Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions[1]

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As a follow-up study to the author's previous paper on "Nonperforming Loans in CESEE – What Do They Comprise?", the present contribution focuses on the definitions of nonperforming loans (NPLs) in a number of Western European nations – Austria, Finland, France, Germany, Ireland, Italy, Portugal, Spain and the United Kingdom. Supervisors or at least general practice in the majority of Western European countries seem to endorse the rule that for a loan to be nonperforming, at least one of two (primary) elements has to be present: (1) principal or interest 90 days or more overdue, and (2) existence of underlying well-defined weaknesses of loan or borrower. However, there are also other (secondary) elements that have an impact on NPL measurement and the comparability of definitions: the question whether a restructured loan is classified as NPL or not, whether the presence of a collateral or guarantee influences loan classification or not, whether the full outstanding value or only part of a loan is reported as nonperforming, and whether a bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired or not. While these elements may introduce upward or downward biases into some nations' NPL definitions and ratios, and these would need to be further investigated, the above-outlined NPL rule appears to constitute a feasible yardstick for most of the countries mentioned above. Moreover, this definition is also in line with a draft EU ruling for a Capital Requirements Regulation (CRR).

JEL classification: G12, G21, G32, G33
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1 Introduction

After stocktaking and comparing credit quality classifications and nonperforming loan (NPL) definitions in Central, Eastern and Southeastern Europe (CESEE) in a previous paper (Barisitz, 2011), the current study briefly describes the respective classifications and definitions used in the Western part of the EU in order to have a broad European picture of how credit qualities tend to be ranked and what is typically regarded as an NPL. This would seem timely in a situation where Europe is coping with financial instability, banking sector weaknesses and a debt crisis. The economic stagnation or slow growth that many European countries are currently facing is not at all conducive to reining in crisis-triggered elevated NPL levels. In order to better capture what these bad loans actually stand for, to develop meaningful benchmarks, therefore to make NPL indicators easier to compare from country to country, and consequently to make it easier for policymakers to interpret comparative data and draw conclusions, it appears helpful to look at

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national NPL definitions in some detail. In this sense, increased international data transparency can be a necessary ingredient to effective policy. As yet, there is no EU- or euro area-wide definition of NPLs. However, this gap will probably soon be closed, a circumstance which will be referred to in more detail below in section 2.

This paper deals with nine selected Western EU Member States for which sufficient relevant information is available and which are perceived to be broadly representative of Western Europe: Austria, Finland, France, Germany, Ireland, Italy, Portugal, Spain and the United Kingdom. The selection appears relatively balanced because it comprises countries often considered as "euro area core countries" (Austria, Finland, France, Germany) as well as others considered as "euro area periphery countries" (Ireland, Portugal, Spain) plus Italy plus the largest EU member outside the euro area (the U.K.).[3] One could also regard the whole sample as including five "large" (France, Germany, Italy, Spain, the U.K.) and four "small" (Austria, Finland, Ireland, Portugal) countries.

Section 2 first describes and compares loan classifications and official (as far as they exist) NPL definitions used in the selected countries. Based on this comparative description, we then aim to derive an analytical NPL definition which should be as comparable as possible across all analyzed countries (and, of course, need not be identical with existing official definitions). Some elements of NPL comparability in CESEE are added in a succinct overview. Section 3 provides a quick glance at available NPL data for Western European countries from international sources (IMF Financial Stability Indicators, ECB Consolidated Banking Data). Respective findings with regard to the aimed-for analytical NPL definition are explained in section 4, which also summarizes the study and draws some conclusions.

2 Overview of Regulatory NPL Definitions in Selected Western European Countries

2.1 NPL Content and Thresholds

Internationally, NPL definitions often refer to three elements (see Barisitz, 2011, p. 46): (1) "principal or interest 90 days or more overdue" (or "90 days+", based on the IMF Financial Soundness Indicators Compilation Guide), (2) the presence of underlying "well-defined weaknesses" of either the loan or the borrower (commonly used, e.g. in the loan classification scheme of the Institute for International Finance (IIF))[4], and (3) the frequently applied credit quality categories[5] (also proposed by the IIF), the weakest three of which ("substandard – doubtful – loss/write-off") typically correspond to NPLs.

Interestingly, while most of the ten CESEE countries analyzed in the previous study work with the above-mentioned credit quality categories, more than half of

[3] *NPLs tend to be relatively higher in the more crisis-prone periphery countries than in the core countries (see charts 1 and 2, even if data are not strictly comparable across charts and countries, which is why this study is being undertaken).*

[4] *A "well-defined weakness" would typically correspond to a bank's assessment that the borrower's economic or financial standing has seriously deteriorated, which could even happen before the expiry of the "three months overdue" period. This could i.a. include the debtor's insolvency and/or bankruptcy, the introduction of bankruptcy proceedings or the debtor's seeking of restructuring measures within this timeframe. Thus it is judged improbable that the borrower will fulfil his or her obligation without the bank resorting to the liquidation of available collateral.*

[5] *The entire range is: standard – watch/special mention – substandard – doubtful – loss/write-off.*

the nine Western European nations the present study focuses on do not provide prescriptive classification categories. Only Austria, Italy and Spain apply such gradings.[6] The risk categories applied in Austria are called "standard," "watch/ special mention," "nonperforming" and "loss." Given that the "nonperforming" category includes "loans whose repayment… appears partly or fully jeopardized" (see table 1), the last two categories can be regarded as impaired. Italy features "performing loans," "substandard loans," "past due/overdrawn more than 90 days," "bad loans" and "restructured exposures." The Banca d'Italia views loans under the last four of these credit quality categories (from "substandard" to "restructured exposure") as NPLs. However, substandard loans in Italy are defined as "loans to customers that are in temporary difficulties that can be expected to be cleared up in a reasonable time" (IMF Monetary and Financial Systems Department, 2004, p. 24; IMF, Coordinated Compilation Exercise for Financial Soundness Indicators, Metadata Questionnaire Italy, 2006, subsection E3.1). This does not appear to qualify as a "well-defined" or "serious weakness" (in the commonly used sense mentioned above). Therefore, the corresponding official NPL definition would seem relatively strict in an international comparison. Spain distinguishes "standard," "substandard," "doubtful due to customer arrears," "doubtful for reasons other than customer arrears," and "write-off" loans. According to the Banco de España, the last three categories comprise NPLs; this appears to be in line with the two NPL elements mentioned above ("90 days+" and "well-defined weakness"), since the category "doubtful due to customer arrears" refers to arrears of more than three months and the category "doubtful for reasons other than customer arrears" relates to reasonable doubts about full repayment on contractual terms. France subdivides NPLs in "créances douteuses" and "créances irrécupérables," but does not provide other categories.

