

# Supervisory Rules and Regulation - SSM NPL Guidance

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The views expressed here are exclusively those of the presenter and do not necessarily reflect the position of the JVI or the ECB / SSM.



# Outline

- 1. Introduction and Overview**
- 2. NPL Strategy**
- 3. Focus on NPL workout**
- 4. NPL Coverage Expectations**
- 5. Measures taken in Response to Covid-19**

## Introduction and Overview

- **Start of the Single Supervisory Mechanism (SSM) (2014)**
- **Creation of a dedicated SSM NPL Task Force (2015)**
- Initial stock take report on national practices (September 2016)
- **NPL guidance (March 2017)**
- Updated stock take report on national practices (June 2017)
- **Addendum to NPL guidance; provisioning of new NPLs (March 2018)**
- **Supervisory expectations for NPL stock (July 2018)**
- **NPE coverage expectations (August 2019)**
- Response to the Covid-19 Pandemic (March 2020)

## Introduction and Overview

- **SSM ‘inherited’ a wide range of supervisory practices and a large legacy stock of NPLs**, resulting from the Global Financial Crisis and the Euro Area Sovereign Debt Crisis
- **Development of the NPL Strategy was the first major project of the SSM**
- **Substantial internal and external resources (consultants) allocated**
- **Lot of attention by SSM senior management** – necessary given time pressure and heterogenous interests and expectations within SSM
- **Use of impact assessment techniques regarding the envisaged measures**; e.g. use of stress testing infrastructure
- **Public consultation with stakeholders**, in particular banks
- **Publication of key documents and inputs**, e.g. stock take reports

## Introduction and Overview

### Overview of ECB guidance to banks on NPLs (final version published in March 2017)



# Outline

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## NPL Strategy

**All high NPL banks expected to develop ambitious and credible Strategies with portfolio level reduction targets over a 3 year period**

- Strategy should lay out bank's approach and objectives regarding the effective management (i.e. maximization of recoveries) and ultimate reduction of NPL stocks for each relevant portfolio

### **Key Stages of the process:**

1. Assessment of the operating environment
2. Development of the NPL Strategy
3. Implementation of the operational plan
4. Embedding strategy in management processes
5. Quarterly supervisory reporting

## NPL Strategy

### Range of implementation options including:

- **Cash recoveries/cures via forbearance:** Requires strong operating model including; forbearance and borrower assessment expertise, NPL management capabilities, outsourcing of servicing and write-off policies
- **Sales: Through portfolio or individual sales.** Strongly linked to provision adequacy, collateral valuations, quality exposure data and NPL investor demand
- **Collateral Liquidation's:** proceeds from the sale of supporting collateral
- **Write –offs:** Writing unrecoverable exposures off the balance sheet
- **Change of exposure type:** Includes foreclosure, debt to equity swapping, debt to asset swapping, or collateral substitution.
- **Significant risk transfer:** often called ‘securitization’

**Well diversified strategy recommended, taking into account available options and their respective financial impact.**

## NPL Strategy - Measuring Ambition

### Idea to create a level playing field and promote consistency:

- Ambition assessed based on **volumes of reduction** as opposed to the absolute NPL ratio (which can be subject to arbitrage depending on the calibration).
- Take bank specifics into account by **accounting for varying banks starting points**.
- Ambition level based on **gross and net non performing asset reduction** ( NPL's + foreclosed assets).
- Measured over **3 year horizon** to account for the fact that NPL's cannot be solved overnight and reductions option can take time to implement.
- Ambition assessed by **comparing against peers, country and SSM benchmarks** to ensure that outliers can be identified and challenged on a bank by bank basis.

## NPL Strategy - Measuring Credibility

### **Granular assessment based on bank specific aspects, looking at e.g.:**

- What are the tools used for reduction, e.g. cures, cash recoveries, write-offs, sales, etc.
- How diversified are the strategies across the drivers and timelines?
- Do the capital and provisioning levels support the delivery of the targets?.
- Does the coverage support the projected targets, impact on the bank's capital position?
- Does the strategy address high risk buckets – concentrations of land, aged buckets of loans etc.?
- Are the strategy assumptions credible – cure rates, inflow rates – do they match historical performance?

