Guidance to banks on non-performing loans (NPLs)

European Central Bank (ECB)

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List of abbreviations

Abbreviation	Meaning
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
IAS	International Accounting Standard
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standard
ITS	Implementing Technical Standards
JST	Joint Supervisory Team
KPI	Key Performing Indicators
NPE	Non-Performing Exposures
NPL	Non-Performing Loans

Abbreviation	Meaning
NPV	Net Present Value
OMV	Open Market Value
PD	Probability of Default
P&L	Profit and Loss
RAF	Risk Appetite Framework
RAS	Risk Appetite Statement
SI	Significant Institution
SSM	Single Supervisory Mechanism
SREP	Supervisory Review and Evaluation Process
UTP	Unlikeliness to Pay
WU	Workout Unit

Index

Introduction

In March 2017 the ECB published a Guidance to banks on non-performing loans (NPLs), with the objective of developing a consistent supervisory approach regarding the identification, measurement, management and write-off of NPLs

Introduction

A number of banks in Member States across the Euro area are currently experiencing high levels of non-performing loans (NPLs)[1] which ultimately have a negative impact on bank lending to the economy. In this regard, addressing asset quality issues is one of the key priorities for ECB banking supervision[2].

In this context, following a period of consultation, the ECB published in March 2017 a **Guidance to banks on NPLs**[3], with the objective of developing a consistent supervisory approach regarding the identification, measurement, management and write-off of NPLs. In particular, this document provides recommendations to banks and sets outs a collection of best practices regarding NPLs that will constitute ECB's supervisory expectations from now on.

- The guidance includes **recommendations** on NPL strategy, governance and operations, forbearance, NPLs recognition, NPLs impairment measurement and write-offs, and collateral valuation for immovable properties.
- The guidance is addressed to **significant banks** under direct supervision of the ECB, including their international subsidiaries. Nevertheless, **materiality and proportionality principles** are applicable so certain parts of the guidance –those related to NPL strategy and to governance and operations- may be more relevant for banks with high levels of NPLs.
- The guidance is a **non-binding** instrument, however any **deviations** should be **explained** upon supervisory request. Moreover, the guidance is taken into consideration in the SSM regular **Supervisory Review and Evaluation Process (SREP)** and non-compliance may trigger supervisory measures.

This Technical Note includes an analysis of the main content of this guidance. Moreover, annex 1 contains a list of the main changes of the final ECB's Guidance compared to the consultative document.

(1) According to data published by the ECB.
(2) For further information regarding ECB's priorities for 2017, see the following document (link).
(3) Link to the ECB's Guidance to banks on NPLs.

Index

Executive summary

The guidance on NPLs provides recommendations on NPL strategy, governance and operations, forbearance, NPL recognition, impairment measurement and write-offs, and collateral assessment for immovable property

Executive summary

Scope of application

- Addressed to all **significant institutions (SIs)** supervised directly by the ECB[1]. It is a **non-binding instrument**, although **deviations** should be explained upon supervisory request and it is integrated into SREP.

Regulatory context

- Capital Requirements Regulation (CRR)
- EBA ITS on supervisory reporting

Next steps

- This guidance should be applicable as of its **date of publication**[2].
- The expected enhanced **disclosures** on NPLs should start from **2018 reference dates**.

Main content

NPL strategy

- Assessing the operating environment
- Developing the NPL strategy
- Implementing the operational plan
- Embedding the NPL strategy
- Supervisory reporting

Governance and operations

- Steering and decision-making
- NPL operating model
- Control framework
- NPL monitoring
- Early warning systems
- Supervisory reporting

Forbearance

- Forbearance options and viability
- Forbearance processes
- Supervisory reporting and disclosure

NPL recognition

- Application of NPE definition
- Link between NPE and forbearance
- Further aspects of NPE definition
- Regulatory and accounting definitions
- Disclosure

NPL impairment measurement

- Individual and collective estimation of provisions
- Other aspects of impairment
- NPL write-off
- Timeliness of provisioning and write-off
- Procedures
- Supervisory reporting and disclosure

Collateral valuation: immovable property

- Governance, procedures and controls
- Frequency and methodology of valuations
- Valuation of foreclosed assets
- Disclosure

(1) Including their international subsidiaries.
(2) SIs may, however, close identified gaps thereafter based on suitable time-bound action plans which should be agreed with their respective JSTs.

Index

Detail

NPL strategy (1/2)

Firstly, banks should assess and regularly review their operating environment, define the NPL strategy (including qualitative and quantitative targets) and develop an operational plan that complements the strategy

Assessing the operating environment

- When developing and implementing an NPL strategy, banks should assess:
  - Their **internal capabilities** to effectively manage and reduce NPLs. To this end, banks should analyse, among others, the size and drivers of NPLs, the outcomes of NPL actions taken in the past, and the operational capacities (processes, tools, etc.), performing a thorough self-assessment to determine strengths, gaps and areas of improvement.
  - **External conditions**, such as macroeconomic conditions, market expectations, NPL investors demand, regulatory framework, tax implications, etc.
  - **Capital implications**, considered in conjunction with the RAF and the ICAAP. Where capital buffers are slim and profitability low, high NPL banks should include capital planning actions to clean-up NPLs.

Developing the NPL strategy

- The NPL strategy, including the operational plan, should be **approved by the management body** and **annually reviewed**.

