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Transition to IFRS 9

Impact on forbearance practices: are there some risks?

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Executive Summary

Forbearance measures were widely applied across EU-countries during the crisis sometimes heterogeneously until the EBA harmonised definitions and the treatment of forbearance in Europe. Supervisory authorities such as the SSM encourage banks to apply forbearance measures when they can prevent a borrower or a group of borrowers to reach the non-performing status.

Under current accounting rules, avoiding the non-performing status had a positive impact on bank accounts in terms of reduced loss allowances. Under expected-credit loss approach, which will enter into force in 2018, all forborne exposures, either performing or non-performing, will require high levels of provisions. This will lead to an increase the provision requirements and potentially to the cost of forbearance for banks.

The EBA regulates the conditions for a forborne exposure to be promoted from a non-performing to a performing status and to exit the forbearance status. They involve completing a probationary period of 2 and 1 years respectively and complying with strict conditions about the performance of the creditors. These criteria do not take into account the specific credit profile of each creditor and could be considered to be too severe in some cases, what can lead to a reluctant use of forbearance measures in detriment of borrowers with high credit quality but temporary financial problems. Moreover, some banks have indicated that they will consider entity-specific policies and, therefore, there is a risk that different criteria for the curation of forborne exposures are applied across national jurisdictions.

Countries that report high *non-performing-loan* ratios tend to have high *forbearance* ratios and both are considered as good indicators of the asset quality of banks' balance sheets. However, the coverage with provisions of forborne exposures is lower than of non-performing loans because forborne exposures include both performing and non-performing borrowers.

1.- Background

Forbearance measures allow a troubled borrower to recover from temporary (sometimes cyclical) difficulties and enable the lender to avoid resolution actions that imply selling collateral at a depressed price and losing the long term client relationship. The key objective from the lender perspective of granting forbearance measures is to pave the way for non-performing borrowers to exit their non-performing status, or to prevent performing borrowers from reaching a

non-performing status. The supervisory expectation is that banks should implement well-defined forbearance policies aligned with the concept of viability and recognise in a timely manner those borrowers who are non-viable[1].

In the run up to the crisis and under a positive economic environment, few customers had difficulties to repay their loans. This was reflected in very low levels on non-performing loans (NPLs). In this context, forbearance practice was marginal and was not regulated at European level and only partially in some countries. With the outbreak of the crisis, more and more borrowers entered into difficulties and the practice of granting forbearance measures became more widespread. Banks had an incentive to forbear a loan to delay the recognition of impairment losses. Forbearance solutions granted to non-viable borrowers may have delayed necessary actions to tackle asset quality issues potentially leading to a misrepresentation of doubtful exposures on the balance sheet and, therefore, of the solvency position and profitability of some banks.

Some national authorities reacted by issuing some rules to increase the allowances of forbearance, with increasing divergences from one country to the other. For instance, Spanish banks must disclose annually the amount of forbearance exposures since the entry into force of Circular 6/2012. In this context, the European Banking Authority (EBA) developed in July 2014 common criteria to identify forbearance measures and harmonised the default and impairment definitions, including in relation to the extension of forbearance. Simultaneously, the IASB published IFRS 9 in July 2014, which includes only indirect references to forbearance measures. To clarify some of the ambiguities left by IFRS 9, the EBA specified how *forbearance* and *non-performing* definitions should be applied under the Expected-Credit Loss (ECL) approach[2].

According to the ECL approach, forborne exposures may be subject to higher provisioning requirements even when they are performing. To avoid that, banks could have the incentive of misaligning from the EBA definition of forbearance with the consequence of underestimating ECLs. On the other hand, while regulation has to prevent the misuse of forbearance, tougher requirements regarding the cure of forbearance measures could provoke other negative effects. For instance, they could contribute to triggering a crisis or increase the probability of crises if banks were reluctant to grant forbearance measures, or were to impose harsher conditions to clients to be forborne in order to avoid those tougher regulatory requirements. Thus, client protection could be affected as well.

In this note, we assess the current legislative framework and the possible implications that the integration of forbearance measures could have within the new accounting model under IFRS 9, including potential unintended consequences stemming from required impairment allowances. In this note, we present the new rules about forbearance and, in particular, 1) when a forborne exposure should be considered as performing or not; and 2) when a forborne exposures can be promoted from stage 3 to stage 2 and further to stage 1. After reviewing the latest data on forbearance, we discussed some potential unintended effects of those rules.

1: European Central Bank (2017): *"Guidance to banks on non-performing loans"*.
2: EBA (2017): *Guidelines on credit institutions credit risk management practices and accounting for expected credit losses.*

2.- Regulatory framework

2.1.- Performing vs. non-performing forborne exposures

Banks can offer forbearance measures to customers confronted with financial difficulties[3]. Sound banking practice requires that these measures are offered to borrowers under transitional problems. They require demonstrating that the financial difficulties experienced by the borrower are of a temporary nature and establishing a plan for the return to normal repayment. Most common forbearance measures include prolonging the maturity, reduced payments, grace periods or even reducing the principal balance. The high flexibility of options leaves a wide room for interpretation about whether an excessive leniency could distort a faithful representation of the solvency and profitability situation of the bank.

IFRS 9 is imprecise about the treatment of forbearance. Many forbearance measures clearly fall under the concept of "significant increase in credit risk" and therefore are to be classified in stage 2, and be subject to the lifetime ECL approach for calculating the impairment allowances. However, forbearance is not explicitly tackled in IFRS 9, so that it leaves a wide room for discretion and interpretation. The EBA provides some clarifications at this respect (Implementing Technical Standard on forbearance). In particular, it provides some criteria to distinguish between performing and non-performing forbearance measures[4].

