

# ADB Virtual Training Course on NPL Resolution for IPAF Members and DMC Officials

## Session 2: Supervisory Rules and Regulation (Global and Regional Best Practices

*Glenn Tasky, Director*

*Financial Stability, Supervision, and Payments*

*The SEACEN Centre*

*20 May 2021*



The South East Asian Central Banks  
Research and Training Centre

## Session Overview

1. Relative lack of global standards and compendiums of best practices on NPL resolution
2. Regulatory stance on NPL resolution in the United States
  - Requirement to submit a plan for gradual reduction of NPLs
  - Avoidance of NPL reduction schemes that leave banks with too much residual risk
  - Policies toward disposal of foreclosed assets
3. Building blocks of a regulatory standard for NPL resolution

Relative lack of global standards and compendiums of best practices

## Basel Core Principles for Effective Banking Supervision (as of January 2019)

**Principle 18: Problem assets, provisions, and reserves:** *Focuses mostly on identification, classification, and provisioning, but a few relevant passages –*

- “The supervisor determines that banks have appropriate policies and processes to ensure that provisions **and write-offs** are timely and reflect realistic repayment and recovery expectations...”
- “The supervisor determines that banks have appropriate policies and processes...for ongoing oversight of problem assets, and for collecting on past due obligations.”
- “The supervisor requires banks to have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives, and collateral. The valuation of collateral reflects the net realizable value...”
- “Laws, regulations, or the supervisor establish criteria for assets to be...reclassified as performing...when all arrears have been cleared and the loan has been brought fully current, repayments have been made in a timely manner over a continuous repayment period and continued collection, in accordance with the contractual terms, is expected.”

**Note: There is no mention of other forms of NPL resolution mentioned besides collection.**

Relative lack of global standards and compendiums of best practices

## The Basel Framework (January 2019)

- The words “non-performing” occur only three times in 1,868 pages.
- The words “workout” and “collection” occur only in the context of determining Loss Given Default.
- The capital treatment of NPL securitization can be a factor in incentivizing NPL resolution.
- According to the BCBS, a securitization is an “NPL securitization” if at least 90 percent of exposures in the pool are “delinquent,” where “delinquent” is defined as:
  - 90 days or more past due, or
  - Subject to bankruptcy or insolvency, or
  - In process of foreclosure, or
  - Held as real estate owned, or
  - In default according to the definition used in the specific pool
- A technical amendment in November 2020 introduced a risk-weight floor of 100% for such securitizations under the internal-ratings based approach or standardized approach.
- If neither approach can be used, the risk weight will be 1,259% (that is, the bank will have to hold capital equal to the exposure).

## Regulatory stance on NPL resolutions in the United States

The U.S. approach to NPL resolution by banks consists of three elements:

- *Requiring banks with excessive NPLs (called Criticized or Classified Assets in the documents) to present a plan to reduce them over a period of time, without specifying how*
- *Generally prohibiting additional loans to borrowers by banks with excessive NPLs, except in certain circumstances*
- *Restricting banks from taking steps to “reduce” NPLs artificially, such as suspicious asset exchanges*

How do the U.S. regulators identify a bank with “excessive” NPLs?

- *Peer group comparisons (see next page)*
- *The “Texas Ratio”:  $NPL / (CET1 + \text{all loan loss allowances})$*

## Regulatory stance on NPL resolutions in the United States

On every one of the 5,001 FDIC-insured banks in the United States, there is an automatically-generated quarterly analytical report called the Uniform Bank Performance Report (UBPR). **The UBPR is not confidential; the report can be accessed for any bank by anyone in the world with an internet connection.**

The UBPR consists of monetary amounts and ratios displayed over various time periods, with peer group comparisons for the ratios.

