IN-DEPTH ANALYSIS

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Provisioning policies for non-performing loans: How to best ensure a "clean balance sheet"?

Banking Union Scrutiny

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Provisioning policies for non-performing loans: How to best ensure a "clean balance sheet"?

Abstract

Non-performing loans (NPLs) are still an important problem in Europe, in particular in the euro area. Provisioning is one way to address such a problem. Although coverage ratios have been increasing in recent years, banks' provisioning policies are quite different across banks and countries. Various reasons, ranging from different collateral characteristics and enforcement systems to tax regimes, accounting methods, managerial and supervisory practises, contribute to explain the observed differences. Recent measures aimed at increasing transparency and disclosure rules and the adoption of new accounting rules are an important step forward. They have to be complemented, however, by appropriate early intervention measures and effective supervisory power.

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LIST OF ABBREVIATIONS

AQR Asset quality review

BCBS Basel Committee on Banking Supervision

EBA European Banking Authority

ECB European Central Bank

ECL Expected credit losses

EU European Union

GDP Gross domestic product

IAS International Accounting Standards

IASB International Accounting Standards Board

IFRS International financial reporting standards

LLPs Loan loss provisions

NPEs Non-performing exposures

NPLs Non-performing loans

RWAs Risk-weighted assets

SMEs Small-medium enterprises

SSM Single Supervisory Mechanism

EXECUTIVE SUMMARY

The 2014 asset quality review (AQR), the first step of the comprehensive assessment was carried out to enhance the quality of information on conditions of banks across Europe. From that time onward resolving non-performing loans (NPLs) has become a priority to restore asset quality in European banks and several initiatives have been undertaken at both national and supranational level. In fact, measuring bank asset quality is not always straightforward due to vast heterogeneity of business models, accounting rules and supervisory practices across banks and countries.

This paper focuses on provisioning policies with the objective of understanding whether and to which extent larger provisions can mitigate the riskiness associated to high stock of NPLs. To this end, it first presents some key concepts and stylized facts on the main indicators of asset quality in European banks. In reporting these stylised facts, the paper sheds some light on the main sources of discrepancies across banks and countries and argues that provisioning policies are not always motivated by credit risk consideration. Other motives can explain diversity across banks and countries, including different accounting approaches and national supervisors' practices, as well as banks' strategical, discretionary behaviors.

To address these issues and reduce unjustified differences across banks' practices, two major changes in the institutional framework are about to be in place: the new international financial reporting standard (IFRS 9) and the European Central Bank (ECB)'s guidelines on NPLs. Both measures, which will become effective as of January 2018, are expected to have a relevant impact on banks' behavior. At the same time, however, they contain some potential drawbacks associated to their implementation. In particular, the introduction of these new rules and guidelines will entail higher costs and complexity for banks, not only in terms of increased provisions, but also because of potential higher disclosure, implementation, modelling and reporting costs.

To make the process successful and avoid undesired behaviour by banks (such as strategic provisioning for purposes unrelated to credit risk consideration), greater coordination among main stakeholders (regulators, supervisors, accounting authorities, and banks' auditors) is needed. Moreover, any unnecessary complexity and burden (especially for smaller banks) should be discouraged considering that simpler models and approaches are easier to understand and back-test, at the advantage of better governance, higher transparency and more effective control by auditors and supervisors.

1. INTRODUCTION

Transparency, repair and confidence building have been priorities to the ECB since the 2014 comprehensive assessment preceding the introduction of the Single Supervisor Mechanism (SSM). The AQR, the first step of the comprehensive assessment, was carried out to enhance the quality of information on conditions of banks across Europe. In such a context, resolving NPLs has become priority to restore asset quality in European banks.[1] In fact, NPLs still stand at more than 900 billion euros in banks directly supervised by the ECB. Such a stock of problem loans represent nearly 9% of the gross domestic product (GDP) and 6% of all loans in the euro area, with large variety across banks and countries (Constâncio, 2017).

This large amount of NPLs is likely to have several micro and macro-prudential effects (Aiyar et al., 2015). In particular, a high level of NPLs makes it harder for investors and other stakeholders to assess asset value and exert market discipline. A lack of transparency may lead to higher funding costs, reduce banks' profits and, by these means, decrease banks' capital. Higher funding and capital constraints are likely to reduce credit supply, with potential negative effects on the real economy. Given the dominance of bank lending in corporate sector finance in Europe, high NPLs are also likely to impair monetary transmission, as credit supply remains heavily influenced by the lending behavior of banks. Moreover, in countries where banks hold large levels of troubled assets, the feedback from bank risk into sovereign risk (the so called "diabolic loop") can be reinforced (Erce, 2015). Spillovers from weaker banks and weaker countries are possible, posing a threat to the economic growth and financial stability of the whole area (IMF, 2015; European Parliament, 2016).

Because of these side effects, the ECB has been outlining the importance of improving asset quality for some time already. In an attempt to clearly identify the magnitude of the problem, in the 2014 comprehensive assessment of 130 euro area banks, the ECB applied for the first time a common definition of non-performing exposure (NPE), i.e., an exposure that is 90 days past due (quantitative criteria) or unlikely to be paid without collateral realisation (qualitative criteria), even if it is not recognised as defaulted or impaired for capital or accounting purposes.[2] The exercise resulted into increased NPEs of nearly euro 140 billion (+18.4%) and higher provisions for euro 45 million (+ 12%) (EBA, 2015). Recently, in March 2017, the ECB published a guidance to banks on how to recognize, provision and resolve NPLs. In October 2017, the ECB complemented this guidance by providing quantitative indications concerning minimum levels of prudential provisions.

Against this background, the paper starts by describing the potential implications of high NPLs for asset quality and lending policies. Then, it presents some stylized facts on the asset quality and provisioning policies of European banks, highlighting the discrepancies across banks and countries and discussing the potential motivations behind them. Particular emphasis is then given to the determinants of banks' provisioning policies, as well as to the recent measures adopted to restore asset quality and favor market discipline through greater transparency and comparability. The paper

[1] There is no global standard definition of NPLs. To reduce uncertainty, the European Banking Authority (EBA) proposed in 2014 harmonized forbearance and non-performing exposures definitions to apply to all loans and debt securities on-balance-sheet (EBA, 2015). In this paper NPLs, NPEs, impaired, troubled, and bad loans are used as synonyms, although we are aware of the fact that, across jurisdictions and even across banks, there might be different meanings associated to these definitions (Bholat et al., 2016; BCBS, 2017a).