As table 1 shows, the existence of "well-defined weaknesses" is a salient feature of NPLs in all but two (Finland, the U.K.) of the Western European countries under observation. In Portugal, the well-defined weaknesses refer only to the bankruptcy or liquidation of the debtor. The NPL requirement of 90 days+ is present (at least as a generally accepted practice) in all Western European countries. Two countries (Finland, the U.K.) limit themselves to a sole 90 days+ rule, not supplemented by any other NPL criterion.

Therefore, supervisors or at least general practice in the majority of the countries under observation appear to endorse the rule that for a loan to be nonperforming, at least one of two elements has to be present: (1) principal or interest 90 days or more overdue, (2) existence of underlying well-defined weaknesses of either the loan or the borrower.[7] This rule means that either of these two elements is a sufficient criterion to classify a loan as nonperforming.

The second element can certainly not be seized with the same precision as the first and therefore leaves some room for interpretation and is probably even associated with some fuzziness. This may be one of the reasons why the Financial Soundness Indicators (FSIs) Compilation Guide (IMF, 2006), particularly in its updated version of November 2007, focused solely on the criterion of 90 days+ (Barisitz,

[6] *Many of the following remarks are illustrated or explained in more detail in table 1, which also provides detailed information on the respective sources.*

[7] *This also goes for the great majority of CESEE countries analyzed in Barisitz (2011).*

2011, pp. 47–48). On the other hand, the reality and ubiquity of the Western European (and the CESEE) authorities' use of the criterion of well-defined weaknesses is such that – at least in the case of European countries – we feel this criterion cannot be ignored. This understanding also corresponds to the definition of default by the Basel Committee on Banking Supervision (2004)[8] and is consistent with the IIF's credit quality classification. As explained above, within the range of its credit quality categories, Spain seems to illustrate well the two salient characteristics of NPLs in its two intermediary grades.

In line with overall international practice (according to the IIF), most of the countries analyzed classify restructured or replacement loans as impaired, at least in the first months after restructuring; in Austria, Germany and the U.K., however, classification depends on banks' practices (see table 1).

Again in line with international practice, the countries analyzed (with the – partial – exception of Portugal) do not take into account collateral or guarantees in classifying loans.

On the question of whether the full value (or only overdue installments or another amount) of an NPL should be recorded as nonperforming, the clear majority of countries opt for recording the full value, which is in line with common practice. However, there is the notable exception of Portugal, and qualifications have to be made for Austria, Germany and the U.K.

Finally, on the issue whether a bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired, a majority can be found against downgrading (except for Finland and Ireland, which are in favor; Portugal and Spain have downgrade requirements which are, however, weaker than such rules usually are), thus adhering to the "NPL product view" as opposed to the "NPL customer view."[9]

[8] *See Basel Committee on Banking Supervision (2004), paragraph 452:*
"Definition of default
A default is considered to have occurred with regard to a particular obligor when either or both of the following events have taken place:
- *The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held).*
- *The obligor is past due more than 90 days on any material credit obligation to the banking group."*

[9] *What we describe as "downgrade requirement" thus corresponds to the "NPL customer view," whereas our "lack of downgrade requirement" equals the "NPL product view."*

Table 1

Outline of Features of National NPL Definitions

Country	Source	Essential features of NPLs (at least one of the following two features should be present): Principal or interest payments 90 days overdue (90 days+)	Essential features of NPLs: Well-defined weak-nesses of borrower or loan	Categories of credit quality classification (customary categories according to the IIF: standard – watch – substandard – doubtful – loss; last three: NPL)	Classifi-cation of restruc-tured/re-placement loans	Existence of col-lateral/ guarantees considered in de-termining classifi-cation of loan	Full out-standing value of loan recor-ded as NPL (or only overdue install-ments or amount estimated as non-recover-able)	Downgrade require-ment (a bank is required to downgrade all loans to a given debtor if any of the-se loans are classified as impaired)
Austria	**OeNB:** Ausweisrichtlinie zur Meldung der Anlage zum Prüfungsbericht (AP), based on Regulation No. 298 of the Austrian Financial Market Authority (September 15, 2010); **Coordinated Compilation Exercise (CCE) for Financial Soundness Indicators (FSIs):** Answers to Austria's Metadata Question-naire (January 2007); **IMF Financial Soundness Indicators (IMF FSIs):** Austria Metadata Tables (2011 Quarterly)	Yes (general-ly accepted practice)	Yes (repay-ment of interest or principal appears partly or fully jeopar-dized)	Risk categories: standard – watch/special mention – nonperforming (loans whose repayment of interest or principal appears partly or fully jeopardized) – loss (credit loss has become a certainty); *author's suggestion: the last two categories should define NPLs*	Depends on banks' practice	No	Outstanding net value of loan (after deduction of cumulative value adjust-ments)	No
Finland	**Finanssivalvonta – Finansinspektionen – Financial Supervisory Authority:** Standard RA 4.6 – Reporting of non-performing and zero-interest assets (February 2011); **CCE FSIs:** Answers to Finland's Metadata Question-naire (April 2007); **IMF FSIs:** Finland Metadata Tables (2007 Annual)	Yes	–	No prescriptive classifica-tion categories (impairment loss measured as difference between loan's carrying amount and present value of loan's estimated future cash flow)	Classification as impaired; reclas-sification as performing upon court decision (until debtor again becomes delinquent on repay-ment of principal or interest for period of 90 days)	–	Yes	Yes
France	**CCE FSIs:** Answers to France's Metadata Questionnaire (January 2007); **IMF FSIs:** France Metadata Tables (2008 Annual)	Yes	Yes (objec-tive evidence of impair-ment of loan)	No prescriptive classification categories, except for NPLs, which according to the Auto-rité de contrôle prudentiel of the Banque de France consist of "créances douteuses" (claims that present a probable, but not certain, risk of default on a loan) and "créances irrécupérables" (claims that are definitely lost)	Usually classification as impaired (yet each bank is responsible for its own credit risk assessment)	No	Yes	No

Source: Author's compilation from various sources.

Note: With the exception of footnotes and source, text in italics indicates author's suggestions or comments. "–" indicates that no information could be found on this particular issue.

