AFME Position Paper: Reviving the NPL action plan – bank specific measures to address NPLs in the context of the Covid-19 Pandemic

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Overview:

On 25 September 2020 the European Commission (EC) held a roundtable to gather industry views on how to tackle the expected rise in NPLs as a result of the Covid-19 pandemic. This consultation, alongside similar events with Member States and national Competent Authorities, will drive the EC's ambition to launch a revised NPLs action plan in January 2021.

To date there has been very limited data on the impact of Covid-19 on credit quality deterioration, although it has been noted that impairment charges from banks that have so far reported Q3 2020 figures are well down on the preceding quarter. This may, however, reflect a combination of very prudent provisioning in Q1 and Q2 as well as an improved economic forecast for 2021 that is taken into account in banks' models for the calculation of their respective collective provisions. It could also reflect the benefits derived from multiple public and private sector support programmes. As a second wave of Covid-19 leads to further restrictions on businesses with negative consequences for economic growth, further significant impairment charges are likely to be required in the coming year. Indeed, the ECB has estimated that in a severe but plausible scenario for non-performing loans at Euro area banks could reach €1.4 trillion. Moreover, while Q2 saw a significant increase in demand for working capital and inventories from corporates and SMEs, the ECB's most recent bank lending survey[1] highlights that "credit standards for housing loans and for consumer credit continued to tighten significantly in the third quarter, related mostly to the deterioration of the economic outlook and worsened creditworthiness of consumers affected by the pandemic". The joint ESAs report on the risks and vulnerabilities of the EU financial sector[2] also highlights credit quality deterioration as a key concern, noting that, on average, 57% of EU banks' loans to non-financial companies were towards sectors most affected by the pandemic such as hospitality and transport.

At the same time, the first three quarters of 2020 were the least active in NPL markets since 2015 with only €39.2bn of deals across Europe. There was also a rise in NPL volumes in EU countries (from a record low of €522.8bn at the end of March to €526.3bn at the end of June)[3].

[1] https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/pdf/ecb.blssurvey2020q3~a04de75e7f.en.pdf

[2] https://www.esma.europa.eu/sites/default/files/library/jc_2020_67_trv_report.pdf

[3] https://events.debtwire.com/npls-rise

Against this backdrop it should be recognised that regulators and central banks have acted quickly to provide unprecedented support to mitigate the impact of the pandemic, and banks have been a conduit for this to the real economy. For instance, in Italy alone, bank lending increased significantly to reach sectors and firms of all sizes – from the beginning of March to the end of July, loans to firms grew by €47 billion, whereas they had fallen by about €2 billion in the same period in 2019[4]. Unlike the previous financial crisis, the impact of Covid-19 has been far more evenly distributed across the EU, yet it has impacted specific subsectors of the economy such as hospitality far more harshly than others. Furthermore, while the rise in NPLs from Covid-19 is not a result of moral hazard or asset bubbles, it will impact otherwise viable businesses and have a knock-on effect on households. Nonetheless, it is clear more will need to be done to avoid a build-up of excessive NPLs and drag on bank balance sheets to enable a strong recovery. In this regard regulators should review all available tools to ensure banks can use them to the fullest extent possible.

Importance of NPL Securitisation

AFME considers there are a range of ways in which NPLs can be managed by banks which are complimentary and should be carefully tailored to the nature of the portfolio and borrowers, which can be very heterogenous. For instance, one important and effective way to manage NPLs is securitisation – this enables banks to maintain and even enhance their capacity to lend to the real economy, while being a useful tool for NPL resolution. This relies, however, on an appropriate NPL securitisation framework. In part, AFME therefore welcomes the targeted amendments of the EC as part of the Capital Markets Review Process to adjust the existing framework for NPL securitisation. Nonetheless, AFME remains concerned regarding the implementation of the Basel proposal for a risk weight floor of 100% and the fixed risk weight for senior tranches, together with a high and unduly conservative non-refundable purchased price discount set at 50%, which will make disposals uneconomic compared to internal work outs (further details of these issues are set out in more detail in our position on these amendments[5]). We therefore urge the EC to carefully consider industry's position as they seek agreement on this legislation by year-end. In addition, we would note that another approach to NPLs, which has proven very successful in developing NPE securitisation markets open to foreign investors, is the use of public national guarantees (e.g. Italian GACS introduced since 2016; Hercules Asset Protection Scheme (HAPS) launched in 2019). If adopted by other Member States, this could be a way of incentivising a more mature market, which could also contribute to solving future NPL challenges.

