



WORLD BANK GROUP
Finance, Competitiveness & Innovation

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Regulatory and supervisory policies and expectations in times of COVID-19 and how to exit the loan forbearance measures

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Agenda

1. **Introduction**
2. International initiatives for regulatory harmonization
3. The impact of COVID-19-related borrower relief measures on asset classification, forbearance, and provisioning
4. Supervisory and regulatory priorities in times of COVID-19

Introduction

Why is the regulatory and supervisory context so important?

Reliable, up-to-date and economically meaningful information on exposures to problem assets is critical

- ✓ Policymakers should be able to **understand the magnitude of the problem** and to **articulate a well-informed NPL resolution strategy**
- ✓ Ascertain whether **banks are provisioning appropriately for credit losses**
- ✓ Evaluate **banks' true financial condition**
- ✓ **Undertake** appropriate **supervisory action** vis-à-vis banks with a **high or increasing NPL exposure**

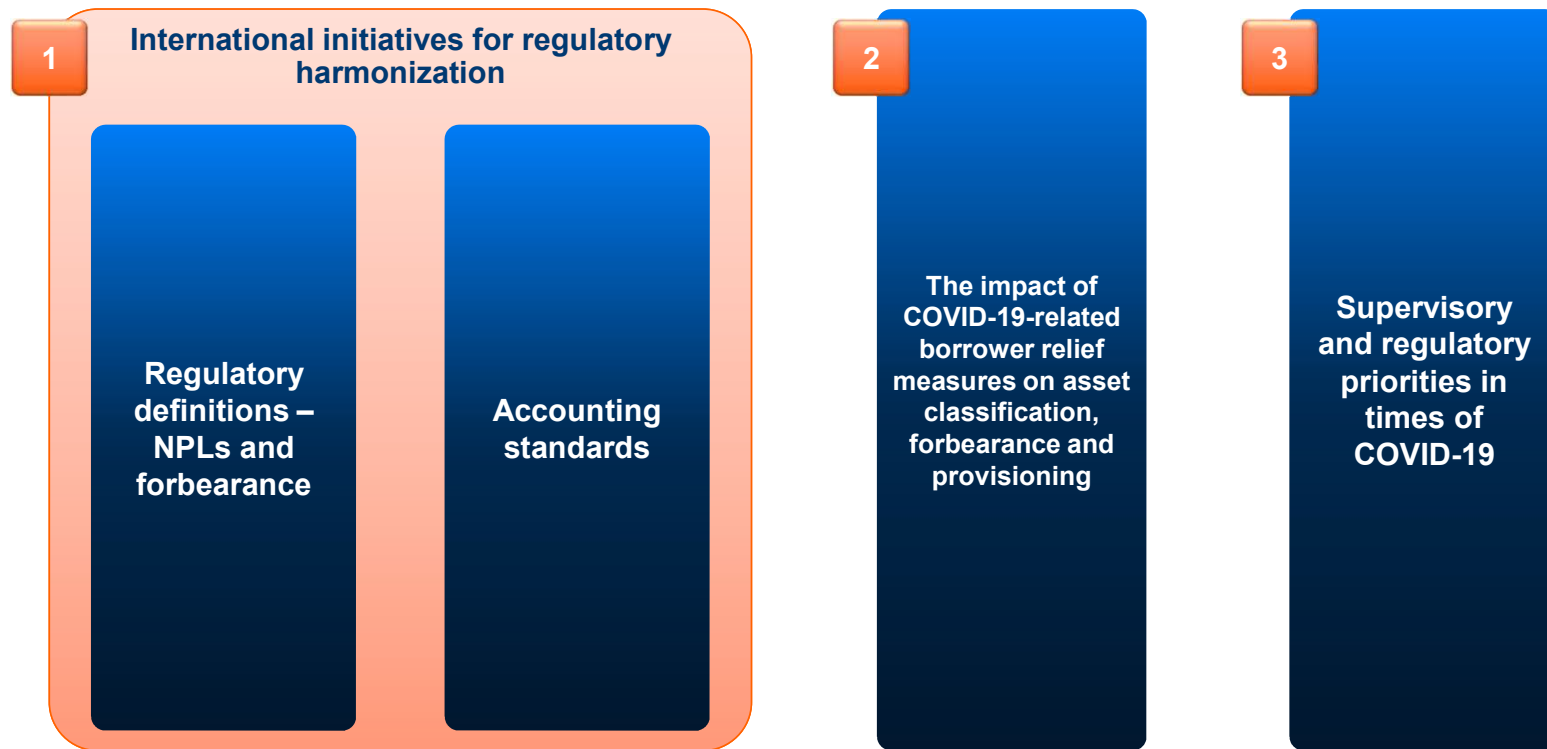
Consequences of weak regulatory definitions and lack of effective supervisory enforcement

