Comments:

Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

(October 2017)

Contact:
Sascha Nell
Telephone: +49 228 509322
E-mail: risikomanagement@bvr.de

Bonn, 17/12/08

Coordinator:
National Association of German
Cooperative Banks
Schellingstraße 4 | 10785 Berlin | Germany
Phone: +49 30 2021-0
Fax: +49 30 2021-1900
www.die-deutsche-kreditwirtschaft.de

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

General comments
Overall, we think that introducing a prudential provisioning backstop for NPLs that goes beyond the requirements and audit processes of the accounting framework is superfluous. Efforts are underway to harmonise the accounting and prudential treatment in many areas. The proposed addendum to the NPL guidance on the provisioning backstop establishes a significant discrepancy here for which there is no economic justification. Moreover, the Supervisory Review and Evaluation Process (SREP) already gives the ECB sufficient tools and information as regards "outlier institutions" to impose additional own funds requirements on those institutions. There is therefore no need for separate requirements in the form of an addendum to the NPL guidance and no need for an additional enforcement of sound treatment of NPLs to stabilize these institutions. Additionally, the requirements set out in the NPL guidance are already expected to be taken into consideration in the SREP process when the individual capital requirement for each institution is elaborated. The proposed addendum to the guidance now contradicts this because it stipulates one-size-fits-all rules for the capital deduction. Furthermore, the ECB has announced additional measures for reducing legacy NPLs for early 2018. Depending on how this arrangement is drafted, there could be a massive capital deduction that will, as a minimum, render the NPL strategy obsolete. We reject a one-size-fits-all solution for NPLs and are therefore calling for a case-by-case analysis as part of the SREP dialogue, based on the NPL strategies prepared by the institutions. We also have concerns about the procedure suggested in the proposed addendum to the NPL guidance for banks to apply deductions to their CET1 capital in accordance with Article 3 of the CRR on their "own initiative", as – in conjunction with the "threat" of prudential (Pillar 2) measures by the back door – this would ultimately create a Pillar 1 own funds requirement without any sound legal basis. We wish to draw attention to the following points, which constitute general comments on the proposed approach: - It seems to be clear that this addendum is aimed primarily at specific countries or banks in the EU. However, we think that one-size-fits-all solutions are not appropriate because they do not adequately reflect any national specificities. We therefore advocate additional planned measures for the definition of criteria or of a filter. Only once this has been reached would a procedure stipulated by the ECB as part of the SREP be applied. An example of such a criterion could be when a bank exceeds a specific average NPL ratio. - Rather, the problem appears to lie in the application and enforcement of the existing rules. New rules will not improve this situation. - It is evident that high NPL levels are associated with correspondingly poor macroeconomic developments. It is therefore a fallacy to assume that the sale of NPLs will (automatically) lead to a higher degree of bank growth and stability. NPLs can only be avoided if banks cease extending loans altogether. Moreover, the possible sale of NPLs (for example, in order to avoid a further CET1 backstop charge) will not free up a significant amount of capital and hence open up greater opportunities for lending in all cases, because the capital was already used up for the sale or the prior provisioning. - We assess the rigid quantitative requirements of the ECBs provisioning expectations (even the related capital measures) as a risk for consensual restructuring solutions, as they are commonly used in Germany. It might also interfere into banks approved business models because they can force the possible sale of NPLs/collateral if the bank really wants to comply with the ECB's requirements, although it would not otherwise have done so for economic reasons. The proposed approach could finally be harmful for debtors, because it could lead to a more restrictive lending practice, especially for corporates with higher risk profiles. In case one single debtor has contracts with several banks, this could lead to a disposal of all NPL exposures via the secondary market at the same time and could lead to further negative economic effects. More flexible periods that

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

better reflect a bank's and debtor's individual circumstances would make more sense here. At the same time, this could benefit the shadow banking sector (hedge funds), which could position itself to take advantage of bargain purchases of NPLs/collateral from troubled banks. This would also further weaken the capital situation at the troubled banks (for example, fire sales).

