AFME Position Paper

Consultation on EBA Guidelines on Management of non-performing and forborne Exposures

8 June 2018

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to contribute to Consultation on EBA Guidelines on **'Management of non-performing and forborne Exposures'**.

Overarching comments:

AFME is generally supportive of measures being taken to tackle NPLs in Europe, in particular, it makes sense for the EBA to provide supervisory guidance to ensure consistent and effective management by banks of NPLs and forborne exposures on their balance sheets across the EU. We believe that a harmonised guidelines approach for all EU banks is the right one, as it promotes consistency and adoption of best practices while accounting for the heterogenous nature of banks' NPL portfolios. We therefore support the approach of the EBA in developing Guidelines, which we think better suited to addressing the issue than others which are currently on the table such as the Pillar 1 backstop proposed by the Commission. Overall, we would urge for EU institutions to reflect on the plethora of overlapping initiatives under the NPL action plan could be better streamlined and coordinated to minimise the operational burden for banks to implement.

Consultation response:

Q1 (scope of application)

It is clear that the EBA's intension is to exclude assets in the trading book, nonetheless, it would be beneficial if the Guidelines included an explicit reference carving out trading book assets in regulatory terms, as per the definition of CRR (Capital Requirements Regulation 575/2013) Article 4(1)(86). The definition used by the EBA Guidelines (Annex V of Commission Implementing Regulation 680/2014 - FINREP) may be understood to exclude trading assets in IFRS terms and not trading book assets in regulatory terms.

On the valuation of movable property collateral, we deem that should be better clarified what the perimeter of movable property to be collateralized should be. In particular, we suggest EBA to provide a better definition of "movable property" and a clear indication of the reason behind it. For example, we deem it is unclear whether we should consider registered movable properties and pledges on commodities/goods and/or not listed Financial Assets.

The scope of application of the proposed threshold for applicability of chapter 4 and 5 is not clear and is open to interpretation by banks and supervisors. We are concerned that the lack of clarity could lead to unintended consequences. [please refer to answer to Question 2 for more details]

Q2 (5% Threshold)

We welcome the EBA's proposal to introduce proportionality to the guidelines. As proposed however, the 5% threshold could lead to banks and supervisors allocating scarce resources to immaterial non-performing exposures related issues. Before the EBA introduces a threshold, an assessment should be carried out to demonstrate that NPLs over and above such threshold will have a significant impact on a bank's overall risk.

If a target is set, then we would recommend using a firm's risk appetite and stress testing framework to set a more meaningful target recognising the differing product mix and risk profile of each firm.

There are also several other impracticalities arising out of the EBA's proposed threshold which should be considered in the finalisation of the guidelines:

First, the guidelines are not clear on the level of application of the threshold relevant to applicability of Chapters 4 and 5, which could lead to a wide range of interpretation. It is not clear if it is applied at a consolidated level only, or, as some paragraphs refer to, it should be applied to the portfolio (industry, country level). On this basis, it could imply that a bank with an elevated portfolio for a country will need an NPE strategy even if this portfolio is immaterial compared to its total loans. The threshold should be applied at consolidated level only, or alternatively at a lower level but with materiality threshold against total loan book. This would reflect the benefits of large diversified financial groups where the ability to lend is determined by the overall capital position rather than any specific (potentially small) portfolio.

Second, we believe that monitoring the gross NPL ratio for determination of applicability of chapters 4 and 5 is not sufficiently clear. There are practical and legal reasons for banks not systematically write off non-performing exposures and fully provision instead, e.g. write off can be interpreted as debt forfeiting in some jurisdictions or would severely impair the recovery value. In those cases, institutions may display elevated gross NPL ratio, while the net NPL ratio remains low. We recommend that monitoring should just consider the net NPL ratio in relation to the threshold for sake of clarity.

