



TOPICS:

Credit Risk

SOURCE:

European Central Bank

ECB: A Risk-Based Approach to Assess NPLs

- The ECB's Supervision Newsletter article outlines a streamlined, **risk-based approach to assessing non-performing loans (NPLs)**, reflecting the significant reduction in legacy problem assets across directly supervised institutions. Following the 2008 financial crisis, elevated NPL levels constrained bank profitability, capital and lending capacity. In response, the ECB introduced comprehensive supervisory measures, including 2017 guidance requiring banks to adopt credible NPL reduction strategies and a 2018 Addendum establishing minimum loss coverage expectations. These expectations were initially applied under Pillar 2 to legacy exposures and subsequently embedded in EU law under Pillar 1 for loans originated after April 2019.
- The **stock of non-performing exposures (NPEs)** subject to coverage expectations declined from nearly €500 billion in 2020 to approximately €180 billion by end-2024. Since 2021, the ECB has applied targeted Pillar 2 Requirement (P2R) add-ons to institutions with insufficient provisioning.

There has been **a reduction in both the number of affected banks and the average add-on levels**: in the 2025 SREP cycle, nine banks were subject to NPE-related P2R add-ons (RWA-weighted average of 12.4 basis points), compared with 22 in 2021. The average NPL ratio has stabilised at around 2.2% over the past three years, down from above 7% in the previous decade.

- Given this improved risk profile, the **ECB will recalibrate its supervisory framework from 2026**. First, NPE coverage expectations will be set through a single multi-year operational act rather than annual SREP recommendations. Second, banks with immaterial legacy NPE stocks will no longer be required to meet or report on coverage expectations. Third, supervisory scrutiny of requests to reduce coverage shortfalls will adopt a more explicitly risk-based focus, concentrating on institutions with material exposures.

