

A Background Briefing from the Eurozone Hub

Complying with the Banking Union's NPL rules

The ECB-SSM's supervisory guidance on non-performing loans and exposures



Executive summary

On 20 March 2017 the European Central Bank (**ECB**), in its role as part of the Single Supervisory Mechanism (**SSM**) within the Banking Union, published its final¹ "Guidance to banks on non-performing loans" (the **NPL Guide**)². The contents of the final version of the NPL Guide are directly relevant for NPL Firms (as defined below). They are also likely to be of reference to other Banking Union Supervised Institutions (**BUSIs**) in relation to tackling impaired assets, non-performing loans (**NPLs**) and non-performing exposures (**NPEs**)³.

Despite being termed an ECB supervisory tool and "non-binding guidance", the content of the final NPL Guide remains clear in that it sets out supervisory expectations, regulatory guidance and desired outcomes. This will impact BUSIs and how they embed and evidence compliance.

This Background Briefing is comprised of nine parts. Each of these parts explore the terms of the NPL Guide step by step and highlight some of the practical impacts for BUSIs' compliance priorities. The NPL Guide applies to all NPLs/NPEs irrespective of whether they are part of the banking or trading book or retail or wholesale in nature.

Pressure from EU policymakers to find a solution to NPLs, which in many ways have been likened to the legacy hangover of the financial crisis that started in 2007, have been mounting. So too is the move to action by EU as well as national level policymakers and supervisors. The NPL Guide may not be the panacea to the NPL problem, but it does mark a key tool to tackling some of the root issues. Increasingly it is a tool that will be rolled-out to a much wider body of BUSIs and credit institutions across the EU-27.

Regulatory roll-outs, SSM's NPL Guide and the EU's far-reaching NPL Action Plan

Given the sheer amount of NPLs, it may be more than a coincidence that the ECB-SSM decided to publish the final version of the NPL Guide on the first day of spring 2017. This publication marked a definitive start to the SSM ordering those BUSIs that are directly supervised by the ECB to begin the "spring cleaning" process on NPLs.

Building upon that publication and whilst most of the EU headed for the summer break, the Council of the European Union (the **Consilium**) met on 11 July 2017 in its ECOFIN-constellation and proceeded to approve an ambitious and definitive **NPL Action Plan**. Details of this NPL Action Plan and the impacts on BUSIs are discussed in our Eurozone Hub's [Client Alert](#)⁴.

One of the main takeaways from the NPL Action Plan, and one with a direct impact on all BUSIs, is that the contents of the SSM's NPL Guide are to be rolled out to a much broader set of BUSIs. Specifically this means that the SSM's NPL Guide will be set to apply to those BUSIs categorised for SSM purposes as "less significant institutions" (**LSIs**). To recap, these are, for SSM purposes, directly supervised by national competent authorities (**NCAs**) and are indirectly supervised by the ECB-SSM.

The roll-out of the SSM's NPL Guide to LSIs is thus scheduled to happen whilst those BUSIs, that are categorised for SSM purposes as "significant credit institutions" (**SCIs**), and thus subject to

¹ The final NPL Guide is largely unchanged in content from the draft version. Relevant changes are flagged herein and an unofficial delta-view comparison of the contents is available to clients on request via: Eurozone-hub@bakermckenzie.com. The ECB has, as of the date hereof, not published an official comparison tool.

² See: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

³ Shortened to "**NPLs**" unless the context requires otherwise.

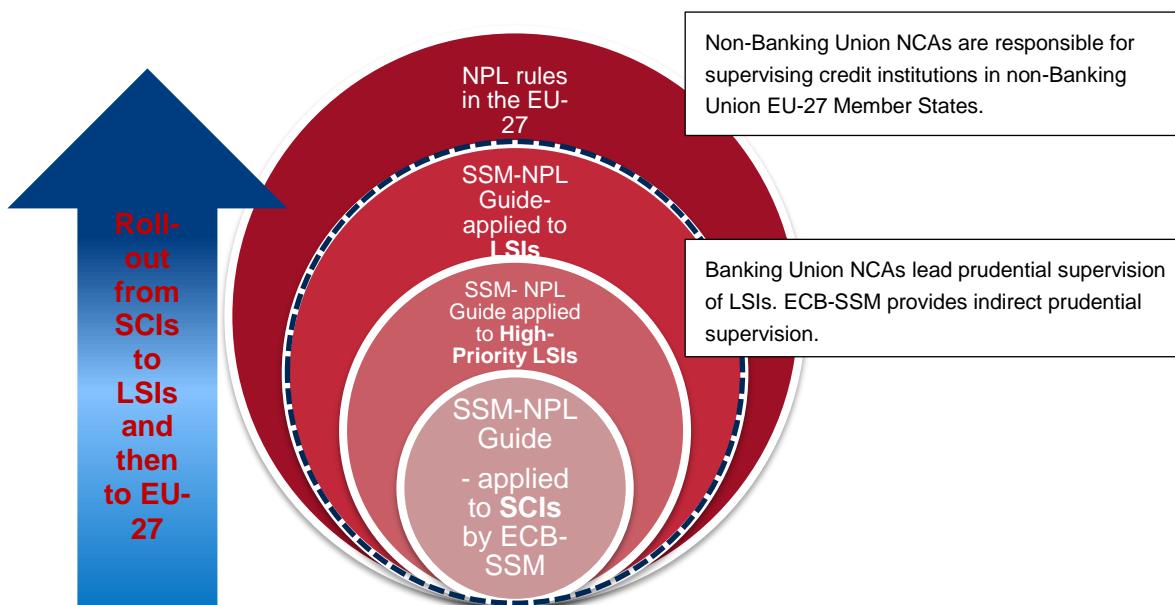
⁴ See: http://www.bakermckenzie.com/-/media/files/insight/publications/nl_germany_euationplan_jul17.pdf?la=en

