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[Handling Restriction]

Subject: Statistical treatment of the '0%-Prämienanleihe' in government accounts

Ref.: EDP Dialogue Visit to Austria on 8-9 November 2017, Your Email of 28 February 2018

Dear Mr. Pesendorfer,

Thank you for your email dated 28 February 2018, which provided further information on specific elements of the so called '0%-Deutsche-Mark-Prämienanleihe 1986-2016' (identified for the first time in the 2017 April EDP notification), for which the correct accounting treatment has been discussed in detail during the recent EDP Dialogue Visit to Austria on 8-9 November 2017.

I. THE ACCOUNTING ISSUE TO BE CLARIFIED

The accounting issue to clarify is the appropriate amount that has to be recognised for the '0%-Deutsche-Mark-Prämienanleihe 1986-2016' (hereafter referred to as 'Prämienanleihe') in the EDP debt figure.

The statistical authorities of Austria recorded the 'Prämienanleihe' at its issue value (which is substantially below the redemption value) in the EDP debt figure until its actual repayment on 28 May 2016. The difference between the issue value recognized in the EDP debt figure and the present value of the government debt was provided in EDP reporting table 4 'Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993'.

Description of the case

On 28 May 1986, the Republic of Austria issued a non-interest bearing bond, the 'Prämienanleihe' which was due on 28 May 2016. The global note of the 'Prämienanleihe' that

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contains the basic provisions of the bond (such as: the total amount, the interest rate, the type of security and the terms and conditions for the relevant issue) stipulated that the issue price of the bond is German mark 385 million. This amount was divided in fifty thousand bonds with a denomination of German mark 192.50 and nineteen thousand five hundred bonds with a denomination of German mark 19,250. This amount is indicated as the 'Gesamtnennbetrag' (total par value) on the global note.

The bonds were due on 28 May 2016 in the following amounts: German mark 1,000 for each bond with a par amount of German mark 192.50 and German mark 100,000 for each bond with a par value of German mark 19,250. Thus the global note of the 'Prämienanleihe' actually provides two figures for the bond: the issue price and the redemption price. There were no periodic payments of interest on these bonds. The interest, which is calculated as the difference between the redemption price and the issue price, was paid at once at the redemption date (i.e. 2016).

In case that those bonds became due prematurely, the 'Conditions of Issue' specified for each year a specific redemption price equal to the issue value of the bond plus capitalised interest and any accrued interest from the preceding 28 May up to date. The exact provision of the 'Conditions of Issue' read: "...will be redeemed, at the redemption prices set out below: together with accrued amounts of capital growth from the immediately preceding May 28 to the date fixed for redemption at a rate of 5.6458176% p.a. on the basis of a year of 360 days...". However, the 'Conditions of Issue' did not specify the exact circumstances and conditions to be met for an early repayment.

The 'Prämienanleihe' is therefore a *de facto* fixed interest debt security even if the global note does not explicitly determine a fixed interest rate.

Analysis by Statistics Austria

As mentioned above Statistics Austria records the 'Prämienanleihe' in the EDP debt figure for an amount of EUR 196.9 million (= German marks 385 million) until its redemption. The interest accrued over time was shown in EDP reporting table 4 under the item "difference between the issue value recognized in the EDP debt figure and the present value of the government debt".

The difference between the issue value and the redemption value constitutes interest (paid in 2016) for the amount of Euro 825.7 million, which is accrued over 1986-2016 according to an exponential formula (e.g. EUR 803.1 million in 2015) since the April 2017 notification¹.

At time of redemption (i.e. 28 May 2016) the difference between interest paid in 2016 (Euro 825.7 million), and actually accrued in 2016 (EUR 22.7 million) was recorded in the respective adjustment lines for the difference of interest paid and accrued in the EDP tables 2A, 3A and 3B.

Statistics Austria emphasizes that the face value of the 'Prämienanleihe' was German mark 384 million (equal to EUR 196.9 million) and therefore the amount that had to be reported in the EDP debt figure is solely EUR 196.9 million. The interest accrued over the life of the bond has no impact on the EDP debt figure.

