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EBF response to the ECB Draft Guidance to banks on non-performing loans

Key messages

- **The EBF supports the objective of the Guidance but stresses that the NPL clean-up program should be conducted in a measured way that avoids further undue pressure on asset values**
- **The Guidance should take into account business strategies, local market conditions and other external factors when considering the NPL reduction targets**
- **The scope of application, ECB expectations and timelines should be clarified**
- **A transitional implementation period should be introduced**
- **The Guidance should be aligned with European legislation and should not override or interpret accounting standards**
- **The EBF does not believe the SSM has legal authority to impose the reporting and disclosure requirements which the draft Guidance envisages**
- **The relevance of governance and NPL management indicators should be reviewed. The requirement regarding organizational structure and operational set up are too detailed and prescriptive and should be replaced by set of principles to be adhered to. Any system triggered classification should be avoided and the Guidance should recognize the need for an expert judgement.**

General comments

The European Banking Federations supports the objective of the draft Guidance to reduce the level of nonperforming loans (NPL/NPE) in the banking industry. Addressing the weak asset quality forms important part of the efforts of banking industry to regain the confidence in banking sector and also enhance long term stability of the financial system as a whole.

However the NPL clean-up program should be conducted in a measured way that avoids further undue pressure on asset values. There is a need to strike a balance between the pace at which the program progresses and the economic results of the potential sudden asset value changes.

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Clarification of expectations and timelines

We understand that the Guidance is to be applied proportionally to the level of non-performing loans, with appropriate urgency. We are concerned with potential complexity and uncertainty given that the average levels of NPLs are subject to frequent moves. We therefore believe it is important to clarify the ECB expectations on applicability of the guidelines as well as timelines for implementation.

For banks not considered as "High NPL banks" or banks having a low level of NPL, we believe that the NPL guidance should be seen as a set of principles and that they should be allowed to demonstrate that their methodologies of governance and management of NPLs are consistent with these principles without necessarily getting into the details of the indicators or triggers listed in the guidance.

While it is understood that it will be the responsibility of each bank to ensure compliance with the Guidelines, we would like to understand whether there will be any formal communication channel established between JSTs and the bank to "trigger" compliance with particular requirements/chapters of the Guidance.

Given that we do not expect these Guidelines to be finalized and issued by the end of 2016 we would appreciate the ECB to clarify whether and to what extent it expects banks to reflect the Guidance in their strategies for 2017 (policies, Risk Appetite, ICAAP, recovery plan). Not only does the draft Guidance require a very high level of granularity, it will be operationally challenging to comply with within a short timeframe. 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. As the implementation and availability of all required information could take some time, we would welcome a prioritization of the most relevant issues the ECB expects banks to comply with.

To enable adaptation of banks processes and technologies, we request a transitional implementation period of reasonable length 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 and for banks looking to apply the guidelines as industry best practice.

It is our view that there is limited supervisory or investor benefit to be gained from the requirement for banks to review their collective impairment measurement models under IAS 39 for alignment with the Guidelines (as per paragraph 6.3.2) as they will become redundant on 31 December 2017, and replaced thereafter by IFRS 9 collective impairment measurement models. It is our view that finalized Guidelines relating to collective impairment measurement should be adapted under IFRS 9 only.

Banks would appreciate to have more clarity as to the next steps in this process, in particular on the expectations and timelines.

Lack of harmonization and comparability

We understand that the Guidelines set supervisory expectations regarding NPL identification, management and write offs and cannot substitute or supersede any applicable EU or national legislation and regulation. However, as long as national rules continue to be applied, full conformity will not be achieved in detail and any comparison of data will not be adequate unless adjusted for differences stemming from the application of national requirements and legislation. The different market conditions should also be considered. Therefore there is a need for more general principles and less detailed requirements.

The extent of the implications deriving from the application of the guidelines demands a significant degree of harmonization concerning concepts, criteria and/or definitions in order for a minimum level playing field to be assured. Further harmonization of supervisory practices would require harmonization of legal, judicial and fiscal framework as well. Inefficiencies in the legal, judicial and extrajudicial framework that may be faced in some countries could pose a serious obstacle even for banks that have in place sound strategic plans for NPL reduction.

Assessment of the level of NPLs

There are banks that purchase NPL portfolios as part of their core business or chose segments with inherent high expected losses (e.g. small and medium businesses). The Guidelines should distinguish between own generated NPL's and purchased NPL. The draft Guideline seems to assume that all NPL´s on the banks' balance sheets are own generated or that all banking models focus on low risk portfolios. High risk portfolios and purchased NPLs' strategies may be profitable with a low unexpected loss risk profile.