Performing forbearance measures are those granted to borrowers facing temporary difficulties in order to accommodate the borrower's affected cash flow situation. They typically include short grace periods of up to one year or reduced payments over a defined short-term period. According to EBA rules, forborne exposures are classified as *performing*[5] (Stage 2 under IFRS 9) if either of the following conditions is met:

- The modification has not led the exposure to be classified as non-performing (for instance, because of a an extension in maturity considered to be too long[6]) or;
- The exposure was not under non-performing status at the date the forbearance measures were extended.

On the other hand, non-performing forbearance measures are granted to debtors facing serious solvency difficulties, broader than cyclical cash flow shortfalls. These measures typically include partial or total debt forgiveness, granting new credit facilities or grace periods of more than 2 years. According to EBA rules, forborne exposures are classified as *non-performing*[7] (Stage 3 under IFRS 9) in the following cases:

- The modification is such that the exposure has to be classified as non-performing (e.g. granting grace periods with an extension greater than 2 years).
- Exposures under probation having been re-forborne (e.g. granting additional grace periods) or more than 30 days past-due.

[3] In some cases, they are not optional. For instance, in Spain, a *Code of good practice* makes forbearance compulsory in certain cases.
4: See also, Commission Implementing Regulation (EU) 2015/227 of 9 January 2015 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.
5: They are called *standard under special monitoring* in the Spanish transposition of EBA rules through the Circular 4/2016 of the Bank of Spain.
6: For instance, according to the Spanish transposition, grace periods should be shorter than 2 years for a forbearance measure to be classified as performing.
7: They are called *doubtful* in the Spanish transposition.

2.2.- Recovery of forborne exposures

The distinction between *performing* and *non-performing exposures* has significant accounting and prudential implications. Forborne exposures are subject to a probationary period which enables assessing the adequacy of the recovery plan and, therefore, the exact credit quality of the loan. Exposures classified as "performing forborne" have a high probability of improving their credit quality up to return to Stage 1 because they are granted to borrowers experiencing temporary liquidity constraints. The EBA ITS on forbearance indicates that performing forborne exposures can be "cured" and therefore moved from Stage 2 to Stage 1 when they comply with all of the following:

a) There is a high probability that the borrower will be able to comply with its obligations in due time and form.

b) The exposure has been under *special monitoring* for a probation period of at least two years (the period restarts in case of a delinquent instalment).

c) The borrower has paid the accrued instalments of principal and interest since the forborne transaction.

d) The borrower does not have any other amounts more than 30-day past due at the end of the probation period.

The probability for a *non-performing forborne* exposure of returning to performing status (i.e. of being reclassified from Stage 3 onto Stage 2) is lower due to the solvency-related difficulties that the borrower faces. This is reflected in the set of conditions that have to be met:

a) The extension of forbearance does not lead to the recognition of impairment or default;

b) One year has passed since the forbearance measures were extended;

c) There is not, following the forbearance measures, any past-due amount or concerns regarding the full repayment of the exposure.

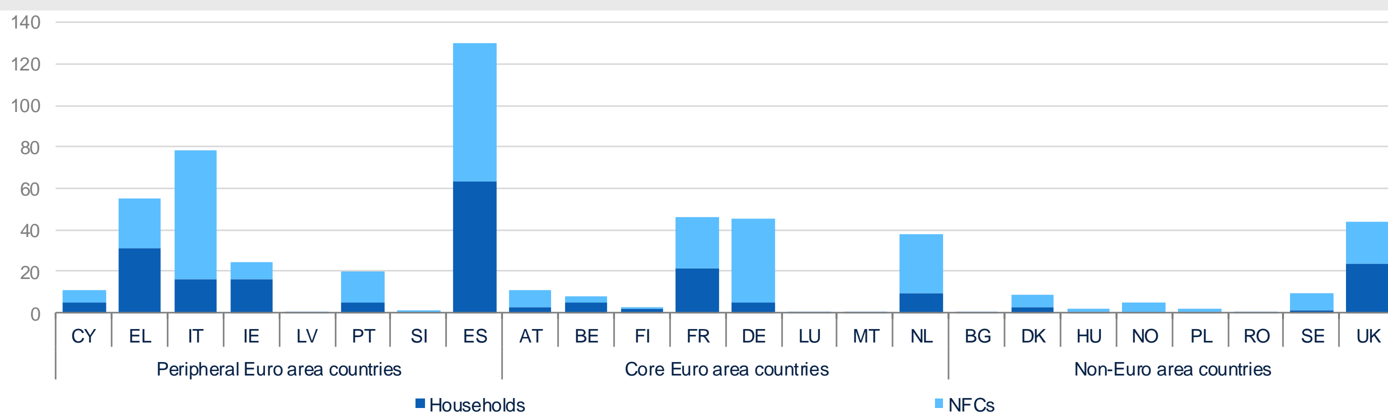
In short, besides complying with the rest of conditions, current rules require at least three years for a non-performing forborne exposure to be considered fully recovered: 1 year to be promoted from Stage 3 to Stage 2 and two additional years to be promoted from Stage 2 to Stage 1.

3.- Recent trends in forborne exposures

Since the adoption of the EBA ITS on forbearance and non-performing in 2014, European banks distinguish between performing forborne and non-performing forborne exposures and report them within FINREP. According with those data, European banks included in the EBA transparency exercise had over €550 bn forborne exposures in June 2017, representing 4.0% of total EU exposures, of which €335 bn corresponded to exposures to non-financial corporations and €216 bn to exposures to households. Forborne exposures concentrate in a few countries. In particular, forborne

exposures in Spanish banks represent almost 24% of the total and, in Italian banks, 14%[8]. Large exposures are also observed in Greece, Germany, the UK, France and the Netherlands (between 5% and 10% of the total) (Figure 1).

