



# BULGARIA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### TECHNICAL NOTE—NONPERFORMING LOANS REDUCTION STRATEGY

July 2017

This Technical Note on Nonperforming Loans Reduction Strategy for Bulgaria was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2017.

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# TECHNICAL NOTE

## NONPERFORMING LOANS REDUCTION STRATEGY

Prepared By  
**Monetary and Capital Markets  
Department, and Finance &  
Markets Global Practice, World  
Bank**

This Technical Note was prepared by IMF and WB staff in the context of the Financial Sector Assessment Program in Bulgaria, led by Michael Moore, IMF and Ilias Skamnelos, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance & Markets Global Practice, World Bank. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>, and [www.worldbank.org/fsap](http://www.worldbank.org/fsap).

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## Glossary

AMC	Asset management company
AQR	Asset quality review
BCBS	Basel Committee on Banking Supervision (Basel Committee)
BCP	Basel Core Principles
BNB	Bulgarian National Bank
BSD	BNB Bank Supervision Department
CBA	Currency Board Arrangement
CET1	Basel capital measure – Common Equity Tier 1
CIT	Corporate income tax
CRR	Capital Requirements Regulation (E.U.)
DGS	Deputy Governor for Supervision
EBA	European Banking Authority
ECB	European Central Bank
ECL	Expected credit loss provisioning, under IFRS 9
EDTF	Enhanced Disclosure Task Force of the FSB
ESRB	European Systemic Risk Board
EWS	Early warning system
FASB	Financial Accounting Standards Board (U.S.)
FSAC	Financial Stability Advisory Committee
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
GAAP	Generally Accepted Accounting Principles (U.S.)
GC	Governing Council
GDP	Gross Domestic Product
IAS	International Accounting Standards of the IASB
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards of the IASB
LLP	Loan loss allowance (a “contra-asset”; also called a loan loss provision)
LTV	Loan to Value ratio
MOF	Ministry of Finance
NPLs	Nonperforming Loans (used interchangeably with distressed assets)
SB	Supervisory Board
SSM	The ECB’s Single Supervisory Mechanism
ROSC	Reports on the Observance of Standards and Codes (World Bank)
TN	Technical Note
VAT	Value added tax

## PREFACE

**This Technical Note (TN) examines the current state of NPLs in Bulgaria and makes recommendations for a strategy to substantially reduce NPLs.** These strategy recommendations were developed based on an assessment of the relevant regulatory and supervisory framework and bank practices, including relevant standards and practices for accounting treatments, early warning systems, NPL market development, and collateral valuation. The TN sets forth macroprudential approaches and other components of a sound strategy for NPL reduction, including improvements to loan loss provisioning, income recognition on NPLs, loan write-downs, early warning systems, collateral valuation, risk information for investors, and the NPL market.

**The NPL management process involves many stakeholders, and their mutual cooperation is important for success.** The Bulgarian National Bank (BNB), in its capacity as bank supervisor and regulator and as macroprudential authority for banks, will be in the lead position on the implementation of key aspects of the NPL reduction strategy that can achieve progress in the near term. Broader policies to enhance NPL resolution entail other stakeholders, including the Ministry of Justice (MoJ) that would need to engage in the areas of insolvency and collateral enforcement regimes.

**During the mission the FSAP mission chiefs and the authors had constructive dialogue with senior BNB officials and staff about the strategy recommendations, as well as discussions with the MoJ on relevant issues addressed in the 2016 World Bank’s Insolvency Report on the Observance of Standards and Codes (ROSC).<sup>1</sup>** In addition, the IMF external advisor provided a seminar for BNB officials and staff on key aspects of the recommended NPL reduction strategy, including macroprudential tools to encourage robust provisioning practices. The team would like to thank the authorities for the excellent cooperation and fruitful discussions.

---

<sup>1</sup> The World Bank ROSC on Insolvency and Creditor/Debtor Regimes, June 2016.

## EXECUTIVE SUMMARY AND KEY RECOMMENDATIONS<sup>2</sup>

**While the BNB has taken steps to promote reductions in nonperforming loans (NPLs) in the banking system, NPL levels remain high.** Based on the BNB's own methodology, gross NPL levels at end-June 2016 were a high 19.7 percent of total gross loans, with most NPLs over one year past due. Using the EBA's NPL measure, this, too, shows Bulgaria among those EU countries with higher NPL levels.<sup>3</sup>

**Banks have generally high buffers in place, but loan loss provisioning coverage needs improvement.** The BNB's macro- and microprudential policies have pushed banks to retain earnings and move toward achieving generally high capital and liquidity buffers. The generally adequate capital positions were largely confirmed in the recent asset quality review (AQR). In addition, the AQR was useful to establish common measures of asset quality and to assess collateral, thereby promoting better risk identification. However, loan loss provisioning coverage shows weakness and will need to be enhanced to address the credit losses associated with NPL reductions.

**The BNB should adopt a comprehensive strategy in the near term to achieve a substantive reduction in NPL levels over a three- to five-year time horizon.** The strategy would be in keeping with the BNB's macroprudential responsibilities for maintaining bank and financial system stability and mitigating systemic risk. The strategy should focus on more intensive measures to enhance bank practices in three main areas: (i) loan loss provisioning (LLP); (ii) loan write-downs of NPLs, in whole or in part, where collection is unlikely; and (iii) collateral valuation. This effort would be supported further by enhanced supervisory guidance, supervisory reporting, and risk disclosure.<sup>4</sup> Moreover, it should include efforts to improve banks' early warning systems (EWS), and to develop the NPL market.

**Key to the effort will be a strengthened supervisory review process using macroprudential tools.** Under this approach, as applied for loan loss provisioning, the BNB would still expect banks to follow International Financial Reporting Standards (IFRS), but would specify certain supervisory expectations using the BNB measurement metrics. For example, if the reported loan loss allowance is insufficient relative to the BNB supervisory metrics calibrated to encourage robust provisioning practices, then there would be additional supervisory scrutiny. A similar approach would also be taken for NPL write-downs and for collateral valuation through the application of additional BNB metrics.

<sup>2</sup> This Technical Note has been prepared by Gerald A. Edwards, Jr., IMF external advisor, and Karlis Bauze, World Bank.

<sup>3</sup> According to the EBA Risk Dashboard, the EU weighted average for the NPL ratio was 5.5 percent as of June 2016, while Bulgaria stood at 13.7 percent.

<sup>4</sup> The supervisory reporting should include both: (i) cash basis (actual received interest income); and (ii) accrued interest income, since IAS 39 and IFRS 9 allow for the accrual of interest income for NPLs and impaired loans, which can provide disincentives for NPL reduction.

**As banks prepare for the adoption of IFRS 9, they will need to adapt their provisioning practices to better identify and recognize loan deterioration.** Estimates of the impact from IFRS 9 based on various samples of larger banks in the EU and in other parts of the world are that loan loss allowances may increase by 18–33 percent from current levels.<sup>5</sup> Under IFRS 9 there will be a rebuttable presumption that loans that are 30 days or more past due will have experienced “a significant increase in credit risk,” thus requiring the recording of higher loan loss allowances based on lifetime expected credit losses. The BNB should prepare now with supervisory guidance to ensure that banks are making appropriate preparations with systems and processes, as well as by enhancing their EWS.

**The BNB should issue supervisory guidance to banks, setting forth robust minimum collateral valuation practices, including on the use of internal and external valuation experts.** Since the highest NPL ratios are in the construction and real estate sectors, and collateral-based lending is extensively practiced, the proper valuation of collateral pledged against loans is essential to a sound NPL reduction strategy. The AQR results and discussions with market participants highlighted that a uniform, conservative set of rules for collateral valuations at banks is necessary to avoid unsound and divergent practices. The issuance of clear and conservative valuation rules will contribute to improved NPL markets consistent with the NPL reduction strategy and help reduce the NPL pricing gap observed in Bulgaria.

**The BNB should promote improved risk information for investors and risk disclosure, starting with the largest banks in line with the recommendations of the Financial Stability Board’s (FSB) Enhanced Disclosure Task Force (EDTF).** Improved credit risk management will require strengthened bank systems for the timely collection of internal loan and collateral data, and this data could also be useful to potential investors in NPLs. In addition, the global financial crisis highlighted the importance to market confidence of reliable valuations and useful risk disclosures. The FSB’s EDTF’s recommendations for improved bank risk disclosures and extensive examples of leading disclosure practices are designed to provide timely information that is useful to investors and other users, and which could contribute over time to improved market confidence in financial institutions. Together, these initiatives can foster better NPL markets through improved information needed for potential investors.

**The BNB should work with banks and other stakeholders to improve conditions for the NPL market.** NPL sales should remain an important option for meaningful NPL resolution. NPL resolution would benefit from a better market infrastructure, including: (i) a standardization of information about NPLs and related collateral (in effect, an extension of the AQR exercise); and (ii) the removal of certain legal impediments in the areas of collateral enforcement and out-of-court settlement.<sup>6</sup>

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<sup>5</sup> Annex 1 includes a summary of global and EBA surveys of banks’ IFRS 9’s estimated impact and related implementation issues. It is important to note that these surveys provide preliminary estimates typically based on samples of larger banks and do not include Bulgarian banks.

<sup>6</sup> See Bulgaria - Insolvency and Credit/Debtor Regimes ROSC, prepared by a World Bank team in 2016.

**Table 1. Bulgaria: Key Recommendations**

<b>Recommendations to Substantially Reduce NPLs</b>	<b>Authority Responsible</b>	<b>Time<sup>1/</sup></b>
<b>Loan loss provisions</b>		
Introduce a macroprudential supervisory review tool to compare a bank's level of LLP relative to supervisory metrics that are calibrated to encourage robust provisioning practices.	BNB	I
Issue supervisory guidance to encourage sound and timely loan loss provisioning.	BNB	I
Promote high quality IFRS 9 implementation practices.	BNB	I
Encourage prudent interest income recognition practices for NPLs through enhanced supervisory reporting requirements.	BNB	I
<b>Loan write-downs</b>		
Introduce a macroprudential supervisory review tool to compare a bank's level of write-offs relative to supervisory metrics that are calibrated to encourage robust write-off practices.	BNB	I
Issue supervisory guidance to encourage timely write-off of loans (in whole or in part) that are deemed uncollectable.	BNB	I
Scrutinize banks' write-off policies and documentation and encourage the use of best practices.	BNB	I
<b>Collateral valuation</b>		
Introduce a macroprudential supervisory review tool to compare a bank's collateral valuation relative to supervisory metrics that are calibrated to encourage conservative valuation practices.	BNB	I
Issue supervisory guidance to banks setting forth robust minimum collateral valuation practices, including on the use of internal and external valuation experts.	BNB	I
<b>Risk transparency</b>		
Encourage improvements of banks' internal loan and collateral data as part of an effort leading major banks to maintain timely, accurate and consistent information useful for credit risk management purposes but also for potential investors in NPLs.	BNB	NT
Issue disclosure guidance that further enhances risk transparency starting with the largest Bulgarian banks using the FSB EDTF's recommendations.	BNB	NT
<b>Early warning systems</b>		
Issue supervisory guidance to banks on minimum requirements for EWS.	BNB	I



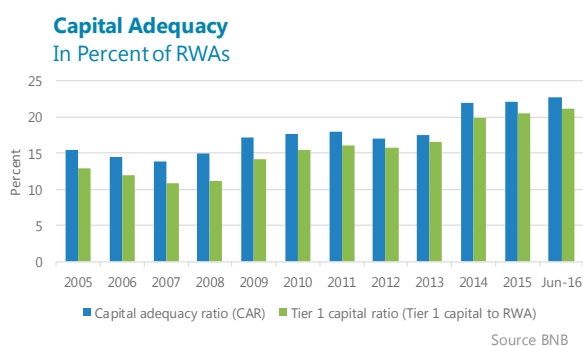
<b>Table 1. Bulgaria: Key Recommendations (continued)</b>		
<b>Collateral enforcement</b>		
Improve the interconnectedness of the Land Office with the Cadastre.	MoJ	NT
Enhance the auctioning process to allow wider participation and more realistic price discovery.	MoJ	NT
Provide clear and unambiguous guidance and amending legislation, for the debtor's notification of rights transfer.	MoJ	NT
Implement the recommendations of the World Bank ROSC on Insolvency and Creditor/Debtor Regimes.	MoJ	NT
<b>The NPL Market</b>		
The BNB should work with other national authorities, the banking industry and investors to improve the NPL market and remove existing impediments.	BNB, MoJ	NT
The BNB should consider equalizing requirements for all NPL investors.	BNB	NT
Consider the development of recovery partnerships (RP) as a viable form of NPL resolution under the current NPL market arrangement.	BNB	NT
1/ Time: I = immediate; NT = near term.		

## THE STATUS OF NONPERFORMING LOANS

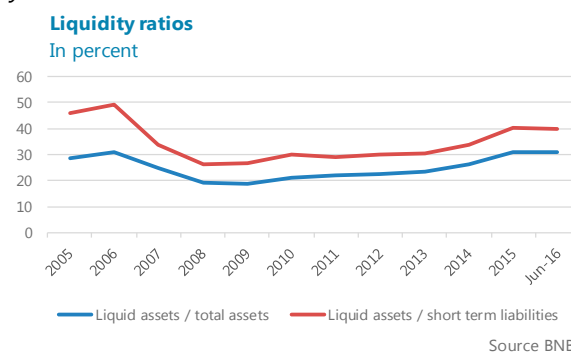
**1. System-wide banking sector soundness indicators have improved since 2014.** As shown in Figure 1, Tier 1 and total capital adequacy ratios were high at 21.2 percent and 22.7 percent, respectively at end-June 2016. The ratio of liquid assets to total assets has steadily increased, reaching 33 percent by mid-2016. Overall, banks remain profitable with Return on Assets (RoA) reaching 1.7 percent in Q2 2016 and there was a sharp but unevenly distributed increase in banks' profits in the first half of 2016, driven by reduced operational and loan loss provisioning expenses and an increase in nonrecurring items. Annualized loan growth has been around 2.6 percent between December 2014 and June 2016.

**Figure 1. Bulgaria: Banking Sector Soundness Indicators**

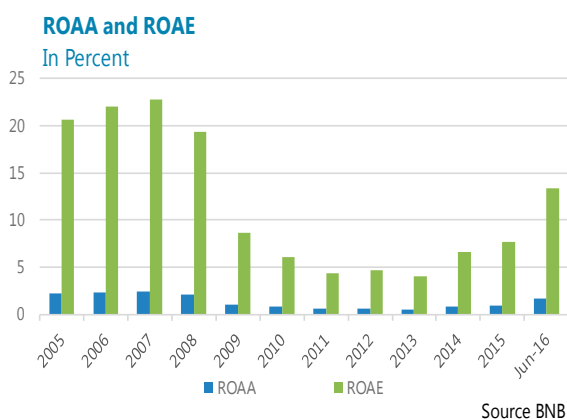
Capital adequacy ratios are high



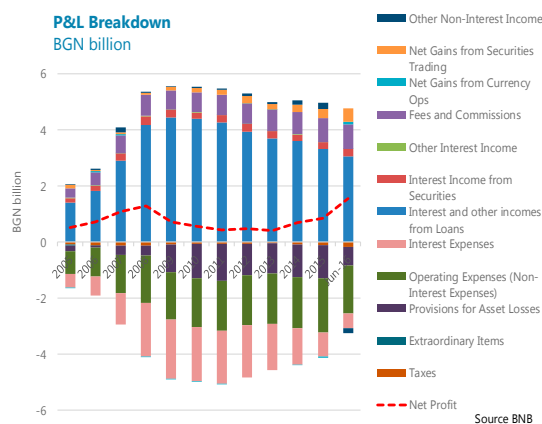
... and the ratio of liquid assets has increased in recent years.



Banks show higher profitability though ...



...this reflects lower provisions and cheaper funding.



**2. The macro-economic context is that following several years of strong economic growth (real GDP averaged 6.5 percent between 2004–07), growth remained weak after the economy contracted 5 percent in 2009, averaging below 1 percent in 2010–13.** Weak exports to Bulgaria’s main trading partner, the euro area, the collapse in foreign direct investment, and increased unemployment levels lowering private consumption, are among the main factors that adversely affected economic growth. Coupled with relaxation of credit standards, problems with collateral enforcement and insolvency regimes, and a weak NPL market, they contributed to the growth of NPLs.

