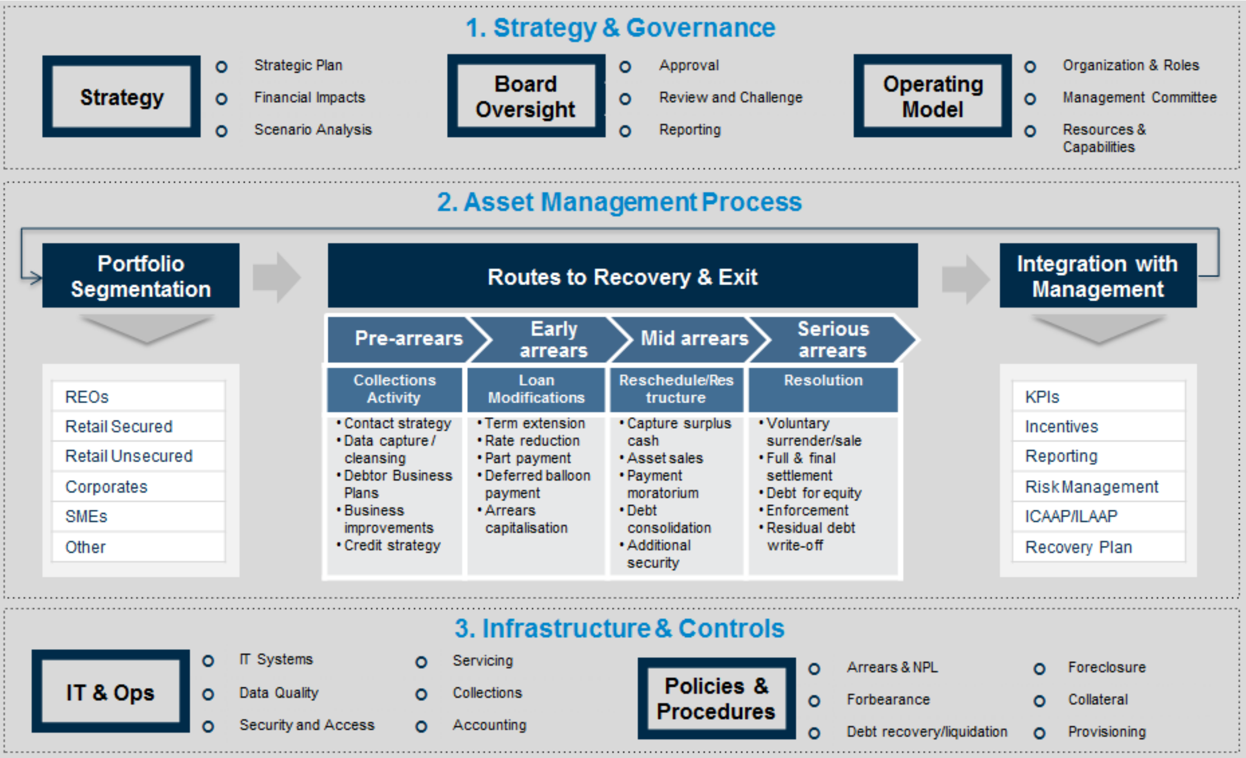
Do the ECB draft guidelines specify information requirements for NPLs processes and management sufficiently? Are there areas where the ECB should aim for greater or less detail, or where more flexibility would be appropriate?

Positive Feedback

- The ECB draft guidelines are **comprehensive and instructive** as they cover the key building blocks and best practices for NPL management (primarily Chapters 2 and 3) including: 1. Strategy and Governance; 2. Management Processes including portfolio segmentation, routes to recovery and exit, and integration with management; 3. Infrastructure and Controls covering technology, operations, policies and procedures (see Figure 1 below for A&M Integrated NPL framework). It might be helpful to use a diagram like this in the document in order to summarise the overall framework.

