EACB Comments

EBA draft GL on management of non-performing and forborne exposures (EBA/CP/2018/01)

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General comments

The members of the EACB welcome the opportunity to comment on the EBA draft GL on the management on management of non-performing and forborne exposures.

We appreciate the intention to consistently align practices for a sound and effective management of NPEs and forborne exposures, however be believe that a number of aspects still need to be clarified and we warn against any mechanistic approach that would ultimately harm the borrowers.

Furthermore, we would suggest to take proportionality in account to a greater extent as the design of certain processes in the draft GL seems rather detailed and oriented towards what would be SIs under the ECB supervision. In this vein a more principle-driven approach would be appropriate, and could be addressed for instance to competent authorities rather than institutions.

Finally, it seems that much of the content of the draft GL was developed with a view to larger commercial or corporate loans, while it does not translate adequately to certain other portfolios, especially retail residential mortgages. This should be adequately taken into account, otherwise unnecessary, inappropriate and burdensome practices may inadvertently be mandated for the management of such mortgages.

Answers to specific questions

Q.1 What are the respondents' views on the scope of application of the guidelines?

The EBA indicates in para. 10 that: "*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*". The wording seems to imply that NPL ratios are defined at a granular level and that NPLs reduction measures are automatically triggered when the threshold is breached.

At a general level, the ratio should only work as a warning indication on the need for enhanced scrutiny by the bank senior management and Competent Authorities. There is in fact a contradiction between calculating the ratio both at consolidated level and at portfolio level. Indeed, an institution may have a specific portfolio with a NPL ratio > 5% due to the specific business activity of the portfolio, for which defaults are more frequent (e.g. consumer finance). At the same time, the consolidated NPL ratio may still be < 5% as the other business activities are less risky and offset the risky portfolio.

We see no justification in having to apply chapters 4 & 5 at portfolio level.

Moreover, process requirements that do not take into account the conditions of the bank (proportionality) would be too broad and would thus not be a suitable supervisory tool. The proportionality principle presented in para. 14 is not declined with sufficient flexibility to achieve a meaningful and feasible implementation of the GL to smaller institutions or the ones with an evident low risk profile. In addition, it is oriented too heavily on the possibility of risk-dependent application of chapters 4 and 5. Instead, it should be clear that a proportionate implementation may be possible for all aspects of the Guidelines.

Finally, looking at the NPL ratio alone (especially when it is computed without taking into account the level of coverage of doubtful loans by provisions) is not sufficient to trigger the application of chapters 4 and 5. Competent Authorities should instead take into account specific features of the credit institution or the portfolio of loans. Indeed some activities have "by definition" a business model that demands high rates of gross NPLs without necessarily bearing high losses: loan restructuring department, consumer finance, social housing, etc. The realized loss, i.e. the net amount lost, is the key parameter to be considered. This is consistent also with the credit risk capital requirements calculations (i.e. use of PD and LGD).

Q.2 What are the respondents view of the proposed threshold of 5 % NPL ratio?

Further to what indicated in Q.1, in the case of residential loans to low income borrowers PD is clearly higher than average-income borrowers (also, down payments from low income borrowers are usually limited or absent). The gross NPL ratio can thus be expected to be above 5%. However, taking this indicator in isolation would be misleading, as banks take multiple remedies to address this and the actual losses experienced are quite low. This can be done for instance with a guarantee scheme put in place at origination.

Our French members for instance report that banks distributing housing loans to borrowers with low incomes (and which meet certain eligibility criteria) can benefit from a State-guaranteed scheme called FGAS. If the value of the loan is > 15.000 €, then a first-rank lien must be taken out by the lender. As a result, "expected losses" are quite low (low LGDs and higher PDs). In that case, the NPL ratio would not be the relevant feature to be considered by Competent Authorities.

We would rather suggest to focus on the net ratio as well as expected losses over the long run as specific portfolios and business models, when properly managed, do not show the criticalities that a single indicator might imply.

