NO 2 2019

14 March

# Economic Commentary

## "Bad loans" and their effects on banks and financial stability

**Olle Fredriksson and Niklas Frykström**

The authors work in the Financial Stability Department of the Riksbank.[1]

The global financial crisis and subsequent European sovereign debt crisis led to a significant increase in the number of bad loans within the European banking system. Bad loans reduce banks' profitability and limit their ability to issue new credit. Large volumes of bad loans can cause banks problems with their capital adequacy and, at worst, can lead to default. Bad loans also risk impairing long-term economic growth and lead to greater uncertainty in the banking system which results in elevated financial stability risks. The share of bad loans in the EU is still higher than before the financial crisis. Reducing the number of bad loans requires measures from authorities, both at the EU and national levels.

This Economic Commentary describes what bad loans are, how they arise, how they impact banks and how they affect financial stability.

Banks have a central role in the economy as they provide credit, accept deposits, mediate payments and help customers manage risk. These services are essential to long-term economic growth. After the global financial crisis, however, many banks – particularly in the EU – have struggled with high levels of bad loans[2] – a factor that has a negative effect on their function in the financial system. Still today, the share of non-performing loans in the EU is much higher than before the crisis, which has an adverse impact on economic development and financial stability. The Riksbank, with its responsibility for financial stability and its role in a financial crisis, therefore has a legitimate interest in following developments in bad loans within the banking system. [3]

Bad loans arise when the borrower no longer pays in accordance with the terms of the loan. This has a negative impact the bank's profitability, can lead to credit losses and, at worst, default. Put simply, large volumes of bad loans risk reducing bank equity, making it more difficult to issue new loans. Adequate management of bad loans involves banks identifying such loans at an early stage and writing down the value of them equal to the expected credit losses. For unprofitable banks, this leads to a reduction in their equity. Following the latest crisis period, many European banks have not had sufficient equity in order to correctly manage their bad loans. This has led to major uncertainty regarding banks' viability, i.e. whether they have sufficient equity to be able to survive in the long term. In several European countries, neither regulation nor banking supervision has been sufficiently strict, which has allowed many banks to neglect fully dealing with their bad loans. This has severely exacerbated the difficulties involved in reducing the volumes of bad loans in Europe.

The Riksbank has previously advocated that the levels of bad loans in the European banking system should be reduced without delay, which requires measures from authorities at both the EU and national levels.[4] This is a sensitive issue in many Member States, however, as it is feared that measures could have negative implications for the economy in the short term. Yet, the cost of doing nothing is weaker long-term growth, which is a worse economic alternative in most cases. It also aggravates financial stability risks in the European banking system, which affects all Member States in the EU.

[1] The authors wish to thank David Forsman, Mattias Hector, Christina Nordh-Berntsson, Emma Sandberg and Jonas Niemeyer for their valuable input.

[2] There is no widely accepted definition of the term 'bad loan'. Rather, 'bad loans' should be considered an umbrella term for loans that pose an elevated risk of credit losses.

[3] See, for instance, Sveriges Riksbank's FSR 2018:2 on the need for adequate credit granting processes.

[4] See, for instance, the Riksbank's consultation response to the ECB's draft addendum to the ECB Guidance to banks on non-performing loans.

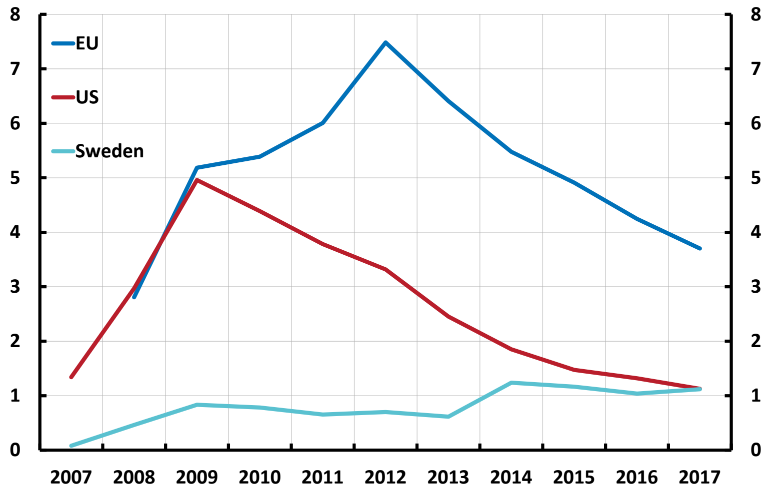
This Economic Commentary describes what bad loans are, how they arise, how they impact banks and what implications they have for financial stability. The Commentary describes international developments with a focus on Europe, and the work that has recently commenced to counteract the problems related to bad loans in the EU.

