



EBA Guidelines on management of non-performing and forborne exposures

**A look at the final guidelines and
the implications for banks**

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01 Executive summary

Banks should begin identifying now what they will need to do in order to comply with the new EBA Guidelines



The large legacy overhang of Non-Performing Exposures (NPEs) still remaining in the European Union (EU) is increasingly seen as a threat to the success of the Banking Union. Regulators have recently increased their interventions to speed up the banks' NPE risk deleveraging process.

In July 2017, the EU Council announced an Action Plan to tackle the issue, which included several initiatives to be implemented by the European Commission (EC) and other EU authorities in a short timeframe. [The final European Banking Authority \(EBA\) Guidelines on management of non-performing and forborne exposures \(EBA/GL/2018/06\)](#)⁽¹⁾, published on 31 October 2018, constitute a significant component of this Action Plan.

This paper analyses the content of the EBA Guidelines and outlines what credit institutions should do to prepare adequately for their implementation, with a focus on risk management practices across Europe for the management of non-performing and forborne exposures, foreclosed assets, as well as the valuation and liquidation of collateral. The paper also details other recent NPE initiatives that are likely to have a substantial impact on EU banks.

The EBA Guidelines will apply from 30 June 2019 and no transition period is foreseen. Banks should therefore begin identifying now what they will need to do in order to comply with the new Guidelines.

The core building block of the Guidelines is the development and operationalisation of an NPE strategy for the effective reduction of NPEs on balance sheets, as well as the sustainable limiting of NPE inflows at banks with a high level of NPEs. Whether a bank has a high level of NPEs is determined using the gross Non-Performing Loan (NPL) ratio. If this ratio is equal to or higher than the defined threshold of 5%, the bank is classified as a high NPE bank.

All banks in the EU, regardless of their NPE level, will need to identify and address any gaps in their internal policies and procedures relating to the Guidelines, including:

- Governance and operations of NPE management;
- Impairment measures and write-off procedures;
- Policies and procedures for the valuation of movable and immovable property collateral for NPEs; and
- Governance and operations of forbearance measures and processes.

Once implemented by the relevant regulatory authorities, the EBA NPE Guidelines will serve as the authoritative standards for all credit institutions in the EU (approximately 6,000).

Significant Institutions (SIs) directly supervised by the European Central Bank (ECB) (119 banks as of December 2018) have also been subject to the [Guidance to banks on non-performing loans](#)⁽²⁾ since 20 March 2017. Compliance with these supervisory expectations is monitored by the Joint Supervisory Team (JST) as part of the Supervisory Review and Evaluation Process (SREP) cycle, where a comply or explain approach is applied. In dialogue with the JSTs, deviations from the supervisory expectations are to be analysed, their effects quantified and, where necessary, time-bound measures applied to eliminate any deficiencies.

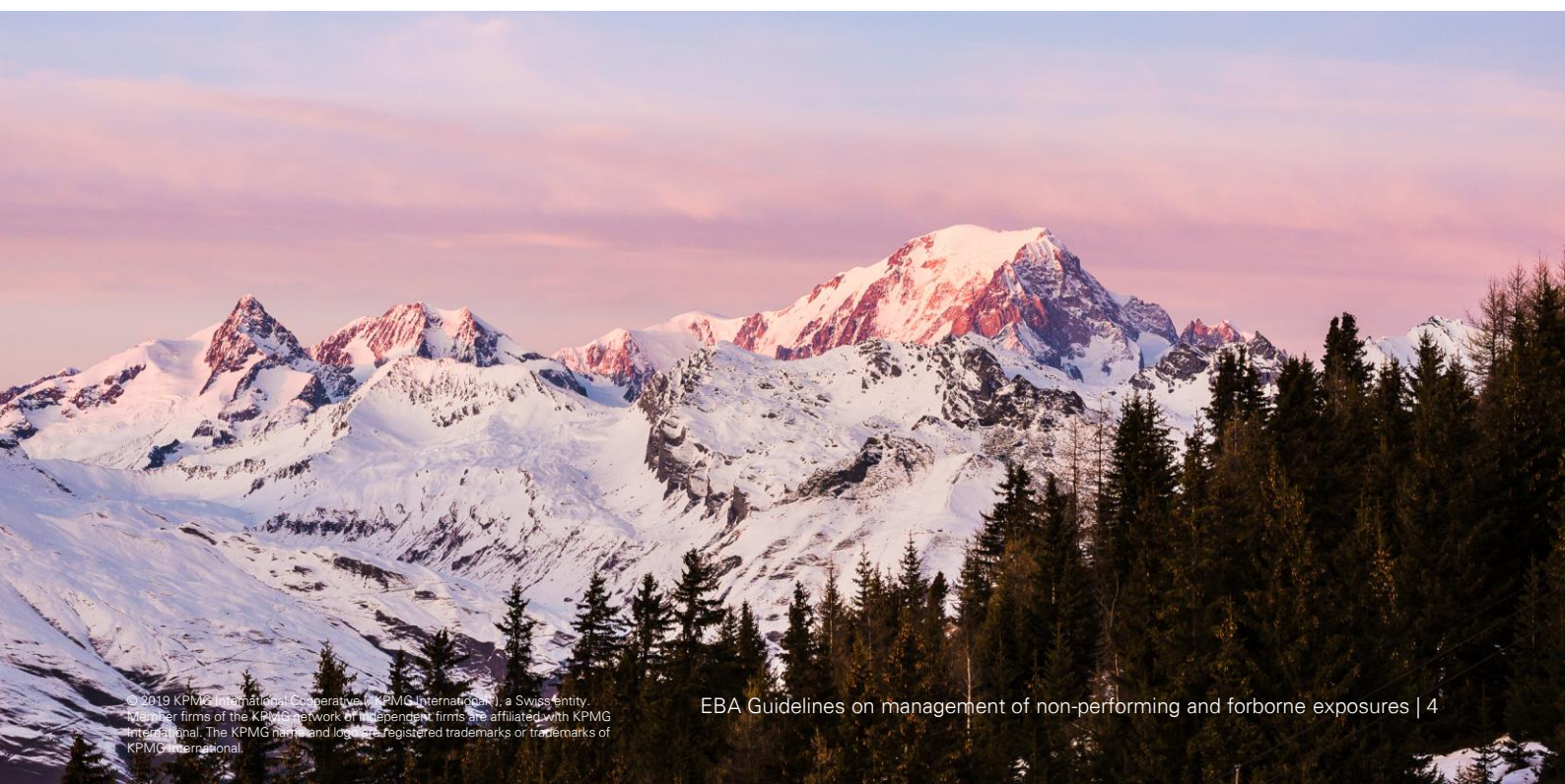


We discussed the ECB guidance in our previous publication on non-performing loans⁽³⁾.

In addition, the EBA published on 17 December 2018 its final Guidelines on disclosure of non-performing and forborne exposures (EBA/GL/2018/10)⁽⁴⁾.

- Notes:
- (1) <https://www.eba.europa.eu/documents/10180/2425705/Final+Guidelines+on+management+of+non-performing+and+forborne+exposures.pdf>.
 - (2) https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.
 - (3) <https://home.kpmg.com/xx/en/home/insights/2017/05/non-performing-loans-in-europe.html>.
 - (4) <https://eba.europa.eu/documents/10180/2531768/Final+GLs+on+disclosure+of+non-performing+and+forborne+exposures.pdf>.

KPMG member firms have developed a suite of tools to help banks address the challenges of managing their NPEs at the various stages of risk management, and to effectively reduce their NPEs.



02 Implications of the EBA Guidelines for EU banks

A significant portion of small and medium sized banks in the EU will be required to comply with the Guidelines in their entirety.