- The existence of a significant mass of **uncaptured credit risk**, leads **banks' provisions for credit losses to fall short** of what is needed given their true exposure to problem assets
- This **resulting provisioning gap** inflates banks' capital and **impedes the timely identification and remediation of problem banks**
- **After GFC some countries made a great progress** against these weaknesses; in others **less work has been done** in the improvement of credit risk supervision

- Weaknesses in regulatory definitions and a lack of effective supervisory enforcement can cause **reported NPL ratios to become detached from economic realities**
- A mass of unrecognized problem assets, and the resulting shortfall in loan loss provisions inflates banks' capital, obfuscates their true financial position and impedes the timely identification and remediation of problem banks

Introduction

Overview



Agenda

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- 2. International initiatives for regulatory harmonization**
3. The impact of COVID-19-related borrower relief measures on asset classification, forbearance, and provisioning
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International initiatives for regulatory harmonization

NPL and forbearance regulatory definitions harmonization (pre-COVID-19)

- The GFC exposed **heterogeneity with respect to regulatory definitions of NPLs**, hindering comparisons of NPL ratios across jurisdictions.
- Standard setters stepped up their efforts to harmonize key definitions for **NPLs and for forborne exposures**.
- **BCBS** 2017 definitions.
- In recent years many countries have adopted these **harmonized regulatory definitions of NPLs and forborne exposures**.

Non-Performing Exposures

- **90 days past due** hard backstop (quantitative threshold).
- **Unlikelihood to pay** – UTP (qualitative criteria): regardless of the number of DPD⁽¹⁾, there is evidence that full repayment of principal and interest is unlikely without realization of collateral.
- Banks are also expected to **regularly assess the creditworthiness and repayment capacity** of their customers to identify whether UTP indicators are present.
- **Pulling effect** for corporate borrowers with multiple loans.-
- **Broader range of problem assets not just loans** (e.g., debt securities).
- **No influence of** (the value of) **collateral** in categorizing an exposure as non-performing.

Forbearance

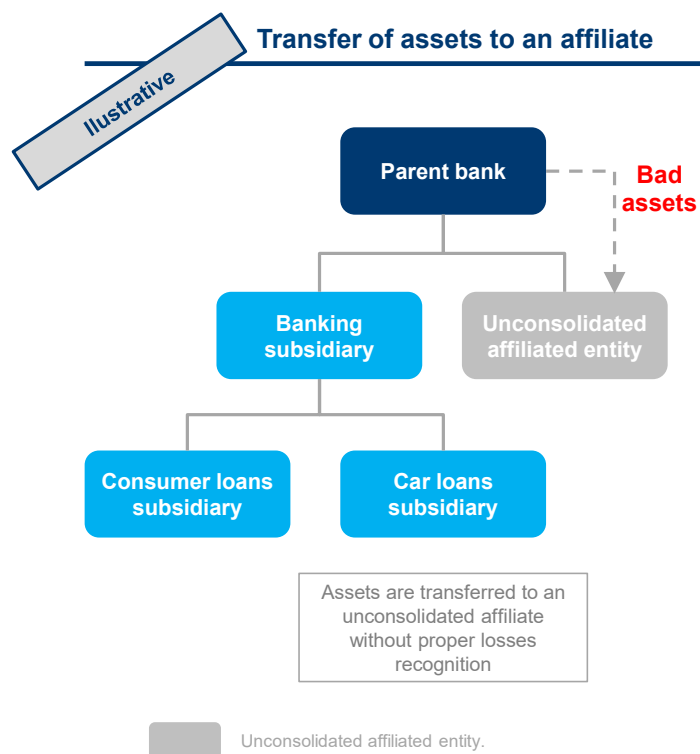
- **Financial difficulties of the borrower prompt the lender to make concessions** (irrespective whether a loan is past due):
 - ✓ Extending maturities; changes in the schedule of payments; granting of grace periods; changes in interest rates; reduction of the actual amount to be paid; etc.
 - ✓ Other: granting additional loans; lowering collateral requirements; release of collaterals; converting debt to equity; forgiving, deferring, or postponing principal and interest; etc.
- Can be included in **both the performing** (when concessions are being offered before financial difficulties occur) **or non-performing category**.
- Should not be used to merely postpone the recognition of inevitable losses (*Extend-and-Pretend*)
- **A solid repayment track record** is required before a previously non-performing forborne exposure can be upgraded

