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Directorate D: Government Finance Statistics (GFS) and quality

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Subject: Treatment of repurchase and subsequent resale transactions of Federal bonds at a premium/ discount

Ref.: Your Email on 22 December 2017

Dear Mr Braakmann,

We thank you for your email dated 22 December 2017 related to the appropriate treatment of premium and discounts on bond repurchases carried out by the German Finance Agency. Eurostat would like to hereby express a preliminary view on this matter.

1. THE ACCOUNTING ISSUE FOR WHICH A CLARIFICATION IS NECESSARY

The issue to be analysed is the appropriate treatment of premiums/ discounts of bond repurchases and subsequent resales on the secondary market that is being carried out by the German Finance Agency ("*Bundesrepublik Deutschland – Finanzagentur GmbH*"), according to national accounts rules.

Description of the case

Trading practice of the German Finance Agency

In Germany, the German Finance Agency is responsible for the portfolio management of Federal government securities. Aside from its task of conducting debt security issuance on the primary market, the agency also conducts thousands of transactions annually on the secondary market for all kinds of federal debt instruments, so as to ensure a high level of liquidity in the market. The table below shows the number and size of these secondary market transactions, which can overtake the volume of primary market issuance.

Table A: secondary market transactions

secondary market transactions (Federal Government including two budgetary Sondervermögen)				
	2013	2014	2015	2016
<i>(number of secondary market transactions)</i>				
Sales	23 330	16 316	10 864	11 280
Purchases	23 455	16 198	11 104	10 638
<i>(value of secondary market transactions in Euro billions)</i>				
Sales	168.20	99.59	69.62	93.49
Purchases	186.01	115.60	82.50	109.73

The line "Sales" in Table A includes not only "resales" of bonds repurchased, but also the sale of securities that were issued on the primary market but not actually sold at issuance and instead withheld for resale on the secondary market at a later stage ("*Marktpflege*", which usually accounts for less than 20% of issue volumes).

Repurchases lead to premiums or discounts, the difference between the price paid (in principle excluding the coupon accrued to date and repurchased) and the face value. This is captured in the EDP Table 3 in the line *Redemptions/repurchase of debt above(+)/below(-) nominal value*. Table B depicts the amounts of premiums and discounts on repurchases in Germany for the Bund, reported for the first time in the context of the October 2017 EDP notification reporting. In previous reporting, these amounts were presumably netted in the line *Issuances above(-)/below(+) nominal value*".

Table B: Premiums from repurchases of Federal Government securities

<i>Values in Euro millions</i>	2013	2014	2015	2016	Total
Redemptions/repurchase of debt above(+)/below(-) nominal value	8 888.49	5 520.44	3 937.54	6 595.84	24 942.30

Due to falling market rates, the German Finance Agency tended, in recent years, to buyback the debt securities at a predominantly higher price than the agreed redemption price, debt being repurchased at a premium, hence at a loss.

Statistical treatment applied by the German Statistical Authorities

Until recently, the compilation of the interest accrued expenditure of the Bund was using an instrument by instrument database not capturing the secondary market transactions, which was a clear limitation of the German compilation.

As a result of the Standard Dialogue Visit to Germany in 2014, to address this limitation and to better reflect premiums and discounts in accrued interest, a provisional solution was implemented by the German Statistical Authorities. The approach combined an instrument-by-instrument approach together with a model calculation. The model calculation consisted in compiling the difference between the actual cash data as shown in the budget and the "estimated cash data" compiled by using the security by security database. The difference was then recorded within D.41, spread forward by way of a model calculation over the average maturity of the securities.

In order to capture all components of interest (including premiums and discounts of repurchase transactions) on a sole instrument-by-instrument basis, the German Finance Agency developed a new model, called "capital cost model" (CCM).

The new model operates on a transaction-by-transaction basis. All discounts/ premiums paid when debt is bought back enter the calculation of interest (D.41) distributed over the remaining theoretical lifetime of the debt instrument.

