EUROPEAN CENTRAL BANK
BANKING SUPERVISION

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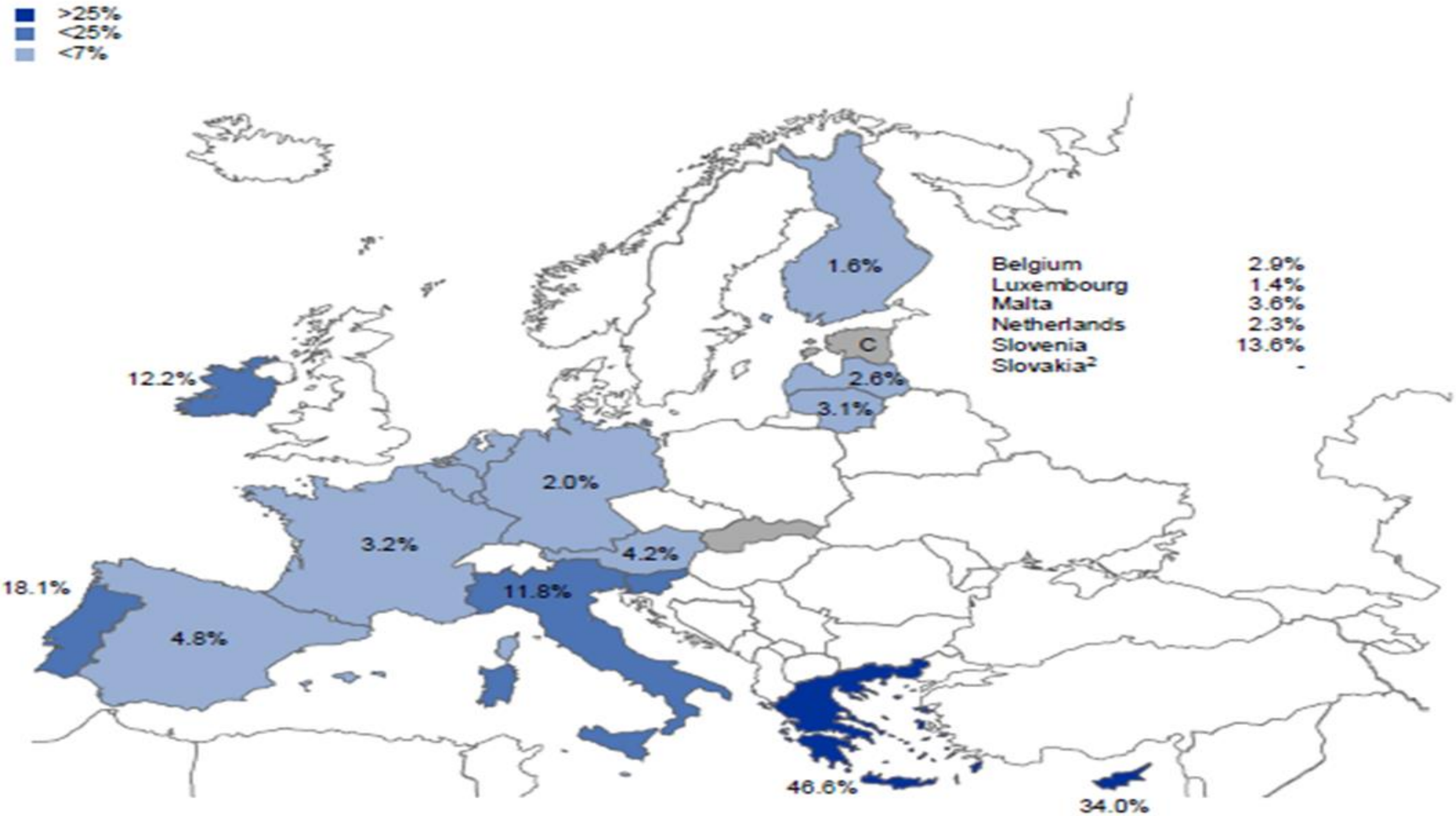
ECB Guidance to banks on NPL’s

World bank conference

15/16 May 2018, Vienna

Non –Performing loans – European perspective

Non-performing loans and advances[1] – ratios by country, reference period Q2 2017



Source: ECB.
Notes: SIs at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available.
C: the value is not included for confidentiality reasons.
1) Loans and advances in the asset quality tables are displayed at gross carrying amount. In line with FINREP: (i) held for trading exposures are excluded, (ii) cash balances at central banks and other demand deposits are included.
2) There are no SIs at the highest level of consolidation in Slovakia.
Some FINREP are net of NPL transfers, which are ongoing and expected to be finalised shortly.

