EBA/CP/2018/01

08 March 2018

Consultation Paper

Draft Guidelines

on management of non-performing and forborne exposures

Contents

Responding to this consultation

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 08.06.2018. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

Executive Summary

1. The financial crises negatively affected the European banking sector and contributed to a build-up of non-performing exposures (NPE) in many bank's balance sheets. The overall level of NPEs remains high by historic standards, especially in some jurisdictions, even if the joint efforts of banks, supervisors, regulators and macro prudential authorities have led to the slow improvement of NPE ratios in recent years. In July 2017, the European Council concluded an Action Plan[1] to tackle non-performing loans (NPLs) in Europe. The Council stressed that a comprehensive approach combining a mix of complementing policy actions, at national and European level, is needed to address the existing stock of non-performing loans (NPLs) as well as to prevent the emergence and accumulation of new NPEs on banks' balance sheets. In this regard, the EBA, along with other bodies and institutions, was invited by the Council to contribute to this Action Plan along four specific lines: (i) supervisory actions to work with banks to improve strategies to reduce NPEs; (ii) measures to improve the functioning of the secondary market;(iii) structural measures to improve the environment for cleaning with NPEs; and (iv) fostering restructuring of the banking system. These guidelines relate to the first work strand.

2. The guidelines are designed primarily to reduce NPEs on banks' balance sheets by providing supervisory guidance to ensure that credit institutions effectively manage NPEs and forborne exposures (FBE) in their balance sheets. The aim is to achieve a sustainable reduction of NPEs in credit institutions' balance sheets which would prove beneficial from both micro and macro perspective. The guidelines are written from a prudential perspective, but also mindful of the pressing need to ensure that consumers, who have taken out loans, are treated fairly at every stage of the loan life cycle. To that end, the guidelines draw attention specifically to provisions under the EU Directives and relevant EBA guidelines relating to consumers, that credit institutions need to be cognisant of when managing NPEs.

3. The development and operationalisation of an NPE strategy is the core building block of the guidelines for banks' NPE management. The NPE strategy should be built on an assessment of the operating environment, should set out time-bound realistic, yet ambitious reduction targets and consider all available strategic options to reduce NPEs. The guidelines outline the key elements of the governance and operations of a NPE workout framework with key aspects related to steering and decision making, the NPE operating model, internal control framework and NPE monitoring as well as early warning processes. Credit institutions with elevated levels of NPEs should establish a NPE strategy, as part of their overall strategy, and related governance and operational arrangements. Effective governance covers all responsibilities that banks have, including to treat customers fairly.

4. Forbearance measures should be granted only when they aim to restore sustainable repayment by the borrower and are thus in the borrowers' interests. These guidelines set out requirements

[1] http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

on processes to recognise NPEs and FBEs, as well as a forbearance granting process with a focus on the viability of forbearance measures. Credit institutions are expected to monitor efficiency and effectiveness of forbearance measures and have in place policies and processes to assess borrowers' financial difficulties and identification of NPEs.

5. The guidelines set out guidance on the estimation of future cash-flows resulting from an active work-out of the exposure and/or the sale of collateral, and require credit institutions to have policies for timely impairments and write-offs. Management of NPEs secured by movable or immovable property collateral require credit institutions to have governance, procedures, including methodology and frequency, and controls for the valuation of the collateral.

6. The guidelines set out requirements for competent authorities' assessment of credit institutions' NPE management activity.

Next steps

7. The EBA aims to finalise the proposed guidelines during summer 2018, taking into account the comments received during the consultation. The guidelines should be implemented by 1 January 2019.

Background and rationale

8. The financial crises negatively affected the European banking sector in various ways and it contributed to the build-up of large stock of non-performing exposures (NPE) in bank balance sheets. The stock of non-performing loans (NPLs) in the EU banking sector amounted to EUR 990 billion at the end of 2016, and EUR 850 billion in Q3 2017, equalling to 5.1% and 4.2% of the total loan portfolio respectively. The EU average NPE ratio was 3.7% at the end of Q3 2017.[2]

9. While the dispersion of the stock of NPEs is uneven across Member States, the problem is undeniably European considering its scale and cross border implications with 12 Member States experiencing above average NPE ratios. The overall level remains high by historic standards, even if the joint efforts of banks, supervisors and macro prudential authorities led to the slow improvement of NPE ratios over recent years.

10. EBA's risk analysis, supported by similar research conducted by other international organisations, pointed out that high levels of NPEs are a drag on profitability and are strongly correlated with weak lending growth. The effects of high levels of NPEs in bank balance sheets on funding costs and capital and efficiency among other, can seriously jeopardise institutions' ability to run a viable and sustainable business model.

11. NPEs are a problem at multiple levels: at micro prudential level, heightened NPEs are associated with lower profitability and lower efficiency; at macro prudential level, high levels of NPEs are connected to stagnant growth as capital is tied up with NPEs and decreased new lending into the real economy. In addition, high stock of NPEs negatively affect the resilience of the banking sector to shocks and hence increases systemic risk. Finally for consumers, the inability to meet the obligations of the credit contract could have a detrimental impact on their financial situation and social circumstances. All of these effects must be tackled in a comprehensive manner.

12. In 2014, in the ITS on supervisory reporting the EBA also introduced definitions of NPE and forborne exposures (FBE) to facilitate the identification of problematic assets. Despite the decreasing trend of level of NPEs in most of EU Member States, the pace of reduction of NPLs has been slow as the discretion by banks' management and supervisors together with the absence of an effective secondary market for NPEs and challenging legal systems have incentivised keeping the loans on balance sheets.

13. In July 2017 the European Union Council concluded on an Action Plan[3] to tackle NPLs in Europe. The Council stressed that a comprehensive approach combining a mix of complementing policy actions, at national and at the European level where appropriate, is the most effective way to address the existing stock of NPEs as well as the emergence and accumulation of new NPEs on banks' balance sheets. The policy actions should cover the following four policy areas: (i) supervision, (ii) structural

[2] The EBA Risk Dashboard – data as of Q3 2017 http://www.eba.europa.eu/risk-analysis-and-data/risk-dashboard

[3] http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/banking-action-plan-non-performing-loans/#

reforms of insolvency and debt recovery frameworks, (iii) development of secondary markets for distressed assets, and (iv) restructuring of the banking system. In this regards, the EBA, along with other bodies and institutions, was invited by the Council to contribute to this Action Plan with a number of initiatives and action points, in particular on (i), (iii).

14. The EBA has therefore undertaken various actions which can be categorised into (i) Supervisory Guidance, (ii) Enhancement of disclosure requirements, and (iii) Improving the efficiency of secondary markets:

(i) These guidelines provide supervisory guidance and set the rules for suitable NPE management that should be followed by credit institutions to facilitate the effective management of the stock and flow of NPEs. The aim is to achieve sustainable reduction of NPEs in credit institutions' balance sheets which would prove beneficial from both micro and macro perspective. Additionally, and in order to enhance supervisory guidance, the EBA will issue guidelines on banks' loan origination monitoring and internal governance.

(ii) The EBA will implement enhanced disclosure requirements on asset quality and NPEs to all banks, essentially broadening the scope of application of the template on non-performing and forborne exposures (FBE) currently included in the EBA Guidelines (GL) on disclosure requirements under Part Eight of the Regulation (EU) No 575/2013[4] to all banks, and further to this implementing additional disclosure items on NPEs, forbearance and foreclosed assets.

(iii) On the secondary market development, in December 2017 the EBA published 14 December 2017 uniform and standardised templates to facilitate the screening and transaction phase of NPLs transactions. In particular the 'EBA NPL transaction templates' will serve for the financial due diligence and valuation of portfolios and the 'EBA NPL portfolio screening templates' will be particularly useful for the initial screening of portfolios.

Objective and structure of the guidelines

15. The guidelines should be applied in a proportionate manner and, in particular, organisational aspects of management of NPEs and forborne exposures (FBEs) should be applied taking into account the size and complexity of the institutions. Significant institutions should have more sophisticated governance arrangements while small and less complex institutions may implement simpler governance arrangements in accordance with the EBA Guidelines on internal governance.

16. The scope of the guidelines is all exposures covered by the definitions of NPE and FBE. Credit institutions should focus their actions on portfolios with material NPEs or FBEs. Some parts of the guidelines may be more relevant for loans and advances than for debt securities or off-balance sheet exposures and similarly some parts are focused towards specific counterparty sectors (households, SMEs, corporates).

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[4] EBA GL2016 11 (http://www.eba.europa.eu/documents/10180/1696202/Final+report+on+the+Guidelines+on+disclosure+requirements+under+Part+Eight+of+Regulation+575+2013+%28EBA-GL-2016-11%29.pdf/20370623-9400-4b5e-ae22-08e5baf4b841)

NPE strategy, governance and operations

17. The NPE strategy is the core building block of the guidelines for the banks' NPE management. The strategy sets the ground for the credit institutions' initial and regular assessment of the operating environment and describes the considerations they should adhere to. These include internal capabilities of the credit institution, external conditions and capital implications. When developing their NPE strategy credit institutions should also consider all available strategic options and their combinations. These include hold/forbearance strategy, active portfolio reductions, taking collateral onto balance sheet and legal options including out-of-court options. Further, implementing the operational plan and embedding the NPE strategy into the institution are both important parameters of the NPE strategy. Credit institutions with an elevated NPE ratio should establish targets by portfolio. The guidelines call for regular reviewing of the strategy, monitoring its operational effectiveness, and its integration in the credit institutions' risk management framework.

18. Credit institutions need to address NPEs in an efficient and sustainable way. Therefore appropriate governance structure and operational set-up should be in place to facilitate this. The guidelines outline the key elements of the governance and operations of a NPE workout framework with key aspects related to steering and decision making, the NPE operating model, internal control framework and NPE monitoring as well as early warning processes.

19. A NPE strategy and its governance and the operational aspects of the strategy are key for the efficient management of NPEs and FBEs. Setting a NPE strategy and operational framework may not be necessary for credit institutions with low levels of NPEs, therefore a threshold has been set to indicate that credit institutions with more than 5% of total NPLs should establish a strategy and all its related operational and governance aspects. A NPL ratio of 5% or above initiates application of chapters 4 and 5 but should not be considered as an automatic target to be used in credit institutions' NPE strategies. Competent authorities could identify other credit institutions that should develop NPE strategies, governance and operations if they detect signals of deteriorating asset quality.

20. The level of 5% for total NPLs has been set to ensure a minimum level of transparency, and that credit institutions are prepared to prevent build-up of NPEs and take actions at early stage to tackle the issue. The rationale behind applying NPL threshold is that the majority of exposures in credit institutions' balance sheets that turned non-performing are loans, therefore a calculation that is based on the share of non-performing loans better depicts the evolution of asset quality overall and therefore is more risk based. Chapters 4 and 5, when triggered, would apply to all material NPEs, including debt securities.

21. The computation of the NPL ratio is defined in the EBA Risk dashboard. For the NPL ratio the gross carrying amount of non-performing loans and advances is divided by the gross carrying amount of total loans and advances subject to NPE definition[5].

[5] FINREP (from Q1 2018 onwards): F18.00; rows (070+191+221); column 060 / F18.00; rows (070+191+221); column 010. FINREP (2014-2017): F18.00; rows (070+250; column 060 / F18.00; rows (070+250); column 010

22.The NPE strategy, governance and operations should cover in general all exposures but should focus on portfolios with material levels of NPEs and/or FBEs.

Forbearance, recognition of non-performing, impairment measurement

23.The chapter on forbearance focuses on the viability of forbearance solutions and the forbearance granting process and not on forbearance classification. Forbearance measures should aim to return the exposure to a situation of sustainable repayment and credit institutions should monitor two aspects of forbearance activity: efficiency and effectiveness.

24.The guidelines aim to ensure consistent recognition of NPEs by setting out policies on policies and processes to assess borrowers' financial difficulties and identification of NPEs, monitoring of cure and probation periods.

25.The chapter on impairment measurement and write-offs provides guidance on estimation of future cash flows resulting from an active workout of the exposure and/or the sale of collateral. Credit institutions are expected to have policies for timely impairments and write-offs of NPEs.

Collateral valuation

26.In order to ensure credit institutions value collateral on immovable and moveable property in a comprehensive manner the guidelines outline the governance, procedures and controls they need to have in place. The guidelines also set the frequency and methodology of valuations. In this regards, credit institutions have to obtain periodic financial information from borrowers and update property valuations regularly in order to assess the quality of loans on their balance sheets and the adequacy of collateral.

Supervisory evaluation of management of NPEs and FBEs

27.The chapter provides guidance to competent authorities on the supervisory evaluation of NPE and FBE management of credit institutions with elevated NPE level to ensure that they have adopted and adhered to a NPE strategy and related governance and operational framework as described in these guidelines. Competent authorities should also assess, as part of the SREP, whether the credit institution has an adequate framework to identify, measure, manage, monitor and mitigate its NPEs and FBEs, including workout activities.

Legal basis

28.These guidelines are issued pursuant to Article 16(1) of Regulation (EU) No 1093/2010[6] in order to ensure common, uniform and consistent application of Union law and to establish consistent, efficient and effective supervisory practices within the ESFS.

29.Article 74 of Directive 2013/36/EU requires institutions to have robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of

[6] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p. 12).

responsibility, effective process to identify, manage, monitor and report the risks they are or might be exposed to and adequate control mechanisms.

30. To further harmonise institutions' internal governance arrangements, processes and mechanisms within the EU, the EBA is mandated by Article 74 of Directive 2013/36/EU to develop guidelines in this area.

31. Article 76 of the Directive 2013/36/EU sets out requirements for the involvement of the management body in risk management, the setting up of a risk committee for significant institutions, and the tasks and organisation of the risk management function and requires in particular that the management body of credit institutions to approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to.

32. Furthermore, in line with Article 79 of Directive 2013/36/EU competent authorities should ensure among others that:

- credit institutions have internal methodologies in place to assess the credit risk of their exposures on an individual and on a portfolio basis,
- the ongoing administration and monitoring of the various credit risk-bearing portfolios is operated through effective systems, including the identification and management of problem credits as well as setting aside adequate value adjustments and provisions.

33. In accordance with Article 97 of Directive 2013/36/EU, competent authorities should review the arrangements, strategies, processes and mechanisms implemented by credit institutions to determine whether the own funds and liquidity held by them ensure a sound management and coverage of their risk. Competent authorities, when conducting the supervisory review and evaluation process (SREP), will review whether credit institutions observe the provisions of these Guidelines. As an outcome of the SREP, and in accordance with Article 104(1)(d) of Directive 2013/36/EU, competent authorities may require the institution to apply a specific provisioning policy, which can thus – where permitted by accounting rules and regulations – result in increase impairments; or the need to hold additional own funds.

34. Article 107 of Directive 2013/36/EU addresses the consistency of supervisory reviews, evaluation and supervisory measures, mandating the EBA to draw up guidelines addressed to the competent authorities, in a manner that is appropriate to the size, the structure and the internal organization of institutions and the nature, scope and complexity of their activities, the common procedures and methodologies for the SREP referred to in paragraph 1 of Article 107 and in Article 97 and for the assessment of the organisation and treatment of the risks referred to in Articles 76 to 87 of that Directive.

35. Article 109(2) of Directive 2013/36/EU requires parent undertakings and subsidiaries subject to this Directive to meet the governance requirements also on a consolidated or sub-consolidated basis, to ensure that their arrangements, processes and mechanisms are consistent and well-integrated and that any data and information relevant to the purpose of supervision can be produced. In

particular, it should be ensured that parent undertakings and subsidiaries subject to Directive 2013/36/EU implement such arrangements, processes and mechanisms in their subsidiaries not subject to this Directive. These arrangements, processes and mechanisms must also be consistent and well-integrated and those subsidiaries not subject to Directive 2013/36/EU must also be able to produce any data and information relevant to the purpose of supervision.

36. Under Article 123(2) of Directive 2013/36/EU, competent authorities must require institutions to have in place adequate risk management processes and internal control mechanisms, including sound reporting and accounting procedures in order to identify, measure, monitor and control transactions with their parent mixed-activity holding company and its subsidiaries appropriately.

37. The evidence from wide ranging asset quality reviews conducted by competent authorities in recent years highlights gaps in credit institutions' credit risk assessment and management practices. Therefore these Guidelines react to legitimate supervisory needs to equip credit institutions with a comprehensive set of requirements that should be considered when devising their NPE management framework.

38. The objective of the guidelines is to increase the convergence of NPE and FBE management practices across EU member's states, by clarifying how credit institutions should effectively manage and ultimately reduce their non-performing and forborne exposures through the establishment and operationalization of an NPL strategy, which is embedded into the credit institution's overall strategy.

39. The guidelines together with the guidelines on loan origination, that the EBA is also invited to issue by the Council's Action Plan, aim to address the existing stock of NPLs and also to prevent the accumulation of NPLs in the future.

40. The provisions of the guidelines should be read in conjunction with and without prejudice to the Commission Implementing Regulation 680/2014 on supervisory reporting, which provides harmonised NPE and FBE definitions for prudential reporting purposes that are applied consistently across these Guidelines.

41. These guidelines should be read in conjunction and without prejudice to other relevant EBA products in particular with the EBA guidelines on internal governance, the EBA SREP guidelines, the EBA Guidelines on credit institutions' credit risk management and accounting for expected credit losses and the joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders.

42. Furthermore the guidelines rely on the harmonised definition of default provided by the Guidelines EBA/GL/2016/07 on the application of the definition of default, which cover key aspects, such as the days past due criterion for default identification, indications of unlikeliness to pay, conditions for the return to non-defaulted status, treatment of the definition of default in external data, application of the default definition in a banking group and specific aspects related with retail exposures. In the context of determining the days past due, these guidelines refer to the Commission Delegated Regulation (EU) 2018/171 on materiality threshold for past due credit

obligations, has been adopted by the European Commission and soon to be published in the Official Journal, that provides the methodology for calculating the days past due.

43. These guidelines should also be read in conjunction with, and without prejudice to, the Mortgage Credit Directive (MCD) (Directive 2014/17/EU), and in particular Article 7 of the MCD on conduct of business obligations when providing credit to consumers and Article 28 on arrears and foreclosure, the Consumer Credit Directive (Directive 2008/48/CE), and in particular Article 17 of this Directive on the assignment of rights under a consumer credit agreement and the EBA Guidelines under the MCD, and in particular to the EBA Guidelines on arrears and foreclosure (EBA/GL/2015/12).

EBA/GL/20XX/XX

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Draft Guidelines on management of non-performing and forborne exposures

1. Compliance and reporting obligations

Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010[7]. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and credit institutions must make every effort to comply with the guidelines.

2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by ([dd.mm.yyyy]). In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to compliance@eba.europa.eu with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to EBA.

4. Notifications will be published on the EBA website, in line with Article 16(3).

[7] Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p.12).

2. Subject matter, scope and definitions

Subject matter

5. These guidelines specify sound risk management practices for credit institutions for managing non-performing exposures (NPE), forborne exposures (FBE) and foreclosed assets.

6. These guidelines also provide competent authorities with guidance on evaluating credit institutions' risk management practices, policies, processes and procedures for managing NPEs and FBEs.

