
# The European Central Bank's guidance to banks on non-performing loans

## September 2016


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### Non-performing loans are a European problem – and a key priority of ECB banking supervision

It is a well-known fact that the European banking sector struggles with a high stock of non-performing loans (NPL). The publication of the results of the EBA stress test in July has brought public attention again to the tensions in the European banking sector resulting from a NPL stock of approximately €1.1 trillion and an average NPL-ratio of 5.7% (almost three times as much compared to the US or Japan).[1] In addition, NPLs vary widely across EU countries (see figure 1). The tensions from the high stock of NPLs represent a multi-faceted threat to the ECB's supervisory priorities for the three reasons:

**1)** NPLs tie up bank capital without providing return
**2)** They reduce bank profitability and threaten business models
**3)** They erode a bank's liquidity

All of this contributes to a weaker banking sector, with less capacity to lend to the European economy.

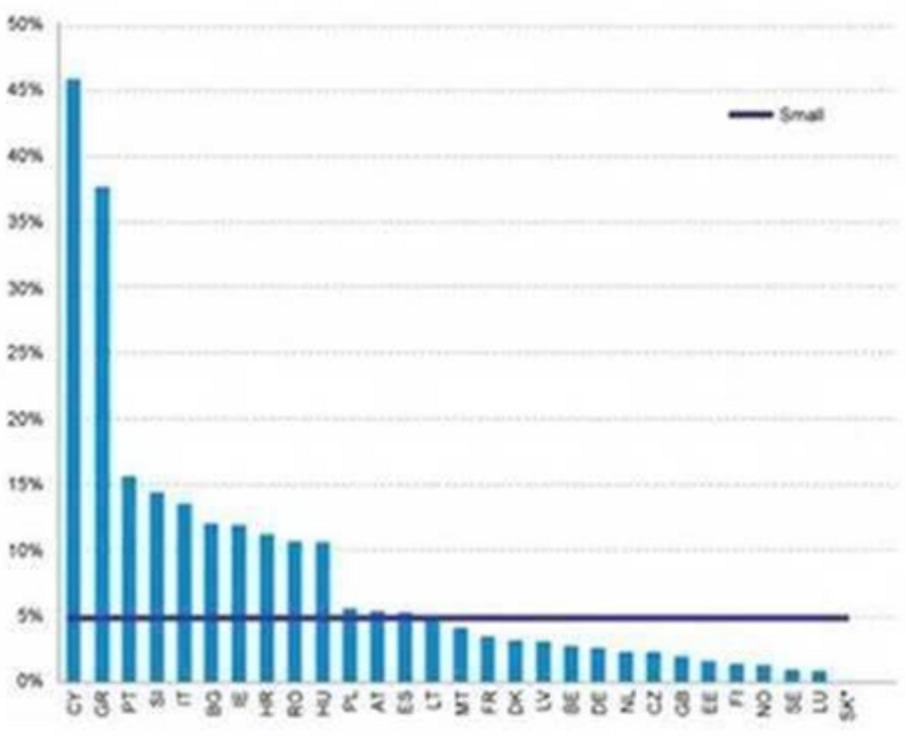
The ECB has addressed NPLs in a number of ways, such as the AQR and stress test within the comprehensive assessment 2014, establishing an SSM NPL Task Force in 2015 and by defining NPLs as a key priority for 2016.

After nearly one year of work by the NPL Task Force, the ECB has published a substantial (126 page) guidance to banks on NPLs. Their objective is to drive strategic and operational focus on the reduction of NPLs, together with further harmonization and common definitions of NPLs and forbearance. Success for the SSM would be driving adoption of NPL workout strategies across the Banking Union, thereby helping to speed up European NPL-sales transactions and increasing the liquidity of NPL-markets (see also our earlier article). The ECB has also released a stock take of national supervisory practices and legal frameworks related to NPLs in eight countries.[2]

[1] Absolute number for large European banks only. Sources: EBA, World Bank.

[2] Countries included in the stock take Cyprus, Germany, Greece, Ireland, Italy, Portugal and Spain.

**Figure 1: Non-performing loan ratio by country and size class, end of March 2016**




Source: EBA Risk dashboard.

