

## **Comments by Philippe de Rougemont<sup>2</sup> to the draft Report of the Moderator of the EDG on Non Performing Loans (August 16, 2004)<sup>3</sup>**

1. The Moderator of the Electronic Discussion Group (EDG) on Non Performing Loans (NPL) circulated a questionnaire (in June or July 2004, with a deadline by July 23) with four proposed options:
  - a. **Option 1:** no change to the *1993 SNA*;
  - b. **Option 2:** no change to the core recording of the *1993 SNA*, with a mere addition of a memorandum item to show expected losses on impaired loans;
  - c. **Option 3:** change the *1993 SNA*, with recording loans on a “market equivalent value” basis when assets, and on a nominal basis when liabilities (therefore abandoning symmetry);
  - d. **Option 4:** change the *1993 SNA*, with recording loans on a “market equivalent value” basis when assets as well as when liabilities.
2. The draft Report<sup>4</sup> of the Moderator of the EDG, dated August 16, 2004, and submitted for comments, concludes in favor of Option 2.

### **An inconclusive consultation process at this stage**

3. **My main comment**, purely personal for the time being, **essentially suggests that flaws in the consultation process (notably in the past few months) cannot allow concluding on a sound basis** at this stage of the international discussion.
4. It can be observed that:
  - a. Many assimilate Option 4 to full fair valuation of loans, which is not particularly helpful giving the emotional debates around the proposal by the International Accounting Standards Board (IASB) to extend fair valuation to (some) loans;
  - b. Many do not customarily distinguish between gross and net values of loans, a distinction fundamental and casually used in business accounting; the issue is not fully documented by the EDG draft Report<sup>5</sup>;
  - c. The terms write-off and write-down are often used to mean various things, or used interchangeably (including in *1993 SNA* and the ESA 1995), a question insufficiently explored in the EDG draft Report<sup>6</sup>.

---

<sup>1</sup> Paragraph 4 amended on request of the EDG Moderator, as well as paragraph 52 and 53.

<sup>2</sup> Philippe de Rougemont is an economist at Eurostat Unit C.3 (Public Finance and Taxation). He is in charge of financial accounts and of excessive deficit procedure issues. **The views mentioned here are personal and do not necessarily reflect those of Eurostat.**

<sup>3</sup> See on the IMF web site at <http://www.imf.org/external/np/sta/npl/eng/discuss/index.htm>

<sup>4</sup> See at: <http://www.imf.org/external/np/sta/npl/eng/2004/081604.pdf>

<sup>5</sup> See example of EDG contributions using this distinction: notably the ECB, para 24 (at: <http://www.imf.org/external/np/sta/npl/eng/2004/080704.pdf>); or Carmencita Santos (at: <http://www.imf.org/forum/Message2.asp?forumid=9&messageid=288&threadid=288>).

<sup>6</sup> See, notably the ECB contribution to the EDG para 8 2<sup>nd</sup> sentence and following. See a case of word substitution in Bloem/Gorter *The treatment of NPL in macroeconomic statistics* (IMF Working Paper/01/209) para 35, 3<sup>rd</sup> bullet (“write-off” used to mean “write-down”). See at: <http://www.imf.org/external/pubs/ft/wp/2001/wp01209.pdf>

