Regulatory and supervisory developments for non-performing loans

POLICY BRIEF

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Objective

The objective of this brief is to provide insight into internationally harmonized definitions of non-performing loans (NPLs) and forbearance, and potential policy actions for prudential supervisors that address the impact of expected loss provisioning.

Background

The fallout from the global financial crisis revealed a number of important concerns in the area of asset quality. Firstly, prudential supervisors and other stakeholders grappled with a lack of robust data quality in banks' data and also in terms of comparability of reported indicators of asset quality across banks. Secondly, when it came to provisioning for impaired exposures, the incurred loss approach resulted in "too little too late" which significantly impacted some banks' ability to deal with the NPL issue in an effective manner.

The development of internationally consistent and harmonized standards for defining problem exposures is recent. Spurred by the establishment of the Single Supervisory Mechanism in 2014, the European Banking Authority (EBA) was at the forefront of the endeavor. Five years ago, the EBA developed harmonized and aligned criteria for two crucial measures of asset quality; "non-performing exposures or NPEs" and "forbearance"[1]. The Basel Committee followed suit last year when it finalized its corresponding harmonized definitions of these concepts[2]. The objectives of these common definitions are aimed at greater harmonization in the measurement, application, supervisory reporting, and Pillar 3 disclosures of these two important measures of asset quality.

While prompt identification, recognition, and derecognition of non-performing exposures (NPEs) is vital, it must go in hand in hand with timely and comprehensive provisioning of credit losses. Accounting standard setters modified provisioning standards to move from incurred loss approaches to expected loss methods by incorporating forward looking assessments in the estimation of credit losses starting in 2018, with the introduction of International Financial

1 EBA (2015) and the EBA Implementing Technical Standards on supervisory reporting and forbearance and non-performing exposures under Article 99(5) of Regulation (EU) No 575/2013. Based on Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2-14 laying down implementing technical standards with regards to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and the Council (OJL 48, 48 20.2.2015, p1)

2 BCBS (2017b)

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Reporting Standard (IFRS) 9[3]. Yet, the prudential impact and some transitional measures are still under consideration by policymakers.

1. Common definitions for non-performing exposures and forbearance

The common definitions[4] allow consistent identification of forbearance and NPLs. The definitions apply to the banking book only and include on-balance sheet loans, debt securities, and other receivables as well as to off-balance sheet items like guarantees and commitments. Broadly speaking, four new asset categories are created; performing, performing forborne, non-performing and non-performing forborne exposures. Classification criteria for each of those four categories have been developed.

a. Non-performing exposures

The proposed definition of NPEs relies on the existing concept of default[5] and impairment but is broader. In particular, the definition of NPEs focuses on a quantitative criterion, a 90-day past due threshold, and a qualitative criterion, unlikeliness to pay[6]. As such, the non-performing definition casts a wide net. It includes exposures for which there is evidence that full repayment of principal and interest is unlikely without realization of collateral, regardless of the number of days past due. The Basel definitions focus on a debtor basis, but allow categorization of exposures as non-performing on a transaction basis for retail exposures. The regulatory approach under NPE definition includes aspects that facilitate a stricter approach to NPL classification in that it moves beyond the traditional approach of using days past due to identify risk but requires banks to have clearly defined indicators of unlikeliness of pay which are implemented homogeneously in all parts of the banking group. Banks are expected to regularly assess the creditworthiness and repayment capacity of its customers in order to identify if unlikeliness to pay indicators are present. In addition, the EBA standard introduces additional aspects in terms of the 'pulling' effect: if a bank has on balance sheet exposures that exceed 20 percent of the gross carrying amount of all on balance sheet exposures of a particular debtor then all on and off-balance sheet exposures shall be considered as non-performing (pulling effect).

