Comments

on the EBA Consultation Paper
Draft Guidelines on management of non-performing and forborne exposures (EBA/CP/2018/01)

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Contact: Dr. Silvio Andrae
Telephone: +49 30 20225- 5437
Telefax: +49 30 20225- 5404
E-Mail: silvio.andrae@dsgv.de

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 1,700 banks.

Coordinator:
German Savings Banks Association
Charlottenstraße 47 | 10117 Berlin | Germany
Telephone: +49 30 20225-0
Telefax: +49 30 20225-250
www.die-deutsche-kreditwirtschaft.de

The European Banking Authority (EBA) published its "Draft Guidelines on management of non-performing and forborne exposures" for consultation on 8 March 2018. We appreciate the opportunity to submit our comments.

1. General comments

With regard to the structure and contents of the Guidelines, it is clear that the ECB guidance for significant institutions already published was used as a "master". Many of the EBA proposals are identical to the ECB requirements. As a general principle, we support harmonising the requirements, especially with regard to reporting requirements and related technical specifications. However, all regulatory projects should always keep an eye on the actual risk and generally enable proportionate application. In the case of the present Guidelines, we have serious concerns that the principle of proportionality is adequately taken into account in light of the different levels of NPLs held and the associated risks, as well as the structures of the institutions. Overall, these Guidelines in part render impossible the necessary proportionality that is provided for by the existing German requirements for treating non-performing loans under the "MaRisk" (Minimum Requirements for Risk Management) in Germany. For smaller banks, for example, applying the specific minimum requirements in the ECB Guidance imposes disproportionately high, granular requirements that significantly limit the scope for proportionate organisation.

As a result, we wish to urge a fundamental streamlining of the EBA Guidelines and putting the focus on a purely principle-driven basis in the same way as the German MaRisk. The particular benchmark for adhering to the principle of proportionality is whether the pursued purpose can also be achieved using less restrictive means. The focus should therefore be put on fundamental principles for which there is methodological freedom or for which there are minimum requirements as far as concrete implementation is concerned.

The proposal that the scope of minimum requirements to be met should additionally be governed by a threshold is something that we view positively overall in terms of ensuring the efficient reduction of existing levels of NPLs in a way that is aligned with the objectives of the NPL Action Plan.

Overall, we wish to emphasise that, in our view, even tremendously detailed and complex prudential requirements for risk management processes relating to NPLs will not achieve the actual goal of reducing the still excessive levels of NPLs in some EU Member States and of avoiding further risk accumulation. Overall, tackling the high levels of NPLs should be pursued using the three-pronged strategy set out in the following:

1. Consistent, clear risk management rules for identifying and treating problem loans that are geared towards sound risk management practices but can be organised to ensure proportionality,

2. Compliance with the existing accounting rules for recognising risk provisions (including strict financial statement audits) and

3. Monitoring of compliance with the above rules by the supervisors in the context of the SREP.

This issue is of fundamental importance for preserving a regulatory environment that is appropriate both for small and regional banks and for internationally operating banks. Anything else would completely frustrate the efforts pursued in the CRR/CRD review to reduce the formal burdens for smaller institutions, but would also unnecessarily burden larger institutions with cross-border activities and unnecessarily overcomplicate established, well-functioning processes.

We are particularly critical of the statements regarding risk provisioning in the present draft. There is absolutely no need for effectively establish prudential rules on loss allowances because the existing accounting rules provide adequate requirements for risk provisioning.

The planned new disclosure requirements and the extension of the templates from EBA/GL/2016/11 to all institutions are critical issues. It is questionable what this is supposed to achieve. If expanded disclosures are supposed to help companies that purchase NPLs, those companies will probably approach the bank directly and do not need any Pillar 3 disclosure. For “normal” readers, the existing disclosures are most likely sufficient and expanding the disclosures will thus tend to lead to “disclosure overload”.

All institutions are required to implement the revised definition of default in Article 178 of the CRR (EBA/GL/2016/07) by 1 January 2021. In addition, the European Commission is proposing a more detailed definition of NPEs in its draft regulation. In our view, the Guidelines should use the definition of NPEs already used for FINREP purposes. To the extent that the new definitions are to be used for the purposes of management and governance of defaulted/non-performing exposures, we urge postponing the period for introduction to the initial application date of the EBA guidelines on the regulatory default definition. This would give banks the opportunity to harmonise the definitions and enable consistent management and reporting.

2. Specific comments

Q1. What are the respondents’ views on the scope of application of the guidelines?