Figure 1 Retail exposures with forbearance measures, June 2017, € billion



Notes: Retail exposures include exposures to households and to non-financial corporations.
Source: EBA and BBVA Research

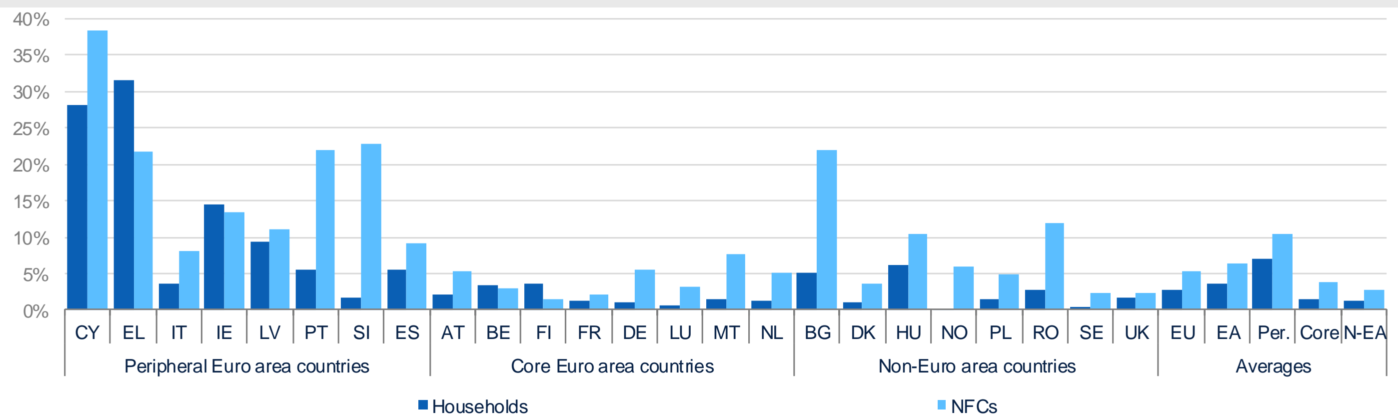
In relative terms, peripheral Euro area countries tend to present larger forborne exposures (7.1% for households and 10.5% for non-financial corporations, on average) than core Euro area countries and non-Euro area countries (below 3% for households and below 6% for non-financial corporations). However, peripheral Euro Area countries have, on average, lower coverage ratio for forborne exposures than core Euro area countries (see below). Some Eastern European countries (Bulgaria, Hungary and Romania) appear also with relatively high levels of forborne exposures, particularly for non-financial corporations. In general, exposures to non-financial corporations tend to have larger forborne measures than exposures to households; Greece outstands as the main exception (Figure 2).

The countries with the highest proportion of forborne exposures are Bulgaria, Cyprus, Greece, Ireland, Portugal and Slovenia, with over 13% of the exposures to either households or non-financial corporations being subject to forborne measures.

Forborne measures are mainly granted to non-performing loans with respect to both households (Figure 3) and non-financial corporations (Figure 4). Spain represents an important exception as almost 60% of forborne exposures are classified as performing (particularly for exposures to households). This may indicate that Spanish banks have a policy of offering forbearance at an early stage before the financial problems may become unsurmountable or that forbearance was granted some time ago and has already being cured[9]. Other countries with a relatively high proportion of performing forborne exposures include Greece, Latvia, Ireland and Cyprus.

[8] Note that in June 2017 the Spanish Banco Popular was resolved. Although the bank was later absorbed by Santander, data for Banco Popular are not reported by the EBA. Forborne exposures for Popular were €15 bn in June 2016; therefore, the actual forborne exposures for Spain are probably slightly larger than what is reported at the EBA Transparency Exercise. A similar situation appears in Italy. The total forborne exposures for the two Italian banks that were liquidated were €4.8 bn in June 2016 (the banks are: Banca Popolare di Vicenza and Veneto Banca).
[9] In Spain, there is a *Code of good banking practice* since 2012 which includes some policies about forbearance.

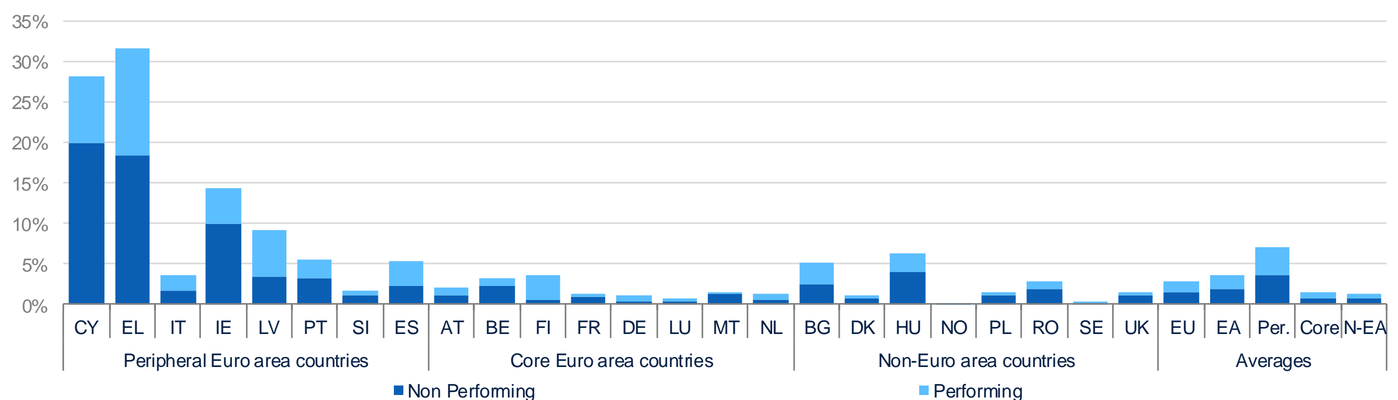
Figure 2 Forbearance ratio, June 2017, percentage of exposures



Source: EBA and BBVA Research

In terms of evolution, we observe a decline in total forborne exposures from 4.6% in December 2015 to 4.1% in June 2017[10], which consolidates a trend already started in December 2014. However, we can also observe a few countries with increasing forborne exposures like Italy, Latvia, Portugal and Cyprus. The latter being the country with the largest forborne exposures, in relative terms (see Figure 10).

