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COVID-19 and NPL Resolution in the ECA region

Recognizing problem assets: regulatory and supervisory context

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Lessons for the COVID-19 era

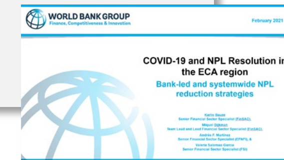
- It is widely anticipated that rising levels of borrower distress will inevitably translate into **fresh pressures on asset quality** in the banking sector.
- A key lesson from the GFC is that **bankers and policymakers need to respond quickly and comprehensively**, to avoid getting stuck in a vicious cycle of lackluster financial sector performance and weak economic growth.
- This requires a decisive policy response in the **following three areas**:

Recognizing problem assets – regulatory and supervisory context:

- **Robust banking regulation and supervision** needed to ensure the proper identification of NPLs and provisioning for credit losses

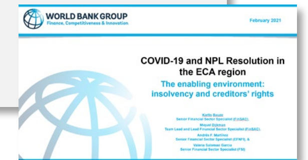
Bank-led and systemwide NPL Resolution strategies:

- **Strengthening of banks' operational readiness** to work out rising volumes of problem assets



The enabling environment – insolvency and creditors' rights:

- **Legal environment** that enables banks to work out bad loans and that avoids steering distressed but viable borrowers towards liquidation



1. Strong regulatory definitions
2. Orderly exit from current borrower relief measures
3. Dedicated workout units
4. Loan restructuring
5. Legal frameworks
6. Bridge gaps between insolvency framework and actual practices
7. Coordination and interaction between involved actors

Why is the regulatory and supervisory context so important?

Reliable, up-to-date and economically meaningful information on exposures to problem assets is critical

- ✓ Reliable data are the starting point for any NPL resolution strategy:
  - ✓ Policymakers need to be able to **understand the magnitude of the problem** and to **articulate a well-informed NPL resolution strategy**
  - ✓ Ascertain whether **banks are provisioning appropriately for credit losses**
  - ✓ Evaluate **banks' true financial condition**
  - ✓ **Undertake** appropriate **supervisory action** vis-à-vis weak banks with a **problematic NPL exposure**

Consequences of weak regulatory definitions and lack of effective supervisory enforcement

- ✓ Regulatory and supervisory weaknesses can cause reported metrics of asset quality to drift away from economic realities:
  - ✓ The existence of a significant mass of uncaptured credit risk, leads banks' provisions for credit losses to fall short of what is needed given their true exposure to problem assets
  - ✓ This **resulting provisioning gap** inflates banks' capital and **impedes the timely identification and remediation of problem banks**
  - ✓ **After GFC some ECA countries made good progress** in strengthening regulation and supervision, but progress is uneven, and there under the current circumstances there is a risk that some of these reforms may be reversed.

Agenda

1. **International initiatives for regulatory harmonization**
2. The impact of COVID-19-related borrower relief measures on asset classification, forbearance, and provisioning
3. Supervisory and regulatory priorities in times of COVID-19

International initiatives for regulatory harmonization

NPL and forbearance regulatory definitions harmonization (pre-COVID-19)

- The GFC exposed **heterogeneity with respect to regulatory definitions of NPLs**, hindering comparisons of NPL ratios across jurisdictions.
- Standard setters stepped up their efforts to harmonize key definitions for **NPLs and for forborne exposures.**
- **EBA**'s Implementing Technical Standards (2014) and **BCBS** 2017 definitions.
- In recent years many ECA countries adopted these **harmonized regulatory definitions of NPLs and forborne exposures**.

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Non-Performing Exposures

- **90 days past due** hard backstop (quantitative threshold).
- **Unlikeliness to pay** – UTP (qualitative criteria): regardless of the number of DPD(1), there is evidence that full repayment of principal and interest is unlikely without realization of collateral.
- In addition:
  - **Pulling effect** for borrowers with multiple loans.- if more than 20% of the exposures of a borrower is considered an NPL, then by extension all the other exposures (on- and off-balance sheet) of that borrower should be considered as NPL as well.
  - **Broader range of problem assets** than loans only (e.g., debt securities) – Non-Performing Exposures/Assets rather than NPLs
  - **Exposures that are more than 90 dps or that are UTP** are considered an NPL, regardless of the availability of **collateral**.

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Forbearance

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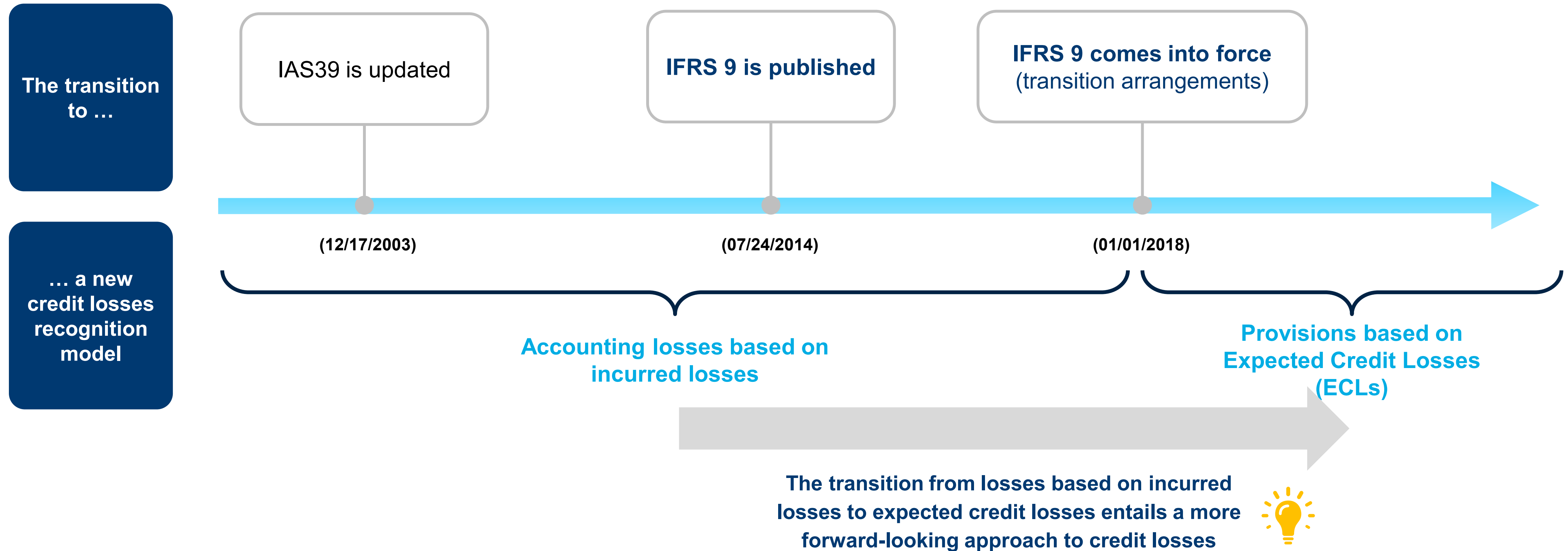
- **Financial difficulties of the borrower prompt the lender to make concessions**:
  - ✓ Extending maturities; changes in the schedule of payments; granting of grace periods; changes in interest rates; reduction of the actual amount to be paid; etc.
  - ✓ Other: granting additional loans; lowering collateral requirements; release of collaterals; converting debt to equity; forgiving, deferring, or postponing principal and interest; etc.
- Can be included in **both the performing** (when concessions are being offered **before** financial difficulties occur) **or non-performing category**.
- Should not be used to merely postpone the recognition of inevitable losses (*Extend-and-Pretend)*
- **A solid repayment track record** is required before a previously non-performing forborne exposure can be upgraded

(1) Days Past Due: refers to the number of days elapsed since the moment the borrower was due to make a payment and did not do so.