[2] Precisely, according to EBA's definition, an NPL is every exposure that is 90 days past due or unlikely to be paid without collateral realization, even if it is not recognized as defaulted or impaired. In addition, any exposure to a debtor has to be considered non-performing when its on-balance sheet 90 days past-due reaches 20% of the outstanding amount of total on-balance sheet exposure to that debtor. Furthermore, NPLs that are forborne do not exit this classification before one year over which the debtor has to prove its ability to meet the restructured conditions, even if forbearance has led to the exit from default or impairment classes.

concludes by illustrating the main contents and some critical aspects related to the new accounting standard (the IFRS 9) and the ECB's guidelines on NPLs, which will be applied starting from January 2018.

2. ASSET QUALITY AND NPLS: KEY CONCEPTS

Assessing the value of loan portfolios is key to measure the asset quality of institutions, such as banks, for which lending is a core business. A common and comprehensive measure of asset quality is the NPL ratio, i.e., the share of non-performing loans to a bank's total loans. The idea is that a large share of these assets increases banks' opacity (Kishan and Opiela, 2012), making it harder for investors to assess the bank's asset value and, hence, to exercise market discipline. This occurs for several reasons.

First, practices how to categorize and when to recognize NPLs have been notoriously inhomogeneous among banks and countries in Europe, making intertemporal and cross-country analysis barely comparable. Practices vary due to the absence of a consistent international framework guiding banks and supervisors on how to categorize problem loans. The influence of local accounting, regulatory, legal, or tax standards leads to situations where, even when similar terms are used, one category bearing the same name in different jurisdictions or banks does not actually cover loans with the same degree of credit risk.[3] In addition, different practices exist for the treatment of collateral, the criteria for income recognition, tax regimes for loan loss provisions and the frequency of assessment for updates. This can create inconsistencies in the amounts of problem loans reported and in the financial and regulatory indicators used by supervisors and analysts to monitor banks. Moreover, the categorisation schemes can be heterogeneous in nature as they may serve different purposes, e.g., the implementation of the accounting framework and the prudential regulation framework or supervisory reporting (BCBS, 2017a).

Second, NPLs is an aggregate including exposures with different degree of creditworthiness, from the past-due category (those that are overdrawn and/or past-due by more than 90 days and for above a predefined amount) to bad loans (exposures to debtors that are insolvent or in substantially similar circumstances), according to the EBA's definition. Hence, unless an accurate detail of NPL portfolio composition is provided, banks holding similar share of NPLs might be, at least in principle, in very different conditions.

Third, some of the exposures labelled as NPLs are adequately collateralized while others are not. The size and quality of the collateral clearly affect the loan portfolio value because they have an impact on the expected losses associated with the loans. The recovery rate of a loan, however, depends on the type of collateral as well as on the enforcement procedure and on the strength of the legal and judicial framework. Weak debt enforcement procedures and ineffective insolvency framework increase the cost of asset recovery and prevent the timely resolution of NPLs. All these factors may vary bank by bank, country by country and discrepancies may exist even within each country.[4]

[3] Drivers for the observed differences include the use of gross or net exposures or the use of a quantitative approach (number of days past due) or a qualitative approach (borrower's financial difficulty or unlikeliness to pay) for categorisation. See Bholat et al. (2016) and BCBS (2017a) on the divergences in the categorization of NPLs.

[4] See Song 2002 on the differences across countries as for the role of collateral in loan classification and provisioning. See IMF (2015), ECB (2016b) and EBA (2016) on differences across national debt enforcement and insolvency regimes in Europe. See Schiantarelli et al. (2016) for an analysis of the effect of the different degree of local judicial efficiency in Italy.

Fourth, all these issues are aggravated by limited disclosure and a generalised lack of detailed and standardized documents on borrowers' loan and collateral characteristics, which exacerbate informational asymmetry, reduce comparability and help explain why the European secondary market for problem loans is still in its infancy (ECB, 2016a).

Besides the level and composition of NPLs, a further aspect to take into account in assessing bank asset quality is whether problem loans are adequately provisioned. Timely and adequate provisions, in fact, mitigate some the concerns associated to holding large stock of NPLs and thus, may contribute to restore asset quality (Constâncio, 2017).

First and foremost, provisioning is a credit risk management tool through which banks alleviate credit risk by setting aside a given amount, referred to as loan loss provision (LLP), as a buffer to absorb expected losses associated to a loan. LLPs allow banks to recognize the estimated loss in their profit and loss statements, even before the actual loss can be determined with accuracy and certainty as events unfold. The stock of LLPs accumulated over years is referred to as loan loss reserves. When loan losses eventually materialize, banks can draw on these reserves, thereby absorbing the losses without impairing capital and preserving banks' capacity to continue extending credit to the economy. Ideally, provisions should anticipate deteriorating economic conditions that may affect borrowers' ability to repay. In such a way, they can be used to cover expected losses, while bank capital serves as a buffer against unexpected losses (Laeven and Majnoni, 2003).

A meaningful indicator to measure the protection degree of problem loans is the coverage ratio, i.e., the share of loan loss reserves over the stock of NPLs. Adequate provisions (sufficiently high coverage ratios) are key to improve transparency because loan contracts are commonly illiquid and not traded; hence, there is no market value, which is approximated through the process of provisioning. The provisioning is in fact equivalent to reducing a loan's original value to its (estimated) present value, taking into account the level of impairment of the loan (Song, 2002). Conversely, if the level of provisions were underestimated, banks' balance sheets would be distorted and capital ratios overstated. Provisions have, in fact, a direct impact on profit and losses account and, through it, on bank capital.