# How bad loans have developed

In conjunction with the latest crisis period, the share of bad loans increased sharply not only in the EU, but also in other parts of the world, such as in the US (see Figure 1).[5] In the US, the share of bad loans culminated in 2009 and has since then dropped to around the same levels as before the crisis. In the EU, the share of bad loans did not peak until 2012, which was probably due to the European debt crisis.[6] Since then, levels in the EU have gradually decreased, which is an effect of improved economic conditions, various initiatives at the EU level and the fact that loans have been removed from the banking system through sales on the secondary market.

**Figure 1: Development of the share of bad loans after the financial crisis**

Percentage of total outstanding loans




Sources: World Bank and Federal Reserve Bank of St. Louis

Note. Refers to bad loans at banking groups with headquarters in each respective country. It is not until in recent years that definitions of bad loans have been harmonised, which creates some uncertainty about the levels. The figure gives an overall presentation of developments. The first two observations for the United States come from the Federal Reserve Bank of St. Louis. All other observations come from the World Bank.

The share of bad loans in the EU is still higher than before the crisis, and in several countries the share is 10 per cent or more of total lending (see Figure 2).[7] In June 2018, there were bad loans in the EU equalling EUR 830 billion[8] or 3.4 per cent of total lending. However, the differences between EU Member States are considerable. In some countries, over 40 per cent

[5] Source: World Bank. https://data.worldbank.org/indicator/FB.AST.NPER.ZS?end=2017&start=2010&view=chart

[6] An aggravating factor for many countries with weak economies is the introduction of the euro and the common interest rate policy in the euro area. This limits the possibilities of these countries to exert influence through monetary policy. In many countries, the introduction of the euro meant a substantial decrease in the cost of borrowing compared to before, which led to excessive credit expansion.

[7] ESRB 2019

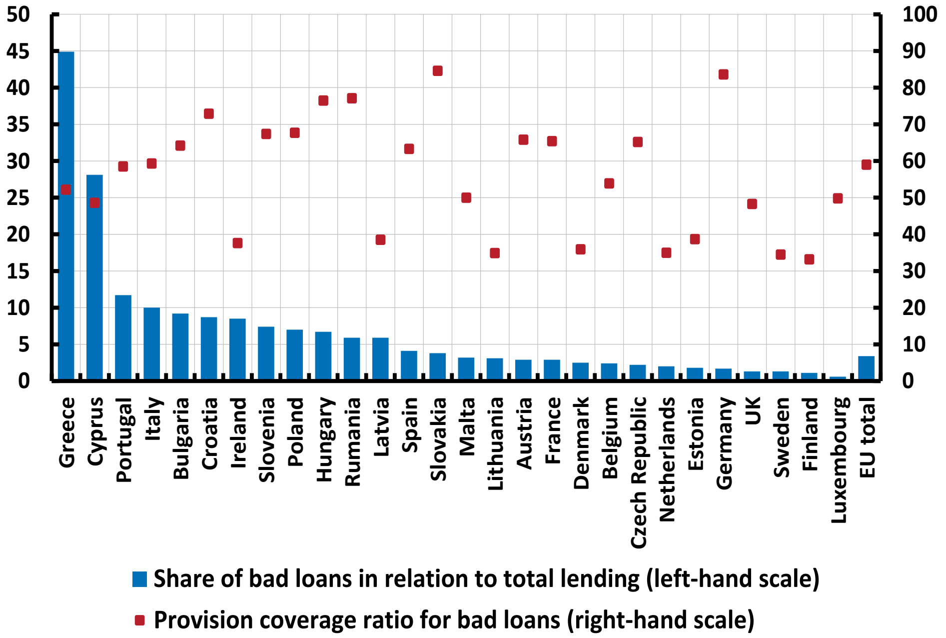
[8] http://europa.eu/rapid/press-release_MEMO-18-6547_en.htm

of loans are classified as bad, while other countries show low levels of around 1 per cent. The spread in volumes is also substantial – for example, Italy accounts for around 20 per cent of all bad loans in the EU. Greece, which is a much smaller economy, accounts for around 10 per cent.[9]

When referring to bad loans, it is also relevant to consider the level of provisions made by banks for bad loans. The share of provisions shows the extent to which banks have already allowed for anticipated credit losses. The higher the provision coverage ratio, the greater the credit losses for which the bank has already made provisions. In this respect too, there are vast differences between EU countries and provision coverage ratios are not always in step with the share of bad loans. For example, Germany has a low share of bad loans, but a high provision coverage ratio. Cyprus is an example of the opposite, with a high share of bad loans, but lower than average provisions for credit losses.[10]

**Figure 2. Share of bad loans and provision coverage ratio in the EU**

Per cent, June 2018




Source: European Central Bank, consolidated bank data.

Note. The provision coverage ratio refers to how much money a bank has set aside in relation to the value of the bad loans.

