UniCredit Position Paper on the EC prudential backstop legislative proposal
October, 2018

UniCredit is aware that the NPLs issue is of significance for banks as well as for regulators and supervisors, and fully supports the European Commission's efforts to address the build-up of non-performing exposures (NPEs), as part of the European Union's intention to further reduce risks in the banking system.

Nonetheless, we deem that the idea of **introducing a full, calendar provisioning of NPLs indiscriminately applied to all institutions is overly penalizing**, **and not necessary**. A Pillar 1 approach, in fact, does not duly take into account the specificities of each institution, as well as the local peculiarities of the legal-judicial environment. Moreover, thanks to the measures already undertaken in order to reduce the overall banking sector risk with respect to NPLs, many European banks have established NPL strategies, management and processes, as demonstrated by the downward trend in NPL ratios and volumes. Finally, being already in force the ECB Addendum, we deem that a Pillar 1 measures is no longer necessary. If it were to be adopted anyhow, it should be clear that the interplay between the Pillar 1 and Pillar 2 measures will be operationally critical, especially when both will entry into force. The two measures are, in fact, not completely aligned, addressing NPLs with different approaches. Therefore we deem that **the introduction of the Pillar 1 EC proposal should be set aside or not be a priority.**

As an additional remark, UniCredit deems that **the calendar provisioning doesn't create the right incentives for a proactive bank approach in managing NPLs**. Indeed it might push banks towards a liquidating approach rather than offering restructuring measures with respect to debtors that are in temporary difficulty so as to release the collateral and minimize short-term costs, that could jeopardize the effectiveness of some reforms recently adopted in some jurisdictions to help firms in temporary difficulty. Overall we are concerned that the backstop might turn out to be excessively restrictive, leading to a severe reduction in bank lending, with important negative spill-over effects on investment, growth and the real economy as a whole.

In addition to this overall considerations, we have set of more detailed issues, that we deem legislators should consider in order to reduce the potential distorsive effect of the backstop that can lead to negative effects on the real economy. Some of them are more general aspects relative to the calibration of the measure, while others raise more technical aspects on the Commission proposal that, in our view, should be further review.

I. General Issues

UniCredit deems important to review:

1. **Treatment of the unsecured part of NPEs:** The EC calendar proposal foresees two years before the unsecured exposures should be fully covered. However, this time interval from default is not supported by statistically grounded data and does not duly take into account the specificities of each institution, as well as the local peculiarities of the legal-judicial environment. Two years are not sufficient to provision for unsecured exposure, and it can push banks towards a liquidating approach rather than offering restructuring alternatives with respect to debtors that are in temporary difficulty. The backstop might, therefore, turn out to be excessively restrictive, leading to a severe reduction in bank lending, with important negative spill-over effects on investment, growth and the real economy as a whole. <u>UniCredit suggests to extend the time threshold for unsecured exposure at least to 4 years (instead of 2 years)</u>.
2. **Reliance on accounting provision and timeline:** UniCredit deems that it is of the utmost importance to align the Commission's proposal with the ECB Addendum on the provisioning timelines. The interplay of the two different measures addressing the same issue, can in fact lead to implementation problems, operationally costly and difficult to solve. Thus, we suggest to prolong

the reliance solely on accounting provisions in line with the ECB Addendum, applying a 0% factor during the first years (at least two for the unsecured and three for the secured) and to align the timetable with the ECB Addendum.

3. **Treatment of forborne Exposures**: In order to incentivize for a proactive approach of banks with respect to the non performing exposures, the Regulation should consider a different treatment for forborne exposures. In particular, the proposal consider forborne non performing exposure during the cure period subject to the prudential backstop. However, this may result in a significant discrepancy between the amount of prudential backstop and the actual economic situation. Depending on the effectiveness of the forbearance measures it is likely that a significant percentage of the obligors will not face significant financial hardship anymore during the cure period, and a further build-up of the prudential backstop is not necessary. It would be more appropriate to exclude the exposure during the cure period, freezing the backstop for a period of three years since a forbearance measure is granted and as long as the exposure is not overdue (as also foreseen by ECB Addendum).

4. **Unclear definition of Newly originated loans and the problems in considering a retroactive date:** the EC prudential backstop does not clearly define the meaning of newly originated exposures, while it should be clarified whether the definition refers only to newly granted amounts (e.g. new financing) or also to new amounts drawn from credit lines granted prior the *cut off* date.

