



The European Central Bank's September 2016 public consultation on “draft guidance to banks on non-performing loans”

*A quantum leap on tackling NPL issues in the Eurozone and
a possible first step to a Banking Union ‘Pillar IV’?*

Speed read

After months of positioning by various EU, Banking Union and ECB policymakers across a range of speeches, interviews, articles as well as position papers, each calling for collective steps to be taken to tackle impaired assets, non-performing loans (NPLs) and non-performing exposures (NPEs)¹, the European Central Bank (ECB) launched its "public consultation on the draft ECB guidance to banks on non-performing loans"² on 12 September 2016. This consultation is open for submission of comments until midnight (CET) on 15 November 2016. Submissions must be made using a set template and may be made by post or email. A public hearing is scheduled for 7 November 2016 at the ECB's Main Building and a webcast will be made available.

The rules being consulted on are set out in the ECB's "Draft guidance to banks on non-performing loans"³ (the **NPL Guide**). This marks the first serious attempt within the Eurozone to tackle NPLs. Despite being termed an ECB supervisory tool and "non-binding guidance", the content is clear that it sets out supervisory expectations, regulatory guidance and desired outcomes. The NPL Guide thus sets out rules in all but name. These rules have some far-reaching consequences and compliance implications for NPLs and NPEs in retail and the wholesale space. This goes beyond what is currently the law in certain Eurozone jurisdictions.

In summary, the NPL Guide introduces rules on:

- the identification of NPLs;
- rules on calculating, offering and implementing restructuring and/or forbearance measures throughout the NPL's lifecycle;
- specific governance, risk, control function compliance obligations;
- contents of detailed NPL business and operational policies; and
- internal and supervisory reporting obligations.

The NPL Guide is expected to enter into force after the final version is made publically available. The current NPL Guide does not include a phased entry and the expectation is that upon being published compliance with the NPL Guide will flow into the supervisory cycle. Even prior to the adoption of the final form of the NPL Guide, firms caught or likely to be caught by these rules will want to forward plan resources, expertise and external counsel in how to deliver the required **NPL Self-Assessment Report** for management body and supervisory approval.

NPLs have been a supervisory priority of the ECB since it started its role as lead competent authority in the Eurozone i.e., through Pillar I in Banking Union, the Single Supervisory Mechanism (SSM). They have remained a priority since the start of Pillar II of Banking Union, the Single Resolution Mechanism (SRM) becoming fully operational in January 2016 and are also important to the Pillar III proposals that in November 2015 called for creation of a European Deposit Insurance Scheme (EDIS).

If it goes ahead, the NPL Guide and its rules marks the first welcome step towards a "Pillar IV"⁴ for Banking Union. These rules, even absent any concurrent structural mechanism, would contribute to tackling Europe's NPL problem through harmonisation and resilience improvements to the Eurozone banking sector due to these rules contributing to the Banking Union's application and finalisation of the EU Single Rulebook on financial within the Eurozone. These resilience improvement measures also aim at delivering deeper integration and economic growth prospects in the Eurozone.

The NPL Guide's contents and possible impacts are examined in detail in this Client Alert along with the supporting published materials⁵. This Client Alert explores these issues as follows:

Part A:
the NPL Guide's
key elements
and key steps

Part B:
background on NPLs
and Eurozone
reforms to date

Part C:
key contacts
and how we
can help

Supervisory developments relating to the NPL Guide should also be read in conjunction with the ECB's actions to streamline other areas of the Single Rulebook as it is applied within the Banking Union. This includes, most recently, the ECB eliminating national options and discretions in relation to **CRR** (Regulation 575/2013/EU) by way of an ECB regulation and a "Guide" (shortened herein as the **NODE Regulation**), which enters into force 1 October 2016⁶.

One thing that is certain is that NPLs and NPEs are costly, even within domestic borders and regimes. They also can cause actual or potential adverse impacts for a wide range of credit institutions, regardless of the institutions' complexity⁷. In the Eurozone, this has some very real fiscal effects⁸. Nearly ten years after the financial crisis that started in 2007, action on NPLs and NPEs has largely been led by individual jurisdictions, often with a specific focus on retail client borrowing in the home loan sector as well as select types of retail commercial debts. In contrast, reforms led by EU or Banking Union/Eurozone policymakers have been piecemeal.

The NPL Guide's proposed scope of application to retail and wholesale NPLs is broader and potentially more far-reaching than equivalent regulatory/legislative responses from certain Eurozone jurisdictions. This is the case, despite certain individual regimes applying to a greater scope of regulated entities than the intended scope of the NPL Guide. Consequently, the NPL Guide's provisions are likely to have varying degrees of impact across the Banking Union. These will be dependent on the business and risk profile of the relevant entity, the size of its NPL and NPE portfolio as well as the existence of tools and measures to identify, mitigate and manage those NPLs and NPEs as they exist both within the regulated entity's capabilities and the relevant jurisdiction in which it operates or in which its NPLs are located.

The ECB's NPL Guide is certainly serious about tackling Europe's NPL problem. It is also an extensive document. 126 pages, split into seven supervisory chapters and seven annexes, are accompanied by 141 pages of analysis in an "NPL Stock-taking document". This useful document, which should be read in conjunction with the NPL Guide, assesses 'best practices' on NPLs from Cyprus, Germany, Greece, Ireland, Italy, Portugal, Slovenia and Spain as well as the shortcomings and areas for improvement. Whilst these

two documents are comprehensive, it is worth noting that the current form of the NPL Guide does have certain parts that are quite detailed whereas other parts are not. Some of the drafting is clear and prescriptive whereas other parts leave room for interpretation. Moreover, there are presently no clear provisions that are designed to be interoperable with other NPL-related structural measures that have been introduced in individual Banking Union jurisdictions, including in relation to asset management companies (**AMCs**) i.e., bad banks. These differences, including differences to NPL rules in individual jurisdictions might cause confusion and potential for further fragmentation.

Before delving into the detail, it is important to note that the NPL Guide, whilst an English language document, is drafted in parts by non-native English speakers and non-lawyers. Its intended audience, i.e. **NPL Firms**, may use languages other than English and some of the nuances of the drafting in the NPL Guide, including when a "should" really means "must" etc., may be lost in translation.

What should be noted from the outset, is that irrespective of being labelled in various parts as "non-binding guidance" that is merely "reflective of supervisory expectations" etc., the NPL Guide is a set of rules and effectively constitutes what might be the NPL Chapter to the Banking Union's application of the EU-wide Single Rulebook on financial services (itself an on-going regulatory workstream).

Moreover, NPL Firms are required to adopt a "comply and explain" approach in relation to the NPL Guide and, as stated therein, NPL Firms could be subject to supervisory triggers for non-compliance. In other words, there is a strong persuasive argument that NPL Firms, despite being able to take a risk-based and proportionate approach to application of the NPL Guide's content, should comply with the provisions as if they were rules. This is similar to the supervisory culture and interpretative approach of certain Banking Union jurisdictions.

¹ Shortened to "NPLs" unless the context requires otherwise.

² See: <https://www.bankingsupervision.europa.eu/legalframework/publications/html/npl.en.html> for details on how to respond, the documentation being consulted on and relevant legislation.

³ See: https://www.bankingsupervision.europa.eu/legalframework/publications/pdf/npl/npl_guidance.en.pdf.

⁴ Albeit absent any single coordinating body of asset management companies (AMCs) i.e. bad banks that exist across the Eurozone.

⁵ Other key documents include:

- an "NPL Stock-taking document" available here: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/stock_taking.en.pdf; and
- an FAQ document on the NPL Guide available here: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_faq.en.pdf.

⁶ See the ECB Regulation 2016/445 (the **NODE Regulation**). For more analysis on this and how it relates to Banking Union supervised credit institutions please see *inter alia* Kunschke and Huertas "Regulation 2016/445 of the European Central Bank on the Exercise of Options and Discretions Available in Union Law (the NODE Regulation): A Milestone towards a Single Rulebook for all Banks in the EU?" in Issue 8, Volume 31 of the Journal of International Banking Law and Regulation.

⁷ Importantly, credit institutions, especially those with sizeable NPL exposures, typically engage with counterparties or market infrastructure that operate across borders. This means that risks from NPLs/NPEs originating in one jurisdiction can, through the credit institution's balance sheet, translate over into markets and exposures in other jurisdictions. Other transmission channels include the issuance and sale of financial instruments, in particular those that are based on asset classes that are potential or actual NPLs/NPEs. In each instance, these transmission channels exist irrespective of mortgage markets, even given the EU's recent harmonising efforts, still being largely drawn along national lines.

⁸ See, in particular, figure in European Parliament's Briefing dated 18 March 2016 on "Non-performing loans in the Banking Union: stocktaking and challenges" available: [http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574400/IPOL_BRI\(2016\)574400_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574400/IPOL_BRI(2016)574400_EN.pdf).

The current version of the NPL Guide therefore:

APPLIES TO:

- entities regulated as "credit institutions" and which are, for Banking Union supervisory purposes, categorised as "Significant Supervised Entities" (SSEs) and thus subject to direct ECB supervision (ca. 129 firms); and
- international subsidiaries of SSEs, summarised herein as **NPL Firms**.