International initiatives for regulatory harmonization

Accounting standards: transition from IAS 39 to IFRS 9



Since the new standard came into force in 2018, financial sector regulators in ECA have undertaken measures to ensure its implementation by banks

An overview of IFRS 9 credit impairment

- Under IFRS 9 banks are required to **monitor changes 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.

Change in credit risk since initial recognition

	Stage 1 – *Performing*	**Stage 2 – *Underperforming***	**Stage 3 – *Non-performing***
Recognition of expected credit losses	**12-month ECL** (PD 12m/LGD)	***Lifetime ECL*** (PD *lifetime*/LGD)	***Lifetime ECL*** (PD *lifetime*/LGD)
Interest revenue	**Effective interest on gross carrying amount**	**Effective interest on gross carrying amount**	**Effective interest on amortized cost carrying amount (that is, net of credit allowance)**

The jury is still out whether the transition towards ECLs implies an increase in accounting provisioning requirements

- The **shift towards forward-looking assessments** of credit risk over the life cycle of a loan **can result in potentially significant increases in provisions**, particularly when **the economic outlook deteriorates drastically within a short period of time**.
- On the other hand, the **requirement that banks already make some provisions for performing loans can help in weathering credit shocks**.

Challenges in ECA countries on implementing IFRS 9

The implementation of IFRS 9 has presented ECA region financial sector regulators with considerable challenges

Although the importance of an early recognition of credit losses is widely recognized among financial sector regulators in ECA, IFRS 9 required **significant enhancements** in:

- **Supervisory processes**
- **Procedures**
- (On occasion) **risk management** to pave the way for a proper implementation

- **Particular challenges** have emerged **around models and analytical tools** that banks have introduced for the assessment of credit risks.
  - **Model risk - banks' reliance on models** that (except for a few specialized insiders) **are not widely understood**.
  - Regulators in ECA countries often lack of the necessary quantitative skills to challenge these models
  - This is a particular concern for regulators in small host countries in ECA region where EU-based parent banks are often seeking to extend models developed at the parent bank level

Banking regulators in ECA have often maintained regulatory provisioning requirements in parallel to IFRS 9 accounting requirements

Agenda

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2. **The impact of COVID-19-related borrower relief measures on asset classification, forbearance, and provisioning**
3. Supervisory and regulatory priorities in times of COVID-19

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

Overview of unprecedented borrower relief measures

Focused on providing temporary debt service relief for borrowers affected by the COVID-19 pandemic by allowing suspension or postponement of payments for a specified period of time

Commonly used instrument

- **Payment moratoria are the most used instrument**, but with many differences in overall design, scope and duration.

*Payment moratoria[1] = "a suspension of **all** principal and interest payments for a predetermined period. While the moratorium is in force, banks are prohibited from charging penalties and fees on loans to which the moratorium applies."*

- Rescheduling and restructuring:
  - **Temporarily reduced payments**.
  - **Temporary switch to interest-only payments**.

\+

- **Extended maturities**.
- **Capitalization of deferred payments**.

Limiting the effect on borrowers' debts in NPV terms

- Payment moratoria are generally NPV-neutral
- To fully **neutralize the effect of the deferment of debt service obligations on NPVs**:

$$\sum \text{additional future payments} \geq \sum \text{deferred debt service obligations}$$

- …. to account for the time value of money

These schemes have been introduced in the majority of ECA countries albeit with important variations in terms of overall design and coercion mechanisms vis-à-vis banks

Regulators have often provided general guidance regarding the broad parameters of payment moratoria, while leaving the ultimate responsibility for borrower selection and relief measures offered to banks.

(1) Different from "enforcement moratoria"

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

A few preliminary guiding principles in setting borrower relief measures

Prerequisites and risks	**Potential impact on banks' financial position**	➢ It is critical that in **designing borrower relief measures**, policymakers have: ✓ Fully assessed how the **measures are likely to financially impact the banking sector** in the near term ✓ Ensured that proposed measures **do not present an unacceptable risk to banks' safety and soundness** ✓ Techniques such as **scenario analysis** and **stress-testing tools** which might be particularly useful to gauge the impact
	Unintended side effects	➢ In addition, policymakers need to be mindful of two categories of borrowers: ✓ **Willful defaulters**: debtors financially capable but unwilling to pay may use moratoria to halt repayments, **undermining repayment discipline** ✓ **Zombie borrowers**: companies that are unable to cover debt servicing costs from current profits over an extended period will seek to use moratoria to get a fresh lease on life, locking up credit in underperforming sectors at the expense of more dynamic ones (**i.e. allocative inefficiencies**)
High-level principles	**Targeting**	➢ Most ECA countries have set up **schemes with the explicit objective of supporting borrowers whose repayment capacity has been negatively affected by COVID-19** ("targeting"). ➢ But within these broad parameters, banks have considerable discretion in selecting borrowers.
	Exit strategies	➢ Borrower relief measures are of a **temporary nature** and they should be unwound as soon as circumstances allow ➢ The **circumstance could include**, among others: a clear **indication that the pandemic is under control**; **suspension of emergency measures** to stop the spread of the disease; or a **sustained period of positive economic growth** ➢ **Public communication** about these preconditions for **revoking the borrower relief measures is important to manage expectations**
	Supervisory reporting and transparency	➢ It is essential that **banks produce reliable, frequent, up-to-date, and comparable information** regarding loans that have benefitted from **borrower relief measures** ➢ Communication must include **policymakers, bank depositors, investors and shareholders**
	Uphold loan loss classification, provisioning and accounting	➢ Stretching regulatory definitions for NPLs and forborne assets: ✓ **Undermines market discipline** and comparability within and across countries ✓ **Distorts the veracity of financial information** and blurring the distinction between borrowers negatively affected by COVID-19 and zombie borrowers. ✓ **Difficult to unwind**, as industry pressures will likely resist the prospect of recognizing a significant spike in NPLs

See 2020 FinSAC policy note by Dijkman and Salomao Garcia about borrower support measures in ECA region. Paper is publicly available here

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

a. Guidance from international standard-setting bodies: implications for loan loss classification and provisioning

- **EBA's and BCBS have issued guidance on the prudential treatment of moratoria** and other temporary borrower relief measures.
- The starting point of the publications is that **policymakers should use the flexibility embedded in existing frameworks** and **leave existing regulatory definitions intact.**

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Non-Performing Exposures

- Payment delays are based on a modified schedule of payments, i.e. **taking into consideration the rearranged debt obligations** after factoring in the specific borrower relief measures.
- **Days past due effectively freeze while a moratorium is in place** (while debt obligations are temporarily suspended, the borrower does not fall further into arrears).
- **UTP criterion**: **based on** bank's assessment whether the borrower is **unlikely to repay the deferred payments**.
  - **Participation in a moratorium does not imply that the borrower should automatically be considered UTP**.
  - But banks should still apply the UTP criteria **to borrowers whose short-term payment challenges** are likely to transpose into **long-term financial difficulties**.

