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Income from Bonds: The *1993 SNA* Approach

Prepared by the Australian Bureau of Statistics

INCOME FROM BONDS : THE 1993 SNA APPROACH

Comments by Australian Bureau on IMF Paper of March 2002

The ABS agrees that this long running issue needs to be resolved. We believe that the conclusions drawn in the IMF paper on some of the crucial issues in the debate are not based on sound analysis of SNA principles. The ABS argues that the creditor approach is the one that is consistent conceptually with the SNA93/BPM5, while the debtor approach is unsatisfactory.

2 We consider the arguments are well presented in the paper *Statistical treatment of accrual of interest on debt securities* IMF working paper WP/01/132 by John Joisce and Chris Wright. The paper *Income from Bonds: The 1993 SNA Treatment - A response* by Chris Wright (August 2002) elegantly rebuts the criticisms made of the creditor approach in the March 2002 IMF paper.

3 While the arguments have been fully aired, the ABS would like to briefly reiterate the main areas of its disagreement with the debtor approach, with reference to the March 2002 IMF paper.

SNA93 treatment of income flows

4 SNA does not explicitly deal with the situation of changing interest rates and the measurement of income flows on tradeable securities. However, the IMF paper starts from the premise that the debtor approach is the existing SNA treatment (Paragraphs 4 and 19). We are of the view that it is far from clear that the debtor approach is the incumbent treatment, and consider that the creditor approach is the one that is consistent with the principles of the SNA93/BPM5.

Market price valuation

5 The SNA93 has as one of its underlying principles the use of market price valuation of assets and liabilities. We believe that the creditor approach is consistent with this principle and the debtor approach is not. The Wright paper - *Income from Bonds: The 1993 SNA Treatment - A response* by Chris Wright includes the results of deliberations by the Joint Working Group of Standard Setters (for general accounting standards). The JWG clearly argues against the debtor approach and suggests that the use of the debtor approach - or in their terms the "effective interest basis" - gives a misleading picture of interest flows under a fair value (or market price) accounting system. The paper contains the useful characterisation of the debtor approach as being consistent with the historic cost valuation of assets and the creditor approach being consistent with the evaluation of assets at current market prices.

Nature of adjustments under the debtor approach

6 The application of the debtor approach requires the introduction of adjustments in all periods when the prevailing interest rate is different from the rate at time of issue. These adjustments have no meaning under SNA93/BPM5. The IMF paper refers to these in paragraphs 53 to 56 and in Appendix 2. We refer to the \$8, \$8, \$9 and \$10 changes shown in the example. We believe that the need to introduce adjustments that have no meaning under SNA93/BPM5 is not a by-product of the application of a conceptually correct treatment, but is indicative that the treatment is at odds with the basic principles of SNA93/BPM5. The paper does not explain what the economic events were that occurred in these particular periods that gave rise to these adjustments.

Consistency of creditor approach with SNA93 framework

7 The IMF paper makes a claim that the acceptance of the creditor approach would undermine parts of the SNA93 framework. It includes a discussion of the principles of asset valuation and the associated income flows more generally within the SNA. It concludes that the income to be recorded in all cases is that specified in the contractual arrangements. This gives insufficient weight to the special nature of bonds. Unlike non-financial assets and many financial instruments, they can be traded readily at little cost. The bond holder is continually reviewing the return compared with alternative investments. It is the prevailing rate that the bond holder accepts, otherwise they would trade their holdings. For a bond that has been purchased in a secondary market the purchaser would have little choice but to regard the prevailing rate as the only applicable rate of interest. If the SNA is to maintain and apply market price principles of valuation then the use of the debtor approach is inconsistent at best and at worst misleading. We believe that the market price principles underlying SNA are fundamental and that every attempt must be made to be consistent with them.

8 Because it is the prevailing interest rate that determines decisions made by bond holders, it is the prevailing rate that is most relevant from an analytical perspective.

9 The IMF paper concludes that because the amount of interest recorded under the creditor approach from different to that using the so-called contractual rate then the creditor approach must be inconsistent with the framework of the SNA93. First, we do not know where such a principle is actually stated in the SNA. Second, there are other instances where the interest flows recorded are different from so-called contractual interest. Two examples are deep-discounted bonds, which have no "contractual interest", and financial intermediation services indirectly measured (FISIM), where "contractual interest" is adjusted to take account of implicit service charges.

The creditor approach and monetary transactions

10 The IMF paper appears to argue that the creditor approach is inconsistent with recording monetary flows. On the contrary, the creditor approach does record monetary flows - it is simply that these flows are apportioned into amounts reflecting interest and amounts reflecting repayment of debt. Such partitioning occurs in other areas (eg the portioning of finance lease payments into interest and repayment amounts).

Ease of collection and estimation of data

11 Besides being conceptually correct, the creditor approach has benefits in terms of ease of estimation. Ideally, both the debtor and creditor approaches should be estimated using line by line information on each debt security. In many countries this information is not available. As with all estimation with incomplete data some assumptions are required. Joisce and Wright (2001) discuss this issue and conclude that the assumptions required to implement the creditor approach are much more reasonable than those required to estimate the debtor approach. ABS experience confirms this.