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**IMPACT ASSESSMENT**

***Accompanying the document***

**Proposal for a Regulation of the European Parliament and of the Council**

**amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures**

{COM(2018) 134 final} - {SWD(2018) 74 final}

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# Glossary and list of abbreviations

| *Term or acronym* | *Meaning or definition* |
|---|---|
| Accelerated Extrajudicial Collateral Enforcement (AECE) | Measures to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans. |
| Asset Management Company (AMC) | A special-purpose vehicle for cleansing bank balance sheets. A credit institution can transfer non-performing assets (NPA) to an AMC, subject to certain requirements and conditions being met. AMCs are often referred to as "bad banks". |
| Asset Quality Review (AQR) | Assessment conducted by supervisors to enhance the transparency of bank exposures, including the adequacy of asset and collateral valuation and related provisions. |
| BU | Banking Union |
| Basel Committee on Banking Supervision (BCBS) | Committee of the Bank for International Settlements which provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. The most important regulatory frameworks are known as Basel II and Basel III. Representatives of central banks and supervisory authorities from different countries are members of the BCBS. |
| CMU | Capital Markets Union |
| Capital Requirements Regulation (CRR) | 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. |
| Capital Requirements Directive IV (CRD IV) | 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. |
| Common Equity Tier 1 (CET1) capital | The highest quality form of regulatory capital ("own funds") under CRR/CRD IV which implement Basel in the EU. It includes common equity shares (ordinary shares) and related share premium, accumulated other comprehensive income, retained earnings together with most other equity reserves, less prudential adjustments and deductions. |
| Competent Authority (CA) | A public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned. |
| Non-performing loans coverage ratio (CovR) | Loan loss provisions for loans and advances to customers as a percentage of non-performing loans and advances to customers. |
| Cure rate (CR) | The percentage of loans that previously presented arrears and, post restructuring, present no arrears. |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| ECOFIN Council | Economic and Financial Affairs Council |
| ESRB | European Systemic Risk Board |
| Expected loss (EL) | The ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution over a one-year period to the amount outstanding at default. |

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|---|---|
| Exposure | Asset (e.g. a loan) or off-balance-sheet item (e.g. guarantee). |
| EP | European Parliament |
| FED | Federal Reserve Board |
| Forbearance | Forbearance measures are concessions towards debtors facing, or about to face, difficulties in meeting their financial commitments. |
| Foreclosed assets | For the purposes of this document, foreclosed assets are defined as assets held on the balance sheet of a credit institution obtained by taking possession of collateral, or by calling on similar credit enhancements. Those assets can be obtained through judicial procedures ("foreclosed" in the strict sense), through bilateral agreement with the debtor (swap or sale) or other types of collateral transfer from debtor to creditor. Foreclosed assets comprise both financial assets and non-financial assets. Foreclosed assets include all collateral obtained irrespective of their classification for accounting purposes (e.g. including assets for own use and for sale). |
| FSC | Financial Services Committee |
| GDP | Gross domestic product |
| International Accounting Standards (IAS) | Rules set by the International Accounting Standards Board (IASB) – an independent body of international accounting experts. The main purpose of the standards is to promote the quality, transparency and comparability – at an international level, too – of financial statements drawn up by various enterprises or by one enterprise for various periods. Publicly traded enterprises domiciled in the EU are required by Regulation (EU) 1606/2002 to prepare consolidated financial statements in accordance with International Accounting Standards. As the IASB is an international association under private law, its standards cannot be immediately legally binding. Each standard has to undergo a recognition procedure in order to become legally binding at EU level or in other countries. Prior to 1 April 2001, the body was called the International Accounting Standards Committee (IASC) and the rules that it issued were called International Accounting Standards (IAS). These rules are still valid and still bear the same name. Any rules published after this date are called International Financial Reporting Standards (IFRS). |
| International Financial Reporting Standards (IFRS) | Set of international accounting standards stating how particular types of transactions and other events should be reported in financial statements. |
| IMF | International Monetary Fund |
| Loss | Economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument. |
| Loss given default (LGD) | The ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default. |
| Loan loss provision (LLP) | Reduction in the carrying amount of an asset to reflect its decrease in creditworthiness. |
| Loan to value (LTV) | Ratio used in the context of mortgage lending expressing the value of a loan compared to the appraised value of the underlying real estate. |
| MS | Member State |
| Non-performing assets (NPAs) | The sum of NPEs and foreclosed assets. |
| Non-performing exposure (NPE) | An exposure (i.e. a loan, debt security or off-balance-sheet item) that is not held for trading purposes and that satisfies at least one of the following criteria:<br>(a) it is material and more than 90 days past-due;<br>(b) the debtor behind the exposure is assessed as unlikely to pay his/her |

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|---|---|
| | obligation in full without selling the collateral guaranteeing the exposure (if any).<br><br>NPEs include defaulted and impaired exposures[1]. |
| Non-performing loan (NPL) | A loan that is not held for trading purposes and that satisfies at least one of the following criteria:<br>(a) it is material and more than 90 days past-due;<br>(b) the debtor is assessed as unlikely to repay the loan in full without selling the collateral guaranteeing the exposure (if any).<br><br>Non-performing loans include defaulted and impaired loans[2]. |
| NPL ratio | The ratio, expressed in percent, between the amount of NPLs and the total amount of bank loans. |
| Probability of default (PD) | The probability of default of a counterparty over a 1-year period. |
| Performing exposure (PE) | An exposures that does not meet the criteria to be considered an NPE. |
| Recovery Rate (RR) | Measures the extent to which the creditor recovers the principal and accrued interest due on a defaulted debt. |
| Significant institution (SI) | In the context of the SSM (see below), a bank that meets any of the following criteria:<br>(a) it is one of the three largest banks in a MS participating in the Single Supervisory Mechanism;<br>(b) it received direct assistance from the European Financial Stability Facility/ the European Stability Mechanism (EFSF/ESM) assistance; or<br>(c) it has total assets in excess of €30 billion or 20% of national gross domestic product (with a balance sheet total of at least €5 billion).<br>In exceptional cases, the ECB can declare significant a bank operating across national borders.<br>If a bank is identified as a significant institution, it is subject to direct supervision of the ECB. |
| SME | Small- and medium-sized enterprise |
| Single Supervisory Mechanism (SSM) | The pillar of the BU that is responsible for banking supervision. It comprises the ECB and the national supervisory authorities of the participating countries. Its main aims are to: (i) ensure the safety and soundness of the EU banking system, (ii) increase financial integration and stability, (iii) ensure consistent supervision. |
| Single Supervisory Mechanism Regulation (SSMR) | Council Regulation (EU) No 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions. |
| Stress test (ST) | An exercise conducted by supervisory authorities in order to provide supervisors, banks and other market participants with a common analytical framework to consistently compare and assess the resilience of banks to economic shocks. |
| TFEU | Treaty on the Functioning of the European Union |
| Unlikeliness to pay (UTP) | The probability that an obligor will not repay his/her debt in full. |

[1] See also Implementing Regulation (EU) No. 680/2014 on Supervisory Reporting
[2] See also Implementing Regulation (EU) No. 680/2014 on Supervisory Reporting

# 1. INTRODUCTION: POLITICAL AND LEGAL CONTEXT

## 1.1. The need to address NPLs in Europe

Following the financial crisis, the regulatory framework for banks has changed substantially. The European Union has taken the lead in implementing reforms agreed globally at the level of the G20 and in the Basel Committee with the objective of reducing risk in the banking sector, reinforcing financial stability and avoiding that taxpayers have to contribute financially to the costs of failing banks. In addition to these measures, the institutional arrangements for the supervision and resolution of banks in the EU have been strengthened fundamentally with the establishment of the first two pillars of the Banking Union (BU): the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).[3] As a result of these measures, the EU banking sector is in a much better shape today than in previous years.

Nevertheless, several challenges remain to be addressed, including how to decisively address the high stocks of non-performing loans (NPLs) and other non-performing exposures (NPEs)[4]. NPLs have piled up in parts of the EU banking sector in the aftermath of the financial and sovereign crises and ensuing recessions. High levels of NPLs in parts of the banking sector pose significant risks to financial stability and the overall economy in the EU, unlike in other major economies such as the United States or Japan which have previously taken a number of actions to reduce the level of NPLs and repair banks' balance sheets.[5]

High NPL ratios[6] can weigh on a bank's short- and longer-term performance through two main channels. First, NPLs generate less income than performing loans – thus reducing bank profitability – and may cause losses that diminish the bank's capital. In the most severe cases, these effects can put in question the viability of a bank with potential implications for financial stability. Second, NPLs tie up significant amounts of a bank's resources, both human and financial.[7] Banks saddled with high levels of NPEs have therefore only a limited capacity to provide new credit to viable businesses. Small and medium-sized enterprises (SMEs) are particularly affected by the reduced credit supply, as they rely on bank lending to a much greater extent than larger companies, thereby affecting economic growth and job creation.[8] For all these reasons, the Commission has for a long time highlighted the urgency of taking the necessary measures to address the risks related to NPLs.

While tackling NPLs is primarily the responsibility of national authorities[9], there is also a clear EU dimension of the NPLs issue. Given the high level of economic and financial integration in the EU, and especially within the euro area (EA), there are important potential spill-over effects from Member States with high levels of NPLs to the economies of other Member States and the EU at large, both in terms of economic growth and financial stability.[10] Weak growth in some Member States due to elevated NPL levels might affect economic growth elsewhere. Also, weak

[3] The third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS), was proposed by the Commission in November 2015.

[4] NPEs include non-performing loans (NPLs), non-performing debt securities and nonperforming off-balance-sheet items. NPLs, which term is well established and commonly used in the policy discussion, represent the largest share of NPEs. Throughout this document the term NPL is meant in a broad sense equivalent to NPE, and hence the two terms are used interchangeably.

[5] See, for example, FSC (2017) and IMF (2015c).

[6] The term NPL ratio refers to the ratio of non-performing loans to total outstanding loans.

[7] A large portion of the employees' time is spent dealing with lengthy procedures required to manage NPLs. As NPLs are considered riskier than performing loans, they may require higher amounts of regulatory capital if left un-provisioned.

[8] Simulations by the IMF (2015b) suggest that a reduction of European Non Performing Loans to the historical average ratio (by selling them at net book value i.e. after provisioning) could increase bank capital by EUR 54 billion. This would under some assumptions enable EUR 553 billion in new lending.

[9] As also underlined in the European Semester recommendations to relevant Member States.

[10] See ESRB (2017) and IMF (2015b).

balance sheets of just a few banks can negatively affect investors' general perception of the value and soundness of other EU banks. This can unnecessarily raise the funding costs for the sector as a whole, which may adversely affect the cost of credit to borrowers.

Addressing high stocks of NPLs and their possible future accumulation is therefore essential for restoring the competitiveness of the banking sector, preserving financial stability and supporting lending to create jobs and growth. This analysis is shared by a number of reports from European institutions, international organisations, and think tanks.[11]

## 1.2. Recent evolution of NPLs

The general improvement in NPL ratios over recent years continued in 2017, as did the quality of banks' loans portfolios. The latest figures confirm the downward trend of the NPL ratio, which declined to 4.6% (Q2 2017), down by roughly 1 percentage point (pp) year-on-year (see Figure 1). This reduction was mainly the result of one-off events that impacted all bank-size classes, in particular smaller banks. However, the ratio remains elevated when compared to historical norms and to other regions[12] and the total volume of NPLs across the EU is still at the level of EUR 950 billion.[13]

The situation differs significantly across Member States (see Figure 2). Several countries still have high NPL ratios (9 had ratios above 10% in the second quarter of 2017), while others have rather low ratios (10 Member States were below 3%).

There is evidence of some progress in reducing NPL ratios in the most affected countries, owing to a combination of policy actions and a stronger macroeconomic environment. However, significant risks to economic growth and financial stability remain and progress is still slow, especially where it is needed the most. Structural impediments continue to hamper a faster fall in NPL stocks. Provisioning is often still too slow and insufficient to allow for effectively resolving and preventing any critical accumulation of NPLs in the future. Among other elements, activity on secondary markets for NPLs is also not yet sufficient to substantially contribute to NPL reduction efforts, notwithstanding the increased interest from certain investor groups and the increasing volume of NPL-related transactions.

Figure 1: EU NPL ratio

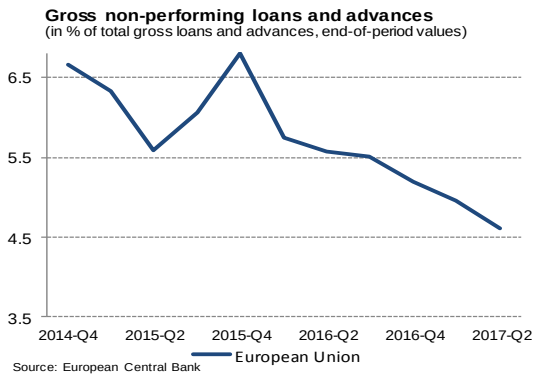
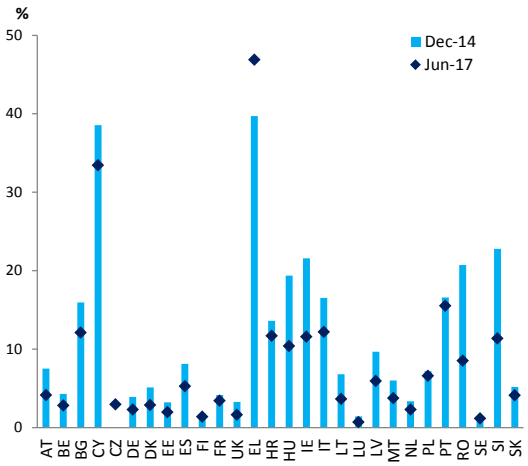



Figure 2: NPL ratio in EU Member States




Source: ECB. Note: Dec-2014 not available for CZ.

[11] See ECB (2016, 2017), EBA (2017), FSC (2017), ESRB (2017), IMF (2015a, b), Vienna Initiative (2012), Baudino and Yun (2017), Bruegel (2017), Barba Navaretti et al. (2017).
[12] The NPL ratio for both the United States and Japan was around 1.5 % in December 2016.
[13] Source: ECB.

## 1.3. Towards a comprehensive package of measures to address NPLs

A comprehensive and credible strategy to address NPLs is an essential and urgent step towards restoring the viability of – and hence investor confidence in – the EU banking sector. Pursuing a comprehensive strategy and taking determined action to address NPLs is also essential for the smooth functioning of the Banking Union and the Capital Markets Union (CMU) and for a stable and integrated financial system. In this way, the resilience of the Economic and Monetary Union to adverse shocks will be enhanced by facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing.

Integrating national and EU-level efforts is needed to address the NPL problem, both on the existing NPL stocks and on future NPL flows. Reflecting the EU dimension and building on previous work by the Commission and other competent EU authorities, the Council adopted in July 2017 an Action Plan To Tackle Non-Performing Loans in Europe.[14] It recognises that work in this area must be based on a comprehensive approach combining a mix of complementary policy actions, since the complexity of the problem simply does not lend itself to a single *'silver bullet'* solution.

The Council Action Plan combines various measures by national governments, bank supervisors and EU institutions/agencies that improve the tools and incentives for banks to pro-actively address NPLs either by internal work-out or through disposal. In practice, this means enhancing legal frameworks relevant for both the prevention and resolution of NPLs, including the functioning of secondary markets. However, other measures such as improving the availability and quality of data on NPLs or improving the market infrastructure (e.g. set-up of trading or information platforms) are equally important. If the right pre-conditions are present, tools such as Asset Management Companies are also an efficient way to allow resolution of NPLs while removing NPLs from the banking system in the short term.

The Commission has committed to delivering on the parts of the NPL Action Plan within its remit. Accordingly, the Commission announced in its October 2017 Communication on completing Banking Union a comprehensive package for tackling high NPL ratios, to be put forward by Spring 2018.[15]

This "Spring package" consists of the following measures:

- A Blueprint for how national Asset Management Companies (AMCs) can be set up in compliance with existing EU banking and State aid rules by building on best practices learned from past experiences in Member States.
- A legislative initiative to further develop secondary markets for NPLs, especially with the aim of removing undue impediments to loan servicing by third parties and to the transfer of loans to third parties.
- A legislative initiative to enhance the protection of secured creditors by allowing them more efficient methods of value recovery from secured loans through Accelerated Extrajudicial Collateral Enforcement (AECE). This refers to an expedited and efficient out-of-court enforcement mechanism which enables secured creditors (banks) in all Member States to recover value from collateral granted by companies and entrepreneurs to secure loans.[16]

[14] See http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

[15] COM(2017) 592 final, 11.10.2017, available at: http://ec.europa.eu/finance/docs/law/171011-communication-banking-union_en.pdf.

[16] This initiative will remain consistent with and complementary to the Commission proposal of November 2016 for a Directive on, inter alia, preventive restructuring frameworks and would not require harmonisation of actual insolvency provisions.

- A legislative initiative amending the Capital Requirement Regulation (CRR), with regard to the introduction of minimum coverage requirements for incurred and expected losses on future NPLs arising from newly originated loans, in order to backstop potential under-provisioning of future NPLs and prevent their build-up on banks' balance sheets.
- A way forward to foster the transparency on NPLs in Europe by improving the data availability and comparability as regards NPLs, and potentially supporting the development by market participants of NPL information platforms or credit registers. [17]

The Council Action plan initiatives under the responsibility of other EU institutions, agencies and competent authorities include, among others:

- General guidelines on NPL management applicable to all EU banks;
- Detailed guidelines on banks' loan origination, monitoring and internal governance, addressing in particular transparency and borrower affordability assessment;
- Macro-prudential approaches to prevent the emergence of system-wide NPL problems, taking into account potential pro-cyclicality and financial stability implications of NPL policy measures;
- Enhanced disclosure requirements on banks' asset quality and non-performing loans.

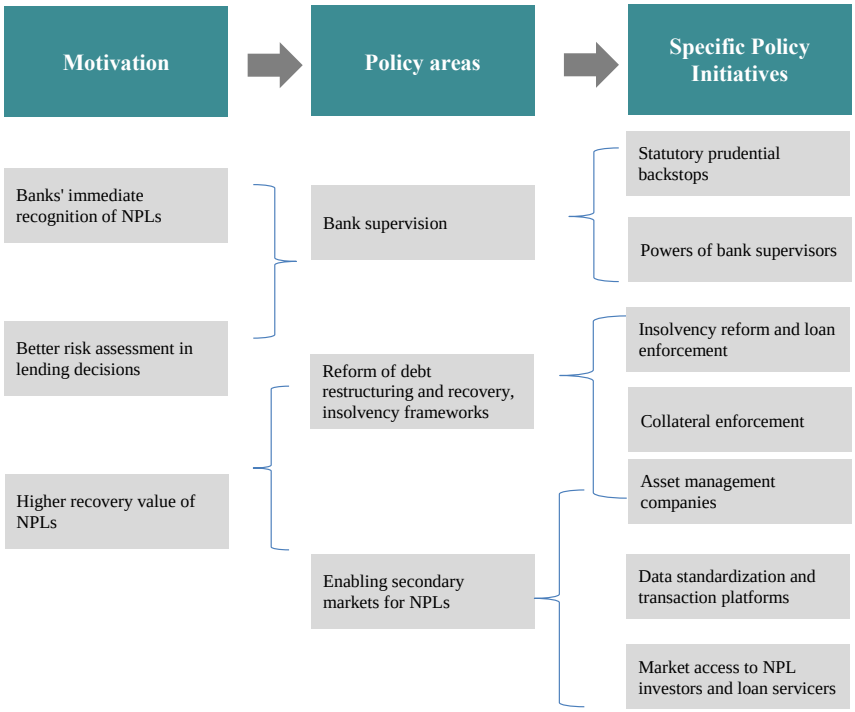
## 1.4. Commonalities and interdependencies of the various measures

The legislative and non-legislative initiatives of the Council Action plan are interlinked and mutually reinforcing. They should create the appropriate environment for dealing with NPLs on banks' balance sheets. Some of them have an impact on the reduction of the current stock of NPLs, and all are relevant for reducing risks of future NPL accumulation. Their impact is expected to be different across Member States and affected institutions. Some will have a stronger impact on banks' ex ante risk assessment at loan origination, some will foster swift recognition and better management of NPLs, and others will enhance the market value of such NPLs.

The Commission's three legislative initiatives, namely i) statutory prudential backstops for loan loss coverage; ii) the development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms, mutually reinforce each other and also interact with the other measures of the Council Action Plan. For example, the prudential backstops initiative ensures that credit losses on future NPLs are sufficiently covered, making their resolution and/or disposal easier. These effects would be complemented by better developed secondary markets for NPLs as these would make demand for NPLs more competitive and raise their market value. Furthermore, accelerated collateral enforcement as a swift mechanism for recovery of collateral value would reduce the costs for resolving NPLs. These interactions are described in greater detail in the below box.

[17] In addition, the Commission is also undertaking a benchmarking exercise of loan enforcement regimes to establish a reliable picture of the delays and value-recovery banks experience when faced with borrowers' defaults, and invites close cooperation from Member States and supervisors to develop a sound and significant benchmarking methodology. In this context, the 2016 Commission proposal for a Directive on business insolvency, restructuring and second chance lays down obligations on Member States to collect comparable data on insolvency and restructuring proceedings.

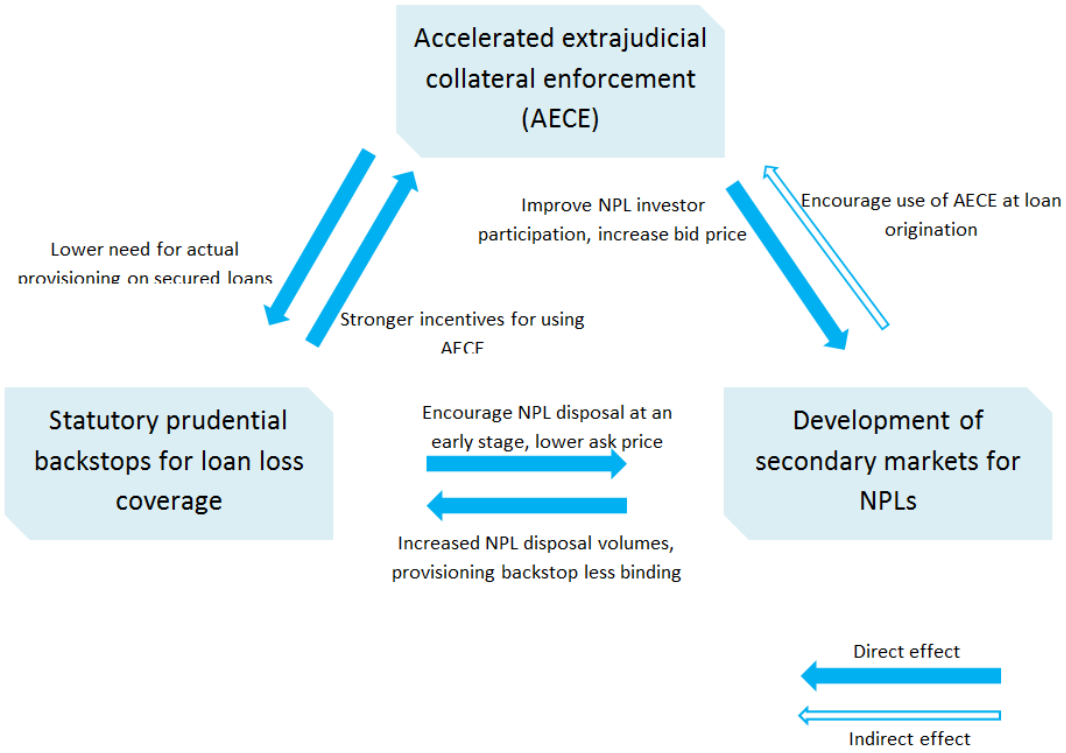
Figure 3 Commission's policy initiatives within the NPL Action Plan




**Box on the reinforcement effects between the Commission's legislative initiatives**

This box assesses the possible reinforcement effects between the three initiatives of the Spring package, namely i) statutory prudential backstops for loan loss coverage; ii) development of secondary markets for NPLs, and iii) accelerated extrajudicial collateral enforcement mechanisms. As is the usual practice, each individual impact assessment gauges the incremental effects of the proposed measure against a no policy change baseline. The underlying idea of the NPL package is, however, that the effects of each initiative will be mutually enhancing. The exact quantification of these feedback effects is a quite complex exercise as it is subject to strong modelling uncertainty. This box hence provides a qualitative description of the feedback channels and their relative strength.

