Draft guidance to banks on non-performing loans (NPLs)

European Central Bank

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In September 2016 the ECB launched a public consultation on guidance to banks regarding non-performing loans (NPLs), providing recommendations and a collection of best practices that will constitute ECB's supervisory expectations from now on

Introduction

A number of banks in Member States across the Euro area are currently experiencing high levels of non-performing loans (NPLs) 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.

In this context, **in September 2016** the ECB launched a **public consultation on guidance to banks on NPLs** 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, refinancing and restructuring (forbearance), NPLs recognition, NPLs impairment measurement and write-offs, and collateral valuation of 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. Furthermore, this guidance does not intend to substitute or supersede any applicable regulatory or accounting requirement or guidance from existing binding regulations.

This technical note includes an analysis of the main content of this guidance[1].

(1) Along with this guidance, the ECB published a stocktake of national practices on NPLs. However, this stocktake is not analysed in this document.

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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

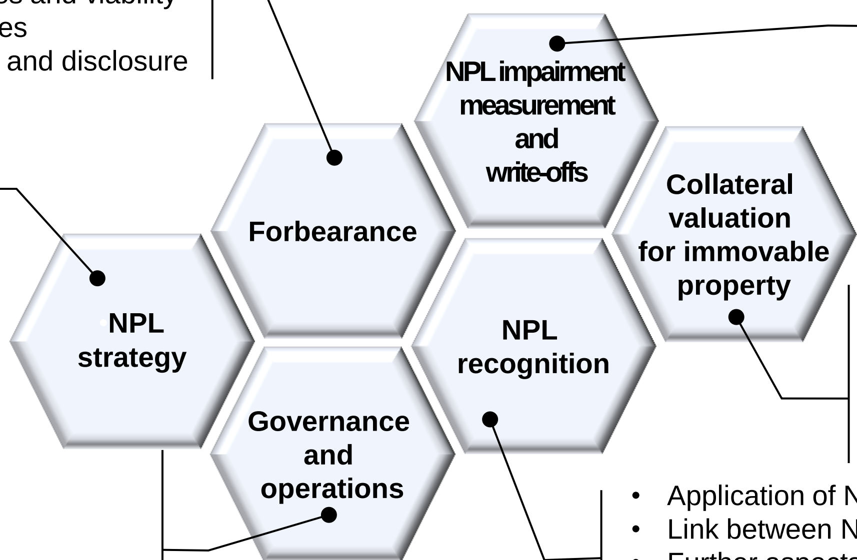
Executive summary

Applicability of the guidance

- Addressed to all **significant institutions (SIs)** supervised directly by the ECB[1].
- **Non-binding instrument**; however, **deviations** should be **explained** upon supervisory request.

Scope of the guidance

- The guidance addresses all **non-performing exposures** (NPE), following the EBA's definition; **foreclosed assets**; and performing exposures with an **elevated risk of turning non-performing**.



Forbearance:
- Forbearance measures and viability
- Forbearance processes
- Supervisory reporting and disclosure

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

NPL strategy:
- Operating environment
- Strategy development
- Operating plan
- Embedding the NPL strategy
- Supervisory reporting

Collateral valuation for immovable property:
- Governance, procedures and controls
- Frequency and methodology of valuations
- Valuation of foreclosed assets
- Disclosure

Governance and operations:
- Decision-making
- NPL operational model
- Control framework
- NPL monitoring
- Early warning systems
- Supervisory reporting

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

(1) Including international subsidiaries.

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In the first place, 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

NPL strategy

Assessing the operating environment

- When defining their NPL strategy, banks should evaluate the following elements:
  - Their **internal capabilities** to reduce NPLs. To this end, banks should analyse, among others, the size and evolution of NPL portfolios, the outcomes of NPL actions, and the operational capacities (processes, tools, etc.), performing a thorough self-assessment to determine strengths, gaps and areas of improvement.
  - **External conditions** (e.g. macroeconomic conditions, market expectations, NPL investors demand, legal framework, tax implications, etc.).
  - **Capital projections and implications**, considered along with the RAF and ICAAP frameworks (e.g. banks with high NPL levels should include capital planning actions to clean-up NPLs).

Strategy development

- The NPL strategy, including the operational plan, should be **approved by the management body** and **annually reviewed**. Its development requires the analysis of the following elements:

Strategy implementation options

- Banks should consider the range of NPL strategy implementation options available (e.g. hold/forbearance, active portfolio reduction through sales), and **combinations** of strategies/options, as well as the **financial impact** of the options.

