BOPCOM-01-23

Fourteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Tokyo, Japan, October 24–26, 2001

Treatment of Allowances for Loan Losses and Non-Performing Loans

Prepared by Art Ridgeway
Statistics Canada

Treatment of Allowances for Loan Losses And Non-Performing Loans

A Note for the Fourteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Tokyo, Japan, October 24-26, 2001

Art Ridgeway
Balance of Payments Division
Statistics Canada

Introduction

This note examines the treatment of allowances for loan losses in the context of the international investment position (IIP) and the national balance sheet accounts. The article will review the current international standards and the Canadian practice with respect to loan allowances as well as discuss how conflicting data demands may be resolved.

Allowances for loan losses are deducted from the face value of a specific financial claim or a group of claims, usually loans, to reflect the realizable value of such claims. Allowances increase as new provisions are booked with respect to loans that have reached some level of non-performance.

The creditor estimates the provisions and allowances, as loans are generally nonmarketable claims. In limited cases secondary markets have appeared for some of these assets and in these cases transaction values would more accurately reflect realizable values. Creditors are, under many situations, expected to declare such allowances so as to present a more accurate valuation of their financial position.

However, the debtor is still liable for the full amount agreed upon at the time of the contract between the creditor and debtor and is generally expected to present his accounts on this basis. This discrepancy between the creditor's and the debtor's books raises issues when aggregate economic accounts are constructed.

Current international standards

Balance of Payments Manual (BPM-5)

In BPM-5, the basis of valuation for assets and liabilities is the market price (paragraph 91). However, for nonmarketable financial items, primarily loans, the manual states that nominal or face values should be used (paragraph 106). In the chapter on the International Investment Position (Chapter XXIII), the possibility of an inconsistency arising from a creditor recording a discounted loan at its realizable value using secondary market quotations while the debtor maintains its book value at the contractual value is discussed (paragraph 471). The manual suggests that the creditors provide supplementary information on the nominal value so that accounts can be reconciled.

1993 System of National Accounts Manual

The SNA states that loans are to be recorded in the balance sheets of both creditors and debtors at the value that the debtors are contractually obliged to repay the creditors (SNA: Loans (AF.4) paragraph 13.72).

Monetary and Financial Statistics Manual

Along with the other standards mentioned above, the MFS recommends to use the value of the debtor's obligation to record loan data and specifically mentions not to adjust loan data for expected losses (Chapter V: Stocks, Flows, and Accounting Rules, paragraph 206). However, the manual recognized that law or regulation might require that lending institutions provide data on the basis of expected realizable value of loans (paragraph 207). It further adds that this information is useful and should, even if not required by law or regulation, be shown as a memorandum item accompanying the balance sheet**.**

Government Finance Statistics Manual (forthcoming?)

As with the other three international manuals, the GFS indicates to value loans at the value of the outstanding principal that the debtor is contractually obliged to repay the creditor (Chapter 10, The Balance Sheet, paragraph 10.85).

Canadian Practice

The Canadian IIP has always made an adjustment to government assets to account for inactive assets (those that are not currently revenue-producing or realizable, C*anadian balance of payments and international investment position: a description of sources and methods*, p. 200). From 1945 and till the late 1970's, the allowances were small (less than $100 million) and related to three bilateral loans to foreign governments[1]. In the mid 1970's, an interdepartmental study recommended that allowances for the valuation of the recorded assets of the government be systematic in order to show more accurately the amount expected to be collected or recovered from financial claims (P.A., vol. 1, 1979-80, introduction). This change increased the allowances published in the IIP by more than $3 billion. The allowances from that time on cover all loans by the federal government and its enterprises. This information was integrated in the IIP data in the late 80's when data on foreign loans became available.

Data on allowances from the corporate sector (banks) were included for the first time in the 1991 IIP (with revisions going back to 1984). Prior to that the allowances were not available on a resident/non-resident basis although by regulation lending institutions had to reduce the carrying value of their loans by an appropriate allowance (Office of the Superintendent of Financial Institutions (OSFI), Guideline C-1: Impaired Loans). The OSFI guideline is based on recommendations of the Canadian Institute of Chartered Accountants (CICA) regarding impaired loans (CICA Handbook, section 3025: Impaired Loans).

