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European Commission

BANKING AND FINANCE

Targeted consultation on statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing

Fields marked with * are mandatory.

Introduction

Non-performing loans (NPLs) have piled up in parts of the EU banking sector in the aftermath of the financial crisis and ensuing recessions, with significant adverse impacts on banks' profitability, viability and ability to lend. High levels of NPLs across a substantial number of banks pose risks to the financial system at large and the overall economy of the EU. While tackling NPLs is primarily the responsibility of affected banks and Member States, there is a distinct European dimension, as clearly manifested in the Commission Reflection Paper on the Deepening of the Economic and Monetary Union and fleshed out in the Commission Communication on completing the Banking Union. Furthermore, the Council concluded a comprehensive action plan to tackle NPLs in Europe inviting the Commission and other actors to act on several fronts to reduce the risk to financial stability, both by addressing the existing stock of NPLs and by preventing the emergence and accumulation of NPLs in the future. The Commission takes active part, together with other European stakeholders and Member States, in the realisation of this Action Plan.

One of the key policy areas in this context is prudential regulation and supervision to be applied to the newly originated loans, which should ensure, inter alia, that new loans that turn non-performing are recognised timely and provisioned adequately in order to prevent loss forbearance and enhance NPL resolution. If sufficiently high provisions credit losses will be made, restructuring, selling or dismissing non-performing assets and non-recoverable collateral will require less, if any, additional capital and will become potentially easier. If, on the contrary, new loans that turn non-performing will be insufficiently provisioned, they are more likely to remain on banks' balance sheets in an attempt by banks to avoid or delay loss recognition. This may cast doubt over banks' future profitability, solvency and long-term viability. In addition, heightened risk perceptions on the part of investors and depositors usually translate into higher funding costs. Together, these factors result in higher lending rates, reduced lending volumes, and increased risk aversion. Experience in several countries that have dealt with NPLs suggests that binding requirements on NPL recognition and provisioning made a significant contribution to the resolution of NPLs.

As announced in its Communication on completing the Banking Union, and as a follow-up to the July 2017 Conclusions of the Council on tackling NPLs in the EU, the Commission is preparing a report on tackling potential under-provisioning for new loans that turn non-performing. That report will consider the possibility of introducing statutory prudential backstops in the form of compulsory and time-bound prudential deductions of NPLs from own funds to prevent or reduce the future build-up of new NPL stocks with insufficient coverage across Member States and banks. As also announced in the aforementioned Communication, in this context the Commission will also consider introducing a common definition of non-performing exposures (NPEs) in accordance with the one already used for supervisory reporting purposes with the view of providing a sound legal basis for the prudential treatment of such exposures and ensuring consistency.

The Commission services launch this public consultation to gather stakeholders' views on the possible introduction of statutory prudential backstops against insufficient loan loss coverage for new loans that turn non-performing, as well as on the potential functioning, scope, design and calibration of such prudential backstops.

Please note: In order to ensure a fair and transparent consultation process **only responses received through our online questionnaire will be taken into account** and included in the report summarising the responses. Should you have a problem completing this questionnaire or if you require particular assistance, please contact fisma-non-performing-loans@ec.europa.eu.

More information

- on this consultation
- on the protection of personal data regime for this consultation

1. Information about you

* Are you replying as:

- ( ) a private individual
- (x) an organisation or a company
- ( ) a public authority or an international organisation

* Name of your organisation:

Association for Financial Markets in Europe

Contact email address:

The information you provide here is for administrative purposes only and will not be published

jacqueline.mills@amfe.eu

* Is your organisation included in the Transparency Register?
(If your organisation is not registered, we invite you to register here, although it is not compulsory to be registered to reply to this consultation. Why a transparency register?)

- (x) Yes
- ( ) No

* If so, please indicate your Register ID number:

65110063986-76

*Type of organisation:

- ○ Academic institution
- ○ Company, SME, micro-enterprise, sole trader
- ○ Consultancy, law firm
- ○ Consumer organisation
- ● Industry association
- ○ Media
- ○ Non-governmental organisation
- ○ Think tank
- ○ Trade union
- ○ Other

*Where are you based and/or where do you carry out your activity?

United Kingdom

*Field of activity or sector (*if applicable*):

at least 1 choice(s)

- [ ] Accounting
- [ ] Auditing
- [x] Banking
- [ ] Credit rating agencies
- [ ] Insurance
- [ ] Pension provision
- [ ] Investment management (e.g. hedge funds, private equity funds, venture capital funds, money market funds, securities)
- [ ] Market infrastructure operation (e.g. CCPs, CSDs, Stock exchanges)
- [ ] Social entrepreneurship
- [ ] Other
- [ ] Not applicable

Important notice on the publication of responses

*Contributions received are intended for publication on the Commission's website. Do you agree to your contribution being published?
(see specific privacy statement)

- ● Yes, I agree to my response being published under the name I indicate (*name of your organisation /company/public authority or your name if your reply as an individual*)
- ○ No, I do not want my response to be published

2. Your opinion

1. What are your views on the rationale for statutory prudential backstops as described above? In particular:

a. Do you support the idea that statutory prudential backstops should complement the improvements that the application of IFRS 9 is expected to bring with regards to loan loss provisioning for the new loans that turn non-performing?

