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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
- ● an organisation or a company
- ○ a public authority or an international organisation

* Name of your organisation:

Asociación Española de Banca (Spanish Banking Association)

Contact email address:

The information you provide here is for administrative purposes only and will not be published

publicpolicy@aebanca.es

* 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?)

- ● Yes
- ○ No

* If so, please indicate your Register ID number:

785157016077-28

*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?

Spain

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

at least 1 choice(s)

- ☐ Accounting
- ☐ Auditing
- ☑ 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
- (x) No
- ( ) Don’t know / no opinion / not relevant

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

No, statutory prudential backstops should not be implemented as a hard requirement. It could be useful for supervision purposes as a benchmark and institutions would be able to explain deviations. This is the situation in Spain with local rules introduced by Bank of Spain through Circular 4/2016. The “Alternative Solutions” introduced by this Circular act as a reference and institutions have to calculate provisions both with their internal models and applying these alternative solutions. Conversely, implementing statutory prudential backstops as a hard constraint would be inconsistent with the applicable accounting framework. IFRS9 is being implemented right now and establishing backstops questions the credibility of the provisions calculation methodologies. Accounting provisions under IFRS 9 for all NPL, new and stock, should show a faithful image of the financial statements of EU institutions. Banks have invested in developing increasingly sophisticated models, including some regulatory expectations, such as considering the age of NPLs in LGDs. With this backstop those models are useless, both, accounting and prudential models.

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

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

No, instead, overlaps may arise. If the supervisor believes that bank’s provisions are not sufficient, it would ask for a higher P2G based on his credit risk rating. At the same time, it forces it to raise those provisions through the proposed backstop. It is the same potential risk covered by two different measures.

We believe it is necessary to allow the time for receiving return from two different measures in process:

- A proper and harmonized recurrent valuation of the guarantees, according to the criteria set by NPL Guidance.
- The clarification of the risk weighted assets calculation for non-performing exposures. TRIM Guide comes to lighten this issue with a clear will of increasing significantly capital requirements for NPL.

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

- ( ) Yes
- (x) 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:

Time in default is not always a clear indicator of loss given lost. Conversely, time in default can represent in some cases a period of cure. Let’s think, for instance in a forborne exposure classified as non-performing. After one year we could consider to reclassify as performing and, at the same time, should we increase provisions following the backstop criterion? Instead of time in default we suggest to apply past due days as the relevant indicatorIn addition, time in default criterion could negatively influence the entities’ classification policy, avoiding the early recognition of default through UTP criteria, instead of encouraging it.

The alternative is to ensure that bank's provision models adequately reflect losses, and therefore provisions, considering classification as default. This is being validated by validation and banks’ internal audit departments, external auditors in terms of provisions and prudential supervisors in the approval of capital models.

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
- [x] a later date of application?

Please explain the reasons for your answer to question 3:

From an accounting point of view, it would be inconsistent to apply some backstops to new NPEs and value the stock NPEs under a different principle.

Having said that, the cut-off date should be clearly later in order to give some time to banks, once the standard is final, to adapt policies, to make the necessary IT developments, integrate it into the banks’ management, etc.

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

We should be consistent with the IFRS9 accounting criteria, where the concept of modification is established.

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

Please explain the reasons for your answer to question 4:

No as a general and hard rule. What is appropriate is what results from the models developed and calibrated for each type of portfolio in each geography of each entity based on its historical data.

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** (selected)
- Don't know / no opinion / not relevant

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

No as a general and hard rule. If the guarantee is considered effective, the NPL should never be fully covered. However, if a guarantee becomes inefficient, the NPE should be considered unsecured, but not depending on a vintage of 6-8 years but on an assessment of the effectiveness of the guarantee. It is rather a valuation concern instead of time.

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** (selected)
- Don't know / no opinion / not relevant

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

The haircut applied should depend on the spread between the appraisal value of the collateral and its fair value, but it should not be affected by the vintage.

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.

As we said before, backstop could be useful as a benchmark for supervision purposes. The SSM should analyze the appropriateness of applying, for supervisory purposes, a higher RW for non performing exposures instead of a deduction. The underlying reasoning behind this, is that the risks associated to non-performing loans could give rise to unexpected losses that the SSM estimates to be higher than the ones actually estimated in Pilar I, both under the Standardized and IRB Approaches. The RWs should be different for the part of the exposure that is guaranteed vs the part that it's not guaranteed, and it should be considered also that they can evolve over time. The revision of the RWAs is an alternative that permits to delink the proposed measure from the accounting standards, because this measure does not put into question the level of provisions and only accounts for the higher risk associated with the part of the exposure that it's not already covered either by provisions or the current Pilar I requirements.

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:

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:

It is important that there are no different methodologies for the same purpose.

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

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

No, valuation requirements should be based on the accounting framework.

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?

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

Please explain the reasons for your answer to question 6:

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?

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

Please explain the reasons for your answer to question 7:

We believe that, if the proposed instrument defined is a backstop, it should act as a barrier or a stop. That is, without establishing gradual or progressive coverage, different to the one resulting from internal models, till the term is reached. In other words, since the exposure is classified as non-performing and until the execution date set by the European Commission for the backstop, the entities should use the coverage resulting from their internal models (without any gradual or progressive way different than the internal models' path). Otherwise, it would not be a backstop but a coverage alternative model. We consider that it might be not fully consistent with the latest regulatory developments in terms of i) valuation of immovable property and other eligible collateral ii) LGD internal model sensitive to vintage years.

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

Once the institution treats an exposure from a gone concern perspective, there is a standard time for repossession and during this period an increase of coverage if not well justified by the course of time. Then, we propose a "grace period" coherent with the standard time for repossession. Given that this time is different by jurisdiction, this is an additional reason why a simple backstop based on a single calendar should be assessed instead of using it as a mechanic rule.

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:

Yes, any deviation between the prudential backstops and the accounting provisions determined under IFRS9 will make that the coverage will not be a faithful representation of the expected losses of EU entities.

The EC backstop only applies to all significant credit institutions supervised by the ECB under the SSM

Regulation. This put significant European institutions of the SSM with subsidiaries in non-Eurozone area at a competitive disadvantage with local credit institutions in these third counties.

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:

db88bcda-3192-4933-9649-d8d895f4d6f2/AEB.17.11.30 __AEB_response_to_EC_Questions_Prudential_Backstop_Consultation_enviado.pdf

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