EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Template for comments

Public consultation on the draft addendum to the ECB guidance to banks on non-performing lo

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General comments

Template for comments

Public consultation on the draft addendum to the ECB guidance to banks on non-performing loans

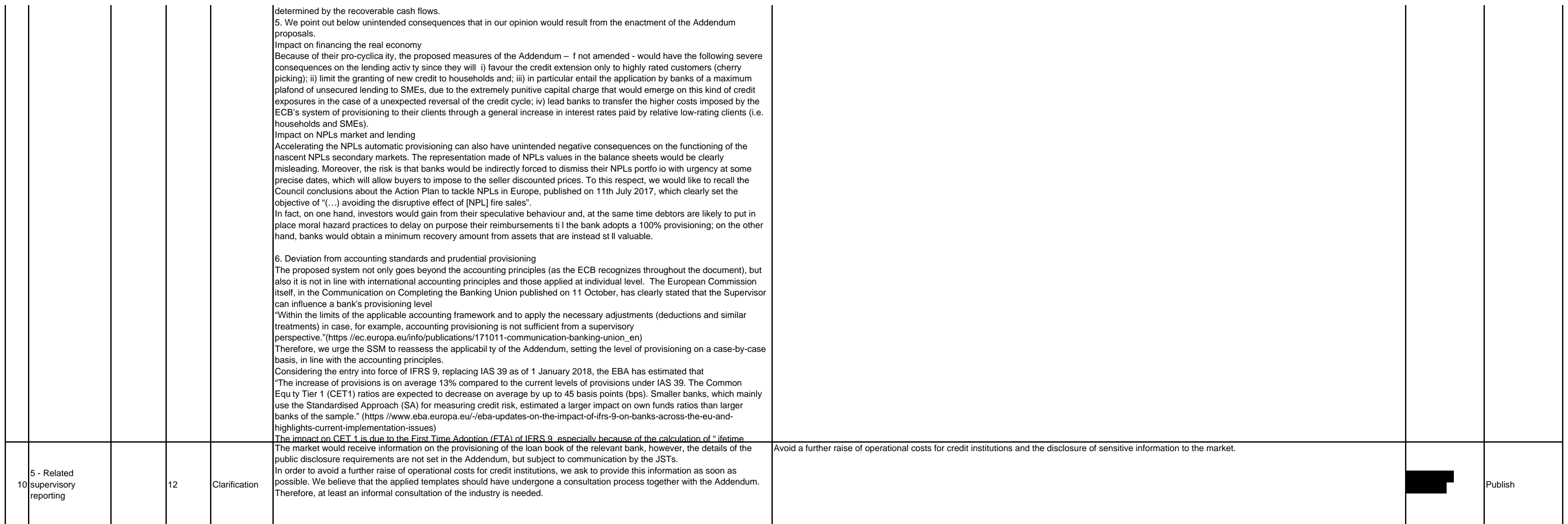
Please enter all your feedback in this list.
When entering feedback, please make sure that:
- **each comment deals with a single issue only;**
- **you indicate the relevant article/chapter/paragraph, where appropriate;**
- **you indicate whether your comment is a proposed amendment, clarification or deletion.**

Deadline:	8 December 2017

ID	Chapter	Paragraph	Page	Type of comment	Detailed comment	Concise statement as to why your comment should be taken on board	Name of commenter	Personal data
1	1 - Background		2	Amendment	1.The ECB had recently published the Guidance on NPLs management (March 2017), introducing a number of organisational measures. It is worth considering that the JSTs are st ll assessing banks' comp iance with the Guidance and their NPLs disposal plans, wh le whether they are sufficient and successful will be assessed in the near future. Therefore, we do not see the urgency of adding new measures, while banks are still putting in place their new organisational structures and operational procedures. 2. Banks have already undertaken important measures to reduce NPLs and good results have been achieved (currently NPLs at EU level are well below the € 1tn threshold), whilst new cred t to the real economy has finally re-started. In particular, Italian banks in 2017 have deconsolidated so far a total amount of € 65bn of NPLs. Taking into account also the planned transactions, that amount would raise to €100bn, i.e. 30% of total NPLs. 3.The Addendum proposes automatic provisioning on NPLs. The ECB justifies the new requirements by stating that they "serve to strengthen the balance sheet of banks enabling them to (re)focus on their core business, most notably lending to the economy". We do not share this reading of the NPLs' issue, as no robust statistical evidence supports this theory. As a matter of fact, we are convinced that the measures – if applied as proposed in the Addendum – would lead to a significant decrease in the amount of lending (especially unsecured lending to SMEs). In fact, a paper published in March 2017 by the Bank of Italy (http //www.bancaditalia.it/pubblicazioni/qef/2017-0374/QEF_374.pdf) presents a study on the influence of non-performing loans (NPLs) on the supply of bank cred t to non-financial firms in Italy between 2008 and 2015, based also on the 2014 Asset Quality Review (AQR) results. The main findings contradict the ECB's theory, showing that there is a negative correlation between the NPLs ratios and credit growth. According to the study, banks' lending behaviour is instead affected by macro-economic conditions affecting firms' demand for credit and driven by other firm-related factors. Moreover, there is evidence that variations in the NPL ratios as in the 8 years' time window analysed were largely driven by cyc ical phenomena rather than by bank-specific shocks. 4. Fina ly, the ECB has announced that by the end of the first quarter of 2018 it will present its consideration of further policies to address the existing stock of NPLs, including appropriate transitional arrangements. We strongly disagree with the SSM approach, since reference to future measures on existing stocks is causing uncertainty in the market, as w tnessed by the strong volatil ty on banks' stock prices after the pub ication of the Consultation Paper.	1. We welcome the European Inst tutions' comm tment in reducing risks and developing more integrated financial markets w th the objective of completing the Banking Union and enhancing the EU economic recovery. However, we believe that it would be wise to wait for the assessments of the application of the NPLs Guidelines and the impact assessment carried on by other EU institutions (e.g. EBA) on NPLs provisioning. Therefore the release of the Addendum should be put on hold. 2. Moreover, despite the average weighted NPL ratio in the EU remains high by historical standards, material improvements can be seen compared to the past. The burdensome legacy of the NPLs is only one of the risks still affecting the stab lity of the EU financial system. There are a number of other "legacies" originated through the crisis that sti l affect many banks and that make the financial system more vulnerable to a potential future crisis. Among those legacies t is worth mentioning - level 3 assets that several banks in the Euro area still have on their balance sheets in a significant amount; - matched books of derivatives that are not cleared through central clearing counterparties and therefore expose banks to significant counterparty risk in the case of very high volatil ty of the markets; - repossessed assets, that banks in some jurisdictions have obtained in the process of managing their NPLs; - business lines developed before the crisis that generate excessive leverage on some banks balance sheets. It is remarkable that while several measures have been successfully put in place to tackle the stock of NPLs and to prevent the build-up of new NPLs on banks' balance sheets, the above "legacies" are far from entering in the policy makers' discussions. 3. In answering point 4.2 here below we wi l raise a number of unintended consequences that would in our view arise in case of application of the proposed Addendum measures. We also point out in point 4.2 accounting issues and interactions with IFRS9 provisioning. 4. In conclusion please note that in supporting a fruitful dialogue among the European Institutions, we invite the ECB to duly consider stakeholders' views on the Addendum and leave to the co-legislators the task of implementing the Council's Action Plan on NPLs, leaving to the SSM its fundamental micro-prudential supervisory powers. Any reviewed requirement should be set as a bank specific measure, as a consequence of the supervisory dialogue between the SSM and the supervised institution. We therefore urge a complete rethinking of the proposed measures, in particular 1) the use of Pillar 1 tools (i.e. deductions from CET1 based on Art.3 of the CRR) should be eliminated, as ECB's expectations can be satisfied only by Pillar 2 instruments. As stated by the Commission, the SSM can impose a deduction from cap tal or other measures, but only if a bank has not been conservative enough in applying the accounting principle; 2) the macro-prudential approach should be corrected, allowing for more flexible principles of calendar provisioning based on bank-specific elements such as bank's d fferent country of establishment, business model and credit portfolio. The length of the legislative processes cannot be excluded as a factor of differentiation. In addition, we stress the need of applying any measure to the new credits granted as of the date of application of any new piece of regulation or Guidance.		Publish
2	2 - General Concept	2.1	3	Amendment	1. The application of a very generic rule to a l banks, without any differentiation based on the country of estab ishment, business model or bank's specific portfolios, amounts de-facto to a macro-prudential measure, hence placing the Addendum outside the scope of the micro-prudential supervision. 2. the ECB states that the Addendum is app icable to the NPLs classified as such from January 2018, date of application of the new provisioning measures. While the ECB believes that the new provisions would not be retroactive, de facto the new requirements are affecting that part of end-2017 performing loans, which is ikely to be classified as non-performing at the beginning of 2018. It has been pub icly stated by distinguished members of the ECB Governing Counc l that the Addendum should target new loans. However, if this is the purpose, the text of the Addendum should be modified. In add tion, considering that the Consultation is closing at the end of 2017 and the Addendum is expected to come into force right after its publication, banks would have a im ted range of poss ble urgent actions to put in place in order to m tigate the impact, as no phase-in is provided. We strongly disagree with such an approach and in this respect we would have expected, for clarity, any new provisioning rule to be applied to new loans, i.e. granted after the date of publication of the Guidance (likely to be after 1 January 2018), in line with the Action Plan on NPLs approved by the July ECOFIN. 3. The proposed measures are addressed to directly supervised credit institutions based within the Euro area. By front-running forthcoming measures currently being considered by the European Commission that would cover the whole EU area, the SSM is fragmenting the Single Market, thus creating an unlevel playing field between Euro area and non-Euro area banks. We do not support such an approach. We would also like to have clarification about the application of the Addendum to banking groups - that have the SSM as a consolidating supervisor - with subsidiaries in jurisdictions outside the Euro area and outside the European Union. 4.The Addendum presents risks of a pronounced pro-cyclical ty. The measure would be in addition to the effects of the entry into force of IFRS9, itself also pro-cyclical. Although, whereas the new accounting standard has the purpose of anticipating the effects of value adjustments on loans in the phase immediately prior to a recession, the Addendum would necess tate a cap tal increase by the banks in case of a significant increase in new flows of NPLs. Furthermore, this need would probably emerge at the deepest point of any crisis (for unsecured loans 2 years after their classification as an NPL). Therefore, an impact assessment on the stabil ty of the European financial system and on the real economy in a scenario of a global European recession should be conducted. Moreover, the possibility of suspending the measure during a recessionary phase should be considered and included in the final document, in order to dampen its pro-cyclical ty. With this proposed amendment, the measure would have on the contrary a function of a counter-cyclical cap tal buffer.	1. The proposed measures are de facto macro-prudential. 2. The Addendum has an unintended retroactive effect, as t covers NPE flows defined as such after 1 January 2018, wh le t should be applied to newly originated loans instead of to new NPEs, in order to be in ine w th the Counc l's Action Plan. 3. The application of the provisioning within a banking group is not clear and might create an unlevel playing field. 4. We stress the risk of a pronounced pro-cyc icality stemming from the proposed measures.		Publish

