

10th July 2017

Hon. Toomas Tõniste
Minister for Finance, Estonia
Endla 13, 10122 Tallinn
Estonia

Dear Minister,

Tackling the problem of non-performing loans (NPLs) in Europe

As the trade body representing Europe's wholesale financial markets, the Association for Financial Markets in Europe (AFME) has a strong interest in debates concerning high levels of non-performing loans (NPLs) in the European banking sector.

Though the majority of Member States are not currently affected by excessively high levels of NPLs, AFME agrees that the negative effects of high NPL ratios where they occur can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole, and particularly within the Banking Union. The continued high NPL ratios affect bank profitability and capital build-up in the EU financial system, thus holding down credit growth and economic activity.

AFME therefore supports the development of a strategy to address the issue of high NPLs even though many European banks, including AFME members, already have proven NPL strategies and management processes in place. This is demonstrated by the downward trend in the cost of risk (loan loss provisions/average gross loans) and NPL ratios and volumes¹ for Tier 1 SSM banks over the past years².

As policymakers consider additional EU level actions, we therefore recommend they be appropriately targeted. We caution against pursuing unduly far-reaching measures which could be duplicative and costly for firms that are currently successfully managing NPLs, without necessarily adding value to their business or the resolution of the broader Eurozone NPL problem itself.

¹ According to ECB data for euro area banks, the NPL ratio of small-sized banks (asset below €30bn) stood at 15% in 2016 compared to below 5% for large banks (assets above €300bn) and for GSIBs. Most recently, non-performing loan volumes for euro area GSIBs have decreased from €268bn in 2Q16 to €241bn in 4Q16, while for smaller banks (with assets below €30bn) have increased by €7.9bn during the same period.

² Thomson Reuters Eikon. The weighted average cost of risk for 10 Tier 1 SSM banks has declined from 1.3% in 2012 to 0.7% in 2015.

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The NPLs problem raises two issues which must be clearly distinguished: on the one hand, the legacy assets accumulated in banks' balance sheets, in some specific jurisdictions, and, on the other hand, the flow of new NPLs and its processing. These different issues call for targeted solutions. By way of example, measures to develop secondary markets for distressed debt may take some time to implement and could be more targeted towards new flow of NPLs; other solutions, such as the establishment of AMCs at national level, may be more appropriate to deal with legacy assets. The need for any additional supervisory measures to prevent/control new NPLs should be very carefully assessed in view of existing supervisory powers.

Below we briefly present our views on potential initiatives to address the NPLs problem. Additional views are provided in the annex.

SSM supervised banks are currently in the process of implementing the recently finalised SSM guidance to banks on NPLs. Before any additional measures are taken at EU level, it is necessary for this process to bed down, and for the SSM to have sufficient time to carry out its reviews of banks' approaches in the framework of these new guidelines, reflect these in its assessments of banks' risk profiles (through the Supervisory Review and Evaluation Process) and in their resulting capital requirement decisions (Pillar 2). In particular, we note that supervisors already have wide-ranging powers to address perceived deficiencies in the banks they supervise. At this stage no case has been made for a need to introduce any additional supervisory tools that go beyond existing powers in the CRD/CRR.

Moreover, while it may well be appropriate to introduce similar supervisory guidelines on NPLs to institutions throughout the EU, we caution against the high risk of duplication and possible conflicts between any future work that may be carried out by EBA with respect to the EU as a whole and the existing SSM guidelines.

Among the solutions that can contribute to addressing the issue of new NPLs, we believe that deeper secondary markets of NPLs can contribute to better management of banks' NPL portfolios.

The volume of NPL secondary market transactions continues to be low compared to the outstanding amount of NPLs, with around EUR 80bn in 2016 in market transactions (against EUR 1tn of NPLs in the EU) with most activity traded in the form of NPL portfolio sales and to a lesser extent as NPL securitisations.

