State Bank of Pakistan
بینک دولت پاکستان

Guidelines for
NPLs Management Strategy

BANKING POLICY & REGULATIONS DEPARTMENT

STATE BANK OF PAKISTAN

1 ***Objectives and Scope of Application:*** The objective of the Guidelines on NPLs Management Strategy is to facilitate banks in reducing the stock of their NPLs and infection ratio. Non-performing loans (NPLs) refer to those loans which are classified in accordance with the applicable instructions/ Prudential Regulations.

2 ***NPLs Management Strategy:*** Managing high and rising stock of NPLs involves financial and opportunity costs, which weigh heavily on the efficiency and soundness of the banks. As such, the banks are required to put in place a well-defined NPLs Management Strategy (NPLs Strategy) to effectively manage NPLs and reduce their quantum. To this end, these guidelines set out key elements and principles that banks may consider for the development and implementation of their NPLs strategy. With due consideration to the size and chronicity of NPLs portfolio and unique dynamics of a bank, the strategy should, at a minimum, include identification, management, monitoring and mitigation of NPLs.

The NPLs Strategy of a bank should, inter alia, establish acceptable limits for the chronicity of NPLs and provide effective tools and arrangements to reduce NPLs, over a defined time-period. It should lay out the bank's approach and objectives regarding the effective management (i.e. maximization of recoveries, settlement etc.) and ultimate reduction in the stock of NPLs. The banks should take into account relevant consumer protection considerations and requirements when developing and implementing their NPL strategies and, at the same time, ensure fair treatment of consumers. The following steps will form the core building blocks of the NPLs Strategy:

a) Assessment of operating environment and external conditions
b) Development of the NPLs Strategy covering short, medium and long-term time horizons
c) Development of Implementation Plan
d) Fully embed the NPLs Strategy into the management processes, including regular review and independent monitoring

2.1 **Assessing the Operating Environment and External Conditions:** The first phase in the formulation and execution of NPLs Strategy is to carry out an assessment of the following elements:

a) Internal capabilities
b) External conditions and operating environment
c) Financial implications of the NPLs strategy

2.1.1 **Internal Capabilities/Self-Assessment**: Banks should perform a comprehensive evaluation of their NPLs portfolio to identify the issues leading to accumulation of NPLs and gaps in their internal capabilities to manage NPLs. Banks should fully understand and assess the following aspects in this regard;

a) Magnitude and drivers of NPLs:
   i. Size and evolution of NPL portfolios at an appropriate level of granularity
   ii. Drivers of NPL inflows and outflows, by portfolio, where relevant

iii. Other potential correlations and causations

b) The outcome of NPL-related actions taken by banks in the past:
   i. The types and nature of actions implemented, including but not limited to restructuring/rescheduling activities
   ii. The effectiveness of the actions taken

c) Operational capacities (processes, tools, data quality, IT/automation, staff expertise, decision making, internal policies etc.) in relation to various steps involved in the process, including but not limited to:
   i. Timely identification of NPLs as per applicable regulatory guidelines and instructions, and banks' own policies
   ii. Financial relief activities
   iii. Impairments and write-offs
   iv. Collateral valuation
   v. Recovery, legal processes and foreclosure
   vi. Management of foreclosed assets, where relevant
   vii. Reporting and monitoring of NPLs
   viii. Effectiveness of NPL workout solutions

Banks should perform a comprehensive assessment covering aforesaid actions to identify strengths, significant gaps and areas of improvement, including changes in organizational structure, required to achieve NPL reduction targets set under Section 2.2.2. Banks should submit outcome of the assessment to their Board of Directors (BoD).

2.1.2 **External Conditions and Operating Environment:** Banks should assess and consider the current and future external operating environment for devising the NPLs Strategy and associated NPL reduction targets. The following external factors, where appropriate, may be taken into account by banks when setting the NPLs strategy:

a) The macroeconomic conditions, including sector-wise dynamics taking into account sectoral concentrations of the NPL portfolios.
b) The regulatory, judicial, legal and taxation framework. Banks should have a good understanding of the legal proceedings related to NPL workouts for different types of assets. In particular, they should assess the average duration of such proceedings, the influence of the types and rankings of collateral and guarantees on the recoveries, the impact of consumer protection issues on legal decisions, and the average total costs associated with legal proceedings.

2.1.3 **Financial Implications of NPLs Strategy:** Banks need to reasonably calculate impact of the planned strategy on their financial standing and make necessary amendments in the NPLs Strategy if it significantly fails to achieve the desired objectives as envisaged.

2.2 **Development of the NPLs Strategy:** The NPLs Strategy should encompass, at a minimum, time-bound quantitative NPL reduction targets and asset foreclosure targets duly supported, where appropriate, by a corresponding comprehensive operational plan. The NPLs strategy and related operational plan shall be approved by the BoD and reviewed at least once in three years, or earlier in case of any material change.

