# ECB consultation on Draft Guidance to banks on non performing loans

*EACB Comment Paper – 15th November 2016*

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| **General comments** | The guide is a non-binding instrument, and is to be applied to Significant Institutions. It should provide clarifications where guidance is not already available at EU level and we understand that the ECB will use these guidelines as a benchmark in its assessments, where deviations can lead to remarks or even SREP capital add-ons. This would be the case in particular for institutions carrying high stocks of NPLs. We believe that a further and more explicit clarification of this double proportionality principle (i.e. application to SIs and in particular to institutions with high NPLs' stocks) is needed to avoid uncertainties, both for SIs and LSIs. This is particularly urgent for aspects of governance and operations.<br><br>The ECB expectations on applicability of the guidelines as well as the timeline for implementation should be clarified. In this respect, we would suggest to have an overall alignment with other related regulatory elements, such as the EBA work on definition of default and past due materiality threshold.<br><br>In addition, while the ECB indicates that this guidance is applicable for all banks (high and low NPL banks), we believe that it should be clarified that this NPL guidance should be seen rather as a set of principles for banks that do not carry high NPL stocks, and that it should be sufficient if they can demonstrate that their governance and management of NPL's are sufficiently aligned with these principles and have shown to be effective.<br><br>More generally we notice that the draft guidance goes in some respects beyond the CRR requirements. This would be beyond the mandate and the role of the supervisor, while boundaries between supervisor and legislator should be clearly identified and maintained. |
| | We notice that the guidelines do not explicitly address the client, taking a rather mechanical approach to the NPL management from the bank perspective. Indeed the outcome of closing customer relationships is not addressing legal and reputational risk for institutions. Not only there are still differences across the legal frameworks in the EU, but these also impact the possibilities regarding NPL strategy and Forbearance measures. For instance, terminating a performing forborne client relationship because of a not 100% viable measure is very difficult from a legal perspective and could raise reputational issues as well. Moreover, financial markets authorities and other bodies are increasingly monitoring customer care. |

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| | At the same time we notice that the guidelines do not seem to consider that certain institutions' business model is naturally linked to both higher level of NPLs and higher profitability, these aspects should not be seen decoupled. The coverage of non- performing loans and the risk mitigation role of collateral to be taken much stronger into account. Level of collateralization and loan loss provisions are both vital to loan quality and make also the dismissal of assets potentially easier. For certain institutions the link between their business model and a higher level of the NPLs is compensated by a higher profitability. The recurring pre-provision and profitability should be considered together with the high level of NPL's.<br><br>Moreover, the draft Guidance seems to suggest that only gross NPLs are looked at, placing institutions with high coverage levels in a critical position as collateral does not seem to be taken into account. |
| | The draft Guidance seems to go even beyond the conservative approaches adopted by many national supervisors with regard to collateral valuation (often audited) and additional actions to be undertaken also where the NPL stock would not seem to justify it. The implementation costs for the institutions would be wide ranging: the impact would be very noticeable in decentralized institutions that would have to build up infrastructure at a central level; the required granularity would entail a huge effort on top of the regulatory reporting; the IT planning and operations will be under pressure; also the required staff would increase dramatically, leaving the open question of how to reallocate these human resources shall the NPL stock fall below certain thresholds (e.g. once the NPL workout units are not needed any longer). |
| | Moreover, it is not sufficiently clear how the long term target should be reached and in which manner the macroeconomic environment is to be taken into account. In particular with regard to the latter aspect we believe that sufficient flexibility should be envisaged and that supervisory actions should not be triggered as an automatism but rather factoring these aspects into account. |
| | Finally, we have some concerns on the incoherent and scattered nature of supervisory regulations and guidelines. The established general principles are significantly altered in subsequent more specific guidelines. This is especially apparent regarding chapter 7 of the draft Guidance and the requirements set in CRR with regard to collateral valuation.<br><br>The costs of fully implementing the guidelines are expected to be very high. Whereas we acknowledge the need for more specific guidelines, the clear benefits, especially in terms of compliance to the full extent of the guidelines for institutions without a problematic stock of NPLs, remain yet to be proven.<br><br>The aim of these guidelines is to harmonize practices across supervised institutions, however significant areas are left open for interpretation, e.g. segmentation, macroeconomic factors etc. This will likely to lead to variation and differing solutions in the industry, possibly leading to further need for convergence (and additional costs) in the future.<br><br>We would also like to point out that there is a need to strike a balance between the benefits of a centralized data solution on the one hand and the cost of implementation on the other hand. If the IT requirements can be also fulfilled via local solutions, these should not be necessarily shifted towards centrally stored NPL data management.<br><br>Finally, the timeline of implementation is left open creating uncertainty in expectations and planning. |