Finally, the type of bad loans varies between Member States. In most countries, it is mainly loans to small and medium-sized companies that make up the majority of remaining bad loans. In some countries, they also consist of large volumes of consumer loans, mainly those without underlying collateral, known as unsecured loans.[11] To date, initiatives to reduce bad loans in the EU have been concentrated to loans with underlying collateral.

In an international comparison, banks that operate in Sweden show low levels of bad loans overall. The share has indeed increased in the past five-year period, albeit from low levels. In

---

[9] ECB consolidated banking data Q2 2018

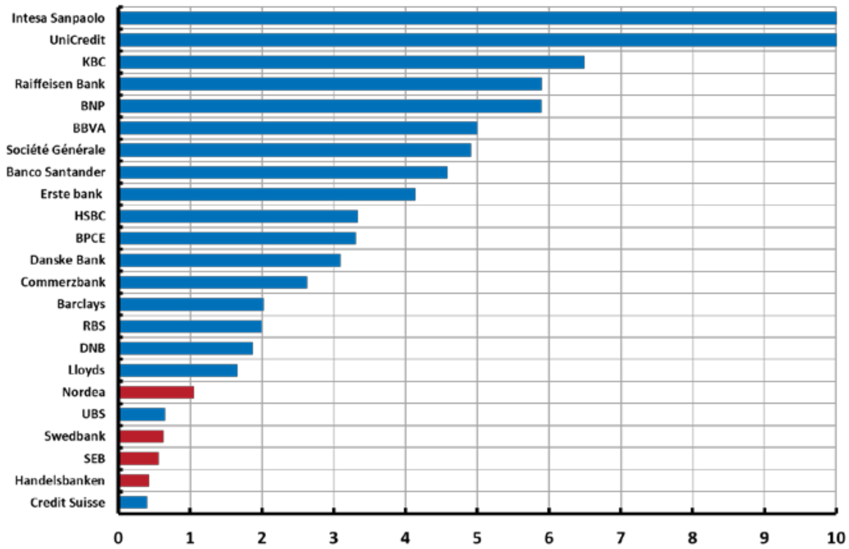
[10] In the EU, the average provision coverage ratio is 59 per cent (European Commission 2018).

[11] European Commission 2018

the second quarter of 2018, bad loans amounted to 1.3 per cent of total lending, which is much lower than the European average. The levels for the four major banks in Sweden are on average below 1 per cent (see Figure 3)[12]. At the same time, the average provision coverage ratio was approximately 35 per cent, which is low in a European perspective.

**Figure 3. Bad loans as a share of total loans for European banks**

Per cent, December 2017




Source: SNL Financial

# What are bad loans, and how do they affect banks and financial stability?

If a borrower stops paying the bank according to the terms of the loan, or something else indicates that the borrower will have difficulty in repaying the loan, the bank will, after a time, be forced to classify the loan as bad (see Appendix 1 for the definition of bad loan). Normally, the bank must classify a loan as bad no later than when payment from the borrower is 90 days past due. When the classification has been made, the bank must, in turn, make a provision for expected credit losses, which in practice means that the value of the loan is written down as a preventive measure.[13]

Small volumes of bad loans can be found in all banks and banks also allow for them as they price the risks in the loans to their customers. An increase in bad loans lead to interest income decreases at the same time as the administrative costs of managing the loans increase. For a profitable bank, small volumes can, as a rule, be addressed without any problems, while the bank can continue to issue new loans. However, problems arise when the volume of bad loans is so large that the bank’s profitability falls significantly. The bank must also write down the value of the loan to allow for any credit losses. For an unprofitable bank, this means – all else equal – that the bank’s equity decreases, which in turn makes it more difficult to issue new loans, as they will be subject to capital charges.

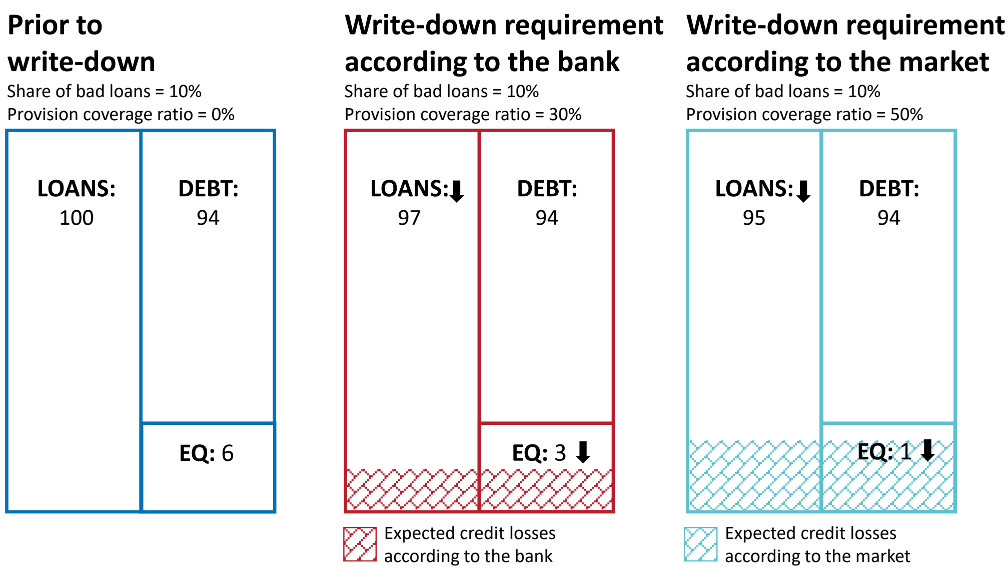
[12] Source: SNL Financial

[13] If the realised credit loss is ultimately less than the amount of the provision, the bank may reverse the difference.

