EBA Guidelines on non-performing and forborne exposures

Regulatory pressures mount on all EU banks to address their NPE issues

April 2018

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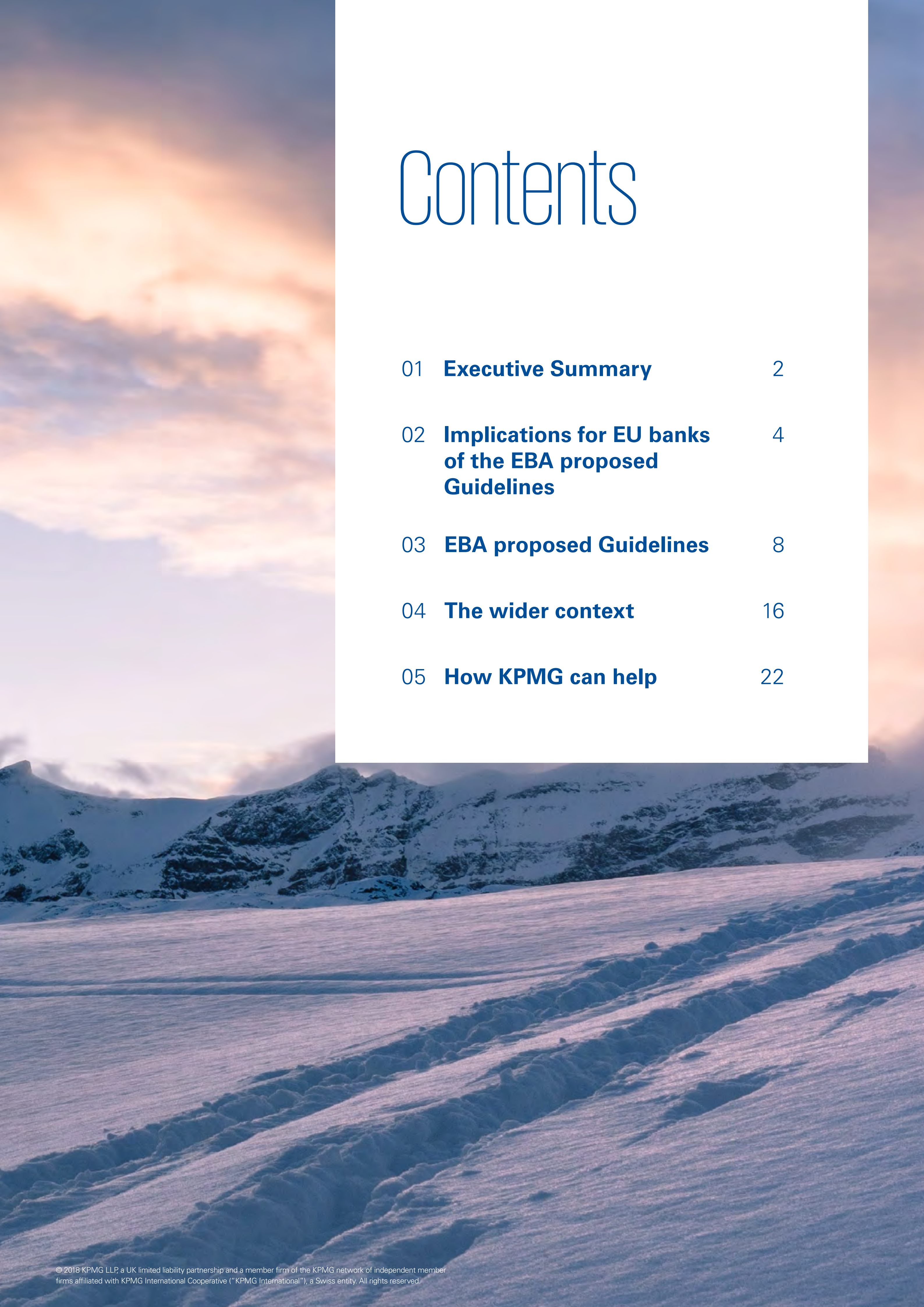

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Executive summary

> Banks should begin identifying now what they will need to do in order to meet the Guidelines.

The large legacy overhang of Non-Performing Exposures (NPEs) still remaining in the European Union (EU) is increasingly seen as a threat to the success of the Banking Union. Regulators have recently increased their interventions to speed up the banks' NPE risk deleveraging process.

In July 2017 the EU Council announced an Action Plan to tackle the issue, which included several initiatives to be implemented by the Commission and other EU authorities in a short timeframe (mostly by the end of 2018). The proposed Guidelines issued in March 2018 by the European Banking Authority (EBA) for the management of non-performing and forborne exposures (the Guidelines) contribute to this Action Plan.

This paper analyses the content of the EBA Guidelines and outlines what banks should do to prepare adequately for their implementation. The paper also details other recent NPE initiatives that are likely to have a substantial impact on EU banks.

The Guidelines specify sound risk management practices for managing non-performing exposures, forborne exposures and foreclosed assets.

The EBA aims to finalise the Guidelines during the summer of 2018 for implementation by 1 January 2019. KPMG experts do not expect significant amendments before they are finalised, so **banks should begin identifying now what they will need to do in order to meet the Guidelines**[1].

Banks with significant NPEs (indicative threshold of five percent Non-Performing Loan [NPL] ratio) will need to identify and address any gaps in their NPE strategy, governance and operations against the Guidelines.

All banks will need to identify and address any gaps in their policies and procedures relating to other parts of the Guidelines, including the governance and operations of NPE recognition, impairment measures and write-off procedures, policies and procedures for the valuation of movable or immovable property collateral for NPEs, and the governance and operations of forbearance measures and processes.

The Guidelines are very similar to the European Central Bank's (ECB) guidance to banks on non-performing loans that was finalised a year ago. Banks supervised directly by the ECB (118 significant institutions) will therefore already be familiar with the substance of the EBA's Guidelines. However, the Guidelines will apply to all (over 6,000) credit institutions (hereafter "banks") in the EU.

We discussed the ECB guidance in our previous publication on non-performing loans[2].

The EBA has already issued guidelines for banks on supervisory reporting and Pillar 3 public disclosures relating to NPEs, and consulted in December 2017 on templates (the EBA NPL Templates, for which KPMG member firms were advisers) for providing sound and complete information to potential investors. Although these reporting and disclosure requirements are outside the scope of the proposed Guidelines they are clearly also a key part of the overall set of requirements for banks.

KPMG member firms have developed a fully-fledged proposition on how banks can address NPEs, including a suite of tools designed to help banks at all stages of their management and/or deleveraging of NPEs.