Bank specific measures

Alongside the measures to address securitisation of NPLs which are underway, this paper sets out how the EC should review the prudential framework as part of their forthcoming action plan to maximise efficient and effective ways of managing NPLs. Such a review should consider targeted amendments to address the CRR regulation (extending the adjustment for LGDs in the case of massive disposals) and the Pillar 1 backstop provisioning calendar for unsecured NPLs. In

[4] https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2020/en-Visco-ABI-16092020.pdf?language_id=1
[5] https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME%20Position%20Paper%20on%20COM%20proposals%20for%20NPEs%20September%202020.pdf

particular, AFME considers that restructuring by dedicated internal bank workout units can provide an effective tool for NPL management, particularly for more heterogenous portfolios.

This paper also comments other actions that may part of the revised EC action plan on NPLs related to reporting and secondary markets. However, we do not touch upon the possible establishment of an Asset Management Company (AMC) or a network of national AMCs, at this stage although we understand that the EC and other European authorities are considering these ideas as additional tools. AFME stands ready to engage in a discussion on this, knowing that many crucial questions remain unaddressed in the EC's non-paper (e.g. scope of intervention or funding of AMC).

1. Targeted amendment to the CRR to extend the deadline for the adjustment of LGD estimates in relation to massive disposals of NPLs

As part of the CRR2 amendments that were agreed in 2018, legislators introduced a provision (Article 500) to support banks in disposing, i.e. selling, of large portfolios of NPLs, known as "massive disposals". The rationale was to incentivise banks to sell their NPLs in order to avoid such exposures becoming a drag on banks' balance sheets and capacity to lend because of the indirect negative effect on LGD modelling. Consequently, this provision allowed banks under certain conditions to adjust their LGD estimates by partly or fully offsetting the effect of massive disposals of defaulted exposures on realised LGDs. This amendment was time limited until June 2022 and therefore unlikely to take into account all, or a significant number of, NPLs arising from the current situation.

Recommendation: We suggest **extending the length of this derogation from models until June 2024** in a targeted amendment to CRR which could be introduced through a fast-tracked procedure (as CRR3 is unlikely to have finished being negotiated by June 2022, when the derogation to adjust LGD estimates ends). Extending the period of application of Article 500 until 2024 in the context of the Covid-19 pandemic would not only provide banks with additional time to complete the dismissal processes already started and perform the adjustment envisaged by this article, but would also continue to incentivise institutions to free-up capital resources for further lending.

In addition, the EC should **review the threshold for meeting the "massive disposal" eligibility** and consider reducing this from 20% of the cumulative amount of all observed defaults as of the date of the first disposal to 10%, as this has proven a considerable barrier for banks wishing to make use of the provision to date.

2. Targeted amendment to the Pillar 1 backstop provisioning calendar for unsecured NPLs

As part of the CRR quick fix this June, legislators amended the regulation to treat public guarantees provided in the context of Covid-19 by national governments or other public entities on a par with the treatment for guarantees made by Export Credit Agencies. This treatment in effect extends the timetable to provision for such non-performing loans to 8 years. This CRR amendment will clearly alleviate the large take up of publicly guaranteed loan schemes, which over the period of April-July were higher than overall net lending flows in all large Euro area countries[6]. Nonetheless, while the treatment and use of such guarantees as well as moratoria granted under the EBA guidelines on the treatment of public and private moratoria in light of Covid-19 has been widely taken up[7], these measures are not expected to address all loans made to households and businesses that become non-performing as a result of Covid-19 (see also Annex 1 for additional data). Under the current provisioning calendar this means banks will be required to make provisions in the case of unsecured NPLs arising from Covid-19 from Q2 2022. However, by encouraging banks to dispose of their exposures prematurely it would most likely amplify the already serious shock of Covid-19 on small and medium size businesses. It would therefore be preferable if banks could use their understanding of such businesses established before and during the crisis and maintain these relationships where appropriate. In turn this would allow for more bespoke restructurings that mitigate the otherwise pro-cyclical effects of flat provisioning requirements.