For the October 2017 notification, the Statistical Authorities implemented the CCM in the ESA 2010 data, changing its reporting to Eurostat in the following way:

- Implementing the new CCM, providing a better estimate of the time of recording of the expenditure compared to the previous model – and *de facto* reducing D.41 expenditure by around 3.2 billion Euro over 2013-2016;
- Reporting, for the first time, the large premiums on repurchases (observed in recent years) separately in EDP table 3 (see table B above) under the dedicated line, which hitherto had been set to zero (being netted off with premiums and discounts at issuance).

Issue being raised

The observation of the very large premiums and discounts on repurchase reported in the October 2017 EDP notification led Eurostat to enquire more in detail on the treatment of these in national accounts. Eurostat then understood the implication of the German practice, which has been in existence for a while (both in the macro-approach and in the CCM) for premiums and discounts on repurchase to enter B.9 – spread over the remaining life of the instrument, given that this concerned very large amounts.

During the October 2017 notification, Eurostat pointed out that this recording is in conflict with the usual (or current) interpretation of ESA 2010, according to which premiums and discounts on repurchase enter the financial accounts, as a settlement of holding losses or gains incurred in the past, and were not to be recorded as expenditure or revenue of government, neither at time of repurchase nor later on.

Eurostat in particular reasoned that – taking into account that repurchases tended to concentrate on soon to mature bonds – interest expenditure of central government was overestimated by around 0.2% of GDP in recent years, on average.

The German Statistical Authorities argued that, whereas they agreed that the CCM was not fully in line with the ESA 2010, the current interpretation of ESA 2010 was not sound. They enquired on whether a new interpretation could be agreed upon or whether specific rules were needed in the case of active trading by the issuer on its own debt.

Eurostat has been in discussions with the German Statistical Authorities concerning this issue since the October 2017 notification, and more recently during the SDV visit in Wiesbaden on 19-20 February and 12 March 2018. The issue was also discussed within Eurostat experts meetings: in the Excessive Deficit Procedure Statistics Working Group in December 2017 and again in the Task Force on methodological issues in March 2018.

The issue to address is therefore to examine what are the potential alternative ways forward in the medium and long run, and what are the temporary correction measures to be applied in the forthcoming notification in the short run, if any.

2. METHODOLOGICAL ANALYSIS AND CLARIFICATION BY EUROSTAT

Applicable accounting rules

- ESA 2010, Chapter 20, paragraphs 20.176ff on interest, in particular paragraph 20.180,
- The Manual on Government Deficit and Debt (MGDD), implementation of ESA 2010, 2016 edition:
Part II.4 “Recording of interest”

Availability of national accounting analysis

The German Statistical Authorities have provided Eurostat with their view on the methodological merit of the recording of premiums and discounts according to the CCM in the context of the October 2017 EDP reporting. The German Statistical Authorities have the opinion that the capital cost model provides a more prudent approach, or a stricter interpretation of the debtor approach, than the current interpretation of ESA 2010, as all cash payments concerning an instrument will be reflected in interest expenditure, and hence the model better reflects the economic reality.

The German Statistical Authorities also agreed that the CCM would not a priori comply with ESA 2010. Thus, Eurostat also received in November 2017 an Email describing three possible model changes to the capital cost model. The model options were the following:

Model change 1: "cumulation of primary market transaction premiums/ discounts, weighted with past primary market transactions, and deriving revaluation effects from repurchases and resales on the secondary market"

Model change 2: "cumulation of primary market transaction premiums/ discounts, weighted with the current volume in circulation, and deriving revaluation effects from repurchases and resales on the secondary market"

Model change 3: "cumulation of primary and secondary market sales premiums/ discounts, weighted with the current volume in circulation, and deriving revaluation effects only from repurchases on the secondary market"

Accrued interests would comprise either premiums/ discounts solely of primary market sales (Model changes 1 and 2) or, in the third case, also premiums/ discounts of secondary market sales. Only in model 3 would a resale of a bond on the secondary market be treated as a new issuance of a new bond.

