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Loan classification and provisioning: Current practices in 26 ECA countries

Overview paper

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Abbreviations and Acronyms

BCBS	Basel Committee on Banking Supervision
EBA	European Banking Authority
EL	Expected Loss
ECA	Europe and Central Asia
ECB	European Central Bank
CRD	Capital Requirements Directive
FSI	Financial Soundness Indicators
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IRB	Internal Rating-Based Approach
IMF	International Monetary Fund
LGD	Loss Given Default
NPL	Non performing Loans
PD	Probability of Default

Preface

Katia D'Hulster is a Senior Financial Sector Specialist at the World Bank Financial Sector Advisory Center (FinSAC)

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The findings, interpretations and conclusions expressed in this paper are entirely those of the authors. They do not represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliate organizations, or those of the Executive Directors of the World Bank or the governments they represent.

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Executive summary

This study attempts to shed light on the regulations and practices in the area of identifying and provisioning for loans losses in 26 countries in EU countries and Emerging Europe. Our analysis is based on the World Bank Survey 2011-2012. Banking supervision responses were validated through a desk review of publicly available regulations.

This overview paper has three objectives. First, we analyze some important considerations that make the comparison of NPL ratios and provisions across jurisdictions so challenging. Second, we explain the interactions between provisioning frameworks based on prudential regulations and accounting standards. Finally, we conclude by sharing some good practices for NPL definitions useful for prudential supervisors who are considering aligning their prudential frameworks more closely with IFRS. We also propose steps for further regional work, knowledge sharing and harmonization.

In the area of NPL definition, we find that almost three quarters of the countries in the region have some type of asset classification system in place covering all types of borrowers, including sovereigns. Non performing exposures in the region are generally defined by two criteria: 90 days past due or the unlikeness of the borrower to pay; and by other criteria such as significant financial difficulty of the borrower, bankruptcy and breach of contract. There is neither a unified definition of forbearance or restructuring, nor a consensus when forborne exposures can be upgraded to the performing category and what the specific conditions for this upgrade should be. About one third of the surveyed jurisdictions allow an upgrade immediately after the forbearance and about half does not require an assessment of the borrowers' creditworthiness before upgrade. The European Banking Authority has recently issued draft technical standards on loan forbearance which could be used as a guideline for harmonization of some of the diverging practices across the region. About three quarters of the supervisors in the region require that when a loan is non performing, all other loans and credit exposures from the same borrower, or the same economic group, are classified as higher risk, meaning that they apply a "single borrower view".

In about half of the countries surveyed, regulatory and accounting loan loss provisioning standards coexist. With regard to regulatory provisioning, less than half of the countries surveyed allow collateral to be taken into account in their regulatory provisioning. Of those countries that consider collateral for provisioning purposes, the majority differentiates between prime and non-prime collateral. In some countries, NPL ratios include a high proportion of fully provisioned loans that remain on the balance sheet for legal, judicial, tax or other reasons. These tend to inflate NPL ratios and the share of provisions allocated to non performing loans; or what is commonly referred to as the coverage ratio. The vast majority of supervisors do not have criteria at what point in time these exposures should be written off.

As a general observation, regulatory provisioning frameworks are based on expected losses (EL), are more forward looking and result in higher provisions than IFRS standards. Divergence between accounting and prudential treatment also occurs in the recognition of accrued and unpaid interest on non performing loans. A little less than half of the supervisors in this analysis do not allow accrued and unpaid interest on non performing

loans to be recorded in the income statement; the remaining explicitly allow it or their regulations are non-specific.

Recently, some countries have come under pressure to do away with their traditional regulatory provisioning and accrued interest adjustments and to rely exclusively on accounting standards to determine provisions. In practice, the latter are often implemented through the use of sophisticated risk management models that rely on internally generated risk estimates and methodologies to calculate provisions. Substantial supervisory resources should thus be allocated to analyze and benchmark banks' methodologies and risk parameters **before** full transition to these accounting frameworks can be made. It is also essential to maintain both accounting and regulatory systems in parallel during this transition period.

There is scope for a deeper understanding, more regional cooperation and sharing of knowledge on banks' provisioning practices among supervisors in the region. This could include data collection and benchmarking of internal risk estimates, sharing of reviews of the provisioning methodologies and expected loss calculations applied by the banking groups active in the region and efforts to further analyze and harmonize NPL definitions. Home supervisors of major regional banks could also assist in this effort.

Introduction

1. Even though it is often stated that NPL ratios and provisions are not easily comparable across jurisdictions, non performing loans and their provisions 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 frequently raised, particularly with respect to the distinction between performing and non performing exposures, provisions for non performing exposures, as well as forbearance definitions.

2. The objective of this study is threefold. First, we analyze some important considerations that make the comparison of NPL ratios and provisions across jurisdictions so difficult. Second, we explain the interactions between provisioning frameworks based on prudential regulations and accounting standards. Finally, we conclude by sharing some good practices for NPL definitions useful for prudential supervisors who are considering aligning their prudential frameworks more closely with IFRS. We also propose steps for further regional work, knowledge sharing and harmonization.

3. With regard to NPL ratios, the IMF Financial Soundness Indicators (FSI) Compilation Guide provides broad guidance for the identification of non performing loans by stating that exposures are non performing if they are 90 days past due.[1] Implementing this seemingly simple definition comes with a common set of policy choices; such as the exact triggers for the classification as a non performing loan, the treatment of sovereign exposures, the handling of forbearance or restructuring, customer versus product view, the treatment of collateral, the timing of write offs and some macro-prudential aspects. While the above criteria are important, they are not the only policy choices to be made. They were selected for analysis in this paper because first; they are relatively simple to compare across jurisdictions and, second; a variety of practices has emerged. Other elements, for example the measurement of the non performing exposure – gross or net of provisions, collateral or the performing part - are not analyzed in detail in this paper.

4. When it comes to setting provisions, there are complex interactions between, on the one hand, prudential provisions and, on the other hand accounting or IFRS provisioning requirements. Differences in practice have emerged, with some supervisors relying on accounting definitions, others holding on to the regulatory provisioning requirements and some selecting the higher of both outcomes for prudential purposes.

5. For the purpose of this study, we perform a desk review of the range of regulations and practices on loan classification and provisioning in 26 countries on the European continent. More specifically, the survey focused on Western Europe as well as ECA with 26 countries surveyed. 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

[1] The FSI compilation guide of March 2006 recommends that loans (and other assets) should be classified as NPL when (1) payment of interest and principal are past due by more than three months (90 days) or more, or (2) interest payments equal to three months (90 days) interest or more have been capitalized (re-invested into the principal amount), re-financed or rolled over.

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. For the countries in the sample that have not participated in the World Bank Survey 2011, or where the responses diverged significantly from the available regulation, clarification from the respective supervisory authorities was obtained.

6. This note concludes by providing good practice guidance on these key topics and the main drivers for loan classification and provisioning. Importantly, the impact of effective implementation of these criteria, often reflected in the robustness of the supervisory approach towards early identification and timely enforcement, cannot be underestimated. Robust and consistent implementation of asset classification and provisioning rules, particularly the application of qualitative criteria for the early recognition of problem assets, are key elements in ensuring comparability across portfolios within a country and across jurisdictions.

7. The classifications in the tables presented in the Annex are based on answers to the 2011 Bank Supervision survey as well as a desk review of the regulations. Where the definitions across countries are not easily comparable, expert judgment has been used and the regulations have been interpreted to the best of the authors' abilities. They welcome any comments or suggestions from the individual authorities on this paper.

A. Asset classification systems

8. Prudential regulations often encompass asset classification systems, which require banks to classify loans and advances into buckets.[2] Those buckets are usually defined by days past due and/or creditworthiness. Such systems can then be used for provisioning, classification of non performing or problem loans and non-accruals, as well as to deal with loans highly likely to result in losses. These types of asset classification systems, if properly implemented, are often perceived as a valuable tool for supervisors, providing for a very broad understanding of the overall quality of assets, particularly on deteriorating or problem loans, as well as a to benchmark banks against their peers.

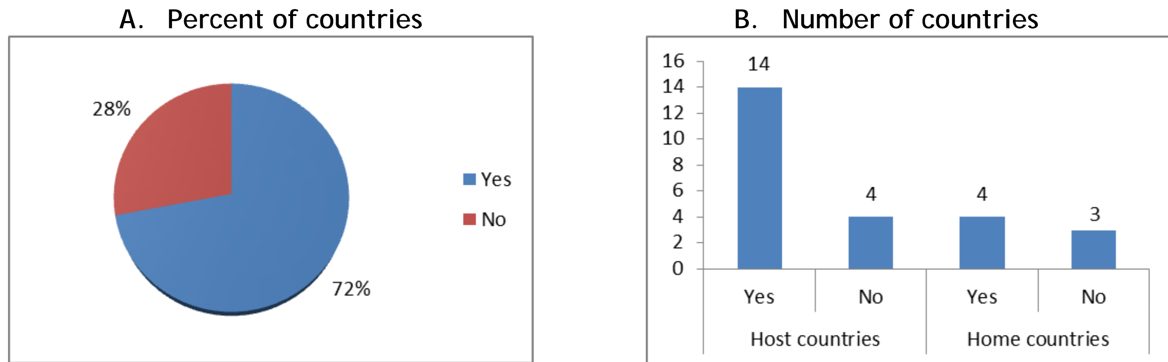
9. What underlines and drives asset classification and provisioning systems is credit risk and, in particular, two of its key components, **default** and **losses** (which might result as a consequence of the default). In that sense, those systems usually have a minimum level of provisions that need to be recorded once the default materializes. Regulatory provisions are required to cover the likely losses that might result from such default, in some cases reflecting the value of the collateral. Usually, those systems are comprised of a few buckets, where loans are classified depending on the likelihood of the default turning into actual losses. Classification is based on number of days past due and/or qualitative criteria- and as a consequence, requiring increasing levels of provisioning.

