EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Guidance to banks on non-performing loans

Key content

September 2016

Aim of this presentation

- The aim of this presentation is to summarise the main content of the “Guidance to banks on non-performing loans” launched by the ECB for public consultation in order to facilitate the consultation process.
- Please note, however, that consultation feedback should relate to the guidance document only and not to this summary.
- In case of doubt, the content of the guidance document prevails.

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Context

Deliberate and sustainable reduction of non-performing loans (NPLs) in banks' balance sheets is beneficial to the economy from a micro- and macroprudential perspective.

This guidance is the result of intensive work by supervisory teams on NPLs. It contains a collection of best practices and constitutes banking supervision expectations from now on.

Applicability of the guidance

The guidance is addressed to all significant institutions (SIs) supervised directly under ECB banking supervision, including their subsidiaries, both national and international. Principles of proportionality and materiality apply, e.g. parts of chapters 2 and 3 on NPL strategy, governance and operations may be more relevant for banks with high levels of NPLs.

A guidance is a non-binding instrument; however, deviations should be explained and substantiated upon supervisory request. Binding laws, regulations or accounting rules addressing the same issue should obviously be complied with; the guidance is a supervisory tool which, in the case of non-compliance, may trigger supervisory measures. Whenever possible, however, banks need to foster a timely convergence of regulatory and accounting views.

Scope of the guidance

The guidance addresses all non-performing exposures (NPEs) following the European Banking Authority (EBA) definition, as well as foreclosed assets, and also touches on performing exposures with an elevated risk of turning non-performing. NPLs and NPEs are used interchangeably within this guidance.

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Chapter 2. NPL strategy (1/2)

Content of the guidance prevails

To develop and implement a fit for purpose NPL strategy, banks should:

NPL strategy assumptions and self assessment

- assess and regularly review their operating environment including:
  - internal capabilities;
  - external conditions (macro, market, investors, servicing, legal, tax, etc.);
  - capital implications, analysis and projections;

NPL strategy development and implementation

- consider/analyse all available strategic options and their combinations, including:
  - hold/forbearance strategy;
  - active portfolio reductions through sales;
  - taking collateral onto balance sheet;
  - legal options including out-of-court options;
- establish targets by portfolio (including foreclosed assets, if relevant), defining:
  - sustainable long-term NPL levels;
  - medium-term (3yr) quantitative targets for gross/net NPL reduction and NPL flows;
  - short-term (1yr) quantitative targets for gross/net NPL reduction and/or NPL flows;
- develop operational/implementation plan including investments (e.g. IT and reporting), staffing, organisation, etc.;
- provide summary of NPL strategy/targets and operational plan to ECB Banking Supervision annually.

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To embed a fit for purpose NPL strategy, banks should:

Embedding the NPL strategy

- regularly review NPL strategy and assumptions;
- implement reporting on NPL targets and operational effectiveness;
- align with performance management/incentives;
- integrate in business plan/projections and risk management framework.

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Chapter 3. NPL governance and operations (1/3)

Content of the guidance prevails

To address NPL issues in an efficient and sustainable way:

Steering and decision-making

The **management body** should:

- annually approve NPL strategy and operational plan;
- oversee the implementation of the NPL strategy;
- define management objectives and incentives for NPL workout activities;
- define adequate approval processes for NPL workout decisions;
- ensure sufficient internal controls over NPL management processes and approve related policies;
- have sufficient expertise with regard to the management of NPLs.

NPL operating model

Banks should:

- establish separate and dedicated NPL workout units (WUs) which help to eliminate potential conflicts of interest with loan granting and ensure sufficient NPL expertise;
- establish different NPL WUs for different phases of the NPL life cycle;
- implement clear hand-over triggers from one WU to the other concerning:
  - early arrears;
  - late arrears/restructuring/forbearance;
  - liquidation/debt recovery/legal cases/foreclosure;
  - management of foreclosed assets (or other assets stemming from NPLs).

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NPL operating model

Banks should (continued):

- apply a sophisticated portfolio segmentation approach to group borrowers with similar characteristics requiring similar treatments;
- ensure NPL organisation, including management, is proportionate to NPL risk (NPL expertise should be built up systematically);
- ensure there is an adequate infrastructure for NPL WUs and related control functions (e.g. IT system, tools, access to external registers, forbearance options).

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Chapter 3. NPL governance and operations (3/3)

Content of the guidance prevails

Banks should:

Control framework	• clearly assign roles across all three lines of defence; • establish policies linked to NPL workout concerning: (1) arrears/NPL management policy; (2) forbearance policy; (3) debt recovery/liquidation/enforcement policy; (4) debt-asset swap/foreclosure policy; (5) multi-bank distressed debt policy; (6) collateral policies; (7) provisioning policy;
NPL monitoring	• develop framework of key performance indicators (KPIs) to measure progress regarding NPL workout activities; • consider grouping KPIs into several high-level categories: – high-level NPL metrics; – customer engagement and cash collection; – forbearance activities (e.g. redefault rates); – liquidation activities; – other (NPL-related P&L items, foreclosed assets, outsourcing activities, etc.);
Early warning process	• ensure suitable early warning system with focus on transaction/borrower level - consider indicator examples provided in the Annex; • implement automated workflow (including alerts and action checks) to ensure effective and efficient processes; • define suitable actions and limit management discretion; implement regular reporting on alerts and actions taken.

