



Media briefing on the addendum to the ECB Guidance on non-performing loans, 4 October 2017

Transcript

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Moderator: Good morning and welcome to our media briefing on the draft addendum to the ECB guidance on non-performing loans [NPLs]. I have with me here this morning Sharon Donnery, Deputy Governor of the Central Bank of Ireland and chair of the ECB Task Force on NPLs, and Giuseppe Siani, ECB Deputy Director General. We published all relevant documents on the addendum this morning. Sharon will now give a short introduction and then we will be at your disposal for questions.

Donnery: Thank you and good morning and welcome to the media call. The aim of today's call is to announce the launch of a public consultation on quantitative guidance for the provisioning of new non-performing loans. First, however, let me start by providing some context for today's announcement. Loans granted by banks are classified as non-performing if the debtor has not paid interest and/or principal for a period of time. High levels of non-performing loans in the banks affect funding and capital, reduce profitability and consequently inhibit the supply of credit to households and companies. Working out NPLs is therefore important for both bank viability and macroeconomic performance. Addressing asset quality has been one of the key priorities of ECB banking supervision since its inception. Following the comprehensive assessment in 2014, it was clear that different banks across the euro area were taking a very different approach to NPL workout and resolution and had been subject to diverse supervisory practices.

For this reason, in 2015 the supervisory board established a high-level group to develop a consistent supervisory approach to the treatment of NPLs. On the 20th of March 2017 we published guidance to banks on non-performing loans. Drawing from best practice in tackling NPLs internationally and across the euro area, the guidance sets out ECB banking supervision's expectations on NPL management going forward. The guidance prescribed a range of measures that banks must implement to address NPLs. This includes that banks should review their internal governance structures and operational arrangements in the context of NPL management. So, for example, banks should establish dedicated workout units. Management bodies must

take full ownership of the problem. The guidance also requires banks to implement time-bound action plans to close potential capacity gaps. In line with the guidance, banks are required to implement ambitious yet realistic NPL strategies for tackling NPLs.

These are the Bank's own plans to reduce non-performing exposures and foreclosed assets. Our supervisory initiatives have started to bear fruit. Over the last year we have observed considerable action by significant institutions to reduce the stock of NPLs across euro area Member States, leading to a decrease of €85.8 billion to around €65 billion when comparing quarter 1 2017 to quarter 1 2016. However, in many cases further work is required and the SSM has already started to follow up with banks in this respect. However, the ECB is not alone in tackling the NPL issue. Addressing Europe's NPL problem goes beyond the supervisory domain. The deliberate and determined reduction of non-performing loans therefore requires concerted action from all relevant stakeholders, both at national and at European level. Against this background, on the 30th of June we published an extended report that analyses national supervisory practices and the legal frameworks related to non-performing loans.

This stocktake shows that lengthy legal procedures and insufficient court capacity represent a significant obstacle to banks in their ability to reduce NPLs. For this reason, proactive and coordinated concrete legislative changes aimed at improving the efficiency of the judicial system as well as developing a framework for timely out-of-court collateral enforcement would contribute to the workout of non-performing loans. We appreciate the ongoing work of the European Commission and Member States as well as the significant contribution by the European Banking Authority to develop a more comprehensive range of measures to tackle non-performing loans in Europe. We are therefore pleased to note the clear action plan included in the ECOFIN [Economic and Financial Affairs] Council conclusions. We stand ready to further work with the interested stakeholders and contribute to the various work streams of that action plan.

Since publishing the guidance to banks on NPLs, we have also continued to work on further measures to address this issue. Today we are publishing for consultation an addendum to that guidance. It supplements the qualitative guidance already issued, with a quantitative element for new non-performing loans. It aims to foster more timely provisioning practices going forward and represents the next step on the journey towards addressing this important issue. In essence we want to prevent a build-up of insufficiently covered non-performing loans in the future. The reason why we have developed this specific policy is that we see that loans that have already been non-performing for a long time are often insufficiently provisioned for. This policy therefore aims to foster a prudent provisioning and write-off culture for new non-performing loans going forward. It outlines a calendar with reasonable limits for banks to address this issue.