In the context of the recording of premiums and discounts of repurchases and resale transactions, the German Statistical Authorities also raised in their Email of 22 December 2017 the question about the presentation of the repurchases in the accounts (consolidated or gross presentation) according to ESA 2010.

Moreover, in the December EDPS WG the notion of recognising a quasi-corporation was discussed. During the EDP Standard Dialogue Visit to Germany 2018, the Bundesbank introduced a possible recognition of a quasi-corporation classified inside government, which would act as primary dealer for the federal government.

Methodological analysis and clarification by Eurostat

Current interpretation of ESA 2010

Background

Interest can be accrued using different approaches. ESA 20.179 mentions two potential approaches (debtor principle, creditor principle), indicating that the debtor principle is to be applied in national accounts.

ESA 20.179 provides the following regarding the debtor principle: *"The debtor approach is from the perspective of the unit issuing the security [...] From the debtor approach, the interest rate agreed on initiation is used throughout the life of the security."* ESA 20.180 states: *"Accrual interest is recorded according to the debtor approach, that is: based on the rate or yield prevailing at the time of creation of the financial instrument."* ESA 2010 hence focuses on the cost of borrowing from the debtor point of view, i.e. as anticipated at issuance of the financial instrument. Market movements or secondary market transactions of the creditor with third parties has no impact on the accrued interest from the point of view of the issuer (see also MGDD 2016 II.4.3.2 paragraph 8 and II.4.3.4 paragraph 13).

Discussions on the appropriate approach on accruing interest date back to the 1980s. In 1999, the Inter Secretariat Working Group for National Accounts (ISWGNA) established an Electronic Discussion Group (EDG, moderated by Cor Gorter) to advise on the appropriate way to record interest. The EDG final report¹ published in 2002 recommended that the ISWGNA confirms that the SNA 1993 follows the debtor principle. The report indicated that *"the abrupt and potentially very large changes in interest under the creditor approach would make little economic sense"*.

At the occasion of the SNA 2008 and ESA 2010 review, the prescription to favour the debtor principle was thus considerably reinforced in the text compared to the SNA 1993 and ESA 1995 versions. In particular, ESA 20.180, explicitly refers to the motivation for favouring the debtor principle: *"Thus, interest expenditure to be recorded on fixed-rate debt securities does not vary over time in sympathy with market fluctuations, despite the fact that the market value of the securities fluctuates and that, accordingly, the opportunity costs of carrying this debt vary. In that way, interest expenditure avoids the volatility that the creditor approach entails"*. The recorded interest in national accounts should hence be principally inelastic to changes in the market rate – contrary to the creditor principle.

However, a problem exists with the debtor principle, in case of debt repurchases, particularly in case of large refinancing by Treasuries. It is important to note that the 2002 EDG Report was aware of this: *"a clear weakness of the debtor approach would be that government buybacks affect future deficits"*, with a proposal to *"sticking to the debtor approach until broad and massive use of refinancing warrants a revisiting"*.

Because of this weakness of the debtor approach, increased repurchase and reissuance activity by government tends to shift the recording towards the creditor approach. Recorded interest flows become, even under the debtor approach, elastic to market yields. This is because, interest expenditure is quasi-continuously revalued, based on bonds partially repurchased and reissued at numerous points in time during their lifetime and hence their accruing interest adapted.

¹ <https://www.imf.org/external/np/sta/na/interest/modrep.pdf>

Treatment of premiums or discounts on repurchases

According to ESA 2010, premiums and discounts stemming from repurchases must not be included in the accruing interest but be treated as the realisation of holding gains/ losses incurred in the past: i.e. financial transactions liquidating, at time of repurchase, the gains or losses that entered the revaluation accounts since issuance.