10. About three quarters of surveyed countries in our sample have an asset classification system in place for loans and advances within their regulatory framework

[2] Those systems usually target loans and advances but in some jurisdictions they are used to classify a much wider range of assets. In the case of Serbia, for instance, the asset classification system covers almost all assets but only requires provisions for loans and advances.

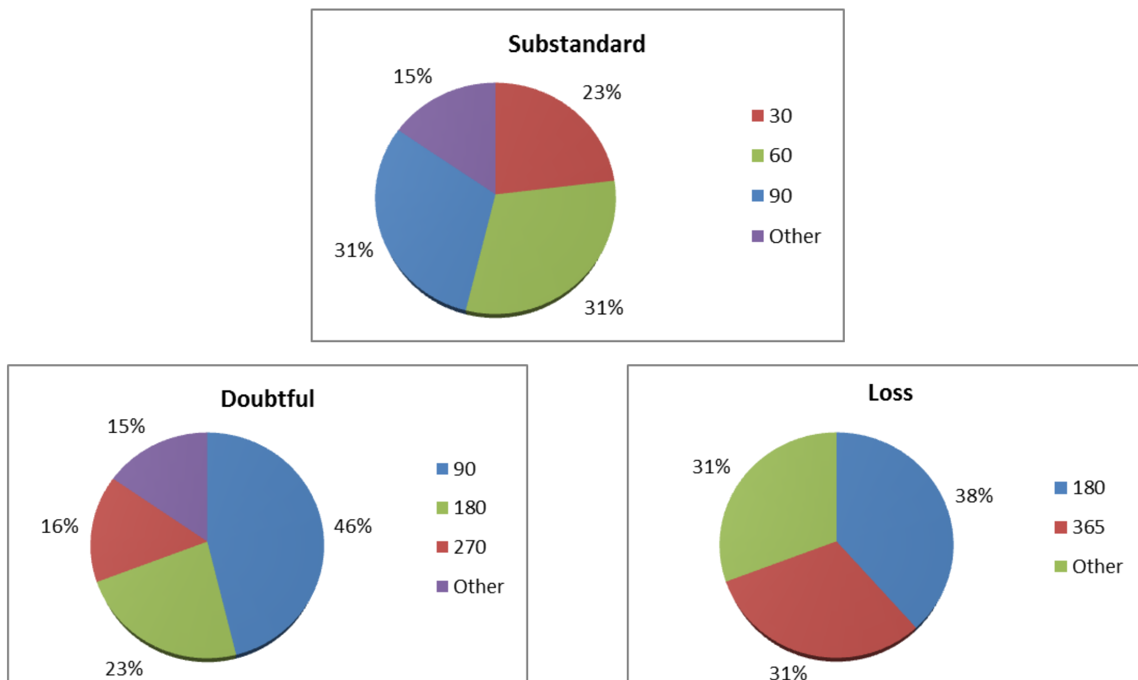
(Chart 1 and Annex Table 1). Asset classification systems are less prominent in typical home countries than in host countries.[3]

Chart 1. Do you have an asset classification system under which banks have to report the quality of their loans and advances using a regulatory scale?



11. Broadly speaking, the systems are comprised of five buckets, mostly roughly with the same structure: pass/standard, watch/special mention, substandard, doubtful and loss. Classification as substandard or equivalent ranges from 30 to 91 days and classification as loss ranges from 150 to 361 days of past due (Chart 2 and Annex Table 2).

Chart 2. Minimum number of days past due for classifying as Substandard, Doubtful and Loss or equivalent:



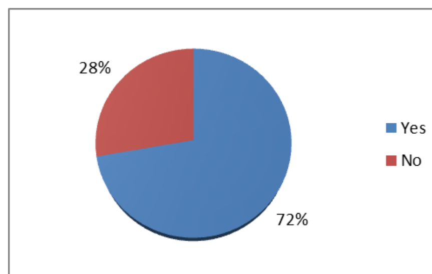
[3] This reflects the early adoption of the United States Office of the Comptroller of the Currency (OCC) practices in numerous ECA countries, following the transition to market economies.

12. Those types of mechanical or "deterministic" frameworks have been in use for decades worldwide and, if properly implemented, can be useful, although crude, tools in monitoring the overall quality of loan portfolios. Nevertheless, such systems are focused on problem loans and are not always granular enough for the segmentation of performing assets. Good practice in asset classification has now evolved towards segmentation of performing exposures with the objective to serve as early warning indicator before the asset becomes non performing.

13. In fact, the BCBS has for several years put efforts in fostering the use of internal rating systems, reflected on its advanced approaches for calculating credit risk capital requirements, which require more granular grading systems to be in place. More advanced grading systems use statistical approaches to assess credit quality and estimate EL. [4] Irrespective of a bank's complexity, the use of a more granular system that also covers performing exposures is always recommended. While jurisdictions might decide not to impose those types of frameworks for classification or provisioning purposes, banks should still be encouraged through guidance on credit risk management to put in place classification systems that enable them to differentiate performing loans by levels of risk.

14. Exposures to the sovereign are often subject to special treatment from a regulatory perspective. Particularly in the case of capital requirements, the Basel standards tie the risk-weight to sovereign exposures to its rating, while also providing discretion to countries to apply a zero risk-weight in case of exposures funded and issued in local currency (discretion which is commonly exercised by countries). Asset classification for loans and advances to the sovereign, on the other hand, is not subject to any particular guidance. In addition, it should be noted that although the Basel framework allows for the application of a zero risk-weight in the case of sovereign exposures in local currency, once such exposure becomes past due or presents indications of deterioration, there are grounds for using the appropriate classification and provision. Critics have argued that the favorable treatment of sovereign risk has provided regulatory incentives for banks to accumulate large sovereign exposures and that there is need to put an end to the fiction of a zero risk weight for sovereigns. Not surprisingly in the majority of the countries surveyed, with a few exceptions (Chart 3 and Annex Table 1), government lending is subject to asset classification similar to other loans and advances.

Chart 3. Does the asset classification system cover all types of borrowers including government?



[4] Expected losses (EL) are generally calculated by multiplying three factors; the PD (probability of default), the LGD (loss given default) and the EAD (exposure at default). Some banks apply more complex systems for example, allowing cure rates and/or correlations between exposures to be factored in. As a general principle, risk parameters should be continuously subject to rigorous statistical validation techniques and long-time data series before they can be used.

B. Defining non performing loans

15. The well accepted threshold for classifying a loan as non performing is when obligations related to the loan become over 90 days past due. Multilateral organizations define non performing along the same lines. The BCBS defines default for capital calculation purposes[5] as follows: "a default is considered to have occurred with regard to a particular obligor when either or both of the two following events have taken place: (i) the bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security; and (ii) the obligor is past due more than 90 days on any material credit obligation to the banking group." The IMF Financial Soundness Indicators (FSIs), which are vastly used for cross-country comparability, also establishes as criteria for defining a loan as non performing past due of principal or interest over 90 days.

16. Basing the criteria only on the number of days past due would pose challenges for balloon payment loans or overdraft type credits. Moreover, information can be available that the borrower is likely to default, even if the loan is not yet past due. Thus, in general, a loan is considered to be non performing when the probability of full repayment is considered to be low or when a loan is in default or highly likely to default. Criteria for classifying a loan as non performing are thus number of days past due, as well as the overall financial performance/creditworthiness of the borrower, sometimes even combined with the assessment of collateral.[6]

17. It should be highlighted though that in order to establish a certain number of days as criteria for classifying a loan as non performing, countries should carefully assess local practices and characteristics, which also might vary from portfolio to portfolio (e.g. working capital versus mortgages). Even when counting the days past due, differences can also occur as grace periods are usually granted to borrowers and the first day past due is therefore not always the first day the payment was due.

18. The majority of countries surveyed use the number of days as one of the criteria for classifying a loan as non performing (Chart 4 and Annex Table 3). In the case of the countries that do rely on number of days past due, 90 days is the criteria used by all countries for classifying a loan as non performing. In addition, countries have in place a set of judgmental criteria and bankruptcy criteria as reasons for automatic classification of loans as non performing (Chart 5 and Annex Table 3).

[5] International Convergence of Capital Measurements and Capital Standards, 2006

[6] Some supervisors allow loans that are 120 days past due to be "upgraded" to 90 days past due because they are well secured. Section E of this paper deals with the treatment of collateral.

Chart 4. Is the number of days past due one of the criteria used to classify a loan as non performing?

