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EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

Accompanying the document

Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures

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Executive Summary Sheet

Impact assessment accompanying a proposal to amend Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures

A. Need for action

Why? What is the problem being addressed?

Following the financial crisis, the regulatory framework for banks has changed substantially. Reforms agreed at the level of the G20 and the Basel Committee have been and are being implemented around the globe in order to reduce the risk in the banking sector and to make the financial system more stable and resilient. Nevertheless, some risks have been addressed only locally. In particular, major jurisdictions (such as the United States or Japan to name just a few) have taken a number of measures to reduce the level of non-performing loans (NPLs) and repair banks' balance sheets, inter alia by introducing or intensifying mandatory provisioning/writing-off regimes for NPLs.

NPLs and other and other non-performing exposures (NPEs)[1] have also piled up in parts of the EU banking sector in the aftermath of the financial crisis and ensuing recessions. These elevated levels of NPLs affect financial stability as they weigh on the profitability and viability of the affected credit institutions and have an impact, by reduced bank lending, on economic growth. To further address the challenges of high NPLs in the EU, the "Action Plan to Tackle Non-Performing Loans in Europe" by the ECOFIN Council calls upon various institutions and agencies to take appropriate measures.

In particular, to reduce the risk of new NPL problems arising in the future, one of the key policy areas is to ensure that NPLs are recognised in a timely way and covered adequately in order to prevent loss forbearance and enhance NPLs resolution. Under-provisioning and loss forbearance are major obstacles to debt restructuring or asset sales, since banks may postpone restructuring or deleverage in order to avoid loss recognition (so-called "wait-and-see" approach). Delays in loss recognition have been found to contribute to reduced lending, as delays put even more pressure on banks to increase provisions during stress times (i.e. when losses materialise and regulatory capital requirements become most binding). This pro-cyclical provisioning implies pro-cyclical bank lending and more ample swings in the business cycle (i.e. boom-bust credit cycles).

Addressing high stocks of NPEs 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.

What is this initiative expected to achieve?

The general objectives of this initiative, which is part of a broader package of measures to tackle the issue of NPLs in the EU, are two fold and mutually reinforcing: the first general objective is to limit risks that high levels of NPEs pose to financial stability by avoiding the build-up or excessive increase of insufficiently covered NPEs in the EU banking system; second this initiative aims at ensuring that EU banks have sufficient loss coverage for NPEs, hence protecting their profitability, capital and funding costs in stressed times. This is particularly important in the EU where financial intermediation is still largely dominated by banking institutions. Coupled with deeper and stronger capital markets thanks to the CMU initiative, this should ensure that stable, less pro-cyclical financing is available to EU households and firms, thus supporting investment, growth and employment.

Operationally, this is pursued by reducing both the ability and the incentives of banks to pursue "wait and see" and "extend and pretend" strategies, by which banks delay the recognition of NPLs provisions. The initiative would do so by introducing a statutory prudential backstop which consist of (i) a requirement for banks 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 Common Equity Tier 1 (CET1) items. The minimum coverage requirement would apply in full only after a certain period of time, which would be different whether the loan is secured (by collateral or guarantee) or not.

[1] NPEs include non-performing loans (NPLs), non-performing debt securities and nonperforming off-balance-sheet items. NPLs, which term is well established and commonly used in the policy discussion, represent the largest share of NPEs. The terms NPE(s) and NPL(s) are therefore used interchangeably within this document.

What is the value added of action at the EU level?

The current EU prudential framework does not provide for a common minimum treatment with regards to incurred/expected losses on NPLs. Supervisors in charge of supervising institutions in the EU have the power to influence a bank's provisioning policy and to require specific adjustments to the own funds calculations on a case-by-case basis (so-called "Pillar 2" of the framework), but no harmonised (minimum) treatment applicable across Member States and banks can be imposed.

Due to the lack of common prudential rules on NPLs provisioning, actual loss coverage for NPLs 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 (for those in the euro area) would face different funding conditions depending on where they are located. Furthermore, on the borrowers' side, two companies with identical risk profiles and the same currency would face different lending conditions depending on their establishment. This creates additional financial fragmentation that hampers one of the most important benefits of the financial and monetary union, namely, the diversification and sharing of economic risks across borders.

Legislative action on the EU level would put automatic EU-wide brakes on the build-up of future NPLs without sufficient loan loss coverage and thus strengthen banks' financial soundness and ability to lend. It would contribute to the good functioning of monetary transmission mechanism and a more sustainable financial integration process in the EU. This would also contribute to the completion of the Banking Union by putting all banks on an equal footing, reducing unnecessary differences in banks' practices, increasing comparability, facilitating market discipline and promoting market confidence. EU wide action would also reduce potential spill-over effects within the Union. The high interconnectedness within the EU (and especially within the euro area) financial system creates a significant danger of spill-overs entailing stability risks which are better addressed at EU level.

B. Solutions

What legislative and non-legislative policy options have been considered? Is there a preferred choice or not? Why?