Banks are required to continuously assess borrowers' repayment capacity, and promptly identify exposures that are considered UTP

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Forbearance

- No requirement that loans subject to a moratorium be considered as forborne provided they **meet certain EBA requirements:**
  - ✓ Launched in **response to the COVID-19 pandemic** (announced and applied before September 30, 2020).
  - ✓ **Broadly and consistently applied** (by other banks).
  - ✓ Apply to a **broad range of obligors**.
  - ✓ **Moratorium changes only the schedule of payments**.
  - ✓ No **material NPV reduction**.
  - ✓ Should **not apply to new lending**.
  - ✓ The **same moratorium offers the same conditions**.

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

b. Guidance from international standard-setting bodies: implications for accounting – IFRS 9

In the current uncertain economic outlook:

- There are **concerns that banks may need to**:
  - **Recalibrate their credit risk parameters** to reassess their expected losses **according to the new economic outlook**.
  - **Reclassify** a significant share of their loan book **from performing to underperforming or non-performing**.
- Both may **trigger a surge in loan loss provisions**, resulting in **sizable bank losses and capital depletion**, that would undermine their capacity to support the economic recovery with credit (“procyclicality”).

Potential tension between the need for pragmatism (to avoid a significant tightening in credit conditions) **while upholding (IFRS 9) forward-looking approach** towards recognizing and provisioning for credit losses.

It is important to highlight that:

- Participation in a **moratorium or other borrower relief measures is not automatically considered a default**.
- The **assessment whether there is a SICR is exceptionally difficult under the current circumstances**.

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

b. Guidance from international standard-setting bodies: implications for accounting – IFRS 9: avoiding procyclicality

- Some **countries / agencies have therefore provided guidance, aimed at avoiding procyclicality** when applying IFRS 9:

Guidance on avoiding procyclicality

EBA

- **Participation in borrower relief schemes** (e.g., moratoria) **should not automatically be considered a default under IFRS 9**.
- Banks should consider the **high degree of uncertainty and changes that might result in impacts over the life of financial instruments**.

ECB

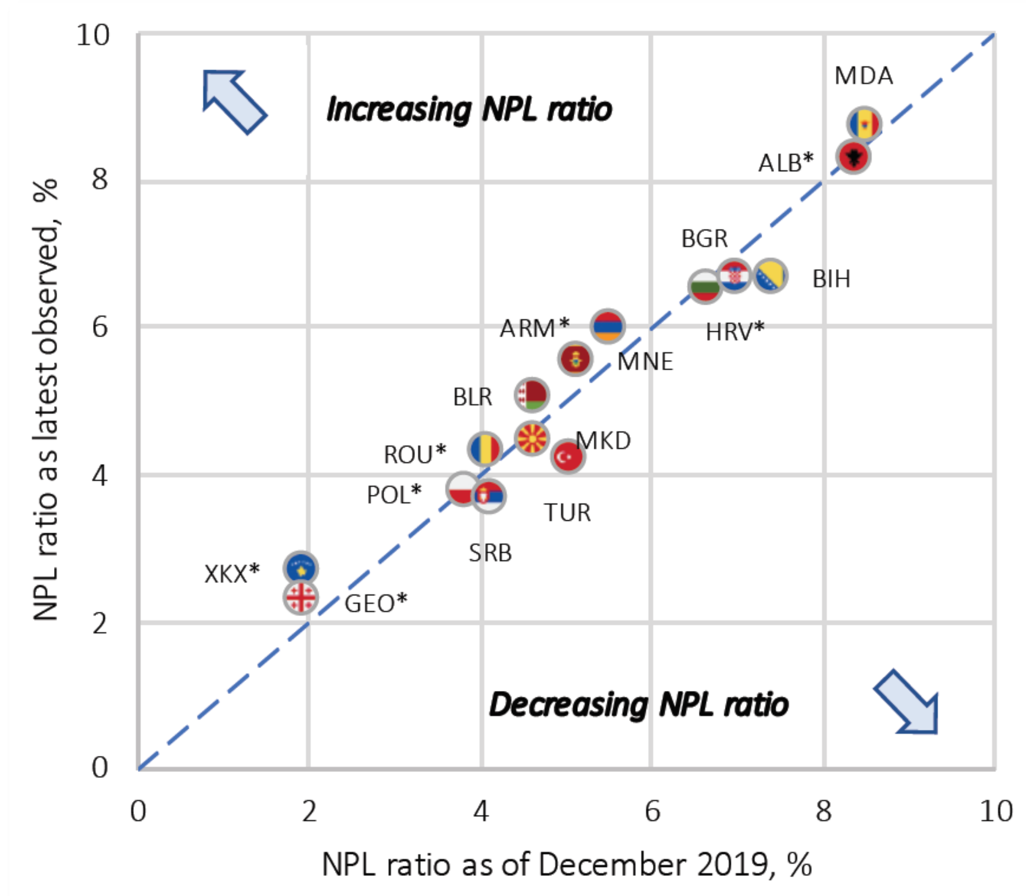
- Banks should **avoid procyclical assumptions in their models and opt for IFRS 9 transitional rules**.
- Reassessments of lifetime Expected Credit Losses (**ECL**) can be **undertaken at the portfolio level**, without the need to identify which individual financial instruments have suffered a SICR.

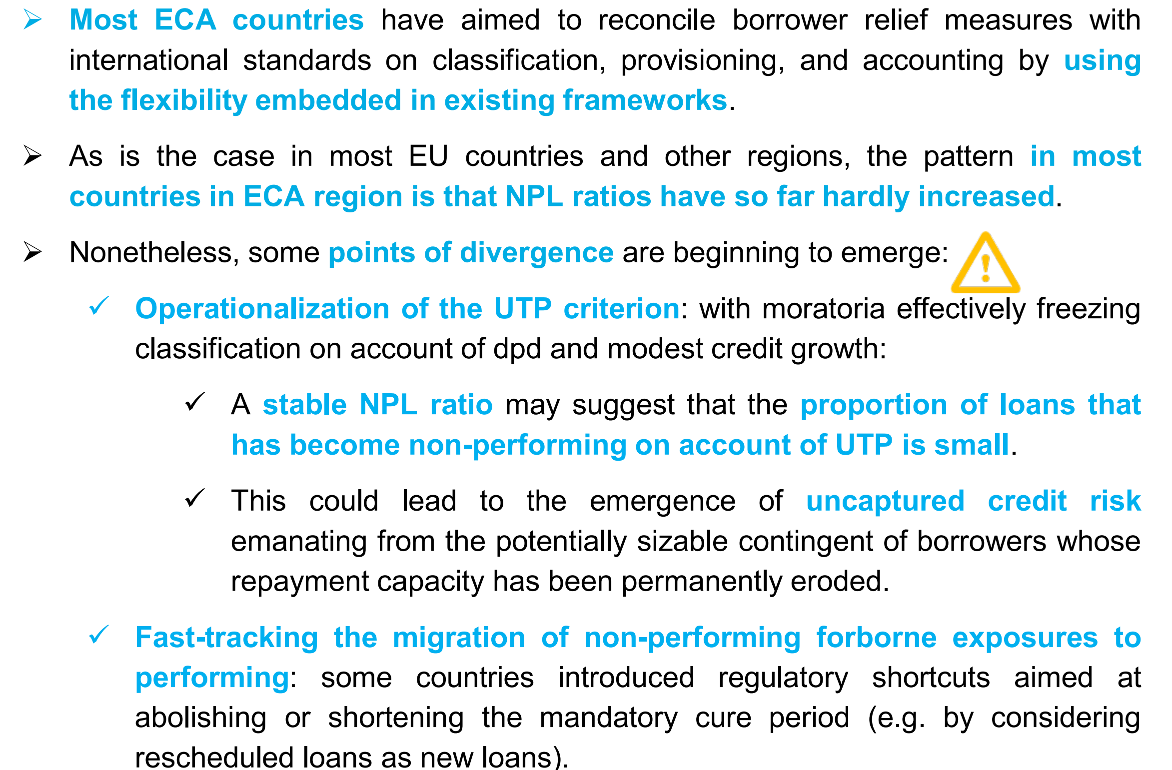
IFRS Foundation

- Acknowledged the difficulty in incorporating the effects of COVID-19 into estimates on a “reasonable and supportable basis”, but **changes in economic conditions should be reflected in macroeconomic scenarios used in those estimates**.

