



## IMPLEMENTING CALENDAR PROVISIONING: RULES AND IMPACTS

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# // INDEX



<b>1.</b>	<b>INTRODUCTION</b>	<b>6</b>
<b>2.</b>	<b>REGULATORY FRAMEWORK</b>	<b>7</b>
2.1.	ECB and European Union regulations	7
2.2.	The role of collateral	13
2.3.	Reporting rules and operating instructions	14
<b>3.</b>	<b>GREY AREAS IN THE NEW RULES</b>	<b>16</b>
3.1.	Portfolio netting	16
3.2.	Interaction between NPL backstop, credit risk mitigation techniques and RWA calculation	17
3.3.	“New exposures” under Article 469a	19
3.4.	The benefit due to the IRB “shortfall”	21
3.5.	Use of Pillar I capital	22
3.6.	Application to off-balance sheet exposures	23
3.7.	Eligible collateral and exposure tranching	24
3.8.	Application to NPL portfolios purchased at a discount	26
<b>4.</b>	<b>THE EFFECTS OF CALENDAR PROVISIONING ON STRATEGIC NPE MANAGEMENT</b>	<b>28</b>
4.1.	Foreword	28
4.2.	Impacts on extraordinary NPE management	29
4.2.1.	Potential impacts on originating banks	29
4.2.2.	Potential impacts on NPE purchasers	33
<b>5.</b>	<b>IMPACTS ON PERFORMING LOANS: PRICING</b>	<b>34</b>
5.1.	Introduction: calendar provisioning and loan disbursement	34
5.2.	Risk-based pricing as a value creation tool	36
5.2.1.	Risk-based pricing: overview	36
5.2.2.	The impact of calendar provisioning on pricing	38
<b>6.</b>	<b>MANAGING THE PROVISIONING GAP</b>	<b>48</b>
6.1.	Supervisory dialogue: comply or explain	48
6.2.	Explain circumstances: a tentative list	50
<b>7.</b>	<b>CALENDAR PROVISIONING DURING COVID-19</b>	<b>53</b>
7.1.	How supervisors and regulators responded to the pandemic	53
7.1.1.	Measures that directly affect calendar provisioning	54
7.1.2.	Measures that indirectly affect calendar provisioning	56
7.2.	Further desirable measures	57
7.3.	Expected impacts of COVID-19 on management practices	58
<b>8.</b>	<b>CONCLUSIONS</b>	<b>60</b>





This paper is based on the work of a technical committee of AIFIRM (Italian Association of Financial Industry Risk Managers), coordinated by Leonardo Bellucci and Andrea Resti with the technical-organizational support of CRIF.

The original paper (in Italian) and the list of the committee members can be found at: <https://www.aifirm.it/wp-content/uploads/2020/10/2020-Position-Paper-23-Calendar-Provisioning.pdf>.

CRIF would like to thank all the participants in the working group and AIFIRM for agreeing to this publication.



# 1. INTRODUCTION<sup>1</sup>



Calendar provisioning (“CP”) is one of the most disruptive and challenging supervisory measures in recent years. Introduced in March 2018 by the ECB through its “Addendum to the guidance on non-performing loans” (“NPLs”<sup>2</sup>), the new rules provide that NPLs be subject to minimum loss coverage requirements, depending on the time elapsed since default, to be achieved through write downs or deductions from regulatory capital. CP has been originally designed as a system of “supervisory expectations” under Basel’s Pillar 2, which are non-binding and subject to change in the context of the “dialogue” between supervisors and supervised institutions, although the Single Supervisory Mechanism (SSM) aims to apply them in a rigorous, uniform manner.

The mechanism, originally meant to apply only to loans defaulting after April 2018, was extended in July 2018 – through an SSM communication – to pre-existing NPLs, which would also be subject to full coverage by 2026 (although based on different time-frames for individual banks, to be defined in their annual Supervisory Review and Evaluation Process, or SREP). Furthermore, in April 2019, European Regulation 2019/630 amended Regulation 575/2013 (the “capital requirements regulation”, “CRR”) by introducing a mandatory calendar provisioning system (known as “backstop”), which dictates Pillar 1 requirements for loans granted after the measure came into force.

The minimum loss coverage required by calendar provisioning is based on a faster time frame than the average recovery procedures in some European countries. This difference may be significant for some facility types and euro area regions, where riskier loan portfolios are combined with less efficient judicial systems. As a result, calendar provisioning may lead banks to perform larger/faster “write-offs” (either through their P&L account and through capital deductions) than justified by past recovery experience. Such an additional burden – in terms of higher costs and reduced leverage – will ultimately impact the profitability of the lending business and/or the cost of credit for customers.

As they affect the viability of banks and the sustainability of investments, the changes brought by calendar provisioning must be managed, rather than just be passively experienced. In this spirit, this paper aims at providing an in-depth look at the current situation, and at possible future developments in the area of calendar provisioning.

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<sup>2</sup> In this paper, the terms “Non-Performing Loans” (NPL<sub>s</sub>) and “Non-Performing Exposures” (NPE<sub>s</sub>) will essentially be used as synonyms. However, not all credit exposures are loans (for example, exposures represented by corporate bonds), and the regulatory framework typically covers all credit exposures.



## 2. REGULATORY FRAMEWORK



In this section, we provide an overview of the existing regulatory framework concerning calendar provisioning, which, as already mentioned, has “stratified” over the years, due to the supervisory expectations published by the European Central Bank and the subsequent regulations issued by the European Commission, Council and Parliament.

### 2.1 ECB AND EUROPEAN UNION REGULATIONS

The current framework is the result of a series of measures introduced by the ECB as supervisor and the European Parliament in its role as regulator.

In March 2017, the ECB published its “Guidance to banks on non-performing loans”, supplemented in March 2018 by an “Addendum to the guidance on non-performing loans”. The latter publication established for the first time a set of guidelines (called “supervisory expectations”) on the prudential coverage of new non-performing exposures (NPE), i.e. exposures classified as non-performing after April 1, 2018.

The ECB coverage expectations are meant to be the first step in a dialogue between the supervised institutions and the supervisor, within which it is possible to justify any “legitimate” gaps. Where such gaps are not adequately justified, the ECB may adopt a Pillar 2 regulatory measure, imposing additional capital to offset the missing write-offs.

The Addendum was followed by a press release, dated July 11, 2018, which introduced the objective of achieving adequate provisioning also for NPEs existing prior to April 2018. This goal was mentioned in the SREP letters sent to banks in 2018 and 2019.

With the publication of European Regulation 2019/630 in April 2019, a further requirement for minimum loss coverage was introduced through an amendment to the Capital Requirements Regulation (CRR). In particular, a system of deductions from the bank’s Common Equity Tier 1 (“CET1”) capital was introduced, for banks failing to achieve the minimum coverage dictated by the new regulation. The new CRR rules are included in the so-called “Pillar 1” capital requirements and hence do not provide for any flexibility. However, they only apply to loans originated after April 26, 2019.



As the two systems of rules (supervisory expectations and CRR amendments) overlap, but are not entirely consistent with each other, in August 2019 the ECB published a “Communication on supervisory coverage expectations for NPEs”, aimed at harmonizing the framework issued in March 2018 and with Regulation 2019/630, while confirming the expectations on pre-existing NPEs set out in the July 2018 communication.

Further supervisory communications were issued in 2019, regarding the “practical” calculation and reporting of calendar provisioning, and the interaction with supervisors. In particular:

- // in October 2019, the EBA published an initial proposal of COREP tables<sup>3</sup> to report the deductions from CET1 items in accordance with Regulation 2019/630, with effect from June 30, 2021. This document was followed by the publication in June 2020 of the “Final Report: Draft Implementing Technical Standards on supervisory requirements for institutions under Regulation (EU) No. 575/2013”, currently submitted to the European Commission;
- // in December 2019, the ECB released reporting templates and technical notes for compiling the reports on the NPEs subject to the SREP process (“instructions for compiling the Short Term Exercise”, or “STE instructions”). The templates require the application of the requirements at December 31, 2020 to the end- 2019 portfolio, and provide initial details on the “comply or explain” process.

In June 2020, European Regulation 2020/873 was approved (known as the “CRR Quick Fix”), which – in the context of wider measures amending the CRR to deal with the COVID emergency – enhances the role of public guarantees in slowing down calendar provisioning, following a similar stance taken by the ECB on Pillar 2 measures<sup>4</sup>.

<sup>3</sup> The Common Reporting Framework (COREP) defines the supervisory reports (mainly on risks and capital requirements) produced by European banks.

<sup>4</sup> See “ECB Banking Supervision provides further flexibility to banks in reaction to coronavirus”, March 20, 2020. Further details on calendar provisioning and Covid-19 are provided in §7 of this paper.



Currently, the minimum loss coverage for NPEs required by Pillar 1 and Pillar 2 measures is the following (see Figure 1):

- // exposures defaulting on or after April 1, 2018 and originated on or after April 26, 2019, fall within the scope of “Pillar 1” measures introduced by Regulation 630;
- // exposures defaulting on or after April 1, 2018 and originated before April 26, 2019, fall within the so-called “Pillar 2 Addendum” scope;
- // NPEs defaulted before April 1, 2018 fall within the so-called “Pillar 2 Stock” perimeter, managed within the so-called “SREP letters”, whereby the ECB shares with individual banks its supervisory requirements and targets.

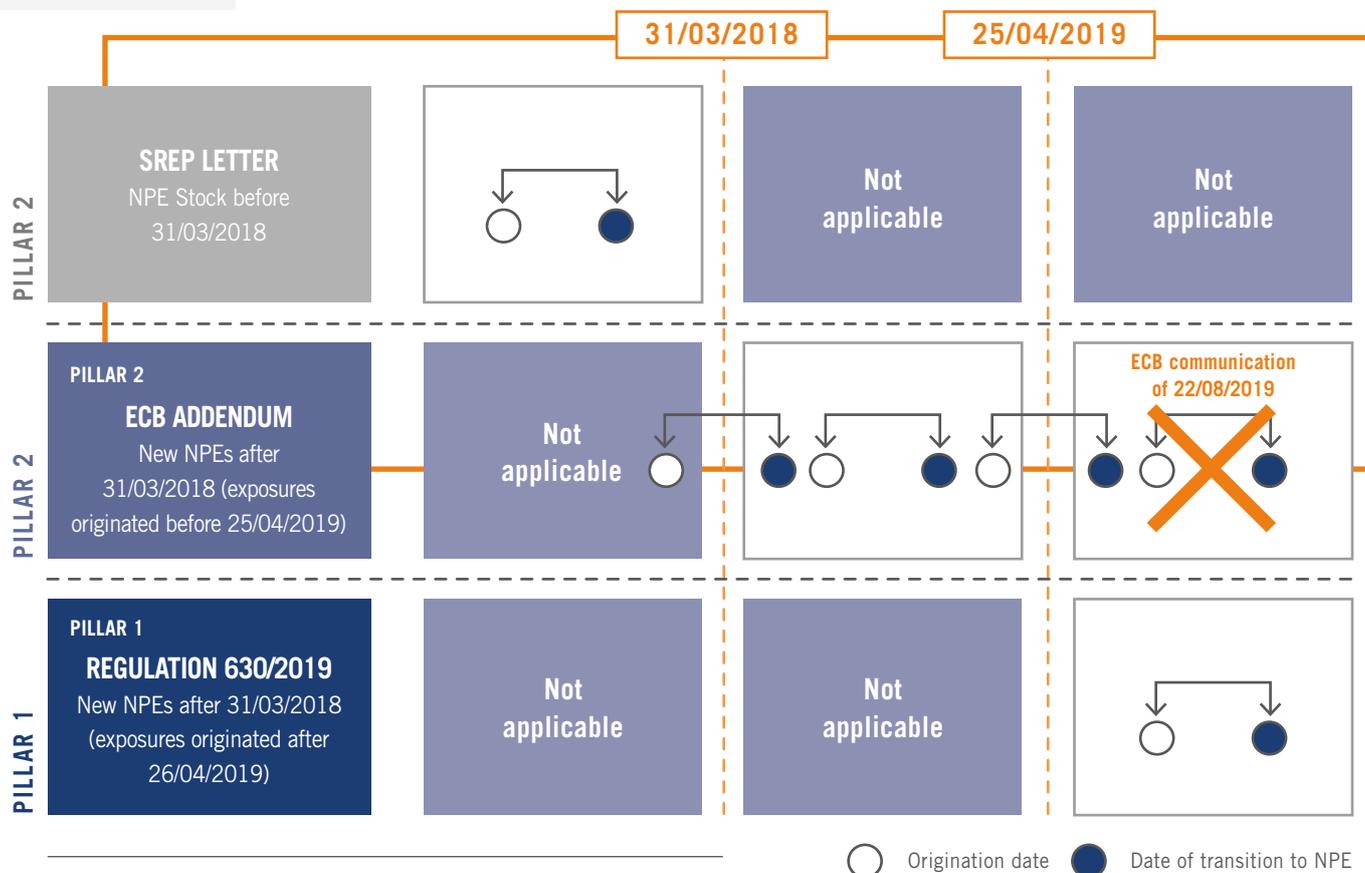
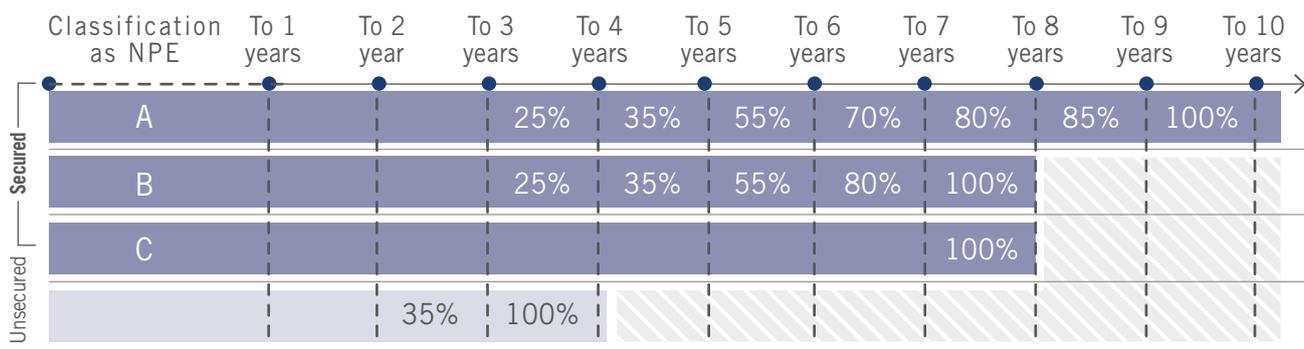


Figure 1 - Calendar provisioning: Scope of application



Let's look at these three components in more detail.