Table 1 continued

Outline of Features of National NPL Definitions

Country	Source	Essential features of NPLs[1]		Categories of credit quality classification[2]	Classification of restructured/replacement loans	Existence of collateral/guarantees considered in determining classification of loan	Full outstanding value of loan recorded as NPL[3]	Downgrade requirement[4]
		Principal or interest payments 90 days overdue (90 days+)	Well-defined weaknesses of borrower or loan					
Germany	**Bundesanstalt für Finanzdienstleistungsaufsicht:** Verordnung über die Prüfung der Jahresabschlüsse der Kreditinstitute und Finanzdienstleistungsinstitute sowie die darüber zu erstellenden Berichte (Prüfungsberichtsverordnung November 2009); **IMF FSIs:** Germany Metadata Tables (2011 Quarterly)	Yes	Yes (the bank deems it improbable that debtors will fulfill their credit obligations without the bank resorting to the liquidation of available collateral)	No prescriptive classification categories	Depends on banks' practice	No	Full outstanding value of loan as well as net value of loan (after deduction of value adjustments) recorded as nonperforming	No
Ireland	**CCE FSIs:** Answers to Ireland's Metadata Questionnaire (February 2007); **IMF FSIs:** Ireland Metadata Tables (2010 Quarterly)	Yes	Yes (payment in full of principal or interest is not expected even if less than 90 days overdue)	No prescriptive classification categories	Classified as nonperforming	No	Yes	No
Italy	**IMF Monetary and Financial Systems Department:** Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision – Italy, April 2004; **CCE FSIs:** Answers to Italy's Metadata Questionnaire (August 2006); **IMF FSIs:** Italy Metadata Tables (2008 Annual)	Yes	Yes (borrower insolvent, even when insolvency is not ascertained by court; or borrower in temporary difficulties that can be expected to be cleared up in a reasonable time; *however, whether this second indication corresponds to a well-defined weakness seems doubtful*	Categories: performing – substandard loans (loans to customers in temporary difficulties that can be expected to be cleared up in a reasonable time) – past due/overdrawn more than 90 days – bad loans (loans to insolvent customers, even when insolvency is not ascertained by court) – restructured exposures (loan for which a bank, upon granting a moratorium on repayment, renegotiates the loan at lower-than-market interest rates); *while, according to Banca d'Italia, the last four (including restructured loans) qualify as NPLs, for purposes of international comparison one could opt for the last three since substandard loans would not appear to correspond to a well-defined weakness of the borrower or loan considering their official definition (temporary nature of difficulties, expectation that they will be cleared up, etc.)*	Classified as nonperforming	No	Yes	Yes

Source: Author's compilation from various sources.

[1] *At least one of the two features quoted should be present.*
[2] *Customary categories according to the IIF: standard – watch – substandard – doubtful – loss; last three: NPL.*
[3] *Or only overdue installments or amount estimated as nonrecoverable.*
[4] *A bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired.*

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		Principal or interest payments 90 days overdue (90 days+)	Well-defined weaknesses of borrower or loan					
Portugal	**CCE FSIs:** Answers to Portugal's Metadata Questionnaire (March 2006); **IMF FSIs:** Portugal Metadata Tables (2008 Quarterly)	Yes	Yes, partly (bankruptcy or liquidation of the debtor)	No prescriptive classification categories	Classified as nonperforming; (in order to change status to performing: at least interest payments fallen due should have been cleared; moreover, the overall value of payments in arrears and respective interest represent less than 25% of outstanding capital plus interest fallen due)	Yes (while the mere existence of a collateral or guarantee does not prevent the classification of an impaired loan as nonperforming, the strengthening of existing collateral can contribute to the upgrading of the loan quality)	No; amount recorded as nonperforming reflects installments overdue for more than 90 days plus, if applicable, an amount considered to be of doubtful recovery[5]	A credit institution is required to classify as doubtful debts all loans granted to the same client only if the overall value of payments in arrears and respective interest represents at least 25% of outstanding capital plus interest fallen due

[5] *An amount is considered to be of doubtful recovery when the interest and capital arrears exceed 25% of outstanding capital plus interest fallen due or payments are overdue for more than 6, 12 or 24 months for operations with an initial maturity of respectively less than 5, 5 to 10 or more than 10 years or payments fall due of all credit granted to an individual client, where the overall value of payment in arrears and respective interest represents at least 25% of outstanding capital plus interest fallen due.*

Source: Author's compilation from various sources.

[1] *At least one of the two features quoted should be present.*
[2] *Customary categories according to the IIF: standard – watch – substandard – doubtful – loss; last three: NPL.*
[3] *Or only overdue installments or amount estimated as nonrecoverable.*
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		Principal or interest payments 90 days overdue (90 days+)	Well-defined weaknesses of borrower or loan					
Spain	**Banco de España:** Circular 4/2004 (CBE 4/2004) Anejo IX, modificado para Circular 2/2012: Entidades de credito: Normas de informacion financiera publica, y reservada, y modelos de estados financieros; **IMF FSIs:** Spain Metadata Tables (2010 Annual)	Yes	Yes (reasonable doubts about full repayment of loan; or loans classified as doubtful due to country risk)	Categories: standard – substandard – doubtful due to customer arrears (of more than three months) – doubtful for reasons other than customer arrears (reasonable doubts about full repayment on contractual terms) – write-off (possibility of recovery is remote); according to Banco de España, the last three qualify as NPLs	Classified as nonperforming (unless at least the current interest receivable – disregarding interest for late payment – is paid and unless new effective guarantees or collateral are provided or there is reasonable certainty that the customer can make payment on schedule)	Generally not	Yes	A creditor is required to downgrade all loans to a common debtor if the loans classified as impaired or doubtful due to arrears exceed 25% of all the outstanding loans to that debtor
United Kingdom	Information provided by the **Bank of England; IMF FSIs:** United Kingdom Metadata Tables (2008 Quarterly)	Yes (while no standardized definition, generally accepted principle)	–	No prescriptive classification categories	Depends on banks' internal policy	No	Yes (after deduction of specific provisions)	No (depends on the individual loan characteristics)

Source: Author's compilation from various sources.

[1] At least one of the two features quoted should be present.
[2] Customary categories according to the IIF: standard – watch – substandard – doubtful – loss; last three: NPL.
[3] Or only overdue installments or amount estimated as nonrecoverable.
[4] A bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired.

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Outline of Features of National NPL Definitions

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		Principal or interest payments 90 days overdue (90 days+)	Well-defined weaknesses of borrower or loan					
Memorandum item								
Institute for International Finance (IIF)	**IMF:** Financial Soundness Indicators Compilation Guide (March 2006), Appendix VI	Yes	Yes (loan shows well-defined weaknesses that could lead to loss if not corrected; collection or liquidation of loan in full is determined by bank management to be improbable due to current conditions)	Standard – watch/special mention – substandard – doubtful – loss/write-off (last three: NPL)	Replacement loans/ restructured loans are those for which the lender grants concessions that would not otherwise be granted because of the debtor's financial difficulty. Restructured loans are often treated identically with impaired assets until a record of payment is established, after which they can be upgraded	Overall international practice: Most jurisdictions do not consider the condition of collateral or guarantees in classifying loans; moreover, declines in the value of collateral or guarantees are predominantly not taken into account as a basis for classifying loan as impaired	Yes	–

Source: Author's compilation from various sources.

