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IBF comments on the EBA Consultation Paper on supervisory reporting on forbearance and non-performing exposures

General comments

The Irish Banking Federation welcomes the opportunity to comment on the European Banking Authority Consultation Paper on Supervisory Reporting on Forbearance and Non-performing Exposures.

In December 2011, the Central Bank of Ireland (CBI) published a comprehensive document entitled 'Impairment Provisioning and Disclosure Guidelines'. This document covered many of the themes and concepts that EBA subsequently addressed in its consultation CP/2013/06 and banks in Ireland have been applying these guidelines since then.

In December 2012, ESMA issued a public statement on 'Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions'. ESMA stated that it expected its recommendation to be implemented in the 2013 annual financial statements of EU financial institutions. As is clear in the IBF's responses below, there are areas where the EBA consultation paper is implicitly or even explicitly not aligned with the ESMA document. We would urge the EBA to ensure such alignment is addressed before the next version of its document (whether a revised consultation paper or a final statement) is issued. It is necessary to strive to achieve much greater consistency of definition between 'non-performing' and existing concepts such as Basel/CRD default, 'impaired' under IAS 39, etc.

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Questions on the definitions

1) Do you agree that building definitions of forbearance and non-performing by taking into consideration existing credit risk related concepts enables to mitigate the implementation costs? If not, please state why.

Yes.

2) Do you agree with the proposed definitions? Especially, do you agree with the inclusion of trading book exposures under the scope of non-performing and forbearance definitions? If you believe alternative definitions could lead to similar results in terms of identification and assessment of asset quality issues, please explain them.

We do not agree with the proposed definitions. The definition of forbearance is too complex and confusing. The inclusion of modified contracts that were 'more than 30 days (without being non-performing) at least once during the three months prior to its modification' introduces arbitrary parameters (30 days, three months) that are difficult to justify and may lead to misinterpretation and wrongful application. A useful definition can be found in the CBI's 'Impairment Provisioning and Disclosure Guidelines' from December 2011:

"Forbearance measures occur when [an institution], for reasons relating to the actual or apparent financial stress of a borrower, grants a concession whether temporarily or permanently to that borrower. A concession may involve restructuring the contractual terms of a debt or payment in some form other than cash, such as an equity interest in the borrower. If the decision to make a concession is not related to the actual or apparent financial distress of the borrower, forbearance has not occurred."

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A very similar definition is used by ESMA in its public statement on 'Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions' from December 2012 (page 3):

"Forbearance measures occur in situations in which the borrower is considered to be unable to meet the terms and conditions of the contract due to financial difficulties. Based on these difficulties, the issuer decides to modify the terms and conditions of the contract to allow the borrower sufficient ability to service the debt or refinance the contract, either totally or partially. If a decision is made to extend a concession, modify the contractual terms or refinance, which is not related to the financial difficulties of the borrower, then forbearance has not occurred."

ESMA acknowledges that judgement is required on the part of lenders (and auditors) to determine whether a concession was extended due to financial difficulties of the borrower. It also makes the point in a footnote that 'lack of action by the lender towards the borrower (e.g. lack of enforcement of covenants in the contract) can be considered a form of forbearance'. The decision by a lender not to enforce covenants (e.g. minimum interest cover, maximum gearing, maximum LTV ratio) on a temporary or permanent basis may be unrelated to, and have no impact on, the scheduled interest and capital payment obligations of the borrower. It should be considered as to whether such actions (or inaction) not related to payment difficulties should be defined as forbearance. The CBI and ESMA documents imply that forbearance can result from action (or inaction) not related to payment difficulties; however, a uniform approach is not taken among European banks that currently report on forbearance in their annual financial statements. The EBA consultation paper is unclear on this point.

Increased clarity around the EBA's definition of non-performing would be beneficial. In the first of the two criteria, 'material' is not defined. In the second criterion, the reference to 'not being paid back in full collateral realisation' should be amended to 'not being paid back in full' or, in other words, 'is subject to a specific provision for impairment' – regardless of whether the exposure is underpinned by collateral and whether than collateral will or will not be realised.

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We do not agree that trading book exposures should be included under the scope of the definitions because such instruments are reported at fair value, which includes credit deteriorations akin to forbearance and indicators of non-performance.

3) How long will it take you to implement, and collect data on, the definitions of forbearance and non-performing?

This is likely to vary by institution but, if the definitions are not changed to address the concerns expressed above and to achieve greater alignment with definitions arising from ESMA, Basel/CRD and IAS 39, it could be as much as two years.

4) What definitions of forbearance and non-performing are you currently using respectively for accounting and prudential purposes?

This varies by institution.

Specific questions on some aspects of the forbearance definition

5) Do you agree with the types of forbearance measures covered by the forbearance definition? If not, what other measures(s) would you like to be considered as forbearance?

