BANCA D'ITALIA
EUROSISTEMA

Guidance on the management of non-performing loans for Italy's 'less significant institutions'

January 2018

1. Introduction

With a view to promoting more active management of NPLs by banks, in March 2017 the Single Supervisory Mechanism (SSM) published its non-binding *Guidance to banks on non-performing loans* (*Guidance*),[1] written for significant institutions (SIs) and outlining best practices for managing NPLs.[2]

This note contains similar guidance for Italy's *less significant institutions* (LSIs).[3] It explains what the Bank of Italy expects in terms of NPL management, is in keeping with the supervisory approach taken to date by the Bank of Italy, and in no way replaces the current regulatory framework.[4]

This guidance is in line with that published by the SSM, to which banks are invited to refer as regards operational details; in application of the principle of proportionality, some changes have been provided to take account of the need for smaller banks to have simpler organizational arrangements.[5]

Based on the specific situations of the banks under supervision and in keeping with its supervisory activities, following its publication on the institutional web site the Bank of Italy will discuss this guidance with individual banks in the course of its regular activities. Italy's LSIs are accordingly invited to assess the basic correspondence of their existing arrangements to this *Guidance* and, where necessary, take appropriate measures.

While it is addressed to all LSIs, Sections 2 and 3 are of particular importance for banks with high levels of NPLs. Identification of these banks will be made by supervisors based on a range of indicators and a number of qualitative considerations.

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[1] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

[2] Non-performing financial assets as defined in the Bank of Italy Circular No. 272, General Instructions, 'Credit Quality'.

[3] The guidance is written for less significant banking groups and stand-alone banks supervised directly by the Bank of Italy. It also covers the Italian branches of EU and non-EU banks not under the ECB's direct supervision. It shall not automatically apply to the banks and banking groups whose main activity is the acquisition and management of NPLs. The Bank of Italy nevertheless expects these banks to adopt advanced NPL management procedures in line with the principles underpinning the guidance.

[4] The relevant applicable provisions are specifically cited in this document when appropriate.

[5] See Section 3.2. In addition, no reference is made to the provisions of the *Guidance* (Annex 7) on supervisory reporting and public disclosures.

The Bank of Italy reserves the right to supplement this *Guidance* in the course of 2018 to take account of similar initiatives that could be taken in light of the Council Conclusions approved at a recent ECOFIN meeting.[6]

2. NPL management strategy

Banks shall adopt a formalized strategy for optimizing NPL management by maximizing the current value of recoveries. This strategy should be defined based on an analysis of their management capabilities, the external environment, and the characteristics of their non-performing portfolios. It must strike the best possible balance between the various recovery options: internal workout solutions or outsourcing to credit collection specialists;[7] forbearance; foreclosure; legal procedures or out-of-court negotiations; disposals (including securitization transactions) with accounting and prudential derecognition of the assets sold.

In particular, banks must draw up short and medium to long-term operational plans[8] (of roughly 1 and 3/5 years respectively) for managing NPLs, which set out the targets for closing out positions (including reclassification to performing) and the actions required to attain them (such as the assignment of positions or portfolios to specialized external servicers, market disposals, etc.).[9] The targets must be established at least at the level of the NPLs, gross and net of value adjustments, expressed both in absolute value terms and as a share of total loans to customers; in Annex 1 a model template is provided that can be used to describe and monitor the objectives. For more complex LSIs, appropriate portfolio segmentation could be advisable for the various NPL sub-portfolios (for example, segmented by client, loan type, size of the position, etc.).

In a phase of cyclical improvement such as the present one, the Bank of Italy expects the banks' strategies to incorporate significant NPL reduction targets with realistic quantification supported by clear implementation timetables. This does not necessarily entail a blanket, immediate reduction. It is expected that banks will adopt a responsible and active policy for NPL management; the strategies adopted must therefore be backed up by solid quantitative analyses that highlight the pros and cons of the various alternatives while taking due account of the corporate environment.

[6] http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/

[7] Without prejudice to the provisions of Bank of Italy Circular No. 285, Part I, Title IV, Chapter 3, on the outsourcing of key operational functions.

[8] In the case of Italian banking groups, the plans will be drawn up by the parent company.

[9] If there is a substantial volume of foreclosed assets, the targets must also cover these assets.