If the market is not sure whether the bank has sufficiently allowed for credit losses in its write-downs, market confidence in the bank can weaken. In turn, this makes it more difficult to raise funding and obtain new capital, because investors now run a greater risk of incurring losses. If the bank continues to make a loss and does not manage to raise new capital from its investors, it risks breaching its own capital requirements which can ultimately lead to default.

Figure 1 shows a simplified example of how the balance sheet is affected when an unprofitable bank writes down the value of bad loans. In the example, it is assumed that 10 per cent of the bank's total lending will be classified as bad loans. The bank judges that the credit losses for these loans will be 30 per cent, and the value is thus written down by the same amount. The write-down equals 3 per cent of the value of the bank's total assets. Because the liabilities are unchanged and the bank does not have any profits with which to offset the write-down, equity decreases to the same extent as the assets. The effect is illustrated by the balance sheet in the middle in red. Following the write-down, half of the equity remains. In cases where the market has a more pessimistic view of the expected credit losses, uncertainty is created regarding the bank's capitalisation, which is illustrated by the balance sheet to the right. In the example, the market believes that the credit losses might be even greater – equalling half of the bad loans nominal value. If the market is correct, this means that only one sixth of the bank's original equity remains, which probably puts the bank in breach of its capital requirements.

**Figure 1. Simplified example of how a balance sheet is affected by write-downs**




Note. In the figure, EQ stands for equity. The example assumes that banks do not have any profits from other operations that can offset the effect of the write-down on equity.

If several banks are affected simultaneously by large volumes of bad loans, this would risk having an impact on the entire economy, as a reduction in access to credit leads to, among other things, lower investment, fewer jobs and lower growth. The share of bad loans also affects the conditions for monetary policy. Central banks can, in different ways, influence banks' funding costs, which are then passed on to households and corporations by means of banks adjusting their interest rates on deposits and lending. This is usually called the transmission mechanism, through which central banks, by increasing or reducing banks’ borrowing costs, can accelerate or slow down economic growth. As large volumes of bad loans limit banks’ lending, they also reduce the ability of central banks to influence the economy.

# The emergence of bad loans and how banks manage them

Historically, the share of bad loans has increased in connection with economic crises, which was the case in Europe in conjunction with the latest crisis period. When there are large volumes of bad loans, they have normally been preceded by sharp credit growth, resulting in higher loan-to-value ratios among corporations and households. During such periods, competition on the lending market has often escalated, which has in many cases led to the banks becoming more lenient in their lending[14]. In other words, they have increased the risk in their lending.[15] Greater leverage, lower credit quality and other vulnerabilities that have often built up during periods of economic boom have subsequently, when the economy has turned downwards, resulted in large volumes of bad loans. The banking sector has, in other words, often underestimated the risk in its lending during periods of economic boom, which has had major consequences in economic downturns.

As a rule, banks that suffer large volumes of bad loans need to consolidate their balance sheets to enable them to issue new loans and hence regain their profitability. There are different ways for banks to do this. The first step is for the bank to hold a dialogue with the borrower with a view of exploring the conditions for paying back the loan.[16] If repayment is still considered possible, the bank and the borrower can renegotiate the terms of the loan agreement, for instance by extending the term of the loan or adjusting the interest rate. This possibility has been abused in certain cases through what is known as ‘evergreening’, which is when banks recurrently renegotiate and renew loans, solely with the aim of avoiding write-downs, instead of classifying them as bad loans.

If, following renegotiation, the borrower is still not able to pay, the bank can initiate legal proceedings to take over any underlying collateral.[17] The bank can subsequently sell the collateral to get its money back. Another alternative is for the bank to sell the bad loan to an external party. In Europe, such sales have been made more difficult by the fact that the book value of the bad loans has often been higher than the value that external buyers have been willing to pay. The main reason is that banks, in many cases, have been reluctant to write down the value of their bad loans to a sufficient degree. Many banks have not had sufficient equity and hence risked becoming insolvent had their write-downs been correct. Uncertainty about pricing on the secondary market can also be due to low transparency, which makes it difficult for investors to estimate what the loan is worth.

