Draft v.3.5

THE CURIOUS CASE OF THE RULES FOR CALCULATING DEBT RELIEF: A Technical Note on EU Accounting for Debt, Especially Restructured and Concessional Debt

Ian Ball

This note explores the relevant guidance for, and appropriate treatment of, restructured debt and concessional debt, as promulgated by Eurostat. In so doing it identifies inconsistencies between the different authoritative sources, and anomalies in the development of the specific guidance contained in the Manual on Government Deficit and Debt (MGDD).

The MGDD, which was first published in 1999, has subsequently been updated a number of times and is now in its seventh (August 2014) edition. The subtitle of the 2014 edition is “Implementation of ESA 2010”. Within the MGDD, in the description of statistical methodology, it is stated that:

> *The reference values for deficit and debt are based on concepts defined in the European System of Accounts (ESA 2010).* …

So the MGDD is intended to be based on concepts that are defined in ESA 2010, while it, in turn,

> *… is derived from, and broadly consistent with the worldwide manual for national accounts (2008 SNA). ESA 2010 is a legislative text in a user-friendly form. Since ESA 2010 is a conceptual framework, it has been necessary for Eurostat to supplement it with additional guidance in the form of this ESA 2010 Manual on Government Deficit and Debt, Eurostat Decisions, and bilateral advice to EU Member States.*

The general position then is that the concepts under-pinning the guidance in the MGDD are those in ESA 2010 and 2008 SNA. At the same time, the protocol on the EDP which formed part of the Maastricht Treaty, and its successor protocol, states that

> *"debt" means total gross debt at nominal value outstanding at the end of the year and consolidated between and within the sectors of general government as defined in the first indent.*

At the time the first MGDD was published in 2002, the relevant European methodology was in ESA93, and the then current SNA was SNA95. At the time it was published in 2002, the MGDD was correct in noting that ESA93 and SNA95 provide very little guidance on debt rescheduling, concessional loans, and related transfers.

Debt restructuring

In 2008, SNA95 was updated and then released, in December 2009, as 2008 SNA. This version of SNA did provide guidance on debt restructurings and concessional loans. It had a new section titled “Debt reorganization” with a subsection titled “Debt rescheduling and refinancing” with five extensive points of guidance. Approximately a year later, in October 2010, an updated MGDD was released. Interestingly, the updated MGDD continued to refer to SNA95 and did not make reference to the new 2008 SNA, notwithstanding the new guidance on debt rescheduling.

Surprisingly, the next version of the MGDD, released in 2012, also continued to refer to SNA95, not 2008 SNA.

Even more surprising is that the next version of the MGDD (MGDD 2013 - published 11/2013) does refer to 2008 SNA, and notes in relation to rescheduling of a loan, that the topic is mentioned, "but in a rather descriptive way only in 20.107 (b)…whereas there is no mention of a possible capital transfer." In fact, as mentioned above, there is a new section titled "Debt reorganization" with a subsection titled "Debt rescheduling and refinancing" with five detailed points. Furthermore, there is a specific reference to a "capital transfer". This same material has been carried through into the 2014 version of the MGDD, with no correction of the 2013 version.

The MGDD does, therefore, over two editions, ignore the most recent version of SNA, and then when it does cite them in the next editions, appears to misrepresent the content. What is significant in this is that the treatment referred to in 2008 SNA is inconsistent with what had been in previous editions of the MGDD.

Effectively, the MGDD did not reflect in an accurate and current manner the content of the new 2008 SNA, and in particular facilitated thereby a misreporting of the effects, on both Greece and its creditors, of the impact of the debt restructurings through a capital transfer.

However, the MGDD's first point of reference is ESA, not SNA, so it is interesting to see how the MGDD accords with the changes to ESA. ESA was updated from the 1993 version in 2010 and the new version was published in April, 2013.

After April, 2013, the next version of the MGDD was released in November 2013. This later version of the MGDD contains the following statement in relation to the rescheduling of a loan:

> *22. There is no real guideline for trea0ing (sic) such a case in ESA 2010. Mention is only made of debt restructuring in ESA 2010 20.236 which states the same principle related to the difference in value (without specifying that it is in nominal terms). It is mentioned in 2008 SNA but in a rather descriptive way indicating only in 20.107 b that it "may or may not result in a reduction in present value terms" whereas there is no mention of a possible capital transfer. Therefore, this manual brings a necessary clarification and in useful practical guidance for national accountants.*

This paragraph is problematic in two ways. First, there is guidance in ESA 2010. At paragraph 20.221 "Debt operations" there is a reference to the appropriate recording of these operations in Chapter 5 on valuation, which deals in some detail with the valuation of financial assets and liabilities. Also paragraph 20.236 (cited above) makes clear that a debt restructuring "is a type of debt cancellation and a capital transfer is necessary to account for the difference".

