EUROPEAN CENTRAL BANK
BANKING SUPERVISION

# Communication on supervisory coverage expectations for NPEs

Addressing NPLs[1] has been one of the key priorities for ECB Banking Supervision since its inception. In line with its responsibility to help ensure the safety and soundness of the European banking system, the SSM has developed a supervisory approach to NPLs within the existing legal framework, as the ECB, in its supervisory capacity, is to execute the framework devised by the Union legislator. The ECB has to execute this framework in the light of any interpretative guidelines adopted by the EBA. Within these boundaries, the ECB contributes to the SSM's objective of ensuring high standards of supervision by publicly communicating its expectations regarding banks' treatment of NPL-related issues. These expectations serve as a starting point for the supervisory dialogue, where the specificities of each bank will be duly considered. Where necessary, the ECB may take further supervisory actions.

The overall objective of developing the supervisory approach to NPLs was to help banks resolve their NPLs and to push for a discontinuation of "wait and see" approaches observed in the past, as well as to provide transparency in respect of the ECB's supervisory expectations regarding banks' treatment of NPLs. This approach includes strategic elements focused on addressing legacy NPLs and aims to limit the build-up of new NPLs in the future. It consists of:

(i) The ECB Guidance to banks on non-performing loans ("the ECB NPL Guidance"), which was published in March 2017.[2] As part of that guidance, high NPL banks are expected to develop their own strategies to address NPL stocks.

(ii) The Addendum to the ECB NPL Guidance ("the Addendum"), which was published in March 2018.[3] The Addendum sets out supervisory expectations for prudential provisioning for new NPEs.

(iii) Supervisory expectations for the provisioning of NPE stock, as communicated in a press release issued on 11 July 2018.[4]

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1 It is important to note that the terms "non-performing exposure" (NPE) and "non-performing loan" (NPL) are used interchangeably in this document. NPL is generally used in this document as a shorthand term. References to NPEs and NPLs are both based on the definition contained in the EBA's ITS on non-performing exposures. The EBA ITS cover all exposures arising from loans, advances and debt securities. For SSM purposes, the term NPL is generally used, as opposed to NPE, but this is not based on a different definition; it is based on the definition set down in the EBA ITS, but refers to loans and advances portfolios more generally. The reason for this is that NPEs are more generally found in loans and advances portfolios in FINREP and so the term NPL is used to describe this population of loans. The ECB NPL Guidance addresses all NPEs, applying the EBA definition, as well as foreclosed assets, and also touches on performing exposures with an elevated risk of turning non-performing, such as "watch-list" exposures and performing forborne exposures.

2 Guidance to banks on non-performing loans (March 2017)

3 Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures (March 2018)

4 ECB press release – "ECB announces further steps in supervisory approach to stock of NPLs" (July 2018)

In addition, in its "Action plan to tackle non-performing loans in Europe"[5] of 11 July 2017, the Council called on various European institutions to take appropriate measures to further address the high stock of NPEs in the EU and prevent their build-up in the future. As one of the deliverables, Regulation (EU) 2019/630 amending the CRR (Regulation (EU) No 575/2013) as regards minimum loss coverage for non-performing exposures was published in the Official Journal of the EU on 25 April 2019.[6] This established prudential treatment under Pillar 1 for NPEs arising from loans originated from 26 April 2019 onwards.[7] These Pillar 1 rules are legally binding and apply to all banks established in the EU.

The ECB has duly assessed the interaction between its approach to NPEs under Pillar 2 and the new Pillar 1 rules on the prudential treatment of NPEs. It has concluded that some adjustments to the ECB's supervisory expectations for prudential provisioning for new NPEs are warranted in order to enhance the consistency and simplicity of the overall approach to NPEs. No further changes to the ECB's supervisory policies to deal with NPLs are expected, and steps towards implementation should continue.

After summarizing related policies and measures in general, this document (i) clarifies aspects relating to the EBA's publication of NPE-related Guidelines; (ii) provides further details regarding the ECB's supervisory expectations for provisioning of NPE stock, (iii) clarifies the interaction between the ECB's NPE coverage expectations under Pillar 2 and the Pillar 1 prudential NPE rules, and (iv) summarises adjustments to the Pillar 2 approach in respect of supervisory expectations for prudential provisioning for new NPEs in scope of the Addendum.

## 1 Reducing the stock of NPLs as an SSM Supervisory priority

Addressing the NPL problem is critical to restoring confidence in the euro area banking system and the wider economy, as NPLs weigh on banks' profitability and absorb valuable resources, restricting their ability to grant new loans, all to the detriment of the outlook for jobs and growth.

