

Banking & Finance
Eurozone Hub

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ECB-SSM launches consultation and publishes Draft NPL-Guide Addendum on prudential provisioning backstops for non-performing exposures (NPL Guide Addendum)

How will the NPL Guide Addendum affect Banking Union Supervised Institutions (BUSIs) and will it interoperate with the EU-27's NPL Action Plan's workstreams?

On 4 October 2017, the European Central Bank (**ECB**), acting in its role in the Single Supervisory Mechanism (**SSM**) component of the Eurozone-19's Banking Union, published a draft of the NPL Guide Addendum¹. This Addendum supplements the supervisory guidance and expectations² contained in the **SSM's NPL Guide**. The NPL Guide has applied to SSM-direct supervised BUSIs since March 2017 and the compliance and business impacts were covered in our standalone Background Briefing³.

The Addendum introduces further "supervisory expectations" on BUSIs and the provisioning of those new non-performing exposures and non-performing loans (collectively herein⁴ **NPLs**) that arise following 1 January 2018. The level of provisioning and vintage of NPLs will also be subject to greater regulatory and public disclosure. This Client Alert assesses the impact of the Addendum and what this means for BUSIs, how this fits in with the wider picture and concludes with an overview of some practical steps that BUSIs may want to take in conjunction with their professional advisors to identify, mitigate, manage and control risks and costs.

What's expected of BUSIs?

In-scope BUSIs are expected to embed and follow the contents of the NPL Guide and the final Addendum in their business operations regardless of whether they

¹ Available here:

https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl2/ssm.npl_addendum_draft_201710.en.pdf

² which read very much like rules.

³ Available here: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/10/ar_germany_backgroundbriefing_2017.pdf?la=en

⁴ and in the NPL Guide plus Addendum, save that the Addendum refers to these as "NPEs". This is perhaps an oversight as the Addendum aims to apply to NPLs and NPEs. If looking at the NPL Guide, notably section 1.3 on page 6 thereof, and as noted in our Background Briefing, the reference in the Addendum goes full circle back to the term NPL. Thus absent this imprecision in the Addendum, the scope of the rules aim to apply to all relevant NPEs and NPLs.

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have NPLs. Those in-scope BUSIs that qualify as "low NPL firms" may apply a more proportionate compliance approach to those that qualify as "high NPL firms". However, a similar distinction does not apply in the current draft of the Addendum.

In any event, the ECB-SSM's supervisory approach to monitoring BUSIs adherence to the NPL Guide is one of a 'comply or explain' approach. This is regardless of whether the BUSI is a no, low or high NPL firm.

For many BUSIs, the NPL Guide's supervisory expectations also meant weighing up the cost of (full) compliance with the contents of the NPL Guide when compared to the cost involved in explaining why a deviation from the NPL Guide is justified. The Addendum's introduction of provisioning, and thus economic and regulatory costs, may shift the pendulum back somewhat on dedicating resources to explaining or justifying a permitted deviation to the ECB-SSM's supervisory expectations in relation to the NPL Guide and its Addendum.

The NPL Guide and its Addendum also have far-wider reaching supervisory effects that go beyond just resolution of existing and prevention of new NPL inventories. BUSIs compliance with the NPL Guide and its Addendum feeds into other ECB-SSM supervisory workstreams and the regulatory capital calculations of BUSIs. In short, for many, the final NPL Guide Addendum will have both "change the business" along with "change the compliance process" impacts. As the NPL Guide and its Addendum apply to all NPLs, and thus the banking and trading books of BUSIs, the effects are potentially quite far-reaching.

What do the new provisioning rules look like?

The Addendum's prudential provisions are referred to as "quantitative supervisory expectations for minimum levels of prudential provisions for new NPLs" (**NPL-QSEs**). All of this aims to deter BUSIs from incurring any new NPLs that would be added to a sizable stock of existing NPLs. Whilst this supervisory aim is understandable this approach is not a panacea nor does it come free from a host of potential, perhaps also unforeseen adverse side-effects as well as costs.

So what exactly qualifies as 'new'? The draft Addendum, building upon the definitions and concepts in the NPL Guide, clarifies that 'new' NPEs/NPLs are those that, following 1 January 2018, are classified or reclassified as non-performing regardless of their status prior to 1 January 2018. Once a NPL is categorised as non-performing, for the purposes of the Addendum, they are given a **NPL vintage count** that is valued at zero.

