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2018/0060 (COD)

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

(Text with EEA relevance)

{SWD(2018) 73 final} - {SWD(2018) 74 final}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

• Reasons for and objectives of the proposal

This proposal is an important part of the work to strengthen Europe's Economic and Monetary Union (EMU). A more integrated financial system will enhance the resilience of the EMU to adverse shocks by facilitating private risk-sharing across borders, while at the same time reducing the need for public risk-sharing. In order to achieve these objectives, the EU must now complete the Banking Union and put in place all building blocks for a Capital Markets Union (CMU). The Commission's Communication of 11 October 2017[1] sets out a way forward to complete the Banking Union by promoting risk reduction and risk sharing in parallel, as part of the roadmap to strengthen EMU set out by the Commission on 6 December 2017.[2]

Addressing high stocks of non-performing loans (NPLs) and non-performing exposures (NPEs)[3] as well as their possible accumulation in the future is an important part of the Union's efforts to further reduce risks in the banking system and enable banks to focus on lending to businesses and citizens. On-going discussions in the Council confirm that further advances in addressing NPLs are essential to complete Banking Union which forms a top priority in the Leaders' Agenda.

High stocks of NPLs can weigh on bank performance through two main channels. First, NPLs generate less income for a bank than performing loans and thus reduce the bank's profitability, and may cause losses that reduce its capital. In the most severe cases, these effects can jeopardise 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. This reduces the bank's capacity to lend, including to small and medium-sized enterprises (SMEs).

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. Bank lending is often overly expensive and bank lending volumes to SMEs have been severely affected by the 2008 financial crisis. This impedes the development and growth of SMEs.

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1 Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on completing the Banking Union, COM(2017) 592 final, 11.10.2017.

2 Communication from the Commission to the European Parliament, the European Council, the Council and the European Central Bank - further steps towards completing Europe's economic and monetary union: a roadmap, COM(2017) 821 final, 06.12.2017.

3 NPEs include NPLs, non-performing debt securities and non-performing off-balance-sheet items. NPLs represent the largest share of NPEs and this term is commonly used as pars pro toto. NPLs denote loans where the borrower faces difficulties to make the scheduled payments to cover interest or capital reimbursements. When the payments are more than 90 days past due, or the loan is assessed as unlikely to be repaid by the borrower, it is classified as an NPL.

Well-developed secondary markets for NPLs are also one of the building blocks for a well-functioning CMU[4]. One of the main objectives driving the Commission's priority of establishing the CMU is to provide new sources of financing for EU businesses, SMEs and high-growth innovative companies in particular. While the CMU project is focused on facilitating access to and diversifying non-bank finance for EU businesses, it also acknowledges the important role played by banks in financing the EU economy. Therefore, one of the CMU work streams aims at enhancing banks' capacity to lend to businesses, including through strengthening their ability to recover value from collateral provided to secure loans.

High levels of NPLs must be addressed by a comprehensive approach. While the primary responsibility for tackling high levels of NPLs remains with banks and Member States[5], there is also a clear EU dimension to reduce current stocks of NPLs, as well as preventing any excessive build-up of NPLs in the future given the interconnectedness of the EU's banking system and in particular that of the euro area. In particular, there are important potential spill-over effects from Member States with high NPL levels to the EU economy as a whole, both in terms of financial stability and economic growth.

The need for decisive and comprehensive action was recognised in the "Action Plan To Tackle Non-Performing Loans in Europe" endorsed by the ECOFIN Council on 11 July 2017. The Action Plan sets out a comprehensive approach that focuses on a mix of complementary policy actions in four areas: (i) bank supervision and regulation, (ii) reform of restructuring, insolvency and debt recovery frameworks, (iii) developing secondary markets for distressed assets, and (iv) fostering restructuring of the banking system. Actions in these areas are to be taken at national level and at Union level, where appropriate. Some measures will have a stronger impact on banks' risk assessment at loan origination, while others will foster swift recognition and better management of NPLs, and further measures will enhance the market value of such NPLs. These measures mutually reinforce each other and would not be sufficiently effective if implemented in isolation.

This proposal, together with the other measures the Commission is putting forward, as well as the action taken by the Single Supervisory Mechanism (SSM) and the European Banking Authority (EBA) are key parts of this effort. In combining several complementary measures, the Commission helps create the appropriate environment for banks to deal with NPLs on their balance sheets, and to reduce the risk of future NPL accumulation.

Banks will be required to put aside sufficient resources when new loans become non-performing, creating appropriate incentives to address NPLs at an early stage and avoid too large accumulation of NPLs.

If loans become non-performing, more efficient enforcement mechanisms for secured loans will allow banks to address NPLs, subject to appropriate safeguards for debtors.

Should NPL stocks nevertheless become too high – as it is currently the case for some banks and some Member States – banks will be able to sell them in efficient, competitive and

[4] Communication by the European Commission to the European Parliament, the European Council, the Council, the European Social and Economic Committee and the Committee of the Regions: Completing the Capital Markets Union by 2019 - Time to accelerate delivery, COM(2018) 114.

[5] The Commission has consistently mentioned this matter, for the Member States concerned, in the context of the European Semester.

transparent secondary markets to other operators. Supervisors will guide them in this, based on their existing bank-specific, so-called Pillar 2 powers under the Capital Requirements Directive (CRD)[6]. Where NPLs have become a significant and broad-based problem, Member States can set up national asset management companies or other measures within the framework of current state aid and banks resolution rules.

