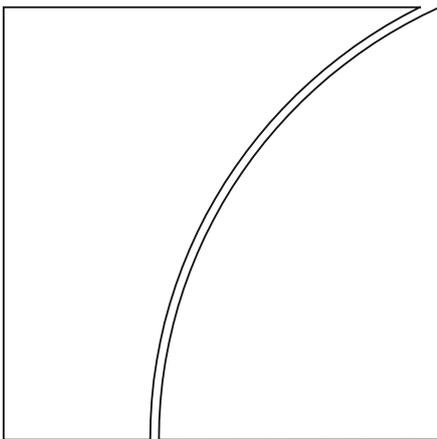


Basel Committee on Banking Supervision

Guidelines



Prudential treatment of
problem assets –
definitions of
non-performing
exposures and
forbearance



BANK FOR INTERNATIONAL SETTLEMENTS

This publication is available on the BIS website (www.bis.org).

© *Bank for International Settlements 2016. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated.*

ISBN 978-92-9197-487-0 (print)

ISBN 978-92-9197-488-7 (online)

Contents

- Executive summary 1
- 1. Purpose and use of the common definitions 3
 - 1.1. Mandate 3
 - 1.2. Purpose and use of the common definitions 3
- 2. Main harmonisation features of the definitions of non-performing exposures and forbearance . 6
 - 2.1. Main harmonisation features of the definition of non-performing exposures..... 6
 - 2.2. Main harmonisation features of the definition of forbearance 7
- 3. Definition of non-performing exposures 8
 - 3.1. Identification of non-performing exposures..... 8
 - 3.2. Recategorisation of non-performing exposures as performing 10
 - 3.3. Additional considerations..... 11
- 4. Definition of forbearance..... 12
 - 4.1. Identification of forbearance..... 12
 - 4.2. Criteria for exit from the forborne exposures category..... 14
 - 4.3. Interaction of forborne exposures with non-performing exposures..... 14
- Annex: Stocktake of key terms and practices on credit risk categorisation for loans 15
- Summary of main findings 15
- Part I – System issues..... 18
- Part II – Thematic review of key terms..... 26
- Case studies 38

Executive summary

- (i) The global financial crisis revealed difficulties for supervisors and other stakeholders in identifying and comparing banks' information across jurisdictions. In particular, the Basel Committee on Banking Supervision recognised that there may be significant differences in how banks identify and report their asset quality.
- (ii) In response to this issue, the Basel Committee formed a dedicated task force to analyse jurisdictions' and banks' practices regarding asset categorisation schemes – the system that requires loans to be grouped based on their credit quality – and to assess the consequences of any differences in practices.
- (iii) The Basel Committee analysed the regulatory frameworks and supervisory practices across jurisdictions through a literature review and a survey of 28 supervisors,¹ as well as industry practices through a questionnaire and case studies sent to 39 banks from the 28 jurisdictions.
- (iv) The literature review and the outcome of the survey questionnaires confirmed that banks categorise problem loans in a variety of ways. There are no consistent international standards for categorising problem loans.
- (v) In addition, the analysis revealed varying practices across jurisdictions, as well as various layers of definitions within jurisdictions. In particular, it noted differences in the definitions of terms used in the accounting and regulatory frameworks, such as the concept of impairment or the definition of default used for modelling purposes. The analysis also identified that more than half of the jurisdictions included in the survey had established local/national supervisory definitions for asset categorisation different from those used in the accounting framework and/or the definition of default in order to achieve consistent supervisory reporting and disclosure on asset quality driven by prudential considerations.
- (vi) Against this background, the Basel Committee developed guidelines for the definitions for two important terms – “non-performing exposures” and “forbearance”. The definitions are built on commonalities in the existing definitions of many countries. These will help harmonise the quantitative and qualitative criteria used for credit categorisation and provide the starting point for countries with no existing definitions to develop them.
- (vii) The definition of non-performing exposures introduces harmonised criteria for categorising loans and debt securities that are centred on delinquency status (90 days past due) or the unlikelihood of repayment. It also clarifies the consideration of collateral in categorising assets as non-performing. The definition focuses on a debtor basis, but allows categorisation of exposures as non-performing on a transaction basis for retail exposures. It also introduces clear rules regarding the upgrading of a non-performing exposure to performing and the interaction between forbearance and non-performing status. The definition of forbearance provides a harmonised view on the modification or refinancing of loans and debt securities that result from a borrower's financial difficulty. The definition allows forborne exposures to be categorised as performing or non-performing exposures. It also sets out criteria for the discontinuation of the forbearance categorisation and emphasises the need to ensure a borrower's financial soundness before the discontinuation.

¹ Surveyed jurisdictions include Thailand and the 27 jurisdictions that are members of the Basel Committee.

- (viii) These guidelines are intended to complement the existing accounting and regulatory framework in relation to asset categorisation. They will harmonise the scope, recognition criteria, and level of application of both terms, thereby promoting a better understanding of the terms, improving identification and monitoring, and promoting consistency in the supervisory reporting and disclosures by banks. The definitions are intended to be used in the following contexts:
- Supervisory asset quality monitoring, including so that supervisory colleges can obtain a more consistent basis for comparison across jurisdictions;
 - Banks' internal credit categorisation systems for credit risk management purposes;
 - Pillar 3 disclosure on asset quality;²
 - Dissemination of data for asset quality indicators; and
 - A reference point for other relevant working groups of the Basel Committee.
- (ix) In turn, this will help supervisors and banks' management to identify levels of non-performing and forborne exposures in absolute and relative terms and facilitate timely action to address rising asset quality problems.

² Specific disclosure proposals will be considered as part of the Basel Committee's ongoing review and update of the Pillar 3 requirements.

1. Purpose and use of the common definitions

1.1. Mandate

1. One of the lessons learnt from the financial crisis is that supervisors and investors could not always understand and compare information about credit categorisation presented in banks' financial statements. Banks used different (and often undisclosed or insufficiently disclosed) methodologies and assumptions for valuations, provisioning and risk weightings, increasing opacity and reducing comparability for end users. This inconsistency increased uncertainty at the height of the crisis and frustrated supervisors and investors who tried to compare and assess banks' performance and risk.

2. The Basel Committee on Banking Supervision formed a task force to analyse the range of practices with respect to the definitions of credit risk management terms, their use in credit categorisation³ schemes by banks and their supervisors, and the causes and consequences of differences. The task force gathered information on the use of such key terms as "weakened", "forbearance", "non-performing loan", "loss" and "write-off" via literature reviews and survey questionnaires and case studies sent to banks and supervisors. These terms are used in credit categorisation schemes – where loans are grouped based on their credit quality – as a key component of internal credit risk management, and in supervisory reporting and public disclosure.

3. The survey of loan categorisation practices indicated that credit categorisation schemes and the terms, as well as their definitions, varied widely across jurisdictions and banks. Practices varied due to the absence of a consistent international framework guiding banks and supervisors in categorising problem loans. The significant influence of local accounting, regulatory, legal or tax standards leads to situations where one category bearing the same name in different jurisdictions or banks does not actually cover loans with the same degree of creditworthiness. This occurred due to different criteria for including loans in the category. More information on the survey of loan categorisation practices is provided in the Annex.

4. Following the initial research, the Basel Committee has developed guidelines for common definitions for the two most important terms assessed – "non-performing exposures" and "forbearance". The definitions are built on commonalities in existing definitions, and they aim to provide clarity in terminology and guidance on quantitative and qualitative criteria for credit categorisation. In addition, the definitions help improve the identification and monitoring of non-performing exposures and forbearance as well as promote consistency in supervisory reporting for these two key categories of asset quality.

5. The Basel Committee did not develop common definitions for three other terms that were analysed, ie "weakened", "loss" and "write-off". This reflected a lower degree of commonality and conflicts with jurisdictions' local, legal and tax considerations.

1.2. Purpose and use of the common definitions

6. Credit risk categorisation is a supervisory and bank management tool used to assess the solvency and the riskiness of banks' credit risk exposures. It helps identify credit risk-related issues that require management or supervisory action. Thus, differences across jurisdictions in credit categorisation schemes and practices are detrimental in several ways:

³ This document uses "categorisation" in order to avoid confusion with the concept of classification (eg "classified loans" or "adversely classified" loans) used in some jurisdictions as a supervisory tool and in the accounting framework.

- At a bank level, they can make it difficult to properly assess credit risk and can delay early detection of an increase in credit risk (deterioration of asset quality) and its consequences, particularly when supervising a cross-border bank with activities in jurisdictions using different credit categorisation schemes. For example, figures at the consolidated level may result from the aggregation of non-comparable asset quality data from different jurisdictions.
- At a system-wide level, they make international comparisons very challenging for supervisors, multilateral public bodies and market analysts. They can also raise questions about the comparability of common indicators used to benchmark asset quality at the global level, such as the IMF Financial Soundness Indicator on non-performing loans.
- At the Basel standards level, they can influence the implementation and assessment of compliance with Basel Core Principle 18 (“Problem assets, provisions and reserves”), as different credit risk categorisation requirements and practices create different incentives to act early on problem assets, and initiate supervisor responses, which can ultimately lead to an unlevel playing field.

7. Enhanced comparability of terminology and the resulting harmonisation of practice enables supervisors and market participants to better understand asset quality issues, including on a cross-border basis and relative to other jurisdictions. Common definitions help set a consistent basis for supervisors to understand levels of problem loans as they discuss and consider supervisory responses.

Interactions with the other credit quality concepts under the Basel and accounting frameworks

8. The Basel Committee’s definitions of non-performing exposures and forbearance are intended to complement the other existing accounting or regulatory concepts of credit categorisation on credit quality.

9. The definitions form a more consistent supervisory basis for the identification of problem loans, regardless of the risk of loss. They are designed to complement existing accounting standards used in various jurisdictions, and in no way undermine standards that are focused on the accuracy of impairments and provisions disclosed in financial statements and reflect the risk of loss. Nor are they designed to replace the existing definitions of default used in the Internal Ratings-Based (IRB) approach and the proposed standardised approach for credit risk. The definitions are focused on a single set of criteria that can be used for comparative purposes. The definition of non-performing exposures is designed to be used alongside the definition of forbearance, which in itself can be categorised as either performing or non-performing based on the criteria outlined here.

10. The definition of non-performing exposures is intended to complement the current categories of “past due” and “defaulted” in the Basel framework (paragraphs 75 and 452, respectively).

11. In this regard, the definition of non-performing exposures builds on the definition of default but, for the purpose of categorising loans into reasonably simple categories, is broader than that definition in the following ways: (i) it is based on a standard 90 days past due (DPD) threshold, while the default definition used in the IRB approach allows for the use of a 180 DPD threshold for retail and public sector exposures; (ii) it offers more harmonised recategorisation criteria than those currently existing under the definition of default; and (iii) it offers more specific guidance regarding the interaction of forbearance measures and non-performing status.

12. There are certain obstacles for effectively using the definition of default for a common understanding of problem loans: (i) it leaves to banks the specific recategorisation criteria from a defaulted category to a non-defaulted category; (ii) it covers only cases of distressed restructuring that inflict a loss on a bank; and (iii) it is open to various interpretations (eg there can be different interpretations about an exposure’s default status when it is impaired, especially for non-significant exposures when impairment may be recognised on a portfolio basis). These two important elements – restructuring and impaired status – are specified by national guidance.

13. While the revised standardised approach proposes to enlarge the definition of default to exposures under the standardised approach, the proposed definition differs from the definition used in the IRB approach as regards primarily the past-due indicators.

14. The definition of non-performing exposures, on the other hand, is designed to uniformly apply to all jurisdictions regardless of the regulatory approach applied to credit exposures. It is a harmonised asset quality indicator that can provide an asset quality comparison across jurisdictions and is indifferent to a jurisdiction's stage of implementation of the different versions of the Basel framework, including use of internal credit models.

Specific benefits from the definitions of non-performing exposures and forbearance

15. The definitions of non-performing exposures and forbearance harmonise the scope, categorisation criteria, and level of application of both terms, and they provide benchmarks for use in the following contexts:

- Supervisory asset quality monitoring;
- Banks' internal credit categorisation systems for credit risk management purposes;
- Potentially Pillar 3 disclosure on asset quality;⁴
- Dissemination of data for asset quality indicators and international assessments of financial systems; and
- A reference point for other relevant working groups of the Basel Committee.

16. Thus, the harmonised definitions and guidelines for non-performing exposures and forbearance are expected to be used by supervisory authorities and banks to monitor and assess banks' asset quality, in a consistent manner, both within and across jurisdictions. The new definitions will also facilitate effective discussion of asset quality within cross-border banking groups in colleges of supervisors. In turn, they will provide an internationally consistent reference point for supervisors and banks' management in identifying levels of non-performing and forborne exposures in absolute and relative terms and facilitate timely action to address rising asset quality problems. Such measures may include increasing coverage ratios, improving arrears management and workout systems, and setting targets for reducing non-performing levels. To this end, the Committee expects that the guidelines will be applied to internationally active banks at a minimum, and wider application is permitted at a supervisor's discretion.

17. The definitions also provide a key foundation for those countries currently without definitions of non-performing exposures and forbearance, and if the information is disclosed, it will also play an important role in influencing market discipline through transparency.