3	2 - General Concept	2.2	3	Clarification	1. The European Parliament, the Council and other stakeholders have questioned the ECB power to issue the proposed prudential provisioning backstop. We believe that if the co-legislators have felt the urgency of publicly stating that their prerogatives should be preserved (http //www.po itico.eu/wp-content/uploads/2017/10/Letter-to-President-Draghi.pdf?utm_source POLITICO.EU&utm_campaign 2ba4af77f0-EMAIL_CAMPAIGN_2017_10_10&utm_medium email&utm_term 0_10959edeb5-2ba4af77f0-189768153) and have requested to investigate whether the new ECB requirements fall within the SSM prerogatives, any measure, which may conflict with the Capital Requirements Regulation (CRR) or modify it, has to be approved by the European co-legislators and not being adopted by the Supervisor. In fact, according to the Opinions of the European Parliament's and Council Legal Services, the current drafting of the Addendum set up binding rules of general scope for all banks, which do not fall among the competences of the SSM. Moreover, banks in order to satisfy supervisory expectations, are required to go beyond the current applicable framework (e.g. by the compulsory use of Art.3 of the CRR, which instead is an option for banks). The ECB in tiative is blurring the lines between Pillar 1 and Pillar 2 measures, with the result of overlapping and front running some of the options already contained in the FSC report published in May 2017. The wording of the FSC report (31 May 2017) is itself proving the ECB's front running. In fact, the report explores a series of policy options that may be put forward by the European Institutions to tackle NPLs, specifying that the SSM is in charge of setting micro-prudential measures, asking for Pillar 2 adjustments. Any macro-prudential power to be granted in the future to the SSM (e.g. specific provisioning quantitative targets) would be subject to amendments to Art.104 of the CRD IV, i.e. by a Level 1 legislative procedure. It is notable that the CRD IV revision is ongoing and no amendment has been tabled so far with this regard. Moreover, the FSC report includes the possibility of providing banking Supervisors with accounting supervisory powers, but it also specifies that i) this approach would entail a radical change in the current European framework; ii) the supplementary powers would be subject to a specific mandate; iii) this approach is not recommended at this stage. 2. The Addendum is also front running, without any coordination with the other European Institutions and taking into account policy measures already in the pipeline at EU level. Upon request of the ECOFIN, the Commission has launched on 10 November a consultation on Statutory Prudential Backstops on NPLs, while the ECB Addendum aims at adopting similar requirements as of 1 January 2018, with a high risk of overlapping requirements and uncertainty in provisioning po icies. Concerning the 1 January 2018 date foreseen by the SSM, we understand from the public hearing that such date may be reconsidered and we support this approach. 3. It should be clar fied that the Addendum should not introduce standard requirements to be applied to all banks, as there is evidence that better resu ts on NPLs' recovery and disposal may be achieved when measures are applied on a bank-specific basis, taking into account also the national characteristics of the market, the real granular ty of banks' portfolios, the collateralisation levels and exogenous factors such as the length of judicial procedures. 4. The Addendum adopts the "comply-or-explain" approach, i.e. any derogation from the provisioning measures set by the ECB should be explained by the relevant bank. Any decision for not applying the automatic thresholds (which may lead to important balance sheet adjustments and impact both income and dividends) should be taken by banks' boards, instead of being the responsibi ity of the supervisor evaluating the risk provisioning policy of the supervised bank, within the SREP process at the end of which cap tal add-ons in the Pillar 2 can be required f t is deemed that risks are not adequately provisioned. 5. By introducing a de facto binding obligation on banks, that goes beyond what is being provided by the CRR, we respectfully believe that the ECB has overstepped the remit of its powers and entered into the co-legislators' one.	1. The Legal Service of the European Parliament and of the Council of the EU have finalised legal opinions concluding that the requirements set in the Addendum go beyond the supervisory powers conferred to the ECB by the European regulatory framework. We share the co-legislators' concerns. 2. We understand that some concerns that have been raised by MEPs during the hearing at the EP will be considered by the SSM, notably the possible delay of the entry into force of the Addendum and the clar fication that the requirements set in the Addendum are Pillar 2 measures. 3. We invite the SSM to launch a new consultation on the amended Addendum, according to the better regulation principles, that should also take into account the European Commission's proposed approach of the Statutory Prudential Backstops, in order to avoid regulatory confusion. Any uncertainty or inconsistency stemming from the d fferent proposals should in principle be avoided, as well as any inter-institutional conf ict. 4. We also understand the SSM has publicly acknowledged that a comply-or-explain approach may not be the right instrument to address such an issue. Please consider that any "dialogue" with the JSTs, once those high standardised supervisory expectations of full provisioning after the 2/7 years period would be set, wi l result de facto in a comply-or-explain approach, without changing the substance of the proposal.		Publish
4	2 - General Concept	2.3	4	Amendment	1. We disagree with the automatic application of a prudential provisioning backstop after a predetermined period of time has elapsed. In our view, the assessment by the supervisor of the adequate provisioning against risks should remain part of the SREP and any request to increase the coverage of risks should fall within the Pillar 2 rem t and within the limits of the applicable accounting standards. 2. Adequate consideration of the execution of the NPL reduction plans – subm tted and approved by the supervisor - should also be paid. Some banks are in fact in the process of modifying their internal plans and organisational structures according to the ECB Guidelines of March 2017. 3. The proposed automatic backstop is a raw measure that fails to consider the NPLs reduction measures undertaken by banks. For instance, according to a study conducted by Bank of Italy (http //www.bancaditalia.it/pubblicazioni/note-stabilita/2017-0007/en_Note_di_stabilita_finanziaria_e_vigilanza_N._7.PDF?language_id 1), recovery rates for bad loans differ from bank to bank and recoveries for positions closed following standard work-out procedures are significantly higher than those recorded for positions sold. This evidence allows for concluding that a bank specific approach is the most efficient and managing bad loans internally (or through specia ised external servicers), would lead to better recovery results according to the Guidelines already published by the ECB. 4. We also underline that as from next year the ECB w ll have further instruments to monitor the level of provisioning, for instance the Anacredit database will be available to the ECB as of the 30 June 2018. Given that Anacredit will provide the Supervisor with information not only by client but also by credit exposure, the benchmarking of provisions would be an easier exercise. As a consequence, under its Pillar 2 powers, the ECB would address effectively unsatisfactory provisioning cases, without the need of any Pi lar 1 measures. 5. On the calculation of the extra provisioning, the reference made by ECB to the application of the Art.3 of the CRR for calculating banks' supply of provisioning is not clear. In fact, according to the Addendum it seems that the application of Art.3 CRR would be mandatory, while in the FAQ is presented as "alternative", but still imposed by the ECB. Both the interpretations appear to be deviations from the CRR, which accords to banks the option to strengthen their own funds on the basis of their own assessment. This would transform this option in a Pillar 1 requirement set by the ECB, which is not the Competent Authority to do that, as it can only set Pillar 2 add-ons. 6. Moreover, banks using IRB models – in particular Expected loss best estimates (ELBE) for the defau ted exposure in accordance with Article 181(1)(h) of the CRR– would be penalized by a double counting on NPLs, in terms of capital requirements, as defau ted assets are already considered in the RWA calculation. More specifica ly, it should be made clear that any request of deduction from own funds according to Article 3 CRR to fulfill the backstop proposed in the Addendum should also consider the negative amounts resulting from the	1. Automatic and standardised levels of provisioning to be applied to all institutions (i.e. not considering e ther the specificity of each loan and collateral, or the reference market or the jurisdiction) do not take into account the functioning of the recovery process, which often goes beyond the 2/7-years period foreseen by ECB. 2. The proposed measures do not seem to take into account the IRB models. 3. Tax consequences should also be carefully evaluated.		Publish

