



Non-performing loans in Europe

What are the solutions?



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Executive summary

The Problem

Many banks across Europe suffer from high levels of non-performing loans (NPLs), in particular in Cyprus, Greece, Portugal, Ireland, Italy and some Central and Eastern European countries. NPLs across the euro area peaked at eight percent¹ of total loans in 2013 and have fallen only gradually in some countries since then.

NPLs consume capital, management time and attention. They decrease profitability and leave some banks in a weak position from which to provide finance to support growth and jobs – which in turn may limit the effectiveness of monetary policy. They may even undermine the viability and sustainability of a bank.

So why have NPLs remained stubbornly high in some banks and some countries? In this paper we highlight four key reasons for this:

Source:
1 – The World Bank. (See chart 1 on page 7).



Banks' lack of preparedness

Some banks are unprepared to manage NPLs effectively.

They may not have stratified data on NPL exposures, optimised strategies to reduce them (through workout or sale), or managers with sufficient NPL expertise.



Structural impediments

In some countries the effective management of NPLs is hampered by unbalanced national insolvency regimes, in which some types of creditor are overly-protected from foreclosure actions; an unavailability of out of court restructuring arrangements; insufficient numbers and skills in the judiciary to process actions against non-performing borrowers; political pressures on lenders and/or the judiciary to avoid foreclosures; and legislative limitations on holders of some asset classes and on the sale of some types of collateral (for example residential property).



Investor pricing

Banks may be reluctant to sell NPLs because of high bid/ask spreads in the market, reflecting information uncertainty about the value of NPLs, the time and cost to recover the value in a NPL or to realise the value of collateral, differing views about the macroeconomic outlook, and the sheer volume of the NPL overhang.



Limitations on government assistance

There are financial and legal constraints on government assistance, including EU State Aid rules, the BRRD resolution framework and EU states' fiscal capacity. All of these factors limit governments' ability to create NPL Asset Management Companies (AMCs), provide guarantees or directly recapitalise banks.

Is there a solution?

It is possible to address these impediments. The European Central Bank guidance on NPLs should increase banks' preparedness; more active markets for NPLs have developed in some countries, assisted in part by national asset management companies; and macro-economic conditions are showing signs of improvement in Europe.

But in some countries it has proved difficult to tackle many of the deep-rooted structural impediments, leaving too wide a gap between bank and investor valuations of NPLs and of underlying collateral. There remains a degree of both uncertainty and perhaps over-restrictiveness in the application of EU State Aid and bank resolution rules to any solution involving public funds or government guarantees.

Managing NPLs should not be viewed as a bank-by-bank issue. Some solutions need to be facilitated by regulators and other authorities. More generally, NPL management has to be considered within the wider picture of the lack of profitability of many banks across Europe, even those with low levels of NPLs; over-banking and slow progress on consolidation in many European countries, and across a fragmented EU banking sector; and the impact of Fintech – and potentially of Capital Markets Union – on the European banking system.



Non-performing loans: the harsh facts

NPLs increased sharply on average across the European Union following the financial crisis, rising from two percent of total loans in 2006 to a peak of seven percent in 2012/2013; and to a peak of eight percent in the euro area. They have declined slowly since then. (See Chart 1).

This average picture masks sharp divergences across EU countries. As at end-June 2016, NPLs in major banks averaged 47 percent in Greece, 45 percent in Cyprus, and around 20 percent in Bulgaria, Hungary, Ireland, Italy, Portugal and Slovenia. Within these country averages there is a wide dispersion across the major banks in some of these countries, in particular in Italy and Portugal. (See Chart 2).

Another difference across countries is the sectoral distribution of NPLs. In all high NPL countries there is a high rate of NPLs in loans to non-financial corporates. But there is a much more varied distribution of NPLs in lending to households and to the financial sector. (See Chart 3).

Forbearance ratios are roughly half the level of NPL ratios in most high NPL countries, with generally less variation across the major banks within these countries. Relative to their NPL ratios, forbearance ratios are highest in Ireland, Portugal and Spain. Indeed, in Spain the forbearance ratio is higher than the NPL ratio, suggesting that there is a risk that the NPL ratio could increase if forbearance does not reflect a purely temporary liquidity problem among borrowers. (See Chart 4).

There is less variation across countries and across major banks in coverage ratios. These are mostly around 40-50 percent. Perhaps surprisingly, there does not appear to be a correlation between coverage ratios and the sectoral distribution of NPLs. (See Chart 5).

Chart 1:
NPLs as a percentage of total loans

Source: The World Bank: World Development Indicators

— European Union
— Euro area

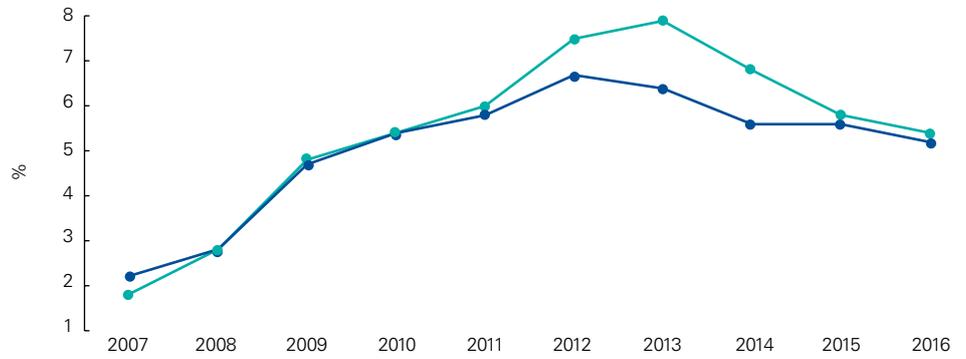


Chart 2:
NPLs (as a percentage of total loans): average and highest/lowest values for major banks End-June 2016