International initiatives for regulatory harmonization

3

Effective supervisory enforcement in times of increasing stress on banks' asset quality: asset transfers

Banks may also attempt to brush up reported asset quality by moving problem assets to affiliated entities, often in a highly untransparent manner to escape supervisory scrutiny



Supervisory challenges

- **Consolidated and cross border supervision** are particularly important in curbing regulatory arbitrage.
- A full understanding of the:
 - Group's business(es)
 - Main shareholders
 - Economic interests
 - Intercompany transactions
- Are **key tools** to **assess the potential** shifting of deteriorated assets in an attempt to **avoid provisioning or increased risk-weights**.

International initiatives for regulatory harmonization

An overview of IFRS 9 credit impairment

- Under IFRS 9 banks are required to **monitor changes in credit risk over the life of their loans** and **compare this to the credit risk at initial recognition** to determine the amount of provisions recognized.

Change in credit risk since initial recognition			
	Stage 1 – <i>Performing</i>	Stage 2 – <i>Underperforming</i>	Stage 3 – <i>Non-performing</i>
Recognition of expected credit losses	12-month ECL (PD 12m/LGD)	<i>Lifetime ECL</i> (PD <i>lifetime</i> /LGD)	<i>Lifetime ECL</i> (PD <i>lifetime</i> /LGD)
Interest revenue	Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortized cost carrying amount (that is, net of credit allowance)

- The **shift towards forward-looking assessments** of credit risk over the life cycle of a loan **can result in potentially significant increases in provisions**, particularly when **the economic outlook deteriorates drastically within a short period of time**.
- On the other hand, the requirement that banks already make some provisions for performing loans can help in **weathering credit shocks**.

International initiatives for regulatory harmonization

Challenges in countries on implementing IFRS 9

The implementation of IFRS 9 has presented financial sector regulators with considerable challenges

Although the importance of an early recognition of credit losses is widely recognized among financial sector regulators, IFRS 9 requires **significant enhancements** in:

- **Supervisory processes**
- **Procedures**
- (On occasion) **risk management** to pave the way for a proper implementation

- **Particular challenges** have emerged **around models and analytical tools** that banks have introduced for the assessment of credit risks.
- The underlying concern is **the so-called model risk, associated with excessive reliance on models** that (except for a few specialized insiders) **are not fully understood**, and for which regulators have understandable concerns that may not fully reflect economic realities.
- Regulators often lack of the necessary quantitative skills to challenge these models and this is a particular concern for foreign banks where the host country subsidiary or branch staff does not always have the expertise.

Banking regulators often maintain regulatory provisioning requirements in parallel to IFRS 9 accounting requirements

International Initiatives for regulatory harmonization

Jurisdiction	Implementation date 1 Jan	IFRS 9 for all	IFRS 9 for subgroup
Cambodia	2019		X
China	2018		X
Indonesia	2020	X	
Lao PDR	2022		
Mongolia	30 June 2022		X
Samoa	2019	X	
Singapore	2018	X	
Solomon Islands	30/9/2018	X	
Korea, Rep	2018		X
Thailand	2020	X	
Timor Leste	To be decided		X

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Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

Overview of unprecedented borrower relief measures

Focused on providing temporary debt service relief for borrowers affected by the COVID-19 pandemic by allowing suspension or postponement of payments for a specified period of time

Commonly used instrument

- **Payment moratoria** are the most commonly used instrument, but with many differences in overall design, scope and duration.

