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Reference NVB response to the ECB Consultation: “Guidance to banks on non-performing loans”.

To: **European Central Bank**
Secretariat to the Supervisory Board
“Public consultation on the draft ECB guidance to banks on non-performing loans”
60640 Frankfurt am Main
Germany

Dear Sir/Madam,

We welcome the opportunity to provide feedback to your Consultative Document: “Guidance to banks on non-performing loans”.

Complementary to the excel template, we kindly provide you our response in this memo.

Introduction points:

- In Europe the regulatory and supervisory responsibilities are divided: EC/EBA role is to regulate, ECB should supervise and judge based on existing regulatory framework and banks should develop their business model within the regulations and supervision. The supervisory reporting and disclosure requirements entailed by this guidance, go well beyond the current requirements as set by EC/EBA, the accounting bodies (IFRS) and (local) market conduct authorities.

- In addition, we note a number of differences in scope and definition between the various requirements and guidelines on non-performing exposures, forbearance, stage 2/3 assets as issued by BCBS, EC, EBA and IASB. Such differences hamper the harmonisation of banks’ practices (and external disclosure thereof) and reduce their effectiveness, as considerable effort is lost in reconciling the various definitions. We kindly suggest to refer to the existing definitions published by EBA and laid down in the CRR/CRD, and refrain from formulating own definitions as it causes (unintended) differences. Also going forward, as RTS’s or CRR/CRD are being updated differences would otherwise arise.

- In general Dutch banks are low NPL banks. Therefore there should be more clarity on the proportionality the guidance is based upon. As long as banks exhibit low levels of NPL as a result of effective policies and practices, including timely client contacts to monitor and address early warning signals, such banks should not be forced to change their approach. In addition, we emphasize that effective policies can never comprise an exhaustive list of potential scenarios and applicable measures but leave room for (adequately controlled) professional judgement.

Therefore we suggest to apply proportionality along the following lines:

- Proportionality criteria could be based on both NPL levels and on the effectiveness of a bank's NPL strategy.
- If a bank's portfolio stays below certain minimum requirements of NPL levels and complies with certain degree of effectiveness of the NPL strategy, proportionality based on data granularity and reporting frequency could be applied accordingly.
- Also we suggest to apply a portfolio per portfolio approach. For example, if the NPL levels on consolidated level are (or became) too high, the bank should provide more granular data and or should report more frequently on the portfolio that caused the rise in NPL levels.

- While the applicability of the guidance for high versus low NPL banks is described in general, we suggest to further clarify under which conditions and NPL levels – either at consolidated or portfolio level – which parts of the guidance become applicable. Additionally, we suggest to clarify the timelines for implementation of the guidance. In light of the background against which this guidance was issued, we expect that immediate priority is assigned to high NPL banks. It is welcomed if this is explicated taking into consideration sufficient alignment with deadlines given for implementation of related regulations (e.g. definitions of default). This to prevent undue efforts and costs.

- Consistent with the above, we welcome the notion of a self-assessment (could probably become part of the ICAAP process) that is reflected in the guidance. Yet we strongly suggest that its scope is extended to the various topics that the guidance addresses, allowing for an implementation of the guidance that is commensurate to the bank's risk profile, as indicated – in part – by its NPL level.

- Comply or explain method seems to indicate that the Guidance should be interpreted as the new set of rules which independently of the principle of proportionate approach should be adhered to even for low NPL banks in order to make comparison possible. This will not effectively lower the NPLs of low NPL banks, but will add a disproportionate amount of implementation costs to these banks. Moreover the strict set of rules might in certain cases even lead to suboptimal mitigating actions or worse than current practices, which might be not in the interest of clients and banks.

NPL Strategy and NPL Governance and Operations

Whereas the guidance differentiates with regard to Strategy, Governance and Operations; the proportionality could better be on the more technical issues as addressed in chapters 4, 5, 6 and 7. Introducing a technical environment to comply to this level of granularity is unnecessary burdensome for low NPL banks. The way provisions are calculated is already part of accounting principles and cannot be subject to proportionality.

