ABI Associazione Bancaria Italiana

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Al Presidente del Consiglio dei ministri,
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Al Ministro dell'economia e delle finanze,
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Al Ministro dello sviluppo economico,
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Al Ministro degli affari esteri e della cooperazione internazionale, Luigi Di Maio

Al Ministro per gli Affari Europei,
Vincenzo Amendola

Al Governatore della Banca d'Italia,
Ignazio Visco

Italian enterprises and lending for recovery

Due to the COVID-19 pandemics, unprecedented limits to personal and productive activity were introduced, while all around the world people habits changed. This determined a tremendous drop in GDP, whose entity is still difficult to assess.

In front of such emergency, leaving outdated approaches in favour of a vision allowing us to concentrate all effort towards the common goal of recovery is paramount.

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In this believe, **Italian banking and entrepreneurial associations - Alleanza delle Cooperative Italiane (AGCI, Confcooperative, Legacoop), Casartigiani, CIA Agricoltori Italiani, CLAAI - Confederazione Libere Associazioni Artigiane Italiane, CNA - Confederazione Nazionale dell'Artigianato e della Piccola e Media Impresa, Coldiretti, Confagricoltura, Confapi, Confartigianato, Confcommercio, Confedilizia, Confesercenti, Confetra, Confimi Industria, Confindustria**[1] - together and unanimously reflected on the need and urgency of certain amendments to banking regulation as certain rules, conceived in a totally different context and entailing overly automatic effects, might prejudice the recovery perspectives of the Italian and European economy.

Bank lending played and is playing a pivotal role, during the crisis, providing businesses with liquidity to face their financial needs despite their sources of income, the demand for their product or their supply chain, are heavily affected. All the more essential bank lending credit will be in the following months, in order to support enterprises recovery path in an economic environment that will likely remain unpredictable for long.

In the first wave of the pandemics, national and EU institutions put in place several measures to tackle the emergency. Anyway, in the banking prudential framework certain issues remain that need to be overcome, in order to avoid that temporary difficulties of enterprises turn into bankruptcy due to the automatic effect of certain pieces of Level 1 and Level 2 legislation and restrictions in credit supply which would prove fatal in the current context.

A few amendments and temporary adjustments are urgently needed, allowing banks to offer the strongest support to the real economy at a moment when this is crucial to its viability.

A temporary adjustment is urgent as regards the so-called "definition of default". Here, the current 90-days past due criterion, together with newly-introduced (applied as of January 2021) thresholds to identify material past due exposures, in addition to new rules on distressed restructuring, are likely to determine the classification as defaulted of a huge number of obligors, however sound. This would severely affect their access to credit, thus hampering their recovery perspectives.

Another measure is of utmost importance, concerning the rules and supervisory expectations about the minimum loss coverage of non-performing exposures in too short timeframe, until their value is reduced to zero (c.d. calendar provisioning). Such approach – per se incentivising more restrictive standards at credit origination – is all

[1] This Associations are part of the Multi-stakeholder Working Group on International Regulatory Initiatives on banking sector, whose the secretary is managed by the Italian Banking Association.

the more detrimental now, as it encourages banks to sell loans (outside the banking regulated market) at first signs of financial difficulty of the client, rather than supporting in a recovery path through forbearance measures. In any case, the slowing down – observed throughout Europe - in judicial proceedings in consequence of the emergency has to be factored in the framework.

In addition, several adjustments are warranted and needed regarding the prudential frameworks on the effects of massive disposals of NPLs, on NPL securitisations, on the treatment of purchased NPLs. These adjustments are essential to allow for smoother management of those exposure which would nonetheless default. Indeed, fair pricing of such loans is beneficial to businesses as well as to banks.

The unprecedented severity of the crisis requires swift and pragmatic reactions, activating all available tools to contain economic and social consequences. The abovementioned problems and the proposals for targeted amendments to the banking prudential framework, that the undersigned Associations share, are illustrated in greater detail in the enclosed document, complementing the NPL action plan recently announced by the European Commission.