Statistics Austria claims that the 'Prämienanleihe' is to be considered as a bond with 'capitalised interest', for which the Manual on Government Deficit and Debt (MGDD) provides that "*the*

¹ Previously, the interest accrued was constant (27.5 million a year = 825.7/30).

face value is the issue value which will differ from redemption value" (MGDD chapter VIII.2.2.1 paragraph 6). According to Statistics Austria, this specific provision would also determine that the EDP debt figure should only be affected by an amount of EUR 196.9 million and not by EUR 1,022.1 million (issue value plus accrued interest).

Statistics Austria also refers to the tax treatment of the interest of the 'Prämienanleihe'. According to Austrian tax law, the difference between the issue price and the redemption price is to be regarded as interest.

Finally, Statistics Austria points out that claims for the payment of interest would become void, when creditors forget to collect them, after only four years, while a period of thirty years exists for the principal.

II. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

Applicable accounting rules

- ESA 2010 paragraph 5.90(d) regarding the face value of debt securities.
- ESA 2010 paragraph 4.45 regarding the face value of zero coupon bills.
- ESA 2010 paragraph 6.53 regarding the face value of zero coupon notes or bonds.
- ESA 2010 paragraph 5.96(c) regarding zero-coupon bonds.
- ESA 2010 paragraphs 1.90 and 20.164 regarding the priority of substance over legal form.
- MGDD Chapter VIII.2.2.1.

Analysis

Background

The issue at stake is whether the characteristics and the EDP debt impact of the 'Prämienanleihe' were correctly identified and assessed by Statistics Austria. This involves, in particular, recognizing the issue price as the face value, which is to be recorded in EDP debt figure according to Council Regulation (EC) No 479/2009, and considering the 'Prämienanleihe' to be a capitalized interest bond in the meaning of the MGDD chapter VIII.2.2.1.

The provisions of Council Regulation (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community defines that "*'Government debt' means the total gross debt at nominal value outstanding at the end of the year ...*" and "*The nominal value of a liability outstanding at the end of the year is the face value*".

It can be noted, although this is not relevant to the problem at stake, that the ESA 2010 (as well as SNA 2008) defines nominal value differently from Council Regulation (EC) No 479/2009. ESA 2010 7.39: "*Nominal valuation reflects the sum of funds originally advanced, plus any subsequent advances, less any repayments, plus any accrued interest. Nominal value is not the same as face value*".

The crucial question concerns the exact definition of 'face value' for statistical purposes (i.e. for EDP reporting) and its application in the specific case 'Prämienanleihe'. An important issue

here is that the aforementioned terms and conditions of the 'Prämienanleihe' make it in practice difficult to see economic differences between this type of debt security and zero-coupon bonds so to justify recognizing two substantially different impacts on the EDP debt figure.

Definition of face value

It is important to note that there does not exist any agreed definition of face value, which is generally perceived as not being a pure statistical concept. Nonetheless, 'face value' is occasionally described in international statistical manuals, usually in the following terms: “*the undiscounted amount of principal to be repaid*” – sometimes qualifying this with “*at (or before) maturity*” (see 2008 SNA 3.157d, GFSM 2014 3.115, Public sector debt guide 2.121, External debt statistics guide Box 2.2).

Aside from that, an obvious definition of face value of a financial instrument is the value that is appearing on its face. As an example, the face value of a coin, a banknote or a materialised security (bills, notes or bonds, or even shares) is reasonably clear and uncontroversial.

In the case of (materialised) debt securities, the face value is generally the amount used to calculate the ‘coupon’, with a coupon rate also often publicised on the face of the instrument. The Public sector statistics debt guide paragraph 2.163 for instance states “*A coupon payment is a contractually agreed cash amount paid by the issuer of the debt security to the holder, at each coupon date. It is calculated from the coupon rate, face value of the debt security, and the number of payments per year, and may differ from the accrued interest.*” The MGDD similarly states: “*The face value is equal to the amount, contractually agreed, that the government will have to refund to creditors at maturity. It is also on this amount (the principal) that the interest is calculated.*”

Eurostat is also currently discussing within the EDPS WG the definition of the face value in the specific case of deposits with capitalised interest that are redeemable at the initiative of creditors. This question has been referred to, for a while, in the EDP press release as an ongoing issue in need of clarification.²

It is important to note that the ESA 2010 seems, however, reasonably prescriptive for the face value of debt securities, which is equated to the redemption price or value:

- ESA 2010 5.90 (d) writes (for all debt securities): “*redemption price or face value, which is the amount to be paid by the issuer to the holder at maturity*”.
- ESA 2010 4.45 is particularly clear that, in the case of a zero coupon bill, the face value is the full redemption value of the instrument. “*The difference between the face value and the price paid at the time of issue (i.e. the discount) is a measure of the interest payable over the life of the bill. The increase in the value of a bill due to the accumulation of accrued interest does not constitute a holding gain because it is due to an increase in the principal outstanding and not a change in the price of the asset. Other changes in the value of the bill are treated as holding gains/losses.*” The face value thus “includes interest” in this specific case.

