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SPECIALISED CONSUMER CREDIT PROVIDERS IN EUROPE

European Commission consultation on statutory prudential backstops
Eurofinas response

Introductory observations

We take note of the Council conclusions on the reduction of non-performing loans (NPLs) across Europe and the specific request to the European Commission to consider the introduction of prudential backstops addressing potential under-provisioning which would apply to newly originated loans.

Eurofinas agrees that a high-stock of NPLs can have important and diverse implications. Against this background, **we believe it is important to address the causes of non-performing exposures and not to restrict action to consequences**. As pointed out by the European Systemic Risk Board in its July 2017 report on the resolution of NPLs in Europe, NPL ratios differ significantly across jurisdictions as well as across banks:

- **The NPL ratio is highly dispersed across EU countries**, ranging from 1% to circa 50%.
- **NPL ratios are the highest in medium-sized banks**. Larger and smaller institutions have been able to contain the growth of NPLs at around 3% (compared to an average 7% for medium-sized institution).
- **The NPL ratio of exposures in SMEs (15.5%) is significantly higher** than exposures in large corporates (7%) and households (4.6%). This may point out to the health of non-financial corporations across Europe but also to applicable origination standards in some jurisdictions.

We believe these findings are critical and should be considered when designing policies concerning the treatment of NPLs.

It is also important to ensure that the strategy and methodologies adopted are indeed consistent with firms' technical abilities and resources. **Smaller and specialised firms with a less complex asset structure are likely to be more severely affected by the concurrent introduction of the IFRS 9 as well as potential prudential backstops for non-performing exposures**.

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

    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?*
    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)?*

- IFRS 9 represents a fundamental change and there is no doubt that this new methodology will help the converging of provisioning levels across the EU. The implementation of the new standards by lending operators represent a considerable investment and we see the Commission's current proposal as undermining the efforts made in this field.

- We understand that the new reporting standards would leave room for discretion as to the determination of the actual provisions. In this context, we are happy to work with the European Commission on the valuation of non-performing exposures (NPEs) or of the underlying collaterals. We are also open to work on a common definition of NPEs in accordance with the one already used for supervisory reporting purposes. However, we are extremely concerned by the potential economic, fiscal and reputational implications on lending institutions of the introduction of an automatic EU-wide minimum prudential treatment for new loans turning non-performing. Eurofinas does not support the proposals as they stand.

- In addition to unintended and detrimental consequences on lending operators, we fail to understand why pillar 1 measures would be required when institution-specific measures related to the capitalisation of NPLs are possible and are precisely discussed in the current period. We understand the Commission's objective to address on a systematic and EU-wide basis the potential under-provisioning for new loans that become non-performing. However, this should not result in a "one-size fits all approach" which does not consider the implications on external investment, access to finance and the pricing of loans as well as compromise market diversity. This is particularly important as tools already exist under Pillar 2.

- Ultimately, we want to better understand how we will be reconciling on one hand a NPL resolution package based on a long-term viability assessment of an institution, a precise valuation of loan portfolios together with a loan-by-loan analysis of NPLs with, on the other hand, a prudential backstop for future loans that takes no account of jurisdiction, size of the lending operator, nature of exposures or underlying cause of default.

- Here again, we insist that smaller and specialised or monoline firms will be considerably more impacted by this initiative than larger international institutions. We strongly encourage the Commission to consider introducing further granularity and proportionality in its proposals.

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

    a. *If yes, please explain your views.*
    b. *If not, what are the features that appear problematic to you and why?*
    c. *Is there any alternative design of backstops via prudential deductions that you could envisage for new loans that turn non-performing? Please provide details.*

- We think the proposed backstops will have an immediate and mechanical impact on firms' ability to finance the real economy. We would like to warn the Commission's services against a potential exclusion of the market of lower income households together with those borrower segments with unconventional risk profiles. We think this is particularly likely in a number of sensitive recovering jurisdictions.

- We think the proposal is principally unfair regarding the treatment of retail exposures which despite showing better performance than exposures to businesses are treated in a similar fashion. We also think that the proposal will particularly badly hit unsecured lending facilities. We believe this will negatively impact risk analysis as it will create an incentive to shift from a cash flow and behavioural assessment to mere collateral valuation. Also, we think that, in the current context, the proposed backstops will create a strong incentive for some providers to transfer non-performing exposures that are not sufficiently profitable in terms of capital to the highest bidder. We think the secondary market is simply not prepared for that. <u>We see this as a major risk which contradicts European stability objectives</u>.

