

Position paper

of the Italian Banking Association (ABI) and the German Banking Industry Committee (GBIC) on relevant European issues concerning the completion of the Banking Union, the Basel III finalisation, and NPLs

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The Italian Banking Association (ABI) and the German Banking Industry Committee (GBIC) share the opinion that some regulatory measures should be considered by the European institutions, in order to support the ability of the whole European banking sector to finance the real economy over the coming months and years, which will be vital to Europe's economic recovery from the coronavirus pandemic.

More precisely, we propose the adoption of provisions allowing: 1) a further development of the crisis management framework for less significant banks, especially for those operating cross-border, and the creation of an enhanced role of national deposit guarantee schemes in safeguarding financial stability; 2) the adoption of legislation needed to complete "Basel III" regulatory framework (herein "finalisation of Basel III") and 3) the treatment of non-performing loans (NPLs) generated by the Covid-19 pandemic.

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1. Harmonisation in the EU of the crisis management for less significant institutions and on the set up of a harmonised enhanced role for national deposit guarantee schemes (DGSs)

- **The Supervisory Mechanism based on the two-layer model is proving to be functioning.** The mechanism adopted in banks' supervision (centralized at EU level for Significant Institutions [SIs], decentralized for Less Significant Institutions [LSIs]) is showing positive outcomes, also thanks to a growing convergence of supervisory practices determined by the use by supervisors of a Single Rulebook.
- **As for the crisis management, the situation is perceived to be unsatisfactory due to the lack of harmonisation in the bank insolvency framework (as opposed to resolution).**
 - While a single resolution mechanism has been designed in the first place for banks whose resolution is in the public interest, there seems to be a lack of harmonisation of rules and procedures regarding medium and small sized banks, which is especially detrimental for those operating cross-border.
 - For the vast majority of banks in the EU – in the event of a crisis – the normal scenario is liquidation under national insolvency or national liquidation regimes due to a negative public interest's assessment. The national bank insolvency or national bank liquidation regimes vary across jurisdictions. The coexistence of the common resolution framework with a plurality of national regimes could generate dysfunctionalities and may give rise to inefficient, costly and heterogeneous outcomes with serious economic and social impact – especially, if the existing instruments and regulations are not applied uniformly. A change in the legal framework is therefore appropriate. This could lead to a targeted harmonisation focused only on bank insolvency law. There is no need or justification for a harmonisation of national insolvency law in general.
 - Solving potential inconsistencies and creating a harmonised insolvency regime not only for banks under the direct remit of the Single Resolution Board (SRB) appears essential for both the banking union and the capital markets union. In this respect, a step-by-step approach is needed that will identify the areas where further alignment is urgently necessary.

- **To fix the existing framework and review the 2nd Pillar of the Banking Union, there is no need to create a new institutional set up.** Especially a transfer of resolution powers from national authorities to the SRB appears counterproductive and not in line with the principle of subsidiarity. There appears to be room for a solution where common administrative procedures for a more homogenous bank insolvency regime can be stressed and in which national deposit guarantee schemes (DGSs) could play a primary role in managing banking crisis compared to the status quo. This does not, however, require a centralised administrative body such as the SRB to govern the management of all LSIs in crisis.
- **A targeted harmonised European bank insolvency framework, with an enhanced role for national DGSs, could deliver substantial benefits.** The objective of this reform should be to provide for alternative instruments for national DGSs in addition to mere liquidation. Also, the strong role of Institutional Protection Schemes (IPSs) in preventing bank failures in the first place should be respected. A crisis management system with broad mandates of DGSs would support the EU Commission's aim to strengthen the Banking Union without changing the institutional setup.
- **An alignment of the state aid regime with the rules of the Banking Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR) with regards to public intervention is also needed.** Especially, an intervention of a DGS or IPS acting within their legal powers should be allowed without prior approval of the EU Commission. The state aid regime (Banking Communication of 2013) and the resolution framework of 2015 are based on different rationales and the experience shows inconsistencies in the interpretation of financial stability and public interest by the EU Commission and by the SRB. Misalignments between the state aid regime and the BRRD/SRMR regime on public intervention have increased legal uncertainty and can lead to inefficient and ineffective solutions.
- **A series of actions on the regulatory side needs to be undertaken to achieve the necessary level of harmonisation.**

From a legal perspective some steps are necessary:

- without jeopardizing well-functioning existing structures, amending the current rules in the DGS Directive where necessary to provide a solid legal framework to DGS comprising the necessary powers to implement and to finance measures to preserve the access of depositors to covered deposits according to Article 11(6) Deposit Guarantee

Scheme Directive (DGSD);

- setting a minimum harmonisation of national insolvency procedures for banks (while retaining Directive 2001/24/EC);
- aligning the rules concerning public intervention set in the state aid framework and the BRRD/SRMR regime, through a review of the Banking Communication (2013).