Strategy implementation options

- Banks should review the range of NPL strategy implementation **options available** (e.g. hold/forbearance, active portfolio reductions, change of exposure type, etc.), and their respective **financial impact**. Banks should ensure that their NPL strategy includes not a single strategic option but **combinations of options**.

Targets

- High NPL banks should include, at a minimum, clearly defined quantitative targets approved by the management body in their NPL strategy. They should be defined at least along the following dimensions:
  - By **time horizons**: short-term -1 year-, medium-term (3 years) and long-term.
  - By **main portfolios**: retail mortgage, retail consumer, SME corporate, large corporate, etc.
  - By **implementation option**: cash recoveries, collateral repossessions, etc..
- The targets described should be aligned with more **granular operational targets**.

Operational plan

- The NPL strategy of a high NPL bank should be supported by an operational plan approved by the management body, defined over a **time horizon of at least 1 to 3 years**. This plan should define how the bank will operationally implement the NPL strategy.

(1) The ECB does not specify when it should be considered that capital buffers and profitability are low.

Detail

NPL strategy (2/2)

Once the NPL strategy has been developed, banks need to implement the operational plan and embed the NPL strategy at all levels of the organisation. The ECB also includes certain expectations regarding supervisory reporting

Implementing the operational plan

- The implementation of the NPL operational plans should rely on suitable **policies and procedures**, clear **ownership** and suitable **governance structures**.
- Any **deviations** from the plan should be highlighted and **reported to the management body** in a timely manner with appropriate remediation actions.

Embedding the NPL strategy

- The NPL strategy should be embedded in processes **at all levels of an organisation** (strategic, tactical and operational).
  - High NPL banks should put significant emphasis on **communicating to all staff** the key components of the NPL strategy.
  - All banks should clearly define and document the **roles, responsibilities and formal reporting lines** for the implementation of the NPL strategy, including the operational plan. Staff and management involved in NPL activities should be provided with clear **incentives aligned with the NPL strategy**.
  - All relevant components of the NPL strategy should be fully aligned with the **business plan and budget**.
  - The NPL strategy should be fully embedded in the **risk control framework**. In that context, special attention should be paid to the **ICAAP** (all relevant components of the NPL strategy should be fully aligned), the **RAF** (RAF metrics approved by the management body should be aligned with the targets of the NPL strategy), and the **recovery plan**.

Supervisory reporting

- High NPL banks should **report** their NPL strategy and their operational plan to their Joint Supervisory Teams (JSTs) in the **first quarter** of each calendar year.
- To facilitate comparison by JSTs, the ECB has provided a **standardized template** for an appropriate reporting of quantitative targets and the level of progress made in the past 12 months against the plan. This standardized template should be submitted on an **annual basis**[1].

(1) The standardized template is included in Annex 2.

Governance and operations (1/2)

The ECB provides guidance on the key elements of the banks' governance and operations framework, such as the decision-making process, the definition of the NPL operating model…

Steering and decision making

- The management body should **approve and monitor the bank's strategy**. Additionally, for **high NPL banks**, 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 and incentives** for NPL workout activities.
  - Periodically (at least quarterly) monitor the NPL **strategy progress**.
  - Approve **NPL-related policies** and ensure they are completely understood by the staff.
  - Ensure sufficient internal **controls** over NPL management processes.
  - Have sufficient **expertise** with regard to the management of NPLs.

NPL operating model

- High NPL banks should establish separate and dedicated **NPL workout units** (WUs)[1]. NPL WUs should be set-up taking into account the full NPL life cycle: i) early arrears (this phase might also involve short-term forbearance options); ii) late arrears, restructuring or forbearance; iii) liquidation, debt recovery, legal cases or foreclosure; iv) management of foreclosed assets.
- High NPL banks should set up **different WUs for the different phases** of the NPL life, considering that:
  - They should define **triggers** describing when an exposure is moved to the NPL WU.
  - When designing an appropriate NPL WU structure, banks should consider the **specificities of their main NPL portfolios** (e.g. industrialised processes for retail, relationship management for corporates).
- **Segmentations** should have a useful purpose, meaning that different segments should generally trigger different treatments by the NPL WUs or dedicated teams within those units[2].
- Regarding **human resources**, high NPL banks are expected to devote an appropriate and proportionate amount of management attention and resources to the workout of those NPLs and to the internal controls of related processes. Resources with dedicated NPL expertise and experience should be hired for key NPL workout tasks. Moreover, for NPL WU staff performance should be monitored on a regular basis.
- As for **technical resources**, it is important that all NPL-related data is centrally stored in robust and secured IT systems. Data has to be complete and up-to-date throughout the NPL workout process.

(1) Though NPL WUs should be separated from loan origination units, a regular feedback between both functions should be defined (e.g. exchange the information needed for planning NPL inflows).
(2) The ECB provides a list of potential segmentation criteria for retail NPL portfolios.

Governance and operations (2/2)

…the definition of the NPL control framework, the NPL monitoring, the early warning mechanisms, and supervisory reporting

Control framework

- Banks, especially high NPL banks, should implement effective and efficient control processes for the NPL workout framework. The control framework should involve the **three lines of defence**:
  - **First line**. The key tools of first-line controls are adequate internal policies on the NPL workout framework and a strong embeddedness of those policies in daily processes.
  - **Second line**. It should place a special focus on: i) monitoring and quantifying NPL-related risks; ii) reviewing the performance of the overall NPL operating model; iii) assuring quality throughout NPL loan processing, reporting, forbearance, provisioning, etc.; and iv) reviewing alignment with internal and public guidance. Second-line functions require a strong degree of independence (including NPL WUs[1]).
  - **Third line**. The internal audit should at least perform regular assessments to verify adherence to internal NPL-related policies as well as to the ECB's guidance on NPLs.

