EBA/REC/2013/04
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Recommendations

on asset quality reviews

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1. Executive summary

As part of a continued effort to restore confidence in the EU banking sector, the EBA is issuing recommendations to competent authorities requiring participating competent authorities to undertake asset quality reviews (AQRs) of asset classes considered to be high risk. The objective of the recommendations is to contribute to a more uniform approach in competent authorities' evaluations of banks' credit portfolios, including risk classification and provisioning, in order to support sufficiently prudent capital levels and provisions to cover the risks associated with these exposures.

These recommendations promote consistency to the process and outcomes of AQRs at the European level so that remaining doubts about the quality of assets across the EU may be alleviated.

The AQRs remain under the responsibility of the competent authorities. Competent authorities are recommended to assess and identify high risk asset classes in banks´ credit portfolios. This assessment, which should be shared with relevant colleges of supervisors, should ensure that risky portfolios are properly assessed for each reviewed bank. With these recommendations the EBA intends to provide some consistency and coordination in the good practices to be voluntarily followed by the competent authorities.

These recommendations are designed to work with existing and/or planned work on AQRs. The work of the single supervisory mechanism (SSM) and its plans for a balance sheet assessment should be supported but not constrained. These recommendations will ensure sufficient space for the SSM and other competent authorities to clarify the objectives, timeline, expectations and process of AQRs already undertaken, in progress and planned. At the same time, these recommendations will provide non-SSM Member States which have not yet engaged in an AQR with a framework for taking them forward. Where banks operate outside the SSM or otherwise across borders in the EU, colleges of supervisors will be involved in this exercise. They will facilitate information exchange, and where applicable and upon request of the consolidating supervisor, contribute to the analysis undertaken for cross-border banks. The results will be communicated to the college and to the EBA. In this context, measures to improve risk coverage and provisioning, and other measures considered necessary and appropriate address any deficiencies, should be discussed.

When reviewing the results, competent authorities should discuss and challenge the outcomes and consider subsequent actions. As a result, competent authorities should be able to challenge the data received from banks and, if appropriate, recommend measures e.g. to adjust loan losses, provisioning or any other measures considered appropriate by the competent authorities to address any deficiencies.

The EBA, while respecting the communication needs of the competent authorities, will make use of the information provided by them to draft a report summarising the main outcomes of the various AQRs and providing some information in a consistent way across jurisdictions about what steps have been taken and the materiality of the outcomes.

These recommendations have been the subject of consultation with relevant competent authorities, but not to a public consultation because they are designed in relation to supervisory responsibilities and address the situation of individual institutions rather than forming part of a general policy. These recommendations will be published on the EBA's website.

2. Background and rationale

The EBA has been monitoring forbearance and asset quality for some time in the context of the deteriorating economic environment. This analysis shows deterioration in asset quality across the EU, although this is markedly different across regions, banks and portfolios.

Concerns still exist about forbearance policies and the consistency of asset quality assessments across the EU. In the face of a variety of definitions, the EBA has released consistent definitions of forbearance and non-performing loans[1] to be applied across the EU. These will help to provide a comparable basis for assessment of balance sheets by the competent authorities.

Many competent authorities have stepped up existing measures to monitor asset quality; there is, however, no single and transparent picture of the extent of asset quality issues across the EU. A degree of coordination in communication across the EU about asset quality exercises is therefore necessary to address supervisory and market concerns.

AQRs are increasingly being used as a thorough method of identifying potential losses in some countries' financial sectors, forming a substantial component of bank restructuring work, and also featuring in many on-going supervisory programmes. At the moment, there are differences both in approach and, more importantly, in communication about AQRs across the EU. These recommendations on AQRs focus on a sample of banks in the EU that are considered relevant by the competent authorities. Given the flexibility required for these recommendations, the final sample of banks is under the control of the competent authorities but it should include all relevant entities and those that were subject to the recapitalisation recommendation should be considered as high priority.

These recommendations should help to identify potential problem areas within regions, banks and portfolios and provide sufficient information about asset quality monitoring as further reassurance that pockets of residual risk will not undermine confidence in the EU banking system.