Source: EBA transparency exercise and KPMG Peer Bank

■ NPLs ratio
● Highest
● Lowest

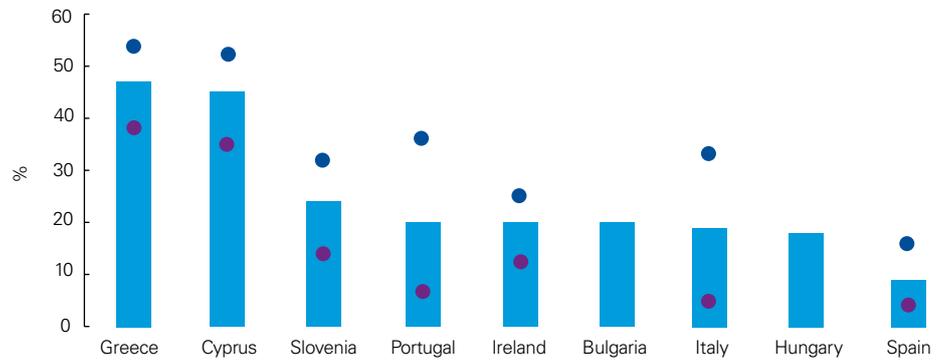


Chart 3:
NPLs (as a percentage of total loans) by sector End-June 2016

Source: EBA transparency exercise and KPMG Peer Bank

■ Government
■ Financial
■ Non-financial corporate
■ Households

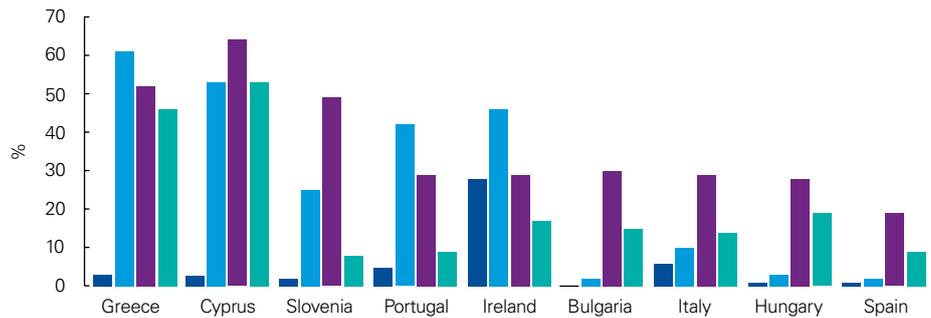


Chart 4:
Forbearance (as a percentage of total loans): average and highest/lowest values for major banks End-June 2016

Source: EBA transparency exercise and KPMG Peer Bank

■ Forbearance ratio
● Highest
● Lowest

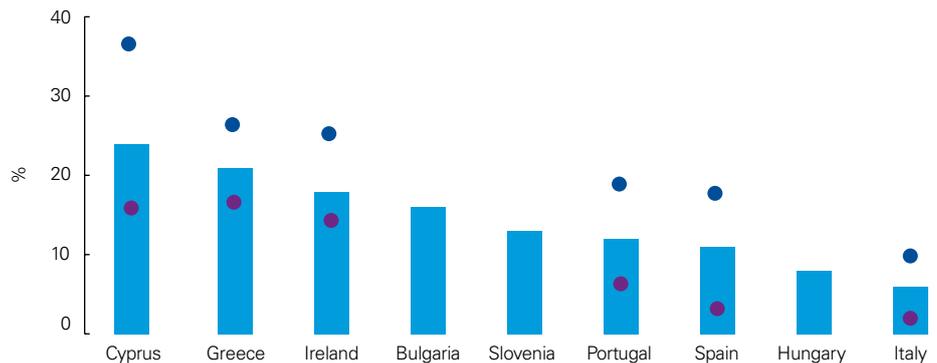
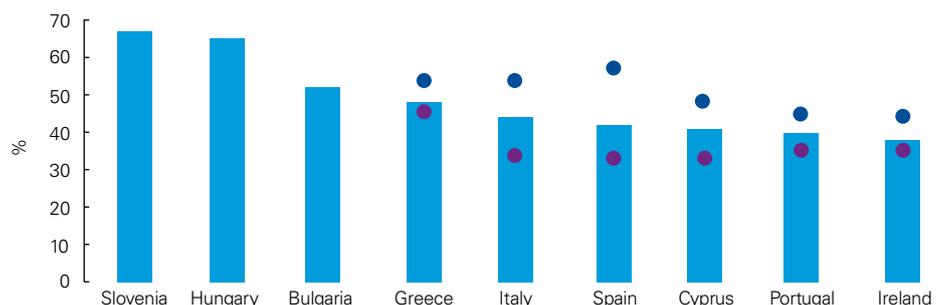


Chart 5:
Coverage (specific provisions as a percentage of NPLs): average and highest/lowest values for major banks End-June 2016

Source: EBA transparency exercise and KPMG Peer Bank

■ Coverage ratio
● Highest
● Lowest



Impediments: why does the problem remain?

NPLs are bad news for banks. They consume capital; they require management time and attention that diverts attention from the bank's core activities; they increase the running costs of the bank; they decrease profitability; and they may even undermine the viability and sustainability of the bank.

