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European Commission publishes its own consultation on statutory prudential backstops for non-performing loans

How does this fit in with the EU's and Eurozone's other NPL workstreams and what does this mean for firms?

On 10 November 2017 the European Commission (the **EC**) published a consultation document on "Statutory Prudential Backstops Addressing Insufficient Provisioning for Newly Originated Loans That Turn Non-Performing" (the **EC's NPL Provisioning Consultation**)[1]. That consultation closes for comment on 30 November. It is likely to have some quite far reaching impact for a breadth of firms. At 12 pages in length it packs quite a punch in terms of proposals. Conceptually there are some similarities to existing EU or Eurozone-specific proposals and this will merit planning along with specific policies, processes, procedures and people on top of prudential capital as well as provisioning.

Aside from this being a very short consultation process, it builds upon the EU Consilium's[2] definitive '**NPL Action Plan**' that was launched in July 2017. To recap, that NPL Action Plan aims to build the work conducted by the European Central Bank (**ECB**) in its role in the Eurozone and the Single Supervisory Mechanism (**SSM**) component of the Banking Union[3]. The ECB-SSM's publication on 4 October 2017 of an Addendum to its NPL Guide (the **NPL Guide Addendum**)[4] has achieved a number of comments, not all of which are positive and was very vocally discussed at the European Parliament's ECON Committee and testimony of the Chair of the SSM's Supervisory Board on 9 November 2017[5].

Even if the NPL Addendum may be subject to further tweaks, the EC's NPL Provisioning Consultation and the proposals therein would, in delivering on the NPL Action Plan's goals, apply to the EU-27 as opposed to just the ECB-SSM's rule changes and measures on provisioning that would primarily affect the Eurozone. The ECB-SSM's NPL Guide applies to non-performing loans and non-

[1] Available here: https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf

[2] A legislative body of the European Union that is comprised of varying representatives of the executive governments of the Member States of the EU. The Consilium develops and coordinates EU Member State's policies in specific fields, negotiates and adopts EU legislative instruments, concludes international agreements and adopts the EU's budget.

[3] See our coverage on this and the context is available here: http://www.bakermckenzie.com/en/insight/publications/2017/07/eu-sets-marching-orders

[4] See our coverage on this and the context available here: http://www.bakermckenzie.com/en/insight/publications/2017/10/ecb-ssm-npl-guide-addendum

[5] Introductory statements available here: https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp171109.en.html

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performing exposures (**NPE**s), whereas the EU-wide NPL Action Plan and the EC's NPL Provisioning Consultation as the first tangible deliverable, applies to non-performing loans.

In any event, this consultation is timely and important in its own right. In short, the EC's proposal on provisioning, like the proposal of the ECB-SSM, will prompt a range of "change the business", "run the business" and "change the compliance" workstreams for financial services firms. This will apply to both those that are holders of NPLs as well as those looking to acquire NPLs.

In terms of steps that firms will need to take, their impact will depend on a number of firm specifics as well as business models types. Some of these steps will be preparatory, i.e., to meet the provisioning regime, which in the case of the ECB-SSM proposal would apply to new NPLs and NPEs that are categorised as such post 1 January 2018. Some of these will also be anticipatory in order to scenario and forward plan how the various items in the EU-wide NPL Action Plan as well as those other steps driven by the ECB-SSM will affect NPL/NPE management within a given firm. Some of that scenario planning will also require an understanding of how the EU plans to apply "targeted adaptations" of ECB-SSM rules on NPLs to the wider EU-27 that the EU NPL Action Plan applies to. Lastly, some of the steps that certain firms will need to take are remedial and may include looking at the degree of ECB-SSM NPL Guide compliance ahead of the 2018 and 2019 supervisory cycles and inspections.

So what does the EC's NPL Provisioning Consultation mean in practice?

As with the ECB-SSM's NPL workstreams and those advancing as part of the EU's wider reaching NPL Action Plan, the EC's NPL Provisioning Consultation sets out justifications for action. In short, these all reiterate that NPLs are the legacy hangover from the 2007 financial crisis and absent remedy put further stresses on financial institutions. Failure of legislators, regulators and supervisors in terms of policy solutions and failure by addresses to act, undermines the finalisation and operation of the Banking Union, advances in the Capital Markets Union project and the general recovery and deepening of the Economic and Monetary Union i.e. the Eurozone.

The rationale for remedying existing NPLs and preventing future NPLs from arising also refers that action is needed so as to promote regulatory and supervisory convergence. That convergence would necessarily preclude the proportionate application of the NPL provisioning principles, i.e., granting certain Member States a degree of gradual compliance as favoured by certain Member States, but it does mean making the Single Rulebook in this area much more uniform.

The EC's NPL Provisioning Consultation goes on to echo a number of statements made by EU-level supervisory authorities along with the ECB-SSM, that the rules of the EU's prudential regulatory regime[6] apply mainly to those firms regulated for EU purposes as credit institutions and MiFID investment firms. In contrast the international driven reforms to accounting treatment, which apply globally, such as IFRS 9 have a far wider reaching impact on a greater body of firms that are either

[6] i.e., CRR and CRD IV, themselves both subject to concurrent amendments at the time of writing hereof.

unregulated or regulated for EU purposes. The EC's NPL Provisioning Consultation[7] specifically states:

> "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. However, the new standard still leaves room for discretion in the valuation of NPLs as well as of the underlying collaterals and, by consequence, in the determination of provisions."