In terms of the specifics of today's announcement, our expectation is that unsecured loans will be 100% covered following two years of being classified as non-performing. For secured loans a 100% coverage will apply after seven years of being classified as non-performing. Therefore banks should provision in a more timely

fashion going forward. The expectations will be applicable to all new non-performing exposures classified as such after the 1st of January 2018. Importantly, this includes not only past-due loans but also the unlikely-to-pay category, as in some countries the amounts of unlikely-to-pay loans are very high. This is purely a prudential tool. The prudential provisioning approach builds on existing accounting provisions, topping them up with CET1 deductions where required. We expect that the existing accounting provisions at most banks will be adequate from a prudential perspective.

The addendum, like the guidance, is applicable to all significant institutions and is non-binding. However, banks will have to explain their decisions if they do not comply. Based on a case-by-case supervisory assessment, ECB banking supervision will consider bank-specific supervisory measures in the case of unjustified deviations. However our journey to addressing non-performing loans does not stop here. In addition to today's policy announcement, by the end of the first quarter of 2018 ECB Banking Supervision will present its consideration of further policies to address the existing stock of non-performing loans, including appropriate transitional arrangements. To conclude, we believe this is an important step in restoring the health of the banking system [that is] necessary for a strong and healthy euro area economy. Thank you and we look forward to your questions.

Question: Two questions from me, the first on quantitative expectations; it's a line that Danièle Nouy used last week and at the conference in Brussels. Now, I don't want to misunderstand. When she was referring to quantitative expectations, which are, she said, a pretty big deal for you, is today's announcement what she was referring to? Or because you haven't stipulated quantitative goals on the part of the banks? Now, what does she mean: is it because the banks are not doing a good enough job that you will come up with an additional thing? Or what we're talking about by the end of the first quarter, is that what I understand on quantitative expectations?

The second one is, I know you noticed sort of good cooperation with the commission and Brussels, but do you think a plan for asset management companies to sell off NPLs can be revised? Would you like to see public money made available to subsidise the banks that can't get rid of them? I'm wondering whether, despite the good cooperation, other parties are moving a bit too slowly on this. Those are my two questions, thank you.

Donnery: Thank you very much for your question. First, in relation to the quantitative expectations, when Madame Nouy was speaking last week she was referring to this forthcoming guidance, so the quantitative expectations I outlined there in terms of the provisioning expectations we would have after two years for unsecured and seven years for secured. Maybe just to also remind people in terms of the original guidance which we published earlier this year, because there was some discussion about the quantitative elements of that at the time, which are more about the banks setting their own specific targets. So in our ongoing supervision of the banks and the implementation of the existing guidance, clearly we look at the banks' own plans for how their non-performing loan situation is going to evolve and what progress they

are going to make also in terms of quantitative aspects. But really her remarks last week were more about this proposal that we are publishing for consultation today.

Now, in relation to your questions around the other actors and the role of asset management companies and so on, maybe a few observations. Firstly, we know that, certainly in some countries, asset management companies have contributed to resolving some of the issues related to non-performing loans. We know that there are considerations ongoing about how asset management companies could work in the future and work on the so-called blueprints and so on that have been discussed. As I said in my opening remarks, I think there is no one single solution, no silver bullet to dealing with NPLs. The work we have done previously, including our stocktake for example, shows that various different people both at national and European level have a role to play in taking different actions to deal with the issue. So we continue to work closely with all of those stakeholders in trying to progress those things as quickly as possible.

Question: So just to understand, the appropriate transitional arrangements for – by the end of the first quarter next year –, that doesn't include specific quantitative reduction targets, then?

Donnery: As I said, we will make some further considerations of what our next step is. If you think about what we have done all along, it started with the comprehensive assessment. Then we had the consultation on our guidance which we published earlier this year. Now we have this consultation so I would say we are going step by step. In terms of the stock, what we're saying today is that work continues with the banks in terms of our engagement on their plans and their strategies and so on. We'll continue to consider the issues related to that and early next year we'll publish some further considerations about where that goes from there.

Questions: I have two questions. The first one is related to the SREP process [Supervisory Review and Evaluation Process]. Could you explain a little bit how the new guidance dealing with new non-performing loans will enter into the SREP process?