direct ECB-SSM supervision, are expected to embed the terms of the SSM's NPL Guide. Furthermore, the Consilium's NPL Action Plan also suggests that the European Banking Authority, working in conjunction with the ECB-SSM, prepare a version of the NPL Guide that mirrors the SSM approach but which is applied to all credit institutions in the EU-27.

It is anticipated that this roll-out from SCIs to LSIs, will first affect those LSIs that are categorised as "High-Priority LSIs" and thus subject to closer scrutiny by ECB-SSM DG MS III. The intensity of indirect supervision by the ECB-SSM is dictated by the priority of an institution. This is determined based on the LSIs risk profile and impact on the financial system. It is conceivable that any further roll-out to the wider body of non-Banking Union credit institutions operating in the EU-27 will build upon the supervisory experience of rolling-out the rules from SCI to High-Priority LSIs, followed by the extension to all LSIs in the Banking Union.

This process of rolling-out rules from the SCI to LSI level within the Banking Union is becoming increasingly common. Moreover, so is the process of non-Banking Union authorities mirroring supervisory approaches of the Banking Union. Both of these developments help the various components of the EU-27's European System of Financial Supervision (**ESFS**) deliver on the priority of supervisory convergence of rules. Supervisory convergence aims to ensure that the Single Rulebook, as it is applied both in the EU-27, and as amended for application within the Banking Union, becomes more single and uniform and that it is based upon a common supervisory culture.

SSM NPL Guide roll-out to a wider body of entities



Please see also Part 2 of this Background Briefing as to how SCIs are grouped between "high NPL banks" and "low NPL banks".

The NPL Guide will likely affect a number of workstreams and stakeholder groups within BUSIs

The developments relating to the SSM's 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 BUSIs currently caught by the NPL Guide or those that will come within its scope or become subject to similar provisions.

In terms of impact, the final version of the NPL Guide goes beyond that of the draft version. This is the case both in terms of the qualitative requirements and the prescriptive nature of the supervisory expectations. Whilst, the draft version already marked a definitive step, possibly even a quasi-quantum leap, to harmonising action on NPLs, the final version of the NPL Guide sets a clear supervisory list of expectations and areas where firms will likely need to evidence how they are embedding compliance.

That being said, the final NPL Guide aims to advance action in a 'jurisdiction agnostic' manner. The content builds a regime that provides both creditors and debtors 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. It aims to do all of this without displacing or replacing existing national or sector specific rules.

Reshaping business in times of change

The NPL Guide aims to change the approach that both creditor and debtor will need to take in dealing with NPLs. The menu of options in the NPL Guide are each drafted with that change in approach in mind. This may prove an area where both creditors and debtors will need to rethink how they engage with one another. This change in approach is embodied by the NPL Guide's focus on affordability and viability of options that look to preserve payments and manage NPLs sustainably and thus advance workable solutions. The move away from enforcement and towards a focus on viability also means creditors may have to offer more solutions to those debtors otherwise stuck between the 'stick of enforcement and the carrot of restructuring' rather than allocating them one way or another.

In summary, firms that are required to embed the NPL Guide will likely be faced with a number of "change the business" "run the business" as well as "business as usual" workstreams. These changes come on top of a range of EU and Banking Union driven regulatory workstreams along with possibilities for further change ahead. Some of that change might be more immediate, as the NPL Action Plan's ambitious goals and timeline set out. Other changes might be longer term projects. Some of these longer-term projects include those that have a high degree of political priority and include the possible creation of a greater pan-European consensus and calibration on insolvency law.

