EaSI Technical Assistance

Non-performing loans: rules and management

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European Commission

Agenda topics

1. *Definitions*
2. *Regulatory framework*
3. *Management of non-performing loans in the current regulatory framework*
4. *NPLs classification in the context of Covid-19*

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Definitions

- A default shall be considered to have occurred with regard to a particular obligor when either or both of the following have taken place:
  a) the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security;
  b) the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries.

- "Securitisation' means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:
  a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
  b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme;
  c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013.

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Regulatory framework

- Art. 178 Regulation (UE) 575/2013 – Capital Requirements Regulation «CRR»;

- Final Report - Draft Regulatory Technical Standards on the materiality threshold for credit obligations past due under Article 178 of CRR "EBA/RTS/2016/06";

- Guidelines on the application of the definition of default under Article 178 of CRR "EBA/RTS/2016/06";

-Commission Delegated Regulation (EU) 2018/171 of 19 October 2017 on supplementing Regulation (EU) No 575/2013;

- Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013;

-Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis (EBA/GL/2020/02).

Regulatory framework

Circ. 272/2008 of Bank of Italy

View EBA/ECB

Performing exposures
Stage 1
Stage 2

Non-performing exposures
Stage 3

Past due

Unlikely to pay

Bad debts

Non performing loans

Unlikely to pay *«subjective criteria»*

Past due *«objective criteria»*

Sequential downgrading

Parallel downgrading

Regulatory framework

In 2016, EBA published the Guidelines on the application of the definition of default under Article 178 of the CRR Regulation and the regulatory technical standards on the materiality threshold for overdue credit obligations.

The regulatory technical standards were transposed by Delegated Regulation 171/2018.

Purpose: harmonisation of the practices used in the different countries of the European Union and comparability of the risk parameters and regulatory capital of the different credit institutions.

Application:

→ The guidelines apply from **1 January 2021**

→ A competent authority shall set a date for the application of the materiality threshold which may vary for different categories of institutions but which shall be no later than **31 December 2020 for institutions using the Standardised Approach**

Regulatory framework

The new discipline declines the definition of "relevant" for the purposes of classifying a debtor as non-performing, mainly reviewing the criteria of backlog and return to a non-default status.

Materiality thresholds	• Absolute: 100€ for Retail and 500€ for Corporate • Relative: 1% retail and corporate
Counting of days past due	The count of days past due starts when both thresholds are simultaneously exceeded for 90 consecutive days
Technical past due situation	Technical past due situation should be limited to data and IT system errors.
Unlikely to pay	Indications of unlikeliness to pay, especially in cases of credit sale and onerous debt restructuring
Return to a non-defaulted status	The cure period must not be less than 3 months (1 year for onerous debt restructuring)
Default propagation	• Univocal classification at group level; • New rules of contagion (e.g., joint credit obligation, conjugal bond in communion of property, etc.)

Source:AIFIRM

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Regulatory framework

Counting of days past due "***objective criteria***"

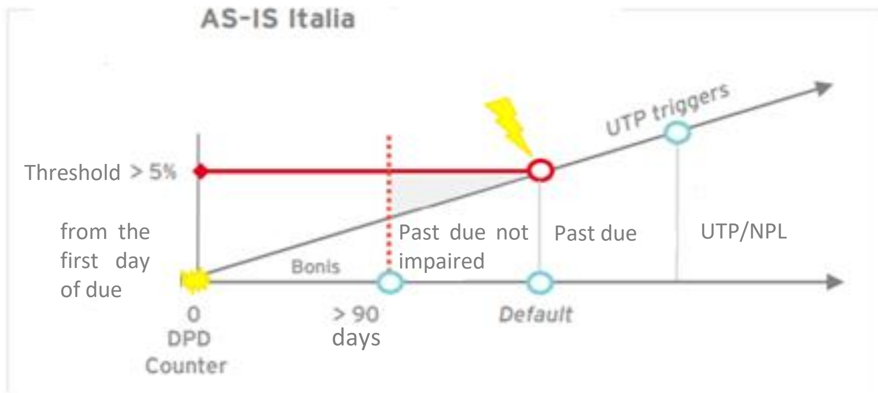
- where any amount of capital, interest or fee has not been paid at the date it was due, institutions should recognise this as the credit obligation past due;
- where there are modifications of the schedule of credit obligations, the institution's policies should clarify that the counting of days past due should be based on the modified schedule of payments.

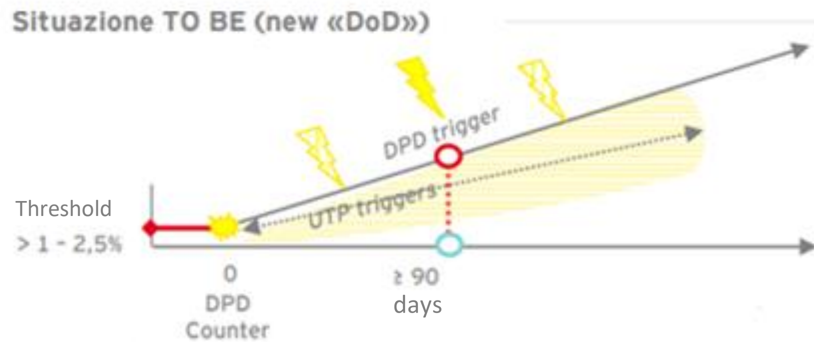
Introduction of symptomatic indicators of unlikely to pay "***subjective criteria"***

- Non-accrued status;
- Specific credit risk adjustments (SCRA);
- Distressed restructuring;
- Bankruptcy;
- Sale of the credit obligation.