Purchased NPL portfolio are often acquired at a price way below nominal amount. A high-NPL level can be a natural result of the management objectives and strategy in regards of purchasing NPL portfolios as part of a business model. The purchased credit impaired loans should therefore be excluded from the scope of this Guidance, unless further material deterioration has occurred following their purchase requiring treatment as a new/originated NPL

We also believe that the Guidelines have to factor in that banks, as part of their business as usual operations buy and sell assets to manage their overall balance sheet, portfolio risk-return profile and return on equity. This can often lead to below par sales of assets that would not be otherwise classed as NPL due to changes in market pricing for long term loans (where selling a part of a loan originated at market price at the time may now be discounted to below par value as market pricing has moved in the opposite direction) or where the buyer has a different risk perception from the seller (e.g. one rating the loan as BBB, the other as BB+). This may also be caused by an otherwise acceptable downwards move in the credit rating as part of the credit cycle of an economy or client (that is not otherwise triggering concerns on repayment), reducing the risk adjusted return on equity from the client/loan, where a loan (or part of a loan) is sold to a 3rd party to manage the overall portfolio risk adjusted returns to internal targets.

Furthermore overcollateralisation (or margin calls) for Specialised Lending, Commodity/Trade Finance, Project finance and/or other Asset Based Lending is a built in aspect of performing book lending due to market value changes of underlying asset and should be excluded from triggers for NPL/UTP or forbearance treatment. Such situations are different from loans which are unsecured and where a call for collateralization should be treated as a trigger for NPL treatment.

When assessing the level of NPLs and related changes, it also has to be considered that the NPL ratio could increase as a result of change that is unrelated to the economic substance such as changes in the accounting standards. For example, under IAS 39, there are three accounting practices that have been identified for interest income recognition. Under IFRS 9 banks will have to adopt an approach that requires grossing up carrying amount in stage 3 for the interest accruals. In case of exposures that are on banks' balance sheet for long time, these continue to be accrued over years. As a result, the non-performing exposure as well as allowances would increase over time. This will negatively impact the non-performing loans ratios.

The liquidity of the market and other external factors could also play a significant role in banks' efforts to reduce the level of NPLs .This is most valid particularly for countries where the impact of financial crisis was most severe and as a consequence banks are facing higher volume of foreclosed assets. These banks have already been charged with higher capital buffers given poor economic prospects and requested to apply impairment triggers and additional forbearance criteria that have by themselves, led to the recognition of further NPL.

A related issue is how actionable NPE reduction measures can be in situations where the unlikely to pay (UTP) share of the NPE is materially relevant. Some of the criteria for the UTP part may not be sustained from a contractual, legal or judicial execution point of view which may constitute an effective impediment to NPE reduction. For comparability purposes and effectiveness of NPE reduction strategies the breakdown between "past due" and UTP needs to be taken into consideration.

All these considerations and factors have to be taken into account in assessing the level of NPLs and the compliance with the Guidelines as well as setting the "realistic yet ambitious targets" for NPL reduction.

Application to retail and non-retail portfolios

We would also appreciate clarification as to the application to retail and non-retail portfolios. We support a clear distinction between wholesale and retail and are concerned that the distinction was not made consistently throughout the document. For example, forbearance options should reflect different portfolio characteristics and this should be made clear in the draft Guidance. Also, Net present value (NPV) comparison for retail NPLs as required by 4.3 are not considered proportionate for relatively low value retail exposures. In general, it is considered unlikely that a forbearance solution would have smaller NPV compared to a straight away liquidation as the liquidation still remains an option after failure of the forbearance measure. We believe a decision tree to be successful in case of retail exposures.

Reporting requirements and disclosure

We note that the consultation paper aims at imposing additional reporting requirements on SSM banks. We believe that supervisory reporting and public disclosure requirements should be set by means of European Regulation and the SSM has no legal authority to impose the reporting and disclosure requirements which consultation paper envisages.

Clarification on supervisory measures

Finally, we understand that non-compliance with the Guidance may trigger supervisory measures. We believe the concept of supervisory measures is however 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 compliant would affect the assessment of the risk control framework. We would appreciate clarification within the Guidelines.

NPL Governance and operations

3.2 Steering and decision making

The Draft Guidance provides that the NPL strategy and the operational plan must be approved and steered by the management body which must, amongst others, oversee their implementation, define management objectives and workout activities, and in general, monitor their progress regularly.

We understand and support the accountability of the management body for the NPL strategy. The level of involvement of the management body should however be coherent with the internal governance framework and 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*.

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. The senior management of the entity is in charge of the day-to-day implementation of such strategies and policies, and will define and steer the processes and milestones affecting them. These Guidelines should recognize it and should not require that the management body performs functions of the senior management, i.e. day-to-day management.