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| **NPL strategy / Chapter 2** | The development of a NPL strategy, as required by the draft Guidance, and its integration in the overall bank strategy is a completely new element in prudential supervision, as requirements in this respect have always been case specific with no general prescription. It is unclear from when onwards and for which institutions this strategy should be/is expected to be applicable.<br><br>The assessment of “environmental” conditions (macroeconomic situation, markets’ developments, servicing, investment appetite in NPLs servicing, juridical and regulatory environment) could be a real challenge for institutions. More concrete indications are needed to translate the supervisory expectations regarding the impact of macro conditions on NPLs. Another element that considerably increases operational difficulties is the lack of information about relevant NPL markets (e.g. in the context of possible NPL reduction of non-core loans/NPL portfolios without an active market), NPL drivers, correlations and relevant benchmarks across institutions, that require extremely complex frameworks. Particularly small institutions can face a disproportionate workload. Moreover, there are some NPL management procedures which are not available for large sector-specific claims (e.g. project financing abroad) due to a lack of active market.<br><br>A tight integration of an NPL implementation plan into the ICAAP and Risk appetite framework (RAF) is required. We suggest to explicitly design this requirement in a way that adequately reflects the proportionality principle.<br><br>In this context, the operative planning or the staffing level should more concretely implement the principle of proportionality. We welcome that the draft stipulates in the section “Applicability of Guidance” the application of the proportionality principle. The ECB recommends an adaption for small institutions with low NPL ratios, for example regarding the frequency of the review and the assessment of the business model and the strategy and also with regard to the operative planning. This should be reinforced in the design of the draft guidance.<br><br>In the first quarter of each calendar year, the institutes are to provide a reporting on the NPL strategy, including the implementation plan, to the supervisory body by means of a standardized template. The use of a standard template is welcome on the one hand, but should not lead to a significant increase in costs, especially for banks with a low NPL stock (i.e. built in proportionality).<br><br>With reference to the targets to be established (page 12), we believe that a differentiation only for larger clusters should be sufficient, particularly for the corporate sector: e.g. retail/non-retail or stay strategy/exit strategy. Alternatively, main large clusters should be used together with sub-clusters. In addition, the guidance provides that “It should be ensured that such additional NPL targets have an appropriate focus on high risk exposures, e.g. legal cases or 720 days past due” (page 13). This proposal is not feasible, as the legal framework and execution process may vary across portfolios (and/or groups of customers) in individual countries particularly for cross-border groups. The ECB should provide different benchmarks for the duration of execution process based on regional and segment level data.<br><br>We also see a need to clarify the approach for banking groups and their network where local banks have a degree of independence, it is unclear whether a single network bank strategy or an overbridging strategy for the whole group would be sufficient.<br><br>The guidance focus on proportionality is in chapters 2 and 3, while it could better be on the more detailed and technical chapters. While ECB indicates that this is a supervisory tool, it is not explicitly indicated how it will be used on an individual bank level. More clarity on this is needed, also due to the differing NPL levels as well as economic and market conditions differ within the EU. |