Payment moratoria⁽¹⁾ = “a suspension of all principal and interest payments for a predetermined period. While the moratorium is in force, banks are prohibited from charging penalties and fees on loans to which the moratorium applies.”

- Rescheduling and restructuring:
 - Temporarily reduced payments.
 - Temporary switch to interest-only payments.



- Extended maturities.
- Capitalization of deferred payments.

Limiting the effect on borrowers' debts in NPV terms

- Payment moratoria are generally NPV-neutral
- To fully **neutralize the effect of the deferment of debt service obligations on NPVs**:

$$\sum \text{additional future payments} \geq \sum \text{deferred debt service obligations}$$

- to account for the time value of money

These schemes have been introduced globally albeit with important variations in terms of overall design and coercion

Impact of COVID-19 borrower relief measures on asset classification, forbearance, and provisioning

a. Guidance from international standard-setting bodies: implications for loan loss classification and provisioning

- **BCBS has issued guidance on the prudential treatment of moratoria** and other temporary borrower relief measures.
- The starting point is that **policymakers should use the flexibility embedded in existing frameworks** and **leave existing regulatory definitions intact**.

Non-Performing Exposures and forbearance



- Payment delays are based on a modified schedule of payments, i.e. **taking into consideration the rearranged debt obligations** after factoring in the specific borrower relief measures.
- **Days past due effectively freeze while a moratorium is in place** (while debt obligations are temporarily suspended, the borrower does not fall further into arrears).
- **UTP criterion: based on** bank's assessment whether the borrower is **unlikely to repay the rescheduled payments**.
 - **Participation in a moratorium does not imply that the borrower should automatically be considered UTP criterion.**
 - But banks should still apply the UTP criteria **to borrowers whose short-term payment challenges** are likely to transpose into **long-term financial difficulties**.
- No requirement that loans subject to a moratorium be considered as forborne provided

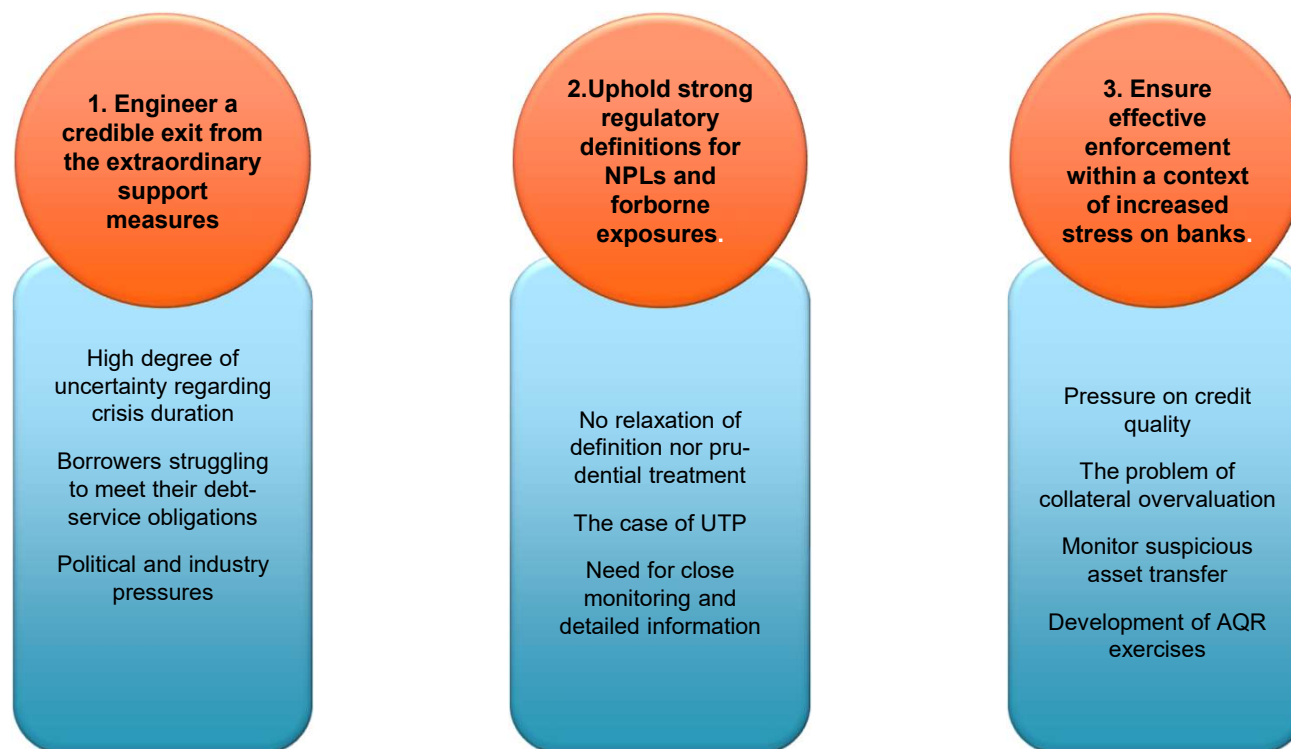
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Supervisory and regulatory priorities in times of COVID-19