5. One can observe that the EDG contributions overall showed strong support for valuing loans on a sounder basis than currently considered in the *1993 SNA*. However, the results of the EDG Moderator questionnaire somewhat reversed this preliminary indication, with a (small) majority favouring Option 2 (although Option 4 was supported by many, **but** in varying degrees).
6. It is, hence, a matter of legitimate question whether the EDG Moderator questionnaire was inadvertently biased, with a potential to mislead respondents or misinterpret answers:
  - a. The term “**market equivalent valuation**” used for Option 4 without extensive explanation was naturally bound to create an emotional rejection with some respondents, particularly at a time of acerbic exchanges in the accounting field on the merit of full fair valuation of loans (suggested by IASB and bitterly resisted in Europe, including by the ECB)<sup>7</sup>;
  - b. The questionnaire advises that Option 2 reflects the debtor’s legal obligations whilst Option 4 does not, were technically incorrect, because financial accounts/flow of funds use the accounts of the creditor (i.e., his time of decision to derecognize loans), irrespective of whether legal obligations remain or not—as the ECB rightly insists in its EDG contribution, see its executive summary point 5, bullet 2, 3<sup>rd</sup> sentence, and also para 25;
  - c. For the same reason as in b-, the questionnaire advice against Option 4 that “market equivalent values is possible, but difficult” was unwarranted because banks (and other creditors) maintain their portfolio of loans net of allowances, and financial accounts use the data of creditors (notably for banking sector claims).
7. It is therefore argued that **Option 4 should have been split in two**:
  - a. (4a) Net valuation (deducting the expected unrecoverable amounts);
  - b. (4b) Full fair valuation.
 This would have allowed respondents not to feel constrained by the heated on-going debate on full fair valuation.
8. The Moderator questionnaire comprised a unique question (i.e., choice between four options), which could not allow measuring objectively the reasons that dominated in the choice of respondents—preventing the Moderator the chance of qualifying the said responses. In addition, the questionnaire was backed by an abbreviated description of only two pages (documentation on Option 4 covered a total of 3 paragraphs encompassing a grand total of 10 lines).
9. It is noted that the questionnaire did not refer to Generally Accepted Accounting Practices (GAAP), a rather stunning feature at a time of renewed dialogue between the statistical and the accounting communities. In this vein, François Lequiller suggests that the emergence of *international* standards in business accounting scores as one criterion eligible to elect issues for the SNA review<sup>8</sup>.

<sup>7</sup> The European Union senior advisory body on statistics, the CMFB (Committee on Monetary, Financial and Balance of payment statistics), took notably position against IASB’s proposals of full fair valuation of (some) loans. See, for instance, its opinion (notably para 12 and 14) of July 7, 2004 on the Fair value option in IAS 39: <http://www.cmfb.org/pdf/CMFB%20opinion%20on%20FVA%20under%20IAS%2039-final.pdf>

<sup>8</sup> See *The treatment of provisions: elements for the review of the SNA*, para 6 at: <http://www.oecd.org/dataoecd/53/49/33740137.pdf>

10. Further consultation was originally scheduled to take place in the context of the Balance of Payments Technical Expert Group (BOPTeG) (December) as well as within the Eurostat's Financial Accounts Working Party (FAWP) (18-19 November 2004)<sup>9</sup>. However, more recently it seems that the Balance of Payments Committee (BOPCOM) October meeting would be asked to come up with a position.
11. On September 22, the Chair of the Eurostat *Task Force on SNA Review (financial accounts and government finance statistics)* indicated<sup>10</sup>: "It is the opinion of the Task force that the debate on a review of the SNA regarding the statistical treatment of non performing loans ought to take into account additional considerations not yet fully treated by the Moderator's Report, notably those related to public finance, before final submission to the AEG and final closure, currently envisaged it would seem for the November 2004 AEG meeting".<sup>11</sup> The note (see Annex I) raised the more general issue of time of derecognition of loans and the link with GAAP, which were felt not fully discussed in the draft EDG Report.

### **Write-off, write-down, gross valuation and net valuation of loans**

#### *Statistical categories, business practices and terminology*

12. Aside from determining how instruments are valued on balance sheet in the *1993 SNA*, there is a need to decide (1) the criteria for asset recognition, and (2) what are the types of flows via which changes in value are recorded: transactions, revaluations, and other changes in volume.
13. As such, the terms "write-offs" or "write-downs" or debt cancellation or debt forgiveness do not correspond to statistical categories. Instead, those terms correspond to types of events that we observe in the "reality"— or to be more precise in the practice of business as well as in the practice of business accounting.
14. The *1993 SNA* uses the terms write-off and write-down sometimes seemingly as synonymous (as well as ESA 1995—see ESA 5.16 and 6.27d), whilst in the business practice they are not. The understanding by the majority of statisticians is to make a distinction, but some do not. This question directly impinges on the interpretation of what the *1993 SNA/ESA 1995* see as the correct valuation of loans.