- The guidance will result in additional implementation and support effort that will require a sufficiently long lead time to realise. Although the ECB states that the addendum is non-binding, it can still be assumed that this will effectively be the case because of market pressures, among other factors. Even though the quantitative impact for German banks is expected not too high, we consider the additional process cost, resulting from "comply or explain" discussions of the "one-size-fits-all" backstop results as disproportional burdensome.
- The substance of the proposed backstop procedure contains weaknesses that run counter to an economic and risk-adequate approach (see specific comments).
- The proposed rules risk amplifying pro-cyclicality, because negative capital effects attributable to the provisioning backstop can additionally increase and thus burden those banks even more.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
1	2 – General concept	2.3	6	Amendment	Despite the statement that the addendum to the NPL guidance does not intend to substitute or supersede any accounting requirements (see page 2, last paragraph, of the addendum), the requirements result in conflicts with International Financial Reporting Standards. We wish to draw particular attention to the trend towards extremely conservative (tending towards worst case) provisioning, rather than based on individual transactions (one-size-fits-all coverage depending on the collateral): Banks are hence encouraged "*to close potential gaps relative to the prudential minimum expectations by booking the maximum level of provisions possible under the applicable accounting standard. If the applicable accounting treatment does not fulfil the prudential provisioning backstop, banks should adjust their Common Equity Tier 1 capital on their own initiative, applying Article 3 of the CRR on the application of stricter requirements.*" This wording raises the question of whether the accounting treatment is not considered prudent if it is not sufficient to satisfy the prudential provisioning backstop although all of the IFRS requirements are met in full. We are of the opinion that the accounting risk provisioning under IFRS 9 offers sufficient coverage. This addition to accounting practice (in particular the "linear path" that is under discussion for building up the backstop) thus potentially conflicts with the	One-size-fits-all coverage without any link to the collateral would increase the pressure to realise the collateral. This would remove the incentive for the institutions to work their way through the economic cycle so as to limit any losses from realisation. We wish to point out in this context that an additional prudential provisioning backstop would result in the need for additional explanation on the capital markets. Alongside the prudential and the accounting provisioning, it would create a third figure that would, however, only apply to a subset. In light of this, we are opposed to the introduction of a prudential provisioning backstop. The prudential provisioning backstop can limit the leeway for accounting measurement in practice; there are conflicts with applicable accounting requirements in some cases.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					fundamental objectives of IFRSs, e.g. as regards the true and fair view and neutrality, if regulatory motives are introduced here. In particular the discussion with the auditor about the appropriate level of provisioning will normally also be sufficient as a supervisory expectation.	
2	2 – General concept	2.3	6	Clarification	We presume that the capital deduction in accordance with Article 3 of the CRR should be interpreted as an "other own funds reduction" within the meaning of Article 159 of the CRR, and that it should therefore be taken into consideration in the comparison of provisioning. We are seeking clarification in this respect.	
3	2 – General concept	2.3	5	Clarification	We presume that the "newly booked provisions" referred to beneath Figure 1 on page 5 of the proposed addendum to the guidance may be recognised immediately without them having to meet the criteria set out in Article 26(2) of the CRR. We are seeking clarification in this respect.	
4	2 – General concept	2.3	5	Clarification	We are seeking clarification that "all accounting provisions" mean all recognised risk provisions and valuation allowances, for example the Stage 1 and 2 loss allowances to be recognised in accordance with IFRSs in addition to specific provisions or valuation allowances and general/global provisions or valuation allowances.	