					calculation of expected loss laid down in Articles 158 and 159 CRR ("regulatory expected loss shortfall") and the capital requirement deriving from RWA calculations for defaulted exposures. Should this not be the case, there would be a double impact on CET 1 deductions resulting from the same NPE. 7. Fina ly, we believe that t should be taken into account that banks obtain a fiscal deduction from the taxable income, while banks applying Art. 3 of the CRR for their deduction do not. Therefore, a mechanism that would ensure the same tax treatment of provisions calculated for accounting purposes should be introduced to avoid further impact on banks' own funds and maintain the level playing field. Without the above adjustment, if it is required to fill the provisioning gap with a 100% bank supply with a deduction from CET 1, without any tax benefit, the final impact on CET 1 would exceed that obtained from the adoption of 100% provisions in the profit and loss. As a result, a differential treatment would be applied to banks that cannot register sufficient accounting provisions versus those that do not have this limitation. In add tion, the national tax authorities, whenever stating that the compulsory provisions may differ from the actual loss estimates according to banks' assessment, could advocate the right to challenge any such tax deduction.			
5	3 - Definitions	3.1	7	Amendment	1. The Addendum makes reference to pos tions to be classified as non performing from 1 January 2018. This does not seem consistent with the ECOFIN Action Plan on NPLs, which specified provisioning on "new loans". 2. According to the ECB, the classification of NPEs adopted in the Addendum is aligned with the EBA's defin tion of NPLs (EBA ITS/2013/03) and app ies the same treatment to positions classified as "unlikely to pay" (UTP) and "past due". Firstly, it has not been assessed whether it is appropriate to apply the same treatment to unlikely to pay and past due, especially because, as it is, the ECB's proposed treatment could prevent the re-financing of UTP under restructuring. In particular, when credits are st ll considered past due and UTP (instead of bad loans) a 2 years' time set for the full provisioning for unsecured credits seems not reasonable as during this period, even though the bank puts in place its internal procedures for obtaining reimbursement, it is only the start of a judicial action that will allow the bank to correctly evaluate the possible recovery amount and consequent provisioning. Secondly, the inclusion of the forborne classification does not seem appropriate, as it contradicts the horizontal nature and flexibil ty of that definition, making it difficult to manage probation periods and reclassifications from forborne non-performing to performing. We highly recommend excluding forborne from the NPEs classification under the scope of the Addendum.	1. The ECB should not deviate from the path set by the ECOFIN Action Plan on NPLs. 2. Desp te ECB applies the EBA's definition of NPEs, within the NPEs classification, there are a number of sub-categories (past due, UTP, forborne), which might need a differentiated treatment and not a one-size-fits-all approach.		Publish
6	3 - Definitions	3.2	7	Amendment	We believe that if collateral is provided, it should have a value even after the elapse of 6/8 years. Therefore, also considering a regular appraisal of collateral overtime, we do not deem correct to treat such exposures as unsecured. For unsecured loans cash flows from on-going operations of debtors in default should also be considered	The repossession of the collateral should not be the only parameter considered.		Publish
7	3 - Definitions	3.3	8	Amendment	1. The proposal to cluster NPLs into two groups, secured and unsecured loans, is ill-conceived. This rough separation is not sufficiently granular to reflect the variation in recovery rates due to a number of factors, among them, the structure of banks' portfolios and different types of collateral. 2. For instance, in the secured cluster, mortgage loans could be distinguished into residential and commercial loans, where among the latter it would be advisable to have a d fferent approach for commercial and industrial real estate. In the unsecured cluster, it would be advisable to provide a different approach for different types of loans, such as to SMEs and consumer credit. 3. After an accurate assessment of European lending markets, any backstop to be introduced should be a function of the recovery curve of each asset class and geographical region.	The proposed separation in two clusters is not sufficiently granular to reflect the variation in recovery rates due to a number of factors, among them, the structure of banks' portfolios and collateral.		Publish
8	4 - Prudential provisioning backstop	4.1	10	Clarification	1. We do not share the ECB's view that "if collateral has not been realised after a period of several years [...] is deemed to be ineffective" (par.4 pag.10), as recoverabil ty is linked to the value of the secured assets and/or of the obligor's enforceable assets. In particular, for secured assets, the length of judicial proceedings does not imply that the collateral will necessarily loose its value over time. Moreover, the recovery time would only affect the Net Present Value of the loans also in line with the accounting principles. 2. Clarification is sought on the functioning of the blended approach proposed by the ECB for partially secured exposures. 3. Fina ly we would l ke to point out that the Addendum explicitly excludes foreclosed assets from its scope. Therefore, it must be made clear that, when introducing new rules on the treatment of NPLs, EU inst tutions should ensure a level playing field and avoid asymmetrical treatments of financial institutions of different countries for such collateral.	1. The Addendum lacks technical details for each cluster, but most of all, may lead to d fferent treatment of sim lar assets. 2. In recent years, the consideration of foreclosed assets within the remit of NPLs reduction in Europe has been to some extent different, undermining the level playing field.		Publish
9	4 - Prudential provisioning backstop	4.2	10	Amendment	1. The ECB does not provide any detailed information on how the calendar and calibration for the backstop have been set (100% provisioning; 2/7-years), which, above all, penalise the granting of unsecured loans (mainly granted to SMEs), limiting banks' core business. We question both the high level of provisioning chosen, the application of the same level to all banks and the time window adopted. The Addendum provisioning would increase volat lity of banks' resu ts and pro-cyclical ty effects (by a severe provisioning up to 100% during the low part of the cycle and subsequently obtaining capital gains in the recovery period). According to the relevant literature, there is no evidence that unsecured and secured exposures are, respectively not recoverable after such time has elapsed. In order to set a sound and prudent provisioning, the recoverable value of collateral and foreclosable assets should be taken into account. For instance, Bank of Italy's statistics (https //www.bancaditalia.it/pubblicazioni/note-stabilita/2017-0007/en_Note_di_stabilita_finanziaria_e_vigilanza_N._7.PDF?language_id 1) show that the average recovery on unsecured loans in Italy is 29% and on secured loans 45% a 100% compulsory provisioning is therefore non evidence-based, thus inadequate. A null recovery is too much conservative. Even in the case of NPL sales, a number of market transactions have been registered in the recent past and in all cases the value of portfolios of secured credits resulted significantly higher to the zero proposed in the Addendum, with minimum values of 20 cents. Even in the case of unsecured portfolios the sale value resulted higher than zero by a few percentage points with values reaching as high as 10-15% on some portfolios. 2. We do not support the decision of excluding the length of legal proceedings in setting the calendar approach, as banks should not be made accountable for the length of judicial proceedings, on which banks have no grip. Some Member states are currently addressing such problems and the benefit of the reforms adopted will be deployed in the short future. Paradoxically, if the length of judicial proceedings is deemed an irrelevant element for the Supervisor, national legislators could lose interest in such reforms and abandon all the efforts for the adoption and implementation of the necessary measures to shorten the legal procedures. 3. Should the calendar approach not be revised, at least, derogations from the application of automatic provisioning should be provided by the ECB following the advice of National Competent Authorities (NCAs), whenever any objective analysis undergone by them will provide evidence that the deadlines of 2/7 years are not appropriate considering that those NPLs can be recovered with a shorter or longer time set. 4. Furthermore, it should be underlined that the empirical evidence observed in the internal models for Loss Given Default (LGD) which are validated by the Supervisory Authorities, is significantly different from the parameters proposed in the Addendum. In particular, it is best practice to define an incomplete workout, that is the period beyond which for the purposes of LGD the pos tions are considered closed and so included in the determination of the RWA of credit risk, even when the legal process in st ll underway. The defin tion of such a cut-off is	1. The ECB does not provide any details on the procedure followed for setting the 2/7 years calendar period. An automatic calendar provisioning would clearly communicate to the market when banks are supposed to dismiss their NPLs portfolios and an estimation of their value on the balance sheet. Because of the required public disclosure by vintage of NPLs, investors and borrowers will be aware of the bank's provisioning strategy and situation. This will lead to distortions in the market, as the number of NPL disposals w ll presumably increase close to the deadline for the 100% provisioning (after 2 and 7 years respectively). The excess of prudential measures will raise market asymmetries, allowing buyers to set a discounted price, as they wi l be aware of when banks need to dismiss the NPL portfolio. Moreover, t is likely that such provisions would also induce debtors to adopt delaying behaviours which would provide them with more negotiating power toward banks. 2. Negative unwanted consequences would in our opinion materialise in case of enactment of an automatic calendar provisioning It would also imply capital transfer from banks – that are used to finance economic growth – to private equity funds (i.e. highly speculative investors). Such an approach would not only have a negative impact on growth, but could also be instrumentally used by political movements that are against the EU and the current establishment. As a consequence, banks w ll reduce their risk appetite, selecting carefully the borrowers, and worsen the conditions offered to customers, applying for instance higher interest rates in order to cover higher costs of provisioning. Higher interest rates affect recovery rates and may ultimately lead to a new raise in NPLs stocks. 3. As it has also been recognised by the ECB, the draft document might require deviations from the accounting system adopted, also considering the newly entry into force of IFRS 9 and the non-harmonisation of individual accounting principles adopted at individual level in different jurisdictions. However, the ECB itself, in Par.1 of the Addendum, notes that the existing accounting system should be respected in applying the provisions contained in the Addendum. This approach is contradictory and creates confusion. In particular, banks' balance sheets would contain information on provisioning practices that would be – in many cases – not consistent with the real expected collections. Finally, should the ECB approach not be revised, all accounting accuracy on recovery expectations w ll be disregarded and misleading representations would be given to the market on the value of the bank loan portfolios.		Publish