This proposal provides for a statutory prudential backstop against any excessive future build-up of NPLs without sufficient loss coverage on banks' balance sheets. This measure is complementary to a number of other measures presented today as set out in the Commission Communication "Second Progress report on the reduction in Non-Performing Loans in Europe"[7]. In order to help banks to better manage NPLs, the Commission also issues a separate proposal that (i) enhances the protection of secured creditors by allowing them more efficient methods of recovering their money from secured loans to business borrowers, out of court, and (ii) removes undue impediments to credit servicing by third parties and to the transfer of credits in order to further develop secondary markets for NPLs. Member States are also provided with guidance on how they can set up, where appropriate, national asset management companies (AMCs) in full compliance with EU banking and State aid rules. The AMC Blueprint provides practical recommendations for the design and set-up of AMCs at the national level, building on best practices from past experiences in Member States[8].

These initiatives mutually reinforce each other. The statutory prudential backstop ensures that credit losses on future NPLs are sufficiently covered, making their resolution or sale easier. The AMC blueprint assists Member States that so wish in the restructuring of their banks by means of the establishment of asset management companies dealing with NPLs. These effects are complemented by the push to further develop 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 reduces the costs for resolving NPLs.

6 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, OJ L 176, p. 338.
7 Communication from the Commission to the European Parliament, the Council and the European Central Bank - second progress report on the reduction of non-performing loans in Europe, insert COM Number once available.
8 insert SWD Number once available.

- **Consistency with existing policy provisions in the policy area**

Provisions have to be made for NPEs in accordance with the applicable accounting framework. The new International Financial Reporting Standard (IFRS) 9, which has applied in the EU since 1 January 2018, is expected to help address the issue of delayed and insufficient provisions, as it operates on an 'expected loss' basis. However, the new standard introduces only limited changes with regard to financial assets that have become non-performing. Furthermore, accounting standards, including IFRS 9, set general principles and approaches for determining credit loss provisions, rather than detailed rules. Despite the available guidance on their application, accounting standards generally leave discretion with regard to the determination of expected credit losses on performing and non-performing exposures, *inter alia* as regards estimated future cash flows from collateral or guarantees and consequently, in the determination of provision levels.

Under the Pillar 2 of the prudential framework established in the CRD, competent authorities (i.e. the supervisor) may influence an institution's provisioning policy and require specific adjustments to own funds calculations on a case-by-case basis.[9] Pillar 2 measures are applied at the discretion of the competent authority and case-by-case, following an assessment that the institution's provisioning policy is inadequate or insufficiently prudent from a supervisory point of view.

In conclusion, losses on credit exposures (including NPEs) are subject to both accounting standards and prudential regulation. However, neither the accounting nor the prudential framework currently provides for common minimum treatment that would effectively prevent the build-up of insufficiently covered NPEs.

In its Action Plan the Council invited the Commission "to consider prudential backstops addressing potential under-provisioning which would apply to newly originated loans. These statutory backstops could take the shape of compulsory prudential deductions from own funds of NPEs, following an assessment of the most appropriate calibrations in line with international practice".

Insufficiently provisioned NPEs are more likely to remain on banks' balance sheets in an attempt by banks to avoid or delay loss recognition ('wait-and-see' approach). Under-provisioning and loss forbearance are major obstacles to debt restructuring and asset sales, since banks may postpone restructuring or deleverage in order to avoid loss recognition. Delays in loss recognition have been found to contribute to reduced lending, as they put even more pressure on banks to increase provisions in times of stress (i.e. when losses materialise and regulatory own funds requirements become most binding).

In response to the ECOFIN Council's request, the Commission conducted a targeted consultation and an impact assessment, concluding that the introduction of prudential minimum treatment acting as a statutory backstop for newly originated exposures that subsequently turn non-performing is appropriate to prevent the build-up of NPEs in future. The proposed amendments to the Capital Requirements Regulation (CRR)[10], which is directly

[9] The Commission clarified the scope of this power in its report reviewing the functioning of the Single Supervisory Mechanism (SSM), COM(2017) 591 final.

[10] 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, OJ L 176, 27.6.2013, p.1.

applicable to all institutions in the EU, established a framework for a prudential backstop for newly originated exposures that become non-performing, in the form of time-bound prudential deductions from own funds. This backstop aims to:

- reduce financial stability risks arising from high levels of insufficiently covered NPEs, by avoiding the build-up or increase of such NPEs with spill-over potential in stressed market conditions; and
- ensure that institutions have sufficient loss coverage for NPEs, hence protecting their profitability, capital and funding costs in times of stress. In turn, this would ensure that stable, less pro-cyclical financing is available to households and businesses.

It would complement (i) the application of accounting standards with regard to loan-loss provisioning for NPEs, and (ii) the use of existing Pillar 2 supervisory powers following case-by-case assessment by the competent authority.

Hence, institutions will have to continue to recognise provisions in line with their assessment and applicable accounting standards. Those provisions, including potential increases because of IFRS 9, will be taken fully into account for the purposes of the prudential backstop. Where the sum of provisions and other adjustments do not suffice to cover losses on NPEs up to common minimum levels, the prudential backstop would apply and require deduction of the difference from Common Equity Tier 1 (CET1) items. Where competent authorities ascertain on a case-by-case basis that, despite the application of the prudential backstop for NPEs under this Regulation, the NPEs of a specific institution are not sufficiently covered, they may make use of their supervisory powers under Pillar 2.

With a view to ensuring consistency in the prudential framework, the proposed Pillar 1 treatment is based on definitions and concepts already used for the purposes of supervisory reporting. The concept of NPE introduced via this amendment, like the criteria relating to forbearance, is consistent with that in Commission Implementing Regulation (EU) No 680/2014[11], which is already commonly applied for supervisory reporting purposes.

Where necessary for the sake of consistency, amendments to relevant provisions in the CRR are also proposed.

- **Consistency with other Union policies**

More than five years after the European Heads of State and Governments agreed to create a Banking Union, two of its pillars – single supervision and resolution – are in place, resting on the solid foundation of a single rulebook for all institutions in the EU. While significant progress has been made, further steps are needed to complete the Banking Union, including the creation of a single deposit guarantee scheme, as set out in the October 2017 Communication and the December 2017 roadmap.

