Loan Classification and Provisioning Practices

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Introduction

• Issues to discuss
  • Challenges in comparing NPL and provisioning ratios across jurisdictions
  • What is out there - which are considered to be good practices?
• Discussion supported by a case study – 26 countries in EU and Emerging Europe
• Reflection on interactions between prudential regulations and accounting standards
Case Study - Countries covered (upcoming paper)

Host countries:
• Albania, Bosnia Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Georgia, Kosovo, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia

Home countries:
• Austria, Denmark, France, Germany, Italy, Greece, Norway and Sweden

Information Source/basis for classification:
• World Bank survey 2011-2012
• Desk review of regulation
• Expert judgment where needed
Asset Classification Systems

- Prudential regulations often encompass asset classification systems requiring loans and advances to be classified into buckets
  - Buckets usually defined by days past due and/or creditworthiness
  - Systems used for provisioning, classification of non-performing, problem loans and non-accruals, as well as to deal with loans highly likely to result in losses
  - If properly implemented, often perceived as a valuable supervisory tool – loan quality/peer analysis
Case Study - asset classification systems

The majority of the 26 countries in the survey have an asset classification system.

Asset classification systems are more common in host countries.

Government exposures are generally included in the asset classification system - for those that have an asset classification system, 72% have a system that covers government exposures.
Defining non performing loans (1)

- Well accepted threshold – 90 days past due and/or obligor unlikely to pay
- For countries with a five bucket system generally ”worst” three buckets are considered NPL

- Some countries also take into account:
  - Materiality thresholds
  - Financial difficulty of the borrower, bankruptcy and breach of contract
Defining non performing loans (2)

But:
• Only past dues poses challenges – e.g. balloon payments, overdrafts
• Objective criteria are easier…but there should be both, with objective as minimum criteria
• When unlikely to pay is taken into account for classifying as NP – how to deal with collateral?
• Amount to be classified as non-performing
  • Gross or net of collateral?
  • Just past due portion or the full amount?

Issues to consider include:
• Setting clear exit criteria
• Supervisory reporting should always encompass information on gross amounts.
Case Study – Non Performing Loans

- Most countries use number of days past due as one of the criteria to classify a loan as non-performing.
- And most of them also take into account other characteristics as restructuring, bankruptcy, breach of contract, significant financial difficulty of the borrower.
Restructuring (loan forbearance)

- Wide variety in the definition
  - Generally 2 components: change in contract terms and financial difficulty of the borrower
  - Sometimes reduction in cash flows or loss
- Can be restructured prior or after being past due
- In principle should be subject to more stringent classification criteria
  - Restructured loans not always are non performing loans
- Banks should be required to clearly flag and report forborne ("restructured") loans, including keeping track of the number of forbearances for each loan
Case Study – Restructuring/Loan forbearance

**Do regulations require forborne loans to be classified as non performing?**
- Yes, 83%
- No, 17%

**Are banks allowed to upgrade the classification of a loan immediately after it has been forborne?**
- Yes, 32%
- No, 63%
- Other, 5%

**Credit Review** - 45% of the surveyed countries require a review of the credit worthiness of the borrower before it can be upgraded to performing.

**Host countries are stricter than home countries** - 10 host countries out of 15 do not allow immediate upgrade while 2 out of 4 home countries allow immediate upgrade after forbearance.
Multiple loans to a single borrower

- When a loan is in default and therefore classified as non-performing, all other loans from the same borrower/economic group should be subject to review/classified at a higher risk.
- Regulation should make explicit reference to those cases – minimum requirements and guidance

Case Study

Are multiple loans to a single borrower all classified as non-performing?
- Yes, 74%
- No, 22%
- Not specified, 4%
Collateral Valuation

- Apart from IAS 39 there are no internationally established standards
- Practices vary widely
  - Taking into account in asset classification – less common
  - Taking into account for provisioning purposes
- If that is the case, careful consideration should be given to valuation criteria, periodical reviews and appropriate haircuts
Case Study - Collateral valuation

Do the provisioning requirements allow the value of collateral to be deducted from the amount of the loan before provisioning is applied?

- Yes, 56%
- Not specified, 39%
- No, 5%

Of those countries that consider collateral, is there any differentiation between prime and other collateral?

- Yes, 70%
- No, 30%
Case Study - Collateral valuation

Some countries allow exposure upgrades due to the existence of good quality collateral

• e.g. 120 days past due can be upgraded into 90 days past due because of prime collateral.

Other countries allow split of exposure into collateralized part and uncollateralized part

• e.g. collateralized part: substandard / uncollateralized part: doubtful
Write-offs

- Heterogeneous criteria can result in important perceived differences in asset quality
  - NPL and coverage ratios affected
  - Legal, judicial, tax and regulatory reasons
  - Good practice should encourage write-offs of fully provisioned NPLs after a reasonable period of time.

Case Study

Do regulators require banks to write off non-performing loans after a specific time period?

- Yes, 10%
- No, 90%
Accrued interest

Good supervisory practices do include not to accrue interest when a loan is classified as non-performing.

Case Study

Does accrued unpaid interest enter the income statement while the loan is classified as non-performing?

- Yes, 26%
- No, 53%
- Not specified, 21%
Provisioning

- Irrespectively of the Capital framework, provisioning prudential rules in several countries have had an “expected loss” component.
- In most cases those result in higher levels of provisioning when comparing to the IFRS.

Case Study

Are there minimum levels of specific provisions set by the supervisor?

- No, 48%
- Yes, 52%
Interactions between prudential regulations and accounting standards

• Usually accounting standards are established by a dedicated body/standard setter
• IFRS is a benchmark, easing comparability and contributing to good quality reporting
  • Principle based
• In several cases bank supervisors set specific standards for bank accounting, asset classification, as well as loan classification and provisioning
• There is no requirement for prudential regulations to be aligned to the accounting standards used
  • Different objectives and incentives – supervisors have (and should have) a clear conservative and prudent bias
Issues when transitioning to IFRS

- How to deal with the “excess” regulatory provisions when starting IFRS?
  - Asset classification systems generally compliant with IFRS
  - ..but regulatory provisioning may have to be addressed…
Thank you!