Comments on Draft Guidelines on management of non-performing and forborne exposures
8 June 2018

Overarching comments:

Standard Chartered Bank (“SCB” or “The Bank”) welcomes the opportunity to comment on the European Banking Authority (“EBA”) draft guidelines on management of non-performing and forborne exposures. We believe that, overall, the proposed guidelines are conceptually sound, sensible and would promote wider adoption of best practices. Our primary concern relates to the definition and applicability of the 5% threshold, which should be revisited to ensure that the guidelines’ objectives are met in a proportionate manner and avoid unintended consequences. We also believe that the guidelines should better account for the varieties of markets, including emerging markets, in which EU banks operate. Finally, we suggest adopting a two-phase implementation approach to allow sufficient time for full operationalization.

Whilst the Bank has contributed to industry responses which encompass all areas of feedback, in these comments we are looking to focus on specific issues directly relevant to the Bank.

Consultation response:

Question 1: What are the respondents' views on the scope of application of the guidelines?

Refer to our comments under Question 2.

Question 2: What are the respondents view of the proposed threshold of 5 % NPL ratio?

The definition and the level of application of the 5% NPL ratio threshold are key to ensure that the objectives of the guidelines are met effectively, in a proportionate manner and avoid unintended consequences.

Paragraph 21 proposes alignment of the NPL ratio definition to the EBA Risk Dashboard and related FINREP submissions, i.e. the gross carrying amount of non-performing loans and advances divided by the gross carrying amount of total loans and advances subject to non-performing exposures (NPEs). In some jurisdictions, the gross NPL ratio is not a fair indicator of banks’ asset quality and/ or the effectiveness of their NPE management framework as
local requirements do not always enable timely write offs. In those circumstances, banks most timely and prudent action is to take provisions against NPEs. This can lead to artificially high gross NPL ratio; net NPL ratio (net of provisions) however, would be low. In China for instance, the Ministry of Finance requires some conditions to be met, such as conclusion of the court judgement, before proceeding to write off. In Ghana, writing off exposures requires pre-approval by Central Bank of Ghana. We would therefore recommend adding the net NPL ratio as another threshold for the purpose of determining whether chapters 4 on NPE Strategy and 5 on NPE governance & operations are applicable.

The draft guidelines are not explicit on the level of application of the threshold, leaving significant room for interpretation. Paragraph 10 sets the scope of application for NPE enhanced governance and strategy when a credit institutions has an NPL ratio above 5%, without specifying the level at which the ratio would be monitored. Paragraph 11 then add that the additional requirements could be applicable despite the NPL ratio standing below the 5% threshold, if there is “(...) material amount of NPEs in an individual portfolio or with a specific concentration of NPEs towards a geographic region, an economic sector or group of connected clients (...)". We believe that the threshold(s) should apply at the bank’s group consolidated level when assessing applicability. Applying threshold(s) at an individual or sub-consolidated levels would risk the guidelines not achieving the objective of proportionality. For instance, elevated NPL ratio for an immaterial portfolio should not risk triggering applicability of chapters 4 and 5, especially if the supervisors do not have material concerns about the institution’s overall asset quality.

Recommendations:

1. Add the net NPL ratio as a threshold to assess applicability of chapters 4 and 5; and
2. Set the NPL ratio(s) threshold(s) monitoring at group consolidated level.

Question 3: Do you see any significant obstacles to the implementation date and if so, what are they?

We note that the annexes contain significant data requirements, and as a result, full compliance with the guidelines by 1 January 2019 will be challenging. This is compounded by the fact that, at this stage, some requirements are not totally clear, while others may need to be revisited. For instance, it is unclear whether the metrics provided in annexes 2 and 3 are intended as recommendations to be selected by banks based on their usefulness and relevance vis-à-vis each bank’s NPE profile and businesses. We would welcome some clarifications from the EBA on this. We also question the benefits of several NPE monitoring metrics for banks and for benchmarking exercise. For instance, even putting aside the question of the practical challenges in implementation of staff activity metrics, the results will likely be inconsistent given different interpretations of “engagements” by banks, making any comparison between institutions inaccurate and misleading. Similarly, monitoring “average” of legal activity is unlikely to provide useful information to institutions, supervisors or policy makers.
Recommendations:

1. Adopt a two-phase implementation approach, starting from 1 January 2019 with the main body of the guidelines and from 30 June 2019 for monitoring metrics;
2. Clarify requirements and review the cost-benefit of the proposed metrics.

**Question 4: Does section 4.3.2 capture all relevant options available for credit institutions to implement their NPE strategy?**

We believe that, while not intended to be exhaustive, the list provided under section 4.3.2 captures the most common options evaluated by banks when developing NPE strategies. It is worth noting that the consideration of all those options depends heavily on the markets in which the institution operates. While in some developed markets the full range of options should be considered, it may not be the case for less developed markets in which the number of available and/or viable options are limited.

We would also like to make two additional comments on chapters 4 and 5. First, we believe that, most importantly, NPE strategies should be developed, approved and monitored at the right level to be meaningful. While the guidelines refer to “overall” or “overarching” NPE strategy, industry practices are more likely to take the form of adopting strategies which are tailored to each top non-performing obligor based on the relevant context. As mentioned above, the jurisdiction which the NPE strategy can be implemented is critical in determining which options are available and most effective. Similarly, it is unlikely that the analytical steps listed under sections 4.1 and 4.2 to develop the NPE strategy and assess the operating environment will lead to a one size fit all strategy. We would encourage the guidelines to explicitly recognize this reality to avoid unintended consequences.