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| **NPL governance and operations / Chapter 3** | The expectations of the ECB seem to contrast with organizational pillar structure of many institutions, where there are all 3 lines of defense already integrated in the process.<br><br>NPL workout units should be set up taking into account the full NPL life cycle and, where appropriate, for different portfolios to ensure that NPL workout activities and borrower obligations are mutually agreed. In addition, the execution of activities, monitoring and quality assurance processes need for each workout unit sufficiently specialized staff. This will create enormous cost pressure for human resources and, if necessary, even HR adjustments (for example, on the basis of time-limited employment conditions), which at the same time entails high costs. While at the same time leaving the question of reallocation of human resources once the NPL workouts are concluded. Often NPLs are already monitored in the context of the special audits, thus we do not see the need for additional specification of requirements in this area.<br><br>We also see a need for clarification on the inception of “early arrears” and more detailed information on when cases would be transferred from the front office into the NPL WU responsibility based on days past due (DPD). From the draft Guidance (page 19), it seems that already one day overdue triggers the transfer to the NPL WU. This would create unnecessary work inflows to NPL WU and low/slow transfer back due to healing period restrictions. On the other hand, Figure 2 on page 20 suggests with regards to intensive loan management in the Front Office for corporates, that such a case should be dealt with in the Front Office for some time. Also, an unnecessary transfer to the WU could occur if only DPD are taken into account. Both overdue as well as financial difficulties should be considered as transfer triggers to NPL WU.<br><br>The ECB draft stipulates in Section 3.3.1 (page 18) a division of NPL work out units from the credit department for reasons of the avoidance of conflicts of interest: “…High NPL banks should therefore implement separate and dedicated NPL WUs, ideally starting from the moment of early arrears ,but latest by the NPL classification of an exposure” and in connection with footnote 14: “Where early arrears are not managed separately, there should be adequate policies, controls and IT infrastructure in place to mitigate the potential conflicts of interest.”<br><br>The guidance, while currently addressed to SIs, might at some point be rolled over to LSIs. In that perspective, proportionality and feasibility of policy choices should be adequately assessed. It has to be considered for instance that for the available human resources of a small cooperative bank (only 3-4 employees) an establishment of separate, organisational divisions of NPL reduction entities is not feasible due to the limited staffing level and the needed specialized know-how. Small banks are not legally obliged to establish separate front-office and back-office units. Moreover, the legal obligation to establish separate NPL workout units would lead to excessive demands for small banks with low NPL ratios. Adjustments are of the utmost importance.<br><br>We agree that all NPL-related data has to be stored in robust and secure IT systems, and that data has to be complete and up-to-date throughout the NPL workout process, however the requirement to store and operate these data centrally is unnecessary and create important difficulties. Indeed, institutions may have to comply with varying local standards and local law (especially in the NPL/restructuring area). Therefore, local business processes have been established depending on local economic and regulatory/legal environment. This legal and economic environment is also driving the IT solutions, which are mainly local (meaning Network units using local IT solutions in local country) in this area of responsibility. Workout processes like access to a “central” credit register, underlying |

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| | documentation, automated workflows throughout the entire NPL life cycle, call centers etc. are operated locally. Thus, the robust and secured IT system should not be necessarily operated centrally but rather locally, while data is regularly provided for management steering purposes to the central/group level.<br><br>Finally, with regard to information gathering and evaluation, there are clear links to risk data aggregation according to the BCBS 239 framework. Duplication of rules, redundancies and overlaps should be avoided and interactions with other existing regulatory pieces should be taken into account in a harmonized manner.<br><br>We would like to stress again that the scope of implementation should be more clearly tied to the institutions level of NPLs. |
| **Forbearance measures / Chapter 4** | Para. 50 of the EBA Guidelines on the application of the definition of default under Art. 178 of CRR stipulates regarding forborne exposures that the obligor should be classified as defaulted where the relevant forbearance measures are likely to result in a diminished financial obligation. Therefore institutions should set a threshold for the diminished financial obligation that is considered to be caused by material forgiveness or postponement of principal, interest, or fees, and the threshold should not be higher than 1% (calculated according to the therein mentioned formula).<br><br>According to para. 4.1. of the ECB Draft Guidance the key objective of granting forbearance measures is to pave the way for non-performing borrowers to exit their non-performing status, or to prevent performing borrowers from reaching a non-performing status. Therefore paragraph 4.2., page 41 provides as an example a list of common forbearance measures.<br><br>However, the forbearance measures listed in the ECB Guidance will regularly lead to a diminished financial obligation of more than 1%. As a result, in many cases the key objective of forbearance measures stated within the ECB Guidance cannot be achieved when applying the EBA Guidelines..<br><br>The guidance focuses on forbearance in isolation while most banks do have a wider range of risk management tools to address (potential) NPL's.<br><br>Additionally, according to para. 4.2. short-term forbearance measures should only be considered as viable where no other short-term forbearance measures have been applied to the same exposure. We assume that, after a short-term measure has been applied only a long-term measure can be granted. If the bank qualifies another short-term measure as being more appropriate than a long-term measure, the policy regarding short-term measures might then not be viable would need to be modified. We would ask for further clarification in this regard.<br><br>The guidance introduces a split between short term and long term forbearance measures, however the added value in terms of decision making is not clear. The additional costs resulting from data sourcing, collection and monitoring are expected to be of such magnitude that the unclear potential benefits would hardly be seen. |
| | The increase of external information to be considered has disproportionately high costs and where such information are unavailable the use of estimations might reveal imprecise and result into fallouts in the analysis.<br><br>It is required that SIs develop a clearly defined concept for forbearance and implement it, however the segmentation required in the draft Guidance is extremely complex to translate into practice. Short term vs. long term, sustainable vs non sustainable, the criteria for |