# NPL Strategy - Measuring Credibility

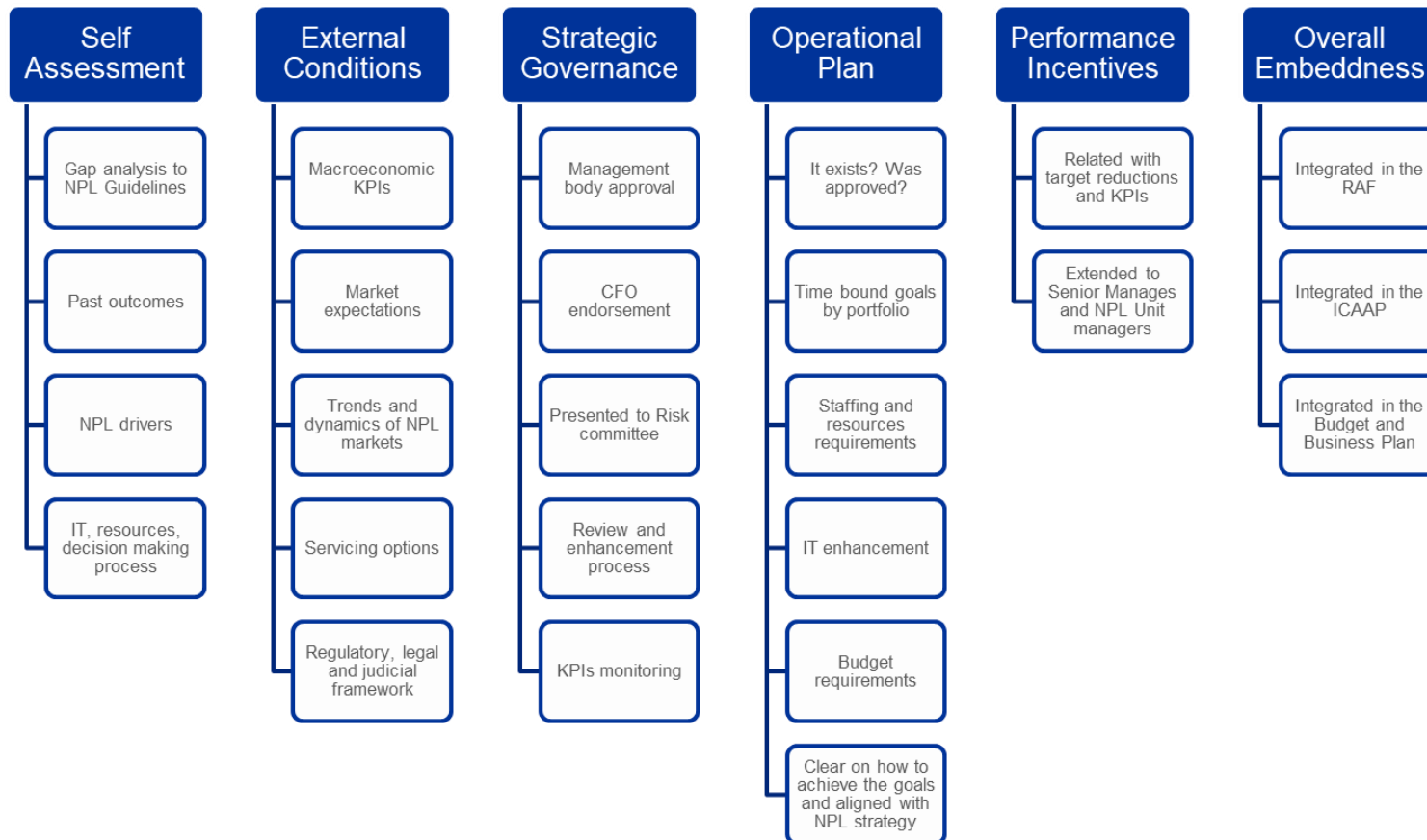
## Strategy drivers and timelines

Example data for illustrative purposes only - not representative of banks									
Example of what it might look like?	Diversification strategy (2017-2019)								
	Cures	Cash Recoveries	Sales	Write off	Collateral liquidation	Foreclosed	Debt to Equity swap	SRT	Others
Bank 1	20%	8%	0%	29%	7%	22%	0%	15%	0%
Bank 2	56%	11%	0%	21%	0%	12%	0%	0%	0%
Bank 3	11%	20%	0%	42%	5%	21%	0%	0%	0%
Bank 4	48%	10%	3%	15%	0%	24%	0%	0%	0%
Bank 5	27%	33%	0%	11%	3%	23%	0%	0%	3%
Bank 6	9%	6%	0%	8%	1%	62%	1%	0%	13%
Bank 7	10%	59%	6%	14%	8%	3%	0%	0%	0%

Example data for illustrative purposes only - not representative of banks data						
Example of what it might look like?	Timelines			Foreclosed reduction timelines		
	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Bank 1	52%	32%	16%	10%	46%	56%
Bank 2	10%	37%	53%	25%	35%	40%
Bank 3	15%	45%	40%	38%	22%	40%
Bank 4	52%	33%	15%	65%	10%	25%
Bank 5	35%	36%	29%	15%	60%	25%
Bank 6	41%	38%	21%	24%	30%	46%
Bank 7	20%	20%	60%	33%	34%	32%

# NPL Strategy - Measuring Governance

## Key Dimensions of Governance to be assessed



## NPL Strategy - Key aspects of Credibility and Ambition

- Clear and unambiguous reduction targets on portfolio level basis
- Diversification of reduction targets across a variety of strategic options
- Well-defined capital plan and timelines
- Detailed operational plan setting on key deliverables, milestones, actions and timelines required in order to execute strategy successfully.
- Strong alignment between NPL Strategy, ICAAP & business plan.
- Sound self assessment of internal capabilities and external environment
- Strong focus in strategy on forbearance i.e. identifying sustainable borrowers and providing borrowers with viable restructurings
- Adequacy of provisioning coverage is regularly assessed and sufficient to deliver NPL Strategy options and reduction targets.
- Robust internal operational capacities including sufficient expert resources, robust policies and procedures & IT capabilities
- Strong commitment by the bank evidenced by Board ownership