Figure 4: The reinforcement effects between the initiatives of the NPL package




*Effects of Accelerated extrajudicial collateral enforcement (AECE) on other initiatives*

As AECE becomes more popular and used by credit institutions, the *statutory prudential backstop* measures would be less binding. Indeed, banks would tend to restructure, recover or dispose of their NPLs earlier and at a higher rate. They would be less affected by the need to increase provisioning as time goes by, as required by the prudential backstops measures.

Given that the AECE feature would follow the NPLs following their disposal to a third party, this would help the *development of the secondary market* by increasing investor participation and thereby its liquidity (NPL demand-side effects). In particular, shorter time of resolution and increased recovery, as expected with AECE, would increase the bid prices. Moreover, the harmonization achieved by AECE would foster development of pan-European NPL investors, further improving market liquidity.

*Effects of Statutory prudential backstops on other initiatives*

The more costly in terms of higher provisioning it becomes for banks to keep secured corporate NPLs on their balance sheets due to the new prudential backstop rules, the higher the incentives for banks to restructure, recover or dispose of NPLs quicker and earlier, and hence the higher the *use of AECE* directly (by triggering it) or indirectly (by disposing of the NPL to a third party).

Holding NPLs on the balance sheet will become costly over time, providing an incentive for banks to dispose of NPLs on *the secondary markets* at an early stage, when the backstops require less minimum coverage. Once the minimum coverage level required by the backstops becomes more binding, the carrying book value of NPLs will be reduced. Both of these mechanisms would ensure more sellers participation on the secondary market (NPL supply-side effect), thereby reducing the ask price of NPLs.

*Effects of the development of secondary markets for NPLs on other initiatives*

Improved investor participation and better functioning of secondary markets would reduce the bid-ask spread and increase the volume of NPLs that are transferred to third parties. Banks would dispose of NPLs more eagerly and at an earlier stage, therefore the *provisioning backstop* would be less often binding.

With a more liquid and better functioning secondary market for NPLs where investors show appetite for NPLs with the AECE feature, there would be additional incentives for credit institutions to *use AECE* at origination of new loans. This indirect feedback effect would become active once sellers realise that it is easier to dispose of NPLs having the AECE feature to third party investors.

The effectiveness of the three aforementioned legislative measures would increase if banks are adequately capitalised in the future. Better capitalised banks will be more eager to sell NPLs in the secondary market or to realise the collateral of a non-performing loan in a timely fashion. Furthermore, statutory minimum coverage requirements would provide strong incentives for banks' management to prevent the accumulation of future NPLs through better NPL management and stronger loan origination practices. This will reinforce the expected effects of the EBA's and ECB's work on banks' loan origination, NPL management, monitoring and internal governance practices. Work on NPL information and market infrastructure would further enhance the functioning of NPLs secondary markets. Lastly, measures related to loan enforcement would complement the Commission's November 2016 proposal for a Directive on business insolvency, preventive restructuring and second chance, by increasing the chances that viable businesses survive while non-viable activities are swiftly resolved.[18]

[18] COM(2016) 723 final.

## BACKGROUND INFORMATION ON LOAN LOSS PROVISIONING

Recent developments in banking systems around the world illustrate the continued importance of proper provisioning. Two such examples are the Asset Quality Review (AQR) exercise in the EU and initiatives of unifying the definitions of NPEs and exposures subject to forbearance measures at the European and international level.[19] Credit quality inadequacies and their resulting losses have always been one of the primary causes of bank failures. Almost ten years after the onset of the global financial crisis, despite ongoing regulatory reforms and rounds of organized stress testing, deleveraging, and balance sheet repair exercises, loan loss provisioning and asset quality remain key issues for banks. Provisioning merits particular attention given its vital role in ensuring the safety and soundness of the banking system. According to IMF staff "[u]nder-provisioning is generally the single greatest distortion in the calculation of capital and capital adequacy".[20]

Provisioning is a risk management tool to address credit risk by setting aside a given amount (of cash/capital), referred to as loan loss provision (LLP)[21], as a buffer to absorb incurred and expected losses on a financial instrument such as a loan. LLPs allow banks to recognize the estimated loss in their income ("profit & loss") statements and balance sheets[22], even before the actual loss can be determined with full accuracy and certainty as events unfold. When loan losses eventually materialise, banks can draw on LLPs, thereby absorbing the losses without reducing capital and preserving banks' capacity to continue lending to the economy.[23]

**Losses on credit exposures including NPLs are subject to both accounting standards and prudential regulation. However, neither the international accounting nor the prudential framework does currently provide for a common minimum treatment with regards to incurred/expected losses on NPLs.**

*Accounting treatment: from IAS 39 to IFRS 9*

Following the global financial crisis, the G20 leaders, investors and regulators called for actions to improve LLP standards and practices, by replacing the International Accounting Standard (IAS) 39 standard with a new, forward-looking principle. In particular, the International Accounting Standards Board (IASB) received the mandate to set a new standard to allow banks to "fully recognise existing credit losses earlier in the credit cycle" and, as such, to address the flaws of a "too little, too late" provisioning. In response to the G20's mandate, the IASB formulated a new accounting standard for the classification and measurement of financial assets and liabilities, the so called International Financial Reporting Standards (IFRS) 9, which will be applied in the EU starting with January 2018[24].

The most important change of IFRS 9 compared to IAS 39 is the change from an "incurred credit loss" approach to an "expected credit loss" (ECL) approach for determining credit losses of

[19] Both the EBA and the BCBS have adopted harmonized and consistent definitions of both NPE and forbearance (i.e., restructuring or refinancing of troubled debt), thereby fostering consistency in supervisory reporting.
[20] Cf. IMF (2014) op. cit.
[21] The terms 'impairments', 'provisions' and 'value adjustments' effectively have the same meaning. To be more accurate, 'impairments' refer to the losses for on balance sheet exposures under IFRS more commonly, 'provisions' refer to the losses for off-balance sheet exposures under Directive 86/635/EEC (Bank Accounting Directive) and 'value adjustments' to the impairment for loans and advances on balance sheet under the same Directive.
[22] On the balance sheet, LLPs are recognised as negative assets and (due to balance sheet identity) as a corresponding decline of the bank's equity.
[23] Ideally, provisions should anticipate deteriorating economic conditions that may affect borrowers' ability to repay their obligations. In such a way, they can be used to cover expected losses, while bank capital serves as a buffer against unexpected losses (see Laeven and Majinoni (2003)).
[24] The Commission adopted on 22 November 2016 a Commission Regulation (OJ L 323, 29.11.2016, p. 1, available at http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2067&from=EN) requiring the use of IFRS 9 "Financial instruments" for financial years starting on or after 1 January 2018.

financial instruments other than those measured at fair value through profit or loss. Specifically, the IFRS 9 requires banks to recognise ECLs before having objective evidence of impairment, that is, even if no past "triggering" events (e.g., loss of employment of the borrower, decrease in collateral values, or past-due status) have occurred. Banks will then update the ECLs recognised at each reporting date to reflect changes in credit risk as estimated using a large set of historical, current, and forecast information, including forward-looking macroeconomic variables. The inclusion of these variables into the assessment procedure is expected to favour earlier and possibly higher provisions.

The IFRS 9 ECL approach is based on three stages.

"Stage 1" refers to performing financial instruments for which the credit risk has not significantly increased since initial recognition. For stage 1 the reporting entity has to determine the expected credit losses from default events over the next twelve months. The amount of expected credit losses is the discounted difference between contractual cash flows and the cash flows the entity actually expects including contractual options and cash flows from the sale of collateral.

"Stage 2" refers to non-impaired (performing) financial assets whose credit risk has significantly increased since initial recognition. There is a rebuttable assumption that this is the case when the loan becomes more than 30 days past due. For stage 2 the reporting entity has to estimate the probably of default over the remaining maturity of the financial instrument and calculate the corresponding expected credit loss.

"Stage 3" refers to financial assets that are credit impaired, i.e. for which an objective impairment event has occurred and hence the probability of default is "1". Stage 3 is referred to as life time expected losses and is broadly speaking the same as what is done under the impairment approach of current IAS 39.

Finally, IFRS 9 requires the reporting entity to write-off a loan when there is no reasonable expectation to recover the loan. A write-off is a "de-recognition" event which implies that the loan will no longer be on the balance sheet of the bank and hence not count towards its stock of NPLs.

To summarise, compared to IAS 39 the new IFRS 9 expected credit loss approach will lead to earlier and fuller recognition of credit losses when loans are still *performing* (Stage 1 and 2). The new rules require banks to build provisions in a timely way only at impairment of the loan. This has the effect of mitigating the risk of cliff effects when many loans become non-performing at the same time (for example during an economic downturn). Regarding loans which are *non-performing* (Stage 3), the new standard will largely keep the same treatment as IAS 39 and, by itself, cannot be expected to ensure that banks will ultimately create sufficient LLPs for NPEs. Also, IFRS 9 sets more general principles and approaches for determining credit loss provisions as opposed to detailed rules. Despite the available guidance on its application, there is discretion within the new standard which in practice might lead to lower levels of LLPs, in particular when valuing collateral or third party guarantees for secured loans.

At the same time not all banks apply IFRS: in several EU MSs and in many third countries national Generally Accepted Accounting Principles (GAAPs) apply which might follow a different provisioning approach than IFRS.

Furthermore, some jurisdictions have adopted specific provisioning rules for banks' NPLs, while a few others have adopted provisioning guidelines specifying the implementation of IFRS (see section 3 and Annex 4).

*Prudential treatment: Pillar 1 and Pillar 2*

Current prudential regulation under so-called "Pillar 1" deals differently with provisions depending on whether banks determine their regulatory minimal capital requirements using the Standardised Approach (SA) or the Internal Ratings-Based (IRB) approach. Only under the IRB approach current regulatory provisions are already determined following an ECL approach, although with differences to IFRS 9.[25] For IRB banks, when there is a "provisioning shortfall", i.e., when regulatory expected losses (EL) exceed accounting provisions, said shortfall is deducted from Common Equity Tier 1 (CET1) capital. As regards credit exposures that are in default (such as NPLs), banks must use their best estimate of expected losses ($EL_{BE}$) based on the principle that banks would have to recognize additional unexpected losses during the recovery period. It is currently widespread practice to use accounting provisions as $EL_{BE}$ estimates and the treatment of NPLs has been found very heterogeneous among banks.[26]

There is no common minimum treatment with regards to incurred and expected losses on NPLs, neither at EU nor at global level. In this respect, several countries have introduced mandatory (prudential) provisioning/writing-off regimes (or have intensified existing regimes), post-crisis. For instance, banks in the United States, Japan or Brazil are required to fully provision and write off NPLs after a set period (see section 3. and Annex 4).

Under so-called "Pillar 2" competent authorities (CAs) in charge of supervising institutions in the EU have the power to influence their provisioning policy and to require specific adjustments to the own funds calculations on a case-by-case basis.[27] Accounting powers do however not fall into the remit of CAs which is why it is not possible for a CA to impose a specific provision to be registered in a bank's financial accounts – supervisory powers rather act as a "prudential overlay" which affects solely a bank's prudential figures, i.e. by decreasing its regulatory own funds with the adjustments being reflected in supervisory reporting and own funds disclosure. Pillar 2 measures can only be applied on discretion of the CA and on a case-by-case basis, following an assessment that the provisioning policy chosen by the institution is not adequate or sufficiently prudent from a supervisory point of view. Under the current rules, no harmonised (minimum) treatment can be imposed by CAs.

[25] The horizon over which ECLs are estimated is always one year and the inputs of the estimation are through-the-cycle (rather than point-in-time) probabilities of default and stressed (rather than unbiased) loss given default.

[26] Cf. EBA (2017a, b); the EBA also found that the proportion of defaulted exposures is one of the main drivers of the variability of risk-weights within each bank's portfolio.

[27] To eliminate any doubts about the scope of this power, the Commission clarified in the SSM review report, that the existing EU legislation, in particular Article 16(2)(d) SSM Regulation (SSMR) and Article 104(1)(d) CRDIV, allows supervisors to require more provisioning within the limits of the applicable accounting standards on a case-by-case basis. In case the accounting framework leaves room for institutions' discretion, and banking supervisors consider the way an institution used this discretion as not adequate or insufficiently prudent, they are entitled to impose higher provisioning, deductions or filters.

## 2. PROBLEM DEFINITION

### 2.1. What is/are the problems?

#### 2.1.1. Build-up of under-provisioned NPLs

**Prudent provisioning of NPLs is essential to ensure banks' financial soundness and by consequence their ability to lend to the economy**. Provisioning is a key risk management tool to address incurred and expected losses on credit exposures without reducing capital when those losses materialise thereby preserving banks' capacity to continue lending to the economy (see above Background Information). A prudent provisioning policy is thus key determinant for banks' financial soundness, in particular in a recession when many loans become non-performing.[28]

**Prudent provisioning of NPLs has proved to be crucial to effectively resolving bad loans in the European and international experience**.[29] Restructuring, selling or dismissing non-performing assets and non-recoverable collateral requires less, if any, additional capital, if sufficiently high provisions for credit losses on NPLs have been made, and therefore becomes potentially easier. Recent analysis confirms that increases in coverage ratios at bank level are usually followed by a higher reduction in NPLs in the following quarters (as illustrated in Figure 5).[30] Insufficiently provisioned NPLs, on the contrary, are more likely to remain on banks' balance sheets in an attempt by banks to avoid or delay loss recognition ("wait-and-see" approach, see below 2.2.). Delays in loss recognition may cast doubt over banks' future profitability, solvency and long-term viability, as delays force banks to increase provisions during economic downturns, when cumulative losses materialise and capital requirements become most binding.[31] In addition, heightened risk perceptions on the part of investors and depositors usually translate into higher funding costs.[32] In sum, under-provisioning and loss forbearance as regards NPLs may ultimately result in higher lending rates, reduced lending volumes, and increased risk aversion (see consequences in 2.2.).

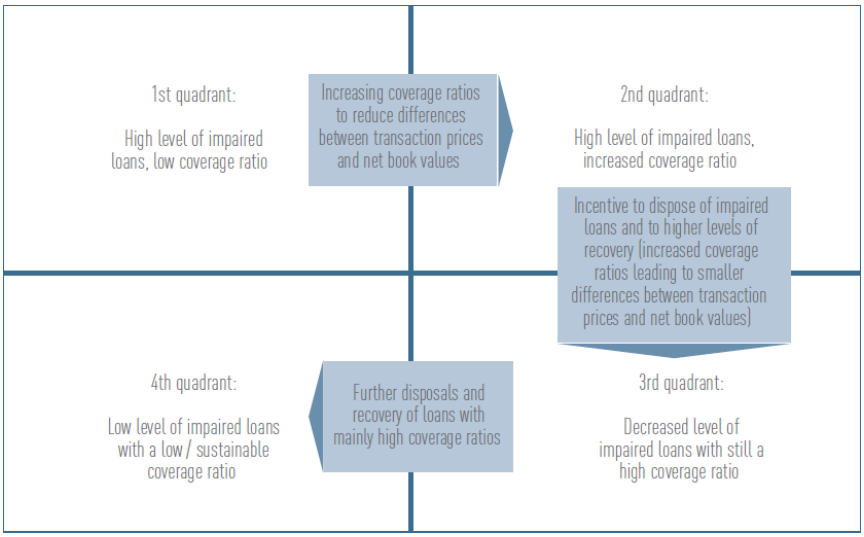



Figure 5: Quadrant model showing a potential relationship between NPL and coverage ratio trends

Source: EBA, Risk Assessment Report of the European Banking System (December 2016)

Notes: Starting off with a high stock of impaired assets and a low coverage ratio (quadrant 1), banks may increase their coverage ratio to reflect the worsening condition of the NPL. As the gap between transaction prices offered by potential buyers ("bid") and net book values ("ask" being the result of the gross carrying amount minus LLPs) at which NPLs are recognised in banks' balance reduces, banks are better able to dispose of NPLs (quadrant 2). After having decreased the level of

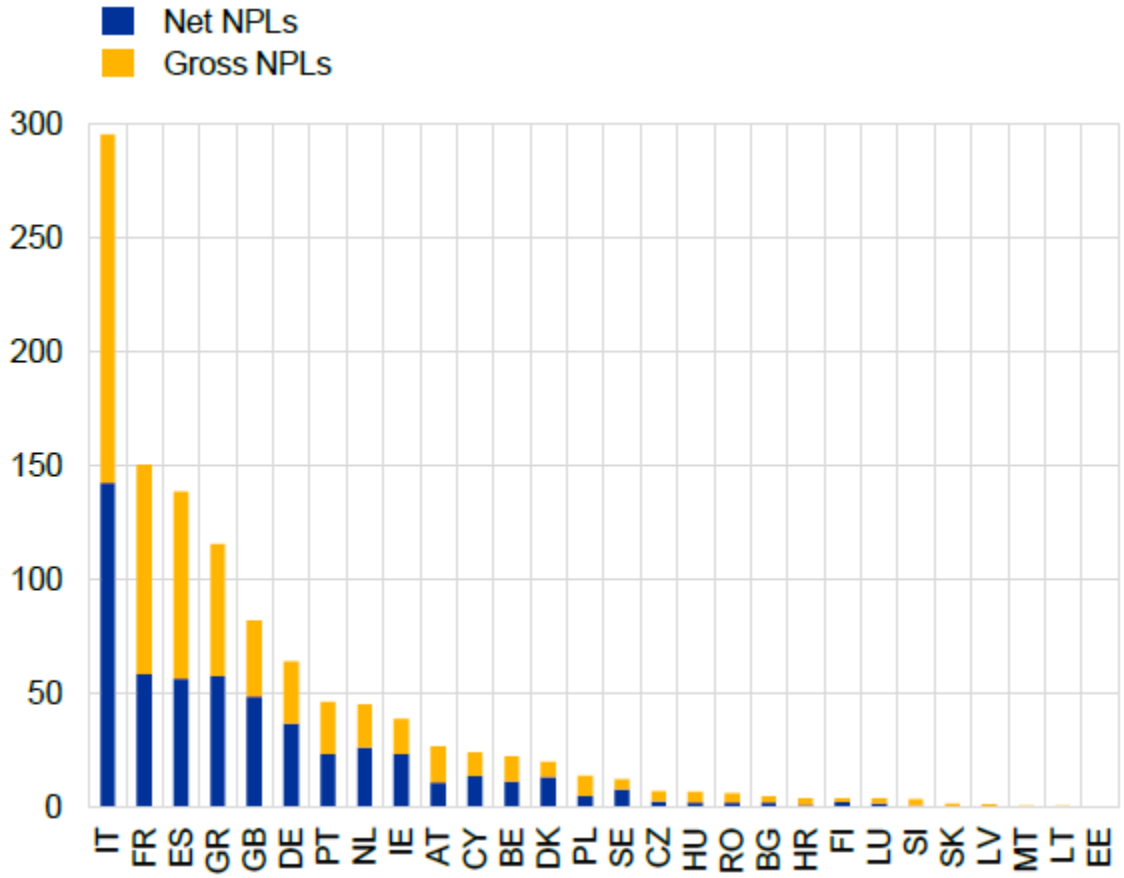
[28] Once the loan is repaid in full and does not default, the LLP is dissolved and the bank reports a correspondingly higher income.
[29] See cet. par. FSI (2017a) or IMF (2015c).
[30] For example, this was noticed in banks in Croatia, Romania and Slovenia; a similar pattern may unfold for Cyprus in the following quarters (EBA [2017c]).
[31] This suggests that delays in expected loss recognition increase the pro-cyclicality of bank lending (BCBS [2015]).
[32] Cf. ESRB (2017), op. cit. and IMF (2015a), op. cit.

impaired loans, thereby freed-up capital and human resources can be used to further reduce the stock of NPLs, in particular "aged" ones with high coverage ratios (moving from quadrant 3 to quadrant 4).

### 2.1.2. "Pockets of risks" in EU banking sector and potential spill-over effects

**The gross carrying amount[33] of NPLs in the EU banking system at the end of 2016 amounted to just below EUR 1 trillion, with remarkable discrepancies across banks and MSs**. The NPL ratio is highly dispersed across EU countries ranging from 1 % to 46%. NPLs are concentrated in a few MSs: almost 90% of the overall amount of NPLs in the EU is located in 10 MSs (see Figure 6). At the same time, in over one-third of EU countries the ratio exceeds 10% (in order of descending NPL ratio: Greece, Cyprus, Portugal, Italy, Slovenia, Ireland, Bulgaria, Hungary, Romania and Croatia).

Figure 6: Gross and net NPLs (EUR bn)



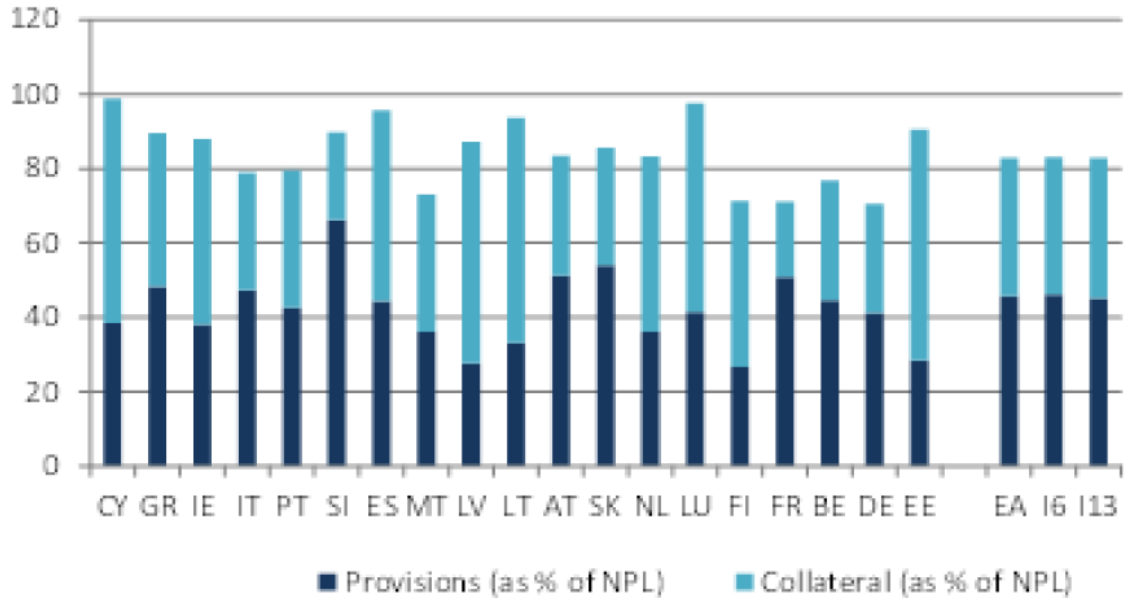

Source: ESRB Secretariat calculations based on ECB Consolidated Banking Data
Notes: Reference date for gross and net NPLs columns is Q4 2016. Data includes domestic banks, stand-alone banks, except Slovenia (Q1 2016) and foreign controlled subsidiaries and branches.