In this regard, the specific strategies and operational plans aimed at the management of particular risks such as NPLs are part of such strategies developed by the senior management of the institution. 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 such management body, as it would be obliged to get directly involved in the regular execution of the processes for the development of the

strategy. Moreover, 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.

3.3 NPL operating model

While we understand and support the objective to separate the units responsible for loan origination from those in charge of NPL management to avoid conflict of interest, we are concerned that the requirements regarding organizational structure and operational set-up to address the principle of separation are too detailed and prescriptive. We believe that it should be left to individual banks to decide how to apply the principle of separation of these units.

While the operating model proposed would alleviate some supervisory concerns, the degree of separation should take account of how shared services are provided to minimize further adverse impact and disruption of daily operation of a vulnerable client and allow an easier transfer to and from performing to non-performing status.

While we support the separation of Relationship teams for non-retail non SME segments, the need to limit separation of relationship teams for SME and retail-SME client is particularly important as change of relationship management could even be a critical event pushing the client further in financial difficulties. This is due to the time taken to arrange an appropriate handover and due to disruption to the business as usual/daily operational and funding processes of clients with limited internal organizational capacity (as expected for the nature and size of the client). To help the client turnaround, guidelines should allow for client facing role to be maintained as is and limit transfers of responsibility to change of ultimate decision making on client's lending and/or payments to a separate team (which could likely be the supporting credit function or dedicated team within it).

Whilst recognising the benefit of maintaining a "factory" approach for retail clients we flag that the triggers set for individual assessment of collateral for retail mortgages should not be fixed at an absolute European level due to market specifics of each country and region.

We would also recommend that separation should not create separate IT architecture and payments/processing stacks as this would lead to a creation of a "bank within a bank" set-up that would not just increase operational risks for the banks but would lead to complex handovers between bank teams, changing daily contacts and procedures for clients in distress, thus further impacting their ability to recover and of the bank(s) to execute a sustainable client turnaround.

From an IT perspective, in addition the comment above on not disrupting a single IT architecture stack, we highlight that requirements for reporting equate to material IT investment in changing existing platforms and data warehouses/data layers, with related high costs and significant operational disruption (especially if done on exceptionally short delivery terms) and recommend that a clear phased transition is in place to assure that client support is not unduly adversely impacted by implementation of the model and that robustness of banks IT platforms is not jeopardised by a rushed roll-out of a grounds-up transformation of IT, Risk, Operations and processes (which itself could result in higher

operational risk losses but also in credit risk losses if focus on client turnaround is unduly diverted to transformation execution).

While we understand that the proportionality principle applies, nevertheless we are concerned that the detailed requirements would force also restructuring of banks that have solved the “potential conflicts of interest” with other means than those required by the guidance. We would advocate for elimination of too prescriptive requirements that could prove to be counterproductive, restricting the efficiency and the effectiveness of existing processes. This applies also to the requirement of mandatory split of the restructuring and liquidation processes in different units.

3.4 Early warning mechanism/watch-lists

We also highlight that any system triggered reclassification to NPL/Watchlist is not supported, especially for specialised lending and trade finance, where delays in payment on often self-liquidating facilities, may be triggered, for example on delayed delivery to final off-taker caused by bad weather, ship engine breakdown, port congestion, etc, all of which are business as usual events that do no impact client’s financial standing or herald financial difficulties. And as such we strongly urge that any reclassification from performing to nonperforming in non-retail segment is always subject to analyst expert judgment.

Forbearance

3.5.3 Forbearance activities as part of 3.5 Monitoring of NPLs and NPL workout activities

Customers that have been granted forbearance measures are about to experience or experiencing financial difficulties. Such customers are already closely monitored as high risk customers. Effects on behavior from granted forbearance measures will be captured in the existing monitoring of high risk customers.

While we appreciate that these provisions are more relevant to high NPL banks, the benefits of monitoring efficiency and in particular effectiveness of forbearance measures are not fully understood. Specifically, as it relates to re-default rate, an array of factors may cause re-default other than the Bank’s forbearance measures (including revised terms and conditions). Therefore, the proposed aggregate analysis per loan segment is not likely to lead to concrete actions which would have the intended effect of addressing high levels of non-performing loans.

Similarly, it is not fully understood how the data on short-term versus long-term forbearance measures could form basis for an impactful risk management decision-making other than increasing awareness of the structure of the portfolio. As such the cost for data sourcing and collection of the short- and long-term types of forbearance measures are estimated to substantially surpass the foreseen benefits of such data or analysis thereof.

Close monitoring of high risk customers’ repayment capacity and overall financial standing is deemed more appropriate for bank’s risk management, rather than monitoring focused on forbearance measures and their types in isolation. In addition, it is unclear what specific

benefits would these analyses bring to effective supervision of high NPL banks or significant institutions.