NPL management

Banks should therefore be expected to be aggressive in managing their NPLs, even if this means bearing operational costs or crystallising losses on a sale. This may however require some recapitalisation of the bank, which too often constrains a bank from taking adequate actions. There is therefore no single solution, but rather a spectrum of possible options here. For example, the bank could follow one (or a combination) of the following routes:

1. Establish an independent "workout" unit within the bank – with or without specialist external assistance – to manage down its NPLs (and if necessary to take collateral against foreclosed loans temporarily onto its balance sheet), while interfering as little as possible with the running of the rest of the bank.
2. Enter into a joint venture risk-sharing agreement with a third party under which the non-performing assets remain on the bank's balance sheet but the bank shares both the upside and the downside from the management of the portfolio.
3. Securitise its NPLs by transferring them to a special purpose vehicle which funds these assets through the sale of tranches of securities to external investors (with the originating bank probably taking the most risky equity-like junior tranche).

The management of the NPLs may also be undertaken by a third party servicing manager. This may enable the bank to achieve some accounting derecognition and regulatory capital relief. This option may also have some advantages over a clean sale of the NPLs - the lender of record remains the originating bank; high taxation on sale of collateral (especially real estate) may be avoided in some countries; there is the possibility for the Government to guarantee or co-invest in more senior tranches (in Italy the Government has guaranteed the senior tranche of some banks' securitisations of NPLs); and some investors may only be able to invest in rated securities.

4. Sell its NPLs to a national AMC established by the Government for this purpose. At present such schemes are national and only exist in a minority of countries, in part due to limitations related to EU State Aid and burden sharing, as well as the complexity of setting up such structures. Policymakers including the European Banking Authority (EBA) are driving a debate on the establishment of a pan-EU AMC, or a blueprint to facilitate the establishment of additional national AMCs.

5. Sell its NPLs to third party private sector investors through a 'clean-sale'. For this option to be realistic, the bid/ask spread usually needs to be no more than 10 percent, so that the "day one" loss to the selling bank remains at a manageable level.

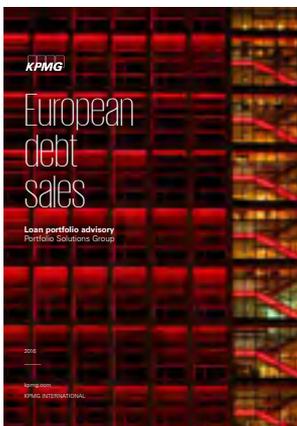
Banks in some countries (Spain is the most notable example here) have been relatively successful in managing down their NPLs. This has generally relied on intensive workouts by these banks; access (by banks and investors) to external specialised NPL servicers; a mature and reasonably active NPL market into which banks can sell or securitise their NPLs; a reasonably well-developed ability for investors to value and to realise collateral; and a national AMC willing and able to purchase large amounts of NPLs or whole portfolios of an asset class. Spanish NPL deleveraging was also supported by the restructuring of the banking sector in 2010 and system-wide recapitalisation of the banking sector in 2012.

Overall, however, the level of NPL transactions in Europe has remained relatively small – transactions in the region of €100 billion across Europe in 2015 represented less than 10 percent of the outstanding stock (see KPMG European Debt Sales Report).

Why is this? The effective management of NPLs by banks may be constrained by four main factors.

Banks' lack of preparedness

First, some banks are unprepared to manage their NPLs effectively. They may be suffering from management inertia and a lack of a clear NPL strategy; they may not have established strong "workout" teams or linked with partners able to bring the necessary resources and expertise; and they may not have undertaken the ground work necessary to establish books of homogeneous NPLs for sale. These internal issues – and many more considerations – are covered in the ECB guidance on NPLs summarised on pages 16-19.



<https://home.kpmg.com/xx/en/home/insights/2016/02/european-debt-sales-2016-edition.html>

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When we speak with NPL investors, their first priority is certainty of legal outcome. The greater the variability in timing and outcome of legal process, the more likely investors are to require “20%+” returns. Viewed through this lens, legislators may partly hold the key to reducing investors’ return targets and high levels of bid-ask spread. ”

Andrew Jenke
Partner, KPMG in the UK



Structural impediments

Second, in some countries the development of an active market for NPLs may be constrained by various structural impediments. These will also tend to increase the time and cost of making recoveries against NPLs or realising the value of collateral, and to widen bid/ask spreads. These structural impediments – which are outside the control of the banks – include:

- Unbalanced national insolvency regimes, in which some types of creditor (for example retail mortgage borrowers) are overly-protected from legal enforcement actions to foreclose NPLs and to take ownership of the underlying collateral;
- The unavailability of out of court restructuring arrangements;
- Insufficient numbers and skills in the judiciary to process enforcement actions against non-performing borrowers;
- Political pressures on lenders and/or the judiciary to avoid foreclosures;
- Legislative limitations on holders of some asset classes, limiting the scope for the involvement of servicer companies and some types of investor (in some cases only other banks may be able to service or buy NPLs);
- Legislative and other limitations on the sale of some types of collateral (for example residential property).

Investor Pricing

Third, banks may be reluctant to sell NPLs because of high bid/ask spreads in the market. Various factors are driving a wedge between a bank's current book value of NPLs (net of the bank's incurred loss provisioning against these impaired assets) and market prices for these NPLs. This may arise because potential investors in these assets may factor into their pricing decisions a series of discounts to reflect (a) inadequate data and information asymmetries – the selling bank has more information about the NPLs than investors so investors may bid lower to reflect this uncertainty; (b) the potential time and cost to recover the value in a NPL, or to realise the value of collateral, which reduces the long-term economic value of NPLs; and (c) differing views about the macroeconomic outlook – local banks may be more optimistic than foreign investors about the strength of, and prospects for, the local economy.

In addition, the sheer volume of the NPL overhang, combined with the attempts by some banks to pull out of non-core businesses even where they are fully performing, raises questions about the capacity of the market to absorb all the assets that banks are seeking to sell. This will also tend to move market prices against the selling banks.