Figure 1 – A&M Integrated NPL Framework



- The ECB draft guidelines also addresses the key areas and treatments (primarily Chapters 4, 5, 6 and 7) including forbearance, NPL recognition & impairment measurement and collateral valuation. Having all of this in one main guidance document will be very helpful for all stakeholders and ensure consistency (and ultimately transparency) across the industry.

- ECB guidelines clearly promote the reduction of bank Non-Productive Assets ("NPAs") (namely NPEs and foreclosed assets) and places adequate strategic focus on this task for banks defined as high NPL banks. A&M agrees with the need for high NPL banks to accelerate the unwinding of their NPAs as their prolonged run-off consumes OPEX, funding cost, capital cost and bank management time. Recent A&M studies have concluded that Non-Productive Assets are one of the main reasons why banks are not able to meet their

cost of equity (e.g., only 2 European banks of the 51 that participated in the 2016 EBA/ECB stress tests met ROE levels above the cost of capital in baseline scenario). For instance, a study conducted for the top 6-banks in Spain using stress test results concluded that non-productive assets generated:
  - a CET1 drag of NPAs of -384bps over the course of 3-year baseline conditions
  - a ROE drag of -11% annually over the course of 3-year baseline conditions

- The ECB guidelines include **a comprehensive and useful set** of market best practices, policies, key performance indicators (“KPIs”) and Early Warning Indicators (“EWIs”) which serve as a reference for the industry to assess and benchmark the state of their progress towards meaningful and ambitious NPL reduction targets, including the efficiency and effectiveness of managing these types of assets. The inclusion of guidelines in the area of **governance** and business model analysis related to NPLs is particularly of interest given the lack of supervisory references elsewhere.

- The ECB guidelines provide **enough flexibility** for bank implementation of NPL management practices and methods according to the proportionality and materiality principles.

- We strongly believe that the ECB’s NPL guidelines will contribute to the decline of NPAs in European banks thus reducing overall capital and profitability in the system over time. We also believe that these draft guidelines are representative of industry best practices and will foster **consistency and harmonization** of the ECB Joint Supervisory Teams approach to supervise banks in this area.

Potential Areas for Enhancement

In this section of the document we identify potential areas of enhancement within the NPL guidelines for the ECB to consider along the following areas 1. Definitions, 2. Business planning, 3. Governance and organization, 4. Best practices and KPI benchmarking, 5. Reporting, disclosure, collateral and provisioning, and 6. Application and enforcement.