1 http://www.eba.europa.eu/documents/10180/2150622/Consultation+Paper+on+Guidelines+on+management+of+non-performing+and+forborne+exposures+%28EBA-CP-2018-01%29.pdf

2 https://home.kpmg.com/xx/en/home/insights/2017/05/non-performing-loans-in-europe.html

02

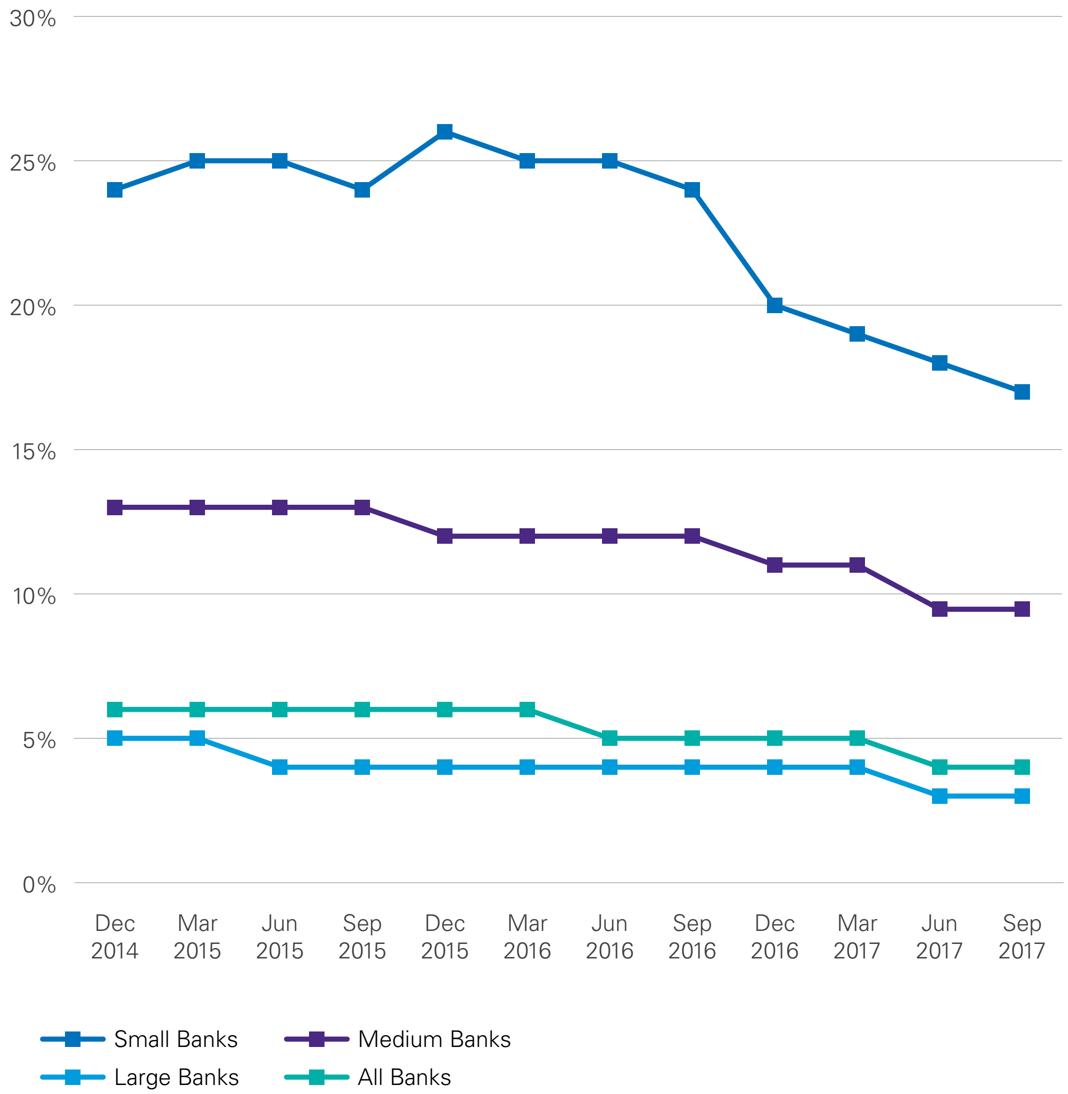
Implications of the EBA Guidelines for EU banks

> A significant portion of small and medium sized banks in the EU will be required to comply with the Guidelines in their entirety.

Some of the proposed Guidelines (namely Chapters four and five for the development and operation of an NPE strategy) will apply only to banks with significant portfolios of NPEs, while the other Guidelines will apply to all EU banks. The indicative threshold for 'significant' is set at a static NPL ratio of five percent. However, banks with high NPE levels in individual portfolios or geographic regions will also be requested to comply, independently of their overall NPL ratio. National supervisors will also have the discretion to deem other banks to have significant NPE exposures, for example in response to signs of deteriorating asset quality.

While the average NPL ratio in Europe was 4.2 percent at the end of Q3 2017, small and medium-sized banks have, on average, much higher NPL ratios (respectively 17.0 percent and 9.6 percent) than larger banks (3.1 percent). It is therefore expected that a significant portion of small and medium sized banks in the EU will be required to comply with the Guidelines in their entirety.

Ratio of NPLs to total assets



Source: EBA

What banks need to do

Banks with significant NPEs in their portfolios will need to:

Identify and address any gaps in their NPE strategy, and the governance and operations of this strategy, against the Guidelines;

Establish an adequate framework to identify, measure, manage, monitor and mitigate their NPEs; and

Assess the effectiveness of their strategies and operational arrangements to manage NPEs, including:

- Establishing and operating a clear plan to reduce NPEs
- Assessing the range of options for reducing their NPEs (outsourcing of workout function, joint ventures, structured credits and clean sales)
- The resources required in terms of people and skills, data and IT systems, organisational structure, and collateral valuations.

All banks will need to:

Identify and address any gaps in their policies and procedures relating to the Guidelines that apply to all banks. These include:

- The governance and operations of NPE recognition, impairment measures and write-off procedures
- Policies and procedures for the valuation of property collateral for NPEs
- Establishing and operating an early warning system to identify and tackle any potential or actual build-up of NPEs
- The governance and operations of forbearance measures and processes

Identify and put in place the people, data, IT, analytical and other systems, and documentation needed to support these policies and procedures;

Continue to focus on measures to reduce the flow of new NPEs, including pricing and credit underwriting processes;

Ensure they can meet the related EBA requirements on enhanced supervisory reporting and public disclosure requirements of NPEs; and

Identify interdependencies with current implementation projects (for example for IFRS 9, definitions of default, and risk data aggregation and reporting) and align these with the actions needed to ensure compliance with the Guidelines.

Application of the concept of proportionality

The Guidelines state that banks should "comply in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities." However, beyond this the concept of proportionality is loosely defined. There are three aspects of this:

1. National supervisors will have some discretion in determining which banks are deemed to have significant NPEs.
2. Some national supervisors may decide to apply parts of the Guidelines relating to NPE strategy and the operation of strategy to some banks that do not have significant NPEs.
3. National supervisors will have discretion to decide how far they craft the application of the Guidelines to take account of the size, nature and complexity of each bank.