Furthermore, there have been several challenges given the current circumstances which limit banks' ability to foreclose. For instance, courts have been formally closed for a significant period and this is expected to continue to limit legal operations further in a second wave of Covid-19[8].Consequently, there will be delayed recovery processes leading to an increase in the duration of both existing NPLs covered by the Addendum and SREP expectations and NPLs falling under the Pillar 1 backstop which in turn will require an increase in provisioning, whereas before the crisis banks foresaw a reduction. In addition, there has been disruption to re-valuations taking place due to lockdowns and a closure of the property market in several Member States. Furthermore, while banks are continuing to undertake proper risk assessments, they must remain alert to the potential increase of NPLs due to the negative Covid-19 economic environment, as well as taking into account the timing of the expected rebound.

Recommendation: We propose **a targeted amendment to the CRR to extend the Pillar 1 backstop calendar for provisioning for unsecured NPLs by one year**. Thus, for first three years the rate of coverage under the backstop would be 0% for unsecured NPLs (n.b. banks will still need to undertake the normal model provisioning) and from the fourth year banks would need to provision 35%. This will mitigate the need to dispose of such NPLs arising from households and businesses that would otherwise be viable and loans that may not have fallen in

[6] Focusing on gross new lending, in Spain and France, where fiscal support for firms was delivered mainly via guarantee schemes, about 65% and 70% respectively of new business volumes in the period April-July consisted of guaranteed loans (see Chart C, panel b). In Germany and Italy, guaranteed loans represented about 20% of new lending flows over this period, while they comprised a negligible share of new lending in other euro area countries. https://www.ecb.europa.eu/pub/economic-bulletin/focus/2020/html/ecb.ebbox202006_07~5a3b3d1f8f.en.html

[7] According to the EBA review of loans under Moratoria and Public guarantee schemes as of June 2020, a nominal loan volume of EUR 871 billion was granted moratoria on loan repayments, comprising about 6% of banks' total loans and close to 7.5% of total loans to households (HHs) and NFCs. In total, 16% of SME loans were granted moratoria, followed by 12% of commercial real estate (CRE) loans and 7% of residential mortgage loans. As of June 2020, newly originated loans subject to PGSs amounted to EUR 181 billion, representing 1.2% of the total loans. These loans were granted predominantly to NFCs, which account for about 95% of the total loans subject to PGSs. Banks in Spain had the highest share of new loans subject to PGSs relative to total loans, while banks in France, Italy and Portugal also reported material volumes. Banks in other European countries reported very low volumes, and some countries had none. https://eba.europa.eu/banks-report-significant-use-covid-19-moratoria-and-public-guarantees

[8] Judicial and enforcement procedures in Austria are suspended until second half 2021; in France courts will stay open but are still impacted by a delay from the first Covid-19 wave.

scope of the government and public guarantees offered during the Covid-19 pandemic. We also expect that by adjusting the provisioning schedule it will better reflect the lengths of the recoveries and the current market disruption[9]. This is also reflected in the latest EBA report on this insolvency framework[10], which shows, based on December 2018 data, that the simple average recovery times in the EU for most asset classes to be 3 years (see Annex 2). The report also acknowledges a wide range in such recovery times across Member States related to length of judicial processes and costs which has been exacerbated by the current circumstances. Furthermore, any adjustment to the Pillar 1 provisioning timetable should be reflected accordingly in supervisory expectations as per the ECB's Addendum to the ECB's guidance on NPEs.

3. Other measures considered for the EC NPL action plan

As part of the EC roundtable on 25 September several other proposals were set out by regulators as a way of mitigating the impact of Covid-19 in relation to NPLs. In terms of the ambition of the EC to achieve an efficient loan enforcement and insolvency framework, we fully support the renewed drive to complete this as central to developing secondary markets and a key piece of the Capital Markets Union, yet significant barriers remain as recognised by the Court of Auditors[11]. At the same time, we have a number of concerns which we set out regarding the proposal to make the – at present voluntary – EBA NPL templates[12] and NPL platforms mandatory by integrating such requirements within existing regulatory guidance for banks.