ESA 20.180 stipulates very clearly the following concerning the repurchase of securities: "*The repurchase of securities on the market, at a premium or at a discount to the principal outstanding, does not lead to any entry in revenue or expenditure at the time of purchase **or later on**. Instead, any repurchase premium or discount reflects the settlement, recorded in the financial accounts, of a holding gain or loss that accrued in the past and was recorded in the revaluation accounts at that time.*" **(bold added)**

Obviously, the gain/loss cannot be expense/revenue at time of repurchase, given that, at that time, the net worth of government does not change – when measured at market value: government has less cash but fewer liabilities for exactly the same amount. In addition, recording such gain/loss in expense/revenue at time of repurchase would allow 'manufacturing' B.9 impacts at will, very easily, and, if not without limit, at least for very large amounts.

But, interestingly, the ESA 2010 writer also added: "*or later on*", seemingly thereby instructing to avoid spreading the premium/discounts forwards either.

This addition by the ESA 2010 writer is consistent with another important text passage in ESA 2010 that prescribes that a repurchase of a bond is *de facto* an early redemption of the bond. Thus the bond repurchased ceases to exist from the statistical point of view. ESA 20.130: "*The repurchase by a unit of a liability is recorded as redemption in liabilities and not as an acquisition of assets.*" This is also supported by ESA 5.30 that states: "*When a department of an institutional unit purchases bonds issued by another department of the same institutional unit, the financial account of the unit does not record the transaction as the acquisition of a claim by one department on another. The transaction is recorded as a redemption of liabilities rather than an acquisition of consolidating assets. Such financial instruments are viewed as netted.*"

This approach taken by ESA 2010 should be understood within the broader context according to which national accounts rules in general prescribe to eliminate all events that are internal to one institutional unit – with specific exceptions. These exceptions concern the production account, where deliveries in between local KAUs are recorded. Otherwise, claims from one department to the other, or payments or any event between departments are not recorded in the system. This rule is obviously important when an institutional unit comprises a number of legal units, as the many interactions between those legal units are accordingly to be discarded. This rule has also some significance, when an institutional unit comprises only one legal unit, as various departments may have different bank accounts, or may maintain creditor/debtors links; here again these are also to be neglected. As an application of this, a bond issued by a unit and held by that unit is not shown in the accounts of the institutional unit.

In addition, ESA 20.130 makes an interesting parallel with the presentation of consolidated accounts of the government sector: "*Likewise, at a subsector or sector level, the purchase by a government unit of a liability issued by another unit of the subsector in question will be presented in the consolidated presentation, as redemption of liability by that subsector*". As a consequence, any resale of a repurchased bond is treated as new issuance, as the bond had already been considered redeemed.

However, this last sentence may imply some intriguing consequences discussed below in relation to resales: was this parallel intended to prescribe that a repurchase and resale carried out by another government unit should lead to the same recording as the repurchase and resale by the same unit in all respects? ESA 20.152 defines consolidation as a method to present a grouping of units as if this was one single institutional unit.

In addition, ESA 5.30 continues with "*Netting is to be avoided if it is necessary to keep the financial instrument on both the asset side and the liability side to follow the legal presentation.*" This is sometimes interpreted as providing a justification for the gross recording of repurchased bonds. However, the reference to "legal presentation" is not particularly convincing, as legal presentation is hardly a driving element in ESA 2010. In addition, the context of the sentence cannot support an interpretation allowing repurchases not to be redemptions in general.

Summary

In summary, the repurchase of its debt securities by the issuer is deemed to be a redemption in national accounts, and the premium/discount on repurchase is not income, and instead enters the revaluation accounts.

Repurchases financed by issuing debt at a yield different than the initial yield applicable to the debt repurchased will impact future deficits (net lending/net borrowing) of the respective units (government). When such repurchases and reissuances become massive, D.41 becomes elastic to market rates, which conflicts with the initial stated intention of the ESA 2010 to favour the debtor principle. This issue is not new, as it was foreseen since the beginning. What is new is the magnitude of the repurchases.