[1] *At least one of the two features quoted should be present.*
[2] *Customary categories according to the IIF: standard – watch – substandard – doubtful – loss; last three: NPL.*
[3] *Or only overdue installments or amount estimated as nonrecoverable.*
[4] *A bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired.*

Note: With the exception of footnotes and source, text in italics indicates author's suggestions or comments. "–" indicates that no information could be found on this particular issue.

2.2 Elements of NPL Comparability

2.2.1 Primary Elements

As regards consideration of the two primary elements found essential for the definition of NPLs – (1) 90 days+, (2) well-defined weaknesses[10] – the majority of definitions or practical understanding of NPLs appear comparable across the countries under observation. This goes for Austria, France, Germany, Ireland, Portugal (with qualification, see below) and Spain (see table 2). These countries' general practice appears to endorse the rule that for a loan to be nonperforming, at least one of the above two primary elements has to be present.

Finland's and the U.K.'s pure 90 days+ rule is probably somewhat less strict than qualifying for either (1) or (2) or both as it does not capture the possibility of a loan not yet 90 days overdue but witnessing a serious weakness. As mentioned above, the Banca d'Italia's official view that NPLs also include loans to customers in temporary difficulties that can be expected to be cleared up in a reasonable time (called substandard loans) would appear stricter than the above-outlined commonly endorsed definition; this is because the latter requires a weakness to be well-defined or serious, in some cases even referring to a borrower's insolvency. Portugal's definition of an impaired loan (90 days+ and/or bankruptcy or liquidation of the borrower) is stricter than Finland's, but less strict than the common definition, since a Portuguese debtor faced with a well-defined weakness but not

Table 2

Qualitative Assessment of the International Comparability of National NPL Definitions

Country	Primary elements of NPL definition and ratio (90 days+, well-defined weakness)	Secondary elements that influence NPL ratio (classification of replacement loans, role of collateral in grading credit quality, part of loan recorded as NPL, existence of downgrade requirement)	Resulting overall assessment of NPL definition and ratio in light of international comparability[1]
Austria	No bias (comparable)	Downward bias	Slight downward bias
Finland	Downward bias	Upward bias	Possibly no bias
France	No bias (comparable)	No bias (comparable)	No bias (comparable)
Germany	No bias (comparable)	Downward bias	Slight downward bias
Ireland	No bias (comparable)	No bias (comparable)	No bias (comparable)
Italy	Upward bias	Upward bias	Upward bias
Portugal	Slight downward bias	Downward bias	Downward bias
Spain	No bias (comparable)	No bias (comparable)	No bias (comparable)
United Kingdom	Downward bias	Downward bias	Downward bias

Source: Author's assessment and compilation.

[1] *A downward (upward) bias of the NPL definition and ratio compared to widespread practice would imply the need for an upward (downward) correction of data to enhance their international comparability. Since this is a definitional, not a data-based study, the bias unfortunately cannot be quantified. Therefore, in qualitative terms, a slight downward bias e.g. for primary elements of a country's NPL definition (like that of Portugal) is found to be a bias that is clearly weaker than the downward bias previously identified for the respective NPL definition of another country (like Finland), as explained in the text. A slight downward bias can also arise as a result of the aggregation of a lack of bias for primary elements of a country's NPL definition and of a downward bias for its secondary elements (like for Austria or Germany).*

Note: Shades of blue indicate degree of bias (ranging from white = upward to dark blue = downward).

[10] *See the first two columns of table 1.*

yet bankrupt nor 90 days in delay with payments would still be performing according to domestic regulations, but not so according the internationally widespread view. At this stage, possible suggested corrections cannot be quantified because the present study is a purely definitional one.

2.2.2 Secondary Elements

Some other important elements do not constitute immediate defining components of NPLs and could therefore be called secondary elements. They may, however, have an upward or downward impact on individual countries' NPL definition and data[11]: The way restructured credits or replacement loans are classified – as NPLs or as performing loans – can influence the overall NPL ratio, particularly in times of crisis, when the share of replacement loans tends to rise. Or if the existence of a collateral or guarantee is taken into account in the grading of a loan in the sense that the quality of a loan deemed to be saddled with serious weaknesses is upgraded to "performing" thanks to the presence of a high-value or liquid collateral, this can of course impact the impaired credit ratio. The same goes more generally for the issue of what is actually recorded as an NPL: the full outstanding value of the loan or just the sum of overdue installments or an amount gauged by the credit institution to be nonrecoverable (which could only be a fraction of the full amount). If NPLs are measured as the latter, resulting ratios of NPLs to total loans can be substantially lower than they would be if full outstanding values were entered. Finally, whether a bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired (downgrade requirement for multiple loans, or NPL customer view) or not (NPL product view) can also make a nonnegligible difference.

Considering international approaches to the classification of assets described in the IMF's FSIs Compilation Guide (2006) and the IIF's suggested credit quality classification as well as average European practice, in the following we try to arrive at some comparability benchmarks for the secondary elements mentioned above. Country-specific practices can then be assessed against these benchmarks, which may reveal upward or downward biases with respect to comparability for countries in question.

Treatment of restructured or replacement loans: According to the FSIs Compilation Guide (IMF, 2006, p. 259), "payments on restructured loans (…) are often treated identically with impaired assets (…) until a record of payment is established, after which they can be upgraded." Moreover, in the majority of analyzed countries, restructured loans are classified as NPLs (at least for an initial period of a couple of months), which can thus serve as a benchmark.

Consideration of collateral or guarantee when measuring loan quality: As the FSIs Compilation Guide (IMF, 2006, p. 258) points out, "there is some prevalence of the practice not to consider declines in the value of loan collateral or guarantees as a basis for classifying the loan as impaired," which gives "weight to the view that the quality of a loan should be judged in its own right independent of collateral and guarantees." This provides a clear benchmark, which is moreover supported by practice in almost all the countries analyzed.

[11] *These elements are described in the four right-hand columns of table 1.*

Total loan or only part of loan recorded as nonperforming: A clear majority of countries analyzed appears to support the view that "the amount of loans (and other assets) recorded as nonperforming should be the gross value of the loan as recorded on the balance sheet, not just the amount that is overdue" (IMF, 2006, p. 46).