# Outline

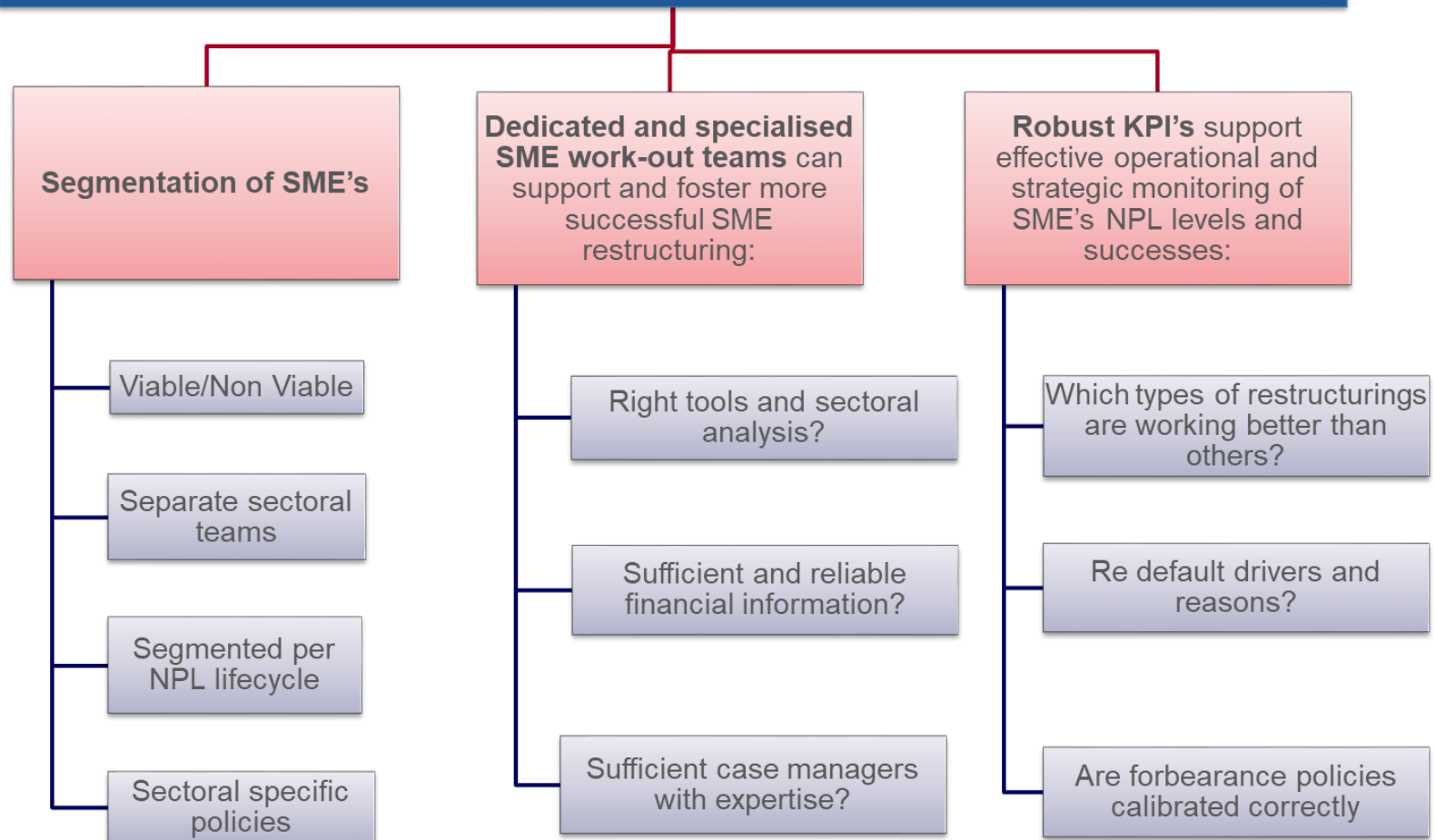
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## Focus on NPL Workout

- High NPL banks should implement separate and dedicated NPL WUs, ideally starting from the moment of early arrears
- The institutional framework needs to ensure that any potential conflicts of interest are sufficiently mitigated.
- Detailed portfolio segmentation is essential!
- Relevant phases in the NPL life cycle are:
  - Early arrears (up to 90 days past due (dpd))
  - Late arrears / Restructuring / forbearance
  - Liquidation / debt recovery / legal cases / foreclosure
  - Management of foreclosed assets
- All NPL workout activities and borrower engagements should be given sufficient attention, including specialized staff!

## Focus on NPL Workout

**What does successful work-out look like:  
illustrative example of SME's: ( not exhaustive list)**



## Focus on NPL Workout

### Collateral Valuation – Key findings from on-site inspections in NPL data integrity (2017)

- A lack of risk data aggregation processes in many SSM high NPL banks, for data relevant to the detection of financial difficulties (e.g. data from income statements, EBITDA,...)
- Key parameters (e.g. collateral haircuts, discount times, cure rates) often significantly misestimated
- Criteria for write-offs (e.g. expressed as time in default) are in many cases not clearly defined

*Source: SSM Annual supervisory priorities report 2017*

## Focus on NPL Workout

### Supervisory Expectations regarding Collateral Valuation

#### Policies & procedures:

- Written documents
- Board approved
- Asset type specific
- Aligned to risk appetite
- Regularly updated