Introduction to priorities

Policymakers will be facing several challenges in the near to medium term, that shows the following priorities



Supervisory and regulatory priorities in times of COVID-19

Exiting from extraordinary borrower relief measures

1

Pressures to extend borrower relief measures

- **Uncertain outlook:** there is still a high degree of uncertainty regarding the duration and the economic recovery trajectory.
- **Political and industry pressures to perpetuate measures:** as many borrowers continue to struggle to meet their debt-service obligations.
- **Banking capital situation:** concerns about the prospect of moving a sizable share of assets into the non-performing category and the corresponding surge in provisioning charges.

Necessity to unwind borrower relief measures

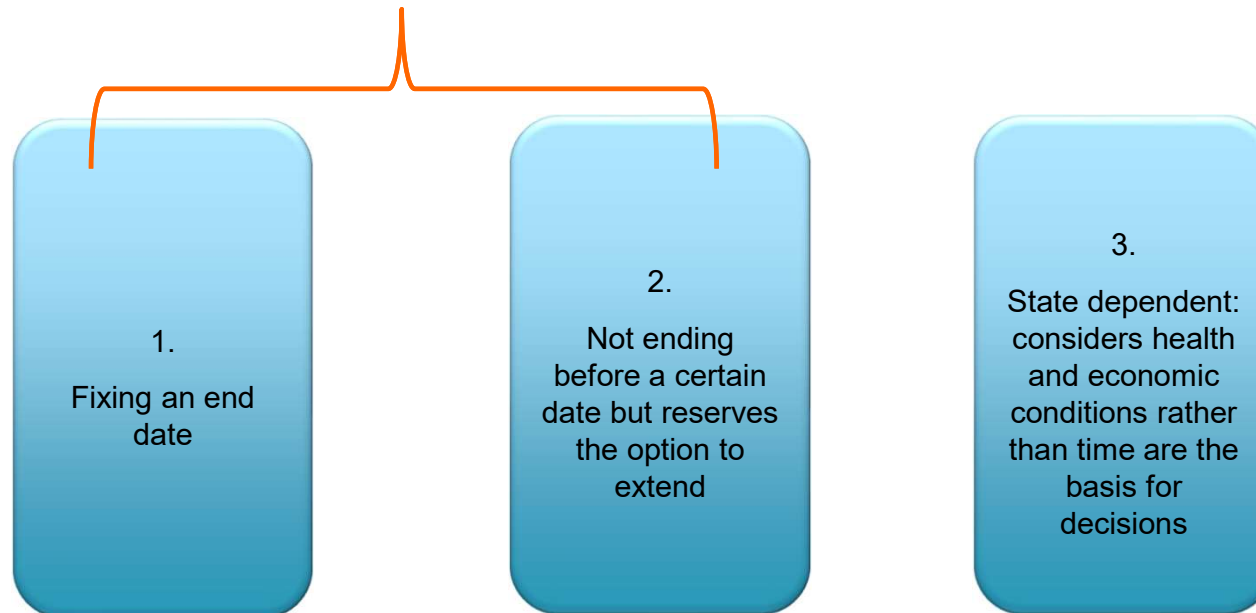
- The **prolongation** of borrower relief measures is also associated with costs:
 - The **extension** of measures may can be associated with a **negative impact on banks' liquidity**, as they translate into a potentially significant reduction on cash flows.
 - **Moratoria is the new normal:** difficulties in reversing to the status quo pre-COVID-19, and **exacerbating moral hazard**.
 - **Misallocation of capital:** **zombie borrowers** will exert considerable **pressure to benefit from the borrower relief measures**. This can **lock up the credit stock in underperforming economic sectors** and crowd out the financing needs of more dynamic borrowers.