NPL monitoring

- A framework of **KPIs** should be developed to allow the management body to measure progress.
- NPL-related KPIs should be established grouped into **5 categories**: i) high-level NPL metrics (e.g. NPL ratio and coverage); ii) customer engagement and cash collection (relative efficiency vs benchmark); iii) forbearance activities (efficiency and effectiveness of activities); iv) liquidation activities (e.g. volumes and recovery rates of legal and foreclosure cases); iv) and others (e.g. P&L items, foreclosed assets, etc.[2]).

Early warning mechanisms

- Banks should implement **adequate internal procedures and reporting** to identify potential non-performing clients at a very early stage.
- A **generic early warning process** includes: an early warning engine owned by the back office; an early warning alert handling by the front office; potential hand-over to NPL units in the case of deteriorating credit quality; and quality assurance and control via second and third lines of defence[3].

Supervisory reporting

- **Material and structural changes** in the NPL operating model or control framework should be communicated to the respective JST in a timely fashion. Further, high NPL banks should proactively share **periodic NPL monitoring reports**, at a suitable level of aggregation, with the supervisor.

(1) NPL WUs are allocated to the first line of defence.
(2) The ECB provides a list of NPL monitoring metrics in an annex to the ECB's guidance.
(3) The ECB provides examples of early warning indicators in an annex to the ECB's guidance.

Detail
Forbearance (1/2)

Regarding forbearance, the ECB provides guidance on the viability of forbearance measures, and highlights best practices related to forbearance processes

Forbearance options[1] and viability

- The **viability assessment** of forbearance options should be carried out by distinguishing between short and long-term options:
  - **Long-term options**. They should be considered viable where:
    - i. The bank can demonstrate that the borrower can realistically afford the forbearance solution;
    - ii. The resolution of outstanding arrears is fully addressed and a significant reduction in the borrower's balance in the medium to long term is expected; and
    - iii. In cases where there have been previous forbearance solutions granted in respect of an exposure (including any previous long-term forbearance measures), the bank ensures that additional internal controls are implemented to ensure the viability of the option.
  - **Short-term options.** They should be considered viable where:
    - i. The bank can demonstrate that the borrower can afford the forbearance solution;
    - ii. It is a solution truly applied temporarily (2 years maximum) and the bank is able to attest that the borrower demonstrates the ability to repay; and
    - iii. The solution does not result in multiple consecutive measures to the same exposure.
- The ECB provides a **list of the most common forbearance measures**.

Forbearance processes

- The ECB highlights **best practices** specifically related to forbearance processes, which are specified below.

Borrower affordability

- Before granting any forbearance measures, banks should conduct a **complete assessment of the borrower's financial situation**[2]. The main areas for banks to analyse, depending on the segment, are the borrower's recurring income, expenditure, employment prospects, cash flows and business plan, etc.
- For the comprehensive and verified disclosure of the borrower's financial position in order to analyse exposures, banks should develop **standardised templates for retail** borrowers and **homogeneous segments of corporate**. External information sources like central credit registers should also be used to inform the bank regarding the overall indebtedness of the borrower and the behaviour.

(1) Forbearance exposures refers to exposures with refinancing and/or restructuring measures.
(2) There is an annex to the ECB's guidance that details the borrower affordability assessment and the associated documentation requirements, for both retail and corporate borrowers.

Detail
Forbearance (2/2)

Moreover, the ECB recommends banks to disclose and report to supervisors some information items regarding forborne exposures

Standardised products and decision trees

- Banks should consider developing "**decision trees**" **and related standardised forbearance solutions** for segments of heterogeneous borrowers with less complex exposures. Decision trees may help to determine and implement appropriate and sustainable forbearance strategies for specific segments of borrowers in a consistent manner based on approved criteria.

Comparison with other options

- Before making a decision on the applicable forbearance option, banks should **review other NPL workout options**.
- In order to determine the most suitable workout option, banks should use a **Net Present Value (NPV)** approach. Parameters used in the calculation (e.g. liquidation time horizon, discount rate, etc.) should be based on observed empirical data.

Forbearance milestones and monitoring

- The forbearance **contract and documentation** should include a well-defined **borrower milestone target schedule**, detailing all necessary milestones to be achieved by the borrower in order to repay the loan over the course of the contract term.
- The **performance** of the forborne borrower, including the borrower's compliance with all agreed milestones/targets, should be **closely monitored by the NPL WU** responsible for granting the forbearance, at least for the duration of the EBA-defined probation period[1].

Disclosure and supervisory reporting

- The ECB recommends that banks should disclose the following quantitative information in addition to that required pursuant to Part Eight of the CRR[1]:
  - **Credit quality** of **forborne exposures** (including classification, amount of impairment, collateral and guarantees).
  - **Quality of forbearance** (e.g. redefault rates).
  - **Ageing of forborne exposure** (time since the granting of forbearance measures).
  - **Net present value impact**.
- Moreover, for reporting purposes, a breakdown of forborne exposures by major types of forbearance options should be provided to supervisors at least on an annual basis[2].