In our view, appropriately proportionate implementation that takes national specificities and starting situations into account can only be achieved if the Guidelines are addressed exclusively to the competent authorities (paragraph 16), without being directly binding on the institutions. Instead of being oriented on the detailed requirements for significant institutions (ECB Guidance), principle-based wording should be implemented in the Guidelines to achieve this goal. The instruments to be used would then be listed as more of a “toolbox” that enables individually proportionate application. The compact, principle-based orientation of MaRisk has proven itself in practice. Any more than this is also not necessary, at least for banks that are not systemically important. Process requirements that do not take into account the conditions of the bank (proportionality) would be too broad and would thus not be a suitable supervisory tool.

The proportionality principle anchored in paragraph 14 is not worded sufficiently flexibly to achieve this. In addition, it is oriented too heavily on the possibility of risk-dependent application of chapters 4 and 5. Instead, it should be clear that an appropriate proportionate implementation may be made for all aspects of the Guidelines.

At best, detailed guidelines in the form proposed would make sense for certain sectors in countries that the supervisors view as particularly at risk of NPLs because of their early warning indicators.

Another critical aspect in the present EBA Guidelines is the expansion of the scope to NPLs in the trading book. Because these do not impact banks’ balance sheets, but are purely held for trading, they generally increase market liquidity and allow other banks to reduce their own NPL portfolios. The definition that the EBA uses (Annex V of Commission Implementing Regulation 680/2014 – FINREP) can be understood in such a way that it would exclude trading assets within the meaning of IFRSs, but not regulatory trading assets. As the EBA evidently intended to exclude trading book assets from the scope, it would be helpful if the Guidelines were also to include an explicit exemption on this issue, based on the definition in Article 4(1)(86) of the CRR (Capital Requirements Regulation 575/2013).

The rule is too concrete in parts with regard to the necessary implementation, which prevents simple implementation variants to ensure proportionality. Compared with the tried and tested existing German practice, this applies to the following excessively detailed implementation requirements, which in our view are not necessary and could be adequately addressed by a principle-based approach. The examples of detailed requirements and instruments given in the following should be understood at most as suggestions or examples for which more general principles could be implemented:

- Breakdown of the NPL strategy into short, long-term, medium, operational plan (incl. inclusion of forbearance) (page 19f.)
- Self-assessment to be sent to the supervisor (page 20, paragraph 27)
- Process evaluations/forecasts (page 21 point f)
- Quantitative NPE targets/foreclosed assets (page 21 paragraph 30, page 23 paragraph 37, for performance measurement page 31 paragraph 76)
- Quarterly monitoring of target achievement (page 26, paragraph 56(d), if applicable in the risk report).
- Time allocation (page 27 paragraph 57)
- Forbearance monitoring (page 28 paragraph 65(b))
- Cost-benefit analysis for different liquidation options (page 28 paragraph 65(c))
- Expansion of the control report (page 33 paragraph 82)
- Reports on early warning indicators/watch list (page 38 paragraph 117)
- Early warning indicators at (sub-)portfolio level (page 38 paragraph 120(b))
- Sensitivity analyses/shock scenarios (page 39 paragraph 123)
- Monthly report on early warning indicators (page 39 paragraph 125)
- Documentation requirements for forbearance, including regarding viability (page 40 paragraph 131)
- Right to review (enforceable) for any forbearance measures (page 40 paragraph 132)
- Forbearance policies and forbearance monitoring (page 42 paragraphs 137 and 140, possibly intensive care, but this does not quite fit, page 65 paragraph 258), also quantitative (paragraph 139).
- Creditworthiness assessment for any forbearance measures (page 43 paragraph 141)
- Grouping of exposures and decision trees for forbearance (page 43 paragraph 143)
- For any forbearance measures: comparison with other options using a net present value approach (page 43 paragraph 145)
- Target definition for any forbearance measures (page 44, paragraph 146)
- Annual creditworthiness assessment (page 44 paragraph 151)
- Non-performing based on the new EBA Guidelines on connected clients (page 48 paragraph 167).
- Use of two years' EBITDA to determine gone concern (page 49 paragraph 174(b)(v))
- If applicable, more far-reaching application of the Guidelines on expected losses EBA/2017/06 (page 52 paragraph 181, footnote 39).
- Back-testing of risk provisions (page 53 paragraph 186).
- Review of collateral valuation policies at least annually (page 54 paragraph 196).
- Regular testing of independence of external appraisers (page 55 paragraph 199)
- Regular comparison of valuations by external appraisers with current market values (page 55 paragraph 199, page 56 paragraph 209)
- Back-testing of valuations (page 55 paragraph 199)
- Rotation for appraisers (page 55 paragraph 201)
- EUR 300,000 limit for indexed valuations (page 56 paragraph 205)