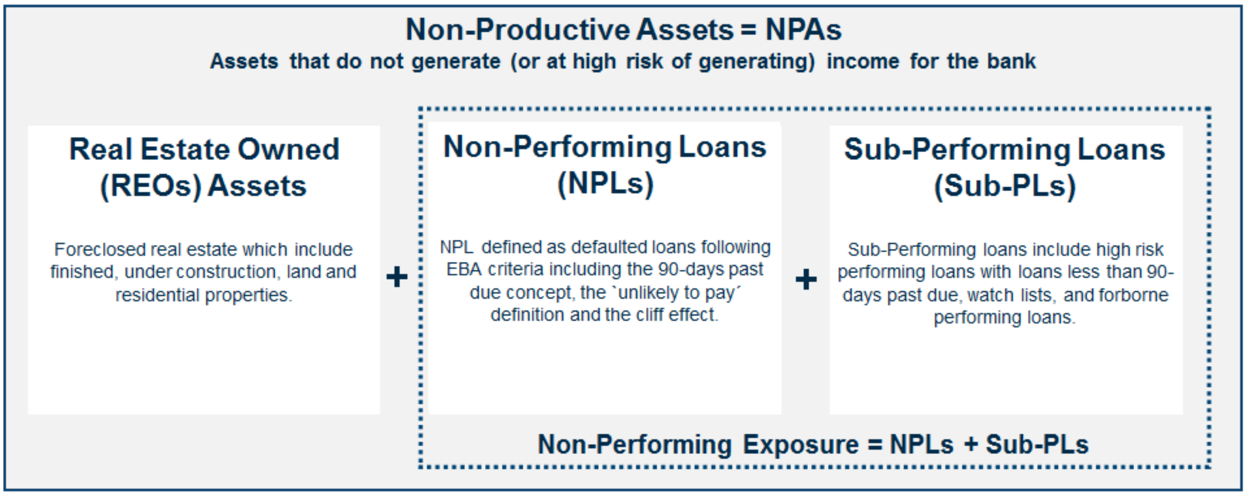
1 – Definitions

- The definition of the **scope and applicability** of the NPL guidelines should be clarified further to avoid any ambiguity. “NPLs" is defined in the guidance in broad terms including all non-performing exposures (NPEs), foreclosed assets, and performing exposures with an elevated risk of turning non-performing, such as “watch-list” exposures and performing forborne exposures. It also states that “NPL” and “NPE” are used interchangeably however this can be confusing.

- When a high NPL bank is defined it seems that the guidance only includes the limited definition for NPL (defaulted loans). In addition, it is unclear whether NPL practices in the document apply to all categories of non-productive assets (foreclosed assets + NPE + High Risk Exposures) or just NPLs:
    - Scope of strategic and business plan
    - Scope of integration with ICAAP and risk appetite
    - Scope of Board oversight and approval
    - Scope of work-out dedicated units

- We recommend the Taskforce to include a dedicated section for scope definition. A&M believes that the guidance should include a **broad definition of non-productive assets** including foreclosed real estate owned assets, non-performing loans and sub-performing loans which should be the over-riding definition in the guidance as depicted in the following illustration:

Figure 2 – A&M proposed scope for NPL guidance



- The guidance states that ‘It is generally applicable to all significant institutions (SIs) supervised by the SSM including international subsidiaries’. Please explain the term 'generally'? Also it was stated at the public hearing that the guidance is not applicable to LSIs – we suggest that a statement to that effect is included in the guidance.

- The **definition of high NPL bank** can be subject for further clarification. It is unclear how a high NPL bank is defined:
  - Does the assignment of the high NPL bank definition apply at the consolidated group level, at the subsidiary level, at the country level, at a business unit level, at the portfolio level or at an asset class level? There might be banks that have 'high NPLs' in one country or business unit but not at the consolidated level due to offsetting effects. It was mentioned at the public hearing that these will also become subject to scrutiny – we would suggest further elaboration on this point (e.g. low NPL banks with high NPL areas).
  - At the public hearing it was mentioned that a high NPL bank would be referenced to the EBA/ECB NPL average for European banks (currently 5.7%). However no quantum or metric was provided to define a high NPL bank (i.e. is it a multiple of the NPL average?).
  - How frequently does the EBA/EU NPL average get updated? There might be banks that change status (in or out) frequently based on the average update. An alternative might be to define constant thresholds for which NPL guidance would apply to. Guidance on this point would be helpful.

2 – Strategic and Business Planning

- A&M agrees with the ECB guidance on the importance of a clearly articulated strategy and business plan for the bank´s non-productive assets. In this section we provide additional considerations of industry best practices when planning non-productive asset bank activity:
  1. We consider that an adequate strategic plan must include baseline and adverse projections with a 3 to 5 years horizon
  2. Strategic options should be developed to look at the 'routes to recovery (i.e. bottom-up)' and the 'routes to exit (i.e. top-down)'
  3. Financial projections should include P&L, profitability, capital, funding, and portfolio net present value metrics. P&L should be calculated on a fully loaded basis including income, operating expenses, cost of new provisions, cost of funding and cost of capital (see Figure 3 for proposed A&M methodology). Capital should consider RWA consumption for NPAs and RWA release based on projected exit flows. The work-out unit should have target responsibility for all these items not just loan balance reduction and costs
  4. Asset reduction goals based on macro / market views / asset liquidity and coverage levels by asset type and portfolio
  5. Asset reduction objectives per country, subsidiary, or business line, distinguishing between gross, net of provisions and gross of collateral in the case of secured NPL.
  6. Consider financial impact of multiple recovery strategies (sale, foreclosure, refinancing, restructuring... etc.)
  7. Analysis of sensitivity of impact in CET1 and ROE of different combinations of objectives in assets reduction, provisions and price levels for exist strategies