Reducing EU NPLs: ingredients for success



Limitations on government assistance

Fourth, there are limitations on government involvement in NPL solutions because of EU rules on State Aid and on bank resolution. In practice nearly all national AMC's have benefited from government support in some form, including:

- guarantees to meet any losses or to guarantee AMC funding (this can result in the AMC having a 'sovereign' rating, such that AMC securities are, for example, eligible as repo collateral);
- the AMC buying assets above their market value (the value an investor

would pay), as a result of taking a longer-term view of economic value. The excess of economic value over market value represents State Aid and requires bank-level approval by the European Commission; and

- the government recapitalising banks that participate in AMC schemes, as occurred in Spain.

Even where some form of government assistance has been permitted the most recent EU bank resolution rules (BRRD) generally require that at least the subordinated debt of a bank is bailed-in (written off or converted into equity)

so that any recapitalisation burden is at least shared between the public and private sectors.

The Atlante fund in Italy illustrates what can be achieved without State Aid, but also the limitations of such solutions. The Atlante fund is financed by the Italian banking sector and uses its funding to support both the recapitalisation and the removal of NPLs from troubled Italian banks that cannot obtain market funding. Such a solution relies on a degree of systemic strength that is not evident in most high-NPL EU countries.

Elements of a solution



The success of the Banking Union project and, to a degree, the success of the Euro itself are now tied to EU bankers' and policymakers' ability to cleanse balance sheets of Non-Performing Loans. This is why the NPL topic is not only core to the SSM's 2017 priorities, but also to that of the European Commission and ECOFIN. ”

Marcus Evans
Partner, KPMG ECB Office

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As is recognised by the Single Supervisory Mechanism (SSM), there is no benefit in simply forcing banks with high NPLs to sell them in cases where constraints are overwhelming. The impediments need to be addressed. Doing so would help to create a more active market for NPLs, with narrower bid/ask spreads. Reducing the structural impediments would also increase the net present value of NPLs, providing banks with more of a buffer to absorb further losses and increasing the range of options available to them to resolve NPLs.

Although no two EU countries are identical, the key areas requiring national or EU-wide action to address legal and process impediments are:

- Introducing a more balanced insolvency regime, with sufficient certainty over the timing and outcomes of legal processes to support both banks' own workouts and an active and mature market in NPLs. The issues here include the rights of debtors, enforcement processes and timescales, test cases to develop case law and provide the basis for out of court settlements, and the training and resourcing of the judiciary;
- Developing a securitisation market for NPLs. In some countries this may require changes to legislation and regulation, and some element of government guarantees to underpin the market, at least initially;
- Developing the provision of non-bank servicers of NPLs by allowing a wider range of investors, not just (other) banks or joint ventures. This could widen the options available to banks with high NPLs and assist with more accurate pricing as information on asset quality and recoveries is shared more widely;

- Creating some type of centralised information platform to lessen the information asymmetry problem between banks and investors; and
- Clarifying and possibly relaxing the EU parameters for EU State Aid being permitted to support AMC's – to facilitate the creation of an EU-wide blueprint for national AMC's that are able to purchase NPLs at their economic value, while ensuring some burden-sharing with the bank and its equity and bond holders.

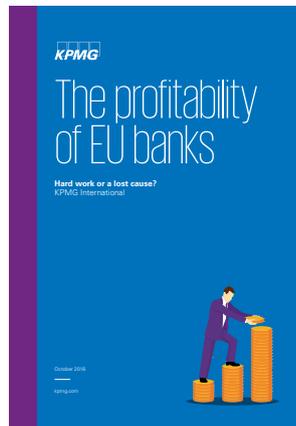
There have also been proposals to create an EU-wide or Banking Union-wide “bad bank” asset management company, notably by Andrea Enria, the Chair of the EBA, in late January 2017. In our view, it may be too complicated to create a multi-country, multi-asset class AMC. Such an AMC would face difficulties in the valuation of apparently similar assets within different legal environments, and would require multi-lingual staff conversant in multiple insolvency frameworks and debt servicing protocols. A pan-EU AMC may become a more feasible option if it followed the implementation of a pan-European insolvency framework. Until then it may be more productive to focus on facilitating the creation of a national AMC blueprint, for EU countries where AMC's do not currently exist, such that Ministries of Finance, supervisory authorities and banks themselves have the template of a solution that key stakeholders (the European Commission, the ECB, the EBA and the Single Resolution Board) would in principle accept.

The final necessary element of any solution is to recognise and respond to the possibility that some banks in some countries may not have a viable and sustainable future even if they

could remove NPLs from their balance sheets. The most optimistic scenario used to estimate the value to banks of addressing their NPL problems is that the capital released can be used to support profitable new lending.

In practice, however, banks may struggle to find higher quality and profitable lending opportunities, even if they adopt stricter underwriting standards. For banks without higher quality lending opportunities – and possibly for the banking sector as a whole in some countries – the removal of NPLs should result in a significant and permanent downward shift in the size of their balance sheets.

Replacing NPLs with new lending that also becomes non-performing is not a viable solution, and we would therefore expect both banks and their supervisors to focus on flows of new NPLs as well as on progress in reducing the historic stock of NPLs. Indeed the European Central Bank has already announced that it will be focusing on the “steady state” level of NPLs in individual banks.



<https://home.kpmg.com/xx/en/home/insights/2016/10/the-profitability-of-eu-banks-fs.html>



Regulation and supervision

The ECB's three main supervisory priority areas for 2017 are business models and profitability drivers; credit risk; and risk management. The approach to NPLs is the most important element within the ECB's focus on credit risk, while for some banks NPLs are a key driver of low profitability and may call into question the viability and sustainability of a bank's business model. NPLs are less of a focus for the UK PRA because UK banks generally have low levels of NPLs.