As regards credit risk, competent authorities should assess whether the level of loan loss provisions and credit valuation adjustments are appropriate for the quality of the

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5 This action plan set out a comprehensive approach focusing on a combination of complementary policy actions in four areas: (i) supervision; (ii) structural reform of insolvency and debt recovery frameworks; (iii) development of secondary markets for distressed assets; and (iv) fostering restructuring of the banking system.

6 Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures (OJ L 111, 25.4.2019, p.4).

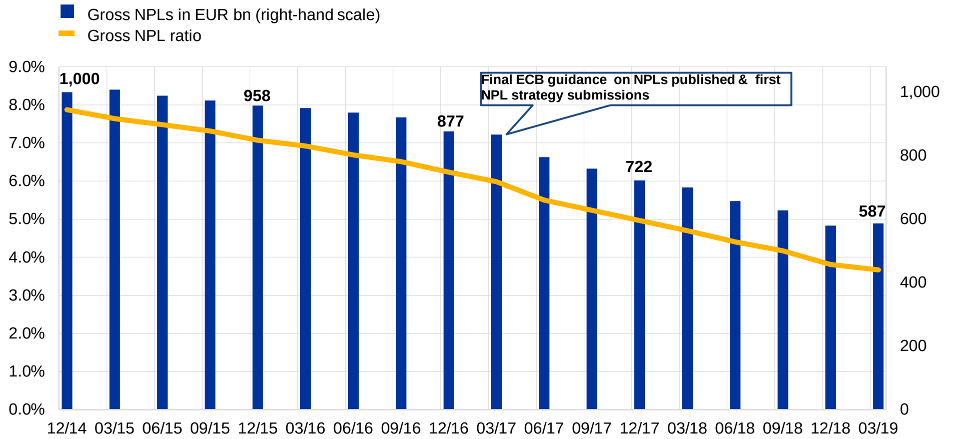
7 It is also important to bear in mind that, according to the prudential treatment under Pillar 1, "*[w]here the terms and conditions of an exposure which was originated prior to 26 April 2019 are modified by the institution in a way that increases the institution's exposure to the obligor, the exposure shall be considered as having been originated on the date when the modification applies*" (Article 469a of the CRR).

exposures.[8] This view is supported by the EBA in several guidelines.[9] As a matter of fact, the assessment of NPEs held by significant credit institutions (SIs) has been part of the ECB's Supervisory Review and Evaluation Process (SREP) for significant credit institutions in past years and has resulted in supervisory measures being adopted in a number of cases with the aim of addressing high levels of NPEs in certain banks.

At the start of the SSM, the volume of NPLs held by SIs stood at around €1 trillion (8% NPL ratio). By the end of March 2019, this had been reduced to €587 billion (3.7% NPL ratio). The decline in NPLs has accelerated over the past 2 years, particularly rapidly in countries with high NPL ratios. This has coincided with the publication of the ECB NPL Guidance in March 2017, which sets out ECB Banking Supervision's expectations on NPL management going forward. It explains a range of measures that banks are expected to consider when addressing NPLs, with a focus on all key aspects relating to NPLs, including strategy, governance, forbearance, recognition, provisioning and collateral valuation.

**Chart 1**

NPL evolution for SIs




As a follow-up, SIs with higher levels of NPLs communicated their NPL reduction strategies to the ECB for the first time in 2017 and have updated them twice since then. The banks themselves are responsible for implementing ambitious, yet credible, NPL strategies and managing their NPL portfolios using a range of strategic options (such as NPL workout, servicing, portfolio sales, etc.).

8 See, in particular, paragraph 197 and further of EBA Guidelines of 19 July 2018 on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing (EBA/GL/2014/13).

9 Ibid.

Despite good progress to date, the aggregate level of NPLs in the European banking sector remains elevated by international standards, and supervisors continue to engage proactively with banks to help them further reduce the level of NPLs.[10]

The ECB considers it of the utmost importance that the level of NPLs is further reduced in a swift manner while economic conditions are still favourable. A failure to do so before moving into the next downturn, would pose a real problem.

## 2 Aspects relating to the publication of related EBA guidelines on NPEs

The supervisory approach to NPLs was further strengthened at the end of 2018 when the EBA published two sets of guidelines relating to NPEs: (i) Guidelines of 31 October 2018 on management of non-performing and forborne exposures ("the EBA GL on NPEs")[11]; and (ii) Guidelines of 17 December 2018 on disclosure of non-performing and forborne exposures ("the EBA GL on Disclosure of NPEs")[12].