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2. Implementation of Basel III

a. Temporary suspension of the Basel III implementation

The effect of the Covid 19 crisis on future capital requirements and capital shortfalls cannot be reliably estimated at this point in time. This also means that the combined impact of the Covid 19 crisis and the final Basel III reform can currently not be measured. We, therefore, believe that a temporary suspension of the legislative process for EU transposition of the new standards is the right path to take as long as the impact of the Covid 19 crisis on the real economy and the financial sector has not been clearly identified. The postponement would not only help to avoid negative reactions in the capital markets. A premature implementation would also run the risk that the Basel III reform will lead to a reduction in lending to corporates and private households, thus hampering the recovery of the European economy.

b. No substantial increase in capital requirements in Europe

One of the major aims of the final Basel III reform was to make the capital requirements of institutions using internal models more comparable without significantly increasing the capital requirements overall. Several studies before the outbreak of the Covid 19 crisis, however, showed the opposite. The EBA recently estimated an increase of 18.5% of capital requirements resulting in a capital shortfall of € 52.2 billion. According to a study carried out in 2019 by Copenhagen Economics, banks would even need at least € 400 billion additional capital to maintain their current capital ratios. These burdens on banks would be the result of the strict implementation of the reform as proposed by the EBA. And those burdens continue to increase because of Covid 19. It would lead to a restriction of lending and would, thus, hamper the rapid and sustainable recovery of the European economy.

c. Considering European specificities

The main reason for the increase in capital requirements is the reduced relevance of internal models for the calculation of capital requirements for all risk types since their usage is widespread among the major European lenders. This is mainly due to the introduction of a new supervisory instrument called “output floor” which limits the extent to which the capital requirements calculated using banks’ internal models can be lower than the capital requirements derived under the standardized approaches. Among other things, this would have a strong impact on real estate financing and lending to corporates and SMEs.

Therefore, the output floor should not be implemented more strictly in the EU than specified by the Basel Committee. In particular, the output floor should neither be applied to Pillar 2 requirements and guidance nor to EU specific buffer requirements like the systemic risk buffer and the capital buffer for other systemically important institutions (O-SIIs) and should be applied at consolidated level only. Thus, the output floor should not go beyond the Basel minimum requirements. It is also important to consider the European characteristics of corporate financing. European companies, as a rule, do not have an external rating from a recognized external rating agency. Therefore, we feel that Europe must take a different path. Just like their American peers European banks should be allowed to assign a preferential risk weight of 65% to corporates with a good credit quality (investment grade) under the future standardized approach for credit risk.

The Basel III reform will also increase the administrative burden considerably, especially for smaller institutions that do not use internal models. Proportional arrangements should be found here. For example, small and medium sized institutions should have the choice to continue using the current standardized approach for credit risk in order to minimize the implementation and process burden. However, such a choice should not open up the opportunity for capital arbitrage. This is why in these cases a multiplier should be introduced in the supervisory formula to secure the level playing field among all market participants.

d. Other drivers for increasing capital requirements

According to the most recent EBA's Basel III Monitoring Report (December 2020), operational risk is one of the most important drivers of capital requirements' increase for European banks (especially large institutions). We deem that banks should be incentivised to manage operational risk through investment in insurance policies, technology and process enhancements, that would result in lower realized losses in the future, rather than on a size based metric and an institution specific loss multiplier that draws on losses over the past 10 years.

We appreciate the proposed phase-in for ILM (see table 13 of EBA Basel III reforms: updated impact study EBA/Rep/2020/34). However, in this regard, we consider key that the EU makes use of the discretion allowed and actually caps the Internal Loss Multiplier (ILM) at 1 and also foresees an option for banks in bucket 1 to use the ILM. In order to avoid cliff effects, we ask to introduce a global operational risk capital requirement phase-in period (with phase-in percentage and time span similar to those of the output floor).

In addition, there are numerous other drivers for increasing capital requirements, which together lead to the effects mentioned above, and which will therefore require refinements and appropriate exercise of discretions (where provided) in the transposition of the new standards in EU law, to ensure a balanced implementation. These drivers are e.g. the other changes to the standardized approach for credit risk, such as certain aspects of the new treatment of real estate financing (including land acquisition, development and construction), claims on banks, subordinated debt and equity and the new credit conversion factors are also worth attention, as well as the changes to the F-IRB approach, where, among other things, the treatment of exposures to corporates belonging to a group will penalise SMEs.

In this context, it is worth mentioning that transactions with non-financial counterparties are currently exempt from the CVA requirement. Although the final Basel III reform does not provide for these exceptions, the current European rule should be maintained in order to not make it more difficult for companies and public bodies to hedge against currency and interest rate risks.