Regulatory framework

Legend :
DPD trigger
Default
UTP triggers
area where UTP triggers can be activated





The implementation of the new default definition will lead to the leave sequential classification to parallel classification

Source:EY

Regulatory framework

New definition will lead to significant changes for credit institutions:

Operational profile

Review of management processes and reconsideration of NPL recovery and management processes

Accounting and income profile

Revision of the criteria for classification, hedging and staging of credit positions and reconsideration of internal models for PD and LGD calculations

Prudential profile

Conceptual mismatch between new and old risk parameter calibrations, increase in RWA for banks SA

Management of non-performing loans in the current regulatory framework

Management of non-performing loans in the current regulatory framework

The substantial deterioration of the loan portfolio, caused by the economic slowdown of recent years, requires credit institutions to reflect deeply and carefully on the management methods used to enhance the stock of non-performing loans.

The high incidence of impaired loans is reflected:

- on the quality of bank assets;
- on the liquidity of banks;
- on the sustainability of the business model.

A PROCESS OF GRADUAL REDUCTION OF IMPAIRED LOANS AND MAXIMIZATION OF THE PRESENT VALUE OF RECOVERIES IS NECESSARY.

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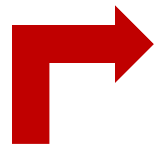
Management of non-performing loans in the current regulatory framework

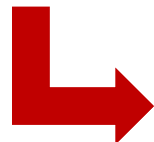
In addition, with the aim of initiating a more active management of impaired loans, the ECB has published guidelines containing best practices for the management of NPLs by significant banks.

The guidelines address the following critical issues



Organisational and management behaviour of intermediaries

Underestimation of the importance and complexity of the debt recovery process



Low level of computerization

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Management of non-performing loans in the current regulatory framework

ECB GUIDELINE RECOMMENDATION: the objective of efficient management of impaired loans is achieved by combining different management strategies that take into account the peculiarities of individual portfolios, positions, in relation to external conditions. This should allow the reduction of non-performing exposures, at least in the medium term.

NPL position active management

Tailor made strategy and combination of available strategic options

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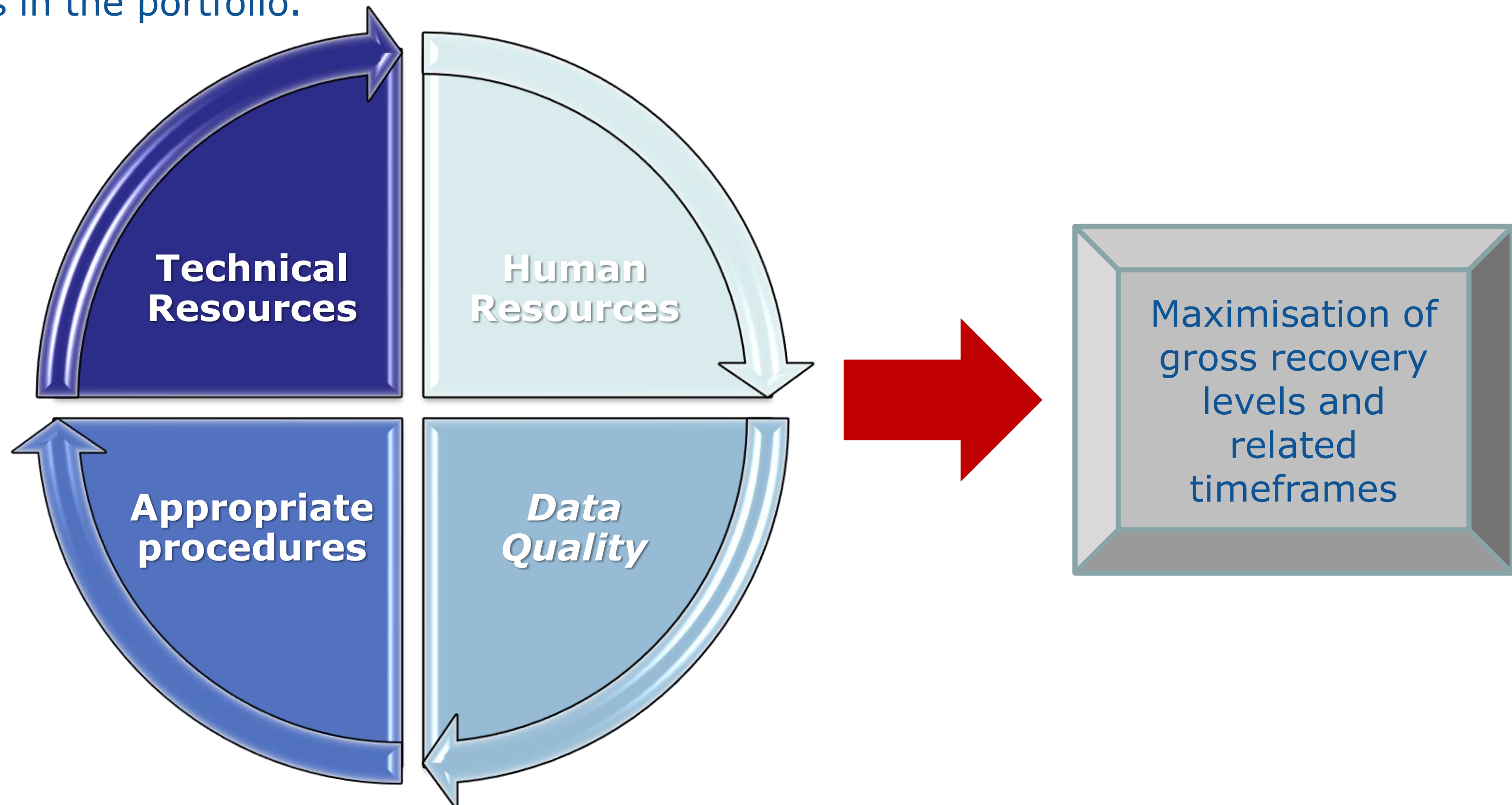
Management of non-performing loans in the current regulatory framework