**3. While the BNB has taken measures to lower NPLs in banks, they remain high.** These steps include the 2016 AQR, limiting dividend payments based on factors such as high NPL ratios, and continual monitoring of forbearance and NPL exposures by the BNB, with follow-up during onsite supervisory reviews. The AQR confirms that banks are better at identifying their credit risk, but NPLs remain persistently high at 19.7 percent of loans<sup>7</sup> at end-June 2016 (Figure 2 and Box 1), with most NPLs over one year past due. Standardized measures across the EU also show Bulgaria among countries with higher NPLs, with the EBA recently showing Bulgaria as among European countries in the second highest category of NPL ratios (Figure 3).<sup>8</sup> The NPLs ratios associated with construction and real estate sectors are the highest, while the two sectors combined are responsible for 25 percent of total loan exposures. The trade and industry sectors were 29.5 percent and 27.7 percent of total loans, respectively.

**4. Loan loss provision coverage ratios have remained low since 2008).** Loan loss provisions to NPLs (the LLP coverage ratio) were slightly above 100 percent in 2008, but new provisions failed to keep pace with the growing NPL flow, which caused the LLP coverage ratio to decline to 51.7 percent at June 2016. The deterioration in the LLP coverage ratio reflected lower provision expenses as managers endeavored to sustain income levels. Bank management increasingly justified lower provisioning coverage because of higher reliance on collateral. The accounting standards require loan loss allowances for the level of impairment, which is reduced by the value of collateral. The high capital positions and improving profitability of most banks are important factors to consider in support of a strategy to reduce NPLs, but apart from the loan loss allowances and retained earnings components of regulatory capital measures, generally, high capital does not provide a buffer for loan losses (Box 2). However, as shown in Figure 4, provisioning coverage should be more substantial, which would be needed during the implementation of a new strategy for a substantial reduction in NPLs. Indeed, the recent EBA analysis summarized in Figure 4 concluded that EU banks need substantially higher LLP coverage to be able to clear their NPL levels.

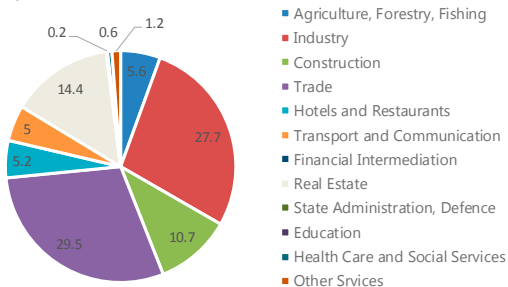
<sup>7</sup> The BNB has traditionally employed a more conservative NPL measure relative to many other European countries. In recent years, the measurement across the EU has been harmonized using the EBA reporting criteria. The NPL ratios cited in this technical note use the BNB measure unless stated as the EBA measure.

<sup>8</sup> As reported by the EBA Risk Dashboard, the EU weighted average for the NPL ratio was 5.5 percent at June 2016, while Bulgaria NPL ratio was 13.7 percent. The Figure 3 NPL ratio “heat map” is from Andrea Enria, EBA, in his ESM presentation entitled, “The EU banking sector - risks and recovery: A single market perspective,” January 2017.

**Figure 2. Bulgaria: Nonperforming Loans**

Exposures are concentrated to few sectors, and...

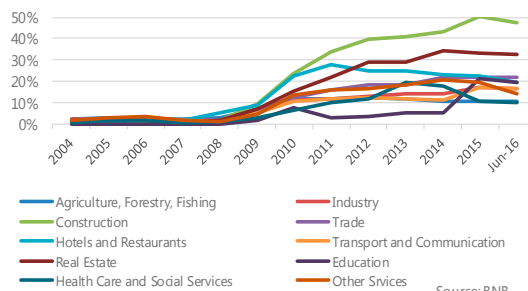
**Composition of loans**  
In Percent, June 2016



Source: BNB

NPL ratios are highest in construction and real estate

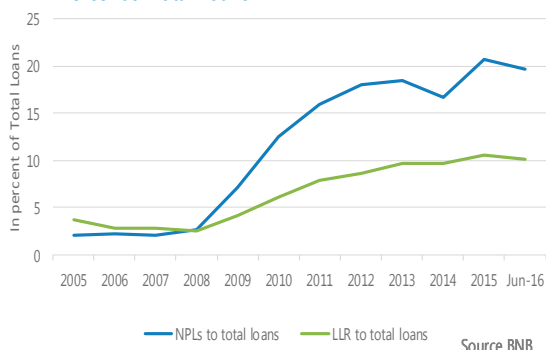
**NPL ratios by sector**  
In Percent, June 2016



Source: BNB

LLR coverage is 52% of NPLs based on local BNB measure,

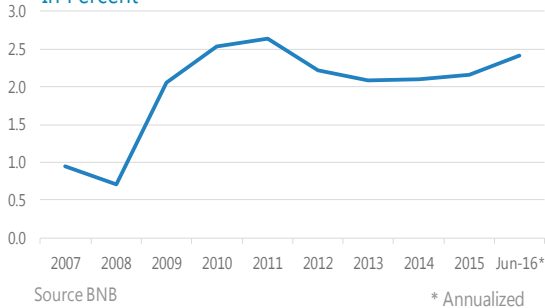
**NPL ratio and Coverage**  
In Percent of Total Loans



Source BNB

...as provision expenses have not kept pace with NPL growth.

**Provision expense to total loans**  
In Percent

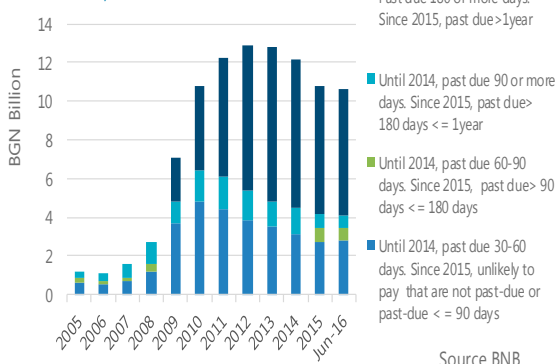


Source BNB

\* Annualized

Most NPLs are over 1 year past due

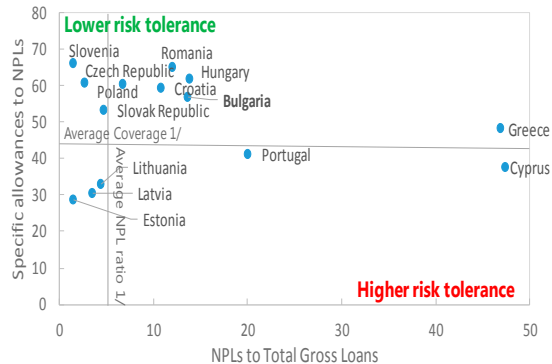
**Non Performing Loans**  
BGN, billions



Source BNB

...resulting in higher risk than many peers (according to EBA measures)

**NPL ratio and Coverage, June 2016**  
In Percent

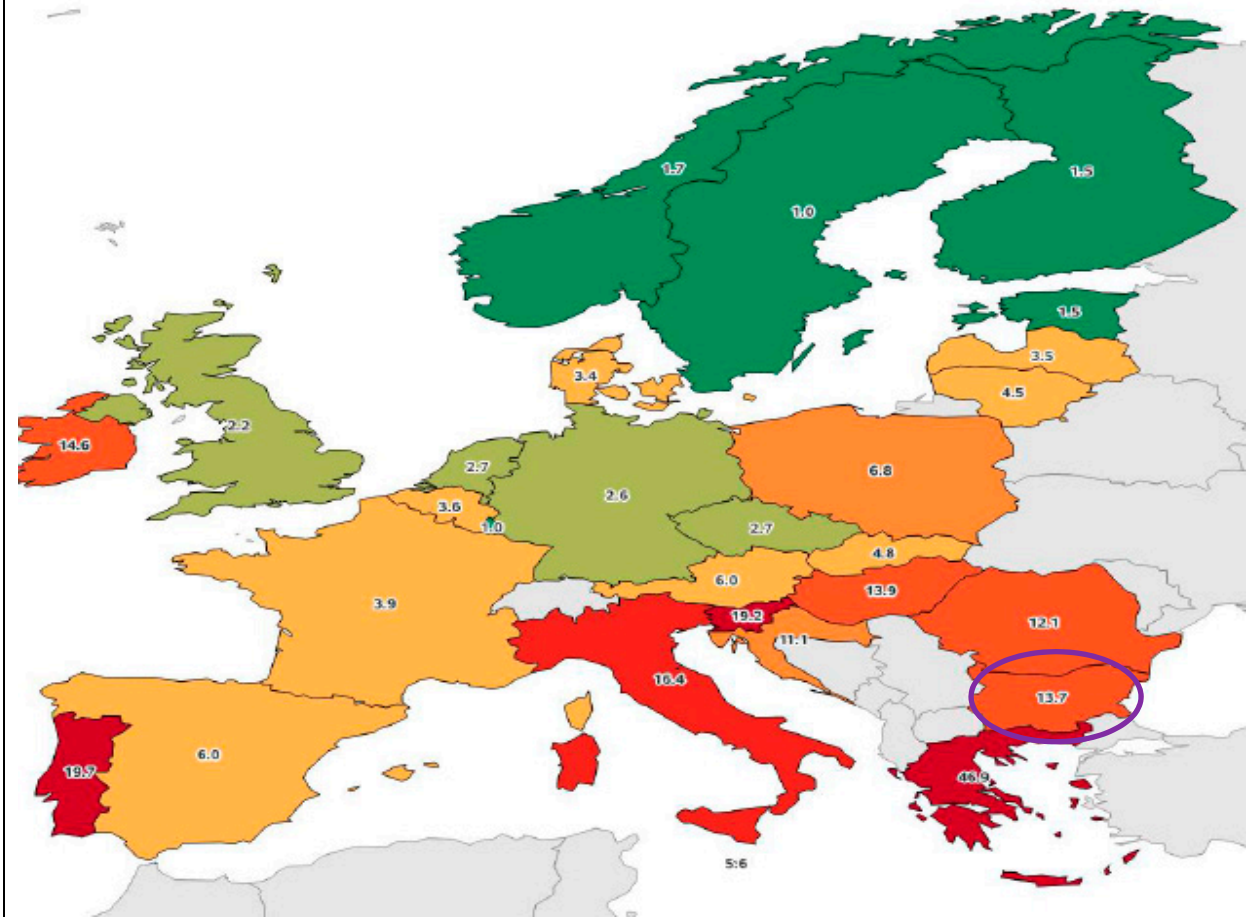


1/ EU weighted average

Source: EBA Risk Dashboard

**Figure 3. Bulgaria: Bulgaria's NPL Ratio in Relation to Other EU Countries (EBA)**

Bulgaria's NPL ratio remains high in relation to other EU countries based on EBA data for June 2016.



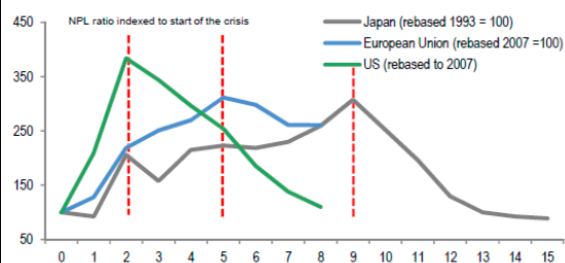
Source: Andrea Enria, EBA, "The EU banking sector—risks and recovery: A single market perspective," presentation to the ESM, January 30, 2017.

**5. Interest accrual practices on impaired loans, although acceptable under IFRS, is a disincentive to NPL reduction.** In the challenging environment post the global financial crisis, many banks provisioned less robustly, instead seeking to show higher profitability. Under IFRS, interest income is allowed to be accrued for NPLs *not treated as impaired* at the effective interest rate of the loan and banks may capitalize the interest not received in cash into the loan principal. Consequently, income is reported though there may be no or only a partial cash payment is received.<sup>9</sup> This accounting practice—which may overstate interest income (relative to cash inflows from NPLs) and may influence a lowering of LLPs—introduces a disincentive for banks to reduce NPLs.

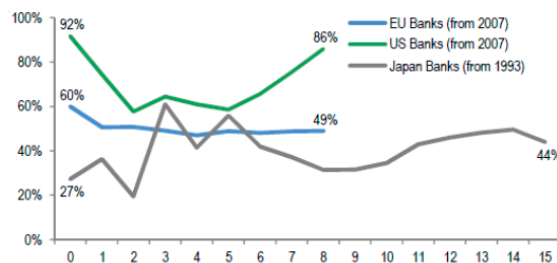
<sup>9</sup> Under both IAS 39 and IFRS 9, a bank or other company can accrue the full interest income due under the contractual terms on an NPL until it is determined to be impaired. IFRS requires that for impaired loans, the interest accrual is based on applying the effective interest rate to the loan balance less the LLP. The treatment is used even if the resulting interest accrual far exceeds the amount of cash interest that the bank has received from the borrower. Depending on the bank's policies all NPLs may not be considered impaired and some impaired loans may be performing loans. Some banks may have fully provisioned for any difference between the interest income accrued and actually received in cash, although this aspect of provisioning is typically not yet publicly disclosed.

**Figure 4. Bulgaria: EBA Contrast of EU, Japanese, and U.S. Banks' Post-Crisis NPLs and LLP Coverage**

*EBA: EU banks resolution of NPLs is faster than Japan banks in the 90s crisis but slower than US banks...*



*EBA: EU banks' NPL coverage is too low to clear NPLs...*



Source: Andrea Enria, EBA, "The EU banking sector - risks and recovery: A single market perspective," presentation to the ESM, January 30, 2017.

**Table 2. Bulgaria: Sample Banks' Interest Income on Impaired Loans, 2015**

Bank Name	Bank Total Assets as a Percent of Banking System Assets	Gross Interest Income	Of which: on Impaired Loans	In Percent of 2015 GII
		(In thousands of BGN)		
Unicredit Bulbank	19.6	560,756	25,814	4.6
DSK Bank	13.0	594,460	8,360	1.4
First Investment Bank	9.6	470,651	26,751	5.7
Eurobank Bulgaria	7.6	303,812	33,710	11.1
Société Générale Express Bank	6.1	180,342	5,635	3.1
Piraeus Bank Bulgaria	3.3	111,076	22,259	20.0
Cibank	3.1	97,426	17,020	17.5

Source: Seven of the 10 largest banks provided this information in their 2015 Annual Financial Statements. Those not reporting were: United Bulgarian Bank, Raiffeisenbank, and Central Cooperative Bank.

## 6. A strategy to reduce NPLs significantly will benefit credit growth and economic activity.<sup>10</sup>

Studies that have analyzed the feedback effects from NPLs on macroeconomic performance found that higher NPL levels tend to reduce the credit-to-GDP ratio and GDP growth, while increasing unemployment.<sup>11</sup> Since substantial capital requirements are in place for NPLs, high levels of NPLs tie up bank capital that could otherwise be used to increase lending. High NPL levels are a significant predictor

<sup>10</sup> IMF Staff Discussion Note, A Strategy for Resolving Europe's Problem Loans, SDN/15/19, September 2015. See [www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf](http://www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf).

<sup>11</sup> See Klein (2013), Nkusu (2011), and Espinoza and Prasad (2010).

of bank failures and distort banks' cost structures and efficiency.<sup>12</sup> In addition, high levels of NPLs reduce bank profitability and equity levels, and may undermine investor confidence in the quality of banks' risk management and prudential supervision. Recent research has shown that countries that reduced their NPL ratios experienced higher GDP growth and investment than those that let high NPL levels persist. Allowing high NPL levels to remain unresolved, on average, cost those economies in excess of 2 percentage points in terms of per capita GDP growth when compared with countries that actively pursued NPL reduction.<sup>13</sup> Furthermore, when coupled with improvements in risk transparency, strategies for a substantive reduction in NPLs can enhance market confidence in the banking industry and its supervision, which should increase banks' ability to access capital when needed, improve funding costs, and enhance market discipline. The next sections outline such an NPL reduction strategy.

