumulation is essential to strengthening the banking union as it is essential for ensuring competition in the banking sector, preserving financial stability and encouraging lending[3].

The prudential backstop requires a deduction from a bank's own funds where NPEs are not sufficiently covered by provisions or other adjustments. The specific applicable amount of insufficient coverage to be deducted from Common Equity Tier 1 (**CET 1**) items will be determined separately for each non-performing exposure pursuant to the criteria set out in new Article 47c of the CRR.

1 EBA Report on NPLs – Progress made and challenges ahead, https://eba.europa.eu/eba-shows-efforts-improve-eu-banks%E2%80%99-asset-quality-have-proven-successful-pockets-risks-remain.

2 The terms "non-performing exposure" (NPE) and "non-performing loan" (NPL) are used interchangeably in this document. However, the CRR, as well as the ECB's expectations, address NPEs, which are broader and include debt instruments.

3 Cf. Recital (3) of Regulation (EU) 2019/630 of April 17 2019.

**The prudential backstop and therefore Pillar 1 NPE treatment fully applies:** (i) after 3 years of NPE status for unsecured NPEs; (ii) after 9 years of NPE status for secured NPEs which are secured by immovable collateral and residential loans guaranteed by an eligible protection provider as defined in the CRR; and (iii) after 7 years of NPE status for other secured NPEs. Moreover, it also specifies paths to full implementation (i.e. 100% coverage) for unsecured and secured exposures before 3/7/9 years of NPE status (as stipulated in Article 1 of Regulation (EU) 2019/630 amending CRR).

In order to apply the prudential backstop, the CRR introduced a clear set of conditions for the classification of NPEs. As the Commission Implementing Regulation (EU) 2014/680 already lays down criteria concerning NPEs for the purposes of supervisory reporting, the classification of NPEs builds on that existing framework. Implementing Regulation (EU) 2014/680 refers to defaulted exposures as defined for the purpose of calculating own funds requirements for credit risk and impaired exposures pursuant to the applicable accounting framework. As forbearance measures might influence whether an exposure is classified as non-performing, the classification criteria is complemented by clear criteria on the impact of forbearance measures. Regulation (EU) 2019/630 therefore provides that a forbearance measure granted to a NPE should not discontinue the classification of that exposure as non-performing unless certain strict discontinuation criteria are fulfilled.

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**The main amendments to the CRR are as follows:**

- Point (m) with regard to NPEs has been added in Article 36(1).
- Article 47a on NPEs, Article 47b on forbearance measures and Article 47c on deduction for NPEs have been inserted.
- Article 159 on Treatment of expected loss amounts and Article 469a on derogation from deductions from CET 1 items for NPEs have been inserted.

To facilitate a smooth transition toward the new prudential backstop, the new rules will not be applied in relation to exposures originated prior to April 26 2019. Where competent authorities ascertain on a case-by-case basis that, despite the application of the prudential backstop for NPEs established by Regulation (EU) 2019/630 amending the CRR, the NPEs of a specific institution are not sufficiently covered, it is possible for them to make use of the supervisory powers provided for in the Capital Requirements Directive IV (**CRD IV**), including the power to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements. Therefore, it is possible, on a case-by-case basis, for the competent authorities to go beyond the requirements laid down in Regulation (EU) 2019/630 amending the CRR for the purpose of ensuring sufficient coverage for NPEs.

## Alignment of supervisory backstop – ECB's communication on supervisory coverage expectations for NPEs (Pillar 2)

In its communication on August 22 2019[4], the ECB decided to align its supervisory expectations for NPEs with the legally binding Pillar 1 provisioning requirements set out in Regulation (EU) 2019/630 amending the CRR as regards minimum loss coverage for NPEs.

**The ECB's Pillar 2 approach to coverage expectations for NPEs at present consists of:**

- Guidance to banks on NPLs published in March 2017 (**ECB Guidance**), whereby the ECB expects banks to set internal coverage thresholds for NPLs depending on their risk profile.
- The addendum to the ECB Guidance to banks on NPLs (**Addendum**) published in March 2018, which clarifies the ECB's supervisory expectations for prudential provisioning of new NPEs (i.e. exposures classified as non-performing according to the EBA's definition from April 1 2018 onwards).
- Supervisory expectations for provisioning of NPE stock (i.e. exposures classified as NPE on March 31 2018), which were communicated in a press release issued on July 11 2018.

In order to align the main differences between the CRR Pillar 1 NPE treatment and the ECB's Pillar 2 approach, the ECB will adjust the Pillar 2 approach for new NPLs.

The scope of the ECB's supervisory expectations for new NPEs under the Pillar 2 approach as communicated in the Addendum will be limited to exposures not subject to Pillar 1 treatment – i.e. to NPEs arising from loans originated before April 26 2019. NPEs arising from loans originated from April 26 2019 onwards will in principle be subject solely to Pillar 1. However, the ECB may still apply Pillar 2 measures if the specific circumstances warrant them.

In order to make the two approaches more consistent, the relevant time frames for NPEs arising from loans originated before April 26 2019 will be changed from 2 and 7 years to 3, 7 and 9 years, to align these time frames with those in the Pillar 1 approach. More precisely, NPEs subject to the Addendum are expected to follow the 3/7/9-year vintage count for unsecured/secured (other than by immovable property)/secured by immovable property, with paths to reach the full implementation as under the Pillar 1 approach.

Lastly, for parts of NPEs guaranteed or insured by an official export credit agency, the expected linear path to full implementation has been removed – i.e. following the Pillar 1 treatment, there are no coverage expectations until the 7-years vintage bucket and the coverage expectation of 100% is only applicable to export credit exposures after more than 7 years of NPE status.

4 EBA communication on supervisory coverage expectations for NPEs - https://www.bankingsupervision.europa.eu/press/letterstobanks/ shared/pdf/2019/ssm.supervisory_coverage_expectations_for_NPEs_201908.en.pdf.

## Final thoughts

It should be noted that the legally binding Pillar 1 approach only applies to exposures that arose on or after April 26 2019. The ECB's supervisory coverage expectations for NPEs under the Pillar 2 approach, however, are not legally binding and follow a 3-step approach. In particular, the expectations communicated are: (1) a starting point for a supervisory dialogue; (2) dependent on a case-by-case assessment after being thoroughly discussed during the supervisory dialogue (including analysis of bank-specific circumstances); and (3) a supervisory measure may be applied under the Pillar 2 approach in the ECB's Supervisory Review and Evaluation Process (**SREP**) cycle. It therefore remains to be seen to what extent the prudential backstop under the Pillar 1 approach can really contribute to the reduction of NPEs.

Finally, banks need to prepare themselves for the transmission of more detailed information as regards NPEs to the regulator on a regular basis as requested according to the current Draft Implementing Technical Standard published on October 16 2019 (which include three new templates for NPEs loss coverage into COREP (Common Reporting[5]) and the latest EBA Guidelines on disclosure of non-performing and forborne exposures[6] which require banks to provide, *inter alia*, information on credit quality of NPEs and collateral valuation.

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5 EBA Consultation Paper – Draft Implementing Technical Standards on supervisory reporting requirements for institutions under Regulation (EU) No 575/2013 dated October 16 2019, page 9.

6 EBA Final Report – Guidelines on disclosure of non-performing and forborne exposures dated December 17 2018.