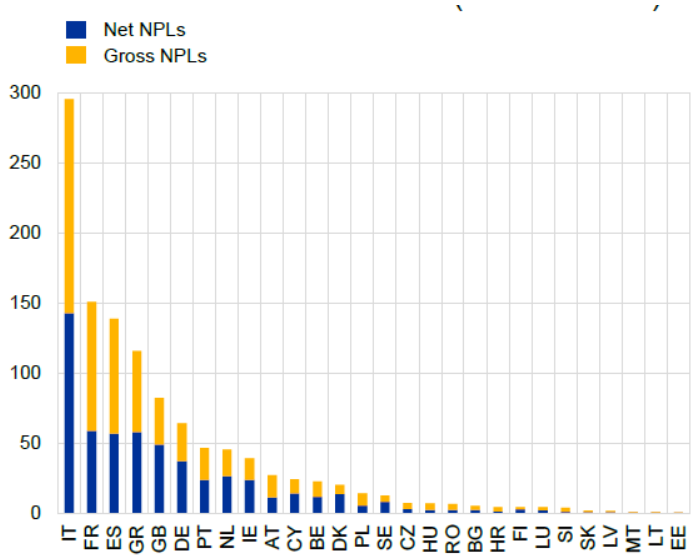
Furthermore, adequately provisioned loans make asset disposal more likely, which can help banks clean balance sheets and restore asset quality quickly. In fact, high coverage ratios correspond to low loan book value. Having moderate NPL book values is a precondition to reduce the bid-ask spread between loan buyers and sellers as it makes any disposal loss more bearable for selling banks. This is key to make banks more willing to sell-off distressed loans in the secondary market (ECB, 2016a).

At the same time, it is worth noticing that low coverage ratios do not necessarily imply under-provisioning and delayed recognition of losses as they may reflect, at least in principle, rigorous lending practices or strong insolvency frameworks, where for example repossession is easy for creditors (European Parliament, 2016). Nevertheless, in a context of poor bank loan quality, low coverage ratios may represent a potential source of instability in that any future loss on the loan portfolio, if not sufficiently provisioned, would be covered by bank capital. This would make banks with large volume of NPLs and moderate coverage ratios more vulnerable to negative shocks affecting borrowers' credit quality, especially in crisis years.

3. NPLS AND COVERAGE RATIOS: STYLIZED FACTS FROM EUROPEAN BANKS

The gross carrying amount of NPLs in the banking system in the European Union (EU) at the end of 2016 amounted to just below EUR 1 trillion, with remarkable discrepancies across banks and countries (ESRB, 2017a). Nearly 38% of this amount is held by banks in member countries with an NPL ratio below the EU average of 5.1%, while about 47% of the overall NPLs appear on the balance sheets of banks in member countries with an NPL ratio greater than 10%. This data show that the NPLs is concentrated in a few countries. In fact, almost 90% of the overall amount of NPLs in the EU is located in ten countries (Figure 1).

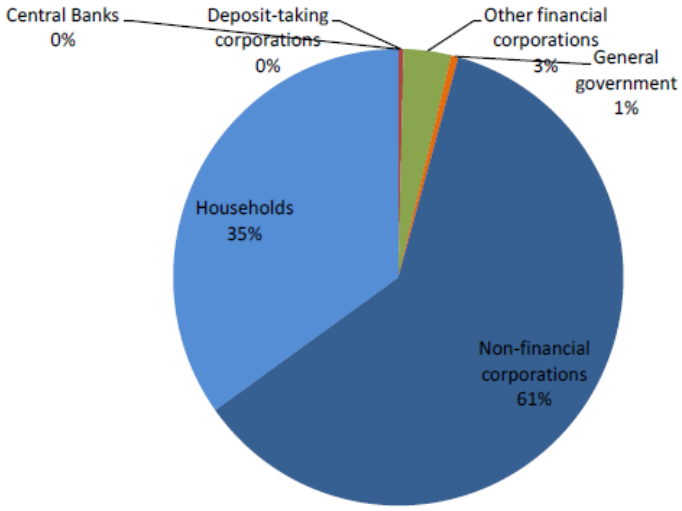
Figure 1: Gross and net NPLs (EUR billions)



Source: ESRB Secretariat based on ECB Consolidated Banking Data

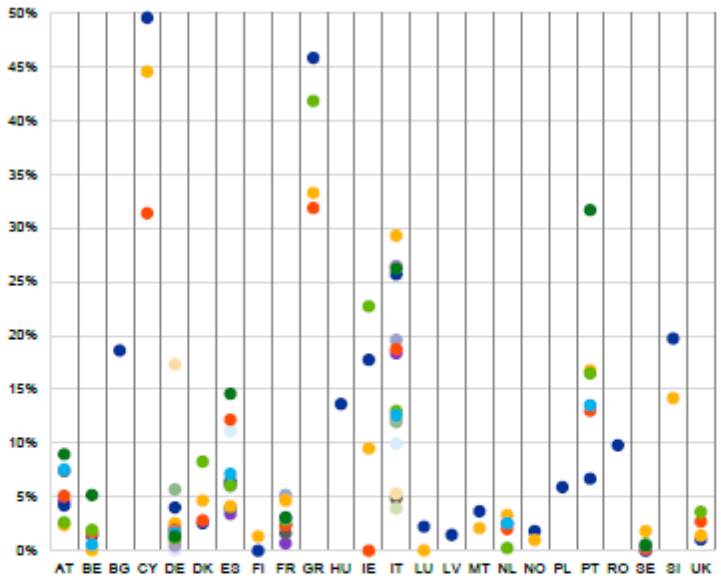
Variation also exists within countries and concerning the composition of the NPL portfolio. While the stock of NPLs in Europe comprises almost exclusively (approx. 96%, Figure 2) loans to businesses and to households, data at national level show large variety (Figure 3). In some countries risky exposures are concentrated in the real estate industry (e.g., Ireland and Spain) or in the corporate sector, especially to small-medium enterprises (SMEs, e.g., Italy); in others, problem loans are scattered across several asset classes. Such a distinction is relevant because it may explain differences in probabilities of default (which tend to be higher for SMEs *vis-à-vis* larger firms), recovery rates (being higher for loans secured by real estate properties such as loans to households, which are mainly mortgages) and, hence, in the expected losses associated to these loans (ESRB, 2017a). Beyond these differences at the loan portfolio level, other idiosyncratic reasons may explain within-country asset quality variation, including differences in managerial ability and risk management procedures (Aiyar et al., 2015).