- ○ Yes
- ◉ No
- ○ Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 1.a:

No. We consider that statutory prudential backstops are unnecessary, particularly as IFRS 9 is on the point of being implemented. Instead of introducing additional measures at this time (the consequences of which are not yet fully understood), we think it would be more appropriate to allow IFRS 9 to bed down and to assess its effects before taking further action. Moreover, any statutory prudential backstop approach to provisions is unlikely to be consistent with the new lifetime ECL basis of accounting. This will create uncertainty in the market amongst users of accounts as to why the two approaches (prudential and accounting) differ. While we understand that the intention is not for the statutory backstop to cut across accounting standards, in practice we think that this will inevitably be the case.

b. Do you support the idea that statutory prudential backstops (Pillar 1 measure) should complement the use of existing supervisory powers to address through institution-specific measures the (under)capitalisation of NPLs (Pillar 2 measure)?

- ○ Yes
- ◉ No
- ○ Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 1.b:

No, because there is no single, justifiable calibration for a Pillar 1 backstop that applies to all banks across the EU. Decisions on provisioning are based on the information institutions have with respect to their particular client portfolios, including customers’ payment history, financial forecasts and their degree of engagement across the full range of an institution’s business. It is also well known that recovery periods vary according to jurisdictions (where national insolvency frameworks, currently being considered in the context of the boarder Council NPL Action Plan, and the tax treatment of write offs both play an important, jurisdiction-specific role) and also according to portfolios (for instance retail versus corporate, where the latter typically have more restructuring options) and type of security (which can go beyond rights on collateral but can also include for instance rights over future cash flows of an entity). Any potential shortcomings in provisioning which have not been clearly justified therefore have to be addressed in an institution-specific manner to address these differences and Pillar 2 is thus the appropriate tool for doing so.

Blunt, statutory prudential backstops are also not consistent with internal model approaches which best reflect idiosyncratic levels of credit risk (by precisely taking into account the differences between jurisdictions, firms and portfolios mentioned above), and where considerable efforts have been undertaken by supervisors (e.g. the ECB’s TRIM exercise), regulators (e.g. the EBA’s IRB Repair Programme) and industry to strengthen internal modelling practices. In particular, we are concerned that a statutory backstop might call into doubt, or be inconsistent with, recent improvements to the credit risk framework such as the newly published EBA Guidelines on PD and LGD estimation. As an example, in these Guidelines, the EBA requires firms to use the period during which they realise the vast majority of their recoveries, an approach which is clearly different to the fixed time lines that would be set out under a backstop. Further reflection on how a backstop would interact with the credit risk framework is therefore required.

Finally, as is shown in the EBA's most recent report on risks and vulnerabilities in the EU banking sector (published on 24 November 2017), it is worth recalling that overall NPL levels have continued to decrease and that higher levels of NPLs are not universally experienced. This is in our view further evidence that any remaining issues should be resolved bilaterally through existing supervisory powers under Pillar 2 rather than through a Pillar 1 backstop.

2. Do you think that the statutory prudential backstops as described above are feasible?

- ○ Yes
- ● No
- ○ Alternative designs of backstops via prudential deductions could be envisaged for new loans that turn non-performing
- ○ Don't know / no opinion / not relevant

Please explain what are the features that appear problematic to you and why:

No. The standardised nature of the approaches described above are by definition problematic (see response to question 1b above). We do not think that international practice (of one country, the US in this case) can be readily transposed into the EU context, also for those reasons. It is also not easy to understand how one of these approaches would contribute to addressing the key issue which is that of legacy NPLs in certain banks and countries, but not all, whereas it could create new, unforeseen consequences.

The introduction of a statutory backstop would also require specification of the level at which it is set (i.e. customer, product, portfolio, entity level, etc.) and consideration of the impact of these different approaches. It is also not clear if purchases of NPL portfolios by banks who intend to trade these assets will be subject to the backstop. Moreover, as we explain in response to question 4, the impact of forborne exposures will also have to be considered, as well other issues, such as how to apply the vintage count to exposures that are re-classified from non-performing to performing will also have to be addressed.

We have reflected on alternatives, but these are extremely difficult to recommend, particularly given the very short time available for consultation and therefore for us to consider impacts and implications of various options -any backstop that is likely to be acceptable is one that will also likely not be impactful.

