

I would like to comment on the draft position paper on *Loan Valuation Issues* (version of 2 June), specifically on Section 1 which covers terminology.

First, I should thank you for the very clear exposition of the different uses of key terminology that you cover. As a user and compiler of data, I am very aware of the confusion that such inconsistencies create. I cannot overemphasize the importance I give to standardising terminology, and would urge that every effort be made to achieve this in the updating of the SNA and BOP manuals.

I think that many of the differences that you highlight across manuals are just due to drafting rather than differences in fundamental principle. It seems to me that if you are explicit about three separate items,

1. The value of loans is the total amount outstanding.
2. The amount outstanding is the principal outstanding plus accrued interest outstanding.
3. The type of valuation that should be used for measuring loans (nominal/market/fair/present/historic etc.),

rather than trying to collapse them into one you can reach a transparent and common way of measuring loans that can be expressed clearly and unambiguously without using a questionable definition of principal, or confusing valuation methods with the item being measured.

I would not recommend use the ED Guide as your basic reference on the definitions of principal and interest (see my comments on this below). In fact, I do not see how any statistical manual can redefine the well established economic and language concepts of *interest* and *principal* which are used by everybody and not only statisticians. The task of these manuals is to statistically define more elusive concepts like *amounts outstanding* and *flows*, and items to put into statistical frameworks. So it is one thing to say that a statistical system defines flows to include all payments (principal and interest) rather than only principal repayments, or that both interest and principal payments should be included in box A.23.1. But it is quite another thing to say that interest is principal. The first definition is legitimate, reasonable and, most importantly, comprehensible by compilers and data users. The second definition is unfounded and bound to lead to inconsistent compilation and interpretation of the data. Of course, it is possible to transform interest into principal through capitalisation, but this should not an automatic invisible process. It would be appropriate for an accounting manual to recommend that all accrued overdue interest is capitalised and then recorded as principal, but not simply to say that interest is principal.

My own recommendations are very simple:

Do not use the ED Guide's definition (see my comments on this below) of principal

Do not attempt to redefine basic language and economic concepts

Principal is principal.

Interest is interest.

Payments on loans include principal repayments and interest payments.

Interest arrears are interest and they have accrued. It is therefore unreasonable to define the term *accrued interest* as excluding interest arrears. If you wish to limit the type of accrued interest reported in a particular table, then it is legitimate to say, "In this table, only accrued interest not yet due should be reported under accrued interest", but it is not legitimate to define the term *accrued interest* as accrued interest not yet due.

Do define items that can vary, or that do not have an undisputedly clear dictionary meaning

Amounts Outstanding (Stocks): The definition of amounts outstanding may vary, depending on what is being measured. *Amounts Outstanding* could apply to principal only, interest only and combinations of all or part of the two. The manual should define these components but not the terms *interest* and *principal*. EG. the ED defines external debt as including outstanding principal plus accrued interest (including interest arrears).

Flows: The categorisation of interest payments as flows can vary so it is important to define what is included under flows. Do they include principal payments and exclude interest payments? Do they include principal payments plus some types of interest payments e.g. late interest payments?

Define nominal and market value in general and then explain how to measure items at nominal and market value but do not confuse valuation methods with the items being measured

Nominal value is a method of valuation and not equivalent to principal. So phrases like “The nominal value of loans is the principal” should be avoided. Principal may be measured in nominal value and market value, but principal is not nominal value and nominal value is not principal. Principal may also be measured in market value, present value, fair value, at historic cost etc.

Comments on Definition of principal in External Debt Guide

Whilst I quite accept that the wording of the definition “*interest can, and usually does, accrue on the principal amount, increasing its value*” could give rise to the interpretation that accrued interest becomes included in the term principal, I cannot agree that this meaning is specifically and explicitly expressed in the ED Guide. Moreover, when you compare the ED Guide’s definition of principal with that of interest “*For the use of principal, interest can, and usually does, accrue on the principal amount, resulting in an interest cost*” you will see that it is clear, that in the latter at least, that interest remains interest. In my view, the ED Guide’s definition lacks clarity because it mixes up the issue of valuation with the definition of principal, and this should be avoided in the future.

I think it is important to recognise that the *amount outstanding* on an external debt instrument includes both outstanding *principal* and outstanding *accrued interest*. This is very clear in the manual, and should be used to inform the debate on the valuation of loans.

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