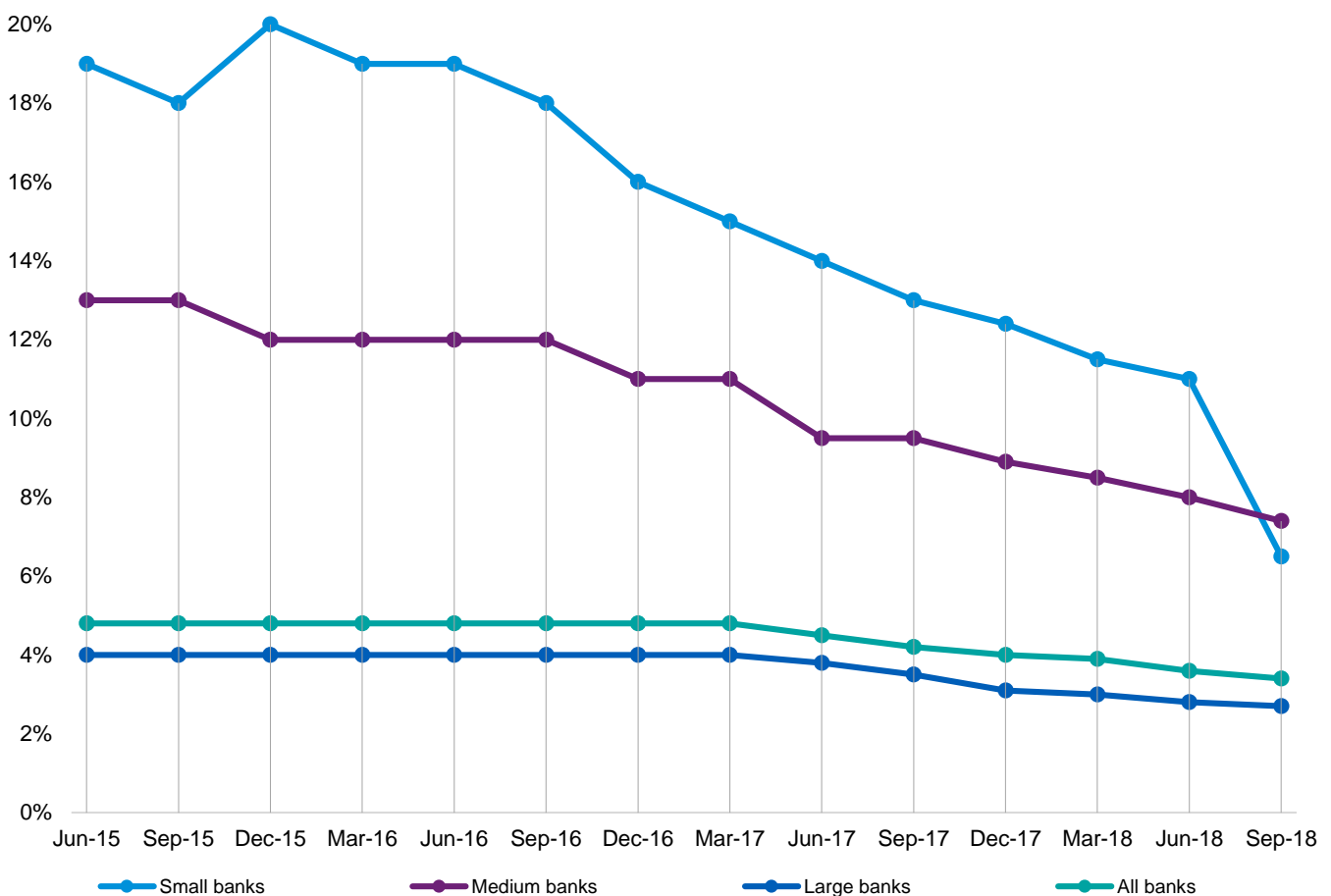


Some of the EBA NPE Guidelines (namely chapter four on the development and implementation of a NPE strategy and chapter five on NPE governance and operations) will apply only to banks with a significant proportion of NPEs, while the other chapters will apply to all EU banks. The Guidelines apply to the entire exposure that falls under the definition of NPE or Forborne Exposure (FBE).

The defined threshold for 'significant' is set at a gross NPL ratio of five percent, which is to be assessed at both the consolidated level and at the level of the individual banks within a banking group. Exposures in the trading book are excluded from the calculation of the gross NPL ratio. Secondary market transactions with NPE portfolios are to be included in the calculation of the gross NPL ratio. A specific definition of what should be contained in the numerator and denominator of the ratio can be found in the FinRep table F18.00 DPM 2.8 (No. 1). National supervisors have the right to request the development and operationalisation of an NPE strategy even in cases where the threshold has not been reached or exceeded, for example if considerable NPE inflows, excessive forbearance measures, significant growth in foreclosed assets or insufficient provisioning levels are identified.

While the average NPL ratio in Europe was 3.4 percent at the end of Q3 2018, small and medium-sized banks have, on average, much higher NPL ratios (6.5 percent and 7.4 percent respectively) than larger banks (2.7 percent). It is therefore expected that a significant portion of small and medium-sized banks in the EU will be required to comply with the EBA NPE Guidelines in their entirety.

Ratio of NPLs to loan volume



Source: EBA Risk Dashboard Q3/2018.

Practical insights

Banks with significant NPEs in their portfolios will need to:



Conduct a thorough analysis of their portfolios to evaluate the drivers of previous NPE inflows.



Carry out a self-assessment of previous NPE reduction measures and of the effectiveness of current forbearance, restructuring and workout strategies.



Highlight internal implementation hurdles and assess projected future general conditions (e.g. economic situation).



Determine suitable reduction strategies for a minimum period of one to three years (outsourcing of work-out unit, joint ventures, structuring of portfolio sales). Outline ambitious, time-bound packages of measures.



Quantify NPL reduction targets and the implementation effect on the capital base. Specify an acceptable loss budget.



Adopt portfolio-specific NPE reduction strategies at management body level and regularly monitor implementation progress and target achievement.



Integrate independent specialised workout units throughout the NPE life cycle at an early stage. Establish a comprehensive monitoring system and a three lines of defence model.

All banks will need to:



Identify and address any gaps in their policies and procedures relating to the EBA NPE Guidelines. These include:

- The governance and operations of NPE recognition, impairment measurements and write-off procedures;
- Policies and procedures for the valuation of property collateral for NPEs;
- Establishing and operating an early warning system to identify and tackle any potential or actual build-up of NPEs; and
- The governance and operations of forbearance measures and processes.



Identify borrowers with potential financial difficulties and arrears at an early stage.



Conduct a structured evaluation of borrowers' capacity to repay principal and interest before granting forbearance measures. Analyse the benefits as compared to other workout options such as write-off or sale. Assess the effectiveness and compliance with deadlines of FBE measures on a continuous basis.



Identify NPEs in line with the new EBA default definition. Adhere to the probation period before reclassifying NPEs as FBEs. Consider renewed forbearance or past due credit obligations as re-defaults.



Impair and write-off uncollectable loans at an early stage. Define internal periods for impairment and write-off of NPEs.



Ensure the current collateral valuation of NPEs. Adhere to the minimum frequency of valuations. Immovable property must be valued separately by independent, qualified appraisers. The appraisers need to be rotated after two consecutive valuations. Comprehensive back-testing activities are to be observed.

Application of the concept of proportionality

Banks should have a risk management system in place that is appropriate to their size and the complexity of their business model.

Following the three-month consultation period which lasted until the end of June 2018, the final EBA Guidelines have to some extent specified the concept of proportionality with reference to the SREP categories.