Scope of application, proportionality

7. These guidelines apply in relation to Article 74 of Directive 2013/36/EU [8] which requires institutions to have robust governance arrangements, including a clear organisational structure with well-defined, transparent and consistent lines of responsibility, effective process to identify, manage, monitor and report the risks they are or might be exposed to and adequate control mechanisms.

8. Competent authorities should ensure that credit institutions comply with these guidelines on an individual, sub-consolidated and consolidated basis in accordance with Article 109 of Directive 2013/36/EU.

9. These guidelines and all chapters apply to all exposures subject to definition of non-performing and forbearance as defined in Annex V of Commission Implementing Regulation 680/2014[9].

10. Credit institutions should apply chapters 4 and 5 when their level of non-performing exposures is elevated. An NPL ratio above 5% should be considered as an elevated level of NPEs. Chapters 4 and 5 should be applied to exposures and portfolios with material levels of NPEs.

11. Credit institutions with an NPL ratio below 5% but with a high share or material amount of NPEs in an individual portfolio or with a specific concentration of NPEs towards a geographic region, an economic sector or group of connected clients, should apply chapters 4 and 5 on these portfolios.

12. Competent authorities may identify credit institutions, other than those covered in paragraphs 10 and 11, which should also apply chapters 4 and 5. Competent authorities should require the application of these chapters if they identify signals of deteriorating asset quality. Competent

[8] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, (OJ L 176, 27.6.2013, p. 338)

[9] Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council, (OJ L 191, 28.6.2014, p. 1)

authorities may also identify individual portfolios where chapters 4 and 5 should be applied to. Competent authorities should consider the following elements and their interactions when assessing applicability of chapters 4 and 5:

a) Increased inflows of NPEs;

b) Heightened or increased level of FBE;

c) Heightened or increased level of foreclosed assets;

d) Low coverage ratios;

e) Breached early warning indicators;

f) Elevated Texas ratio

g) Quality and appropriateness of workout activity

13. All credit institutions should apply chapter 5.5 and chapters 6 to 9.

14. Credit institutions should comply with these guidelines in a manner that is appropriate to their size and internal organisation and the nature, scope and complexity of their activities, in particular, credit institutions may comply with chapter 4 and 5 considering the proportionality criteria in chapter 4, Title I of the EBA Guidelines on internal governance[10].

15. Proportionality in terms of the supervisory evaluation of the NPE strategy of a category 3 and 4 institution[11] can be considered by aligning assessment with the SREP engagement model, which ensures a risk based approach to supervision and takes into account the systemic importance of global or domestic institutions.

Addressees

16. These guidelines are addressed to competent authorities as defined in point 40 of Article 4(1) of Regulation (EU) No 575/2013 including the European Central Bank with regards to matters relating to the tasks conferred on it by Regulation (EU) No 1024/2013 and to credit institutions as defined in point 1 of Article 4(1) of Regulation No 575/2013.

Definitions

17. Unless otherwise specified, terms used and defined in Directive 2013/36/EU, Regulation (EU) 575/2013[12], Commission Implementing Regulation (EU) No 680/2014 as amended and in force,

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[10] EBA/2017/11 Guidelines on internal governance under Directive 2013/36/EU

[11] Described in Chapter 2.1.1 Categorisation of institutions in the EBA/GL/2014/13 Guidelines on SREP

[12] Regulation (EU) 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/201,2 (OJ L 176, 27.6.2013, p. 1)

have the same meaning in the guidelines. In addition and in particular, for the purposes of these guidelines, the following definitions apply:

Cure period	as defined in part 2, paragraph 231 (b) of Annex V of Regulation (EU) 680/2014
EBITDA	earnings before interest, taxes, depreciation and amortisation (EBITDA)
Early Warning Indicators (EWI)	indicators that inform the credit institution of the evolution of the asset quality and are able to signal emerging risk at portfolio or transaction level, including the deteriorating financial situation of the borrower
Forbearance	Forbearance measures as referred in Annex V of Regulation (EU) 680/2014
Forborne exposures (FBE)	Exposures in respect to which forbearance measures have been applied according to Annex V of Regulation (EU) 680/2014
Foreclosed assets	Assets obtained by taking possession of collateral and which remains recognised in the balance sheet. Foreclosed assets can be obtained through judicial procedures, through bilateral agreement with the borrower, through other types of collateral transfer from the borrower to the credit institution. Foreclosed assets may include financial and non-financial assets and should include all collateral obtained irrespective of their accounting classification.
Liquidation cost	Liquidation costs are defined as the cash outflows incurred during collateral execution and the sales process and include: a) all applicable legal costs; b) selling costs, taxes and other expenses; c) any additional maintenance costs to be incurred by the credit institution in relation to the repossession and disposal of the collateral; d) any cash inflows up to the date of liquidation.
Non-performing exposure (NPE)	Exposures classified as non-performing according to Annex V of Regulation (EU) 680/2014
Non-performing loans (NPL)	Loans and advances as defined in Annex V of Regulation (EU) 680/2014 that are classified as non-performing according to in Annex V of Regulation (EU) 680/2014
NPL ratio	Non-performing loans and advances / total loans and advances subject to NPE definition.
NPE framework	Policies, processes, controls and systems for risk management of NPE
NPE Workout unit	Separated and dedicated specialist function managing NPEs.
Portfolio	Group of exposures with similar credit risk characteristics
Probation period	as defined in Annex V of Regulation (EU) 680/2014
Risk appetite framework (RAF)	The overall approach, including policies, processes, controls and systems, through which risk appetite is

	established, communicated and monitored. It includes a risk appetite statement, risk limits and an outline of the roles and responsibilities of those overseeing the implementation and monitoring of the RAF. The RAF should consider material risks to the bank, as well as to its reputation vis-à-vis policyholders, depositors, investors and customers. The RAF aligns with the bank's strategy.
Texas ratio	Texas ratio: Ratio comparing stock of NPLs to credit institution's equity. NPLs (gross carrying amount / equity and accumulated impairments.

Question 1: What are the respondents' views on the scope of application of the guidelines?

Question 2: What are the respondents' view of the proposed threshold of 5 % NPL ratio?

3. Implementation

Date of application

18.These guidelines apply from [1 January 2019].

Question 3: Do you see any significant obstacles to the implementation date and if so what are they?

4. NPE strategy

19.This chapter sets out the key elements for developing and implementing an NPE strategy. Credit institutions should have an adequate framework to identify, measure, manage, monitor and mitigate its NPEs, including workout activities.

4.1 Developing the NPE strategy

20.Credit institutions should establish an NPE strategy to target a time-bound reduction of NPEs over a realistic but sufficiently ambitious time horizon (NPE reduction targets). The NPE strategy should lay out the credit institution's approach and objectives regarding the effective management to maximise recoveries and ultimate reduction of NPE stocks in a clear, credible and feasible manner for each relevant portfolio. When developing and implementing the NPE strategy for retail portfolios, credit institutions should consider provisions aimed at protecting consumers, including Directive 2014/17/EU[13], Directive 2008/48/EC[14], the EBA Guidelines on arrears and foreclosure[15].

21. The following steps should form the core building blocks of the development and implementation of the NPE strategy:

   a) Assessment of the operating environment and external conditions (see section 4.2);

   b) Development of the NPE strategy over short, medium and long-term time horizons (see section 4.3);

   c) Implementation of the operational plan (see section 4.4);

   d) Fully embedding the NPE strategy into the management processes of the credit institution, including regular review and independent monitoring (see section 4.5).

22. When credit institutions develop their NPE strategy they should also consider policies that aim to ensure the fair treatment of borrowers.

4.2 Assessing the operating environment

23. As a first phase in the formulation and execution of an appropriate NPE strategy, credit institutions should complete an assessment of the following elements:

   a) internal capabilities to effectively manage and reduce NPEs;

   b) external conditions and operating environment;

   c) capital implications of the NPE strategy.

4.2.1 Internal capabilities/self-assessment

24. Credit institutions should perform a comprehensive self-assessment to evaluate the actual situation and the steps to be taken internally to address any gaps in the internal capabilities to manage NPEs.

25. Institutions should fully understand and assess:

   a) Magnitude and drivers of their NPEs:

[13] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34)

[14] Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC (OJ L 133, 22.5.2008, p. 66)

[15] EBA/GL/2015/12 EBA Guidelines on arrears and foreclosure

i. size and evolution of NPE portfolios on an appropriate level of granularity, which requires appropriate grouping of exposures as outlined in section 5.2.3;

ii. drivers of NPE in-flows and out-flows, by portfolio where relevant;

iii. other potential correlations and causations.

b) Outcomes of NPE actions taken in the past:

i. types and nature of actions implemented, including forbearance activities;

ii. effectiveness of those activities and related drivers.

c) Operational capacities (processes, tools, data quality, IT/automation, staff/expertise, decision making, internal policies, and any other relevant area for the implementation of the strategy) for the different process steps involved, including but not limited to:

i. early warning identification of NPEs;

ii. forbearance activities;

iii. impairments and write-offs;

iv. collateral valuations;

v. recovery, legal process and foreclosure;

vi. management of foreclosed assets, where relevant;

vii. reporting and monitoring of NPEs and effectiveness of NPE workout solutions.

26. Credit institutions should perform a comprehensive self-assessment covering at least the items listed in paragraph 23 on an annual basis to determine strengths, significant gaps and areas of improvement required to reach NPE reduction targets.

27. Credit institutions should report the outcome of the comprehensive self-assessment to the institution's management body and the competent authority.

28. Credit institutions should consider seeking independent expert views from the institution's risk management or from external sources on a periodic basis on its operational capabilities to manage NPEs.

4.2.2 External conditions and operational environment

29. Credit institutions should assess and consider the current and likely future external operating conditions and environment when establishing the NPE strategy and associated NPE reduction

targets. The following list of external factors, where appropriate, should be taken into account by credit institutions when setting the NPE strategy:

a) Macroeconomic conditions, including the dynamics of the real estate market or other relevant sectors, considering sector concentrations in NPE portfolios;

b) Market expectations with regard to acceptable NPE levels and coverage, including but not limited to the views of rating agencies, market analysts, and available research; as well as taking proper account of the interests of borrowers.

c) NPE investor demand, including trends and dynamics of the domestic and international NPE market for portfolio sales;

d) Maturity of the NPE servicing industry and the availability and coverage of specialised servicers;

e) Regulatory, legal and judicial framework. Credit institutions should have a good understanding of the legal proceedings linked to the NPE workout for different types of assets and different jurisdictions. In particular, credit institutions should assess the average length of such proceedings, the average financial outcomes, the rank of different types of exposures and related implications for the outcome, the influence of the types and ranks of collateral and guarantees on the outcomes, the impact of consumer protection issues on legal decisions, and the average total costs associated with legal proceedings. The legal provisions aimed at protecting consumers, in particular for residential mortgage exposures, should also be considered by credit institutions when setting the NPE strategy.

f) National tax implications of impairments and NPE write-offs.

4.3 Development of the NPE strategy

30. The NPE strategy should encompass, at a minimum, time-bound quantitative NPE targets and foreclosed assets targets where appropriate supported by a corresponding comprehensive operational plan. The development of the NPE strategy should consider the self-assessment and an analysis of strategic options to implement this NPE strategy. The NPE strategy and the operational plan, should be defined and approved by the management body and reviewed at least annually.

4.3.1 Capital implications of the NPE strategy

31. Credit institutions should be able to calculate a detailed assessment of the impact of the planned strategy from a capital, risk exposure amounts, profit or loss and impairment perspective for each of the reduction drivers and they should assess whether the bank has identified a strategic process to resolve any shortfalls under different economic scenarios. The assessment criteria,

underlying assumptions and implications should be aligned with the risk appetite framework (RAF) as well as the internal capital adequacy assessment process[16] (ICAAP).

32. Credit institutions should include suitable actions in their capital planning to ensure that the level of available capital and capital buffers will enable a sustainable reduction of NPEs from the balance sheet.

4.3.2 Strategy implementation options

33. Credit institutions should consider including a combination of strategies and options in the NPE strategy to achieve its objectives over the short, medium and long term. In order to successfully operationalise the NPE strategy, credit institutions should consider at least the below, non-mutually exclusive implementation options for different portfolios and under different conditions:

a) Hold/forbearance strategy: suitable workout strategy and forbearance options. A hold strategy option is strongly linked to the credit institution’s operating model, forbearance and borrower assessment expertise, operational NPE management capabilities, outsourcing of servicing and write-off policies.

b) Active portfolio reductions: sales, securitisation, or in the case of NPEs that are deemed unrecoverable write offs. This option is strongly linked to adequacy of impairments, collateral valuations, quality of exposure data and NPE investor demand.

c) Change of type of exposure or collateral, including foreclosure, debt to equity swapping, debt to asset swapping, or collateral substitution.

d) Legal options: including insolvency proceedings or out-of-court solutions.

34. Credit institutions should identify medium and long-term strategy options for NPE reductions, which may not be achievable immediately, e.g. due to a lack of immediate NPE investor demand that might change in the medium to long term. The operational plans may therefore need to foresee such changes and prepare for them, e.g. the need for enhancing the quality of NPE data in order to be ready for future investor transactions.

35. When a credit institution concludes that none of the above options lead to an efficient NPE reduction in the medium to long-term horison for certain portfolios or individual exposures, this should be clearly reflected in a timely impairment and write-off approach.

36. Credit institutions aiming to engage in complex processes, such as NPE risk transfer and securitisation transactions, should conduct robust risk analysis and to have adequate risk control processes in place[17].

[16] See EBA/GL/2016/10 Guidelines on ICAAP and ILAAP information collected for SREP purposes.

[17] As required for securitization under Article 82 (1) of the Directive 2013/36/EU.

4.3.3 Targets

37. Before commencing the short to medium-term target-setting process, credit institutions should establish a view of the reasonable long-term NPE levels, both on portfolio-level as well as on aggregate level. Credit institutions should take into account historic or international benchmarks in order to define reasonable long-term NPE levels.

38. Credit institutions should include, at a minimum, clearly defined realistic yet ambitious quantitative targets in their NPE strategy, including foreclosed assets where relevant. These targets should lead to a concrete reduction, gross and net of impairments, of NPEs, at least in the medium term. While expectations about changes in macroeconomic conditions, when based on solid external forecasts, can play a role in determining target levels, they should not be the sole driver for the established NPE reduction targets.

39. Credit institutions should establish targets along the following dimensions:

    a) by time horizons, short-term (indicative 1 year), medium-term (indicative 3 years) and possibly long-term;

    b) by main portfolios e.g. retail mortgage, retail consumer, retail, SME, corporate, large corporate, commercial real estate;

    c) by implementation options, e.g. cash recoveries from hold strategy, collateral repossessions, recoveries from legal proceedings, revenues from sale of NPEs or write-offs.

40. The NPE targets for credit institutions should at a minimum include a projected absolute or percentage NPE reduction, both gross and net of impairments, not only on an overall basis but also for the main NPE portfolios. Where foreclosed assets are material, a foreclosed assets strategy should be defined or, at least, foreclosed assets reduction targets should be included in the NPE strategy.

41. The NPE targets should be aligned with the more granular operational targets. Further monitoring indicators can be implemented as additional targets, if deemed appropriate.

4.3.4 Operational plan

42. The NPE strategy of the credit institution should be supported by an operational plan which should be defined, approved and reviewed by the management body. The operational plan should clearly define how the credit institution will operationally implement its NPE strategy over a time horizon of at least 1 to 3 years (depending on the type of operational measures required).

43. The NPE operational plan should contain at a minimum:

    a) clear time-bound objectives and goals;

b) activities to be carried out on a portfolio basis;

c) governance arrangements and structures including responsibilities and reporting mechanisms for activities and outcomes;

d) quality standards to ensure successful outcomes;

e) staffing and resource requirements;

f) required technical infrastructure and enhancement plan;

g) granular and consolidated budget requirements for the implementation of the NPE strategy;

h) communication plans with internal and external stakeholders e.g. for sales, servicing, efficiency initiatives.

44. The operational plan should put a specific focus on internal factors that could present impediments to a successful delivery of the NPE strategy.

4.4 Implementing the operational plan

45. The implementation of the NPE strategy operational plan should rely on suitable policies and procedures, clear ownership and suitable governance structures, including escalation procedures and should incorporate wide-ranging change management measures in order to integrate the NPE workout framework as a key element in the corporate culture.

46. Credit institutions should report material deviations from the plan to the management body and to the competent authority in a timely manner with appropriate remediation actions to be put in place.

4.5 Embedding the NPE strategy

47. As execution and delivery of the NPE strategy involves and depends on many different areas within the credit institution, it should be embedded in processes at all levels of the organisation, including strategic and operational, including the risk committee as defined in Article 76(3) of Directive 2013/36/EU.

48. Credit institutions should emphasise to all relevant staff the key components of the NPE strategy in line with the approach taken for the institutions' overall strategy and in particular the risk strategy as defined in Article 76 of Directive 2013/36/EU. This is especially important if the implementation of the NPE strategy involves wide-ranging changes to business procedures.

49. Credit institutions should clearly define and document the roles, responsibilities and formal reporting lines for the implementation of the NPE strategy, and the operational plan.

50. Staff and management involved in NPE workout activities should be provided with clear individual (or team) goals and incentives geared towards reaching the targets agreed in the NPE strategy, and the operational plan. Related remuneration policies, career development objectives and performance monitoring frameworks should take the NPE targets into account in order to ensure the full engagement of staff and management in the NPE reduction. The incentive scheme of staff and managers of the loan origination/business units should also consider the feedback from the workout activities and the quality of the credit institution's exposures in order to disincentives excessive risk taking. For retail exposures these remuneration policies should be developed in accordance with the EBA Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services[18].

51. All relevant components of the NPE strategy should be fully aligned with and integrated into the business plan and budget, including all the relevant costs associated with the implementation of the operational plan, but also potential losses stemming from NPE workout activities.

52. The NPE strategy should be fully embedded in the risk management framework. In that context, special attention should be paid to:

a) ICAAP[19]: All relevant components of the NPE strategy should be fully aligned with and integrated into the ICAAP. Credit institutions should prepare the quantitative and qualitative assessment of NPE developments under base and stressed conditions including the impact on capital planning;

b) RAF[20]: RAF and NPE strategy are closely interlinked. In this regard, there should be clearly defined RAF metrics and limits approved by the management body which are in alignment with the core elements and targets forming part of the NPE strategy;

c) Recovery plan[21]: Where NPE related indicator levels and actions form part of the recovery plan, credit institutions should ensure they are in alignment with the NPE strategy targets and operational plan.

[18] EBA Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services (EBA/GL/2016/06)

[19] As defined in Article 108 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (OJ L 176, 27.6.2013, p. 338)

[20] As described in the Financial Stability Board's "Principles for An Effective Risk Appetite Framework"

[21] As required by Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190),

53. Credit institutions should ensure a strong level of monitoring and oversight by the risk management functions in respect of the formulation and implementation of the NPE strategy and operational plan.

Question 4: Does section 4.3.2 capture all relevant options available for credit institutions to implement their NPE strategy?

5. NPE governance and operations

54. In order for credit institutions to be able to address their NPE issues in an efficient and sustainable manner, appropriate governance structure and operational set-up should be in place.

55. This chapter sets out the key elements of the governance and operations of an NPE workout framework with key aspects related to steering and decision making, the NPE operating model, internal control framework and NPE monitoring as well as early warning processes.