It therefore remains unclear how exactly the Guidelines will be applied to each bank, and how intensively they will be applied to smaller banks. This is also likely to differ across EU member states.

The concept of proportionality and applicability is also relevant to the broader perspective of NPE portfolio concentrations in specific geographic regions, economic sectors or groups of connected clients. This brings additional nuances to how banks should perceive the potential impact of the Guidelines. Different measures might be required for different clusters of NPE risks. Banks should ensure they thoroughly understand their NPEs across all ranges of sub-portfolios and risks to avoid undue surprises and to prepare adequately.

The Guidelines also specify that banks must comply "on an individual, sub-consolidated and consolidated basis." Thus, the approach taken at the group level for a bank with an overall low level of NPEs may differ substantially from the approach taken at the level of any EU subsidiaries that have higher NPE levels.

> While these banks may be smaller and less complex, meeting the Guidelines will require skills and know-how which may be scarce within the bank itself or even within the country.

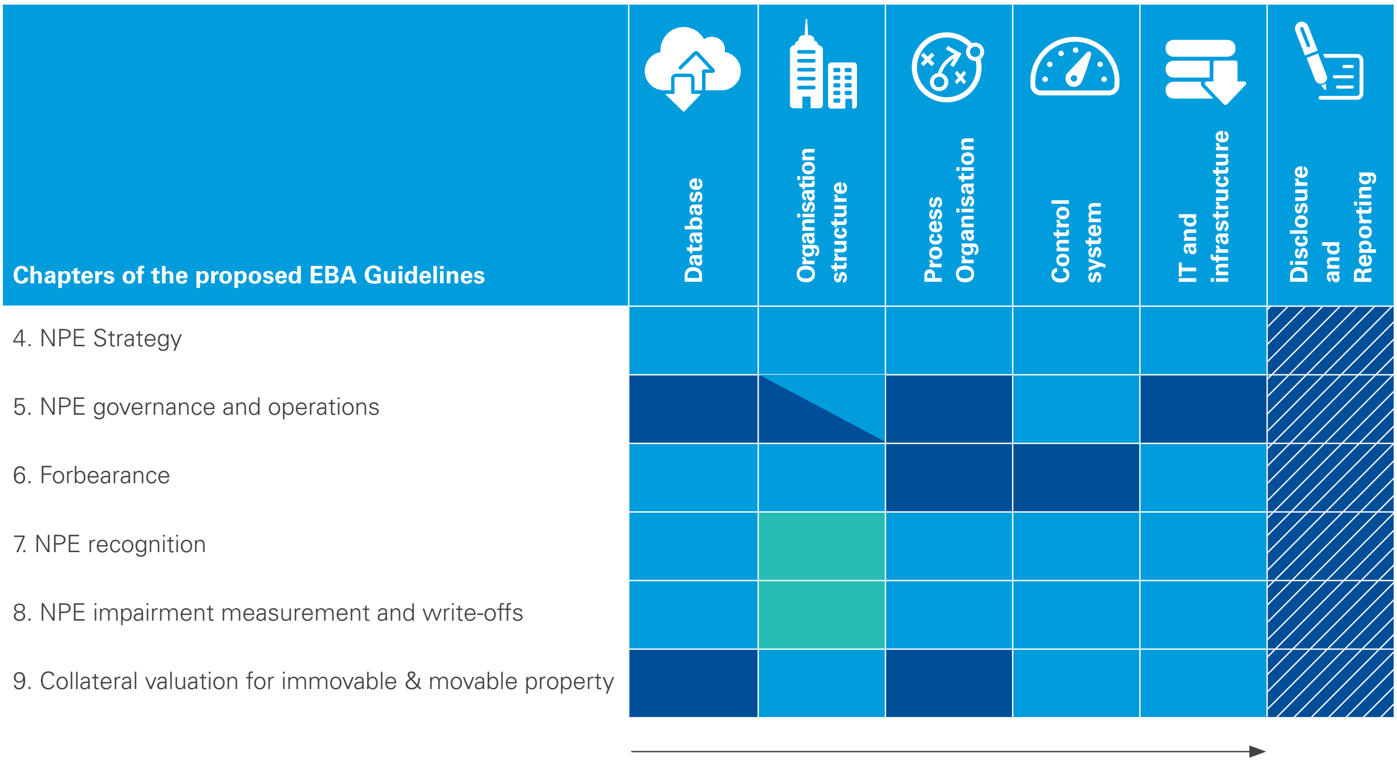
Potential challenges and impact areas

Significant institutions that are directly supervised by the ECB will already be familiar with the substance of the Guidelines as they mirror the existing ECB guidance on NPLs, and some of them will already be subject to supervisory pressure to reduce their NPEs.

However, the ECB guidance has proved to be (and remains) challenging for many of these ECB directly supervised banks, particularly when demonstrating that a bank's NPE strategy is robust, has been based on adequate and accurate data, and can be implemented effectively.

Smaller banks are likely to face similar challenges, and will potentially be more heavily impacted by the introduction of the Guidelines. While these banks may be smaller and less complex, meeting the Guidelines will require skills and know-how which may be scarce within the bank itself or even within the country. Moreover, it may simply not make operational (and financial) sense for smaller banks to meet all the Guidelines and this will have to be considered carefully by supervisors.

Indicative impact areas of the proposed EBA Guidelines



Key

Large impact | Moderate impact | Low impact

Not explicitly covered by the EBA Guidelines but expected to have high impacts across all areas.

Source: KPMG

03 EBA proposed Guidelines

> The Guidelines follow the "life cycle" of a bank's NPE management.

Scope

The Guidelines:

- Apply to all EU credit institutions;
- Apply to all exposures covered by the definitions of NPEs and forborne exposures - loans, advances, debt securities and off-balance sheet items;
- Apply chapters 4 and 5 (on a bank's strategy for reducing NPEs, and the governance and operations of that strategy) only to banks with significant NPEs (where the bank's NPL ratio is at or above 5 percent, or meet this threshold within a material specific portfolio, or where a national supervisor deems a bank's NPEs to be significant, for example because of signs of deteriorating asset quality);
- Refer in addition to the principle of proportionality, so banks should meet the Guidelines in a manner that is appropriate to their size, structure and the nature and complexity of their activities;
- Are intended to be implemented on 1 January 2019;
- Do not yet reflect the Commission's proposed 'statutory prudential backstop'.

Structure

The Guidelines:

- Follow the "life cycle" of a bank's NPE management: strategy; governance and operations; forbearance; NPE recognition; NPE provisioning and write-off; and collateral valuations;
- Build on the EBA's common definition of NPEs (more than 90 days past due or "unlikely to pay") and recognise the interlinkages with IFRS 9.

Focus

The Guidelines focus on a bank's strategy for reducing its NPEs; governance and operations of a NPE workout framework; internal control framework and NPE monitoring; early warning processes; and collateral valuation.