A. Percent of countries B. Number of countries

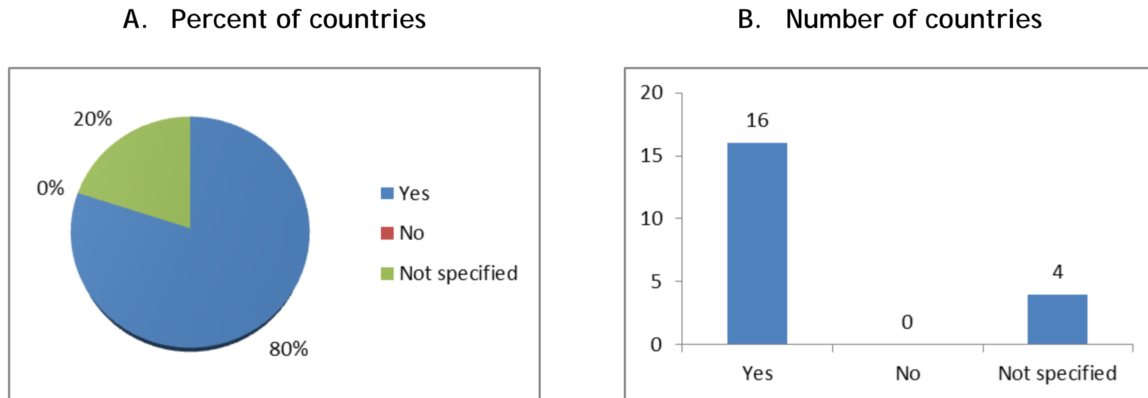
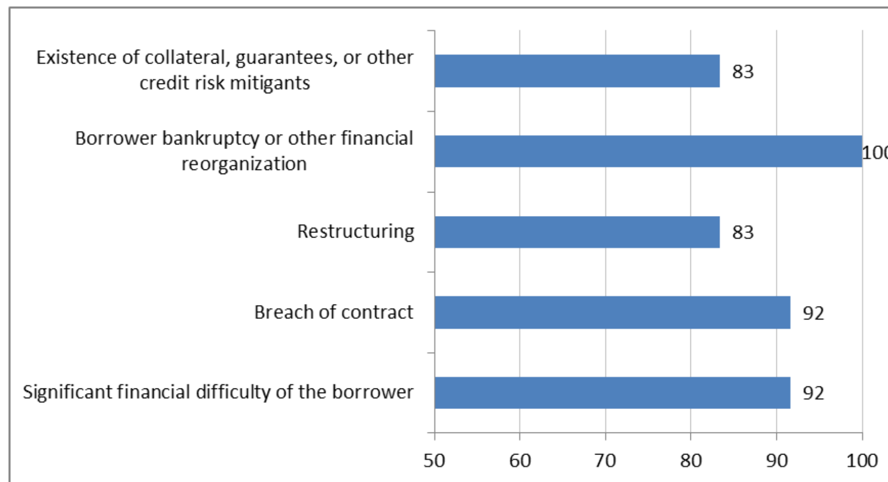


Chart 5. What other criteria are used to classify assets as non performing? (% of "yes" answers)



19. The number of days past due is not the only indication that a loan is to be considered non performing, and probably is not even the most accurate predictor of loss in certain cases. On average though, days past due does provide strong indications of the likelihood of default. While regulations should require the use of qualitative criteria for classifying a loan as non performing, the establishment of number of days past due as minimum criteria has important advantages, providing supervisors with an objective measurement to assess and compare banks, as well to enforce compliance.

20. NPL ratios are commonly calculated as total non performing loans over the gross loan portfolio. Noteworthy is that in some jurisdictions, it is not the full outstanding value of the loan that is recorded as non performing, but the net value (after deduction of the provisions). Another practice is to include only the amount that is overdue in the measurement of the non performing loan. These practices lead to downward biases in NPL ratios. Similar adjustments are sometimes made for the value of the collateral (see section E).

21. While there is consensus on the 90 day "entry" criterion to the non performing loan category, the "exit" criteria are generally more ambiguous. Judgment will need to be exercised when part of the installments is 90 days past due and the borrower has started paying again and under which conditions. Similarly, disputed fees and surcharges sometimes cause a loan to go into the 90 days past due bucket even if the borrower has resumed his monthly payments. In those cases, supervisors might choose to apply materiality thresholds when applying the number of days past due, and also consider specific characteristics of the loan (e.g. collateral, type of portfolio) to defer classifying a loan as non performing. Other supervisors require banks to set particular policies in this area and review and then rely on the banks' policy.

22. Irrespective of the quantitative criteria, regulations should ensure that banks are required to classify loans as non performing whenever there are qualitative indications of default and that clear exit criteria exist. While there is merit in establishing exclusively qualitative criteria for classifying a loan as non performing, in practice, the resulting burden to supervisors in ensuring that banks perform a proper and continuous assessment of their loans cannot be underestimated. The reality is that it is quite common for supervisors in our client-countries to order the bank to reclassify a significant portion of its credits after a credit risk inspection. This usually results in higher provisions as a result of a more conservative assessment of the condition of the loans.

C. Restructuring or loan forbearance

23. Loans that have had 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 classification and provisioning and be subject to more stringent classification criteria. The rationale behind such recommendation is the fact that a loan that has been restructured or forborne does not necessarily result in the loan being turned into a regular performing loan. In fact, forbearance often means an increase in the riskiness of a loan.

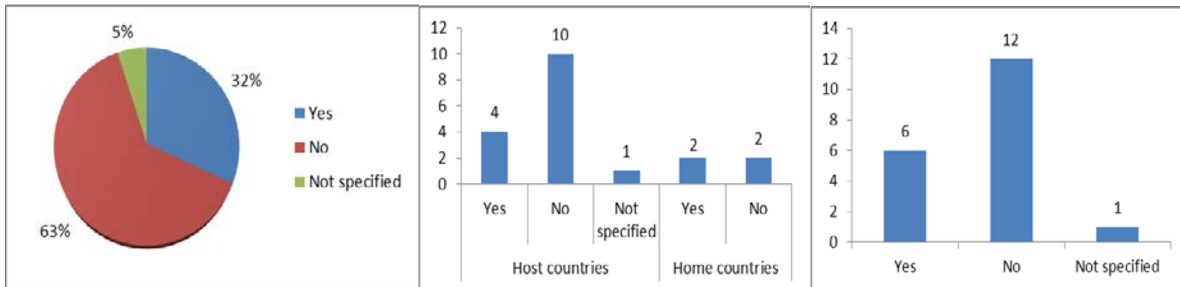
24. The regulatory definition of forbearance, if it exists, generally includes certain "forbearance events" and their strictness and scope can vary widely among jurisdictions. Broadly speaking, two constant factors in the various definitions are first: "a change in contract terms" and second, "financial difficulty of the borrower". Forbearance as a result of other factors that are outside the control of the borrower are 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, 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".

25. 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 more tolerant 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.

26. 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 (Chart 6 and Annex Table 4).

Chart 6. Are banks allowed to upgrade the classification of a loan immediately after it has been forborne?



27. 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 (Chart 7 and Annex Table 4).[7] Most of the countries surveyed indicated that restructured loans are to be classified as non performing (Chart 8 and Annex Table 4).

Chart 7. Do regulations require banks to ensure the borrower's creditworthiness to upgrade the classification of a forborne loan?

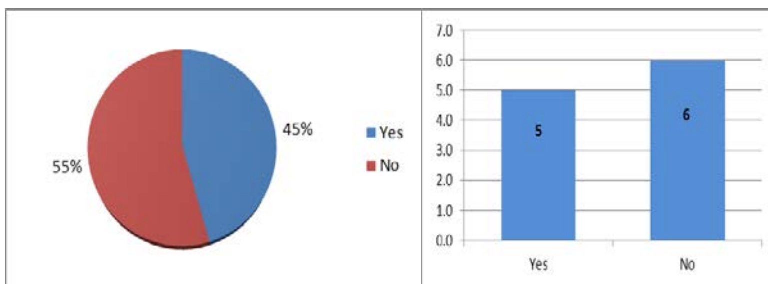
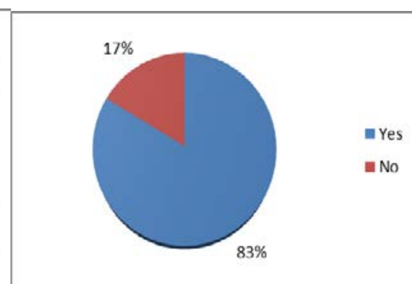


Chart 8. Do regulations require forborne loans to be classified as non performing?



28. Overall, prudential supervisors should be very careful when dealing with restructured loans. While in theory a good restructure might allow a loan to significantly improve its risk profile, forbearance can also be used simply to defer payment, not necessarily increasing the likelihood of payment of a particular loan ("ever greening"). As a consequence, it can also be used to manipulate bank specific NPL ratios and reduce provisions, by repeated forbearance of loans before they become 90 days past due, masquerading the effective quality of loan the portfolios.

[7] For example, an assessment of the creditworthiness of the borrower may reveal that the borrower got a new loan to pay off the existing debt.

29. Adequate regulations and supervision are key tools in preventing ever greening that undermine the quality of loan portfolios. In that regard, it is also of particular importance to monitor the history of loans and recurrence of restructuring. Defining restructuring for prudential purposes, collection of data on their number, as well as more stringent criteria for classifying loans that have been restructured more than once can be useful monitoring tools as well as the collection of loss numbers on first and second restructures.

European Banking Authority technical standards on supervisory reporting on forbearance and non performing exposures

Given a slowdown in the economic recovery in the Eurozone area, high levels of NPLs in many EU countries and strong commitments of the EU governments to establish the Banking Union, a harmonized approach to the NPLs classifications is required. The Banking Union includes four pillars: a Single Supervisory Mechanism, a Single Prudential Rulebook, a Single Resolution Board and Fund, and a Single Deposit Protection Scheme. The mandate for a Single Supervisory Mechanism was given to the European Central Bank (ECB) which will assume its responsibilities in the Fall 2014. The other Pillars of the Banking Union are at various stages of implementation.