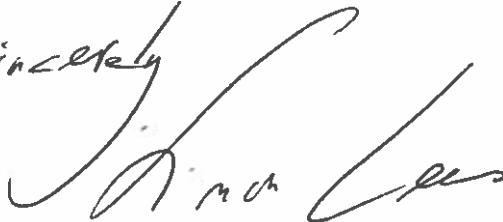
We believe that the impediments to a more active secondary market converge around the following themes:

- i) quality of and access to data on NPLs and their underlying assets;
- ii) quality of judicial, legal and insolvency frameworks;
- iii) subdued securitisation market;

- iv) lack of licensing and regulatory regimes to enable non-banks to own and manage NPLs and enlarge the market of potential investors;
- v) tax disincentives relating to the transfer of NPL portfolios and loan loss deductibility;
- vi) lack of economies of scale for small banks, heterogeneity of loans and possible role of AMCs in that context;
- vii) costs of recovery/servicing;
- viii) other regulatory disincentives – e.g. see comments on bank capital issues in the annex below.

More broadly, the Capital Markets Union project can play a major role in dismantling financial market barriers, deepening secondary markets and improving access to finance for smaller businesses, all of which would help in tackling the issue of high NPLs. In particular, we hope that significant progress can be achieved during the Estonian Presidency on the proposed Directive on preventive restructuring frameworks and second chance, which is a crucial measure in this context.

High NPL ratios and volumes continue to hold back the capacity of the European banking sector to support economic recovery. AFME stands ready to work with EU policymakers and the Estonian Presidency on well-defined solutions to address this multifaceted problem.

Yours sincerely


Simon Lewis OBE
Chief Executive

cc: Vice-President Valdis Dombrovskis, European Commission
Roberto Gualtieri MEP, Chairman of the Economic and Monetary Affairs Committee
Thomas Wieser, President of the Economic and Financial Committee and President of the Eurogroup Working Group

Annex: Resolving the problem of non-performing loans – major issues for consideration

Summary

This annex summarises AFME's initial views on potential measures to address the problem of NPLs. These key policy areas include: i) improving creditor rights and insolvency frameworks; ii) secondary markets for distressed debt; iii) supervisory guidance & bank capital; and iv) other structural features of the banking system. The table at the end of this annex provides initial views on specific proposals considered in the Report of the FSC Subgroup on Non-Performing Loans.

Insolvency reform

More efficient restructuring and insolvency frameworks can contribute in a significant way to the efficient management of defaulting loans, including through secondary market solutions (e.g. reducing time to recovery) and help to avoid the accumulation of such loans on banks' balance sheets.

AFME believes that further harmonisation of minimum insolvency standards across Europe, as set out in the proposed Directive on preventive restructuring frameworks and second chance, would help to facilitate more predictable and orderly outcomes for corporate restructurings. We fully support the proposed Directive, which is a key step in developing a single market, as well as an important component of the Capital Markets Union.

However, we note that there are areas where the proposed Directive does not go far enough, or for which further clarifications or explanatory provisions may be necessary, including:

- creditor rights: it should be clear that, under appropriate circumstances, creditors with a remaining economic interest are able to structure and propose a restructuring plan for a viable debtor;
- in the context of new and interim financing, the ranking of, and protections for, secured creditors remain unclear and in some cases may be unduly prejudiced by the proposed Directive – the ranking is not sufficient to provide adequate incentives for creditors (banks) to continue granting new and interim financing;
- the proposed Directive should provide guidance on how to distinguish a “viable” company from a “non-viable” company and who should make such determination;
- early warning tools: we believe that it is unclear how these tools should work in practice; therefore, it would be important to specify how third parties could contribute to detecting financial distress in a company;
- debt discharge procedures: Member States with procedures should retain a degree of flexibility on the conditions under which debt discharge can be granted.

In this context, we also support the European Commission's announcement to launch an impact assessment with a view to considering a possible legislative initiative to strengthen the ability of secured creditors to recover value from secured loans to corporates and entrepreneurs. We also welcome the future publication of the Commission's benchmarking exercise to shed light on the features of enforcement/insolvency systems which contribute to better/worse outcomes.