DOES NOT APPLY TO (BUT MAY BE OF INTEREST FOR):

- entities regulated as "financial holding companies" and "mixed financial holding companies";
- "credit institutions" and which are, for Banking Union supervisory purposes, categorised as "Less Significant Institutions" (LSIs) and thus subject to indirect ECB supervision (ca. 5,000+ firms);
- entities regulated as "credit institutions" but which operate outside the supervisory scope of Banking Union (i.e. domestic banks in the United Kingdom with no presence in the Eurozone);
- branches of credit institutions in non-participating Banking Union Member States;
- lenders that are not categorised and regulated as a credit institution (i.e. an Alternative Investment Fund Management vehicle managing a private debt fund or certain peer to peer lending platforms); or
- providers of NPL management and servicing solutions,

summarised herein as **Non-NPL Firms**.

Why this matters and *who* might be interested

The developments relating to this NPL Guide are likely to be of interest and relevance to a wide range of business units, in-house counsel as well as stakeholder groups responsible for governance, risk and compliance functions within NPL Firms and Non-NPL Firms. In terms of impact, the NPL Guide marks a definitive step, possibly a quasi-quantum leap, to harmonising action on NPLs. It does so in a ‘jurisdiction agnostic’ manner that builds a regime that provides both creditor and debtor with a menu of options, greater certainty and equally operates prior to, or as an alternative to, triggering insolvency law measures in relation to the debtor. The focus on affordability and viability of options that sits at the heart of the NPL Guide looks to preserve payments and manage NPLs sustainably and thus advance

workable solutions, including for those debtors otherwise stuck between the ‘stick of enforcement and the carrot of restructuring’.

The NPL Guide will likely bring with it a number of “*change the business*”, “*run the business*” as well as “*business as usual*” workstreams. It does so on top of a range of EU and Banking Union driven regulatory workstreams along with possibilities for further change ahead, in particular EU goals to create greater pan-European consensus and calibration on insolvency law. Despite this tall order of change ahead, any move to a more level playing field may reduce the costs of compliance and generate greater business efficiency.

Should you wish to discuss any of the contents in this Client Alert in further detail please contact your usual Allen & Overy contact or any member of our multi-jurisdictional ‘Eurozone Team’ and our ‘Banking Union Monitoring Centre’ in Frankfurt via EUROZONE@allenoverly.com. Details of our key contacts and further background material are also available [here](#).



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Part A:

The NPL Guide's key elements and key steps

Who does the NPL Guide apply to?

The NPL Guide is addressed to NPL Firms and introduces far-reaching extraterritorial application as it applies to SSE's branches and 'international subsidiaries'. This would mean that, a hypothetical "AustroMegaBank AG, New York Branch" as well as the hypothetical "Superbanco S.A." and its Russian subsidiary would be covered by the NPL Guide's intended scope of application.

This is important as the inclusion of subsidiaries may open up questions as to the actual hierarchy of legal and regulatory terms or conflicts between rules that are binding on the subsidiary by virtue of being regulated in that jurisdiction and how these interoperate or are compatible with the rules that the NPL Guide imposes on:

- the **parent company** i.e., the NPL Firm in the Banking Union, which must take a "group view" in applying the NPL Guide within its organisation (and probably across brands); and
- the '**international subsidiary**' itself.

As a result, clients will need to carefully examine distinctions and common elements across jurisdictions and assess what this means for its policies, processes and client facing documentation and how to reflect those elements. For some NPL Firms, questions on how to treat and classify certain corporate vehicles or representative offices, some of which may be hard to classify, are important.

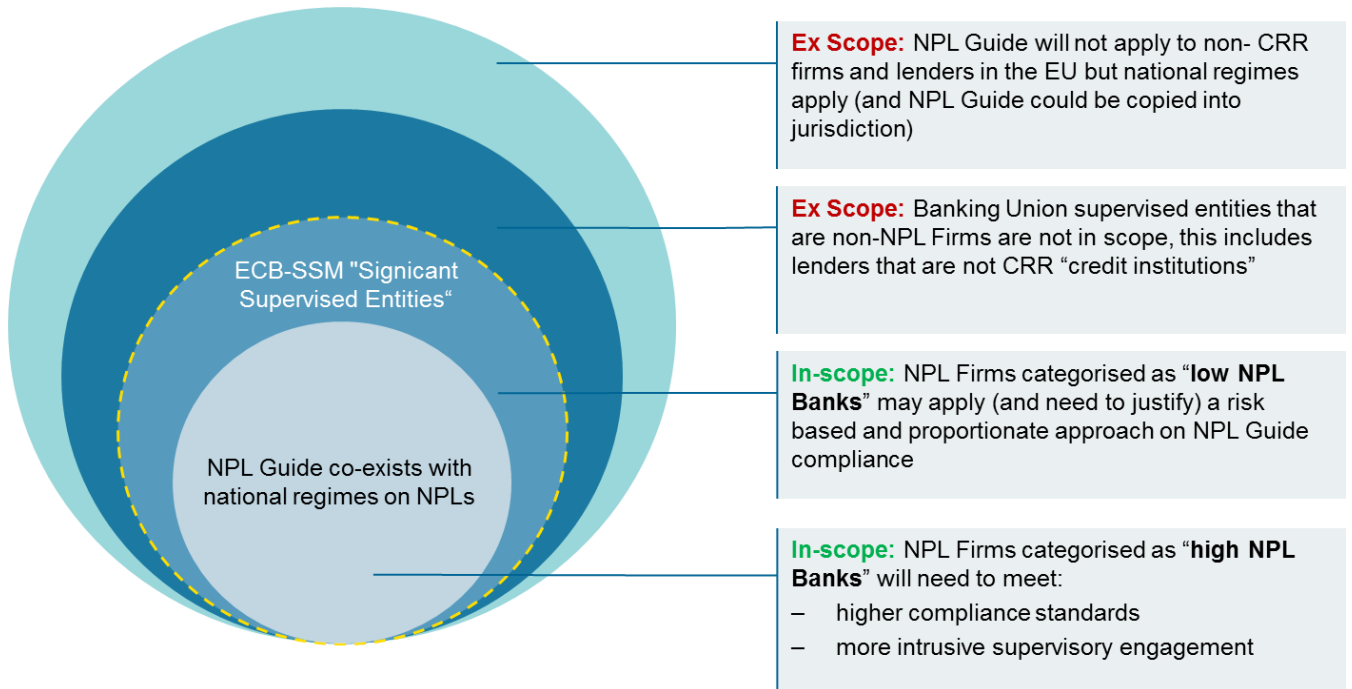
To further complicate matters, the NPL Guide distinguishes between those NPL Firms that are:

- "**high NPL banks**" – defined as "*banks with an NPL level that is considerably higher than the EU average*"¹; and
- "**low NPL banks**".

The NPL Guide does not define what is meant by "*considerably higher than the EU average*". This distinction is however important as it holds the high NPL banks to a stricter standard of compliance with the NPL Guide's rules and reporting obligations whereas low NPL banks are able to adapt a more flexible, proportionate and risk-based approach to their compliance. This supervisory approach is not new, however there may be scope for disagreement between a supervised NPL Firm and the ECB's joint supervisory teams (**JSTs**) or amongst the national competent authorities in the SSM as to how well compliance is met but equally whether a low NPL bank is effectively a high NPL bank. An NPL Firm might be seen by different supervisors in different ways and low NPL banks may need to justify their decisions in a more detailed manner.

¹ Despite the NPL Guide's frequent use of the word "bank", this term has no defined legal meaning in EU legislation or in rulemaking instruments that are specific to the Eurozone or ECB. The correct term in EU legislation is, as per CRR, "credit institution".

How the "high NPL bank" categorisation affects the scope of the NPL Guide's application



How are the rules and the NPL Guide structured?

Aside from language issues and how the NPL Guide's rules are positioned, the contents of the NPL Guide may differ from what NPL Firms might be accustomed to in certain jurisdictions. This also includes those jurisdictions where the NPL Guide has taken inspiration from and drawn upon experiences of national supervisors and their approaches, concepts and materials.

The NPL Guide's current drafting does have degrees of conceptual gaps, contradicting statements, divergences and overlapping elements within its 126 pages.

In addition, the NPL Guide's rules do not in any way 'switch-off', waive, disapply or move the pecking order of supervisory priorities, legislation and regulation in each of the constituent jurisdictions of the Banking Union, including those with multiple competent authorities that are responsible for supervision of activity that this NPL Guide concerns itself with.

As an example, statutory codes in Spain or Ireland, notably the Central Bank of Ireland's third version of the Code of Conduct on Mortgage Arrears (**CCMA3**) (from which the NPL Guide draws some inspiration) continue to apply. Where conceptual differences exist between what is expected in the NPL Guide and what is expected by the national regime, NPL Firms should strive to find a middle ground that does not breach binding rules. The NPL Guide is clear that the provisions do:

"...not intend to substitute or supersede any applicable regulatory or guidance from existing EU regulations or directives and their national transpositions or equivalent or guidelines issued by the European Banking Authority (EBA). Instead, the guidance is a supervisory tool with the aim of clarifying the supervisory expectations regarding NPL identification, management, measurement and write-offs in areas where existing guidelines are silent or lack specificity. Where binding laws, accounting rules and national regulations on the same topic exist, banks should comply with those. It is also expected that banks do not intend to enlarge already existing deviations between regulatory and accounting views in light of this guidance, but rather the opposite: whenever possible, banks need to foster a timely convergence of regulatory and accounting views where those differ substantially."

