Consultative Document on Guidelines: Prudential treatment of problem assets – definitions of non-performing exposures and forbearance

Basel Committee on Banking Supervision (BCBS)

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Introduction

The BCBS published in April 2016 a consultative document on guidelines with regard to the definitions of non-performing exposures (NPEs) and forbearance

Introduction

- The global financial crisis revealed difficulties for supervisors and other stakeholders in identifying and comparing banks' information across jurisdictions. In particular, the BCBS recognised that there may be significant differences in how banks identify and report their asset quality.
- In response to this issue, the BCBS analysed jurisdictions' and banks' practices regarding asset categorisation schemes. This analysis confirmed varying practices across jurisdictions, as well as various layers of definitions within jurisdictions (e.g. the definitions of terms such as default or impairment).

- In this context, the BCBS has published a consultative document on guidelines with regard to the **definitions of non-performing exposures (NPEs) and forbearance**, which aims to harmonize both concepts.
- In particular, they should help to harmonise the scope, recognition and derecognition criteria, and the level of application of both terms, thereby promoting a better understanding of the two terms, improving identification and monitoring, and promoting consistency in the supervisory reporting and disclosures by banks.
- This consultation paper intents to complement the existing accounting and regulatory framework in relation to asset categorisation. Thus, the definitions have not been designed to undermine those used for accounting purposes or the definitions of default which are used in the Internal Ratings-Based (IRB) approach or in the standardised approach (SA) for credit risk.

This technical note analyses the definitions of non-performing exposures and forbearance proposed by the BCBS. Moreover, an analysis of the regulatory framework in the EU and the US on this matter is included.

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Executive summary

The definitions of NPEs and forbearance are applied to credit exposures within the banking book and to off-balance-sheet items. They will be used for the purpose of supervisory asset quality monitoring, Pillar 3 disclosure, etc.

Executive summary

Scope

- The definitions are applied to **on-balance sheet loans**, **debt securities** and **other amounts due** within the banking book under BIS II; and to **off-balance sheet items**.

Regulation context

- The **accounting and regulatory frameworks** regarding the asset categorisation scheme in each jurisdiction (e.g. IFRS, US GAAP, BIS II/BIS III).

Next steps

- Comments to this consultation document shall be submitted to the BCBS by **15 July 2016**.

Main content

Non-performing exposures (NPEs)

1. **Scope**: credit exposures within the banking book (including debt securities) and off-balance sheet items.
2. **Definition**: material exposures that are more than 90 days past due and those for which there is evidence that the full repayment is unlikely (in addition to defaulted and impaired exposures according to the accounting/regulatory framework, which are included also within the NPE definition).
3. **Reclassification of NPE as performing**: certain conditions shall be met (e.g. the debtor does not have any material exposure more than 90 days past due , etc.)
4. **Interaction with forbearance**: the application of forbearance measures will not alter the NPE status.

Forbearance

1. **Scope**: same as for NPE.
2. **Definition**: concession granted to a counterparty for reasons of financial difficulties that would not be otherwise considered by the lender.
3. **Exit from the forborne exposures category**: a forborne exposure will be identified as such until it meets two criteria (i.e. repayments have been made in a timely manner over a probation period of not less than one year; and the counterparty has solved its financial difficulties).
4. **Interaction with other credit risk categories**: banks should not use forbearance measures to avoid classifying loans as non-performing.

Application of definitions[1]

- The BCBS will use the final version of these definitions in the following contexts: supervisory asset quality monitoring, bank's internal credit categorisation systems, Pillar 3 disclosure on asset quality, and dissemination of data for asset quality, among others.

(1) The definitions proposed by the BCBS have not been designed to undermine those used for accounting or regulatory purposes, but to complement them.

The definitions of NPE and forbearance proposed by the BCBS are quite similar to those included in the regulatory and accounting frameworks of the EU and USA

Comparative analysis

BCBS

NPE

- All exposures **defaulted** under the Basel framework or **impaired** under the applicable accounting framework.
- **Material** exposures that are more than **90 days past due**.
- Exposures where there is evidence that **full repayment** is **unlikely**.

Forbearance

- Concessions to a counterparty that is experiencing **financial difficulty** in meeting its financial commitments.