Figure 3 Forbearance ratio for household exposures, June 2017, percentage of exposures

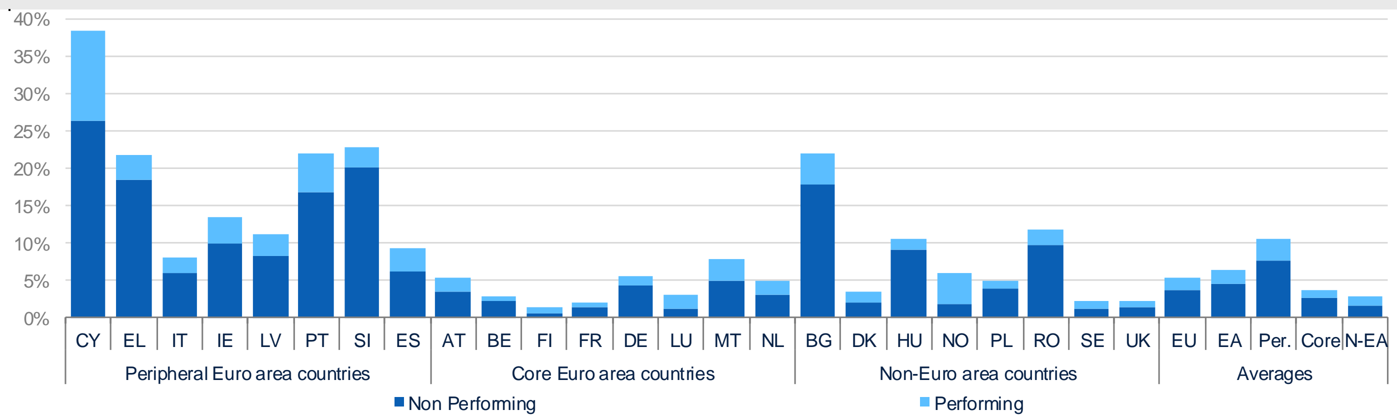


Source: EBA and BBVA Research

Forborne exposures entail specific risks, thus, the appropriate coverage of forborne exposures is a key issue to evaluate the loss-absorbing capacity of banks. Up to 40% of non-performing forborne exposures are covered with provisions in the case of exposures to non-financial corporations. The coverage for exposures to households is lower (about 30% of the exposures) because of the importance of mortgage loans and the corresponding collateral. Cyprus and Greece present relatively low coverage ratio even if they are among the countries with the highest forborne exposures, in relative terms.

10: Figures based on a fixed sample of banks across the period, according to EBA data.

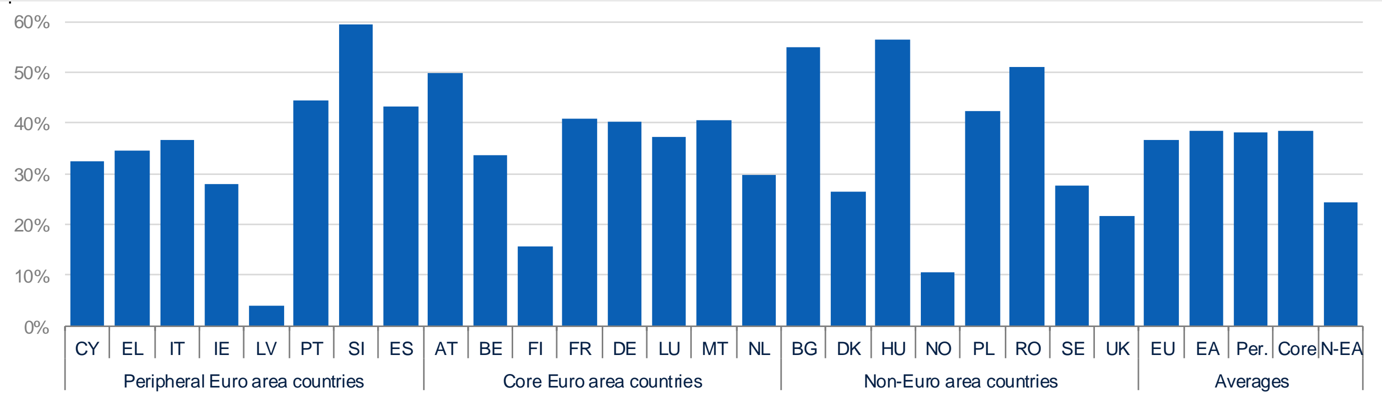
Figure 4 Forbearance ratio for non-financial corporation exposures, June 2017, percentage of exposures



Source: EBA and BBVA Research

On average, peripheral Euro area countries present coverage ratios for non-performing forborne exposures similar to the ones in core Euro area countries, although they have higher forbearance ratios. In non-Euro area countries, coverage ratios are, on average, below the EU average, however in some cases they are well above that average (Slovenia, Bulgaria, Hungary and Romania) (Figure 5). In general, coverage ratios for non-performing forborne exposures tend to be lower than overall non-performing exposures. This can be explained by the expectation that the forbearance measures granted will contribute to cure the status of the borrower.