[1] EBA/ITS/2013/03

3. EBA recommendations on asset quality reviews

Status of these recommendations

This document contains recommendations issued pursuant to Article 16 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC ('the EBA Regulation'). In accordance with Article 16(3) of the EBA Regulation, competent authorities and financial institutions must make every effort to comply with the recommendations.

Recommendations set out the EBA's view of appropriate supervisory practices within the European System of Financial Supervision or of how European Union law should be applied in a particular area. The EBA therefore expects all competent authorities to whom recommendations are addressed to comply with them. Competent authorities to whom recommendations apply should comply by incorporating them into their supervisory practices as appropriate (e.g. by amending their legal framework or their supervisory processes).

Reporting requirements

Pursuant to Article 16(3) of the EBA Regulation, competent authorities must notify the EBA as to whether they comply or intend to comply with these recommendations, or otherwise with reasons for non-compliance, by 23.12.2013[2]. In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form provided at Section 5 to compliance@eba.europa.eu with the reference 'EBA/Rec/2013/XX'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities.

Notifications will be published on the EBA website, in line with Article 16(3) of the EBA Regulation.

[2] In the case of the European Central Bank, notification must be provided within two months of the date on which it becomes a competent authority.

Title I – Subject matter, scope and definitions

1. These recommendations concern the conduct by competent authorities of asset quality reviews (AQRs) on credit institutions in relation to asset classes and exposures considered to be high risk as part of their supervisory oversight of those institutions pursuant to Directive 2006/48/EC[3]. The objective of these recommendations is to contribute to a more uniform approach in the evaluation of credit institutions' credit portfolios, including risk classification and provisioning, in order to support sufficiently prudent capital levels and provisions to cover the risks associated with these exposures.

2. These recommendations apply to the competent authorities listed in Annex I.

3. The following definitions apply:

   - As far as possible and appropriate, the definition of 'non-performing exposures' is that in paragraphs 145 to 157 of the final draft ITS included in EBA/ITS/2013/03[4].

   - As far as possible and appropriate, the definition of 'debt forbearance' is that in paragraphs 163 to 179 of the final draft ITS included in EBA/ITS/2013/03[5]. The definitions in Article 4 of Directive 2006/48/EC also apply.

Title II – Recommendations

4. Competent authorities should carry out a review of the quality of all relevant credit institutions' assets. Competent authorities should treat as a high priority those credit institutions listed in Annex II to the Recommendation of the European Banking Authority of 8 December 2011 on the creation and supervisory oversight of temporary capital buffers to restore market confidence (EBA/REC/2011/1).

5. Competent authorities should assess and identify which asset classes and/or exposures require reviews of asset quality, based on an assessment of materiality and risk.

6. The depth of the reviews to be conducted depends on the assessment of materiality and risk.

7. Where the credit institution has an established college of supervisors in place, the selection of asset classes and/or exposures should be communicated to and discussed within the college where activities extend beyond the SSM.

[3] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L 177, 30.6.2006, p.1.
[4] EBA final Draft Implementing Technical Standards on supervisory reporting of forbearance and non-performing exposures under article 99(4) of Regulation (UE) 575/2013 [EBA/ITS/2013/03]
[5] ibid

8. Competent authorities should undertake asset quality reviews taking into account the good practices identified by the EBA and described in Annex II to these recommendations.

Title III – Final provisions and implementation

9. The communication of the outcomes of the AQR by the EBA will fully respect the communication needs of the competent authorities. In particular, the SSM may need to develop its own communication policy for the outcomes of the balance sheet assessment that it will conduct before assuming its full operational functions, in compliance with the SSM regulation.

10. Competent authorities should complete their AQR by no later than 31 October 2014. The preliminary outcome of the AQR should be reported to the EBA as soon as possible in order to ensure that it can be taken into account and support the EU-wide stress test due to be carried out in 2014.

11. Competent authorities are requested to report to the EBA, in a consistent manner, as soon as possible following conclusion of their AQRs.

