Accountable states

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Is Greece's debt 170 per cent of GDP or below 100 per cent? The default risk for countries will become more evident if a common, international accounting standard was introduced for governments, writes Dag Dyrdal.

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The Greek bankruptcy in 2012 was a powerful reminder that government bonds are not risk-free. However, investors' willingness and ability to assess credit risk in the euro zone is still missing. The solution may lie in something as mundane as an accounting standard.

Most euro states currently have a debt ratio well above the Maastricht Agreement, 60 per cent -- considered a sustainable limit for debt-to-GDP. Countries like France and Italy are respectively at 93 and 133 per cent -- levels many would argue are not sustainable. At the same time, the euro zone is exhibiting great interest in making governing debt restructurings more efficient, which should be a concern to investors.

In January 2013, the euro area introduced mandatory rules for new government bond issues ('collection action clauses '), which means that it only requires a qualified majority of bondholders to modify loan terms - such as lower interest rates , extended maturities or reduced principal amounts. The rules contain so-called aggregation, which allows one decision to affect several loan series. International investors should see the lowest acceptance limit of 50 per cent against the share of domestically held government bonds in the euro zone, in Spain probably closer to 65 per cent.

The changes have thus increased credit risk for investors, but are not met with actions which enable them to better assess the risk. Euro states are even exempt from the EU Prospectus Directive, which requires detailed information from issuers. Euro states present no detailed accounts or debt sustainability analyses for their new bond issues, merely a brief term sheet.

In the wake of the financial crisis, investors were told by authorities to reduce their reliance on credit rating agencies, which has not really happened. Many investors have indeed reduced their exposure to government bonds with low ratings, and some have developed models for countries' fiscal strength. However, both models and credit ratings use official debt figures, and assume that they are relevant and comparable.

One reason that investors do not go deeper into the matter, may be historically and culturally determined. For decades, bond investments have ridden a wave of falling interest rates. A 'lost generation' of government bond investors have not given much emphasis to credit risk and instead regarded government bonds as risk -free. History, however, indicates that restructuring of sovereign debt is a recurring phenomenon. Is Greece a statistical outlier, or the first in a series of defaults? Many investors lack the skills and tools to provide a qualified answer. Competence can be built by strengthening internal analytical skills in government accounts, for example by including the topic in the CFA certification.

But still they lack coherent and relevant data. The EU used different accounting standards and different ways to report on debt. While investors take for granted that companies they invest in follow GAAP or IFRS, there is no such requirement for states. The main international accounting standard for states is IPSAS, the public version of IFRS. It is used by pioneers such as New Zealand and Canada, but not by many euro countries.

In the wake of the euro crisis, European financial experts recommend the EU to implement IPSAS, to bring greater transparency, greater accountability and better management. Still, the euro zone report sovereign debt on a gross nominal basis, not taking into account financial assets or the time value of money. With Greece as an example, this means that effects of the restructuring such as lower interest expenses, deferred interest payments and extended maturities, are not reflected in the debt-to-GDP figures from Eurostat. While the official number is 172 per cent, Greece would if applying an IPSAS-based accounting, have a debt ratio well below 100 per cent. Introduction of IPSAS would also mean recognition of financial liabilities which are currently not on the balance sheet of some euro states.

For bond investors, IPSAS will thus provide a more complete picture of debt levels and future liabilities, and not least a basis for comparing countries. Without such a common standard, investments in euro zone government bonds will continue to happen - expressed as a Norwegian mountaineering rule – with no visibility, map or compass.

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