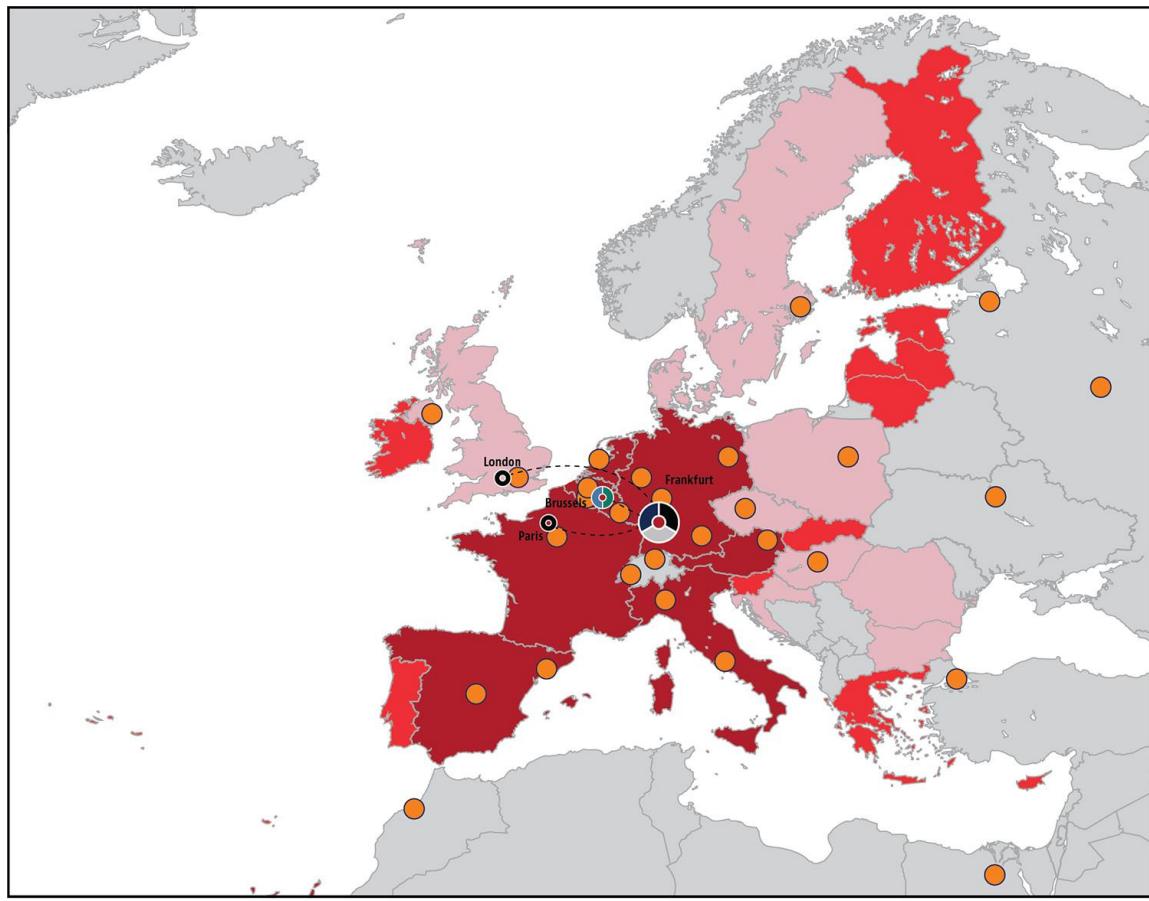
Despite this tall order of change ahead, any move to a more level playing field may have positive effects. Notably the menu of harmonised options in the NPL Guide might reduce the costs of compliance and generate greater business efficiency. As a result, BUSIs will want to be proactive in embedding change, seizing first mover advantages (in divesting or managing NPL portfolios) but also in terms of engagement with EU policymakers to shape how the NPL Action Plan will affect them, their compliance workstreams and their business strategy.



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We would love to continue the conversation

Should you wish to discuss any of the contents of this Background Briefing in further detail please contact any of our Eurozone Hub team or any member of our multi-jurisdictional 'Eurozone Group'. Please do also visit www.eurozone-hub.com or contact us via eurozone-hub@bakermckenzie.com to receive access to a full breadth of material that might be helpful in navigating the challenges and opportunities across the Banking Union, Capital Markets Union and Eurozone monetary policy.



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Part 1 - Background and putting the NPL Guide into context

Despite being termed an ECB supervisory tool and "non-binding guidance", the content of the final NPL Guide remains clear in that it sets out supervisory expectations, regulatory guidance and desired outcomes. In many ways, 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 the retail and the wholesale space. This goes beyond what is currently the law in certain Eurozone jurisdictions and will thus be of relevance for those SCIs that are already required to comply with the SSM's NPL Guide. It will also be relevant for the wider body of legal entities that are currently categorised as LSIs, or as a result of their relocation (including due to BREXIT) to the EU-27 and/or Eurozone-19, will be categorised as LSIs and thus come into scope of the roll-out of the NPL Guide when that begins to take place.

This Background Briefing provides an overview of the contents of the final version of the NPL Guide and follows on from our previous coverage a selection of which is available below:

- Client Alert (July 2017): "[EU sets marching orders in the form of a definitive NPL "Action Plan" for 2017: Are these the first steps to a Banking Union Pillar IV and a comprehensive solution for NPLs in the EU-27?](#)"⁵
- Client Alert (August 2017): "[Consultation launched on draft ECB-SSM Supervisory Guide to on-site inspections and internal model investigations.](#)"⁶
- Client Alert (July 2017): "[The EU and the Banking Union bring out their "SPoRs"](#)"⁷; and
- Background Briefing (July 2017): "[Being "fit and proper" in the Banking Union in 2017 - ECB-SSM's supervisory guidance on fit and proper assessments](#)"⁸.

NPLs as a supervisory priority

The publication of the final version of the NPL Guide followed a consultation process that ran from 12 September 2016 until 15 September 2016. A public hearing was held on 7 November 2016.