The NPL vintage count rises over time (i.e. days converted to years) for the same period that the NPL is categorised, with reference to the NPL Guide's definitions and terms etc., as non-performing. The NPL vintage count will only be reset to zero when the NPL returns to being performing (please see our Background Briefing on the NPL Guide on this). This aims to incentivise BUSIs to prevent exposures from becoming NPLs and to also return those new NPLs to performing status.

Moreover, there is no "stop the clock" mechanism on the NPL vintage count as there might be in certain jurisdictions for certain types of retail or home loan products that are in arrears or are non-performing where the Borrower is seen to be cooperating with an agreed restructuring mechanism and/or making minimum

acceptable payments. As discussed in our Background Briefing, rules in Ireland and Spain have similar stop the clock features, and the rules in those jurisdictions to some extent formed the basis of much of what has become the ECB-SSM's NPL Guide.

The Addendum, whilst aimed at discouraging BUSIs incurring new NPLs, also has spillover effects for existing NPLs. As per the above this primarily applies, where an existing NPL requalifies as "new". Consequently, BUSIs will want to take preventive measures to ensure they can forward-plan the amount of existing exposures and NPLs could requalify as new.

However, looking further afield, especially in light of the wider context of how the Addendum fits in, it is conceivable, especially given the wider workstreams on NPLs at the Banking Union and EU level that this could change and provisioning also be applied backward-looking to the existing stock of NPLs. The current draft in Section 2.1 of the Addendum states (clarifications in square brackets and emphasis in bold): "Finally, the backstops [i.e. the NPL-QSEs] are applicable **at a minimum to new NPEs** [and also NPLs] classified as such from [1] January 2018 onward."

So what might the immediate impact of provisioning look like for BUSIs?

Unless the draft Addendum's rules change, BUSIs will have to fully provision for these new NPLs and do so over a certain time period and by reference to the NPL vintage count. Full provisioning means allocating prudential capital up to 100% of the NPL. The 'time period to move' to that full allocation of 100% is determined by reference to whether a NPL qualifies for allocation to the 'unsecured' or 'secured' NPL-QSE category. Partially secured NPLs are split by relevant part and allocated to the unsecured and secured NPL-QSE categories.

For secured NPLs the timeline to move is determined after a given years of the NPL vintage count. For secured NPLs that timeline is seven years. For unsecured NPLs the timeline is two years. An assessment of whether the NPL qualifies as falling within the secured NPL-QSE category will also require an assessment of the strength of collateral, security and credit protection and whether it can be realised in a "timely manner". According to the current draft of the Addendum "timely" is seven years i.e., in keeping with the NPL vintage count move to NPL-QSE provision deadline. The Addendum states that it is (clarifications in square brackets): "...immaterial whether the delays in realising the security were due to reasons beyond the [in-scope BUSIs'] control (e.g. the length of time it takes to conclude legal proceedings [and enforce the security, collateral or credit protection]).

Whilst the Addendum states, possibly without sufficient clarity, that: "...foreclosed assets are not currently in the scope of this addendum...", that seven year period may be difficult in certain jurisdictions. This includes those jurisdictions where relative enforcement is quick, but where certain NPL exposures and existing rules protect say family homes or primary residence from being realised in the "timely" manner. Assuming this qualitative requirement, which has some immediate and future quantitative impact, stays as is, then BUSIs will need to assess both at origination of an exposure and at the time it becomes non-performing whether that security is capable of timely enforcement and justifications how/why.

This may require suitably qualified written evidence from internal and/or external legal counsel to support any future discussions with the ECB-SSM and auditors as to why a particular exposure should be allocated to the secured as opposed to being recategorised and allocated to the unsecured provisioning category and timeframes. Where a secured NPL is recategorised as an unsecured NPL, then BUSIs will need to act much faster in provisioning. This could entail costs including beyond just the allocation of NPL-QSE provisioning.

In calculating the level of prudential provisioning, in-scope BUSIs will need to look at how items are treated in the relevant accounting regime applicable to the items as well as the treatment for purposes of the prudential capital regime. The NPL-QSE's and the level of prudential provisioning may go beyond, but not stand in the contradiction to, the accounting rules applicable to the BUSI. The Addendum is not clear, but one would assume these are the accounting rules where the asset/exposure was originated and where it is booked to.

In simplified terms in order to fulfil the full prudential provisioning requirement this means aggregating the following items:

1. all accounting provisions under the applicable accounting standard including potential newly booked provisions;
2. expected loss shortfalls for the respective exposures in default in accordance with the EU prudential capital rules binding upon BUSIs;
3. deducting, in accordance with the EU prudential capital rules binding upon BUSIs, Common Equity Tier 1 (CET-1) capital items from "own funds".