Figure 3 – A&M Proposed Methodology for Business Planning

	Financial Impact Areas	Methodology and Assumptions
1	Revenue	• Revenue projections impacted by haircut on sale value net of provisions based on NPL reduction forecast over 5-year horizon (initial stock + yearly new entries) • Reduction sale targets done by asset class, most of reduction performed in first 3 years • Haircuts applied according to market estimations on REOs and NPL over NBV
2	Provisions	• Coverage increased to market price levels in several years for both REOs and NPLs • Target coverage for performing past due and performing forborne • New provision estimates based on bank business plan for baseline and adverse scenarios
3	OPEX	• OPEX estimates based on AUM average projections (REOs & NPLs) and efficiency rates per bank
4	Funding Cost	• Funding cost estimates based on AUM average projections and funding rates per bank estimated as interest expense over average interest bearing liabilities
5	Capital Cost	• Capital cost estimated as RWA projections at CET 1 target of 11% times cost of equity assumed at 10%

	Scenarios	Methodology and Assumptions
1	Baseline	• Baseline credit defaults flows as provided by bank business plan.
2	Adverse	• Adverse credit defaults flows as provided by bank business plan.
3	Accelerated Unwinding & Improved Recovery	• Scenario designed to target total NPA <=10% over the course of 3-year horizon and <=5% in the course of 5 years horizon.

- The guidance outlines the type of targets that should be established covering various dimensions. In addition at the public meeting it was stated that banks must make **meaningful and realistic reduction targets**. In relation to targets the following should be considered:
  - The industry will expect more granular detail in order to define and set targets at various levels / categories including group, country, subsidiary, business line, or asset class
  - Clarity is also needed on whether the NPL targets will be 'gross' or 'net' or 'after' collateral in the case of secured NPLs
  - How will targets be treated where certain assets are restricted from reduction due to legal, regulatory or judicial issues under the new guidance?
  - The focus is clearly on long-term reduction targets however further guidance on the use of short-term versus long-term resolutions would be helpful

- Banks that have very **decentralized structures** will require further guidance on how they should establish strategy, the operational plan and overall governance as the best practice advocates a centralization of the NPL management unit and strategy.

3 – Governance and organization

- **Management Body definition**. The NPL guidance refers to the oversight and approval by the management body.
  - Is the management Body referred to as the Board or to a management committee?
  - If the scope for NPL practices refers to a country, subsidiary or portfolio what should be the level of oversight and approval at each level?

- **Organizational structure and three lines of defense ("LOD")**: A&M agrees with the proposed guidance on dedicated work-out units that the management of NPLs should separate from the loan origination units. We also agree with using the concept of three lines of defense for the management of non-core bank activities. However, in many banks work-out units report through the risk management organization (i.e. second LOD). We advocate for organizational flexibility as long as the principles of independent business oversight is respected.

a) In banks where work-out units report hierarchically into the risk management function, independent risk controls should be implemented within separate units of the risk management function to avoid conflicts of interest. In addition a separate risk unit must provide independent challenge to the NPL unit
b) In banks where work-out units are considered separate business lines with their own P&L and capital, the risk management unit should implement independent risk management controls and challenge of that unit

- The draft document references an NPL committee however guidance is required for scope, terms of reference and members. This committee may have a similar mandate as the Divestment Committee outlined above. Overlaps with other committees (i.e. credit or risk) should be cleared defined and delineated.

