Addendum to the ECB
Guidance to banks on non-performing loans:
Prudential supervisory expectations for prudential provisioning backstop for non-performing exposures

This document has been generated for the sole purpose of facilitating a comparison of the pre-consultation document with the final guidance. Only the final guidance is authentic.
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1 Background

On 20 March 2017 the ECB published its final guidance to banks on non-performing loans (NPL Guidance). The NPL Guidance is a supervisory tool that clarifies supervisory expectations regarding the identification, management, measurement and write-off of NPLs in the context of existing regulations, directives and guidelines.

The NPL Guidance stresses the need for timely provisioning and write-off practices related to non-performing loans, as these serve to strengthen the banks’ balance sheets, enabling them to (re)focus on their core business, most notably lending to the economy.

This addendum thus reinforces and supplements the NPL Guidance by specifying quantitative supervisory expectations concerning the minimum levels of prudential provisions expected for non-performing exposures (NPEs). The expectations are based on the ECB’s supervisory expectations set out what the ECB deems to be seen as “prudential provisioning backstops” aimed at a prudent treatment of NPEs and therefore avoiding an excessive build-up of non-covered aged NPEs on banks’ balance sheets in the future, which would require supervisory measures. This addendum does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing EU regulations or directives and their national transpositions, applicable national regulation of accounting, binding rules and guidelines of accounting standard setters or equivalent, or guidelines issued by the European Banking Authority (EBA).

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1 Available on the ECB’s banking supervision website: Guidance to banks on non-performing loans.
2 See Section 6.6 of the NPL guidance.
3 As in the NPL Guidance, “NPL” and “NPE” are used interchangeably within this addendum.
2 General concept

2.1 Scope and applicability

In line with the NPL Guidance, this addendum specifies the ECB’s supervisory expectations relating to all significant banks directly supervised by the ECB. While the addendum is non-binding, banks are expected to explain any deviations and should report on the compliance with the backstop expectations laid out in this addendum at least annually.

The ECB will link the supervisory expectations in Section 5 of this Addendum to new NPEs classified as such from 1 April 2018 onwards. Taking into account the specificities of the supervisory expectations (see Section 4.2), banks will thus be asked to inform the ECB of any differences between their practices and the prudential provisioning expectations, as part of the SREP supervisory dialogue, from early 2021 onwards.

This addendum will be applicable as of its date of publication. Finally, the backstops are applicable at a minimum to new NPEs classified as such from January 2018 onward.

2.3 Regulatory basis

2.2 General prudential framework

As also outlined in Chapter 6.1 of the NPL Guidance, the existing prudential framework requires supervisors to make decisions as to whether banks’ provisions are adequate and timely.

The Basel Committee on Banking Supervision (BCBS) highlights supervisory responsibilities in assessing the responsibility of supervisors to assess banks’ processes for credit risk management control and asset valuation, as well as ensuring that they have sufficient loan loss provisions, particularly from the standpoint of the assessment of credit risk exposures and capital adequacy. This is reflected in the respective guidelines, including:

- BCBS “Guidance on credit risk and accounting for expected credit losses” (2015) and EBA “Guidelines on credit institutions’ credit risk management practices and accounting for expected credit losses” (2017);
• BCBS “Core Principles for Effective Banking Supervision” (2012), and Basel II, Pillar 2 (2006).

More specifically, in the existing regulatory framework applicable for significant institutions, the following articles of the Capital Requirements Directive (CRD)⁴ are relevant.

• Article 74 requires banks to have “adequate internal control mechanisms, including sound administration and accounting procedures, […] that are consistent with and promote sound and effective risk management”.

• Article 79(b) and (c) requires the competent authorities to ensure that “institutions have internal methodologies that enable them to assess the credit risk of exposures to individual obligors […] and credit risk at the portfolio level” and “the ongoing administration and monitoring of the various credit risk-bearing portfolios and exposures of institutions, including for identifying and managing problem credits and for making adequate value adjustments and provisions, is operated through effective systems”.

• In addition, Article 88 includes the principle that “the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards.”