In order to assess the suitability of the various strategies, it is important to consider the indirect costs of keeping a large volume of NPLs in banks' portfolios and to collect quantitative data on the costs of their management as well as on cash flows, and on past recovery rates and times.

All aspects of the NPL management strategy should be fully embedded in strategic and corporate management processes, such as those that define industrial and budget plans, the risk appetite framework (RAF), the internal capital adequacy assessment process (ICAAP), recovery plans, remuneration policies and incentives. At least during the phase in which the first operational plan is being drawn up, where necessary banks should define internal reorganization processes, make appropriate investments in IT and human resources, and identify the resources necessary to achieve the targets set.

The Bank of Italy reserves the right to request banks with high levels of NPLs to submit the operational plans described above and the annual updates. It will then assess their adequacy whilst taking due account of the corresponding levels of total value adjustments.

Should the banks consider that the strategy identified cannot lead to an effective reduction of NPLs in the medium to long term, this should be reflected in adequate coverage levels. Accordingly, the Bank of Italy further reserves the right to assess the application of Pillar II measures designed to ensure the coverage of risks stemming from relatively high levels of NPLs and to promote the attainment of the targets for their reduction.

3. Governance and operational arrangements for NPL management

3.1 Tasks of the Board of Directors

Without prejudice to the existing supervisory provisions,[10] the Board of Directors must participate fully and purposefully in the definition and monitoring of the NPL management strategy. Accordingly, this body shall:

1. define and update annually the plan outlined in Section 2;
2. assess, at least on a quarterly basis, the progress towards achieving the set objectives;
3. establish, in special resolutions, the criteria for classifying, valuing and managing NPLs (for example, through monitoring, classification, provisioning, recovery activities, collateral valuation, etc.) and ensure these are properly understood by staff;

[10] See Part I, Title IV, Chapter 3 (internal controls) in Circular No. 285 of 17 December 2013 and Title V, Chapter 5 (Risk exposures and conflicts of interest towards related entities) in Circular No. 263 of 27 December 2006.

4. identify the units in charge of NPL classification, valuation and management and define the management objectives;
5. verify that the organizational arrangements in place limit the management discretion of the entities involved in NPL classification, valuation and management when there are conflicts of interest; ensure that the necessary NPL management interventions are not delayed or omitted to prevent the emergence of deficiencies in past lending policies. This principle does not only concern NPLs in the narrowest sense of the term but also exposures displaying early warning signs;
6. define and approve impartial systems for selecting counterparties and monitoring the efficiency of activities related to the outsourcing of credit collection;[11]
7. ensure adequate internal controls of NPL management processes.

3.2 Conflicts of interest and incentives

Without prejudice to the existing supervisory provisions,[12] banks shall adopt safeguards to ensure that non-performing positions are managed swiftly and appropriately, organizing lending and NPL management activities in a way that mitigates conflicts of interest. To this end, it is useful to distinguish between the following phases of the lifecycle of an anomalous credit exposure:

(i) positions displaying early warning signs (for example, up to 90 days past due or small overdrafts);

(ii) non-performing positions that can be dealt with by adopting forbearance/restructuring measures;

(iii) non-performing positions that should be managed with a view to liquidation;

(iv) foreclosed asset management.

Corporate policies shall regulate the allocation of responsibilities for the various phases to the appropriate centres. For the phases potentially requiring the involvement of a number of centres in the management of positions, as for example in scenarios (ii) and (iii) cited above, the centres involved shall collaborate actively whilst maintaining a clear demarcation of responsibilities and targets. An efficient mechanism shall be put in place for mitigating conflicts of interest, involving independent staff members or decision-making bodies. Banks shall draw up internal policies for determining how to transfer non-performing assets from one centre to another (for example, with the help of indicators).

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[11] See footnote 7.
[12] See footnote 10.

Incentives for the heads of the centres involved in NPL management (and for the staff with key decision-making powers) are also specifically linked to the extent to which the operational targets for NPL management, as per the strategy described in Section 2, have been met. The incentives must be defined as part of banks' remuneration policies[13] and comply with the criteria of transparency and fair treatment of borrowers/guarantors.

Without prejudice to the need to avoid conflicts of interest and to specialize/optimize management processes, the arrangements described shall be simplified and adapted to the complexity and specificity of each bank, in accordance with the criterion of proportionality, for example in terms of appropriate organizational level (divisions, units, teams, small nuclei) and number of centres of responsibility.