In addition to the comprehensive package of reforms proposed by the Commission in November 2016 ("Banking reform package"), the proposed prudential backstop is one of the risk-reducing measures needed to strengthen the resilience of the banking sector, in parallel with the staged introduction of the European Deposit Insurance Scheme (EDIS). These measures aim at the same time to ensure a continued single rulebook for all institutions in the

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[11] Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 191, 28.6.2014, p. 1).

EU, whether inside or outside the Banking Union. The overall objectives of this initiative, as described above, are fully consistent and coherent with the EU's fundamental goals of promoting financial stability, reducing the likelihood and extent of taxpayers' support where an institution is resolved and contributing to the harmonious and sustainable financing of economic activity, which is conducive to a high level of competitiveness and consumer protection.

2. LEGAL BASIS, SUBSIDIARITY AND PROPORTIONALITY

- **Legal basis**

The legal basis for the proposed amendments is the same as that for the legislative act being amended, i.e. Article 114 TFEU.

- **Subsidiarity (for non-exclusive competence)**

The current EU prudential framework does not provide for harmonised prudential treatment as regards NPEs. As a consequence, actual loss coverage for NPEs may vary across banks in different jurisdictions, even if they bear the same underlying risk. This may limit the cross-country comparability of capital ratios and undermine their reliability. Banks with the same risk profile and sharing the same currency would face different funding conditions depending on where they are located in the Union. This creates additional financial fragmentation that hampers one of the most important benefits of the internal market, namely the diversification and sharing of economic risks across borders.

However, Member States have only limited scope to introduce generally applicable and legally binding provisioning requirements. The specification of IFRSs, for instance, is the responsibility of the International Accounting Standards Board (IASB). As regards prudential treatment, minimum requirements that are directly applicable to institutions (including for NPEs, such as deductions from own funds) are subject to maximum harmonisation throughout the internal market.

Competent authorities in charge of supervising institutions in the EU have the power to influence institutions’ provisioning policy and to require specific adjustments to own funds calculations case by case under Pillar 2 of the framework, taking into account the specific situation of the institution. However, they cannot impose harmonised (minimum) treatment across Member States and institutions, nor effectively address on a systematic and EU-wide basis the potential under-provisioning for NPEs.

The objective of the proposed measures is to supplement existing EU legislation; This can best be achieved at EU level, rather than through different national or supervisory measures. Legislative action at EU level will lead to harmonised treatment requiring all institutions established in the EU to cater for losses on newly originated exposures that turn non-performing at a common prudential minimum level. Such a prudential backstop would put an automatic EU-wide brake on the build-up of future NPEs without sufficient loan-loss coverage and thus strengthen banks’ financial soundness and ability to lend. EU-wide action will reduce potential spillover effects within the Union. It will also help to strengthen risk reduction and level the playing field in the internal market by putting all banks on an equal footing with regard to prudential treatment for NPEs, reducing unnecessary differences in banks’ practices, increasing comparability, facilitating market discipline and promoting market confidence.

- **Proportionality**

Proportionality has been an integral part of the impact assessment accompanying the proposal. Not only have all proposed options been individually assessed against the proportionality objective, but also the lack of proportionality of the existing rules has been analysed, with a view to minimising administrative and compliance costs while ensuring common treatment throughout the Union.

The proposal sets out a harmonised treatment of NPEs for prudential purposes so as to ensure that all institutions in the EU have a minimum level of coverage for their NPEs-related risks. The applicable minimum coverage requirements take into account how long an exposure has been classified as non-performing, differentiate between unsecured and secured NPEs as well as between NPEs where the obligor is past due more than 90 days and other NPEs. The proposed treatment is thus commensurate with the different risk characteristics NPEs may have and, at the same time, still provides for a relatively simple approach that can be easily applied across the board. The most proportionate means to ensure a level playing field, reduce regulatory complexity and avoid unwarranted compliance costs (particularly for cross-border activities), promote further integration in the EU market and contribute to the elimination of regulatory arbitrage opportunities is to amend the existing Union rules on own funds requirements.

- **Choice of the instrument**

It is proposed that the measures be implemented by amending Regulation (EU) No 575/2013, as they refer to or develop existing provisions in that Regulation, in particular as regards own funds calculations.

3. RESULTS OF EX-POST EVALUATIONS, STAKEHOLDER CONSULTATIONS AND IMPACT ASSESSMENTS

- **Stakeholder consultations**

The Commission held a targeted consultation in November 2017 to assess whether it was appropriate to introduce a prudential backstop to tackle under-provisioning for NPEs.

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

The consultation was open to all interested parties. Most responses were from banks or banking associations and a few came from supervisors. In total, 38 responses were received: 29 from private stakeholders (including one private individual) and 9 from public stakeholders. Most were from respondents in Member States with the highest NPE ratios.

As regards the design of a prudential backstop, most stakeholders favoured a progressive path of deduction, on the basis that it would better recognise early recoveries of loans. This is the option followed in the proposal. Some argued in favour of a distinction between NPEs where the obligor is still paying its obligations and NPEs where the obligor is insolvent. This has been taken up in the proposal.

Annex 2 to the impact assessment summarises the responses to the consultation.

• **Collection and use of expertise**

The Commission asked for input from the European Banking authority (EBA), which responded in a constrained timeframe to a call for advice on the impact of a possible prudential backstop. The EBA estimates were included in the impact assessment.

• **Impact assessment**

The impact assessment[12] was discussed with the Regulatory Scrutiny Board and approved without reservations on 17 January 2018[13]. The proposal is accompanied by the impact assessment and remains consistent with it.