18. These definitions may also be used, if so desired, as reference points for regulatory and accounting concepts (eg default and impairment) to promote comparability for risk-weighting, provisioning and credit loss recognition.

⁴ Specific disclosure proposals may be developed by the Basel Committee as part of its ongoing review and update of the Pillar 3 requirements. In the meantime, banks can use the definitions of non-performing and forbearance to complement some of the requirements of the revised Pillar 3 framework released in January 2015, especially in Table CRB, which requires information on impaired, past-due, defaulted and restructured exposures.

2. Main harmonisation features of the definitions of non-performing exposures and forbearance

2.1. Main harmonisation features of the definition of non-performing exposures

19. Building on the areas of commonality, the definition of non-performing exposures is designed to provide consistency in banks' practices in credit categorisation mainly for supervisory reporting and disclosure purposes.

20. As explained above, this definition is not intended to replace the accounting concept of impairment or the regulatory concept of default but, if consistently applied by banks, it can provide supervisors with a better understanding of asset quality and improve the comparability of credit risk information reported/disclosed by banks.

21. To this end, the definition of non-performing exposures includes the following harmonisation features that address the main areas of divergence currently observed in credit risk categorisation schemes:

- **Scope:** the definition will be applied to on-balance sheet loans, debt securities and other amounts due (eg interest and fees) that a bank includes in its banking book for the purpose of computing its capital requirements under the June 2006 *International convergence of capital measurement and capital standards* ("Basel II"), regardless of their measurement basis under the accounting standards. The definition will also be applied to off-balance sheet items (eg loan commitments and financial guarantees). Exposures that a bank includes in its trading book under Basel II, or that are treated as derivatives, are not within the scope of the definition of non-performing exposures.
- **Harmonised recognition criteria:** a uniform 90 days past due criterion is applied to all types of exposure within the scope, including those secured by real estate and public sector exposures.⁵ The 90 days past due criterion is supplemented by considerations for analysing a counterparty's unlikelihood to pay, for which the definition emphasises the importance of financial analysis.
- **Role of collateralisation:** collateralisation plays no direct role in the categorisation of non-performing exposures. Any recourse by the bank shall not be considered in this judgment. Collateral may, however, influence a borrower's economic incentive to pay and, therefore, has an indirect impact on the assessment of a borrower's unlikelihood to pay. Any recourse by the bank shall not be considered in this judgment. Collateral may be one of the inputs, along with other factors, in assessing the borrower's unlikelihood to pay.
- **Level of application:**
 - In the case of exposures to a non-retail counterparty where the bank has more than one exposure to that counterparty, the bank must consider all exposures to that counterparty as non-performing when any one of the material exposures is non-performing. In other words, non-performing status should be applied at the level of the counterparty.
 - In the case of exposures to a retail counterparty, the non-performing status can be applied at the transaction level. In the case of a retail counterparty with more than one

⁵ The definition of default in the IRB approach allows a 180 days past due threshold for retail and public sector exposures.

exposure from a bank, the bank should consider the non-performing or performing status of the other exposures when deciding about the status of a given exposure.

- In the case of exposures to a group, non-performing status can be applied at the counterparty level. At the same time, the bank should consider the non-performing or performing status of the other group entities when deciding about the status of any of the group entities.
- **Upgrading to performing:** the definition identifies specific criteria that need to be met to upgrade a non-performing exposure to performing status, especially regarding the amounts in arrears status and the counterparty's degree of solvency.
- **Interaction of forbearance with non-performing exposures:** the granting of forbearance measures to a counterparty or an exposure will not automatically alter the non-performing status of the counterparty or the exposure, but can be an additional input for moving a performing exposure to non-performing status.

2.2. Main harmonisation features of the definition of forbearance

22. Building upon the existing definitions of forbearance and restructuring in different jurisdictions, the Basel Committee's definition of forbearance includes the following harmonisation features:

- **Scope:** same as for non-performing exposures.
- **Level of application:** applied on a transaction basis.
- **Concept of forbearance:** forbearance is a *concession* granted to a counterparty for reasons of *financial difficulty* that would not be otherwise considered by the lender. Forbearance recognition is not limited to measures that give rise to an economic loss for the lender.
- **Examples of financial difficulty and concessions:** the definition includes a list of examples intended to help banks understand what these two concepts cover, and help them differentiate forbearance from commercial renegotiation not resulting from financial difficulty. Concessions can include refinancing of exposures.
- **Categorisation of forborne exposures:** forborne exposures can be included within the performing or non-performing category. The appropriate categorisation depends on: (i) the status of the exposure at the time when forbearance is granted; and (ii) the counterparty's payment history or creditworthiness after the extension of forbearance.
- **Discontinuation of the forbearance categorisation:** a forborne exposure can cease being categorised as such when both an objective criterion (a probation period for which a minimum duration is set) and a solvency criterion are met.
- **Interaction of forbearance with non-performing exposures:** banks should not use forbearance practices to avoid categorising loans as non-performing. Categorising loans as performing or as less risky by extending forbearance is a source of divergence. Therefore, the definition prohibits the upgrading of a non-performing exposure by granting forbearance measures and requires a separate categorisation for forborne exposures.

3. Definition of non-performing exposures

3.1. Identification of non-performing exposures

23. Non-performing exposures should always be categorised for the whole exposure, including when non-performance relates to only a part of the exposure, for instance, unpaid interest. For off-balance sheet exposures, such as loan commitments or financial guarantees, the whole exposure is the entire uncancellable nominal amount.

24. The following exposures are considered as non-performing:

- (i) all exposures that are "defaulted" under the Basel framework (eg paragraphs 452⁶ and following the Basel II rules text and their subsequent amendments), where applicable; or
- (ii) all exposures that are credit-impaired (in the meaning of exposures having experienced a downward adjustment to their valuation due to deterioration of their creditworthiness) according to the applicable accounting framework;⁷ or
- (iii) all other exposures that are not defaulted or impaired but nevertheless:
 - (a) are material exposures that are more than 90 days past due; or
 - (b) where there is evidence that full repayment based on the contractual terms, original or, when applicable, modified (eg repayment of principal and interest) is unlikely without the bank's realisation of collateral, whether or not the exposure is current and regardless of the number of days the exposure is past due.

25. The identification of an exposure as non-performing is not intended to affect its categorisation as impaired for accounting purposes⁸ or as defaulted in accordance with the regulatory framework.

26. Forborne exposures should be identified as non-performing when they meet the specific criteria provided for in this definition.

27. **Collateralisation** or received guarantees should have no direct influence on the categorisation of an exposure as non-performing. However, the bank may consider the collateral when assessing a

⁶ Paragraph 452 of the Basel II framework: 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.

- 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 realising security (if held).
- The obligor is past due more than 90 days on any material credit obligation to the banking group (footnote 89). Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings.
- (footnote 89) In the case of retail and public sector entities obligations, for the 90-day figure, a supervisor may substitute a figure of up to 180 days for different products, as it considers appropriate to local conditions. In one member country, local conditions make it appropriate to use a figure of up to 180 days also for lending by its banks to corporates; this applies for a transitional period of five years.

⁷ In particular, when the accounting framework is IFRS 9, "impaired exposures" are those that are considered "credit-impaired" in the meaning of IFRS 9 Appendix A. When the accounting framework is US GAAP, "impaired exposures" are those exposures for which credit losses are measured under ASC Topic 326 and for which the bank has recorded a partial write-off.

⁸ Under IFRS 9, the identification of an exposure as non-performing does not necessarily have an effect on the impairment stage in which this exposure is allocated for accounting purposes. Under the US GAAP Current Expected Credit Loss model, the identification of an exposure as non-performing is not intended to affect the estimation of credit losses.

borrower's economic incentive (both positive and negative) to repay under the unlikelihood to repay criteria. Any recourse by the bank shall not be considered in this judgment. The collateralisation or guarantee status does not influence the past-due status, including the counting of past-due days and the determination of the exposure as non-performing, once the materiality and overdue days threshold have been met. When the relevant criteria are met, an exposure should be categorised as non-performing even if the collateral value exceeds the amount of the past-due exposure.

28. A **counterparty** is a natural or legal person to which a bank has exposure. When a material exposure to a counterparty is categorised as non-performing, all exposures to that counterparty should be categorised as non-performing. However, for retail exposures as defined in the Basel II standard, exposures can be categorised as non-performing on a transaction-by-transaction basis. In these cases, banks should consider the categorisation status of other exposures to the same counterparty, except in the rare circumstances when this information is not available.

29. When applied, the debtor approach applies at the level of a single counterparty. When a counterparty belongs to a group, designating an exposure to one entity belonging to a group as non-performing does not mandatorily lead to designating all exposures to the other entities from the same group as such. However, designating the exposure to one of the group entities as non-performing should be one of the inputs, along with the respective financial situation of other entities from the same group, when assessing the creditworthiness and determining the performing or non-performing status of exposures to the other entities in the group.

30. Explanation of terms

- **Past due:** an exposure where any amount due under the contract (interest, principal, fee or other amount) has not been paid in full at the date when it was due. An exposure should be considered past due from the first day of missed payment, even when the amount of the exposure or the past-due amount, as applicable, is not considered material.
- **Material:** an exposure that hits the materiality threshold in force in a given jurisdiction as defined by supervisors. Nonetheless, a bank needs to have a categorisation process in place for all exposures. The materiality threshold should be applied by reference to an aggregated exposure or past-due amount determined by supervisors that is connected with the counterparty's debt and not the bank.
- **Unlikely full repayment:** an exposure where full repayment of principal and/or interest by the counterparty is unlikely without relying on the bank's realisation of collateral or risk mitigants, even when it is not past due or has been past due for less than 90 days. For these exposures, paragraph 453 of Basel II provides examples of possible indicators of unlikelihood to pay.⁹ The likelihood of repayment could also be assessed through a comprehensive analysis of the financial situation of the counterparty, using all inputs available, including but not limited to: (i) patterns of payment behaviours in past circumstances; (ii) new facts that change the counterparty's situation; and (iii) financial analysis.

⁹ These include: the bank puts the credit obligation on non-accrued status; the bank makes a charge-off or account-specific provision resulting from a significant perceived decline in credit quality subsequent to the bank taking on the exposure; the bank sells other credit obligations from the same counterparty at a material credit-related economic loss; the bank consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or (where relevant) fees; the bank has filed for the obligor's bankruptcy or a similar order in respect of the obligor's credit obligation to the banking group; and the obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of the credit obligation to the banking group.

- **Financial analysis** of non-retail counterparties may include, as appropriate, the following ratios: leverage ratio; debt/EBITDA ratio; interest coverage ratio; current liquidity ratio; or ratio of (operating cash flow + interest expenses)/interest expenses; loan-to-value ratio; and any other relevant indicators.
- For retail counterparties, this analysis may include consideration of debt service coverage ratio, loan-to-value ratio, credit scores and any other relevant indicators.
- In the case of debt securities, a situation of partially or totally missed payment for more than 30 days will trigger a specific assessment of the counterparty's creditworthiness. When the assessment evidences a situation where the full repayment of the security is unlikely, the security will be considered as non-performing regardless of the number of days it is past due.

When applying the criterion of unlikely full repayment to an exposure, the contractual features of the exposure (eg an interest-only mortgage loan, or a loan in which the repossession of collateral for repayment is contractually provided for, or a retained first-loss tranche in a securitisation transaction) should not automatically result in its categorisation as non-performing without analysis of payment behaviours or the financial situation of the counterparty. However, regardless of its contractual features, an exposure is categorised as non-performing when it is more than 90 days past due and meets the materiality threshold.

3.2. Recategorisation of non-performing exposures as performing

31. An exposure ceases to be non-performing and can be recategorised as performing when all the following criteria are simultaneously met:

- (i) the counterparty does not have any material exposure more than 90 days past due;
- (ii) repayments have been made when due over a continuous repayment period as specified by the supervisor of at least three months.¹⁰ A longer repayment period can be required for non-performing forbore exposures;
- (iii) the counterparty's situation has improved so that the full repayment of the exposure is likely, according to the original or, when applicable, modified conditions; and
- (iv) the exposure is not "defaulted" according to the Basel II standard or "impaired" according to the applicable accounting framework.

32. The following situations will not lead to the recategorisation of a non-performing exposure as performing:

- (i) partial write-off of an existing non-performing exposure, (ie when a bank writes off part of a non-performing exposure that it deems to be uncollectible);
- (ii) repossession of collateral on a non-performing exposure, until the collateral is actually disposed of and the bank realises the proceeds (when the exposure is kept on balance sheet, it is deemed non-performing); or

¹⁰ In exceptional circumstances and subject to prior agreement from supervisors, a shortened period may be used when a bank puts in place specific remedial measures to restructure the borrower's business, that include a direct participation in the borrower, that are immediately applicable and make the full repayment of the exposure likely.

- (iii) extension or granting of forbearance measures to an exposure that is already identified as non-performing subject to the relevant exit criteria for non-performing exposures.

The recategorisation of a non-performing exposure as performing should be made on the same level (ie debtor or transaction approach) as when the exposure was originally categorised as non-performing.

3.3. Additional considerations

33. Banks should be in a position to provide information on the amount of existing non-performing exposures for both the gross carrying amount and the carrying amount net of value adjustments and provisions. These value adjustments and provisions refer to both the allowance for credit losses and direct reductions of the outstanding of an exposure to reflect a decline in the counterparty's creditworthiness.