For a correct management of anomalous positions, individual banks are required to strengthen their internal structure in order to detect the first signs of deterioration of credit positions in the portfolio.



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Management of non-performing loans in the current regulatory framework

This implies for the banks:

- **definition of internal recovery strategies** by product/size/warranty;
- **operational processes suitable for credit management** from the very first stages of impairment;
- **structures dedicated to the elaboration of internal analysis/reports** that monitor performance and management costs;
- creation of a **clear and complete data set** - data quality;
- **ensuring an organisational structure dedicated to NPLs** with significant expertise in the sector;
- adoption of **adequate infrastructures for the collection of internal and external data** (e.g., IT system, access to external registers, etc.).

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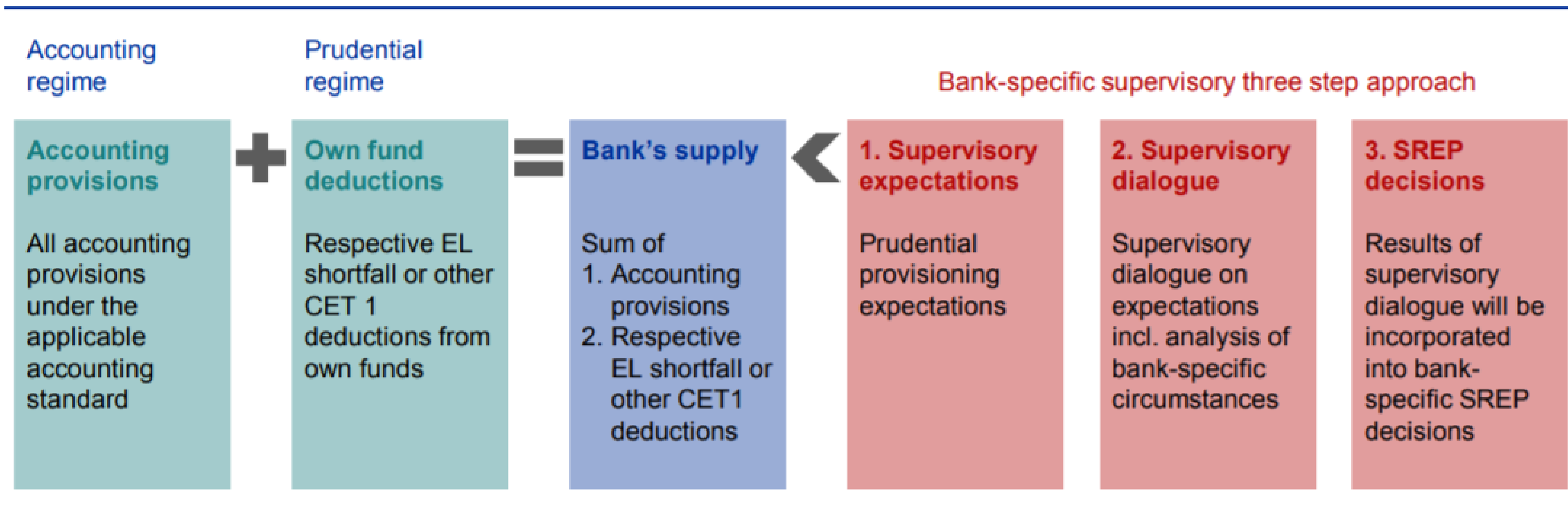
Management of non-performing loans in the current regulatory framework



Source: Addendum to the ECB Guidance to banks on nonperforming loans: supervisory expectations for prudential provisioning of non-performing exposures – March 2018

Management of non-performing loans in the current regulatory framework

As part of the Backstop Regulation Programme, Regulation UE 2019/630 has also been published, which complements the CRR and whose main amendments concern:

1. the introduction of minimum coverage percentages for impaired exposures differentiated by part of the secured and unsecured exposure: institutions shall deduct from Tier 1 capital the difference between:
   - the amount of the minimum coverage identified pursuant to Article 47 quarter, paragraph 1(a), and
   - provisions and amounts written off relating to the individual position*.
2. The possibility of adopting a partial derogation regime from these percentages provided for non-performing exposures for which the first concession measure was granted (forborne non-performing)

The minimum coverage percentages are to be applied for exposures arising **from 26 April 2019** onwards.

* If an impaired exposure is purchased at a price lower than the amount due by the debtor, the institutions shall add to the provisions and amounts written off the difference between the purchase price and the amount due by the debtor.