As mentioned under response 2) above, clarity is needed as to whether forbearance measures relate only to payment difficulties or whether they also relate to non-payment difficulties experienced (or likely to be experienced) by the borrower, such as compliance with interest cover, LTV ratio or other financial covenants.

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6) Do you agree with the following elements of the forbearance definition:

a. the criteria used to distinguish between forbearance and commercial renegotiation?

b. the criteria used to qualify refinancing as forbearance measures?

c. a 30 days past-due threshold met at least once in the three months prior to modification or refinancing, as a safety net criterion to always consider modification or refinancing as forbearance measures?

d. the proposed treatment for exposures with embedded forbearance clauses?

In case you disagree with the EBA proposals on the above-mentioned issues, please explain and provide an alternative to them.

a. No. The presumption that 'the contract has received "concessions" [i.e. forbearance] when the modified contract includes more favourable terms than those the debtor could have obtained in the market' does not allow for cases whereby an institution has gained or retained a non-troubled debtor as a result of providing more favourable terms (e.g. lower pricing, less onerous repayment schedule) following a commercial, competitive process. Also, the linkage of forbearance to 30 days past-due status is too prescriptive and arbitrary.

b. Broadly, yes. Such refinancing can be identified when the institution is refinancing debt that it has provided – this is akin to term extension and/or capitalisation of arrears. However, it may be more difficult to recognise when the institution is refinancing troubled debt provided by another institution.

c. No. This is too prescriptive and arbitrary, and may be difficult to track accurately.

d. Yes – as long as embedded forbearance clauses that do not require any lender consent are not within scope.

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7) Do you agree with the proposed scope of on- and off-balance sheet exposures to be covered by the definition of forbearance?

Broadly, yes. However, this will be more difficult to implement than if the scope was limited to on-balance sheet exposures only (which would be more aligned with loan balances reported in the financial statements).

8) Do you agree not all forbearance transactions should be considered as defaulted or impaired?

Yes. In its paper on forbearance from December 2012, ESMA also acknowledges that forbearance does not necessarily lead to impairment but it does require an assessment as whether impairment exists. By referring to IAS 39, ESMA makes a convincing connection (but not complete overlap) between forbearance and impairment that is consistent with the accounting standards that lenders have to apply.

9) What types of forbearance transactions are likely, according to you, not to lead to the recognition of default or impairment?

We do not agree with EBA's expectation that 'most forbearance transactions [will] lead to impairment or default, and institutions should be cautious in classifying a forborne exposure as performing'. Forbearance is a strategy employed to avoid default, impairment and/or enforcement, for the benefit of both the debtor and the institution. Types of forbearance that are likely to help avoid default or impairment include the adjustment of covenants, the reduction of principal repayments, the capitalisation of arrears and term extension, and may be applied on a temporary or permanent basis.

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10) Do you agree with the proposed definitions of debtors and lenders and the scope of application of the forbearance definition (i.e. accounting scope of consolidation)?

Yes.

11) Do you agree with the proposed mixed approach (debtor and transaction approaches) for forbearance classification?

Yes.

12) Do you agree with the exit criteria for the forbearance classification? In particular:

a. what would be your policy to assess whether the debtor has repaid more than an insignificant amount of principal or interest?

b. do you support having a probation period mechanism?

No, we don't agree with the exit criteria. The reference to 'more than an insignificant amount' is too vague, and the requirement for the debtor to have paid 'an amount equal to all amounts past-due before the forbearance measures were extended' is too harsh. We do support having a probation period mechanism, but believe that the probation period should involve a period of satisfactory compliance with the revised terms of the loan (following the granting of forbearance). If a temporary measure of forbearance is granted, then reaching the expiration date of the measure should permit exit from forbearance.

13) Do you agree with the proposed approach regarding the inclusion of forborne exposures within the non-performing category? In particular:

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a. do you agree the generic non-performing criteria allow for proper identification for neither defaulted nor impaired non-performing forborne exposures? Would you prefer to have the stricter approach (all forborne exposures identified as non-performing) implemented instead?

b. do you agree with the proposed consequences of forbearance measures extended to an already non-performing exposure? Especially, are the proposed exit criteria strict enough to prevent any misuse of forbearance measures or would stricter criteria be needed?

a. More detail on the generic non-performing criteria would be useful. However, our understanding from this section of the document is that all exposures that are 90 days past due or carrying a specific provision (due to unlikely full repayment of the obligation) are defined as non-performing. Based on this understanding, all exposures that we report as 'defaulted' will be non-performing, i.e. we will not have non-performing exposures that are neither defaulted nor impaired. We agree that some forborne exposures are performing, i.e. we would prefer not to have the 'stricter approach' implemented.

b. No comment.

Specific questions on some aspects of the non-performing definition

14) Do you agree with the following elements of the non-performing exposures definition:

a. the use of 90 days past-due threshold to identify exposures as non-performing?

b. the proposed guidance for past-due amounts?

c. the proposed treatment of collateral and especially the proposed valuation methodology for its reporting?