Second, while we welcome the comprehensive and thorough approach described in chapters 4 and 5, we would highlight the need to apply the guidelines’ recommendations in a proportional manner based on the specific NPE profile of each institution and the results from internal and external audit reviews. In this regard, we are concerned about the assumption expressed in paragraph 15 under the “Objective and structure of the guidelines” section, that size and complexity of an institution is a primary indicator to set supervisory expectations on “organizational aspects of management of NPEs and FBEs.” It should be made clearer that the additional guidance from those guidelines is primarily targeted at institutions for which assets quality, adequacy of the existing governance and NPE strategy are not deemed satisfactory, regardless of their size and complexity. In other words, alignment with those guidelines should not disproportionally impact large and complex institutions if key stakeholders are satisfied with their current NPL level and management of non-performing and forborne exposures.

**Question 5: Do you see any significant obstacles to the operationalisation of the NPE strategy as described in chapter 5?**

NPE Workout Units set ups vary significantly between institutions, and we believe that in many cases, the three lines of defense framework described in section 5.3 may not necessarily be
embedded into the organizational structure. Assessment of the adequacy of the control framework should focus on the independence of the control functions rather than the organizational structure. In our experience, independence of controls is often achieved via by oversight of governance committee(s) as well as delegated authority(ies) to approved officers.

We believe the best operating models adequately balance control and recovery objectives. SCB sees the cooperation and the sharing of information between the front line and the second line as critical to achieve the best outcomes. Referring to paragraph 59 under section 5.2 for instance, we believe that the creation of a NPE Committee could be lead to sub-optimal results by breaking down the information flow in decision making.

**Question 6: Does the viability assessment of forbearance measures capture all relevant aspects?**

No comment.

**Question 7: What are the respondents view on the proposed requirements for recognition of non-performing and performing/non-performing forborne exposures?**

No comment.

**Question 8: What are respondents view on the requirements on timeliness of impairments and write-offs of NPEs?**

We agree in principle that NPE exposures with no reasonable expectations of recovering contractual cash flows should be partially or fully written off as per paragraph 181 under section 8.4. As highlighted in our response to Question 2 however, there are circumstances under which timing of write offs is subject to events outside the control of banks. We would therefore suggest that the guidelines acknowledge those situations and include additional flexibility in the language accordingly.

The Bank seeks clarification on paragraph 182, which reads: “(...). A write-off should not be considered as the credit institution forfeiting the legal right to recover the debt (...).” We are concerned that this statement is either factually incorrect or misleading. Some jurisdictions treat partial or a full write-off of an exposure as a decision to forfeit the legal claim on the debt, or debt forgiveness.

With reference to paragraph 183, we believe that the industry practice is not to recognize as income the cash or other assets collected after write-offs. Recoveries would first be credited against previously recognized impairments, with only excess taken to income. We also note that, under section 8.2, the guidelines provide more detailed recommendations compared to International Financial Reporting Standard 9 (“IFRS9”) on the topic of estimation of future cash flows. We would assume that the guidelines intent is not to lead to outcomes which would be different or inconsistent with accounting standard, but simply to provide further guidance to institutions. Against that backdrop, we note, for instance, that paragraph 174 suggests two
approaches when estimating cash flows: (1) going concern scenario and (2) gone concern scenario. IFRS9 does not prescribe those approaches and requires instead a probability weighted estimate for impairment provisions based on “reasonably possible” scenarios. Similarly, IFRS9 does not refer to the level of collateralization for estimation of future cash flow, while paragraph 174 introduces distinctions between limited and significantly collateralized exposures. We would welcome confirmation from the EBA on its intent when putting forward such detailed recommendations vis-à-vis IFRS9.

Recommendations:

1. Acknowledge circumstances where write-offs cannot be made on a timely basis;
2. Review and amend as necessary the language under paragraph 182; and
3. Confirm that the guidelines are intended as additional guidance to IFRS9 and do not introduce different expectations on institutions.

Question 9: Do you have any significant objection against the proposed threshold for property-specific valuation (EUR 300,000)?

The proposed property-specific valuation threshold would be too low in the context of property located in large cities. There are also practical questions around foreign currency (FX) conversion for property not valued in Euro, i.e. which FX rate should be used for the conversion back to Euro and whether the appreciation of FX currency would potentially trigger the requirement for valuation if pushing the valuation above the Euro threshold.

Question 10: Do the requirements for valuation of movable property collateral capture all relevant aspects?

The Bank is concerned about some of the recommendations on monitoring and control under section 9.1.2. We view several of those recommendations as unnecessary and believe that monitoring and controls must be specific to the type of collateral and market in which the collateral is held. For instance, paragraph 199 sets expectations on institutions to systematically challenge valuations conducted externally. We believe that external specialist appraisers are best placed to provide an accurate and reliable valuation, and it is unclear on what basis institutions would be expected to challenge those experts. The value of residential or commercial buildings is often driven by very local attributes, which local valuation experts are best placed to assess compared to international banks. Similarly, the value of very specific collaterals (e.g. oil field, coal mine) would be best appraised by appropriate experts external to the institutions. It would be disproportionate to expect institutions to house this level of expertise simply to be able to challenge external valuation on an ad hoc/infrequent basis. Seeking additional external valuations as benchmark would be costly and in some cases not an available option. The Bank also sees the recommendations introduced in paragraph 201 to have rotation between the appraisers for immovable property as impractical and unnecessary.

We see the primary objective of those recommendations to reduce potential conflict of interests, and we believe that this objective could be achieved effectively and efficiently by
adequate governance and controls on the selection and appointment of external evaluators. Those governance and controls would be subject to audit reviews to ensure they are and remain adequate.