



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

Sir William Cash MP
European Scrutiny Committee
House of Commons
London
SW1A 0AA

25th October 2018

Dear Sir Bill,

EM 7403/18 and 7407/18: Update on the Commission's package on non-performing loans

I am writing to update you on the negotiations relating to the Commission's package on non-performing loans, which includes a regulation (the "Regulation") amending EU capital rules to introduce a new prudential "backstop" for non-performing loans ("NPLs") and a directive (the "Directive") on credit servicers, credit purchasers and the recovery of capital, which aims at improving secondary markets for NPLs in the EU.

The Presidency has nearly reached a compromise position on the Regulation, and I expect that negotiations will progress to the General Approach in November. Progress on the Directive has been slower, which reflects concerns around the interaction of that proposal with domestic consumer protection and collateral enforcement rules. Accordingly, the Council announced this month that the Regulation and the Directive would progress at different speeds.

The Regulation

At Council Working Party level, we have strived to balance the need to maintain the flexibility of UK supervisors in dealing with NPL build-up against the wider political context in which the NPL package was proposed.

High NPL concentrations in some EU Member States increase the risk of economic contagion, and NPL reduction is seen by many EU Member States as a prerequisite to further economic integration under the Capital Markets Union and Banking Union initiatives.

The UK has among the lowest levels of NPLs in the EU and is unlikely to be as affected by the reforms as other EU Member States. We have therefore opted to support the proposal while pushing for compromises that would maintain appropriate supervisory flexibility. Our other main concern is the interaction of the proposed backstop with the five-year transitional period under IFRS 9; it is currently unclear how the two will interact.

In this context, we welcomed agreement among EU Member States in several key areas, including:

- **Prolongation of accounting provisions along the lines of the ECB Addendum:** This ensures that accounting provisions can be relied upon for a period before the prudential backstop applies. Supervisors have powers to require additional provisioning where accounting reveals under-provisioning of NPLs.
- **Cut-off date:** Several EU Member States pushed for the backstop to apply from the date of the publication of the Commission proposal, or earlier. Under the final agreement, the new rules will apply from the entry into force of the Regulation, not retrospectively.
- **Definition of non-performing exposures¹:** It was agreed that the same definition that is currently used for supervisory reporting purposes will be used for the backstop.

As the Council Working Party negotiations conclude, the Council has put forward two options for compromise.

The first option proposes to introduce a transitional period for new NPLs. Under this approach, banks would have additional time to fully provision loans that become NPLs in the first three years after the entry into force of the Regulation. The Regulation would also include a freeze period that would disapply the backstop where a firm has exercised forbearance measures in respect of an NPL. At the end of the calendar period, firms would be required to provide 100% coverage.

The second option proposes a permanent solution that would not include a transitional or freeze period, but it would only require 85% coverage at the end of the calendar period. On balance, we prefer the second option. The benefits of the transitional under the first option do not accrue until the seventh year after a loan becomes non-performing, this option would not address our concern around the interaction of the backstop with the IFRS 9 transitional. A lower coverage requirement is less complex than a transitional. It provides more certainty and is less operationally challenging for industry to implement.

Although many EU Member States have expressed a preference for the first option, technical discussions are ongoing, and we expect both options and possibly a compromise text to be taken forward to the Committee of Permanent Representatives in late October.

A General Approach on the Regulation may be tabled at the November ECOFIN. In that event, I would be grateful if the Committee find themselves able to grant clearance, or waive scrutiny, to enable us to support an agreement that meets UK objectives.

The Directive

The Directive has been broadly unpopular with EU Member States for two reasons.

¹ The term 'non-performing exposure' is used to refer to NPLs in the Regulation. For the purposes of this proposal, it should be treated as synonymous with 'NPL'.

Firstly, it introduces a passport for credit servicers, which are companies that manage portfolios of NPLs on behalf of lenders. Many Member States are concerned that allowing such companies to passport across the EU would undermine consumer protection standards, as firms from Member States with lower authorisation requirements would be able to passport to Member States with higher standards. We share these concerns and one of our negotiating objectives is to ensure that the Directive, if passed, does not undermine consumer protections in the UK. The new passporting regime also introduces additional reporting obligations which, in our view, are unnecessary and excessive.

Secondly, it introduces an out-of-court collateral enforcement tool that many Member States believe could undermine their existing tools for recovering value from collateral. You may recall from our letter earlier this year that we have decided to not opt-in to this measure, as the UK's existing collateral enforcement tools are sufficiently robust and could be undermined by the new mechanism.

Based on the response of EU Member States to date, it is unclear how the Directive will evolve over the course of the Council negotiations, or whether it will pass at all in its current form.

We have been working closely with the Financial Conduct Authority and the Bank of England to assess both proposals and will provide a further update on both in due course.

I am copying this letter to Lord Boswell, Chair of the House of Lords EU Select Committee; Philip Aylett, Clerk of the House of Commons European Scrutiny Committee; Arnold Ridout, Legal Advisor of the House of Commons European Scrutiny Committee; Christopher Johnson, Clerk to the Lords Committee; Les Saunders; Department for Exiting the EU and to Barbara Armstrong and Dan Jones, HM Treasury.

with best regards,

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JOHN GLEN
ECONOMIC SECRETARY TO THE TREASURY