While we welcome interest only and reduced payments as a list of common forbearance measures, it should be noted that some banks' strategy is to keep co-operating borrowers in their homes, and consequently facilitate interest only restructures beyond 2 years. Specifically, in cases where the underlying collateral has sufficient equity to repay the loan in full, the forbearance measure is sustainable as the customer has the resources to pay off the loan via sale of the collateral at any time and can continue servicing a minimum of interest due. In addition, while we believe credit institutions should limit the number of times a capitalisation of arrears can take place on each customer, a limit of one capitalisation over the life of a loan is too low and may result in delays in returning customers to a performing status.

5.3.1 General definition of forbearance

We believe the identification of the financial difficulties should be aligned with the EBA ITS. The following two conditions should not be considered as direct triggers of financial difficulties

- *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.*

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). Furthermore, as clients PD ratings will change (up or down) over time and in normal course of business, in line with their own business but also macroeconomic cycle, we recommend that this item should be seen only as an indicator, not as a direct trigger to identify conditions of financial difficulties.

4.2 Forbearance options and their viability

It is recognized that "additional security" improves the bank's position and probability of recovery of the credit in case of default. However, we do not support classification of "additional security" as a forbearance measure, as it does not constitute a concession on the terms of the credit provided to the customer.

Specialised Lending, Commodity & Trade Finance, Project finance and/or other Asset Based Lending type financing (or settlement/clearing, derivative or market trading facilities) often have, at their inception, built in collateral top-up (or collateral/margin call) clauses due to inherent market volatility of the assets that are being used as the basis for level of financing and if these collateral calls, built in at the inception of the facility and considered part of the normal operation of such financings/facilities are triggered they should not be treated as a trigger for NPL or forbearance treatment.

However, we do recognise that, where a bank holds an unsecured (or part secured) asset and it is asking for additional security to be provided in light of deterioration of client credit

metrics (not of the market realisible value of an asset), such an event should not be discounted and should be treated as an NPL/Forbearance trigger event, unless it is specifically done under margin calls that have been previously included in the asset/instrument or settlement/ISDA framework agreement. Similarly if an asset backed or other secured (or unsecured) facility that has an inbuilt collateral/margin call option is subject to a call for additional collateralization over and above the one intended by the original facility agreement this could be considered a trigger for watchlist treatment.

According to the draft Guidance, forbearance measure should only be considered viable where no other short–term forbearance measures have been applied in the past to the same exposure. However it is rather usual to provide short term forbearance to the same transaction due to seasonality. It should not be automatically seen as not viable.
The forbearance approach does not take sufficient account of the legitimate interest of secured creditors. Depending on the legal framework allowing a long grace period for loan repayment before enforcement actions are taken can have detrimental effects on the position of secured creditors. It should be left to the discretion of the banks to offer forbearance to borrowers and the Guidance should only set a high level framework but no specific standards and procedures. At least, it should be clearly stated that the specific forbearance measures laid down in the Guidance only have to applied by banks if they fit into the legal and tax framework of the relevant jurisdiction and do not bring the bank to a worse legal or tax position than immediate enforcement.

NPL recognition

5.1 Figure 6 - 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

We suggest a rewording of section 5.2.2 '…Banks should ensure that the criteria for identifying unlikeliness to pay are implemented identically in all parts of the group…', as an identical implementation would not leave room for the proportionality principle. In particular, attention should be paid in understanding those geographies where local requirements regarding a topic differ with these or other guidelines and rules. An effort to understand the different features of these economies and the drivers to those differences is needed, to ensure a proportionate supervision of the portfolios in these geographies. For instance, if a portfolio has an average maturity significantly lower than the average in Europe, flexibility when dealing with cure or probation periods should apply. Otherwise, not only subsidiaries of European banks in these geographies might be under competitive disadvantages to local peers, but also measures with no financial sense could appear (as in the example, probation periods almost as large as the maturity itself of the refinanced deals).

5.3.3 and 5.3.4 - cure periods

To ensure harmonisation and avoid further fragmentation, the cure periods should be aligned with those of existing legislation. We would therefore recommend to align the cure periods and adopt the wording of paragraph 157, 176 and 178 of EBA ITS on forbearance and non-performing exposures. We believe that the text of paragraph 178 of EBA ITS should be replicated to avoid that cure periods applied under the Guidelines could differ from those of EBA ITS which we believe was not the intention of the ECB.

5.4.2 Group of connected clients

The indication that banks should ensure consistency in the implementation of the definition in all subsidiaries and branches may be too ambitious not only because concepts may differ across geographies, as described in section "5.6 Supervisory reporting and public disclosures", but also IT systems may need adjustments for sake of harmonization.