Before assuming the mandate of the Single European Supervisor, the ECB is conducting a comprehensive assessment of approximately 130 systemically important Eurozone banks. The assessment started in November 2013 and will consist of three components: (i) a risk assessment; (ii) an asset quality review; and (iii) stress tests.

EU banks base their problem loan definitions on two different sources; (i) International Financial Reporting Standards (IFRS) and (ii) bank regulatory requirements, the most recent being the Capital Requirements Regulation (EU) 575/2013 (CRR). Additionally, the European Banking Authority (EBA) has developed technical standards on supervisory reporting of forbearance and non performing exposure to (i) establish benchmarks for the ECB comprehensive assessment; (ii) perform harmonized overall data collection on asset quality; (iii) address market uncertainty over the financial position of EU banks; (iv) lower costs for international banks by gradually decreasing divergent definitions; and (v) address publicly stated concerns by other European authorities on the asset quality requirements for EU banks.

The new definitions were designed as an umbrella concept, i.e. they cover some of the existing risk-related concepts, without superseding or modifying the way in which different jurisdictions implement them. As such, the proposed definitions will not have an impact on individual institutions profitability, capital requirements or ratios. They are thus purely reporting definitions. Although this approach is somewhat disappointing, harmonized reporting will provide this important information to prudential supervisors and could be used in scenario analysis or stress testing. Hopefully, this will be a first step in moving to a harmonized definition that will have an impact on the profit and loss account of banks at a later stage.

According to the EBA technical standards, forborne exposures can be performing or non performing. 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. However, they do not cover exposures held for trading. The NPLs are measured taking

the total amount, without 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.

There is still a large scope for improvement, as the definitions do not cover important concepts, such as credit grading systems or internal rating systems for performing exposures; provisioning percentages linked to asset classification systems; treatment of collateral; write offs; macroprudential aspects; 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, for a much needed and timely effort to harmonize different approaches to NPLs classification.

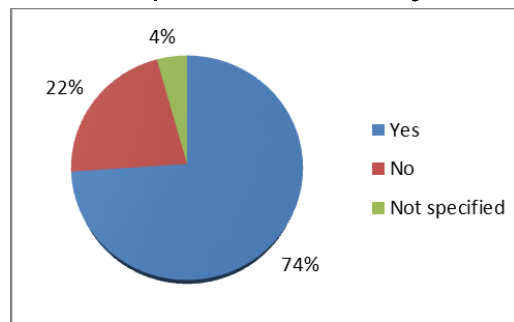
D. Multiple loans to a single borrower

30. 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 at higher risk. From a prudential perspective, it should be expected that regulations would make explicit reference to those cases, establishing minimum requirements, or providing guidance on how banks are expected to deal with such cases.

31. While in the case of economic groups there might be more flexibility on asset classification and provisioning, regulations should, at minimum, clearly indicate the need for banks to review the adequacy of classification and provisioning.

32. The majority of the countries surveyed (Chart 9 and Annex Table 5) 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. The economic impact of this decision on the borrower could be significant, both in terms of access to credit, as well as in terms of higher borrowing cost.

Chart 9. Indicate if in case a customer has multiple loans and one of them is classified as non performing, are all the other exposures automatically classified as non performing



E. Collateral valuation

33. Apart from IAS 39, there are no internationally established standards regarding the treatment of collateral for asset classification and provisioning purposes. Overall practices vary widely in areas such as whether collateral should be included in asset classification, whether it should be taken into account in determining the appropriate level of provisions and on valuation criteria. In broad terms, the practice of many jurisdictions is not to take into account collateral in classifying assets while considering it for provisioning purposes.

34. More than half of the surveyed countries indicated taking into account collateral for provisioning purposes (Chart 10 and Annex Table 6). The countries that do not specify anything in their regulations, are likely not to allow collateral in the regulatory provisions. Among host countries, almost three quarters that allow collateral to be taken into account differentiate between prime and other types of collateral (Chart 11 and Annex Table 6).

Chart 10. Do the minimum specific provisioning rules allow for the value of collateral to be deducted from the amount of the loan before provisioning is applied?

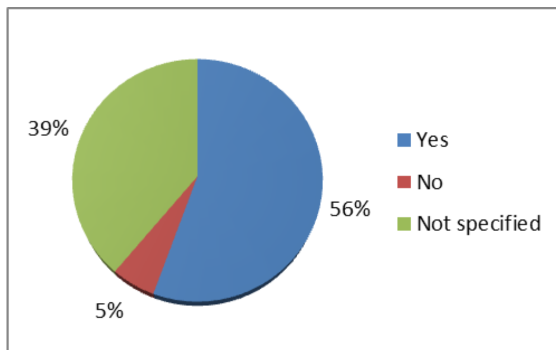
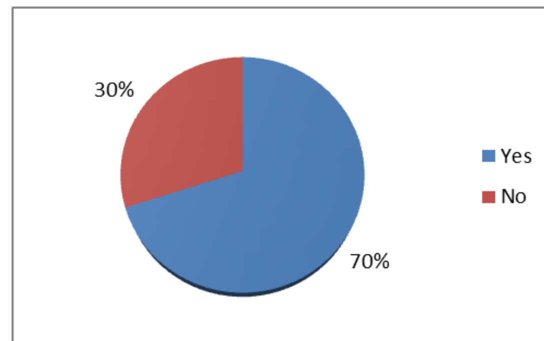


Chart 11. Of those countries that consider collateral for provisioning purposes, is there any differentiation between prime and other collateral in the regulation of host countries?



35. On the other hand, it has also been observed that some supervisors allow well collateralized loans to be "upgraded" in the past due classification. This happens when supervisors try to fit two dimensions (the probability of default and the loss given default) in a one dimensional system of days past due. In practice, this could mean that a loan that is 120 days past due is reclassified to 90 days past due because of the existence of prime collateral.

36. When calculating NPL ratios, some countries take collateral into account although most do not. Collateral is taken into account by deducting the assessed value of collateral from the gross exposure, in some instances this is only allowed for government securities or government guarantees. Nevertheless, the value of the non performing loan will thus decrease and there will be downward bias in the NPL ratio.

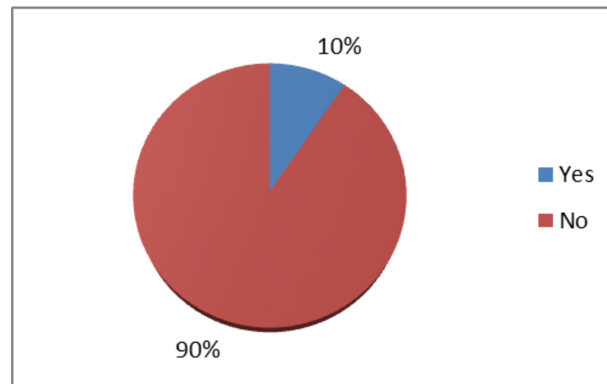
F. Write offs

37. Heterogeneous criteria for writing-off non performing loans can result in important perceived differences in terms of asset quality. For as long as non performing loans, even fully provisioned, are maintained in the balance sheet, NPL ratios as well as coverage

ratios are affected. Some jurisdictions reporting high NPL ratios are characterized by large parts of those NPL ratios consisting of fully provided balances that have been outstanding for long periods and that are not written off for legal, judicial, tax and regulatory reasons. For example, in a particular country, once the receivable was written off the bank's balance sheet, a judge declared the claim did not exist anymore. This leads to banks keeping fully provided claims on their balance sheets for long periods.

38. Nevertheless, it is good practice for prudential supervisors to encourage or even force write offs of fully provisioned NPLs. Banks can be encouraged to do so by requiring the Board to review the NPL portfolio every 6 months (Albania). Only 10% of the authorities surveyed force non performing loans to be written off after a specific time period (Chart 15 and Annex Table 7). Irrespectively of the criteria chosen, disclosure requirements should be such to allow supervisors and stakeholders to perform meaningful comparisons of fully provided but not yet written off NPLs among banks.

Chart 12. Do regulators require banks to write off non performing loans after a specific time period?



G. Macro prudential aspects

39. While a common prudential approach for provisioning worldwide is not likely in the medium and long term, some authorities have opted to have more complex frameworks, incorporating a macro prudential element into provisioning regulations.

40. Some countries, like Spain, have adopted dynamic provisioning approaches, requiring additional levels of general provisioning in "good times" and releasing them in "bad times". There have been also cases of jurisdictions relaxing prudential provisioning requirements (formally or informally) or loosening the enforcement of those requirements as NPL ratios soared.

41. While there are certainly good reasons to build-up reserves in various forms in good times, in order to ease the bad times, care should be taken in order to avoid overly complex regulations, which might not be transparent. Moreover, simply relaxing prudential requirements in bad times might pose a serious threat in terms of moral hazard, where banks might have imprudent practices, knowing that if things worsen there will be relief.

H. Interactions between accounting rules and prudential regulations

1) International Financial Reporting Standards

42. Individual countries' accounting standards are commonly established by a dedicated standard setter. The International Accounting Standards Board (IASB) issues IFRSs, high-quality, accounting standards that are adopted and of mandatory use in many jurisdictions worldwide, easing comparability and contributing to good quality reporting. IFRS is also the main benchmark for countries wishing to modernize their own accounting standards. IFRS is an accounting framework that is based more on principles than specific rules, which requires a fairly sophisticated environment with the required checks and balances to be effective. Any transition to IFRS thus requires a broad assessment and management of the financial system.