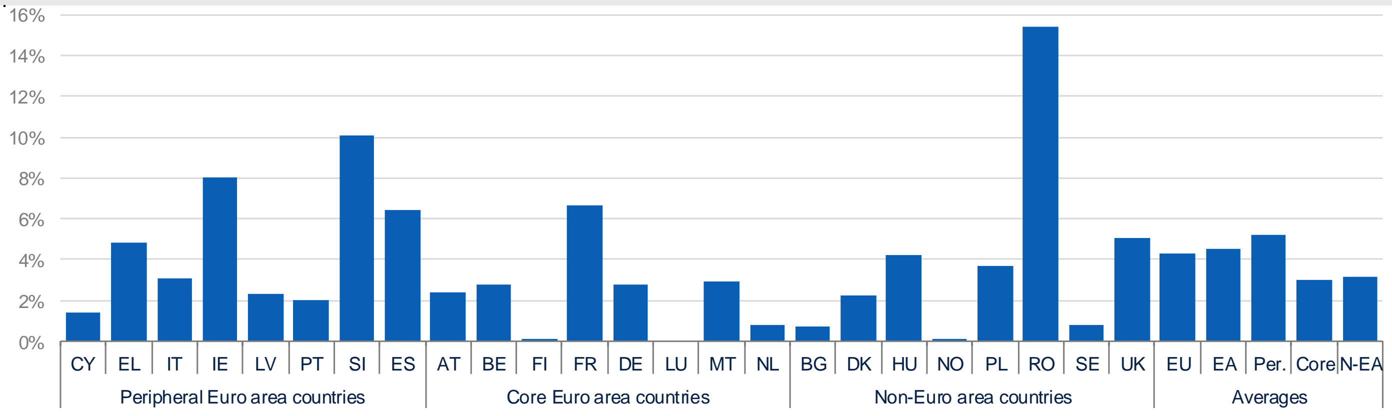
Figure 5 Coverage ratio of non-performing forborne exposures, June 2017, percentage



Notes: Average for exposures to households and to non-financial corporations.
Source: EBA and BBVA Research

Given the lower risk of performing exposures and the lower loss allowance requirements in the international accounting framework, their coverage ratio is also much lower, about 4% for the EU average (Figure 6). With the entry into force of IFRS 9, we expect that provisioning, and therefore the coverage ratios, for performing forborne exposures will increase because the future classification within Stage 2 and the calculation of lifetime expected credit losses.

Figure 6 Coverage ratio of performing forborne exposures, June 2017, percentage.

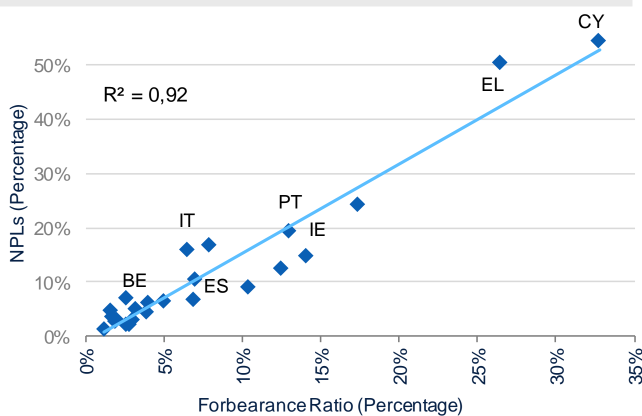


Notes: Average of exposures to households and to non-financial corporations.
Source: EBA and BBVA Research

4.- Discussion

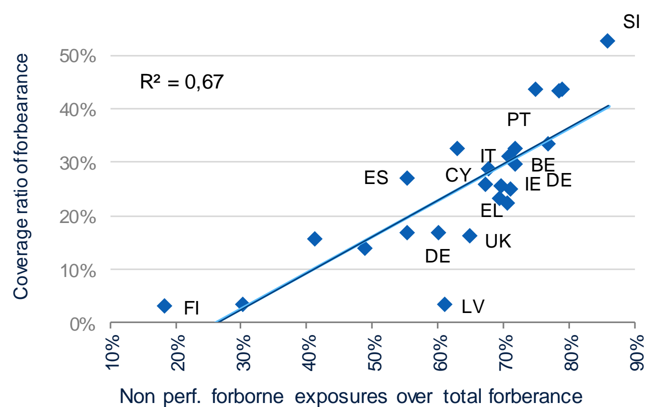
The EBA established a two year probation period for a forborne exposure to be reclassified from Stage 2 to Stage 1. Given the special features of forbearance, an observation period to assess the quality of the exposure seems necessary. However, making it compulsory for two years could be too long and restrictive and potentially generate incentives for banks for misaligning from EBA rules to avoid excessive provisioning. Although the misalignment from EBA rules is highly unlikely due to the direct application within the EU, this could provoke heterogeneity across European banks because some national legislators have already adopted the 2-year approach (e.g. Bank of Spain Circular). There could be the possibility of misrepresenting lifetime expected-credit losses and the solvency position of banks.