Best regards,

Giovanni Sabatini
General Manager

Annex

Covid-19 and NPLs

General reflections and proposals for <u>temporary</u> adjustments to the NPL regulatory framework

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FOREWORD

The Covid-19 outbreak has determined a large economic and social shock. European Institutions are providing a large number of tools to sustain the economy, also through the banking sector. European Banks are therefore part of the solution and are actively helping households and businesses by providing lending, allowing moratoria and several kinds of Covid-related loans and financial assistance, while ensuring continued services to customers and maintaining their risk management procedures at best.

As at mid-December 2020, Italian banks have provided nearly EUR 120 billion new loans backed with public guarantees, to around 1.5 million corporates, and granted payment holidays under public and private moratoria for around EUR 300 billion, to over 2.7 million clients.

Some **general reflections** are worth highlighting.

1. Volume and flexibility of credit supply

The shock has relevant impact on the cash flows of enterprises, as it affects their sales, the supply chain, the fixed investment cycles as well as the working capital cycles. Banks at the European level are doing their best to meet the financial needs of businesses and households, while assessing borrowers' risks profile as usual.
Not only the amount of credit supply is of utmost importance, but also the flexibility of credit facilities, given the high degree of uncertainty of the scenario and hence of the forecasts of clients' future financial needs.

2. Difficulties in forecasting and planning.

Indeed, Covid-19 has an impact on the ability of all actors – Governments, Authorities, international bodies, banks, large corporate, SMEs, households - in forecasting the future trends of all relevant variables.

3. Civil Courts and bad loans

The pandemic shock also heavily affected the civil courts proceedings. In some areas, Courts have been closed during the period of application of confinement measures, and all proceedings have been rescheduled or postponed. Moreover, second wave lockdowns would hamper further the situation. Due to this, the usual banks' internal workflow for credit recovery has suffered an impact. The negative impact on the length of the processes for credit recovery and enforcement of guarantees (see DG Justice map) may cause a temporary price depression on NPL market prices.

4. Impact of Next Generation EU

It is to be estimated that the positive impact of NGEU on the real economy and on borrowers' creditworthiness might be delayed to the second half of 2021, at best.

5. European Economic and Social Committee Opinion

Furthermore, on 29th October 2020 the European Economic and Social Committee (EESC) in its Plenary session approved its report ECO/529-EESC-2020. The latter stated that it is of utmost importance to address some concerns raised by the regulatory framework on Non-Performing Exposures. As underlined in the Opinion, the EESC endorses the objective behind the recent Commission's proposals, but it considers that the Commission's measures should be even broader than the ones proposed. The regulatory framework securing non-performing loans currently in force

was structured before the pandemic and contains rigidities that could have a negative procyclical impact on the real economy, and in particular on SMEs, in the current economic context that is undermined by the pandemic.

6. Expectations for an NPL rise across the EU

According to the ECB analysis published in July, under a central scenario, envisaging a very harsh recession, with euro area GDP falling by 8.7% in 2020, followed by a fairly robust recovery in 2021-22, the banking sector would be able to withstand the effects of the shock on its asset quality and capital, but under a worst-case scenario asset deterioration may reach EUR 1,400 bn of NPLs.
According to the EBA Risk Dashboard published on 5 October, the share of stage 2 loans, which are not yet NPLs, but a reasonable indicator to monitor, rose from 7% in Q1 2020 to 8.2% in Q2. Raising impairments are the signals of the expectation of defaults to come. However, the EBA recognised that Payment moratoria and public guarantee schemes are providing time to both borrowers and banks to gauge the impact of the crisis. The phase out of support measures too early would further deteriorate those exposures and prevent the recovery of investment in 2021.

7. Regulatory treatment of NPLs

The regulatory treatment of NPLs was set out in totally different circumstances from the current environment and should therefore be reconsidered in light of the emergency underway. ABI and other entrepreneurial associations would here, in particular, make reference to the NPL minimum loss coverage Regulation (NPL Backstop Regulation), which requires a predetermined level of coverage of NPLs - de facto implying cutting the exposure value. This regulatory approach is likely to result in procyclical effects, at a time when instead fostering the credit supply to the economy will be essential.

Moreover, as far as the NPLs prudential treatment is concerned, the current regulatory framework does not guarantee the same regulatory treatment between banks (on one side) and funds specialised on NPLs (on the other side). This unlevelled playing field should be eliminated.