FDIC Certificate # 4218  
OCC Charter # 4704  
Public Report

FRB District/ID\_RSSD 10 / 288358  
County: CRAIG

FIRST NATIONAL BANK AND TRUST COMPANY OF VINI; VINITA, OK  
Summary Ratios--Page 1

Summary Ratios  
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Earnings and Profitability	<u>3/31/2021</u>			<u>3/31/2020</u>			<u>12/31/2020</u>			<u>12/31/2019</u>			<u>12/31/2018</u>		
	BANK	PG 9	PCT	BANK	PG 5	PCT	BANK	PG 5	PCT	BANK	PG 5	PCT	BANK	PG 5	PCT
Total LN&LS-90+ Days Past Due	1.07	0.08	95	0.00	0.06	45	0.00	0.04	53	0.14	0.05	83	0.03	0.04	65
-Nonaccrual	4.92	0.65	97	4.69	0.62	99	5.01	0.56	99	5.33	0.58	99	1.81	0.55	91
-Total	6.00	0.79	98	4.69	0.72	98	5.01	0.63	98	5.47	0.66	99	1.84	0.62	90

**In the U.S. regulatory regime, a non-performing loan is defined as 90 days or more past due, or in non-accrual status. This bank in March 2021 had a total of 6 percent of its loans in those categories, compared to 0.79 for the median of a peer group of similar banks.**

# Regulatory stance on NPL resolutions in the United States

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Earnings and Profitability															
Total LN&LS-90+ Days Past Due	1.07	0.08	95	0.00	0.06	45	0.00	0.04	53	0.14	0.05	83	0.03	0.04	65
-Nonaccrual	4.92	0.65	97	4.69	0.62	99	5.01	0.56	99	5.33	0.58	99	1.81	0.55	91
-Total	6.00	0.79	98	4.69	0.72	98	5.01	0.63	98	5.47	0.66	99	1.84	0.62	90

## How would the U.S. authorities handle a bank with such a high ratio of NPLs?

**Normally, through the use of *enforcement actions*: consent orders that require the bank to take certain steps or stop certain activities.**

IN TESTIMONY WHEREOF, the undersigned, authorized by the Comptroller as his duly authorized representative, has hereunto set his/her signature on behalf of the Comptroller.

//s// Digitally Signed, Date: 2020.07.16  
Julie A. Thieman  
Director for Special Supervision

**UNITED STATES OF AMERICA  
DEPARTMENT OF THE TREASURY  
OFFICE OF THE COMPTROLLER OF THE CURRENCY**

IN TESTIMONY WHEREOF, the undersigned, as the duly elected and acting Board of Directors of The First National Bank and Trust Company of Vinita have hereunto set their signatures on behalf of the Bank.

NAMES:	SIGNATURES:	DATES:
James N. Ratcliff	<u>/s/</u>	<u>7/16/2020</u>
H. Dee Robison	<u>/s/</u>	
Richard Mark Londagin	<u>/s/</u>	<u>7/16/20</u>
Joann L. Sauer		

**In the Matter of:**

The First National Bank and Trust Company of Vinita  
Vinita, Oklahoma

AA-EC-2020-43

**CONSENT ORDER**

# Regulatory stance on NPL resolutions in the United States

## What did the OCC order the bank to do in July 2020?

(3) Within ninety (90) days of the date of this Order, the Board shall adopt, implement and thereafter ensure Bank adherence to a written program designed to reduce the Bank's problem assets (the "Problem Assets Program") to a safe and sound level and to govern the management of problem assets. The Problem Assets Program shall include or address the following matters:

- (a) policies that detail responsibility of problem loan management, including oversight of action plans, reporting, and escalation;
- (b) oversight of obtaining updated collateral valuations by applicable committee; and
- (c) oversight of problem loan management by a qualified senior executive officer.

(6) Effective as of the date of this Order, the Bank may not extend credit, directly or indirectly, including renewals, extensions, or capitalization of accrued interest, but excluding advances on previously approved lines of credit, to a borrower whose loans or other extensions of credit are considered problem assets by the OCC examiners, external loan review, or the Bank, and whose aggregate loans or other extensions of credit, exceed three hundred and fifty thousand dollars (\$350,000) unless each of the following conditions is met:

- (a) a majority of the full Board approves the credit extension;
- (b) the Board explains in writing how the extension of additional credit is necessary to promote the best interests of the Bank;
- (c) the Board explains in writing how the extension of additional credit will not compromise the Board's formal plan to collect or strengthen the problem asset; and
- (d) the Board's written determinations required by this Article are maintained in the borrower's credit file.