Second, while the MGDD asserts that the proper treatment of debt is to measure it at its nominal value, in Chapter 5 (at paragraph 5.20 (c)) ESA 2010 states very clearly that "transaction value is the current market value of the financial assets and/or liabilities", i.e. it is not in nominal terms. The reason paragraph 20.236 does not specify that "it is in nominal terms" is that this is inconsistent with and not intended by ESA 2010, and 20.236 states explicitly that "a capital transfer is necessary to account for the difference", which logically requires that debt not be measured at nominal value (if it remains at nominal value there is no gain or loss to transfer).

Both ESA 2010 Section 20:236 and 2008 SNA Section 22.110 use the same language to state that restructured or rescheduled debt is considered to be extinguished and replaced by a new debt instrument with new terms and conditions.

Concessional Loans

When one examines the treatment of concessional loans in the MGDD, ESA and SNA, there also appear to be anomalies and inconsistencies.

Looking first at the way in which concessional loans are dealt with in the MGDD in 2012, we find (my emphasis):

> *IV.6.1.8 MDB concessional loans are characterized by a very low interest rate and long maturities with grace periods. IDA credits typically have maturities of 35 or 40 years with a 10-year grace period on repayment of principal. There is no interest charge, but credits do carry a small service charge of 0.75 percent on disbursed balances. These are not only below market interest rates, but do not even cover funding and administrative costs.*
>
> *IV.6.1.9 The treatment in national accounts of government injections in MDBs depends on the type of loans provided by multilateral development banks. Injections into MDB facilities whose main or sole purpose is to provide concessional loans at marginal or zero interest rate should be recorded as capital transfers, while investments in MDB facilities providing non-concessional loans should be recorded as acquisition of other equity, as set out in ESA95, paragraph 5.95 (c):...*

While in the context of loans made by multilateral development banks (MDBs) the quotes are clear as to the nature of a concessional loan and the fact that the concession constitutes a capital transfer.

ESA 2010, published in April 2013, also recognizes that concessional loans involve a capital transfer, although would report the transfer as a memorandum item:

> *20.242 Concessional loans are recorded at their nominal value just as other loans, but a capital transfer is recorded as a memorandum item at the point of loan origination equal to the difference between the contract value of the debt and its present value using a relevant market discount rate.*

Reference to 2008 SNA also makes clear that the concession involves a capital transfer (again my emphasis):

> *22.123 Debt issued on concessional terms. There is no precise definition of concessional loans, but it is generally accepted that they occur when units lend to other units and the contractual interest rate is intentionally set below the market interest rate that would otherwise apply. The degree of concessionality can be enhanced with grace periods, frequencies of payments and a maturity period favourable to the debtor. Since the terms of a concessional loan are more favourable to the debtor than market conditions would otherwise permit, concessional loans effectively include a transfer from the creditor to the debtor.*
>
> *22.124 Loans with concessional interest rates to a foreign government could be seen as providing a current transfer equal to the difference between the actual interest and the market equivalent interest. If such a transfer were recognized, it would usually be recorded as current international cooperation, and the interest recorded would be adjusted by the same amount. However, the means of incorporating the impact within the SNA and international accounts have not been fully developed, although various alternatives have been advanced. Accordingly, until the appropriate treatment of concessional debt is agreed, information on concessional debt should be provided in supplementary tables.*

2008 SNA thus recognizes the existence of the capital transfer, but because the appropriate recording has “not been fully developed”, would have it reported in supplementary tables.

MGDD 2013 addresses more explicitly the treatment of concessional loans:

> *V.6.1.1 As a part of public policy activities, governments provide loans at a lower interest rate than the market rate observed at the time of loan issuance (sometimes called "concessional loans").*
> *V.6.2.4 The ESA 2010 rules do not require to record in national accounts the implicit benefit element, i.e. the difference between the market interest rate and the interest rate contractually agreed, in order to reflect all transactions undertaken by government by reference to market conditions. As set out in ESA 2010, the amount of interest recorded on an accrual basis follows the contractual interest rate agreed at inception between the creditor and the debtor.*
> *V.6.2.5 It must be stressed that the impact on net lending/borrowing (B.9) is already reflected implicitly in national accounts as a difference between the cost of government financing and the low interest revenue from the loans granted by the government in the context of its public policy.*
> *V.6.2.6 In this context, the interest has to be recorded on the basis of the contractually agreed interest rate. Consequently, no implicit benefit for the debtor is recorded in national accounts.*