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Comprehensive strategy to address NPLs requires action from all stakeholders including EU and national public authorities

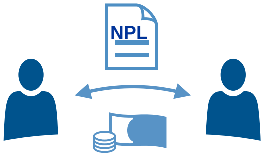
I. Supervisory actions

ECB has clearly and transparently set supervisory expectations

II. Legal and judicial reforms

Reform to legal, judicial and extra-judicial frameworks necessary to create a more favourable environment for NPL workout

III. Secondary markets



Development of the secondary markets and possibly creation of national AMCs

On 11 July 2017, the ECOFIN agreed an action plan to address the problem of non-performing loans in the banking sector

SSM created a dedicated NPL Taskforce in 2015

Supervisory tools developed by the Taskforce

i. NPL guidance (March 2017)
– published on ECB website –

ii. Stocktake report on national practices (June 2017)
– published on ECB website –

iii. Addendum to the NPL guidance (March 2018)
– published on ECB website–

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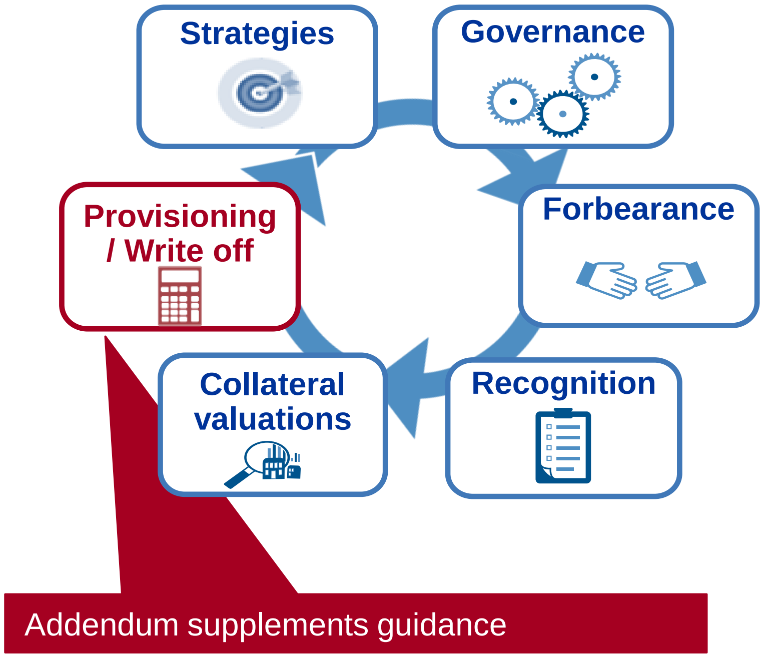
ECB has clearly and transparently set supervisory expectations by publishing NPL main guidance on 20 March 2017

Overview of ECB guidance to banks on NPLs

(final version published in March 2017)



- SSM continues to engage with banks and follow-up on the guidance in the context of normal supervisory interaction
- Key initial area of attention are the strategies of high NPL banks (these are banks' own reduction plans)
- Deliberate and determined action on NPLs is required, and the banks themselves are responsible for implementing realistic and credible strategies to **manage and reduce** their NPL portfolio
- "Wait and see" approaches often observed in the past cannot continue