• In accordance with Article 97(1), the competent authorities must review the arrangements, strategies, processes and mechanisms implemented by institutions to comply with the CRD and the Capital Requirements Regulation (CRR)⁵. Article 97(3) of the CRD IV further specifies that “…the competent authorities shall determine whether the arrangements, strategies, processes and mechanisms implemented by institutions and the own funds and liquidity held by them ensure a sound management and coverage of their risks.”

• In this regard, Article 104(1) enumerates the minimum powers that the competent authorities must have, including, under (b), the power “to require the reinforcement of the arrangements, processes, mechanisms and strategies implemented in accordance with Articles 73 and 74”; and, under (d), “to require institutions to apply a specific provisioning policy or treatment of assets in terms of own funds requirements”. This is also reflected in the EBA’s “Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP)”, paragraph 479(a) of which states that “the competent authorities may require the institution to apply a specific provisioning policy, and – where permitted by accounting rules and regulations – require it to increase provisions”.

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Therefore, as part of the current regulatory regime, supervisors need to determine whether banks have effective provisioning methodologies and processes, which should ensure that NPE-related risks are adequately covered. Where provisioning levels are inadequate for prudential purposes, supervisors are obliged to ensure that banks reassess and increase respective risk coverage in order to meet prudential expectations.  

Furthermore, the ECB is allowed “to require credit institutions to apply specific adjustments (deductions, filters or similar measures) to own funds calculations where the accounting treatment applied by the bank is considered inadequate for prudential purposes, supervisors are obliged to ensure that banks reassess and increase respective risk coverage in order to meet prudential expectations, not prudent from a supervisory perspective.”  

As part of this process, supervisors 

The addendum is to be seen in this context. 

2.42.3 Functioning of the prudential provisioning backstop supervisory expectations

The prudential provisioning backstops outlined in this addendum supplement the NPL Guidance by specifying quantitative supervisory expectations with regard to what the minimum ECB deems to be prudent levels of provisions within the prudential regime. Figure 1 provides an overview of the prudential provisioning concept.  

The underlying aim is to ensure that NPEs are subject to sufficient provisioning, taking into account the level of existing credit protection and, crucially, the NPE vintage category. Section 3.2 clarifies which forms of collateral or other forms of credit risk protection are accepted by the ECB to be adequate from a prudential perspective. In this addendum, the minimum prudential provisioning expectations are defined in Chapter 4.

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Figure 1

Overview of the prudential provisioning concept

The quantitative prudential expectations may go beyond, but not stand in contradiction to, accounting rules. If the applicable accounting treatment is not considered prudent from a supervisory perspective, the accounting provisioning level is fully integrated in the banks’ supply to meet the supervisory demand, expectation. In order to fulfill A bank’s supply for the full purposes of the prudential provisioning backstop, the sum of expectations is made up of the following items forms the bank’s supply:

1. all accounting provisions under the applicable accounting standard including potential newly booked provisions;
2. expected loss shortfalls for the respective exposures in default in accordance with Articles 158 and 159 of the CRR; and, other CET 1 deductions from own funds related to these exposures;
3. CET 1 deductions from own funds under the bank’s own initiative in accordance with Article 3 of the CRR.

Banks are encouraged to close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the

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7. Partial write-offs made since the most recent NPE classification can also be included where relevant.

8. Unless other CET 1 deductions are already reflected in the calculations of expected loss shortfalls.
applicable accounting standard. If the applicable accounting treatment does not
fulfil match the prudential provisioning backstop expectations, banks should also have
the possibility to adjust their Common Equity Tier 1 capital on their own initiative,
applying Article 3 of the CRR on the application of stricter requirements.\footnote{Those
deductions are to be reported in the common reporting (COREP) template C01.00 in row 524
\textquotedblleft(-) Additional deductions of CET1 Capital due to Article 3 CRR	extquotedblright.}

Banks should report on the compliance supervise dialogue – at least
annually in the context of the SREP – the ECB will discuss with banks any
divergences from the prudential provisioning backstop expectations outlined in this
addendum at least annually and explain deviations to the supervisor (see Section 5
on supervisory reporting). Addendum.