The ECB has already begun to look closely at some banks' NPL classifications, targets and operational management. Some ECB supervisory visits have been used to develop a consistent assessment methodology, and some banks have received, or will receive, bank-specific targets from the

ECB for NPL reductions over the next few years.

The ECB issued in March 2017 the final version of its guidance to banks on how they should manage their NPLs (see pages 16-19). The ECB views the guidance as a supervisory tool that

clarifies and harmonises supervisory expectations across the banking union area regarding NPL identification, management, measurement and write-offs, where existing EU and national regulations, directives or guidelines are silent or lack specificity.

The ECB guidance:

- Follows the “life cycle” of NPL management: strategy; governance and operations; forbearance; NPL recognition; NPL provisioning and write-off; and collateral valuations.
- Builds on the European Banking Authority's (EBA) common definition of non-performing exposures (more than 90 days past due or “unlikely to pay”) and recognises the interlinkages with existing and prospective accounting standards (in particular the move to IFRS 9 in 2018).
- Applies to all banks directly supervised by the ECB. National regulators are likely to apply it (proportionately) to a wider range of banks. Some parts of the guidance (strategy, governance and operations) are of most relevance to high NPL (in terms of stocks or flows) banks, but other parts are seen by the ECB as being relevant to all banks.

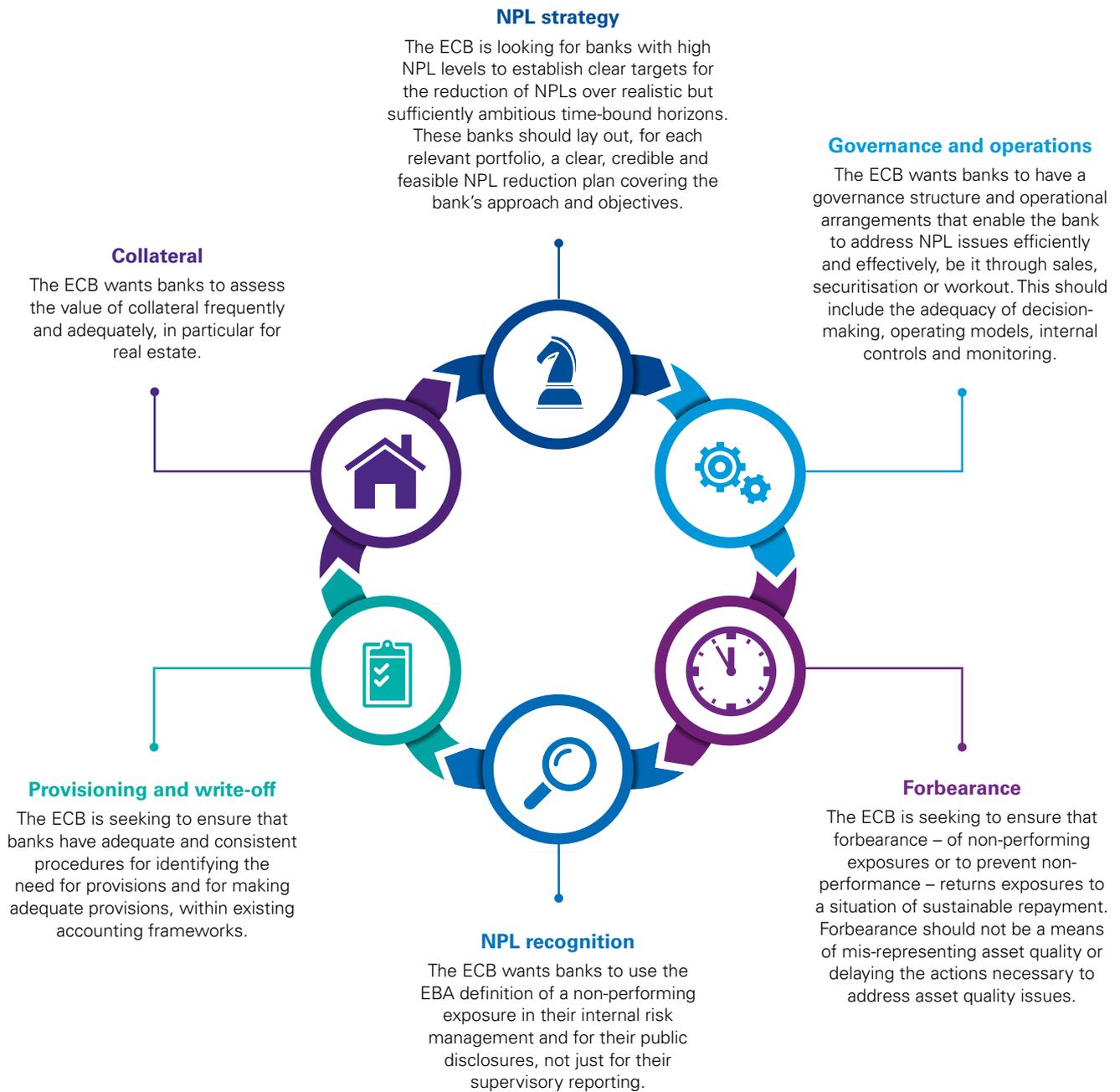
- Is applicable immediately from its date of publication, although banks may close identified gaps based on suitable time-bound action plans agreed with their joint supervisory team. The enhanced disclosures on NPLs should start from 2018.
- Will form part of the basis for the ECB's regular Supervisory Review and Evaluation Process (SREP).

The emphasis throughout the guidance is on banks putting in place:

- Board level (unitary board or supervisory board in a dual board structure) oversight of NPL strategy and policies;
- Sufficient operational capacity at all levels and covering all three lines of defence, including:
 - standard and documented operational policies and procedures

- people and skills
- data and information – on which to base classification and provisioning decisions, develop early warning indicators, and to monitor and report performance
- IT systems and infrastructure for NPL management and monitoring - to capture and report data and to support the implementation of consistent policies
- A portfolio-by-portfolio approach to the strategy and management of NPLs
- Systems for supervisory reporting and public disclosure.