Existence of downgrade requirement for multiple loans: On the issue whether to downgrade all loans to a common debtor if any of these loans are classified as impaired (NPL customer view versus NPL product view), neither the FSIs Compilation Guide nor the IIF's credit quality classification seem to take a clear stand. Most countries under observation do not apply the downgrade requirement. They thus practice the NPL product view. Therefore, to judge comparability with respect to this issue we choose the less demanding benchmark, namely the nonexistence of a downgrade requirement.[12]

Proceeding from these comparative benchmarks, which are in line with the predominant practices in the region (replacement loans treated as NPLs at least for initial period, collateral not considered when judging loan quality, total gross value of loan recorded as nonperforming, no downgrade requirement for multiple loans), some of the countries analyzed may feature upward or downward biases of NPL ratios worth mentioning (see tables 1 and 2).

In Austria replacement loans are not generally or categorically classified as NPLs, but according to banks' practice; and it is not the full outstanding value of the loan that is recorded as nonperforming, but the net value (after deduction of cumulative value adjustments). Regarding the other secondary elements, Austria hits the benchmark. This would point in the direction of a downward bias of secondary elements that influence Austria's NPL ratio, which, combined with the lack of bias of primary elements, implies that Austrian NPL data would have to be slightly corrected upward to be internationally comparable to most of the countries analyzed in this study. As mentioned earlier, as Finland's NPL definition does not include well-defined weaknesses, the primary elements for Finland may be biased downward; but the country applies the downgrade requirement for multiple loans (i.e. it adheres to the NPL customer view), which according to our chosen standard would influence the NPL ratio in the opposite sense. Downward and upward pressures may (possibly) cancel each other out in Finland's case.

Whereas France occupies a relatively balanced position regarding primary as well as secondary elements of NPL definition and data, Germany's NPL ratio, on account of secondary elements, not unlike Austria's, would appear somewhat downward biased, implying that Germany's NPL data might need to be (somewhat) corrected upward to be internationally comparable. Yet differences between Germany and France may not be very large either. Ireland's NPL definition overall appears comparable to that of France and quite balanced (as tables 1 and 2 depict).

As mentioned earlier, Italy's NPL definition regarding primary elements appears relatively strict by international comparison. And if one adds the fact that Italy applies the downgrade requirement (to multiple loans), the upward bias of the country's NPL ratio is reinforced. Therefore, based on the available information, in Italy's case it would appear strongly recommendable to exclude "substandard

[12] *From a general supervisory viewpoint it would of course be preferable to apply the stricter NPL customer view (downgrade requirement) as a benchmark.*

loans" (defined as loans to customers in temporary difficulties) from the NPL definition to facilitate comparability across borders and to avoid providing possibly too high indications of Italian NPL ratios in international comparisons.

The downward bias of Portugal's NPL definition and ratio is not only due to its primary elements (as explained above), but also to other factors, among them an interesting peculiarity of the country's recording of NPLs: According to the Banco de Portugal, in contrast to the authorities of almost all other analyzed countries, an NPL is not measured at its full outstanding value, but at the sum of installments overdue for more than three months plus, if applicable, an amount assessed to be of doubtful recovery (see table 1). For international comparability, therefore, an upward adjustment of Portugal's NPL ratio would very likely be needed.

While Spain, somewhat along the lines of France, features a rather balanced overall position, the U.K.'s NPL definition and ratio would seem to be biased downward, given its sole 90 days+ rule, supplemented by two rather generously formulated secondary elements (classification of replacement loans according to banks' internal policy, NPL recorded net of specific provisions).

2.2.3 Elements of NPL Comparability in CESEE: A Succinct Overview

As described in Barisitz (2011), the great majority of NPL definitions of CESEE countries analyzed (Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Russian Federation, Serbia, Slovakia and Ukraine) feature both of the above-mentioned primary elements (90 days+, well-defined weaknesses). As regards secondary elements of NPL comparability in CESEE (that have not yet been discussed): Like in Western Europe, a majority of analyzed CESEE countries tend to classify restructured or replacement loans as impaired. They quasi-unanimously favor recording the full value of an NPL as nonperforming. However, in contrast to the practice of the majority of analyzed Western European countries, the majority of CESEE countries, under some conditions, do allow for the (change of) value of collateral or guarantee to impact loan classification. Moreover, also at variance with the typical approach in the Western part of the continent, yet in line with a conservative supervisory stance, a clear CESEE majority comes out in favor of downgrading all loans to a given debtor if any of these loans are classified as impaired (NPL customer view).[13]

2.2.4 EU-Wide Definition of NPLs in the Making

Therefore, we can conclude that the general NPL rule (90 days+ and/or serious weaknesses) we hoped could serve as a common yardstick and basis for further refining international and European comparisons has broadly fulfilled our expectations. What's more, this definition is not only in line with the Basel Committee of Banking Supervision's definition of default, but it also essentially corresponds to the respective definition of default contained in the European Commission's proposal for a Capital Requirements Regulation (CRR), a draft EU Council and

[13] *The author suggests to deal with these secondary elements of NPL comparability for CESEE countries as well as with implications of the above Western European findings for the respective assessment of comparable NPL concepts in CESEE in more detail in a brief future study.*

Parliamentary regulation.[14] Apart from only minor modifications, the Council (Ecofin) maintained this definition in its CRR proposal submitted to the European Parliament in May 2012.[15] It may be expected that an EU-wide definition of NPLs will enter into force along these lines in the next couple of years and thus become applicable across EU member countries.[16] The relevant article in the CRR proposal includes a provision for the European Banking Authority's (EBA) guidelines on its application. This provides an opportunity to achieve an EU standard also for the secondary elements of NPLs, and thus for refining the definition of NPLs. Whether these guidelines will be sufficiently detailed to assure a better comparability of data and how much national scope for interpretation will actually be retained remains to be seen.

3 NPL Developments in Selected Western European Countries

Two prominent sources for international or European NPL data are the IMF Financial Soundness Indicators (FSIs)[17] and ECB Consolidated Banking Data (CBD[18]). Both sources provide general NPL definitions: IMF FSI data would ideally correspond to the recommendation given in the FSIs Compilation Guide, which focuses on the criterion of "principal or interest payments 90 days overdue" (IMF, 2007, p. 6; see also Barisitz, 2011, pp. 47–48). ECB CBD define loans as "doubtful and nonperforming if either the obligor has filed for bankruptcy or similar protection from creditors or the obligor is past due more than 90 days on any material credit obligation to the banking group or the bank has taken action because it considers that the obligor is unlikely to pay his or her debt obligations to the banking group in full without recourse by the bank to actions such as realizing the security."[19] Yet the relevance to be attached to these indicators, particularly for comparative purposes, is immediately cut back in both cases by qualifications:

- FSIs: "Due to differences in consolidation methods, national accounting, taxation, and supervisory regimes, data are not strictly comparable across countries."
- CBD: "Doubtful and nonperforming loans should be interpreted with caution, since their definitions differ between countries."