(1) For further information See Annex V of ITS 680/2014 on supervisory reporting
(2) The example disclosure and reporting templates are included in Annex 2.

Detail

NPL recognition (1/2)

The guidance establishes that banks should apply the definition of NPE issued by the EBA, and includes provisions on the classification of forborne exposures as performing or non-performing

Application of NPE definition

- Banks are **strongly encouraged to use the NPE definition** issued by the EBA, not only por supervisory purposes but also in their internal risk control and public financial reporting (or at least to publish a reconciliation between impaired and NPE) . According to the definition of the EBA, NPEs are those that satisfy either or both of the following criteria:
  - Material[1] exposures which are more than **90 days past-due**.
  - The debtor is assessed as **unlikely to pay** its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.
- Banks should have clearly defined **internal policies** to identify **indicators of unlikeliness to pay (UTP)**, including a list of **UTP events** (e.g. the debtor enters into an insolvency procedure).

Link between NPE and forbearance

- Apart from the provisions in this guidance regarding the link between NPE and forbearance, banks should consider the **requirements set by the EBA** in this regard[2].
- Forbearance measures are concessions towards a debtor facing or about to face financial difficulties.
  - Banks should be able to identify **signs of possible future financial difficulties** at an **early stage**. An assessment of financial difficulties should also be conducted for exposures where the borrower does not have apparent financial difficulties, but where market conditions have changed significantly in a way that could impact the ability to repay. This assessment should be only based on the **situation of the debtor**, and certain triggers could be used (e.g. increase of PD, past due>30 days, etc.).
  - Granting **new conditions** such as a new interest rate more favourable could be an **indicator of concession**.
- With regard to classification, forborne exposures can be either **performing or non-performing**:

Borrower affordability

- Unless there is evidence to the contrary, forborne exposures meeting any of the following criteria should be classified as **non-performing**: i) they are supported by **inadequate payment plans**; ii) they include contract terms that **delay the time for the regular payments**; iii) they include **de-recognised** amounts that exceed the accumulated credit risk losses for a NPE with a similar profile risk.

(1) The CRR and the RTS on the materiality threshold should be considered .
(2) Annex V of ITS 680/2014 on supervisory reporting. For further information see Annex 3.

Detail

NPL recognition (2/2)

Furthermore, the guidance include further aspects of the NPE definition, such as the pulling effect, the links between the NPE definition and the regulatory definition of default and the accounting definition of impaired; and includes disclosure expectations

Cure from non-performing status

- Specific requirements for reclassifying non-performing forborne exposures comprise the completion of a **“cure period” of 1 year** from the date the forbearance measures were extended, and a requirement for the **debtor’s behaviour** to demonstrate that concerns regarding full repayment no longer exist.
- Institutions are required to perform a **financial analysis of the debtor** to establish the absence of such concerns. For the requirements to be met all of the following criteria should be satisfied: i) the exposure is **not considered as impaired or defaulted**; ii) there is **no past-due amount on the exposure**; and iii) the borrower has **settled an amount equivalent** to all those previously past due (or equal to the amount previously written off, or has demonstrated its ability to comply with the postforbearance conditions).
- The credit institution’s policies regarding reclassification should **specify practices for dispelling concerns regarding the borrower’s ability** to comply with the post-forbearance conditions.

Forborne exposure as performing

- Once a forborne exposure has been classified as performing, it will **continue to be identified as forborne** until some conditions are met (e.g. a minimum of 2 years has elapsed since the later of the date of concession or the date of reclassification from non-performing).

Further aspects of NPE definition

- If more than **20%** of the exposures of one obligor are past due by more than 90 days, all other exposures to this obligor should be considered as non-performing (**pulling effect**).
- The exposures should be categorised as non-performing **for their entire amount** (not classified partly).
- Banks should ensure that the identification of NPEs is **consistent at the banking group level**.

Regulatory and accounting definitions

- The ECB provides the links between the **definition of NPEs** and the accounting definition of **impaired** and the prudential definition of **default**, providing tables with the **main gaps** between the definitions.

Disclosure

- As part of the CRR requirements, banks shall disclose some information items such as the **assumptions** underlying the NPE definition, the **materiality thresholds**, the **methods used for days past due counting**, the **UTP indicators**, etc.

Detail

NPL impairment measurement and write-offs (1/2)

The guidance covers also NPL impairment measurement and write-offs. In particular, it includes expectations with regard to both individual and collective estimation of provisions…

Individual estimation of provisions

- Banks should define the criteria to identify exposures subject to **individual estimation of loss provisions**, taking into account several factors (e.g. individual significance of the exposure[1], there are no other exposures with common risk characteristics, etc.) These criteria should be **documented in the internal policy** of the bank.
- When conducting a specific assessment for impairment, banks are expected to apply a **true and fair view** to the estimation of both the future cash flows and the collateral valuations.
- The estimation of **future cash-flow provisions** can be done using a “going concern” or a “gone concern” scenario[2]. Guidance on how estimation of cash flows should be done under each scenario is provided.
- **Other provisions** on individual estimation are included (e.g. documentation for the purpose of checking the reliability of the individual estimations, review of the methods when backtesting reveals significant differences, etc.).

