



EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Template for comments

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

Institution/Company

Assifact

Contact person

Mr/Ms

█

First name

█

Surname

█

Email address

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Telephone number

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Please tick here if you do not wish your personal data to be published.

General comments

Large empty text area for 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	1	2	Clarification	The "Addendum" states that "This addendum does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing EU regulations or directives and their national transpositions, applicable national regulation of accounting, binding rules and guidelines of accounting standard setters or equivalent, or guidelines issued by the European Banking Authority (EBA)". However, we underline that in this Addendum the SSM sets its expectations and ask institutions to "comply or explain" so that those expectations cannot be really considered as "non-binding" while we also see significant conflict with existing applicable accounting rules (both at national and international level) and in particular with IFRS 9. We also wish to highlight that the Addendum addresses an issue that should need primary legislation, so that the proposed approach looks to go far beyond the SSM powers: the addendum indeed lacks the absence of legal effects as non-compliance could trigger Pillar 2 effects.	We believe the Addendum generates conflicts with existing accounting rules and addresses an issue that goes beyond the SSM powers		Publish
2	1 - Background	1	2	Clarification	We feel uncomfortable with such important issue being treated with lack of coordination between the European bodies (two ongoing consultation on the same topic providing different approaches by the European Commission and the ECB) and without a proper time schedule to analyze the framework, provide impact assessment and propose appropriate solutions to the numerous issues that the proposal raises.	Lack of coordination generates uncertainty in institutions and markets		Publish
3	2 - General Concept	1	2	Deletion	The calendar approach is not consistent with the prudential and accounting systems that has been at the basis of the current regulatory environment (CRD/CRR, IFRS 9) and that is based on the reliance to the institutions' internal estimates of expected losses	Inconsistency between calendar approach and current prudential and accounting regulation		Publish
4	2 - General Concept	2.1	3	Deletion	"This addendum will be applicable as of its date of publication. Finally, the backstops are applicable at a minimum to new NPEs classified as such from January 2018 onward". We advise that the deadline for the consultation and the date of application are too close. The Addendum would impact significantly on business models and operations if adopted. Moreover, as the institutions are already engaged in the implementation of IFRS 9, that already requires significant efforts, we believe that the discussion of such new requirement should be postponed at least at the end of the first year of application of IFRS 9. Indeed, one of the main innovations of IFRS 9 is that it seek a more accurate and forward-looking provisioning based on the expected loss. We therefore suggest to wait for IFRS 9 to show its effects before to introduce another piece of regulation which looks in open conflict with the former.	The discussion should be postponed at least at the end of the first IFRS 9 exercise, as the Addendum appears to be in open conflict with IFRS 9, which already aims to prompt and adequate provisioning		Publish
5	2 - General Concept			Clarification	We would like however to underline some potential pitfalls of the approach that could generate practical and feasibility issues: <ul style="list-style-type: none"> • Potential conflict with the CRR treatment for credit risk, as the approach does not explain the effects of the deduction on risk weighted assets (150% for default exposures under the standardized approach). In perspective, it looks like the waiver that allows to weight 100% instead of 150% NPEs that are impaired for more than 20% of the value is being questioned in the future evolution of the Basel agreement, so that there could be a double counting of risk; • Conflict with national laws or international regulation, such IFRS 9, providing different principles for loan loss provisioning; • Conflict between the legal validity of collaterals/guarantees and the proposed approach to consider only collaterals eligible for credit risk mitigation purposes; • Conflict with insolvency frameworks that are more and more oriented to allow the continuity of the client's business as institutions will be incentivized to enforce promptly and immediately any client in default status, thus reducing the likelihood of its survival. 	A calendar approach to provisioning would rise a number of unintended consequences.		Publish
6	5 - Related supervisory reporting	5	12	Amendment	"All banks should report to their respective JSTs at least on an annual basis the coverage levels by NPE vintage, with regard to the newly classified NPEs after 1 January 2018." We disagree. Considered the profound impact of such approach on the institutions' credit policies, it should apply only to newly originated exposures and not on newly classified NPEs in order to avoid bias. For revolving facilities, any backstop would apply to new client relationships starting from the cut-off date.	Impacts on credit policies suggest to apply only to newly originated loans		Publish