The EBA GL on NPEs specify sound risk management practices for credit institutions in their management of NPEs and forborne exposures (FBEs), including requirements for NPE reduction strategies, governance and operations of the NPE workout framework, the internal control framework and monitoring. As the ECB NPL Guidance published in March 2017 is deemed to be aligned with the EBA GL on NPEs, the ECB has notified the EBA of its intention to comply with the EBA GL on NPEs. There are a number of considerations for SIs to take into account in this respect:

First, there are no contradictions in terms of substance between the EBA Guidelines and the ECB's expectations regarding NPLs. While the ECB's expectations are, in some cases, more detailed, they are in line with the EBA GL on NPEs. Consequently, SIs are expected to continue to implement the ECB NPL Guidance, and JSTs will continue to monitor implementation. Additionally, the EBA GL on NPEs do not contain a specific expectation as to the threshold for the individual valuation of immovable property, rather they allow the relevant competent authority to set that expectation accordingly.[13] In this regard, an expectation regarding the threshold for SIs is already included in the public ECB NPL Guidance and is set at €300,000.

Secondly, the EBA GL on NPEs specify that credit institutions with gross NPL ratios (as defined in the EBA GL on NPEs) at a level of 5% or above should establish an NPE strategy as part of their overall strategy, with related governance and operational arrangements. In addition, the EBA GL on NPEs also provide for

[10] ECB Banking Supervision: SSM Supervisory Priorities 2019

[11] EBA/GL/2018/06

[12] EBA/GL/2018/10

[13] See paragraph 189 of the EBA GL on NPEs.

supervisory discretion[14] to request strategies and associated NPL governance and operational aspects from additional banks on the basis of their specific risk profile and/or bank-specific circumstances. What this means in practice for SIs is that JSTs have the ability, where justified and necessary, to request an NPL reduction strategy from banks and to ask SIs to implement dedicated NPL-related actions where the NPL ratio is below 5% at a set date. The circumstances under which such a request will be made will be bank-specific but aligned to the criteria specified in the EBA GL NPEs as follows: '"Where credit institutions have a gross NPL ratio below the 5% level but have a high share or material amount of NPEs in an individual portfolio or individual portfolios with a specific concentration of NPEs in a geographical region, an economic sector or a group of connected clients, competent authorities may require credit institutions to apply sections 4 and 5 at the level of these portfolios."[15] In addition, JSTs may identify SIs that show signs of deteriorating asset quality. In this regard, the EBA GL on NPEs specify criteria and indicators which JSTs will monitor and review to determine whether bank-specific actions are needed. Those criteria and indicators include increased inflows, high levels of forbearance, high levels of foreclosed assets, low coverage ratios, early warning indicators being breached, an elevated Texas ratio,[16] and the quality and appropriateness of workout activity.[17] An SI's ability to exit the obligation to implement an NPE reduction strategy and associated actions will be determined by the JST on an annual basis. This will take into consideration specific performance against the institution's NPE strategy, supervisory assessment and dialogue regarding the appropriateness of the strategy, and the associated risk profile of the bank, including an assessment of its NPL ratio.[18] It may be the case that an SI falls below the 5% NPL ratio specified in the EBA GL on NPEs but is still required to submit an NPL reduction strategy and associated actions. Each year, as part of the SREP decision and the associated supervisory dialogue process, all related bank-specific requirements and recommendations will be communicated to SIs.

In terms of the level of application, the EBA has clarified in its guidelines that the threshold will be applicable at consolidated, sub-consolidated and solo levels and that the application of Sections 4 and 5 of the EBA GL on NPEs will be required where NPL ratios at any of these levels are equal to or greater than 5%.[19] For example, where a credit institution has an NPL ratio below 5% at consolidated level

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14 "Competent authorities could identify other credit institutions that should develop NPE strategies, governance and operations if they detect signs of deteriorating asset quality." "Furthermore, the EBA clarifies that the guidelines do not set any NPL threshold at portfolio level and leave it to competent authorities' discretion to apply the requirements based on banks' portfolios. Competent authorities are expected to assess the materiality of a given portfolio (e.g. the nature and size of the portfolio in terms of total exposures) and of the NPEs, including their number, size and concentration, associated with that portfolio. It is then up to competent authorities to decide, following the materiality assessment, whether affected credit institutions are subject to the provisions of Sections 4 and 5 of the guidelines at portfolio level." See p. 8, paragraph 10 and p. 100 of the EBA Final report – Guidelines on management of non-performing and forborne exposures of 31 October 2018 (EBA/GL/2018/06).