- In addition, A&M has observed the following governance and organization **leading best practices** that are not mentioned in the ECB guidance:
    - A **Divestment Committee** implemented at the management level to oversee and coordinate divestiture strategies, oversight of unwinding targets, issue resolution and corrective actions. Committee mandate includes
        - Determining strategy, business plan, budget and incentives
        - Assessing proposals put forward by the work-out units
        - Developing and assessing proposed divestment policies for the Board
        - Determining key performance indicators (KPIs) and monitoring them
        - Resolving conflicts and undertaking actions to meet asset reduction goals
        - Evaluating capabilities and resources and developing action plans to address gaps
    - A **Project Management Office** in charge of the introduction and implementation of work-out and restructuring best practices, prioritization of gaps, design and execution of actions plans, project risk management and corrective actions, tracking of regulatory expectations and coordination of strategic initiatives.
    - **Outsourcing to external servicers** or sale of servicing platform have been used successfully as strategies to improve efficiency and effectiveness of recovery practices and should be considered as part of the strategic options analysis. In such cases, **governance protocols** need to be mutually agreed between the bank and the platform to cover service delivery and commercial engagement including decision making, authority levels and control processes and they must comply with the guidelines.
    - Lastly, those banks that have successfully used portfolio sales have instituted a **Capital Markets unit** within their work-out functions to coordinate investor relationships and manage end-to end sale processes.

- One other point worth considering in the governance section is the assessment of the calibre, expertise and the fitness of the respective NPL unit staff. Typically NPL unit staff should be different to the staff that originated and approved the loans initially. In addition the unit should ensure that staff have adequate and appropriate expertise including asset class (i.e. CRE or corporate) and function (i.e. work-out, restructuring or legal) required to carry out the various unit activities. Additionally the bank should also assess fitness of staff where a staff member has a high degree of indebtedness and are in arrears with their own bank (i.e. staff loans) or other banks which may impact on their impartiality or pose potential conflicts.

- **Data Quality**. Even though this is an on-going dialogue between the banks and JSTs on this topic, we believe it is important to emphasis the importance of up-to-date documentation and data with respect to NPL portfolios. This is even more important where banks may have to engage or re-engage the market for loan sales. Value can be lost when data and document quality is not adequate as investors will discount on any data / documentation gaps. We have seen this time again while working with banks and investors.

4 – Best practices and KPI Benchmarking

- **Best practices**. The NPL guidance provides a comprehensive list of best industry practices for non-productive asset management. It would be helpful to understand the criticality or importance of the management practices differentiating practices that are necessary for the sound management of NPLs versus “nice to have” or least critical practices. A&M recommends to organize management practices along a maturity based capability model differentiating between foundational, functional and leading guidelines.
    a) Foundational – basic set of capabilities in some instances uncontrolled, unstable or inefficient
    b) Functional – operational set of capabilities in some instances implemented with manual processes and controls
    c) Leading – best set of capabilities consistently controlled, repeatable, efficient and high performing

  It may be appropriate to apply these levels to various categories of banks (i.e. high NPL banks, low NPL banks with various high NPL areas, low NPL banks). A&M has developed a tool to conduct NPA capability self assessments which incorporates a maturity target model with ≈200 capabilities that have been inventoried based on the SSM guidance and industry practices. An illustration of A&M assessment tool applied to the area of NPL strategy is shown in Figure 4.

