



Template for comments

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

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Febelfin

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

General comments

First of all, Febelfin, the Belgian Financial Sector Federation, welcomes the opportunity to comment the ECB draft Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures as published on 4 October 2017.

We have in the meantime also taken note of your introductory remarks to the ECB public hearing of 30 November 2017 on the draft Addendum to the ECB guidance to banks on non-performing loans: "The main purpose of the draft addendum is to make our approach transparent. And I would like to mention something which has sometimes been misunderstood: our expectations are firm, but there are no automatic actions attached to them. We will discuss provisioning with each affected bank: and we will duly consider the clarifications as well as the specific circumstances of the bank. If we are content with the clarifications, then no further action will be proposed. However, if we are not convinced and believe that a bank's provisions do not adequately cover the credit risk, we may consider supervisory, prudential measures under the Pillar 2 framework."

Nevertheless, we would like to share with you some of our main concerns in respect of the draft Addendum.

Indeed, albeit the Belgian banking industry fully agrees with the need for a sound and responsible supervisory oversight of banks' management of non-performing loans ("NPLs"), Belgian banks strongly support a proportionate approach more specifically focused on high NPL banks. It is to be observed that such a proportionate approach is already applicable today, when relevant, to banks under direct SSM supervision based on the existing supervisory powers attributed to the ECB since November 2014.

We wonder thus if the proportionality and materiality principles will be applicable, i.e. Addendum only applicable for high NPL banks?

The text of the draft Addendum seems to rather promote a one-size-fits-all, mechanical approach for all (significant) banks within the Banking Union, whatever the level of their exposures to NPLs and the way they manage them, based on new prescriptive rules banks would a priori have to comply with – or to explain, with the burden of the proof being attributed to the banks, not to the supervisor: based on the draft Addendum it would not be to the supervisor to provide evidence that the provisioning level of the supervised bank is inadequate, but to the bank to demonstrate that its provision policy is adequate despite the auditors' control. It should be the other way around.

Therefore, from Belgian banks' point of view, the draft Addendum should be reworded.

Our most important concerns are detailed in the comments sheet.