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<sup>12</sup> See Lu and Whidbee (2013), Maggi and Guida (2009), Cucinelli (2015). While research has pointed to this in a number of jurisdictions, it is important to note that as of December 2016, on average, Bulgarian banks maintained a [liquidity ratio](#) (calculated under BNB Ordinance No. 11) of 38.24 percent and a CET1 [capital adequacy](#) ratio of 20.41 percent.

<sup>13</sup> See Balgova, Nies and Plekhanov (2016).

### Box 1. Supervisory Reporting for NPLs

**Historically, Bulgaria has used a conservative NPL definition to report NPL levels, as well as forbearance that now are supplemented with the BNB's introduction of the EBA measures that harmonizes NPL reporting across the EU.**<sup>1/</sup> Since 2015, Bulgarian financial institutions also report nonperforming exposure (NPE) and forbearance levels according to EBA Implementing Technical Standards (ITS).

**Under the EBA definition**, nonperforming exposures (NPEs) are those exposures that satisfy either of the following criteria: (i) material exposures which are more than 90 days past-due; or (ii) the debtor is assessed as unlikely to pay in full without realization of collateral, regardless of the existence of any past-due amount or of the number of days past due.

**While the BNB uses the EBA definitions, it also uses for analytical purposes a more conservative measure of the NPL ratio** that eliminates loans to central banks and financial institutions from the denominator, thus resulting in a higher NPL ratio than the one reflected in EBA reports. With regard to the EBA measures, banks are required to report separately performing and nonperforming loans after forbearance (restructuring).

**Following the introduction of the FinRep reporting format (F19) in 2015, banks are reporting separately performing exposures with forbearance measures from nonperforming exposures with forbearance measures.** This is in line with EBA ITS requirements. For reporting purposes (FinRep form F18), the four categories for exposures (loans) with impaired credit quality are: (i) "exposures up to 90 days-past-due" (dpd); (ii) "exposures with >90 dpd but <180 dpd;" (iii) "exposures with >180 dpd but < 360 dpd;" and (iv) "exposures above 360 dpd." Banks have to report separately performing exposures that are: (i) <30 dpd; (ii) >30dpd but <60dpd; and (iii) >60dpd but <90dpd.

**The EBA also requires that banks report their forbore exposures.** Forbearance measures are concessions toward a debtor facing or about to face financial difficulties (loans, debt securities, commitments—no trading exposures). These involve (i) modification of the terms and conditions of the contract that would not have been granted had the debtor not been in financial difficulties; and (ii) total or partial refinancing of an exposure that would not have been granted had the debtor not been in financial difficulties. EBA rules require mandatory classification as forbore exposures when: (a) the modified/refinanced contract is or would have been nonperforming without modification or refinancing or embedded forbearance clauses are used by a nonperforming debtor; (b) repayment is done on a nonperforming contract close in time to the granting of additional debt; (c) modification leads to a total or partial cancellation through write-off; or (d) the modified/refinanced contract is or would have been 30 days past-due (although this last category is rebuttable).

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1/ Bulgarian banks have reported forbearance measures to the BNB since 2009.



### Box 2. Achieving NPL Reduction: It Is Much More Than Having Regulatory Capital

**Although the Bulgarian banking system is generally well capitalized, apart from the loan loss allowance and retained earnings component of regulatory capital measures, generally, high capital ratios alone do not provide buffers that allow for a reduction of NPLs since, under IFRS, loan losses should not be recorded as a direct reduction of regulatory capital or capital reserves.** Instead, loan losses are generally taken against loan loss allowances (sometimes called loan loss provisions or loan loss reserves) that are on the balance sheet. The loan loss allowance is a contra-asset created when recording a loan loss provision expense which reduces the banks' earnings and, eventually, the retained earnings component of shareholders' equity for accounting purposes.<sup>1/</sup>

**Weak loan loss allowances arise because implementing practices may not be robust.** For example, the observed practice may not have been sufficiently guided by sound supervisory guidance, close scrutiny through onsite and offsite supervisory reviews, and risk transparency which are recognized in certain countries as acceptably shaping bank accounting practices. Also, until IFRS 9 becomes effective in 2018, IFRS lacks guidance on the need for timely loan write-downs, in whole or in part. BCBS supervisory guidance in 2006 and 2015, which encourages certain robust practices, may not have been fully implemented in certain jurisdictions (e.g., the EBA's final IFRS 9 guidance was delayed until May 2017). This lack of guidance and intense supervisory scrutiny results in considerable latitude for banks to determine provisioning levels, which may be robust for conservative banks but inadequate for others. To reduce NPLs, banks first must have sufficient loan loss allowances. Consequently, weak loan loss allowances will impede NPL reductions.

**Broadly speaking, there are four ways to reduce NPLs.** The first three involve some actions with borrowers and/or other parties that involve changes to the underlying nonperforming loans: restructuring of the credit exposures so that borrowers are able to repay the loans according to their new terms; sales or securitizations of the NPLs; or legal judgments for recovery of the collateral and/or some form of insolvency proceeding. The fourth approach involves accounting write-downs that affect only the loans' carrying values on banks' balance sheets.

- a. **Loan restructurings (forbearance) can be designed in ways that can assist in restoring NPLs or parts of NPLs to performing status.**<sup>2/</sup> Features of restructurings may include: (i) changes to NPL terms—e.g., extending the maturity, lowering the interest rate—which ensures the borrower can stay current throughout the remaining life of the loan; (ii) changes in terms that break the NPLs into parts, with one part that would be performing<sup>3/</sup> (e.g., with payments that amortize principal and interest) and a second part whereby interest is deferred (i.e., the nonperforming part); and/or (iii) partial debt forgiveness whereby the borrower is relieved of a part of the original lending obligation to allow the borrower to service that part that remains.
- b. **Loan sales or securitizations** reflect agreements by the bank to sell NPLs in arm's length transactions to acquirers. For final disposition—i.e., a true sale—generally, the selling bank would no longer retain any interest in the risks and rewards of owning the loans; e.g., either in terms of exposure to loss or opportunity for gain. To the extent that sale prices for NPLs are below the carrying value of the NPLs on the banks' balance sheets, the selling banks will need to record the loan loss against their loan loss

## Box 2. Achieving NPL Reduction: It Is Much More Than Having Regulatory Capital (concluded)

allowances. To the extent that the loan loss allowances are insufficient, selling banks will need to increase their loan loss provision expense, thus reducing earnings.

- c. **Legal judgments** could come about through (i) foreclosure/repossession of the security interests (usually collateral), which may or may not be sufficient to discharge the loans' balances; and/or (ii) legal judgments that absolve borrowers from some portion of their loan obligations through an insolvency process (e.g., borrowers may forfeit an interest in real assets in exchange for legal release from further debt obligations). Similar to loan sales, if the bank receives less than the carrying value of the NPLs, the banks will need to record the loan losses against their loan loss allowances.
- d. **Loan write-downs for accounting purposes** are actions by banks to charge down either partially or fully the value of loans against their loan loss allowances on the balance sheet. Such loan write-downs do not change borrowers' legal obligations to repay all loan principal, interest, and any penalties. Instead, they reflect that the bank is unlikely to collect the full amount of the NPLs in the foreseeable future or that the loans' cash flows have expired, and the continued retention of the loans as bankable assets is no longer appropriate for financial reporting purposes. Banks should continue their efforts to collect NPLs even after loan write-downs have been taken for accounting purposes. Indeed, there should be a review by the supervisor that banks are maintaining appropriate documentation to support their collection activities and are continuing to pursue repayment.

**Conditions are that NPL restructuring, sales, or legal judgements will usually involve a need to record additional LLPs as there is likely insufficient credit loss reflected in the current loan loss allowance.**

For example, on average banks have a coverage ratio of 51.7 percent at end-June 2016, whereas NPL sale prices typically are in the range of 6.5–15 percent of book value, thus implying a need for an increase of LLP coverage from 51.7 percent to a range of 85–93.5 percent if NPL sales were to be the primary method of NPL resolution. Direct bank sales of collateral, may have somewhat higher recovery rates, but still they would entail legal costs and other expenses before the restructuring or sale, which would still result in the recognition of credit losses that are much higher than implied by the current LLP coverage levels.

Discussions with banks have also indicated that in some cases collateral valuations may be overstated when compared with potential sale values and recovery delays may be substantial (5–10 years) and expensive, thus also indicating a need for higher LLP coverage of NPLs. (See also discussion of the challenges of collection summarized in the Broader Policies section-subpart Collateral Enforcement and Insolvency Regimes.)

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1/ In the case of unaudited retained earnings which are not included in regulatory capital, the BNB requires (letter №44718/22.03.2017) credit institutions to reflect the effect of any credit risk adjustment in the calculation of the capital ratios. Therefore, the loan loss provisions additionally reduce own funds until final recognition of the retained earnings as an element of the regulatory capital.

2/ Though loans are performing in principle under the restructured terms, under EBA rules, such loans will continue to be reported as NPLs until 24 months of repayment performance has been demonstrated.

3/ Under such approaches, changes in terms could include conversion to an interest-only loan with a balloon payment, but such a restructuring should have a clear path to repayment.

# A MACROPRUDENTIAL APPROACH TO REDUCING NONPERFORMING LOANS

## A. Macprudential Context and Motivation

**7. The BNB has actively used macroprudential tools since 2004 that could be further extended to address NPLs.** In legislation, the BNB macroprudential mandate is to “exercise also macroprudential supervision of banks in order to maintain the stability of the banking system and in relation to the prevention or reduction of both systemic risks resulting from the activity of credit institutions and the identification and limitation of the incidence of macroeconomic factors threatening the stability of the banking system.”<sup>14</sup> Most macroprudential measures have exhorted banks to be more conservative in their lending (e.g., through lower loan-to-value ratios, stricter lending requirements); and to maintain higher capital, including through a higher capital requirement than generally applied for most EU countries<sup>15</sup> and limitations on dividends if capital and provisioning buffers were not sufficient. The institutional arrangement for macroprudential supervision remains broadly appropriate.<sup>16</sup>

**8. The measures in this technical note are designed to lower the systemic risks associated with the buildup of NPLs.** This is achieved through earlier recognition of deterioration which, as a result, shortens the lag time between the economic cycle and the credit cycle. As there will be a future down turn in the economic cycle, the measures compel earlier feedback to lending decisions to allow banks to begin to constrain credit growth, thereby moderating the buildup of NPLs as the credit cycle turns. The subsequent benefit is that banks have better balance sheet strength to supply credit later as the economic cycle turns positive thereby able to contribute to nascent economic recovery. Although macroprudential in nature, the recommended efforts would be bank specific to take account of individual bank circumstances for capital adequacy and earnings.

**9. The timing for such a macroprudential approach is opportune.** Key motivations include: (i) the AQR has quantified credit issues confronting banks; (ii) the banks broadly have the capital and earnings to implement the measures; and (iii) the economic environment is supportive, which would allow the initial introduction of the measures to be countercyclical as the credit environment is improving.<sup>17</sup> Moreover, some of the largest Bulgarian banks have substantially reduced their NPL ratios

<sup>14</sup> See Article 79279 (2) of the Banking Act (Chapter 11).

<sup>15</sup> More recently, the BNB on 29 May 2014 required that all banks maintain a capital conservation buffer, and a systemic risk buffer <http://bnb.bg/BankSupervision/BSCapitalBuffers/index.htm?toLang= EN%20&toLang= EN>.

<sup>16</sup> Macroprudential policy uses primarily prudential tools to limit systemic or system-wide financial risk. See “Organizing Framework for Macroprudential Policy” (IMF, 2011a) <https://imf.org/external/np/pp/eng/2011/031411.pdf>. Also, the compliance report of the ESRB on the recommendation on intermediate objectives and instruments of macroprudential policy, published on February 9, 2017, assessed Bulgaria as “fully compliant.”

<sup>17</sup> The economy has been resilient to shocks in recent years as repercussions from the failure of a large domestically owned bank in 2014, and spillovers on Bulgarian banks from the Greek crisis in 2015, were largely contained. Going forward, growth is projected to converge at around 2½ percent in the medium term. Discussions with the BNB and banking officials indicate that credit markets and collateral prices are continuing to improve.

to between 7 percent and 14 percent by end-2016, and are planning further significant reductions during the three years through end-2019. In some cases, their targets are for NPL ratios to fall to 4–5 percent by end-2019. Nevertheless, while certain large banks have these targets in mind, there is less impetus by other Bulgarian banks toward achieving these kinds of reductions.

**10. The BNB should adopt a comprehensive strategy in the near term to achieve a substantive reduction in NPL levels over a three- to five-year time horizon.** This strategy would primarily focus on promoting: (i) robust loan loss provisioning practices and improvements in risk management (including what can be obliged under IAS 39 and in anticipation of the implementation of IFRS 9); (ii) timely loan charge-offs partially or fully for exposures that are unlikely to be collected (considers, in particular, legacy NPLs and any excessive interest accruals on NPLs); and (iii) improved collateral valuation practices (considers minimum appraisal criteria set for banks and qualifications for appraisers). In these three areas, new macroprudential supervisory review tools would be used to promote robust practices and improvements in risk management. Also, supervisory guidance and other measures would seek to improve risk disclosures for the largest banks, banks' early warning systems, as well as collateral enforcement and the NPL market (see subpart E in this section and subparts A–C in the section on broader policies).

**11. As part of this macroprudential effort, the BNB should oblige strengthened bank practices through supervisory guidance and accompanied by enhanced supervisory reporting.** This strengthening process launched with the issuance of the new supervisory guidance should be promoted within the applicable IFRS standard (the existing IAS 39 standard in 2017 and the forthcoming IFRS 9, effective in 2018). These standards reflect the Basel Committee inputs, leading to robust provisioning practices that are further supported by the BCBS supervisory guidance.<sup>18</sup> More specifically, enhanced supervisory reporting should include both: (i) cash basis interest income (actual received interest income); and (ii) accrued interest income, since IAS 39 and IFRS 9 allow for the accrual of interest income on NPLs. This will help the BNB to identify potential under-provisioning and excessive income recognition on NPLs and prompt banks to correct this, thus contributing to the recommended NPL reduction strategy.

## B. Loan Loss Provisioning

### Loan loss allowance macroprudential tool

**12. As the first pillar of the macroprudential supervisory review toolkit, the BNB would compare the bank's level of the loan loss allowance relative to supervisory metrics that are calibrated to encourage robust provisioning practices.** Under this approach, the BNB would still expect banks to follow IFRS, but the supervisory expectation would be initially based on the BNB measurement metrics. For LLP levels that do not measure up, the BNB would introduce greater supervisory scrutiny of bank practices. For example, the BNB metrics for LLPs could be developed based

<sup>18</sup> BCBS Supervisory Guidance: [Sound Credit Risk Assessment and Valuation of Loans](#), 2006; [Guidance on Credit Risk and Accounting for Expected Credit Losses](#), 2015.

on estimated loan loss percentages applied to (i) regulatory credit risk classification categories; (ii) various categories of past due status; and (iii) could include a measure for credit losses arising from the growth of emerging credit risks or other factors.<sup>19</sup> The BNB metrics would **not** be used to calculate the LLP for financial reporting purposes, but instead would be used as a supervisory analytical tool and *as a starting point* for the BNB in assessing whether provisioning practices are robust. This BNB supervisory approach to encourage robust provisioning practices will not conflict with IFRS, since IFRS does not govern the analytical approaches used by supervisors.<sup>20</sup>

**13. Banks are currently required to prepare their financial statements under IFRS, notably the IAS 39 standard on financial instruments through the rest of 2017.** Under IAS 39, banks must determine loan impairment based on an *incurred loss* model that, in essence, requires the occurrence of an observable loss event (or events) as a trigger for a determination that a loan has become impaired. Notwithstanding the incurred loss model in IAS 39, there are several aspects of IAS 39 that the BNB can emphasize that could result in more robust provisioning practices by banks. Particularly, the Basel Committee has worked with the IASB in the development of IAS 39 (also reflected in the Basel Committee supervisory guidance). These aspects, which are critical to improved provisioning practices, could be addressed in new BNB supervisory guidance and are summarized in Annex 1.<sup>21</sup>

**14. Certain loan restructurings/modifications (forbearance) may include approaches that can be helpful in restoring NPLs to performing status, but care must be taken to ensure that sound LLP policies and practices and appropriate supervisory reporting are maintained by banks for such loans.** Forbearance can take many forms,<sup>22</sup> including, but not limited to, a renewal or extension of terms, other concessions to the borrower, or a modification of the terms with or without concessions to the borrower.<sup>23</sup> The LLP methodology should ensure that the LLP reflects the collectability of the substance of the restructured/modified exposure whether or not the original asset is written off or

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<sup>19</sup> For example, the BNB could include in its metrics an estimated loan loss rate of X percent applied to loans past due between 90 days to 180 days, as well as other loss rates applied to other past due categories, and also include measures for emerging credit risks not yet reflected through changes in past-due loan categories.