Question marks about classifications of and provisioning for bad loans have created great uncertainty over banks’ ability to survive, i.e. whether they have sufficient capital to ultimately enable them to manage their credit losses without becoming insolvent. This

[14] ECB 2013
[15] Borio and Lowe 2002
[16] EBA 2015
[17] The majority of bank lending is granted against some type of collateral, such as real estate. A small part of bank lending consists of non-collateralised or unsecured loans.

uncertainty has made it more difficult for troubled banks to secure ongoing funding and procure new capital from investors. Many banks have, after the latest crisis period, therefore been dependent on national support programmes and temporary funding from the European Central Bank (ECB).[18] In light of this, some find that there may be a need to close down banks that are not viable, and to promote consolidation of the banking sector in order to break the negative spiral.[19] For example, the ECB finds that consolidation in the banking sector could bring about economies of scale as regards the management and disposal of bad loans.[20]

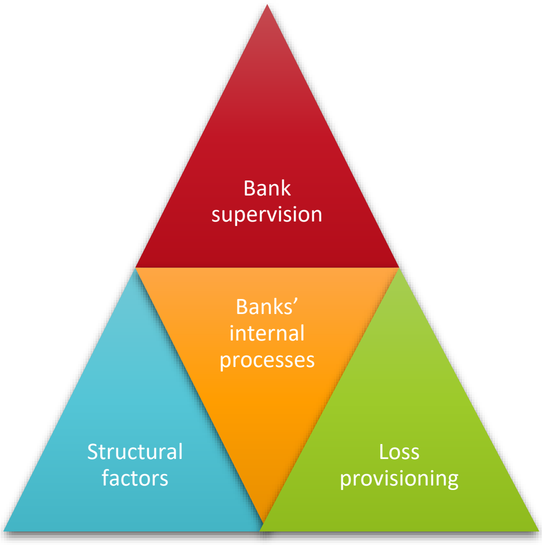
# Factors that affect the management of bad loans

Corporate culture, risk appetite and internal processes are bank-specific factors that govern the quality of lending and how well a bank can manage new flows of bad loans.[21] The life cycle of a loan can, in simplified terms, be divided into three stages. How banks manage each stage determines how large risk the volumes of bad loans become, and the effect they have on banks' profitability and long-term ability to survive. The first stage is banks' credit assessment, which determines whether a loan is to be granted or not. Among the factors analysed is the borrower's ability to repay the loan. The second stage is ongoing loan monitoring, whereby the bank shall continually ensure that the borrower does not breach, or risks being in breach of, the terms of the loan. The third and final stage is managing a loan after it has been classified as bad.

Banks are themselves ultimately responsible for having internal processes to ensure sound lending, efficient loan monitoring and correct management of bad loans once that they have arisen. Ensuring this requires efficient bank supervision. Supervisory authorities shall continually monitor banks' risks and regulatory compliance, for instance by ensuring they have made correct loss provisions. Other determinants that affect banks' ability to manage bad loans are structural factors such as the design of insolvency rules, bankruptcy legislation and how well the secondary market for bad loans functions.

[18] Targeted longer-term refinancing operations (TLTRO) are one of the European Central Bank's (ECB's) extraordinary monetary policy measures. TLTROs are offered by the ECB as long-term loans to banks. The purpose is for the banks to increase lending to companies and consumers.
[19] Supporting substandard banks without actually addressing their fundamental problems creates so-called 'zombie banks'. This involves keeping alive a bank that lacks the prerequisites for future profitability. Liquidity is constantly supplied to the bank, enabling it to conduct its daily operations without anything happening. In the long run, a bank that is not viable cannot issue new loans, which hampers growth in the economy. The expression 'zombie bank' comes from the Japanese banking crisis in the 1990s, in which many Japanese banks were kept alive solely with the help of state credits.
[20] https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/ssm.sp170927.en.html
[21] ESRB 2019

**Figure 2. Conditions for the effective management of bad loans**




Source: The Riksbank

The earlier a bank detects problems in its lending and starts implementing measures, the better its chances of being able to counteract high levels of bad loans.[22] Banks should therefore continually stress-test their credit portfolios. Loan monitoring also includes managing underlying collateral. It is important that the collateral is correctly valued and that banks allow for poorer economic conditions or falling asset prices that cause the value of the collateral to diminish.

Finally, there are many structural factors that affect how bad loans are managed. The effectiveness of the legal system can, for instance, determine how quickly it is possible to realise the value of the collateral linked to bad loans.[23] An ineffective system could make it difficult to both value a loan and sell it on to an external party. There are major differences in the EU today in insolvency regulations, and clear lending guidelines are also absent. A review and harmonisation of the legal framework surrounding bad loans, for example common bankruptcy legislation, would therefore reduce the risk of the amount of bad loans growing so large that it poses a threat to the financial system. Initiatives on the EU level has recently been taken to tackle these structural problems (see the section below on measures to reduce the number of bad loans).