43. An effective implementation of IFRS requires the existence of some essential preconditions in the financial system's infrastructure. Factors that should be considered when assessing this environment include (i) quality and quantity of specialized IFRS human resources in the banks (accounting and controlling departments), with the prudential supervisor and with external auditors; (iii) risk management and control practices in banks (ii) the soundness of the legal framework in key areas such as corporate governance insolvency and collateral enforcement frameworks; (iv) the degree of maturity of the local external audit market; and (v) the sophistication of the financial markets and the financial instruments used.

44. All companies whose securities are admitted to trading on a regulated market in the EU are required to prepare their consolidated financial statements in accordance with IFRS. [8] Since this requirement was implemented back in 2005, many other jurisdictions have followed suit. The EU does have a process of "endorsement" of the IFRS standards, but the cases where the full standard has not been adopted or has been adopted with amendments are very limited.

45. In the case of banks, although there are cases where the supervisor also sets specific standards for bank accounting, like the Bank of Spain, the leading practice among the surveyed countries is the use regulatory powers to issue regulations on asset classification, as well as loan classification and provisioning. Some EU countries have required banks to report under IFRS on a standalone basis, regardless of their issuer status, such as Italy.

2) Provisioning

46. There is no formal requirement for prudential regulations on provisioning and the definition of non performing loans to be aligned to the accounting standards used. In fact, it can be argued that the objectives and incentives of accounting bodies and supervisors are not necessarily aligned, as supervisors have a clear conservative and prudent bias in establishing prudential regulations, aiming at minimizing the occurrence of bank runs and

[8] Companies listed on non-regulated markets in the EU have no obligation to publish IFRS based consolidated financial statements; they usually use national accounting standards.

failures. Accounting standard setters, on the other hand, are driven by the usefulness and relevance of financial statements to investors.

47. That said, pressures on prudential supervisors to move away from their regulatory provisioning models and rely exclusively on accounting figures for provisioning have been increasing, particularly in Europe. Clearly, there are benefits in doing so. Perhaps the main benefit is that the move to general-purpose accounting standards will align practices among banks with those of listed companies, whereby the responsibility to prepare the financial statements - which includes estimating provisions on reported assets -- lies squarely with management and those charged with governance (board and audit committee). This is a fundamental tenet of good corporate governance. One could reasonably expect that those who run or oversee the business (if they do it well) know what their estimated losses are. Also, it is less burdensome for international and domestic banks to have a single set of provisioning figures for accounting and prudential purposes, provisions become more transparent and more easily comparable across jurisdictions.

48. There are, however, some important drawbacks for prudential supervisors which should not be underestimated. On top of the list are the complexity of the accounting standards and the flexibility in implementation practice allowed under the current accounting frameworks. This should lead to significant expert supervisory resources being allocated with the objective to understand the accounting standards and their implementation. It is thus recommended to be well-prepared and keep bank's regulatory and accounting systems in parallel for at least a number of years before fully transitioning. Once the decision has been made to rely on accounting standards, resources should also be permanently assigned to keep up to date with changes in banks' methodologies and IFRS standards and guidance.

49. International Accounting Standard 39 (IAS 39) is the current standard for recognition and measurement of financial instruments; all countries surveyed have formally adopted IFRS (as endorsed by the EU, adopted by the IASB, or a translation of a previous version of IFRS, depending on the country).

50. According to IAS 39, loans and receivables are to be measured at amortized cost. [9] IAS 39 addresses also the impairment of financial instruments in two steps: first, an asset is considered to be impaired if there is objective evidence of impairment as a result of loss events, and second, if these loss events have an impact on the estimated cash flows of the asset. In such case, the amount of loss is to be calculated as the difference between the carrying amount and the present value of the estimated future cash flows, discounted at the effective rate, not taking into account not incurred future credit losses. The loss is to be deducted directly or through the use of an allowance account. IAS 39 does not establish quantitative criteria to classify a loan as impaired, to cease accrual of income, or to require provisioning.

[9] Amortized cost is the amount at which a financial asset or financial liability is measured at initial recognition, less principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between the amount at initial recognition and the maturity amount, minus any reduction for impairment or un-collectability. The effective interest rate in a financial instrument is the rate that exactly discounts the cash flows associated with the financial instrument through maturity or the next re-pricing date to the net carrying amount at initial recognition i.e. a constant rate on the carrying amount. The effective interest rate is sometimes termed the level yield to maturity or the next re-pricing date, and is the internal rate of return of the financial asset or financial liability for that period.

51. IAS 39 allows the concept of "incurred but not reported" (IBNR) losses. This means that banks can provide for losses that have not yet occurred but are likely to have been incurred at the balance sheet date, based on past experience. Under IFRS, banks have to identify the events that have occurred before balance sheet date which will cause impairment. The bank will then have to provide evidence that correlates these events to the likely level of loss. The accounting standard gives two examples of triggers: one relates to changes in economic conditions and the other to changes in the payment status of borrowers. For example, a rise in unemployment before year-end can give rise to a provision if the bank can demonstrate that in the past losses have increased when unemployment rose. A trigger event is thus required before a provision can be recorded. Losses that are expected as a result of future events, no matter how likely, cannot be recognized under IAS 39.

52. Since the implementation of internal rating based (IRB) approaches under Basel II, banks have used internal risks parameters, such as Probability of Default (PD) and Loss Given Default (LGD), in the regulatory capital calculation. Similar estimates are also being used by banks to calculate EL and/or provisions using statistical approaches. For prudential supervisors, it is crucial to fully understand the inputs and methodologies supporting these calculations **before** allowing banks to rely fully on IFRS for prudential purposes. This is a complex and time consuming task that requires a scarce combination of expert accounting and regulatory skills.

53. The first step of this analysis would be a deep vertical analysis by individual bank of the methodologies, provisioning levels and the risk parameters used in statistical provisioning models. A second step would consist of a benchmarking exercise or horizontal assessment of the parameters and methodologies used by the entire banking population. This exercise would ideally be performed at a regional level for example by benchmarking PDs and LGDs across different asset classes and borrowers. Third, supervisors should consider, as part of their regulatory provisioning, spelling out to supervised institutions their expectations and even possibly the "acceptable ranges" for some or all of these parameters. In order to enhance comparability across banks, prudential supervisors could require them to run scenario analyses with predetermined parameters.[10]

54. Loss and probability estimates for the capital calculation are different from the inputs used for provisioning models in many respects. For example, there is a difference in time horizon. The Basel II framework calculates EL over a one year horizon while IFRS calculates the losses over the lifetime of the loan. Also, the Basel II quantitative estimates should be measured as averages over the economic cycle or "through the cycle" estimates. Under IFRS, impairment is measured as the loss that the bank expects to realize in the current economic conditions or a more "point in time" estimate. In practice, however, many of the methodologies used have been hybrids with characteristics of both measurement assumptions.

[10] We are not advocating setting fixed values that would feed into the IFRS provisions. Rather, we are encouraging supervisors to establish a range of regional or country-specific loss estimates that would be used when assessing IFRS provisions. Banks should be required to explain why they deviate from these estimates and if they are unable to do so, adjustments to the capital adequacy ratio or the provisions should be considered.

55. Since the first date of application of IAS 39 on 1 January 2005, its approach to impairment has been controversial among banking supervisors. Several jurisdictions have favored what is perceived to be a more conservative approach by having a set of relative homogeneous criteria for requiring the suspension of income accrual and the establishment of provisions to cover potential losses.

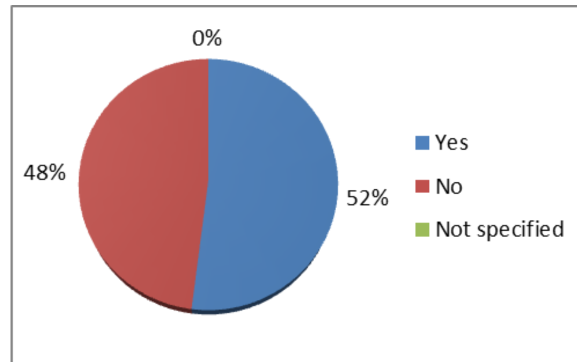
56. The IASB has replaced IAS 39 with IFRS 9 "Financial Instruments", which should become applicable around 2017-2018. In November 2009, the first new set of chapters was issued, covering the classification and measurement of financial assets. The new IFRS standard bring significant changes by replacing the incurred loss model by an expected loss approach, thus allowing ex ante provisioning. IFRS 9 has a "three bucket" approach for impairment provisions. In simple terms, the proposal suggests that loans would migrate from bucket one to bucket two if evidence supports a deterioration in financial performance, which leads to an increase in uncertainty about the ability to fully recover the cash flows. Loans would migrate from bucket two to bucket three when there is a further deterioration of the financial performance of the borrower and expected non-recoverability of the cash flows. Loans in bucket one would carry a provision of 12 months EL. Loans in buckets two and three would carry provisions of full lifetime EL, and bucket three would see loans impaired individually. Under the expected loss approach, losses are recognized earlier than under the incurred loss model. Proponents of the expected loss model believe it better reflects the lending decision and is more forward looking.