					determined by the recoverable cash flows. 5. We point out below unintended consequences that in our opinion would result from the enactment of the Addendum proposals. Impact on financing the real economy Because of their pro-cyclica ity, the proposed measures of the Addendum – f not amended - would have the following severe consequences on the lending activ ty since they will i) favour the credit extension only to highly rated customers (cherry picking); ii) limit the granting of new credit to households and; iii) in particular entail the application by banks of a maximum plafond of unsecured lending to SMEs, due to the extremely punitive capital charge that would emerge on this kind of credit exposures in the case of a unexpected reversal of the credit cycle; iv) lead banks to transfer the higher costs imposed by the ECB's system of provisioning to their clients through a general increase in interest rates paid by relative low-rating clients (i.e. households and SMEs). Impact on NPLs market and lending Accelerating the NPLs automatic provisioning can also have unintended negative consequences on the functioning of the nascent NPLs secondary markets. The representation made of NPLs values in the balance sheets would be clearly misleading. Moreover, the risk is that banks would be indirectly forced to dismiss their NPLs portfo io with urgency at some precise dates, which will allow buyers to impose to the seller discounted prices. To this respect, we would like to recall the Council conclusions about the Action Plan to tackle NPLs in Europe, published on 11th July 2017, which clearly set the objective of "(…) avoiding the disruptive effect of [NPL] fire sales". In fact, on one hand, investors would gain from their speculative behaviour and, at the same time debtors are likely to put in place moral hazard practices to delay on purpose their reimbursements ti l the bank adopts a 100% provisioning; on the other hand, banks would obtain a minimum recovery amount from assets that are instead st ll valuable. 6. Deviation from accounting standards and prudential provisioning The proposed system not only goes beyond the accounting principles (as the ECB recognizes throughout the document), but also it is not in line with international accounting principles and those applied at individual level. The European Commission itself, in the Communication on Completing the Banking Union published on 11 October, has clearly stated that the Supervisor can influence a bank's provisioning level "Within the limits of the applicable accounting framework and to apply the necessary adjustments (deductions and similar treatments) in case, for example, accounting provisioning is not sufficient from a supervisory perspective."(https //ec.europa.eu/info/publications/171011-communication-banking-union_en) Therefore, we urge the SSM to reassess the applicabil ty of the Addendum, setting the level of provisioning on a case-by-case basis, in line with the accounting principles. Considering the entry into force of IFRS 9, replacing IAS 39 as of 1 January 2018, the EBA has estimated that "The increase of provisions is on average 13% compared to the current levels of provisions under IAS 39. The Common Equ ty Tier 1 (CET1) ratios are expected to decrease on average by up to 45 basis points (bps). Smaller banks, which mainly use the Standardised Approach (SA) for measuring credit risk, estimated a larger impact on own funds ratios than larger banks of the sample." (https //www.eba.europa.eu/-/eba-updates-on-the-impact-of-ifrs-9-on-banks-across-the-eu-and-highlights-current-implementation-issues) The impact on CET 1 is due to the First Time Adoption (FTA) of IFRS 9 especially because of the calculation of " ifetime			
10	5 - Related supervisory reporting		12	Clarification	The market would receive information on the provisioning of the loan book of the relevant bank, however, the details of the public disclosure requirements are not set in the Addendum, but subject to communication by the JSTs. In order to avoid a further raise of operational costs for credit institutions, we ask to provide this information as soon as possible. We believe that the applied templates should have undergone a consultation process together with the Addendum. Therefore, at least an informal consultation of the industry is needed.	Avoid a further raise of operational costs for credit institutions and the disclosure of sensitive information to the market.	[redacted]	Publish

INTESA SANPAOLO
International and Regulatory Affairs Department

INTESA SANPAOLO Position Paper

ECB Consultation
"Addendum to the ECB Guidance to banks on non-performing loans: prudential provisioning backstop for non-performing exposures"
8 December 2017

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Executive summary

Intesa Sanpaolo believes that, if not amended, the Addendum may lead to unintended consequences that would impact banks' capital ratios, credit supply and lead to market distortions. We have identified a number of issues and, should the ECB decide to push forward its proposal, we make some suggestions of amendments and requests for clarifications, which can be summarised below.