15 See paragraph 12 of the EBA GL on NPEs.

16 The Texas ratio compares the stock of NPLs with a credit institution's equity and is calculated by dividing NPLs (gross carrying amount) by equity and accumulated impairments.

17 See paragraph 13 of the EBA GL on NPEs.

18 NPL ratio calculated using loans and advances, excluding debt securities.

19 See paragraph 11 of the EBA GL on NPEs.

but a subsidiary of that institution has an NPL ratio[20] above 5%, according to the guidelines, the subsidiary in question should apply the provisions of Sections 4 and 5. The ECB intends to apply the same scope as indicated in the EBA GL on NPEs.

If banks have any queries or concerns relating to the continued application of the ECB NPL Guidance, they are encouraged to discuss such issues with their respective JST representatives.

With the publication of the EBA GL on Disclosure of NPEs in December 2018, banks were given greater clarity regarding specific aspects of NPE disclosure. The ECB fully supports the EBA's approach and intends to comply with the EBA GL on Disclosure of NPEs. Accordingly, from the date of application of the EBA guidelines, namely 31 December 2019, banks are expected to follow the EBA Guidelines on disclosure of non-performing exposures and forborne exposures instead of the current Annex 7 of the ECB NPL Guidance.

## 3 ECB's Pillar 2 approach to NPE coverage

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

- Guidance to banks on non-performing loans published in March 2017, 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 non-performing loans 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 1 April 2018 onwards).
- Supervisory expectations for provisioning of NPE stock (i.e. exposures classified as NPE on 31 March 2018), which were communicated in a press release issued on 11 July 2018[21]

The functioning of supervisory expectations, definitions and treatment of bank-specific circumstances (which may make prudential provisioning expectations inappropriate for a specific portfolio/exposure) are all described in the Addendum to the ECB NPL Guidance to banks on non-performing loans and are applicable to both NPE stock and new NPEs. The same prudential rationale applies to both new NPEs and stock of NPEs and is part of the ECB's Pillar 2 approach.

The ECB's supervisory expectations are institution-specific, and further bank-specific data will be taken into account in order to fully consider the specific situation of each institution on an ongoing basis when assessing a bank's credit risk coverage. The ECB is in the process of developing a framework for reporting, which will commence in 2020, using end-2019 as a reference date, and which will be developed in full

[20] NPL ratio calculated using loans and advances, excluding debt securities.

[21] ECB press release – "ECB announces further steps in supervisory approach to stock of NPLs"

coordination with the EBA and will be consistent with the related Pillar 1 reporting template.

From end-2020 onwards, JSTs will discuss with banks as part of the supervisory dialogue the supervisory coverage expectations, including any bank-specific circumstances that warrant divergence from the ECB's expectations with regard to a specific group of exposures/portfolio. This process might include additional data requests, off-site activities (such as deep dives performed by the relevant JST), on-site examinations or a combined approach based on the specific circumstances of the bank. The outcome of the supervisory dialogue will be taken into account in upcoming SREP cycles, starting with SREP 2021, as part of the normal supervisory engagement.

It should be noted in this regard that the ECB's supervisory expectations are not legally binding and do not constitute a decision. If banks do apply the expectations, they can expect the ECB to consider their treatment of NPEs to be prudent. If a bank does not apply the expectations and, after giving due consideration to the specific circumstances presented by the bank, the ECB is of the view that its prudential provisions do not adequately cover the credit risk, a supervisory measure under the Pillar 2 framework may be adopted.

## 4 Supervisory expectations for the provisioning of NPE stock

In this context, the ECB announced in a press release on 11 July 2018 that legacy stock of NPEs would be addressed by discussing bank-specific supervisory expectations for the provisioning of NPEs.

The overall approach was designed on the basis of a few underlying principles. The first guiding principle was simplicity. This principle is reflected in: the low number of initial peer groups with different paths to full coverage levels (i.e. 100% for unsecured/secured NPEs over 2/7-years vintage count); straightforward parameters for the grouping of entities, accounting for NPL levels and capacity; and a flexible framework for the path to full provisioning levels. This has allowed a simple and transparent starting point for the supervisory dialogue in which institution-specific additional elements can then be further taken into account. The second guiding principle of the approach was to promote a level playing field. This principle is very important and aims to achieve the same treatment of NPL stock and flow over the medium term, but with full consideration of the specific individual situation of each bank. The third guiding principle was to give banks sufficient time to prepare – i.e. recommendations are made only for the time starting in end-2020 in order to encourage banks to prepare and implement their NPL reduction strategies coupled with the consideration that SIs with larger NPL challenges may face additional issues and may need more time than those with smaller NPL challenges.

