

The author of this contribution to the discussion group on this site bears the sole responsibility for both the substance and the style of the contents. The purpose of the discussion group is to elicit comments and to promote debate on specific topics. As such, the views expressed on any of the issues raised are not to be attributed to the IMF.

The Treatment of Nonperforming and Interest Accrual

By Isaac Svartsman
MFD, IMF
May 15, 2003

While the current SNA standard with respect to the treatment of impaired loans is fairly uncomplicated, easily understood, and applied, I question its usefulness in the current environment. That is, the concept of loan impairment is critical not only for microprudential, but for macroprudential purposes as well. Thus, other related definitions, such as total credit to economy should factor in the reduction in the loan (asset) volume due to the deterioration in credit quality of the loan portfolio. Thus, the standard should be revised to incorporate either the fair value or provisioning approach.

What constitutes a non-performance has been a subject to a lengthy debate. While there seems to be some convergence among different countries, there is still no uniform standard. What is clear is the need to establish a set of rules that would include at least one objective criterion that can be utilized by all countries subject to reporting. The criterion that seems to be getting acceptance is the past due status of the credit (usually 90 days or more). In addition, the standard should include an additional criterion that would allow categorizing a loan as impaired based on a subjective judgement as to the probability of collection of interest or principal. Often, a careful forward looking evaluation of individual loan quality shows that either interest or principal will not be repaid well before the 90 day period has passed.

Generally, the draft FSI Guide contains, in my view, an adequate definition of what may constitute NPL. However, it requires that payments of **both** interest and principal be past due, while I would recommend that either event should trigger classification of the loan as NPL. In addition the Guide assumes that national guidance would mandate that loans be classified as nonperforming “even in the absence of a 90 day past due payment, such as if the debtor files for bankruptcy.” Such additional standard does not exist in many countries. Thus, I would recommend that definition include the following two factors in addition to the 90 day criterion: “When: a) collection of interest **or** principal in full is in doubt; and b) the national standard for other reasons requires classification as NPL”.

Once the loan categorized as NPL, it should be considered value-impaired. This leads to another issue: how to quantify the impairment. There are two major approaches that seem to have gained acceptance: fair value approach as defined by the IAS 39 and provisioning approach. The provisioning approach implies that a loan categorized as

NPL should be classified at a minimum as a “substandard loan¹”. While the provisioning approach may seem to be more arbitrary and less “scientific”, it is preferable, in my view, because:

- It is better understood, more accepted, and less complicated than the IAS 39 fair value standard.
- As a result, the value adjustment can be expected to be more reflective of the impairment, particularly in the emerging economies when loans are generally short-term (under one year) and “market interest rates” are not easily determinable.

The amount of the adjustment depends on the provisioning rules tied to the loan classifications. While banks in many developed countries have developed fairly sophisticated approaches to provisioning utilizing assumption-intensive computer models, the provisioning rules in many other countries are based on percentages of total loans (loss allowances for loans classified substandard, doubtful and loss generally range from 15% to 25%, 40% to 60%, and 100% respectively).

The recognition of the impairment by the lender does not imply, of course, that the contractual obligation of the debtor is also reduced. To ensure symmetry, the obligation should be shown at its contractual (nominal) value. The adjustment could be handled by the establishment of special reserves, reported as a contra asset², and general reserve in the “Share and other equity accounts”. The relevant disclosures should be clear as to their attribution as they are relevant for the purposes of macro analysis.

When a loan is recognized as nonperforming, interest accrual should immediately cease. Since the collection of the interest accrued to date is now in doubt, it would be appropriate to either reverse the accrual or fully provide for interest that is not expected to be received.

¹ Under the system that employs the following widely accepted in many countries loan classification categories: satisfactory, watch, substandard, doubtful, and loss.

² The presentation of specific reserves on the liability side of the balance sheet is an acceptable practice in some countries. However, the impairment value from the disclosure standpoint is more appropriate if shown as a contra asset.