In-scope BUSIs are encouraged to close potential gaps in calculations and levels and possibly booking the maximum level of provisions possible under the applicable accounting standard.

How does the Addendum's impact fit into the wider picture?

Putting this all into context, the contents of this Client Alert and the impacts from the draft NPL Guide Addendum supplement the supervisory expectations, rules and principles happening across related Eurozone workstreams. Some of the key items were discussed in dedicated coverage from our Eurozone Hub:

1. a **Background Briefing**⁵ analysing the final version of the **NPL Guide** and its impact on in-scope BUSIs. To recap, the final NPL Guide, which was published 20 March 2017, introduced a 'jurisdiction agnostic' set of rules that apply to ECB-SSM direct supervised BUSIs. This NPL Guide also introduces a set of common tools to deal with NPLs. In summary the rules require that NPLs are either classified as non-viable and must be divested, or as viable and prompt BUSIs to comply with the NPL Guide and the menu of restructuring options to make viable NPLs sustainable and capable of returning back to performing status; and

⁵ Available here: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/10/ar_germany_backgroundbriefing_2017.pdf?la=en

2. a **Client Alert**⁶ assessing the **EU's NPL Action Plan** that was announced by the Consilium on 11 July 2017. The primary aim of this EU-wide plan for 2018 is to roll-out the NPL Guide's contents to a wider body of BUSIs and equally to replicate (i.e., mirror) the relevant provisions and apply these to the wider body of credit institutions active in the EU-27's banking sector.

In short, the NPL Guide Addendum might have some very real and immediate impact for BUSIs but it might also serve as additional material that could be rolled-out or mirrored as part of the EU's NPL Action Plan's workstreams. Some of these immediate impacts might mean that in-scope BUSIs may have to effectively apply the NPL Guide's menu of restructuring options in a much faster manner to ensure NPLs can be cured before the NPL vintage count requires provisioning and costs.

Moreover, in-scope BUSIs may have to invest in people, processes and new policies to ensure they can capture and test the strength of collateral. During the ECB's inaugural Asset Quality Review in 2014 a number of BUSIs were found to have lacking systems and controls to capture security, collateral and or credit protection arrangements as fully as would be required or how these correspond to the exposures they were supposed to secure.

If these deficiencies are not rectified, certain BUSIs may find that they will need to allocate or recategorise new NPLs into the unsecured instead of secured NPL-QSE category and thus have a much shorter deadline by which they must fully provision that NPL by.

Looking at costs more generally, assuming that the EU and Eurozone secondary markets⁷ for NPL portfolios remains relatively illiquid despite the best efforts of the EU Commission's 2017 consultation⁸ on developing such markets, the pressure for BUSIs to provision may impact balance sheets and business models. That may also impact existing and future debtors and counterparties.

As a result, despite the rationale to use provisioning as a supervisory tool to prevent further NPLs from developing, the impact of the Addendum, even if it aims to deliver on longstanding EU and Eurozone specific supervisory policy, may have a number of unforeseen and possibly adverse consequences for clients and counterparties of in-scope BUSIs.

That being said, the advent of the NPL Guide's rules in March 2017 provided some commercial opportunities for those looking to grow their NPL exposure. The impact on the Addendum might provide some further opportunities. This is especially the case for certain types of private debt funds that have, certainly since the 2008 financial crisis, entered EU financial markets as vital facilitators of "alternative lending". As the majority of these entities are not regulated as credit institutions, they are (currently) not subject to the rules of the Banking Union and thus NPL Guide. A separate Client Alert is available on how this will impact private debt funds.

⁶ Available here: http://www.bakermckenzie.com/-/media/files/insight/publications/nl_germany_euactionplan_jul17.pdf?la=en

⁷ Including auction processes.

⁸ See the following Consultation Document that closed 20 October 2017: https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-consultation-document_en.pdf

Further and wider-reaching changes ahead?

The press release⁹ accompanying the draft NPL Guide Addendum noted that many in-scope BUSIs have made progress with their NPL Guide compliance obligations. For others there was still much work to be done. The ECB-SSM has not provided an assessment of its own supervisory activity in relation of NPLs.

The press release, possibly as a nod towards the EU's NPL Action Plan deliverables that are set for 1Q through to 3Q 2018, highlights that the ECB-SSM may announce further policy measures in 2Q 2018. These measures will aim to improve the application the NPL Guide and BUSIs compliance with the rules.