#### Monitoring & quality control:

- Robust processes
- Regular review
- Challenge valuations
- Back testing
- Independence of valuer's

#### IT capabilities

- Collateral database
- Transaction database
- Data quality & integrity
- Common sources & definitions

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## Coverage Expectations

### Key ECB communications

- [Addendum](#) to the NPL guidance (March 2018). The Addendum set the prudential provisioning expectations for new NPLs (since 1/4/2018);
- Supervisory expectations for the provisioning of the NPL stock (classified as NPE before 1/4/2018) ([press release issued on 11 July 2018](#)).

### EBA guidelines on NPEs

- [GL on non-performing and forborne exposures](#) (31 October 2018) and [GL on disclosure on non-performing and forborne exposures](#) (17 Dec 2018)

### Relevant European Commission initiative

- [Regulation \(EU\) 2019/630](#) amending the CRR (Regulation (EU) No 575/2013, published in April 2019; all banks to hold Pillar 1 minimum loss coverage for new NPEs classified from 26 April 2019.

**Decision: ECB supervisory coverage expectations for ‘new’ NPLs (Pillar 2) aligned with legislative (European Commission) package (Pillar 1).**

# Coverage Expectations

## Calendar alignment for ‘new’ NPLs (classified from 1 April 2018)

- Previous 2/7-year calibration for new NPEs was changed to 3/7/9-year calibration and path to 100% coverage aligned with the Pillar 1 treatment for NPEs;
- A split of secured exposures was introduced for new NPEs subject to the Addendum (including a special treatment of export credit)

Number of years as NPE	Unsecured part	Secured part	
	Pillar 2 – Addendum (adjusted calibration)	Pillar 2 – Addendum (adjusted calibration)	
		Secured by collateral other than immovable property	Secured by immovable property
More than 1			
More than 2	35%		
More than 3	100%	25%	25%
More than 4	100%	35%	35%
More than 5	100%	55%	55%
More than 6	100%	80%	70%
More than 7	100%	100%	80%
More than 8	100%	100%	85%
More than 9	100%	100%	100%

Note: For parts of NPEs that are guaranteed or insured by an official export credit agency, there are no coverage expectation until more than 7 years of NPE status.

# Coverage Expectations

## Summary of the current approach for the three types of NPLs

NPE classified on or after 1 April 2018	Exposure origination date on or after 26 April 2019	<b>Pillar 1 – Backstop</b> 3/7/9 calendar Progressive Path to 100% CRR	NPE reduction strategies, reporting, etc. <b>Pillar 2 measures</b>	*Special treatment of export credit as under Pillar 1 for Pillar 2 scope under Addendum
	Exposure origination date before 26 April 2019	<b>Pillar 2 – Addendum*</b> 3/7/9 calendar Progressive Path to 100% Addendum exemptions		
NPE classified before 1 April 2018		<b>Pillar 2 - Stock of NPEs (ECB press release)</b> As communicated in SREP letters <b>No progressive path</b> Addendum exemptions		

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## Measures taken in response to Covid-19

- Postponement of the deadline for the submission of NPL strategies by 6-months to end-September
- Exposures that will benefit from government guarantees in the context of the COVID-19 pandemic benefit from preferential treatment foreseen in the Guidance for NPLs guaranteed or insured by Official Export Credit Agencies (i.e. no coverage expectations for the first 7-years in NPE status)
- Flexibility to the UTP classification of exposures covered by payment moratoria related to COVID-19 – i.e. payment moratoria meeting the EBA criteria for a general moratoria:
  - It does not trigger forbearance classification and the assessment of distressed restructuring
  - Institutions should continue to apply their normal policies for the regular reviews of indications of unlikeliness to pay in a risk-based manner, taking into account all available support measure.

**Thank you for your attention!**

Questions / Comments / Feedback?

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