AFME Position Paper
Draft Addendum to the ECB NPL Guidance
8 December 2017

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to the ECB's consultation on its "**Draft Addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures**".

AFME represents a broad array of European and global participants in the wholesale financial markets. We are contributing to this consultation on behalf of our Special Committee on European Supervision (SCES) which, in its SSM configuration, provides a platform for the most systemically relevant banks who are lead-supervised by the SSM to engage with the ECB's supervisory function and, in its full configuration, is a vehicle for engagement on the future development of supervision within the EU more generally.

Overarching comments

Any measures taken by the ECB should be consistent with the Council's Action Plan in both substance and timing

AFME is generally supportive of measures being taken to tackle NPLs in Europe. We have notably expressed support of the ECB's NPL Guidance to tackle the issue within the Eurozone, on the condition that it would not require unnecessary or duplicative change in NPL processes and management when sound and proven NPL practices are already in place. In addition to this, we have also expressed our strong support for many of the measures included in the Council's broader NPL Action Plan.

This being said, given that the Action Plan specifically asked the European Commission to explore whether a Pillar 1 prudential backstop applying to all EU banks (regardless of the jurisdiction in which they operate or their size) should be introduced into EU legislation, the present ECB proposal for introducing a Pillar 2 prudential backstop for SSM banks came as somewhat of a surprise to the industry, particularly as it is applies to new NPEs, rather than newly originated loans as envisaged by the Council in its Action Plan and in the recent Commission consultation on statutory backstops. The simultaneous consultations of the ECB and Commission on these different approaches has given rise to a certain level of confusion and it would be helpful if both institutions could clarify precisely how their different approaches will interact and what their combined impacts may be.

While we recognise and welcome the fact that the ECB is using this opportunity to publicly set out its supervisory expectations with respect to prudential provisioning of new NPEs, we nevertheless find its proposed Guidance to be close to a Pillar 1 approach, even though it is formally presented as a Pillar 2 approach. Indeed, CRR Article 3 provides banks with the possibility to strengthen their own funds based on their *own* assessments. The proposed requirement that Article 3 be used to build up the necessary "provisioning supply" is therefore not consistent with a Pillar 2 approach.

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Moreover, as the ECB's expectations are the basis for a strict "comply and explain" procedure, the Guidance is does not come across as a true Pillar 2 backstop. Instead, it amplifies the risk we see that the proposed calendar approach of 2/7 years will be a de facto, binding requirement that will override alternative but economically justified provision approaches, as well as the lifetime approach to expected credit losses adopted in IFRS 9 more generally. Market participants (including investors, but also banks and supervisors, for instance when examining banks' implementation of IFRS 9) are likely to have difficulty in practice understanding how the new lifetime expected credit loss approach of IFRS 9 can be different to the supervisory expectation in the draft Guidance. There is therefore likely to be a significant degree of uncertainty as to why accounting and prudential approaches co-exist but differ and, ultimately, it is the prudential approach that is likely to dominate. As such, the prudential backstop approach seems to run counter to the stated intention to not cut across accounting rules.

Additionally, through its application to an entire segment of EU banks, the SSM-supervised population, the ECB proposal can be understood as addressing a macroprudential risk, whereas the Council's Action plan has tasked the ESRB to consider whether there is a such a risk, which macroprudential tools would be appropriate for dealing with it and what the consequences might be, as part of the broader NPL Action Plan. As such the ECB's approach blurs somewhat the lines between micro and macro-supervision and, again, there is a need to consider whether these multiple approaches will be compatible.

Finally, although economic conditions are more favourable than they have been in the past, we find the 1 January 2018 date for new NPE identification to be unjustified given that the original ECB NPL Guidance is in the process of being implemented, with firms carrying out their individual NPL plans accordingly. Moreover, the Guidance already contains disclosure requirements that will help ensure potential investors in NPL portfolios to have relevant information, with further information initiatives underway as part of the Council's Action Plan. Last, but not least, IFRS9 will be going live in just a few weeks. Instead of introducing additional measures at this point, it would be more appropriate for the ECB to allow the above measures to bed down and to assess their affects before taking any further action.

Should the ECB decide however to retain the 1 January 2018 date, it must be made clear that this is an identification date, as opposed to an implementation date (as this has been a source of confusion in the consultation process) and that supervisory expectations will only be effective from 1 January 2020 earliest (i.e. for unsecured exposures).

Given all of the above, we are concerned that the present ECB proposal is frontrunning the ongoing, broader reflection at European level on NPLs, while at the same time potentially conveying the signal that the provision levels of the banks the ECB supervises are not adequate.

We are also concerned that the ECB's proposal is not accompanied by any explanation of its potential costs and benefits, or consideration of its effects and possible alternatives. At the very least, communication from the ECB on how it will monitor the impacts of the proposal on new lending, secondary markets (where it is important that actions taken by the ECB and other institutions do not create undue price distortions or unduly incentivise certain categories of market participants) and the potential transfer of risk to actors that are not under direct prudential supervision is necessary.

An institution-specific approach appears preferable at this point in time

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 importantly can go beyond rights on collateral but can also include for instance rights over future cash flows of an entity). We are concerned that the guidance will result in these idiosyncratic factors, which form the basis for provisioning that justifiably differs from the ECB's calendar approach, being overruled.

The proposal also does not take into account the tax deductible nature of accounting provisions as opposed to the non-tax deductible use of CRR Article 3. Without adjusting for this, the impact on CET 1 would exceed that obtained from the adoption of 100% provisions. As a result, a differential treatment would be applied to banks that cannot register sufficient accounting provisions compared to those in a different situation.

Finally, it is not clear to what extent measures that promote a calendar approach to provisioning are consistent with the EBA's Guidelines on PD and LGD estimation (where LGDs must be determined based on the institution-specific notion of maximum recovery period rather than a prescribed number of years).

It is therefore difficult to see how the ECB can define a single supervisory expectation which will be appropriate for application to all SSM institutions, especially as very little information has been given as to how the backstop has been calibrated.

The ECB has itself recognised that there cannot be a "one-size-fits-all" solution for all banks when it comes to dealing with NPLs[1] and, in the context of its wider NPL Guidelines, it noted that "setting a generic NPL reduction strategy would not have allowed supervisors to take into account the existing disparity in the starting points of banks and the specificities of the environment in which they operate"[2]. We find these statements difficult to reconcile with the present proposals and are concerned that the proposals could create undue distortions between SSM institutions.

We also see risks of other level playing field issues occurring and encourage the ECB to consider these carefully. For instance, SSM supervised firms may be placed at a disadvantage compared to other EU banks which do not fall under the ECB's scope, as will the subsidiaries of SSM firms competing in third country markets with local institutions which do not have to respect such rules. The ECB should also reflect on whether

[1] Danièle Nouy, ECB Supervisory Board Chair, Handelsblatt 18 April 2017
[2] Sharon Donnery, Deputy Governor of the Central Bank of Ireland, February 2017

undue distortions may occur for SSM players engaging in the legitimate activity of purchasing and selling of NPL portfolios compared to non-SSM supervised players carrying out similar activities.

In light of the above, our members consider it would be preferable for any ECB provisioning measures at this stage to remain purely institution-specific, building on firms' implementation programmes of the existing NPL Guidance.

Clarity on the ECB's intentions regarding the NPL stock is required as a matter of urgency

We note that accompanying FAQs to the draft addendum mentions that "Supervisors will continue to monitor bank-specific progress in NPL reductions and present by Q1 2018 their considerations of further policies to address the existing stock of NPLs, including appropriate transitional arrangements". Timely communication on the ECB's intentions in this area is paramount and it is essential that the ECB engages with the industry prior to putting forward any such measures to ensure that its mechanism and impacts are well understood.

AFME would welcome the opportunity to facilitate such engagement between the industry and the ECB in the near future.

Issues that must be addressed in the Guidance if it is to be adopted

Clarification on the comply or explain approach

The "comply and explain" section of the Guidance requires significant redrafting so that it is clear the proposed 2/7 years are a backstop supervisory expectation only, and not the starting point for firm's provisioning approaches. As written, it is not at all clear whether "comply and explain" would be on a portfolio or exposure basis or what the expectations are for non-homogenous portfolios. Importantly, under "comply or explain" there is no transparency on how a JST will determine whether a deviation is acceptable or not. This is a significant cause for concern as there is a risk that supervisors may be incentivized by the Guidance to ignore sound economic reasons (and therefore inadvertently promote the destruction of economic value on banks' balance sheets).

Rather than imposing a relatively opaque and burdensome justification process on firms in the case of deviations from the 2/7 years, the starting point should be the bank's accounting provisions. The onus should then be on the JST to duly explain to an institution through a robust supervisory dialogue why the bank's existing approach for a specific portfolio may not be sufficiently prudent. In these specific cases, if the firm does not implement the supervisor's justified expectation, we understand that this would be factored into the institution's SREP.

Scope of the backstop

There are subsets of NPEs that should not be subject to the prudential backstop. These include forborne exposures and exposures that are classified as NPEs solely through contagion and are exposure types already

identified by the ECB as being examples of justifications for non-compliance in the section of the draft Guidance that addresses deviations. We consider that the final Guidance should specify that these are automatically exempt from the backstop (instead of forcing the comply or explain procedure and placing the burden of proof on banks).

Indeed, the March 2017 ECB NPL Guidance includes an expectation that banks should "implement well-defined forbearance policies" (something that banks would generally undertake through their normal course of business). Where a bank has aligned with this guidance and implemented a well-defined forbearance policy, NPE exposures that respect a forbearance plan agreed in line with such a policy should not be subject to further regulatory provisions.

Furthermore, we do not consider it coherent to have a backstop generated purely on the time spent in NPE. Even for accounts which do conform to a formal forbearance plan, payments may well be made on an ad-hoc basis through the recovery period. It does not appear credible to assume a regulatory provision of 100%, implying zero value, for such exposures where payments have been received and probability of future payments would therefore not be 0%. A backstop based on the time since last payment to the account would therefore be more consistent with the underlying risk of exposures that may be in long term NPE status.

Other issues requiring clarification

- The ECB should clarify that the Guidance applies only to the banking book and not to trading positions.
- It should also be clarified that any backstop would apply to exposure values already used for capital requirement purposes; i.e. credit conversion factors as provided for in the CRR should apply to off-balance sheet exposures.
- We note the ECB's view that application of the backstop should not result in cliff edge effects, but should rather be implemented in a suitably gradual way from the moment of NPE classification. Nevertheless, there is no evidence to justify that this "suitably gradual way" coincides with "at least a linear path" for the secured backstop. Moreover, a linear path may not be consistent with the latest regulatory development in terms of valuation of immovable property and other eligible collateral or LGD internal models sensitive to vintage years. It should therefore be clarified that the linear path is not a requirement.
- For the avoidance of doubt, the Guidance should clarify that when a bank engages in NPL purchases as an activity that is part of its business model and, where the necessary valuation due diligence has been carried out, there should be no further provisioning expectations.
- Again, for the avoidance of doubt, the Guidance should clarify that the RWA and associated capital requirement of defaulted assets can be taken into account in banks' "supply" towards fulfilling backstop expectations.
- We understand that the intention of the ECB is to allow the recognition of all credit risk mitigation forms that are eligible under the CRR. However, the draft guidance refers to all immovable property and other eligible collateral or other forms of credit risk protection that fulfil the criteria of credit risk mitigation of Part Three, Title II, *Chapter 4* of the CRR. *Chapter 4* of the CRR does not apply to IRBA banks and the reference to the CRR text needs to be adjusted accordingly so that CRM eligibility is not restricted for IRBA banks.

- Finally, the Guidance would also need to explain the interaction between the approach adopted for prudential provisioning with the securitisation proposals regarding significant risk transfer for NPL transactions.

Additional reflections on the links between the accounting framework and regulatory provisions are required

We understand the objective sought by the SSM to encourage banks to book '…the maximum level of provisions possible under the applicable accounting standard…'. Nonetheless, the current treatment of provisions under the prudential framework makes this approach inefficient from a "loss absorbency perspective", due to the current asymmetric treatment of excesses and shortfalls of provisions with respect to the levels of regulatory expected losses.

In fact, banks might have the opposite incentive to the one pursued, i.e. to hold the *minimum* level of provisions complying with the applicable accounting standard, so that they can absorb the increments of provisions required by the expected credit loss (ECL) provisions approach of IFRS9 without impacting levels of capital. To align all incentives in the direction intended by the SSM a new prudential framework that treats the "loss absorbance" capacity of both provisions and capital symmetrically must be defined as soon as possible.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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