It is not clear how granular the concept of "same topic" is likely to be interpreted by Banking Union supervisors. Despite these issues, the NPL Guide, in its 'jurisdiction agnostic' approach, does aim to fill the gaps in the EU's fragmented NPL toolkit. It provides a foundation for common rules where these have either diverged or failed to even exist. However, it only does this for those NPL Firms in scope, with Non-NPL Firms and their regulators (including conduct of business supervisors) being left in a position to either not apply, apply or even 'gold plate' the NPL Guide's provisions, especially where they have extensive NPL portfolios. Specifically those LSI's or those categorised as "High-Priority LSIs" for Banking Union supervisory purposes will need to take note of how the NPL Guide applies or might apply to their operations. Consequently, this creates a potentially multi-tiered supervisory environment with a possibility of further divergences in rules. The same applies for non-Banking Union credit institutions operating within the EU.

The NPL Guide does not create a hierarchy as to how these issues might be resolved. Nor does the NPL Guide create common rules for how to deal with asset management companies (AMCs) i.e. bad banks, nor principles on interoperability amongst AMCs or the operations of AMCs themselves.



Nevertheless, the NPL Guide clearly states that it forms part of the "...*basic framework for conducting the supervisory evaluation... in this area*" furthermore "*it is expected that [relevant supervised entities] will apply the guidance proportionately and with appropriate urgency, in line with the scale and severity of the NPL challenges they face*".

The supervisory expectation that NPL Firms self-assess and then justify their standards and level of compliance to the Banking Union supervisors is new. Documented consideration, discussions and even disagreements could arise.

These disagreements could arise between ECB and the national authorities, including those conduct of business supervisors given that the ECB's SSM mandate is limited to *prudential* supervision and NPLs, parts of the NPL Guide even, straddle the divide between what is understood¹ as *conduct of business* regulatory issues and *prudential* regulatory issues despite both elements being rather intertwined.

¹ There is no generally accepted definition in legislation, policy or commentary as to what is meant by conduct regulation. A general supervisory and market driven understanding distinguishes "conduct of business" regulation as areas that look at the supervised entity and its firm, the individuals within the firm and the impact that the activity of the aforementioned components may have on elements outside the firm. Prudential regulation looks at the regulatory capital aspects of the supervised entity. The scope and contents of CRR contain elements that fit within the prudential and conduct of business components of regulation. The ECB, in discharging its SSM responsibilities, may inadvertently, due to the overlap, especially in the CRR, on elements that are conduct of business and those that are prudential regulatory issues, engage in 'mission creep'.



The NPL Guide’s structure aims to follow the “lifecycle” of NPL management:

Chapter	Title	Introduces rules, supervisory expectations or compliance obligations? (Y and/or N)	Contents:
1	Introduction	N	Sets the scene, introduces key concepts and key regulatory outcomes, explains the positioning of NPL Guide’s rules vis-à-vis national laws, accounting principles and regulatory requirements
2	NPL strategy	Y	Sets out the supervisory expectations on self-assessment of capabilities, establishment of “NPL strategies” and the requirement that NPL Firms design and implement an NPL Operational Plan
3	NPL governance and arrangements	Y	Covers the NPL governance and operational compliance requirements i.e. the bulk of how the NPL Strategy and NPL Operational Plan (see below) are to operate
4	Forbearance	Y	Details the rules on affordability assessments and stipulates the range of “standardised” forbearance and restructuring solutions that the NPL Guide considers common
5	NPL recognition	Y	Provides a short outline on selected issues regarding calibration of terminology and what constitutes an NPL/NPE. Specifically, it contrasts the views taken in a regulatory context with accounting rules. The contents of this Chapter aim to assist calibration on terminology (including consistent terms within the NPL Firm) and ensuring accurate capture and categorisation of assets so that they are either in or out of scope of the NPL Guide’s rules and are accurately categorised as to when they are either: <ul style="list-style-type: none"> – in arrears; – non-performing; – performing but forborne; – non-performing but forborne; or – when they exit or are “cured” of their non-performing status
6	NPL impairment measurement and write-offs	Y	Introduces principal objectives that NPL Firms must implement and apply namely: <ul style="list-style-type: none"> – adequate measurement of impairment provisions across all relevant portfolios through sound and robust provisioning methodologies; – timely recognition of loan losses within the context of relevant and applicable accounting standards (IAS/IFRS in particular) and timely write-offs; and – enhanced procedures, including significant improvement to the number and granularity of asset quality and credit risk management disclosures
7	Collateral valuation for immovable property	Y	Introduces key rules on how immovable property valuation is to be administered and how compliance is to be tested and audited

Chapter	Title	Introduces rules, supervisory expectations or compliance obligations? (Y and/or N)	Contents:
Annexes			
1	Glossary	N	Contains a glossary of abbreviations/terms used plus references to their origin
2	Sample of NPL segmentation criteria in retail	Y&N	Introduces a sample of NPL segmentation criteria for retail portfolios which may be the basis for some NPL Firms on how to categorise types of NPLs
3	Benchmark for NPL monitoring metrics	Y&N	Contains an indicative set of metrics that may be used by NPL Firms in assessing performance as part of review and benchmarking against their NPL Strategy and the NPL Operational Plan
4	Samples of early warning indicators	Y&N	Provides an indicative sample of early warning indicators from various sources, segmentation levels and customer/sector types which may assist NPL Firms in designing their own metrics
5	Common NPL-related policies	Y	Details a list of policies/procedures (see overleaf) that NPL Firms are expected to implement and which high NPL firms are required to review and approve at least annually
6	Affordability assessment for retail and corporate borrowers	Y&N	Gives examples of key items to consider and analyse as part of any affordability assessment for retail and corporate borrowers as well as the types of documentation to be provided
7	Summary of supervisory reporting and disclosure items related to NPLs	Y	Summarises the NPL Guide specific supervisory reporting and disclosure items

The NPL Guide's key requirements

The NPL Guide requires that NPL Firms develop a written **NPL Strategy** and document how it is implemented in an **NPL Operational Plan**. Before developing a strategy, a plan and drafting relevant policies, processes and procedures that the NPL Guide requires (collectively, the **NPL Business Policies**), all NPL Firms are required to collate findings from a self-assessment of their NPL capabilities and the impact of external factors into an **NPL Self-Assessment Report**. This is likely to be a detailed, possibly lengthy, exercise and the final document is subject to management body approval and supervisory team sign-off. Early planning and allocation of action points is therefore encouraged. The NPL Guide specifically mentions that external advisers may assist in the validation and approval process in preparing an NPL Self-Assessment Report.

The NPL Self-Assessment Report, the NPL Strategy and the NPL Operational Plan (including the NPL Business Policies), as the core compliance documents, are likely to be subjected to supervisory scrutiny, both at inception of these rules and on an on-going basis. Consequently, they are working documents, which will require inclusion in the NPL Firm's general compliance review programme as well as any specific compliance monitoring framework driven by the NPL governance framework. This ensures that these core documents and client-facing documentation continue to meet supervisory expectations and the realities of the business operations as opposed to being 'filed and forgotten'.

The NPL Guide is also clear that these core documents all have elements that factor into other supervisory workstreams and reporting obligations. This includes compliance obligations driven by both the SSM as well as national regulations. Those rules are also supplemented by compliance obligations stemming from SSM and national supervisory priorities.

Challenges may arise where a "low NPL bank" receives less SSM supervisory scrutiny than its "high NPL bank" peers or affiliates in the same group, but no such distinction exists when a national regulator, including a conduct regulator, discharges its supervisory powers. These supervisory challenges may need reflection in

NPL Firm's risk assessments as well as the NPL core compliance documents.

To summarise, the NPL core compliance documents include:

NPL SELF-ASSESSMENT REPORT:

- this working document is completed as part of the initial compliance with the NPL Guide's rules and must, following inception, be reviewed periodically and at least annually; and
- NPL Firms must conduct a comprehensive self-assessment of the operating environment, impact of external factors, adequacy of their internal capabilities¹ in dealing with NPLs and the implications that NPLs have on regulatory and economic capital.

NPL STRATEGY:

- NPL Firms must develop and document an NPL-specific strategy;
- high NPL banks' NPL Strategy must be approved by the management body;
- NPL Strategies must set 'sufficiently ambitious time-bound targets' over the short- (one year), medium- (three years) and longer-term (three years plus) and address how these **NPL reduction targets** are to be achieved;
- NPL Strategies must apply a combination of sustainable, action and result-orientated targets;
- the NPL Strategy must review the range of NPL Strategy 'implementation options' and their financial and regulatory capital impact depending on different economic scenarios, market perception/expectation, NPL investor demand, maturity and depth of NPL servicing solutions, regulatory, legal and judicial and tax framework affecting NPLs and also develop a "foreclosed assets strategy" as part of the NPL Business Policies (detailed below);
- the NPL Guide provides non-mutually exclusive examples of implementation options and encourages that NPL Firms ensure that the overall NPL strategy uses a combination of such strategies/options to best

achieve the NPL reduction targets in an effective manner².