**PILLAR 1 RULES** - with reference to the **Pillar 1** scope, the coverage targets vary according to the length of time an exposure has been classified as non-performing (the so-called "vintage") and also depend on whether it is secured by appropriate collateral, as shown in Figure 2.



The percentages are referred to the minimum loss coverage («prudential backstop»)

■ = Secured    ■ = Unsecured

**Secured by:**

- A. Real estate eligible under CRR criteria;
- B. Other forms of collateral eligible under CRR criteria;
- C. Exposure guaranteed or insured by an official export credit agency or other guarantees pursuant to article 1 of EU Regulation No. 2020/873 (so-called "CRR Quick Fix")

**Figure 2** - Applicable Pillar 1 scope requirements

Within these general rules, specific measures are provided for certain forborne exposures: Article 47c establishes a one-year freeze in the minimum loss coverage when the first forbearance measure is granted<sup>5</sup>. As a result, the percentage of coverage remains unchanged for an additional year, after which, if the exposure is still in default, the write-down requirement is computed as if no measure had been granted, i.e. based on date on which the exposure first became non-performing.

Although the Pillar 1 rules are already in force, the deductions resulting from the introduction of the NPL prudential backstop will show in the COREP reports since June 30, 2021.

<sup>5</sup> The situation may reoccur over time in relation to subsequent default cycles.



**PILLAR 2 ADDENDUM** - with reference to the **Pillar 2 Addendum** scope, the targets are the same as for Pillar 1, based on vintage and collateral<sup>6</sup>. However, no special treatment for forbore exposures exists, like that introduced by article 47c of the CRR for Pillar 1 rules.

Since the “vintage” count starts on April 1, 2018 and the first minimum target (35% for unsecured exposures) kicks in after two years, the “Addendum” targets have become binding, by construction, since April 1, 2020.

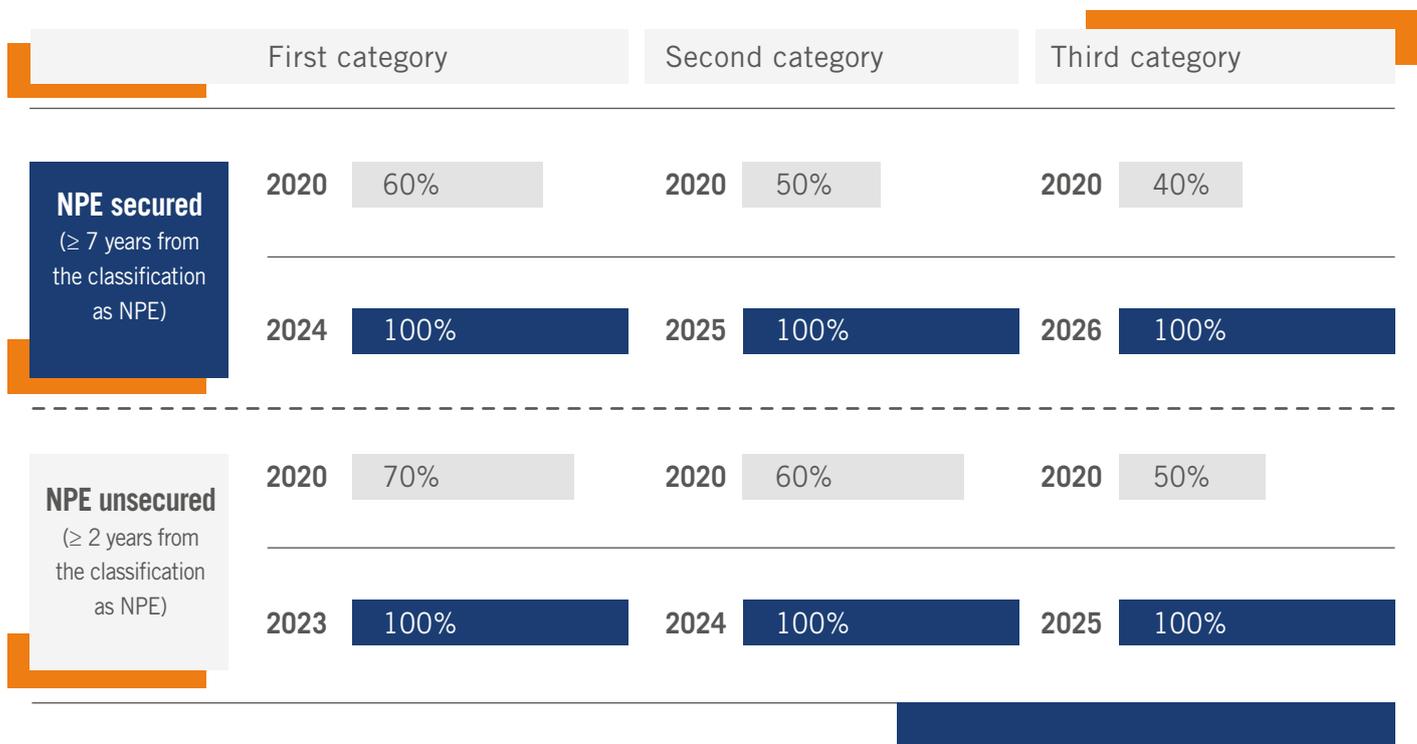
According to the STE instructions, an exemption from the expected coverage requested by the Pillar 2 Addendum can be requested if:

- // regular payments will lead to full settlement;
- // the combination of Pillar 2 expectations and Pillar 1 capital requirements generates a coverage requirement of more than 100% of the exposure.

No exemption applies to positions with payments due for more than 30 days or where at least one contractual payment has been missed in the last 12 months.

**PILLAR 2 STOCK** - with reference to **Pillar 2 Stock**, a minimum loss coverage is required starting from the end of 2020 on exposures with a vintage of more than 2 years (7 years when secured by adequate collateral). ECB-supervised institutions have been sorted into three categories (see Figure 3). Different minimum loss coverage requirements have been associated with each group, depending on the institutions’ actual sustainability. Minimum loss coverage requirements increase by 10% per year until they reach 100%.

<sup>6</sup> Notwithstanding the provisions of the ECB Addendum, as can be seen from the “Instructions for compiling the STE” sent by the ECB to individual institutions in December 2019, the concept of the portion of exposures covered by guarantees to be applied to the Pillar 2 framework (stock and addendum) incorporates the concepts of eligibility and quantification inherent to the CRR. For further details, refer to §3.7.



**Figure 3** - NPE stock requirements as of March 31, 2018

For both Pillar 2 targets (stock and addendum), the March 2018 Addendum states that “banks will [...] be asked to inform the ECB of any differences between their practices and the prudential provisioning expectations, as part of the SREP supervisory dialogue, from early 2021 onwards.”



## 2.2 THE ROLE OF COLLATERAL

As seen above, the minimum loss coverage required by calendar provisioning also depends on collateral. An exposure can be fully secured (if the collateral value exceeds that of the exposure), fully unsecured (if there is no collateral), or partially secured (where the collateral value is below that of the exposure). One has to look at the collateral's nominal value (as indicated, e.g., in the mortgage registration), fair value (FV, based on a valuation that is updated over time) and net realizable value (NRV, which corresponds to FV minus the costs faced for an "immediate" sale of the asset).

The allocation of collateral must be carried out in accordance with the rules established for prudential purposes in the CRR (for the calculation of risk-weighted assets), including the eligibility criteria to be met if a collateral is to be used for risk mitigation purposes.

However, these requirements are not always consistent with the specific characteristics of the NPE portfolio. For example, the lack of correlation between the counterparty's creditworthiness and the cash flows generated by the collateral is irrelevant, for two reasons. First, the recovery levels and the related provisioning do not depend on the ability of the property to produce income, but rather on its liquidation value. Second, the concept of "counterparty creditworthiness" is not appropriate, since a default has already occurred. However, if one were to conclude that such correlation is present and that the collateral is not eligible for calendar provisioning purposes, such a choice would be costly and totally unjustified. This shows that the requirements for collateral eligibility dictated by the CRR are not immediately applicable to non-performing loans.



## 2.3 REPORTING RULES AND OPERATING INSTRUCTIONS

Following the amendments specified in EU Regulation 2019/876 (the so-called “CRR2” package) and EU Regulation 2019/630, in June 2020 the EBA issued its “ITS on supervisory reporting requirements for institutions under Regulation (EU) No 575/2013”. The main changes concerned COREP, with the introduction of three new templates<sup>7</sup> within Annex 1 (“Reporting on own funds and own funds requirements”); the first reference date for application of the new framework is June 2021.

The Final Draft of the EBA ITS contains some operational and procedural clarifications for the correct calculation of the capital deductions due to calendar provisioning. Although it was issued for mere reporting purposes, it is the only source of detailed operating guidelines for the interpretation of the general requirements set out in Regulation 2019/630.

According to the ITS, the relevant aggregate should be determined through the following steps:

- // 1. calculation of the minimum loss coverage for exposure tranches (secured/unsecured);
- // 2. calculation of the provisioning and other items referred to in point (b) of Article 47c of EU Regulation No. 2019/630;
- // 3. calculation of the components referred to in step 2 limited to the requirement calculated in step 1 (“capped”) based on the following equation:

*Provisions and adjustments or deductions (capped) for*  
$$EVi=CCi=\min(Ci, MCEi)$$

<sup>7</sup> These templates are: C 35.01 - NPE loss coverage: the calculation of deductions for non-performing exposures (“npe lc1”), C 35.02 - NPE loss coverage: minimum coverage requirements and exposure values of non-performing exposures excluding forbore exposures that fall under article 47c (6) of the crr (“npe lc2”), C 35.03 - NPE loss coverage: minimum coverage requirements and exposure values of non-performing forbore exposures that fall under article 47c (6) of the crr (“npe lc3”).



// **Where:**

EVi: exposure value of exposure  $i$

CCi: provisions and adjustments or deductions (capped) per EVi

Ci: provisions and adjustments or deductions (uncapped) per EVi

MCEi: Minimum coverage requirement for EVi

This calculation is made at an exposure level. Coverage gaps are then aggregated across exposures ignoring any excess coverage.

The EBA ITS introduces some meaningful clarifications that are not included in calendar provisioning rules: these include the fact that excess coverage (cases where provisions exceed the minimum coverage requirement for individual exposures or tranches) cannot be used in the calculation of the aggregate capital deduction for loan portfolios.



## 3. GREY AREAS IN THE NEW RULES



While §2 has provided an overview of the new rules, this section looks at some aspects of calendar provisioning that are still open to interpretation (or even revisitation). This includes netting arrangements, the interaction with rules on RWA calculation and credit risk mitigation, new exposures, the use of the IRB shortfall and of Pillar 1 capital, off-balance sheet exposures, the allocation of collateral to individual exposures, and non-performing loan portfolios purchased “at a discount” by third parties.

### 3.1 PORTFOLIO NETTING

Although calendar provisioning rules do not provide specific guidance on the subject, the instructions on the application of Pillar 1 and Pillar 2 regulations prohibit netting between coverage shortfalls and excesses identified for individual exposures: this holds true both for the EBA COREP templates (see §2.3) and the STE templates prepared by the ECB.

This approach looks conceptually flawed and overly complex. Furthermore, it seems at odds with the ECB March 2018 Addendum, where the gap between actual coverage levels and supervisory expectations is assessed by considering the characteristics of specific “portfolios”, not “exposures”<sup>8</sup>. Additionally, the logic of the “capped” coverage is not consistent with the netting between excess and IRB “shortfall” (the misalignment between accounting provisions and expected loss) allowed under art. 159 of the CRR, as the latter is computed at a portfolio level. Moreover, it is clear that, although it is formally allocated to different exposures, excess provisioning still affects the amount of regulatory capital and helps cover future losses on NPEs.

<sup>8</sup> “When assessing such divergences, the ECB will consider specific circumstances (e.g. pulling effect) which may make the prudential provisioning expectations inappropriate for a specific portfolio/exposure.”



## 3.2 INTERACTION BETWEEN NPL BACKSTOP, CREDIT RISK MITIGATION TECHNIQUES AND RWA CALCULATION

The new EBA supervisory reporting standards (see §2.3) require that information on the Pillar 1 backstop information be provided in a specific section (“NPE Loss Coverage”) of the COREP templates.

NPEs are also covered by other templates dedicated to credit risk capital requirements, such as template C7 on the standardized approach (line 015, “of which: Defaulted exposures”) and C8 on the IRB approach (line 0170, “Default”). For both templates, the instructions specify that reported figures should take into account the effects of credit risk mitigation techniques (thus assigning any secured portions to the guarantor exposure class, according to the so-called “substitution approach”). Under the CRR this also applies to defaulted debtors guaranteed by a performing party. Therefore, the number of NPEs changes depending on whether the portfolio is considered before or after the substitution.

