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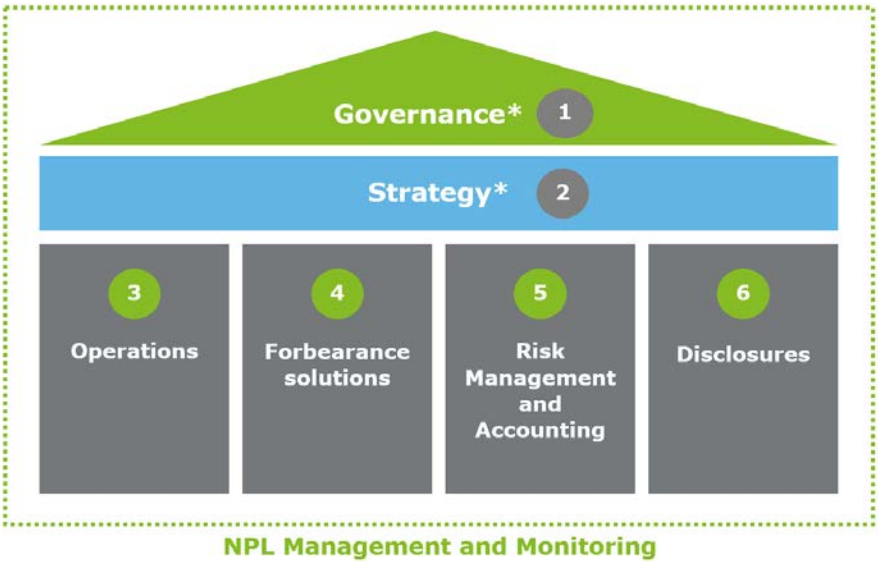
Regulatory News Alert

ECB final guidance on non-performing loans

6 April 2017

On 20 March, the European Central Bank published its final guidance on non-performing loans (NPLs), setting out expectations in relation to strategy, governance, and operations. These rules are not binding, but they aim to provide EU banks with best practices regarding NPL management and monitoring. The guidance will be considered for the day-to-day ECB supervisory dialogue with the significant institutions. Some requirements are more relevant for banks with a high level of NPLs, but they might be also considered for a sound monitoring by all institutions.

It can be expected that the national competent authorities—the CSSF in Luxembourg—will take this guidance into consideration for the supervision of less significant institutions.



* More relevant for banks with high levels of NPLs

Banks are expected to fully comply and in a manner proportional with the size and severity of their NPL portfolios. Banks with elevated levels of NPLs will receive supervisory letters “in the near future” with further details and qualitative elements.

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1. Governance

To address NPL issues, financial institutions are required to set up an appropriate governance structure. The management body should, among other things:

- Oversee the implementation of the NPL strategy
- Define objectives (including a sufficient number of quantitative ones) and incentives for NPL workout activities
- Periodically (at least quarterly) monitor progress made in comparison with the targets and milestones defined in the NPL strategy
- Define adequate approval processes for NPL workout decisions
- Ensure sufficient internal controls over NPL management processes (with a special focus on activities linked to NPL classifications, provisioning, collateral valuations, and sustainability of forbearance solutions)

2. Strategy

Institutions with high levels of NPLs are required to implement “realistic and ambitious strategies” to effectively reduce their NPL portfolios. The ECB does not set any quantitative targets for NPL reduction, but stipulates that banks should set these targets and develop a detailed implementation plan, considering their operating environment.

To meet these objectives, banks should use a combination of strategies instead of a single one. The ECB is referring to a number of strategies:

- Hold/forbearance strategy
- Active portfolio reductions
- Change of exposure type
- Legal options

The choice between these different options will depend on the internal abilities, the external environment conditions (macroeconomic, NPL investor demand, tax implications, etc.) and the capital implications of the NPL strategy.

The NPL strategy of a high-NPL bank should be supported by an operational plan that should clearly define how the bank will operationally implement its NPL strategy over a time horizon of at least one to three years. This operating plan shall be approved by the management body.