**NPL coverage ratios[34] (CovR) in the EU also differ across banks and MSs both in terms of level and evolution and according to the size of banks**.[35] Differences depend on a number of

[33] The gross carrying amount of NPLs corresponds to the total amount owed by the borrower which has not been written off. The book value of NPLs, or the net carrying amount, is calculated by adjusting the gross carrying amount by: i) accumulated impairments, for loans measured at amortised costs; or ii) accumulated changes in fair .value due to credit risk, for loans measured at fair value. The net NPL amount excludes losses already recognised by the bank (e.g. through LLPs) and, therefore, represents the potential additional loss for the bank. At the same time, it is important to note that impairment (or provisioning) is not always estimated in accordance with the same accounting standards.
[34] LLPs for loans and advances to customers as a percentage of NPLs and advances to customers.

factors which are difficult to disentangle (see also below 2.2.3.). One of these factors is the collateralization of NPLs which may play a relevant role in explaining provisioning policies across banks. In principle NPLs secured by collateral are perceived to be less risky. For this reason, banks normally provision less compared to provisioning non-collateralized loans. The quality and the amount of collateral affect loan recovery rates and, therefore, the "expected loss" on a NPL. Consequently, collateralized loans have on average lower NPL coverage ratios. Within the EA, 36% of the gross carrying amount of NPLs are covered by collateral ("secured NPLs") while 46% are covered by provisions (see Figure 7).

Figure 7: Provisioning and collateral (% of NPLs)

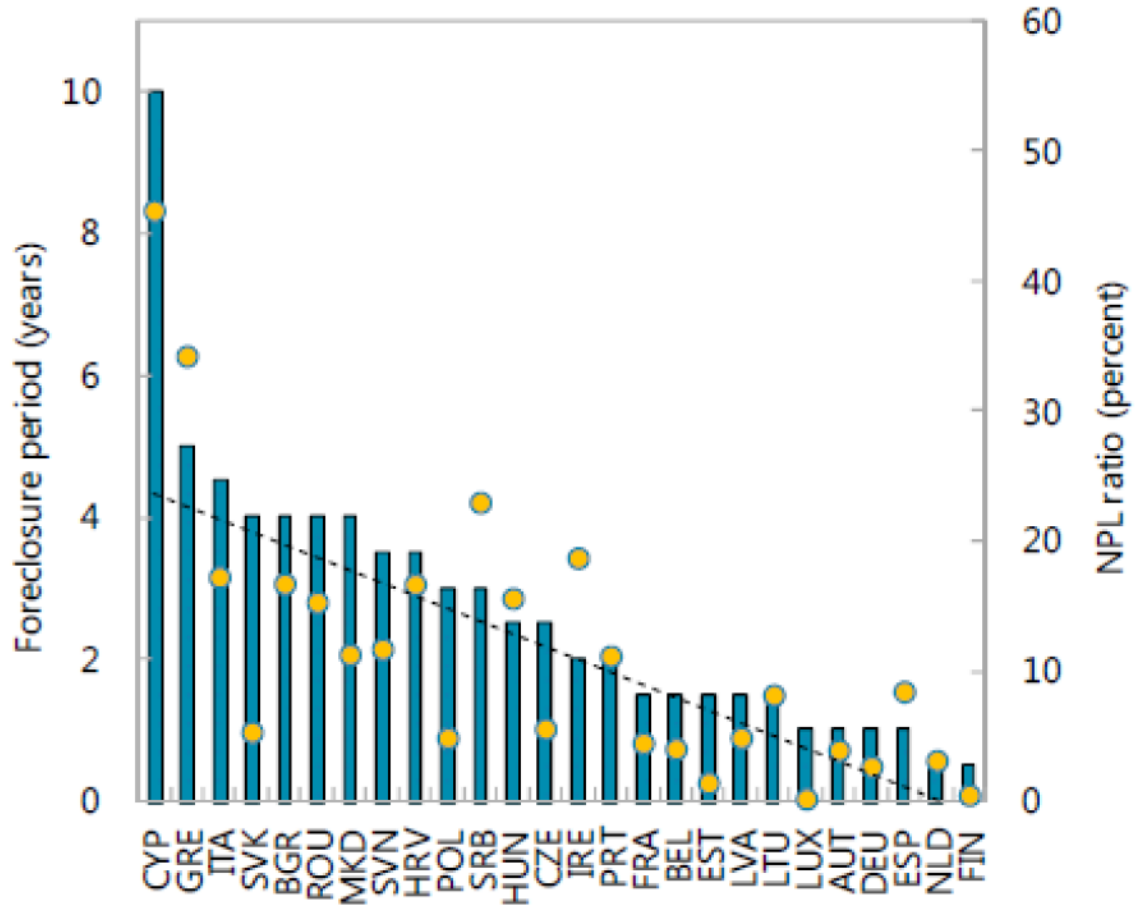



Source: Constancio, Resolving Europe's NPL burden (2017) based on ECB Supervisory Statistics
Note: Countries ordered by NPL ratio; I6 refers to high-NPL MSs: CY, GR, IE, IT, PT and SI; I13 are other EA MSs)

Taking at face value, these figures would suggest that 20% of NPLs stock in the EA represents a true risk on banks' balance sheets, being the residual covered through either collateral or provisions.[36] However, effective loss coverage provided by existing collateral depends, inter alia, on the characteristics of the underlying asset market as well as on the actual accessibility to that collateral.[37] For example, collateral provides for effective protection against losses on NPLs only as long as its present value is not eroded by lengthy and costly enforcement procedures (see Figure 8).[38]

[35] Dispersion of the provision coverage ratio across MSs and banks is significant, with the EU average slightly at 45% and values in the range of 26% to 68% (cf. *EBA*, Risk Assessment Report of the European Banking System [November 2017]).
[36] Carletti and Brunella (2017), "Provisioning policies for non-performing loans: How to best ensure a clean balance sheet?" European Parliament Economic Governance Support Unit.
[37] Ibidem.
[38] Cf. Constancio (2017) "Resolving Europe's NPL burden". For example, the average length of foreclosure proceedings in Italy is almost five years compared to less than one year in Germany and Spain.

Figure 8: Average time to foreclosure (years) and NPL ratios (%)



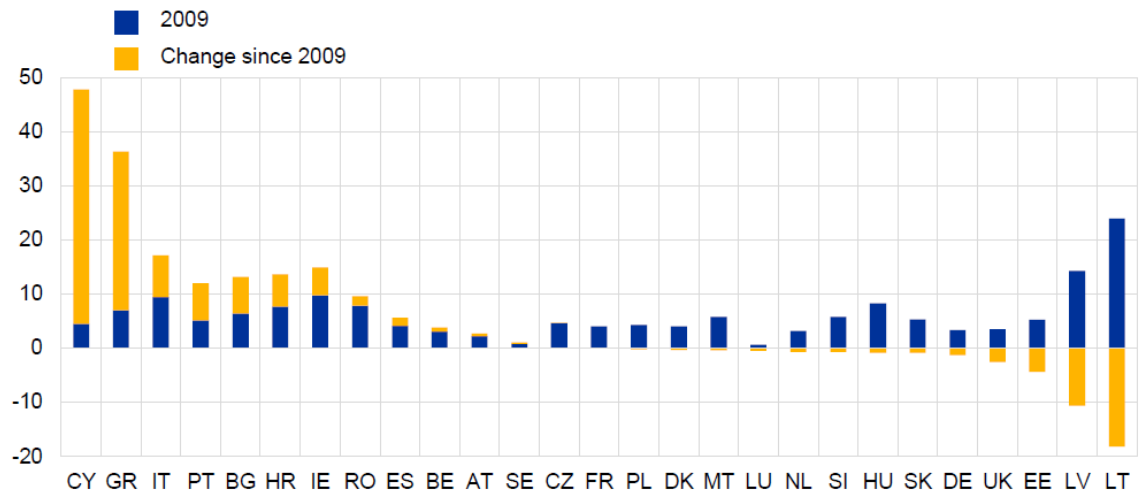

Source: IMF, Country Report 15/205

**The uncertainty about the valuation of NPLs, in particular secured ones, translates into a wide gap in price expectations of investors and banks** (i.e. differences between transaction prices offered by potential buyers ["bid"] and net book values ["ask"] at which NPLs are recognised in banks' balance – so-called "bid-ask spread" or "pricing gap"). The data on the size of that gap is scant but it is thought to be very large. For instance, estimates suggest that, for a fully collateralised NPL, the discount required by a private investor may exceed 40% mainly due to the cost, time and uncertainty of the recoveries.[39] It follows that provisioning levels might not yet truly reflect the actual risk of losses on NPLs.

**The pace of reduction in NPLs in the EU has been slow.** As shown in Figure 5 NPL ratios are now higher than in 2009, and in most cases, they have not returned to pre-crisis levels. A large majority of EU MSs reports NPL ratios to be above those of the United States or Japan.[40] The *ESRB* noted that in spite of the recent improvement in macroeconomic conditions and the subsequent decrease in flows of new NPLs have helped some countries to start to reduce their NPL stock from the peak levels seen in 2012/13, EU banks have generally not shown satisfactory progress in resolving their stocks of NPLs, which have been piling up on their balance sheets for a number of years.[41]

[39] Ibidem.
[40] For both the United States and Japan, the NPL ratio was around 1.5 % in December 2016, according to IMF and World Bank data (see e.g. http://data. worldbank.org/indicator/FB.AST.NPER.ZS?locations=US).
[41] Cf. ESRB (2017) op. cit. and IMF (2015a) op. cit.

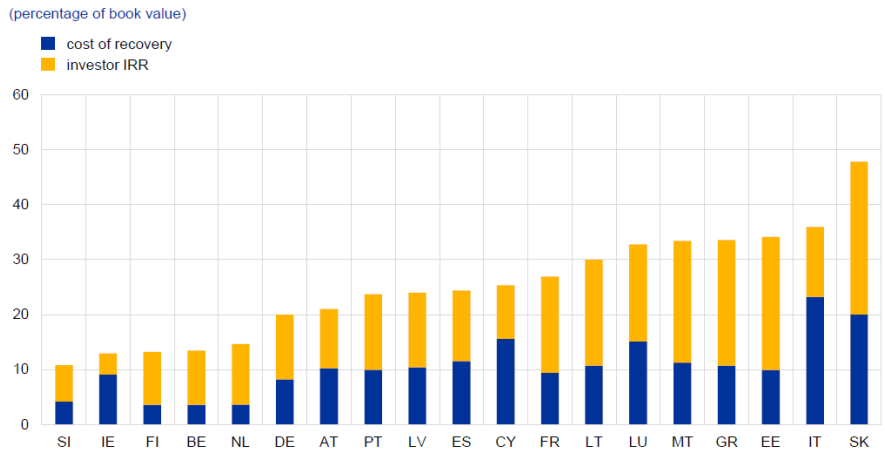
Figure 9: NPL ratio and changes since 2009 (% of gross loans)




Source: IMF Financial Soundness Indicators and ESRB Secretariat calculations
Notes: Data refers to Q4-2016, except for Cyprus, Portugal, Ireland, Belgium, Denmark, Germany, United Kingdom and Lithuania (all Q4-2015), and Luxembourg (Q4-2014). Data for Denmark starts in 2010. No data is available for Finland. Countries are ordered according to the change in the NPL rate since 2009

**Although average provisioning levels have recently increased in certain MSs facing high NPL stocks, loss recognition is often still too slow and insufficient to allow for effectively resolving NPLs and preventing the accumulation of future NPL-stocks**. Additional efforts are necessary; especially in some MSs and for some banks, provisioning levels may need to be increased further, reducing, inter alia, the large bid-ask spreads[42] (see Figure 10) and allowing banks to dispose of NPLs more easily at an earlier stage and to higher levels of recovery.

Figure 10: Difference between the net book value and the estimated bid price of a sample of collateralised NPLs




Sources: ECB calculations based on the World Bank's *Doing Business 2017* and ECB data.
Notes: The market price for secured NPEs reflects the expected time to recover the residual value of distressed assets (being lower where foreclosure times are longer and debt enforcement regimes weaker) and the expected return on investment consistent with general profit expectations in distressed debt markets. The blue segments of the bars represent the reported average cost of enforcing claims through individual legal systems, whereas the yellow segments represent the additional discount that results from using an internal rate of return (IRR) of 15%, assumed to represent the premium required by investors for the risk of acquiring NPLs. The cost of debt recovery includes court fees and government levies; fees of insolvency administrators, auctioneers, assessors and lawyers; and all other fees and costs. It does not include

[42] The Commission's initiative on Secondary Markets for NPLs identifies the associated problems and proposes solutions which would be complemented and reinforced by the initiative statutory prudential backstops (see section 6.5.).

operational expenses incurred by the creditor, such as wages and salaries of involved staff members, or the cost of IT infrastructure used to manage NPLs. Inclusion of these costs would reduce net present values even further.

**The accumulation of NPLs without sufficient loan loss coverage in parts of the EU banking sector creates "pockets of risk"**. The EU banking system is fairly integrated, even more in the EA: the percentage of banking institutions controlled by a parent institution outside a MS continuously increased and recently reached 22%. Cross-border banking loans also grew consistently and reached 8.5% of total loans outstanding in the EA.[43] While there are strong benefits from financial integration in terms of risk diversification, disruptions of the financial system in one MS may also affect the financial system in other MSs.

**Spillovers from weaker banks and weaker countries are possible, posing a threat to financial stability and economic growth of the Union, particularly in the BU**.[44] The spillover effects may arise both within the banking sector and between the banking and non-banking sectors.[45] Banking spillovers relate to banks' cross-border lending activities and cross-border ownership links.[46] Moreover, financial interconnections and interdependencies between banks across the BU and existing crisis management mechanisms lead to a more integrated perception of the EA banking sector by market participants (such as international investors), and occasionally, international institutions.[47]

Because national economies are also highly interconnected in the EA, negative effects on the growth perspectives in individual MSs can potentially spill-over to other Member States. These indirect channels relate to the overall deterioration of the macroeconomic environment in high-NPL countries, which affects other countries through lower import demand (trade channel) and a loss of value of equity and debt claims on residents of the affected countries (financial channel).[48]

## 2.2. Consequences of insufficient loan loss coverage

### 2.2.1. Negative impacts on EU banks' financial soundness and financial stability

Excessively discretional ("too little and too late") recognition of losses on NPLs has several negative effects in terms of banks' financial soundness and financial stability.

**If NPLs are not recognised early and provisioned adequately, banks' true loss absorbing capacity may be called into question**, especially during a crisis. As discussed above (see section 2.1.1.), delayed recognition of expected losses or incorrect estimates have an immediate effect on banks' earnings (current expenses are lower than they should be) and significant implications for their soundness.[49] Outright losses can arise that weaken banks' capital base, potentially bringing capital levels below or close to the minima required – giving rise to insolvency or illiquidity. At that point, banks might have to recapitalise when financing conditions are cumbersome, especially when they and the wider system are in crisis. However, crises are the worst possible moment for a bank to raise capital, as investors may be wary of subscribing new shares when profits are falling and general economic conditions may be poor. Overall financial stability would be at risk if such problems were to arise in a substantial part of the banking system.

[43] See ECB consolidated banking data, available at https://www.ecb.europa.eu/stats/supervisory_prudential_statistics/consolidated_banking_data/html/index.en.html.
[44] EP (2016); IMF (2015b). In the same vein the Council concluded that "the negative effects of current high NPL ratios in a substantial number of MSs can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole, especially within the Banking Union" (Council conclusions on Action Plan to Tackle Non-performing Loans in Europe, 11 July 2017).
[45] Cf. ESRB (2017) op. cit.
[46] Ibidem.
[47] Cf. FSC (2017) "Report of the FSC Subgroup on Non-Performing Loans".
[48] Cf. ESRB (2017) op. cit.
[49] Carletti and Brunella (2017), op. cit.

**Moreover, delaying loss recognition damages transparency and increases investors' uncertainty about banks' fundamentals**, which may impair market confidence in the sector more generally. Heightened risk perceptions on the part of investors and depositors usually translate into increased risk aversion and higher funding costs (see section 2.2.2.) with potentially negative effects on the provision of credit to the real economy.[50]

For all these reasons, an early and transparent recognition of NPLs and adequate provisioning are crucial to ensure banks have clear and sound balance sheets.[51]

### 2.2.2. Impaired credit provision with negative impacts on real economy financing and growth

As already mentioned in section 2.2.1., **insufficiently provisioned NPLs may result in reduced bank lending to the real economy thereby potentially dragging on economic growth**.

There are two main channels through which NPLs could slow down economic recovery. First, banks with under-provisioned NPLs might be impeded to extend fresh credit (credit supply channels) Second, borrowers face reduced incentives to invest. Assets remain under their control rather than being reallocated to more productive uses (non-credit supply channels).

*Credit supply channels*

**Credit growth remains subdued in most of the MSs with currently high levels of NPLs** (so-called Category 3 MSs)[52] (see Figure 11). While subdued credit dynamics reflect low credit demand in a generally soft economy, the weakening of credit supply by high levels of NPLs play a significant role too. Weak credit demand and weak credit supply are closely intertwined: a credit crunch is bound to weaken macroeconomic performance and this will in turn weaken credit demand. Banks' reduced lending capacity tends to disproportionately affect firms that are most dependent on bank finance[53] such as SMEs.[54]

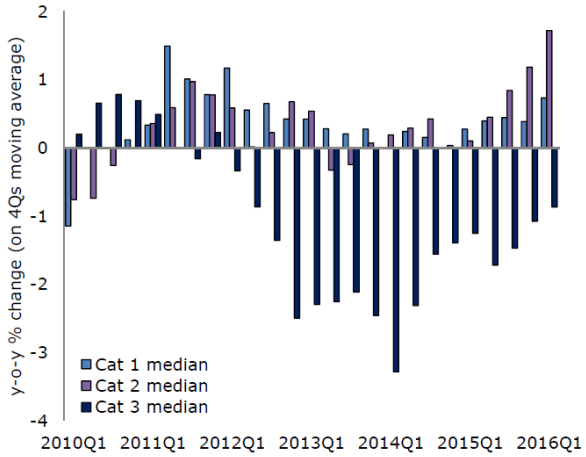



Figure 11: MFI lending to non-financial corporations, EU

(2010Q1-2016Q1)
Source: ECB, DG ECFIN calculations

Several mechanisms are identifiable through which under-provisioned NPLs affect credit supply.

**Funding costs increase when NPL levels rise, because high NPL levels raise doubts about the true capitalization of a bank**. In particular, this effect is likely when provisioning is not considered sufficient to cover loan losses. The increased uncertainty will be reflected in a higher risk premium on banks' funding and reduced access to financing (such as notably wholesale

[50] Cf. ESRB (2017) op. cit. and IMF (2015a) op. cit.
[51] Carletti and Brunella (2017), op. cit.
[52] Bulgaria, Cyprus, Greece, Croatia, Ireland, Italy, Malta, Portugal, Romania, Slovenia.
[53] IMF (2015a) op. cit.
[54] Klein (2013) op. cit. shows that tight financial conditions for SMEs in Europe have been a drag on the pace of economic recovery.

funding).[55] To the extent that it is passed through to banks' lending rates, credit supply declines. Higher funding costs and reduced credit supply again translate into less profitability.

**Overvalued NPLs imply underestimation of risks and potentially worsened allocation of credit**, as non-viable businesses are kept artificially alive or restructuring is unduly delayed (so-called "extend and pretend" practices, see section 2.3.1.). In addition, banks might also try to price-in some of their loan losses through raising interest margins for performing borrowers. In either case, lending rates will be higher and credit supply lower. Together, this impedes the efficiency of the banking system.

Past experience suggests that ignoring banking problems and delaying losses in the interests of sustaining credit will, on average, lead to a more severe contraction of credit at a later stage.[56]

*Non-credit supply channels*

**NPLs without sufficient loss coverage can also weigh on economic developments through channels other than credit supply.** Loss forbearance, for instance, enables "extend and pretend" practices which may ultimately result in debt overhangs. Overextended borrowers invest too little and supply too little labour, even in the absence of financing bottlenecks. Unless repayment difficulties are temporary or purely strategic, all the distortions identified by the extensive literature on debt overhang arise: overextended companies have little incentive to invest because any return is effectively shared with the banks holding the NPLs; overextended owners will show little enthusiasm in maintaining or improving the houses or apartments that they might lose in any event; and overextended households are unlikely to work harder and longer if the additional income remains insufficient to escape the debt trap.[57] All this reduces economic activity to inefficiently low levels. Debt restructuring and partial debt forgiveness that reduce the debt burden can unlock efficiency gains with scope for debtors and creditors to both benefit; sufficient loan loss coverage is key for these relief measures, as it makes any resulting loss more bearable for the restructuring/forgiving banks.

**Failure to resolve** N**PLs timely also tends to trap resources in unproductive uses.** Loans might have become non-performing because too much credit has gone into particular sectors, to underperforming entrepreneurs, or to poorly selected projects. In this case, the efficient way forward may involve recovering remaining resources from these failed investments quickly with a view to redeploying them in more promising areas. A prolonged hold out for a recovery of existing projects, or of the value of the collateral backing them, might be inefficient and hold back economic recovery more broadly.

## 2.3. What are the problem drivers?

### 2.3.1. Incentives to delay loss recognition and reduce provisioning levels ("wait and see" and "extend and pretend")

LLPs reflect incurred and/or expected losses on future loan defaults and are reported in the bank's annual income statement. On the balance sheet, LLPs cause a decline of the carrying value of the loans and a corresponding decline of the bank's equity (see section 2.1.1.).

In particular when their regulatory capital levels are already low, **banks may attempt to delay loss recognition** and reduce provisioning levels, in order to avoid a breach of capital requirements. Another incentive may be maintaining (or even increasing) the level of earnings to

[55] Cf. Diwan and Rodrik (1992).
[56] Ibidem.
[57] Cf. Vienna Initiative (2012) op. cit.

signal financial strength. In this context and more in particular the literature review by Ozili and Outa[58] identified the following two main motives for the under-provisioning of loan losses:

- A **capital management** motive: Banks may time LLPs to ensure that they meet the regulatory minimum capital requirements. This implies that the incentives to reduce provisioning levels are high when regulatory capital levels are already low.[59] Capital management of this kind could reduce the co-movement between reported provisioning levels and the growth rate of GDP, as bank capitalization rates are more likely to be stressed during economic downturns.[60]

- A **signalling** motive: Banks may set the level of LLPs to signal some information about the quality of their loan portfolio, in particular as regards NPLs, and/or to signal information about its future earnings prospect.[61] Banks may, in some cases, prioritise distributions to shareholders over increases in the coverage of NPLs through provisioning.

Particularly when the economic outlook is positive, **banks may also have incentives to delay loss recognition and hold onto their NPLs in the hope that the assets would recover naturally ("wait and see")**. They may in some instances be overly optimistic regarding NPL recognition and their provisioning levels, depending on their assessment of the final expected recovery value (including the underlying collateral) or the sustainability of forborne loans and the assessment of loan management costs for the bank.[62]

Finally, **banks may have an incentive to refinance or "forebear" NPLs in order to avoid or delay loss recognition on these loans, or in the context of a close relationship with the client (also known as "extend and pretend")**. This means that credit is allocated to barely surviving firms ("zombie companies") at the expense of firms that have a viable future. In this vein, IMF staff[63] assesses the impact of NPL sales on the amount of capital that would be freed for a representative sample of European banks. Micro-level analysis on corporate-bank relations suggest that corporate investment is reduced both by self-restriction by corporates in debt overhang and by a change in behaviour of banks with weak balance sheets.[64]

### 2.3.2. Excessive discretion in NPL recognition and provisioning policies across the Union

**LLPs recognised by banks for NPLs in accordance with the applicable accounting framework might not always be adequate from a prudential perspective, which has a different scope, objective and purpose**. For instance the IFRS apply to undertakings from various industries and are based on the principles of neutrality and faithful representation of the underlying economic transactions at the reporting date (point-in-time). On the other hand, the CRD/R only applies to credit institutions and investment firms and is based on a risk-based approach, ultimately aiming at the stability of individual institutions through the economic cycle and of the financial system as a whole.