As a consequence, while originally conceived as a short-term instrument to provide temporary support for liquidity-distressed borrowers, borrower relief measures have been extended in many countries

Three main approaches to withdrawing measures

Risk of repeated extensions



Supervisory and regulatory priorities in times of COVID-19

Exiting from extraordinary borrower relief measures: how and when?

1



The general principle should be to unwind borrower relief as soon as circumstances permit



Instead of phasing out borrower relief measures altogether when reaching the closing date, measures can also be wound down in a more gradual manner

1	Make the support progressively less generous	<ul style="list-style-type: none">➤ Policy makers can increase costs of the guarantee schemes or lower the proportion guaranteed
2	Impose more stringent requirements	<ul style="list-style-type: none">➤ Policymakers can usefully introduce more stringent requirements regarding the financial viability of the borrowers, and require that the borrowers' financial difficulties can be credibly attributed to the pandemic➤ Exclude zombie borrowers by requiring a pre-COVID-19 sufficiently strong payment track record to those benefitting from borrower relief measures
3	Assessment of the debtor's viability	<ul style="list-style-type: none">➤ Policymakers can also usefully introduce a requirement for corporate borrowers that banks conduct an assessment of the debtor's viability in order to be eligible for borrower support measures
4	Targeting	<ul style="list-style-type: none">➤ Policymakers may also opt to exclude certain industries that are manifestly facing difficulties that go beyond short-term liquidity needs (e.g. hospitality, transportation), and whose financial difficulties are best addressed with proper long-term loan restructuring measures
5	Sequencing of support measures	<ul style="list-style-type: none">➤ Operational relief measures have generally been allowed to expire before borrower relief measures

Supervisory and regulatory priorities in times of COVID-19

Exiting from extraordinary borrower relief measures: the impacts on banks

1

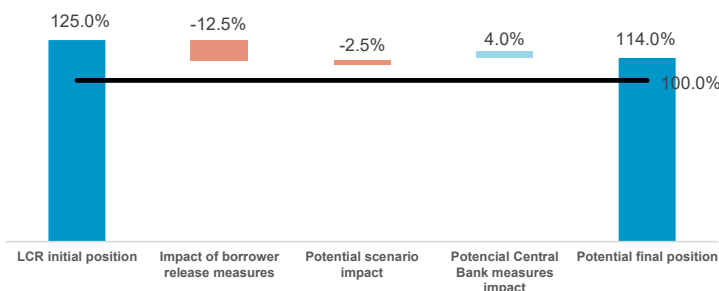
- Decisions about the **extension or phasing out** of borrower relief measures **need also to consider the financial impact on banks**.
- An **extension** implies that banks must forego regular debt service payments on a potentially significant part of their loan portfolio, which **may impact their liquidity**.
- **But phasing out** the measures will likely lead to an **increase in total NPL volumes and provisioning charges**, which will **affect capital**.
- It is therefore critical that **decisions are informed by assessments of the likely financial impact on banks**.

Countries that entered the pandemic with weaknesses in the banking system face a delicate balancing act and need to take great care to avoid jeopardizing safety and soundness in the banking sector

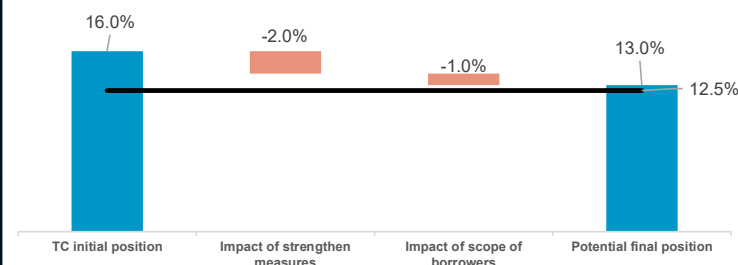
Illustrative

The expected financial impact needs to be compared with banks' financial shock-absorbing capacity (minimum requirements)

Extension
-
Impact on banks' liquidity positions
(sector-wide analysis)



