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How to value bank loans in a crisis?

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The sharp cool down of the European economy caused by the measures to slow down the spread of COVID-19 infections has ended the decade-old upswing in the credit cycle and will result in an increasing number of troubled assets and non-performing bank loans (NPL). Understanding the value of bank loans in general and NPL in particular becomes a critical step when governments and supervisors must decide about how best to support banks to avoid a financial crisis and which institutions may require support measures or bail-outs. We discuss the different ways of valuing loans in the current crisis with a particular focus on NPL. Most bank loans and NPL are illiquid with no readily observable market prices. This was the case even prior to the current drought in market liquidity. We explain the different valuation methods with a focus on the valuations used in a bank resolution. We distinguish hold values from disposal values and focus on the significant data requirements imposed on banks by supervisors including an analysis of the data template for the valuation in resolution recently published by the European Banking Authority (EBA).

The current crisis

Compared to the Global Financial Crisis (GFC) in 2008, European banks are now better capitalized to weather a period of economic stress and banks have successfully reduced their stock of NPL. However, the volume of legacy NPL is still elevated in many of the European countries (EBA 2019b) which are now severely hit by the coronavirus pandemic. The longer the widespread lockdown of the economies continues, the more likely we will see a prolonged economic shock turn into another financial crisis with an increase in credit risk. Bank liquidity is a concern as well, however, given the increased liquidity buffers and ready-to-use supply by central banks we expect the main focus will soon shift to asset quality and solvency. Airlines, transportation, tourism, retail and oil-price sensitive energy businesses are particularly vulnerable, but most economic sectors and many geographic regions will be impacted by the slow-down in consumer demand as indicated by the widespread decline of equity prices and

increased credit spreads since the beginning of March 2020. The price of European leveraged loans have been declining since mid-February and have dropped below 80% on average, the lowest since 2009, according to the S&P European Leveraged Loan Index. Contingent convertible bonds of European banks have also been hard hit recently with yields jumping to over 10% from about 3.5% a month ago according to a Bloomberg Barclays index. In the US, the volume of high yield bonds trading at more than 10% spread over treasuries and loans trading at less than 80 cents has jumped to nearly \$1 trillion signalling a level of distressed assets not seen since the GFC (bloomberg.com/news accessed March 29, 2020).

Several countries have announced measures to help individuals and small and medium enterprises with their loan payments, but it remains to be seen to what extent these measures will be hurting bank balance sheets in addition to the expected pain caused by defaults of larger business loans. In contrast to the GFC which many considered a crisis inflicted on the taxpayer and the real economy by the reckless behaviour of some financial institutions, this time European banks have shored up their balance sheet in terms of capital and liquidity and continue to play a vital role in lending to companies and households. Political support for the use of public funds to overcome the economic fallout from the pandemic reaches across the political spectrum and appears to have widespread popular support. In today's crisis there are few concerns about the moral hazard of spending tax money on supporting banks together with other direct support measures for households and non-financial companies. Banking industry support measures are likely to be put in place without regard to the individual bank's balance sheet. However, to the extent that individual banks require specific support measures or bail-outs a careful assessment of their balance sheets including a detailed valuation of their loan books will be required.

Valuation data demands under the Bank Recovery and Resolution Directive

One important set of measures introduced in Europe after the GFC regarding public bail-out measures for banks are part of the Bank Resolution and Restructuring Directive (BRRD) that came into force in 2014. The BRRD has been put in place to require banks to develop credible recovery plans that identify options to survive a severe stress scenario. Recovery plans require different valuation activities to determine whether a bank should be put into resolution and to determine the choice of resolution tools. Resolution tools include, for instance, the bail-in of bank liabilities or the disposals of assets or businesses. If the bail-in tool is used then an ex-post determination will be required of whether any creditors would have been better off had the bank gone into insolvency.

To support the recovery and resolution decisions, banks need to have robust systems to provide complete, accurate and readily available data and the capabilities to support different types of valuation by a third party valuer appointed by the resolution authority at short notice. The EBA has issued Regulatory Technical Standards (RTS) including a Handbook on Valuation for Purposes of Resolution (the Handbook, EBA 2019a, published February 22, 2019) which includes the recently finalized data dictionary as annex 2 and an amended chapter 10 on Management Information Systems (MIS, EBA

2020, published on March 10, 2020). The Systemic Resolution Board also published a framework for valuation (SRB 2019).