#### *Basics of business accounting*

15. At the risk of appearing pedantic, I think it useful to come back to traditional business accounting recording, and the practice of recording impairment of loans and other assets. Bloem and Gorter mention three ways for such an impairment recording<sup>12</sup>. It would have seemed an essential input to the EDG to enquire about current accounting practices across countries—in addition to IASs (see Gorter/Bloem para 34) or Basel Committee on Banking Supervision (see Gorter/Bloem para 35).

---

<sup>9</sup> Eurostat and its FAWP, managed by the Unit C.3 and Chaired by Dieter Glatzel (Advisor to Directorate C), have leadership in methodology in Europe regarding financial accounts/flow of funds as well as government finance statistics (both based on ESA 1995).

<sup>10</sup> See at: <http://www.imf.org/forum/Message2.asp?forumid=9&messageid=426&threadid=425>

<sup>11</sup> The EDG Moderator was invited to the Task Force meeting of 17 November 2004 in Luxembourg.

<sup>12</sup> See *The treatment of NPL in macroeconomic statistics* (IMF Working Paper/01/209) para 33. See at: <http://www.imf.org/external/pubs/ft/wp/2001/wp01209.pdf>

16. The presentation of financial statements often uses the practice of showing 3 columns on the assets side of the balance sheet: (1) gross value, (2) amortization/provisions/allowances, and (3) net values—i.e., net in the sense of  $(3)=(1)-(2)$ . Note that this presentation is relaxed when assets are valued at market values. To some extent, the two first columns should be seen as “memorandum items” to the balance sheet. Therefore, the reference to book value of assets should be more conceived as the net amounts.

Gross values		amortizations provisions allowances		Balance sheet			
(1)	(2)	assets (3)		liabilities			
200	140	60	Buildings	Shareholder equity		300	
1050	110	940	Loans	debts		700	
		1000	Total	Total		1000	

17. Additions to amortization/provisions/allowances reduce shareholder equity<sup>13</sup> and are charged in the profit and loss. (see a numerical example in Annex II).
18. Fixed assets are thereby amortized and shown in the balance sheet net of amortization. Similarly, impaired loans (or other assets not valued at market) are marked down by way of adding to the provisions/allowances.
19. When the fixed asset is decommissioned or when the loan is deemed irrecoverable, gross amounts are deleted. It is likely that such events impact neither shareholder equity nor the profit and loss of the period, because the assets in question will have been fully amortized or provisioned before then.
20. In this context:
- A **write-down** is a reduction of the net value by way of adding to amortization/provisions/allowances;
  - A **write-off** is a reduction of the gross value;
  - A **partial write-off** is when the gross value is deleted in part instead of in full.

*Write-off, cancellation and legal obligations*

21. Claims in the form of loans are shown in the balance sheet of the creditor because they usually represent cash flows receivable that are enforceable, in the sense that the debtor has a contractual/legal obligation to pay.

<sup>13</sup> Shareholder equity corresponds to the net value of the company, where assets and liabilities are values at book value and having in mind that shares issued are not liabilities. Shareholder equity is similar in concept to SNA/ESA “Own funds” (i.e., assets minus liabilities, excluding equity liabilities), rather than “Net worth”. Net worth (B.90) is equal to assets minus liabilities. As ESA/SNA treat equity issues as liabilities of the issuer, the ESA/SNA net worth is a residual balance. ESA 7.05 defines Own funds (as B.90+AF.5 liabilities), whilst SNA does not. In business parlance, net worth corresponds to shareholder equity; this is extremely confusing because the statistical equivalent is Own funds, instead of Net worth. It is very common to observe statisticians borrowing common business terminology and using the term Net worth to mean Own funds. See for instance Lequiller: *The treatment of provisions: elements for the review of the SNA*, para 14 at: <http://www.oecd.org/dataoecd/53/49/33740137.pdf>