Strategic targets

- They should be established along the following dimensions:
  - **Time horizons**: short-term (1 year), medium-term (3 years) and long-term.
  - **Main portfolios** (e.g. retail mortgage, SME corporate, etc.): quantitative targets by portfolio would be set, including targets for NPL exposure reduction, both gross and net of provisions.
  - **Selected implementation option** (e.g. cash recoveries, collateral repossessions, etc.).

Operational plan

- The NPL strategy should be supported by an operational plan approved by the management body over a time horizon of at least 1 to 3 years. This plan should define how the bank will operationally implement (from an operational point of view) the **NPL strategy** and the measures, tools and requirements for its fulfilment.

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 provisions regarding supervisory reporting

NPL strategy

Implementing the operational plan

- For an appropriate implementation, banks should:
  - Rely on **suitable policies**, clear ownership and suitable governance structures.
  - Report any **deviation** to the management body and put in place **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). For an appropriate strategy integration, banks should, among other aspects:
  - Align it with **performance management/incentives**.
  - Integrate it into the **business plan and budget**, as well as into the **risk management framework**. Special attention should be paid to the ICAAP (all relevant components of the NPL strategy should be fully aligned), the RAF (there should be RAF metrics approved by the management body which are in alignment with NPL strategy), and on the recovery plan.

Supervisory reporting

- Banks should report their NPL strategy and their operational plan to their Joint Supervisory Teams (**JST**) in the **first quarter** of each calendar year.
- To facilitate comparison by JTS, the ECB has provided **templates** for an appropriate disclosure of quantitative targets and the level of progress made in the past 12 months against the plan.

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 operational model…

Governance and operations

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

- Banks should establish separate and dedicated **NPL workout units** (WUs), establishing different NPL WUs for different phases of the NPL life cycle, allocating specific tasks for each phase:
  - ensuring a **sufficient mitigation of potential conflicts of interest** and an appropriate **internal control** framework;
  - establishing **triggers** for each phase of the life cycle; and
  - adapting the processes to each type of portfolio, applying **industrialised processes** for retail portfolios and a relationship management with a **strong sectorial specialisation of NPL WU staff** for corporate portfolios.
- Regarding **portfolio segmentation**, banks should develop appropriate management information (MI) systems and a sufficiently high data quality, considering the principle of proportionality. A list of potential segmentation criteria for retail NPL portfolios is included in an annex to the ECB's guidance.
- With regard to **human resources**, resources with dedicated NPL expertise and experience should be hired for key NPL workout tasks.
- Regarding **technical resources**, banks should ensure 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.

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

Governance and operations

Control framework	• Banks should implement effective control processes for all **three lines of defence**: • **First line**: establishing internal policies on the NPL workout framework and a strong embeddedness of those policies in daily processes, incorporating them into IT procedures. • **Second line**: monitoring and quantification of NPL-related risks, reviewing the performance of the overall NPL operating model, assuring quality throughout NPL loan processing, and reviewing alignment with internal policy/public guidance. Second-line functions require a strong degree of independence (including NPL WUs). • **Third line**: the internal audit should be totally independent of functions performing business activities and, for high NPL banks, needs to have sufficient NPL workout expertise.
NPL monitoring	• **NPL-related KPIs** should be established grouped into **5 categories**: high-level NPL metrics (e.g. NPL ratio and coverage), costumer engagement and cash collection (relative efficiency vs benchmark), forbearance activities (efficiency and effectiveness of activities), liquidation activities (e.g. volumes and recovery rates of legal and foreclosure cases) and others (e.g. P&L items, foreclosed assets, early warning indicators, outsourcing activities[1]).
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[2].
Supervisory reporting	• **Notable 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) There is a list of NPL monitoring metrics in an annex to the ECB's guidance.
(2) There are some examples of early warning indicators in an annex to the ECB's guidance.

The ECB also provides guidance on the viability of forbearance measures, on processes for those exposures…

Forbearance[1]

Forbearance measures 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 is to ensure 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) a transitional solution is established (2 years maximum) and the bank is able to attest that the borrower demonstrates the ability to repay the principal and the interests of the loan; and (iii) no other short-term forbearance measures have been applied to the same exposure.

Forbearance processes

- Before granting any forbearance measures, banks should **analyse** the following **aspects of the borrower**[2].