3.3 Organizational safeguards

Without prejudice to the existing supervisory provisions,[14] banks shall make appropriate organizational arrangements for the swift adoption of the measures best suited to classifying, valuing and managing NPLs. To this end, the following safeguards should be provided:

1. the formalization of procedures designed to identify possible actions to take in the case of a deterioration of exposures (in particular, the management of arrears, forbearance, legal actions, purchase/realisation of collateral etc.). The following should also be defined: the criteria for classifying, valuing and managing non-performing exposures, the entities/units involved and the related tasks, as well as decision-making processes, which must ensure appropriate coordination of the various functions involved;

2. the adoption of an adequate early warning system that incorporates automatic workflow procedures for NPL management. Such a system must include credit performance indicators, to be monitored at least monthly, based on internal data (including the number of days past due and the degree to which credit lines have been drawn) and on qualitative and quantitative data from external sources (for example, the Central Credit Register, balance sheets, public records of legal proceedings, collateral valuations, data on the economic sectors to which borrowers belong). The emergence of early warning signs shall trigger appropriate management actions by the competent units according to corporate policies and procedures, which also envisage adequate reporting and escalation procedures;

3. the adoption of a system for analysing and monitoring the performance of NPL management activities based on a series of key indicators of the quality of the loan portfolios (data on

[13] See Circular No. 285, Part I, Title IV, Chapter 2.
[14] See Part I, Title IV, Chapter 3 (internal controls) of Circular No. 285 of 17 December 2013.

stocks and flows, where opportune broken down by type of non-performing exposure, and location and economic sector of the debtor, reported at total loans level and by main portfolios) and economic performance (losses, write-backs, overall discounted recovery rate on the closure of the position) associated with the various management actions, divided by management strategy (internal workouts, outsourcing, disposals, etc.);

4. appropriate monitoring activities by the risk management function to verify the effective and correct application of corporate policies and ensure the quality of NPL management processes, including by helping to define them;
5. regular assessments by the internal audit function of compliance with NPL policies and this guidance.

To ensure effective organizational arrangements such as those described above it is crucial that there be a suitable database populated in a timely and accurate manner (see Section 8).

4. Forbearance

Banks shall approve forbearance measures if they are deemed suited to maximizing the expected recoveries on exposures to debtors in financial difficulty; to this end, banks shall rapidly identify the best solution on a case by case basis, although this decision must never serve as a pretext for delaying the classification of credit exposures among NPLs. To this end, banks shall:

1. assess the financial situation of debtors whenever forbearance measures are being considered;
2. adopt forbearance policies, which identify the best solutions, standardized to the greatest possible extent, from a range of options. Typically, in the event of the debtor experiencing temporary difficulties, short-term forbearance measures can be applied (for example, partial payments – i.e. interest only – or stand-still agreements) while other types of forbearance are better suited to respond to structural changes in the debtor's repayment capacity (such as a permanent reduction of interest rate payments, the extension of payment deadlines, debt consolidation, and partial write-offs);
3. establish a system for monitoring the effectiveness of the forbearance measures applied.

These steps are incorporated in corporate IT systems. The decision to grant forbearance shall stem from discussions between the heads of the various centres and, as mentioned above, a comparison with other management strategies.

5. **Classification**

The banks shall formalize the criteria for implementing the relevant supervisory provisions on loan classification with a view to ensuring the accurate identification and classification of risks.

To this end, the banks shall:

1. define criteria for calculating the number of days exposures are past due in accordance with the applicable regulatory provisions;
2. establish a list of indicators and thresholds to determine when exposures should be classified as unlikely to pay, in accordance with the provisions of Article 178 of the Capital Requirements Regulation (CRR) and the *Guidance* for SIs. These indicators consist in a series of qualitative-quantitative triggers, broken down by type of debtor, with respect to which the potential classification of an exposure as NPL should be assessed.[15] Should the outcome of the assessment made not lead to the position's reclassification, the reasons for this shall be recorded in the corporate IT system;
3. define the criteria for identifying, classifying and reclassifying as performing forborne exposures.[16] In particular, and in keeping with the indications contained in Sections 5.3.1-5.3.4 of the *Guidance* for SIs, they will draw up internal guidelines to establish: i) when a client encounters financial difficulties requiring forbearance measures and accordingly the exposure must be classified as 'forborne'; ii) when a forborne exposure should be classified as non-performing; iii) when a forborne exposure should be classified among performing forborne exposures; iv) when an exposure can be considered to no longer belong to the forborne category;
4. ensure consistent treatment of the groups of connected clients.