Figure 4 – A&M NPA Self Assessment NPA maturity based capabilities

3. Execution, reporting and control

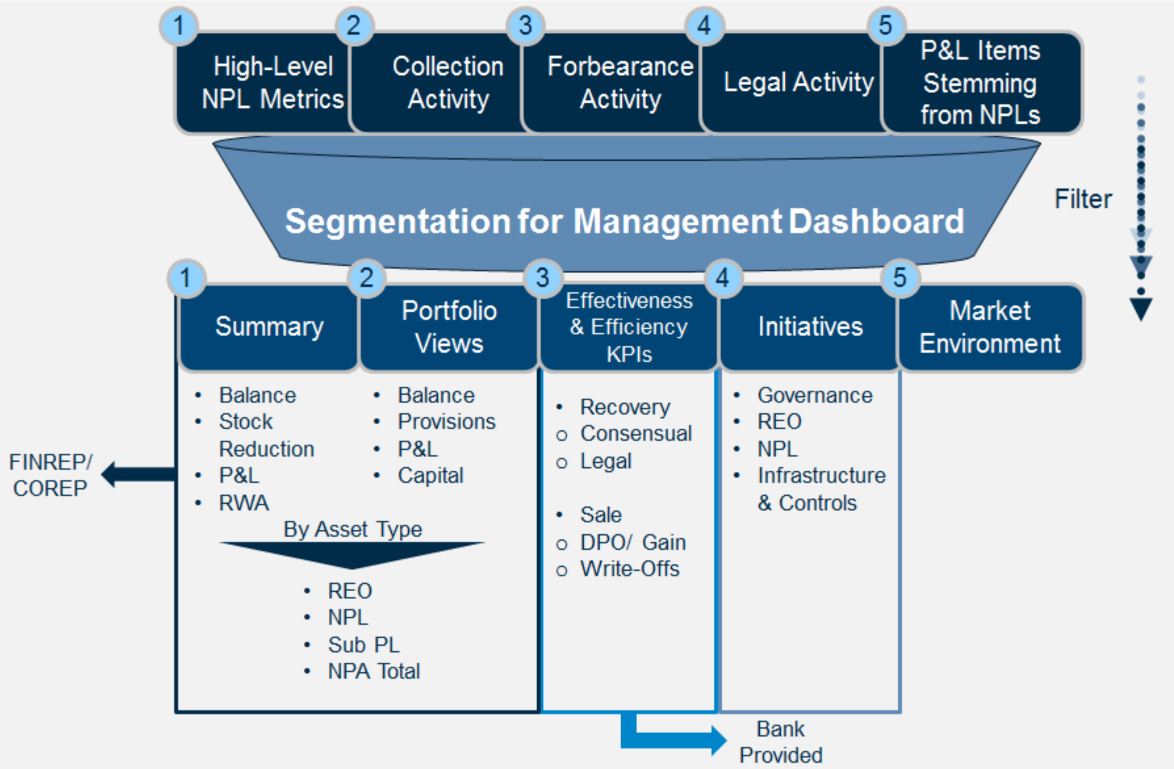
2. Improved Governance

1. Improved NPL Strategy

FOUNDATIONAL	FUNCTIONAL	LEADING
Preliminary / Uncontrolled / Unstable / Inefficient	Operational with Manual Process and Controls	Controlled / Repeatable / Efficient / High Performing
• Strategy of the bank should clearly estate the objective of NPA reduction and the timeline • Asset reduction goals have to be plausible, adequately justified and documented • The projections are realistic under reasonable assumptions with regard to the operating environment • The level of provisions is also included in the projection to determine the additional provisions needed and the targets • The operating plan contains suitable governance arrangements • The plan contains adequate staffing and resource requirements specifications	• Specific targets are set for foreclosed assets • Adequate haircuts are applied when calculating the objectives, with enough reasoning provided • The bank performed a thorough self-assessment of strengths and weaknesses identifying potential gaps and remediation • The self-assessment is updated annually • The RAF is taken into account for the decision making process on objectives • The external operating environment is adequately assessed and taken into account in the business plan • The bank calculates projections of the NPE by asset class and per different scenarios • The cost of funding and capital is included in the calculation of the NPA burden of the bank • The projections include enough assumptions related with liquidity of assets, haircuts to apply, and costs for selling • The plan contains communication process and procedures with stakeholders (also staff) • The plan contains IT and technical infrastructure support arrangements	• Objectives should be broken down by business lines, collateral type and recovery routes • The bank has intermediate objectives in terms of the most relevant KPIs with a high correlation with final NPA reduction goals • The bank obtains independent opinion on the business plan and management capabilities • Not only quantitative but also qualitative objectives in terms of weaknesses are identified in the planning process • Relevant KPIs are also projected in the business plan • The impact analysis is consistent with ICAAP and the Recovery Plan • The operating model includes an assessment of potential impediments • The operating plan already includes mechanisms to address deviations from the plan in the short term

