ISSUES PAPER (BOPTEG) # 20B

INTEREST ON DEBT SECURITIES

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BOPTEG Issues Paper

Interest on Debt Securities

Current international standards for the treatment of the issue

There is disagreement on the interpretation of current international recommendations on this issue. The SNA93 does not deal explicitly with the situation of changing interest rates and the measurement of income flows on tradeable securities. The proponents of the debtor approach interpret the SNA as recommending that approach. The proponents of the creditor approach start with the SNA principle of the market price valuation of assets and liabilities, and argue that the creditor approach is consistent with this principle and that the debtor approach is not. They do not agree that the debtor approach is the incumbent treatment.

The debtor approach is consistent with the historic cost valuation of assets and the creditor approach is consistent with the valuation of assets at current market prices, and there is a close relationship between this debate and that on the market valuation of financial assets.

Concerns/shortcomings of the current treatment

Inconsistent or incorrect measurement of interest flows and the related valuation of assets and liabilities can undermine the main function of economic accounts, that is to quantify and monitor economic behaviour. Failures to foresee major problems such as the Asian crisis is partly due to these shortcomings. Inconsistent and incorrect measurement can result in asset and liability pairs being recorded at different values, and a breakdown in the ability to reconcile the changes between opening and closing levels of assets and liabilities. Problems also arise in reconciling observed asset values and income flows on those assets. The adoption of methods which diverge significantly from market and commercial practices can undermine the credibility of the System.

Possible alternative treatments

Proponents of the creditor approach argue that the approach:

- is consistent with commercial accounting principles
- is consistent with investor behaviour
• provides a meaningful reconciliation between income flows and changes in market values as shown on the balance sheet;
• does not require the introduction of conceptually inexplicable adjustments in periods when the prevailing interest rates are different to the rate at the time of issue;
• can be applied in a coherent, consistent way to any financial instrument, for instance indexed debt securities;
• is easy to implement in practice using data on asset values available from business accounts and current yield information;
• is consistent conceptually with the trend, evident in emerging international accounting standards, towards "fair value" valuation of assets and the use of "effective yields" to calculate interest flows.

The arguments for the creditor approach have been represented in papers submitted to the Electronic Discussion Group, as well as in *Statistical Treatment of accrual of interest on debt securities*, IMF working paper WP/01/132 by John Joisce and Chris Wright. References are at the end of this paper.

Proponents of the debtor approach claim that the approach:

• is consistent with SNA93;
• reflects the contractual obligations of the debtor, which are passed on to new creditors upon sale of a security;
• generates results which transactors recognise, reflecting actual commercial transactions such as coupon payments.

The merits of the debtor approach are presented in papers submitted to the Electronic Discussion Group, in particular in the IMF paper, *Income from Bonds: The 1993 SNA Treatment* by Lucie Laliberté.

This issue has already been debated at length without consensus being reached. An electronic discussion has been held (see reference below).

**Questions/points for discussion**

• is there any point in continuing the debate on the interpretation of SNA93 or is it preferable to proceed with arguments based on the basic SNA/BPM principles of market valuation of assets and the coherence of stocks and flows?
• should the market value principle, which is fundamental to the SNA/BPM, be applied to interest income, or should interest be treated on an historic cost basis?
• can the treatment of interest on debt securities be decided in isolation?
of the broader discussion of the treatment of income and the measurement of financial services in the SNA/BPM?

Supplementary information

The arguments for the adoption of the debtor or creditor approach to the recording of income flows on tradeable securities have been spelt out in several papers. The Electronic Discussion Group is available at http://www.imf.org/external/np/sta/na/interest/index.htm A full discussion of the issues is in *Statistical Treatment of accrual of interest on debt securities*, IMF working paper WP/01/132 by John Joisce and Chris Wright which is available at http://www.imf.org/external/pubs/ft/wp/2001/wp01132.pdf The summary by the moderator of the EDG contains references to a large amount of background material.