NPL OPERATIONAL PLAN AND EMBEDDING OF THE NPL STRATEGY:

- this working document is based on the NPL Self-Assessment Report and details how the NPL Strategy is implemented within the NPL Firm's (risk) culture and throughout the various NPL-related functions;
- the NPL Operational Plan must also detail which organisational changes, governance arrangements (see below), resourcing and staffing of human, financial and technical capital, quality control and interaction with communication plans with internal and external stakeholders are required and implemented to deliver the NPL Strategy;
- NPL Firms are required to set-up (standalone) Workout Units (WUs) which are tasked with day-to-day operation of the NPL Strategy according to the NPL Operational Plan, the NPL Business Policies and the NPL governance framework and related control functions; and
- the NPL Operational Plan also aims to deliver on the regulatory outcome that the NPL Strategy is (emphasis added in square brackets) *“fully embedded in the risk management framework. In that context, special attention should [must] be paid to”* the following (although the list in practice is likely to be longer as a result of SSM and national regulatory requirements) items:
 - the Internal Capital Adequacy Assessment Procedure (ICAAP)³: and, specifically, the NPL Guide requires that all relevant NPL Strategy components are fully aligned and integrated into the ICAAP. High NPL banks are required to prepare the quantitative and qualitative assessment of NPL developments under base and stressed conditions including the impact on capital planning;
 - the Risk Appetite Framework (RAF): and the NPL Guide explicitly mentions that the RAF and NPL Strategy are closely interlinked. As a result, RAF metrics and limits must align with the core elements and targets forming part of the NPL Strategy; and

- the **“Recovery Plan”**⁴: in instances where NPL-related trigger levels and actions form part of the Recovery Plan, NPL Firms must ensure they apply and are in alignment with the NPL Strategy, the relevant targets and the NPL Operational Plan.

IDENTIFICATION OF UNRESOLVABLE NPLS:

- NPL Firms are required to identify which NPL types can be resolved within the NPL reduction targets on an outright basis and/or where changes in the NPL Operational Plan might occur. Those NPLs that cannot, or are unlikely to, be able to be resolved, or resolved efficiently, over a medium-to long-term horizon must, once adequately provisioned, be written-off. This applies to portfolios, segments and/or individual exposures.
- Those NPLs that are identified as unresolvable must be provisioned and worked-out in accordance with the relevant NPL Business Policies.

The general tone of drafting of the NPL Guide's provisions and its supervisory expectations are that NPL Firms are expected to rapidly move away from the pre-crisis approach to NPLs that could be summarised as *“amend, extend and pretend (even pray)”* for NPL resolution and instead focus on achieving workable solutions that focus on *“maximisation of recoveries and ultimate reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio”*.

That being said, in certain jurisdictions, despite the NPL Guide's goal of *“maximisation of recoveries”*, firms may need to observe and comply with jurisdiction specifics that either (i) afford debtors protection from creditor enforcement or (ii) otherwise impose preconditions to enforcement.

In this context it is important to note that parts of the NPL Guide bear resemblance with the obligations, processes and supervisory objectives set out in the Central Bank of Ireland's statutory code⁵, the third version of the Code of Conduct of Mortgage Arrears (CCMA3).

The CCMA3 is comparably more detailed than the NPL Guide and statutory protections or stays on enforcement on the debtor only apply where the debtor meets the code's definition of *‘cooperating’*. This distinction does not exist in the NPL Guide and even where the CCMA3

co-exists with the NPL Guide, absent any consensus in the NPL Guide on how to deal with ‘difficult borrowers’ in a fair manner, friction might arise between the NPL Guide’s goals and national regimes.

¹ Including assessing scales and drivers of NPLs with an appropriate level of granularity, NPL drivers on in-flows, out-flows and the NPL portfolio, where relevant, other potential correlations and causations of NPLs, assessment of previous actions taken on NPL management, including forbearance measures and the success of those implementation actions, operational capacity and readiness in relation to processes, highlighting strengths significant gaps and improvement areas to reach the relevant NPL reduction targets.

² I.e. maximisation of recoveries and ultimate reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio.

³ As defined in Article 108 of Directive 2013/36/EU also known as CRD IV available here: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=EN>. It should be noted that the ICAAP is also likely to interlink with the Internal Liquidity Adequacy Assessment Process (**ILAAP**), which is also an area that the ECB has indicated it would begin supervising more closely along with ILAAP stress-testing progress in 2017 and beyond.

⁴ As required by BRRD, i.e. Directive 2014/59/EU on the recovery and resolution of credit institutions and investment firms available here: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=en>.

⁵ Issued under Section 117 of the Central Bank Act 1989. The CBI may administer administrative sanctions against lenders who fail to comply with the CCMA.



NPL governance, operations and business requirements

If all good things are supposed to come in threes, then Chapter 3 of the NPL Guide provides the 'nuts and bolts' of how the NPL Strategy and the NPL Operational Plan are to be run in practice. For certain Banking Union jurisdictions, notably Ireland, these types of rules may have familiar elements. For others, these requirements may require a raft of reforms and allocation of resources. Even where familiar and common elements exist with national NPL rules in certain Eurozone Member States, NPL Firms are still likely to undertake a gap analysis to ensure they are compliant across their group operations. The compliance requirements that Chapter 3 introduces should be considered in conjunction with the NPL core compliance documents, in particular the NPL Business Policies. The NPL Guide's supervisory expectations state that NPL Firms must:

1. **maintain an NPL governance framework** to assist the NPL Firm's management body in the approval and management of the NPL Strategy and the NPL Operational Plan in delivery of that strategy. As with the NPL Operational Plan, the NPL governance framework (including any of the NPL Business Policies) is permitted to be designed and applied in a matter that is proportionate to the organisation of the NPL Firm and on a risk-based approach that is reflective and relative to their business yet also reflects "...*international and national regulatory guidance*". As stated previously, this presumably means that the NPL governance framework should also reflect those provisions that derive from relevant rules that are in place in individual jurisdictions, including where these are beyond the SSM's supervisory scope.

The NPL Guide's supervisory expectations emphasise that NPL Firms use terms clearly and consistently across the individual business units and at the group level and use a high degree of granularity and clearly defined borrower segments to achieve "portfolio segmentation". An NPL governance framework, like the NPL Strategy and the NPL Business Policies, will thus most likely need to differentiate as to how approaches differ per asset class and client type.

For high NPL banks aside from meeting the NPL Guide's threshold obligations, an NPL governance framework must also include annual and periodic reviews, defined management objectives and incentives for NPL workout activities, ownership of delivery and risk awareness, sufficient internal controls over NPL management processes (including special focus on NPL classifications, provisioning, collateral valuations and sustainability of forbearance solutions) as well as compliance with any regulatory outsourcing arrangements;

2. **implement as part of the NPL Business Policies a dedicated Arrears Management Policy and Forbearance Management Policy** containing guidance on the work-out procedures and forbearance measures, responsibilities throughout the NPL Lifecycle (see below) including hand-over triggers into a WU or between WUs and detail these to the respective NPL portfolio and borrower types. The NPL Guide suggests that some exposures, notably retail NPLs, could have more "industrialised" solutions i.e., call/contact centres supported by dedicated specialists, whereas other more complex relationships or products will require bespoke solutions and staffing and engagement of relationship managers;
3. **apply a detailed collateral valuation policy and procedures including specifically in relation to the valuation of immovable property collateral** with defined policy owners, calibration with the NPL Firms "Risk Appetite Statement", subject to internal reviews of the policy (at least annually) and escalation of changes to the management body for approval as well as a robust internal quality assurance policy and procedure for challenging internal and external valuations. The control framework for this specific policy may be applied on a risk-based and proportionate approach.

