AFME Position Paper

ECB Draft Guidance on NPLs

15 November 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to the ECB's consultation on its "draft Guidance on Non Performing Loans (NPLs)".

AFME represents a broad array of European and global participants in the wholesale financial markets. We are contributing to this consultation on behalf of our Special Committee on European Supervision (SCES) which, in its SSM configuration, provides a platform for the most systemically relevant banks who are lead-supervised by the SSM to engage with the ECB's supervisory function and, in its full configuration, is a vehicle for engagement on the future development of supervision within the EU more generally.

AFME is fully supportive of the ECB's objective to address asset quality issues in the Eurozone. We also welcome the approach the ECB has adopted by engaging in the present public consultation process. We encourage the ECB to maintain this approach going forward in relation to other future supervisory priorities.

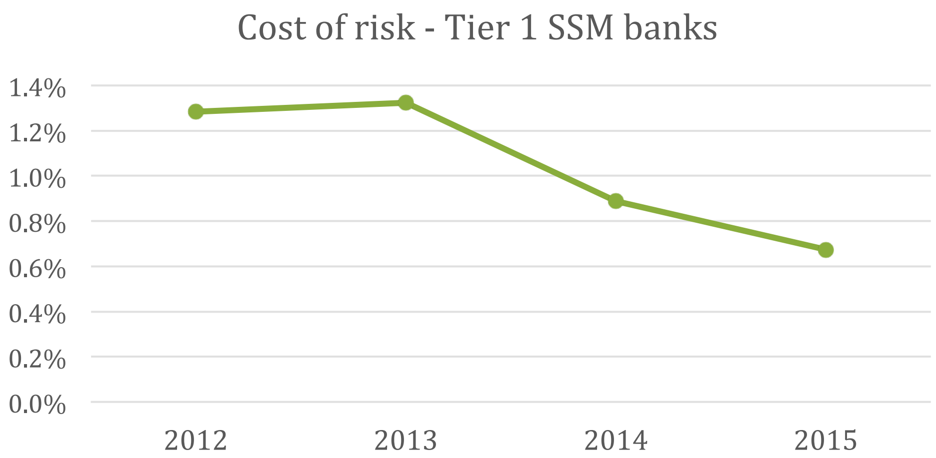
The comments below are intended to engage in a constructive discussion on how best to resolve Eurozone's NPL issues in the Eurozone and should be read in conjunction with other industry contributions on the details of the guidance itself.

Tackling NPLs in the most effective and efficient manner

We fully recognise the importance of the ECB demonstrating to the market that the NPL issue in the Eurozone is being tackled. Publicly setting out its supervisory expectations in this respect is very helpful. We also acknowledge that the ECB has observed varying practices between SSM supervised banks with respect to the "identification, measurement, management and write-off of NPLs" and is thus seeking with this document to provide guidance based on best in class examples of how NPL practices should be carried out most effectively.

In our view, an underlying objective of the draft guidance is also to foster harmonised approaches to banks' NPL practices to facilitate the ECB's supervisory task with respect to its asset quality objective. While fully understandable, this ancillary objective creates several issues for our members in practice.

This is because AFME's members are amongst those banks who have already identified problematic NPL portfolios, put NPL strategies in place and actively manage their NPL portfolios. They engage with and report extensively to their supervisors on these matters. Their approach to NPL management has proven to be effective, as is shown in the downward trend in their cost of risk over past years:



Weighted average cost of risk (loan loss provisions/average gross loans) for 10 SSM banks, data taken from Reuters: Deutsche Bank, Commerzbank, BBVA, Santander, BNP Paribas, Credit Agricole, Société Générale, UniCredit, Intesa San Paolo and ING. Does not include Commerzbank in 2012 and 2013 and ING in 2012 due to missing data.

At the same time, the draft guidance is extremely detailed and far-reaching and, as it is currently written, may suggest that the ECB will require the introduction of new processes, reports, organisational changes and IT adjustments regardless of whether a firm already has sound NPL practices in place. As such, its implementation could be duplicative and costly for these firms who are successfully managing NPLs, without necessarily being of any added-value to their business or the resolution of the broader Eurozone NPL problem itself. Moreover, from a risk perceptive, we see a down-side to asking firms to replace their proven NPL processes with new practices and fear that this could be disruptive and counterproductive.