34. In some jurisdictions, repossessed collateral is reported as a non-performing exposure. Such exposures should be identified separately from other non-performing exposures.

35. When banks are required under the applicable accounting standards to recognise interest income on non-performing exposures, they should be in a position to provide information about the amount of income recognised on non-performing exposures, as well as any adjustment to this income that they are required to implement, such as provisions or the establishment of reserves (post-tax appropriation of profits).

4. Definition of forbearance

4.1. Identification of forbearance

36. Forbearance occurs when:

- a counterparty¹¹ is experiencing **financial difficulty** in meeting its financial commitments; and
- a bank grants a **concession** that it would not otherwise consider, whether or not the concession is at the discretion of the bank and/or the counterparty. A concession is at the discretion of the counterparty (debtor) when the initial contract allows the counterparty (debtor) to change the terms of the contract in its own favour (embedded forbearance clauses) due to financial difficulty.
- The identification of an exposure as forborne does not affect its categorisation as impaired for accounting purposes¹² or as defaulted in accordance with the regulatory framework.

37. Forbearance includes concessions that are granted due to the counterparty's financial difficulty on any exposure in the form of a loan, a debt security or an off-balance sheet item (eg loan commitments or financial guarantees), regardless of the measurement method for accounting purposes.

38. Forbearance is identified at the individual exposure level to which concessions are granted due to financial difficulty of the counterparty.

39. Explanation of terms

- **Financial difficulty:** in order to identify cases of forbearance, banks should first determine if the counterparty is experiencing financial difficulty at the time when the forbearance is granted.
- The following list provides examples of possible indicators of financial difficulty, but is not intended to constitute an exhaustive enumeration of financial difficulty indicators with respect to forbearance. In particular, financial difficulty can be identified even in the absence of arrears on an exposure:
 - (a) A counterparty is currently past due on any of its material exposures.
 - (b) A counterparty is not currently past due, but it is probable that the counterparty will be past due on any of its material exposures in the foreseeable future without the concession, for instance, when there has been a pattern of delinquency in payments on its material exposures.
 - (c) A counterparty's outstanding securities have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange due to non-compliance with the listing requirements or for financial reasons.
 - (d) On the basis of actual performance, estimates and projections that encompass the counterparty's current capabilities, the bank forecasts that all the counterparty's committed/available cash flows will be insufficient to service all of its loans or debt

¹¹ A counterparty is a natural or legal person to which a bank has exposures.

¹² Under IFRS 9, this means that forborne exposures may or may not overlap with the concept of modified assets, and that the identification of an exposure as forborne should have no incidence on the impairment stage in which this exposure is allocated for accounting purposes. Under US GAAP, this means that forborne exposures may or may not overlap with the category of Troubled Debt Restructuring and that the identification as forborne should have no incidence on the provisioning analysis under the Current Expected Credit Loss model.

securities (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future.

- (e) A counterparty's existing exposures are categorised as exposures that have already evidenced difficulty in the counterparty's 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.
 - (f) A counterparty is in non-performing status or would be categorised as non-performing without the concessions.
 - (g) The counterparty cannot obtain funds from sources other than the existing banks at an effective interest rate equal to the current market interest rate for similar loans or debt securities for a non-troubled counterparty.
- **Concession:** concessions are special contractual terms and conditions provided by a lender to a counterparty facing financial difficulty so that the counterparty can sufficiently service its debt. The main characteristic of these concessions is that a lender would not extend loans or grant commitments to the counterparty, or purchase its debt securities, on such terms and conditions under normal market conditions. Supervisors may set specific materiality thresholds for what constitutes a concession.
 - Concessions can be triggered by:
 - (a) changes in the conditions of the existing contract, giving considerably more favourable terms for the counterparty;
 - (b) a supplementary agreement, or a new contract to refinance the current transaction; or
 - (c) the exercise of clauses embedded in the contract that enable the counterparty to change the terms and conditions of its contract or to take on additional loans, debt securities or off-balance sheet items at its own discretion. These actions should only be treated as concessions if the bank assesses that the counterparty is in financial difficulty.
 - There are many types of concession granted by lenders, or exercised by counterparties in existing contracts, that could be considered as forbearance. Not all concessions lead to a reduction in the net present value of the loan, and therefore a concession does not necessarily lead to the recognition of a loss by the lender. There is no concession when the borrower is not in financial difficulty. When a borrower is assessed as experiencing financial difficulty, examples of potential concessions are:
 - (a) extending the loan term;
 - (b) rescheduling the dates of principal or interest payments;
 - (c) granting new or additional periods of non-payment (grace period);
 - (d) reducing the interest rate, resulting in an effective interest rate below the current interest rate that counterparties with similar risk characteristics could obtain from the same or other institutions in the market;
 - (e) capitalising arrears;
 - (f) forgiving, deferring or postponing principal, interest or relevant fees;
 - (g) changing an amortising loan to an interest payment only;
 - (h) releasing collateral or accepting lower levels of collateralisation;
 - (i) allowing the conversion of debt to equity of the counterparty;
 - (j) deferring recovery/collection actions for extended periods of time; and

- (k) easing of covenants.
- Refinancing an existing exposure with a new contract due to the financial difficulty of a counterparty could qualify as a concession, even if the terms of the new contract are no more favourable for the counterparty than those of the existing transaction.

4.2. Criteria for exit from the forbore exposures category

40. A forbore exposure will be identified as such until it meets both of the following exit criteria:
- (i) When all payments, as per the revised contractual terms, have been made in a timely manner over a continuous repayment period of not less than one year (probation period for reporting). The starting date of the probation period should be the scheduled start of payments under the revised terms, regardless of the performing or non-performing status of the exposure at the time that forbearance was granted; and
 - (ii) The counterparty has resolved its financial difficulty.

4.3. Interaction of forbearance with non-performing exposures

41. Forbearance may be granted on performing or non-performing exposures. When forbearance is applied to a non-performing exposure, the exposure should remain non-performing. When forbearance is applied to a performing exposure, the bank then needs to assess whether the exposure meets the non-performing criteria, even if the forbearance resulted in a new exposure. When the original exposure would have been categorised as non-performing at the time of granting forbearance, had the forbearance not been granted, the new exposure should be categorised as non-performing.

42. Banks should pay particular attention to the appropriate categorisation of exposures on which forbearance has been granted more than once. When a forbore exposure under the probation period is granted new forbearance, this should trigger a re-start of the probation period, and banks should consider whether the exposure should be categorised as non-performing.

43. The continuous repayment period for non-performing and the probation period for forbearance can run concurrently. All non-performing forbore exposures should remain non-performing until they meet the criteria in paragraph 31. Thereafter, the remaining probation period for forbearance exit in paragraph 40 shall apply and the exposure should be identified as a performing forbore exposure.

44. When a forbore exposure becomes non-performing during the 12-month probation period, the probation period starts again.

Annex: Stocktake of key terms and practices on credit risk categorisation for loans

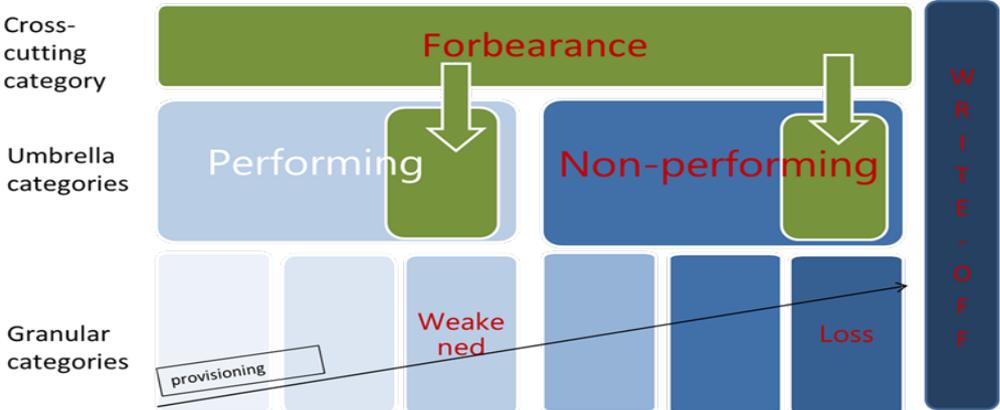
Summary of main findings

45. The task force conducted surveys of banks and supervisors as described in the main section. The jurisdictions surveyed were the 27 members of the Basel Committee and Thailand. The task force focused on the credit risk categorisation of loans, considering three areas in particular:
- (i) a literature review, including supervisory, academic, accounting and industry reports on credit risk categorisation practices;
 - (ii) a stocktake of regulatory frameworks and supervisory practices through a questionnaire to 28 supervisors regarding credit risk categorisation; and
 - (iii) a stocktake of industry practices through a questionnaire and case studies regarding credit risk categorisation sent to 39 banks from the 28 jurisdictions.
46. Each case and scenario under the case studies are described in "Case studies".

Credit risk categorisation of problem loans varies widely

47. The following chart shows some of the observations identified regarding credit risk categorisation among jurisdictions and banks. The task force found that there are no consistent international standards for categorising problem loans. Supervisors and banks use key terms such as "performing"/"non-performing", "forbearance", "weakened", "loss" and "write-off" in their credit categorisation schemes, internal credit risk management or supervisory reporting and public disclosure, but the terms are not consistently defined or reported. Although the provisions of the accounting standards and the Basel framework on impaired and defaulted loans provide a bottom line for categorising loans, there is no comprehensive, granular framework to allocate loans to different categories based on their riskiness. As for banks, their internal categorisation systems may be very idiosyncratic (eg IRB models).

Overview of key terms and their interactions



The concepts of performing and non-performing are often umbrella categories (ie encompassing more than one subcategory). The concept of forbearance cuts across categories. The concept of write-off refers to a derecognition technique which may be implemented in any category but especially in the "loss" category. Although different minimum accounting or regulatory provisioning requirements were observed in different categories, the task force did not address provisioning.

48. The literature review and the stocktakes confirmed that there are varied practices for categorising problem loans, with no consistent international standards for doing so. The Basel Committee identified multiple layers of credit risk categorisation: (i) definitions used for banks' internal credit risk categorisation; (ii) definitions used for regulatory and supervisory credit risk categorisation; and (iii) definitions used in the accounting frameworks for financial statements. Within these layers, similar loans fall into different categories in various jurisdictions, although some commonalities were noted.

Findings on non-performing loans and forbearance

Non-performing loans (NPLs)

49. The majority of jurisdictions and banks surveyed (82% of jurisdictions and 65% of banks) do have a category for non-performing loans, which belongs to the regulatory categorisation layer, the internal credit risk categorisation layer, the supervisory credit risk categorisation layer or, rarely, to the accounting layer. Definitions commonly focus on qualitative factors relating to doubts about full collectability and/or quantitative factors, primarily a number of days past due trigger (generally 90 DPD).

50. Nonetheless, there are clear differences in the detailed, practical implementation of these common criteria across jurisdictions and banks. The main drivers for the differences among jurisdictions and banks, including within a given jurisdiction, are as follows:

- The scope of the definitions: some jurisdictions or banks apply their definition of non-performing to loans only, while others also apply the definition to debt securities and/or off-balance sheet commitments.
- The use and level of a materiality threshold: some jurisdictions and banks apply their definition of non-performing only to material loans, while others apply the definition to all loans. Also, the materiality threshold in place is not consistent across jurisdictions or banks in the same jurisdiction.
- The treatment of different types of exposure: some exposures can be granted waivers or special criteria (such as longer past-due periods) for the recognition of non-performing status depending on the nature of the exposure or collateral.
- The possible use of qualitative assessment for early NPL identification: there is varying guidance for the qualitative criteria that can trigger NPL categorisation prior to past-due status. The case studies revealed that some banks identify problem loans before they reach 90 DPD although many do not.
- The level of application: NPL categorisation can be applied either at the level of a single loan or at the level of all the loans towards a counterparty. Jurisdictions have different practices on the level of application according to the nature of the loans. Practices of banks vary as well. Some jurisdictions allow banks to choose the level of application of the non-performing status. This variety of approaches is also observed when the counterparty belongs to a group.
- The exit criteria: the criteria for upgrading a non-performing loan to performing vary across jurisdictions, eg a requirement for the loan to undergo a cure period. Often, the lack of specificity of the exit criteria allows banks wide variability in the upgrading time frames.
- The incidence of forbearance: the conditions under which forbearance measures can lead to the recognition of non-performing status or the exit from non-performing status vary.

Forbearance

51. Forbearance, including synonyms such as “restructuring”,¹³ is widely used, with over 80% of respondent banks having a specific definition, which is linked primarily to the regulatory framework. Although forbearance is a common strategy for credit risk management, there is no formal international definition of this term, and it is therefore described and used in different ways across jurisdictions and banks around the world.

52. The task force identified significant areas of commonality within the definition. For example, the definition refers to a change of the credit terms to address a borrower’s financial difficulty and that the bank could assign forborne loans to various other credit categories (forbearance is a cross-cutting category). Unlike other categories, the case studies showed a greater degree of commonality in the treatment of commercial loans than in that of retail loans.