The SME and infrastructure supporting factors should also be maintained, next to the 85% risk weight for SME in the standardised approach as proposed by the Basel Committee, and enhanced in order to cater for the specific nature of the European market, where bank lending is crucial for SME and infrastructure financing.

Moreover, there are still some aspects of the FRTB framework where there is room for improvement, since the proposed methodology is still challenging (especially in terms of capital requirement) and could likely lead to disincentives to adopt the Internal Model Approach, considering also that VaR models have been under severe stress during the Covid 19 crisis, thereby generating an increased market risk capital charge.

3. Covid-19 and Non-Performing Loans (NPLs)

The Covid-19 outbreak is determining a large economic and social shock. European Institutions are providing a large number of tools to sustain the economy. German and Italian banks are part of the solution and are actively helping households and businesses by providing lending, allowing moratoria and several kinds of Covid-related loans as well as other financial assistance, while ensuring continued services to customers and maintaining their risk management procedures at best.

Some general reflections are worth highlighting.

- **Volume and flexibility of credit supply**

The shock has a significant impact on the cash flows of enterprises, on supply chains, on fixed investment cycles and on working capital cycles. Not only the amount of credit supply is of utmost importance, but also the flexibility of credit facilities.

- **Impact of Next Generation EU**

It is to be estimated that the positive impact of NGEU on the real economy might be delayed.

- **Procyclical effects of NPLs**

The regulatory treatment of NPLs was set out under different circumstances from the current environment and should, therefore, be reconsidered in light of the emergency underway. This regulatory approach is likely to result in negative strong procyclical effects on SMEs and household, at a time when instead fostering the credit supply to the economy will be essential.

- **Level playing field**

Moreover, as far as the NPLs prudential treatment is concerned, the current regulatory framework does not guarantee the same regulatory treatment for banks on one side and hedge funds specialised on NPLs on the other side. This unlevel playing field should be eliminated. In the case that the NPL rules are not modified, this may lead to banks selling NPLs to hedge funds that will unwind them accordingly.

Level 1 measures

In light of the above, the following measures could be useful:

- **Temporary freeze of the calendar of minimum loss coverage requirements set in the “NPL backstop Regulation” (referred to loans originated starting from 26 April 2019) and of supervisory expectations**

The NPL minimum loss coverage Regulation (NPL backstop Regulation), under Regulation (EU) n. 575/2013 as amended by Regulation (EU) 2019/630, requires a predetermined level of coverage of NPLs - de facto implying a deduction of the exposure value from capital - within a timetable that in certain cases falls short to take due account of the presence of collateral.

Indeed, the NPL backstop framework affects the conditions and price of credit supply – which become more restrictive especially with regard to new clients – and establishes a perverse incentive for banks towards starting judicial procedures for credit recovery and collateral enforcement as soon as possible, rather than granting forbearance measures and supporting business restructuring (which require time to show results). In the current environment, preserving credit supply to clients facing difficulties is crucial for recovery and social cohesion.

Given the extraordinary economic scenario, an "NPL backstop Regulation" adjustment would be appropriate, through a temporary freeze, shifting forward the provisioning curves for a time period of at least 24 months (amendment Art. 47c CRR).

In addition, the following reasons should be considered:

- technical delays - in many countries civil courts have been closed or their activity significantly reduced and collateral enforcement procedures have been postponed or delayed (see DG Justice map): this will permanently increase the length of recovery actions, with negative impacts on the internal workout and/or NPLs values on primary and secondary markets;
- such stop/delays will increase the existing competitive gap between banks and non-financial institutions, being the latter out of the prudential framework.

The scope of the abovementioned minimum loss coverage requirements under Pillar 1 regulation, encompasses NPLs resulting from new loans originated as of 26 April 2019. A

similar calendar provisioning approach is applied – based on different supervisory measures – also to the other NPLs in banks’ balance sheets. More precisely, the so called “ECB Addendum” addresses the new NPLs referred to loans originated before 26 April 2019, while supervisory expectations regarding the existing stock as of 31 March 2018 have been communicated individually to each bank.

For the same reasons behind the need for a 24-month freeze of the Pillar 1 calendar - to avoid unintended consequences and procyclical effects - such supervisory expectations should be reconsidered accordingly.

- **For buyers of NPLs, the calendar (47c CRR) should only start from the date of acquisition of a non-performing position**

The key regulatory impediment is due to the CET1 loss coverage that treats purchased NPLs the same as originated NPLs. Indeed, it seems not fair that the purchaser be charged based on the time the exposure has been held by the originating bank, since the recovery procedure is likely to be revamped by the purchaser following the acquisition. Hence, for buyers of NPLs, the calendar should start to run only at the time of acquisition of a non-performing exposure.