Figure 2: Composition of the stock of NPLs (%)



Source: ESRB Secretariat based on ECB Consolidated Banking Data

Figure 3: Distribution of NPL ratios within EU countries (% of gross debt instruments)

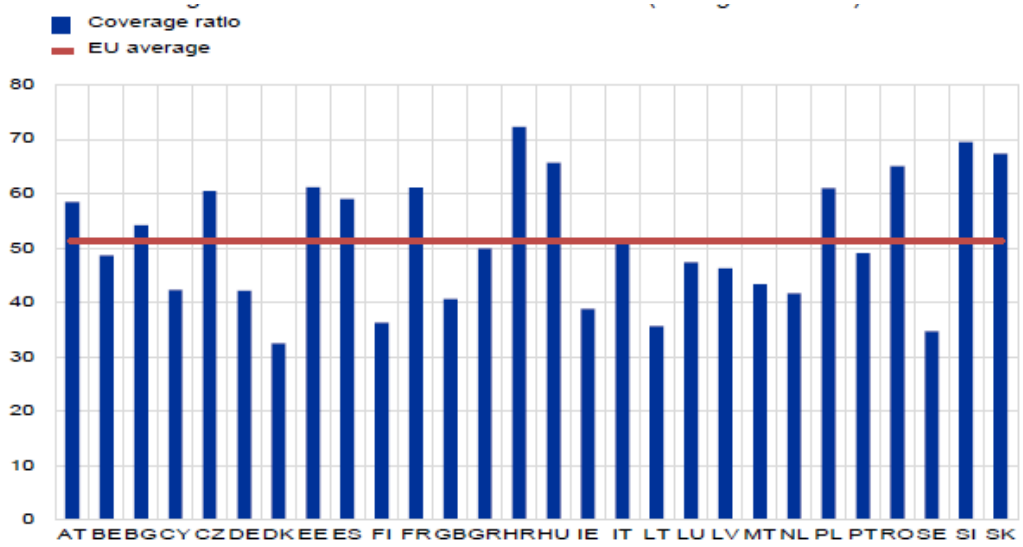


Source: EBA, 2016 Transparency Exercise

(Note: NPL ratios disclosed by individual banks, illustrated by color dots)

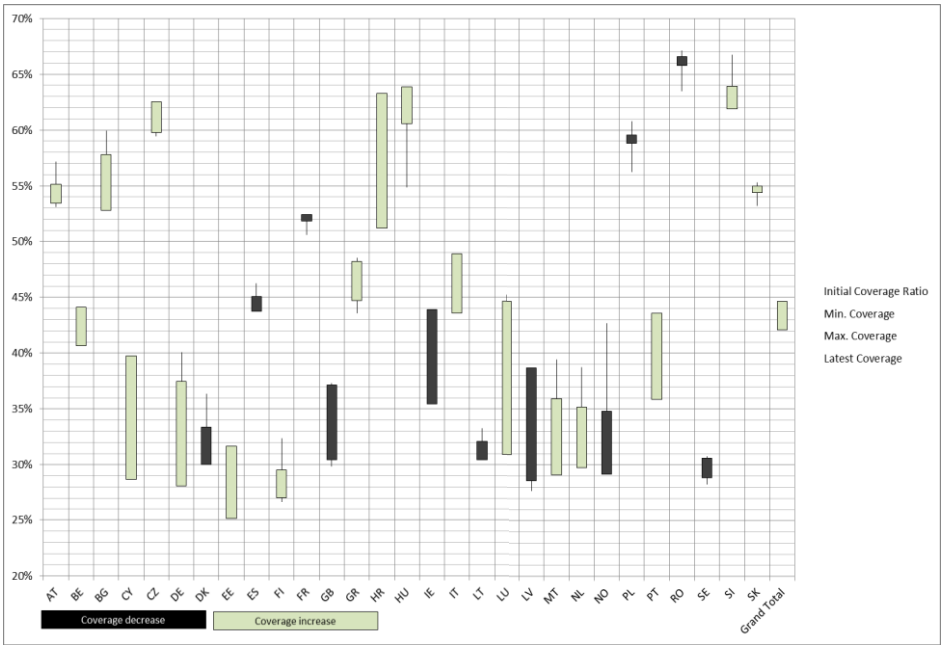
Coverage ratios in the EU also differ across banks and countries both in terms of level and evolution (Figures 4 and 5), and according to the size of banks (Figure 6). Figure 6, in particular, shows that, on average, smaller banks are featured by lower coverage ratios; it seems, however, that they have made a great effort, since 2014, to strengthen their provisioning policies and have coverage ratios more aligned to those of larger institutions.

Figure 4: Coverage ratios (% of gross loans)



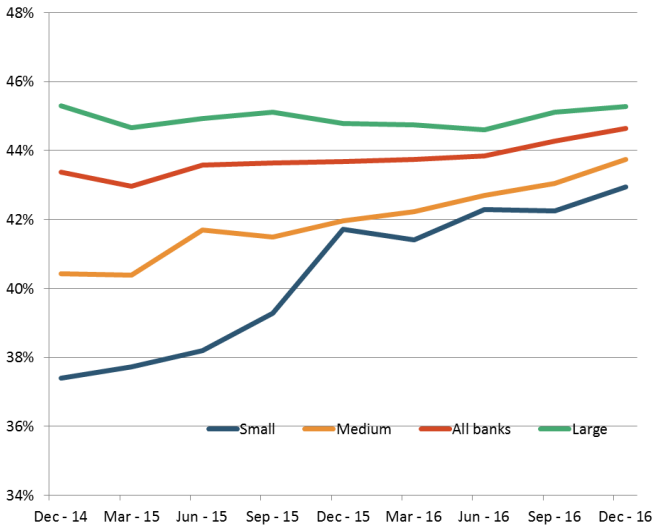
Source: ESRB Secretariat based on ECB Consolidated Data

Figure 5: Change in coverage ratios by countries since September 2014 (%)



Source: EBA, Report on the dynamic of NPEs in EU banking sector (11 July 2016)

Figure 6: Coverage ratios by bank size (%)



Source: Report of the FSC group on NPLs (31 May 2017) based on EBA data

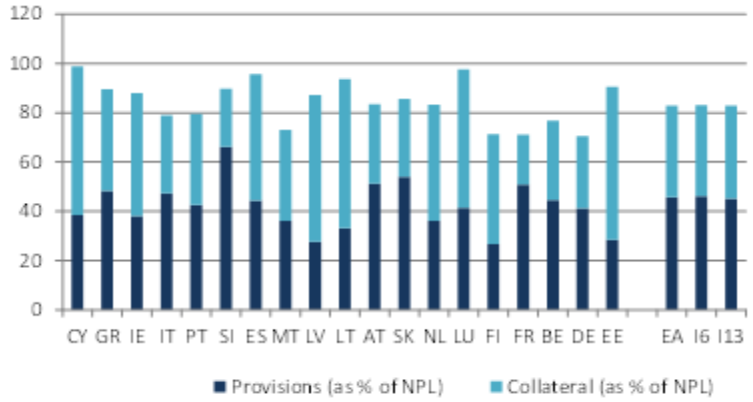
Over time, coverage ratios have increased among most countries facing high NPL ratios, in particular since September 2014. This may be due to stricter supervisory and regulatory scrutiny in relation to AQR exercises, increased market pressures, as well as negative developments of collateral values leading to higher impairment (Council of the European Commission, 2017).