53. Conversely, the task force also observed significant differences, particularly on qualitative issues such as:

- the definition of financial difficulty (the essential characteristic to distinguish forbearance from other changes in credit terms that are commercially motivated);
- the types of forbearance measure and concession that qualify as forbearance;
- the recognition of forborne exposures as impaired, defaulted, non-performing or the categories of the credit categorisation schemes in which they are included, and whether a forborne exposure must at a minimum be included in a given category (ie cap on the creditworthiness that can be attached to a forborne exposure); and
- the conditions under which forbearance could allow the upgrade of a non-performing exposure to performing status and whether such an upgrade is possible (the conditions imposed before the upgrade to performing vary, including the mandatory probation period, if any, during which the restructured borrower has to show good compliance with the restructured conditions before being considered as performing). For example, Asian banks and banks from the Americas broadly required six to 12 months of performance while European banks required 12–24 months of performance prior to upgrading.

54. Forborne loans are typically assessed via the concept of financial difficulty of a counterparty, but practices for identifying underlying weaknesses vary, as do the measures that qualify as forbearance. These facts make forbearance a blanket concept that refers to different situations across jurisdictions.

¹³ The most common terms referring to modified contracts due to a borrower’s financial difficulty are “forborne” and “restructured”. Most definitions of restructuring are quite similar to the concept of forbearance. Thus, the terms seem to be equivalent. In the following, they are used as synonyms.

Part I – System issues

55. This section highlights a number of regulatory and supervisory issues and implications relating to credit categorisation. The level of problem loans¹⁴ is an important indicator of banks' asset quality, on which banks' management and supervisors place great reliance.

56. The importance of identification, measurement and prudential treatment of problem loans can be perceived from the following perspectives:

- (i) From a credit risk management perspective, identification of problem loans can lead to the bank's directing greater attention or resources to reduce the risk of further loss arising from non-recoverability of amounts due from the borrower or from the liquidation of the collateral securing the credit risk and improving their credit risk appraisal standards.
- (ii) From a bank management perspective, the bank's management is also expected to respond appropriately to any deterioration in the quality of the credit portfolio that could lead to recognition of incurred losses, provisioning for expected losses and capital allocation to cover unexpected losses; these decisions will impact banks' profitability, solvency and dividend policies.
- (iii) From a supervisory perspective, identification of problem loans and the recognition of, and provisioning for, losses will have a bearing on banks' prudential indicators, particularly solvency and profitability metrics, and can influence bank ratings, or trigger supervisory responses when banks breach supervisory thresholds.
- (iv) From a market discipline perspective, disclosure about the promptness and accuracy of identification of problem loans, adequacy of provisioning or write-offs and adequacy of capital can promote effective market discipline.

57. In this context, the Basel Committee places great emphasis on the soundness of credit risk assessment and valuation of credit loss by banks. Basel Committee guidance, especially the *Core principles for effective banking supervision* (Core Principles), require that laws, regulations or the supervisor establish criteria for assets to be identified as problem assets and recategorised as performing. As for banks, the Core Principles require them, as part of their credit risk assessment process, to develop and implement comprehensive procedures and information systems to monitor the quality of their loan portfolios. These should include criteria that identify and report problem loans to reasonably assure that they are appropriately monitored, administered and provided. The credit risk monitoring system at each bank is expected to provide the foundation upon which a bank's loan loss or provisioning methodology is built.

58. Loan categorisation, ie the assignment by banks of their loans to categories or buckets according to their perceived credit risk features, matters for supervisory purposes. That is, for ensuring the proper identification of problem loans to ensure, among other things, the adequacy of provisioning to cover expected losses, which impacts the computation of capital, and the adequacy of capital available to cover unexpected losses. As a result, variations in credit categorisation systems affect the comparability and consistency of banks' asset quality and solvency indicators across jurisdictions.

¹⁴ Basel Committee on Banking Supervision, *Core principles for effective banking supervision*, September 2012, defines problem loans as "asset[s] where there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the agreement with the counterparty".

59. In practice, several jurisdictions have established the requirements for identification, measurement and prudential treatment of problem loans, in law, regulations, guidelines or accounting standards.

60. Asset categorisation practices vary across jurisdictions because there is no international standard or guideline, accounting or otherwise, except for standards around defaulted and impaired loans that nevertheless only provide a bottom line for the categorisation of loans, but no comprehensive framework for their allocation into different categories.

61. However, there is some commonality in practices as most banks use a categorisation system either imposed by supervisors or self-imposed. The task force identified credit categorisation schemes with a number of categories varying from three to nine, with half of the jurisdictions having a credit categorisation scheme made up of five categories.¹⁵ This variation in practice can lead to inconsistency and a lack of comparability in asset quality and solvency indicators. The major overarching or system issues and their implications are discussed in this section.

I. Typology and different layers of credit categorisation schemes

62. Accounting standards and the Basel framework provide some bottom layers regarding asset categorisation, namely impaired/not-impaired and defaulted/non-defaulted. In addition, in some jurisdictions supervisory authorities implement supervisory categorisation schemes aimed at assisting them in supervising and monitoring credit risk. All surveyed jurisdictions currently have a credit categorisation system in force, but there are wide variations in the features of these systems as there is no comprehensive, granular framework to allocate loans to different categories based on their riskiness.

63. The categorisation schemes can be different in nature as they belong to different layers of asset categorisation. Some systems are linked to the implementation of the accounting framework (specification on the notion of impairment into various creditworthiness buckets), whereas others are linked to the implementation of the Basel framework (specification of the notion of default and past due into various creditworthiness buckets) or ad hoc systems (used for other purposes, like supervisory reporting).

64. As a result, concepts used to categorise loans can belong to different layers in different jurisdictions. For example, an accounting-related concept in a jurisdiction can be a regulatory-related concept in another jurisdiction. Divergent terminology can make analysis and comparisons difficult. For example, the supervisors' survey showed that eight jurisdictions relied on an accounting layer, 10 relied on a regulatory layer and 18 had an ad hoc layer for credit categorisation. Moreover, more than one layer can be in force in a given jurisdiction.

65. Moreover, many banks have transformed the accounting, regulatory and reporting frameworks into their own internal rating scales to categorise loans. These scales range from four to 20 categories, which can be aligned or not – more or less granularly – on schemes set by supervisors.

¹⁵ The categorisation systems for banks may align on the number of categories specified in supervisory categorisation schemes, or may be more granular, especially for banks in which the internal categorisation scheme relies on the IRB models.

II. Drivers for differences in credit categorisation schemes

66. The loan categorisation systems of surveyed jurisdictions vary as to the number of categories used and the definitions of terms. Even when similar terms are used, practices differ and can create inconsistencies in the amounts of problem loans and impairment reported. The drivers for differences apply to all categories within the existing credit categorisation schemes, including the categories related to problem loans and the categories used for non-problem loans (for instance, watch list or special-mention loans).

67. Possible drivers for differences include: (i) the scope of application (ie all loans or other types of instrument); (ii) the use of gross exposures or net exposures (ie whether the entire loan amount or only the overdue/risky portion is included); (iii) extension of the same categorisation to other exposures (ie whether the categorisation is assessed on a facility-, borrower- or group-wide basis); and (iv) the use of a quantitative approach (number of days past due) or a qualitative approach (borrower's financial difficulty or unlikelihood to pay) for categorisation. In addition, practices vary on the treatment of collateral, the criteria for income recognition, tax regimes for loan loss provisions and the frequency of assessment for updates.¹⁶

68. These drivers may result in banks' having different practices for provisioning and income recognition, and eventually in differences in the financial and regulatory indicators and ratios used by supervisors and analysts to monitor banks.

Scope of application

69. The scope of application of credit categorisation systems contains loans in all jurisdictions surveyed. The scope extends to off-balance sheet items in 17 jurisdictions; debt securities and off-balance sheet items in 11 jurisdictions; all on-balance sheet and off-balance sheet items carrying credit risk (including derivatives) in six jurisdictions; and other variations of loans plus on-balance sheet receivables in five jurisdictions.

Gross exposures or net exposures

70. Once an exposure is included in a given category, the entire exposure (ie not only the overdue portion) is counted as a problem loan by all 39 banks, of which 24 jurisdictions require this treatment. This exposure value is the entire exposure, gross of provisions, in 21 jurisdictions. Four jurisdictions allow their banks to take the gross exposure or the net exposure, and a few jurisdictions require their banks to take the gross exposure but split the exposure across various asset rating categories (eg the secured part of a loan can be included in the substandard category, and the unsecured part of a loan could be included in the doubtful or loss categories).

Extension of the same categorisation to other exposures (borrower- or group-wide)

71. There is wide variation in the supervisory requirements and bank practices when it comes to applying the same categorisation to all borrower's exposures (and, if needed, identifying all exposures to

¹⁶ Practices also vary on the frequency of assessment (monthly, quarterly, semiannually or annually), and in some jurisdictions more frequent, specific assessment rules apply to some exposures (eg non-performing and large/significant exposures).

a borrower as problem loans). The principle of borrower categorisation is seen to operate at three levels: the borrower, the borrower group and the consortium or syndicate members.

- Thirteen jurisdictions apply the principle of uniform adverse categorisation to all amounts due from a borrower when any exposure to that borrower is included in a given category, including when it is determined as a problem loan, while only three jurisdictions require a categorisation at the facility level. In addition, banks are allowed to choose a borrower-wide categorisation or facility-wide categorisation for non-performing exposures in 12 jurisdictions (“Other levels”) – this choice is sometimes constrained and banks are required to revert to a borrower approach when the problem loans reach a certain level. Sixteen of the 39 banks apply a borrower-wide categorisation, 17 differentiate their approach by portfolio (for instance, retail and non-retail) and six apply a facility-wide categorisation.
- Five jurisdictions require categorisation on a group-wide basis, and other jurisdictions do not apply the principle of uniform adverse categorisation to all amounts due from the borrower group. However, in 15 jurisdictions (categorised as “Other levels”), banks are required to assess the likely impact on the credit quality of the exposures to the group. In practice, five banks apply the group-wide categorisation, including when not required to do so.
- In seven jurisdictions, all banks in a syndicate or consortium are required to adopt the principle of uniform categorisation, but 21 jurisdictions do not apply the principle of uniform adverse categorisation to exposures across all banks that are members of a syndicate or consortium. Data on bank practices with regard to adoption of uniform NPL categorisation by all members of the syndicate or consortium are not available.

Application of uniform categorisation: supervisory and bank practices

Number of jurisdictions and banks

Table 1

Level of application (facility or borrower)	Americas		Asia, Africa & Pacific		Europe		Total	
	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>
Facility level	2	5	1	1	0	0	3	6
Borrower level	2	2	10	9	1	5	13	16
Other levels	1	1	2	4	9	12	12	17
Total	5	8	13	14	10	17	28	39
Level of application (borrower group)¹	Americas		Asia, Africa & Pacific		Europe		Total	
	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>	<i>Jurisdictions</i>	<i>Banks</i>
Group basis	2	3	2	2	1 ²	0	5	5
Individual basis	1	4	8	6	0	3	9	13
Other levels	2	1	3	6	10 ²	14	15	21
Level of application (syndicate)	1	na	5	na	1	na	7	na

¹ Includes the case where the approach is used only for non-retail portfolios or as an exception to the facility basis approach. ² One jurisdiction provided two categorisation schemes based on national rules and European Banking Authority's rules, both of which are counted as one jurisdiction.

Influence of collateral on asset categorisation

72. The different consideration of collateral and guarantees in categorising exposures and determining the amount of provision may lead to significant variations in the amounts recognised in loan categories. The availability of collateral can influence the loan categorisation in 13 jurisdictions. In three of these jurisdictions, collateral can influence categorisation through banks' assessment of the

likelihood of recoverability of all amounts due from the borrower. In the other 10 jurisdictions, collateral can influence the asset categorisation when they are of sufficiently high quality and liquidity, such as cash collateral, government securities and government guarantees. Collateral does not influence asset categorisation in the remaining 15 jurisdictions.

73 Collateral influences asset categorisation at 10 of the 39 banks. Problem loan determination and hence measurement can also diverge when collateral is repossessed since some banks transfer the assets from loans to another asset category in the balance sheet.

Criteria used to categorise loans

74. Loans can be assigned to categories based on objective criteria, such as those based on the number of days past due. These criteria are mostly ex post criteria, ie the loan is categorised based on its creditworthiness when a specific event indicative of increased credit risk has occurred. Loans can also be allocated to categories based on qualitative criteria, such as the existence of financial difficulty. These qualitative criteria tend to be considered ex ante, as they may allow the category of a loan to be downgraded before financial difficulty has materialised in the form of actual events, such as missed payments.

75. Many jurisdictions use a mix of criteria with the objective criteria – often, but not always, a 90 DPD threshold – used as a backstop. The practices for using a mix of criteria vary among jurisdictions.

III. Implications of different credit categorisation practices

76. Differences in categorisation may have consequences for provisioning requirements, which are in force in most of the schemes, as well as for income recognition. In both areas, jurisdictions have different rules and various degrees of specificity.

Provisioning requirements¹⁷

77. In most jurisdictions, banks are required to make provisions for problem loans. Some jurisdictions have specified standard or minimum rates of provisioning for different credit categories, whereas others have left it to banks to determine in line with the accounting standards and their internal assessment policies.