Secondary markets of NPLs

Deeper secondary markets of NPLs can contribute to the acceleration of the NPL adjustment process as banks continue internal processes towards restructuring their NPL portfolios.

The volume of NPL secondary market transactions continues to be low compared to the outstanding amount of NPLs, with around EUR 80bn in 2016 in market transactions (against EUR 1tn of NPLs in the EU) with most activity traded in the form of NPL portfolio sales and to a lesser extent as NPL securitisations (only EUR 155m issued in 2016). According to the EBA since 2013 NPL transactions (including securitisation) were recorded in only 13 out of 27 European countries surveyed.

Several proposals have been made to address current impediments to the development of secondary markets for distressed debt. The proposals have challenges of their own, which are summarised in the table at the end of this annex. Secondary markets of NPLs are fairly opaque and there is little evidence about their operation and policy impact in Europe.

As announced by the European Commission in the CMU mid-term review, we very much welcome the launch of a public consultation on potential EU action in areas such as loan servicing by third parties and the transfer of loans, including to non-bank entities.

Supervision & bank capital

The European Central Bank (ECB) published on 20 March 2017 its final guidance introducing “measures processes and best practices for banks when tackling NPLs”. The ECB intends for the guidance to be a call for action for SSM banks to implement “realistic and ambitious” strategies for NPL reduction, and at the same time to address governance and risk management issues.

The implementation of the guidance is non-binding for banks. However, the ECB expects banks to “fully adhere to the guidance in line with the severity and scale of NPLs in their portfolios”. The ECB also intends the guidance to form part of the day-to-day supervisory dialogue with banks and will be taken into consideration in the “SSM regular Supervisory Review and Evaluation Process (SREP) and non-compliance may trigger supervisory measures” (potentially triggering additional capital requirements under the Pillar 2R assessment for SSM banks).

AFME, through its Special Committee on European Supervision (SCES), contributed to the ECB's consultation process. In its response, AFME acknowledged that the ECB has observed varying practices between SSM supervised banks with respect to the “identification, measurement, management and write-off of NPLs” and is thus seeking to provide guidance based on best in class examples of how NPL practices should be carried out most effectively.

However, AFME's membership includes banks which have already identified problematic NPL portfolios, put NPL strategies in place and are actively managing their NPL portfolios. They already engage with and report extensively to their supervisors on these matters. Their approach to NPL management has proven to be effective, as is shown in the downward trend in their cost of risk in recent years.

The draft guidance was deemed to be extremely detailed and far-reaching and may suggest that the ECB will require the introduction of new processes, reports, organisational changes and IT adjustments regardless of whether a firm already has sound NPL practices in place.

As such, its implementation could be duplicative and costly for firms which are successfully managing NPLs, without necessarily adding any value to their business or the resolution of the broader Eurozone NPL problem itself.

Moreover, from a risk perspective, there are disadvantages in asking firms to replace their proven NPL processes with new practices; such outcomes could be counterproductive and disruptive. We also note that outdated regulatory requirements should be reviewed. The CRR's Article 181 para1(a) requires all defaults to be used in the LGD development sample. As this is a Level 1 requirement, the EBA is required to perpetuate it in its Guidelines on PD and LGD estimation. This implies that data that is no longer representative of a bank's portfolio, for instance because there has been a disposal of NPLs, but must still be used to estimate LGDs. LGD accuracy and the banks' capital requirements will therefore be negatively affected. The CRR2 legislative process is an opportunity to correct the Level 1 text for such instances, thereby allowing the EBA to adapt its guidelines accordingly.