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
5	2 – General concept	2.3	5	Amendment	The own funds requirement for the credit risk of the relevant NPL exposures should be included as a further summand/element in the components for satisfying the prudential provisioning backstop. The fundamental question also arises in this context of whether the risk of a higher and additional loss from NPLs is not already adequately taken into account in the Pillar 1 framework through the calculation of higher own funds requirements for NPL exposures (e.g. in the SA in accordance with Article 127 of the CRR with a risk weight of 150%).	If the own funds requirement for NPL exposures is not recognised, capital will be double-counted because the capital deduction (in accordance with Article 3 of the CRR) would be calculated inclusive of own funds requirements that have already been included, and thus too high.
6	2 – General concept	2.3	6	Clarification	We are seeking clarification that the potential application of the comply-or-explain principle can also apply to an institution as a whole or at least to portfolios, such that an institution or individual portfolios can be exempted overall if the level of NPLs is low or if there is extensive, recoverable collateral.	
7	3 – Definitions applied in this addendum	3.1	7	Amendment	Recovery and a significant reduction in the risk of loss happen in practice, especially when borrowers are being restructured or reorganised. However, cases like this are still classified as NPEs according to the EBA's definition. In light of the provisioning backstop, however, such exposures should continue to be disregarded and not result in capital deductions.	If no exceptions to the formal classification as NPEs according to the EBA's ITS are provided, the result may be unintended capital deductions for cured exposures.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
8	3 – Definitions applied in this addendum	3.1	7	Amendment	Because the definition of NPEs according to the EBA's Implementing Technical Standards (ITS) relates to borrowers, it may happen that "healthy" senior exposures are classified as NPEs especially in the case of tranched or tranched cover transactions. Corresponding exposures that are "protected" by subordination or downstream tranches, but that are formally classified as NPE positions, should therefore be excluded from the scope of the backstop.	If no exceptions to the formal classification as NPEs according to the EBA's ITS are provided, the result may be unintended capital deductions for cured exposures.
9	3 – Definitions applied in this addendum	3.2	7	Amendment	The proposed addendum to the NPL guidance effectively invalidates established concepts that have been accepted by the supervisors (loss given default, expected loss, excess amount/shortfall calculation in accordance with Articles 158–159 of the CRR). The restriction to collateral defined by the CRR conceals the fact that there is economically recoverable collateral for which a LGD history or appraised mortgage lending values can be demonstrated. The recognition of collateral should therefore not be restricted to the collateral recognised by the CRR, but – in line with the use test principle – should follow the economically recoverable collateral actually used in risk management.	Restricting the recognition of collateral results in the inappropriate calculation of the backstop provisioning requirement and significantly exaggerates the actual risk provisioning requirement. It runs counter to the principle of substance over form and thus leads to unjustified capital deductions.
10	3 – Definitions applied in this addendum	3.2	7	Clarification	Page 6 of the proposed addendum to the NPL guidance explicitly allows the option to deviate from the backstops on a comply-or-explain basis. To enhance the certainty of application at the institutions, we are calling for examples of	Clarification using examples is necessary to ensure uniform administrative and audit practice.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					stable value collateral or exemptions to be included. The following would be of particular interest, among others: • loans backed by federal/state guarantees, ECA-backed loans • other loans secured by an e.g. investment grade guarantor. We are also seeking clarification with regard to the treatment of this or other stable value collateral. However, we wish to point out that any examples of deviations from the backstops that are given should not be understood as an exhaustive list.	
11	3 – Definitions applied in this addendum	3.2	7	Amendment	The requirements for recognising collateral for the purposes of determining the need for the prudential provisioning backstop for NPLs are too rigid. Physical collateral that is not immovable property collateral or leasing object should also be allowed if the collateral valuations are conservative and are regularly validated. The ECB should clarify that – at least in the EEA countries – the conditions of Article 199 (6)(a) and b) of the CRR with regard to criteria for liquid markets and well-established, publicly available market prices are deemed to be satisfied for various types of physical collateral such as motor vehicles, ships or aircraft. This would be important in this	The collateral eligibility requirements disadvantage credit institutions that have only implemented the credit risk standardised approach and hence do not satisfy the IRB criteria for recognition of credit risk mitigation under the CRR. They also disadvantage credit institutions at which collateral other than real estate and financial collateral plays a major role.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					respect because the EBA has decided not to disclose a list of types of physical collateral in accordance with Article 199(8) of the CRR for which institutions can assume that the conditions referred to in Article 199(6)(a) and (b) of the CRR are met. Corresponding clarification is urgently required in order to give the institutions – and in particular SA institutions – the necessary legal certainty for calculating the prudential backstop provisions. This applies in particular in the event that the ECB sticks to its view that – regardless of the CRR credit risk approach applied – only physical collateral that satisfies the IRB requirements in the CRR for eligibility of credit risk mitigation may be used for the purpose of calculating the prudential provisioning backstop.	