57. While some supervisors choose to accept and implement the IFRS criteria in full, several other jurisdictions, albeit implementing the IFRS for financial reporting purposes, have chosen to maintain their own prudential criteria for loans and receivables, particularly for provisioning purposes and accrual of income. This results in two sets of accounts; regulatory accounts and financial accounts in accordance with IFRS. The regulatory accounts are then used for the calculation of capital requirements as well as the calculation of other prudential thresholds. In those cases, banks will be required to deduct the regulatory excess provisions from regulatory capital or to account them through the P/L account. In most countries prudential requirements result in higher levels of provisioning when comparing to IFRS. In some countries though the application of the IFRS standard for provisioning purposes has not resulted in material differences from the regulatory approach.

58. In the case of countries that do have specific regulation for asset classification and provisioning, it is not unusual for banks to disclose (or to be required to disclose) information on asset quality based on prudential requirements, encompassing asset classification, definition of non performing loans and provisioning requirements, which lead to adjusted figures for balance sheets, prudential capital ratios and/or the profit and loss accounts.

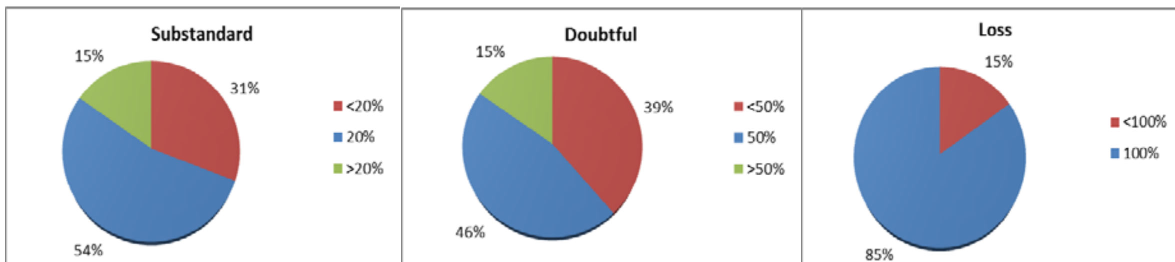
59. The slight majority of surveyed countries set minimum levels of provision (Chart 13 and Annex Table 8) and, with the exception of Poland, all countries have asset classification systems associated with provisioning requirements. Provisioning requirements are applied to all commercial banks in all jurisdictions surveyed and mostly cover all types of borrowers, exempting government loans in only a couple of countries.

Chart 13. Are there minimum levels of specific provisions for loans that are set by the regulator?



60. Percentages of provisioning applied to each bucket vary among the surveyed countries, albeit all of those that do require provisioning having specific provisions for loans and advances classified as substandard, doubtful and loss or equivalent. The vast majority requires 100 percent provisioning in case of loans classified as loss, except for two countries which require 70 and between 70 and 100 percent, respectively. For the remaining buckets, percentages vary (Chart 14 and Annex Table 8). In all cases the calculations of regulatory provisions are resulting in discrete and not continuous provision outcomes and can thus result in cliff effects.

Chart 14. Minimum provisioning required as loans become:

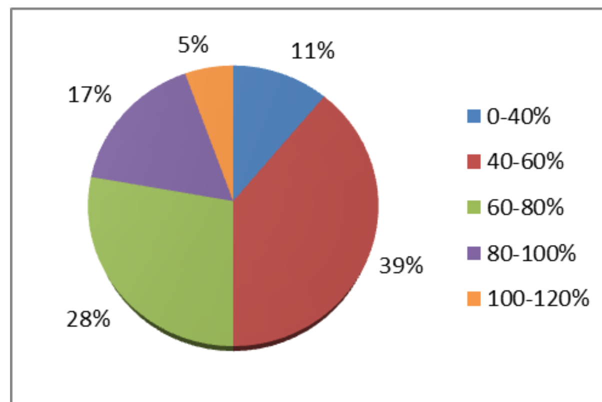


61. It should be highlighted that although regulations commonly refer to minimum levels of provisions, they rarely provide guidance or criteria for applying higher levels of provisioning. As a result, in principle, banks have no incentives to book more than the minimum. Although it is comprehensible that supervisors might want to offer discretion to banks, or have discretion for corrective action purposes, they should also ensure that adequate levels of provisions are being held and regulations should explicitly require banks to do so.

62. A periodic review of the minimum regulatory provisioning percentages based on loss data may also be recommended. The long list of obstacles in the legal, judicial, tax, and regulatory areas that is currently holding up NPL resolution in the region should be considered when determining provisioning percentages for non performing loans or assessing bank's business models and underwriting practices.

63. Regular practice is to give an indication of the level of provisions using a coverage ratio. Generally, the coverage ratio is defined as total regulatory provisions divided by gross non performing loan exposures, but IFRS accounting provisions to gross non performing loans or specific provisions for non performing loans over gross non performing loans have also been used. Evidently, coverage ratios will differ across jurisdictions based on the loan portfolio mix (secured and non secured portfolios) and the provisioning practices in the country. One must thus be careful before drawing conclusions on the quality of banking sector loan portfolios. Nonetheless, the median range in the region is between 40 and 60% (Chart 15 and Annex Table 7).

Chart 15. Coverage ratios as per the IMF Financial soundness indicators



64. Coverage ratios may go well above 100%. While this may appear a little counterintuitive, it is explained by what is referred to in regulatory terms as "pooling of provisions". Generally, jurisdictions with high coverage ratios also have mandatory provisions in place for the EL of performing exposures[11]. These "general provisions" are then pooled with the specific provisions in place for the non performing exposures and divided by the total of non performing exposures. Hence, this can lead to instances where the outcome is higher than 100%. Although high coverage ratios do provide additional comfort and generally are a good indication of a sound provisioning framework, strictly speaking they do not mean that all NPLs are fully provided for. Indeed, provisions for EL on performing exposures can offset shortfalls in specific provisions.

3) Accruing interest on non performing loans and reversing accrued interest

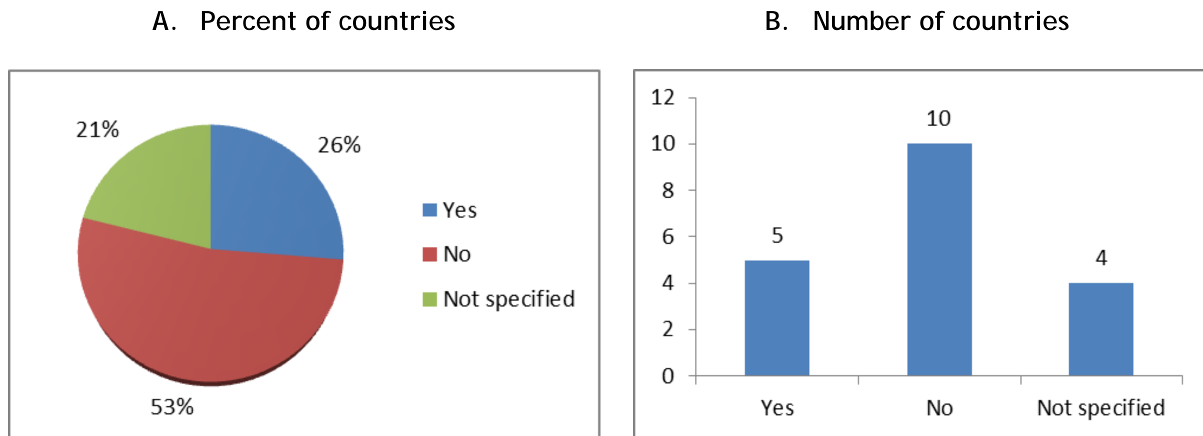
65. A loan considered to be non performing is usually expected to be classified as non-accrual for prudential purposes; as the likelihood of full repayment is considered to be low it makes little sense to keep on accruing income. An additional question to be considered is if the already accrued but not paid interest should also be reversed. There is no consensus on the treatment of interest accrued but not paid before the loan becomes classified as non performing. In some instances though, the existence of good quality collateral or guarantees are used to justify the non-reversal of accrued interest and the continuation of the accrual; although the loan is considered to be non performing, the expectation is that the recovery of the loan, through foreclosure of the collateral or guarantee will result in no losses.

[11] For example, provisions of 1 or 2% of standard or watch loans have been observed.

66. For purposes of calculating the FSIs, the IMF also considers classification as NPLs sufficient evidence to cease accruing interest on the asset and to record interest income only if the debtor subsequently makes an interest payment. Over half of the surveyed countries do not explicitly require accrued but unpaid interest to be reversed (Chart 16 and Annex Table 8) thus resulting in an overstatement of incurred interest.

Chart 16. Does accrued, although unpaid interest enter the banks income statement while the loan is classified as non performing?

A. Percent of countries **B. Number of countries**



67. There are clear differences between the IFRS and prudential regulations on this topic, as the discussion of accruing non performing loans simply does not exist under the IFRS. From an IAS 39 perspective, reversal of accrued interest or even the decision to stop accruing income depends on the assessment of the impairment of the loan and on the calculation of incurred losses based on net discounted cash-flows. In other words, under the IAS 39, the fact that a loan is considered to be impaired does not have automatic accrual implications because the continued interest accruing is balanced by the discounting of the cash flows when calculating provisions.

68. Supervisors and their prudential regulations are (and should be) guided by conservatism and prudence, bringing tensions and sometimes irreconcilable differences with the accounting principles. As a result, the removal of accrued interest is often an additional requirement from supervisors for prudential reporting purposes. Banks being required to issue separate reports or to include the prudential requirements into the notes to the financial statements issued under the IFRS.