It can be noted that modalities of debt repurchase is to fund them through new issuance, through resale, or through drawing down the government cash account. One issue concerns whether 'resale' or 'new issuance' is sufficiently different to venture a different accounting treatment when of material size.

The CCM: an alternative interpretation for prudent recording under ESA

Gains on trading: economic gains, accounting gains

It is important to understand that the economic gains or losses arising from debt repurchases and reissuances – which would typically not be very large, although significant – should not be assimilated or confused with the accounting impact that can be large or very large: e.g. the accounting impact of the use of the debtor approach versus the creditor approach is solely an accounting effect.

The active trading by debt agencies can generate two/three types of genuine economic gain or "income", directly or indirectly:

- By ensuring better liquidity, the debt agency can issue debt at lower yields in general, although this cannot be measured in the financial statements;
- By actively trading, the debt agency will typically generate accounting gains and losses, just like any market maker ('buying low and selling high') that would have the nature of trading income – and to be recorded as production of services according to ESA 3.73;

- By holding a trading book, the debt agency is generating potentially other types of gains of a nature of revaluation: holding gains if yields fall, holding losses if yields increase; amortisation of discounts/premiums on debt repurchased.

It is likely that, in the financial statement, the trading gains will be captured together with the holding gains on the trading book, such that separating them may not be easy.

Advantage of the CCM

As the German Statistical Authorities have pointed out, the alternative approach used by the CCM, can be seen as more in line with economic reality.

The accounting effect of the current interpretation of the debtor principle in ESA 2010 can indeed have a significant impact on the debt management of Treasuries:

- It can provide a significant incentive to repurchase debt securities before their maturity solely for pure accounting reasons – in case of falling/low market rates.
- It can provide a significant disincentive for actively buying back debt, in case of rising/high market rates. This would have a negative impact on welfare, as such trading in debt securities provides liquidity.

In contrast to the ESA 2010 approach, the CCM recording stabilises the accrued interest and eliminates its elasticity to market yields in the case of repurchases and reissuances. Under this approach, there would be no difference in the accruing interest between conducting no secondary market transactions and therefore letting the outstanding volume of the bond unchanged, or actively repurchasing bonds early and reselling or reissuing them.

The CCM could be considered a 'reinforced debtor principle'.

Inconveniences of the CCM

However, such a recording would lead to a number of problems. The most difficult issue concerns the counterparty recording: when debt securities are bought back, the counterparty ceases to exist. Continuing to record some interest expenditure (i.e. the premium/discount spread forward) by the debtor is then judged not palatable by many, because it implies recording interest revenue in a sector that does not hold the instrument anymore. By the same token, the imputation of some artificial interest seems to imply creating a discrepancy between non-financial and financial accounts.

Another problem of the CCM is that it is in conflict with one sentence of ESA 20.180 ("*The repurchase of securities on the market, at a premium or at a discount to the principal outstanding, does not lead to any entry in revenue or expenditure at the time of purchase or later on.*")

Limits to these inconveniences of the CCM

Although these inconveniences are considered by some as incontrovertible, Eurostat thinks this issue needs to be discussed. The CCM may well be a way to enforce a 'reinforced debtor principle' recording.

Absence of counterpart

The problem of absence of counterpart – which is considered fundamental by many – may however be relativized once it is realised that the debtor principle *de facto* implies an imputation.

One can for instance observe that the sale of a new tranche at a different yield than previously issued tranches leads to changes in D.41 revenue of new creditors even when no transaction by the older creditors has occurred. Similarly, no discrepancy occurs in this case (neither for new nor for old creditors), because the change in D.41 revenue is matched by a change in F.3 transactions and different sequences of other economic flows in the AF.3 instrument, in the accounts of the creditors. It is well-known that the debtor principle leads to artificial entries in the OEF, in both the debtor but also the creditor(s) accounts. It could thus be argued that the problem created by the CCM is just an extension of the well-known 'anomalies' created by the debtor principle.