In case you disagree with the EBA proposals on the above mentioned issues, please explain and provide an alternative to them.

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a. Yes.

b. Yes.

c. Yes.

15) Do you agree with the coverage of the proposed definition and with the possibility to apply the generic non-performing criteria to all fair-valued non-performing exposures? Do you expect challenges when implementing them and collecting data on fair-valued non-performing exposures? Would you suggest other criteria instead?

No, we do not agree that non-performing criteria should be applied to fair-valued exposures as the carrying value already reflects any credit deterioration.

16) Do you agree with the proposed treatment for derivatives exposures? If not, what criteria would you suggest to enable identification of non-performing derivatives?

Yes, we agree with the proposed treatment for derivatives exposures.

17) Do you agree with the proposed criteria to identify off-balance sheet exposures as non-performing?

Yes, although the comments in response 7) above apply here also.

18) Do you agree not to consider exposures subject to incurred but not reported losses as non-performing?

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No. We believe that defaulted exposures (e.g. those greater than 90 days in arrears) should be included as 'non-performing' even if they do not have a specific impairment provision attaching to them and therefore are subject to IBNR. The EBA seems to recognise this possibility on page 29: assets subject to IBNR 'are not to be included as non-performing exposures, unless these assets comply with either the default or the generic criteria to identify non-performing exposures'.

19) Do you agree with the proposed approach regarding the materiality threshold?

Yes.

20) Do you agree with the proposed definitions of debtors and lenders and the application of the non-performing exposures definition on an accounting scope of consolidation?

Yes.

21) Do you agree with the proposed approaches (debtor approach for non-retail exposures, and possibility of a transaction approach for retail exposures)? In particular, do you agree with the idea of a threshold for mandatory application of the debtor approach? If so, which ratio methodology would you favour and why?

We agree with the principle of a debtor approach for non-retail exposures and a transaction approach for retail exposures.

We do not agree with the idea of a threshold for mandatory application of the debtor approach. Instead, the debtor approach should be used by an institution for those exposures it deems to be non-retail.

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The ratio methodology is not clearly explained or rationalised – for example, it seems counter-intuitive that the 1 day past-due threshold should be lower than the 90 days past-due threshold (5% vs. 20%).

22) Do you agree with the exit criteria from the non-performing category?

No. It is not consistent that a past-due exposure must be 90 days past-due to enter into the non-performing category but must be 0 days past-due to exit from that category. The threshold for exit from the non-performing category should be set at 90 days past-due, i.e. an exposure can return to performing status if it is less than 90 days past-due. The criteria for entry to and exit from the non-performing category should be symmetrical, not asymmetrical.

23) Do you agree with the separate monitoring in a specific category of exposures ceasing to be non-performing? Do you think this specific category should be integrated within the performing or the non-performing category?

We do not agree with the separate monitoring of such a specific category – it introduces further complication and will make it more difficult for institutions to implement the EBA requirements.

An exposure should be either performing or non-performing; a specific category for exposures that were non-performing during the last 12 months (itself an arbitrary period) seems to make little sense. The specific category should instead be integrated within the performing category.

24) Would you favour specific exit or specific separate monitoring criteria for non-performing exposures to which forbearance measures are extended?

No.

25) – 27) - No comment.

28) Do the instructions provide a clear description of the reporting framework? If not, which parts should be clarified?

i) FBE columns 040 and 050: ‘Debt refinanced by the institution’ and ‘Refinancing debt granted by the institution’ would benefit from greater clarify around definition and the difference between them.

ii) FBE and NBE: The requirement to determine the component of Fair Value changes ‘due to credit risk’ is excessive and is not required by IFRS disclosures.

iii) NPE: Is clarification required for para. 35? How are banks to comply with the requirement to ‘separately report for one year’ exposures exiting the non-performing category? It does not seem to be requested in the templates.

iv) NPE columns 080 and 170: It would be preferable to keep these components separate, i.e. ‘unlikely to pay that are not past due’ and ‘past due <90 days’.

v) NPE column 030: It would be preferable to keep these components separate, i.e. ‘not past due’ and ‘past due <30 days’.

vi) The explanations of ‘non-performing’, ‘defaulted’ and ‘impaired’ would benefit from greater clarity. For FBE, column 100 (‘defaulted’) and column 110 (‘impaired’) should be clearly defined and presented in such a manner that the distinction between them (and ‘non-performing’) is easily understood.

29) - No comment.

30) Do the reporting requirements include items which would be disproportionately costly to implement? If yes, how could the templates be modified to cover the necessary supervisory

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information? Institutions are especially encouraged to provide their views on which break-downs are easier to fill in, or whether they believe there are redundancies with information reported in other supervisory reporting templates, or if they believe alternative definitions could achieve similar results as those in this Consultation Paper but at lesser costs.

There is considerable overlap between NPE and FINREP Table 4 – this should be addressed.