Notes: (1) * Not reported. (2) Weighted Averages by country.

### Non-compliance with the new guidance may trigger supervisory measures

The guidance is addressed to significant institutions directly supervised by the ECB. Applying the principle of proportionality, the ECB considers some chapters of the guidance (i.e. strategy, governance and operations) to be more relevant for high NPL-banks. Interesting to note, the guidance defines *high NPL banks* as banks with a NPL level 'considerably higher than the EU average level'.

Although the guidance is a non-binding supervisory instrument, non-compliance may trigger supervisory measures that are not further specified in the guidance (though a higher SREP Pillar 2 capital requirement cannot be ruled out). The ECB acknowledges that addressing NPL will require a medium-term focus, and therefore expects that banks will implement the guidance proportionately and with appropriate urgency and with close engagement of their Joint Supervisory Teams. The ECB is also aware of its interdependency on other stakeholders, including the EBA and European Commission, as well as national legislators, law courts and insolvency practitioners.

## Structure of the new guidance

The structure of the guidance follows a NPL management lifecycle and includes six chapters together with seven annexes that contain best practice examples, some of which are summarized below.

### NPL Strategy

Clearly, the ECB expects from SSM banks a **thorough roadmap** for their NPL-management and has formulated its expectations regarding the roadmaps' granularity on topics like:

**Strategy assumptions and self-assessment**: Assessment and reporting of internal/external capabilities, capital implications and inclusion in ICAAP and RAF, sustainable clean-up of NPLs from the balance sheet for banks with slim capital buffers and low profitability.

**Strategy development and implementation**: Analysis of strategic options, benchmarking with international and/or historical values, establishment of *sustainable* portfolio targets (long-term NPL levels and short (1yr)/medium (3yr) term targets for NPL reduction (otherwise high provisioning/write-offs), implementation plan, reporting to JSTs (first quarter of each calendar year using a standardized template).

**Embedding NPL strategy**: Regular review, reporting on NPL targets and operational effectiveness, incentive alignment, integration in business plan and risk management framework.

### NPL Governance and Operations

The guidance also requires a **strict and separate oversight** during all NPL-management processes, i.e. with regard to:

**Steering and decision-making**: Strategy approval, oversight, internal controls, etc.

**NPL operating model**: Separate and dedicated NPL workout units (WUs) for different phases of the NPL life cycle and clear hand-over triggers between WUs

**Control framework**: Definition of roles and responsibilities (3LoD) and policies for available NPL workout options

**NPL monitoring**: KPI framework to monitor the workout progress

**Early warning system**: Warning indicators computed at least monthly for each portfolio separately with automated workflow and limited management discretion.

### Forbearance

The guidance also outlines some general principles for the categorization of **viable forbearance solutions**:

**Forbearance options and viability**: Viability definition with distinction between viable long-term forbearance options and short-term options (examples provided)

**Sound forbearance processes and affordability assessment**: Mandatory affordability assessment, use of standardized forbearance products and decision trees, consideration of alternative NPL workout options, monitoring of workout solutions

**Disclosure** of credit quality of forborne exposures, quality of forbearance, net present value impact.

### NPL Recognition

The guidance also aims to enhance a further **harmonization of NPL definitions** within the SSM, in particular with regard to:

Consistent application **of the regulatory NPE definition** (EBA ITS) and link to forbearance at group level for groups of connected clients

**Alignment** of regulatory and accounting definitions (wherever possible)

**Disclosure**: public disclosure including a reconciliation of deviations between accounting and regulatory exposure and disclose of assumptions underlying the definition of impaired financial assets.

### NPL impairment measurement and write-offs

Furthermore, the guidance specifies criteria for the:

**Individual and collective estimation of provisions**

**Further aspects to provisioning and write-off**, e.g. for financial guarantees and loan commitments, triggers for recognition of impairment losses

**Documentation, reporting and disclosure**, e.g. level of documentation including level of and assumptions behind loss-given default (LGD) and cure rates, quantitative and qualitative disclosures).

