ACCOUNTING & REPORTING

GUIDANCE NOTES FOR BOARD MEMBERS

ACCOUNTING FOR NON – PERFORMING LOANS (“NPL”)

By LuxCMA Best Practice Working Group
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LUX CMA Luxembourg Capital Markets Association

GUIDANCE NOTES FOR BOARD MEMBERS - ACCOUNTING FOR NON – PERFORMING LOANS

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TABLE OF CONTENTS

INTRODUCTION 3

ACCOUNTING POLICY FOR NPL (COST LESS IMPAIRMENT) 5

Initial recognition 6

Subsequent accounting 6

DIFFERENT TREATMENTS OF COLLECTIONS 7

Accurate split between interest income and return of capital available 7

Return of cost only 7

Expected Yield method...8

TREATMENT OF INTEREST EXPENSES 10

TREATMENT OF UNREALISED / REALISED GAINS AND LOSSES ON NPLS / NOTES 10

Impairment on NPL...10

Realised gains on NPL 11

Realised losses on NPL 11

Unrealised gain from valuation of Notes at repayable amount at year-end (equalization provision) 11

Realised gain from redemption of Notes 12

Realised loss from redemption of Notes 12

TREATMENT IN CONNECTION WITH ATAD IMPLICATION 12

GLOSSARY 13

GUIDANCE NOTES FOR BOARD MEMBERS - ACCOUNTING FOR NON – PERFORMING LOANS

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INTRODUCTION

In non-performing loan transactions, the securitisation vehicle or financial vehicle corporation **(“FVC”)** securitises a portfolio of non-performing loans (“**NPL**”) which are generally defined as loans in which the borrowers are in default due to the fact that they have not made the scheduled payments for a specified period.

The exact elements of non-performing status can vary depending on the specific loan's terms. The specified period also varies, depending on the industry and the type of loan. In an EU regulatory context, it is a financial exposure that is either “*overdue by 90 days*” or which debtor is “*assessed unlikely to repay its debt*”.

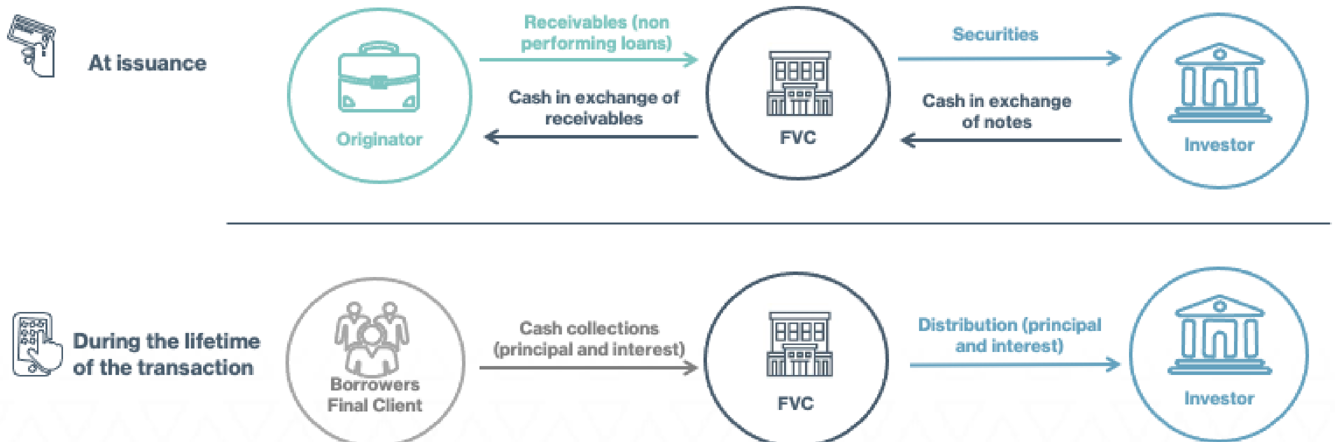
Debt may be acquired at a significant discount reflecting the fact that the debtor is in financial distress. A distressed / non-performing debt can be broadly defined if, based on all the facts and circumstances, there is no reasonable expectation that the holder will recover the debt instrument’s principal amount and any unpaid interest that accrued before the instrument became distressed.

In a securitisation context, the contemplated situation is where debt receivables purchased (or in some cases issued) at a deep discount are transferred to a FVC, usually by the Originator (often a bank) as original lender. That entails such new debtholder to either directly hold the debt (true sale), manager the borrower relationships and receive the income derived from the borrowers, or to keep the original lender fronting the relationship with the borrowers and acting as collecting agent whereas the FVC will receive the cash flows as pass-through on a regular basis from the original lender acting as collection agent.

Receivables acquired or subscribed at discount will typically deliver two types of returns to the FVC: the interest received from the debt as contractually agreed with the original holder ("*contractual interest*") or part of it and a realised gain in case the capital repayment cash flows from the NPL exceed the purchase price.

NPLs may be secured by collateral (e.g., commercial, or residential real estate) or unsecured (e.g., consumer loans).