22. The obligation to pay will disappear only when<sup>14</sup>:
  - a. The creditor forgives the amount—which involves an intention to convey a benefit;
  - b. The creditor observes that the debtor has died or is bankrupt, that its estate has been fully liquidated and that there is no other recourse against other parties;
  - c. The contract is cancelled by an external party, such as a court.
23. However, the creditor may write-off the claim before those events, or even without envisaging such events, as an example:
  - a. When the bankruptcy or estate liquidation proceeding clearly show that in all likelihood the cash flow on claim will be nil;
  - b. When the creditor abandons seeking enforcement of the contract, as it may be not well established, or as expected recovery costs exceed expected recoverable amounts.

#### *Write-downs and regulatory or fiscal requirements*

24. In contrast to write-offs, claims are quickly written-down to reflect the impairment of assets, well before the final situation of the claim is assessed. This is because accountants are obligated to write-down claims once they are privy to any information suggesting impairment, as their primary duty is to faithfully report to the shareholder the company's worth and the profit/loss of the period.
25. Banking supervision requirements may also impact the provisioning or writing-down policy (for banks) in the context of the calculation of solvability ratios. It is unlikely however that those requirements depart noticeably from what the normal reporting obligations to the shareholder require.
26. More seriously, fiscal considerations may also guide the provisioning or writing-down policy. It is more likely than not that, to preserve the sanctity of the reporting to the shareholder, the taxable profit will depart from the accounting profit or that fiscal considerations will involve the use of general provisions or reserves instead of asset-specific provisions (the same also applies to Banking supervision requirement).

#### *Reversals*

27. Once claims are written off, they are not necessarily abandoned by the creditor. Many instances occur where write-offs are reversed (with a likely positive impact on the profit and loss and shareholder equity). This is because the write-off is not an abandonment of the rights of the creditor under the contract. This is in contrast of what the draft EDG Report states para 16. **The write-off is merely an accounting device designed to give a meaning to gross values**, and to avoid that the gross amounts of loans grow to the sky.
28. Conclusion: there exists a pool of written off assets that, whilst remaining technically legally enforceable, will not show in the balance sheet of creditors (gross basis). A survey of debtors (if this were possible) would likely show those amounts or part of those.

---

<sup>14</sup> The creditor may exchange the claim for something else with the debtor or another party. This is akin to a redemption, at least for the value of the consideration exchanged.

29. **One issue that attracted little interest so far is whether business accounting practices are more homogenous worldwide with respect to write-offs or with respect to write-downs.** The obligation of accountants to faithfully represent the shareholder equity would suggest write-down policies are more consistent. However, statisticians commonly assume the reverse<sup>15</sup>. This would need to be documented by the EDG, perhaps via a short questionnaire on this specific subject.

### **Statistical transcription of those business practices**

30. One issue relates to balance sheets. Another concerns transactions.

#### *Balance Sheet*

31. SNA Balance sheet cannot recognize claims that are legally cancelled or where the debtor has disappeared without recourse. This therefore provides the maximum boundary for claim recognition in the SNA. But should balance sheet show or not those other claims or parts thereof that are expected not to be collectable?
32. If some of such other claims or parts thereof ought not to appear in the balance sheet, what should be the criteria for derecognition?
- The common view of the 1993 SNA prescription is that the criterion is whether the claim is written off or not. This is an “all-or-nothing approach”<sup>16</sup>;
  - The GAAP view is whether the claim is written down or not; What is the best criterion in the new SNA? And why?
33. Disappearance of balance sheets can transit via transactions, revaluations or other changes in volume. What is the best flow involved when it is determined that the loan is partially/totally derecognised or reduced in value in the SNA balance sheet?

#### *Transactions*

34. Transactions are interactions between institutional units (and events that are analytically useful to treat as transactions, such as: consumption of fixed capital—K.1). Debt cancellation involves an intention to convey a benefit. This is why SNA says that it is a capital transfer (i.e., a transaction). Debt assumptions are another technique to convey a benefit.
35. However, there are other ways to convey benefits via debt operations: debt reschedulings involve postponing or reducing promised cash flows without necessarily changing the reference of the “nominal” debt (more appropriately to be called the face value of the debt, the amount written in the contract), with the effect of reducing the net present value of the new sequence of contractual cash flows. SNA 14.51c recommends recording the new debt at its nominal value, and any difference with the former being a revaluation. This position is inconsistent with debt cancellation.