Depending on the size and business model of the NPL Firm, this may also impose an obligation that an independent risk management unit carry out the quality assurance checks of this policy, incorporate regular testing on whether

there are sufficient levels of independence in the selection of the external appraiser as well as to back-test and random sample test valuations on a regular basis in addition to any periodic internal audit testing;

4. **maintain clear distinctions on NPL Lifecycles** the NPL Guide terms these as:

- a. the “**Early arrears**” stage i.e. up to 90 days past due. During this stage NPL Firms must focus on initial engagement with borrowers to drive early recoveries and information collection required for a “...*detailed assessment of the borrower’s circumstances (e.g. financial position, stats of loan documentation, status of collateral, level of cooperation, etc.)*”. Information that is received is used to determine the most appropriate workout strategy. NPL Firms may offer borrowers short-term forbearance strategies to stabilise the financial position of the borrower(s) before establishing a suitable workout strategy or NPL Firms may take actions to improve its position “...*for instance by signing new loan documents, perfecting outstanding security, minimising cash leakage, taking additional security if available*”;
- b. the “**Late arrears/Restructuring/forbearance**” stage i.e. starting from 90 days past due onwards. During this stage NPL Firms must focus on implementing and formalising restructuring/forbearance arrangements with borrowers¹. These restructuring/forbearance options are only to be put in place where the borrower(s) have completed and satisfied an affordability assessment and the outcome has concluded that viable restructuring options exist. The NPL Guide emphasises that following completion of a restructuring/forbearance arrangement the NPL Firm constantly monitor the borrower(s) for a clearly defined minimum period given the increased risk before they cease to be NPLs. This period is similar to the EBA’s “probation period” which can run up to three years from the date of the forbearance measure;
- c. the “**Liquidation/debt recovery/legal cases/foreclosure**” or, as simplified herein, the “**enforcement stage**” in which the NPL Firm engages with borrowers for whom no viable forbearance solutions can be found and, based on a cost-benefit analysis, the NPL Guide is clear that the NPL Firm can choose the relevant enforcement measure and speedily proceed to implement it. The NPL Guide is also clear that the NPL Firm themselves can enforce or use “external experts” provided “*sufficient internal control mechanisms are in place to ensure an effective and efficient liquidation process*”. For certain jurisdictions, the types of borrowers and types of debts may mean that enforcement may be more protracted due to a wide array of restrictions on enforcement or a need to do so in a manner that treats the borrower “fairly” i.e., avoids foreclosure and evicting the borrower or its dependents; and
- d. the “**Management of foreclosed assets (or other assets stemming from NPLs)**” or, as simplified herein, the “**post-enforcement stage**”;

5. **maintain a separate and dedicated NPL workout unit (WUs)** that ensures NPL workout activities and engagements with borrowers are tailored to the circumstances. WU staff must be sufficiently well trained and able to deal with the specifics in each stage of the NPL lifecycle. Equally, WUs are required to have clear formal definitions of “hand-over” triggers, which describe when exposures move from regular business units to WUs as well as when there is a handover of management responsibilities from one WU to another WU. These policies are required to be drafted in a manner that allows only for minimal management discretion;
6. **high NPL banks are required to maintain multiple WUs per NPL Lifecycle** and also place exposures into a WU process from the moment exposures go into “early arrears” but at the latest when the relevant exposure is classified as an NPL i.e., at the latest at 90 days past due;
7. **separate duties and responsibilities of staff and have a conflicts of interest policy for WUs** so that client relationship activities (negotiation of forbearance or workout solutions with clients) are distinct from the decision-making bodies related to consideration and approval of the NPL workout. The NPL Guide suggests NPL Firms take a proportionate approach to implement and maintain an “NPL Committee” or, if not proportionate, ensure that potential and actual conflicts are sufficiently mitigated. In contrast to certain jurisdictions, in particular Ireland,

the NPL Guide does not mention a need to treat borrowers fairly in the assessment of the work-out strategy or isolate those borrowers that are not cooperating. Conduct rules of the various national regimes are likely to dictate how to treat clients, in particular retail clients, but the question of how to engage with unresponsive and non-cooperating borrowers is important as this can have an impact on whether an exposure is considered to count towards being an NPL or an NPL that is being resolved;

8. **ensure that WU and NPL relevant risk and control functions have sufficient expertise, experience and training** including (quite boldly) that “...*wherever possible, resources with dedicated expertise and experience should be hired for key NPL workout tasks. When this is not possible banks need to put an even higher emphasis on implementing adequate dedicated NPL training and staff development plans to quickly build in-house expertise using available talent....where it is not possible or efficient to build in-house expertise and infrastructure the NPL WU should have easy access to qualified independent external resources (such as property appraisers, legal advisors, business planners, industry experts) or to those parts of the NPL workout activities which are outsourced to dedicated NPL servicing companies*”;

The NPL Guide requires that NPL-training and development plans should be proportionate and tailored to delivering embedding of the NPL Strategy and the NPL Operational Plan as well as “...*negotiating skills, dealing with difficult borrowers, guidance on internal NPL policies and procedures, different forbearance approaches, understanding the local legal framework, obtaining personal and financial information from clients, conducting borrower affordability assessments (tailored to different borrowing segments)*” and highlighting difference between role and skills required for normal business operations and those tasked with NPLs;

9. **implement performance management metrics for WU staff, individuals and team performance to be monitored and measured on a regular basis** which may include WU-specific appraisal systems, targets, remuneration, incentives (including promoting pro-active remedy of pre-arrears and other early warnings) and employment conditions for staff as well as performance and risk ownership concepts for high NPL banks;
10. **implement and maintain sufficient technical resources, including central storage of NPL-related data** in robust and secured IT systems that still allows easy access to all relevant data and documentation, efficient NPL and workout activity processing as well as tracking and efficient analysis of metrics and performance against the NPL Strategy, the NPL reduction targets and the NPL Operational Plan; and
11. **be supported by an effective and efficient control framework specific to the NPL Strategy, the NPL Operational Plan and the overall business strategy and compliance obligations of the NPL Firm** that apply a ‘three lines of defence’ model with clear allocation and apportionment of responsibilities and escalation channels as well as controls and reviews on a range of quantitative decisions, notably with relation to estimates on impairments and provisioning calculations.

¹ This should be contrasted say with much more rigid requirements in Ireland and the requirement of relevant current and lenders to maintain “Arrears Support Units”, effectively WUs for the retail home loan sector, that may begin to apply from a much earlier stage than what the NPL Guide requires.

Affordability assessments

The NPL Guide focuses on creating “viable forbearance solutions”. The NPL Guide contains “general supervisory guidance” that states that a forbearance solution will be considered viable where:

- A. the institution can demonstrate (based on reasonable documented financial information) that the borrower(s) can “*realistically afford the forbearance solution*”; and
- B. the resolution of outstanding arrears is fully addressed and a significant reduction in the borrower’s balance in the medium- to long-term is expected.

The affordability assessment forms the starting point as to what restructuring or forbearance option may be offered to the debtor by the NPL Firm and whether that option is likely to be viable given the debtor’s circumstances at the time. This assessment must be made with reference to the borrower and its group as well as any connected clients. Affordability assessments must include verification of data provided, including by checking central credit registers and tangible evidence.

Unlike the approach taken in certain jurisdictions, notably Ireland, the NPL Guide does not introduce a ‘standard pack of *pro formas*’ such as the CCMA3 did with its ‘*Standard Financial Statement*’ but instead requires that NPL Firms (and it might be prudent to do this at group level with jurisdictional modules) themselves develop their own “...*standardised financial information templates for retail borrowers and homogenous segments of corporate borrowers (if proportionate)*”. The NPL Guide does point to the CCMA3 Standard Financial Statement and an equivalent template from the Central Bank of Cyprus as possible starting points for NPL Firms to consider.

Forbearance and restructuring measures

In the regulatory preparation of the NPL Guide it became clear that different jurisdictions had different tools, used different names, concepts and systems as well as used different terminology to identify, report and in some instances manage NPLs. Even the definition of NPL itself was not (and still is not) uniform across the EU. The NPL Guide provides a minimum list of common types of forbearance and restructuring measures (i.e. the “*menu of restructuring options*”). It requires that the NPL Firm establish clear policies (presumably as part of the NPL Business Policies) as to how, when and to whom this menu may be offered in compliance with the NPL Strategy. This is a ‘quantum leap’ in comparison to individual responses on NPLs and offers clarity to NPL Firms and their clients.

The NPL Guide is clear that for NPL Firms to deliver on their NPL reduction targets, the supervisory expectation is that NPL Firms should have well defined forbearance policies, linked to the other NPL Business Policies embedded as part of their NPL Operational Plan. The forbearance policy must look at legacy stocks of NPLs but also at preventing future forbearance by inserting control measures and restrictions on when the menu of restructuring options may be applied. NPL Firms are encouraged to use a mix of forbearance options including adjusting these and applying these to specifics relevant to the maturity i.e. short-, medium- and long-term measures.

The NPL Guide contains a detailed yet non-exhaustive list of 14 common types of short-, medium- and long-term forbearance/restructuring measures. This list includes a brief description of their attributes and their “viability” considerations (starting on page 41 to and including page 42 of the NPL Guide). NPL Firms might benefit in contrasting this list with equivalent measures that exist in relevant jurisdictions (to the extent these exist). Otherwise, this list might serve as a good starting point for NPL Firms to build their own “*menu of restructuring options*” that can be included in

their NPL Business Policies. Some differences between the Irish and Spanish provisions and those of the NPL Guide's list of 14 measures may need aligning.

Supervisory reporting

Despite the NPL Guide stating that its rules defer to binding laws, accounting rules and national regulations on the 'same topic', the NPL Guide does introduce standalone supervisory reporting requirements. There is probably little scope that would exempt the hypothetical AustroMegabank AG from only reporting to its national regulators instead of also reporting NPL data to the ECB and the SSM.