Collective estimation of provisions

- The **management body** should be responsible for ensuring that the bank has appropriate methods for estimating provisions on a collective basis, which should be **integrated** in the credit risk control system.
- The methods for monitoring and updating estimates of provisions should ensure at all times that the results obtained are based on a **robust method for the estimation** of the provisioning levels which can be justified based on **empirical data**. Moreover, robust policies and procedures should be in place to **validate** the accuracy and consistency of the collective provisions estimations (the expectation is that banks will **backtest** the provisions estimations for every significant portfolios, at least once a year).
- An **internal policy** of the banks should establish the methodology for **grouping exposures** (e.g. instrument type, geographical localisation, collateralisation, industry/market segment, etc.).
- Estimations should be based on **historical loss experience** for assets with similar credit risk characteristics, and they should be adjusted on the basis of **current observable data**.
- **Other expectations** related to the collective estimation of provisions are included (e.g. annually review of methodology and assumptions, documentation, etc.).

(1) Banks are responsible for defining the relevant thresholds (absolute and relative thresholds).
(2) The first one will be used when the debtor’s cash flows can be used to pay the debt, and the second one when the collateral is executed and the obligor’s cash flows ceased.

Detail

NPL impairment measurement and write-offs (2/2)

… as well as to timeline of provisioning and write-off, procedures, and supervisory reporting and disclosure

Other aspects related to impairment	• A sophisticated approach for estimating provisions for **financial guarantee contracts and loan commitments** (e.g. use of robust historical data and backtesting) should be used. • A non-exhaustive list of **cases** where the **reversal of impairment** may be assumed (e.g. cash flows have improved, the debtor has provided additional collateral, etc.) is included. Regarding foreclosed assets classified as held for sale, banks should develop internal policies that clearly define the main methodologies and assumptions used to determine both the **fair value of foreclosed assets and the cost of selling** them.
NPL write-offs	• When loans are deemed **unrecoverable**, they should be written off in a timely manner, taking into account several criteria. Once an amount has been written off from the balance sheet, it **is not possible to write-back/reverse** that adjustment (in opposition to impairment provisions).
Timeliness of provisioning and write-off	• Banks should include in their internal policies clear guidance on the **timeliness** of provisions and write-offs. Especially for exposures that are not covered by collateral, banks should determine **suitable maximum periods** for full provisioning and write-off; and for exposures covered by collateral, the establishment of a **minimum provisioning level** depending on the type of collateral is deemed supervisory best practice.
Procedures	• The **management body** should be responsible for ensuring that the bank has appropriate credit risk practices. Moreover, banks should adopt **sound methodologies**[1]. Regarding write-offs, they should have an **internal policy** approved by the management body. • Banks should comply with certain **documentation requirements** specified in the guidance. • Banks should have **databases** compliant with certain **requirements** (e.g. accuracy, integrity, etc.).
Supervisory reporting and disclosure	• Upon request by supervisors, banks should, at a minimum, be able to provide them with data regarding the models they use to **calculate impairment provisions for NPLs** and the **interest accrued on NPEs**[2]. • Moreover, banks are expected to disclose a set of **quantitative and qualitative disclosures**.

(1) The document provides guidelines and supervisory expectations concerning those methodologies (e.g. backtesting of their loss rates every 6 months).
(2) The reporting templates are included in Annex 2.

Collateral valuation for immovable property (1/2)

Finally, the guidance defines the supervisory expectations on policies and procedures that banks should adopt when calculating the valuation of immovable properties collateral for NPLs…

Governance, procedures and controls[1]

- Banks **should have written policies and procedures** in place, approved by the management body, governing the valuation of immovable property collateral for NPLs. These policies:
  - Should have **defined owners** with responsibility for reviewing them.
  - Should be **reviewed** at least on an **annual basis**.
  - Should be fully **aligned** with the **risk appetite statement (RAS).**
- Banks are expected to **monitor and review the valuations** performed by appraisers on a regular basis. Moreover, they are expected to develop and implement a **robust and independent control procedure** for appraiser selection process, sample reviews and backtesting valuations, according to a set of principles.
- Additionally, the **internal audit department** should regularly review the valuation policies and procedures, the independence of the appraiser selection process and the appropriateness of the valuations.
- All valuations should be performed by **qualified independent appraisers**[2], internal or external.
- In the collateral valuation for immovable properties, two methods are set out: i) **individual valuation**, performed by individual appraisers on a specific immovable property; and ii) **indexed valuation**, consisting on automated valuation processes for NPLs < 300.000€ (gross value).

Valuation frequency

- The valuation of collateral of all exposures should be updated periodically, at a minimum:
  - **Every year** for commercial immovable properties.
  - **Every 3 years** for residential immovable properties.
- The valuation of immovable properties for NPLs should be **updated on an individual basis** at the time the loan is classified as a **NPE** and at least **annually** while it continues to be classified as such.
- Furthermore, banks should carry out **more frequent valuations** where the market is subject to significant negative changes and/or where there are signs of significant decline in the value of the individual collateral. In this regard, banks should **define criteria in their collateral valuation policies** for determining that a significant decline in collateral value has taken place (e.g. quantitative thresholds for each type of collateral).

(1) The expectations in this section regarding policies, monitoring and controls, relate to collateral securing NPLs. Nonetheless, supervisors should consider these as best practices for performing exposures.
(2) The ECB establishes certain requirements regarding independence and qualifications.