As shown above, this study is an attempt to indicate some of the salient national definitional differences, relating to the explained primary and secondary elements of definitions; this study also points to possible adjustments in order to render NPL definitions more comparable across the country sample.

Bearing in mind the above-mentioned important provisos as well as the fact that national authorities are the ultimate sources of both the FSI and the CBD data series, we can now compare NPL data provided by the IMF and the ECB regarding

[14] *European Commission (2011), Article 174: Default of an obligor; for the wording of the draft article, see annex.*

[15] *Council of the European Union (2012), Article 174: Default of an obligor.*

[16] *Furthermore, the NPL rule also appears to be consistent with the NPL definition used by the European Banking Authority (EBA) in the compilation of its "Key risk indicators."*

[17] *See http://fsi.imf.org and Barisitz (2011, pp. 47–49, 61).*

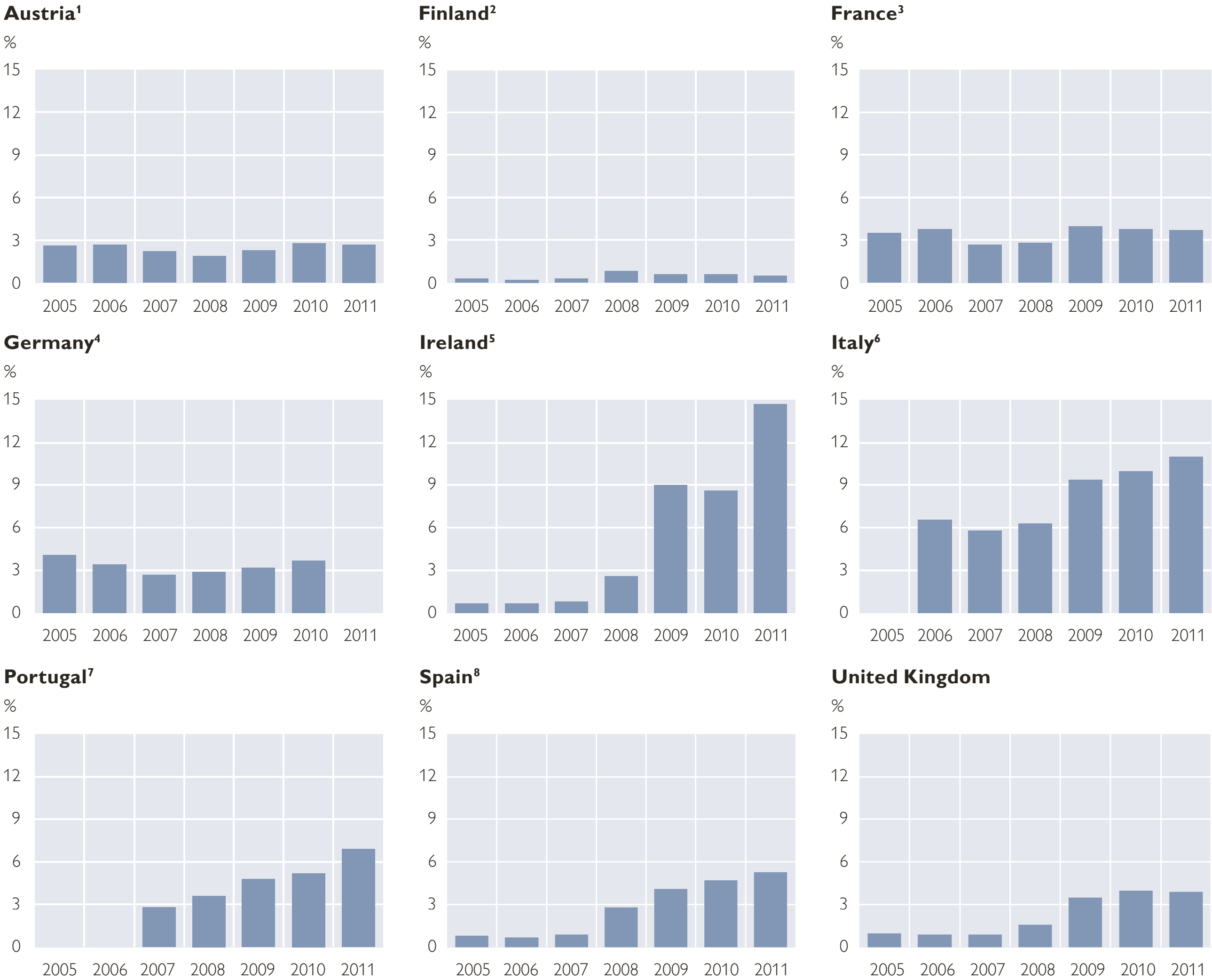
[18] *See http://www.ecb.int/stats/money/consolidated/html/index.en.html.*

[19] *This definition shows some similarity to the definition of default by the Basel Committee on Banking Supervision (2004), although it is not immediately clear what doubtful loans are in relation to NPLs.*

the countries under observation. Interestingly, a look at charts 1 and 2 reveals that depicted dynamics of NPL developments for the same countries bear some resemblance, while absolute levels clearly differ in most cases. Overall, as expected, we typically see declines in NPL ratios in the economic boom period up to 2007/08, which are followed by increases or higher levels in the crisis years. Euro area periphery countries, like Ireland, Portugal and Spain, feature relatively high NPL ratios which, moreover, tend to further rise pronouncedly. Austria, Finland, France and Germany, by contrast, show overall lower and less sharply rising rates.