[58] Ozili and Outa (2017) "Bank loan loss provisions research: a review", Borsa Istanbul Review vol. 17, 144-163.
[59] Bank managers' awareness of the consequences associated with violating minimum capital requirements is argued to create strong incentives to use their discretion to lower LLPs estimates to increase the bank's regulatory capital ratio above the minimum limit.
[60] Evidence in favour of this hypothesis is provided by Ahmed et al. (1999) for the case of US banks during 1986-1995. Consistent with a capital management motive, Huizinga and Laeven (2012) find that during the crisis in 2008 US banks with large exposures to mortgage backed securities that had declined in value displayed relatively low LLPs.
[61] For instance, Kanagaretnam, Lobo, and Mathieu (2003) find that managers of undervalued banks use LLPs to increase the level of earnings to signal banks' future earnings prospects.
[62] Cf. FSC, (2017) op cit.
[63] Cf. IMF (2015a) op. cit.
[64] FSC (2017) op. cit, with reference to Kalemli-Ozcan et al. (2015).

**IFRS 9 is expected to bring much closer alignment with the prudential standards than IAS 39, and to contribute to address the issue of delayed and inadequate provisions**, as it operates on an "expected loss" approach (see Background Information).[65] The new standard leaves, however, room for discretion in determining the expected credit losses on performing and non-performing loans including the underlying valuation of collaterals[66] and, by consequence, in the determination of provisions.[67] IFRS 9 sets more general principles and approaches for determining LLPs opposed to detailed rules. However, the management discretion is not absolute but framed by requirements within the standard, supervisory guidance, supervision and statutory audit.[68]

**Despite this framing there is nevertheless discretion within IFRS 9 which in practice could lead to lower levels of credit loss provisions, in particular when valuing collateral or third party guarantees for secured loans.** Therefore, IFRS 9 cannot fully ensure that banks will ultimately create sufficient levels of credit loss provisions for non-performing loans.

**At the same time, it is important to recall that LLPs are not always estimated in accordance with the same accounting standards**: in several EU countries some banks have to apply national GAAPs (instead of IFRS) which might follow a different approach.

### 2.3.3. Other drivers for insufficient loan provisioning (*out of scope*)

As also pointed out by stakeholders in the context of the targeted consultation, a number of further factors, which are not addressed here, may influence banks' provisioning policies.

Large discrepancies exist, for instance, in the **characteristics of national legal and judicial frameworks as regards collateral enforcement**. Differences may emerge within countries, too: while civil law and procedures are formally the same across the national territory, the effectiveness of the court system may vary widely, depending upon local jurisdictional court proceedings.[69] The Commission's initiative on AECE identifies the associated problems and proposes solutions.

**National tax regimes** can also play a decisive role for provisioning policies. In some countries, charge offs and/or losses as a result of higher provisions are not eligible (or are subject to a certain cap) as deductions for income tax purposes.[70]

[65] IFRS 9 requires banks to make provisions against performing (and not impaired) assets from the date of origination leading to higher amounts of provisions.
[66] The lack of standardised valuation approaches was found being detrimental for the quality of impairment calculations (cf. FSC 2017 op. cit.).
[67] Cf. IMF (2015a) op. cit. and IMF (2014) "Supervisory Roles in Countries implementing IFRS".
[68] For example, for determining expected credit losses IFRS 9 uses as a rebuttable assumption that loans are non-performing when they are more than 90 days past due, and that changes in the value of collateral have to be considered for determining an increase in credit risk. The EBA has issued guidelines[68] on accounting for expected credit losses under IFRS 9 which further frame the discretion for banks when determining credit loss provisions so as to ensure timely, adequate and comparable credit loss provisioning (see EBA (2017) "Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses").
[69] Cf. Carletti and Brunella (2017), op. cit. and references therein.
[70] Ibidem: "For example, until recently the tax treatment in Italy penalized banks that wrote off problem loans more aggressively, allowing tax deductibility for write-offs only in the state of insolvency. Tax deductibility of LLPs was limited to 0.3% of outstanding loans, a clear disincentive to provisioning (IMF (2015a) op cit.). A 2013 reform allowed provisions and write-offs to be fully deducted in equal instalments over five years, and with a higher tax rate; In June 2015, this period was further shortened to a year. To take another example, Spain recently eliminated taxes on debt-to-equity swaps in a similar move to encourage banks to recognize losses from impaired assets".

## 2.4. How will the problem evolve?

Without policy intervention, banks will still have incentives and ample discretion to excessively delay loss recognition and reduce provisioning levels.

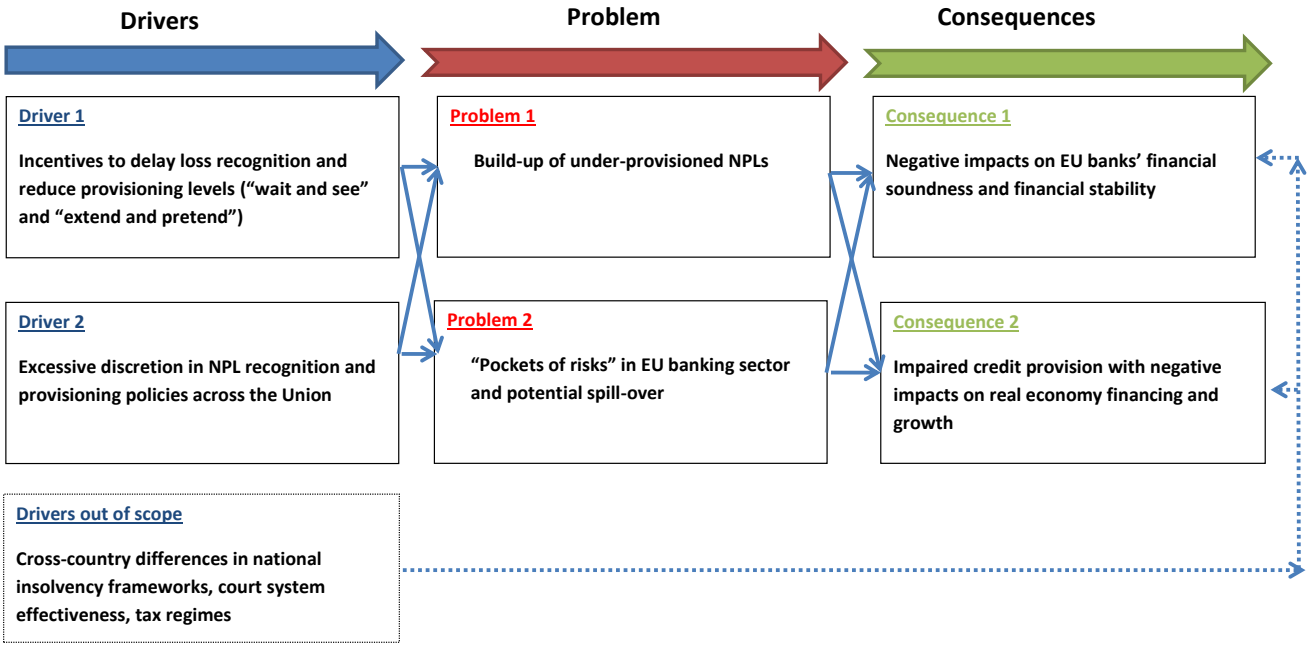
**Historical evidence corroborates the argument that a "wait-and-see" approach is detrimental in the longer run**.[71] Experience suggests that ignoring banking problems in the interests of sustaining credit in the short run will, on average, lead to a more severe contraction of credit at a later stage. Whilst recovery in the real economy has already been followed by a reduction in NPL levels and ratios, the reduction of the stock of NPLs has been rather slow and the recovery, particularly in some of the high-NPL countries, remains fragile. As the linkages between growth and NPLs work in both directions, it is unclear whether growth would be able to overcome the adverse effects on the real economy caused by the large stock of NPLs.[72] In the absence of action to address the problem of the high stock of existing NPLs together with prudential rules for the flow of new NPLs risks to financial stability may materialise. While the treatment of the existing stock and the new flow requires a different set of actions, the problem for financial stability and growth would evolve as accumulated effect of old and new NPL. Finally, through important cross-over spill-overs in a deeply integrated area like the EU and especially the EA the future NPL problems in one part of the banking sector can have negative impact on other parts of the system.

The implementation of IFRS 9 is expected to lead to higher provisioning levels, but given, inter alia, its principle-based approach, it might not suffice to effectively prevent the build-up of insufficiently covered NPL stocks on EU banks' balance sheets. Supervisory action, in particular the application of Pillar 2 measures, will help address specific NPL-related risks of individual banks. However, it might not prevent the build-up of insufficiently covered NPLs on an EU-wide basis as long as there no harmonised (minimum) treatment (being applicable across MSs and banks).

When there is insufficient regulatory framing, banks might accordingly take a passive ("wait and see") approach. Attempting to avoid or delay loss recognition, insufficiently provisioned NPLs would likely pile up on banks' balance sheets, which in turn would undermine banks' financial soundness and pose risks to financial stability at whole. This approach would also affect future lending, which could be granted under suboptimal lending standards, if the stock of NPLs does not imply significant costs for the bank when loans are non-performing. The same cycle could thus constantly be repeated over time to the detriment of financial stability, real economy financing and growth and the public sector might be called upon to support the banks when they are in difficulties.

[71] Cf. ESRB (2017) op. cit.
[72] Cf. ESRB (2017) op. cit. and IMF (2015a) op. cit.

Figure 12: Problem tree



## 3. WHY SHOULD THE EU ACT?

### 3.1. Legal basis

Article 114 of the Treaty on the Functioning of the European Union (TFEU) confers the European Parliament and the Council the competence to adopt measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market. **Article 114 TFEU allows the EU to adopt measures (such as prudential requirements for institutions) that relate to the functioning of banking and financial services markets and are meant to ensure the financial stability of the operators on those markets as well as a high level of protection of investors and depositors.**

### 3.2. Subsidiarity: Necessity and added value of EU action

The previous section has shown that discretional ("too little and too late") recognition of losses on NPLs ultimately has several negative effects on banks' financial soundness and financial stability of the banking system as a whole.

**Some MSs have established concrete provisioning rules for banks' NPLs, while a few others have adopted provisioning guidelines** (see Table 1). In those MSs, as well as several third countries, provisioning requirements played an important role in successfully dealing with both (aged) NPL stocks and (new) NPL flows (see detailed overview in Annex 4).[73] Still, these rules are quite divergent – thereby hampering comparability of capital ratios – and do not cover the risks associated with under-provisioned NPLs comprehensively.

Also, MSs have only limited scope to introduce generally applicable and legally binding provisioning requirements. The specification of IFRS, which are global standards and applied by the vast majority of larger banks, is ultimately in the competence of the IASB. On the prudential side again, MSs are not entitled to impose prudential minimum requirements (including with regards to NPLs), such as deductions from regulatory capital, which are directly applicable to credit institutions, as this area (so-called "Pillar 1" of the framework) is subject to maximum harmonisation throughout the internal market. MSs can therefore only regulate prudential provisioning for specialised institutions which are not subject to EU regulation. The current EU prudential framework however does not provide for a common minimum treatment with regards to incurred/expected losses on NPLs.

As explained in the Background Information section, CAs in charge of supervising institutions in the EU have the power to influence a bank's provisioning policy and to require specific adjustments to the own funds calculations on a case-by-case basis (so-called "Pillar 2" of the framework). The application of Pillar 2 measures will help address specific NPL-related risks of individual banks. However, no harmonised

Table 1: Minimum provisioning requirements in EU28 (yes/no)

| MS | Minimum provisioning requirements in force? |
|---|---|
| AT | no |
| BE | no |
| BG | no |
| CY | no |
| CZ | yes |
| DE | no |
| DK | no |
| EE | no |
| EL | no |
| ES | yes |
| FI | no |
| FR | no |
| HR | yes |
| HU | yes |
| IE | no |
| IT | no |
| LT | no |
| LU | no |
| LV | yes |
| MT | no |
| NL | no |
| PL | yes |
| PT | yes |
| RO | yes |

[73] Cf. FSC (2017) op cit. ; IMF (2015a) op cit.; World Bank (2014) "Report on loan classification and provisioning" and Inter-American Development Bank (2011) "Report on provisioning requirements in Latin America".

(minimum) treatment (being applicable across MSs and banks) can be imposed by supervisors. In absence of an EU regulation, it is therefore not possible to address the issue of under-provisioning of NPEs on an EU-wide and systemic basis.

| | |
|---|---|
| SE | no |
| SI | yes |
| SK | no |
| UK | no |

**Legislative action on the EU level would require all institutions established in the EU to cater for incurred and expected losses on newly originated loans that turn non-performing at a common prudential minimum level – irrespective of the applicable accounting standards and the location of the bank and its supervisor**. Such minimum coverage requirements would act as "prudential backstops" putting automatic EU-wide brakes on the build-up of future NPLs without sufficient loan loss coverage and thus strengthen banks' financial soundness and ability to lend.

**EU wide action would also reduce potential spill-over effects within the Union**. As set out above (section 2.1.2) the high interconnectedness within the EU (and especially EA) financial system creates a significant danger of spill-overs entailing systemic risks which are better addressed at EU level.

**On this basis, the EU has a right to act to ensure the financial stability of financial market operators as well as a protecting investors and depositors in banks.**

**Due to the lack of common prudential rules on NPL provisioning actual loss coverage for NPLs may vary across banks in different jurisdictions even if they bear the same underlying risk (defined as a function of the type, location, collateralisation, age etc. of the exposure)**. This may limit the cross-country comparability of capital ratios and undermine their reliability and thereby the single rulebook, a cornerstone of the Banking Union.[74] Banks with the same risk profile and sharing the same currency would face different funding conditions depending on where they are located inside the EA. Furthermore, on the borrowers' side, two companies with identical risk profiles and the same currency would face different lending conditions depending on their establishment in the EA. As shown in section 2.2.2, lending availability and costs of credit to non-financial corporates is more tightly related to the level of NPLs in a given MSs.

**This creates additional financial fragmentation that hampers one of the most important benefits of the financial and monetary union, namely, the diversification and sharing of economic risks across borders**. Avoiding the accumulation of future NPLs would reduce those differences, hence contributing to the good functioning of monetary transmission mechanism and a more sustainable financial integration process in the EU. This would also contribute to the completion of the BU by putting all banks on an equal footing, reducing unnecessary differences in banks' practices, increasing comparability, facilitating market discipline and promoting market confidence.

[74] Bank capital without sufficient loan loss coverage is overstated and conceals the issues associated with credit deterioration.

# 4. OBJECTIVES: WHAT IS TO BE ACHIEVED?

## 4.1. General objectives

### 4.1.1. Reduce financial stability risks

As discussed in section 2.2.1, high levels of insufficiently covered NPLs can become a serious threat to financial stability. The first general objective of this initiative is **to limit these risks to financial stability by avoiding the build-up or excessive increase of insufficiently covered NPLs in the EU banking system.**

The risks to financial stability have also an important geographical dimension. While cross-border banking brings important stability and risk-sharing benefits, through its effects on risk diversification, it also strengthens channels of propagation of shocks from one jurisdiction to others. It is thus paramount to ensure that build-ups of under-provisioned NPLs are prevented to arise in any jurisdiction. Pockets of NPL risk represent in fact a risk for other jurisdiction via spill-overs. By introducing statutory backstops, **this initiative aims at capping the levels of under-provisioned NPLs that can arise in EU MSs thereby ensuring that no new "pockets of NPL risks" with spill-over potential in stressed market conditions arise.**

### 4.1.2. Support stable financing of the real economy and growth

**Banks saddled with NPLs tend to face higher funding costs and capital requirements and lower resource efficiency and profitability**[75]. This limits their ability to extend new credit. Persistently weak loan portfolios are thus a potential drag on financing firms, households and ultimately economic growth. Indeed, recoveries after financial crises are found to be particularly protracted because the economy faces a credit crunch due to impaired financial intermediation[76]. The impaired credit supply clearly weighs on aggregate demand and investment.

Hence, the **second general objective of this initiative is to ensure institutions have sufficient loss coverage for NPLs, hence protecting their profitability, capital and funding costs in stressed times.** This is particularly important in the EU where financial intermediation is still largely dominated by banking institutions. Coupled with deeper and stronger capital markets thanks to the CMU initiative, this should ensure that stable, less pro-cyclical financing is available to EU households and firms.

It is worth noticing that more stable credit provision and higher growth increase debtors' wealth and ability to repay, thereby reducing the probability of a loan being defaulted and the expected losses in such cases while improving banks' balance sheets. In other words, higher growth reduces financial stability risks. Lower financial stability risks reduce funding costs for banks and the economy, thereby fostering economic growth. Hence, **the two general objectives of this initiative are mutually reinforcing**.

## 4.2. Specific objectives

### 4.2.1. Reduce ability to implement “wait and see” and “extend and pretend” strategies

The initiative aims at reducing banks' discretion with regards to the recognition of and provisioning for NPLs (problem driver 2). Such discretion has indeed provided room for “wait

[75] See, among others, Vienna Initiative (2012), op. cit. and ESRB (2017), op. cit.
[76] See Abiad et al. (2011) op. cit.

and see" and "extend and pretend" strategies whose negative effects on banks profitability and, in severe cases, viability manifest itself during economic downturns.

### 4.2.2. Reduce incentives to implement "wait and see" and "extend and pretend" strategies

By removing the possibility to postpone excessively the tackling of NPLs, based on, inter alia, optimistic expectations of future improvement in loans performance, the legislative intervention would incentivise bank management to act proactively and pre-emptively. In other words, knowing that NPLs need to be covered within a limited time frame would incentivise banks to start implementing NPLs resolution strategies even before these become mandatory (i.e. before the date when the minimum coverage requirement becomes applicable). In this way, the initiative will change banks conduct towards more forward-looking practises (i.e. tackling problem driver 1).

## 5. WHAT ARE THE AVAILABLE POLICY OPTIONS?

### 5.1. What is the baseline from which options are assessed?

The baseline for comparing policy options is the current state of play, with no further legislative change at EU level. Loss coverage for NPEs would mainly be determined by two already existing instruments (as explained in detail in the background information):

- Application of either IFRS 9, which will better address the issue of delayed and inadequate provisions, or, where applicable, national GAAPs; and

- Supervisory action, in particular Pillar 2 measures allowing bank supervisors to require more provisioning within the limits of the applicable accounting standards on a case-by-case basis.

The implementation of IFRS 9 is expected to lead to higher provisioning levels particularly for performing exposures (classified in Stage 1 and Stage 2), whereas for NPEs (classified in Stage 3), the new accounting standard will largely keep the same treatment as IAS 39 and is expected to lead only to a minor increase in provisions of around 5% on average (see section 6.). Given, inter alia, its principle-based approach for determining credit loss provisions (as opposed to non-discretionary rules), it might not suffice to effectively prevent the build-up of insufficiently covered NPL stocks on EU banks' balance sheets. At the same time, in several EU countries some banks have to apply national GAAPs as their accounting standards (instead of IFRS) which might follow a different provisioning approach. Hence the accounting framework might not ensure that EU banks will ultimately create sufficient levels of credit loss provisions for NPLs.

Existing and forthcoming supervisory guidance by the ECB/SSM[77] and the EBA[78] on NPE management will urge banks with elevated levels of NPEs to implement effective strategies for tackling those exposures and can thus be expected to help reduce (primarily the stock of) NPEs on affected banks' balance sheets. Furthermore, the ECB/SSM[79] will publish supervisory expectations when assessing a bank's levels of loan loss coverage for new NPEs as part of the supervisory review and evaluation process in the context of Pillar 2. Where the supervisor including the ECB/SSM ascertains on a case-by-case basis that the provisioning policy chosen by the institution is not adequate or sufficiently prudent from a supervisory point of view, it may set binding supervisory measures. The application of Pillar 2 measures will help address specific NPL-related risks of individual banks. However, no harmonised (minimum) treatment (being applicable across MSs and banks) can be imposed by supervisors.

In absence of an EU regulation, it is therefore not possible to address the issue of under-provisioning of NPEs on an EU-wide and systemic basis.

[77] In March 2017 the ECB published guidance to banks on non-performing loans, which provides information on how banks are expected to manage NPLs.
[78] In accordance with the NPL Action Plan the EBA will issue guidelines on NPE Management which will be consistent with the ECB's guidance on NPLs applicable to significant credit institutions. The EBA guidelines will have an extended scope and will hence apply to all banks in the Union.
[79] See ECB (2017) "Addendum to the ECB Guidance to banks on nonperforming loans", available at: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf.

## 5.2. Description of the policy options

### 5.2.1. Common principles applying to all three options

Statutory prudential backstops would influence banks' prudential figures. They would not have any direct impact on the banks' financial statements which would remain to be determined by accounting rules. **Statutory prudential backstops would consist of two main elements: (i) a requirement for banks to cover up to common minimum levels the incurred and expected losses on newly originated loans once such loans become non-performing ("minimum coverage requirement"), and (ii) where the minimum coverage requirement is not met, a deduction of the difference between the level of the actual coverage and the minimum coverage from Common Equity Tier 1 (CET1) items.**

Different coverage requirements, depending on the classification of the NPLs as "unsecured" or "secured" are considered. NPLs or part of NPLs, covered by eligible credit protection as set out in the CRR are considered as *secured*. On the other hand, NPLs, or parts of NPLs, which are not covered by an eligible credit protection are categorised as *unsecured*. A loan only partly covered with collateral would be considered as secured for the covered part, and as unsecured for the part which is not covered with collateral.

In principle, non-performing unsecured credit exposures and non-performing credit exposures secured by collateral could be treated in the exact same way. However, these types of exposures have different characteristics in terms of risk. Secured NPLs are in general less risky for a bank than unsecured NPLs as the credit protection securing the loan gives the lender a specific claim on an asset or against a third party without reducing his/her general claim against the defaulted borrower.[80] On the contrary, in case an unsecured loan becomes non-performing the bank would not have such specific preferential claim. Recovery rates are on average higher for secured NPLs than for unsecured ones.[81] However, it takes some additional time to enforce the credit protection and, where applicable, realise the collateral.[82] Unsecured NPLs should therefore require higher and timelier minimum coverage by the creditor bank than secured NPLs. However, after a certain number of years without being successfully enforced (i.e. the collateral/guarantee could not be realised), the credit protection should not be seen as effective anymore. In such case, full coverage of the exposure amount of secured NPLs is deemed necessary. Therefore, the time period for unsecured NPLs is not the same than for secured ones.

**Given the considerations above, the minimum coverage requirement would be a function of:**

**(i) the time period an exposure has been classified as non-performing – since the longer the exposure has been non-performing, the lower is the probability to recover its value[83];**

**(ii) and, where available, the level of credit protection (collateral and guarantees) held for this NPL (applying the relevant eligibility criteria set out in the CRR for credit risk mitigation purposes) – since credit protection increases the probability to recover the exposures value.**

The chosen approach should ensure that the level of credit protection follows a prudent approach, in particular regarding assumptions pertaining to recoverability and enforceability[84]. To ensure

[80] At face value, the value of the assets given as collateral can in general be sufficient to cover the value of the outstanding debt obligation. However in practice a security right has a reduced value to a secured creditor if it cannot be enforced effectively and efficiently.
[81] See for example Gupton et al. (2000), Banca d'Italia (2017).
[82] Cf. ESRB (2017) op. cit. and IMF (2015a) op cit.
[83] Recovery rates decline as the age of the NPEs increase: the longer they remain on banks' balance sheets, the less banks succeed in recovering.

consistent outcomes across banks, a common methodology, including possible minimum requirements for re-valuation in terms of timing and ad hoc methods, would have to be developed[85] (e.g. by the EBA). In cases where institutions fail to perform prudent collateral valuation alongside the defined methodology or the valuation has not been updated on a timely basis, the whole exposure should be treated as unsecured from a prudential perspective.