The impact assessment describes the baseline scenario and compares it with three possible options for the introduction of a prudential backstop taking into account all relevant assumptions. The baseline takes into account the current state of play regarding the provisioning of NPEs, i.e. the application of the new rules in line with IFRS 9 and the existing supervisory powers of competent authorities to increase provisioning for NPEs. Two options were designed as a prudential deduction from own funds in case of insufficient provisioning, using either an end-of-period approach or a gradual path (which could be linear or progressive). The third option was designed as a haircut approach for secured NPEs, where the specific type of credit protection used to secure the NPE would be taken into account in the calculation of the backstop. Following the analysis in the impact assessment, the preferred option is a gradual deduction approach following a progressive path. As compared with an end-of-period approach, this avoids a significant cliff-edge effect. It also better enables banks to enforce credit protection or recover loans in the first few years, as compared with a linear path of deduction. Finally, it is seen as being less complex and operationally burdensome than an option based on a haircut approach.

As shown in the impact assessment, the costs to be expected from the introduction of a prudential backstop for under-provisioned NPEs can be considered manageable. According to EBA estimates, the cumulative decrease in the median EU bank's CET1 ratio due to the introduction of a prudential backstop (similar to that envisaged) amounts to approximately 138 basis points after twenty years. However, this result still represents the upper bound for the potential impact of the proposed measure, as the underlying assumptions are quite conservative (see impact assessment), and the effects of a softer calibration applying to specific cases of unlikely-to-pay NPEs are not factored in.

The impact assessment report has been amended slightly in line with the recommendations in the Regulatory Scrutiny Board's opinion. The common introduction to the three reports on NPEs has been expanded to explain better the synergies between the three. Additional justifications of the need for action at EU level have been included and the report has been changed to reflect better the impact of existing measures such as IFRS 9 and Pillar 2 powers. Updated EBA estimates have been inserted, alongside more developed explanations of the results and assumptions used. Finally, the quantification tables have been adjusted in line with the updated estimates and to strengthen the quantification of the macroeconomic impacts of the preferred option.

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12 Insert link to the IA.

13 Insert link to the positive opinion.

- **Regulatory fitness and simplification**

This initiative introduces a new tool (minimum coverage requirements for incurred/expected losses on NPEs) that adds to existing legislation by introducing new prudential treatment and integrating existing definitions. It improves the efficiency of existing legislation by ensuring a standardised minimum level of coverage rules across the Union. It should be pointed out that other current and past initiatives relating to NPEs will also impact NPE levels, so it is hard to disentangle the efficiency gains from each individual measure (see Annex 3 to the impact assessment for details).

By strengthening banks' balance sheets with more timely and effective management of NPEs, a prudential backstop for insufficiently provisioned NPEs will support a more stable supply of credit in the future. The positive impact should be particularly to the benefit of SMEs, which are more dependent on bank lending than large corporates.

- **Fundamental rights**

The EU is committed to high standards of protection of fundamental rights and is signatory to a broad set of conventions on human rights. In this context, the proposal respects the fundamental rights and observes the principles recognised by the Charter of Fundamental Rights of the European Union, in particular the freedom to conduct a business, the right to property, the right to a fair trial, the protection of personal data and consumer protection.

4. BUDGETARY IMPLICATIONS

The proposal does not have implications for the Union budget.

5. OTHER ELEMENTS

- **Implementation plans and monitoring, evaluation and reporting arrangements**

As this proposal will introduce modifications to the own funds calculations set forth in the CRR, its evaluation will be performed as part of the monitoring of that Regulation.

- **Detailed explanation of the specific provisions of the proposal**

Definition of NPE – proposed Article 47a:

For the purposes of the prudential backstop, a definition of NPE is introduced in the CRR. This definition is based on the concept of NPE set forth by Commission Implementing Regulation (EU) No 680/2014, which is already commonly applied for supervisory reporting purposes. This definition includes, among others, defaulted exposures as defined for the purposes of calculating own funds requirements for credit risk and exposures impaired pursuant to the applicable accounting framework. Moreover, and also in line with Commission Implementing Regulation (EU) No 680/2014, the proposed amendments introduce strict criteria on the conditions to discontinue the treatment of an exposure as non-performing as well as on the regulatory consequences of refinancing and other forbearance actions.

General principle of the prudential backstop – proposed Articles 36(1)(m) and 47c:

The prudential backstop consists of two main elements: (i) a requirement for institutions 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 CET1 items.

The minimum coverage requirement increases gradually depending on how long an exposure has been classified as non-performing. The annual increase of the minimum coverage requirement is lower during the first years after the classification of an exposure as non-performing. This gradual increase reflects the fact that the longer an exposure has been non-performing, the lower is the probability to recover the amounts due.

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 institutions 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 backstop applies. The deduction would ensure that the risks associated with NPEs are appropriately reflected in institutions' CET1 capital ratios in one way or another.

Distinction between unsecured and secured NPEs – Article 47c(2) and (3):

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

In principle, non-performing unsecured credit exposures and non-performing credit exposures secured by collateral could be treated in the same way. However, both types of exposures have different characteristics in terms of risk. Secured NPEs are in general less risky for a institution than unsecured NPEs 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. On the contrary, an institution has typically no other viable recourse in case an unsecured loan becomes non-performing than to forbear it. Recovery rates are on average significantly higher for secured NPEs than for unsecured ones. However, it takes some additional time to enforce the credit protection and, where applicable, realise the collateral. Unsecured NPEs should therefore require higher and timelier minimum loss coverage by the creditor bank than secured NPEs. 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, also full coverage of the exposure amount of secured NPEs is deemed necessary. Timely resolution of secured NPEs should be facilitated going forward by ongoing efforts in several Member States to reform insolvency systems and by the use of accelerated extrajudicial enforcement procedures for collateral, which are envisaged in the Commission proposal for a Directive on credit servicers, credit purchases and collateral enforcement adopted on the same day as this proposal . Banks using extrajudicial enforcement procedures tend to restructure, recover or dispose of their NPEs earlier and at a higher rate. They would be less affected by the need to increase their loss coverage for NPEs.

