George Markides
Manager, Credit Risk Management
Bank of Cyprus

11 November 2016

European Central Bank

Dear Sirs,

Subject: Bank of Cyprus response to the ECB Draft Guidance to banks on non-performing loans

Having reviewed the Guidance on non-performing loans we would like to raise a few points that require clarifications.

Firstly, we feel that depending on the intensity of the financial crisis, issues need to be addressed proportionally to more affected countries and more specifically, to severely affected banking institutions and their expected compliance to the Guidance. Since the Bank of Cyprus is one of those severely affected banks we would welcome a prioritization of the various issues raised in the Guidance in order to enable the gradual adaptation of our bank's processes and technologies.

Furthermore, we would like to stress out that due to the Arrears Management Directive issued by the Central Bank of Cyprus, there are already different deviations applied and approved by the regulators. As a result the Guideline's "NPL Governance and operations" section 3, referring to the RRD approach is somewhat different than what is applied by the Bank of Cyprus.

As far as the Guidance specifics are concerned, we believe it is important to clarify certain ECB issues and expectations which have been raised during our initial review of the Guidance, as follows:

4. FOREBEARANCE

4.2 Forbearance Options and their viability

ECB Guidance:
Forbearance solutions should only be considered viable where "No other short-term forbearance measures have been applied in the past to the same exposure".

Annex 6
For the capitalisation of arrears the bank should be able to provide evidence that the borrower has been performing against the revised arrangement for 6 months before arrears are capitalised.

Bank's comment / recommendation:

Both points above cannot be applied for very stressed economies with high delinquency problems and viable but delinquent customers who have been in non-performing status for a prolonged period. In such economies capitalisation of arrears is a common restructuring solution.

In practical terms, if the above is implemented it will cause the following. (i) Further delay in reaching agreement for the restructuring of clients. This is because in difficult cases, it is very probable for the customer to refuse signing as they will view this as an optionality in the bank's benefit. (ii) Even in cases that the customer agrees to do that prior to signing the agreement, full restructuring will not be agreed and settled unless this period lapses, hence extending the time that a restructured exposure will be coming out NPE status. Both practical implications will simply exacerbate the asset quality issues in very stressed economies

In our view the NPE definition when combined with the forbearance exit criteria are structured in such a way that the above safety net is not required and does not add any extra information on whether a client will be abiding or not with the new restructuring terms.

5. NPL Recognition

5.3.4 Identification as performing forborne

ECB Guidance:
During the probation period, new forbearance measures granted to performing forborne exposures that have been reclassified out of the non-performing category will entail the reclassification of these transactions to the non-performing category. The same will apply when these exposures become more than 30 days past-due.

Bank's comment / recommendation:
Reclassifying a performing forborne account back to NPE status if it presents more than 30dpd, for at least one year is a major change in the NPE exit criteria. In our opinion this criterion is too strict and it will affect the NPE volumes considerably. In fact in stressed economies this will convert the NPE status into a perpetual or at least, very long NPE status for some exposures. This is contrary to the genuine efforts of financial institutions to contain and reverse NPEs in stressed economies; a necessary prerequisite to bring back investor confidence and hence facilitate a quicker resolution of extreme asset quality issues.

The guidance also seems to differentiate the performing forborne exposures to the ones coming from a previously NPE status, (after fulfilling the already strict exit criteria) and the ones coming from previously performing status. We will need clarification if this will also apply for reporting purposes.

6. NPL Impairment measurement and write-offs

6.3.2 Methodology for collective estimation of allowances

Criteria for grouping exposures for collective assessment

Following the recent issuance of the directive on Default Definition, the alignment of the NPE definition to the new Default definition should be gradually but decisively planned in the same timeframes as the ones stipulated in the directive.

7. Collateral valuation for immovable property

7.2.2 Monitoring and Controls

ECB Guidance:

The quality assurance to be carried out by Risk Management Unit.

Bank's comment / recommendation:

The above can be carried out by different department provided proper Governance and control is applied. A department reporting to a director outside of the influence of business lines provides the necessary quality assurance. The normal second line of defence provided by risk and the monitoring of an independent valuations department will continue to exist.

7.2.4 Appraisers

ECB Guidance:

appraiser should not receive a fee linked to the result of the valuation

Bank's comment / recommendation:

The fee policy of all commercial banks is based on the estimated value of the property. Even though we have considered the matter many times, we have concluded that the risk is mitigated since the fee increases are very small. Despite examining the issue in detail we could not come to a better matrix as we could not identify a different method to account for the liability level that the appraiser undertakes according to the MV level. Moreover, the risk associated with the current practice is significantly mitigated due to the small increases in fees as estimated values increase further and also with the setting of a maximum fee.