In 1984, OSFI issued to banks a guideline on establishing provisions for exposures to designated countries (OSFI, Guideline C-4: *Exposure to Designated Countries*). These countries had experienced difficulties in servicing their external debt to commercial banks. By using the total allowances published by the banks in their annual report (based on the Guideline C-4) and the data received from banks on their loan portfolio by place of booking, an estimate is derived and integrated in the IIP statement along with the allowances for Government loans.

---

[1] This information is published annually in the Public Accounts (P.A.) of the Government of Canada.

In the Canadian IIP statement, the allowances are shown as a negative entry beside the gross loan assets category under 'Other investment'. Total Canadian assets are therefore shown net of loan allowances. Canadian data published by the IMF in the *Balance of Payments Statistics Yearbook* presents the loans gross of allowances and the offsetting entry for allowances is included in the category 'Other assets' under 'Other investment'. At present, the series covering allowances is not sent to the IMF.

Canada publishes regional IIPs for the following six geographical areas: United Sates, the United Kingdom, Japan, Other countries of the European Economic Union, Other countries of the O.E.C.D. and All other countries. Data on loan allowances are shown in these regional accounts where applicable. This level of aggregation is sufficient to maintain confidentiality of the data for loan allowances, required by law in Canada. However, any further disaggregation by region or sector of the debtors would soon be constrained by confidentiality considerations.

The Canadian IIP data show that allowances have recently represented about 20% of the nominal value of international loan assets. These allowances had reached a peak of more than 60% in the late 1980's. The value of such information for the data user, as stressed in the MFS Manual, is recognized in the Canadian presentation.

The National Balance Sheet Accounts for Canada have reported domestic loan claims net of allowances for many years, in order to reflect business accounting practices for assets reflected on Statistics Canada surveys. In order to balance the assets with the liabilities, loan liabilities for the borrowing economic sectors were reduced. This treatment pre-dates the publication recommendations of the 1993 SNA. This practice of only showing the net loan assets and liabilities has meant that the information content of the loan allowances is not explicitly presented.

The allowances for the federal government and its agents lending to non-residents were incorporated in the balance sheet accounts at the same time as in the IIP. The practice of reporting loans net of allowances was further extended to other government loans (specifically, those of government business enterprises) at the time of implementation of the 1993 SNA[2].

Issues for discussion

The variety of users and uses of macro economic accounts often leads to conflicting demands for a single data set. Balance sheet accounts are no exception. Users want to have a clear picture of the creditor country/sector, a clear picture of the debtor country/sector **and** a system that is internally consistent.

Those who wish to study the accounts of the financial sector or the governments of developed countries will demand and deserve accounts for these sectors that fairly present the financial assets and liabilities in question. This principle of an investor's right to fair market valuations of

[2] The 1997 Historical Revision of the Canadian System of National Accounts: Record of changes in Classification of Sectors and Transactions, Concepts and Methodology, p. 45, paragraph 2.37

assets of companies in which he is considering investing has long been established as reasonable. In recent years, the deficit and debt problems faced by many developed countries, including Canada, has raised the awareness among citizens of the need to assess the balance sheets of their governments in assessing their overall fiscal performance. Canadians have come to demand and expect that the statistical system will also provide information that lives up to these principles for sectors of the economy. The Canadian statistical system could not possibly present only gross loan assets, particularly as in relatively recent years we have seen provisions reach the 60% range for international loans.

These same principles lead to a need to have the liabilities of debtor countries and sectors evaluated on a conservative basis – gross outstanding debt. For investors to properly assess the risks in investing in a country or sector, they require a fair valuation of both the assets and the liabilities of the country or sector.

In addition, as noted in the MFS manual, the data on allowances themselves are a valuable source of information. Aggregate data on allowances, within an economy or across international markets, should be monitored as a measure of imbalance in the financial markets.

In the case of allowances on loans, the needs of analysts can only fully be met through the presentation of both gross and net positions for these assets along with the allowances. This would provide a conservative valuation for both creditors and debtors while allowing the system to balance under the gross presentation.

It must be acknowledged that there will be cases where data and confidentiality constraints will prevent detailed disclosure of allowances for some sectors and geographic areas. It would not be expected that confidentiality constraints would exist at the total asset level for most developed countries or their financial sectors. This may not hold for some developing countries where the financial sector is less well developed.