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PROPOSALS

In light of the above, ABI and other entrepreneurial associations suggest introducing some **temporary** relief, on a few targeted issues, without jeopardising the overall prudential framework in place. This is aimed to just temporarily absorb the impact of the Covid-19 pandemic on banks' balance sheets, thus allowing for them to provide the largest support to the economy, in order to limit the economic and social consequences of the crisis.

In the following, some proposals are illustrated for temporary modification of level 1 and level 2 EU regulation respectively.

LEVEL 1 MEASURES

1. Temporary freeze of the "NPL backstop Regulation" calendar (referred to loans originated starting from 26 April 2019)

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 cutting the exposure value - within a strict 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.

This regulatory approach will now be even more problematic in the post-pandemic economy due to the expected rise in NPL across the whole EU27. Given the extraordinary economic scenario, the "NPL backstop Regulation" should therefore be adjusted and the coverage curves should be suspended or recalibrated, at least on a temporary basis. In fact, according to the calendar defined by the Pillar 1 regulation, the first compulsory provisions should be made in 2Q 2021, at a time when the economy deserves more support. Therefore, a temporary suspension of the backstop would produce a positive countercyclical effect.

In addition, a temporary modification is necessary for the following reasons:

a) in many countries civil courts have been closed or their activity significantly reduced (in some countries this is still the case), and collateral enforcement procedures have been postponed or delayed: 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. It might be conservatively assumed that it will take at least 24 months after the end of the Pandemic to return to normal conditions;

b) such stop/delays will increase the existing competitive gap between banks and non-financial institutions, being the latter out of the prudential framework;

c) the markets for financial assets could be under stress very soon: selling NPLs portfolios in these extreme circumstances could be overly difficult and counterproductive as it may give rise to another massive transfer of wealth from banks to non-regulated entities.

To this end, the NPLs backstop should be temporarily amended in order to allow for shifting forward the provisioning curves for a time period of at least 24 months, both for secured and unsecured NPLs.

Proposal:

Introducing 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-months period to the factors set therein.

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2. Extension of Article 500 CRR ("Adjustment for massive disposals")

As well known, Article 500 CRR ("Adjustment for massive disposals")[1], 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.

In recent years, due to the regulatory and supervisory pressure (e.g. the ECB "Addendum") to reduce the size of the NPL stock in their balance sheets, many banks decided for massive disposals. Given the specific context, the sudden abundant supply led to low sale prices.

The much lower recovery rates observed in the case of NPLs massive disposals - compared to the recovery rates realised in case of internal workout or disposals under normal conditions - would 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.

The above-mentioned Article covers the effects of the disposals carried out in a time window which runs from 23 November 2016 to 28 June 2022, as long as the corresponding exposures are included in the institutions' own LGD estimation.

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[1] 'Article 500 Adjustment for massive disposals

1. By way of derogation from point (a) of Article 181(1), an institution may adjust its LGD estimates by partly or fully offsetting the effect of massive disposals of defaulted exposures on realised LGDs up to the difference between the average estimated LGDs for comparable exposures in default that have not been finally liquidated and the average realised LGDs including on the basis of the losses realised due to massive disposals, as soon as all the following conditions are met:

(a) the institution has notified the competent authority of a plan providing the scale, composition and the dates of the disposals of defaulted exposures;

(b) dates of the disposals of defaulted exposures are after 23 November 2016 but not later than 28 June 2022;

(c) the cumulative amount of defaulted exposures disposed of since the date of the first disposal in accordance with the plan referred to in point (a) has surpassed 20 % of the cumulative amount of all observed defaults as of the date of the first disposal referred to in points (a) and (b).

That said, the European institutions are now drafting rules aimed at tackling the severe economic shock caused by the COVID-19 pandemic and its consequences on banks' accounts.

A time extension until 2024 of the mechanism provided by Article 500 CRR would be appropriate 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.

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3. Article 178 CRR on the definition of default: temporary modification to the 90 days past due rule

Given the current economic scenario and the uncertainty raised by a potential spread of the contagion, some reflections are needed on the current framework for the prudential classification of an obligor as defaulted, as per Article 178 CRR.

While the moratorium tools already in place, granting clients payment holidays, could be continued to some extent at national level, it would be important that some temporary flexibility be introduced on credit flows which could suffer payment delays in this particular situation. To this end, a possible solution could be a temporary deviation from the 90 days past due of any material obligation currently used as trigger for the classification of an obligor as defaulted.

