ECO FLASH

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European banks: Political agreement on common minimum loss coverage for non-performing exposures

Thomas Humblot

- **The European Parliament and Council have reached a political agreement on common minimum loss coverage for non-performing exposures.**
- **In the future, new exposures that become non-performing will have to be fully covered by provisions no later than nine years after their classification as such. The minimum coverage levels will apply at the earliest from two years after an exposure has been classified as non-performing.**
- **Compared to the calendar initially proposed, the compromise therefore allows an additional period before minimum coverage levels begin to be applied. Similarly, the calendar for full coverage of non-performing exposures has been extended.**
- **The minimum coverage levels will apply only to those exposures taken on after publication in the Official Journal of the European Union of this amendment to the EU Capital Requirements Regulation (CRR[1]). The date of 14 March 2018, which had been initially suggested by the European Commission, was not in fact adopted.**
- **The classification of exposures on the basis of the 90-day past due criterion was not adopted either. However, exposures secured by immovable property or guaranteed residential loans will receive a more favorable treatment. Lastly, forbearance measures and write-offs of loans are encouraged.**

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013

On 18 December 2018, negotiators from the European Parliament and the Austrian Presidency of the EU Council reached a political agreement on common minimum coverage levels for non-performing exposures (the 'prudential backstop'[2]). This agreement was reached under an ordinary legislative procedure (formerly the 'co-decision procedure'). It is therefore the result of a compromise between the levels approved by the permanent representatives of the member states to the EU[3] and the final counter-proposal of the European Parliament's Committee on Economic and Monetary Affairs[4].

Several significant modifications were made to the European Commission's original proposal[5], notably with regard to the levels themselves and the calendar for their application (1). Certain aspects of the amendment seek to encourage forbearance measures and the write-offs of loans (2).

[2] European Commission, *Proposal for a regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures – Confirmation of the final compromise text with a view to agreement, 03/01/2019*

[3] Council of the EU, *Non-performing loans: Council approves position on capital requirements for banks' bad loans*, Press Release 594/18, 31/10/2018

[4] Committee on Economic and Monetary Affairs, *Report on the proposal for a regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 (COM(2018)0134 – 2018/0060(COD))*, European Parliament, 07/12/2018

[5] European Commission, *Proposal for a regulation of the European Parliament and of the Council on amending Regulation (EU) No 575/2013 (COM(2018)0134 – 2018/0060(COD))*, 14/03/2018

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ECONOMIC RESEARCH DEPARTMENT

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The bank for a changing world

The final compromise brings significant changes to the common minimum coverage levels and extends the calendar of their implementation

The initial proposals for amendment to the CRR envisaged the creation of common minimum loss coverage levels from the first year after classification of an exposure as non-performing. The final compromise pushes back the start date to two years. In addition, the 90-day past due criterion is no longer a determinant of the common minimum coverage levels.

Exposures secured by immovable property are distinguished from those secured by other asset types

Initially, the European Commission suggested applying distinct minimum coverage levels for exposures that had been classified as non-performing, depending on the duration of payment arrears. Thus, non-performing exposures that were past due more than 90 days would have higher minimum coverage levels than those required for non-performing exposures that were past due less than 90 days (see Table 1).

Significantly, this 90-day criterion is one of the two used in the regulatory approach to estimate that a debtor is in default[6]. The other criterion is based on the institution's estimate that without measures such as realizing security, the debtor is unlikely to be able to meet its obligations in full. Meanwhile, the new accounting standard IFRS 9 *Financial Instruments*[7], entered into force on 1 January 2018, does not automatically classify an exposure that is past due more than 90 days as non-performing.

In the future, banks will have two additional years to achieve full coverage of exposures secured by immovable property ("*or that is a residential loan guaranteed by an eligible protection provider*") which turn non-performing, compared to the calendar for exposures secured by other credit protection.

The distinction between the secured and unsecured part of exposures has been retained. The final agreement also stipulates that this distinction is based on the same criteria as used in the regulatory approach.

Exposures must be fully covered no later than 9 years after being classified as non-performing

The final calendar for implementation of common minimum loss coverage levels has been extended relative to that originally proposed by the European Commission.

- **Unsecured part** Two years after being classified as non-performing, at least 35% of the gross book value of the unsecured part of an exposure must be covered by provisions. In the event that accounting provisions are below this level, the difference must be deducted from bank's Common Equity Tier 1. After three years or at the beginning of the fourth year, this level must reach 100% of the gross book value of the unsecured part of the non-performing exposure.
- **Secured part** The secured part of an exposure is subject to minimum loss coverage levels three years (i.e. at the beginning of the fourth year) after it turned non-performing. The compromise between the European Parliament and the Council of the EU thus gives banks more flexibility in the management of their non-performing exposures. Such exposures are not excessively punitive in the first years after their classification as non-performing. Indeed, it is during this period that measures such as renegotiation and refinancing are more widely used to help the debtor return to better fortune.
- **Part secured by immovable property** The part of exposures secured by immovable property must be fully covered by provisions no later than 9 years after becoming non-performing, giving an additional period of 2 years relative to the initial proposals. However, the part secured by other instruments must be fully covered no more than 7 years after initial classification of the exposure as non-performing, in line with the Council's initial proposal.