Structural features of the banking system

Europe's banking system remains fragmented, with 6000 banks in the Eurozone alone. In broad terms, Europe's banking system has structural over-capacity, low profitability and is slow to adjust and consolidate¹. The NPL problem is particularly evident among smaller banks. Smaller banks may lack the resources and reach necessary to diversify their credit exposures, manage their NPL portfolios efficiently or to lay them off in secondary markets. Such fragmentation may also make it more challenging to attract capital which could be deployed in enabling a speedier reduction in NPLs. Put simply, fragmented markets add a layer of complexity to the management of NPL portfolios.

A key structural component of the banking system are the rules on bank recovery and resolution, where authorities have made extensive progress in addressing the potential fallout from the failure of systemically important banks. Europe now has the framework and tools to deal with the failure of banks without resorting to taxpayer funded bail-outs or threatening financial stability through disorderly liquidation. The Bank Recovery and Resolution Directive (BRRD) implements the Financial Stability Board's international agreed Key Attributes of Effective Resolution Regimes for Financial Institutions. In this context, it is important that any approach to deal with NPLs is consistent with the recovery and resolution framework.

¹ See for example Mario Draghi speech to ESRB Annual Conference, September 2016:
<https://www.ecb.europa.eu/press/key/date/2016/html/sp160922.en.html>

| Area | FSC proposed measures | AFME initial views |
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| <p>Supervision & bank capital</p> | <p>Implement the SSM NPL Guidance and seek further steps, including EBA guidelines covering all credit institutions in the EU</p> | <ul style="list-style-type: none"> -Too prescriptive an approach could add undue operational costs and burdensome procedures to banks that have actively restructured NPL portfolios -Duplicative reporting between agencies and supervisors should be avoided |
| | <p>Enhance supervisory powers:</p> <ul style="list-style-type: none"> -Provide banking supervisors with accounting supervisory powers -Require adjustments filters or deductions from own funds -Establish binding NPL reduction targets | <ul style="list-style-type: none"> -Consistency with harmonised implementation of IFRS 9 rules across EU countries and banks is needed - The current regulatory and supervisory framework already provides supervisors with appropriate powers to assess banks' risks and capital/liquidity adequacy and to impose additional capital for risks that are not sufficiently covered by Pillar 1 requirements if necessary. Additional powers, and in particular accounting supervisory powers, are not necessary -Ambitious prudential backstops or NPL targets could generate high costs to the banking sector (mainly smaller banks in some jurisdictions) with consequences in economic activity, loan supply and valuations |
| | <p>Enhance loan origination standards and upgrade credit management practices:</p> <ul style="list-style-type: none"> -EBA to issue guidelines on loan origination -Loans performance to be monitored -Enhance the attention on risks associated to inefficient insolvency frameworks | <ul style="list-style-type: none"> -Too prescriptive an approach on loan origination standards and credit management could add undue operational costs and burdensome procedures to banks that have actively restructured NPL portfolios. -See insolvency section for inefficiencies regarding insolvency frameworks |

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| | <p>ESRB to explore macro-prudential tools (e.g. dynamic provisioning, add-on to the provisions, haircuts on collateral that supervisors consider overvalued)</p> | <ul style="list-style-type: none"> -Consistency with other macro-prudential tools (e.g. countercyclical buffers) is needed. Multiple policy tools at discretion of each Member State could harm the effectiveness of the transmission mechanism of monetary policy by European central banks. -Governance and decision-making process of multiple macro-prudential tools (countercyclical buffers, reserve requirements and surcharges by central banks, while proposed dynamic/ add-on provisioning and collateral haircuts by supervisors) need to be considered -Financial stability costs and benefits of developing additional macro-prudential tools should be evaluated |
| <p>Insolvency</p> | <p>Improve the transparency of insolvency outcomes in national proceedings</p> | <ul style="list-style-type: none"> -Political compromise might prevent the approval of an ambitious EU legal framework on insolvency proceedings (proposed Directive might not go far enough) |
| | <p>Benchmarking exercise, dedicated peer reviews between Member States, and focus on improvement of insolvency frameworks</p> | <ul style="list-style-type: none"> -An appropriate balance between creditors' and debtors' rights needs to be achieved -A framework for peer-reviews and best practice comparison should be developed |
| | <p>Consider an optional European harmonised regime on collateral for lending to corporates Clear definition of the term "insolvency" could be introduced in Union law Harmonisation of avoidance actions</p> | <ul style="list-style-type: none"> -It is encouraging that more information will be collated on insolvency outcomes as requested in Article 29 of the proposed Insolvency Directive. -There would be value in fostering the use of out-of-court proceedings in order to avoid lengthy judicial procedures. |
| <p>Secondary markets</p> | <p>Implement enhanced disclosures requirements on asset quality and non-performing loans</p> | <ul style="list-style-type: none"> -The challenge is to strike a balance between the full transparency required by investors and the release of sensitive information on credit institutions' lending book |
| | <p>Produce guidelines to specify minimal detailed information required from banks on their credit exposures</p> | <ul style="list-style-type: none"> -Too prescriptive an approach could add burdensome operational costs and procedures to banks that have actively restructured NPL portfolios -Duplicative reporting between agencies and supervisors should be avoided |