Detail

Collateral valuation for immovable property (2/2)

…including expectations on valuation methodology, valuation of foreclosed assets and disclosure

Valuation methodology

- Banks should have defined collateral valuation approaches per collateral product type. Immovable property collateral should be valued on the basis of **market value** (and not on the discounted replacement cost).
- Banks should have **databases** of transactions to enable the proper assessment and monitoring of credit risk and the preparation of reports, subject to certain expectations[1].

Individual estimations of allowances

- It can be carried out by **discounting future cash flows** using two broad approaches:
  - '**Going concern scenario**': the operating cash flows of the debtor can be used to repay the financial debt an collateral may be exercised to the extent it does not influence operating cash flows.
  - '**Gone concern scenario**': the collateral is exercised (operating cash flows ceased), applying the appropriate liquidation costs and market price discount to the open market value (OMV) under certain sale conditions[1], and taking into account time-to-sale considerations and maintenance costs.
- Guidance is provided regarding **documentation** on how the recoverable amount of the exposure has been determined once the collateral is exercised (e.g. how to calculate the value, selling costs, etc.).

Backtesting

- Banks should **regularly backtest their valuation history** (last valuation before the object was classified as a NPL) vs. their **sales history** (net sales price of collateral). The results should be used to determine **discounts** on collateral valuations, supporting exposures remaining on the balance sheet.

Foreclosed assets valuation

- Banks are encouraged to classify foreclosed real estate assets as non-current assets held for sale **under IFRS 5** (and discouraged from applying IAS 40).
- Foreclosed assets should be valued at the **lower** of the: i) amount of the financial assets applied treating the asset foreclosed as collateral or; ii) the fair value of the repossessed asset, less selling costs. The inability to sell the foreclosed assets should be reflected in **appropriate liquidity discounts**.

Disclosure

- As part of their disclosures, banks should provide information on **collateral and guarantees held** against performing exposures and NPEs, **foreclosed assets values**, etc.

(1) E.g. depth and breadth; accuracy, integrity, reliability and timeliness of data; etc.
(2) Banks should apply the discounts at market price according to IAS 39 or IFRS 9, applying a minimum discount of 10% when collateral is sold by auction.

Index

Next steps

The guidance clarifies that it is applicable as of its date of publication. Nonetheless, the expected enhanced disclosures on NPLs should start from 2018 reference dates

Next steps

- This guidance should be applicable as of its **date of publication**. SIs may, however, close identified gaps thereafter based on **suitable time-bound action plans** which should be agreed with their respective JSTs.
- In order to ensure consistency and comparability, the expected enhanced **disclosures** on NPLs should start from **2018 reference dates**.
- The guidance works as a basis for the **supervisory dialogue with individual banks**. Thus, as part of its ongoing supervisory work, the ECB will review, benchmark and, as part of its annual SREP, ensure that banks have reacted appropriately.

Index

Annex 1
Main changes compared to the consultative document

The main points that have been changed or clarified as a result of the consultation relate to integration into SREP, implementation date, risk transfer of NPLs, targets within the NPL strategy, second line of defense, workout units…

Main changes compared to the consultative document

1 Integration into SREP

- Although this NPL guidance is currently non-binding in nature, it is taken into consideration in the SSM regular **Supervisory Review and Evaluation Process**, and non-compliance may trigger supervisory measures.

2 Implementation date

- This guidance should be **applicable as of its date of publication**. SIs may, however, close **identified gaps** thereafter based on suitable time-bound action plans which should be agreed with their respective JSTs.
- The expected enhanced disclosures on NPLs should start from **2018 reference dates**.

3 Risk transfer of NPLs

- More detail regarding **NPL risk transfers** is added (Annex 8 to ECB's guidance). Institutions wanting to engage in such transactions are expected to conduct **robust risk analysis** and to have adequate **risk control processes**.

4 Targets within the NPL strategy

- The targets that are to be included in the NPL strategy should be aligned with **more granular operational targets**.

5 Second line of defence

- The NPL strategy should be fully embedded in the **risk control framework** (in the consultative document the ECB referred to 'risk management framework').
- In this regard, the second-line function should have sufficient power to **intervene ex ante** on the implementation of **individual workout solutions** (including forbearance) or **provisions**.

6 Workout Units

- Though NPL WUs should be separated from loan origination units, a **regular feedback loop between both functions** should be established (e.g. to exchange the information needed for planning NPL inflows).
- Regarding the NPL life cycle, **unlikely-to-pay exposures** could be part of either early arrears or restructuring units, depending on the complexity.

Annex 1
Main changes compared to the consultative document

…forbearance, IFRS 9 and collateral valuation for immovable property

Main changes compared to the consultative document

7 Forbearance

- The **contractual terms** of any forbearance solution should ensure that the bank has the right to review the agreed forbearance measures if the situation of the borrower improves and more favourable conditions for the bank could therefore be enforced.
- A **new criterion** is introduced (additional to the two existing criteria) regarding the assessment of a borrower, that shall be also satisfied for a forborne exposure to be reclassified as normal (i.e. cure or exit from non-performing status). According to this criterion, the borrower should have:
  - Settled, by means of regular payments, an amount equivalent to all those previously past due (if there were past-due amounts at the date the forbearance measures were granted); or
  - Settled a total equal to the amount written off as part of the forbearance measures (if there was no past-due amount), or
  - Demonstrated its ability to comply with the postforbearance conditions.
- It is stated that credit institutions should have in place **policies** for the reclassification of non-performing forborne exposures **specifying practices for dispelling concerns regarding** the borrower's ability to comply with the post-forbearance conditions.