Consequently, this may mean that data items are reported multiple times to different sources, which may require changes to IT systems and reporting architecture. Annex 7 to the NPL Guide summarises the NPL-specific reporting obligations, but NPL Firms, in particular high NPL banks must also be cognisant of the internal data and governance reporting items that the NPL Guide requires of them as well as relevant higher standards required of high NPL banks. These in particular are required to:

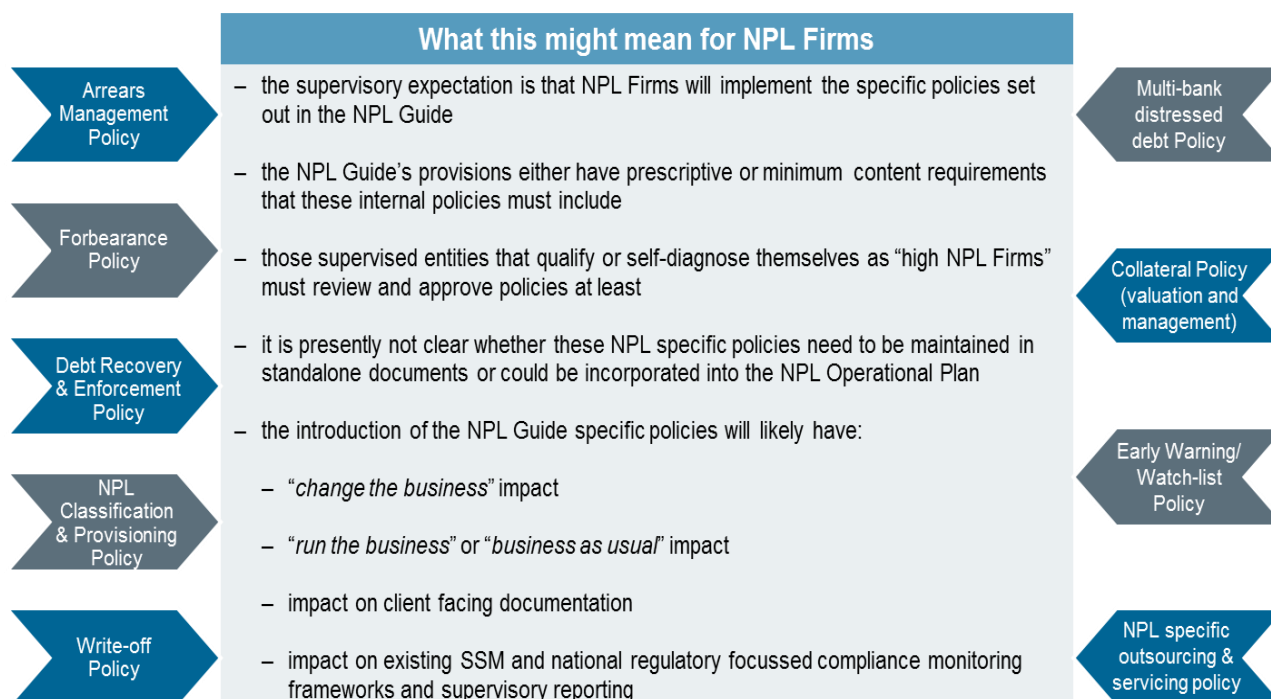
- **report** their NPL Strategy and their NPL Operational Plan to their SSM JST contacts in the first quarter of each calendar year; and
- **submit**, on an annual basis, a completed and accompanying standardised template, Annex 7 of the NPL Guide, which is to be submitted annually and which summarises quantitative targets that the NPL Firm has set itself and the level of progress over the preceding 12 months in meeting those targets.

The management body is required to approve the reporting documents. NPL Firms may have to find solutions so that existing accounting and/or operational cycles that are relevant to the data items that the NPL Guide requires are capable of interoperating. In the case of likely barriers and delays in submitting supervisory reporting data items, the NPL Guide encourages dialogue with the regulator and making potential amendments. NPL Firms are also required to ensure internal NPL reporting and data metrics are clearly understood, applied and monitored for data quality on a range of areas including, but not limited to:

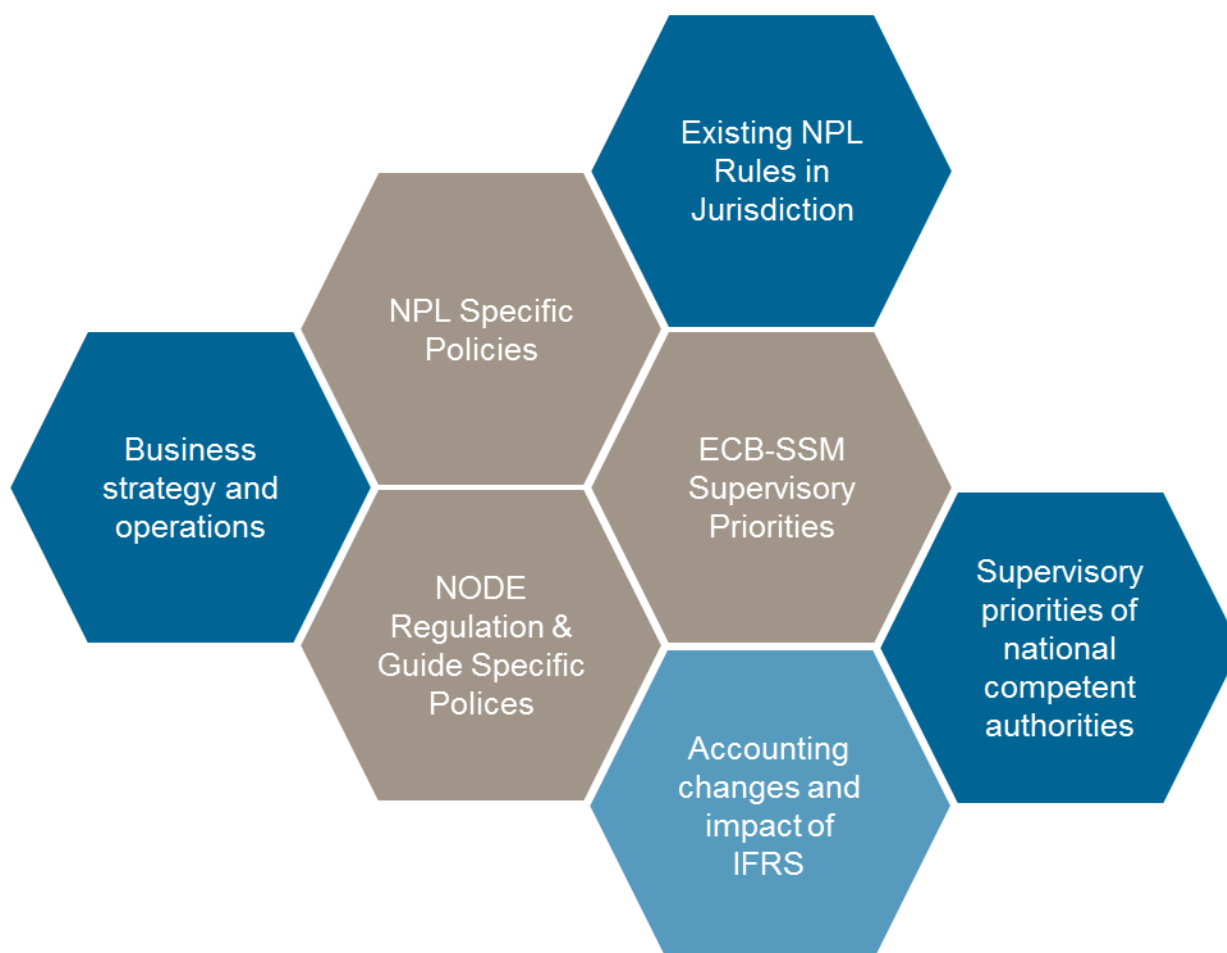
- *high-level NPL metrics;*
- *operational metrics on customer engagement and cash collection;*
- *efficiency and effectiveness of forbearance activities;*
- *efficiency and effectiveness of actions taken as part of the enforcement stage;*
- *levels of P&L, speed of spotting and escalating early warning triggers as well as the efficacy of any early warning engine/indicator and monitoring of efficacy of outsourcing arrangements.*

The above, as the NPL Guides sets out, should be periodically and proactively shared with supervisors at a suitable level of data aggregation. More generally, the NPL Guide requires that any changes to the NPL Operational Plan including the control framework or the NPL Strategy are to be "...communicated to the supervisor in a timely fashion".

The required NPL Business Policies and their likely impact



How the NPL Guide's provisions fit within the wider Banking Union compliance challenge that NPL Firms face



Some key steps on what to do next:

The NPL Guide brings with it a lot of operational challenges. The Banking Union authorities and policymakers are unequivocally clear that action is necessary. Supervised entities may thus want to consider their strategic options on supervisory engagement whilst forward-planning how best to comply.

Moreover, looking to 2017 and beyond, NPL Firms and Non-NPL Firms are likely to be busy with not only implementing the NPL Guide compliance obligations, but also engage with the range of other Banking Union-specific measures, including the NODD Regulation. These developments are on top of a wider range of “*change the business*” and “*business as usual*” workstreams that are either being implemented or are in the pipeline as part of Banking Union and non-Banking Union regulations.

These tasks are being requested of regulated firms against a backdrop of continued change within Banking Union’s supervisory culture, the identity, level, experience and expectations of staff involved as part of the supervisory engagement process at the ECB and national authorities. Careful and considered planning is thus likely to be important even for those NPL Firms that are categorised as low NPL banks.

