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BANKING AND FINANCE

Targeted consultation on statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing

Fields marked with * are mandatory.

Introduction

Non-performing loans (NPLs) have piled up in parts of the EU banking sector in the aftermath of the financial crisis and ensuing recessions, with significant adverse impacts on banks' profitability, viability and ability to lend. High levels of NPLs across a substantial number of banks pose risks to the financial system at large and the overall economy of the EU. While tackling NPLs is primarily the responsibility of affected banks and Member States, there is a distinct European dimension, as clearly manifested in the Commission Reflection Paper on the Deepening of the Economic and Monetary Union and fleshed out in the Commission Communication on completing the Banking Union. Furthermore, the Council concluded a comprehensive action plan to tackle NPLs in Europe inviting the Commission and other actors to act on several fronts to reduce the risk to financial stability, both by addressing the existing stock of NPLs and by preventing the emergence and accumulation of NPLs in the future. The Commission takes active part, together with other European stakeholders and Member States, in the realisation of this Action Plan.

One of the key policy areas in this context is prudential regulation and supervision to be applied to the newly originated loans, which should ensure, inter alia, that new loans that turn non-performing are recognised timely and provisioned adequately in order to prevent loss forbearance and enhance NPL resolution. If sufficiently high provisions credit losses will be made, restructuring, selling or dismissing non-performing assets and non-recoverable collateral will require less, if any, additional capital and will become potentially easier. If, on the contrary, new loans that turn non-performing will be insufficiently provisioned, they are more likely to remain on banks' balance sheets in an attempt by banks to avoid or delay loss recognition. This may cast doubt over banks' future profitability, solvency and long-term viability. In addition, heightened risk perceptions on the part of investors and depositors usually translate into higher funding costs. Together, these factors result in higher lending rates, reduced lending volumes, and increased risk aversion. Experience in several countries that have dealt with NPLs suggests that binding requirements on NPL recognition and provisioning made a significant contribution to the resolution of NPLs.

As announced in its Communication on completing the Banking Union, and as a follow-up to the July 2017 Conclusions of the Council on tackling NPLs in the EU, the Commission is preparing a report on tackling potential under-provisioning for new loans that turn non-performing. That report will consider the possibility of introducing statutory prudential backstops in the form of compulsory and time-bound prudential deductions of NPLs from own funds to prevent or reduce the future build-up of new NPL stocks with insufficient coverage across Member States and banks. As also announced in the aforementioned Communication, in this context the Commission will also consider introducing a common definition of non-performing exposures (NPEs) in accordance with the one already used for supervisory reporting purposes with the view of providing a sound legal basis for the prudential treatment of such exposures and ensuring consistency.

The Commission services launch this public consultation to gather stakeholders' views on the possible introduction of statutory prudential backstops against insufficient loan loss coverage for new loans that turn non-performing, as well as on the potential functioning, scope, design and calibration of such prudential backstops.

Please note: In order to ensure a fair and transparent consultation process **only responses received through our online questionnaire will be taken into account** and included in the report summarising the responses. Should you have a problem completing this questionnaire or if you require particular assistance, please contact fisma-non-performing-loans@ec.europa.eu.

More information:

- on this consultation
- on the protection of personal data regime for this consultation

1. Information about you

* Are you replying as:

- ○ a private individual
- ● an organisation or a company
- ○ a public authority or an international organisation

* Name of your organisation:

Accountancy Europe

Contact email address:

The information you provide here is for administrative purposes only and will not be published

elenik@accountancyeurope.eu

* Is your organisation included in the Transparency Register?
(If your organisation is not registered, we invite you to register here, although it is not compulsory to be registered to reply to this consultation. Why a transparency register?)

- ● Yes
- ○ No

* If so, please indicate your Register ID number:

4713568401-18

* Type of organisation:

- ◯ Academic institution
- ◯ Company, SME, micro-enterprise, sole trader
- ◯ Consultancy, law firm
- ◯ Consumer organisation
- ◯ Industry association
- ◯ Media
- ◯ Non-governmental organisation
- ◯ Think tank
- ◯ Trade union
- ◉ Other

* Please specify the type of organisation:

Trade and Business Association / Nonprofit association

* Where are you based and/or where do you carry out your activity?