The emphasis throughout the Guidelines is on banks putting in place:

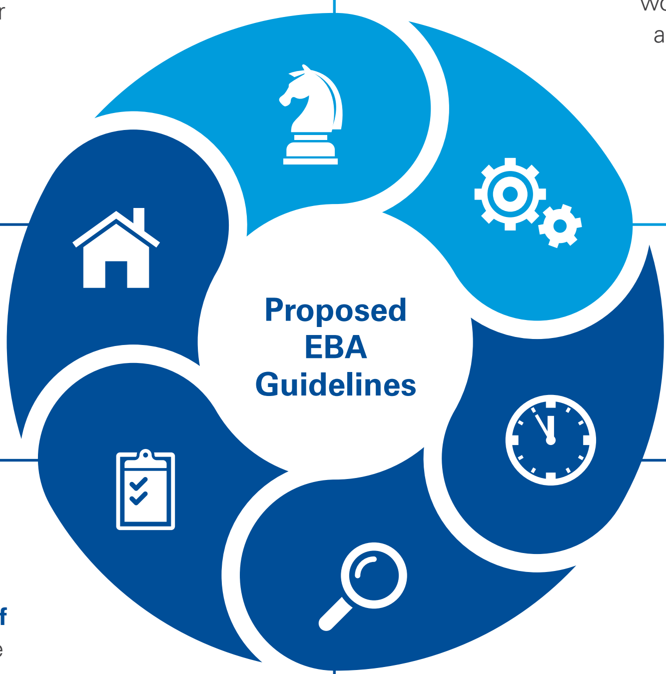
- Board level (unitary board or supervisory board in a dual board structure) oversight of NPE strategy and policies;
- Sufficient operational capacity at all levels and covering all three lines of defence:
  - Standard and documented operational policies and procedures
  - People and skills
  - Data and information – on which to base classification and provisioning decisions, develop early warning indicators, and monitor and report performance
  - IT systems and infrastructure for NPE management and monitoring - to capture and report data and to support the implementation of consistent policies
  - A portfolio-by-portfolio approach to the strategy and management of NPEs
  - Systems for supervisory reporting and public disclosure – the Guidelines do not explicitly cover public disclosure and reporting, but each bank should have processes and procedures in place to ensure proper reporting and disclosure, subject to the proportionality principle (size and complexity of the bank)
- Fair treatment of consumers at every stage of the loan life cycle (this is an important addition to the earlier ECB guidance, reflecting the EBA's mandate in this respect).

The EBA proposed Guidelines

NPE strategy
Banks with significant NPEs should establish clear targets for the reduction of NPEs over realistic but sufficiently ambitious time-bound horizons. These banks should lay out, for each relevant portfolio, a clear, credible and feasible NPE reduction plan covering the bank's approach and objectives.

NPE governance and operations
Banks with significant NPEs should have a governance structure and operational arrangements that enable the bank to address NPE issues efficiently and effectively, be it through sales, securitisation or workout. This should include the adequacy of decision-making, operating models, internal controls and monitoring.

Collateral valuation for immovable and movable property
Banks should assess the value of collateral frequently and adequately, in particular for real estate.



NPE impairment measurement and write-off
Banks should have adequate and consistent procedures for identifying the need for provisions and for making adequate provisions, within existing accounting frameworks.

NPE recognition
Banks should use the EBA definition of an NPE in their internal risk management and for their public disclosures, not just for their supervisory reporting.

Forbearance
Banks should ensure that forbearance – of NPEs or to prevent non-performance – returns exposures to a situation of sustainable repayment. Forbearance should not be a means of mis-representing asset quality or delaying the actions necessary to address asset quality issues.

Banks with NPL ratios >5% (overall/ portfolio level)

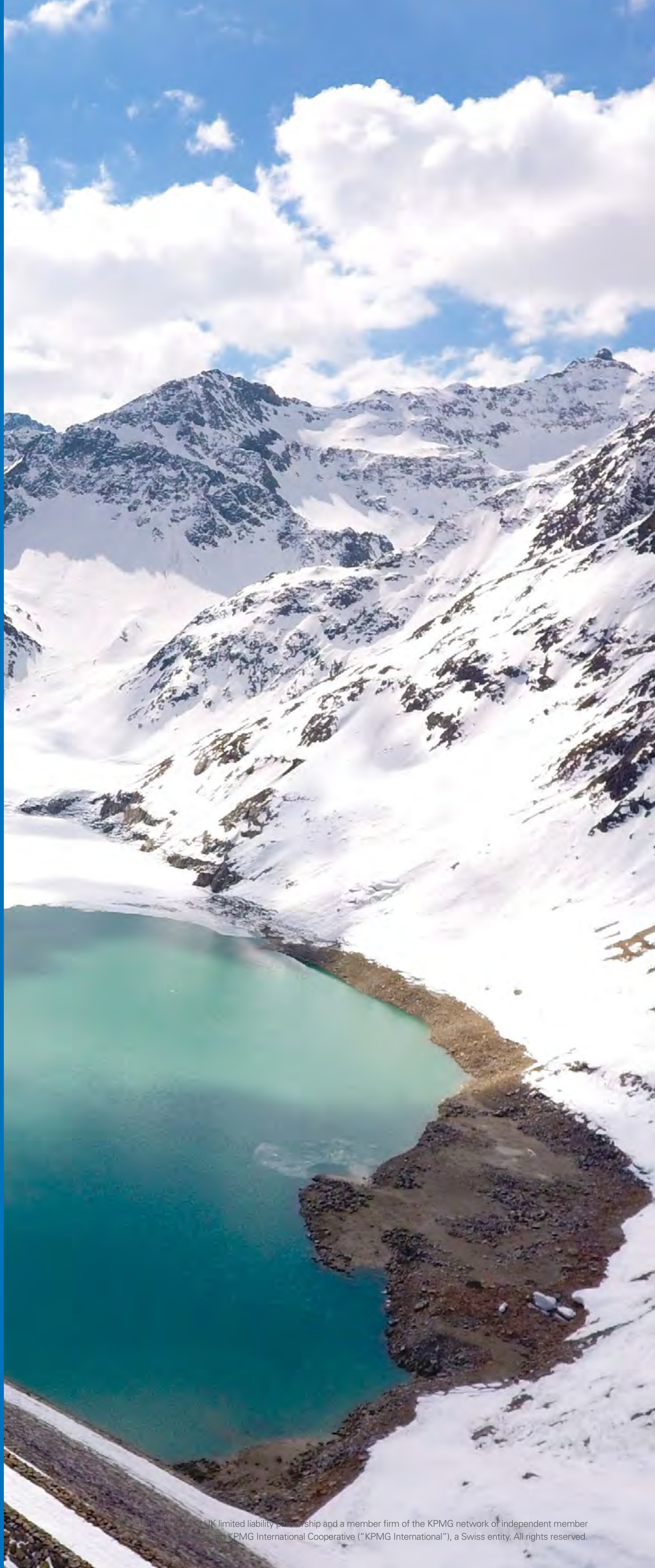
All banks

Comparing the proposed EBA Guidelines with the ECB's NPL Guidance

The Guidelines are very similar to the ECB's NPL Guidance issued in March 2017. The main differences relate to the broader scope of application of the Guidelines and the introduction of a threshold (together with national supervisor discretion) to trigger the application of the Guidelines relating to putting in place an NPE strategy and the governance and operations of this strategy.