Phase out
-
Impact on banks' capital positions
(sector-wide analysis)



The phasing out of borrower relief measures may require that weak banks replenish capital, so that they have the capital space necessary to fully recognize credit losses

Supervisory and regulatory priorities in times of COVID-19

2

Upholding strong regulatory definitions for NPLs and forborne exposures

It is important that the hard-earned gains are preserved and that pressures to dilute regulatory definitions are resisted

- Over the past years, many countries have undertaken a considerable effort to **align regulatory definitions of NPLs and forborne exposures BCBS standards**, to ensure that **standard metrics of asset quality and capital strength are economically meaningful**
- Although the **work is far from finished**, the use of these definitions by banks and supervisors is **critical for monitoring and assessing banks' asset quality in a consistent manner**, both within and across jurisdictions, as well as to **facilitate timely action to address rising asset quality problems**.

Different treatment has been observed across definitions:

- By and large, the **90 dpd hard backstop** for classifying exposures as non-performing has been upheld in most countries **but some countries have extended the number of dpd** ✓

- In a bid to **promote restructuring of problem exposures**, certain countries have **relaxed the definition and prudential treatment of forborne exposures**. ✗
- In this manner, the mandatory **cure period is effectively abolished**, and **banks are allowed to roll back any provisions**.

This is problematic if borrowers' debt-servicing capacity fails to improve after restructuring, which is a considerable risk given the indications that banks are not vigorously applying the UTP criterion

- The abolishment of the cure period may also inadvertently **disincentivize banks from dealing resolutely with unviable borrowers**, by widening the scope for engaging in **extend-and-pretend practices** merely delaying the recognition of inevitable credit losses.
- This can lead to the emergence of **uncaptured credit risk, under-provisioning, and overstated capital**, obfuscating the comparability of asset quality indicators across banks.

Supervisory and regulatory priorities in times of COVID-19

Upholding strong regulatory definitions for NPLs and forbore exposures: the case of UTP

2

Unlikelihood to pay (UTP) criterion

Non-accrued
status

Specific credit
risk adjustments
(SCRA)

Sale of the credit
obligation

Distressed
restructuring

Bankruptcy

Other indications
of UTP

- **Absent proper UTP assessments:** banks will defer the recognition and provisioning of problematic exposures **until actual payment delays occur**.
- The **stability of reported NPL ratios** may point to challenges in the **operationalization of the UTP criterion** that predate the COVID-19 pandemic.
- Nonetheless, a **rigorous application of the UTP criterion is critical for a proactive identification of non-performing exposures**, considering that payment holidays have been offered to borrowers across the board, regardless of long-term repayment capacity.
- While there is an unusually **high degree of uncertainty** under the current circumstances, it is vital that banks make **continuous efforts to identify those borrowers whose difficulties** are likely to transpire into longer term repayment difficulties, in line with the spirit of the UTP criterion.

Proper enforcement of the UTP criterion is necessary for proactive identification of likely payment difficulties and to ensure that unviable borrowers are pushed towards an orderly exit

Supervisory and regulatory priorities in times of COVID-19

Upholding strong regulatory definitions for NPLs and forbore exposures: close monitoring and detailed information

2

A proper evaluation of asset quality requires close monitoring and detailed information regarding loans that have benefitted from borrower relief measures

It is essential that **banks produce reliable, frequent, up-to-date and detailed information** on loans that benefit from **borrower relief measures** and their impact on balance sheets:

1. Banks should be required to **tag loans that have benefitted from borrower relief measures, perform periodic assessments, and report a set of standard indicators for assessing the credit risk of such loans** (e.g., collateral and repayment behavior).
2. Periodic reporting to **policymakers should be required to assess whether the measures are having the desired effect, and to banking supervisory agencies to be able to closely monitor the impact on banks' asset quality, capital, and overall financial standing, is also important.**

Balance between specificity and simplicity needs to be achieved, aimed at avoiding unnecessary administrative burdens on banks.

