

AEG recommendations on

## **Non-performing loans**

Status: Preliminary recommendations from the AEG  
Website open for comments

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### **Background**

The financial crises of the 1990s led to new interest in the question of how nonperforming loans (NPLs) should be accounted for in macroeconomic statistics.

The *1993 SNA* does not reflect the existence of NPLs in either the flow accounts or the balance sheets.

An electronic discussion group (EDG) was set up by the IMF.

## The current SNA

The criteria used in the *1993 SNA* for the measurement of loans were based on considerations such as

- (i) avoiding entries in the accounts without sound basis in observable transactions,
- (ii) the need to facilitate comparisons between different economic agents and countries, and
- (iii) the need for the valuation of loans to be consistent with the debtor's legal obligations.

## The current SNA

In the *1993 SNA*, loans are measured at nominal value, which is the total amount outstanding (the amount required to pay off the loan in full, inclusive of accrued interest).

The valuation principle is the same whether loans are being measured as assets or liabilities.

## The current SNA

Other than transactions, changes are allowed only by cancellation, write-off, or rescheduling.

The cancellation of debt by mutual agreement between the creditor and the debtor is treated as a capital transfer.

The writing off of debt — the recognition by a creditor that the financial claim can no longer be collected—is recorded in the “other changes in volume” accounts.

Rescheduled loans, the difference between the nominal value of the original loan and the rescheduled value is recorded as a holding gain or loss.

## Problems with the current SNA

- The *1993 SNA* balance sheets record all loans at their full nominal values irrespective of their quality, including changes in the credit risk of the debtors.
- Writedowns are not reflected at all in the national accounts.
- The *1993 SNA* continues to record the accrual of interest on loans even in cases when it is not ultimately received (reflects legal view)
- It does not reflect the true financial position of the transactors involved. For NPLs, it paints a too rosy picture of the value of loans in creditors’ balance sheets and of their income.
- Nominal valuation for loans represents an important departure from the principle of valuing assets at current market prices in the system.

## Valuation options

- nominal value
- nominal value adjusted for credit risk
- market value
- recording of dual valuations

The advantages and disadvantages in terms of

- analytical usefulness
- consistency with the recording principles regarding valuation and symmetry
- consistency with legal and business accounting standards
- data availability

## Nominal value

Measure of legal obligation

Loans are exception to the market principle for transactions and stocks (no established market by definition)

Does not reflect impairment or nonperformance of loans  
(see definitions)

Gives misleading signals about loan holding and interest

May impede comparison with other types of assets/liabilities

Accounting standards: liabilities to nominal values, assets valued net of allowance for impairment or fair value

Easy obtainable data

Symmetry

## Nominal valuation adjusted for credit risk

Principle: Subtract expected loss on a bad debt from nominal values (changes in expected losses recorded in holding gain/loss).  
Suspend accrual of interest from income accounts.

For loan holdings: more accurate measure, but available data may provide weak statistics (different standards)

Closer to accounting standard for holdings.  
Not consistent with 1993 SNA's concept of market valuation (other risk categories not taken into account)

Symmetric only if debtor data can be estimated at market value  
Easily obtainable data for holdings, but how to transform the losses to debtor accounts (especially cross border)

## Market valuation

By definition: no market for loans – and no observable price (if a functioning secondary market: securities)  
Make a 'best estimate', taking into account individual and general circumstances like interest rates

In line with the market principle, but the effect of interest rates may obscure economic analysis since most loans are held to maturity

Symmetric only if debtor data can be estimated at market value  
Accounting rules: liabilities (nominal), fair value of holdings if loans available for sale (+)

Obtainable data if the creditors apply fair value (= market value), else statisticians may estimate (may be inaccurate).

## Dual recording of valuation

Adding mandatory memorandum items to the valuation used in the accounts.

“Pragmatic approach” suggested:

Compile nominal values and available source data such as (possibly a mix of) adjusted nominal values and fair values, named “market-equivalent values”

The approach requires metadata

## Recommendations (1)

The AEG agreed that loans should continue to be recorded at nominal value for both creditors and debtors.

In addition, memorandum items should be shown at market value; these should be mandatory for at least financial institutions and government as creditors.

## Recommendations (2)

More clarification is required in respect of:

- i. The definition of which loans are non-performing;
- ii. The exact nature of the memorandum items (whether market-equivalent value or nominal value less expected provisions for impairment);
- iii. A worked example of the accounts showing the memorandum items;
- iv. Harmonization of terms used in various manuals;
- v. The implications for the recording of FISIM; and
- vi. Whether similar treatment should be extended to other financial instruments (in particular trade credits).

The IMF agreed to prepare a paper addressing these issues.

## Definitions (1)

**Nominal value** is the total amount outstanding (the amount required to pay off the loan in full, inclusive of accrued interest).

**Impairment** refers to the risk of failure of debtors to meet their obligations. Circumstances may cast doubt on the ability of a debtor to make future contractual payments (in other words, the loan is impaired), even if all payments have been made punctually up till the present.

**Nonperformance** is the manifestation of such failure.

## Definitions (2)

**Nonperforming loans (NPLs)** are loans on which debtors have failed to make contractual payments for a predetermined time.

*Compilation Guide on Financial Soundness Indicators* says:

A loan is **nonperforming** when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full.

**Fair value** is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction