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Position paper

European Commission proposal on minimum loss coverage for non-performing exposures

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The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's proposal on amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures.

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. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76. Information about AFME and its activities is available on the Association's website: www.afme.eu

Overview

AFME supports the intention behind the European Commission's proposal to address the build-up of non-performing loans (NPLs) and non-performing exposures (NPEs), as part of the European Union's efforts to further reduce risks in the banking system. Nonetheless, AFME's members are not only highly concerned by the approach chosen by the Commission (on minimum provisioning), but also uncertain as to how these Commission's Pillar 1 proposal will interact with the addendum to the ECB's guidance on NPLs (March 2018) which sets a Pillar 2 supervisory expectation (to which AFME also submitted comments). In particular, it is of concern that banks will operationally have to run two processes to comply with a measure intended to have the same outcome. In this respect we strongly urge EU institutions to collaborate more in standard setting to avoid multiple non-aligned and duplicative requirements.

AFME has long held the position that the heterogenous nature of NPLs makes a Pillar 1 backstop approach inadequate. A well-designed Pillar 2 approach best takes into account the specific nature of banks' NPL portfolio, NPL strategy, and the economic environment and other relevant constraints of the country in which the NPLs are to be managed. The Commission's proposed prudential approach (and also the ECB's addendum) does not reflect the economic value of the provisioned assets which reflects the estimated recovery value related to the realization of the collateral and the cash flow perspective (which is the basis of banks' accounting provision). In addition, the calibration of the minimum coverage requirement for unsecured loans proposed by both the Commission and the ECB fails to recognise the range of recovery periods across various jurisdictions, as well as recovery perspectives which depend on insolvency legislation among other factors.

Furthermore, the IFRS 9 standard, which covers current as well as expected credit losses, will become the base requirement for NPL provisioning. Regulators should give this standard chance to perform and deliver before applying the "one size fits all" approach of the ECB addendum and EC proposals. Indeed, any benefit of the transitional provisions derived under IFRS9 may well be rendered inconsequential as a result of the introduction Pillar 1 backstop.

We would also note the minimum provisioning levels of the EC proposal are very prescriptive and complex. Therefore, the compliance costs linked to both Pillar 1 and Pillar 2 measures, especially for banks not subject to ECB supervision, are likely to be high and disproportionate. We fail to see how these significant incremental costs are justified for such banks which demonstrate good or satisfactory NPL governance and operations strategy together with low NPL ratios and credit losses, especially as they look to reduce them further in future.

Legislators should further consider the negative unintended consequences of the Commission's proposal, which, by forcing banks to book a provision, could put the long standing and successful approach of consensual restructurings in some markets and jurisdictions at risk and have a pro-cyclical effect. In addition, the new requirements could also impact the cost of funding and volume of lending to SMEs and to all corporate clients which often ask for unsecured loans. The consequence of the aggregation of all banks needing to exit NPLs at an early stage or at the bottom of a credit cycle to avoid the impact of provisioning from a cost / equity perspective, could potentially flood the market and hence depress price and undermine other EU objectives such as developing a secondary market. In this case, borrowers too would be penalised by over-reaction from lenders, and by market prices, which are likely to fall, as the market is saturated by an excess of supply compared to the demand. This would be counter-productive for the EU economy as banks become more reluctant to grant (and clients to take) new loans, in fear of the severe consequences.

More generally, in spite of the EBA's work to assess quantitatively the impact of a Pillar 1 backstop, it lacks any analysis of the compounded effects of all accounting (IFRS 9) and regulatory initiatives (including new EBA default definition) in relation to NPLs, notably in stressed situations where the cumulative impact could be considerable for banks. We think therefore that a more comprehensive impact study of all recent European initiatives in this field should be undertaken before applying any further measures in order to avoid possible major unintended effects in stressed situations.

If the Commission and EU legislators are to pursue a Pillar 1 legislative proposal to address the high NPLs in Europe, then as a guiding principle, convergence and alignment of the proposal with the current prudential/accounting framework and supervisory measures should be key to limit as far as possible the operational burden for banks to implement. Indeed, when co-legislators agree on the Pillar 1 proposal, we would expect the ECB and NCAs to revisit any existing P2 approaches to ensure they are aligned with the Pillar 1 measures. We have also set out in detail below a number of specific and technical areas legislators should further review in the context of the Commission's proposal.

Date of application to new NPLs and entry into force

It would be helpful for industry to have early clarity from legislators if this will be implemented as part of the CRR2 or CRR3 proposals, or as a stand-alone piece with its own timeline. This will be key, considering that the legislative procedure for CRR2 is expected to be concluded this year. If this proposal is included as part of the CRR2 process, then it will be necessary for the ECB to align its addendum before banks are required to apply it. The ECB addendum applies to all newly classified NPLs after 1 April 2018 and banks will have to comply with this by SREP 2021. By contrast the Commission's Pillar 1 proposal applies to NPLs arising on loans originated from the date the proposal was published on 14 March 2018 (to be agreed by the co-legislators) and will become effective once the regulation is published in the EU Official Journal. In order for banks to be operationally ready to apply the legislation and collect the required data by which to apply the new rules, we consider the reference date to adopt in order to identify newly originated loans that might be classified as NPLs should be the date of entry into force of the Pillar 1 regulation. This will mean banks have legal certainty of the definition of NPLs to be able identify them on their balance sheet. Setting the date of application to the date of entry into force will avoid negative interaction with the application of ECB guidance.

Definition of 'new loans'

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The ECB addendum and the EC proposal apply to loans which are reclassified as non-performing as of 1 April and newly originated loans as of 14 March 2018 respectively. Nonetheless, the EC proposal lacks clarity as regards the application to reclassified loans as it is not completely exhaustive. For instance, it should be clarified whether the definition refers only to newly granted amounts (e.g. new financing) or also to new amounts drawn from credit lines granted prior the *cut-off* date. According to our understanding amended and restated agreements for existing loans with a.o. tenor extension are excluded from scope as they are not considered new loans. However, in order to avoid any misinterpretation, the scope needs to be made clear in order to ensure that banks inside and outside the remit of the SSM do not have dissimilar sets of capital provisioning which could lead to unequal treatment of clients.

In addition, neither the ECB nor the Commission set out the provisioning treatment for NPLs that have been purchased and are held on the banking book (although the Commission excludes NPLs in the trading book). Such assets, regardless of whether they qualify as NPLs, are mainly held at fair value and have a market determined value. Thus, in our view all fair value loans, and purchased loans, also if booked in the banking book, should be excluded, also in the interest of fair competition between EU-regulated institutions and other institutional investors. In particular, for fair value assets in the banking book, they are already in scope of the prudential filter of CRR Article 34 "additional value adjustments" (AVA) (Commission Delegated Regulation (EU) 2016/101). Hence banks already face a significant capital deduction as a result of this process. It would therefore be disproportionate to subject purchased NPLs in the banking book and other fair value assets (i.e. any assets that are subject to the AVA process), to a potential NPL capital deduction, on top of their fair valuation and AVA. Consequently, such assets should be explicitly exempted from the scope of this proposal, or at least not provisioned higher than their fair value. Indeed, the same holds true for all fair value loans whether purchased or originated.

Finally, we would also urge the ECB to reflect on this in any further guidance they issue.

Timing of deductions

Both the ECB and Commission follow a very similar time frame for provisioning, however, the way in which the Commission text is drafted could give rise to ambiguity. In the Commission's proposal it provides for full deduction of secured exposures from the first day of year 8 – i.e. seven full years. The ECB's proposal provides for a 100% cover from the 7th year of vintage of the NPL. Therefore, depending on when the NPL is identified e.g. 31 December, the difference could be as little as 1 day i.e. 100% required under ECB proposal on 31 December of year 7 and 1st January of year 8 under the Commission's proposals. Ideally it should be made clear that the provisioning timelines in the ECB guidance and Commission proposal are intended to be completely aligned to avoid banks needing to implement duplicative processes.

AFME also considers that, from experience of actual recovery rates, 2 years is not sufficient for unsecured exposures. Value adjustments for loans for which secondary market prices exist are unlikely to reflect the value of the loan if 100% provisioned. Such provisioning is more likely to motivate banks to sell exposures to simply avoid negative CET1 impact. This would negatively impact market practices, as it would allow buyers to force discounted prices on the seller. To this end, we would recall the Council conclusions about the Action Plan to tackle NPLs in Europe, published on 11th July 2017, which instead clearly set the objective of "*(…) avoiding the disruptive effect of [NPL] fire sales*".

Indeed, introducing an automatic calendar for provisioning would clearly communicate to the market when banks are supposed to dismiss their NPLs portfolios and an estimation of their value on the balance sheet because of the required public disclosure by vintage of NPLs, investors and borrowers will be aware of the bank's provisioning strategy and situation.

This will lead to distortions in the market, as the number of NPL disposals will likely increase close to the deadline for the 100% provisioning (after 2 and 7 years respectively). The excess of prudential measures will raise market asymmetries, allowing buyers to set a discounted price, as they will be aware of when a bank is looking to dispose of an NPL portfolio.

An increase of NPL sales activities, should be as a result of favourable market conditions, not by being indirectly forced to as a result of a predefined timetable for provisioning, which could penalise the buyer or seller for different reasons.

Consequently, the calibration of the provisioning schedule should consequently reflect the lengths of the recovery process where a sale is strategically in the best interest of the bank given the broader economic framework. Therefore, at the very least, AFME suggests a four-year time window to provision for unsecured loans. Should policy measures aiming at speeding up the recovery processes bear fruit, the minimum provisioning schedule could be recalibrated in due time.

Partial write offs

Both the ECB "Guidance to banks on non-performing loans" and the EBA "Draft guidelines on management of non-performing and forborne exposures" highlight that when a bank has no reasonable expectation of recovering contractual cash flows of an exposure it should lead to a partial or full write-off of the exposure. The Commission's proposal, however, incentivises to banks not to perform partial write-offs. For example, assume a secured exposure with a 5 year default vintage of 100 and an impairment of 50. In this case the proposed prudential backstop would have no effect (factor of 0.4). However, if the bank executes a partial write-off of 50, the remaining exposure would have zero impairment cover, meaning the P1 backstop would therefore have an immediate CET1 impact. This creates a situation where any partial write-off would be detrimental to the capital ratios of the bank. To mitigate this effect AFME proposes to add the amount of partial write-offs to the list of items considered under article 47c paragraph 1b.

Inconsistent outcomes between IFRS9 and the backstop

The Commission proposal does not allow a reduction in minimum provision requirements unless the exposures is reclassified from non-performing to performing. Under IFRS9 however, positive developments, such as a take-over of part of the business of a non-performing obligor/ account by a healthy third party, could justify a reduction in the existing provisioning level. In such a case, the inconsistency between accounting and prudential standards would lead to the regulatory capital ratios mis-representing the banks' financial health. Indeed, the provision release under the accounting standard, reflecting a real reduction in the credit risk, will increase profit and feed into the bank's capital base. The prudential backstop however, could command an "offsetting" increase in provision or a deduction to CET1 according to Article 47c paragraph 2 and 3 schedules. The EC proposal would also likely yield very different outcomes when forbearances measures are taken on non-performing exposures and the non-performing obligor meet the revised payment schedule. Again, in those cases, the backstop mechanism would keep "accruing" provision while the accounting framework could lead to significantly lower provisioning requirements.

Provisioning for 'Unlikely to pay'

The Commission proposal makes a positive departure from the ECB addendum in respect of NPLs classified as 'Unlikely to Pay' (UTP) and which are not past due (i.e. less than 90 days). For such loans the EC proposes 80% provisioning on unsecured NPLs after 2 years if not past due 90-days vs. 100% under the ECB guidance, as well as 60% on secured after 7 years if not past due 90-days vs. 100% under the ECB guidelines. Although it is welcome distinction, we consider the Commission text should also allow the possibility to reclassify a past due exposure to UTP once the obligor returns to regular payment. If it was not possible for this to happen, the different treatment of UTP with respect to past due would be less effective i.e. only for UTP scenarios prior past due default classification, and there would be no incentive to restructure them.