<sup>20</sup> This determination has been confirmed in informal discussions with IASB leaders.

<sup>21</sup> Supervisory guidance on LLPs is needed in 2017. According to a survey taken after the 2016 AQR, 57 percent of bank managers do not expect any need to take specific actions as a result of the AQR and only 21 percent of the surveyed banks expect additional provisions for impairment losses (whereas one year ago, 80 percent of the bank managers expected additional provisions (Ernst and Young, 2016). This highlights the need for BNB supervisory guidance recognizing how IAS 39's requirements that reflect BCBS input and related BCBS supervisory guidance could help banks implement more robust provisioning practices for their NPLs and impaired loans, even before IFRS 9 becomes effective on January 1, 2018.

<sup>22</sup> When considering potential forbearance, banks should evaluate the distressed debtor's financial strength and prospects. Such an assessment should be multi-faceted, taking into consideration the borrower's past and projected financial performance; an analysis of the debtor's outstanding exposures including to other creditors; an analysis of the borrower's capacity to generate sufficient cash flow to support restructured debt; and an assessment of the borrower's capacity to stay in business and generate a sustainable cash flow. Borrowers that do not pass such a viability test should not be considered for restructuring.

<sup>23</sup> As mentioned in Box 1, banks must report their forborne exposures using the EBA definitions and related rules. These include EBA rules for addressing NPLs subject to forbearance measures (such as restructurings) and criteria for restoring forborne exposures and NPLs to performing status.

otherwise derecognized under IFRS. Banks should not assume that restructurings always result in an immediate decrease in the loan's credit risk, and any decrease in the reported LLP due to improved credit risk should be well supported by strong evidence. Typically, borrowers should demonstrate consistently satisfactory payment performance over a reasonable period before credit risk would be considered to have decreased. Afterwards, a bank may be able to demonstrate that it has increased its likelihood of receiving full repayment of the principal and interest due, but repayment performance in the form of interest payments alone may not be indicative of whether the collection of loan principal is reasonably assured. Furthermore, payment delays may evidence that credit risk has not improved, and thus the level of the related LLP should be carefully reassessed. These policies and practices should be reviewed by bank supervisors.

**15. Starting in 2018 the BNB macroprudential supervisory review metrics would need to be more forward-looking, since IFRS 9 becomes effective with its new provisioning requirements based on expected credit losses (ECL).** As banks prepare for the adoption of IFRS 9 in January 2018, they will need to adapt their provisioning practices to more quickly identify and recognize loan deterioration. Estimates of the impact from IFRS 9 are that loan loss allowances may increase by 18–33 percent from current levels, primarily due to the recording of lifetime ECL for loans that have experienced “a significant increase in credit risk.”<sup>24</sup> Under IFRS 9 there will be a rebuttable presumption that loans that are 30 days or more past due will have experienced “a significant increase in credit risk,” thus requiring the recording of higher loan loss allowances based on lifetime ECL. In addition, IFRS 9's new approach should be implemented in the context of the BCBS supervisory guidance issued in December 2015. The new IFRS 9 ECL approach, related BCBS guidance, and related global surveys of implementation impact and issues are summarized in Annex 1.<sup>25</sup> The BNB should prepare now by issuing supervisory guidance to ensure that banks are making appropriate preparations with systems and processes, and that auditors understand supervisory expectations for robust implementation practices.

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<sup>24</sup> Annex 1 includes a summary of global and EBA surveys of banks' IFRS 9's estimated impact and related implementation issues.

<sup>25</sup> While IFRS 9 must be implemented effective January 1, 2018 for financial reporting purposes, given the limited time until the effective date of IFRS 9, in March 2017 the BCBS issued final guidance stating that it will retain the current regulatory treatment of provisions under the Basel capital framework for an interim period. This will allow the BCBS to consider more thoroughly the longer-term regulatory treatment of loan loss provisions. The BCBS also notes that jurisdictions may adopt transitional arrangements to smooth any potential significant negative impact on regulatory capital arising from the introduction of IFRS 9's expected credit loss accounting.

**16. In the first stage, which are actions for 2017, banks should undertake a robust provisioning approach.** The allowance for loan losses would be subject to BNB supervisory review metrics, with the key objective that banks have sufficient loan loss allowances to absorb loan write-offs, while continuing to sustain subsequently an adequate allowance for those NPLs that remain. In this first stage, the BNB would seek robust provisioning by banks under the IAS 39 standard, for which the BNB would consider two supervisory review metrics to judge 2017 implementation:

- Banks should be expected to write-off the loss exposures in the credit portfolio against existing provisions. The minimum loss exposures that should be wholly or partially written off are long-dated NPLs (e.g., NPLs greater than 365 days) and any interest accrual on NPLs that has not been received in cash. For collateral-dependent loans, the write-offs would be for those exposures that exceed the discounted cash-flow value of collateral (conservatively valued).
- Following the loan write-offs, the aggregate loan loss allowances should cover a significant percent (over 60–70 or more percent) of remaining NPLs, consistent with a strategy for substantial reduction in NPLs during a three- to five-year time period.

**17. The second stage would be to issue guidance to come into force in 2018 with the adoption of IFRS 9.** The guidance would anticipate that IFRS9 is expected to lead to higher provisioning for most banks, and that it will be accompanied by a recalibration of the BNB's supervisory review metrics (taking into account, for example, more forward-looking measures). The new metrics should come into force early in 2018.

### IFRS 9 implementation

**18. In addition to issuing supervisory guidance and applying the macroprudential supervisory review tools to encourage robust practices, the BNB should promote high quality IFRS 9 implementation practices through the following activities with key stakeholders:**<sup>26</sup>

- **Encourage industry and supervisory participation in seminars and dialogue about the new standards and their implementation.** BNB should ensure periodic training programs for their officials and supervisory experts, but should also encourage and participate in periodic industry seminars and roundtables on key implementation topics. Participating in these programs can also help foster dialogue about important issues arising during the transition period.
- **Require banks to periodically present updates that will enable BNB to monitor their IFRS 9 implementation strategies and efforts, and related timetables and understand their implementation challenges.** For example, the ECB announced earlier this year that it would be undertaking a review of IFRS 9 implementation practices. Some supervisors have also incorporated IFRS 9 implementation reviews into their follow up with banks about asset quality reviews (AQRs). We understand that the BNB has launched its own implementation assessment on the effect of

<sup>26</sup> Moreover, recent research suggests that robust implementation of the new IFRS 9 provisioning rules, as recommended below, is likely to alter the behavior of banks in credit downturns, potentially dampening the procyclicality of the financial system (Cohen and Edwards 2017).



IFRS 9, which includes a request for qualitative and quantitative information from Bulgarian banks. The banks' responses are expected during mid-April 2017.

- Encourage those charged with bank governance to achieve a greater understanding of IFRS 9 and related implementation efforts and to be more active in discussing these matters during meetings of the Board of Directors (or its equivalent) and its Risk and Audit Committees.** In addition to the principles and other guidance in the BCBS supervisory guidance previously discussed, those charged with governance may find useful the paper published by the Global Public Policy Committee (GPPC) on implementation of IFRS 9's impairment requirements.<sup>27</sup> The paper includes recommendations on governance and controls, and factors affecting the selection of modelling approaches and transition approaches. It also includes 10 questions that audit committees of SIFIs and other institutions can use to focus their discussions with management about implementation efforts.
- Encourage auditors to achieve a greater understanding of IFRS 9 and related implementation efforts and supervisory guidance, and BNB should gain a better understanding of auditor roles, meeting with them when appropriate.** This could be helpful in encouraging an improvement in the quality of bank auditor practices. The BCBS supervisory guidance recognizes that supervisors may make use of the work performed by banks' internal and external auditors in reviewing banks' credit risk assessment and ECL measurement functions. Thus, it is very important that auditors understand the accounting requirements and supervisory guidance, *and* that BNB supervisors fully understand the role of auditors when determining whether to "rely" on their work, in whole or in part. In this regard, documents issued by the International Auditing and Assurance Standards Board (IAASB) on IFRS 9 implementation issues,<sup>28</sup> the Global Public Policy Committee (GPPC) on certain governance matters,<sup>29</sup> and the International Forum of Independent Audit Regulators (IFIAR)<sup>30</sup> on audit quality issues could be particularly helpful to the BNB.

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<sup>27</sup> *The implementation of IFRS 9 impairment requirements by banks—Considerations for those charged with governance of systemically important banks*, Global Public Policy Committee, June 2016. The Global Public Policy Committee ("GPPC") is the global forum of representatives from the six largest international accounting networks—BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC. Its public interest objective is to enhance quality in auditing and financial reporting.

<sup>28</sup> *Project to Revise ISA 540 (An Update on the Project and Initial Thinking on the Auditing Challenges Arising from the Adoption of Expected Credit Loss Models)*, IAASB, March 2016.

<sup>29</sup> *The internal audit function in banks*, BCBS, June 2012 (available at [www.bis.org/publ/bcbs223.pdf](http://www.bis.org/publ/bcbs223.pdf)); and *External audits of banks*, BCBS, March 2014 (available at [www.bis.org/publ/bcbs280.pdf](http://www.bis.org/publ/bcbs280.pdf)). Consistent with the BCBS external audit policy, supervisors should also have discussions about these provisioning and audit quality matters with audit regulators when appropriate. While very informative and helpful, unfortunately, the above BCBS policies were issued before IFRS 9 was published and have not yet been updated for ECL provisioning considerations.

<sup>30</sup> *Report on 2015 Survey of Inspections Findings*, IFIAR, March 2016. (See the report at the following link: [www.ifiar.org/IFIAR/media/Documents/General/About%20Us/IFIAR-2015-Survey-of-Inspection-Findings.pdf](http://www.ifiar.org/IFIAR/media/Documents/General/About%20Us/IFIAR-2015-Survey-of-Inspection-Findings.pdf).)



- **Consider the impact of ECL requirements on supervisory financial reports, analysis reports, AQRs, stress tests, and other tools to ensure that prudential objectives are met.** The potential impacts of the new impairment standards will be important for the BNB to carefully evaluate. *This will be particularly important if surveys or other analyses indicate that the level of loan loss allowances of certain banks might be reduced when implementing ECL provisioning.*

## Interest income on NPLs and impaired loans

**19. IFRS allows for the accrual of NPL interest payments due to the bank that have not been received in cash.** Under both IAS 39 and IFRS 9, a bank or other company can accrue the full interest income due under the contractual terms on an NPL until it is determined to be impaired.<sup>31</sup> For NPLs that are impaired, after an impairment loss has been recognized and has reduced the loan's carrying amount, interest income is recognized by accruing based on the rate used to discount the future cash flows when measuring the amount of the impairment loss. Assuming that robust loan loss provisioning has occurred, for NPLs that are impaired the amount of interest income should be much lower than the contractual accrual of interest. However, the amount of interest income recorded may far exceed the amount of cash interest income collected by the bank from the borrower. Therefore, when IAS 39 was first issued, as recommended by the BCBS, a disclosure was required of the amount of accrued interest income recognized in the income statement that had not been received in cash, although this disclosure requirement was unfortunately removed later by the IASB. This original disclosure was helpful in allowing investors and supervisors to assess whether interest accruals for impaired loans were not in line with interest received on a cash basis and, thus, were potentially overstated.

**20. Many banks follow nonaccrual treatment for NPLs in their internal systems and IFRS financial statements.** Prior to the preparation of the Bulgarian banks' financial statements under IFRS, nonaccrual of interest income on NPLs was expected. In practice, many Bulgarian banks still utilize nonaccrual treatment for NPLs in their internal systems while they are making the necessary adjustments to their internal systems for generating effective interest rates used for accrual purposes in accordance with IAS 39. Banks in certain other jurisdictions with similar standards to IFRS often utilize a nonaccrual approach for NPLs, viewing this as a sound accounting practice that avoids overstatement of interest income when some or all of the loan principal or interest may be uncollectable.<sup>32</sup>

**21. Under IFRS, when banks are under pressure to improve their net interest income, they may choose to have lower LLP coverage, since that will increase the amount of interest income accrued for NPLs that are impaired.** This accounting practice can provide a disincentive to banks' recognition of the credit losses inherent in their NPLs and to take reasonable measures to reduce their

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<sup>31</sup> Depending on the bank's policies for applying IFRS, all NPLs may not be considered impaired.

<sup>32</sup> For example, while similar in many respects to IAS 39's impairment rules, U.S. GAAP does not specify how a bank or other creditor should recognize, measure, or display interest income on an impaired loan, although the cost recovery method, a cash basis method (two forms of nonaccrual treatment), or a combination of the two are provided as examples. It is normal banking practice in the U.S. for banks to place their NPLs in a nonaccrual status when the loans become 90 days or more past due or are otherwise viewed as uncollectable in whole or in part, both in their regulatory financial reports and published financial statements.

NPLs. The opposite occurs when robust provisioning practices and conservative income recognition practices are used.

**22. The BNB should encourage prudent interest income recognition practices for NPLs through enhanced supervisory reporting requirements.** Since many Bulgarian banks already utilize nonaccrual treatment for their NPLs in their internal systems, the BNB should require banks to include in their regulatory reports filed with BNB (i) the interest income from NPLs; and (ii) the amount of interest income on NPLs that has not been received in cash. This would enable the BNB to better ensure that interest income recognition for NPLs is not overstated. This is similar to the approach used in the final NPL guidance issued by the ECB in March 2017.

### Recommendations

- a. Introduce a macroprudential supervisory review tool to compare a bank's level of LLP relative to supervisory metrics that are calibrated to encourage robust provisioning practices.
- b. Issue supervisory guidance to encourage sound and timely loan loss provisioning.
- c. Promote high quality IFRS 9 implementation practices.
- d. Encourage prudent interest income recognition practices for NPLs through enhanced supervisory reporting requirements.

## C. Loan Write-Downs

**23. The second pillar of the macroprudential supervisory review toolkit should consider banks' treatment of NPL write-downs to promote robust write-down practices for loans or portions of loans that are unlikely to be collected.** This approach would additionally entail the application of BNB metrics. The bank's loan write-downs would be compared with the BNB metric for initially assessing loan write-downs, and if the bank loan write-downs are insufficient, then they would be subject to additional scrutiny by BNB supervisors. For example, for NPL write-downs, the macroprudential supervisory review tool could be based on: (i) estimated loss rates applied to various categories of past due status (e.g., days past due); and include (ii) an expectation that for impaired collateral dependent loans a write-down should be recorded for the entire difference between the loan's carrying amount and the fair value of the collateral, conservatively measured.<sup>33</sup> This macroprudential tool should also address timely write-downs of interest accrued for NPLs when those amounts exceed the amount of cash interest payments received by banks and are considered uncollectible. When addressing these write-downs of accrued interest income on NPLs, estimated loss rates applied to various categories of the past due status (e.g., days past due) for the underlying NPL

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<sup>33</sup> Impaired collateral dependent loans are those for which repayment is expected to come solely from the sale or continued operation of the collateral. In contrast, when the repayment of an impaired loan collateralized by real estate depends on cash flow generated by the operation of a business or sources other than the collateral, the loan generally is not considered collateral dependent. For an impaired loan that is not collateral dependent, impairment should be measured under the applicable accounting standard (e.g., IAS 39 or IFRS 9) using the present value of expected future cash flows.

exposure could be useful to include as part of this aspect of the macroprudential supervisory review tool.

