AT A GLANCE

European Parliament

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

At present, a number of banks in Europe are still faced by a high stock of non-performing loans (NPLs). In March 2017, the European Central Bank (ECB) published a Guidance to banks on non-performing loans that clearly spells out that the "***timely recognition of provisions and timely write-off of unrecoverable loans is a key supervisory focus***".

One of the challenges in reviewing provisioning policies and specific provisions is that the accounting perspective is not necessarily aligned with the prudential view of supervisors (notably, both the European Commission and the ECB have just launched public consultations regarding Statutory Prudential Backstops that aim to address insufficient provisioning levels). In any case, the supervisory arm of the ECB, which directly supervises the most significant banks in the euro area, has from its very beginning put a strong focus on the question whether non-performing loans are adequately provisioned for (see in this context for example the ECB Note Comprehensive Assessment October 2013, p. 6).

In view of a regular public hearing with the Chair of the Supervisory Board of the ECB in ECON on 9 November 2017, some academic experts for banking supervision were asked to assess which provisioning practices best ensure from a prudential perspective that banks present "sound and clean balance sheets" that do not carry uncovered or hidden losses. Some of the points raised by the experts in their briefing papers are highlighted in the following summary:

Prof Andrea Resti (Bocconi University)

Andrea Resti points out that the link between NPLs, profitability and loan growth is mostly about correlation, not causality. The long-term dynamics of NPLs are mainly driven by two factors: the macroeconomic cycle and the banks' lending practices. While NPLs tend to be associated with modest profits and poor loan supply, they are not causing them. Instead, bad loans, operational inefficiency and modest profitability may all follow from adverse macroeconomic conditions, ineffective management and inadequate governance schemes. **Against this backdrop, Resti reminds that bank profitability and lending capacity cannot be magically restored by forcing lenders to hastily offload, or write off, non-performing exposures.** In his paper Resti discusses in more detail the pros and cons of four levers that can be used to curb high NPL stocks, namely internal recovery processes, NPL sales, support by external asset management companies, and finally provisioning regimes.

Prof Mark Wahrenburg (Goethe University)

Mark Wahrenburg explains the accounting mechanics regarding loan loss provisions and introduces the three most important models for loan loss provisioning: the incurred loss model, the expected credit loss model and the counter-cyclical buffer model. Based on economic reasoning **Wahrenburg finds that the expected loss model should be the preferred model for both financial accounting needs and prudential regulation**.

The new IFRS 9 accounting standard, however, adopted in the EU by the Commission Regulation (EU) 2016/2067 of 22 November 2016 and applicable as of 1 January 2018, is a mixture between the current incurred loss and the expected credit risk model while the American standard setter FASB has introduced a pure version of the expected credit loss model in the US.

Prof Harry Huizinga (Tilburg University)

Harry Huizinga warns that supervisory guidance provided to banks on how to implement IFRS 9 has mostly been of a qualitative nature and may prove inadequate to prevent an undesirably wide future variation in provisioning among EU banks.

Assuming that the heterogeneity among banks in the procyclicality of provisioning may not only reflect the formal accounting rules, but also the variation in discretionary provisioning policies, Huizinga's paper presents empirical evidence on the heterogeneity of provisioning procyclicality among significant banks that are directly supervised by the ECB.

Prof Elena Carletti (Bocconi University, European University Institute) and Ms Brunella Bruno (Bocconi University)

Elena Carletti and Brunella Bruno finally also point to the problem that banks' provisioning policies are still quite different across banks and countries, and look into the various underlying reasons, ranging from different collateral characteristics and enforcement systems to tax regimes, accounting methods, to different managerial and supervisory practises. **Carletti and Bruno see the new accounting rules and recent measures that increase transparency as an important step forward,** but also point to the need of complementary early intervention powers at the supervisory level.

Contact: egov@europarl.europa.eu

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