7	2 - General Concept			Amendment	<p>Given that NPLs are not a real issue for the factoring industry, we understand that the backstop does not address it directly. Nevertheless, as we already mentioned, we see a number of significant pitfalls and unintended consequences due to the design and calibration of a prudential backstop.</p> <p>In general:</p> <ul style="list-style-type: none"> • an incentive to institutions to enforce promptly and immediately the collaterals any time a client falls in default status, thus reducing the likelihood of its survival, in spite of the attention that the insolvency frameworks put on the necessary efforts to save the business • an increase of legal claims against the institutions due to the previous incentive to enforce • an alteration of the parity between European institutions and a breach of the level playing field principle due to the impossibility to make provisions consistently with the legal context in which each institution operates. <p>In particular, in the case of factoring and purchased trade receivables:</p> <ul style="list-style-type: none"> • an inconsistent treatment of the collaterals (trade receivables or credit insurance) in case the collaterals would be considered only if eligible for CRM (the requirements stated by the CRR do not necessarily take into account the effective recoverability of the collaterals as they pursue different goals) • a massive use of exemptions under a "comply or explain" principle which would also require significant operational burden • an increase in volatility of P&Ls or CET1 due to the large amount of past due exposures that falls under the EBA definition of default but gets back to performing status after a while • all in all, factoring, as well as other low risk products, would be unduly punished by an unnecessary increase in the cost of risk <p>We therefore suggest that no general prudential backstops but individual assessment of insufficient provisioning under the current powers of the SSM would be the best solution to properly treat the issue of insufficient provisioning for non performing exposures.</p> <p>In the case a prudential backstop was however introduced, we feel that a common rule based on the proposed approach would be oversimplified and could generate more problems than benefits. To summarize, a common regulatory prudential backstop on provisioning for NPLs could have unintended negative effects on:</p> <ul style="list-style-type: none"> • the regulatory capital level and the credit policies of the institutions • the par condicio between European institutions • the comparability of financial reportings of institutions operating in different Countries • the cost of risk of low risk, asset based financial products such as factoring due to unnecessary provisioning that could disincentivize their use, thus eventually increasing the overall systeming risk • the real economy, that will eventually be harmed by stricter credit policies and reduced possibilities of turnaround the business in case of financial distress <p>Thus we strongly suggest, again, to have a granular approach, considering the type of collateral, the type of security, the type of debtor and the length of legal proceedings to provide a reliable picture of the actual value and recoverability of the collateral. In particular, the inclusion of trade receivables and credit insurance among the eligible collaterals is essential to avoid illogical provisioning on factoring and purchased trade receivables, as well as an exemption for debtors that are public entities (thus not generating an actual credit risk even in the case of past due-driven default) looks like necessary. In order to minimize the negative effects of the backstops, a progressive approach would also help.</p>	In general, an approach to provisioning based exclusively on vintage will generate significant biases for low risk exposures like factoring	Publish