Quick Take: Key supervisory principles in the ECB-SSM's NPL Guide:

In summary, the NPL Guide introduces supervisory principles on:

- the identification of NPLs;
- 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.

⁵ See: Footnote 4.

⁶ See: <http://www.bakermckenzie.com/en/insight/publications/2017/08/consultation-launched-on-draft-eccb-ssm>

⁷ See: <http://www.bakermckenzie.com/en/insight/publications/2017/08/eu-banking-union-spos>

⁸ See: http://www.bakermckenzie.com/-/media/files/insight/publications/ar_germany_backgroundbriefing_jul17.pdf?la=en

Resolving NPLs remains very much a central supervisory priority for the Banking Union and ties in to a number of other regulatory and supervisory workstreams that ought to be at the forefront of BUSI's compliance and risk planning. This is the case irrespective of whether the BUSI is subject to direct Banking Union supervision through the ECB-SSM or whether direct supervision is conducted by the NCAs.

Quick Take: Key supervisory messages from the final NPL Guide:

The supervisory expectations are clear in that the NPL Guide, which entered into force on 20 March 2017, sets out the following key messages:

- the NPL Guide reflects 'best practices' from across the Eurozone. These are now the SSM's supervisory expectation of BUSIs to embed the best practices;
- the SSM plans to place a stronger focus on enhancing the timeliness of provisions and write-offs; and
- SSM Joint Supervisory Teams (**JSTs**) will engage with BUSIs to monitor compliance. BUSIs are expected to apply the NPL Guide proportionately and with the appropriate urgency. The final version now permits a compliance longstop date to be agreed between those BUSIs that are categorised by the SSM as SCIs and their respective JSTs.

Timing will be an issue for BUSIs

The final NPL Guide does not include a timeline nor does it foresee a phased entry approach. The final version is clearer than the draft in that it replaces and now sets out that (clarifications in square brackets and emphasis in bold):

"This guidance should be applicable as of its date of publication. **[SCIs]**, may however close identified gaps thereafter based on suitable time-bound action plans which should be agreed with their respective **JSTs**. In order to ensure consistency and comparability, the expected enhanced disclosures on NPLs should start from 2018 reference dates."

While this may give some preparation time, firms caught or likely to be caught by these rules will want to forward plan resources, expertise and retain external counsel to assist on how to deliver the NPL Self-Assessment Report for management body and supervisory approval. In the final version of the NPL Guide, the reference to this report being "required" has been replaced with "should be performed". Even if this indicates that some NPL Firms may not in fact need to prepare such a report, given the importance that the output that the self-assessment report has for meeting the compliance objectives of the NPL Guide it is still conceivable that some form of document or evidence of a self-assessment will be expected to meet the supervisory principle.

How does this all fit in with the wider Banking Union's workstreams?

Tackling 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 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**).

Background on Banking Union

In 2012, European leaders took the decision to deepen the Economic and Monetary Union i.e. the Eurozone by creating a European Banking Union with the purpose of 'breaking the vicious circle between banks and states' and addressing the weaknesses affecting the Eurozone's banking sector. Achieving this aim means that the pillars of the Banking Union seek to make European banking more:

- a. '**transparent**' by consistently applying common rules and administrative standards for supervision, recovery and resolution of BUSIs through application of a Single Rulebook;
- b. '**unified**' by treating national and cross-border banking activities and by removing the link between location of BUSI and sovereign; and
- c. '**safer within a stable and well-functioning financial system**' by intervening early if BUSIs face problems in order to help them prevent failing or, where necessary, ensuring they undergo an efficient resolution.

The final NPL Guide thus marks the first welcome step towards a possible "Pillar IV" for Banking Union. These rules, even absent any concurrent structural mechanism, aim to resolve Europe's NPL problem through harmonisation and resilience of the rules of the EU's Single Rulebook for financial services, as it is applied within the Banking Union, as well as borrowing from principles and rules as they exist in certain jurisdictions, such as Ireland and Spain. These resilience improvement measures also aim at delivering deeper integration and economic growth prospects across the Eurozone.

Supervisory developments relating to the NPL Guide should also be read in conjunction with the ECB's actions to streamline other NPL-relevant 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 entered into force 1 October 2016.

What however is important to note is that in terms of scope: the NPL Guide's 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 national 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.

Drafting matters

The ECB's NPL Guide is certainly serious about tackling Europe's NPL problem. It is also an extensive document. 131 pages (up from 126 in the draft version), split into seven supervisory

chapters and eight annexes (up from seven in the draft), are flanked by 141 pages of analysis in the first "NPL Stock-taking document"⁹.

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 final form of the NPL Guide, like the draft, still has 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. The first stocktake document was complemented by the second stocktake document published¹⁰ June 2017. The second stocktake document covers the remaining 11 jurisdictions of the Banking Union.

