3 NPL - ECB guidelines

Background

The **Single Supervisory Mechanism (SSM)**, in order to set out focus areas for supervision, builds on an assessment of key risks faced by supervised banks, bearing in mind developments within the economic, regulatory and supervisory environment.

Among the significant drivers of risk identified by the SSM, the high stock of **non-performing loans (NPLs)**[1] held by institutions deserved heightened attention. Seeking to help banks to tackle this issue, and after nearly one year of work by the NPL Task Force, **the European Central Bank (ECB) published a guidance to banks on NPLs**. Banks should engage on its proportionate implementation, regardless of its non-binding nature, as non-compliance with the guidance may trigger supervisory measures.

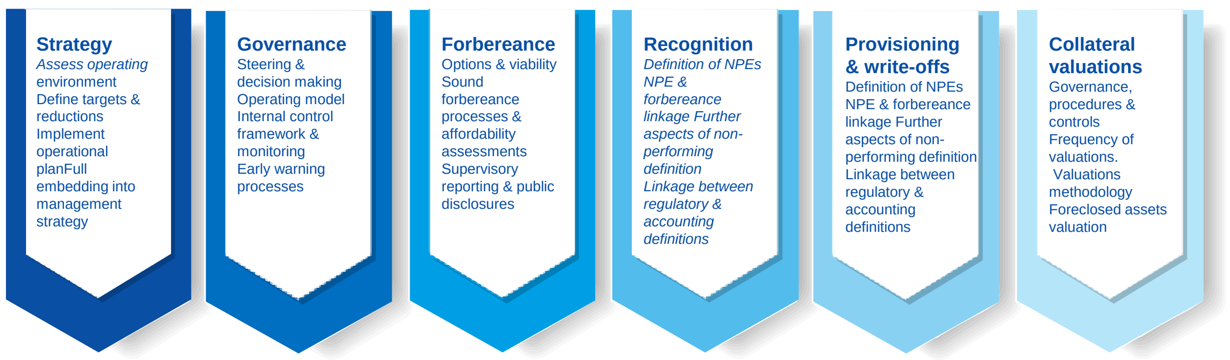
Content of the guidance

For the purpose of this guidance, the SSM defines a high NPL bank as a bank with an NPL level considerably higher than the EU average as defined by the EBA Risk Dashboard[2]. It is addressed to significant institutions under SSM direct supervision, but the SSM considers some chapters of the guidance (strategy, governance and operations) to be more relevant for high NPL-banks.

With a clear scope defined, the guidance follows the **NPL management lifecycle** including six chapters which cover: i) strategy, ii) governance and operations, iii) forbearance treatments, iv) NPL recognition[3], v) provisioning and write-offs and vi) collateral valuations.

Figure 2

NPL Management Lifecycle



Source: Guidance to banks on non-performing loans

1: In technical terms, the guidance addresses all non-performing exposures (NPEs), touching on performing exposures with a high risk of turning non-performing. NPL and NPE are used interchangeably within this guidance.
2: Last data: 5.1% in Q4 2016.
3: Banks should implement the definition of NPE and unlikely to pay criteria homogeneously in all parts of the group.

Assessment

Tackling down NPLs is not only relevant for banks, but for the wider economy. A reduction of these exposures will have an impact on bank profitability, capital allocation, credit concession (and therefore monetary policy transmission), and financial institutions' valuation.

We acknowledge the importance of the ECB guidance to banks on NPEs and consider it is adequate to enhance the quality of European bank's balance sheets. It will be very useful as it intends to provide a harmonised framework for NPL resolution across the Banking Union. Nevertheless, as long as national accounting rules continue to be applied, full comparison will not be possible.

It is important to highlight that, despite the fact that the guidance is applicable as of its date of publication, a phasing-in period has been granted. Institutions along with Joint Supervisory Teams (JSTs) should work together on a case-by-case basis, in order to decide a suitable time-bound action plan.

These supervisory efforts have a significant potential to deal with the NPL burden. Supervisory tools to implement the guidance on a mandatory basis – as part of the Supervisory Review and Evaluation Process (SREP) - are available. Europe's NPL burden should be solved in a comprehensive manner, taking into account the efforts already made in some countries, and no compulsory measures should be imposed on all banks. Aligned with this idea and the guidance, a stocktake of national supervisory practices and legal frameworks related to NPLs was released in the guidelines, identifying country challenges and possible enhancements.

Other institutional initiatives to dilute the NPL burden are under discussion. For instance, a **European Clearinghouse** (information platform without risk transfer) could be useful to foster NPL secondary market, increasing transparency and facilitating transactions. On the other hand, a **European Asset Management Company** (AMC) could be less preferable, as it could face difficulties given the different measures that have already been implemented in some countries, the heterogeneity of national assets and procedures, the short term costs for banks, and the mutualisation of risks. Moreover, depending on the price of transfer - at market value or at long-term (real) economic value - it could be enacted without being considered State Aid (in the European Clearinghouse case) or triggering State Aid rules (in the AMC case).

In any event, a proactive and coordinated approach will be desirable from all agents involved in NPEs' life cycle. Institutional initiatives such as increasing transparency, easing judicial procedures or fiscal harmonisation, are necessary to increase banks' asset quality, and strengthen its capacity to support the wider economy.

DISCLAIMER

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