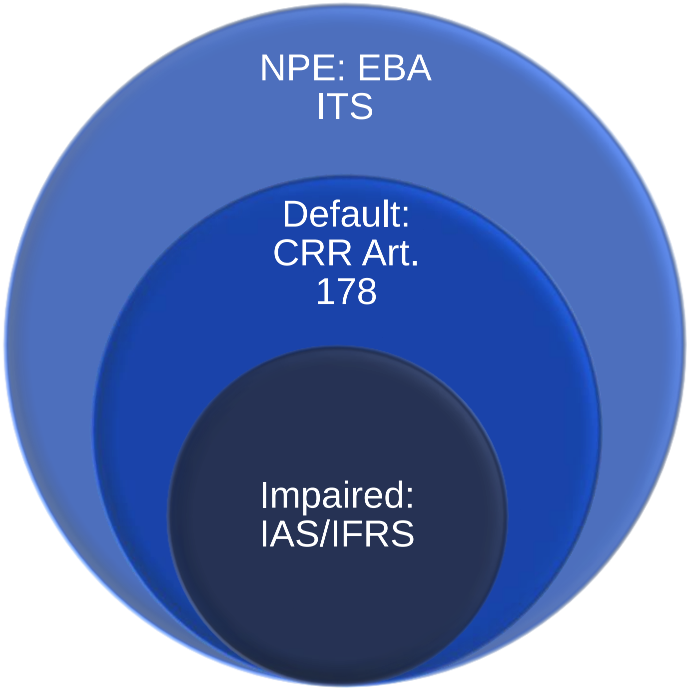
NPE, Default and Impaired

- The NPE, Default and Impaired classifications map as follows:

1. **NPE** – EBA definition acts as a harmonised asset quality concept, and is broader than default and impaired [Commission Implementing Regulation on Supervisory Reporting 680/2014]

2. **Default** – A prudential concept as per CRR article 178. Additionally regulated by:
   EBA/GL/2016/07 "definition of default" (apply from 01 January 2021)

3. **Impaired** – Accounting concept as per IAS 39 / IFRS 9 (from January 2018).



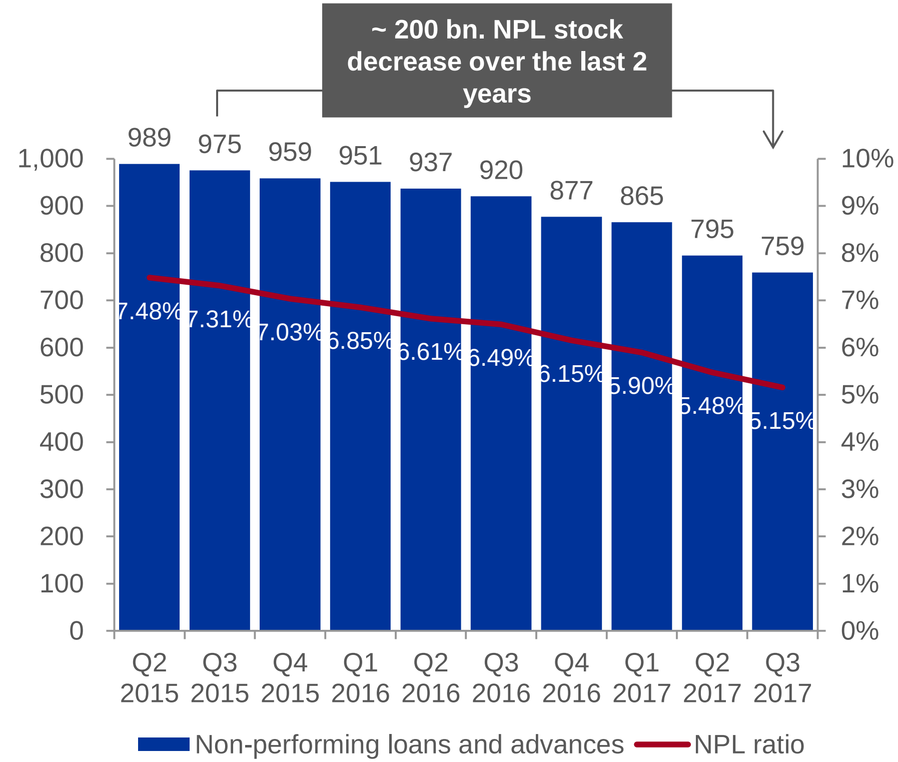
NPE is the broadest of the three definitions!

Strategies

NPL & foreclosed asset reduction strategies

- Guidance requires banks to implement ambitious, yet credible NPL strategies, for tackling the NPL stock
- These are banks' own plans to reduce non-performing exposures and foreclosed assets.
- The joint supervisory teams closely follow and challenge the bank's NPL strategies and the way they are implemented.
- Given that it was the first time for many banks where their NPL strategies are subject to scrutiny, the stringent assessment is an iterative process between the banks and the Joint Supervisory Teams.
- The supervisory assessment also included benchmarking analysis in order to ensure a level playing field and sufficiently ambitious and realistic targets. We have provided banks with our feedback on this in December.

