

Accounting for Impaired Assets in Bank Credit Analysis

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Accounting for impaired assets not only differs markedly from country to country, it also offers substantial scope for management judgment. The accounting method prescribed and the judgment exercised in following that method has a profound impact on bank balance sheets and income statements. Although not new, accounting for impaired assets probably remains the biggest accounting-related issue in the credit analysis of a bank. Whether triggered by systemic crises or by poor lending practices specific to a single bank, poor asset quality is the most common fundamental cause of bank failure, although a liquidity crisis when depositors or lenders begin to suspect the poor asset quality typically is the proximate cause. Thus, the credit analyst must understand accounting for impaired assets and attempt to adjust for differences in order to make more meaningful comparisons between banks, particularly banks in different countries. For rating purposes, Standard & Poor's will make these adjustments and generally opt for the more conservative accounting techniques, given the dangers of underestimating the extent of (or underreserving for) impaired assets.

The following major issues must be considered in accounting for impaired assets:

- What is the definition of an impaired asset?
- To what extent is interest accrued on impaired assets?
- What is the policy for providing or reserving against losses on impaired assets?
- What is the policy for finally writing off impaired assets?

Even the terminology of impaired assets differs from system to system. In some countries, both a contra-asset account used to reduce the accounting value of the loan portfolio and the income statement item used to create it are called "loan loss reserves" (or something similar). In other countries, both items are called "provisions." To distinguish between the two in its publications, Standard & Poor's calls the balance sheet item a "reserve" and the income statement item a "provision." Thus, in Standard & Poor's terminology, a provision creates a reserve. When the loan is ultimately judged to be uncollectable, it is either "written off" directly against the income statement or "charged off" by reducing a previously created reserve (although this may also be called a "write-off"). "Write-backs" refer to the reversal of a reserve no longer considered necessary, and "recoveries" refer to the recuperation of all or part of a previously written-off loan.

Types of Impaired Assets

Impaired assets can include loans, loan-related assets such as foreclosed properties, securities, off-balance-sheet assets such as guarantees receivable, or in-the-money derivatives. Additionally, there can be off-balance-sheet commitments that require provisioning, such as guarantees provided or LOCs payable, where the primary obligor is expected to default, and commitments to lend to problem borrowers. Securitized assets on which the bank still bears the risk are also off balance sheet.

In a number of cases, banks suffering from large amounts of problem loans have "sold" them to special purpose companies, sometimes called "bad banks," designed to remove the problem loan portfolios from the bank's balance sheets and liquidate them. On a few occasions, these companies have been set up by individual banks; more frequently, they have been set up by governments following a systemic crisis. In most cases, these special purpose companies have been funded by the banks, which also bear all or most of the risk of eventual losses. Standard & Poor's puts the assets sold to these companies back on a bank's balance sheet for the purpose of analyzing the amount of a bank's impaired assets and the adequacy of its reserves.

The loan portfolio is typically a bank's largest asset category; it is also the category most likely to suffer impairment. For this reason, knowing the definition of nonperforming loans (NPLs) is the key first step in analyzing asset quality. In the U.S., the definition of nonaccrual loans is standardized as loans that are maintained on a cash basis because of deterioration in the borrower's financial condition, where payment in full of principal or interest is not expected and where principal and interest have been in default for 90 days, unless the asset is both well-secured and in the process of collection. Restructured loans (loans restructured for credit reasons at a below-market interest rate) and "other real estate owned" (OREO, or properties obtained through or in lieu of foreclosure) must also be disclosed and are considered nonperforming.

In other countries, the definition can vary considerably. Nonperforming consumer loans and residential mortgage loans are typically identified by aging, but the past-due period necessary for the loan to be considered nonperforming can vary from as short as 30 days to as long as 180 days. Some countries and banks define delinquency on a contractual basis, and others define it on a recency of payments basis. If delinquency is defined on a recency basis, sometimes only full payments are counted, and sometimes partial payments are sufficient to show the loan as performing. In some countries, there can be different standards for mortgage and other consumer installment loans, with the mortgage loans being put in nonperforming categories only after longer periods.

In terms of corporate loans, in most countries management judgment is the most important factor in deciding whether a loan is classified as nonperforming or not. For certain types of loans, such as overdraft loans, which are very common in some countries such as the U.K., management judgment is actually the only possible standard for determining if the loan is performing or not, since there are no specific maturities as long as the borrower is within its credit limit. Deciding just how liberal or conservative management is in making that judgment is one of the most difficult parts of the analysis and is generally possible only after extensive discussions.

The Basel Committee on Banking Supervision proposed a "reference definition" of a default to be used by banks that plan to use the "internal ratings-based approach" to the proposed new capital standards. Under the proposed definition, "a default is considered to have occurred with regard to a particular obligor when one or more of the following events has taken place:

- The obligor is unlikely to pay its debt obligations (principal, interest, or fees) in full;
- A credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision, or distressed restructuring involving the forgiveness or postponement of principal, interest, or fees;
- The obligor is past due more than 90 days on any credit obligation; or
- The obligor has filed for bankruptcy or similar protection from creditors."