Finally, we welcome the statement of paragraph 19 of the "Background and Rationale" chapter that the 5% threshold does not act as an automatic trigger. The guidelines should however recognize the need for an expert judgement where NPL reduction actions already made by the institutions as the most relevant driver. The level of NPLs should be considered holistically as part of a firm's overall risk management and addressed through the regular dialogue between firms and regulators. Experience is that any setting of targets brings the risk of unintended consequences. Management of exposures in difficulty is a key part of a bank's duty of care to its customers and any target threatens this delicate relationship with clear conduct risks. This is especially the case if there are "time-bound quantitative targets" for reduction. Setting such a threshold may encourage some institutions to target their NPL ratios, which may not be compatible with best practice with respect to NPL recognition and management. Further, if the measures also include forbearance accounts, then this might mean that deserving customers in financial distress would not be granted forbearance to prevent reaching the threshold. Similarly, for foreclosed accounts; waiting to foreclose / dispose of a property purely to meet a target (e.g. para 38 of 4.3.3) could erode customer equity in a declining house price market and would be detrimental. We note that paragraph 50 mentions staff being incentivised to reach targets set by NPE reduction strategy – historically these types of incentives have proved counter-productive to customer outcomes.

Q3 (timeline)

Banks are currently adjusting their systems to comply with the reporting requirements of the ECB Guidance. Such IT adjustments take significant time, and the proposed implementation date of the EBA guidelines by January 2019 therefore would be extremely challenging for banks, given the Annexes contain significant data requirements on top of those required by the ECB. The annexes of the EBA guidelines also include some key metrics which would benefit from being revised or clarified. A more realistic timeframe for banks to comply with these reporting requirements would be from 2020, possibly later in relation to collateral reporting. Moreover, we clearly urge the EBA to ensure the reporting requirements in the EBA Guidelines are aligned with the ECB Guidance requirements.

We would like to highlight that, although the NPE Guidelines makes explicit reference to the EBA Guidelines on the application of the definition of default and Commission Delegated Regulation (EU) 2018/71 on materiality threshold in relation to certain criteria used for the identification of default (paragraph 149 (Past due criterion), paragraph 150 (Indications of unlikeliness to pay) and paragraph 166 (Consistent application of definition of non-performing)), it does not require explicitly alignment regarding other criteria that should be applied (paragraph 159 (Exit from non-performing status) and paragraphs 152 to 158 (Forbearance and performing status)).

We would also like to highlight that there might be a misalignment regarding the implementation date (taking into account that NPE Guidelines refers to EBA Guidelines on the application of the definition of default and Commission Delegated Regulation (EU) 2018/171 on materiality threshold):

- NPES (CP "Draft Guidelines on management of non-performing and forborne exposures): These guidelines apply from 1 January 2019.
- EBA Guidelines on the application of the definition of default applies from 1 January 2021 and Commission Delegated Regulation (EU) 2018/171 on materiality threshold) shall apply shall be no later than 31 December 2020 for institutions using the Standardised Approach.

Additionally, entities need a reasonable period to adapt their internal procedures to this type of legal thresholds, once the competent authority had decided it is applicable.

Industry also would welcome greater clarity on what information must be reported and in which format.

Q4: Implementation of NPE strategy

The definition of the "management body" is unclear. It would be unreasonable to consider that it always implies the bank's Management Board. The MB of an internationally-active bank is not the appropriate body to approve lower-level policy document, as such policies are better delegated, understood and monitored by lower policy committees that are closer to the details. Such MB are also not often available for frequent or short-notice meetings due to extensive travelling of their members, and their agenda is often occupied by international strategic decisions.

We would thus require from the EBA more clarity about the expectations around the definition of "management body", adopting a proportionate approach especially for internationally-active banks. Plans or other policy documents should be adopted by policy committees that are of sufficient calibre to understand the issues and of appropriate seniority and scope so that they can monitor implementation and consider adjustments as necessary.

Additionally, it should be made clear that the requirements under this article do not and are not intended to supplement nor amend the relevant Securitization/Credit Risk Mitigation regulations currently within the CRR (in particular but not exclusive to CRR 119(5), CRR 243/244) and the Securitization Regulation.

Q5 (operationalisation of NPE strategy)

We agree with the principles presented in section 5.3 on the control framework. We would like to point out however that the three lines of defence concept may not necessarily be reflected in the organisational structure of the institutions, and could take different forms, which would be proportionate to the resources dedicated to NPE management. With reference to paragraph 15 of the "Background and rationale" chapter also, the guidelines should not automatically assume that large and complex institutions will have the most

developed NPE management organisational structure, but rather for organisational aspect of management of NPE to be commensurate with the size and complexity of the NPE of an institution.