2.2.1 **Strategy Implementation Options:** Banks should consider a combination of approaches and options in their NPLs Strategy to achieve the desired objectives over the short, medium, and long-term horizons. The following implementation options may be considered:

a) Restructuring/rescheduling options;
b) Active portfolio reductions through sales, transfer and assignment to/agency agreements with Corporate Restructuring Companies (CRCs) etc., or, in case of NPLs that are deemed irrecoverable, write-offs;
c) Debt to equity swapping, debt to asset swapping, or collateral substitution; or
d) Legal options, including court proceedings and out-of-court settlements.

In addition to above, the bank can also exercise other options for effective implementation of NPLs Strategy.

2.2.2 **NPL Reduction Targets:** Banks should consider multiple options, both at the portfolio and aggregate levels, for setting NPL reduction targets over the short-term, medium-term and long-term. Banks should include, at a minimum, clearly defined quantitative targets in their NPLs strategy. It is expected that these targets would lead to a concrete reduction in NPLs, over the medium to long term.

Banks should establish targets in terms of:

a) time horizons: short-term (one year), medium-term (up to three years), and long-term (over three years).
b) portfolio categories (e.g. consumer, corporate/commercial, SME etc.)
c) implementation options (e.g. cash recoveries from restructuring/rescheduling, collateral repossessions, recoveries from legal proceedings, revenues from the sale of NPLs, out of court settlements or write-offs).

The NPL reduction targets should include, at a minimum, a projected absolute target or percentage of NPLs reduction, both gross and net of provisions, not only on an overall basis but also for the major NPL portfolios. The following examples depict some high-level quantitative targets that can be used by the banks:

- **Result-oriented Operational Targets**
  i. Decrease in volume of NPLs (Gross) to a certain level
  ii. Decrease in volume of NPLs (Net) to a certain level
  iii. Increase in Cash recoveries (collections, liquidations and sales) from NPLs as a percentage of Total average NPLs

- **Action-oriented Operational Targets**
  i. Decrease in the ratio of NPLs categorized as loss TO total NPLs
  ii. Decrease in the ratio of NPLs categorized as loss for up to two (02) years TO Total NPLs
  iii. Decrease in the ratio of NPLs categorized as loss between two (02) to four (04) years TO Total NPLs
  iv. Decrease in the ratio of NPLs under litigation TO total NPLs
  v. Increase in the ratio of legal cases resolved TO NPLs under litigation

2.2.3 **Operational Plan:** The NPLs Strategy of the banks should be supported by an effective operational plan. The operational plan should clearly define how a bank would implement its NPLs Strategy over a time horizon of at least one to three years (depending on the type of operational measures required). The NPLs operational plan should contain at least:

a) Clear time-bound objectives and goals
b) Activities to be carried out on a portfolio basis
c) Governance arrangements and structures, including responsibilities and reporting mechanisms for activities and outcomes
d) Quality standards to ensure successful outcomes
e) Staffing and resource requirements
f) Granular and consolidated budget requirements for the implementation of the NPLs strategy
g) Plans for communication with internal and external stakeholders (e.g. sales, servicing of NPLs portfolio etc.)

The operational plan should focus on internal factors that might cause significant impediments to the successful execution of the NPLs strategy. Any significant deviations from the operational plan should be reported to the senior management and BoD, along with recommendations for remedial actions.

2.2.4 **Judicial Follow-ups**: To efficiently handle lawsuits, banks may, as a part of their strategy, devise a plan to systematically address legal issues and ensure adequate efforts are made by their legal teams for timely conclusion of recovery cases in courts of law. In this regard, the banks may consider taking measures like constituting a specialized body for monitoring the progress of litigation cases and making the progress of recovery cases a key performance indicator (KPI) of relevant bank officials and contracted external parties including, inter alia, Heads of Legal, Special Asset Management (SAM) functions and bank's legal counsel(s) for assessing their performance.

2.3 **Embedding the NPLs Strategy:** The following factors may be considered to effectively embed the NPLs Strategy in the operations and governance mechanisms of the banks:

a) Clearly defined roles, responsibilities and reporting lines for the implementation of the NPLs Strategy.
b) Appropriate communication and dissemination of the NPLs Strategy to the relevant staff.
c) Individual/team goals and incentives for relevant staff, geared towards the accomplishing NPL reduction targets.

d) Alignment and integration of all the components of NPLs Strategy with the governance framework, business plan and budget, including all the relevant costs associated with the implementation of the operational plan, and potential losses stemming from NPL workout activities.
e) Incorporation of NPLs Strategy in the bank's overall risk management policy and procedures.
f) High-level monitoring and oversight by the control functions with respect to implementation of the NPLs strategy and operational plan.

3 ***NPLs Governance and Operations*:** This section sets out the key elements of governance and operations related to NPLs workout framework, covering aspects related to steering and decision-making, the NPLs operating model and NPL monitoring processes.