Despite the findings in the second stocktake document, the final version of the NPL Guide does not contain clear provisions that are designed to be interoperable with other NPL-related structural measures, including in relation to asset management companies (**AMCs**) i.e., bad banks that exist in certain jurisdictions. Despite being drafted as 'jurisdiction agnostic', there are certain gaps and differences between NPL Guide and rules in individual jurisdictions. These differences, including differences to NPL rules in individual jurisdictions might cause confusion and potential for further fragmentation.

What is however welcome is that the final NPL Guide's Annex 8 sets out concisely the supervisory expectations in respect of NPL risk transfers and NPL securitisation transactions and the requisite "robust risk analysis" and the "adequate risk control processes" detailed therein.

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. This is further complicated by the final version replacing a lot of references to "must" or "need to" with "should".

What is also worthy to note 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. The final NPL Guide also, in contrast to the draft, amended the wording (in bold) so that there is no doubt that:

"This guidance is taken into consideration in the SSM regular Supervisory Review and Evaluation Process and non-compliance may trigger supervisory measures."

Like in the draft, the final NPL Guide is now ever more clear 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.

⁹ See: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/stock_taking.en.pdf

¹⁰ See: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.stock_taking2017.en.pdf

Part 2 - Current scope of application of the NPL Guide

The final version of the NPL Guide as at the time of writing has the following scope of application:

Applies to:	Does not currently apply to (but may be of interest for):	NPL Action Plan plans to roll out/mirror NPL Guide Rules to the following:
<ul style="list-style-type: none"> entities regulated as "credit institutions" and which are, for Banking Union supervisory purposes, categorised as "Significant Supervised Entities" (SCIs) and thus subject to direct ECB supervision (ca. 129 firms); and international subsidiaries of SCIs, <p>summarised herein as NPL Firms</p>	<ul style="list-style-type: none"> 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); EU entities regulated as "credit institutions" but which operate outside the supervisory scope of Banking Union (i.e. domestic banks in Sweden with no presence in the Eurozone); branches of EU credit institutions headquartered in non-participating Banking Union Member States (i.e. Swedish bank's branch in Paris); 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, <p>summarised herein as Non-NPL Firms</p>	<ul style="list-style-type: none"> "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); EU entities regulated as "credit institutions" but which operate outside the supervisory scope of Banking Union (i.e. domestic banks in Sweden with no presence in the Eurozone); branches of EU credit institutions in non-participating Banking Union Member States.

The NPL Guide is addressed to NPL Firms and introduces far reaching extraterritorial application as it applies to SCI'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. It also raises the more general question as to how these issues will be affected by the NPL Guide's provisions that apply to:

- 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,

and consequently, this territorial scope may pose issues for a number of existing legal entity structures as well as those that are restructuring due to relocations or otherwise.

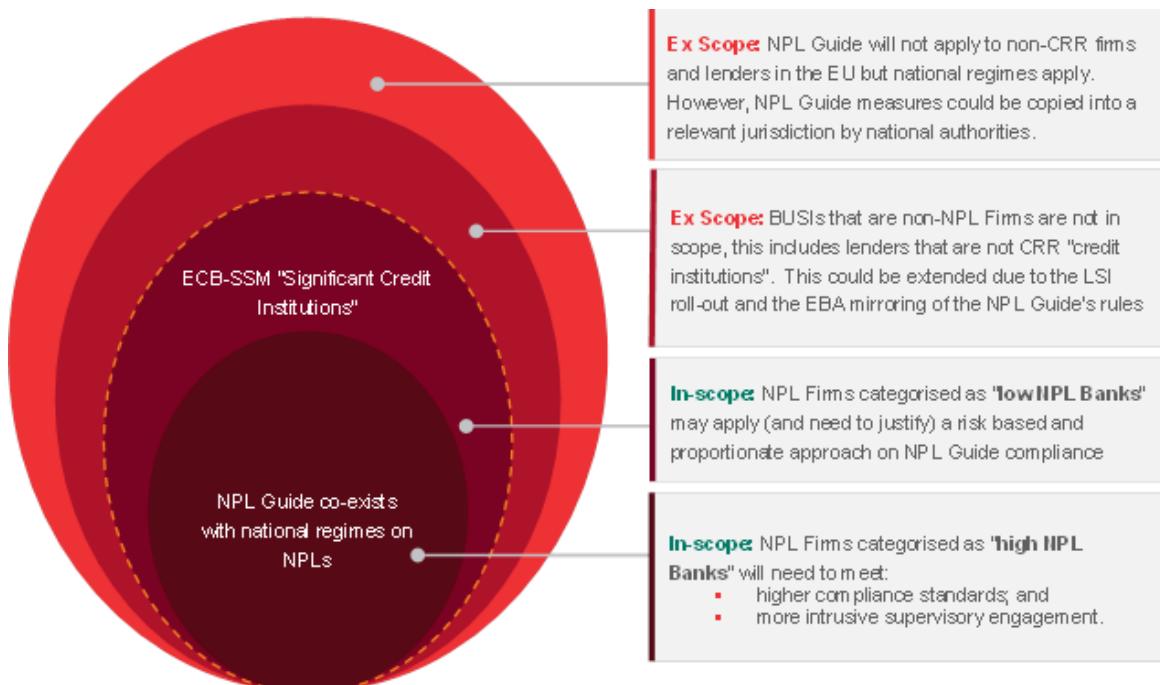
As a result, clients will need to carefully examine distinctions and common elements across jurisdictions and assess what this means for its policies, processes and client facing documentation and how to reflect those elements. For some NPL Firms, questions on how to treat and classify certain corporate 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"¹¹; 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. A 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.