8	3 - Definitions	3.2	7	Amendment	<p>we are concerned with the very definition of "secured NPLs", intended here as "covered by eligible credit protection". Indeed, the factoring industry presents some peculiarity: it is based upon the purchase by a bank or financial company of a business' trade receivables, against which the factor might advance part of all of the purchase price (otherwise paid to the client when the factor collects the invoice) and thus definitely represents a form of asset based lending. Please note that factoring usually entails a revolving facility available to the client.</p> <p>Such purchase agreement (depending on the legal context) provides recourse to the client if the assigned debtor fails to fulfill the payment, unless the factor agrees to underwrite the risk of the receivables, upon request from the client, under a "without recourse" agreement. It is useful to highlight that from a legal point of view, in any case, "recourse to the client" means that the factor's risk is, in first instance, related to the fulfillment by the assigned debtor of its payment obligation rising from the receivables, while the client only guarantees in case of non-fulfillment by the former.</p> <p>According to IAS 39 and IFRS 9, the balance sheet exposures generated by such purchase depends on the substantial transfer of all risk and rewards of the receivable. To make it simple, the factor shows an exposure to the debtor of the purchased receivables when the assignment transfers substantially all risks and rewards and an exposure to the client otherwise. Please note that around Europe the International Financial Reporting Standards are not applied uniformly, so that the factoring transaction is not represented in the same way, as well as accounting standards may provide different rules for provisioning: that introduce another factor of variability among different Countries that may breach the level playing field in the factoring industry.</p> <p>According to the CRR, purchased trade receivables are not considered as eligible credit protection for the purposes of credit risk mitigation exception made, under some circumstances, for Internal Rating Based Models (see artt. 199, 209 and 230). The CRR also allows the adoption, under the IRB approaches, of specific approaches to the estimate of expected credit loss in the case of purchased trade receivables that build on the role of the underlying receivables as the primary source for reimbursement (see artt. 153, 154 e 184). However, Internal Rating Models are not common in factoring, also due to its low risk profile and the consequent lack of property deep default time series, so, generally, factoring transactions and in general invoice-based finance would be considered as unsecured loans.</p> <p>On the other side, when the factor purchases trade receivables, it often obtains further protection through insurance policies offered by a credit insurance company. Such policies can combine both recourse and non recourse agreement, in the latter case operating as a re-insurance of the debtor risk underwritten by the factor. Although they provide a very effective protection, credit insurance policies are usually not eligible as credit protection under the CRM framework.</p> <p>In both the abovementioned situation, according to the proposed model, the factor would have an unsecured exposure while, actually, it has strong collaterals provided by the purchased trade receivables and re-insurance. It is not a case that, in Italy, according to the latest figures, the factoring industry shows a significantly lower NPL ratio than traditional banking, respectively 7% (5.4% unlikely to pay) vs 15% (14.8% unlikely to pay). The numbers are even more compelling when looking to the full EU picture: data from the EUF White Paper on Factoring and Commercial Finance show that the total cost of risk in factoring is immaterial compared to that of banks (0.09% vs 0.32% in low risk Countries, 0.43% vs 1.6% in high risk Countries).</p> <p>We strongly challenge the assumption that factoring represents a form of unsecured lending and advise that every approach based on that assumption would generate bias on provisioning.</p>	The definition of "eligible credit protection to secure exposures" must be clarified and amended to clearly include trade receivables and credit insurance	Publish