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Management of non-performing loans in the current regulatory framework

<table>
<tr><th colspan="2">NPL exposure entrance (for exposures born on or after 26 April 2019)</th><th>1st year</th><th>2nd year</th><th>3rd year</th><th>4th Year</th><th>5th Year</th><th>6th year</th><th>7th Year</th><th>8th Year</th><th>9th Year</th><th>10th year</th></tr>
<tr><td rowspan="2">Secured</td><td>NPL part secured by residential properties</td><td></td><td></td><td></td><td>25%</td><td>35%</td><td>55%</td><td>70%</td><td>80%</td><td>85%</td><td>100%</td></tr>
<tr><td>NPL part secured by other personal or real credit protection</td><td></td><td></td><td></td><td>25%</td><td>35%</td><td>55%</td><td>80%</td><td colspan="3">100%</td></tr>
<tr><td>Unsecured</td><td>NPL part unsecured</td><td></td><td></td><td>35%</td><td colspan="7">100%</td></tr>
</table>

- If an impaired exposure is subject to a forborne measure between two and six years after the classification as impaired, for the part of the secured exposure, the coverage percentage foreseen at the date the concession measure was granted is applicable for a further year;

- if an impaired exposure is subject to a forborne measure between one and two years after classification as impaired, for the unsecured portion of the exposure, the coverage percentage foreseen at the date the concession measure is granted is applicable for a further year.

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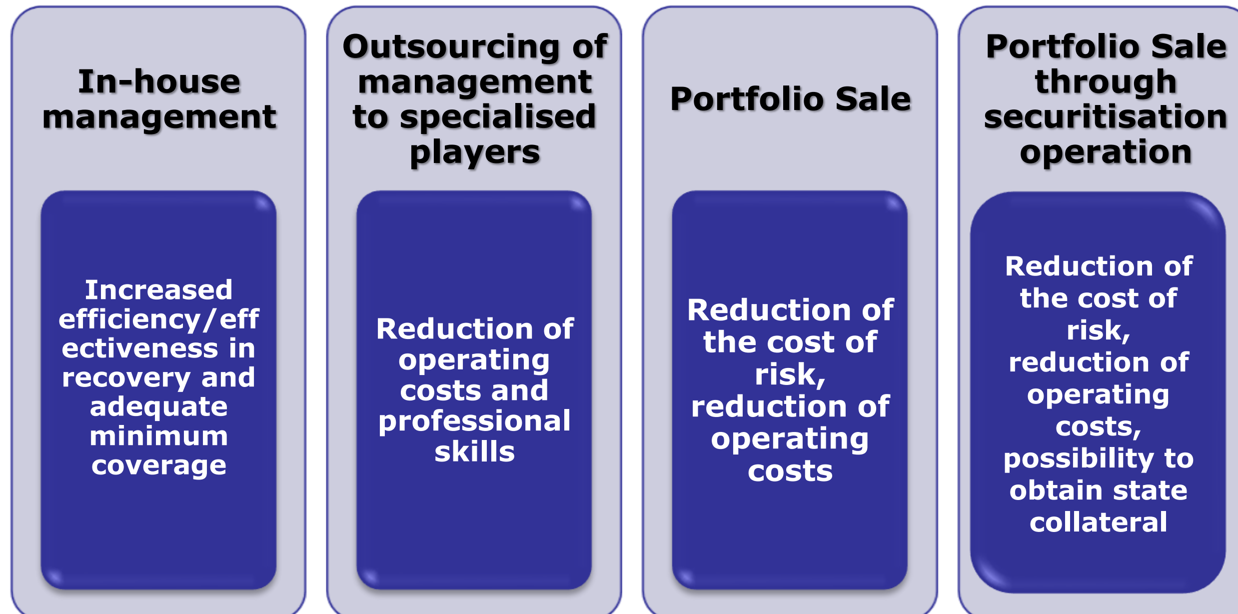
Management of non-performing loans in the current regulatory framework

The reduction of non-performing loans, therefore, can be attributed to the right mix of the following strategies:



The elaboration and implementation of strategies for the management of non-performing exposures require a careful assessment of the operational context, both internal and external, and the possible effects deriving from them.

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Management of non-performing loans in the current regulatory framework

Internal capacity/self-assessment

In order to determine the severity of the impaired loan portfolio component, each bank should conduct robust qualitative and quantitative analyses to understand:

- ***Entity and causes of credit impairment***: size and evolution of NPL portfolios, determinants of NPLs inflows and outflows, correlations and causality links
- ***Outcome and management measures of NPLs undertaken in the past***
- ***Operational capacity***: procedures, tools, data quality, personnel/professional skills, decision-making process, provisioning policies, guarantee evaluation, debt recovery, granting measures, etc.

Management of non-performing loans in the current regulatory framework

Conditions and external operating environment

It is also necessary to consider the current and prospective configuration of the external operating context:

- ***Macroeconomic context***
- ***Market expectation***
- ***Investors' interest in NPLs***: projections on possible sales probabilities and price (bid-ask gap)
- ***NPLs Servicing***
- ***Legal, regulatory and judicial framework***: possible legal or judicial impediments to enforcement actions on guarantees, duration and average total costs of legal proceedings, tax implications

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Management of non-performing loans in the current regulatory framework

Asset implications

Finally, it is necessary to dynamically assess the capital implications on financial statements, integrated into strategic and management processes, for example:

- ***Definition of the business plan/budget***
- ***Definition of risk appetite (RAF)***
- ***Determination of the internal capital adequacy assessment process (ICAAP)***
- ***Determination of recovery plans***
- ***Definition of remuneration and incentive policies***