The CCM merely records an adjustment that can be either negative or positive to D.41 expenditure. Imputing these adjustments on the remaining bonds on tranches subject to repurchase could appear justified. Imputing these adjustments on other tranches would seem merely an extension of this.

Conflict with ESA 20.180

In relation to the deviation of the CCM with one sentence of ESA 20.180, although this is undeniable, one could argue that the new situation where Treasuries repurchase large amounts of their debts creates a new situation that conflicts with the previous sentence in ESA 20.180 ("*In that way, interest expenditure avoids the volatility that the creditor approach entails.*"). The latter is arguably perhaps more important, because it states the intention of the legislator.

Conclusions

During the discussions in the TF on methodological issues and the EDPSWG, it was clear that the CCM did not receive a lot of support. However, Eurostat considers that the issue needs to be reflected upon, given the significant impact stemming from active debt repurchases by Treasuries.

The issue had been left open by the 2002 EDG, and a clarification of the appropriate rule should be discussed.

In the meanwhile, the CCM is not in line with the current interpretation of the ESA 2010, and interest expenditure seems overestimated by around 0.2% of GDP in Germany.

Alternative conceptual recordings

Treating differently issuances and resales

It has been envisaged to treat differently 'resales' from 'issuances'. Following the ESA 2010 recommendation that repurchases are redemptions, this appears difficult to justify, however.

The argument according to which issuances on the primary market are materially different or of a different nature to that of resales on the secondary market is not completely convincing. Whereas primary market issuances are generally subject to specific procedures and transparency requirements that do not apply to secondary market transactions, arbitrage occurs such that the two markets cannot be convincingly separated from an economic point of view.

Furthermore, treating differently resales from issuances would lead to unsound incentives, allowing selective control of the impact on the deficit depending on the simple modality of debt sale: e.g. organising issuance through additional volumes issued under a given ISIN, or though the resale of volumes held under the same ISIN.

Average price or Last in – First out (LIFO) model

An issue that has not received sufficient attention until recently is the question of the appropriate model to use when repurchasing bonds issued in tranches. As explained in the previous section, D.41 is imputed in the sense that D.41 accruing on each bond must be an average, from the point of view of each creditor. This is because each creditor may have sold and repurchased the said bonds (in whole or in part), such that one cannot generally assign them the specific, distinct D.41 at each issuance that the debtor can and does recognise. In contrast, there is no need for such an average, from the point of view of the issuer, as long as it is not repurchasing.

However, a problem arises when the debtor starts repurchasing its debt. Whereas one would a priori think of selecting, for such repurchases, the average price method (as any other creditor), one could also envisage an alternative approach, sometimes used in "inventory accounting": the LIFO model. Under the LIFO method, the repurchased bond would be deemed to have the D.41 yield of the most recently issued bond.

In case of active trading, the LIFO method would largely (but not completely) neutralise the adverse effect observed with the current interpretation by the ESA 2010. This is because the sequence of buys and sells tends to leave unchanged the bulk of the yield of the bonds under each tranche, under the LIFO method. In contrast, the average yield is affected under an average yield method.

It can be noted that the LIFO method can be applied for repurchases and separately for resales, also in conjunction with the decision to treat issuances identically to resales or separately to them.

Recognizing a primary dealer activity

Primary dealers' margin

One interesting way to address the issue at hand is to recognize that the debt agency is *de facto* acting – in its repurchase activity – as a 'primary dealer', whose function, by buying and selling, is to provide market liquidity to buyers and sellers alike – against an implicit 'fee'. This activity can be seen as distinct from the activity of providing financing to government.

ESA 3.73 recognizes this productive activity by 'financial institutions' such as primary dealers, prescribing to record financial services, by way of partitioning each transaction between a pure financial transaction and the purchase of a service. As noted above, this basically implies classifying a large fraction of the gains/losses of the debt agency as income (output).