Definition of 'obligor'

The Commission proposal introduces the notion of contagion into the evaluation of an obligor for forbearance purposes by extending it to the obligor's group position and natural persons that control the group. Instead we believe this would be better if the proposal just referenced the EBA ITS on forbearance and non-performing exposures in order to achieve full alignment with what banks already have to comply with. For example, under para 155 of the ITS banks are allowed to exempt from the scope of the debtor's group "exposures affected by isolated disputes unrelated to the solvency of the counterparty", this is not currently reflected in the Commission proposal.

Calculation of deductions

AFME is concerned by the reference in the Commission proposal to the nominal amount for off balance sheet exposures as the basis for calculating the prudential backstop as does the ECB Addendum in par 3.1 to the NPEs EBA Definition specifying in footnote number 11 ("this also includes off-balance-sheet exposures"). As a general principle, the underlying parameter used both for prudential and accounting purposes is the exposure at default (EAD), that is calculated applying to the off-balance sheet nominal amount a credit conversion factor. Therefore, we deem that using the nominal amount for the off-balance sheet is inconsistent with the general criteria for calculating provisions under IFRS9 and for RWAs calculation in the CRR and it therefore makes sense to maintain the current well-defined measure. If not, it could be particularly punitive for some business lines such as project finance, which use off balance sheet exposure intensively (guarantees, commitments and revocable credit lines).

We recommend both the EC proposal and ECB Guidance to make explicit reference to the EAD like in the accounting provisions in IFRS9 and the prudential requirements of CRR.

In addition, revocable lines should be explicitly excluded from the scope of application of the prudential backstop in the Commission proposal. Revocable lines are not considered in the provision calculation under IFRS 9 and the same is true for prudential requirements of CRR where the CCF for revocable credit lines under standardized approach is set to 0% (and will move up to 10% under BIS 4). This is reflected in the ECB Addendum which allows the exclusion of undrawn credit facilities which may be cancelled unconditionally at any time and without notice from the provisioning (para. 3.3 "definition of ensured and unsecured parts of NPEs"). We understand that it was not the intention of the Commission to include revocable lines.

Eligibility of RWAs on Unexpected Loss

The Commission proposal does not include the RWAs for Unexpected Loss as an eligible element to fill the gap vis à vis the minimum level of provisioning foreseen by the prudential backstop under Article 47c, paragraph 1, letter (b). We consider the RWAs on defaulted assets should be treated similarly to the shortfall and the other capital deductions, and thus eligible to fill the provisioning gap in order to avoid double counting or cases of exposures covered more than 100%. By contrast the ECB Addendum (section 2.3) will take Pillar 1 capital requirements into consideration when assessing divergences from their supervisory expectations and when the provisioning results in *"more than 100% of the exposure being covered".*

In a similar vein, in respect of the treatment of defaulted loans the CRR (e.g. Art. 159(2)) allows for purchase price discounts to be treated as specific credit risk adjustments. We consider this provision should be extended to NPLs and used in Article 47c to reduce the potential deduction amount.

Evaluation of eligible collateral

The Commission proposal does not allow to extend the collateral eligibility to all immovable properties. By contrast the ECB allows for a wider approach which recognizes all "*type of immovable properties*" as eligible regardless of the adoption of the Standard/Foundation/AIRB approach, which we consider more measured. Nonetheless, the ECB could restrict the collateral that AIRB banks can recognise. This would be counterintuitive and go against what AFME understands was the intent of the ECB in the final addendum. In particular, by specifying in Section 3.2 that all CRM techniques fulfilling the criteria in Part 3, Title II, Chapters 3 and 4 of the CRR it may be limiting for AIRB banks because Chapter 4 does not apply to them (according to Art 108(2) of the CRR). This could restrict recognition of non-real estate collateral and credit protection for AIRB banks to what FIRB banks can recognise. We therefore urge clarity on this and for the scope of eligible collateral in the Commission to be extended and aligned with the ECB.

Finally, we do not consider it necessary for the EBA to develop valuation guidelines specifying common minimum requirements for re-valuation as existing standards are sufficient. Moreover, given the wide array of types of collateral it is impossible to adopt a standardised prescriptive approach.

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