- **KPI Benchmarking**: The NPL guidance provides a comprehensive list of KPIs for non-productive asset management in *Annex 3 Benchmark for NPL monitoring metrics*. While we share the importance of using KPIs for NPA planning and management we would encourage the ECB to use a taxanomy that can be used by the industry in their management reports and for peer benchmarking purposes. In this regard we differentiate different levels:
    a) Level 1 – Summary NPA balance sheet (stock and flow), stock reduction, P&L, provisions, RWA consumption and profitability. This can be supplemented with summary KPIs and EWIs.
    b) Level 2 – Portfolio level information including balance sheet, stock reduction, P&L, provisions, RWA consumption and profitability. This can be supplemented with summary portfolio KPIs and EWIs.
    c) Level 3 – Efficiency KPIs (unit, team and individual activity targets and performance against) and effectiveness KPIs (unit, team and individual outcome targets and performance against) by portfolio and recovery / exit strategy.
    d) Level 4 – Status of key operational actions and strategic initiatives

Figure 5 – A&M Management Dashboard taxonomy



A&M encourages the ECB to perform and publish NPA KPI industry-wide benchmarks on a regular basis including metrics already available in FINREP or COREP as well as bank provided KPI information.

5 – Reporting, disclosure, collateral and provisioning

- Regarding the reporting *Annex 7 Summary of supervisory reporting and disclosure items related to NPLs* it is not clear in the document the **periodicity of the submissions** to the SSM, it could be good to clarify according to the level of NPLs of the bank.

- Regarding the **disclosure** of the level of NPLs it would be important to clarify with ESMA the level of granularity required by the market authorities in order to have similar pillar 3 disclosures that would facilitate peer comparison by public analysts.

- Regarding the collateral valuation it is remarkable the effort on choosing best practices, nevertheless some of the requirements in terms of frequency of valuation might be excessive for some more stable markets. At the public hearing it was stated that for high NPL banks that collateral must be 'reviewed' annually – please define 'reviewed'.

- A&M restructuring experience with corporate assets in Europe continues to show large disparity of provision coverage levels for exposures to single name companies with similar collateral levels. Disparity in coverage levels among banks in these cases becomes the biggest obstacle for achieving bank consensus in corporate restructuring solutions. We encourage the ECB to perform targeted single name industry-wide AQRs for forborne corporate exposures as this will serve as a catalysis for asset reduction and recovery in this particular segment.

6 – Application and enforcement

- Regarding the **application** of the guidance some clarification is needed, it was mentioned during the public hearing that some parts are already in use by the industry (i.e. high NPL banks), whereas some others might take time. In any case it is a JST tool and the application is embedded in the supervisory dialogue.

- During the public hearing it was also commented the fact that the guidance could affect the price level of NPL markets given that potential buyers may expect an additional reduction in price from the banks side in order to comply with their revised asset reduction goals. This is an issue that will depend on supply and demand dynamics, thus difficult to remediate and hence supervisors should be aware that setting the objectives is one task and executing the sales, recovery or write offs is another different one that depends basically on the market price level, the capital flexibility of the banks to absorb potential losses when coverage is not enough, the availability of servicing and elimination of transaction impediments.

- Some other concerns expressed by other participants in the public hearing were related with the different recovery legal processes around the SSM and the different accounting rules for provisioning. In this regard the guidance has been drafted taking into account all specificities and not trying to supersede any local or international regulations, so we do not think it is a big issue besides that additional integration is of course desirable.

- Regarding the measures to be applied in case of breaches, further clarification on how it would be included in the supervisory dialogue through joint decision / Pilar 2R or other alternatives would be desirable.

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