The EBA RTS clarify the basis for three different types of valuation:

Valuation 1: To determine whether the conditions for triggering resolution are met. This type of valuation should follow normal accounting and prudential rules relevant to an assessment of whether a bank meets the conditions for continuing authorisation. Valuation 1 is performed irrespective of the resolution strategy. Providing the accounting values for Valuation 1 (e.g. for loans in the bank book the net book values (NBV) i.e. carry amount less loan loss provisions) is straightforward for banks on a regular financial reporting date and some larger banks have implemented changes to their MIS to improve month-end accounting processes. However, for many banks it remains doubtful whether they are currently prepared to incorporate resolution-specific valuation assumptions in the MIS required under Valuation 2 and 3.

Valuation 2: To inform the choice of resolution tools, including the extent of any bail-in of liabilities. This valuation is the main focus of the Handbook and the valuation to determine the economic value of the bank's assets, liabilities and equity is much more detailed. The economic value is based on discounted future cash flows, ensuring that all losses are fully recognized and may depart from accounting and prudential rules in particular where the resolution strategy is based on the sale of businesses or assets within a defined disposal period. The economic value depends on the choice of the resolution tool and distinguishes hold values from disposal values.

Valuation 3: To determine whether any creditor should be compensated under the "no creditor worse off than under liquidation" principle. This valuation should be undertaken ex-post on a gone-concern basis, estimating the discounted value of cash flows that could reasonably have been expected to arise under the relevant national insolvency procedures for banks. This counterfactual outcome then needs to be compared with the treatment of creditors and shareholders in resolution.

Banks face a major challenge to provide a large set of accurate data within a very short timeframe (e.g. one or two days) leading up to a possible resolution. A robust valuation is essential for the resolution actions to be effective and for taking legitimate and sound decisions. Only the timely provision of high-quality data and information to the independent valuer will result in a robust valuation. The Bank of England issued a consultation paper out of concern that systemically important banks may not have the data, systems and processes in place to enable them to be valued by a third party valuer in a timely and robust manner (Bank of England 2018). UK banks have been asked to demonstrate their preparedness for valuation in resolution by year end 2020, a deadline which was set before the current crisis materialized.

Given the extreme time pressure in a resolution situation, the independent valuer will not only require data from the bank, but also have access to the bank's own valuation models and outcomes. Thus banks would be expected to ensure that the underlying data and valuation models are complete and accurate

and are supported by robust processes and controls. All relevant data and information should be capable of being made readily available to an independent valuer, for example through a virtual data room.

Valuation of bank loans: accounting versus economic value

We first describe the accounting values for loans subject to international accounting standards held to maturity or held with the intention to sell. We then compare those accounting values with the economic hold and disposal values described in the Handbook during resolution. The revised IFRS 9 accounting framework for loan loss provisions came into force in 2018. It addresses the way commercial and consumer banks value the vast majority of their loans and other financial instruments where the bank's business model is "hold to collect". IFRS 9 requires banks to consider future events and forecasts in determining credit loss provisions and requires banks to place financial instruments into one of three distinct risk buckets. For loans in Stage 1, provisions are required based on one year expected credit losses (ECL). Once a loan has experienced a significant increase in credit risk, it should be moved to Stage 2 with provisions calculated based on lifetime ECL including the lifetime probability of default. Estimated provisions for non-performing loans in Stage 3 are also based on lifetime losses. Banks use internal models to calculate ECL under forward-looking scenarios, which need to be unbiased estimates and calculated based on all available information (also known as point-in-time). The point-in-time nature of ECL has been a long standing concern that ECL models will cause too much cyclical in an economic downturn. Importantly under IFRS 9, projected cash flows are discounted at the effective interest rate which is close to the current contracted interest rate of the loan. Valuation 1 largely follows the bank's existing valuation methodologies for accounting purposes, unless amended by assumptions made by the independent valuer. For banks reporting under IFRS, Valuation 1 of a loan is close to the net book value i.e. the carrying value less IFRS 9 ECL.

On March 20, 2020 the ECB encouraged banks to avoid excessive procyclical effects from IFRS 9 loan loss provisions (ECB 2020). The ECB also relaxed the prudential treatment of NPL as a temporary support measure for banks expected to free up EUR 120 billion of additional bank core tier 1 capital. Supervisors will show flexibility for loans classified as "unlikely to pay" when banks call on public guarantees granted in the context of coronavirus. NPL under public guarantees will benefit from preferential prudential treatment regarding expectations about loan loss provisions and supervisors will be flexible in the implementation of agreed NPL reduction strategies. Also on March 20th, the Bank of England announced that UK borrowers eligible for the recently introduced mortgage payment holidays should not automatically be classified as underperforming and thus as IFRS 9 Stage 2 (Bank of England 2020).