5.1 Steering and decision making

56. The overarching strategy of a credit institution and its implementation should cover the NPE strategy and operational plan and should therefore be set, approved and reviewed by the management body. In particular, the management body should:

a) approve annually and regularly review the NPE strategy and the operational plan in line with the overall risk strategy;

b) oversee the implementation of the NPE strategy;

c) define quantitative and qualitative management objectives and incentives for NPE workout activities;

d) monitoring on a quarterly basis progress made in comparison with the targets defined in the NPE strategy, and the operational plan;

e) define adequate approval processes for NPE workout decisions; for large NPE exposures this should involve management body approval;

f) approve NPE related policies (including those listed in Annex 4) and processes and should review them at least annually and proceed with any necessary amendments. They should ensure that the policies and processes are completely understood by the staff;

g) ensure sufficient internal controls over NPE management processes(with a special focus on activities linked to NPE classifications, impairments, write-offs, collateral valuations and sustainability of forbearance solutions;

h) have sufficient knowledge, experience and expertise with regard to the management of NPEs.

57. The management body and other relevant managers should dedicate an amount of their capacity and devote sufficient time to NPE workout-related matters in line with Article 76 of Directive 2013/36/EU, which is proportionate to the risks connected to NPEs within the credit institution. Credit institutions should establish and document clearly defined, efficient and consistent decision-making procedures with adequate second line of defence involvement at all times.

5.2 NPE operating model

5.2.1 NPE workout units

58. In order to eliminate conflict of interest in managing NPEs as well as to make good use of dedicated NPE expertise across the organisation, the NPE operating model should be based on dedicated NPE workout units (WUs) which are separate from units responsible for loan origination.

59. Credit institutions should implement separate and dedicated NPE WUs. Credit institutions should establish adequate segregation of duties and establish information barriers, e.g. through the physical separation of certain departments. This separation of duties approach should encompass not only client relationship activities (e.g. negotiation of forbearance solutions with clients), but also the decision-making process. In this context, credit institutions should consider implementing dedicated decision-making bodies related to NPE workout (e.g. NPE committee).

60. Where overlaps with the decision-making bodies, managers or experts involved in the loan origination process are not avoidable, the institutional framework and internal controls should ensure that any potential conflicts of interest are sufficiently mitigated.

61. Credit institutions should have arrangements in place to ensure that regular feedback between loan origination units and NPE WUs is established.

62. When designing an appropriate NPE WU structure, credit institutions should take into account the specificities of their main NPE portfolios, including the type of exposure (retail, SME, corporate) and the type of collateral.

63. Credit institutions should consider designing automated processes for NPE WUs for homogenous retail NPE portfolios, while for those for corporate NPE portfolios a relationship management approach should be used with a strong sectorial specialisation of NPE WU staff.

For sole traders and micro-SMEs, a combination of automated elements and relationship approaches should be considered.

5.2.2 Alignment with NPE life cycle

64. NPE WUs should be set-up to ensure that NPE workout activities and borrower engagements are tailored to the NPE life cycle[22] phases. Credit institutions should set up different WUs for the different phases of the NPE life cycle and also for different portfolios, if appropriate. All applicable workout stages should receive adequate focus and should be equipped with sufficiently specialised staff.

65. Credit institutions should consider the following phases in the NPE life cycle:

a) Early arrears (up to 90 days past due)[23]: During this phase, the focus should be on initial engagement with the borrower for early recoveries and on collecting information required for a detailed assessment of the borrower's circumstances (e.g. financial position, status of loan documentation, status of collateral, level of cooperation, etc.). The type of exposure and collateral should ultimately determine the most suitable workout strategy, which may involve short-term forbearance options with the aim of stabilising the financial position of the borrower before establishing a suitable workout strategy. In addition, the credit institution should seek options to improve its position while taking into account the rights and interests of consumers (for instance by signing new loan documents, perfecting outstanding collateral, minimising cash leakage, taking additional collateral if available). A dedicated arrears management policy should contain guidance on the overall NPE workout procedures and responsibilities, including hand-over triggers.

b) Late arrears /forbearance[24]: Credit institutions should implement and formalise forbearance arrangements with borrowers in this phase. Forbearance arrangements should be put into place only where the borrower affordability assessment concluded that viable restructuring options indeed exist considering also Article 28 of Directive 2014/17/EU[25] and other legal provisions aimed at protecting consumers, to the extent applicable. A forbearance arrangement should be monitored for at least 1 year in line with the Commission Implementing Regulation 680/2014, given their increased risk, before they can eventually be transferred out of the NPE WUs if no further NPE triggers are observed.

c) Liquidation/debt recovery/legal cases /foreclosure: If no viable forbearance solution has been found due to the borrower's financial circumstances or cooperation level, credit institutions should perform a cost-benefit analysis of different liquidation options including

[22] This also encompasses assets not classified as NPEs such as early arrears, FBEs or foreclosed assets – which play an essential role in the NPE workout process.

[23] Unlikely-to-pay exposures could be part of either early arrears or restructuring units, depending on the complexity.

[24] See footnote 23.

[25] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34)

in-court and out-of-court procedures. Based on this analysis, credit institutions should speedily proceed with the chosen liquidation option, supported by legal and business liquidation expertise. Credit institutions that are engaged in extensive use of external experts should ensure that sufficient internal control mechanisms are in place to ensure an effective and efficient liquidation process. Aged NPE stocks should be given special attention in this regard. A dedicated debt recovery policy should contain guidance on the liquidation procedures.

66. Managing foreclosed assets (or other assets stemming from NPEs): Collateral repossession generally commences after other attempts by the credit institution to collect the outstanding amounts have failed. The credit institution should have a policy in place that describes the recovery process from foreclosed assets, in particular covering the steps of repossession, valuation of the collateral and realisation of various types of collateral through appropriate means.

5.2.3 Grouping exposures

67. The EBA Guidelines on credit risk management practices and accounting for expected credit losses[26] describe the policies for credit institutions of grouping exposures with shared credit risk characteristics. Homogeneous portfolios should be built up in order to tailor the treatments specifically to NPEs. Credit institutions should consider designing customised processes for each portfolio with dedicated expert teams taking ownership of it. NPE portfolios should be analysed with a high degree of granularity, resulting in clearly defined borrower sub-portfolios. For this analysis credit institutions should develop appropriate management information systems and sufficiently high data quality.

68. A list of potential selection criteria for grouping retail NPE portfolios is contained in Annex 1.

69. For corporate NPE portfolios, grouping by asset class or sector (e.g. commercial real estate, land and development, shipping, trading businesses) should be considered a key driver for NPE WU specialisation. These portfolios should then be further divided in line with the NPE strategy and the level of financial difficulties to ensure that the workout activities are sufficiently focused.

5.2.4 Human resources

70. Credit institutions should have in place an appropriate organisational framework relative to their business model and taking into account their risks, including risks stemming from NPEs. Credit institutions therefore should devote an appropriate and proportionate amount of management attention and resources to the workout of NPEs and to the internal controls of related processes.

[26] EBA/2017/06 Guidelines on credit institutions' credit risk management and practices and accounting for expected credit losses

71. Sharing management and resources with other parts of the value chain (e.g. loan origination) should be carefully reviewed before implementing so as to avoid conflicts of interest and to ensure sufficient specialisation as discussed above.

72. Based on the findings of the credit institution's NPE self-assessment on capabilities, as included in section 4.2.1, credit institutions should regularly review the adequacy of their internal and external NPE workout resources and address any human resourcing gaps in a timely fashion. As workout activities may place significant demands on resources, credit institutions should consider if it is appropriate to choose to use fixed term contracts, internal/external outsourcing or joint ventures for NPE workout activities. However, the final responsibility for this activity remains with the credit institution. In the event that external outsourcing is used, credit institutions should have dedicated experts to closely control and monitor the effectiveness and efficiency of the outsourced activities. Any outsourcing should be made in accordance with the requirements of the Guidelines on outsourcing issued by CEBS[27].

73. Credit institutions should build up the relevant expertise required for the defined NPE operating model, including the NPE WUs and internal control functions in line with the provisions of the Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders[28]. Resources for key NPE workout tasks should hold dedicated NPE expertise and experience. Credit institutions should implement adequate and dedicated NPE training, including consumer protection, and should design staff development plans to build in-house expertise using available talent.

74. Where it is not possible or efficient to build in-house expertise and infrastructure, the NPE WUs should have easy access to qualified independent external resources (such as property appraisers, legal advisors, business planners, industry experts) or to dedicated NPE servicing companies.

75. The credit institution, in alignment with the overall NPE strategy and operational plan, should implement an appraisal system tailored to the requirements of the NPE WUs. The appraisal system should be designed in line with the provisions of the EBA Guidelines on sound remuneration policies[29] and Article 7 of Directive 2014/17/EU[30] as well as the EBA Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services[31] for retail exposures. The appraisal system should be mainly linked to the quantitative elements of the credit institution's NPE targets, but may also include qualitative elements (the level of technical abilities relating to the analysis of financial information and data

[27] Committee of European Banking Supervisors, predecessor of the EBA

[28] EBA/GL/2017/12 Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders under Directive 2013/36/EU and Directive 2014/65/EU

[29] EBA/GL/2015/22 EBA Guidelines on sound remuneration policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013

[30] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010, (OJ L 60, 28.2.2014, p34)

[31] EBA/GL/2016/06 EBA Guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services

received, structuring of proposals, quality of recommendations, or monitoring of restructured cases, as well as effective negotiation skills). The performance of the NPE WU staff should be regularly monitored and measured against these targets either on an individual basis or at team level, as appropriate.

76. The performance measurement framework of management bodies and relevant managers should include specific indicators linked to the targets defined in the credit institution's NPE strategy and operational plan. The importance of the respective weight given to these indicators within the overall performance measurement frameworks should be proportionate to the severity of the NPE issues faced by the credit institution.

77. Addressing early warnings signals and indicators should be fostered by credit institutions through the remuneration policy and incentives framework in order to efficiently addressing pre-arrears and thus effectively reduce NPE inflows.

5.2.5 Technical resources

78. In terms of adequate technical infrastructure, credit institutions should ensure that all NPE-related data is centrally stored in robust and secured IT systems and that it is complete and up-to-date throughout the NPE workout process.

79. An adequate technical infrastructure should enable NPE WUs to:

a) Easily access all relevant data and documentation including:

   i. current NPE and early arrears borrower information including automated notifications;

   ii. exposure, collateral and guarantee information linked to the borrower or connected clients;

   iii. monitoring tools with the IT capabilities to track forbearance performance and effectiveness;

   iv. status of workout activities and borrower interaction as well as details on forbearance measures agreed;

   v. foreclosed assets, where relevant;

   vi. tracked cash flows of the loan and collateral;

   vii. sources of underlying information and complete underlying documentation;

   viii. access to central credit registers, land registers and other relevant external data sources where technically possible.

b) Efficiently process and monitor NPE workout activities including:

i. automated workflows throughout the entire NPE life cycle;

ii. automated monitoring process for the loan status ensuring a correct flagging of NPE and FBE;

iii. incorporated early warning signals (see also chapter 6.4);

iv. automated quantitative reporting throughout the NPE workout lifecycle as a basis for the analysis which should be provided to NPE WU management, the management body and other relevant managers as well as the regulator;

v. performance analysis of workout activities by NPE WU, sub-team and expert (e.g. cure/success rate, rollover information, effectiveness of restructuring options offered, cash collection rate, vintage analysis of cure rates, promises kept rate at call centre, etc.);

vi. evolution monitoring of portfolio(s), sub-portfolio(s), cohorts, individual borrowers.

c) Define, analyse and measure NPEs and related borrowers:

i. recognise NPEs and measure impairments;

ii. perform suitable NPE portfolio analysis and store outcomes for each borrower;

iii. support the assessment of the borrower’s personal data, financial position and repayment ability (borrower creditworthiness assessment), at least for non-complex borrowers;

iv. conduct calculations of (i) the net present value and (ii) the impact on the capital position of the credit institution for each restructuring option and/or any likely restructuring plan under any relevant legislation (e.g. foreclosures law, insolvency laws) for each borrower.

80. The adequacy of the technical infrastructure, including data quality, should be assessed by an independent internal or external audit function on a regular basis.

5.3 Control framework

81. The management body should be responsible for establishing and monitoring the adequacy and effectiveness of the internal control framework. In particular effective and efficient internal control processes should be implemented for the NPE workout framework in order to ensure full alignment between the NPE strategy and operational plan on the one hand, and the credit institution’s overall business strategy, including NPE strategy and operational plan and risk appetite on the other hand.

82. Internal control functions should regularly submit to the management body written reports on NPE management highlighting major identified deficiencies. These reports should include, for each new identified major deficiency, the relevant risks involved, an impact assessment, recommendations and corrective measures to be taken. Where necessary, the heads of internal control functions should be able to have access and report directly to the management body in its supervisory function to raise concerns and warn the supervisory function, where appropriate, when specific developments affect or may affect the institution. This should not prevent the heads of internal control functions from reporting within the regular reporting lines as well.

83. The management body should follow up on the findings of the internal control functions in a timely and effective manner and require adequate remedial actions. A formal follow-up procedure on findings and corrective measures taken should be put in place.

84. The internal control framework should involve all three lines of defence in line with the EBA Guidelines on internal governance under Directive 2013/36/EU (EBA/GL/2017/11). The roles of the different functions involved should be assigned and documented clearly to avoid gaps or overlaps. Key outcomes of second and third-line activities as well as defined mitigating actions and progress on those needs should be reported to the management body regularly.

5.3.1 First line of defence controls

85. Credit institutions should ensure that the first line of defence is embedded into the procedures and processes of the operational units, mainly the NPE WUs, that actually own and manage the credit institution’s risks in the specific NPE workout context.

86. In order to ensure that adequate control mechanisms are implemented, credit institutions should have internal policies in place on the NPE workout framework. The managers of the operational units are responsible to ensure that these internal policies are implemented, including their incorporation into IT procedures. Annex 4 provides key elements of NPE framework-related policies that should be implemented at credit institutions.

5.3.2 Second line of defence controls

87. Second line of defence functions should perform controls on a continuous basis to monitor that the NPE management in the first line of defence is operating as intended. To adequately perform their control tasks, second line functions require a strong degree of independence from functions performing business activities, including the NPE WUs and should have sufficient resources. They should have an adequate number of qualified staff. Staff should remain qualified on an ongoing basis and should receive training as necessary.

88. The second line of defence controls the implementation of risk management measures by the NPE WUs and should place a special focus on:

a) monitoring and measuring of NPE related risks on a granular and aggregate basis, including linkage to internal/regulatory capital adequacy;

b) reviewing the performance of the overall NPE operating model as well as elements of it (e.g. NPE WUs management/staff, outsourcing/servicing arrangements, NPE reduction targets and early warning mechanisms);

c) assuring quality throughout the NPE loan processing, monitoring/reporting (internal and external), forbearance, impairments, write-offs, collateral valuation and NPE reporting; in order to fulfil this role, a second-line function should have sufficient power to intervene ex ante on the implementation of individual workout solutions;

d) reviewing alignment of NPE related processes with internal policy and public guidance, most notably related to NPE classifications, provisioning, write-offs, collateral valuations, forbearance and early warning mechanisms.

89. Risk control and compliance functions should also provide guidance in the process of designing and reviewing NPE related policies and procedures and controls being established across the NPE WUs. These functions should be involved in the design and review of the policies before they are approved by the management body.

90. The second line controls constitute continuous activities. For the early warning mechanism, the following activities should be performed at a minimum on a quarterly basis:

a) review the status of early warning indications and actions taken upon them;

b) ensure that actions taken are in line with internal policies;

c) review adequacy and accuracy of early warning reporting;

d) check whether the early warning indicators (EWIs) are effective, i.e. to what extent have NPEs been detected (or not) at an early stage and provide feedback loop directly to the respective function owning the early warning/watch list process; progress on methodology improvements should then be tracked subsequently (at least semi-annually).

5.3.3 Third line of defence controls

91. The third line of defence, the independent internal audit function should have sufficient NPE workout expertise in order to perform its periodic control activities on the efficiency and effectiveness of the NPE framework, including first and second line controls.

92. With regard to the NPE framework, the internal audit function should at least perform regular assessments to verify adherence to internal NPE-related policies (see Annex 4) as well as to this guidance. This should also include random and unannounced inspections and credit file reviews.

93. In determining the frequency, scope and scale of the controls to be carried out credit institutions should take into account the level of NPEs and whether significant irregularities and weaknesses have been identified by recent audits.

94. Based on the results of its controls, the internal audit function should make recommendations to the management body, bringing possible improvements to their attention.

5.4 Monitoring of NPEs and NPE workout activities

95. The monitoring systems should be based on NPE targets approved in the NPE strategy and related operational plans which are subsequently cascaded down to the operational targets of the NPE WUs and has feedback loop towards pricing of credit risk and provisioning. A related framework of NPE related key performance indicators (KPIs) should be developed to allow the management body and other relevant managers to measure progress.

96. Credit institutions should define and monitor NPE related KPIs. The NPE related KPIs, should include, but not necessarily be limited to:

a) NPE metrics;

b) borrower engagement and cash collection;

c) forbearance activities;

d) liquidation activities;

e) other (e.g. NPE related profit or loss items, foreclosed assets, early warning indicators, outsourcing activities).

97. Annex 2 contains benchmark indicators for further reference.

5.4.1 NPE metrics

98. Credit institutions should closely monitor the relative and absolute levels of NPEs and early arrears in their books at a sufficient level of portfolio granularity. Absolute and relative levels of foreclosed assets (or other assets stemming from NPE activities) as well as the levels of performing FBE should also be monitored.

99. Credit institutions should monitor level of impairments of NPEs in order to provide the management body with comprehensive information on coverage. The analysis should cover data on aggregate level as well as for different NPE portfolios. The selection of NPE portfolios should consider aspects like the type of exposure, including secured/unsecured, type of collateral and guarantees, geographic area, number of years since NPE classification, time to recovery and the use of the going and gone concern approach. Coverage movements should also be monitored and reductions clearly explained.

100. Indicators related to the NPE ratio and coverage should be benchmarked against the available indicators of peers in order to provide the management body with a clear picture on competitive positioning and potential high-level shortcomings.

101. Credit institutions should monitor their deviations from the budget , in order for the management body to understand the drivers of significant deviations from the plan.

102. Key figures on NPE inflows and outflows should be included in periodic reporting to the management body, including transfers from/to NPEs, non-performing FBE, NPEs under probation, performing, performing FBE and early arrears (≤90 days past due).

103. Credit institutions should consider if it would be useful to establish migration matrices, which will track the flow of exposures into and out of non-performing classification.

104. Credit institutions should estimate the migration rates and the quality of the performing exposures month by month, so that actions can be prioritised and taken promptly to inhibit deterioration of portfolio quality. Migration matrices can be further elaborated by exposure type (housing, consumer, real estate), by business unit or by other sub-portfolio to identify whether the driver of the flows is attributed to a specific sub-portfolio.

5.4.2 Borrower engagement and cash collection

105. Once NPE WUs have been established, key operational performance metrics should be implemented to assess the unit or employees' efficiency relative to the average performance and/or standard benchmark indicators (if they exist).

