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Ladies and Gentlemen

Consultation Paper on Guidelines on management of non-performing and forborne exposures (EBA-CP-2018-01)

We appreciate the opportunity to comment on the above Consultation Paper. We have consulted with, and this letter represents the views of, the KPMG network.

We support the EBA's objective of promoting effective management of non-performing and forborne exposures by banks, including consistent requirements for assessment by competent authorities.

We have also supported the EBA's efforts to promote high-quality and consistent application of IFRS 9 *Financial Instruments* which resulted in the final *Guidelines on Credit Institutions' Credit Risk Management Practices and Accounting for Expected Credit Losses* ("GCRAECL"). The GRAECL principles emphasised the need for robust management systems and controls in order to ensure high-quality data and methodologies for estimating expected credit losses under IFRS 9, including the use of experienced credit judgement. The GCRAECL requirements were designed not to conflict with the requirements of IFRS 9 and appear to have achieved this by not mandating the application of specific assumptions or quantitative estimates that might create an inconsistency with IFRS 9.

By contrast, we are concerned that some of the proposed guidance on impairment measurement and valuation included in the Consultation Paper may give rise to material conflicts with the requirements of IFRS 9. IFRS 9 requires expected credit losses to reflect an unbiased (ie. neutral) probability-weighted estimate that is determined by considering a range of possible outcomes and all reasonable and supportable information that is available without undue cost and effort. As acknowledged in the recent *EBA Report on Statutory Prudential Backstops (Response to the Commission's call for advice of November 2017)*, the application of IFRS 9 depends on a case-by-case assessment – that is, the use of judgement to apply principles to the specific facts and circumstances. In a number of instances the Consultation Paper indicates the use of specific assumptions or techniques that, in the particular circumstances, may not align with the objective of IFRS 9 but might instead introduce bias. We detail these instances in the attached Appendix.

To avoid the risk of conflict between the final Guidelines and IFRS 9, we recommend that the EBA do either or both of the following:

— Clarify that the Guidelines represent supervisory guidance and expectations with a prudential objective and are not intended to override or supersede applicable accounting requirements stemming from EU or national law. Thus, where a bank applies IFRS in accordance with applicable laws, the bank should comply with IFRS as endorsed by those laws for the purposes of its statutory financial reporting. The Guidelines might then address how a supervisor should deal with any difference between impairments recognised for accounting purposes under IFRS and any more conservative treatment indicated by the Guidelines for prudential purposes. This would be similar to the approach taken by the European Central Bank in its 2017 *Guidance to banks on non-performing loans*. In addition, the European Commission *Consultation Document: Statutory Prudential Backstops Addressing Insufficient Provisioning For Newly Originated Loans That Turn Non-performing*, the *EBA Report on Statutory Prudential Backstops* and the ECB's 2018 *Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures* all illustrate how guidance for banks can be framed as a requirement for additional provisions and write-offs to be recognised for prudential purposes (but not accounting purposes) if those recognised under the applicable accounting framework are not considered enough to meet prudential objectives.

— Modify the specific elements highlighted in Appendix 1 to remove any actual or potential inconsistency.

Please contact Chris Spall +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

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Appendix – Detailed comments

The Appendix includes our detailed comments with respect to specific areas of the Consultation Paper where there is a risk of conflict with the requirements of IFRS 9. The Appendix should be read in conjunction with the comments in the covering letter.

Chapter 8.2 Estimating future cash flows

Paragraph 184 states that application of a going concern approach is dependent on and should reflect reliable estimates of the future operating cash flows of the borrower and suggests that the gone concern approach should be considered if there is a significant degree of uncertainty about estimating future cash flows. The terms “reliable” and “reliably” are used at other points in this chapter. It is unclear what the term “reliable” is precisely intended to communicate. Predictions about the future are always subject to uncertainty and this will often be significant at the individual exposure level, especially if the exposure is non-performing. Rather than using the term “reliable”, IFRS 9 instead requires that estimates of expected credit losses are based on reasonable and supportable information that is available without undue cost and effort at the reporting date. We recommend that the terms “reliable” and “reliably” be eliminated from the guidance on measurement included in the Guidelines and that the language is instead conformed to that in IFRS 9.

Whereas paragraph 173 states that expected cash flows take into consideration the probabilities of different realisation approaches (ie. workout, sale of collateral, sale of exposure), we recommend that the guidance also remind banks that they may need to consider, on a probability-weighted basis, the range of possible outcomes within each realisation approach (eg. an active workout could result in a multiplicity of different outcomes and a single “best estimate” might not reasonably reflect the objective of IFRS 9 because there could be a significant probability of recovering much less than this “best estimate”).

Chapter 8.2.1 Estimation of operating cash flows under a going concern scenario

Paragraph 176(b) states that when projections assume a growth rate, a steady or declining growth rate over a growth period should be used, and afterwards steady cash flows. We agree that scepticism should be applied in determining whether projections of positive growth in cash flows are reasonable and supportable. However, we do not think that such a one-size-fits-all rule of thumb as that expressed in paragraph 176(b) is appropriate for all circumstances. Depending on the circumstances: growth rates might increase before declining; growth rates might turn and remain negative rather than there being steady cash flows; and/or cash flows into the future might be assumed to increase in line with inflation.

Chapter 8.3 Loss allowances for financial guarantee contracts and loan commitments given

Paragraph 180 refers to determining the "most likely drawn exposure" of off-balance sheet items. It is unclear why this phrase is used since IFRS 9 requires expected credit losses to be measured on a probability-weighted basis and for these items there may be a strong correlation between the degree of utilisation of a facility and both the probability of default (if relevant) and the loss given default.

See comments above on use of the word "reliable."

Chapter 8.5 NPE impairment and write-off

Paragraphs 185(a) and (c) refer to write-offs when an exposure is deemed unrecoverable or there is reasonable financial evidence that the borrower is unable to repay the full amount. This terminology differs from the criterion required by IFRS 9 (ie. no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof). We recommend that these paragraphs are amended to conform with IFRS 9.

Chapter 9.3.2 Expected future cash flows

See comments above on use of the word "reliable."

Chapter 9.4 Further considerations on estimating cash flows from property collateral liquidation

The guidance in paragraph 238 appears to be both internally inconsistent and potentially inconsistent with the requirements of IFRS 9. Sub-paragraph (a) states the time to disposal should take into account expected market conditions but sub-paragraph (b) states that an improvement on current market conditions is not taken into account when estimating the price at disposal. Sub-paragraph (b) states that the estimated price should not be more optimistic "than projections produced by international organisations … and therefore does not assume an improvement on the current market conditions." The logic and meaning of this is not clear since "international organisations" may be projecting an improvement in prices compared to current market conditions. Also, it is unclear who or what these "international organisations" might be and why their projections should be used in preference to those of other organisations, such as national organisations who might have greater knowledge of the local market. We recommend that this paragraph is redrafted to conform with IFRS 9, in particular:

- The amounts and timing of expected cash flows from collateral should reflect reasonable and supportable information about current and future market conditions.

- It may be necessary to consider a number of different scenarios and probability-weight their outcomes. A bank should consider the interdependency between real estate prices and macro-economic variables.

- A bank should consider available and relevant third-party/external forecasts in developing and validating its estimates and should be able to justify any differences between external forecasts and its own. This exercise includes considering the competence and objectivity of external forecasts.

Other matters

— Paragraph 181 should refer to IFRS 9.B3.2.16r (not B3.3.16r).