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	Detailed comment	Concise statement as to why your	Name of	Personal data
1	1 - Background	1.		Clarification	<p>a. Level of application: the draft Addendum is rather unclear with regard to the level at which the backstop would apply. Should the backstop be calculated at facility, debtor, vintage, portfolio or bank level? Can excess provisions on one loan be used to offset shortfalls on another loan? E.g. for loans where the build-up of provisions is quicker than anticipated through a linear increase up to 100%?</p> <p>b. "Comply or explain" basis: deviations from the backstops are possible, if the bank can demonstrate that the backstop is not justified for specific portfolios or exposures (e.g. client is still making regular payments, application of the backstop in combination with RWAs would cover more than 100% of the risk, pulling effects,...). At this stage it is unclear how strict the ECB will be, i.e. whether it will allow deviations on very large parts of the portfolio or only for a very limited selection of sub-portfolios. Some comfort can be sought in the statement that "banks should continue booking accounting provisions in line with their assessment which, in the vast majority of cases, should result in the backstop not having any effect."</p> <p>c. Increase of the volatility and cyclicity of provisions and/or CET1: implementation is likely to increase the volatility and cyclicity of provisions and/or CET1. While the initial effect of applying the ECB backstop will be one of an increase in provisions and/or decrease of CET, this is likely to be in part temporary. Overly conservative provisions which are not economically justified will at a later point in time lead to larger provision releases (either through cures or recoveries). Therefore the long term effect of the ECB guidance may well lead to a significant increase in the volatility and cyclicity of provisions and/or capital.</p> <p>d. Interaction between the backstop and the calculation of required capital for credit risk: the interaction between the backstop and the calculation of required capital for credit risk is insufficiently clear and there is a risk of double-counting between the backstop on the one side and the RWA calculated under the Standardized or IRB-Advanced approach on the other hand. It should be clarified whether required capital can be considered in the calculation of the backstop or whether the effect of the backstop can be considered in the calculation of capital requirements.</p>	Some other important general considerations on the proposed backstop: on the level of application, "comply or explain" basis, increase of the volatility and cyclicity of provisions and/or CET1 and interaction between the backstop and the calculation of required capital for credit risk		Don't publish
2	2 - General Concept	2.2.	3	Clarification	<p>Pillar 1 vs. Pillar 2 Approach</p> <p>The SSM already has the necessary authority to adjust provisions, on a case-by-case basis, as part of the SREP, whenever it deems it necessary – as reminded quite recently by the European Commission: "Prudential regulation empowers the bank supervisor to influence a bank's provisioning level (including as regards NPLs) within the limits of the applicable accounting framework and to require specific adjustments to the own funds calculations of that bank if, for example, accounting provisioning is not sufficient from a supervisory perspective. Binding measures and requirements, however, can only be applied by the supervisor on a case-by-case basis depending on the individual circumstances of the bank (so called Pillar 2 measures). Individually tailored supervisory measures following a case-by-case assessment by the competent supervisor are appropriate for dealing with the specific NPL-related risks of individual banks. (European Commission's consultation document on Statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing", p. 4 sq., 10 November 2017).</p>	Belgian banks fully support such individually tailored supervisory measures following a case-by-case assessment by the ECB: it appears to be in our opinion the best way to address the NPL issue where (and only where) it is an issue. Due to its one-size-fits-all and quasi automatic nature, however, the new mechanism contemplated in the draft Addendum – setting the same minimal expected levels of provisioning for all (significant) banks in all participating Member States – can be considered as a Pillar 1 more than a Pillar 2 instrument.		Don't publish
3	2 - General Concept	2.2.	3	Clarification	<p>Quantitative vs. Qualitative Guidance</p> <p>Belgian banks consider that the ECB "qualitative" Guidance on NPLs (March 2017) is going in the right direction.</p>	In this respect, the timing of the measure contemplated in the draft Addendum is also questionable as the ECB "qualitative" Guidance on NPLs is now in the process of being implemented, with banks carrying out their individual NPL plans accordingly.		Don't publish
4	2 - General Concept	2.3.	4-6	Clarification	<p>Prudential backstop vs. IFRS 9</p> <p>Moreover, a quantitative prudential backstop does not seem to be necessary as the new IFRS 9 standard is going to be implemented from the 1st of January 2018.</p> <p>Indeed, IFRS 9 will lead banks to build an additional capital buffer based on a forward looking expected loss basis. Therefore, it would be more appropriate to allow the new standard to be applied and to assess its effects before taking any further action.</p>	IFRS 9 will lead banks to build an additional capital buffer based on a forward looking expected loss basis.		Don't publish
5	3 - Definitions	3.	7-9	Clarification	<p>Vintage vs. Cash Flows</p> <p>Belgian banks do not totally agree with the supervisory expectation of banks fully and automatically writing off their NPLs based on the sole vintage.</p>			Don't publish

