



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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

BANKENTOEZICHT

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# 1 Background

On 20 March 2017 the ECB published its final guidance to banks on non-performing loans<sup>1</sup> (NPL Guidance). The NPL Guidance is a supervisory tool that clarifies supervisory expectations regarding identification, management, measurement and write-offs 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<sup>2</sup> as these serve to strengthen the balance sheet of banks 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)<sup>3</sup>. The expectations are based on the length of time an exposure has been classified as non-performing (i.e. the “vintage”) as well as the collateral held (if any). The measures should be seen as “prudential provisioning backstops” aimed at a prudent treatment of NPEs and therefore avoiding the excessive build-up of non-covered aged NPEs on banks’ balance sheets in the future.

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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<sup>1</sup> Available on the [ECB's banking supervision website](#).

<sup>2</sup> See Section 6.6 of the NPL guidance.

<sup>3</sup> 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 applies 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 prudential provisioning backstop laid out in this addendum at least annually as outlined in Section 5.

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.

### 2.2 Regulatory basis

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 banks' processes for credit risk management control and asset valuation, as well as in ensuring 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)<sup>4</sup> 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*".

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<sup>4</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 176, 27.6.2013, p. 338).

- Article 79(b) and (c) require 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), competent authorities must review the arrangements, strategies, processes and mechanisms implemented by institutions to comply with the CRD and the Capital Requirements Regulation (CRR)<sup>5</sup>.
- In this regard, Article 104(1) enumerates the minimum powers that 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 of which states that *“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”*.

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 considered to be inadequate for prudential purposes, supervisors are obliged to ensure that banks reassess and increase respective risk coverage in order to meet prudential expectations.

As part of this process, supervisors need to provide guidance as to their expectations. The addendum is to be seen in this context.

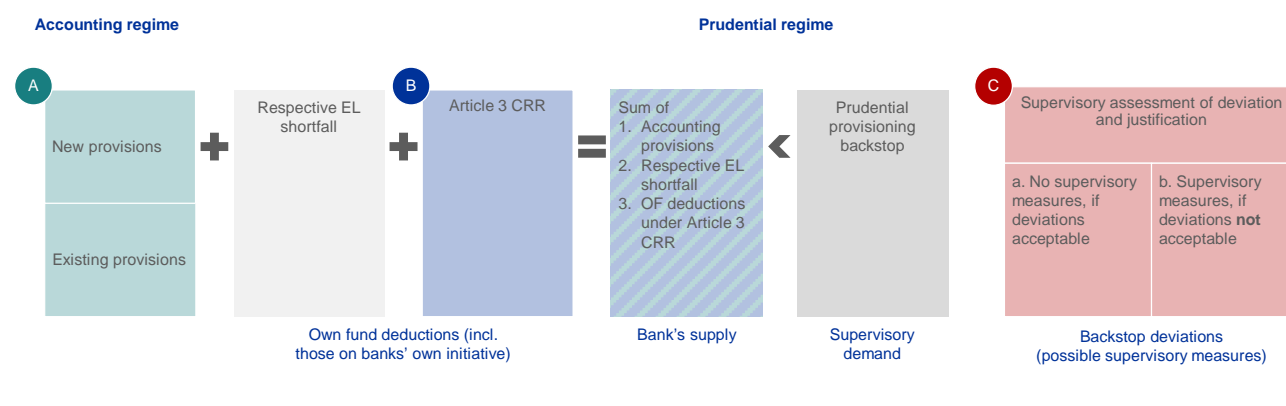
## 2.3 Functioning of the prudential provisioning backstop

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

<sup>5</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

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 from a prudential perspective in this addendum. The minimum prudential provisioning expectations are defined in Chapter 4.

**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.

In order to fulfil the full prudential provisioning backstop, the sum 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
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 applicable accounting standard. If the applicable accounting treatment does not fulfil the prudential provisioning backstop, banks should adjust their Common Equity Tier 1 capital on their own initiative, applying Article 3 of the CRR on the application of stricter requirements.<sup>6</sup>

<sup>6</sup> Those deductions are to be reported in the common reporting (COREP) template C01.00 in row 524 "(-) Additional deductions of CET1 Capital due to Article 3 CRR".

Banks should report on the compliance with the prudential provisioning backstop outlined in this addendum at least annually and explain deviations to the supervisor (see Section 5 on supervisory reporting).

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

- (a) the calibration of the prudential provisioning backstop is not justified for a specific portfolio/exposure (e.g. debtor verifiably makes regular partial payments amounting to a significant portion of the initial contractual payments, or the application of the backstop would result in covering more than 100% of the exposure in combination with Pillar 1 capital requirements for credit risk), or
- (b) the application 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 the deviations and related justifications. 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 in the Single Supervisory Mechanism SREP, and non-compliance may trigger supervisory measures based on the supervisory powers specified in the European and national regulatory frameworks.