4. PROVISIONING POLICIES: WHY DIFFERENT ACROSS BANKS AND COUNTRIES?

Comparing coverage ratios across banks and jurisdictions is not always a meaningful way to assess the level of residual risks associated to banks' NPL portfolios. Heterogeneity in banks' provisioning policies may, in fact, depend on a number of factors that goes beyond the level of NPLs, which are often difficult to disentangle. In fact, as shown by the EBA in a recent report (EBA, 2016), the correlation between NPL and coverage ratios is low over time (with a correlation coefficient close to 0 at least since September 2014). This suggests that coverage ratios may be linked to additional factors.

Collateralization may play a relevant role in explaining provisioning policies across banks, since the quality and the amount of collateral affect loan recovery rates and, therefore, loan expected losses. In principle, as they are perceived as less risky, well collateralised loans may require reduced provisions and thus, lower coverage ratios. On average, in the euro area more than 80% of NPLs are covered through either collateral or provisions (Figure 7).

Figure 7: Provisioning and collateral (% of NPLs)

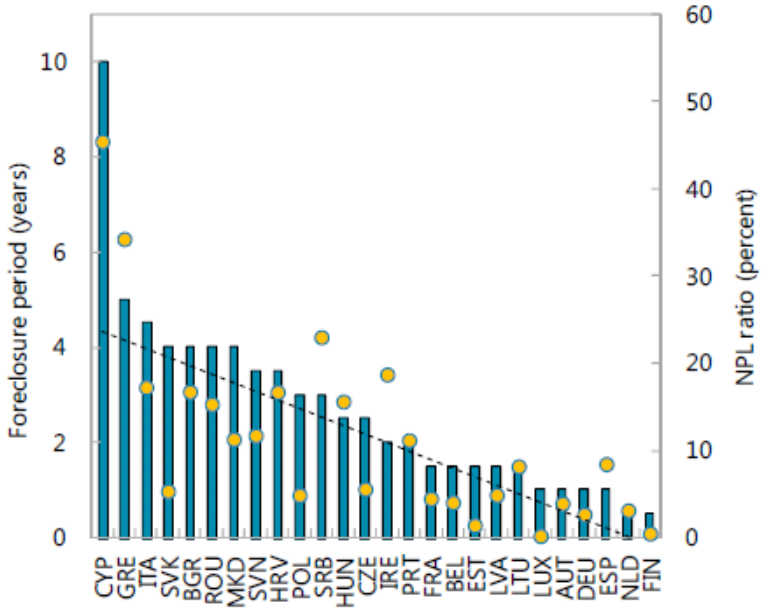


Source: V. Constâncio, Resolving Europe's NPL burden (7 Feb 2017)
based on ECB Supervisory Statistics (Note: Countries ordered by NPL ratio. I6 are High-NPL countries: CY, GR, IE, IT, PT, and SI; I13 are other euro area countries)

Taking at face value, this number would suggest that only 20% of the NPLs stock in the euro area represents a true risk to bank balance sheet, being the residual covered. However, the extent to which the protection offered by collateral is effective depends on the characteristics of the underlying asset market as well as on the actual accessibility to that collateral. For example, collateral is an effective protection to bank balance sheet as long as its present value is not eroded by lengthy and costly enforcement procedures (Constâncio, 2017). Consistently, coverage ratios should be higher for loan portfolios featured by higher loan-to-value ratios (i.e., the outstanding loan amount over the market value of the collateral) and/or when the enforcement procedures to access to that collateral are long and ineffective.

As discussed in Section 2, large discrepancies exist in Europe in the characteristics of national legal and judicial frameworks. For example, the average length of foreclosure proceedings in Italy is almost five years compared to less than one year in Germany and Spain (Figure 8). Differences may emerge within countries, too: while civil law and procedures are formally the same across the national territory, the effectiveness of the court system may vary widely, depending upon local jurisdictional court proceedings (see Schiantarelli et al., 2015 for the Italian case).

Figure 8: Average time to foreclosure (yrs.) and NPL ratios (%)



Source: IMF country report No 15/205 (Note: Data refer to 2014)

National tax regimes can also play a role in influencing provision policies. In some countries, charge offs and/or losses as a result of higher provisions are not eligible (or are subject to a certain cap) as deductions for income tax purposes. For example, until recently the tax treatment in Italy penalized banks that wrote off problem loans more aggressively, allowing tax deductibility for write-offs only in the state of insolvency. Tax deductibility of LLPs was limited to 0.3% of outstanding loans, a clear disincentive to provisioning (IMF, 2015). A 2013 reform allowed provisions and write-offs to be fully deducted in equal instalments over five years, and with a higher tax rate; in June 2015, this period was further shortened to a year.[5]

Another driver of heterogeneity in provisioning policies is the prevalent accounting standard. Banks under different accounting standards are, in fact, likely to show different provisioning (by timing and amount). In most, but not all, European countries, the current provisioning system is the international accounting standard (IAS) 39, an approach requiring to make provisions depending on credit losses that have been incurred as of the balance sheet date, rather than on probable future (expected) losses. This provisioning system is considered to be backward-looking because loss identification is based on the occurrence of historical "triggering" events (e.g., borrower's loss of employment), which caused delayed and scarce provisioning during the crisis years (BIS, 2017). However, some countries and some banks in Europe adopt different approaches. Notably, Spanish banks have introduced since 2000 a different, more forward-looking provisioning regime, which was intended to address procyclicality issues and which led, at least at a first stage, to more timely and higher general provisions (de Lis et al., 2010; Jiménez et al., 2017).[6] In addition, there are banks in

[5] To take another example, Spain recently eliminated taxes on debt-to-equity swaps in a similar move to encourage banks to recognize losses from impaired assets (IMF, 2015).

[6] Dynamic provisions were first set up in Spain in 2000 (commonly known at that time as statistical provisions), and were modified in 2005 to comply and to be consistent with IFRS. Since then, formally, the provision took the name of general provision (while more informally it has been called dynamic provision.