With regard to voluntary **EBA NPL data templates**, while we support the transparency objective, we do not consider them fit for purpose for non-performing loans and have the following shortcomings:

- The templates include 462 data fields many of which are not relevant for investors whilst at the same time will incur a significant cost for banks to supply, either because the information does not exist, it is difficult to collect, or the quality of the data is low[13].The hierarchy of information as proposed by the EBA ("crucial", "important" or "moderate") is debatable and should be discussed further with originators and investors, especially if templates are to become compulsory.
- At the same time, the templates do not include some information which could be more relevant for investors, such as the "judicial status quo" of the loan.

[9] See also the European Justice overview of the measures taken within the European Union in relation to the Covid-19 pandemic, which affect the judiciary, national authorities and legal practitioners, but also businesses and citizen where it is shown that Covid-19 produces impacts on the routinely procedures of the NPL recovery processes, due to extraordinary reasons outside of the control of financial institutions
[10] https://eba.europa.eu/eba-publishes-report-benchmarking-national-insolvency-frameworks-across-eu
[11] https://www.eca.europa.eu/Lists/ECADocuments/SR20_25/SR_CMU_EN.pdf (see from page 37)
[12] https://eba.europa.eu/eba-revises-standardised-npl-data-templates
[13] As part of the work undertaken by the Technical Working Group (TWG) on the EBA Data Template, led by the European Data Warehouse with participation of various banks and other relevant organisations, their analysis showed that only 50%-60% of the information requested by the EBA data template are readily available in the IT systems of some of the largest banks in Europe. This percentage is likely to be smaller for some of the medium and smaller banking institutions.

- The templates assume that the information that is managed by the different banks is comparable, when it is usually not the case.
- The templates are unharmonized with and duplicate parts of the ESMA securitisation templates with regard to NPEs.

Aside from the aforementioned operational challenges with the EBA NPL templates, we note that the main aim of making these templates mandatory is an implicit assumption of asymmetry of information between sellers and buyers of the NPLs. AFME would challenge this assumption – at present sellers of NPLs provide the information they have, and the information deemed important by investors, within the limits of data protection regulation requirements. It is also in the interest of the sellers to disclose as much information as possible to achieve a higher price. Consequently, it would be counterproductive and carry reputational risk over time for sellers not to undertake appropriate disclosure in the selling process. All market participants emphasise that data quality is the key driver of portfolio value. In addition, we remain concerned that standardized templates might not fit the heterogenous nature of most NPL portfolios. In this respect, we believe that small or very specific transactions are much easier to organize based on ad-hoc data files, closely connected with operational management history.

We note that the EC and other EU bodies are also considering **integrating the use of NPL data platforms into regulatory requirements** e.g. for AMC sales, under SSM guidelines of NPL management, or within the SREP framework. While our members recognise that NPL Platforms provide valuable services to some banks **-** especially for small transactions –, we believe their use should remain voluntary for market participants. Platforms are likely to work best for pools of similar assets with similar characteristics and performance experiences such as mortgages and they may have a role for certain types of portfolios but not all. Furthermore, NPL platforms should not be mandatory because banks might have different and established channels to dispose of their NPL portfolios. Indeed, NPLs are not commoditised assets – every NPL has distinct characteristics with individual clients of businesses in difficulty and links with the specific national legislation in terms of insolvency. Transactions, by definition, need the buyer to devote time and resources to understand the challenges and assess realistic recovery expectations and for this, the buyer needs to have direct interaction with the originator and the manager, or in other cases transactions come in the form of securitisations with the exposures bundled by risk and sold accordingly. A mandatory requirement to use platforms may therefore delay the execution of transactions.