5.4.3 Forbearance activities

106. For resolving or limiting the impact of NPEs credit institutions should explore the possibilities forgranting forbearance measures. Credit institutions should monitor two aspects of the forbearance activity, efficiency and effectiveness. Chapter 7 specifies the requirements on the application of forbearance measures.

107. The main objective of forbearance measures should be the repayment of the amount due and avoidance of foreclosure, in the interest of the borrower and taking into account the relevant consumer protection requirements that may be applicable. The credit institution should monitor the quality of the forbearance activity to make sure that it is not used for delaying impairments or the assessment that the exposure is uncollectable. The monitoring should cover forbearance activity of both performing and non-performing exposures.

5.4.4 Liquidation activities

108. Provided that no sustainable restructuring solution has been reached, credit institutions should still resolve the NPE. Resolution may involve initiating legal procedures, foreclosing assets, debt to asset/equity swap, disposal of credit facilities by sales, transferring to an asset management company or securitisation. Where the price obtained from the foreclosure of immovable property affects the amount owed by a consumer, credit institutions should take

into account, when deciding on the liquidation measure and next steps, the provisions of Article 17(5) of Directive 2014/17/EU[32], to the extent applicable.

109. Liquidation activities should be monitored by the credit institution to help inform strategy and policies. Credit institutions should monitor disposals and monitor realised sales/transfer prices against net carrying amounts.

110. Credit institutions should monitor the volumes and recovery rates of legal and foreclosure cases. This performance should be measured against set targets, in terms of number of months/years and loss to the institution. In monitoring the actual loss rate, institutions are expected to build historical time series per loan portfolio to back up the assumptions used for impairment review purposes and stress test exercises.

111. For exposures covered with collateral or another type of guarantee, credit institutions should monitor the time period needed to liquidate the collateral or to enforce a guarantee. Credit institutions should also monitor potential forced sale haircuts upon liquidation and developments in certain markets (e.g. property markets) to obtain an outlook regarding the potential recovery rates.

112. Monitoring the recovery rates from foreclosure and other legal proceedings should support credit institutions to reliably assess whether the decision to foreclose will provide a higher net present value than pursuing a forbearance option. The data regarding the recovery rates from foreclosures should be monitored on an ongoing basis and feed potential amendments to credit institutions' strategies for handling their debt recovery/legal portfolios.

113. Credit institutions should also monitor the average lengths of legal procedures recently completed and the average recovery amounts (including related recovery costs) from these completed procedures.

114. Credit institutions should carefully monitor cases where the debt is swapped with an asset or equity of the borrower, at least by using the volume indicators by type of assets, and ensure compliance with any limits set by the relevant national regulations on holdings. The use of this approach as a forbearance measure should be backed by a proper business plan and limited to assets where the institution has sufficient expertise and the market realistically allows the determined value to be extracted from the asset in a short to medium-term horizon. The institution should also make sure that the valuation of the assets is carried out by qualified and experienced appraisers.

5.4.5 Other monitoring items

115. Credit institutions should monitor and report to their management bodies the amount of interest income accounted stemming from NPEs. Additionally, a distinction should be made

[32] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34)

between the interest payments on those NPEs actually received and those not actually received. The evolution of loss allowances and the respective drivers should also be monitored.

116. If foreclosure is a part of credit institutions' NPE strategy, they should also monitor the volume, ageing, coverage and flows of foreclosed assets (or other assets stemming from NPEs) at sufficient granularity for material types of assets. The performance of the foreclosed assets vis-a-vis the predefined business plan should be monitored and reported to the management body and other relevant managers on an aggregate level.

117. The management body, relevant committees and other relevant managers should receive periodic reports about the early warning or "watch-list" status for portfolios where downward trends are expected as well as the watch-list status at transaction/borrower level for large exposures. The reporting should also include the development of portfolios over time, e.g. monthly migration effects between the levels of arrears and indicators of early warning indicator`s (EWI) effectiveness.

5.5 Early warning /watch-lists process

118. In order to monitor performing exposures and prevent the deterioration of credit quality, all credit institutions should implement adequate internal procedures and reporting to identify and manage potential non-performing borrowers at a very early stage.

119. The following paragraphs detail the components of an early warning (or watch list) and reporting and escalation process. The process should be compatible with the procedures implemented for NPE management, including the hand-over of NPEs to the NPE WUs.

5.5.1 Identification of early warning indicators

120. Credit institutions should firstly develop a suitable set of EWIs to identify early signals of deterioration to promptly trigger recovery procedures of performing borrowers on a transaction/borrower and portfolio basis:

a) transaction/borrower level: EWIs should cover the credit monitoring process.

b) portfolio level and sub-portfolio level: EWIs should consider aspects like business lines, borrower segments, geographical area, products, concentration risks, level of collateralisation and type of collateral provided, or debt-service ability.

121. EWIs should be set on the basis of internal (e.g. internal score systems) or external information (rating agencies, specialised sector research, or macroeconomic indicators for specific geographical areas) and refer to a point in time or an observation period. Annex 3 includes examples of EWIs as inputs into the early warning system.

122. Credit institutions should identify specific EWIs in order to detect potential credit deterioration across risk bucket before negative events occur at transaction level.

123. In addition to the EWIs, credit institutions should perform sensitivity analyses based on internal and external information (e.g. market overview released by external providers regarding specific sectors or area) in order to identify the exposures which could be affected by potential shocks.

5.5.2 Escalation process

124. Credit institutions should have a defined escalation process in place, which should specify different types of predefined actions according to EWIs triggered. On identifying a triggered EWI events at the level of a portfolio, sub-portfolio or borrower group, credit institutions should place the identified portfolio, sub-portfolio or borrower on a watch-list and undertake a review of the portfolio concerned, and involve both the first and second lines of defence in undertaking the predefined measures and mitigation actions. Where the actions include interaction with the borrower, the credit institution should have due regard to their individual circumstances. The level of contact and communication with the borrower in payment difficulties should be proportionate to the information requirements as defined in EBA Guidelines on arrears and foreclosure[33].

125. Alerts from the EWIs to the first line of defence and related operational and management should be reported at least monthly and also on an ad hoc automated basis whenever triggered.

126. The first line of defence should be provided with effective tools and reporting customised to the relevant portfolio/borrower types that has initiated the trigger, in order to promptly evaluate the potential non-performing exposure. The monitoring tools include automated alerts at borrower level with a clear workflow and indications of required actions as well as timelines. IT systems should enable the tracking of actions taken.

Question 5: Do you see any significant obstacles to the operationalisation of the NPE strategy as described in chapter 5?

6. Forbearance

127. Credit institutions should use the definition of forbearance measures and forborne exposures as defined in Annex V of Commission Implementing Regulation (EU) 680/2014 in their risk management. Forbearance measures should aim to return the exposure to a situation of sustainable repayment and avoid foreclosure. When deciding on which steps or forbearance measures to take credit institutions should take into account and comply with consumer

[33] EBA Guidelines on Arrears and foreclosure (EBA/GL/2015/12)

protection requirements, and in particular Article 28 of Directive 2014/17/EU[34], the EBA Guidelines on arrears and foreclosure[35]. Credit institutions should monitor efficiency and effectiveness of the forbearance activity.

128. This chapter sets out the key elements of the governance and operations of forborne exposures (FBE).

6.1 Forbearance measures and their viability

129. Credit institutions should distinguish between short-term and long-term measures implemented via forbearance. Credit institutions should consider using a combination of different forbearance measures, potentially over a different time horizon with a mix of short-term and long-term options. Credit institutions should consider the list of possible forbearance measures in Annex 5.

130. Short-term measures should generally not exceed two years and, in the case of project finance and the construction of commercial property, one year. Short-term forbearance measures should be defined as modification of the terms and conditions of a temporary nature designed to address financial difficulties in the short-term, but which do not address the resolution of outstanding arrears unless combined with suitable long-term measures.

131. Short-term forbearance measures should be considered and offered when the borrower meets the two following criteria.

a) The borrower has experienced an identifiable event which has caused temporary liquidity constraints. Evidence of such an event should be demonstrated in a formal manner (and not speculatively) via written documentation with defined evidence showing that the borrower's income will recover in the short-term or on the basis of the credit institution concluding that a long-term forbearance solution was not possible due to a temporary financial uncertainty of a general or borrower-specific nature.

b) The borrower has tangibly exhibited a good financial relationship with the credit institution, including significant repayment of capital outstanding prior to the event and demonstrates clear willingness to cooperate.

132. The contractual terms for any forbearance measure should ensure that the credit institution has the right to review the agreed forbearance measures if the situation of the borrower improves and more favourable conditions for the credit institution (ranging from the forbearance to the original contractual conditions) could therefore be enforced. Credit institutions should also consider including strict consequences, like a requirement for additional

[34] Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (OJ L 60, 28.2.2014, p. 34)

[35] EBA/GL/2015/12 EBA Guidelines on arrears and foreclosure

collateral, in the contractual terms for borrowers who fail to comply with the forbearance agreement.

6.1.1 Viable versus non-viable forbearance

133. Credit institutions should distinguish between viable forbearance measures contributing to reducing the borrower’s exposure and non-viable forbearance measures.

134. Credit institutions should consider the following factors when assessing viability of forbearance measures:

a) a forbearance measure with long-term focus should be considered viable where:

i. The credit institution can demonstrate (based on reasonable documented financial information) that the borrower can realistically afford the forbearance solution, i.e. full repayment is expected.

ii. 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.

iii. In cases where there have been previous forbearance measures granted, including any previous long-term forbearance measures, the credit institution should ensure that additional internal controls are implemented to ensure this subsequent forbearance treatment meets the viability criteria as outlined below. These controls should include, at a minimum, that such cases are explicitly brought to the attention of the risk control function ex ante. Furthermore, explicit approval of the relevant senior decision-making body should be sought.

b) a forbearance measure with short-term focus should be considered viable where:

i. The credit institution can demonstrate based on reasonable documented financial information that the borrower can afford the forbearance measure.

ii. Short-term measures are applied temporarily and the credit institution is able to demonstrate, based on reasonable documented financial information, that the borrower the ability to repay the original or agreed modified amount on a full principal and interest basis commencing from the end of the short-term temporary arrangement expiry date.

iii. The measure does not result in multiple consecutive forbearance measures having been granted to the same exposure.

135. Assessment of viability should be based on the financial characteristics of the borrower and the forbearance measure to be granted at that time. The viability assessment should take place irrespective of the source of forbearance. Different sources for forbearance measures are among others borrower using forbearance clauses embedded in a contract, bilateral negotiation

of forbearance between a borrower and a credit institution, public forbearance scheme extended to all borrowers in a specific situation.

6.2 Sound forbearance processes

6.2.1 Forbearance policy

136. Credit institutions should develop a policy for their forbearance activities. The policy should cover at least:

a) The process and procedures for granting forbearance measures including responsibilities and decision-making.

b) Description of available forbearance measures including those embedded in contracts.

c) Information requirements for assessing viability of a forbearance measures.

d) Documentation of granted forbearance measures.

e) Process and metrics to monitor efficiency and effectiveness of forbearance measures.

137. Credit institutions should regularly review their forbearance policies and options based on the collective monitoring of the performance of different forbearance measures including examination of potential causes and instances of re-defaults.

6.2.2 Efficiency and effectiveness of forbearance activity

138. Credit institutions should monitor the quality of the forbearance activity to make sure that it is not used for delaying of the assessment that the exposure is uncollectable. The monitoring should cover forbearance activity of both performing and non-performing exposures and differentiate between types of forbearance measures and portfolios.

139. Credit institutions should measure efficiency of the process for granting forbearance measures and monitor the length of decision-making process and volumes of forbearance measures at each stage of the granting process.

140. Credit institutions should monitor effectiveness of granted forbearance measures. This monitoring should measure the degree of success of the forbearance measure and whether the modified contractual obligations of the borrower are met and the exposure is performing. The following metrics by portfolio and by types of forbearance measures should be used:

a) Forbearance cure rate and rate of exposure being reclassified as non-performing: Credit institutions should conduct a vintage analysis and monitor the behaviour of FBEs from the date of modification to determine the cure rate. This analysis should be conducted separately for cured exposures with and without forbearance measures.

b) Cash collection rate: Credit institutions should monitor cash collected from FBEs.

c) Write-off: Where granting a forbearance measure leads to a partial write-off credit institutions should record and monitor these exposures against an approved loss budget. The net present value loss associated with the decision to write off an unrecoverable exposure should be monitored against the cure rate.

141. Credit institutions should monitor indicators relating to forbearance activities using a meaningful breakdown which could include the type and length of arrears, the type of exposure, the probability of recovery, the size of the exposures or the total amount of exposures to the same borrower or group of connected clients, or the number of forbearance solutions applied in the past.

6.2.3 Borrower creditworthiness assessment

142. Before granting any forbearance measures, credit institutions should assess borrower's creditworthiness. This should include an assessment of the borrower's financial situation taking into account all relevant factors and, in particular, the debt servicing capacity and overall indebtedness of the borrower or the property/project. This assessment should be based on documented current and verified financial information as described in [*future EBA GL on loan origination, monitoring and internal governance*].

6.2.4 Standardised forbearance products and decision trees

143. Credit institutions should have adequate policies and procedures in place with a range of sustainable and effective solutions for the borrower when granting forbearance. Grouping of exposures into portfolios should be reflected in these policies and procedures as it enables credit institutions to adopt and tailor different forbearance measures to different segments of borrowers.

144. Credit institutions should consider developing decision trees and standardised forbearance measures for portfolios of homogenous borrowers with less complex exposures. Decision trees may help to determine and implement appropriate and sustainable forbearance strategies for specific portfolios of borrowers in a consistent manner based on approved criteria.

6.2.5 Comparison with other NPE workout options

145. Credit institutions should use a net present value approach to determine the most suitable and sustainable workout option for borrowers' varied circumstances and compare net present value (NPV) of the envisaged forbearance measure with the net present value of repossession and other available liquidation options. Parameters used in the calculation, such as the assumed liquidation time horizon, discount rate and cost of capital and liquidation cost should be based on observed empirical data.

6.2.6 Forbearance targets and monitoring

146. Forbearance contracts and documentation should include a well-defined borrower target schedule, detailing all necessary targets to be achieved by the borrower in order to repay the exposure over the course of the contract term. These milestones/targets should be credible, appropriately conservative and take account of any potential deterioration of the borrower's financial situation. The performance of the forborne borrower, including the borrower's compliance with all agreed targets, should be closely monitored by the NPE WU responsible for granting the forbearance, at least for the duration of the probation period.

Question 6: Does the viability assessment of forbearance measures capture all relevant aspects?

7. NPE recognition

147. Credit institutions should use the definition of NPE as defined in Annex V of Commission Implementing Regulation (EU) 680/2014 in their risk management.

148. This chapter sets out the key elements of the governance and operations of NPE recognition.

7.1 Past due criterion

149. Credit institutions should recognise exposures as being past due in accordance with section 4 of the EBA Guidelines on the application of the definition of default[36] and Commission Delegated Regulation (EU) 2018/171 on the materiality threshold for credit obligations past due[37].

7.2 Indications of unlikeliness to pay

150. Credit institutions should recognise exposures as unlikely to pay and identify indications of unlikeliness to pay in accordance with chapter 5 of the EBA Guidelines on the application of the definition of default.

151. Credit institutions should regularly assess the creditworthiness and repayment capacity of borrowers. For corporate borrowers this should be done, at least at annually and at key reporting dates where financial data is available. Credit institutions should collect the latest financial information from corporate borrowers in a timely fashion. The non-provision or the unreasonably late provision of information may be seen as a negative sign for the borrower's creditworthiness. For borrowers on a watch-list or with a weak rating, more frequent review

[36] EBA GL 2016 07; Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013

[37] Commission Implementing Regulation (EU)2018/171 of 19 October 2017 on supplementing Regulation (EU) 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the materiality threshold for credit obligations past due, (OJ L 32, 6.2.2018, p. 1)

processes should be in place depending on the materiality, portfolio and the borrower's financial standing. The regular assessment of the borrower creditworthiness and repayment capabilities should also apply to bullet loans as these loans represent a higher level of risk than a loan subject to regular amortisation and also since continuous payment by the borrower of the interest amounts due is not enough to assume that the final bullet repayment of the loan will take place.

7.3 Forbearance and performing status

7.3.1 Forbearance

152. For identifying forbearance measures credit institutions should be able to identify signs of possible future financial difficulties at an early stage. In order to do so, an assessment of the financial situation of the borrower should not be limited to exposures with apparent signs of financial difficulties. An assessment of financial difficulties should also be conducted for exposures where the borrower does not have apparent financial difficulties, but where market conditions have changed significantly in a way that could impact the ability to repay (e.g. bullet loans where the repayment relies on a sale of immovable property or foreign currency loans).

153. The assessment of any financial difficulties on the part of a borrower should be based on the situation of the borrower only, disregarding collateral or any guarantees provided by third parties. When assessing financial difficulties of the borrower credit institutions should consider at least the following:

a) borrower/facility more than 30 days past due during the three months prior to its modification or refinancing;

b) increase of probability of default (PD) of credit institution's internal rating class during the three months prior to its modification or refinancing;

c) presence in watch-list during the three months prior to its modification or refinancing.

154. Exposures should not be identified as forborne when concessions are made to borrowers that are not in financial difficulties. Credit institutions should distinguish based on a detailed financial assessment between renegotiations or rollovers granted to borrowers not in financial difficulties and forbearance measures, such as concessions granted to borrowers in financial difficulties.

155. Granting new conditions such as a new interest rate more favourable than the rate borrowers with a similar risk profile could obtain may be considered as an indication of concession. Receiving more favourable new conditions than those practised by the market should not be considered as a prerequisite for the identification of concessions and therefore forbearance. When a borrower is in financial difficulties, a change in conditions in line with what other borrowers with a similar risk profile could get from the credit institution should qualify as a concession, including when borrowers are embedded in public forbearance schemes that are offered by credit institutions.

156. Borrowers may request modifications in the contractual conditions of their loans without facing or being about to face difficulties in meeting their financial commitments. An assessment of the financial situation of a borrower should always be performed when changes in the contractual conditions are requested.

7.3.2 Classification of forborne exposures as non-performing

157. When granting forbearance measures to performing exposures, credit institutions should assess whether these measures lead to a need to reclassify the exposure as non-performing. Granting forbearance measures to NPEs does not clear their non-performing status: the exposures should continue to be identified as non-performing for at least one year of cure period after the granting of the forbearance measures as defined in Annex V of Commission Implementing Regulation 680/2014 and in section 7.3.3.

158. When assessing if FBEs should be classified as non-performing credit institutions should assess if exposures:

a) are supported by inadequate payment plans (either initial or subsequent payment plans, as applicable) which encompass, inter alia, a repeated failure to comply with the payment plan, changes to the payment plan to avoid breaches, or the payment plan’s resting on expectations that are not supported by macroeconomic forecasts or by realistic assumptions on the repayment capability or willingness of the borrower;

b) include contract terms that delay the time for the regular repayment instalments on the transaction, in such a way that hinders its assessment for a proper classification, such as when grace periods of more than two years for the repayment of the principal are granted;

c) include de-recognised amounts that exceed the accumulated credit risk losses for NPEs with a similar risk profile.

