ECB publishes guidance to banks on non-performing loans

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On 20 March 2017, the European Central Bank ("**ECB**") published its final guidance to banks on how to tackle one of the European banking industry's most pressing issues: non-performing loans. The ECB's guidance forms a key part of European authorities' increasingly interventionist approach towards reducing NPL levels in European banks. Despite being non-binding, the ECB fully expects all significant institutions ("**SIs**") including their international subsidiaries to adopt its guidance in line with the scale and severity of their NPL stock with immediate effect, with enhanced disclosure of NPLs expected to start from 2018 reference dates. However, to what extent does the ECB's guidance mark an increase in bank accountability for high NPL ratios across Europe and how effective will it be in practice?

Introduction

Non-performing loans, or NPLs, have become a major headache for European banks and authorities in recent years, climbing rapidly to the top of their priority list. Following the European Banking Authority's ("**EBA**") proposals for a centralised, European asset management company ("**AMC**") to purchase banks' NPLs (discussed in our February 2017 client alert, "*Is a pan-European asset management company a panacea to Europe's growing NPL problem?*"), momentum has been building for even more direct action from the top down. This is unsurprising: the ECB's guidance acknowledges the negative impact that NPLs have had not only on the wider banking sector, in terms of capital constraints and bank profitability, but also, most importantly, on real economies across Member States. NPLs inhibit the capacity of banks in terms of risk-weighted assets, which hinders banks' ability to lend. At the same time, NPLs require considerable attention by bank management teams in terms of restructuring and enforcement. With respect to the high levels of NPLs, this proves to be quite the challenge for market participants. It is therefore clear that the adverse effect of high NPL levels is being felt Europe-wide; it is not an isolated issue plaguing a small number of banks.

Cornerstones of the guidance

NPL strategy

The ECB's guidance mandates banks with material NPL exposures ("**high NPL banks**")[1] to establish strategic objectives for the "time-bound reduction of NPLs over realistic but sufficiently ambitious time-bound horizons". The following steps are listed as core building blocks relating to an NPL strategy: (i) assessing the operating

1 The ECB's banking supervision defines high NPL banks as banks with an NPL level that is considerably higher than the EU average.

environment; (ii) developing qualitative and quantitative targets over the short, medium and long-term; (iii) implementing the operational plan; and (iv) fully embedding the NPL strategy into the management processes of the bank, including a regular review and 'independent' monitoring by risk control functions within the organisation. The guidance also encourages a degree of retrospective review by carrying out an assessment of the evolution of NPL portfolios, potential causations, outcomes of NPL actions taken in the past and operational capacities (e.g. internal policies, processes, tools and data quality) in order to develop the strategy. The ECB regards this process as a fundamental component in understanding the current and possible future external operating environment and achieving NPL reduction targets.

The NPL strategy, including an operational plan, should be approved by the management body and reviewed at least annually. High NPL banks should report their NPL strategy, including an operational plan, to their Joint Supervisory Teams in the first quarter of each calendar year. The operational plan should contain at a minimum clear time-bound objectives and goals; activities to be delivered on a segmented portfolio basis; governance arrangements; quality standards; staffing and resource requirements; required technical infrastructure enhancement plan; granular and consolidated budget requirements and an interaction and communication plan with internal and external stakeholders.

NPL governance and operations

In tandem with the development of the NPL strategy, the guidance expects each SI's management body to oversee the implementation of the NPL strategy as well as (amongst other things) monitor progress at least quarterly and ensure sufficient internal controls over NPL management processes. High NPL banks are expected to implement dedicated NPL workout units, which are separate from units responsible for loan origination, ideally starting from the moment of early arrears but at the latest by the time of NPL classification of an exposure. High NPLs banks are also encouraged to proactively share periodic NPL monitoring reports, at a suitable level of aggregation, with their supervisor.

Forbearance

The ECB states that the key objective of granting forbearance measures is to pave the way for non-performing borrowers to exit their non-performing status, or to prevent performing borrowers from reaching a non-performing status. As such, forbearance is seen as a key component in NPL reduction as a way of returning the exposure to a situation of sustainable repayment. However, the ECB recognises in its guidance that forbearance solutions granted by banks to borrowers in financial difficulties may lead to a misrepresentation of asset quality on the balance sheet. Consequently, the ECB distinguishes between viable and non-viable forbearance solutions. Viable measures include circumstances where the bank can demonstrate that the borrower can realistically afford the solution and the resolution of outstanding arrears is fully addressed and results in a significant reduction in the borrower's balance in the medium to long term. The solution should not result in multiple consecutive forbearance measures having been granted to the same exposure. The ultimate outcome of the forbearance measure should be the repayment of the amount due and not a delaying of the assessment that the exposure is uncollectable. If no sustainable restructuring solution has been reached, banks are expected to enforce their rights, either through initiating legal procedures, foreclosing assets, debt to asset/equity swap and/or disposal of credit facilities/transfer to an AMC/securitisation. Banks are expected to submit quantitative information regarding forbearance measures and standard templates are set out in Annex 7 to the guidance. It is expected that the bank's management body will approve the information before submission to the supervisory authorities.