Chart 1

Ratio of Banks' NPLs to Total Loans According to IMF FSIs



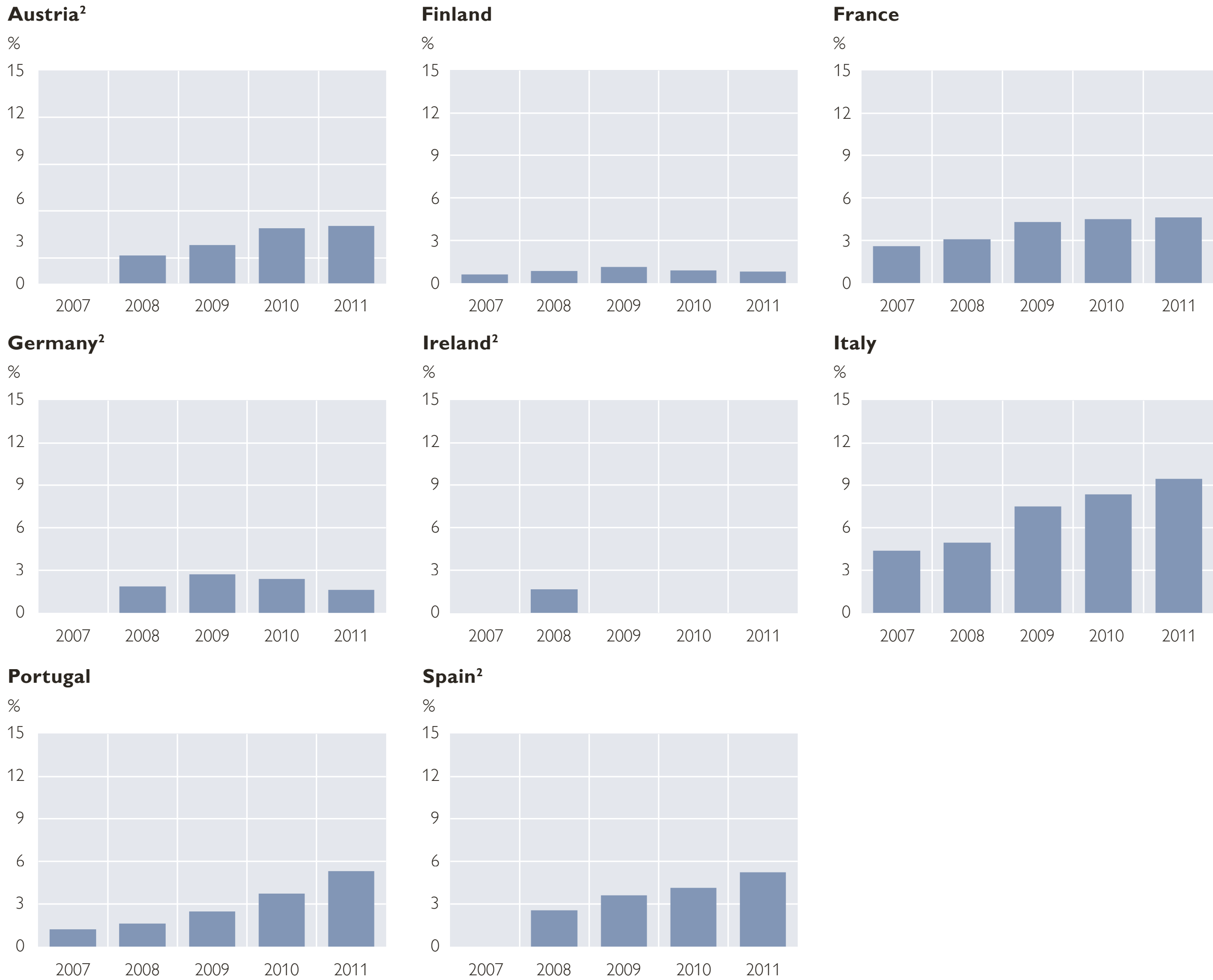
Source: IMF, Global Financial Stability Report (GFSR) statistics (FSI data), April 2012.

[1] Does not include subsidiaries and branches abroad of foreign-controlled deposit takers.
[2] NPLs reported net of specific provisions.
[3] Loans are classified as nonperforming on the basis of impairment, which is not linked to a 90-day criterion.
[4] Methodological break in 2009 due to changes in the regulatory reporting framework for the audit of banks.
[5] All licensed banks.
[6] Exposure to borrowers in a state of insolvency (even when not recognized in a court of law) plus exposures to borrowers in a temporary situation of difficulty.
[7] Break in the series in 2007 due to more comprehensive coverage. An new calculation method for NPLs that follows the methodology of the FSIs Compilation Guide was introduced in September 2011. Historical annual data have been revised accordingly, back to 2006.
[8] Includes loans to the private sector, public administration, other credit institutions and nonresidents.

Chart 2

Gross Total Doubtful and Nonperforming Loans in Selected Countries According to ECB CBD

% of total debt instruments and total loans and advances, year-end, according to ECB CBD[1]



Source: ECB CBD.

[1] *Loans are defined as doubtful and nonperforming if either the obligor has filed for bankruptcy or similar protection from creditors or the obligor is past due more than 90 days on any material credit obligation to the banking group or the bank has taken action because it considers that the obligor is unlikely to pay his or her debt obligations to the banking group in full without recourse by the bank to actions such realizing the security. Doubtful and nonperforming loans should be interpreted with caution, since their definitions differ between countries.*

[2] *Where data are not available, columns are not depicted. This is particularly the case for the U.K., for which no CBD NPL data are currently available and whose chart therefore has been omitted from this presentation, and for Ireland, for which only data for 2008 are available.*

Both the FSI and CBD sets expectedly feature Italian data at a relatively high level, while U.K. data are among the more modest (according to the FSI series, while the CBD do not feature U.K. data). This is in line with our expectations because, as noted above, we have found Italy's NPL ratio to bear a pronounced upward bias (which would require a downward correction to make the ratio internationally comparable) and the U.K.'s ratio to contain a distinct downward bias (calling for an upward correction).

4 Summary and Conclusions

After comparing credit quality classifications and nonperforming loan (NPL) definitions in selected CESEE countries in a previous paper (Barisitz, 2011), the current study focuses on these gradings and definitions in selected Western European nations (Austria, Finland, France, Germany, Ireland, Italy, Portugal, Spain and the U.K.) in order to generate a broad European picture of how loan qualities are ranked and NPLs typically identified. As table 1 shows, supervisors or at least general practice in the majority of the countries analyzed (i.e. except Finland, Italy and the U.K.) appear to endorse the rule that for a loan to be nonperforming, at least one of two (primary) elements has to be present: (1) principal or interest 90 days or more overdue, and (2) existence of underlying well-defined weaknesses of the loan or the borrower. Finland and the U.K. have a slightly weaker standard in this respect, while Italy has a stricter one.

However, there are also other (secondary) elements that have an impact on NPL measurement and on the comparability of definitions: the question whether a restructured loan is classified as NPL or not, whether the presence of a collateral or guarantee influences loan classification or not, whether the full outstanding gross value or only (the overdue or net) part of a loan is reported as nonperforming and whether a bank is required to downgrade all loans to a given debtor if any of these loans are classified as impaired (NPL customer view) or not (NPL product view).

