EUROPEAN CENTRAL BANK

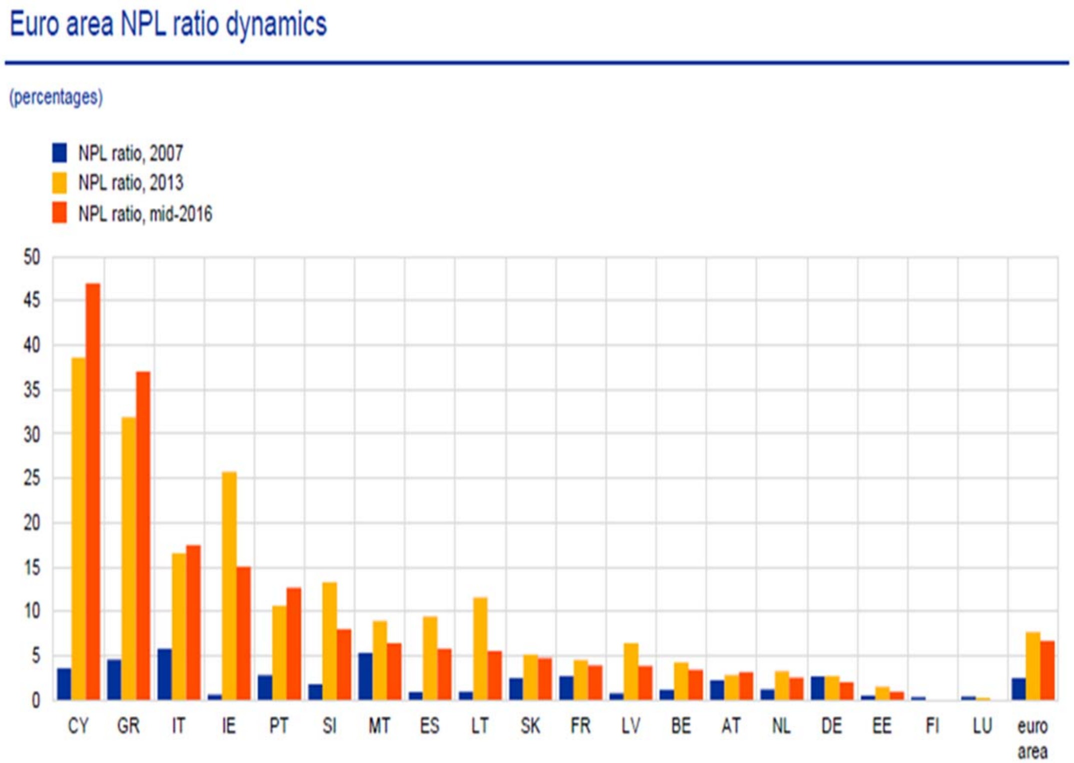
BANKING SUPERVISION

SSM action plan on Non-Performing Loans

Frankfurt , 19 September 18

Context – why the supervisory focus on NPL's?

ECB-PUBLIC



Extract from ECB's Annual report 2016

NPL's in Europe:

- The chart on the left shows the significant NPL increases across Europe in the period 2017-2013.
- By 2016 the situation had not resolved itself sufficiently and the SSM work on NPL's intensified.
- The NPL issue was not solely the result of an economic crisis but also partly the result of improper credit screening, recognition, inadequate and/or delayed provisioning and internal governance by banks.
- This can be evidenced the heterogeneity of the NPL levels across SSM countries and fact that in some countries a certain level of NPL's predated the financial crisis.

Why the need to solve the NPL issue in Europe?