Less complex banks in the SREP categories 3 and 4 are subject to simplified obligations for the operationalisation and governance arrangements supporting the NPE strategies. This means that banks can implement a less strict separation of non-market units in accordance with the three lines of defence model (3LOD), particularly in the workout units, provided that potential conflicts of interest can be effectively limited or avoided by other means.

Links to other areas

There are numerous interdependencies between the EBA NPE Guidelines and other areas of credit risk management. Banks need to identify links to other implementation projects such as IFRS 9, the new EBA definition of default, risk data aggregation, stress testing and supervisory reporting, and synchronise their activities accordingly.

Meeting the Guidelines will require skills and know-how which may be scarce within the bank itself or even within the country.

Potential challenges and impact areas

Significant Institutions (SIs) that are directly supervised by the ECB will already be familiar with the substance of the EBA NPE Guidelines as they mirror the existing ECB NPL Guidance, and some of them will already be subject to supervisory pressure to reduce their NPEs. Depending on the materiality of their NPE problem, Single Supervisory Mechanism (SSM) banks are also subject to additional pressure to reduce their NPEs on a timely basis, and as part of the SREP cycle, have to report comprehensively on the status of the ECB NPL Guidance implementation to the JST.

Nevertheless, SSM banks that are compliant with the ECB NPL Guidance cannot automatically assume that they meet the EBA NPE Guidelines. The ECB NPL Guidance should be understood rather as an additional supervisory expectation; i.e. where the two documents' contents differ, the stricter regulation is applicable for SIs.

The ECB NPL Guidance has proved to be challenging for many directly supervised banks, particularly when it comes to demonstrating that their NPE strategy is robust, has been based on adequate and accurate data, and can be effectively implemented. Smaller banks are likely to face similar challenges with the implementation of the EBA NPE Guidelines. Even though the principle of proportionality applies to the implementation of the Guidelines within small and medium-sized banks at the national level, meeting them will require banks to quickly develop skills and know-how, or call on external expertise. The short implementation phase (effective date 30 June 2019) contained in the Guidelines represents an additional obstacle.

Indicative impact areas of the EBA Guidelines

Chapters of the EBA Guidelines	Database	Organisation structure	Process organisation	Control system	IT and infrastructure	Disclosure and reporting
NPE strategy (chapter n.4)	Moderate impact	Moderate impact	Moderate impact	Moderate impact	Moderate impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.
NPE governance and operations (chapter n.5)	Large impact	Moderate impact	Large impact	Moderate impact	Large impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.
Forbearance (chapter n.6)	Moderate impact	Moderate impact	Large impact	Large impact	Moderate impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.
NPE recognition (chapter n.7)	Moderate impact	Low impact	Moderate impact	Moderate impact	Moderate impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.
NPE impairment and write-offs (chapter n.8)	Moderate impact	Low impact	Moderate impact	Moderate impact	Moderate impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.
Collateral valuation of immovable and movable property (chapter n.9)	Large impact	Moderate impact	Large impact	Moderate impact	Moderate impact	Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.

Keys: ■ Large impact ■ Moderate impact ■ Low impact ■ Not explicitly covered by the EBA NPE Guidelines but expected to have high impact across all topics.

Source: KPMG International

Disclosure requirements and supervisory reporting

In contrast to the ECB NPL Guidance, the EBA NPE Guidelines do not contain any explicit disclosure requirements. These are defined in separate EBA Guidelines on the disclosure of non-performing and forborne exposures (EBA/GL/2018/10), published on 17 December 2018, and in the EBA consultation paper on amendments to FinRep Data Point Model 2.9 published on August 2018.

03 EBA Guidelines on management of non-performing and forborne exposures

The Guidelines follow the "life cycle" of a bank's NPE management



Scope

The EBA NPE Guidelines:

- Apply to all EU credit institutions;
- Apply to all exposures covered by the definitions of non-performing and forborne exposures (loans, advances, debt securities);
- Chapters 4 and 5 (on NPE strategy and on NPE governance and operations) apply only to banks with significant NPEs (where the bank's gross NPL ratio is at or above five percent, or where a national supervisor deems a bank's NPEs to be significant in total or in a specific portfolio, for example because of signs of deteriorating asset quality);
- Refer to the principle of proportionality, so banks should meet the Guidelines in a manner that is appropriate to their size, structure and the nature and complexity of their activities;
- Will need to be implemented by 30 June 2019;
- Do not explicitly reflect the Commission's proposed 'statutory prudential backstop' (including no minimum risk provisioning broken down by NPE vintage [time since exposure classified as NPE]).

Structure

The EBA NPE Guidelines:

- Follow the "life cycle" of a bank's NPE management: strategy; governance and operations including early warning systems; forbearance; NPE recognition; NPE impairment and write-off; and collateral valuations;
- Build on the EBA's new definition of default and recognise the interlinkages with IFRS 9.

Focus

The EBA NPE Guidelines focus on high NPE banks which need to develop a strategy to effectively reduce their NPEs on the balance sheet. A bank-specific NPE strategy serves as a type of early warning instrument for the supervisory authorities for European NPE management.

In addition, the Guidelines outline the regulatory requirements with respect to the governance and operations of an NPE workout framework, internal control framework, continuous NPE monitoring, as well as the up-to-date and appropriate independent collateral valuation.

The emphasis throughout the Guidelines is on banks putting in place:

- Board level (board and/or supervisory board in a dual board structure) oversight of NPE strategy and policies;
- Comprehensive and prompt monitoring of the bank's NPL management strategy and policies;
- Sufficient operational capacity at all levels and covering all three lines of defence:
 - Standardised and documented operational policies and procedures;
 - Sufficient skilled staff with the necessary expertise in NPL management;
 - Data and information, on which to base classification and provisioning decisions in the reporting and accounting system, develop early warning indicators, and monitor and report performance;
 - Compliance with criteria of the new EBA definition of default (EBA/GL/2016/07);
 - IT systems and infrastructure for NPE management and monitoring, to capture and report data and to support the implementation of consistent policies;
 - IT systems and structures for reporting: while the EBA NPE Guidelines do not explicitly cover public disclosure and reporting requirements, each bank should have processes and procedures in place to ensure proper reporting and disclosure, subject to the proportionality principle (size and complexity of the bank);
 - Initial requirements concerning back-testing activities in lending business with reference to the EBA Guidelines on credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06).
- Fair treatment of consumers at every stage of the loan life cycle (this is an important addition to the earlier ECB NPL Guidance).

Structure of the EBA Guidelines on management of non-performing and forborne exposures

Collateral valuation of immovable and movable property

Banks should assess the value of collateral frequently and adequately, in particular for real estate.

NPE strategy

Banks with significant levels of NPEs should establish clear targets for the reduction of NPEs over realistic but sufficiently ambitious time-bound horizons. These banks should lay out, for each relevant portfolio, a clear, credible and feasible NPE reduction plan covering the bank's approach and objectives.

NPE governance and operations

Banks with significant NPEs should have a governance structure and operational arrangements that enable the bank to address NPE issues efficiently and effectively, be it through sales, securitisation or workout. This should include the adequacy of decision-making, operating models, internal controls and monitoring.



NPE impairment and write-offs

Banks should have adequate and consistent procedures for identifying the need for provisions and for making adequate provisions, within existing accounting frameworks.

NPE recognition

Banks should use the EBA definition of an NPE in their internal risk management and for their public disclosures, not just for their supervisory reporting.

Forbearance

Banks should ensure that forbearance – of NPEs or to prevent non-performance – returns exposures to a situation of sustainable repayment. Forbearance should not be a means of mis-representing asset quality or delaying the actions necessary to address asset quality issues.