3. In your view, which should be the cut-off date for the origination of loans that will be covered by the prudential backstop?

- ○ the date of publication of this consultative document
- ○ the date of the publication of a possible legislative proposal introducing prudential backstops
- ○ the date of entry into force of such possible legislative measure
- ● a later date of application?

Please explain the reasons for your answer to question 3:

As indicated above, we do not think that a Pillar 1 backstop should be introduced, however, if this is proposed to be included in the prudential framework, we would support a later date of application. The changes required to ensure relevant new data flows into calculation engines should not be underestimated and would require a suitably long lag time to deliver. Depending on the functioning of the backstop and the design of any build-up these changes could prove laborious, bringing into further doubt the validity of a Pillar 1 approach to an isolated issue.

3.a. Would you see a need to address explicitly potential circumvention possibilities, for instance through prolongation of existing contracts? Please explain:

n/a

4. Do you think a full coverage of unsecured (parts of) NPLs after 2 years and of secured (parts of) NPLs after 6 to 8 years is appropriate?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 4:

4.a. For secured (parts of) NPLs, do you think it appropriate to treat them as unsecured after 6 to 8 years, effectively adding two more years before full coverage?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 4.a:

We do not think that any of these approaches work as explained in our responses to the questions above.

With respect to treatment of secured NPLs as unsecured NPLs after 6 to 8 years, we would point out that this approach still does not take into account the fact that recovery sources can be wider than those obtained just from collateral and that in such cases recovery cash flows can still arise after periods of 6-8 years.
It also fails to take into account the impact of forborne exposures. Forbearance measures can be of long duration with full recoveries taking longer than 6 to 8 years, even when regular payments are being made as planned. Furthermore, given that the unlikely to pay criteria encourages the prompt classification of an exposure as defaulted, restructuring plans may only be agreed and finalised a few years after the internal default rating of an exposure. Exposures operating within forbearance plans agreed in line with banks’ internal policies should not be covered by any vintage-based increase in regulatory coverage that potentially could ascribe zero value to accounts regularly receiving payments. Should the Commission proceed with

any prudential backstop, it should therefore consider how best to exclude exposures subject to active restructuring efforts.

While there may well be cases where future cash flows are not likely to be recovered a Pillar 1 backstop would have to be adapted to reflect cases where future cash flows are likely, otherwise the legislator will be forcing the artificial destruction of value. Again, the tailoring of a Pillar 1 backstop to accommodate these various situations is extremely difficult and at the basis of our reasoning for rejecting the feasibility of such an approach.

4.b. For secured (parts of) NPLs, do you think an alternative approach, such as the introduction of specific levels of haircuts on collateral/guarantee values, would be more appropriate?

- ○ Yes
- ○ No
- ○ Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 4.b:

We do not think that the use of haircuts alleviates any of the fundamental issues already raised. Moreover, regulatory haircuts are already applied on eligible collateral for the purpose of RWA calculations. These are sufficiently prudent and more stringent for example than those that would for instance be mandated by the recent ECB Guidance on NPLs.

We encourage the Commission to take a closer look at the risk mitigation role collateral plays in practice – sale of collateral is not the only mechanism for risk mitigation, indeed collateral can also act as an incentive mechanism for a borrower to return to a regular repayment situation precisely to avoid repossession of collateral and access to its economic benefits.

In the meantime, we recommend that an institution-specific approach to NPL prudential provisioning be maintained.

4.c. If none of the approaches work in your view, how should the backstops be alternatively calibrated? Please explain the reasons for your answer.

Please see 4a and 4b above

5. Do you agree that prudentially sound collateral valuation is an important element for addressing NPL-related risks?

- ◉ Yes
- ○ No
- ○ Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 5:

Yes, we agree and recall that sound valuation requirements already exist in the computation of credit RWAs through collateral eligibility rules and haircuts.

5.a. In this context:

- would a common (non-binding) methodology for collateral valuation suffice to foster consistent outcomes and transparency?
- or would specific (binding) valuation rules be needed?

Please explain the reasons for your answer to question 5.a:

We do not think that additional work is required by the EBA to introduce possible minimum requirements for collateral valuation as suggested in the present consultation. We think that existing mechanisms are sufficient. Moreover, given the wide array range of types of collateral and the variety of contexts in which they are, it is impossible to adopt a standardised, prescriptive approach. For accounting purposes, to be prudentially assessed under Pillar 2, the ECB's NPL guidance provides appropriate guidelines for collateral valuation.

5.b. More generally, should specific prudent valuation requirements apply to assets and off-balance sheet items accounted for amortised cost as it is already the case for fair-valued assets?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 5.b:

No. The prudent valuation regime is not appropriate to be applied to amortised cost exposures.

