Treatment of Non-Performing Assets (NPAs) in macroeconomic statistics

Part A - Policies and Practices

Classification of loans and off-balance sheet items

There is no uniform system of classification of loans and off-balance sheet items. Many countries have adopted, mainly through regulatory and supervisory framework, a three- tier approach towards classification of Non-Performing Assets (NPAs), corresponding to 'substandard', 'doubtful' and 'loss' categories, using delinquency period as the main bench mark. Thus, 'substandard' assets are those where principal and/or interest are more than 90 days past due; 'doubtful' assets are those where principal and/or interest are at least 180 days past due; and 'loss' assets are those where principal and/or interest are at least 1 year past due. This classification categories is also applied to contingent accounts or Off-Balance Sheet items, since they are treated the same way as loans.

The delinquency period is applied for classification of various 'on-balance' sheet assets and 'off-balance' sheet items, so as to provide, among others, an objective criterion for appropriate classification, depending on the possibility of collectibility. However, if, in the bank's judgement, an asset is impaired to such an extent and its collectibility is in serious doubt that it should straightaway be classified as 'doubtful' or 'loss', the bank will do so, at any time, without waiting for the delinquency period.

The delinquency period varies across countries and it differs in relation to the types of accounts. Also, in some countries, banks themselves classify the loans, on the basis of judgmental factors.

In view of the varied practices followed, primarily depending on the structure of the banking system, credit delivery systems, and socio-economic conditions, it will not be advisable to prescribe a set of definition of Non-Performing Assets. One may rely on the approach adopted by the national authorities. It should, however, be made a requirement that the system followed in the matter of classification of assets, should be explained fully, in the form of footnotes to the accounts .

Provisioning requirements

The practices of provisioning differ among countries, following the asset classification system adopted. Most of the countries have adopted the standard requirements of provisioning - 20 percent of the outstanding balance in respect of 'substandard' category of assets; 50 percent in respect of 'doubtful' category; and 100 percent in respect of 'loss' category.

While some countries have imposed lower percentages, yet, some others have adopted the system of provisioning, in a phased manner. Recognition of collateral - fully or partially - in assessing the provisioning requirements, as applicable in some countries, has great impact on provisioning. Also, tax deductibility of specific provisions towards loan losses, as extended by tax authorities in some countries, constitutes a strong positive incentive for banks to make adequate provisions. It is, therefore, necessary that banks should be required to fully explain the policies and procedures adopted in making provisions towards NPAs.

Recognition of income on Non-Performing Loans (NPLs)

Stricter regulations have been laid down by supervisory authorities in many countries with regard to income recognition on Non-Performing Loans (NPLs). The suspension of interest payments is required on loans that are classified as 'non-performing' ['substandard', 'doubtful' and 'loss']. Any uncollected interest payments on NPLs is considered non-accrued interest. Previously accrued, but uncollected interest, is reversed out of income. Failure to do so would overstate income. Uncollected interest is normally put in a memorandum account. NPLs are restored on an accrual basis only after full settlement has been made on all delinquent principal and interest. It would, therefore, be useful, if the accounts carry a footnote, explaining the accounting policies followed with regard to recognition of income on NPLs.

Criteria for 'write-off' of bad loans

The policy with regard to 'write-off' of bad loans by banks is set by the Board of Directors, depending, among others, on the repayment culture and legal system prevalent. It will be inadvisable for the regulatory authority to lay down specific guidelines as to when a loan could be considered as 'non-recoverable' and written- off. The banks may, however, be exhorted that balance sheets would need to be cleansed, as early as possible.

Part B - Reporting requirements

Interest Income

Ideally, interest income should reflect only interest income realised and should exclude interest accrued on NPLs, so as to avoid overstating of income.

The banks may be required to report the balance of uncollected interest on NPLs, as a memorandum item. It would be useful, if additions and deletions during the preceding specified period are also reflected.

Loans

It will be appropriate to record the "specific provisions" as a contra item, thus reducing the total loans outstanding, so as to reflect the recoverable value of the loans. Thus, while specific loan loss provisions are reported as contra asset, nonetheless, provisions, other than for loan losses, should, however, appear under "liabilities"

Non-Performing Assets (NPAs)

The banks may be required to report Non-Performing Loans (NPLs), preferably under various categories, as a memorandum item. It is important that the amount of outstanding NPLs should not include interest not realized. The additions and deletions during the preceding specified period may also be reflected.

The total of on-balance sheet assets, other than loans, and off-balance sheet items, classified as 'non-performing', may be reported separately, under various categories. Additions and deletions during the preceding specified period should also be reported.

Provisions

"General" provisions may be required to be reported as a separate item under 'capital and reserves'.

The "specific" provisions may be required to be reported, so as to facilitate arriving at provision-adjusted NPLs i.e., Net NPLs. Additions and deletions during the preceding specified period may also be required to be reported.

General

Cross country comparison of financial soundness

If the policies and practices followed in the matter of classification of assets, provisioning, income recognition etc., are fully explained, it will be possible for the analysts to make meaningful cross country comparison of financial soundness.

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