   With respect to these issues Article 469a is not completely exhaustive: *"Where the terms and conditions of an exposure which was incurred prior to 14 March 2018 are modified by the institution in a way that increases the institution's exposure to the obligor, the exposure shall be considered as having been incurred on the date when the modification applies and shall cease to be subject to the derogation provided in the first subparagraph.*

   Moreover, the retroactive cut off date of March 14th raises some issues on how to avoid undue operational difficulties and implementation inefficiencies as banks need to implement in IT systems the new perimeter immediately, on the basis of a regulation that is not final. UniCredit suggests therefore to consider the date of publication of the legislation for the application of the backstop.

II. More technical aspects

We would like to outline in particular the following:

1. **The Amount to consider as basis for the calculation of the backstop provisioning on Off-Balance Exposures should be the Exposure at Default (EAD) Value**: The use of the nominal amount to be applied for the provisions' calculation for backstop purposes will be particularly penalizing, especially for some businesses (e.g. Project financing). Moreover revocable lines should be excluded from the scope of application of the prudential backstop.

   The EC legislative proposal states in Article 47 a) paragraph 2 that: "*For the purposes of Article 36(1)(m), the exposure value of a loan commitment given, a financial guarantee given or other commitments given shall be its nominal value, which shall represent the institution's maximum exposure to credit risk without taking account of any funded or unfunded credit protection". In particular, (a) the nominal value of financial guarantees given shall be the maximum amount the entity could have to pay if the guarantee is called on;*
   (b) the nominal value of loan commitments shall be the undrawn amount that the institution has committed to lend. The nominal value referred to in the second subparagraph shall not take into account any specific credit risk adjustment, additional value adjustments in accordance with Articles

34 and 105, amounts deducted in accordance with Article 36(1)(m) or other own funds reductions related to the exposure".

The reference to the nominal value for the calculation of the provisions on off balance sheet exposures is inconsistent with the criteria for provision calculation applied both for prudential and accounting purposes which uses the exposure at default (EAD). The EAD estimates the extent to which a bank may be exposed to a counterparty at the time of its default and is calculated applying to the off-balance sheet nominal amount a credit conversion factor ("CCF"), which represents the percentage that converts the amount of the off balance sheet exposure in what is in reality expected to be drawn by the debtor at the default (Exposure at default, or EAD).

As to **revocable lines**, the provision calculation applied under IFRS9 excludes them, and the same is true for the prudential requirements of CRR where the CCF for revocable credit lines under the standardized approach is set at 0% (while it will move up to 10% under BIS 4). We therefore deem appropriate to align the revocable lines' treatment under the calendar provisioning to that in force in the accounting provisions in IFRS9 and the prudential requirements of CRR which do not require provisioning or make explicit reference to the EAD. This is in fact already the case in the ECB Addendum which allows the exclusion from the provisioning of **undrawn credit facilities which may be cancelled unconditionally at any time and without notice** (para. 3.3 "Definition of ensured and unsecured parts of NPEs").

2. Calculation of the backstop should include the followings elements as eligible for provisioning under article 47c, paragraph 1, letter (b):

- **RWA Unexpected Loss**: the EC proposal does not seem to include the RWAs for Unexpected Loss as an eligible element to fill the gap vis à vis the minimum level of provisioning foreseen by the prudential backstop under Article 47c, paragraph 1, letter (b).

  Therefore we would ask to treat the RWAs on defaulted assets similarly to the shortfall and the other capital deductions, and thus as applicable instrument to fill the provisioning gap in order to avoid the cases of exposures covered more than 100%. The ECB Addendum recognizes these as it allows the ECB to diverge from the prudential provisioning expectation[1] when the provisioning results in *"more than 100% of the exposure being covered".*

- **Partial write offs***:* While a number of recent guidelines (such as the ECB "Guidance to banks on non-performing loans" and the EBA "Draft guidelines on management of non-performing and forborne exposures") suggest to partially or fully write off the exposure when there is no reasonable expectation of recovering contractual cash flows, the EC proposal goes in the opposite direction. Under the current proposal of regulation, a bank would not be incentivized to perform partial write off: as the bank executes a partial write-off, in fact, the remaining exposure would have zero impairment cover, that under the proposed measure leads to an immediate impact on the capital ratios. On the contrary, the ECB Addendum recognizes this aspect envisaging the possibility to consider partial write offs within the accounting provisioning to be used as "supply" for the purposes of the prudential provisioning (Note 7 on page 5). To avoid distorsive effects, we suggest to include also the partial write offs in the list of items foreseen by the prudential backstop under Article 47c, paragraph 1, letter (b).