4 - Prudential 6 provisioning backstop	4.1.-4.2.	10-1	Clarification	<p>Unsecured loans</p> <p>Full write-off of unsecured (parts of) NPPLs after 2 years is expected by the supervisor whatever the cash flows collected on the NPLs.</p> <p>The mere existence of cash flows should be enough to demonstrate that full provisioning is far from being justified – and, in practice, is far from being applied in the financial statements, under the auditors' control.</p> <p>Therefore, supervisors are invited to adopt a differentiated approach, based on case-by-case analysis and expert judgment and building on banks' implementation of the ECB "qualitative" Guidance.</p>	The crucial point for supervision in this matter is to make sure that NPL portfolios still generate cash flows and that provisions are taken accordingly.		Don't publish
4 - Prudential 7 provisioning backstop	4.1.-4.2.	10-11	Clarification	<p>Secured loans</p> <p>Full write-off of secured (parts of) NPLs after 7 years is expected by the supervisor based on the (wrong) assumption that a collateral that has not been realised is no more efficient.</p> <p>Actually, facts show that the (forced) sale of collateral is far from being the ideal solution. Indeed, it is in no-one's interest to exercise collateral. When banks have recourse to their debtors (which is the case for the majority of loans granted in Europe, where non-recourse loans are the exception), collateral should first be seen as an essential lever to incentivise debtors to pay.</p> <p>To focus on collateral valuation may induce banks to lend against collateral, i.e. to move from cash flow banking (that is banking proper), in which loans are made according to the value of the expected cash flows, to collateral-oriented banking (that is pawn brokering) in which loans are granted based on the value of their underlying collateral. As we are all aware, the problem of non-performing loans in connection with deteriorated underlying asset quality has played a central role in the last financial crisis.</p> <p>The metric supervisors should focus on the net accounting value of the portfolio. Indeed it is on this amount that the bank is at risk.</p>	Accordingly, it is the quality of the impairment process that should be at the heart of the supervisory approach, not collateral. Indeed the key weakness in proposals for prudential backstops on loan loss provisioning is that they only give value to collateral, and ignore cash flows from ongoing operations of debtors in default. These cash flows are significant (the net accounting value is actually the present value of these expected cash flows) and in some cases represent the majority of recoveries (for instance for unsecured loans, or when collateral is not enforced to ensure maximum recovery and preserve overall economic value). Accounting rules recognise the need to assess impairment allowances based on ultimate recoverability, and prudential coverage should do the same.		Don't publish
4 - Prudential 8 provisioning backstop	4.1.-4.2.	10-11	Clarification	<p>SA/F-IRBA vs. A-IRBA Collateral Recognition</p> <p>In order to define "secured" (parts of) NPLs, the draft Addendum refers to eligibility criteria applicable under the Basel non-model based approaches, namely, the Standardised Approach ("SA") and the Foundation Internal Ratings-Based Approach ("F-IRBA"). Both approaches are very restrictive regarding physical collateral compared to their wide recognition under the Advanced Internal Ratings-Based Approach ("A-IRBA").</p> <p>In this way, physical collaterals other than immovable properties will receive a very limited recognition under the prudential provisioning backstop while they significantly contribute to high recovery rates in the real life – and, accordingly, to low LGD values under A-IRBA.</p>	As a consequence, a significant part of collateralised corporate loans (incl. specialised lending and leasing) turning non-performing might have to be treated as "unsecured" after 2 years and, consequently, subject to a full write-off.		Don't publish
5 - Related 9 supervisory reporting	5.	12	Clarification	<p>Finally, Belgian banks are of the opinion that the ECB use of the "Guidance" instrument to define new minimum requirements expected to be met by all (significant) banks within the Banking Union is per se questionable.</p> <p>In their opinion, a supervisory "Guidance" should normally be restricted to clarify the implementation of Level 1 and 2 legislative texts instead of 'goldplating' existing regulations or anticipating regulations still under discussion.</p>	In this respect, the draft Addendum might unfortunately be seen as falling under the second case (anticipation of regulation under discussion) if we compare it to the above Commission's consultation on statutory prudential backstops published at virtually the same time.		Don't publish

Brussels, 08 December 2017

First of all, Febelfin, the Belgian Financial Sector Federation, welcomes the opportunity to comment the ECB draft *Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non-performing exposures* as published on 4 October 2017.

We have in the meantime also taken note of Mrs. Nouy’s introductory remarks to the ECB public hearing of 30 November 2017 on the draft Addendum to the ECB guidance to banks on non-performing loans: *“The main purpose of the draft addendum is to make our approach transparent. And I would like to mention something which has sometimes been misunderstood: our expectations are firm, but there are no automatic actions attached to them. We will discuss provisioning with each affected bank: and we will duly consider the clarifications as well as the specific circumstances of the bank. If we are content with the clarifications, then no further action will be proposed. However, if we are not convinced and believe that a bank’s provisions do not adequately cover the credit risk, we may consider supervisory, prudential measures under the Pillar 2 framework.”*

Nevertheless, we would like to share with you some of our main concerns in respect of the draft Addendum.

Indeed, albeit the Belgian banking industry fully agrees with the need for a sound and responsible supervisory oversight of banks’ management of non-performing loans (“NPLs”), Belgian banks strongly support a *proportionate* approach more specifically focused on high NPL banks. It is to be observed that such a proportionate approach is already applicable today, when relevant, to banks under direct SSM supervision based on the existing supervisory powers attributed to the ECB since November 2014.

We wonder thus if the proportionality and materiality principles will be applicable, i.e. Addendum only applicable for high NPL banks?

