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BORDERLINE BETWEEN SECURITIES AND OTHER FINANCIAL INSTRUMENTS[1]

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Executive Summary

1. This paper deals with the distinction between components of the financial instrument classification. The basic distinction between securities and other instruments is based on tradability, but issues arise when an instrument initially a loan subsequently becomes traded or a security subsequently ceases to be traded.

2. The main issue is to determine when and under what circumstances loans that are traded become debt securities and, vice versa, debt securities that are not traded cease to be 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. This issue is discussed in *1993 SNA* paragraph 11.75. An alternative approach is not to reclassify traded loans as debt securities.

3. The converse case is that some securities cease to be traded and therefore lose some of the special characteristics. Again, the choice is to reclassify them, or to keep the original classification regardless of subsequent developments.

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[1] The original version of this paper was considered at the November-December 2004 meeting of the Balance of Payments Technical Expert Group (BOPTEG), which was set up to consider issues and advise the IMF Committee on Balance of Payments Statistics (the Committee). BOPTEG's recommendations to the Committee are available from the IMF website. The paper will be considered by the Committee at its meeting of June 27-July 1, 2005. The conclusions of the Committee will be supplied to the AEG in time for the July 18-22, 2005 meeting.

1. Current international standards

4. 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).

5. *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.

6. *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.”

7. *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”.

8. *BPM5* does not mention traded loans becoming securities.

9. 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.

10. Some securities cease to be traded due to delisting. The possibility of reclassifying these is not discussed in any of the manuals. However, by being untraded they lose the characteristics of instruments traded on financial markets.

2. Concerns/shortcomings of the current treatment

11. The manuals should be more consistent on when reclassifications occur and how the flows are to be recorded. It may be preferable to make classification on the basis of the original character of the arrangement, rather than subsequent changes which could vary over time and be hard to identify.

3. Possible alternative treatments

12. Concerning the criteria for traded loans to become securities, the *Annotated Outline for the Revision of the Balance of Payments Manual* 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).

13. If that approach is adopted, 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.

14. 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*.

15. An alternative approach is not to reclassify traded loans as debt securities, so changing the *1993 SNA* advice. The reasoning behind the approach is that because of the contracts between parties, loans have particular characteristics of their own and so their reclassification to debt securities would lose important information. Reclassification could also raise practical implementation problems.

4. Responses to Annotated Outline

16. 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 members agree that traded loans are to be reclassified as securities if a loan becomes tradable and is, or has been, traded in the secondary market? Alternatively, do members conclude that traded loans not be reclassified as debt securities?

2. If traded loans are reclassified as debt securities, should the definition of the requirements for a secondary market be elaborated according to the criteria in the External Debt Guide or some other criteria? What are the members' views 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. If traded loans are reclassified as debt securities, do members agree that the flows arising from traded loans becoming securities be treated as reclassifications in other changes in assets and liabilities account?

3. If traded loans are not reclassified, do members agree that loans should be broken down between traded and nontraded loans?

4. Do members agree that untraded securities should not be reclassified?

References

Annotated Outline for the Revision of the Balance of Payments Manual (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 (para. 7.111).

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

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

Monetary and Financial Statistics Manual 2000 (para. 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.