[1] Text paragraph 2.3 page 6 "*When assessing such divergences, the ECB will consider specific circumstances (…) which may make the prudential provisioning expectations inappropriate for a specific portfolio/exposure. Such circumstances might include, for example, (…) where the application of the supervisory expectations would, in combination with Pillar 1 capital requirements for credit risk, result in more than 100% of the exposure being covered, or any other relevant circumstances*").

3. **In defining the secured part of an exposure the following has to be taken into account:**

- **Possibility to consider as eligible collateral all the immovable properties**: The EC prudential backstop text does not allow to extend the eligibility to all immovable properties, but we deem that it is important to apply a wider approach as in the ECB Addendum, which recognizes all "*type of immovable properties*" as eligible regardless of the adoption of the Standard/Foundation/AIRB approach[2] and as long as the valuation of the property is aligned to provisions set in Chapter 7 of the NPL Guidance.

- **Define the secured part of the exposure according to the title II chapter 3 and 4 of the CRR independently of the use of Standard or internal Risk Based approach**: being trade receivables eligible for Credit Mitigating Purposes only under the AIRB approach (when some requirements are fulfilled) and not under the Standard Approach, a relevant number of exposures in **factoring** are considered unsecured for the purposes of the backstop, leading to unrealistic levels of provisions. Therefore we suggest to consider secured "the part of such exposure which is covered by a funded credit protection or unfunded credit protection in accordance with Chapters 3 and 4 of Title Il, irrespective of whether an institution uses the standardized approach or the internal ratings-based approach", solution that has already been adopted by the ECB in its own Addendum to the ECB Guidance to banks on non-performing loans.

- **Special recognition for Leasing contracts**: UniCredit deems that a special recognition as secured loans should be granted to all leasing contracts which envisage the asset property, independently whether movable or immovable, or whether treated under IRB or Standard approach, as long as they fulfil the requirements foreseen in the CRR Article 208, 210 and 211[3]. As a matter of fact, in these cases the Leasing contract entails the property of the asset, therefore as soon as the debtor goes to default, the leasing firm undertakes the activities to repossess the asset, sells it and eventually starts the work out activities to recover the residual claim. For this reason all leasing contracts underlying the asset property should be considered secured.

[2] See paragraph 3.2 page 7 of the Addendum. *"For the purposes of this Addendum, the following types of collateral or other forms of credit risk protection are considered by the ECB as either fully or partially securing NPEs. (a) All types of immovable property collateral. (b) Other eligible collateral or other forms of credit risk protection that fulfil the criteria of credit risk mitigation set out in Part Three, Title II, Chapters 3 and 4 of the CRR, irrespective of whether an institution uses the standardised approach or the internal-ratings-based approach. In this way, a level playing field is ensured for all banks.*

[3] Article 208 of the CRR establishes the following requirements for Immovable property: i) A mortgage or charge is enforceable and is filed on a timely basis, all legal requirements have been fulfilled and the institution is legally able to realise the value within a reasonable timeframe.; ii) The valuation's monitoring shall be frequent, reviewed when information available to institutions indicates that the value of the property may have declined, and the review should be carried out by an independent qualified valuer. iii) Institutions shall document the types of property they accept and their lending policies; iv) Institutions shall have in place procedures to monitor that the property taken as credit protection is insured against the risk of damage.

Article 210 of the CRR establishes the requirements for the Physical collateral other than immovable property: (a) the collateral arrangement shall be legally effective and enforceable and the institution is able to realise the value within a reasonable timeframe; (b) only first liens on, or charges over, collateral shall qualify as eligible collateral and an institution shall have priority to the realised proceeds of the collateral; (c) institutions monitoring should be frequent; (d) the loan agreement shall include detailed descriptions of the value as well as detailed specifications of revaluation; (e) institutions shall document the internal policies and practices for examination of the types of physical collateral; (f) institutions' credit policies shall address the appropriate collateral requirements, the ability to liquidate it, as well as the frequency with which the value can readily be obtained and its volatility. (g) institutions shall take into account any deterioration or obsolescence of the collateral; (h) institutions shall have the right to inspect the collateral and policies addressing this right; (i) the collateral shall be adequately insured against the risk of damage.

Article 211. Institutions shall treat exposures arising from leasing transactions as collateralised by the type of property leased under the following conditions: (a) the conditions set out in Article 208 or 210; (b) the lessor has in place robust risk management, including appropriate monitoring of the value; (c) the lessor has legal ownership of the asset and is able to exercise its rights in a timely fashion; (d) where this has not already been ascertained in calculating the LGD level, the difference between the value of the unamortised amount and the market value of the security is not so large as to overstate the credit risk mitigation attributed to the leased assets.