**24. The write-down is only for the bank's accounts and has no impact on the bank's legal rights to collect the full amount owed by the borrower.** In accounting terms, loan write-downs (also known as charge-offs) entail the partial or full removal from the bank's balance sheet of those loans that are not likely to be collected along with any associated loan loss allowances. Banks will record their loan loss allowances (through a loan loss provision expense in the income statement) for their estimates of the current amount of loans that the bank will likely be unable to collect, given facts and circumstances as of the balance sheet date. As collection efforts progress, when available information confirms that specific loans, or portions thereof, are uncollectable, or that their cash flows have expired, these amounts should be promptly charged off (written down) against the loan loss allowance. All charge-offs of loans should be charged directly to the loan loss allowance. Under no circumstances should loan losses be charged directly to "retained earnings" or regulatory capital reserves. Thus, loan loss allowances, in essence, represent net loan write-downs (charge-offs) that are likely to be recorded in the future for a loan, or pool of loans, due to the confirmation of the expiration (or uncollectibility) of their principal or interest cash flows. *It should be noted, however, that write-downs differ from debt forgiveness, as the bank retains the right to pursue reasonable efforts to collect the loans' full contractual principal and interest. Banks should maintain records that enable them to seek full repayment from borrowers, despite loan loss allowances or write-downs taken for accounting purposes.*<sup>34</sup>

**25. While IAS 39 does not provide details on write-off modalities, it does explicitly permit loan write-downs for impairment losses.**<sup>35</sup> Thus, it is entirely appropriate to write-down loans in whole or in part when they become uncollectable. Box 3 provides an illustration of a write-off policy, taken from the published 2015 annual financial statements of a global systemically important bank. IFRS 9 provides limited guidance on loan write-offs (in whole or in part).

**26. Timely write-downs of uncollectable loans can have multiple benefits:**

- Timely loan write-downs, together with robust provisioning, are consistent with enhanced risk transparency in financial reporting. The BCBS and FSB policies and reports summarized in Annex 1 encouraged efforts that would result in an earlier recognition of loan losses. Robust provisioning, coupled with timely write-downs of loan balances when losses are confirmed through reasonable collection efforts, are broadly consistent with these themes.
- Timely loan write-downs also provide accurate confirming information about loan losses that enhance the calibration of loan loss rates used for collective provisioning and loss rates associated with internal credit grades for risk management and capital adequacy purposes.

<sup>34</sup> Discussions with bank NPL workout experts confirmed that when banks maintain records that clearly indicate the amount the borrower owes, including loan principal, interest and fees contractually due, less any payments received, that they have had no difficulty in proceeding against the borrower in legal collection proceedings, even when loan write-downs have been taken for accounting purposes. These write-downs are not viewed as loan forgiveness and do not impede the banks' collection efforts.

<sup>35</sup> IAS 39, paragraph 63.

- Removing confirmed loan losses from the balance sheet through timely loan write-downs allows management to put NPL losses behind them and focus their attention on better allocation of scarce resources in the form of loans to viable borrowers.
- In the past, banks that have experienced asset quality problems have often been rewarded by investors and market participants when they have increased their loan loss provisions and loan charge-offs to address uncollectable loans, when those efforts are viewed as truly resulting in the banks recognizing their losses and “turning the corner” with respect to their NPLs. Thus, actions to better implement loan write-downs for confirmed loan losses could improve the standing of Bulgarian banks following a material reduction of NPLs.

### Box 3. Loan Write-off Policies in Practice

Internationally active banks often avail themselves of write-off policies that facilitate the clean-up of materially distressed assets well before all legal claims have been relinquished. The 2015 annual report for HSBC (reporting under IFRS) provides an extensive audited qualitative disclosure about its write-off policies that reveals how they are tied to the past due status of loans.

“Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

In HSBC Finance, the carrying amounts of residential mortgage and second lien loans in excess of net realisable value are written off at or before the time foreclosure is completed or settlement is reached with the borrower. If there is no reasonable expectation of recovery, and foreclosure is pursued, the loan is normally written off no later than the end of the month in which the loan becomes 180 days contractually past due. We regularly obtain new appraisals for these collateral dependent loans (every 180 days) and adjust carrying values to the most recent appraisal if they have improved or deteriorated as the best estimate of the cash flows that will be received on the disposal of the collateral. Unsecured personal facilities, including credit cards, are generally written off at between 150 and 210 days past due, the standard period being the end of the month in which the account becomes 180 days contractually delinquent. Write-off periods may be extended, generally to no more than 360 days past due but, in very exceptional circumstances, to longer than that figure in a few countries where local regulation or legislation constrain earlier write-off or where the realization of collateral for secured real estate lending takes this time. For secured personal facilities, final write-off should generally occur within 60 months of the default at the latest. In the event of bankruptcy or analogous proceedings, write-off may occur earlier than at the periods stated above. Collections procedures may continue after write-off.”

**27. Going forward, the BNB should clarify supervisory expectations pertaining to write-offs and foster consistent practices across Bulgarian banks.** In particular, the BNB should issue a supervisory policy underscoring the importance of timely write-offs of uncollectable loans before having exhausted all legal means to collect the debt. At a minimum, the policy should encourage the write-off, in whole or in part, of provisioned loans that cannot, within a reasonable timeframe, be recovered and

as such do not warrant continuance as a bankable asset. Banks should also be encouraged to maintain appropriate internal records to support their claims. The BNB should strongly encourage banks to evaluate the collectability of their NPLs based on individual loan characteristics (e.g., solvency of the borrower; aging of the arrears, status of legal proceedings, if any; or expected cost to further pursue collection vis-à-vis the estimated recovery amount), and consider writing off (part of or all of) the loan if such characteristics point to protracted delays—or material shortfalls—in collections. Moreover, the BNB should initiate a horizontal review of banks' internal write-off policies, with the aim to identify best practices, and conduct an evaluation of their' historic loss rates. A detailed understanding of banks' collateral valuation practices will be important

### Recommendations

- a. Introduce a macroprudential supervisory review tool to compare a bank's level of write-offs relative to supervisory metrics that are calibrated to encourage robust write-off practices.
- b. Issue supervisory guidance to encourage timely write-off of loans (in whole or in part) that are deemed uncollectable.
- c. Scrutinize banks' write-off policies and documentation and encourage the use of best practices. to reviewing the recovery prospects of loans.

## D. Collateral Valuation

### 28. The valuation process for collateral pledged against a loan has substantial shortcomings.

The two most important issues identified by BNB and market participants were (i) outdated collateral estimates; and (ii) excessive collateral valuations. Both shortcomings are among the major obstacles to an effective NPL resolution process in Bulgaria. Inaccurate and outdated collateral estimates (a) delay the determination of an appropriate NPL resolution strategy (e.g., restructuring/forbearance, insolvency, sale, or collateral enforcement), and (b) undermine investor confidence in valuations, thus contributing substantially to the NPL pricing gap.

### 29. Consistent with the macroprudential supervisory review, the third pillar of the approach is to assess collateral valuation practices measured against BNB metrics.

If the bank's collateral valuation exceeds the BNB metric *calibrated to reflect a conservative valuation of the collateral*, then the bank's collateral valuation would be subject to additional BNB supervisory scrutiny. For example, for collateral valuation, the macroprudential supervisory review tool could be based on: (i) BNB-developed minimum valuation criteria specifying requirements that for each appraisal are to be met by both the Banks and the appraisers; (ii) criteria for appropriate time lines under which there would be a supervisory expectation that the bank is working to recover value from the collateral; and (iii) criteria that includes a presumption in the supervisory review process that for very delinquent loans (e.g., those past due more than one year) the amount of a collateral valuation that can be used to reduce the provisioning requirement would decrease according to specific amounts (e.g., after 12 months without action on the loan, the value of the collateral would be subject to a 20 percent discount, and after 24 months, the discount would be 40 percent).

**30. Based on discussions with banks and other market participants, workouts of certain NPLs have shown that in some cases collateral values have been overestimated. In some cases,** purchases of certain NPLs by investors have identified substantial discrepancies in collateral valuation by NPL sellers, namely banks, and new market estimates provided by an internationally recognized appraiser (e.g., Colliers International). In certain cases, the new assessment could be lower than valuations done by the sellers. Anecdotal evidence indicates that some reputable local appraisal companies might issue substantially different appraisals, (using the same valuation methodology and time period), for a potential new buyer on a non-movable asset being considered and for the current owner (a bank).

**31. Despite a specific EU regulatory requirement on valuation frequency, outdated collateral estimates are a common problem.** The EU regulation No. 575/2013 on prudential requirements for credit institutions and investment firms (CRR) requires banks to value at a minimum, once every year, commercial immovable property, and once every three years, residential real estate.<sup>36</sup> The same regulation requires more frequent monitoring when significant changes occur in market prices. While there was a significant adverse market price adjustment in the Bulgarian real estate market in the years 2008–2010, on most occasions banks did not revalue pledged collateral due to adverse market movements. BNB did require attention to collateral values in connection with the 2016 AQR, but it has not provided any further regulation or guidance, besides the CRR, in this area.

**32. The valuation of pledged collateral is done by external and/or internal appraisers.** Most large banks are using services of external appraisers, pre-approved by the bank. However, these estimates are re-approved by internal experts to ensure consistency with market prices. This might be an indication that banks do not fully rely on the trustworthiness and accuracy of appraisers. Some banks are using internal appraisers for property valuation, to help ensure that there is no conflict of interest during the valuation process.

**33. The Chamber of Independent Appraisers of Bulgaria is a professional body for appraisers operating in Bulgaria.** The profession follows TEGOVA (European Group of Valuers' Associations) valuation standards—European Valuation Standards (EVS, also called the “Blue Book”). However, a few banks are using appraiser service providers that are not members of the local association and do not adhere to international valuation standards. The BNB encourages the banks to use external collateral valuers who are members of the local association.

**34. Besides appraiser estimates, banks are using indexed valuations.** These assessments are performed only for residential real estate valuations, using methodologies developed by individual banks. This practice is more often used by “sophisticated” banks. The BNB does not review the methodologies used and the valuations produced by indexed valuation approaches.

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<sup>36</sup> CRR, Article 208.

**35. There is no consistency in methods used for appraisal of non-movable assets.** As the BNB does not provide guidance on the methodologies to be used for appraisals (e.g., market value, cost method, liquidation value), banks have selected different frameworks for estimating values. The most common are: (i) applied weights between methods (e.g., market value, cost value, comparison, and replacement value); (ii) only market value; and (iii) market value and liquidation value for legacy or “seasoned” loans. On many occasions banks apply internal haircuts to external appraisals.

**36. Different collateral valuation standards might be applied by diverse groups of banks after the ECB publishes final guidance on NPLs.** In March 2017, the ECB published its final guidance to banks on NPLs, and substantial parts of this guidance addresses collateral valuation. After the implementation of the ECB’s new requirements, SSM regulated banks that have branches and subsidiaries in Bulgaria will likely have more conservative valuation standards than other Bulgarian banks, thus creating an environment of different appraisal requirements, which may further diminish the quality and comparability of collateral valuations.

## Recommendations

- a. The BNB should introduce a macroprudential supervisory review tool to compare a bank’s collateral valuation relative to supervisory metrics that are calibrated to encourage robust valuation practices.
- b. The BNB should issue supervisory guidance to banks setting forth robust minimum collateral valuation practices, including on the use of internal and external valuation experts. Since the highest NPL ratios are in the construction and real estate sectors and collateral-based lending is extensively practiced, the proper valuation of collateral pledged against a loan is essential to a sound NPL reduction strategy. The AQR results and discussions with market participants highlighted that a uniform, conservative set of rules for collateral valuations at banks is necessary to avoid unsound and divergent practices. The issuance of clear and conservative valuation rules for banks should help reduce the significant NPL pricing gap observed in Bulgaria, and thus can contribute to improved NPL markets consistent with the NPL reduction strategy. The BNB supervisory guidance could summarize (i) general governance requirements covering aspects of policies, procedures, monitoring and controls along with requirements for appraisers; as well as guidance on the (ii) frequency of valuations; (iii) valuation methodology; and (iv) the valuation of foreclosed assets.

## E. Risk Transparency

**37. Beginning with the largest banks, the BNB should encourage Bulgarian banks to develop and maintain better risk information for investors.** The BNB should encourage improvements in banks’ internal loan and collateral data as part of an effort leading banks to maintain timely, accurate information useful for internal credit risk management purposes as well as for potential investors in NPLs. Such improvements in data quality and management information could facilitate NPL sales. Gaps in loan and collateral data hamper due diligence by potential investors and may prompt investors to introduce additional conservatism in their offer pricing. The development of more uniform loan and collateral data and other risk information about loans can help spur NPL sales by facilitating due diligence by potential investors. In parallel, residual gaps in public registries—which may hamper the analyses of troubled borrowers and the preparation of realistic recovery estimates—should be carefully identified



and remedied. As part of this initiative, the BNB may wish to convene an advisory group comprised of senior representatives of major banks, investors, and audit firms to recommend specific uniform loan, collateral, and risk information that should be maintained by major banks.

**38. The BNB should encourage the largest Bulgarian banks to implement the risk disclosure recommendations of the FSB's EDTF to improve risk transparency and market confidence.** In addition, the global financial crisis highlighted the importance to market confidence of reliable valuations and useful risk disclosures. The FSB's EDTF's recommendations for improved bank risk disclosures and extensive examples of leading disclosure practices are designed to provide timely information that is useful to investors and other users, and which can contribute over time to improved market confidence in financial institutions. Together, these initiatives can foster better NPL markets through improved information needed for potential investors. Annex 2 summarizes information on the EDTF and its credit risk and ECL disclosure recommendations.

**39. The EDTF report includes a number of principles and recommendations, along with illustrations of leading disclosure practices in recent bank annual reports, which could be useful in enhancing the risk transparency of Bulgarian banks.** While these are primarily directed at major banks, a number of banks that own Bulgarian banks have taken up the EDTF's recommendations (e.g., Unicredit and Société Générale). Relevant recommendations are summarized in Annex 2 and Box 8. The use of these recommended disclosures could also be useful in preparing Bulgarian banks for more interest from investors in their NPLs and other bank exposures. However, given their smaller size, Bulgarian banks should be given sufficient lead time (e.g., 1–2 years) to fully develop the needed internal systems to implement these disclosure recommendations.

### **Recommendations**

- a. Encourage improvements of banks' internal loan and collateral data as part of an effort leading major banks to maintain timely, accurate and consistent information useful for credit risk management purposes but also for potential investors in NPLs.
- b. Issue disclosure guidance that further enhances risk transparency for the largest Bulgarian banks using the FSB EDTF's recommendations.



## BROADER POLICIES TO ENHANCE NPL RESOLUTION

### A. Early Warning Systems

**40. The BNB monitors early warning systems (EWS) in banks as part of its supervisory activities.** The BNB reviews EWS during its onsite credit risk review process. All banks have some aspects of EWS in place, but there is no homogeneity among banks in terms of their systems' sophistication and the methodologies used. In addition, all banks have "watch lists" with similar criteria for inclusion but may have different approaches to define triggers for alerts to management with respect to watch list status. While the BNB has authority to impose recommendations and measures for improvement in case of identified shortcomings, it has not yet issued supervisory guidance setting forth its expectations for the attributes of sound EWS at banks.

**41. The automatization of EWS is not homogeneous across the banks.** Many banks, subsidiaries, and branches of Western European banks, in particular, have automated their EWS systems using bank IT platforms. However, in less sophisticated banks the process is implemented manually, thus increasing the possibility of errors and slowing the process.

**42. While banks are using a broad range of indicators for early identification of borrowers in payment difficulties, some of the indicators used may identify problems too late, i.e., *ex-post*.** For example, an indicator of days-past-due—7 days for retail and 30 days for corporate clients—recognizes *de facto* payment failure. Such indicators do not provide early enough warning signals, particularly, since under IFRS 9 there will be a rebuttable presumption that loans 30 days or more past due will have experienced "a significant increase in credit risk," thus requiring the recording of higher loan loss allowances based on lifetime ECL.<sup>37</sup> While banks are using indicators for identifying problems with (i) collateral; (ii) cash flows (delayed); and (iii) ownership structures, the measures of leverage, debt repayment capacity (e.g., debt/EBITDA ratio) and interest coverage are not among the indicators used. Examples from other countries indicate that overleveraging is one of substantial risk factors contributing to borrowers' difficulties in repay loans.