Proposal:

Introducing a temporary amendment to Article 178 CRR (until 31.12.2022), in order to:

- apply 180 days (instead of 90 days) past due as trigger for the classification of obligors as defaulted;
- exclude Public Administrations and Public sector entities from the application of the past-due criterion; as a result, such entities would be subject to the assessment of the Unlikeliness to Pay only.

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4. Application of Article 127 CRR (to facilitate the purchase of NPLs on the secondary market)

Article 127[2] of Regulation EU n. 575/2013 (CRR) states that the unsecured part of any item where the obligor has defaulted shall be assigned a risk weight of 100 %, where specific credit risk adjustments are not less than 20 % of the unsecured part of the exposure value. Where specific credit risk adjustments are lower than 20% a 150% risk weight shall be assigned.

The application of Article 127 leads to a disproportionate capital charge when a bank buys a non-performing exposure on the secondary market from another bank.

As a matter of fact, in this latter case, the purchaser records a relevant credit impairment at initial recognition, where a "total provision" is embedded in the NPL purchase price.

Therefore, the mechanical application of Article 127 to the bank on the buy side–requiring another 20% provisioning on the book value (net purchasing price) of the NPL to benefit from the reduced (100%) risk weight - generates an undue difference in capital requirements for the same exposure.

This undue effect could represent a significant limit for an efficient NPLs' secondary market, discouraging the participation of banks.

It is also worth highlighting that new Article 47c - point b CRR takes into account the difference between the purchase price and the amount owed by the debtor for the purpose of the required NPLs coverage.

Proposal:

Introducing a modification of Article 127 CRR, clarifying that the purchase of NPLs on the secondary market is treated consistently with the NPL backstop approach, i.e. allowing for the difference between the amount owed by the debtor and the purchase price to be computed as provisioning for the purpose of the identification of the applicable risk weight (100% in case provisioning exceeds 20% vs 150% otherwise).

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[2] Article 127 Exposures in default

1. The unsecured part of any item where the obligor has defaulted in accordance with Article 178, or in the case of retail exposures, the unsecured part of any credit facility which has defaulted in accordance with Article 178 shall be assigned a risk weight of:

(a) 150 %, where specific credit risk adjustments are less than 20 % of the unsecured part of the exposure value if these specific credit risk adjustments were not applied;

(b) 100 %, where specific credit risk adjustments are no less than 20 % of the unsecured part of the exposure value if these specific credit risk adjustments were not applied.

2. For the purpose of determining the secured part of the past due item, eligible collateral and guarantees shall be those eligible for credit risk mitigation purposes under Chapter 4.

3. The exposure value remaining after specific credit risk adjustments of exposures fully and completely secured by mortgages on residential property in accordance with Article 125 shall be assigned a risk weight of 100 % if a default has occurred in accordance with Article 178.

4. The exposure value remaining after specific credit risk adjustments of exposures fully and completely secured by mortgages on commercial immovable property in accordance with Article 126 shall be assigned a risk weight of 100 % if a default has occurred in accordance with Article 178.

5. European framework for State guarantee on NPLs securitisations

Among the various tools to tackle the consequences of the crisis, a European harmonised scheme of State guarantee on NPLs securitisations should be considered. This would be also in line with the recent considerations by the ECB, advocating for measures that improve the efficiency of secondary markets for NPLs, such as Government-sponsored securitisation schemes, which have been successful in dealing with NPLs in some jurisdictions[3].

In this field, Italy has successfully experimented the "Garanzia sulla Cartolarizzazione delle Sofferenze" ("GACS"), a public guarantee on the senior tranches of securitisations with underlying non-performing loans (NPLs).

Such mechanism aims at facilitating banks' disposals of NPLs via securitisations, by increasing the appeal of these securities for investors and reducing the cost for the banking sector. The GACS has been largely used by Italian banks, thus contributing to the sharp reduction of their NPL ratio observed in the recent years.

Being the GACS a public guarantee for which the bank pays a commission, it is subject to scrutiny and authorization by the DG COMP. Currently the authorization is granted on the basis of long and, sometimes, complex negotiations.

