EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Transcript of a Question and Answer session with media, held by Sharon Donnery, Deputy Governor of the Central Bank of Ireland, on 15 March 2018

Miss Donnery, if you could explain to me the 2021 deadline; does this mean that banks will be expected to comply but will not be made to comply? Is that what it means? Or how should I read this, please?

[Sharon Donnery] It's not so much expected to comply or not to comply in that sense. As I said firstly, I think it's important to be clear that the guidance is non-binding. In itself there is no automatic application of the guidance; rather the dates are there for a slightly different purpose. As I said in the statement, the expectations apply for new non-performing loans from the 1st April 2018, so if the loan becomes non-performing from that time. The addendum sets out the timeframes over which we expect provisions to be built up, so that's two years for unsecured and seven years for secured. The SREP process in 2021 will be the process where an unsecured loan which has potentially become non-performing from the 1st April 2018 will be for discussion as part of the SREP process in terms of the provisioning approach to that loan.

I would add, though, that it's important that banks look at the addendum now. I think rather than wait until then, banks should already be looking at what our expectations are. Even if you don't consider the dates for the two years and the seven years, it's obviously important that banks have provisioning policies, that they understand the approach that they're taking, that they have their own internal processes for thinking about provisions as well as the accounting rules that apply. That really is the context for the dates.

I have a question on the lessons you learned from this guidance and whether they can be applied to the stock of non-performing loans, because obviously that's on everyone's mind. What do you draw from this experience as to how to tackle the stock? Can one issue a quantitative guidance, or will it have to stay with the qualitative guidance you issued last year?

[Sharon Donnery] I think the focus today is very much on new non-performing loans and actually trying to learn the lessons from the crisis about the way stocks of non-performing loans build up. What we're trying to do is make sure that in the future, if non-performing loans emerge, they are tackled early and quickly. I think all of the work that we've done over the last few years shows that tackling the problem earlier is better both in terms of how banks engage with their customers and also their approach to provisioning.

I would say in terms of the stock it's not an either/or, so the addendum that we're announcing today, as I said, applies to the new non-performing loans. The stock we have been working on intensively for many years, as I mentioned in the statement we have already requested that the banks submit their strategies. The Joint Supervisory teams have given them quite detailed feedback on the strategies that they have presented. Banks have their own internal targets and so on and I would say in relation to the stock, that we continue to monitor very closely the progress that they're making against those targets and as part of our ongoing supervisory dialogue, we continue to discuss the progress on the stock with each of the individual banks.

That doesn't sound like you will consider in the first quarter anything quantitative, though?

[Sharon Donnery]: I think that we will continue to see what progress banks are making; if they are making progress, that points in one direction. If they're not making progress, then we have to consider whether we have to take any further steps or not.

Maybe you could explain a bit about how the addendum has changed through the consultation process and where you've seen comments that have been taken on board.

[Sharon Donnery]: Clearly as soon as the addendum was published, I think the first set of responses were about its legal standing. I would say firstly it was never our intention to imply that it was binding or that this was an automatic instrument. It was always our intention that the addendum was setting out our expectations, that it was to be used as part of the supervisory dialogue, and that really the purpose of it was to bring transparency so that everybody knows what our expectations are. Then we engage with each of the individual banks and decide on a bank-by-bank basis what needs to happen next.

That was always the original intention and I think it was clear during the consultation period that that maybe had not been articulated clearly enough in the addendum. I would say a number of the changes are around making it clearer that the addendum is non-binding, that it's being published in the interests of transparency and to set out our expectations, and that no measures will apply automatically to any individual bank. Rather we will have a case-by-case discussion with each individual bank. We look at their policies and practices and their approach to the individual provisions that they are taking in each case.

There has also obviously been a change to the timeline, so our original proposal was that it would apply slightly sooner. That has moved on to the 1st April 2018 simply because the consultation process was taking a little bit longer than we expected. We're only publishing the final outcome today. We also made some changes to how we articulate what was called in the original addendum the linear path. One thing we were trying to avoid was that banks would take a big jump in provisions at some point, a cliff-edge effect. We've articulated that slightly differently in this case. There are a number of other technical amendments and the feedback statement tries to address all of the different aspects that were raised. Hopefully people will see, if they raised particular aspects, how they've been addressed.

I just wanted to clarify, I didn't quite understand this issue: the legacy, dealing with the legacy NPLs, is there going to be a guidance or any specific guidance on this at this point? Or no, it's going to just be discussed with each bank and dealt with individually?

[Sharon Donnery]: The addendum we're publishing today, as I said, it's related to new non-performing exposures. In relation to the legacy, we already last year published a very detailed guidance document in relation to that. Banks are already expected to be looking at that guidance in terms of what we expect. The Joint Supervisory teams have already had the first submissions from the banks in terms of their strategies and their plans for dealing with the legacy. The Joint Supervisory teams are heavily engaged with the banks in relation to that, so giving them feedback on their proposals and so on. As part of that guidance, banks are required to have their own targets that they set themselves, their own progress milestones that they set themselves. The Supervisory teams monitor those. The stock has been dealt with primarily through that process.