In the case of banking groups, the classification criteria adopted by all the group entities should be consistent.

[15] Some non-exhaustive examples include: indicators based on balance-sheet analysis (for example, a drastic fall in turnover, equity reduction due to significant losses, etc.); requests for the start of insolvency proceedings; debtor downgrades; reports of financial difficulties of the company/entities linked to the debtor; rising LTV ratios; the reduction to unsustainable levels of debt service ratios; layoffs; any other event that could make the fulfillment of contractual obligations improbable.

[16] Without prejudice to the one-year 'cure' period and two-year probation period envisaged by the supervisory legislation on forborne exposures (Regulation 680/2014 and the Accounts Matrix).

6. Value adjustments and write-offs[17]

In line with the existing supervisory provisions, which readers are referred to, the banks shall formalize credit valuation policies, including their policies on write-offs[18] that are as comprehensive as possible and that ensure consistency. The use of management discretion is regulated by the valuation process and subject to appropriate supervision.

In particular, banks shall:

1. define the criteria for identifying positions whose specific value adjustments are determined collectively (for example, for exposures below a certain amount) and identify methodologies and parameters to assess the relative allowances; these parameters (for example, loss rates for unsecured and collateralized exposures) shall be identified and updated using statistically robust analyses, which also take account of the historical observation of data broken down by portfolio type.[19] Upon request by the Bank of Italy, banks should be capable of demonstrating the effectiveness of these parameters;[20]

2. in line with the provisions of Section 6.2.4 of the *Guidance*, define the criteria for identifying positions whose specific value adjustments are determined individually and to identify when the valuation must be made under a 'going concern' or 'gone concern' scenario. In this connection, banks shall define the methodologies to estimate future cash flows that may be achieved by the debtor for the payment of the residual debt (in a going concern scenario) and the amount of recoverable collateral (in a gone concern scenario);[21]

3. establish criteria to estimate potential losses stemming from exposures in the form of collateral and commitments, based on forecast cash flows or credit conversion factors determined in relation to historical data;[22]

4. account for write-backs only when there is objective evidence that the reduction in value is lower than the previously recorded loss; in the case of write-offs, write-backs can only be made following a credit recovery;

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[17] The principles enunciated and the indications provided in this section shall be applied also taking account of the provisions of the international accounting standard IFRS 9 covering financial instruments and the *Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses*, issued by the EBA on 12 May 2017.
[18] In line with the provisions of Sections 6.5, 6.6 and 6.7 of the *Guidance*.
[19] In order to estimate value adjustments banks must take account of the provisions of Section 6.3.2 of the *Guidance*.
[20] In line with the provisions of Section 6.7.1 of the *Guidance*, banks should retrospectively test on an annual basis their estimates of value write-downs compared with actual losses.
[21] For collateral valuations the estimation methodologies used must incorporate specific criteria for estimating the realizable market price of the assets under current sales conditions, the costs of liquidation, the time to sale (established based on internal data on past recovery times) and potential maintenance costs (for foreclosed assets).
[22] Alternatively, the credit conversion factors set out in Article 166 of the CRR can be taken into account.

5. proceed swiftly to write off exposures for the amounts deemed irrecoverable when there are no reasonable expectations of recovering a financial asset in its entirety or a portion thereof.[23]

The motivations underlying individual evaluations or evaluations that deviate from the internal guidelines shall be recorded in corporate IT systems.

7. Valuation of real estate collateral

Banks shall define and formalize procedures that guarantee comprehensive, up to date and accurate valuations. Without prejudice to the provisions of the CRR on exposures secured by real estate collateral[24] and risk mitigation techniques[25] and to the supervisory provisions contained in Circular No. 285 (Part I, Title IV, Chapter 3, Annex A), it is recommended that banks:

1. avail of external or internal appraisers[26] who, from an organizational perspective, are independent from the loan origination process and who have the requisite qualifications and skills, avoiding an excessive concentration of valuations in the hands of one or a few appraisers;[27]
2. monitor the activities of the appraisers as described in (1) above;
3. estimate, in line with the provisions of the CRR and of Circular No. 285, the value of the properties held as collateral against exposures when these are classified as NPLs[28] and subsequently update this value at least once yearly for as long as the exposures are classified as non-performing; to this end, statistical methods are used to estimate the value of the properties pledged, providing that the gross value[29] of the exposures does not exceed €300,000.