Borrower affordability

- Banks should **assess** the borrower's regular/recurring income, expenditure, other assets, other debt, reasonable living expenses, employment prospects, willingness to repay and cooperativeness, etc.
- For the comprehensive and verified disclosure of the borrower's financial position in order to analyse exposure, 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.

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

…and on information regarding forborne measures that banks should report to the supervisor and disclose to the market

Forbearance

Standardised products and decision trees

- Banks should consider developing "**decision trees**" **and related standardised forbearance solutions** (or "products") 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 workout options** (e.g. legal options).
- In order to determine the most suitable workout option, banks should use a **Net Present Value (NPV)** approach as well as certain parameters (e.g. liquidation time horizon, discount rate, etc.).

Forbearance milestones and monitoring

- Banks should **establish forbearance milestones and monitoring** in order to ensure that the borrower repay the loan over the course of the contract term. The monitoring should be made at least for the duration of the EBA-defined probation period.

Supervisory reporting and disclosure

- As a part of the CRR **disclosure requirements**, banks should provide quantitative information on:
  - **Credit quality** of **forborne exposures** (including classification, amount of impairment, collateral and guarantees).
  - **Quality of forbearance** (e.g. redefault rates).
  - **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.
- The ECB provides a **template** for both disclosure and reporting.

The guidance establishes that banks should apply the definition of NPE issued by the EBA, and includes provisions on the link between NPE and forborne exposures

NPL recognition

Application of NPE definition

- Banks are strongly encouraged to use the NPE definition issued by the EBA, under which NPE 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). When setting out the list of UTP events, banks should consider certain provisions of the guidance (e.g. the ECB provides a mapping of UTP events).

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 consist of concessions extended 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 performing or non-performing:

Classification as NPE at the concession date

- 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 threshold may be used to determine the materiality of an exposure.
(2) Annex V of ITS 680/2014 on supervisory reporting. See annex for more detail.

Furthermore, the guidance include further aspects of the NPE definition, such as the pulling effect, the alignment of the NPE definition with the regulatory definition of default and the accounting definition of impaired; and includes disclosure requirements

NPL recognition

Cure/exit from NPE status

- To reclassify a non-performing forborne exposure as performing, it should fulfil the **general requirements** for reclassifying exposures from non-performing to performing as well as **specific requirements** applicable to forborne exposures (i.e. **cure period of 1 year** and the debtor's behaviour demonstrates that **financial difficulties no longer exists**).
- To dispel concerns regarding financial difficulties, some conditions should be met (e.g. the exposure is not considered as impaired or defaulted under the regulatory and accounting definitions). The policies should specify practices for **dispelling concerns regarding the financial difficulties of the debtor** (including minimum thresholds).

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

- **Further aspects** related to the definition of NPE are included, such as:
  - The **pulling effect** is set at **20%**.
  - 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

- Banks should **align the NPE definition** with the regulatory definition in the CRR (**default**) and with the accounting definition of IFRS (**impairment**). To this end, the ECB provides tables with the main gaps between definitions and examples of how to align these definitions.

Disclosure

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

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

NPL impairment measurement and write-offs

Individual estimation of provisions

- Banks should define the criteria to identify exposures subject to **individual estimation of loss allowances**, 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 allowances** can be done using a "going concern" or a "gone concern" scenario[2]. Guidance on how estimates 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** is responsible for ensuring that the bank has appropriate methods and procedures for estimating allowances on a collective basis, which must be integrated in the **credit risk management system**. Furthermore, robust policies and procedures should be in place to **validate the accuracy and consistency** of the collective allowance estimations on an on-going basis (the expectation is that banks will **backtest** the allowance 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, industry/market segment, etc.).
- Estimation should be based on **historical loss experience** for assets with similar credit risk characteristics, although it should be adjusted on the basis of **current observable data**.
- **Other provisions** related to the collective estimation of allowances 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.

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

NPL impairment measurement and write-offs

Other aspects related to impairment	• A sophisticated approach for estimating allowances 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.
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**[1] 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** is responsible for ensuring that the bank has appropriate credit risk practices. Furthermore, banks should adopt **sound methodologies**[2] for estimating allowances. 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 must have **databases** complying with certain **requirements** (e.g. accuracy, integrity, reliability, consistency, traceability, 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 allowance for NPLs**. • The guidance details some quantitative and qualitative **disclosures** (specific **templates** are provided).

(1) Empirical evidence and conservatism should be applied when calibrating these periods.
(2) The guidance detail guidelines and supervisory expectations concerning those sound methodologies (e.g. backtesting of their loss rates every 6 months).