The MGDD treatment above appears both to take a position that there is no transfer, which is inconsistent with both ESA 2010 and 2008 SNA, and also to misrepresent (my emphasis in V.6.2.4 above) ESA 2010. The misrepresentation arises in that while it (ESA 2010) does not require the transfer to be formally recorded in the national accounts, it does require it to be shown as a memorandum item, which the MGDD ignores. Similarly, 2008 SNA would report this information in supplementary tables. By not stipulating at least this form of disclosure in the MGDD, the economic consequences of concessional loans are not transparent.

MGDD vs ESA and SNA

In effect, these examples place the MGDD as being consistent in its treatment with the protocol established to give effect to the Maastricht Treaty, but inconsistent with ESA and SNA. Both ESA and SNA are seeking to establish national income measurement rules which reflect economic reality, and are internationally comparable. The protocol may refer to “nominal terms” but ESA and SNA are designed to provide the information necessary for financial and economic measurement, reporting, analysis and decision-making, none of which are served by using nominal terms for any asset or liability transaction or event.

It may (or may not) be reasonable, in the context of the Treaty, for the member states to agree a reporting protocol which focuses on legal form rather than economic substance. Clearly, for debt restructurings, adherence to legal form (nominal value) misrepresents the reality of what has occurred. Both ESA 2010 and 2008 SNA seek to reflect the economic reality rather than legal form, and reporting by member state governments should conform to this. It should be noted that this would not preclude member state governments from separately reporting to Eurostat their debt and deficit positions consistent with the protocol – it does suggest however that it would be highly misleading to present this information as reflecting the fiscal and economic position of a government. And, given the nature of the protocol, it suggests that the MGDD, if it is intended to clarify reporting for Maastricht purposes, should not be presented as seeking to apply the concepts of ESA, as the Treaty protocol is inconsistent with the principles underlying ESA.

Concluding Comments - Accounting Standards

Finally, and importantly, it should be noted that the MGDD does not refer at all to relevant accounting standards, either International Financial Reporting Standards (developed for companies) or International Public Sector Accounting Standards (developed for governments). In this respect it is important that these are specifically referenced in 2008 SNA, which states as below:

> *21.60 In recent years, the International Accounting Standards Board (IASB) has become increasingly important as the standard setter for commercial accounting. The IASB promulgates International Financial Reporting Standards (IFRS) and at present more than 100 countries are involved in this process of harmonization. Many large companies, especially multinationals, already apply these international accounting standards.*
> *21.61 The principles underlying the IFRS are in most cases entirely consistent with the principles of the SNA. In particular, it is worth noting that the introduction to the standards explains that economic substance should take precedence over legal form. The IFRS, like the SNA, pays attention not only to the conceptually preferred approach but also practical possibilities.*

And in the same section:

> *21.66 In addition to the IASB that sets standards for private corporations, the International Public Sector Accounting Standards Board (IPSASB) performs a similar function for government bodies. There is reference to the IPSASB in chapter 22.*

Given the very close relationship between IFRS and IPSAS, it is not surprising that both sets of accounting standards require reporting of debt and debt restructurings, as well as concessional loans, in a way that reflects economic substance not legal form. Further, it should be noted that accounting standards in relation to concessional debt are “fully developed” and would require that the gain or loss associated with a concessional loan be recognized in the financial statements of both the creditor country and the debtor country.

Not only are these standards well-developed, through a due process which ensures very wide consultation, they are effectively the basis for most financial reporting globally, whether by listed companies or governments. In Europe, these rules apply to all publicly listed companies on European stock exchanges and many governments, as well as the European Commission itself (for its own financial statements), the OECD and NATO.

Accounting standards, which are significantly more specific and detailed than ESA and SNA, provide guidance which would yield more accurate, consistent and comparable information concerning the financial position and performance, including debt operations, of EU member states. What the accounting standards would not permit is ad hoc variations to reporting requirements simply to make them comply with a legal agreement, even if it is a Treaty. Accounting standards, like SNA and ESA, are designed to make transparent the economic reality, rather than the legal form, of governments’ financial performance and position. It both misrepresents and undermines ESA and SNA when the MGDD holds them out as justification for failing to recognize and report properly the effect of debt restructurings and concessional loans.