Parties involved in such transaction are the **Originator,** the **Investor,** the **Borrowers** and the **FVC**. A typical NPL Securitisation is summarised in the following diagram:



ACCOUNTING POLICY FOR NPL (COST LESS IMPAIRMENT)

The FVC (if in the corporate form) must comply with the Law of 19 December 2002 which is setting up the Luxembourg accounting principles (“**LuxGAAP**” and/or the “**Accounting Law**”)[1]

Under LuxGAAP, the FVC can opt to choose from different accounting frameworks for the initial and subsequent accounting treatment of the valuation of the assets:

- The LuxGAAP valuation under the historical cost model or,
- The LuxGAAP valuation under the fair value option,
- The LuxGAAP valuation under the lower of cost or market value.

In practice, NPL FVCs often opt for the LuxGAAP valuation model using the historical cost method, hence the example of accounting entries below illustrates the application of the historical cost model. The loans would normally be classified as fixed assets since they are intended for use on a continuing basis for the purpose of the undertaking’s activity (Art. 39 (2)).

Should the NPL be held for the purpose of resale they would be qualified as current assets with the respective accounting and valuation consequences. We shall concentrate here on the former case.

[1] Securitisation Vehicles may also opt for the application of the International Financial Reporting Standards (IFRS). In practice, this is very rarely used.

- **Initial recognition**

The portfolio of NPL is, initially, valued at its purchase price including expenses incidental thereto. This means that the NPL are not accounted for their notional amount but for the (deep) discounted purchase value.

- **Subsequent accounting**

At the financial period end, and in case the Management concludes that there is a durable depreciation in value of the NPL, value adjustments are booked so that the NPL are valued at the lower figure to be attributed to it at the balance sheet date. These value adjustments are not continued if the reasons for which the value adjustments were made have ceased to apply.

NPL are illiquid assets, and the Management needs to use relevant valuation methods mainly reflecting the uncertainty surrounding the future cash flows from the loans. The valuation models in question are structured around the historical performance, the type, size and maturity of the loans and suitable risk factors.

In theory, such valuation assessment needs to be performed on an asset-by-asset basis (Art. 51 (1) e)). However, in practice and subject to the relative importance of the single loans, a grouping of the loans into (sub-)portfolios is often acceptable for valuation purposes.

DIFFERENT TREATMENTS OF COLLECTIONS

The FVC will receive cash flows from the NPL which comprise interest and capital elements. The split between these two is not always obvious. Several methods may be applied:

- **Accurate split between interest income and return of capital available**

  The collection (100) is split into return of capital (80) and interest income (20):

		Debit	Credit
D.IV. Cash	Assets	100	
C.III. Financial Assets – 6. Other loans	Assets		80
10. Income from other investments and loans forming part of the fixed assets – b) Other income not included under a)	P&L		20

- **Return of cost only**

  The collection (100) is considered as return of capital:

		Debit	Credit
D.IV. Cash	Assets	100	
C.III. Financial Assets – 6. Other loans	Assets		100

When the cumulated collections reached the acquisition cost, the net book value is kept at 1 in financial assets and any surplus/subsequent collections (10) is recognised as capital gain:

		Debit	Credit
D.IV. Cash	Assets	10	
10. Income from other investments and loans forming part of the fixed assets – b) Other income not included under a)	P&L		10

- **Expected Yield method**

Market standards for the determination of the yield of NPLs is based on a valuation of the recovery that the FVC should expect when it acquires the debt. The internal rate of return is determined at purchase date. Once the maximum recovery amount has been reasonably assessed, it will be used to determine the internal rate of return (IRR). The IRR (EIR under IFRS) is the rate that exactly discounts estimated future cash payments through the expected life of the loan portfolio to the net carrying amount, i.e. the acquisition costs.[2]

Therefore, to the extent that this method to assess revenue recognition is considered as a valid method representing the market approach, the interest rate that is derived therefrom should be accepted as being the adequate remuneration for the risk taken by the FVC in holding the debt for a certain maturity.

We understand that it is acceptable under Lux GAAP (particularly considering the requirement for the accounts to give a true and fair view) to reflect income up to the amount of the original reasonable expectation as “interest income”.

[2] The IRR will provide the return that capital invested in this debt asset will achieve if collections are made according to expectations. The IRR being based on a forecast of income, some accounting norms such as IFRS 9 refer rather to it as being an expected interest rate (EIR) on invested capital, which would be adjusted for credit-impaired assets, i.e. a credit-adjusted effective interest rate.

There may be certain differences as regards timing of recognition as income, but these timing differences are not considered relevant for FVCs.

Any further collection beyond initial forecast will generally be considered as capital gains.

When a collection is received (100), the expected IRR (e.g., 4%) is used to determine the split between interest income and return of capital. The expected return (i.e., carrying amount (e.g., 1,000) x IRR) is accounted for as interest income. The remaining part is treated as a return of capital.