**43. All banks have established rules for the inclusion and operation of EWS as part of their credit risk management systems, but the granularity and quality of this guidance varies among banks.** For example, the internal reporting requirements for inclusion of exposures on the "watch list" and for reporting to management differ among banks.

<sup>37</sup> An effective EWS does not help reduce legacy NPLs, since many of these may be substantially past due. Instead, it helps banks better address the potential for *future* NPLs and mitigate their risks by spurring prompt attention and resolution. Also, for NPLs that return to performing loan status through loan restructurings or other repayment measures, an EWS would monitor for early signs of deterioration in the credit risk of those loans.

## Recommendations

**44. BNB should issue supervisory guidance to banks on minimum requirements for EWS.** We encourage the BNB to include the following key topics in the supervisory guidance:

- a. **Key EWS policies** such as (i) *ex-ante* indicators to be included in the EWS list; (ii) maximum time period for exposures to stay on the “watch list;” (iii) the materiality principle; and (iv) bank’s internal reporting requirements, including to senior management. Particular attention should be paid to the indicators included for monitoring. For example, indicators of creditworthiness (e.g., financial liabilities/EBITDA), capital adequacy (e.g., negative equity, insufficient proportion of equity), and interest coverage (e.g., times interest earned (TIE) ratio or EBIT/interest expenses)) with indicative thresholds for triggers must be included in the guidance. The BNB should ensure that this information is included in banks’ internal policies and in documents used in EWS in practice.
- b. **The supervisory guidance should encourage banks which have not yet automated their EWS to achieve a complete automatization of EWS.** Banks should ensure that their EWS are operating on automated IT platforms that are part of their risk management systems.
- c. **As part of this supervisory guidance, BNB could consider requesting a closer link between bank’s credit risk management system and EWS.** During preparations for the introduction of IFRS 9, the banks will have to review their internal credit models to update them for the new ECL requirements, including the criteria to assess to determine if a loan should move from stage 1 (12-month ECL) to stage 2 (lifetime ECL), as discussed in Annex 1. These preparations could be used to establish closer link between bank’s credit models and EWS which may provide benefits to management through more comprehensive information about emerging credit risks.

## B. Collateral Enforcement<sup>38</sup>

**45. Mortgage enforcement in Bulgaria is lengthy and rather ineffective, affecting in most cases loan recovery rates.** The average time for collateral realization is 2.5–3.0 years for commercial real estate and 1.5–2.0 years for residential real estate. Banks do not yet consider movable assets as secure collateral and require special pledges as a fully effective security mechanism. Insufficient regulation of non-judicial enforcement of special pledges affects recovery effectiveness. Frequent fraudulent actions committed by pledgers to harm the rights of pledgees, due to existing gaps in the legal framework, negatively affect the widespread use of special pledges.

**46. The land registration system is largely satisfactory.** The registry information is integrated and accessible online. Legally effective information, however, can only be obtained in person from the Land Office. Searches must be done by asset owner’s name (not by asset), thus allowing for information gaps. The lack of ownership history per asset complicates the transfer of ownership rights. Time periods for registration (6–15 days) delay loan disbursements. The Land Office is not interconnected with Cadastre,

<sup>38</sup> For more detailed information and recommendations on collateral enforcement and insolvency regime matters, please refer to the World Bank ROSC on Insolvency and Creditor/Debtor Regimes in June 2016.

making it difficult to resolve inconsistent data kept by both entities. Mortgage costs are reasonable: 0.1 percent of the loan amount for registration, plus notary fees, which cannot exceed EUR 3,000.

**47. The Central Pledge Registry is a centralized, public and electronic registry for recording nonpossessory security rights over movable assets.** Online access to the registry is not currently available. Information is provided in paper form, not electronically. The registry charges BGN 50 for initial registration and BGN 5 per page for information on pledges. Users of the system consider the charge per page as being somewhat expensive. Searches by asset are not possible, so third parties may in good faith buy an asset ignoring whether it may be encumbered.

**48. Enforcement of unpaid claims is inefficient, thus negatively affecting loan recovery rates.** In the case of unsecured debts and debts secured over movable assets recovery rate is less than 50 percent and 75 percent of mortgage loans. Non-judicial enforcement procedures are available for special pledges, which work well in some cases; however, debtors frequently act fraudulently—in particular, by creating a second or third degree pledge in favor of a phony creditor. Other secured and unsecured claims should be enforced using judicial procedures, which are generally considered to be too complex, ineffective, and slow.

**49. Enforcement costs are high.** Creditors must pay upfront 2 percent of the claim value as a judicial enforcement fee. If the enforcement is objected to and the creditor should initiate an ordinary proceeding to ascertain its claim, another 2 percent court fee must be satisfied in advance. Lawyers' fees are also high. Private enforcement agents' (bailiffs) fees also increase execution costs. Debtors are allowed to raise numerous objections and appeals that, in some cases, convert the enforcement proceeding into a protracted ordinary lawsuit.

**50. Auction procedures are generally considered satisfactory but further improvements could be made.** Some market participants consider that auction price steps are not sufficiently flexible in order to discover the true market price. The MoJ intends to introduce "tax value" as the initial auction price to compare with the current requirement for the appraiser's estimate. However, timing of this amendment is not clear. Furthermore, buying a property at auction using bank financing is currently very difficult; usually, there is very little time (seven days) to have the loan approved and disbursed before the auction price must be paid. The buyer's rights are not sufficiently protected. In many instances the participant is asked to disburse the price before the auction is finally approved. Also, the transfer of ownership is not materialized until after the decision approving the auction becomes final.

**51. Notification of the debtor is a problematic area.** The current regulation does not clearly identify the debtor's notification process during the transfer of rights. This ambiguity creates a situation where the new ownership of NPL rights is impossible to discharge due to a change of a borrower's address. Anecdotal evidence indicates that some debt collection companies cannot execute their rights or the legal process is substantially delayed for up to 30 percent of their retail clients.

## Insolvency regimes

**52. The bankruptcy legislation is rather comprehensive, but, in practice, insolvency proceedings are not working effectively.** Many creditors consider bankruptcy proceedings not as an effective collection mechanism but rather as a vehicle used by debtors to evade their obligations—in many cases, fraudulently. A widespread and significant mistrust between debtors and creditors prevents more frequent and timely use of rehabilitation. Successful rehabilitations are rare—only six cases in three years. Most bankruptcy cases end up as piece-meal asset liquidations. Opening a bankruptcy case often takes too long—five months usually, and up to two years if the case is complicated. Opened bankruptcy proceedings may take 10 or more years to be completed.

**53. A culture of out-of-court collective negotiation and agreements (workouts) to restore an enterprise financial viability is insufficiently developed.** The legal framework does not encourage the use of workouts. Most transactions that could be entered into by the debtor and some creditors in a workout would be at a risk of being challenged in bankruptcy under the avoidable transactions regime. There is no recognized code of conduct for informal workouts.

## Recommendations

**54. To remove impediments to collateral enforcement, the following are recommended:**

- **Improve the interconnectedness of the Land Office with the Cadastre.** Improvements will help minimize errors during the collateral enforcement process by reducing the inconsistency of the data kept by both parties.
- **Enhance the auctioning process to allow wider participation and more realistic price discovery.** The current auction timeline does not allow for buyer's participation with borrowed resources from a financial institution, thus limiting the number of interested participants. The current price steps during auction process should be widened to allow more realistic price adjustment process in the current illiquid market. Alternatively, "tax value" could be set as the first auction price.
- **Provide clear and unambiguous guidance and amending legislation, for the debtor's notification of rights' transfer.** A precise procedure for this notification in the Article 99 of Obligation and Contract Act will eliminate the current different interpretations by the courts.
- **Implement the recommendations of the World Bank ROSC on Insolvency and Creditor/Debtor Regimes.** The report was delivered to authorities in June 2016.

## C. NPL Markets

**55. The Bulgarian NPL market is developing but remains shallow.** The retail NPL segment, particularly consumer NPLs, which are sold in the price range of 8–12 cents per euro, is more developed than the corporate segment. However, during 2016 and early 2017 a few sizable (around EUR 100 million) corporate NPL transactions were completed. The latest large corporate NPL sale by UniCredit Bulbank, at a price only in single digits, indicates that banks are experiencing challenges when they seek to sell corporate portfolios. Generally, they seek such NPL sales only when all legal measures are exhausted and there are no regulatory pressures on them to facilitate timely NPL workouts. Buyers of NPLs are both local and international companies (e.g., B2, APS Holding, EOS Matrix, OTP Factoring Bulgaria). Due to the limited market size, major international NPL investors are not active in this market. Transactions in a magnitude of EUR 500 million (gross value) are a normal threshold for larger NPL purchasers.

**56. The total amount of unsecured retail NPL transactions in H1 2016 was around BGN 600 million.**<sup>39</sup> This was a substantial increase compared with previous years when only BGN 100 million to BGN 300 million volume per year was the norm. In 2016, most of the transactions were done with retail loans—81 percent, followed by 18 percent in corporate secured loans.

**57. The major obstacles for a more active corporate NPL market are of an administrative and legal nature.** For more details, please refer to the previous TN section on collateral enforcement and Insolvency regimes.

**58. NPL pricing gap remains an impediment to further market development, in particular for corporate NPLs.** The difference between prices of willing investors and sellers of NPLs (i.e., banks) is determined by two aspects: (i) the level of NPL provisioning in the bank's balance sheet; and (ii) the valuation of collateral. On many occasions, the prices offered by investors are too low for banks to sell their NPLs without having to record substantial additional loan loss provisions, thus diminishing their earnings. A more robust provisioning policy by banks could narrow the NPL price gap, consequently stimulating the NPL market and reducing NPL levels in the banking system. As previously mentioned, anecdotal evidence indicates that collateral valuations requested by investors often may substantially differ from the valuations recorded by the bank, thus undermining investor confidence.

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<sup>39</sup> Survey of the Association of the Collection Agencies in Bulgaria. Data only for retail unsecured loans.

#### Box 4. NPL Tax Considerations

In some countries, the tax framework can provide impediments to an NPL reduction strategy. However, based on discussions with major accounting firms and investors, the current Bulgarian NPL taxation framework is not considered to be a major impediment for NPL resolution. The following are the main tax aspects:

- a. Bulgarian legislation determines that any income and expenses arising from loan loss provision recognition and reversal of financial assets shall be recognized for tax purposes in the year of occurrence. This is irrespective of the accounting treatment applied;
- b. Certain rules, defined in the Corporate Income Tax (CIT) Act, should be followed by banks in order to allow tax deductions for write-offs;
- c. In cases involving debt forgiveness, the part of the debt forgiven is subject to 10 percent CIT, as tax authorities recognize this as income or gift. This also applies to individual persons;
- d. Tax losses recognized by a bank can be carried forward during the following five years after the loss is realized. There are no restrictions on tax losses carried forward after an ownership change. However, the applicability of this practice is limited due to the lack of precedents; and
- e. The sale of NPLs is not subject to Value Added Tax (VAT), the principle that applies to other financial transactions as well.

The transfer of NPLs does not qualify for the local transfer tax. This rule applies both to secured and unsecured transactions. However, applicable state fees should be paid upon the registration of the new collateral ownership.

**59. The NPL servicing business is becoming more developed and competitive.** EOS Matrix, B2, Creditreform, Mellon Bulgaria, and Frontex are the leading debt servicing companies that are active in providing NPL servicing platforms and NPL investment opportunities in Bulgaria. These companies are affiliates of international companies. However, only a few are active in corporate debt restructuring and servicing. The Association of Collection Agencies in Bulgaria (ACABG) is a nonprofit umbrella organization for debt servicing professionals. The organization's mission is to encourage the establishment of sound practices in the Bulgarian receivables management industry

**60. The BNB has implemented monitoring of NPL investors in Bulgaria, but not all firms are subject to registration and oversight.** Foreign investors interested in purchasing NPLs should register as a nonbanking financial institution, monitored by the BNB, if its core business is the acquisition of loan receivables. If such business represents less than 30 percent of its total revenue or the assets related to this activity, and less than 30 percent of its total assets, this special registration is not needed. This approach toward NPL market participants leaves some investors unregulated and is distorting competition and may result in practices by unregulated firms that may damage the industry's reputation. Also, the companies not required to be licensed do not have to register in the local association, and thus are not subject to ethical and other professional standards. Furthermore, these companies are not subject to the BNB's strict reporting requirements, thus reducing the BNB's ability to collect accurate market statistics and limiting market transparency. The minimum required paid-in capital for the entry of a nonbanking financial institution in the register is BGN 1 million, and each

company should have management free from criminal records. Unregulated firms are not subject to these rules.

### **Recommendations**

- a. The BNB should work with other national authorities, the banking industry and investors to improve the NPL market and remove existing impediments, in line with the World Bank's Insolvency and Creditor/Debtor Regimes ROSC in June 2016.<sup>40</sup>
- b. The BNB should consider equalizing requirements for all NPL investors. The current arrangement for the companies which are not primarily managers of NPLs distorts (i) market competition; (ii) correct data collection; and (iii) transparency in the NPL market.
- c. Consider the development of recovery partnerships (RP) as a viable form of NPL resolution under the current NPL market arrangement in Bulgaria. The resolution of NPLs is not a core business of banks because it requires specific expertise (e.g., real estate management, industry knowledge, company turnaround skills) and it is resource and time consuming. Thus, third party NPL management expertise could be utilized using recovery partnerships. Under this arrangement, a third party would provide NPL resolution expertise but revenues from the recovery of assets would be shared according to a pre-agreed scheme. This arrangement would allow a bank to maintain an exposure to any upside potential from business development or collateral realization, which is cited as one of the reasons why banks are reluctant to sell their NPLs.

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<sup>40</sup> NPL tax considerations are summarized in Box 4 and do not present impediments to NPL resolution.

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## Annex I. Robust Provisioning Under IAS 39 and IFRS 9

### A. Robust Loan Loss Provisioning Under IAS 39

**1. The Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) have worked with accounting standard setters, banks, and auditors for a number of years to encourage more robust provisioning standards.** For example, the BCBS issued its policy paper, Sound Credit Risk Assessment and Valuation for Loans (2006),<sup>1</sup> Guiding Principles for the Replacement of IAS 39 (2009),<sup>2</sup> updated Core Principles for Effective Banking Supervision (2012),<sup>3</sup> and an updated policy on External Audits of Banks (2014),<sup>4</sup> all of which include important discussions about robust loan loss provisioning in the banks' financial statements under the relevant accounting standards. Moreover, the Financial Stability Board (FSB) and its predecessor, the Financial Stability Forum (FSF), included the IASB Chairman as a member, and commissioned a Working Group on Provisioning, which reported to the G20 on ways to improve provisioning under existing accounting standards and the need for reconsideration of the incurred loss model for provisioning.<sup>5</sup> This effort, together with those of the BCBS and investors, and the IASB-FASB Financial Crisis Advisory Group encouraged the IASB and U.S. Financial Accounting Standards Board (FASB) to embrace expected credit loss provisioning approaches in their new accounting standards for financial instruments summarized in the next sub-section.

**2. Bulgarian banks are required to prepare their financial statements under IFRS, notably the standard on financial instruments, IAS 39.** Until the expected credit loss provisioning model of IFRS 9 becomes effective in 2018, banks and other companies following IASB standards must determine loan impairment on the basis of an incurred loss model that, in essence, requires the occurrence of an observable loss event (or events) as a trigger for a determination that a loan has become impaired. Notwithstanding the incurred loss model in IAS 39, there are a number of aspects of IAS 39 that the BNB can emphasize that could result in more robust provisioning practices by banks in Bulgaria.

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<sup>1</sup> <http://www.bis.org/publ/bcbs126.pdf>

<sup>2</sup> <http://www.bis.org/publ/bcbs161.pdf>

<sup>3</sup> <http://www.bis.org/publ/bcbs230.pdf>

<sup>4</sup> <http://www.bis.org/publ/bcbs280.pdf>

<sup>5</sup> Addressing Procyclicality in the Financial System, 2009, [http://www.financialstabilityboard.org/wp-content/uploads/r\\_0904a.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_0904a.pdf) and Report of the FSF Working Group on Provisioning, 2009, [http://www.financialstabilityboard.org/wp-content/uploads/r\\_0904g.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_0904g.pdf). This work led the G20 Leaders in April 2009 to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards.