Additional details

The agreement states that the common minimum coverage levels shall be applied on an exposure-by-exposure basis and, if an exposure is transferred from one bank to another, that the classification of an exposure will not be changed, nor the minimum coverage level reset to zero. Lastly, renegotiations and write-offs of loans are encouraged in order to facilitate the cleaning up of bank balance sheets.

Coverage levels apply exposure by exposure

The final compromise stipulates that the common minimum coverage levels apply to each exposure considered individually. Thus, deductions for insufficient provision cover will be made to banks' CET1 on an exposure-by-exposure basis.

Such an approach is justified in particular in view of the sale of an exposure. Moreover, in order to guarantee equality of regulatory treatment of vendors and buyers, the minimum coverage level applicable before and after the sale of a non-performing exposure will be identical. In the event of the purchase of an exposure at a discount, this discount shall be treated by the purchaser as a partial write-off, thus reducing the additional amount of regulatory provisions proportionately.

Forbearance measures and write-offs of loans are encouraged.

Forbearance measures are treated better in the final version of the CRR amendment. The common minimum coverage level applicable to exposures subject to such measures will be delayed by one year at the time of forbearance. However, in the event that the exposure remains classified as non-performing at the end of this relief period, it will be subject to the same coverage level as it would have been if no forbearance measure had taken place. These provisions are likely to encourage banks to make wider use of forbearance measures.

The treatment of partial write-offs is set out in the final version of the compromise. Write-offs are treated similarly to regulatory provisions, but they are not deducted from the outstanding amount of the non-performing exposure used in calculating the coverage level. The difference between the

[6] Article 178 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013
[7] Commission Regulation (EU) 2016/2067 of 22 November 2016

outstanding amount of non-performing exposures and the figure used in calculating regulatory provisions will therefore be equal to any partial write-off. The amount of additional provisions for non-performing exposures subject to write-offs will therefore be reduced. The aim of the authors of the amendment to CRR is thus to encourage banks to write off exposures more readily, and thus accelerate the cleaning up of their balance sheets.

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The political agreement between the European Parliament and EU Council on common minimum loss coverage for non-performing exposures places their regulatory treatment in the broader context of strengthening the stability of the banking system.

In addition to the introduction in March 2018 of the ECB's "supervisory expectations" for prudential provisioning of non-performing exposures, which are not legally binding but serve to set the additional capital requirements for Pillar 2[8], the finalisation of the CRR amendment was awaited.

In the end, the gap between the ECB's "expectations" for major banks under its direct supervision and the common minimum coverage levels defined by the European Commission, which will apply to all banks, has been reduced.

The European Parliament and EU Council have sought to strengthen the stability of the European banking system, notably by introducing a *de facto* pressure on banks to sell more of their non-performing exposures. In the event that these sales are made on unfavourable terms for banks, such a regulation might exacerbate the difficulties faced by some banks. This risk will be all the greater if the development of the secondary market that the European Commission hopes to see takes time.

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Final compromise on common minimum loss coverage levels for non-performing exposures

	Unsecured part					Secured part							
Level at first day of considered year after exposure became non-performing	Council proposal (14/03/2018)		Approval of permanent representatives of member states to the EU (31/10/2018)	Counter-proposal of the European Parliament Committee (07/12/2018)	***Final compromise (03/01/2019)***	Council proposal (14/03/2018)		Approval of permanent representatives of member states to the EU (31/10/2018)		Counter-proposal of the European Parliament Committee (07/12/2018)		***Final compromise (03/01/2019)***	
	Past due > 90 days	Past due < 90 days				Past due > 90 days	Past due < 90 days	Immovable property	Other	Immovable property	Other	***Immovable property***	***Other***
1	35%	28%				5%	4%						
2	100%	80%				10%	8%						
3			35%		***35%***	17.5%	14%						
4			100%	100%	***100%***	27.5%	22%	25.5%	25.5%	20%	23%	***25%***	***25%***
5						40%	32%	41.5%	41.5%	30%	35%	***35%***	***35%***
6						55%	44%	69%	69%	40%	50%	***55%***	***55%***
7						75%	60%	80%	80%	55%	80%	***70%***	***80%***
8						100%	80%	80%	100%	75%	100%	***80%***	***100%***
9								85%		80%		***85%***	
10								100%		100%		***100%***	

Table 1

Source: European Commission, BNP Paribas

8 The Supervisory review and evaluation process gives rise to an individual quantitative and qualitative evaluation of the resilience and governance of banks which serves to define the additional capital requirements (Pillar 2) over and above the minimum capital requirements of Pillar 1.

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