NPL stock and ratio evolution of significant institutions (Q2 2015 – Q3 2017)



Ambitiousness of the strategy: from NPE to NPA

For a number of banks the % NPE reduction also accounts for the share of **NPE's being converted into foreclosed assets** (i.e. taking them on to balance sheet with the objective of selling them over time).

In order to **facilitate a level playing field** and **promote a more consistent calculation**, the focus is on **NPA gross and net reduction**, instead of solely NPE reduction:

- "NPAs" refer to the sum of NPEs: HH & NFC's, and gross foreclosed assets, as defined in Chapter 7 of the ECB Guidance to banks on non-performing loans.
- NPA percentage reduction is measured over 3 year strategy cycle comparing the stock of NPA's at start of period as compared to the stock projected at end of 3 year cycle.
- On-going monitoring of quarterly progress focuses on **'HOW'** the reductions have been achieved via JST assessment of dedicated supervisory quarterly reporting on NPL's & foreclosed assets.

NPL Governance – supervisory expectations

Governance

Governance considerations to enable successful NPE workout:

Segmentation of NPLs

- Viable/Non Viable
- Separate sectoral teams
- Segmented per NPL lifecycle
- Sectoral specific policies

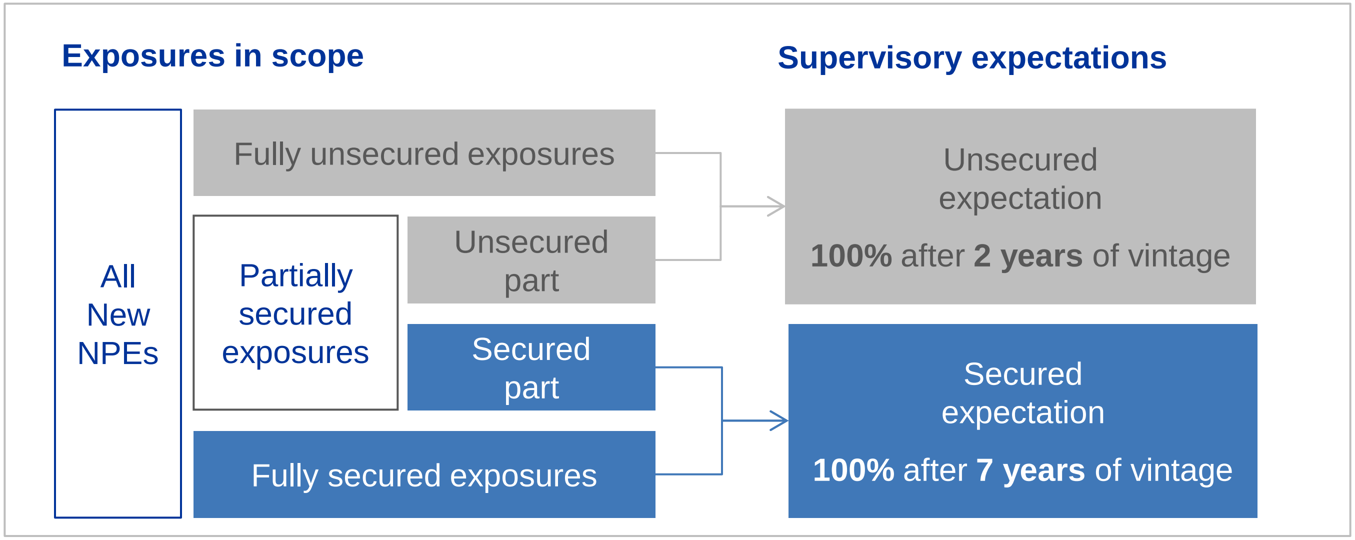
Dedicated and specialised work-out teams can support and foster more successful restructuring:

- Right tools and sectoral analysis?
- Sufficient and reliable financial information?
- Sufficient case managers with expertise?