**The following items would be eligible for compliance with the minimum coverage requirements:**

a) provisions recognised under the applicable accounting framework ("credit risk adjustments"), i.e. the amount of specific and general loan loss provision for credit risks that has been recognised in the financial statements of the institution;

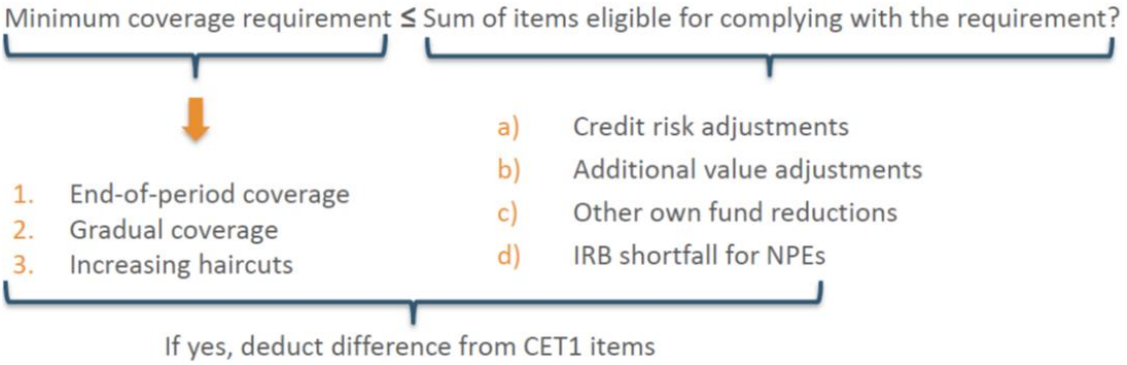
b) additional value adjustments for fair-valued assets;

c) other own funds reductions. For instance, institutions have the possibility to apply higher deductions from their own funds than required by the regulation; and

d) for banks calculating risk-weighted assets (RWAs) using the internal ratings-based (IRB) approach, the regulatory expected loss shortfall which is already deducted from own funds.

Only where the sum of the amounts listed under a) to d) does not suffice to meet the applicable minimum coverage requirement, the prudential backstops would apply. The difference between the two (uncovered exposure amount or "coverage gap") from CET1 items would be deducted. The deduction would ensure that the risks associated with NPLs are appropriately reflected in banks' CET1 capital ratios in one way or another.

Figure 13: Main components and functioning of the statutory backstop proposal




Source: European Commission, EBA

**Furthermore, the following common features would apply to all three policy options presented in the remainder of this section:**

- Common definition: NPLs would be defined in CRR using the already existing definition established by the EBA for supervisory reporting[86].

- Pillar 1 deduction: the common backstop would be a Pillar 1 deduction (in case the minimum coverage requirement is not met), i.e. it will apply mandatorily to all banks before supervisors assess whether banks need to hold additional own funds for Pillar 2 purposes. The sequence would be to first apply the accounting provisions in accordance with the

[84] Deficiencies in the approaches employed by banks have been found most notably for immovable property collateral (cf. ECB [2014]).
[85] EBA (2016).
86 Implementing Regulation (EU) No. 680/2014.

applicable accounting framework, then the statutory backstops and last a Pillar 2 requirement in case the supervisor sees a need to go further than the statutory backstops already require.

- Safeguards: the design of a prudential backstop should ensure that it does not lead to any "double-counting" of provisioning or risks.

- Time calibration: given that recovery times for secured and unsecured NPLs differ empirically, the time period after which full coverage for NPLs would be required should be different depending on whether the NPLs are secured or not. In case of unsecured NPLs, banks should fully cover them more quickly than secured NPLs. The FSC report[87] suggests a time period of 2 years for unsecured NPLs after the classification of the exposure as non-performing. For secured NPLs, the proposed time period envisaged by the FSC report ranges from 6 to 8 years.

    - Time calibration for unsecured NPLs:

According to some private stakeholders in their answer to the targeted consultation, imposing a full coverage of unsecured NPLs 2 years after their classification as non-performing would be overly conservative. In some cases institutions will fully recover unsecured loans after three or four years. These stakeholders have argued that it would be unduly strict to require full coverage for NPLs which have been forborne for a period beyond 2 years and where the counterparty meets its obligations.
However, a time period of 2 years for unsecured NPLs appears to be justified for two main reasons:

i) in a number of third countries requiring full provisioning or write-off of NPLs, non-performing exposures have to be fully provisioned and/or written off earlier than 2 years (see Figure 14 and Annex 4). In the EU, the length after which unsecured NPLs have to be fully provisioned or written-off (where such requirement exists) varies but evolves on average close to 2 years after the classification as non-performing (it is for instance 180 days in Romania and less than 2 years in Spain). Choosing a time period of 2 years before full coverage of unsecured NPLs would be in line with the current practices in- and outside the EU;
ii) under this option, any amount that has been deducted and which is finally recovered afterwards would be added back to the banks' CET1. In this way, there would be no undue provisioning of loans which are actually paid back.

A time period of 2 years would also be in line with the FSC recommendations. All public stakeholders answering to the consultation support such time calibration. Furthermore, the ECB in its role as single supervisor of EA banks (ECB/SSM) considers a timeframe of maximum 2 years for a full provisioning of unsecured NPEs as a benchmark when assessing a bank's provisioning policy.[88]

[87] Cf. FSC (2017).
[88] The ECB Banking Supervision is currently consulting on how Pillar 2 powers could be applied to address under-provisioning of NPLs (cf. ECB [2017]).

Figure 14: Provisioning requirements for unsecured NPLs and non-collateralised parts of secured NPLs (days of past due after which a 100% loan provisioning is required; excluding EA countries)


Note: For USA and Brasil data refer to write-offs. Write-offs after 180 dpd in US (only household loans), in Brazil, distressed loans are written off after 180 dpd. In Argentina, Chile, Colombia, Ecuador, Mexico and Peru, for the computation of loan loss provision the applicable regulations differentiate by type loans (Consumer, Commercial, Microcredit and Mortgage loans). For these countries, the figure above reports only the requirement for corporate loans.

- Time calibration for secured NPLs:

As far as the time calibration for secured NPLs provisioning is concerned, the consultation showed divided views. While private stakeholders held that 6-8 years as proposed by the FSC was overly conservative, public stakeholders support this timeframe. This timeframe seems also proportionate in view of the average foreclosure period which ranges from 3 to 5 years in the majority of EU MSs.[89] Furthermore, the ECB/SSM considers a timeframe of maximum 7 years for a full provisioning of secured NPEs as a benchmark when assessing a bank's provisioning policy.[90] There are also solid (macro-)economic arguments to choose a time period between 6 and 8 years. Literature on the length of economic downturns caused by financial crises[91] suggests that economic conditions such as GDP growth, unemployment levels and debt increases reach the peak of distress around 5 years after the onset of a crisis. The following recovery to pre-crisis levels takes on average 3 more years. In order to avoid pro-cyclical effects by forcing banks to provision during the depth of the crisis, full provisioning of the secured part should therefore not be triggered before 6 to 8 years after a secured loan is identified as non-performing. Furthermore, the introduction of automatic backstops has the effect of mitigating pro-cyclicality of credit provision by reducing discretion in the application of NPLs recognition and provisioning. In this way, it prevents the emergence of "outlier institutions", i.e. banks whose NPLs levels grow to a level which is endangering their solvency and impairing their ability to provide credit. These institutions' problems typically become manifest in stressed times which leads to further declines in credit provisioning, growth and employment.

In its response to the Commission's call for advice the EBA analysed the differences in terms of impact of a full coverage requirement for secured NPLs after 6, 7 or 8 years (for an overview of the methodology and caveats applied see section 6). As expected, the cumulative impact is decreasing with the years by when the full coverage is required for secured NPEs, i.e. the overall cumulative impact is lowest for the 8 yeas calibration. The difference between the three calibration is however small and in the region of 10 basis points (bps).

[89] Cf. ESRB (2017) op. cit. and IMF (2015a) op. cit.
[90] Cf. ECB (2017).
[91] The most quoted papers of this literature are: Reinhart and Rogoff (2009): "The aftermath of financial crises", NBER WP14656 (2009) and Reinhart and Rogoff (2014): "Recovery from financial crises: evidence from 100 episodes" American Economic Review: Papers & Proceedings 2014, 104(5): 50–55.

**For all these reasons the starting point for the design of all policy options would be: (i) full coverage of unsecured NPLs after 2 years, and (ii) full coverage of secured NPLs after 6 to 8 years.**

The following **three policy options** to tackle under-provisioned NPLs are considered in the remainder of this section:

i) Option 1: full coverage of unsecured and secured NPLs at the end of defined time periods without any coverage requirement beforehand;

ii) Option 2: gradual coverage requirement starting after the classification as non-performing and leading to a full coverage of unsecured and secured NPLs at the end of defined time periods;

iii) Option 3: for secured NPLs, application of haircuts depending on the type of collateral (unsecured NPLs would be treated as under Option 1 or 2).

### 5.2.2. Option 1: Statutory backstop with end-of-period full coverage requirement

As explained under section 5.2.1., statutory prudential backstops would consist of two main elements: (i) a minimum coverage requirement for banks to be compared to the actual coverage by the bank; and (ii) where the minimum coverage requirement is not met, a deduction of the difference between the level of the actual coverage and the minimum coverage (i.e. the uncovered exposure amount) from Common Equity Tier 1 (CET1) items.

For both secured and unsecured NPLs, it is proposed under Option 1 that their full coverage would be required at the end of a defined time period, without any gradual requirement beforehand (and therefore no required deduction before the end of the period). As explained in section 5.2.1. above, it is justified to apply a shorter period to unsecured NPLs, as RR are significantly lower compared to secured loans. Therefore the envisaged time period and deduction mechanism are different for both types.

Full coverage of unsecured NPLs:

International comparison and experience gained in jurisdictions in- and outside the EU suggest that institutions could be required to fully cover their unsecured (parts of) NPLs two years after the identification of the loan as non-performing.

This means that, where the minimum coverage requirement is not met and the backstops apply, institutions would have to deduct from their CET1 items the uncovered exposure amount of unsecured (parts of) NPLs. The uncovered exposure amount would be the accounting value remaining after specific credit risk adjustments, additional value adjustments, other own funds reductions and deduction of the regulatory expected loss shortfall related to the exposure (i.e. items a) to d) listed in Figure 13 above). It will ensure full prudential loss coverage of unsecured NPLs.

Full coverage of secured NPLs:

For secured NPLs, the approach would be based on an assessment whether the collateral securing the loan can be realised in a timely manner. Where the collateral/guarantee has not been realised within a defined time period (following the classification of the underlying exposure as non-performing), the credit protection should be considered ineffective from a prudential perspective. By consequence, the exposure would be treated as unsecured for the purposes of the backstops, irrespective of the collateral valuation. Institutions would therefore be required to fully cover the exposure amount after the defined time period for unsecured NPLs elapsed: in case the minimum coverage requirement is not met, institutions would have to deduct from their CET1 items the difference between the amount covered by the provisions, additional value adjustments, other

own funds reductions, regulatory expected loss shortfall and additional deductions (see items a) to d) listed above in Figure 13) on the one hand, and the minimum coverage requirement on the other hand.

The requirement to have a full coverage for secured NPLs could apply at the end of the defined time period.

### 5.2.3. Option 2: Statutory backstop with gradual full coverage requirement

Option 2 would be the same as Option 1 with the following modifications.

On the one hand, abrupt and potentially harmful cliff-effects should be avoided and potentially pro-cyclical effects should be limited. On the other hand some time for viable forbearance and possible recoveries (in particular in case of collateral held for NPEs) should be given before the requirements effectively bite. To achieve both goals, a gradually increasing scaling factor would be applied to the minimum coverage requirements. Banks would have to follow a gradual path towards the required coverage level with the effect that banks would have to anticipate the requirement, which under Option 1 would be applicable only at the end of the time period.

Under option 2, either a linear or a progressive path could be applied. In case of a linear path, the minimum coverage level would equally increase over the years during the different time periods set for unsecured NPLs and secured NPLs. In case of a progressive path, the amount to be covered each year would be lower at the beginning of the time period and would increase over time.

Progressively phased in minimum coverage levels would reflect the observation that loan recoveries in most cases happen during the first years after its classification as non-performing, especially for secured NPLs. The same applies for viable forbearance measures. A progressive path would therefore be better aligned with the observed recovery practices.

Institutions would have 2 years to fully cover unsecured NPLs and 6 to 8 years until full coverage of the gross exposure amount of secured NPLs has to be reached. In such a scenario, coverage levels could for instance be set as shown in Table 2: full coverage requirement is reached in two years for unsecured NPLs and in 8 years for secured NPLs; for both it follows either an end-of-period (no scalar), linear or progressive path.

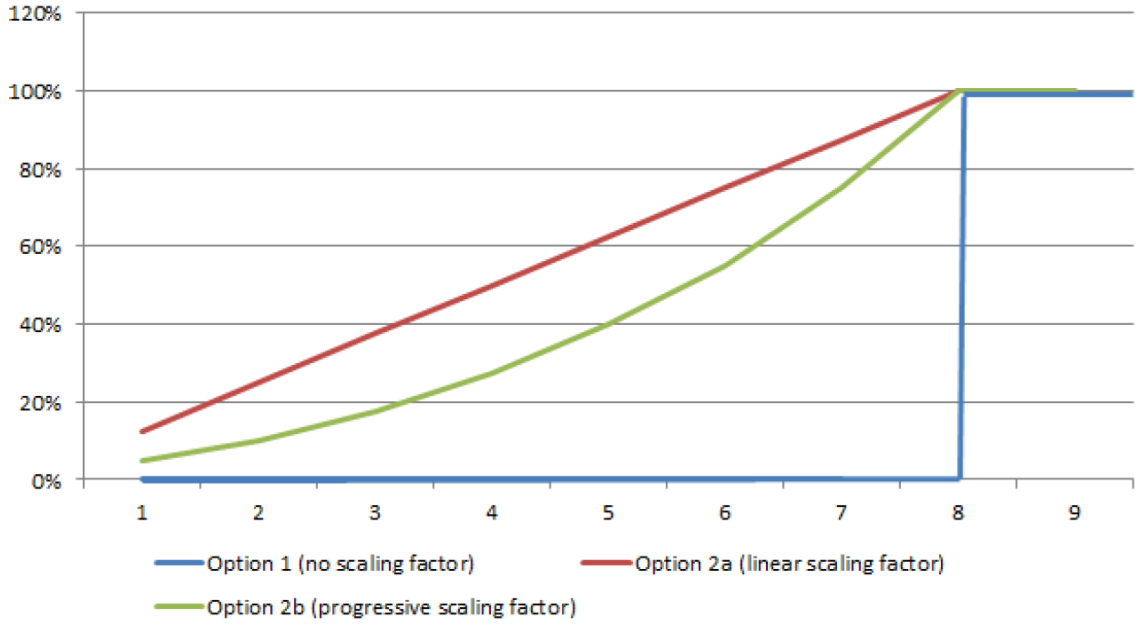
Table 2: Illustration for minimum coverage levels for unsecured and secured (parts of) NPLs applying no scalar (Option 1), a linear one or a progressive one (Option 2)

| **Vintage** | **Unsecured (parts of) NPLs** | | | **Secured (parts of) NPLs** | | |
|---|---|---|---|---|---|---|
| | No scalar | Progressive | Linear | No scalar | Progressive | Linear |
| Min coverage after 1y | 0% | 35% | 50% | 0% | 5% | 12,5% |
| Min coverage after 2y | 100% | 100% | 100% | 0% | 10% | 25% |
| Min coverage after 3y | | | | 0% | 17,5% | 37,5% |
| Min coverage after 4y | | | | 0% | 27,5% | 50% |
| Min coverage after 5y | | | | 0% | 40% | 62,5% |
| Min coverage after 6y | | | | 0% | 55% | 75% |
| Min coverage after 7y | | | | 0%/35%*/50%** | 75% | 87,5% |
| Min coverage after 8y | | | | 100% | 100% | 100% |

Notes: * If a progressive scalar for unsecured (parts of) NPLs was applied (as secured NPEs would be considered as unsecured after 6 years);
** If a linear scalar for unsecured (parts of) NPLs was applied (as secured NPEs would be considered as unsecured after 6 years).

Figure 15 visualises the different paths of the minimum coverage requirement under the end-of-period deduction (Option 1) and the gradual deduction (option 2) for secured exposures reaching 100% coverage after 8 years.

Figure 15: Different paths of the minimum coverage requirement in the end-of-period deduction (option 1) and gradual deduction (option 2) approach (secured exposures) reaching 100% after 8 years




Source: EBA (2018)

### 5.2.4. Option 3: Statutory backstop with prudential haircuts

Option 3 is only considered for secured NPLs, as this approach is based on the value of the collateral or guarantee. The treatment of unsecured NPLs would remain the same as under Options 1 or 2 (end-of-period or gradual coverage level requirement).

For secured NPLs, the method to determine the amount to be deducted would be more risk-sensitive than under Options 1 and 2. At the same time, option 3 would allow to address risks associated with the effectiveness of credit protection for NPLs in a more targeted way.

In a first step, specific minimum levels of prudential haircuts[92] on the collateral/guarantee values (as determined in accordance with the applicable accounting standards and prudential requirements) of a secured loan would be applied. More specifically, the magnitude of the applicable haircut would depend on the form of the credit protection and the actual length of time to its realisation. Forms of credit protection for which credit assessments by a recognised ECAI[93] are available, operate in liquid markets and show well-established, publicly available and sufficiently stable market prices would be subject to relatively lower initial haircut levels.

In a second step, the level of haircuts would gradually increase with every subsequent year starting from the second year after the classification as non-performing. The longer the realisation of collateral takes, the more additional haircuts would apply. It will thereby reflect the increasing

[92] Prudential haircut means applying a reduction in the value of the protection recognised for prudential purposes.
[93] External Credit Assessment Institution.

uncertainty as to the ultimate recovery values[94], accumulating maintenance costs[95] and discounting.

Table 3 sets out possible minimum haircut levels for selected forms of collateral (including a concrete example for commercial real estate) based on international practice for a time period of 6 years.[96] The haircuts increase over time, therefore increasing the minimum coverage level requirement.

Table 3: Possible minimum haircut levels for selected forms of collateral over time

| *Form of Credit Protection*[97] | *Initial Haircut Level* | *Additional Haircut per year to realisation* | *Applicable Haircut after 8 years* |
|---|---|---|---|
| *Financial collateral* | 20%-40% | 5-15% | 60%-100% |
| *Immovable property (e.g. Commercial RE)* | 30%-60% (40%) | 5-20% (7,5%) | 70%-100% (40%+5*7.5%=100%) |
| *Other collateral* | 40%-50% | 5-20% | 80%-100% |

## 5.3 Discarded option: granting binding accounting powers to supervisors

In the current EU rules, supervisors do not have binding accounting powers or a mandate to adopt binding accounting regulations. The power is provided to national jurisdictions for national GAAPs in the context of the implementation of the Accounting Directive (Directive 2013/34/EU). With the exception of one MS (Spain), accounting powers are not granted banking supervisors. According to the SSM Regulation, also the ECB as competent authority for the EA does not have such powers, and is not entitled to change institutions' financial statements. At EU level, it is the European Securities and Markets Authority (ESMA) which is responsible for promoting a consistent application of IFRS and coordinating national regulators' enforcement practices.

Under this option, EU legislation would give regulatory and horizontal accounting powers to supervisors, both to adopt accounting texts and to enforce them. Competent authorities would be empowered to set stricter standards and require higher provisioning of NPLs in the financial statements, and, consequently, in the prudential reporting. National supervisors would be able to address all banks in their jurisdiction, and not only be able to act on a case-by-case basis.

This option would entail a very significant change to the current European framework and go much beyond the scope of solely tackling the NPLs issue. Accounting powers would encompass other aspects than NPLs provisioning; assessing potential unintended consequences to grant such powers to supervisors would require a much broader reflection outside the mandate of this impact assessment.

Granting new accounting powers to supervisors would be highly challenging in terms of human and financial resources (recruitment and training). It would also imply modifications of the SSM Regulation, which would be politically and legally challenging, or to leave the competencies to national authorities. In such case, it would not only increase the complexity of the institutional

[94] Cf. EBA (2016) "Report on the dynamics and drivers of non-performing exposures in the EU banking sector".
[95] Incurred by the bank in relation to the management and execution (including, where applicable, repossession and disposal) of the collateral/guarantee.
[96] See also ECB (2017) "Stocktake of national supervisory practices and legal frameworks related to NPLs"; IMF (2015) op cit. and World Bank (2014) op. cit.
[97] As per the applicable eligibility criteria set out in the CRR for credit risk mitigation purposes.

framework but also fail to harmonize the treatment of NPLs within the EU; NPLs provisioning would be tackled through statutory measures across institutions, but would remain country-specific.

Besides, financial statements are used for other purposes than prudential reporting. Market participants assessed them for investments purposes, or economic analysis. They are also the basis to determine the fiscal result. Any direct modification to the financial statements would have to be duly justified in regards of all aspects beyond prudential matters.

More generally, accounting standards have different objectives than banking regulation. They apply to all kind of companies, and mainly aim to present a faithful, transparent and neutral picture of financial performance and financial position at a certain reporting date. Contrary to the banking rules, accounting standards do not have an objective of financial stability over the cycle and are not inherently risk-based. Amending the accounting framework in the pursuit of prudential objectives might have undesirable effects and would lead to undue complexity for all stakeholders. Moreover, IFRS were adopted to improve the efficiency of the single European capital market. Supervisory induced modifications to IFRS would impede comparability and defeat the purpose of the single capital market where banks compete with other types of entities.

Therefore, the option to grant supervisors direct accounting powers has been discarded.

## 6. WHAT ARE THE IMPACTS OF THE POLICY OPTIONS?

**Benefits and costs of the three proposed options are assessed under this section.** They are compared with the baseline scenario and in respect of their effectiveness in terms of the objectives set out in section 4. Thereby, two specific objectives to i) reduce ability to implement "wait and see" and "extend and pretend" strategies and ii) to remove incentives to "wait and see" and "extend and pretend" strategies will be assessed against the background of the general objectives to i) reduce financial stability risks, and ii) support stable financing of the real economy and growth. Other considerations will also be taken into account, such as the relative costs for institutions (such as implementation and administrative costs, increase of capital requirements, etc.).

**In this way, all three options and the baseline scenario are assessed in terms of effectiveness in regards of the objectives, cost efficiency to achieve them, consistency with other EU policies and impact on key stakeholders.** A summary of stakeholders' feedback is provided for each option; further details on the replies to the targeted consultation (38 in total) can be found in Annex 2.

### 6.1. Impact on bank capital (quantitative analysis)

**In order to assess the potential impact of the three options on bank capital, technical assistance has been sought from the EBA**.[98] In particular, the EBA was asked to provide estimates on accelerated capital needs triggered for EU banks by the prudential backstops under the three options, compared to the expected increases in provisions as a result of the application of IFRS 9 (baseline). Crucially, impact estimates should be seen as accelerated rather than additional drags on capital in a steady state scenario, as they will either occur anyway in the form of losses (for non-recoverable exposures)[99], or they will be offset by respective recoveries (for exposures that are recovered after the backstop was applied)[100]. In other words, the introduction of prudential backstops would only alter the distribution of capital needs to cover losses on NPEs over time, but it would not increase their overall size. The aim of this initiative is not to increase capital requirements due to NPE coverage but only to spread such coverage more evenly over time instead of leaving it concentrated at the time when recognition is not deferrable any further.

*Methodology and caveats*

**For this quantitative analysis a projection horizon of 20 years is foreseen, meaning that the impact of the backstops has been calculated over the period 2018 – 2037**. The calculation of the impact is therefore subject to large confidence bounds.

**The sample assessed consists of 129 EU banks, 98 from the EA and 31 from non-EA MSs**, as for those institutions supervisory reporting in the needed quantity and quality is available. The

[98] "Call for advice to the EBA for the purposes of considering statutory prudential measures to address insufficient provisioning for newly originated loans once they become non-performing", available at: https://www.eba.europa.eu/documents/10180/2022642/EBA+Call+for+advice_NPLs_prudential+backstops.pdf/8f41cc22-c096-4ab9-ae5c-2101de848a05.

[99] Banks need to cover non-recoverable NPLs regardless of the prudential backstop.