7.3 Frequency of valuations

ECB Guidance:

The valuation of the immovable property collateral should be updated on an individual basis at the time the loan is classified as a non-performing exposure and at least annually while it continues to be classified as such.

Bank's comment / recommendation:

Unless the bank has cause to believe that the market has materially changed we fail to see the reasoning behind this. If an exposure is classified as non-performing the status or value of its collateral is not affected in any way, nor is there any value from updating its valuation annually.

7.5 Valuation of foreclosed assets

ECB Guidance:
Banks are strongly encouraged to classify foreclosed real estate assets as non-current assets held for sale under IFRS 5

Bank's comment / recommendation:
IFRS 5 sets out specific classification criteria [1] in order for a property to be classified as held for sale. One of the criteria is that the sale should be expected to be completed within one year from the date of classification. It is not possible that classification of all foreclosed properties as 'assets held for sale under IFRS 5' would be met given the volume of properties repossessed and the thin property market in certain countries including Cyprus. Therefore banks may not comply with the requirements of IFRS5 and hence would not be able to use such classification.
We consider that for such cases the ECB Guidance should be enhanced as to allow banks to classify such assets as properties held for sale in the ordinary course of business as inventories (IAS 2) provided that this is supported by their business model and strategy to hold property for sale rather than for long-term capital appreciation, which would imply an IAS 40 classification.
We consider that the measurement basis of the two standards (eg. held for sale under IFRS 5 or classified as inventories under IAS 2) would achieve similar outcomes when it comes to measurement of such assets on the balance sheet of banks. We set out below a brief analysis which explains the valuation under IAS2 and IFRS5
The following definitions are used to defined fair value less costs to sell (IFRS5)
Fair value: The price that would be received to sell an asset or paid a liability in an orderly transaction between market participants at the measurement date
Costs to sell: Incremental costs directly attributable to disposal of asset, excluding finance costs and income tax expense
Under IAS2 such assets would be measured at lower of cost and net realisable value (NRV)
Cost: The agreed/foreclosed price plus any directly attributable costs
NRV: is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.
In order to determine the NRV, the following are taken into account either the (i) fair value/OMV (as valued by professional valuers at each reporting date) or (ii) the agreed selling price (if any) or (iii) the selling price that the bank is willing to sell the property (as advertised). In addition the NRV reduced by the estimated selling costs.
[1] As at the date of asset classification into IFRS5 the following criteria should be met:

- Carrying amount will be recovered principally through a sale transaction rather than through continuing use {IFRS 5.6}.
- must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and
- sale must be highly probable. {IFRS 5.8}
- the appropriate level of management must be committed to a plan to sell the asset (or disposal group),
- an active programme to locate a buyer and complete the plan must have been initiated.
- the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.

- the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification, except as permitted by paragraph 9, and
- actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

---

[1] **As at the date of asset classification into IFRS5 the following criteria should be met:**
- Carrying amount will be recovered principally through a sale transaction rather than through continuing use {IFRS 5.6}.
- must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and
- sale must be highly probable. {IFRS 5.8}
- the appropriate level of management must be committed to a plan to sell the asset (or disposal group),
- an active programme to locate a buyer and complete the plan must have been initiated.
- the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.
- **the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification,** except as permitted by paragraph 9, and
- actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

7.5 Valuation of foreclosed assets

ECB Guidance:
When a foreclosed asset has exceeded the average holding period of similar assets, for which active sale policies are in place, banks should revise the illiquidity discount applied in the valuation process mentioned above, and increase it accordingly.

Bank's comment / recommendation:
In the case of valuations carried out by professional appraisers adhering to European and International standards, market conditions (e.g. illiquidity of the market) are taken into account on a case by case basis according to the geographical, physical property condition and legal characteristics of each property as part of the estimation of the fair value of each property. Hence in countries where there are relatively illiquid real estate markets, this should be captured in the OMV arrived by appraisers. We consider that the ECB guidance should clarify that additional illiquidity discount should only be incorporated if there is property specific indications that the illiquidity for specific properties is not in line with the illiquidity of the market and additional liquidity discount should be taken over and above the discount already incorporated in the valuation or in cases where there is no recent valuation.