- Independence requirements for appraisers with regard to the loan process (page 57 paragraph 210(a))
- Independence requirements for first-grade relatives of the appraiser (page 56/57 paragraph 210(a)–(g))
- Annual requirements for valuations (page 57 paragraph 215)
- Mandatory list of criteria for determining a significant decline in value (page 58 paragraph 218)
- European Valuation Standards for valuing collateral (page 59 paragraph 226)
- Documentation of the expected timing of cash flows (page 61 paragraph 239(c))
- Back-testing for haircuts (page 61 paragraph 242).
- Transaction database with predefined content (point 9.6, page 61f. paragraph 244f.)
- Description of resource requirements (human and technical resources), page 75 Annex 4
- Minimum key financial repayment capacity metrics/ratios, pricing policy (page 76).

Q2. What are the respondents' view of the proposed threshold of 5% NPL ratio?

We generally support a statistical threshold because it is almost impossible to predict the effects of a variable threshold. In addition, a distinction can be made between low- and high-NPL banks. However, an approach to implementing the priority that is exclusively or primarily based on the threshold is not sufficient.

It is not possible to reproduce the quantitative justification of the threshold of 5% in its entirety, but it should not be smaller, especially when it also refers to a sub-portfolio level. Anyway, it seems not feasible to apply chapters 4 & 5 at portfolio level, when breaking the thresholds for single portfolios. So we suggest to delete the application of the threshold on portfolio level.

We are concerned in particular that the NPL ratios are calculated based on gross values (see definitions in paragraph 17 that refer to Annex V of the Reporting Regulation (EU) 680/2014), i.e. without taking account of collateral and specific provisions that have already been recognised. What this means is that even banks with a thoroughly sound structure with regard to collateral coverage and risk provisioning could also fall (possibly temporarily) under the scope of the complex rules in these sections in individual cases.

Q3. Do you see any significant obstacles to the implementation date and if so what are they?

The detailed nature of the requirements means that the use of IT will play an important role. This is not only because a manual implementation would be almost impossible, but also because it is a direct requirement in some of the requisitions (e.g. page 31 paragraph 70(a), database in point 9.6, page 61f., paragraph 244f.). Such complex instruments need an implementation period of at least one year after publication of the final requirements (by the competent authorities).

In addition, the precise reporting requirements that are still outstanding should be announced at an early stage. The implementation period until 1 January 2019 is in any case very tight and implementation by the specified date – especially with regard to possible IT requirements – is further complicated by outstanding rules.

Q4. Does section 4.3.2 capture all relevant options available for credit institutions to implement their NPE strategy?

n/a

Q5. Do you see any significant obstacles to the operationalisation of the NPE strategy as described in chapter 5?

A positive factor is that the EBA accepts all forms of collateral and there are no restrictions such as in the COM proposal or the ECB Guidance.

Q6. Does the viability assessment of forbearance measures capture all relevant aspects?

We do not believe that the distinction between short- and long-term forbearance measures is rational.

The statement that a detailed assessment of the borrower's financial position should be made before granting forbearance measures contradicts other rules (e.g. in the context of the Mortgage Credit Directive with reference to section 505a(3) of the German Civil Code (BGB)). The assessment of debt servicing capacity in the course of restructuring is technically advisable, but only makes sense to a limited extent if repayments are forborne.

Some defined criteria are too narrow and are not understandable in part. If a less concrete and principle-based approach is not pursued, in our view the following aspects in particular need to be expanded:

- short-term period for project finance (paragraph 131a)
- "formal manner via written documentation … concluding that a long-term … was not possible" (paragraph 131a)
- "good financial relationship" (paragraph 131b)

Q7. What are the respondents view on the proposed requirements for recognition of non-performing and performing/non-performing forborne exposures?

We welcome the proposed harmonisation with the FINREP requirements and definitions. It should be ensured at all events that no parallel processes are developed and that there is complete harmonisation. With regard to the explanations in the Guidelines, however, we see the risk that contrary statements could emerge in the course of the administrative practice regarding FINREP. In this respect, any content-related discussion of the classification should be avoided at this point or kept to an absolute minimum and, if possible, reference should be made to existing requirements and criteria.

Q8. What are respondents view on the requirements on timeliness of impairments and write-offs of NPEs?

This issue should be answered solely from the perspectives of accounting or financial reporting, and no parallel world should be created by the supervisors. It is certainly true that accounting issues are fundamental for supervisory law. However, responsibility for them lies elsewhere (national lawmakers, the IDW (Institute of Public Auditors in Germany), university departments of accounting, the IASB, etc.)