It goes on to explain that:

> "In order to effectively address on a systematic and EU-wide basis the potential under-provisioning for new loans that become non-performing, a prudential minimum treatment acting as a backstop, which would be directly applicable to all EU institutions (so called Pillar 1 measure), might be considered. By requiring all institutions established in the EU to set aside capital to cover 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 "prudential backstops" would put on automatic EU-wide brakes on the build-up of future loans that turn non-performing with insufficient loan loss coverage. Statutory minimum coverage requirements can also be expected to provide strong incentives for banks' management to prevent the accumulation of NPLs altogether through better NPL restructuring and stronger origination standards. Finally, minimum requirements set at EU level would not carry national stigma and could rather foster a consistent treatment across Member States and help to restore confidence in the EU banking sector as a whole."

The above is clear in setting the tone that:

- real action needs to be advanced under the NPL Action Plan to replicate the ECB-SSM's successes and to do so for the benefit of the wider EU; and
- failure to act in introducing prudential brakes to the wider body of firms, would undermine restoring faith in the EU's financial services and notably the banking sector.

Consequently, the EC's NPL Provisioning Consultation, aside from being timely in delivering on one of the key components of the EU's NPL Action Plan, also dampens some of the criticism that have been directed by certain parliamentary members, and some within the ECON Committee, towards the ECB-SSM and the rules on provisioning proposed in the draft NPL Guide Addendum. It is conceivable that going forward the ECB-SSM's and the EC's proposals might yield one single set of rules.

What's in a backstop?

The EC's NPL Provisioning Consultation proposes backstops that are made up of two elements:

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[7] Available here: https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf

1. a "**minimum coverage requirement**" (**MCR**) a common minimum level of coverage for incurred and expected losses on loans originated after entry into force of the MCR once such loans are categorised as non-performing. This follows on from existing work and concepts being advanced by policymakers across the EU and ECB-SSM; and
2. where the MCR is not met, a deduction of the difference between the level of the actual coverage and the MCR level from Common Equity Tier 1 (CET1) items (**prudential capital deductions** - i.e., **PCD**).

The following regulatory capital relevant items would be eligible to meet MCR compliance provided they relate to new loans that turn non-performing i.e. 90 days past due or unlikely to be paid without collateral realisation etc.:

a. provisions recognised under the applicable accounting framework ("credit risk adjustments")[8];

b. additional value adjustments in accordance with Articles 34 and 110 CRR,

c. other own funds reductions, and

d. for banks calculating risk-weighted assets (RWAs) using the internal ratings based (IRB) approach, negative amounts resulting from the calculation of expected loss laid down in Articles 158 and 159 CRR ("regulatory expected loss shortfall").

The EC's NPL Provisioning Consultation[9] goes on to clarify that:

> "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 and require deduction of the difference between the two (uncovered exposure amount or "coverage gap") from Common Equity Tier 1 (CET1) items. This deduction would thus ensure that the risks associated with NPLs are appropriately reflected in banks' CET1 capital ratios one way or another."

As with the ECB-SSM's Guide provisions including that of the proposed NP Guide Addendum, that Banking Union Supervised Institutions (BUSIs) directly supervised by the ECB-SSM currently have to comply with, and which will likely be rolled-out to those BUSIs that are indirectly supervised, the prudential backstops introduced here in the EC's NPL Provisioning Consultation would be solely a regulatory capital adjustment to level of "own funds" and not influence accounting provisions nor profit and loss. In contrast the accounting provisions are taken into full account for the purposes of the prudential backstops that are proposed.

Following the proposals of the NPL Guide Addendum, the EC's NPL Provisioning Consultation sets the MCR dependent on the time period (i.e. 'vintage') that a loan has been categorised as non-performing and the level of collateral and guarantees i.e. credit-protection held against the loan. As with the NPL Guide Addendum where no prudent collateral valuation has been performed or the credit protection has not been acted upon then the exposure on the NPL is reallocated from being

[8] "Credit risk adjustment" means the amount of specific and general loan loss provision for credit risks that has been recognised in the financial statements of the institution in accordance with the applicable accounting framework" (Article 4(1)(95) CRR).

[9] Available here: https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf

secured to being unsecured for purposes of the prudential backstops and deductions for purposes of the PCD.

So how is this different to the NPL Guide Addendum?

The EC's NPL Provisioning Consultation is somewhat more simplistic in introducing a PCD approach as opposed to ramping up of provisioning levels within tight timeframes. Those timeframes are roughly similar in that unsecured loans or those reallocated as such MCR levels are to be achieved within two years (as in the NPL Guide Addendum) and for secured loans MCR coverage is to be achieved within six to eight years (the NPL Guide Addendum calls for seven). The EC's NPL Provisioning Consultation is far more flexible in how one gets to those MCR levels. This will matter in relation to any PCD and effectively regulatory capital needs. Moreover, the questions in the EC's consultation, when compared to that of the ECB-SSM focus on testing the feasibility of perhaps a somewhat more flexible solution for affected firms as offered by the EC's proposal.

Whilst the jury is still out, and will be a different jury for each BUSI or other supervised firms, the impact of both approaches will be significant. Based on firm specifics, one can scenario plan which solution one might want to back along with, working with relevant advisers, on what this means from a quantitative perspective, as well as what steps one can take to improve qualitative factors to prevent new NPLs whilst reducing existing inventories. What is certain is that conceptually, the notion of adding some form of discouragement to the current available toolbox so as to prevent future new NPLs from arising is likely to stay.

Please do get in touch with any of our Eurozone Hub key contacts below if you require specialist support with forward planning or testing your compliance with rules, principles and supervisory expectations on NPLs set by the EU level, Eurozone specific as well as by national competent authorities or if you require assistance with responding to the EC NPL Provisioning Consultation or other workstreams advancing as part of the EU's NPL Action Plan.

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