The net book value under IFRS 9 is different from the fair value of the loan. When a financial asset is measured or disclosed at fair value, IFRS 13 applies. IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value therefore represents an exit price and is a market-based measurement. The objective of a fair value measurement is the same regardless of whether an

observable market price is available or not - to estimate the price at which an orderly transaction to sell the asset would take place under current market conditions. The income approach or discounted cash flow (DCF) analysis is a common valuation method to determine fair value. The expected cash flows and applicable discount rate are those that a willing buyer would assume to price the asset. Other valuation techniques are the cost approach that reflects the amount that would be required currently to replace the service capacity of an asset (the current replacement cost) or the market approach that uses prices generated by market transactions involving identical or comparable assets. For example, the market approach often uses market multiples derived from a set of comparables.

Why does the economic value in Valuation 2 of the Handbook differ from the accounting value? Two major differences result from different assumptions on discount rates and costs. Similar to the different accounting values depending on the business model of the asset holder, the Handbook acknowledges that valuation is dependent on resolution scenarios and the intention to hold or sell:

The **hold value** is based on “cash flows that the entity can reasonably expect under fair, prudent and realistic assumptions from retaining particular assets and liabilities”. The valuer may consider the use of inputs and assumptions regarding the cash flows that are particular to the entity that is holding the assets and there is no presumed transfer of the asset between a willing buyer and willing seller. Therefore, the hold value may be based on different performance assumptions that an alternative market participant might consider. The hold value is not required to be based on the effective interest rate for discounting future cash flows as in IFRS 9, but can be based on a discount rate reflecting the current cost of funds and capital.

The **disposal value** applies where assets (or liabilities) are transferred from the bank under resolution to a third party purchaser, e.g. an asset management vehicle. The valuer may need to consider the appropriateness of the disposal costs that it may incur to get the assets into a saleable condition. This differs from the IFRS 13 fair value that ignores transfer costs. The valuer may also wish to consider the effect that a split sale may have as opposed to a combined sale. Similarly, the valuer may wish to consider differences between an orderly transaction with a typical marketing period and a forced transaction with a shortened marketing period (a fire sale). The IFRS 13 fair value instead assumes an orderly market with a willing buyer and seller and hence does not represent a fire sale value. To determine the disposal value of assets which do not have a liquid market, the valuer shall consider observable prices on markets where similar assets are traded or model calculations using observable market parameters, with discounts for illiquidity reflected as appropriate. For the purpose of Valuation 2, operational costs should be considered. Such operational costs might for instance result from liquidation costs and/or costs related to the implementation of the resolution tool. Sensitivity and scenario analyses may be performed to address valuation uncertainties.

What is the true cost of holding a non-performing loan?

Hellwig (2018) cautions that the concept of economic value, as distinct from market value, is problematic if it is not attached to a feasible strategy. The judgment that prices are abnormally low during a crisis, so that holding and managing the assets promises greater value may be a legitimate business judgment, but it presumes that this strategy of holding and managing the assets is actually feasible. If valuation is based on this hold strategy, an assessment of hold value should take account of the cost of risk and of illiquidity as any strategy of holding assets needs funding and capital. Hellwig criticizes that the BRRD is silent on the subject of funding in resolution that would be desirable to relieve the time pressure which in turn could improve the available information for the independent valuer.

In general, at what price should a bank sell a loan, especially a non-performing loan? Ciavoliello et al. (2016) identify the main reasons for the difference in the book value of an NPL and the market value that investors are willing to pay. As mentioned, the Stage 3 IFRS 9 loan loss provision for NPL is built on the lifetime expected credit loss based on recovery cash flows discounted at the effective interest rate. Investors, however, demand a higher rate of return which partly reflects the higher uncertainty of the future cash flows and partly reflects their lower financial leverage compared to banks and higher cost of capital. In addition, banks expense the indirect costs of managing NPLs in each accounting period in which they occur, whereas investors deduct them from the purchase price upfront. Hence, the market for NPL in Europe has suffered from the substantial difference between net book value (NBV) and available market values. The difference is exaggerated by the fact that the effective interest rate does not reflect the true cost of capital of holding the NPL for the bank.

