

SPANISH BANKING ASSOCIATION RESPONSE ON THE EUROPEAN COMMISSION'S PROPOSAL ON STATUTORY PRUDENTIAL BACKSTOPS ADDRESSING INSUFFICIENT PROVISIONING FOR NEWLY ORIGINATED LOANS THAT TURN NON-PERFORMING

The Spanish Banking Association (from now on, "AEB") welcomes the opportunity to provide feedback on the European Commission's proposal for regulation on statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing.

Our main concerns in this regard are:

1. The coexistence of two different prudential backstop (ECB vs. European Commission) may generate uncertainty and entails a high cost for the entities:

The proposals on non-performing loans (NPL) of the European Commission and the ECB referring to the enforceability of a minimum of provisions with prudential criteria (backstop), are not coincidental neither in their nature (Pillar 1 vs Pillar 2), nor in the objective scope of application (new operations vs. new NPLs), nor in the treatment of unlikely-to-pay exposures, nor, especially, in the calendar and percentages with which such backstops must be constituted.

The Spanish banking industry considers, therefore, that we should take into consideration the following elements:

- The need to clarify the interactions between both models of constitution of prudential provision. In this sense, the ECB's timetable is stricter than the one presented by the European Commission.
- The coexistence of two different calendars with a similar objective drives necessarily one of them to be useless. Even considering the different legal nature of both proposals (the Regulation is a standard -binding-, while the ECB Guide includes supervisory expectations), the truth is that, in fact, entities will have to meet the most demanding one and the ECB Guide can become the framework that prevails.
- The coexistence of two similar frameworks regarding their objectives, but different in their methods, implies high costs for the entities in terms of maintaining more than one parallel calculation, reporting, ...
- In addition, it should be noted that it is still not clear which calculation, or even both, whether should be included in reporting, disclosure, internal management, ...

2. A good alternative method might be an approach of increasing the RWAs to NPL exposures instead of applying a deduction.

According to the proposal, the designed prudential backstop aims at preventing excessive stocks of NPLs in the future and at reducing the risk of future NPL accumulation.

The risks associated with non-performing loans could lead to an amount of unexpected losses even higher than those actually estimated under Pillar I, both under SA and IRB approach. In this sense, instead of establishing a deduction, we consider that the RWAs associated with non-performing loans should be reviewed in Regulation 575/2013/EU and reflect a higher risk for

those exposures in default that are not sufficiently provisioned in accordance with the accounting framework. We believe that it would be appropriate to differentiate between the secured and unsecured part of the loan as far as RWAs are concerned. Reviewing the RWAs is an alternative that would unlink the European Commission's proposal from the accounting standards. Not only it would not question the level of accounting provisions, but it would allow associating a higher risk (and only) to the unsecured part of the exposure.

On the other hand, it should be noted that entities have developed, in many cases, robust internal models based on their historical experience of default and recovery and on the quality of their credit portfolios for quantifying the necessary coverage.

In this regard, it is important to note that the proposed backstop should be part of the entities prudential framework, and therefore be included in the CRR, without questioning whether the provisions established for credit losses according to the accounting framework are adequate or not.

In summary, a greater weighting for credit risk of NPL exposures is consistent with the Basel framework and with Title II of the Third Part of Regulation 575/2013 CRR, both with the standard approach (SA) and with the internal ratings-based models (IRB). On the other hand, a minimum of prudential provisions based only on calendar is not consistent with the solvency requirements framework. This last proposal implies denying the reliability of the internal models to calculate the expected and unexpected losses, established according to the conditions required by CRR and approved by the supervisor.

3. The scope of application of the backstop must be consistent with the current regulatory framework and not encourage regulatory arbitrage.

Firstly, the definition of "non-performing", in this context, should be aligned with the EBA's definition, included in the "EBA FINAL Draft Implementing Technical Standards On Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013 (EBA/ITS/2013/03/ rev1, of 24/07/2014), which states that the definition of non-performing exposures includes the notions of impairment and default, but also other exposures that meet the EBA's own criteria for inclusion in the category of non-performing exposures ('entry criteria')." In this sense, we propose to delete the paragraphs c, d and e of the article 47a.3 of the European Commission proposal.

In this sense, the risk management procedures for "unlikely to pay" exposures vary from one entity to another. Therefore, and in application of what a given entity could consider as best practices, that entity could decide to maintain an unlikely to pay exposure as NPL both, for risk management purposes and for its accounting classification, even if there is no default:

- As long as the debtor is fulfilling its contractual obligations, the guarantee of the operation will not be executed, and, therefore, a greater prudential provision for these operations does not seem appropriate.
- Negative incentives could arise if these exposures were included within the scope of these backstops (this could imply an immediate reclassification of the loan as "performing").

Secondly, the definition of the perimeter of "non-performing loans" is directly affected by the definition of the materiality thresholds (absolute and relative) used to determine when a debtor is past due: more than 90 days of default on any obligation of credit. Since these thresholds

were already defined by the EBA¹ and will come into force in January 2021, we understand that the definition of default must be adapted to the current regulation and that it cannot be applied in advance.

4. The setting of minimum percentages to be met at the end of each year when an exposure is unpaid is inconsistent with the objective of a backstop.

By definition, a backstop is an instrument that works as a barrier or support, so we do not think it is appropriate to regulate the path to reach the levels set by the backstops. The minimum levels of provisions should be understood as prudential retaining walls, and in this sense, they must guarantee that the provisions are constituted at the end of the defined periods: 2 years for unsecured exposures and 7 or 8 years for secured exposures. From a prudential perspective, the objective should be to make sure that secured and unsecured NPLs are covered after a specific period of time.

5. Collaterals retain value after a certain number of years, even though when by management criteria it is decided not to execute.

The collateral value of the exposures must be recognized in accordance with the valuations carried out by qualified independent third parties. In this sense, we do not agree with the proposed approach, which establishes that after a certain number of years without the collateral being executed, the operation will be classified as unsecured. When calculating the backstop, the collateral's value must be taken into account instead of adopting a gradual and predetermined path without taking into account factors such as an updated valuation, the type of asset, phase of the cycle economic, ...

¹ Draft Regulatory Technical Standards on the materiality threshold for credit obligations past due under Article 178 of Regulation (EU) No 575/2013

<https://www.eba.europa.eu/documents/10180/1597002/Final+draft+RTS+on+the+materiality+threshold+for+credit+obligations+%28EBA-RTS-2016-06%29.pdf/fe1db887-c6dc-4777-89c1-4f243584cafd>