² The Press release of Eurostat in October 2017 again indicated: “*Valuation of debt instruments. Eurostat is currently reviewing, in co-operation with Member States, the valuation of certain debt instruments, such as non-negotiable saving and treasury certificates, for EDP purposes. This may lead to a future increase in government debt in some Member States due to the inclusion of accumulated capitalised interest under these instruments.*”

- ESA 2010 6.53 extends what is written on zero coupon bills in ESA 2010 4.45 to zero-coupon notes, or bonds: *"When a long-term debt security, such as a bond, is issued at premium or discount, including deep discounted and zero coupon bonds, the difference between its issue price and its face or redemption value when it matures measures interest that the issuer is obliged to pay over the life of the debt security. Such interest is recorded as property income payable by the issuer of the long-term debt security and receivable by the holder of the debt security, in addition to any coupon interest actually paid by the issuer at specified intervals over the life of the debt security"*.

The ESA 2010 5.90(c) reference of the face value being the redemption value can be seen as circular or at least ambiguous on a regular bond to the extent that the final payment on such a bond contains both a (final) coupon and the redemption of the principal. However, this ambiguity does not exist in a zero-coupon instrument under ESA 2010, following ESA 2010 4.45 and 6.53: the final payment is both the redemption value and the face value.

Case of 'Prämienanleihe' compared to zero coupon bond

ESA 2010 5.96 (c) defines a zero-coupon bond as a single-payment debt security with no coupon payment. Such a bond is sold at a discount and the holder receives the nominal value of the bond (the redemption value) at maturity. Consistently with ESA 2010 4.45 and 6.53, the MGDD chapter VIII.2.2.1 paragraph 6 provides that the face value is the redemption value for zero-coupons bonds.

Thus, for a zero-coupon structured in a similar way as the present 'Prämienanleihe', the global note would provide for two values: the nominal amount (redemption value) of EUR 1,022.1 million and the (discounted) issue price of EUR 196.9 million. Like in the case of the 'Prämienanleihe', there are no periodic interest payments and the actual interest that the creditor receives at maturity is EUR 825.7 million (= redemption price minus issue price).

However, due to ESA 2010 5.90 and 4.45 (and the related provisions for zero-coupons in MGDD chapter VIII.2.2.1 paragraph 6), the amount to be recorded in the EDP debt figure is EUR 1,022.1 million, instead of EUR 196.9 million for the 'Prämienanleihe' according to Statistics Austria. However, the only observable difference between both bonds is that the value printed on the zero-coupon bond is EUR 1,022.1 million and the value printed on the 'Prämienanleihe' is EUR 196.9 million. However, the global note of the 'Prämienanleihe' provides also the redemption price for each denomination. Eurostat considers therefore that, in substance, the present form of the 'Prämienanleihe' is not different from a zero-coupon bond. As a result the impact on the EDP debt figure should be the same as in the case of similar structured zero-coupon bond.

Eurostat takes note of the argument put forward by Statistics Austria concerning Council Regulation (EC) No 479/2009, which provides that the nominal value of a liability outstanding at the end of the year is the face value. However, the face value can be either one of the two amounts foreseen in the contract. In deciding which one of the two amounts should be seen as the face value in the meaning of the Council Regulation (EC) No 479/2009, legal arguments or terminology cannot be the guiding principles or at least the sole guiding elements. There are no reasons to deviate from the ESA 2010 references to face value. A key principle of ESA 2010 is recording economic substance over legal form (see ESA 2010 1.90 and 20.164). This implies that an accounting treatment of an operation should reflect economic reality and not the legal framework or a legal provision in which the operation is carried out, or the terminology used.