How the "high NPL bank" categorisation defines the current scope of the NPL Guide's application prior to the roll-out to LSIs and EU-27



¹¹ 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".

Part 3 - How are the rules and the NPL Guide structured?

Aside from language issues and how the final 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 final NPL Guide has taken inspiration from and drawn upon experiences of national supervisors and their approaches, concepts and materials. The final NPL Guide's current drafting does have degrees of conceptual gaps, contradicting statements, divergences and overlapping elements within its 131 pages. This might pose issues even prior to assessing a different and quite Banking Union-specific tone being set in the supervisory engagement process or culture.

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. In fact the final NPL Guide, unlike the draft, specifically obliges NPL firms to be cognisant of the:

"...consumer protection legal environment...as it also plays a role in client communication and interaction."

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 (emphasis added in **bold**):

"...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 should 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, especially 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 understood¹² as conduct of business regulatory issues and prudential regulatory issues despite both elements being rather intertwined.

¹² 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'.

Part 4 - Divergences in the rules of draft and final version of NPL Guide?

The NPL Guide's structure aims to follow the "lifecycle" of how NPLs are managed. Major changes from the draft to the final version of the NPL Guide are highlighted below for reference.

Chap.	Title	Introduces rules, supervisory expectations or compliance obligations? (Y or N)	Contents	Major changes between "draft" and "final" NPL Guide (Y/N)
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	Y – clarification of scope and embedding into SREP
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 a NPL Operational Plan	Y – NPL Self-Assessment Report no longer mandatory. Greater emphasis on consumer protection aspects
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	N – but clarification on "unlikely to pay exposures" included
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	Y – deletion of mandatory requirement that contractual terms for any forbearance solution of has to be reviewed at least once annually – although this may be a requirement in certain Eurozone jurisdictions for certain NPL types – and rather a review is driven by a change of situation. Considerable amount of changes to how certain forbearance measures should be granted, monitored and controlled

Chap.	Title	Introduces rules, supervisory expectations or compliance obligations? (Y or N)	Contents	Major changes between "draft" and "final" NPL Guide (Y/N)
5	NPL recognition	Y	<p>Provides a short outline on selected issues regarding calibration of terminology and what constitutes a 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:</p>	<p>Y – updates are mostly to the cross-references to legislative or regulatory standards as well as updates to the table covering the interrelation between non-performing, default and impairment "Unlikely-To-Pay" indicators</p>
			<ul style="list-style-type: none"> ▪ in arrears; 	
			<ul style="list-style-type: none"> ▪ non-performing; 	<p>Y – including further clarification than if more 20% of exposures to one obligor are non-performing all other on and off balance sheet exposures to should be non-performing.</p>
			<ul style="list-style-type: none"> ▪ performing but forborne; 	
			<ul style="list-style-type: none"> ▪ non-performing but forborne; or 	<p>Y</p>
			<ul style="list-style-type: none"> ▪ when they exit or are "cured" of their non-performing status; 	<p>Y – significant changes</p>
6	NPL impairment measurement and write-offs	Y	<p>Introduces principal objectives that NPL Firms must implement and apply namely:</p>	<p>Y – further requirements included to cover treatment of foreclosed assets</p>
			<ul style="list-style-type: none"> ▪ adequate measurement of impairment provisions across all relevant portfolios through sound and robust provisioning methodologies; 	

Chap.	Title	Introduces rules, supervisory expectations or compliance obligations? (Y or N)	Contents	Major changes between "draft" and "final" NPL Guide (Y/N)
			<ul style="list-style-type: none"> ▪ timely recognition of loan losses within the context of relevant and applicable accounting standards (IAS/IFRS in particular) and timely write-offs; and 	
			<ul style="list-style-type: none"> ▪ 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	Y – the scope of the contents has been expanded somewhat to best practice for the general governance, monitoring and control of <u>performing</u> exposures

The following table provides an overview of the contents in the Annexes.

Annex	Title	Introduces rules, supervisory expectations or compliance obligations? (Y or N)	Contents	Major changes between "draft" and "final" NPL Guide (Y/N)
1	Glossary	N	Contains a glossary of abbreviations/terms used plus references to their origin	Y – update to certain terms including reference to "Denounced loans"
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	N – but now includes reference to "leased assets" for purpose of a credit facility
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	N

Annex	Title	Introduces rules, supervisory expectations or compliance obligations? (Y or N)	Contents	Major changes between "draft" and "final" NPL Guide (Y/N)
			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	N
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.	N – save that references to the function of "risk management" are now to "risk control"
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	N
7	Summary of supervisory reporting and disclosure items related to NPLs	Y	Summarises the NPL Guide specific supervisory reporting and disclosures	Y – the disclosure template has been revised in whole
8	Risk transfer of NPLs	Y	Sets out a list of "essential elements" that NPL Firms should observe when securitising NPLs or entering into risk transfers of NPLs.	Y – new Annex

Part 5 - The NPL Guide's key compliance requirements

The NPL Guide requires that NPL Firms develop a written **NPL Strategy** and document how it is implemented in a **NPL Operational Plan**. Before NPL Firms develop a strategy, a plan and begin 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 the **NPL Self-Assessment Report**, where such report is required or the NPL Firm elects to complete one.