Bank-specific recommendations for the provisioning of the NPE stock were developed in a two-step approach:

In a first step, banks were allocated to three comparable groups[22] on the basis of their net NPL ratios[23] as of end-2017 – i.e. banks with low, medium-high and high NPL ratios. For each group, a phase-in path to 100% coverage expectations was envisaged, separately for unsecured and secured NPEs, with the aim of achieving adequate provisioning levels of legacy NPLs and the same coverage of the stock and flow of NPEs over the medium term (see Table 1).

In a second step, an assessment of capacity regarding the potential impact was carried out for each individual bank with a horizon of end-2026. This was followed by a detailed review of each individual case by the JST, with a particular focus on cases where some potential capacity issues were detected, which allowed to determine whether the tested phase-in path was appropriate, or whether some adjustments or particular treatments outside of the established peer groups were needed. This also included adjustment for any major restructuring or transaction taking place. After thorough analysis, a series of informed adjustments was made to the initial bank group allocation resulting from the first step. These adjustments were based on bank-specific circumstances and involved some banks being included in a peer group that had demonstrated a capacity to deliver a faster path to appropriate coverage and a number of other banks that based on their specific circumstances were included in peer groups that facilitated a slower path to appropriate coverage.

**Table 1**

Phase-in paths for NPE coverage recommendations

| | | Group 1 | Group 2 | Group 3 |
|---|---|---|---|---|
| **Secured loans > 7 years** | Policy starting date | 2020 | 2020 | 2020 |
| | Initial coverage target (%) | 60 | 50 | 40 |
| | Annual increase in coverage (pp) | 10 | 10 | 10 |
| | Full applicability (i.e. 100%) | 2024 | 2025 | 2026 |
| | Linear path before 7 years | No | No | No |
| **Unsecured loans > 2 years** | Policy starting date | 2020 | 2020 | 2020 |
| | Initial coverage target (%) | 70 | 60 | 50 |
| | Annual increase in coverage (pp) | 10 | 10 | 10 |
| | Full applicability (i.e. 100%) | 2023 | 2024 | 2025 |
| | Linear path before 2 years | No | No | No |

22 Group 1: net NPL ratio below 5%; Group 2: net NPL ratio between 5% and 12.5%; Group 3: net NPL ratio above 12.5%.

23 These net NPL ratios were calculated using loans and advances only, excluding debt securities. A net ratio was chosen as it better captures the residual outstanding exposure that potentially still needs to be provisioned for and thus results in a better correlation with the bank’s capacity to absorb the impact of the supervisory NPL policy.

# 5 Interaction between NPE coverage expectations under the ECB's Pillar 2 approach and CRR (Pillar 1) prudential NPE treatment

On 25 April 2019, Regulation (EU) 2019/630 amending the CRR (Regulation (EU) No 575/2013) as regards minimum loss coverage for non-performing exposures was published in the Official Journal of the EU. This established statutory prudential treatment under Pillar 1 for NPEs arising from loans originated from 26 April 2019 onwards.[24] It requires a deduction from own funds for NPEs which are not sufficiently covered by provisions or other adjustments.

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 secured by immovable collateral and residential loans guaranteed by an eligible protection provider as defined in Regulation (EU) No 575/2013; and (iii) after 7 years of NPE status for other secured NPEs. Moreover, it also specifies paths to full implementation for unsecured and secured exposures before 3/7/9 years of NPE status (as stipulated in Article 1 of Regulation (EU) 2019/630 amending Regulation (EU) No 575/2013[25] (CRR)).

In line with the Capital Requirements Directive[26] (CRD IV), supervisors have to assess and address institution-specific risks which are not already covered, or are insufficiently covered, by the mandatory prudential requirements in the CRR (often referred to as the "Pillar 1 rules"). In particular, the existing prudential framework requires supervisors to assess and decide whether banks' provisions are adequate and timely from a prudential perspective. The ECB's NPE coverage expectations are subject to any binding legislation, including Regulation EU 2019/630 as regards minimum loss coverage for NPEs.