Q6 (forbearance):

The proposed viability assessment can be difficult to implement in the case of corporate clients. Although there are standard procedures, given the peculiarities of each case it is difficult to have an automatic viability assessment in place.

Paragraph 132 is related to reverting forbearance measures in case some conditions are met, but this may not be consistent with local legislation in some MS For example, in Spain banks cannot ask for additional guarantees, while in Italy the concession of an "additional security" as stand-alone measure is subject to some legal constraints. Therefore, this measure can be implemented only in combination with other FBE measures.

Moreover, we deem that not only "*modification of the terms and conditions*" but also "*refinancing*" should be included within the short-term measures.

Finally, pending the final issuance of the "*EBA Guidelines on loan origination, monitoring and internal governance"*, banks should be allowed to suspend the implementation on the affordability assessment criteria until the final guidelines are in force.

Q8: (Requirements on timeliness of impairments and write-offs of NPEs):

AFME considers there needs to be greater flexibility. For example, in the case of non-EU subsidiaries, in some countries partial write-offs are common, while in others it is not the case. In the case of portfolios of small, similar exposures, using quantitative indicators at client level is not advisable as the analysis is usually performed at portfolio level.

Q9 (proposed threshold for property-specific valuation (EUR 300,000))

The EBA explicitly mentions that Articles 208 and 229 of the CRR apply. However, the proposed requirements concerning valuation and monitoring/review of property values are stricter than those in the CRR. The requirements in the draft guideline on annual valuations should be consistent with those of the CRR.

In particular, we have serious reservations about the requirement for regular property-specific appraisals of collateral for NPEs of over EUR 300,000, since it is inconsistent with the CRR. Annual monitoring based on the so-called prudential market fluctuation concept already ensures a close analysis of the market for commercial and residential property. The value of collateral is also reviewed and, if necessary, adjusted if there is a specific reason to do so. Furthermore, the introduction of a fixed de minimis threshold of EUR 300,000 for a simplified valuation procedure would conflict with national market practices, placing an additional operational burden on banks, despite the high-quality monitoring, review and revaluation processes already in place.

We are therefore opposed to the introduction of a fixed de minimis threshold and would instead recommend aligning the valuation and monitoring/review requirements in the draft guidance with those in Articles 208 and 229 of the CRR.

If the threshold is to be introduced, we also consider there to be several impracticalities with the EBA proposal:

- The threshold is too low, in particular for big cities.
- The threshold should take into consideration non-euro denominated properties – for instance the situation where the local currency has appreciated significantly against the euro-denominated threshold. On the valuation of movable property collateral, it should be better clarified what the perimeter of movable property to be collateralized should be. The EBA should provides a better definition of "movable property" and a clear indication of the rationale behind this - for example, it is unclear whether we should consider registered movable properties and pledges on commodities/goods and/or not listed Financial Assets.
- It is not feasible nor necessary to complete physical valuations of all NPE properties given the volume, even introducing a threshold of €300k would result in significant volumes of physical valuations.
- Many FBEs are only in short term fin different so we consider it unnecessary to include these in a physical evaluation. For long term FBE we see strong rehabilitation performance hence we would disagree with imposing a physical valuation on these collaterals.
- The additional cost of more frequent & physical valuations would increase the cost of managing NPE's and cost to the customer which could lead to unnecessary erosion of equity.
- Our recommendation would be to limit physical valuation to those collaterals which are at repossession only (which are more likely be the result of no contact and/or inability to engage in a plan).
- Regarding frequency of valuation for non-residential immoveable property, 1 year is considered too short given that the sale process can take longer than this. It is recommended that only in the event of a sale not being in progress (i.e. no offer post 1 year from repossession) would a further annual assessment be made. (Worth also noting that whilst It is unlikely that following repossession on a residential property, a sale would not be complete within 3 years, the "sale in progress" exclusion would also be recommended in this situation also).
- In addition to above, with regards to Section 9.7.249 may conflict with some securitisation agreements, especially in the case of Reverse Mortgage Backed Securities or Commercial/Residential Development CMBS whereby the originator may be required to complete renovations/construction/development on properties to realise market value for investors in the notes in an event of default of the borrowers. Noteholders (especially in a publicly offered RMBS/CMBS) would often chose this route despite it being it being less economical (i.e. the land plus development cost is less than the market value of the developed property) due to the differences in liquidity of the underlying and the operational burden of the former.

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