

Box 12

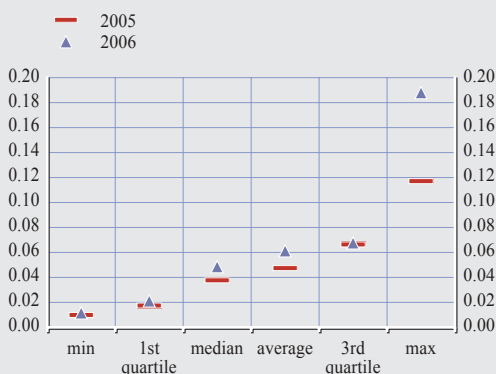
LOAN LOSS IMPAIRMENTS: WHAT IS BEHIND THE NUMBERS?

Credit risk is the most important risk that banks must face. This means that for assessing the effect of credit risk on banks profitability and solvency, adequate disclosures of potential and realised credit risk are important. Furthermore, information about how this risk is quantified and managed is important for effective market discipline.¹ One key piece of information that is needed for the assessment of credit risk is the loan loss impairment figures that are contained in banks' financial statements. Both 2005 and 2006 were transitional years in the euro area

¹ See R. Gropp and A. Kadareja (2006), "Stale Information, Shocks and Volatility", *ECB Working Paper*, No 686. For a broader discussion of accounting standards from a financial stability perspective, see ECB/BSC (2006), "Assessment of Accounting Standards from a Financial Stability Perspective", and P. Amis and E. Rospars (2005), "Prudential Standards and the Evolution of Accounting Standards: The Stakes for Financial Stability", *Banque de France Financial Stability Review*, November. For a general discussion of IFRS and banks' asset quality, see Fitch Ratings (2005), "IFRS: The Impact on Asset Quality Assessment in the Banking Sector", Special Report, December.

Chart B12.1 Loan impairment charges for large and complex banking groups in the euro area

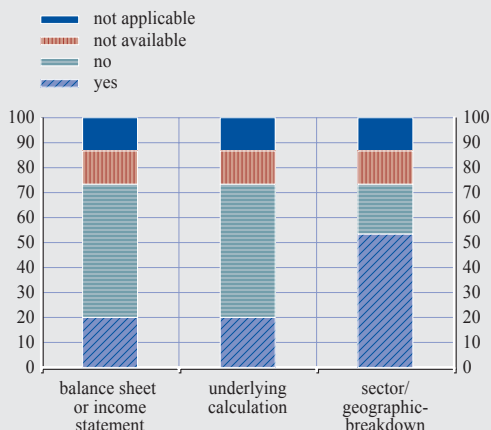
(% total assets)



Sources: Published annual reports, presentations of results and ECB calculations for 11 LCBGs.
Note: Impairments are new net impairment charges taken from the financial statements of LCBGs as a percentage of total assets.

Chart B12.2 Extent of information on the composition of loan impairment charges for large and complex banking groups in the euro area

(2005 - 2006)



Sources: Published annual reports, presentations of results and ECB calculations for 13 LCBGs.
Note: "Balance sheet or income statement" refers to whether or not the institution provides a detailed break down of net loan impairments in either of these financial statement; "Underlying calculation" refers to whether or not any quantitative or qualitative information is provided on how the impairment figures are calculated; "Sector/geographic" refers to whether or not the institution provides any information concerning the economic sector or geographical location of the impaired loans; "Not applicable" refers to two LCBGs that report a breakdown of impairment charges in both balance sheets and income statements because regulatory requirements in their home country requires them to do so.

banking sector since the full implementation of the new IFRS accounting standards by euro area LCBGs. This Box explains what loan impairments are; describes the figures that euro area LCBGs provided under IFRS in their 2006 results; as well as the information provided to interpret and compare these figures.²

The implementation of IFRS accounting standards has led to a change in the terminology and the way banks report actual or potential losses on loans. Following the implementation of IFRS, a loan is now regarded as impaired on the balance sheet date when there is objective evidence that a loss has occurred.³ The implementation of IFRS has seen some banks report impairments both on individual loans and on portfolios of loans that are impaired but where the individual impairments have not yet been identified (this is known as "impaired but not reported", or IBNR), or alternatively, portfolio allowances.⁴ As IBNR allowances are not explicitly described in IFRS, differing methodologies may have been applied to determine when loss events occur and when they are observed. The technical assumption that losses may have occurred in the portfolio but have not been recognised or observed by the bank leads to the IBNR or collective impairment allowance.

2 The comparability of 2004 local Generally Accepted Accounting Principles (GAAP) plus the 2004 data restated into IFRS with 2005 IFRS data is limited by the fact that most banks availed themselves of the transitional options for the restating of 2004 by not applying IFRS 4 ("Insurance activities"), and IAS 32/IAS 39 on financial instruments.
3 This evidence includes financial difficulty in the case of the borrower, breach of contract, and the probability that the borrower will enter into bankruptcy.
4 For a loan to be impaired, IFRS requires observable data on decreased estimated cash flows on the portfolio of assets.

The distribution of new impairment charges differs considerably across LCBGs that had reported IFRS results at end-2006 (see Chart B12.1). While this might reflect differences in the composition and quality of loan portfolios across these institutions, it is not possible to assess this with a high degree of confidence given wide variety in the amount and extent of the information provided by these institutions on their loan impairment charges (see Chart 12.2). Three main observations can be drawn from these disparities. First, the majority of LCBGs do not make a distinction in their loan impairment figures between specific and IBNR figures, either in their balance sheets (in terms of the stock of impaired loans) or in their profit and loss statements (in terms of new impairment charges). As such, it is difficult to determine what role – if any – is played by IBNR impairment charges in the overall figures.⁵ Second, the majority of LCBGs do not disclose quantitative information on how they arrived at their impairment figures. Some LCBGs provide quantitative information – such as migrations on their internal rating scales – which determines whether impairment charges are made or not; most include somewhat vague qualitative descriptions in their financial statements, or provide additional information on the sources of credit risk in separate presentations. Third, several LCBGs provide a breakdown of their overall impairment figures by geographic region and/or business line, indicating where the sources of current credit losses originate.

Overall, only a few LCBGs currently break down their impairment figures into sub-categories, and provide relatively limited information to aid their interpretation, thus hindering comparability across institutions and countries. Notwithstanding the transition to IFRS, as well as Pillar 3 requirements from Basel II, additional quantitative and qualitative information could aid the interpretation of loan impairment charges and would prove more useful for assessing credit risk in euro area LCBGs. More encouragingly, this aspect of euro area LCBGs' financial disclosures may be improved by the implementation of IFRS 7 for 2007 financial results, as this requires particular disclosures concerning credit risk for loans and other financial instruments.⁶

⁵ For banks that make this distinction, IBNR impairments are typically much smaller than specific impairments.

⁶ IFRS 7 ("Financial instrument disclosures") contains various disclosure requirements for credit and other risks. Among the requirements for credit risk, banks should provide information about their maximum credit risk exposures on the balance sheet date, collateral and other credit enhancements, information on assets that are not past due or impaired, and various disclosures – such as vintage and how the assets were deemed to be past due and/or impaired. IFRS 7 has been mandatory since 1 January 2007.