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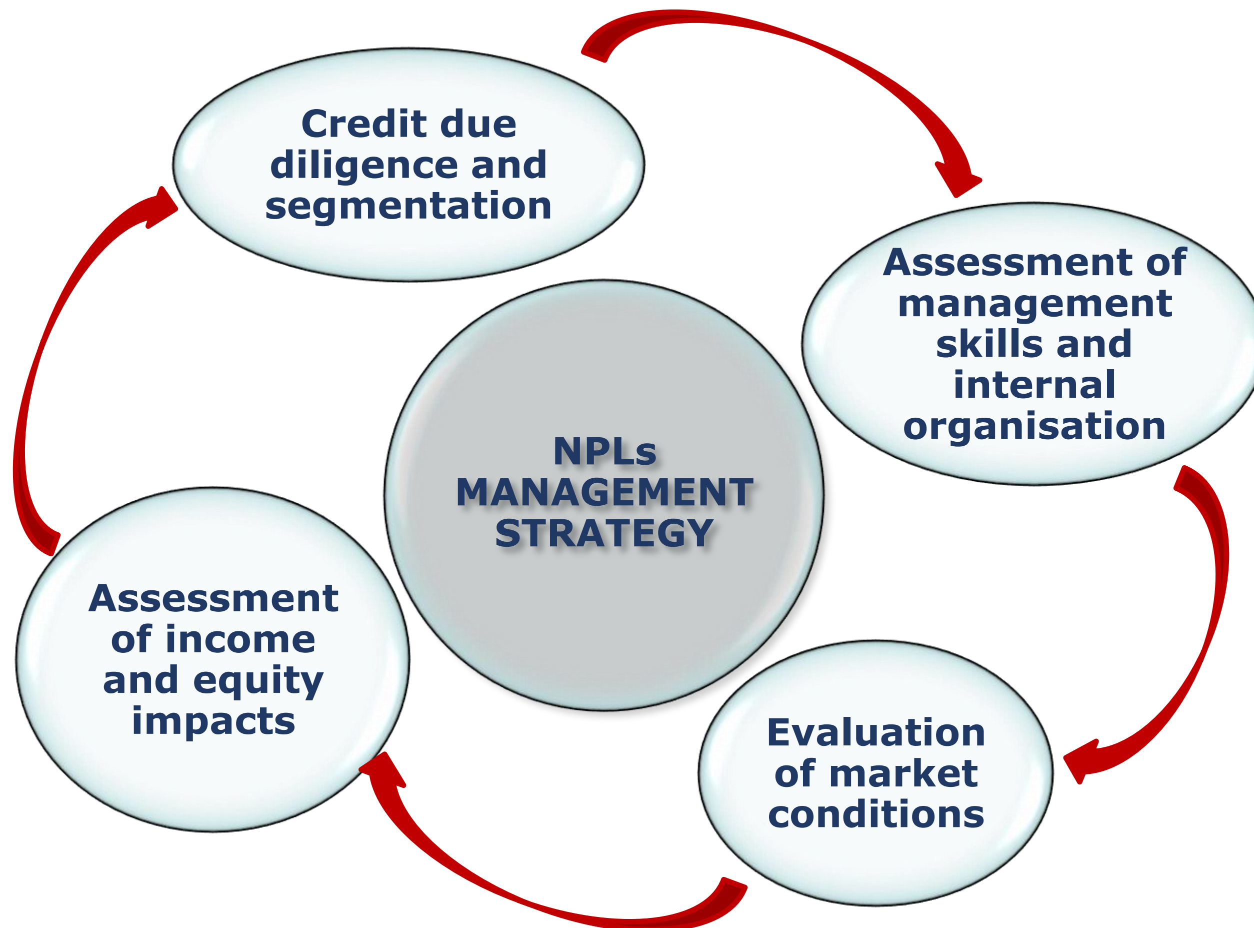
Management of non-performing loans in the current regulatory framework



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Management of non-performing loans in the current regulatory framework

Sale of impaired positions

The sale of impaired loans on the market is increasingly frequent, also through securitisation operations.

Although the sale of bank assets reduces high internal management costs and improves the bank's asset quality, it exposes the bank to negative economic and financial impacts due to the high discount rate granted to investors which, on the one hand, directly affects profits and equity and, on the other, the loss given default due to the worsening of recovery rates.

BID-ASK SPREAD

- ***Data quality:*** poor visibility of the assets sold due to the lack of homogeneous, organised and complete data in internal databases;
- ***Servicing***: poorly efficient and specialised debt collection market;
- ***Time to recovery:*** uncertainty about the time needed for credit recovery and future cash flows.

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Management of non-performing loans in the current regulatory framework

Sale of impaired positions

Market conditions are also pushing towards widening the bid-ask spread:

the market for investors is currently very thin;

high structural costs and high management fees, borne by investors, raise the minimum acceptable interest recovery rate.