All banks
 Banks with NPL ratios $\geq 5\%$ (entity/group level)

Comparing the ECB NPL Guidance with the EBA Guidelines

The Guidelines are very similar to the ECB NPL Guidance issued in March 2017, which currently applies to all SIs directly supervised by the ECB. The main differences relate to:

- The broader scope of application of the EBA Guidelines;
- The introduction of a threshold to distinguish between banks with and without high levels of NPEs;
- The inclusion of other physical collateral in NPE management; and
- The absence of supervisory expectations regarding prudential provisioning after initial classification as an NPE.

Overview of the main differences

	ECB NPL Guidance (March 2017)	EBA NPE Guidelines (October 2018)
Scope	Banks directly supervised by the ECB (119 significant institutions – as of end of December 2018).	All EU banks (CRR institutions; approx. 6,000 operating in the EU).
Status	Final	Final
Implementation date	20 March 2017	30 June 2019
Basis of the document	<ul style="list-style-type: none"> — Supervisory expectations (comply or explain approach). — Non-binding. 	Binding (after transposition into national supervisory practices by the competent supervisory authorities).
Focus	Refers primarily to NPLs but also addresses NPEs (synonymous use of terms).	All exposures covered by the definition of NPEs and FBEs.
Accounting standard	Pre-dated the implementation of IFRS 9, so includes material relating to pre-IFRS 9 accounting standards (IAS 39).	IFRS 9, local GAAP
Proportionality	<p>Yes (based on size and complexity of NPLs in balance sheet).</p> <p>Defines 'high NPL' banks as having a NPL level considerably higher than the EU average (currently defined in the quarterly EBA Risk Dashboard as 3.4% as at Q3/2018).</p> <p>Chapters on NPL strategy, governance and operations are only relevant for high NPL banks.</p>	<p>Yes (based on size, internal organisation, nature, scope and complexity of activities).</p> <p>Application of SREP categories to differentiate less complex banks.</p> <p>Sets an indicative NPL threshold of 5% (static) from which banks should establish an NPE strategy and related governance and operations.</p> <p>Threshold applies at both entity and banking group level. Discretion to deem a bank to have significant level of NPEs even if the threshold is not reached.</p>
Expectations regarding minimum provisioning	Yes (ECB NPL Addendum – March 2018).	No (Amendments to CRR will apply when in place).
Consumer protection angle	No	Yes
Collateral valuation	For immovable collateral only.	For immovable and movable collaterals.

A closer look at the EBA Guidelines

**Issues and recommendations
for banks**





NPE strategy

For banks with significant levels of NPEs, the development and implementation of an NPE strategy is the core building block of the Guidelines for banks' NPE management. Both overall and for each portfolio, the NPE strategy should be built on an assessment of the operating environment; should set out time-bound reduction targets; and should consider all available strategic options to reduce NPEs. There are four key stages in developing and executing an NPE reduction plan:

1. Self-assessment, analysis of the operating environment and of external conditions:

- Comprehensive portfolio analysis and self-assessment to evaluate the bank's internal capabilities to manage (by maximising recoveries) and reduce NPEs effectively over a defined time horizon;
- Analysis of the external conditions and operating environment (macro-economic prospects, market, potential investors, legal, consumer protection and tax);
- Evaluation of previous effects on the capital structure.

2. Developing the NPE strategy:

- Targets (high level targets, aligned with more granular operational targets) for projected NPE reductions over the short, medium and long term;
- Consider, analyse and decide upon implementation options (hold and forbearance NPEs, active NPE reduction, restructuring of NPEs, and insolvency proceedings or out-of-court settlements) and targets for each relevant portfolio;
- The capital implications (analysis and projections) of the NPE strategy;
- Approval of a clear plan for developing operational capabilities.

3. Implementing the operational plan:

- Putting the required resources, capabilities, structures and IT systems in place to implement the strategy;
- Data availability and integrity;
- Establishment of clear decision-making channels, escalation procedures in case of conflicting goals and internal guidelines.

4. Embedding the strategy:

- Comprehensively communicating the defined NPE reduction strategy internally;
- Clear allocation of responsibilities, accountability, reporting lines and specification of targets within the incentive system;
- Integrating the NPE strategy into the budget plan and establishment of a loss budget;
- Integrating the strategy into ICAAP, RAF and the recovery plan, and quantifying the effects;
- Ensuring a comprehensive monitoring approach via the back office regarding:
 - Progress control and NPE target achievement;
 - Adherence to the NPE reduction schedule;
 - Effectiveness of past NPE reduction measures;
 - Efficiency of implemented FBE measures; and
 - Utilisation of the defined loss budget.
- Reporting of strategy and operational plan to supervisors.



NPE governance and operations

The Guidelines also outline the key elements of the governance and operations of an NPE workout framework, including decision making, the NPE operating model, internal control framework, and NPE monitoring and early warning processes.

Banks with significant NPEs need to put the necessary building blocks in place to govern and implement their NPE strategies. The Guidelines focus on:

1. The role of the management body in governance and decision-making:

- Approve on annual basis the NPE strategy and the implementation plan;
- Oversee and monitor the NPE reduction strategy implementation on a quarterly basis;
- Introduce in a timely manner mitigating measures in case of significant deviations from the plan;
- Develop and approve a framework of internal guidelines (forbearance, restructuring, workout, debt recovery, collateral valuation, provisioning, liquidation and foreclosure).

2. NPE operating model:

- Establishment of dedicated workout units (WUs) separated from loan origination processes (to avoid conflicts of interest) – principle of proportionality applies for less complex banks;
- Early (initially consultative) involvement of WUs in all phases of the NPE life cycle: early warning, forbearance, restructuring, workout and management of foreclosed assets;
- Definition of clear criteria for the transfer of sole client responsibility to the WUs;
- Establishment of feedback loops between the front and back office (performing business) and between the restructuring units (intensified loan management/problem loan handling) and the WUs;
- Establishment of an independent function to monitor the effectiveness and efficiency of the implementation options with an explicit veto right (ex ante) in cases where multiple FBE measures have been granted to a borrower;
- Findings of the internal control function regarding any implementation hurdles are to be recognised by management and dealt with swiftly using appropriate countermeasures;
- The management body must monitor the effectiveness and efficiency of the WUs and evaluate the interdependencies between the implementation plan for NPE reduction and the bank's overall strategy and, if necessary, balance these out;
- Ensuring the appropriateness of the resources, know-how, technical infrastructure and management attention of the WUs.



Forbearance

Banks should grant forbearance measures only if these measures can prevent the borrower defaulting due to a temporary liquidity shortage or allow the exposure to be repaid to a significant extent in the medium to long term. Forbearance measures are permissible only if they promise a better outcome in terms of present value compared to other options (e.g. sale, workout) and the measures are sustainable for the borrower. Forbearance measures should not be misused to defer default to a later date. The Guidelines focus on:

1. Forbearance options

- Short-term: to meet temporary liquidity constraints, e.g. through suspension/reduction of redemption payments, covenant waivers/holidays etc, with a term of max. 2 years (in case of project financing, max. 1 year);
- Long-term: comprehensive settlement of existing arrears (e.g. collateral liquidation) and actual reduction of the credit balance.

2. Affordability assessments

- No forbearance measures without prior detailed review of borrower's capacity to repay principal and interest;
- Use of up-to-date and audited financial data;
- Consideration of borrower's total debt and assets;
- Assessment of current and future situation using conservative projections;
- External information should be included;
- The borrower's willingness to pay and to cooperate should also be considered in the decision-making process (previous experience).

3. Forbearance processes

- Assessment of borrower's capacity to repay principal and interest;
- Agree on suitable time-bound measures;
- Net present value test to determine profitability compared to other options;
- WU assumes responsibility for ongoing milestone monitoring;
- Multiple forbearance measures to the same client require explicit approval from an independent function.