7.3.3 Cure/exit from non-performing status

159. Credit institutions should reclassify NPEs, including forborne exposures, as performing in accordance with Annex V of Commission Implementing Regulation 680/2014. Credit institutions should perform a financial analysis of the borrower to establish the absence of concerns regarding the borrower’s ability to pay its credit obligations.

160. Credit institutions’ policies for the reclassification of non-performing FBEs should specify practices for dispelling concerns regarding the borrower’s ability to comply with the post-forbearance conditions in Annex V of Commission Implementing Regulation 680/2014. These policies should establish criterion in terms of payments made during the cure period of at least one year and define the borrower’s ability to comply with post-forbearance conditions (to the extent that full repayment of the debt is likely) at least by demonstrating payments of a not-

insignificant amount of principal. These policies should require payments of both principal and interest.

161. Additionally, where a borrower has other exposure(s) to a credit institution which are not the subject of a forbearance measure the credit institution should consider the impact and the performance of these exposures in its assessment of the borrower's ability to comply with post-forbearance conditions. The consideration of arrears should not change the level of application of non-performing status in accordance with of Annex V of Regulation (EU) 680/2014.

162. The existence of contract terms that extend the repayment period, such as grace periods for the principal, should confirm the classification of these FBEs as non-performing until the requirements of Annex V of Commission Implementing Regulation 680/2014 have been satisfied. Elapsing of the one-year cure period should not automatically lead to reclassification to performing unless regular payments have been made over these 12 months and assessment of unlikeliness to pay has been done and concluded with no indication of unlikeliness to pay.

7.3.4 Identification as performing forborne (5.3.4)

163. Once FBEs are classified as performing, either because they have met the conditions for being reclassified from the non-performing category or because the granting of forbearance measures did not lead to the classification of the exposure as non-performing, they should continue to be identified as forborne until all conditions for discontinuation for classification of exposures as forborne of paragraph 256 of Annex V of Commission Implementing Regulation (EU) 680/2014 have been met.

164. Credit institutions' policies for identifying performing FBEs should specify practices for dispelling concerns regarding the borrower's financial difficulties. Credit institutions' policies should require the borrower to have settled, by means of regular payments, an amount equal to all the amounts (principal and interest) that were previously past due or de-recognised at the time of the concession, or to otherwise demonstrate its ability to comply with the post-forbearance conditions under alternative objective criteria that imply a repayment of principal.

165. In accordance with paragraph 260 of Annex V of Commission Implementing Regulation (EU) No 680/2014, new forbearance measures granted to performing FBEs that have been reclassified out of the non-performing category will entail the reclassification of these transactions to the non-performing category. The same should apply when these exposures become more than 30 days past-due.

7.4 Consistent application of definition of non-performing

166. Credit institutions should adopt adequate mechanisms and procedures, in accordance with chapter 8 of the EBA Guidelines on definition of default, for the harmonised implementation of the definition in all subsidiaries and branches. This will ensure that the identification of NPEs is consistent at the entity and at the banking group level.

167. Credit institutions' policies should ensure consistent treatment of individual clients and groups of connected clients as defined in Regulation (EU) No 575/2013, the EBA Guidelines on connected clients[38]and paragraph 61 of the EBA guidelines on the definition of default. Credit institutions' policies should also ensure a consistent assessment of the underlying legal relationships between legal entities across a group of connected clients. In view of possible contagion, credit institutions should, whenever feasible, apply a group perspective when assessing the status of a borrower's exposure as non-performing, unless it is affected by isolated disputes that are unrelated to the solvency of the counterparty.

168. Consistently with paragraphs 109(c) and 113 in the EBA Guidelines on definition of default, credit institutions should keep a register of all classification criteria.

Question 7: What are the respondents view on the proposed requirements for recognition of non-performing and performing/non-performing forborne exposures?

8. NPE impairment measurement and write-offs

169. Credit institutions should estimate loss allowances for NPEs and FBEs subject to impairment in accordance with the EBA Guidelines on credit institutions' credit risk management and practices and accounting for expected credit losses.

170. This chapter sets out the key elements of the governance and operations of the NPE impairment measurement and write-offs.

8.1 Individual estimation of loss allowances

171. Credit institutions' policies should include criteria to identify exposures subject to individual estimation of loss allowances. Such criteria should take the following factors into account:

a) Individual significance of the exposure. Loss allowances for individually significant exposures should be assessed on an individual basis. Institutions should set thresholds (absolute and relative terms) for identifying significant exposures, taking into account, among other factors, the possible impact of the exposure in the financial statements and the concentration level (individual and sectorial).

b) Common credit risk characteristics and availability of historical data. Other cases where exposures do not share common credit risk characteristics or for which no relevant historical data that enable a collective analysis are available.

[38] EBA/2017/15 Guidelines on connected clients under Article 4(1)(39) of Regulation (EU) No 575/2013

8.2 Estimating future cash flows

172. The credit institution should measure the loss allowances through calculating the difference between the gross carrying amount of the exposure and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate.

173. Credit institution should estimate future cash flows, which are usually the result of an active workout of the exposure and/or the sale of collateral. These cash flows may also stem from the sale of the collateralised or uncollateralised exposure if this reflects the NPE strategy. Therefore, the expected cash flows should take into consideration the probabilities of the different scenarios (active workout, sale of collateral, sale of exposure)(IFRS 9.5.5.17-18).

174. The estimation of future cash-flows should be done under the following two broad approaches:

a) Under a going concern scenario, the operating cash flows of the borrower or the guarantor, continue and can be used to repay the financial debt to all creditors. In addition, collateral may be exercised to the extent it does not influence operating cash flows. The going concern scenario should be considered if:

   i. future operating cash flows of the borrower are material and can be reliably estimated;

   ii. there is only limited collateralisation of the exposure.

b) Under a gone concern scenario, the collateral is exercised and the operating cash flows of the borrower cease. The gone concern scenario should be considered if:

   i. The exposure has been past due for a long period. There is a rebuttable presumption that the allowance should be estimated under gone concern criteria when arrears are longer than 18 months.

   ii. Future operating cash flows of the borrower are estimated to be low or negative.

   iii. Exposure is significantly collateralised, and this collateral is central to cash-flow generation.

   iv. Application of the going concern scenario would impact materially and negatively the amount recoverable by the institution.

   v. There is a significant degree of uncertainty surrounding the estimation of the future cash flows. Credit institutions should consider as indications of increased uncertainty at least if the earnings before interest, taxes, depreciation and amortisation (EBITDA) of the two previous years had been negative, or if the business plans of the previous years had been flawed.

vi. Insufficient information is available to perform a going concern analysis.

8.2.1 Estimation of operating cash flows under a going concern scenario

175. When estimating future cash flows credit institutions should conduct a thorough analysis of the borrower's financial situation, the available cash flows, financial indicators, business plans, forecasts to determine the most realistic future cash flows to be collected. Credit institutions should also consider adverse scenarios on cash flow projections.

176. When estimating future operating cash flows for estimating loss allowances credit institutions should consider the following:

a) Estimation should be based on updated and reliable information on cash flows and the business plan of the borrower, or the guarantor.

b) Estimation should use the financial statements of the borrower as a starting point. When projections assume a growth rate, a steady or declining growth rate over a growth period should be used, and afterwards steady cash flows. The growth rate should take into account economic environment and use the financial statements of the borrower as a starting point or should be based on a robust and implementable business restructuring plan, taking into account the resulting changes in the structure of the business. (Re)-investments to preserve cash flows should be considered, as well as any extraordinary future cash-flow changes.

c) Estimation of amounts obtained under the realisation of a financial guarantee alone should be considered only when there is reliable information as to the creditworthiness of the guarantor and the legal effectiveness of the guarantee.

d) Appropriate and reliable adjustments may be applied when data for the previous year do not yet lead to a sustainable level of cash flows due to financial accounting choices/methodology.

e) When the recoverability of the exposure relies on the realisation of the disposal of collateral or other assets by the borrower, the selling price should reflect the estimated future cash flows that may result from the sale of the assets less the estimated costs associated with the disposal. Allocation of cash flows to claims should be made according to their seniority ranking.

f) The length of the projection should be the expected life of the financial instrument restricted to the length of the reliable cash-flow projection.

177. For non-significant exposures credit institutions may use simplified methods. Credit institutions should document in their policies when it is appropriate to apply simplified methods for individual estimation and to use the selected method consistently over time. Credit institutions should use the following simplified methods:

a) Estimation of future recurrent cash flows to be generated by the borrower by means of applying multiples to adjusted EBITDA. The cash flows should then be allocated to each exposure. Credit institutions should consider how to estimate an adjusted EBITDA to neutralise impact of non-recurring items, one-off effects and capital expenditure.

b) Estimation by discounted cash flow method. Credit institutions should allocate the present value of the cash flows to each exposure based on a period-by-period analysis followed by an estimation of the terminal value. The terminal value should be calculated by assessing a sustainable one-period at the end of the projection and applying a multiple as stated in the steady cash-flow approach.

178. Credit institutions should consider using a detailed cash-flow analysis with multi-period cash-flow projections, in particular if the financing transaction is targeted at income-generating business or asset-based lending transactions. Where the repayment of an exposure mainly depends on revenues from financed income-generating assets credit institutions should be conscious not to consider the same cash-flow twice, e.g. both when assessing the repayment capacity of the borrower and the value of collateral to be sold. The length of the multi-period projection should be restricted to the length of the reliable cash-flow projection. The following types of exposures could be considered for multi-period cash flow projections:

a) Shipping and aircraft with long-term charter and/or collateral to be sold after the end of the cash-flow projection period;

b) commercial real estate with rental income or where real estate is forecasted to be sold after the end of the cash-flow projection period;

c) project finance where generated income is pledged and/or collateral is forecasted to be sold;

d) real estate where residential or commercial property is forecasted to be sold;

e) income-producing business where the service of loans is based on the sale of one or more commercial properties.

8.2.2 Estimation of the recoverable amount of the collateral under the gone concern approach

179. The recoverable amount should correspond to the present value of estimated future cash flows that may result from sale of collateral (IFRS 9 B5.5.55) less the cost of obtaining and selling the collateral. Valuation of collateral under gone concerns scenario is defined in section 9.3.3.

8.3 Loss allowances for financial guarantee contracts and loan commitments given

180. The impairment requirements also apply to financial guarantee contracts and loan commitments that are accounted for under IFRS 9 (IFRS 9.2.1 (e) and (g) as well as IFRS 9 B2.5(a)).To measure the most likely drawn exposure of off-balance sheet items, such as financial guarantees and loan commitments, and that accordingly represent potential additional credit losses, reliable cash-flow forecasts or credit conversion factors should be used. This reliability should be confirmed through the existence of robust historical data and back-testing procedures demonstrating adherence of past estimations to the actual credit losses. In the determination of the most likely drawn exposure of off-balance-sheet items percentages stipulated in Article 166(10) of Regulation (EU) No 575/2013 following the classifications in Annex I of Regulation (EU) No 575/2013 on the nominal value of the commitment should also be taken into consideration, if appropriate.

8.4 NPE write-offs

181. In accordance with paragraph 141(d) of EBA Guidelines on credit risk management and accounting for expected credit losses[39] unrecoverability should be recognised in the appropriate period through loss allowances or write-offs. When the credit institution has no reasonable expectations of recovering contractual cash flows of the exposure it should lead to a partial or full write-off of the exposure (IFRS 9.B3.3.16.r).

182. A write-off may be done before legal actions against the borrower to recover the debt have been concluded in full. A write-off should not be considered as the credit institution forfeiting the legal right to recover the debt; a credit institution's decision to forfeit the legal claim on the debt is debt forgiveness.

183. Write-offs constitute a de-recognition event (IFRS 9.5.4.4). If cash or other assets are eventually collected these collections should be directly recognised as income in the statement of profit or loss.

184. Credit institutions should maintain detailed records of all NPE write-offs performed on a portfolio-level basis.

8.5 NPE impairment and write-off

185. Credit institutions should include in their internal policies clear guidance on the timeliness of impairments and write-offs. Especially for exposures or parts of exposures that are not covered by collateral, credit institutions should consider suitable maximum periods for full impairment coverage and write-off. For parts of exposures covered by collateral, the establishment of a minimum impairment level should take the type of collateral into account.

[39] EBA/2017/06 Guidelines on credit institutions' credit risk management and practices and accounting for expected credit losses

Empirical evidence should be applied when calibrating the described impairment and write-off periods referred to above. When assessing the recoverability of NPEs and in determining internal NPE write-off approaches, credit institutions should pay particular attention to the cohorts shown below as they may represent higher levels of permanent unrecoverability.

a) Exposures with prolonged arrears: Different thresholds may be adequate for different portfolios. Credit institutions should assess the recoverability of NPEs due to arrears for a prolonged length of time. If, following this assessment, an exposure or part of an exposure is deemed as unrecoverable, it should lead to a partial or full written-off the exposure.

b) Exposures under insolvency procedure: where the collateralisation of the exposure is low, legal expenses often absorb a significant portion of the proceeds from the bankruptcy procedure and therefore estimated recoveries are expected to be very low.

c) A partial write-off may be justified when there is reasonable financial evidence that the borrower is unable to repay the full amount of the exposure.

8.6 Impairment and write-off procedures

186. Credit institutions should adopt, document and adhere to sound policies, procedures and controls for assessing and measuring loss allowances and write-off on NPEs in accordance with the EBA Guidelines on credit risk management and accounting for expected credit losses. Credit institutions should back-test their loss allowance estimations against actual losses.

187. These methodologies should include also policies and procedures on write-offs and recoveries as defined in paragraph 33(m) of the EBA Guidelines on credit risk management and accounting for expected credit losses. The policy should include indicators used to assess the expectations on recovery and detailed information on those exposures that have been written-off but are still subject to enforcement activity.

188. In accordance with section 4.2.7 of the EBA Guidelines on credit risk management and accounting for expected credit losses credit institutions should have in place common processes, systems, tools and data.

189. Credit institution's internal audit function should verify used methodologies in accordance with paragraph 202 of the EBA Guidelines on internal governance[40].

Question 8 What are respondents view on the requirements on timeliness of impairments and write-offs of NPEs?

[40] EBA/2017/11 Guidelines on internal governance under Directive 2013/36/EU

9. Collateral valuation for immovable and movable property

190. This chapter sets out the key elements for collateral valuation for immovable and movable property pledged for NPEs. Section 9.1.3 and paragraph 201 is applicable only for immovable property. Paragraphs 222 and 223 are applicable only for movable property.

191. Credit institutions should obtain periodic financial information from borrowers and update property valuations regularly in order to assess the quality of exposures on their balance sheets and the adequacy of collateral. The collection and assessment of this information should support the credit institution in recognising the early warning signs of declining asset quality, which may result in an understatement of impairments.

192. Credit institutions should adopt policies, and procedures which sets clear expectations regarding the valuation of immovable and moveable property held as collateral for NPEs.

193. For the purposes of the guidance set out in this chapter, all types of immoveable and movable property includes collateral such as commercial real estate, residential real estate, land, shipping vessels and offshore assets. All types of immovable and movable property collateral are eligible regardless of if they meet the requirements of Article 208 and Article 210 of Regulation (EU) No 575/2013.

9.1 Governance, procedures and controls

9.1.1 General policies and procedures

194. Credit institution should have written policies and procedures in place, approved by the management body and complying with the criteria established herein, governing the valuation of property collateral.

195. The policy and procedures documents should have defined owners with responsibility for reviewing them and ensuring that material changes are submitted to the management body for approval.

196. Credit institutions’ written collateral valuation policies and procedures should be reviewed at least on an annual basis. Credit institutions should ensure that any knowledge gaps are identified during the review process and remediation plans are implemented in a timely manner to close any such gaps.

197. Policies and procedures should be fully aligned with the credit institution’s risk appetite framework (RAF).

9.1.2 Monitoring and controls

198. Credit institutions should monitor and review the valuations performed by internal or external appraisers on a regular basis as set out in this section.

199. Credit institutions should develop and implement a robust internal quality assurance policy and procedures for challenging valuations conducted internally and externally. The following general principles should be considered when credit institutions design the quality assurance process:

a) the quality assurance process should be carried out by a risk control unit that is independent from the loan processing, loan monitoring and underwriting process;

b) the independence of the external appraiser selection process should be tested on a regular basis as part of the quality assurance process;

c) an appropriate similar sample of internal and external valuations should be compared against market observations on a regular basis;

d) back-testing of both internal and external collateral valuations should be carried out on a regular basis;

e) the quality assurance process should be based on an appropriate sample size.

200. Additionally, the internal audit department should regularly review the consistency and quality of the property valuation policies and procedures, the independence of the appraiser selection process and the appropriateness of the valuations carried out by both external and internal appraisers.

201. For immovable property, credit institutions should ensure adequate diversification among the valuations assigned by appraisers. Two sequential individual valuations of the immovable property, by the same appraiser should result in the rotation of the appraiser either to a different internal appraiser or to a different external appraisal provider.

9.1.3 Individual versus indexed valuations of immovable property

202. Credit institutions should monitor the value of immovable property collateral on a frequent basis and at a minimum as prescribed in Article 208(3) of Regulation (EU) No 575/2013.

203. Credit institutions should have in place a policy based on which they determine the i) group of collaterals subject to property-specific appraisal (individual property valuations and revaluations) on a regular basis and ii) the group of collaterals which may be subject to indexation. The policy should take into account the collateral type (e.g. commercial real estate, residential real estate, land), the value of the collateral and the transaction value secured by a given collateral and the non-performing status of the exposure a collateral is pledged.

204. For property specific appraisals, conducted through individual valuations and revaluations, should be performed by an appraiser and the valuation should not be based on indexation or any other automated process. Individual property valuations should be performed in line with the provisions of this section.

205. Valuations derived from indexation or any other automated processes are defined as indexed valuations and do not constitute a revaluation or an individual property valuation. Indexation may be used to update the valuation for NPE secured by immovable property collateral which according to the credit institutions' policy is not subject to regular property specific appraisal provided that the collateral to be valued is susceptible to measurement by such methods. Indexed valuation should not be used to update the valuation of immovable property collateral for a NPE the gross carrying amount of the which is larger than EUR 300,000 or a lower amount defined by the competent authority.

206. Indices used to carry out this indexation may be internal or external as long as they are:

a) Reviewed regularly and the results of this review are documented and are readily available. The review cycle and governance requirements should be clearly defined in a management body approved policy document.

b) Sufficiently granular and the methodology should be adequate and appropriate for the asset class in question.

c) Based on a sufficient time series of observed empirical evidence of actual property transactions.

9.1.4 Appraisers

207. All valuations, including updated valuations, should be performed by independent and qualified appraiser, internal or external, who possess the necessary qualifications, ability and experience to execute a valuation, as provided for in Article 208(3)(b) and 229 of Regulation (EU) No 575/2013.

208. Credit institutions should have a panel of independent and qualified appraisers, internal or external, based on the criteria below. The appraisers' performance should be assessed on an on-going basis and a decision should be made whether an appraiser remains in the panel, or not.

209. Credit institutions should ensure that external appraisers have an appropriate level of professional indemnity insurance and should review this insurance on an annual basis to ensure that it is adequate and valid.

