



EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Andrea ENRIA

Chair of the Supervisory Board

COURTESY TRANSLATION

Mr Marco Zanni
Ms Francesca Donato
Mr Valentino Grant
Mr Antonio Maria Rinaldi
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 9 June 2020

Re: Your letter (QZ-032)

Honourable Members of the European Parliament,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 7 May 2020.

ECB Banking Supervision gives careful consideration to the financial stability implications of banks' provisioning policies in the context of the coronavirus (COVID-19) pandemic. We have announced several mitigating measures to ensure that our directly supervised banks can continue to fulfil their role in funding households and corporations amid the shock to the global economy.¹ Some of these measures, adopted by the ECB within our remit as a prudential supervisory authority under the SSM Regulation², relate to ensuring that European banks have adequate provisioning policies and to foster comparability in capital ratios.

Given that credit risk is cyclical and that banks' accounts reflect the cyclical movements of the economy, banks' provisioning levels increase when the economic outlook deteriorates. The international accounting standard IFRS 9 requires banks to consider forward-looking information, including macroeconomic factors, in their estimate of expected credit loss provisions. However, in times of high economic uncertainty, forward-looking estimates for specific years in the future can lose reliability, making forecasting more challenging. Banks' expected credit risk models therefore rely on a greater degree of subjective judgement. Leading auditors and other experts have raised concerns that the level of provisions could start to diverge widely and become difficult to compare across banks, with implications for the level playing field and the comparability of

¹ See [press releases](#) of 12 March, 20 March, 27 March and 16 April.

prudential ratios. Moreover, US and European banks cannot be easily compared, for one because of fundamental differences in accounting standards. In particular, the applicable US accounting standard on provisions (US-CECL) has been applied for the first time by the largest US banks in the first quarter of 2020 and contributed to the increase of their loan loss allowances. It requires estimates of expected credit losses for the remaining lifetime for all loans, whereas IFRS 9 requires a shorter time horizon (of only 12 months) for exposures that have not yet suffered a significant increase in credit risk. Those exposures are by far the largest component on European banks' balance sheets.

In order to improve comparability among European banks and prevent procyclical provisioning, ECB Banking Supervision recommended banks to consider the regularly published ECB macroeconomic projections as anchor points for calibrating their models.³ These forecasts generally cover the current calendar year and the following two years. Given the prevailing uncertainty, ECB Banking Supervision encouraged banks to give greater weight to historical trends when estimating longer-term expected credit losses for the purposes of IFRS 9 provisioning policies. At the time of the recommendation, the latest ECB publication on macroeconomic projections included information as of end-February 2020 and did not incorporate the impact of the lockdowns and severe social distancing restrictions imposed across countries in March 2020, nor did they take into account the unprecedented public support measures announced and implemented by several Member States. Therefore, banks had to exercise judgement to update those projections for their estimates as of 31 March 2020 and still took different approaches which led to difference in provisioning behaviours. ECB Banking Supervision expects that recent macroeconomic projections, published on 4 June 2020, will provide a more solid anchor and will foster greater consistency in provisioning behaviour across banks. ECB Banking Supervision expects banks to adhere to these recommendations, and will use the June macroeconomic projections as a reference to identify significant outliers and further challenge insufficiently prudent provisioning behaviours.

In addition, ECB Banking Supervision encouraged banks to apply the IFRS 9 transitional arrangements under the Capital Requirements Regulation (CRR), which provide banks with more room for taking additional precautions where needed on the basis of forecasts, without fully impacting the prudential capital ratios.

Excessively high provisions could lead to unwarranted procyclical effects by constraining banks' capacity to lend to households and corporations. ECB Banking Supervision encourages banks to make neutral forecasts that are neither overly optimistic nor excessively conservative. Some banks might feel obliged to make use of excessively conservative estimates to be on the safe side. However, others might even be motivated to be excessively conservative on the grounds that higher losses would now be perceived as resulting from the pandemic, whereas the expected reversal of excessively conservative provisions could in future be used to justify higher dividends and remunerations.

Moreover, European governments have taken unprecedented support measures aimed at addressing the economic consequences of the outbreak for individuals, households and businesses. These support measures have implications for banks' estimates of the credit risk of borrowers and hence also affect banks' provisioning levels.

² Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

³ See the letter to banks from Andrea Enria, Chair of the Supervisory Board, dated 1 April 2020, on [IFRS 9 in the context of the coronavirus \(COVID-19\) pandemic](#).

With regard to provisioning for non-performing loans (NPLs), ECB Banking Supervision's mitigating measures in response to the COVID-19 pandemic form part of its wider supervisory approach to NPLs, which is composed of the following three main elements:

- the ECB Guidance to banks on non-performing loans, which outlines measures, processes and best practices for banks when tackling NPLs;⁴
- the Addendum to the ECB NPL Guidance, which sets the supervisory expectations for prudential provisioning of new non-performing exposures (i.e. NPEs⁵ classified as such from 1 April 2018);⁶
- supervisory expectations for the provisioning of the NPE stock, as communicated in a press release on 11 July 2018.⁷

The ECB's supervisory expectations set out what the ECB deems to be a prudent treatment of NPEs and are aimed at avoiding an excessive build-up of non-covered aged NPEs on banks' balance sheets in the future. The ECB's supervisory coverage expectations on NPEs were recently reviewed⁸ following the publication of the amendment to the CRR ("Pillar 1 backstop regulation")⁹, which establishes minimum loss coverage for NPEs in order to enhance the consistency and simplicity of the overall approach to NPEs. This should also reduce the reporting burden for banks.

In conclusion, I would like to stress that these combined measures taken by ECB Banking Supervision and national governments should ensure that EU banks have consistent provisioning policies in place for both their performing and non-performing loans, enabling them to remain resilient and to fulfil their role in funding the European economy.

Yours sincerely,

[signed]

Andrea Enria

⁴ See [Guidance to banks on non-performing loans \(March 2017\)](#).

⁵ As in the NPL Guidance, "NPLs" and "NPEs" are used interchangeably.

⁶ See Addendum to the [ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures \(March 2018\)](#).

⁷ See [press release of 11 July 2018](#).

⁸ See [ECB Communication on supervisory coverage expectations for NPEs \(August 2019\)](#).

⁹ Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures (OJ L 111, 25.4.2019, p.4).