					<p>Usually, such collaterals deploy their benefits in the short term. However, in the case of legal proceedings, it is not uncommon that the enforcement takes a certain number of months or even years (that is the case, e.g. of public entities which are subject to administrative procedures). There is no reason to penalize the related exposures by way of a minimum required level of provisioning or deduction from the regulatory capital. We therefore suggest that a backstop model on provisioning built on the separation between "secured" and "unsecured" exposures is too simplified and biased.</p> <p>Moreover, we wish to underline that, due to the link with late payments in trade relationships, the factoring industry shows, in some Countries more than in others, a significantly larger amount of default exposures to debtors due to the 90 days past due rule, which is close to 21 times the same share in traditional banking (Assifact estimates). Such default are normally not a real indicator of increasing risk, reflecting the payment behaviours of a business or industry. Thus, the cure ratio of those past due exposures is very high (Assifact estimates that for Italy only 1.72% of new unlikely to pay exposures in 2016 in factoring came from the past due over 90 days exposures). The coverage ratio on those exposures is lower than in traditional banking reflecting the abovementioned overestimation of default due to late payment (while, to provide a full picture, the coverage ratio on unlikely to pay exposures is higher, on average).</p> <p>We wish to underline that a prudential backstop would unnecessarily exacerbate volatility in P&Ls or prudential CET1 of the factoring companies if applied. Indeed, it is highly probable that such unnecessary increased provisions would be compensated by recoveries in the following quarter(s) or year.</p>			
4 - Prudential provisioning backstop	4.2	10	Amendment	<p>We note that the calibration lacks of any justification and statistical reference. We feel that the calibration of the approach should not be set arbitrarily but should take into consideration the length of legal proceedings to enforce the loan, which is different from country to country, so that any EU common backstop would breach the level playing field if not properly adjusted. In the case a regulatory prudential backstop was to be implemented, we suggest that the National Supervision Authority could make such adjustments in order to get a consistent balance between the expectations of the EU Supervisors, the needs of the banking industry and the need of transparency and accountability of their financial reports at investors' benefit</p>	A "one size fits all" calibration would disrupt the level playing field. Country-specific adjustment must be allowed		Publish	
4 - Prudential provisioning backstop	4.2	10	Amendment	<p>One should also discriminate according to the counterparty: an unsecured loan to a business and an unsecured loan to a public administration bear very different risk profiles (credit risk is almost non-existent in the latter case, even though the enforcement of the loan may take a long time).</p> <p>It is worth noticing that losses on public debtors are extremely infrequent, even if the delay in payments might be relevant. The long-standing experience of factoring companies active towards the public sectors in Europe and notably in Italy, Spain, Portugal, Poland and Slovakia shows that losses generated by past due receivables to the public health sector and local governments (even when distressed) are non-existent; on the contrary, past due receivables to PAs usually generate overrecoveries thanks to legal interests accruing on late payments in trade relationships.</p> <p>A preliminary impact assessment made by Assifact shows that such approach would significantly affect the reliability of the accounting reporting made by the banks, as it would compel them to take unnecessary provisions that will not result in losses but rather in recoveries, thus reducing the transparency to the markets. We strongly advise that debtors that are public entities should be exempted from such minimum level of provisioning.</p>	Public debtors deserve an exemption from minimum provisioning due to absence of real credit risk		Publish	
4 - Prudential provisioning backstop	4.2	10	Amendment	<p>A calendar approach to provisioning applied to all institutions would be inconsistent with the actual recoverability of collaterals, which is a function of various factors that need careful assessment and valuation like, e.g.:</p> <ul style="list-style-type: none"> • Type of collateral • Type of security (i.e. pledge / assignment / ...) • Type of debtor (e.g. private / public entity) • Local legal environment • And so on... <p>The high recovery power of purchased trade receivables is confirmed by the low NPL ratio in factoring, which (see above) in the case of Italy is in average 50% lower compared to that of general banking and even 64% lower when true unlikely to pay exposures are compared. Provisioning basing only on vintage would frustrate the institutions' efforts to estimate the LGD and penalize low risk products.</p>	A calendar approach to provisioning is not consistent with the actual recoverability of a loan, thus penalizing low risk products such as factoring		Publish	
4 - Prudential provisioning backstop			Clarification	<p>The Addendum, in its current form, proposes an innovative approach to provisioning, the impact of which seems to go far beyond its purposes, with the counterproductive consequence to penalize low risk exposure such as factoring by way of the introduction of a methodology to provisioning merely based on "vintage", that does not take into account the peculiarity of trade receivables.</p> <p>According to the impact assessment performed by Assifact (attached), the largest impact is indeed expected on the lowest risk exposures such as purchased receivables to debtors that are past due but, especially in the case of public debtors, do not present any actual significant increase in credit risk. The current provision practices of factoring companies consider such features of the purchased receivables, that would be frustrated in the case a linear calendar approach to determine minimum regulatory backstops for provisioning was adopted.</p> <p>The large amount of unnecessary provisioning on such exposures, that will exceed by far the actual future losses and generate proportionally large recoveries in the following reporting periods, would also reduce the reliability and transparency of the financial reporting of banks, making them less intelligible for the markets, in open contrast with the very purposes of the Addendum. Such statements are backed up by strong evidence in the factoring sector: in Italy, as above mentioned, only 1,72% of new unlikely to pay exposures in 2016 came from a "past due over 90 days status", so that for trade receivables the default based on the past due rule represents a mere accounting classification but not a real credit risk event. In particular, the unintended consequences impact on factoring companies active on public administrations' debts: according to figures to end of year 2016, unlikely to pay exposures to PA are only 0,9% of the total net exposures, while looking to actual bad debts the figures show a net value below 0,2%, suggesting there is no need to address such exposures with minimum backstops on provisioning.</p>	The application of the calendar backstop to factoring could harm reliability and transparency of financial reporting of factoring companies		Publish	