I thought there was going to be – maybe I'm completely mistaken – but my impression was that eventually the ECB was going to come with specific, let's not call rules because it's non-binding, but basically, specific rules for legacy. Did I get that all wrong completely?

[Sharon Donnery]: As I said, the existing guidance already applies to the legacy; it's quite detailed in terms of the expectations it sets out. We had said at the time that we published this addendum – which, as I said, very clearly applies to new NPLs – that we would continue to consider whether further policies on the legacy are necessary or not. We continue to do that while the Joint Supervisory teams continue to be engaged with the individual banks.

You said that these guidelines are not binding and are complementary to what has been done yesterday by the Commission, which is Pillar 1 and is binding. Can you explain this complementary aspect in the sense that banks are worried that there would be not a smooth, let's say, link between the binding and the non-binding. Are there similarities and differences on today's addendum compared to the Pillar 1 coming on new non-performing loans from new contracts?

[Sharon Donnery]: Firstly, I would say before I even address the Commission's proposals of yesterday, it's important to note that the objectives of Pillar 1 requirements and Pillar 2 are different. The approaches that they take are different and that is the case normally in different aspects of supervision. I think in relation to the proposals yesterday from the Commission, which we welcome very much, I think they are an important part of the response to non-performing loans. The ECB has said all along that we are not the only stakeholder in this and that other stakeholders have important roles to play. The Commission's proposals are very important in that regard.

The Commission's proposals of course are proposals and they will now go through the legislative process. They are also, importantly, applicable to new loans into the future. They will be introduced at some point in the future and they will apply to new loans. Therefore it will take some time for them to be fully applicable to the entire book of loans that any individual banks would have. In the meantime as a supervisor, we are obliged of course to take into account risks that banks may have that are not already captured by Pillar 1. We're required to think about, what are the other things that maybe haven't been captured by Pillar 1 requirements already and how does the bank address those?

What we are trying to do in setting out the addendum today is transparently explain publically what our expectations are of how the banks will deal with those other risks.

Then we will follow that up through the supervisory dialogue. I think they are complementary in the sense that Pillar 1 obviously would be a binding rule. It will take some time for the Commission's proposal to come fully to fruition. In the meantime we still have important work to do as supervisors. We have tried to set out our approach to that work so the banks know what the starting point is for the supervisory dialogue.

I have one question also regarding the date, 2021. Does it mean that in between, that means from now on to 2021, that banks don't have to tell within the SREP dialogue deviations from your new proposals, and that they will not be taken into account in the yearly SREP process?

[Sharon Donnery]: I think it's important to say that the SREP process in any year, regardless of what we say today, that the SREP process of course has to take into account credit risk. Of course it has to take into account what the banks are doing on non-performing loans, whether they are legacy non-performing loans or new ones that might be emerging. This is an issue that's extremely important for the ECB. It's a normal part of the supervisory dialogue in all cases and in all SREP processes.

What we were saying here is that the expectations that we are setting out today, because they have a time element – so, new non-performing loans from the 1st April, and they set out an expectation around provisioning over time - the real focus of those discussions will begin in the SREP process in 2021 because that is in two years – for example for an unsecured loan to be non-performing over the course of two years from the 1st April 2018.

I would emphasise again that banks need to understand this is a very important issue that they need to be tackling. Regardless of the dates that are set out in the addendum and so on, we would expect banks to be giving non-performing loans a very high priority. We would expect to be discussing it with them as part of the SREP process in any event.

Many banking and business association think that these measures will have a huge impact on lending; what do you think about that? Given the potential effect of the addendum, why didn't you publish a detailed impact analysis?

The second question: why now did you decide to include new NPL also from existing loans, going beyond EU proposal and the Council action plan? Of course I know it is a Pillar 2 measure but it will have a retroactive effect and it could generate confusion in markets. Did you consider this retroactive effect and the continued risk?

[Sharon Donnery]: First of all, in relation to the impact, I think the first thing it's important to say is that non-performing loans – so the existence of non-performing loans - also has negative economic effects. They tie up banks' capital and because banks have to put resources, both financial resources and human resources, into the management of non-performing loans, they can distract banks from actually generating new lending into the economy. So there are negative side effects from banks having non-performing loans.

Clearly, proposals like this have some form of impact also and we did look at a number of different scenarios in terms of the effect it might have on banks. Clearly, all of those scenarios are subject to certain caveats and assumptions and so on. But I think overall we believe that the effect will be modest and manageable particularly because, as I said, these are Pillar 2 measures. They're therefore subject to supervisory dialogue. We will engage with each individual bank about its own individual circumstances in terms of how these expectations would apply.