For example, assume that a bank holds an unsecured loan that defaulted two years ago and the bank expects to resolve the loan within the next two years recovering 50% of gross book value. The net book value, say, is 45% whereas the market value is 30%. If the bank holds the loan for another year, the prudential backstop will force the bank to deduct the NBV from core tier one capital. If the bank does not have sufficient capital available then holding the asset will not be feasible. If the bank has sufficient capital, the deduction will result in an additional capital cost incurred every year until completion of the recovery, a cost that is not reflected in the current determination of NBV. For more detail on the calculation of a break-even sale price for banks that take calendar provisions and operational costs into account see NPL Markets (2020). Hence, the price at which the bank should be willing to sell the NPL today should be less than the NBV even if this means realising an immediate accounting loss upon sale.

For the years 2016 and 2017, researchers from the ECB analysed the prices of 30 NPL portfolio sales and estimated an investor IRR in the range of 10-20% and a difference between net book value and market value of 20-40% of gross book value (Grodzicki et al. 2018). Given the limited number of transactions and the lack of detailed information about the portfolios, these estimates are necessarily high-level only especially as the time to completion of recoveries is assumed as a constant four years throughout. For mixed secured and unsecured Italian NPL portfolios valued on the NPL Markets platform

(www.nplmarkets.com) from 2018 until the start of the coronavirus downturn in early March 2020 we would expect most such deals to happen at the lower end of the stated IRR and price discount ranges. The current market dislocation will likely reduce NPL sales activities in the short term and increase the IRR expectation of investors and thus increase the bid-offer spreads. In the medium term of the next two years or so we expect NPL sales activity to increase again as market participants digest the impact of the downturn and NPL sales are likely to exceed the volume of activity of the pre-coronavirus years.

Valuation demands on banks to prepare for resolution

We summarize some key demands expected by resolution authorities and supervisors regarding the valuation of assets and liabilities in preparation of resolution. We focus on the hard to value illiquid bank loan assets whether performing or non-performing, which for commercial banks should constitute the majority of their assets and contribute the most to valuation uncertainty. Banks should have management information systems that provide complete and accurate data required for the valuation in resolution, especially for Valuation 2 and 3 which differ from accounting values as explained above. The EBA and Systemic Resolution Board both emphasize their preference for the discounted cash-flow analysis, which relies most heavily on the timely provision of a large set of accurate data. From both a theoretical perspective and a practical standpoint, the DCF is the valuation method that best incorporates all factors affecting the valuation for different resolution scenarios and tools. In addition to varying the discount rates and cost assumptions, valuation models need to capture different recovery expectations between the bank and the investor to reflect hold and disposal values e.g. by applying different haircuts to the foreclosure of collateral and different recovery times reflecting the varying workout strategies pursued by the bank and the investors. Varying the assumptions around recovery time are particularly important during a crisis. For example, for countries currently in lockdown, prior assumptions on timing and efficiencies of the relevant regional court to foreclose a collateral may need to be extended to reflect delays and the expected backlog of new court cases caused by the crisis. Valuation tools should provide best point estimates or value ranges to reflect the inherent uncertainty in valuing illiquid assets.

The data dictionary of the EBA Valuation Handbook

Central banks, bank supervisors and resolution authorities have emphasized the importance of complete and accurate data for valuation and the current crisis accelerates the need for banks to be prepared. What data should a bank prepare to provide and how can the bank be sure it will be adequate? To the extent that the bank has its own valuation models in place with the desired level of granularity and flexibility, the bank can prepare to provide the valuer with all required input data for the bank's models plus model outcomes. Where this is not the case or where the models are operating at an aggregate level that a third party valuer might find not sufficiently granular, the bank can prepare to deliver the most

important data fields of the data dictionary drafted by the EBA which operates at the highest level of granularity (i.e. individual loans, borrowers, and collaterals).

The EBA data dictionary annexed to the Handbook (Data Dictionary) constitutes an EU-wide benchmark for resolution authorities (RA) by setting expectations of data that institutions should be prepared to collect and submit to the RAs or valuers via upload in a virtual data room to support a valuation before resolution. The data and information included in the Data Dictionary are not exhaustive and the RA or valuer may ask institutions for any other information deemed relevant to conduct the valuation for resolution, or may disregard data fields included in the Data Dictionary if not deemed relevant. The Data Dictionary is for benchmarking purposes only. The set of data needs may vary in relation to the ability of an institution's internal valuation models to calculate or support the calculation of economic values and specifically vary depending on the performance status of the loans (performing versus non-performing loans). The Data Dictionary is built upon existing common EU supervisory definitions such as the FINREP and COREP templates from the EBA, the ECB's AnaCredit template, and the EBA NPL templates. For performing and non-performing loans the Data Dictionary contains a list of data fields that split the loan book into loan, counterparty and collateral modules (Table 1).