Impact study on

Consultation document

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

This note addresses the potential impact on the Italian factoring industry of the proposed calendar approach to provisioning for NPLs as introduced by the draft *“addendum to the ECB Guidance to banks on nonperforming loans: Prudential provisioning backstop for non-performing exposures”*.

Summary of results

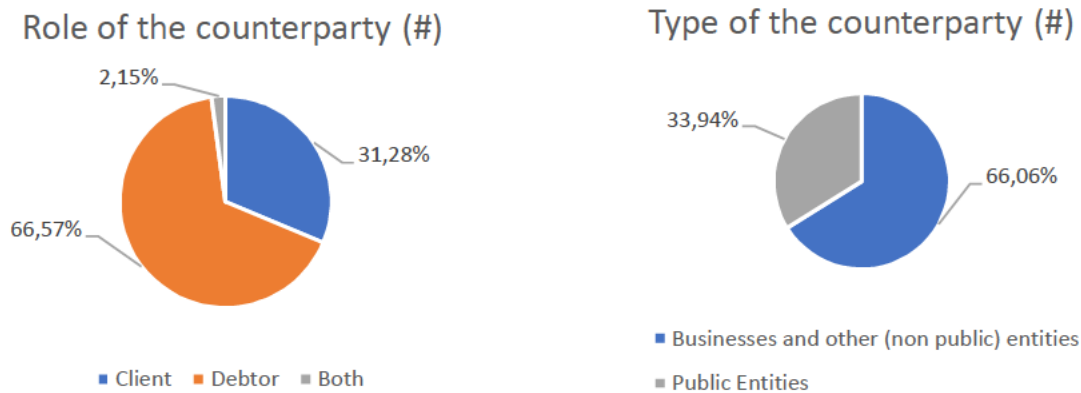
- The Addendum is likely to impact strongly on factoring with an overall increase of required provisioning of +165.9% with respect to the current level of provisioning
- The impact is higher for debtors, especially PA
- The impact would be tremendous with regard to past due over 90 days exposures, with linear minimum backstops representing up to 6,3 times the current level of provisioning
- Such impact would be counterdeductive as it would strike mostly on a low risk kind of exposures, such as receivables, where past due over 90 days is not a real indicator of impairment.

1. Sample

The impact has been analyzed on a sample of non performing exposures gathered by Assifact from 8 members, representing 39% of the total factoring turnover of year 2016.

The sample is made of 4.585 records representing different subjects that have been classified as non performing from 1st January 2014 to 31st December 2016.

Picture 1.1 – Description of the sample



Most of the analyzed records refer to exposures to account debtors related to non recourse purchased of trade receivables. About 1/3 of the sample is made of public entities.

2. Methodology

In order to assess the potential impact of the proposed approach, we performed a backward analysis on the previous 3 (complete) years. For each NPL we gathered info on:

- Date of default
- Role of the counterparty
- Type of the counterparty
- Status on 31/12/2014, 31/12/2015, 31/12/2016
- Balance at 31/12/2014, 31/12/2015, 31/12/2016
- Total provisioning on the exposures at 31/12/2014, 31/12/2015, 31/12/2016

The impact of the proposed calendar approach has been estimated through re-elaboration the total provisioning according to the calendar approach, under the following assumptions:

- Linear calendar provisioning proportional to the vintage of the default exposures (that has been determined as the number of days since default)
- Calendar provisioning as a minimum backstop (where current provisioning exceeds calendar provisioning, the first has been considered also in the new scenario)
- Exposures to factoring have been considered as “unsecured”. Although the consultation paper refers to the eligibility of collaterals under CRM-rules, notwithstanding the application of a Standardized or IRB approach, the eligibility of trade receivables and credit insurance is questionable and uncertain so that factoring might be considered as fully “unsecured” and subject to the 2 years full provisioning deadline. A 3-year period has then been considered as proxy of a “full provisioning cycle” under the ECB calendar approach
- All NPLs of the sample have been classified under the current classes:
 - PDU (past due over 0 days)
 - UTP (unlikely to pay)
 - SFG (bad debts)
- To simplify the analysis, only final default status has been considered.

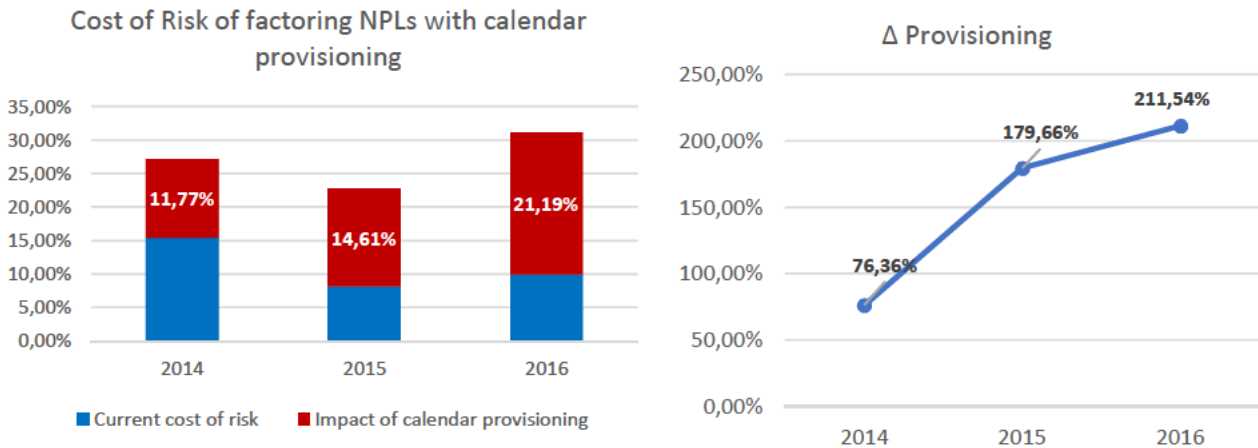
The difference between the current provisioning and the calendar provisioning for each year has been considered in order to estimate the impact on the profit and loss for each of the three year. Although the analysis is “backward looking” and not “forward looking”, the working group assessed that provisioning in factoring are more stable than in banking so the past 3 years could provide the best and simplest proxy of the actual impact on the next 3 years, also considering the strict timing of the consultation.

