UniCredit

**7 December 2017**

# UniCredit reply to the consultation on the draft Addendum to the ECB Guidance to banks on Non-Performing Loans

(Deadline: 8 December)

UniCredit is fully aware that the NPLs issue is of significance for banks as well as for regulators and supervisors, as the persistently high level of NPLs within the eurozone banking sector is constraining banks profitability and represents a material impediment to a full-blown recovery in lending. UniCredit regards the surge in NPLs ratio undoubtedly as the legacy of the severe recession, while the difficulties to address NPLs also stem from poor financial market infrastructures and inefficient judicial systems. Nevertheless, UniCredit acknowledges that a consistent effort on the part of banks to clean their balance sheet from distressed loans and prevent their re-emergence is, at this juncture, of the utmost importance. For these reasons, UniCredit has been from some time now to the forefront to work through its backlog of distressed loans and to tackle the shortcomings in the bank's management of NPLs in order to prevent the build-up of new non-performing exposures in the future.

In light of these considerations, UniCredit welcomes the ECB's valuable effort to intensify the supervisory dialogue with banks on their NPLs' management. We already had the chance to express the view that the ECB's Guidance on non-performing loans (hereinafter NPL Guidance) will surely encourage convergence to best practices and make it easier for banks to prioritize and enact the necessary corrective measures.

While for the reasons outlined above, UniCredit fully understands the rationale for setting out supervisory expectations for minimum level of provisioning of new NPLs as envisaged in the draft Addendum to the ECB Guidance to banks on non-performing loans (hereinafter "Addendum"), we would take the opportunity of the consultative process to raise a number of concerns that such approach raises if adopted as proposed.

First of all, UniCredit is particularly concerned that the proposed approach to NPLs provisioning might turn out to be excessively restrictive. The impact for the banking system might be significant, leading to a **severe reduction in bank lending, with important negative spill-over effects on investment, growth and the real economy as a whole.** This concern is accentuated as we consider the **definition of eligible collaterals too restrictive,** in so far as it does not allow to qualify as secured some forms of financing like factoring or working capital financing (invoices discounts, receivables financing). This would make unsecured products less attractive for banks, that would react reducing the volumes of unsecured loans, with significant consequences on the real economy.
Secondly, the ECB should carefully assess the impact of the fixed "calendar approach"  on the development of NPLs secondary markets. On one hand, we acknowledge that the existence of a provisioning backstop would in medium-term favor more NPLs transactions and help reduce the bid-ask spread. On the other hand, however, we are concerned of the significant **indirect impacts on banks' RWA that might stem from the increase of the internal LGD, especially in the**

**absence of clear regulatory provisions to minimize the effects of the massive disposals**.
Last but not least, UniCredit acknowledges that the prescriptions in the Addendum are not binding, in so far as banks can benefit from a comply-or-explain process. However, the fact that the supervisors' expectations are so strictly defined and applicable indiscriminately to all institutions, and that the circumstances under which the non-compliance is admitted are so strict makes these prescriptions de facto compulsory and much more similar to a Pillar I than a Pillar II measure.
UniCredit believes that the idea of **introducing a full, calendar provisioning of NPLs indiscriminately applied to all institutions is overly penalizing**, and it does not duly take into account the specificities of each institution, as well as the local peculiarities of the legal-judicial environment. This is, to some extent, at odds with supervisors' and regulators' efforts to strengthen banks' internal methodologies to assess credit risk, and with the ECL approach to provisioning envisaged in the IFRS9 accounting principle – which has been conceived precisely to overcome the "too little-too late" issue and to grant the coherence between the prudential and the accounting framework.

Given the considerations above, the following aspects of the "Calendar Provisioning" approach need, in our view, to be carefully re-considered:

- UniCredit believes that a **Pillar II approach is the most preferable tool to deal with potential NPLs under-provisioning, however a "real" Pillar II measure should in our view rely on:**
  - I. a real flexible comply-or-explain mechanism which would not invert the burden of the proof and would not so explicitly limit the circumstances under which the bank can deviate from complying with the backstop;
  - II. quantitative targets which should be set bank-by-bank.