Taking an overall view of primary and secondary elements and relating to widespread approaches, four of the analyzed Western European countries' NPL ratios would seem comparable, while two countries' NPL ratios appear to feature a downward bias, two a slight downward bias and one an upward bias. Common international practice (a loan is identified as NPL if at least one of two criteria apply: loan overdue 90 days+ or serious underlying weaknesses; a replacement loan is at least initially classified as impaired; collateral is not considered in loan classification; the full outstanding gross value of a loan is recorded as NPL) is essentially applied in three (France, Ireland, Spain) of the nine countries analyzed. Finland seems to possess an upward and a downward bias with regard to different aspects important for NPL assessment, which therefore could imply some reciprocal canceling out.

Two countries – Austria and Germany – show slight downward biases. Thus, the NPL definitions and ratios of these two countries, in order to be internationally comparable, would need minor upward corrections. Two countries exhibit clear downward biases (Portugal, the U.K.) and one country (Italy) stands out due to its upward bias. In the case of Italy, the upward bias (pointing to a possibly too high recording of NPLs when regarded in an international environment) could be somewhat attenuated by excluding "substandard loans" (loans to customers in temporary difficulties that can be expected to be cleared up in a reasonable time) from NPLs. At this stage, possible suggested corrections cannot be quantified because the present study is a purely definitional one.

As described in Barisitz (2011), the great majority of NPL definitions of the CESEE countries analyzed then (Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, the Russian Federation, Serbia, Slovakia and Ukraine) feature both of the above mentioned primary elements (90 days+, well-defined weaknesses). In this important respect, therefore, the majority of CESEE countries join the majority of Western European countries analyzed. Secondary elements of NPL comparability in CESEE are partly treated like in Western Europe.

A quick glance at available NPL data series from international sources (IMF Financial Stability Indicators, ECB Consolidated Banking Data) for the Western European countries under observation reveals that underlying definitions include qualifications ("not strictly comparable across countries," "should be interpreted with caution, since (...) definitions differ across countries") which imply that these definitions – for lack of more detailed country-specific information – unfortunately fail to provide a breakthrough to sufficiently tackle the comparability problem (for FSI data, see also Barisitz, 2011).

Summing up, we can conclude that the general NPL rule (90 days+ and/ or serious weaknesses) we hoped could serve as a common yardstick and basis for further refining international and European comparisons has broadly fulfilled our expectations. What's more, this definition is not only in line with the Basel Committee of Banking Supervision's definition of default, but it also essentially corresponds to the respective definition of default contained in the European Commission's proposal for a Capital Requirements Regulation (CRR), which the Council (Ecofin) submitted to the European Parliament in May 2012. It may be expected that an EU-wide definition of NPLs will enter into force along these lines in the next couple of years and thus become applicable across EU member countries. The relevant article in the CRR proposal includes a provision for EBA guidelines on its application. This provides an opportunity to achieve an EU standard also for the secondary elements of NPLs and thus for refining the definition of NPLs.

There are fields for future research. We suggest to deal with the secondary elements of NPL comparability for CESEE countries as well as with implications of the findings on Western Europe for the respective assessment of comparable NPL concepts in CESEE in more detail in an upcoming study. Depending on the availability of sufficient data, analytical work could also investigate economic implications or consequences of the definitional differences and could attempt the quantitative estimation of national upward or downward biases. Moreover, follow-up studies could strive to cover the entire euro area, or better all EU countries, to provide a comprehensive reference for policymakers.

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In addition to the above sources, various national regulatory announcements, guidelines, annual reports, reviews and other publications as well as information provided by national experts have been taken into account.

Annex: Default of an Obligor According to the European Commission (2011)

Excerpt from **European Commission (2011).**
Article 174
Default of an obligor

1. In quantifying the risk parameters to be associated with rating grades and pools, institutions shall apply the following approach to determining when an obligor has defaulted. For the purposes of this Chapter, a default shall occur with regard to a particular obligor when either of the following has taken place:
   (a) the institution considers that the obligor is unlikely to pay its credit obligations to the institution, the parent undertaking or any of its subsidiaries in full, without recourse by the institution to actions such as realising security;
   (b) the obligor is past due more than 90 days on any material credit obligation to the institution, the parent undertaking or any of its subsidiaries.

For overdrafts, days past due commence once an obligor has breached an advised limit, has been advised a limit smaller than current outstandings, or has drawn credit without authorisation and the underlying amount is material.

In the case of retail exposures, default at facility level shall also be considered for the purposes of paragraph 2.

An advised limit comprises any credit limit determined by the institution and about which the obligor has been informed by the institution.

Days past due for credit cards commence on the minimum payment due date.

In all cases, the exposure past due shall be above a threshold, defined by the competent authorities. This threshold shall reflect a level of risk that the competent authority considers to be reasonable.

Institutions shall have documented policies in respect of the counting of days past due, in particular in respect of the re-ageing of the facilities and the granting of extensions, amendments or deferrals, renewals, and netting of existing accounts. These policies shall be applied consistently over time, and shall be in line with the internal risk management and decision processes of the institution.

2. For the purpose of point (a) of the paragraph 1, elements to be taken as indications of unlikeliness to pay shall include:
   (a) the institution puts the credit obligation on non-accrued status;
   (b) the institution recognises a specific credit adjustment resulting from a significant perceived decline in credit quality subsequent to the institution taking on the exposure;
   (c) the institution sells the credit obligation at a material credit-related economic loss;
   (d) the institution consents to a distressed restructuring of the credit obligation where this is likely to result in a diminished financial obligation caused by the material forgiveness, or postponement, of principal, interest or, where relevant fees. This includes, in the case of equity exposures assessed under a PD/LGD Approach, distressed restructuring of the equity itself;
   (e) the institution has filed for the obligor's bankruptcy or a similar order in respect of an obligor's credit obligation to the institution, the parent undertaking or any of its subsidiaries;
   (f) the obligor has sought or has been placed in bankruptcy or similar protection where this would avoid or delay repayment of a credit obligation to the institution, the parent undertaking or any of its subsidiaries.
3. Institutions that use external data that is not itself consistent with the determination of default laid down in paragraph 1, shall make appropriate adjustments to achieve broad equivalence with the definition of default.
4. If the institution considers that a previously defaulted exposure is such that no trigger of default continues to apply, the institution shall rate the obligor or facility as they would for a non-defaulted exposure. Should the definition of default subsequently be triggered, another default would be deemed to have occurred.
5. EBA shall develop draft regulatory technical standards to specify the conditions according to which a competent authority shall set the threshold referred to in paragraph 1 which an exposure shall qualify as past due.
   EBA shall submit those draft regulatory technical standards to the Commission by 31 December 2014.
   Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first sub-paragraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.
6. EBA shall issue guidelines on the application of this Article. Those guidelines shall be adopted in accordance with Article 16 of Regulation (EU) No 1093/2010.