'Prämienanleihe' as a capitalised bond

Statistics Austria also makes use of the argument that the 'Prämienanleihe' is to be considered as a 'capitalised interest bond' in line with the provisions of the MGDD Chapter VIII.2.2.1 paragraph 6. The question is whether this reference is valid.

A preliminary observation is that ESA 2010 5.96 (which refers to fixed interest rate debt securities) does not explicitly mention bonds with capitalised interest. This may indicate that the related MGDD provision is obsolete. Aside from that, the MGDD does not provide any definition of what exactly constitutes these bonds with capitalized interest. In particular the MGDD does not explain what would make the economic difference between a zero-coupon bond and a bond with capitalized interest. The MGDD only provides that, for such a specific capitalised bond, the face value is the issue value, which will differ from the redemption value.

The missing definition of what a bond with capitalised interest stands for (and the uncertainty about what features makes a bond to be a bond with capitalized interest and not to be a zero-coupon bond) has led to a discussion of this issue in the meeting of EDPS Working Group (EDPS WG) on 20-22 June 2016. The discussions during the meeting concluded that the notion of bond with capitalised interest was rather unclear, in particular where such a bond is issued with fixed interest. In this meeting, no participant was able to provide the elements that would make a capitalized interest bond clearly distinguishable from a zero-coupon bond.

The situation would be very different for bonds with capitalized variable interest. Unlike in the case of a fixed interest bond, the actual interest payments to be made during the lifetime of variable rate bond are not predictable at inception: such a bond looks more like an indexed bond. It is clear that the global note of such a bond can only indicate the issue price and the reference for the variable interest rate. In contrast to the present 'Prämienanleihe', no redemption price could be then specified. In such a case, it may be justified to regard the issue price as the face value.³

Other arguments raised

A legal issue may question the wisdom of recording the redemption value of the 'Prämienanleihe' as face value: the fact that creditors may forget to collect their interest claims on time and risk therefore lose their claims after expiry of the limitation period – which is for interest substantially shorter in Austria than for the principal (3 years against 30 years). Eurostat considers that the distinction between coupons and principal could perhaps make sense when coupons can be materially separated from the principal. However, this is not the case for the 'Prämienanleihe'. In addition, the likelihood that a substantial number of the creditors will not be in a position to claim their interest because they lost the global note through fire, water or other events seems to be very small. There may be some individual cases to which this applies but, the overall impact will most probably be rather small and thus should not be considered for the determination of the face value.

The fact that the interest on 'Prämienanleihe' is taxable at time of redemption would not prevent to consider the face value to be the redemption value. It is also likely that the gain on a zero-coupon is taxable.

³ However, even then, such a bond with capitalised variable interest could economically be seen as a continuously increasing loan/deposit (principal plus accrued interest) provided by the creditors. The face value could then be the issue value plus capitalised interest – consistently with indexed securities.

III. CONCLUSION

In general, Eurostat considers that, for capitalized interest debt securities with a fixed interest either in the form of a basic zero-coupons bond, or any other form, the appropriate impact on the EDP debt figure should be the redemption value. The features of a bond of the kind of the 'Prämienanleihe' do not allow the recording of a different EDP debt impact in comparison with a basic zero-coupon bond. The structure of the 'Prämienanleihe' is basically not distinguishable from a similar structured zero-coupon bond.

Thus, Eurostat considers that the EDP debt impact of the 'Prämienanleihe' should correspond to the redemption value (i.e. EUR 1,022.1 million) mentioned in the respective global note and to be recorded immediately at issuance. This also corresponds with a key principle of ESA 2010 to record data according to its economic substance rather than its legal design or form.

Eurostat further considers that the statutory limitation of interest claims does not preclude to record the 'Prämienanleihe' with its redemption value in the EDP debt figure, since the principal and the interest is guaranteed and called by the same global note (no separate coupons). In addition, no evidence does exist that a non-negligible amount of interest claims actually became invalid.

IV. PROCEDURE

This view of Eurostat is based on the information provided so far by the Statistical Authorities of Austria. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, or there may be inaccuracies in the assessment due to the translation risk, Eurostat reserves the right to reconsider its view.

In this context, we would like to remind you that Eurostat is committed to adopt a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, as amended, and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat therefore publishes all official methodological advice given to Member States on its website.

(e-Signed)

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