Under this line of reasoning, the active trading by the debt agency could plausibly be considered of a different nature compared to ad-hoc repurchases, the latter designed to avoid excess liquidity of government and the former of providing liquidity on the market and of hence generally assuring lower yields than would otherwise be the case.

The primary dealer identified within the debt agency would have a certain B.9 corresponding (aside from its operating costs) to the margins earned on trading following ESA 3.73, as well

as net interest earned (on the trading book, net of financing costs). This trading margin should in principle exclude gains/losses arising from merely holding the securities (trading portfolio). The latter contain in turn two components that are useful to distinguish: (1) the gains/losses stemming from changes in market yields, (2) the amortisation of premiums/discounts on debt repurchased.

The trade margin calculable is supposed to be positive. In contrast, the gains and losses of the two types can either be positive or negative. Nonetheless, these gains and losses can be fairly systematically positive (in case of repurchases at a discount) or negative (in case of repurchases at a premium – as is currently the case).

In a sense, the CCM could be analysed as a variant of the ESA 3.73 with all gains/losses recorded within income, and with a different time of recording (spread over time for the CCM rather than recorded at time of actual transactions).

Recognizing a market quasi-corporation

In this context, one variant could consider recognising a market quasi-corporation classified outside government. As a result, the repurchases (and resales) would not be reflected in government accounts anymore, which would potentially lead to the same impact as the CCM on B.9 (neglecting operational costs of the part of the debt agency that would be partitioned).

The debt agency would have a B.9 corresponding to the trading margins discussed above (net of costs identified to be associated to this activity) as well as net interest earned: interest earned on the portfolio minus some remuneration on the funding *de facto* provided by the Bund. This remuneration could be designed so to achieve the same general government B.9 as generated by the CCM.

One would then expect that the quasi-corporation holds the trading book, which would cause the Maastricht debt to increase by that amount, being not any more consolidated.

The quasi-corporation would be classified in S.125. The trading margin is recorded within P.11. The clients of the entity are the counterpart transactors (the sellers or buyers on the market), as prescribed by ESA 3.73.

Recognizing a non-market quasi-corporation

An interesting alternative, proposed by the Deutsche Bundesbank, would consist of recognising a separate institutional unit within general government, as if the German Finance Agency consisted of two entities: one issuing debt, being an ancillary unit of the Bund; another carrying out primary dealers' functions.

The rationale for this classification would be that this specific primary dealer would be considered as nonmarket. Although the clients of the primary dealers are a priori well identified, it could be argued that the German Finance Agency is not pricing its services in a manner that meets the economically significant price, with no intention to turn a benefit. As a result, the true client of this primary dealer would be the Bund.

Eurostat considers that non-market financial intermediation is possible, though rare.²

² It can be noted that ESA 2010 contains a certain ambiguity, with recognising dealers as financial intermediaries (ESA 2.91) although classifying the service provided (ESA 3.73) as other financial services (ESA 3.66).

Trading margins would be recorded within P.131, with the inconvenience of leading to negative P.132 (which also occurs in other cases).

The classification inside government would permit being neutral from a Maastricht debt point of view. It would permit *de facto* treating repurchases and resales similarly to purchases and (re)sales carried out by some autonomous funds classified inside government, such as social security funds.

The proposal deviates from the CCM because of the interest generated by the trading portfolio (using the D.41 yield of the debtor principle on the asset side) as compared to its funding cost, assimilable to the market yield (creditor principle).

Summary of possible options

In summary, pending discussions at the EU and international level regarding the merit and applicability of the 'reinforced debtor principle', Eurostat could accept an interim conceptual solution consisting of recognising a market quasi-corporation, consistently with the CCM, but with an impact on the Maastricht debt.