- The European Parliament, the Council and other stakeholders have questioned the ECB power to issue the proposed prudential provisioning backstop. The Legal Service of the European Parliament and of the Council of the EU have issued legal Opinions concluding that the requirements set in the Addendum go beyond the supervisory powers conferred to the ECB by the European regulatory framework. We share the co-legislators' concerns.
- We question the lack of impact assessment accompanying the proposed new rules.
- We observe that the provisions required go beyond the international accounting standards.
- The Addendum seems to front-run some policy options described in the Financial Services Committee (FSC) Report, adopted by the ECOFIN on 11 July 2017, to be implemented in the following years. In particular, the EC has already issued on 10 November a Consultation addressing Statutory Prudential backstops on NPLs. Any uncertainty or inconsistency stemming from the different proposals should in principle be avoided.
- The ECB initiative is blurring the lines between Pillar 1 and Pillar 2 measures, with the result of overlapping and front running some of the options already contained in the FSC report published in May 2017
- The Addendum has an unintended retroactive effect, as it covers NPLs flows defined as such after 1 January 2018, while it should have been applied to loans originated as of 1 January 2018.
- The Addendum introduces standard requirements to be applied to all banks, while there is evidence that better results on NPLs' recovery and disposal may be achieved when measures are applied on a bank-specific basis, taking into account also the national characteristics of the market, the real granularity of banks' portfolios, the collateralisation levels and exogenous factors such as the length of judicial procedures.
- Furthermore, the application of a very generic rule to all banks, without any differentiation based on the country of establishment, business model or bank's specific portfolios, amounts de-facto to a macro-prudential measure, hence placing the Addendum outside the scope of the micro-prudential supervision.
- The description of the "calendar approach" (i.e. full provisioning after 2/7-years) is high level and rough. Apparently, there is no economic rationale behind the chosen time-window.
- The vintage count and the provisioning backstop would provide impediments to the development of a secondary market for NPLs, giving misleading information to the market and putting banks in a competitive disadvantage, when negotiating NPLs portfolio disposals. Moreover, such a predictable provisioning rule may also favour debtors' moral hazard behaviours in delaying the repayment of their loans.
- Due to exogenous factors, such as the low profitability environment and the adverse scenario that the Addendum will set up, banks' credit supply will be heavily hampered. The higher cost of detaining higher level of capital will be transferred to the clients (mainly households and SMEs), under the form of stricter contractual conditions, higher interest rates and debtors' selection based on their ratings only.

In addition, considering the mild recovery trend in the EU and the progress that banks have achieved in tackling NPLs, it is difficult to understand why so much attention is devoted to them by the introduction of

more and more intrusive and radical measures, while so little consideration is given to other "legacies" of the crisis (such as derivatives and level 3 assets in general) that – as a matter of fact – seem to have a higher disruptive potential impact on banks' capital adequacy, in the case of a new unexpected shock.

We understand that some concerns that have been raised by MEPs during the hearing in the EP will be considered by the SSM, notably the possible delay of the entry into force of the Addendum and the clarification that the requirements set in the Addendum are Pillar 2 measures. We invite the SSM to launch a new consultation on the amended Addendum, according to the better regulation principles, that should also take into account the European Commission's proposed approach of the Statutory Prudential Backstops.

General comments

We welcome the European Institutions' commitment in reducing risks and developing more integrated financial markets with the objective of completing the Banking Union and enhancing the EU economic recovery.

The ECB has published on 4th October a consultation on the "Addendum to the ECB Guidance to banks on non-performing loans: prudential provisioning backstop for non-performing exposures" (the "Addendum").

The average weighted NPL ratio in the EU remains high by historical standards. However, the burdensome legacy of the NPLs is only one of the risks still affecting the stability of the EU financial system and material improvements can be seen compared to the past.

There are a number of other "legacies" originated through the crisis that still affect many banks and that make the financial system more vulnerable to a potential future crisis. Among these "legacies" it is worth mentioning:

- level 3 assets that several banks in the Euro area still have on their balance sheets in a significant amount;
- matched books of derivatives that are not cleared through central clearing counterparties and therefore expose banks to significant counterparty risk in the case of very high volatility of the markets;
- repossessed assets, that banks in some jurisdictions have obtained in the process of managing their NPLs;
- business lines developed before the crisis that generate excessive leverage on some banks balance sheets.

It is remarkable that while several measures have been successfully put in place to tackle the stock of NPLs[1] and to prevent the build-up of new NPLs on banks' balance sheets, the above "legacies" are far from entering in the policy makers' discussions.

Further measures to tackle NPLs have been approved by the ECOFIN Council in July 2017. We support the comprehensive approach adopted by the European Institutions on NPLs, in particular the proposal of developing secondary markets for NPLs, also by fostering securitisation transactions.

Banks as well have already undertaken important measures to reduce NPLs and good results have been achieved (currently NPLs at EU level are well below the € 1tn threshold), whilst new credit to the real economy has finally re-started. In particular, Italian banks in 2017 have deconsolidated so far a total amount of € 65bn of NPLs. Taking into account also the planned transactions, that amount would raise to €100bn, i.e. 30% of total NPLs.

[1] Relevant statistics have shown a NPLs ratio in the EU decreasing by 30 bps to 4.5% (Q2 2017) and reaching its lowest level since 4Q2014. (EBA Dashboard, 2Q 2017, 5 October 2017)

Therefore, we strongly believe that further prudential and supervisory requirements should be carefully considered and be set only after a thorough impact assessment, which should consider also the risk reduction measures that are expected to come into force soon.

The Addendum proposes automatic provisioning on NPLs. The ECB justifies the new requirements by stating that they *"serve to strengthen the balance sheet of banks enabling them to (re)focus on their core business, most notably lending to the economy"*. We do not share this reading of the NPLs' issue, as no robust statistical evidence supports this theory. As a matter of fact, we are convinced that the measures – if applied as proposed in the Addendum – would lead to a significant decrease in the amount of lending (especially unsecured lending to SMEs).

In fact, a paper published in March 2017 by the Bank of Italy[2] presents a study on the influence of non-performing loans (NPLs) on the supply of bank credit to non-financial firms in Italy between 2008 and 2015, based also on the 2014 Asset Quality Review (AQR) results. The main findings contradict the ECB's theory, showing that there is a negative correlation between the NPLs ratios and credit growth. According to the study, banks' lending behaviour is instead affected by macro-economic conditions affecting firms' demand for credit and driven by other firm-related factors.

Moreover, there is evidence that variations in the NPL ratios as in the 8 years' time window analysed were largely driven by cyclical phenomena rather than by bank-specific shocks. Bank-related factors that may influence credit supply appear to be capital ratios and bank size rather than NPLs. Any policy measure that would negatively impact capital ratios, such as the forced and rushed liquidation of NPLs, may be counterproductive and may contract new lending to the real economy.

Because of their pro-cyclicality, the proposed measures of the Addendum – if not amended - would have the following severe consequences on the lending activity since they will: i) favour the credit extension only to highly rated customers (cherry picking); ii) limit the granting of new credit to households and; iii) in particular entail the application by banks of a maximum plafond of unsecured lending to SMEs, due to the extremely punitive capital charge that would emerge on this kind of credit exposures in the case of a unexpected reversal of the credit cycle; iv) lead banks to transfer the higher costs imposed by the ECB's system of provisioning to their clients through a general increase in interest rates paid by relative low-rating clients (i.e. households and SMEs).

Accelerating the NPLs automatic provisioning can also have unintended negative consequences on the functioning of the nascent NPLs secondary markets. The representation made of NPLs values in the balance sheets would be clearly misleading. Moreover, the risk is that banks would be indirectly forced to dismiss their NPLs portfolio with urgency at some precise dates, which will allow buyers to impose to the seller discounted prices. To this respect, we would like to recall the Council conclusions about the Action Plan to tackle NPLs in Europe, published on 11th July 2017, which clearly set the objective of "*(…) avoiding the disruptive effect of [NPL] fire sales*".