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

c. Practices in ECA countries





- **Most ECA countries** have aimed to reconcile borrower relief measures with international standards on classification, provisioning, and accounting by **using the flexibility embedded in existing frameworks**.
- As is the case in most EU countries and other regions, the pattern **in most countries in ECA region is that NPL ratios have so far hardly increased**.
- Nonetheless, some **points of divergence** are beginning to emerge:
  - ✓ **Operationalization of the UTP criterion**: with moratoria effectively freezing classification on account of dpd and modest credit growth:
    - ✓ A **stable NPL ratio** may suggest that the **proportion of loans that has become non-performing on account of UTP is small**.
    - ✓ This could lead to the emergence of **uncaptured credit risk** emanating from the potentially sizable contingent of borrowers whose repayment capacity has been permanently eroded.
  - ✓ **Fast-tracking the migration of non-performing forborne exposures to performing**: some countries introduced regulatory shortcuts aimed at abolishing or shortening the mandatory cure period (e.g. by considering rescheduled loans as new loans).

*Notes: 1) The vertical axis represents levels of NPL ratio as observed on November 19, 2020. The data points generally reflect values of June 2020, except those marked with *: Albania, Armenia, Georgia and Kosovo - September 2020; Romania and Ukraine - August 2020; Croatia and Poland - March 2020. 2) The NPL ratio of Ukraine was 48.36% as of December 2019, and 48.05% as of August 2020. **Source**: IMF Financial Soundness Indicators, supplemented with statistics from national authorities. (1) EBA's Risk Dashboard covering Q2 2020 (link)*

Agenda

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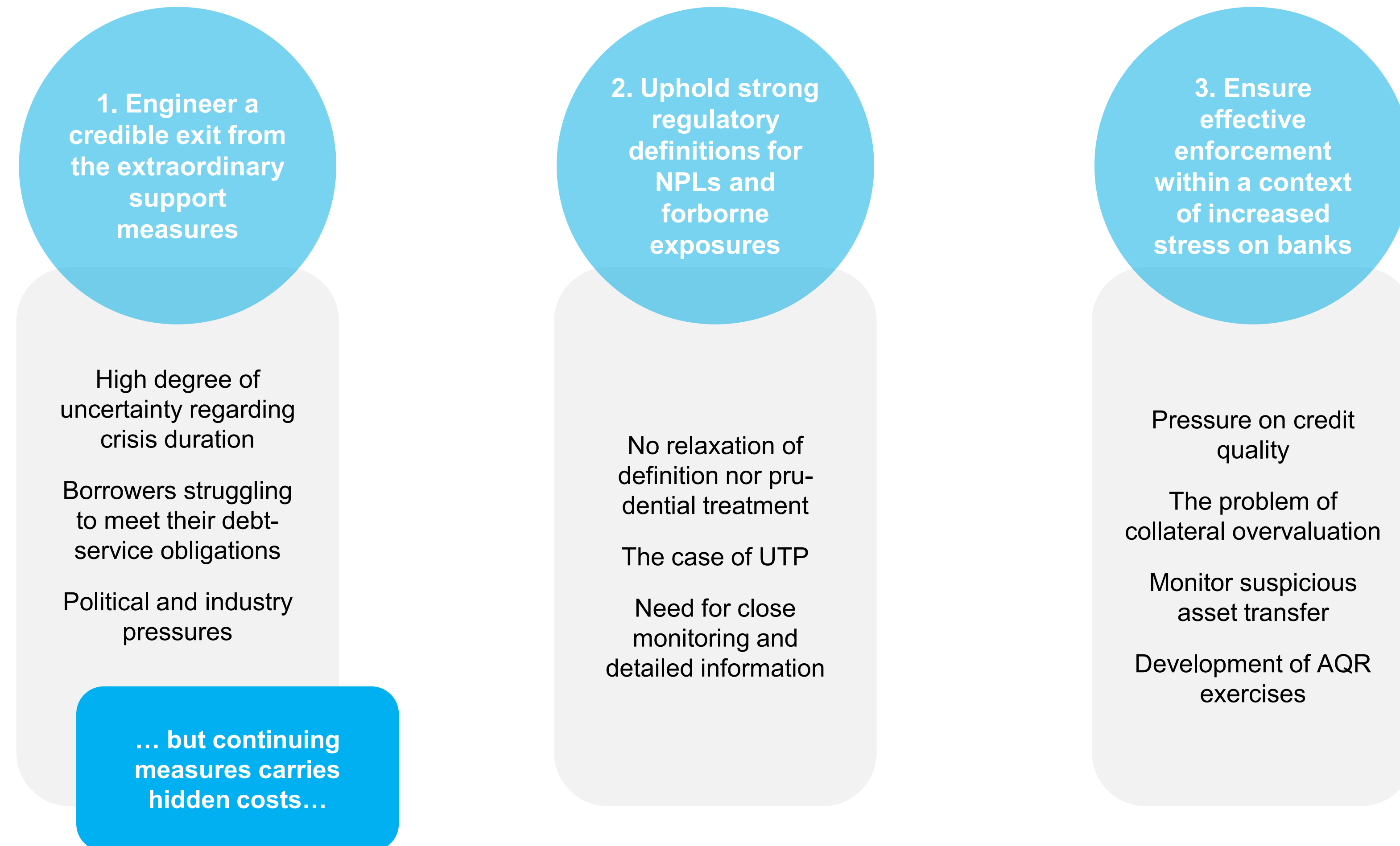
3. **Supervisory and regulatory priorities in times of COVID-19**

Introduction to priorities

Policymakers will be facing several challenges in the near to medium term, that shows the following priorities



Exiting from extraordinary borrower relief measures

Pressures to extend borrower relief measures

- **Uncertain outlook**: a year into the pandemic, there is still a high degree of **uncertainty regarding its duration and the economic recovery trajectory**.
- **Political and industry pressures to perpetuate measures**: as many borrowers continue to **struggle to meet their debt-service obligations**.
- **Banking capital situation**: concerns about the prospect of moving a sizable share of assets into the non-performing category and the corresponding **surge in provisioning charges that could deplete capital**.