78. Banks in 10 jurisdictions are required to make a minimum level of provisioning for problem loans. The minimum rates of provisioning in these countries range from 10 to 100% of exposures, depending on the level of asset quality (reflected in the category in which the loan is included). In 18 jurisdictions, a more judgmental approach is applied as banks are required to make provisions as determined by the applicable accounting standards, but there are no minimum requirements. In many

¹⁷ Accounting provisioning has an impact on the amounts in the financial statements while regulatory provisioning requirements affect only regulatory capital. For more information regarding regulatory and accounting provisioning requirements in the different categorisation schemes as well as the practices of banks, see K d'Huelster, V Salomao-Garcia and R Letelier, *Loan classification and provisioning: Current practices in 26 ECA countries – an overview*, World Bank, 2014, and E Gaston and I W Song, "Supervisory roles in loan loss provisioning in countries implementing IFRS", *IMF Working Paper WP/14/170*, 2014.

jurisdictions, identification as a problem loan does not automatically trigger impairment (as the category of NPLs used for identifying problem loans is broader than the category of impaired loans).

79. In addition to provisions for problem loans, 15 jurisdictions require banks to make provisions on a portfolio basis or for inherent losses in loans that are yet to be identified as problem. In 13 of these jurisdictions, banks make provisions, and in two countries, they meet these requirements through reserves (appropriation of retained earnings). Similarly, the range of minimum requirements varies depending on the category and the asset class in eight jurisdictions. In the remaining 13 jurisdictions, there are no such minimum provision requirements, but banks only apply the accounting requirements to make provisions on a portfolio basis for a pool of homogenous loans. Disclosure of general provisions or reserves is only required in nine jurisdictions.

80. In all surveyed jurisdictions but two, collateral held by banks influences the amount of provisions for problem loans.

81. As regards the practice of banks, 30 are not bound by any minimum provisioning requirements, and almost all banks (38 of 39) consider collateral when making provisions. The effective rate of provisions held by banks for problem loans may not be comparable even when minimum requirements are in force for given categories of loans. Indeed, the minimum requirement acts as a floor while the actual amount of provisions is usually determined on a case-by-case basis by (i) the prospects of recovery; (ii) the amount that is likely to be recoverable; and (iii) the time period over which the recoveries are anticipated.

82. In addition, the methodology for calculating provisions may vary, with methodologies based on indicators that are forward-looking (provisions for probable losses are set in good times so that they can be drawn down when loan quality deteriorates) or backward-looking (addressing losses that follow from actual and identifiable events). Pure forward-looking provisioning is still uncommon; nevertheless, minimum general provisioning requirements for standard/performing loans can be considered a kind of forward-looking system and is being practised by some jurisdictions.

83. Lastly, significant variations in tax treatment for loan losses between different jurisdictions can also result in different practices as regards the timing and amount of impairment versus write-off.

Income recognition

84. Income recognition on problem loans generally follows the requirements in the accounting standards or regulatory requirements set by the supervisor, whichever is binding. The criteria and timing for recognition of interest income and/or transfer of income to memoranda/suspense account and reversal therefrom present some differences, which could have an impact on the timeliness of categorisation of loans.

85. More jurisdictions (18) allow the recognition of accrued interest on problem loans than not (14), including 12 where this amount has to be provisioned (either directly or via the inclusion of the total outstanding of the loan plus accrued and unpaid interest, in the impairment testing).

86. Some jurisdictions allow banks to choose between accruing and not accruing, depending on the accounting standard applicable or the category in which the loan is included. Some limit the accrual to amounts that are expected to be collected and require the non-accrual of interest when those are not expected to be recoverable or impose non-accrual only when the delinquency status of the problem exceeds 60 DPD, 90 DPD or three months.

87. In some jurisdictions, interest payments on problem loans can be recognised as income on receipt. In one jurisdiction, interest payments can be recognised when cash payments are received and the loan is expected to be fully collectible, and, in another jurisdiction, when the loan is recategorised into a non-problem category.

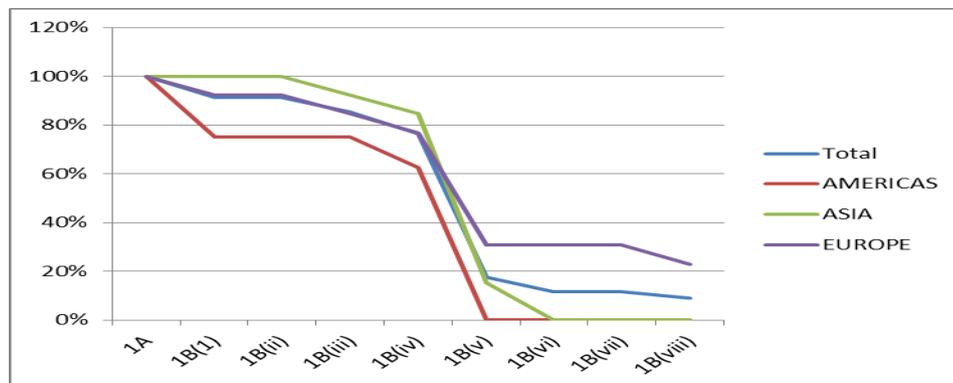
88. However, the case studies showed a general consistency in banks' practices, with the majority stopping the accrual of interest when a wholesale or retail loan reaches 90 DPD or more, and taking interest to income (or, in a few cases, as principal reduction) only when actually paid. The accrual of interest also seems sensitive to the collateralisation/guaranteed status of the loan for wholesale loans and to qualitative characteristics of the borrower for retail mortgage loans.

89. In the commercial loan case study, 82% of banks stop accruing interest at 90 DPD (scenario 1B(v)) and 65% do so in the commercial real estate loan case (scenario 2C(i), where in addition to being more than 90 DPD, the debt service coverage ratio on the loan has also declined since origination). Non-accrual is a general practice for banks in the Americas, where no banks keep accruing interest on the commercial loan, compared with 85% in Asia and 69% in Europe (although the gap would narrow if it is taken into account that many European banks fully provision accrued interest).

90. Early non-accrual on signs of financial deterioration prior to delinquency is also predominantly practised in the Americas (scenarios 1B(i), 1B(iii), 2A and 2B(i)). In these scenarios, only slightly more than one third of Americas, one fourth of European and one 10th of Asian banks stop accruing interest. However, almost all banks in each region keep the loan in accrual status when a guarantee can mitigate the borrower's financial difficulty (scenario 2B(ii)).

91. The graphs below represent the observations from case study scenarios provided during the bank survey portion of the analysis. They show the general magnitude of differences, by region, of credit categorisation. The x-axis of each graph represents various scenarios of an individual loan detailed in "Case studies". Each scenario across the x-axis shows the credit categorisation of the same loan under generally deteriorating financial conditions. The graphs generally demonstrate the varied recognition of financial deterioration of counterparties by banks given the same limited information.

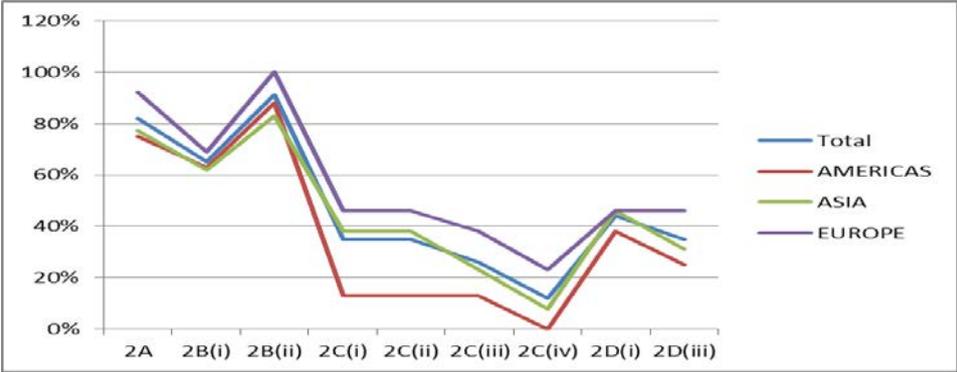
Graph 1: Percentage of banks recognising accruing interest on a corporate loan (Case 1)



See "Case studies" for the scenarios under Case 1.

92. Earlier non-accrual treatments in the Americas were also observed upon forbearance of a commercial real estate loan (scenarios 2C(i)–(ii), where the collateral value is inferior to the outstanding loan and counterparty is granted replacement loans either under preferential conditions or combining a market terms and a preferential loan). More Americas banks stop interest accruals (88%) than do Asian (62%) and European (54%) banks. However, the value of collateral appears to matter more in the Americas than in Europe when deciding accruing interest: no bank in the Americas accrues interest in a collateral deficit situation (scenario 2C(iv)) while some do in scenario 2D (where the collateral value exceeds the outstanding loan when forbearance measures are granted). Some European and Asian banks accrue interest in both scenarios.

Graph 2: Percentage of banks recognising accruing interest on a commercial real estate loan (Case 2)



See "Case studies" for the scenarios under Case 2.

Part II – Thematic review of key terms

I. Non-performing loans

93. Non-performing loans (NPLs) are widely used in the academic and official sector literature as an indicator to assess the creditworthiness of institutions or financial systems in general. Nevertheless, since the beginning of the 2000s, several reports have highlighted the lack of consistency at the global¹⁸ or regional¹⁹ level in the definitions of NPLs among jurisdictions and even among banks within a single jurisdiction. Lack of comparability has complicated the use of NPLs as an indicator for reliable comparisons of the situation among jurisdictions and institutions due to the inherent need for caution when comparing NPL data. This may have hampered the effectiveness of cross-border supervision related to the identification of asset quality issues and the drafting of strategies to deal with them.

94. The observed linkages between the concept of NPLs and other concepts used to quantify problem loans in the accounting and regulatory frameworks (non-accrual, default, past due and impaired) make it important to get a deeper understanding of the possible differences and to identify ways to address them.

95. The lack of consistency in the definition of NPLs and its effects on the consistency of NPL data available to stakeholders are an important caveat in research aimed at investigating the relationship between NPLs and dynamics in the real economy.²⁰ A better understanding of the inconsistencies in NPL definitions might therefore help improve research on asset quality and its consequences on the real economy.

Hierarchy and primacy of operating frameworks and use of NPLs in banks

96. NPL is a commonly used term across jurisdictions despite the current lack of a Basel reference point for this concept – the Basel framework does not refer to NPLs but to “problem assets” (Core Principle 18), “defaulted exposures” (Basel II rules text paragraph 452) and “past-due exposures” (Basel II rules text paragraph 75).²¹ Of the 28 jurisdictions, 23, or 82%, have a definition of NPL, either explicitly (with a regulation defining this notion) or implicitly (with supervisors considering that loans in some categories of their credit categorisation scheme should be considered NPLs). In some of these jurisdictions, NPL is used as a synonym for problem loans.

97. NPL is principally a regulatory term used for credit risk monitoring and management perspectives rather than an accounting concept, with 21 jurisdictions referring to this concept in their supervisory regulations (either regulations implementing the Basel framework, or other credit risk

¹⁸ See eg IMF, *The treatment of non-performing loans*, 2005, or World Bank, *Bank classification and provisioning practices in selected developed and emerging countries*, 2003.

¹⁹ See eg K d’Huelster et al, op cit.

²⁰ See eg the caveats in M Nkusu, “Nonperforming loans and macrofinancial vulnerabilities in advanced economies”, *IMF Working Paper*, WP/11/161, 2011; ECB, “Empirical determinants of non-performing loans”, *Financial Stability Review*, December 2011; R Beck, P Jakubik and A PiloIU, “Non-performing loans - What matters in addition to the economic cycle?”, *ECB Working Paper Series*, no 1515, 2013; and N Klein, “Non-performing loans in CESEE: determinants and impact on macroeconomic performance”, *IMF Working Paper*, WP/13/72, 2013.

²¹ The December 2015 consultative document on the revised standardised approach for credit risk introduces the concept of defaulted exposures under the Standardised Approach (www.bis.org/bcbs/publ/d347.pdf).

management regulations, including supervisory reporting). Only two jurisdictions refer to this concept in their accounting framework.

98. Bank practices also show variation and complexity in the structure of the internal schemes. Overall, 26 of 39 banks (66%) either explicitly or implicitly use a category of NPLs in their internal categorisation schemes. Less than half (17 of 39) refer expressly to NPL in the internal categories, even in jurisdictions with a definition of NPLs. In addition, a small group of other banks indirectly have an NPL category since their internal schemes are modelled on the supervisory schemes in which some categories are considered as NPLs. Within each bank, the NPL category can come in different positions on the internal rating scale.

99. The definitions of NPLs suffer from the same differences and inconsistencies as those of problem loans identified in the system issues. The following part focuses on the differences regarding the entry and exit criteria used for NPLs as well as on the linkages between the concept of NPL and the other concepts used for the identification of problem loans.

Drivers for determining NPLs in supervisory regulations

100. The 23 jurisdictions with a definition of NPL fall into two categories:

- The majority of jurisdictions identify loans as NPLs based on qualitative considerations supplemented by a quantitative backstop, generally 90 DPD, but sometimes 180 DPD. There is no need for the past-due threshold to be hit for a loan to be identified as an NPL, but all loans beyond the past-due threshold are NPLs.
- In a minority of jurisdictions, only objective criteria (more than 90 DPD) seem to be used to identify NPLs.