My second question: two years and seven years, that implies that there must be some kind of stepwise process to secure the loans. Is there any kind of more detailed process you have in mind like you – that you – so that you can exclude that the banks will act only like very late in the sixth or seventh year?

Donnery: So maybe on the last point first, the guidance sets out a proposal that it would be introduced or phased in on at least a linear basis. But as I mentioned, I think an important aspect of that is this dialogue that we will have with the banks from a comply-and-explain perspective. So if there were a valid reason for example for not doing that, then we would consider that. But the guidance tries to deal with exactly the point you raise: that you don't kind of put off everything until the very end by saying that we would expect at least a linear approach.

Then, in relation to the SREP, we have the guidance that we published already earlier this year and now this proposed addendum. Of course it is intended that all of that, the implementation of that guidance and indeed this addendum, would be part of our SREP analysis. So the progress the banks are making on implementing that guidance and demonstrating to us how they are doing that and what progress they are making would be a factor that we would consider as part of the normal kind of SREP process and our normal credit assessment in the SREP.

Question: I have a couple of questions. The first is, you talked – at least the statement this morning said – you're kind of happy with how a number of the banks are dealing with NPLs. Do you have a percentage of banks you think: yes, okay, they're doing pretty good right now; they don't really need much guidance? Also, are there specific reasons or countries that seem to be doing better with NPLs than others?

Donnery: I think what I tried to say in the statement is really that the situation varies in different banks. If you think back even to the point of the comprehensive assessment, as I said it was clear that different banks were in different situations in terms of the progress that they had made up until then. We also know, even for example from the effect of the macroeconomy on NPLs and how that interacts, that different economic circumstances in different countries also impact on how NPLs can be worked out. So I would say we have seen some banks make good progress. We have seen other banks make not so good progress. We would be engaging quite intensively with them to ensure that that progress is made better, I think. I don't think it's possible to say there's one particular group of banks or indeed one particular country that's doing better than others. I would say the circumstances vary.

You can see of course, from the data which I mentioned, that overall progress is being made and we will continue to engage with the banks to make sure that that progress is sustained. I think the words I used in the statement were “deliberate and determined reduction” of non-performing loans. I think one thing we want to make sure of is that we don't see banks who initially make some progress then slip back into the bad habits of the past. So we really want to see determined progress that continues on and that's the kind of focus of our engagement.

Question: Two questions, if I may. One, can you explain just why it is that these amendments, this addendum is not binding? What's the point of doing something if you can't make the banks do it?

I guess also as follow-up to that, under what circumstances would you allow a bank, in your words, to explain rather than comply?

Donnery: I suppose the framework of law sets out different ways that we can go about doing things in terms of how we impose things on banks. I think in this case our view is that we have been completely transparent about setting out what our expectations are. So our earlier guidance and this guidance are published for

everyone to see. We have a public consultation process. After the public consultation process we will show everybody the comments we received and to what extent those comments have been taken on board or not. Our view is, because of that transparency, it's clear to everyone – both the banks but also external analysts and commentators and investors and so on – exactly what our expectations are. So everybody knows what they are and in a way that is part of the discipline, I suppose, of ensuring that things get actioned upon.

In terms of comply-or-explain, I think it's really about evidence. So, you know, a bank can say maybe that they don't think they should comply with something. But that's not enough for us to accept that that's the case. Why is it that they don't think they can comply? Is it a problem with their own internal systems and controls, for example, that needs to be fixed? Is it some particular issue about the profile of their borrowers or the particular profile of the book of loans that they have that means they can't comply? So it's really down to the engagement that will happen between our supervisors and the bank about what exactly that issue is and why it's a valid reason for them not to comply, or if for example they can comply but not comply right now and they need to make some changes to something to actually be able to implement it. That's very much how the process works.

Question: Could I just clarify two things, if you'll indulge? One is just how this works with the expected loss accounting because I just don't have a clear sense of if your proposed two years ends up being an acceleration of what's coming in the accounting change.