Necessity to unwind borrower relief measures

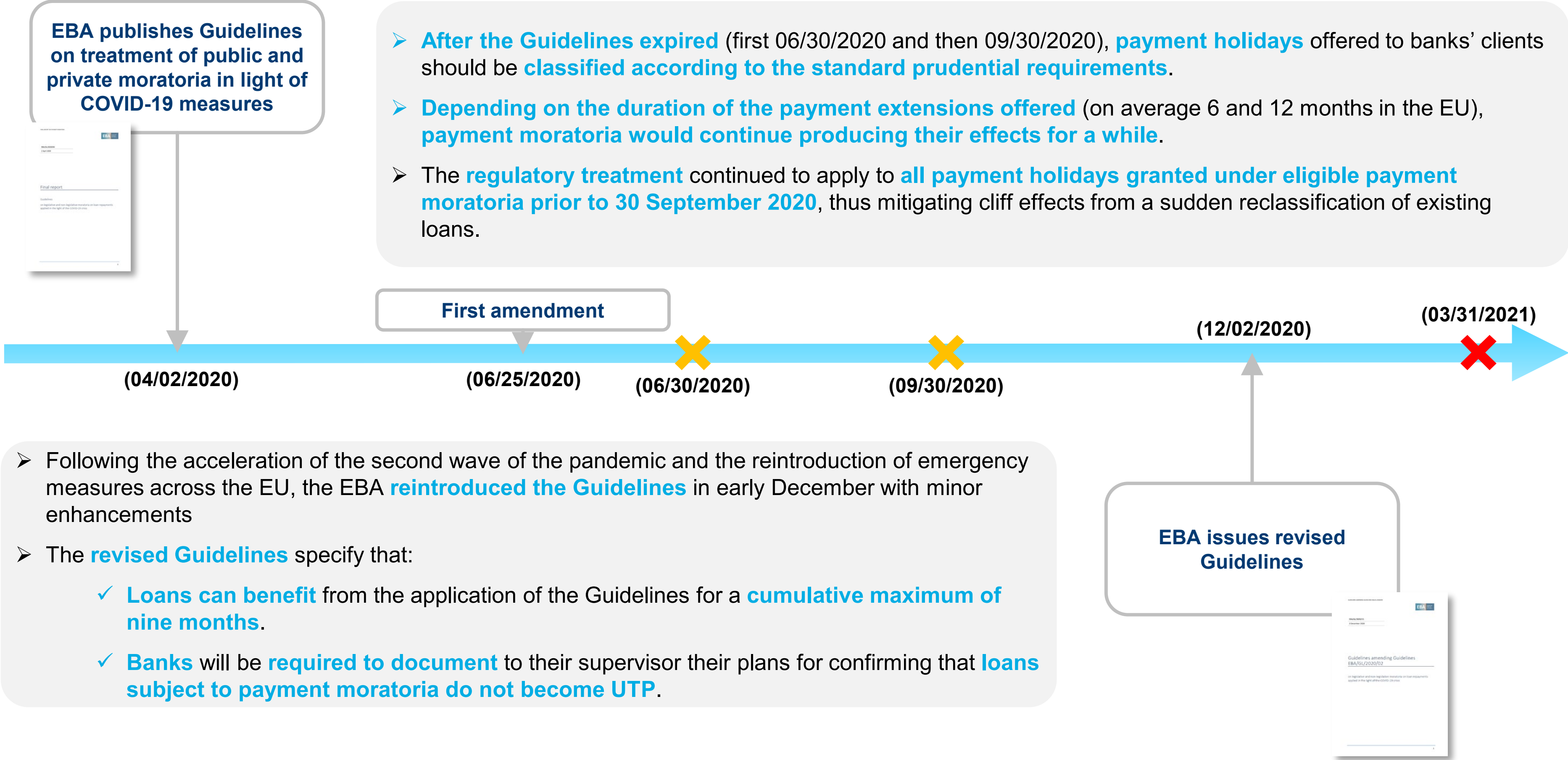
- The **prolongation** of borrower relief measures is also **associated with costs**:
  - **Moratoria become the new normal**: difficulties in reversing to the status quo pre-COVID-19, and **exacerbating moral hazard**.
  - **Misallocation of capital**: **zombie borrowers** will exert considerable **pressure to benefit from the borrower relief measures**. This can **lock up the credit stock in underperforming economic sectors** and crowd out the financing needs of more dynamic borrowers.
  - The **extension** of measures may can be associated with a **negative impact on banks' liquidity**, as they translate into a potentially significant reduction on cash flows.

NPLs can be expected to increase quickly once the borrower relief measures are phased out

As a consequence, while originally conceived as a short-term instrument to provide temporary support for liquidity-distressed borrowers, borrower relief measures adopted in ECA countries have been extended

Exiting from extraordinary borrower relief measures: the EU

Recent events in the EU have highlighted the difficulties of exit planning in a highly uncertain environment, with changes in outlook requiring policy reversals



Exiting from extraordinary borrower relief measures: how and when?

The general principle should be to unwind borrower relief as soon as circumstances permit

Instead of phasing out borrower relief measures altogether when reaching the closing date, measures can also be wound down in a more gradual manner

1	**Strengthen measures**	➢ An approaching closing date provides a window of opportunity to **strengthen the overall design** as some countries in ECA have done
2	**Narrow down the scope of borrowers eligible**	➢ Policymakers can usefully introduce **more stringent requirements** regarding the **financial viability** of the borrowers, and require that the borrowers' financial difficulties can be credibly attributed to the pandemic ➢ **Exclude zombie borrowers** by requiring a **pre-COVID-19 sufficiently strong payment track record** to those benefitting from borrower relief measures
3	**Assessment of the debtor's viability**	➢ Policymakers can also usefully introduce a requirement for **corporate borrowers** that banks conduct an **assessment of the debtor's viability** in order to be eligible for borrower support measures
4	**Exclusion of troubled sectors**	➢ Policymakers may also opt to **exclude certain industries** that are manifestly facing **difficulties that go beyond short-term liquidity needs** (e.g. hospitality, transportation), and whose financial difficulties are best addressed with **proper long-term loan restructuring measures**
5	**Replace legislative moratoria with bank-led moratoria**	➢ **Banks** are generally **in a better position to select eligible borrowers**, addressing, for instance, improper use by willful defaulters (who have the financial capacity to repay but choose not to)

Exiting from extraordinary borrower relief measures: the impacts on banks

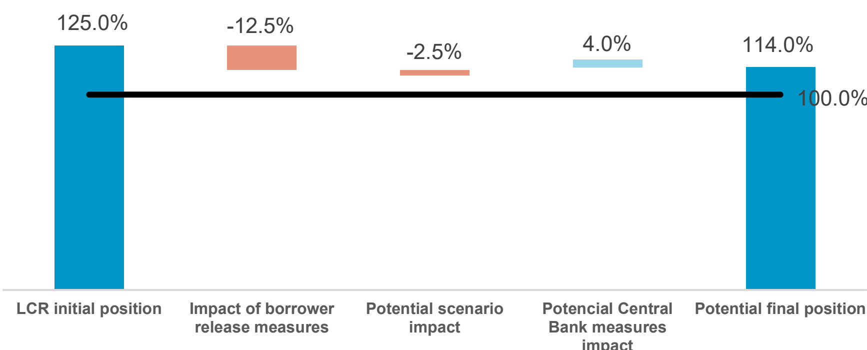
- Decisions about the **extension or phasing out** of borrower relief measures **need also to consider the financial impact on banks**.
- An **extension** implies that banks must forego regular debt service payments on a potentially significant part of their loan portfolio, which **may impact their liquidity**.
- **But phasing out** the measures will likely lead to an **increase in total NPL** volumes **and provisioning charges**, which will **affect capital**.
- It is therefore critical that **decisions are informed by assessments of the likely financial impact on banks**.