3. Results

The total impact on the profit and loss of factoring companies the three years analysed is estimated to +247.093.343 €, representing an overall increase on the current provisioning of +165.9%. The increase in provisioning is growing during the three years. The lower impact on the first exercise is in line with expectations and consistent with the linear provisioning proportional to the vintage of the exposure as all analyzed counterparties defaulted after 1st January 2014. The large impact on 2016 profit and loss is consistent with the full provisioning backstop under the ECB calendar approach after 2 years since default.

The impact on the total cost of risk ranges from 11.77% in 2014 to 21.19% in 2016.

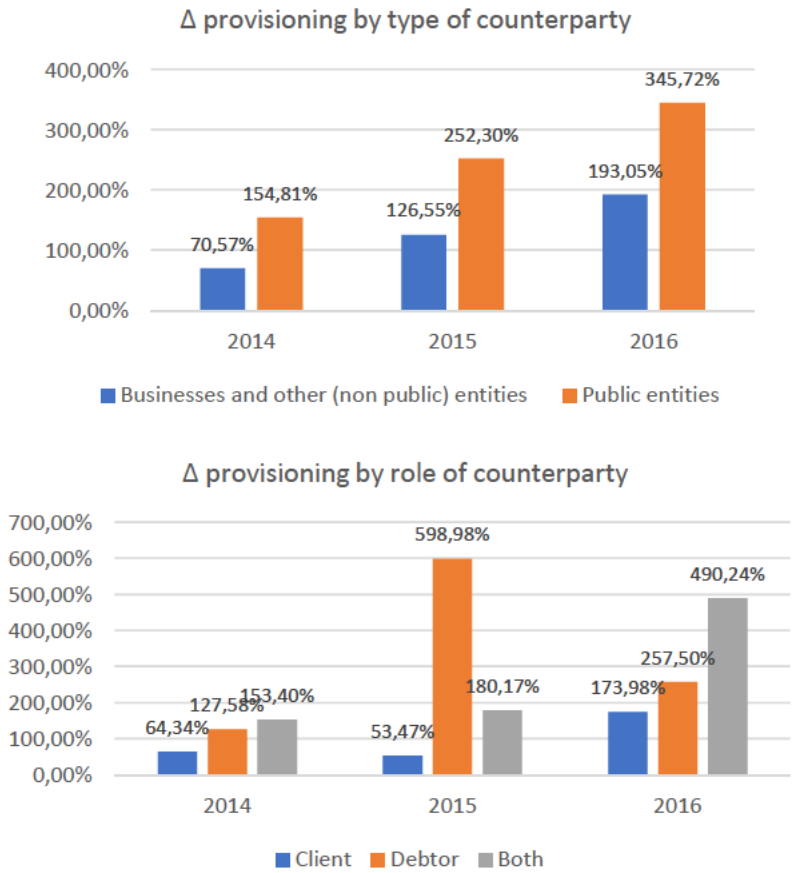
Picture 3.1 – Cost of Risk of factoring NPLs with calendar provisioning



The impact looks higher for non performing exposures to assigned debtors than for clients, and in particular to public administrations.