Deviations from the backstops are possible if a bank can demonstrate in the course
of a periodic comply-or-explain process, and on the basis of acceptable evidence, that
the calibration of the ECB will consider specific circumstances (e.g. pulling effect) which
may make the prudential provisioning backstop not justified expectations
inappropriate for a specific portfolio/exposure (e.g. Such circumstances might include,
for example, a situation where a debtor verifiably makes regular partial
payments amounting to a significant portion of the initial contractual payments, or
those payments enable the exposure to be cured\footnote{Where banks decide to make deductions from CET1 capital on their own initiative, those deductions are to be reported in the common reporting (COREP) template C01.00 in row 524 \textquotedblleft(-) Additional deductions of CET1 Capital due to Article 3 CRR	extquotedblright.} irrespectively of whether it is past
due or unlikely to pay, or where the application of the backstop supervisory
expectations would result in covering more than 100% of the exposure, in
combination with Pillar 1 capital requirements for credit risk), or, result in more than
100% of the exposure being covered, or any other relevant circumstances. In this
context, any portfolio-specific robust evidence can be used to inform the supervisory
dialogue.

\textbf{(.)\textsuperscript{11} In the application course of the backstop is not reasonable in justified circumstances (e.g. pulling effect on a debtor’s performing exposures).}

The comply-or-explain process will be followed by a supervisory assessment
of dialogue the deviations ECB will assess any differences between the ECB’s
supervisory expectations and related justifications an individual bank’s provisioning
approach. This process might include off-site activities such as deep dives performed
by the respective Joint Supervisory Team (JST), on-site examinations or both. The
outcome of the supervisory assessment of deviations will be taken into consideration
account in the Single Supervisory Mechanism SREP, and non-compliance may
trigger. If, after giving due consideration to the specific circumstances presented by a
bank, the ECB is of the view that its prudential provisions do not adequately cover
the expected credit risk, a supervisory measures based on the supervisory powers
specified in the European and national regulatory frameworkmeasure under Pillar 2
framework might be adopted.

\footnote{Also taking into account Chapters 4 and 5.3.3 of the ECB NPL Guidance.}
The general relevance of the Addendum is to be assessed on exposure level (i.e., the date of the last NPE classification and respective NPE vintage). The starting point of the supervisory dialogue will be an assessment performed at the applicable consolidation level (solo, sub-consolidated or consolidated in line with the SREP approach). This could be followed by further supervisory analysis on a more granular level if need be.
3 Definitions applied in this addendum

3.1 Definition of new NPEs and vintage count

New NPEs in the context of this addendum, "new NPEs" are all those exposures that are reclassified from performing to non-performing in line with the EBA’s definition after 1 January 2018, irrespective of their classification at any moment prior to that date.

This addendum uses an “NPE vintage” concept for the application of the backstop supervisory expectations. In this context, NPE’s vintage is defined as the number of days (converted into years) from the date on which an exposure was classified as non-performing to the relevant reporting or reference date, regardless of the trigger that triggered the NPE classification. Thus, the vintage count for “unlikely to pay” and “past due” exposures is the same, and for exposures moving from “unlikely to pay” to “past due” the counting continues and is not reset. If an exposure returns to performing classification in line with the EBA’s Implementing Technical Standards and also taking into account Chapter 5 of the NPL guidance, the NPE vintage count will be re-set to zero.

Exposures classified as NPEs and cured before 1 January 2018 that are reclassified to non-performing status after 1 January 2018 should be treated as new NPEs for the purpose of this guidance, with the NPE vintage count starting at zero.

3.2 Eligible credit protection to secure exposures

This addendum applies prudential principles to define the eligibility criteria for credit protection which are used to determine which parts of NPEs are to be secured or unsecured and, consequently, whether to apply the supervisory expectations for secured or unsecured backstop exposures. This is based on the principle that the prudential regime has to deviate from risk coverage may have to be increased if the accounting treatment is not considered prudent from a supervisory perspective, as outlined above.