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[23] The write-off can occur before the completion of the legal actions to recover the financial assets and does not necessarily entail a renouncement of the bank's legal right to recover the credit (see Circular No. 267, Chapter 1, 'General principles', Section 5, 'Definitions').

[24] See, in particular, Articles 125 and 126 of the CRR.

[25] See, in particular, Articles 192 to 194, 208 and 229 of the CCR.

[26] Reliance on external appraisers for assessing the value of real estate collateral is in keeping with the recommendation to avoid an excessive concentration of assessments in the hands of one or a few entities, provided that their rotation over time is assured and/or that they adopt reliable processes capable of guaranteeing the rotation of the natural persons who from time to time are entrusted with carrying out the assessments. In this last instance, banks shall ensure that these persons or entities have implemented the processes described.

[27] Banks can refer to the estimates made by the experts as part of collateral enforcement or insolvency proceedings for the year in which the estimate was made, provided that the expert appointed and the assessment comply with the requirements stated for the assessment of real estate collateral pursuant to the applicable provisions (CRR and Circular No. 285). In determining the value of the non-performing loan, banks shall consider the expected recovery value of the collateral and, subsequently, the eventual decrease of auction prices, credit recovery times and any other factors that could affect the NPL recovery value (i.e. liquidation costs).

[28] See Section 7.3 of the *Guidance*.

[29] The value of the exposure is calculated gross of value adjustments and net of any write-offs.

8. NPL database

It is crucial that banks maintain an adequate database in which to record and manage NPL data, to ensure the adoption of well-informed and timely management decisions and to monitor and optimize the performance of the management activities.[30] The following elements should therefore be available in an organized fashion:

1. the information enabling banks to verify the state of progress of management/recovery procedures and the related interventions, starting from the early warning signs to possible enforcement procedures assigned to external law firms and/or specialized companies, with potential effects on the valuations of the underlying assets (for example, the succession of auctions held and relative variations in auctions' starting prices, etc.);
2. detailed information on the collateral securing positions, which enable a valuation of expected cash flows and, therefore, the portion of recoverable exposures;[31]

A database featuring the above characteristics can also serve in analyses by investors interested in buying a part of the NPL portfolio. Granular supervisory reporting on bad loans and the archive of historical losses on default positions provided by the Bank of Italy[32] are a useful starting point for creating the database.

[30] To this end, the information should be recorded in a way that is as standardized as possible to enable it to be handled en masse. For example, for monitoring the effectiveness and efficiency of forbearance practices, data on the type of forbearance applied should be recorded.

[31] For example, for real estate collateral this should include information enabling the precise identification of the assets involved (for example, land register data), their estimated value (appraisals and valuations of the assets), the bank's claims (for example, mortgage type and value), and any precedent rights (higher priority mortgages and their value).

[32] See Bank of Italy Communication dated 29 March 2016 on new bad loan reporting and subsequent updates; and Circular No. 284 of 18 June 2013 containing instructions for compiling reports on historical losses on default positions and subsequent updates.

Annex 1. Template to describe and monitor the objectives set out in the NPL management strategy

Banking group/Bank XXXX	Current situation	Projections				
Operational objectives	Year T	Year T+1	Year T+2	Year T+3	Year T+4	Year T+5
Non-performing exposures (gross)	0	0	0	0	0	0
of which unlikely to pay						
of which bad loans						
Non-performing exposures (net)	0	0	0	0	0	0
of which over 90 days past due						
of which unlikely to pay						
of which bad loans						
Flows of non-performing exposures (gross)		0	0	0	0	0
From performing to non-performing (+)						
From non-performing to performing (-)						
Sources of NPL reduction (-)		0	0	0	0	0
Repayments						
Collections from sales						
Losses from sales						
Foreclosure						
Purchase of holdings for credit collection						
Write-offs						
Other						
Performing exposures (gross)						
Performing exposures (net)						
Gross NPL ratio	0	0	0	0	0	0
Net NPL ratio	0	0	0	0	0	0