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Finance for Europe

Association for Financial Markets in Europe

AFME response to EBA consultation on RTS on the treatment of defaulted exposures under CRR's Standardised Approach for credit risk

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AFME welcomes the opportunity to respond to the EBA consultation on suggested changes to the RTS on the treatment of defaulted exposures under CRR's Standardised Approach for Credit Risk.

We note the intent of this RTS is in response to the call by the European Commission in its December 2020 NPLs action plan to introduce a more lenient prudential treatment of purchased NPLs on banks' balance sheets, which would increase competition on the buy-side.

Consultation question: Do you agree with the proposed amendment to Commission Delegated Regulation (EU) No 183/2014?

AFME members support the intent of what the EBA is trying to achieve in this RTS and that the treatment set out should only apply to purchased NPLs (as indicated in the background information), nonetheless, we consider that there is a lack of clarity in the proposed drafting set out below.

1. The RTS should make clear that the proposed change would also apply to purchases of NPLs by a securitisation Special Purpose Entity (SPE), where the bank (acting as, for example, an investor in the securitisation tranche) calculates the capital requirements for the underlying pool based on the Credit Risk Standardised Approach (i.e. using the SEC-SA). This should be in line with the EBA opinion on the regulatory treatment of NPE securitisations.[1]

2. We suggest that Article 1 (6) of the proposed text could be more aligned with the wording in recitals 4 and 6 as per our suggested track changes below.

   "6. To calculate the sum of specific credit risk adjustments in the cases referred to in Article 127, paragraph 1, points (a) and (b) of Regulation (EU) No 575/2013 for an exposure constituted by an item, where the obligor has defaulted in accordance with Article 178 of that Regulation, or in the case of retail exposures, constituted by a credit facility which has defaulted in accordance with Article 178 of that Regulation, institutions shall include any positive difference between the total outstanding amount of credit obligations on the exposure and the sum of ***(i)*** ***all own funds reductions made by the buyer*** ~~***the additional own funds reduction if the exposure was written-off fully***~~ and (ii) any ***discount in a transaction price that the buyer has not recognised by increasing CET1 capital*** ~~***already existing own funds reductions related to this exposure***~~."

   In addition we would note a small editorial comment regarding the phrase in the above paragraph: "the sum of specific credit risk adjustments in the cases referred to in Article 127" – in the cross referenced paragraph 127 it does not refer to 'cases' so we propose instead 'for the purpose of…'. With regard to "institutions shall include any positive difference between the total outstanding

[1] Opinion on the regulatory treatment of NPE securitisations.pdf (europa.eu) cf. section 1.2

amount of credit obligations…" could it be confirmed what "total" means in this case? Does this mean the total of the obligor? (In which case isn't this calculation done at an exposure level?).

Additional policy concerns related to NPLs:

While AFME supports the overarching intent of the RTS, albeit with the aforementioned clarifications, we would also like to take this opportunity to highlight a number of outstanding issues related to the treatment of NPLs which should be considered in this context.

The overriding issue in managing NPLs is the prudential backstop itself, which is unduly penal, particularly for transactions for which defaults are generally solved through restructuring and which may require some time to resolve without necessarily being sold on. For instance, regarding Specialised Lending transactions - because loans are granted with maturities shorter than the life of the assets, it's possible to restructure in case of default by postponing the maturity. "Time" is useful in such a case, and it is not always necessary therefore to sell the asset quickly, which could result in a fire sale leading to a worse outcome for both the institution and the counterparty.

Debt restructuring is also highly penalised under EBA GL assumptions in relation to the discount rate of xbor + 500 bps for historical LGD calculations on NPEs. The calculation of the economic loss and hence the workout LGD is largely overestimated by this discount rate which is much higher than the loan rates. This discount rate leads to a calculated loss even in the case where the borrower fully repays the principal and the interest. Therefore, where there are long recovery periods prior to exit from default these conservative rules further exacerbate the overestimation of loss.

In addition, private insurance is not considered as a mitigant in the backstop rules whereas it should be considered as an ECA, notably when provided by an insurer with a high rating. In the context of securitisation, whilst CRR is not precise[2], we believe the right interpretation is that if an originator / original lender meets significant risk transfer for a traditional or synthetic securitisation, there should be no backstop calculated on the securitised portfolio. This should, therefore, be clarified in CRR. It should also be clarified within Article 47(a) of the CRR, that securitisation positions as such are out of scope of the prudential backstop.

Furthermore, as mentioned in our **position paper on the NPL action plan** we strongly consider that the forthcoming CRR3 revision should review the derogation for massive disposals of NPLs which is due to last until June 30 2022. In light of the Covid-19 pandemic, this should be extended to June 30, 2024, and the threshold by which to attain the treatment reconsidered.

Consequently, as part of CRR3 we would support a review of the Pillar 1 prudential backstop as well as other aspects of the prudential treatment of NPLs to ensure they are fit for purpose and operating as intended, particularly given the nature of the Covid-19 pandemic.

One additional area of NPL policy that should be reviewed is the adoption of a standard definition of default in the EU (EBA/GL/2016/07) and the Regulatory Technical Standards on the materiality threshold (EBA/RTS/2016/06), that specify how default definition should be applied. These new rules have been applied for the first time in the middle of the Covid-19 pandemic environment. An aspect that deserves more

[2] Industry has sought previous clarification on this Answer for question E-001621/21 (europa.eu)

consideration in light of this experience is the new standard definition provides a new quantitative trigger for losses arising from a distressed restructuring (1% Net Present Value, NPV).

We propose regulators set **a higher NPV limit (i.e. 5%).** One of the major lessons that can be drawn from the recent experiences of the pandemic is that, in an emergency situation, one of the best outcomes for banks and customers is an agreement in the reduction (or suspension) of payments for a certain period. This allows the customer to recover and the bank not to face a default (of the consumer) and further weaken an already stressed economic system. Given the experience to date, it seems reasonable not to bind the maximum limit of concession to customers to the current 1% limit set by the EBA, but to set a higher limit (i.e. 5%).

It should also be noted that a 5% NPV limit should not lead to an excessive relaxation of the prudential framework, as the forbearance would still qualify as a renegotiation while maintaining the credit classified as solvent with a reinforced provisioning (stage 2 under IFRS9). Furthermore, the cash loss due to the higher NPV trigger would immediately affect the income statement of the banks, in accordance with the IFRS9 provisions.

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