Basel Committee on Banking Supervision's consultative document on the prudential treatment of problem assets – definitions of non performing exposures and forbearance

Insight Investment response

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A BNY MELLON COMPANY℠

Insight INVESTMENT

Summary

Insight Investment is an investment management firm with offices in London, New York, Sydney and Tokyo. We specialise in fixed income instruments and liability-driven investment management. We manage over €555 billion[1] (at March 2016) of assets for institutional clients including pension funds, sovereign wealth funds, charities and corporations.

As an asset manager investing in bank bonds across the world, we commend the development of the Basel Committee on Banking Supervision's consultative document on the prudential treatment of problem assets – definitions of non-performing exposures (NPEs) and forbearance. We believe that it is critically important for financial institutions to disclose NPE and forbearance data to help investors analyse the strength, quality and potential risks of individual issuers/securitised instruments.

We support the adoption in full of a consistent definition of non-performing exposures for categorising loans and debt securities, to be adopted by institutions across the 28 jurisdictions surveyed and beyond. We believe the Committee's proposals have the potential to significantly enhance reporting quality, which may improve investment opportunities and capital flows.

We have provided a summary of our key observations for the Committee to consider and explain the points in more detail in the following pages. We would be happy to discuss these further.

Summary of key observations

1) **Scope of disclosure**
2) **Definition of impairment**
3) **Definition of NPE by delinquency status**
4) **Criteria for exit from forbearance category**
5) **Trading book exposures**
6) **Frequency of NPE and forbearance assets disclosure**
7) **Granularity of disclosure by country**
8) **Interest accrual status**
9) **Movements in NPEs intra-period**

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Scope of disclosure

We consider standardisation of NPE definitions across countries to be positive. However, Insight would like to see a breakdown of NPE and forbearance exposures on an on-balance sheet-only basis, as well as on- and off-balance sheet basis. This is because off-balance sheet exposures have not necessarily materialised. Including all on- and off-balance sheet exposures together would distort the NPE ratios of those banks with significant volumes of corporate guarantees and contingent liabilities, while retail banks would typically be less affected.

Inconsistent disclosure by banks on their net and gross NPE and forbearance assets has been identified by the Committee as a risk. We share that view and welcome the suggestion to mandate the disclosure of both gross and net of provision basis, excluding collateral. Currently, a few institutions will provide a net figure only, which has less information content.

Definition of impairment

There are currently multiple definitions of 'impairment', and we consider it especially important for investors and banks alike to follow a more consistent definition. While IFRS and US GAAP are the principal global standards, there are still numerous local accounting standards used around the world, and we would encourage the Committee to explicitly define impairment. This definition could be taken from IFRS or US GAAP, but it is important that one single definition is used.

Definition of NPE by delinquency status

While we support the use of a single consistent number of days past due for the definition of an NPE (if not otherwise impaired, see above), and believe 90 days is a reasonable choice, it does throw up some complications.

For example, where banks structure loans as a series of rolling short term exposures, or where there is a payment holiday for several periods, it may be that the exposure never becomes 90 days overdue. It is important that the definition of NPE is sufficiently broad to capture deterioration in these exposures.

We would also be wary of encouraging banks to only report their 90 day delinquencies, and no other delinquency data. In some jurisdictions (particularly those which have significant volumes of international debt to refinance, and therefore need to demonstrate their performance stats to investors on a regular basis) and for some product lines (e.g. payday loans), banks currently report 15, 30, 60 and 90 day arrears. This disclosure is extremely useful, and it would be inappropriate to risk losing this granularity for the sake of compliance with a "Basel standard" of 90 days.

Criteria for exit from forbearance category

Looking at the criteria for exit from NPE or forbearance disclosures, we consider the one-year recommendation too short. This is especially the case in emerging markets given the length of grace periods and payment holidays seen in many jurisdictions. We would prefer to see restructured loans reported in the forbearance category for at least 2 years, if not longer, and ideally would like to see them remain in the category indefinitely (once forborne, always forborne).

Trading book exposures

We would like to see the scope extended to the trading book, as well as the banking book. Some large investment banks or brokerages may have relatively large losses on their balance sheet that the consultation paper does not capture (e.g. leveraged loans, bonds, loans repackaged as securities). Looking only at the banking book does not give a full picture of the performance of a bank's credit exposures.

We would argue that all credit exposures, wherever they are booked, should be included in NPE and forbearance data. We are aware of several jurisdictions where banks have repackaged a significant volume of loans as traded securities, specifically to avoid disclosing the exposures in the NPE categories.

Frequency of NPE and forbearance assets disclosure

We have observed significant discrepancies in the frequency of disclosure across geographies and institutions.

Although standards have improved since 2008, we consider that banks should disclose NPE and forbearance of assets information on a quarterly basis. Once or twice a year does not provide enough information to the market. We would therefore find it useful for the Committee to recommend a quarterly disclosure.

Granularity of disclosure by country

For banks operating in multiple geographies, we generally experience both excellent and very poor disclosure. We think it would be useful for the Committee to widen the disclosure recommendation to include country-by-country information. We consider single lines could mask a wide variety of underlying credit risks and quality of controls.

Interest accrual status

We agree with the Committee's suggestion in point 35 requiring disclosure of the accrual/non-accrual status of NPEs, as this can make a material difference to a banks' income statement and therefore also to management's approach to dealing with the NPEs. Market participants need to assess the extent to which accrued interest and fees on NPEs is included in interest income. This is particularly relevant for some markets where, for example, over 50% of loans are non-performing but interest income is still accruing, even though the cash flow statement shows it is not being received.

Movements in NPEs intra-period

It is important that disclosure captures movements in NPEs, such as write-offs and NPEs sold during the period. Simply giving a stock of NPEs at a particular balance sheet date does not give meaningful information about the quality of the bank's credit exposures. Banks in several jurisdictions regularly sell portfolios of NPLs just before year-end (occasionally to related parties, and sometimes without full risk transfer). Some local regulators have recognised the problem and are responding, but a more uniform standard is required.

Should you have any questions in relation to the issues raised above please do not hesitate to contact ri@insightinvestment.com.

Yours sincerely,

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