

## **AEB Comments on ECB “Draft guidance to banks on non-performing loans”**

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### **GENERAL COMMENTS**

- The Spanish Banking Association finds important to clarify ECB expectations and timeline in the implementation of this Guidance. The fact that the compliance depends in the relative NPL level adds complexity and certain uncertainty about ECB expectations. Therefore, clarification about the process to determine how and to which extend this guidance will be applicable to each bank, is needed. Specifically, and due to the fact that the Guidance would be issued in 2017, ECB should clarify their expectations about the inclusion of the NPL requirements in the entities strategy for 2017 (policies, Risk Appetite, ICAAP, recovery plan).
- Due to the fact that the Guidance requires a very detailed comprehensive operational plan which could require potential changes in the organizational and governance structure of the entities, as well as in the banks processes and systems, we request a transitional implementation period of reasonable length and a prioritization of issues allowing banks to prepare for the compliance with the Guidelines (adapting IT systems, arranging market deals for securitizations, disposal of assets, need to set up additional/autonomous entities to manage NPLs etc.). This is equally valid for banks with high level NPLs at the time of the issuance of the Guidelines, for banks that will reach the trigger of materiality and proportionality when application of all chapters of the Guidance becomes more relevant at a later point when application of all chapters of the Guidance becomes more relevant at a later point and for banks looking to apply the guidelines as industry best practice.
- We think that supervisory reporting and public disclosure should be guided by the European regulation on this regards (EBA requirements for supervisory reporting; IFRS and ESMA requirements for public disclosure). This regulation already contents the information deemed as necessary for analyzing NPLs, forbearance, etc. In order to avoid heterogeneity, misunderstandings, and differences with other jurisdictions, we advocate for not including additional information requests at supervisory level.
- We understand that the Guidelines cannot substitute or supersede any applicable EU or national legislation and regulation. However, as long as national rules continue to be applied, full harmonization will not be achieved and any comparison of data will not be adequate unless adjusted for differences stemming from the application of national requirements and legislation. We firmly support that national discretions should be avoided.

- As further described herein, the level of involvement of the management body in the approval and steering of the NPL strategy and operational plan set out in the Guidelines would not be consistent with the applicable regulation (such as Directive 2013/36/EU on access to the activity of credit institutions and prudential supervision) and the best practices within the banking sector.
- It is still too vague how and to which extend this guidance will be applicable to each bank, once it has been approved. More precisely, we would like to know how the communication channel is designed between the ECB (JST, DGIV...) and each distinctive bank in order to trigger the applicability of the guidance.
- The Guidance should recognise that the practical application of the definitions in a Group must take into consideration subsidiary-specific products/portfolios and local economic factors so that local specificities are considered.

Specifically, comments on some paragraphs that the guidance contains are:

## 1. Introduction

### Context of this guidance

- *“It is expected that Banks will apply the guidance proportionately and with appropriate urgency” and “JSTs will engage with banks the implementation of this Guidance” (pg 5).*

It is important to clarify ECB expectations and timeline in the implementation of this Guidance. The fact that the compliance depends in the relative NPL level adds complexity and certain uncertainty about ECB expectations (i.e. the average moves frequently and an entity can be above or below it). Specifically, and due to the fact that the Guidance could not be issue by the end of 2016, ECB should clarify their expectations about the inclusion of the NPL requirements in the entities strategy for 2017 (policies, Risk Appetite, ICAAP, recovery plan).

Clarifying the ECB expectations about the inclusion of the Guidance in the strategy for 2017 is not only a matter of "granularity", getting the required information or being a very costly operative implementation, but the draft Guidance also requires a very detailed comprehensive operational plan which could require potential changes in the organizational and governance structure of the entities. That's why we understand that a transitional implementation period is needed to better understand and implement the requirements.

### Applicability of this guidance

- *“This NPL guidance is currently non-binding in nature. However, banks should explain and substantiate any deviations upon supervisory request. Non-compliance may trigger supervisory measures” (pg. 6)*

From our perspective, this concept of supervisory measures is too wide. To our understanding the supervisory measures would be comprehended in the context of the SREP process, therefore, the consequences of not being fully compliance would affect the assessment of the risk control framework.

- *“The guidance does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing EU regulations or directives or their national transpositions or equivalent... Instead the guidance is a supervisory expectation regarding NPL identification, management, measurement and write-offs in areas where existing regulations, directives or guidelines are silent or lack specificity. Where binding laws, accounting rules and national regulations on the same topic exist, banks should comply with those” (pg. 6)*

In order to overcome the existing problems deriving from different practical implementations of the accounting and regulatory definitions, national discretions should be avoided in all cases. If national rules keep being applied, the comparison of data will not be adequate.