Belgium

* Field of activity or sector (*if applicable*):

at least 1 choice(s)

- [x] Accounting
- [x] Auditing
- [ ] Banking
- [ ] Credit rating agencies
- [ ] Insurance
- [ ] Pension provision
- [ ] Investment management (e.g. hedge funds, private equity funds, venture capital funds, money market funds, securities)
- [ ] Market infrastructure operation (e.g. CCPs, CSDs, Stock exchanges)
- [ ] Social entrepreneurship
- [ ] Other
- [ ] Not applicable

Important notice on the publication of responses

* Contributions received are intended for publication on the Commission's website. Do you agree to your contribution being published?
(see specific privacy statement)

- ◉ Yes, I agree to my response being published under the name I indicate (*name of your organisation /company/public authority or your name if your reply as an individual*)
- ◯ No, I do not want my response to be published

2. Your opinion

1. What are your views on the rationale for statutory prudential backstops as described above? In particular:

a. Do you support the idea that statutory prudential backstops should complement the improvements that the application of IFRS 9 is expected to bring with regards to loan loss provisioning for the new loans that turn non-performing?

- Yes
- No
- Don't know / no opinion / not relevant

Please explain the reasons for your answer to question 1.a:

Accountancy Europe welcomes the European Commission's initiative to address the persisting issue of Non-Performing Loans (NPLs). High levels of NPLs across a substantial number of banks pose risks to the financial system at large and the accountancy profession remains committed to contributing to NPLs' reduction in the EU's banking system and economy overall. We do so by providing transparency on the effective financial reality in accordance with the reporting framework.

Accountancy Europe also understands that the purpose of this initiative is to foster more timely provisioning practices for new NPLs from 2018 onwards in order to avoid an increase of NPLs in the future. We are also very well aware that any initiatives launched by the Commission do not intend to substitute accounting requirements but rather being consistent with the IFRS rules.

We see accordingly a lot of value in any initiative aiming at reducing NPLs from banks' statements and we intend to support the Commission and the EU institutions in their efforts on this. Nevertheless, in order to ensure that this aim is well served we also need to ensure the integrity of the accounting rules and that technical specificities are taken into account. For this reason, we have raised specific comments under the relevant questions which we are willing to explain further and discuss in order to find the best suited solutions.

Regarding question 1a: When IFRS 9 becomes applicable, it will be grounded on internal credit risk management systems and forward looking expectations. Any pre-determined provisioning schedule on prudential backstops would be in contrast with their principles. It looks highly unlikely, if not impossible, that all banks have internal credit risk management systems that provide totally aligned outcomes and also have the same view of future scenarios.

Any proposed prudential backstop should be in line with the existing accounting rules and should not create additional burdens without having evidence that this will bring in benefits for the banking sector of all Member States.

b. Do you support the idea that statutory prudential backstops (Pillar 1 measure) should complement the use of existing supervisory powers to address through institution-specific measures the (under)capitalisation of NPLs (Pillar 2 measure)?

- Yes
- No

- [x] Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 1.b:

2. Do you think that the statutory prudential backstops as described above are feasible?

- [ ] Yes
- [ ] No
- [x] Alternative designs of backstops via prudential deductions could be envisaged for new loans that turn non-performing
- [ ] Don’t know / no opinion / not relevant

Please provide details on possible alternative designs of backstops via prudential deductions that you could envisage for new loans that turn non-performing:

We see the following proposed aspects as potentially problematic.
Scope: Separating Non Performing Exposures (NPEs) pre and post 2018 is not line with IFRS rules. It is not clear how these proposed provisions would be able to apply solely to new originated loans and not to existing ones.
Linear path:
- Ensuring full prudential loss coverage: This requirement is non-compliant with IFRS9 which does not consider worst case scenarios as a sole/single basis for recognising ECL.
- Cash collection: Banks may have NPL secured where they collect a small amount continuously. However, exposure remains a non performing one for a long period. As a result cash collection is ignored in mechanical prudential backstops.
- Legal constraints: in some countries the proposed number of years (6+2) is not sustainable. There are cases in which the liquidation of collateral takes more than 8 years and it is still legally enforceable. We need a level playing field from a prudential aspect but we cannot ignore the existing legal aspects.
- Fully coverage after 2 years (unsecured) or 8 years (unsecured): this would drive the accounting treatment and would prove not compliant with IFRS 9.
- Collateral sale: the expected linear profile is not consistent with the assumption that the last recovery flow is resulting from the collateral sale which might represent a significant part of the overall recovery.

We consider that the haircut approach would work better than the linear provisioning.

3. In your view, which should be the cut-off date for the origination of loans that will be covered by the prudential backstop?

- [ ] the date of publication of this consultative document
- [ ] the date of the publication of a possible legislative proposal introducing prudential backstops
- [ ] the date of entry into force of such possible legislative measure
- [ ] a later date of application?

3.a. Would you see a need to address explicitly potential circumvention possibilities, for instance through prolongation of existing contracts? Please explain:

4. Do you think a full coverage of unsecured (parts of) NPLs after 2 years and of secured (parts of) NPLs after 6 to 8 years is appropriate?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 4:

Please see below our more specific replies.