## 3 Definitions applied in this addendum

### 3.1 Definition of new NPEs and vintage count

New NPEs in the context of this addendum 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 backstops. In this context, NPE vintage is defined as the amount of days (converted into years) from when an exposure was classified as non-performing to the relevant reporting or reference date, regardless of the trigger of 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 a performing classification in line with the EBA's Implementing Technical Standards<sup>7</sup> 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 a 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 used in determining which parts of NPEs are to be considered secured or unsecured and, consequently, whether to apply the secured or unsecured backstop. This is based on the principle that the prudential regime has to deviate from the accounting treatment if that treatment is not considered prudent from a supervisory perspective.

For the purposes of this addendum, the following types of collateral or other forms of credit risk protection are accepted for 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 of Part Three, Title II, Chapter 4 of the CRR, irrespective of whether an institution uses the standardised approach or the internal ratings-based approach.

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<sup>7</sup> Final draft Implementing Technical Standards on forbearance and non-performing exposures (EBA ITS 2013/03)

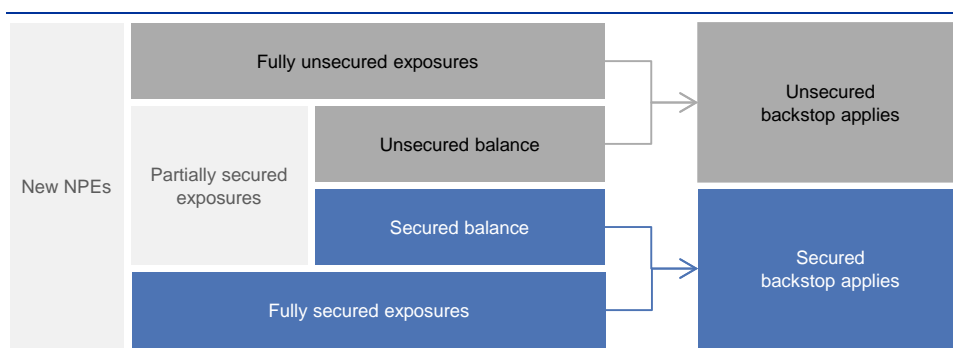


### 3.3 Definition of secured and unsecured parts of NPEs

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



#### Fully unsecured exposures

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

#### Fully secured exposures

In the context of this addendum, NPEs are fully secured if the credit risk protection acceptable under Section 3.2 exceeds the current drawn and potential undrawn credit facilities of the debtor. These exposures should be assessed with the secured backstop.

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<sup>8</sup> under “Collateral and guarantees received”, corrected by deducting collateral and other credit risk protection not acceptable 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 Chapter 7 of the NPL Guidance, including adequately prudent haircuts or adjustments.

<sup>8</sup> Commission Implementing Regulation (EU) 2017/1443 of 29 June 2017 amending Implementing Regulation (EU) No 680/2014

## Partially secured exposures

A blended approach is required for NPEs which are partially collateralised (i.e. the value of eligible credit risk protection 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 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 with the secured backstop.
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 with the unsecured backstop.

For fully and partially secured exposures, the collateral value should be regularly reviewed in line with the NPL Guidance, and any changes should be taken into account in a timely manner in the context of the provisioning backstops. 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

### 4.1 Provisioning backstop categories

#### Unsecured backstop

Fully unsecured NPEs and the unsecured balance of partially secured NPEs are subject to the unsecured backstop as set out in Section 4.2.

#### Secured backstop

As part of the prudential framework, a bank needs to be able to realise its security 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, the collateral is deemed to be ineffective and as such, the exposure is treated as unsecured from a prudential perspective. This means that full prudential provisioning is required after seven 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 exposures and the secured balance of partially secured exposures are subject to the secured backstop.

It should be noted that foreclosed assets are not currently in scope of this addendum. However, regarding the valuation of foreclosed assets, banks should be fully compliant with the criteria set out in Section 7.5 of the NPL Guidance including adequately prudent haircuts or adjustments. Furthermore, Annex 7 of the NPL Guidance also contains clear reporting and disclosure recommendations for foreclosed assets, including a breakdown by vintage.

### 4.2 Calibration

All banks should ensure that prudential provisioning levels of new NPEs as defined above are compared with the below table.

	Unsecured part	Secured part
After two years of vintage	100%	
After seven years of vintage		100%

The application of the backstops should not result in cliff edge effects, but should rather be implemented in a suitably gradual way by banks from the moment of NPE classification until the moment when 100% prudential provisioning is expected. For

the secured backstop, banks should therefore assume at least a linear path for the backstop, building up to 100% over the seven years.

The backstop should not to be seen as a best practice timetable for provisioning, but rather as a supervisory tool for addressing outliers to ensure that banks are not building up aged NPEs with insufficient provision coverage. Therefore, banks need to continue booking accounting provisions in line with their assessment and existing accounting principles which, in the vast majority of cases, should result in the backstop not having any effect.

## 5 Related supervisory reporting and public disclosure

All banks should report to their respective JSTs at least on an annual basis the coverage levels by NPE vintage, with regard to the newly classified NPEs after 1 January 2018. In this context, deviations from the prudential provisioning backstops as outlined in this addendum need to be duly explained. 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, a public disclosure of NPE coverage by vintage – and thus the degree of alignment with this addendum – is an important tool for banks to convey their credit risk profiles comprehensively to market participants.

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