The instructions for the “NPE Loss Coverage” section indirectly refer to credit risk mitigation techniques but do not clarify whether NPEs are identified using the substitution approach. In the latter case, NPE exposures guaranteed by a performing protection provider would not be included. This would be consistent with the fact that, in the prudential backstop calculation, collateral must be allocated after the application of CRM techniques. However, it looks difficult to reconcile with other provisions concerning the allocation of exposures by credit protection type, which include the following clusters:

- // part of NPEs secured by other funded or unfunded credit protection
- // part of NPEs guaranteed or insured by an official export credit agency

Such clusters would, of course, be strongly depleted if one applies the substitution approach.



Regarding the correct application of the substitution approach, the EBA issued some clarifications in the CRM guidelines for institutions adopting the AIRB approach. Compared to the first draft, the document no longer states that the guaranteed part of the exposure should remain in the original exposure class (which appears to be in direct contrast to COREP instructions). In addition, it should be noted that:

- // the risk weight adopted for the guaranteed part should be the same as for comparable direct exposures to the performing guarantor;
- // the expected loss related to the guaranteed part should be the same as for comparable direct exposures to the performing guarantor;
- // however, for the purpose of calculating the AIRB shortfall, the guaranteed part of the exposure must be considered as defaulted.

We are therefore faced with a “hybrid” approach in which substitution (resulting in transfer to the “performing” portfolio) is allowed only for certain specific purposes.

A similar case relates to exposures underlying synthetic securitizations, for which no accounting derecognition is carried out, but where a so-called “significant risk transfer” (SRT) occurs.

In order to determine the risk-weighted assets from which the capital requirements derive, one has to consider the amount of the securitization, not that of the underlying assets (which are also excluded from the treatment of expected loss).



However, it is not clear whether this also applies to calendar provisioning. In fact, several options are possible:

- // the exposures underlying a synthetic securitization with SRT could be excluded from calendar provisioning, given that there is a significant risk transfer. This approach would be consistent with the actual portfolio risk, with the calculation of the RWA and of the IRB shortfall. This would also be easier to implement in practice;
- // the allocation of a personal guarantee to the underlying exposures, related to the existence of “protection”, with a “supplementary” nature compared to those already present on the exposure itself;
- // the straight application of calendar provisioning to the underlying exposures (only taking into account the other existing guarantees); this solution would be the most unfavorable and the one least consistent with the overall prudential approach.

Other cases of synthetic risk transfer, such as public guarantees on credit portfolios, widely used to deal with the COVID-19 emergency (see §7), can be treated as a synthetic securitization. The attractiveness of such guarantees will certainly be influenced by the treatment of the underlying exposures for calendar provisioning purposes.

### 3.3 “NEW EXPOSURES” UNDER ARTICLE 469a

As explained in §2, Pillar 1 rules on calendar provisions only apply to new credit exposures originated after 26 April 2019. It is therefore essential to define such “new exposures”, especially for facility types other than fixed-maturity loans, for which the origination date is easier to identify. This includes revocable, revolving and self-liquidating loans, which are open to multiple interpretations.

Article 469a of EU Regulation No. 2019/630 specifies that “where the terms and conditions of an exposure which was originated prior to 26 April 2019 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 originated on the date when the modification applies”.



This means that a new exposure occurs when its size increases following a modification in the loan terms, not just because of increased use by the borrower.

Accordingly:

- // for revocable, revolving and self-liquidating credit commitments to which one or more credit lines are associated, the origination date is that when credit line was first opened if the total agreed amount has never been increased. Otherwise, the date when the agreed amount was last increased becomes the new origination date;
- // for revolving accounts where a new contract exists for each advance made within a framework agreement, the origination date coincides with the date of the new contract, irrespective of any increase in the credit line;
- // for overdrafts on accounts that do not benefit from a credit line, the starting date of the most recent overdraft is used or, alternatively, the opening date of the account<sup>9</sup>. In case of past due and/or revoked credit lines, the starting date of the credit line must be used.

In the case of new loans granted to a counterparty already classified as non-performing, it would be appropriate to start the vintage count from the date on which the new loans were granted. The alternative of using the borrower's original default date would be excessively severe to institutions that determine defaults "by counterparty" (as opposed to "by facility") and hence include new loans within the NPEs. The choice between the two options should not be automatic, but rather be based on a case-by-case assessment based on an expert opinion. For NPLs already subject to calendar provisioning under the "Pillar 2 Addendum", the application of minimum coverage ratios to new loans should start when the latter are originated, since using the original default date would force the bank to quickly write-down new disbursements (especially unsecured ones) regardless of the fact that the borrower's financial conditions may be recovering.

<sup>9</sup> For bad loans (which typically give rise to new accounts at the moment when transition to bad loan status occurs) arising after 26/04/2019, it is necessary to reconstruct the situation prior to the classification as a bad loan



Moreover, if new loans to troubled borrowers should automatically trigger the Pillar 1 backstop this would discourage banks from granting additional credit, making it harder to support the debtor in overcoming a financial crisis. In case of new loans that remain performing, this would create a disparity between institutions that assign defaults by counterparty (as the new exposure would be subject to the Pillar 1 backstop) and institutions that classify default on a single facility basis.

It would therefore be appropriate to allow greater flexibility for banks in the management of new finance, avoiding any automatic application of the Pillar 1 backstop unless the debtor shows new signs of impairment. If this were not the case, troubled borrowers would eventually turn to different lenders (e.g., private equity funds, hedge funds, non-EU banks), getting better repayment terms and guarantees than the previous creditors. This could lead to a worsening in the prospects of recovering the original debts, causing further damage to institutions that are subject to calendar provisioning.

### **3.4 THE BENEFIT DUE TO THE IRB “SHORTFALL”**

As noted above, the regulatory shortfall associated with the application of the IRB methodology (i.e., the difference between regulatory expected loss and provisions) can be used to meet the minimum coverage levels required by calendar provisioning.

Article 47c of EU Regulation No. 2019/630 dictates how the IRB shortfall must be allocated to individual exposures: “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”. A similar provision is contained in the ECB instructions for compiling the “STE” template.



The instructions are not entirely clear, and lend themselves to different possible interpretations. They also appear to involve only a partial use of the benefit due to the IRB shortfall, as it apparently would not include the share of the shortfall related to those non-performing exposures that are not subject to calendar provisioning: this would be the case, e.g., the shortfall associated with an exposure classified as defaulted for less than one year, for which no minimum loss coverage is required.

To us, it seems advisable to ensure that the whole shortfall deriving from non-performing positions can be used and allocated across positions subject to the calendar provisioning. The allocation should therefore take place according to the expected loss of exposures that fall under calendar provisioning requirements. This would allow banks to use the whole shortfall amount already deducted from capital in relation to the NPE portfolio.

### 3.5 USE OF PILLAR I CAPITAL

Section 3.3 of the STE instructions states that the sum of the coverage dictated by calendar provisioning and the Pillar 1 capital requirement for any given exposure may not exceed 100%. If this happens, the coverage requirement beyond this limit can be ignored.

However, in our opinion, Pillar 1 capital requirements originating from IRB models (similar to the shortfall mentioned in §3.4) should always count towards the coverage level required by calendar provisioning rules, even if the sum does not exceed 100%. This should apply to both Pillar 2 rules (to which the STE refers) and in the context of the Pillar 1 backstop dictated by Regulation 2019/630.

Otherwise, banks that apply internal ratings would be penalized compared to those using the standardized approach. For the latter, capital requirements are calculated on the exposure value net of any provisions, meaning that provisions produce a benefit in terms of lower risk-weighted assets and lower regulatory capital. IRB institutions should enjoy a similar benefit, which could be achieved by considering Pillar 1 capital requirements in order to meet the minimum coverage levels dictated by calendar provisioning.



### 3.6 APPLICATION TO OFF-BALANCE SHEET EXPOSURES

An important step in implementing calendar provisioning is to define the types of exposures that are subject to this requirement.

With regard to Pillar 1, Regulation 2019/630 gives a general indication, specifying that the following are included, provided they are not in the trading book:

- // a) a debt instrument, including a debt security, a loan, an advance and a demand deposit;
  
- // b) a loan commitment, a financial guarantee or any other commitment, irrespective of whether it is revocable or irrevocable, with the exception of undrawn credit facilities that may be cancelled unconditionally at any time and without notice, or that effectively provide for automatic cancellation due to deterioration in the borrower's creditworthiness.

Similar criteria appear in the instructions for compiling the STE, which also include off-balance sheet exposures.

On this latter point, however, it must be noted that the use of the nominal value of off-balance sheet exposures (including margins) to determine minimum coverage expectations may give rise to possible biases, particularly with regard to loan commitments (although margins on NPEs are often negligible in value).

Therefore, similar to capital requirements, the basis for calculating calendar provisioning should be the "credit equivalent" based on an appropriate credit conversion factor, which represents an estimate of the actual "amount at risk". Otherwise, the risk generated by off-balance sheet exposures would be overestimated, requiring excess coverage and leading to a divergence from current credit risk measurement methodologies.



### 3.7 ELIGIBLE COLLATERAL AND EXPOSURE TRANCING

The amount covered by collateral is significant in determining an exposure's calendar provisioning requirements; accordingly, it is mentioned, in various forms, in all the regulations mentioned in §2.1 (Pillar 1, Pillar 2 Addendum, and Pillar 2 Stock).

With regard to Pillar 1, Regulation 630 clearly refers to the eligibility and quantification criteria already laid down by the CRR, specifying that “The secured part of a non-performing exposure is that part of the exposure which, for the purpose of calculating own funds requirements pursuant to Title II of Part Three, is considered to be covered by a funded credit protection or unfunded credit protection or fully and completely secured by mortgages. 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.” The same article states that the “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 may also include a common methodology for the determination of the secured part of a non-performing exposure”.

Accordingly:

- // the identification of the secured portion of an exposure for the purposes of the NPL backstop must be carried out in accordance with the collateral eligibility and quantification criteria already used for the calculation of risk-weighted assets;
- // any unsecured portion must, on the other hand, be determined on a residual basis, since the exposure value is measured differently from that provided for in the own funds calculation.



To date, the EBA has not issued any guidance on the subject, nor has it provided any information or specific indication on “if” and “when” it intends to comment.

With regard to Pillar 2, the ECB, in its August 2019 communication, provided some initial guidance to bring its provisions into line with the Pillar 1 rules; however, only the STE instructions have explicitly required the application of the criteria established by the CRR. While streamlining the implementation of the new rules, this choice may prove restrictive, since it excludes the possibility of using collateral types which are not eligible under the CRR, even if they provide an effective risk reduction (see §2.2).

Despite this alignment, when several collaterals exist for the same exposure it is still unclear whether they must be considered in the same order used for the RWA calculation: this would make things simpler, but possibly less effective in terms of capital absorption.

With regard to Pillar 2, in the STE instructions the ECB requires that priority be given to the higher-quality collateral. On the other hand, with regard to Pillar 1, Regulation 2019/630 recommends compliance with Regulation 2013/575. Therefore, the following two alternative approaches should be acceptable:

- // a) a simplified process that uses the allocations already made in the RWA calculation, except for the recalculation of the unsecured exposure on a residual basis after determining the total exposure, which, as already indicated, differs to the quantification envisaged for the RWA calculation (e.g. partial write-off);
- // b) implementation based on a double allocation process, where a second process for calculating the minimum coverage target is added to the RWA calculation process.

A further issue concerns the allocation of coverage to a partially secured exposure. Both the EBA ITS on Supervisory Reporting and the STE instructions specify that in this case, write-offs should be allocated first to the “unsecured” part of the exposure. Moreover, in December 2019, the ECB provided for the allocation of write-offs in excess of the unsecured part of the exposure first to the portion secured by “other funded or unfunded credit protection” and only finally to the part (if any) secured by “immovable property or residential immovable property”.



This clarification would be unnecessary if, as we believe, the coverage gap must only be computed at the exposure level without taking into consideration secured or unsecured portions. Indeed, if the cap on write-offs seen in §2.3 only applies at the exposure level, it is not necessary to specify a criterion for allocating coverage between secured and unsecured portions, since it would have no effect on the final requirement. Such a criterion would only become relevant if the cap were applied to the individual portions (secured and unsecured) of each exposure, something we consider highly unlikely.

### **3.8 APPLICATION TO NPL PORTFOLIOS PURCHASED AT A DISCOUNT**

NPEs purchased at a discount are covered by Regulation 630, which requires that “the exposure value of a debt instrument that was purchased at a price lower than the amount owed by the debtor shall include the difference between the purchase price and the amount owed by the debtor.” However, according to the Regulation, this difference must also be included in the available coverage.

The reference to the “amount owed by the debtor” (i.e. the gross book value, or GBV) is consistent with fact that calendar provisioning starts from the original transition into default, regardless of whether the exposure was subsequently sold. This means that the current carrying value of the exposure (net book value, NBV) is irrelevant<sup>10</sup>.

The calculation of the available coverage can be performed in two ways: one may look at the GBV at the time of purchase or, alternatively, at the GBV at the time of reporting. In the latter case, recoveries may lead to deterioration in coverage. That is why we believe that the first approach is more plausible, as the coverage calculation should include a “price discount benefit” that keeps stable over time, even when the GBV decreases as a result of the payments received.

<sup>10</sup> On the balance sheet, these positions are quantified starting from a gross value reflecting the purchase price, which may be significantly lower than the amount contractually owed by the debtor.



The framework for purchased NPEs deserves further examination also in light of the STE instructions, which provide that “potential exemptions from supervisory coverage expectations may be considered for NPEs where ongoing regular payments of principal and interest, based on the official debtor’s cash flows, will lead to full repayment.” For NPLs purchased at a discount, “full repayment” can hardly be associated with the original contractually agreed amounts, since the purchaser compares recoveries with the purchase price, which by definition is lower than the original debt. Consequently, this exemption from calendar provisioning should be extended to all purchased exposures where recoveries are consistent with the expectations embedded in the purchase price.