It is important to note that collateralization has no influence on the categorization of an exposure as non-performing. When an exposure becomes non-performing, it should be classified as such, even if the collateral value exceeds the past due or non-past due exposure amounts outstanding.

b. Forbearance

Credit exposures that have their characteristics altered, such as duration, maturity, interest rate, or others, due to the inability (or potential inability) of the borrower to fulfill its contractual obligations should be explicitly addressed by prudential regulations. The objective of this loan forbearance is a return to a situation of sustainable repayment. However, forbearance has often been used to grant repeated grace periods without addressing the over-indebtedness of the borrower, leading to manipulation in bank specific NPE forborne ratios.

Forbearance measures consist of "concessions" extended to any exposure – in the form of a loan, a debt security as well as a (revocable or irrevocable) loan commitment – towards a debtor facing or about to face difficulties in meeting its financial commitments ("financial difficulties"). It means that an exposure can only be forborne if the debtor is facing financial difficulties which have led the bank to make some concessions. A concession can be at the discretion of the bank or the debtor. The latter occurs when the initial contract allows the debtor to change the terms of the contract in its favor. These "embedded forbearance" clauses became common as banks circumvented regulators' requirements for "a change of legal terms or contract" as a requirement for forbearance.

3 IFRS 9 "Financial Instruments" as published by the International Accounting Standards Board (IASB) in July 2014, comes into effect from 2018.

4 This section discusses the main features of the Common Definitions of NPE and forbearance of the Basel Committee and EBA in general terms. Broadly speaking, both sets of definitions are generally comparable. Nevertheless, the EBA definitions are binding for all EU countries while the Basel Committee definitions are considered as "guidelines", meaning that they provide additional guidance to existing minimum requirements.

5 Paragraph 452 of the Basel II framework and Article 178 of Regulation 575/2013.

6 Unlikeliness to pay indicators include the bank putting the credit obligation on non-accrual status; the bank making a charge off or account specific provision resulting from a perceived decline in credit quality; the bank consenting to a distressed restructuring; and the obligor being placed in bankruptcy.

Table 1: Common examples of financial difficulties and concessions

Examples of financial difficulty	Examples of concessions and/or forbearance measures
• A counterparty is past due on any of its material exposures • A counterparty is not currently past due, but it is probable that the counterparty will be past due on any of its material exposures in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its material exposures • A counterparty's outstanding securities have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange due to non-compliance with the listing requirements or for financial reasons • On the basis of actual performance, estimates and projections that encompass the counterparty's current capabilities, the bank forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans or debt securities (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.	• Extending the loan term • Debt consolidation • Granting new or additional payments of non-payment – grace periods • Reducing the interest rate, resulting in an effective interest rate below the current interest rate that counterparties with similar characteristics could obtain from the same or other institutions in the market • Forgiving, deferring, or postponing principal, interest, or relevant fees (even partially). • Changing an amortizing loan to an interest payment only • New credit facilities • Releasing collateral or accepting lower levels of collateralization • Allowing the conversion of part of the debt to equity of the counterparty • Deferring recovery/collection actions for extended periods of time • Easing of covenants • Rescheduling the dates of principal and interest payments

Forbearance measures because of factors that are outside the control of the borrower (for example, capital controls) are not captured. Also, renegotiations and rollovers granted to creditors that are not in financial difficulty are not forbearance measures. There is no requirement for the bank to suffer a loss for an event to qualify as forbearance. Hence, simply extending the maturity of a loan contract because the debtor is in financial difficulty is forbearance.

Forborne exposures can be included in the performing and non-performing category, depending on the status at the time when forbearance is extended and the counterparty's payment history or creditworthiness after the extension of forbearance. Allowing forborne exposures in the performing category may feel somewhat counterintuitive at first, because the notion of "financial difficulty" is at the core of the definition. Yet, there are understandable limited instances where an exposure would remain in the performing bucket, for example when the debtor approaches the bank to request forbearance before entering financial difficulty; however, the banks are expected to perform a detailed assessment to fully satisfy itself that no financial difficulty exists and that a non-performing classification is not warranted. Specific criteria focused on sustainability need to be met before an exposure can be upgraded from non-performing forborne to performing forborne classification. Typically, these include a minimum of 12 months principal and interest repayments, no past due amounts on the exposure, exposures are not considered as impaired or defaulted, and the bank has dispelled all concerns regarding full repayment under the post forbearance arrangements and are satisfied that unlikeliness to pay indicators are absent, including no reliance on collateral to repay the debt in full.