3.1 **Steering and Decision Making:** The BoD of the banks shall:

a) Approve and review the NPLs strategy in line with the overall risk appetite
b) Oversee the implementation of the NPLs strategy
c) Define quantitative and qualitative targets and incentives for NPL workout activities
d) Monitor the progress vis-a-vis the defined targets on a periodic basis
e) Clearly define procedures and an authority matrix for NPL workout decisions
f) Ensure robust internal controls for NPLs management, particularly regarding classifications, impairments, write-offs, collateral valuations and for other NPL workout solutions

3.2 Organizational Structure for Management of NPLs

3.2.1 **NPL Workout Units/ Special Assets Management Divisions (SAMD):** To mitigate any conflict of interest in managing NPLs and make good use of dedicated NPLs management expertise across the organization, banks may assess the need to strengthen the NPL Workout Units (NPL WUs/SAMD), considering, inter alia, the quantum/concentration of NPLs in various sectors/portfolios.

In this context, banks may consider forming dedicated decision-making bodies related to NPLs workout (e.g. NPLs committee). Although NPL WUs/SAMD should be separated from loan origination units, a regular feedback mechanism between both functions should be established. Moreover, the BoD may determine the minimum criteria/triggers for the transfer of non-performing loans to remedial function i.e. NPL WUs/SAMD and flexibility for deviations on the transfer of NPLs (provided conditions subject to which such deviations are permissible and approval authority thereof should also be specified).

3.2.2 The dedicated NPLs Strategy developed by the banks may also cover the following areas:

a) **Rescheduling/Restructuring of NPLs:** Banks should define the framework/parameters whereby they may reschedule/restructure or provide financial relief measures to borrowers that face or are expected to face financial difficulty. Indicatively, the framework should prescribe at least:

i. The necessary financial and non-financial documentation that the bank may require the borrowers to provide to demonstrate their capacity for repayment of principal amount and accrued interest/mark-up.
ii. The minimum key financial repayment capacity metrics and ratios to be applied by the credit officer on a portfolio/product-specific basis to fully assess the borrowers' repayment capacity.
iii. The process to be followed in determining and implementing the most appropriate restructuring/rescheduling solution for different types of borrowers.

b) **Debt Recovery/Enforcement:** The NPL WUs/SAMD responsible for debt recovery should take appropriate actions in a timely manner to improve debt collection and maximize debt recovery. Related processes and procedures should be defined in accordance with the NPLs strategy, which should address, at a minimum:

i. The range of available options to resolve the case such as voluntary asset sale (borrower re-engages and agrees to sale the asset), forced sale of assets, debt collection (internal or external), debt to property/equity swap, sale of loan/loan portfolio to CRCs etc.
ii. The procedure to be followed to decide the most appropriate recovery option and the team of experts to be involved (e.g. credit officer, lawyers, real estate experts, risk control officers etc.) to assist in decision-making.
iii. The recovery option should take into account the existence of collateral, type of legal documentation, type of borrower, local market conditions and macroeconomic outlook, the legislative framework in place and potential historical recovery rates per option versus the costs involved per option.
iv. Clearly defined parameters for categorization of non-cooperative borrowers.
v. A clearly defined approval process for each stage of the debt recovery process for different recovery options available to the bank.
vi. The procedure to be followed post repossession of the collateral including but not limited to development and implementation of disposal strategy, and clearly defined responsibility(ies) within the bank to undertake the management of such assets.
vii. The role of compliance, risk control and internal audit departments in the procedure and in the monitoring process.

c) **Multi-bank Distressed Debt Accounts:** Banks should also consider interaction with other banks for such non-performing borrowers having exposures with multiple banks. Banks should put in place a clear procedure for negotiating and interacting with other banks with whom the defaulting borrower is indebted.

d) **Early Warning/Watch list Accounts:** Banks should consider specifying, inter alia:

i. the types of actions required in response to the different types of early warning alerts. Particularly, such early warning triggers should not be suppressed unless a suitable action has been taken and documented;
ii. escalation procedures;
iii. key elements, frequency and recipients of the reporting.

If the aforesaid areas are already covered under bank's existing policies/manuals, the same shall suffice and the bank does not need to develop new policies/manuals.

3.3 **Monitoring of NPLs and Charged-off Loans:** A monitoring system should be put in place that appropriately updates the relevant staff, senior management and BoDs about the quantum, flows, chronicity, recoveries, settlement etc. of NPLs, and accomplishment of NPL reduction targets. A framework of NPL-related key performance indicators (KPIs) may also be developed to allow the BoD and senior management to measure progress, which shall be reviewed by the BoD periodically.

The banks shall also put in place a dedicated mechanism for reporting and monitoring charged-off loans. The BoD shall, inter-alia, review the movement of charged-off loans and their recovery status at least quarterly. Moreover, the bank shall report the detail of charged-off loans in the financial statements as per relevant regulatory requirements.

3.4 **Role of Internal Audit:** The internal audit shall assess the implementation of the bank's NPLs strategy. The findings/deviations shall be reported to the Board Audit Committee (BAC) for seeking an independent view of the efficacy of the NPLs Strategy and enable the BAC to make informed decisions.

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