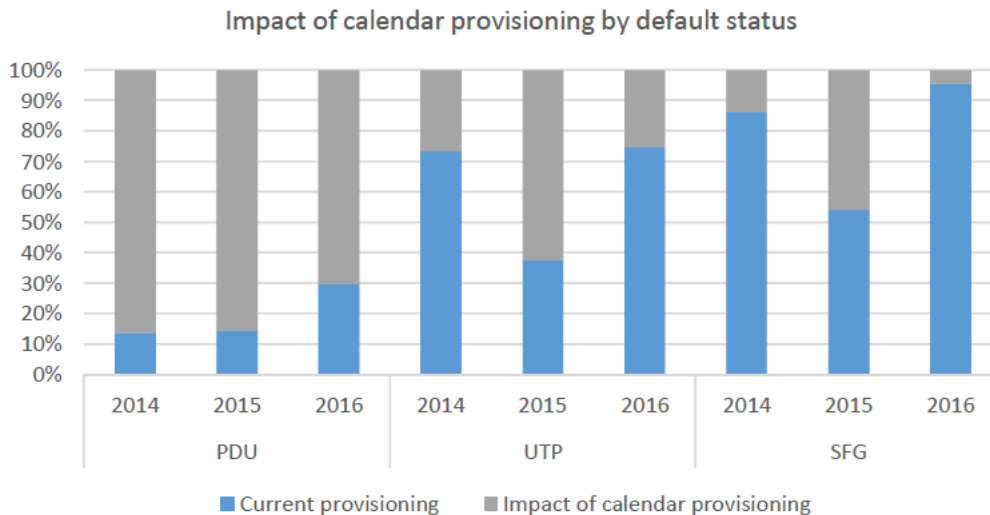


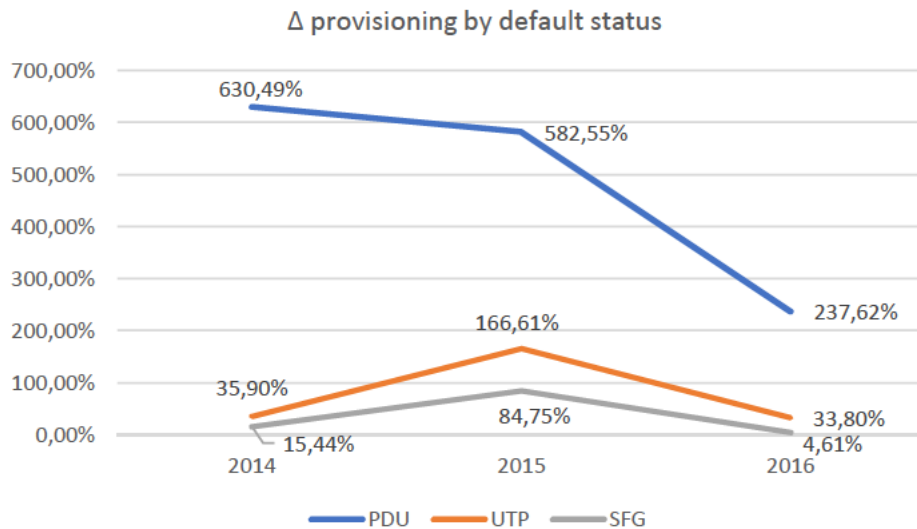
Picture 3.2 – Impact of increased provisioning under calendar approach by type and role of counterparty



The impact varies depending also in default status. In particular, the impact is significant for UTP and SFG, and it is dramatically higher on past due over 90 days exposures.

Picture 3.3 – Impact of increased provisioning under calendar approach by default status of counterparty





Such an impact on PDU was far from unexpected: past due over 90 days, especially on debtors, does not represent a true indicator of default in factoring. There usually is lot of volatility in such status, with a significantly high cure ratio. Thus, factoring companies usually consider these peculiarities when assessing the value of the purchased receivables for provisioning. Therefore, it is not surprising that past due status would be significantly impacted by a linear calendar approach. The magnitude of such impact, however, looks tremendous, especially considered that PDU does not represent a real sign of default when trade receivables are involved.

Conclusions

Although the exercise necessarily presents some flaws, namely a simplified backward approach and a sample not covering the whole market, the estimated impact is consistent with expectations.

The Addendum, in its current form, proposes an approach the impact of which seems to go far beyond its purposes, with the counterdeductive consequence to penalize low risk exposure such as factoring introducing a methodology to provisioning merely based on “vintage”, that does not take into account the peculiarity of trade receivables.

The largest impact is indeed on the lowest risk exposures such as purchased receivables to debtors that are past due but, especially in the case of public debtors, do not present any actual increase in credit risk. The current provision practices consider such features of the purchased receivables, that would be frustrated in the case a linear calendar approach to determine minimum regulatory backstops for provisioning would be adopted.

A wider sample and clearer instruction on the treatment of purchased trade receivables could allow deeper analysis.