NPE recognition

An NPE arises when the payment from the borrower is more than 90 days past due (dpd) or the bank deems it highly probable that the contractually owed capital and/or interest will not be repaid in full (unlikely to pay (UTP)). Banks should establish appropriate internal guidelines and processes for the recognition of NPEs.

1. EBA definition of an NPE

- Observance of NPE definition which previously only applied to statutory reporting (cf. FINREP-reporting form);
- Consideration of default criteria according to the new EBA default definition (EBA/GL/2016/07);
- The NPE definition is broader than the currently valid CRR 178 default definition. The key differences are:
 - Pulling effect: If more than 20% of risk exposures relating to a single borrower are more than 90 days-past-due, all risk exposures of the borrower are to be considered non-performing;
 - In case of a group of debtors as different entities belonging to the same group, non-defaulted group members must be individually assessed (no automatism) whether they are affected by the default of connected clients and therefor are recognized as NPE or not.
 - Re-forbearance or repeated past-due situation of more than 30 days during the two-year probation period results in NPE status.

2. Classification according to forbearance status

- Consideration of defined probation periods;
- Compliance with strict conditions and time limits for when a risk exposure is reclassified from performing to non-performing/forborne and classified downstream to non-performing;

3. Implementation requirements

- Definition of group-wide mechanism for determining days-past-due and UTP criteria, consideration of the borrower's debt capacity, no assessment of guarantees or potential collateral;
- Establishment of an evidence process for the uniform detection of potential defaults of GCCs;
- Synchronisation with projects for the implementation of the EBA default definition (initial application from 31 December 2020).





NPE impairment and write-offs

One aim of the EBA NPE Guidelines is the timely impairment of NPEs and the write-off of uncollectible debts.

Banks therefore should develop comprehensive internal guidelines with clear criteria for:

- The uncollectibility of exposures;
- Associated write-offs;
- Ensuring the appropriate measurement of impairments in all portfolios; and
- A robust method for risk provisioning.

Impairments should be estimated in line with the EBA Guidelines on credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06) and to be applied in the accounting system.

Unlike in the SSM Guidance, there is no specific reference to IFRS 9, since most Less Significant Institutions (LSIs) only apply national accounting standards.

Furthermore, the EBA NPE Guidelines do not contain expectations regarding minimum provisioning for NPEs, separated according to the time lapsed since initial classification as an NPE and the consideration of potential collateral (secured/unsecured).

1. NPE impairment and write-offs

- Definition of binding impairment and write-off guidelines, with detailed instructions regarding:
 - Valuation methodology;
 - Criteria for 'going concern' and 'gone concern' scenarios;
 - Required information for the objective assessment of the uncollectibility of exposures;
 - Criteria for partial and full write-offs;
 - Internal time intervals leading up to complete impairment of secured and unsecured exposures;
 - Controls to ensure compliance with the guidelines.

2. Impairment processes

Assessment of provisioning based on conservative assumptions regarding the borrower's future capacity to repay principal and interest;

Interdependencies with financial reporting and regulatory disclosure should be taken into account;

Banks are required to expand their databases for the validation and backtesting of the provisioning;

Back-testing of the expected loss using actual realised losses should be conducted.



Collateral valuation for immovable and movable property

Banks should be able to demonstrate that their valuations of collateral for NPEs are up-to-date, well-founded, and based on independent assessments.

In contrast to the SSM Guidance, the EBA Guidelines cover physical collateral beyond real estate, e.g. high-quality liens on raw materials, precious metals (excluding gold, which is valued as financial collateral), automobiles, ships and aircraft.

1. Governance, procedures and monitoring

- Banks must have comprehensive valuation methods and guidelines for collateral in place, approved and reviewed by the management body on a regular basis;
- Collateral valuation methods should be updated and reviewed at regular intervals. The review should be conducted by an independent body which is not involved in the initial credit assessment, issuing or processing of loans or the ongoing monitoring;
- Requirements regarding the independence, qualification and experience of the appraiser should be specified;
- In the case of immovable property, the appraiser must rotate after two individual valuations of the same collateral in order to avoid any potential conflicts of interest.

2. Valuation approach and frequency

- Commercial real estate must be valued individually at least once a year by an independent appraiser, and residential real estate every three years;
- A review of the valuation is also required in the case of highly volatile markets, negative market movements or changes in the NPE status;
- Where possible, the individual evaluation of the market value should follow the present-value cash flow method;
- The replacement cost method widely used in certain European countries, such as Germany, for private residential real estate is also permissible;
- Immovable property should not be valued using a statistical model alone;
- Indexed valuations are permitted only within narrow limits and only for use in subsequent valuations of the property.

3. Back-testing

- Expected valuations are to be compared with actual results on a regular basis.

4. Foreclosed assets

- Banks must plan to sell collateral within a short timeframe;
- A value-conserving hold strategy is not acceptable in the case of immovable property collateral, i.e. non-adjustment of collateral value to current lower-market values (in the expectation of a future market recovery) is not permitted.

04 The wider context





In July 2017 the European Council announced an Action Plan to tackle the NPL problem in the EU. This included a package of measures published by the European Commission in March 2018. The EBA NPE Guidelines are just one part of this package.



European Council NPL Action Plan

The European Council set out in July 2017 an Action Plan to tackle NPLs in Europe. This Action Plan called on the European Commission (EC), the European banking Authority (EBA), the ECB, the European Systemic Risk Board (ESRB) and member states to introduce a series of measures.

Summary of the measures under the European Council NPL Action Plan

	 European Commission	 EBA	 ECB	 Other
Managing the stock of NPEs		EBA Guidelines on management of NPEs and FBEs (October 2018)	ECB Guidance to banks on NPLs (for directly supervised banks, March 2017) NPL Guidance for smaller (non-directly supervised) banks – see EBA Guidelines on management of NPEs and FBEs Intensive supervision and regular assessments (SREP) (continuing) Supervisory expectations for prudential provisioning against stock of NPEs included in the SREP letter (December 2018)	Supervision of banks not directly supervised by the ECB, including outside the banking union (continuing)
Managing the flow of new NPEs, including calendar provisioning and prudential backstop	Regulation for a NPE prudential backstop (amendment to the CRR) (first draft issued in March 2018 and approved by EC Permanent Representatives Committee in January 2019)	EBA Guidelines on banks' loan origination monitoring and internal governance (forthcoming)	Supervisory expectations for prudential provisioning of NPEs (March 2018)	ESRB to develop macro-prudential approaches to prevent the emergence of system-wide NPL problems (January 2019)
Increasing investor demand for banks' NPEs	Blueprint for national Asset Management Companies (March 2018)	EBA NPL transaction templates to provide data transparency for investors (December 2017)		Indirectly: standard valuation method for risk exposures according to IFRS 9 (from January 2018)
Improving market structure	Proposed directive on insolvency, restructuring and second chance (November 2016) Proposed Directive on credit servicers, credit purchasers and the liquidation of collateral (March 2018)	Harmonised definition of NPEs for supervisory reporting purposes (April 2014)		Member states to consider changes to national insolvency regimes

European Commission package published in March 2018

In line with the EU Council Action Plan, in March 2018 the EC published a series of measures and proposals designed to tackle NPLs, along with a progress report on NPL management. This package outlines a comprehensive approach including policy actions that target three key areas to support NPL reductions:

- Ensuring sufficient loss coverage by banks for future NPLs;
- Developing a secondary market for NPEs and facilitating out-of-court collateral enforcement; and
- A technical blueprint for how to set up national Asset Management Companies (AMCs).