c. Supervisory guidance

Of significant importance for prudential supervisors is the European Central Bank's (ECB) "Guidance to banks on non-performing loans" (the Guidance) calling on banks to implement realistic and ambitious strategies supported by comprehensive capital plans to reduce NPLs in a timely manner. The Guidance applies on a proportional basis and lays out sound practices with respect to the development and implementation of the NPL strategy including the setting and monitoring of NPL targets. Supervisory expectations in areas such as governance and risk management are also covered, with the role of the management body, the special NPL unit, and a sound control framework spelt out. In addition, the Guidance focuses on the need for strong strategic involvement by the Board of the bank in the formulation and execution of the strategy and the need for strong incentive structures within the bank to embed and operationalize the strategy in the day to day activities of the bank.

The Guidance also details sound forbearance processes and practices, including the need for regular affordability assessments, standardized forbearance products and decision trees, forbearance milestones and monitoring, and supervisory reporting and public disclosures. The Guidance includes numerous examples of unlikely to pay events and forbearance events. It also gives many illustrations of forbearance measures that can be used as a starting point by prudential supervisors when setting their own supervisory expectations.

In March 2018, the EBA launched a consultation on its guidelines for credit institutions on how to effectively manage NPEs and forborne exposures. These guidelines are significantly based on, and fully aligned with, the single supervisory mechanism NPL guidelines following the EU Action Plan. They target high NPE banks with the aim of achieving a sustainable reduction of NPEs to strengthen the resilience of their balance sheets and support lending into the real economy. The proposed guidelines build on existing EBA expectations in the area of consumer lending and are designed to ensure that consumers, who have taken out loans, are treated fairly at every stage of the loan life cycle. The consultation runs until 8 June 2018.

The consultation paper asks for views on the threshold for assessing high NPE banks noting that credit institutions with elevated levels of NPEs, measured as a NPL ratio of 5% or above, should establish a NPE strategy and related governance and operational arrangements. Effective governance covers all responsibilities that banks have, as laid out in the consultation paper. The consultation paper also sets out requirements for competent authorities' assessment of credit institutions' NPE management activity as part of the supervisory review and evaluation process.

2. Expected credit loss provisioning

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have adopted provisioning standards that require expected credit loss (ECL) rather than incurred loss accounting[7]. By moving from an incurred loss to an ECL framework, the intention is that credit losses would be recognized earlier. Indeed, both the IASB and the FASB standards estimate ECL not only based on past events and current conditions, but also reasonable and supportable forecasts about the future, including future economic conditions.

IFRS 9 introduces new classification and measurement requirements, according to which financial assets are classified based on the business model within which they are held and their contractual cash flow characteristics. It requires banks to monitor the change in credit risk over the life of their loans and compare this to the credit risk at initial recognition to determine the amount of provisions recognized. The loss allowance for those exposures whose credit risk has not increased significantly ("stage 1 or performing" exposures) is based on 12 months ECL. The allowance for those exposures that have suffered a significant increase in credit risk ("stage 2 or underperforming" and "stage 3 or impaired" exposures) is based on life time ECL. These changes, especially the new impairment framework with its stage 2 classification, is likely to introduce significant volatility to banks' profit and loss statements.

7 The IASB published International Financial Reporting Standard (IFRS) 9 in July 2014, which took effect on 1 January 2018 (earlier application was permitted). The FASB published its final standard on current expected credit losses (CECL) in June 2016. The FASB's new standard will take effect on 1 January 2020 for certain banks that are public companies and in 2021 for all other banks, with early application permitted for all banks in 2019.