## Regulatory stance on NPL resolutions in the United States

### Note that the OCC:

- *Required the bank to develop and adopt a plan to reduce its problem assets to a safe and sound level (without specifying what that level should be), and*
- *Prohibited the bank from extending additional loans to borrowers whose loans are considered problem loans, unless the Board determines that they are necessary to promote the best interest of the bank.*

The other bank regulators have adopted a similar approach. The FDIC goes into even more detail:

FDIC Certificate # 15009  
OCC Charter # 0  
Public Report

FRB District/ID\_RSSD 10 / 63751  
County: BUTLER

TOWANDA STATE BANK; TOWANDA, KS  
Summary Ratios--Page 1

Summary Ratios  
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Earnings and Profitability	3/31/2020			3/31/2019			12/31/2019			12/31/2018			12/31/2017		
	BANK	PG 16	PCT	BANK	PG 16	PCT	BANK	PG 16	PCT	BANK	PG 16	PCT	BANK	PG 16	PCT
Total LN&LS-90+ Days Past Due	0.68	0.16	89	4.20	0.18	97	3.34	0.15	94	0.71	0.06	93	0.24	0.05	88
-Nonaccrual	6.45	0.64	97	0.14	0.58	53	4.26	0.53	97	0.13	0.61	47	1.08	0.64	72
-Total	7.13	0.98	96	4.34	0.88	93	7.61	0.82	97	0.84	0.76	64	1.32	0.77	74

# Regulatory stance on NPL resolutions in the United States

## Consider the following enforcement action by the FDIC:

### 5. Risk Reduction Plans and Reduction of Adversely Classified Assets

(a) Within 60 days from the effective date of this ORDER, and within 60 days from the receipt of future reports of examination from either of the Supervisory Authorities, and within 60 days following receipt of any review downgrading an asset to a “Substandard” or “Doubtful” classification, the Bank shall prepare a written asset plan to reduce the Bank's risk exposure (Risk Reduction Plans) in each asset or borrower with aggregate indebtedness equal to or exceeding \$50,000. Progress toward meeting the Risk Reduction Plans shall be reported to the Board monthly. The Risk Reduction Plans shall, at a minimum, include:

- (i) Target dollar levels for each adversely classified asset within the next 6 and 12 months;
- (ii) each borrower's current financial condition, current and alternative repayment sources, and ability to refinance;
- (iii) valuations on pledged collateral and plans for repayment; and
- (iv) other action to improve the Bank's position.

### Notice the FDIC language:

- **Clarifies that it refers to Substandard and Doubtful loans**
- **Includes *future* NPLs**
- **Specifies timeframes for reducing risk exposure on *individual* NPLs**
- **Requires valuations of collateral**

# Regulatory stance on NPL resolutions in the United States

## Consider the following enforcement action by the FDIC (continued):

As used in this paragraph, the term "reduce" means (1) to collect, (2) to charge off, or (3) to improve the quality of an asset to warrant removal of any adverse classification. A loan or extension of credit to the same borrower that is renewed is not considered collected.

(b) Within 60 days from the effective date of this ORDER, the Board shall also adopt plans to reduce the aggregate volume of assets classified "Substandard" or "Doubtful" in the Report (Aggregate Volume Plan) to target dollar levels and target percentages of Tier 1 Capital plus the Allowance for Loan and Lease Losses (ALLL) within the next 6 and 12 months.

(c) The Risk Reduction Plans and Aggregate Volume Plan, and any subsequent modifications thereto, shall be approved by the Board, which approval shall be recorded in the Board's minutes. Thereafter, the Bank shall implement and fully comply with these plans. A copy of these plans, and any modifications thereto, shall be provided to the Supervisory Authorities with the next due progress report required below under the terms of this ORDER.