In fact, on one hand, investors' would gain from their speculative behaviour and, at the same time debtors are likely to put in place moral hazard practices to delay on purpose their reimbursements till the bank adopts a 100% provisioning; on the other hand, banks would obtain a minimum recovery amount from assets that are instead still valuable.

Finally, we would like to point out that the Addendum explicitly excludes foreclosed assets from its scope. In recent years, the consideration of such collateral within the remit of NPLs reduction in Europe has been to some extent different. Therefore, it must be made clear that, when introducing new rules on the

[2] http://www.bancaditalia.it/pubblicazioni/qef/2017-0374/QEF_374.pdf

treatment of NPLs, EU institutions should ensure a level playing field and avoid asymmetrical treatments of financial institutions of different countries.

Part I – Main issues raised by the Addendum

Overlapping of supervisory and legislative powers

The financial services industry and some national and European institutions have questioned the ECB powers to issue the Addendum to the ECB Guidance on NPLs. Such an approach can potentially lead to inter-institutional conflicts.

We believe that if the co-legislators have felt the urgency of publicly stating that their prerogatives should be preserved[3] and have requested to investigate whether the new ECB requirements fall within the SSM prerogatives, any measure, which may conflict with the Capital Requirements Regulation (CRR) or modify it, has to be approved by the European co-legislators and not being adopted by the Supervisor.

In fact, according to the Opinions of the European Parliament's and Council Legal Services, the current drafting of the Addendum set up binding rules of general scope for all banks, which do not fall among the competences of the SSM. Moreover, banks in order to satisfy supervisory expectations, are required to go beyond the current applicable framework (e.g. by the compulsory use of Art.3 of the CRR, which instead is an option for banks).

The comply or explain approach

The Addendum adopts the "*comply or explain*" approach, i.e. any derogation from the provisioning measures set by the ECB should be explained by the relevant bank. Any decision for not applying the automatic thresholds (which may lead to important balance sheet adjustments and impact both income and dividends) should be taken by banks' boards, instead of being the responsibility of the supervisor evaluating the risk provisioning policy of the supervised bank, within the SREP process at the end of which capital add-ons in the Pillar 2 can be required if it is deemed that risks are not adequately provisioned.

By introducing a de facto binding obligation on banks, that goes beyond what is being provided by the CRR, we respectfully believe that the ECB has overstepped the remit of its powers and entered into the co-legislators' one.

To this regard we understand the SSM has publicly acknowledged that a *comply-or-explain* approach may not be the right instrument to address such an issue.

Front-running of other policy initiatives on NPLs

The ECB had recently published the Guidance on NPLs management (March 2017), introducing a number of organisational measures. It is worth considering that the JSTs are still assessing banks' compliance with the Guidance and their NPLs disposal plans, while whether they are sufficient and successful will be assessed in the near future. Therefore, we do not see the urgency of adding new measures, while banks are still putting in place their new organisational structures and operational procedures. The SSM does not seem to consider the progress that has been reached so far and will further be made on reducing the NPLs level, together with the effects of the policy initiatives already in place.

The Addendum is also front running, without any coordination with the other European Institutions and taking into account policy measures already in the pipeline at EU level. Upon request of the ECOFIN, the Commission has launched on 10 November a consultation on Statutory Prudential Backstops on NPLs, while the ECB Addendum aims at adopting similar requirements as of 1 January 2018, with a high risk of

[3] http://www.politico.eu/wp-content/uploads/2017/10/Letter-to-President-Draghi.pdf?utm_source=POLITICO.EU&utm_campaign=2ba4af77f0-EMAIL_CAMPAIGN_2017_10_10&utm_medium=email&utm_term=0_10959edeb5-2ba4af77f0-189768153

overlapping requirements and uncertainty in provisioning policies. Concerning the 1 January 2018 date foreseen by the SSM, we understand from the public EP hearing that such date may be reconsidered.

In this respect, please note that the wording of the FSC report (31 May 2017) is itself proving the ECB's front running. In fact, the report explores a series of policy options that may be put forward by the European Institutions to tackle NPLs, specifying that the SSM is in charge of setting micro-prudential measures, asking for Pillar 2 adjustments. Any macro-prudential power to be granted in the future to the SSM (e.g. specific provisioning quantitative targets) would be subject to amendments to Art.104 of the CRD IV, i.e. by a Level 1 legislative procedure. It is notable that the CRD IV revision is ongoing and no amendment has been tabled so far with this regard.

Moreover, the FSC report includes the possibility of providing banking Supervisors with accounting supervisory powers, but it also specifies that:

- this approach would entail a radical change in the current European framework;
- the supplementary powers would be subject to a specific mandate;
- this approach is not recommended at this stage.

Automatic and standardised levels of provisioning

Automatic and standardised levels of provisioning to be applied to all institutions (i.e. not considering either the specificity of each loan and collateral, or the reference market or the jurisdiction) simply does not take into account the functioning of the recovery process, which often goes beyond the 2/7-years period foreseen by ECB.

The ECB does not provide any details on the procedure followed for setting the 2/7 years calendar period and, according to the relevant literature, there is no evidence that unsecured and secured exposures are, respectively not recoverable after such time has elapsed. In order to set a sound and prudent provisioning, the recoverable value of collateral and foreclosable assets should be taken into account. For instance, Bank of Italy's statistics[4] show that the average recovery on unsecured loans in Italy is 29% and on secured loans 45%: a 100% compulsory provisioning is therefore non evidence-based, thus inadequate.

A null recovery is too much conservative. Even in the case of NPL sales, a number of market transactions have been registered in the recent past and in all cases the value of portfolios of secured credits resulted significantly higher to the zero proposed in the Addendum, with minimum values of 20 cents. Even in the case of unsecured portfolios the sale value resulted higher by a few percentage points with values reaching as high as 10-15% on some portfolios.

Furthermore, it should be underlined that the empirical evidence observed in the internal models for Loss Given Default (LGD) which are validated by the Supervisory Authorities, is significantly different from the parameters proposed in the Addendum. In particular, it is best practice to define an incomplete workout, that is the period beyond which for the purposes of LGD the positions are considered closed and so included in the determination of the RWA of credit risk, even when the legal process in still underway. The definition of such a cut-off is determined by the recoverable cash flows.

Procyclicality of the Addendum

It should be emphasized that in our opinion the measure presents risks of a pronounced pro-cyclicality. The measure would be in addition to the effects of the entry into force of IFRS9, itself also pro-cyclical. Although, whereas the new accounting standard has the purpose of anticipating the effects of value adjustments on loans in the phase immediately prior to a recession, the Addendum would necessitate a capital increase by the banks in case of a significant increase in new flows of NPLs. Furthermore, this need would probably emerge at the deepest point of any crisis (for unsecured loans 2 years after their classification as an NPL). Therefore, an impact assessment on the stability of the European financial system

[4] https://www.bancaditalia.it/pubblicazioni/note-stabilita/2017-0007/en_Note_di_stabilita_finanziaria_e_vigilanza_N._7.PDF?language_id=1

and on the real economy in a scenario of a global European recession should be conducted. Moreover, the possibility of suspending the measure during a recessionary phase should be considered and included in the final document, in order to dampen its pro-cyclicality. With this proposed amendment, the measure would have on the contrary a function of a counter-cyclical capital buffer.

Deviation from accounting standards

As it has also been recognised by the ECB, the draft document might require deviations from the accounting system adopted, also considering the newly entry into force of IFRS 9 and the non-harmonisation of individual accounting principles adopted at individual level in different jurisdictions. However, the ECB itself, in Par.1 of the Addendum, notes that the existing accounting system should be respected in applying the provisions contained in the Addendum. This approach is contradictory and creates confusion.

In particular, banks' balance sheets would contain information on provisioning practices that would be – in many cases–not consistent with the real expected collections.

In addition, should the ECB approach not be revised, all accounting accuracy on recovery expectations will be disregarded and misleading representations would be given to the market on the value of the bank loan portfolios.