	ECB NPL Guidance (March 2017)	EBA NPE / FBE Guidelines (March 2018)
Scope	**Banks directly supervised by the ECB** (118 Significant Institutions)	**All EU banks** (over 6,000 operating in the EU)
Status	– Final	– Draft (in consultation)
Implementation date	– March 2017	– Aiming for 1 January 2019
Basis of the document	– **Supervisory expectations** – **Non-binding**	– **Legal basis** (developed on the basis of the EBA Pillar 2 mandates in the CRD IV) – **Prescriptive** (compulsory)
Application	– Refers to NPLs but addresses all non-performing exposures (NPEs) as in the EBA definition	– All exposures covered by the definition of NPE and forborne exposures (FBE)
Accounting standard	– Pre-dated the implementation IFRS 9, so includes material relating to pre-IFRS 9 accounting standards (IAS 39)	– IFRS 9
Proportionality	– **Yes** (based on size and severity of NPL problem) – Defines "High NPL" banks as having a NPL level considerably higher than the EU average – Chapters on NPL strategy, governance and operations may be more relevant to High NPL banks	– **Yes** (based on size, internal organization, nature, scope and complexity of activities) – No reference to "High NPL banks" – But sets an indicative NPL threshold **of 5%** (static) from which banks should establish a NPE strategy and related governance and operations – Threshold to be considered at both the entity and portfolio level – Discretion to deem a bank's NPEs to be significant even if the threshold is not met.
Provisioning calendar	**Yes** (ECB NPL Addendum)	**No** (Amendments to CRR will apply when in place)
Consumer protection angle	**No**	**Yes**
Collateral valuation	– For immovable properties only	– For immovable and movable collaterals

Details on the EBA proposed Guidelines



NPE strategy

For banks with significant NPEs, the development and operation of an NPE strategy is the core building block of the Guidelines for banks' NPE management. Both overall and for each portfolio, the NPE strategy should be built on an assessment of the operating environment; should set out time-bound realistic, yet ambitious reduction targets; and should consider all available strategic options to reduce NPEs. There are four key stages in developing and executing an NPE reduction plan:

1. Assessing the operating environment and external conditions:

- The bank's internal capabilities to manage (maximise recoveries) and reduce NPEs effectively over a defined time horizon;
- The external conditions and operating environment (macro-economic prospects, market, potential investors, servicing capacity, legal, consumer protection and tax);
- Relevant portfolios that the strategy needs to cover.

2. Developing the NPE strategy:

- Targets (high level targets, aligned with more granular operational targets) for projected NPE reductions over the short, medium and long term;
- Consider, analyse and decide upon implementation options (hold and forbear NPEs, active NPE reduction, restructuring of NPEs, and insolvency proceedings or out-of-court settlements) and targets for each relevant portfolio;
- The capital implications (analysis and projections) of the NPE strategy;
- A clear plan for developing operational capabilities.

3. Implementing the operational plan:

- Putting the required resources, capabilities and structure in place;
- Data availability and integrity;
- Work-out capacity if that is a chosen option for one or more portfolios.

4. Embedding the strategy:

- Communicating the NPE strategy internally;
- Clear allocation of responsibilities and accountability;
- Integrate in overall business plan, risk management framework and performance management framework;
- Internal reporting and independent monitoring of evidence-based progress against the plan;
- Reporting of strategy and operational plan to supervisors.

NPE governance and operations

The Guidelines also outline the key elements of the governance and operations of a NPE workout framework, including decision making, the NPE operating model, internal control framework, and NPE monitoring and early warning processes.

Banks with significant NPEs need to put the necessary building blocks in place to govern and implement their NPE strategies. The Guidelines focus on:

1. The role of the management body in governance and decision-making:

- Approve annually the NPE strategy and operational plan;
- Define management objectives and incentives, and approval processes for workout decisions;
- Approve NPE policies (arrears, forbearance, debt recovery, foreclosure, collateral and provisioning) and ensure sufficient internal controls over NPE management processes;
- Oversee and monitor the implementation of the NPE strategy;
- Have sufficient experience and expertise on the management body with regard to the management of NPEs.

2. NPE operating model:

- Dedicated NPE workout units with sufficient expertise, infrastructure and related control functions (covering all three lines of defence), separate and independent from loan origination;
- Establishing different workout units for each phase of the NPE life cycle – early arrears, restructuring and forbearance, liquidation and foreclosure, and the management of foreclosed assets;
- As with the NPE strategy itself, aligning the workout units with the segmentation of non-performing portfolios;
- Regular feedback loops and smooth flow of information between credit units and NPE workout units;
- Minimum monitoring period (at least once a year) for forborne exposures for transfer out of the NPE workout units;
- Explicit veto right for risk control functions, to ensure independence of the risk control function and sufficient power to intervene in risk-related decision-making.

3. Monitoring and early warning mechanisms

- Develop key performance indicators to measure progress, covering high-level NPE metrics, customer engagement and cash collection, forbearance activities, and liquidation activities;
- Develop early warning indicators and alerts for each portfolio to spot signs of emerging credit quality deterioration.

Forbearance

Banks need to be able to assess the viability of forbearance solutions. The Guidelines focus on:

1. Affordability assessments

- Analysis of standardised financial information templates for borrowers;
- Use of external credit registers, where available;
- Conservative projections.

2. Forbearance options

- Short term, to meet temporary liquidity constraints facing a borrower with a good financial relationship with the bank;
- Long term, where based on an affordability assessment and where the forbearance option fully addresses outstanding arrears;
- Usually not appropriate where multiple consecutive forbearance options have been applied previously to the same exposure.

3. Forbearance processes

- Affordability assessment;
- Standardised solutions and decision trees;
- Comparison against other workout options;
- Multiple forbearance measures need the attention of the risk control function and the explicit approval of the relevant senior decision-making body;
- Milestones and monitoring for each solution.

NPE recognition

Banks should base their NPE policies and procedures on the EBA definition of an NPE:

1. EBA definition of an NPE

- Wider definition than accounting standards;
- Based on more than 90 days past due and/or on an "unlikely to pay" assessment;
- List of triggers for the "unlikely to pay" assessment;
- Aligns regulatory and accounting definitions wherever possible, including for impairment.

2. Forbearance

- Conditions under which forborne exposures can be classified as performing or non-performing, and can move from non-performing to performing.

3. Additional definition issues

- Consistent definition of NPEs at banking group level.
- Groups of connected clients.