Conclusions

69. Comparing regulatory asset classification systems across countries is a difficult and complex task. One should be particularly cautious when drawing conclusions on the quality of the loan portfolios in a particular country. The analysis in this paper of a number of factors influencing the definition of a non performing loan allows us to establish some good practices, such as;

- Requiring banks to segment performing exposures using an internal rating system with the objective to serve as early warning indicator before the asset becomes non performing;
- Including exposures to the sovereign in the asset classification and provisioning framework;
- 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 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 restructured loans can be upgraded to performing loans;
- Performing an in depth assessment of banks' statistical provisioning methodologies and, when applicable, reconciling the risk inputs with the parameters used in the regulatory capital calculations;
- Including clear qualitative criteria in the definition of default and not just basing it on the number of days past due;
- Including clear criteria for the calculation of regulatory provisions and not just minimum percentages in the regulations;
- 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;
- Performing a thorough analysis of provisioning methodologies; and
- Establishing a clear position on the single customer view or the product view.

70. There are also a number of conclusions that can be drawn. First, 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.

71. Second, the majority of the countries surveyed have asset classification systems in place and they generally cover all exposures, including sovereign exposures. About half of those asset classification systems set minimum provisioning percentages but do generally not provide additional guidance to banks on provisioning requirements. 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 consensus on the treatment of multiple loans to a single customer.

72. Third, most divergences in practice were also 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.

73. Fourth, the macro prudential policy stance in the area of loan classification and provisioning should be well thought through and formally determined in advance. Frequent changes to asset classification and provisioning requirements that come under the guise of macro prudential policy but are in fact designed to cover-up real NPL ratios should be avoided. These do not provide incentives to banks to book losses early and only delay the day of reckoning.

74. Finally, prudential regulations on provisioning are not necessarily aligned to accounting standards. Many prudential supervisors of developed countries have done away with asset classification systems and are now relying on IFRS for the identification and provisioning of impaired loans. For prudential supervisors, it is crucial to fully understand the inputs and methodologies supporting these calculations **before** allowing banks to rely fully on IFRS for prudential purposes. This is a complex and time consuming task that requires a scarce combination of expert accounting and regulatory skills.

75. The introduction of IFRS 9 will only partly bridge the divide between EL used by regulators and incurred losses used by accountants. For banks using statistical approaches for the calculation of their loan loss provisions, it is important for supervisors to understand the discrepancies between the internal risk estimates used for the capital calculation and for provisioning.

76. Going forward, there is scope for a deeper understanding, more regional cooperation and sharing of knowledge on banks' provisioning practices among supervisors in the region. This could include data collection and benchmarking of internal risk estimates, sharing of reviews of the provisioning methodologies and expected loss calculations applied by the banking groups active in the region and efforts to further analyze and harmonize NPL definitions.

Annexes

Table 1. Asset Classifications Systems across countries surveyed

	Asset Classification System in place	Covers all type of borrowers
Host Countries		
Albania	✓	
Bosnia and Herzegovina	✓	✓
Bulgaria[12]		
Croatia	✓	✓
Czech Republic	✓	✓
Estonia	✓	✓
Georgia	✓	✓
Hungary	✓	
Kosovo	✓	✓
Latvia[13]		✓
Lithuania		
Macedonia	✓	✓
Montenegro	✓	✓
Poland	✓	
Romania	✓	✓
Serbia	✓	[14]
Slovakia		
Slovenia	✓	
Home Countries		
Austria	✓	✓
Denmark	✓	
France	✓	✓
Greece		
Italy	✓	✓
Norway		
Sweden		

[12] Bulgaria recently repealed Ordinance nr 9 but it continues to exist as a reference point for banks. As this regulation is not binding, it has been excluded from the analysis in this paper.

[13] Latvian authorities have a regulation on asset quality assessment and provisioning, but it is only applied if supervisors consider the institution's process for credit quality assessment to be unsatisfactory.

[14] In principle, the Serbian regulation covers all types of borrowers, with the exception of the receivables from government and central banks, autonomous territorial and local government units, public administrative bodies, international development banks and international organizations assigned a 0% credit risk weight pursuant to the decision on bank capital adequacy.

Table 2. Numbers of days past due for classifying loans as:

Host countries	Substandard	Doubtful	Loss
Albania	61-90	91-180	>180
Bosnia and Herzegovina	90-180	181-270	>271
Bulgaria	-	-	-
Croatia	181-270	271-365	>365
Czech Republic	91- 180	181-360	>360
Estonia	Not specified [15]		
Georgia[16]	31-90 61-120	91-120 121-150	>150
Hungary	Not specified		
Kosovo	61-90	91-180	>180
Latvia	31-90	91-180	>180
Lithuania	-	-	-
Macedonia	61-120	121-240	>241
Montenegro	91-270	271-364	>365
Poland	60-90	91-180	>181
Romania[17]	0-30	31-60	61-90
Serbia	60-90	91-180	>180
Slovakia	-	-	-
Slovenia	31-90	91-180	>360
Home countries			
Austria			90
Denmark	Not specified		
France		90	
Greece			
Italy	151		
Norway			
Sweden			

[15] The only reference in the regulation says a claim will always be considered non performing if the party to transaction delays the payment of interest or principal over 90 calendar days.

[16] The Georgian regulation determines the categories based on different buckets for fully secured and partially secured loans. The bucket with the higher number of days relates to fully secured exposures. Banks can split a loan between the different categories based on the collateral

[17] Romania uses days past due in combination with an assessment of credit worthiness to be performed by the institution. All exposures more than 90 days past due are loss exposures.

Table 3. Criteria to classify assets as non performing

	Days past due status	Significant financial difficulty of the borrower	Breach of contract	Forbearance	Borrower bankruptcy or other financial reorganization	Existence of collateral, guarantees and/or other credit mitigants
Albania	✓	✓			✓	
Bosnia and Herzegovina	✓	✓	✓	✓	✓	✓
Bulgaria						
Croatia	✓	✓	✓	✓	✓	✓
Czech Republic	✓					
Estonia	✓	✓	✓	✓	✓	✓
Georgia	✓	✓	✓	✓	✓	✓
Hungary	✓	✓	✓	✓	✓	✓
Kosovo	✓	✓	✓	✓	✓	✓
Latvia						
Lithuania		✓	✓	✓	✓	✓
Macedonia	✓					
Montenegro	✓	✓	✓	✓	✓	✓
Poland	✓	✓	✓	✓	✓	✓
Romania					✓	
Serbia		✓	✓		✓	
Slovakia						
Slovenia	✓	✓	✓	✓	✓	✓

Table 4. Rules for classification of restructured loans

Country	Upgrade of loan classification immediately it has been restructured	Specific conditions for upgrade	Ensure borrower's creditworthiness to upgrade classification of restructured loan	Restructured loans classified as non performing
Albania	No	Not until the borrower has paid regularly the instalments (principal and interest) for 6 months from the restructuring date AND it has regularly settled at least 3 instalments (principal and interest).	No	No
Bosnia and Herzegovina	No	If the borrower has paid the matured, accrued interest on the loan before it was renegotiated, the bank is obliged to classify the assets as substandard, unless it has good proof enabling the eventual classification of the assets as watch loans.	Not specified	Yes
Bulgaria				
Croatia	No		Not specified	Yes
Czech Republic	Yes	If the bank is able to prove that the risk of non-payment of the loan is lower than prior to restructuring, it may assign it to a better subcategory.	Yes	No
Estonia	No	A loan restructured due to solvency problems will not be considered a standard loan until the circumstances that have caused the decrease of the borrower's creditworthiness have been removed.	Yes	Yes
Georgia	Yes	The classification of a restructured loan shall be made after the bank has taken into account the number of times the original loan has been renewed or its maturity extended, changes in terms of interest payment compared with its initial terms, the specific changes in the terms or conditions of the original loan which have been incorporated into the restructured loan agreement and the reasons why the changes were made. Regardless the terms of a loan restructuring, it shall be prohibited to classify it as "Standard", but can still be "Watch" loan.	No	Yes, although it can still be "watch loan"
Hungary	No	Restructured troubled loans are not allowed to be treated as problem-free.	Not specified	Yes
Kosovo	No	Restructured loan must be classified at the minimum substandard category or worse and will continue to be classified at the same category until sustained performance is observed. After the completion of each period of sustained performance, the bank can upgrade such loans by one category only.	No	Yes
Latvia	No		Yes	Not specif
Lithuania				

Country	Upgrade of loan classification immediately it has been restructured	Specific conditions for upgrade	Ensure borrower's creditworthiness to upgrade classification of restructured loan	Restructured loans classified as non performing
Montenegro	No	The bank may not classify a restructured loan into a higher classification category until regular payment of principal and interest have been received for at least 3 months after the restructuring.	No	Yes
Poland	No	Restructured loans may be moved to another exposure category with a lower risk, but only after full recovery of the debtor's creditworthiness and not earlier than after 3 months of timely debt service.	Yes	Yes
Romania	No	Banks will classify restructured loans by evaluating the financial performance of the debtor using more stringent standards than those used prior to the restructuring.	Yes	No
Serbia	No	Restructured will not be regarded as in default if the borrower settles his/her obligations pursuant to the new repayment schedule with a delay of not more than 30 days during the last three previous months, and/or three consecutive payments pursuant to the repayment schedule agreed upon within the effected restructuring.	No	No
Slovakia				
Slovenia	Not specified		Not specified	Yes