SET UP AN NPL GUIDE PROJECT GROUP ACROSS THE EUROZONE:

with involvement from stakeholders from all relevant Eurozone and non-Eurozone jurisdictions as well as across business and control functions. Involve external counsel and advisers, as early as possible where relevant to assist with the mapping exercise or “implementation readiness and risk analysis” of where and how the gap analysis, exposure analysis, peer and competitor benchmarking reviews as well as general business strategy assessments as part of the NPL Self-Assessment Report will be run. This preliminary analysis and early stage project management might assist with a more timely delivery of the various documents, internal workstreams and supervisory deliverables and approvals.

It is worth noting that the NPL Self-Assessment Report process is expected to be repeated and updated with relevant information at least annually and possibly subjected to independent expert review.

FORWARD PLAN STAFFING AND TIMELINES FOR THE NPL SELF-ASSESSMENT REPORT:

as this is the first key driver to understanding how the NPL Guide might influence existing compliance deliverables and/or introduce new compliance frameworks, policies (including the NPL Guide’s detailed requirements regarding a ‘three lines of defence’ control framework) and reporting processes.

Firms may find benefit in assessing how such an implementation plan would interoperate with collation, assessment and delivery by the supervised entity of any SSM-specific compliance deliverables, including measures highlighted as part of the SSM’s Supervisory Review and Evaluation Procedure (**SREP**), any *ad hoc* reviews as well as more generally completing SSM deliverables as part of the Internal Capital Adequacy Assessment Procedure (**ICAAP**) and the Risk Appetite Framework (**RAF**).

SET UP A SEPARATE REGULATORY ENGAGEMENT TEAM:

to liaise with national supervisory authorities, central banks, the European Banking Authority and the ECB in relation to general issues and firm-specific issues that may arise as a matter of the NPL Guide as well as any lobbying activity.

BENCHMARK THE FIRM’S REGULATORY EXPOSURE:

and assess how current affordability assessment processes (if any) and standardised options of forbearance measures (if any) differ to the provisions set out in the NPL Guide and document conceptual gaps or deficiencies.

Part B:

Background on NPLs and Eurozone reforms to date

Nearly ten years after the start of the 2007 financial crisis (the **GFC**) action on NPL and NPE reductions have been largely led by individual EU jurisdictions (notably Spain and Ireland) implementing individual regimes to mitigate systemic risks from propagating as well as the human cost from NPLs hitting home on the doorsteps of home loan borrowers. The legislative, regulatory and structural approaches taken by individual jurisdictions have, in comparison to EU-led responses, been more detailed and in parts broader in their scope of application. Actions taken by individual Member States have largely focused on:

- **introducing detailed statutory codes** that govern how lenders may deal with borrowers in financial difficulty in respect of their NPLs and obliging lenders to promote restructuring of debt in a manner that safeguards affordability, continuity of repayments and is based on a 'menu of restructuring options'. These regimes apply prior to and as an alternative to the relevant insolvency regime; and
- **introducing legislative and structural measures** governing how 'bad banks' also known as asset management companies (**AMCs**) operate (including in some jurisdictions how they cooperate) and how they interact with government sponsored asset protection schemes.

Even where common features in the responses to the common problems do exist, coordination and convergence of these responses have largely been limited to adherence to high-level post-GFC reform commitments and calibration of terminology. As a result, the tools implemented in each jurisdiction differ in scope and breadth. Consequently, these divergences in the legislative and regulatory toolkit may give rise for concern especially if exposure from NPLs can move across borders, especially in the Eurozone and a Banking Union that is integrating further.

Moreover, the fact that structural capabilities differ amongst jurisdictions is another area of concern in containing the problem. In a number of jurisdictions there are no accepted means to isolate and resolve NPLs from creditors' balance sheets and the range of divestment options available in some jurisdictions may not extend to others. Equally, there is no certainty that there are a sufficient amount of willing buyers of NPL portfolios or where they do exist, they may not be

interested in NPLs from specific jurisdictions, asset classes and/or client types.

Politicians and policymakers have continued to highlight the need to act on NPLs and do so in a coordinated manner. A range of post-GFC regulatory reforms, ranging from those focused on mortgage lending to prudential capital regulation reform as well as more wide-ranging supervisory, architectural changes or harmonisation efforts such as Banking Union itself, the continued aim to complete Eurozone integration as well as the "Single Rulebook" or more recently the Capital Markets Union (**CMU**) project all speak about NPLs, but action on "impaired assets, NPLs, foreclosure" etc., have largely been focused in the context of making banks "safe to fail".

To recap, the EU's Mortgage Credit Directive (Directive 2014/17/EU) (the **MCD**)¹ aimed to tackle some problems, however the drafting and regulatory outcomes in the MCD pre-date the start of the Banking Union. The MCD aims to harmonise lending practices and addresses

arrears and foreclosure, but largely does so in passing². Despite the MCD, the EU's NPL problem has continued to grow.

These risks were also identified by the European Banking Authority (EBA), i.e. the regulatory 'gatekeeper' for banking sector rulemaking and contributor to Single Rulebook for banking sector regulation. A general call for more action on NPL rules and tools has been a recurring theme from the EBA.

In its July 2016 "Report on the Dynamics of Non-Performing Exposures in the EU Banking Sector"³ (the **July 2016 Report**) the EBA concluded⁴ and warned that only 15 out of 28 current EU jurisdictions have legal means to facilitate a transfer of assets to AMCs and that the weighted average NPL ratio to balance sheets across the EU was 5.7%⁵ in March 2016 and thus up to three times higher in the EU than in other global jurisdictions. The EBA summarised the need for action succinctly as follows:

"The need for policies to tackle asset quality issues in the EU is compelling, also in light of high NPLs on the real economy. NPLs are a problem at multiple levels: at a micro prudential level, heightened NPLs, are associated with lower profitability and lower efficiency; at a macro level high levels of NPLs are associated with stagnant growth as capital is tied up with NPLs and not funding new lending into the real economy; finally for consumers, proactive engagement on NPLs by banks can help avoid the situation of paying interest and fees on an asset that they may eventually not own..."

Moreover and unsurprisingly the ratio of NPLs had a high dispersion across lenders in jurisdictions that underwent significant economic adjustments⁶ i.e., were hard-hit by the GFC. That July 2016 Report publically called for action on NPLs and NPEs. The NPL Guide aims to deliver on that call for action.

¹ See: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0017&from=EN>.

² See: Recital 3 that describes the adverse impact that NPLs have and Article 28 (Arrears and foreclosure) of the MCD that is exceptionally widely drafted at a high-level and, in parts, conceptually different to the aims of reducing and managing forbearance from becoming NPLs. To summarise, the provisions of Article 28 obliges Member States to: encourage creditors to exercise "reasonable forbearance [undefined/unqualified term] before foreclosure proceedings are initiated"; to cap borrower default charges and where possible at the actual cost to the creditor; to impose an obligation that upon sale of a foreclosed property, the sale is conducted on a best efforts basis to achieve the best price in any sale of foreclosed property; and to facilitate repayment of debt that remains outstanding following a foreclosure in a manner that protects consumers.

³ See: <https://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+NPLs.pdf>.

⁴ Using the newly harmonised EBA definitions on NPL terminology and sampling data from 166 lenders in a time-period from September 2014 to March 2016.

⁵ As an aggregate total across the EU 28 Outliers include those jurisdictions directly or indirectly adversely affected by the financial crisis including:

	Forborne loans – ratio on balance sheet	Forborne loans that are non-performing	NPLs – as ratio on balance sheet
Bulgaria (in part, courtesy of Greek-owned lenders)	9%	75%	14%
Croatia	5%	81%	13%
Cyprus	27%	78%	49%
Greece	20%	73%	47%
Hungary	6%	81%	14%
Ireland	14%	67%	15%
Italy	5%	67%	17%
Portugal	12%	66%	19%
Romania	8%	86%	14%
Slovenia	13%	77%	20%
Spain	8%	42%	6%

⁶ The July 2016 Report also concluded that there is a strong correlation (above 60% in adversely and non-adversely affected EU jurisdictions) of forborne loans becoming or constituting NPLs, evidencing that more needs to be done to avoid forbearance as a path to NPLs and to improve early intervention focusing on restructuring and affordability.

The NPL Guide as a first step to Pillar IV and tackling a Eurozone and EU-wide problem?

As a result, the NPL Guide would mark a first step by providing a chapter of common rules within the Banking Union in the on-going project to finalise the Single Rulebook. This is the case despite the NPL Guide (currently) focusing on establishing common rules. Notwithstanding the fact that NPLs go back to the very root of Banking Union, including specific supervisory findings in the 2014 Asset Quality Review (**AQR**), they have remained an ECB supervisory priority since then but coordinated action had been limited. Coordinated action in this area, beyond tackling NPLs, also improves the overall strength of the resilience that the rules and infrastructure that form a part of each of Banking Union's existing Pillar I and Pillar II and the proposed Pillar III.