Then on the future guidance I'm just not sure what “transitional arrangements” would be referring to. I have the feeling like it's code for something, I should probably have already immediately understood it. But can you just maybe elaborate on what are the transitional arrangements that we're looking at for the existing stock?

Donnery: So just in relation to transitional arrangements, I suppose it would be normal when we introduce something, a new set of expectations or a new requirement, that some aspects of them maybe would become immediately applicable. Some aspects would take time for banks, just even from a systems and controls point of view, to be able to implement them. So we would often allow a kind of phasing-in approach for something new that we were introducing. But again I would go back to my earlier comment about transparency. If we were to do that it would be clear to people what became implemented immediately, what was going to be phased in on some basis and so on. So I think it's – our statement there is really just to reassure people that if something significant were happening, we would of course consider whether it should be implemented straight away or whether it should be implemented with some phase-in. Giuseppe will explain the issue around IFRS 9 and so on I think you were referring to there.

Siani: As Sharon said during her introductory statement, these calendar provisions fully consider the accounting developments and so it's just [that] they're topping up [where needed]. So these policies do not interfere with accounting. You know that we

do not have any accounting-related power so it's just a prudential tool, like Sharon said. Banks will still follow the application, the accounting standards. Then it will be a top-up from a prudential perspective, where needed, of course, subject to the conditions that Sharon explained before.

Question: So IFRS 9 might not require, say, 100% provisioning after two years so you in a sense could be accelerating that?

Siani: I would not say that. It really depends on the expected loss accounting that the banks are – and how they are – implementing that. In principle this could maybe promote a higher provision also from an accounting perspective. But this is really something that is purely separate; we'd just top up on what the accounting provisions would require.

Question: It's again a question on the stock of existing NPLs. My question is why the SB [Supervisory Board] has already taken a decision in principle on the coverage of the stock of existing ones – that the coverage must be similar to the one for the flow of new NPLs, so 100% in two and seven years –; whether in principle that decision has already been taken and it's a matter of how to implement it. My second question, it's really a follow-up. Given that we have nearly one trillion of existing NPLs in the euro area and the coverage is roughly 50%, if the decision has been already taken in principle it would be a big deal for banks no matter what the terms of the transition will be. So the question is, have you given any consideration to the fact that by announcing that you will announce something in the first quarter of 2018, you may already be introducing uncertainty? The banks might respond with credit retrenchment because they don't know what is going to happen to them.

Donnery: To be absolutely clear, the existing guidance that we published earlier this year in March is our supervisory expectations in relation to how the stock is to be managed. So the examples that I gave in my statement about, for example, setting up independent workout units, the item I mentioned in response to an earlier question, for example, about the banks having to have strategic plans for dealing with NPLs, having their own NPL reduction targets, the board of the bank being clearly responsible for overseeing the strategy and ensuring it's implemented and so on. The existing guidance that we published earlier this year is how we expect banks to be working through the stock of loans that they have already. I think we've been very clear today that the proposals we are making around the calendar relate only to new non-performing loans. I also said in my opening statement that the reason for that is [that] part of our job is also to prevent a further build-up of non-performing loans in the future.

So we are trying to address both aspects through our earlier guidance with the stock and this guidance today for the new. In relation to our announcement that further considerations will emerge early next year around the stock, including appropriate transition arrangements, I think in fact we were trying to avoid any uncertainty or any

concerns by making it clear that today's announcement only applies to the new, and that our work on the stock continues, particularly in terms of our engagement with the banks and looking at the progress that the banks are making. To the extent that the banks continue to make good progress, I think we will be able to take that into account in our further considerations before we make an announcement. But we were trying to avoid that.

Question: Can I follow-up on that because I don't think you have quite responded to my first question, which was whether the SB has already taken a decision in principle on the hypothesis of 100% coverage for the existing ones.

Donnery: The decision of the supervisory board I think is clear in what we are publishing today and that the decision relates only to the new and it is clear that that is the case. It relates only to the new and therefore I think it's clear that no decision was taken in relation to the stock because the proposal only relates to the new.

Question: I'm sorry to ask such a basic question but I just want to be clear about something. You were talking about the fact that the unsecured parts of loans need to be 100% provided for after two years. Is there any way that you can put that into the context of what's actually the current situation for non-performing loans?

