# Keepling Insights

# NON PERFORMING LOANS

**NPL are loans that are subject to late repayment or unlikely to be repaid by the customer. NPL management is a key issue for banks and supervisors which shall require regulatory and operational adjustments in the near future.**

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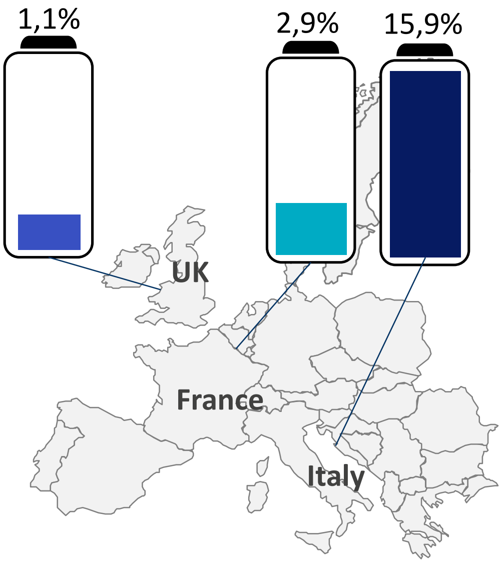
## NPLs - facts and figures

The financial crisis and the ensuing recessions aggravated the inability of many borrowers to pay back their loans which in turn led to a build-up of non-performing loans in many banks.

NPLs deteriorate the banks' profitability and threaten their ability to provide financing to the real economy. Average pre-crisis NPL levels in the European Union which were around 2 to 3% reached 7% in 2012-13 and even 8% if one looks at the broader euro area. In some countries such as Cyprus and Greece it even climbed above 45% of total outstanding loans.

The conjugated effects of the worldwide economic recovery and the actions recently taken by banks have slightly improved the situation: ratios are now down to 5%, which remains an elevated level compared to international standards for Banking Supervisors.




Additional actions must be initiated, both on banks and supervisors' side, to durably and significantly clean banks' balance sheets and reduce the inventory of NPLs. It will require an arsenal of preventive and curative solutions.

## Why is it so difficult to reduce level of NPLs ?

The reduction of NPLs level is a difficult exercise as the solutions all raise significant difficulties.


The management of NPLs is something banks are often not (enough) prepared for. It requires dedicated workout teams or at least association with partners having such specific resource and expertise. It also requires due diligences and the ability to classify / segment NPLs portfolios prior to their sales.

Legal and/or operational barriers make the sale of NPLs particularly difficult in some countries. From unbalanced insolvency regime to inefficient judiciary process against non-performing borrowers, all these elements, outside of the control of banks, can be detrimental to NPL management by increasing time and costs to make recoveries or widening the bid/ask spread on NPL markets.

The importance of the gap between the bank's current book value and the market prices of NPLs is a strong barrier as investors in such assets factor in their prices all the uncertainty around the borrower, the time to recover value and their view of the economic situation of the area which is traditionally more bearish than the banks' view.

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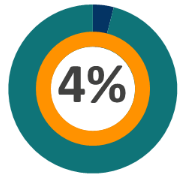
National AMC, which are often presented as a tool if not the solution, are never easy to set up as EU rules on State Aid prevent government to support such structures.

Cause or consequence, the NPL secondary market is still very limited due to persisting operational difficulties and psychological barriers.




The transaction volume remains limited to only 4%* in France. In addition, there is a lack of competition between purchasers, no real representative pricing and a low level of liquidity.

* Up to 21% in the UK

## The regulatory and supervisory response

03/17

**ECB**
Guidance on non-performing loans

04/17

**BCBS**
Final guidance on the prudential treatment of problem assets – definitions of non-performing exposures and forebearance

10/18

**EBA**
Final guidelines on Management of non performing and forborne exposure | FTA 6/19

12/18

**EBA**
Final guidelines on disclosure of non-performing and forborne exposure | FTA 12/19

In April 2017, the **BCBS** published its guidance on prudential treatment of problem assets (PTA), which provides harmonized definitions for “non-performing” and “forborne” exposures, including entry and exit criteria (BCBS (2017)).

The Basel framework does not refer to NPLs but to “problem assets” (Core Principle 18), “defaulted exposures” (Basel II rules text paragraph 452) and “past-due exposures” (Basel II rules text paragraph 75).