Eurostat considers also possible that the German Statistical Authorities adopt, as interim solution, the notion of non-market dealer (dealing for providing liquidity, and not for profit by way of providing liquidity). However, this may need some justification and deviates from the CCM for the 'net' carrying costs of the trading portfolio. The trading margins would also need to be measured.

Eurostat also accepts that the German Statistical Authorities may use a LIFO model, which would go a long way towards the CCM, in case of active purchase and resale activities.

Eurostat finds it not justifiable to create a specific rule for repurchases for resale, compared to simple repurchases – and would prefer to await the opinion of the ESS before considering such an approach.

Short term solutions

Given the uncertainty in relation to the possible treatment of the premiums/discounts on repurchases, to be both compatible with the ESA 2010 and without impairing the comparability across Member States, the following actions seem possible in the short term.

In line with the market quasi-corporation approach, the German Statistical Authorities may elect keeping the CCM but at the cost of increasing the Maastricht debt.

As an alternative, the German Statistical Authorities may decide to privilege the non-market quasi-corporation or the LIFO model, and approximate this, in the short run, by recognising the net impact on D.41 of the trading portfolio held.

Another alternative is to implement the ESA 2010 as currently interpreted and eliminate altogether the spreading of the premium/discounts on repurchases. This could be carried out in the short term by spreading forward premiums/ discounts on repurchases, using an appropriate average maturity hypothesis advised by experts, applying a macro adjustment (similarly to what was carried out the German Statistical Authorities in previous notifications).

3. CONCLUSION

Eurostat is of the opinion that the capital cost model (CCM) does not comply with ESA 2010 – until an agreement is reached at EU or international level in its favour. It is debatable if currently an opportunity to change the interpretation of ESA 2010 exists. Naturally such a change would need the consensus of statisticians across the European Union and possibly would need to be, ideally, also aligned with the statistical treatment in non-EU Member States. The issue was discussed in context of the EDPS WG in December 2017. During this expert meeting, it became clear that, at the moment, no Member State actively supports a deviation from the current interpretation of ESA 2010. Nevertheless, Eurostat is not opposed to continue discussions in the wider statistical community concerning this issue.

This means that according to ESA 2010, the difference between the market and the face value at the time of repurchase is treated as a revaluation. The resale is to be treated as new issuance and the difference between the issue price and the face value enters the calculation of interest. Eurostat is aware that such a structural amendment in the model/database will be time-consuming. Eurostat therefore suggests, for the April 2018 EDP notification, estimating the interest by spreading forward premiums/ discounts on an appropriate average maturity hypothesis advised by experts, applying a macro adjustment (similar in nature to what was carried out by the German Statistical Authorities in previous notifications). Eurostat expects this to lead to a reduction in government interest expenditure (an improvement in B.9) in the order of 0.2% of GDP a year in the past four years.

Eurostat would however not object that the German Statistical Authorities keep the current interest recording (its B.9 impact) if they decided to recognise a market quasi-corporation for the trading activity – which would however imply increasing the Maastricht debt (owing to deconsolidation of the trading portfolio).

Given the difficulty of the case, Eurostat considers that it could also accept that the German Statistical Authorities adopt, for the medium term (i.e. for the October 2018 notification), either the nonmarket quasi-corporation hypothesis or the LIFO accounting method that were mentioned above. Each hypothesis or method would imply a detailed calculation, along the lines discussed above, and would not be without inconvenience. For the April 2018 notification, Eurostat would nonetheless recommend the German Statistical Authorities to approximate the reduction in net interest expenditure that would arise from the implementation of these methods by way of considering the net interest income on the trading portfolio.

Eurostat would therefore welcome to know which option the German Statistical Authorities will elect to follow.

4. PROCEDURE

This preliminary view of Eurostat is based on the information provided by the German authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with Council Regulation 479/2009 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 (ex-ante and ex-post) given to Member States, on the Eurostat web site.

Yours sincerely,

(e-Signed)

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