101. Regarding the objective criterion, there is broad convergence towards the use of a 90 DPD threshold for all types of exposure (retail and commercial). Nevertheless, a deeper analysis of the definitions in different jurisdictions reveals that:

- Different DPD thresholds can be applied to some exposures due to their nature (secured, unsecured, amortising loans, collateral status or type).
- The DPD threshold is not expressed in the same way in all jurisdictions: it can be 90 days or more, more than 90 days or three months.
- The definition of past due can vary. Most jurisdictions specify that the DPD threshold consists of late payment of principal or interest, but others also include fees/commissions in the past-due cash flows. Finally, some jurisdictions define a full payment equivalent to 90% or more of the contractual payment for consumer instalment loans.
- The methodology of counting DPD can vary between jurisdictions due to the allocation of partial repayment (first-in-first-out or last-in-first-out) and the interaction with the materiality threshold (only the EU definition of NPL clearly refers to a materiality threshold, but materiality thresholds may be required or implemented by banks in jurisdictions where there are overlaps between the definitions of NPL and default in the Basel framework).²²

²² The Basel definition of default under the IRB approach (paragraph 452) refers to a more than 90 DPD threshold “on any material credit obligation”. There is no such reference to materiality for past due loans (the unsecured portion of more than 90 DPD loans) under the Standardised Approach (paragraph 75).

102. As regards the subjective criterion, the different frameworks provide for a broad range of qualitative indicators, although almost all refer to financial difficulty of a borrower leading to a risk of non-payment. Nevertheless, jurisdictions use a variety of terms to describe the concept of financial difficulty:

- Unlikelihood to pay may be appreciated without taking the collateral into consideration (EU jurisdictions) or as regards the ability to fully repay the principal and interest.
- The full repayment of principal or interest can be highly questionable and improbable based on facts, conditions or values, or improbable due to a considerably weakened or seriously weakened situation, or there can be a considerable risk of financial loss.
- There can be significant deterioration in the creditworthiness, obvious deterioration of the financial situation, significant difficulties, well defined weaknesses, specific financial difficulty, financing or liquidity problems, deteriorated financial performance, reasonable doubts about collectability or a high probability of loss.

103. While some of these variations may be due only to wording choices when translating national regulations into English, some nuances (for instance, between unlikelihood to pay, highly questionable or improbable recovery, or reasonable doubt about repayment) may reveal different gradations and emphasis in the degree to which subjective criteria are considered in the recognition of NPL (eg in terms of type or conservativeness of loss events considered). Such differences may, in turn, contribute to the differences regarding the amount of NPLs identified on the basis of the qualitative criteria (see Graph 3).²³

104. Another area of divergence is the treatment of forbore loans. Some jurisdictions include these in the non-performing category, others include them until there is a cure, and others do not specify whether or not forbore loans are included. More details on this issue are provided in the forbearance section.

105. Although its point-in-time nature restricts its conclusiveness, the dispersion of NPL levels at banks within the Americas, Europe and Asia suggests that the identification of NPLs at Asian and European banks may be more heterogeneous in terms of criteria used than in the Americas, where a more clustered pattern is observed. Differences could stem from the use of different objective and subjective entry criteria to identify NPLs.

²³ Forborne loans have been excluded, as the granting of forbearance measures is more likely to lead these loans to be considered as NPL even in the absence of arrears (ie it is more likely that a loan that was in arrears less than 90 days that has been forbore for clearing the arrears will be identified as an NPL than a loan in arrears that has not been forbore).

Graph 3: Non-forborne NPLs with less than 90 DPD to total non-forborne NPLs, by bank



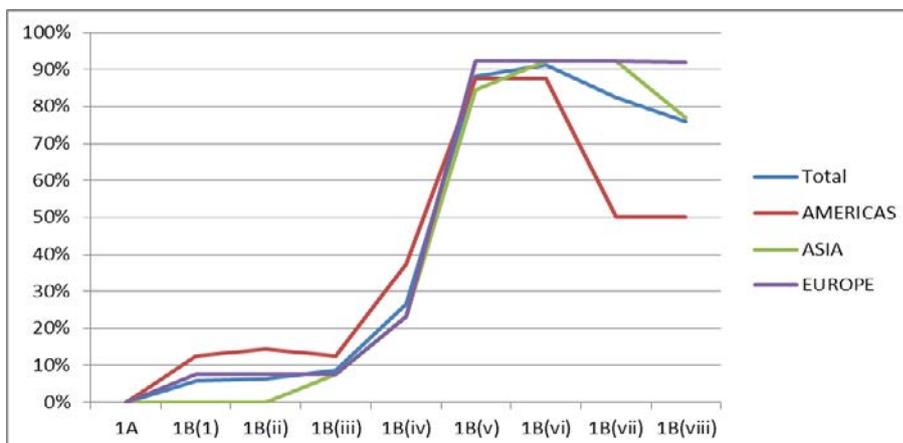
Note: as of September 2014.

Drivers for determining NPLs at banks

106. To identify NPLs, banks generally use objective and qualitative factors similar to those in regulations. This means that there is some convergence in the identification of NPLs towards the use of an objective criterion (essentially 90 DPD or more) and qualitative criteria (centred on financial difficulty). Nevertheless, there are inconsistencies in these objective and subjective criteria.

107. The different quantitative and qualitative criteria used by banks in recognising NPLs is evident from the case studies, which show a reliance on the arrears criteria for considering loans as NPLs, with the 90 DPD threshold being universally enforced. Qualitative indicators, or at least those that were described in the case studies, seem to be used more rarely to identify NPLs, whether retail or wholesale. Divergences in the categorisation practices are especially identifiable for real estate loans (because of differences regarding the consideration of collateral, the incidence of restructuring and probably different uses of the NPL concept). The case studies also revealed linkages between the NPLs and the impairment status, although there are cases where a loan can be impaired without being an NPL, especially when the bank does not use the NPL concept.

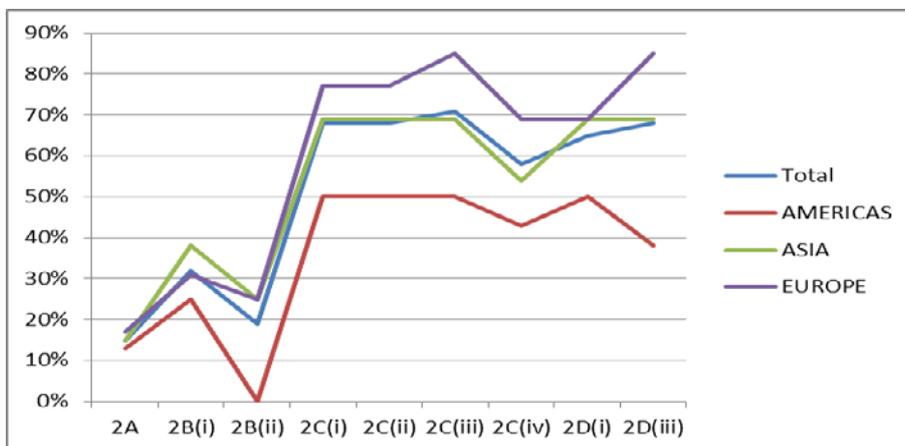
Graph 4: Non-performing status of a corporate loan collateralised by machinery



See "Case studies" for the scenarios under Case 1.

108. Ninety per cent of the surveyed banks categorise a corporate loan as an NPL when it reaches 90 DPD (scenario 1B(v)–(vi)), where the loan becomes more than 90 DPD without and with additional damages to the collateral), with some differences between jurisdictions (92% in Europe, 88% in the Americas, 85% in Asia). Situations of repeated 30 DPD (scenario 1B(iv)) only trigger NPL categorisation in 26% of banks, especially in the Americas (38%). In situations of possible financial difficulty where the borrower remains current in its payments (scenarios 1B(i)–1B(iii), where the counterparty of a commercial loan is facing a deteriorated financial and liquidity situation with insufficient cash for debt service and increased use of short-term financing), only a minority of banks consider the loan an NPL (eg in scenario 1Bi, more than 90% of banks did not categorise the loan as impaired where the worsening of the financial situation and the decrease in value of collateral is not accompanied by days in arrears). A fall in the value of collateral with payments and the financial health and liquidity while the situation of the borrower remains steady (scenario 1A) does not trigger an NPL categorisation. When repossessed collateral is sold (scenarios 1B(vii) and 1B(viii)), some banks, especially in the Americas, cease to consider the assets as a loan.

Graph 5: Non-performing status of a real estate corporate loan

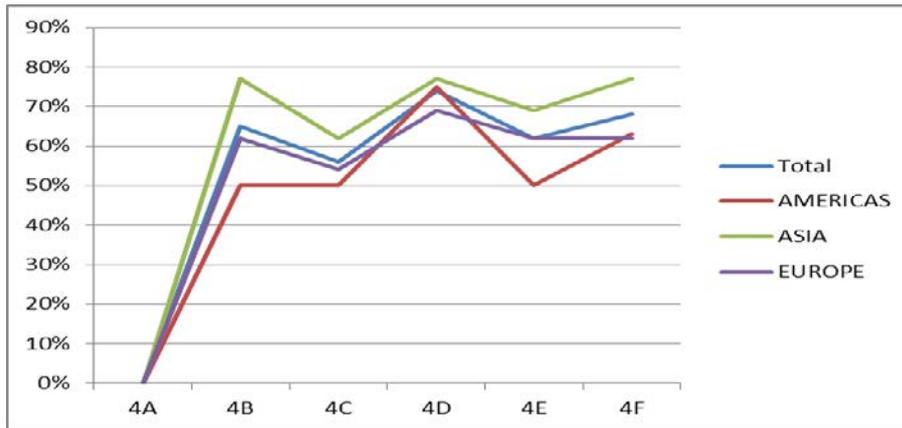


See "Case studies" for the scenarios under Case 2.

109. Uncertainty in a counterparty's business prospects (scenario 2A, where the counterparty of a commercial real estate loan is facing a deteriorated financial situation and insufficient cash for debt service) leads only a minority of banks (15%) to consider the loan an NPL, but one third do so (especially in Asia, 38%) when financial difficulty despite current payments come along with uncertainty in the soundness of the guarantor (scenario 2B(i)). Banks in the Americas seem to rely more on guarantors to categorise a loan as an NPL than Asian or European banks: no banks in the Americas consider the loan an NPL when the guarantor can make up for the borrower's financial difficulty (scenario 2B(ii)), while 25% of banks in Asia or Europe categorise the loan as an NPL.

110. Only 69% of Asian banks and 50% of banks in the Americas, compared with 77% to 85% of European banks, categorise a 90 DPD loan that is restructured with different measures (scenarios 2C(i)–(iv), where the counterparty is granted a new loan at preferential terms) while the value of the real estate collateral has decreased since origination. Nevertheless, almost all banks identify the loan as forborne. The percentage of banks considering the loan an NPL when the value of the real estate collateral is increasing (scenario D(i) and (iii)) falls to 38% in the Americas but remains quite stable in Europe and Asia. This confirms that risk mitigants are more important for loan categorisation in the Americas. In all these scenarios, however, the lack of use of the NPL concept in three banks in the Americas may explain the differences observed.

Graph 6: Non-performing status of a credit card loan



See "Case studies" for the scenarios under Case 4.

111. A number of banks do not use the term non-performing for credit card loans.

112. The 90 DPD threshold (scenario 4B) appears as the main trigger for categorisation as an NPL for 65% of banks, especially in Asia (77%). When the loan reaches 180 DPD (scenario 4F), 68% of banks consider it a NPL, which is less than when the loan was 120 DPD (scenarios 4D and 4E) due to write-offs (25% in the Americas, 15% in Europe and 0% in Asia write off the loan after 120 DPD).

113. Financial difficulty of the borrower but with no payment in arrears (scenario 4A, where the borrower is current in their payments but has become unemployed and has inquired about the possibility for restructuring without any decision made yet regarding forbearance) do not lead any bank to identify the loan as an NPL. However, a combination of qualitative and quantitative factors leads to a greater identification of NPLs (74%) in scenario 4D (the borrower is 120 DPD and informs the bank that they have become unemployed and are unwilling to resume payments).

114. A number of banks do not consider the loan an NPL when the borrower resumes payments without clearing their accumulated 90 or 120 days in arrears (scenario 4C, where a previously unemployed borrower resumes payments without clearing arrears and scenario 4E, where resumption of payments without clearing of arrears takes place).

Timing of restoration of NPLs as performing loans in supervisory regulations

115. The criteria for upgrading NPLs to the performing status vary.²⁴ In general, NPLs are upgraded without a probation period when arrears are repaid (objective criterion) and when there is a positive outlook regarding full repayment of debt (subjective criterion). However, differences may arise when considering whether these two criteria are fulfilled:

- For the objective criterion, the difference is between jurisdictions for which all past-due amounts of principal and interest need to be repaid and those for which only arrears over 90 days need to be repaid.
- The subjective criterion refers to the expectation or likelihood of full repayments, but can also refer to the meeting of the criteria to be included in the performing categories, to the reversal

²⁴ Relevant information was only available for 17 jurisdictions.

of impairment or default status, to the increase in the collateralisation level or the use of a guarantee/disposal of collateral. However, there is little guidance for banks to assess the fulfilment of these criteria.

116. There is also variation regarding the treatment of related loans, with some jurisdictions preventing the discontinuation of a loan's NPL status if related loans are past due or more than 90 DPD.