Compiling such a report, even if it is no longer a strict mandatory requirement in the final version of the NPL Guide, may be a detailed, possibly lengthy, exercise. Even where it is not mandatory, it is likely to still remain a useful exercise as it may assist in greater efficiencies in designing and implementing the other NPL Guide deliverables. 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 a 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 program 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.

The core compliance outputs for BUSIs.

To summarise the NPL Guide sets the supervisory expectation that BUSIs use the following core compliance documents. These include:

1. NPL SELF-ASSESSMENT REPORT:

- if the NPL Firm elects to compile this report, then this will be a 'working' document that 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;
- NPL Firms are supposed to (whereas in the draft NPL Guide this was a strict requirement) conduct a comprehensive self-assessment of the operating environment,

impact of external factors, adequacy of their internal capabilities¹³ in dealing with NPLs and the implications that NPLs have on regulatory and economic capital;

2. NPL STRATEGY:

- NPL Firms must develop and document a NPL-specific strategy. In the final NPL Guide this extends to foreclosed assets, where relevant;
- the NPL Strategy of high NPL banks' must be approved by the management body;
- NPL Strategies must set 'sufficiently ambitious time-bound targets' over the short- (1 year), medium- (3 years) and longer-term (3 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 manner¹⁴;

3. NPL OPERATIONAL PLAN AND EMBEDDING OF THE NPL STRATEGY:

- this working document is based on the NPL Firm's specific findings and, where it exists, the NPL Self-Assessment Report. The aim of the document is to detail 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. The final NPL Guide adds that whilst origination units and WUs should be separated, regular "feedback loops" to exchange information and lessons should be established;

¹³ 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.

¹⁴ i.e. maximisation of recoveries and ultimate reduction of NPL stocks in a clear, credible and feasible manner for each relevant portfolio.

- 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 control 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) following items:

- the Internal Capital Adequacy Assessment Procedure (**ICAAP**)¹⁵: 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**"¹⁶: in instances where NPL-related indicator 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.

4. 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; and
- 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

¹⁵ As defined in Article 108 of Directive 2013/36/EU also known as CRD IV available here: <http://eur-lex.europa.eu/legalcontent/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.

¹⁶ 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>

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 code¹⁷, 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.



¹⁷ 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.

Part 6 - Focus on 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 a 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 should use terms clearly and consistently. Such consistency should be applied 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". A 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, a 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 final 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".

The final NPL Guide added that, depending on the complexity, relevant "unlikely to pay exposures" (**UTPEs**) should be included in the early arrears stage or the late arrears stage;

- 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 borrowers¹⁸. 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 aims to correspond to the EBA's "cure period" which can run for at least one year 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

¹⁸ 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.

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;

- 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 a 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 a "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 a 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 proactive 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.

Part 7 - Focus on affordability, forbearance and restructuring

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 42 to and including page 44 of the final NPL Guide). The contents of this part of the final NPL Guide have been updated since the draft version.

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. Some of the issues are explored below

The required NPL Business Policies and their likely impact:



Part 8 - Focus on 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. A full list of disclosures that are required in compliance with the NPL Guide are set out in Annex 7. This annex has been revised since the draft version. Certain NPL Firm specific templates are to be provided to each NPL Firm by their JST whereas others are to be taken from Annex 7 and embedded into the NPL Firm's operations. It is important to note that 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. Crucially, 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:

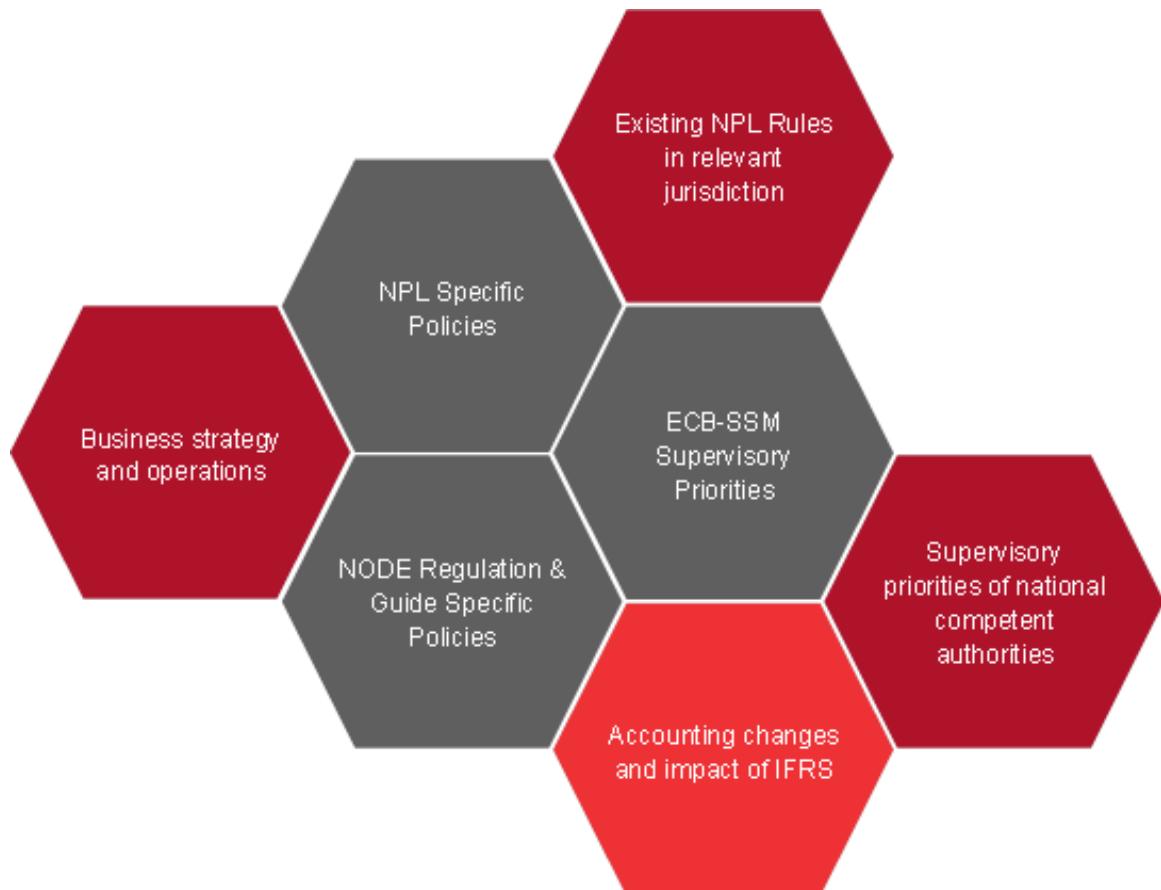
- **report** their NPL Strategy and their NPL Operational Plan to their SSM JST contacts in the first quarter of each calendar year; and
- **submit**, on an annual basis, a completed and accompanying standardised template, Annex 7 of the NPL Guide, which is to be submitted annually and which summarises 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."

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



Part 9 - Outlook and some possible next steps

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 NODE 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 regulatory reform.

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. Some of this planning might involve:

1. setting up a NPL Guide Project Group across the Eurozone:

In a manner that seeks involvement from stakeholders from all relevant Eurozone and non-Eurozone jurisdictions as well as across business and control functions. The Steering Committee of the Project Group should 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.

2. forward planning staffing and timelines for the NPL Self-Assessment Report:

As the NPL Self-Assessment Report is in many ways 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**).

3. Setting up a separate NPL regulatory/supervisory engagement team:

Such a team, especially in the case of a high NPL bank, may be invaluable. In terms of its remit, it should act both as subject matter expert and liaison with the Steering Committee of the Project Group, but should also act as diplomat and primary expert interface with national supervisory authorities, central banks, the European Banking Authority and the ECB-SSM 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.

4. Benchmark the NPL Firm's regulatory exposure:

Periodic self-assessment is a core part of monitoring exposure in the NPL Guide. NPL Firms might thus want to consider how they embed specific monitoring and benchmarking into their compliance frameworks. This might include checking 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.

Key contacts and how we can help

Baker McKenzie's dedicated and integrated Eurozone Hub is composed of lawyers from across the Eurozone and other continental EU member states. The Eurozone Hub and the wider Eurozone Group supports in-house 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 programs, 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 meet the legislative requirements and supervisory expectations in various Eurozone jurisdictions.

Eurozone Hub Contacts



Michael Huertas, LL.M., MBA
Counsel
Solicitor (England & Wales and
Ireland)
Registered European Lawyer -
Frankfurt
[michael.huertas@
bakermckenzie.com](mailto:michael.huertas@bakermckenzie.com)



Sandra Wittinghofer
Partner
Rechtsanwältin and Solicitor
(England & Wales)



Dr. Manuel Lorenz, LL.M.
Partner
Rechtsanwalt and Solicitor
(England & Wales)

Baker & McKenzie - Partnerschaft von Rechtsanwälten, Wirtschaftsprüfern und Steuerberatern mbB

Berlin

Friedrichstrasse 88/Unter den Linden
10117 Berlin
Tel.: + 49 30 2 20 02 81 0
Fax: + 49 30 2 20 02 81 199

Frankfurt am Main

Bethmannstrasse 50-54
60311 Frankfurt / Main
Tel.: + 49 69 2 99 08 0
Fax: + 49 69 2 99 08 108

Dusseldorf

Neuer Zollhof 2
40221 Dusseldorf
Tel.: + 49 211 3 11 16 0
Fax: + 49 211 3 11 16 199

Munich

Theatinerstrasse 23
80333 Munich
Tel.: + 49 89 5 52 38 0
Fax: + 49 89 5 52 38 199

www.bakermckenzie.com

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