One further remark concerns the purchase of entire NPE portfolios, where the price does not generally relate to the individual exposures, but rather to uniform groups for which an expected average collection performance is estimated. In this context, it comes as no surprise that some exposures in a pool experience a performance below average, offset by the results obtained on other exposures in the same group. Accordingly, performance evaluation for exemption purposes should be conducted on a pool level, not on an individual exposure level. Otherwise, the approach adopted would be too conservative because it would not take into account the fact that some under-performance will inevitably occur (“by construction”), but this does not represent an issue as long as it is offset by the over-performance of other exposures in the same pool.



## 4. THE EFFECTS OF CALENDAR PROVISIONING ON STRATEGIC NPE MANAGEMENT

In this section, we will look at the potential strategic implications of calendar provisioning for the use of extraordinary portfolio clean-up operations, such as disposals and securitizations.

### 4.1 FOREWORD

Calendar provisioning will lead banks to further review their NPL strategies and management methods, analyzing whether, and by how much, collection activities can be accelerated in a cost-effective way, or rather whether one-off disposal transactions should be increased with the aim of reducing total provisions.

The best strategy should minimize the expected impacts on the income statement and balance sheet, based on the characteristics of the loans classified as non-performing (e.g. the date of origination), and will have to take into account the different coverage expectations arising from the alternative approaches, in order to minimize any biases arising from the new rules.

The strategic mix should be defined in close coordination with the planning unit, with a view to capital allocation and RWA optimization, assessing whether it is possible (and more cost-effective) to cover any shortfall due to calendar provisioning through actual provisions – hitting the income statement – or through a CET1 deduction.

Overall, calendar provisioning may trigger an increased use of one-off disposals and/or securitizations. Such extraordinary NPL management tools are further discussed in the remainder of this chapter.



## 4.2 IMPACTS ON EXTRAORDINARY NPE MANAGEMENT

### 4.2.1 POTENTIAL IMPACTS ON ORIGINATING BANKS

In the management of non-performing loans, banks are called upon to choose between different, complementary strategies, all of which may be affected by calendar provisioning.

These are:

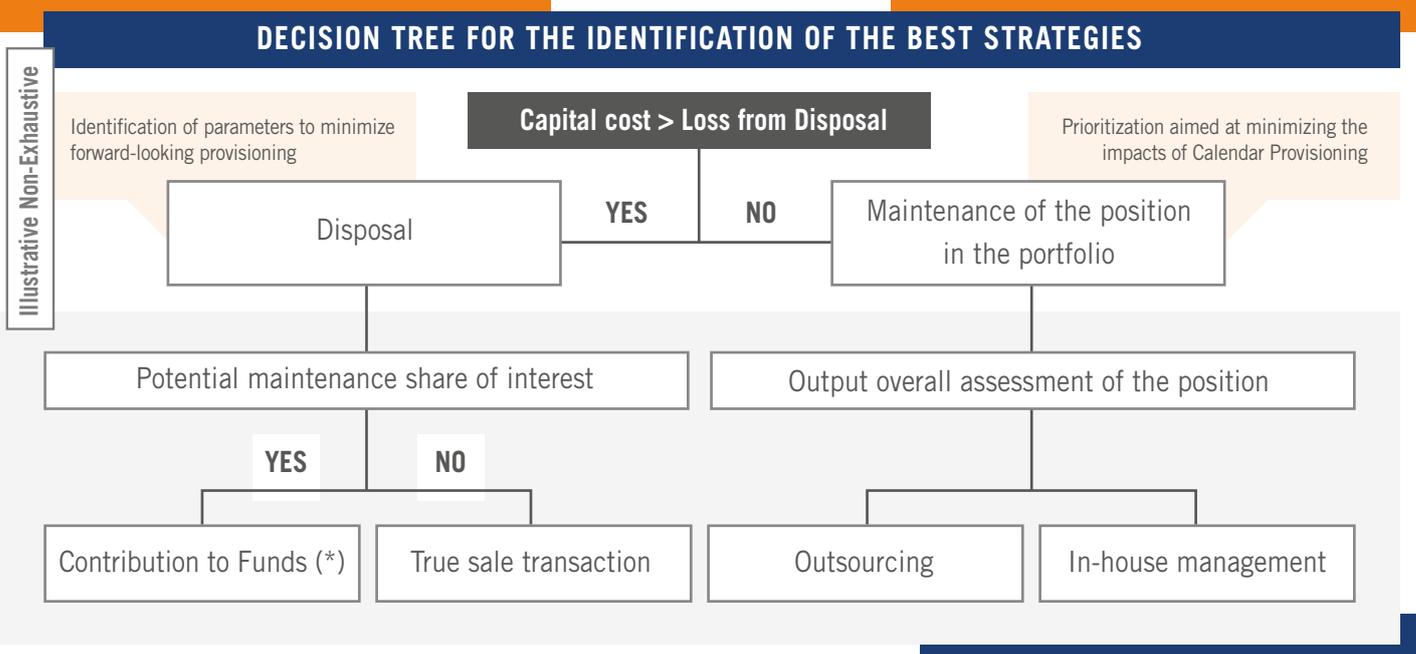
- // **in-house management:** to pursue this strategy, banks should optimize operational efficiency, increase the average collection rate, allow greater focus on high-value activities, contain legal costs, and deploy a more rigorous performance monitoring. However, even if results are improved, in-house management involves the application of the minimum loss coverage requirements imposed by the new regulations. For this reason, it requires a careful analysis and clustering of the portfolio, including based on the parameters driving calendar provisioning (for example the type of associated collateral and the vintage of the exposures);
- // **selective outsourcing:** following the introduction of calendar provisioning, there may be an increase in the use of outsourcing for selected positions to specialist players as part of a partnership approach. In particular, unsecured positions characterized by more complex management, and often longer term, will experience faster prudential provisioning, with full coverage in three years. If outsourcing leads to an acceleration in collection, there will be a resulting reduction in the costs associated with keeping the NPEs on the balance sheet. However, even in this case, the bank would not perform derecognition of the NPEs, with the result that calendar provisioning will apply to the exposures, which will be written off in full within the established time frame;
- // **disposal:** if the capital cost required to keep the exposures on the bank's books is greater than the expected loss from disposal, then an NPE sale may be the best option. These transactions trigger a one-off loss but allow for the removal of the negative impact of the prudential backstop and the deleveraging of the bank's assets via the derecognition of the NPEs;



// **synthetic risk transfer solutions:** synthetic risk transfer solutions (e.g. synthetic securitizations, possibly accompanied by some kind of public guarantees like those introduced in some EU jurisdictions) imply a derecognition of the exposures from a prudential standpoint, without a deconsolidation from the bank's balance sheet. If the positions underlying the transaction are not subject to calendar provisioning, the bank could benefit from lower capital charges and maintain its relationship with the customer. Otherwise, they would continue to be subject to minimum levels of prudential provisioning;

// **sale to alternative investment funds:** this solution, which provides for management and collection strategies differentiated by asset type, allows the bank to remove NPEs from its balance sheet while maintaining an upside thanks to the possible investment in shares of the fund (subject to constraints due to the need to ensure a substantial transfer of risks). However, it should be clarified whether the fund's shares would be subjected to some form of calendar provisioning as part of the bank's supervisory dialogue.

Figure 4 shows an example of a decision tree aimed at defining the best management strategy based on the drivers and reasoning described above.



(\*) For example, securitization, disposal

Figure 4 - Possible decision tree



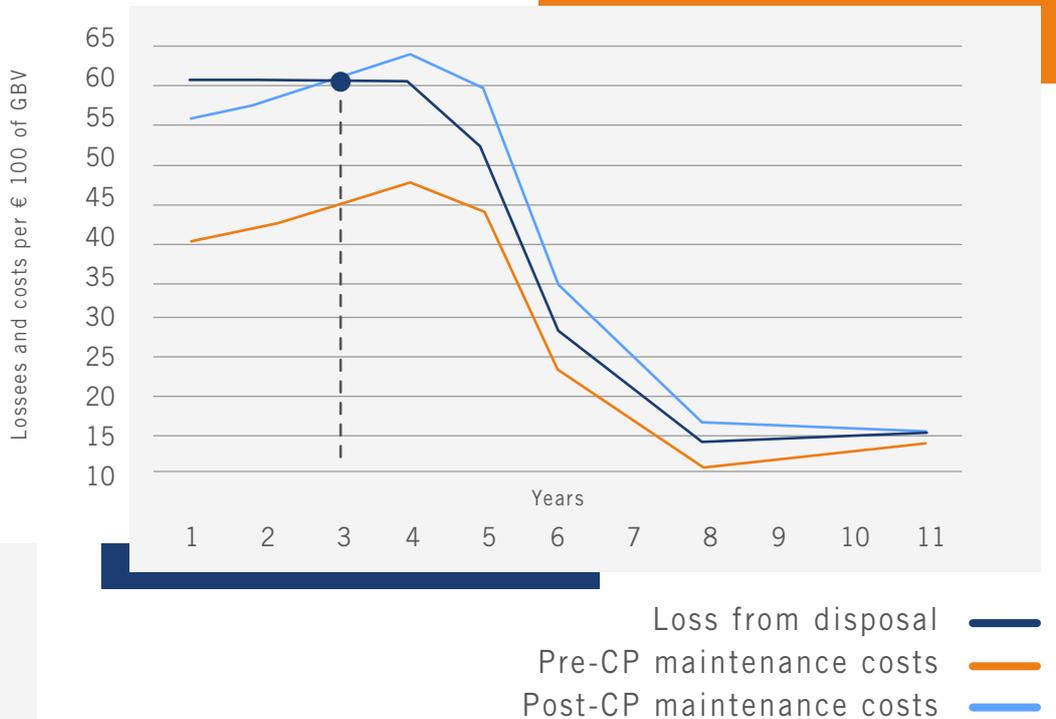
From the above list, it is clear that banks are also called upon to adjust their strategy mix in order to mitigate the impacts of calendar provisioning on their own funds requirements. In particular, in estimating the capital cost, not only should the accounting adjustments and absorption linked to risk-weighted assets be considered, but also the capital charges arising from the current or future application of calendar provisioning. Therefore, comparing the capital cost and disposal losses in order to assess whether it is cost-effective to maintain the position in the portfolio or to dispose of it, potentially leads to a higher propensity for derisking strategies than in the past.

As an example, a potential case study is reported for the disbursement of an unsecured credit to a retail customer classified as having defaulted<sup>11</sup>.

Figure 5 shows an example of the relationship between the loss generated by a disposal (the “disposal payoff”) and the cost associated with maintaining the loan on the bank’s balance sheet (the “maintenance payoff”), both before and after the introduction of calendar provisioning. The disposal payoff is equal to the difference between the disposal price (calculated as the net present value of the expected recovery at the IRR required by a third-party investor) and the NBV of the position.

The maintenance payoff, on the other hand, is calculated as the net present value of the recoveries discounted at the originator’s weighted average cost of capital (WACC), net of the total costs of retaining the exposure, which include the cost of funding, the cost of the capital absorbed by the RWA of the exposure and of the capital required by calendar provisioning, and the losses due to the increase in accounting provisions or write-offs. The x-axis indicates the time expired since default (“vintage”).

<sup>11</sup> The following assumptions are considered for the purposes of the analysis: GBV: 100; time period considered (in years): 11; capital cost: 12%; cost of funding: 1%; capital absorption: 12%; IRR (Investor): 12%; 100% RW applied; overall expected recovery: 25% of GBV; increasing accounting provisioning, from 20% over the eleven years; other costs (both management and disposal) were not taken into account in the analysis.



**Figure 5** - Relationship between the disposal payoff and maintenance payoff (pre- and post-calendar provisioning)

The analysis shows that, in order to choose between in-house management and disposal, it is important to consider the impact of calendar provisioning in terms of higher capital charges. Indeed, without calendar provisioning, disposal would never be optimal in this example. However, when the maintenance payoff also takes into account the impact of calendar provisioning, the difference between the disposal payoff and the maintenance payoff is reduced until, in the third year after default, the disposal becomes cost-effective.

To capture this shift in the relative effectiveness of the two alternatives:

- // the models designed assess the disposal must not only take into account the expected sale price and resulting losses, but also the positive of the capital freed up by the disposal;
- // if NPEs are retained, the use of an outside servicer may prove appropriate if it drives down collection times, especially for small unsecured positions that are subject to full coverage in just three years.

The increased propensity to disposals caused by calendar provisioning could lead to a reduction in prices. However, the expansion of the market for disposed NPEs could generate an increase in investor demand that would help sustain price levels.

The impact of calendar provisioning will in any case be different for unlikely-to-pay (“UTP”) positions, given that they are subject to the same minimum loss coverage as bad loans, but with higher expected collection times and lower accounting provisions. For UTP, in-house management may also enable the bank to “cure” the borrower.



#### 4.2.2 POTENTIAL IMPACTS ON NPE PURCHASERS

Calendar provisioning could also significantly impact the business model of banks purchasing NPEs on the market (both bad loans and UTPs). When defining the purchasing process and strategies, it will be necessary to minimize the capital impact of the new rules on purchased exposures until they are recovered or “cured”.

This includes the following:

- // Acquisition of NPEs for collection purposes: since the purchase involves the application of minimum prudential provisioning rates, the due diligence process carried out ahead of the purchase will take into account the greater amount of capital absorbed and its negative effects on demand and prices;
- // UTP management aimed at restructuring: calendar provisioning will negatively affect the provision of new funds often used to bring debtors back to a performing status. As a result – unless the regulatory provisions are appropriately fine-tuned, as suggested in §3.3 – the granting of new credit lines to non-performing customers may be discouraged, despite the fact that they usually rank senior to pre-existing creditors and therefore are usually associated with higher expected recoveries.

