ECB Guidance on NPLs and Leveraged Transactions

Impact on the restructuring practice

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Agenda

- **Overview**
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Overview

ECB Guidance to banks on non-performing loans (March 2017)

- Implements a consistent supervisory approach for non-performing loans regarding identification, management, measurement and write-offs
- Establishes a level playing field regarding NPLs
- To be seen in the overall efforts by ECB to force certain banks to reduce level of NPLs
- To be seen in the context of existing regulations, directives and guidelines
- Closely aligned with EBA Guidelines regarding the definition of default under Art. 178 Regulation (EU) 575/2013 (CRR)
- Draft addendum: Prudential provisioning backstop for new non-preforming exposures (October 2017)

ECB Guidance on Leveraged Transactions (May 2017)

- Promote safe and sound origination and distribution practices by banks re leveraged transactions
- Level playing field for banks operating on a global basis
- Closely aligned with ECB guidance on NPL‘s and US guidance on leveraged lending
- Defines "leveraged transactions"
- Laying down standards to both ensure the credit quality in the banks leveraged transactions and monitor related risks to their balance sheets
- The standards also address underwriting and syndication considerations as well as risk monitoring, reporting and IT tools

ECB Guidance

Applicability and enforcement of the ECB Guidance

- Directly applicable to 120 significant institutions in the Eurozone directly supervised by the ECB (“SSM-Institutions”)
- Applicable to Czech branches of SSM-Institutions
- Not directly applicable to Czech subsidiaries of SSM-Institutions
- Guidance are non-binding (“comply or explain”)
- However, non compliance can trigger supervisory measures through the SREP mechanism i.e. higher capital requirements

Impact on non-Eurozone member states

- Guidance will have an indirect impact on Czech subsidiaries of SSM-Institutions through group wide risk strategy of its Eurozone parents
- ECB expects SSM-Institutions to apply standards also in its international (non-Eurozone) subsidiaries
- Institutions not affected by the guidance may be able to act more flexible depending on its local supervisor and applicable laws

ECB Guidance on NPLs

- NPL Guidance sets out rules regarding the implementation of an NPL strategy, NPL governance and operations, viable and sound forbearance processes, rules regrading the NPL recognition, impairment measurement and write-offs, and collateral valuation for immovable property.

NPL strategy	NPL governance and operations	Forbearance	NPL recognition	Impairment measurement and write-offs	Collateral valuation for immovable property
• External conditions assessment • Self assessment • Defining qualitative and quantitative targets • Operational plan • Supervisory reporting mechanism	• Approval and monitoring of NPL strategy • Specialized and separated NPL workout units • Appropriate resources • Appropriate control framework • Monitoring of NPLs and workout activities • Monitoring of forbearance and liquidation activities • Early warning mechanisms/watch-list	• Target: Prevent/exit NPL status • Short-, medium- and long-term measures • Clear distinction between viable and non-viable forbearance measures • Implementation of a sound forbearance process	• Same definition as in the EBA ITS on reporting of NPEs • Clarifies NPE definition • “90 days past due“ criterion • “Unlikely to pay criterion” • Usage of internal and external data • Unlikely to pay (UTP) indicators • Definition on group-wide basis • Regulatory vs. accounting definition for “defaulted” and “impaired”	• NPL impairment measurement • Individual estimations of provisions vs. collective estimation of provisions • Write-offs • Timeliness of provisioning and write-offs • Provisioning and write-off procedures • Consistent with BCBS recommendations / IAS 39/IFRS 9	• Governance, procedures and controls • Individual vs. indexed valuations • All valuations should be performed by independent qualified appraisers • Frequency of valuations • Valuation methodology • Valuation of foreclosed assets

Addendum to the ECB Guidance On NPLs

- Draft addendum to the ECB Guidance on non-performing loans: Prudential provisioning backstop for non-preforming exposures (October 2017)
- Implementation of a prudential provisioning backstop of 100% for new NPLs
- Aims at avoiding excessive build-up of non-covered NPEs in the future
- Public consultation until December 8, 2017; on-site hearing November 30, 2017