ECB guidance to banks on NPLs: ECB objectives



ECB guidance to banks on NPLs:

Key issues for banks



NPL strategy

Banks need a fit for purpose NPL strategy. The ECB guidance sets out four key stages in developing and executing an NPL reduction plan:

1. Assessing:

- The bank's internal capabilities to manage (maximise recoveries) and reduce NPLs effectively over a defined time horizon;
- The external conditions and operating environment (macro-economic prospects, market, potential investors, servicing capacity, legal, consumer protection and tax);
- The capital implications (analysis and projections) of the NPL strategy;
- Relevant portfolios that the strategy needs to cover.

2. Developing a strategy:

- Targets (high level targets, aligned with more granular operational targets) for projected NPL reductions over the short, medium and long term;
- Consider, analyse and decide upon implementation options and targets for each relevant portfolio;
- A clear operational plan for developing operational capabilities.

3. Implementing the operational plan:

- Putting the required resources, capabilities and structure in place;
- Data availability and integrity;
- Work-out capacity if that is a chosen option for one or more portfolios.

4. Embedding the strategy:

- Communicating the NPL strategy internally;
- Clear allocation of responsibilities and accountability;
- Integrate in overall business plan, risk management framework and performance management framework;
- Internal reporting and independent monitoring of evidence-based progress against the plan;
- Reporting of strategy and operational plan to supervisors.



Governance and operations

Banks need to put the necessary building blocks in place to govern and implement their NPL strategies. The ECB guidance focuses on:

1. Role of the management body in governance and decision-making:

- Approve annually the NPL strategy and operational plan;
- Define management objectives and incentives, and approval processes for workout decisions;
- Approve NPL policies (arrears, forbearance, debt recovery, foreclosure, collateral and provisioning) and ensure sufficient internal controls over NPL management processes;
- Oversee and monitor the implementation of the NPL strategy;
- Have sufficient expertise on the management body with regard to the management of NPLs.

2. NPL operating model:

- Dedicated NPL workout units with sufficient expertise, infrastructure and related control functions (covering all three lines of defence), separate and independent from loan origination;
- High NPL banks should set up different workout units for each phase of the NPL life cycle – early arrears, restructuring and forbearance, liquidation and foreclosure, and the management of foreclosed assets;
- As with the NPL strategy itself, aligning the workout units with the segmentation of non-performing portfolios;
- Regular feedback loops and smooth flow of information between credit units and NPL workout units;
- Minimum monitoring period for forborne exposures for transfer out the NPL workout units (at least one year, in line with the EBA's probation cure period definition);
- Explicit veto right for risk control functions, to ensure independence of the risk control function and sufficient power to intervene in risk-related decision-making.

3. Monitoring and early warning mechanisms

- Develop key performance indicators to measure progress, covering high-level NPL metrics, customer engagement and cash collection, forbearance activities, and liquidation activities;
- Develop early warning indicators and alerts for each portfolio to spot signs of emerging credit quality deterioration.



Forbearance

Banks need to be able to assess the viability of forbearance solutions. The ECB guidance focuses on:

1. Affordability assessments

- Analysis of standardised financial information templates for borrowers;
- Use of external credit registers, where available;
- Conservative projections.

2. Forbearance options

- Short term, to meet temporary liquidity constraints facing a borrower with a good financial relationship with the bank;
- Long term, where based on an affordability assessment and where the forbearance option fully addresses outstanding arrears;
- Usually not appropriate where multiple consecutive forbearance options have been applied previously to the same exposure.

3. Forbearance processes

- Affordability assessment;
- Standardised solutions and decision trees;
- Comparison against other workout options;
- Multiple forbearance measures need the attention of the risk control function and the explicit approval of the relevant senior decision-making body;
- Milestones and monitoring for each solution;
- Supervisory reporting and public disclosure.



NPL recognition

Banks should base their NPL policies and procedures on the EBA definition of a non-performing exposure:

1. EBA definition of a non-performing exposure

- Wider definition than accounting standards;
- Based on more than 90 days past due and/or on an “unlikely to pay” assessment;
- List of triggers for the “unlikely to pay” assessment.

2. Forbearance

- Conditions under which forbore exposures can be classified as performing or non-performing, and can move from non-performing to performing.

3. Additional definition issues

- Consistent definition of non-performing exposures at banking group level;
- Groups of connected clients;
- “Pulling effect” – classify all exposures to a borrower as non-performing if 20 percent or more of exposures to the borrower are non-performing;
- If part of an exposure is non-performing then the entire exposure should be classified as non-performing.

4. Links with accounting definitions

- Align regulatory and accounting definitions wherever possible, including for impairment;
- When IFRS 9 comes into force, at least all Stage 3 exposures are expected to be subject to this NPL guidance;
- Use EBA definition for public disclosures.



Provisioning and write-off

Banks need to be able to assess accurately the required level of provisions and write-offs and to follow proper policies and procedures for determining this:

1. Individual estimation of provisions

- Criteria to determine individually significant exposures;
- Conservative approach to estimation of future cash flow and recoverable collateral, under “going concern” and “gone concern” scenarios.

2. Collective estimation of provisions

- Criteria for grouping exposures for collective assessment;
- Define methods and parameters, based on suitable data series, to avoid arbitrage and undue discretion;
- Integrated into a bank’s risk management systems.

3. Related issues

- Treatment of off-balance sheet items such as guarantees and loan commitments;
- Recognition and reversal of impairment losses;
- Policies and criteria for the timely writing-off of uncollectable loans;
- Documentation, supervisory reporting and public disclosure.