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| | the appropriate application are defined together with the list of most appropriate options. The choice for the most appropriate option can be more difficult due to the complexity and multi faceted reality of forbearance. The highly costly steps envisaged for the forbearance process and the requirements under Pillar III have disproportionately high costs compared to the benefits especially for smaller institutions and institutions with low NPLs' stocks.<br><br>Borrowers' financial difficulties should be more clearly defined. In addition, the guidelines do not recognize country-specific differences in e.g. debt maturity, high vs. low amortizations. Typical loans in some countries (with long maturities) could be considered distressed in others. Moreover, applicable, comprehensive and concrete examples of standardized forbearance products are required.<br><br>Finally, it seems that there is not sufficient and appropriate consideration of the potential effects on capital in the context of IFRS 9 implementation. |
| **List of forbearance measures / Chapter 4** | "Other alteration of contract conditions/covenants" appears in the list of long-term measures. We believe that this measure should also be mentioned in the list of short-term measures since, depending on the characteristics of the contract conditions and covenants they may also qualify as short-term measures.<br><br>We believe that some of the forbearance measures mentioned in the guidance should not be considered as such as they do not by themselves imply a concession to a borrower: those are additional security, debt consolidation, total debt forgiveness. |
| **NPL recognition / Chapter 5** | Institutions are already required to use the EBA-ITS classification of NPLs as part of the regulatory reporting, and institutions must review the risk assessment of a credit portfolio annually. Also, in some jurisdictions the management of problem loans is assessed by external auditors, and institutions develop risk-early warning indicators on the basis of quantitative and qualitative risk characteristics.<br><br>Definitions of NPL and forbearance should be based on the EBA RTS (including definitions). The ECB should not go beyond its mandate by adding requirements. Furthermore the overview given in table 2 is not clear since we see an inconsistent use of terminology like triggers and indications (first column) , indications only (second column) and combinations (third column).<br><br>The definition of unlikeliness to pay (UTP) triggers and NPL criteria restricts the room to adjust to the specificities of business models (e.g. definition of UTP events, automatic trigger, regular manual verification criteria). In the context of the double proportionality recalled above, an undue increase in costs should be avoided for institutions with a low NPL ratio, and the relevance of this section should be emphasized for institutions with high NPL stocks. The transposition of bank-internal and supervisory definitions is also already partially addressed in BCBS 239. We would highlight again the need to take a harmonized approach that avoids overlaps, inconsistencies and redundancies. |
| **NPL impairment measurement and write-offs / Chapter 6** | According to FINREP, all credit institutions are obliged to report information about the credit quality, provisions and the amount of loans with an increased default probability (PD) or NPLs quarterly. In addition, where IFRS is not the sole accounting standard, institutions indicate on the basis of which accounting standards they calculate impairments, depreciation and provisions for credit risks (including country risk provisions). The necessary risk provisioning must be determined promptly and continued. A considerable need for provisions is to be communicated immediately to the management.<br><br>Overall, the draft Guidance has more far reaching objectives than local laws in some Member States. In some EU jurisdictions timely |

