German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

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

https://ec.europa.eu/info/consultations/finance-2017-non-performing-loans-backstops_en

Contact:

Sascha Nell

Telephone: +49 228 509-322

E-Mail: risikomanagement@bvr.de

Berlin, 2017-11-30

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 1,700 banks.

Coordinator:
National Association of German Cooperative Banks
Schellingstraße 4 | 10785 Berlin | Germany
Telephone: +49 30 2021-0
Telefax: +49 30 2021-1900
www.die-deutsche-kreditwirtschaft.de

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

Questionnaire: (https://ec.europa.eu/eusurvey/runner/non-performing-loans-backstops-2017?surveylanguage=en)

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

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

We welcome the possibility to comment on the Commission's proposal to implement a statutory prudential backstop. Having said this, we think that existing loans that have turned or will in the future turn non-perfoming are sufficiently covered by existing supervisory instruments, in particular the SREP dialogue and the ECB's NPL guideline published in March, 2017.

Although we acknowledge that action in the area of NPLs is necessary, we nevertheless think that the suggestions of the Commission concerning prudential backstops are superfluous.

We have serious reservations about one-size-fits-all approaches of this kind. Problems doubtless exist in some (southern) European countries, for which the Commission's proposals seem to be intended – but the new rules would have to be applied by all. It would therefore be better if supervisors approached high NPL banks individually to discuss the issue and decide what action to take (e.g. via the SREP, as mentioned above).

With regard to the current discussions, we would like to begin by outlining our perception of high NPL ratios. First of all, we think the views about high NPL ratios and their possible implications lack balance. High/higher NPL ratios are not necessarily a problem per se if the bank has built up enough (accounting) provisions or has enough collateral. Comparatively high NPL ratios exist in retail banking, in particular, but banks negotiate higher margins in this area to cover future defaults. It should be borne in mind that a business policy of this kind gives people with low creditworthiness the chance to obtain a loan – by restricting such business, this chance would fall away and such people would have to look for opportunities on the grey market or in the shadow banking sector, which does not seem preferable.

In addition, it is evident that high NPL ratios correlate with weak national economies. New regulations/backstops would not solve the underlying problems but just tackle the symptoms to a certain degree. New NPLs could be prevented simply by not granting any loans.

As indicated above, we think accounting and sound NPL governance / operations are the key points for tackling the issue of NPLs. If adequate accounting provisions have been built up, NPLs should be covered sufficiently. We have the impression that the current rules have not always been applied appropriately in the past (i.e. the build-up of accounting provisions was delayed or prevented by granting forbearance

measures) and that compliance with these rules has not always been supervised appropriately. As already mentioned, new rules are not necessary if the current (accounting and Pillar 2) regulations are properly applied and if supervisors monitor compliance attentively and take suitable action in the event of non-compliance (e.g. in the context of the SREP).

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

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

See our answer above.

In our view, some application issues are in need of further clarification.

There is no need to introduce an additional statutory prudential backstop regime. Competent authorities in general and the ECB in particular already have sufficient tools at their disposal in the form of the SREP and asset quality reviews to be able to identify banks with high levels of NPLs and with provisioning which supervisors consider inadequate to ensure sound risk coverage.

Under Article 97(3) of CRD IV, competent authorities have to determine whether a bank's arrangements, strategies, processes and mechanisms, together with its regulatory capital, are sufficient to ensure sound management and coverage of its risks. Article 104(1)(d) in conjunction with Article 97 of CRD IV requires competent authorities, for the purposes of ensuring sound risk coverage under Article 97(3) of CRD IV, to have at least the power to stipulate that banks apply a specific provisioning policy or treatment of assets in terms of own funds requirements. In addition, Article 104(1)(a) of CRD IV empowers competent authorities to require banks to hold additional regulatory capital if this is deemed necessary to ensure sound risk coverage. In Germany, these requirements have been implemented by the German Banking Act. Under section 6b(2) of the German Banking Act, the competent authority has to evaluate whether the arrangements, strategies, processes and mechanisms implemented by a bank and the liquidity and own funds held by it ensure appropriate and effective risk management and sound coverage of its risks. Under section 10(3) of the German Banking Act, it can impose additional capital requirements if risks and risk elements are not covered by the capital requirements pursuant to CRR. The ECB also has sufficient means at its disposal to ensure adequate risk coverage by prescribing appropriate measures if it deems a bank's existing risk coverage to be inadequate. Article 16(2)(d) of the SSM Regulation gives the ECB the power to prescribe a "specific provisioning policy or treatment of assets in terms of own funds requirements". When carrying out supervisory reviews pursuant to Article 4(1)(f) of the SSM Regulation it can, in addition, impose further capital requirements if it finds a bank's arrangements, strategies, processes and mechanisms, together with its regulatory capital, to be insufficient to ensure sound risk coverage.

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

Against this background, the introduction of an additional prudential backstop regime for NPLs would be unreasonable and at odds with the principle of proportionality within the meaning of Article 5 of the Treaty on the European Union. The objective of ensuring adequate coverage of risks can already be achieved by existing, more proportionate means.