Part II – Technical aspects

Scope of application

The ECB states that the Addendum is applicable to the NPLs classified as such from January 2018, date of application of the new provisioning measures. While the ECB believes that the new provisions would not be retroactive, de facto the new requirements are affecting that part of end-2017 performing loans, which is likely to be classified as non-performing at the beginning of 2018.

It has been publicly stated by distinguished members of the ECB Governing Council that the Addendum should target new loans. However, if this is the purpose, the text of the Addendum should be modified.

In addition, considering that the Consultation is closing at the end of 2017 and the Addendum is expected to come into force right after its publication, banks would have a limited range of possible urgent actions to put in place in order to mitigate the impact, as no phase-in is provided.

We strongly disagree with such an approach and in this respect we would have expected, for clarity, any new provisioning rule to be applied to new loans, i.e. granted after 1 January 2018, in line with the Action Plan on NPLs approved by the July ECOFIN.

We also question the consistency between these proposed rules of the SSM and any possible future regulation to be introduced by the co-legislators (which, as per the Council's explicit mandate, addresses newly granted loans only and not "new NPLs"). In particular, the EC has issued a Consultation on Statutory Prudential Backstops on 10 November mentioning possible Pillar 1 measures on new granted loans. Any uncertainty or possible inconsistency between different sets of measures addressing the same issue should be avoided.

Future treatment of NPLs stocks

The ECB has announced that by the end of the first quarter of 2018 it will present its consideration of further policies to address the existing stock of NPLs, including appropriate transitional arrangements.

We strongly disagree with the SSM approach, since reference to future measures on existing stocks is causing uncertainty in the market, as witnessed by the strong volatility on banks' stock prices after the publication of the Consultation Paper.

Moreover, as stated in the previous paragraph, the Addendum would have already unintended consequences on the current stock of loans (i.e. now performing and becoming NPL as of January 2018).

Bank-specific approach instead of standardisation

We disagree with the automatic application of a prudential provisioning backstop after a predetermined period of time has elapsed. In our view, the assessment by the supervisor of the adequate provisioning against risks should remain part of the SREP and any request to increase the coverage of risks should fall within the Pillar 2 remit and within the limits of the applicable accounting standards.

Adequate consideration of the execution of the NPL reduction plans – submitted and approved by the supervisor - should also be paid. Some banks are in fact in the process of modifying their internal plans and organisational structures according to the ECB Guidelines of March 2017.

The proposed automatic backstop is a raw measure that fails to consider the NPLs reduction measures undertaken by banks according to the SSM Guidance. For instance, according to a study conducted by Bank of Italy[5], recovery rates for bad loans differ from bank to bank and recoveries for positions closed following standard work-out procedures are significantly higher than those recorded for positions sold. This evidence allows for concluding that a bank specific approach is the most efficient and managing bad loans internally (or through specialised external servicers), would lead to better recovery results according to the Guidelines already published by the ECB.

We also underline that as from next year the ECB will have further instruments to monitor the level of provisioning, for instance the Anacredit database will be available to the ECB as of the 30 June 2018. Given that Anacredit will provide the Supervisor with information not only by client but also by credit exposure, the benchmarking of provisions would be an easier exercise. As a consequence, under its Pillar 2 powers, the ECB would address effectively unsatisfactory provisioning cases, without the need of any Pillar 1 measures.

Clustering of NPLs

The proposal to cluster NPLs into two groups, secured and unsecured loans, is ill-conceived. This rough separation is not sufficiently granular to reflect the variation in recovery rates due to a number of factors, among them, the structure of banks' portfolios.

In the secured cluster, mortgage loans could be distinguished into residential and commercial loans, where among the latter it would be advisable to have a different approach for commercial and industrial real estate. In the unsecured cluster, it would be advisable to provide a different approach for different types of loans, such as to SMEs and consumer credit.

Moreover, clarification is sought on the functioning of the blended approach proposed by the ECB for partially secured exposures, as the Addendum lacks technical details for this cluster, but most of all, may lead to different treatment of similar assets.

After an accurate assessment of European lending markets, any back-stop to be introduced should be a function of the recovery curve of each asset class and geographical region.

Scope of geographic application of the Addendum

The proposed measures are addressed to directly supervised credit institutions based within the Euro area. By front-running forthcoming measures currently being considered by the European Commission that would cover the whole EU area, the SSM is fragmenting the Single Market, thus creating an unlevel playing field between Euro area and non-Euro area banks. We do not support such an approach.

[5] http://www.bancaditalia.it/pubblicazioni/note-stabilita/2017-0007/en_Note_di_stabilita_finanziaria_e_vigilanza_N._7.PDF?language_id=1

We would also like to have clarification about the application of the Addendum to banking groups - that have the SSM as a consolidating supervisor - with subsidiaries in jurisdictions outside the Euro area and outside the European Union.

Definition of NPEs subject to the vintage count

According to the ECB, the classification of NPEs adopted in the Addendum is aligned with the EBA's definition of NPLs (EBA ITS/2013/03) and applies the same treatment to positions classified as "unlikely to pay" (UTP) and "past due".

Firstly, it has not been assessed whether it is appropriate to apply the same treatment to unlikely to pay and past due, especially because, as it is, the ECB's proposed treatment could prevent the re-financing of UTP under restructuring. In particular, when credits are still considered past due and UTP (instead of bad loans) a 2 years' time set for the full provisioning for unsecured credits seems not reasonable as during this period, even though the bank puts in place its internal procedures for obtaining reimbursement, it is only the start of a judicial action that will allow the bank to correctly evaluate the possible recovery amount and consequent provisioning.

Secondly, the inclusion of the forborne classification does not seem appropriate, as it contradicts the horizontal nature and flexibility of that definition, making it difficult to manage probation periods and reclassifications from forborne non-performing to performing. We highly recommend excluding forborne from the NPEs classification under the scope of the Addendum.

Impact on the NPLs market and lending

An automatic calendar provisioning would clearly communicate to the market when banks are supposed to dismiss their NPLs portfolios and an estimation of their value on the balance sheet. Because of the required public disclosure by vintage of NPLs, investors and borrowers will be aware of the bank's provisioning strategy and situation.

This will lead to distortions in the market, as the number of NPL disposals will presumably increase close to the deadline for the 100% provisioning (after 2 and 7 years respectively). The excess of prudential measures will raise market asymmetries, allowing buyers to set a discounted price, as they will be aware of when banks need to dismiss the NPL portfolio. Moreover, it is likely that such provisions would also induce debtors to adopt delaying behaviours which would provide them with more negotiating power toward banks.

An automatic calendar provisioning would also imply capital transfer from banks – that are used to finance economic growth – to private equity funds (i.e. highly speculative investors). Such an approach would not only have a negative impact on growth, but could also be instrumentally used by political movements that are against the EU and the current establishment.

As a consequence, banks will reduce their risk appetite, selecting carefully the borrowers, and worsen the conditions offered to customers, applying for instance higher interest rates in order to cover higher costs of provisioning. Higher interest rates affect recovery rates and may ultimately lead to a new raise in NPLs stocks.

Functioning of the prudential provisioning backstop

The ECB does not provide any detailed information on how the calendar and calibration for the backstop have been set (100% provisioning; 2/7-years), which, above all, penalise the granting of unsecured loans, limiting banks' core business. We question both the level of provisioning chosen, the application of the same level to all banks and the time window adopted. The Addendum provisioning would increase volatility of banks' results and pro-cyclicality effects (by a severe provisioning up to 100% during the low part of the cycle and subsequently obtaining capital gains in the recovery period).

In particular, we do not share the ECB's view that "if collateral has not been realised after a period of several years […] is deemed to be ineffective" (par.4 pag.10), as recoverability is linked to the value of the secured assets and/or of the obligor's enforceable assets. In particular, for secured assets, the length of judicial proceedings does not imply that the collateral will necessarily loose its value over time. Moreover the recovery time would only affect the Net Present Value of the loans also in line with the accounting principles.

Moreover, we do not support the decision of excluding the length of legal proceedings in setting the calendar approach, as banks should not be made accountable for the length of judicial proceedings, on which banks have no grip. Some Member states are currently addressing such problems and the benefit of the reforms adopted will be deployed in the short future. Paradoxically, if the length of judicial proceedings is deemed an irrelevant element for the Supervisor, national legislators could lose interest in such reforms and abandon all the efforts for the adoption and implementation of the necessary measures to shorten the legal procedures.