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Forbearance options and their viability

The focus of this chapter is on the viability of forbearance solutions and forbearance-granting processes and not on forbearance classification.

It is useful to distinguish between short-term and long-term options embedded in the forbearance solution:

- Viable long-term forbearance options have the following characteristics:
  - the borrower can afford them based on an affordability assessment;
  - they address the arrears in full or at least to a large extent;
  - no long-term forbearance options have been granted before.
- Short-term options address difficulties of a temporary nature (maximum 2 years) and should only be offered/considered viable under strict conditions. Examples of short-term options include interest only or reduced payments, grace period/payment moratorium and arrears/interest capitalisation.

Sound forbearance processes and affordability assessment

Borrower affordability assessment is always required.

Banks should:

- use standardised forbearance products and decision trees wherever possible;
- compare other NPL workout options (e.g. legal options) before decision is made;
- establish forbearance milestones and monitoring for each solution;

Disclosure

- disclose, among other items: credit quality of forborne exposures (including classification, provision, collateral and guarantees), quality of forbearance (e.g. redefault rates), net present value impact;
- note that supervisory reporting on exposures by type of forbearance option is needed.

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Content of the guidance prevails

To ensure a consistent approach, banks should:

Implementation of NPE definition and link to forbearance

- apply regulatory definition of non-performing exposures and related publications by EBA;
- implement in-bank policy clarifications regarding:
  - past-due criterion, for instance on past-due counting and materiality threshold;
  - “unlikely to pay” criterion, including a clear list of triggers;
  - identification, classification and cure criteria for forborne exposures;
- implement clarifications on consistent definition at the banking group level for groups of connected clients, obligor “pulling effect”, and classification of the operation in its entirety;

Links between regulatory and accounting definitions

- align regulatory and accounting definitions wherever possible;

Disclosure

- use the EBA’s Implementing Technical Standards (ITS) supervisory reporting requirements for NPE and forbearance as supported by the European Securities and Markets Authority (ESMA) for public disclosure;
- reconcile any deviations between exposure classification in accounting and regulatory view (conceptual and quantitative);
- disclose assumptions underlying the definition of impaired financial assets (including materiality thresholds or methods used for past-due counting), in addition to disclosures already requested under IFRS 7.

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Chapter 6. NPL impairment measurement and write-offs

To apply best practices in NPL impairment recognition, banks should:

Individual estimation of provisions

- define criteria for exposures requiring individual assessment of provisions;
- follow conservative approach for estimation of future cash flows and collateral;
- take into account list of criteria to use "going concern" vs. "gone concern";
- consider restrictions and simple examples of "going concern" approach;

Collective estimation of provisions

- follow criteria for grouping exposures for collective assessment;
- avoid arbitrage and undue discretion in provisioning approach by defining methods and parameters for collective provisioning based on suitable data series;
- review methods and parameters regularly;

Further aspects to provisioning and write-off

- use sophisticated approach to impairment allowances for financial guarantee contracts and loan commitments;
- consider triggers for recognition and reversal of impairment losses;
- foster timely provisioning and write-off through internal policies;

Documentation, reporting and disclosure

- keep sufficient level of documentation detailing provisioning methodology and parameters;
- include collective provisioning information in supervisory reporting, e.g. level of and assumptions behind loss-given default (LGD) and cure rates; also include NPL accrued interest collected/not collected and related provisions;
- provide quantitative and qualitative disclosures (e.g. individual/collective impairment charges and collateral by relevant portfolio, methodology of impairment calculations and management judgements applied).

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Chapter 7. Collateral valuation for immovable property

To comprehensively value collateral on immovable property, banks should:

Governance, procedures and controls

- ensure strong independent control process including for appointment of appraisers, for sample reviews and for back-testing of valuations;
- implement criteria for use of individual vs. indexed valuation (small exposures);
- use panel of independent appraisers (internal or external) with suitable qualifications and skill set;

Frequency and methodology of valuations

- update valuations for all NPL collateral at least annually and define clear triggers for more frequent revaluations;
- base valuations on market value, not on discounted replacement cost;
- in a “gone concern” approach, apply adequate discounts for liquidation costs and actual market price under given sales conditions, and also take into account an adequate time-to-disposal and possible maintenance costs;
- consistently track all collateral information and transactions in database;

Valuation of foreclosed assets

- pursue active sales policy for finished properties, and thus apply IFRS 5;
- generally, value foreclosed assets received at either (1) the amount of the financial assets applied treating the asset as collateral, or (2) the fair value of the repossessed asset, less cost of selling, whichever is lower;
- Reflect inability to sell foreclosed assets in appropriate liquidity discounts;

Disclosure

- disclose for NPL collateral and foreclosed assets separately: value, NPV and provisions by type of assets and by vintage.

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Annexes of the NPL guidance

Content of the guidance prevails

Annex 1: Glossary

Annex 2: Sample of NPL segmentation criteria in retail

Annex 3: Benchmark for NPL monitoring metrics

Annex 4: Samples of early warning indicators

Annex 5: Common NPL-related policies

Annex 6: Affordability assessment for retail and corporate borrowers

Annex 7: Summary of supervisory reporting and disclosure items related to NPLs

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