

# Convergence in NPL definitions will facilitate comparison and resolution efforts

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*Non-performing loans in the European and Central Asian (ECA) region are frequently charted and analyzed across multiple jurisdictions. As a result of the lack of harmonized regulations in this area, concerns regarding the consistency of loan quality assessments are regularly raised, particularly with respect to the differences between performing and non-performing exposures, provisions for non-performing exposures, and forbearance definitions.*

This note summarizes the World Bank's paper "Loan classification and provisioning: Current practices in 26 ECA countries".<sup>2</sup> The FinSAC study had three objectives. First, it analyzes some important considerations that make the comparison of NPL ratios and provisions across jurisdictions so challenging. Second, it explains the interactions between provisioning frameworks based on prudential regulations and accounting standards. Finally, it shares some good practices for NPL definitions useful for prudential supervisors who are considering aligning their prudential frameworks more closely with IFRS. This brief focusses on the first and third objectives of the overview paper.

## A comprehensive survey of standards in asset quality accounting

The 26 countries analyzed in the overview paper include both EU and Emerging European countries. For some of the analysis, a distinction has been made between predominantly home supervisors in Western Europe and the more typical host countries in the ECA region. The countries included in the analysis are Albania, Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Georgia, Kosovo, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia and Slovenia. Home countries for subsidiaries and branches operating in those countries, comprise Austria, Denmark, France, Germany, Italy, Greece, Norway and Sweden. The main source of information is the World Bank Survey 2011 – Banking Supervision responses, validated through a desk review of publicly available regulations.

## Key Findings of the World Bank survey

### *i. Classification as non-performing and exit of the non-performing category*

About three quarter of the participating jurisdictions have an asset classification system, which requires assets to be classified into buckets reflecting asset quality. The vast majority of the surveyed countries use the number of days past as one of the criteria for

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<sup>2</sup> Loan classification and provisioning: Current practices in 26 countries by Katia D'Hulster, Raquel Letelier and Valeria Salomoa-Garcia  
<http://pubdocs.worldbank.org/pubdocs/publicdoc/2015/12/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

classifying a loan as non-performing.<sup>3</sup> 90 days past due is the criterion used by all of them for classifying a loan as non-performing. In line with good practice, all countries also apply judgmental criteria, such as significant financial difficulty of the borrower and restructuring, as triggers for classification of loans as non-performing.

Even though the 90 days past due definition appears simple to apply, important differences in application can occur. In some jurisdictions, what is considered a non-performing loan, is only the net value (after the deduction of the provisions) and not the full outstanding value of the loan. In others, the non-performing loans are measured only by the amount that is actually overdue, not the full value of the loan. These practices lead to downward biases in NPL ratios.

There are also cases where supervisors choose to apply materiality thresholds when applying the number of days past due, or choose to consider specific characteristics of the loan (e.g. collateral, type of portfolio) before classifying a loan as non-performing. This means that a loan that is well collateralized is in some cases not consistently classified as non-performing; it could be 120 days past due, but it is allowed to be “upgraded” to 90 days past due because it is collateralized. The use of these practices is a rather unfortunate attempt to fit two dimensions, probability of default and losses, into a one dimensional system that focusses on the creditworthiness of the borrower.

Some supervisors require banks to establish their own policies to rely on. If that is the case, regulations should provide banks with the incentive to classify loans as non-performing whenever there are indications of default or unlikelihood to pay, regardless of the size of the expected losses, and list clear exit criteria.

While there is common agreement when a loan is non-performing, it is not as clear when a non-performing loan “exits” and becomes performing again. Exposures that exit the non-performing category should satisfy three conditions:

- not belong to the impaired and defaulted categories;
- display improvement of the financial situation of the debtor and full repayment ability; and
- no evidence of more than 90 days past due.

## *ii. The use of regulatory provisions and coverage ratios is common*

In about half of the countries surveyed, prudential supervisors set minimum levels for specific provisions. More than half of these, indicated taking into account collateral for regulatory provisioning purposes, and almost three quarters of these countries, differentiate between prime and other types of collateral.<sup>4</sup>

It is regular practice to give an indication of the size provisions by using a coverage ratio. Generally this is calculated as total regulatory provisions divided by gross non-performing loans, but IFRS accounting provisions to gross non-performing loans or

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<sup>3</sup> Chart 4 and Annex Table 3-Loan classification and provisioning: Current practices in 26 countries  
<http://pubdocs.worldbank.org/pubdocs/publicdoc/2015/12/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

<sup>4</sup> Chart 10,11 and Annex Table 6- Loan classification and provisioning: Current practices in 26 countries  
<http://pubdocs.worldbank.org/pubdocs/publicdoc/2015/12/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

specific provisions have also been used. Coverage ratios may go well above 100%. While this may appear a little counterintuitive, it is explained by what is referred to as the “pooling of regulatory provisions”. Generally, jurisdictions that have very high coverage ratios also have mandatory provisions to cover the expected losses of performing exposures. When these are added to the specific provisions for non-performing exposures, the coverage ratio can exceed 100%. Although high coverage ratios do provide additional comfort and are an indication of a sound provisioning framework, strictly speaking they do not mean that all NPLs are fully provided for. Indeed, provisions for expected losses on performing exposures can offset shortfalls in specific provisions for non-performing exposures.