Donnery: Sorry, do you mean in terms of the gap in terms of how highly covered this is?

Question: Yes, well, I'm aware that you said in March, I think 45% of non-performing loans are currently provided for, I think was the figure you gave. But I'm trying to understand this two-year time horizon; what perspective can that be put in, in terms of what the current situation is for non-performing loans?

Donnery: Yes, I think the issue is that coverage levels vary across different banks and vary across different countries. So it's difficult to give you an exact number, I think, in terms of how exactly the situation is now. What we tried to do in relation to the two years and the seven years was to think about kind of balancing what is feasible and practical against where the banks are now and also things like, more so for secured really than for unsecured, judicial proceedings and how long those things take. So the two and seven years are really, I suppose, a judgement around what's appropriate from a prudential point of view to make sure that it's cautious and prudent enough balanced against giving banks a reasonable time to work out a loan, and then for secured balanced against how long it might take for a bank to recover their collateral. We can check up maybe if there is a figure or something that we can provide you [with] after the call.

Question: Two questions. The first is, why did you choose not to apply the new provisions to the stock of NPLs? The second is, do you have any evidence so far that banks that have been quicker in reducing the NPL ratio are then lending more, which was the – one of the aims of the exercise?

Donnery: I think in relation to the first question, in relation to the stock, we set out very extensive expectations in the guidance that we published earlier this year. The banks are working to implement that. Our supervisory teams, through their ongoing supervision and also through other tools like our on-site inspections and so on, are working to ensure that progress is being made on that. So I think our view was that that was an important intervention that covered a wide range of aspects of how non-performing loans should be managed. It's kind of almost a guide through the entire lifecycle of a loan in terms of, once it becomes non-performing, how it should be managed. We felt that that was a quite extensive way to set out our expectations for the banks.

As I said in response to one of the questions earlier, there is clearly also a concern about the build-up of non-performing loans into the future, that either this could continue or could at some point in the future begin again. This has been such a significant problem and once a non-performing loan problem builds up, it takes a great deal of effort and a great deal of time to deal with it. So we felt it was important that we would try to mitigate against that also happening in the future. From our point of view, we consider that [to be] an important part of our supervisory role. So I think that's why we've made this distinction, that this particular aspect of our guidance applies only to the new.

In terms of your other question, I don't want to get into discussions about specific banks. But I would say in general the literature and analysis which is out there in public would demonstrate that in general banks that have high levels of non-performing loans lend less, and banks that have lower levels of non-performing loans lend more, and that therefore non-performing loan [levels] are also important for the channel through which credit gets into the real economy. It can also impact, for example, the transmission mechanism for monetary policy. There is a wide range of literature out there related to that. So I think that would also support our view that it's important that both the stock gets tackled but also that into the future, a further non-performing loan problem isn't allowed to build up.

Question: Just a quick follow-up, the problem for some at least is that while they're in the process of cutting the NPL ratio, they lend even less because they have got – it's in their interests to I guess set aside provisions, try to accumulate capital. They certainly don't want to take on more risk. So there's a pro-cyclical element in that, in the economy which is already struggling and banks [being] asked to cut the NPL ratio leads to less lending.

Donnery: I think that in effect is why we want progress to be made on the stock. For the banks that have an existing stock of non-performing loans, clearly it impacts on their capital, their funding costs. If you are diverting large numbers of resources even

in terms of your staff time and your IT systems and so on to deal with the large non-performing loan problem, then clearly that's a drag on resources that could also be dealing with other parts of your business and lending new loans, for example. So I do think that's part of the rationale for why we issued such comprehensive guidance to deal with the stock. But it is also a factor in considering the future in terms of how banks operate into the future and trying to ensure that they don't get into that problem again. In a sense, with the stock we are where we are and it has to be dealt with. We can't go back so the banks will have to make the kind of efforts that are needed to deal with that problem. But we also want to avoid a problem in the future.

Question: Very short questions.

The first: If you considered or made any impact analysis on lending activity after the measures announced today.

The second, about the prudential tool; how this prudential tool will apply. Would there be a request of increasing provisioning above the accounting requirements, for example? Or will there be a reduction in capital?

Third, about the existing stock: maybe there is a risk of increasing the uncertainty if you cannot give us some details about the measures that will be announced next year. Maybe it could be interesting to understand also if there will be a request for a reduction in the existing stock of NPLs in a quantitative manner similar to the one that has been announced today.

Donnery: First, in relation to the impact: I think you said on new lending, how it would impact on new lending? From that point of view, we have looked at various different options for the two and seven years. We have looked at various different options around how it could be phased in and introduced. So I think we have tried to take into account a wide range of factors and come up with a balanced and reasonable proposal that we think is reasonable for the banks to implement. In terms of new lending and so on, I would say again that in general we expect as banks deal with non-performing loans that it makes it easier for them to re-enter a situation where they can grant credit.

In relation to the stock and reduction targets, I would just clarify again maybe an issue with your roles when we published the original guidance in March. At that time there were a lot of questions about targets for the banks. We were very clear in saying that the situation for the individual banks clearly varies in terms of how much progress they have made up until now. So it would not be reasonable for us to simply say, "The target for everybody is x." The approach that we took in the guidance at that time was that we would engage with the individual banks. They would be expected to set out a strategy for how they were going to deal with their non-performing loans. That strategy would have to be ambitious but realistic, so it would have to demonstrate to us that they were making good progress but also that it was possible for them to implement that strategy, that it wasn't kind of wishful thinking, for want of a better word. So we have engaged with all of the banks in relation to those strategies and what their own targets are. Then we will continue to engage with them about the progress that they are making or not, to make sure that they are actually

delivering. That was the reason for not having a blanket target for everybody that would be a kind of standardised approach for everyone. Sorry, your third question was in relation to?

About how the prudential tool will...

Donnery: Maybe Giuseppe will clarify that.

Siani: I think that we will apply other – the option of applying deductions from CET1, but we can also consider this as part of the Pillar 2 add-on. This is really, again, based on the assessment of the specific banks.

Question: Just a follow-up: if I understand well, you think that there will not be any consequence for lending also in the short term, right?

Donnery: I'm not sure I fully understand what you mean. I would say for any individual bank, of course they have to take into account their current situation in relation to how that impacts on their current approach to new lending. So of course different banks who have non-performing loan problems on different scales may have a view on how that impacts whether they can engage in new lending. But I don't particularly see that any individual bank would see this as an immediate problem for new lending. The idea is to foster prudent provisioning, prudent write-off policies and to give banks a reasonable time, if a loan becomes non-performing, for them to deal with that before it has to be fully provisioned.

Question: My question is the following, since it's not a mandatory rule or guidance, will there be a possibility of sanctions for banks not respecting the guidance, for instance after a number of dialogues with this bank not complying? We have seen the ECB imposing penalties in the recent past for banks not applying correctly the guidance on other matters. But now my question relates to this new one.

Donnery: The guidance itself, as I mentioned earlier, is non-binding and so a breach of the guidance in the way you describe cannot automatically lead to a sanction. But if you imagine the process we might go through, we have this comply-and-explain that I mentioned. Of course your progress on implementing both our earlier guidance and this would be taken into account, for example as part of the SREP. We could have an on-site inspection, for example, to look at the progress that you were making on implementing it. As I said earlier, we would look at the evidence and so on in relation to all of that. Now, all of that engagement and ongoing supervision may ultimately lead to some form of legally-binding decision through some other process where at that point you were told, "From a legal perspective you must comply with the following." If you didn't comply with that, then that of course would lead to a sanction. But I would say initially [that] non-compliance with the actual document of the guidance itself couldn't lead to a sanction unless you had been through that kind of fuller process and had had a formal legally-binding decision imposed on you.

Question: So maybe the possibility of a sanction is not ruled out; it's just after a long process of dialogue – not automatically, of course.

Siani: This is really the usual practice, right, also with other guidance. You need to have the comply-and-explain process. Once you have an ECB formal decision that can be also part of the SREP the SSM can use all the tools available, including enforcement and sanction tools.

[End of media briefing.]