EU

NPE

- EBA[1]: material exposures which are more than **90 days past due** or when the debtor is assessed as **unlikely to pay** its credit obligations in full without realisation of collateral.
- CRR: exposures for which there is a **default**.
- Accounting framework: assets for which there is an **impairment**.

Forbearance

- EBA[1]: debt contracts for which **forbearance measures** have been applied.

USA

NPE

- Fed/OCC:
  - IRB: for wholesale obligors, when the obligor is **unlikely to pay its credit obligations** in full, without actions such as realizing collateral, or the obligor is **past due more than 90 days** on any material credit obligation; for retail exposures, when the exposure is **120 days past due** (not residential mortgage exposures) or more than **180 days past due** (residential mortgage exposure).
  - SA: exposures that are **more than 90 days past due**.
- US GAAP: a loan is impaired it is **probable** that a **creditor will be unable to collect** all amounts due.

Forbearance

- US GAAP: any **restructuring of a debt** where the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

(1) ITS on supervisory reporting on forbearance and non-performing exposures.

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Detail

Non-performing exposures (NPEs)

NPEs are all exposures defaulted or impaired in accordance with the applicable regulatory and accounting framework, and all other material exposures that are more than 90 days past due or those for which there is evidence that full repayment of principal and interest is unlikely

Scope and definition of NPEs

Scope

- **On-balance sheet loans**, **debt securities** and **other amounts due** (e.g. fees) that a bank includes in its banking book (BB) for the purpose of computing its capital requirements under Basel II.
- **Off-balance sheet items** (e.g. loan commitments and financial guarantees).

Definition

- All exposures **defaulted** under the Basel framework.
- All exposures **impaired** (i.e. exposures having experienced a downward adjustment to their valuation due to deterioration of their creditworthiness) in accordance with the applicable accounting framework.
- All other exposures that are not defaulted or impaired but nevertheless are:
  - **Material** exposures that are more than **90 days past due**; or
  - Where there is evidence that **full repayment** of principal and interest without realisation of collateral is **unlikely**, regardless of the number of days past due.

90 days past due

- This criterion is applied to **all exposures**.
- An exposure should be considered **past due** if any amount due (interest, principal, fee or other amount) has not been paid in full at the date when it was due.

Unlikely full repayment

- **BIS II** provides elements to be taken as **indications of unlikeliness to pay**. Moreover, the likelihood of repayment could also be assessed through a **comprehensive analysis** of the financial situation of the counterparty.

Material

- A material exposure is an exposure that hits the materiality threshold in a given **jurisdiction**:
  - Materiality thresholds may **differ for retail and non-retail exposures**.
  - It should comprise a **relative and absolute threshold**.
  - It should be applied by **reference** to the counterparty's aggregated exposure or past due amount as determined by supervisors.

Level of application

- **Non-retail** : when one exposure is NPE, all the exposures to that counterparty are NPE.
- **Retail**: exposures can be recognised as NPEs on a transaction by transaction basis.
- **Group of connected counterparties**[1]: designating an exposure to one entity belonging to a group as NPE may not mandatorily lead to designating all exposures to the other entities as such, but it will be an input to determine the exposures to the other entities as NPE.

(1) Group of counterparties with specific relationships such that, were one of the counterparties to fail, all of the counterparties would very likely to fail.

Detail

Non-performing exposures (NPEs)

For an exposure to cease to be non-performing it is required that certain criteria are simultaneously met. In this regard, the granting of forbearance measures to a counterparty or in an exposure will not alter the non-performing status of the counterparty or the exposure

Reclassification and interaction with forbearance

Reclassification of NPEs as performing

- An exposure ceases to be non-performing and can be **reclassified as performing** when all the following criteria are simultaneously met:
  - The debtor does not have any material exposure more than **90 days past due**.
  - **Repayment have been made** when due over a continuous repayment period specified by the supervisor.
  - The counterparty's situation has improved so that the **full repayment is likely** to be made.
  - The exposure is not **defaulted** (under Basel II) or **impaired** (under the accounting framework).

No reclassification

- **Partial write-off** of a non-performing exposure.
- **Repossession of collateral** on a non-performing exposure, until the collateral is actually disposed of and the bank realises the proceeds.
- **Extension or granting** of forbearance measures.