Should the calendar approach not be revised, at least, derogations from the application of automatic provisioning should be provided by the ECB following the advice of National Competent Authorities (NCAs), whenever any objective analysis undergone by them will provide evidence that the deadlines of 2/7 years are not appropriate considering that those NPLs can be recovered with a shorter or longer time set.

On the calculation of the extra provisioning, the reference made by ECB to the application of the Art.3 of the CRR for calculating banks' supply of provisioning is not clear. In fact, according to the Addendum it seems that the application of Art.3 CRR would be mandatory, while in the FAQ is presented as "alternative", but still imposed by the ECB. Both the interpretations appear to be deviations from the CRR, which accords to banks the option to strengthen their own funds on the basis of their own assessment. This would transform this option in a Pillar 1 requirement set by the ECB, which is not the Competent Authority to do that, as it can only set Pillar 2 add-ons.

Moreover, banks using IRB models – in particular Expected loss best estimates (EL_{BE}) for the defaulted exposure in accordance with Article 181(1)(h)of the CRR – would be penalized by a double counting on NPLs, in terms of capital requirements, as defaulted assets are already considered in the RWA calculation. More specifically, it should be made clear that any request of deduction from own funds according to Article 3 CRR to fulfill the backstop proposed in the Addendum should also consider the negative amounts resulting from the calculation of expected loss laid down in Articles 158 and 159 CRR ("regulatory expected loss shortfall") and the capital requirement deriving from RWA calculations for defaulted exposures. Should this not be the case, there would be a double impact on CET 1 deductions resulting from the same NPE.

Tax considerations

On the functioning of the prudential provisioning backstop, we believe that it should be taken into account that banks obtain a fiscal deduction from the taxable income, while banks applying Art. 3 of the CRR for their deduction do not.

Therefore, a mechanism that would ensure the same tax treatment of provisions calculated for accounting purposes should be introduced to avoid further impact on banks' own funds and maintain the level playing field.

Without the above adjustment, if it is required to fill the provisioning gap with a 100% bank supply with a deduction from CET 1, without any tax benefit, the final impact on CET 1 would exceed that obtained from the adoption of 100% provisions in the profit and loss. As a result, a differential treatment would be applied to banks that cannot register sufficient accounting provisions versus those that do not have this limitation.

In addition, the national tax authorities, whenever stating that the compulsory provisions may differ from the actual loss estimates according to banks' assessment, could advocate the right to challenge any such tax deduction.

Accounting issues and interaction with IFRS 9 provisioning

The proposed system not only goes beyond the accounting principles (as the ECB recognizes throughout the document), but also it is not in line with international accounting principles and those applied at individual level. The European Commission itself, in the Communication on Completing the Banking Union[6] published on 11 October, has clearly stated that the Supervisor can influence a bank's provisioning level:

"*Within the limits of the applicable accounting framework and to apply the necessary adjustments (deductions and similar treatments) in case, for example, accounting provisioning is not sufficient from a supervisory perspective."*

Therefore, we urge the SSM to reassess the applicability of the Addendum, setting the level of provisioning on a case-by-case basis, in line with the accounting principles.

Considering the entry into force of IFRS 9, replacing IAS 39 as of 1 January 2018, the EBA has estimated that:

"The increase of provisions is on average 13% compared to the current levels of provisions under IAS 39. The Common Equity Tier 1 (CET1) ratios are expected to decrease on average by up to 45 basis points (bps). Smaller banks, which mainly use the Standardised Approach (SA) for measuring credit risk, estimated a larger impact on own funds ratios than larger banks of the sample."[7]

The impact on CET 1 is due to the First Time Adoption (FTA) of IFRS 9, especially because of the calculation of "lifetime expected credit losses" for assets that have had a significant increase in credit risk since their initial recognition, but that do not have objective evidence of impairment.

The European Institutions have publicly remarked the pro-cyclicality of IFRS 9 on the economy and the resulting high level of provisioning required. For this reason, the impact of IFRS 9 on the CET 1 will be partially mitigated by the transitional arrangement inserted in the revised CRR, which co-legislators adopted by a fast track procedure and are entering into force 1 January 2018. Nevertheless, the final legislative text hasn't been approved yet, and the phased-in impact on CET 1 depends on the compromise that will be agreed by co-legislators.

The provisioning system set by the ECB will amplify the pro-cyclicality, which is in contrast with the purpose of the NPLs disposal that has the final objective of revamping the EU economy. In fact, the own funds ratios will be affected not only by the IFRS 9 FTA, but also from what is being required by the Addendum for NPLs, which does not introduce any mitigation system. As a consequence, banks' will face a material decrease of own funds.

Furthermore, the application of the prudential provisioning pursuant to Art.3 of the CRR shall be computed in the own funds' calculation up to the limit of 0,6% pursuant to Art.62 (d) and consistently with Arts. 158 and 159 of the CRR, i.e. it should be considered as an increase of the accounting provision when it is compared to the prudential provision in order to determine the excess/shortfall. The prudential provisioning must therefore be considered as any other own funds reduction related to NPLs exposures.

Lastly, while the classification of loans between secured vs unsecured proposed in the Addendum for provisioning backstop purposes is based on the prudential eligible forms of credit risk mitigation pursuant

[6] https://ec.europa.eu/info/publications/171011-communication-banking-union_en

[7] https://www.eba.europa.eu/-/eba-updates-on-the-impact-of-ifrs-9-on-banks-across-the-eu-and-highlights-current-implementation-issues

to chapter 4, Arts 192-241 of the CRR, the provisions calculated for accounting purposes are based on international accounting standards adopted at individual level in different jurisdictions, with the consequence that the application of Art.3 of the CRR would require an extra provisioning although the NPL portfolio's expected loss (ECL) is widely covered by accounting provisions or even in excess reserve for prudential purposes.

Disclosure issues

The market would receive information on the provisioning of the loan book of the relevant bank, however, the details of the public disclosure requirements are not set in the Addendum, but subject to communication by the JSTs.

In order to avoid a further raise of operational costs for credit institutions, we ask to provide this information as soon as possible. We believe that the applied templates should have undergone a consultation process together with the Addendum. Therefore, at least an informal consultation of the industry is needed.

Conclusions

In supporting a fruitful dialogue among the European Institutions, we invite the ECB to duly consider stakeholders' views on the Addendum and leave to the co-legislators the task of implementing the Council's Action Plan on NPLs, leaving to the SSM its fundamental micro-prudential supervisory powers.

Any reviewed requirement should be set as a bank specific measure, as a consequence of the supervisory dialogue between the SSM and the supervised institution.

We therefore urge a complete rethinking of the proposed measures, in particular:

1) the use of Pillar 1 tools (i.e. deductions from CET1 based on Art.3 of the CRR) should be eliminated, as ECB's expectations can be satisfied only by Pillar 2 instruments. As stated by the Commission, the SSM can impose a deduction from capital or other measures, but only if a bank has not been conservative enough in applying the accounting principle;

2) the macro-prudential approach should be corrected, allowing for more flexible principles of calendar provisioning based on bank-specific elements such as bank's different country of establishment, business model and credit portfolio. The length of the legislative processes cannot be excluded as a factor of differentiation.

In addition, we stress the need of applying any measure to the new credits granted as of the date of application of any new piece of regulation or Guidance, in order to avoid retroactive effects on the NPLs stocks and flows and to align with the scope of Council of the EU Action Plan. Moreover, loans subject to forbearance measures should be clearly excluded on the application and the possibility of suspending the measure during a recessionary phase should be considered and included in the final document, in order to dampen its pro-cyclicality.

Finally, in the case of alternative methods of accounting (i.e. provisions through P&L vs deductions from capital), the different tax treatment should be considered so that the final impact on CET1 will be the same.

Given the deadline set for the present Consultation, we find not feasible the entry into force of any new requirement as of 1 January 2018, as banks would not have the necessary time to amortise the impact of the new measures and modify they internal NPLs management strategies.

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