[100] Exposures which had been fully deducted from capital in accordance with the prudential backstop but finally were recovered by the bank would increase capital up to the recovered amount.

credit risk weighted assets (RWAs) of these institutions account for around 83% of EU credit RWAs[101].

**As regards the evolvement under the baseline scenario, a small increase in the provisioning ratio of 5% (compared to current levels) is applied to reflect the introduction of IFRS 9 rules**, based on the results of the EBA Quantitative Impact Study (QIS) on the implementation of the new standard[102].

In order to accurately assess the inflow of new NPLs stemming from newly originated loans, data on historical loan originations and the corresponding default behaviour would be needed, which are not available neither to the EBA nor to the Commission. **In view of this and other data limitations it was necessary to make some simplifying assumption with regards to the available historic data; in particular, the quantitative analysis is based on the static balance sheet assumption.**[103] Under the static balance sheet assumption, the only change considered in the analysis is the future inflow of newly originated NPEs. As such, no changes are assumed in the outstanding stock of exposures (defaulted and non-defaulted) and in the newly originated non-defaulted exposures. The same holds for other balance sheet items, such as for instance the CET1 and Tier 2 capital.[104] The only change considered in the analysis is the future inflow of newly originated NPEs. As such, no changes are assumed in the outstanding stock of exposures (performing and non-performing) and in the newly originated performing exposures. The same holds for other balance sheet items, such as for instance the regulatory capital. In addition, it is assumed that there will be no changes in some key ratios observed at the institution level. It is assumed that the shares of secured versus unsecured exposures that is observed historically remains constant in the future, that there is no improvement in cure rates (CRs)[105] in spite of the recent introduction of qualitative NPL guidance, that there is no change in the provision and write-off coverage, that default rates remain constant, i.e. it is assumed that there is no improvement in the origination standards.

**The results of the quantitative analysis would appear to present an upper bound to the estimated effects because of two main reasons.** First, the methodology makes use of historical data which have been collected at time periods where generally high levels of NPEs have been observed (resulting in high projected inflows of NPEs), when generally profitability was very low and where provisioning levels were below today's levels, and extrapolates these inputs to a 20-year horizon. Second, the analysis excludes any kind of dynamic effects but makes the historical parameters static albeit they are likely to change given the economic recovery and banks actions in response to the backstop and possible supervisory measures. In particular, it is expected that banks take actions to change loan origination standards and improve NPE management (such as work-out, restructuring or disposal of NPEs) as a result of the prudential backstop measure, such that the actual impact will definitely be lower. Such behavioural changes however are not taken into account in the quantitative analysis.

[101] Domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches, All institutions, Risk weighted exposure amounts for credit risk (Link to the general SDW, consolidate banking data: http://sdw.ecb.europa.eu/browse.do?node=9689685).

[102] The results of the EBA IFRS QIS exercise are available at: https://www.eba.europa.eu/-/eba-updates-on-the-impact-of-ifrs-9-on-banks-across-the-eu-and-highlights-current-implementation-issues.

[103] For more details on the data sources used for the quantitive analysis see EBA (2018) "Report on statutory prudential backstops".

[104] In its response to the Commission's call for advice, the EBA further elaborates on these assumptions and explains which sensitivity analysis it has conducted in order to address related uncertainties.

[105] CR is the percentage of loans that previously presented arrears and, post restructuring, present no arrears.

## 6.2. Option 1: Statutory backstop with end-of-period coverage requirement

### 6.2.1. Benefits

Option 1 would help constraining the ability for banks to delay the provisioning of NPEs in comparison with the baseline, as banks would have a time limit after which they will have to ensure for a full coverage of their NPEs.

As it would imply only a simple deduction at the end of a defined time period without looking at the collateral value, Option 1 would be the least complex option. For banks currently subject to Pillar 2 measures, it would be even less complex than the baseline as they are already facing costs related to the implementation of Pillar 2 measures imposed by their supervisors.

### 6.2.2. Costs

Option 1 would give fewer incentives to banks not to delay loss recognition for secured NPLs in the short term in comparison with the other options, as the coverage requirements would apply only after a perennial period of time. This would also hold true for unsecured NPEs in comparison with Option 2 (gradual coverage requirement) as the potential deduction would only be triggered after two years.

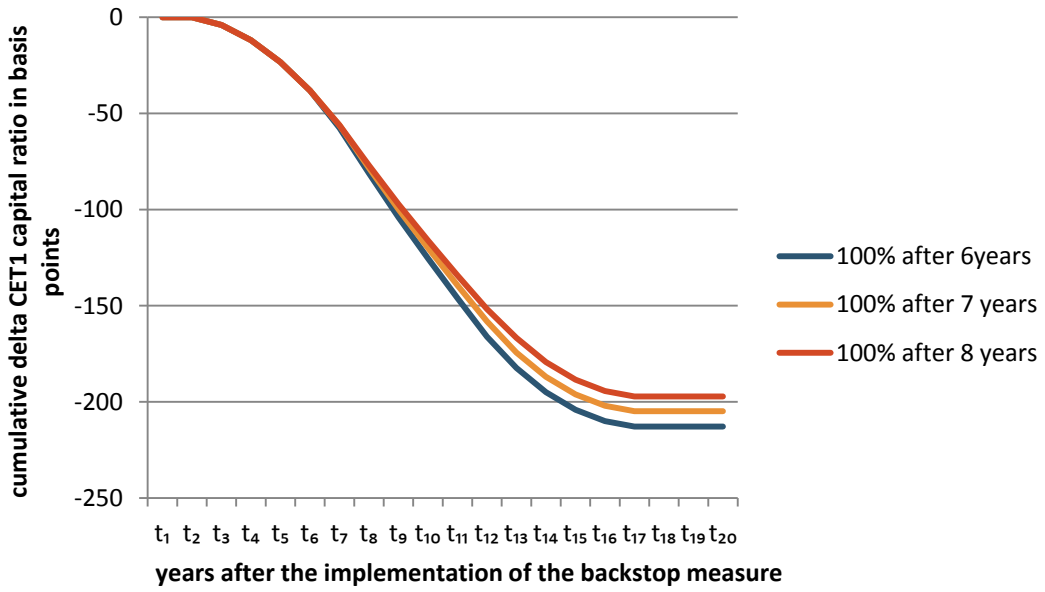
More importantly, as the full coverage requirement would apply only at the end of the defined time period, Option 1 would potentially lead to considerable cliff-effects. Banks which do not meet the minimum coverage requirement could then face abrupt increases in deductions after 2 years for unsecured NPEs and after 6 to 8 years for secured NPEs.

EBA estimates indicate that this option would lead to an average reduction in EU banks' CET1 capital ratio of equal to 197 to 213 bps on cumulative basis over 20 years, depending on the period after which full coverage is required (6 to 8 years for secured NPEs). Figure 16 shows the cumulative impact on CET1 capital ratio in bps (Y-axis) over the years after the implementation of the backstop measure (X-axis).[106] There is zero effect on capital ratio before year 2 ($t_2$) since the backstop is not binding. In year 3 (4 and so on) the backstop starts biting the new unsecured NPEs that have been originated in year 0 (1 and so on) and in year 7 (8 and so on) also the secured NPEs that have been originated in year 0 (1 and so on).

Option 1 would induce a moderate increase of administrative costs compared to the baseline, as all banks would have to implement a common prudential backstop. This holds also for banks which would actually not be affected by an effective deduction because they would still have to implement the framework to monitor their coverage level. The accelerated capital needs induced by the prudential backstop might be compensated by a decrease in Pillar 2 requirements, for those banks which were subject to dedicated Pillar 2 measures in this regard.

[106] Note that the subscripts $t_1, t_2, t_3$ in the x axis of Figure 16 refer to a future point in time, respectively 1 year, 2 years and 3 years after implementation of the new backstop legislation. There is zero effect on capital ratio before year 2 ($t_2$) since the backstop is not binding. In year 3 (4 and so on) the backstop starts biting the new unsecured NPEs that have been originated in year 0 (1 and so on) and in year 7 (8 and so on) also the secured NPEs that have been originated in year 0 (1 and so on).

Figure 16: backstop with end-of-period coverage requirement (cumulative impact, weighted average)




Source: EBA (2018)

### 6.2.3. Impact on key stakeholders

The impact on the key stakeholders (corporates including SMEs and retail, banks, public authorities) is assessed against the baseline scenario. The three policy options present common features and might to a certain extent have similar effects. Some impacts are however specific to the relevant option.

Table 4: Positive and negative impacts, stakeholder type – Option 1

| Impact on key stakeholders | Corporate (including SME) and retail customers as borrowers | Banks | Member States and supervisors |
|---|---|---|---|
| **Positive** | + (more stable provision of credit to corporates) | + (limited provisioning needs in the short run, increased resilience in the long run) | + (strengthened financial stability, higher growth) |
| **Negative** | ≈ | - - (end of period cliff effect, smaller long term effect on banks resilience) | - (deductions would not trigger before several years) |

*Notes: ++ = strongly positive; + = positive; - = negative; -- = strongly negative; ≈ = neutral/marginal.*

- **Corporate (including SME) and retail customers as borrowers:**

By strengthening banking banks' balance sheets with a more timely and effective management of NPEs, this option would support a more stable supply of credit (see section 6.6). The positive impact should be particularly to the benefit of SMEs, since these are more dependent on bank lending than large corporates which might access more easily financial markets. Freeing lending capacity of banks will therefore have a direct positive impact on SMEs funding.

- **Banks**

For what concerns their secured NPEs, no changes would occur for banks with respect to the status quo in the short run. There would be little incentives (in comparison with the baseline as

well as the other options) to increase their loss coverage particularly for secured NPEs in a timely manner. Early movers (i.e. those banks building up coverage voluntary before [full] coverage is statutorily required at the end of the period) could indeed be put at a disadvantage with respect to late movers since they would adjust their own funds and/or recognise losses impacting their CET1 ratios and/or profits earlier than late movers. On the other hand, a cliff-effect at the end of the coverage period might have a severe impact on the late movers, as the required coverage level would abruptly jump from 0% to 100% after the defined time period. For what concerns unsecured NPEs, the minimum requirement (full deduction after 2 years) would decrease banks' profitability in the short run.

In the long run, the impacts on all banks would be beneficial because, by avoiding that under-provisioned NPEs reach unsustainable levels, the backstop would help strengthen their resilience to economic crisis, lowering their funding and administrative costs and protecting their profitability. The prudential backstop would indeed not increase capital requirements for NPEs, but only alter the distribution of capital needs to cover losses on NPEs over time (without increasing their overall size).

As regards bank profitability, for institutions with sound provisioning practices already in place, i.e. where existing provisions exceed the levels required by the backstop, no impact will be observed. In the cases, where the backstop does lead to increased coverage (via prudential deductions from own funds or increases in accounting provisions), the impact on profitability will depend on a wide range of factors, most notably the requirements of the accounting framework, tax regimes, mitigating effects deriving from any proceeds from sales (which depend on the sale price), as well as other firm-specific circumstances.[107]

- **Member States and supervisors**

Tackling the issue of under-provisioning of NPEs would reduce financial stability risks and foster a more stable supply of credit to firms and households. In the short term, requiring minimum loss coverage for NPEs would reduce the risk of banks' failures and resulting spill-overs across jurisdiction, and therefore strengthen the stability of the EU banking sector as a whole. In the longer run, reducing the net NPL ratio of EU banks will support economic growth. These beneficial effects are however mitigated by the design of Option 1 where the backstop only applies after the defined time period has elapsed.

Under Option 1 full coverage of secured NPEs would only be triggered at the end of the defined time period (6 to 8 years). Banks having insufficient coverage for their NPEs might therefore change their behaviour only to a small extent during the first years of this period. Consequently, supervisors might need to strengthen their Pillar 2 reviews for a large population of banks, aiming at ensuring sufficient loss coverage at any point in time and mitigating the cliff effects of a harmonised Pillar 1 backstop kicking in abruptly.

### 6.1.4 Stakeholders' feedback during the targeted consultation

A number of banks and most public authorities expressed support for the introduction of a statutory backstop to harmonise NPEs provisioning. Most answers stressed however the disadvantages of having an end-of-period deduction, as this would lead to major cliff-edge effects. In fact, most banks and public authorities stated option 1 (end-of-period deduction, both for secured and unsecured NPEs) as their least preferred. Banks supporting the introduction of a prudential backstop showed a preference for a design entailing a gradual deduction (i.e. option 2).

Some banks argued more generally that the existing Pillar 2 powers of competent authorities should be enough to tackle the issue of under-provisioned NPEs.

[107] Cf. EBA (2018).

## 6.3. Option 2: Statutory backstop with gradually increasing coverage requirement

### 6.3.1. Benefits

In terms of effectiveness to meet the specific objectives, this option would require banks ultimately to fully cover their NPEs after a certain period of time, therefore strongly reducing their ability to "wait and see" (first specific objective laid down in section 4.2). The objective would be quickly met, as the minimum coverage would by design kick in as soon as the exposure becomes non-performing. At the same time institutions would have strong incentives to provision NPEs at an early stage (second specific objective laid down in section 4.2) since they would not have the possibility to wait until the end of the period to increase their provisioning. Therefore, the main benefit of this option is the avoidance of too abrupt and potentially harmful impact at the end of the defined time period.

Option 2 would also be consistent and coherent with other EU policies. Supervisors could focus their work on outlier banks also during the first years as compared to option 1. This would help ensure efficient use of resources and support EU-wide harmonisation in addressing NPEs.

By choosing a progressive path, the design of the backstop would be aligned with another envisaged initiative of the Commission which is the acceleration of extra-judicial collateral enforcement. It would require less coverage during the first years when the collateral is more likely to be realised.

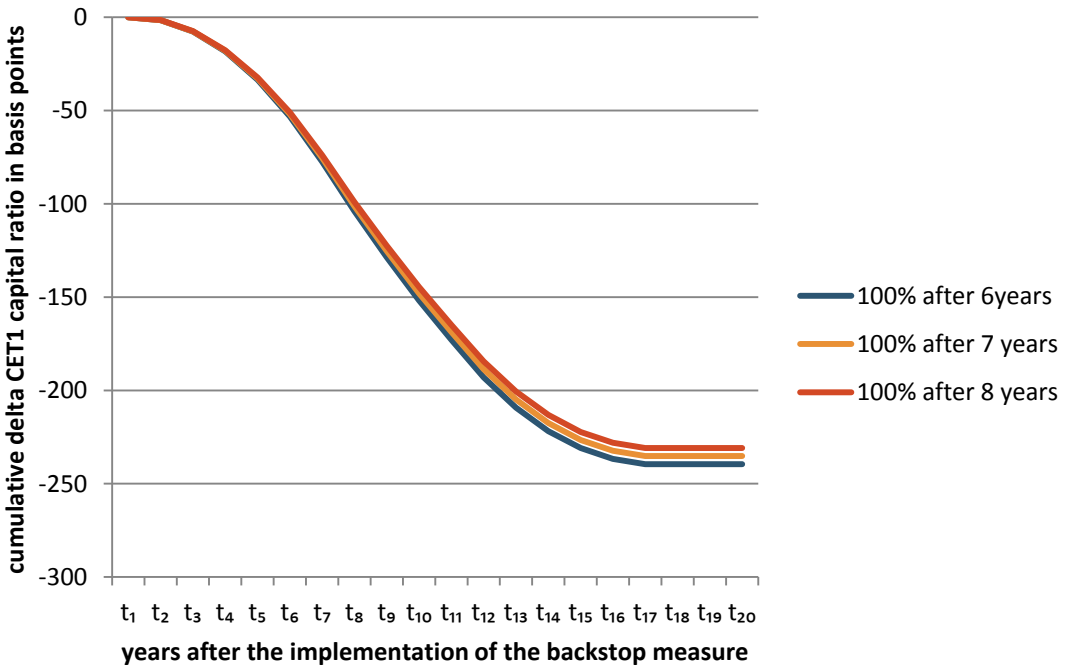
### 6.3.2. Costs

Option 2 would induce higher costs in terms of capital needs and implementation costs compared to the baseline for banks not currently subject to any Pillar 2 measures increasing their NPEs provisioning. Additional costs would also exist for banks subject to Pillar 2 measures in case these measures are insufficient to fully address the under-provisioning of NPEs.

Option 2 would potentially be costlier at an earlier stage than Options 1 and 3 as the potential deduction would trigger immediately the first year following the classification as NPE, and would be less risk-sensitive than under Option 3. However, choosing a progressive path would help to alleviate this concern as the amount to be covered would be lower in the first years, giving banks time to proactively address the NPEs (including through forbearance measures).

EBA estimates indicate that the option with a *linear* coverage path would lead to an average reduction in EU banks' CET1 capital ratio of equal to 231 to 239 bps on cumulative basis over 20 years, depending on the period after which full coverage is required (6/7/8 years for secured NPEs; see Figure 17).

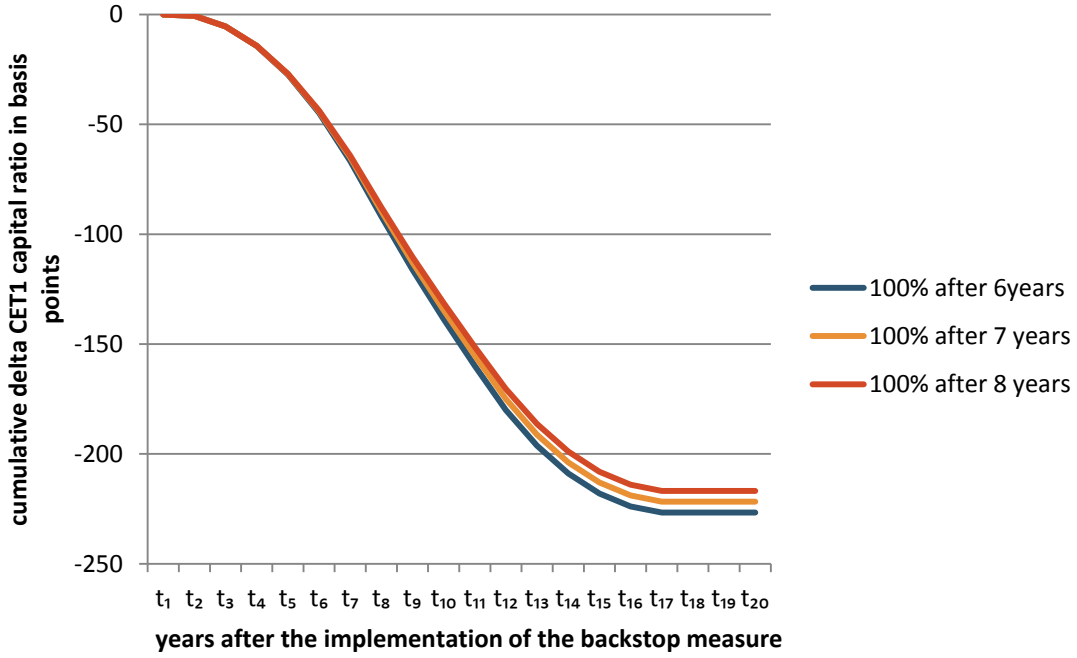
Figure 17: backstop with linearly increasing coverage requirement (cumulative impact, weighted average)




Source: EBA (2018)

However, applying a *progressive* coverage path under this option would slightly lower the average impacts and lead to an average reduction in EU banks' CET1 capital ratio of equal to 217 to 227 bps on cumulative basis over 20 years, depending on the period after which full coverage is required (6/7/8 years for secured NPEs; see Figure 18).

Figure 18: backstop with progressively increasing coverage requirement (cumulative impact, weighted average)




Source: EBA (2018)

### 6.3.3. Impact on key stakeholders

Table 5: Positive and negative impacts, stakeholder type – Option 2

| Impact on key stakeholders | Corporate (including SME) and retail customers as borrowers | Banks | Member States and supervisors |
|---|---|---|---|
| **Positive** | ++ (more stable provision of credit to corporates ) | + + (strong increase in bank resilience in the long term) | ++ (strengthened financial stability, higher growth) |
| **Negative** | ≈ | - (higher capital needs in the short-run) | ≈ (slight increase of human and financial resources) |

*Notes: ++ = strongly positive; + = positive; - = negative; -- = strongly negative; ≈ = neutral/marginal.*

- **Corporate (including SME) and retail customers as borrowers:**

The application of a gradual coverage requirement would be more effective than option 1 in terms of providing incentives and ability to overcome bank's "wait and see" practises at early stages of a defaulted credit. In this way the option reduces financial stability risks associated with NPLs and supports a more stable supply of credit (see section 6.4). As a consequence credit supply for large and smaller corporates would be strengthened, especially during stressed times. As for option 1, the positive effects on total credit availability should be particularly to the benefit of SMEs, because they are depending to a greater extent on bank loans than large corporates.

- **Banks**

In the short run, the own funds of banks that do not meet the applicable minimum coverage level (and that would therefore be subject to the gradual deduction) would decline compared to the baseline. However, all banks would be measured against a common yardstick at each point in time which increases comparability and promotes a level-playing throughout the Single Market. Furthermore, cliff-edge effects at the end of the deduction period would not take place, thus avoiding potentially severe impacts on banks' capital further down.

In the long run, the impacts on banks would be beneficial because, by avoiding that under-provisioned NPEs accumulate and reach unsustainable levels, the backstop would help strengthen their resilience to economic crisis, lowering their funding and administrative costs and protecting their profitability. The prudential backstop would indeed not increase capital requirements for NPEs, but only alter the distribution of capital needs to cover losses on NPEs more evenly over time (without increasing their overall size).

As regards the impact on bank profitability, the same considerations as set out for Option 1 (see section 6.2.3.) apply to Option 1.

- **Member States and supervisors**

By tackling the issue of under-provisioning of NPEs in the most effective way, this option would reduce financial stability risks and foster a more stable credit access for firms and households.

Compared to Option 1 supervisors could focus on more problematic or outlier cases because minimum coverage levels would be required from the first year after the classification of an exposure as non-performing. This would allow for a more targeted use of human and financial resources, thereby increasing the efficiency of the framework.

### 6.3.4. Stakeholders' feedback during the targeted consultation

Public authorities and banks preferred a gradual coverage path over and end-of-period one, mostly for fear of cliff-edge effects in the latter design. Among gradual deduction designs, banks showed some reluctance in respect to a linear path of full coverage requirement, because this approach would be overly conservative in the first years, where the chances to recover the loan or the collateral are higher than towards the end of the period. Consequently, they preferred a progressive path of full coverage requirement which would to a greater extent recognise the current practices in terms of loan recovery and collateral realisation. This was also the view expressed by most public authorities. Some stakeholders argued in favour of full discretion for banks to decide on the path within the defined time period.

## 6.4. Option 3: Statutory backstop with haircuts

### 6.4.1. Benefits

Option 3 would present the same benefits as Option 2 in terms of effectiveness as regard to reducing the ability and the incentives for banks to delay NPEs provisioning, as it would require a minimum coverage requirement in the first years after the classification as non-performing.

However, the haircut approach would be more risk-sensitive because it would distinguish between different types of credit protection. As it would be more granular, it would capture more specifically valuation uncertainties and possible falls in value up to the realisation of the collateral/guarantee. It would also better capture maintenance costs and costs to exercise/sell/liquidate the credit protection. In that regards, it can be assessed as highly coherent with the general principles of the EU credit risk rules, which generally follow a risk-based approach.

### 6.4.2. Costs

As the other options, this option 3 would likely induce accelerated capital needs compared the baseline for banks which do not have sufficient loss coverage for their NPEs and which are not subject to dedicated Pillar 2 measures. As Option 2, these capital needs would kick in earlier than under Option 1.

This option would require banks to implement specific methodologies to apply adequate haircuts depending on the type of credit protection (collateral/guarantee). Compared to the baseline, this would likely imply material implementation costs.

Option 3 would require thorough and lengthy work from the EBA and CAs to list the different types of credit protection and determine the haircuts which could be applied to them.

