EAPB Comments on the Commission Proposal for a Regulation amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures

(May 2018)

General comments

In general, EAPB supports the intention of the "Action Plan" to reduce non-performing loans (NPLs). In order to ensure stability in the banking sector and to move towards the completion of the banking union, a reduction of NPLs seems necessary. Therefore, ensuring that financial institutions make sufficient provisions for loans that are non-performing is of importance.

The Commission's proposal of dealing with NPLs then is to create minimum coverage levels for newly originated loans that become non-performing. These will act as a statutory prudential backstop. For the EAPB however, the creation of a minimum level that is fixed for all institutions, independent of risk and independent of the amount of NPLs seems excessive.
Such a measure would specifically disadvantage promotional banks, ignore the current working practices for dealing with NPLs, increase the administrative burden and potentially damage the bank's relationships with its clients. Furthermore, the proposed measures are not based on international standards, which is why they would result in an unlevel playing field.

Comments on policy rationale

For the EAPB, one of the main fundamental points leveraged against the minimum coverage levels is their imprecise nature.Current models for provisioning are based on creditworthiness and collateral, expectations regarding their future development, and the strategy a bank wishes to follow.
However, this approach does not seem to use empricial values and future expectations as the basis of loss estimations. Instead, it seems to build a seperate concept for regulatory purposes. It thereby invalidates banks' own strategies for dealing with existing risks through loan-loss provisions. It also overwrites the work done in the the guidelines and guidance issued by the ECB and the EBA, and ignores that some national regulatory and accounting provisions already provide sufficient requirements.
EAPB is also critical towards the fact that the requirements shall apply to all credit institutions, irrespective of their business model and the concrete risk and collateral structure associated with it, without the possibility of taking special circumstances into account (e.g. by expressly excluding certain valuable collateral) or at least by way of a "comply or explain".

Additionally, the creation of a backstop would impact the banks' relationships with their customers by changing the incentives. Dealing with problem loans would be less focused on consensual arrangement with borrowers, and more on selling of problem loans to specialised credit purchasers. The envisaged further development of secondary markets would only incentivise this further. The EAPB-member feel uneasy about changing the way in which they interact with their clients. Moreover, they fail to see how pushing for the sale of NPLs to unregulated market participants, who would then be in charge of collecting the acquired receivables, would benefit consumers.

Finally, the administrative burden of such a minimum coverage level would be quite significant. Initially, there are implementations costs to replace the current systems, and in the medium term, the system would lead to more capital deductions which are difficult to comprehend and to calculate.

Instead of minimum coverage requirements, the EAPB thinks that the following steps are necessary to ensure sufficient loss coverage for NPLs:

- Clear and harmonized risk management rules for identifying and managing problem loans at Pillar 2.
- Adherence to existing accounting rules for the creation of value adjustments (including stringent annual audit). As there are doubts as to compliance with the accounting rules for the creation of sufficient value adjustments in some Member States, this problem should be addressed more directly. A minimum coverage level is no substitue as it would make the situation more complicated by adding extra rules.
- Supervision of compliance with the above rules by the supervisory authorities under the SREP. Assesing whether risk management is appropriate and setting supervisory expectations is part of the SREP. This forms the basis for discussions with banks and works on the basis of the comply-or-explain principle. This appproach is more effective than the blanket approach of the minimum loss coverage levels.

A harmonized set of rules for identifying and managing NPLs, followed by strict adherence to these rules and an evalation in the SREP whould then be the main pillars of tackling NPLs.

Should the co-legislators deem the creation of the mimimum coverage levels absolutely necessary, the EAPB would propose to set a treshhold that can trigger this pillar 1 action, so as to decrease the regulatory burden on institutions with a very low NPL-stock. As already put up for consultation by the EBA as part of its guidelines, a threshold for the selection of relevant banks could be set on the basis of an NPL-quota. Further, currently used size criteria in prudential regulation or the relation between the absolute amount of NPLs and the respective GDP could be used in this context.

Comments on proposal details

Commenting on the details of the legislative propose, the EAPB would like to also point out some elements that it believes could be improved.

The proposed definition of secured and unsecured NPEs for example should be further clarified. While the EBA accepts all collateral in its guidelines, this proposal allows only collateral where the CRR-criteria for risk mitigation collateral apply to fall into the category of a secured loan. As a minimum requirement it has to be the common understanding that defining a secured loan is independent of the usage of a collateral for risk mitigation purposes e.g. calculating the capital ratios, but it is solely based on meeting the CRR-criteria. Further, the general approach that collateral is not considered recoverable after 8 years at the latest and therefore cannot be realised or can no longer be realised in full, does not correspond to reality for various types of collateral, such as state guarantees for export credit financing. Therefore, more flexibility regarding the time periods would be welcomed.

EAPB is also critical concerning the short period of 2 years within which full coverage with risk provision for unsecured exposures is required. After 2 years it is not always clear whether remediation measures will be successful. A requirement for complete risk provisioning could therefore ultimately have a procyclical effect, since the two-year period does not allow a sufficient consideration of the restructuring perspective and banks are forced into liquidation prematurely (e.g. by a quick sale). We therefore consider it desirable to extend the 2-year period by at least one year.

Furthermore, it is problematic that NPLs issued up to 14 March 2018 fall within the scope of the rules, since their application requires a reasonable implementation time for IT systems. The Commission proposal also does not provide for a transposition period. Since the specific requirements are still subject to changes in the legislative process, the EAPB estamates that banks would need at least 18 months after the entry into force of the amending Regulation on the CRR. Moreover, for loans that according to IFRS 9 are measured at fair value no risk provisions can be made, creating a troublesome interaction with the proposed legislation. The loans measured at fair value should then be exempted from the

scheme. Alternatively, there should be a proper consideration of fair value adjustments, e.g. as specific credit risk adjustments.

Finally, the EAPB would suggest that the scope of issuance of NPLs is changed from 14 march 2018 to 1 January 2019. Moreover, the initial application date of the proposal should not be before 1 January 2021, giving institutions enough time to adapt. This would also lead to a harmonization with first date of application of the ECB's Guidance.

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