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Deloitte Banking Alert

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"EU banks urged to prepare for bad loans as pandemic hits economy", according to a prediction made by chair of the Single Resolution Board (SRB)

European banks need to prepare their balance sheets for the risk of pandemic-induced non-performing loans hitting them next year, Elke König, Chair of the Single Resolution Board has said in an interview to Financial Times.

In addition, **she urged the EU to properly harmonize its state aid rules for handling embattled banks with its "resolution" regime, which intervenes to ward off systemic financial crises.** Ms König argued that, as things stand, there was a "misalignment" in the system.

What is the NPL projection for the next period?

Last month, the ECB's top bank supervisor Andrea Enria wrote in the FT magazine that, **in a "severe but plausible" scenario, non-performing loans at eurozone banks could reach €1.4tn, well above the levels of the 2008 financial crisis and the ensuing EU sovereign debt crisis.**

At this moment it is too soon to make an exact estimation on NPLs volume, because this would depend on the nature of the downturn and recovery. In addition, actions taken by governments, such as state guarantee schemes were "shielding" the lenders, she added.

However, non-performing loans could start coming through in Q1 and Q2 of 2021. Thus, the best thing that the banks could do is to address them early, and then it is steering through the fog.

Another resolution wave coming?

Especially during this period of time banks need to be fully transparent. Regarding these portfolios, banks need to be able to separate good loans from bad loans and set out how they would like to service it and how they will deal with it.

Since the last crisis, a lot of work has been done to strengthen the bank's resilience and ensure that they can be safely resolved if they fail. This work has included making sure money can be raised by wiping out bank bondholders, so shielding taxpayers from footing the bill.

One of the tools used by Single Resolution Board during the last crisis was asset separation – power to strip bad loans out of banks' balance sheets.

Since new resolution framework was adopted in 2016, there is only 1 large case that was handled by SRB: Spain's Banco Popular failure. On 7 June 2017, the Single Resolution Board transferred all shares of

Banco Popular Español to Banco Santander S.A. That meant that Banco Popular continued to operate under normal business conditions as a solvent and liquid member of the Santander Group with immediate effect.

However, in 2017 two regional Italian banks received state aid as part of bankruptcy proceedings while senior creditors were shielded from losses. This prompted complaints from Berlin and other EU capitals that those measures allowing governments to get around the EU recovery and resolution principles were not so appropriate and **investors, including senior creditors should face losses before the taxpayer in the case of a crisis.**

Thus, The European Commission is set to review the bank resolution system next year.

The EBA is taking action

New EBA Guidelines addressed to NPEs management

At the end of 2018, **EBA published its final Guidelines on management of non-performing and forborne exposures which aim to ensure that credit institutions have adequate prudential tools and frameworks in place to manage effectively their non-performing exposures (NPEs) and to achieve a sustainable reduction on their balance sheets.** It also requires institutions to establish NPE reduction strategies and introduce governance and operational requirements to support them.

The new EBA management framework covers the following guidelines requirements of non- performing and forborne exposures:

(i) NPE strategy – taking into account relevant consumer protection considerations and requirements, and ensure fair treatment of consumers, describing:

(ii) NPE governance and operations;

(iii) Forbearance;

(iv) NPE recognition;

(v) NPE impairment and write-offs;

(vi) Collateral valuation of immovable and movable property;

(vii) Supervisory evaluation of management of NPEs and FBEs.

The Guidelines became applicable starting from 30 June 2019.

Final EBA Guidelines on loan origination and monitoring

The European Banking Authority (EBA) published on May 29th 2020 its Guidelines on loan origination and monitoring, requiring institutions to develop robust and prudent standards in order to ensure the proper assessment of the newly originated loans.

According to new Guidelines, **institutions should have a robust and effective monitoring framework, supported by an adequate data infrastructure, to ensure that information regarding their credit risk exposures, borrowers and collateral is relevant and up to date, and that the external reporting is reliable, complete and up to date.**

As part of their monitoring framework, institutions should develop, maintain and regularly evaluate relevant quantitative and qualitative EWIs that are supported by an appropriate IT and data infrastructure that would allow the timely detection of increased credit risk in their portfolio.

These guidelines will start applying from June 30th 2021, but institutions will benefit from a couple of transitional arrangements:

- The application of the guidelines to the existing loans and advances that required either a renegotiation or a contractual change with the borrower, will apply starting June 30th 2022;
- Institutions will be permitted to address any data gaps and adjust their monitoring framework and infrastructure until June 30th 2024;

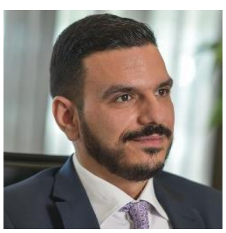
How can we help? Non-performing exposures management

Deloitte is the leading loan portfolio advisor in the market and has been active in advising on loan portfolio transactions and deleveraging projects covering assets across the world.

Deloitte can help you:

- Assess the entire lending process to establish potential gaps that contribute the generation of NPLs;
- Evaluate the forbearance/restructuring methodologies to establish effectiveness on the long term health of the loan;
- Stress your workout strategy and operations to determine which areas could potentially contribute to more efficient troubled loan resolution.

For further questions regarding the aspects mentioned in this alert, please don't hesitate to contact us.



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