Europe that have opted for an earlier adoption of IFRS 9, the new accounting standard that will officially replace the IAS 39 starting January 2018.

Irrespective of the accounting system in use in the country, because accounting standards set only general principles, details for implementation are often left to reporting entities and national supervisors. It follows that bank managers may exploit such a discretion for purposes unrelated to credit risk considerations, including: 1) to smooth income; 2) to manage capital; and 3) to signal financial strength (see ESRB, 2017b and related literature therein). As their importance may vary across banks, these considerations may be important explanations of the differences in provisioning policies across banks.

The income-smoothing hypothesis in LLPs states that banks provision during times of higher earnings in order to smooth profits over time: when earning are expected to be low, provisions are deliberately understated to mitigate the adverse effect of other factors on earnings; the contrary when earning are thought to be high. Hence, under this income-smoothing behavior banks' provisioning policy is used to minimize the variance of reported earnings.

Concerning capital management purposes, capital constrained banks may have the incentive to use provisions to achieve regulatory capital targets. For example, and simplifying, higher provisions, by reducing earning (net of tax effect), have a mechanical detrimental effect on Tier 1. In fact, an increase in (general) provisions may actually increase Tier 2 capital (with different limits depending on whether banks use the standardized or the internal rating based approach). If the Tier 2 increase exceeds the decrease in Tier 1 capital, then (general) provisions may *de facto* increase regulatory capital.[7]

A third managerial behavior associated to provisioning relates to signaling financial strength. The idea is that banks may want to increase current provisions to signal better ability to face potential losses in the future, as well as to signal higher cash flow and profit predictions.

Finally, different supervisory practises in Europe may have steered banks' provisioning, depending on the style of supervision and/or the extent to which supervisors are lenient with national banks (Barth et al., 2013). As highlighted by Laurin and Majnoni (2003), banks tend to make strategic provisioning when supervisors appear to rely more on moral suasion and threat of sanctions rather than on sanctions to enforce provisioning regulations.[8] Conversely (but consistently), according to an IMF survey on obstacles to NPL resolution, the robustness of coverage ratios appears to be linked to the stringency of supervision (Aiyar et al., 2015).[9] In this respect, the presence of a Single Supervisory Mechanism should, almost by definition, promote homogenous supervisory practices.

[7] For banks under the standardized approach to calculate regulatory capital ratios, the provisions regime vary across jurisdictions, building on the distinction between specific and general provisions. The former refer to identified problem loans for which trigger events (e.g., due payment) exist; the latter is made against a portfolio of loans, and the computation of which varies significantly across countries (ESRBb, 2017). See Section 5.1 for more details on the regulatory implications of provisioning.

[8] Supervisory practices (e.g., the periodicity of inspections, whether these are carried out on- or off- site, whether work of external auditors is incorporated into the assessment process, and so on) vary largely among European countries. In general, efficient supervision depends on the right combination of supervisory powers, including sanctions and penalties, and moral suasion. When supervisors have too much flexibility in enforcing prudential rules, it can result in supervisory forbearance, with negative effects on their credibility and on market discipline. See Laurin and Majnoni (2003). See also ECB (2016b) for a stocktaking of different national supervisory practices and legal frameworks related to NPLs in Europe.

[9] The survey focuses on countries where the aggregate NPL ratio over 2008-2014 exceeded 10% and reflects the views of authorities as well as banks operating in those countries. See Aiyar et al. (2015) for the main outcomes of the survey.

As will be discussed in Section 5.2, the recent issuance of a guidance on NPLs and provisioning should reinforce the supervisory toolkit and provide the SSM with the proper framework to assess and monitor NPLs and the adequacy of provisions.

To summarize, several factors may explain the observed differences in provisioning and coverage ratios in European banks. Some are related to loan portfolio's characteristics, while others refer to bank- or country- specific aspects. Not all of these factors are justifiable in light of credit risk management considerations, and there exists room of maneuver for strategic usage of provisioning to achieve different goals.

Discretionary recognition of loan losses has several potential negative effects. For example, it may call into question banks' true loss absorbing capacity, especially during a crisis. As discussed, LLPs provide the buffer against expected losses while bank capital is needed to cover unexpected losses. Strategic delay in recognizing expected losses or incorrect estimates have an immediate effect on banks' earnings (current expenses are lower than they should be) and significant implications for their soundness. Moreover, delaying loss recognition damages transparency and increases investors' uncertainty about banks' fundamentals, which may impair market confidence, especially during crisis periods (Bushman and Williams, 2015). For all these reasons, an early and transparent recognition of problem loans and adequate provisioning are crucial to ensure banks have clear balance sheets.

5. RECENT MEASURES TO ENSURE BETTER ASSET QUALITY GOING FORWARD

Against this background, two major measures, which are meant to address some of the abovementioned issues, are about to be implemented in Europe (as of January 2018). The first measure deals with the introduction of a new, more forward-looking, accounting standard, which is explicitly aimed to favor timely and adequate provisioning. The second, more comprehensive measure, introduces detailed guidelines and common standards as for how banks need to deals with NPLs, from the recognition and provisioning, to the workout and resolutions phases. Such measures will have an impact on banks' credit risk management and will strengthen supervisory practices by providing the SSM with more powerful tools to enforce better practices.

Altogether, these measures are expected to promote asset quality, reduce unjustified sources of differences across banks and countries and foster market discipline. Together with these potential benefits, however, they may entail some drawbacks in particular in the transition phase because of the necessary adjustments they require to banks; and they call the attention on supervisory practices and enforcement powers in terms of early recognition and disclosure of problem loans and adequate provisioning.

5.1 Towards a more timely and adequate provisioning: the IFRS 9

Following the global financial crisis, the G20 leaders, investors and regulators called for actions to improve LLP standard and practices, by replacing the IAS 39 standard with a new, forward-looking principle.

In particular, the International Accounting Standards Board (IASB) received the mandate to set a new standard to allow banks to "fully recognise existing credit losses earlier in the credit cycle" and, as such, to address the flaws of a "too little, too late" provisioning. According to many commentators, one major criticism of IAS 39 is, in fact, that it led to late and incomplete recognition ("too little, too late") of credit losses, being the approach based on past information signalling the effective materialisation of a credit loss (incurred loss principle) rather than a timely anticipation of the potential (expected) credit losses. A further side effect of IAS 39 is that it contributed to procyclicality, by spurring excessive credit during the boom and forcing a sharp contraction in downturn (BIS, 2017; Beatty and Liao, 2011).