Countries that entered the pandemic with weaknesses in the banking system face a delicate balancing act and need to take great care to avoid jeopardizing safety and soundness in the banking sector

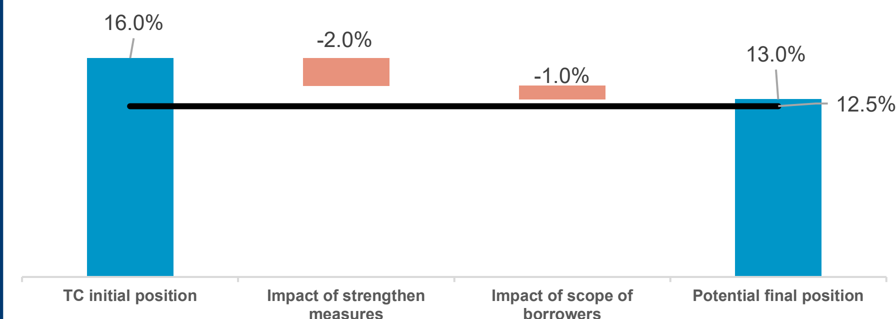
Illustrative

The expected financial impact needs to be compared with banks' financial shock-absorbing capacity (minimum requirements)

Extension - Impact on banks' liquidity positions (sector-wide analysis)



Phase out - Impact on banks' capital positions (sector-wide analysis)



The phasing out of borrower relief measures may require that weak banks replenish capital, so that they have the capital space necessary to fully recognize credit losses

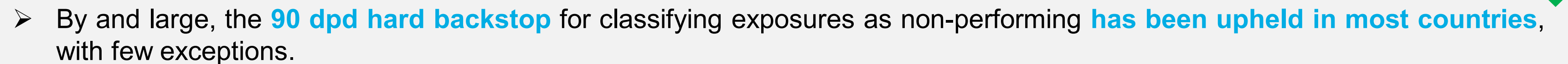
(1) Example only considers Total Capital (TC), but also CET1 and Tier1 requirements shall be ensured. Requirement is considering an average of: Pillar 1 = 8%, Pillar 2R = 2%, Combined Capital Buffer = 2.5%

Upholding strong regulatory definitions for NPLs and forborne exposures

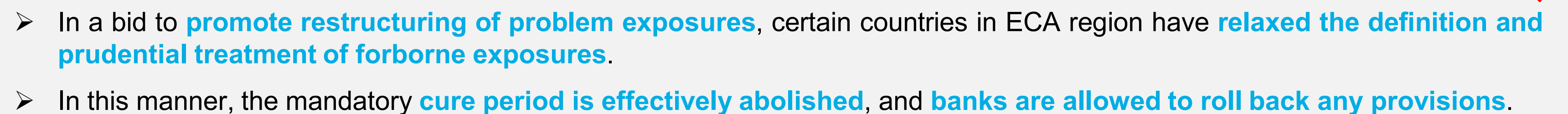
It is important that the hard-earned gains are preserved and that pressures to dilute regulatory definitions are resisted

- Over the past years, many countries in ECA have undertaken a considerable effort to **align regulatory definitions of NPLs and forborne exposures with EBA and BCBS standards**, to ensure that **standard metrics of asset quality and capital strength are economically meaningful**
- Although the **work is far from finished**, the use of these definitions by banks and supervisors is **critical for monitoring and assessing banks' asset quality in a consistent manner**, both within and across jurisdictions, as well as to **facilitate timely action to address rising asset quality problems**.

Different treatment has been observed across definitions:



- By and large, the **90 dpd hard backstop** for classifying exposures as non-performing **has been upheld in most countries**, with few exceptions.

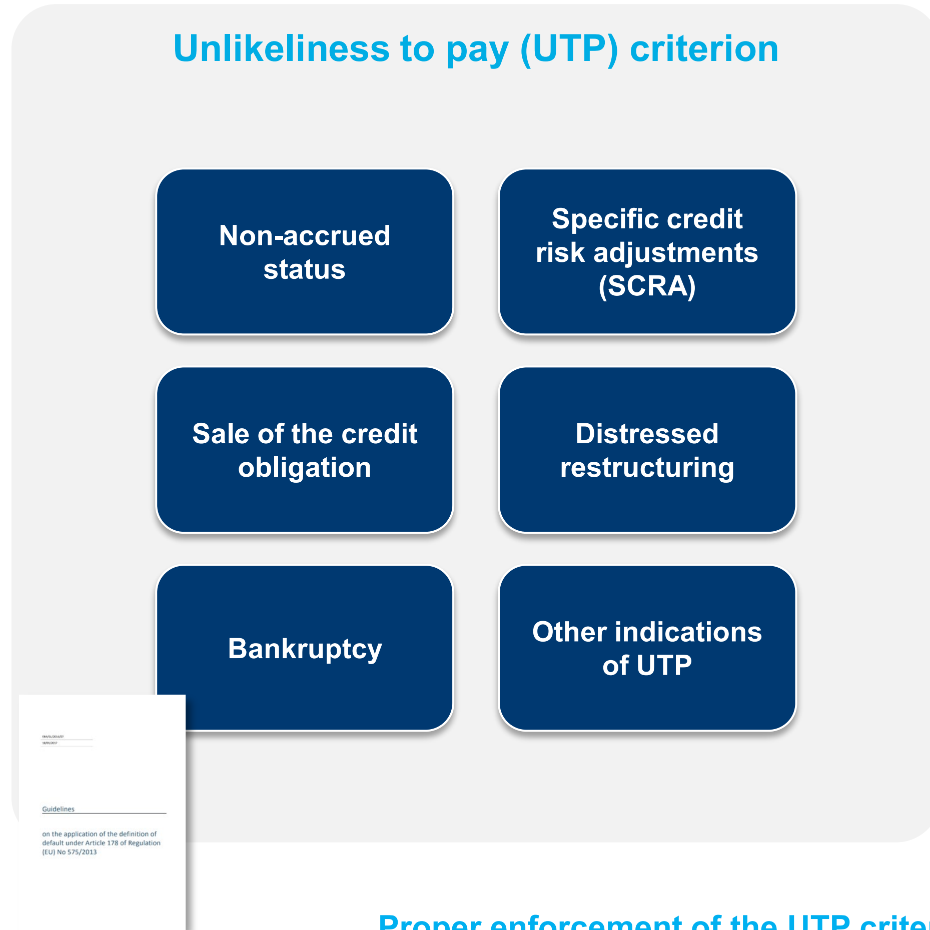


- In a bid to **promote restructuring of problem exposures**, certain countries in ECA region have **relaxed the definition and prudential treatment of forborne exposures**.
- In this manner, the mandatory **cure period is effectively abolished**, and **banks are allowed to roll back any provisions**.

This is problematic if borrowers' debt-servicing capacity fails to improve after restructuring, which is a considerable risk given the indications that banks are not vigorously applying the UTP criterion

- The abolishment of the cure period may also inadvertently **disincentivize banks from dealing resolutely with unviable borrowers**, by widening the scope for engaging in **extend-and-pretend practices** merely delaying the recognition of inevitable credit losses.
- This can lead to the emergence of **uncaptured credit risk, under-provisioning, and overstated capital**, obfuscating the comparability of asset quality indicators across banks.

Upholding strong regulatory definitions for NPLs and forborne exposures: the case of UTP



- **Absent proper UTP assessments**: banks will defer the recognition and provisioning of problematic exposures **until actual payment delays occur**.
- The **stability of reported NPL ratios** may point to challenges in the **operationalization of the UTP criterion** that predate the COVID-19 pandemic.
- Nonetheless, a **rigorous application of the UTP criterion is critical for a proactive identification of non-performing exposures**, considering that payment holidays have been offered to borrowers across the board, regardless of long-term repayment capacity.
- While there is an unusually **high degree of uncertainty** under the current circumstances, it is vital that banks make **continuous efforts to identify those borrowers whose difficulties** are likely to transpire into longer term repayment difficulties, in line with the spirit of the UTP criterion.