# The recovery after the financial crisis – differences between the EU and US

Unlike in the EU, the volume of bad loans decreased relatively quickly in the US after the crisis, and in the last few years it has been back at pre-2008 levels (see Figure 1). There are several perceivable reasons for why the recovery has been slower in the EU. One important reason is that the EU, at the time of the financial crisis and in contrast with the US, had no common bank supervision. All European banks were under national supervision, with different sets of regulations to follow. There was no common definition of bad loans in the

[22] Banks' monitoring of loans and their ability to detect problems early indicated substantial shortcomings in connection with the financial crisis (ESRB 2019).
[23] ESRB 2019

EU, or clear rules for dealing with the bad loans once they had arisen. This has enabled troubled European banks to defer the problems and hence avoid addressing their bad loans on a continual basis. In the US, even before the crisis, more uniform bank supervision and relatively strict regulations were in place. This allowed many of the problems that emerged in Europe to be avoided. For instance, in the US there were clear rules setting out when, at the latest, bad loans must be written down in their entirety, and rules for the valuation of underlying collateral. There are also differences in the taxation system compared with European countries, which give banks in the US stronger incentives to manage their bad loans at an early stage.[24]

In the EU, several structural factors can be identified, which, after the crisis, have delayed the consolidation of bad loans in the banking system. Examples of this are ineffective insolvency regulations and bankruptcy procedures that can take many years to complete. In some European countries, this involves banks going through long and complex processes before they can take possession of underlying collateral. It has also made it less attractive for external investors to buy bad loans from banks. Finally, in the US, banks' consolidation of bad loans has been facilitated by the existence of an established and well-functioning secondary market for them, which has not been the case in Europe. Inadequate write-downs, low transparency surrounding bad loans and differences in national legislation are examples of factors that have prevented the emergence of a similar secondary market in the EU.

# Measures to reduce the number of bad loans today and in the future

After the financial crisis, considerable effort has gone into designing frameworks and measures that aim for both reducing the risk in the banking system, and mitigating the consequences of future crises. Both regulations and transparency regarding banks' operations have been improved in recent years. An important piece of the puzzle has been the work of the Basel Committee[25] on the international harmonisation of regulations regarding definitions and credit risk management.[26] The Basel III regulatory framework, finalised in 2017, lays down tougher requirements for transparency in banks' financial reports.[27] This has made it easier to gain an overall picture of the risks associated with bad loans, even though there are still differences at the international level, for example with regard to definitions.[28] Another example of improvement is the provisioning rules in IFRS 9[29], which were implemented in 2018. Under these rules, banks must now set aside funds for future expected credit losses as soon as the loan is granted. Before IFRS 9, provisions only needed to be made at the time of classifying a loan as bad. Now, however, banks have to build up a buffer much earlier, which will facilitate the management of bad loans in the future.

---

[24] ESRB 2018
[25] Basel Committee on Banking Supervision
[26] The Basel Committee aims to promote global financial stability by improving and harmonising bank regulation and supervision. The Committee prepares guidelines and standards in different areas of banking supervision, and is the primary standard-setter for global banking rules.
[27] See Pillar 3 – updated disclosure requirements, https://www.bis.org/bcbs/publ/d455.htm and Guidelines on problem assets, https://www.bis.org/bcbs/publ/d403.htm
[28] For instance, consideration can be given to collateral, different requirements regarding how long it takes for a loan to be classed as non-performing, and how loan reconstruction and forbearance are to be assessed.
30 IFRS is a global accounting standard developed by the International Accounting Standards Board (IASB). All listed companies in the EU are obliged to apply the IFRS accounting standards.

At EU level, several initiatives have been taken to manage bad loans more effectively. Examples of measures are an EU-wide definition of bad loans devised by the European Banking Authority in 2013. Guidelines for how banks are to manage bad loans have been issued by the EU's bank supervision authority (SSM), and several reports have been written to study the background to the problems and propose solutions. In 2017 the European Council prepared an extensive plan of not only preventive measures to prevent new flows of bad loans, but also measures aiming to reduce the existing stock (see Appendix 3). One example of important preventive measures is the new statutory rules for when a bank must, at the latest, have written down the value of a bad loan.[30]

# Normalisation of interest rates can lead to increased volumes of bad loans

If the problems of low profitability and high volumes of bad loans in Europe spread, there would also be a risk that the Swedish banking system can be affected. Today, in Sweden, we can see high levels of debt among households and relatively low provisions[31] for expected credit losses at the banks, while levels of bad loans are relatively low. However, a normalisation of the interest rate level would probably lead to more bad loans and hence heightened risks in the financial system.