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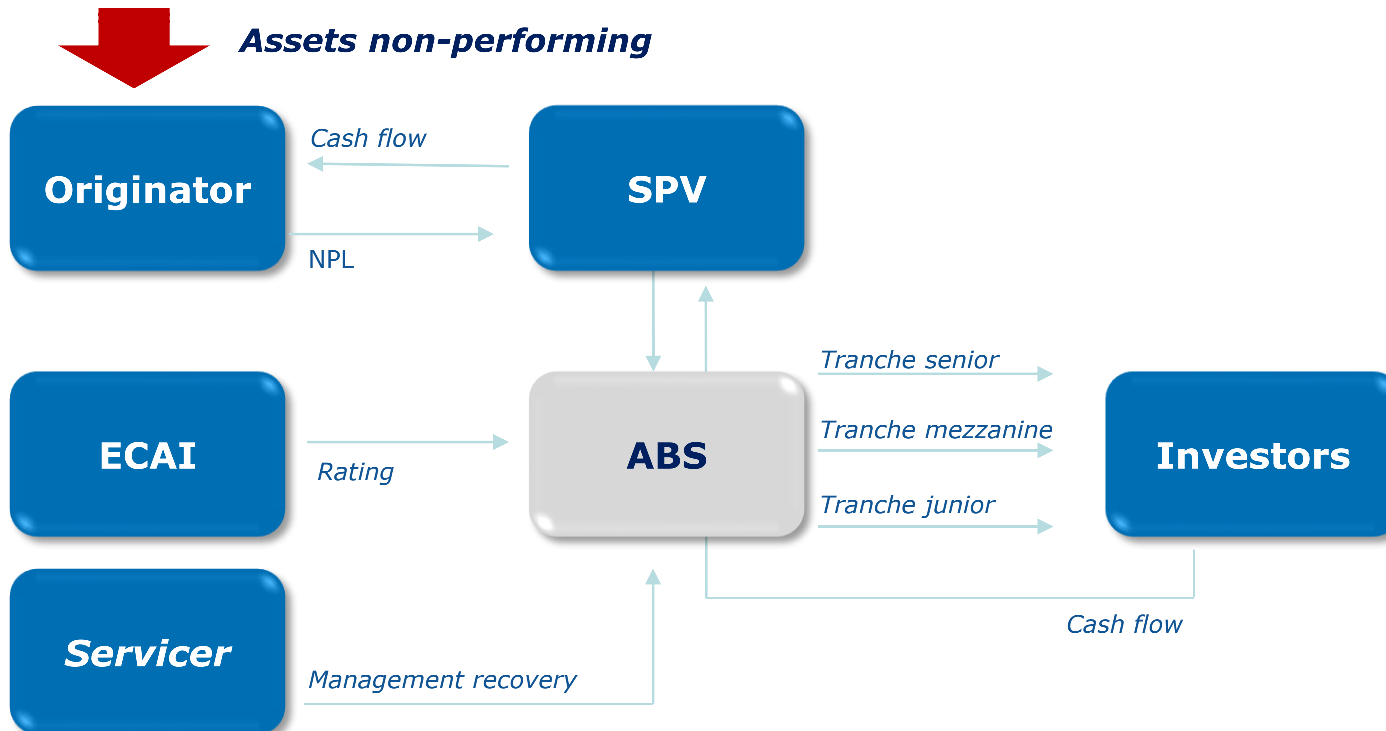
Management of non-performing loans in the current regulatory framework

The use of credit securitisation operations remains a valid form of reducing the risk of default, financing for the banking sector and disposal of impaired loans.



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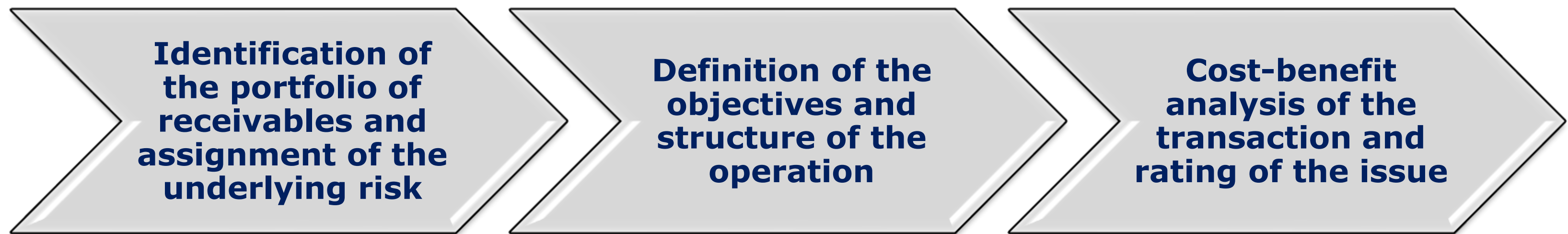
Management of non-performing loans in the current regulatory framework

Three main phases of an NPLs securitization operation:



Moreover, the securitization of non-performing receivables requires the selection - within a model representative of the portfolio subject to the transaction - of a sample of receivables to be subjected to an appropriate documentary due diligence, aimed at defining the "quality" of the debtors.

All this not only for the purpose of a correct formulation of the price, but also for the drafting of a business plan (by the servicer/originator) in relation to the percentage of receivables expected to be recovered, as well as the amount of costs to be incurred for this purpose