Annex I – List of competent authorities

Austria	Finanzmarktaufsicht (Financial Market Authority)
Belgium	National Bank of Belgium
Bulgaria	Bulgarian National Banks
Croatia	Hrvatska Narodna Banka (Croatian National Bank)
Cyprus	Central Bank of Cyprus
Czech Republic	Ceska Narodni Banka (Czech National Bank)
Denmark	Finanstilsynet (Danish Financial Supervisory Authority)
Estonia	Finantsinspektsioon (Financial Supervision Authority)
Finland	Finanssivalvonta (Finnish Financial Supervisory Authority)
France	Autorité de Contrôle Prudentiel (Prudential Control Authority)
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
Greece	Bank of Greece
Hungary	Magyar Nemzeti Bank (Hungarian National Bank)
Ireland	Central Bank of Ireland
Italy	Banca d'Italia (Bank of Italy)
Latvia	Finansu un Kapitala Tirgus Komisija (Financial and Capital Market Commission)
Lithuania	Lietuvos Bankas (Bank of Lithuania)
Luxembourg	Commission de Surveillance du Secteur Financier (Commission for the Supervision of Financial Sector)
Malta	Malta Financial Services Authority
Netherlands	De Nederlandsche Bank (National Bank of Netherlands)
Poland	Komisja Nadzoru Finansowego (Polish Financial Supervision Authority)
Portugal	Banco de Portugal (Bank of Portugal)
Romania	Banca Naţională a României (National Bank of Romania)
Slovenia	Banka Slovenije (Bank of Slovenia)
Slovakia	Narodna Banka Slovenska (National Bank of Slovakia)
Spain	Banco de España (Bank of Spain)
Sweden	Finansinspektionen (Swedish Financial Supervisory Authority)
United Kingdom	Prudential Regulation Authority
	European Central Bank[6]

EEA-EFTA competent authorities[7]

Iceland	Fjármálaeftirlitið (Icelandic Financial Supervisory Authority - FME)

[6] These recommendations will apply to the European Central Bank following the entry into force of the proposed Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM(2012) 511 final).

[7] EEA-EFTA State competent authorities are not currently required to confirm compliance with EBA guidelines and recommendations. These recommendations therefore apply to them on a voluntary basis.

Liechtenstein	Finanzmarktaufsicht - FMA (Financial Market Authority)
Norway	Finanstilsynet (Norwegian Financial Supervisory Authority)

Annex II - Good practice for performing asset quality reviews

Drawing on the experience of experts around the European Union who have undertaken, or are undertaking, various AQRs appropriate to their circumstances and requirements, this Annex sets out some good practice identified by the experts. This does not mean that all steps described below are always relevant for all asset classes and/or exposures. Rather, these are steps that can be considered and assessed depending on the materiality and relevance for priority asset classes and/or exposures.

1. Competent authorities aim to select the asset classes and/or exposures using the risk and materiality guidance below, as far as possible, and following the process outlined below.

2. Competent authorities aim to undertake AQRs using in-depth quantitative and qualitative analysis of the selected set of asset classes and/or exposures, determining which steps are most appropriate based on their assessment of materiality and risk.

Typical tasks undertaken on an overall loan book level

Data integrity, risk classification and quantitative portfolio analysis

3. As a starting point for an AQR, competent authorities indicate that an assessment of data integrity based on accounting standards and correct risk classification is often undertaken along with a quantitative portfolio analysis of the overall loan book.

4. To ensure there is an effective starting point, competent authorities check the quality and integrity of the data and the proper allocation of exposures across risk categories, including asset classes and/or exposures of the overall loan book. They may:

   a. assess whether the classifications of loans into the asset class are correct and whether the boundaries between (sub-) portfolios are clear and consistently applied across the whole banking group (e.g. SME loans: separate category, partially included in corporate portfolio, partially in retail portfolio);

   b. evaluate the segments / subcategories used by the credit institutions – including definitions and boundaries – for different loan quality levels (e.g. low risk, management attention, watch list, substandard, restructured/renegotiated, forborne, non-performing);

   c. check whether there is a coherent default definition and/or non-performing definition and how these compare to the definition on 'non-performing exposures' set out in paragraphs 145 to 157 of the final draft ITS included in EBA/ITS/2013/03;

   d. analyse the characteristics and structure of the portfolio given the segmentation under point (b) above.