- Banks with high NPL's will face balance sheet constraints as high NPL's require banks to hold provisions, which lowers net income and reduces banks profitability.
- NPL's can lead to a weak balance sheet, which can raise the cost of funding because of lower expected revenue streams, which also will affect profitability.
- The smooth and deliberate reduction of NPL's is beneficial to the economy allowing banks to generate more profitable loans whilst supporting economic growth in the process.

www.bankingsupervision.europa.eu ©

Comprehensive strategy to tackle NPLs

Comprehensive strategy to address NPLs requires action from all stakeholders including EU and national public authorities

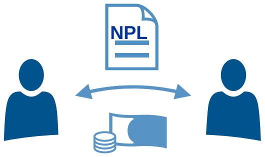
Supervisory actions

ECB has clearly and transparently set supervisory expectations

Legal and judicial reforms

Reform to legal, judicial and extra-judicial frameworks necessary to create a more favourable environment for NPL workout

Secondary markets



Development of the secondary markets and possibly creation of national AMCs

On 11 July 2017, the ECOFIN agreed an action plan to address the problem of non-performing loans in the banking sector (see later)

Comprehensive supervisory strategy to tackle NPLs

SSM created a dedicated NPL Taskforce in 2015

i. First stocktake report on national practices (September 16)

– published on ECB website –

ii. NPL guidance (March 2017)

– published on ECB website –

iii. Updated stocktake report on national practices (June 2017)

– published on ECB website –

iv. Addendum to the NPL guidance (March 2018)

– published on ECB website –

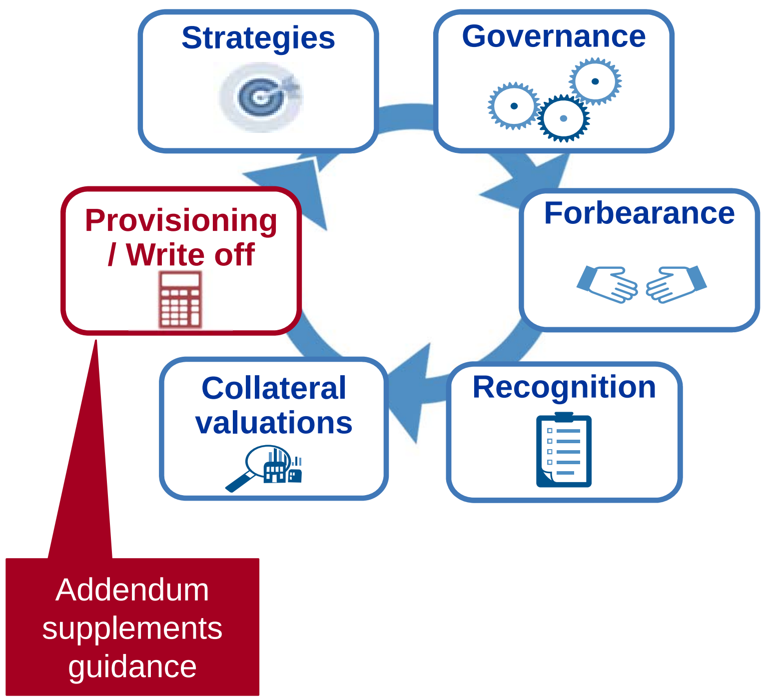
v. ECB press release on supervisory expectations for NPL stock (July 18)

– published on ECB website–

European banking supervision puts much effort into helping the banks resolve their NPLs

Overview of ECB guidance to banks on NPLs

(final version published in March 2017)



- Guidance outlines measures, processes and best practices for banks to tackle NPLs
- In addition, we have published our “supervisory expectations” to avoid the piling-up of new NPLs in the future
- Guidance to serve as basis for ongoing supervisory dialogue with banks in all relevant areas.
- The addendum and the subsequent press announcement on the NPL tock serve to compliment the NPL methodology and approach
- ‘’ Wait and see” approaches often observed in the past is not in line with supervisory expectations.

NPL & foreclosed asset reduction strategies

- Guidance requires banks to implement ambitious, yet credible portfolio level reduction strategies, for tackling the NPL stock
- These are banks' own plans to reduce non-performing exposures and foreclosed assets.
- The joint supervisory teams closely follow and challenge the bank's NPL strategies and the way they are implemented. Process is integrated into SREP
- The NPL strategies are subject to scrutiny, the stringent assessment is an iterative process between the banks and the Joint Supervisory Teams.
- Supervisors monitor and track the level of foreclosed assets on banks balance sheets and expect banks to have effective reduction plans in place.
- The supervisory assessment also includes benchmarking analysis in order to ensure a level playing field and sufficiently ambitious and realistic targets.

Strategies are assessed under 3 core blocks:

Ambition

↓

Credibility

↓

Governance

Ambitiousness: How do we measure ambition?

