BOPCOM-05/28

Eighteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., June 27–July 1, 2005

Untraded Loans and Formerly Traded Loans

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

OUTCOME PAPER (BOPTEG) # 12

JANUARY 2005

(1) Topic: **Untraded and formerly traded securities**

(2) Issues – see BOPTEG Issues Paper # 12

(3) Recommendations:

(i) BOPTEG reviewed the "functionality" of portfolio investment: whether liquidity is the essential element for inclusion of instruments, or whether portfolio investment implicitly represents a residual security instrument category, capturing all those securities that do not meet the criteria for inclusion in either direct investment or reserve assets. Though a majority of BOPTEG did not favor labeling portfolio investment as a residual category, it was also considered that classification solely on the grounds of liquidity would be too difficult. Some members felt that tradability should be the determining characteristic.

(ii) BOPTEG concluded that loans and securities should be distinguished on their characteristics ex ante. Therefore, the classification of the instrument would not change during the lifetime of the financial instrument,, and the existing guidelines for traded loans to be reclassified as securities based on subsequent developments should be changed (see also Issue #13). However, it was recognized that this proposal would require consultation with financial statisticians.

(iii) BOPTEG also discussed whether a split (as in the *1993 SNA* as a supplementary item in the case of equity securities) between quoted and unquoted securities should be included in the new balance of payments manual, given the probable differences in valuation techniques. Most members felt that such a split was desirable for equity securities as a supplementary item but should not be standard. Most members thought that such a split was not necessary for debt securities (consistent with BOPTEG's view on the Classification of Financial Instruments (Outcome paper #28).

(4) Rejected alternatives

Adoption of liquidity and tradability as the defining features of the portfolio investment.

(5) Question for the Committee

> *(i) Does the Committee agree that portfolio investment should not be considered as a residual instrument category (i.e. for all securities that are not otherwise classified either to direct investment or reserve assets)? Is this conclusion compatible with the lack of a clearcut (not subject to interpretation) distinctive criterion between portfolio and other investment? See 3(i) above.*

(ii) Does the Committee agree that the classification of an instrument should be made on its characteristics ex ante? See 3(ii) above.

(iii) Does the Committee agree that the new manual should not include a split between quoted and unquoted equity securities within portfolio investment as a standard item but as supplementary? Does the Committee agree that the split not be made for debt securities. See 3(iii) above.

IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS

BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

BOPTEG ISSUE PAPER #12

Untraded and formerly traded securities

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BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

BOPTEG ISSUE PAPER #12

Untraded and formerly traded securities

At present, "portfolio investment" in *BPM5* covers all equity and debt securities that are not included in either direct investment or reserve assets. In this manner, it is less a functional category than a residual instrument category.

What might have been a more-or-less clear cut distinction between securities (which were seen as usually tradable) and other instruments (which were seen as not being tradable to any significant extent) when *BPM5* was written has become increasingly blurred as financial markets have developed in the past decade. Loans are now more often traded and private investment vehicles, which purchase equity securities but not with a view to hold for passive trading purposes, as well as the increasing role of limited partnerships and similar vehicles, have made the close identity between securities (tradability) and non-securities (nontradability) less evident.

1. Current international standards

In *BPM5*, the functional category of "portfolio investment" is described as equity and debt securities (bonds, notes, money market instruments) that are not included in direct investment or reserve assets (see para. 385[1]). Para. 387 refers to securities that are "usually traded (or tradable) in organized and other financial markets".

The distinction between traded and untraded securities is not one that is relevant for the *1993 SNA* as the financial account and balance sheet in that system are instrument, not functionally, based. However, the *1993 SNA* (para. 11.86 and Table 11.3a) recommends the separate identification of "quoted" from "unquoted" for "shares and other equity" but not "securities other than shares". (BOPTEG Issues Paper # 28 raises the possibility of adding a quoted/unquoted distinction to the instruments classification.)