In terms of your question about going beyond the proposal of the European Commission, I would say two things. First of all our objective in trying to address new non-performing loans is to prevent the buildup of non-performing loans into the future. We know from past experience that unfortunately if non-performing loans aren't tackled early, that the problem grows and grows. You end up with a large stockpile and that's exactly what's happened. We're trying to prevent that happening into the future. This is why we focused particularly on new non-performing loans to try and stop the problem emerging into the future. As I said, also as supervisors we are obliged to consider risks that aren't captured elsewhere, so risks for example that aren't captured as part of Pillar 1. Again we feel that that is part of our obligation and we have to look at that.

In terms of confusion, I think in fact what we are trying to do, by being very transparent and setting out our expectations, is exactly to avoid confusion. Through the guidance that we published previously in 2017 and through this guidance we are trying to say not only to banks but also more widely, publically, to say these are the things that we expect in a clear and transparent way. We've published a whole package of materials today including frequently asked questions and so on to try and help people understand the proposals. What we hope is that it's transparency rather than confusion.

For the first part, of course when banks have no NPLs they could do more lending in the long term, but in the short term, there could be some effect. You mentioned some scenarios. Have you a precise estimate of the impact like the one the EBA has made for their Commission proposal?

For the second question: if I understood well, you didn't answer the problem of the retroactive effect.

[Sharon Donnery]: In terms of retroactive effects, clearly we understand that in applying the addendum to new non-performing loans, it is being applied to loans that are already granted. As I said, I think the concern is that if we didn't do that then it's possible that banks have loans on their books for many years to come that could become non-performing where there may be slow action or no action. We saw that in the past. Really what we are trying to do is mitigate against that happening again.

In terms of impact assessment, I would say again that we looked at different scenarios and options. One of the challenges in terms of understanding the impact of new non-performing loans, it's trying to understand how non-performing loans might emerge into the future. Clearly, that requires a certain set of assumptions and so on. The way in which non-performing loans emerge in the future may be very different depending on economic conditions. It may vary across countries and so on. For these reasons, while we have looked at different scenarios, we have not published something in terms of the impact but we do expect that it will be manageable for the banks.

I'm wondering what impact, if any, you think might derive from this addendum on the development of a secondary market in non-performing loans. I gather, one of the objectives of the

Commission proposals is to try and develop this secondary market as part of capital markets union. Do you envisage any kind of a steady stream of sell-offs into the future of non-performing loans as a regular feature now of the management by banks of their NPLs?

[Sharon Donnery]: I don't think this particular measure, so that the addendum in itself is particularly related directly to developing markets in non-performing loans. I would say perhaps that the two together, so the addendum and the full guidance, obviously try to cover the entire life cycle of non-performing loans. We have been clear in the guidance that we've published in 2017 that there are many ways in which banks can tackle the problem of non-performing loans, be that sales but also workout. In fact the guidance that we published for 2017 puts a lot of emphasis, I would say, on workout and how we expect banks to deal with workout.

As I said earlier, the ECB has always been clear that there are many players in relation to non-performing loans, including the Commission and the EBA and others. The proposals in relation to secondary markets made yesterday are obviously an important aspect.

A couple of questions, if I may. One is about the April 1st deadline. You must have asked yourself the question whether there is an incentive for banks to actually classify as NPLs doubtful loans during the first quarter in order to avoid being subject to the calendar approach. There might be an impact on Q1 for many banks and whether that might be non-linear. I was just wondering whether you asked yourself the question.

Then especially for the unsecured loans and the two-years deadline. Do I really understand well that there are no specific levels of provisioning that you expect for the first year or for the second year, as the Commission yesterday set out?

[Sharon Donnery]: In relation to the date, first of course we had to be practical in that a date had to be selected. Of course we didn't really feel that we could select a date prior to the addendum being published. We've selected a date quite soon after it's been published, so there was a practical element, I suppose. Of course you are right that we also have to be careful that there isn't some sort of approach to provisioning then to avoid looking at the addendum. On all of these things I would say we monitor quite a large set of data that come from the banks. As I've emphasised a lot during the call as part of the supervisory dialogue, we are discussing these issues all the time with the banks. So we will see what approach they take to looking at the addendum and how they fulfil those expectations.

In relation to the unsecured, yes, you are correct; we don't have a pathway set out for that so I think what we expect to see is a suitable and gradual approach. Again as part of the supervisory dialogue we will be discussing with the banks their own practices and policies in relation to how they implement their own approach to that and then how they address our expectation.

How much of an impact do you expect the publication of this addendum today and of the proposals of the European Commission yesterday to have on the discussions about risk reduction, on a possible agreement on a deposit insurance in Europe?

[Sharon Donnery]: I think our priority in publishing the addendum today is to set out our expectations in a transparent way. We know of course that non-performing loans is a key issue across the eurozone. It has been one of our top priorities since ECB banking supervision was set up. We have said many times that there are lots of players that need to take different actions to deal with the problem. I think we feel that we are playing our part in that debate. Of course that's part of a wider debate about further deepening of Banking Union and so on. I think that's not really the topic for discussion today, though.

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