Collateral

Banks need to be able to demonstrate that their valuations of real estate collateral are up-to-date, well founded, and are based on independent assessments. The ECB guidance focuses on:

1. Governance

- Valuation policies and procedures approved by the management body;
- Monitoring and controls, with strong quality assurance independent of the loan origination process;
- Independence and rotation of (internal or external) valuation appraisers.

2. Valuation approach

- At least annually for real estate collateral against NPLs;
- Value on basis of market value or mortgage lending value, not discounted replacement cost;
- Back-testing requirement aligned with IFRS 9 (in particular where indexation is applied);
- In a “gone concern” scenario, apply discounts for liquidation costs, stressed sale price, time to disposal and maintenance costs.

3. Foreclosed assets

- Plan to sell within short timeframe;
- Value at lower of (a) fair value less costs of selling and (b) financial assets applied;
- Liquidity discounts where difficult to sell foreclosed assets.

KPMG Survey results

Responses from 18 banks in 10 SSM countries imply that the average bank requires approximately 1-2 years to implement the ECB guidance, will spend over €5 million in the process, and views the highest impact areas as: data and documentation; internal reporting; IT; and collateral management.

KPMG survey on implementation challenges in reducing NPLs

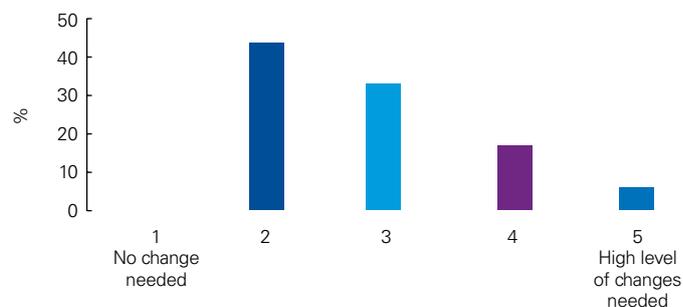
The KPMG ECB Office conducted a survey at the end of last year (following the publication of the consultative version of the ECB guidance paper) on the implementation challenges facing banking union area banks seeking to reduce their NPLs. The responses from 18 banks in 10 SSM countries show that many banks expect to have to make significant improvements to their processes for the internal reporting of NPLs; to their NPL-related IT infrastructures and the data and documentation for NPL management;

and to their collateral management. These improvements are generally expected to take one to two years to implement.

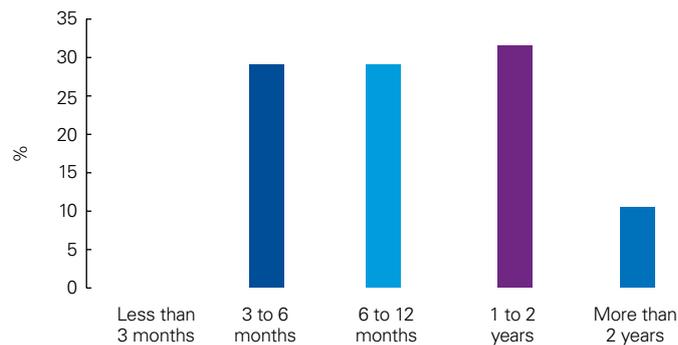
Banks expect the ECB guidance to have a significant overall impact

Banks in the survey expect to have to make significant changes to implement the ECB guidance. This could take one to two years to complete, and cost around €5 million on average for each bank.

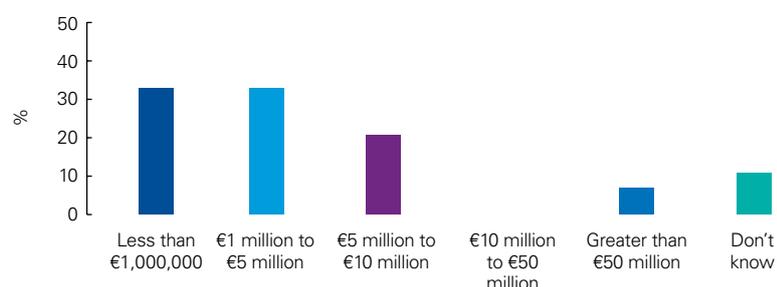
To what extent do you expect your organisation will need to implement changes to comply with the ECB guidance?



What is your expected timeframe to implement the changes proposed in the ECB guidance?



What would you envisage being the cost of reviewing and implementing the requirements of the ECB guidance?



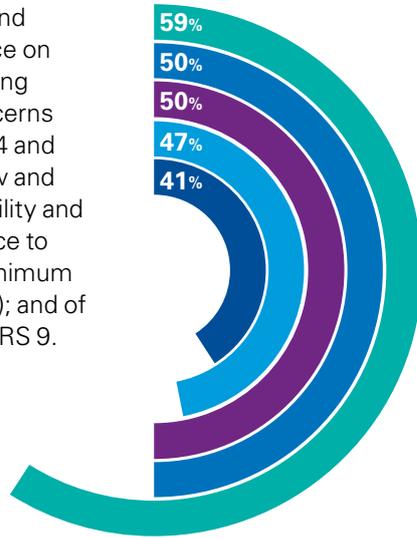
Banks are concerned about the effective management of their NPLs

Banks in the survey reported that NPL management (and meeting the ECB guidance on NPLs) ranked higher among chief executive level concerns than the impact of Basel 4 and SREP (supervisory review and evaluation), bank profitability and Brexit; of equal importance to resolution and MREL (minimum required eligible liabilities); and of lower importance than IFRS 9.