For both types of purchasers, the adverse effects will increase over time, as more and more exposures become subject to the new rules. In the short run, however, the impact will depend on how the date of origination is interpreted. If the purchase of a portfolio of non-performing loans granted before the entry into force of Regulation 2019/630 (i.e. April 26, 2019) is considered as a new exposure for the purchasing bank, the portfolio will be immediately subject to the Pillar 1 backstop, causing a significant deduction to CET1 capital. However, it seems natural to define the origination date as the date on which the loans were first granted by the selling bank (including for purchased NPEs that are intended for restructuring).

Moreover, credit purchasers may be less likely to maintain NPEs on their balance sheets, and may instead choose to manage them on behalf of third-party players that are not non-calendar provisioning players (possibly investing in the NPEs indirectly through securitizations and fund shares, to such an extent as not to trigger NPE recognition).

## 5. IMPACTS ON PERFORMING LOANS: PRICING

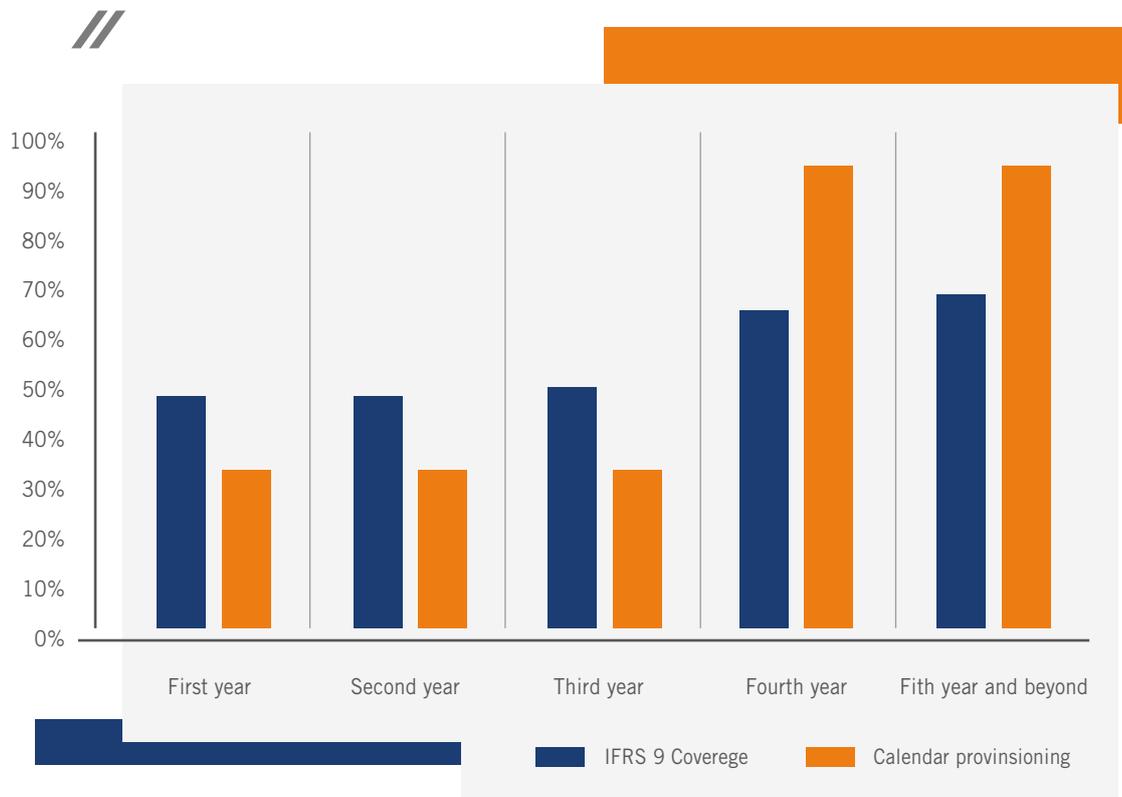
This section focuses on pricing and shows how the new regulations could lead to a double increase in the cost of credit, to account for both the additional Pillar 1 capital tied up against higher regulatory coverage and the incentive created by new regulations toward faster collection strategies reducing total recoveries.

### 5.1 INTRODUCTION: CALENDAR PROVISIONING AND LOAN DISBURSEMENT

Calendar provisioning is indirectly aimed at preventing credit losses (or at least at reducing them) as early as the origination phase. In fact, it reinforces the need to develop tools which, starting from when loan applications are assessed, enable:

- // a reduction in the risk of transition to a non-performing status (for example, through an improved ability to estimate risk and manage it by adjusting parameters such as the term and/or amount of the loan) and/or
- // a lower impact in terms of expected loss and capital absorption, mitigating the impacts of the ECB minimum loss coverage ratios (for example, by prioritizing exposures covered by eligible collateral, which benefit from more gradual coverage requirements in the years following a default).

With regard to the latter aspect, the new loan write-off ratios dictated by calendar provisioning can lead to negative impact on regulatory capital due to the gap between “accounting” and “prudential” write-offs. An example is shown in Figure 6 (for a portfolio of unsecured exposures), which compares the historical accounting write-offs of a typical lender (according to NPE vintage) with those required by calendar provisioning: the two percentages are close in the first three years after default, where accounting coverage is marginally higher than supervisory expectations; from the fourth year onwards, however, the trend briskly reverses as accounting coverage is far lower than the 100% required by calendar provisioning.



**Figure 6** - Comparison between accounting write-offs and prudential coverage (due to calendar provisioning) for a portfolio of unsecured exposures

The adoption of increasingly efficient tools, models, and policies in credit risk estimation and management is a key element in mitigating the impact of calendar provisioning. Such tools must, however, be part of a value-creation risk management framework based economic value added (EVA). Indeed, it is essential that the risk taken is adequately compensated through pricing strategies that cover all the expected costs, and selection strategies based on the expected economic value of individual loan applications.

Against this backdrop, calendar provisioning requires that risk-based pricing models be updated to account for the higher costs generated by calendar provisioning when supervisory coverage is faster than the average accounting write-offs experienced in the past. Let us therefore consider in greater detail the effect of calendar provisioning on credit pricing.



## 5.2 RISK-BASED PRICING AS A VALUE CREATION TOOL

### 5.2.1 RISK-BASED PRICING: OVERVIEW

Risk-based pricing consists in defining of the minimum price applicable to each individual credit line, i.e. the lending rate (“break-even rate”) that guarantees that the present value of all future costs expected throughout the loan’s lifetime (both stochastic and deterministic) are offset by the present value of expected income. Risk-based pricing is an essential tool to develop a ‘sustainable’ business, capable of defining value creation strategies, where the impact of each loan, customer, or portfolio on the overall profitability can be reliably estimated.

Pricing is therefore a key factor in the credit value chain that translates the bank’s risk appetite framework (RAF) strategies into operating practices, capable of supporting lending activities.

To set the break-even lending rate, let us consider the main cost and income items expected from a loan or credit portfolio. The Economic Value Added (EVA) generated by the /portfolio can be calculated as follows:

$$\begin{aligned} \text{Economic Value Added (EVA)} &= \text{Interest margin} + \text{Net Commission} - \text{Provisions} \\ &\quad - \text{Operating Cost} - \text{Cost of Economic Capital} \\ &\quad (1) \end{aligned}$$

In other words, the net interest income, plus any additional revenues net of relevant commissions, must be such as to cover the expected provisions and operating costs linked to the loan, plus the cost of the economic capital held against the loan (which depends on the minimum return on equity required by shareholders).

If the EVA is greater than to zero, then value is being created because there is adequate return on the invested capital; if the EVA is negative, the return on capital is lower than the target level requested by shareholders and value destruction occurs.

In equation (1), the components relating to provisions and the cost of capital absorbed are directly influenced by credit risk: hence, higher credit risk will command a higher break-even rate (see the blue curve in Figure 7).



**Figure 7** - Minimum pricing and effects on value creation

In the absence of an adequate risk-based pricing model, there is a risk that a uniform, flat rate (the red curve in the figure) will be applied to customers with different risk levels. In this case, cross-subsidization will occur within the portfolio (something that is not entirely unusual in practice), leading to a negative EVA for high-risk customers, “financed” by low-risk customers who pay a higher-than-necessary price and thus generate extra value that covers the losses due the former. This triggers two main effects: (i) suboptimal portfolio performance due to the value destroyed by high-risk customers, and (ii) adverse selection, as low-risk customers will leave the bank to find lower rates elsewhere.

Although equation (1) may seem conceptually simple, its estimation is complex in that it requires an educated forecast of the expected evolution of all revenues and costs across the whole life of the loan (i.e., at all possible stages in its amortization plan). From the origination (time 0) up to the final maturity (time “N”), a number of intermediate moments  $n$  exist, when the loan may transition to default (with probability  $p_n$ ), be paid back early (with probability  $e_n$ ), or remain performing (with probability  $1-p_n-e_n$ ). Each of these probabilities of course depends on the survival (without default or early closure) until  $n-1$ . The cash flows expected from the loan must be associated with each node, taking into account the relevant operating and financial costs, interest income (if the loan is performing) or recovery flows (if the loan is impaired).

To make things even more complex, one may also want to consider a range of alternative macroeconomic forecasts and estimate expected losses for each of these scenarios. The final rate would then be an average of the rates determined under the different scenarios, each one weighted by its own probability.



## 5.2.2 THE IMPACT OF CALENDAR PROVISIONING ON PRICING

The effect of calendar provisioning on pricing can be modeled, at least as a first approximation, through the cost of the additional capital absorbed due to supervisory coverage<sup>12</sup>. A bank whose accounting write-off rate on an impaired position is lower than that specified by calendar provisioning (see Figure 6 above) must cover the difference with CET1 capital, bearing its cost, until the two values converge again (for example, because the collection process has ended and the NPE has been written off). If the cost of additional CET1 capital due to calendar provisioning is not included in equation (1), the lending rate will be too low, leading to a negative EVA.

Such an effect is of course greater for loans having a high probability of default. It is also driven by collateral, which affects both supervisory coverage and the expected recoveries embedded in the accounting provisions. The costs of calendar provisioning may also lead the bank to change its collection processes in order to reduce the gap from supervisory coverage ratios.

To understand how calendar affects pricing, we now apply equation (1) to a specific case study: a 5-year unsecured mortgage requested by a small business<sup>13</sup> for €100,000, whose details can be found in Table 1.

<sup>12</sup> A bank faced with higher regulatory coverage ratios than accounting coverage ratios could of course also decide to raise the latter (in the ways permitted by IFRS 9, for example, by assigning a higher probability to NPE disposal scenarios) in order to avoid capital being immobilized and to immediately enjoy the tax benefit linked to the increased value adjustments made to the income statement. This type of scenario will be indirectly considered in the following section, where the effects on pricing of more aggressive collection strategies (aimed at shortening the duration of collection even at the cost of a reduction in cash flows) are explained.

<sup>13</sup> For greater clarity, we will make some simplifications: (i) we will not consider the impact of taxation (in practice the tax rate will be zero) and the impact of the economic cycle on risk parameters; (ii) we will not consider the possibility of early closure (in practice, Pen will always be zero); and (iii) we will not discount the expected cash flows (the discount rate will be zero); (iv) we will use a single LGD value for both accounting purposes (to decide the percentage of coverage of NPEs at the time of default) and prudential purposes (to calculate capital absorption on performing exposures). We will use an LGD for a defaulted asset that is greater than the accounting value, in particular obtained by discounting the expected cash flows from collection with a higher discount rate (5% instead of 0%) so as to take into account the possible unexpected losses deriving from the collection process.



### Application information

<b>Product Type</b>	Unsecured loan
<b>Requested amount</b>	€ 100,000
<b>Term</b>	5 years

### Risk assessment

<b>PD Rating</b>	5
<b>PD (yield curve)</b>	2.1% first year - 2.6% second year - 2.9% third year 3.0% fourth year - 3.1% fifth year
<b>LGD</b>	See text

### Cost / income items

<b>Operating costs</b>	1.5% of exposure at the beginning of each year
<b>Cost of funding</b>	2.0% per year
<b>Cost of equity</b>	10.0% per year

**Table 1** – Example details

Suppose that, in case of default, the annual recovery percentages assumed by the bank are those given in Table 2, column Pt. Starting from an initial GBV of 100, the expected collection streams can be derived from these percentages. Using a zero discount rate for the sake of simplicity (so that discounted amounts are equal to face values) one can estimate the following for each future year:

- // the Net Book Value  $NBV_t$ , equal to the sum of future collection amounts;
- // the accounting coverage ratio  $C_t$ , which equals one minus the ratio between  $NBV$  and  $GBV$  (where the  $GBV$  decreases over time as a result of the collections obtained in the previous years).

$C_t$  can then be compared to the supervisory coverage ratio,  $CP_t$ , dictated by calendar provisioning.