Proper enforcement of the UTP criterion is necessary for proactive identification of likely payment difficulties and to ensure that unviable borrowers are pushed towards an orderly exit

Upholding strong regulatory definitions for NPLs and forborne exposures: close monitoring and detailed information

A proper evaluation of asset quality requires close monitoring and detailed information regarding loans that have benefitted from borrower relief measures

Although supervisory reporting has been streamlined during the pandemic, it is essential that **banks produce reliable, frequent, up-to-date and detailed information** on loans that benefit from **borrower relief measures** and their impact on balance sheets:

1. Banks should be required to **tag loans that have benefitted from borrower relief measures**, **perform periodic assessments**, and **report a set of standard indicators for assessing the credit risk of such loans** (e.g., collateral and repayment behavior).

2. Periodic reporting to **policymakers should be required to assess whether the measures are having the desired effect**, and to **banking supervisory agencies to be able to closely monitor the impact on banks**' asset quality, capital, and overall financial standing, is also important.

   Balance between specificity and simplicity needs to be achieved, aimed at avoiding unnecessary administrative burdens on banks while meeting legitimate supervisory needs.

Illustrative

Form COV-RM

Report on restructured loans and loans under moratorium in accordance with interim measures

EUR 000

No.	POSITION	Total number of debtors	Number of sub-accounts	Amount
1.	RESTRUCTURED LOANS			
1.1.	Natural persons			
1.2.	Entrepreneurs			
1.3.	SME up to EUR 100 thousand			
1.4.	SME over EUR 100 thousand			
1.5.	Other business undertakings			

2.	RESTRUCTURED CASH UNSECURED LOANS	Total number of debtors	Number of sub-accounts	Amount
2.1.	Natural persons			

3.	MORATORIUM	Total number of debtors	Number of sub-accounts	Amount
3.1.	Natural persons			
3.2.	Entrepreneurs			
3.3.	SME up to EUR 100 thousand			
3.4.	SME over EUR 100 thousand			
3.5.	Other business undertakings			

Note:

Loans shown under #1 do not include loans shown under #2.

Effective supervisory enforcement in times of increasing stress on banks' asset quality: overview

Increasing pressures on asset quality will make supervisors' jobs more challenging

- Banks may become increasingly creative in presenting an **optimistic picture of asset quality** in a bid to delay the recognition of inevitable credit losses.
- Pressures on the operational **independence of prudential regulators**.

Supervisory responses

- **Thematic examinations** and in-depth **on-site inspections** focused on credit risk.
- Scrutinize banks on the **operationalization of the UTP criterion**.
- Challenge banks on the quality and depth of **debtor affordability assessments** that underpin **loan restructurings**.
- **Targeted market-wide reviews** over collateral, **random sample** checks, or through **special assessments** conducted by **external firms**.
- Monitoring of **intercompany transactions**.
- **Robust regulation** and **adequate reporting**.

Given the increasing incentives that banks (the especially weaker ones) face to perform a wide range of questionable activities, strong supervision is necessary to effectively challenge banks on these practices

Effective supervisory enforcement in times of increasing stress on banks' asset quality: pressures on credit quality

Weak banks face particular incentives to disguise the true extent of their difficulties

Pressure on banks' credit quality

- Full recognition of credit losses may cause their **capital to fall below regulatory requirements**, triggering:
  - ✓ **Enhanced regulatory scrutiny**.
  - ✓ **Supervisory restrictions** (e.g. on the payout of dividends and executive bonuses and launch of new products and business lines).
  - ✓ **Reputational risks**.
  - ✓ Adverse impact on the **costs and availability of funding and capital**.

Extend-and-pretend practices

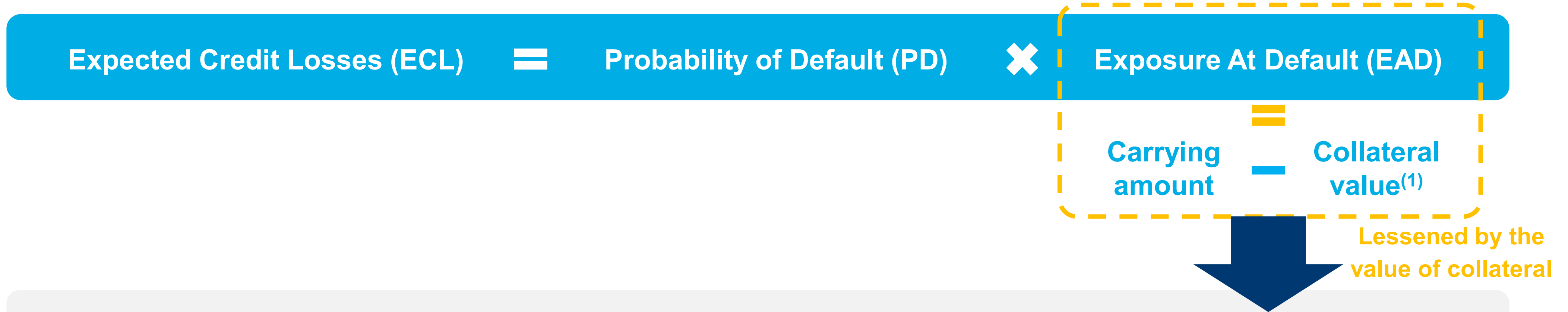
- Faced with rising borrower distress, banks may resort to questionable loan restructuring practices to avoid the recognition and provisioning for credit losses in their portfolio.
- Some **red flags**:
  - ✓ **Frequent preemptive rescheduling of problem loans** (i.e., repeated restructuring before a loan become past due).
  - ✓ Absent or perfunctory **assessments of borrowers viability**.
  - ✓ **Bullet loans**.

Supervisory priorities

- **Credit risk tops the list of supervisory priorities in 2021**.
- Supervisory **work programs** will likely shift towards **thematic examinations** and in-depth **on-site inspections focused on credit risk**.
- Pressing banks on their **operational readiness to manage rising volumes of bad assets**.
- Despite difficulties due to current uncertain outlook:
  - ✓ **Scrutinize banks** on the **operationalization of the UTP criterion**.
  - ✓ **Challenge banks** on the **quality and depth of debtor affordability assessments** that underpin **loan restructurings**.
  - ✓ **Require banks** to proactively **address cases where borrowers are manifestly non-viable**.

This pressure may be compounded by political and industry pressures on the operational independence of prudential regulators

Effective supervisory enforcement in times of increasing stress on banks' asset quality: collateral overvaluation



- **Overvalued collateral** is another **frequent cause of under provisioning for credit losses**.
- **Collateral prices**, particularly commercial real estate, **are likely to suffer downward pressures**.
- In a bid to **reduce provisioning expenses**, banks may be incentivized to **maintain collateral at inflated prices**.

What can supervisors do?

- Be prepared to **ensure that collateral values are kept up-to-date** and adjusted as necessary, and to **challenge banks on collateral values** that appear optimistic.
- **Supervisory scrutiny is critical** both from a **loan portfolio management perspective and** also in cases where collateral enforcement results in **repossession by banks**.
- If **repossessions become material**, supervisors might consider paying particular attention to "other assets" accounts through: (i) **targeted market-wide reviews** as part of supervisory cycles, (ii) **random sample** checks, or (iii) through **special assessments** conducted by external firms (e.g. auditing firms) or reputable valuation companies.