Distinction between NPEs where the obligor is past due more than 90 days and other NPEs – Article 47c(2) and (3):

The definition of NPE includes cases where the obligor is considered unlikely-to-pay albeit actually still paying its instalments. Since the institution still receives full payment from the obligor without excessive delay, the credit risk is in general expected to be lower than for exposures where the obligor is past due more than 90 days, and it is justified to apply a less strict calendar in such cases. Concretely, NPEs shall then be covered up to 80% of the exposure value after the defined time period (i.e. after two years for unsecured NPEs and after eight years for secured ones). Conversely, in cases where the obligor is past due more than 90 days on any material credit obligation to the institution, a full coverage level should be required after the defined time period.

Derogation for past loans – Article 469a

The prudential backstop would apply only to exposures originated after 14 March 2018 as from that date there is sufficient clarity how the new rule would apply. In order to avoid circumvention of this derogation, exposures originated before the adoption of the proposal but that are afterwards amended by the institution in a way that increases its exposure value should be treated as newly originated exposures. By contrast, exposures originated before the date of the adoption of this proposal should be treated accordingly to the rules in force at that date, even if they are refinanced or subject to other forbearance measures.

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(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 114 thereof,

Having regard to the proposal from the European Commission,

After transmission of the draft legislative act to the national parliaments,

Having regard to the opinion of the European Central Bank[14],

Having regard to the opinion of the European Economic and Social Committee[15],

Acting in accordance with the ordinary legislative procedure,

Whereas:

(1) The establishment of a comprehensive strategy to address the issue of non-performing exposures (NPEs) is a priority for the Union. While addressing NPEs is primarily the responsibility of banks and Member States, there is also a clear Union dimension to reduce current stocks of NPEs, as well as to prevent any excessive build-up of NPEs in the future. Given the interconnectedness of the banking and financial systems across the Union where banks operate in multiple jurisdictions and Member States, there is significant potential for spill-over effects for Member States and the Union at large, both in terms of economic growth and financial stability.

(2) An integrated financial system will enhance the resilience of the European Monetary Union to adverse shocks by facilitating private cross-border risk-sharing, while at the same time reducing the need for public risk-sharing. In order to achieve these objectives, the Union should complete the Banking Union and further develop a Capital Markets Union. Addressing high stocks of NPEs and their possible future accumulation is essential to completing the Banking Union as it is essential for ensuring competition in the banking sector, preserving financial stability and encouraging lending so as to create jobs and growth within the Union.

(3) In July 2017 the Council in its 'Action Plan to Tackle Non-Performing Loans in Europe' called upon various institutions to take appropriate measures to further address the high number of NPEs in the Union. The Action Plan sets out a comprehensive

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14 OJ C […], […], p. […].

15 OJ C , , p. .

approach that focuses on a mix of complementary policy actions in four areas: (i) bank supervision and regulation; (ii) reform of restructuring, insolvency and debt recovery frameworks; (iii) developing secondary markets for distressed assets; (iv) fostering restructuring of the banking system. Actions in these areas are to be taken at national level and at Union level, where appropriate. The Commission announced a similar intention in its 'Communication on completing the Banking Union' of 11 October 2017[16], which called for a comprehensive package on tackling NPLs within the Union.

(4) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013[17] forms, together with Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013[18], the legal framework governing the prudential rules for institutions. Regulation (EU) No 575/2013 contains, inter alia, provisions directly applicable to institutions for determining their own funds. It is therefore necessary to complement the existing prudential rules in Regulation (EU) No 575/2013 relating to own-funds with provisions requiring a deduction from own funds where NPEs are not sufficiently covered via provisions or other adjustments. This would amount to effectively creating a prudential backstop for NPEs that will apply uniformly to all Union institutions.

(5) The prudential backstop should not prevent competent authorities from exercising their supervisory powers in accordance with Directive 2013/36/EU. Where competent authorities ascertain on a case-by-case basis that, despite the application of the prudential backstop for NPEs established in this Regulation, the NPEs of a specific institution are not sufficiently covered, they may make use of the supervisory powers envisaged in Directive 2013/36/EU, including the power referred to in Article 104(1)(d) of that Directive.

(6) For the purposes of applying the backstop, it is appropriate to introduce in Regulation (EU) No 575/2013 a clear set of conditions for the classification of NPEs. As Commission Implementing Regulation (EU) No 680/2014 already lays down criteria concerning NPEs for the purposes of supervisory reporting, it is appropriate that the classification of NPEs builds on that existing framework. Commission Implementing Regulation (EU) No 680/2014 refers to defaulted exposures as defined for the purposes of calculating own funds requirements for credit risk and exposures impaired pursuant to the applicable accounting framework. As forbearance measures may influence whether an exposure is classified as non-performing, the classification criteria are complemented by clear criteria on the impact of forbearance measures. Forbearance measures may have different justifications and consequences, it is therefore appropriate to provide that a forbearance measure granted to a non-performing exposure should not discontinue the classification of that exposure as non-performing unless certain strict discontinuation criteria are fulfilled.

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[16] COM(2017) 592 final, 11.10.2017.

[17] 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, OJ L 176, 27.6.2013, p.1.

[18] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, OJ L 191, 28.6.2014, p. 1.

(7) The longer an exposure has been non-performing, the lower the probability for the recovery of its value. Therefore, the portion of the exposure that should be covered by provisions, other adjustments or deductions should increase with time, following a pre-defined calendar.

(8) Secured NPEs generally entail less risk than unsecured NPEs, as the credit protection securing the loan gives the institution a specific claim on an asset or against a third party in addition to the institution's general claim against the defaulted borrower. In the case of an unsecured loan, only the general claim against the defaulted borrower would be available. Given the higher risk of unsecured loans, a stricter calendar should be applied. An exposure which is only partly covered by collateral should be considered as secured for the covered part, and as unsecured for the part which is not covered by collateral.

