F.9 Valuation of Loans (Fair Value) (BOPCOM 21/05)

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Background

- *BPM6/2008 SNA* Valuation of loans at nominal value could be seen as a deviation from the general *BPM6/2008 SNA* principles, partially influenced by practical concerns…

- …including those on data availability and on the way to easily ensure symmetry between debtors and creditors.

- Nominal value can be defended as an approximation in the absence of standard markets. However, “it is recognized that nominal value provides an incomplete view of the financial position, particularly when some loans are nonperforming” (*MFSMCG*, paragraph 5.123).
Reasons for Changes

- Review process leading to the 2008 SNA was completed before the outbreak of the 2008 great financial crisis and subsequent long-term effects. Need for further guidance on several issues highlighted by the crisis, and related policy responses.

- Traditional preferences for preventing underestimation of debt have been challenged by the need to avoid optimistic views on the creditor side.

- Post-2008 events and financial stability studies stressed the need for not overestimating assets.

- Memorandum items are better than nothing. But they are not reflected in the main balancing items: change in net worth may be considerably distorted.
Option 1 – Maintaining Current Nominal Valuation

- **Option 1a:** Do not change the current valuation of loans (status quo)
  - Leave in the updated SNA and BPM the provisions recommending that loans be recorded in the balance sheets of both creditors and debtors at nominal value.

- **Option 1b (recommended):** extend the existing guidance within the limits of the existing framework.
  - **Nominal valuation allowing for value resets**, in publicly known extraordinary events.
Option 2 – Shifting to Fair Valuation

- **Option 2a:** Change the existing valuation rules in the updated SNA and BPM, shifting to a simplified estimate for fair value, based on **nominal value less expected loan losses**.

- **Option 2b:** Change the existing valuation rules in the updated SNA and BPM, shifting to full **fair valuation at any time** for all loans in the core accounts.
Symmetry Between Debtors and Creditors Accounts

• The symmetry between debtor and creditor accounts is a fundamental principle of macroeconomic statistics, that should be achieved under any option.

• Nominal valuation has the advantage in reflecting the symmetry independently for creditors and debtors.

• In the options 1b, 2a, and 2b, the creditor’s view should be reflected in the debtor's accounts as well, as it is currently done for write-offs (recommended by the 2008 SNA, paragraph 12.40).
Comparing Options 1a (Status Quo) and 1b (Recommended Option)

- The current rules (Option 1a), while preventing continuous updates based on estimates, explicitly allow for value reset in a few cases: bankruptcy, liquidation, and other factors (=court orders). The issue of creditor/debtor symmetry is addressed by imposing the creditor view to counterparties, “to maintain balance in the accounts of the total economy” (2008 SNA, paragraph 12.40).

- Option 1b extends this approach beyond simple cases (bankruptcy, liquidation, and court orders). The same logic would be applied to other cases of reassessment of loans by a formal, publicly known process (e.g., in the context of bank recovery operations, imposing on shareholders to absorb a corresponding loss). The set of relevant cases should then be increased, but clearly identified and limited.

- Under Option 1b, the loans would still be recorded at nominal value, and standard provisioning would not affect balance sheets. Symmetry would be achieved as in Option 1a.
Comparing Option 1b with Options 2a (Written-down Value) and 2b (Full Fair Value)

- Option 2a provides a better approximation to full market valuation. In the absence of fair value data, it shows nominal value less expected loan losses. It is based on expectations and provisions. It takes continuously into account changes in value arising from impairment.

- Option 2a differs from Option 1b (nominal value adjusted for extraordinary events) in the regular use of provisions for impaired loans, implying revaluations of loans even if not traded. In Option 1b, loan values are revised ex-post (after the fact), only in cases of extraordinary events or formal procedures.

- Similar differences exist between Options 1b and 2b (full fair value approach), which is even more forward looking than Option 2a. Inter alia, Options 2a and 2b differ by the discount rate used (initial/at inception instead of current).
Merits and Costs

- The main **advantage** of the recommended Option 1b is the improved measurement of financial positions, notably for fiscal and financial stability analysis, minimizing the burden of changes. As a main **drawback**, it does not achieve a full alignment with the general market valuation principle (2008 SNA, paragraph 2.60).

- The main **advantages** of Option 2a (written-down value) and Option 2b (fair value) include consistency with the general principle of market valuation in the SNA and BPM, and better reconciliation with available business accounting data. The main **drawback** is the risk of inconsistencies at the cross-country level, and significant statistical burden of changing the current practice.
GN Recommendation

• Most FITT members supported maintaining the concept of nominal valuation within the current framework or with the extension to extraordinary events. Most authors of the GN supported Option 1b, one co-author is in favor of Option 2a (nominal value less expected losses).

• Several authors of the GN and FITT members expressed their concern on practical difficulties related to implementation of full market valuation, including difficulties in achieving the symmetry between creditors and debtors in cross-border positions.

• Some comments asked to clarify the “other factors” leading to a loan reset (extending what is already in the 2008 SNA).
Global Consultation Outcomes (1/2)

- A large majority of respondents favored Option 1 (maintaining the current nominal valuation)—59 out of 66 respondents (89 percent).

- Option 1b gained wider support—36 respondents (55 percent)—as it was seen as a flexible option allowing to reset loan values under additional specific circumstances, when the nominal value is not reflective of its actual value. It also strikes the right balance between users’ needs and source data availability.

- Option 1a (status quo) was supported by 22 respondents (33 percent). Some reporters considered that any fair valuation of loans—even in the limited scope of Option 1b—would be subjective, and hence potentially would create asymmetries.

- On practicality of implementation, half of the respondents (32) affirmed having access to the relevant source data for the implementation of Option 1b. Thirteen of them would be interested in testing this option, with nine indicating a need for technical assistance.
Global Consultation Outcomes (2/2)

- There was minority support for Option 2—only 4 respondents (6 percent).
- **Three respondents favored Option 2a** and considered it more feasible for implementation than Option 2b given the existing data sources. Full fair valuation was broadly viewed as challenging to achieve from the methodological and the practical perspectives.
- **On practicality of implementation**, eight respondents have access to the source data for Option 2a. Two respondents confirmed this for Option 2b. One respondent would be interested in testing Option 2b, and there is no interest in testing Option 2a.
Questions for Discussion

1. What option do the Committee and the AEG favor for the valuation of loans: nominal value (Option 1) or fair value (Option 2)?

2. If nominal value (Option 1) is the preferred option, do the Committee and the AEG favor the status-quo of the existing treatment (Option 1a), or its extension allowing for value reset in extraordinary events publicly known (Option 1b)?

3. If fair value (Option 2) is chosen instead of nominal value, would the Committee and the AEG prefer shifting to a full fair value approach (Option 2.b) or would they prefer its simplified version (Option 2.a) based on the measurement of nominal value less expected loan losses?