NPE impairment measurement and write-offs

Banks need to assess accurately the required level of loss allowances and write-offs and to follow proper policies and procedures for determining this:

1. **Individual estimation of loss allowances**

– Criteria to determine individually significant exposures;
– Conservative approach to estimation of future cash flow and recoverable collateral, under "going concern" and "gone concern" scenarios;
– Loss allowances for financial guarantees and loan commitments.

2. **NPE impairment and write-offs**

– Clear internal policies and procedures for assessing and measuring loss allowances and write-offs, based on common processes, systems, tools and data;
– Clear internal policies and procedures for ensuring the timeliness of impairments and write-offs;
– Application of IFRS 9 definition of when full or partial write-off should be applied;
– May apply write-off before taking legal action against a borrower;
– Verification of methodologies by Internal Audit.

Collateral valuation for immovable and movable property

Banks should be able to demonstrate that their valuations of real estate collateral are up-to-date, well founded, and are based on independent assessments. The Guidelines focus on:

1. **Governance**

– Valuation policies and procedures approved by the management body;
– Monitoring and controls, with strong quality assurance independent of the loan origination process.

2. **Valuation approach**

– At least annually for movable property and commercial immovable property, and every three years for residential immovable property;
– Value immovable property on basis of market value or mortgage lending value, and movable property on basis of market value (and can use a market comparable or discounted cash-flow approach for income-generating properties);
– Criteria (type of collateral, value of collateral, exposure value and exposure status) for choosing between property-specific appraisal and indexation as basis for valuation;
– Quality, independence and rotation of (internal or external) valuation appraisers
– For movable property, periodic assessment of the liquidity of property, and legal review confirming the enforceability of the collateral;
– In a "gone concern" scenario, apply discounts for liquidation costs, stressed sale price, time to disposal and maintenance costs;
– Back-testing requirement to demonstrate the reasonableness of assumptions used.

3. **Foreclosed assets**

– Plan to sell within short timeframe;
– Value at lower of (a) fair value less costs of selling and (b) financial assets applied;
– Liquidity discounts where difficult to sell foreclosed assets.

04

The wider context

> In March 2018 the European Commission published a series of measures and proposals designed to tackle NPLs.

European Council NPL Action Plan

The European Council set out in July 2017 an Action Plan to tackle non-performing loans in Europe. This called on the European Commission (EC), the EBA, the ECB, the European Systemic Risk Board (ESRB) and member states to introduce a series of measures.

Summary of the measures under the European Council NPL Action Plan

	European Commission	EBA	ECB	Other
Managing the stock of NPEs		Proposed Guidelines on NPEs and FBEs (March 2018) (Draft in consultation)	NPL Guidance for directly supervised banks (March 2017) NPL Guidance for non-directly supervised banks in banking union (forthcoming) Intensive supervision and regular assessments (SREP) (continuing)	Supervision of banks not directly supervised by the ECB, including outside the banking union (continuing)
Managing the flow of new NPEs	Statutory prudential backstop (proposed Regulation, March 2018)	Guidelines on loan origination monitoring and governance (forthcoming)	Supervisory expectations for prudential provisioning of NPEs (March 2018)	ESRB to develop macro-prudential approaches to prevent the emergence of system-wide NPL problems (forthcoming)
Increasing investor demand for banks' NPEs	Blueprint for national asset management companies (March 2018) Proposed Directive on credit servicers, credit purchasers and the recovery of collateral (March 2018)	Proposed NPL transaction templates to provide data transparency for investors (December 2017)	Supervisory expectations for provisioning against stock of NPEs (forthcoming)	IFRS 9 (from January 2018)
Improving market structure	Proposed Directive on insolvency, restructuring and second chance (November 2016) Proposed Directive on credit servicers, credit purchasers and the recovery of collateral (March 2018)	Harmonised definition of NPEs for supervisory reporting purposes (April 2014)		Member states to consider changes to national insolvency regimes

EC package of measures published in March 2018

In line with the Action Plan, in March 2018 the EC published a series of measures and proposals designed to tackle NPLs, along with its second progress report on NPLs. This package outlines a comprehensive approach including policy actions that target three key areas to support NPL reductions:

- Ensuring sufficient loss coverage by banks for future NPLs
- Developing a secondary market for NPLs and facilitating out-of-court collateral enforcement
- A technical blueprint for how to set up national Asset Management Companies (AMCs)

Elements of the EC package of measures published in March 2018

Addressing potential under-provisioning through automatic and time-bound provisioning	– **Proposals for amendments to the Capital Requirements Regulation** (CRR) with the aim of introducing minimum provisioning levels for newly originated loans that become non-performing (**statutory prudential backstop**) – No indication of when this would enter in force

Developing secondary markets for NPLs
 	
Enhancing the protection of secured creditors
	– **Proposal for a Directive** designed to:
	  – Foster the **development of secondary markets** for NPLs (including loan servicers)
	  – Enable **accelerated out-of-court enforcement** of loans secured by collateral (introducing a more efficient value recovery from secured loans)
	– No indication of when this would enter in force

Developing an AMC blueprint	– **Final non-binding** technical guidance (blueprint) for how national Asset Management Companies can be set up – Includes common principles on all aspects, such as set-up, governance and operations – Based on previous experiences in member States, including SAREB (Spain) and NAMA (Ireland)

Prudential provisioning for NPEs: EC and ECB

The most significant of these measures for banks is likely to be the EC's proposed Regulation on a prudential backstop and the closely related ECB supervisory expectations for the prudential provisioning of non-performing loans. However, these two prudential provisioning expectations differ in scope, nature, and the timing of provisioning.

	Supervisory expectations (ECB, March 2018)	**Statutory prudential backstop (EC, March 2018)**
Status	Final	Amendment proposal to CRR (not yet in force, with no explicit planned finalisation date)
Scope	Banks directly supervised by the ECB	All EU banks
Application	– All **exposures newly classified as non-performing** as of **1 April 2018** – Non-binding guidance (but with possible supervisory implications)	– **Newly originated loans becoming non-performing**, after entry into force – Compulsory time-bound prudential deductions
Provisioning backstops mechanism	– **Unsecured** exposures (new NPEs): **full coverage** after **two years, with no step up after year one** – **Secured** exposures (new NPEs): **full coverage** after **seven years, starting from year three** – Banks are expected to inform the ECB of any differences between their practices and the prudential provisioning expectations as a part of the SREP supervisory dialogue from early 2021 onwards	– **Deduction from CET1 capital** the difference between the level of actual coverage and the Minimum Coverage Requirement" (MCR) – MCR dependent on **"NPEs vintage"** and level of **credit protection** (secured vs. unsecured) – Different coverage requirements apply depending on the classification of the NPE as "secured" or "unsecured"
(Potential) capital implications	Pillar 2	Pillar 1

EC statutory prudential backstop

The Commission has proposed amending the Capital Requirements Regulation (CRR) with the aim of introducing minimum provisioning levels for newly originated loans that become non-performing (the 'statutory prudential backstop'). The level of minimum provisions would be:

Required minimum provision (percentage of exposure)

At end of year	1	2	3	4	5	6	7	8
Unsecured exposure	35	100						
Secured exposure	5	10	17.5	27.5	40	55	75	100

This proposed non-linear provisioning schedule would give banks time to pursue other options such as sales of exposures or out-of-court settlements. Insufficient provisions would require corresponding deductions from a bank's common equity tier 1 capital (Pillar 1 measure).