NPLs and mapping to existing concepts for credit risk assessment

117. Credit categorisation systems around the world are applied in different layers (accounting, regulatory and supervisory). Mapping the concept of NPLs, often included in the regulatory layer, with the concepts from other layers (defaulted and impaired) is a complex exercise and remains in some cases uncertain.

118. It appears that the definition of "default" can overlap totally with that of NPLs, as it does in at least eight jurisdictions, or partially, due to eg different DPD criteria, as it does in a majority of jurisdictions, or not at all, as is the case in one jurisdiction.

119. Regarding the concept of "impaired", the overlaps of NPLs and impaired loans appear uncertain. NPLs appear to have impairment raised against them in 10 jurisdictions, although it is not possible to ascertain from the responses received if all NPLs are impaired loans in the financial statements or the extent of the overlap, ie whether NPL is a broader notion than impaired loans in the financial statements. In 10 other jurisdictions, however, NPLs are not necessarily impaired loans, although impaired loans are all NPLs.

What are the implications of the differences in the definition of NPL?

120. The numerous differences in the identification of NPLs, coupled with the different rules for income recognition and provisioning that are associated with NPL status, create challenges in comparing data and can hinder the assessment of banks' performance and solvency. In turn, these differences may have implications for bank managers, supervisors and market players and can lead to:

- (i) distortion of the incentive framework for prudent and well managed banks;
- (ii) lack of proper functioning of market discipline, leading to unsound pricing of risk;
- (iii) weakness in credit risk management at banks and in the banking system; and
- (iv) distortions in asset quality, provisioning, and earnings and capital, which can collectively undermine the effectiveness of the supervisory framework and market discipline.

Greater consistency in the definition of NPLs would help address these shortcomings.

II. Forbearance

121. Although forbearance (also often referred to as restructuring) is a common strategy for credit risk management, there is no formal international definition of this term and its equivalents. The term is described and used in different ways across jurisdictions and banks around the world. This lack of harmonisation pertains to practices regarding the exercise of forbearance, including the definition of forbore exposures, the concessions and modifications that are considered as forbearance, the recognition of forbore exposures as impaired or defaulted and the policies to categorise forbore exposures.

122. When talking about forbearance, it is essential to consider two perspectives. On the one hand, “good forbearance” may enable borrowers experiencing temporary financial difficulties to continue repaying their debt, maintain their business or stay in their property. Forbearance also allows banks to maximise the recovery value of borrowers’ assets, reduce the potential of a fire sale and avoid bankruptcy costs and provisions. Therefore, forbearance can be a tool for sound risk management of problem loans by reducing credit risk and credit losses. From a macroeconomic view, good forbearance may limit the erosion of the economy’s supply potential during a temporary or isolated downturn.

123. On the other hand, “bad forbearance” can be used to mask borrowers’ underlying difficulties by, for example, extending maturities and capitalising interest arrearages without giving careful consideration to borrower’s individual circumstances. In these instances, forbearance gives cause for concern as it can place borrowers and banks in a steadily deteriorating position without supporting action. It can also be a strategy to bring down non-performing/problem exposures to avoid negative attention and repercussions. This can become damaging in the case of a widespread and persistent (systemic) deterioration in portfolio quality, as institutions may choose the forbearance solution that means less risk for them as opposed to the most suitable solution for the borrower, for instance by being reluctant to repossess collateral and take write-offs (“forbear rather than foreclose”). Individual banks’ incentives, eg to reduce losses on their credit portfolio, may conflict with helping the economy to recover (eg braking economic growth by misallocating resources to non-viable borrowers at the expense of healthy firms) and ensuring financial stability (eg by concealing poor asset quality).

Observations regarding supervisory approaches

124. The most common terms referring to modified contracts due to borrower’s financial difficulty are “forborne” and “restructured”. Thus, the differences in the way banks deal with concessions granted to borrowers start with the term used.

125. According to the supervisory survey, 26 of 28 jurisdictions, or 92%, have a defined term for changes to a loan due to financial difficulty of the borrower. Nine jurisdictions use the term “forborne” while 17 jurisdictions use a synonym such as “restructured,” “renegotiated,” “rescheduled” or “troubled debt restructuring”, with most using “restructured” (14 jurisdictions, including two that also use the concept of forborne). “Restructured” and its variations are used in jurisdictions from Asia, Africa and the Americas.

126. Most jurisdictions with definitions of restructured have included the term in the regulatory framework. The concept of “restructured” varies across jurisdictions: some of them have detailed definitions and others have more generic ones. Most are quite similar to the concept of forborne used in the EU. Thus, the terms forbearance and restructuring seem to be equivalent, and “forborne exposures” and “restructured exposures” may be related to the same category and riskiness of transactions. While both restructured and forborne are widely used, the term forborne is largely unique to credit categorisation terminology whereas restructured is also used in the definition of default with the concept of distressed restructuring.

127. Most jurisdictions define different rules and criteria for banks to assign forborne exposures to categories, in some cases creating specific categories for loans subject to forbearance measures. Therefore, forbearance can be a category cutting across all the categories in a given scheme, or an input that leads to loans being assigned to a specific category of a categorisation scheme.

128. Strong commonalities and some variety can be identified in the definitions of forbearance and restructured across the jurisdictions and banks surveyed.

- Origin: forbearance applies to borrowers unable to meet their obligations in compliance with the original terms agreed. Such borrowers’ financial difficulty can be a consequence of several factors that affect the borrowers more or less severely, and can be transitory or definitive. However, the situations of financial difficulty that could be an occasion for forbearance are not

precisely defined by supervisors and thus a specific case considered as a financial difficulty for forbearance purposes in one jurisdiction might not be considered as such in another.

- Purpose: forbearance is a tool for dealing with problem loans with the aim of mitigating or even eliminating potential losses.
- Approach: granting borrowers concessions that would not be considered in normal circumstances, in order to stimulate the repayment of the debt. These concessions generally represent an amendment to the original conditions of the current transactions or granting new facilities to repay or refinance the current non-performing transactions. Some jurisdictions have a comprehensive list of concessions that could be granted in the scope of forbearance while others do not. The types of concession granted can also be a source of divergence in forbearance practices.

129. An impairment assessment is often required. There are differences in monitoring requirements for forborne loans and whether forborne loans should be considered as potential bad loans.

130. Another source of divergence is the set of conditions that allow banks to upgrade forborne exposures to a less risky category following the extension of more favourable terms. All jurisdictions prohibit the clearing of non-performing status and the recategorisation of a non-performing exposure as performing via restructuring. Given the uncertainty about the actual level of the borrower's risk, upgrading forborne exposures as soon as forbearance measures are extended is clearly undesirable but is not always forbidden by supervisors.

131. Twenty of 23 surveyed jurisdictions with the definition only allow upgrading or recategorisation of forborne exposures after several conditions have been met and/or after a certain period of performing (ie a cure or probation period), during which the restructured borrower has to show good compliance with the restructured conditions. This probation period varies in respect of:

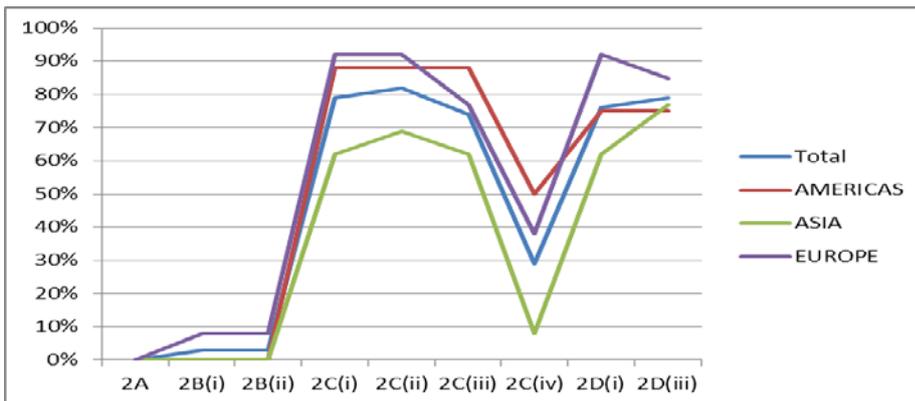
- Its duration, with many jurisdictions having a minimum one-year probation period.
- Its starting date, with almost all jurisdictions starting from the date of restructuring, except for one that starts on the date of the first payment of interest or principal, whichever is later, on the credit facility with the longest period of moratorium under the terms of restructuring package.
- Compliance with the new terms that may be attached to the probation period (number of minimum payments, percentage of payment of the loan amount and the clearing of the past due amount or concerns regarding full repayment) and whether the period during which these conditions must be satisfied encompasses the whole probation period.
- The scope for categorising a restructured exposure as performing can be constrained. For instance, in the EU, this does not apply when the restructured exposure is already an NPL.

Observations regarding banks' approaches

132. Definitions of forbearance seem to have a degree of consistency across jurisdictions and banks. Supporting this commonality of high-level definitions, the answers provided by banks to the case studies point to a convergence around the identification of loans where a concession was made to a troubled borrower as forbearance, particularly for commercial loans. A few banks do not use the term in any situation, and one bank uses the term expansively, ie when the borrower breaches a covenant (especially for corporate loans). The divergence of practices is more apparent for consumer loans.

133. However, divergences in practice can often be linked to more granular criteria for the treatment of forborne loans, sometimes depending on jurisdiction-specific requirements. Banks require different probation periods prior to upgrading forborne exposures, but most have some minimum standard requirements. For example, Asian and American banks broadly use the six- to 12-month range and European banks use the 12- to 24-month range.

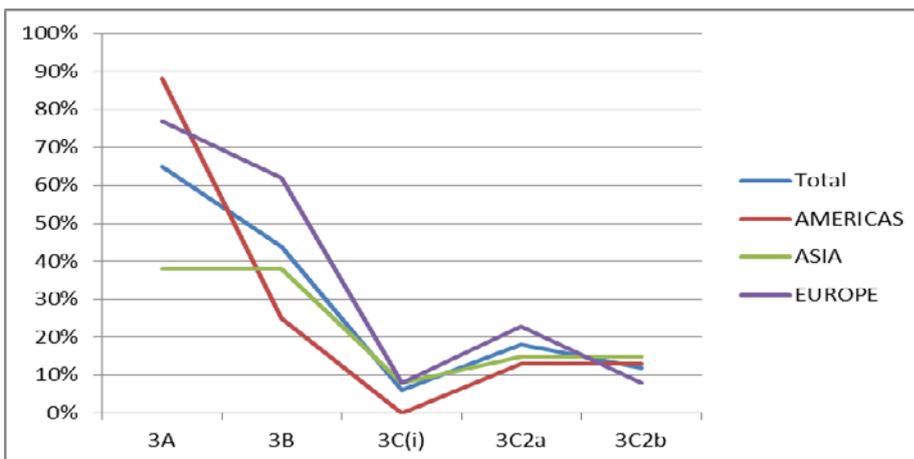
Graph 7: Forborne status of a corporate real estate loan



See "Case studies" for the scenarios under Case 2.

134. In Case 2 (corporate real estate loan), eight of the nine scenarios have convergent answers regarding the categorisation of the loan as forbearance (five scenarios) or not forbearance (four scenarios). Banks that designated the scenarios as forbearance ranged from 74% to 82% by region.

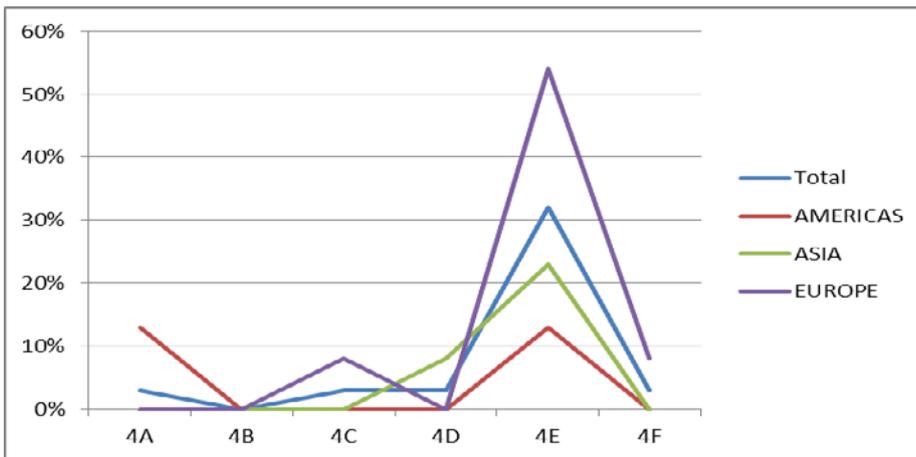
Graph 8: Forborne status of a residential real estate loan



Note: See "Case studies" for each scenario under Case 3.

135. In Case 3 (residential real estate loan), most Asian banks do not categorise residential real estate as forbearance/restructuring, although some Asian and most European banks consider an interest suspension allowed by the contract to be forbearance/restructuring (scenario 3B).