Overall, the implementation of an additional prudential backstop in the manner proposed could lead to unjustified capital measures even for banks with sound accounting measures already implemented and hence sufficient provisioning.

We would like to point out that the treatment of NPLs is already regulated under pillar 1. In Art. 125 CRR NPL exposures in the Standardised Approach are weighted with a higher risk weight of 150% to address the higher credit risk of NPL exposures. This underlines the reasons that additional capitalisation measures for NPLs would surely be better suited with an individual pillar 2 measure.

Furthermore, we assume that the potential capital deduction under Art. 3 CRR, that results from the parallel consulted pillar 2 backstop (ECB-addendum), is to be interpreted as "further reduction of own funds" within the meaning of Art. 159 CRR and may therefore be taken into account in the valuation allowance comparison. We ask for clarification in this regard.

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

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

See our answer above.

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
- X 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:

Circumvention possibilities as prolongations are already part of existing forbearance rules in accounting and pillar 2 frameworks such as the existing ECB NPL guideline. We do not see any further need for prudential regulation.

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

The discussion about a cut-off-date can certainly lead to circumvention possibilities. In addition, it is a further argument against a common prudential pillar 1 measure. The appropriate treatment of NPLs in a prudential backstop must be evaluated in individual pillar 2 supervisory evaluation processes.

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

Please explain the reasons for your answer to question 4:

See our answer above. In addition, we would like to mention that such requirements are too rigid and that deviations should be possible. It is clear that a bank should take action after a certain time (e.g. if it is foreseeable that collateral may become worthless). But if the bank can demonstrate cash flows (e.g. as a result of selling the collateral) at a later stage (e.g. by a letter from the insolvency administrator), longer realisation times should be accepted.

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

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

See our answer above.

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:

Yes, we clearly favour a haircut approach. A deduction approach would limit the level of credit protection to guarantees and other collateral that are eligible within the CRR. However, there are numerous protection instruments which are not eligible, yet still have substantial economic value. Therefore, a haircut approach should be chosen with the proviso that haircuts may only be applied to collateral for which no qualified, up-to date valuation is available.

The Commission should further provide examples of stable value collaterals or other exemptions for which a deviation from the backstops would be appropriate. The following would be of particular interest:

- loans backed by federal/state guarantees, ECA-backed loans

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

• other loans secured by an e.g. investment grade guarantor.

Notwithstanding the foregoing, we would like to note, that a methodological synchronisation with the pillar 2 approach is preferable to prevent inconsistencies.

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.

The existing pillar 2 instruments available to supervisors already function as backstops, in our view, and are sufficient to address the issue.

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

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

Please explain the reasons for your answer to question 5:

Yes, we think that a prudent collateral valuation is an important element for addressing NPL related risks. But we are also convinced, that sufficient rules and guidance are already existing, e.g.
- the computation of credit RWAs through eligibility rules and haircuts (however, the eligibility of physical assets such as immovable assets and leased assets is too restrictive);
- proper application of IFRS9. In addition the existing NPL guideline of the ECB and existing national requirement, e.g. the German minimum requirements for risk management (MaRisk), include requirements concerning collateral valuation.

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:

A binding and common European-wide methodology for collateral valuation is not useful. We highly recommend a common principle based standard to assure a consistent understanding and transparency in collateral valuation. Functionality of property markets, valuation methodologies and data availability differ widely in Europe. Therefore only a principle based standard should be applicable all over Europe but no detailed methodology.

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

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

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

See our answers above.

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

Please explain the reasons for your answer to question 6:

See our answers above.

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

Please explain the reasons for your answer to question 7:

See our answers above. Irrespective of this, we would like to point out that a gradual build-up of provisions would run counter to accounting rules (IFRS).

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

As already mentioned, the current accounting rules and accounting provisions should be the main elements of NPL coverage. Nevertheless, should the Commission - despite the above mentioned concerns - decide to introduce a prudential backstop, the „progressive approach“ appears to be more appropriate to penalize the unwanted „wait and see approach“. As for example, collateral realization requires a certain period of time, it would be misleading to require significant provisioning or capital deduction, even for short term NPLs as this is not necessarily an indicator for „bad“ NPL risk management.

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

- X Yes
- No

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

- Don't know / no opinion / not relevant

In the long run such proposals and rigid requirements would lead to lending business focusing on borrowers of the highest quality while borrowers outside of this scope, including the vast majority of SMEs, would find their access to credit significantly restricted. In addition, an overly strict quantitative measure could result in the unregulated shadow banking sector (hedge funds) being supported.

It would also be too restrictive to base the eligibility of collateral just on the CRR requirements. Also it would be important to accept other types of physical collateral as long as their valuation is conservative and regularly validated. In addition, it should be clarified that other commonly used or other physical collaterals, e.g. motor vehicles, fulfil the requirements of Article 199(6)(a) and (b) of the CRR with respect to liquid markets and general acceptable and publicly available market prices. This would be important, because the EBA has not discloses a list of collateral in accordance with Article 199(8) of the CRR for which institutions can assume that the conditions referred to in Article 199(6) points (a) and (b) of the CRR are met. Without such clarification, other physical collaterals could not be used for risk mitigation purposes. That would be harmful to the real economy.