### Collateral Valuation of Immovable Property

Similar to the NPL recognition, the guidance also specifies criteria for the collateral valuation of immovable property, such as the:

**Governance, procedures and controls**: Independent control processes, criteria for use of valuation, panel of independent appraisers

**Frequency and methodology of valuations**: Annual valuation update, revaluation triggers, discounts for liquidation costs, market price under given sales conditions, consistent track in database

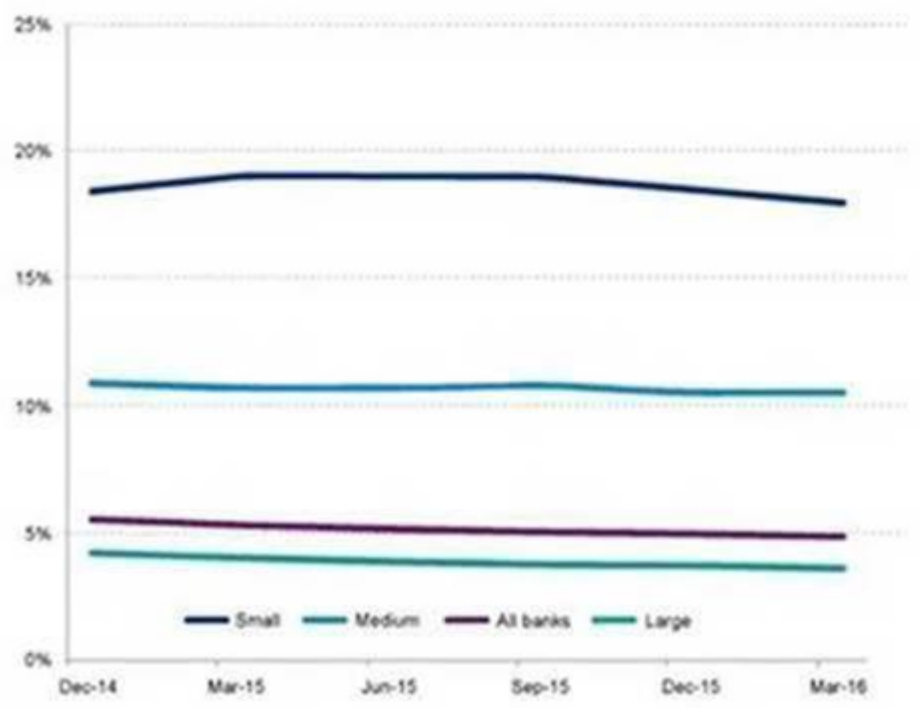
**Valuation of foreclosed assets**: Pursue active sales policy for finished properties, reflect inability to sell foreclosed assets in appropriate liquidity discounts, among others

**Disclosure**: Separate disclosure for NPL collateral and foreclosed assets.

## Push towards non-viability for some banks, increased regulatory costs for others

The guidance represents a comprehensive approach from the ECB to improve the NPL management of SSM banks and is likely to increase NPL-management costs for both low and, in particular, high level NPL-banks (see figure 2). Due to that, it appears that high level NPL banks are pushed further towards non-viability, while for others the full implementation of the requirements are likely to increase operational costs of their NPL-management.

**Figure 2: Non-performing loan ratio by size class, end of March 2016**




Source: EBA Risk dashboard.
Note: Weighted average. Banks are classified in the size class according to their average total assets between Dec. 2014 and March 2016.

## What's next?

The public consultation of the draft guidance will last until November 15. Given the potentially large impact for some European banks, it will be important how the market perceives the ECB's harmonization effort of European banks' NPL management framework and to what extent the guidance can further harmonize cross-border differences in European NPL-markets. For the future, the ECB has already announced that it plans to place a stronger focus on enhancing the timeliness of provisions and write-offs by extending the scope of the guidance.

Given that previous ECB consultations have typically resulted in limited adjustments rather than wholesale changes, banks are well advised to analyze thoroughly the main requirements of the NPL guidance and to begin a gap analysis against their own strategy, operations and systems.

## About us

Our team believes in knowledge and passion for what we do builds value. As such, we strive to proactively bring our clients top products to enable them to succeed in their business activities. At the forefront of advising banks on regulatory change, we are here to help you successfully navigate the complex maze of interlinked European regulations.

**Let's meet and discuss on how we can add tangible value to your organization.**