If, however, the intention is to take account of uncertainty in valuation of the provision, we note that this is already captured under the regulatory regime via the EL deduction and the RWA for ELBE. Under the standardised approach, a similar EL deduction to address this risk is already under consideration at Basel as part of the long-term treatment of IFRS 9. It would therefore be appropriate to wait until Basel has completed its deliberations before developing any regime. In any case, we consider that any proposal to develop an amortised cost prudent valuation adjustment now would represent an additional, unwarranted deviation between accounting and prudential standards, further exacerbating the situation.

6. Do you agree that prudential coverage needs should ultimately depend on the actual recoverability rather than the valuation of the collateral to provide for a backstop?

- [x] Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 6:

We agree with this statement if the notion of ultimate recovery is understood to be broader than collateral value. A key weakness of the various proposals for prudential backstops on loan loss provisioning is that they only give value to collateral sales, and ignore the other effects of collateral and cashflows from ongoing operations of debtors in default as we have explained above. These are significant, and in some cases, represent the majority of recoveries (for instance for unsecured loans, or when collateral is not enforced to ensure maximum recovery and preserve overall economic value). Accounting rules recognise the need to assess impairment allowances based on ultimate recoverability, and prudential coverage should do the same.

7. Do you agree that the application of the statutory prudential backstops should not result in cliff-edge effects, but should rather be implemented in a suitably gradual or progressive way by banks from the moment of the classification of the exposure as non-performing?

- (x) Yes
- ( ) No
- ( ) Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 7:

We agree that statutory backstops should not result in cliff edge effects.

7.a. In particular, which approach (gradual or progressive) would you consider better suited and why?
Please explain the reasons for your answer:

We are not aware of any evidence however that a “suitably gradual way” would always coincides with “a linear path”. We therefore think that provisioning paths should be a matter of choice that is specific to the exposure in question, which is again something that is not suited to a Pillar 1 approach. We also note that linear paths are not fully consistent with the latest regulatory development in terms of i) valuation of immovable property and other eligible collateral and ii) LGD internal models sensitive to vintage years.

8. Would you see any unintended consequences due to the design and calibration of the prudential backstops?

- (x) Yes
- ( ) No
- ( ) Don’t know / no opinion / not relevant

If yes, which measures would you consider necessary to prevent or address unintended effects (including double-coverage of risks)? Please explain the reasons for your answer:

Increased regulatory provisioning could undermine both ELBE and allowances calculated under IFRS 9 by inferring that the “correct” estimate of loss is neither of these parameters, both of which have recently been reviewed. There is also a risk that the increased amount of regulatory provisioning will have a negative impact by encouraging banks to sell at an increased discount, crystallising greater losses than would otherwise have been experienced. While we support initiatives that are part of the broader NPL Action Plan to develop efficient secondary markets for NPLs, there should be a balanced approach to supply and demand without the introduction of price distortions. Lastly, the prudential provisioning approach may encourage banks to rely more frequently on recovery approaches that prioritise taking control of collateral with undesirable impacts on customers, instead of operating flexible approaches that not only maximise recoveries but keep fair treatment of customers to the forefront.

We also encourage the Commission to consider interactions with other frameworks, regulations or aspects of the CRR. For instance, Article 181 para 1(a) of the CRR requires all defaults to be used in Loss Given Default (LGD) model development samples. As this is a level 1 requirement, the EBA has perpetuated it in its Guidelines on parameter estimation. As a result, data that may no longer representative of a bank's portfolio, for instance because it will relate to a sold NPL portfolio, must still be used to estimate LGDs, thus affect LGD accuracy and ultimately capital ratios.

Furthermore, it should be recalled that banks' NPL "status" (i.e. higher or lower NPLs) is already reflected in their capital requirements as the LGD estimates made by IRBA firms are required reflect time to recovery and include a downturn effect according to the EBA's parameter estimate Guidelines. IN this context, we invite the Commission to review the interactions and consistency between any possible statutory backstop and the EBA's modelling guidelines.

As a final example, any statutory backstop proposals would also need to explain the interaction with the securitisation proposals regarding significant risk transfer for NPL transactions.

Given the short timeframe available for consultation, the already wide range of issues we have identified in the above response, the potential for reinforcing interactions or inconsistencies with other areas of the prudential framework and the fact that various institutions are engaging in simultaneous consultations on related but somewhat differing approaches, we are very much of the view that a period of coordinated reflection between the EU institutions is required before any further action on this matter is taken.

3. Additional information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) here:

Useful links

More on the Transparency register (http://ec.europa.eu/transparencyregister/public/homePage.do?locale=en)

Consultation details (http://ec.europa.eu/info/consultations/finance-2017-non-performing-loans-backstops_en)

Specific privacy statement (https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-specific-privacy-statement_en.pdf)

Contact

fisma-non-performing-loans@ec.europa.eu