(9) A different calendar should be applied depending on whether the exposure is non-performing because the obligor is past due more than 90 days or if it is non-performing for other reasons. In the first case, the minimum coverage requirement should be higher as the institution has not received any payment from the obligor over a long period. In the second case, there should be no full coverage requirement as there is still some repayment or a higher probability of repayment.

(10) When an exposure is classified as non-performing for reasons other than being past due more than 90 days and subsequently becomes past due more than 90 days, it should be subject to the stricter calendar applicable for NPEs being past due more than 90 days. The new calendar should not be retroactive and should apply from the day the exposure becomes past due more than 90 days. However, the factor to be applied should be the one which would have been applicable if the exposure had, from the beginning, been classified as NPE because it was past due more than 90 days.

(11) In order to ensure that the credit protection valuation of institutions' NPEs follows a prudent approach, EBA should consider the need for and, if necessary, develop a common methodology, in particular regarding assumptions pertaining to recoverability and enforceability, and possibly including minimum requirements for re-valuation in terms of timing.

(12) In order to facilitate a smooth transition towards this new prudential backstop, the new rules should not be applied in relation to exposures originated prior to 14 March 2018. The Commission has repeatedly made public its intention to introduce a prudential backstop for NPEs. As of the date of the legislative proposal there should be sufficient clarity for institutions and other stakeholders on how the prudential backstop envisaged by the Commission would apply.

(13) Regulation (EU) No 575/2013 should therefore be amended accordingly,

HAVE ADOPTED THIS REGULATION:

Article 1

Amendments to Regulation (EU) No 575/2013

(1) in Article 36, the following point (m) is added:

'(m) the applicable amount of insufficient coverage for non-performing exposures.';

(2) the following Articles 47a, 47b and 47c are inserted:

'Article 47a

Non-performing exposures

1. For the purposes of Article 36(1)(m), 'exposure' shall include any of the following items, provided they are not included in the trading book of the institution:

   (a) a debt instrument, including a debt security, a loan, an advance, a cash balance at a central bank and any other demand deposit;

   (b) a loan commitment given, a financial guarantee given or any other commitment given, irrespective whether revocable or irrevocable.

2. For the purposes of Article 36(1)(m), the exposure value of a debt instrument shall be its accounting value measured without taking into account any specific credit risk adjustments, additional value adjustments in accordance with Articles 34 and 105, amounts deducted in accordance with Article 36(1)(m) or other own funds reductions related to the exposure.

   For the purposes of Article 36(1)(m), the exposure value of a loan commitment given, a financial guarantee given or other commitments given shall be its nominal value, which shall represent the institution's maximum exposure to credit risk without taking account of any funded or unfunded credit protection. In particular,

   (a) the nominal value of financial guarantees given shall be the maximum amount the entity could have to pay if the guarantee is called on;

   (b) the nominal value of loan commitments shall be the undrawn amount that the institution has committed to lend.

   The nominal value referred to in the second subparagraph shall not take into account any specific credit risk adjustment, additional value adjustments in accordance with Articles 34 and 105, amounts deducted in accordance with Article 36(1)(m) or other own funds reductions related to the exposure.

3. For the purposes of Article 36(1)(m), the following exposures shall be classified as non-performing:

   (a) an exposure in respect of which a default is considered to have occurred in accordance with Article 178;

   (b) an exposure considered impaired in accordance with the applicable accounting framework;

   (c) an exposure under probation pursuant to paragraph 7, where additional forbearance measures are granted or where it becomes more than 30 days past due;

   (d) an exposure in form of a commitment that, were it drawn down or otherwise used, would present a risk of not being paid back in full without realisation of collateral;

   (e) an exposure in form of a financial guarantee that is at risk of being called by the guaranteed party, including where the underlying guaranteed exposure meets the criteria to be considered as non-performing.

   For the purpose of point (a), where an institution has on-balance sheet exposures to an obligor that are past due by more than 90 days and that represent more than 20% of all on-balance sheet exposures to that obligor, all on- and off-balance sheet exposures to that obligor shall be considered as past due by more than 90 days.

4. Exposures that have not been subject to a forbearance measure shall cease to be classified as non-performing for the purposes of Article 36(1)(m) where all of the following conditions are met:

(a) the exposure meets the exit criteria applied by the institution for the discontinuation of the classification as impaired in accordance with the applicable accounting framework and of the classification as defaulted in accordance with Article 178;

(b) the situation of the obligor has improved to the extent that the institution is satisfied that full and timely repayment is likely to be made;

(c) the obligor does not have any amount past-due by more than 90 days.

5. The classification of a non-performing exposure as non-current asset held for sale in accordance with the applicable accounting framework shall not discontinue its classification as non-performing exposure for the purposes of Article 36(1)(m).

6. Non-performing exposures subject to forbearance measures shall cease to be classified as non-performing for the purposes of Article 36(1)(m), where all of the following conditions are met:

(a) exposures have ceased to be in a situation that would lead to their classification as non-performing under paragraph 3;

(b) at least one year has passed since the latest between the moment where the forbearance measures have been granted and the moment where exposures have been classified as non-performing;

(c) there is no past-due amount following the forbearance measures or the institution, on the basis of the analysis of the obligor's financial situation, is satisfied about the likelihood of the full and timely repayment of the exposure.

For the purposes of point (c), full and timely repayment may be considered likely where the obligor has executed regular and timely payments of amounts equal to either of the following:

(i) the amount that was past-due before the forbearance measure was granted, where there were past-due amounts;

(ii) the amount that has been written-off under the forbearance measures granted, where there were no past-due amounts.