The text of the draft Addendum seems to rather promote a *one-size-fits-all*, mechanical approach for *all* (significant) banks within the Banking Union, whatever the level of their exposures to NPLs and the way they manage them, based on new prescriptive rules banks would *a priori* have to comply with – or to explain, with the burden of the proof being attributed to the banks, not to the supervisor: based on the draft Addendum it would not be to the supervisor to provide evidence that the provisioning level of the supervised bank is inadequate, but to the bank to demonstrate that its provision policy is adequate despite the auditors’ control. It should be the other way around.



Therefore, from Belgian banks' point of view, the draft Addendum should be reworded.

Our most important concerns are detailed here below.

1. Some other important general considerations on the proposed backstop

a. Level of application

The draft Addendum is rather unclear with regard to the level at which the backstop would apply. Should the backstop be calculated at facility, debtor, vintage, portfolio or bank level? Can excess provisions on one loan be used to offset shortfalls on another loan? E.g. for loans where the build-up of provisions is quicker than anticipated through a linear increase up to 100%?

b. "Comply or explain" basis

Deviations from the backstops are possible, if the bank can demonstrate that the backstop is not justified for specific portfolios or exposures (e.g. client is still making regular payments, application of the backstop in combination with RWAs would cover more than 100% of the risk, pulling effects,...). At this stage it is unclear how strict the ECB will be, i.e. whether it will allow deviations on very large parts of the portfolio or only for a very limited selection of sub-portfolios. Some comfort can be sought in the statement that "*banks should continue booking accounting provisions in line with their assessment which, in the vast majority of cases, should result in the backstop not having any effect.*"

c. Increase of the volatility and cyclicity of provisions and/or CET1

Implementation is likely to increase the volatility and cyclicity of provisions and/or CET1. While the initial effect of applying the ECB backstop will be one of an increase in provisions and/or decrease of CET, this is likely to be in part temporary. Overly conservative provisions which are not economically justified will at a later point in time lead to larger provision releases (either through cures or recoveries). Therefore the long term effect of the ECB guidance may well lead to a significant increase in the volatility and cyclicity of provisions and/or capital.

d. Interaction between the backstop and the calculation of required capital for credit risk

The interaction between the backstop and the calculation of required capital for credit risk is insufficiently clear and there is a risk of double-counting between the backstop on the one side and the RWA calculated under the Standardized or IRB-Advanced approach on the other hand. It should be clarified whether required capital can be considered in the calculation of the backstop or whether the effect of the backstop can be considered in the calculation of capital requirements.





2. Pillar 1 vs. Pillar 2 Approach

The SSM already has the necessary authority to adjust provisions, on a case-by-case basis, as part of the SREP, whenever it deems it necessary – as reminded quite recently by the European Commission: *“Prudential regulation empowers the bank supervisor to influence a bank’s provisioning level (including as regards NPLs) within the limits of the applicable accounting framework and to require specific adjustments to the own funds calculations of that bank if, for example, accounting provisioning is not sufficient from a supervisory perspective. Binding measures and requirements, however, can only be applied by the supervisor on a case-by-case basis depending on the individual circumstances of the bank (so called Pillar 2 measures).”*

Individually tailored supervisory measures following a case-by-case assessment by the competent supervisor are appropriate for dealing with the specific NPL-related risks of individual banks. (European Commission’s consultation document on Statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing”, p. 4 sq., 10 November 2017).

Belgian banks fully support such *individually tailored supervisory measures following a case-by-case assessment* by the ECB: it appears to be in our opinion the best way to address the NPL issue where (and only where) it is an issue.

Due to its one-size-fits-all and quasi automatic nature, however, the new mechanism contemplated in the draft Addendum – setting the same *minimal* expected levels of provisioning for all (significant) banks in all participating Member States – can be considered as a Pillar 1 more than a Pillar 2 instrument.

3. Quantitative vs. Qualitative Guidance

Belgian banks consider that the ECB “qualitative” Guidance on NPLs (March 2017) is going in the right direction.

In this respect, the timing of the measure contemplated in the draft Addendum is also questionable as the ECB “qualitative” Guidance on NPLs is now in the process of being implemented, with banks carrying out their individual NPL plans accordingly.

