3 Impaired assets in Europe: significant efforts have been made, but much remains to be done

Following the crisis, authorities and analysts have expressed concern about the large volume and low degree of comparability of the impaired assets that have accumulated in banks’ balance sheets. In the context of the Banking Union (BU), work is being done to quantify the volume and standardise the definitions used in the various countries. Thus the Single Supervisory Mechanism (SSM) included among its strategic priorities for 2016 a study of the credit quality of loans to businesses and households. For this, it has set up a working group on NPLs, which is evaluating the situation of banks with high levels of NPLs and will propose actions to be taken. In the same line, this month, September, the European supervisor has launched a public consultation on the definition of NPLs, and it will probably propose objectives for reducing banks’ NPLs, which will be confidential and not mandatory.

The EBA (European Banking Authority) gave the first definitions of NPLs (non-performing loans) and forbearance (restructured or refinanced exposures) in the context of Regulation (EU) No. 575/2013 on prudential requirements, with a view to having banks present a complete picture of their risk profiles in the 2014 AQR (Asset Quality Review). Both have come to form part of the supervisory financial reporting forms known as FINREP which all EU credit institutions are obliged to complete, and they will be in addition to those required by member states’ national authorities. Also in process is a consultation on guidelines on default and the regulatory technical standards on the materiality threshold of credit obligations past due.

The Basel Committee on Banking Supervision (BCBS) has also carried out a study of the various criteria for determining impaired assets, making some recommendations for strengthening the applicable accounting and supervisory frameworks and making them more consistent. Lastly, IFRS 9, which comes into force for listed companies in January 2018, classifies assets by reference to risk and determines the loss allowance required in terms of expected loss, for which it defines the concepts of default and impairment.

All the work being done at international level is between two different frameworks: the prudential supervisory framework (of the EBA) and the accounting framework (of IFRS 9). There are numerous definitions straddling the two worlds, such as the new Banco de España Circular 4/2016 which seeks to adapt itself to the current prudential supervisory framework and lays the bases for the coming into force of the international accounting standards. The two frameworks must be compatible and mutually consistent. If the same names are used, they must refer to the same concepts; and if different terminology is used there must be clarity as to the differences. Once they have been implemented they must coexist and support one another. Clarity and transparency in these aspects will make it easier for banks to fulfil their obligations and for investors and supervisors to ascertain the banks’ risk profiles.

It is also important to standardise the various definitions and frameworks, or at least to minimise the differences among them, for the following reasons:

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2: ECB Banking Supervision: SSM Priorities 2016
3: Italy’s Banca Monte Paschi di Siena (MPS) admitted on 4 July that the European Central Bank (ECB) had urged it to reduce the volume of its bad and doubtful debts by €10 billion.
4: In its recommendations for carrying out the AQR (EBA/REC/2013/04) it asks banks to use uniform definitions as far as possible.
5: Implementing Technical Standard (ITS) on Supervisory Reporting (Forbearance and non-performing exposures), published in the OJEU as Regulation (EU) No. 680/2014
Greater transparency regarding the risk profile of each institution, and greater comparability among them, thus making it possible to discriminate among them according to their fundamentals.

Limitation of the effect of the different definitions on the calculation of provisions and risk-weighted assets and therefore on coverage and solvency ratios.

It will be positive for the real economy. Gaining proper insight into the quality of the assets on banks’ balance sheets will help provide a correct valuation of the assets and facilitate their sale, which will lead to more solvent banks with greater ability to perform their true role of financial intermediation. Furthermore, the literature points to there being a link between the level of impaired assets and the price of new lending transactions, so improvements in banks’ credit quality could lead to adjustments in prices.

All this work on standardising criteria at European level will enable progress to be made towards the banking union.

At European level, the data published by the EBA in its 2015 transparency exercise allow the first analysis with a standardised criterion to be made among the 105 institutions from 21 countries and also allow us to see which of them apply the standardised definition to their financial statements and not just top their supervisory reporting. In this way, we see that there are countries where the difference between the financial statements and the reporting to the supervisor is less than in others. The banks assessed in Belgium, the Netherlands and Slovenia declare more impaired assets in their balance sheets than with the EBA criterion.

In Italy and Spain, institutions have adapted to a considerable extent to the standardised definition. However, there is a significant difference between the two countries. In Spain the process of adjustment took place at the end of 2012 thanks to the Banco de España guidelines on accounting for refinanced assets. In Italy on the other hand, the convergence between accounting and supervisory concepts took place in the second half of 2015, after the amendment to the definition of impaired banking business.

A third group of countries shows differences between the two frameworks. In general terms, the differences observed in Portugal, the UK, Ireland, Germany and France arise from different criteria for the number of days overdue and details of the notion of refinanced transaction or of carry-over effects at both transaction and borrower level.

All the work done so far on appropriately defining concepts and precisely quantifying impaired assets on banks’ balance sheets must continue, since some points still need to be clarified in order for the accounting and supervisory frameworks to communicate easily with one another and for the institutions not to be overburdened by having to fulfil both reporting requirements. Being able to measure impaired assets with the same criterion is a first step for being able to advance towards a real banking union.
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