210. In order to avoid conflict of interest, credit institutions should ensure that all appraisers and their first grade relatives, both internal and external, meet the requirements of independence and therefore

a) are not involved in the loan processing, loan decision and credit underwriting process;

b) are not guided or influenced by the borrower's creditworthiness;

c) do not have an actual or potential, current or prospective conflict of interest regarding the result of the valuation;

d) do not have an interest in the property;

e) are not a connected person to either the buyer or the seller of the property;

f) provide an impartial, clear, transparent and objective valuation report;

g) should not receive a fee linked to the result of the valuation.

211. The credit institution should ensure that the qualified appraiser:

a) is professionally competent and have at least the minimum educational level that meets any national requirements to carry out such valuations;

b) has appropriate technical skills and experience to perform the assignment;

c) is familiar with, and able to demonstrate ability to comply with, any laws, regulations and property valuation standards that apply to the appraiser and the assignment;

d) has the necessary knowledge of the subject of the valuation, the property market in which it would trade and the purpose of the valuation.

212. A panel of appraisers should contain expertise in various areas of the property sector appropriate to the lending business of the credit institution and the location of lending.

9.2 Frequency of valuations

213. For the purposes of these Guidelines, credit institutions should use the procedures described below to review and monitor the valuation of property collateral.

214. In accordance with the requirement of Article 208(3) and Article 210 (c) of Regulation (EU) No 575/2013 on monitoring property values, credit institutions should update individual valuations for the collateral of all exposures on a frequent basis and at a minimum every year for moveable property and commercial immovable property, and every three years for residential immoveable property.

215. The group of collaterals that are subject to property-specific appraisal (individual property valuations and revaluations) on a regular basis should be updated at the time the exposure is classified as non-performing and at least annually while it continues to be classified as such. Credit institutions should make sure that NPEs, the collateral of which may be revalued by

indexation and updated at least annually, in line with the credit institution's policy, is measured with such methods.

216. For properties with an updated individual valuation that has taken place within the past 12 months (in line with all applicable principles and requirements as set out in this chapter), the property value may be indexed up to the period of the impairment review.

217. Credit institutions should carry out more frequent valuations 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.

218. Therefore, credit institutions should define criteria in their collateral valuation policies and procedures for determining if a significant decline in collateral value has taken place. These will include quantitative thresholds for each type of collateral established, based on the observed empirical data and any relevant qualitative credit institution experience, bearing in mind relevant factors such as market price trends or the opinion of independent appraisers.

219. Credit institutions should have appropriate IT processes and systems in place to flag out-dated valuations and to trigger valuation reports.

9.3 Valuation methodology

9.3.1 General approach

220. Credit institutions should have defined collateral valuation approaches per collateral product type which are adequate and appropriate for the asset class in question.

221. All immovable property collateral should be valued on the basis of market value or mortgage lending value as allowable under Article 229 of Regulation (EU) No 575/2013. Movable property shall be valued at its market value.

222. For movable property, credit institutions should, in accordance with the requirement of Article 199 (6) of Regulation (EU) No 575/2013, periodically assess the liquidity of the property. If there is a material volatility in the market prices, the institution should demonstrate that the valuation of the collateral is sufficiently conservative.

223. For movable property, credit institutions should, in accordance with the requirement of Article 210(c) of Regulation (EU) No 575/2013, conduct a sufficient legal review confirming the enforceability of the collateral including an assessment of the legal right to enforce and liquidate the collateral in an event of default within a reasonable timeframe.

224. Overall valuations based only on the discounted replacement cost should not be used.

225. For income-generating properties, a market comparable or discounted cash-flow approach can be used.

226. Property collateral should be valued, adhering to European and international standards[41]. National standards can also be accepted if they follow similar principles.

9.3.2 Expected future cash flows

227. In accordance with the principles in chapter 8 on NPE measurement, individual estimations of loss allowances by discounting future cash flows should be carried out using two broad approaches:

a) “going concern” scenario, where the operating cash flows of the borrower continue and can be used to repay the financial debt and collateral may be exercised to the extent it does not influence operating cash flows;

b) ''gone concern'' scenario, where the operating cash flows of the borrower cease and collateral is exercised.

228. In a going concern scenario, since estimation of allowance is based on the assumption of operating cash flows of the borrower including cash flows being received from the collateral, updated and reliable information on cash flows is a requisite for such estimation. Please refer to chapter 8 NPE Measurement, which includes further reference to a going concern scenario.

9.3.3 Gone concern approach

229. In a gone concern scenario, the future sale proceeds from collateral execution should be adjusted taking into account the appropriate liquidation costs and market price discount.

230. In addition to the above liquidation costs, a market price discount, if appropriate, should be applied to the updated valuation as outlined below.

231. The property price at the time of liquidation should take into account current and expected market conditions.

232. Time-to-sale considerations in connection with the disposal of mortgaged properties should also be included based on the debt enforcement practices and experiences from judiciary proceedings at national level based on empirical evidence and backtested accordingly. These considerations should include any operational costs or capital expenditures to be incurred before the time of sale.

233. The execution of collateral may include both consensual and non-consensual (forced) liquidation strategies.

[41] These include the European Valuation Standards EVS-2016 (Blue Book) and the Royal Institute of Chartered Surveyors (RICS) standards.

234. The liquidation cost discount should reflect the manner of collateral execution i.e. whether it is consensual or non-consensual.

235. The market price discount should reflect the liquidity of the market and the liquidation strategy. It should not reflect fire sale conditions unless the anticipated liquidation strategy actually involves a fire sale.

236. Credit institutions should apply adequate market price discounts for the purposes of IFRS 9, for the calculation of regulatory capital and for risk control purposes. A market price discount may be close to zero only for highly liquid and non-distressed collateral types, which are not affected by any significant correlation risks.

237. All credit institutions should develop their own liquidation cost and market price discount assumptions based on observed empirical evidence. If insufficient empirical evidence is available, discount assumptions should be based on, at a minimum, liquidity, passage of time, and the quality/ageing of the appraisal. If a credit institution faces the situation of a frozen property market and only a small number of properties have been sold or the sales history has to be considered as not sufficient, a more conservative market price discount should apply.

9.4 Further considerations on estimating cash flows from property collateral liquidation

238. In estimating cash flows from property collateral liquidation, credit institutions should use adequate and realistic assumptions. In addition, credit institutions should pay attention to the requirements of valuing cash flows under IFRS 13 on fair value measurements. In particular, financial institutions should comply with the following requirements:

a) Determine the assumed time of disposal taking into account current and expected market conditions as well as the underlying national legal framework regarding the disposal of mortgaged properties.

b) Ensure that the property price used to determine the estimated market value of property collateral at the point of liquidation is not more optimistic than projections produced by international organisations, and therefore does not assume an improvement on the current market conditions.

c) Ensure that income from property collateral is not assumed to increase from the current levels unless there is an existing contractual arrangement for such increase. Moreover, current income from property should be adjusted when calculating the cash flows in order to reflect the expected economic conditions. Credit institutions should consider whether, it is appropriate to project a flat income in a recessionary environment where vacant properties are increasing and/or demand for transportation is decreasing, putting downward pressure on income.

d) A “hold” strategy on property collateral is not acceptable. A hold strategy is defined as holding the asset at above market value assuming that the asset will be sold after the market recovers.

239. When using the value of collateral in assessing the recoverable amount of the exposure, at least the following should be documented:

a) how the value was determined, including the use of appraisals, valuation assumptions, and calculations;

b) the supporting rationale for adjustments to appraised values, if any;

c) the determination of selling costs, if applicable;

d) the expertise and independence of the appraiser;

e) the assumed timeline to recover.

240. When the observable market price is used to assess the recoverable amount of the exposure, the amount, source and date of the observable market price should also be documented.

241. Credit institutions should be able to substantiate the assumptions used when assessing the recoverable amount by providing to the competent authority, if requested, details on the property market value, the market price discount, legal and selling expenses applied, and the term used for the time to liquidation. Credit institutions should be able to fully justify their assumptions, both qualitatively and quantitatively, and explain the drivers of their expectations, taking past and current experience into account.

9.5 Back-testing

242. Credit institutions should demonstrate via sound back-testing that the assumptions used for assessing the recoverable amount are reasonable and grounded in observed experience. In this context, credit institutions should regularly back-test their valuation history (last valuation before the object was classified as a NPE) vs. their sales history (net sales price of collateral). Depending on the size and business model of the credit institution, it should differentiate between object types (e.g. single family home, apartment, warehouse, tankers, drilling units, support vessels, etc.), valuation models/approaches, type of sale (voluntary/forced) and regions for their back-testing process. The back-testing results should be used to determine haircuts on collateral valuations supporting exposures remaining on the balance sheet.

243. Alternatively, credit institutions using the A-IRB approach may use secured LGDs to determine haircuts.

9.6 IT database requirements in respect of collateral

244. Credit institutions should have databases of transactions to enable a proper assessment, monitoring and control of credit risk, to respond to request from management and supervisors, and to enable information to periodic reports and other timely and comprehensive documentation. In particular, databases should comply with the following requirements:

a) depth and breadth, in that they cover all the significant risk factors;

b) accuracy, integrity, reliability and timeliness of data;

c) consistency – they should be based on common sources of information and uniform definitions of the concepts used for credit-risk control;

d) traceability, such that the source of information can be identified.

245. These databases should include all the relevant information on properties and other collateral for the credit institutions' transactions and on the links between collateral and specific transactions.

9.7 Valuation of foreclosed assets

246. Credit institutions should strongly consider to classify foreclosed assets as non-current assets held for sale under IFRS 5. This accounting treatment implies that the asset must be available for immediate sale in its present condition (IFRS 5.7), and the management should approve an individual plan to sell the asset within a short timeframe (normally one year) and that an active sales policy should be pursued (IFRS 5.8); thus, it favours recoveries.

247. Foreclosed assets received should be valued at the lower of:

a) the amount of the financial assets applied, treating the asset foreclosed or received in payment of debt as collateral;

b) the fair value of the repossessed asset, less selling costs.

248. When fair value is not obtained by reference to an active market but is based on a valuation technique (either level 2 or level 3), some adjustments are necessary, in particular as a result of two factors:

a) The condition or location of the assets. Risk and uncertainties regarding the asset should be incorporated in the fair value estimation.

b) The volume or level of activity of the markets for these assets. The credit institutions previous experience of the entity in the realisations and the differences between the valuation technique and the final amount obtained in the realisation should be incorporated. Assumptions made in order to measure this adjustment may be documented, and should be available to the supervisor on request. Illiquidity discounts may be considered.

249. When credit institutions foreclosed assets are still under construction and decide to complete construction before selling the asset, they should demonstrate the merits of such a strategy and the cost should not exceed the fair value less costs to complete and sell the asset considering adequate illiquidity discounts as described above.

250. When a foreclosed asset has exceeded the average holding period of similar assets, for which active sale policies are in place, credit institutions should revise the illiquidity discount applied in the valuation process mentioned above, and increase it accordingly. In these circumstances, the credit institution should refrain from recognising write-backs/reversals of existing accumulated impairment on the asset as its prolonged presence on the balance sheet provides evidence that the credit institution is unable to sell the assets at an increased valuation.

251. The frequency of valuation of foreclosed assets and the applicable procedures should follow the treatment of immovable property as set out in section 9.2 and 9.1.2.

Question 9: Do you have any significant objection against the proposed threshold for property-specific valuation (EUR 300,000)?

Question 10: Do the requirements for valuation of movable property collateral capture all relevant aspects?

10. Supervisory evaluation of management of NPEs and FBEs

252. Competent authorities should monitor that credit institutions, which have elevated NPE levels, have developed and implemented an NPE strategy and related governance and operational framework described in chapters 4 and 5 of these guidelines. Competent authorities' evaluation should include, but not be limited to whether the credit institution's NPE strategy

a) is embedded into the credit institution's overall strategy and is subject to appropriate NPE governance, including risk management and control framework;

b) relies on a credible self-assessment of the credit institution's internal capabilities;

c) adequately takes into account the credit institution's operating environment, external conditions and capital situation;

d) covers not only short term time horizon, but also medium and/or long term timeframe

e) includes time-bound realistic, yet ambitious quantitative NPE targets and foreclosed assets targets where appropriate and is supported by an operational plan.

253. If competent authorities conclude that the NPE strategy of a credit institution clearly lacks one or more elements listed in a) to e) of the paragraph 252, it should be considered as a serious shortcoming of the NPE strategy. In this case, competent authorities should require the immediate revision of the NPE strategy.

254. If the outcome of the competent authorities' assessment is that the requirements of a) to e) of paragraph 252 are broadly fulfilled by the NPE strategy, but some deficiencies are identified, competent authorities should ensure that credit institutions present an action plan on how to address the deficiencies and establish an effective and timely NPE management framework.

255. Proportionality in terms of the supervisory evaluation of the NPE strategy of a category 3 and 4 institution[42] can be considered by aligning assessment with the SREP engagement model, which ensures a risk based approach to supervision and takes into account the systemic importance of global or domestic institutions.

256. Competent authorities should challenge credit institutions'

a) operational plan and organisational arrangements if any of the following is not met,

    i. the framework to identify, measure, manage, monitor and mitigate NPEs and FBEs, including early recognition of NPE and appropriate workout activities, is deemed as inadequate by the competent authorities considering the size and complexity of the NPE problem at the credit institution.

    ii. it does not allocate or does not foresee the future allocation of the necessary human and technical resources as well as the appropriate coverage by the internal control functions.

    iii. it does not adequately describes the operationalisation of the monitoring process of NPEs, including the monitoring of early warning indicators.

b) NPE strategy, if the combination of strategic options for the different portfolios and segments does not result, in their view, in the most effective and efficient NPE reduction.

c) capital plan, if it does not appropriately consider the planned reduction of NPEs from the balance sheet as per the NPE strategy and does not include suitable actions to ensure that sufficient amount of capital and capital buffers are available, considering also timely and adequate impairments and write-offs.

[42] Described in Chapter 2.1.1 Categorisation of institutions in the EBA/GL/2014/13 Guidelines on SREP

d) performance appraisal system, if the incentives for the management bodies and relevant managers and staff lacks specific quantitative elements linked to the NPE reduction targets defined in the credit institution’s NPE strategy.

257. Considering the utmost importance of early detection and prevention of deteriorating credit quality, competent authorities should assess whether the early warning mechanisms are implemented in the credit institutions’ internal procedures.

258. Competent authorities should assess that credit institutions

a) have in place a forbearance policy and related processes to assess viability of forbearance measures and monitor efficiency and effectiveness of forbearance measures;

b) recognise and classify NPEs and FBEs, including entry and exit criteria, consistently across the group and based on the definitions in Annex V of Commission Implementing Regulation (EU) 680/2014;

c) have in place policies and methodologies to ensure measurement of impairments and write-offs for timely recognition of impairments and write-offs.

259. Competent authorities should ensure that credit institutions have appropriate written policies and procedures in place targeting the valuation of property as described in chapter 9. In particular, competent authorities should verify that these policies cover all immoveable and movable property types that are used to secure credit exposures, the criteria for the application of individual versus indexed valuation and the requirements towards eligible appraisers.

260. If credit institutions reported material deviations from the operational plan in accordance with chapter 4.4, competent authorities should assess whether the proposed remediation actions are sufficient to eliminate the deviation from the plan. Competent authorities should request further actions from the credit institution, if they are concerned about the effectiveness of the proposed actions.

261. The supervisory evaluation of the management of NPEs and FBEs supplements and further specifies the assessment of NPEs and FBEs as part of credit risk put forward in the EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP). The findings of this supervisory evaluation would feed into the assessment of credit risk under Title 6.2 of the EBA SREP Guidelines and would respectively inform the credit risk score.

Annex 1 - Sample criteria for grouping NPE in retail

1. Natural or legal person

    a) Retail borrower

    a) Sole trader

    b) Small businesses and professionals

    c) Small and medium-sized enterprises (SMEs) (overlap with corporates)

2. Arrears bucket/days past due (the higher the level of arrears the narrower the range of possible solutions)

    a) Early arrears (>1 dpd and ≤90 dpd)

    b) Late arrears of (>90 dpd and <180dpd)

    c) Debt Recovery Unit > 180dpd, including also legal cases (borrowers for which legal actions have taken place or are in progress)

3. Re-restructured cases (restructured loans with arrears, indicative of persistence of repayment problems and/or failure of restructuring solution offered)

    a) Number of previous restructurings

4. Exposure balance

    a) High value

    b) Low value

    c) Multiple exposures

5. Level of risk (based on credit institution's assessment / behaviour scoring / internal behaviour data / transaction history / credit rating). Clients with better payment histories are more likely to respond positively to restructuring offers.

    a) very high

b) high

c) medium

d) low

6. Based on borrower's behaviour

a) seasonal repayments

b) cooperative vs. non cooperative

7. Purpose of credit facility (by product)

a) principal private residence loan

b) secondary home/holiday home loan

c) investment property loan/buy to let loan

d) personal loan

e) overdraft account

f) leased asset

g) credit card

h) sole traders, micro businesses, small and medium-sized business loan

i. for the setup of the business: premises; infrastructure, machinery; renovations

ii. working capital

8. Loan currency (euro, Swiss franc, dollar etc.)

9. Loan interest rate (interest rate reduction consideration for loans burdened by high interest rates, if possible)

10. Borrower outlook (borrower's age, health, employment type and history, employment prospects, professional skills, industry).

11. Country of residence/incorporation

a) residents

b) non-residents

12. Location of the underlying collateral

   a) rural vs. urban

   b) prime location, city centre, outskirts etc.