### 3. NPL governance and operations

#### 3.2 Steering and decision making

- *“In accordance with international and national regulatory guidance, a bank’s management body must approve and monitor the institution’s strategy. For high NPL banks, the NPL strategy and operational plan forms a vital part of the overarching strategy and should therefore be approved and steered by the management body. In particular, the management body should:*
  - *approve annually and regularly review the NPL strategy including the operational plan;*
  - *oversee the implementation of the NPL strategy;*
  - *define management objectives (including a sufficient number of quantitative ones) and incentives for NPL workout activities;*
  - *periodically (at least quarterly) monitor progress made in comparison with the targets and milestones defined in the NPL strategy, including the operational plan;*
  - *define adequate approval processes for NPL workout decisions; for certain large NPL exposures this should involve management body approval;*
  - *approve NPL-related policies and ensure that they are completely understood by the staff;*
  - *ensure sufficient internal controls over NPL management processes (with a special focus on activities linked to NPL classifications, provisioning, collateral valuations and sustainability of forbearance solutions);*
  - *have sufficient expertise with regard to the management of NPLs.*

*The management body and other relevant managers are expected to dedicate an amount of their capacity to NPL workout-related matters that is proportionate to the NPL risks within the bank.*

*Especially as NPL workout volumes pick up, the bank needs to establish and document clearly defined, efficient and consistent decision-making procedures. In this context, an adequate second line of defence involvement needs to be ensured at all times.” (pg. 17)*

We agree that defining and implementing a corporate strategy aimed at reducing the banks’ NPLs could be very relevant for the micro and macro-prudential perspective of the economy, as set out in the Draft Guidance. However, we believe that the level of governance included in the Draft Guidance is not entirely consistent with the nature of the role and responsibilities of the management body of a credit institution. In this regard, it is worth mentioning that, as defined by Directive 2013/36/EU on access to the activity of credit institutions and prudential supervision (“CRD IV”), the Management Body of an institution is the body empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision-making.

As part of the general strategy of a credit institution, the management body should be responsible for approving and periodically reviewing the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to, including those posed by the macroeconomic environment in which it

operates in relation to the status of the business cycle. Moreover, the management body should ensure that the institution has in place robust governance arrangements, which include a clear organizational structure with well- defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks they are or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management, as set forth in CRD IV.

In sum, in accordance with applicable regulation and best practices, the management body of an institution is the corporate body in charge of the supervision and control of the activities of such entity, and will approve its strategic and most relevant decisions and policies. In turn, the senior management of the entity is in charge of the detailed implementation of such strategies and policies, and will define and steer the processes and milestones affecting them. Therefore, the management body should not get directly involved in the concrete development of the bank's strategies and policies.

In accordance with the nature of the management body's responsibilities, we understand that the role of the management body should remain focused on the approval of general policies and strategies of the institution, including those related with risks, and monitoring their implementation. Hence, and in order to keep up with the ever-increasing number of tasks and responsibilities assigned by the regulators and supervisors to the management body, the assignment to this body of duties related with the approval of specific strategies and operational plans aimed at the management of particular risks within the institution such as NPLs, should be avoided as we believe these are part of the strategies developed by the senior management of the institution, who are responsible, and accountable to the management body, for the day-to-day management of the institution. The above would mean that the management body would perform functions related to the specific ordinary management of the business.

The concrete approval and steering of NPLs' strategy and operating plan by the management body may hinder the appropriate development of the supervisory and control functions of the management body, as it would be obliged to get directly involved in the regular execution of the processes for the development of the strategy. Also, the required participation of the management body in the definition of most of the aspects of the operating plan related to the strategy goes well beyond the level of faculties that are commonly attributed to a management body.

Additionally, the management body of the banks (especially those that may be considered as "high-NPL banks") currently considers, directly or indirectly, the NPL levels and reduction plans through the review and approval of the financial statements, the Information of Prudential Relevance or matters related to credit risk, but does not (and we consider that it shall not) perform the ordinary monitoring of the bank's processes related to NPLs, nor does it define management objectives or incentives related to them.

Due to the above, we suggest substituting all the references to management body by references to the management or senior management of the entity, leaving the

management body with pure supervisory functions related to the NPL strategy and operation plan, as it currently does with relation to other areas of the strategy.