3. Operations

High-NPL banks are expected to set up separate and dedicated workout units for the monitoring of NPLs. To avoid potential conflicts of interest, these workout units should be separated from units responsible for loans origination. The staff in charge of NPLs has to be sufficiently trained to deal with the issues related to each stage of the NPL lifecycle.

NPL workout units should be set up taking into account the full NPL life cycle:

- Early arrears (up to 90 days past due)
- Late arrears/Restructuring/forbearance
- Liquidation/debt recovery/legal cases/foreclosure

The ECB highlights that a suitable operating model is based on analyzing the bank's NPL portfolio with a high degree of granularity. For corporate NPL portfolios, for instance, segmentation by asset class or sector is likely to be a key driver for NPL workout unit specialization.

In addition, one of the key success factors for the successful implementation of any NPL strategy option is an adequate technical infrastructure. In this context, it is important that all NPL-related data is centrally stored in robust and secured IT systems.

4. Forbearance solutions

The supervisory expectation is that banks should implement well-defined forbearance policies aligned with the concept of viability and recognize those borrowers who are non-viable in a timely manner.

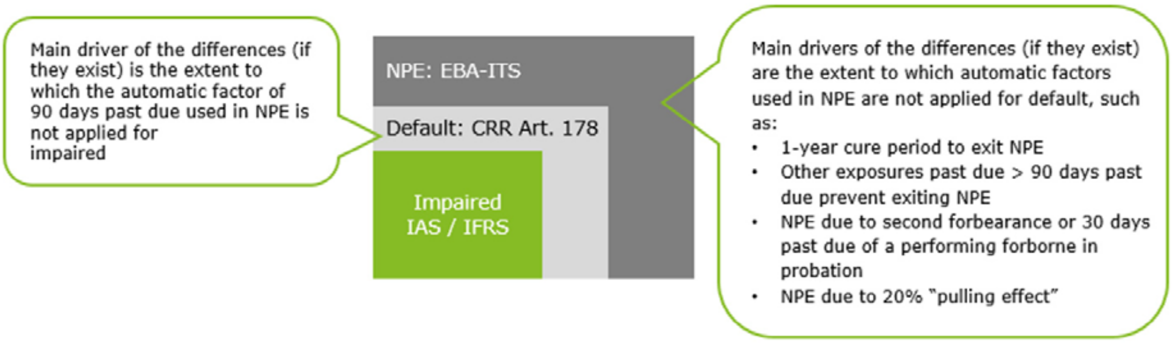
The guidance foresees conditions to consider forbearance solutions as viable:

- The institution can demonstrate based on reasonable documented financial information that the borrower can realistically afford the forbearance solution
- 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
- In cases where there have been previous forbearance solutions granted in respect of an exposure, the bank should ensure that additional internal controls are implemented to ensure this subsequent forbearance treatment meets the viability criteria (long-term forbearance measures)
- The solution does not result in multiple consecutive forbearance measures having been granted to the same exposure (short term forbearance measures)

The ECB guidance contains a non-exhaustive list of 14 common short-term and long-term forbearance measures. This list includes a brief description of their attributes and their viability considerations.

5. Accounting and Risk Management

The Non-Performing Exposures (NPE) definition provided by the European Banking Authority (EBA) in the context of the implementation of the Capital Requirement Regulation is, strictly speaking, currently only binding for supervisory reporting purposes. However, banks are strongly encouraged to use the NPE definition also in their internal risk control and public financial reporting.



The ECB highlights that its guidance does not intend to substitute or supersede any applicable regulatory or accounting requirement. It also provides details on forbearance solutions, measuring impairment, and write-offs in line with IFRS9, both on an individual and collective basis.

The guidance also provides best practices regarding the policies, procedures, and disclosures that banks should adopt when valuing immovable property held as collateral for NPLs.

6. Disclosures

In the aim of the financial markets transparency, banks are strongly encouraged to use the definitions of NPE and forbearance in their public financial statement or, if not, to publish a reconciliation between their own definitions of impaired and modified financial assets and the definitions in Annex V of Commission Implementing Regulation (EU) No 680/2014. This reconciliation should comprise both a conceptual explanation of the differences and quantitative information on the effects of these conceptual differences.

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