13. Type of underlying collateral

   a) land

      i. building plot

      ii. agriculture land

   b) building

      i. house

      ii. shop

      iii. factory

14. Based on the LTV

   a) For low LTV loans, sale of underlying collateral may be the preferred option, as opposed to high LTV loans

15. Hardship cases (health problems, separations, divorce)

16. Borrower's creditworthiness assessment

   a) can afford loan repayment vs. cannot afford

   b) income less expenditure vs. reasonable living expenses vs. loan instalment

Annex 2 - Benchmark for NPE monitoring metrics

Benchmark for NPE monitoring metrics

NPE metrics	
NPE level and flows	NPE stock / Total volume of exposures
	NPE stock + foreclosed assets + performing forborne / Total volume of exposures + foreclosed assets
	Quarterly flow of NPEs (+/-) / Total NPE stock
	Quarterly flow from PE to NPE
	Quarterly flow from performing forborne to NPE
	Quarterly flow from NPE to PE
	Quarterly flow from NPE to performing forborne
	Quarterly flow from performing forborne to PE
	Quarterly flow from PE to performing forborne
Impairments	Quarterly increase in stock of loss allowances
	Quarterly level of reversal of impairments
	Quarterly change in stock of loss allowances(+/-) / Total NPE Stock
	Accumulated total provisions / Total NPE Stock
	By cohort (e.g. number of years since NPE classification, secured/unsecured)
Loss budget	Total loss as a result of forbearance activity
	Total loss versus budget
Collection Activity	
Staff activity	Number of borrower engagements per quarter versus plan
	Number of borrower engagements leading to forbearance agreement
	Number of borrower engagements leading to cash recovery
Cash recovery	Quarterly cash recovery from NPE / Total NPE stock
	Quarterly cash recovery from interest on NPE / Total NPE stock

Benchmark for NPE monitoring metrics	
	Quarterly cash recovery from capital & fees on NPE / Total NPE stock
	Quarterly cash recovery from property related liquidations; also as a percentage of Total NPE stock
	Quarterly cash recovery from non-property related liquidations; also as a percentage of Total NPE Stock
	Quarterly cash recovery from sales of NPEs; also as a percentage of Total NPE Stock
	Quarterly cash recovery from NPE; also as a percentage of Total NPE Stock
Forbearance Activity	
Debt forgiveness	Quarterly debt forgiveness
	Quarterly debt forgiveness / Specific assigned provisions
	Quarterly debt forgiveness / Total NPE stock
Accounting write-offs	Quarterly accounting write-offs (full and partial)
	Quarterly accounting write-offs (full and partial) / individually assessed stock of loss allowances
	Quarterly accounting write-offs (full and partial) / Total NPE stock
Forbearance activity	Value of NPE currently in short-term forbearance
	Value of NPE currently in long-term forbearance
	Value of recently agreed forbearance solutions by characteristics (e.g. payment holiday > 12 months)
	Value of loans currently in forbearance / Total NPE stock
	Value of PE currently in forbearance
	Quarterly non-performing forborne / Total NPE stock
	Total non-performing forborne / Total NPE stock
	Value of non-performing forborne currently experiencing financial difficulties
	Cure rate
	Cash collection rate
Re-default rate	Re-default rate on non-performing forborne
	Re-default rate on performing forborne

Benchmark for NPE monitoring metrics

Debt/asset swap	Quarterly debt to equity swaps; also as a percentage of total NPE stock Quarterly debt to asset swap; also as a percentage of total NPE stock
Legal activity	
Legal activity	Value and count of loans currently in legal activity Value and count of assets recently foreclosed Quarterly value and count of new loans entering legal activity Quarterly value and count of loans exiting legal activity Average length of legal procedures recently closed Average recovery amounts from legal procedures recently closed (including total costs) Loss rate on loans exiting legal activity
P&L items stemming from NPEs	
Interest from NPEs	Interest payments recognised on NPEs in the P&L Percentage of recognised interest payments from NPEs actually received

Annex 3 – Sample of early warning indicators

Samples of early warning indicators

EWI at a borrower level from external sources

External sources	Debt and collateral increase in other credit institutions Past-due or other NP classifications in other credit institutions Guarantor default Debt in private central register (if any) Legal proceeding Bankruptcy Changes in the company structure (e.g. merger, capital reduction) External rating assigned and trends Other negative information regarding major borrowers/counterparties of the borrower/suppliers

EWI at a borrower level from internal sources

	Negative trend in internal rating Unpaid cheques Significant change in liquidity profile Liabilities leverage (e.g. equity/total < 5% or 10%) Number of days past due Number of months with any overdraft/overdraft exceeded Profit before taxes/revenue (e.g. ratio < -1%) Continued losses Continued excess in commercial paper discount Negative own funds Payments delay Decrease of turnover

Samples of early warning indicators

Individuals	Reduction in credit lines related to trade receivables (e.g. year-on-year variation, 3m average/1y average)
	Unexpected reduction in undrawn credit lines (e.g. undrawn amount/total credit line)
	Negative trend in behavioural scoring
	Negative trend in probability of default and/or internal rating
	Mortgage loan instalment > x time credit balance
	Mortgage and consumer credit days past due
	Decrease in the credit balance > 95% in the last 6 months
	Average total credit balance < 0.05% of total debt balance
	Forborne
	Related historic loss rates
	Decrease of payroll in the last 3 months
	Unemployment
	Early arrears (e.g. 5-30 days of past due, depending on portfolio/borrower types)
	Reduction in bank transfers in current accounts
	Increase of loan instalment over the payroll ratio
Individuals	Number of months with any overdraft, exceeded
	Negative trend in behavioural scoring
	Negative trend in probability of default and/or internal rating

EWI at portfolio level	
Portfolio distribution	Size distribution and concentration level
	Top X (e.g. 10) groups of connected clients and related risk indicators
	Asset class distribution
	Breakdown by industry, sector, collateral types, countries, maturities, etc.
Risk parameters	PD/LGD evolution (overall and per portfolio)
	PD/LGD forecasts and projections
	Overall EL
	Default exposure

Samples of early warning indicators	
Stock of loss allowances	stocks and flows of loss allowances (overall and per portfolio)
	Volumes and trends of significant risk provisions on individual level
NPE/forbearance status/foreclosure	NPE volume by category (>90 past due, loss allowances, etc.)
	Forbearance volume and grouping of exposures (restructuring, workout, forced prolongation, other modifications, deferrals, >90 past due, LLP)
	Foreclosed assets on total exposures
	NPE ratio without foreclosed assets
	NPE ratio with foreclosed assets
	NPE coverage (loss allowances, collateral, other guarantees)

EWI by specific type of borrowers/sectors	
Legal activity	Value and count of loans currently in legal activity
	Value and count of assets recently foreclosed
	Quarterly value and count of new loans entering legal activity
	Quarterly value and count of loans exiting legal activity
	Average length of legal procedures recently closed
	Average recovery amounts from legal procedures recently closed (including total costs)
	Loss rate on loans exiting legal activity

Annex 4 – Common NPE-related policies

Credit institutions should develop, regularly review and monitor their adherence to policies related to the NPE management framework.

The following policies should be established, considering the principle of proportionality, aiming the implementation of the strategy of the credit institution (including its NPL strategy and operational plan where relevant)

Arrears management policy

This policy should prescribe the credit institution's NPE operating model (see chapter 5.2), including at least the following elements:

- The structure and responsibilities of the NPE WUs, with clear hand-over triggers and link to grouping of exposures (see section 5.2.3);
- the procedure to be followed by the functions involved to include at a minimum:
  - the procedure and handover criteria to be followed for each stage of arrears, early arrears and late arrears;
  - the procedure to be followed in cases where a borrower is classified as non-cooperating and/or non-viable and the criteria for the borrower to be classified as such;
  - the communication with the borrower at each step, which should be aligned with the legislative framework of the country of operation (e.g. code of conduct);
  - monitoring tools and methods to be applied;
- the human and technical resource requirements;
- the reports to be produced internally for monitoring purposes and for regular updates to the management body.

Credit institutions, when developing their Arrears management policy should consider Article 28 set out in Directive 2014/17/EU and especially the provisions of the EBA Guidelines on arrears and foreclosure.

Forbearance policy

The forbearance policy described in chapter 6.2.1 should prescribe at least:

- The necessary financial and non-financial documentation to be requested and provided by the different types of borrowers in order for the responsible credit officer to demonstrate repayment capacity on a principal and interest basis.

- The minimum key financial repayment capacity metrics and ratios to be applied by the credit officer, detailed on a portfolio/product/sector-specific basis in order to fully assess the borrower’s repayment capacity. Sector-specific guidelines to establish key financial metrics and ratios on a sector-specific basis (SMEs & corporates).

- The process to determine and implement the most appropriate forbearance solution for a borrower:

    - For retail customers, decision trees to be used. The process for retail customers should be in line with the provisions in the EBA Guidelines on arrears and foreclosure. For non-retail borrowers, if a decision tree approach is not appropriate, then the policy should provide clear instructions to the credit officer on how to assess the suitability of a forbearance treatment.

    - In case of borrowers for whom no solution can be reached (either non-viable and/or non-cooperating borrowers), time-bound process and procedure should be established for the transfer of these borrowers to the NPE WU responsible for liquidation.

- A toolkit of short-term and long-term forbearance measures as outlined in chapter 6.

- Clear instructions to the credit officer regarding the requirements for revaluation of collateral in line with chapter 9.

- The decision-making process, approval levels and procedures for each type of forbearance measure and size of exposure.

- The process and procedure for the monitoring of the forbearance solutions awarded and borrower performance following the completion of a restructuring, including frequency of the review of the borrower, the re-default definition and the process for reassessment and requirements for reporting of re-defaults.

- Pricing policy for each forbearance measure and the type of borrower.

Debt recovery/enforcement policy

The NPE WUs responsible for debt recovery should take the most appropriate actions in a timely manner to effectively reduce NPEs over a defined time horizon. The debt recovery policy, in accordance with the NPL strategy, should address, at a minimum:

- The range of available options per collateral type. Indicatively, the following can be considered(not in any prescribed order):

- voluntary asset sale (borrower re-engages and agrees to sell the asset)
- forced asset sale via receivers/court proceedings (assets are not held on the balance sheet of a credit institution)
- foreclosure of asset (assets are held on the balance sheet of a credit institution)
- debt collection (internal or external)
- debt to asset/equity swap;
- sale of loan/loan portfolio to a third party.

- The procedure to be followed to select the most appropriate recovery option and the team of internal and external experts to be involved to assist in taking the decision.
- The recovery option should take into account the existence of collateral, type of legal documentation, type of borrower, local market conditions and macroeconomic outlook, the legislative framework in place and potential historical recovery rates per option vs. the costs involved per option.
- A clear definition of non-cooperating borrowers or link to related policies including such definition.
- A clearly defined approval process for each stage of the debt recovery process for the different recovery options available to the credit institution.
- The role of risk control and internal audit departments in the procedure and in the monitoring process.

With respect to the liquidation of collateral, the following should be defined in the policy:

- The valuation approach to be followed in respect of the asset (in line with chapter 97) including the liquidation costs to be applied. The liquidation costs should be in line with requirements as set out in section 9.3.3
- Involvement of internal or external experts.
- Limits
  - to the amount of assets that could be held by the credit institution at any point of time taking into account large exposure limits described in the CRD and industry concentration risk, e.g. in the real estate sector and;
  - to the amount of repossessed or foreclosed assets that will be acquired by the credit institution within a certain time period.

- The procedure to be followed post repossession or foreclosure to develop and implement a sale strategy, and the responsible unit within the credit institution to undertake the management of the assets concerned (may also be defined in a separate foreclosed/repossessed asset policy).

Credit institutions should consider the interaction with other creditors for NPE borrowers with multiple creditors, usually corporate borrowers. Therefore, credit institutions should put in place a clear procedure for negotiating and interacting with other financial institutions (or other third parties) with whom the borrower is indebted.

Collateral policies

Given the importance of credit risk mitigation in the NPE work-out process, credit institutions should develop clear and consistent collateral policies. These policies should comprehensively cover the management, valuation and reporting of all collateral types. Given the complexity and specialisation of some collaterals, credit institutions should seek external expertise in drafting and reviewing these policies. Credit institutions should ensure a consistency of approach to managing and valuing similar collateral across the portfolio as per chapter 9.

Early warning/watch-list policy

A dedicated policy should be established specifying, amongst other things:

- the types of actions required in response to the different types of early warning alerts –;
- escalation procedures;
- key elements, frequency and recipients of the reporting;
- hand-over criteria/link to NPL procedures.

Outsourcing/NPL servicing policy

A dedicated policy should be established for the outsourcing of services to third parties if this is relevant. This needs to include the required procedures for the selection of outsourcing partners, the required legal contract content and the decision-making process for outsourcing agreements as well as the monitoring of those agreements.

Annex 5 - Possible forbearance measures

Forbearance measure	Description	Viability and other important considerations
Short-term measures		
1. Interest only	During a defined short-term period, only interest is paid on credit facilities and no principal repayment is made. The principal amount thus remains unchanged and the terms for the repayment structure are reassessed at the end of the interest-only period, subject to the assessed repayment ability.	This measure should only be considered viable if the credit institution can demonstrate (based on reasonable documented financial information) that the financial difficulties experienced by the borrower are of a temporary nature and that after the defined interest-only period the borrower will be able to service the loan at least based on the previous repayment ability. The measure should generally not exceed a period of 24 months and, in the case of construction of commercial property and project finance, 12 months. Once the defined period of this forbearance measure is over, institutions should reassess the borrower's debt servicing capacity in order to proceed with a revised repayment schedule that is able to account for the unpaid capital element during this interest-only period. In most cases, this measure will be offered in combination with other measures of a longer-term nature to compensate for the temporary lower repayments (e.g. extension of maturity).
2. Reduced payments	Decrease of the amount of repayment instalments over a defined short-term period in order to accommodate the borrower's affected cash flow situation and then continue with the repayments on the basis of projected repayment ability. The interest remains to be paid in full.	See "1. Interest only. If the amount of payment reduction is moderate and all other conditions mentioned above are met, this measure could be applied for a period longer than 24 months.
3. Grace period/payment moratorium	An agreement allowing the borrower a defined delay in fulfilling the repayment	See "1. Interest only.

Forbearance measure	Description	Viability and other important considerations
	obligations, usually with regard to the principal and interest.	
4. Arrears/interest capitalisation	Forbearance of arrears and/or accrued interest arrears by the addition of those unpaid amounts to the outstanding principal balance for repayment under a sustainable rescheduled programme.	The measure should only be granted/considered viable where the institution has assessed that the borrower's verified income/expenditure levels (based on reasonable documented financial information) and the proposed revised repayments are sufficient to enable the borrower to service the revised loan repayment on a principal and interest basis for the duration of the revised repayment schedule; and where the institution has formally sought confirmation that the borrower understands and accepts the capitalisation conditions. Arrears capitalisation should only be provided selectively in cases where the recovery of historical arrears or payments due under the contract is not possible and capitalisation is the only option realistically available. Institutions should generally avoid offering this measure to a borrower more than once; and the measure should only be applied to arrears that do not exceed a predefined size relative to the overall principal (which should be defined in the credit institution's forbearance policy). The institution should assess the percentage of arrears being capitalised compared to the principal and interest repayments as adequate and appropriate for the borrower.
Long-term measures		
5. Interest rate reduction	Permanent (or temporary) reduction of interest rate (fixed or variable) to a fair and sustainable rate.	Exposures with high interest rates are one of the common causes of financial distress. The financial difficulties of a borrower may partly derive from the fact that the interest rates are excessively high compared to the income of the borrower or from the fact that the evolution of interest rates, as opposed to a fixed rate, has resulted in the borrower receiving finance at an exorbitant cost, compared with prevailing market conditions. In such cases, an

Forbearance measure	Description	Viability and other important considerations
		interest rate reduction could be considered. It should be clearly flagged if the affordability can only be achieved at below-risk or below cost rates. This measure could be applied also as a short-term measure.
6. Extension of maturity/term	Extension of the maturity of the loan (i.e. of the last contractual loan instalment date), which allows a reduction in instalment amounts by spreading the repayments over a longer period.	If the borrower is subject to a compulsory retirement age, term extension should only be considered viable where the institution has assessed and can demonstrate that the borrower can, through a pension or other sources of verified income, service the revised loan repayments on an affordable basis. Term extension should only be considered viable where it is in line with the lifecycle of existing collaterals or proper substitution of the existing collaterals occur.
7. Additional collateral	When additional liens on unencumbered assets are obtained as additional collateral from the borrower in order to compensate for the higher risk exposure and as part of the restructuring process.	This measure is not a viable standalone forbearance measure as it does not by itself resolve the presence of arrears on a loan. It usually aims to improve or cure loan-to-value (LTV) ratio covenants. Additional collateral may take many forms, such as a pledge on a cash deposit, assignment of receivables or a new/additional mortgage on immovable property. Institutions should value second and third liens on assets as well as personal guarantees with care.
8. Sale by agreement/assisted sale	When the credit institution and the borrower agree to voluntarily dispose of the secured asset(s) to partially or fully repay the debt.	Credit institutions should restructure any residual debt post the assisted sale with an appropriate repayment schedule in line with the borrower's reassessed repayment ability. For forbearance measures which may require the sale of the property at the end of the term, credit institutions should conservatively consider the future approach to any shortfall that could remain after the sale of the property and address it as early as possible. For exposures that are repaid by repossession of collateral at a predefined

Forbearance measure	Description	Viability and other important considerations
		moment, the repossession does not constitute a forbearance measure unless it is exercised ahead of the predefined moment due to financial difficulties.
9. Rescheduled payments	The existing contractual repayment schedule is adjusted to a new sustainable repayment programme based on a realistic, current and forecasted assessment of the borrower's cash flows	Different repayment options may include: i. Partial repayment: When a payment is made against the exposure, e.g. from a sale of assets that is lower than the outstanding balance. This option is applied to significantly reduce the exposure at risk and to enable a sustainable repayment programme for the remaining outstanding amount. This option should be preferred to the bullet or step-up options described below. ii. Balloon or bullet payments: When the rescheduled repayment ensures a large payment of the principal at a later date before loan maturity. This option should only be used/considered viable in exceptional circumstances and when the institution can duly demonstrate future cash flow availability by the borrower to meet the balloon or bullet payment. iii. Step-up payments: Credit institutions should only consider a solution including this option viable when they can ensure, and are able to demonstrate, that there is good reason to expect that future increases in payments can be met by the borrower.
10. Conversion of currency	When the currency of the exposure is aligned to the currency of the cash flows.	Credit institutions should explain fully to borrowers the risks of foreign exchange and should also refer to currency conversion insurance.
11. Other alteration of contract conditions/covenants	When the credit institution discharges the borrower of covenants or conditions included in a loan agreement not yet listed above.	
12. Refinancing/New credit facilities	Providing new financing arrangements in order to support the recovery of a distressed borrower.	This is usually not a viable standalone forbearance measure, but should be combined with other forbearance measures addressing existing arrears. It should only be applied in exceptional cases.

Forbearance measure	Description	Viability and other important considerations
		New credit facilities may be granted which may entail the pledge of additional collateral. In the case of inter-creditor arrangements, the introduction of covenants should be necessary to compensate for the additional risk incurred by the credit institution. This measure may be more suitable for corporate exposures accompanied by a thorough assessment of the borrower's ability to pay should be performed, including sufficient involvement of independent sector experts to judge on the viability of provided business plans and cash-flow projections. This measure should only be considered viable when the thorough affordability assessment demonstrates repayment capacity in full.
13. Debt consolidation	Combining multiple exposures into a single exposure or a limited number of exposures.	This is usually not a viable standalone forbearance measure, but needs to be combined with other forbearance measures addressing existing arrears. This measure is particularly beneficial in situations where combining collateral and secured cash flows provides greater overall collateral coverage for the entire debt than individually. For example, by minimising cash leaks or by facilitating re-allocation of cash flow surplus between exposures.
14. Partial or total debt forgiveness	The credit institution forfeiting the right to legally recover part or the whole of the amount of debt outstanding by the borrower.	This measure should be used where the credit institution agrees to a "reduced payment in full and final settlement", whereby the credit institution accepts to forgive all of the remaining debt if the borrower repays the reduced amount of the principal balance within an agreed timeframe. Credit institutions should apply debt forgiveness options carefully since the possibility of forgiveness can give rise to moral hazard and thus might encourage "strategic defaults". Therefore, institutions should define specific forgiveness policies and procedures to ensure strong controls are in place.

Accompanying documents

Draft impact assessment

Council conclusions on Action plan to tackle NPLs in Europe request the EBA to issue, by summer 2018, general guidelines on NPL management and internal governance, consistent with the SSM Guidance for significant institutions, i.e. "Guidance to banks on Non-Performing Loans".[43] More precisely, this Council request follows one of the (preferred) policy options presented in the Report of the FSC Subgroup on Non-Performing Loans.[44] As a result, this section uses the latter as a baseline for the analysis.

As per Article 16(2) of the EBA regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council), any guidelines developed by the EBA shall be accompanied by an Impact Assessment (IA) annex which analyses 'the potential related costs and benefits'. Such annex shall provide the reader with an overview of the findings as regards the problem identification, the options identified to remove the problem and their potential impacts.