Sound loan valuation and provisioning practices have always been an area of focus for prudential supervisors because of their impact on regulatory capital ratios and profitability. Therefore, prudential supervisors must have powers to impose adjustments to regulatory capital when accounting provisions are insufficient to cover expected losses from a prudential perspective[8]. There are several ways this power can be applied. One way is to use asset classification systems with minimum regulatory provisioning requirements for each maturity bucket. In other instances, supervisors allow accounting standards as the basis for recognizing provisions but still have prudential back stops in place. For example, they can require banks to apply regulatory calculations, compare them with accounting provisions, and deduct any shortfalls from capital. Alternatively, supervisors can also provide qualitative or quantitative guidance of their expectations to banks.

A recent example of the latter approach is the ECB's publication of an addendum to its NPL Guidance[9]. This document is applicable to all banks directly supervised by the ECB for exposures classified as NPEs from 1 April 2018. It reinforces and supplements the Guidance by stipulating quantitative supervisory expectations regarding the minimum levels of prudential provisions expected for NPEs. The expectations are driven by two factors; first, vintage or the length of time an exposure has been classified as non-performing; second, collateralization. These measures are referred to as "prudential provisioning expectations". In a nutshell, fully unsecured and the unsecured balance of partially secured NPEs are subject to 100% provisioning after 2 years. Similarly, fully secured exposures and the secured balance of partially secured exposures are subject to 100% provisioning after 7 years. The addendum outlines a starting point for the supervisory dialogue with individual banks.

Supervisors are generally supportive of the new ECL approaches and expect their application, if implemented properly, will lead to the earlier recognition of credit losses than incurred loss models, enhance the transparency of financial statements, and improve the accuracy of reported asset values. It also further aligns prudential objectives and accounting standards.

The introduction of IFRS 9, however, comes with several implementation challenges and prudential implications. In addition to building their own expertise and capacity to deal with this complex accounting standard, there are several policy actions that supervisors should take. Financial Stability Institute (2017) details a range of policy actions for standardized and IRB banks. Below, some examples of the Financial Stability Institute (2017) policy considerations for client countries are laid out.

a. Policy actions

Detail supervisory expectations for the application of IFRS 9

The Basel Committee has issued supervisory guidance on accounting for ECL provisioning[10] with the objective to support high quality IFRS 9 implementation. The guidance outlines sound credit risk practices with respect to the implementation and ongoing application of ECL accounting frameworks, including the Committee's expectations on the application of key aspects of IFRS 9 provisioning. The document's appendix details supervisory expectations that can be used as a starting point by all supervisors. The EBA also issued guidelines[11], building on the Basel Committee guidance, to ensure sound credit risk management practices when implementing and applying ECL accounting models.

For instance, there are many ways to assess changes in credit risk and to use forward looking information to calculate provisions. The approach used will reflect a range of factors including; the bank's sophistication, its risk management policies and practices, the nature of the loan book, and the available data. The calculation of ECL involves significant credit judgment and the use of internal models, comparable to the discretion allowed under the most sophisticated regulatory capital calculation approaches, like the advanced internal ratings-based approach which was

8 See Basel Core Principles on Banking Supervision, CP 17, EC7 "The supervisor assesses whether the classification of the assets and the provisioning is adequate for prudential purposes. If asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes (eg if the supervisor considers existing or anticipated deterioration in asset quality to be of concern or if the provisions do not fully reflect losses expected to be incurred), the supervisor has the power to require the bank to adjust its classifications of individual assets, increase its levels of provisioning, reserves or capital and, if necessary, impose other remedial measures."

9 ECB (2017)

10 See BCBS (2015)

11 EBA (2017)

only permitted after obtaining explicit supervisory approval. This will accentuate differences in loan loss provisioning outcomes across banks and jurisdictions. The stage 1 and stage 2 coverage especially will be heavily reliant on modelling, and as such the outcomes of the models and the associated coverage will be dependent on the data used, parameter assumptions utilized, and the level of managerial judgment exercised by banks. Intrusive and intense supervision on ECL may be necessary, with a range of supervisory tools, most notably benchmarking and backtesting, prepared and used for that purpose.