Figure 7 NPL vs. forborne exposures, EU countries, June 2017, percentage of total exposures



Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA and BBVA Research

Figure 8 Coverage of forborne exposures vs NPL forborne exposures, EU countries, June 2017, percentage of total exposures



Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA and BBVA Research

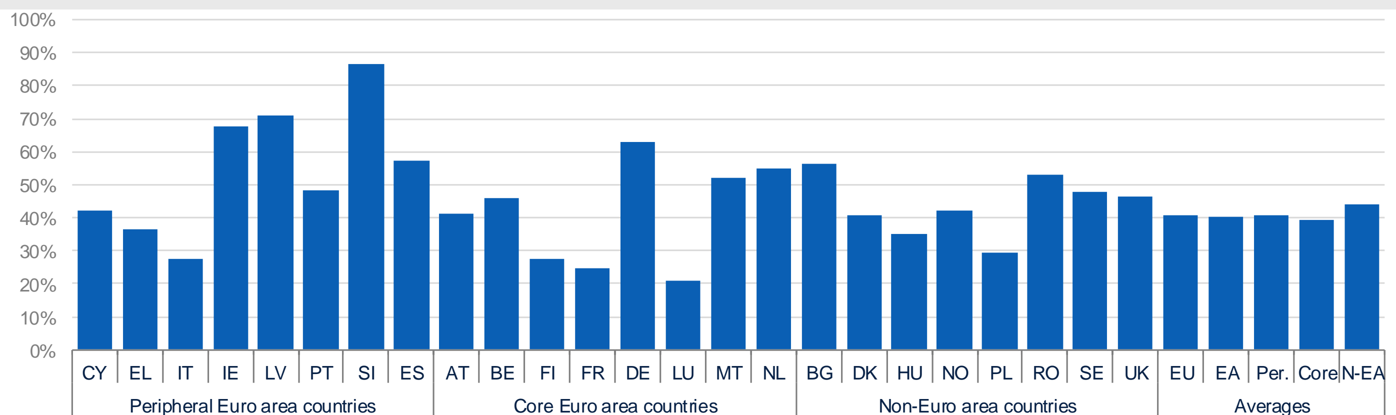
Both the forbearance ratio and the non-performing loans ratio are indicators of asset quality for a bank or a country. Therefore, they should be highly correlated, i.e. high forbearance ratio should be accompanied by high NPL ratio. The data for European countries in 2016 seem to indeed be consistent with the expectations (Figure 7).

The correlation between the coverage ratio of forbearance and the proportion of non-performing exposures in forborne portfolios is less strong, but still quite significant (Figure 8). This correlation is explained mainly because of the high provisioning requirements for non-performing exposures under IAS 39 framework. We expect that this correlation will increase under expected credit loss framework, mainly derived from the application of lifetime expected-credit loss to performing exposures and the subsequent increase in provisions (and in coverage ratios).

We observe, therefore, some heterogeneity among EU countries not only in the classification of forborne exposures among performing and non-performing category but also in the coverage of those exposures. If this heterogeneity continues in 2018, there could be significant differences across banks in lifetime expected credit losses calculated for forborne exposures.

Non-performing forborne exposures represent 40% of total non-performing exposures in the EU (Figure 9). Only in seven Euro area countries, more than 50% of non-performing loans have benefited from forbearance. This indicates that the majority of distressed debtors classified as non-performing (Stage 3) are not offered (or are not granted) forbearance procedures, seeing limited opportunities of exiting the non-performing status. This could stem from a lack of incentives for banks to grant forbearance measures or from credits being of such a bad quality that they are considered to be almost incurable. Moreover, this can raise the question about whether this situation stems from unexpected events or from an inadequate initial assessment of the credit quality of potential borrowers; or even whether some borrowers have managed to improve their financial situation and exit the NPL pool.

Figure 9 Non-performing forborne exposures over total NPL, June 2017, percentage



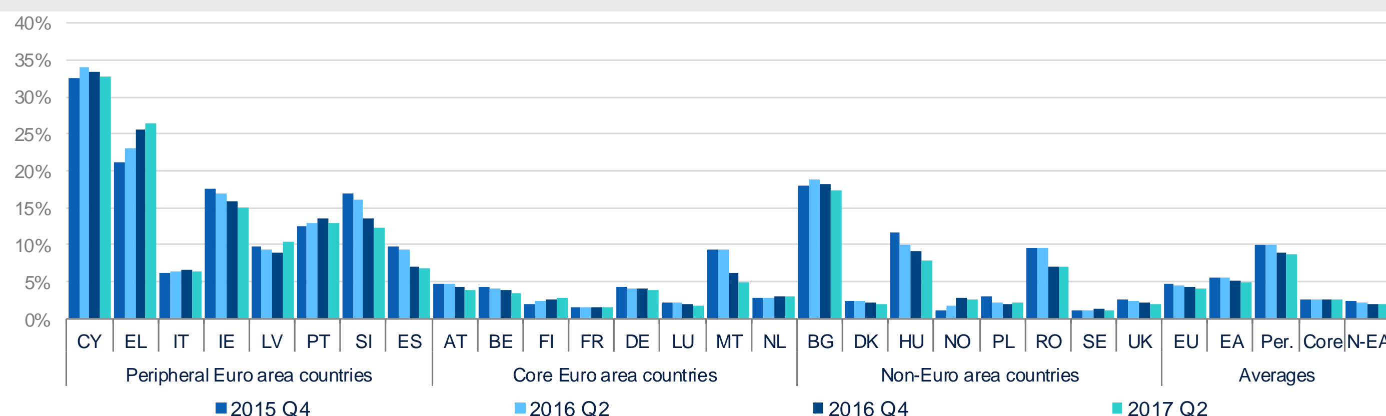
Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA and BBVA Research

Under IFRS 9, we expect that the weight of non-performing forborne exposures over total non-performing exposures will decrease for those countries that implement the EBA ITS on forbearance within their expected-loss methodology

framework. This is because these exposures need an extra year in the non-performing status (Stage 3), plus two years classified within Stage 2. This “probation periods” can represent a significant cost in terms of loss allowances, calculated with lifetime expected credit loss approach for at least three years.