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Furthermore it is not clear what the expectations of ECB are with regard to the timelines for implementing these guidelines

Although we support the objective of the guidance to reduce the level of NPL we feel that the interests of clients are not properly reflected. We suggest to add regulations regarding market conduct and customer care as one of the elements to be incorporated in the approach to NPL, which requires the interests of the bank and the interests of its clients to be balanced.

As stated above the Dutch banks consider that the NPL strategy already is an integral part of the overall strategy of the bank, which in turn determines the (annual) strategic plans of the responsible departments. This way banks can be consistent in the way they encounter the market e.g. the clients. Consistent with the above, we emphasise that the guidelines should leave more discretion to the banks on how to reach their long-term targets, including the way banks want to address clients, and the plans for next year.

And although the macro-economic circumstances are taken into account drawing these plans, certain flexibility has to be incorporated for those cases in which markets develop different from the forecast or different from the general European perspective.

We suggest to clarify not only the guidance itself but also its use by ECB in its capacity as supervisor. In the guidance it is stated that the guidance is a supervisory tool without making explicit how it will be used on an individual bank level. More clarity is requested how to differentiate the use and application of this European guidance between banks, considering that NPL levels as well as economic and market conditions differ across the Member States.

We do agree with the proportionality of the NPL framework, however, and consistent with our view on strategic plans we consider the guidance on performance management for specific parts of the organisation as too detailed and prescriptive. We consider that performance management already is an integral part of banks' strategy and operating model.

Scope of the guidance in relation to existing regulatory and accounting concepts

With regard to the scope of the guidance and the NPL life cycle it seems logical to take the IFRS9 rules into account, i.e. the loans in stage 2 and 3 capturing all the loans with signs of credit quality deterioration. Part of the early recognition of credit quality deterioration is the transfer from stage 1 to stage 2.

At the same time, we emphasise that the assimilation of default and impaired is not consistent with the EBA Final Report - Guidelines on the application of the definition of default. The EBA guidelines clarify that not all impaired (Stage 3) assets should be treated as default. Similarly, not all defaulted exposures should be classified as Stage 3, considering that regulatory probation periods may not be consistent with the symmetry required under accounting rules.

Forbearance

The guidance on the use of forbearance measures focuses primarily on three aspects (i) viability of the forbearance measures (ii) forbearance processes and (iii) affordability assessments. In general our primary concern is that the ECB guidance focuses specifically on forbearance measures in isolation, while banks do have more risk management tools to address (potential) non-performing loans. Another concern is the effort and resources required to source the very detailed information on forborne and non-performing exposures. The required information significantly exceeds what is currently required and the guidance does not make clear whether the potential benefits exceed the costs, especially for banks that currently have effective NPL strategies.

(i) Viability of forbearance measures

The ECB guidance aims to foster the application of 'viable forbearance solutions' and sets criteria for when forbearance measures are considered viable. The viability of a forbearance measure is very context-specific (i.e. they depend on the individual circumstances of the borrower, the external environment etc.) and does not lend itself for a one-size fits all approach. In addition there is a multitude of factors that affect the outcome of the forbearance measure, part of which are outside of the control of the institution. It is not clear from the guidance how the ECB has ascertained that forbearance measures would only be considered viable when these specific criteria are met. By prescribing viability criteria we fear that this would unduly limit the ability and willingness to extend forbearance measures. In turn this would not be in the interests of the clients nor of the banks.

The guidance distinguishes between short-term and long-term forbearance measures. It is not clear why this distinction would be relevant for decision making. The potential benefit of this distinction do not outweigh the additional costs resulting from data sourcing, collection and monitoring.

More specifically the guidance states that a forbearance measure is not viable if another short-term forbearance measure has been applied in the past. It is not clear from the guidance what the risk is of extending short term measures versus long term measures. This is not in all circumstances appropriate, because 1) a former measure might have been applied years ago and the applicable probation period has been ended and 2) good risk management practices might prefer short term measures to ensure a better control and monitoring. In addition it is in conflict with Dutch government guaranteed credit loans (BSK) that do have the possibility to apply for a short term payment holiday for more than one time. Also it is not clear how to analyse the effectiveness of a long term forbearance measure when operating in a volatile economic environment.