  Should the European Commission confirm prudential backstops for new NPLs, <u>we would recommend excluding retail exposures from the scope of this initiative</u>. We would also support the introduction of a specific threshold under which an institution should not apply the prudential backstops. Further consideration could also be given to a reinforcement of pillar 2 measures should the NPL ratio of an institution exceed this threshold. Against this background, we would like to stress that for retail consumer loans, lending institutions' recovery processes are very efficient as evidenced by high recovery rates. The latter are closely monitored, and the models used for their estimation are based on sound statistical methodologies and data. Regular back-testing of predictive models are also in place to guarantee their efficiency.

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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? Please explain.*

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

- We understood that the prudential backstops were to be considered in the context of the ongoing review of the CRD/CRR. Given the potential implications of these measures, it is extremely

important to provide a maximum legal certainty to lending operators and make sure that any future requirement is phased-in progressively.

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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?*

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?*
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?*
c. *If none of the approaches work in your view, how should the backstops be alternatively calibrated?*

Please explain the reasons for your answer.

- As previously highlighted, we believe that the treatment of unsecured loans will lead to a major business and market transformation. This proposal will not only affect lending operators but also all business partners involved in the distribution of credit as well as households who will have a reduced number of financing options at higher costs. The proposed period of 2 years for statutory prudential backstops for unsecured exposures is also inconsistent with the various local bankruptcy regimes in several countries which are designed to bring back borrowers to a solvency position and which impact the performance status of an exposure. We think additional reflection should be given to the classification/reclassification of exposures.

- By default, we would advocate for an alignment of the treatment of retail exposures and require a full coverage of all non-performing retail exposures after 8 years.

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

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

- Eurofinas would support the development of a common methodology for collateral valuation. We take the view that the binding nature of such methodology should depend on how convergent practices are currently across Europe and how detailed the common methodology could/should be. We believe a preliminary assessment by the European Banking Authority would be useful before any decision is taken in this field.

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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?*

- We see the valuation of collateral as one part of a recoverability analysis, that also relies on the expert judgement of a lending institution as well as a thorough understanding of its customers. We fear that the proposed measure will create an eviction effect, especially for weakest households and SMEs since it could lead to systematic requests of collateral, and even to over collateralization. Recoverability requires an analysis on a cash flow perspective and not on mere, sometimes artificial, collateral value perspective.

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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?*

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

No comment.

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

    a. *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.

We believe that the design of Pillar 1 prudential backstops carries many unintended consequences:

- As a “one size fits all” measure, it carries the risk of stigmatizing the entire EU banking system when the most significant NPL issues concern only part of the European banking system.

- Planed at the same time as the implementation of the new IFRS 9, it seems to deny the value of the new IFRS 9 accounting regime and raises taxation issues. The lack of coordination between accounting and regulatory initiatives would result in blurring interactions and make it difficult to understand relied effects on cost of risk.

- It seems redundant with the existing Pillar 2 framework which already allows specific prudential treatment of NPLs, in a more accurate manner.

- The use of capital as an additional buffer for NPL coverage might trigger lower risk appetite and higher lending price. The measure would have major impacts on the credit granting processes of credit institutions, and would restrict access to credit. The proposed measures also seem contradictory with current modelling rules and practices.

- The measure will induce a bias in the price on the side of banks/sale side (weaker negotiation position of banks in any NPL sale as vintage buckets approach deadlines under the proposed backstops). The impacts of the measures on pricing and issuance volume of NPL securitizations have not been properly assessed.

About Eurofinas

As a Federation, Eurofinas brings together associations throughout Europe that represent finance houses, universal banks, specialised banks and captive finance companies of car or equipment manufacturers. The products sold by Eurofinas members include all forms of consumer credit products such as personal loans, linked credit, credit cards and store cards.

It is estimated that together the Eurofinas members financed almost 427 billion euros worth of new loans during 2016 with outstandings reaching 1024 billion euros at the end of the year[1]. Consumer lending is procyclical and is highly positively correlated with households' disposable income. By providing access to finance to individuals and households, consumer credit supports the social and economic well-being of millions of consumers across Europe.

Eurofinas is entered into the European Transparency Register of Interest Representatives with ID n° 83211441580-56.

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[1] This includes 320.4 billion euros in new consumer loans in 2016. Of that amount, 108 billion euros was consumer vehicles. Outstanding portfolio reached 709.5 billion euros.