- UniCredit recommends that, when assessing bank's compliance *vis as vis* its supervisory expectations, the **ECB duly takes into account the improvement of internal methodologies banks have achieved so far in the wake of both the TRIM supervisory exercise and the broader EBA's IRB repair program**. Both initiatives build, indeed, on the premise that internal models are a valuable instrument to measure risks and they have been conceived to make the approach to estimate credit risk parameters fit-for-purpose to catch the idiosyncratic level of risk of each bank – and in a homogenous way across EU jurisdictions. In particular, the EBA Guidelines on PD estimation, LGD estimation and treatment of defaulted assets (EBA/GL/2017/16) – which is one of the milestone of the EBA repair program - require that banks take into account in the estimation of the LGD parameters the length of workout process, the time in default, as well as the economic downturn effect. As all these three factors are relevant reasons behind the high level of the NPLs ratio in some jurisdictions, there are no doubt that IRB institutions with high NPLs ratio will face higher LGD estimates and, in turn, higher RWA and capital requirements because of the implementation of the EBA Methodological Standards. Against this backdrop, the application of a top-down and strictly-defined backstop as envisaged in the Addendum seem to be overcoming to some extent the EBA guidelines and it unduly over-burdens high-NPLs banks. In particular, we think that the ex-ante fixation envisaged in the Addendum of the period after which unsecured and secured exposures have to be fully provisioned overrides the EBA Guidelines with respect to the

requirement for banks to define their own "Maximum Recovery Period", based on their specific internal recovery experiences.

- UniCredit deems the **timing** of the introduction of these new provisions on NPLs (1 January 2018) too strict. The ECB should duly take into account that SSM-supervised banks are already in the process of implementing the ECB Guidance, which, if properly applied, is not only an incentive to reduce the existing high stock of NPLs, but it is also an important backstop to prevent a further, excessive build-up of new NPLs in the future. UniCredit believes that banks should be given more time in order to digest the prescriptions envisaged in the NPL Guidance and to assess the impact of banks' compliance with this Guidance before complying with further obligations. Moreover, the proposed timeline is extremely strict as banks should be granted enough time to adapt internal IT systems, reporting and disclosure processes.

- **In light of the proposal by the European Commission to implement a statutory Pillar I** measure, which is to some extent in overlap with the ECB backstop, it is important that, should the two backstops be both applied, the **ECB grants a coherence, in terms of perimeter, scope, and timing of application, between its own proposal and the one proposed by European Commission.** The overlap between these two proposals has, indeed, created noises and uncertainties on the markets, as banks and investors are struggling to understand how the interplay between the EC Pillar I and ECB Pillar II backstop will work and how the European Commission and the ECB will avoid blurred lines between the Pillar 1 and the Pillar 2 measure. In particular, the following aspects have to be considered:

    I. Concerning the **perimeter** of application, we would welcome that the ECB would revise the approach to apply the new provisions to **newly classified NPLs and adopt the same approach proposed by the European Commission to apply the "Calendar Provisioning" only to loans originated after a specific reference date.** This approach would be much more reasonable in our view, first of all because we deem it appropriate not to apply new rules to loans that have been originated according to different ones, but also because this would give banks more time to adapt to the new provisions. Lastly, we strongly advice to make absolutely clear that the existing **stock on NPLs won't** be subject to the prudential backstop envisaged in the Addendum.

    II. Concerning the **scope** of application of the Addendum, only the Significant Institutions under the SSM supervision are required to comply with the Addendum, while the Less Significant Institutions and the banks outside the SSM are excluded, at least until the national supervisors do not decide to adopt similar measures. This would mean that, should the misalignments with the proposed Pillar I measure not be addressed, SSM's supervised banks will have to adapt their level of provisioning much earlier than banks outside the SSM perimeter. Moreover, the ECB Addendum is more stringent not only in terms of perimeter but also in terms of **calibration** of the backstop (seven vs eight years threshold for full provisioning of collateralized exposures and different criteria for collateral treatment) compared to the European Commission proposal. Therefore, should the two backstops be in place simultaneously in their current form, the burden for SSM significant banks (Pillar I

plus Pillar II backstops) would be much higher than for other banks, posing a significant **level playing field issue**.

- Last but not least, another relevant aspect is the **definition of "non-performing exposure"** to be considered for the prudential backstop. In general, exposures classified in Past Due or Unlikely to Pay status are managed with a "soft-collection" approach while a "hard collection" strategy is applied to Bad Loans. Thus, the "recovery/workout process" is effectively initiated only when an exposure enters into a bad loans status. In our view, the backstop should be calibrated with respect to the moment when the "real" recovery process starts.

Further comments regarding detailed technical aspects have been enclosed in the ECB excel template herewith attached.