Counterparty Module	Loan Module	Collateral Module
Corporates and SME	Loans	Residential Real Estate
Households		Land plots
Central banks, public sector and credit institutions		Office buildings
Counterparty Group		Hotels / entertainment
		Retail
		Infrastructure projects
		Factories/Warehouses
		Equipment/machinery
		Automotive
		Aircraft
		Shipping
		Financial guarantees
		Financial instruments
		Cash collateral received

Table 1: Loan asset modules defined in the EBA Data Dictionary for valuation in resolution.

Banks that are familiar with the EBA NPL template will benefit from the significant overlap between fields defined for the valuation in resolution and the EBA NPL template defined for NPL sale transactions. Table 2 shows the number of fields defined in the different modules that overlap with EBA NPL. In our experience with valuing performing and NPL using data mapped to the EBA NPL template, a meaningful valuation can be conducted with a relatively limited number of data fields only. For example, the value of a residential mortgage loan could be based, among other fields, on the latest valuation amount available for the property even if a detailed description of the property is missing. If the loan is non-performing, a number of additional fields will become relevant such as the date of default and the nature and stage of the workout process. As a loose guide, banks and valuers should be able to conduct a valuation based on the top priority data fields only (Priority 1 in Table 2). For NPL we summarized the most important data fields in NPL Markets (2019).

EBA Data Dictionary Module	Priority	EBA Dictionary	EBA NPL	AnaCredit	FINREP
Loan	1	31	29	17	5
Loan	2	43	26	15	7
Loan	3	19	15	1	0
Corporates SME	1	9	8	3	0
Corporates SME	2	26	23	6	0
Corporates SME	3	13	5	2	0
Households	1	15	14	0	0
Households	2	12	8	0	0
Households	3	1	1	0	0
Residential Real Estate Collateral	1	19	17	2	1
Residential Real Estate Collateral	2	10	8	0	0
Residential Real Estate Collateral	3	4	4	1	0
Office Building Collateral	1	19	15	2	1
Office Building Collateral	2	12	11	0	0
Office Building Collateral	3	6	6	1	0
Financial Guarantees Collateral	1	7	3	1	2
Financial Guarantees Collateral	2	10	2	0	0
Financial Guarantees Collateral	3	0	0	0	0
Sum of Field Count		256	195	51	16

Table 2: Comparison of the data field overlap between the EBA Data Dictionary for valuation in resolution with other supervisory data templates. Selected modules only.

To conclude, banks together with large parts of the economy currently face an unprecedented slow-down in economic activity. Depending on central bank and government intervention, the economic shock is expected to increase the volume of non-performing loans and put a severe stress on many

financial institutions in Europe. Since the last financial crisis, supervisors and resolution authorities have put regulations in place to swiftly and efficiently deal with financial institutions at risk of failure. To assess recovery and resolutions plans, banks face a significant challenge to provide large amounts of accurate data about the assets and liabilities on their balance sheet. We describe the benchmark data dictionary which was recently published by the EBA for valuation in resolution and explain why this data is required and why there are various different valuation methods for different purposes and resolution tools. We explain why economic values required for resolution decisions differ from accounting values. The significant technological progress that banks have made on their data and valuation systems since the last crisis should help institutions to reach better recovery decisions more quickly, but unfortunately the time to prepare and adjust to the supervisory data and model demands in resolution has been cut short abruptly by the current crisis.

About NPL Markets

NPL Markets is an innovative marketplace for illiquid loan trading operating throughout Europe that is based on the four pillars: Data preparation, Marketplace execution and investor reach, Valuation, and Reporting. NPL Markets helps sellers to prepare and standardize transaction data and select the optimal transaction portfolio based on balance sheet impact, supports investors with deal screening and initial valuation and provides online revaluation and reporting tools.

With the help of its proprietary data mapping and transformation tool NPL Markets helps financial institutions to map their data to the data formats defined by EBA for NPL transactions, EBA for the valuation in resolution, and by ESMA for securitisation disclosures. Once standardized and validated the loan-level data can be uploaded to the NPL Markets valuation tool to conduct a detailed discounted cash flow analysis using pre-populated pricing parameters in different macroeconomic scenarios across all major asset classes.

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