

Single Rulebook Q&A

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Status	Final Q&A
Legal act	Regulation (EU) No 575/2013 as amended by Regulation (EU) 2019/876 (CRR2)
Topic	Credit risk
Article	500
Paragraph	1
Subparagraph	-
COM Delegated or Implementing Acts/RTS/ITS/GLs/Recommendations	Not applicable
Article/Paragraph	-
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Disclose name of institution / entity	Yes
Name of institution / submitter	Banca d'Italia
Country of incorporation / residence	Italy
Type of submitter	Competent authority
Subject matter	LGD adjustment for massive disposals.
Question	Article 500, first paragraph, point (c) of the Regulation (EU) 2013/575 as amended by Regulation (EU) 2019/876 provides for a 20% threshold to qualify disposal operation as “massive”. This question seeks clarification on how to compute the threshold.
Background on the question	Regulation (EU) 2013/575 as amended by Regulation (EU) 2019/876 introduces Article 500 as “ad-hoc tool” aimed at incentivizing institutions to dispose large shares of their NPLs portfolios (“massive disposals”) by offsetting fully or in part the effects of massive disposals on LGD estimates. Article 500 envisages three conditions. Among these, point (c) prescribes that “the cumulative amount of defaulted exposures disposed of since the first date for disposals in accordance with the plan referred to in point (a) has surpassed 20 % of the cumulative amount of all observed defaults as of the date of the first disposal referred to in points (a) and (b).” Clarification is sought on how to compute: “the cumulative amount of

defaulted exposures disposed of since the first date for disposals in accordance with the plan referred to in point (a)” (the numerator of the ratio); “the cumulative amount of all observed defaults as of the date of the first disposal referred to in points (a) and (b)” (the denominator of the ratio). In this regard, it is worth considering that 20% threshold is a quantitative criterion set to qualify what can be considered as “massive” disposals: large amounts of NPL sales that occur in a limited amount of time and with a direct link to a defined plan of NPL reduction. In order to ensure consistency in the ratio calculation, the terms of reference for both the numerator and the denominator have to be consistent: the amount of NPL disposed and the amount of NPL outstanding as of the date of the first disposal. Along this line, the “cumulative amount” should be interpreted as the cumulative gross amount (i.e.: gross book value) of the NPL disposed. This way the ratio would give a fair indication of the magnitude of the NPL disposals by comparing the “disposed amount”, vis-à-vis a “disposable amount” so that a disposal can be considered as “massive”. Indeed, the reference of the article to “cumulative amount” (i.e., cumulative NPL gross amount) avoids situations in which disposals of very granular portfolios (e.g. panoply of small loans) would be qualified as “massive disposals”, while potentially having a negligible impact on the fulfilment of the plan. On the other hand, ignoring the “cumulative amount” concept might potentially give rise to scenarios where the adjustment envisaged in the Article are not activated even though the overall NPL portfolio is dismissed (target NPL ratio equals to zero), and it would be tantamount to questioning the real intent of the legislator. In this regard, alternative interpretations that consider the threshold computed on the basis of the number of defaulted exposures included in the reference data set (“RDS”), in light of the meaning in Article 181 of “all observed defaults”, are not viable since Article 500 provides for a special and transitional regime (“by way of derogation from Article 181”) so that cross reference to Article 181 cannot be used to clarify the meaning of “all observed defaults”; Even if such cross reference was used, it would be not possible to reconcile the reference to “cumulative amount” in Article 500 (absolute monetary value) with the “all observed defaults” in Article 181(1)(a) (number of defaulted exposure); Article 500 makes explicit reference to “cumulative amount of all observed defaults as of a specific date”, and not to “number of position disposed”; Such interpretations would lead to an inconsistent application of Article 500 across banks by violating the level playing field as its usability would ultimately depend on the Reference Data Set (“RDS”) size, data length, composition and structure (e.g.: calibration segments), irrespective of the amount of NPL disposed and its impact on the NPL disposal strategy; The use of the expression “as of” clearly points to a specific date, and not to a “time span”. This confirms that the reference to RDS (which relates to a time window) is not appropriate.

EBA answer

The computation of the threshold for the adjustment for massive disposals according to Article 500 of Regulation (EU) 2013/575 (Capital Requirements Regulation – CRR) as amended by Regulation (EU) 2019/876 is based on 'all observed defaults'. This term is referred to in point (c) of Article 500(1) as well as in point (a) of Article 181(1) of the CRR.

Article 181 is part of the section of the CRR that sets out the rules for risk quantification. The article contains specific requirements for institutions' estimates of loss-given default (LGD). Point (a) of Article 181(1) requires institutions to use all observed defaults for the estimation of their own LGD. The purpose of paragraph (1) of Article 181 is to ensure that institutions use all available data points so that their own LGD estimates are representative of their long-run loss experience.

Article 500(1) provides for a derogation from the requirement in point (a) of Article 181(1). This derogation is temporary and can only be applied under strict conditions. One of these conditions, as set out in point (c) of Article 500(1), is the requirement that an institution must have disposed of a significant amount of defaulted exposures. According to that provision, a disposal can be considered as 'massive' when it has surpassed 20% of the cumulative amount of all observed defaults as of the date of the first disposal according to a plan notified to the competent authority.

Although the term 'all observed defaults' is used in both articles, the context and purpose of Article 181(1)(a) and Article 500(1)(c) are different. Point (c) of Article 500(1) refers to an amount of all observed defaults in order to assess whether a cumulative amount of defaulted exposures has reached a defined threshold. On the other hand, point (a) of Article 181(1) requires using all observations in order to ensure that LGDs are estimated on the basis of long-run average realised LGDs.

In order to ensure that an institution can only apply the derogation in Article 500(1) when it has made sufficient progress with disposing of NPLs, the denominator for the calculation of the 20% threshold must be understood as the outstanding amount of defaulted exposures as of the date of the first disposal according to the plan submitted to the competent authority.

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