**3. Unfortunately, banks and their auditors may focus on a too narrow interpretation of IAS 39’s observable evidence requirement for determining impairments.** IAS 39 prescribes that impairment decisions are based on “observable evidence” of incurred losses, such as:<sup>6</sup>

- significant financial difficulty of the issuer or obligor;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- the lender, for economic or legal reasons relating to the borrower’s financial difficulty, grants the borrower a concession or restructuring that the lender would not otherwise consider;
- it becomes probable that the borrower will enter insolvency or other financial reorganization;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group. In addition, a credit rating downgrade, when considered together with other observable data, may indicate that a loan is impaired.

**4. However, IAS 39 allows for experienced judgment on a number of critical elements, including factors that affect the amount and timing of cash flow projections of loan repayments.** If misapplied, such judgment may result in an underestimation and/or delayed recognition of credit losses. The standard recognizes that loss estimates may vary and directs entities to select the most credible estimate within a range of possible outcomes. In this context, the IASB and the BCBS reached consensus in 2003 on sound application of IAS 39, with revisions reflected in modifications to IAS 39 that year. When properly understood and implemented, these aspects of IAS 39 can result in more informed and robust loan loss provisioning by banks.

**5. Building on the BCBS’ input to the IASB reflected in IAS 39 and related supervisory guidance, the following aspects should be emphasized by the BNB in supervisory guidance to encourage more robust loan loss provisioning practices.**

- **IAS 39 recognizes the importance of “experienced judgment” in the provisioning process. The use of experienced judgment and reasonable estimates are required under IAS 39 when estimating loan loss provisions.** The methods chosen for provisions should result in timely recognition of existing loan losses. While historical loss rates and recent economic conditions can be a starting point for a bank’s analysis, they are not by themselves a sufficient basis for determining an appropriate level for the loan loss provision. Banks’ management should also take into account current factors that indicate that existing loan losses differ from

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<sup>6</sup> IAS 39, paragraph 59.

the historical loan loss experience. Such factors include changes in relevant economic and environmental trends, lending policies and procedures, and changes related to new loan segments and products. IAS 39 recognizes that it is appropriate to use experienced judgment; for example:<sup>7</sup> (i) in adjusting historical loss rates for current information and circumstances; and (ii) in determining loan loss provisions when data is lacking or is no longer fully relevant. This may be particularly important when valuations of collateral are not realistic and reliable or are not fully relevant due to recent developments.

- **With respect to adjusting historical loss rates for current information, the BCBS has provided helpful guidance on the types of factors that bank management should consider, which include:**<sup>8</sup>
  - a. changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
  - b. changes in international, national, and local economic and business conditions and developments, including the condition of various market segments;
  - c. changes in the trend, volume, and severity of past-due loans and loans graded as low quality, as well as trends in the volume of impaired loans, troubled debt restructurings, and other loan modifications;
  - d. changes in the experience, ability, and depth of lending management and staff;
  - e. changes related to new market segments and products;
  - f. changes in the quality of the bank's loan review system and the degree of oversight by the bank's senior management and Board of Directors;
  - g. the existence and effect of any concentrations of credit and changes in the level of such concentrations;
  - h. the effect of external factors, such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio; and
  - i. changes in the credit risk profile of the loan portfolio as a whole.

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<sup>7</sup> IAS 39, paragraphs 62 and AG89.

<sup>8</sup> See "Principle 6: A bank's use of experienced credit judgement and reasonable estimates are an essential part of the recognition and measurement of loan losses," <http://www.bis.org/publ/bcbs126.pdf>.

- **IAS 39 recognizes that the use of reasonable estimates is an essential part of the financial statement process and does not undermine the reliability of financial statements.**<sup>9</sup> In addition to the BCBS guidance noted above, the need for the sound use of experienced judgment in determining reasonable estimates for loan loss provisioning purposes was emphasized by the report to the G20 in 2009 by the FSF Working Group on Provisioning as important to achieve an earlier recognition of credit losses and more robust bank provisioning practices.<sup>10</sup>
- **IAS 39 recognizes the need for the loan loss provisioning process to consider all credit exposures in all internal credit grades.**<sup>11</sup> Some banks will only focus their provisioning on credit losses associated with the most severe credit grades (e.g., only those loans classified “doubtful” or “loss”) under their internal credit grading system or regulatory credit grades. However, IAS 39 requires that provisioning should take place not just for credit losses associated with loans in lower quality credit grades (e.g., not just loans classified as “doubtful” and “loss”), but also include estimated credit losses for loans in each of the earlier, better quality credit grades.
- **Banks should consider all factors affecting the collectability of the loan portfolio at the balance sheet date, including information identified after the balance sheet date, but before the financial statements are issued** (which, during a downturn, could result in higher loan loss provisions).<sup>12</sup>
- **IAS 39 provides for assessing individual loan impairment as well as impairment of groups of loans.** In addition, an individually reviewed loan, which is deemed not to be impaired, may be included with other loans with similar credit risk and evaluated as part of this portfolio, such as a group of similar loans in a particular credit grade and impairment losses associated with that credit grade may be applied for this portfolio of loans, including the loan that had been individually reviewed for impairment but had been found not to be impaired.<sup>13</sup> This can result in higher loan loss allowances for various loan portfolios with common risk characteristics than might have been the case if the loans were solely reviewed individually.
- **Impairment provisions should be seen as best estimates in a range of estimated credit losses, rather than as artificially precise amounts.**<sup>14</sup> This is an important concept because it recognizes that, in practice, banks should look at their loan loss estimates as resulting in a high and low range for estimated credit losses, and then bank management should determine its best

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<sup>9</sup> IAS 39, paragraph 62.

<sup>10</sup> [http://www.financialstabilityboard.org/wp-content/uploads/r\\_0904g.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_0904g.pdf).

<sup>11</sup> IAS 39, paragraph AG85.

<sup>12</sup> IAS 39, paragraph AG86.

<sup>13</sup> IAS 39, paragraph 64.

<sup>14</sup> IAS 39, paragraph AG86.

estimate within the range of high and low credit loss estimates. When looked at in this way, instead of the loan loss provision being solely a “point estimate,” higher loan loss provisions can result, as management uses its experienced judgment to choose where its best estimate for loan loss provisions should be in relation to the high and low estimates of credit losses— considering all factors affecting the collectability of loan portfolio, including the reasonableness of collateral valuations.

**6. These aspects, which are critical to improved provisioning practices in 2017, should be addressed in new BNB supervisory guidance.**

## **B. IFRS 9 Provisioning for Expected Credit Losses**

**7. IFRS 9 impairment approach requires banks and other companies to recognize ECL and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial assets.** The IASB approach is forward-looking and eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a “trigger event” to have occurred before credit losses are reported. IFRS 9 requires companies to base their measurements of ECL on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and—*for the first time*—forecast information. Thus, the effects of possible future credit loss events on expected credit losses must be considered.<sup>15</sup>

**8. In summary, all banks and other companies that hold financial assets or commitments to extend credit that are not accounted for at fair value through profit or loss (e.g., trading portfolios) would be affected by IFRS 9’s impairment rules.** This includes loans and other financial assets measured at amortized cost or that are reported at “fair value through other comprehensive income” (like today’s available-for-sale assets), trade receivables and lease receivables, loan commitments and financial guarantee contracts. The standard is mandatorily effective for annual periods beginning on or after January 1, 2018, although earlier adoption is permitted.

**9. As summarized below and in Figure 6, IFRS 9 requires banks and other companies to report ECL in three stages as deterioration in credit quality takes place after initial recognition of loans.**<sup>16</sup> For stage 1, they would report “12-month expected credit losses” and for stages 2 and 3, full “lifetime expected credit losses” would be reported.

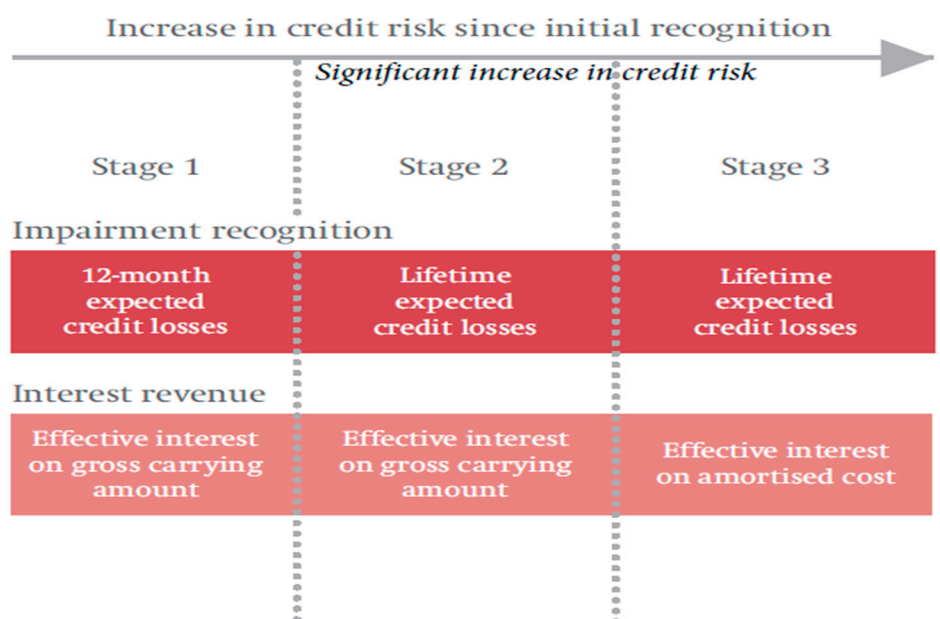
**10. Stage 1. As soon as a financial instrument is originated or purchased, 12-month ECL are recognized as an expense and a loss allowance is established.** This serves as a proxy for the

<sup>15</sup> IFRS 9 applies the same impairment approach to all financial assets that are subject to impairment accounting, thus removing a source of current complexity.

<sup>16</sup> Project Summary: *IFRS 9 Financial Instruments*, IASB, July 2014.

initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (i.e., without adjustment for the loss allowance). A bank or other company would calculate 12-month ECL as the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. The IASB stresses that this is not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months. Also, 12-month ECL are not the credit losses on assets that are forecast to default in the next 12 months, and if a bank can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, their lifetime ECL must be recognized. If a financial instrument is determined to have “low credit risk” at the reporting date—for example, a loan or debt security with an investment grade rating—a bank may assume that the credit risk of the financial instrument has not increased significantly since initial recognition. Credit risk is considered low if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its obligations.

**Figure 1. Bulgaria: IFRS 9 Impairment Stages**



Source: Adapted from IASB Project Summary: *IFRS 9 Financial Instruments*, July 2014.

**11. Stage 2. When the credit risk increases (or credit quality deteriorates) significantly and the resulting credit quality is not considered to be “low credit risk,” full lifetime ECL would be reported** (if the credit quality deteriorates significantly from that at origination or purchase). The increase in the loan loss allowances resulting from a move from 12-month to lifetime ECL is typically

expected to be significant. The calculation of interest revenue on financial assets remains unchanged from the approach set forth for Stage 1.

**12. Under IFRS 9, lifetime ECL are an expected present value measure of losses that arise if borrowers default on their obligations throughout the life of the financial assets.** They are the weighted average credit losses with the probability of default as the weight. Since expected credit losses consider the amount and timing of payments, a credit loss (i.e., a cash shortfall) arises even if the bank expects to be paid in full but later than when contractually due. Banks and other companies should base their measurement of ECL on relevant information about past events, including historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts. Assessment of significant increases in credit risk may be done on a collective basis, for example on a group or sub-group of financial instruments. This should ensure that lifetime ECL are recognized when there is a significant increase in credit risk, even if evidence of that increase is not yet available on an individual level.

**13. However, regardless of the way in which an entity assesses significant increases in credit risk, there is a *rebuttable presumption* that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.** The IASB stresses that the rebuttable presumption is not an absolute indicator, but is presumed to be the latest point at which lifetime ECL should be recognized even when using forward-looking information.

**14. *Stage 3*. This stage occurs when the credit quality of a financial asset deteriorates to the point that credit losses are incurred or the asset is credit-impaired.** Lifetime ECL would continue to be reported for loans in this stage of credit deterioration but interest revenue is calculated based on the lower net amortized cost carrying amount (i.e., the gross carrying amount adjusted for the loan loss allowance).

**15. Thus, IFRS 9 approach initially recognizes a portion of the lifetime expected credit losses, and then the full lifetime ECL only after significant deterioration in credit quality is expected.** As discussed below, IFRS 9 also includes new guidance on loan write-offs which was not included in the current standard, IAS 39, *Financial Instruments: Recognition and Measurement*. Moreover, IFRS 9 requires extensive new qualitative and quantitative disclosures about credit risk management policies, expected credit losses, loan write-offs, and changes in the credit risk of the loan portfolio and other financial instruments subject to its impairment approach.

### **BCBS Supervisory Guidance on ECL Provisioning**

**16. In December 2015 the BCBS published its final supervisory guidance to address how ECL accounting approaches—whether set forth in IASB, FASB or other accounting standards—should interact with a bank's overall credit risk practices.** It expresses the BCBS' support for the use of ECL approaches and encourages their application in a manner that will provide incentives for



banks to follow sound credit risk management practices and achieve earlier recognition of credit losses than takes place using incurred loss provisioning approaches. The guidance replaces the BCBS' 2006 loan loss provisioning. As the policy document begins, it states, "This paper is intended to set out supervisory guidance on accounting for expected credit losses that does not contradict applicable accounting standards established by standard setters. Representatives of the IASB have been provided with the opportunity to comment on this document and have not identified any aspects of it that would prevent a bank from meeting the impairment requirements of International Financial Reporting Standard (IFRS) 9 Financial Instruments." Consistent with the Basel Core Principles, the BCBS recognizes that supervisors may adopt proportionate approaches that should enable banks to adopt sound allowance methodologies commensurate with the size, complexity, structure, economic significance, risk profile and all other relevant facts and circumstances.

**17. The BCBS understands that the implementation of ECL accounting frameworks will require an investment in resources and in system development and system upgrades.** However, because the accounting standard setters have given banks and other firms over three years to transition to the new accounting requirements, the BCBS expects internationally active banks to ensure a disciplined, high-quality implementation of the ECL accounting requirements.<sup>17</sup>

**18. The 11 principles for banks and supervisors are listed in Box 1.**

**19. For allowances for 12-month ECL, the BCBS expects banks will always measure ECL for all lending exposures, and that a nil (zero) allowance will be rare** because ECL estimates are a probability-weighted amount—informed by management's experienced credit judgment—that should always reflect the possibility that a credit loss will occur. The guidance recommends using the BCBS' regulatory default definition (Basel II capital framework, para. 452). For any high-credit-risk exposures with ECL initially measured at 12-month ECL, banks should closely monitor for significant increases in credit risk.

**20. With respect to IFRS 9's required assessment of significant increases in credit risk, this is very challenging and the guidance sets forth the BCBS expectations in this area.** For example, the BCBS:

- Strongly endorses the IASB's view that lifetime expected credit losses are generally expected to be recognized before a financial asset becomes past due and that credit risk typically increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed.

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<sup>17</sup> The BCBS notes that banks may have well established regulatory capital models for the measurement of expected losses. However, due to differences between the objectives and inputs for accounting versus capital purposes, while these models may be used as important starting points for estimating ECL for accounting purposes, regulatory capital models may not be directly usable without adjustment in the measurement of accounting ECL. For example, the Basel capital framework's expected loss calculation for regulatory capital differs from accounting ECL in that the Basel capital framework's probability of default (PD) may be "through the cycle" and is based on a 12-month time horizon. Additionally, loss-given-default (LGD) in the Basel capital framework reflects downturn economic conditions.

- Gives specific guidance on assessing for significant credit risk increases, as summarized in Box 2.
- Emphasizes that, when assessing whether credit risk has increased significantly, banks should consider changes in the risk of default occurring over the expected life of the credit exposure, since it may not always be appropriate to use changes in the 12-month risk of default for this purpose.