Reconcile specific and general provisions with IFRS 9 provisions

The Basel capital frameworks distinguish between general provisions (GP) and specific provisions (SP), even though neither concept is part of the accounting framework. As banks move towards ECL provisioning an important issue is to define which, if any, portions of provisions should be regarded as specific or general provisions for regulatory purposes. The Basel Committee's plan is to retain, for an interim period, the current regulatory capital treatment of accounting provisions. Under the standardized approach, up to 1.25% of gross risk weighted assets can be included in Tier 2. Hence, prudential supervisors will need to provide guidance on how they intend to categorize ECL provisions as GP or SP under the standardized approach in their jurisdiction. It is obvious that the IFRS stage 3 provisions are to be classified as SP, yet policy decisions will need to be made to assess how stage 2 and stage 1 provisions should be classified. In 2017, the EBA issued an opinion[12] that all IFRS9 credit risk provisions should be considered specific credit risk adjustments.

Consider relying on regulatory probation periods for forborne or modified exposures

IFRS 9 allows banks to upgrade modified loans (from stage 3 to stage 2 and from stage 2 to stage 1) if the customer has demonstrated its repayment capacity based on the revised terms for a "period of time". The EBA and Basel Committee use of probation periods could be useful references for supervisors when assessing banks' practices. Again, supervisors should clearly state the specific periods and clarify if they are to be used for prudential provisioning.

Mandate clear rules for write offs in banks' internal policies

Fully provided underperforming loans that are not written off artificially impact asset quality measures. IFRS 9 requires loans to be written off partially or fully when there is no reasonable expectation of recovery, fully disclosing the write off criteria per IFRS 7. The Guidance requires banks to include in their internal policies clear guidance on the timeliness of write offs, particularly for non-collateralized exposures where maximum periods for full write off should be set.

Assess the role of asset classification and credit grading systems under IFRS 9

Many regulatory asset classification and provisioning systems have between five and six buckets, usually defined by days past due and/or credit worthiness (standard, watch, substandard, doubtful, and loss). As indicated above, IFRS 9 has three stages. Broadly speaking, the last three buckets map to stage 3 loans and the first two regulatory buckets are similar to stage 1 and stage 2 exposures. Authorities will have to decide if the existing classification system should be maintained in parallel to IFRS.

Consider establishing regulatory provisioning back stops

Supervisory authorities should consider if regulatory provisioning frameworks or back stops should be retained or developed under IFRS 9. Minimum provisioning percentages might be applied across all banks, or initially only to the smaller banks that do not (yet) have the capacity to develop and monitor robust ECL methodologies that comply with supervisory expectations. The calibration of regulatory provisioning models should also be regularly assessed against actual losses to ensure they continue to produce realistic provisioning.

12 EBA (2017b)

Use supervisory powers to ensure provisioning levels meet prudential expectations

When provisioning is deemed inadequate for prudential purposes, supervisors should have a range of powers to require the bank to increase its levels of provisioning. If they do not have the power to require higher provisions, the power to deduct provisioning shortfalls from CET1 capital has been commonly used. In case this latter power does not exist, supervisors could resort to requiring Pillar 2 add-ons, even though this is a less transparent approach.

Work out transitional arrangements

Given uncertainty of the quantitative impact of IFRS 9 on capital ratios, the Basel Committee (2017a) has allowed jurisdictions to adopt transitional arrangements to avoid a "capital shock". Transitional arrangements should apply only to "new" provisions arising because of a move to ECL approaches. The transitional arrangements can extend up to 5 years and can be static (calculated just once) or dynamic.

The European transitional arrangement is 5 years long and during that time percentages of "new" provisions recognized as a result of IFRS 9 adoption will be added back to CET1 capital. The adoption of the transitional arrangements will be at the discretion of the banks on the assumption that they inform their supervisor.

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