---

<sup>15</sup> See O’Konnor’s EDG contribution (June 25, 2004): “*During the SNA revision process (discussed in 1988 in Washington, 1990 in Washington, and 1991 in Harare) we opted for nominal (or principal) value, because there was no clear, unambiguous, and internationally comparable way of reducing the nominal value of nonperforming loans, except where the loans were de facto traded. That is still the case today, but there has been much more work done (Basel Committee) on defining nonperforming loans and standardizing treatments. Therefore, there is more basis for determining comparable memorandum items that the analyst (but not the compiler) can use to reduce nominal value*”. See at:

<http://www.imf.org/forum/Message2.asp?forumid=9&messageid=417&threadid=412>

<sup>16</sup> See Bloem/Gorter para 45.

- a. First, it is questionable that the valuation of a loan would depend on the mere label in a contract. This touches upon the question of how to value zero interest rate loans (at face value or like a zero-coupon bond?).<sup>17</sup> It is worth noting that the external debt guide para 2.32 defines nominal value in a way that tries to escape from labels<sup>18</sup>;
  - b. Second, it is questionable that the grant element relating to rescheduling be not expensed and instead transit via revaluation.
36. The draft EDG Report para 16 assimilates rescheduling to write-downs, whilst in fact they involve a partial write-off: it is akin to a legal derecognition of part of a loan. It is therefore questionable why such a flow would be a revaluation (instead of an other change in volume; or, even better, a transaction).
37. In contrast, cases of disappearance of debtors (at least when not controlled by the creditor), without recourse, would seem not to meet the transactions criteria.<sup>19</sup> Who is the beneficiary of a gift?

*Write-down as revaluation*

38. It would seem that write-downs have the feature of revaluations. The instrument should be seen as still existing, with a volume unchanged, but at a different price.
39. The fact that the “price” is not observed is a difficulty to the debtor, in concept and in practice. However:
- a. In *concept*: the debtor knows that the banker has provisioned its claims. The only point is that he can only guess to what extent. Debtors use this feature to negotiate settlements with creditors, as loans officers have incentives to settle quickly and book a reversal of provisions.
  - b. In *practice*: the debtor cannot report on the amount of provision, for instance for statistical purposes. But is it important? It is suggested not because financial accounts largely use information from creditors, particularly regarding the banking sector as creditor.
40. If write-downs are seen as price changes instead of volume changes, interest continues to accrue on the impaired instrument, similarly to cases of bonds: changes in price of securities do not change the amount of interest flow (D.41) (for a fixed rate security).
41. If write-downs are seen as price changes, how should we conceive write-offs due to debt forgiveness (or rescheduling) and due to other events?
- a. Because debt forgiveness involves a gift, it is suggested that a capital transfer be recorded, with a need to revalue the asset (somewhat artificially);

---

<sup>17</sup> This issue is part of the Advisory Expert Group work program (item 43.b).

<sup>18</sup> “The nominal value of a debt instrument reflects the value of the debt at creation; any subsequent economic flows, such as transactions (for example, repayment of principal); valuation changes (including exchange rate and other valuation changes other than market price changes); and any other changes. Conceptually, the nominal value of a debt instrument can be calculated by discounting future interest and principal payments at the existing contractual interest rate(s) on the instrument; these interest rates may be fixed rate or variable rate. For fixed-rate instruments and instruments with contractually predetermined interest rates, this principle is straightforward to apply because the future payment schedule and the rate(s) to apply are known, but it is less straightforward to apply to debt liabilities with variable rates that change with market conditions.”