In response to the G20's mandate, the IASB formulated a new accounting standard for the classification and measurement of financial assets and liabilities, the so called IFSR 9, which will be adopted in the EU starting with January 2018 (earlier application is permitted).

The new approach has been conceived to favour higher and timely provisioning through several mechanisms. First and foremost, the crucial novelty of IFRS 9 is the concept of "expected" rather than "incurred" credit losses. Specifically, the IFRS 9 requires banks to recognise expected credit losses (ECLs) before having objective evidence of impairment, that is, even if no past "triggering" events (e.g., loss of employment of the borrower, decrease in collateral values, or past-due status) have yet occurred. Banks will then update the ECLs recognised at each reporting date to reflect changes in credit risk as estimated using a large set of historical, current, and – for the first time - forecast information, including forward-looking macroeconomic variables. The inclusion of these variables into the assessment procedure is expected to favour earlier and possibly higher provisions.

Evidence shows, in fact, that the determinants of credit losses (including macroeconomic variables, such as GDP growth) start deteriorating well before they result into cumulative delinquency (ESRB,

2017b). Moreover, the approach establishes a distinction between three stages into which loans are classified according to their relative credit risk at the reporting date. Such a distinction influences the way provisions are measured and interest revenues are recognised. In particular, the shift from low credit risk (Stage 1) to riskier stages (Stage 2 and 3) will entail a significant increase in provisions, since these will be calculated on a lifetime ECL rather than on the 12 month after the reporting date (as in Stage 1).[10]

Yet, the implications of IFRS 9 are not fully understood. In particular, the regulatory implications of the new accounting standard, which are expected to be relevant, need to be clarified. In principle, any variation on credit provisioning has a direct impact on banks' profit and loss account and, through it, on accounting and then on regulatory capital. It follows that increased provisioning may affect banks' ability to meet regulatory capital requirements. As such, it may trigger undesired behaviour by banks (especially capital constrained ones). For example, to avoid any capital reduction induced by higher provisioning, banks might be tempted to implement the standard in an inconsistent way.[11] Alternatively, banks may implement it correctly, but try to accommodate the impact on capital, for example by cutting lending.

To mitigate these side effects, regulators are debating on the temporary and longer term adjustments to introduce (BCBS, 2016; BCBS, 2017b; EBA, 2017). The magnitude of the impact of IFRS 9 on regulatory capital, whether it will be short term or longer term and how it will affect banks under the internal rating based (IRB) approach *vis-à-vis* those under the standardized approach (SA), are central issues in such a debate.[12]

An important aspect to consider is the so-called "day-one effect". The first implementation of IFRS 9 is likely to produce a remarkable increase of provisions compared with the situation under IAS 39. Hence, a significant negative impact on capital is expected. Recent estimates from ESRB, EBA, as well as from market analysts (see ESRB, 2017b for details), place this increase between 20% and 30%, with significant heterogeneity across banks. Under these circumstances, in the absence of transitional arrangements, the impact of the increase in provisions on bank capital would occur all at once.

To smooth the day-one effect of IFRS 9 and avoid a "capital shock", the Basel Committee of Banking Supervision (BCBS) has proposed transitional arrangements, by giving banks time to rebuild their capital resources following the introduction of IFRS 9 (BCBS, 2017b). The final proposal depicts the

[10] In particular, if credit risk has not increased significantly since initial recognition (Stage 1) the bank measures the loss provision at an amount equal to 12-month ECLs; For non-impaired/non-defaulted assets whose credit risk has significantly increased since initial recognition (Stage 2), lifetime ECLs shall be recognized; If a financial asset reaches Stage 3 if it is specifically identified as credit-impaired. Equivalent to the treatment of impaired assets under IAS 39, the loss allowance must equal full lifetime. (ESRBb, 20127; BIS, 2017).

[11] An example of inconsistent implementation is keeping loans that should belong to a riskier category (Stage 2) into a low risk class (Stage 1), with the only purpose of reducing the amount of provisions. As such, that bank's capital would be overstated.

[12] Briefly, under the current accounting standard, the regulatory implications of provisions varies according to the approach used by banks for calculating capital requirements. IRB banks have to compare eligible provisions to the regulatory measure of expected loss (calculated as probability of default x loss given default x exposure at default). Any provision shortfall is fully deducted, without considering tax effects, from common equity Tier 1 capital, whereas any excess is added to Tier 2 capital, up to a limit of 0.6% of credit risk-weighted assets (RWA) calculated under the IRB approach. SA banks are permitted to include general provisions in Tier 2 capital up to a limit of 1.25% of credit RWAs. Specific provisions, while do not qualify for inclusion in Tier 2 capital, are deducted from RWAs. It follows that the provision regime matters for these banks, since general and specific provision have different impact on either the numerator or the denominator of regulatory capital ratios.

broad picture and leaves discretion to national authorities to fix details such as, the length of the phasing-in period or whether the transitional adjustment should be "static" (calculated just once at the transition) or "dynamic" (recalculated in the light of changes in the stock of provisions post-transition).[13]

The discussion in Europe concerning many of these details remains open.[14] Overall, there seems to be confusion and potential different impacts on banks related to the introduction of the new accounting standard. These may undermine the effort to standardize practices across banks and countries. What is certain, instead, is that, because of the IFRS 9 introduction, banks will be subject to large investment into data collection, IT infrastructure, skilled human resources and sophisticated methodology to, e.g., collect large source of data and estimate forward-looking expected losses. Not all banks have sufficient and adequate internal resources to manage the process, taking also into account that the complexity of the accounting process is likely to increase.[15]

A further implication of IFRS 9 is that it may raise the risk of discretionary behaviour and managers' manipulation, since the new standard, while establishing broad principles for the modelling of the ECL, leaves several details to the judgment of banks and their interactions with auditors and regulators (ESRBb, 2017). Modelling risk can also occur, due to a greater dependence on internal models needed to produce more sophisticated forecasts and estimates. This would be in contrast with the Basel Committee's recent effort to explore ways to reduce undue dependence on internal rating models to calculate minimum capital requirements. Relatedly, an extended usage of internal models can provide large banks with a competitive advantage relative to small banks that are more likely to lack experience, data and resources to implement sophisticated modelling.