Thus, NPL management could be affected by the integration of the ITS on forbearance within expected-loss methodology. Some banks have already communicated to the EBA (in the framework of a public consultation) their intention to replace the “minimum two year probation period” for institution-specific internal credit risk assessment in deciding when exposures can be promoted from Stage 2 to Stage1[11]. In some country, the national regulator has transposed the EBA ITS on forbearance and may not allow for such flexibility, what may affect the level playing field. This is the case in Spain, where Circular 4/2016 makes compulsory the 2-year probation period.

Figure 10 Forborne exposures, percentage of total exposures



Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA, ECB and BBVA Research.

In terms of evolution, data on forbearance show a downward trend for the EU as a whole going from 4.6% in December 2015 to 4.1% in June 2017 and consolidating a trend already started in December 2014. Spain and Ireland appear as the countries that register the biggest efforts to reduce forbearance exposures (Figure 10 and Figure A2 in the Annex). In the case of Spain, the decrease is mainly explained by the reduction in performing forborne exposures (Figure A3) between 2016 Q2 and Q4, the moment when the new rules on forbearance entered into force.

On the other hand, forbearance exposures remain significantly high in Cyprus and Greece, without signs of being contained. This may be pointing to some structural issues still to be resolved. An abrupt fall in forbearance is observed in Spain in the second half of 2016, when the Circular 4/2016 entered into force. Given the previous trends and the evolution observed in other countries it seems that Spanish banks did a great effort of reclassification of forborne exposures before the effective application of the rule to avoid, at least partially, its potential negative impact. With the future framework of IFRS 9, these exposures will be considered Stage 2 exposures and therefore provisioned with lifetime expected credit losses.

11: *Guidelines on credit institutions’ credit risk management practices and accounting for expected credit losses* (EBA): Summary of responses to the consultation (May 2017)

This anecdotal evidence could be generalised in other countries. Banks seem to have an incentive of being more restrictive in offering forbearance to their customers to avoid exposures entering Stage 2 and, therefore, deviating from the ECB and ESRB guidelines issued to contribute to solve the NPL problem. According to such guidelines, a non-performing borrower found to be viable should be restructured to pave the way to exit their non-performing status.

4.- Conclusion

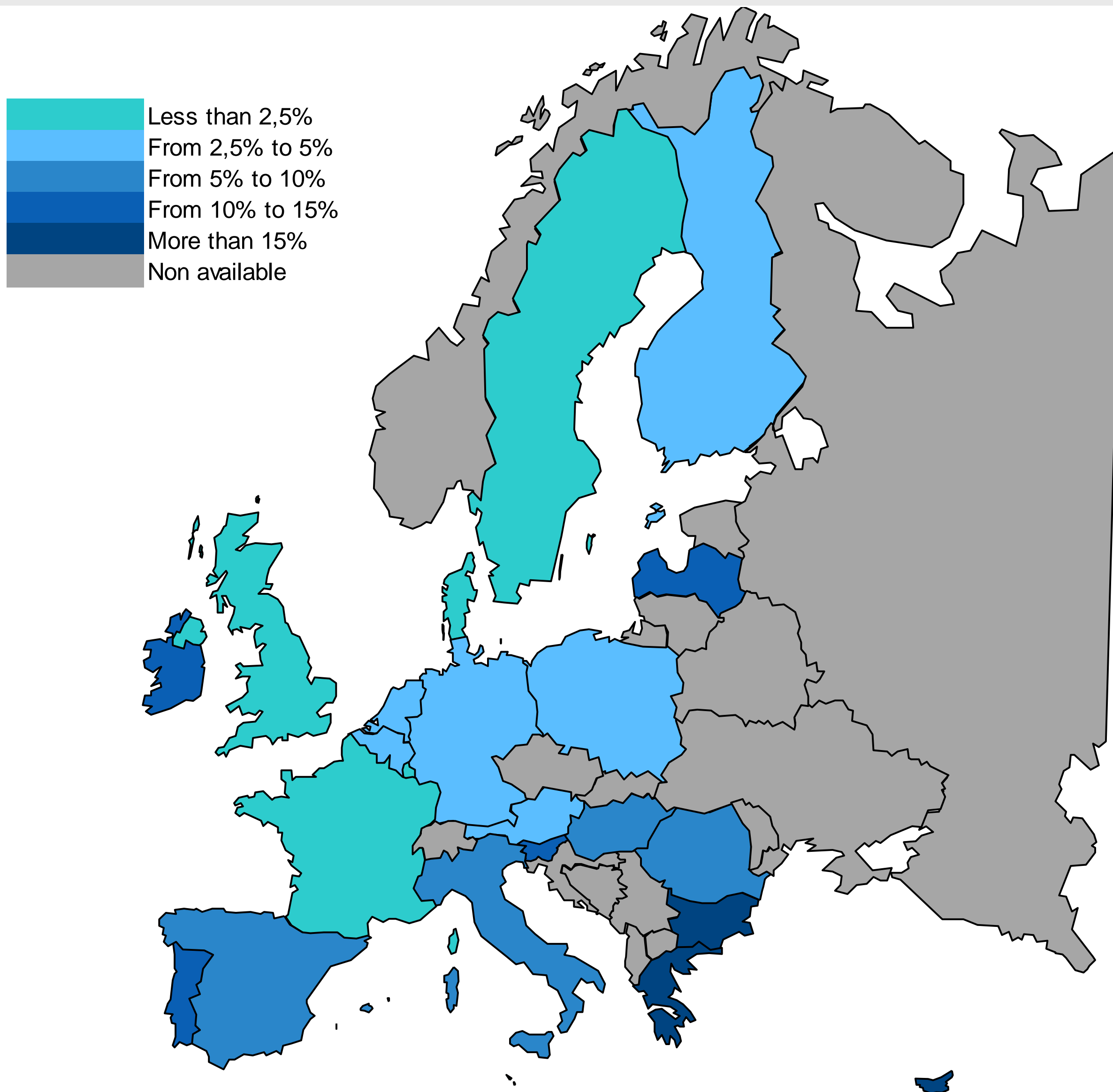
Forbearance practices play a crucial role in credit risk management because they improve the likelihood of NPLs to recover a performing status; therefore, they can also be considered as a tool to improve client protection. The new expected credit loss framework may negatively affect forbearance practice by European banks. Banks may be inclined to reduce the early forbearance measures to avoid the recognition of lifetime credit losses on Stage 2. Moreover, they may also try to reduce the forbearance granted to non-performing debtors because the requirement of maintaining the classification for at least one year within non-performing plus two years within performing status. In this case, their asset quality and solvency indicators would be misleading and difficult the comparison across banks. Accounting regulation, while usually neutral, may be influencing business decisions.