### **Notice the FDIC language:**

- **Describes what it means to "reduce" NPLs – resolution options**
- **Requires targets in terms of monetary amounts and as percentages of capital for reductions in aggregate NPLs**

# Regulatory stance on NPL resolutions in the United States

**A common prohibition is the advancement of additional funds to borrowers whose loans are already NPL, except in limited circumstances:**

## 9. Restrictions on Advances to Adversely Classified Borrowers

(a) Without prior Board approval, the Bank shall not extend or renew, directly or indirectly, any additional credit to or for the benefit of any, borrower who has:

- (i) Nonledger debt;
- (ii) any loan classified “Substandard,” “Doubtful,” or “Loss” which is uncollected; and
- (iii) any loan where the borrower has not provided current financial statements and/or adequate information concerning collateral protection so that the borrower's primary and/or secondary repayment ability cannot be properly assessed.

(b) Prior to the renewal, extension, or advancement of any additional credit pursuant to this provision, such credit shall be approved by a majority of the Board or a designated committee thereof, who shall state in writing:

- (i) That it would be detrimental to the Bank’s best interests not to renew, extend, or advance such credit;
- (ii) how the renewal, extension, or advance will improve the Bank’s position; and
- (iii) that an appropriate workout plan has been developed and will be implemented in conjunction with, or furthered by, the additional credit to be extended.

***Discussion: Under what circumstances would it be desirable to advance additional funds to a delinquent borrower?***

## Regulatory stance on NPL resolution in the United States

**U.S. regulators also look for evidence that NPLs have been “resolved” in a manner that still poses risks to the bank. A common technique is the “asset exchange”:**

- *In an asset exchange, a third party offers to buy NPLs from a bank and replace them with performing loans. This activity is generally OK, but***
- *The bank should know what its recourse might be if the acquired loans do not perform as expected.***
- *The examiners should look for evidence of possibly imprudent asset exchanges:***
  - If the bank sold NPLs at or very near book value (suspicious)**
  - If the bank bought from and sold to many loans from the same counterparty on or around the same date**
  - If the bank accepted loans in exchange that are outside the bank’s market area or inconsistent with its business plan**
  - If the bank accepted loans that are currently performing, but very high risk**

## Regulatory stance on NPL resolution in the United States

**And if the bank has taken real property of the borrower in exchange for forgiving all or part of the outstanding principal balance – a foreclosure – the examiners should:**

- Review the carrying value of the foreclosed property relative to its fair value***
- Review the source and quality of the appraisal of the property. Has the property been appraised at least once a year?***
- If the property has been on the market for a long time, question the bank's pricing and marketing strategy. Banks should not hold onto foreclosed property indefinitely with no plan of disposal.***
- Review the bank's overall track record in disposing of foreclosed property.***
- Review the incomes and expenses generated.***
- Look for possible environmental risks.***

**A foreclosure is not a final resolution of the NPL until the property is sold!**

## A start toward a set of “global best practices” for NPL resolution

Since there is no global set of regulatory/supervisory standards or best practices for NPL resolution, we can make a start here. Could there be a set of “Core Principles for Effective NPL Resolution”?

- ✓ **Any compendium of principles must start out with the idea that the NPL has to be valued fairly on the bank’s balance sheet before any steps toward resolution can be taken. This means setting up loan-loss allowances in line with the applicable accounting regime (expected credit loss or other method).**
- ✓ **Principles should cover write-off/charge-off, workout, foreclosure and sales of foreclosed assets, and sales of whole NPLs (to another bank, to an asset management company, to a securitization pool, etc.)**

A start toward a set of “global best practices” for NPL resolution

### Could there be “Core Principles for Effective NPL Resolution”?

- ✓ Principles should also cover if, when, and how a bank should pursue insolvency proceedings against a delinquent borrower. It may be difficult to outline a “global standard” because national insolvency laws and procedures, as well as the efficiency with which they’re carried out, differ across jurisdictions, and there may be other means, such as out-of-court proceedings (arbitration, alternative dispute resolution).
- ✓ These topics will be developed as the seminar continues.

# CONTACT US

## EMAIL

[glenn@seacen.org](mailto:glenn@seacen.org)

## PHONE NUMBER

+603 91951888

## WEBSITE & SOCIAL

[www.seacen.org](http://www.seacen.org)



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