Establishing a unique identifier throughout the group for each global obligor as requested in the Guidance will not be possible as local consumer protection legislation in several countries prohibits the exchange of client data within the banking group, and it may be too burdensome to prove the immateriality.

We also do not agree with 20% of exposures of a group of entities being an automatic trigger for placing the entire group on watchlist or treating all the group's exposures as NPL as a number of them may be dedicated SPVs (project or asset/specialised lending related) that have a firebreak between them and the Holdco (or other ring-fenced assets/SPVs). As such we would consider the 20% as trigger for considering inclusion on the watchlist, which would be subject to analyst expert judgment, unless the aggregate amount of the individual defaulted/NPL exposures is triggering any cross-default clauses across group's members/facilities.

5.4.3 Obligor "pulling effect"

Paragraph 5.4.3 states that "According to paragraph 155…if 20% of the exposures of one obligor are determined as non-performing, all other exposures to this obligor should be considered as non-performing."

However, Section 155 actually states that "When a debtor has on-balance sheet exposures **past due by more than 90 days** the gross carrying amount of which represents 20% of the gross carrying amount of all its on-balance sheet exposures, all on and off-balance sheet exposures to this debtor shall be considered as non-performing."

It is very important that it remains clear that the 20% rule **only** applies when other exposures of the debtor are **more than 90 days past due** (and not just non-performing as currently stated).

5.5.2 Accounting definition of impaired

The Guidance assimilates the concepts of default and IFRS 9 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).
The current EBA Definition of Default (effective from September 2014), Paragraph 157 (c) states that:

"Concerns may be considered as no longer existing when the debtor has paid, via its regular payments in accordance with the post-forbearance conditions, a total equal to the amount that was previously past-due (if there were past-due amounts) OR that has been written-off (if there were no past-due amounts) under the forbearance measures OR the debtor has otherwise demonstrated its ability to comply with the post-forbearance conditions."

The requirement that the "debtor has otherwise demonstrated its ability to comply with the post-forbearance conditions" has been removed from the EBA Consultation Paper, however we would consider this an important and more reliable indicator that the customer's situation has fully resolved itself. Therefore we would have a strong preference that the criterion for curing to non-defaulted status read as follows "a material payment has been made (a total equal to the amount that was past due or has been written off) *OR the debtor has otherwise demonstrated its ability to comply with the post-forbearance conditions*".

Supervisory reporting and public disclosures

The consultation paper aims at imposing additional reporting requirements on SSM banks. We believe that supervisory reporting and public disclosure requirements should be set by means of European Regulation and the SSM has no legal authority to impose the reporting and disclosure requirements which the consultation paper envisages.

Within the EU – including the SSM zone – the European Banking Authority (EBA) 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 throughout the EU. The EBA has been mandated, amongst others, 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 (Article 99 of Regulation 575/2013). The EBA has effectively prepared those ITS which have been adopted by the European Commission subsequently by means of EU Regulation 680/2014.

Nevertheless, if a competent authority, such as the SSM, takes the view that the supervisory reporting package which the EBA has developed does not meet all its information needs and that financial information not covered by EU Regulation 680/2014 is necessary to obtain a comprehensive view of the risk profile of an institution's activities and a view on the systemic risks posed by institutions to the financial sector or the real economy, Article 99 of Regulation 575/2013 sets out a specific process that it needs to go through.

Article 99, §7, explains, more particularly that, in such an event, it shall notify EBA and the ESRB about the additional information it deems necessary to include in the implementing technical standards referred to in Article 99, § 5. If the EBA and the ESRB agree with such a request to top up the financial information requirements included in EU Regulation 680/2014, the EBA is expected to submit proposals for amendments of EU Regulation 680/2014 to the European Commission for endorsement.

Apart from the above comments, we do believe that the existing information requirements are deemed sufficient for analyzing NPLs, forbearance, etc. In our view, the reporting forms as required in 5.6 and 6.8, while requiring severe IT adjustments, would not add value neither for the banks, nor investors or supervisors. In table 6, the ECB proposes that a breakdown of forborne exposures separately for short-term and long-term forbearance measures shall be newly provided at least on an annual basis. The table includes a new format and a new breakdown compared to the existing EBA ITS. Data sourcing and collection to facilitate such reporting would represent a significant bank-wide undertaking with significant costs attached. The benefits of such undertaking for reasonable risk management decision-taking or supervision are not understood and therefore, this supervisory reporting requirement is not deemed proportionate.

The Guidance encourages banks to use the EBA NPL/NPE definition not only for supervisory reporting but also for general disclosures purposes. Notwithstanding the use of EBA´s common definitions for NPL and forbearance, in some member states, additional measures in NPL recognition and classification have been taken, leading to a diversity of situations in terms of NPL/ NPE recognition and return to performing status, across the EU and even within the same jurisdiction.