8 IFRS 9

- The ECB clarifies that it is expected that as of the **date IFRS9 comes into force at least all Stage 3 exposures** will fall into the **scope of this NPL guidance**.

9 Collateral valuation for immovable property

- The ECB clarifies that collateral valuation expectations regarding governance, monitoring and control **only apply to non-performing loans**, not to performing exposures (although supervisors would also consider these sections to represent best practice for performing exposures).
- For the purpose of recognition and reversal of impairment losses, banks should develop internal policies that clearly define the main methodologies and assumptions used to determine both the **fair value of foreclosed assets and the cost of selling** them.

Annex 2
Reporting and disclosure templates

The standardized template[1] on the NPL strategy that significant institutions should report to the JSTs is provided below

NPL strategy – Reporting

Example/extract of NPE and foreclosed asset strategy template[65]:

Credit Institution:		Actual	Projections					
xxxx								
Operational TARGETS and KPIs		2016	2017 1H	2017	2018	2019	2020	2021
Line								
PART A: Stocks & Flows								
1	NPE Volume (Gross)							
2	of which: Past due > 90 days							
3	of which unlikely to pay							
4	NPE Volume (Net)							
5	of which: Past due > 90 days							
6	of which unlikely to pay							
7	Total loans (Gross)							
8=1/7	NPE Ratio							
9=2/7	90 dpd ratio							
10=3/7	unlikely to pay ratio							
11=12+19	NPE Flows (Gross)							
12=13+16	NPE transitions (+/-)							
13=14+15	From performing to non-performing(+)							
14	of which: from non-forborne performing to NPE							
15	of which: from forborne performing to NPE							
16=17+18	From non-performing to performing(-)							
17	of which: from NPE to non-forborne performing							
18	of which: from NPE to forborne performing							
19=20+29	NPE reduction/increase							
20=21+22+23+24+25+26+27+28	Sources of NPE balance sheetreductions (-)							
21	Cash recoveries							
22	Sales of NPEs (Gross)							
23	Write-offs							
24	Collateral liquidations (cash)							
25	Foreclosure							
26	Debt to equity swaps							
27	Significant risk transfer							
28	Other adjustments							
29=30+31+32	Other sources of NPE increase (+)							
30	Purchase of loans							
31	Additional disbursements to customers with NPE							
32	Arrears capitalisation							
33=34+37+38+39	Cash recoveries from NPEs							
34=35+36	Cash recoveries from collections of NPEs							
35	of which:principal amount							
36	of which:interest amount							
37	Cash recoveries from liquidations of NPEs							
38	Cash recoveries from sales of NPEs							
39	Other cash collections							
40=41+42+43	Loss budget							
41	Envisaged use of impairment allowance							
42	Envisaged use of capital (amount not covered by impairment allowance)							
43	Associated tax impact							
44	Estimated CET1 amount impact from implementation of NPE strategy							
45	Estimated RWA impact from implementation of NPE strategy							
46=47+48	Forborne exposures (Gross)							
47	of which: Forborne non-performing exposures							
48	of which: Forborne performing exposures							
56	NPE (gross) where an independent servicer has been contracted							
57	Total denounced loans (gross)							
58	Denounced loans for which legal action has been initiated (gross)							

(1) The templates included in these Annex are example templates. Banks will receive the actual template(s) from their JSTs, which will probably incorporate additional tables.

Annex 2
Reporting and disclosure templates

Regarding forbearance, the ECB provides a disclosure template…

Forbearance (1/2) – Disclosure

Table 5
Public disclosure example tables for forbearance

a. Credit quality of forborne exposures

	All forborne exposures (million €)					Impairment, provisions and value adjustments				Collateral and financial guarantees received on forborne exposures
						Performing forborne exposures		Non-performing forborne exposures		
		of which: performing past-due	of which non-performing	of which: impaired	of which: defaulted		of which: value adjustments		of which: value adjustments	
Debt securities (including at amortised cost and fair value)										
Central banks										
General governments										
Credit institutions										
Other financial corporations										
Non-financial corporations										
Loans and advances (including at amortised cost and fair value)										
Central banks										
General governments										
Credit institutions										
Other financial corporations										
Non-financial corporations (consider breakdown)										
Households (consider breakdown)										
DEBT INSTRUMENTS other than HFT										
LOAN COMMITMENTS GIVEN										
TOTAL EXPOSURES WITH FORBEARANCE MEASURES										

b. Quality of forbearance

	Forborne exposures (million €)
Having been forborne more than once	
Having been forborne more than twice	
Having re-defaulted in the past 12 months	

c. Forborne exposures by credit category

	< 3 months	3-6 months	6-12 months	> 12 months
TOTAL EXPOSURES WITH FORBEARANCE MEASURES				
of which: performing exposures				
of which: non-performing exposures				

d. NPV impact of exposures forborne in the past 6/12/24 months

	Past 6 months	Past 12 months	Past 24 months
Net present value of original contract cash flows			
Net present value of forborne contract cash flows			
Description of discounting approach applied by the bank			

Annex 2
Reporting and disclosure templates

…and also a template on the use of different types of forbearance options that should be used for supervisory reporting

Forbearance (2/2) – Reporting

Table 6
Additional supervisory reporting on the use of different types of forbearance options

For forbearance options multiple options can apply for a single exposure and amounts should be included for each relevant option; thus "Total" is not expected to be the sum of all options granted