Interaction with forbearance

- The granting of **forbearance measures** to a counterparty or in an exposure **will not alter the non-performing status**. Thus, forborne exposures should remain non-performing if the exposures have been categorised as non-performing prior to the forbearance measure or if they meet the criteria to be categorised as non-performing.

Forbearance

Forbearance occurs when a concession is granted by a bank to a counterparty for reasons of financial difficulties. The BCBS provides a non-exhaustive list of examples of financial difficulties, as well as examples of common concessions

Scope and definition of forbearance

Scope

- **On-balance sheet loans**, **debt securities** and **other amounts due** (e.g. fees) that a bank includes in its banking book (BB) for the purpose of computing its capital requirements under Basel II.
- **Off-balance sheet items** (e.g. loan commitments and financial guarantees).

Definition

- Forbearance occurs when:
  - A counterparty is experiencing **financial difficulty** in meeting its financial commitments; and
  - A bank grants a **concession** that it would not otherwise consider, irrespective of whether the concession is at the discretion of the bank and/or the counterparty. The latter will occur when the initial contract allows to change the terms of the contract in the counterparty's favour (i.e. embedded forbearance clauses).

Financial difficulties[1]

- A counterparty is currently **past due** on any of its **material exposures** or is probable that the counterparty will be past due in the foreseeable future without the modification.
- A counterparty's **outstanding securities** have been **delisted** or are in the process of being delisted.
- A bank forecasts that all the counterparty's committed/available **cash flows** will be insufficient to service all of its loans or debt securities.
- A counterparty's existing exposures are categorised as exposures that have already evidenced **difficulties** in its **ability to repay** in accordance with the supervisory categorisation scheme in force or the credit categorisation scheme within a bank's internal credit rating system.
- A counterparty is in **non-performing status** or would be considered as non-performing without the concessions.
- The counterparty cannot **obtain funds** from sources other than the existing banks at similar interest rates.

Concession

- Concessions are **special contractual terms and conditions** provided by a lender to a counterparty facing financial difficulties to make the counterparty sufficiently able to service the debt.
- **Common concessions** are the following: extending the loan term, rescheduling the dates of payment of principal and interest, granting new or additional periods of no payments, reducing the interest rate, etc.

(1) Some examples are provided although this is a non-exhaustive list.

A forborne exposure will be identified as such until repayments have been made in a timely manner over a probation period of not less than one year and the financial difficulties have been solved

Exit from the forborne category and interaction with other categories

Exit from the forborne category

- A forborne exposure will be identified as such until it meets both of the following exit criteria:
  - When **repayments** as per the revised terms have been made in a timely manner over a continuous repayment **period of not less than one year** (minimum probation period for reporting). The starting date of the probation period should be the scheduled start of principal or interest payments under the revised terms.
  - The counterparty has solved its **financial difficulties**.

Interaction with other credit risk categorisations

- The exposure that banks identified as forborne shall be categorised in the following way:
  - **Performing** forborne exposures should be categorised separately from other performing exposures.
  - An exposure that was categorised as **non-performing** at the time of granting forbearance should remain non-performing until a continuous **repayment period specified by the supervisor passes** after the application of the forbearance measures and the exposure meets the **other criteria** for exit from the non-performing category.
- Banks should not use **forbearance measures** to avoid classifying loans as non-performing.

Application of definitions

It should be noted that the definitions do not aim to replace the definitions of the regulatory and accounting frameworks, but to complement them. Thus, they will be used for the purposes of supervisory asset quality monitoring, disclosure of quality assets under Pillar 3, etc.

Application of definitions

Application

- It should be noted that the **definitions of NPEs and forbearance** are not designed to replace the definitions used in the regulatory and accounting frameworks, but to complement them.
- These definitions, once the consultation period have finalised, will be used in the following contexts:
  - **Supervisory asset quality monitoring**.
  - Bank's **internal credit categorisation systems for credit risk** management purposes.
  - **Pillar 3 disclosure** on asset quality.
  - **Dissemination of data** for asset quality indicators.
  - To act as a **reference point** of other relevant working groups of the BCBS.

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Next steps

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