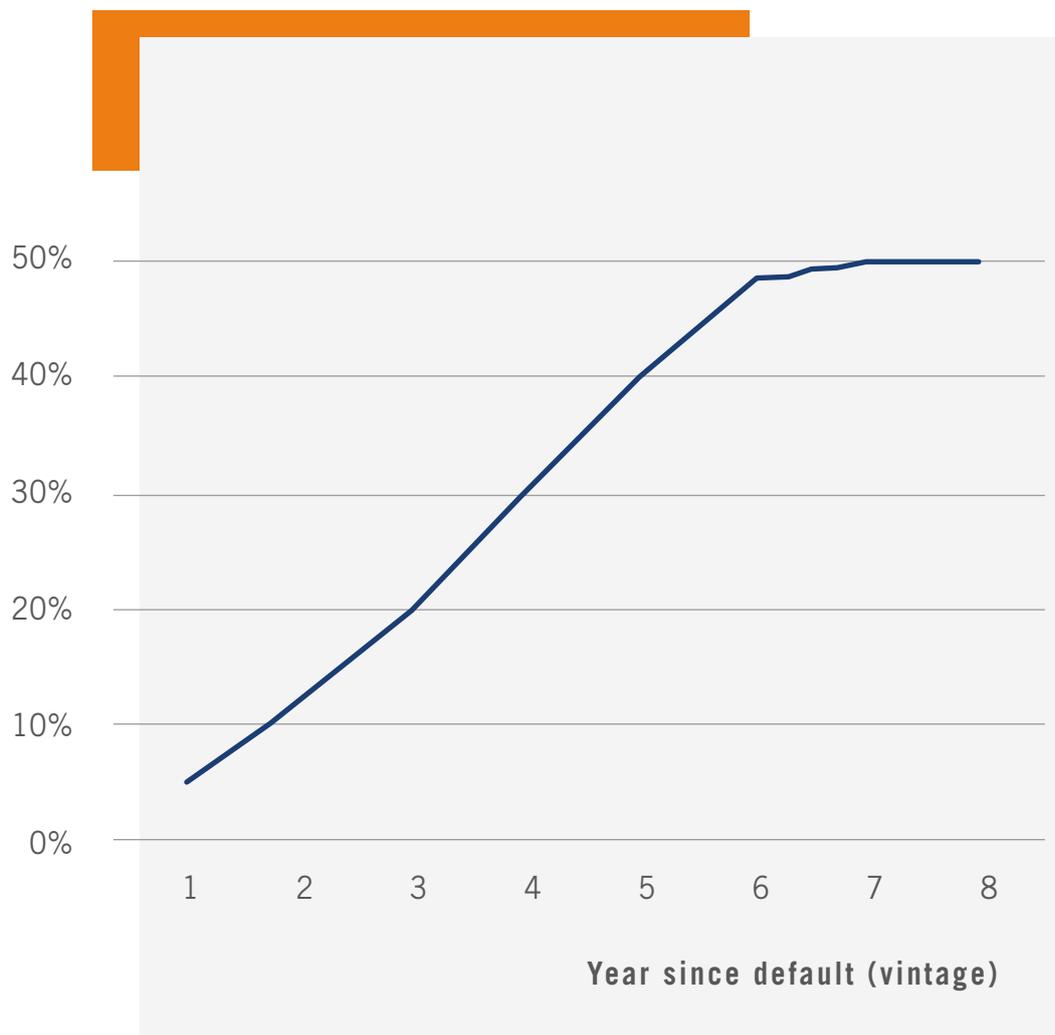
Year of entry into default	Percentage of GBV at default for which recovery is expected in the year	Percentage of GBV at default for which recovery is expected in the year or in previous years	GBV at year start	Value of expected recovery in the year	Value of expected recovery in the current year and subsequent years (NBV at year start)	Accounting coverage at year start	Minimum regulatory coverage
t	$P_t$	$P_{cum_t}$	GBV <sub>t</sub>	$R_t$	NBV <sub>t</sub> = sum from $R_{t+1}$ to $R_T$	$C_t = 1 - NBV_t/GBV_t$	$CP_t$
1	5%	5%	100	5	50	50%	35%
2	7%	12%	95	7	45	53%	35%
3	8%	20%	88	8	38	57%	35%
4	10%	30%	80	10	30	63%	100%
5	10%	40%	70	10	20	71%	100%
6	8%	48%	60	8	10	83%	100%
7	2%	50%	52	2	2	96%	100%
8	0%	50%	50	0	0	100%	100%

**Table 2** - Collection assumptions, accounting coverage

The initial coverage value ( $C_1$ , equal to 50% in the example shown in the table) will also be used as an estimate of the regulatory LGD for the purpose of estimating the amount of regulatory capital needed if the exposure remains performing. On the other hand, to estimate regulatory capital in the event of a default, an ad-hoc estimate of the LGD for defaulted assets will be produced for each year following default, by discounting expected future recoveries at 5% (this is just a simplified method to account for the possible unexpected losses resulting from the collection process).

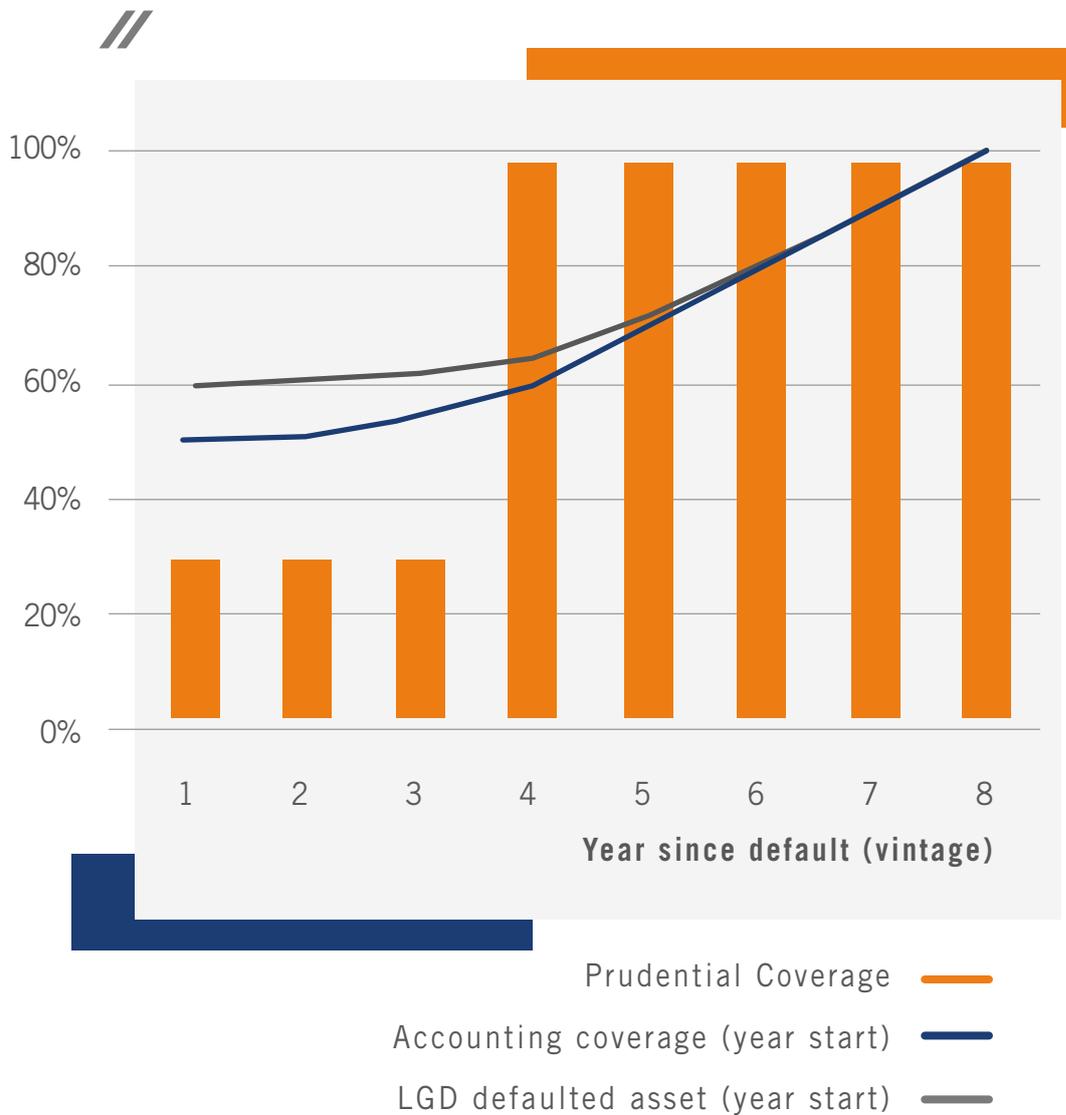


Figure 8 (panel 1) shows the bank's empirical recovery curve. Based on that, Figure 8 (panel 2) shows how accounting coverage evolves as a function of the NPE vintage. The orange bars represent supervisory coverage, while the grey line (slightly more conservative than the accounting coverage) shows the LGD for defaulted assets.



Cumulative collection in previous scenario —

**Figure 8** - Empirical recovery curve



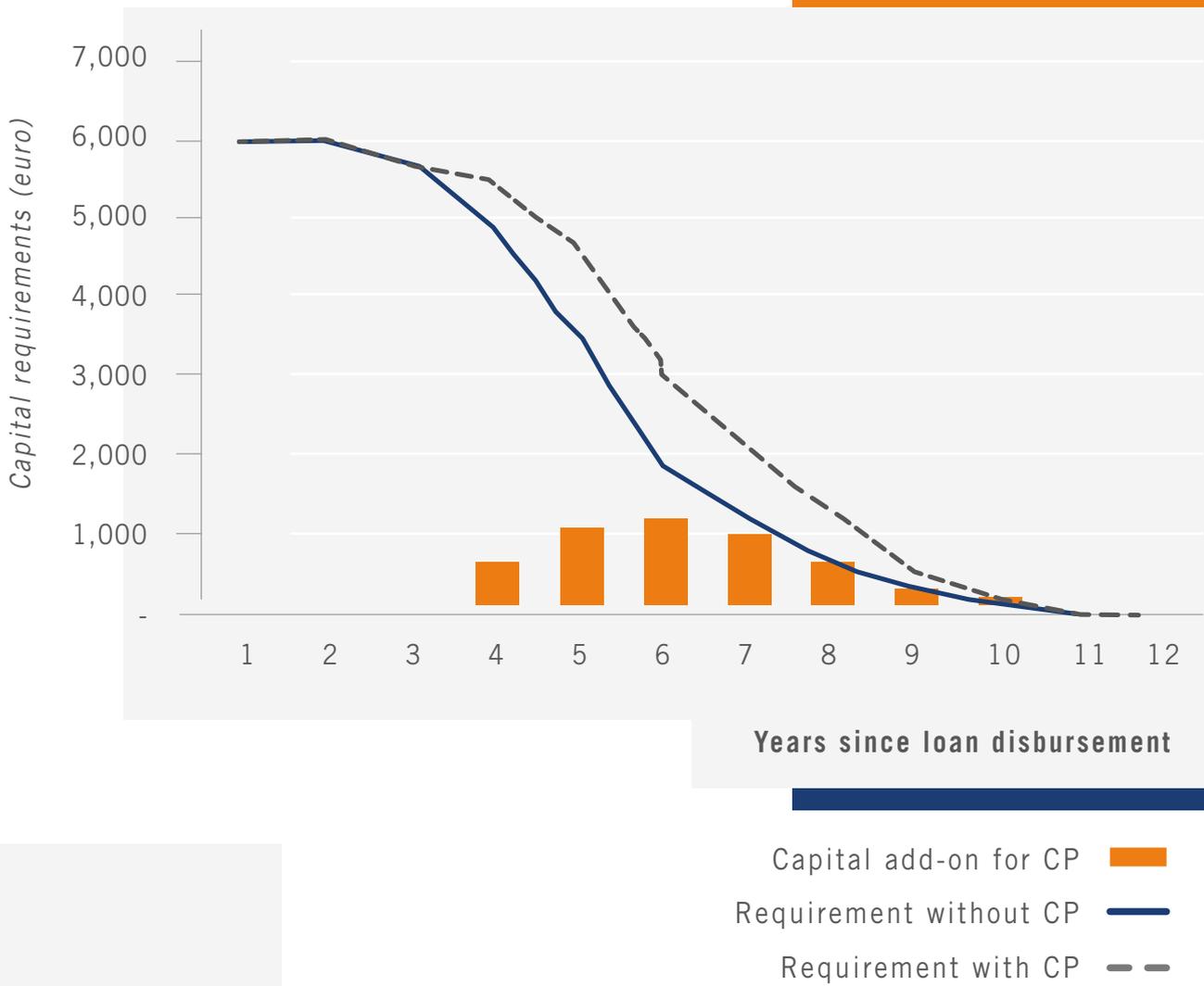
**Figure 8** - Coverage and LGD for defaulted assets



At the beginning of year four (that is, three years after the default) the negative impact of calendar provisioning becomes apparent, as it jumps to 100% compared to an accounting coverage of around 63%. The gap between the two only closes towards the beginning year 8.

The effect on capital requirements is shown in Figure 9 , which shows:

- // the expected capital requirements for the loan throughout its whole lifetime in the absence of calendar provisioning (blue line). Such requirements depend on the loan's PD and LGD if it is performing, whereas in case of default they are driven by accounting coverage and the LGD for defaulted assets;
- // the same requirements, increased by the effect of calendar provisioning when prudential coverage exceeds accounting coverage and the difference must be covered by capital (gray line);
- // the difference between the two curves, which represents the additional capital due to calendar provisioning (orange bars). As can be seen, it becomes positive at the beginning of year 4, when the scenarios where the loan defaults shortly after its origination reach a vintage where supervisory coverage exceeds the accounting coverage, as shown in Figure 8.



**Figure 9** - Capital requirement on the loan (€100,000, amortizing).



Suppose we now set the break-even lending rate ignoring calendar provisioning, i.e., covering all expected provisions and operating costs and compensating capital absorbed (see the green bar in Figure 10) but ignoring the cost of the additional capital due to calendar provisioning (see the last bar in the figure, which makes EVA negative). The latter component (the orange bar on the right) is about 26% of the next-to-last one (the green bar indicating a “fair” return on equity): overlooking calendar provisioning, therefore, results in shareholders receiving just under three-quarters of their desired target return.

