*Proposed treatment of nonperforming loans in the new SNA*

The treatment of nonperforming loans (NPL) in the new SNA follows the decisions taken by the AEG. The implementation of this decision requires further input on how to classify loans, and specifically NPL, according to their quality and provisioning level? for provisioning purposes. The proposal here follows the loan classification as described in the Appendix VI of the IMF's Compilation Guide on Financial Soundness Indicators of July 30, 2004.

Based on a World Bank study titled "Bank Loan Classification and Provisioning Practices in Selected Developed and Emerging Countries" (BLCP), an example is provided by the Institute for International Finance (IIF) for how to classify loans. Five categories are proposed: (1) Standard: Credit is sound and all principal and interest payments are current. Repayment difficulties are not foreseen under current circumstances and full repayment is expected. (2) Watch (special mention): The credit is subject to conditions that, if left uncorrected, could raise concerns about full repayment. Such credit requires more than normal attention by credit officers. (3) Substandard: Full repayment is in doubt due to inadequate protection (e.g., on account of diminished obligor net worth or collateral) and/or interest or principal or both are more than 90 days overdue. These assets show underlying, well-defined weaknesses that could lead to probable loss if not corrected. (4) Doubtful: Assets for which collection/liquidation in full is determined by bank management to be improbable due to current conditions and/or interest or principal or both are overdue more than 180 days. Assets in this category are considered impaired but are not yet considered total losses because some pending factors may strengthen the asset's quality (merger, new financing, or capital injection). (5) Loss (write-off): An asset is downgraded to loss when management considers it to be virtually uncollectible and/or principal or interest or both are overdue more than one year.

Country practices differ on whether ex-post or ex-ante information should be used to assess loan classification. Ex-post methods rely on specific observable evidence from past behaviour (such as 90-day non-payment of interest and/or principal) or the current condition of the debtor. Ex-ante methods assess future losses by considering forward-looking information and a wide range of factors that could affect the ability of the debtor to meet the loan conditions. Reliance on ex-ante methods has been increasing with the shift towards more risk-focused supervision and the use of internal models to evaluate risk.

The classification of loans as non-performing corresponds to the classification categories 3 and 4. It means that principal or interest payments are overdue for more than three months and provisioning might be based, for example on the unsecured portion of the loan and assessed at 20% of sub-standard loans, 50% of doubtful loans, and 100% of uncollectible loans. Despite some major empirical issues rough estimates of NPL may be carried out and recorded - preferably in a system of supplementary accounts.[1]

The stock of loans can be split into performing loans, belonging to the categories 1 and 2, and NPL, belonging to the categories 3 and 4. According to the AEG decision the stock of loans has to be recorded at nominal value. Uncollectible loans (category 5) are written-off and do not show up anymore in the balance sheet.

In addition to the nominal value of loans, supplementary information has to be provided for NPL. One part of the NPL might be fully covered by loan loss provisions, while this might not be the case for others:

The table describes which positions and flows have to be recorded for non-performing loans to allow a rather complete picture on stocks, transactions, reclassifications and write-offs of nonperforming loans. It starts with the recording of nominal values for loans, performing and nonperforming. Information is also included on loan loss provisions made for type 3 and 4 of loans. One part of the nonperforming loans might also not yet be covered by loan loss provisions. The second part of the table provides data on the

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1 Such an accounting treatment might also be used for other "implicit asset and liabilities" like unfunded employer pension liabilities and social security liabilities or one-off government guarantees. See R. Mink, "Implicit assets and liabilities within an updated System of National Accounts," note prepared for the IMF Task Force Meeting on Pensions of 21 to 23 September 2005.

market equivalent values of the various types of nonperforming loans based on the calculation of loan loss provisions.

The example in the table shows an outstanding amount of loans at nominal value of 1000 in t-1, of which 500 are performing and 500 are nonperforming. The major part of the nonperforming loans, 400, is covered by loan loss provisions, while 100 are not. The second part of the table provides detailed supplementary information on the market equivalent value of the non-performing loans. It is derived as the difference between the nominal value and the loan loss provisions. It t-1, it is assumed to be 375. During the period from t-1 to t, parts of the loans are reclassified (from performing or not yet covered to nonperforming or from nonperforming, type 3, to nonperforming, type 4, and vice versa) or written-off. The flows are shown in the corresponding columns of the table. For the loan loss provisions the nominal values and the market equivalent values are also presented.

In conclusion, the assessments on loan loss provisions have to be made in the framework of the accounting standards, the legal status and the taxation rules applicable to the units, which might lead to rather heterogeneous results in terms of amounts and duration of loan loss provisions. This makes it difficult to treat nonperforming loans in the core accounts. It seems preferable instead to provide market equivalent values as a supplement to the standard table showing the nominal values of loans, performing and nonperforming.

**Recording of non-performing loans**

| Positions | Stock | Transaction | Reclassification | Write-off | Stock |
|---|---|---|---|---|---|
| | t-1 | period t-1 to t | | | t |
| | ***Nominal value*** | | | | |
| *Loans* | *1000* | *200* | *0* | *-90* | *1110* |
| *Performing loans* | *500* | *200* | *-50* | | *650* |
| *Non-performing loans* | *500* | | *50* | *-90* | *460* |
| *Covered by loan loss provisions* | *400* | | *70* | *-90* | *380* |
| *Type 3* | *250* | | *30* | *-20* | *260* |
| *Type 4* | *150* | | *40* | *-70* | *120* |
| *Not yet covered by loan loss provisions* | *100* | | *-20* | | *80* |
| | ***Market equivalent value*** | | | | |
| Non-performing loans | 375 | | 24 | -51 | 348 |
| = Nominal value | *500* | | *50* | *-90* | *460* |
| - Loan loss provisions | 125 | | 26 | -39 | 112 |
| Type 3 (20% of nominal value) | 50 | | 6 | -4 | 52 |
| Type 4 (50% of nominal value) | 75 | | 20 | -35 | 60 |
| o/w not yet covered | *100* | | *-20* | | *80* |