Applicability	Vintage count	Prudential provisioning backstop
• Applicable to all exposures that are reclassified as non-performing after January 1, 2018 (new NPLs) • Directly applicable to 120 significant institutions in the Eurozone directly supervised by the ECB ("SSM-Institutions")	• Introduction of a vintage count starting from the first day of the reclassification as NPL • Vintage count for "unlikely to pay" and "past due" is the same	• Unsecured NPL: Prudential provisioning of 100% within two years of vintage • Secured NPL: prudential provisioning of 100% within seven years of vintage • Partially secured NPLs have to be split into the secured balance and the unsecured balance

Impact on the restructuring practice

- Many elements of NPL Guidance not new, but the definition of “best practices”
- Stronger focus by supervisory authorities on NPL levels
- All restructuring measures have to be in line with the NPL Guidance and the NPL strategy of the institution
- Stricter focus by supervisory authorities on viability of forbearance measures and NPL provisioning/write-off
- Continuing pressure on banks to reduce NPLs
- Stricter provisioning increases incentive to reduce NPLs through NPL sales

ECB Guidance on leveraged transactions

Topic	Description
Type of covered transactions	○ Material scope of the guidance are **Leveraged Transactions of the whole group** (to be internally defined by credit institution)
Leveraged transaction definition	○ Loan or credit exposures where the borrowers post financing level of **leverage exceeds the Total Debt to EBITDA ratio of 4.0 times** and/or ○ Loan or credit exposures where the borrower is owned by one or more **financial sponsors** ○ The designation of a financing as a leveraged transaction must be made **at loan origination, modification, extension and refinancing** ○ "**Credit Exposure**" refers to all gross direct commitments to a leveraged borrower, including drawn and undrawn facilities, term loans, bridge loans or revolving credit facilities, committed exposures not yet syndicated or distributed and exposures being warehoused for later sale (incl. club deals; best efforts transaction; bilateral loans) ○ **EBITDA** refers to earnings before interest, tax, depreciation and amortisation. Any **enhancements** to EBITDA should be **duly justified and reviewed** by a function independent of the front office function
Exclusions from the scope of leveraged transactions	○ Loans with **natural persons, credit institutions, investment firms, public sector entities and financial sector entities** ○ Loans where the own consolidated exposure of the credit institution is **below €5 million** ○ Loans to small and medium-sized enterprises (**SMEs**) (< 250 employees, annual turnover < EUR 50mn and/or balance sheet ≤ EUR 43 mn), except where the borrower is owned by one or more financial sponsors ○ Loans classified as "**specialized lending**"; asset-based => real estate loans ○ **Trade finance** ○ Loans to **investment-grade borrowers** (i.e. with a rating equivalent to BBB- (S&P)/BBB-(Fitch)/Baa3 (Moody's) or above)
Risk appetite and governance	○ Credit institutions must define **appetite and strategy for leveraged transactions** ○ This includes setting limits for leveraged transactions
Approval process for leveraged transactions	○ The due diligence shall in particular include an assessment of the **ability of the borrower to repay a significant share of its debt within a reasonable timeframe** (50% of its Total Debt or to fully amortize senior secured debt within 5-7 years)
Underwriting and syndication	○ Underwriting of transactions exceeding a ratio of Total Debt to **EBITDA of 6.0 times at deal inception should remain exceptional** ○ **Exceptions to be justified duly** and to be approved internally
Monitoring and managing leveraged lending portfolio	○ Credit institutions should ensure regular • **Monitoring of the portfolio**, encompassing all relevant risks for leveraged transactions held for the longer term • Review of "hold book" exposures should occur **at least once a year** • More targeted and frequent reviews shall be performed on deteriorated exposures

Impact on the restructuring practice

- Many of the elements of the ECB Leveraged Lending Guidance are not entirely new, but rather a specification of best practices
- Main impact of the ECB Guidance results from
  - the higher level of detail concerning risk management regarding leveraged transactions and
  - the 6.0 times debt to EBIDTA ratio threshold, exceeding of which should be exceptional
- No general exemption for “fallen angels” or distressed situations
- Banks subject to ECB supervision may be more hesitant to grant highly leveraged loans
- Banks that are not subject to ECB supervision could get a competitive advantage over ECB supervised banks if national regulators do not implement similar guidelines for its local banks
- The ECB Leveraged Lending Guidance could make it more difficult for smaller entities that do not qualify as SMEs or turn around companies to access bank financing

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