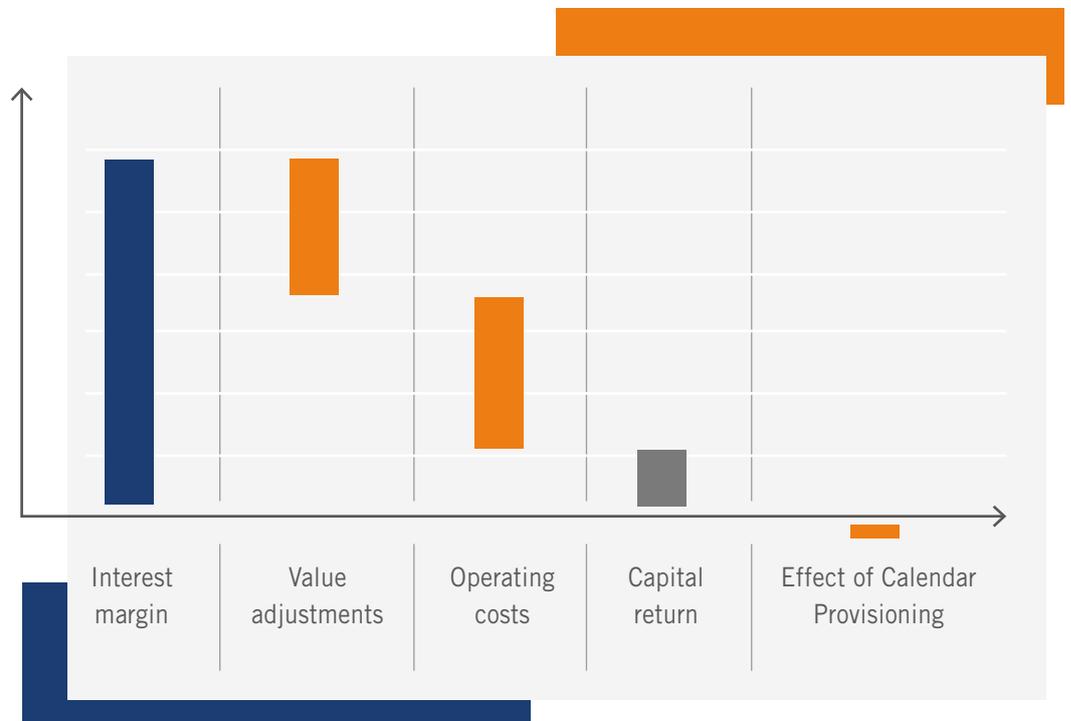


Figure 10- Effect of Calendar Provisioning on value creation



If the lending rate is revised and the bank also incorporates the cost of the additional capital due to calendar provisioning, the return paid to shareholders gets back in line with the required target but the credit spread experiences an increase of about 18 basis points.

This increase in the lending rate is the direct effect of the new regulations. However, there could also be an indirect one. Indeed, calendar provisioning may trigger a change in collection processes with banks striving to shorten collection times at the cost of reducing total recoveries, in order to close the gap between accounting coverage and supervisory provisions. One way to achieve such an acceleration would be to increase the use of NPL disposals (even for exposures with relatively low vintage), reducing the load of internal management.

This change would reduce the additional capital due calendar provisioning while increasing write-downs in the P&L account (which reduce taxable profits and thus generate a tax benefit. Although such action may not be optimal in terms of long-term profitability, it may be encouraged by the supervisory authorities and by the bank's own managers (who may prefer to avoid an increase in capital absorbed in the face of uncertain windfall profits in the future, for which someone else could possibly take credit).

To simulate the effects of such a scenario, let's change the profile of expected recovery by assuming it amounts to 10% (of the GBV at default) at the end of the first year, 20% at the end of the second year, and 35% at the end of the third year, when the exposure would be written off in full as suggested by calendar provisioning. Under this alternative scenario, recoveries are faster but lower: 35% in total, compared to 50% in the previous case.



It can be shown that this “accelerated” recovery curve leads to an increase of 30 basis points in the break-even lending rate (almost twice as much as the 18 basis points experienced in the previous case, with a more gradual and “patient” collection). In case the lending rate cannot be increased (e.g. because of the competition by non-bank lenders, the return on capital would be about 36% lower than the shareholders’ target rate).

While these simulations are based on a simplified example, they highlight how the increase in capital requirements generated by calendar provisioning (direct effect) the quest for more short-termism collection strategies (indirect effect) may negatively impact value creation. The increased capital consumption resulting from the new regulations will water down the returns generated for shareholders and/or trigger a rise in the cost of credit for non-financial companies. The effect will be particularly significant if banks succumb to the temptation of reducing collection times, even at the cost of increasing the LGD. Moreover, it can be shown that high-risk exposures (those that already pay a higher risk premium on their loans) are likely to suffer a more significant rate increase due to calendar provisioning.

These effects will be further amplified under a negative phase of the macroeconomic cycle, which is likely to lead to an increase in the PD, as well as in collection times (due, e.g., to higher judiciary workload and to a depressed market for real estate collateral). Longer collection times would of course lead to an increase in the capital add-on due to calendar provisioning, further diluting the return on equity earned by bank shareholders.



## 6. MANAGING THE PROVISIONING GAP



In this section, we focus on the “Pillar 2” version of calendar provisioning and discuss how banks can engage in the dialogue with their supervisor (the so-called “supervisory dialogue”) in order to justify any misalignments (“provisioning gap”) from the minimum coverage requirements set out by the new rules.

In particular, we look at a range of situations in which a supervised institution can, in our opinion, make a convincing argument for the legitimacy of a gap (under the so called “explain” approach), including both the situations explicitly mentioned by supervisors in past documents and those which, in our opinion, are motivated by equally legitimate reasons.

### 6.1 SUPERVISORY DIALOGUE: COMPLY OR EXPLAIN

Unlike the Pillar 1 treatment defined by the EU Regulation, ECB supervisory expectations are not binding and form the starting point for supervisory dialogue.

As explained in §2.1, the ECB Addendum and SREP letters set out the supervisor’s expectations regarding a bank’s provisioning gap and describe the supervisory dialogue. While the functioning of the supervisory expectations, the definitions and the treatment of specific circumstances (“explain circumstances”, under which gaps can be validly explained) were described in the Addendum for new NPE only, the ECB communication of August 2020 has clarified that they also apply to NPE stocks covered by the SREP letters sent to banks. Further indications have been provided in the STE instructions.

As mentioned above, “explain circumstances” can be defined as circumstances under which banks may adopt a coverage rate that is below the one dictated by calendar provisioning. Accordingly, the existing differences with respect to supervisory expectations will not be included in the overall provisioning gap that an institution is required to fill in the future.



The ECB Addendum identifies several examples of such circumstances, including the following:

- // a situation where a debtor verifiably makes regular partial payments amounting to a significant portion of the initial contractual payments, if those partial payments enable the exposure to be cured (also considering the provisions of the ECB Guidance in relation to forbearance measures) irrespective of whether it is past due or unlikely to pay. The situation relates to the debtor's ability to comply with post-forbearance conditions, and/or it is expected that he/she will fully repay the outstanding amount;
- // a situation where the application of the supervisory expectations would, in combination with Pillar 1 capital requirements for credit risk, result in a coverage above 100%;
- // any other relevant circumstances.

In November 2019, in the context of the above-mentioned STE<sup>14</sup>, the ECB provided further details. Firstly, it is emphasized that any other potential exception can be assessed by banks on a case-by-case basis where a full repayment of the exposure is expected. In addition, the following situations were specified, which are not explain circumstances and therefore require the provisioning gap to be filled:

- // capital and interest payments not met so that a timely repayment cannot occur;
- // capital and interest payments not met, but past due for more than 30 days;
- // contractual payments not made for at least 12 months.

Finally, “explain” circumstances can only be considered after the bank has carried out a suitable internal assessment (where any solid evidence relating to a specific exposure/ portfolio can be used to strengthen the supervisory dialogue) and such assessment has been reviewed and approved by the bank's relevant internal body.

<sup>14</sup> ECB, Reporting Instructions for coverage of non-performing exposures template (November 2019) par. 3.3.



## 6.2 EXPLAIN CIRCUMSTANCES: A TENTATIVE LIST

Based on the general indications described in the previous section, we propose a list of practical situations which, in our opinion, may represent “explain” circumstances:

- // **regular amortization:** exposures which, on the reference date for measuring the provisioning gap, do not exceed the agreed credit line (for overdrafts) or have paid back all instalments indicated in the amortization schedule (for term loans).
- // **UTP non-performing and forborne positions (cure period):** non-performing and forborne positions with regular payments (no payments past due for more than 30 days) even though the cure period for returning to a performing status has not yet elapsed;
- // **restructuring agreements:** restructuring agreements in force and where payments are being performed in line with expectations (as certified by the credit manager on the basis of the documentary evidence held);
- // **significant payments:** facilities which, although some payments are currently past due, have experienced a significant amount of repayments in the last 12 months. This case similar to the one mentioned in the Addendum and mentioned above (where a debtor “verifiably makes regular partial payments amounting to a significant portion of the initial contractual payments”). Of course, banks should set a clear threshold to define what qualifies as “a significant amount of repayments”.
- // **coverage above 100%:** this is one of the explain circumstances explicitly covered by the supervisor (and mentioned in the previous section), where supervisory expectations, together with Pillar 1 credit risk requirements, result in a coverage above 100%. In these cases, an exemption is granted for the share of coverage above 100%.



Next to these situations (that are directly covered by the indications issued by the supervisor), further cases are listed below whose characteristics can be taken into account for the purposes of the “explain” mechanism. These are:

- // **exposures overdue by more than 30 days, but waiting for full repayment:** generally speaking, the STE instructions specify that situations where “there are regular payments of capital and interest, but with late payments greater than 30 days past due” are not eligible as “explain” circumstances. However, leave the door open for the assessment of other (duly documented) circumstances that justify an expectation of full repayment;
- // **loans subject to future disposal:** for portfolios whose disposal has already been planned, some details should be further clarified by the supervisor. Firstly, it should be explained whether the exemption only applies to portfolios already earmarked for disposal in the bank’s “NPL Strategy”, or also to additional portfolios that are “highly likely” to be disposed of. Secondly, the possibility of applying the exemption on a provisional basis should be allowed if the disposal has not been formally confirmed. Finally, it should be clarified whether the exemption also applies when the selling price is below the current net book value;
- // **positions already sold or written off after the date of reporting:** these are loans disposed of (or subject to full impairment) after the reporting reference date but before the date on which reporting actually occurs;
- // **large collateral:** exposures with high collateral value that can be expected to be recovered in full (at least as far as the current net book value is concerned). This possible “explain” circumstance is not mentioned in the Addendum. However, on the basis of ECB guidelines in the Responses to the public consultation on the draft Addendum to the ECB Guidance to banks on non-performing loans (March 2018), this looks as a legitimate cause of exemption, provided that the possibility of enforcing the collateral is reasonably certain and that the loan-to-value is low enough to ensure full recovery;



// **purchased defaulted exposures:** the STE instructions specify that calendar provisioning must start from the time of the original default, meaning that the sale does reset the vintage count. This is seems consistent with Pillar 1 regulations regarding the prudential backstop. However, in the abovementioned response to the Addendum 2018 consultation, this approach was described by the ECB as “subject to case-by-case assessment”. Accordingly, for purchased NPLs, the time of purchase may be proposed as the starting date for calendar provisioning application, as the purchasing bank starts its own recovery processes (internal, outsourced, or through a possible new sale) only after the NPE has been acquired.



## 7. CALENDAR PROVISIONING DURING COVID-19



The COVID-19 pandemic will have a material impact on the additional capital requirements triggered by calendar provisioning, owing to a foreseeable increase in new NPLs, a slowdown in collection processes, and a downturn in economic activities that may freeze the sale of collaterals. This chapter looks at the main responses from supervisors and regulators in the early months of the pandemic, then highlights what still needs to be done in order to provide banks with adequate safeguards in the face of the foreseeable resurgence of non-performing loans. Finally, it also surveys the main responses to COVID-19 being developed by bank management, with a view to collection processes and additional provisions.

### 7.1 HOW SUPERVISORS AND REGULATORS RESPONDED TO THE PANDEMIC

The severe economic shock caused by COVID-19 and the exceptional measures taken to contain it have had a far-reaching impact on the economy. Businesses are facing significant difficulties due to temporary closures and reduced demand, while households have to deal with unemployment and reduced income. As a result, new and significant flows of NPEs are expected. For this very reason, public authorities at an EU and Member State level have taken measures to support households and businesses in dealing with the serious – but hopefully temporary – slowdown in economic activities and the resulting liquidity shortages.

One of the first steps taken was the intervention of the ECB, starting on March 20 through a press release followed by a “frequently asked questions” (FAQ) document. This was aimed at easing capital and liquidity requirements, as well as at introducing measures mitigating credit risk.

Concerning the latter – where the also EBA quickly stepped in<sup>15</sup>, it is useful to distinguish between those that directly affect the rules on calendar provisioning and those that have an indirect – but not necessarily less significant – effect since they impact the streams of new NPEs.

<sup>15</sup> In this regard, reference is also made to the EBA note of March 25, 2020 “Statement on the application of the prudential framework regarding Default, Forbearance and IFRS9 in light of COVID-19 measures”. Furthermore, on March 25, the EBA issued a statement (“Postponed EBA activities”), in which it analyzed all ongoing activities requiring input from banks in the coming months, with the aim of limiting, in the short term, any non-essential requests.