7. Where a non-performing exposure has ceased being classified as non-performing pursuant to paragraph 6, such exposure shall be under probation until all of the following conditions are met:

(a) at least two years have passed since the date the forborne exposure was re-classified as performing;

(b) regular and timely payments have been made during at least half of the period that the exposure would be under probation, leading to the payment of a substantial aggregate amount of principal or interest;

(c) none of the exposures to the obligor is more than 30 days past due.

Article 47b

Forbearance measures

1. For the purposes of Article 47a, 'forbearance measure' shall include a concession by an institution towards an obligor that is experiencing or is likely to experience a deterioration in its financial situation. A concession may entail a loss for the lender and shall refer to either of the following actions:

   (a) a modification of the terms and conditions of a debt obligation, where such modification would not have been granted had the financial situation of the obligor not deteriorated;

   (b) a total or partial refinancing of a debt obligation, where such refinancing would not have been granted had the financial situation of the obligor not deteriorated.

2. For the purpose of paragraph 1, at least the following situations shall be considered forbearance measures:

   (a) new contract terms that are more favourable to the obligor than the previous contract terms;

   (b) new contract terms that are more favourable to the obligor than contract terms offered by the same institution to obligors with a similar risk profile at that time;

   (c) the exposure under the initial contract terms was classified as non-performing before the modification to the contract terms or would have been classified as non-performing in the absence of modification to the contract terms;

   (d) the measure results in a total or partial cancellation of the debt obligation;

   (e) the institution approves the exercise of clauses that enable the obligor to modify the terms of the contract and the exposure was classified as non-performing before the exercise of those clauses, or would be classified as non-performing were those clauses not exercised;

   (f) at or close to the time of the granting of debt the obligor made payments of principal or interest on another debt obligation with the same institution, which was classified as a non-performing exposure or would have been classified as non-performing in the absence of those payments;

   (g) the modification to the contract terms involves repayments made by taking possession of collateral, where such modification constitutes a concession.

3. For the purpose of paragraph 1, the following circumstances are indicators that forbearance measures may have been adopted:

   (a) the initial contract was past due by more than 30 days at least once during the three months prior to its modification or would be more than 30 days past due without modification;

   (b) at or close to the time of concluding the credit agreement, the obligor made payments of principal or interest on another debt obligation with the same institution that was past due by 30 days at least once during the three months prior to the granting of new debt;

(c) the institution approves the exercise of clauses that enable the obligor to change the terms of the contract, and the exposure is 30 days past due or would be 30 days past due were those clauses not exercised.

4. For the purposes of this Article, the deterioration of the financial situation of an obligor shall be assessed at obligor level, taking into account all the legal entities in the obligor's group which are within the perimeter of the accounting consolidation of the group and natural persons who control that group.

Article 47c

Deduction for non-performing exposures

1. For the purposes of Article 36(1)(m), institutions shall determine the applicable amount of insufficient coverage for non-performing exposures to be deducted from Common Equity Tier 1 items by subtracting the amount determined in point (b) from the amount determined in point (a):

(a) the sum of:

(i) the unsecured part of each non-performing exposure, if any, multiplied by the applicable factor referred to in paragraph 2;

(ii) the secured part of each non-performing exposure, if any, multiplied by the applicable factor referred to in paragraph 3;

(b) the sum of the following items provided they relate to a specific non-performing exposure:

(i) specific credit risk adjustments;

(ii) additional value adjustments in accordance with Articles 34 and 105;

(iii) other own funds reductions;

(iv) for institutions calculating risk-weighted exposure amounts using the Internal Ratings Based Approach, the absolute value of the amounts deducted pursuant to point (d) of Article 36(1) which relate to non-performing exposures, where the absolute value attributable to each non-performing exposure is determined by multiplying the amounts deducted pursuant to point (d) of Article 36(1) by the contribution of the expected loss amount for the non-performing exposure to total expected loss amounts for defaulted or non-defaulted exposures, as applicable.

The secured part of a non-performing exposure is the part of such exposure which is covered by a funded credit protection or unfunded credit protection in accordance with Chapters 3 and 4 of Title II.

The unsecured part of a non-performing exposure corresponds to the difference, if any, between the value of the exposure as referred to in Article 47a(1) and the secured part of the exposure, if any.

2. For the purposes of paragraph 1(a)(i), the following factors shall apply:

(a) 0.35 for the unsecured part of a non-performing exposure to be applied during the period between one year and two years following its classification as non-performing, where the obligor is past due more than 90 days;

(b) 0.28 for the unsecured part of a non-performing exposure to be applied during the period between one year and two years following its classification as non-performing, where the obligor is not past due more than 90 days;

(c) 1 for the unsecured part of a non-performing exposure to be applied as of the first day of the second year following its classification as non-performing, where the obligor is past due more than 90 days;

(d) 0.8 for the unsecured part of a non-performing exposure to be applied as of the first day of the second year following its classification as non-performing, where the obligor is not past due more than 90 days;

3. For the purposes of paragraph 1(a)(ii), the following factors shall apply:

(a) 0.05 for the secured part of a non-performing exposure to be applied during the period between one year and two years following its classification as non-performing, where the obligor is past due more than 90 days;

(b) 0.04 for the secured part of a non-performing exposure to be applied during the period between one year and two years following its classification as non-performing, where the obligor is not past due more than 90 days;

(c) 0.1 for the secured part of a non-performing exposure to be applied during the period between two and three years following its classification as non-performing, where the obligor is past due more than 90 days;

(d) 0.08 for the secured part of a non-performing exposure to be applied during the period between two and three years following its classification as non-performing, where the obligor is not past due more than 90 days;

(e) 0.175 for the secured part of a non-performing exposure to be applied during the period between three and four years following its classification as non-performing, where the obligor is past due more than 90 days;

(f) 0.14 for the secured part of a non-performing exposure to be applied during the period between three and four years following its classification as non-performing, where the obligor is not past due more than 90 days;