This annex presents the IA with cost-benefit analysis of the provisions included in the Guidelines described in this Consultation Paper. Given the nature of the study, the IA is high-level and qualitative in nature.

A. Problem identification

The main (specific) problem that the current draft guidelines aim to address is the limitations in the scope of implementation of the SSM Guidance. SSM Guidance covers a set of micro-prudential measures and supervisory tools to monitor and assess the performance of significant institutions under the SSM's direct supervision regarding their strategy, governance and operations in relation to NPL management. In other words, the current scope of the policy implementation on NPL management is limited to significant institutions (and to their national, European and international subsidiaries) and does not cover other (less significant) institutions and banks outside the Banking Union. Yet, there may be some other banks that are not subject to SSM Guidance and continue having high levels of NPLs.

Overall, exclusion of the banks that fall outside the scope of the SSM's direct supervision from NPE management rules would prevent reaching the ultimate policy objectives of tackling the high NPE levels in the EU.[45] This would lead to:

[43] Press Release 459/17 (11/07/2017)

[44] Report of the FSC Subgroup on Non-Performing Loans (9854/17), see Policy Option A.1 (p.55)

[45] Report of the FSC Subgroup on Non-Performing Loans (9854/17), see Policy objectives (p.50)

- lack of necessary monitoring and assessment tools for the supervisors to oversee the management of NPEs,
- lack of timely recognition and intervention to tackle problems related to high levels of NPEs,
- obstacles to achieve supervisory convergence in the treatment of NPLs and to implement a proactive NPE management strategy, and
- obstacles to foster and monitor sound credit management and internal governance, to prevent the emergence of excessive levels of NPEs.

The current practice not only leaves a large number of EU banks outside the scope of NPE monitoring and assessment but may also deteriorate level-playing field and supervisory convergence in the EU banking sector.

B. Policy objectives

The general objectives of the draft Guidelines are i) to provide supervisors with the necessary and effective tools to oversee the management of NPEs by banks and ensure their timely recognition and provisioning, ii) promote supervisory convergence in the treatment of NPEs across EU banks, iii) provide for all relevant high NPE banks to implement a proactive NPL management strategy, and iv) foster and monitor sound credit originating standards, risk management and internal governance, to prevent the (re-)emergence of excessive levels of NPEs.

The specific objective of the Guidelines for this purpose is to extent the scope of the supervisory monitoring and assessment of banks' NPE management to the entire EU banking sector i) to ensure effective supervisory framework to tackle NPE-related problems, ii) promote supervisory convergence across EU banks and iii) promote level-playing field in the EU banking sector.

C. Baseline scenario

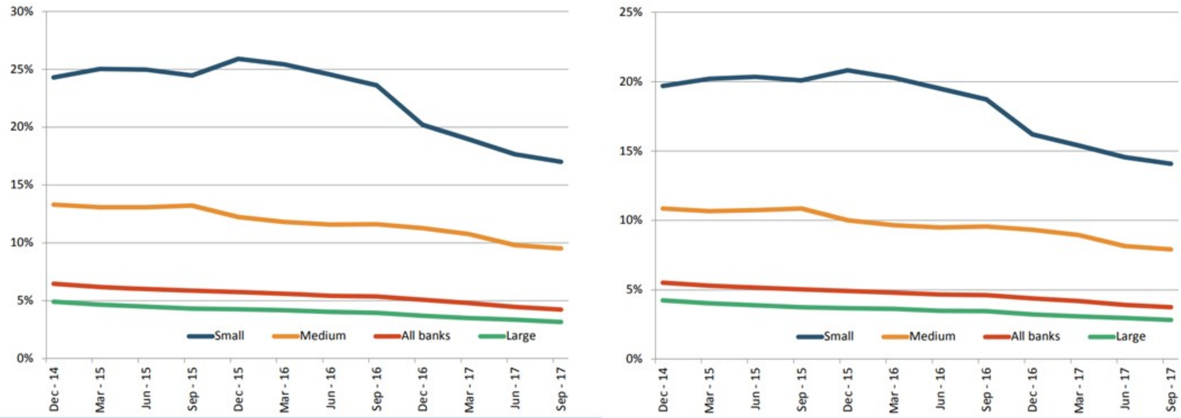
In March 2017, the SSM adopted "Guidance to banks on Non-Performing Loans". The objective of the Guidance is for banks to define and implement quantitative policies and targets to address high levels of NPLs.

A total of 119 banks fall under the scope of the SSM Guidance and the current rules do not cover over 6000 other institutions that are operating in the EU. Furthermore, significant banks are mostly large banks that have also relatively lower levels of NPL/NPE ratios, while medium and small banks in terms of their volume of total assets and the level of cross-border activities, on average, have larger NPL/NPE ratios. The EBA is collecting supervisory data from a sample of EU banks.[46] These

[46] See EBA decision on reporting by competent authorities and the list of reporting institutions: http://www.eba.europa.eu/risk-analysis-and-data;jsessionid=22757A060AF21D5FD05EE81F270578EC

banking data show similar trends (Figure 1). If no policy intervention takes place, the current problems related to high NPL/NPE levels are expected to persist.

Figure 1 Evolution of NPL ratios (left-hand panel) and NPE ratios (right-hand panel) by the size of EU banks – EBA risk dashboard data as of Q3 2017

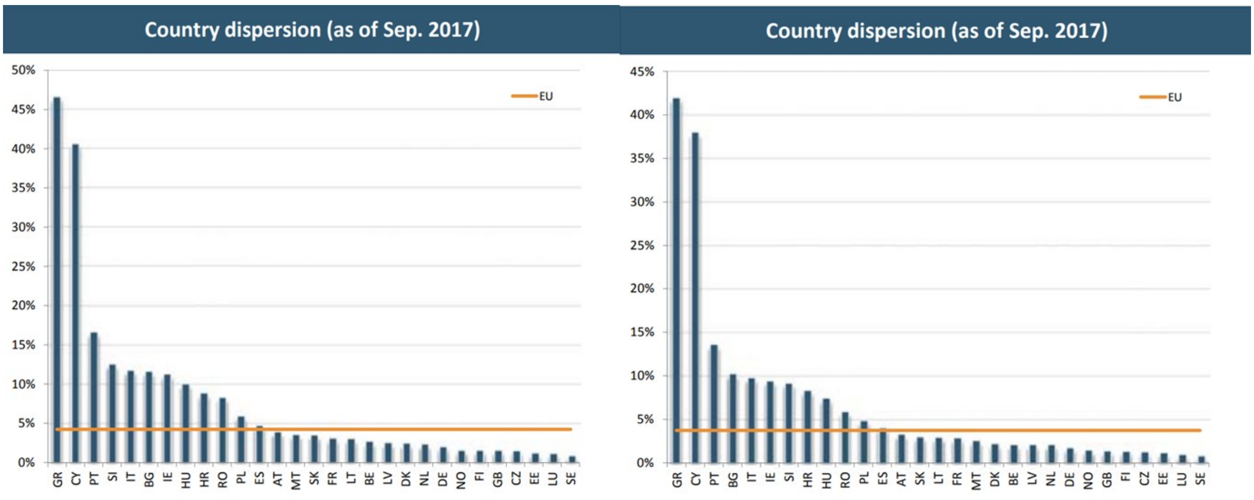


Weighted average. Banks are classified in the size class according to their average total assets between Dec. 2014 and Sep. 2017.

Weighted average. Banks are classified in the size class according to their average total assets between Dec. 2014 and Sep. 2017.

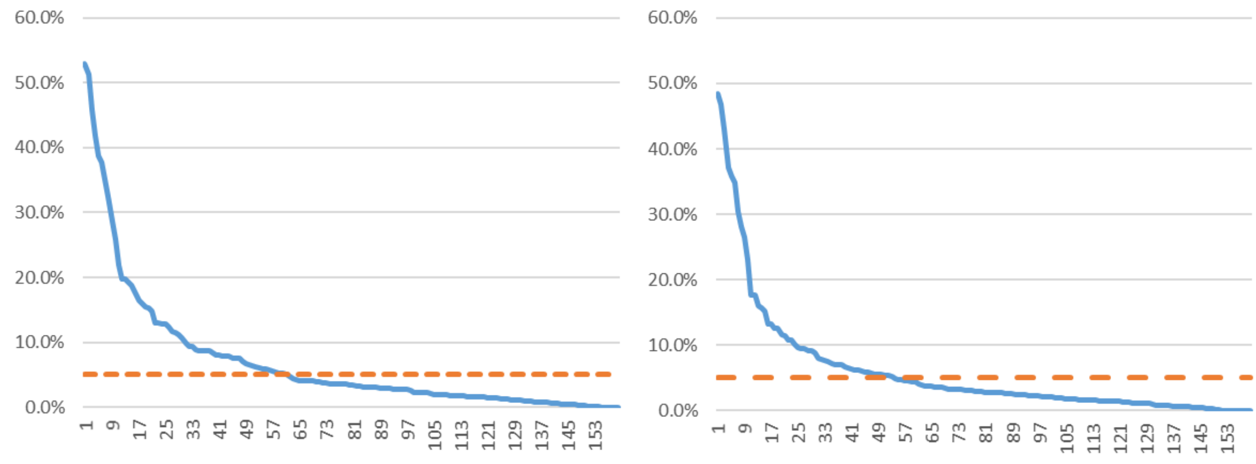
A further analysis indicates that there are no country-specific patterns in the NPL/NPE risk status of banks in relation to their Eurozone membership. Countries with NPL/NPE ratios above the EU averages include a combination of both Eurozone and non-Eurozone countries (Figure 2).

Figure 2 Country dispersion in NPL ratios (left-hand panel) and NPE ratios (right-hand panel) – EBA risk dashboard data as of Q3 2017



The EBA’s supervisory data as of end-September 2017 show that the (weighted) average NPL ratio is 4.2% and the median value is 3.4%, while the (weighted) average NPE ratio is 3.7% and the median value is 2.8% for EU banks. Figure 3 shows the distribution of NPL and NPE ratios across EU banks.

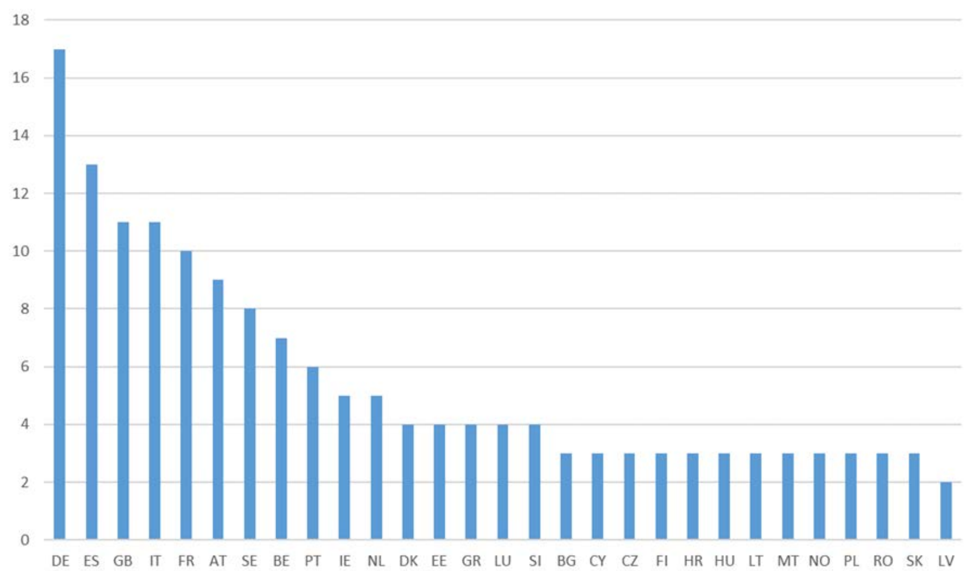
Figure 3 Individual banks level distribution of NPL ratios (left-hand panel) and NPE ratios (right-hand panel) – EBA FINREP data as of Q3 2017



Under this distribution among 160 banks included in the analysis, 64 banks (40% of the sample) have an NPL ratio above the average ratio and 65 banks (41% of the sample) have an NPE ratio above the average ratio.

In terms of cost and benefits, it is expected that the current draft guidelines will have an impact only on the banks in the EU banking sector that falls outside the scope of the SSM's direct supervision, as currently significant banks are subject the SSM Guidance and they bear the costs and benefits of the NPL management rules.[47]

Figure 4 Sample of the analysis by member state - EBA FINREP data as of Q3 2017



[47] This statement does not consider any positive externalities that may generate under the policy intervention from the implementation of the rules on the systemic institutions that are already subject to the rules.

D. Options considered

Scope of implementation

a) Option 1a: Guidelines to cover loans to specific sectors only

b) Option 1b: Guidelines to cover all exposures

Proportionality

a) Option 2a: Application of proportionality in terms of institution-specific characteristics

b) Option 2b: No application of proportionality in terms of institution-specific characteristics

Implementation of a threshold

a) Option 3a: Introduction of a threshold for the implementation of NPE strategy, governance and operations

   i. Option 3a (i): Variable threshold

   ii. Option 3a (ii): Static threshold

b) Option 3b: No threshold for the implementation of NPE strategy, governance and operations

E. Assessment of the options and cost-benefit analysis

Scope of implementation

The assessment looks at the loans and exposure categories of banks that should be included in the scope of the guidelines. Supervisory data show that NPLs, NPE to households and to NFCs are the major categories where banks have critical risk ratios. Option 1a proposes including these categories. Option 1b suggests that regardless the current dynamics in the risk profiles of banks in relation to any loan or exposure category the scope of implementation should cover the entire non-performing and forbearance scope of definition.

The EBA guidelines choses option 1b because it is expected to be more prudential and forward looking, i.e. although currently data do not indicate any major risk in exposures classes other than loans, households and NFCs, this may not be the case in the future. Therefore, the guidelines apply to all instruments and sectors – to exposures subject to definition of non-performing and forbearance as defined in Annex V of Commission Implementing Regulation 680/2014.

Also, it is expected that the additional cost of expanding the scope of implementation beyond loans, exposures to households and NFC does not increase the operational cost and administrative cost to the banks or supervisors but the expected benefits are greater. If critical values appear on other sectors and instruments in the future, the guidelines are not needed to be revised to include them in the scope.

Proportionality

The options assess whether the current guidelines introduce a balance between the policy requirements and the characteristics of the institutions, i.e. whether the policy requirements for the institutions are appropriate and fair given a set of criteria.

The application of proportionality principle (option 2a) intends to introduce a framework that the institutions comply with the NPE strategy, governance and operational requirements in proportion to their characteristics.

More precisely, it aims to avoid disproportionately large (administrative and operational) costs for the institutions with respect to their characteristics such as their size, internal organisation, and the nature, scope and complexity of their activities.

For example, the implementation of separate and dedicated NPE WUs may be disproportionately costlier for a small institution with less complex and local business activities than for a large international institution with a more complex set of portfolios. In this case the guidelines introduce simplified requirements for some banks. These banks, meeting certain proportionality criteria may not need to or be able to set out a separate workout unit but it needs to separate these tasks only. Also, for small banks that do not have internal models, it would be costly to impose requirements on advanced back-testing. In this case, guidelines introduce simplified requirements for small banks that do not use internal models. Such proportionality application applies in other technical areas such as definition of borrower sub-portfolios.

However, the recognition and accounting aspects as presented in Chapters 6, 7 and 8 of the guidelines do not justify differential treatment among banks and apply all institutions regardless of proportionality assessment criteria.

The application of the proportionality principle does not refer to the risk profiles of the institutions (which depends in this case on the NPL/NPE indicators) but is based on the (non-risk) indicators that are published in Chapter 4 of the previous EBA guidelines on internal governance under Directive 2013/36/EU.

Due to its cost-effective implication, option 2a is the preferred option.

Implementation of a threshold

The objective of setting a threshold is expected to link the requirements of the current guidelines (as presented in chapters 4 and 5) to risk profiles of the institutions. This would provide further efficiency in supervision and increase cost-effectiveness of the policy measures.

An NPL/NPE ratio level to be applied at individual institution level would indicate a systemic threshold above which the institutions would be subject to more prudential rules under the scope of the guidelines.

Such threshold would not be a clear cut-off point; CAs would have discretionary power not to wait for the institutions to reach this threshold and apply certain (precautionary) rules when the NPL/NPE ratios of the institutions are below the set threshold but show somewhat signaling trends. Such threshold is a risk-based metric and would apply to all banks.

Option 3b (not introducing a threshold) would not remove the potential problems related to NPE and does not set the policy objectives, e.g. comparability and consistency across banks and jurisdictions. Preferred option is option 3a.

Left-hand panel in Figure 3 shows the distribution of NPL ratios across EU banks, where horizontal dashed line indicates the hypothetical 5% threshold.

The number of banks with NPL ratio below 5% (and 10%) are calculated to present the potential binding effect of the threshold. If a 5% threshold is introduced about 38% of the banks in the sample remains above this threshold. If this threshold is introduced at a (more relaxed) 10% level, the number of banks that remains above the critical value falls to 19%. One limitation of this analysis is that the EBA sample includes mostly large banks while the baseline scenario shows that the problems related to NPE/NPL across the EU is greater among small and medium-sized banks.

Similarly, as of end-September 2017, the EBA data show that 33% of the banks have an NPE ratio above the hypothetical 5% level while this figure goes down to 15% for an hypothetical threshold of 10%.

Then the question is whether such threshold should be static or varying depending on other microeconomic and macroeconomic conditions. Varying threshold that is applicable at the industry level is not justified on microeconomic (current risk profile of banks in relation to NPL/NPE ratios) and macroeconomic (dynamics of macroeconomic conditions) ground. Indeed, the average NPL/NPE ratio for all banks is fairly stable, yet following a decreasing trend, over the last years (Figure 1). The objective of the guidelines is to ensure an early warning system and to establish preventive measures against critical NPE/NPL. A static threshold is expected to establish an effective signal towards this, while a varying threshold that accounts for the tendency of NPE/NPL to fluctuate around a trend during the economic cycle is not expected to reach these objectives. In other words, the justification for a decrease in the threshold would be related to more (stable) long-term average risk performance of banks and not necessarily (short or medium-term) economic conditions that a varying threshold would capture. The EBA guidelines introduce a static threshold (option 3a (ii)).

Overview of questions for consultation

Question 1: What are the respondents' views on the scope of application of the guidelines?

Question 2: What are the respondents view of the proposed threshold of 5 % NPL ratio?

Question 3: Do you see any significant obstacles to the implementation date and if so, what are they?

Question 4: Does section 4.3.2 capture all relevant options available for credit institutions to implement their NPE strategy?

Question 5: Do you see any significant obstacles to the operationalisation of the NPE strategy as described in chapter 5?

Question 6: Does the viability assessment of forbearance measures capture all relevant aspects?

Question 7: What are the respondents view on the proposed requirements for recognition of non-performing and performing/non-performing forborne exposures?

Question 8: What are respondents view on the requirements on timeliness of impairments and write-offs of NPEs?

Question 9: Do you have any significant objection against the proposed threshold for property-specific valuation (EUR 300,000)?

Question 10: Do the requirements for valuation of movable property collateral capture all relevant aspects?