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| | write off is hindered by local legal or tax system (e.g. Croatia, Poland). Deterministic rules such as the ones providing that “a write-off can take place before legal actions against the borrower to recover the debt have been concluded in full” create disincentives for the institutions to perform timely write-offs.<br><br>We also see that the aim to provide guidance on the provisioning and methodology for NPLs to be applied within existing accounting framework, goes well beyond what is established in the regulation for supervisory reporting (EBA, FINREP) and on disclosures, and beyond existing accounting requirements.<br><br>The non-availability of benchmarking data may lead to difficulties in meeting the requirements for individual impairments. We believe that an institute-specific materiality limit for this requirement would be appropriate in order to avoid additional costs, in particular for institutions with a low NPL inventory. Without materiality limits, an unreasonably high level of documentation would be required to calculate specific adjustments. The introduction of institute-specific materiality limits for the required documentation for individual value calculations is appropriate.<br><br>Ensuring the consistency of LGD, cure rates and re-default rates with current market data may lead to a considerable increase costs. In particular, for institutions with a small NPL portfolio, the resulting implementation effort should not be unduly burdensome (explicit application of the proportionality principle).<br><br>Interactions with the impairment policy under IFRS9 are not taken into account, in particular in the transition between stage 2 and 3. Instead, IFRS 9 interactions should be explicitly taken into account in the guidelines. |
| **Collateral valuation for immovable properties / Chapter 7** | The minimum frequency for evaluating immovable property collateral is already established in the CRR (e.g. Art. 208(3)). Banks are also required to set up their own valuation procedures. For the purpose of updating the collateral valuation, the market value or the outstanding loan value is to be considered. Moreover, in some Member States the adequacy of the collateral is reviewed annually by external auditors.<br><br>The guide calls for an updating of valuation policies in institutions (for example, the clarity and clarity of assessment approaches used, residues in evaluation cycles, appropriate control processes), which seem a requirement too far reaching. Also in this respect the use of a materiality threshold to be defined by the institution according to its NPL stock, could help avoiding disproportionate costs without recognizable additional benefits when fulfilling the requirements.<br><br>The required level of documentation is not entirely clear, in particular for already identified collateral. We also note that hold strategies for finished properties in the event of forced sale are no longer considered acceptable, while a short-term sale is required within one year. We believe that this requirement is extremely far reaching in terms of business practice and should be deleted. Moreover, the implementation cost due to required planning for the treatment of assets from forced sale is unreasonably high and should be subject to the proportionality principle.<br><br>The availability of sufficient staff resources and special know how will be a critical implementation challenge, particularly for smaller institutions and institutions that do not have NPL stocks. The draft guidance demands in Chapter 7 the assignability, assessment, monitoring and backtesting of immovable property. These activities for the management of the securities require enormous human resources and know how. Hence, adjustments by size of institutions and NPL stocks are essential, such as no obligation to consult |

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| | external experts for the valuation of the immovable property. |
| | With regard to collateral valuation, the draft guidance goes well beyond CRR requirements and should be revisited. CRR already indicates frequent/annual monitoring of commercial immovable collateral values and reappraisal every 3 years for loans exceeding EUR 3 million or 5 % of the own funds. At minimum the collateral evaluation frequency should be specified to apply only significant NPLs. |
| **Transitional period** | Institutions need appropriate time to implement the supervisory expectations. The ECB Guidance in particular is strictly related to the recently finalised EBA Guidelines on the definition of default. Also, full implementation of IFRS9 should be considered when assessing the length of transitional period. In the upcoming CRR review, the IFRS9 phase in period is expected to run until 2023. The same transitional period would be appropriate in these guidelines taking into account the huge impact on processes and resources of SIs. Since the implementation of these regulatory pieces affects the same staff and resources which are already under pressure, the ECB and the JSTs should provide banks with an appropriate transitional period for a meaningful implementation. |
| **Disclosure** | The consultation paper aims at imposing additional disclosure and reporting requirements on SSM banks. However, we believe that the supervisory reporting and public disclosure requirements should be set by European Regulation.<br><br>The European Banking Authority has been provided with the task to contribute to the creation of the European Single Rulebook in banking, the objective of which is to provide a single set of harmonised prudential rules for financial institutions in the European Union. The EBA has been mandated to develop implementing technical standards to specify the uniform formats, frequencies, dates of reporting, definitions and the IT solutions to be applied in the European Union for the reporting on own funds requirements and financial information. Those ITS have been adopted by the European Commission subsequently and published in the official journal of the European Union.<br><br>Moreover, the upcoming CRR review will foresee substantial amendments to the regulatory reporting framework as well as disclosure requirements. In this context, the introduction of new regulatory reporting or disclosure requirements does not seem proportionate. New reporting and disclosure requirements should only be considered as part of forthcoming wider review of these requirements. |
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