### 3.4 Control framework

#### 3.4.2 Second line of defence controls

- *“The degree of control of the NPL framework by the second line should be proportionate to the risk posed by NPLs and should place a special focus on:*

*3) assuring quality throughout NPL loan processing, monitoring reporting (internal and external), forbearance, provisioning, collateral valuation and NPL reporting; in order to fulfil this role, a second-line function should have sufficient power to exercise at least a veto right when required on the implementation of individual workout solutions (including forbearance) or provisions” (pg 26);*

We think that the second-line function must have more a “check & balance” role than a “veto right” for provisioning or implementation of workout solutions.

## **5. NPL recognition**

### 5.1 Purpose and overview

#### Regulatory versus accounting view

- Figure 6 (pg 47) *“Illustrative connection between NPE, defaulted and impaired definitions & 5.5. Links between regulatory and accounting definitions”*

The analysis about the link between the accounting definition of “impaired” and the regulatory definition of “default” is not complete. It does not mention possible differences in the practical application of the CRR “debtor analysis for non-retail exposures” and the “materiality thresholds” in accounting.

### 5.2 Implementation of the NPE definition

#### 5.2.2 Remarks on the “unlikely-to-pay” criterion

- *“Banks should ensure that the definition of NPE and the criteria for identifying UTP are implemented identically in all parts of the group.” (pg49);*

As it is mentioned in section 1.2 *Applicability of this guidance*, we suggest the rewording of this section so that it can comply with the the proportionality and materiality principles as an identical implementation would not leave room for the proportionality principle.

### 5.3 Link between NPEs and forbearance

#### 5.3.1 General definition of forbearance

- *“General definition of forbearance” - To identify the condition of financial difficulties of the debtor the following triggers can be used (not an exhaustive list):*

- *debtor/facility more than 30 days past due during the three months prior to its modification or refinancing;*
- *increase of probability of default (PD) of institution's internal rating class during the three months prior to its modification or refinancing;*
- *presence in watch-list during the three months prior to its modification or refinancing.” (pg. 54)*

The last two indicators (not included in the EBA definitions) should not be considered a direct “trigger” to consider a transaction as forbearance.

The two last indicators are additional of the indicators provided in the ITS EBA. We think that an increase of PD during three months prior to modification or refinancing should not trigger directly the inclusion of the exposure as “forbearance”. An increase in PD could be caused for reasons not directly related to the financial difficulties of the debtor (i.e. impact of macroeconomic factors). Therefore, this item should be seen only as an indicator, not as a direct trigger.

#### 5.4 Further aspects of the non-performing definition

##### 5.4.1 Consistent definition at the banking group level

- *“Banks should ensure that the identification of NPEs is consistent at the entity and at the banking group levels, with a harmonised implementation of the definition in all subsidiaries and branches.” (pg 58)*

We think the identification should be consistent, but considering the proportionality principle in portfolios with specific characteristics. For instance, probation and cure periods should be adapted to portfolios/geographies where the average maturity of the facilities is shorter than others (there could be the case in which the 2 + 1 year of cure + probation period is almost as long –or longer- than the facility itself, so it would never cure)

#### 5.5 Links between regulatory and accounting definitions

##### 5.5.2 Accounting definition of impaired

##### **Outlook: IFRS 9**

- *“Under IFRS 9, default leads to a transfer from Stage 2 to Stage 3. However, both Stages 2 and 3 require provisions for lifetime losses, and lifetime losses grow continuously as creditworthiness decreases” (pg 62)*

The Guidance assimilates the concepts of Default and Stage 3. However, EBA Final Report - Guidelines on the application of the definition of default recognizes that there could be exceptions for the general rule that all exposures classified as Stage 3 should be treated as “default”. On the other way round, we think that there could also be default exposures also in Stage 2 if economically justified (i.e. regulatory cure criteria excessively prudent from an accounting point of view).

## 7. Collateral valuation for immovable propriety

### 7.4 Valuation methodology

#### 7.4.3 Gone concern approach

- *“In a gone concern scenario, the future sale proceeds from collateral execution should be adjusted taking into account the appropriate liquidation costs and market price discount to the open market value (OMV).... The property price (i.e. OMV) at the time of liquidation should take into account current and expected market conditions.” (pg 91)*

Clarification about the concept “Open Market Value (OMV)” is needed. In particular, as the Guidance says the OMV should be a value “at the time of liquidation”, and, however, updated valuations that can be obtained from appraisers are always “at the current date”, we would like to obtain confirmation that reasonable sound expectations about price of collateral can be considered (both upside & downside).