NPL-QSEs as introduced in this Addendum may be flanked by further measures. One point that the Addendum crucially does not address is how the rules will differentiate (if at all) in how this Addendum's provisions will apply to those in-scope BUSIs are categorised as "low NPL Firms" and can thus apply the contents of the NPL Guide in a more proportionate manner than those that are categorised as "high NPL Firms".

How are NPL-QSE levels reported to the regulator and to the public?

The level of the prudential provisioning backstop should be reported annually to the ECB-SSM and the respective Joint Supervisory Team. The report should detail the NPL vintage(s) and coverage of provisioning for all NPLs newly categorised from 1 January 2018. Any deviations should be periodically explained on a "comply-or-explain" process on the basis of acceptable evidence justifying the deviation.

The current draft of the NPL Guide Addendum also requires that in-scope BUSIs provide a public disclosure of NPL coverage by vintage so as to "...convey their credit risk profiles comprehensively to market participants". For a number of in-scope BUSIs, this public reporting requirement may prove to be burdensome and quite unattractive.

How might this affect supervisory touchpoints?

Regulatory measures usually come flanked with supervisory checks. The ECB-SSM does apply proportionality and balance of needs in its supervisory approach. Part of this is reflected in the rules and processes but also in the scope and quality of people. It remains to be seen whether the ECB-SSM might also improve the resourcing of supervisory staff responsible for monitoring this area that has been a longstanding ECB-SSM if not equally an EU supervisory priority.

Ensuring the rules work as intended might also mean having the right skill set and resources at the SSM and the supervised BUSI. This would echo what has been done on say the Targeted Review of Internal Models (**TRIM**) workstream. At the ECB-SSM, the process of streamlining certain operations and how resources are allocated is underway and will continue through to 2019. Moreover, one-third of the current Joint Supervisory Teams are being rotated to new teams/positions. This may cause some pressures on supervisory engagements and touchpoints between SSM and BUSIs.

⁹ See:

<https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr171004.en.html>

As a result, affected BUSIs may want to already ensure they and their professional advisers have sufficient continuity of channels of communication to facilitate efficient costs of compliance. This is important not only in meeting the Addendum's requirements but other workstreams such as the supervisory review and evaluation procedure (**SREP**) tool that the SSM uses to monitor BUSIs' compliance but also to set regulatory capital levels.

So what might in-scope BUSIs want to do now?

Irrespective of there being a number of tweaks and technical changes to improve interoperability with the NPL Guide that BUSIs may want to highlight in their response to consultation process on the Addendum, there are a number of immediate preparatory steps that might be worth considering.

This is especially the case as NPLs have since the ECB-SSM's inception been a core supervisory priority. The EU-level institutions are using the ECB-SSM's NPL Guide as the starting point to roll it out to a much wider set of BUSIs and mirror the provisions across the EU-27 and its banking sector. In summary, the view from the policymaker is that all the tools have been put in place to clean up the hangover from the financial crisis and it is now upon the afflicted to carry out the appropriate measure of spring cleaning. It is unlikely that the ECB-SSM will backtrack on this compliance expectation that acts as a catalyst for in-scope firms to apply the NPL Guide's menu of restructuring options.

As a result, the immediate steps that are relevant for in-scope BUSIs and those that may become in-scope BUSIs due to being categorised as such (including due to relocation to the Banking Union) or due to the contents of the Addendum being extended in a same manner as the NPL Guide is to be extended include in-scope BUSIs assessing:

- their compliance process and embedding of the contents and supervisory expectations of the NPL Guide and related compliance workstreams and retaining professional advisers where necessary to assist with policies, processes, categorisation of exposures and strength of security, feasibility of divestment and work-out options as well as the engagement with national, EU, ECB-SSM and global supervisors;
- the sufficiency of resources and processes to competently justify any deviations to the supervisory expectations set in the NPL Guide and/or the Addendum;
- the amount and type of existing NPLs (including their existing vintage) as well as proxy for new business that will from 1 January 2018 qualify as a new NPL and become subject to the terms of the Addendum;
- whether there are sufficient (structuring, origination/sales and control) processes and IT improvements that can mitigate and minimise the emergence of "new" NPLs; and
- the likely level of provisioning (best and worst case) and the impacts on economic and prudential capital requirements.

Hot Topics

In conclusion, the Addendum marks a much sharper supervisory tone from the ECB-SSM and one that is being echoed across other pan-EU workstreams. Affected BUSIs may wish to start forward-planning sooner rather than later.

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above or in the text of NPL Guide Addendum, then please do get in touch with any of our Eurozone Hub key contacts below.

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