It would be misleading to broaden the disclosure requirements to an indicator that is far from being harmonised and in which a level-playing field has not been achieved. Misinterpretations may be more recurrent distorting peer comparisons and in extreme situations may lead to significant market disturbances.

A relevant example of how difficult it is to harmonize the definition of NPL can be found in the "best practices" regarding supervisory guidance for the implementation of the "unlikely to pay triggers". While being quite exhaustive, the disclosed list on page 52 of the Guidance leaves room for subjectivity and the application of different criteria for identical situations. Furthermore, it does not seem reasonable that the Guidance recommends that banks should develop their own thresholds based on national specificities and at the same time ignores other "national specificities" when drafting or requiring ambitious "NPL reduction plans".

Another good example is the results and conclusions in the recent guidelines for definition of default and associated QIS evidencing very different stages of implementation of the concept which may affect NPL levels. In that regard we also draw attention for the very long transition period embedded in the definition of default guideline (up to 2021), reflecting the complexity, potential impact and relevance of the proposed changes.

In addition, coverage levels may not provide the right information when not considering their usage for other than impairments (being the impairment coverage ratio negatively

correlated with the collateral value – due to lower LGDs - it will be normal that banks more oriented to mortgage loans and other secured segments have lower impairment coverage ratios).

Given that abovementioned issues, the disclosed NPL levels, ratios and coverage, may not be totally comparable, distorting market perceptions which can be very disruptive and lead to misguided decisions.

In addition, paragraph 2.6 requires yearly reporting in Q1. Depending on local regulatory cycle for supervision, another quarter may be more appropriate. Reporting should be required on a yearly basis without specifying the quarter.

NPL impairment measurement and write-offs

6.2.3 General methodology for individual estimation of allowances

The guidance seems to require either a going concern approach or a gone concern approach however the boundaries between them are not always clear in the document. Moreover some arguments in favour of the gone concern approach does not appear to reflect the businesses' economic and financial reality. We believe a combined approach might be also possible when it better justifies the impairment measurement or (partial) write-offs. The tax aspect have also to be taken in consideration in this regard.

6.2.4 Estimation of the recoverable amount of the collateral under the gone concern approach

The wording of the draft Guidance on gone concern implies that the evaluation of the recoverable amount is exclusively coming from the sale of the collateral. We believe that the recoverable amount should consider also the presence of: (i) personal guarantees, (ii) assets of the debtor to be settled, (iii) market hedging, (iv) ECA or private credit or asset insurance (and related payout periods), (v) protection through CDS's or other liquid (or market traded) assets that may be subject to a general pledge, (vi) off-take/receivables/insurance pay in primacy through payment waterfalls and if the asset held by the bank is either supersenior, ring-fenced from other creditors, or structurally superior to other claims (e.g. Trade finance, receivables finance, pre-exports, etc) as well as any possible cash flow, different from the collateral, as it is provided by the LGD of lines non secured by mortgages.

6.3.2 Methodology for collective estimation of allowances

The draft guidelines refer to collective allowances for unimpaired exposures, such as when the allowances are raised to cover incurred but not reported losses. We note that the concept of "incurred but not reported losses" is one that is relevant under IAS 39 and we are concerned that there is limited benefit (from both a bank and supervisory perspective) of requiring banks to change IAS 39 collective provisioning models during 2017 as they will effectively become redundant on 31 December 2017. It is our view that banks, investors and supervisors would be best served by devoting resources and effort to ensure that IFRS 9 collective impairment models (which are currently in development across the industry) are compliant with the finalized guidelines.

6.5 NPL write-offs

The draft guidelines request that all banks include in their internal policies clear guidance on the timeliness of provision and write-offs. While we do not object to the request, we would like to highlight the link to the EBA's interpretation emerging from the answer to the question ID nr. 2014_1064, published as final Q&A on 19//12/2014. The Q&A is related to the inclusion of partial write-offs in the computation of general and specific credit risk adjustments which has a potential high impact on CET1 for the banks that are licensed to use their internal models in measuring their credit risks. The issue refers to the treatment of so-called "partial write-offs" of defaulted loans in the calculation of the shortfall /excess (comparison of expected loss and credit risk adjustments under Article 159 CRR).

In its answer EBA affirms that "A partial write-off would not be included in the calculation of general and specific credit risk adjustments. However, as per Article 166 of the CRR, the calculation of the expected loss amount for the application of Articles 158 and 159 of the CRR would be based on the exposure value gross of value adjustments but net of write-offs.