If widely adopted, this definition would lead to greater standardization between countries, but it still relies heavily on management judgment.

There are also differences as to whether a particular loan is considered nonperforming only when it goes into arrears, or if all loans to that legal entity are treated as nonperforming. The most conservative method is to consider all loans to the defaulting entity and loans to closely related entities as nonperforming. In some countries, only that portion of a loan that is actually past due is considered nonperforming. In a few countries, the latter condition is the rule for mortgage loans, but the entire balance of other loans is considered nonperforming.

In addition, restructured loans may or may not be separately disclosed depending on the country. In many countries, the figures for restructured loans will not be disclosed, and loans may be reclassified from nonperforming to performing as soon as they are restructured. In other countries, they will be reclassified to performing only after they have met the new terms for a specified period.

Foreclosed properties are only grouped with NPLs in a few countries, as they are in the U.S. In most countries, they will not be considered in management discussions of nonperforming asset (NPA) trends. However, they frequently are available as a separate category on the balance sheet or else are disclosed in the footnotes.

Although the analysis of impaired assets is focused on the loan portfolio (and the real estate portfolio, to the extent that it represents foreclosed assets), impaired assets can also be present in the securities portfolio, including:

- Debt securities either purchased as investments or as loan-equivalents, which have defaulted; and
- Debt and equity securities received in exchange for loans as part of reorganizations or debt restructurings, or as foreclosed collateral.

Equity securities purchased as investments that declined sharply in value might also be considered impaired, but would be looked at separately rather than combined with NPAs.

For analytical purposes, Standard & Poor's believes a broad definition of NPAs is appropriate. According to that definition, NPAs should include:

- The full amount of all loans 90 days or more past due, and any other loans to the same legal entity;
- The full amount of all loans to an entity whose creditworthiness is believed to be impaired to the point where collection is doubtful, which would typically include any closely related entities of borrowers that were nonperforming;
- All loans restructured at nonmarket rates of interest, even if they are performing according to the new terms;
- All foreclosed properties, and properties received in lieu of foreclosure;
- Impaired securities as described above; and
- Impaired off-balance-sheet assets, including loans sold to problem asset disposition companies where there is recourse back to the bank, and nonperforming securitized assets where the bank retains the risk.

To the extent possible, Standard & Poor's will adjust total NPAs to conform to this broad definition. If this is not possible, Standard & Poor's will make

qualitative distinctions to recognize the difference in definitions.

Policies on Accrual of Interest

Policies related to the accrual of interest on NPAs also differ substantially from country to country. The cleanest method is that which is used currently in most countries, where interest is not accrued on NPLs. Even there, there are differences as to whether interest previously accrued but not received is reversed or capitalized. In addition, the treatment of cash interest received is a matter of management judgment: typically, it would flow into interest income if the bank believed it would likely recoup its principal, but if this were in doubt, it would be used instead to reduce the principal balance on the bank's books.

In other countries, interest continues to accrue but is fully provisioned. On a bottom-line basis, this provides the same results as the first policy: net NPAs and net income are the same as they would be under the nonaccrual method. However, a number of line items will differ: gross NPAs, reserves on the balance sheet, gross and net interest income, and loan loss provisions charged to the income statement will all be higher than they would be at banks that use the nonaccrual method. Comparisons between banks in different countries using the two methods will have to be adjusted to take this into account.

From a credit analyst's viewpoint, the most pernicious policy is the methodology of ceasing to accrue interest or provide for it only in those cases where management believes that collateral on the loan will be insufficient for it to recover the interest. This is consistent with "mark-to-market" accounting (which will be covered more generally in a separate article that will be forthcoming from Standard & Poor's). This methodology suffers from the following disadvantages:

- It relies more heavily on valuations of collateral.
- Even if collateral valuations are theoretically correct, a bank may have great difficulty realizing these values.
- The costs of workout and recovery can be very high.
- Unless detailed information is provided on how much interest is accrued on NPLs, comparisons with banks using more conservative accounting methods will be impossible.

All of these issues concerning accrual of interest apply to restructured loans and nonperforming debt securities as well as to identified NPLs. This is particularly true in restructurings that involve grace periods or extremely low payments in early years, postponing the day of reckoning where the borrower's true ability to repay will be tested.

Unfortunately, it is generally impossible to actually adjust for differences in accrual policies where provisioning for interest is not done fully. However, in many cases the balance sheet asset of accrued interest receivable is available. If this figure grows significantly more rapidly than that of earning assets (taking into account interest rate fluctuations) or the liability item of accrued interest payable, it can be an indication of aggressive accounting.

Policies on Loan Loss Reserves

Loan loss reserving policies also differ substantially from country to country, and can vary to a greater or lesser extent among banks within a country. The most conservative policy is to fully write off or reserve for any identified problem loans, as well as to establish general reserves for potential future loan losses that have not yet been identified as problems.

In the U.S. the emphasis has been on writing off problem loans, while in most other countries the emphasis has been on reserving. The policy itself is much less important than the adequacy of the amount. Comparison between NPLs in systems emphasizing charge-offs and NPLs in systems emphasizing reserving needs must be made net of reserves, however.