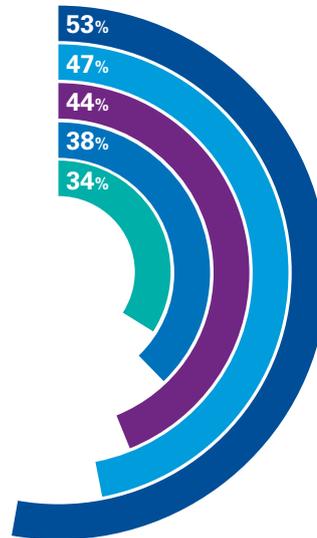
- Key:**
- IFRS9
 - Resolution and MREL
 - Brexit
 - Profitability
 - Basel 4 and SREP

NPLs compared with other bank concerns:

NPLs More important:



NPLs Less important:



Don't know:



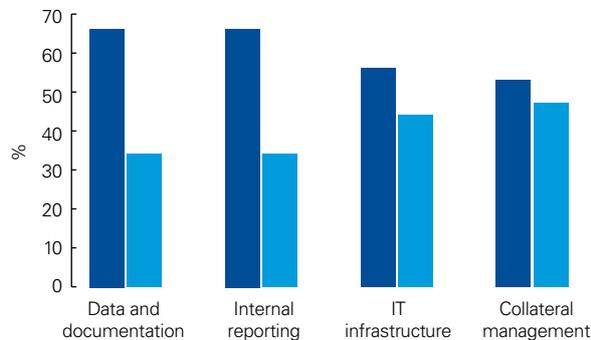
Banks expect the greatest impact of the ECB guidance to be on reporting, data and documentation, IT infrastructure and collateral management

Banks in the survey expect that the ECB guidance will have the greatest impact on their internal reporting, data and documentation, IT infrastructure and collateral management.

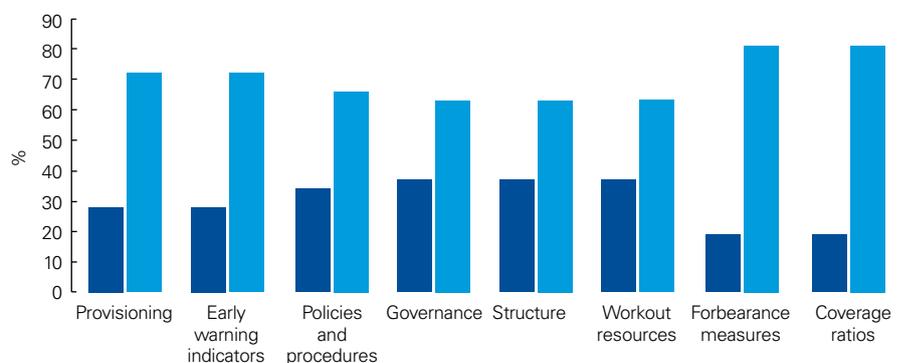
Meanwhile, these banks expect there to be less need for improvement in their governance, policies and procedures, structure, early warning indicators, measures of forbearance, provisioning, coverage ratios and workout units. However, banks may be underestimating the extent to which the ECB may push for improvements to be made in these areas, not least given the prominence attached to them in the ECB guidance.

Banks also expect the ECB guidance to have only a limited impact on NPL sale volumes.

Higher impact areas – Bank responses on expected areas of improvement



Lower impact areas – Bank responses on expected areas of improvement



- Key:**
- Significant changes required
 - Little or no change required

Conclusions and key issues for banks

The effectiveness of NPL management is not entirely within the control of banks. We have highlighted in this paper a range of structural impediments that need to be addressed in some countries to facilitate the effective management of NPLs.

Key areas requiring national or EU-wide action to address structural impediments include:

- Introducing a more balanced insolvency regime, with sufficient certainty over the timing and outcomes of legal processes to support both banks' own workouts and an active and mature market in NPLs;
- Developing a securitisation market for NPLs may require changes to legislation and regulation, and some element of government guarantees to underpin the market, at least initially;
- Developing the provision of non-bank servicers of NPLs by allowing a wider range of investors, not just (other) banks or joint ventures;
- Creating some type of centralised information platform; and
- Clarifying and possibly relaxing the EU parameters for the bank resolution regime (BRRD) such that state support to accelerate the deleveraging of NPLs is permitted.

Meanwhile, some banks in some countries may struggle to demonstrate that they have a viable and sustainable future even if they could remove NPLs from their balance sheets. They may find it difficult to replace NPLs with higher quality and profitable lending opportunities. Fundamental issues of over-banking and the lack of consolidation in the banking sector therefore also need to be addressed.

Nevertheless, much can also be achieved at an individual bank level. The ECB guidance to banks on NPLs provides a helpful and constructive starting point here.

In response, banks should:

- Analyse potential gaps in their NPL management against the ECB's guidance, over the entire 'life cycle' of NPLs on which the ECB guidance is based;
- Develop action plans to be prepared for discussion with their supervisory team and the next Supervisory Review and Evaluation Process (SREP) cycle;

- Reconsider the effectiveness of their strategies and operational arrangements to manage NPLs, including the range of options (outsourcing of workout function, joint ventures, structured credits and clean sales), people and skills, data and IT systems enhancement, and collateral valuations;
- Ensure they can meet the enhanced supervisory reporting and public disclosure requirements;
- More generally, identify interdependencies with current implementation projects (for example for IFRS 9, definitions of default, and risk data aggregation and reporting) and align these with the actions needed to ensure compliance with the ECB guidance;
- Consider which of their assets could potentially be sold to an AMC at or below their economic value, and lobby national and EU authorities for such schemes to be made available; and
- Continue to focus on measures to reduce the flow of NPLs, including pricing and underwriting processes. This is likely to become an increasing focus for supervisors and investors going forward.

KPMG member firms across Europe have already supported banking clients in all these areas.



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