In light of the above, the introduction of a harmonised framework of such gurantees at European level would incentivise its adoption by other Member States and would facilitate and reduce the times of the authorizations by competent Authorities.

Therefore, a EU scheme would give the securitisation instruments homogeneity, legal certainty and speed of execution.

Proposal:

Introducing a European harmonised scheme for State Guarantee on NPLs securitisations, as to facilitate banks' disposals of NPLs via securitisations. Such a scheme could follow the example of the successful Italian "Garanzia sulla Cartolarizzazione delle Sofferenze" ("GACS"), a public guarantee on the senior tranches of securitisations with underlying non-performing loans (NPLs).

[3] See the ECB November 2020 "Financial Stability Review", page 106

LEVEL 2 MEASURES

6. Temporary freeze of the supervisory expectations on the NPL backstop

As illustrated above, an adjustment is deemed essential regarding the required coverage of NPLs under Pillar 1 regulation, whose scope 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 at 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.

Proposal:

Modification of the ECB Addendum consistent with the modification proposed for Article 47c CRR (24 months additional to the current calendar).
Consistent reconsideration of supervisory expectations set for individual banks regarding the existing NPL stock.

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7. Definition of Default

In light of all the above mentioned observations, and of the uncertainty which makes assessing the recovery perspectives of each single client all the more difficult, it is deemed crucial that – without prejudice to banks overall setting aside appropriate provisioning for the risks envisaged – classification of individual obligors as defaulted be as flexible as possible.

(a) New Definition of Default (postponement)

In this respect, the so called "new definition of default" as per the EBA Guidelines on the application of the Definition of Default (EBA/GL/2016/07) and the RTS on materiality thresholds (Commission Delegated Regulation (EU) 2018/171 and relating implementing measures by competent authorities) are introducing – via strict interpretation of existing rules - major constraint as of next year, i.e. where the pandemic crisis will still be unfolding its effects.

ABI and other entrepreneurial associations would urge this deadline to be reconsidered and the application date of such regulations to be postponed, in order to avert the unintended consequence of restrictions in credit supply.
Indeed, classification of an obligor as defaulted entails major consequences not only on the bank side but also in terms of a client's access to credit. The introduction of stricter criteria for identification of defaults would therefore immediately result in severe social and economic consequences, due to the

direct effect on households and corporates involved, and in procyclical effects at macroeconomic level, which would hamper the recovery perspectives.

It should be borne in mind that, since those piece of regulation constitutes interpretation of existing CRR rules, the application date set therein are to be intended as ultimate date for application, therefore the postponement would not affect banks already applying the new rules in their systems and not willing to restore the pre-existing approach (this holds true also for the subsequent proposal on materiality thresholds, that are to be considered as the higher applicable thresholds).

Proposal:

Postponement of the (ultimate) date of application of the new definition of default - EBA Guidelines on the application of the Definition of Default (EBA/GL/2016/07) and RTS on materiality thresholds (Commission Delegated Regulation (EU) 2018/171 and relating implementing measures by competent authorities) – until 31.12.2022.

(b) New Definition of Default (materiality thresholds)

For the same reasons stated before, the risk of identifying an obligor as defaulted based on exceeding relatively low threshold of obligations past due would entail unintended consequences and should be avoided.

Introducing lower thresholds for the identification of material obligations past due – compared to what is currently common practices in certain countries – is hence deemed not appropriate.
This point could be addressed via raising the thresholds set in the abovementioned regulations.

Proposal:

The materiality threshold includes two components, both of which should be exceeded to trigger the classification of any obligation as "material".
Raising the absolute threshold (500 EUR threshold - 100 EUR for retail exposures only) requires modifying the Commission Delegated Regulation (EU) 2018/171 and in particular Articles 1(2) and 2(2).
The relative threshold (1% of total exposure to the client) could be raised amending the implementing measures by competent authorities, to the extent that the threshold remains below 2.5% (i.e. within the range 0%-2.5% allowed by the Commission Delegated Regulation (EU) 2018/171, Article 1(2)).

(c) EBA GL on the Definition of Default (threshold to identify distressed restructuring)

A temporary modification to the EBA GL on the definition of default would be crucial.

In particular, 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, encouraging banks to grant forbearance measures will be of the utmost importance. It is therefore crucial to avoid 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.

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.