4. Prudential backstop vs. IFRS 9

Moreover, a quantitative prudential backstop does not seem to be necessary as the new IFRS 9 standard is going to be implemented from the 1st of January 2018.

Indeed, IFRS 9 will lead banks to build an additional capital buffer based on a forward looking expected loss basis.

Therefore, it would be more appropriate to allow the new standard to be applied and to assess its effects before taking any further action.

5. Vintage vs. Cash Flows

Belgian banks do not totally agree with the supervisory expectation of banks fully and automatically writing off their NPLs based on the sole vintage. Indeed:





a. Unsecured loans

Full write-off of unsecured (parts of) NPPLs after 2 years is expected by the supervisor *whatever the cash flows collected on the NPLs*.

The mere existence of cash flows should be enough to demonstrate that full provisioning is far from being justified – and, in practice, is far from being applied in the financial statements, under the auditors' control.

Therefore, supervisors are invited to adopt a differentiated approach, based on case-by-case analysis and expert judgment and building on banks' implementation of the ECB "qualitative" Guidance. The crucial point for supervision in this matter is to make sure that NPL portfolios still generate cash flows and that provisions are taken accordingly.

b. Secured loans

Full write-off of secured (parts of) NPLs after 7 years is expected by the supervisor *based on the (wrong) assumption that a collateral that has not been realised is no more efficient*.

Actually, facts show that the (forced) sale of collateral is far from being the ideal solution. Indeed, it is in no-one's interest to exercise collateral. When banks have recourse on their debtors (which is the case for the majority of loans granted in Europe, where non-recourse loans are the exception), collateral should first be seen as an essential lever to incentivise debtors to pay.

To focus on collateral valuation may induce banks to lend against collateral, i.e. to move from cash flow banking (that is banking proper), in which loans are made according to the value of the expected cash flows, to collateral-oriented banking (that is pawn brokering) in which loans are granted based on the value of their underlying collateral. As we are all aware, the problem of non-performing loans in connection with deteriorated underlying asset quality has played a central role in the last financial crisis.

The metric supervisors should focus on the net accounting value of the portfolio. Indeed it is on this amount that the bank is at risk.

Accordingly, it is the quality of the impairment process that should be at the heart of the supervisory approach, not collateral. Indeed the key weakness in proposals for prudential backstops on loan loss provisioning is that *they only give value to collateral, and ignore cash flows from ongoing operations of debtors in default*. These cash flows are significant (the net accounting value is actually the present value of these expected cash flows) and in some cases represent the majority of recoveries (for instance for unsecured loans, or when collateral is not enforced to ensure maximum recovery and preserve overall economic value). Accounting rules recognise the need to assess impairment allowances based on ultimate recoverability, and prudential coverage should do the same.

6. SA/F-IRBA vs. A-IRBA Collateral Recognition

In order to define "secured" (parts of) NPLs, the draft Addendum refers to eligibility criteria applicable under the Basel non-model based approaches, namely, the Standardised Approach ("SA") and the Foundation Internal Ratings-Based Approach ("F-IRBA"). Both approaches are very restrictive regarding physical collateral compared to their wide recognition under the Advanced Internal Ratings-Based Approach ("A-IRBA").

In this way, physical collaterals other than immovable properties will receive a very limited recognition under the prudential provisioning backstop while they significantly contribute to high recovery rates in the real life – and, accordingly, to low LGD values under A-IRBA.





As a consequence, a significant part of collateralised corporate loans (incl. specialised lending and leasing) turning non-performing might have to be treated as “unsecured” after 2 years and, consequently, subject to a full write-off.

7. Guidance vs. Regulation

Finally, Belgian banks are of the opinion that the ECB use of the “Guidance” instrument to define new *minimum requirements* expected to be met by all (significant) banks within the Banking Union is *per se* questionable.

In their opinion, a supervisory “Guidance” should normally be restricted to clarify the implementation of Level 1 and 2 legislative texts instead of ‘goldplating’ existing regulations or anticipating regulations still under discussion.

In this respect, the draft Addendum might unfortunately be seen as falling under the second case (anticipation of regulation under discussion) if we compare it to the above Commission’s consultation on statutory prudential backstops published at virtually the same time.