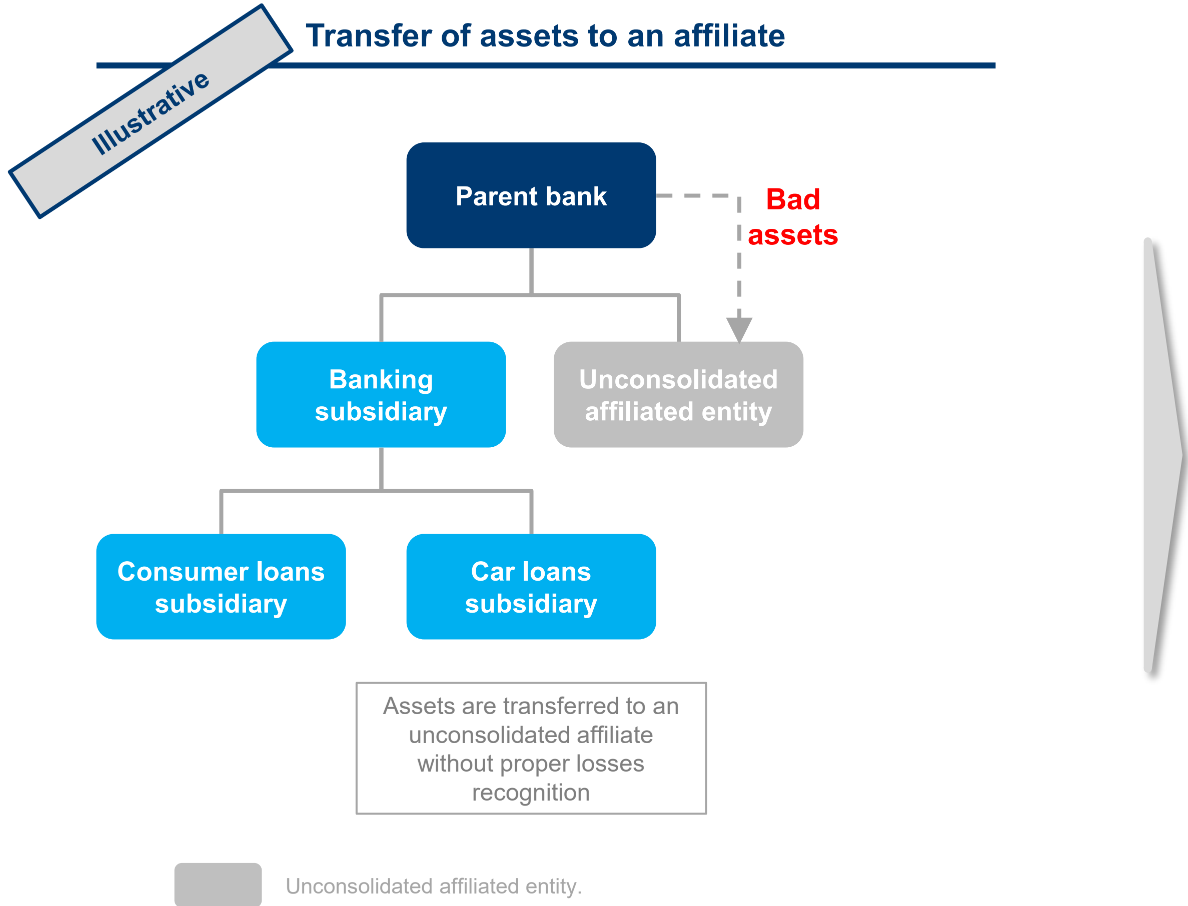
(1) After (potentially) applying a discount factor.

Supervisory and regulatory priorities in times of COVID-19

3

Effective supervisory enforcement in times of increasing stress on banks' asset quality: asset transfers

Banks may also attempt to brush up reported asset quality by moving problem assets to affiliated entities, often in a highly untransparent manner to escape supervisory scrutiny



Supervisory challenges

- **Consolidated and cross border supervision** are particularly important in curbing regulatory arbitrage.
- A full understanding of the:
  - Group's business(es)
  - Main shareholders
  - Economic interests
  - Intercompany transactions

Are **key tools** to **assess the potential** shifting of deteriorated assets in an attempt to **avoid provisioning or increased risk-weights**.

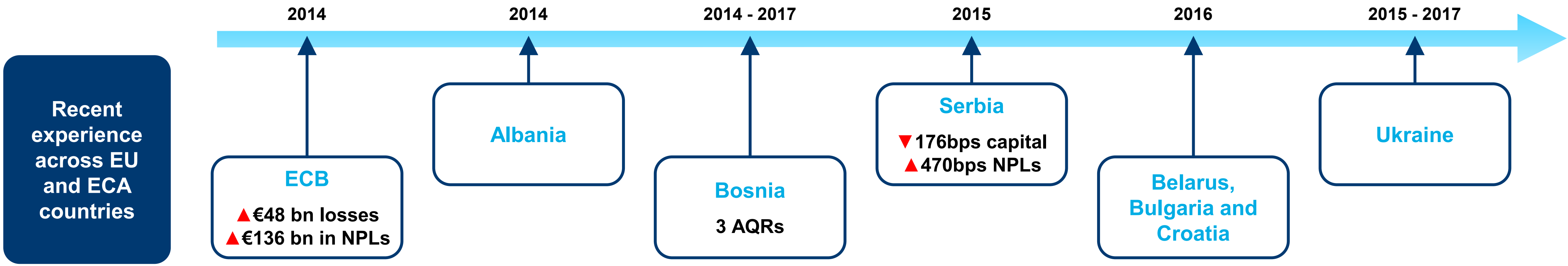
Supervisory and regulatory priorities in times of COVID-19

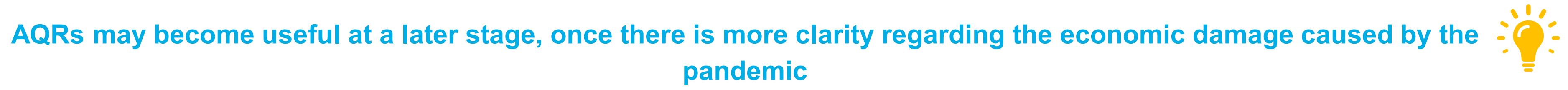
Effective supervisory enforcement in times of increasing stress on banks' asset quality: Asset Quality Reviews

AQRs can be a useful tool to bring much-needed transparency regarding the financial position of banks and to strategize the restructuring of banking systems

What is an AQR?

- A **point in time assessment** of the accuracy of the **carrying value of banks' assets**.
- Can be particularly helpful when there are **lingering doubts about the economic significance of reported asset quality indicators**.
- In undertaking a **line-by-line assessment of banks' assets**, AQRs help to obtain a **more accurate picture of banks' asset quality**, taking stock of **classification and provisioning practices** and **identifying deviations from regulations**, guidance, and accounting practices





AQRs may become useful at a later stage, once there is more clarity regarding the economic damage caused by the pandemic

WORLD BANK GROUP
Finance, Competitiveness & Innovation

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Policy Note “**COVID-19 and Non-Performing Loan Resolution in the Europe and Central Asia region**” is available:

- on the FinSAC website (link).

Policy Note “**Borrower Relief Measures in ECA Region**” is available:

- on the FCI internal website (link);
- on the FinSAC website (link).

Thank you!