Elements of the EC package of measures published in March 2018



Addressing potential under-provisioning through automatic and time-bound provisioning

- **Proposals for amendments to the Capital Requirements Regulation (CRR)** with the aim of introducing minimum provisioning levels for newly originated loans that become non-performing ("**statutory prudential backstop**").
- Political agreement reached by the European Parliament and the Council of the EU on 18 December 2018, and under EC Permanent Representatives Committee approval (January 2019).
- Currently no indication of when this would enter into force.



Developing secondary markets for NPLs

- **Proposal for a Directive designed to:**
 - Foster the development of secondary markets for NPEs (including loan servicers).
 - Enable accelerated out-of-court enforcement of loans secured by collateral (introducing a more efficient means of collateral liquidation from secured loans).
- Currently no indication of when this would enter into force.



Enhancing the protection of secured creditors

- Currently no indication of when this would enter into force.





Development of an AMC blueprint

- **Technical guidance** (blueprint) for how national AMCs can be set up.
- Includes common principles on all aspects, such as set-up, governance and operations.
- Based on previous experiences in member states, including SAREB (Spain) and NAMA (Ireland).

Addressing potential under-provisioning: EC and ECB

The most significant of these measures for banks is likely to be the EC's proposed regulation on a prudential backstop and the closely related ECB supervisory expectations for the prudential provisioning of non-performing loans. However, these two prudential provisioning measures differ in scope, nature, and the timing of provisioning.

 Regulation for a NPE prudential backstop (EC, March 2018/Jan. 2019)	 Supervisory expectations (ECB, March 2018)	
Status	Amendment proposal to CRR (not yet in force, with no explicit planned finalisation date). Text under EC Permanent Representatives Committee approval (January 2019)	Final
Scope	All EU banks (CRR institutions).	Banks directly supervised by the ECB
Application	<ul style="list-style-type: none"> — Loans that are newly originated and become non-performing after entry into force. — Compulsory time-bound prudential deductions. — Applicable on a exposure-by-exposure level. 	<ul style="list-style-type: none"> — All exposures newly classified as non performing as of 1 April 2018. — Non-binding guidance (but with supervisory implications) in comply-or-explain approach.
Provisioning backstops mechanism	<ul style="list-style-type: none"> — Deduction from the Common Equity Tier 1 (CET 1) capital, of the difference between (if a)>b): <ul style="list-style-type: none"> a) The sum of i) the unsecured part of each non-performing exposure, if any, multiplied by the applicable factor in the calendar; and/or ii) the secured part of each non-performing exposure, if any, multiplied by the applicable factor in the calendar; b) the sum of: <ul style="list-style-type: none"> – amounts written-off by the institution since the exposure was classified as non-performing – specific credit risk adjustments; – additional value adjustments; – other own funds reductions; – for institutions calculating risk-weighted exposure amounts using the IRB Approach, the absolute value of the amounts deducted; – where a non-performing exposure is purchased at a price lower than the amount owed by the debtor, the difference between the purchase price and the amount owed by the debtor; — Unsecured exposures: full coverage in four years. — Secured exposures (immovable collateral): full coverage after ten years. — Secured exposures (collateral other than immovable property): full coverage after eight years. 	<ul style="list-style-type: none"> — Unsecured exposures (new NPEs): full coverage after two years, with no step up after one year. — Secured exposures (new NPEs): full coverage after seven years, starting from year three — Banks are expected to inform the ECB of any differences between their practices and the prudential provisioning expectations as part of the SREP supervisory dialogue from early 2021 onwards.
(Potential) capital implications	Pillar 1	Pillar 2

Regulation for a NPE prudential backstop

The European Commission has proposed amending the CRR with the aim of introducing minimum provisioning levels for newly originated loans that become non-performing (the 'statutory prudential backstop').

In December 2018, the European Parliament and the Council of the EU reached a political agreement on the proposed text. The text is under the EC Permanent Representatives Committee approval (January 2019)

The required minimum provisions were moderated considerably and would be:

Required minimum provision (percentage of exposure)⁽¹⁾

At beginning of year	1	2	3	4	5	6	7	8	9	10
Unsecured exposure	0	0	35	100						
Secured (immovable property collateral)	0	0	0	25	35	55	70	80	85	100
Secured (other collateral)	0	0	0	25	35	55	80	100		
Export credit guarantee/ insurance	0	0	0	0	0	0	0	100		

This revised non-linear provisioning schedule would give banks more time to pursue other options such as sales of exposures or out-of-court settlements. Insufficient provisions would require corresponding deductions from a bank's CET 1 capital (Pillar 1 measure).

This applies only to exposures originated after this regulation came into force. Exposures originating prior to this which are then forborne are considered newly originated from the moment of this change in status.

Based on the considerably stricter backstop in the consultation draft (before the political agreement reached in December 2018), the EBA has calculated that this prudential backstop could reduce an average bank's common equity tier 1 capital ratio by 56 basis points over a seven year horizon, and by 205 basis points over a 20-year horizon.

ECB supervisory expectation

Banks that are directly supervised by the ECB are currently subject to the supervisory expectation that, from 1 April 2018, all exposures newly classified as non-performing must be provisioned at least in line with the following levels:

Minimum provisioning levels (percentage of exposure)

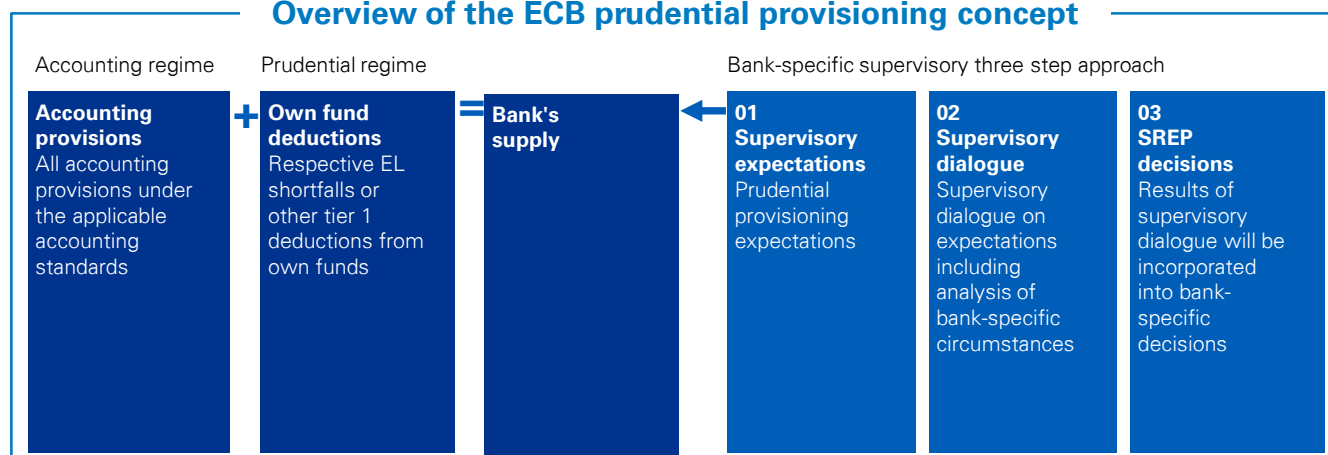
At end of year	1	2	3	4	5	6	7
Unsecured exposure	0	100					
Secured exposure	0	0	40	55	70	85	100

Directly supervised banks will be required to inform the ECB of any deviations from these expectations from early 2021 onwards as part of the SREP supervisory dialogue, with the expectation that any shortfalls would be reflected in Pillar 2 capital requirements.

This supervisory dialogue could entail off-site activities (for example by JSTs) and/or on-site examinations. Any divergences from the prudential provisioning expectations would be discussed and any portfolio-specific robust evidence could be used to inform the dialogue.