In order to **facilitate a level playing field** and promote a more consistent approach:

- Ambition is based on the **volumes of reduction** as opposed to the absolute NPL ratio which can be subject to arbitrage depending on the calibration. This approach takes the bank specifics into account by accounting for varying banks starting points.
- Ambition level is based on the **level of gross and net non performing asset reduction** (NPL's + foreclosed assets) instead of solely NPE reduction to minimise arbitrage.
- NPA reduction is measured over **3 year strategy horizon** to account for the fact that NPL's cannot be solved overnight and reductions option can take time to implement.
- Ambition is assessed by comparing banks against **peers, country and SSM benchmarks** to ensure that outliers can be identified and challenged on a bank by bank basis by JST's.

Collateral Valuation – a key focus of the SSM NPL Guidance

Key findings from 2017 on-site inspections in NPL data integrity:

Many findings in this area including:
- a lack of risk data aggregation processes, for data relevant to the detection of financial difficulties (e.g. data from income statements, EBITDA, DSCR).
- Key parameters (e.g. **collateral haircuts, discount times, cure rates**) are often significantly misestimated and the criteria for write-offs (e.g. expressed as time in default) are in many cases not clearly defined. -
- *Source: SSM Annual supervisory priorities report 2017*

Supervisory priorities for 2018 and beyond

Priorities 2018	Supervisory activities for 2018 & beyond	Continued from 2017	Likely to be continued in 2019[5]
Business models	Interest rate risk implications for banks' business models/profitability	✓	✓
Credit risk	Consistent approach to NPLs[1]/forborne exposures (e.g. deep dives/OSIs)	✓	✓
	Exposure concentrations & collateral management and valuation (e.g. real estate, Level 3 assets)	✓	✓
Risk management	TRIM[2]: Credit risk, market risk and counterparty credit risk models	✓	✓
	Improvement of banks' ICAAP[3] and ILAAP[4] approaches	✓	✓
	Evaluate banks' preparedness for IFRS 9 and other regulatory changes	✓	✓
Multiple risk dimensions	Brexit preparations	✓	✓
	EU-wide (biennial) and SSM-wide stress test exercise	○	✓

1) Non-performing loans.
2) Targeted review of internal models.
3) Internal capital adequacy assessment process.
4) Internal liquidity adequacy assessment process.
5) Light blue ticks indicate follow-up activities.

Collateral Valuations – NPL Guidance Supervisory expectations

ECB-PUBLIC

Supervisory expectation is that Banks (SI's) will have …..

Policies & procedures:

- Written documents
- Board approved
- Asset type specific
- Aligned to risk appetite
- Regularly updated

Monitoring & quality control:

- Robust processes
- Regular review
- Challenge valuations
- Back testing
- Independence of valuer's

IT capabilities

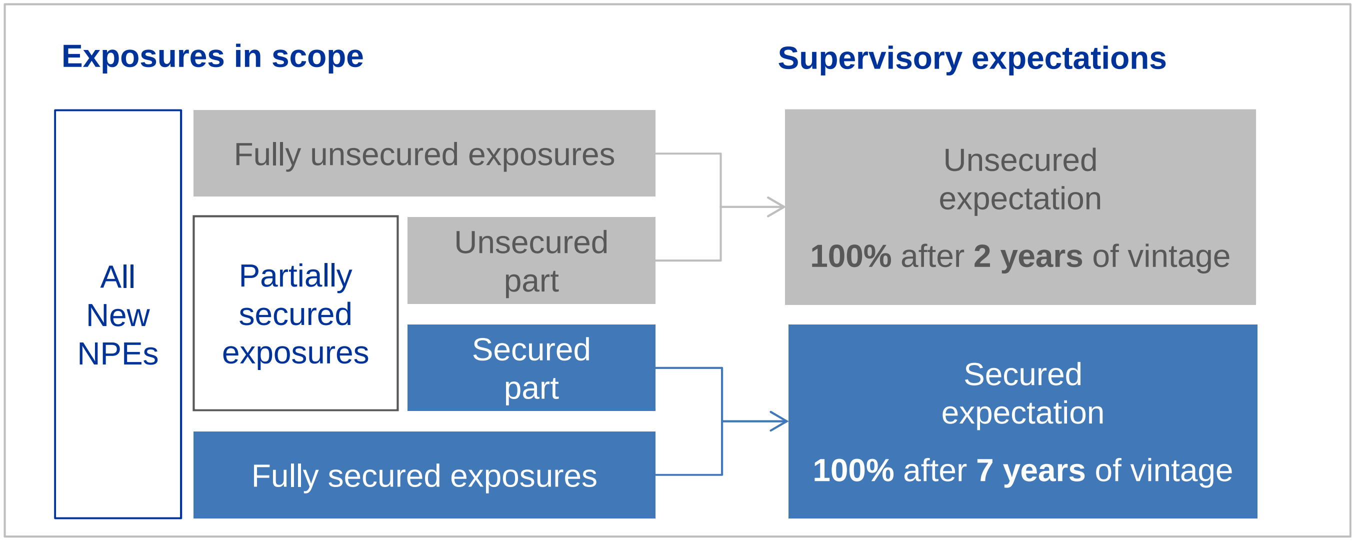
- Collateral database
- Transaction database
- Data quality & integrity
- Common sources & definitions