Data on forbearance show a declining trend which, in some cases, goes beyond the expected reduction in the relative amount of troubled creditors.

Under the incurred-loss model, there were advantages of forbearance measures, which were focused on providing the debtor a “second opportunity” to avoid the inclusion in non-performing category. Under the IFRS 9 framework, forbearance measures will be associated with lifetime expected-credit losses, either classified within Stage 2 or Stage 3. As the advantages are reduced, we expect a reduction in the probability for granting forbearance both for performing and non-performing debtors. This goes in detriment of client protection and does not contribute to solving the NPL problem.

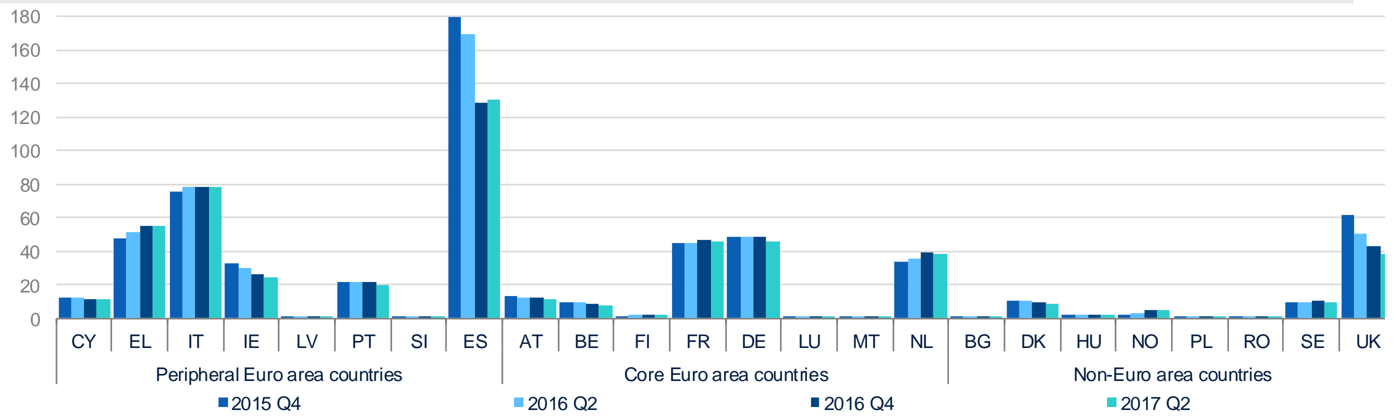
Annex: Additional charts

Figure A1 Forbearance ratio, retail exposures, June 2017, percentage



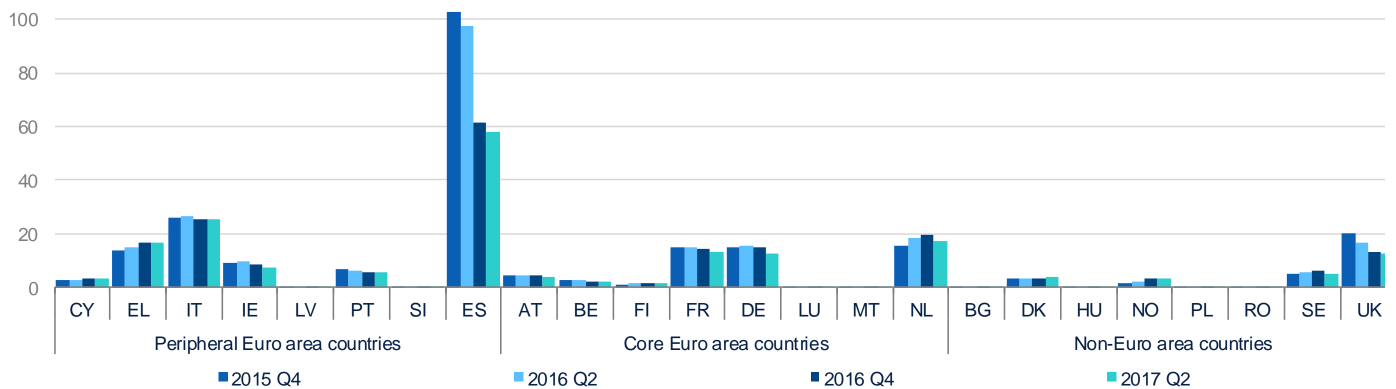
Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA, ECB and BBVA Research.

Figure A2 Forborne exposures, € billion



Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA, ECB and BBVA Research.

Figure A3 Performing forborne exposures, € billion



Notes: Exposures include exposures to households and non-financial corporations.
Source: EBA, ECB and BBVA Research.

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