Thirteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Washington, D.C., October 23–27, 2000

Classification and Valuation of Domestic Loans Sold to Non-residents at a Discount
in the Balance of Payments Statistics and International Investment Position

Prepared by the International Department
Bank of Japan
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Discussion Paper by
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1. Introduction

Since the BPM5 was published in 1993, domestic loans sold to non-residents at a discount (mostly bad loans) have been increasing in practice. In Japan, Balance of Payments showed a substantial amount of errors and omissions in 1997 figures, and we found that it was largely due to the insufficient coverage of the overseas sales of domestic bad loans. Hereafter, the Japanese authorities tried to measure and include these transactions into our Balance of Payments Statement.

The purpose of this paper is to present to the Committee the current situation of the loan sales in Japan, and to raise the issue for discussion as to the treatment and measurement of the transactions of bad loans in the Balance of Payments and International Investment Position.

2. Current Practices of Sales and Purchases of Bad Loans

In most cases, bad loans are sold by Japanese banks, trust banks, and insurance companies to American or European securities companies. In practice, there are mainly three types of loan sale: designated credit transfer, loan participation, and credit transfer method by using trust scheme. All methods share advantage that the bad loans in the creditor’s balance sheet can be eliminated. It may be noted that there is no buying-back of loans practiced by debtors in Japan, although there are no contractual restrictions that prohibit the debtor from buying back the loans in secondary markets.

In “designated credit transfer” method, the debtor/creditor relation as well as ownership is usually transferred from the original creditor to the new creditor with the consent of the debtor. This method reduces management burden and costs for debt collection on the part of original creditors.

On the other hand, in “loan participation”, the original creditor keeps receiving the principal payments and interests from the debtor, and passes them on to the new creditor. The consent of the debtor is not necessary in this process, and usually the debtor is not aware of the change in the ultimate creditor. Loan participation has the same economic effect as “credit transfer” without changing debtor/creditor relation.
In the trust scheme transaction, the loan is entrusted to a trust bank, and the creditor receives the beneficiary certificate issued by the bank in return. The original creditor keeps collecting repayments, but the trust bank becomes the ultimate creditor. In this transaction, the debtor is not notified of the selling arrangements, and the consent of the debtor is unnecessary.

However, under the “trust scheme”, the beneficiary certificate issued by the trust bank is treated as securities under the Japanese Law. Thus, this type of loan sales is included in the portfolio investment in Japan’s balance of payments.

Securitization of loan in Japan is rarely conducted, although there are cases when European and American securities firms issue bonds backed by collected debts. One obstacle to the loan market in Japan is that the investors do not have enough information for pricing. For loans to become frequently traded in the market, pricing mechanism of loans are essential. In Japan, the main bank tends to have more access to information of
the debtor, contrary to, for example, the sharing of debtor information among creditors under the syndicated loan system in the US. With regard to the marketability of Japanese loans in the international market, not much activity has been reported.

------- In consultation with the APLMA (Asia Pacific Loan Market Association), the situation may be different in the US and Europe, where there is an active secondary market for loans. Also, we have been told that the secondary market for loans is developing in Asia. We have also obtained information that the debtors can buy back their loan in market and cancel their debts, although it is not often the case by private companies.

3. Accounting Treatment

We set an example where bad loans of resident (face value of 100) are sold to non-resident for the price of 80. In the original creditor’s balance sheet, the asset is deducted by the amount equal to the face value. The difference (20) between the face value and the amount sold are then covered by loan loss reserves. If the discount exceeds the reserves, then the difference is treated as a “loss” in the other operational cost.

If it is the case where a Japanese firm bought the loan, the new creditor records the increase in asset (loan) by the face value (100) and the difference between the face value and the purchase price (20) is recorded as other liabilities.

4. Measurement and Classification of Traded Bad Loans

(1) Balance of Payments

The BPM5 recommends that “transactions are generally valued at the actual price agreed upon by transactors” (paragraph 91). When a loan with face value of 100 is traded with a non-resident at the price of 80, it seems that only 80 should be recorded in the Balance of Payments.

The current recording practice for traded bad loans in Japan is as follows. When a Japanese bank sold a domestic loan (with a face value of 100) to a non-resident at a price of 80, we record 100 increase in “loans (liabilities)” as we now owe non-resident 100. However, as the loan is sold at 80, there is a difference of 20. We regard this difference as a transfer to the buyer, and record this amount in “capital transfers”.