The BCBS definition of NPE includes all exposures that are **defaulted** under the Basel II framework; all exposures that are **impaired** under applicable accounting standards; and all other exposures that are not defaulted or impaired but are material exposures that are more than **90 days past due** or where there is evidence that **full repayment is unlikely**.

The guidance specifies that collateral should not be considered in the classification of an exposure as non-performing; requires the uniform classification of exposures on a debtor basis, outside of retail exposures where a transaction basis is possible; and introduces specific rules to exit the NPE category.

The EBA guidelines aim at reducing NPEs on bank’s balance sheet by providing supervisory guidance to ensure banks effectively manage NPEs and Forborne exposures (FBEs). Development and operationalisation of an NPE Strategy is the cornerstone of these guidelines.

The complementary disclosure guidelines specify the common content and disclosure formats for the information on NPEs, forborne exposure and foreclosed assets banks should disclose.

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## The 2018 EBA guidelines are setting the direction in Europe

This management of NPLs is a major concern for the European Commission. NPL consume capital, require time and effort to manage, raise running costs, all of which can lead bank to reduce their lending activity and hence reduce the effectiveness of the monetary policy. Furthermore the Commission is concerned that a slow-down of the economy could lead this ratio higher again.

In order to improve the situation, national authorities and European institutions have joined forces. The ECOFIN council agreed in July 2017 on an action plan which called upon various institutions to take appropriate measures to help banks to reduce their level of NPLs.

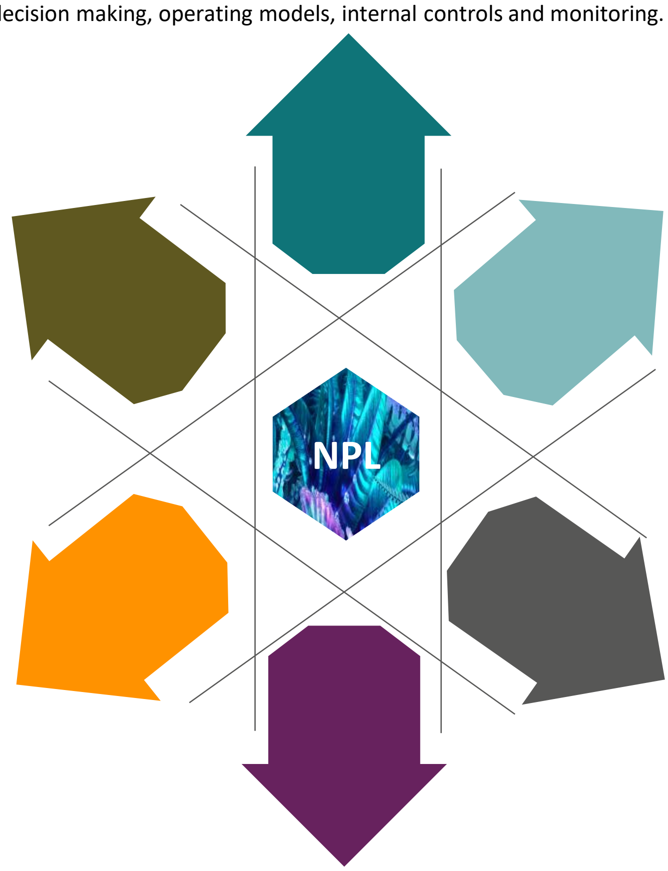
To support their recommendations, the ECB published in March 2017 its “Guidance to Banks on non-performing loans”. This guidance is viewed as a supervisory tool that clarifies and harmonizes supervisory expectations regarding NPL identification, management, measurement and disposals.

It was completed in 2018 with two guidelines from the EBA on Management and Disclosure of NPE and FBE which cover the following six sections.

**Operationalisation**
Set a governance structure and operational process to address NPL issues efficiently and effectively (through sales, securitisation or workout). This should include the adequacy of decision making, operating models, internal controls and monitoring.

**Build a NPE Strategy**
Credit institutions should have a framework to identify, measure, manage, monitor and mitigate NPEs including through workout activities, whilst ensuring fair treatment of consumers.

**Use of forbearance**
Forbearance measures, both short term and long term, should aim to return the borrower to a sustainable performing repayment status. They should also take into account the interest of consumers.




**Recognise NPLs**
Use the EBA definition of a non-performing exposure in the internal risk management and for public disclosures, not just for supervisory reporting.