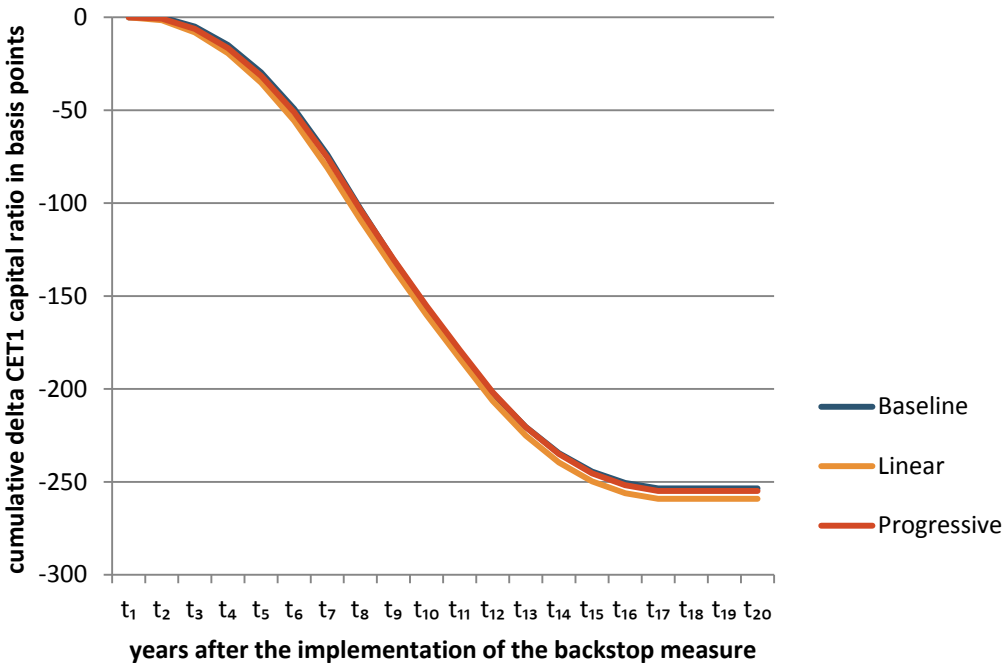
Besides, a backstop focusing on the type of credit protection might send the wrong signal to institutions, as they could be incentivized to base their decision to grant loans depending on the regulatory treatment of the credit protection rather than the ability of debtors to generate cash-flows in the future to reimburse the loan. This tendency observed before and during the crisis is precisely one of the reasons which led to the build-up of NPEs and should be avoided.

Option 3 is therefore poorly efficient in terms of cost to reach the specific objectives set out in section 4.2.

EBA estimates indicate that this option would lead to an average reduction in EU banks' CET1 capital ratio of equal to 248 to 262 bps on cumulative basis over 20 years, depending on (i) the period after which full coverage is required (6/7/8 years for secured NPEs) and (ii) the level of initial haircut applied to the credit protection (20%/30%/40%) as well as on (iii) the approach applied to the unsecured part of NPEs (end-of-period/linear/progressive path). Figure 18 shows

minimal differences in the cumulative (annual) capital impact between the end-of-period (here referred to as 'baseline'), linear and progressive path under the haircut approach where the impact is around 252 to 259 bps for the three approaches.

Figure 18: backstop with haircut approach (100% coverage after 7 years, cumulative impact, weighted average)




Source: EBA (2018)

### 6.4.3. Impact on key stakeholders

Table 6: Positive and negative impacts, stakeholder type – Option 3

| Impact on key stakeholders | Corporate (including SME) and retail customers as borrowers | Banks | Member States and supervisors |
|---|---|---|---|
| **Positive** | ++ (more stable provision of credit to corporates ) | + + (strong increase in bank resilience in the long term) | ++ (strengthened financial stability, higher growth) |
| **Negative** | - (focus on collateral only) | - - (higher capital needs, complexity and IT/administrative costs causing lower profitability in the short term) | - (sizeable increase in human and financial resources) |

*Notes: ++ = strongly positive; + = positive; - = negative; -- = strongly negative; ≈ = neutral/marginal.*

- **Corporate (including SME) and retail customers as borrowers:**

This option would have the same beneficial effect on credit provision stability as option 2. However, as a drawback, option 3 might also encourage banks to base their decision-making when granting loans depending on the collateral value rather than the actual ability of the customer to pay back his loan in the future. This might undermine the objective of reducing the build-up of NPEs.

- **Banks**

As for option 2, option 3 could affect banks capital levels in the short run compared to the baseline, as their own funds would decrease as soon as the loan is classified as non-performing, for those which are subject to the deduction. For banks which already have sufficient coverage, no impact on profitability would occur. The additional complexity of option 3 with respect to option 2 would render the former costlier for banks in terms of operationalisation burden as they would face higher implementation and IT costs. From an administrative costs perspective it would require higher human and financial resources to adequately monitor and manage the credit protection of NPEs.

The same positive effects on long term bank profitability and resilience expected for Option 2 would also be expected to materialise in Option 3.

- **Member States and supervisors**

Option 3 would be effective in a way similar to Option 2 in tackling the issue of under-provisioning of NPEs. However, it would be considerably more complex to implement and supervise. Hence, the beneficial effects in terms of financial stability risk reduction and credit provision would be reduced by the increase in human and financial resources supervisors would need to deploy to oversee the more complex system introduced under this option.

### 6.4.4. Stakeholders' feedback during the targeted consultation

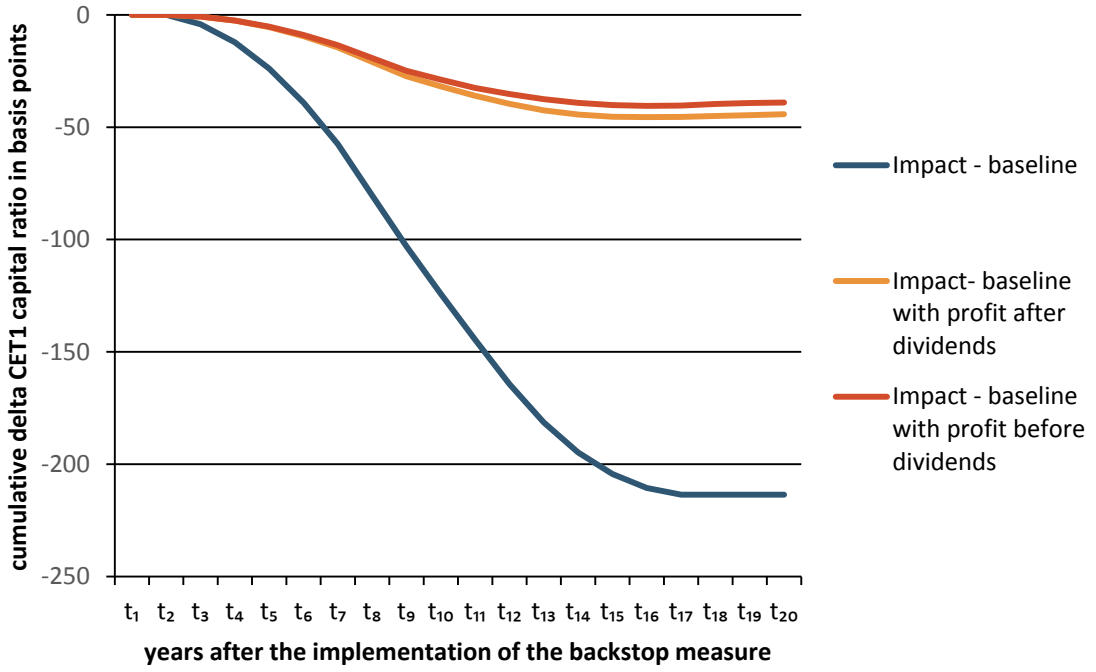
Few banks have showed a preference for the more risk-sensitive and granular framework of Option 3, based on a valuation of the NPEs credit protection. The majority of banks did not find any added value in the approach based on haircuts, arguing that the complexity and the additional implementation costs would outweigh the small benefits they would get in terms of more risk-sensitive deductions. They also did not fully understand the interaction with the regulatory haircuts already applied in the credit risk framework. Public authorities did not express an interest for an approach based on haircuts.

## 6.5. Taking into account profitability (quantitative analysis)

According to EBA estimates, on average the negative impact of the additional coverage on banks' CET1 ratio can partly be offset by the profits generated by institutions and after dividends are paid out. Assuming that institutions use the respective profits remaining after paying out dividends for additional coverage, the cumulative impact on CET1 over the 20 year projection horizon is reduced by around two thirds (e.g. from 205 bps basis points to less than 50 bps, if the end-of-period coverage approach with a 100% coverage after 7 years is used as baseline, see Figure 19).[108]

[108] Note that the impact of the end-of-period coverage approach presented in this section differs slightly from the impact in the main analysis, because 10 institutions without the required supervisory reporting were dropped from the sample, reducing the sample to 117 institutions. To ensure comparability the impact is presented for the reduced sample.

Figure 19: Impact of accelerated coverage (end-of-period coverage approach = baseline) on CET1 with and without considering profits




Source: EBA (2018)

### 6.6. Statutory prudential backstop under an adverse economic situation (crisis)

In the case of severe impairment of EU financial markets GDP growth would sharply decelerate, unemployment rise and therefore default rates on outstanding loans would increase substantially. NPLs will therefore rise. The key question to understand the interactions between a statutory backstop, capital requirements and credit procyclicality is how quick the increase in NPLs would be. History suggests that this increase is slow but persistent: the EA NPLs ratio reached its peak four years after it had increased first at the onset of the crisis.

Without a minimum backstop banks would exert discretion in their NPLs policy, some institutions would act pre-emptively while others would not act until the level of NPLs is jeopardising their viability, attracting investors' attention and pushing their funding costs up. The pervasiveness of pro-cyclical provisioning is well documented across banks and jurisdictions[109] and leads to situations where banks with under-provisioned NPLs are forced to raise capital precisely when risk aversion is at its highest and thus markets are the least willing to provide capital. This forces them to sharply reduce credit provision in order to save the scarce capital available, which adds to the credit tightening that is naturally triggered by an economic downturn. Pro-cyclical provisioning thus translates into pro-cyclical credit provision and wider swings in the economic cycle (from boom to bust). In most severe cases, under-provisioned banks become insolvent or illiquid, thereby threatening the stability of the wider banking system in a typical contagion fashion, with further pro-cyclical effects.

Introducing a statutory backstop would ensure a minimum level of provisioning applied to all banks. This would imply that: a) all NPLs generated before the onset of the crisis have a minimum coverage and thus institutions enter the crisis with more cushion and less legacy risk,

[109] See BCBS (2015) as well as Bikker and Metzemakers (2005).

b) NPLs generated after the onset of the crisis start to be covered before their level reach the point in which the bank's viability is put into question and its funding costs shoot up. Both implications would be counter-cyclical, they would reduce the procyclicality of provisioning, credit supply and thus growth.

## 7. HOW DO THE OPTIONS COMPARE?

The quantitative analysis of the potential impact on bank capital shows that the statutory prudential backstop would lead to an average decrease in the CET1 ratio of 197 to 262 bps after 20 years whereby the cumulative impact is highest for the haircut approach (ranging from 248 to 262 bps) and lowest for the end-of-period deduction approach (ranging from 197 to 213 bps) followed by the progressive deduction approach (ranging from 217 to 227 bps) and the linear deduction approach (ranging from 231 to 239 bps). It needs to be stressed, though, that the results of the quantitative analysis present an upper bound to the estimated effects because of the conservative input variables and the static balance sheet assumption.[110] Furthermore, these results include – and, to a significant extent, seem to be driven by – outliers, as the comparison with median values suggests.[111]

Table 7 compares the baseline to the three policy options in terms of effectiveness in meeting the specific objectives laid down in section 4, the cost efficiency to reach these objectives and consistency with other EU policies. The scores are attributed to each option in comparison to the baseline on the basis of the analysis provided in section 6.

Table 7: Summary of options in terms of effectiveness, efficiency and coherence

| | **Effectiveness** | | **Efficiency** | **Coherence** | **Score** |
|---|---|---|---|---|---|
| | Objective 1<br>To reduce the ability of banks to "wait and see" | Objective 2<br>To reduce the incentives for banks to "wait and see" | | | |
| Baseline | 0 | 0 | 0 | 0 | 0 |
| Option 1 | + | ≈/- | + | - | 1 |
| Option 2 | ++ | ++ | - | ++ | 5 |
| Option 3 | ++ | ++ | - - | + | 3 |

*Magnitude of impact as compared with the baseline scenario: ++ strongly positive (score 2); + positive (score 1); – – strongly negative (score -2); – negative (score -1); ≈ marginal/neutral (score 0).*

Table 7 shows that Options 2 and 3 are the most effective to meet the objectives set out in section 4. Option 3 is however less performing in terms of cost efficiency than Option 2, which is itself less performing than Option 1. Option 2 is the most consistent with other EU policies in comparison with Options 2 and 3. In total, Option 2 scores the best.

Table 8 also shows how the baseline and the options score in terms of stakeholder support and overall level of regulatory ambition. The latter could be an indication of the political challenges which could be triggered by the option.

[110] First, the methodology makes use of historical data which have been collected at time periods where generally high levels of NPEs have been observed (resulting in high projected inflows of NPEs), when generally profitability was very low and where provisioning levels were below today's levels, and extrapolates these inputs to a 20-year horizon. Second, the analysis excludes any kind of dynamic effects but makes the historical parameters static albeit they are likely to change given the economic recovery and banks actions in response to the backstop and possible supervisory measures. In particular, it is expected that banks take actions to change loan origination standards and improve NPE management (such as work-out, restructuring or disposal of NPEs) as a result of the prudential backstop measure, such that the actual impact will definitely be lower. Such behavioural changes however are not taken into account in the quantitative analysis (cf. section 6.).

[111] The steady state median cumulative impact on the median EU bank's CET1 capital ratio is around 132 bps for the end-of-period coverage approach, 152 bps for the coverage approach with linear path and 138 bps for the coverage approach with progressive path (when full coverage is required after 7 years). These figures are significantly lower than the average capital impact signalling the presence of outliers (cf. EBA [2018]).

Table 8: Summary of pros/cons of options in terms of support and ambition

| Option | Effectiveness/efficiency/coherence | Private stakeholders support | Supervisors' support | Level of ambition/challenge |
|---|---|---|---|---|
| Baseline | Low | High | Low | Low |
| 1 | Low (1) | Low | Medium | Medium |
| 2 | High (5) | Low | High | High |
| 3 | Low (1) | Medium | Low | High |

Table 8 shows that Option 2 present the best combination of the criteria of effectiveness, efficiency and coherence underlined by its high score. At the same time, public authorities' support is high for this option, while it is medium for Option 1 and low for Option 3 or the baseline. Private stakeholders such as banks showed little support for Options 1, 2 and 3, as they would prefer to retain the current state of play. Options 2 and 3 are rated to be more ambitious.

## 8. PREFERRED OPTION

In light of the above assessment of the different policy options, the most adequate measure to ensure adequate levels of credit risk provisioning of NPEs is **option 2: statutory backstop with a progressively increasing coverage requirement**. It is the most effective option in achieving the objectives set in section 4. The build-up of the required minimum coverage level is smoother; it starts earlier and progressively increases without cliff-edge effects. EBA estimates[112] indicate that this option would imply manageable impacts on EU banks' CET1 ratio. This option is also preferred by all public stakeholders who responded to the public consultation except one. It is also the option preferred by the vast majority of private stakeholders who responded to the public consultation.

### 8.1 REFIT (simplification and improved efficiency)

This initiative introduces a new tool (minimum coverage requirements for incurred/expected losses on NPEs) which is not simplifying existing legislation. However, it is improving its efficiency by ensuring a standardised minimum level of the existing provisioning rules across the Union. Insofar as this efficiency leads to lower levels on NPLs, the additional efficiency is estimated in Annex 3. It should however be pointed out that other current and past initiatives in the NPLs areas will also impact on NPLs levels, rendering hard a precise disentanglement of the efficiency gains delivered by each measure separately (see Annex 3 for details).

[112] Cf. EBA (2018).

## 9. HOW WILL ACTUAL IMPACTS BE MONITORED AND EVALUATED?

6 to 8 years (depending on the final calibration of the period after which full coverage of NPLs would be required) after the date of application of this initiative, the Commission shall carry out an evaluation. The objective of the evaluation will be to assess, among other things, how effective and efficient the measure has been in terms of achieving the objectives presented in this impact assessment and to decide whether new measures or amendments are needed.

The Commission services would monitor the effects of the retained policy option on the basis of the following non-exhaustive list of indicators:

- *NPL/NPE ratio (amount of NPLs/NPEs as % of total banking sector assets, amount of NPLs/NPEs as % of GDP)*

Controlling for NPLs drivers such as GDP growth, unemployment, policy rates, we would expect a decline in NPLs held in the banking sector following the introduction of statutory backstops.

- *Ratio of NPLs/NPEs covered by provisions and other adjustments*

Coverage for NPLs/NPEs should increase as banks are required to meet certain minimum levels.

- *Cyclicality of credit to non-financial corporations and households (i.e. correlation between GDP growth and growth of credit to non-financial corporations and households)*

As discussed in the problem definition section, high levels of insufficiently covered NPEs increase the procyclicality of credit. The introduction of statutory backstop should therefore reduce credit procyclicality.

- *Cyclicality of the price of credit to non-financial corporations and households (i.e. correlation between GDP growth and interest rates paid by non-financial corporations and households on credit provided)*

High levels of insufficiently covered NPEs also increase the procyclicality of the cost credit (i.e. of interest rates). The introduction of minimum coverage requirements should therefore reduce credit costs' procyclicality.

- *NPL/NPE ratio and coverage ratio country by country*

The lack of a minimum standard for NPLs recognition and loss coverage has caused, together with other factors, different levels of NPLs in different EU jurisdiction. The introduction of such a standard should thus contribute to reduce the variation of both NPL and coverage levels across MSs (*ceteris paribus*).

## ANNEX 1: Procedural information

### 1. LEAD DG, DECIDE PLANNING/CWP REFERENCES

This Impact Assessment Report was prepared by Directorate D "Regulation and prudential supervision of financial Institutions" of the Directorate-General for Financial Stability, Financial Services and Capital Markets Union" (DG FISMA).

The Decide Planning reference of the "Statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing is PLAN/2017/1991, published 9 November 2017.

Ensuring sufficient level of provisioning for losses derived from NPLs is part of the broader strategy of the Commission to deal with NPLs. This possible legislative initiative has been announced in the Banking Union Communication (11.10.2017).

### 2. ORGANISATION AND TIMING

Several services of the Commission with an interest in the assessment of the initiative have been associated in the development of this analysis.

Three Inter-Service Steering Group (ISSG) meetings, consisting of representatives from various Directorates-General of the Commission, were held in 2017.

The first meeting took place on 2 October 2017, attended by DG ECFIN, COMP, GROW, JUST, TRADE and the Secretariat General (SG).

The second meeting was held on 8 November 2017. The representatives from DG ECFIN, JUST, GROW and the Secretariat General (SG) were present.

The third meeting was held on 11 December 2017 and was attended by DG GROW and SG. This was the last meeting of the ISSG before the submission to the Regulatory Scrutiny Board on 6 December 2017.

The meetings were chaired by SG.

DG FISMA has updated the Impact Assessment Report by taking into account the comments made by SG, ECFIN, JUST and GROW. In particular, the following changes were made

- Subsidiarity: justification included that national/supervisory discretion is unfit to addressing the problem.
- Baseline: explanation included on IFRS9, national discretion and Pillar 2 measures.
- Assessment of policy options: a) possible short-term negative impacts of prudential backstops on corporate lending (incl. SMEs), b) clarification that impact of IFRS 9 is considered; and c) feedback from the targeted consultation presented more prominently.

### 3. CONSULTATION OF THE RSB

The Impact Assessment report was examined by the Regulatory Scrutiny Board on 17 January 2018. The Board gave a positive opinion (without reservations).

### 4. EVIDENCE, SOURCES AND QUALITY

The impact assessment has been carried out with the comprehensive qualitative and quantitative evidence from:

- Targeted consultation carried out by the Commission in November 2017;
- Impact analysis by the EBA
- Other sources used: ECB, ESRB, IMF, FSC, World Bank, Vienna Initiative for NPL reduction, EBRD, SSM report and other studies and papers referred to in the Text.

## ANNEX 2: STAKEHOLDER CONSULTATION

The Commission has consulted stakeholders in targeted ways. Below a list of the most important consultations:

- **Targeted public consultation during November 2017**: 38 contributions received from private stakeholders (banks and interest groups) and public stakeholders (supervisory authorities and MSs).
- **Meeting with representatives of Ministries of Finance at the Council Financial Services Committee on 6 November 2017**
- **Bilateral Meeting with stakeholders** (i.e. bank associations, industry, SME representatives etc.) **(on-going)**
- **Banking expert group meeting on 25 September and 14 December 2017 (a closing meeting is scheduled for 26 February 2018)**

## 1. TARGETED CONSULTATION

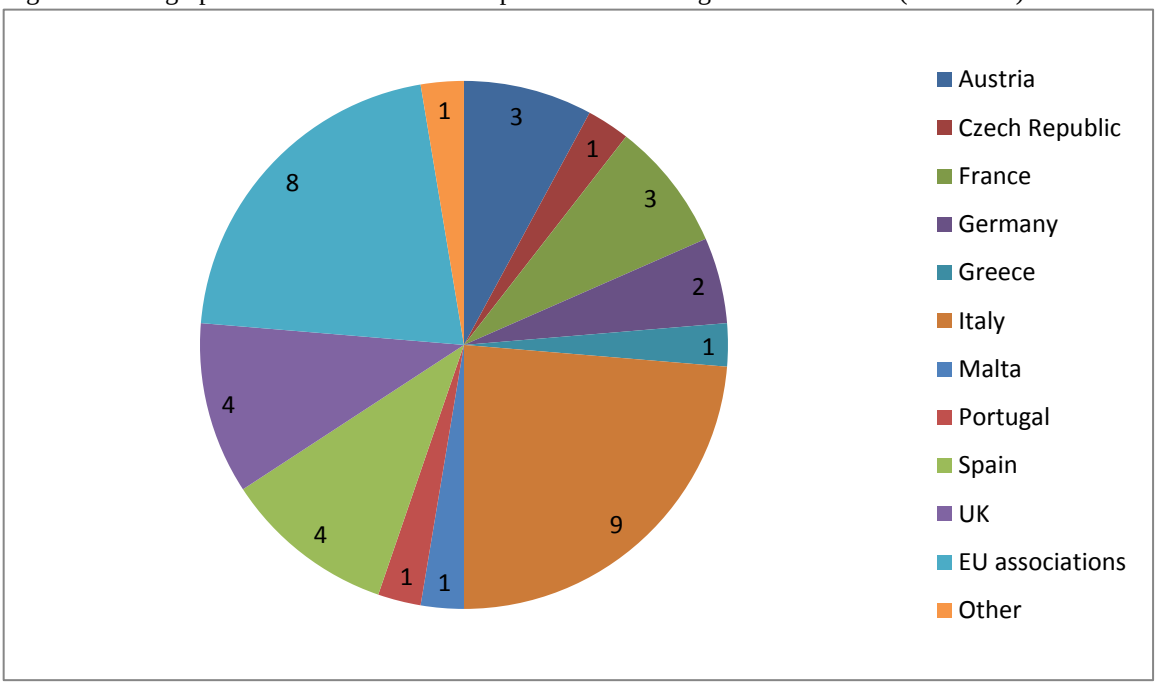
### 1.1. Context and coverage

The Commission held a targeted consultation during November 2017 to assess the opportunity of introducing a prudential common backstop to tackle under-provisioning NPLs.

The objective of the consultation was to collect views of private and public stakeholders on the feasibility of a prudential backstop, on its usefulness, on its possible design and on its possible unintended consequences. The questions covered all three policy options analysed in this impact assessment.