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

Collateral valuation for immovable property

Governance, procedures and controls

- Banks **must have written policies and procedures** in place governing the valuation of immovable property collateral, which should be fully aligned with the risk appetite statement **(RAS)**. Moreover, they should have defined **owners with responsibility** for reviewing, at least annually, material changes on valuation and ensuring that these changes are submitted to the management body for approval.
- Banks are required 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.
- In the collateral valuation for immovable properties, two methods are set out:
  - **Individual valuation**[1]: performed by individual appraisers on a specific immovable property
  - **Indexed valuation**[1]: automated valuation processes for NPL < 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 and;
  - Every **three 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) For loans exceeding EUR 3 million or 5 % of the own funds of a bank, the property valuation shall be reviewed by such appraiser at least every three years.

… and includes provisions on valuation methodology, valuation of foreclosed assets and disclosure

Collateral valuation for immovable property

Valuation methodology

- All immovable property collateral should be valued on the basis of **market value** instead of on the discounted replacement cost.

Individual estimations of allowances

- It can be carried out by **discounting future cash flows** under:
  - '**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.

Foreclosed assets valuation

- Banks are encouraged to classify foreclosed real estate assets as noncurrent assets held for sale **under IFRS 5**.
- They 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

- Banks should provide information on **collateral and guarantees held** against performing and non-performing exposures, a breakdown for the most relevant collateralised NPE portfolios, etc.

(1) 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.

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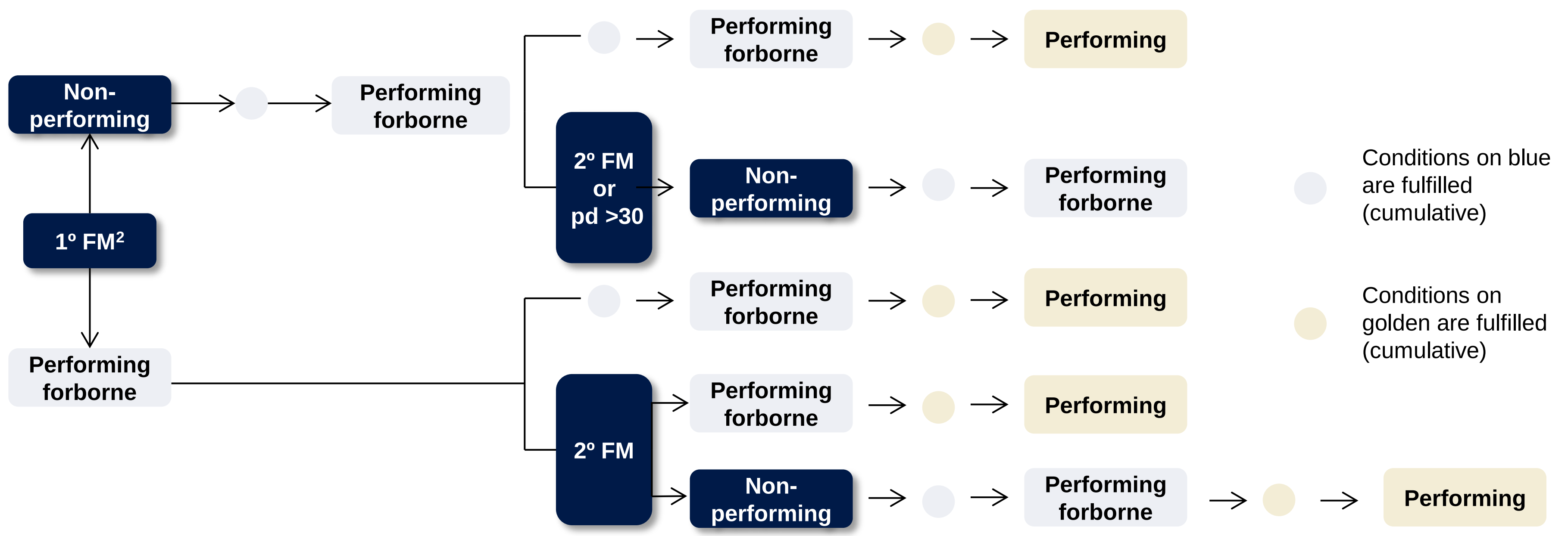
Annex
NPE relation with exposures with forbearance measures

Annex V of EBA ITS on supervisory reporting sets 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/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.