With regard to the definition of forbearance the ECB lists a number of most common forbearance measures (page 41-42). The following 3 measures should not be considered forbearance measures as they do not itself imply a concession to the borrower:

- Additional security
- Debt consolidation
- Total debt forgiveness, as this implies a recovery strategy which is not aimed at returning to a sustainable repayment situation. This measure should not be considered forbearance.

(ii) Forbearance processes

As forbearance is aimed at returning to a situation of sustainable repayment and may be used in the performing as well as non-performing portfolio, not all banks are handling forborne files within a dedicated NPL WU. This flexibility is important for the effective use of resources when treating potential non-performing loans and should not be restricted by the supervisory guidance when in general the banks NPL solutions are effective.

(iii) Affordability assessment
We acknowledge that affordability assessments are an important prerequisite for the extension of forbearance measures however the prescription of requirements for affordability should be proportionate. For example when the existing assessments are sufficient and do not demonstrate significant deficiencies than the guidance should not prescribe affordability assessments.

NPL Recognition

The current set of definitions and the linkages between them are complex for institutions, supervisors and users of financial statements. Given these complex definitions we would prefer that in providing guidance the ECB refers to EBA regulations, accounting standards and does not provide additional or alternative interpretations as this further complicates an already complex topic. For example regarding the unlikely-to-pay criterion, the guidance requires an identical implementation in all parts of the group. This is clearly not consistent with the new EBA requirements on the default application.

While it would be useful to provide a mapping of triggers and indications for the definitions of default, impaired and non-performing, table 2 is rather confusing because it does not distinguish triggers and indications. An indication requires analysis or judgement to change classification, while a trigger would automatically change the classification. The first column contains both triggers and indications while the second column only contains indications (i.e. an assessment whether an impairment must be incurred still needs to determined), while the final column mixes indications and triggers (examples).

The identification of the financial difficulties should be aligned with the EBA RTS. The presence on a bank's watch-list and increase of probability of default (PD) of institution's internal rating class during the three months prior to its modification should not be considered as <u>direct</u> indicators of financial difficulty, as both indicators could be driven by factors not directly related to the financial performance of the debtors (e.g. macroeconomic factors for PD, changes in management for watch list).

The guidance states that when a debtor is in financial difficulties, a change in conditions in line with what other debtors could get from the credit institution or is in line with market practices qualifies as a concession. This is inconsistent with EBA RTS on forbearance (paragraph 165) as the above does not provide evidence of a concession.

Regarding Figure 4, first line: For a performing forborne exposure not article 157 but article 176 should apply.

NPL impairments measurement and write-offs
The overarching aim of the best practice on NPL impairments measurement and write-offs seems to be to provide ECB guidance on provisioning principles and methodology for non-performing loans that may be applied <u>within</u> existing accounting frameworks. However, Chapter 6 links to Annex 7 which contains detailed supervisory reporting and disclosure items related to NPLs. This seems to go beyond what is required under the ITS on supervisory reporting (EBA; FINREP) and the ITSs on Disclosure.

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Moreover, specific elements of the guidance seem to go beyond existing accounting requirements. This applies to the expectation that all NPEs have some impairment raised against them, as well as the minimum provision level as a supervisory best practice for collateralised exposures. In addition, it is questionable whether establishment of a maximum period for full provisioning and write off is in line with IFRS.

Collateral valuation for immovable property

The control framework for this specific guidance on collateral valuation may be applied on a risk-based and proportionate approach. However, the requirements are very detailed and for some areas reach beyond the requirements currently laid down in the CRR (e.g. when it comes to indexation of immovable property collateral and the proposed threshold of EUR 300k instead of the EUR 3mln threshold in CRR 208(3)b). Implementation of these requirements will require the introduction of new control processes and reports, even for low NPL banks.

Supervisory reporting and public disclosure

The additional details included in the supervisory reporting and public disclosures sections would require extensive adjustment of existing databases. Examples of items that are currently not published, and for which the document suggests additional disclosure include the following:

- reduction in NPL strategy, % realisation
- Forborne exposures in time-buckets
- forborne exposure per forbearance measure
- model parameters, LGD, cure rate , per sector/country, calibration period
- original effective interest income and accrued effective interest income