4.a. For secured (parts of) NPLs, do you think it appropriate to treat them as unsecured after 6 to 8 years, effectively adding two more years before full coverage?

- Yes
- No
- Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 4.a:

(Consistent with our reply under 2 – linear path)
- Legal constraints: in some countries the proposed number of years (6+2) is not sustainable. There are cases in which the liquidation of collateral takes more than 8 years and it is still legally enforceable. We need a level playing field from a prudential aspect but we cannot ignore the existing legal aspects.
- Ensuring full prudential loss coverage: This requirement is non-compliant with IFRS9 which does not consider worst case scenarios as a sole/single basis for recognising ECL.
- Full coverage after 2 years (unsecured) or 8 years (unsecured): this would drive the accounting treatment and would prove not compliant with IFRS 9. Also, banks may have NPL secured where they collect a small amount continuously. However, exposure remains NPE for a long period. As a result cash collection is ignored in mechanical prudential backstops.

4.b. For secured (parts of) NPLs, do you think an alternative approach, such as the introduction of specific levels of haircuts on collateral/guarantee values, would be more appropriate?

- [x] Yes
- [ ] No
- [ ] Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 4.b:

We consider that the haircut approach would work better than the linear provisioning.

4.c. If none of the approaches work in your view, how should the backstops be alternatively calibrated? Please explain the reasons for your answer.

5. Do you agree that prudentially sound collateral valuation is an important element for addressing NPL-related risks?

- ( ) Yes
- ( ) No
- ( ) Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 5:

Please see below our more specific reply.

5.a. In this context:

- (x) would a common (non-binding) methodology for collateral valuation suffice to foster consistent outcomes and transparency?
- ( ) or would specific (binding) valuation rules be needed?

Please explain the reasons for your answer to question 5.a:

Common non-binding methodology should be sufficient. If at amortised cost, there is no need for prudent valuation requirements as this applies to assets at fair value.

5.b. More generally, should specific prudent valuation requirements apply to assets and off-balance sheet items accounted for amortised cost as it is already the case for fair-valued assets?

- ( ) Yes
- ( ) No
- (x) Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 5.b:

6. Do you agree that prudential coverage needs should ultimately depend on the actual recoverability rather than the valuation of the collateral to provide for a backstop?

- ( ) Yes
- ( ) No
- (x) Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 6:

7. Do you agree that the application of the statutory prudential backstops should not result in cliff-edge effects, but should rather be implemented in a suitably gradual or progressive way by banks from the moment of the classification of the exposure as non-performing?

- ( ) Yes
- ( ) No
- (x) Don’t know / no opinion / not relevant

Please explain the reasons for your answer to question 7:

7.a. In particular, which approach (gradual or progressive) would you consider better suited and why?
Please explain the reasons for your answer:

8. Would you see any unintended consequences due to the design and calibration of the prudential backstops?

- (x) Yes
- ( ) No
- ( ) Don’t know / no opinion / not relevant

If yes, which measures would you consider necessary to prevent or address unintended effects (including double-coverage of risks)? Please explain the reasons for your answer:

In light of our comments submitted above (see questions 2, 4): some of the proposed prudential requirements are expected to influence accounting rules' interpretation.
- An ill-defined scope (how to distinguish between existing and new originated loans) can leave room for speculation by stakeholders.
- As provisions would not reflect the actual expectations banks have about the outcome of the recovery process, the additional prudential backstops would depart from the original intention of IFRS9 to favour a convergence of accounting/disclosed numbers to internal estimates of recovery risk, thus forcing banks to maintain separate flows of information and recovery numbers for the different purposes (financial statements, internal risk reporting, prudential regulation). This would imply an additional effort with no significant benefits neither for the banks (especially in terms of awareness of the true risk from Board of Directors and top management) nor for the market.
- Any proposal submitted by the European Commission should be in line with the proposed recommendations by the European Central Bank (ECB). Despite the differentiation between Pillar 1 and Pillar 2 legislation and the voluntary aspects of the ECB proposed guidelines and addendum, the banks do follow what is being suggested to them by the ECB (even if voluntary). Accordingly, we should not end up with duplicated proposals for prudential backstops or even worse contradictory proposals submitted by the two institutions.

3. Additional information

Should you wish to provide additional information (e.g. a position paper, report) or raise specific points not covered by the questionnaire, you can upload your additional document(s) here:

Useful links

More on the Transparency register (http://ec.europa.eu/transparencyregister/public/homePage.do?locale=en)

Consultation details (http://ec.europa.eu/info/consultations/finance-2017-non-performing-loans-backstops_en)

Specific privacy statement (https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-specific-privacy-statement_en.pdf)

Contact

fisma-non-performing-loans@ec.europa.eu