The following factors must be considered in terms of reserves and provisioning:

- Are necessary reserves determined based solely on the number of days past due, on regulatory or internal loan classification, or (for the larger loans) on loan-by-loan estimates of loss?
- To what extent is collateral taken into account in determining necessary reserves, how is its value calculated, and are related costs fully taken into account?
- How does the percentage coverage of NPLs by reserves compare to regulatory minimums, historical figures, and that of the bank's peers?
- Have reserves been constituted for other impaired assets, such as securities, and for off-balance-sheet items such as guarantees of debt of problem clients or commitments to lend to them, and are both the income-statement and balance sheet figures disclosed?
- In addition to (or instead of, if the bank charges off rapidly) "specific" reserves covering individual problem loans, are there "general" reserves? If so, how are they calculated?
- Are there also "country risk reserves"?
- How does the tax treatment of the provisions affect the adequacy of the reserves?
- Are loan loss provisions shown only as net, or are both gross new provisions and write-backs disclosed?

Generally, reserves that are determined based on loan-by-loan analysis for corporate loans are preferable to those that are determined based on some mechanical method, assuming they are conservatively estimated. Unfortunately, it is also more difficult to judge how conservative such reserves are, although detailed discussions with management can help. From a credit rating viewpoint, the ideal is probably a situation in which the reserve on a given loan is the larger of (a) a minimum based on the number of days past due, or (b) the necessary amount estimated through detailed analysis.

For consumer and residential mortgage loans, typically the reserve amount will be determined through a formula either based on the aging of the portfolio or on the bank's experience with the particular type of loan.

Similarly, from a credit rating viewpoint, one needs to be very skeptical of taking collateral into account in determining the adequacy of reserves. There are difficulties in valuing the collateral, with banks often using valuations assuming "normal" markets when they are in the midst of a recession with markets falling sharply. There can be legal and other difficulties in foreclosing, and these difficulties intensify in bad economic times. Even if banks eventually can foreclose, substantial costs may be involved that may not have been fully taken into account in the valuations. Finally, in a bad market, even if the bank can foreclose, it may be difficult to sell the collateral.

Provisions taken against foreclosed assets, impaired securities, off-balance-sheet items, and the like also must be aggregated with the loan loss provisions in order to judge the bank's credit track record. These provisions frequently are included in securities losses or other expenses, and they may or may not be disclosed in the footnotes.

Write-backs of provisions are generally (but not always) disclosed separately for banks that emphasize specific reserves. Sometimes necessary reserves are added up and then compared to those of the previous period, with the difference being the loan loss provision, so there are no gross and write-back figures available. The more robust method calls for looking at each loan individually, recording new and increased reserves separately from decreased reserves. The total of the new reserves and the increases to the reserves is the gross new provision, and the total of the decreases in reserves is the write-back figure. These separate figures are usually disclosed in the footnotes. The loan loss provision shown on the income statement is normally the net figure, although it is sometimes the gross figure, with write-backs included in other income. Ideally, specific and general provisions are disclosed separately. When the information is available, Standard & Poor's use net new provisions as the expense item, but it will analyze the separate components to help evaluate the conservatism of a bank's reserving policies.

Charge-Off Policies

Charge-off policies are subject to most of the same considerations as reserving policies. This is true at banks such as those in the U.S., which are more likely to charge off quickly than they are to create a specific reserve. In most countries, however, the issue of when and how much of a loan is actually charged off is much less important. In these countries, loans are not charged off until:

- The borrower has completely gone through the bankruptcy process, or the bank is nearly certain it will not recover anything for other reasons;
- A time period prescribed by regulation has elapsed;
- The tax authorities allow them to; or
- Some combination of the above.

Even in these cases, however, the analyst must be aware of the charge-off procedures to make more meaningful comparisons of bank loan loss records: if charge-offs are quick, NPAs will tend to be low compared to where charge-offs take longer. Loan loss reserves also tend to be lower at banks where charge-offs are quicker; if not, it is probably a sign of more conservative accounting.

Tax Treatment of Impaired Assets

Finally, there is the question of tax treatment. In some countries, banks account for the tax benefits of a loan loss when the provision is made, even though the loss cannot be taken for tax purposes until the charge-off is made. Where there is a big delay between the two and loan loss provisions are increasing more rapidly than charge-offs, banks can build up large deferred tax assets, which can amount to a substantial proportion of reported equity. This was the case for both the Japanese and the Mexican banks in the 1990s. Analysts had to question when or even whether the banks would actually be able to realize these future tax benefits, taking into account both the difficulties in getting charge-offs accepted by tax authorities and whether profits would be sufficient to use the tax benefits, even if the charge-offs were allowed.

On the other hand, if provisions or certain types of provisions are not deductible for tax purposes, and the bank does not immediately account for the deferred tax benefit, the bank will be able to realize and account for these benefits in the future. Thus, reserves created without booking the tax benefits can cover more than their face value of loan losses, if the future charge-off is tax deductible and the bank has taxable income at the time the charge-off is made.

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