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| | <p>Strengthen the data infrastructure for secondary market transactions and consider the setting-up of platforms for NPL transactions</p> | <ul style="list-style-type: none"> -Data availability, enforcement of accuracy and continued updates are pre-requisites for setting-up effective infrastructure facilities -Data confidentiality/previous borrower consent for sharing borrowers' data to third parties are important issues to be addressed -The establishment of a standardised NPL template could be considered, with a minimum information set to meet investors' information needs -Multiple methods and assumptions of collateral valuation (book value, market value) need to be considered -New infrastructures or platforms will need to establish rules on information exchange, taking into consideration issues such as: where the exchange of information would take place; who would be given access to information; how would the information be presented |
| <ul style="list-style-type: none"> -Develop a European harmonised set of principles for the transfer, ownership and management of NPLs by both bank and non-bank investors, also in the context of CMU -Develop a common European approach to the development of the loan servicing industry -Develop codes of conduct for the transfer and management of NPLs | | <ul style="list-style-type: none"> -Review laws relating to licensing and regulatory regimes to enable non-banks to own and manage NPLs (e.g., obligation to debtor's consent, simplification for SPVs/foreign investors to enter the NPL market) -Guarantee financial expertise from servicing providers preventing undue asset recovery practices (i.e. predatory lending practices) -Consider the use of tax policy in facilitating NPL disposal, including withholding taxes (currently in discussion in the CMU agenda), loan-loss deductibility to provide incentives for banks to accumulate loan losses, or eliminate stamp duties and register tax on loan transactions -Consider the need for an electronic register of real estate on foreclosure and bankruptcy proceeding data -Consider measures to help grow and expand the loan servicing industry which is currently fragmented and made up of only a few sizeable players -A closer supervision of the loan servicing industry would be advisable to assess the adequacy of its IT infrastructures, resources and past performances |
| <p>Develop a blueprint of AMC set-up</p> | | <ul style="list-style-type: none"> -The potential complexities and benefits of establishing national or pan-European AMCs need to be carefully assessed -Any blueprint should be consistent with the recovery and resolution framework |

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| <p>Restructuring of banks</p> | <p>Develop initiatives to adapt the structure of banking sectors and facilitate the raising of new capital</p> | <p>-Any state intervention to NPL resolution should be consistent with the recovery and resolution framework</p> <p>-The CMU agenda can contribute to removing cross-border barriers to capital allocation (including investment by distressed debt funds) and develop the secondary market of NPLs</p> |
| | <p>-Complete Banking Union to facilitate bank restructuring</p> <p>-Progress on CMU may contribute to the diversification of funding sources</p> <p>-Assessment of Member States' legal frameworks related to the sale and transfer of loans</p> | |
| | <p>EU legislative framework (BRRD/SRMR) establishes a framework for restructuring and resolution. Where appropriate and consistent with the EU legislative framework, orderly liquidation may be granted</p> | |