A possible prohibition of the partial write-offs to provisions would inevitably lead to an adverse impact on capital ratios (the shortfall increases or decreases any excess) which is paradoxical, because in theory, it leads to different treatment of two identical positions: if a bank has two credits in default of 100€, both of which with a 65% LGD, one of which is provisioned for 60€ and the other written off for 30€ and provisioned for 30€ - on the basis of a different, legitimate, internal accounting practice, in the first case the bank will have a shortfall equal to 5€ (65% x 100€ - 60€ = 5€), in the second case of 15,5€ (65% x 70€ - 30€ = 15,5€), which will be deducted from the CET1.

The issue is very technical and concerns only the banks using internal models for measuring credit risk, but we think that it's very relevant in terms of potential impact on capital ratios and that it risks to hinder, inter alia, the use of partial write offs in a timely manner unless EBA revisits its interpretation.

6.6 Timeliness of provisions and write – off

The Guidelines requirement to establish a minimum provisioning level depending on the type of collateral as a supervisory best practice for exposures covered by collateral is in contradiction with IFRS 9. It is also questionable whether establishment of a maximum period for full provisioning and write off is in line with IFRS.

Collateral valuation for immovable property

The valuation of assets under real estate enforcement procedures should not be required. In fact, the value of the immovable properties subject to auction procedures is set by an independent technical advisor appointed by the court. Banks should be allowed to retain such valuation.

Additionally, we understand the drafted requirements as a stricter handling of property valuation compared to the CRR requirements (more frequent valuation, valuation

compared to current reviews, independence of external appraiser process, critical link between fee and result of valuation, restricted usage of indexed valuations). We propose to align valuation requirements with the Articles 208 and 229 of CRR. Moreover, the currently accepted valuation standards (e.g. mortgage lending value according to EU country regulations are not explicitly mentioned, allowed and in some cases even forbidden. Usually, the value of real estate collateral will be reviewed in the course of a hand-over of an exposure to a workout unit. A further annual assessment is not necessary, as – in line with CRR – an event-triggered valuation review is already prescribed. Especially for workout exposures special triggers for collateral revaluation are more often given than for collateral with performing loans. That is why a proper valuation of such collateral is sufficiently ensured.

7.2.1-General policies and procedures

The draft Guidance does not address the situation when the collateral valuation might be made only if an event would modify the collateral value especially when its value is well above the remaining debt or when cash-flows cover instalments.

7.2.2 Monitoring and controls

We agree with the principle and benefit of rotating appraisers every 2 years. However, it is not always practical that the appraiser rotates after two sequentially updated individual valuations of the same property particularly in rural locations where there may be a limited supply of appraisers with sufficient knowledge of the property market and locality. Such a rotation may result inaccurate property valuations, which may negate the benefit of rotation.

We fail to see the benefits of rotation requirement as long as other sufficient processes are in place that ensure the accuracy of the valuation. We propose to replace the requirement by the following:

Accuracy and appropriateness of appraisals have to be checked and verified by use of sufficient quality assurance and monitoring processes and "4-eyes" or rotation principles.

Moreover, we question an added value by implementing the controls required in this passage (e.g. comparison of a valuation sample with market observations) and do not consider this to be clear enough in some parts. It is still unclear which staff is supposed to challenge internal or external expert opinions. There cannot be more checks than a basic plausibility check of the assumptions made by the experts. It is also unclear how a sample is to be taken from expert opinions and on the basis of which data a back-testing should be carried out.

7.2.3 – Indexed valuations

The €300.000 threshold for indexed valuation is too low. Banks should be allowed to set the threshold in relation to their collateral portfolio characteristics.

In jurisdictions that were most affected by financial crisis and are facing high levels of NPLs, it would be burdensome to proceed immediately with individual property valuations

of all NPL loans exceeding €300.000 (e.g. residential and not residential real estate portfolios' average values could be very different).

Furthermore this threshold should be applied only to exposures managed under gone concern. For the exposures managed with the going concern approach with no need to sell the collateral, the collateral value still must be reasonably monitored with a statistical method.

In addition, regarding the gone concern approach exposures, it should be considered that, if the foreclosed activities are proceeding, the value certified by the technical expert appointed by the court and the auction base price set by the judge should be applied to all the effects as an appraisal, regardless of the amount guaranteed.
Regarding indexed valuations it should be stressed that the use of indices based solely on actual property transactions entails serious drawbacks and poses risks to small countries with relatively low (limited) number of transactions. Specifically, the low number of property transactions may lead transaction-based Property Price Indices to exhibit sample bias, thus distorting the actual picture of property price developments. This may be particularly relevant during periods of crises, where transactions are unavoidably affected. Therefore, we suggest (last bullet point of paragraph 7.2.4., page 88) to alternatively allow the use of property indices based on other sources of data (e.g. actual property valuations) instead of only transaction based indices. This is especially warranted for small countries where sufficiently granular data of various asset classes is not available."