In addition, the ECB included recommendations for provisioning the stock of NPLs over the coming years in their 2018 SREP letters. Through this, the ECB is following up on their announcement in July 2018 whereby they communicated that they plan to set bank-specific supervisory expectations for the provisioning of NPLs with the aim of achieving the same coverage of NPL stock and flow in the medium term.

Overview of the ECB prudential provisioning concept



Note: (1) Status of discussions as at January 2019; amendments are expected as part of the legislative process in the European Parliament
Source: ECB

An improved quality, scope, transparency and availability of relevant financial information on distressed assets could greatly contribute to functioning secondary markets for distressed assets, as buyers would face less uncertainty, and this should lead to narrower bid-ask spreads

VP of the European Commission, Valdis Dombrovskis, 29/03/2017

KPMG was selected to support the EBA with delivering this important project. KPMG member firms have extensive experience with assisting banks and investors across Europe with data preparation for NPL transactions.

EBA NPL Templates

The EBA published its NPL Templates in December 2017 with the aim that they should become the new banking industry standard for NPL data templates for EU banks.

The templates were produced as part of the EC request to the EBA to work further on reducing information asymmetries between potential buyers and sellers of NPLs and to help the development of a functioning secondary market for NPLs.

The templates provide potential investors with minimum data requirements before commencing transactions. They are pan-European, multi-asset class and consistent with existing regulatory data requirements. They are of voluntary use but are encouraged to be used for NPL transactions.

The templates take into account different data needs for the initial data screening of an NPL portfolio on the one hand, and for the subsequent financial due diligence (FDD) and valuation on the other hand.



05 How KPMG can help

KPMG member firms offer a wide range of strategies, services and tools aimed at supporting and advising banking clients on NPE related tasks, leveraging a network of multidisciplinary professionals across Europe and beyond





Gap analysis

Assessments of banks against the EBA Guidelines (or ECB NPL Guidance) with the support of **KPMG's Gap Analysis Tool**, allowing for cost effective identification of critical shortfalls and possible targeted remediating actions.



Portfolio analysis

Combining technology and modelling skills to provide integrated technology solutions for data analytics, segmentation and assessment of loans and collateral books.



NPE strategy

Assistance with the development of realistic and implementable NPE strategies, divestment plans and possible realisation options for portfolio optimisation.



Data quality

Assessment of data adequacy and suitability, and provision of automated data remediation solutions supported by KPMG's "**DealTech**". Our approach and technology is aligned with the **EBA NPL Templates**.



Forbearance solutions

Development and implementation of sound restructuring strategies and workout plans for NPEs, improvement of loan collection processes, hands-on restructuring and workout support for complex exposures.



Sale process

Support vendors and buyers of NPEs and non-core banking assets globally, encompassing the transaction phase from the deal structuring to the negotiation phase and post-closing activities.



NPE servicing

Bespoke servicing solutions including developing and implementing the bank's specific servicing platforms by combining internal resources and infrastructure with third party providers and investors.



Governance and operational change

Definition of optimal governance and operating models for NPE management, building upon the bank's existing state for suitability and minimal disruptions.



Collateral valuation and portfolio pricing

Assistance in the valuation process of any type of collateral.

Pricing and analytics of the portfolio and underlying segments to evaluate the market values and define the optimum assets mix to sell.



Provision and impairment analysis

Independent review of methodologies for NPE classification, impairment measurement, loss allowances and write-offs and advice on adequacy of underlying processes, systems and tools.



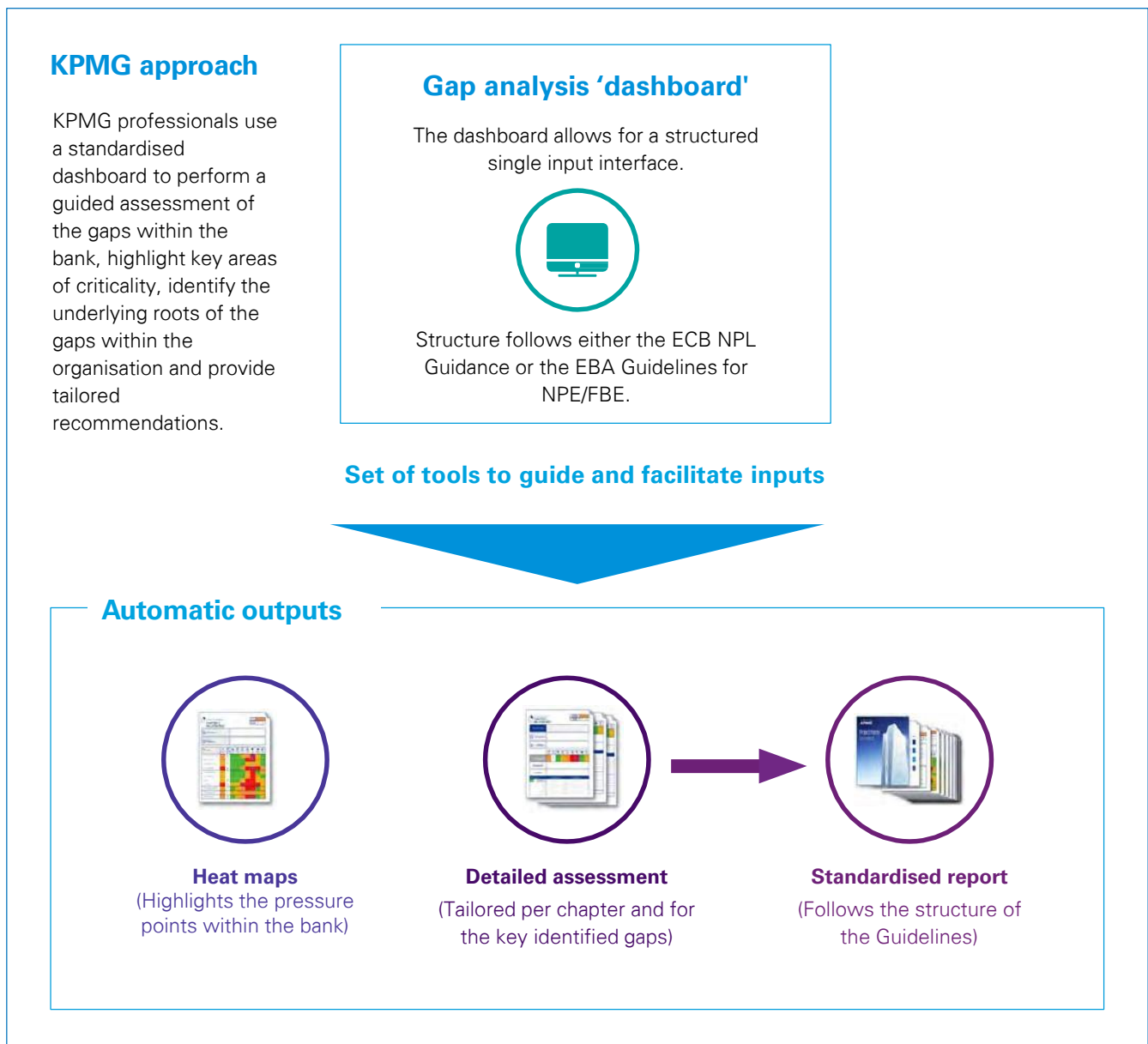
Regulation

Assistance and support to banking clients in a broad range of areas, including (i) analysis of compliance with regulation and with supervisory expectations; (ii) preparation of audit-proof arguments in cases where simplifications are used; (iii) preparation for supervisory inspections; and (iv) provision of integrated reporting and monitoring systems.

KPMG's Gap Analysis Tool

This tool is designed to be a structured and cost effective solution to assess a bank's compliance with the requirements of the EBA Guidelines on management of non-performing and forborne exposures, as well as the ECB NPL Guidance.