## 5.1 Interplay between the ECB's Pillar 2 approach and CRR (Pillar 1) prudential NPE treatment

There are three main differences between the CRR Pillar 1 NPE treatment and the ECB's Pillar 2 approach:

First, the CRR Pillar 1 NPE treatment requires all banks to make a deduction from own funds where NPEs are not sufficiently covered by provisions or other adjustments in an automatic manner. In contrast, the ECB's supervisory expectations for prudential provisioning under Pillar 2 approach are not legally binding and follow a 3-step approach. In particular, the expectations communicated are (1) a starting point for a supervisory dialogue and (2) dependent on a case-by-case assessment

[24] See also footnote 7.

[25] 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 176, 27.6.2013, p.1).

[26] 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p.338).

after being thoroughly discussed during the supervisory dialogue (including analysis of bank-specific circumstances), (3) a supervisory measure may be applied under the Pillar 2 framework in the SREP cycle.

Second, the CRR Pillar 1 NPE treatment and the supervisory approach to new and legacy NPLs under Pillar 2 differ slightly in terms of the calendar calibration – i.e. 2/7 years vintage count for unsecured/secured NPEs under Pillar 2 vs 3/7/9 years vintage count for NPEs that are unsecured/secured (other than by immovable property)/secured by immovable property. In addition, there are also different paths to reach the adjustments in the case of the ECB's Pillar 2 approach and full implementation in the case of the Pillar 1 framework (i.e. 100% coverage).

**Table 2**

Comparison of calibration between CRR Pillar 1 NPE treatment and the Addendum

| Number of years as NPE | Unsecured part | | Secured part | | |
|---|---|---|---|---|---|
| | | | CRR Pillar 1 NPE treatment | | |
| | CRR Pillar 1 NPE treatment | ECB Pillar 2 - Addendum | Secured by collateral other than immovable property | Secured by immovable property | ECB Pillar 2 - Addendum |
| More than 1 | - | - | - | - | - |
| More than 2 | 35% | 100% | - | - | - |
| More than 3 | 100% | 100% | 25% | 25% | 40% |
| More than 4 | 100% | 100% | 35% | 35% | 55% |
| More than 5 | 100% | 100% | 55% | 55% | 70% |
| More than 6 | 100% | 100% | 80% | 70% | 85% |
| More than 7 | 100% | 100% | 100% | 80% | 100% |
| More than 8 | 100% | 100% | 100% | 85% | 100% |
| More than 9 | 100% | 100% | 100% | 100% | 100% |

Note: Pillar 1 treatment differs from the Addendum in terms of the treatment of parts of NPEs that are guaranteed or insured by an official export credit agency, with no coverage requirement until more than 7 years of NPE status, while a linear path is followed for new secured NPEs under Pillar 2.

Third, there is a significant difference in terms of scope, in that the Pillar 1 NPE treatment applies only to NPEs that will emerge from new loans originated from 26 April 2019 onwards and will never apply to (i) existing stock of NPEs and (ii) full population of existing performing loans on the balance sheets of banks originated before 26 April 2019 which may turn into NPEs in the future. This difference in scope is especially important when we consider the time it takes for banks to turn over the current performing book, which could, during that period, potentially be subject to macroeconomic shocks adversely affecting the credit quality of performing exposures originated before 26 April 2019. Consequently, supervisors need to have tools available to deal with this potential risk.

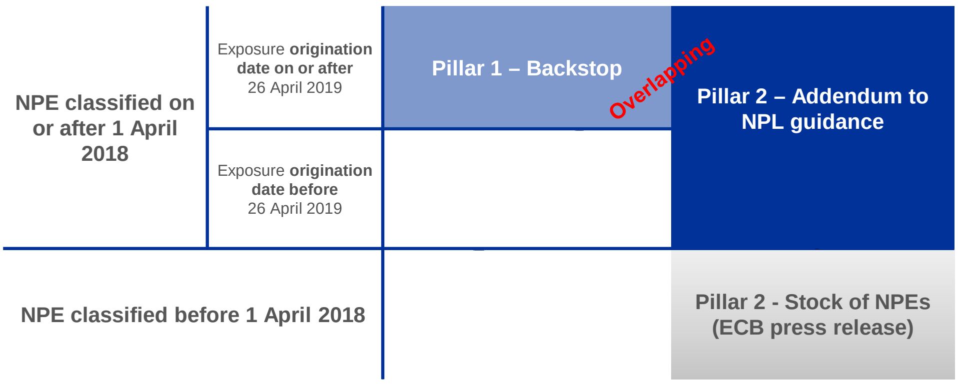
For several years, the provisioning inadequacy related to the NPEs will not be addressed by Pillar 1 NPE treatment. Instead, the supervisory expectations for prudential provisioning for NPEs under the ECB's Pillar 2 approach[27] will remain the

[27] As communicated in the press release of July 2018 (NPE stock) and the Addendum of March 2018 (new NPEs).

key tool for several years to bridge the gap to a state where the majority of exposures become subject to the CRR Pillar 1 NPE treatment. Over time, however, the population of potential future NPEs arising from performing exposures originated from 26 April 2019 onwards, which will be subject to both the CRR Pillar 1 NPE treatment and the Addendum to the ECB NPL Guidance, will increase.[28] This will result in an overlap (see Chart 2), which needs to be addressed.