Finally clarifications would be welcomed regarding what is needed in terms of sufficiency in «sufficiently granular" and "sufficient time series".

7.2.4 – Appraisers

We would appreciate clarification of the requirements of independence whereby "*the appraiser should not receive a fee linked to the result of the valuation*". Should this be understood as meaning that the appraiser's fee should not be determined based on the appraised property's value? This will mean a departure from current practice. Banks have pre-agreed specific scale formulas with appraisers whereby the risk associated with such practice is mitigated significantly due to the small increases in fees as estimated values increase further and also by setting of a maximum fee.

7.3 – Frequency of valuations

We question the added value of the requirement to proceed immediately with an individual property valuation once the loan is classified as NPL, aside from high value financing (see 7.2.3 above). Banks initiate an assessment of individual property value irrespective of whether the loan is classified as NPL or not, at the very beginning of the restructuring (forbearance) process where appropriate. The most important point for the bank is to have knowledge of the market value of the property collateral at the point in time of structuring a viable forbearance measure where appropriate.

7.4.3 Going and Gone concern approach

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).

Furthermore, for specialised lending (including project finance), export/trade finance (including structured/specialist long term infrastructure development) and asset based lending, we do not agree with the limitation of projected growth rates and/or cash flows to 3-5 and 10 years respectively as these financings are for very long term assets, with long term concessions/cash generating life/off-take (or supply) undertakings with in-depth (often IMF, Central bank or other governmental statistical bureau) based assumptions used to obtain at origination of the facility the necessary public/license approvals and their treatment if they become a NPL/watchlist asset should be consistent with this approach.
Moreover the «market price discount» to be applied, if appropriate, to an updated valuation needs clarification. Does the ECB expect banks to use internal thresholds while valuation is based on an expert judgment in this area?

7.5 – Valuation of foreclosed assets

In countries where NPL markets do not exist or are not yet fully developed, the bank/appraisals should consider and be careful of a set of factors to assess the foreclosed asset value instead of applying a theoretic sale price to all banks in that country.

When forming a sale policy for the foreclosed asset the bank also needs to take into consideration exogenous factors such as the economic situation, the liquidity and activity of the market as well as the possible impact) on the values of similar assets and on the bank's financial position. Solid procedures for the valuation of foreclosed assets is more important in cases where NPL distressed markets are not fully developed.

In this sense, we understand that the management should approve an individual plan to sell the assets within a timeframe that should be consistent with the economic situation, the liquidity and activity of the market in each jurisdiction.

The guidance indicates that every foreclosed real estate asset automatically fulfils the definition[1] of "Non-current Assets Held for Sale" in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. We are of the view that not all foreclosed real estate assets fulfil automatically the definition of "Non-current Assets Held for Sale" in accordance with IFRS 5 and, as such, this assessment should be performed for every foreclosed real estate asset to determine whether the definition is met or not.

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1 IFRS 5.7 stipulates the two criteria that must be met before an asset can be classified as "non-current assets held for sale".

Annex 6 - Affordability assessment for retail borrowers

Whilst recognising the need for having a mandatory affordability calculation as part of the NPL process, ECB's current proposal is seen as unnecessarily prescriptive and not conducive as:

- Retail - individual countries will have specifics of their markets (e.g. higher or lower unemployment insurance benefits, government guarantees for mortgages, etc) and we thus recommend that setting of the affordability calculation is set by national prudential supervisors.
- Corporate/wholesale – setting any guidelines using ratios (e.g. EBITDA multiples) would not factor in individual national tax treatments, or sophistication of hedging that may be undertaken by client (e.g. preselling/hedging their inventories which are financed by a borrowing base facility) or the nature of individual sectors, sub-sectors and infrastructure types/projects/concession. As such we would recommend that guidelines is limited to mandating that a lending decision for a corporate includes a clear judgment by the analyst on affordability, however that no fixed "trigger" or a prescriptive format is set.

The Annex indicates that for the capitalization of arrears the bank should assess and be able to provide evidence of the borrower's repayment ability and the borrower has been performing against the revised arrangement for 6 months before arrears are capitalized.

As part of establishing a suitable restructuring (forborne) solution for a distressed borrower's credit facilities, a bank may consider to propose an option to capitalize arrears (type of a forbearance measure). But according to Annex 6, in order for the bank to be able to proceed with capitalization of arrears the "*borrower needs to be performing against the revised arrangement for 6 months before arrears are capitalized".* In our view the requirement is confusing and could hamper banks' efforts to conclude a possibly viable forbearance proposal to the borrower because it excludes the option of capitalizing arrears.

In addition, the 6-month probation period will further prolong the exit of the facility from NPL classification.