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Guidance on NPL

Dear ladies and gentlemen,

on behalf of the Austrian banking industry we would like to submit the following remarks to the ongoing consultation on the guidance on non-performing loans (NPL):

- Setting the "EU average NPL" as a benchmark and incentivizing banks to be below this threshold would have unintended negative consequences:

a) Such an average is a moving target and in the proposed set up it would become continuously lower. After a while the threshold will not only be unsustainable but also economically unjustifiable.

b) The banks' business models are very different: the share of private individuals, micro, SME and corporate is different and each of these segments have a different level of healthy and manageable NPL. In addition banks have to pursue different workout strategies based on the regulatory environment they operate in. So for some NPL sell-off options are limited, while others can benefit from a regular sell-off process. Hence, setting one non-performing exposure target (NPE) for all, independently from business and operating models, does not create a level playing field. Contrary, it would create an environment where some businesses become indirectly promoted whilst others would experience a silent cutback. We see it as highly critical if an intention for risk reduction becomes realized by the increasing focus on a diminishing variety of businesses.

As an alternative we would propose the following: The entry trigger could be the EU NPL average plus 1.5%, but not lower than an absolute NPL level of at least 6%. In addition a differentiation between business lines should be (re-) considered.

- It is not clear whether - in case of a banking group - the proposed benchmark for “high NPL bank” applies to individual entities or for the group as a whole or both. Related to this it is also not clear, in case a banking group is breaching the threshold, will the proposed strict regulatory measures have to be applied to the whole group or to the individual entity - or whether it is the decision of the banking group as to where the regulatory measures would have to be applied as well as setting a timeline for these measures to implement?
- The proposed regulatory measures (defined in chapter 2 and 3) for those banks that breach the NPL threshold are formulated more at detailed procedure’s manual level vs. as policy requirements. Given the wide range of business models of the banks, trying to formulate detailed process level requirements would be rather counter-productive.

An alternative could be to allow banks in 'breach' a reasonable timeframe (e.g. 1-2 years) to reduce their NPL to the required level within their own operative environment. In case no progress is made or the NPL target is not reached, a detailed work-out strategy could be requested for application. This could also help to phase out NPL workout actions in any market in order to avoid a market situation where several banks are trying to work out their NPL influencing asset prices and reducing the recovery potential for all.

Forbearance measures

Paragraph 50 of the EBA Guidelines on the application of the definition of default under Article 178 of CRR (“the EBA Guidelines”) stipulates regarding forbore 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).

According to paragraph 4.1. of the ECB Draft Guidance to banks on non-performing loans (“the ECB 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 institutions with an exemplary list of common forbearance measures.

In the vein of the above mentioned provisions we would like to point out that 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. The threshold of 1% is far too low and could hinder future forbearance measures.

Additionally, according to paragraph 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 was not viable in this aspect and has to be modified. We would ask the ECB for further clarification if this assumption is right.

List of forbearance measures

“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 their characteristics - they may qualify either as long-term or as short-term measures.

Transitional period

The ECB Guidance needs to be implemented in a proper way, as well as the recently published Final Report on the EBA Guidelines. Since the implementation of these two acts affects the same staff (also the Consultation on BCBS on non-performing exposures) and therefore resources in this area are rare we would ask the ECB to provide banks with an appropriate transitional period regarding the ECB Guidance.

Moreover we would like to submit three examples, which show the impacts and implementing challenges with regards to the proposed measures and provisions particularly for smaller banks:

Example 1 - NPL Strategy (Draft Chapter 2):

In the context of the development of an adequate NPL-strategy institutions have to consider/implement the following aspects:

- periodic review and assessment of the business model (internal capacities, economic trends, impact on the capital base of the bank);
- analysis of the available strategic options (reduction of the portfolio due to sales, legal options, et cetera);
- short-term and long-term objectives for the reduction of NPL;
- operative planning (IT and reporting), staffing level et cetera;
- integration of the NPL-strategy into the risk management system (ICAAP¹, Risk Appetite Framework-RAF² und Recovery Plan³).

Difficulties in Implementation:

In this context regarding the operative planning or the staffing level the principle of proportionality has to be taken into consideration.

Explaining Comments:

The draft stipulates in the section „Applicability of Guidance“⁴ 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.

Example 2 - NPL Governance and Operations (Draft Chapter 3):

In this context institutions have to consider/implement the following aspects:

- Controlling and decision processes:
 - annual approval of strategy and planning by the board of management, monitoring of the NPL strategy, approval processes, internal controls et cetera;

¹ See Article 108 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 176, 27.6.2013, p. 338).

² See the Financial Stability Board's "Principles for An Effective Risk Appetite Framework".

³ See Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190), known as the Bank Recovery and Resolution Directive (BRRD) (Directive 2014/59/EU).

⁴ See page 5 of the draft.

- Availability of sufficient specialist know-how concerning the regulatory treatment of NPL;
- Operativ model for NPL:
 - Establishment of organisationally seperated specialised NPL reduction entities (work-out-process), adequate infrastructure for NPL workout units (WU) and control functions, IT-systems, tools, et cetera;
- Development of performance ratios (such as the Key Performance Indicators-KPIs) for measuring the progress concerning the reduction of NPL.

Difficulties in Implementation:

It has to be considered that in view of the available human ressources of a small cooperative bank (only 3-4 employees) an establishment of separate, organisational divisions of NPL reduction entities isn't feasible due to the mentioned limited staffing level and the needed specialized know-how.

Small banks are not legally obliged to establish separate front-office and back-office units. The legal obligation to establish separate NPL workout units would lead to excessive demands for small banks with low NPL ratios. For that reasons an adaption of the draft is needed that small banks with low NPL ratios do not have to establish separate NPL workout units.

Explaining Comments:

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 with the following explanation:

"...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"

In connection with this footnote 14 reads as follows:

"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."

Example 3 - Collateral valuation for immovable property (Draft Chapter 7):

According to this section of the draft the institutions have to consider/implement the following aspects:

- Independent monitoring and control process, independent internal and external experts with adequate qualifications⁵;
- regular valuation of the immovable property, periodic monitoring and on a random basis, backtesting of valuations and implementation of IT-systems for the registration of the immovable property.

Difficulties in Implementation:

Availability of sufficient staff resources and special know how.

Explaining Comments:

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. This is in particular true for small

⁵ See draft page 88.

institutions. Hence adaptations for small banks are essential, f.e no obligation to consult external experts for the valuation of the immovable property.

We ask you to take our comments in due consideration.

Kind regards,

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