------- As previously stated, in the case for “trust scheme” we treat the transaction as securities transaction.
The Fund’s Statistics Department pointed out several problems regarding Japan’s treatment. First, since no “credit” will be recorded in the “capital account” of the buyer country, this recording will cause discrepancy among the world’s balance of payments, therefore, the difference of face value and the amount actually paid should not be included in the “capital account”.

Second, as recommended in BPM5, these transactions should be recorded at 80 in the “financial account”, and the difference (20) should be treated as “change in prices”, and not treated as a “transaction”.

We see the argument by the Fund to be acceptable, and are ready to change our methodology such that recording the loan at the market price (80 in the above example) and no record be made in “capital transfers.”

(2) International Investment Position

The BPM5 also recommends that “stocks of assets and liabilities are valued at market prices in effect at the time to which the balance sheet relates” (paragraph 91). Here, the important issue is whether the secondary market exists for loans and the debtors can freely buy back their debts. The argument goes that if the secondary market for loans exist with no restriction for buy backs, then the loan should be recorded as “securities” with market price. However, if buy backs are prohibited, then the loans should be recorded as “loans” with the face value as agreed at the initial stage of transaction (paragraph 471 of BPM5).
In the case of Japanese loans, it seems that there are no large secondary market and as the actual exposure remains at its face value on debtor’s balance sheet, we feel that measuring the debt at its face value for IIP may be practical and adequate.

----- On the creditor side (in this case US or European countries), claims would be valued on the basis of market price, and on the debtor side, the amounts of principal that debtors are contractually obliged to repay creditors when loans mature are used as the basis of valuation. This use of market values on the creditor side and nominal values on the debtor side results in an asymmetry between debtor and creditor positions, and this is acknowledged in BPM5 (paragraph 471).

**Japan’s recording practice of discounted loans**

< Stock >

Other investment (liabilities): loan 100

**Suggested Fund’s Recording Method**

< Stock > Other investment (liabilities) : loan

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<th>Position at end of year</th>
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<td>20</td>
<td>100</td>
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(3) Classification of Traded Loans

The System of National Accounts (SNA) 1993 notes that loans which have become negotiable de facto should also be classified under securities other than shares (paragraph 11.75). The argument goes that if the loan is circulated in the market, it is treated as securities and is classified in the “portfolio investment”. However, there are some points against such treatment.

Regarding Japanese loans, there are almost no buy backs in the current practices. Since most loans are sold to specific buyer on a negotiation basis, change in ownership will require the consent of debtor, and are not “highly tradable” like securities.

Also, it should be noted that loans are different from securities in the sense that common strict regulations are designed to protect individual investors of securities. Loans are documented in accordance with the individual terms and conditions. The Asia Pacific Loan Market Association (APLMA) pointed out that in business practices, loans are not specifically listed in any organized market; and are very different from securities.
Following the SNA 1993 and BPM5, there is no option of recording traded loans as 80 in the category of loans. That is, if a loan is regarded as tradable and should be recorded in the value of 80, it is classified as “securities”. As is written above, characteristic of loans and securities is different, and recording 80 as “loans” and not “securities” would be another option.

------ Although actual exposure remains at its face value, the loan was once traded and the traded amount may be regarded as market price (the buyer has made an assessment of the present value of the loan, taking into account the factors including the probability of it being repaid).

4. Issues for Discussion

• In Balance of Payments, we may agree that loan sale transaction should be recorded with “market price”. With regard to its classification, however, is it appropriate to treat it as “loans”, or is it plausible to treat it as “securities”?

• In International Investment Position, does the creditor country record the traded loan with “market price”? In this case, which category is it recorded; “loans” or “portfolio investment”?

On the debtor’s side, we think that the “loans” should be valued as the amounts of principal that debtors are contractually obliged to repay creditors when loans mature (face value). If the traded loan is recorded with face value, it may be natural to record it as “loans”. But if it is recorded with market price, which is appropriate; to record in “loans” or in “portfolio investment”? Although 1993 SNA recommends that loans traded in secondary market should be reclassified as “securities”, could it be acceptable to classify such transaction as “loans”?

------ In Japan’s accounting practice, for example, the huge decrease in market value for holding securities must be reflected in the balance sheet (significant decline of more than 50% from its acquired price is used as a guideline). From this practice, can we argue that if the creditor sold loans significantly lower than the debtor’s contracted repayment, should the loans be recorded in market price?