**Chart 2**

Current scope of Pillar 2 approach to NPE coverage and Pillar 1 treatment of NPEs




After assessing the interaction between the ECB's approach to new NPEs under Pillar 2 and the new Pillar 1 prudential requirements for NPEs, the ECB has concluded that specific adjustments to its approach to new NPEs as communicated in the Addendum to the ECB NPL Guidance are warranted. Changes to the ECB's supervisory policies to deal with NPLs are described below. Further changes are not expected.

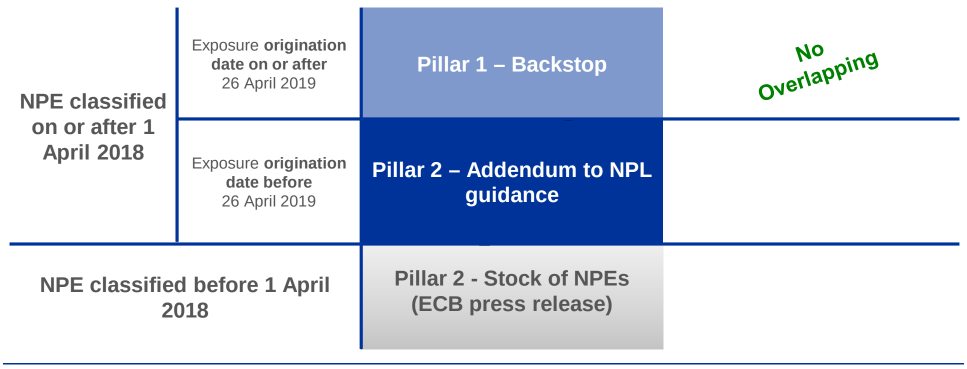
## 5.2 Adjustments to the ECB's Pillar 2 approach for new NPLs

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 26 April 2019. NPEs arising from loans originated from 26 April 2019 onwards (see Chart 3) will in principle be subject solely to Pillar 1. However, the ECB may still apply Pillar 2 measures if the specific circumstances really warrant them.

[28] Theoretically, this overlap regarding full coverage could be at the earliest by 2022 for unsecured and by 2026 (2028) for secured exposures (by immovable property).

**Chart 3**

Adjusted scope of Pillar 2 approach to NPE coverage and Pillar 1 treatment of NPEs




In order to make the two approaches more consistent and thereby simplify banks' reporting, the relevant time frames for NPEs arising from loans originated before 26 April 2019 will be changed from 2/7 years to 3/7/9 years, to align these time frames with those in the Pillar 1 framework. 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 framework (i.e. 100% coverage).

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 applicable to export credit exposures after more than 7 years of NPE status.

All other aspects of the treatment of new NPEs under the Pillar 2 approach remain as described in the Addendum. For the avoidance of doubt, specific circumstances which may make prudential provisioning expectations inappropriate for a specific portfolio/exposure will still be considered in the assessment of divergences from supervisory coverage expectations under the Pillar 2 approach.[29]

## 5.3 Supervisory expectations for the stock of NPEs remain unchanged

For the avoidance of doubt, supervisory expectations for the stock of NPEs (i.e. exposures classified as NPEs on 31 March 2018) remain unchanged, with the same starting point of 2/7 years vintage buckets for unsecured/secured NPEs, subject to supervisory coverage recommendations and phase-in paths as communicated in SREP letters.[30] At the current juncture, swift reduction of the stock should be the first

29 As a consequence the Pillar 2 approach differs from Pillar 1 treatment with regard to forborne exposures, as coverage expectations will not automatically remain stable for one additional year in the case of the first forbearance measure. The reason for this is that NPEs with forbearance measures under the Pillar 2 approach are assessed under the bank specific circumstances.

