BALANCE OF PAYMENTS TECHNICAL EXPERT GROUP (BOPTEG)

OUTCOME PAPER (BOPTEG) # 26

MAY 2005

(1) Topic: **Interest on Indexed Debt Instruments**

(2) Issues – see BOPTEG Issues Paper # 26 and Background paper prepared by Chris Wright

(i) The BOPTEG meeting in December 2004 discussed the treatment of index-linked instruments and recognized the complexity of the issue. The discussion was based on an approach consistent with the debtor approach to recording interest.

(ii) The group considered two methods for determining interest (using the movement in reference index during a period or using the most recent observation of relevant index) without changing the definition of interest in the *1993 SNA* (Alternative 1 from the IMF Statistics Department's paper). Most members considered the use of recent observations to estimate interest accruals as the most acceptable option, but considered after-the-fact revisions as impractical. BOPTEG members expressed reservations on limiting the discussion. Some members felt that other alternatives (such as interest expectation at inception [Alternative 2] or embedded derivative approach [Alternative 4]) should be explored. It was also noted that instruments linked to inflation indicators have special nature than those linked to speculative indicators. Some members felt that *ESA95* intended to make such a distinction.

(iii) The issue paper was also presented at the December 2004 AEG meeting as an information item. The AEG expressed the view that the debtor approach did not limit discussion to Alternative 1 from the attachment (IMF Statistics Department's paper), but also encompassed Alternatives 2 and 4, which received some support.

(iv) As a result, the BOPTEG issues paper # 26 was revised and a background paper including numerical examples was prepared (by Chris Wright) for an electronic discussion among the BOPTEG members of all three alternatives.

(3) Recommendations:

(i) Ten BOPTEG members responded to the revised paper. The following summarizes their views:

- Four members preferred to determine interest as the difference between redemption and issue prices accrued over the life of the instrument, in line with the *1993 SNA* approach. For calculating interest for each accounting period, two responses favored using the movement in the relevant index, of which one suggested no revisions so that it would be closer to the existing SNA guidelines. Two other responses considered the use of the most recent observation of the relevant index to be more practical, but one response felt that continuous revision is undesirable.

- One member thought that while a split between interest and holding gains/losses as a result of indexation seems appropriate; on practical grounds and for achieving symmetry of reporting by debtors and creditors, using the movement in the relevant index is to be preferred. The member also considered the revision of past periods as not favorable.
- One member thought that when the index reflects a general price level, it seems appropriate to associate its movements with (nominal) interest. But, when the index is linked to anything else, it is appropriate to associate its movements with valuation gains and losses. Thus, the economic reality is best captured by using the movement in the relevant index for instruments indexed to a general price level and market expectation at the time of issue for instruments indexed to anything else.
- Four members preferred either market expectation at the time of issue or embedded derivative approach. Two members favored market expectation at the time of issue while two favored embedded derivative approach. The main reason noted was that these approaches reflect the economic reality of the separate motivations of the investor behind each aspect of the instruments, return on investment (via the expected yield to maturity) and holding gains due to the indexation.

(4) Rejected Alternatives:

The creditor approach was not under discussion.

(5) Questions for the Committee:

Which alternative does the Committee prefer?

- *Keeping the 1993 SNA unchanged for the concept of interest and not allowing revisions of interest accruals (when the coupons are index-linked, the full amounts paid as coupons, after indexation, are accrued as interest; and when the value of the principal is index-linked the difference between the actual redemption value and the issue price is treated as interest accruing over the life of the instrument). For determining interest accruing in an accounting period, the movement in the relevant index during the period is used to determine interest accruing in that period, without revising them later.*

- *Keeping the 1993 SNA unchanged for the concept of interest, and accepting revisions of interest accruals that will be determined in each accounting period either*
  (a) by using the movement in the relevant index in each accounting period and revising interest when actual redemption value is known, or
  (b) by using the most recent observation of the relevant index and revising interest continuously.

- *Clarifying or changing the 1993 SNA for defining interest on index-linked instruments by fixing the rate of accrual at the time of issue, and treating any deviation of the index from the expected path as holding gains/losses.*

- *Clarifying or changing the 1993 SNA for defining interest by regarding indexed-linked instruments as effectively including derivative contracts. This is similar to previous approach. However, interest is imputed based on a similar instrument that is not indexed and the value of the embedded derivative reflects the deviation (of the imputed interest) from actual movements in the relevant index.*