**Collateral valuation**
Credit institution should have written policy and procedures governing the valuation of property collateral. Value of immovable property collateral should be monitored on a frequent basis.

**Provision NPLs**
Have adequate and consistent procedures to identify the need for provisions and to make adequate provisions according to existing accounting frameworks.

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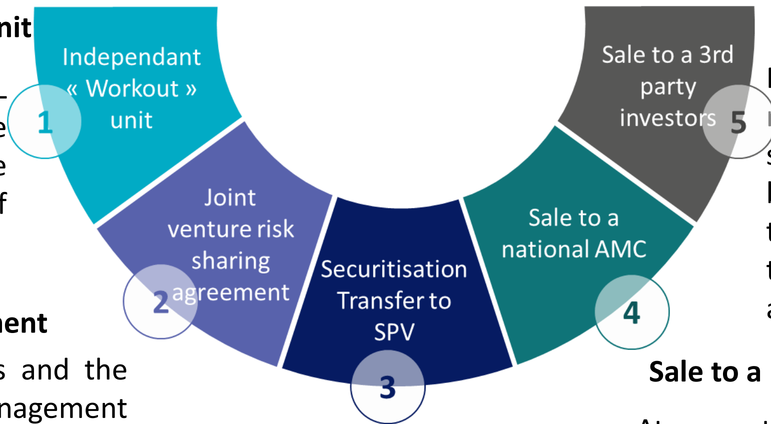
## The credit institutions expected response

## 1st lever of action: widen NPL management techniques

**Externalise all or part of the risks or operational burden incurred by NPLs**




**Independant Workout unit**

Manage down the NPL while interfering as little as possible with the running of the rest of the bank

**JV risk sharing agreement**

Share both the upsides and the downsides from the management of the NPL portfolio that remains on the bank's balance sheet

**Securitisation Transfer to SPV**

Fund the NPL through the sale of tranches of securities to external investors. NPL management may also be undertaken by a third party servicing manager

**Sale to a National AMC***

At present such schemes only exist in a minority of countries

**Sale to a 3rd party**

For this option to be realistic, the bid/ask spread usually needs to be no more than 10 %, so that the "day one" loss to the selling bank remains at a manageable level

* National Asset Management Company

## 2nd lever of action: adapt the operating model

**One of NPLs' challenges is a quick identification in order to set an efficient management**

**Client profiling & targeting**: use available client data to have a better knowledge of the client's behaviour and financial background in order to adapt actions to reduce time recovery and offer them adapted products.

**Smart articulation:** develop a management tool to simplify the communication process between credit and commercial units.

**Prior to loan closing** | **Loan closing** | **After loan closing**

**Optimize legal services** : adopting a value-based compensation model based on the amounts effectively recovered to reduce legal costs and accelerate recovery.

**Collateral** : leverage on information on collateral agreements and define dedicated crash programs to improve collateral management and strategies.

**Early warning and forward-looking models:** process predictive analytics to anticipate incidents and improve credit portfolio quality.

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## What are the next steps?

European supervisors, fully aware of the fragmented landscape in terms of jurisdiction, local accounting policy, and NPL market investors are well aware that forcing banks to sell their NPL is not the best option and that lifting all the impediments is a pre-requisite to efficient NPL level reduction. The Action plan to tackle non-performing loans aims at addressing all these potential barriers:


Non-Performing Loans will remain a key item on the supervisors’ agenda in the coming years. They will build on the work that has already been done to foster progress in reducing the legacy risks and achieve a good coverage of NPL flows over the medium term.

Their inquiry on this matter will become more and more frequent and as soon as the EU institution work on lifting impediments will be achieved, or showing good progress, no doubt that the pressure on banks will increase. As far as banks are concerned and even if, today, the issue is not entirely in their hand, important operational process optimization, improved classification and business cases should be considered to be fully ready when time comes.

* Harmonization of these elements might be able in the future to support the creation of a EU wide AMC, but this is still at that stage a long term project.

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## About us

At Keepling, we specialize in the intricacies of management consulting and business organization. We assist our customers across the Financial Industry at every step of their transformation, from the initial impact study to the implementation phase.

Each one of our Keepling specialists has spent time on the client-side so we know the ins and outs of business and operating models. We have been in our clients’ shoes which enables us to find pragmatic and efficient solutions to their complex problems.

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