**21. In addition to the conditions and factors summarized in Box 2, the BCBS cautions that modifications or renegotiations of loans and other financial assets can mask increases in credit risk**, resulting in ECL being underestimated, delaying the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated, or can inappropriately result in a move from lifetime ECL measurement back to 12-month ECL measurement. When assessing whether there is a significant increase in credit risk for a modified lending exposure, the BCBS expects a bank to demonstrate whether such modifications or renegotiations have improved or restored the bank's ability to collect principal and interest payments compared with the situation upon initial recognition.

**22. With respect to the use of the practical expedients mentioned in IFRS 9, the BCBS expects banks will make limited use of the "low credit risk" exception and will not use "30 days past due" as a primary indicator of when it is appropriate to recognize lifetime ECL.** The BCBS expects that any use by banks of these practical expedients should be documented and should be reviewed by banking supervisors.

### Box 1. BCBS Principles for Banks and Supervisors

#### *Supervisory guidance principles (expectations for banks)*

**Principle 1 – Board and management responsibilities:** A bank’s Board of Directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances in accordance with the bank’s stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

**Principle 2 – Sound ECL methodologies:** A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of ECL in accordance with the applicable accounting framework.

**Principle 3 – Credit risk rating process and grouping:** A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

**Principle 4 – Adequacy of the allowance:** A bank’s aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.

**Principle 5 – ECL model validation:** A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.

**Principle 6 – Experienced credit judgment:** A bank’s use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

**Principle 7 – Common data:** A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.

**Principle 8 – Disclosure:** A bank’s public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

#### *Evaluation principles for supervisors*

**Principle 9 – Credit risk management assessment:** Banking supervisors should periodically evaluate the effectiveness of a bank’s credit risk practices.

**Principle 10 – ECL measurement assessment:** Banking supervisors should be satisfied that the methods employed by a bank to determine accounting allowances lead to an appropriate measurement of ECL in accordance with the applicable accounting framework.

**Principle 11 – Capital adequacy assessment:** Banking supervisors should consider a bank’s credit risk practices when assessing a bank’s capital adequacy.

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Source: *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015.

### Box 2. Conditions and Factors That May Indicate a Significant Increase in Credit Risk

- A discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be significantly higher than it was when the loan was originated because of an increase in the credit risk of the specific borrower or class of borrowers since inception;
- Management’s decision to strengthen collateral and/or covenant requirements for new exposures similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition;
- Borrower downgrades by a recognized credit rating agency, or within a bank’s internal credit rating system;
- For performing credits subject to individual monitoring and review, an internal credit assessment summary credit-quality indicator that is weaker than upon initial recognition;
- Deterioration of relevant determinants of credit risk (e.g., future cash flows) for an individual obligor (or pool of obligors); and
- Expectation of forbearance or restructuring due to financial difficulties.
- In addition, banks should consider more general factors such as the deterioration of the macroeconomic outlook relevant to a specific borrower or group of borrowers; and deterioration of prospects for the sector or industries within which a borrower operates.

Source: *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015.

## Global surveys of IFRS 9’s impact and implementation issues

**23. In 2016, global surveys by major accounting firms and other organizations noted progress by banks in implementing IFRS 9’s ECL impairment approach but found considerable work remains to be completed before 2018.** For example, Deloitte’s Global Banking IFRS Survey captured the views of 91 banks—16 from the Asia-Pacific region, seven from Canada, and 69 from Europe, Middle East and Africa—including 16 global systemically important financial institutions (SIFIs).<sup>1</sup> Key findings in 2016 include:

- **60 percent of banks either did not disclose or could not quantify the transition impact of IFRS 9.** Of the banks who responded, the majority estimate that total impairment provisions will increase by up to 25 percent across asset classes due to the new ECL approach. (PwC’s 2016 global survey of 43 institutions across 10 countries found that, “Overall the majority of the institutions expect IFRS 9 to increase their provision requirements: 19 percent of respondents

<sup>18</sup> Deloitte, 2016, *Sixth Global IFRS Banking Survey—No time like the present*, May.

expect an increase of 0 percent-10 percent in provisions, 32 percent expect an increase between 10–30 percent, while we note that 30 percent of respondents do not yet have an indication of the impact of IFRS 9.”<sup>2)</sup>

- **70 percent of respondents anticipate a reduction of up to 50 bps in core tier 1 capital ratios due to IFRS 9.** However, most banks do not yet know how their regulators will incorporate IFRS 9 ECL allowance estimates into regulatory capital estimates.
- **In general, approximately half of participants are unsure of the answer to many key ECL modelling design questions, which may delay banks’ IFRS 9 implementation programs.** Data quality and the availability of the origination lifetime PD (needed as part of the assessment to determine whether a significant increase in credit risk has occurred), is the biggest data concern for most banks.

**24. In addition, in November 2016, the European Banking Authority (EBA) published its report on IFRS 9 implementation progress of over 50 financial institutions across the European Economic Area.**<sup>3</sup> The survey was launched in January 2016 and found many of the same broad types of issues related to banks’ implementation progress that had been noted in the global surveys summarized above. The EBA found that the involvement of some key stakeholders in IFRS 9 implementation seemed limited currently and that sufficient resources needed to be assigned by banks to ensure high quality implementation. As the implementation process requires collaboration between different departments within banks, key functions should be involved in this effort, including senior credit risk experts, audit committees and the Board of Directors.

- **While noting that quantitative estimates provided by survey respondents were preliminary, the EBA report estimated the increase of loan loss provisions compared to the current levels of provisions under IAS 39 will be 18 percent on average and up to 30 percent for 86 percent (seventy-fifth percentile) of respondents.** CET1 and total capital ratios are estimated to decrease, on average, by 59 basis points (bps) and 45 bps respectively. CET1 and total capital ratios are estimated to decrease by up to 75 bps for 79 percent of respondents (75th percentile).

**25. Moreover, in January 2017, Barclays reported its estimates of the impact of IFRS 9 on capital and provisions in Europe based on a thorough review of disclosures by 28 large European banks.**<sup>4</sup> Barclays estimates an increase in loan loss provisions of about one-third on average for the banks reviewed, mostly from the recognition of lifetime ECL for loans in Stage 2, and estimates more earnings volatility, and this translates into an average reduction in bank capital levels of about 50 bps.

<sup>19</sup> PricewaterhouseCoopers UK, 2016, *IFRS 9: Impairment - Global banking industry benchmark*, May.

<sup>20</sup> *Report on results from the EBA impact assessment of IFRS 9*, EBA, November 2016. See the report at: [www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+impact+assessment+of+IFRS9](http://www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+impact+assessment+of+IFRS9).

<sup>21</sup> Barclays: “European Banks: IFRS9—Bigger than Basel IV,” January 9, 2017.

**26. These summary survey results indicate a need for BNB to become more active in encouraging banks to devote more resources to implement ECL provisioning requirements in a more robust, consistent and transparent manner.** Prudential authorities had a key role in encouraging accounting standards setters to issue the new ECL accounting standards. BNB can also have a very important role in promoting high quality bank implementation practices through its banking supervisory activities in a manner that compliments the efforts of accounting standards setters.<sup>5</sup> The TN section on “A macroprudential approach to reducing nonperforming loans,” paragraph 20, shows how BNB can promote high quality implementation practices.

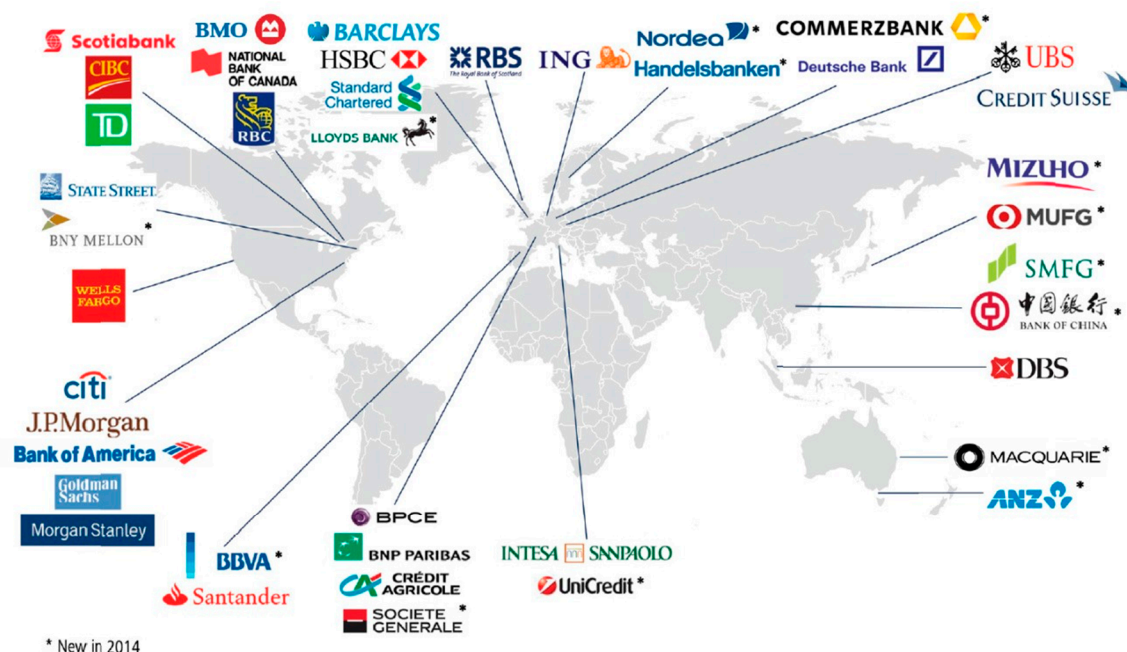
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<sup>22</sup> These supervisory activities focus on encouraging *sound implementation practices* and not on developing accounting standards or interpretations, so they do not infringe on the roles and independence of accounting standard setters. In our experience, such carefully developed, sound activities are appreciated by accounting standard setters and securities regulators.

## Annex II. FSB EDTF Risk Disclosure Initiative

1. **The importance to market confidence of useful disclosure by financial institutions of their risk exposures and risk management practices has been underscored during the global financial crisis and its aftermath.** In May 2012, the FSB appointed a private-sector task force to develop principles for improved bank disclosures and identify leading practice risk disclosures. The EDTF was comprised of senior officials and experts representing financial institutions, investors and analysts, credit rating agencies, and external auditors. In October 2012, it reported recommendations to the FSB in which were welcomed by the G20 Leaders, FSB, and the chairs of the IASB and FASB.<sup>6</sup> Each year from 2013 to 2015 the EDTF reported ever improving global voluntary implementation of these recommendations in annual implementation progress assessments. For example, in its implementation progress survey for 2015, 40 major international banks participated in the survey.<sup>7</sup>

**Box 1. Banks Participating in the EDTF Implementation Progress Survey for 2014**



Source: EDTF progress report, September 2014.

<sup>1</sup> Many large banks are implementing the recommendations of the FSB's Enhanced Disclosure Task Force, issued in October 2012, to improve their risk disclosure practices and transparency to investors. See [www.financialstabilityboard.org/press/pr\\_121029.pdf](http://www.financialstabilityboard.org/press/pr_121029.pdf).

<sup>2</sup> 2015 Progress Report on Implementation of the EDTF Principles and Recommendations, EDTF, December 2015. See [www.fsb.org/2015/12/2015-progress-report-on-implementation-of-the-edtf-principles-and-recommendations/](http://www.fsb.org/2015/12/2015-progress-report-on-implementation-of-the-edtf-principles-and-recommendations/).

**2. The EDTF recommendations have been welcomed by the industry and are generally regarded as a valuable step to improving the quality of banks' risk disclosure practices.** The seven principles and 32 recommendations for improved bank risk disclosures, together with the extensive examples of leading disclosure practices are designed to provide timely information that is useful to investors and other users, and which can contribute over time to improve market confidence in financial institutions. Box 2 presents the EDTF's recommendations that are most relevant for enhancing disclosures about credit risk, including those about NPLs.

### **Enhanced risk disclosure needed during the transition period to IFRS 9**

**3. Given the importance of the new IASB and FASB ECL accounting standards for the banking industry, the FSB requested the EDTF to recommend disclosures to help market participants understand the upcoming changes resulting from ECL approaches and to promote consistency and comparability.** The EDTF's report, published in December 2015, found that investors and other financial report users want to understand the specific reasons for any changes at transition in ECL loan loss provisions compared to the existing approach and the ongoing drivers of variability in credit losses.<sup>8</sup> Key areas of user focus during the transition period include:

- concepts and policies developed to implement the new ECL approaches, including the "significant increase in credit risk" assessment required by IFRS 9;
- the specific bank methodologies and estimation techniques developed;
- the impact of moving from an incurred loss approach to an ECL approach;
- understanding the dynamics of changes in credit losses and their sensitivity to significant assumptions, including those resulting from the application of macro-economic assumptions;
- any changes made to the governance over financial reporting, and how they link with existing governance over other key areas including credit risk management and regulatory reporting; and
- understanding the differences between accounting ECL and regulatory capital EL.

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<sup>3</sup> *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures*, EDTF, November 30, 2015. See [www.fsb.org/2015/12/impact-of-expected-credit-loss-approaches-on-bank-risk-disclosures/](http://www.fsb.org/2015/12/impact-of-expected-credit-loss-approaches-on-bank-risk-disclosures/).



## Box 2. Selected EDTF Recommendations That Are Relevant for Credit Risk and NPLs

### **General:**

- 1: Present all related risk information together in any particular report. Where this is not practicable, provide an index or an aid to navigation to help users locate risk disclosures within the bank's reports.
- 2: Define the bank's risk terminology and risk measures and present key parameter values used.
- 3: Describe and discuss top and emerging risks, incorporating relevant information in the bank's external reports on a timely basis. This should include quantitative disclosures, if possible, and a discussion of any changes in those risk exposures during the reporting period.

### **Risk Governance and Risk Management Strategies/Business Models:**

- 5: Summarize prominently the bank's risk management organization, processes and key functions.
- 6: Provide a description of the bank's risk culture, and how procedures and strategies are applied to support the culture.
- 7: Describe the key risks that arise from the bank's business models and activities, the bank's risk appetite in the context of its business models, and how the bank manages such risks. This is to enable users to understand how business activities are reflected in the bank's risk measures and how those risk measures relate to line items in the balance sheet and income statement.

### **Credit Risk:**

- 26: Provide information that facilitates users' understanding of the bank's credit risk profile, including any significant credit risk concentrations. This should include a quantitative summary of aggregate credit risk exposures that reconciles to the balance sheet, including detailed tables for both retail and corporate portfolios that segments them by relevant factors. The disclosure should also incorporate credit risk likely to arise from off-balance sheet commitments by type.
- 27: Describe the policies for identifying impaired or nonperforming loans, including how the bank defines impaired or nonperforming, restructured, and returned-to-performing (cured) loans as well as explanations of loan forbearance policies.
- 28: Provide a reconciliation of the opening and closing balances of nonperforming or impaired loans in the period and the allowance for loan losses. Disclosures should include an explanation of the effects of loan acquisitions on ratio trends, and qualitative and quantitative information about restructured loans.

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Source: EDTF Report, October 2012.

**4. The EDTF recommended that a gradual and phased approach during the transition period would be most useful to users to give them clearer insights as implementation progresses into the likely impacts of the new ECL standards and to allow users to make increasingly useful comparisons between banks.** The initial focus should be on qualitative disclosures but quantitative disclosures – including the impact of ECL approaches—should be added as soon as they can be practicably determined and are reliable but, at the latest, in 2017 annual reports for banks following IFRS. For example, the EDTF recommends banks following IFRS should provide:

- **qualitative disclosures** about general ECL concepts, differences from the current approach, and implementation strategy starting with 2015 and 2016 annual reports;
- **qualitative disclosures** about detailed principles, governance organization, and capital planning impact starting with 2016 annual reports; and
- **disclosure of quantitative assessments** of the impact of adoption of the ECL approach starting when practicable and reliable, but at the latest in 2017 annual reports.

**5. In addition, the EDTF recommended that the granularity of disclosures should improve each year during this transition period.** When IFRS 9 becomes effective in 2018 or when adopted if earlier, banks would provide the required IFRS 9 ECL disclosures.