5. Based on an assessment of materiality and risk, and differences in the depth and breadth of the initial portfolio, further analysis may be necessary and justifiable.

6. Such further analysis is often considered of the following:

- exposure value
- maturity
- collateralisation
- risk classification
- type of asset
- regional distribution
- year of underwriting (vintage analysis)
- major concentrations
- provisioning
- coverage ratio.

Loan underwriting and monitoring

7. Competent authorities may assess credit institutions' loan underwriting and monitoring practices, which are relevant for the initial segmentation.

Tasks on a specific portfolio level

8. Having assessed data quality across the loan portfolio, an assessment of priority portfolios often follows. This analysis narrows down which asset classes and specific portfolios are to be the focus of the more detailed analysis described below.

Forbearance

9. Using, as far as possible and appropriate, the definition of forbearance in paragraph 3 of these recommendations, competent authorities identify the potential use of forbearance and its impact on valuation. They may:

   a. assess how restructuring is defined; check if the definition is uniform across the banking group and benchmark the internal definition to the harmonised one;

   b. check whether consistent reporting of forborne exposures is in place, and whether forborne exposures are systematically flagged in the reporting system(s) across the credit institution;

   c. assess whether defined processes and policies are in place for the application of forbearance practices and consider how they are defined across the banking group;

   d. quantify the amount of forborne exposures in the portfolio analysed;

   e. assess whether or not forborne and restructured loans are sufficiently provisioned;

f. analyse a sample of forborne loans to assess whether they are properly classified;

g. identify the standards and procedures for monitoring, evaluating and updating loan performance and loan risk profiles.

Non-performing loans and arrears management

10. Competent authorities may assess how credit institutions manage non-performing loans (in line with the harmonised definition of non-performing exposures as far as possible (paragraphs 145 to 157 of the final draft ITS included in EBA/ITS/2013/03) and also how they manage arrears. Competent authorities may:

    a. assess the existence/functioning of workout departments and related policies (early warning systems, conditions for transferring customers into workout, restructurings, legal procedures, etc.);

    b. identify the processes for early and late collection and their efficiency (e.g. analysis of the days past due status of customers);

    c. assess the conditions for transferring customers back into the performing portfolio or out of the balance sheet;

    d. quantify potential sales of distressed assets/portfolios.

Collateral management and assessment

11. Competent authorities often assess how credit institutions evaluate, manage and monitor collateral. In particular, they can:

    a. evaluate how responsibility for collateral evaluation is allocated (internal versus external appraisal) and their independence for loan underwriting;

    b. gather evidence on the frequency of appraisals, reasons for revaluation, age of appraisals;

    c. assess how haircuts and valuation parameters are derived and validated and whether they are based on historic data. Additionally assess the link to provisioning, specifically if this data (internal collateral values) is used to derive the level of provisions;

    d. assess statistical revaluation tools for small real estate assets and investigate parameter estimations and how they are validated.

Provisioning and risk coverage

12. Competent authorities also assess whether the level of provisions and risk coverage are consistent with the quality of the assets in credit institutions' portfolios. In particular, they can:

    a. identify which rules apply for building specific as well as general loan loss provisions and risk coverage and assess whether they are consistently applied;

    b. evaluate which parameters are used for the general loan loss provisions and risk coverage calculation and whether they are validated and adequate;

    c. compare coverage ratios in different segments, if possible also comparing with the relevant peer group;

    d. check whether or not the level of provisioning and risk coverage in individual cases is adequate based on a sample of problematic loans;

    e. assess whether provisioning requirements are applied to foreclosed assets.