<sup>19</sup> Curiously, the *GFSM 2001 (Government Finance Statistics Manual 2001)* Appendix II para 6 indicates that a capital transfer is recorded in case of debt assumption. More consistently (but not necessarily analytically superior), ESA 5.16 treats debt cancellation and debt assumption generally identically, and as other changes in volume when the debtor disappears.

- b. Other cases (most other cases) would seem to be an other change in volume, but with a value presumably close or at zero. No revaluation entry is needed.

### Cases of tax recording

- 42. ESA 1995 as amended by European Regulations 2516/2000 and 995/2001 values taxes accrued by excluding the “amounts...unlikely to be collected” (ESA 1.57). GFSM 2001 takes a similar view.
- 43. SNA 7.60 says: “In some countries, and for some taxes, the amounts of taxes may diverge substantially and systematically from the amounts due to be paid.(...) In such cases, it may be preferable to ignore unpaid liabilities and confine the measurement of taxes within the System to those actually paid. Nevertheless, the taxes actually paid should still be recorded on an accrual basis at the times which the events took place which gave the rise to the liabilities.”
- 44. There is a wide consensus that SNA 7.60 should be reinforced and should adopt an approach similar to that of ESA 1995. This would allow aligning on the practice of GAAP, where gross amounts of taxes owed are provisioned by an estimate of likely nonrecoverables (based on experience). The question is being discussed, for submission to the AEG, by the Task Force on Harmonization of Public Sector Accounting (TFHPSA)<sup>20</sup>.
- 45. However, following ESA 1995 supposes that the amount of tax receivable to be recognized on balance sheet is the provisioned amount, i.e., the written down amount = the net amount, with a likelihood that SNA will also be clarified in the same direction. **Hence, for other receivables/payables related to taxes, the ESA already departs from the all-or-nothing approach of loans.** The issue of the valuation of other instruments was mentioned by Bloem/Gorter, but is not mentioned in the draft EDG Report.

### Asymmetry

- 46. The draft EDG Report para 42 indicates that Option 2 “reflects respondents preference for the advantage of symmetry and consistency in the accounts”; it suggests in para 41.c that the symmetry enforced in Option 4 would be “artificial”.
- 47. As explained, financial accounts use the accounts of some creditors to impose amounts on the debtor. Both Option 2 and Option 4 enforce an artificial symmetry. The question is to what extent one valuation is analytically superior to the other.
- 48. Clearly, the measurement of net worth requires using Option 4 (4a or 4b should I say).

### Consistency with other Manuals

- 49. The draft EDG Report states that “manuals are generally consistent with each other”. This is not the case: the IMF’s *MFSM 2001 (Monetary and Financial Statistics Manual 2001)* certainly follows the gross valuation of loans envisaged in the 1993 *SNA*, but also records the provisions/allowances under other accounts payable (MFSM 179).

---

<sup>20</sup> See: <http://www.imf.org/external/np/sta/tfhpsa/index.htm>

50. This is a rather shocking development, as the measure of own funds is not the same in both manuals and that the instrument liability recognized in *MFSM 2001* is not an asset of anybody.
51. Such a situation can only lead to confusion by users and noticeable added difficulties for compilers. Camencita Santor, among others, commented on this issue.
52. It would have seemed an essential aspect of the EDG questionnaire that the question be raised as to what would be the preferred option amongst two:
  - a. Recognize a liability for the provision/allowance;
  - b. Record loans at net value.

In this context, it is not unreasonable to wonder how to interpret answers to the EDG questionnaire by colleagues of the money and banking field, if they started with the hypothesis that the provision/allowance is recognized in the first place as a liability; because, whilst a standard of *MFSM 2001*, this is not envisaged in SNA.
53. Another inconsistency is internal to the *1993 SNA*, with paragraph 14.51 indicating that loans that are treated would be recorded at the traded value by the creditor and at the nominal value by the debtor. One interprets the draft EDG Report para 21 as suggesting deleting this *1993 SNA* inconsistency.