The consultation was open to the public; most answers came from banks or banking associations, a few came from supervisors. In total, 38 answers were received: 29 from private stakeholders including one private individual, and 9 from public stakeholders. Geographical distribution of the replies is not balanced, as most replies came from Member States with the highest NPLs ratios.

Figure 12: Geographical distribution of the respondents to the targeted consultation (38 in total)



### 1.2. Need for a prudential backstop

- Banks or banking associations:

A few respondents from the private sector acknowledged the importance of a harmonised EU treatment. They pointed out the fact that IFRS 9 leaves too high discretion to set loan loss provisions, which would hamper the comparability between banks.

Most of the banks or banking associations which answered to the consultation did not see the benefits of introducing a prudential common backstop. They would prefer IFRS 9 to be fully implemented to assess afterwards if a prudential backstop is still needed. They also believe that Pillar 2 measures are sufficient to address on a case-by-case basis potential under-provisioning of NPEs.

- Public authorities:

All public respondents except two insisted on the relevance and usefulness of a prudential backstop. Some pointed out that such backstop would adequately complement accounting rules, although the latter would remain the main tool to tackle under-provisioned NPEs.

The two public stakeholders not in favour of a prudential backstop would prefer to leave time to IFRS 9 to be implemented before assessing again whether such backstop is needed.

### 1.3. Feasibility of a prudential backstop

- Banks or banking associations:

A few banks consider feasible a prudential common backstop, and not too burdensome to implement.

Some banks showed reluctance for an automatic deduction which would not sufficiently take into account forbearance measures (as forborne loans can still fall under the non-performing category while the counterparty meets its requirements). They insisted on the need to distinguish between "going-concern" loans (i.e. where the counterparty is able to meet its obligations after the application of forborne measures) and "gone-concern" ones (i.e. where the counterparty is defaulted).

Some stakeholders would also favour recognising value to the collateral even after the time period of 6 to 8 years, for instance by waiving the applicable of the backstop in case the credit protection is still considered effective after assessment by an independent expert.

Some respondents also disagree with the proposed time period for secured NPEs of 6 to 8 years, arguing that the length of judicial proceedings differs between countries, and by way of consequence that the proposed time periods should be longer to ensure all cases are covered. Alternatively, different time periods could be applied depending on the type of NPEs.

Other options were proposed by some banks, such as strengthening the credit risk models to require more conservative collateral valuation or higher credit risk haircuts.

- Public authorities:

Almost all public stakeholders considered the backstop as feasible, pending some technical clarifications.

Some public authorities recommended analysing the possibility of having longer periods than 2 years for unsecured NPEs or 6 to 8 years for secured ones, based on a benchmark across Member States.

Some respondents would also prefer recognising value to the credit protection of secured NPEs even after the defined time period has elapsed, and distinguishing between forborne loans where

the counterparty is able to meet its obligations and NPEs where the counterparty really defaulted. Some also advocated excluding from the scope of the prudential backstop loans where the counterparty is only "unlikely to pay" but is still not in default.

### 1.4. Design of a prudential backstop

*a) Option 1 (end-of-period full coverage requirement)*

- Banks or banking associations:

Some respondents preferred not to give any preference to the three proposed options, as they are against the introduction of any kind of backstop.

Among those which gave preferences, most showed reluctance to set an end-of-period full coverage requirement which would lead to important cliff-effects. Banks would prefer to smooth the impact of the deduction over several years. Some also suggested differentiating between banks specialised in managing NPLs and the others. Those whose core business is to purchase and manage NPLs should be given a longer time period before full provisioning than traditional banks.

- Public authorities:

Supervisors and other public stakeholders did not express support for an end-of-period deduction option, as cliff-effects might be too high.

*b) Option 2 (gradual full coverage requirement)*

- Banks or banking associations:

This option attracted the support of most respondents among those which expressed a preference between the three options. They favour in particular a progressive path of coverage requirement, as it would reflect more adequately the actual decrease in the proportion of NPLs (loans are more likely to be recovered in the first years after their classification as non-performing, i.e. it would be more justified to require lower coverage level at the beginning to give time to recover the loan or collateral in the first years).

- Public authorities:

Most of public stakeholders would favour a progressive approach rather than a linear one, as it would better recognise early recoveries of loans. One respondent favoured a linear approach for unsecured NPEs only, and another one would favour linear approach for both types of NPEs.

For the same reason, one respondent suggested starting the gradual increase of the coverage level requirement only after a certain number of years after classification as non-performing, before reaching 100% at the end of the defined time period.

Another respondent proposed to combine Option 1 (end-of-period requirement) for unsecured NPEs with Option 2 (progressive path) for secured NPEs.

*c) Option 3 (haircut approach)*

- Banks or banking associations:

Two respondents from the banking sector supported an approach based on haircuts, as it would be more risk-sensitive.

Other banks did not show any appetite for Option 3 as it would lead to undue complexity and possible double-count with the haircuts already applied in the credit-risk framework.

- Public authorities:

Most of public stakeholders did not favour an approach based on haircuts, which would be unduly complex and would require high amounts of resources to determine the appropriate levels of haircuts.

Other more technical questions were asked to the public on the methodology for collateral valuation, on its recoverability and on prudent valuations requirements for assets and off-balance sheet items valued at amortised cost. Most of the respondents either agreed with the proposed way forward (if any) or did not express any views. Some argued that collateral valuation should remain the main driver to assess the need of prudential coverage. Most of the stakeholders did not favour a common binding methodology for collateral valuation, although some public authorities and one private stakeholder did.

### 1.5. Possible unintended consequences of a prudential backstop

- Banks or banking associations:

Some banks argued that a prudential backstop would induce higher mortgage or loans pricing (through a higher LGD). It might also have an important impact on the volatility of their CET1 as non-performing loans might perform again after a few years or might be recovered after the defined time periods (i.e. after a full coverage will already have been imposed) in jurisdictions where judicial procedures are longer. According to them, this could have an impact on the overall financing of the real economy.

Other respondents also argued that imposing a time limit after which full coverage of NPEs should be applied might incentivise banks to fire sale NPEs at very low prices.

Another drawback of the introduction of a backstop according to some respondents would be that banks are incentivised to enforce the collateral of secured loans as soon as the counterparty defaults, potentially increasing its difficulties.

- Public authorities:

Most of the supervisors did not see any unintended consequence of the introduction of a prudential backstop.

Some public authorities however pointed out the risk to decrease debtors' chances to recover in case banks enforce as quickly as possible the collateral of secured loans.

Some also pointed out the risk to incentivise banks to grant secured loans rather than unsecured ones in order to benefit from a longer time period before the full coverage requirement kicks in.

## 2. EXPERT GROUP ON BANKING, PAYMENTS AND INSURANCE (EGBPI) MEETINGS

**An EGBPI meeting was organised on 25/09/17 to collect Member States views on the micro-prudential aspects of the Commission envisaged work on NPLs.**

The Commission explained its intention to issue an interpretation of Art 16 SSMR and Art 104 CRD IV and to introduce a dedicated recital giving further details on these articles, hence clarifying that EU legislation (already) provides supervisors with powers to address risks stemming from NPLs, including the power to influence a bank's provisioning level and to require specific adjustments to own funds where necessary for prudential purposes.

Moving beyond this interpretation, the Commission explained to Member States considering, within the framework of the ongoing review of the CRR/CRD IV, the introduction of statutory prudential backstops to prevent the build-up and potential under-provisioning of future NPLs stocks across Member States and banks. The Commission mentioned the need to conduct an

impact assessment, preceded by a short public consultation; on the basis of this impact assessment, the Commission will decide on how to proceed.

Regarding the clarification of existing supervisory powers, one Member State enquired about the exact mechanism that would be used to clarify existing powers. The Commission clarified that a recital is the most effective and time-efficient manner to do so. It is Commission's opinion that the powers are already present, so clarifying through a recital is the most suitable way forward. Responding to a question from another Member State, the Commission explained that this also constitutes a public clarification, as it will also be part of the SSM Review report. This Member State also enquired about the potential consequences of extending powers. The Commission made clear that there is no question of an extension of powers, only clarifying what already exists in the legislation. A third Member State welcomed Commission's interpretation, although conveyed its preference for Level 1 legislative text. The Commission emphasised that the recital in fact constitutes Level 1. As regards questions about the timing of the interpretation, the Commission emphasised that it is not and cannot be late, as the legislation already exists.

Concerning the potential introduction of statutory prudential backstops, a Member State asked whether the process would entail only an impact assessment or would also involve calibration. The Commission indicated that it would indeed perform the necessary calibration. Another Member State suggested the need to take into account IFRS, but another one cautioned, however, that discussions about IFRS should not be reopened. A Member State stated that it would also be warranted to consider the stock of NPLs, rather than only future flows. The Commission responded that the Action Plan only asked to look at new loans, so this will be the focus. Lastly, following a comment from a Member State about the method, the Commission explained that, since the banking package has nothing on credit risk, a new proposal is the only option going forward.

**Another EGBPI meeting took place on 14/12/17 on all Commission's initiatives on NPLs being currently in the making.**

The Commission presented the consultation paper which was published in November 2017 on a possible prudential backstop to tackle insufficient provisioning of NPLs. At the same occasion, the SSM also presented their consultation document on an Addendum to the guidance on NPLs already published in March 2017. All Member States welcomed the envisaged initiative of the Commission and indicated their support for the introduction of a prudential backstop. Some Member States showed support for a deduction approach following a progressive path. Several Member States insisted on the need to introduce it quickly in the legislation, to use the benign economic circumstances and bring clarity to banks and other stakeholders. The Commission recalled its intention to present a legislative proposal, if any, at the same time as the other NPLs initiatives in Spring 2018. A few Member States recommended distinguishing between loans which are "unlikely to pay" or "past due" and those which are defaulted. In their views, the former could be subject to longer time period before full coverage than the latter. The Commission (backed by the EBA and the ECB) recalled however the need to use a harmonised definition of NPLs, as already used by the EBA for supervisory reporting purposes. This definition includes loans which are "unlikely to pay". One Member State inquired how loans recovery values would be taken into account. The Commission confirmed that any deducted amount which would be recovered by the bank would be added back to its CET1. Other technical questions on the state of play (i.e. delay) of the answer to the Call for Advice were addressed by the EBA.

## ANNEX 3: WHO IS AFFECTED AND HOW?

### 2.1. Practical implications of the initiative

Under the retained option (*option 2: statutory backstop with a gradual deduction*) a harmonized minimum requirement for gradual provisioning of secured and unsecured NPEs will be established at EU level. This EU framework would aim at a minimum level of harmonization across the EU, building on the characteristics of existing national jurisdictions and seeking to avoid disrupting well-functioning markets. This option will require institutions to adjust their NPEs management policies to implement the minimum requirement while supervisors should integrate this in their supervisory conduct.

The retained option is supported by all public stakeholders who answered to the public consultation. It also obtained the highest support of private stakeholders relative to the other proposed options.

### 2.2. Summary of costs and benefits

As explained in the main text, the main objective of this initiative is to foster timelier NPL provisioning so as to reduce NPL build up, which in turn has various negative effects on bank profitability, financial stability, employment and economic growth. Several studies estimated these effects. We use them to provide qualitative estimates of the costs and benefits of this initiative. In other words, we provide indications on the main macro-financial magnitudes that should be affected by this initiative and on their expected direction.

We refrain from quantitative point estimates as these would require modelling of the whole economy and would be based on data on effects of several measures taken to tackle NPLs issues. In practice, most countries that have faced the NPL problem have implemented various policies of NPL reduction together with the statutory backstop. For example, Spain also set up an AMC (named SAREB) where NPLs were transferred from banks and dealt with in an organic and coordinated way. Furthermore, some of the policies were applied to the entire stock of existing NPLs while the statutory backstop would be applied to newly originated loans only. Finally, this initiative (statutory backstops introduction) is twinned with the AECE and the secondary market development initiatives, whose results are expected to be mutually reinforcing (as discussed in section 6.5), and IFRS9 and Pillar 2 measures tackling NPLs were introduced recently. For these reasons, it is hard to disentangle the effect of this single initiative from the others in the package.

The qualitative estimates of this initiative's benefits are presented in the table below.

| ***I. Overview of Benefits (total for all provisions) – Preferred Option*** | | |
|---|---|---|
| ***Description*** | ***Amount*** | ***Comments*** |
| ***Direct benefits*** | | |
| Lower cost of funding for issuers | Reduction of bank average funding cost | Stakeholders who benefit:<br>a) issuers<br>b) citizens (firms and households) |
| More efficient banks | Reduction of average interest margin charged to customer | Stakeholders who benefit:<br>a) issuers<br>b) citizens (firms and households) |
| Lower due diligence costs | Reduction of costs related to assessing a bank's coverage of problematic loans | Stakeholders who benefit:<br>a) investors |
| Easier comparability of NPEs for supervisors | Reduced discretion in NPLs reporting standards | Stakeholders who benefit:<br>a) institutions |

| *Indirect benefits* | | |
|---|---|---|
| Higher economic growth | Increase of EU GDP growth | Stakeholders who benefit:<br>a) issuers<br>b) citizens (firms and households)<br>c) institutions |
| Lower unemployment | Reduction in EU unemployment | Stakeholders who benefit:<br>a) citizens (firms and households) |
| Lower risks of financial instability | Removal of "pockets of risks" due to under provisioning in some part of EU financial markets/credit institutions – Lower contagion risk | Stakeholders who benefit:<br>a) issuers<br>b) citizens (firms and households)<br>c) institutions |
| Higher credit provision | Increase in credit growth | Stakeholders who benefit:<br>a) issuers<br>b) citizens (firms and households) |
| More liquid secondary markets for NPEs | Reduced uncertainty on NPL portfolios' fair value, narrower bid-ask spreads | Stakeholders who benefit:<br>a) issuers<br>b) investors |

Source: own estimations and Nkusu (2011); "Vienna Initiative" (2012); and ESRB (2017)

| *II. Overview of costs – Preferred option* | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | Citizens/Consumers | | Businesses | | Administrations | |
| | | One-off | Recurrent | One-off | Recurrent | One-off | Recurrent |
| **Introduction of statutory backstop** | Direct costs | N/A | N/A | Administrative and compliance costs for implementing changes (IT systems, legal advice..): minimal as provisioning is already part of SREP procedure applied to all EU banks, systems should only have to be adapted | Accelerated provisions required by the statutory prudential backstops (EBA estimates): cumulative average impact on CET1 ratio between 197 and 262 bps after 20 years | Adjustment to new supervision rules | N/A |
| | Indirect costs | Stronger provisioning requirements may reduce lending available to some segments in the short run | N/A | N/A | N/A | N/A | N/A |

## ANNEX 4: PROVISIONING RULES FOR PROBLEM LOANS ACROSS THE GLOBE – OVERVIEW

| Area | Country | Substandard<br><br>ranges from 30 to 91 days past due | Doubtful<br><br>ranges from 91 to 150 days past due | Loss<br><br>ranges from 150 to 361 days of past due | Secured or unsecured part of problem loan and other comments | Source |
|---|---|---|---|---|---|---|
| Asia- Pacific | China | 25% | 75% | 100% | NA | 2003 WB |
| Asia- Pacific | Hong Kong | 20-25%<br><br>90<dpd<180 | 50-75%<br><br>dpd > 180 | 100% | % range depends on partly secured/unsecured. % are "benchmark provisioning levels" by CA | 2003 WB, Hong Kong Monetary Authority |
| Asia- Pacific | Indonesia | NA | NA | NA | Requirement mentioned in BCBS stocktake 2015 but % not available | BCBS stocktake 2015 |
| Asia- Pacific | India | 15% secured<br><br>25% unsecured | 25% for secured doubtful < 1Y pd<br><br>40% for 1Y < secured in doubtful category < 3Y.<br><br>100% for unsecured and secured doubtful > 3Y | 100% | Entire loan should be written off for category "loss" | BCBS stocktake 2015, Reserve Bank of India 2015 |
| Asia- Pacific | Japan | 15% (2003) dpd < 180 | 70% (2003) | 100% (2003) | Unsecured part (% to value net of collateral value) | BCBS stocktake 2015<br><br>2003 WB |

| | | | | | | |
|---|---|---|---|---|---|---|
| Asia-Pacific | South Korea | 20% | 50% | 100% | higher provisioning requirements for residential housing and credit card loans relative to corporate loans in place since December 2006 | BCBS stocktake 2015<br><br>2003 WB |
| Asia- Pacific | Singapore | 10% | 50% | 100% | Unsecured part (% to value net of collateral value) | BCBS stocktake 2015 |
| Asia- Pacific | Thailand | NA | NA | NA | Requirement mentioned in BCBS stocktake 2015 but % not available | BCBS stocktake 2015 |
| Europe | Albania | Min 20%<br><br>61 < dpd <90 | Min 50%<br><br>91 < dpd< 180 | Min 100%<br><br>dpd > 180 | Unsecured part (% to value net of collateral value) | 2014 WB |
| Europe | Bosnia | 16%-40%<br><br>90 <dpd<180 | 41%-60%<br><br>181<dpd<270 | 100%<br><br>dpd > 271 | | 2014 WB |
| Europe | Georgia | 30%<br><br>31<dpd<90<br><br>61<dpd<120 | 50%<br><br>91<dpd<120<br><br>121<dpd<150 | 100%<br><br>dpd > 150 | Dpd calibrated on fully secured and partially secured/unsecured loans. | 2014 WB |
| Europe | Kosovo | Min 20%<br><br>61 <dpd< 90 | Min 50%<br><br>91 <dpd< 180 | Min 100%<br><br>dpd > 180 | Unsecured part (% to value net of collateral | 2014 WB |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | value) | |
| Europe | Macedonia | 20%-45%<br>61<dpd<120 | 45%-70%<br>121<dpd<240 | 70%-100%<br>dpd > 241 | | 2014 WB |
| Europe | Montenegro | 20%-40%<br>91<dpd<270 | 70%<br>271<dpd<364 | 100%<br>dpd >365 | Unsecured part (% to value net of collateral value). Write off NPL after 24 months | 2014 WB |
| Europe | Russia | 20% | 50% | 100% | | 2003 WB |
| Europe | Serbia | 15%<br>60<dpd<90 | 30%<br>91<dpd<180 | 100%<br>dpd >180 | Unsecured part (% to value net of collateral value) | 2014 WB, EBRD feedback 2016 |
| Europe | Turkey | NA | NA | NA | % not available | BCBS stocktake 2015 |
| **European Union** | | | | | | |
| EU | Czech Republic | 20%<br>91<dpd<180 | 50%<br>181<dpd<360 | 100%<br>dpd>360 | | 2014 WB |
| EU | Croatia | 30-70%<br>181<dpd<270 | 70-100%<br>271<dpd<365 | 100%<br>Dpd > 365 | Unsecured part (% to value net of collateral value) | 2014 WB, EBRD feedback 2016 |
| EU | Hungary | 11% | 31% | 71% | Unsecured part (% to value net of collateral value) | 2014 WB, EBRD feedback 2016 |
| EU | Poland | 20%<br>60<dpd<90 | 50%<br>91<dpd<180 | 100%<br>dpd >181 | Unsecured part (% to value net of collateral | 2014 WB, EBRD feedback 2016 |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | value). Write off NPL after 12M | |
| EU | Romania | 20%<br><br>0<dpd<30 | 50%<br><br>31<dpd<60 | 100%<br><br>dpd>90 | | 2014 WB, EBRD feedback 2016 |
| **Euro Area** | | | | | | |
| ***Member State*** | ***Binding/non-binding*** | ***Provisioning calendar*** | ***Write offs calendar (excluding write offs in case of bankruptcy proceedings)*** | ***Legal source*** | ***Unsecured/ secured*** | ***Source*** |
| ES<br><br>Spain | Provisioning % are offered in the accounting circular (binding regulation) as an alternative to the use of estimations of provisions derived from banks' internal accounting methodologies; such alternative solutions are to be used by banks unable to develop sound accounting methodologies for collective estimations of provisions (e.g. lack of appropriate data). Additionally, the provisioning percentages are to be used as benchmarks for the different portfolios by banks developing | Provisioning calendar depending of time and the kind of the portfolio (on unsecured part, i.e. collateral to be deducted from amount of the loan before provisioning applied) | 100% write offs for:<br>• Doubtful exposure > 4Y past due or<br>• Doubtful unsecured exposure < 4Y past due and with 100% provisioning for at least 2Y<br>• Doubtful secured exposure < 4Y past due and with 100% provisioning for at least 2 years and effective collateral < 10% GBV | New Annex IX, BdE accounting powers | Ranges depends on secured/unsecured | BCBS stocktake 2015 |

| | | | | | | |
|---|---|---|---|---|---|---|
| | their own collective estimations and by supervisors. | | | | | |
| Slovenia | Binding | | • Unsecured loans or exercised contingency off balance sheet > 1Y past due<br>• Loans or exercised contingency secured by real estate collateral off balance sheet > 4Y past due and no realization of collateral during 4Y | 2015 Bank of Slovenia Regulation on the assessment of credit risk losses of banks and savings banks | Distressed loans (H loans) to be written off after 180 dpd | BCBS stocktake 2015 and WB 2003 |
| Latvia | Non-binding but "Basis for supervisors' analysis and comparisons" (i.e. benchmark levels)<br><br>Applied if supervisors consider institution's assessment to unsatisfactory | Loans Substandard Min 30% Doubtful Min 60%<br><br>Loss Min 100%<br><br>Substandard = 31< dpd <90<br><br>Doubtful = 91< dpd < 180<br><br>Loss = dpd > 180 | | FKTK Regulations on Valuation of Assets and Supervisory Provisioning<br><br>(amended in 2015) | | IDB 2011<br><br>2003 WB |
| Portugal | Non-binding comply-or-explain prudential guidance | Minimum level of provisioning for NFC loans depending on the occurrence of specific conditions.<br><br>7 impairment intervals are | | Circular No 02/2014/DSP | Dynamic provisions available: higher provisionin g when bank's credit growth exceeds pre-determined | IDB 2011 |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | provided and, for each interval, specific conditions are described. | | | threshold | |
| **Area** | **Country** | **Substandard**<br><br>ranges from 30 to 91 days past due | **Doubtful**<br><br>ranges from 91 to 150 days past due | **Loss**<br><br>ranges from 150 to 361 days of past due | **Secured or unsecured part of problem loan and other comments** | **Source** |
| Latin America | EC<br><br>Ecuador | NA | NA | 100% consumer loans > 120dpd, commercial loans > 270dpd, microcredit > 90dpd, mortgage loans > 730dpd | | IDB 2011 |
| Latin America | MX<br><br>Mexico | NA | NA | 100% consumer loans > 126dpd, commercial loans > 240dpd, microcredit > 126dpd, mortgage loans > 210dpd | | IDB 2011 |
| Latin America | PE<br><br>Peru | NA | NA | 100% consumer loans > 120dpd, commercial loans > 365dpd, microcredit > 120dpd, mortgage loans > 365dpd | Dynamic provisions available: higher provisionin g when GDP growth exceeds a threshold. | IDB 2011 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Middle East | SA<br><br>Saudi Arabia | NA | NA | NA | Requirement mentioned in BCBS stocktake 2015 | BCBS stocktake 2015 |
| North America | Unites States | Banks must suspend and reverse interest income on NPLs once the loan is 90 dpd on any payment or is deemed uncollectible in whole or in part (i.e., the non-accrual principle | "Charge off" of consumer loans after 120 days past due for a closed-end (instalment) account. In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process. | "Charge off" of consumer loans after 120 days past due for a closed-end (instalment) account. In lieu of charging off the entire loan balance, loans with non-real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.<br><br>"Charge off" of consumer loans after 180 dpd:<br><br>(i) Unsecured open-end (revolving) account.<br><br>(ii) Open- and closed-end loans secured by residential real estate, a current assessment of value should be made by 180 dpd. Any outstanding loan balance in excess of the value of the property, | | Uniform Retail Credit Classification and Account Management Policy, 65 Fed. Reg. 36903 (June 12, 2000) |

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | less cost to sell, should be classified Loss and charged off. | | |

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