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Issue 4(a)
Non-performing loans

**REPORT ON e-DISCUSSION ON
NON-PERFORMING LOANS — IMPACT ON FISIM**

United Nations Statistics Division

**Update of the 1993 SNA – Issue No. 4a
Jan-Feb 2006 AEG meeting, Frankfurt**

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Introduction

1. During the discussion on non-performing loans (NPL) in Bangkok, one issue unresolved was how to deal with FISIM on an NPL. It was suggested that there were three possibilities:

- Continue to estimate FISIM on NPLs and allocate it to the corresponding borrowers but consider how unpaid FISIM is recorded in the accounts in such a way as to increment principal outstanding;
- Estimate FISIM on interest received (rather than receivable) and on interest payable so that FISIM is not attributable to NPLs;
- Estimate FISIM on a basis including NPLs but allocate the whole amount of FISIM only to those borrowers servicing their loans.

2. Examples on these three possibilities and a fourth possibility were presented in the paper SNA/M1.06/25.1

3. Option 1 is the option in the 1993 SNA, except that an amendment is needed to say that any FISIM associated with unpaid interest must also be accrued as part of the principal outstanding. It is consistent with the decision to record non-performing loans at nominal value. It is operationally feasible and would lead to no change in GDP.

4. Option 2 appears to recommend a change in the SNA by choosing to record interest on a cash rather than an accrual basis. The possible impact on GDP, compared with measuring interest on a full accrual basis is described in the full explanation of option 2. In practice, if a statistical office records interest in the accounts on the basis of interest reported by banks, it is probable that this may exclude interest due on loans the bank considers to be non-performing. To the extent this is so, a conceptual change in the SNA would not lead to any change in practice.

5. Option 3 is a change from the SNA. The consequences for the impact on GDP and other aggregates are described. Although this option starts from the reference rate approach to calculating FISIM the implication is that the final estimate for (SNA) interest is not derivable by applying the reference rate to the stock of performing loans.

6. Option 4 is noted mainly for the record. If a decision were to be made to change

the valuation of loans in the balance sheet from nominal value to market value, then options 1 and 2 would not apply and the choice would then be between options 3 and 4. However, option 4 is inconsistent with the decision to keep the valuation of NPLs at nominal value in the balance sheet.

Response received

7. The proposals of the paper SNA/M1.06/25.1 were referred to the AEG members to solicit their opinion through a questionnaire. The questions asked of AEG members and responses received through e-discussions have been summarized in the following table.

As on 24 January 2006

No.	Question(s)	Response received			
		Total	Agree	Disagree	No opinion
1	Do you agree with this analysis of the options available for recording FISIM on a non-performing loan?	22	20	1	1
	If so which option do you prefer?				
2	Option 1	22	21	1	-
3	Option 2	12	1	11	-
4	Option 3	12	-	12	-
5	Option 4	12	-	11	1
6	If not, what alternative do you propose?	4	1	1	2

Conclusion

8. The AEG members participating in the e-discussion overwhelmingly support option 1 of the analysis of the options available for recording FISIM on non-performing loans.

An extract of comments made by AEG members is annexed.

Extract of Comments Made by AEG Members in the Questionnaire

The original response and full comments are available on the UN website¹. The objective of this annex is only to give limited extracts to encourage readers to read the full comments of the AEG members.

On the question: "Do you agree with this analysis of the options available for recording FISIM on a non-performing loan?"

One participant responded that there are three issues that need to be dealt with:

(1) The principles and their application for interest, FISIM, and increase in principal outstanding should be elaborated together for performing and nonperforming loans. When interest accrues but is not yet due, the increase in principal outstanding reflects the total bank interest without distinguishing SNA interest and FISIM. If so, why is it necessary to have specific guidance that unpaid FISIM on NPLs should be included in principal outstanding? Even for performing loans, FISIM may not be "required to be paid" (as discussed in the paper's option 2) because interest may be due for payment only periodically and even at maturity. If SNA tightens up its definition of "principal" to mean "the full outstanding amount of the loan liability" then unpaid FISIM fits naturally in there. At the moment, it does not even say that unpaid interest is "part of principal." Refer to appendix 1 of the final EDG report.

(2) The question of how long interest should accrue on NPLs should be first decided. For the period interest accrues, the treatment of interest, FISIM, and principal outstanding should be same whether interest accruals refer to performing or nonperforming loans. If a decision is taken to have a period after which interest does not accrue on NPLs, the issue of loans subsequently regaining performance status would need to be dealt with.

(3) Pricing for financial intermediation services may be further developed to elaborate the volume and prices of financial services. For example, one argument is that financial service providers would take into account some default in determining their charges. We realize that this is beyond the scope of current update.

Some participants regarded option 1 as closest to the 'correct' option in a system that records NPLs at nominal, rather than market, values. However, there are significant reservations about recording FISIM on NPLs for loans that are 'dead and buried', but have not been written off because of the 'damage' this would do to the balance sheet. The view is that there is no service provided on such loans. Option 2 says switch to cash accounting, but that creates excess lumpiness and it doesn't always give a reliable picture of the bank's situation. Option 3 is internally inconsistent—we can't say that the interest is there for some purposes, but not for others. Option 4 also results in inconsistencies.

A participant commented regarding the implementation of option 1, that the goal is to give an informative picture of the bank's true situation. This means that we do want to count accrued interest on NPLs, but only to the extent that that interest is likely to actually get collected one day. In most countries, banks are required to stop accruing interest if collection is doubtful or they are more than 90 days past due. So during normal times, the amount of interest that banks are accruing on their income statement is usually very close to what's actually going to get collected in cash.

During the financial (savings and loan) crisis in the US, 15 years ago, some banks were egregious counter-examples to this statement. If there is a crisis type situation, where there is reason to believe that banks' accrual accounting is overly optimistic, we must make our own estimate of what's really going to get collected. But under normal conditions, we can probably take the banks' word for it without much risk of allowing a material distortion into our accounts. Of course, even in normal conditions, one could argue that some portion of the "provision for credit losses" should be deducted from accrued income for national accounts purposes.

In countries that have effective bank regulation, the income and balance sheet measures that are viewed as the most important and reliable ones by the regulators are going to be the ones that give the truest picture of the actual situation. For other countries, the national income accountant should make independent estimates of accrual measures of income and assets.

Yet another participant finds the analysis of options as generally satisfactory, but do not agree with any of the options put forward! The preference is option 1, but with a time limit to NPLs that have been non-performing for, say, less than a year. After that, FISIM on NPLs. should not be recorded.

¹ <http://unstats.un.org/unsd/sna1993/viewvote.asp?tID=4&stID=1&sstID=0>