Achieving the objective through increased transparency and disclosure requires more fundamental change

The draft guidance requires banks to report to supervisors and publicly disclose a significant amount of information relating to NPLs. We agree that transparency is key in restoring market confidence and ultimately enabling markets to play a role in NPL management. At this point in time however, we do not consider that there is a sufficiently deep and liquid market for Eurozone NPLs and, in the absence of such a market, it will ultimately be difficult to fully address the issue of Eurozone bank balance sheet quality. General efforts to promote the development of this market are thus welcome.

In the present legal environment, we have however some reservations as to whether the proposed disclosures will achieve this intended outcome of enabling comparability. This is because there are still too many national differences in implementation of the various concepts covered by the guidance. For instance, the link between forborne, (non) performing and defaulted exposures is not always aligned between countries and banks and it will remain difficult for true comparisons to be made by the market. Additionally, the different approaches between accounting and prudential frameworks continue to complicate the matter and greater harmonisation of insolvency laws across the Eurozone (and EU) is necessary to facilitate NPL workout. We therefore welcome the forthcoming European Commission proposals for closer harmonisation of insolvency standards across the EU.

In our view, the types of issues described above will need to be dealt as a matter of priority as they are pre-requisites to effectively addressing NPL issues. Unless addressed, there will be still be barriers to achieving the objectives of the present guidance. Before finalising the guidance, we therefore recommend that the ECB analyse carefully how the proposed guidance and disclosures may impact secondary market demand and we recommend that they commit to closely monitoring market developments going forward, standing ready to adapt the guidance if necessary. Finally, we wish to recall that the guidance should not introduce additional classification requirements or definition components above those that already exist at EU level.

More information on intended supervisory approach is necessary

Bearing in mind the above considerations, the draft guidance currently does not set out sufficiently clearly what the supervisory approach will be[1], particularly for "low NPL" firms or firms with well performing NPL strategies and management. In other words, it is not clear how the principles of materiality and proportionality will apply, particularly when viewed against the stated applicability of the guidance.
As the ECB is undoubtedly aware, the definition of a high NPL firm proposed in the consultation is quite vague and firms may fall in and out of the definition over time as the average EU (or Eurozone?) NPL ratios will constantly evolve.

Specifically, more information on the circumstances where firms will be required to explain and substantiate any deviations, and situations where supervisory measures (and indeed what type of supervisory measures) will be applied is required. Setting out publicly this supervisory approach in more detail, together the time frame the ECB will require for changes to be made (to what extent will these changes be considered already for 2017?), will provide more market certainty and enable banks to engage in a more constructive and efficient supervisory dialogue.

In summary, we therefore encourage the ECB to provide more information to banks on the timeline for implementation as well as their key priorities so that firms are clear on deliverables and timings

The drafting of the guidance needs to be clarified in certain other areas

In addition to further clarifying supervisory expectations as explained above, the guidance also needs to be clarified, or being drafted in a more targeted manner some areas.

For instance, differences in practice and behaviour between retail and non-retail NPLs should be recognised consistently throughout the guidance. Further consideration should also be given to whether and how the guidance should apply to purchased NPL portfolios. Additionally, while we welcome recognition that the concept of management body used is the EBA concept, the guidance

[1] We note that the Supervisory Board mandated the high-level group to set out a consistent supervisory approach to NPLs as opposed to requiring harmonised bank NPL practices

must also be neutral to firms' board structures (one tier vs two tier board structures) so that ultimate responsibility lies with the most appropriate organ in the firm. We also consider that the level of involvement of the management body should be coherent with the internal governance framework of each firm. Therefore, not all the tasks and activities identified and assigned in the guidance to the management body, should be directly addressed, at least with this granularity, by the Board of Directors. Finally, to achieve the right balance, the guidance also should refrain from requiring specific organisational change when this is not essential to achieving high quality NPL management. This may require further specification of the proportionality and materiality principles so that it is clear the cost/benefit of change will be taken into account by supervisors.

Overall, we recommend that the level of detail of the final guidance be reconsidered to avoid forcing change in a very specific way when this is not justified in terms of the final objective. We remain at the ECB's disposal to assist in achieving this objective and in facilitating dialogue between the SSM and our member firms.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

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