Illustrative

Form COV-RM
Report on restructured loans and loans under moratorium in accordance with interim measures
EUR 000

No.	POSITION	Total number of debtors	Number of sub-accounts	Amount
1.	RESTRUCTURED LOANS			
1.1.	Natural persons			
1.2.	Entrepreneurs			
1.3.	SME up to EUR 100 thousand			
1.4.	SME over EUR 100 thousand			
1.5.	Other business undertakings			
2.	RESTRUCTURED CASH UNSECURED LOANS			
2.1.	Natural persons			
3.	MORATORIUM			
3.1.	Natural persons			
3.2.	Entrepreneurs			
3.3.	SME up to EUR 100 thousand			
3.4.	SME over EUR 100 thousand			
3.5.	Other business undertakings			

Note:

Loans shown under #1 do not include loans shown under #2.

Supervisory and regulatory priorities in times of COVID-19

Effective supervisory enforcement in times of increasing stress on banks' asset quality: overview

3

Sources of main pressures

- Renewed **pressures on banks' asset quality** as a consequence of the economic situation.
- Pressures on the operational **independence of prudential regulators**.
- **Extend-and-pretend banking practices**, aimed at evading classification and provisioning requirements.
- Banks' efforts to **delay the recognition of inevitable losses**.
- **Collateral** maintained at **inflated prices**.
- Moving **problem assets to affiliated entities**.



Main actions to be followed by supervisors

- **Thematic examinations** and in-depth **on-site inspections** focused on credit risk.
- Scrutinize banks on the **operationalization of the UTP criterion**.
- Challenge banks on the quality and depth of **debtor affordability assessments** that underpin **loan restructurings**.
- **Targeted market-wide reviews** over collateral, **random sample** checks, or through **special assessments** conducted by **external firms**.
- Monitoring of **intercompany transactions**.
- **Robust regulation** and **adequate reporting**.

Given the increasing incentives that banks (the especially weaker ones) face to perform a wide range of questionable activities, strong supervision is necessary to effectively challenge banks on these practices

Supervisory and regulatory priorities in times of COVID-19

3

Effective supervisory enforcement in times of increasing stress on banks' asset quality: pressure on credit quality

As pressure on banks' asset quality increases, banks are increasingly incentivized to step up efforts to disguise the true extent of their difficulties

Pressure on banks' credit quality

- Full recognition of credit losses may cause their **capital to fall below regulatory requirements**, triggering:
 - ✓ **Enhanced regulatory scrutiny.**
 - ✓ **Supervisory restrictions** (e.g. on the payout of dividends and executive bonuses and launch of new products and business lines).
 - ✓ **Reputational risks.**
 - ✓ Adverse impact on the **costs and availability of funding and capital.**

Extend-and-pretend practices

- Faced with rising borrower distress, banks may resort to evergreening to avoid the recognition and provisioning for credit losses in their portfolio.
- Some **red flags**:
 - ✓ **Preemptive rescheduling of problem loans** (i.e., restructuring before loans become past due).
 - ✓ Absent or perfunctory **assessments of borrowers viability.**
 - ✓ **Bullet loans.**

Main efforts from supervisors

- **Credit risk tops the list of supervisory priorities in 2021.**
- Supervisory **work programs** will likely shift towards **thematic examinations** and in-depth **on-site inspections** focused on credit risk.
- Pressing banks on their **operational readiness to manage rising volumes of bad assets.**
- Despite difficulties due to current uncertain outlook:
 - ✓ **Scrutinize banks** on the **operationalization of the UTP criterion.**
 - ✓ **Challenge banks** on the **quality and depth of debtor affordability assessments** that underpin loan restructurings.
 - ✓ **Require banks** to proactively **address cases** where borrowers are manifestly non-viable.

This pressure may be compounded by political and industry pressures on the operational independence of prudential regulators



Work done in Vietnam – Banking Soundness and Development

Selected deliverables

- Three reports on the legal obstacles for a successful implementation of the debt trading market
- Note and presentation on developing a comprehensive, coordinated approach to creating a market for NPLs
- Legal mapping on debts and on performing loans resolution in Vietnam
- Legal review on bank loans trading and non performing loan resolution in Vietnam
- Two country case studies on debt market development experience in Korea and China
- Technical Note on securitization covering legal structures, prudential regulation, financial stability and consumer protection including country case studies on Singapore, Italy and Korea.
- Provided comments on MOF Business Valuation standards
- Business viability assessment workshop including developing syllabus, hiring trainer, and review of all materials to ensure responsiveness to VAMC's needs



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Thank you!