NPL recognition

The ECB acknowledges in its guidance that the commonly used term of NPLs is based on a variety of different definitions. In a previous attempt to remedy this, the EBA issued a uniform definition of 'non-performing exposure'[2] ("**NPEs**") based on the "past-due" and "unlikely to pay" criterion. The ECB encourages institutions to adopt this definition in their internal risk control and public financial reporting and also to ensure that the identification of NPEs is consistent at the entity and banking group levels, with a harmonised implementation in all subsidiaries and branches.

NPL impairment measurement and write-offs

The ECB remarks that asset quality reviews and stress tests have highlighted the need for consistent provisioning methodology and adequate provisioning levels across banks. The guidance requests that banks

[2] Source: Paragraph 145, Annex V of the EBA's Implementing Technical Standards on Supervisory Reporting.

adequately measure impairment provisions across all loan portfolios through sound and robust provisioning methodologies, timely recognise loan losses within the context of relevant and applicable accounting standards and timely write-offs, and implement enhanced procedures to significantly improve the number and granularity of asset quality and credit risk control disclosures. The ECB expects that as of the date IFRS 9 comes into force in 2018, at least all Stage 3 exposures (assets for which there has been a significant increase in credit risk i.e. credit impairment) will fall into the scope of its guidance. Under IFRS 9, lifetime credit losses are generally expected to be recognised before the financial instrument becomes past due or other borrower-specific default events are observed. Upon request by supervisors, banks should, at a minimum, be able to provide them with data regarding the models they use to calculate impairment allowances for NPLs on a collective basis. Banks are also expected to disclose the detailed set of quantitative and qualitative disclosures in their financial statements to provide an understanding of their loan portfolio quality and credit risk control practices.

Collateral valuation for immovable property

The ECB comments that, in the past, banks have often failed to obtain periodic financial information from borrowers or updated real estate valuations in order to assess the quality of loans on their balance sheets and the adequacy of collateral. This has resulted, says the ECB, in banks failing to recognise early warning signs that asset quality was declining, which has caused an understatement of balance sheet loan loss provisions. Consequently, the ECB now recommends that all valuations are performed by independent qualified appraisers, either internal or external, who possess necessary qualifications, ability and experience. Banks must ensure that all appraisers meet certain requirements of independence, including (amongst other things) that they are not involved in the loan processing, loan decision and credit underwriting processes, they do not have any interests in the property and they are not connected to either the buyer or the seller of the property. The ECB recommends that banks update individual valuations for the collateral of all exposures on a frequent basis – at least every year for commercial immovable property and every three years for residential immovable property. Such valuations should be carried out more frequently 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.

Outlook

Despite the ECB starting to focus on NPLs in 2014 (when its comprehensive assessment resulted in increased NPL supervisory work), the scale of the information-gathering exercise together with the pressures of an intense workload and an organisation in its infancy meant that it has taken some time to publish meaningful NPL guidance on how to improve processes, governance and risk management within the banks themselves. In the meantime, NPLs reached €1 trillion.

The ECB's guidance states that SIs should explain and substantiate any deviation from the guidance upon supervisory request and that it will be taken into consideration during the regular Supervisory Review and Evaluation Process. Non-compliance may trigger supervisory measures. In this respect, it is clear that the ECB is keen to be able to shine a spotlight on banks with persistently high NPL levels and take a more hard lined approach in dismissing repeat excuses as to why and how certain institutions are struggling to offload their NPLs. Heightened regulatory scrutiny has already shown signs of bearing fruit: the EBA announced in January that the NPL ratio for the whole European banking sector had fallen 10 basis points to 5.4% in the second quarter of 2016. The CBRE's Head of Loan Advisory, Paul Lewis, was also recently quoted as saying that the CBRE is expecting a significant uptick in bank loan portfolio trades given both regulatory pressures and deep buyer demand for the right product, particularly in Southern Europe.[3]

However, only time will tell whether SIs across Europe rigidly adopt – and benefit from – the ECB's guidance, and whether non-compliance really does trigger supervisory measures. In the context of high numbers of distressed banks across Europe and volatile share prices, it is important that the ECB is seen to be taking an active role in monitoring conformity with the guidance if European authorities are to boost confidence in the sector and "send a strong signal to investors that they are serious about tackling bad loans".[4]

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[3] Source: Property Magazine International, "European CRE debt stock stable at €1.1 trillion", 10 March 2017.

[4] Source: Sophia Furber: "Pan-EU „bad bank" proposal fraught with challenges" Quote by Eleni Panagiotarea from the Hellenic Foundation for European and Foreign Policy.

In light of the new ECB guidelines, it remains to be seen how the NPL markets are changing. It will be especially interesting to see whether there will be more exit-options – such as straight sales or securitisations of NPL-portfolios – in the market. With the mandatory implementation of IFRS 9 before 1 January 2018, there will be additional pressure on banks to correct the book values of their NPLs. This should address the current discrepancy between market value and book value, which is preventing today's NPL market from flourishing.

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