- **Specific treatment of secured portion of NPE guaranteed by a securitization transaction eligible for Credit Risk Mitigation:** Securitization is an eligible credit risk mitigation technique used by financial institutions to transfer the credit risk of a portfolio to third parties. Securitizations are called Synthetic Securitisation (SS) when they do not transfer the underlying asset pool (thus the label "synthetic") but only the related risk. This risk mitigation technique also has a direct consequence on Accounting Provisions (AP), that are reduced accordingly. Considering that capital deduction arising from Calendar Provisioning must be calculated on a loan by loan basis as the difference (if positive) between Calendar Provisioning and Accounting Provisioning, we deem it is appropriate to introduce a specific treatment for those loans covered by SS that would otherwise produce an unintended excessive Provisioning (because the documentary AP of a loan could artificially result to be excessively small thanks to the SS risk mitigating impact). In order to avoid such unintended implication, the originating bank should apply the backstop considering the level of Accounting Provisioning without the impact of SS.

4. The scope of application of the backstop should exclude the following exposures:

- **Defaulting loans guaranteed by an official export credit agency** (the "ECA"). It is common practice that, in case of a default of the borrower, ECAs which guarantee export credits indemnify the banks according to the original repayment schedule of the loan. An immediate indemnification for the whole amount of the loan after a default is an exception. Their repayment period may reach up to 18 years, so a default may occur several years before their final repayment. However, according to the definition of NPE now transposed in Article 47, when there is an unpaid instalment in an export credit covered by an ECA, after 90 days the whole export credit and not only the unpaid instalment has to be considered as an NPE despite the ECA assumes the future payment obligations of the counterparty covered by the guarantee. Therefore the 100% coverage would result in an unjustifiably high prudential risk provision. For this reason, the provisioning of the secured portion of a Non-Performing Exposure should not be requested as long as the guarantor has paid the bank for previous defaulted instalments according to the original repayment schedule and there is no reason to question its capacity to observe its commitments on the future instalments.

  The practices of the ECAs are in line with the guidelines of BCBS d128 (Basel 2 - paragraph 190) and d424 (Finalization of Basel 3 - paragraph 194) states:

  "In addition to the legal certainty requirements in paragraphs 117 and 118 above, in order for a guarantee to be recognised, the following conditions must be satisfied:

  (a) On the qualifying default/non-payment of the counterparty, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counterparty covered by the guarantee."

  and should be acknowledged in the CRR, where the article 213 requests for a timely payment but does not mention the options offered for a lump sum payment or for payments according the original schedules.

- **Purchased NPLs:** The proposal does not mention the provisioning treatment for NPLs that have been purchased and are held on the banking book (although the Commission excludes NPLs in the trading book). Such assets, regardless of whether they qualify as NPLs, are mainly held at fair value and have a market determined value. Thus, they are already in scope of the prudential filter of CRR Article 34 "additional value adjustments" (AVA) (Commission Delegated Regulation (EU) 2016/101). Hence banks already face a significant capital deduction as a result of this process. It

would therefore be disproportionate to subject purchased NPLs in the banking book and other fair value assets (i.e. any assets that are subject to the AVA process), to a potential NPL capital deduction, on top of their fair valuation and AVA. Consequently, such assets should be explicitly exempted from the scope of this proposal, or at least not provisioned higher than their fair value.

5. **Past due reclassification should be allowed**: the EC backstop allows for a less restrictive treatment of UTP non-past due. vs. past due. However, once an exposure is classified as past due, it is not foreseen that it might be reclassified to UTP once the obligor returns to regular payments albeit remaining non-performing (e.g. restructuring). The EC text should allow the possibility to reclassify a past due exposure to UTP once the obligor returns to regular payment. If this was not the case, the different treatment of UTP with respect to past due would be not effective and would prompt the bank to dismiss the exposures as it has no incentives in restructuring them.

6. **Possibility to grant to the NCAs the possibility to waive the 180 days past due:** for the purpose of the provision calculations the EC prudential backstop does not consider the possibility to grant to the NCAs the possibility to waive the 180 days past due for exposures secured by (i) residential property, (ii) SMEs commercial immovable property in the retail exposure class, or (iii) exposures to public sector. We deem important to fully align the Past Due definition applied under the prudential rules (for the purposes of the application of the backstop and the calculation of RWAs) in order not to oblige banks to comply with two different definitions.

   The EC proposal Article 47c , paragraph 5 (5) states in fact that: "*Competent authorities may replace the 90 days with 180 days for exposures secured by residential property or SME commercial immovable property in the retail exposure class, as well as exposures to public sector entities. The 180 days shall not apply for the purposes of Article 36(1)(m) or Article 127.*"