Table 5. Rules for customer with multiple loans

Country	All exposures classified as non performing	Specific conditions
Albania	Yes	Banks, for individual or related group of individuals with more than one exposure, will classify their loans into one category, based on the lowest classification amongst the individual classifications.
Bosnia and Herzegovina	Yes	The bank is obliged to classify all those receivables to the same category, related to the category of the worst classified claim of one debtor.
Bulgaria		
Croatia	No	
Czech Republic	Yes	If a bank has several receivables towards the same debtor, and at least one of these are non performing, all the receivables of that debtor will be assigned to the non performing category of receivables (except for retail exposures in accordance with the capital adequacy regulations).
Estonia	Yes	Loans of related parties will not be classified standard loans if at least one of those loans has been classified as non performing.
Georgia	No	Even in the case when debt service capability is low, but the repayment source of a loan depends on a separate project performance and highly liquid collateral is available, the loan can fall into standard class despite other loans to the same borrower being non performing. In cases when servicing different loans to the same borrower depend on the same income source and/or are mitigated by the same collateral, they would usually fall into the same asset class.
Hungary	Yes	
Kosovo	Yes	The Central Bank of Kosovo requires that loan exposures, including off-balance sheet exposure, to a single borrower should be classified in the same category.
Latvia	Yes	Several loans granted to one borrower are classified by determining a risk group for each loan separately and applying the highest risk group to all loans.
Lithuania		
Macedonia	Not specified	
Montenegro	Yes	If one person holds several loans with a bank, and one or more of those loans are classified as non performing, the bank will classify all loans into the lowest classification category and/or subcategory.
Poland	Yes	
Romania	Yes	Loans in relation to a particular debtor will be included in a single category of classification, on the basis of the principle of downgrading by contamination, by taking into consideration the weakest of the individual classification categories.
Serbia	Yes	All receivables from a borrower will be classified in the lowest category in which any of its receivables is classified. Exception for receivables with prime collateral
Slovakia		
Slovenia	Yes	

Table 6. Treatment of collateral for asset classification and provisioning purposes

Country	Collateral to be deducted from amount of the loan before provisioning is applied	Specific conditions	Differentiation between prime and other collateral
Albania	Yes	Banks, with the purpose to calculate the reserves for loan loss provisioning, may use the value of guarantees and financial collaterals set forth in this Regulation, to reduce their exposure from credits.	Yes
Bosnia and Herzegovina		Not specified	
Bulgaria			
Croatia	Yes	All other instruments of collateral accepted by the credit institution, not listed in this decision, shall be deemed ineligible instruments of collateral, which the credit institution cannot take into account in assessing the expected cash flows, i.e. for the purpose of impairment of placements or for making provisions for losses arising for the assumed off balance sheet liabilities.	Yes
Czech Republic		Not specified for coefficient method	
Estonia	Yes	If a credit institution has no assurance that a claim should be discounted based on cash flows, on discounting such loan the security or claim net realization value shall serve as a basis.	
Georgia			
Hungary	Yes	Guarantees and collateral, including the liquity and the enforceability of claims on collateral, are taken into consideration in determining if exposure is impaired.	No
Kosovo	Yes	Collateral security should be taken into consideration in the classification process. Classification of amounts should always be net of eligible collateral values.	Yes
Latvia			
Lithuania			
Macedonia	Yes	When calculating impairment and special reserve on an individual basis, collateral shall be included in the calculation of the present value of expected future cash flows, in the amount that is equal to the lesser of the value of collateral and the total credit exposure covered by collateral, while the discounting covers the period up to the date of expected recovery of collateral.	Yes
Montenegro	Yes	A bank may take into account cash flows based on collateral when calculating impairment of balance sheet assets and probable losses related to off-balance sheet items.	Yes
Poland	Yes		No

Country	Collateral to be deducted from amount of the loan before provisioning is applied	Specific conditions	Differentiation between prime and other collateral
Romania			
Serbia	Yes	In calculating the amount of impairment of balance sheet assets and probable losses on off-balance sheet items, a bank may take into account cash flows deriving from collateral instruments that secure the receivables.	Yes
Slovakia			
Slovenia	Yes	The projected cash flows from the exercise of collateral are taken into consideration in the calculation of the impairment of a financial asset or provision for contingency and commitment including off-balance sheet items.	Yes

Table 7. Write off on non performing loans

Country	Requirement to write off non performing loss	Maximum amount of time as non performing before writing off
Albania	No, but requirement for 6 monthly review.	
Bosnia and Herzegovina	No, until legal proceedings are taken to terminate the liability of the debtor.	
Bulgaria	Not specified	
Croatia	No	
Czech Republic	No	
Estonia	No	
Georgia	No	
Hungary	No	
Kosovo	No	
Latvia	No	
Lithuania	Not specified	
Macedonia	No	
Montenegro	Yes	24 months
Poland	Yes	12 months
Romania	No	
Serbia	No	
Slovakia	Not specified	
Slovenia	No	

Table 8. Minimum provisioning requirements as loans become:

	Minimum levels of specific provisions for loans set by the regulator?	Substandard	Doubtful	Loss
Host Countries				
Albania	Yes	Min 20%	Min 50%	Min 100%
Bosnia and Herzegovina	Yes	16%-40%	41%-60%	100%
Bulgaria	No	-	-	-
Croatia	Yes	30-70%	70-100%	100%
Czech Republic[18]	Yes	20%	50%	100%
Estonia	No	-	-	-
Georgia	Yes	30%	50%	100%
Hungary	Yes	11%	31%	71%
Kosovo	Yes	Min 20%	Min 50%	Min 100%
Latvia	Yes	Min 30%	Min 60%	Min 100%
Lithuania	No	-	-	-
Macedonia	Yes	20%-45%	45%-70%	70%-100%
Montenegro	Yes	20%-40%	70%	100%
Poland	Yes	20%	50%	100%
Romania	Yes	20% FX loans: 23%	50% FX loans: 53%	100% FX loans: 100%
Serbia	Yes	15%	30%	100%
Slovakia	No			
Slovenia	No			
Home Countries				
Austria	No			
Denmark	No			
France	No			
Greece	No			
Italy	No			
Norway	No			
Sweden	No			

[18] This is one of three provisioning methods allowed in the Czech Republic. The two other methods are discounting expected future cash flows and statistical methods.

Table 9. Coverage ratio (provisions/NPL)

Country	Coverage ratio in %	Period
Albania	65.2	12/2013
Bosnia and Herzegovina	64.9	09/2013
Bulgaria	63.0	12/2012
Croatia	46.2	12/2013
Czech Republic	50.5	12/2013
Estonia	28.9	12/2013
Georgia	54.5	09/2013
Hungary	47.8	09/2013
Kosovo	85.2	12/2013
Latvia	73.6	12/2013
Lithuania	29.4	09/2013
Macedonia	80.0	12/2013
Montenegro	40.2	12/2012
Poland	67.3	06/2013
Romania	90.4	09/2013
Serbia	116.2	11/2013
Slovak Republic	54.5	12/2013
Slovenia	47.4	09/2013

Table 10. Rules for accrued but not paid interest for loans classified as non performing

Country	Enter income statement?	Specific conditions
Albania	No	Banks, regarding credits which are not paid for more than 90 days and for the credits classified as either "doubtful" or "loss", shall not account the accrued interest.
Bosnia and Herzegovina	No	In FBiH, accrued and unpaid interest remains reported as a balance sheet position until it is collected or legal action is (?)taken to terminate the liability of the debtor, Interest income calculated on the poor performing assets is recognized in compliance with MRS/MSFI. Capitalized interest in case of restructuring and extension of loans cannot be included in income until it is actually collected for the debtor. In RS, banks have to terminate accrual of the interest on non performing assets and cannot include it as income in its balance sheet until beneficiary makes true cash payment of the interest. Exception is granted to non performing assets that are secured by high quality collateral.
Bulgaria		
Croatia	No	Recognition of interest income on non performing assets in the income statement is postponed until its collection. Receivables on the basis of interest income shall be recorded in the off-balance sheet accounts. Interest income may be recognized if there is evidence that it will be collected in the following accounting period.
Czech Republic	No	Where a bank or credit union applies the accrual principle to a non performing receivable, it shall use the principal of the receivable without the accrued interest and fees in the calculation and it shall add an amount equal to the accrued interest and fees to the computed loss.
Estonia	No	The calculation of accrued interest on non performing claims shall be suspended.
Georgia	No	Interest income is no longer recognized on balance sheet when they are past due for over 30 days. Such accrued interest is classified as off-balance-sheet item until the actual payment of the interest.
Hungary	Yes	
Kosovo	No	A loan classified as non performing must stop the accrual into the income statement of its interest. All uncollected interest that has been previously accrued and recognized as income must be reversed out of income.
Latvia	Yes	The bank will recognize interest income of non performing assets only in case of sound assurance on repayment of full principal and interest and this assurance is based on reasonable and justified assumptions and projections, which are duly documented, and the institution shall take into account all information available at the moment of assessment.

Country	Enter income statement?	Specific conditions
Lithuania		
Macedonia	No	The bank shall make full impairment of accrued interest on non performing claims.
Montenegro	Not specified	
Poland	Yes	
Romania	Not specified	
Serbia	Not specified	
Slovakia		
Slovenia	Not specified	

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