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12 This also includes off-balance-sheet exposures as well as NPEs held by the international subsidiaries of significant institutions. For purchased NPEs, the supervisors will take into account evidence from the related due diligence process.

13 Final draft Implementing Technical Standards on forbearance and non-performing exposures (EBA ITS 2013/03)
For the purposes of this addendum, the following types of collateral or other forms of credit risk protection are accepted by the ECB as either fully or partially securing NPEs.

(a) All types of immovable property collateral. Valuation of immovable property collateral should be carried out in accordance with the NPL Guidance, Chapter 7.

(b) Other eligible collateral or other forms of credit risk protection that fulfil the criteria of credit risk mitigation as set out in Part Three, Title II, Chapters 3 and 4 of the CRR, irrespective of whether an institution uses the standardised approach or the internal-ratings-based approach. In this way, a level playing field is ensured for all banks.

3.3 Definition of secured and unsecured parts of NPEs

The supervisory guidance contained in this addendum distinguishes between secured and unsecured (parts of) NPEs as described below.

Figure 2
Blended approach for new NPEs in scope

Exposures and assets in scope

Supervisory expectations

Generally, the supervisory expectations are relevant to all drawn and undrawn credit facilities with non-performing status. However, they may be disregarded for undrawn
credit facilities which may be cancelled unconditionally at any time and without notice, or that effectively provide for automatic cancellation owing to deterioration in the borrower’s creditworthiness.

Fully unsecured exposures

In the context of this addendum, NPEs are considered fully unsecured if they do not benefit from credit risk protection acceptable as described under Section 3.2. These exposures should be assessed with the supervisory dialogue using the supervisory expectations for unsecured backstop exposures as further specified in Section 4.

Fully secured exposures

In the context of this addendum, NPEs are considered fully secured if they benefit from credit risk protection acceptable as described under Section 3.2, which exceeds the current drawn and potential undrawn credit facilities of the debtor. These exposures should be assessed with the supervisory dialogue using the supervisory expectations for secured backstop exposures as further specified in Section 4.

The backstop is applicable to all drawn and undrawn credit facilities. However, undrawn credit facilities need not be included if they may be cancelled unconditionally at any time and without notice.

Collateral values used by the bank should represent the collateral value reported for the exposure in line with the financial reporting (FINREP) instructions set out in Annex V under “Collateral and guarantees received”, corrected by deducting collateral and other credit risk protection not acceptable as considered for the purposes of this addendum (see Section 3.2). With respect to the valuation of immovable property, banks should be fully compliant with the criteria set out in reference to Chapter 7 of the NPL Guidance, which spells out the supervisory expectations in this regard, including adequately prudent haircuts or adjustments.

Partially secured exposures

A blended approach is required for NPEs which are partially collateralised (i.e. the value of eligible credit risk protection as described in accordance with Section 3.2 does not exceed the current drawn and potential undrawn credit facilities). Once the bank has established the value of its credit risk protection, the exposure should be regarded as split into the following two elements.

1. **Secured balance:** In order to determine the secured balance of the NPE, the bank values the credit risk protection as outlined above for fully secured exposures. The secured balance should be assessed in line with the supervisory expectations for secured backstop exposures.

2. **Unsecured balance:** The unsecured balance will be equal to the original drawn and potential undrawn credit facilities minus the secured balance of the exposure. The unsecured balance should be assessed in line with the supervisory expectations for unsecured backstop exposures.

For fully and partially secured exposures, banks are expected to review regularly the collateral value should be regularly reviewed in line with the NPL Guidance, and any changes should be taken into account any changes in a timely manner in the context of the provisioning backstop expectations. Given the inherent execution risk in realising the value of collateral, banks should very carefully consider cases where the secured element increases over time. Such cases should be backed by solid evidence that increased valuations are sustainable as also outlined for immovable property in the NPL Guidance.
4 Prudential provisioning
backstop expectations

4.1 Provisioning backstop categories

Unsecured backstop

4.1 Categories of provisioning expectations

Supervisory expectations for unsecured exposures

Fully unsecured NPEs and the unsecured balance of partially secured NPEs are subject to will be assessed by the unsecured backstop as set out ECB using the supervisory expectations outlined in Section 4.2.