All in all, given the current uncertainty surrounding its introduction, the new accounting system may obscure (instead of strengthen) the informational content of balance sheets and generate distrust across market participants. To mitigate these side effects, the practical implementation of the standard should be inspired by principles of simplicity, disclosure and coordination to favour comparability, and ensure market discipline can still work. In particular:

- unnecessary complexity should be discouraged, since simpler models and approaches are easier to understand, validate and review;
- stringent disclosure requirements are needed to help market participants understand the upcoming changes to ECL approaches;
- enhanced cooperation and timely exchange of information among main involved parties (auditors, market regulators, accounting enforcers, banking supervisors) has to be encouraged.

[13] Briefly, in the final proposal, the Committee has opted for a transitional phasing-in period of no more than five years, with a linear spread of the impact on CET1 capital. It has also confirmed temporary maintenance of the current regulatory treatment of provisions (including the distinction between specific and general provision for SA banks). For transparency purposes, the Committee has set disclosure requirements for jurisdictions on the details of any transitional arrangement applied, and for banks (through Pillar 3 documents) on the bank's regulatory ratios, to be compared to the bank's "fully loaded" ratios, had the transitional arrangement not been applied (BCBS, 2017b).

[14] For example, according to a proposal by the EU Presidency, dated May 2017 the Commission has expressed a preference for a phased-in, dynamic approach over a period of five years. See the Presidency compromise Interinstitutional file 2016/0360 (COD).The EBA, instead, in commenting on the European Commission's proposals, has expressed preference for a more simple, static approach over a four-year transitional period, starting in 2018, not resulting in a complete neutralisation of the impact from the move to an ECL model and giving banks discretion to decide whether to use the transitional arrangement (EBA, 2017).

[15] Surveys carried out by consulting firms show that for many banks the actual internal technical resources are insufficient to deliver the IFRS 9 project. See ESRB (2017b), p. 20 for details on these surveys.

5.2 Towards strengthened supervisory activity: the ECB guidance on NPLs and provisioning

In March 2017, the ECB issued a guidance providing comprehensive and qualitative indications on how to recognize, monitor and resolve problem loans, as well as assess collateral, and make timely and adequate provisions for prudential purposes. The guidance also provides detailed standards of supervisory reporting and disclosures related to NPLs, in addition to information required under the prudential regulatory capital framework. The guidance is addressed to large banks under the SSM but also, because principles of proportionality and materiality apply, to smaller institutions with high NPLs (ECB, 2017).

In October 2017, the ECB released an addendum to supplement the NPL guidance with quantitative supervisory "expectations" concerning the minimum levels of prudential provisions expected for NPLs. The aim is to ensure that NPLs are sufficiently provisioned taking into account the level of existing protection (the collateral held, if any) and the "vintage" of the loan (the length of time an exposure has been classified as non-performing). In particular, any unsecured problem loan that after 2 years is still in the NPL category, as well any secured NPL, classified as such after 7 years, has to be fully provisioned, i.e., it is expected to have a coverage ratio of 100%. The full protection applies to secured NPLs because if collateral has not been realised after a period of several years from the date when the exposure was classified as non-performing, the collateral is deemed to be ineffective and as such, the exposure is treated as unsecured from a prudential perspective.

This measure suggests that loan collateral, if not enforced over a long time period, proves an inadequate tool to protect banks. Thus, a more effective protection mechanism (i.e., increased provisions) is needed. This is in the spirit of what discussed in Section 4 and outlined in Constâncio (2017). Moreover, a likely effect of this measure is that, although costly for banks, it should favour NPLs resolution. In fact, by promoting higher coverage ratios for uncovered and / or old NPLs, it would make loan write-offs and asset sales more likely. Both strategies would reduce the stock of NPLs and lead to cleaner balance-sheets. The prudential provisioning expectations will apply to all exposures that are newly classified as non-performing in line with the EBA definition as of 1 January 2018.

The guidance and the addendum are a comprehensive supervisory tool which clarify the supervisory expectations in areas where existing regulations, directives or guidelines are silent or lack specificity. While the expectations are not formally binding, a "comply-or-explain" process applies, according to which any deviation from the expectations needs to be adequately explained by the banks. The process may include off-site activities, onsite examinations or both and non-compliance could trigger supervisory measures if deviations are not backed by sufficiently strong arguments and evidence.

As such, the guidance and the addendum complement the available range of supervisory tools with mechanisms that favour early intervention, strengthen the supervisor's enforcement power and reduce the risk of supervisory forbearance.

It remains to be seen, however, how this guidance will be implemented in practise, i.e., to what extent the SSM will have the adequate tools to enforce measures to restore any deviation from the expectations. To this end, it is crucial that the legal framework underneath the SSM action is clear and transparent. Also, in order to guarantee a level playing field across banks also of different size and supervisory control, it is important that proportionality fully applies.

6. CONCLUDING REMARKS

Great efforts at the bank and institutional level have been made in recent years to resolve the NPL issue in Europe. Within these, the importance of reinforcing banks' provisioning policy as a necessary step to improve asset quality is widely recognized. However, the process to achieve clean and transparent balance sheet is long-term and requires several interventions at different levels.

Greater homogeneity in definitions and comprehensive guidelines, higher disclosure, more effective validation and stronger supervisory activity are all necessary ingredients to favour early recognition of problem loans and timely provisioning. Without these, it will not be possible to restore asset quality, improve balance sheet transparency, reduce unnecessary differences in banks' practices, increase comparability, facilitate market discipline and promotes market confidence.

In this respect, both the new accounting standard and the ECB's guidance on NPLs go in the right direction. For the latter to be effective, it is important to ensure adequate powers to the SSM in terms of early recognition of problem loans through adequate inspection practises, disclosure and enforcement rules on banks' coverage ratios and provisioning needs.

Nevertheless, the process toward healthier and more transparent bank balance sheets may entail costs. The process is inherently expensive, not only because it will lead to increased provisions, but also because it will require considerable efforts to banks to bear disclosure, implementation, modelling, and reporting costs. To make the process successful, not only banks, but also regulators, supervisors, accounting authorities and banks' auditors will have to play a role. Greater coordination across these stakeholders will be key to achieve a better understanding of rules, principles and practices. The IASB, the SSM and national supervisors, auditors and banks should explore how to achieve asset quality and transparency, in compliance with the new accounting rules and guidelines, while at the same time reducing unnecessary complexity and burden on banks, including smaller institutions.

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