*iii. No clear regulations on when exposures should be written off*

For as long as non-performing loans, including fully provisioned ones, still show in the balance sheet, they will have an impact on the NPL and coverage ratios. Prudential supervisors should encourage or even force write offs of fully provisioned NPLs. However, only 10% of the authorities surveyed force non-performing loans to be written off after a specific time period.<sup>5</sup>

*iv. Multiple loans to a single borrower are generally all classified as non-performing*

Good risk management requires that, in principle, when a loan is in default and therefore classified as non-performing, all other loans from the same borrower (or the same economic group) are also classified as higher risk. For a prudential perspective, it should be expected that regulations would make an explicit reference to those cases, establishing minimum requirements, or providing guidance on how banks are expected to deal with such cases. The majority of the countries surveyed indicated to have requirements to classify as non-performing all loans, advances and other credit exposures related to a particular borrower which has a loan classified as non-performing.

*v. The treatment of forbore exposures still varies widely*

Loans 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 in principle be explicitly addressed by regulations on asset classifications and provisioning and be subject to more stringent classification criteria. The rationale behind this is the fact that a loan that has been restructured or forbore does not necessarily result in a loan being turned into a regular performing loan. In fact, forbearance increases the risk of a loan.

The survey indicated that the regulatory definition of forbearance, if it exists, generally includes certain “forbearance events” and their strictness and scope can vary widely among jurisdictions. Broadly speaking, two constant factors in the various definitions are first: “a change in contract terms” and second, “financial difficulty of the borrower”. Forbearance as a result of other factors that are outside the control of the borrower is thus generally not captured. The formal requirement for “change in contract terms” has incited some banks to include embedded forbearance clauses in their loan contracts,

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<sup>5</sup> Chart 12 and Annex Table 7- Loan classification and provisioning: Current practices in 26 countries <http://pubdocs.worldbank.org/pubdocs/publicdoc/2015/12/314911450690270267/FinSAC-LoanClassification-Provisioning-Paper.pdf>

which many regulatory definitions do not capture. A number of authorities also require the bank to suffer a loss, while others don't mention this. Some jurisdictions do not consider a two to three years maturity extension as forbearance as long as there is no reduction in cash flows, or no principal or interest debt forgiveness. Others have a well-defined and exhaustive list of events that are to be considered a "forbearance".

A particular issue arises when the borrower faces financial difficulty but requests a renegotiation before the loan becomes non-performing. In that case, when forbearance occurs, some authorities require the loan to be reclassified as non-performing, regardless of the days past due. Others are less strict and allow the loan to remain in the performing category. In those cases, the loan often does not remain flagged as "restructured" and when it gets past due it will not always be clear that the original loan terms have already been modified once or more and the loan is in fact more risky than similar loans in the same past due bucket.

Several supervisors indicated that once a loan is restructured it cannot be upgraded to the performing loans category immediately, and they have special criteria and steps to follow to do so.<sup>6</sup> One of the countries surveyed applies such criteria solely in the case of loans that were classified as substandard/ doubtful/ loss at the time of forbearance, requiring a track record of payment for prior upgrades or the passing of a certain period of time showing good loan service performance. Less than half of the countries surveyed that allow upgrades state explicitly the need to ensure the borrower creditworthiness.<sup>7</sup> Most of the countries surveyed indicated that restructured loans are to be classified as non-performing.<sup>8</sup>

Overall, prudential supervisors should deal carefully with restructured loans. In theory, forbearance might allow a loan to improve its risk profile, but it can also be used to defer payment, leading to manipulations of banks' specific NPL ratios and reduced provisions by repeated forbearance of loans before they become 90 days past due. Adequate regulations and supervision are crucial tools in preventing ever greening that undermine the quality of loan portfolios. Defining forbearance, collection of data on their number, as well as more stringent criteria for classifying loans that have been restructured before, can be useful monitoring tools as well as the collection of loss numbers on first and second restructures.