Secured backstop

Supervisory expectations for secured exposures

As part of the prudential framework, a bank needs to be able to realise its security credit protection in a “timely manner”. If collateral has not been realised after a period of several years from the date when the underlying exposure was classified as non-performing, because of failures in the internal processes of the bank or because of reasons beyond the bank’s control (e.g. the length of time it takes to conclude legal proceedings), the collateral is would in principle be deemed to be ineffective and as such, the exposure is expected to be treated as unsecured from a prudential perspective in the context of this Addendum. This means that full prudential provisioning is required considered prudent after sevena period of several years as set out in Section 4.2. It is immaterial whether the delays in realising the security were due to reasons beyond the banks control (e.g. length of time it takes to conclude legal proceedings).

Against this background, fully secured exposuresNPEs and the secured balance of partially secured exposures are subject to NPEs will be assessed by the secured backstop ECB in line with the supervisory expectations outlined in Section 4.2.

It should be noted that foreclosed assets aredo not currently fall within the scope of this addendum. However, regarding Section 7.5 of the NPL Guidance addresses the valuation of foreclosed assets, banks should be fully compliant with
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4.2 Calibration

4.2 All banks should ensure that quantitative supervisory expectations in detail

The ECB will assess prudential provisioning levels of new NPEs as defined above are compared with during the below table, supervisory dialogue described in Section 2.3 of this Addendum, taking into account the quantitative expectations summarised in Table 1.

Table 1
Overview of the quantitative expectations

<table>
<thead>
<tr>
<th>Vintage of NPE</th>
<th>Unsecured part</th>
<th>Secured part</th>
</tr>
</thead>
<tbody>
<tr>
<td>After two years of NPE vintage</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>After three years of NPE vintage</td>
<td></td>
<td>40%</td>
</tr>
<tr>
<td>After four years of NPE vintage</td>
<td></td>
<td>55%</td>
</tr>
<tr>
<td>After five years of NPE vintage</td>
<td></td>
<td>70%</td>
</tr>
<tr>
<td>After six years of NPE vintage</td>
<td></td>
<td>85%</td>
</tr>
<tr>
<td>After seven years of NPE vintage</td>
<td></td>
<td>100%</td>
</tr>
</tbody>
</table>

To avoid cliff edge effects, but should rather be implemented in a suitably gradual way by bankspath towards those supervisory expectations is important, starting from the moment of NPE classification until. Therefore, the ECB will assess secured exposures in the moment when 100% prudential provisioning is expected. For context of the secured backstop, banks should therefore assume at least supervisory dialogue, taking into account a linear path for the backstop, building up to 100% over the seven years, starting from year three onwards.

These expectations aim to ensure that banks are not building up aged NPEs with insufficient provision coverage. Therefore, banks need to continue. Therefore, the ECB considers that prudent provisioning implies the continuation of booking accounting provisions in line with their assessment banks’ assessments and existing accounting principles which, in the vast majority of cases, should result in the backstop not having any effect. Only in the event that the accounting treatment applied is considered not prudent from a supervisory perspective may supervisors determine adequate measures on a case-by-case basis.
5. Related During the supervisory reporting and public disclosure

All dialogue all banks should report are expected to inform their respective JSTs at least on an annual basis the of coverage levels by NPE vintage, with regard to the newly NPEs classified NPEs after 1 January April 2018. In this context, deviations from the prudential provisioning backstop expectations as outlined in this addendum need to be duly explained carefully scrutinised. The JSTs will provide banks with further details regarding this process, and the related templates, sufficiently in advance.

Furthermore, in line with the recommendations contained in Annex 7 of the NPL Guidance, banks are also encouraged to include in their public disclosure of NPE coverage disclosures the provisions by vintage type of asset and thus the degree of alignment with different NPE vintages, as this addendum is an important tool for banks to convey means of conveying their credit risk profiles comprehensively to market participants.