Large volumes of bad loans can cause banks problems with their capital adequacy and, at worst, can lead to default. Bad loans also negatively affect banks' profitability, making it more difficult for them to issue new loans, which can hamper long-term economic growth. Bad loans also increase uncertainty in the banking system, resulting in heightened financial stability risks. It is banks themselves that are ultimately responsible for ensuring sound lending, efficient loan monitoring and correct management of bad loans. Therefore, in order to manage the risks posed by bad loans, the problems must be tackled at an early stage. This requires a high level of transparency surrounding bad loans, and an adequate supervisory process.

[30] https://data.consilium.europa.eu/doc/document/ST-5014-2019-INIT/en/pdf
[31] In Sweden, the provision coverage ratio is 35 per cent compared with the EU average, which is 59 per cent. The provision coverage ratio shows the size of a bank's provisions made in relation to the share of non-performing loans (European Commission 2018).

# Appendix 1

## What is a bad loan?

'Bad loan' is not an unequivocally defined term, but is rather used as an umbrella term for loans with some type of payment problem. This could include doubtful receivables, problem assets, credit loss provisions, distressed loans, non-performing assets (NPA), non-performing loans (NPL) and non-performing exposures (NPE). See table 1 below for a comparison and brief description of different terms that can be designated as bad loans. Even if the concept differs, the term has the same basic meaning: it is a question of some form of exposure where the borrower has payment difficulties. The terms are similar in different countries but often differ regarding the exposures included in each respective concept, how these exposures are to be valued and when a loan is to be classified as bad. Furthermore, the definitions change over time. This makes it difficult to compare bad loans in different countries.[32]

The formal term in Europe for bad loans is 'non-performing exposures' (NPE), and has been devised by the EBA.[33] The NPE definition must be used by all banks in Europe and harmonises how a bad loan is defined and valued. An NPE consists of both a quantitative and a qualitative component where only one of these needs to be fulfilled for a loan to be classified as an NPE. The quantitative criterion is 90 days past due payment, and the qualitative assessment is whether the borrower is unable to fulfil the loan terms (unlikely to pay). The bank itself makes the qualitative assessment, which means that there is still a certain measure of discretion when reporting bad loans. In the strict sense, the NPE definition is currently only binding in supervisory reporting. However, banks are encouraged to also use the NPE definition in internal risk control and public reporting. The NPE definition is also used in many related surveys by authorities (for example SSM's asset quality supervision, EBA's stress test and measures to increase transparency in bad loans).

Table 1 Comparison of terms for bad loans

| Terms for bad loans | Definition and comment |
|---|---|
| Non-performing exposures, NPE | NPE has been used since 2014 within the EU as a harmonised definition of bad loans. An exposure[34] is classified as a non-performing if payment is either 90 days past due or if there is a risk of non-payment. An exposure that has been impaired in the accounts shall always be classified as non-performing. |
| Non-performing loans, NPL | NPL follows the same definition as NPE, with the difference that only loan exposures are included in the definition. In other words, it is a narrower term than NPE. |
| Non-performing assets, NPA | Used by certain countries and normally follows the quantitative assessment, i.e. if the payment is 90 days late, the loan is classified as non-performing. Here, only assets are included in the definition. This means that the |

[32] FSI 2018
[33] EBA 2013
[34] 'Exposure' means banking book loans, debt securities, loan commitments and financial guarantees.

| | |
|---|---|
| | definition of NPA coincides in some cases with the definition of NPL, but other assets can also be included. |
| Doubtful receivables | Doubtful receivables is a term that was used until IFRS 9 was implemented. It is a receivable for which payments will probably not follow the terms of the contract. Normally, a doubtful receivable refers to a receivable for which payment of interest, amortisation or overdraft is more than 60 days past due. However, the term ‘doubtful receivable’ is not harmonised and its exact definition varies between banks. The concept of doubtful receivables used to be employed in financial reports and resembles the EBA’s definition of non-performing, as it covers loans that are past due. |
| Credit loss provision | A credit loss provision is a provision made in accordance with IFRS 9 for expected credit losses. IFRS 9 defines credit-impaired financial assets and also includes financial guarantees and loan commitments. IFRS 9 requires provision to also be made for performing loans (i.e. loans that have not yet shown any impaired credit rating) and not just for loans that have been classified as non-performing. |
| Provision coverage ratio | The provision coverage ratio shows how much the bank has set aside for bad loans. |
| Problem assets | This is the American term for bad loans and follows a loan classification into five categories depending on credit quality. The three categories with the lowest credit quality – Substandard, Doubtful and Loss – normally fall within the term ‘bad loan’. |

# Appendix 2

## Accounting rules (IFRS 9) in relation to bad loans

The designation ‘bad loan’ is not an accounting term. The recently implemented international accounting rules (IFRS 9) refer instead to provision of expected credit losses, which is a forward-looking credit loss model. [35]

IFRS 9 introduces a model in which the size of the provision increases if there has been a significant increase in the credit risk. In other words, the bank must reserve a larger amount for expected credit losses. However, IFRS 9 does not define what is to be considered a significant increase in credit risk. This is instead up to the bank’s management to determine. The size of the expected credit loss and provision for the credit loss are determined by the estimated credit risk at the time of the report. For example, a loan with payment 30 days past due is considered to have a significantly increased credit risk according to IFRS 9.