12	4. Prudential provisioning backstop	4.1	11	Amendment	In the case of unsecured positions, the capital deduction takes full effect from year 2 of the default and encourages the faster reduction of the NPL exposure. As a rule, however, this is not sufficient to restructure an NPL, especially a corporate loan, und creates incentives to outsource problem loans, e.g. to unregulated funds. We therefore suggest reviewing the arbitrary two-year period for unsecured positions. A distinction by client classes should also be made. Alternatively, the comply-or-explain approach should be clarified, i.e. corresponding aspects to justify deviations from the one-size-fits all approach should be specified.	The undifferentiated two-year vintage for all unsecured NPE is too restrictive.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
13	4 – Prudential provisioning backstop	4.2	12	Amendment	Because realising collateral mostly takes quite some time, the banks would already have to “set aside” 1/7 in the first year for almost all secured loan components, which conflicts with the IFRS accounting rules. We think that a lower collateral valuation and thus higher risk provisioning is not justified because normal realisation periods are involved here. If a gradual increase of the provision is deemed to be necessary, we believe it would be appropriate to take account of a normal realisation period and only to start building up the backstop after that period. Practical experience shows that a period of seven years is too short to build up a 100% backstop, for example in the case of public guarantees realisation can only start once the insolvency proceedings have been completed. The objective to avoid a wait-and-see-approach in the provisioning practice is understandable. But this aim will not be reached by the linear provisioning approach. Regarding the principle of proportionality a “suitable gradual provisioning” would be preferable, because it is targeted in the same way and in addition is stronger reflecting the individual risk case-by-case.	It is not possible to state on the basis of a merely one-year realisation period whether the collateral has lost value or whether a wait-and-see approach (to be penalised) is necessary. The one-size-fits-all treatment of secured positions over a seven-year period also runs counter to practical and business experience. Ultimately, it can lead to excessively restrictive capital deductions and also punishes banks with appropriate NPL management.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					Regardless of the reservations about the approach in general, we wish to note that the sort of progressive approach that is currently being offered up for discussion as an alternative by the European Commission is more likely to fit with the intention of penalising wait-and-see approaches. In this case too, however, we think that spreading over a longer period is appropriate, and that 100% backstops will then only be applied in the most problematic cases. As also suggested by the Commission, a haircut approach to measuring collateral if it has to be realised should be considered as an alternative to the (linear) write-down of all secured NPLs over a vintage of seven or more years. Because of its more economically driven basis and the differentiated consideration of the type of collateral, this methodology is definitely preferable to a one-size-fits-all approach.	
14	4 – Prudential provisioning backstop	4.2	12	Amendment	The application of the vintage is too undifferentiated. For example, progress in NPL work-outs should be taken into consideration, and rewarded in the calculation of the vintages through resets or prolongation. Examples of eligible progress could be certain milestones in the recovery and resolution of NPLs, such as (partial) realisation of collateral, cash recoveries or restructurings.	Only the wait-and-see approach should be penalised. A strict NPL process also takes some time and should not lead to penalties in the shape of supervisory measures.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					We appreciate that there are banks in Europe with very high NPL levels and that are presumably the primary addressees of the ECB's requirements. As already described, however, those requirements also impact banks with low levels of NPLs that have done their homework. To exclude these banks, we urge introducing input filters/criteria so that the ECB's requirements only kick in when they are reached or exceeded. An example of such a criterion could be when a bank repeatedly exceeds a specified average NPL ratio. This would also ensure that banks with high levels of NPLs – for which the ECB's proposed addendum to the NPL guidance are evidently solely designed – would have to apply the proposed addendum, while banks with low levels of NPLs would not, thereby reducing at least their process-related effort.	
15	5 – Related supervisory reporting and public disclosure	5	13	Amendment	With regard to the proposed templates to be submitted to the ECB, we wish to note that a sufficiently long lead time will be needed for the IT implementation. A corresponding reporting obligation should not therefore take effect before 2019. This would also allow the coordinated implementation of the extended disclosure requirements expected by the ECB, which are supposed to be implemented by the end of 2018 and disclosed for the first time in 2019 in the 2018 disclosure report. Moreover, the templates already to be submitted in	A lack of transition periods leads to disproportionately high implementation effort and expense in light of the achievable benefits.

Comments – Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board
					2018 would not be very meaningful because there are supposed to be provisions for new NPLs for at least one year to allow an assessment as to whether the institution in question recognises sufficient provisions for new NPLs.	