IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

BOPTEG ISSUES PAPER # 13

Traded Loans - Criteria to Become Securities

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Traded Loans - Criteria to Become Debt Securities

The main issue is to determine when and under what circumstances loans that are traded become debt securities. This is an important issue because virtually all loans are potentially tradable and trading has increased. Classifying traded loans as securities also has consequences for valuation as positions on debt securities are valued at market prices and those on loans at nominal values.

BOPTEG Background Paper for Issues # 12/13 reviews existing statistical standards and discusses some possible options.

BOPTEG Issues Paper # 12 deals with a related issue of the classification of securities between portfolio investment and other investment within the functional classification of financial assets/liabilities.

1. Current international standards

The *1993 SNA* (para. 11.75) states that "Loans which have become negotiable de facto should also be classified under securities other than shares". *MFSM 2000* uses the same sentence (para. 134).

ESA 95 (para. 5.79) mentions that "Secondary trade in loans exists. However, individual loans are only traded incidentally. In cases where a loan becomes negotiable on an organized market, it is to classify in the category securities other than shares". Para. 5.62.j explains that "loans that have become negotiable de facto" should be interpreted "to mean only if they are traded on an organized secondary market." Describing various types of instruments covered in the category long -term securities other than shares, para. 5.62.k mentions "securities resulting from the conversion of loans" and states that "A conversion involves two financial transactions: the liquidation of the loan and the creation of the new securities". It seems that *ESA95* chose to use the term "conversion" rather than "reclassification" because in para. 5.62.k it suggested to impute two financial transactions.

GFSM 2001 (para. 7.111) states "Loans that have become marketable in secondary markets should be reclassified under securities other than shares and should be valued on the basis of market prices or fair values in the same manner as other types of securities other than shares."

External Debt Guide (para. 3.29) suggests the following. "If a loan becomes tradable and is, or has been, traded in the secondary market, the loan should be reclassified as a debt security. Given the significance of reclassification, there needs to be evidence of secondary market trading before a debt instrument is reclassified from a loan to a security. Evidence of trading on secondary markets would include the existence of market makers and bid offer spreads for the debt instrument. The Guide encourages the separate identification of the outstanding value of any such loans reclassified".

BPM5 does not mention traded loans becoming securities. While discussing valuation of loans that are traded (transaction values for creditors and nominal values for debtors) para. 471 mentions that the use of nominal values for debtors (a departure from market values) is due to “contractual restrictions that are usually applicable to such loans and that prohibit the debtor from buying back the loans in secondary markets unless the restriction are waived”. It further notes that “these limitations usually do not apply to bonds or other securities”. While positions on debt securities are valued at market prices, non-traded loans are valued at nominal values. For traded loans, *BPM5* para 471 mentions that “on the debtor side, the amounts of principal that debtors are contractually obliged to repay creditors when loans mature are used as the basis of valuation, and this practice represents a departure from the market price principle”. It seems that the ability to buy back is regarded in the *BPM5* as a condition for using market value on the debtor side.

2. Concerns/shortcomings of the current treatment

BPM5 does not address the issue of traded loans becoming securities. *ESA95* and *External Debt Guide* provide clear guidance on criteria for traded loans to become securities. While *BPM5* implies that unless the debtor can buy back the loans in secondary markets, the loans should not be reclassified as securities. *ESA95* and *External Debt Guide* do not mention the issue of buying back the securities by the debtor.

Concerning the treatment of flows arising from traded loans becoming securities:

- *ESA95* suggests imputing financial transactions;
- *GFSM 2001* and *External Debt Guide* imply recording in other changes in assets and liabilities account as they use the term “reclassification”;
- Even though the *BPM5* does not address the issue of traded loans becoming securities, para. 374 states that the shifts between portfolio and direct investment are reclassifications. Logically, the shifts from one instrument category to another should also be treated as reclassifications.

3. Possible alternative treatments

Concerning the criteria for traded loans to become securities, the *Annotated Outline* noted that “Loans that have been traded will be classified as securities under certain conditions, as stated in the *External Debt Guide* para 3.29. It will be noted that many loans are traded but not sufficiently to become securities” (para. 5.8.f). [1]

A question then arises as to whether trade in secondary markets is sufficient for reclassifying loans to securities or in addition to that there should be no restriction for buying back by the debtor.

When loans become securities, the resulting flows can be recorded as reclassification from loans to securities in the other changes in assets and liabilities account or as imputed transactions in loans and in securities. It seems more appropriate to treat these flows as reclassifications as implied in *GFSM 2001, External Debt Guide,* and *BPM5*. This will be a change to *ESA95*.

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[1] It should be noted that, following these criteria, all securities that result from the reclassification of traded loans will be treated as portfolio investment [irrespective of whether portfolio investment is defined according to the *BPM5* or the proposal in BOPTEG Issues Paper # 12 (that portfolio investment cover only securities that are readily tradable on organized financial markets)].

4. Responses to Annotated Outline

Paragraph 5.45(a): *Should the requirement for a tradable loan to become a security include that the debtor is not legally prevented from buying back the debt, which is necessary to ensure that the market value is also relevant to the debtor?*

Total responses	11	
Yes	7	• Elaborate the rationale for this treatment (1).
No	3	
Other	1	• Agree with the idea, but prefer that the focus is placed on “transferable loan” rather than “tradable loan” (1).

6. Questions/points for discussion

1. Do BOPTEG members agree that traded loans are reclassified as securities if a loan becomes tradable and is, or has been, traded in the secondary market?

2. What is the BOPTEG members’ view on whether, in addition to being tradable in secondary markets, there should be a requirement that the debtor is not legally prevented from buying back the debt?

3. Do BOPTEG members agree that the flows arising from traded loans becoming securities be treated as reclassifications in other changes in assets and liabilities account?

References

Annotated Outline paras. 3.17.e, 5.8.f, 5.34.a, 5.45.a, 6.16.c.

BPM5 paras. 374, 471.

1993 SNA para. 11.75

Government Finance Statistics Manual 2001 (paras. 7.111).

European System of Accounts 1995 (paras. 5.62, 5.79).

External Debt Statistics: Guide for Compilers and Users (paras. 3.29).

Monetary and Financial Statistics Manual 2000 (paras. 134).

Bank of Japan, *Classification and Valuation of Domestic Loans Sold to Non-Residents at a Discount in the Balance of Payments Statistics and International Investment Position*, BOPCOM-00/15.