EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Danièle NOUY
Chair of the Supervisory Board

Mr Matt Carthy
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 23 April 2018

Re: Your letter (QZ101/2017)

Honourable Member of the European Parliament, dear Mr Carthy,

As a follow-up to my letter dated 6 December 2017, I would now like to provide you with an update on the outcome of the ECB's review of split mortgages.

Split mortgages are a forbearance product currently being offered to retail residential mortgage borrowers in distress in a number of European countries. The primary feature of the product is that the original principal amount of a non-performing retail loan is restructured by splitting it into separate obligations with substantially different terms and conditions, comprising an ongoing sustainable loan (senior) subject to regular repayments and a 'warehoused' loan (junior). The content of this letter does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing EU regulations or directives and their national transpositions or equivalent, or guidelines issued by the European Banking Authority (EBA). Instead, the purpose of this letter is intended to clarify the supervisory expectations regarding the classification of split mortgages based on existing regulations. Of course, where binding laws, accounting rules and national regulations on the same topic exist, banks should comply with those.

The definition of a non-performing loan for regulatory purposes is laid down in European Banking Authority (EBA) technical standards on non-performing exposures and forbearance[1]. These technical standards provide consistent criteria in respect of the classification and the curing of non-performing exposures and forbearance. In respect of retail split loan restructuring, in order for the senior to return to performing classification, it is essential that the retail split-loan restructuring has resulted in two separate and independent payment obligations with substantially different terms and conditions, i.e. two separate exposures. As such, an obligor should not be subject to any contractual repayment obligations in respect

[1] Final Report on final draft implementing technical standards amending Commission Implementing Regulation (EU) 680/2014 (EBA/ITS/2016/07)

European Central Bank
60640 Frankfurt am Main

Tel.: +49 69 1344 0
E-mail: info@ecb.europa.eu
Website: www.bankingsupervision.europa.eu

of repayment of the junior until the senior has been repaid in full or if the obligor defaults on the senior. In cases where the retail split-loan restructuring has not resulted in two separate and independent payment obligations, the senior and the junior cannot be treated as separate exposures and are considered non–performing from a regulatory classification perspective.

Please note that the described approach is intended to be applied only to retail residential mortgage loans for which the definition of default is applied at the level of the individual credit facility rather than in relation to the total credit obligations of a borrower[2]. This approach will also be applied on a case-by-case basis, taking the bank-specific circumstances into account.

In addition, in order to facilitate a return to performing classification, the EBA technical standards require the senior to be fully sustainable. It should be set at a level that is considered fully affordable to the borrower, , and subject to monthly principal and interest repayments over a minimum twelve-month period, before it can be considered as cured; moreover, the repayments should be sufficient to repay in full the capital amount over the term of the loan[3].

It is important to highlight that if there are actions by a bank over the term of the senior, indicating that the payment obligations under the senior and the junior are not independent and separate from each other (for example, by ongoing increases in the senior notes and reductions in the junior claims) this would call into question this independence criteria that allowed the senior to be considered as a separate exposure from the junior. This situation would impact the classification of the senior and its treatment as a separate performing exposure.

Furthermore, the ECB expects that banks would treat the junior in a specific manner from a capital perspective, namely in a way that results in a reduction in Common Equity Tier (CET) 1 capital equal to the CET1 reduction from writing the junior off in full and derecognising it from the balance sheet. As stated in Chapter 6.5 of the ECB guidance to banks on non-performing loans "*a write off does not involve the bank forfeiting the legal right to recover the debt: a bank's decision to forfeit the legal claim on the debt is called 'debt forgiveness'*".

Accordingly, split mortgages can be considered a sustainable long term method of restructuring of retail mortgage debt on the basis that the restructuring complies with all relevant criteria specified under the Union law and certain key supervisory expectations as outlined.

With respect to the question regarding the effects of a change in the classification rule on the capital of the Irish banks, as outlined above, this review does not constitute a change in existing rules but rather serves as a clarification of existing supervisory expectations. The impact, if any, on Irish banks depends on the bank specific circumstances and their compliance with existing regulations in line with all other credit-related topics. These aspects are being reviewed as part of our regular supervisory engagement.

---

[2] Last sub-paragraph of Article 178(1) CRR.

[3] Paragraph 231(b) of Annex V, Part 2 of Commission Implementing Regulation (EU) No 680/2014 requires one year to be passed since the latest between the moment where forbearance measures were applied and the moment where exposures have been classified as non-performing.

I trust that this provides an overview of the outcomes of our investigation and clearly outlines our supervisory expectations as to when senior loans resulting from retail split-loan restructuring can return to being classified as performing exposures.

Yours sincerely,

Danièle Nouy