Finally, we would also highlight that certain portfolios and customers segments like the one recalled of low-income borrowers might be excluded from the credit market. Moreover, a strict application of the suggested provisions to elaborate and execute a plan to reduce the NPL ratio of the portfolio would be counterproductive: since the Expected Loss is low, margins are also relatively low, and operating a NPL portfolio according to the principles described would put additional pressures on the operational margin of institutions.

Chapters 4 and 5 of the draft guidelines should not have to be automatically applied when the 5% NPL ratio is breached. Supervisory dialogue remains essential and credit institutions should have the possibility to provide explanations to competent authorities as regard their portfolio with an elevated level of NPL.

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

An obstacle could be the uncertainty with regard to the cut-off date, i.e. the point in time for applying the threshold to define banks as high NPL. This can have a significant impact on a number of institutions as many banks already decreased their level of NPLs to a large extent (for instance driven by ECB requirements) recently, but they might still be classified as high NPL banks by EBA as the 5% threshold can differ from the ECB position.

It would be also key to clarify how the EBA and the ECB guidance are to be applied/resolved if they seem to be pointing at different approaches.

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

In general, some members have reported that the draft GL are quite extensive and in many aspects strongly similar to the ECB guidance already implemented.

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

Overall, a sectorial specialization is not feasible in some cases, in particular where the critical mass of non-performing exposures is not reached. Also, it does not make sense to overload individual workout-managers. In this regard it is also important to note that the closer the loan gets to bankruptcy proceeding, the more detailed legal knowledge is necessary.

In addition, the implementation of a second line of defense controls is also not a concept that can be translated into practice in all situations and institutions. This would unnecessarily slow down the workout process and result in additional costs. If a bank has a fully-fledged approval process in place including 4 eyes principle and third parties participation for large exposures, then a second line of defense controls is not necessary.

Q.6 Does the viability assessment of forbearance measures capture all relevant aspects?

We see that overall the approach outlined in Chapter 6 seems rather targeted for corporate/commercial loans than to retail mortgages. Forbearance practices for retail loans in some jurisdictions are already well regulated, so there is a risk that the EBA GLs will cut across or conflict with such rules and cause confusion and operational uncertainties.

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

Also Chapter 7 does not sufficiently reflect the reality of retail mortgages or other retail loans. The regular re-performance of individual creditworthiness assessments or repayment capacities (para. 151) for retail borrowers who are fully meeting their contractual payments in a timely manner is both unnecessary and impractical. Moreover, equivalent but more useful aggregate-level assessments of such portfolios are already carried out through various stress tests. Policy duplications should be avoided.

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

The methodologies proposed may be suitable for larger commercial or corporate loans but are massively over-engineered for retail loans. For instance, even the "simplified method" (para. 177) calls for "multi-period cashflow projections", which is a modelling that is way too complex for simple retail loans.

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

The EBA suggestion to use of a property specific appraisal (individual property valuation) instead of an indexed valuation when the gross carrying amount of a NPE is higher than € 300.000, or a lower amount defined by the competent authority, provides an insufficiently sensitive tool.

The threshold is too low, and the rule will lead to a substantial increase in the cost of operating NPEs. We would recommend to increase the threshold (for instance to cater for the market valuations in large European cities) and to require a less frequent individual property valuation (for instance, banks could use indexed valuation every year and property specific appraisal every 3 years).

Otherwise, the threshold should not be a fixed value but rather one that is based on the price level of immovable properties in a certain region. For instance, it could cover only the highest decile [or quartile], of values in a particular region and category.

Q.10 Do the requirements for valuation of movable property collateral capture all relevant aspects?

All in all it seems that the requirements in the draft GL are more than sufficient to cover all aspects. However, two points should be addressed. The independence requirements (para. 199) seem too broad, in particular with regard to process-related separation and testing requirement for life insurance policies (e.g. back-testing for life insurance policies and seized deposits does not correspond to the actual requirements).

Moreover the reference in para. 207 to Art. 229 CRR creates some uncertainty on the application of the requirements: i.e. is the framework to be understood as before (only immovable property has to be valued by independent appraisers) or does EBA mean that all collateral would now have to be valued by independent appraisers? This would in fact be contrary to the level 1 text.