- **The collateral requirements should be designed to be approach-independent**

Loans which are not secured by eligible collateral according to NPL backstop have to be covered by 100 % CET 1 after three years. This also applies if the value of the collateral fully covers the loan so as not to require the inclusion of specific commercial provisions. SMEs, in particular, often provide physical collateral or assign receivables that can be used by IRB banks to mitigate credit risk. In the case of credit institutions using the standardised approach (CRSA banks), physical collateral and assignment of receivables are not eligible for recognition, so the credit exposures are to be treated as unsecured for CRR purposes and must then be covered with 100% CET1. The ECB, in its supplementary guidance to banks on non-performing exposures for Pillar II purposes (“Addendum”), allows CRSA institutions to treat NPL as secured by IRB collateral if they meet the IRB requirements. The ECB justifies this approach to ensure a level playing field for all banks.

If an institution using the Standardised Approach to Credit meets the IRB requirements for certain collateral, such an institution should be allowed to treat non-performing exposures secured by such collateral as secured for the purposes of the minimum loss coverage

(amendment Art. 47c para. 1, subpara. 2 CRR).

Proposal

1. Introducing: i) a temporary modification of Article 47c of Regulation (EU) n. 575/2013, as amended by Regulation (EU) 2019/630, in order to provide for an extra 24-month period to the factors set therein; ii) modification of the ECB Addendum consistent with the modification proposed for Article 47c CRR (24 months additional to the current calendar); iii) consistent reconsideration of supervisory expectations set for individual banks regarding the existing NPL stock.
2. For buyers of NPLs, the calendar (47c CRR) should only start from the date of acquisition of a non-performing position (recital 8).
3. The collateral requirements should be designed to be approach-independent. If an institution using the Standardised Approach to Credit meets the IRB requirements for certain collateral, such an institution should be allowed to treat non-performing exposures secured by such collateral as secured for the purposes of the minimum loss coverage (amendment Art. 47c para. 1, subpara. 2 CRR).

▪ **Extension of Article 500 CRR (“Adjustment for massive disposals”)**

As known, Article 500 CRR (“Adjustment for massive disposals”), as introduced by Regulation (EU) 2019/876 (“CRR2”), allows banks to partially offset the impact of massive disposals of NPL (between 2016 and 2022) in the calculation of the LGD, provided that several conditions are met.

The much lower recovery rates normally observed in the case of NPLs massive disposals - compared to the recovery rates realised in case of internal workout or disposals under normal conditions - could heavily affect the Loss Given Default (LGD) parameter, which is one of the main driver of the calculation of the capital requirements for banks using internal models for credit risk. Due to the above, the European legislator adopted in 2019 Article 500 in the CRR in order to mitigate the potential distortions that could arise from the tighter regulatory framework and the peculiar economic scenario. A time extension until 2024 of the mechanism provided by Article 500 CRR would be appropriate, as a new wave of massive sale of NPL will take place in the coming years to help banks dealing with the expected increase of NPLs that will arise in the next years, for which another wave of NPL

massive disposals might be envisaged. Indeed, the LGD offset mechanism is crucial to avoid that such disposals entail a disproportionate capital charge over remaining exposures, which could turn into unintended consequences on the banks' ability to supply credit to the economy. The above-mentioned provision is also essential to reduce the disparity between banks and other specialised entities, being the latter out of the banking regulatory framework.

Proposal

Introducing a temporary modification to Article 500 (b) CRR as amended by Regulation 2019/876, in order to extend, without any additional notification or request for approval to the Supervisor, the application of the offsetting mechanism to massive disposals occurred until 31.12.2024.

Level 2 measures

In light of the uncertainty which makes assessing the recovery perspectives of each single client more difficult, certain aspects of the definition of default for prudential purposes are worth attention and – without prejudice to banks overall setting aside appropriate provisioning for the risks envisaged, certain measures determining automatic classification of individual obligors as defaulted could be reconsidered.

▪ **EBA GL on the Definition of Default - 1% NPV threshold to identify distressed restructuring**

Reference is made to the 1% NPV threshold for diminished obligation that triggers the classification of forbearance measures as distressed restructuring (hence to the classification as “unlikely to pay” which in turn results into the default of the obligor). In the aftermath of the crisis, banks should be encouraged to grant forbearance measures. The abovementioned threshold triggers almost automatic classification of forborne exposures as defaulted, which would determine a stricter regulatory treatment on bank's side and restrictions in credit supply for the borrower.

It would therefore be beneficial for many banks – and in turn for borrowers, to preserve recovery perspectives and maintain access to credit – allowing greater flexibility in the approach applied to identify forbearance measures that trigger the definition of unlikely to pay.

Proposal

Introducing a temporary modification of the EBA GL as per increasing the 1% NPV threshold currently applied to identify distressed restructuring to 5%.

At least excluding from the determination of 1% the penalty interest cancelled under legislative and non-legislative moratoria would be necessary.