		Debit	Credit
D.IV. Cash	Assets	100	
C.III. Financial Assets – 6. Other loans	Assets		60
10. Income from other investments and loans forming part of the fixed assets – b) Other income not included under a)	P&L		40

No accrual for interest based on the expected IRR is recorded. This is in line with Article 51 1) c) of the Accounting Law which states that only certain revenues at closing date should be recorded. However, if collections in one period are lower than the forecast, it seems to be appropriate to record the shortfall in interest in a sub-ledger and to defer the income recognition until the next interest payment date provided that collections are sufficient to record the interest. Interest recognition in each period is capped at the amount of collection received.

The IRR will not be re-calculated following a change in future estimated cash flows. Hence, any further collections beyond the initial forecast will be treated as capital gains. The carrying book value of the NPL portfolio needs to be assessed for potential impairment on a regular basis (at least once a year).

TREATMENT OF INTEREST EXPENSES

Any interest received from the NPL would normally be passed-through (after costs) as interest expenses to the noteholders.

		Debit	Credit
14. Interest payable and interest expenses – b) Other interest and similar expenses	P&L	10	
D.IV. Cash	Assets		10

TREATMENT OF UNREALISED / REALISED GAINS AND LOSSES ON NPLS / NOTES

FINANCIAL ASSET

- **Impairment on NPL**

		Debit	Credit
13. Value adjustments in respect of financial assets and of investments held as current assets	P&L	10	
C.III. Financial assets – 6. Other loans	Assets		10

- **Realised gains on NPL**

		Debit	Credit
D.IV. Cash	Assets	10	
10. Income from other investments and loans forming part of the fixed assets – b) Other income not included under a)	P&L		10

- **Realised losses on NPL**

		Debit	Credit
14. Interest payable and similar expenses - b) Other interest and similar expenses	P&L	10	
C.III. Financial assets – 6. Other loans	Assets		10

NOTES

- **Unrealised gain from valuation of Notes at repayable amount at year-end (equalization provision)**

		Debit	Credit
C.1.b Debenture loans	Liabilities	10	
4. Other operating income	P&L		10

- **Realised gain from redemption of Notes**

Redemption amount (90) below the nominal value (100)

		Debit	Credit
C.1.b Debenture loans	Liabilities	100	
Cash	Assets		90
4. Other operating income	P&L		10

- **Realised loss from redemption of Notes**

Redemption amount (110) above the nominal value (100)

		Debit	Credit
C.1.b Debenture loans	Liabilities	100	
8. Other operating expenses	P&L	10	
Cash	Assets		110

TREATMENT IN CONNECTION WITH ATAD IMPLICATION

In relation to the potential impact of ATAD 1 interest limitation rules we reference to the LuxCMA position paper "TECHNICAL POSITION PAPER ON THE DEDUCTIBILITY OF PAYMENTS BY SECURITISATION COMPANIES FINANCED BY DEBT".

GLOSSARY

A

ACCOUNTING LAW	means the Law of 19 December 2002 which is setting up the Luxembourg accounting principles
ATAD 1	means Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market
ATAD 2	means Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 (ATAD) regarding hybrid mismatches with third countries

C

COLLECTION AGENT	means a party that collects receivables on behalf of the FVC

E

ECB	means the European Central Bank
EIR	means Effective Interest Rate

F

FVC	means Financial Vehicle Corporation as per ECB definition

I

IFRS	means the International Financial Reporting Standards – the accounting standards issued by the IFRS Foundation and the International Accounting Standards Board
IPD	means Interest Payment Date
IRR	means Internal Rate of Return

L

LuxCMA	means the Luxembourg Capital Markets Association
LuxGAAP	means Luxembourg generally accepted accounting principles

M

MANAGEMENT	means the Board of directors or the Board of managers of the FVC or its Management company

N

NPL	means Non-Performing Loans

O

ORIGINATOR	means the party that purchases a third party's exposures for their own account and then securitise them

P

PUBLICATION	means this document as well as the information contained herein

S

SECURITISATION LAW	means the Law of 22 March 2004 on securitisation, as amended

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About the LuxCMA – Luxembourg Capital Markets Association

Created on 1 March 2019, the LuxCMA is a not-for-profit association (a.s.b.l.), registered at the RCSL (F12205), whose registered office is 6 rue Jean Monnet, L-2180 Luxembourg. The LuxCMA today represents memberships detailed on LuxCMA's website (www.luxcma.com), which is composed by banks, law firms and services providers, amongst others.

Working Group – Best Practice

The aim of this working group is to find practical solutions (or answers) to practical problems. Capital market participants are often confronted with varying practices among the numerous practitioners active in Luxembourg, including when it comes to compliance, accounting, presentation of the financial statements, clearing, reporting, or general legal questions, and the purpose of the group will be to identify any recurring problems or inconsistencies in such practices and to analyse whether it is possible to work out practical recommendations and good market standards which address such issues.

For more information, please contact info@luxcma.lu

LuxCMA – Luxembourg Capital Markets Association

6 rue Jean Monnet | L-2180 Luxembourg

info@luxcma.lu | www.luxcma.com | Follow us on LinkedIn and YouTube