		Year t		Year t-1	
		All forborne exposures (million €)		All forborne exposures (million €)	
			of which non-performing		of which non-performing
Short-term options granted					
of which	Interest only				
	Reduced payments				
	Grace period/payment moratorium				
	Arrears/interest capitalisation				
	Other (providing detail if significant)				
Long-term options granted					
of which	Interest rate reduction				
	Term extension				
	Additional security				
	Rescheduled payments				
	Debt forgiveness				
	Voluntary sale				
	Other (providing detail if significant)				
Total					

Annex 2
Reporting and disclosure templates

Regarding NPL measurement, significant institutions should report to the ECB information on the models they use to calculate impairment provisions for NPLs (table 7) and on the interest accrued on NPEs (table 8)

NPL – Reporting

Table 7
Supervisory reporting on the estimation of allowances on a collective basis

A. Portfolio		B. Segment	C. LGD				D. Cure rate				E. NPE exposure at default
A.1 Sector of the counter-party	A.2 Residence of the counter-party		C.1 Rate in %	C.2 Calibration period	C.3 Adj. for current conditions	C.4 Alt. approach applied	D.1 Rate in %	D.2 Calibration period	D.3 Adj. for current conditions	D.4 Alt. approach applied	

Table 8
Supervisory reporting on interest accrued on NPEs

€m	Original effective interest income in Profit & Loss (before impairment)	Accrued effective interest income after consideration of impairment and unwinding	Cash collected (only interest-related)
Total loans			
Performing loans			
Specifically/individually assessed NPLs, of which			
- impaired			
- not impaired			
- forborne			
Restructured unimpaired NPLs			
≤90 dpd			
>90 dpd			
Non-restructured unimpaired NPLs			
≤90 dpd			
>90 dpd			
Collectively assessed NPLs			
Impaired NPLs			
Unimpaired NPLs			
Restructured unimpaired NPLs			
≤90 dpd			
>90 dpd			
Non-restructured unimpaired NPLs			
≤90 dpd			
>90 dpd			

Management Solutions
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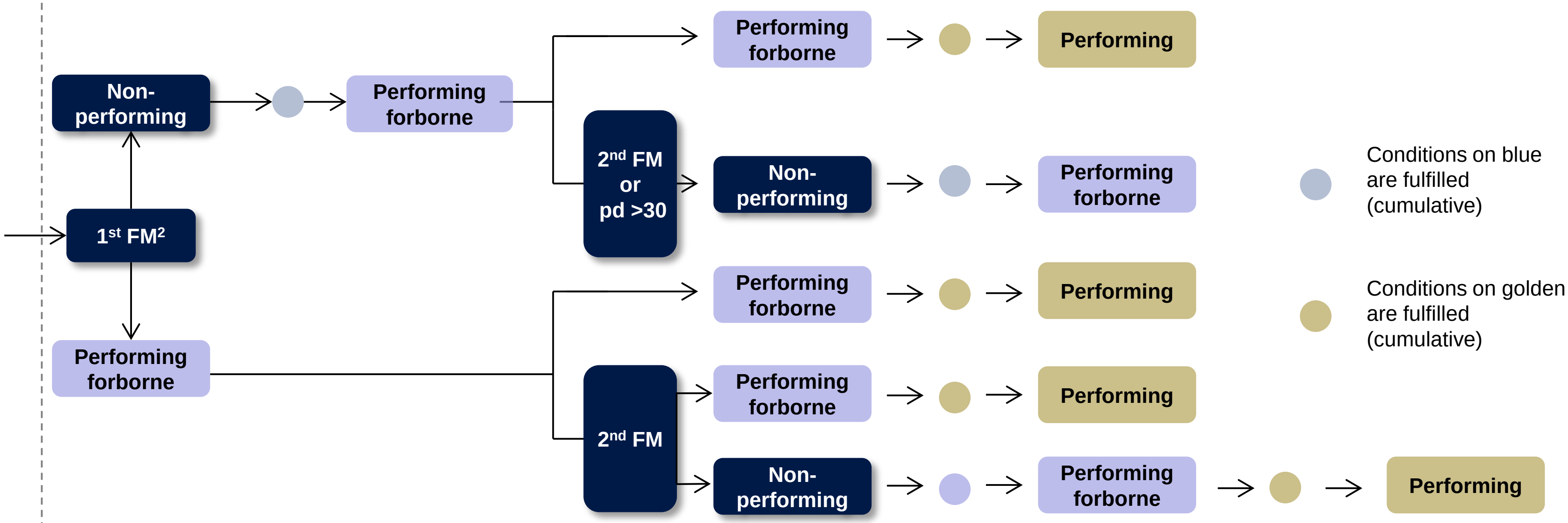
Annex 3
NPE relation with exposures with forbearance measures

Annex V of EBA ITS on supervisory reporting sets out the NPE treatment of forborne exposures

NPE relation with forbearance

Overview of the link between NPE and forborne exposures[1]



- 1 year since forbearance measures
- No past-due amounts following forbearance measures
- Payment of amounts previously past-due or written-off
- No other exposures are non-performing (when non-performing status assessed on a debtor basis)

- 2 years probation period since performing status
- Regular payments of more than an insignificant aggregate amount of interest and principal over at least 1 year
- No other exposure past due > 30 days

(1) According to Annex V of ITS 680/2014 published by the EBA.
(2) Forbearance measure.