### **7.1.1 MEASURES THAT DIRECTLY AFFECT CALENDAR PROVISIONING**

With specific reference to the supervisory expectations on NPE coverage, the ECB has established that the treatment of loans covered by public guarantees established under the government schemes following the COVID-19 emergency should be treated in the same way as exposures guaranteed or insured by an official export credit agency. Accordingly, there will be no minimum coverage for the first 7 years of the NPE vintage count. This amendment originally concerned only Pillar 2 measures, but – as suggested by the ECB itself – it was extended to Pillar 1 measures by Regulation 2020/873 of June 24, 2020, containing several adjustments to the CRR aimed at dealing with the COVID-19 pandemic, which will be further discussed below.

As part of the measures aimed at dealing with the COVID-19 emergency, the SMM also provided for greater flexibility in the implementation of the banks' NPE plans (whereby future disposal targets are shared with the supervisors), as lenders may not reach the objectives set before COVID. Although the NPE stock existing at the outbreak of the pandemic does not benefit from any ad hoc measures, some flexibility may be granted on a case-by-case basis within the so-called “supervisory dialogue” between individual banks and their joint supervisory teams (JST).

These measures are certainly a positive development. It should be noted, however, that the increased flexibility with regard to NPE disposals could lead to higher NPE stocks, and therefore to greater calendar provisioning requirements. Moreover, the case-by-case approach announced by the ECB could prove overly discretionary, given that it is still unclear how the “supervisory dialogue” will take shape (all we know is that it will be included in the SREP process starting in early 2021).

As mentioned above, next to the actions by the ECB and EBA, the European legislators stepped in with Regulation 2020/873 (the so-called “CRR Quick Fix” published in the Official Journal of the European Union on June 24), approving an urgent package of amendments to Regulation 2013/575 containing anti-pandemic measures.



As noted in Chapter 2, the new article 47c follows on the measure adopted by the ECB for Pillar 2 rules, whereby guarantees and counter-guarantees granted by national public entities<sup>16</sup> are made equivalent to those provided by export credit agencies. The reason, as explained in the initial “whereas” section, is the substantial equivalence of the two guarantees in terms of risk mitigation capacity.

The text approved by European Parliament has made this equivalence permanent<sup>17</sup>. However, unlike for the ECB Pillar 2 measure, this “preferential” treatment requires that the guarantor enjoys a zero risk weight under the standardized approach to credit risk. Accordingly, while the ECB’s measure appears to be limited in time (as it is part of temporary anti-COVID actions), the one introduced with Regulation 873 is permanent but focused on (counter) guarantees provided by a more specific group of protection providers.

Indeed, since the purpose of the rule is to allow substantial alignment with the treatment of guarantees granted by export credit agencies and the latter are not subject to further eligibility criteria, it would seem natural to have a broad interpretation of the rule, whereby all public sector entities are accepted under Pillar 1 while Pillar 2 measures are adopted on a permanent basis. This would ensure a more uniform implementation of Pillar 1 and Pillar 2 rules.

In any case, the seven-year “shield” on calendar provisioning relating to loans backed by the public sector is likely to lead to greater reliance on such guarantees. In the immediate future, this could also result in lower capital for credit risk (and, of course, a lower increase in post-pandemic credit risk than would have occurred in the absence of government guarantees). In the medium term, banks may feel less incentivized to sell secured portfolios (although they may be increasingly interested in disposal as the eighth year approaches, resulting in full coverage requirements).

<sup>16</sup> These are the eligible protection providers referred to in Article 201(1)(a) to (e) of the CRR.

<sup>17</sup> The rule proposed by the Commission – unlike the Pillar 2 measure announced by the ECB – would be temporary in nature and would only apply within seven years of the date of approval of the quick fix. Thus, a “step” effect would occur, with a sharp return to the “scheme” of ordinary write-offs (that of the so-called “type-b collateral”) at the end of the derogation. For example, a loan guaranteed by anti-COVID-19 government measures classified as an NPE in 2024 would only have three years of the more favorable regime.



### 7.1.2 MEASURES THAT INDIRECTLY AFFECT CALENDAR PROVISIONING

Other measures coming from various authorities (Basel Committee, ECB, EBA, EFMA, to name a few) could have an indirect effect on calendar provisioning by helping mitigate the flow of new NPEs.

Firstly, supervisors have required banks to avoid pro-cyclical effects on regulatory capital and balance sheets, in particular, avoiding pro-cyclical assumptions in the models that determine provision levels within the IFRS 9 framework by assessing the possibility that the debtor has experienced a significant increase in credit risk over the whole residual life of the loan. Such measures will certainly have positive effects on the income statement, but could theoretically increase the gap between accounting provisions and the coverage targets set by calendar provisioning. Indeed, measures aimed at reduce the impact of IFRS 9 a mostly focused on exposures that are likely to shift to “Stage 2”, whereas calendar provisioning mainly concentrates on Stage 3 exposures.

The ECB has introduced some flexibility in the classification of loans as unlikely-to-pay when covered by public guarantees related to the COVID-19 emergency or subject to public and private moratoria extended in response to the pandemic. Similarly, the EBA guidelines allow for greater flexibility in the classification as defaulted of forbore exposures, reducing the automatic mechanisms that could unduly increase NPEs and hence the capital deductions required by calendar provisioning. In the short run, this positive effect could be limited by the fact that forbearance measures on defaulted exposures (when granted for the first time) would anyway result in a one-year “freeze” of the coverage requirements dictated by Pillar 1 regulations (prudential backstop), as discussed in Chapter 2.

Our assessment of anti-COVID measures and their impact is certainly positive. Nevertheless, there needs to be a comprehensive approach which also takes into account the foreseeable effects (direct and indirect) on calendar provisioning in the medium to long term, and guarantees a level playing field across different banks. There are also a number of other areas of action which could be usefully explored in the near future, as discussed in the next section.



## 7.2 FURTHER DESIRABLE MEASURES

The measures already put in place by the supervisory authorities, as outlined above, are primarily aimed at mitigating credit risk for the new defaults originated by the COVID-19 crisis, while the pre-existing stock of impaired loans is not subject to specific mitigation measures (the only exception being the abovementioned “flexibility” regarding the NPL plans drafted by individual banks).

However, the pandemic shock affects both the effectiveness and speed of a bank’s collection processes, as well as the price offered by specialized investors for impaired loan portfolios.

It would therefore seem desirable to have further regulatory changes in relation to the stock of defaulted exposures that were in place from before the start of the COVID-19 pandemic.

In particular, with reference to the management of the “provisioning gap” (see §6), it appears necessary to extend the exemptions (“explain circumstances”) beyond those outlined by the ECB for Pillar 2 purposes, or at least provide flexibility in the case-by-case assessment of the debtor’s ability to achieve full repayment of impaired exposures in the medium term.

More generally, with regard to the entire regulatory framework on calendar provisioning (including Pillar 1 rules), consideration should be given to suspending the vintage count under exceptional circumstances related to the COVID-19 emergency<sup>18</sup> (e.g., when real estate enforcement measures are postponed by courts).

With reference to the first aspect (greater flexibility in assessing explain circumstances), positions associated with a restructuring plan and/or forbearance measures prior to the pandemic may be affected by the crisis, as expected cash flows estimated before the pandemic might have to be reassessed, as customers may not be able to comply with the previously established repayment plans. However, where the debtor pays part of his/her debt on a timely and regular basis, an expectation of full repayment may still hold, although possibly at the cost of agreeing an extension relative to the original schedule due the exceptional, adverse economic situation.

<sup>18</sup> This was also expressed in the letters from the ABI to the Chair of the ECB Supervisory Board (SSM) and the Chair of the European Banking Authority (EBA) in March 2020.



With regard to the second aspect (the interruption of the vintage count in the presence of exceptional circumstances related to the pandemic), this could provide an opportunity for reconsidering the whole coverage profile associated with calendar provisioning. Indeed, the minimum coverage requirements in the current rules were based on a favorable macro-economic context, characterized by a trend of constant reduction in the NPL stock in banks and by collection processes that were not affected by the critical factors related to the current health emergency. Against that backdrop, leaving coverage expectations unchanged would trigger strong pro-cyclical effects on the regulatory capital available to banks to increase loans and support the economy, in sharp contrast with the need – constantly highlighted by supervisors – to avoid pro-cyclical impacts on regulatory capital and bank financial statements. It therefore seems appropriate to look at additional measures aimed at: dealing with pre-COVID-19 NPE stocks, freezing the vintage count under exceptional circumstances and/or recalibrating the time profile of the minimum coverage ratios.

### **7.3 EXPECTED IMPACTS OF COVID-19 ON MANAGEMENT PRACTICES**

Of course, regulatory response is not the only perspective from which the impact of COVID-19 on calendar provisioning should be assessed. Equally important are the improvements in management practices that banks must implement in the coming months to contain the effects of the pandemic. The COVID-19 emergency has had a significant impact on the banking system, requiring a substantial effort to serve the real economy and materially impacting profitability. The new scenario has generated needs and priorities that are different from the past, including in the NPL sector, making it necessary to review strategic plans, update coverage and revise the entire collection chain. In this context, the measures implemented by the public sector and the guidance issued by European regulators have been focused on curbing the risk of new defaults, through incentives towards adopting moratoria and/or issuing new loans, aimed at customers who were still classified as performing at the outset of the crisis.

The banking industry, on the other hand, has moved in two main directions: a review of collection strategies and a preemptive increase in NPL provisioning.



On the first aspect, banks first reviewed their “cure” strategies for impaired loans based on the granting of new credit. While estimates of the cure rate (exposures gone back to a performing status over total exposures classified as unlikely to pay one year before) have reduced in the short to medium term, reflecting the reduced effectiveness of forbearance and restructuring measures, it is also true that lockdown has generated the need for firms to finance short-term cash requirements with new debt, increasing leverage and therefore the risk profile of the debtor. Moreover, some companies already in a precarious financial situation have shown greater difficulties in stabilizing their cash flow and returning a performing status, leading banks to adopt a gone-concern approach.

Lockdowns will have a negative impact on estimated collection times and could also lead to a decrease in potential buyers for collateral (among qualified investors with long-term investment strategies), resulting in lower auction prices.

Longer legal proceedings could temporarily increase the propensity of banks to pursue out-of-court credit management, encouraging “full and final” settlements and strengthening collection processes via digital channels (written correspondence, phone collection) in line with social distancing rules. A strong push toward the rescheduling of instalment loans is to be expected, in order to avoid a material increase in delinquency rates.

On the second aspect mentioned (i.e. the increase in NPL provisioning), it should be noted that the lower recoveries observed, the worsening of macroeconomic parameters, and the prospect of higher danger rates are all factors taken into account by the credit adjustment models used for financial reporting purposes (according to the IFRS 9 accounting standard). This has led to a rise in coverage levels, particularly for those industries most affected by the crisis and, in general, for small and medium-sized enterprises, which are typically less resilient.

In addition to ordinary, in-house channels, the expected increase in NPLs will probably also be managed by banks through the use of outsourcers and innovative structures, emphasizing the need to deal with the crisis in a holistic way, making the most of all available external skills and solutions in the field of collection.

## 8. CONCLUSIONS

To conclude, we would like to briefly summarize the main “messages” that have emerged on the previous pages.

A first important point, in our view, is that rules on calendar provisioning, although now crystallized in their core mechanisms, still requires a more precise definition of certain details that may significantly affect its impact on the banking sector and the real economy.

A second point concerns the treatment of defaulted exposures and of high-risk performing loans. For the former, collection processes must facilitate – as far as possible – the alignment between the actual recovery timeline and that implicit in calendar provisioning; this can be achieved through a strong management-by-objectives approach and better integration (in terms of both information and performance) between internal structures, servicers, and external lawyers. The management of high-risk positions must focus more than ever on the early signs of increasing probability of default, in order to timely deploy financial solutions that prevent exposures from becoming impaired. Triggering the “timer” that leads to compulsory write-offs.

The third point concerns performing loans, as calendar provisioning may have a significant impact on healthy exposures (perhaps even beyond the intentions of its creators). To prevent such unwelcome effects, increasing efforts must take place to thoroughly revise the origination process, making it more effective and cost efficient.

A fourth consideration concerns Pillar 2 measures, which, in the short run, will likely lead to a significant share of the new “write-offs” triggered by calendar provisioning. Given that such circumstances are based on supervisory expectations, it is possible – and indeed appropriate – for them to be implemented with adequate flexibility. Against this backdrop, it would be desirable for the ECB – in addition to allowing exemptions based on a “case-by-case” perspective – to define a more extensive list of “explain situations”, in order to facilitate a uniform application across individual supervised entities.



A theme running through every aspect of this work is the ongoing COVID-19 pandemic. Faced with such a watershed moment, European supervisors, co-legislators and of course central governments have proved ready to quickly implement a range of useful and valuable tools. However, their interventions have remarkably fallen short of addressing, through a set of clear and universally applicable principles, the impact of the Covid-19 on the collection process for loans that were already impaired in early 2019. Should the authorities decide to act with more ambition and courage, the timeline currently used for calendar provisioning could be revised, or at least frozen to take account of the months “lost”, because of the pandemic, in legal proceedings and out-of-court settlements.

While further regulatory measures would certainly be welcome, banks should not forget that an effective response to the crisis (as well as the ability to absorb the negative impacts of calendar provisioning) firmly depends on their ability to react and innovate. Introducing this paper, we noticed that the mandatory minimum coverage required by calendar provisioning follows faster time frame than the average recovery processes in several European countries, posing a risk that their banks be penalised. However, as calendar provisioning is now in place and entering full implementation, it would be useless to look back and indulge in self-soothing considerations.

There is no point in dwelling on the past, although further reflection could become necessary in the years to come if the new CP rules were to result in a drag on the European banking system and its customers, fueling the role of shadow banks system in NPL management and the refinancing of strained businesses. A smart, pragmatic interpretation of the new regulatory regime is the best guarantee that such unintended effects will not occur.



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