(g) 0.275 for the secured part of a non-performing exposure to be applied during the period between four and five years following its classification as non-performing, where the obligor is past due more than 90 days;

(h) 0.22 for the secured part of a non-performing exposure to be applied during the period between four and five years following its classification as non-performing, where the obligor is not past due more than 90 days;

(i) 0.4 for the secured part of a non-performing exposure to be applied during the period between five and six years following its classification as non-performing, where the obligor is past due more than 90 days;

(j) 0.32 for the secured part of a non-performing exposure to be applied during the period between five and six years following its classification as non-performing, where the obligor is not past due more than 90 days;

(k) 0.55 for the secured part of a non-performing exposure to be applied during the period between six and seven years following its classification as non-performing, where the obligor is past due more than 90 days;

(l) 0.44 for the secured part of a non-performing exposure to be applied during the period between six and seven years following its classification as non-performing, where the obligor is not past due more than 90 days;

(m) 0.75 for the secured part of a non-performing exposure to be applied during the period between seven and eight years following its classification as non-performing, where the obligor is past due more than 90 days;

(n) 0.6 for the secured part of a non-performing exposure to be applied during the period between seven and eight years following its classification as non-performing, where the obligor is not past due more than 90 days;

(o) 1 for the secured part of a non-performing exposure to be applied as of the first day of the eighth year following its classification as non-performing, where the obligor is past due more than 90 days;

(p) 0.8 for the secured part of a non-performing exposure to be applied as of the first day of the eighth year following its classification as non-performing, where the obligor is not past due more than 90 days.

4. For the purposes of determining the factor referred to in paragraphs 2 and 3 applicable to the secured or unsecured part of an exposure the following rules shall apply:

(a) where an exposure that has been classified as non-performing for reasons other than being past due more than 90 days and subsequently becomes past due more than 90 days, it shall be treated, from the day it becomes past due more than 90 days, as if it had been past due more than 90 days on the date of its classification as non-performing;

(b) an exposure that has been classified as non-performing because it is past due more than 90 days shall be treated as such until it ceases to be classified as non-performing in accordance with paragraphs 4 and 6 of Article 47a, regardless of the repayment of past due amounts by the obligor;

(c) an exposure that has been classified as non-performing because it is past due more than 90 days and which subsequently benefits from forbearance measures shall still be treated as being past due more than 90 days;

(d) whether an exposure is past due more than 90 days shall be determined in accordance with Article 178.

5. EBA shall assess the range of practices applied for the valuation of secured non-performing exposures and may develop guidelines to specify a common methodology, including possible minimum requirements for re-valuation in terms of timing and ad hoc methods, for the prudential valuation of eligible forms of funded and unfunded credit protection, in particular regarding assumptions pertaining to their recoverability and enforceability.

Those guidelines shall be issued in accordance with Article 16 of Regulation (EU) No 1093/2010.';

(3) the first sub-paragraph of Article 111(1) is replaced by the following:

'1. The exposure value of an asset item shall be its accounting value remaining after specific credit risk adjustments, additional value adjustments in accordance with Articles 34 and 105, amounts deducted in accordance with Article 36(1)(m) and other own funds reductions related to the asset item have been applied. The exposure value of an off-balance sheet item listed in Annex I shall be the following percentage of its nominal value after reduction of specific credit risk adjustments and amounts deducted in accordance with Article 36(1)(m):';

(4) paragraph 1 of Article 127 is replaced by the following:

'1. The unsecured part of any item where the obligor has defaulted in accordance with Article 178, or in the case of retail exposures, the unsecured part of any credit facility which has defaulted in accordance with Article 178 shall be assigned a risk weight of:

(a) 150 %, where the sum of specific credit risk adjustments and of the amounts deducted in accordance with Article 36(1)(m) are less than 20 % of the unsecured part of the exposure value if these specific credit risk adjustments and deductions were not applied;

(b) 100 %, where the sum of the specific credit risk adjustments and of the amounts deducted in accordance with Article 36(1)(m) are no less than 20 % of the unsecured part of the exposure value if these specific credit risk adjustments and deductions were not applied.';

(5) Article 159 is replaced by the following:

'Article 159
Treatment of expected loss amounts

Institutions shall subtract the expected loss amounts calculated in accordance with Article 158 (5), (6) and (10) from the general and specific credit risk adjustments and additional value adjustments in accordance with Articles 34 and 110 and other own funds reductions related to these exposures except for the deductions made in accordance with Article 36(1)(m). Discounts on balance sheet exposures purchased when in default in accordance with Article 166(1) shall be treated in the same manner as specific credit risk adjustments. Specific credit risk adjustments on exposures in default shall not be used to cover expected loss amounts on other exposures. Expected loss amounts for securitised exposures and general and specific credit risk adjustments related to these exposures shall not be included in this calculation.';

(6) point (b) of Article 178(1) is replaced by the following:

'(b) the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries. Competent authorities may replace the 90 days with 180 days for exposures secured by residential property or SME commercial immovable property in the retail exposure class, as well as exposures to public sector entities. The 180 days shall not apply for the purposes of Article 36(1)(m) or Article 127.';

(7) the following Article 469a is inserted:

'Article 469a
Derogation from deductions from Common Equity Tier 1 items for non-performing exposures

By way of derogation from Article 36(1)(m), institutions shall not deduct from Common Equity Tier 1 items the applicable amount of insufficient coverage for non performing exposures where the exposure was incurred prior to 14 March 2018.

Where the terms and conditions of an exposure which was incurred prior to 14 March 2018 are modified by the institution in a way that increases the institution's exposure to the obligor, the exposure shall be considered as having been incurred on the date when the modification applies and shall cease to be subject to the derogation provided in the first subparagraph.'.

Article 2

Entry into force

This Regulation shall enter into force on the day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the European Parliament
The President

For the Council
The President