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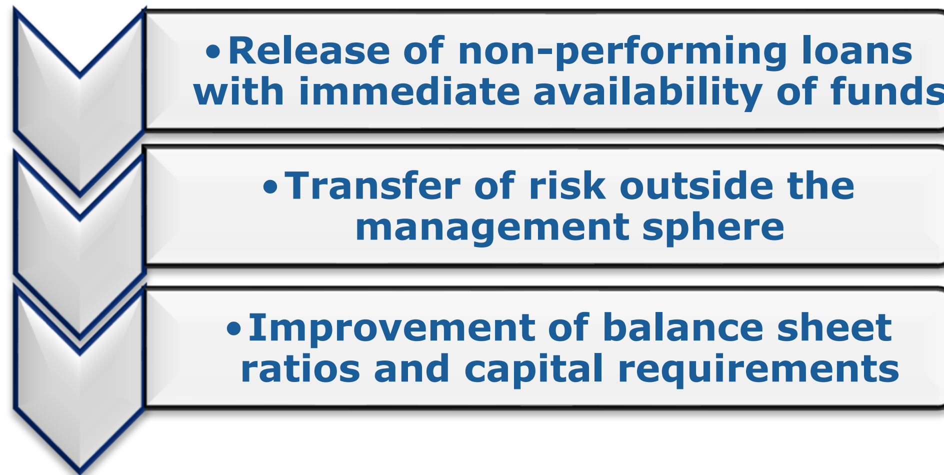
Management of non-performing loans in the current regulatory framework

The NPLs sales by banks has some economic and financial objectives:



It also allows for the management of:

- Reduce the management costs of problematic assets;
- Diversify sources of funding.

Management of non-performing loans in the current regulatory framework

However, sales operations exposes credit institutions to the following disadvantages:

High operating costs due:
- due diligence activities
- administrative expenses
- external warranty claim

Reputational risk

High organisational effort

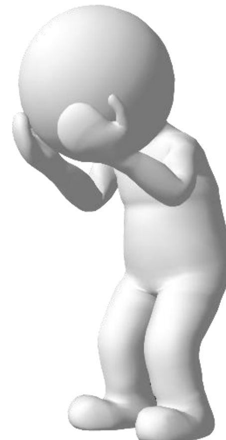
NPLs classification in the context of Covid-19

NPLs classification in the context of Covid-19

The outbreak of the **COVID-19 pandemic** and the response measures that have been adopted in many countries across the globe and in the European Union, including various forms of

population confinement, **have significant economic consequences.**

In particular, many businesses and private individuals affected by the crisis **may face liquidity shortages and difficulties in timely payment** of their financial and other commitments



This could in turn have an impact on credit institutions, as **delays in the repayment of credit obligations lead to a larger number of defaults and increased own funds requirements** for credit institutions

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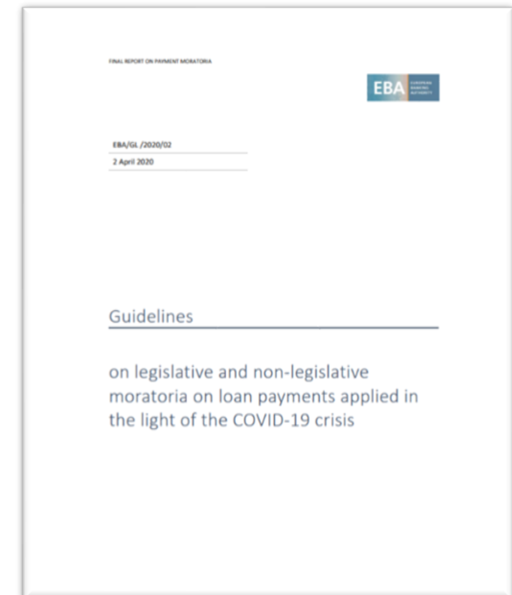
NPLs classification in the context of Covid-19

In these circumstances **Member States have implemented a broad range of support measures.** These measures include, in many circumstances, some forms of **moratorium on payments of credit obligations**, with the aim of supporting the short-term operational and liquidity challenges faced by borrowers.

As these moratoria in practice are adopted in various forms across jurisdictions, **clarification is necessary on the application of the definition of default and classification of forbearance in the context of these various measures.**

For this reason the European Banking Authority (EBA) published on April 2020 the **Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis**


EBA

EBA/GL/2020/02
2 April 2020

Guidelines

on legislative and non-legislative moratoria on loan payments applied in the light of the COVID-19 crisis

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NPLs classification in the context of Covid-19

- These guidelines provide **best management practices** for exposures benefiting from the Covid-19 moratorium on payment for their **classification as NPLs**

- This type of moratorium, called **general payment moratorium**, can be granted by banks and other financial institutions that work as lenders of funds

- The clarifications provided are in line with:
  - Article 178 of Regulation (EU) n. 575/2013 (Capital Requirement Regulation, CRR)
  - Commission Delegated Regulation (EU) n. 2018/171 on the materiality threshold for credit obligations past due
  - EBA Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013.