The Impact Assessment has considered the following policy options (on top of the baseline scenario i.e. no EU action):

- Option 1 – full coverage requirements of unsecured and secured NPLs at the end of defined time periods without any coverage requirement beforehand;
- Option 2 – gradually (linearly or progressively) increasing coverage requirements starting after the classification as non-performing and leading to a full coverage of unsecured and secured NPEs at the end of defined time periods;
- Option 3 – for secured NPLs, application of haircuts depending on the type of collateral (unsecured NPLs would be treated as under Option 1 and 2).

Upon evaluation and consideration of the impacts, option 2 (applying a progressive path to full coverage) was found to be preferable, because it achieves the policy objectives whilst maximising the cost-benefit ratio. It strikes the right balance between leaving sufficient time for possible recoveries and avoiding abrupt cliff-effects after this period of time.

Who supports which option?

Option 1 has been opposed by most of the stakeholders as it requires full coverage of NPLs only at the end of the defined time periods which could lead to important cliff-effects for banks that would be subject to a deduction from their own funds.

Option 2 (gradual approach) was supported by some banks and most of the public stakeholders. Banks showed a preference for a progressive path rather than a linear one, as the latter would be overly conservative in the first years, where the chances to recover the loan or the collateral are higher than towards the end of the period.

Option 3 (approach based on haircuts) has been criticised by most of the private and public stakeholders as being unduly complex. The majority of stakeholders did not find added value in it, as the complexity and the additional implementation costs would outweigh the small benefits banks would get in terms of higher risk-sensitivity.

C. Impacts of the preferred option

What are the benefits of the preferred option (if any, otherwise main ones)?

Option 2 (gradual approach) would require banks to start covering their NPLs at an early stage, therefore strongly reducing both their ability and their incentives to "wait and see" and "extend and pretend". This objective would be quickly met, as the coverage requirement would by design kick in as soon as the exposure becomes non-performing. Banks would not have the possibility to wait until the end of the period to increase their provisioning. Therefore, the main benefit of this option is the avoidance of too abrupt and potentially harmful impact at the end of the defined time period.

Option 2 would also be consistent and coherent with other EU policies. Supervisors would have fewer cases to impose or maintain dedicated Pillar 2 measures during the first years as compared to option 1. This would help ensure efficient use of resources and support EU-wide harmonisation in addressing NPEs.

By choosing a progressive path, the design of the backstop would be aligned with another envisaged initiative of the Commission which is the acceleration of extra-judicial collateral enforcement. It would require lower coverage levels during the first years when the collateral is more likely to be realised.

What are the costs of the preferred option (if any, otherwise main ones)?

Option 2 would induce higher costs in terms of capital requirements and implementation costs compared to the baseline for banks not currently subject to any Pillar 2 measures increasing their NPLs provisioning. Additional costs would also exist for banks subject to Pillar 2 measures in case these measures are insufficient to fully address the under-provisioning of NPLs.

Option 2 would potentially be costlier than Options 1 and 3 in the short run, as the potential deduction would apply already in the first year following the classification as NPL, and would be less risk-sensitive than under Option 3. However, choosing a progressive path would help to alleviate this concern as the amount to be covered would be lower in the first years, giving time for banks to recover the loan or realise the collateral at the beginning.

How will businesses, SMEs and micro-enterprises be affected?

The application of minimum coverage requirements would reduce banks’ incentives and ability to pursue "wait and see" practises. By strengthening banking banks' balance sheets with a more timely and effective management of NPEs, this option would support a more stable supply of credit, both in terms of credit quantity and price. The positive impact should be to the benefit of SMEs in particular, since these are more dependent on bank lending than large corporates which might access more easily financial markets.

Will there be significant impacts on national budgets and administrations?

Significant impacts on national budgets and administrations are not expected. The introduction of a Pillar 1 measure should reduce the need for Pillar 2 measures (which are assessed on a case-by-case basis). This would allow for a more targeted use of human and financial resources, thereby increasing efficiency.

Will there be other significant impacts?

In the short run, the own funds of banks that do not meet the applicable minimum coverage level (and that would therefore be subject to the gradual deduction) would decline compared to the baseline. However, all banks would be measured against a common yardstick at each point in time which increases comparability across banks and promotes a level-playing throughout the Single Market. Because of the progressively increasing coverage requirements possible cliff-edge effects as result of delayed losses with potentially severe impacts on banks' capital would be avoided. The prudential backstop would indeed not increase capital requirements for NPEs, but only alter the distribution of capital needs to cover losses on NPEs over time (without increasing their overall size).

In the long run, the impacts on banks would be beneficial because, by avoiding that under-provisioned NPEs accumulate and reach unsustainable levels, the backstop would help strengthening their resilience to stress times and economic crisis, lowering their funding and administrative costs and protecting their profitability. The prudential backstop would indeed not increase capital requirements for NPEs, but only alter the distribution of capital needs to cover losses on NPEs more evenly over time (without increasing their overall size).

D. Follow up

When will the policy be reviewed?

6 to 8 years (depending on the final calibration of the period after which full coverage of NPLs would be required) after the date of application of this initiative, the Commission shall carry out an evaluation. The objective of the evaluation will be to assess, among other things, how effective and efficient the measure has been in terms of achieving the objectives presented in this impact assessment and to decide whether new measures or amendments are needed.