It has been developed around the structure of both documents, to allow for simple and cost effective analysis in relation to every aspect of the Guidelines, tailored to reflect the characteristics of the bank (including proportionality).



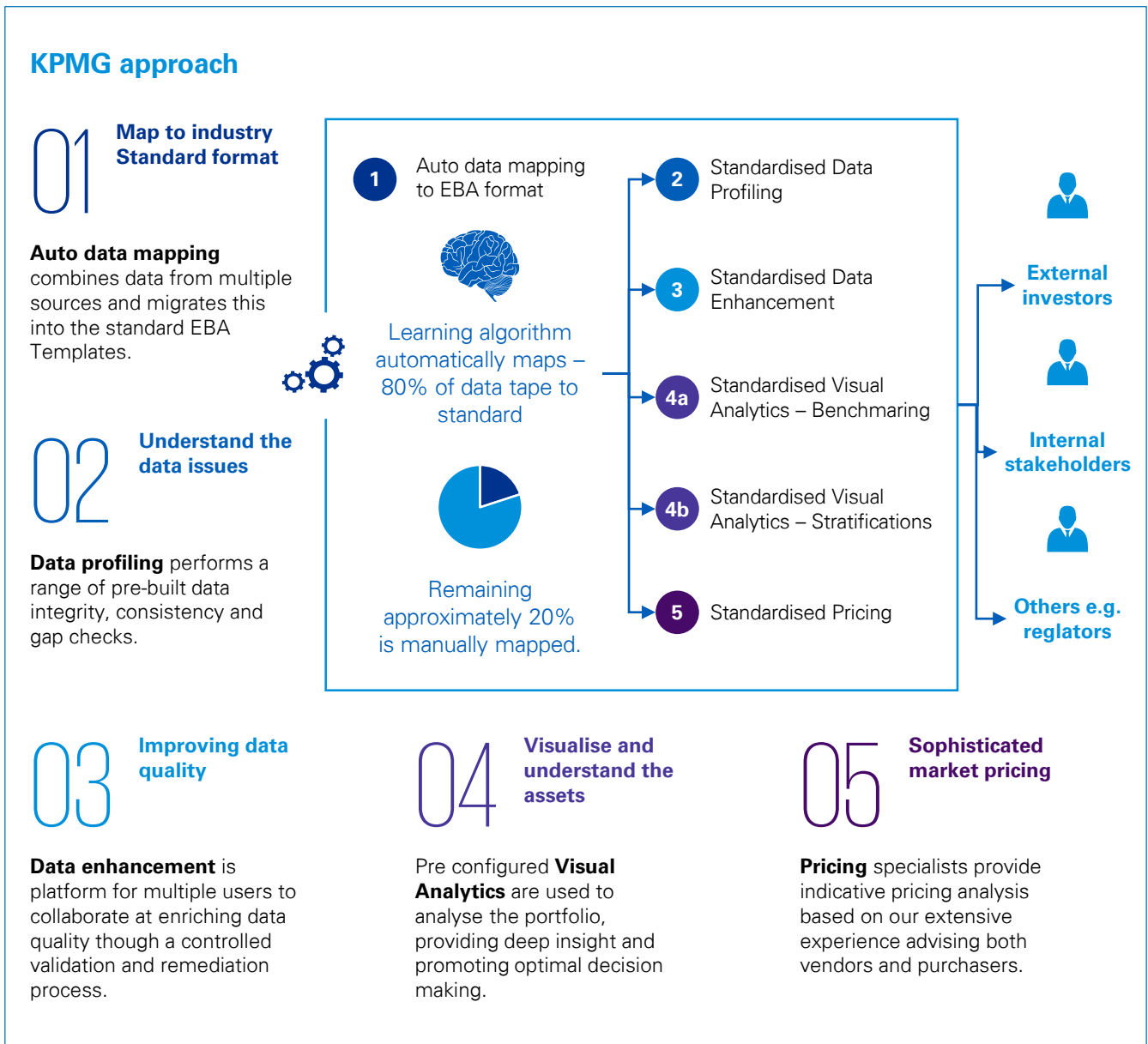
- Focuses on rapidly identifying the critical deficiencies, interdependencies and potential implications.

- Provides the bank with the necessary overview of the key problem areas and critical remediation needs in order to develop a precise action plan.

- Develops a clear and precise understanding of the gaps with the Guidelines to aid in regulatory dialogue and develop relevant remediation plans.

KPMG Deal Tech

DealTech has been designed to assist understanding, improve quality and develop insight for the preparation and execution of loan portfolio sales. In light of KPMG professionals’ unique insight into the EBA NPL Templates, DealTech has been enhanced to be compatible and integrated into the various parts of the deal process.



- Supports banks in understanding impacts of the new EBA NPL Templates.
- Helps map banks’ data into the EBA NPL Templates.
- Applies Data Profiling checks to understand data quality limitations within banks portfolio.
- Helps fixing data issues with Data Enhancement.
- Supports in visualising the banks portfolio to maximise value/price.
- Facilities transactions with Deal Room (KPMG’s proprietary Data Room platform).

Annex: EBA Guidelines on the disclosure of non-performing and forborne exposures (EBA/GL/2018/10).

On 17 December 2018, the EBA published the final Guidelines on the disclosure of NPEs and FBEs with the aim of reducing information asymmetry and promoting comparability of banks' risk profile and market discipline through the specification of uniform disclosure formats for banks.

EBA Disclosure Guidelines:

- Apply to all banks subject to the disclosure requirements of the CRR either in full or in part;
- Set out a standard disclosure format for NPEs, FBEs and foreclosed assets;
- Outline disclosure requirements according to the principle of proportionality, i.e. dependent on the significance of the bank as well as its share of NPEs (threshold: gross NPL ratio $\geq 5\%$);
- Should particularly help banks with high levels of NPEs to gain a better understanding of the characteristics and distribution of their NPEs and FBEs, and the quality and value of their collateral; and
- High consistency with the adjusted FINREP reporting framework (DPM 2.9).

Template description		Application		Frequency	
		All Banks	Significant banks with high NPLs	Annual	Semi-annual
FBEs (#1-2)	1 – Overview of the credit quality of forborne exposures.	✓		✓	✓(a)
	2 – Information on quality of forbearance (gross amount of loans that had been granted forbearance measures more than twice).		✓	✓	
NPEs (#3-6)	3 – Information on credit quality of performing/non-performing exposures by past due days (# of days).	✓		✓	✓(a)
	4 – Detailed information on performing and non-performing exposures and related provisions.	✓		✓	✓(a)
	5 – Information on quality of non-performing exposures by geography.		✓	✓	
	6 – Information on quality of loans and advances by industry (i.e. industry/sector of activity of the counterparty).		✓	✓	
Collateral (#7)	7 – Information on loans/advances collateralised and collateral valuation (broken down by past-due bucket).		✓	✓	
Change in NPLs (#8)	8 – Overview of the movements (in/out flows) of non-performing loans/advances.		✓	✓	
Foreclosed assets (#9-10)	9 – Overview of collaterals obtained by taking possession and execution processes.	✓		✓	✓(a)
	10 – Information on collaterals obtained by taking possession and execution processes (breakdown by vintage and type of possession processes).		✓	✓	

Note: (a) More frequently than annually for i) significant banks with an elevated level of NPEs, ii) G-SIIs or iii) O-SIIs.

How KPMG can help

- Impact analysis of the new EBA requirements for the disclosure of NPEs.
- Review of data availability and quality as well as identification of gaps with the help of an analysis tool.
- Support in comparison of data requirements with other reporting requirements (e.g. FinRep) for efficient project and process design.

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