Strong Governance will enhance banks ability to implement robust collateral valuation framework

ECB Addendum for new NPLs of Significant Institutions

ECB-PUBLIC

Overview of key features of NPL addendum



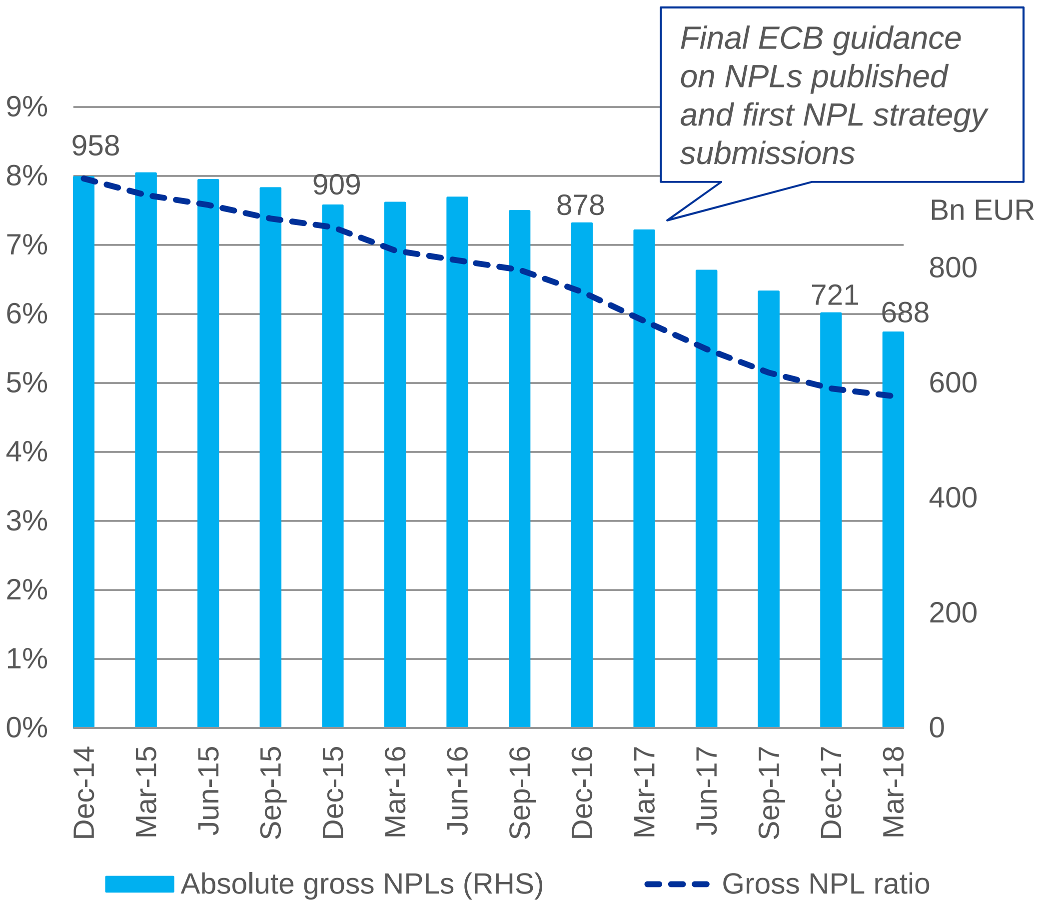
- The ECB addendum is **non-binding guidance that serves as a starting point** for the dialogue between the supervisor and individual Significant Institutions.
- **Expected to be considered by banks for all new NPEs** classified as such from April 2018
- **Different expectations** for unsecured and secured exposures
- Secured expectations rely on the prudential principle that **credit risk protection must be enforceable in a timely manner**
- **Deviations from supervisory expectations** do not trigger automatic actions but **form starting point of an institution-specific supervisory dialogue**