Graph 9: Forborne status of a credit card loan



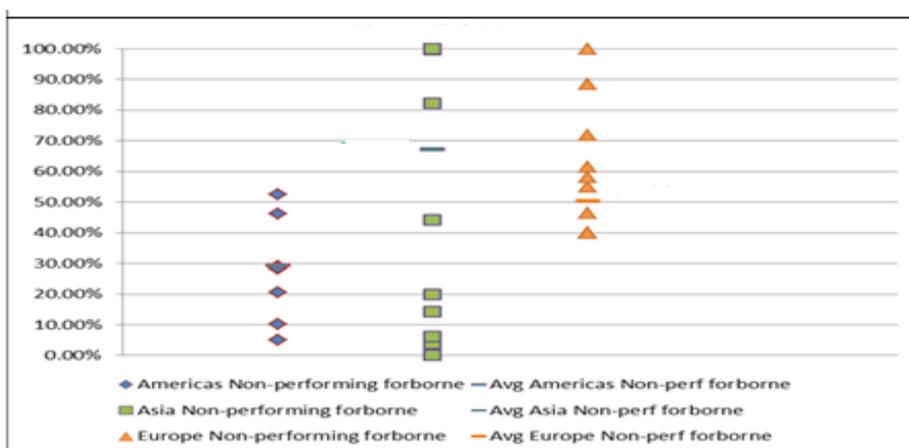
See "Case studies" for the scenarios under Case 4.

136. In Case 4 (credit card loan), banks have adopted different criteria for categorising forborne credit card loans. Most banks in Asia and the Americas do not categorise credit cards as forbearance/restructuring, and only half of banks in Europe do, even in the specific scenario where a borrower has been enrolled in a six-month workout programme that temporarily lowered their monthly payments (scenario 4E).

137. The commonalities and differences in banks' categorisation practices are particularly relevant regarding the categorisation of forborne exposures as performing or non-performing. The analysis of the data collected from banks shows that forbearance is an important criterion for categorising loans as non-performing, since about one third of the non-performing loans are forborne exposures. Nevertheless, the data also point to some relevant divergences in forborne figures across regions (the Americas, Asia and Europe), which can be partially explained by differences in banks' practices and regulators' requirements.

138. The following differences in the percentage of non-performing forborne loans to total forborne loans were observed. For example, 29% of the total forborne loans in Americas are non-performing, while this amount reaches 67% in Asia and 50% in Europe. Furthermore, data indicated that 73% of the non-performing forborne loans are 90 DPD in Europe, while this figure is only 8% in Asia.

Graph 10: Share of non-performing forborne loans in forborne loans



Note: as of September 2014.

What are the implications of the differences in the definition of forbearance?

139. Despite the fact that most jurisdictions define the term and use similar definitions, practices appear to vary widely. The different practices in identifying, monitoring and acting on forborne loans have potentially material implications for banks' financial health under different regimes. For example, differences in the impetus to monitor and report forborne loans, the identification of borrowers' financial difficulty under restructuring, types of concession granted, approaches for categorising forborne exposures and conditions for upgrading restructured exposures create uncertainties about the actual level of credit risk in banks' balance sheets and the valuation of bank assets. Indeed, forborne exposures are an important component of total non-performing loans, and thus different definitions and practices of forbearance across banks and jurisdictions can lead to distinct amounts of non-performing loans and may prejudice the comparability of prudential metrics.

140. The variety of definitions used in different jurisdictions may blur the extent of deteriorating asset quality and sustain unwise practices for credit categorisation and the use of forbearance measures.²⁵

141. Ultimately, forbearance points to higher credit risk and other default behaviour characteristics. It is therefore important that the supervisory and accounting frameworks do not allow banks to use forbearance practices to avoid categorising loans as non-performing, thereby postponing provisioning and eroding confidence in a bank's capital adequacy.

²⁵ See the developments in the report of the European Bank Coordination "Vienna" Initiative, Working Group on NPLs in Central, Eastern and Southeastern Europe, March 2012.

Case studies

Case 1

142. The bank is the main source of funding for a large producer of consumer goods. The bank has extended a EUR 40 million, five-year loan to this domestic corporate borrower to finance the EUR 50 million acquisition of machinery. The loan is priced at 5% fixed, fully amortises over the loan term with level monthly payments, and is secured by a first lien on the acquired machinery. In addition, the bank has granted a short-term revolving credit facility of up to EUR 10 million secured by inventory at a rate of 2.5%. The short-term credit line has a one-year maturity. The company's fixed charge coverage ratio (EBITDA/debt service, taxes and necessary capital investment) is 2.1 x, leverage (Debt/EBITDA) is 2.5x, and liquidity is adequate. The company is rated BB at origination.

143. The following scenarios and subscenarios are independent from each other.

Scenario A: At the end of year two, the financial condition of the borrower is unchanged. Payments are current. The credit facility is not drawn. The value of the machinery serving as collateral, however, has fallen to EUR 23 million; the loan balance is EUR 25 million.

Scenario B: At the end of year three, the financial and economic situation of the borrower has deteriorated. Sales are slowing and one of the company's main customers is leaving for a competitor. Leverage (debt/EBITDA) is now 5.7x, and the fixed charge coverage ratio is now 0.95x with cash flow insufficient to cover debt service. The short-term revolving credit facility is now fully drawn and the borrower has little liquidity. The collateral value is EUR 15 million and the balance of the loan is EUR 17 million. Using these facts, consider these alternative scenarios for each facility (assume no negotiations have taken place with the borrower):

- (i) The borrower is still current with its payment obligations.
- (ii) The borrower is still current but a noticeable increase in the use of the short-term revolving credit line appeared in the most recent financial releases without a corresponding increase in sales or pending orders.
- (iii) The borrower is still current with its obligations. However, the bank recently provided financing to a subsidiary of the borrower and it appears that, shortly after closing, a transfer from the subsidiary was made to the borrower in the approximate amount of the payments due under the credit line and the term loan.
- (iv) The borrower repeatedly becomes more than 30 days past due on its term loan payments.
- (v) The borrower becomes more than 90 days past due on its term loan payments.
- (vi) The borrower becomes more than 90 days past due on its term loan payments. In addition, the collateral was recently damaged in a fire and the salvage value is EUR 5 million. Although the financial condition of the borrower's insurer is adequate, it is currently uncertain whether the insurer is liable for payment to cover the EUR 10 million in damage (the damage to the machine and any loss of production capacity was not a cause of the borrower's past-due status and the bank has determined that the collateral is likely to be the only source of repayment).
- (vii) The borrower is now more than 120 days past due on its term loan payments and the lender has repossessed the machinery (assume no collateral damage).
- (viii) The borrower has become more than 120 days past due on its term loan payments and the lender has repossessed the machinery (assume no damage to the collateral) and sold it for EUR 14 million, with a EUR 1 million loss.

Case 2

144. The bank, as part of a consortium of five banks, has extended a five-year EUR 15 million loan (corresponding to a share of total funding of 20%) to a borrowing entity owned by an investment fund to finance the purchase of an office building at an interest rate of 5% fixed with monthly payments based on an amortisation of 20 years. The building is the entity's only asset; however, the loan is guaranteed by a third party. At origination, the loan had a 75% loan-to-value (LTV) ratio based on an independent appraisal reflecting a EUR 20 million market value, a debt service coverage ratio of 1.35x (net operating income/debt service). The borrower is rated BBB at origination.

145. The following scenarios and subscenarios are independent from each other.

Scenario A: In year three, a major tenant has notified the borrower that it will not renew its lease, which expires in three months. While the leasing market is stable, it is not known how long it will take to find a new tenant to lease this very large space. The pro forma debt service coverage ratio (net operating income/debt service) without the tenant is 0.85x. Payments on the loan remain current. A review of the guarantor's cash flow shows an inability to support the debt service should it be required. The current balance of the loan is EUR 14 million and the value of the building is now EUR 12 million for an LTV of 115%.

Scenario B: In year three, net operating income has declined such that the debt service coverage ratio is 0.85x. Current balance of the loan is EUR 14 million and the current value of the building is EUR 12 million for an LTV of 110%. Payments remain current. Using these facts, consider each of these alternative scenarios:

- (i) A review of the guarantor's cash flow shows an inability to support the debt service.
- (ii) A guarantor cash flow analysis demonstrates that the guarantor could cover the debt service for the foreseeable future.

Scenario C: By the end of year four, debt service coverage has declined to 0.85x and the loan is over 90 days past due. The loan outstanding balance is EUR 13 million and the current value of the collateral is EUR 12 million for a current LTV of 110%. Using these facts, consider each of these alternative scenarios:

- (i) The lender has renewed the loan (ie granted a new loan that repaid and replaced the previous loan) at a below-market rate with an extended amortisation period such that the debt service coverage is now 1.12x.
- (ii) The lender has renewed the outstanding balance (ie granted a new loan that repaid and replaced the previous loan) utilising two loans. The first loan (the "A" loan) was in the amount of EUR 11 million on market terms with a debt service coverage of 1.12x. The remaining EUR 2 million was financed with a second loan (the "B" loan) with a below-market rate of interest of 2%, interest only.
- (iii) The lender forgives the past due interest and postpones the payment of all interest due during year five until the end of that year.
- (iv) The guarantor is deemed uncollectible and the counterparty transfers a 100% ownership interest in the building to the consortium of banks worth 100% of the building value (in this case EUR 13 million) in exchange for full forgiveness of the loan.

Scenario D: Similar to scenario C, but the loan is estimated to be 50% of the current value of the building at the transaction date (ie the value of the building increased from EUR 20 million to EUR 26 million). Using these facts, please consider scenarios (i) and (iii) described above.

Case 3

146. The bank has granted a 10-year mortgage loan to a retail customer for an amount of EUR 100,000 with a fixed interest rate of 3%. The loan amortises according to a constant amortisation schedule. The value of the collateral is EUR 110,000. The borrower is well qualified with a total debt payments to income (or debt-to-income) ratio of 33%. For the first three years, the loan remained current with all payments made as agreed.

147. The following scenarios and subscenarios are independent from each other.

Scenario A: At the end of year four, the retail customer has regularly been 30 days late in his payments. The bank has become aware that he has lost his job and, while he has been hired recently by another company, it is at a lower salary. Consequently, to avoid the situation becoming unsustainable for its retail customer, the bank has agreed to extend the loan period for two additional years at a lower than market rate of 2.75%. The value of the collateral is unchanged. The loan balance is EUR 64,000.

Scenario B: Similar to Scenario A. To avoid the situation becoming unsustainable for its retail customer, the bank agrees to let the customer make use of provisions in the loan contract allowing him to suspend payments on the loan for a three-month period.

Scenario C: Assuming the facts in the original case, at the end of year five, the borrower has fallen behind in his payments and has become more than 90 days past due. The lender agrees to permit the borrower to, and the borrower does, sell the property to pay back the loan for EUR 15,000 less than the loan amount. Using these facts, consider each of these alternative scenarios:

- (i) The borrower is released from his obligation to repay the remaining balance.
- (ii) The borrower is not released from his obligation to repay the remaining balance.
 - (a) The borrower has the capacity, and expresses a willingness, to repay the deficiency.
 - (b) The borrower does not have the capacity to repay the deficiency.

Case 4

148. The bank has extended a EUR 5,000 unsecured revolving line of credit (credit card loan) to a retail borrower. The loan agreement requires minimum monthly payments that include all interest and fees, plus 1% of the outstanding principal balance. When underwritten, the borrower's loan application showed a mortgage loan and an auto loan outstanding with other banks. The borrower had no history of delinquency, was employed for five years and showed income adequate to service all debts with a total monthly debt service (including minimum payments under the subject credit card line) that equalled 35% of the borrower's gross monthly income.

149. The following scenarios and subscenarios are independent from each other.

Scenario A: The outstanding balance is EUR 3,800 and the account is current. The borrower recently contacted the bank and informed them that he has lost his job and is now living off savings. Although he seemed optimistic and hoped to find another job shortly, he asked what kind of alternative arrangements could be made for repayment if he failed to find a new job soon. The loan has not been restructured and the original terms remain in effect.

Scenario B: The outstanding balance is EUR 3,800, and payments on the credit card line are 90 days past due. The bank has been unable to contact the borrower to discuss the situation.

Scenario C: The outstanding balance is EUR 3,800 and the account has been 90 days past due. However, the borrower, who had been unemployed, has now contacted the bank and told them he has found a job paying close to his old salary and wishes to resume payments. He has been making full monthly payments for the last six months, but has not made any of the outstanding past due payments associated with his prior delinquency.

Scenario D: The outstanding balance is EUR 3,800 and the account is more than 120 days past due. After a number of attempts, the bank was able to make contact with the borrower to discuss his situation. The borrower said he has lost his job and is now living off savings. He seemed optimistic and hoped to find another job shortly but was unwilling to make a payment on the credit card.

Scenario E: The outstanding balance is EUR 3,800 and the account is 120 days past due. Discussions with the borrower indicated that he has lost his full-time job and is working part-time while looking for full-time employment. Based on the part-time employment, the bank has enrolled the borrower in a six-month workout programme that temporarily lowered his monthly payments to EUR 25 per month in the hope that he would soon find full-time employment. The borrower has now made six consecutive EUR 25 payments under the workout agreement, but has not made any other past due payments. The borrower remains 120 days past due and indicates he cannot make the resumed contractual minimum monthly payment.

Scenario F: The outstanding balance is EUR 3,800 and the account is 180 days past due. The borrower is unemployed and has been unable to find full-time employment. There is no indication that he has sufficient funds to make the monthly payments and the bank is now unable to contact the borrower.