We are thus particularly critical of the statements regarding risk provisioning. There is absolutely no need here for effectively establish prudential rules on loss allowances (especially not if they are clearly weighted towards IFRSs, as they are in the EBA draft). Rather, the existing accounting rules apply (incl. nGAAP; German GAAP loss allowances were and are prudent and sound). In this respect, the risk management requirements should merely stipulate – in line with the MaRisk – that exposures must be valued in a timely manner in the course of problem loan management and that a risk provision must be recognised or adjusted if necessary.

Ultimately, the indirect route via “prudential loss allowances” results in a requirement for IFRS rules for all banks, for which neither the ECB nor the EBA have a mandate.

Q9. Do you have any significant objection against the proposed threshold for property-specific valuation (EUR 300,000)?

We are highly critical of the requirement to regularly review property-specific collateral for NPLs larger than EUR 300,000 and believe that it is not consistent with the CRR. Regular monitoring on the basis of statistical methods (Article 208(3) of CRR) ensures the close monitoring of the real estate market for commercial and residential property. The valuations are then assessed if required and collateral is revalued if necessary. For loans exceeding EUR 3 million or 5% of the institution’s own funds, property valuations are in any case reviewed at least every three years.

Moreover, a single threshold for all European real estate markets is not appropriate and must therefore be rejected. Prices on national and in some cases also regional real estate markets often exhibit considerable differences. There may be regions in Europe in which property values of EUR 300,000 can still be found for more complex properties. In other regions, simple, standard properties are already higher than this threshold. The aim of any threshold should be to ensure that it captures properties for which there is a sufficiently transparent market, and hence there is sufficient data availability and quality to allow a sound index to be derived. This does not necessarily have to be stipulated by using a arbitrarily chosen maximum amount. If a *de minimis* rule is to be introduced, it should not be focused on a concrete euro amount, but rather on the property type and characteristics, in order to ensure equal treatment across Europe regarding the monitoring requirements. For example, the *de minimis* rule could cover standard property types such as single and two-family homes, as well as condominiums.

All relevant aspects of real estate valuation are addressed in principle. It should generally be ensured that sufficient scope remains for the credit institutions to reflect in their implementation the relevant national specificities regarding functioning and data availability on the real estate markets, as well as the national valuation methods. Paragraph 226 should therefore be expanded; instead of “National Standards can also be accepted...”, it should read “National Standards are accepted…”.

We would like to make the following specific comments:

We wish to propose the following clarification regarding external appraisers: “[The appraisers] must be engaged by the credit institution and may not have been engaged in the preceding two years by or on behalf of the borrower to perform a valuation of the property.”

Paragraph 199: Quality assurance of internal appraisals should be implemented in particular by means of a dual-control principle in the valuation unit, and by an internal plausibility check in the case of external appraisals. Can it be presumed that these requirements can be implemented directly in the appraisal unit?

Paragraph 200: We suggest making the organisational embedding for this process more flexible in order to ensure that it is located where the best possible knowledge and experience of making these reviews is present.

Paragraph 201: We believe that the requirement to use another external appraisal provider under certain circumstances is too far-reaching. It goes beyond the requirements in the ECB Guidance on NPLs. It should be sufficient in such cases to ensure the rotation of responsibility within the external appraisal provider. Specifically, we suggest amending the end of the last sentence to read "…or to a different external appraiser."

Paragraph 218: The requirements in Article 208(3) of CRR to monitor real estate markets and review property valuations mean that relevant processes already exist at the credit institutions. It should be clarified that the requirements in paragraph 218 correspond to those of the CRR.

Paragraph 224: It is common practice in Germany to value single and two-family homes using the "Sachwertverfahren", which is a specifically German form of modified cost approach. To confuse matters, the discounted replacement cost approach is often mistranslated into German as "Sachwertverfahren", although there are methodological differences between the two approaches. This requirement could result in the non-recognition of all valuations of single and two-family homes using the "Sachwertverfahren", which would thus negate the longstanding valuation practice in Germany. We therefore propose deleting this requirement. As an alternative, the requirement could be expanded to specify that an exclusively cost approach within a valuation methodology will not be accepted. The "Sachwertverfahren" combines the cost and market approaches by including the land value – generally derived from comparative values – and applying a market adjustment if necessary.

Q10. Do the requirements for valuation of movable property collateral capture all relevant aspects?

The independence requirements (paragraph 199) are too broad: For example, there is no such process-related separation and testing requirement for life insurance policies (e.g. back-testing for life insurance policies and seized deposits does not correspond to the actual requirements).

We would ask you to clarify whether Article 229 of CRR continues to apply as before (only immovable property has to be valued by independent appraisers) or whether, in accordance with the wording in the consultative document, all collateral now has to be valued by independent appraisers (section 9.1.4, paragraph 207).