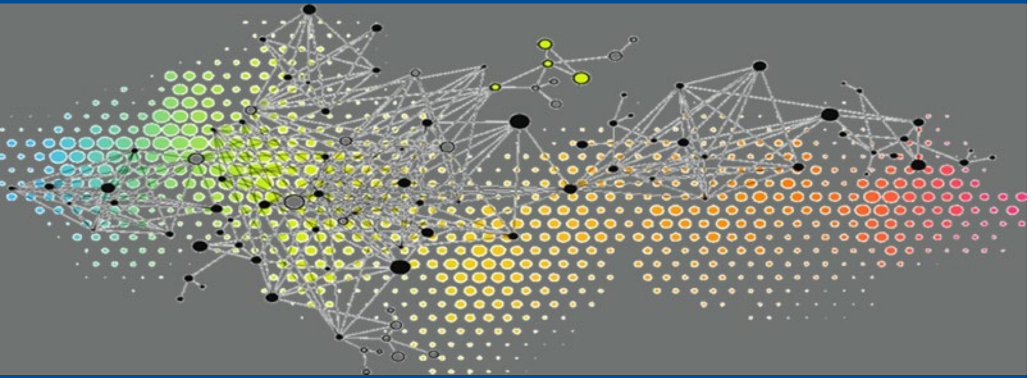

STATISTICS

Equity: The Case of Negative Valuations

24th Meeting of the Advisory Expert Group on National Accounts

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Background and Scope

Guidance Note D.2 narrows recommended valuation methods down to three

- Own funds at book value
- Recent transaction price
- Market capitalization (for instance, price-to-book value ratios)

The issue to be tackled

- Valuation methods can generate negative valuations of equity positions.
- Current statistical standards provide no explicit guidance on the treatment of such negative equity positions.
- Negative positions allowed in other cases, e.g., short positions.

Previous Discussions

IMF Committee on Balance of Payments Statistics (2019)

- Allow recording of negative equity positions (except if reporting is erroneous).

Government Finance Statistics Manual 2014

- **Unincorporated entities**: Allow recording of negative equity positions.
- **Incorporated corporations** with limited shareholder liability: Minimum value of equity position is zero.

European System of Central Banks Working Group on Financial Accounts (2019)

- Negative values for equity positions should not be recorded when the liability is limited.

Guidance Note D.2 on *Valuation of Unlisted Equity*

- Recognizes the need for further research.

When Is Negative Valuation of Equity Positions Meaningful?

Unlimited liability entities

- Typically branches, trusts, or quasicorporations that operate separately from their owner or notional units created to avoid combining entities in different economies.
- Owners are liable for all the debts and obligations of the entity.
  - Negative equity valuations are both legally and economically meaningful for unlimited liability entities.

Limited liability entities

- Limited liability protects investors from losses exceeding the value of their invested capital.
  - Recording negative equity positions for such entities in macroeconomic statistics would not be consistent with the limited liability aspect for equity owners.
- However, there are certain legal and economic exceptions.

Legal Exceptions to Limited Liability (I)

The case for legal exceptions

- Even for limited liability entities, there are exceptions to the limited liability aspects of legal nature.
- Investors may be liable for the debts of their subsidiaries due to legal obligations, bilateral arrangements with the authorities, or following decisions of the tax authorities.
  - Such cases should be assessed by the compilers on a case-by-case basis against the general rules.

Loan guarantees

- The authors are divided on whether a legal exception should be applied in the case of loan guarantees.

Legal Exceptions to Limited Liability (II)

Option 1 (recommended by one of the authors and the BPM and SNA editorial teams):

- Treat **loan guarantees** like other legal obligations and **allow for the recording of negative equity** (up to the amount of the guarantee) when shareholders have provided such guarantees.
- The rationale for this treatment is that loan guarantees are as legally binding as other legal obligations, and there are no economic or legal reasons to treat them differently.
- While this option allows negative equity to be recorded when there is a loan guarantee, it does not deviate from the general principle that the guarantee itself is only recorded when it is called.
- Since other legal arrangements mentioned on the previous slide are also contingent assets and liabilities, differences in the treatments of loan guarantees and other legal obligations would lead to inconsistencies.

Legal Exceptions to Limited Liability (III)

Option 2 (recommended by the other author):

- **Do <u>not allow</u> the recording of negative equity** when the shareholders have provided **loan guarantees**.
- The rationale for this treatment is that it would represent a departure from the general treatment of one-off guarantees which are not recorded in the accounts.
- The only exception to the general treatment is one-off guarantees granted by governments to corporations in certain well-defined financially distressed situations and with a very high likelihood to be called.
- Therefore, if allowing negative equity to be recorded in case of loan guarantees, what is now a rare exception only for guarantees granted by government would become the standard rule for guarantees granted by shareholders on the debt of the corporations they have a stake in.

Economic Exceptions to Limited Liability

The case for economic exceptions

- Majority shareholders choose the financing mix they provide to the corporations in which they participate in the form of either debt or equity.
- For instance, an MNE may choose to provide debt rather than equity financing for tax arbitrage purposes, with little impact on the overall ultimate risk borne by the parent.
  - Allow negative equity (up to the amount of loans provided by shareholders) when the shareholders would be subject to loan losses in case of bankruptcy.

Recommendations

Recording of negative equity positions

- **Unlimited liability entities**: Negative equity positions may be recorded.
- **Limited liability entities**: Negative equity positions should be zeroed out, except for certain legal and economic cases explained in previous slides.

Stock-flow consistency

- Should be ensured by recording **revaluations** equal to the change in the value of the lower-zero-bound adjustment within the period.

Horizontal and vertical consistency

- **Horizontal consistency** is maintained, provided the same value is recorded for liabilities of the corporation and the assets of the holders.
- Zeroing out negative equity could lead to **vertical imbalances** (total assets of an entity would no longer match total liabilities).
  - This will be picked up by net worth in the national accounts and is not an issue uniquely linked to the zeroing out of negative equity (e.g., also seen for listed equity).

Questions for the AEG

- Do AEG members agree that negative valuation of equity may be recorded for unlimited liability entities and should generally be zeroed out for limited liability entities, except for certain legal and economic cases explained in the note?

- Do AEG members support Option 1 (recommended by one of the authors and the BPM and SNA editorial teams) or Option 2 (recommended by the other author) regarding the recording of negative equity when shareholders have provided loan guarantees?

- Do AEG members agree that, for zeroed-out values, stock-flow consistency should be ensured by recording revaluations equal to the change in the value of the lower-zero-bound adjustment?