### **The EBA's technical standards on supervisory reporting on forbearance and non-performing exposures**

In July 2014, EBA published Implementing Technical Standards (ITS) containing uniform definitions and reporting requirements for forbearance and non-performing exposures. According to the EBA technical standards, forborne exposures can be performing or nonperforming. Two essential criteria are required for an exposure to be forborne; first, a change in the contract and second, financial difficulty of the borrower. The standard introduces a 2-year probation period for the reclassification of a performing forborne exposure into the fully performing category. NPL definitions are based on the days past due concept and assessments of the debtors ability to pay its credit obligations. The NPL, and debt securities as well as off-balance sheet exposures, and all impaired exposures are addressed in the standards. However, they do not cover exposures held for trading. The NPLs are measured taking the total amount, without

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<sup>6</sup> Chart 6 and Annex Table 4- Loan classification and provisioning: Current practices in 26 countries

<sup>7</sup> Chart 7 and Annex Table 4- Loan classification and provisioning: Current practices in 26 countries

<sup>8</sup> Chart 8 and Annex Table 4- Loan classification and provisioning: Current practices in 26 countries

taking into account collateral. NPL exposures are assessed on an individual basis (transaction approach) or, when more than 20% of retail borrower's total exposure is non-performing, based on the debtor approach. The definitions state that NPLs become performing when: (i) the exposure meets the exit criteria applied by the reporting institution for the discontinuation of the impairment and default classification; (ii) the situation of the debtor has improved to the extent that full repayment, according to the original or when applicable the modified conditions, is likely to be made without further assistance; and (iii) the debtor does not have any amount past-due by more than 90 days.

EBA defines s as non-performing exposures those that satisfy either or both of the following criteria:<sup>9</sup>

- Material exposures which are more than 90 days past-due;
- The debtor is assessed as unlikely to pay its credit obligations in full without realization of collateral, regardless of the existence of any past-due amount or of the number of days past due.

EBA's technical standards are now the benchmark for harmonization for non-EU countries, but there is scope for further strengthening, as the definitions do not cover important concepts, such as credit grading systems or internal rating systems for performing exposures; treatment of collateral; write offs; and calculation of NPL ratios and NPL coverage ratios. Nevertheless, the EBA's definitions on non-performing exposures provide a good starting point, also for non EU countries.

## Conclusion

Comparing NPL definitions and asset classification systems across countries is a complex and time consuming task. Some benchmarks are widely known and accepted, such as the 90 days past due benchmark for non-performing loans and the five categories for asset classification. But there are a number of, at first sight seemingly insignificant implementation and regulatory issues which can have a serious impact on prudential benchmarks, such as NPL and coverage ratios. When comparing NPL ratios of different countries, one should be mindful of these upward and downward biases.

The majority of the countries surveyed in the World Bank paper have asset classification systems in place. About half of those asset classification systems set minimum provisioning percentages for regulatory provisions. Moreover, the treatment of collateral in regulatory provisioning requirements varies widely. Nonetheless, of the countries that allow collateral to be taken into account in provisioning, the majority defines at least two quality classes of collateral. Also, there appears to be a prudent consensus on the treatment of multiple loans to a single customer.

Most divergences in practice were observed in the area of loan forbearance. These cover the definition of restructured loans as well the treatment for upgrading and classifying restructured loans. The EBA definitions can certainly provide a benchmark for harmonization of the regulatory treatment of forborne exposures to supervisors in the region.

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<sup>9</sup> Part 2 of Annex V, 29. NON-PERFORMING EXPOSURES (18), Reporting on financial information [https://www.eba.europa.eu/documents/10180/1017687/Annex+5+\(Annex+5+of+EC+Implementing+Act+on+Reporting\).doc](https://www.eba.europa.eu/documents/10180/1017687/Annex+5+(Annex+5+of+EC+Implementing+Act+on+Reporting).doc)

The analysis of factors influencing the definition of non-performing loans allows us to establish a number of desirable good practices.

- Reporting non-performing loans using the gross value of the loan, not the amount that is overdue, the value net of provisions or the value net of collateral;
- Requiring banks to clearly flag and report restructured loans, including by keeping track of the number of forbearances for each loan;
- Including maturity extensions and embedded forbearance clauses in the regulatory forbearance definitions;
- Establishing a probation period and a creditworthiness verification before non-performing forborne loans can be upgraded to performing loans;
- Including clear qualitative criteria in the definition of default and not just basing it on the number of days past due;
- Requiring prompt write offs of fully provided or uncollectable loans remains an area where prudential supervisors and tax authorities can provide the right incentives for banks; and
- Establishing a clear position on the single customer view or the product view.