The *External Debt Guide* uses the similar wording to *BPM5* (para. 3.19) in describing "portfolio investment" as "instruments [that] are usually traded (or tradable) in organized and other financial markets, including over-the-counter (OTC) markets"[2].

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[1] Financial derivatives such as options, which had been included in *portfolio investment* in *BPM5*, are now included in their own category.

[2] The *External Debt Guide* (para. 3.29) also raises the issue of loans that have become tradable, and sets out criteria to determine whether such tradability represents a reclassification from "other investment" to "portfolio investment".

2. Concerns/shortcomings of the current treatment

"Portfolio investment" is more of a residual instrument based, rather than a functional, category. The primary characteristic for inclusion in the category is determined, not on the basis of a unique function (ready tradability), but on whether *most* of the instruments are traded. As nearly all assets can be traded in one way or another, the qualification of "on organized financial markets" (in para. 387 of *BPM5*) is important. However, general practice is for all securities, whether traded, tradable, or not, that are not included in direct investment or reserve assets, to be included in portfolio investment, in part, perhaps, because there is nowhere else to put those securities that are not readily traded. As markets and instruments have evolved, the close link indicated between financial markets and the composition of "portfolio investment" has tended to be less straightforward.

3. Possible alternative treatments

The alternative to the present treatment would be for "portfolio investment" to cover only securities that are readily tradable on organized financial markets. Securities that are not readily tradable, or have ceased trading, would be included under "other investment", either as "equity finance" or under "other debt instruments", depending on the nature of the instrument.

This approach has the advantage of valuing all those instruments that are tradable on an organized financial market in the same manner – by use of an observed price. Those securities that do not trade would, therefore, be included in "other investment". As well as linking of function with the valuation principle, it also links the portfolio investment category more closely with market volatility.

However, while this approach may provide better analytical clarity, it does present two problems. The first problem concerns identifying those instruments that are traded on organized financial markets from those that are not. While some countries may be able to make a ready distinction (depending on their data sources) for balance of payments purposes, others may not. Moreover, it may be even more difficult to make that distinction for the IIP. The second problem is reclassification of a debt security that once traded but has subsequently ceased to do so. Assuming that it could be identified, if that instrument were then to be reclassified to "other investment", there would be the question as to how it should be valued, either at market-equivalent value, as in portfolio investment, or at nominal value, as in other investment. (This issue of different valuation does not apply to equities as there is no "nominal" value: par value or issue price are not meaningful measures for equity.) This may cause some difficulty in understanding the data. The situation could also work the other way round: that is, formerly untraded securities that had been classified to "other investment" could become traded, and would then be valued at market price (in positions data). The reclassification needs to be recorded in other changes in financial assets and liabilities account.

4. Responses to Annotated Outline

Paragraph 5.32: *Should portfolio investment be defined by instrument or by tradability?*

Total responses	13	
Instrument	7	
Tradability	6	

Paragraph 5.34(b): *Should debt securities that previously traded but no longer do so be treated as portfolio investment or other investment?*

Total responses	9	
Remain portfolio investment	7	
Reclassify	2	

6. Questions/points for discussion

1. Do BOPTEG members have a view as to whether "portfolio investment" should be defined:
(a) in the current way, i.e., to include securities (not otherwise included in direct investment or reserve assets) whether traded in organized financial markets or not? or
(b) in a more restrictive way to include only those securities that trade in organized financial markets, in order to give a more functional characteristic?

2. If members of BOPTEG support the continuation of the current scope of portfolio investment, would they support making a distinction between quoted and unquoted securities? Should this distinction be adopted for equity securities only or extended to debt securities as well?

3. If members of BOPTEG support a change to the more restrictive definition of portfolio investment:
(a) should the untraded securities be included in a new category under other investment?
(b) what should be the valuation principle for the untraded securities?

Annex of the most relevant documents

Annotated Outline paras. 5.32 – 5.34

BPM5 paras. 385 – 387.

1993 SNA para. 11.86, Table 11.3a