The NPL solution is unlikely to stop at the current form of the NPL Guide. Further work in this area might also consider the merits in ensuring that common rules on dealing with NPLs are perhaps flanked by common rules:

1. applicable to AMCs operating within the Banking Union;
2. how NPL Firms should deal with AMCs and asset protection schemes or equivalent schemes etc.; and
3. in the longer term, it remains to be seen whether the common NPL Guide rules might benefit from institutional support, i.e., to create a true "Pillar IV" on the assumption that any assessment would find that there are efficiencies in creating a common backstop for Banking Union AMCs or even creating a "**Single Troubled Asset Management Agency**" (**STAMA**) for the Eurozone.



Part C:

Key contacts and how we can help

Allen & Overy's dedicated and integrated Eurozone Team is composed of lawyers from across the Eurozone and other continental EU member states. The Eurozone Team and Banking Union Monitoring Centre supports internal counsel, regulatory and compliance teams with smarter, more efficient solutions in the evolving European regulatory and supervisory landscape.

We are well versed in acting in the context of loan portfolio trades and have extensive experience on loan trading, seller-side and buyer-side. Our lawyers routinely advise banks, investment banks and other institutions on a variety of transactions, including trades of large portfolios of NPLs and other loan types (including, without limitation, consumer loan portfolios), servicing arrangements and asset realisation. We have been involved in some of the largest and most innovative non-performing loan transactions, including joint

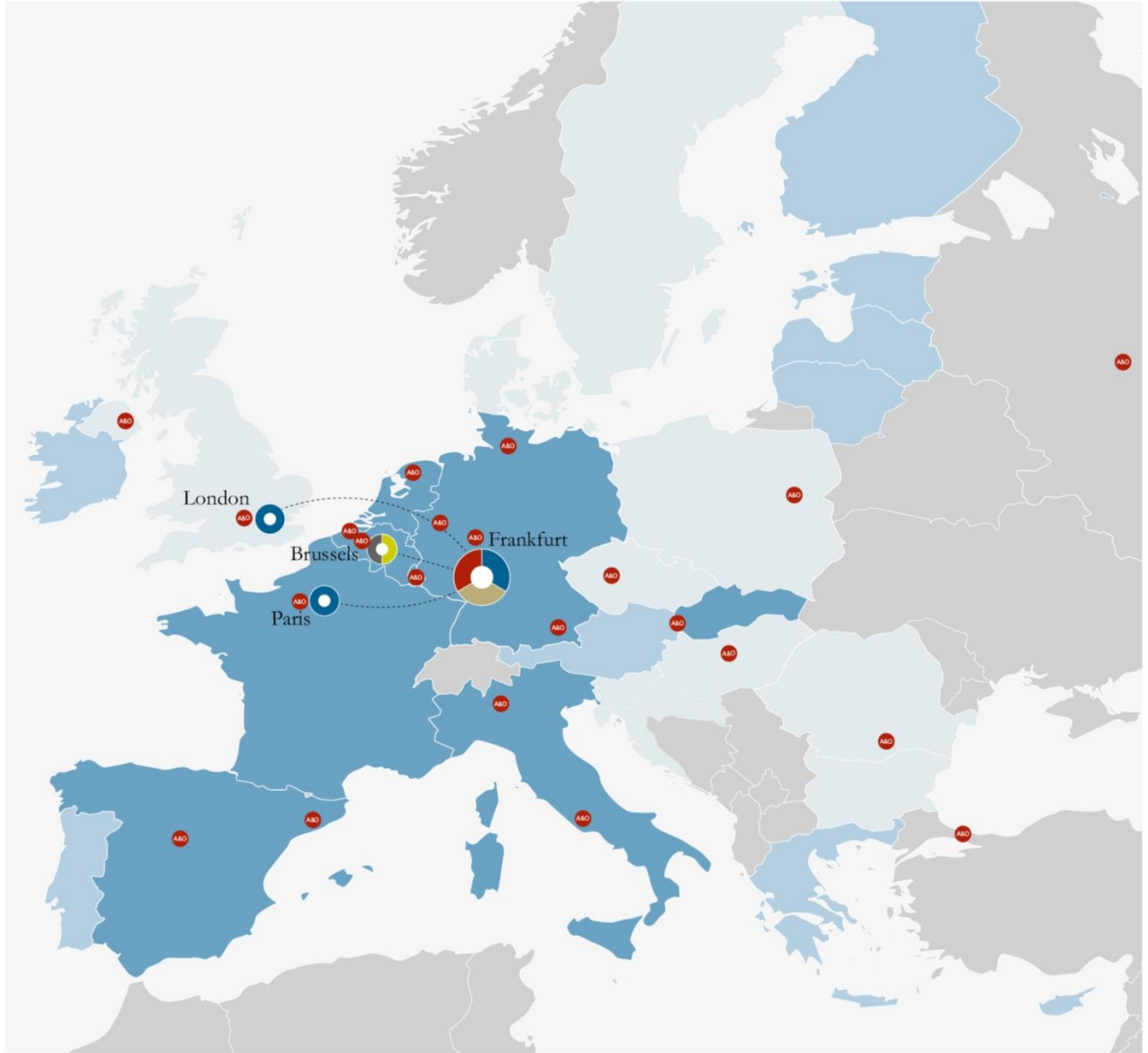
ventures with sellers and other co-purchasers, on-going purchase programmes, securitisations and restructurings involving non-performing loan dispositions and other methods of dealing with NPLs. We also advise on real estate portfolio transactions and prepare high-level due diligence reports.

A number of our lawyers also have specific regulatory, project management and governance expertise in assisting as in-house counsel or as external lawyers in the design, implementation and running of NPL-specific governance measures across asset classes and divestment target timelines. Our lawyers have acted for a number of major financial institutions in assisting their policies, processes, client-facing communications, internal governance and control frameworks as well as regulatory outsourcing arrangements meeting the legislative requirements and supervisory expectations in various Eurozone jurisdictions.

Should you wish to discuss any of the contents in this Client Alert in further detail please contact your usual Allen & Overy contact or any member of our multi-jurisdictional 'Eurozone Team' and our 'Banking Union Monitoring Centre' in Frankfurt via Eurozone@allenoverly.com. Details of our key contacts and further background material are also available [here](#).



Our footprint in the Eurozone and Europe



Our Global Markets Group has established close partnerships with independent relationship law firms in European and global jurisdictions where we do not currently have an office.

Selected Expertise

Portfolio trades and NPL-specific regulatory advice

<p>Hypotheekbank Frankfurt AG, a subsidiary of Commerzbank Aktiengesellschaft, in connection with the tender for the sale of a Europe-wide commercial real estate (CRE) loan portfolio with a nominal volume of EUR2.2bn to a syndicate consisting of J. P. Morgan and Lone Star. The portfolio comprises properties in Austria, Belgium, the Czech Republic, Cyprus, Denmark, Finland, Hungary, Luxembourg, the Netherlands, Romania, Sweden, Switzerland, Slovakia and Turkey.</p>	<p>A major UK financial institution on the reverse merger of their Irish banking subsidiary and implementation of governance, risk and compliance policies, operational processes (incl. regulatory outsourcing and vendor engagement) and retail client-facing documentation suite to comply with the regulations of the Central Bank of Ireland and its “Code of Conduct on Mortgage Arrears”.</p>	<p>An Italian asset management company on the establishment of a fund investing in NPLs and the setting up of the relevant infrastructure.</p>	<p>Chenavari Investment Managers on the acquisition of an NPL portfolio sold by Bankia under Project Wind (total outstanding principal balance of EUR1.3bn, purchased by Chenavari and Oaktree Capital Management on the second quarter of 2015).</p>
<p>A group of lenders on the leveraging of two real estate secured NPL transactions purchased by two funds in Spain, by means of “debt-on-debt” specialised financing transactions.</p>	<p>Fortress on the acquisition of three companies from Grupo Lico (Geslico, Auseco and Geasa) whose main business consists of activities related to debt recovery and additionally on the acquisition of various portfolios of real estate assets and NPLs in Spain.</p>	<p>An investment management company on the acquisition of a non-performing loan from a major German bank.</p>	<p>A financial investor on the acquisition of a portfolio of German shipping loans relating to a pool of tanker ships.</p>
<p>An Irish bad bank, on the transfer of commercial real estate loan portfolios from Irish Banks.</p>	<p>A global private equity firm on the acquisition of a bank’s USD multi-billion non-performing U.S. commercial real estate loan portfolio.</p>	<p>Bankia in the sale of an NPL portfolio including secured and unsecured loans with a face value of EUR700m.</p>	<p>A U.S. private equity fund as bidder on the on-going acquisition of a commercial real estate loan portfolio secured against properties in Germany, France, Luxembourg, Italy, Spain, Romania and Holland from a continental European bank.</p>
<p>A consortium of bidders in connection with the potential acquisition of a mortgage, large corporate and SMEs NPL portfolio originated by an Italian bank for a GBV of EUR20bn.</p>	<p>A market leading loan servicer on the proposed acquisition of a non-performing loan from a major international bank, including its servicing entity. (Transaction size: more than EUR1bn)</p>	<p>The arrangers in connection with the acquisition and subsequent securitisation of a diversified NPL portfolio originated by an Italian banking group for a GBV in excess of EUR25bn.</p>	<p>A global diversified technology, media and financial services company on its potential investment, as senior notes subscriber, in the securitisation of an NPL lease portfolio originated by an Italian leasing and factoring company.</p>

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