According to IFRS 9, each loan has a provision irrespective of whether or not it is past due. There is always a risk of the bank making a loss on the loan, even if the loan is considered to be performing and currently being paid. This means that, irrespective of whether or not the loan is considered to be non-performing, a certain provision must be made for any potential future credit loss.

In IFRS 9 there is also a requirement setting out that all loans with payment 90 days past due shall be considered non-performing, in line with the customary definition of NPE. One of the purposes of the EBA’s NPE definition (see Appendix 1) is to make data more comparable by reducing the differences in the definition of non-performing in the EU. According to the EBA, an exposure that is written down according to accounting rules shall always be considered non-performing.[36] However, NPE can also include exposures that are not reported as defaulting in current accounting. The EBA’s definition of NPE is therefore a broader definition than that in IFRS 9, but the two are largely consistent.

---

[35] The corresponding forthcoming credit loss model in the US is termed CECL. IFRS 9 and CECL are not harmonised, however. See Economic Commentary on IFRS 9 for a more detailed description of IFRS 9 and differences between IFRS 9 and CECL: https://www.riksbank.se/globalassets/media/rapporter/ekonomiska-kommentarer/engelska/2018/ifrs-9--the-new-accounting-standard-for-credit-loss-recognition.pdf

[36] See EBA ITS on supervisory reporting point 147 in Annex V. https://eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standards-amending-commission-implementing-regulation-eu-no-680/2014-on-supervisory-reporting-of-institutions

# Appendix 3

## Status of the implementation of the European Council’s action plan for managing bad loans[37]

| |
|---|
| Accomplished |
| Ongoing |

| | | | | |
|---|---|---|---|---|
| **1.** | Interpretation of existing supervisory powers in EU legislation as regards NPL provisioning. | | **8.** | Improving loan tape information required from banks. |
| **2.** | Addressing potential under provisioning via automatic and time-bound provisioning. | | **9.** | Strengthening data infrastructure from NPLs, including potential transaction platforms. |
| **3.** | Extend Single Supervisory Mechanism NPL guidelines to small banks. | | **10.** | Develop a Blueprint for asset management companies. |
| **4.** | Adopting EU-wide management guidelines for non-performing exposures. | | **11.** | Develop the secondary markets for NPLs. |
| **5.** | New guidelines on banks’ loan origination, monitoring and internal governance. | | **12.** | Benchmarking of national loan enforcement an insolvency frameworks. |
| **6.** | Develop macroprudential approaches to tackle the build-up of future NPLs. | | **13.** | Develop the focus on insolvency issues in the European Semester. |
| **7.** | Enhanced disclosure requirements on asset quality and NPLs for all banks. | | **14.** | Enhancing the protection of secured creditors. |

# Abbreviations

BCBS Basel Committee on Banking Supervision
CECL Current Expected Credit Loss
EBA European Banking Authority
ECB European Central Bank
ECL Expected Credit Loss
ESRB European Systemic Risk Board
IASB International Accounting Standards Board
IFRS International Financial Reporting Standard
NPA Non-performing assets
NPE Non-performing exposures
NPL Non-performing loans
SSM Single Supervisory Mechanism

[37] European Commission 2018

# References


BCBS (1988), *International Convergence of Capital Measurement and Capital Standards*, http://www.bis.org/publ/bcbs04a.pdf

BCBS (2017), *Basel III: Finalising post-crisis reforms*, https://www.bis.org/bcbs/publ/d424.htm

Borio and Lowe (2002), *Assessing the risk of banking crises*

EBA (2013), *EBA FINAL draft Implementing Technical Standards On Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013*

ECB (2013), *Guidance to banks on non-performing loans*, https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

EBA (2014), *ITS on supervisory reporting*, https://eba.europa.eu/regulation-and-policy/supervisory-reporting/implementing-technical-standards-amending-commission-implementing-regulation-eu-no-680/2014-on-supervisory-reporting-of-institutions

EBA (2015), *EBA Guidelines on arrears and foreclosure*, https://eba.europa.eu/documents/10180/1163130/EBA-GL-2015-12_EN_GL+on+arrears+and+foreclosure

ESRB (2018), *Approaching non-performing loans from a macroprudential angle*, https://www.esrb.europa.eu/pub/pdf/asc/esrb.asc181001_7_ApproachingNPLsmacroprudentialangle.en.pdf

ESRB (2019), *Report on macroprudential approaches to non-performing loans*

European Commission (2018), *Third Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union*

FSI (2018), *The identification and measurement of nonperforming assets: a crosscountry comparison*, https://www.bis.org/fsi/publ/insights7.pdf

Riksbank (2018), *Financial Stability Report 2018:2*