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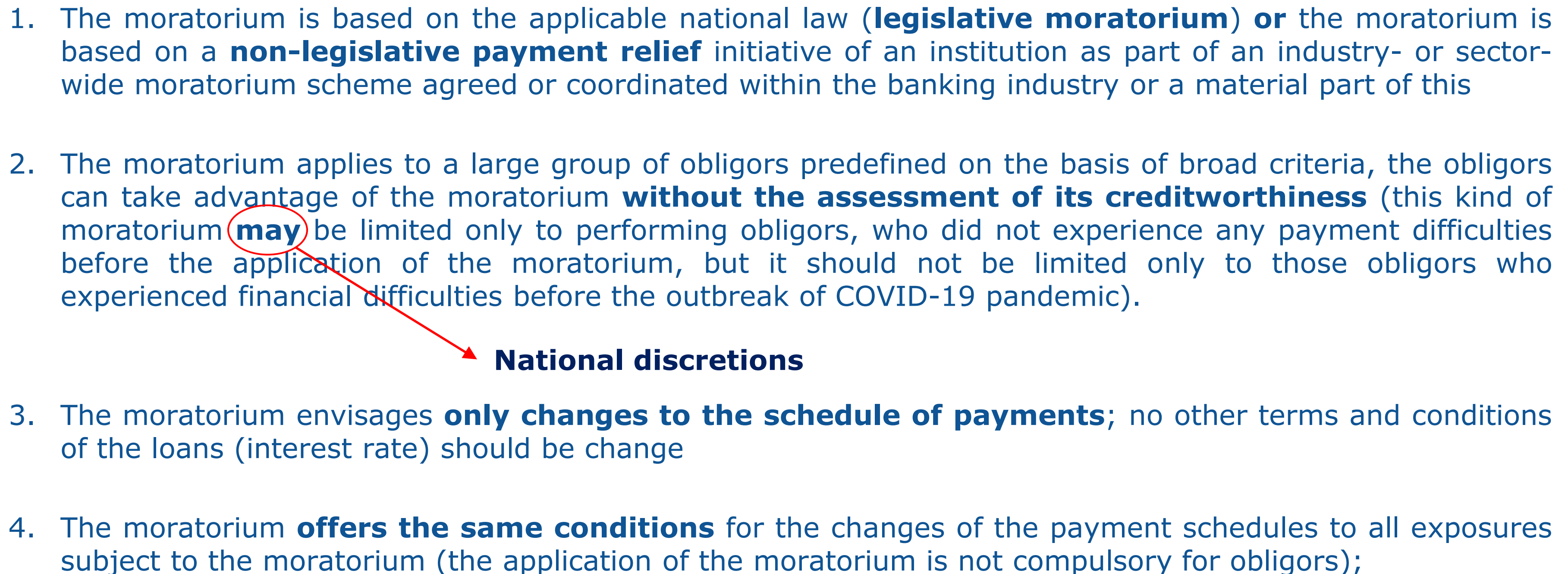
NPLs classification in the context of Covid-19

In particular, a moratorium should be considered a general payment moratorium where **all** of the following conditions are met:



1. The moratorium is based on the applicable national law (**legislative moratorium**) **or** the moratorium is based on a **non-legislative payment relief** initiative of an institution as part of an industry- or sector-wide moratorium scheme agreed or coordinated within the banking industry or a material part of this

2. The moratorium applies to a large group of obligors predefined on the basis of broad criteria, the obligors can take advantage of the moratorium **without the assessment of its creditworthiness** (this kind of moratorium **may** be limited only to performing obligors, who did not experience any payment difficulties before the application of the moratorium, but it should not be limited only to those obligors who experienced financial difficulties before the outbreak of COVID-19 pandemic).

   National discretions

3. The moratorium envisages **only changes to the schedule of payments**; no other terms and conditions of the loans (interest rate) should be change

4. The moratorium **offers the same conditions** for the changes of the payment schedules to all exposures subject to the moratorium (the application of the moratorium is not compulsory for obligors);

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NPLs classification in the context of Covid-19

In particular, a moratorium should be considered a general payment moratorium where **all** of the following conditions are met:

5. the moratorium does not apply to new loan contracts granted after the date when the moratorium was announced

6. The moratorium **was launched in response to the COVID-19 pandemic and was applied before 30 September 2020**. However, this deadline can be revised in the future depending on the evolution of the current situation associated to the COVID-19 pandemic.

A specific amendment published in June 2020 **postponed the deadline from 30 June to 30 September** due to the prolonged economic crisis linked to the pandemic.

NPLs classification in the context of Covid-19

When moratorium meets the conditions defined, **such measures should not change the classification of exposures**

In order to **application of the definition of default** to exposures subject to payment moratoria, the exposure should be treated in accordance with paragraphs 16 to 18 of the EBA Guidelines on the application of the definition of default

Par. 16*: Where there are modifications of the schedule of credit obligations the institution's policies should clarify that* ***the counting of days past due should be based on the modified schedule of payments****.*

EBA/GL/2016/07
28/09/2016

Final Report

Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013

Par. 18*: Where the repayment of the obligation is suspended because of a law allowing this option or other legal restrictions,* ***the counting of days past due should also be suspended during that period.***

Consequently institutions **should count the days past due based on the revised schedule of payments, resulting from the application of any moratorium**

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NPLs classification in the context of Covid-19

When moratorium meets the conditions defined, **such measures should not change the classification of exposures**

In order to **application of the definition of forbearance** to exposures subject to payment moratoria, the exposure should be treated in accordance with Article 47b of Regulation n. 575/2013

- The application of the general payment moratorium in itself **should not lead to reclassification of the exposure as forborne (either performing or non-performing)**

- Also where institutions **grant new loans** to obligors subject to a general payment moratorium, **this does not automatically lead to reclassification of exposures as forborne**

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NPLs classification in the context of Covid-19

In the **assessments of unlikeliness to pay** of individual obligors **following the end of the application of the moratoria** that respect the defined conditions, institutions should prioritise the assessment of the following cases:

- ❑ where obligors **experience payment delays** shortly after the end of the moratorium
- ❑ where any **forbearance measures** are applied shortly after the end of the moratorium

Institutions should perform the **assessment of unlikeliness to pay based on the most up-to-date schedule of payment**, resulting from the application of the general payment moratorium.

Where any **additional supportive measures** (<u>public guarantees</u>) set out by public authorities in response to the COVID-19 pandemic are available to the obligor and **may affect its creditworthiness, these should be taken into account in the assessment of unlikeliness to pay**

EaSI Technical Assistance

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