It also introduces a slightly more lenient provisioning schedule for exposures of less than 90 days past due which leads to 80 percent provisioning instead of 100 percent (at year 2 for unsecured exposures and year 8 for secured exposures).

The EBA has calculated that this prudential backstop could reduce an average bank's common equity tier 1 capital ratio by 56 basis points over a 7-year horizon, and by 205 basis points over a 20-year horizon.

ECB supervisory expectation

Banks that are directly supervised by the ECB will be subject to an ECB supervisory expectation that all exposures newly classified as non-performing from 1 April 2018 onwards will be subject to provisioning at least in line with the following levels:

Minimum provisioning levels (percentage of exposure)

At end of year	1	2	3	4	5	6	7
Unsecured exposure	0	100					
Secured exposure	0	0	40	55	70	85	100

Directly supervised banks will be required to inform the ECB of any deviations from these expectations from early 2021 onwards, as part of the SREP supervisory dialogue, with the expectation that any shortfalls would be reflected in Pillar 2 capital requirements.

This supervisory dialogue could entail off-site activities (for example by Joint Supervision Teams) and/or on-site examinations. Any divergences from the prudential provisioning expectations would be discussed and any portfolio-specific robust evidence could be used to inform the dialogue.

Overview of the ECB prudential provisioning concept

Accounting regime

Accounting provisions
All accounting provisions under the applicable accounting standard

+

Prudential regime

Own fund deductions
Respective EL shortfall or other CET1 deductions from own funds

=

Bank´s supply

←

Bank-specific supervisory three step approach

01 Supervisory expectations
Prudential provisioning expectations

02 Supervisory dialogue
Supervisory dialogue on expectations including analysis of bank-specific circumstances

03 SREP decisions
Results of supervisory dialogue will be incorporated into bank-specific decisions

Source: ECB

EBA NPL Templates

The EBA published its NPL Templates in December 2017 with the aim that they should become the new banking industry standard for NPL data templates for EU banks.

The templates were produced as part of the EC request to the EBA to work further on reducing information asymmetries between potential buyers and sellers of NPLs, to help the development of a functioning secondary market for NPLs.

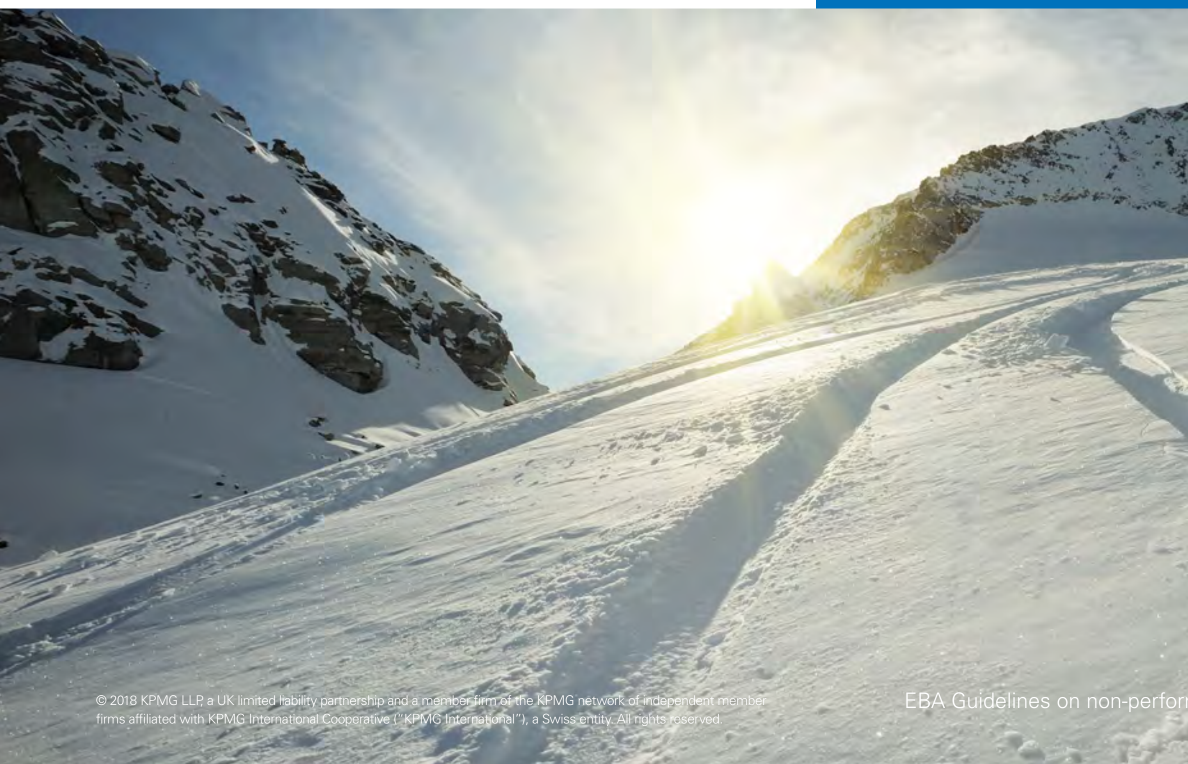
The templates provide potential investors with minimum data requirements before commencing transactions. They are pan-European, multi-asset class and consistent with existing regulatory data requirements. They are of voluntary use but are encouraged to be used for NPL transactions.

The templates take into account different data needs for the initial data screening of an NPL portfolio on the one hand, and for the subsequent financial due diligence (FDD) and valuation on the other hand.

KPMG was selected to support the EBA with delivering this important project. Our member firms have extensive experience with assisting banks and investors across Europe with data preparation for NPL transactions.

> An improved quality, scope, transparency and availability of relevant financial information on distressed assets could greatly contribute to functioning secondary markets for distressed assets, as buyers would face less uncertainty, and this should lead to narrower bid-ask spreads
>
> VP of the European Commission, Valdis Dombrovskis, 29/03/2017

> The EBA is to issue, by the end of 2017, a tool for banks on loan tapes monitoring, specifying minimal detailed information required from banks on their credit exposures in the banking book.
>
> European Council, 'Council conclusions on Action plan to tackle non-performing loans in Europe, 11/07/2017



05

How KPMG can help

> KPMG member firms offer a wide range of strategies, services and tools aimed at supporting and advising banking clients in all NPE related tasks, leveraging the unique and integrated approach and on a network of multidisciplinary teams of professionals across Europe and beyond.