#### **Source data issues**

54. The draft EDG Report para 42.c refers to “difficulty in estimating market value of liabilities”, with a special reference to the BOP side.
55. The semantic slippage is interesting. Now the issue is recording loans at “market value”! Again, the real discussion is whether loans should be recorded gross or net of provisions/allowances. And again, the financial accounts practice is to use a lot of information from the creditor. Creditors keep primarily information on a net value basis and as a memorandum item on a gross value basis.
56. As a reminder, financial accounts practices (at least in Europe) require that assets balance liabilities across sectors. Data collected from the debtor side are compared to those of the creditor. Because they generally disagree, the financial accounts compiler establishes rules of priorities and of allocation of residuals across sectors and across instruments.
57. As an example, loans liabilities of government may be collected directly from government sources. When compared with money and banking sources (banks’ lending) [or BOP sources (non residents’ lending)], the financial accountant decides of what to do of the residual, using an assessment of the quality of source data:
  - a. Decide to correct the total government debt;
  - b. Decide to reclassify government debt in loan into another instrument;
  - c. Decide to impose the government information on loan from banks to money and banking statistics;
  - d. Decide to allocate the difference on another sector: Rest of the World, or other non government domestic sector.
58. It is common practices that bank lending is taken as core data that are imposed on others (at least for the total amount).

59. In this complex set-up, the question of the consistency of data between debtor and creditors is nearly completely irrelevant in practice.
60. It is nonetheless correct that, in this set-up, the BOP has more difficulties than other sectors, especially for lending from non-residents, as one often does not have easy access to information from the non-resident creditors.

### **Confidentiality issues**

61. It is sometimes claimed that valuing loans net of provisions (draft EDG Report page 21 1<sup>st</sup> paragraph) would somehow send the wrong message to debtors.
62. First, traditional statistical practices on confidentiality do not allow debtors to identify their instruments, particularly in the hands of whose individual creditors they are. An exception may be related to loans to governments.
63. Secondly, the argument of wrong message does not prevent the *1993 SNA* to value securities at market value. One does not suggest that such a practice is akin to a statistical recommendation towards debt forgiveness.
64. As already mentioned, creditors and debtors are no fools. The debtor knows that the creditor has provisioned his claims. The creditor knows that the debtor knows. The debtor knows the creditor knows he knows. And so on. This is a basic part of the debt renegotiation process.
65. In practice government debts are tradable. Quotes are available. Statistical reporting would merely add further global information on those quotes.
66. The US Bureau of Economic Analysis reports its practice to record loans to governments at the written down values in accounts at the global level, but at the gross value when broken down by counterpart countries.

### **Prohibition to buyback**

67. The *1993 SNA*, notably SNA 14.51, explains that departure from market value principles is associated with the contractual restrictions applicable to such loans that prohibit the debtor from buying back the loans in secondary market.
68. The argument seems well placed on first inspection. However, after second thought, it does not seem to make much sense: to the extent that the original lender sold the claim to a second party, the latter will do what it likes with that claim, including selling to the debtor (by adding a covenant to the contract, in case of need).
69. With the sophistication of governments and world finance, a renewed capacity for indirect buybacks via intermediaries or by way of Special Purpose Vehicles destroys the operational validity of the argument.

### **Nominal values and market values for debtors**

70. Whilst fair value is relevant for the creditor, it is not the main relevant valuation for the debtor—although it has some relevance, as it allows measuring the opportunity costs.
71. The relevant primary valuation of debt for the debtor is the nominal value. The *1993 SNA* recognizes this point by suggesting a memorandum item for “nominal (face) value for long-term bonds” (SNA 13.89) “in the balance sheets for corporations”. Two obvious comments come to mind:
- a. The exclusive reference to corporations, whilst government are primary long bond issuers;
  - b. The reference to face value as if identical to nominal value.
72. Analysts require nominal valuation for government debts. It is rather unfortunate that the *GFSM 2001* follows market valuation of liabilities, with a mere memorandum items for nominal valuation. In Europe, the protocol of the Maastricht Treaty indicates that government debt is at nominal value. Council Regulation 3605/1993 that sketches out the statistical reporting for the Excessive Deficit Procedure (European multilateral fiscal surveillance mechanism) further defines “nominal value” to be “face value”.
73. Instead, it is suggested that, in addition to reporting liabilities at market values in the core accounts, an additional complete set of nominal value reporting of debt should be instigated.
74. This supposes to precise what nominal value means; this was also suggested in the ECB contribution to the EDG: point 6 of the executive summary.
75. In this perspective, the draft EDG Report is incomplete as it hardly suggests debt reporting, an important requirement for Government Finance. It introduces further chaos by having a memorandum item on expected losses for loans, whilst the memorandum item for securities is the other way round. In that way, neither government net worth nor government debt are shown appropriately in either the core accounts on the supplementary tables. Users will be forced to reconstruct them, hardly a consumer friendly option.