Robust KPI's support effective operational and strategic monitoring of NPL levels and successes:

- Which types of restructurings are working better than others?
- Re default drivers and reasons?
- Are forbearance policies calibrated correctly

Overview of key features of NPL addendum



- The SSM aims to **determine whether accounting allowances adequately cover expected credit risk losses** at individual banks
- **Expected to be considered by banks for all new NPEs** classified as such from April 2018 (including unlikely to pay)
- **Different expectations** for unsecured and secured exposures
- Secured expectations rely on the prudential principle that **credit risk protection must be enforceable in a timely manner**
- **Deviations from supervisory expectations** do not trigger automatic actions but **form starting point of an institution-specific supervisory dialogue**

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Interactions between NPL work across European stakeholders

- Tackling the NPL issue goes beyond the supervisory tasks.
- **European authorities have launched several initiatives to address the high NPL stock.**
- The **EU Council action plan on NPLs**, announced in July 2017, constitutes a comprehensive policy response to asset quality issues in the EU.
- Several initiatives under the Action plan including (not all actions points listed below):

  - ➢ Addressing potential under provisioning, via automatic and time-bound provisioning (Commission proposal – see annex)
  - ➢ Develop an AMC Blueprint – ***completed***
  - ➢ Develop the focus on insolvency issues in the EU – ***underway***
  - ➢ Strengthen the data infrastructure for NPLs and consider the set-up of NPL transaction platforms – ***underway***
  - ➢ Enhanced disclosure requirements on asset quality and non-performing loans for all banks – ***underway*** .

- **The ECB is fully supportive of the action plan and works closely with all relevant stakeholders on delivering the action points.**

Q&A

Thank you!!

Annex – supplementary slides

Interactions between NPL work across European stakeholders

Key points:

- The European Commission's proposal on statutory provisioning backstops if finalised is a Pillar 1 tool and if appropriately defined **would strengthen the supervisory toolkit** and **complement** the ECB's efforts in Pillar 2, including the Addendum on NPLs.
- **The EC legislative proposal and the ECB addendum are considered complementary by the ECB & the European Commission.**
- Some key aspects:
  - The EC proposal introduces a Pillar 1 requirement acting as a statutory prudential backstop, while the ECB addendum is relevant for the Pillar 2 framework.
  - In line with CRD IV, supervisors have to assess and address institution-specific risks which are not already covered or which are insufficiently covered by the mandatory prudential requirements in the Capital Requirements Regulation (the so-called Pillar 1 rules).
  - The ECB addendum is **non-binding guidance that serves as a starting point** for the dialogue between the supervisor and individual banks ECB Banking Supervision
  - The **ECB will discuss with each bank divergences** from the prudential provisioning expectations laid out in the addendum during the supervisory dialogue. After this dialogue and taking into account the bank's specific situation, ECB Banking Supervision will decide, on a **case-by-case basis**, whether and which supervisory measures are appropriate.

Key aspects of the Commission proposal and the ECB addendum

1. **Calibration:** Minimum requirements and supervisory expectations differ in terms of calibration.
   - ❖ Automatic Pillar 1 rules would apply to all institutions (Commission proposal) treating the average risk case,
   - ❖ While supervisors (ECB addendum) take into account specific situations that might lead to different magnitudes of risk during supervisory dialogues.
2. **Legal basis:**
   - ❖ The Commission proposal will hopefully become part of the Capital Requirements Regulation (CRR) after it has gone through the legislative process and will apply to all banks equally.
   - ❖ In contrast, the ECB addendum is non-binding guidance that serves as a starting point for the dialogue between the supervisor and individual banks.
3. **Timelines regarding implementation**
   - ❖ The EC's proposal will enter into force once the legislative process has been completed
   - ❖ The ECB will discuss with each bank divergences from the prudential provisioning expectations laid out in the addendum during supervisory dialogue. After this dialogue and taking into account the bank's specific situation, ECB Banking Supervision will decide, on a case-by-case basis, whether and which supervisory measures are appropriate.
   - ❖ The result of this dialogue will be incorporated, for the first time, in the 2021 Supervisory Review and Evaluation Process (SREP).
4. **Applicability:**
   - The EC proposal addresses NPLs that will emerge from new loans granted after 14 March 2018.
   - The ECB addendum addresses loans that have been classified as NPLs after 1 April, 2018.