Gap Analysis

Assessments of banks against all areas of the EBA Guidelines (or ECB Guidance on NPLs) with the support of **KPMG's Gap Analysis Tool**, allowing for cost effective identification of critical shortfalls and possible targeted remediating actions.

Portfolio Analysis

Combining technology and modelling skills to provide integrated technology solutions for data analytics, segmentation and assessment of loans and collateral books.

NPE Strategy

Assistance with the development of realistic and implementable NPE strategies, divestment plans and possible realisation options for portfolio optimisation.

Data Quality

Assessment of data adequacy and suitability, and provision of automated data remediation solutions supported by **KPMG's "DealTech".** Our approach and technology is fully aligned with the **EBA NPL Templates**.

Forbearance solutions

Development and implementation of sound restructuring strategies and workout plans for NPEs, improvement of loan collection processes, hands-on restructuring and work-out support for complex exposures.

Sale Process

Support vendors and buyers of NPEs and non-core banking assets globally, encompassing the entire transaction phase from the deal structuring to the negotiation phase and post-closing activities.

NPE Servicing

Bespoke servicing solutions including developing and implementing the bank's specific servicing platforms by combining internal resources and infrastructure with third party providers and investors.

Governance and Operational Change

Definition of optimal governance and operating models for NPE management, building upon the bank's existing state for suitability and minimal disruptions.

Collateral Valuation and Portfolio Pricing

Assistance in the valuation process of any type of collateral.

Pricing and analytics of the portfolio and underlying segments to evaluate the market values and define the optimum assets mix to sell.

Provision and Impairment Analysis

Independent review of methodologies for NPE classification, impairment measurement, loss allowances and write-offs and advice on adequacy of underlying processes, systems and tools.

Regulation

Assistance and support to banking clients in a broad range of areas, including (i) analysis of compliance with regulation and with supervisory expectations; (ii) preparation for supervisory inspections; and (iii) provision of integrated reporting systems.

KPMG's Gap Analysis Tool

This is designed to be a structured and cost effective solution to assess a bank's compliance with the requirements of the EBA Guidelines on NPEs and FBEs, as well as the ECB NPL Guidance.

It has been developed around the structure of both documents, to allow for simple and cost effective analysis in relation to every aspect of the Guidelines, tailored to reflect the characteristics of the bank (including proportionality).

KPMG approach

KPMG uses a standardised dashboard to perform a guided assessment of the gaps within the bank, highlight key areas of criticality, identify the underlying roots of the gaps within the organisation and provide tailored recommendations.

Gap Analysis "Dashboard"

The dashboard allows for a structured single input interface.

Structure follows either the ECB NPL Guidance or the EBA Guidelines for NPE / FBE.

Set of tools to guide and facilitate inputs

Automatic outputs

Heat maps

(Highlights the pressure points within the bank)

Detailed assessment

(Tailored per chapter and for the key identified gaps)

Standardised report

(Follows the structure of the Guidelines)

- Focuses on rapidly identifying the critical inadequacies, interdependencies and potential implications.
- Provides the bank with the necessary overview of the key problem areas and critical remediation needs in order to develop a precise action plan.
- Develops a clear and precise understanding of the gaps with the Guidelines to aid in regulatory dialogue and develop relevant remediation plans.

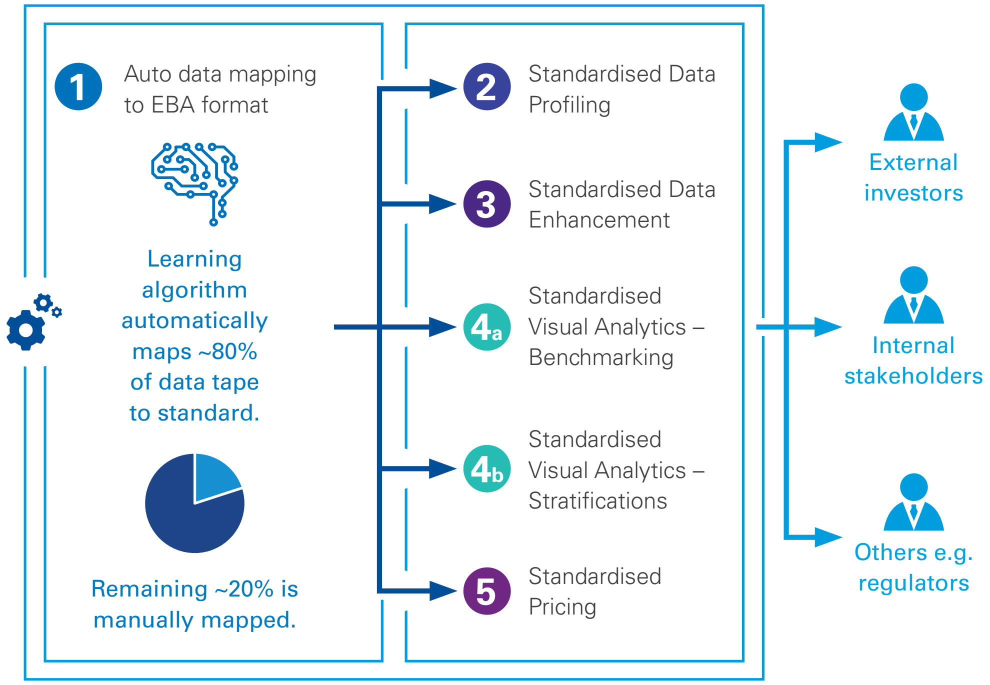
KPMG DealTech

DealTech has been designed to assist understanding, improve quality and develop insight for the preparation and execution of loan portfolio sales. In light of KPMG's unique insight into the **EBA NPL Templates**, KPMG has enhanced DealTech to be fully compatible and integrated into all parts of the deal process.

KPMG approach

01 Map to industry standard format

Auto Data Mapping combines data from multiple sources and migrates this into the standard EBA Templates.



02 Understand the data issues

Data Profiling performs a range of pre-built data integrity, consistency and gap checks.

03 Improving data quality

Data Enhancement is a platform for multiple users to collaborate at enriching data quality though a controlled validation and remediation process.

04 Visualise and understand the assets

Pre configured **Visual Analytics** are used to analyse the portfolio, providing deep insight and promoting optimal decision making.

05 Sophisticated market pricing

Pricing specialists provide indicative pricing analysis based on our extensive experience advising both vendors and purchasers.

- Supports banks in understanding impacts of the new EBA NPL Templates.
- Helps map banks' data into the EBA NPL Templates.

- Applies Data Profiling checks to understand data quality limitations within banks portfolio.
- Helps fixing data issues with Data Enhancement.

- Supports in visualising the banks portfolio to maximise value/price.
- Facilities transactions with Deal Room (KPMG's proprietary Data Room platform).

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