Recommendations:

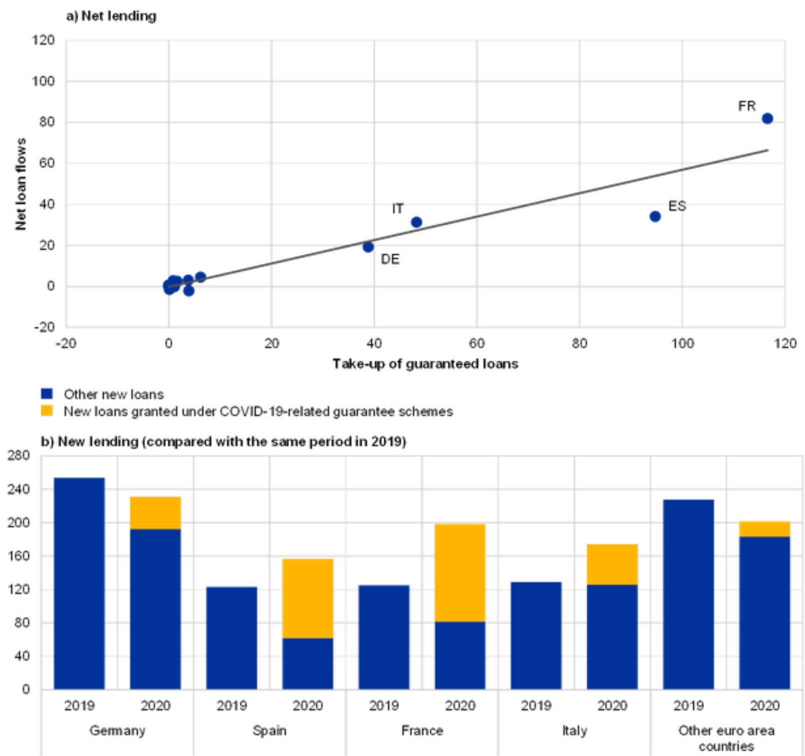
- In respect of **data templates** we recommend these **remain optional**. If EU authorities contemplate making their use mandatory, the EBA and EC should first undertake a Cost/Benefit analysis to demonstrate how the additional cost of compliance at origination would be offset by the expected higher valuation achieved on the eventual NPL transaction. In particular, it should reflect on the economics for loans which have already been granted and become non-performing, but do not factor in additional origination costs. From an industry perspective, if such templates are mandated it would necessitate an Internal Assessment and Cost Benefit analysis on how to offset the cost of such mandatory disclosure which might end up being passed on to borrowers and disrupt market liquidity. Should templates be made mandatory via an ITS then EBA should avoid duplication with the existing ESMA securitisation templates and other guidelines, and the draft ITS should be subject to the usual industry consultation process, which should help identify the most relevant fields.

- We support the development of NPL data platforms and infrastructure **only if it is market-led** (i.e. non-mandatory).

Annex 1

Take-up of guaranteed loans and loans to non-financial corporations and the self-employed over the period April-July 2020

(EUR billions)



Sources: Kreditanstalt für Wiederaufbau for Germany, Instituto de Crédito Oficial for Spain, Ministère de l'Économie et des Finances for France, Ministero dell'Economia e delle Finanze and Banca d'Italia for Italy, various national authorities for other euro area countries, news sources, ECB and ECB calculations.

Notes: Net lending refers to loans net of repayments, as reported in the MFI balance sheet statistics. New lending refers to pure new loans, as reported in the MFI interest rate statistics. Net and new loan flows are non-seasonally adjusted. Net loan flows are adjusted for sales, securitisation and loan transfers.

Annex 2

Source: EBA, data reference Dec 2018. https://eba.europa.eu/eba-publishes-report-benchmarking-national-insolvency-frameworks-across-eu (figure 1)

Table 1: Recovery rates (gross and net), time to recovery and judicial cost to recovery by asset class (EU27 simple average: two indicators)[6]

	Gross Recovery Rate (%)		Net Recovery Rate (%)		Time to Recovery (years)		Judicial Cost to Recovery (%)	
Asset class	Simple Average at loan level	Simple Average by country	Simple Average at loan level	Simple Average by country	Simple Average at loan level	Simple Average by country	Simple Average at loan level	Simple Average by country
Corporates	40.4	44.6	36.8	41.6	3.4	3.3	1.4	2.7
SMEs	33.8	41.4	31.5	39.6	3.3	3.0	3.5	3.9
RRE	46.1	53.5	43.9	51.3	3.1	3.0	2.0	1.6
CRE	42.2	50.9	38.4	49.1	4.1	3.0	1.6	1.4
Retail – credit cards	25.2	52.1	21.0	48.7	2.3	2.3	5.4	6.4
Retail – other consumer loans	38.2	41.7	32.9	38.3	2.9	3.0	6.7	7.0