Assessment of materiality and risks

13. In assessing and identifying asset classes and/or exposures to be reviewed and in determining the depth and breadth of the analysis, competent authorities can assess the materiality and risks of asset classes and/or exposures.

14. In assessing materiality and risks, competent authorities can consider different aspects, among which are the following:

    - quantitative factors on the basis of:
        - asset class and/or portfolio level;
        - risk concentration versus risk diversification;
        - collateralisation;
        - provisioning;
        - environmental factors (macro-economic conditions, e.g. sharp correction of commercial real estate prices);
    - qualitative factors on the basis of:
        - inherent risks;
        - effectiveness of credit controls.

15. Based on the assessment of materiality and risks, competent authorities may identify areas that require review or more in depth investigation, including:

    - asset class and/or sub-portfolio at national level;
    - quantitative asset class and/or sub-portfolio level of individual credit institutions; and
    - qualitative components level of individual asset classes and/or sub-portfolios.

16. Based on this assessment, portfolios which are relevant to a meaningful and effective AQR can be identified, analysed and reviewed in detail.

Resources

17. Competent authorities note that, to effectively undertake an AQR, adequate resources need to be allocated to the exercise. The size of the exercise and resources should be proportionate not only to the components to be included but also to the depth and breadth of the assessment and the materiality and risks identified.

18. Competent authorities may use appropriate teams of experts to undertake the reviews, which may include outsourcing to host supervisors, or using mixed teams, for analysis on relevant portfolios.

19. In some cases competent authorities can consider the possibility to rely on the support of third parties for the purpose of carrying out the asset quality review or parts of it, which would remain under their oversight and responsibility anyway.

Reporting requirements

20. Reporting requirements may reflect the level of detail of the assessments carried out.

21. Quantitative reporting may, as far as possible, use existing frameworks such as the COREP and FINREP frameworks.

22. Reporting should cover the following areas at least:

    a. basic information about banks in the sample;

    b. loan portfolio risk classification;

    c. forbearance and non-performing loans;

    d. arrears levels and arrears resolution measures;

    e. risk coverage and provisioning levels and targets.

23. Qualitative reporting may be done using a scoring system established by the competent authorities responsible.

Undertaking AQRs using the colleges of supervisors

Phase 1: Scope of Application

24. Consolidating competent authorities of cross-border credit institutions inform the college that the AQR will be performed on the bank in question and they discuss the selection of the relevant asset classes and/or exposures for review.

25. Consolidating competent authorities share the results of their assessment of materiality and risk of the asset classes and/or exposures with both EU host supervisors and the EBA, using criteria of materiality and risk as described above.

Phase 2: Undertaking the AQR exercise

26. Host supervisors can be invited to nominate experts to help carry out the reviews where necessary and appropriate.

Phase 3: Sharing of results in the colleges

27. Consolidating competent authorities inform the college of, and discuss within the college, the outcome of the reviews. The college reviews and discusses the results.

28. Additionally, the college may:

- if subsidiaries are affected, seek to find common ground in their recommendations, e.g. on extra provisions needed;
- seek a coordinated supervisory approach by making appropriate adjustments as a result of the AQRs.

4. Confirmation of compliance Recommendation

Date:

Member/EEA State:

Competent authority:

Guidelines/recommendations:

Name:

Position:

Telephone number:

E-mail address:

I am authorised to confirm compliance with the guidelines/recommendations on behalf of my competent authority: ☐ **Yes**

The competent authority complies or intends to comply with the guidelines and recommendations:

☒ **Yes** ☐ **No** ☐ **Partial compliance**

My competent authority does not, and does not intend to, comply with the guidelines and recommendations for the following **reasons**[8]:

Details of the partial compliance and reasoning:

Please send this notification to compliance@eba.europa.eu[9].

8 In cases of partial compliance, please include the extent of compliance and of non-compliance and provide the reasons for non-compliance for the respective subject matter areas.

9 Please note that other methods of communication of this confirmation of compliance, such as communication to a different e-mail address from the above, or by e-mail that does not contain the required form, shall not be accepted as valid.