30 The same items as for the new NPEs described in the Addendum form banks' supply of provisions for prudential purposes (see the Addendum to the ECB NPL Guidance for further details).

priority to ensure that bank balance sheets are "cleaned" before economic conditions become less favourable. At the level of all SIs, around 50% of NPLs were more than 1 year in arrears at end-2018 and around 19% were more than 5 years in arrears. For high NPL banks, 52% of NPLs were more than 2 years in arrears at end-2018 and 30% were more than 5 years in arrears.

## 5.4 Summary of the adjusted approach to NPE coverage

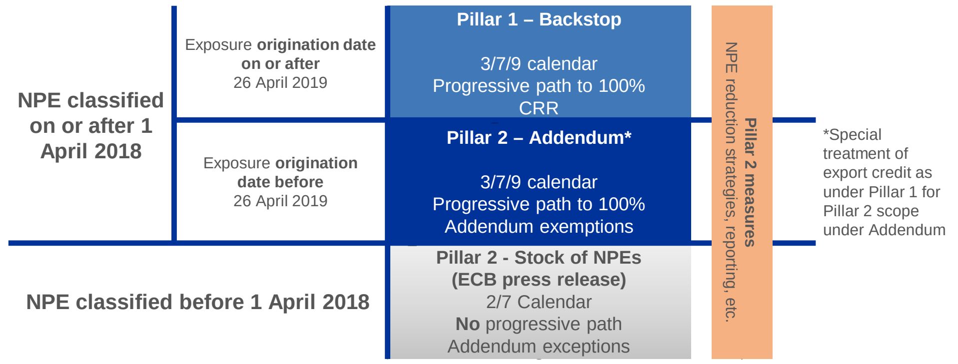
The above-described adjustments result in three "buckets" of NPEs based on (i) the date of the exposure's origination and (ii) the date of the NPE's classification. All new NPEs, irrespective of the date of the exposure's origination, follow the same calendar calibration and breakdown of secured exposures, as well as being treated in the same way as regards any part of the NPE that is guaranteed or insured by an official export credit agency. This will reduce the complexity of reporting for new NPEs. The supervisory expectations for coverage of the stock of NPEs – defined according to the methodology described in Section 4 and already communicated to banks in the 2018 SREP cycle – remain unchanged.

For both stock and new NPEs in scope of supervisory coverage expectations under Pillar 2, the ECB will consider specific circumstances which may make the supervisory expectations for prudential provisioning inappropriate for a specific portfolio/exposure. More precisely, potential exemptions from supervisory coverage expectations may be considered for NPEs where ongoing regular payments of principal and interest, based on the official debtor's cash flows, will lead to full repayment. The focus will be on whether the borrower has demonstrated its ability to comply with the post-forbearance conditions (of a sustainable forbearance solution) and/or is expected to be able to repay the outstanding debt in full. Such an approach should not distort banks' incentives to provide forbearance solutions to viable distressed debtors and promote sustainable forbearance solutions. Moreover, for both stock and new NPEs, specific circumstances will also be considered where the application of the supervisory coverage expectations would, in combination with Pillar 1 capital requirements for credit risk, result in more than 100% of the exposure being covered. Further details and criteria for potential exemptions that may be considered will be provided to banks by end-2019, along with the reporting template and instructions.

Chart 4 provides an overview of approaches to the three different "buckets" of NPEs, and Table 3 indicates the adjusted coverage expectations for new NPEs falling within the amended scope of the Addendum (i.e. exposures originated before 26 April 2019 and classified as NPEs from 1 April 2018 onwards).

### Chart 4

Overview of supervisory and regulatory approaches to NPE coverage




### Table 3

Adjusted calibration of the coverage expectations calendar for new NPEs subject to the Addendum

| Number of years as NPE | Unsecured part | Secured part | |
|---|---|---|---|
| | Pillar 2 – Addendum (adjusted calibration) | Pillar 2 – Addendum (adjusted calibration) | |
| | | Secured by collateral other than immovable property | Secured by immovable property |
| More than 1 | - | - | - |
| More than 2 | 35% | - | - |
| More than 3 | 100% | 25% | 25% |
| More than 4 | 100% | 35% | 35% |
| More than 5 | 100% | 55% | 55% |
| More than 6 | 100% | 80% | 70% |
| More than 7 | 100% | 100% | 80% |
| More than 8 | 100% | 100% | 85% |
| More than 9 | 100% | 100% | 100% |

Note: For parts of NPEs that are guaranteed or insured by an official export credit agency, there are no coverage expectations until more than 7 years of NPE status.



Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.bankingsupervision.europa.eu



For specific terminology please refer to the SSM glossary (available in English only).