## Annex I

The Chair of the Eurostat *Task Force on the SNA review (financial accounts and government finance statistics)*, Dieter Glatzel, wrote in his contribution to the EDG on NPL dated September 22, 2004:

“The Task Force notes that the question of the impact on government accounts has been raised by prominent EDG contributors, notably: Kevin O’Connor,<sup>21</sup> François Lequiller.<sup>22</sup>

Various members noted the impact on budgetary statistics of valuation loans for both the general government *net worth* (B.90) and the *net lending / net borrowing* (B.9). Among the questions not fully enquired in the EDG Moderator report are:

- a. The time of write-off, which is an unresolved issue of the report, and which is of significant importance for Government Finance Statistics (GFS); Government can have an incentive to time they write-off to achieve an accounting effect, instead of to reflect the economic reality;
- b. Governments can even sometimes time their cancellations instead of participating to needed recapitalization operations or internationally coordinated debt reliefs (Paris Club). More in general, the accounting of rescheduling is of importance; one principal consideration lays on the valuation of the instrument itself. There also exists a dynamic activity of secondary market quotations of Paris Club (as well as London Club) debts, whilst government sometimes dispose of claims by way of secondary market transactions, or structured deals;
- c. There is a consistency difficulty between the EDG report and the Eurostat *ESA 1995 Manual on Government Deficit and Debt* view of how to account for loans purchased at above market price in the case of restructuring agencies,<sup>23</sup> that would need to be further analysed (point raised notably by François Lequiller in his EDG contribution: *Nonperforming loans: a contribution in favour of option 3*)<sup>24</sup>;
- d. The report ought to outline the lack of consistency of the proposed loan valuation method with that required (i.e., valuation net of bad loans allowances/provisions) in most, if not all, accounting standards, such as the International Public Sector Accounting Standards (IPSAS) of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC), or as the International Accounting Standards (IASs) of the International Accounting Standards Board (IASB).”

---

<sup>21</sup> <http://www.imf.org/forum/Message2.asp?forumid=9&messageid=417&threadid=412>

<sup>22</sup> <http://www.imf.org/forum/Message2.asp?forumid=9&messageid=422&threadid=412>

<sup>23</sup> Called “defeasance structures” in the *ESA 1995 Manual on Government Deficit and Debt*, and sometimes referred to as “bad banks” (in the press).

<sup>24</sup> <http://www.imf.org/forum/Message2.asp?forumid=9&messageid=422&threadid=412>

## Annex II

### Starting point

Gross	amortizations	Balance sheet			
Values	provisions	assets		Liabilities	
	allowances	(3)			
(1)	(2)				
200	140	60	Buildings	Shareholder equity	300
1050	110	940	loans	debts	700
		1000	Total	Total	1000

### After a write-down of 40

Gross	amortizations	Balance sheet			
Values	provisions	assets		Liabilities	
	allowances	(3)			
(1)	(2)				
200	140	60	Buildings	Shareholder equity	260
1050	150	900	loans	debts	700
		960	Total	Total	960

### After a further write-off of 100

Gross	amortizations	Balance sheet			
Values	provisions	assets		liabilities	
	allowances	(3)			
(1)	(2)				
200	140	60	Buildings	Shareholder equity	260
950	50	900	loans	debts	700
		960	Total	Total	960