www.bankingsupervision.europa.eu ©

NPL stock – Status of reduction efforts

The levels of NPLs have fallen over the past years, but at €688 billion NPLs still pose a significant problem and further actions are needed.

Evolution of NPL ratios and levels for all Significant Institutions (SIs)



- There has been good progress in recent years; however, with a stock of € 688bn remaining there is considerable further effort needed.
- On-going work in the SSM since 2015 to establish a consistent supervisory approach to NPLs has contributed to the NPL reductions.
- ECB bank lending surveys show that credit conditions have become more expansionary. This shows that SSM actions did not interfere with the recovery of the bank lending process and of the real economy.
- Comprehensive package of supervisory tools in place on NPLs; however, solving the issues goes far beyond supervisory action

Source: ECB Supervisory Banking Statistics

NPL stock – Recent announcement and next steps

ECB-PUBLIC

SSM announcement of 11 July 2018

- ECB to address the stock of NPLs by setting bank-specific supervisory expectations for the provisioning of NPLs
- Aim is to achieve same coverage of NPL stock and flow over the medium term
- Bank-specific expectations are guided by individual banks' current NPL ratio and main financial features in a consistent way across comparable banks
- Joint Supervisory Teams (JSTs) will further engage with each bank to define its supervisory expectations

Further next steps in terms of supervisory approach to NPLs

- JSTs will continue to closely review NPL frameworks of Significant Institutions and challenge banks' own NPL Strategies as part of ongoing supervisory engagement while horizontal benchmarking will ensure consistency

Interactions between NPL work across European stakeholders

ECB-PUBLIC

- **Tackling the NPL issue goes beyond the supervisory tasks.**

- European and national authorities have launched several initiatives to address the high NPL stock.

- The **EU Council action plan on NPLs**, announced in July 2017, constitutes a comprehensive policy response to asset quality issues in the EU.

- Several initiatives under the Action plan have already been completed and others are expected to be completed in the near future.

- Besides, the presented supervisory actions the **ECB is fully supportive of the action plan and works closely with all relevant stakeholders** on delivering the action points.

www.bankingsupervision.europa.eu ©

Broader picture on EU actions aiming to speed up NPL resolution

European Council's NPL Action Plan of July 2017

Supervision	Macroprudential solutions	Secondary markets	Insolvency frameworks
• Clarify **supervisory powers** as regards bank provisioning policies • Consider **prudential provisioning backstops for new NPLs (Pillar 1)** • Implement guidance on NPLs for LSIs and for non-SSM member states • Guidelines on **loan origination**	• Develop approaches to prevent the future emergence of system-wide NPL problems • Develop a **blueprint for national AMCs**, consistent with EU legal framework (State aid rules, BRRD)	• Issue **disclosure requirements** on asset quality • **Strengthen the data infrastructure** with uniform and standardised data for NPLs • Consider the setting-up of **NPL transaction platforms** • **Remove impediments to the transfer of NPLs** by banks to non-banks and simplify the licensing requirements for third-party loan servicers	• Publish the results of the **benchmarking** exercise on the efficiency of **national loan enforcement regimes** • Consider to carry out dedicated **peer reviews of national insolvency regimes** • Analyse the possibility of **enhancing the protection of secured creditors**

Source: http://www.consilium.europa.eu/en/press/press-releases/2017/07/11-conclusions-non-performing-loans/

Thank you!